Western Asset Management

November 2017

GLOBAL FIXED INCOME REVIEW

- Global bonds posted modest positive returns.
- Jerome Powell was nominated as the next Fed Chair.
- Subordinated financials and Emerging Markets (EM) bonds outperformed.
- The US dollar weakened versus most major currencies.
- The extraordinary monetary policy effort to arrest the decline of inflation in developed nations appears to be bearing fruit. There is also room for optimism on the global recovery front, but secular challenges persist.

MARKET REVIEW

Global bonds posted modest positive returns in November. Major government 10-year bond yields ended the month much unchanged. The US yield curve continued to flatten. Shorter-dated US Treasury yields rose as markets anticipated additional hikes from the US Federal Reserve (Fed) and optimism over a potential deal on tax reform increased. Long bond yields declined, supported by ongoing concerns over the benign global inflation environment. Jerome Powell was nominated as the next Fed Chair. In Japan, Shinzo Abe was re-elected prime minster after his Liberal Democratic Party won a resounding victory in parliamentary elections in October. Ongoing European Central Bank (ECB) asset purchases benefitted peripheral eurozone bonds and Italian spreads continued to tighten. Mexican assets recovered as the Mexican central bank announced an increase in US dollar sales to support the peso. Corporate bond spreads remained relatively stable but high-yield spreads widened modestly. Subordinated European financials outperformed, benefitting from stronger growth expectations, a more positive tone in the ongoing Brexit negotiations and as the Bank of England's 2017 stress test results indicated UK banks were not required to strengthen their capital positions further.

MARKET OUTLOOK

In our opinion, the current steady but unspectacular global growth backdrop has not materially changed. We remain optimistic that global growth of around 3% is sustainable while recognizing that high debt loads and other headwinds, including low productivity and aging populations, continue to flash a cautionary sign in many economies. Global inflation appears to have stopped declining, as the extraordinary monetary policy effort seen in developed nations finally seems to be bearing fruit. Our view, however, remains that this will be a very slow process, taking many years and continuing to require meaningful monetary and even fiscal support. This view suggests that spread sectors will continue to be preferable to holding developed market government bonds. It also suggests, though, that any meaningful or swift increase in inflation or interest rates is not imminent.

In the US, inflation has remained low even though the economy has improved. With tighter credit spreads and US dollar depreciation, financial conditions have become more accommodative despite higher short-term rates. The US Fed has been pretty clear in stating its desire to move away from emergency policy and we think this will continue with a few more slow, gradual and cautious hikes, with another increase in December this year. We remain tactical with respect to overall portfolio duration and yield-curve positioning. We maintain a long US duration position in global portfolios with a bias towards 30-year US maturities with short-duration positions in core European bonds and Japan.

Eurozone Gross Domestic Product (GDP) is growing at its fastest pace in seven years, with momentum, it seems, for further improvement. The growth dynamic is broad-based, with the reliance on net exports being dissipated as domestic demand has strengthened. Furthermore, it is not only the 'core' economies that are benefitting; the periphery economies are also on an upward trajectory. Despite the ECB extending asset purchases to September 2018 and ECB President Mario Draghi's recent dovish announcement that policy will remain accommodative until at least 2019, we believe the continued cyclical recovery aided by accommodative policy should help close the output gap further. We believe bund yields will eventually correct to reflect the possibility of policy normalization post 2019 but in the near term yields are unlikely to rise materially. We remain constructive on the Italian economic recovery story but less so on valuations. As we approach elections in the first half of 2018, the market may look to price in some additional risk premium.

In Japan, we expect growth to improve to around 1.5% to 2.0% in the context of the current fiscal and monetary policy mix and the improving global economy. Inflation remains low although it should increase gradually due to a tighter labor market and the receding effects of the decline in oil prices. We expect the Bank of Japan (BoJ) to continue with its accommodative monetary policy for some time, however, to meet its inflation goal. With 10-year nominal yields capped around 0.0% by the BoJ, we expect real yields to decline further and maintain exposure to Japanese inflation-linked bonds.

With the political risk in Europe receding overall following the outcome of the French elections, we maintain a modest long position in European currencies versus the US dollar. We maintain a short exposure to the Japanese yen as, over time, we expect the yen to continue its weakening trend versus the US dollar.

Our base case view for credit spreads remains a modestly tighter destination in the near-to-midterm, but the aggressive move tighter in spreads over the past several months has valuations nearing what can only be described as fair and we have been reducing exposure to investment-grade corporate bonds in global portfolios. We remain vigilant about global risks that may impact credit markets, such as a sharp deceleration in Chinese growth. Although the technical tailwind remains favorable as demand remains firm despite the decline in spreads, 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 continue to be constructive on EM debt as fundamentals, valuations and technicals are likely to support the asset class over the medium-term. We expect further spread compression versus developed markets. We believe EM economies have stabilized for the most part and are now better positioned to absorb shocks than at any time over the past three to four years. The stabilization in commodity prices should also provide some support to commodity-producing EM countries.

Global portfolios remain positioned with a modest overweight to spread sectors, in particular to investment-grade corporate bonds and 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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Western Asset Management

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* As of 31 October 2017.

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