Regime change
Outlook 2017

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BlueBay
Asset Management

Introduction

This is the second annual Outlook prepared by the Head of Credit Strategy and draws on the expertise of BlueBay's analysts and economists and the judgements of its investment professionals. BlueBay's investment process emphasises rigorous debate and inevitably a summary outlook simplifies the depth and diversity of investment views expressed across portfolios.

There is, however, broad consensus at BlueBay that a regime shift is underway from ultra-easy money, fiscal austerity and globalisation to less easy money, fiscal activism and economic as well as political nationalism. It is an environment characterised by greater political and policy uncertainty and the probability of positive as well as negative tail outcomes is even greater than usual. With that health warning in mind, the judgements and forecasts in our 2017 Outlook broadly reflect our current thinking and expectations as we enter the new year.

Regime change is never smooth. It poses threats as well as investment opportunities and the preservation of capital will weigh as heavily as the return on capital. Hopefully, our 2017 Outlook will make a modest contribution to your success in navigating these interesting and challenging times.

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Overview: regime change

BlueBay Asset Management

Overview

The lesson from 2016 is that the status quo is breaking down. Investors face regime change - from an era of ultra-easy money, fiscal austerity and globalisation to less easy money, fiscal activism and economic as well as political nationalism. The probability of positive as well as negative tail outcomes is greater than ever.

The reflation of the global economy underway since the middle of 2016 will accelerate if President-elect Trump pours fiscal fuel into the US engine. Reflation is positive for risk, negative for duration.

Reflation favours higher-yielding shorter-duration assets. Risk premia – credit, liquidity and alpha – we believe, will be the primary source of return.

More volatility and dispersion creates opportunities for active strategies to enhance returns and preserve capital.

Executive Summary

- **Regime change.** The beginning of the end of the era of central bank repression of market volatility and dispersion is underway. Real and nominal interest rates are much more likely to rise than fall over the foreseeable future, challenging portfolios built upon the even lower for even longer theme. Duration is now the key risk to investors' capital, exacerbated by passive investment in 'safe' fixed-income benchmarks. Risk premia – credit, liquidity and alpha – we believe, will be the primary source of return for investors
- **Political & policy risk.** The US President-elect is a maverick not beholden to Washington 'insiders'. While we are confident his administration will deliver fiscal stimulus, the conduct of international trade and foreign relations is much more uncertain. Political risk in Europe is once again at the fore with elections in Netherlands, Germany and crucially for the EU and euro, the French presidential election in May. We expect the ECB to begin to taper bond purchases in 2017 and for some fiscal easing across the region. Monetary policy in Japan is likely to evolve further, especially if the yen weakens dramatically
- **Reflation.** We forecast the fastest rate of global growth and inflation since 2011. Trump fiscal stimulus will turbo-charge a US economy already near full employment. Nominal growth will be higher in Europe and Japan and the growth outlook for major emerging economies is improving. China has opted for growth over reform and deleveraging, a choice that raises financial risks. But 2017 is unlikely to be the year of reckoning for China despite currency weakness and volatility. Commodity prices have stabilised and may rise further despite a stronger US dollar that will export US growth and inflation to the rest of the world
- **Long risk, short duration.** Global reflation will underpin higher corporate earnings and lower default risk. We expect shorter-duration and higher-yielding assets to outperform high-quality long-duration fixed income. Excess returns from shorter-duration global leveraged finance, as well as higher-yielding segments of EM debt, will in our opinion offset the negative impact of rising core rates. More growth and volatility will be favourable for equity-sensitive convertible bonds and bank capital that underperformed through much of 2016. Beta returns on passive 'safe' government bonds and high grade will be flat at best
- **Divergence and dispersion.** Regime change creates winners and losers at a country, sector and individual security level. Rising growth and inflation in the US will be a source of volatility for global rates markets and implies steeper yield curves that will benefit financial institutions. Open emerging economies exporting manufactures will benefit from stronger US growth but are more exposed to the rise in protectionism. Despite ECB tapering, monetary policy will remain highly accommodative in response to still large output gaps and muted inflation pressures. The demographic and structural features that constrain growth and inflation in Japan remain in place. Divergence and dispersion broadens the opportunity set for global unconstrained strategies able to exploit relative value and idiosyncratic risk to generate excess returns while limiting drawdowns

Global economy: reflating

Global growth is forecast to accelerate to 3.4%, its fastest rate since 2011 and close to its historical average.

US and major emerging markets (ex-China) are driving stronger global growth.

Base-effects from higher oil prices, stabilisation of producer prices in China and fiscal reflation supports higher global inflation.

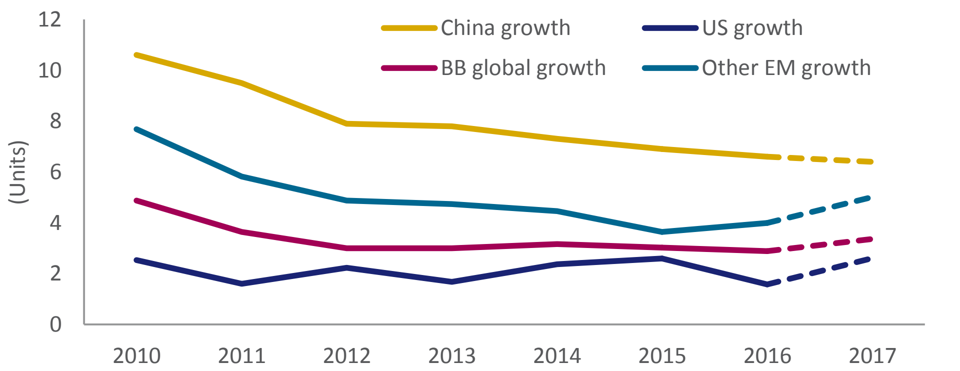
The key downside risks are China financial crash, EU political risk and US protectionism that act as a deflationary global shock.

- **Rising US growth and inflation.** The US economy has overcome the previous headwinds from a stronger dollar and lower oil-related capex. Corporate earnings are rebounding, real wages are rising and the housing market continues to recover. The incoming Trump administration will further boost the economy that is close to full employment. Along with base-effects from higher oil prices, inflation as well as growth is expected to surprise on the upside and prompt higher US rates and dollar
- **Major emerging markets emerge from recession.** Brazil, Russia and Argentina are coming out of recession and along with modest acceleration in growth in other emerging markets (EMs) such as Indonesia, underpins a broadening recovery in EM growth. EMs have adjusted to lower commodity prices and the end of the most import-and-investment-intensive phase of China growth. Improving external (and corporate) balance sheets and higher real domestic interest rates renders EM less vulnerable to higher US rates and dollar
- **China prioritise growth over reform.** New leaders will be chosen in October 2017 and a new government in March 2018. President Xi wants economic stability as he seeks to ensure a smooth and favourable (to him) leadership transition. Though corporate debt is high, it is almost wholly domestically funded and the strength of China's external balance sheet means that Beijing can avoid a 'credit crunch' and economic 'hard landing'. A stronger dollar and capital outflows means the currency will remain a weak point and source of risk
- **Eurozone steady despite politics.** Eurozone growth is expected to be resilient in the face of noisy politics and some spill-over from lower external demand from the UK. Mildly supportive fiscal policy, gradual recovery in bank credit and an improving labour market should be sufficient to maintain growth momentum through 2017. However, a shock victory for National Front candidate Le Pen in the French presidential elections in May would likely de-rail the recovery as fears of an EU and eurozone break-up resurface. Absent major shocks, the ECB will begin to taper down its bond purchases during 2017, but monetary policy will remain highly accommodative

Global forecast summary

	GDP growth		Inflation	
	2016E	2017F	2016E	2017F
US	1.6	2.6	1.4	2.7
Eurozone	1.7	1.5	0.2	1.5
Japan	0.8	1.0	-0.2	0.7
UK	2.0	1.4	0.7	3.0
China	6.6	6.4	2.0	2.4
Other EM	4.0	5.0	4.5	4.7
World	2.9	3.4	2.9	3.6

Global growth



Source: left table: BlueBay Asset Management; right chart: IMF; BlueBay estimates and forecasts for 2016 and 2017
Note: Dotted lines = BlueBay forecast data

Valuations and returns: higher core rates challenge beta returns

Reflation means that duration is a threat to capital while risk premia - credit, liquidity and alpha - we believe, will be the sources of return.

Beta returns on government and high grade debt are likely to be flat at best. Assets with yields equal to or greater than duration will generate positive total as well excess returns in our opinion.

Reflation is positive for emerging market debt. But if a Trump-led US reverses 'globalisation', more rather than less risk premium will be required as emerging economies adjust and investors identify the winners and losers.

- After a turbulent first quarter of 2016, developed market (DM) credit spreads end the year tighter. Based on the simple valuation of current spreads relative to their 10-year history, DM credit is fair to rich. Nonetheless, against a backdrop of rising corporate earnings and falling default risk, in our opinion there is still room for spread tightening to partially offset higher rates and generate positive excess returns
- In contrast to developed market credit, emerging corporate and sovereign credit valuations appear fair to cheap relative to their 10-year spread history. EM assets have partially re-priced in response to the surprise victory of Donald Trump in the US presidential election. However, stronger EM growth and fewer corporate defaults supports spread compression. But the outlook for international trade and geo-politics are even more uncertain and higher US rates and dollar are powerful headwinds for EM assets
- A reflationary environment is positive for risk assets, including credit and EM. However, the rise in core rates meaningfully compromises beta returns on fixed income and credit in light of the extension of duration in benchmarks. Consequently, our beta return projections favour shorter-duration and higher-yielding asset classes such as global leveraged finance as well as equity-sensitive credit such as bank capital (coco bonds) and convertible bonds

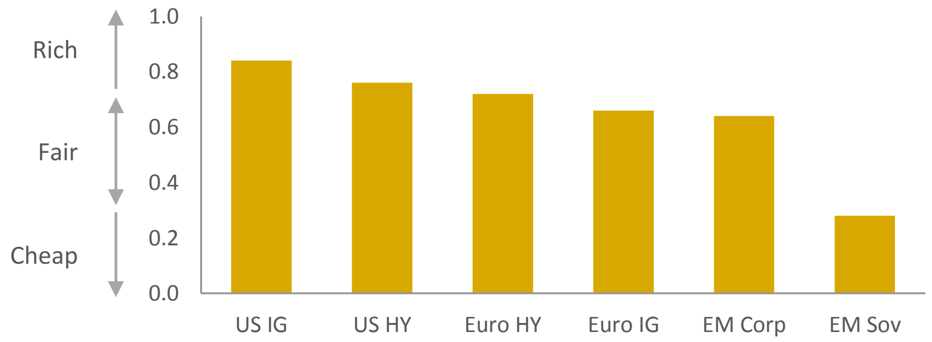
Valuation metric - credit spreads

Credit spreads are expressed in percentile terms relative to their 10-year history. For example, if credit spreads are in the 25th percentile, it means that spreads have been greater for only 25% of the daily observations over the last 10 years. Spreads that sit in the 25th or 75th percentile are considered 'cheap' or 'expensive' by historic standards.

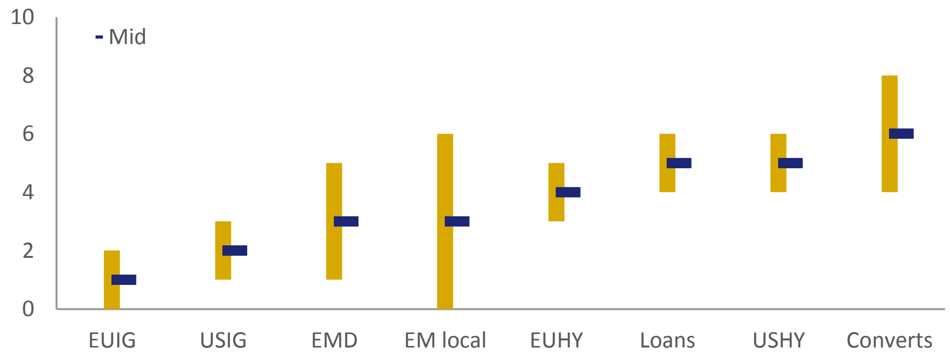
Total 'beta' return projections

The range for beta (index) return projections are based on the spread and interest rate forecasts prepared by the Head of Credit Strategy. They illustrate a return range judged to have a 50% probability (i.e. the most likely outcome range). These projections do not incorporate potential 'alpha' and may differ from projections maintained on an ongoing basis by BBAM investment teams.

Credit spreads - percentile distribution



Beta return ranges



Source: BAML and BlueBay calculations, as at 1 December 2016
Note: percentile rank of current credit spreads over 10yr period.
Euro HY = BAML European Currency High Yield Index (HP00), **Euro IG** = BAML Euro Corporate Index (ER00), **US IG** = BAML US Corporate Index (C0A0), **US HY** = BAML US High Yield Index (H0A0),
EMD = JP Morgan CEMBI Broad Diversified Index and JP Morgan EMBIG Global Diversified Index

The credit cycle: reflation extends the cycle

Rising growth and inflation extends the credit cycle. The recovery in corporate earnings and still historically low borrowing costs mean that default rates will stay low and spreads relatively stable.

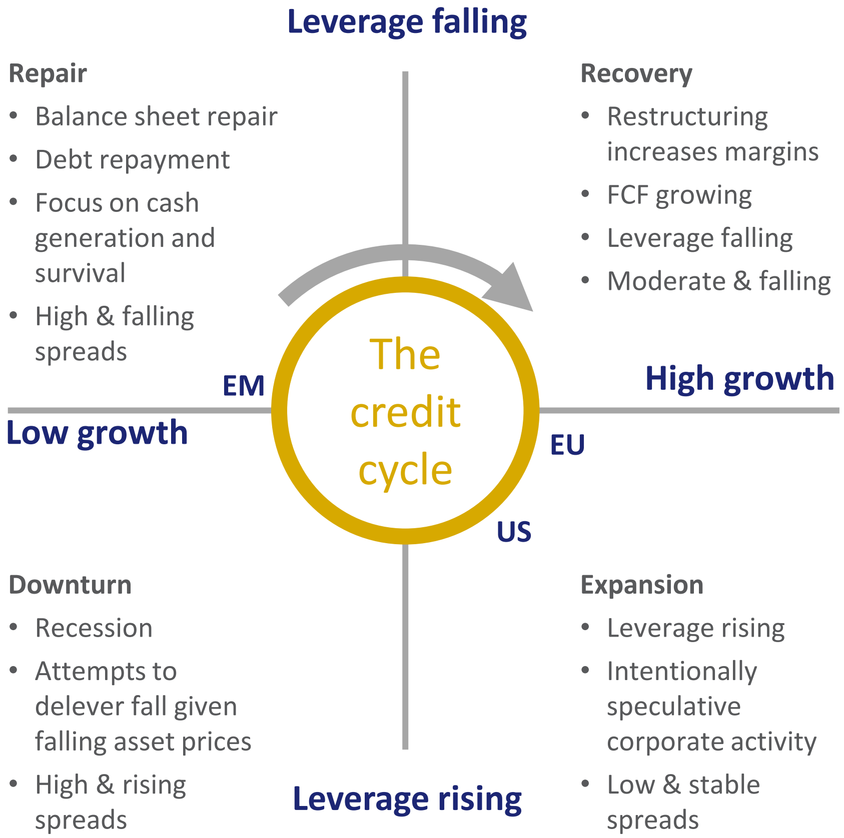
Economic and credit conditions should incentivise EU companies to re-leverage and graduate into the 'expansion' phase of the cycle.

Fiscal reflation of the US economy extends the US credit cycle, especially for IG that will benefit from tax cuts and off-shore cash repatriation.

Higher core rates, steeper yield curves and more market volatility will boost bank profitability. Banks remain in the credit-friendly 'recovery' phase of the credit cycle.

EM corporate credit has moved into the 'repair' phase of the cycle that is typically associated with credit outperformance.

- **Reflation extends the credit cycle**. The end of the corporate earnings recession, fiscal easing including corporate tax cuts, profit repatriation and de-regulation extends the credit cycle
- **Europe to begin to re-leverage.** European companies have been focused on balance sheet repair since the financial and eurozone crises. Against the backdrop of historically low borrowing costs and continuing economic recovery we expect more M&A and a modest up-turn in leverage. We now consider European credit to be in the early 'expansion' phase of the credit cycle
- **EM corporate credit under repair.** EM economies and corporates have been adjusting to tighter credit conditions post the 2013 'taper tantrum' and the collapse in commodity prices in 2014-15. Progress has been made and is reducing leverage, especially in the commodity-related sectors. The recovery in EM economic growth that started around the middle of 2016 is forecast to continue into 2017 offering a positive macro backdrop for EM credit, despite higher US rates and dollar. Country and regional factors also remain a key influence on EM corporate credit. In the event of Trump protectionism, relatively closed and commodity-orientated countries will likely outperform exporters of manufactures to the US economy
- **Sector overlay.** At a sector level, credit markets in 2016 were dominated by the ups and downs of the financial and commodity sectors. The decline in energy-related defaults is largely already reflected in valuations and in our opinion financials are more likely to outperform in 2017. The market environment for banks is becoming more favourable with rising rates, steeper yield curves and greater volatility. The era of regulatory 'punishment' of banks is coming to an end



Core interest rates: breaking higher

In our opinion, 'core' government bond yields are trending higher over the next few years and by more than most investors are currently anticipating.

In our opinion, rising inflation and the exhaustion of unconventional monetary policy means switching away from the 'ever lower for ever longer' theme. We expect core rates to move higher led by the US Treasury market.

Regime change will benefit active over passive investment strategies in core fixed income.

The key risk to our view is a global deflationary shock.

- The US enters 2017 with considerable economic momentum and domestic inflation pressures are building. Add Trump tax cuts and infrastructure spending to an economy already near full employment as well as powerful base-effects on inflation from higher oil prices and the Federal Reserve (Fed) is likely to raise rates between two and four times next year. The main constraint on Fed rates moving much quicker is further appreciation of the US dollar
- Higher Fed rates, rising inflation and above potential growth should prompt investors to demand some term premium putting upward pressure on long-end US rates. The yield on the 10-year US Treasury may well break through the 3% level and US Treasury 5-year through 2.5%
- We believe that central bankers will take the opportunity afforded by a reflating global economy to move away from QE and negative interest rates as the costs of such polices begin to outweigh the benefits. The Bank of Japan (BoJ) is already engaged in a 'soft taper' and we expect the European Central Bank (ECB) to taper its quantitative easing (QE) programme during 2017. Nonetheless, underlying inflation pressures in the eurozone remain subdued and the relative scarcity of euro 'safe assets' and elevated political risks means a widening yield gap between the US and Europe
- A rising rate environment will be especially painful for passive strategies that have become excessively exposed to the lengthening duration risk of core fixed income benchmarks. Opportunities exist for strategies able to exploit global divergence, shifts in yield curves and inflation expectations as well as from outright short rate and relative value positions

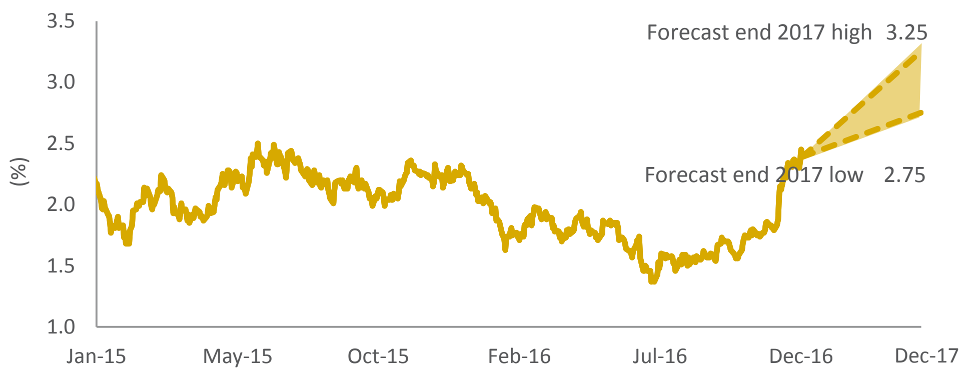
10-year US Treasury yield
(End-17 projection range): 2.75%–3.25%

- Upside risk: bigger rise in term premium
- Downside risk: much stronger US dollar
- UST5yr range: 2.25%–2.75%

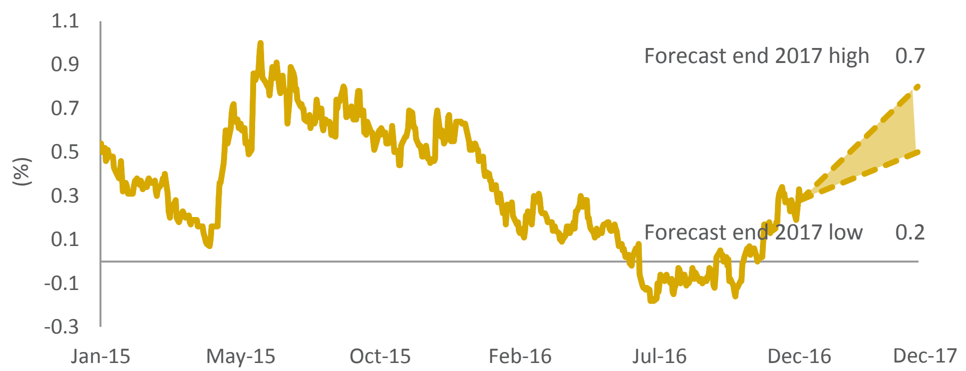
10-year Bund yield
(End-17 projection range): 0.2%–0.7%

- Upside risk: ECB taper faster than expected
- Downside risk: political/country risk
- DEM5yr range: -0.2%–0.2%

US 10-year yields and forecasts [1]



DEM 10-year yields and forecasts [1]



Source: Macrobond and BlueBay forecasts, as at 2 December 2016
Note:
1 Past performance is not an indication of future returns

Global leveraged finance: reflation winner

Rising growth and corporate earnings, along with falling default rates, should allow US high yield (HY) to generate coupon-like returns despite rising rates.

Solid demand and stable credit fundamentals will allow European HY credit spreads to grind tighter even if the ECB tapers. However, euro risk assets, including HY, are vulnerable to heightened political risk in an election year in Europe.

The investment case for leveraged loans is strengthened in a rising rate environment.

- The rebound in the oil price and a cautious Fed after a turbulent first quarter allowed the US HY market to recover and post double-digit returns in 2016 [2]. Oil continues to move higher, bank lending conditions have stabilised after four quarters of tightening and the default rate is falling (from 7% in 2016 to a forecast 4% in 2017). Against such a backdrop, we expect the usual negative correlation between spreads and rising rates. The key downside risk is a reversal of the second half of 2016 recovery in commodity and oil prices
- Against the backdrop of a resumption of the Fed hiking cycle, US loans are likely to attract inflows as investors reduce duration. However, there is not much room for price appreciation as most are at or near par and so returns will be in-line with carry of 6%. European loans currently yield around 4% and 2016 was characterised by some deterioration in credit quality, though on a volatility-adjusted basis European loans remain attractive
- The European HY market benefits from the ongoing economic recovery, broadly stable corporate leverage and sub-2% default rate. Limited net supply is comfortably absorbed by euro investors starved of yield. Solid credit fundamentals and supply-demand balance provides confidence that there would not be a meaningful re-pricing of high yield credit if the ECB tapers in response to rising growth and inflation. Spreads can grind tighter to 375bps and total returns in the range 3% - 5%. The key downside risk is political instability, especially in Italy, the largest segment of the HY market

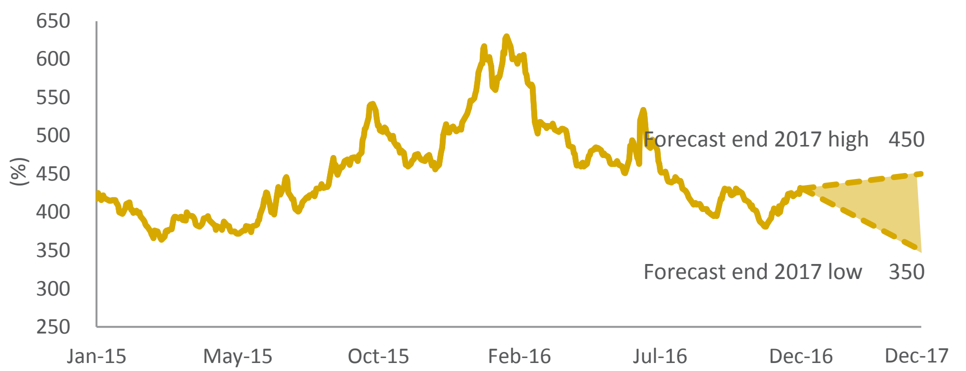
US high yield
12 month index return: 4.0%–6.0%

- Spread forecast: 400–500 (current: 464bps)
- Upside risk: higher growth and earnings
- Downside risk: fall in commodity prices

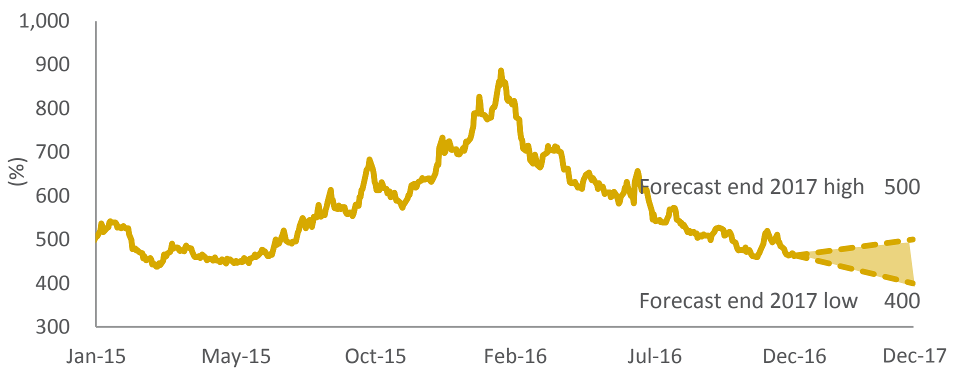
EU high yield
12 month index return: 3.0%–5.0%

- Spread forecast: 350–450 (current: 430bps)
- Upside risk: stronger growth
- Downside risk: political instability

Euro HY credit spreads [1]



US HY credit spreads [1]



Source: BAML and BlueBay forecasts, as at 2 December 2016
Note: US HY is BAML US High Yield Index (H0A0) and EU IHY is BAML European Currency High Yield Index (HP00)
1 Past performance is not an indication of future returns
2 As at 2 December 2016

Investment grade: alpha rather than beta

We expect greater volatility and credit dispersion in 2017 to create a richer opportunity set for active strategies to generate alpha.

We expect some spread compression in US investment grade (IG) to partially offset higher rates. Political risk and the overhang of ECB tapering implies less potential for spreads in Europe to meaningfully tighten at an index level.

Credit and sector picking allied to active duration and risk management can limit drawdowns and generate incremental yield even in an environment of rising rates.

- Duration meaningfully contributed to beta returns in 2016. In 2017 we expect duration to detract rather than add to returns. Current spreads offer some, albeit limited, upside for incremental spread compression. Beta returns including roll-down from steeper yield and credit curves will likely be flat-to-low single-digit in the face of rising interest rates
- In Europe, with elevated political risk and likely ECB tapering, we anticipate greater credit dispersion and rewards from bottom-up credit selection as QE-repression and compression unwinds. Although core rates in Europe will remain extremely low, we think the scope for meaningful spread tightening is also limited because of political risk and more supply. We expect beta returns will be low but it would be a much more favourable environment for alpha generation
- We believe corporate tax reform and cuts, repatriation of overseas cash, and fiscal stimulus will boost earnings and be positive for US credit and especially IG. Tighter credit spreads will at least partially offset higher US rates. Foreign demand for higher-yielding US credit is expected to remain strong and the supply of new bonds could decline in response to tax changes and investor push-back against 'financial engineering'
- Policy divergence and political risk will broaden the opportunity set for macro-orientated strategies as well as for global credit portfolios. Active duration management, relative value and idiosyncratic risk and the flexibility afforded to deviate from long-duration benchmarks can allow IG credit portfolios to generate positive returns despite rising rates

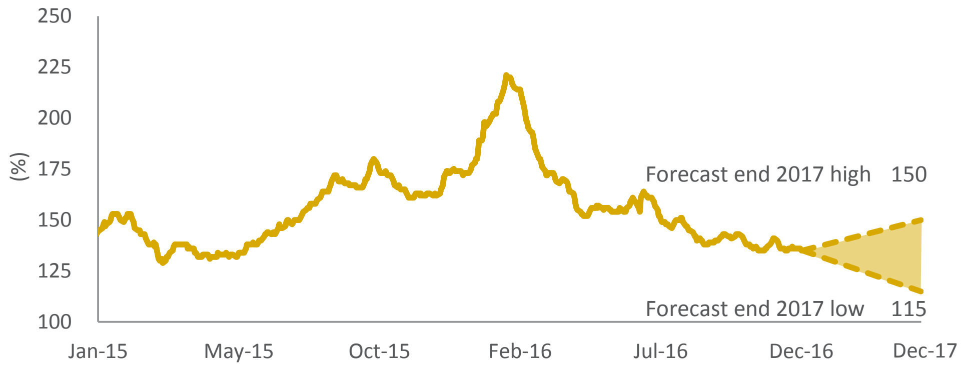
US investment grade
12-month 'index' return range: 1%–3.0%

- Spread forecast: 115–150 (current 135bps)
- Upside risk: meaningful decline in supply
- Downside risk: foreign investor outflows

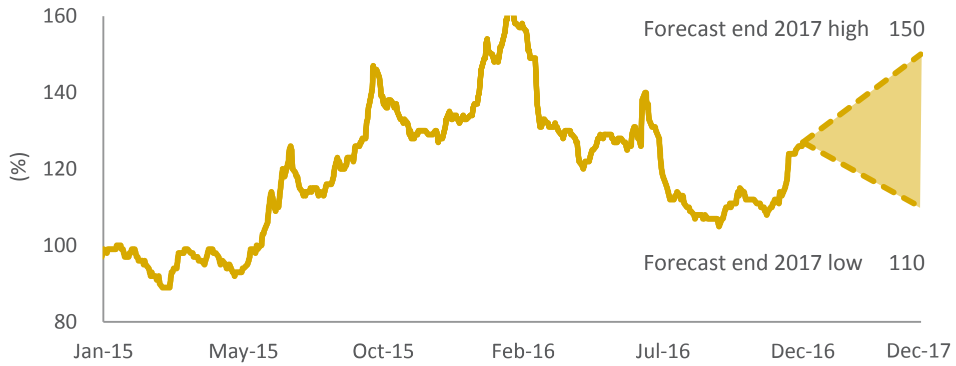
EU investment grade
12-month 'index' return range: 0.0%–2.0%

- Spread forecast: 110–150 (current 126bps)
- Upside risk: stronger growth & inflation
- Downside risk: political risk

US IG credit spreads and forecast [1]



EU IG credit spreads and forecast [1]



Source: BAML and BlueBay forecasts, as at 2 December 2016
Note: US IG is BAML US Corporate Index (C0A0) and EU IG is BAML Euro Corporate Index (ER00)
1 Past performance is not an indication of future returns

Emerging market debt: for better or for worse

BlueBay Asset Management

The election of Donald Trump raises two potential headwinds for EM assets: rising US rates and dollar; and the threat of trade protectionism.

Until there is greater clarity on President Trump priorities, US policy uncertainty will weigh on EM assets.

Nonetheless, under our base case of higher US Treasury yields, returns on EM dollar credit are likely to be low single digit. The range is wider and more positively skewed for EM local debt because of high local rates.

- 2016 marked an inflection point for EM fundamentals with a widening growth advantage over DMs. The positive trends that underpinned EM asset outperformance – stabilisation in China and commodity prices, correction of macro-imbalances and improving growth – are set to continue into 2017
- Rising US rates and dollar in response to meaningful Trump fiscal stimulus is a headwind for EM hard currency debt (EMD). But global reflation is a fundamentally positive environment for EM. However, an aggressively protectionist US would hurt global growth, trade and investment flows that would require further painful adjustment to new growth models for many EMs. EM assets have underperformed since the US election in part reflecting US policy uncertainty
- Our projected range for EMD beta returns in 2017 is 1% - 5% given rising US Treasury yields and limited scope for meaningful spread tightening in light of uncertainties around US trade and foreign polices. Relatively high real rates support mid-single-digit returns on local currency debt with currency the key source of volatility for international investors. Consequently the range for EM local debt returns (unhedged in US dollar) is wide: 0% to 6%
- 2017 could be good year for EM as fundamentals continue to improve, or it could take a turn for the worse if the US actively reverses global trade and capital flows

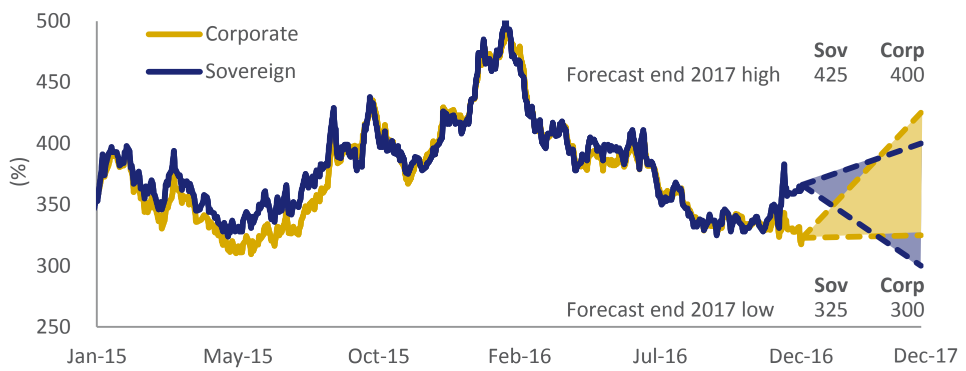
EMD 'hard currency'
12-month 'index' return range: 1.0%–5.0%

- Sovereign spread: 325–425 (current 360bps)
- Corp spread: 300–400 (current:320bps)
- Corporate HY default rate: 3%–5%
- Upside risk: mild Trump & stable US rates
- Downside risk: protectionism

EM local currency debt
12-month 'index' return range: 0.0%–6.0%

- Yield: 6.5%–7.5% (current 6.9%)
- EMFX: -6% to +0%
- Upside risk: stable/weaker US dollar
- Downside risk: much higher US rates

EM sovereign and corporate credit spreads



EMFX and local bond yields

Source: JP Morgan, BlueBay forecasts, as at 2 December 2016

Notes: Indices: Corporate is JPM Corporate EMBI Diversified Composite spread to worst; Sovereign is JP Morgan EMBI Global Diversified Face Constrained Index, All Maturities, spread to worst; EMFX is JP Morgan Emerging Market Currency Index (EMCI) Live Spot and Local yield is JP Morgan GBI-EM Global Diversified Index, All Maturities, Yield

1 Past performance is not an indication of future returns

Convertible bonds: duration protection and an attractive risk reward

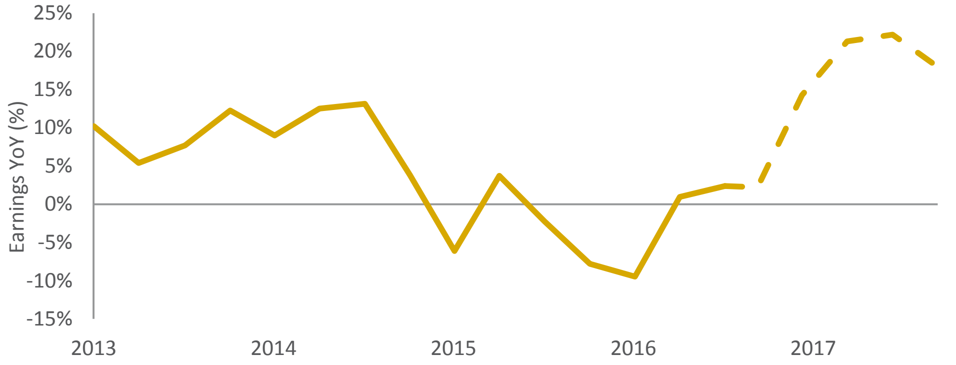
We project global convertible bond returns (at an index level) of between 4% and 8% in 2017.

US-led global reflation implies higher equity markets and rising core rates. Convertible bonds provide access to the equity upside with less volatility.

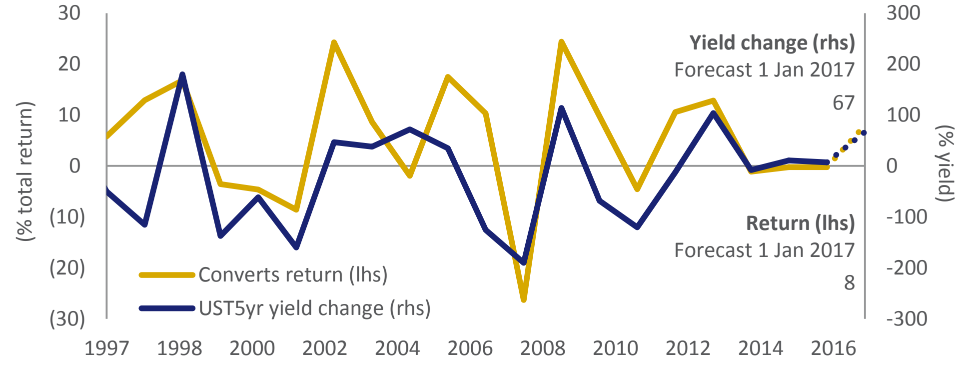
Fixed income investors can reduce duration risk by adding convertibles to their portfolios and gain exposure to equity upside.

- Due to their hybrid nature, convertible bonds have the potential to generate strong returns even as core rates move higher. Although fixed-income instruments, convertibles have limited interest rate sensitivity (duration) due to their embedded equity optionality. Reflation is positive for risk assets - equity and credit - and hence convertible bond valuations , despite rising interest rates. Convertibles typically have a negative correlation to Treasury yields so long as rising interest rates go hand in hand with rising equity markets
- In the US, rising nominal and real growth, higher corporate earnings and tax reform provides a positive backdrop for equity-sensitive assets. Moreover, a cut in the tax liability on cash repatriated from overseas is a potential boon for the tech and pharmaceutical sectors that are a big component of the US convertible bond universe. Rising rates and M&A are likely to be the catalyst for an increase in supply that will improve market liquidity and the opportunities for investors. Very low interest rates, high valuations and elevated political risk mean that European convertible bonds will continue to be relatively unattractive to investors as well as issuers. In contrast, a weaker yen and global reflation renders Japanese convertible bonds more attractive. However for Asia as a whole, if a Trump administration aggressively pursues a protectionist trade agenda, risk assets in the region will suffer
- The key downside risk to our projections is that US economic growth and corporate earnings fall meaningfully short of our expectations. In such an environment, equity markets will, at best, be flat and credit spreads will widen as fears of a downturn re-emerge
- After a year of underperformance, the market and macro backdrop for convertible bonds is much more favourable and we expect returns of between 4% and 8%

Year-on-year change in S&P500 earnings



Returns versus interest rate changes



Source LHS chart: S&P500 quarterly earnings per share and consensus analyst forecasts; Bloomberg, as at 2 December 2016
Source RHS chart: Thomson Reuters Global Focus Convertible bond index; Macrobond; BlueBay forecasts, as at 2 December 2016
Note:
1 Past performance is not an indication of future returns

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