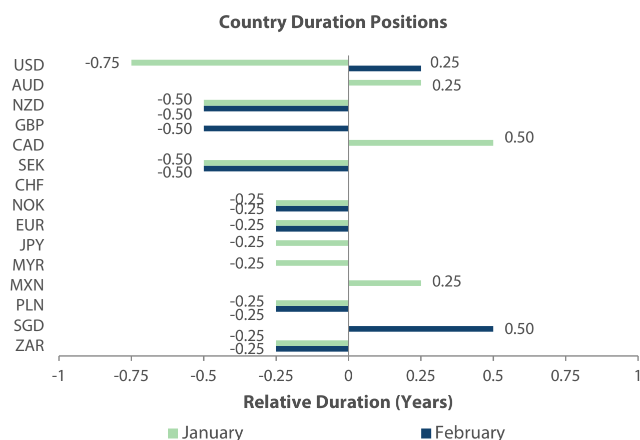
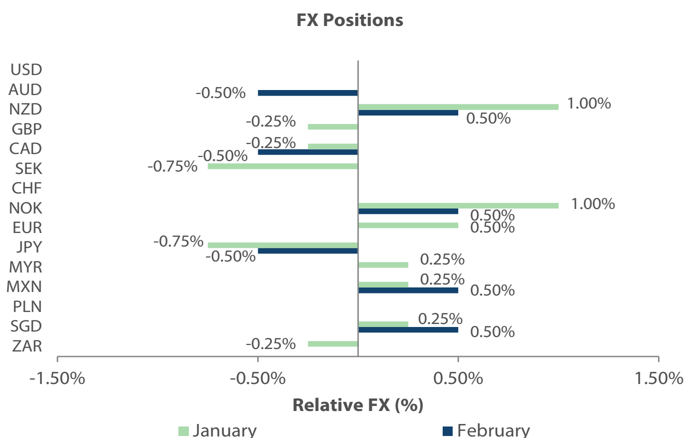
GLOBAL FIXED INCOME & CREDIT OUTLOOK

February 2018





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Global Outlook

A broad-based synchronized 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's early forecasts see it edging higher to 3.1%, before moderating to 3% in 2019-20. This marked improvement in global economic activity comes on the heels of benign global financial conditions, accommodative monetary policy, rising confidence and firming commodity prices. One of the most instrumental factors behind the global growth acceleration has been a notable recovery in global capital spending, supported by cheap financing, which has led to rising profits and improved business sentiment across both developed and emerging markets.

This synchronized pick up in investment has also resulted in a marked acceleration in global trade volumes, which will likely continue in the near 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 amongst commodity exporters in both emerging markets and, 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 expectations becoming entrenched. However, global core inflation, continues to be subdued, but the broad based improvement in labor market conditions across the globe is likely to put upward pressure on global wage dynamics, putting demand-led price pressure on a more typical 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 global bonds.

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. US rates now appear to have priced in a good portion of expected growth as well as Fed hikes over the next year and we now believe they have been oversold. On duration the team has taken a more neutral stance, with only a slight underweight bias on the portfolio level. The fixed income team has been expecting headline CPI to surprise to the upside based on the recent movement in the price of oil. The team has also maintained its neutral stance on the US dollar from the previous month as the team views oil prices and relative term- premiums as the primary drivers of the DXY for the near-term which have been overwhelming the increased carry of US assets as the team moved to reduce its underweight versus the Yen on the expected sideways dollar and near-term increased market volatility. The US dollar appears cheap based upon interest rate differentials. However, momentum has been a greater driver of DXY underperformance in the near term. We are concerned that curve flattening in the US will continue as well as recovery in energy markets which will both serve to offset any strength associated with interest rates differentials over the near term.

In the US, after a significant length of time of rates failing to move higher, we expected ten year U.S. Treasury yields to rise meaningfully in January to 2.71% from 2.41% at the end of December. The broader optimism for growth and modestly increased in expectations of inflation has helped to cause this rise. As expected, the Federal Reserve (Fed) did not change the Fed Funds rate when it met in January. This was the final meeting led by Chairwoman Janet Yellen. Jerome Powell (nominee for the next Chair of the Fed) was confirmed by the Senate in January and he will begin his term at the beginning

of February. Markets are currently projecting a 90% probability of a hike in the Fed Funds rate at his first meeting as Chair.

Elsewhere in the US, the tax reform passed in December has created a greater impact than anticipated, with many companies publically announcing bonuses and raises for employees. This has led several major companies announcing investments into the U.S. based on impacts of the changes in tax legislation. These announcements have contributed to an increasingly positive economic sentiment in the country, which should have a significant economic ripple effect within the economy. Lastly, the U.S. government shut down briefly in January, but reopened quickly with little impact to markets.

Regarding the UK and the continued Brexit fallout, the EU withdrawal bill was passed in the lower house (House of Commons) by 324 to 295 votes. The bill is the first stage in the legislation process of bringing existing EU Law into UK Law. The bill was then delivered to the upper house (House of Lords) where it passed its first test without complications. However, the bill faces further challenges in the coming weeks where it can be amended before being brought back to the House of Commons for its second reading. The team moved to fully neutralize its GBP exposure from underweight at the previous meeting as political events rather than fundamental in terms of interest rate differentials and commodities continue to remain the dominant driver of Sterling strength. The team made further moves to underweight duration in the UK on the expectation that the BOE would turn more hawkish in the future on the rising threat of inflation.

More broadly in Europe, the European Central Bank (ECB) left interest rates unchanged at its January meeting. The Euro jumped above to a three year high against the USD dollar $1.25 on Thursday afternoon despite ECB President Mario Draghi's efforts to pause the single currency's recent rally. Draghi made it also clear that he does not expect interest rates to increase during 2018 and kept the QE programme of €30 billion per month. The bank decided in October to reduce the purchases to €30 billion a month from €60 billion and to extend them at least until September, or longer if necessary. We expect the ECB to announce a further lowering of its monthly purchases at some point in Q4 2018, with them announcing the course of their action at its June meeting.

The team had a previous long NOK vs SEK position, but decided that the NOK vs CAD represented better relative value on a weaker CAD in light of a less optimistic BOC while the SEK would still benefit from increasing optimism in the Eurozone. On the Euro in particular, the team had moved to temporarily neutralize positioning on key technical levels and the lack of expected change of stance from the ECB over the immediate term.

In Canada, the Bank of Canada raised its interest rate as expected to 1.25%. This rise was made more likely following a good January Labor Market Report. There had been concern within the Central Bank with respect to the current NAFTA negotiations which gave a rise to short-term uncertainty, but still preceded with the hike. CAD depreciated initially, but rallied until the end of January, given positive sentiment in the market towards the development of the economy. On Canada, the team moved to neutralize its overweight duration positioning to neutral on the teams uncertainty over the direction of the BOC in the face of a more hawkish US Fed.

In Australia, there was weaker than expected trade data for November. The print fell short of a consensus AUD550m surplus, coming in instead with a deficit of AUD628m. There was mixed reaction to the labour market data, which caused the currency to initially weaken before reversing. Employment change came in stronger than expected at 34.7k (consensus 15.0k), but the unemployment rate rose to 5.5% (consensus 5.4%) largely due to the increase in the participation rate to 65.7% (consensus 65.5%). Towards the end of January, AUD underperformed against its G10 peers due to a sharp drop in iron ore prices before bouncing back to reach a 32-month high of 0.81 against the USD.

In New Zealand, unemployment data and economic data remained firm on balance in January, with house prices and building permits coming in stronger than expected. Manufacturing PMI's were in fact weaker than expected, but it is worth noting the services index still returned above the trend rate of growth in this particular sector of the economy. The CPI data that was released towards the end of the month was weaker than expected, but this was largely discounted by the market as the calculation of car sales data was skewed, which caused NZD to decline initially before returning to previous level. The team had moved to reduce its overweight NZD positioning to less overweight and moving more in line with a relative value call against the Australian dollar after bond currencies moved in advance of what interest rate differentials would warrant in valuation, with AUD moving relatively more out of line.

Oil prices continued to climb in January, closing just shy of $65 a barrel. This is the highest oil price since 2014 and represents over a 22% increase over the past twelve months. In January it was reported that U.S. oil production topped 10 million barrels a day as of November 2017, the highest domestic production since 1970. Despite this increase in production, prices have risen as lower inventories suggest the OPEC production cuts have been working, and improving global economic conditions are expected to increase demand for oil. Additionally, in January Iraq joined the United Arab Emirates, Qatar and Oman in calling for OPEC and allied producers to stick with their agreement to cut oil output until the end of the year, despite the recent price gains listed above. The team moved to make a relative value call in the strength of oil prices with a relative long NOK versus CAD exposure. The team also viewed the Norges bank as likely to increased hawkishness in the face of higher energy prices while the Bank of Canada optimism had already been fully priced into the forward curve.

Emerging Markets

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

We removed our positive bias towards the Malaysian Ringgit as its near-term outperformance looks stretched, following the recent strength in the domestic economy, strong rebound in energy prices and the strong correlation to the Chinese Renminbi. The central bank hiked rates in January, as expected, however, given the lack of inflation pressures in the economy we are likely to see an extended pause in monetary policy tightening; as a result we have also neutralised our underweight duration position.

We have increased our overweight in the Mexican Peso due to its relative undervaluation and increased carry following Banxico's latest hike, which was coupled with an increasingly hawkish rhetoric, implying the rate hike cycle may be extended further. We believe that the proposed changes to NAFTA have weighed disproportionately highly on the currency, with diminishing risks of an imminent end to the agreement likely to spur a continued rebound over the coming months. Inflation, however, remains stubbornly high and we await concrete signs that inflation has peaked before re-establishing a long duration trade.

We remain neutral on the Polish Zloty as 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 also remain underweight duration in Poland as inflationary pressures are building due to robust domestic demand and tightening labour markets, with valuations also stretched.

We remain 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. We also upgrade duration given the currency strength is likely to put renewed downward pressure on inflation.

We have neutralised our South African Rand exposure following the earlier than expected removal of President Jacob Zuma. With Cyril Ramaphosa now in charge of the country (rather than just the party), we expect the positive sentiment toward South Africa to persist for now. However, we refrain from an overweight position at this juncture, as 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. 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

Overall, we currently hold a constructive view on credit. The valuation picture has not changed in recent weeks where spreads have widened, but by not a sufficient amount, which makes us currently moderately bullish. For January, no credit market was able to deliver a total positive return. Spreads have widened in most markets except European IG, which comes as no surprise given European Central Bank (ECB) support. All markets that were not impacted by central banks widened. Excess returns were positive (where credit outperformed rates) except for European and Asia HY. The main performer in terms of excess returns remained LATAM mainly due to carry, which is still attractive. Given recent weeks volatility within global markets, we believe dislocation has arisen, which will bring opportunities within the credit space.

In Europe, we still believe we are currently in a favourable market for credit. Although the economic surprise index has started to trend downwards and equity markets have not performed well in the early weeks of February due to volatility. Overall, PMI data continued to be strong and well above expectations, while new orders and export order books trended to new highs which are all positive for the macro environment for credit.

On the Micro front, default rates remain low and there are no signs of any change, earnings remain supportive and relatively healthy and consensus in 2018 for EPS growth is in the region of 10% YoY, which is slightly down on the 12% for 2017.

Leverage in Europe has been creeping up and for the start of this year, due to the volatility there has been a decline in new deals in HY markets. The main risk we see for leverage later in the year is more shareholder initiatives and M&A. In terms of technicals there hasn't been much change from previous months, it is worth mentioning that outflows have been quite persistent in European HY, which isn't beneficial for spreads. Additionally, supply in the primary market has been quite lean in recent weeks, however there are expectations that the pipeline is building with a number of large LBO deals waiting on the sidelines before coming into the market, which will kick start the market once again. Valuation remains very tight due to the ECB's purchasing programme.

In the US, we had the first widening in quite a while. Despite the substantial increase in the VIX, it only managed to increase IG spreads by 10 basis points (therefore we didn't really see any major sell off). We observed outflows through ETFs, but in large part IG credit markets stayed consistent after the recent spike in volatility and the market continues to be dominated by the overall interest rate environment. Within the IG credit space, something that we will continue to monitor closely is yield curves and potential M&A activity. Overall credit spreads remain tight, but we could see spreads grind tighter from here as volatility stabilises. This is due to the expected outcome from tax reform, which will restrict supply and well as increase demand for corporates in general. In terms of investment

themes, we still have a focus on sector rotation where buying the wides remains the dominant approach in play. We will continue with this strategy until we see the economy turning.

The Australian credit market has been particularly slow for the start of the year. This is partly due to being holiday season, which meant there has been a lack of engagement in the market. There was also a strong demand for credit and stable spreads, which meant although it was a month where spreads widened in most other markets, Australia remained the same. The economy itself is currently somewhat benign and there are currently no potential headwinds ahead of us. There is some talk of tightening of rates, but that is unlikely to be seen until a year away. Physical spreads continue to be tight, and the Australian Dollar is staying in the $0.75-0.80 range and thus continues with this theme of stability. Issuance has been surprisingly strong, especially in financials, but also a small amount of corporates.

In Asia, there are currently solid macro fundamentals, with leading indicators all pointing to economic growth within the region. Supply of credit is currently low due to the holiday season, and we expect pent up supply to come. In performance terms Asia credit remains solid. We are currently playing a waiting game to invest, in which we want US Treasuries to stabilise before allocating further. Additionally, we have observed the Chinese SOE 10yr underperforming recently and this presents us an opportunity in the coming weeks.

For Japan, there is no change in the yield for JGB's, and it has been announced that Governor Kuroda will continue in his position. Interest rates are expected to decline gradually and we expect credit spreads to tighten due to strong demand as a result of favourable performance. In terms of investment themes, due to the Japanese Yen (JPY) appreciating, we have observed that when JPY is at ¥100-105/$1 level exporters' operating performance gets hit and their profits decline. However, having said that, we are not facing a situation where the quality of the credit declines.

Lastly in LATAM, we hold a positive view on Brazil and other high yielders in the region which have not been affected by the rise in US treasuries. Valuation continues to be expensive, which is supported by low default rates. Flows in LATAM credit remain stable, and the region continues to outperform. 2018 is a heavy election year with the likes of Brazil and Mexico going to the polls. Due to the potential risks that comes with elections, we will monitor this closely in the coming months. We will consider increasing our allocation over time once we have a clearer idea of the outcomes.

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

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