GLOBAL FIXED INCOME & CREDIT OUTLOOK

August 2016

Recent Developments

Fixed Income

In developed markets, global bonds have benefited from recent flows out of Japan into positive-yielding markets. The New Zealand and Canadian economies face continued pressure and a September US rate rise is now looking more unlikely. We maintain the view that there is a positive environment for emerging markets.

Credit

Global credit markets have been remarkably quiet over the past four weeks, although de-linkage of spreads and fundamentals continued in August. However, central bank support and attractive relative value opportunities keep us optimistic for the rest of the year.

Global Fixed Income

Current Views

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

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

Key Views

- Markets benefiting from Japanese flows
- Bank of England (BoE) quantitative easing (QE) programme should benefit the market
- Pressure on Canadian central bank to intervene
- September US rate hike unlikely
- Positive current environment for emerging markets (EMs)

Developed Markets

Global bonds benefiting from Japan flows
Global bond markets appear to be benefiting from flows out of Japan into other markets that generate a positive currency-hedged yield. As a result, we are constructive on longer maturity bonds although we struggle to see how current yields can be sustainable in the medium term.

With our conviction call in longer-dated Swedish bonds generating significant returns in recent months, we have moved part of that allocation towards the UK. Although longer maturity gilts have already rallied strongly (given the delay in Brexit) and there are signs that growth may not be as weak as previously expected, the BoE's new QE programme should support the market and investors who are targeting the German/UK spread, which we expect to contract further.

Pressure on New Zealand and Canada
We continue to hold a negative outlook on currencies of New Zealand and Canada. The Reserve Bank of New Zealand has cut interest rates by 50 basis points (bps) so far in 2016 and further rate cuts are expected. In Canada, weak economic growth is likely to place increasing pressure on the central bank to intervene in coming months.

Federal Reserve rate rise dilemma
We marginally reduced our overweight in the US dollar. Although it is still possible that the Federal Reserve (Fed) will raise interest rates in September, we believe it is more likely that it will wait until the end of the year, following the Presidential election. However, the Fed is still the most likely developed market central bank to surprise the market with a hawkish move and so we have maintained a duration underweight to US Treasuries, counterbalanced by overweights to other regions.

Emerging Markets

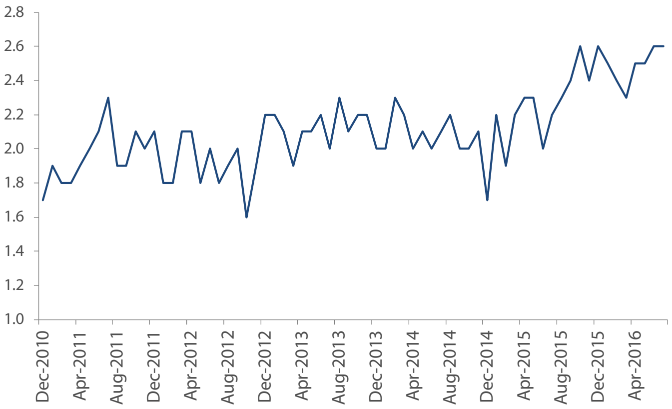
Positive current environment for EMs
Our top-down process continues to indicate a positive environment for EMs, so we remain overweight in aggregate.

Concerns in South Africa
We moved tactically neutral in South Africa at our previous meeting. However, we transitioned back to an overweight position at our recent meeting as the Rand fell back from its highs due to concerns over a corruption investigation of Finance Minister Gordhan. Conversely, we cut Poland to a neutral position.

Discussion Points

The US labour market continues to tighten and this is now clearly feeding into higher wages. Average hourly earnings have started to accelerate, which we expect to lead to higher inflation in the medium term. This is one reason why it is possible that the Fed could surprise with a September hike.

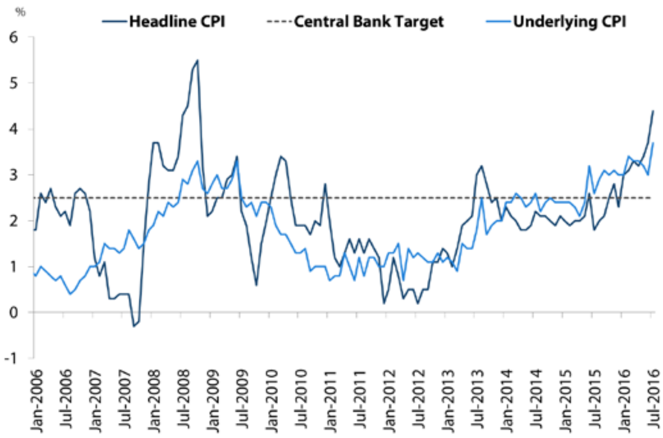
US average hourly earnings YoY% growth



Source: Bloomberg

Both core and headline inflation in Norway are rising sharply. The central bank, however, is hamstrung by the European Central Bank's (ECB's) negative interest rate policy. As a result, we are more cautious on Norwegian bonds, which we have downgraded to neutral.

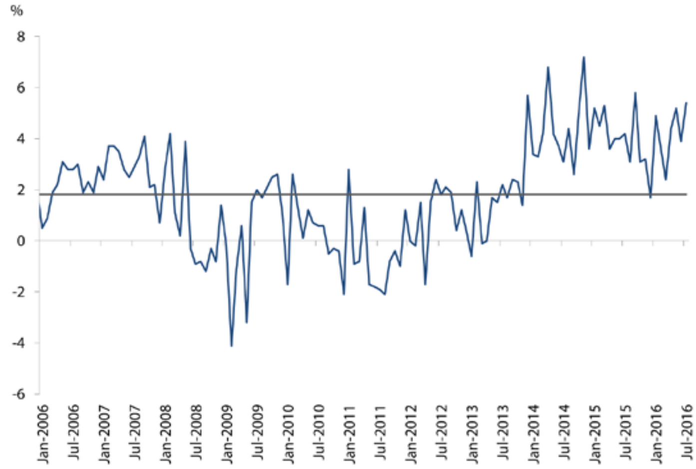
Norwegian inflation vs. target (%)



Source: Bloomberg

We are more positive on the UK bond market given the BoE's QE programme. The economy appears to be holding up better than initially expected, with consumers so far showing few signs of concern about the Brexit vote.

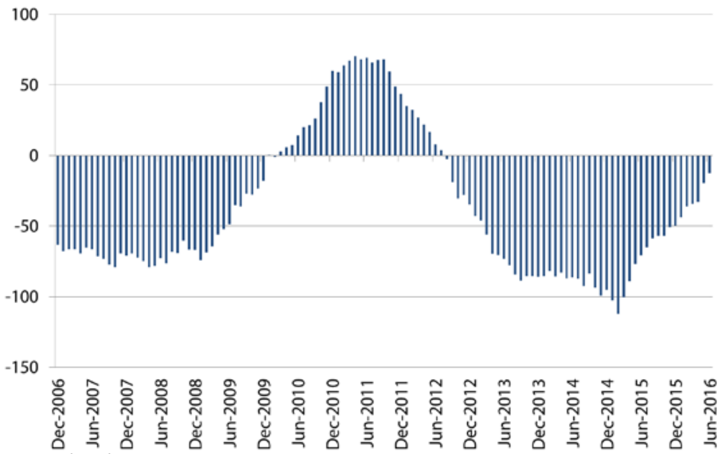
UK retail sales (ex fuel) year-on-year (%)



Source: Bloomberg

South Africa's trade balance has improved gradually over time, although the country as a whole has poor fundamentals. However, as one of the highest Beta FX markets it can still perform well whilst EM FX is rallying.

South African 12-month trade balance (USD bn.)



Source: Bloomberg

Global Credit

Key Views

- Our view on Europe is now more neutral
- Currently, we are positioning our portfolios more defensively in terms of Asia
- Risk-adjusted spreads for US credit, investment-grade as well as high yield, still compensate for the increasing risks

Global credit markets were remarkably quiet in August, with positive performance for all major markets. Spreads continued to tighten, although weaker rate markets have had a small negative impact on total returns. The top performers during the month were US and Latin American high yield due to the high carry, combined with tighter spreads. In the investment-grade space, Asian and Latin American corporate bonds topped the performance table. Besides the main credit markets, UK credit delivered another strong month, as the BoE's QE programme met market expectations with the announcement of corporate bond purchases in the coming months.

Europe

Given the strong rally in credit over the past few months, our view on Europe is now more neutral. Europe has been one of our main overweight positions and positive economic fundamentals and strong technicals (inflows, the Corporate Sector Purchase Programme (CSPP), lack of new issues) still support investment in European credit. However, mixed micro data, several challenges ahead (such as the Italian referendum) and tight valuations make us more cautious. In particular, cyclical UK credits look expensive. Nevertheless, some areas of the European credit markets still offer value, such as non-financial hybrids, longer-dated corporate bonds (7-15 years.) and European high yield.

Japan

Japanese corporates reported weaker earnings in Q2 due to the stronger Yen. However, most credit profiles remain healthy and demand for assets that offer a pick up vs. Japanese government bonds (JGBs) continues to be solid.

US

In the US, the overall macro picture remains healthy and markets are currently speculating on a potential rate hike in September. Although such a move would be slightly negative for credit, we do not expect significant spread movement on the back of a rate hike. Of greater concern to us is the issue of weak corporate fundamentals. The increasing focus on shareholder value, a pickup in M&A activities and another lacklustre earning season are worrying. However, risk-adjusted spreads for US credit, investment-grade as well as high yield, still compensate for the increasing risks.

South America

Latin America is currently offering some areas of strength, such as Mexico, which is benefiting from strong domestic consumption. However, this is coupled with some areas of weakness, such as Chile (slow Q2 growth, given still weak copper prices) and Columbia (still struggling with the lower oil price). Brazil is still struggling with a deep recession, although some early signs of improvement can be observed. Nevertheless, the Brazilian stock market looks expensive and a set-back would weigh on credit spreads. We are continuing to gradually increase investment in Latin America and currently see value in selected telecommunications companies.

Australia

Australian markets are in need of an improvement in primary liquidity, but August saw even the supply of financial bonds dry up. If new issues increase in September, this could present investment opportunities in a market with solid fundamentals and fair valuation. In particular, non-financial offshore issuers could be of interest. In the secondary markets, we focus on the front end of the curve and real estate-related issuers.

Asia ex Japan

Tight valuations are not only affecting European markets. De-linkage of spreads and fundamentals are becoming a global theme and are also affecting our view on Asian credit. Although macroeconomic fundamentals still look strong, we feel that weaker micro data is not fully reflected in current spread levels. While some commodity-related corporates reported better performance for Q2, we view the last earnings season as rather weak. Nevertheless, the negative credit migration in Asian credit, accompanied by higher default rates, has stabilised and technicals remain strong, with positive inflows and slow supply. However, we currently prefer a more defensive portfolio view and see value in 6- to 10-year Chinese quasi-sovereigns.

Discussion Points

The ECB, via six European national central banks, has bought EUR 19.3 billion of corporate bonds (as of 26 August) since the start of the CSPP in June. The portfolio comprises 555 bonds from 189 issuers. Bond purchases so far have been in excess of original expectations and continued at a high run rate even during the slower summer months. This has helped to reduce volatility in the corporate bond market.

Since July, the ECB has regularly released an ISIN list of acquired bonds. Although volume information is not released, the focus of the CSPP has been primarily on infrastructure-related bonds (such as transportation and utilities). Initially, after the launch of the programme, ECB eligible bonds outperformed the broader market, but eligible bonds have struggled over recent weeks.

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