Western Asset Management

September 2017

GLOBAL FIXED INCOME REVIEW

- Major government yields rose as global growth indicators firmed.
- The Fed articulated a very moderate plan to reduce the size of its balance sheet.
- Spread sectors outperformed.
- The US dollar recovered modestly versus most major currencies.
- The extraordinary monetary policy effort to arrest the decline of inflation in developed nations appeared to be bearing fruit. There was also room for optimism on the global recovery front, but secular challenges persisted.

MARKET REVIEW

Economic data were supportive of continued slow and steady global economic growth. In the US, manufacturing data and durable goods orders were better than expected while 2Q17 GDP was revised marginally higher. The US Federal Reserve (Fed) left rates unchanged but announced that balance sheet reduction will begin in October. Eurozone and UK economic indicators surprised to the upside with increased export activity driving growth. The Bank of England (BoE) minutes suggested the case for rate hikes had increased. Spread sectors continued to perform well despite rising geopolitical tensions, catastrophic hurricanes and earthquakes that struck the US and Mexico as well. The Trump Administration released its proposed tax reform plan that included a significant cut in corporate tax rates as well as a path for companies to efficiently repatriate overseas cash. Emerging markets (EMs) continued to perform well as oil prices picked up and concerns over US protectionist policies continued to abate.

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. 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 Fed has been pretty clear in stating its desire to move away from emergency policy and we think this will continue with a few more slow, gradual and cautious hikes, with another increase in December this year. We remain tactical with respect to overall portfolio duration and yield-curve positioning. We maintain a long US duration position in global portfolios with a bias towards 30-year US maturities with short-duration positions in core European bonds and Japan.

We expect the eurozone to continue to grow at around 1.7% to 2.0% into 2018, notwithstanding the uncertainty caused by the UK's decision to leave the EU. With deflation risks in the eurozone dissipating, however, the market's focus has shifted to when and how the European Central Bank (ECB) will normalize its monetary policy stance. While underlying measures of core inflation remain subdued, we believe the ECB will continue to keep interest rates low and we expect asset purchases to continue into 2018. 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 bunds.

In Japan, we expect growth to remain around 1% to 1.5% 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. We expect the Bank of Japan (BoJ) to continue with its accommodative monetary policy for some time to meet its inflation goal. With 10-year nominal yields capped around 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, we maintain a modest long position in European currencies versus the US dollar. We maintain a short exposure to the Japanese yen as, over time, we still 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. We remain vigilant about global risks that may impact credit markets, such as a sharp deceleration in Chinese growth. 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.

Global portfolios remain positioned with an 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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