2017 Global Investment Outlook

Global fixed income

From views on the political events now shaping the landscape, to thoughts on low yields, our fixed income leaders explore issues such as the outlook on credit, the environment for the U.S. municipal bond market, and global currencies.

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Fixed income perspectives

Charting new territory with rates still low

Paul Grillo, Co-Head of Total Return Fixed Income/Philadelphia
David Hillmeyer, Portfolio Manager/Philadelphia
Graham McDevitt, Portfolio Manager/London

In recent decades, we’ve witnessed a whole new era of monetary policy, complete with unprecedented balance sheets from central banks around the world. In the more immediate past, globalization and productivity gains have shifted from high gear to a screeching halt. In the year ahead, policymakers and markets will navigate the next steps in this uncharted territory.

Our key outlook for 2017 includes several themes:

• We anticipate a year of coupon-like returns and incremental changes.
• The search for yield will continue.
• Small, incremental steps in monetary policy are possible around the globe, with fiscal policy in the discussion.
• Political upheaval and protectionist trends are the key risks — particularly with the implications of the Brexit vote and the presidential election in the U.S. — although the true economic outcome of such movements remains to be seen.
2016: Setting the stage for another eventful year

The year 2016 was eventful for fixed income markets, including of course the shock of Brexit and the unexpected outcome in the U.S. presidential election. Much of the year was marked by low and negative interest rates around the world, sending investors hunting for yield. Expectations were high early in the year that the U.S. Federal Reserve would undertake a series of rate hikes. However, there were multiple delays in the Fed’s plans in the face of varied uncertainties: plummeting energy prices, a slowdown in China and other emerging markets, pockets of labor market weakness in the U.S., and the rise of protectionist politics in the U.K. and U.S.

Treasury yields touched a record low in the year before recovering, yet remain historically low.

Meanwhile, key central banks outside the U.S., including the European Central Bank (ECB) and the Bank of Japan (BoJ), are still in easing mode. A number of central banks have been experimenting with negative rates and other new quantitative easing policies, with mixed success. By year end, markets were starting to question the unintended consequences of negative rates in particular, though the prospect of continued easing outside the U.S. is all but assured.

Low global rates mean high bond prices, but also inflated values for other asset classes, via a lower discount rate. Global demand for yield has only supported that trend. Indeed, the search for yield took on ever-more creative forms in recent years, with bursts of interest in smaller fixed income markets like bank loans, direct lending, and infrastructure debt. We even saw pronounced foreign investor interest in taxable U.S. municipal bonds. The search for yield has led investors, liability-driven institutions especially, further out on the risk spectrum.

Central banks: No sudden moves

Central banks around the world are between a rock and a hard place. Seven-plus years after deploying record-breaking liquidity, central bankers are finding it’s not so easy to claw back. The Fed’s tentative and halted efforts to raise rates, even to a “normalized” zone, are exhibit A. As such, we see the Fed and other major central banks in tweaking mode. Economies do not appear to be ready for traditional monetary policy, according to current GDP and inflation levels, and we don’t expect that to change suddenly in 2017. However, there is political risk to consider, particularly in light of the U.S. presidential election. This, along with the populist movement underlying Brexit, could pose a threat to the delicate balance the central banks have managed to establish in keeping any extreme market reactions to problems like heavy debt and slow growth reasonably contained.

The year 2016 also saw a growing consensus that monetary policy may have found its limits. Quantitative easing can alleviate liquidity problems and provide medium-term support for asset values. But as ECB and BoJ bankers have seen with the lack of effectiveness of negative rates, monetary policy is no magic wand. The central banks’ actions have had limited effect on real GDP growth, increased lending activity, capital expenditures, or the velocity of money (i.e. the turnover of money supply in an economy). What’s more, the consequences of some of the quantitative easing policies — such as creating losses for lending banks — can cause more harm than good.

But with inflation and growth in a fragile state, at least at the start of 2017, policymakers would seem to have little leeway to withdraw support. We expect 2017 to be a year of only small changes, and likely continued low yields. The implication is that the search for yield will continue to be a driving force among investors.

The fundamentals: Clarity on structural shifts

One of the ideas of post-crisis easing was to provide a stopgap measure until fundamental economic activity — such as growth, inflation, job creation, borrowing activity, and corporate profits — returned to normal levels. But that day still hasn’t come.

In fact, it’s becoming clearer that structural shifts have not taken hold. This may mean that returning to a sustainable level of growth, like that experienced prior to the global financial crisis, will remain elusive for many economies around the globe. Productivity gains have slowed. Global trade activity fell in 2016. And demographics around the world set the stage for more challenges ahead. The global labor market is shrinking as the population ages, changing the ratio of workers to retirees and shifting the landscape of saving and consumption.
Growth is in a positive zone and muddling through. But the prospect of higher growth rates may be a mirage until the structural challenges in many global economies are addressed. One implication is that inflation is likely to remain relatively muted, even if the new U.S. presidential administration does become more aggressive with deficit spending and fiscal policies. There could be a series of inflation scares, but certain self-correcting mechanisms in economies, which put pressure on risk assets when inflation threatens, to “snuff out” these inflation spikes.

Our expectation for 2017 is that these dynamics will persist — growth will muddle along, and inflation will remain moderate. Gains in fundamentals — like profits, job creation, wage growth, and household formation — are likely to be incremental.

Global politics: Fallout and aftermath
The economic developments of the last two market cycles have left a broad swath of the population behind, and global politics seem to be offering up the proof. The Brexit result stunned markets, but turned out to be the opening act for the U.S. election of Donald Trump.

While the pot of economic growth has shrunk, technology gains and global trade patterns have divided the pot. The trend seems to be that opportunities are available only for the most-educated and the lowest-hourly-wage workers, with nothing for the enormous population in between. These trends are not limited to the U.K. and the U.S.

The resulting wave of populist and protectionist politics will likely be a dominant theme of 2017. We anticipate further strength in these movements around the globe, which is potentially destabilizing across trade relations. This is a key risk for the year ahead.

Another issue that comes down to politics is fiscal stimulus. While interest has clearly gone up as seen in the number of media mentions alone (as seen in the chart below), capacity and political will are a different matter. Many emerging market countries have already chosen fiscal stimulus in the form of running budget deficits when commodity prices plummeted. Among developed countries, Germany and perhaps the U.K. are in the strongest positions to add debt and provide fiscal stimulus, but the political will may not be strong enough. China is another country that may have the capacity, and may be more politically able to put it in place.

Our expectation is that major fiscal stimulus is unlikely. As for politics, the result of U.S. and U.K. elections are sure to bring changes, but we believe the true economic impact remains to be seen.

*Sources: Productivity, various including World Economic Forum; global trade, World Trade Organization.

The year ahead
As we look to 2017, we are reminded how much the bond markets can be moved by sentiment and other non-technical factors. The math of coupons and durations is concrete, but the very human developments driving economic activity and politics are infinitely variable.

Still, we can look at the likelihood of changes to yields and spreads, and consider how these three themes — central banks, fundamentals, and politics — are likely to influence market activity. Our expectation is that 2017 will be a year of small steps and careful navigation.

In such an environment, fixed income returns are likely to be coupon-like, rather than being driven by capital appreciation. The debt markets are walking the tightrope of low growth and high anxiety, fertile ground for volatility. In our view, fundamental research and analysis continues to be crucial in choosing investments with true long-term potential.

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Spike in mentions of “fiscal stimulus” in the news

Source: Bloomberg News Trends
Spotlight: Currency

Headwinds for emerging markets; U.S. dollar to gain ground

Geopolitical friction is fast becoming a dominant theme for financial markets, and currency markets are no exception. The rise of populism, which produced the surprising Brexit vote and helped elect Donald Trump to the U.S. presidency, may create a distinct layer of pressure on international relations.

Ramifications for the U.S.
Looking at the United States, let’s separate risks into two categories.

Domestic: Within the U.S., monetary easing will likely give way to fiscal easing, given Republican control of the White House and both chambers of Congress. The immediate bias toward reflationary trades in the wake of the election — due to expected infrastructure spending — is likely to be short lived. Any advance in global economic growth will be capped by factors that include higher interest rates from U.S. Federal Reserve hikes, a stronger U.S. dollar, repatriation of dollars parked overseas, and tax cuts.

International: By all indications, U.S. foreign policy will concentrate on trade protectionism. Renegotiation of the North American Free Trade Agreement (NAFTA), or a recasting of agreements with Asian nations could generate potential risks for countries in those two regions. Still, we expect little change in the balance of exports and imports, which we believe will ultimately be driven by sustained global growth. Despite strong words during the election campaign, the Trump administration’s global security effort may result only in minor adjustments.

Putting a finer point on implications for the U.S. dollar
Our core view is that the dollar will gain ground in 2017. However, the move higher will likely be volatile and capped by its own appreciation, considering that an ascending dollar can have potentially unhelpful effects on corporate earnings, U.S. exports, and inflation.

Although we believe that dollar strength will be limited relative to most growth- and commodity-centric currencies, we do expect to see continued strength against the euro, as the political situation in the euro zone continues to deteriorate. Given that negotiations between the U.K. and the European Union (EU) will probably begin in early 2017, a second nation calling a referendum on their EU membership would produce weakness and instability in the Euro zone. We also maintain that the dollar will have greater strength versus Asian currencies.

A note on emerging markets
Throughout 2017, we expect currency markets in the developing world to generally remain range-bound, though violently so. Two points help summarize what we foresee.

• Trade negotiations could have negative consequences for Mexico and Canada (Canada’s economy is often considered more in sync with emerging markets), as well as for China, South Korea, and Taiwan. All of these countries rely significantly on global trade.

• China will face pressure as it attempts a controlled currency depreciation program. This will be coupled with the Trump administration’s threats of painting China as a currency manipulator.

Despite the headwinds noted above, foreign exchange markets across developing nations will likely provide investment opportunities in 2017. But we don’t expect a truly robust positive trend unless the Trump administration’s economic policies prove supportive of global growth, or if Chinese growth returns to its former pace.

Lloyd Alty, Head of Currencies/Sydney

Sean Simmons, Currency Specialist/Philadelphia

U.S. dollar since 2008

Source: U.S. Dollar Index, Lipper
The premium for risk assets continues to be low across the globe, and that’s a key driver of credit today. In the year ahead, we see a continuation of trends that began to take hold in the spring of 2016. Our expectations for 2017 encompass a number of factors:

- Low spreads are a product of a low risk premium, likely to continue with small but positive growth and foreign central bank monetary easing.
- Credit is at the center of the search for yield.
- A wave of debt refinancing has extended the credit cycle.
- Valuations may overlook real political risk in the year ahead.

Assessing credit markets in 2016
Credit markets saw a lot of volatility at the start of 2016, as energy prices were still looking for a bottom. While this environment pushed some high yield oil and metals-and-mining companies to the brink of insolvency, they ultimately stabilized after commodity prices rebounded. As a result of the turnaround in these industries, companies were able to repair their balance sheets in the form of debt restructuring and/or refinancing. This activity allowed high yield issues to be top performers for the year, while also extending the corporate credit cycle.

Great demand as the cycle extends

U.S. credit markets experienced massive inflows from a diverse set of buyers in 2016. Quantitative easing (QE) programs like the one that allowed the European Central Bank (ECB) to purchase corporate bonds caused near-zero and even negative rates in some regions. With little compensation from local credit markets, European and Asian investors directed dollars to the U.S. This trend of “crossover investors” has turned the U.S. bond landscape into something of an absolute return, any-yield-will-do environment. As such, foreign buyers have even pursued taxable municipal bonds, historically dominated by U.S.-based investors. We anticipate a continuation of that trend in 2017.

Anticipating smaller shocks in 2017
The 2016 activity in energy and metals and mining sector spreads was extreme in scale and speed. This reaction was a result of a violent exogenous shock in which some commodity prices plummeted more than 60% in less than 12 months.

Today, we see a more stable outlook for commodity prices, without the same kind of exogenous shock on the horizon. If we are correct in anticipating smaller shocks, then we would expect credit market valuations to be more broadly connected to corporate cash flows, defaults, and growth prospects. Healthcare, banking, media, and technology are some of the sectors that could see heightened volatility, however, as the new political regime may affect legislation and the regulatory environment.

Valuations are tight
Since the spring rally in spreads, high yield and investment grade valuations are looking particularly tight. We would argue that they are more in line with what investors would expect with a 2% to 3% GDP growth environment relative to this point in the credit cycle.

These spreads may not price in enough risk, or be dependent on forecasts that are too optimistic — such as $50-plus-per-barrel oil prices. In our view, spreads on an absolute basis are disconnected from fundamentals, but that can persist for long periods given the technical backdrop. Unless the economy goes into recession, we believe that credit spreads could stay flat or even compress slightly further in 2017.

In summary, with valuations as tight as they are, we believe this market warrants discriminating credit research. Relative to historical averages, today’s spread levels imply less upside than downside. So in our view, discerning valuation based on in-depth credit research is paramount to success in this environment.
The surprise election of Donald Trump as U.S. president, along with Republican majorities in both houses of Congress, had an immediate effect on all markets — with the U.S. municipal bond market feeling the impact in particular. The election caused municipal bonds to end 2016 on a decidedly weaker note, due to concerns over Trump’s campaign pledge to increase fiscal spending while cutting taxes. While there were fears this action would add to the federal deficit and accelerate inflation, the bigger concern for municipal bonds would be the double jeopardy of lower taxes, which would render the tax exemption on municipal bonds less valuable.

There could be uncertainty and volatility in the municipal market for some time to come. In fact, we believe volatility could be a dominant theme in 2017. However, the change in Washington, D.C., could also mean the opportunity to break long-standing logjams, and could have some positive fiscal outcomes such as infrastructure projects.

The lead-up in 2016 to the election

A correction in the municipal market started well before the November election as new issue supply surged after Labor Day, and demand, as measured by mutual fund flows, moderated. Supply often picks up after the summer but this surge was significant, occurring in September and October ahead of the election and the December interest rate hike by the Federal Reserve. In 2016, the market set an all-time record for new issue supply, with a total supply of $440 billion as of Dec. 15, surpassing the previous high of $433 billion in 2010.

From late August until immediately after the election, the municipal market lost about 4% in return, with more than half of the loss coming since the election. For example, the Bloomberg Barclays Municipal Bond Index had a 1-year return as of Nov. 30, 2016, of -0.92%, after being up 4.54% on Aug. 31. Since the summer, rates have risen, the yield curve has steepened, and credit spreads have widened.

Tax proposals and the muni impact

Presidential election years always seem to bring about talk of tax cuts, tax hikes, and tax reform. This in turn generally leads to some volatility in the municipal bond market over concern about the tax-exemption aspect of the investment. (The higher the tax bracket, the higher the taxable-equivalent yield when compared to taxable securities such as U.S. Treasurys or corporate bonds. The converse is true when tax brackets go lower.)

Trump comes to office with a tax proposal to lower the top individual income tax rate from 39.6% to 33%, and the corporate tax rate from 35% to 15%, as well as eliminate the alternative minimum tax (AMT). Republicans in the House of Representatives have put forth a similar plan, with the exception that they would cut the corporate tax rate only to 20%. Some type of tax cut or tax reform has a higher chance of passing with the GOP holding the majority in the House and Senate as well as the presidency. But while both the House and Trump have discussed capping deductions and exclusions, they have been silent on the treatment of municipal bonds. Previous Obama administration budgets have proposed capping the municipal exemption at 28%, below the top individual tax bracket. This type of cap would most likely hurt municipal bond evaluations and would cause a repricing in the market, unless existing securities were grandfathered.

We have a high degree of confidence that a lower personal tax rate, such as 33%, could pass next year, along with a lower corporate tax rate — one probably closer to the House’s proposed 20% level. Our confidence level is lower on a 28% cap on the municipal bond exclusion. This is because we believe that municipalities will play a significant role in the national discussion on infrastructure, another key campaign promise. That said, we feel that the municipal bond exclusion cap may be on
the table for discussion at some point, and if so, this could cause volatility with valuations. Still, it’s possible that many will reach the conclusion that a 28% cap would serve as somewhat self-defeating for any infrastructure stimulus plan.

Renewed focus on infrastructure

While tax cuts or reform may affect the demand component of the municipal bond market, Trump’s campaign pledge to enact a major infrastructure program has the potential to significantly increase new issue supply in the future. Unlike the tax cut proposals, however, details surrounding the infrastructure plan have been vague.

Infrastructure programs can be funded at federal or local levels, or through public and/or private partnerships. Other, more innovative ideas have been put forth. For example, in a recent paper, Standard & Poor’s suggested repatriation of overseas corporate profits and the creation of an infrastructure fund using a percentage of those profits. There is also always the possibility of resurrecting the Build America Bond (BAB) program, in which state and local governments issued taxable municipal bonds with a portion of the interest costs subsidized by the federal government.

With or without an infrastructure program in the new Trump administration, investment in replacing crumbling roads, bridges, gas and water lines, and many other projects, has become an issue that local municipalities already turned their attention to, with important implications for the municipal bond market. For example, in a 2013 report, the American Society of Civil Engineers set the price tag to fix or replace current infrastructure at $3.6 billion, of which $1.6 billion would need to be raised by local governments. This may already be starting — in 2016, we saw new money issue supply increase to $172 billion as of Dec. 15, representing a 12% increase over 2015. And at the ballot box in November, voters approved approximately $60 billion in new bond issues to address these needs going forward.

While infrastructure needs are likely to continue to add to municipal supply in 2017, refunding issues may start to decline if interest rates become higher, whether a result of fiscal or monetary policy, or a combination of both.

We have a high level of confidence that some type of infrastructure program will be enacted by the federal government, and we are fairly confident that the municipal bond market will play a role in its financing. Some combination of federal, local, and private financing will likely be used to address these problems and stimulate the economy.

We have less confidence in the corporate profit repatriation concept. But we believe some repatriation law can be passed and these returning profits can help stimulate the economy through business investment. We also have a lower confidence level in a resurgence of the BAB program, as in the past Republicans have resisted the subsidy. We would add, however, that there could be a healthy audience for an increase in some type of taxable municipal bond issuance as we have seen strong demand from overseas clients for this asset class.

2017: An interesting year to come

We believe 2017 will be an interesting year as the U.S., after years of gridlock, should be very active on the fiscal side. However, it’s important not to lose sight of the moderate domestic growth and weak global growth that have been driving the lower-for-longer interest rate environment. We are fairly certain that economics and global central banks will steal the spotlight from domestic fiscal policy at times during the year. Regardless of the environment we find ourselves in, we feel that our bottom-up, credit-driven approach to security selection and portfolio construction, will continue to be keys to generating alpha in 2017.
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Contact us by region

Americas
Market Street
Philadelphia
☎ 215 255 2012
✉ dia@delinvest.com

Australia
Martin Place
Sydney
☎ 1800 814523
✉ mim@macquarie.com

Europe/Middle East/Africa
Ropemaker Place
London
☎ 44 020 3037 2049
✉ mim.emea@macquarie.com

Asia
Harbor View
Hong Kong
☎ 852 3922 1256
✉ macsquare.funds.hk@macquarie.com

Additional portfolio management centers
Boston
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