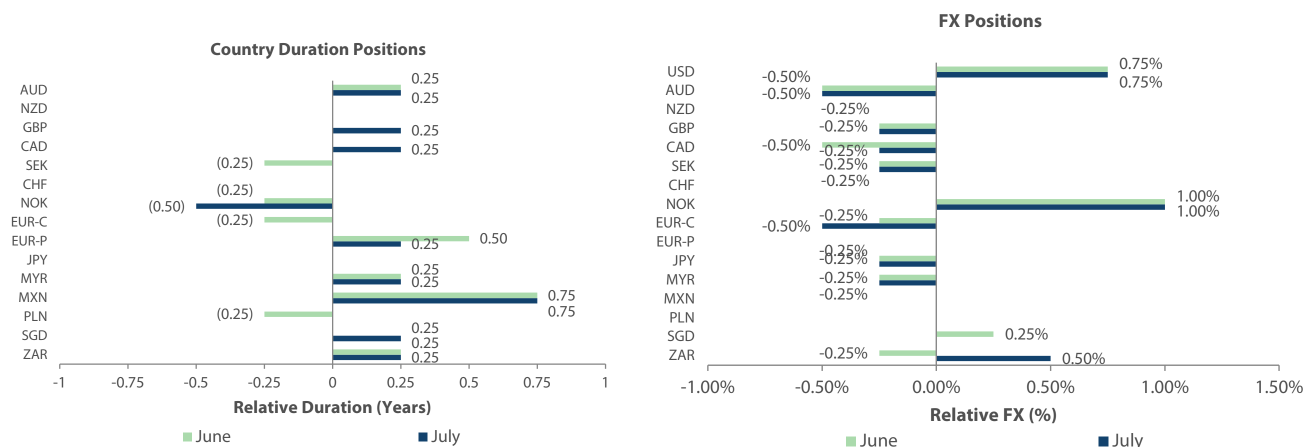
# GLOBAL FIXED INCOME & CREDIT OUTLOOK




*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 showing a further moderation in growth, while the US remains robust. Nevertheless, generally still benign global financial conditions, including highly accommodative monetary policy in the Eurozone and Japan, as well as more stimulus measures in China, should limit the extent of the global slowdown.

Firmer oil prices this year has 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 this year. However, the majority of the impact is now behind us and we expect global headline inflation to moderate in the coming months. Global core inflation meanwhile 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 scale back from their highly accommodative policy stance over the coming months. Nevertheless, there are also significant risks to global growth, the most prevalent being the threat to global trade via increased protectionism. The US has 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.

On the domestic front strong US economic activity is keeping the Fed on course for a total of four interest rate rises this year, despite the risks from global trade tensions. The outlook for core inflation also continues to rise, with the domestic labour market showing no signs of cooling. 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.

Growth momentum across the Eurozone, however, continues to slow, driven by weakness in the manufacturing sector. The ongoing tightening of labour market conditions, the European Central Bank (ECB) is reducing 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. Inflation has picked up of late, primarily driven by higher energy prices. More critical for policy however, core inflation remains benign, at close to 1.0%, though this is expected to rise gradually as unemployment rates continue to grind lower. Meanwhile, political risks remain elevated as a new populist government in Italy pushes back against fiscal austerity and the ruling German coalition government continues to fare poorly in local elections.

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 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 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 engulf Argentina and Turkey. EM inflation will 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, on the back of rising DM rates, as they strive to maintain their higher real yield relative to DM.

## Developed Markets Positioning

The Global Fixed Income team has moved to increase its overall duration outlook from neutral while maintaining a positive view on the dollar overall. The investment team noted several upcoming risks to its horizon period most notably the upcoming US election. The Democratic Party is likely to regain control of the US House of Representatives as polls lean heavily for a Democratic majority. While the Democratic victory remains our base case scenario, we have observed a similar overconfidence in election outcomes two years ago. The tail risk would be for the republicans retaining both the House and the Senate. Our rationale remains solidly in favor of the US dollar due to the higher relative rates, the path of the Fed as well as increasing uncertainty in Europe.

In Europe, Italy remains a source of increased political and economic risk as the EU has decidedly rejected the 2.4% budget deficit. We moved to reduce the previous positioning increase in European periphery as the situation in Italy had unexpectedly deteriorated while the team remained marginally positive on non-Italian periphery exposure. The team maintained its underweight positioning on SEK exposure as the political situation remains unclear with the Swedish parliament now commencing its third attempt at forming a government with the looming risk of new elections if they fail to form a government four times. In Norway, the team had remained positive on the more hawkish central bank view while maintaining its underweight duration position given the higher short-rates view while maintaining exposure to the NOK given rising Brent prices.

The team had moved to increase its duration exposure to Sterling rates as the market had sold off sufficiently to warrant an increase in exposure to the prior meeting as an entry point along with the view that the potential for a hard Brexit has increased given the lack of progress on the Irish border while maintaining a marginal underweight on GBP.

The team had increased its exposure to Canada given the removal of headwinds as the new NAFTA agreement was put in place as well as the view that the Canadian dollar will benefit from the overall correlation to US rates in the Canadian dollar will experience a limited benefit from rally in energy prices.
For JPY, the team has maintained its short bias despite the perception that the BOJ has tapered as we expect the BOJ and Abe's policies to remain in place for the foreseeable future.

In Australasia, the team continued to be positioned defensively with respect to the Australian Dollar, uncertainties related to the ongoing China-US trade rhetoric are set to continue weighing down the AUD itself. Duration wise, we maintained our small o/w allocation to the bond market, given subdued inflationary outcomes of late, and the RBA's forward guidance itself are likely to see rates on hold for a prolonged period of time. In New Zealand, despite slowing economic activity earlier this year, domestic price pressures continue to build as tightening labour market conditions together with recent hikes to minimum wages, saw a meaningful upturn in wage growth, in turn fueling core inflation. With further buildup in price pressures on the cards, the RBNZ is likely to amend its current very dovish bias, which is likely to support the currency and lead to repricing of interest rate expectations in the local bond market space. For the time being however, the team decided to maintain its neutral rates and fx exposure to New Zealand, given the external backdrop continues to be contaminated by US protectionist policies.

## 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 constructive of late 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.

We are underweight the Malaysian Ringgit as the manufacturing side of the economy has slowed somewhat of late as global demand enters a soft-patch. We expect the Ringgit to continue to closely track the Chinese Renminbi 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 new 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 are now neutral in the Mexican Peso, from a previous overweight, as optimism regarding the agreement of the USMCA trade deal will likely recede from investors' minds, to be replaced with uncertainty regarding president elect Andrés Manuel López Obrador (AMLO)'s stance towards energy reforms. Overall, however, we remain constructive due to its relative undervaluation and high carry, coupled with an increasingly hawkish rhetoric from Banxico. Meanwhile, inflation continues to move lower, giving us more confidence in maintaining our long duration trade, with real yields now approaching 4% vs. core CPI.
We are neutral on the Polish Zloty as despite strong economic growth so far this year, recent indicators points to a softening of economic activity. Political risks also remain, with respect to the triggering of Article 7 from the European Union in relation to alleged breaches of "Rule of Law" principles. We also turn neutral duration in Poland due to the recent softening of domestic inflation data.

We remain neutral on the Singapore Dollar 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 Singapore Dollar outperform its regional peers. We turned marginally positive duration due to the high correlation with US Treasuries.

Finally, we turned positive on the South African Rand as the appointment of Tito Mboweni as finance minister bodes well for the government's commitment to fiscal consolidation. Meanwhile, with core inflation remaining below the mid-point of the SARB's inflation target, and growth disappointing of late, the SARB are unlikely to hike rates.

## Global Credit Positioning

Throughout 2018, we have a faced position where one month has been positive and the next negative. And during October we have seen this similar trend continuing. The worst performing sector in the last few weeks has been European High Yield. On the whole, we would take the view that this is due to idiosyncratic risk here in Europe. This in turn has caused confidence among investors to fall due to the heightened uncertainty. Such as the Brexit discussions still not resolved with a deal still not being agreed between the UK and the EU on its future relationship. Elsewhere in Europe on a Macro level is the Italian government budget negotiations, The European Commission has told Italy to revise its budget, which is an unprecedented move with regard to an EU member state where they implied it should be 2.1% of GDP rather than 2.4% that was wanted by Italy. Politics has also caused additional effects on credit markets especially the effects of the trade war between the US and China. Both the Asia region and Australia has seen negative spillover effects from the unresolved trade negotiations.

Asia FX has weakened against the USD due to its policy monetary policy tightening, which looks set to continue in December and also going into next year. This should remain a headwind for fixed income assets going into the coming quarter. Local currency weakness has abated for a number of countries such as in Indonesia and India. However, credit in these countries remains susceptible to broader EM developments and increased scrutiny over their twin deficits in an environment of tighter US monetary policy and rising oil price. Because of this we take the view that it would be better to be more defensively positioned to low beta countries such as South Korea & Singapore.

In Australia, the macro side on the whole is stable, supply in credit is strong and stable but valuation still not being properly priced given the risk. The two areas concern for Australian credit is the ramifications of the potential trade war with the US and China and its impact on Australia (as mentioned above), but closer to home the fall in domestic housing prices. There has been approx. a 15% decline in Australian house prices and given the credit supply for financials in the Australian credit market it is something to monitor closely. We would argue that we don't foresee a strong sell off in the market and a big downtown but instead a correction. One area which supports this conviction is overall construction where there is still considerable construction taking place particularly in New South Wales and Victoria.

Lastly, focusing on EM credit, LATAM was a stable month supported a strong rebound in Brazilian assets. Deteriorating diplomatic ties in the Middle East would warrant a cautious stance in credit in that region.

# 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. 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.