
GLOBAL FIXED INCOME REVIEW

- The Fed announced a 0.25% hike to 0.5%-0.75%.
- The ECB extended its QE asset purchases to December 2017.
- Global bonds posted mixed returns.
- Spread sectors outperformed, continuing the post-election risk-on rally.
- The US yield curve flattened.
- US growth and inflation may rise with fiscal stimulus but the optimistic scenario currently priced by markets may be overdone.
- Spread sectors are expected to continue to outperform government bonds over the longer term.



MARKET REVIEW

The US Federal Reserve (Fed) turned more hawkish, raising interest rates for the first time in a year, albeit only the second time since 2008, while predicting three further rate increases in 2017. Optimism over a pro-growth, pro-business agenda under the new US administration encouraged a further rally in US equities and credit markets while concerns over a more proactive Fed pushed shorter-dated US bond yields higher and strengthened the US dollar. Uncertainty over the new administration's trade and immigration policies continued to undermine Mexican assets. The European Central Bank (ECB) extended its quantitative easing (QE) asset purchase program at €60 billion per month from April to December 2017 and removed the deposit rate floor for bond purchases from January 2017. Although the Italian electorate voted "no" in the referendum on constitutional reforms and Prime Minister Matteo Renzi resigned, Italian government bond spreads narrowed. With a new prime minister, the government quickly established a new €20 billion fund to provide support to the Italian banking system.



MARKET OUTLOOK

Markets have priced in the expectation of an imminent and radical shift in US growth. While we don't dismiss this possibility, we also recognize that disappointment would prove painful. In our opinion, the current steady but unspectacular global growth and low inflation backdrop have not materially changed. Our working premise has been a trend growth rate of roughly 1.5% for the US and 3% for the global economy. We believe global growth of around 3% is sustainable, but high debt loads and other headwinds, including low productivity and aging populations, continue to flash a cautionary sign in many economies. We expect that any improvement in the global recovery is going to continue to take time as well as requiring ongoing policy support. While we have modestly reconfigured global portfolio positioning to reflect a stronger US growth scenario, we also recognize that the optimistic scenario reflected in current market pricing is likely to be gradual and may be overdone in the near term.

In the US, fiscal stimulus and the withdrawal of anti-growth regulations is expected to provide a more favorable climate for business and growth. If anti-globalization and foreign policy missteps are avoided, the addition of meaningful fiscal stimulus to a substantially closed economy such as that of the US—which is already operating near full employment—could become a game changer. Growth could accelerate and the Fed could tighten more meaningfully. Additionally, the disinflation backdrop could reverse, helping to boost interest rates. Igniting US growth in the context of a very weak global environment, however, has proven exceedingly difficult. The implications of labeling China a currency manipulator and the erection of trade barriers may reinforce the global risk-off episodes we have seen intermittently over the last five years. Most importantly, the market's optimistic growth expectation is based on policies that may come over the next 12 months, but the bond market has already raised interest rates today. We continue to believe the Fed will remain cautious, especially into the first half of 2017, mindful of the many unknowns surrounding the new administration's policies. We continue to hold a long US duration position in global portfolios with a bias towards 30-year US maturities, but have been switching towards 5-years as the yield curve has flattened. We maintain an allocation to US TIPS as a hedge to any unexpected rise in inflation and maintain short duration positions in core European bonds and Japan.

With long-term inflation expectations only modestly higher in Europe, the ECB has extended its QE program to December 2017. We expect the eurozone to grow at around 1.7%-2% in 2017, notwithstanding the uncertainty caused by the UK's decision to leave the EU and an increase in anti-establishment politics across the eurozone. Despite the Italian electorate voting "no" in the recent referendum on constitutional reforms, we expect the new Prime Minister Paolo Gentiloni to establish a new electoral law ahead of spring 2018 elections. Global portfolios maintain a modest long position in Italian government bonds.

In the UK, we believe Brexit-induced uncertainty is likely to slow growth to around 1.5% in 2017 as companies defer spending plans until there is more clarity over the UK's future relationship with the EU. Consumer confidence is also likely to be hit, further impacting the growth outlook. Against this, ongoing policy support by the Bank of England (BoE) should cushion the downturn and the depreciation in sterling on a trade-weighted basis over the last 18 months should support the export sector. The direct exposure in global portfolios to UK assets remains low, with investments focused primarily in financial sector



issuers. While the headwinds for the UK bank and insurance sectors have increased post the Brexit vote, and we expect further pressure on profitability, capital ratios remain solid and we are comfortable with the issuers we hold.

In Japan, we expect growth to improve to around 1% in the context of the current fiscal and monetary policy mix and the delay in the consumption tax increase. Inflation is expected to remain around 0% year-over-year (YoY) for the time being, but should increase gradually due to a tighter labor market and the recent rise in oil prices. With 10-year nominal yields capped at 0% by the Bank of Japan (BoJ), we expect real yields to decline further and maintain exposure to Japanese inflation-linked bonds.

We continue to believe that the divergence of growth and interest rate differentials between the US and Europe/Japan combined with the continued expansion of the ECB's and BoJ's balance sheets should continue to push the yen and euro weaker versus the US dollar.

US policy moving towards a looser fiscal and regulatory landscape that should be more business-friendly should also be supportive for credit markets. The technical tailwinds for credit also remain positive with strong investor inflows in search of higher-yielding assets and ongoing ECB, BoJ and BoE corporate bond purchases. After many years of supply increasing YoY, expectations are for a deceleration in the pace of new issues as we head further into 2017. While we remain vigilant that concerns over growth in China and US trade policies may reemerge, our base case view is for credit spreads to tighten further in the short to medium term. We remain overweight to financial issuers given the continued secular de-risking of that sector and attractive valuations outweighing market concerns over a move towards deregulation by the new US administration. We continue to view the overall market as being in the latter half of the credit cycle and are cautious about the potential for further M&A and shareholder-friendly activities in certain sectors such as technology and healthcare/pharmaceuticals. Energy is a sector that we believe has passed through the end of its cycle and is in deleveraging mode. We increased exposure to energy issues in global portfolios early last year with many issuers continuing to take the necessary steps towards rightsizing their operations.

The outlook for emerging market (EM) countries has become more uncertain given the potential for a diminution in global trade under the new Trump administration. The recent improvement in commodity prices should, however, provide some support to commodity producing EM countries. We believe that valuations in select EM countries remain attractive with currencies such as the Mexican peso having the potential to rebound sharply should the actual US trade and immigration policies be less harsh than the pre-election rhetoric. In Poland, decent (albeit slowing) growth and continued weak inflation make Polish rates attractive, especially relative to core eurozone yields.

Global portfolios remain positioned with an overweight to spread sectors, in particular to investment-grade corporate bonds and select EM bonds, to take advantage of attractive valuations. With volatility likely to remain elevated, 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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Clarion Partners
ClearBridge Investments
EnTrustPermal
Martin Currie
QS Investors
RARE Infrastructure
Royce & Associates
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* As of 30 November 2016.

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