Western Asset Management

June 2018

GLOBAL FIXED INCOME REVIEW

- The US Fed raised interest rates by a further 25 bps to 1.75%–2.0%.
- The ECB announced it will end QE in December 2018, but keep rates on hold until summer 2019.
- Global trade tensions continued to escalate.
- Major government bond yields ended the month broadly unchanged.
- Spread sectors posted mixed returns; EM sovereign issues underperformed.
- The US dollar strengthened.

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MARKET REVIEW

Major government yields rose in the first half of June as Italian political risks receded and the US Federal Reserve (Fed) raised interest rates by a further 0.25% to 1.75%-2.0%. Fed Chair Jerome Powell described the US economy as "very strong" and the median expectations for further rate hikes in 2018 and 2019 were revised higher. Later on in the month risk markets traded poorly in response to rising fears over an escalation in trade wars between the US and China, and government yields receded while corporate bonds underperformed. The US yield curve flattened as shorter-dated issues rose but yields on longer-dated issues ended the month modestly lower. The European yield curve steepened following the European Central Bank's (ECB) dovish policy meeting mid-month. While the ECB announced net asset purchases will be tapered to €15 billion per month starting in October and quantitative easing (QE) is likely to end in December, it made a strong commitment to keep policy rates unchanged at least through the summer of 2019. Emerging markets (EM) posted mixed returns but in general ended the month weaker. There were some exceptions; for example, in Mexico where the currency stabilized and yields declined despite the general election in early July. Currency markets produced mixed results although currencies highly geared towards Chinese growth, such as the Korean won and Australian dollar, materially underperformed towards month-end.

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MARKET OUTLOOK

Recent changes to US fiscal policy are likely to improve the near-term growth outlook, but are unlikely to materially improve the longer-term growth trajectory. We also believe this economic cycle will extend much further before we see signs of inflationary pressures building simply because the magnitude of growth created in the last nine years has been so low relative to what has been experienced in previous cycles. Absent an acceleration in nominal GDP, we view the expected uptick in inflation this year as merely a move back to more normal levels while the economy heals and is fully priced into forward markets. Despite our below-consensus view on growth and inflation we remain optimists on select risk assets. If the economy continues to improve as we expect and policy is adjusted at a gradual pace, investment-grade corporate bonds and government bond yields should remain well supported. With the flattening of the US yield curve over recent years and forward bond yields above the Fed's long-run expectation of 2.9%, 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 Japan, we believe the slowdown in growth is temporary and expect growth to improve to around 1.5% to 2.0% in the context of the current fiscal and monetary policy mix. Inflation remains low although it should increase gradually due to a tighter labor market and the recent increase in oil prices. We expect the Bank of Japan (BoJ) to continue with its accommodative monetary policy for some time, however, to meet its 2% inflation goal. With 10-year nominal yields capped around 0.0% by the BoJ, we expect the nominal yield curve to steepen and real yields to decline and maintain exposure to Japanese inflation-linked bonds.

We view the recent spread widening and 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.

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 now 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. Over the longer term, we remain constructive on EM debt and currencies given steady EM

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growth, improved external accounts, prudent fiscal policy and advantageous positive real rates.

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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