Western Asset Management

February 2017

GLOBAL FIXED INCOME REVIEW

- The Fed indicated a readiness to hike rates again as financial conditions have improved.
- Political uncertainty undermined French and Italian assets.
- Global bonds posted positive returns, spread sectors outperformed and emerging market currencies posted strong returns.
- The extraordinary monetary policy effort seen in developed nations to arrest the decline in inflation appears to be bearing fruit. There is also room for optimism on the global recovery front, but secular challenges persist.

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MARKET REVIEW

Political headlines continued to dominate market sentiment. US President Donald Trump's first address to Congress struck a more conciliatory tone. Less harsh rhetoric over global trade reduced the risk premia in emerging market assets with Mexican bonds and the Mexican peso benefiting in particular. As US financial conditions continued to improve, the Federal Reserve (Fed) indicated a readiness to hike interest rates again. Shorter-dated US yields rose and the US yield curve flattened. US corporate and high-yield bonds continued to outperform despite increased expectations for Fed tightening. German government bonds outperformed other European markets as political uncertainty increased ahead of upcoming elections in France and the Netherlands, while in Italy former Prime Minister Matteo Renzi resigned as leader of the Democratic party.

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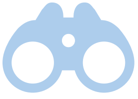

MARKET OUTLOOK

In our opinion, the current steady but unspectacular global growth backdrop has not materially changed. We remain optimistic that global growth of around 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. We remain cognizant that core global inflation remains low and policymakers must therefore continue to support recoveries meaningfully. While the US Fed is expected to continue on its path towards gradual policy normalization, in Japan and Europe we expect continued monetary support.

In the US, fiscal stimulus and the withdrawal of anti-growth regulations are 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, the disinflation backdrop could reverse and the Federal Reserve (Fed) could tighten more meaningfully. Igniting US growth in the context of a weak global environment, however, has proven exceedingly difficult. US financial conditions have improved in the past few months and the Fed has indicated a readiness to reduce policy accommodation further. Market expectations for the peak level in interest rates are now close to the Fed's own forecast. We continue to believe the Fed will remain cautious, however, 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 remain tactical with respect to overall portfolio duration and yield curve positioning. We maintain short duration positions in core European bonds and Japan.

We expect the eurozone to grow at around 1.7% to 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 uncertain political landscape, over the longer term we believe Italy will continue with its reform agenda and that valuations remain attractive versus German bonds at current levels. 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. 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 remains low but should increase gradually due to a tighter labor market and the recent rise in oil prices. With 10-year nominal yields capped around 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

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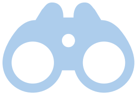

differentials between the US and Europe/Japan combined with the continued expansion of the European Central Bank's (ECB's) and BoJ's balance sheets should continue to push the yen and euro weaker versus the US dollar.

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 year-over-year, 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, and recognizing credit spreads are now closer to fair valuations overall, our base case view is for credit spreads to tighten somewhat further in medium term. The largest sector bias remains in the financial sector, where deleveraging, capital build and regulatory constraint remain credit-positive despite rising margin pressures.

The outlook for EM countries remains 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. Mexican bonds and the peso have begun to recover after weakening significantly after the US elections. We expect the worst case outcomes with respect to potential border tariffs and immigration will be avoided and Mexican assets therefore have the potential to continue to recover further. In Poland, macro fundamentals remain solid and yields are attractive in our opinion, especially versus 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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