Western Asset Management

July 2018

# GLOBAL FIXED INCOME REVIEW

- US economic reports remained upbeat with GDP growing 4.1% in 2Q18.
- The BoJ introduced more flexibility in its yield curve control policy.
- Global growth fears abated somewhat as trade tensions eased.
- Major government bond yields rose.
- The US yield curve continued to flatten.
- Spread sectors recovered and posted strong returns.
- Most EM currencies rebounded versus the US dollar.

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# MARKET REVIEW

Global yields remained volatile as the market navigated the crosscurrents of greater optimism on US growth against concerns around escalating trade tensions and weaker data from China. As growth fears outside of the US abated somewhat during the month, credit spreads tightened and emerging market (EM) bonds and currencies rebounded. Developed government bond yields rose with German bunds slightly underperforming US Treasuries (USTs). US economic reports generally exceeded expectations with employment data, consumer spending and manufacturing reports coming in better than expected. The US GDP grew by 4.1% in 2Q18, albeit boosted by a number of one-time adjustments. The European Central Bank (ECB) meeting was a non-event with policy effectively on autopilot until the end of the summer recess. The Bank of Japan (BoJ) introduced enhancements to its monetary easing framework with new forward guidance to keep rates low for an extended period, as well as more flexibility in its yield curve control and ETF purchase operations.

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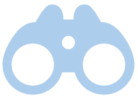

# MARKET OUTLOOK

Notwithstanding the improved near term growth outlook in the US, we see little evidence that recent tax changes and government spending will materially improve the longer term trajectory for the economy. Absent any meaningful acceleration in nominal GDP, we view the expected uptick in inflation this year as merely a move back to more normal levels as the economy heals; we believe this scenario is fully priced into the forward markets. We continue to believe the US Federal Reserve (Fed) will not hike past its own estimate of neutral policy rates and that this should continue to support UST yields. With the flattening of the US yield curve in recent years, over the past few months we have reduced duration in US long bonds in favor of shorter maturities.

In Europe, despite the recent dovish ECB meeting, we remain confident that growth data will improve in the second half of 2018, led predominantly by domestic consumption and investment. We believe firmer ECB forward guidance is supportive for higher-yielding eurozone government bond markets and have added to Italian bonds in a prudent fashion. An improving economy coupled with very supportive monetary conditions should support inflation rising towards the ECB's target. Under this scenario we expect steeper curves and higher German yields towards year-end.

In line with recent forward guidance, we expect the BoJ to maintain its accommodative monetary policy for some time to meet its 2% inflation goal. With 10-year nominal yields capped around 0.0%, we expect the nominal yield curve to steepen over time and real yields to decline and maintain exposure to Japanese inflation-linked bonds.

We view spread widening seen in 2018 and the increase in new-issue premiums as an opportunity to add to investment-grade credit exposure. We remain cautious about the potential for further M&A and shareholder-friendly activities in certain industrial sectors such as healthcare/pharmaceuticals and telecommunications. The largest sector bias remains in the financial sector, where deleveraging, capital build and regulatory constraint remain credit-positive.

We also remain comfortable maintaining a modest overweight in the energy and metals/mining sectors where many issuers remain in deleveraging mode.

In currency markets, we continue to believe the long-term trend for the US dollar to weaken as Fed policy normalization is fully priced and growth expectations outside of the US are likely to improve over the coming quarters. Recent political developments in Italy had reignited concerns over the sustainability of the single currency. The new government, however, is expected to produce a 2019 budget that appeases the rating agencies as well as the markets and we will look for opportunities to reinstate an overweight position in the euro.

EM bond markets have underperformed recently on global growth fears with a number of isolated stories further contributing to weakness. We remain mindful of the downside risks to growth from an escalation in global trade tensions, but over the longer term we remain constructive on EM debt and currencies given steady EM growth, improved external accounts, prudent fiscal policy and advantageous positive real rates.

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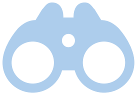

Risks to our view include a stronger US growth and inflation outcome or a material downshift in the European economy that would push the US versus Germany spread wider. A global growth shock could also create challenges which is why we continue to own high-quality duration for diversification.

Global portfolios remain positioned with a modest overweight to spread sectors, in particular select EM USD- and local-currency-denominated bonds, to take advantage of attractive valuations. We continue to look for opportunities to benefit from market anomalies. Our focus remains on longer-term fundamentals with diversified strategies to manage risk.

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