LEGG MASON
GLOBAL ASSET MANAGEMENT

Western Asset Management December 2017

GLOBAL FIXED INCOME REVIEW

- Global bonds posted mixed returns.
- The Fed raised rates as expected and the US tax reform bill was signed into law.
- The ECB reiterated its willingness to continue QE beyond September 2018.
- EU leaders agreed to move to the next phase of Brexit negotiations.
- Spread sectors continued to outperform.
- The US dollar weakened.

MARKET REVIEW

Global bonds posted mixed returns in December. The US Federal Reserve (Fed) raised rates as expected and kept its outlook for three rate hikes in 2018 unchanged. The US tax reform bill was finally signed into law on December 22. With inflation data remaining subdued, the US yield curve flattened as short rates rose and intermediate- to long-term rates declined. European yields rose on continued eurozone growth optimism and increasing expectations that the European Central Bank's (ECB) recent quantitative easing (QE) extension might be its last, despite the ECB reiterating its willingness to continue asset purchases after September 2018. In Italy, rising political uncertainty ahead of the March general election pushed yields sharply higher. Mexican assets continued to underperform with the Mexican peso as one of only a handful of currencies to underperform the US dollar in December. Credit markets remained firm into the year-end.

MARKET OUTLOOK

In our opinion, the current steady but unspectacular global growth backdrop has not materially changed. We remain optimistic that global growth above 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 growth outlook for 2018 looks to be another 2+% year—and with the recent tax cuts, perhaps better. We think the Fed will continue with a few more slow, gradual and cautious hikes in 2018. We remain tactical with respect to overall portfolio duration and yield-curve positioning. We maintain a long US duration position in global portfolios with short-duration positions in core European bonds and Japan.

Eurozone 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 narrow 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 and have reduced Italian overweight exposures accordingly. As we approach elections in the first half of 2018, the market may look to price in some additional risk premium and we will look to re-establish a more significant position.

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 last year, and with the market still potentially underestimating the improvement in economic data and sentiment, we maintain a modest long position in the euro 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. We expect further spread compression versus developed 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 December 2017.