GLOBAL FIXED INCOME & CREDIT OUTLOOK

January 2017

Recent Developments

Global Fixed Income

1) There is continued uncertainty in global bond markets due to a lack of clarity around President Trump's agenda; 2) We see some growth in Europe, but the ECB is likely to stick to its QE program for now. We favour peripheral Europe over the Eurozone; 3) In emerging markets, Mexico should continue to attract attention given Trump's rhetoric and early policy statements.

Global Credit

Credit markets are expected to have another positive year. We expect economic growth in Asia to be stable but see some potential downside risks. In Europe, political risk remains high for 2017. Some of our key themes are: hybrid bonds, financials, oil/emerging markets and High Yield.

Global Fixed Income

Current Views

	January 2017	
	FX	Duration
USA	OW	N
Australia	OW	OW
New Zealand	N	OW
UK	UW	UW
Canada	UW	N
Sweden	OW	N
Norway	OW	N
Euro	UW	UW
Japan	UW	N
Malaysia	N	N
Mexico	N	N
Poland	N	N
Singapore	N	OW
South Africa	N	N

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

Key Factors

- The Trump administration 's lack of clarity around its agenda is continuing to cause market speculation in both developed and emerging markets
- Growth acceleration in Europe with the ECB continuing its QE program
- Short-term interest rates in Japan should favour the US dollar
- Mexico to be the main focus for EM bond markets

Developed Markets

Markets continue to speculate on what a Trump Administration will bring and have largely focused on the positive effects of tax cuts and stimulus, which are expected to boost US growth in the medium term. The proposals for a US border tax appear unlikely to pass through Congress, whereas a bill to allow firms to repatriate cash held abroad seems an easier victory. These factors leave us cautious on US bond markets in the medium term, as a stronger economy and relatively tight labour market should see inflation accelerate. In the short term, though, we believe that the sharp sell-off in global bond markets could reverse, and so we have moved to a neutral stance on US bonds within our portfolio.

In Europe, we see some acceleration in growth but the ECB looks like it will stick to its QE program for now, although there is some risk that it will struggle to keep longer-dated yields anchored. We favour peripheral Europe over the Eurozone, given strong Swedish growth and the positive outlook for oil prices that should support Norway. We remain cautious on the UK, given the uncertainties surrounding it leaving the European Union.

In Japan, we believe that short-term interest rate differentials should continue to dominate this crossrate in the short term, and so favour the US dollar vs. the Yen.

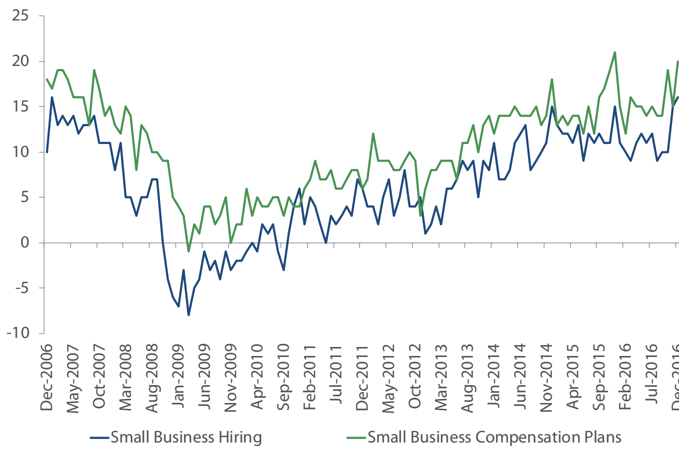
Emerging Markets

With the uncertainties surrounding President Trump's protectionist trade policies, we have shifted to a neutral position in emerging markets as we wait for greater clarity.

While Mexico has been hit hard in 2017 and now offers significant value, we would expect it to remain the focus of bond markets, given the US could pull out of NAFTA and President Trump's comments about imposing a 35% tariff on Mexican goods.

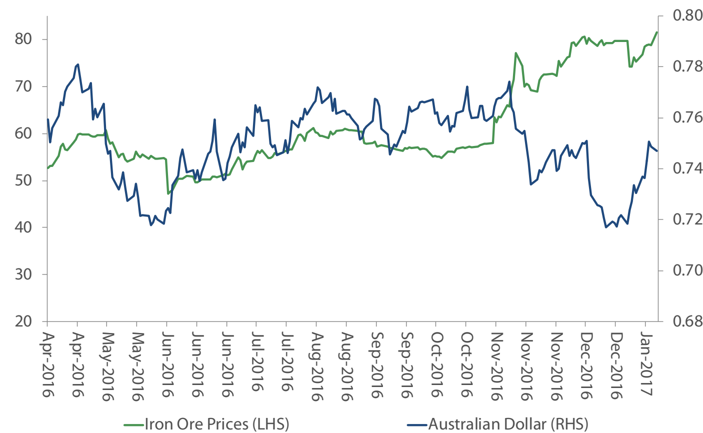
Discussion Points

1) US small business sentiment has surged since the election, due to optimism about the economic outlook. Both hiring and compensations plans have moved sharply upwards, and this could be critical for the US inflation outlook over 2017, given unemployment is already low.



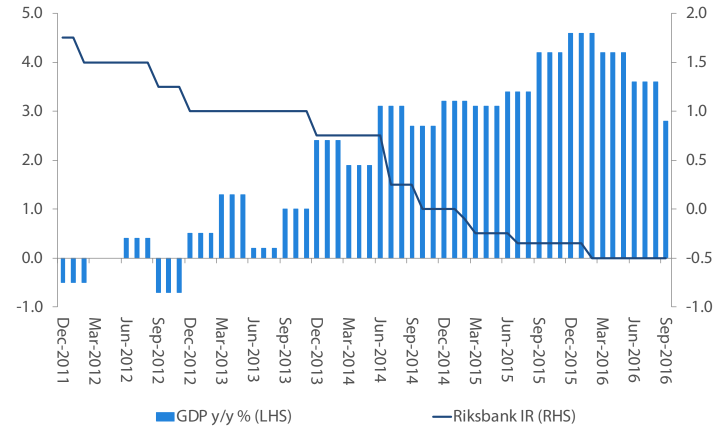
Source: Bloomberg

2) Although the Australian economy still appears to be soft, a significant gap has opened up between iron ore prices and the Australian dollar. This, along with our constructive view on Chinese growth, leaves us positive on the Australian dollar.



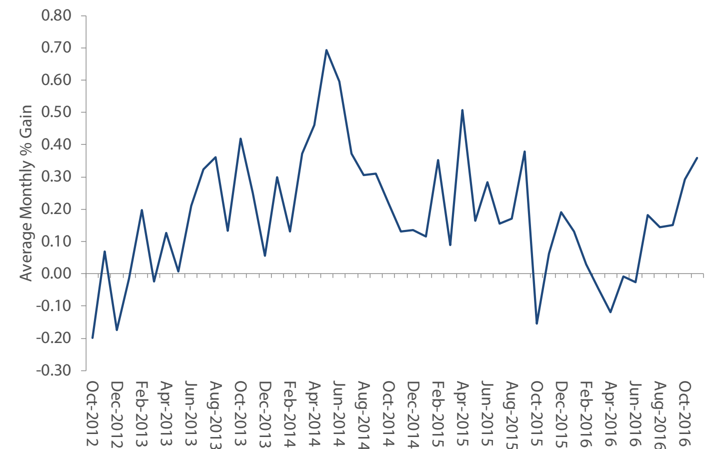
Source: Bloomberg

3) In Sweden, the central bank's easing, driven by low inflation, has caused economic growth to surge. Although still below its highs, this economic strength should make it more difficult for the central bank to maintain its QE program, with any announcement around this expected to be positive for its currency.



Source: Bloomberg

4) In Mexico, the Peso's new found competitiveness has seen the local manufacturing sector gain traction. Uncertainty still reigns however, given the potential for a more protectionist US government.



Source: Bloomberg

Global Credit

Key Views

Global credit markets performed well in 2016. Despite rising interest rates in Q4, returns across most markets remained positive. The main drivers of outperformance were some investment themes that we highlighted previously, such as the focus on high yielding bonds.

- We expect 2017 to be another positive year for global credit markets
- Top-down themes should prevail as the main drivers of returns
- Key themes that we are looking at are hybrid bonds, financials, oil/emerging markets and High Yield
- We expect default rates to remain low in 2017 but macro and political risks to remain high

Europe

We have a positive outlook for Europe, with the macro and technical indicators for December and the start of January looking quite favourable for credit spreads. Like other global regions, valuations in Europe are currently at very tight levels, which make it more difficult to find value investment opportunities. Most macro indicators have been improving and we believe the main area of concern this year will be political risk, with elections taking place in the Netherlands, France and Germany. On the micro front, the quarterly numbers for Europe have been very positive, while in High Yield, companies are actively deleveraging.

At the end of 2016 we saw a turnaround in flows in High Yield retail funds, which bodes well for new issuances this year. Since the start of 2017, there has also been sound demand for BB and Investment Grade issuances, which has mirrored the strong demand seen in the US. In terms of sectors to watch, we would expect Telecommunications and bank loans to offer room for catch-up in the first part of the year. Interestingly, CCC-rated credit returned 5% last year, but High Yield returned over 7.5%. In normal market conditions, you would expect CCC to be the main component of the outperformance, but in 2016 this was not the case. So this could be a space where investors may focus on in 2017.

Japan

On a micro level, we have gradually become more confident, given credit fundamentals were more stable towards the end of 2016. The Trump effect following the presidential election resulted in the Japanese Yen (JPY) depreciating substantially, which has had a positive impact on corporate earnings. This is significant, as a weaker JPY against the US dollar (USD) should be positive for Japanese company fundamentals, which in turn will help to support the Japanese credit market.

A key theme during 2016 was negative JGB yields becoming problematic for the Japanese credit markets, as spreads expanded sustainably. However, after the Bank of Japan's (BOJ) review in July where it announced that it was going to newly assess monetary policy, JGB yields started to move up slowly. It was during the BOJ's September meeting that it changed the focus of monetary policy further to control interest rates, which led interest rates to rise further. It is worth noting that, since September, non-financials issuances have started to increase, relative to last year. This is on the back of companies wanting to issue credit before interest rates start to increase. In total, JPY 2 trillion of new issuances hit the market in September 2016 (three times that in September 2015). These new issuances were moderately taken up as short-duration bonds (5 and 7 years) but strong demand for longer duration bonds (30 years) ensured these were snapped up by investors.

While interest rates are inching up, the BOJ is still controlling the yield curve, and so rates are not expected to increase drastically. We would expect new issuances to be lower in 2017 than last year. Credit fundamentals appear stable, which means supply should be reduced. At the JGB's current yield, we expect credit demand to be quite strong, especially as credit spreads in Japan should remain good for some time.

US

Despite President Trump's rhetoric and early policy statements which may have an impact on credit markets, our current outlook for the US credit is positive. With the default outlook taking a turn for the better, we would expect the returns for 2017 to be derived from carry, rather than spread tightening. While valuations appear to be stretched, we still have some way to go before this becomes problematic.

We currently face a situation where CCC-rated credits are trading at 10.3%. This implies a break-even default rate of nearly one standard deviation below the historical average. This presents some concerns around valuations relative to historical levels, especially when comparing default rates at a break-even level, where the current implied default rate of 16.5% is much lower to the historical average of 25.3%. Demand remains quite robust despite the overall increase in yields, with the Investment Grade market issuing USD 60 billion of bonds in the first couple of weeks of January. However, this increase in supply was perhaps more due to President Trump's election, where supply was held back in November and December, with only USD 116 billion issued. We still expect spreads to tighten from here, albeit at a slower pace. We are also likely to see some sector rotation over the course of this year, as investors' trade into the cheaper sectors of 2016, such as metals and mining.

South America

Not much has changed since the end of 2016. Brazil is expected to return to positive growth, although these forecasts have been reduced to the point that the expected recovery now looks patchy. Chile's growth continues to be poor, with its central bank expected to cut interest rates by 50 basis points. The Chilean government's socialist policy has hurt growth, despite the fall in copper prices. Peru still has pretty

robust headline growth but this has been mostly derived from the rise in copper production and exports. The fact that this growth is due to previous investment means the domestic economy remains pretty weak. The political situation is better in Peru than Brazil, with Peru's incoming president having a range of policies going through Congress that have been relatively well received, and could potentially increase growth. In Colombia, as inflation topped out at 5.5%, its central bank also cut interest rates, with further cuts expected in the coming months. The Colombian government has pushed ahead with its fiscal package and has appeared to have made some progress during 2016, which should help to prevent rating downgrades. And lastly, we address Mexico, which will be the South American country most affected by President Trump's administration. As his tax policy comes clearer, it looks like a border tax aimed at American companies to produce domestically rather than abroad will be implemented. A change in government policy to remove its gasoline subsidy is also likely increase inflation. This should lead to a 50 basis point rise in interest rates, which would ultimately be positive for Mexico's trade balance. Overall we currently favour oil companies and Banks in Brazil.

Australia

We are not expecting to see much activity from Australia in January, unless other global markets start to move. However, its economy has not been showing convincing results in recent months, as it continues its transformation from a mining economy to a services-focused economy. We are currently watching the housing market closely, as some indicators suggest it is slowing down. We hold a fairly positive view on the macro economy as well as the micro side, given we have seen a slight negative drift in ratings but no defaults from any Australian issuer. The technicals are not very supportive but not alarming either, as the Australian market tends to be forward-looking, with investors prepared to buy offshore and convert back into AUD.

Supply of credit in the Australian market continues to be weak, which should put pressure on spreads to tighten. Despite there being one large issue from a major financial institution, January in general tends to have low issuance, with any new issuance likely to come from either financials or larger corporates. Valuations are currently average and earnings are at the levels that you would expect given current spreads. Regarding the Australian housing market, we currently do not see any fundamental challenges unless unemployment goes up considerably. This market has been a similar situation for a long time and the banks should be in a tolerable position. As a result, Australia's banks could be downgraded by some credit agencies in the longer term, although we don't see Australian banks being vulnerable in the short-run, especially the four major institutions.

Asia ex Japan

We expect economic growth in Asia to be stable but see some potential downside risks in the region. In Chinese financials, for example, there are a number of risks to be monitored going into 2017, such as capital outflows, CNY volatility, shadow banking, off-shore bond yields and on-shore corporate defaults. These risks would not have arisen without a systematic crisis occurring, however we believe that there will be a period of weakness in 2017 that will be driven by negative headlines in the financial sectors. Risks also exist in India, mainly due to the monetary reforms implemented by Prime Minister Modi's government. These could present short-term downside risks, as the near-term impact of these reforms on economic growth has been far more severe than what perhaps Modi and his government had expected. We still maintain the view that these structural reforms will be positive in the medium term. Alongside these reforms, however, there are some question marks over the asset quality of Indian banks.

In terms of the policies that governments in Asia have at their disposal, we would argue that the monetary easing cycle will likely be put on hold, given the constraints exerted by rising US treasury yields. We have also seen inflation increase quite rapidly from a low base. As for India, it is likely to continue its policy of easing interest rates, due to the short-term growth pressures mentioned above.

However, it is the fiscal space that remains open for most economies, especially China. We would argue that if Chinese economic growth were to dip below 6%, for example, China has the fiscal resources available to support the economy.

We expect the divergence in credit profile between Asian Investment Grade and High Yield to carry on in 2017, albeit to a lesser extent than last year. We think that many of the negatives have already been factored into the current ratings. The negative rating drift in High Yield, which was quite substantial in 2016, will most likely moderate this year, while upgrades for a large number of Investment Grade companies is probably coming to an end. We are therefore likely to see some convergence in the ratings between Investment Grade and High yield this year. Moving onto default rates in the region, last year we saw an extremely low default rate of 0.9%, which we believe is unlikely to be repeated in 2017. While it is likely to be greater than 1% this year, it is still relatively positive compared to other regions.

In terms of valuations, we still consider Investment Grade and High Yield spreads to be relatively expensive from a historical perspective. We think when looking at the spreads in US credit, their relative value still doesn't look compelling, particularly for High Yield, where the spread in Asia is almost the same as its US equivalent. We still prefer Investment Grade over High Yield, but given the risk/reward characteristics in the High Yield space, the total return could still be higher than Investment Grade. Looking at the market from a technical perspective, we believe that emerging market fund flows could be vulnerable to rising interest rates and a stronger US dollar. Gross supply should be higher this year than last, and although a lot of this is going to be down to refinancing, we still expect net supply to be lower.

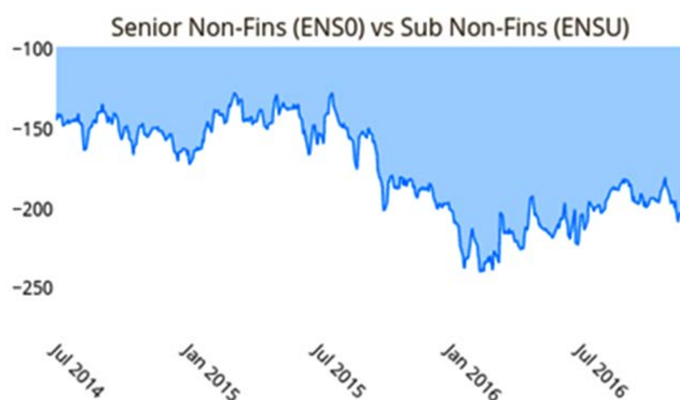
Overall, we expect modest total returns for Investment Grade and High Yield this year, and see spreads of Investment Grade widening by approximately 25 basis points from current levels. On the High Yield side, we expect spreads to widen slightly

more, on average, by around 50bps. However, due to the shorter duration and higher carry, their total return is expected to be higher than Investment Grade.

Discussion Points

Hybrid bonds pose an interesting investment opportunity, as they trade with an attractive spread versus senior bonds (Figure 2). Most hybrid bonds are issued by European corporates and offer a cheap way to access a market where senior spreads have been heavily repressed by the central bank's corporate bond purchasing programs. Investment Grade-rated hybrid bonds currently offer spreads of 253 basis points (Libor OAS) versus senior spreads of 68 basis points.

Figure 1 Senior versus Subordinated Non Financials, in bps



Source: BofA ML Research

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