LEGG MASON
GLOBAL ASSET MANAGEMENT

Western Asset Management

April 2018

GLOBAL FIXED INCOME REVIEW

- Fears over an acceleration in trade tensions eased.
- North and South Korea agreed to end hostilities.
- US economic data was stronger than expected.
- Economic data outside the US was generally weaker than expected.
- US Treasury yields continued to rise and the yield curve flattened further.
- The US dollar strengthened versus most currencies.

MARKET REVIEW

Economic data releases were generally stronger than expected while the sustained rally in oil prices heightened concerns around rising inflationary pressures. Economic data releases outside the US were generally weaker than expected. Possible changes to European Central Bank (ECB) guidance were not discussed by the Governing Council at its April meeting which provided support to eurozone yields and put downward pressure on the euro. In Italy, negotiations to form the next government continued but the major parties failed to find a compromise. Emerging markets (EM) underperformed, suffering from broad US dollar strength and growing fears over a more protracted global growth slowdown. The Russian ruble, in particular, was negatively impacted as the US imposed additional sanctions. Credit spreads remained resilient, with investment-grade and high-yield corporate bonds outperforming government bonds.

MARKET OUTLOOK

We continue to believe inflation in the US economy remains benign. 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 as 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 as the economy heals. If the economy continues to improve as we expect and policy is adjusted at a gradual pace, risk assets should do well and government bond yields should remain well supported. With the continued flattening of the US yield curve and forward bond yields already above the US Federal Reserve's (Fed's) long run expectation of 2.9%, we have continued to reduce duration in US long bonds in favour of shorter maturities.

Despite the recent softening, the growth dynamic in the eurozone remains broad-based, with the reliance on net exports being dissipated as domestic demand has strengthened. It is not only the "core" economies that are benefitting; the periphery economies are also on an upward trajectory. We believe the continued cyclical recovery aided by accommodative policy should help the output gap narrow further. We expect bund yields will eventually rise to reflect the possibility of policy normalization or a change in ECB guidance, but in the near term, yields are unlikely to rise materially.

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 2% 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.

In portfolios that allow credit strategies we view the recent spread widening in short-dated maturities as a buying opportunity and have added exposure where possible. Our base case view for credit spreads remains a modestly tighter destination in the near-to-midterm. 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 maintain an overweight position in the euro initiated in 1Q17. We continue to believe the long term trend for the US dollar to weaken as Fed policy normalization is fully priced and growth outside of the US is likely to improve over the coming quarters. Where possible, in the near term, we reduced US dollar underweights against currencies we believe offer diversification against further EM weakness and appear overvalued relative to fundamentals. The Australian dollar satisfies most of these conditions and we have initiated an underweight position.

We remain constructive on EM debt and currencies as fundamentals over the medium term. We believe EM economies have stabilized for the most part and are now better positioned to absorb shocks than at any other time over the past three to four years. The improvement in commodity prices should also provide support to commodity-producing EM countries. We expect further spread compression versus developed countries.

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 and the euro lower. While growth in the eurozone has decelerated from very high levels in 2017, we expect growth to remain firm later this year as lending growth remains resilient. 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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* As of 30 April 2018.

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