NOMURA

Global Fixed Income – Reflections on 2017 and Market Outlook

Key takeaways:

1. Expect rising yields, but no drama – periods of volatility to be short-lived
2. Fed Funds rate above 2% likely in 2018
3. Major risk scenario: excessive monetary tightening pushes US into recession

One thread runs through our views of the Fixed Income markets for 2018: do not expect sustained drama.

The market still does not believe the Fed's famous "dot plots" that sees their short-term interest rate rising to more than 2% on average by the end of 2018. But the market does now believe that an additional hike will hit in December.

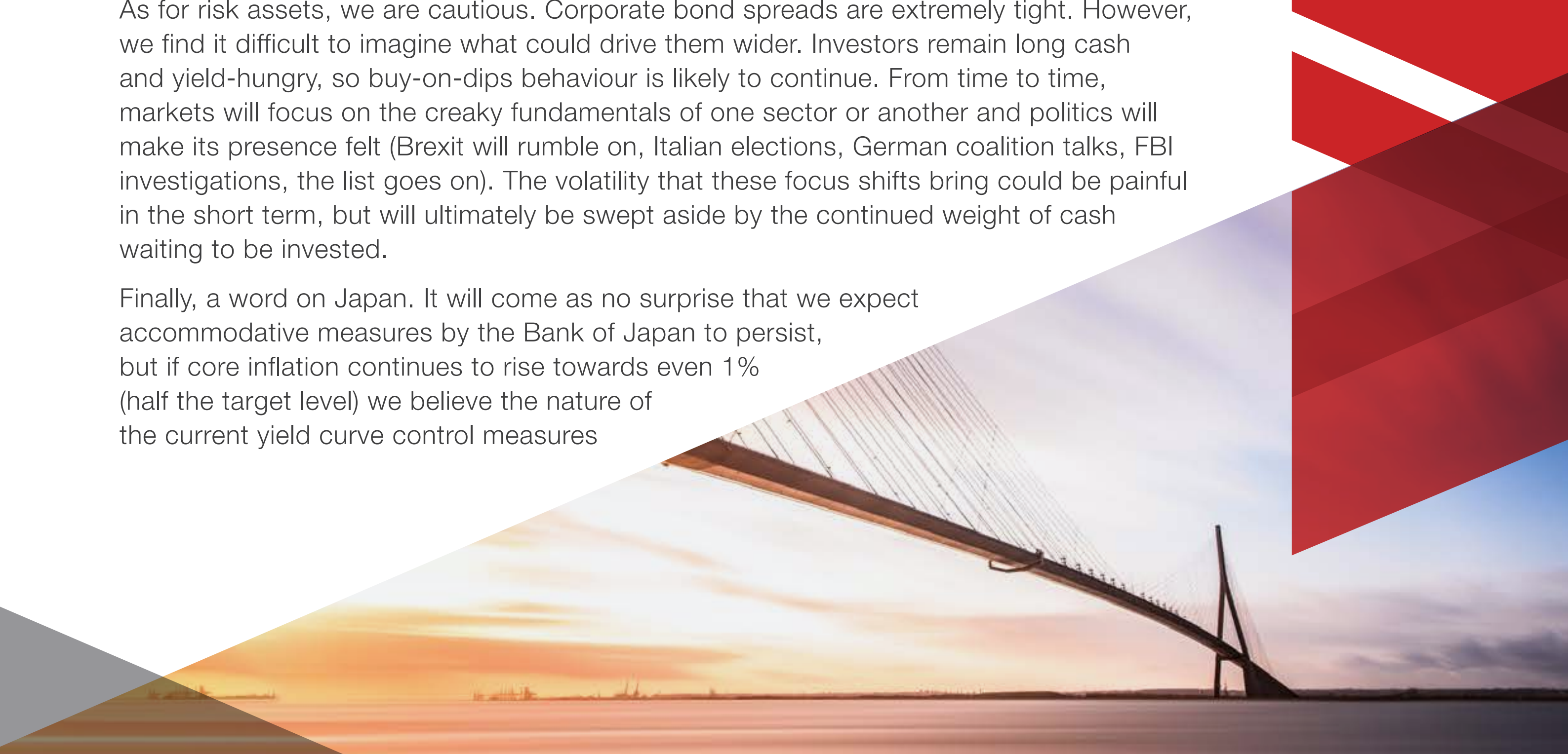
Our central view is that a 2% Fed Funds rate is quite likely in 2018. The Fed has recognised that the economy in the US continues to be relatively strong, despite stubbornly low inflation. The Fed may have even come to the realisation that continued ultra-low interest rates may be contributing to the uncertainty of workers who feel unable to negotiate and demand higher wages from employers. But probably foremost in Central Bank minds is that the employment picture is healthy and continues to improve, and their expectation is that the Phillips Curve will eventually re-assert itself.

Where there is real debate within the team is over what impact this move will have on markets. In theory rate hikes beyond market expectations should feed through to higher bond yields, even at the long end. But some of our team are concerned that a succession of rate hikes could damage the economy, discourage investment and tip the US back into recession, with potentially significant consequences for risk assets and lower long term yields.

This remains a risk scenario for us – on the whole we expect that already ironed-flat yield curves will see limited yield rises at the long end and that the global and US economies will continue their expansion.

As for risk assets, we are cautious. Corporate bond spreads are extremely tight. However, we find it difficult to imagine what could drive them wider. Investors remain long cash and yield-hungry, so buy-on-dips behaviour is likely to continue. From time to time, markets will focus on the creaky fundamentals of one sector or another and politics will make its presence felt (Brexit will rumble on, Italian elections, German coalition talks, FBI investigations, the list goes on). The volatility that these focus shifts bring could be painful in the short term, but will ultimately be swept aside by the continued weight of cash waiting to be invested.

Finally, a word on Japan. It will come as no surprise that we expect accommodative measures by the Bank of Japan to persist, but if core inflation continues to rise towards even 1% (half the target level) we believe the nature of the current yield curve control measures



could change, particularly as a suppressed curve is expected to impact the financial intermediation function in the long term. As for risk assets, where our accounts permit allocation to Japanese convertible bonds, we are long due to favourable risk/reward skew in this market but after recent rapid price appreciation in Japanese stocks, we have been taking some of the indirect equity risk off the table.

The Yen has long term support from Japan's trade surplus, even if the interest rate differential to the US is rising. We do not hold a strong view on the Yen, however; where we do have long Yen positions, they are held as a hedge to risk-off behaviour.

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