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News & Views

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NEWTON'S PAUL BRAIN: WHY THE US COULD ENTER A RECESSION NEXT YEAR

By Geoff Spiteri, BNY Mellon Investment Management

The Newton Global Dynamic Bond manager says that with US corporates reaching peak profitability, the world's largest economy is becoming overly reliant on consumer spending.

Declining corporate earnings could help drive the US economy into a 'natural' slowdown in 2016 or even a recession, says Paul Brain, fund manager of Newton's Global Dynamic Bond Fund.

Brain's view is based on his belief that US corporates have reached peak profitability as they face the twin headwinds of higher wage bills and the difficulty of raising prices. The result, he says, is that US growth in 2016 will increasingly depend on consumers maintaining spending in the economy. To date, this has been achieved through discretionary items such as eating out and the purchase of new cars – but this is unsustainable in the long run.

Exacerbating the potential for a downturn, in Brain's view, is an expected round of high yield energy bond defaults, as a number of smaller, highly leveraged US oil companies struggle to refinance amid low commodity pricing. For Brain this means that while the fund will remain cautious in its positioning in high yield debt it will also be looking to selectively deploy capital on attractively priced assets.

"From its current defensive mind-set the investment team views the prospect of defaults and of an associated bond market correction as a possible buying opportunity, especially if mutual funds and Exchange Traded Funds (ETFs) take part in a sell-off," says Brain. "If we reach that inflection point we would start putting more money into risk assets. That said, we're not ready to press the button quite yet."

In line with this, emerging market bonds could be one future area of buying focus for the fund – where "there are some attractive opportunities, especially if China stabilises".

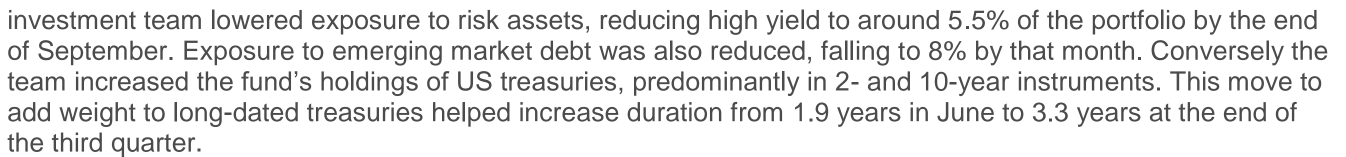
US rate rise: A shrinking window of opportunity

On the question of central bank policy, Brain views the prospect of a US rate rise as increasingly remote. Leading up to the start of Q3, he says, the investment team took the position that even if the Federal Reserve had raised rates it would have been a small increase. For 2016 the team takes the view that the US central bank only has a very limited opportunity to raise rates before the economy slows. "If they don't do it soon they will have missed their opportunity," he says.

Likewise, the Bank of England could follow the Fed's lead by postponing its long-expected rate rise while the European Central Bank could accelerate its quantitative easing programme. In the rest of the world, says Brain, "there is clearly a propensity to keep on cutting interest rates". This is true for both developing markets and other countries such as Norway, Australia and New Zealand where there is scope to further cut rates even from their current low levels.

Reduced exposure to high yield; increased duration

For the fund, the summer sell-off in equity and bond markets resulted in mixed performance. Until the half-year point, risk assets and emerging market debt contributed positively. In June, however, with the strength of emerging market economic growth being called into question even as China's stockmarkets began to fall, the



investment team lowered exposure to risk assets, reducing high yield to around 5.5% of the portfolio by the end of September. Exposure to emerging market debt was also reduced, falling to 8% by that month. Conversely the team increased the fund’s holdings of US treasuries, predominantly in 2- and 10-year instruments. This move to add weight to long-dated treasuries helped increase duration from 1.9 years in June to 3.3 years at the end of the third quarter.

In currencies the investment team introduced short positions in the Singapore dollar and South Korean won in response to downward pressure on Asian currencies, which intensified with the People’s Bank of China’s currency regime change.

According to Brain, the early reduction of exposure to high yield ahead of the summer sell-off “was a good call”. It meant the fund was able to protect capital and not be caught out by the change in the market. “When the markets go wobbly our performance tends to move sideways rather than dropping like a stone,” he says. “This makes it easier to reinvest when markets are moving up once more.”

Important Information

Past performance is not a guide to future performance.

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