Western Asset Management

September 2018

GLOBAL FIXED INCOME REVIEW

- DM government yields rose as risk sentiment improved.
- The Fed raised rates by a further 0.25%.
- EM bonds and currencies stabilized as several EM central banks raised rates.
- The US imposed additional tariffs on imports from China.
- The new Italian government released budget proposals that indicated a higher than expected budget deficit

MARKET REVIEW

Developed market (DM) government yields rose over the month as risk sentiment improved. The US Federal Reserve (Fed) raised rates by a further 0.25% to a range of 2.0%–2.25%. The Fed's forecast for the future path of interest rates was largely static but the characterization of monetary policy as being "accommodative" was removed from its statement. Despite the US imposing additional tariffs on imports from China, emerging market (EM) bonds and currencies stabilized as several EM central banks raised rates, including a surprise 6.25% rate hike in Turkey, and the International Monetary Fund's (IMF) announcement of a new financing program for Argentina. Italian bonds outperformed, but spreads over Germany rose sharply at the end of the month as the new government released budget proposals that indicated a higher than expected deficit of 2.4% of GDP. Core eurozone yields also rose as European Central Bank (ECB) President Mario Draghi described underlying inflation as "vigorous". High-yield corporate bonds and bank loans posted positive returns as demand remained strong and investment-grade corporate bonds outperformed government bonds.

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. US inflation has moved up to the Fed's 2% target, but has not shown any acceleration past it. The limited increase in inflation, even though growth has improved meaningfully, speaks to the magnitude and persistence of the long-term disinflationary pressures on the US economy. Absent any further acceleration in nominal GDP, we view the uptick in inflation as merely a move back to more normal levels as the economy heals; we believe this scenario is fully priced into the forward markets. Accordingly, we retain a long US duration bias which we also believe remains an effective hedge against risk exposures in global portfolios.

In Europe, we remain underweight 10-year German duration on our view that European data will stabilize in the second half of 2018, led predominantly by domestic consumption and investment. Overall, we expect growth of around 2.0% for 2018 and 2019. Core eurozone inflation is expected to move higher by the end of the year as spare capacity diminishes. As the market begins to look forward to a significant pick-up in net supply in 2019 with the end of the Public Sector Purchase Programme, we expect core European bond yields to move higher. While Italian yields are likely to remain volatile, ultimately we expect the Italian risk premium to recede and continue to retain a modest overweight to Italian bonds.

In line with recent forward guidance, we expect the Bank of Japan 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 remain modestly overweight in investment-grade corporate bonds. The largest sector bias remains in the financial sector, where deleveraging, capital build and regulatory constraint remain credit-positive. We also remain comfortable keeping a modest overweight in the energy and metals and mining sectors where many issuers remain in deleveraging mode. We continue to be cautious about the potential for further M&A and shareholder-friendly activities in certain industrial sectors such as healthcare/pharmaceuticals and telecommunications.

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 have reignited concerns over the sustainability of the single currency. However, we remain constructive on this front and will look for opportunities to reinstate an overweight position in the euro.

EM bond markets remain volatile 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 are still constructive on EM debt and currencies given steady EM growth, improved external accounts, prudent fiscal policy and advantageous positive real rates.

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 August 2018.