GLOBAL FIXED INCOME & CREDIT OUTLOOK

September 2016

Recent Developments

Fixed Income

Central bank policy from the US, Japan and Europe are strongly affecting the current global fixed income markets. New Zealand and Canadian economies also face continued pressure. We maintain the view that there is a positive environment for emerging markets, but have moved slightly more cautious.

Credit

September proved to be a difficult month for credit. Some regions warrant a risk reduction but global credit markets still offer ample opportunities as the de-linkage of spreads and fundamentals continues.

Global Fixed Income

Current Views

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

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

Key Views

- Markets are benefiting from Japanese flows.
- Bank of England (BOE) quantitative easing (QE) programme should benefit the market.
- Questions over fiscal policy in Canada and its impact on economic growth as we go into the 3rd and 4th Quarter
- A September US rate hike looks unlikely.
- There is a positive current environment for emerging markets (EMs).

Developed Markets

Ramifications from Central Bank meetings
The major discussion point this month was the central bank policy decisions made by the Federal Reserve (Fed), Bank of Japan (BOJ) and European Central Bank (ECB).

In Japan, there has been a change of policy towards yield curve targeting, with the BOJ attempting to achieve a target for a 10-year yield of around 0%. Long-term yields are likely to be capped slightly above 0% as the policy includes the ability for commercial banks to borrow from the central bank for 10 years at that rate - creating an arbitrage opportunity if yields were to rise.

However, it is more difficult to see how the BOJ can prevent yields from moving into deeper negative territory. Although they can reduce Quantitative Easing (QE) purchases and the government can increase issuance, markets could still test this boundary. In Europe, there is increasing talk of the ECB tapering but no firm news of such as yet.

Finally, in the US, we still believe that the Fed will raise interest rates again in 2016, most likely at the December meeting.

Pressure on New Zealand and Canada
We continue to be more cautious on New Zealand and Canadian Dollar and currently hold an underweight FX position for each currency. In New Zealand, the central bank cut rates and further rate cuts are expected. In Canada, the weakness of growth should see pressure building on the central bank to intervene in the coming months.

Varied view on Japan
This month we added Japan to the model portfolio and started with a neutral weight in the Japanese Yen and overweight on duration. The Yen is at a critical juncture and in the short/medium term we may see fluctuations in value against the US dollar.

Emerging Markets

Risk on EM with a Trump victory
Our top down process continues to show a positive environment for EM, but we have moved slightly more cautious.

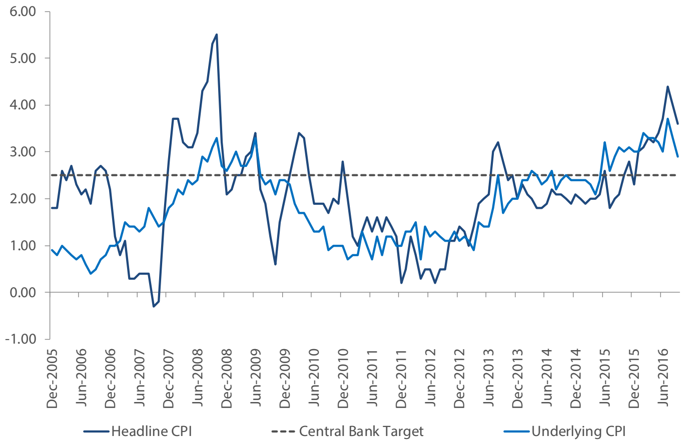
With the US elections looming and significant risks for EM on a Trump win, we have moved to a more cautious position, removing our overweights on both Mexico and South Africa.

We are also underweight in Malaysia and Singapore as Asian Foreign Exchange (FX) could be most vulnerable to a rise in protectionist policy.

Discussion Points

Our positive outlook for global oil prices combined with a less dovish central bank in Norway leads us to be overweight the FX with a neutral duration. Inflation is now well above the central bank's 2.5% target.

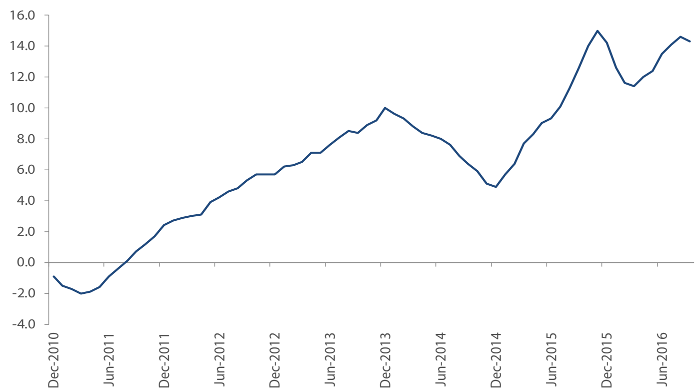
Norway Inflation v Target Inflation



Source: Bloomberg

In New Zealand, the central bank continues to cut rates to weaken the FX despite strong domestic data. However, house price growth is now showing signs of possibly peaking after tighter lending rules were introduced for banks.

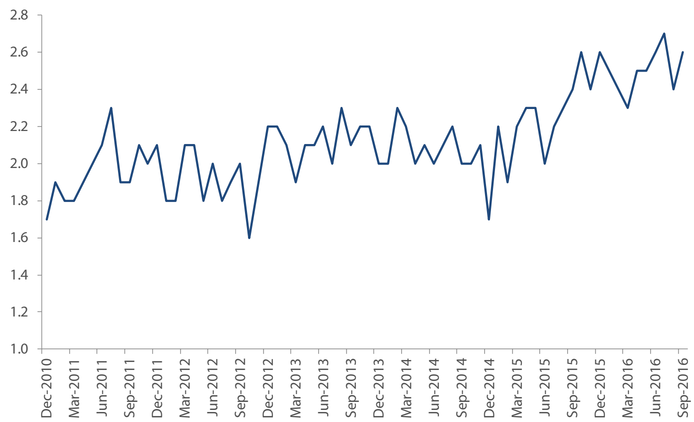
New Zealand QV House Prices Y/Y Change (%)



Source: Bloomberg

With US hourly earnings now clearly breaking out of their range and employment still holding up well, the Fed should raise rates by 25bps in 2016, most likely in December once the election is complete.

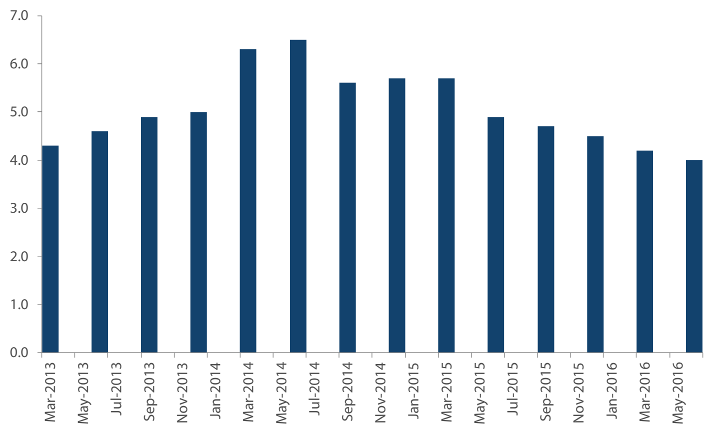
US Average Hourly Earnings y/y %



Source: Bloomberg

In Malaysia, growth is now weakening and is below the government's target. Combined with some political uncertainties and the country's open economy, this leaves us more cautious in the run up to the US election.

Malaysia GDP% Change Y/Y



Source: Bloomberg

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Global Credit

Key Views

- Despite the positive performance of Asian credit last month, we remain cautious.
- In Europe, we expect political risk to be on the rise, as valuations are starting to look tight. Therefore, a reduction of positions in European credit is warranted.
- US credit still looks attractive compared to other markets and offers compensation for the prevailing risk factors currently in the market.

September proved to be a difficult month for credit. Markets traded weaker ahead of the BOJ and Fed meetings.

The BOJ announced the reconfiguration of its QE programme, with the focus to be moved away from asset volume to target prices.

Despite these changes, the markets remained unconvinced. However, the Fed's more dovish tone helped to shift rate hike expectation forward to December and led to a recovery of credit spreads. Nevertheless, weakness in the banking sector driven by the fears of Deutsche Bank's litigation risk in the US, were negatively impacting the market towards the end of the months.

European credit bonds finished September in negative performance territory. Nonetheless, positive contribution from lower rates was partially able to offset weaker spreads.

In the US, Investment Grade (IG) credit finished the month negatively, as high issuance volume and weaker rate markets were putting pressure on total returns. In contrast, US High Yield continued its positive trends from previous months. Also, Asian and Latin American High Yield bonds reported positive returns. The latter benefitted strongly from a bond price recovery of Petróleos de Venezuela, an oil company, which proposed a debt exchange.

In contrast, Latin American IG bonds had a month with negative performance, driven by wider credit spreads in the energy sector and higher rates.
Asian IG outperformed other IG markets in September and reported positive absolute as well as excess returns.

Europe

In Europe, we expect political risk to be on the rise, with the Brexit negotiations supposed to start in early 2017 and the Italian referendum looming in December.

Nevertheless, our macro and micro economic scores are pointing to solid and steady growth. Technicals are still looking supportive for credit markets as the BOE started their corporate bonds purchase programs at the end of September.

However, valuations are starting to look tight and warrant a reduction of positions in European credit. As a team, one of our favourite investment themes is still an overweight of European High Yield bonds.

Japan

We believe the change in the BOJ strategy should keep yields in the Japan credit market positive and therefore attractive, although spreads might get squeezed tighter over time. Macro data is improving and positive net inflows (for the first time since 2010) has helped to absorb new issuance.

US

After a market-supportive Fed meeting, focus in the US has now shifted to the presidential election and macro data; the latter of which, is putting doubt on a Fed hike in December.

Micro data is also deteriorating as new issue proceeds are being heavily used for payouts. Nevertheless, valuation in US credit currently still looks attractive compared to other markets and continues to offer compensation for the prevailing risk factors. We currently see value in the long-end of the US credit curve.

South America

Latin America was one of the most volatile credit markets in September. The drivers of this were softer data coming out of Columbia (due to weaker domestic sales) and Chile (caused by the negative impact of left wing government on the economy).

In addition, Brazil's data started to weaken again and Argentina was hit by political risk as the supreme court ruled against the removal of subsidies.

On a more positive note, Mexico's economic data held up well and showed reasonable growth.   Additionally, consumer prices indices in Latin America seem to have peaked, which could lead into rate cuts going forward, while, recent price moves in oil and iron are supportive for the region.

In terms of investment themes, we are currently viewing Brazil as an attractive option compared to Russia at current oil prices and also find value in some of their local telecommunications providers.

Australia

The Australian credit market is supported by the recovery of the economy. However, corporate fundamentals are mixed and the rating drift for Australia corporates is still negative.

Despite this, last month liquidity improved as a few larger issuers drove new issue volume up. In terms of investment themes, our credit specialists in Sydney have been able identify attractive opportunities in the basic industry space.

Asia ex Japan

We continue to remain cautious despite the positive performance of Asian credit last month. On one hand, the macroeconomics in most countries remain healthy, as commodity prices stabilise and currencies hold up.

However, valuation remains tight and technicals are deteriorating, as the primary market has picked up. Furthermore, we are closely monitoring political risk in the region and currently hold positive observations for Indonesia and India but negative for the Philippines. Therefore, underweighting the latter has become an important investment theme, and similar to our overweight of Chinese Yuan vs. Korean Won and Hong Kong quasi-sovereign bonds.

Discussion Points

During the last month, banks in Europe have moved back into the limelight (although for the wrong reasons). Woes around Deutsche Bank's financial health have driven spreads wider in the financial sector. However, what got overlooked were upcoming regulatory changes, which look to be supportive for the European banking industry.

The ECB is expected to inform banks at the end of 2016 what their Supervisory Review and Evaluation Process (SREP's) Pillar 2 obligations will be and have recently made it clear that it will split these obligations into guidance and requirements.

The split will reduce capital needs to the original expectations by an average of 175 basis points (bps). Other than a breach of requirements, a breach of guidance won't automatically lead to restriction on AT1 coupons.

The EU commission is expected to recognise these suggestions in its Consultation Paper (CP) linked to the Capital Requirements Directive IV/ Capital Requirements Regulation (CRD IV/CRR) () review.

The CP forms the basis for later changes of the CRD IV/CRR. The document is expected to be released in Q4 2016 and supposed to offer various reliefs to AT1 bondholders.

Beside the above mentioned support, the commission could put AT1 coupon before dividends, (as recently suggested by ECB President Draghi) and clarify Additional Distributable Items (ADI) as the interpretation is varying across Europe.

The latter could help issuers like Deutsche Bank, as they are currently required to provide ADI calculation under German GAAP, which is more detrimental than the use of IFRS would be.

Beside supportive steps from the ECB and the EU Commission, we also expect the Single Resolution Board (SRB) to indicate towards the end of the year what Minimum Requirement for Eligible Liabilities (MREL) requirements Eurozone banks will have to full fill.

According to recent comments, a broad range of instruments will be eligible for MREL. Banks will be able to use Tier 2, non-preferred senior (France) as well as statutory subordinated senior (Germany) bonds for MREL compliance. We believe, the broad range of eligible bonds will be positive for the banking sector.

Moreover, European officials have tried to shield the banking sector from international pressure. German and Italian regulators recently told the Basel Committee on Banking Supervision that the latest proposal on credit market and operational risk was going too far and is expected to be watered down. The German finance minister, Wolfgang Schäuble, stressed that additional capital requirements have to be kept to a minimum.

To conclude, all current regulatory undertakings are aimed to support the banking industry in Europe and not put further burden on the industry, which is also currently suffering from high capital requirements but also from a low yield environment. The changing paradigm in banking regulation forms a more reassuring investment case for the sector. The latter is particular true for the lower end of the subordination curve, i.e. AT1 bonds.

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