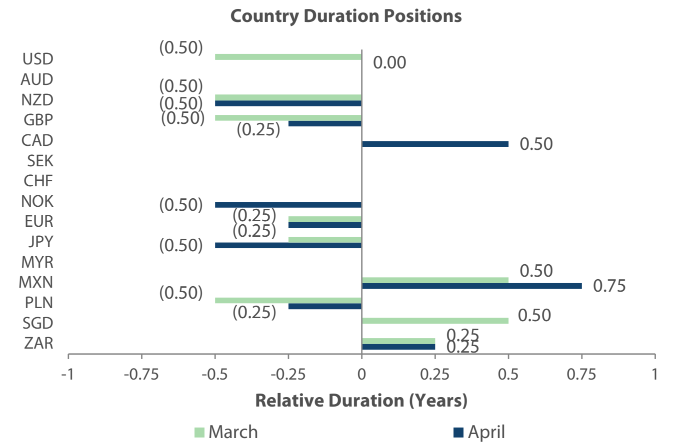
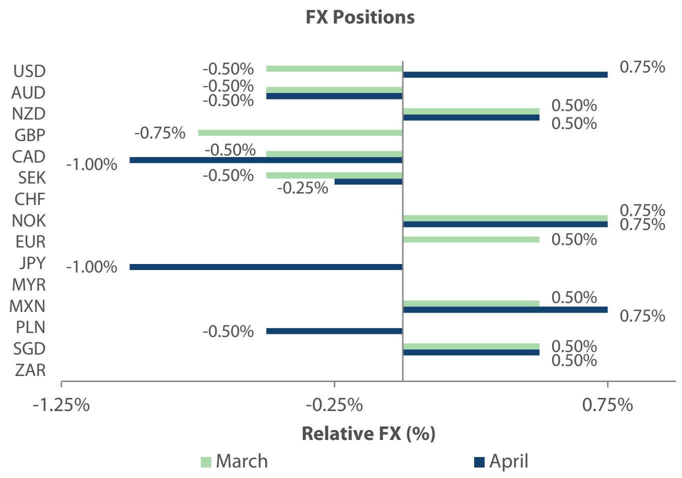
GLOBAL FIXED INCOME & CREDIT OUTLOOK

April 2018





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Global Outlook

The broad-based synchronized growth story continued to soften through March, as consumers pared back purchases in the face of rising prices. Unfavorable weather conditions earlier in the year have also seen some output disruptions within the manufacturing sector, particularly in Europe, though the negative impact is likely to be only temporary. Despite this, consensus growth forecasts for the current year remain robust. The strength of global economic activity remains supported by generally still benign global financial conditions (despite some deterioration of late), accommodative monetary policy, rising confidence and firmer commodity prices. One of the most instrumental factors behind the global growth acceleration has been a notable 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.

This synchronized pick up in investment has also resulted in a marked acceleration in global trade volumes, though we expect to see further moderation in the coming months. 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.

Firmer commodity prices this year have seen a rise in global headline inflation (albeit from a low base) reducing the risk of deflationary expectations becoming entrenched. More recently, however, some of the positive base effects have fallen out of the year-over-year comparison, including softer food prices, which has seen headline inflation rollover, in a number of major developed markets. Higher geopolitical risks related to the Syrian war, Iran nuclear deal and Venezuelan crisis, continue to lend support to crude oil, which is likely to prevent headline inflation from decelerating materially. Global core inflation, however, remains subdued, but the broad based improvement in labor market conditions across the globe is likely to put upward pressure on global wage dynamics. The improved outlook for both real economic activity and inflation should see a number of major central banks continue to look to scale back from their highly accommodative policy stance over the course of the year, putting sustained pressure on global bonds.

One risk to the global growth outlook has surfaced in recent months in the form of increased protectionism. The recent imposition of tariffs on imported steel and aluminum by the Trump administration, which remains subject to a number of exemptions for countries considered security allies, was initially met with relatively minor retaliatory measures from China. The potential imposition of a further $200bn tariffs by 2020, in addition to a previously announced $60bn, appears to be directly aimed at China's alleged intellectual property rights violations. This latest proposed set of tariffs, has resulted in China threatening to retaliate in full force, with many investors now feeling anxious about the escalation in the trade war rhetoric between the world's two largest economies. A US trade delegation is expected to sit around the negotiating table with their Chinese counterparts in the coming weeks, with the aim of coming to an amicable agreement on trade arrangements and hopefully, in turn, mitigate the negative impact that an increase in global protectionism could have for the global economy.

In the US, the Federal Reserve Chairman Jerome Powell, has suggested that the US economic outlook has improved substantially with the Fed on course for a further two or three interest rate rises this year, following a hike in March, as the outlook for inflation also continues to rise and with the domestic labour market showing no signs of cooling. We believe that the broad based strength of the economy, as evidenced by tightening labour market conditions, improved household spending and larger fixed capital investment; together with a higher inflation trajectory, should see the Fed deliver a total of four hikes this year. Despite the bond market sell off so far 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, though we are cognizant that our indicators do suggest that a degree of value has been restored, and that the scale of further moves higher in yields could be rather limited at this stage. Despite moderation in economic activity, partly caused by weather related anomalies this year, growth momentum across the Eurozone remains robust. This together with the ongoing tightening of labour market conditions ought to see the European Central Bank (ECB) reduce its Quantitative Easing (QE) program, halting net purchases by the end of 2018. A rate hike is likely to follow, but not until next year. With the latest food and energy price inflation showing signs of softness, mainly on the back of the currency strength earlier in the year, headline measures continued to ease, marking this year's low of 1.1% y/y as of February. Core inflation, however, remains stable, at 1%, with Q4 Eurozone GDP running at 2.7% y/y.

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 stands at close to 1.6, a level that surpasses the bubble peak recorded in the mid-90s, yet wage pressures remain nowhere in sight. The BoJ Governor Kuroda has recently suggested that inflation is on the right path to satisfy its official 2% target, yet in the latest communique the timing by which inflation hits this target, initially set at 2019-20, has been removed altogether. As such, withdrawing monetary accommodation at this stage would certainly be premature. The BoJ, has however reduced the total amount of long bonds purchases. In our view, the move by the BoJ is an adjustment to reality, as opposed to some meaningful shift in its monetary policy, as the Bank of Japan purchases have already been trending lower.

In Emerging Markets, growth is forecast to be slightly higher than in 2017, at circa 5%. Despite China being projected to slow down further this year, as authorities focus on the quality rather than the quantity of growth, with particular focus on reducing financial instability and pollution; EM ex-China should continue to improve, driven mainly by domestic demand. EM inflation should continue to gradually move higher in 2018, but the increase will not be broad-based. The end of disinflation will also see further monetary policy divergence within EM. With a number of low yielding countries continuing to hike their policy rates in order to restore positive real yields, on the back of rising DM rates. EM FX should, therefore, benefit from a number of interest rate hikes, which will maintain a higher real yield relative to DM, specifically in the low-yielding segment of the asset class. High yielding currencies, on the other hand, which already offer high real yields. will generally continue to benefit from stronger commodity prices.

Developed Markets Positioning

The team has moved to reduced the overall duration underweight to a 0.25yr from a 0.5yr underweight position in the previous month on the backup in the overall level of interest rates in the US. The team additionally increased our US- specific duration to neutral from an underweight of 0.5yr due to bond yields reverting back to levels not seen since 2014. We feel that there are more opportunities to remain underweight duration in other Developed Markets given absolute yield levels outside the US. In terms of the USD, the team has turned more positive on it given the US market's position as the highest yielding developed market in the world, leading to an increase allocation to 0.75% from an underweight of -0.50% in the previous month. Another reason for increasing the USD weight at these levels is the technical support of the DXY over the near-term in the face of rising geopolitical risk.

For the Euro, the team has maintained its marginal underweight on duration as the absolute level of yields remains unattractive despite the steepness of the curve. The team has noted that the macro economic environment has begun to trend negative over the near-term; however, it notes event risk given the potential for a near-term correction on an ECB tapering move. On the FX side, the team has reduced its overweight position to neutral on the same ECB rationale, noting the binary event risk surrounding the ECB decision, which will likely remain dovish in the face of weakening macro data.

For Japan, the team has returned to its short bias position on the currency on the stronger view of the USD over the near-term, expectation for considerable monetary accommodation and increasing political event risk surrounding Abe and the LDP in the face of the growing land scandal. The team has maintained its underweight bias given the near 0% levels in the face of YCC (yield curve control), as we fail to see the rational for continued upside to long rates in Japan at current levels of interest rates.

For Canada, the team has moved to increase its duration position on the view that the market remains far too optimistic on the pace of hikes from the Bank of Canada. The team has also reduced its FX exposure to CAD underweight to 1%, as well, on its overall central bank view.

We have marginally reduced our FX position in NOK by 0.50% to take profit and note the risk to further appreciation in oil prices given the resurgence of shale production in the US as recent EIA data have reported quite strong production figures. We note though that the Norges Bank is likely to hike sooner than expected and maintain our positive overall view on NOK and have taken a slight underweight in duration on the prospect of early hikes from the Norges Bank.

For Sterling, we have moved to neutralize our duration and FX positioning on the increased uncertainty surrounding Brexit negotiations. While GBP does appear to be overvalued measured on an interest differentials basis, momentum and the political environment remain the dominant factors for now

Emerging Markets Positioning

In Emerging Markets we maintain a generally constructive view on FX due to widening growth differentials relative to developed markets. We also remain selectively bullish on a number of EM rates markets as disinflation is facilitating a more dovish stance in a number of countries.

We remain neutral on the Malaysian Ringgit as its near-term outperformance looks stretched. Following earlier strength, the manufacturing side of the economy has slowed somewhat of late as global technology demand enters a soft-patch; nevertheless, this is likely to be offset by a strong rebound in energy prices. We expect the Ringgit to continue to closely track the Chinese Renminbi which may exhibit a slight weakening bias as it has strengthened relative to its reference currency basket. 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 also remain neutral on duration.

We have increased our overweight in the Mexican Peso due to its relative undervaluation and high carry, coupled with an increasingly hawkish rhetoric from Banxico. We believe that the proposed changes to NAFTA have weighed disproportionately high on the currency, with more concrete signs of an imminent agreement of late likely to spur a rebound over the coming months. Meanwhile, inflation continues to move lower, giving us more confidence in increasing our long duration trade, with real yields now approaching 4% vs. core CPI.

We have turned negative on the Polish Zloty as growth momentum has slowed materially of late, 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, and moreover, the latest EU draft budget proposal for 2021-2027 indicates a material shift of funds away from central and eastern European countries, such as Poland, towards southern Europe. We also remain underweight duration in Poland, though to a lesser extent, as despite the softening of inflation data, which will likely delay rate hikes beyond the next twelve months, underlying inflationary pressures remain due to robust domestic demand and tightening labour markets, with valuations also stretched.

We remain positive on the Singapore Dollar as a rebound in property prices is helping to support domestic demand whilst external demand has softened somewhat. As expected the Monetary Authority of Singapore moved to a positive appreciation bias in April, which should see the Singapore Dollar outperform its regional peers. We have, however, removed our overweight duration position due to rich valuations and high correlation with US Treasuries.

We remain neutral 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. Meanwhile, with core inflation continuing to trend lower beyond the mid-point of the SARB's inflation target, and a benign inflation outlook thereafter, the SARB could yet ease policy further in order to support growth.

Global Credit Positioning

Over the last four weeks, Global Credit markets have seen a challenging period. Excess return were negative in Investment Grade, but positive in High Yield with the exception for Asia. Similarly, absolute returns in IG were negative, where we have seen rates having an impact. On an absolute basis, High Yield was positive but like in IG, Asia saw a negative return. We have expressed caution in our past outlooks towards Asia credit, and this has been reflected in recent performance in the region. In the last two weeks of March, we observed quite negative performance globally. However, during the start of April we had somewhat of a recovery in spread terms and we believe we are currently on a better path for credit.

All eyes were on the ECB during its latest policy meeting where in recent months it was the expectation among investors that the ECB would stop buying bonds towards the end of this year before raising interest rates towards the middle of 2019. Purchases are currently running at €30bn a month, down from €80bn at the height of the quantitative easing programme. Despite the decline in the rate of purchases in recent months, credit spreads in Europe have not reacted much. Across the board, credit spreads have rallied since March. From a macro perspective, there has been an easing off of positive indicators of region over the last month including sentimental indicators and PMI's. However, elsewhere the macro environment is still supportive for credit. Moving onto a micro focus, we are still waiting to get full Q1 earnings, but we expect to see strong data from the majority of companies. On a similar trend, default rates continue to be low and are ranking lower.

Valuations remain very tight and flows into credit remain quite favourable. New issuance in IG is slightly behind the level of last year, whereas we have observed a surge in the primary pipeline for HY issuance. We would note overall that Europe still remains attractive, but we need to pay particular concern and caution as valuation gets tighter.

US fundamentals remain quite strong. On the micro side, we do see some risks due to potential M&A activity. However, looking at recent S&P earnings results, they have surprised on the upside on the whole. Spreads have nearly recovered since early-year volatility. Flows have turned negative in HY and we have seen strong negative technicals in terms of supply. Like other regions, we still take the view that valuation remains overpriced. Looking at the fundamentals, we don't see any cause for concern among corporates and we expect spreads to grind tighter. The only concern that we currently have is on rates. Underlying credit had strong excess returns during April but performance remains negative on absolute terms due to rates being higher. From a sector allocation point of view, we believe in the policy of investing in wider sectors (eg energy, media and telecommunications) where we believe it will help in generating excess returns.

In Japan, we currently see a stronger Yen since the back end of March. Japan corporate performance had before that point been supported by a depreciating Yen. However, given the current level, we need to monitor closely on how the Yen will effect exports and corporate profits in the coming months. More generally, the recent land scandal that has involved Prime Minister Abe has been a major point of interest in the last couple of months. The current approval rate of Abe remains low and it is worth noting that in September there is an election for LDP President (a title Abe currently holds). If Abe were to lose this internal vote, we predict that there won't be any change in QE policy and we do not see interest rate policy changing. Credit valuation remains quite high, however, we still see a strong demand for credit. Hybrid bonds have been tightening over the last year, but (compared to other bonds) demand remains high. We see this demand continuing in hybrid bonds due to the attractive investment case.

Asia credit markets have recently been the weak link within the broader global credit market in recent weeks. This coincides with our recent bearish view on Asia credit. Over the last few weeks, we have seen issuers in the HY Chinese property market. These issuers are currently not very price sensitive and as such each issue is repricing the secondary curve. Fundamentals seem to be in line, but the avalanche of supply puts pressure on the secondary market. Incidentally the hybrid market is also following a similar theme. Valuation continues to be tight, and we argue other regions to be more attractive. Moving onto fundamentals of the region, there are a few themes where we have become more problematic over the last couple of months. Notably, the rise in the price of real US yields and the steepening of US Treasury curve puts pressure on Asian markets. We are monitoring the price of interest of US yields on Asia FX, correlation between rates and equities, export growth and outlook and PMI numbers.

In Australia we have not seen much change. The economy continues to be healthy and there is no real short term concern in Australian Credit. We have started to see supply among corporates especially in automobiles and financials. There continues to be Australian corporates going offshore ($4bn market), who believe supply and outlay is better than onshore. We remain slightly negative on valuations as credit is quite expensive, but we are looking into domestic banks, despite a recent enquiry on credit quality of mortgages that made the headlines domestically. We will not be concerned on the state of the Banks until we see arrears rise to alarming levels (which we are currently not close to). We still hold a positive view on Australian RMBS, but the price level may still be a bit high.

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