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Fixed Income
Reflections on 2018 and Market Outlook

Ouch. That was a tough year for fixed income and for capital markets in general! Global debt markets gradually woke up to the Federal Reserve's intention to hike interest rates in the US, and the US yield curve moved flatter and higher, dragging European yields with them. The US 10 year yield burst through 3% and kept going. Even Japanese Government Bonds twitched (ever so slightly), prompting the Bank of Japan to intervene to keep the 10 year yield near the positively vertiginous heights of 10 basis points.

Higher yields meant negative returns for sovereign bonds and other assets priced relative to them, with credit markets generally feeling pain, even deep into the corporate capital structure, as high yield bonds sold off.

Emerging debt markets were no place to hide. Although there were some spectacular falls related to idiosyncratic concerns in markets such as Turkey and Argentina, more generally EM currencies were under pressure from a higher US dollar and an escalation in US trade tensions, particularly with China.

Europe faced political uncertainty in Italy and surrounding the Brexit negotiations. UK assets continued to sell-off, with the exception of UK gilts (which have shown resilience, given their relative safe-haven status) whilst Italian spreads have widened and remain highly volatile, driven by endless headlines, many of which seem to be contradicted as soon as they make print.

Only towards the end of the year did the US 10 year yield dip back below 3%, in response to comments perceived as dovish from the Fed's chairperson, Jerome Powell.

Nomura's Global Fixed Income clients benefited from positioning ahead of the rising yield environment. Our traditionally-benchmarked clients benefited from outright underweight duration positions in both the US and Europe and an overweight position in the US dollar held throughout the year. Clients of our "unconstrained" Global Dynamic Bond Fund strategy in turn benefited from option-based protection against rises in the front end of the US yield curve. These generated positive returns, particularly in the first half of the year.

For next year, expect more volatility and more uncertainty. A major source of that volatility will be the data-driven rate hike path of the Fed. If the economy continues to be strong with healthy growth and unemployment data, additional rate hikes will introduce risky market stress, even though equity markets should be supported by earnings growth. If, however, the US joins the EU in having lower growth rates next year, a slower path of hikes should be supportive of both core developed government bonds and risky assets alike.

If that sounds like "sitting on the fence," forgive me; even within our Fixed Income team, opinion is divided. Our Head of Unconstrained Fixed Income, Dickie Hodges, has option-based strategies in place to benefit clients from market sentiment changes after the kind of rhetoric Jerome Powell revealed recently – that rates were "just below" the estimated neutral range. Meanwhile, the Chair of Nomura's Global Fixed Income Investment Strategy Committee, Yuji Maeda, points out that the Fed's own range of estimates of the neutral rate is wide, so Powell's comments are entirely consistent with previous statements that monetary policy remains accommodative (for

now). Maeda expects further rate hikes in 2019 and the economy in the US to remain both strong and well ahead of that in Europe, with positive consequences for the US dollar.

Where the team is in broad agreement, though, is on European politics, where the “noise” around Italian fiscal spending and Brexit will continue to reveal attractive yield opportunities. Italy’s government has no remit to remove Italy from the EU; they will negotiate and Italian spreads offer value. Meanwhile, a deal, delay or a remain vote from a second referendum would also be positive for UK assets, but with uncertainty so great, it is not an area where we wish to risk significant capital.

Lastly, being Nomura we must mention Japan, where (surprise, surprise) we expect the Bank of Japan to retain tight control of the yield curve, whilst the Yen should be supported by fundamental strength, particularly the steadily improving account surplus.

Fraser Hedgley, CFA, Head, Investment Specialist Team

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NAM UK’s registered office is at 1 Angel Lane, London, EC4R 3AB.