GLOBAL FIXED INCOME & CREDIT OUTLOOK

July 2016

Recent Developments

Fixed Income

The major consideration for markets in June was the Brexit vote in the UK. Although we are sceptical about the most pessimistic scenarios for the UK, there will be some negative impact on growth. Other than in the US, we remain generally constructive on global bond markets and continue to view the current environment for emerging markets (EMs) as positive.

Credit

June was a difficult month for credit markets, as the UK's EU referendum caused spread levels to widen across the globe. However, in some parts of the markets, risk premiums are now wider than fair value, presenting opportunities to invest in fundamentally sound and attractively priced credits.

Global Fixed Income

Current Views

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

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

Key Views

- Generally constructive on global bond markets, other than in the US
- Expect negative impact on UK growth and uncertainty, leading to an underweight on both UK and Euro FX
- Negative outlook on Canada and New Zealand remains
- Swedish bonds remain attractive
- Positive current environment for EMs, but moved to neutral on South Africa

Developed Markets

Underweight both UK and Euro FX

Markets were rocked by the UK vote to exit the EU towards the end of June. With Prime Minister Cameron resigning, the leadership contest has been swift and the new Prime Minister Theresa May has appointed a strong team for her new cabinet. However, the outlook remains highly uncertain and negotiations with the EU can only take place after the UK triggers Article 50 of the Lisbon treaty, which we don't expect to happen until at least Q4. Although we are sceptical about the most pessimistic scenarios for the UK, there will be some negative impact on growth and this, combined with the uncertainty, has led us to underweight both the UK and Euro FX.

Negative outlook on Canada and New Zealand continues

We continue to have a negative outlook on New Zealand and Canada. In New Zealand, the central bank has introduced strict controls on lending, which are being seen by markets as a precursor to an early rate cut. One concern for our position was whether the market has moved too quickly and that the central bank may disappoint.

Generally constructive on global bond markets, other than in the US

We remain positive on Swedish bonds and this continues to be our greatest conviction call in bond markets. Other than in the US, we remain generally constructive on global bond markets given that negative interest rates in Japan and Europe are driving investors in those areas into other bond markets, whilst domestic bonds remain underpinned by quantitative easing (QE) programmes.

The US Federal Reserve (Fed) is the central bank that we believe has the greatest potential to surprise with an unexpected policy move.

Emerging Markets

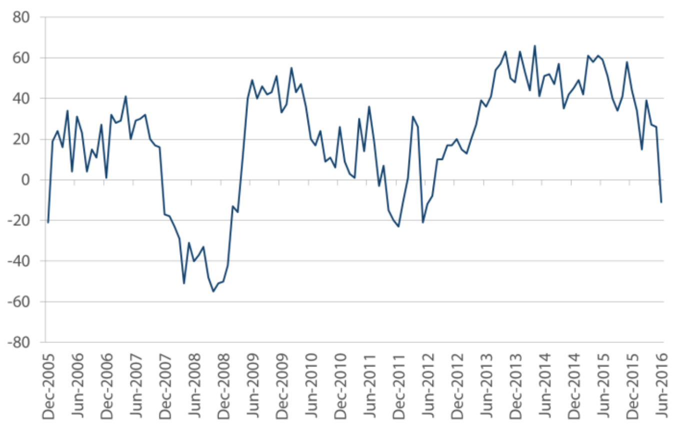
Positive current environment for EMs
Our top-down process continues to show a positive environment for EMs. As a result, we continue to maintain our overweight position on EMs in aggregate.

Moved to neutral in South Africa
Following very strong performance in recent months, we have moved to neutral in South Africa and will look to re-enter this trade on any correction in coming months.

Discussion Points

Forward indicators for the UK, such as the Lloyds Business Barometer, fell sharply after the Brexit vote. It remains to be seen how much the hard data will be impacted, but there is a high probability that the Bank of England will reduce interest rates in coming months in order to support growth.

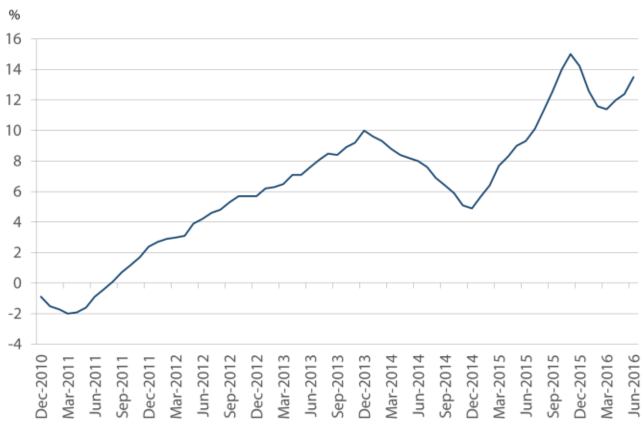
Chart 1: UK Lloyds Business Barometer



Source: Bloomberg

The strong housing market has been the main impediment to the Reserve Bank of New Zealand (RBNZ) reducing interest rates. New rules will restrict investment purchases considerably and this could open a window for the RBNZ to cut rates and weaken the currency.

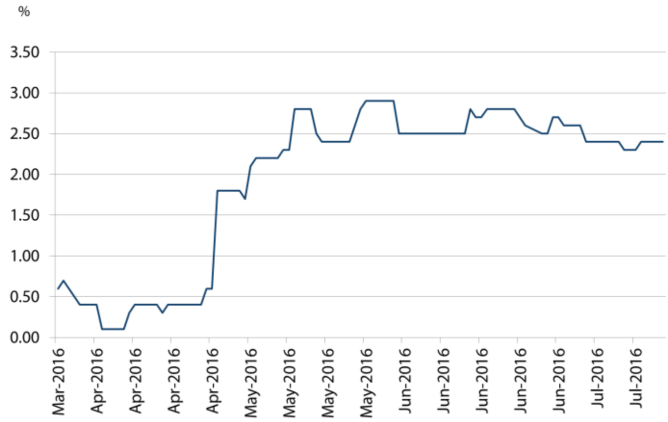
Chart 2: New Zealand house prices (year-on-year change)



Source: Bloomberg

In the US, the Atlanta Fed GDP model is suggesting growth of 2.4% for Q2, which should be sufficient for the Fed to move back to a hiking path if they so choose. As a result, the US central bank has the greatest potential to surprise the market, either by shifting to a more hawkish stance or by starting to discuss balance sheet reduction.

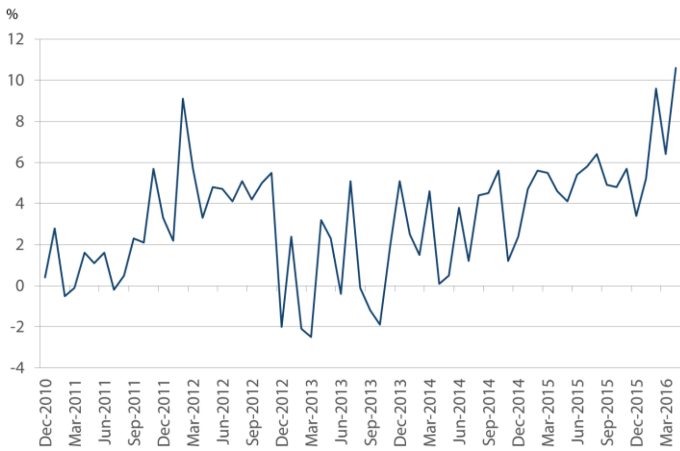
Chart 3: Atlanta Fed GDP Now



Source: Bloomberg

In Mexico, retail sales data is now growing by over 10% year-on-year as strong employment growth and wage gains are feeding into consumption. This led to the central bank hiking rates by 50 bps in June.

Chart 4: Mexico retail sales year-on-year



Source: Bloomberg

Global Credit

Key Views

- Despite the unexpected outcome of the UK referendum on the EU, our view on Europe remains positive.
- Asian credit is currently trading at the same valuation levels as US risk, which we view as expensive.
- The most fundamental improvements we observed in June were in South America.

Most global credit markets reported positive total returns in June. Only European high yield finished the month with a negative total return, which isn't a surprise, given the outcome of the EU referendum in the UK.

However, looking at the excess returns, the impact of Brexit becomes much more obvious. European and US credit suffered from wider spreads, although both markets still delivered positive total returns as declining interest rates offset losses from wider spreads. The strongest performance was seen in the Latin American credit markets, which seemed to be somewhat shielded from Brexit jitters, with positive total and excess returns. Besides Latin America, Asian high yield also had a strong month, generating solid returns.

Europe

In June, the focus was clearly on the Brexit referendum. Despite the unexpected outcome, our view on Europe remains positive. However, some indicators that we monitor turned negative. Our assessment of political risk in Europe has changed to negative, given the risk of more countries trying to leave the EU and the likely protracted negotiations over the exit terms for the UK. In addition, the outlook for the European stock market is now dented by the uncertainty.

Furthermore, given rating agencies' downgrades and changes of outlook on UK government and bank bonds, we now expect the rating drift (upgrades-downgrades/issuers) in Europe to worsen. But despite all these uncertainties, the European Central Bank's (ECB's) various bond purchase programmes are supporting credit markets in Europe and ensuring that technical remain favourable. Some credits were punished more than was justified by fundamentals in the aftermath of the Brexit vote but, in our view, this can provide good investment opportunities.

Asia ex Japan

In Asia (ex Japan) spreads widened initially when the Brexit result hit the market, but losses were recovered quickly. Now the focus is back on fundamentals, which are not improving yet. For instance, the contraction in exports and imports in Asia continues, suggesting that demand conditions remain weak. Fiscal stimulus in China, improving commodity prices and gradual reforms in some Asian countries may lead to improvements in the months to come. However, for now, we don't believe that investors are being sufficiently compensated for the embedded risk, following the strong performance of Asian credit markets earlier this year.

Some assistance for the market might come from favourable technicals as the primary market will slow down over the summer, but Asian credit currently trades at the same valuation levels as US risk, which we view as expensive. To reflect our defensive stance, we identified Chinese quasi-sovereign bonds as an interesting investment theme. We prefer them over Korean bonds and would highlight the 'belly' of the yield curve as particularly attractive.

Japan

Japan has experienced deterioration in growth, with Yen strength hurting the economy. A JPY level of 103 is a critical point where export-oriented corporates in particular start to lose money. For now, corporate fundamentals remain stable and technically the Japanese corporate market continues to be strong, as positive yield is attracting domestic buyers and supply remains low.

US

Economic growth in the US is progressing slowly but steadily, but not at a sufficient pace to convince the Fed to execute a long-expected increase in rates. Uncertainty about the implications of the Brexit vote for the global economy seems to have put the Fed on hold. Meanwhile, micro data in the US currently looks weak: default rates are rising, rating drift is turning increasingly negative and earnings are declining.

Nevertheless, Brexit appeared to have stemmed the flood of new issuance in June and spreads for US credit still look attractive. We prefer to focus on US-centric companies with a strong domestic business that can shield them from a Brexit-driven global slowdown.

Australia

A modest improvement in growth means that we remain fundamentally positive on the market, although we still have liquidity concerns. New issuance activity is low and Brexit-related volatility seems to be exacerbating supply weakness. In our view, the best way to access liquidity and express our trading views is via the Australian iTraxx. In cash bonds, we continue to prefer short-dated domestic bank issuance.

South America

The most fundamental improvements that we observed in June were in South America. Higher commodity prices, a more dovish Fed and political changes in some countries (Brazil, Argentina) have led to changes in our scoring model. This means that we now view the macro-economic situation in South America much more positively. Further support is provided by a low level of new issuance and attractive spreads. We plan to move our focus away from safe investments in Mexico since we believe that appealing opportunities now also exist in other countries. However, we note that in-depth credit research is required as corporate fundamentals continue to be weak and default rates remain elevated.

Discussion Points

The impact of the British vote to leave the EU was not equally felt across the European credit markets. European non-financials finished the months 9 bps tighter as the ECB started to buy corporate bonds more aggressively than originally expected. In contrast, GBP issues finished June 13 bps wider.

The main area of underperformance was the banking sector, particularly GBP-denominated issues, which widened 37 bps. Concerns are focused on the profit decline for banks due to lower interest rates and a potential economic slowdown following the Brexit vote. In addition, worries over the financial health of Italian banks have impacted valuations in financials.

In contrast to the European cash bond markets, credit default swap (CDS) spreads widened much more in percentage terms than bonds. CDS—in particular the indices—are more liquid than bonds and often used by investors to express short-term trading views. As a result, CDS indices are more volatile than bonds and subsequently reported bigger losses in June. In addition, CDS didn't benefit from the ECB's corporate bond programme.

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