FIXED INCOME **COMPASS**

Proceed with caution

On a probability adjusted basis, we believe that credit spreads will widen during 2017, interest rates should fall and the US dollar could rally further.

PROCEED WITH CAUTION: HEADWINDS IN 2017

Despite a number of downside political surprises throughout 2016, market volatility was subdued by aggressive support from central banks together with the hope that a reflationary shift will solve global structural problems.

Valuations are pricing in a continuation of this environment with low credit spreads, strong emerging markets, buoyant equities and restrained government bond yields. However, we believe this is an unstable state of affairs. Structural problems have deteriorated in the last twelve months and political risk remains acute. Any resultant weakness is now less likely to be met with central bank support due to rising inflation and political pressure. On this basis we have a cautious overall outlook for the year ahead, focusing investments in areas that adequately compensate for these structural and cyclical risks.

*Fixed Income Compass represents the viewpoint of the Global Fixed Income Team at LGIM.

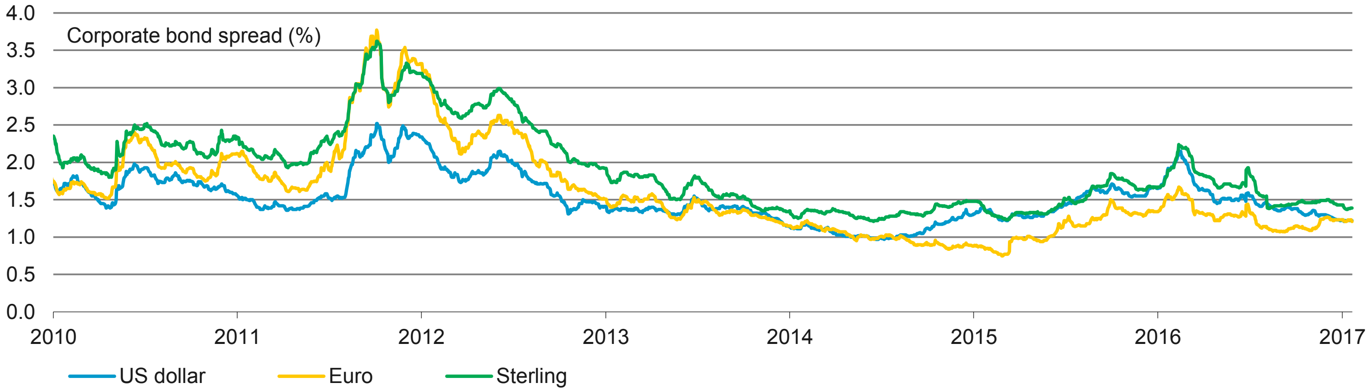
STRUCTURAL PROBLEMS REMAIN UNRESOLVED

After a shaky start, global growth stabilised in the second half of 2016, with both business and consumer sentiment indicators picking up in the final weeks of the year. This suggests a positive outlook for the start of 2017, with very few people predicting a slump in the first quarter or so.

However, this positive momentum needs to be considered relative to the major structural headwinds facing the global economy. High levels of debt and deteriorating demographics should continue to constrain global growth, which has been stuck at around 2.5% for the last five years.

Legal & General
INVESTMENT MANAGEMENT

Figure 1: Low global corporate bond spreads are pricing in a supportive environment



Source: Bloomberg L.P., Barclays Credit Indices

As shown in **Figure 2**, consensus economic forecasts have consistently predicted accelerating growth for the coming year, which has subsequently failed to materialise. In our view, this is because the consensus underestimates the structural drag from debt and demographics on trend growth rates. We see no reason why 2017 will be any different, and indeed there are a number of downside risks that could result in a more substantial disappointment than usual: a Trump tantrum, Chinese currency volatility and European politics.

TRUMP TANTRUM

Many market participants are looking for a positive outcome from Trumponomics. Consumer and business confidence indicators have increased since the election, boosted by the prospect of three main policies: tax reduction (corporate taxes in particular), less regulation and greater fiscal spending. This has boosted the global reflation narrative, predicting a paradigm shift away from suppressed inflation and the multi-decade downward trend in bond yields.

Such hope may persist if the Republican controlled House of Representatives and Senate throw their weight behind these policies. Notably, there is upside risk for US equity markets should large tax cuts be fully priced in.

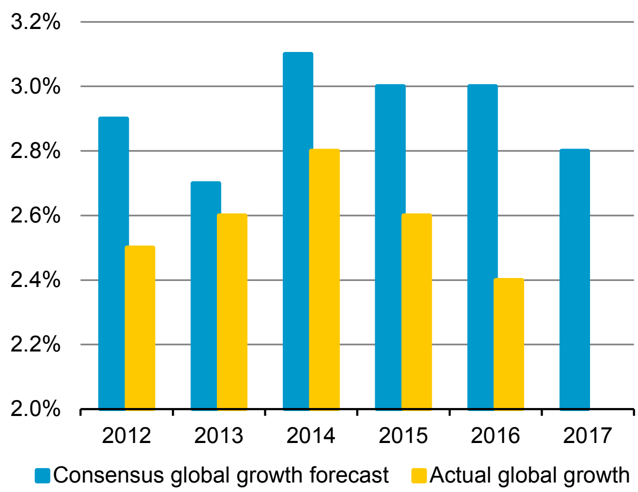
However, for a world still weighed down by excess debt, we suspect that such a boost will prove temporary, with the steady withdrawal of monetary policy support resulting in weaker growth and a return to lower inflation and bond yields.

PREPARING FOR POSSIBLE DISAPPOINTMENT: AMERICA FIRST

We think there are three main areas for possible disappointment.

First, the Fed already hiked interest rates in December, and a significant loosening of fiscal policy and an acceleration of inflation expectations would probably be met with further hawkish policy. Not only does this undermine the liquidity crunch that markets rely on as they are buffeted by waves of political turmoil, it also impacts debt-driven economic growth. For example, US mortgage rates have increased significantly since Trump's election, which may dampen housing activity. More importantly, from a global perspective, the last couple of years have demonstrated the negative impact of higher US interest rates and a strong US dollar on emerging markets.

Figure 2: Global growth expectations are consistently too high



Source: LGIM, taking consensus economic estimates at the end of the previous year

Second, US consumers are facing a headwind from rising expenses. For example, while not yet a serious impediment, higher gasoline prices would be a drag on disposable income. To offset this, wage inflation would need to rise and new jobs would need to be created. But US corporates have been reluctant to increase costs given the trend of weak profitability, focusing instead on dividends and share buybacks. Now they face a strong US dollar, which impacts exports and overseas earnings. This is likely to continue to constrain US corporate investment and their ability to increase wages.

Finally, there is a risk that President Trump is less positive for economic growth than widely hoped. He has to rely on Congress agreeing with his fiscal policies, and it already seems that Trump's ideas are different to those of Paul Ryan, the Republican Speaker of the House. Indeed, Trump's main power is in matters of foreign policy and trade, where he can be far more disruptive. Alongside a stronger US dollar and higher interest rates, this may have serious repercussions for Mexico and the other key economy in 2017, China.

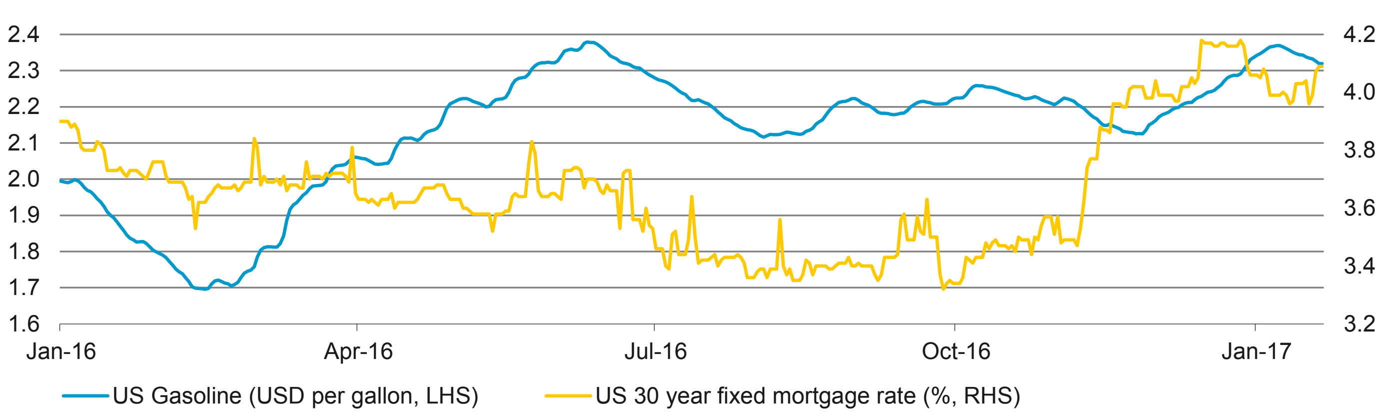
CHINA: DECISION TIME FOR POLICYMAKERS

China also suffers from serious structural problems. Its debt growth continues to outstrip nominal GDP to an alarming degree. Attempts to alleviate its demographic troubles have been disappointing, with the relaxation of the one-child policy only resulting in an extra one million babies being born in 2016, compared to the additional three million that was hoped for.

Cyclically, China is also suffering from slowing global trade, and this pressure is likely to increase with the Trump administration. With such burdens, Chinese policymakers face three choices in the coming months:

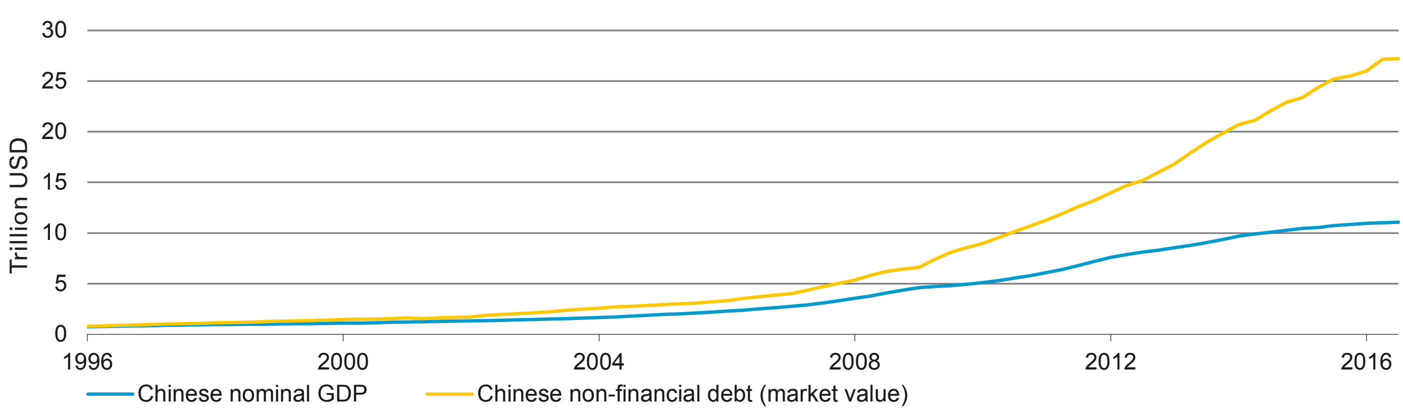
1. Slow credit growth to a sustainable level, risking a domestic recession.
2. Depreciate the currency, improving competitiveness, but risking domestic asset price volatility and a trade war.
3. Keep credit growth high, tighten capital controls and hope for stronger global growth and domestic demand in the future.

Figure 3: The US faces more expensive gasoline and higher mortgage costs



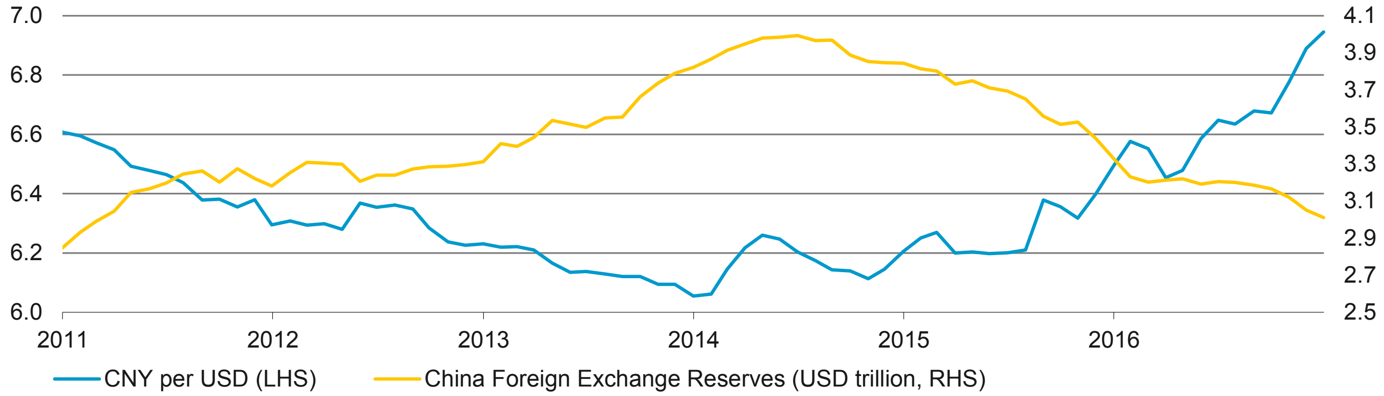
Source: Bloomberg L.P.

Figure 4: Chinese debt continues to outstrip economic growth



Source: Bloomberg L.P., Bank for International Settlements

Figure 5: Renminbi depreciation alongside falling foreign exchange reserves



Source: Bloomberg L.P.

In the absence of a crisis, and with the 19th Communist Party Congress due to take place later in the year, policymakers will not want to rock the boat. The third option therefore remains the easiest choice. But we believe that hopes for stronger global growth and domestic demand will ultimately prove elusive, and therefore structural pressures will continue to build in China.

The currency remains the key pressure point. The US dollar has been appreciating in anticipation of Fed rate hikes, mixed with Trump's reflationary and anti-globalisation rhetoric. We anticipate that this trend will continue in 2017. Such strength puts downward pressure on the renminbi, encouraging outflows that policymakers will try to resist for fear of undermining the country's key asset markets, such as the property sector. But even for a tightly controlled economy, pressure can reach boiling point, forcing policymakers to choose between the two other options, both with clear negative implications for global growth and risk sentiment.

EUROPEAN FRAGILITY IN FOCUS

China is not the only country going through a political transition in 2017, with the European electoral cycle turning once again. But the key for us is that Europe continues to be hampered by fragilities in its banking system and, in its current form, an unsustainable single currency. We have long believed that the euro area will face a make or break moment where policymakers (and the voting public) will have to choose between full fiscal integration and a disintegration of the single currency. This might not happen in 2017, but the election cycle provides a number of possible catalysts.

The UK's outlook is more mixed. It seems that the UK is prepared to give up single market access if the membership condition is free movement of labour. But the equation won't be as simple as this, with negotiations taking place over many years.

This extended time horizon probably explains positive growth surprises since the referendum: volatility and uncertainty have yet to take hold. But once negotiations start in earnest, we believe that Brexit will have a negative impact on growth in the next couple of years. Having said that, if the European Union continues to fragment, it will have made sense for the UK to leave the EU as early as possible and to have negotiated trade deals before everyone has to do the same.

While UK trade competitiveness is currently benefiting from a weaker pound, the downside tail-risk is if the currency's decline becomes a rout, accelerating imported inflation and necessitating defensive interest rate hikes from the Bank of England. But we don't think this is a very likely outcome.

WHAT DOES THIS MEAN FOR INVESTORS?

We therefore see a world weighed down by structural problems, facing three key downside risks in 2017. Policymakers are still prepared to support asset prices, but are increasingly being constrained by inflation and politics. We have distilled this volatile mix into three broad scenarios for returns but, before going into detail, we should consider their interdependence with the credit cycle and the outlook for commodity prices.

THE CREDIT CYCLE: THE END WOULD NORMALLY BE NIGH

If this was a normal credit cycle, judged by corporate leverage or M&A activity, we would be either at the end, or very close to it.

But this is not a normal credit cycle. Policymakers bailed out many industries following the 2008/9 crash and have provided vast quantities of liquidity to paper over the structural cracks of over-indebtedness. In subsequent years, policymakers have doubled-down on this support, forcing credit spreads ever tighter even as the credit cycle stretched to breaking point. This most recently occurred following the oil/commodity bubble bursting in mid-2014. We also saw a period of sustained negative profit growth in US corporates which would normally validate the cycle turn as rising debt is met with falling earnings. But ultra-easy central bank policy has helped companies ride out this volatility.

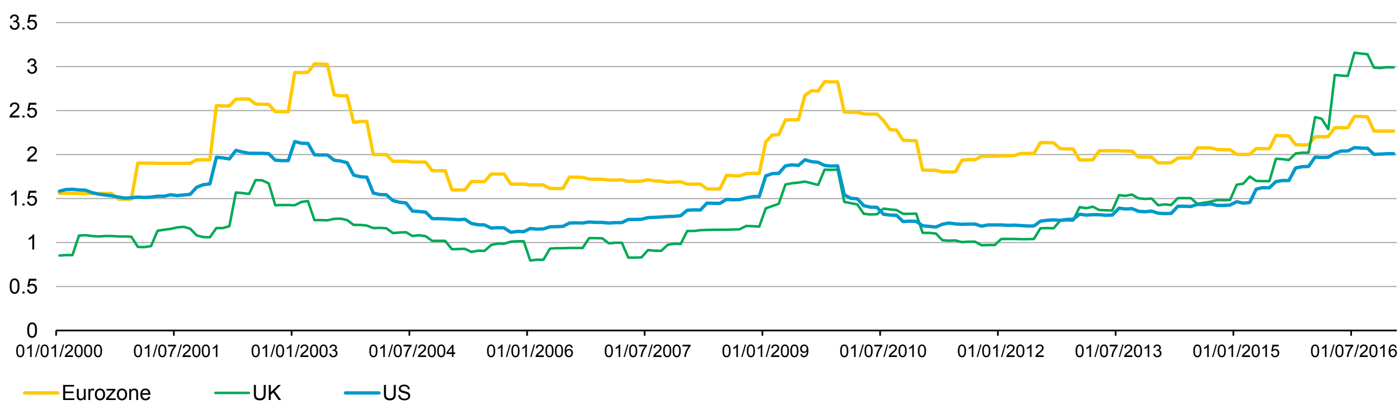
The significant test comes as financial support is withdrawn via rising inflation, political opposition or a loss of central bank credibility. We are getting closer to this moment.

OIL AND COMMODITIES: RUNNING ON EMPTY?

Commodity prices found a floor during 2016, with a focus on oil supply cuts from OPEC members as well as Chinese capacity reductions for other commodities. However, we are not convinced about the permanence of such supply reductions. Just as importantly, our structural growth concerns mean that commodity demand could disappoint market expectations. In addition, it is possible that Chinese capital flow restrictions have temporarily boosted demand for some metals, with stored holdings being used to diversify away from local currency exposure. This may prove a fickle source of demand.

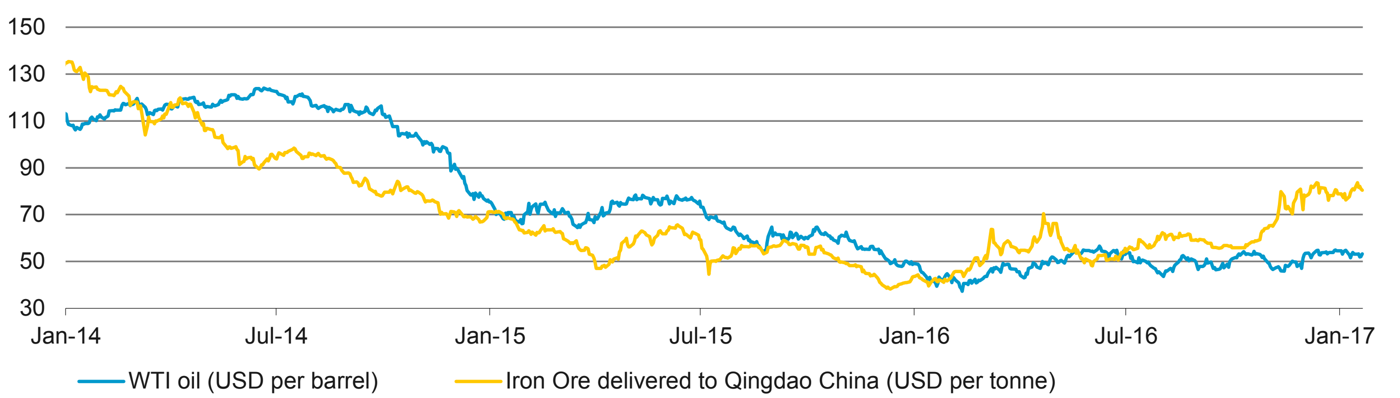
So, while we have a relatively neutral near-term outlook for oil, for example, we believe that commodity prices could fall further at some point in 2017. This would again negatively impact producing companies, in particular those in emerging markets that borrow heavily in US dollars. This is just one example of how over-indebtedness and the associated misallocation of resources feeds back into weaker economic growth.

Figure 6: Corporate leverage (Net debt/EBITDA) close to prior cycle peak



Source: HSBC calculations, Thomson Reuters Datastream
Note: Non-financial corporates; country buckets represent companies domiciled/headquartered in those countries

Figure 7: A number of commodities found a floor in 2016



Source: Bloomberg L.P.

SCENARIOS FOR 2017

BASE CASE: SECULAR STRANGULATION (50%)

This scenario is our most likely outcome, driven by tightening US dollar funding conditions (rising US rates and an appreciating US dollar) weighing on an overly indebted and vulnerable global macro backdrop.

The year could begin with an initial period of higher growth, alongside tighter credit spreads, in the hope of a successful reflation outcome, followed by a relapse as tighter monetary policy bites into the global economy. Unlike in 2016, we think that as growth is choked off, loosening monetary policy in response would be less successful given inflationary and political constraints, even if credit benefits to some degree.

Overall, even if they head higher in the near-term, we would anticipate government bond yields ending the year lower than where they began, with wider credit spreads reflecting lower investor risk appetite mixed with central bank support. High yield defaults would remain relatively high as overly-indebted entities face a more challenging refinancing environment. On a relative basis, US investment grade assets would be an outperforming asset class while European and emerging markets risk assets would be particularly vulnerable.

BEAR CASE: POLITICAL UPHEAVAL (30%)

This scenario is a combination of the base case and the realisation of the key downside risks:

- Negative repercussions of Trump's Presidential election victory, focusing on trade wars and geopolitical instability
- The future of the European Union coming under question once again, given Brexit and the busy election calendar
- Policy missteps caused by the Chinese power transition and currency depreciation

Again, policymakers would aim to suppress volatility but under this scenario, they would either be constrained politically or markets would fail to react positively given the size of the structural problems that come into view.

Negative growth implications would lead to government bond yields falling back to their recent lows, and credit spreads moving significantly wider. We would also expect high yield default rates to increase towards recessionary levels. Currency volatility would spike, with the US dollar gaining from a risk-off environment, putting downward pressure on emerging market currencies in particular. Again, US investment grade credit would be a relative safe haven but, even here, spreads would likely end the year substantially wider than current levels. European risk would rise, with the banking sector potentially seeing significant stress.

BULL CASE: REFLATION (20%)

Given global structural problems and looming potential risks, this is our lowest probability scenario. However, we think that many other investors believe it has a high chance of playing out in 2017, and the view is therefore increasingly being reflected in market pricing.

This scenario envisages accelerating nominal GDP with companies benefitting from rising sales, allowing them to increase investment and wages without undermining profit growth. Monetary policy would be gradually tightened while avoiding destabilising pressure on the global debt overhang. Social tension regarding inequality, globalisation and immigration would be reduced, and anti-establishment politicians would fail to win power.

Government bond yields would end the year higher and the US dollar may continue to appreciate, but not to the extent that emerging markets are put under pressure. Credit spreads would tighten, but only modestly given their starting point. Global financial debt would be a relative winner given its sensitivity to the economic cycle, alongside a return to higher and steeper government yields curves. High yield and emerging market debt would do well given their relatively large credit spread buffer in a rising interest rate environment.

WHAT ABOUT STAGFLATION?

In the coming months some countries may face a toxic mix of rising inflation and depressed economic growth, known as stagflation.

However, we do not believe such an environment is stable given the global debt overhang. Without accelerating economic growth, rising inflation and the resultant tightening of monetary policy should quickly lead to funding stress, which brings you back to one of the first two scenarios. For us, stagflation could sustainably result from a central bank losing control of their currency, importing inflation through a large devaluation. This may ultimately be the destination some countries reach, but it does not appear to be a significant risk in the next few quarters.

WHAT ARE THE IMPLICATIONS FOR CREDIT?

On a probability adjusted basis, we believe that credit spreads will widen during 2017, interest rates should fall and the US dollar could rally further.

Just like in 2016, central banks should look to support markets as macro conditions deteriorate, and we need to be able to tactically trade reversals of the underlying trend. But we believe such periods will provide only temporary relief, and our bias is towards being underweight credit risk and overweight duration. On a regional basis, our preference is the relative domestic strength offered by US investment grade credit, with a particularly cautious outlook for European financials. Where we do take high yield exposure, we will again look for US domestic risk, avoiding the parts of emerging markets that are exposed to a stronger US dollar.

Figure 8: Fixed income return forecasts for 2017

TOTAL RETURNS	Scenario 1	Scenario 2	Scenario 3
Probability	50%	30%	20%
Global IG	2.7%	-0.6%	0.7%
US IG	4.6%	2.4%	1.0%
Euro IG	-1.5%	-6.2%	0.1%
GBP IG	3.4%	-1.3%	-0.4%
US HY	1.5%	-7.4%	6.5%
Euro HY	-0.8%	-13.5%	4.2%
US Leveraged Loans	0.3%	-5.5%	4.3%
Euro Leveraged Loans	0.3%	-7.3%	5.0%
ABS/Securitized (USD)	2.1%	1.5%	1.1%
EMD Local Currency Debt	-2.1%	-12.3%	7.8%
EMD Sovereign Debt (EMBI)	2.0%	-3.9%	3.6%
EMD Corporate Debt (CEMBI)	0.4%	-4.3%	2.7%

EXCESS RETURNS	Scenario 1	Scenario 2	Scenario 3
Probability	50%	30%	20%
Global IG	-1.0%	-6.3%	2.9%
US IG	-0.7%	-5.9%	3.6%
Euro IG	-1.2%	-6.5%	3.0%
GBP IG	-1.3%	-7.7%	2.5%
US HY	-1.8%	-12.6%	5.6%
Euro HY	-0.6%	-13.3%	6.4%
ABS/Securitized (USD)	0.2%	-1.5%	1.0%
EMD Sovereign Debt (EMBI)	-2.7%	-11.7%	4.7%
EMD Corporate Debt (CEMBI)	-2.9%	-10.6%	3.0%

Source: LGIM. Returns figures are forecast only and are not guaranteed

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