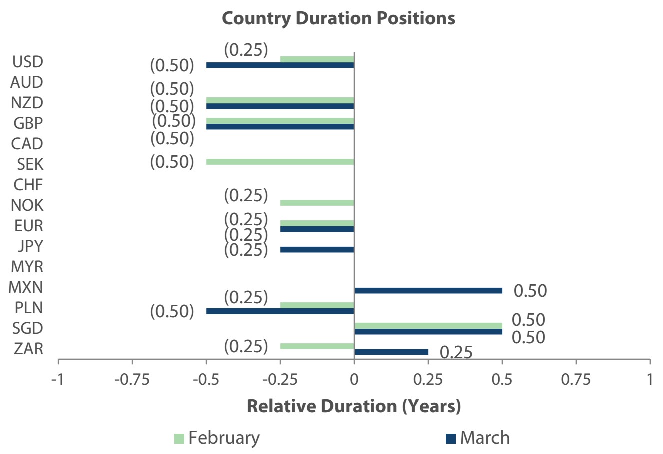
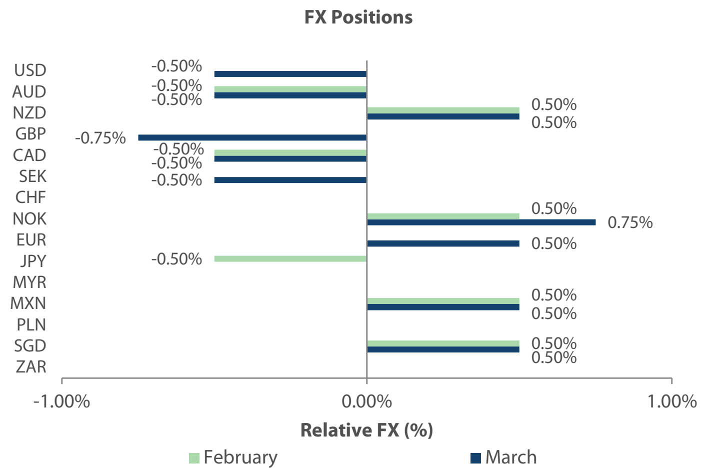
GLOBAL FIXED INCOME & CREDIT OUTLOOK

March 2018





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Global Outlook

A broad-based synchronized recovery continues to gain traction. Following the strongest year of global growth since 2010 (estimated at 3%) the consensus forecast for the current year looks to be even rosier. The World Bank early forecasts see it edging higher to 3.1%, before moderating to 3% in 2019-20. This marked improvement in global economic activity comes on the heels of supportive fiscal stimulus in the US, accommodative monetary policy, rising confidence and firming commodity prices. One of the most instrumental factors behind the global growth acceleration has been a notable recovery in global capital spending, which has been supported by cheap financing, which in turn has led to rising profits and improved business sentiment across both developed and emerging markets.

This synchronized pick up in investment has also resulted also in a marked acceleration in global trade volumes, though we expect to see some moderation in the coming months. The acceleration in aggregate demand has also had positive implications for commodity prices. This has paved the way for a significant pickup in economic activity amongst commodity exporters in both emerging markets and, to a lesser degree, developed markets. A pick up in commodity prices has also seen a rise in global headline inflation (albeit from a low base) reducing the risk of deflationary expectations becoming entrenched. However, global core inflation continues to be subdued, but the broad based improvement in labor market conditions across the globe is likely to put upward pressure on global wage dynamics, putting demand-led price pressure on a more sustainable trajectory. The much improved outlook for both real economic activity and inflation ought to see a number of key central banks looking to scale back from their highly accommodative policy stance, putting sustained pressure on global bonds.

Developed Markets Positioning

The team has made a few key changes versus the prior month's investment meeting. Notable changes were reverting back to the 0.5 year underweight on duration within the US in light of the supportive economic data with employment data in particular reporting at quite robust levels with jobless claims at 50 year lows. On the US Dollar (USD) the team has reduced its FX position by 0.50% as trade policy and valuation have temporarily taken over as primary driver of USD weakness over the short-term. On trade policy, President Trump's recent announcement of Steel and Aluminum tariffs in our view was driven by the special congressional election in Pennsylvania as the Trump administration wants to maintain support in the rust-belt states ahead of the mid-term elections taking place in November. We note the increased rate of personnel departures has raised future political uncertainty, which will weight on the dollar due to increasing risk premium.

For the Japanese Yen (JPY), the team has moved to neutralise its underweight position after the lack reaction to the catalyst on Kuroda's reappointment as the dollar remains the primary driver in FX movement for the near-term. The team noted that Kuroda's recent committee statements citing the possibility of 2% inflation by mid 2019 remain were more politically driven in order to foster support for continued yield curve control.

In Europe, we increased our positioning in Norwegian Krone (NOK) relative to Swedish Krone (SEK) on the improving macro fundamentals as the team expects the Norges Bank to hike sooner than expected, while we see Swedish monetary tied to the ECB for the foreseeable future. In our view the Norges Bank's reduction in its inflation target supports our view that it is positioning for a hike sooner than expected by the market. Additionally, we see additional risks to Sweden's economy, with house prices beginning to decline. On a technical basis while the team agreed on the fundamental outlook, it noted that the short-term entry point for this view was sub-optimal given SEK is oversold on a technical basis.

For the Euro, the team has increased its view from neutral to overweight, while remaining underweight duration. Increasing PMI's support a more robust outlook, however we note the ECB remains cautious on indicating an end to QE until inflation is at more sustainable levels.

In Canada, the team has maintained its underweight positioning, as the recent Bank of Canada meeting underwhelmed market hawks underpinning the notion that the there is no immediate urgency for a rate hike in the near future.

In Australia, we maintained our underweight FX position. This is because local rates are now trading through US rates, interest rate differentials have become less compelling and there has been slowing PMI data from China. In New Zealand, the team has remained positive on FX, as we think there is still a political risk premium priced into the market and will gradually compress once the political situation normalizes with the RBNZ more than likely to hike rates in the near future.

The team moved Pound Sterling (GBP) to its largest underweight based on the rationale of a more doubtful Brexit outlook. The team made this judgment as it had appeared that Eurozone negotiators imposed hard hurdles on a final UK exit such as a hard border with Northern Ireland and European Court of Justice. However, unexpectedly a transition deal had been agreed between both parties that brought an upside to GBP. Besides Brexit, interest rate differentials, higher inflation and lower growth expectations all remain unsupportive of further GBP strength.

Emerging Markets Positioning

In Emerging Markets we maintain a generally constructive view on FX on widening growth differentials relative to developed markets. We have also turned selectively bullish on a number of EM rates markets as disinflation is facilitating a more dovish stance in a number of countries.

We remain neutral on the Malaysian Ringgit (MYR) as its near-term outperformance looks stretched, following the recent strength in the domestic economy, strong rebound in energy prices and the strong correlation to the Chinese Renminbi (CNY). The central bank hiked rates in January, as expected, however, given the lack of inflation pressures in the economy, we are likely to see an extended pause in monetary policy tightening; as a result we also remain neutral on duration.

We have maintained our overweight in the Mexican Peso (MXN) due to its relative undervaluation and high carry, coupled with an increasingly hawkish rhetoric from Banxico. We believe that the proposed changes to NAFTA have weighed disproportionately highly on the currency, with diminishing risks of an imminent end to the agreement likely to spur a continued rebound over the coming months. Meanwhile, inflation looks to have turned decisively lower, giving us more confidence in re-establishing a long duration trade.

We remain neutral on the Polish Zloty (PLN) as despite strong growth momentum, political risks still linger with respect to the triggering of Article 7 proceedings from the European Union in relation to alleged breaches of "Rule of Law" principles. If triggered, this would leave Poland vulnerable to a removal of structural fund flows over the medium term. We also remain underweight duration in Poland as, despite the recent dovish rhetoric from the NBP, underlying inflationary pressures are building due to robust domestic demand and tightening labour markets, with valuations also stretched.

We remain positive on the Singapore Dollar (SGD) as external demand continues to support both manufacturing and financial service sectors of the economy. As a result we expect the Monetary Authority of Singapore to indicate a positive appreciation bias in April. We also maintain an overweight duration position as currency strength is likely to put renewed downward pressure on inflation.

We remain neutral on the South African Rand (ZAR) as despite the positive sentiment toward the change in leadership in South Africa, investors are likely to encounter episodes of disappointment as Ramaphosa's reform agenda faces obstacles. Meanwhile, with core inflation now below the mid-point of the SARBs inflation target, assuming South Africa avoids a sovereign ratings downgrade by Moody's, we now expect the SARB to cut the policy rate in the coming months in order to facilitate growth.

Global Credit Positioning

Negative excess returns across the globe, generated by negative equity markets on the back of political turmoil such as the tariff discussion in the US, which has impacted spreads. There has been quite a significant pickup in supply especially in IG, and there has been large new issuance such as CVS, which completed the third-largest corporate bond sale on record to fund its acquisition of Aetna. The main underperformers were US and LATAM HY and these were the only markets that finished with a negative absolute return. Therefore it is an interesting time in which investors can still outperform with credit, but it is no longer as straight and forward as it was in 2017.

In Europe, we exited the early-month volatility in the second week of February. Leading macro indicators remained strong and at least in line with expectation if not above expectations. One noteworthy event was the Italian election, in which we correctly took the view that it wouldn't move the needle too much in terms of structural reform or shifts in Italy's broader economy. On a micro level, more companies have reported Q4 earnings and they have largely been positive. The upside surprise is lower than in previous quarters, but this is largely because the previous quarters in 2017 were very weak, which contributed more to the upside surprise. Otherwise the micro environment remains healthy and conducive to European credit.

In the US, Credit markets experienced their first rough patch in some time as spreads widened on the spike in volatility in early February. Despite the recent spread widening, the US IG market has only retraced to mid-December 2017 levels. As we approach the 1Q earnings season, we expect US credit markets to remain well supported on the boost from tax reform impact as well as restricted supply. The best performing sector was Telecommunications and the AA2 ratings bucket was the best performer, while the energy sectors were the worst performers.

The Australian credit market has stayed on the same course as previous months. Some key points are that the economy is healthy and we are not seeing any worrisome fundamental credit events. Supply is reasonably strong, but healthy demand in Australia is developing. We are seeing strong and continued issuance since the start of the year. The supply is still being dominated by financials, but we have seen corporates such as utilities and AREIT's also issuing recently. An emerging trend is a strong demand for credit from Asia and we will continue to monitor this closely in the coming months. Overall we are currently getting more defensive on credit in Australia as volatility has been increasing.

It was a poor month in Asia, where IG spreads widened by 8bps, and HY by 15bps. A large part of this widening has been driven by technical factors such as the significant increase in supply of credit since the start of the year. The fundamentals for the Asia region has not changed much over the month and remain strong. Challenges arise in terms of technicals and valuation. IG and HY supply is already 10-15% higher than the run rate of last year, which was a record itself in issuance in Asia credit. In terms of demand, we sense it has weakened on the margin and we have not seen any aggressive buying. However, at the same time we do not report any major outflows from funds within the asset class and the market weakness is largely driven from the supply overhang that we have seen since the start of the year.

For Japan, credit is currently stable thanks to depressed yields as the Bank of Japan (BoJ) continues to control the yield curve. Political scandal in Japan has rattled the market. At the heart of the scandal, Prime Minister Shinzo Abe has been alleged of covering-up of a land sale to Moritomo Gakuen, a controversial organisation known for its ultra-conservative, nationalistic principles. The organisation wanted to set up a school in Osaka, and bought a plot of land from the transport ministry in 2016. It later emerged that Moritomo Gakuen had paid about a sixth of the market price, and as a result we hold a concern about Abe's position. We also have concern regarding the recent strength of the Yen and we will monitor the impact on corporate earnings. In terms of demand for credit, it has recently slowed down as supply has fallen.

Lastly in LATAM, generally speaking, performance in credit was negative. Its weak fundamentals remain unchanged, but the focus currently in the region is on upcoming elections. In Colombia, it has now emerged we have two candidates for the presidential election and in both scenarios we expect a market positive outcome. In Mexico, the victory of Andrés Manuel López Obrador (AMLO) has been priced in. With the help of a strong social media presence, AMLO has been able to tap into the widespread public anger against the established parties, and hence cement his place as the anti-establishment candidate in Mexico, and currently leads the polls by a healthy margin. Despite initial concerns of AMLO we expect rhetoric to be more market friendly once in power. Lastly, switching our focus to Brazil we expect a binary election outcome, which all depends on whether President Luiz Inácio Lula da Silva (Lula) is able to run. Despite allegations against him, the former President still has large support and if allowed to run, Lula would lead the race comfortably in the first round and would likely beat every other candidates in the second round, assuming that he failed to secure 50% in the first round. Outside of politics, in Brazil we still economic growth around 2%, but given global growth this number should be closer to 6% range. Elsewhere we are currently seeing signs of improvement in Mexico and Colombia.

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