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INVESTMENT MANAGEMENT

China and Brexit Uncertainty Creates Fixed Income Opportunities

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Uncertainties in the market around a Brexit plan and a bumpy landing for China are causing central banks to ease policy. This "taking the foot off the pedal" of rising rates has created a positive environment for riskier fixed income assets.

1. **Brexit**
   The current political strategy seems to be to delay and put more time on the clock. While this reduces the immediate risk, it does not remove it.

2. **China**
   China is building a bumpy runway for their landing. China has been easing and adding liquidity to the market aggressively since mid-2018.

   Since mid-2018, they have cut reserve requirement ratios (RRRs) by 300 basis points, and the Chinese Yuan (CNY) has been devalued to 8% weaker vs the U.S. dollar (USD). [1]

   Tax cuts, fiscal stimulus and investment incentives were put in place, but there is usually about a nine-month lag for stimulus to kick in. This would put stabilization for China on schedule to begin in March of 2019.

   While we believe China is building a bumpy runway, we are seeing some signs of recovery. For example, their Caixin Manufacturing Purchasing Managers' Index (PMI) rebounded in February 2019, decreasing from 49.9 vs 48.3.

[1] Peoples Bank of China. Data from June 2018 through February 2019.

Global central banks are now recognizing and incorporating these global risk factors into policy (U.S. Federal Reserve and the European Central Bank notably) and have been easing from their previously hawkish stance. Global sovereign rates have declined as a result. We see this as **“causality”** for the positive performance in riskier assets (equity & fixed income spread products).

However, U.S. Treasury (UST) yields and risky markets seemingly have a different view of the future, as equities are near record highs vs UST yields are near 2019 lows. Are markets ignoring China and Brexit risks? No! But we believe it’s the delta that matters. Risks have not gone away, but in our opinion they have been reduced and changed toward the better. This is the relief rally the market is currently experiencing.

If 1Q19 can be explained as a partial reversal of 4Q18, then what’s left to propel the markets higher for the rest of 2019? While it is not clear, we feel comfortable saying rates will remain low. Thus, we recommend allocating toward fixed income where assets still have good return potential.

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DEFINITIONS

Delta is the ratio of the change in price of an option to the change in price of the underlying asset.

Caixin Manufacturing Purchasing Managers' Index is a gauge of China's nationwide manufacturing activity.

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