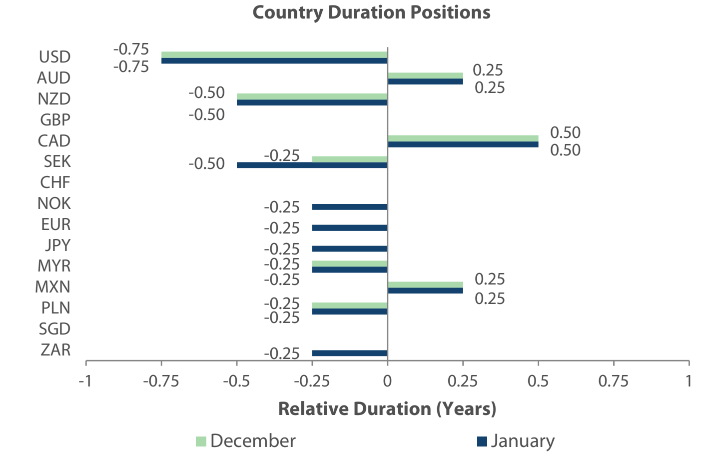
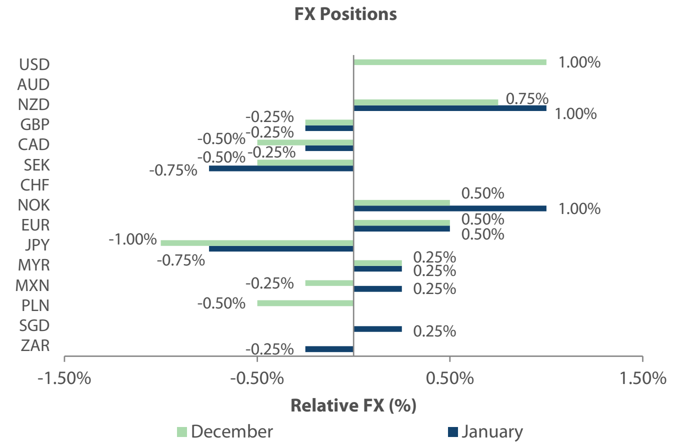
GLOBAL FIXED INCOME & CREDIT OUTLOOK

January 2018





Source: Nikko AM

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Global Outlook

A broad-based synchronised recovery continues to gain traction. Following the strongest year of global growth since 2010 (estimated at 3%) the consensus forecast for the current year looks to be even rosier. The World Bank early forecasts see it edging higher at 3.1%, before moderating to 3% in 2019-20. This marked improvement in global economic activity came on the heels of benign global financial conditions, accommodative policies, rising confidence and firming commodity prices. One of the most instrumental factors behind the global growth acceleration was a notable recovery in global capital spending, which was generally supported by cheap financing costs, which led to rising profits and more generally improved business sentiment across both developed and emerging markets.

This synchronised pick up in investment led to economic recovery and has resulted also in a marked acceleration in global trade volumes, and will likely continue in the short term. The acceleration in aggregate demand has also had positive implications for commodity prices. This has paved the way for a significant pickup in economic activity among commodity exporters in both emerging markets and also to a lesser degree, developed markets. A pick up in commodity prices has also seen global headline inflation on the rise (albeit from a low base) reducing the risk of deflationary tendencies being entrenched in expectations. However, global core inflation, continues to be subdued, but the close harmonised improvement in labour market conditions across the globe is likely to put upward pressure on global wage dynamics, putting demand-led price pressure on a more sustainable trajectory. The much improved outlook for both economic activity and inflation ought to see a number of key central banks seeking to scale back from their very accommodative policy stance, putting inevitable pressure on the global bond yields.

Developed Markets

We feel confident that developed market rates will remain under selling pressure in the short to medium term, which we see as a signal to remain generally underweight duration at the portfolio level. We continued to be underweight duration among a number of developed markets, with a notable exception of Australia and Canada, where we have stayed long duration on a tactical basis.

In the US, the tightness of the labour market, combined with recent higher oil prices ought to see both headline and core inflation move higher from its current level. We also believe the expectations for further rate hikes by the Federal Reserve (Fed), together with a concomitant reduction of the balance sheet ought to see US rates under selling pressure, which is a key justification behind maintaining our short duration position. Despite the ongoing normalisation of monetary policy by the Fed, the USD performance has been somewhat underwhelming. We attribute this to a broad based acceleration in economic activity outside of US, causing a number of central banks to turn increasingly less accommodative, which has helped support respective currencies in the process. Furthermore, despite widening 2 year interest rate differential between the US and Eurozone, which historically had good explanatory power behind the directional FX market moves, the USD has underperformed. The weakness of the USD, however, has appeared to have tracked the 10-year EUR-US Term Premium Differential neatly, and we feel there is some room for a further divergence. This together with our expectation for a stronger global growth and in turn normalisation of monetary policy across a number of other central banks outside of the Fed has led us to believe that the USD upside appears somewhat limited at this stage. We expressed this by reducing our overweight down to a market neutral weight for now.

The improving growth momentum across the Eurozone, and the ongoing tightening of the labour market conditions ought to see the European Central Bank (ECB) reduce its Quantitative Easing (QE) purchases to a level that will no longer expand their balance sheet and halt by the end of 2018. The first rate hike is likely to follow suit but not until the following year. Even though we expect the ECB to begin monetary policy tightening only later this year, we feel the forward guidance will be amended well ahead of that. The assumed increased hawkishness of the central bank ought to be supportive of the currency and lead to a backup in Eurozone market rates. As such we feel confident in our call to stay FX positive maintaining our short duration call too.

In the UK, we believe that the level of GBP currently is primarily whole being driven by politics. The Brexit newsflow continues to dominate the level of the currency. We believe there is a limited chance of another general election or referendum over the near term. We have also seen better than expected macroeconomic data especially within manufacturing. However, we would argue the relative downside risk of the GBP is high as it seems most positive news has been priced in. Therefore, it is skewed to the downside and in the longer term we see little upside; therefore, we have maintained our underweight. For duration we have kept our neutral position given we believe that some of the inflationary pressures related to higher commodity prices are likely to be offset by the stronger currency we have seen as of late.

The ongoing rally in energy prices and an improving outlook for the Norwegian economy makes us confident in keeping our overweight position in NOK. The narrowing of the output gap, one of the key highlights by the Norges Bank during the December meeting, ought to see a shift towards a more hawkish tone at the next MPC meeting. We decided to express this view by increasing our overweight in NOK and moving our duration call to underweight

In Sweden, the economic momentum appears to be levelling off. Recent data suggest a marked decline in property prices, particularly within the key city centres. The negative dynamic within the country's housing market is seen as a key cayalyst derailing further improvement in economic activity. The divergent growth path between the Eurozone and Sweden will likely see the SEK underperform. We have decided to express this theme by further extending our short position there. Switching our focus to rates, we believe that a strong correlation with Eurozone rates should see the domestic bond market also underperform, justifying our short duration exposure.

Moving on to Australia and New Zealand, we have increased our allocation to NZD, which we expressed by our long position against the AUD. Firstly, we believe that following the unexpected victory of the Labour party in New Zealand's general elections, the negative sentiment towards the kiwi was exaggerated, which resulted in a large sell of the NZD/AUD cross. With the still relatively strong economic activity, supported by large net migration, the ongoing strength of the construction industry and some recovery in dairy price inflation dynamics ought to see the RBNZ turn increasingly hawkish. As such the favourable relative valuation of NZD over AUD and our expectations for an imminent hawkish turn by the RBNZ before long, should be supportive of NZD. On the flip side, we feel the rally in the price of iron ore, which was instrument in supporting the AUD is unlikely to be sustained, which should lead to AUD correction from its current high levels.

As for rates, our econometric model screens New Zealand bond market as one of the most expensive among our investable universe, which gives us confidence in our current short duration exposure. In Australia we hold a small overweight duration call as we feel a much needed correction to the housing market should put pressure on consumer confidence via the wealth effect. At the same time, the lack of wage growth continues to feed through to lower inflationary outcomes, which will see the RBA stay on hold for longer than its peers. As such we are happy to stay long duration, earning some 20bps carry over US rates.

Following the announcement by the Bank of Japan (BoJ) to reduce the total amount of super long bonds with maturity between 10-25years, the JPY strengthened. However, the move by the BoJ is an adjustment to reality, as opposed to some meaningful shift in its monetary policy, as the Bank of Japan purchases were already trending lower prior to the announcement. The currency response, appears to be triggered by unwinding of the stretched JPY short position, as the market is looking for a hawkish turn by the Bank of Japan in order to capitalise on the attractive JPY valuations. Since the introduction of Yield curve control, the core CPI moved from -0.4 to 0.9%, the Nikkei is up by 40%, whilst the 10year Japan Government Bonds (JGBs) remained unchanged. Given an improved outlook for both inflation and growth, and much higher interest rates globally, the need to keep interest rates at these low levels is perhaps unwarranted. We believe, at some point during yield curve control, the target is likely to be lifted by 10-20bps to reflect the new environment. Despite this, we still believe that the scope for JPY to move on a sustained appreciation path is limited by a number of factors such as negative real yields and large US-Japan nominal rate differential. As such, we decided to increase our overall exposure, but remained underweight. Moving on to rates, given the latest comment from Governor Kuroda that the BoJ is becoming more confident in reaching its inflation target, we will likely see the back end of the curve steepen, and as such decided to tactically reduce our duration call to underweight.

Emerging Markets

In Emerging Markets we have a generally constructive view on FX due to widening growth differentials relative to developed markets. We prefer to be more selective on rates, however, given the divergence in monetary policy across the complex.

We retain a positive bias towards the Malaysian Ringgit as it remains fundamentally undervalued with improving and broad based growth dynamics. Malaysia is well placed to benefit from the resurgence in the global economy through both manufacturing and energy related exports and ever stronger economic ties to China. Given the strength on the domestic economy, we believe that the central bank will turn increasingly hawkish, with interest rate hikes likely later in 2018. Hence, we remain underweight duration, particularly given stretched valuations.

We have moved to overweight in the Mexican Peso due to its relative undervaluation and increased carry following Banxico's latest hike. We believe that the proposed changes to NAFTA have weighed disproportionately on the currency, with diminishing risks of an imminent end to the agreement likely to spur a rebound over the coming months. Inflation appears to have peaked as the pass-through from a weaker currency fades. Given this inflation dynamic we also believe that Mexican bonds offer value.

We remain neutral on the Polish Zloty despite strong growth momentum, political risks still linger with respect to the triggering of Article 7 proceedings from the European Union in relation to alleged breaches of "Rule of Law" principles. If triggered, this would leave Poland vulnerable to a removal of structural fund flows over the medium term. We are also underweight duration in Poland as inflationary pressures are building due to robust domestic demand and tightening labour markets, with valuations also stretched.

We are positive on the Singapore Dollar as external demand continues to support both manufacturing and financial service sectors of the economy. As a result we expect the Monetary Authority of Singapore to indicate a positive appreciation bias in April. Despite the appreciation bias relative to the USD, we refrain from a long duration position on valuation grounds and high correlation with US Treasuries.

We have cut our South African Rand exposure to underweight from neutral following the recent rally due to Ramaphosa's election as chairman of the ruling African National Congress party. Whilst Ramaphosa offers a glimmer of hope for investors wary of high levels of corruption and deeply rooted structural issues, he remains as yet unproven and likely to be hampered by the ongoing presence of Jacob Zuma as president. Hence we believe the near term positive sentiment is not fully justified. Similarly on rates, whilst the inflation risks have diminished somewhat, we believe it is premature to expect policy easing from the SARB given ongoing fiscal vulnerabilities.

Global Credit

For December, Investment grade credit in most markets (except for LATAM) saw a negative return. This was due to the Fed raising interest rates and the continued inflation concerns. Nevertheless spreads came in tighter, which meant excess returns remained positive. Going into 2018 we predict there to be more months similar to December whereby rates start to become under pressure (a theme that we have already started to see in January).

Positive news from December was the continued outperformance of High Yield credit. This was a theme we were expecting when rates were selling off. We continue to like High Yield and is quite a defensive position when rates are rising.

For the US, the tax reform is now in fruition which reduces the overall incentive for many corporations to add leverage. We are seeing bond demand increasing and supply decreasing and this will cause spreads to tighten. Given the absence of any economic shocks on the horizon, we expect the wider sectors to outperform. We are therefore positive on Energy (in the IG space), Media, Telecommunications and Financials.

Asian credits registered gains in December. While the supply of new issues remained robust, the lower amount of supply compared to November was technically supportive. As the backdrop for Asian economic and corporate credit fundamentals is expected to remain constructive heading into 2018, an extended credit cycle with credit spreads well supported could continue for some time. However, tight spread valuation and more neutral demand-supply dynamics could hinder significant spread tightening from current levels. For Asian high-grade credits, bond carry will again dominate returns as the expected rise in UST yields will negatively impact total returns. Asian high-yield corporates should outperform high-grade due to their shorter duration and higher carry, with risk-free rates expected to continue rising.

The strongest regional performer was LATAM, which acheived positive performance in both Investment Grade and High Yield. The story of inflation decreasing and an increase in economic growth continues to be true and has been a significant positive in the last few months. Going into 2018 we would like to further explore additional investment opportunities. We are of the opinion that although we should be cautious in investing in LATAM, the market is seeing strong growth trends and as an investor you are now being suitably compensated for the risk undertaken.

In Australia, we would note that there hasn't been much change in the region over the last several months. One place where we did have concern previously was credit availability, but this has seemed to have recovered. Although spreads didn't tighten in December, valuation remains a concern.

Generally in Europe we are operating within a favorable credit environment. Macro indicators continue to remain strong, especially consumer confidence. Default rates have declined, as we estimated, and we expect them to fall further. Leverage continues low and not currently a major cause of concern. Issuance for the start of 2018 has been strong which bodes well for investor sentiment and appetite. Telecommunications and Media have performed well. Another sector where we see strong investment opportunities going into 2018 is the automobile and auto parts sector, particularity in high quality High Yield issuers.

For Japan, after April there is a possibility that Governor Kuroda and his key executives may be replaced. On the whole it is predicted that Kuroda will keep his position. If this were to transpire, a policy of tightening or rate hikes are not expected. Therefore from that perspective JGB yields will continue to be compressed and in that case the demand for Japanese Credit will continue.

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* Consolidated assets under management and sub-advisory of Nikko Asset Management and its subsidiaries as of March 31, 201 7 .
** As of March 31, 2017, including employees of Nikko Asset Management and its subsidiaries.

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