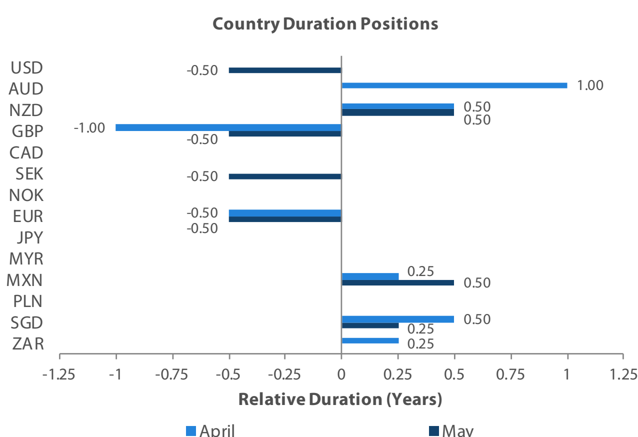
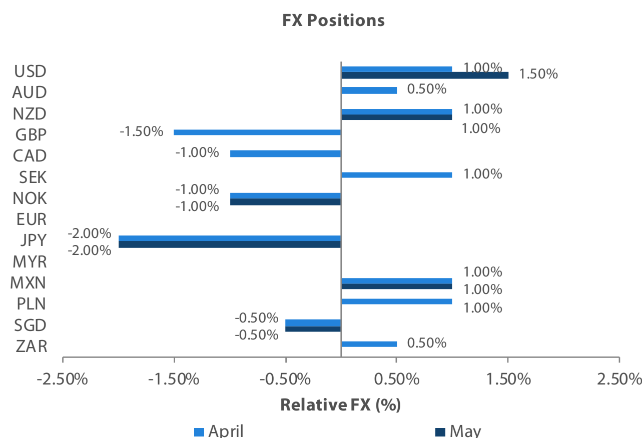
GLOBAL FIXED INCOME & CREDIT OUTLOOK

May 2017

Current Positioning





Source: Nikko AM

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Recent Developments

The result of the French Presidential election was consistent with opinion polls and delivered a decisive victory for Emmanuel Macron. His position is highly dependent on support from Parliament (Assemblée Nationale). Elections for such will take place on 11 and 18 June and the results will provide a greater indication on whether he has a feasible chance of achieving his ambitious reforms.

In the UK, Prime Minister Theresa May announced a snap general election to take place on 8 June. The outcome is expected to be a large majority for her Conservative Party.

There continues to be disappointment and frustration within the market over President Trump's fiscal reforms in the US. However, the recent passage of a new healthcare bill in the House of Representatives could be a start of future reforms being passed.

Positioning & Themes

Activity in the US has disappointed relative to the high market expectations when Donald Trump first entered the White House. However, a cyclical recovery remains intact, with potential headwinds from prior fiscal policy tightening reversing and the pace of monetary policy tightening expected to remain gradual. We have recently taken a tactical short position on US duration, as sentiment on reform seems to be underpriced. Indeed, we believe that there remains a reasonable chance of tax reform of being approved, such as the passing of the recent repeal healthcare bill in the House of Representatives.

In Europe, the latest PMI data continues to shows that sentiment in the manufacturing sector is close to multi-year highs. Unemployment rates have declined globally and it seems economies are showing signs of breaking free from the stuttering growth that it has experienced since the global financial crisis. In Europe, we left our short duration position as we view rates could potentially move higher as a result of risk premium being removed from the market.

Within the UK, it became increasingly apparent to Prime Minister May that the two-year exit period was likely to prove too short for a negotiation process. A factor for her calling a snap election is to allow a transition period of a few years, where the UK potentially continues to pay into the EU budget, allows freedom of movement and remains subject to the European Court of Justice. This would form part of a 'softer' Brexit, which is less economically disruptive for the UK and the option that is desired by the market. With a term of five years, the new parliament would also oversee the entire Brexit process. We take the view that a larger parliamentary majority increases her chances of getting the UK a better deal in the Brexit negotiations. As a result, we have reduced our underweight in duration and GBP FX position, ahead of the election in June.

In Australia, the Reserve Bank of Australia (RBA) Governor warned that wage growth will need to catch up to housing inflation if the economy is to become more resilient to the problems caused by burgeoning household debt. We would argue the resilience of the economy would be enhanced by an extended period in which housing prices and outstanding debt increased no faster than incomes. It is well expected within the market that Australia will get a downgrade from the major agencies. We have reduced our duration position to neutral in rates, as we think it offers poor value, based on historical analysis and because of the spread against US Treasuries. We have additionally cut our FX AUD position for the time being due to the recent fall in iron ore prices.

We continue to hold a positive view towards higher risk markets within Emerging Markets (EM) such as Brazil, Mexico and Russia, as the outlook for EM overall is quite propitious. Terms of trade are improving for many markets, as commodity prices rebound from their cyclical lows. The growth differential between emerging and developed markets is set to grow once again, as emerging market growth outpaces the developed world. Current account deficits have closed in many markets and positioning remains light, as investors sold their positions over the last few years and have yet to return in any meaningful size. We also hold some lower volatility, yet still high yield, markets such as India, in order to balance portfolio risks.

Investors took the result of the Turkish referendum and recent announcements from its Central Bank positively. The comments from the Central Bank that it won't rush to cut rates, and assertions from government officials that there will be no early snap election, were well-received by investors. Thus, we expect further appreciation of Turkish assets.

Negative news continues to come out of South Africa. The dismissal of the prominent Finance Minister Gordhan by President Zuma triggered a sharp market sell off and a decisive response from the rating agencies. The latter argued that the dismissal of Gordhan not only threatens policy predictability, but is likely to put a strain on public finances, warranting a one notch downgrade by both S&P and Fitch. We have cut our duration and FX exposure, and we will continue to follow this closely during the year.

Volatility within Credit and EM remains fuelled by uncertainty surrounding President Trump's policies, geopolitics in Europe, and the potential withdrawal of QE from Central Banks. The recent spike in volatility, however, provides a better potential entry point into these markets from where value can be gained. We continue to view China as a major influencing factor on EMs and a source of stability for this asset class. US-Chinese relations seem to be healthier and we expect GDP growth to stay around 6.5%. In Credit, we are currently bullish on Chinese property Credit.

Another area where we foresee strength is European banks. Economic growth continues to be on an upward trend, which should lead to higher rates. Capital and asset quality within the banks has improved, which has helped to diminish litigation risk. We currently prefer European Yankee Bank Bonds to gain access to this market. In the US, we like home builders and we are currently cautious on energy bonds given the recent volatility in oil.

Outlook

The European Central Bank (ECB) has suggested that it might be able to embark on the process of scaling back on quantitative easing. This is based on the current confidence within the single currency area that economic risks are starting to fade. However, the ECB's dilemma is that exiting too early could jeopardize the recovery and the return to price stability. Exiting too late could, over time, generate higher inflation and potentially fuel financial bubbles.

The strong victory for Macron could lead to further spread tightening and is an important step in ascertaining the policy direction for France, and perhaps Europe. However, his victory is insufficient to gain a complete picture, given the lack of clarity on the outcome of the forthcoming Assemblée Nationale elections. Market expectations of Macron succeeding in his reforms remain quite low, and so these parliamentary elections are going to be an important event early in Macron's presidency. We will await the outcome with interest.

Despite inflationary pressure, the Bank of England's Monetary Policy Committee is unlikely to hike interest rates in the near future from the current level of 0.25%. Rates had been cut by half in August, after the UK voted to leave the EU. However, in the following months, economic growth has beaten expectations, while the increase in inflation is expected to hit close to 3% for 2017, above the committee's 2% target. We are currently cautious on potential excessive inflation in the UK, which will be a catalyst to raise rates.

The overall outlook for EM remains stable, and so far similar factors have been influencing the asset class throughout the year. We expect new growth catalysts to emerge for EM in the coming months. We would argue that local markets still have better fundamentals and inflow prospects.

Oil fell below $45 a barrel for the first time since OPEC agreed its production output in November. With the price falling, we view it is sensible to take profits on any further gains before for the next announcements made by OPEC members. Incidentally, Saudi Arabia and Russia signaled they could extend production cuts into 2018, doubling down on an effort to eliminate a supply surplus, just as its impact on prices decreases.

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