

GLOBAL CREDIT STRATEGY: MIDYEAR REVIEW

Key Themes

We have recently passed the mid-year point for 2018 and this is always a good time to review our existing global credit strategy.

We entered the year optimistic, with the expectation of a low-volatility environment, continuing support from global central banks, solid economic growth and higher rates as well as attractive investment themes. Our key themes for 2018 were a long position in US High Yield, an overweight in European hybrid and financial bonds, and a preference for rising stars and Chinese SOEs. We expected a positive return for 2018, similar to the strategy's yield, in line with our long-term performance objectives for the strategy.

With the knowledge of the last six months, we are pleased that most of our expectations worked out. Yields were rising in the first half, as the positive economic trend continued and inflation started to pick up globally. Also, central banks' support in the period have helped financial markets. The latter will also stay with us for a while as the ECB just announced the extension of its purchasing program and confirmed that maturing bonds from its portfolio will be re-invested from the beginning of 2019. The only forecast that didn't meet our expectation was the hope for a low-volatility environment. Volatility, compared to 2017, was elevated, as US President Donald Trump initiated a heated debate about trade tariffs, as well as reinstalling sanctions against Iran. However, even with higher volatility, most of our investment themes have contributed positively to the strategy's performance, except for some investments in the financial sector that didn't meet our expectations, specifically subordinated insurance bonds. The latter underperformed for no sector-specific reasons. Insurance bonds are viewed by the market as "high beta bonds" (highly sensitive to market moves) and weren't liked by the market in an environment of widening spreads.

For the second half of the year, we remain optimistic and would like to confirm our expectations from the beginning of the year. Exhibit 1 visualises how Nikko AM's Global Credit team currently views the investment prospects in its key markets. In most regions, we see credit markets solidly supported by positive macro as well as micro fundamentals. Also, the technical picture still looks benign, even as some asset classes (EMD, US HY) have experienced significant outflows this year. However, as money has left these markets, issuance also came down and helped to balance supply and demand. The only area where our investment team is currently concerned is valuation. Nevertheless, even as credit markets

have become tight, compared with historical spread levels, we are still able to identify investment themes, which offer pockets of value.

Exhibit 1

Region	Macro	Micro	Technicals	Valuation	Overall Assessment
Europe	ON	ON	ON	OFF	ON
North America	OFF	ON	ON	OFF	Neutral
Asia	Neutral	ON	ON	OFF	ON
Japan	ON	ON	ON	OFF	ON
South America	ON	OFF	Neutral	OFF	OFF
Australia	ON	ON	ON	OFF	ON

Source: NAM (Please refer to Important Information on the last page of the document.)

Regions where we remain more cautious are Asia and North America. In Asia, we therefore focus our investments on higher rated Chinese SOEs and in North America we're underweight BBB-rated credits. The only region that we are currently underweighting is South America, where corporate fundamentals are weak and market technicals are unfavourable.

Besides being overweight in SOEs, the other investment themes from the beginning of the year will that we still continue to be in place are; financials, US High Yield and hybrid bonds. The reason why we still like financials, in particular banks, is our belief that they should benefit from higher rates. However, we will also keep our investments in the insurance sector. Furthermore, prospects for the US High Yield market look good, as the sector is less impacted by the trade war, given its domestic nature, and the growth trend of the US economy continues. Also hybrid bonds and rising stars remain core investments in our strategy. The only new theme joining the portfolio of ideas will be investments in the short end of the US corporate bond market. Given the flattening trend of the US yield curve, breakeven yields for short-dated bonds have become attractive.

Investment themes we favour in 2018:

- Chinese SOEs
- Financials
- US High Yield

- Hybrid bonds
- Rising stars
- Short-dated US IG bonds

What about the goals for 2018? The increased level of volatility is playing into the hands of active managers and should help us achieve our goals. In terms of absolute performance, we still expect it to be positive in 2018 but think it could be below the initial yield level from the beginning of the year. We expect the trend for higher rates to persist and impact the absolute performance of our strategy.

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