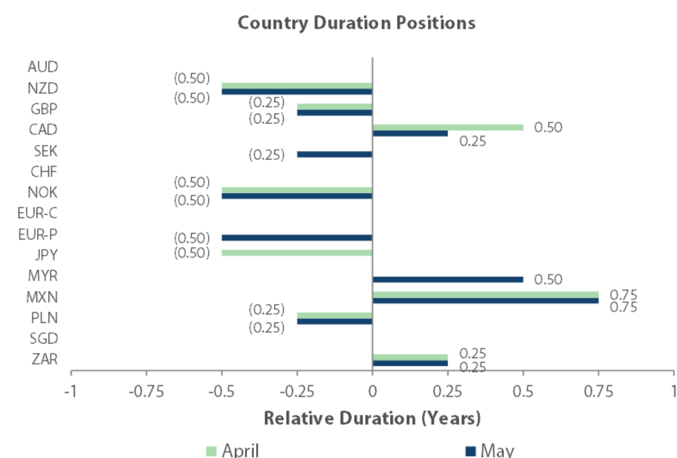
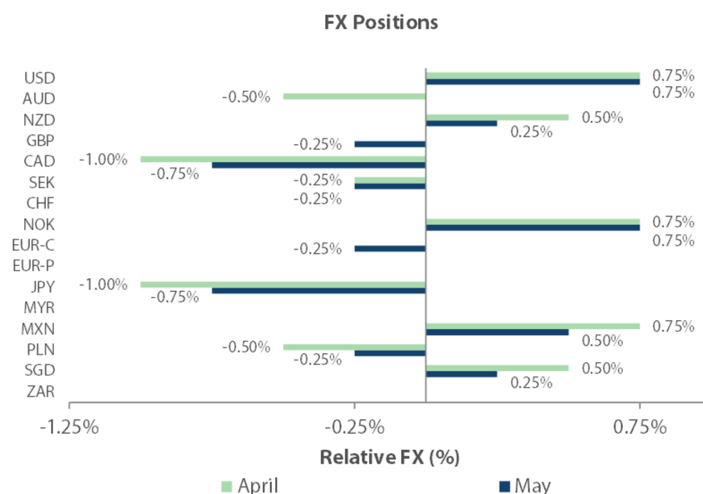
GLOBAL FIXED INCOME & CREDIT OUTLOOK





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Global Outlook

Global growth is becoming increasingly less synchronized, with the Eurozone, Japan and UK showing some moderation in growth, whilst the US remains relatively robust. Unfavorable weather conditions, mainly in Europe, earlier in the year led to output disruptions within the manufacturing sector; though the negative impact should only temporary we are also seeing softening of confidence indicators which could continue to weigh on activity. Nevertheless, generally still benign global financial conditions, including highly accommodative monetary policy in the Eurozone and Japan should see growth recover later this year. One of the most instrumental factors that continues to underpin the global growth acceleration has been a notable recovery in global capital spending, which has been supported by cheap financing, leading to rising profits and improved business sentiment across both developed and emerging markets. 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.

Firmer commodity prices this year have seen a rise in global headline inflation (albeit from a low base) reducing the risk of deflationary expectations becoming entrenched. Higher geopolitical risks related to the Syrian war, Iran nuclear deal and Venezuelan crisis, have all lent support to crude oil, which is likely to push headline inflation higher in the coming months. Global core inflation, however, remains subdued, but the broad based improvement in labor market conditions across the globe is starting to put upward pressure on global wage dynamics. The still robust outlook for both real economic activity coupled with higher inflation should see a number of major central banks continue to look to scale back from their highly accommodative policy stance over the course of the year, putting sustained pressure on global bonds.

One risk to the global growth outlook has surfaced in recent months in the form of increased protectionism. The recent removal of exemptions from tariffs on imported steel and aluminum by the Trump administration for Mexico, Canada and the EU, has increased trade tensions anew after something of a lull. The potential imposition of a further $100bn of tariffs against China, in addition to a previously announced $50bn, appears to be directly aimed at China's alleged intellectual property rights violations. This previously proposed set of tariffs, resulted in China threatening to retaliate in full force, with many investors now feeling anxious about the escalation in the trade war rhetoric between the world's two largest economies. US trade delegates are negotiating with their Chinese counterparts with the aim of coming to an amicable agreement on trade arrangements and hopefully, in turn, mitigate the negative impact that an increase in global protectionism could have for the global economy.

In the US, with the Federal Reserve Chairman Jerome Powell suggesting that the US economic outlook has improved substantially, the Fed is on course for a further two or three interest rate rises this year, following a hike in March. The outlook for inflation also continues to rise and with the domestic labour market showing no signs of cooling. We continue to believe that the broad based strength of the economy, as evidenced by tightening labour market conditions, improved household spending and larger fixed

capital investment; together with a higher inflation trajectory, should see the Fed deliver a total of four hikes this year. Despite the bond market sell off so far this year, we continue to believe that the ongoing normalization of interest rates by the Fed, in conjunction with its balance sheet reduction should result in continual pressure on US treasuries over the course of the year, though we are cognizant that our indicators do suggest that a degree of value has been restored, and that the scale of further moves higher in yields could be rather limited at this stage.

Despite moderation in economic activity, partly caused by weather related anomalies this year, growth momentum across the Eurozone remains reasonably strong. This together with the ongoing tightening of labour market conditions ought to see the European Central Bank (ECB) reduce its Quantitative Easing (QE) program, halting net purchases by the end of 2018. A rate hike is likely to follow, but not until next year. Headline inflation is starting to show signs of life, primarily driven by higher commodity prices, estimated at 1.9% y/y as of May. More critical for policy however, core inflation remains relatively stable, at 1.1%; with Q1 Eurozone GDP running at 2.5% y/y. Political risks have also escalated in recent months with the formation of a populist government in Italy and change of leadership in Spain, which may give the ECB cause for delay.

In Japan, labour market conditions remain tight, on the back of a demography related declining supply of workers. The ratio of open jobs to applicants stands at close to 1.6, a level that surpasses the bubble peak recorded in the mid-90s, yet wage pressures remain nowhere in sight. The BoJ Governor Kuroda has suggested that inflation remains on the right path to satisfy its official 2% target, yet the timing by which inflation hits this target, initially set at 2019-20, has now been removed. As such, withdrawing monetary accommodation at this stage would certainly be premature. The BoJ, has however continued to reduce the total amount of bonds purchases. In our view, the move by the BoJ is an adjustment to reality, as opposed to some meaningful shift in its monetary policy.

In Emerging Markets, growth is forecast to be slightly higher than in 2017, at circa 5%. Despite China being projected to slow down further this year, as authorities focus on the quality rather than the quantity of growth, with particular focus on reducing financial instability and pollution; EM ex-China should continue to improve, driven mainly by improving domestic demand. EM inflation should also continue to move higher in 2018, but the increase will not be broad-based. The end of disinflation will see further monetary policy divergence within EM. With a number of countries continuing to hike their policy rates in order to restore positive real yields, on the back of rising DM rates. EM FX should, therefore, recover, as they maintain their higher real yield relative to DM. Currencies of commodity exporters, on the other hand, which generally already offer high real yields, should continue to benefit from stronger commodity prices.

Developed Markets Positioning

We moved our neutral US duration position back to an underweight. This was based on the belief that there was a lack of term premium and due to the risk of rising headline inflation over the next several months could lead to higher US interest rates. The team has moved their view to alight with their long dollar bias on expectation of a stronger USD will be buoyed by rising interest rate differentials and a softening of Emerging and peripheral European economies. The team has noted that headline CPI will likely pear at north of 3.3% sometime during this summer and will begin to decline during the second half of the year as higher year-on-year oil prices will have a more diminished effect in the latter half of the year.

On Europe, we decided to take a portion of the profit made in our underweight Euro position as technical valuations on absolute level warranted taking profit. However, the team has maintained its underweight positon in the Euro due to the increasing turmoil surrounding the current political situation in Italy. The team has introduced a separation of core and peripheral Europe in its duration process notably underweighting periphery, maintaining existing portfolio positioning, and preserving its neutral weight in European core duration from the previous month's meeting.

In New Zealand, the team has maintained its underweight positioning as Kiwi rates markets screens as one of the most expensive in developed markets on its recent rally in rates while concurrently reducing its overweight bias on the increased uncertainty surrounding monetary policy with Adrian Orr as the new head of the Central Bank. While the team maintains a positive view on the New Zealand dollar over the longer term, the team has decided to reduce positioning given the increased volatility and uncertainty.

In Australia, the team has maintained its neutral duration positioning and neutralized its underweight FX positioning to lock in profit on the recent sell-off. The team has noted conflicting data as rates through US levels conflict with stronger commodity prices leading to a lack of directional bias on the Australian dollar.

The team has shifted to an underweight bias on Sterling on the political stalemate between Theresa May, Parliament and the EU as the push for Brexit policy is currently in conflict with the desire to stay in the customs union and a lack of clarity surrounding the border with Northern Ireland.

The team remained quite positive of the Norwegian Krona and one of the team's conviction selections on the month as the Krona has yet to catch up with the recent rally in Brent oil. Additionally it's worth noting the Norges bank has become increasingly hawkish hinting that it may be apt to hike earlier than its aforementioned September expectation.

The team was particularly negative on Canada as the team views the market implied rate hikes are far too aggressively priced in given the slowing data, potential risk from NAFTA and the lack of Oil sands benefit from the recent resurgence in the price of oil given their high overall cost of operation.

The team has maintained its negative view on the Japanese Yen on increased US Japan interest differentials, but has reduced its underweight slightly on a take profit motive. The team noted concerns on the increasing risk-off market environment as well as political risk uncertainty surrounding the future of Abe as the leader of LDP. Recent economic data supports the team's negative bias as both slower GDP growth and weaker inflation data support the notion of continued BOJ stimulus.

Emerging Markets Positioning

In Emerging Markets we maintain a generally constructive view on FX due to widening growth differentials relative to developed markets, though we have reduced our bullish stance somewhat of late given concerns over a tightening of US monetary policy and escalating trade tensions. We also remain selectively bullish on a number of EM rates markets as despite greater risks from the external environment inflation dynamics remain highly divergent with disinflation facilitating a more dovish stance in a select few countries.

We remain neutral on the Malaysian Ringgit as its recent outperformance looks stretched, with valuations no longer excessively cheap, as well as an increase in political uncertainty. Following earlier strength, the manufacturing side of the economy has slowed somewhat of late as global technology demand enters a soft-patch; nevertheless, this is likely to be offset by a strong rebound in energy prices. We expect the Ringgit to continue to closely track the Chinese Renminbi which may exhibit a slight weakening bias as it has strengthened relative to its reference currency basket. Bank Negara Malaysia 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. Following the surprise election victory for the opposition Pakatan Harapan coalition the Goods and Services tax is set to be repealed which will likely cause a mild deterioration in the government's fiscal position, offset by lower inflation for consumers. Hence, we have turned more bullish on Malaysian rates.

We have reduced our overweight in the Mexican Peso due to greater uncertainty regarding trade and politics. Overall, however, we remain constructive 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 high on the currency, with a termination of the deal still highly unlikely. Concerns regarding the rise of leftist Andrés Manuel López Obrador (AMLO) in the polls has also rattled investors of late, however, with the lack of congressional support, we expect that AMLO will likely moderate his stance towards both NAFTA and energy reforms. Meanwhile, inflation continues to move lower, giving us more confidence in maintaining our long duration trade, with real yields now approaching 4% vs. core CPI.

We have reduced our bearish take on the Polish Zloty as despite a slowing growth momentum of late, political risks with respect to the triggering of Article 7 proceedings from the European Union in relation to alleged breaches of "Rule of Law" principles have receded somewhat. However, risks remain as the latest EU draft budget proposal for 2021-2027 indicates a material shift of funds away from Central and Eastern European (CEE) countries, such as Poland, towards southern Europe. We also remain underweight duration in Poland as despite the recent softening of inflation data, underlying inflationary pressures remain due to robust domestic demand and tightening labour markets, with valuations also stretched.

We reduced our overweight on the Singapore Dollar as slowing external demand has weighed on the electronic sector this year with a softening of domestic consumption of late as well. As expected the Monetary Authority of Singapore moved to a positive appreciation bias in April, which should still see the Singapore Dollar outperform its regional peers. We remain neutral on duration despite a softening of inflation of late due to rich valuations and high correlation with US Treasuries.

Finally, we remain neutral on the South African Rand 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 remaining low, close to the mid-point of the SARB's inflation target, and growth disappointing of late, the SARB are unlikely to hike rates.

Global Credit Positioning

Since our last Global Credit meeting, we saw performance under pressure in Asia credit markets, but it was still able to outperform other EM credit regions such as LATAM, where yield to risk is much higher. In terms of absolute returns US, Asia and LATAM (markets bound by USD) performance was hit by rates. The European market outperformed its dollar counterparts and we expect this divergence of European markets outperforming US credit in rates terms to remain that way in the short term foreseeable future. Elsewhere US High Yield was a strong performing market where it was the only market to make a positive absolute return in the period. Outflows in US High Yield has seen to stabilized especially in the retail sector, growth has settled and so far in recent Q1 earning season we have witnessed solid results so far from US corporates. European Invested Grade has also performed admirably, where we must question whether if QE has been a significant catalyst to this performance. Over the period there are 4 themes that we would like to focus on in Global Credit markets; the outperformance of Asia Credit in relation to other markets in EM, the underwhelming supply of Credit globally. The risk posed by the situation currently in Italy and the continued support of the ECB.

Asia Credit has performed better than its EM counterparts in recent weeks. This trend has occurred due to the welcomed support from international investors (mainly US & Europe) who have recently come back into investing in Asia credit markets. A theme we have noticed globally is supply has been underwhelming in recent weeks. Supply for the year has not been as high as it was by this point in 2017, and of that we have noticed supply in Australia (particularly in Australia market) has tended to be dominated by financials. Spreads at

this time remain unconvincing and still not quite wide enough to justify investing.

Moving onto Europe, towards the end of May we saw heightened political risk in Italy, where the anti-establishment 5 Star Movement and the far-right League agreeing to build a coalition. The new Eurosceptic Government is only populist in the name, with the new cabinet consisting of 40-50% technocrats. Although it might work, you cannot rule out the agreement not working and a snap election being called. The question of unknown caused volatility in the markets and spreads to widen.

On this note, the volatility that was caused led to questions as to whether the ECB would manage the volatility through buying Italian bonds or give more dovish comments of a softer taper which would support the market.

About the Global Fixed Income Team

Andre Severino
Global Head of Fixed Income

Holger Mertens
Head Portfolio Manager, Global Credit, CFA

Steven Williams
Head Portfolio Manager, Core Markets

Raphael Marechal
Head Portfolio Manager, Global Emerging Markets

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