GLOBAL FIXED INCOME & CREDIT OUTLOOK

December 2016

Recent Developments

Global Fixed Income

Developed bond markets have been affected by Trump's victory in the US Presidential election and we are currently in a position where we are facing more questions than answers regarding his policy stance as he comes into office and how it will affect the market. We currently hold a cautious view on Emerging Markets as a whole, but favour Mexico given the sharp fall in assets following the election.

Global Credit

Credit markets have experienced a tough month in November, with no regional markets achieving positive return. High Yield credits are still outperforming Investment Grade. We expect US High Yield to benefit from Trump's victory, and in Europe heightened political risk in the region is a cause of concern in the market.

Global Fixed Income

Current Views

	December 2016	
	FX	Duration
USA	OW	UW
Australia	UW	N
New Zealand	N	N
UK	UW	N
Canada	UW	OW
Sweden	OW	OW
Norway	OW	N
Euro	UW	OW
Japan	UW	N
Malaysia	UW	N
Mexico	OW	OW
Poland	OW	OW
Singapore	UW	N
South Africa	N	UW

FX—Foreign exchange. OW—Overweight. UW—Underweight. N—Neutral.

Key Factors

- Impact of Donald Trump on Global bond markets
- Valuation Uncertainty and US Yields
- Resilience in New Zealand but caution in Australia
- Caution on EMs as a whole but positive on Mexico
- Surprise inflation in South Africa

Developed Markets

Impact of Donald Trump Election

Global bond markets were again a major focus this month with a significant global rise in yields in the immediate aftermath of Donald Trump's US Presidential election victory. The President Elect proposed a sizeable fiscal stimulus in the form of both tax cuts and increased infrastructure spending. This points to larger budget deficits, increased issuance and higher inflationary pressures particularly if growth starts to accelerate in the relatively tight current US labour market conditions.

Valuation uncertainty and US Yields

In the short term, bond markets do offer some value and positioning could see some buying into year end. There is event risk around the Presidential inauguration on January 20, where it is likely Trump will have a package of actions and announcements ready for his first day in the Oval Office.

In the medium term, if Trump is able to execute his policies we would anticipate a continued rise in bond yields. Because higher US yields are expected to put pressure on yields globally, we moved to a neutral duration position on a number of markets where this impact would be most felt in order to bring the overall portfolio duration lower.

Resilience in New Zealand but caution in Australia

With economic data showing ongoing resilience in New Zealand, we moved to a neutral position on the NZ Dollar as the risk of further rate cuts appear reduced for the time being.

We also shifted to an underweight position in the Australian Dollar driven by expectations of a stronger USD and some softness in the economic indicators. We also expect the anticipated higher US interest rates to drive continued outperformance of the USD vs. its G3 counterparts (Euro and Yen).

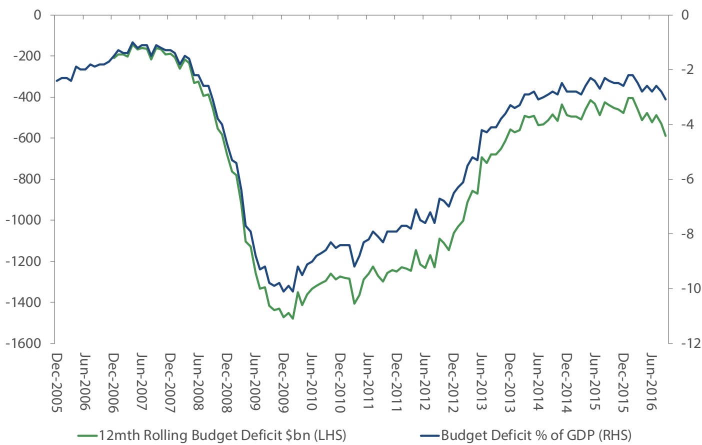
Emerging Markets

Caution on EMs as a whole, but Mexico is an exception
Our top down process indicates a cautious approach to EMs, which leaves us neutral on EM currencies as a whole. However, we moved to overweight both in the Mexican Peso and on Mexican duration, to take advantage of the sharp fall in Mexican asset values following the US election. We maintain our overweight in Poland vs. the Euro.

Surprise South Africa Inflation
Recent inflation data in South Africa has surprised on the upside, leading us to be more cautious on duration and to shift to an underweight position.

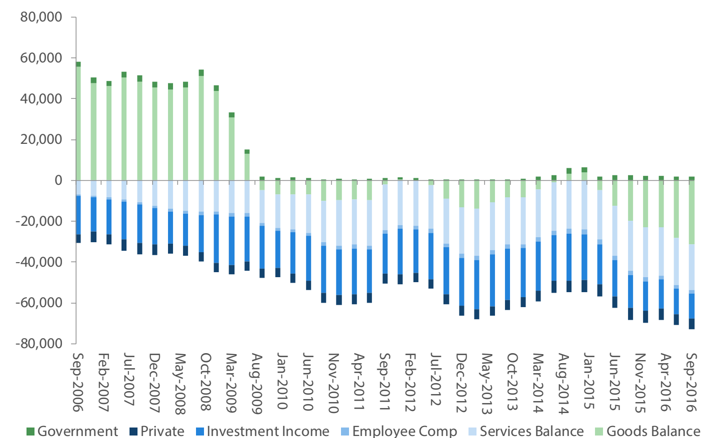
Discussion Points

1) The US budget position had improved steadily for years, but recently has started to deteriorate once again, even before the US election. The recent trend is set to continue with Trump's plans to add trillions of USD in stimulus measures over the course of his Presidential term.



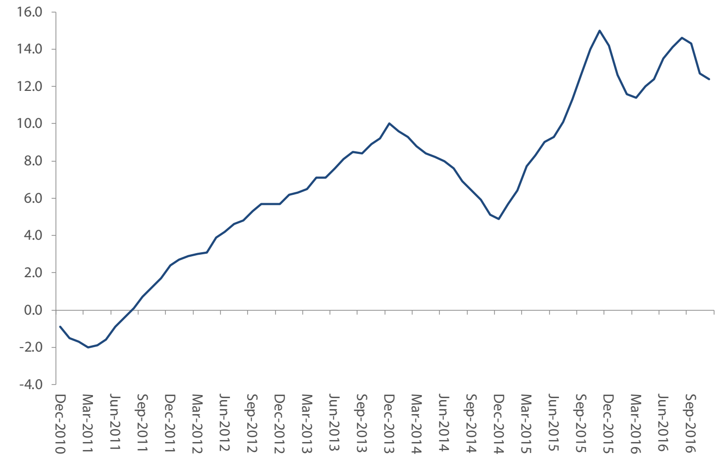
Source: Bloomberg

2) The Canadian current account deficit has remained wide. Despite FX depreciation, the break-even price on oil sands production is very high relative to international prices, so overall exports are weak. The country still has some adjustment to go to close the balance of payments gap.



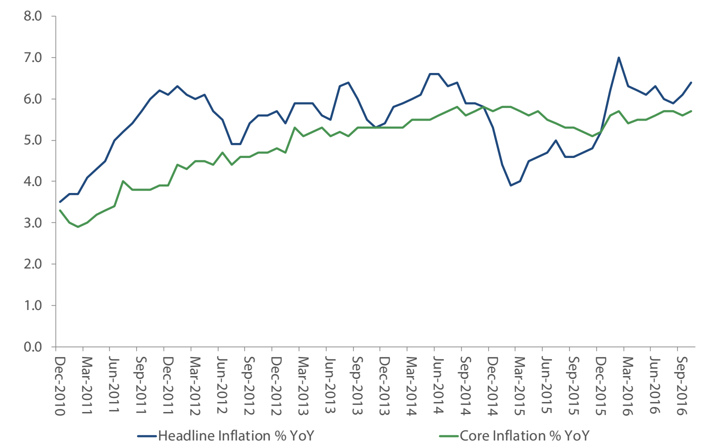
Source: Bloomberg

3) The New Zealand economy is performing well, but measures by the central bank to rein in the housing market now appear to be taking effect, with prices starting to abate in recent months. We believe that the central bank may now be nearing the end of its easing cycle.



Source: Bloomberg

4) Headline inflation in South Africa is picking up once again, but the central bank will still be reluctant to raise rates. This could put pressure on longer maturing bonds.



Source: Bloomberg

Global Credit

Key Views

- Europe is experiencing heightened political risk which may impact credit markets
- US HY still looks attractive compared to other markets and offers compensation for the prevailing risk factors
- Caution on Asia. Going into 2017 expect localised idiosyncratic risks in the region

Global credit markets have experienced a tough month in November with none of the regional markets achieving a total positive return. High Yield (HY) corporates continued to outperform Investment Grade (IG) with the differential being most pronounced in LATAM. US HY offered the highest excess return in the month, where we saw the Trump effect being priced into the market. Going into 2017, a key question is whether the trend of outperformance in HY over IG is set to continue? For the record, market consensus is for a continuation of the trend.

Europe

There has been no major fundamental change in the month; however, political risk within the region has heightened in recent months. The continued uncertainty instigated by the Brexit outcome and the lack of clarity of the UK government's position over triggering Article 50, plus the rejection of Renzi's constitutional reform in the recent Italian referendum are events that may pose a threat to European credit markets. Similarly as we enter 2017, we are facing additional geopolitical risk from the upcoming elections in France and Germany. Despite these risks, we are positive on the region as a whole. This is supported by the recent earnings season, in which we expect to see 55% of companies announcing positive outcomes for first time in several quarters. This bodes well for credit fundamentals in the region.

Within the market, there has been little new issuance in HY, most likely because of the volatility after the Trump victory. Issuance in IG remains strong, and by the close of the year should be slightly ahead of 2016 levels. We expect HY to outperform IG in 2017, mainly driven from the spreads in IG which have been squeezed to quite tight levels. HY presents a good buffer at the BB and BBB boundary, and a sufficient hunting ground for returns. We are continuing to monitor the impact of the ECB and BOE bond purchasing programs as we navigate to find exposure in good value issuance. It may be necessary in time to shift more towards lower-rated sub-investment grade bonds.

At the sector level, one of the areas where we hold a strong view is in building materials. Despite being generally a pro-cyclical sector, we believe it will benefit from the current macro-economic health of Europe.

Japan

Over the last couple of months, there has been a period of increased risk both from a Macro and Micro perspective. The current earnings period is set to be positive - with support from a weaker JPY - and this should lead to recovery. Because of the recent policy stance taken by the Bank of Japan, credit spreads with JGBs have widened. However, with global and Japanese rates rising, spreads have started to tighten a bit. Credit markets do seem to be showing signs of recovery, and credit (despite interest rates and yield curves increasing) should continue to look like an attractive investment.

Two sectors where we have concerns are shipping and transport. There are currently numerous bankruptcies within the market as well as much volatility - and spreads have been gradually widening. As a result, rating agencies are starting to downgrade issuers.

US

Following the Trump victory, most of the moves in IG were felt in the rates space, while spreads remained relatively stable. Putting the election of Trump to one side, the only real negative was the change in the yield curve, following the sell-off in bonds after the election. In the US, we are currently seeing the pace of earnings growth continuing to slow. In addition, default rates have started to pick up - the rating drift is downward - and leverage risk has been increasing. This causes concern given current valuation levels. Sectors that stand out are ones that have gathered solid returns in the past, and are expected to continue to do so. Therefore, we prefer life insurance, financials and energy. The latter sector was impacted by the OPEC meeting on 30 November. However, with the cuts announced, and the likely ensuing stabilisation of oil prices, this should benefit US energy firms.

HY remains favourable given the current outlook, with the carry and lower duration in HY looking more positive with the increase in interest rate volatility. Overall supply issuance and flows into credit have tended to pick up over the last month and valuation is holding. From our standpoint, there is minimal near term economic risk. We remain positive on the US outlook in the short and longer term.

South America

Brazil has experienced a deep recession and its subsequent recovery has been weaker than expected. The government is continuing to find it difficult to escape the persisting saga of ongoing political "donations" and corruption. In credit markets, the consensus on Brazil is that there are values to be found, and people are making comparison with Russia, implying a rally to take place in equivalent credits. Elsewhere, banks are popular and will likely see growth in 2017.

Mexico has experienced much attention and turmoil following the Trump victory, and faces a period of uncertainty. Yet, domestic data continues to remain strong, with retail sales up around 7% and unemployment remaining below 4%. Before the US election, the consensus was that FDI would drop; however, there has been almost no backlash against Trump from companies such as Tesla, who had talked of investing more in Mexico in the future. The credit market in Mexico is starting to get more attention and the local sovereign spread is widening over the USD. The banking

sector is likely of particular interest, as it is still relatively underdeveloped and, despite Trump, there could be opportunity for growth, and an interesting proposition to gain exposure too. Another sector which could see a positive impact from the Trump victory is building materials, as it should gain from the projected increase in infrastructure spending in the US.

Australia

We continue to be reasonably positive on Australia with the economic environment remaining remarkably consistent over the course of 2016. However, it is worth mentioning the current ratings risk. It can be reasonably assumed that sovereigns will be downgraded from AAA to AA+ by S&P. The other two rating agencies are not currently at the downgrade stage, but there is notable political risk in Australia from a fragmented parliament creating a weak position for Turnball's government. Supply within the credit markets faces an imbalance. On one hand, financials have plenty of supply, yet on the other, non-financials face limited supply - and this imbalance is reflected in the spreads. Financials weakened over the month, whereas non-financials tended to perform well. Credit on the whole offers fair value, as prices are not exceptionally attractive, but are certainly not unaffordable either. The financial sector deserves the most concern because of the imminent sovereign downgrade (mentioned above). We anticipate that Australian major banks may also be downgraded from AA+ to AA-. This is not everyone's view, but we hold a cautious stance.

Asia ex Japan

November was challenging for Asia Credit, with total returns down 2.1%. The market moved strongly after the US election and subsequent US Treasury sell-off. Most of the negative performance was driven by IG credit, which was down 2.4%. Spread changes were marginal, with a 15bp tightening in the month. Crucially, it was not only the bond markets that suffered, but also Asian currencies. The Malaysian Ringgit, Korean Won and Indian Rupee in particular felt the squeeze, which had an added effect in the broader EM credit market.

In recent weeks, the market seems to be holding up well, but we believe spreads are quite expensive, and remain watchful of the situation, particularly as there is still an oversupply of IG and HY credit, in our opinion. Nevertheless, with the focus on a total return basis (assuming the yield curve for 10-year US T Bills increases), we envisage that HY will likely be an interesting asset class. One area of the market in which we have a concern is China Property. We will continue to monitor this area very closely.

Discussion Points

Italy rejected the constitutional reforms proposed by Renzi in the recent referendum, with final results showing a strong 'No' vote of 59.1%. The result reflected what polls had predicted in the run up to Sunday's vote with a clear majority voting down the proposed reforms. Renzi resigned in the immediate aftermath of the result, with the Euro subsequently falling to a 20-month low against the USD, caused by the immediate market uncertainty facing Italy and Europe.

Markets following the result opened weaker but recovered quickly from very early lows. We expect Italian assets to underperform until it becomes clear who will be able to form and lead a new government, and when the general election will likely take place. Nevertheless, the outcome of the referendum was already priced into financial markets. Italian bonds and stocks have started to recover since the middle of last week, as valuations for both asset classes have become attractive. A quick solution to the current crisis might turn Italian assets into an attractive near term investment. But the market was also directed by the ECB decision on the future extent and size of its bond buying programme, which will be extended until at least December 2017, but with purchases reduced by €20bn a month. Previously, the €80bn-a-month QE scheme had been due to end in March, although the bank had been expected to extend it for at least six months.

About the Global Fixed Income Team

Andre Severino
Co-Head of Global Fixed Income

Holger Mertens
Head Portfolio Manager, Global Credit, CFA

Steven Williams
Head Portfolio Manager, Core Markets

Raphael Marechal
Head Portfolio Manager, Global Emerging Markets

Simon Down
Senior Portfolio Manager, CFA

About Nikko Asset Management

Nikko Asset Management, together with its investment advisory affiliates, has 206 investment professionals around the world and approximately USD 176.3 billion in assets under management or supervision as of 30 September 2016. Nikko Asset Management strives to provide outstanding long-term performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes governments, institutions, corporations and private individuals worldwide. For more information, please contact us using the details below or visit our website at **www.emea.nikkoam.com**

Contact Us

Nikko Asset Management Europe Ltd
1 London Wall, London, EC2Y 5AD
Phone: +44 (0)20 7796 9866
Fax: +44 (0)20 7796 9816
Email: Emarketing@nikkoam.com

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 a 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/Japan Securities Dealers 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.

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.

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.

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 and the Nikko AM NZ Wholesale Investment 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 websitewww.nikkoam.co.nz).