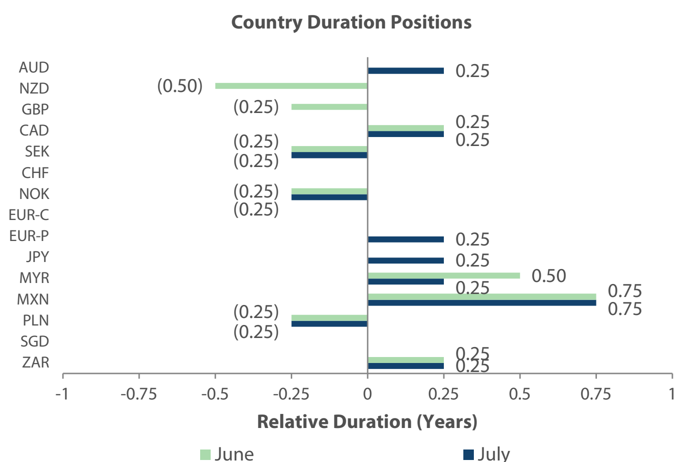
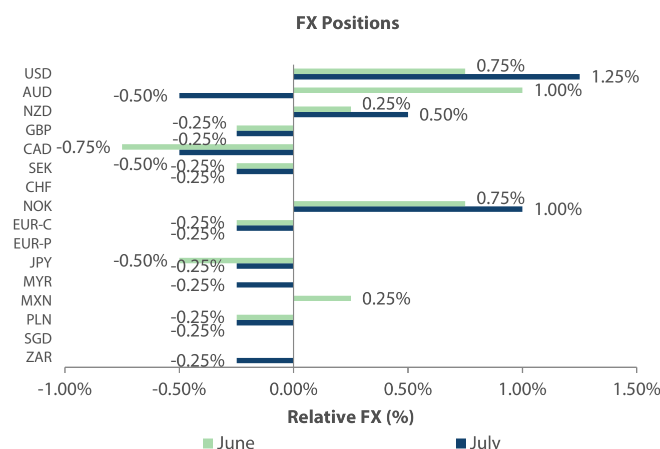
GLOBAL FIXED INCOME & CREDIT OUTLOOK





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Global Outlook

Global growth remains desynchronized, with the Eurozone, Japan and the UK showing an ongoing moderation in growth, whilst the US remains robust. We are seeing a broad softening of global ex-US confidence indicators which could continue to weigh on economic activity. Nevertheless, generally still benign global financial conditions, including highly accommodative monetary policy in the Eurozone and Japan should see growth recover later this year. One of the most instrumental factors that has underpinned the global growth acceleration to-date has been a recovery in global capital spending, which has been supported by cheap financing, leading to rising profits and improved business sentiment across both developed and emerging markets. The acceleration in aggregate demand also had positive implications for commodity prices. This paved the way for a significant pickup in economic activity amongst commodity exporters in both emerging markets and, to a lesser degree, developed markets. However, as financial conditions continue to tighten investment growth could be at risk of slowing from its earlier, elevated, pace.

Firmer commodity prices this year have seen a rise in global headline inflation (albeit from a low base). Higher geopolitical risks related to the war in Syria, Iran nuclear deal and Venezuelan crisis, have all lent support to crude oil, which has pushed headline inflation higher in recent months. Global core inflation, however, remains subdued, but the broad based improvement in labor market conditions across the globe is starting to put upward pressure on global wage dynamics. The still robust outlook for both real economic activity coupled with higher inflation should see a number of major central banks continue to look to scale back from their highly accommodative policy stance over the remainder of the year, putting sustained pressure on global bonds.

One risk to the global growth outlook has escalated in recent months in the form of increased protectionism. The threat of Auto sector related tariffs has subsided for now as the US and EU have agreed to refrain from imposing tariffs in favor of a period of broader trade discussions, which could also include agricultural goods and liquefied natural gas. On another front, the potential imposition of a further $200bn of tariffs against China, in addition to a previously announced $50bn, remains at large, with the potential level of tariffs allegedly raised to 25% from 10% previously. The previous imposition of tariffs has already been met with retaliation from China, including restrictions on US private investment. Investors are feeling increasingly anxious about the escalation in the trade war rhetoric between the world's largest economies.

On the domestic front, US economic activity looks to have improved substantially, with the Fed still on course for a further two interest rate rises this year, despite the risk from global trade tensions. The outlook for inflation also continues to rise, with the domestic labour market showing no signs of cooling. We continue to believe that the broad based strength of the economy, as evidenced by tightening labour market conditions, improved household spending and fixed capital investment; together with a higher inflation trajectory, should see the Fed deliver a total of four hikes this year. We continue to believe that the ongoing normalization of interest rates by the Fed, in conjunction with its balance sheet reduction should result in continual pressure on US treasuries over the course of the year. However, as global trade tensions are showing signs of impacting business confidence market expectations for the pace of Fed hikes may well have peaked.

With a moderation in economic activity, albeit partly caused by weather related anomalies this year, growth momentum across the Eurozone remains soft. In spite of this, the ongoing tightening of labour market conditions, has seen the European Central Bank (ECB) reduce its Quantitative Easing (QE) program, halting net

purchases by the end of 2018. ECB president Mario Draghi has however tempered expectations for rate hikes, unlikely until late next year. Headline inflation is starting to show signs of life, primarily driven by higher energy prices, estimated at 2.1% y/y as of July. More critical for policy however, core inflation remains relatively stable, at 1.1%, though this is expected to rise gradually as unemployment rates continue to grind lower. Political risks remain elevated as a new populist government in Italy pushes back against fiscal austerity as well as ongoing divisions within the German ruling coalition with regards to immigration policies.

In Japan, labour market conditions remain tight, on the back of a demography related declining supply of workers. The ratio of open jobs to applicants now stands at above 1.6, a level that surpasses the bubble peak recorded in the mid-90s, yet wage pressures remain nowhere in sight, as business investment remains weak and wage negotiations remain cautious. As a result, the BoJ has continued to push out it's inflation forecasts (1.1% from 1.3% for FY 2018, 1.5% from 1.8% for FY 2019 and 1.6% from 1.8% for FY 2020). As such, withdrawing monetary accommodation at this stage would certainly be premature. Indeed the latest changes announced by the BOJ at its July meeting: halving the balance on which bank's incur negative interest; increasing flexibility in the 10yr yield curve target (to -0.2% to 0.2%); and introducing forward guidance on interest rates; are all geared towards improving the sustainability, and hence longevity, of its highly accommodative monetary policy.

In Emerging Markets, downside risks to growth have increased of late, with expectations currently standing at 4.8% y/y for 2018, slightly below 2017 levels. Chinese growth has been the main drag, as authorities focus on the quality rather than the quantity of growth, with particular focus on reducing financial instability and pollution. However with growth softening more than expected in the second quarter, and trade conflicts now posing the threat of a more meaningful slowdown in the second half of the year, Chinese authorities have responded by resorting to a combination of front loaded fiscal and targeted monetary stimulus measures. EM ex-China should continue to recover, driven mainly by improving domestic demand, yet political uncertainty in a number of large economies, such as Brazil, may endanger the nascent recovery for the region. EM inflation should also continue to move higher in 2018, but the increase will not be broad-based. The end of disinflation will see further monetary policy divergence within EM. With a number of countries continuing to hike their policy rates in order to restore positive real yields, on the back of rising DM rates, as they strive to maintain their higher real yield relative to DM. Currencies of commodity exporters, on the other hand, which generally already offer high real yields, should continue to benefit from stronger commodity prices.

Developed Markets Positioning

At the Global Fixed Income's team July investment process meeting, we maintained a positive view on our US Dollar (USD) positioning, increased duration risk to the portfolio and cut exposure to the Australian Dollar (AUD). The team have taken a positive view on the USD because of a number of market events which we believe will be supportive of a stronger USD. For example; the high relative level of interest rates currently in the US, further developed market divergence in monetary policy and the current trade conflict with China. In terms of interest rate positioning, the team noted the positive seasonality effect of late summer interest rate rallies in the face of a positive catalyst from the increase trade war escalation. For the month, Core European rates market were seen as overvalued while US and EM rates appear as undervalued, when measured on a carry, curve and momentum perspective. Regarding FX, the USD and Norwegian Krona (NOK) were seen as the least expensive currencies while the Mexican Peso (MXN) and AUD measured as overvalued which was largely driven by the recent decline in commodity prices.

The team has decided to reduce positioning in the AUD, based on the increased concerns over trade-war escalation with China. We have observed as of late, the AUD to have demonstrated increase correlation with the Chinese Yuan. China's further devaluation of the Yuan and recent weakening in commodity prices, especially Copper and Iron Ore is also a concern. Especially given the significant export value to China, this has raised concerns that the AUD remains quite fragile in the current low interest rate environment, especially compared with rates in the US. The team has maintained its duration positioning view, based on the current China story and expectation of a dovish RBA for the upcoming months.

The team increased its positioning in the New Zealand Dollar (NZD), based on the view the currency was seen as offering value relative to interest rate differentials and commodity factors. The team expects that the RBNZ has potential to hike rates. However, we view that the market has priced out any rate hikes for the remainder of 2018. There is some concern over spillover effects of the US led trade conflict.

The team has maintained its overweight positioning in Norway as the team views NOK as undervalued relative to rates and the YTD rally in oil prices. The team also believes that there is positive potential of the Norges Bank will raise its target rate when it meets in September. We have balanced our positioning in Norway with an underweight position in Canada. This is because we maintain a view that the market has priced in rate hikes too aggressively and that Canada will not benefit from higher oil prices as much as Norway.

The team has noted recent weakness in Pound Sterling due to both the volatile political environment surrounding Brexit and weaker inflation data which raises concern that the Bank of England will slow monetary policy tightening which had been thought to have been considered given more encouraging economic data.

The team has moved to an overweight in Italy and peripheral spreads intra Eurozone as Italian debt remains the cheapest on a relative basis. This is because of overall carry and diminished threat of a near-term political event serve to support yield hungry investors. The team has remained underweight on the Euro due to slowing PMI data as well as the expectation of a more Dovish policy stance from the European Central Bank.
The team has maintained its underweight view on the Japanese Yen (JPY) given the expectation that the Bank of Japan will more than likely maintain its monetary policy stance for the foreseeable future. The team noted that the JPY remained undervalued from a model and real effective exchange rate basis and took action to reduce the level of its underweight.

Emerging Markets Positioning

In Emerging Markets we have turned more cautious given concerns over a tightening of US monetary policy and escalating trade tensions. We remain selectively bullish on a number of EM rates markets as despite greater risks from the external environment inflation dynamics remain highly divergent and generally benign in a number of countries facilitating a more dovish stance.

We have turned marginally bearish on the Malaysian Ringgit as the manufacturing side of the economy is highly dependent on global trade volumes, which would be under threat should trade tensions between the US and China escalate further. Following earlier strength, the manufacturing side of the economy continues to slow; nevertheless, this has been partially offset by a strong rebound in energy prices. Bank Negara Malaysia 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. Following the surprise election victory for the opposition Pakatan Harapan coalition the Goods and Services tax has been repealed which will likely cause a mild deterioration in the government's fiscal position, offset by lower inflation for consumers. Hence, we remain bullish on Malaysian rates though we have reduced the position given the recent rally.

We have removed our overweight in the Mexican Peso due to greater uncertainty regarding trade and politics. We believe that the proposed changes to NAFTA have weighed disproportionately high on the currency, with a termination of the deal still highly unlikely, though as discussions recommence we may see heightened volatility in the Peso in the coming months. Concerns regarding the election of Andrés Manuel López Obrador (AMLO) had also rattled investors, however, we continue to expect that AMLO will moderate his stance towards both NAFTA and energy reforms. Meanwhile, inflation should continue to move lower, giving us more confidence in maintaining our long duration trade, with real yields now over 4% vs. core CPI.

We retain our bearish take on the Polish Zloty due to a recent slowing of growth momentum , as well as political risks associated with infringement proceedings from the European Union in relation to alleged breaches of "Rule of Law" principles related to recent judicial reforms. Longer term uncertainties also persist as the latest EU draft budget proposal for 2021-2027 indicates a material shift of funds away from Central and Eastern European (CEE) countries, such as Poland, towards southern Europe. We also remain underweight duration in Poland as despite the recent softening of inflation data, underlying inflationary pressures remain due to robust domestic demand and tightening labour markets, with valuations also stretched.

We remain neutral on the Singapore Dollar as slowing external demand has weighed on the electronics sector this year, this sector would also be impacted further should the Sino-American trade conflict escalate. The Monetary Authority of Singapore moved to a positive appreciation bias in April which may still see the Singapore Dollar outperform some of its regional peers, despite these concerns. We remain neutral on duration despite a benign inflation outlook due to rich valuations and a high correlation with US Treasuries.

Finally, we have turned marginally bearish on the South African Rand as despite the positive sentiment toward the change in leadership in South Africa, investors are likely to encounter episodes of disappointment as Ramaphosa's reform agenda faces obstacles. The South African economy is also highly exposed to a slowdown in Chinese demand for raw commodities. Meanwhile, with core inflation remaining low, close to the mid-point of the SARB's inflation target, and growth disappointing of late, the SARB are unlikely to hike rates.

Global Credit Positioning

For the second half of the year, we remain optimistic and would like to confirm our expectations from the beginning of the year. 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.

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.

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