GLOBAL FIXED INCOME & CREDIT OUTLOOK

November 2016

Recent Developments

Fixed Income

* German 10-year Bunds have started to enter positive territory. * The Federal Reserve is likely to hike rates in December - but inflation could be affected by the OPEC meeting at the end of November. * UK currency and bond markets have underperformed despite the relative resilience of the UK economy since the Brexit result. * We currently hold a cautious view on Emerging Markets, apart from Poland relative to the Euro.

Credit

October was another difficult month for Global credit markets, in particular for Investment Grade bonds. By contrast, more risky High Yield bonds outperformed. In terms of sector results, financial issuers outperformed.

Global Fixed Income

Current Views

	October 2016	
	FX	Duration
USA	OW	N
Australia	OW	OW
New Zealand	UW	OW
UK	UW	UW
Canada	UW	OW
Sweden	OW	OW
Norway	OW	N
Euro	UW	N
Japan	UW	OW
Malaysia	UW	OW
Mexico	N	N
Poland	OW	OW
Singapore	UW	UW
South Africa	N	OW

FX—Foreign exchange. OW—Overweight. UW—Underweight. N—Neutral.

Key Factors

- German 10-year Bunds entering positive territory
- US inflation & December US Federal Reserve rate hike
- Central bank policy in New Zealand & Canada
- UK economy & EU negotiations
- More cautious on EM due to the US election
- Poland showing positive fundamentals

Developed Markets

German 10 Year Bunds & US yield curve

Global bond markets were a major discussion point this month with German 10-year Bund yields moving back into positive territory and the US yield curve shifting upwards.

Federal Reserve rate hike in December

There is a strong consensus that the probability of a December interest rate hike from the Federal Reserve (Fed) is extremely high and inflationary concerns are now growing, driven mostly by higher wage costs. Over the coming months, oil could either be a key driver of inflation, or have little impact, depending on whether Brent crude prices are closer to $40 or $50 a barrel. The OPEC meeting at the end of November will be an important determinant of this.

Pressure on New Zealand and Canada

We continue to have a negative outlook on New Zealand and Canada. The Reserve Bank of New Zealand cut rates to 2.00%, with a further 0.25% cut expected in November. This is despite domestic data suggesting that we may be coming to the end of the easing cycle. In Canada, because of the weakness in economic growth, we should see pressure building on the Royal Bank of Canada for monetary policy intervention.

UK underperformance despite resilience

The UK, bond and currency markets have been clear underperformers as concerns about the negotiations with the EU have grown. Although, we remain UW in the UK, we have reduced the size of this position to reflect the extent of the recent underperformance and the continued resilient economy.

Emerging Markets

Caution on EMs due to US election and Fed rate hike

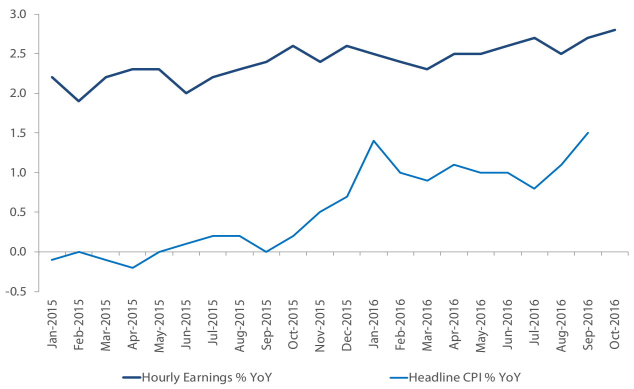
We had become more cautious on our macro positioning in EMs given the probable binary impact of the US election. This reflected the negative impact a surprise that Trump victory would have for Emerging Market assets, and the potential for a Fed rate hike in December. This factor led us to neutralise our positions in South Africa and Mexico before November 8th.

More optimism in Poland

One market where we are positive is Poland - especially in comparison to the Euro. Higher yields and strong growth should see the Zloty's performance improve in coming months.

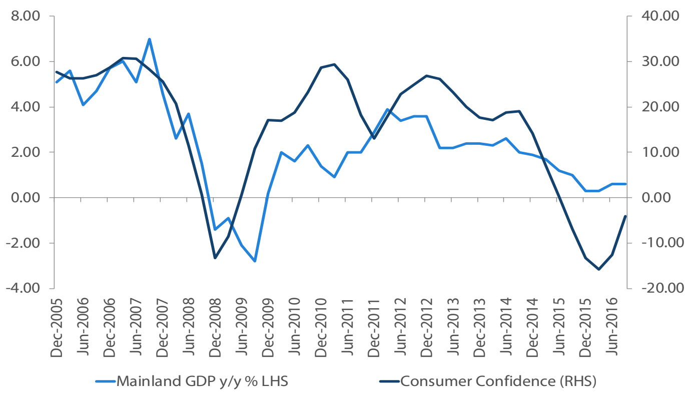
Discussion Points

1) US Inflation & Wages: inflationary pressures appear to be growing in the US. Wages are starting to trend upward as the labour market slowly tightens. The impact of a rising oil price will also contribute to the YoY rate of inflation in coming months. The November OPEC meeting will be an important factor. If production cuts are enforced, causing a price above $50/bbl, this could change the short-term inflationary outlook.



Source: Bloomberg

2) Norway GDP and Consumer confidence



Source: Bloomberg

Mainland GDP has stabilised but consumer confidence is now accelerating. We believe that Norges Bank could now be at the end of its easing cycle.

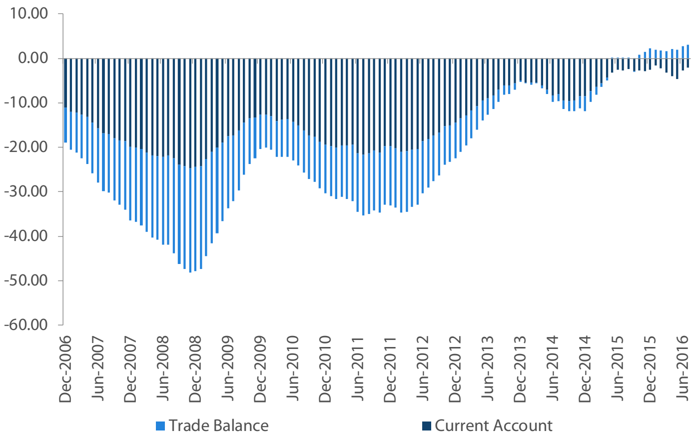
3) UK Interest rate futures

Rising inflation and a more resilient economy than expected in the UK, has caused markets to price out further interest rate cuts, which has in turn weighed down on UK bond markets. Sterling has continued to drop, though, as uncertainty has eroded investor demand.

Source: Bloomberg

4) Poland: Improving trade and current account balance

The Polish economy is growing strongly and the country's current account has moved into balance, driven by a strong ongoing positive shift in the trade surplus. This should support the Zloty vs the Euro.



Source: Bloomberg

Global Credit

Key Views

- Valuation in Asia remains expensive and our positioning remains defensive
- We view US BB- rated bonds as one of the most attractive investment opportunities
- US credit still looks attractive compared to other markets and offers compensation for the prevailing risk factors

October was another difficult month for global credit markets, with Investment Grade (IG) bonds suffering in particular. Total returns for the latter turned negative, driven by a rise of 10-15 bps in risk free rates across developed markets. Latin America was the main exception to this, with strong excess returns overcompensating for rising yields. All other markets reported similar lacklustre returns for October. The worst performing sub-segment was Sterling corporate bonds, which lost more than 3.5%, caused by increased expectation of a “hard BREXIT”. In general, the drivers for the rise in yields were: higher inflation reports across the globe and growing uncertainty about the future direction of central bank policies. In contrast, more risky High Yield (HY) bonds performed better than IG. This was especially witnessed in European HY issuers where strong returns were recorded. However even the HY segment was negatively impacted by the rise in rates. In terms of sector performance, financials outperformed, as earnings for the Q3 came in stronger than anticipated, and the profitability outlook brightened on the back of rising rate expectations.

Europe

Our view on the European credit market remains positive as the European Central Bank’s (ECB) Corporate Sector Purchase Program (CSPP) continued to support credit spreads in October. The overall purchased volume so far has exceeded expectations. Nevertheless, political risk looms high for European markets and could negatively impact spreads. In particular, December’s Senate referendum in Italy could influence performance. In addition, the last ECB’s lending survey points to a tightening of lending conditions in the Eurozone. As valuations for IG have become extremely tight, we are seeking opportunities in HY, especially for crossover and subordinated bonds.

Japan

The Japanese economy continues to grow despite the strong JPY negatively impacting the export sector. Nevertheless, credit quality for most exporters should remain stable, as the JPY remains in the 100-105 range. Beside solid credit quality, we also expect the technicals for Japanese corporate bonds to remain favourable. However valuations remain expensive, as the Bank of Japan continues to buy corporate bonds at the short end of the curve.

US

Macro data in the US showed an improving trend last month, as ISM indices recovered from a weaker level in September. However corporate fundamentals remain under pressure, due to increased M&A activity and a high level of corporate defaults in the energy sector. The result of the Presidential election will do little to reduce these uncertainties. In addition, outflows from retail funds and heavy new issuance activity put pressure on technicals. Despite this, excess returns for US credit remained positive, as attractive valuations were driving demand for the asset class. In particular, the energy sector outperformed in October, and bank bonds also benefitted from strong Q3 corporate results. Currently, we view US BB-rated bonds as one of the most attractive investment areas, given stable fundamentals and the appealing valuation levels.

South America

In Latin America, we expect Brazil and Argentina to rebound from recession in 2017. Monetary easing, reduced political uncertainty, reform activity and infrastructure investment should support both countries. The turnaround would create attractive opportunities in the corporate bond market. Brazilian banks, as well as oil companies, could benefit. Beside Brazil’s and Argentina’s recovery, growth in Mexico remains steady, driven by strong domestic consumption. However, Trump’s victory will continue to hurt the Peso. Mexican building material companies currently look attractive.

Australia

Australia’s economy has stabilised, as the strength in the housing market has offset weakness in the commodity sectors. In addition, the weak AUD is still supporting corporates. Nevertheless, the looming sovereign downgrade by S&P could result in negative ratings in the domestic banking sector. Beside domestic banks, we have also turned more cautious on some of the mining companies, as the spread rally has reduced their attractiveness from a valuations standpoint. New issuance in the coming weeks could represent attractive alternatives. October brought out some interesting new deals in the transportation and airport sector, and we expect this trend to continue. We also see value in selective subordinated insurance bonds.

Asia ex Japan

Asia continued to grow last month as commodity prices stabilised and benign inflation allowed continued monetary accommodation in some countries such as Singapore, India and Indonesia. Currencies remained range-bound in October, even as the USD continued to strengthen. On the negative side, concerns over Philippine foreign policy (given President Duterte’s recent remarks) weighed on the local bond market and credit spreads widened. Solid macroeconomic data were partly offset by weaker micro data, but Q3 earnings are expected to show some improvement. In particular, commodity related issuers should benefit from price recoveries. Asian markets have absorbed the recent increase in supply fairly well, as positive inflows from developed markets have helped to support bond demand. Nevertheless, valuations remain expensive and our positioning remains defensive, with underweights for Philippine bonds and Chinese property issuers.

Finally…the Italian Referendum

In Europe, the most prominent event will be the Italian referendum on Italian Prime Minister Renzi's constitutional reforms. The key component of the reform would be the abolition of the "perfect bicameralism" that gives the lower and upper house equal status within Italian constitutional law. Under the existing system, both houses have legislative competence. In the past, differing majorities in both chambers led to mutual blockage of new laws and lengthy mediation processes. Renzi wants to streamline the approval process for new laws by watering down the constitutional rights of the Senate.

A successful referendum on constitutional reforms would reduce the Senate to a small regional assembly with competences largely confined to laws applying to the local level. The referendum goes hand in hand with electoral reform, although this is not an actual part of the referendum. This reform aims to ensure that the winning party of a general election will reign with a clear majority. If a party wins more than 40% of votes, it will receive 340 seats in the lower house out of 630 seats. If no party reaches 40% in the first round, the two most voted parties will enter into a second round. The winner will then receive 327 seats. No party or coalition will enter the lower house if they receive less than 3% of the votes casted.

At the moment, polls show a small lead for the No campaign, although almost 1/3 of voters are still undecided. Initially, Renzi linked his political career to the outcome of the referendum, but his stance has since been toned down and is expected to remain in office even if he were to lose the referendum. Nevertheless, his position would be considerably weaker and the momentum in his reform efforts is greatly reduced.

Before and after the referendum, we expect rates as well as credit markets to be affected by the inevitable uncertainty that the prospect of such major change would bring, with any impact expected to be felt in all Italian bonds, and potentially in the Eurozone market as a whole.

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About Nikko Asset Management

Nikko Asset Management, together with its investment advisory affiliates, has 206 investment professionals around the world and approximately USD 176.3 billion in assets under management or supervision as of 30 September 2016. Nikko Asset Management strives to provide outstanding long-term performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes governments, institutions, corporations and private individuals worldwide. For more information, please contact us using the details below or visit our website at **www.nikkoam.co.uk**

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Important Information