

# GLOBAL FIXED INCOME & CREDIT OUTLOOK

November 2016

## Recent Developments

### Fixed Income

\* German 10-year Bunds have started to enter positive territory. \* The Federal Reserve is likely to hike rates in December - but inflation could be affected by the OPEC meeting at the end of November. \* UK currency and bond markets have underperformed despite the relative resilience of the UK economy since the Brexit result. \* We currently hold a cautious view on Emerging Markets, apart from Poland relative to the Euro.

### Credit

October was another difficult month for Global credit markets, in particular for Investment Grade bonds. By contrast, more risky High Yield bonds outperformed. In terms of sector results, financial issuers outperformed.

## Key Factors

- German 10-year Bunds entering positive territory
- US inflation & December US Federal Reserve rate hike
- Central bank policy in New Zealand & Canada
- UK economy & EU negotiations
- More cautious on EM due to the US election
- Poland showing positive fundamentals

## Developed Markets

### German 10 Year Bunds & US yield curve

Global bond markets were a major discussion point this month with German 10-year Bund yields moving back into positive territory and the US yield curve shifting upwards.

### Federal Reserve rate hike in December

There is a strong consensus that the probability of a December interest rate hike from the Federal Reserve (Fed) is extremely high and inflationary concerns are now growing, driven mostly by higher wage costs. Over the coming months, oil could either be a key driver of inflation, or have little impact, depending on whether Brent crude prices are closer to \$40 or \$50 a barrel. The OPEC meeting at the end of November will be an important determinant of this.

### Pressure on New Zealand and Canada

We continue to have a negative outlook on New Zealand and Canada. The Reserve Bank of New Zealand cut rates to 2.00%, with a further 0.25% cut expected in November. This is despite domestic data suggesting that we may be coming to the end of the easing cycle. In Canada, because of the weakness in economic growth, we should see pressure building on the Royal Bank of Canada for monetary policy intervention.

### UK underperformance despite resilience

The UK, bond and currency markets have been clear underperformers as concerns about the negotiations with the EU have grown. Although, we remain UW in the UK, we have reduced the size of this position to reflect the extent of the recent underperformance and the continued resilient economy.

## Global Fixed Income

### Current Views

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

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

## Emerging Markets

### Caution on EMs due to US election and Fed rate hike

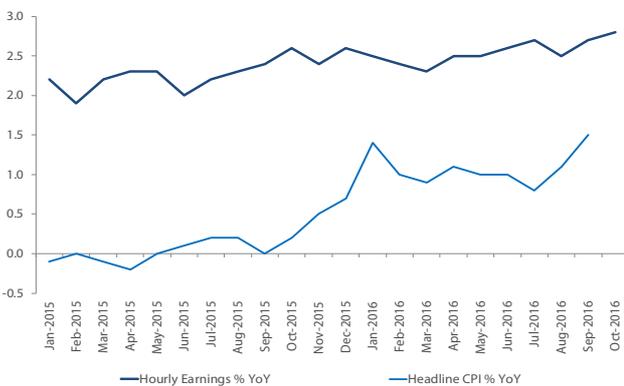
We had become more cautious on our macro positioning in EMs given the probable binary impact of the US election. This reflected the negative impact a surprise that Trump victory would have for Emerging Market assets, and the potential for a Fed rate hike in December. This factor led us to neutralise our positions in South Africa and Mexico before November 8<sup>th</sup>.

### More optimism in Poland

One market where we are positive is Poland - especially in comparison to the Euro. Higher yields and strong growth should see the Zloty's performance improve in coming months.

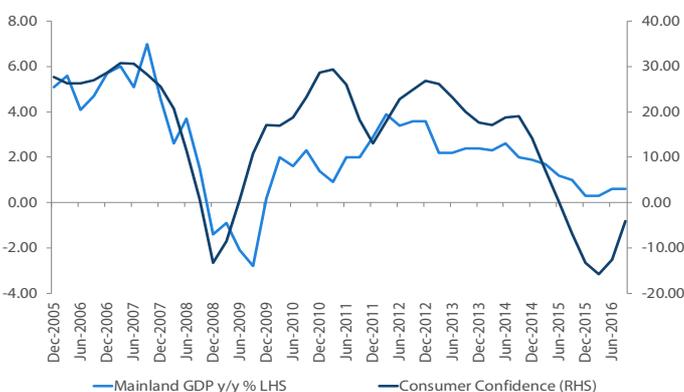
## Discussion Points

**1) US Inflation & Wages:** inflationary pressures appear to be growing in the US. Wages are starting to trend upward as the labour market slowly tightens. The impact of a rising oil price will also contribute to the YoY rate of inflation in coming months. The November OPEC meeting will be an important factor. If production cuts are enforced, causing a price above \$50/bbl, this could change the short-term inflationary outlook.



Source: Bloomberg

### 2) Norway GDP and Consumer confidence

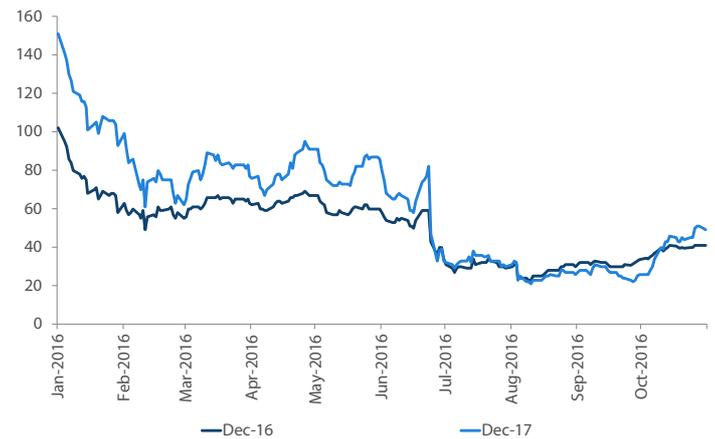


Source: Bloomberg

Mainland GDP has stabilised but consumer confidence is now accelerating. We believe that Norges Bank could now be at the end of its easing cycle.

### 3) UK Interest rate futures

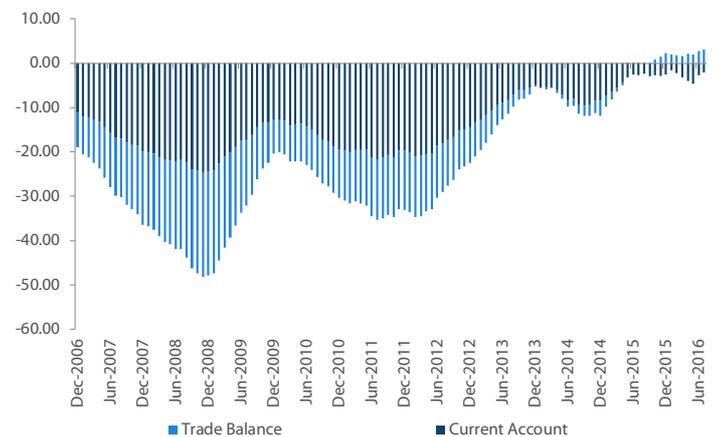
Rising inflation and a more resilient economy than expected in the UK, has caused markets to price out further interest rate cuts, which has in turn weighed down on UK bond markets. Sterling has continued to drop, though, as uncertainty has eroded investor demand.



Source: Bloomberg

### 4) Poland: Improving trade and current account balance

The Polish economy is growing strongly and the country's current account has moved into balance, driven by a strong ongoing positive shift in the trade surplus. This should support the Zloty vs the Euro.



Source: Bloomberg

## Global Credit

### Key Views

- Valuation in Asia remains expensive and our positioning remains defensive
- We view US BB- rated bonds as one of the most attractive investment opportunities
- US credit still looks attractive compared to other markets and offers compensation for the prevailing risk factors

October was another difficult month for global credit markets, with Investment Grade (IG) bonds suffering in particular. Total returns for the latter turned negative, driven by a rise of 10-15 bps in risk free rates across developed markets. Latin America was the main exception to this, with strong excess returns overcompensating for rising yields. All other markets reported similar lacklustre returns for October. The worst performing sub-segment was Sterling corporate bonds, which lost more than 3.5%, caused by increased expectation of a "hard BREXIT". In general, the drivers for the rise in yields were: higher inflation reports across the globe and growing uncertainty about the future direction of central bank policies. In contrast, more risky High Yield (HY) bonds performed better than IG. This was especially witnessed in European HY issuers where strong returns were recorded. However even the HY segment was negatively impacted by the rise in rates. In terms of sector performance, financials outperformed, as earnings for the Q3 came in stronger than anticipated, and the profitability outlook brightened on the back of rising rate expectations.

### Europe

Our view on the European credit market remains positive as the European Central Bank's (ECB) Corporate Sector Purchase Program (CSPP) continued to support credit spreads in October. The overall purchased volume so far has exceeded expectations. Nevertheless, political risk looms high for European markets and could negatively impact spreads. In particular, December's Senate referendum in Italy could influence performance. In addition, the last ECB's lending survey points to a tightening of lending conditions in the Eurozone. As valuations for IG have become extremely tight, we are seeking opportunities in HY, especially for crossover and subordinated bonds.

### Japan

The Japanese economy continues to grow despite the strong JPY negatively impacting the export sector. Nevertheless, credit quality for most exporters should remain stable, as the JPY remains in the 100-105 range. Beside solid credit quality, we also expect the technicals for Japanese corporate bonds to remain favourable. However valuations remain expensive, as the Bank of Japan continues to buy corporate bonds at the short end of the curve.

### US

Macro data in the US showed an improving trend last month, as ISM indices recovered from a weaker level in September.

However corporate fundamentals remain under pressure, due to increased M&A activity and a high level of corporate defaults in the energy sector. The result of the Presidential election will do little to reduce these uncertainties. In addition, outflows from retail funds and heavy new issuance activity put pressure on technicals. Despite this, excess returns for US credit remained positive, as attractive valuations were driving demand for the asset class. In particular, the energy sector outperformed in October, and bank bonds also benefitted from strong Q3 corporate results. Currently, we view US BB-rated bonds as one of the most attractive investment areas, given stable fundamentals and the appealing valuation levels.

### South America

In Latin America, we expect Brazil and Argentina to rebound from recession in 2017. Monetary easing, reduced political uncertainty, reform activity and infrastructure investment should support both countries. The turnaround would create attractive opportunities in the corporate bond market. Brazilian banks, as well as oil companies, could benefit. Beside Brazil's and Argentina's recovery, growth in Mexico remains steady, driven by strong domestic consumption. However, Trump's victory will continue to hurt the Peso. Mexican building material companies currently look attractive.

### Australia

Australia's economy has stabilised, as the strength in the housing market has offset weakness in the commodity sectors. In addition, the weak AUD is still supporting corporates. Nevertheless, the looming sovereign downgrade by S&P could result in negative ratings in the domestic banking sector. Beside domestic banks, we have also turned more cautious on some of the mining companies, as the spread rally has reduced their attractiveness from a valuations standpoint. New issuance in the coming weeks could represent attractive alternatives. October brought out some interesting new deals in the transportation and airport sector, and we expect this trend to continue. We also see value in selective subordinated insurance bonds.

### Asia ex Japan

Asia continued to grow last month as commodity prices stabilised and benign inflation allowed continued monetary accommodation in some countries such as Singapore, India and Indonesia. Currencies remained range-bound in October, even as the USD continued to strengthen. On the negative side, concerns over Philippine foreign policy (given President Duterte's recent remarks) weighed on the local bond market and credit spreads widened. Solid macroeconomic data were partly offset by weaker micro data, but Q3 earnings are expected to show some improvement. In particular, commodity related issuers should benefit from price recoveries. Asian markets have absorbed the recent increase in supply fairly well, as positive inflows from developed markets have helped to support bond demand. Nevertheless, valuations remain expensive and our positioning remains defensive, with underweights for Philippine bonds and Chinese property issuers.

## Finally...the Italian Referendum

In Europe, the most prominent event will be the Italian referendum on Italian Prime Minister Renzi's constitutional reforms. The key component of the reform would be the abolition of the "perfect bicameralism" that gives the lower and upper house equal status within Italian constitutional law. Under the existing system, both houses have legislative competence. In the past, differing majorities in both chambers led to mutual blockage of new laws and lengthy mediation processes. Renzi wants to streamline the approval process for new laws by watering down the constitutional rights of the Senate.

A successful referendum on constitutional reforms would reduce the Senate to a small regional assembly with competences largely confined to laws applying to the local level. The referendum goes hand in hand with electoral reform, although this is not an actual part of the referendum. This reform aims to ensure that the winning party of a general election will reign with a clear majority. If a party wins more than 40% of votes, it will receive 340 seats in the lower house out of 630 seats. If no party reaches 40% in the first round, the two most voted parties will enter into a second round. The winner will then receive 327 seats. No party or coalition will enter the lower house if they receive less than 3% of the votes casted.

At the moment, polls show a small lead for the No campaign, although almost 1/3 of voters are still undecided. Initially, Renzi linked his political career to the outcome of the referendum, but his stance has since been toned down and is expected to remain in office even if he were to lose the referendum. Nevertheless, his position would be considerably weaker and the momentum in his reform efforts is greatly reduced.

Before and after the referendum, we expect rates as well as credit markets to be affected by the inevitable uncertainty that the prospect of such major change would bring, with any impact expected to be felt in all Italian bonds, and potentially in the Eurozone market as a whole.

## About Nikko Asset Management

Nikko Asset Management, together with its investment advisory affiliates, has 206 investment professionals around the world and approximately USD 176.3 billion in assets under management or supervision as of 30 September 2016. Nikko Asset Management strives to provide outstanding long-term performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes governments, institutions, corporations and private individuals worldwide. For more information, please contact us using the details below or visit our website at [www.nikkoam.co.uk](http://www.nikkoam.co.uk)

## Contact Us

**Nikko Asset Management Europe Ltd**  
 1 London Wall, London, EC2Y 5AD  
 Phone: +44 (0)20 7796 9866  
 Fax: +44 (0)20 7796 9816  
 Email: [Emarketing@nikkoam.com](mailto:Emarketing@nikkoam.com)

## About the Global Fixed Income Team

### Andre Severino

*Co-Head of Global Fixed Income*

### Holger Mertens

*Head Portfolio Manager, Global Credit, CFA*

### Steve Williams

*Head Portfolio Manager, Core Markets*

### Raphael Marechal

*Head Portfolio Manager, Global Emerging Markets*

### Simon Down

*Senior Portfolio Manager, CFA*

## Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (**Nikko AM**) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor a guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

**Japan:** The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

**United Kingdom and rest of Europe:** This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

**United States:** This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity.

**Singapore:** This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you.

**Hong Kong:** This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you

should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong.

**Australia:** Nikko AM Limited ABN 99 003 376 252 (**Nikko AM Australia**) is responsible for the distribution of this information in Australia. **Nikko AM Australia** holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

**New Zealand:** Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor's objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website [www.nikkoam.co.nz](http://www.nikkoam.co.nz)).