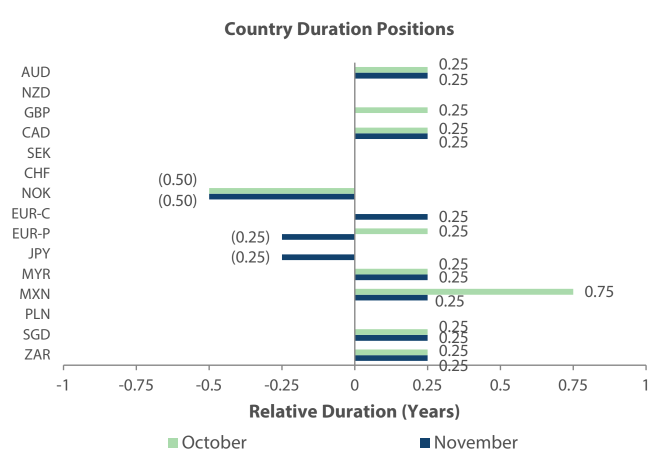
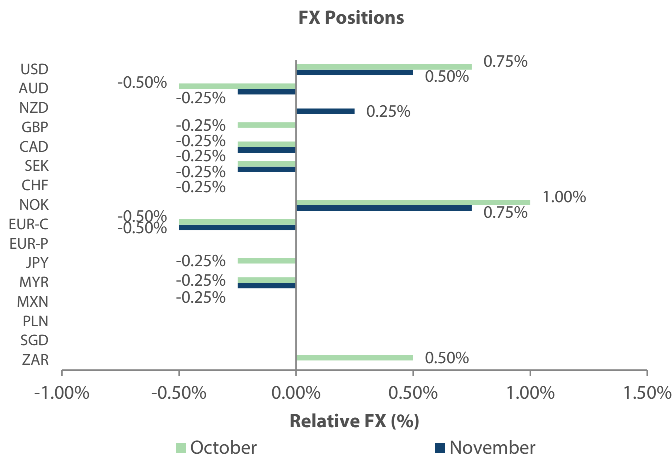
GLOBAL FIXED INCOME & CREDIT OUTLOOK





Source: Nikko AM

Please Note: Relative positions against the WGBI (Citigroup World Government Bond Index)

Copyright © Citigroup Inc

Global Outlook

Global growth remains desynchronized, with China, the Eurozone and Japan continuing to show further signs of moderation, while the US remains relatively robust. Despite a recent sell off in equity markets, global financial conditions are still generally benign, supported by highly accommodative monetary policy in the Eurozone and Japan, and additional stimulus measures in China, which ought to limit the extent of the global economic slowdown.

Firmer oil prices, particularly in the former part of the year, led to a marked pick-up in headline inflation globally. However, the majority of the impact is now behind us and we expect global headline inflation to moderate in the coming months. More recently, concerns related to an excess supply of crude have resulted in a significant correction to oil prices, which should lead to a disinflationary impulse in the coming months. Global core inflation, meanwhile, remains subdued, but the broad-based improvement in labour market conditions across the globe is starting to put upward pressure on global wage dynamics. The still relatively robust outlook for real economic activity coupled with higher, albeit moderating, inflation ought to see major central banks continue to normalise their excessively accommodative policy stance over the coming quarters.

Nevertheless, there are also significant risks to global growth, the most prevalent being the threat to global trade via increased protectionism. The US recently initiated a further $200bn of tariffs against China, in addition to a previously announced $50bn, at a level of 10%, with an increase to 25%, and a broadening of the product range, still possible should bi-lateral trade negotiations fail. Encouragingly though, during the latest G20 meeting, the US and China struck a 90-day truce in the "trade war", alleviating some of the concern, albeit temporarily.

On the domestic front strong US economic activity is keeping the Fed on course for a total of four interest rate hikes this year. The outlook for the coming year, however, has become less clear with Fed Chairman Jerome Powell suggesting that US interest rates are nearing neutral levels. As such, the pace of monetary policy tightening next year is likely to slow, with markets currently pricing in just one rate hike for 2019.

Growth momentum across the Eurozone continues to slow, driven by weakness in the manufacturing sector. The ongoing tightening of labour market conditions, has led the European Central Bank (ECB) to reduce its Quantitative Easing (QE) program, and will halt net purchases at the end of 2018. ECB president Mario Draghi has however tempered expectations for rate hikes, unlikely until late next year, or even beyond, as inflation is starting to moderate across a number of Eurozone Countries. Meanwhile, political risks remain elevated as the populist government in Italy has pushed back against fiscal austerity, which has seen the European Commission launch excessive deficit procedures against the country.

In Emerging Markets, downside risks to growth remain, 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 levels. However, with growth softening more than expected in the third quarter, and trade conflicts continuing to pose the threat of a more meaningful slowdown, Chinese authorities have responded by resorting to a combination of front-loaded fiscal and targeted monetary stimulus measures. EM ex-China should generally continue to recover, driven mainly by improving domestic demand. Idiosyncratic risks will, however, weigh on a few countries as balance of payments crises have

engulfed Argentina and Turkey. EM inflation has generally moved higher in 2018. The end of disinflation has seen monetary policy divergence within EM. A number of countries have hiked their policy rates on the back of rising DM rates, as they strive to maintain their higher real yield relative to DM. However, with price pressures now easing, much of the normalisation in EM is now likely behind us.

Developed Markets Positioning

The Global Fixed Income investment team has reduced, but maintained its positive outlook on the US Dollar (USD). This is because of the robust outlook for the US economy, higher rates over the longer-term and the continued stimulus injection in both Europe and Japan will be positive to USD performance over the last quarter in 2018. However, the team has increased its long duration position based on the assessment that the significant declines in energy prices will likely translate into substantial drops in headline inflation. Furthermore, recent equity market weakness will likely persist into the end of the year as the market reprices a lower growth outlook for 2019 and as the Federal Reserve will likely shift to a dovish stance in dialing back its recent aggressive forward guidance. Further north in Canada, the team has remained marginally negative on the Canadian dollar (CAD) due to increased energy market risk, the lack of refining capacity and an overly aggressive forward interest rates curve will remain key catalysts for appreciation against the USD. The team has conversely marginally increased its long-duration view on the correlation with US rates as well as our assessment that the forward curve is mispriced.

Looking at the Eurozone, the team has persisted with its negative view on the Euro as Economic momentum continues to slow. Interest rates remain low and Italy has now become increasingly problematic for any hawkish rhetoric from the ECB. The team has moved to increase core Euro duration relative to periphery noting that while Italy remains cheap, it does not appear there is a rationale for spread performance into a weak credit environment and a lack of progress on the deficit dispute with the EU. In Scandinavia, the team has moved to reduce its bullish outlook on the Norwegian Krona (NOK) given the historical correlation with energy prices despite its undervaluation based on interest rate differentials as it is a risk that the Norges bank will have to address the recent energy market weakness with a dovish monetary policy statement. In Sweden, the team remains negative on the Swedish Krona (SEK) given the overall correlation with the Euro despite the likelihood that the Riksbank will raise rates at either the December or February meeting, as continued Eurozone weakness will be the key headwind in further rate hikes.

Pound Sterling (GBP) remains a special case for the team-view given the binary nature of a deal outcome with the EU. The team has decided to neutralize exposure on both its FX and duration exposure in light of the upcoming UK parliament vote on the deal that was agreed with the UK and EU this December.

In Australasia, the team continued to be positioned defensively with respect to the Australian Dollar (AUD), as uncertainties related to the ongoing China-US trade rhetoric are set to continue weighing down the AUD in the medium term. However, the team felt prudent to lock in some profits, by reducing the overall underweight position, as a relief rally of late saw momentum reverse. By the same token, we have increased our allocation to New Zealand Dollar (NZD), which effectively left our long NZD/AUD exposure intact.

In the rates market, we kept our active weights unchanged, with a small, long-duration exposure to Australia's local bond market, on the back of subdued inflation dynamics domestically and largely elsewhere. In New Zealand, we maintained our flat-duration risk for now, as the external backdrop continues to be contaminated by US –China trade war rhetoric; yet the team remains cognisant that domestically led price pressures in New Zealand will continue to build, with tightening labour market and rise to minimum wages at its core.

Emerging Markets Positioning

In Emerging Markets, we have been generally cautious due to concerns over a tightening of US monetary policy and escalating trade tensions. However, we are turning marginally more positive given generally attractive valuations. We also remain selectively bullish on a number of EM rates markets as despite greater risks from the external environment inflation dynamics remain highly divergent with disinflation facilitating a more dovish stance in a select few countries. The lower oil prices of late should also generally pass through to lower headline inflation across most EM countries and elsewhere.

We continue to be underweight the Malaysian Ringgit (MYR) as the manufacturing side of the economy has slowed somewhat of late as global demand enters a soft-patch. We expect the MYR to continue to closely track the Chinese Renminbi (CNY) which may exhibit a slight weakening in order to maintain competitiveness. Given the lack of inflation pressures in the economy, we are likely to see an extended pause in monetary policy in Malaysia. The government's decision to repeal the Goods and Services tax will likely cause a deterioration in the government's long term fiscal position, though compensated in the near term by lower inflation for consumers. Hence, we remain mildly bullish on Malaysian rates.

We have maintained our market weight exposure to the Mexican Peso (MXN), as optimism regarding the agreement of the USMCA trade deal has begun to recede from investors' minds, to be replaced with uncertainty regarding president elect Andrés Manuel López Obrador (AMLO)'s stance particularly towards energy reforms. However, overall we remain constructive due to its relative undervaluation and high carry, coupled with an increasingly hawkish rhetoric from Banxico. On rates, we decided to reduce our overweight duration exposure to Mexican local bond market, despite largely contained domestic inflationary pressures, as the latest set of market unfriendly initiatives by AMLO, have continued to put pressure on the domestic rates market.

We remained neutral on the Polish Zloty (PLN), as strong economic momentum observed year to date is unlikely to be sustained in the coming quarters, potentially weighting down the PLN. In the rates market we also kept our neutral duration exposure, as the National Bank of Poland is expected to maintain its dovish stance for some time still, despite tightening labour market conditions, as inflation (headline in particular) is starting to show signs of fatigue.

We remain neutral on the Singapore Dollar (SGD) as slowing external demand weighs on the electronic sector. However, with a focus on domestic demand the Monetary Authority of Singapore have increased the positive appreciation slope of the currency, which should still see the SGD outperform its regional peers. We turned marginally positive duration due to the high correlation with US Treasuries.

Finally, in South Africa, better risk on environment and generally positive market reaction to the appointment of Tito Mboweni as finance minister, continued to support the currency, despite fairly disappointing incoming macroeconomic data. The SARB also maintained its hawkish stance delivering a 25bps rate hike in order to anchor inflation expectations, further propping up the currency. Given the strong performance, the team felt it was prudent to lock in profits, bringing the currency exposure to market weight. In the rates space, we continue to be marginally overweight, as strong performance of the currency and lower oil prices, ought to see price pressure wane in the coming quarters in turn supporting local bond market.

Global Credit

Overall, globally we currently see value in the short-end of the corporate bond curve where it offers an enticing risk/reward trade off. For example, we have noticed in the current market that in 1-3 years space within US corporates you receive a breakeven spread of 100-150bps. We argue that this is appropriate amount of breakeven spread which can withstand further spread widening which is different if you go to the longer end where the margin for error is much smaller.

In terms of spreads, within global markets we currently see credit premiums moving sideways as the best outcome we can hope for in the remainder of 2018. As a result we don't currently expect an instant rebound in spreads.

A recent investment theme we have currently implemented into the portfolio has been a sector rotation within European credit where we have moved out of cyclicals and into non-cyclicals. We felt that this rotation in sectors will allow us to avoid more negative sentiment and headlines regarding the trade war. This conviction was assisted through seeing attractive spreads in the non-cyclical sector. Valuation is becoming less of a worry globally and has improved from September onwards especially within Europe, given recent spread moves which has provided more attractive levels than compared to the rest of 2018. However, we would note that in Australian credit, valuation has been more stable. This may be viewed as a concern that we have not had as much of a reaction in Australia yet.

Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. This publication has not been reviewed by the Monetary Authority of Singapore. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed institution in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme, the Nikko AM NZ Wholesale Investment Scheme and the Nikko AM KiwiSaver Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website: www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document nether constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No

transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.