GLOBAL FIXED INCOME & CREDIT OUTLOOK

June 2016

Recent Developments

Fixed Income

Continued easy monetary policy in Europe and Japan will be supportive for global interest rates, but the case for further limited rate hikes in the US remains in place for 2016. Emerging markets are supported by an improving backdrop in China, a global search for yield and continued low positioning. Sentiment remains fragile, though, and this will likely continue until global growth starts to accelerate.

Credit

Last month's rally has removed some of the performance potential in credit markets. Latin America and US Investment Grade had negative returns in May. The weakness in credit markets were driven by a variety of factors including heavy supply, caution and profit taking.

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Global Fixed Income

Current Views

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

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

Key Views

- US Federal Reserve reversing its stance
- Negative outlook on Canada and New Zealand
- Swedish bonds attractive, Japanese/European bonds affected by QE
- No short-term action expected from ECB
- Positive current environment for emerging markets (EMs)
- Mixed messages coming from South Africa

Developed Markets

US Federal Reserve reversing stance

In May, various speakers from the US Federal Reserve (Fed) had reversed their previously dovish stance in what was a clear effort to position markets for additional interest rate hikes and to ensure that the June and July meetings were both 'live.' This gave the US dollar some traction during the month and it rallied vs. most currencies and led us to maintain our overweight in the US dollar and underweight in US duration. Although the recent jobs reports changed the Fed's outlook, we still believe the Fed could hike in July.

Negative outlook on Canada and New Zealand

We continue to have a negative outlook on New Zealand and Canada. In New Zealand, we expect the Reserve Bank of New Zealand (RBNZ) to reduce interest rates later in the year, with some risk of a surprise early cut given the currency's strength. However, housing dynamics may make the RBNZ more cautious. In Canada, we expect economic growth to struggle given high consumer debt levels. In addition, the oil sector will remain under pressure given its high cost structure and collapsing capital spending.

Swedish bonds attractive, Japanese/European bonds affected by QE

In bond markets, we became significantly more positive on Swedish bonds and moved to a very overweight position in that bond market, although we remain underweight towards the currency. Other than in the US, we remain generally constructive on global bond markets given the negative interest rates in Japan and Europe, which are driving investors into other bond markets while domestic bonds remain underpinned by QE buying.

No short-term action expected from ECB

Although we don't expect any further action from the European Central Bank (ECB) in the short term as it assesses the effects of previous policy moves, we expect rates to move deeper into negative territory over time. This should weaken the Euro, in which we remain underweight.

Emerging Markets

Positive current environment for EMs

Our top-down process continues to show a positive environment for EMs. As a result, we continue to maintain our overweight position on EMs in aggregate.

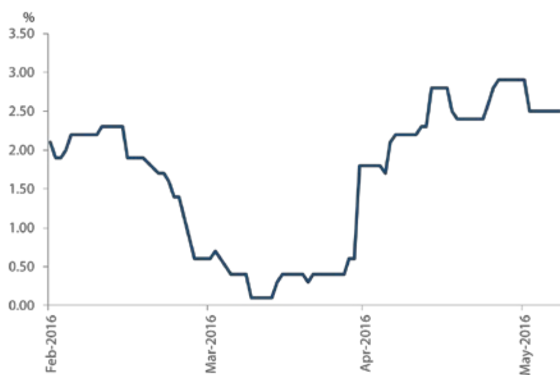
Mixed messages coming from South Africa

Our bottom-up process for country selection within EMs highlights significant problems in the South African market but the high liquidity, high yield and high Beta relative to other EMs make it a strong performer during risk-on periods and so we remain overweight.

Discussion Points

Markets are currently pricing in very little monetary tightening in the US in 2016. However, Q2 should see growth rebound while higher commodity prices should push inflation upwards in the coming months. This should increase pressure on the Fed as we move further into 2016.

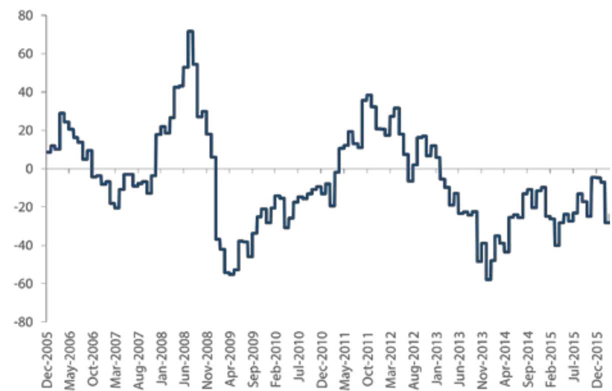
Chart 1: Atlanta Fed GDP Now



Source: Bloomberg

In Europe, the Citigroup Inflation Surprise Index remains very subdued, albeit well above its 2009 and 2013 lows, highlighting the challenge that Europe is facing on inflation even with stronger commodity prices.

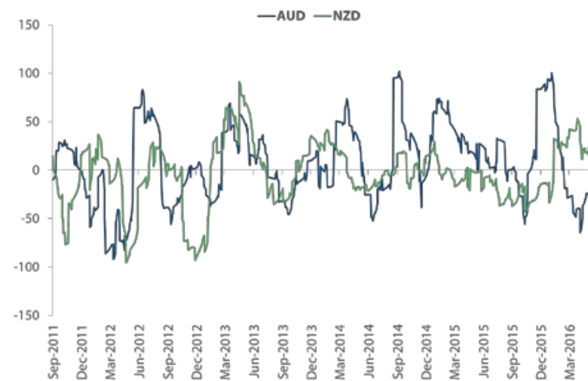
Chart 2: Citi Inflation Surprise Index - Euro



Source: Bloomberg

Recently, data has started to improve in Australia, but deteriorate in New Zealand, captured by the closing gap between the two economic surprise indices. From current levels, we expected the AUD to outperform the NZD with a greater chance of rate cuts in New Zealand despite the housing market.

Chart 3: Citi Economic Surprise AUD/NZD



Source: Bloomberg

In Mexico, economic data has become significantly stronger with unemployment back at pre-financial crisis levels, which is feeding into very strong retail sales. There is a growing chance that the central bank will raise rates by 50bps in June.

Chart 4: Citi Economic Surprise Index - Mexico

Source: Bloomberg

Global Credit

Key Views

- Valuations in Asian credit are already tight, so we are currently taking a neutral view on the market.
- We remain confident on the prospects for the European credit market, with supportive economic growth and healthy credit profiles for most companies.
- We continue to be overweight US credit as our macroeconomic assessment remains favourable for the region and valuations still look cheap.

Overall, we remain optimistic for global credit in the coming weeks, although last month's rally has removed some of the performance potential in the credit market. As a result, we believe that profit taking, ahead of an eventful month, seems justified.

In May, the rally in credit markets petered out. All markets reported negative excess returns except for Asian credit and US high yield. Despite spread widening, most markets were still able to deliver positive total returns. Only Latin American and US investment-grade credit had negative returns in May. The weakness in credit markets was driven by a variety of factors, including the heavy supply of new bonds, which led to spread widening. Furthermore, cautiousness ahead of June's major events (the British EU referendum and the Fed rate decision) and profit taking after two strong months have also impacted the markets.

Europe

We remain confident on the prospects for the European credit market, with supportive economic growth and healthy credit profiles for most companies. Although supply pressured the market in May, it was met by inflows for investment-grade as well as high yield. Valuations for the latter still look attractive but the former have tightened to expensive levels. This is due to the ECB's Corporate Sector Purchase Program (CSPP), which starts in June with likely purchase volumes of EUR 5–10 billion.

The main risk to our positive view on the European credit market is event risk, most notably the UK's EU referendum and several central bank meetings in June. Our key investment themes for the coming weeks are an overweight to the service sector vs. the manufacturing sector, a preference for high yield over investment grade and the long end of the credit curve.

Japan

Japanese corporate bonds benefit from strong demand for positive yield, as supply and demand remains at healthy levels. Although earnings are under pressure due to the rise in JPY, credit quality for most companies remains solid.

US

We also remain positive on the US credit market as our macroeconomic assessment remains favourable for the region and valuations still look cheap. However, our positive view is partly counter-balanced by an overall weakening of credit profiles and a negative rating drift (more downgrades than upgrades), as well as the threat of a Fed rate hike over the summer.

Our investment themes for US credit remain unchanged, with a preference for European Yankee bonds and US high yield. However, the performance potential of the latter is currently capped by expensive equity valuations (particularly in the energy sector), e.g. EV/EBITDA.

South America

South America's economies continue their recovery as commodity prices continue to soar. In addition, government changes in Argentina and Brazil are helping to improve sentiment. Despite these positive developments, overall credit quality and market technicals remain weak.

Australia

In the Australian credit market, supply has recently picked up in the non-financial sector with two multinational groups (Apple and Coca Cola) issuing AUD bonds. We have changed our outlook for the Australian credit market to positive due to the improvement in primary markets, a neutral view on valuations and still healthy economic growth. We see value in Australian banks, REITs and the short-end of the credit curve (0 to 5 years).

Asia ex Japan

Asian credit continued to outperform in May and delivered positive total returns for the fifth consecutive month. It is worth mentioning that the Chinese property and commodity sectors reported particularly solid returns. Even though Chinese macroeconomic data showed some moderation in May, we still expect growth to remain in line with government expectations and, thus, we continue to support a positive assessment of Asia's macroeconomic situation.

Another supportive factor for risk sentiment has been the recovery in the oil price, although the longer-term risk of this development could be higher inflation rates. However, positive macroeconomic factors in Asia are counter-balanced by weak microeconomics. Rating actions are still skewed negatively, with a focus on weaker Chinese state-owned enterprises (SOEs), private industrials and non-investment grade property companies. Supply and demand remain well balanced, although activities in the primary market in Asia started to pick up in May and may put upward pressure on spreads going forward.

Valuations in Asian credit are already tight and are one of the main reasons why we are taking a neutral view on the market, despite the recent outperformance. We currently see value in longer-dated Chinese quasi-sovereign financials and remain

underweight high yield. The main risk to our market assessment would be a potential US rate hike, which might put pressure on Asian currencies.

In summary, although the rally of the past few months has removed some of the relative value in the market, we remain optimistic on global credit. Therefore, some profit taking, ahead of an eventful month seems justified, although we remain risk-on for credit.

Discussion Points

Implications of the UK's EU referendum for the European credit market

At the time of writing, bookmakers in the UK viewed the possibility of 'Brexit' as low. The betting exchange company Betfair currently quotes 1.35/1 for the UK to 'remain' in the EU and 3.75 for the UK to 'leave'. Polls, on the other hand, currently present a more mixed picture, with the 'remain' and 'leave' polling being much closer at almost a 50/50 split.

Were Brexit to occur, the initial reaction of the European credit market would probably be negative, with spreads widening. We have already seen spreads in some parts of European credit markets (i.e. UK banks) widening this year due to concerns that the UK will vote to leave the EU. However, the CSPP launched in March has expanded the ECB's QE asset purchases to include corporate bonds. We believe this should allow spreads and volatility to recover quickly.

In the context of bond issuance, issuers may want to consider preparing for the consequences of an exit. New issue volumes could decline, as issuers will assess the market impact carefully and be reluctant to issue due to this uncertainty. However, it should be noted that the new-issue market has seemed to revive in recent weeks and this has been partly helped by the CSPP. New issuance since the announcement of the policy has totalled EUR 22 billion, with issuers taking advantage of the increasingly favourable market conditions ahead of the start of the CSPP in June.

It has been widely accepted by commentators that Brexit could have a negative impact in the short term on the British economy and currency. We might also see some safe-haven trades into European credit. We would expect British issuers in EUR and GBP issues to underperform European/EUR issuers.

Companies within Europe may also be affected. A key theme in the European credit market is that investment-grade companies often have international exposure and rely on their international trade relationships. However, high yield companies are usually more focused on domestic markets. As such, investment-grade companies might be more affected than high yield companies if Brexit were to take place.

If Britain does vote to leave the EU, London's financial centre faces losing some of its top revenue generators given its huge trade in Euro-denominated bonds and derivatives. This is because if Brexit were to take place, EU countries will be pushing hard for that business to move back to the continent. Some banks (such as Deutsche Bank and ING) have announced already that they will move their European fixed income trading to a destination within the EU and potentially many more could follow.

Therefore, a 'leave' vote is a distinct possibility and is something European credit investors should be prepared for, including all the ramifications that they could be potentially exposed to.

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