
Global Fixed Income Outlook

Brightest Spot for Global Growth

Executive Summary

The US job market has been one of the brightest spots in a global economic recovery that has otherwise disappointed on many levels. Steady job gains in the US have provided critical fundamental support for financial markets in an environment where growth in many economies is faltering, political and geopolitical event risk is elevated and monetary policy is increasingly disruptive. A reversal of US employment gains would be a game-changer, but we think this is more of a risk for 2017 or later.

- **In the near-term, we expect global growth to be slow but steady.** The US could accelerate a bit over the next few months and China is likely to be stable, but we think a meaningful pick-up in global growth this year is unlikely (see our regional forecasts, p.2).
- **Over the longer-term, we think US downside risks are growing.** Tight US labor markets are creating wage growth, which could eventually lead companies to cut jobs or accept lower earnings. We think either scenario increases the risk of a US recession over the next year or two. The big unknown is whether higher wages lead consumers to spend more, which could boost corporate revenues and offset some of the effect of higher wages on earnings (see p.3).
- **The headwinds from Brexit are likely to be felt in 2017.** The main near-term risk from Brexit has not materialized; markets have been orderly and contagion via the financial channel has been limited. Over the longer-term, however, we think the UK is likely to experience a recession and Eurozone growth is also likely to slow (see p.4).
- **China's credit growth remains more of a long-term risk as well.** Credit growth has helped stabilize China's economy, which has served to reduce capital outflows. But the transmission of credit to the economy appears less and less efficient and we think the resulting financial imbalances create longer-term risks to the sustainability of growth and credit (see p.5).
- **Downside risks put more pressure on policy.** The limits—and negative side-effects—of extreme central bank easing measures have become increasingly apparent, leaving monetary policymakers with limited options to address downside risk. Fiscal stimulus is coming in Japan, but we see little scope for meaningful fiscal measures elsewhere (see p.6).
- **In this environment, we think security selection and relative value offer the most opportunity.** We see little value, and growing downside risks, in the government and corporate bond markets. We prefer to be below the market-weight in both sectors. In our view, most of the opportunity is in specific emerging market and corporate issuers, the securitized sector and in relative value positioning across different regions and markets (see p.7).

Growth Outlook

We expect slow global growth to continue, with Brexit adding downside risk to the UK and European outlook. We believe the impact of Brexit will take time to play out, with much of the effect coming in 2017, and we have lowered our forecasts for 2017 growth in both the UK and Eurozone. We left forecasts for the US, Japan and China unchanged as we expect Brexit to have limited effects on these economies. We generally expect inflation to remain low across developed economies, although we see clear signs of a pick-up in US wage pressures.

- **We expect near-term improvement in US economic growth, though we see growing risk of a US recession in late 2017.** We think US growth is likely to improve as various headwinds fade, including the oil-driven decline in business investment and the effects of the strong US dollar. The housing sector outlook remains positive; given the low level of interest rates, borrowing costs for developers and consumers remain quite attractive, which is supportive for US real estate fundamentals. Our base case is that the US grows at around 2% this year and next, but we see a growing risk of a US recession in 2017 as tight labor markets put upward pressure on wages and downward pressure on corporate sector profits. The upcoming Presidential election could produce some volatility in markets but we think fiscal policy under either candidate will remain supportive of economic growth.
- **China appears stable near-term, while rising debt could make policymakers' growth push unsustainable over the longer-term.** Economic activity has stabilized on a combination of easier monetary policy and more aggressive fiscal stimulus targeted at infrastructure. The property market has improved following a period of volatility, although recent price rises and new project starts are both slowing. Export data have been mixed, suffering in particular from weak demand in Asia. The growth outlook is challenged by excess capacity in manufacturing, potential spillover from weakness in industrial activity into the services sector and reduced efficiency of policy levers. Our forecast is for 6.5% growth in 2016 and 6.0% in 2017.
- **We expect Eurozone growth of about 1.3% in 2016 and 0.6% in 2017.** We think trend growth in the Eurozone is roughly 0.5%, so the current modest level of growth should still lead to a gradual reduction in slack and unemployment. Nevertheless, without much wage growth, rising headline inflation will likely reduce disposable income and weigh on consumption activity despite a firming labor market. The impact of Brexit on the Eurozone is likely to be manageable, as exports to the UK account for only 3% of GDP. We expect a modest slowdown in growth and increasingly supportive fiscal and monetary policy, with the ECB more likely to focus on additional easing via asset purchases rather than further rate cuts to avoid renewed rounds of competitive currency devaluation.
- **Japanese growth and inflation have disappointed, however increased fiscal support should provide some help.** Prime Minister Shinzo Abe's decision to delay the consumption tax hike that had been set for April 2017 moved growth expectations a touch higher in 2017 and inflation forecasts modestly lower. A lack of wage growth has been the key disappointment and threat to achieving a sustainable rise in inflation. Abe is scheduled to release the details of a new fiscal stimulus package by July-end, which is likely to further support growth. However, the additional stimulus on the fiscal side may deter the Bank of Japan from cutting rates, which, along with a rising current account surplus, could make it more challenging for Japan to counter persistent yen strength.
- **In the UK, post-Brexit we expect growth of 1.2% in 2016 and 0.5% in 2017.** We believe the risks to this forecast are likely to the downside, with the potential for the UK to experience a recession over the next one or two years. We expect the Bank of England to weather the post-Brexit storm with monetary stimulus this summer. Reduced political uncertainty given the accelerated accession of Theresa May as Prime Minister has helped risk assets retrace Brexit-induced sell-offs. Nevertheless, several sources of uncertainty remain and while the impact of the UK's exit is likely to be limited globally, the vote has put the brakes on an economy that expanded at a rate of above 2% in each of the last two years.

US Employment: How Will Global Growth's Brightest Spot Evolve?

The resiliency of US employment growth has been the main bright spot in an otherwise gloomy global economic environment. Weak business investment, low inflation, low productivity growth, limited wage growth and modest consumption all contribute to a disappointing fundamental picture.

Against this backdrop, rising US employment has provided an important sign of consistent fundamental improvement which, along with ever-increasing central bank accommodation, has supported risk appetite despite the numerous macroeconomic and political challenges.

Looking ahead, the US labor market cannot continue to expand indefinitely at its current pace, so we think the critical question is how the global economy's main bright spot evolves. Right now, tight US labor markets are leading to some acceleration in wage gains. Looking ahead, we expect wage growth to pressure corporate profit margins, which raises risks for the US economic cycle. Historically, earnings recessions tend to be followed by economic recessions. The good news is that earnings probably bottomed in the first quarter of 2016. Consensus estimates suggest revenue growth is likely to drive overall earnings growth back into positive territory over the next few quarters, followed by margin expansion and stronger overall growth in 2017.

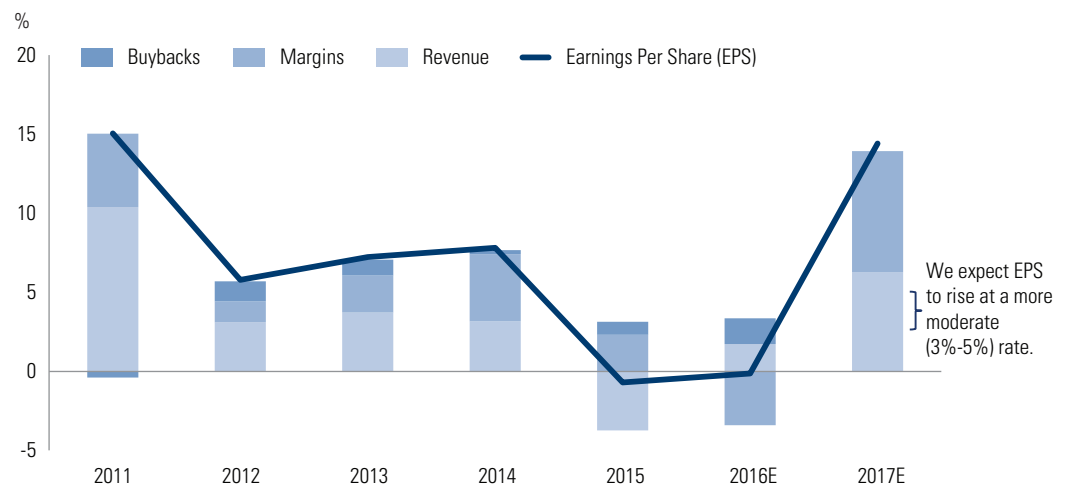
Expectations for a rebound in earnings are probably too high, but we do think the corporate sector can maintain profits and earnings at a relatively healthy level even after adjusting for higher wages. Continued wage gains seem likely to provide some support for consumption that could flow back to corporations through higher revenues, helping to mitigate the impact of wages on overall profits. That would be a relatively benign evolution of the employment story.

The risk to the benign scenario is that wage growth could lead to some combination of lower earnings and reduced job growth, or potentially layoffs. Companies have already taken many of the available steps for preserving earnings in a period of weak demand growth: cutting costs, engaging in mergers and acquisitions, adding leverage and buying back shares. That leaves fewer options for maintaining earnings if wages continue to rise, and companies might choose to reduce employment rather than materially increase wage costs.

There is also the question of how consumers will adjust. So far, consumers have chosen to save much of the additional income from lower gasoline prices and higher wages. Saving as a percent of disposable income hit a three-year high in March. Some of that could simply be due to a gradual accumulation of extra income rather than a conscious decision to save, and saving has declined in recent months. However, if the employment story evolves into layoffs and/or falling earnings, we think consumers are likely to remain cautious, raising the risk of a US recession over the next 12-24 months.

US Corporate Earnings Can Probably Absorb Some Wage Growth

S&P 500 Earnings Components: Actual and 2016-2017 Consensus Estimates



Source: Thomson Financial, S&P, Morgan Stanley Research, GSAM.

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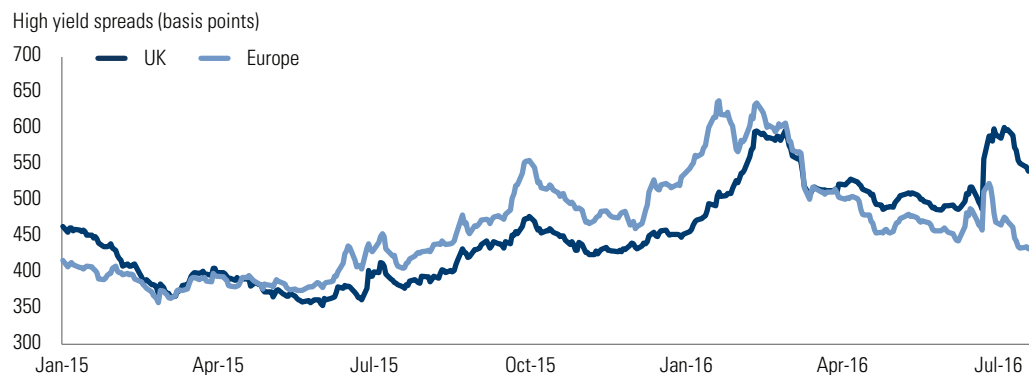
Brexit: Short-Term Volatility, Long-Term Headwinds

The impact of the UK's vote to exit the European Union (EU) has so far been modest. After an initial burst of volatility across global markets, most sectors have recovered to pre-Brexit levels or better.

Risk premiums remain somewhat elevated in sectors that are most directly exposed to Brexit risks, but even the UK high yield market—which includes many smaller companies with primarily domestic sales—has seen spreads tighten from the elevated post-Brexit levels. European high yield spreads have fallen back below their pre-Brexit levels. With markets taking Brexit in stride, the biggest near-term risk—broad contagion via the financial channel—has not materialized.

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UK and European Credit Markets are Taking Brexit in Stride



Source: Bank of America Merrill Lynch Sterling and Euro High Yield Indices. As of July 20, 2016.

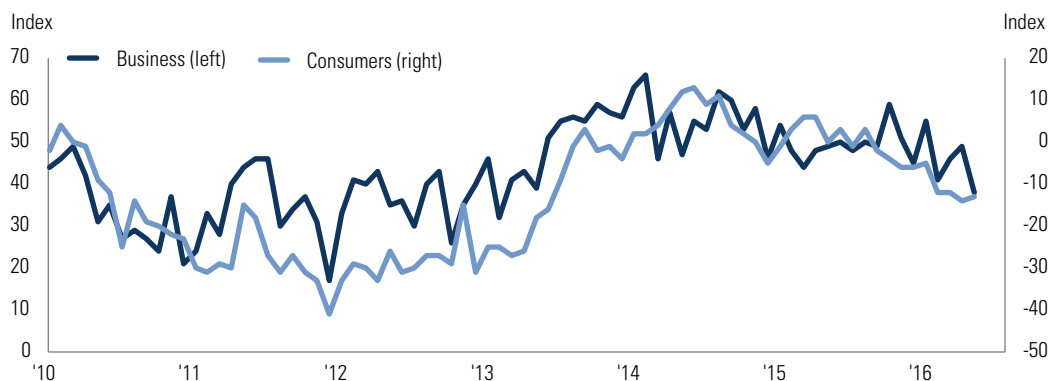
Over the longer-term, we think Brexit will be a continuing headwind, primarily for the UK but also for Europe. Uncertainty about the operating environment and economic outlook will likely restrain business investment and consumer spending. We think business investment in the UK will be particularly restrained, and a slowdown in the housing market appears very likely, both in terms of transactions and prices. Housing market developments could affect consumption through the wealth channel but also via a direct loss of consumption associated with moving to a new house. Weakness in the British pound should provide some offset in the form of more competitive exports, but we think a UK recession—or at least near-zero growth—is likely over the next 12-18 months.

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In Europe, the direct effect via the trade channel is likely to be relatively modest, but Brexit compounds the existing challenges. We think uncertainty over the political implications of Brexit for the future of the European Union and upcoming elections are likely to be an ongoing headwind to confidence and activity.

Brexit is Likely to Weigh on UK Business Investment and Consumer Spending

UK Confidence: Next 12 Months



Source: GfK Consumer Confidence Indicator, Lloyds Bank Business Barometer. As of July 8, 2016.

China: Kicking the Credit Can Down the Road

Credit expansion is becoming less and less efficient at generating economic growth, requiring more and more credit to maintain growth near the government's target.

Looking ahead, we think the growth of non-performing loans in excess-capacity sectors will increase pressure on the banking system and eventually require some form of recapitalization.

The risk scenario is that new credit is directed to unproductive investment and capital outflows eventually create a funding crisis that leads to a larger need for recapitalization.

In our view, China's current pace of credit and economic growth are ultimately unsustainable. Credit seems to be becoming less and less efficient at generating economic growth, requiring more and more loans to keep growth near the government's target. Eventually, something has to give, but we think policymakers can continue to kick the can down the road for the foreseeable future.

The optimistic explanation for the declining efficiency of credit is that China's economic transition, high savings and financial structure all support higher credit growth. In an export-oriented economy, a loan to a start-up company looking to sell goods abroad can boost economic output relatively quickly. The credit required to invest in a new subway line may not produce economic benefits for several years. Thus, as China has transitioned to an economy driven more by domestic demand and investment, credit expansion may simply be taking longer to flow through to economic growth. China's high savings rate and relatively small equity market may also be contributing to debt growth, as savings flow to borrowers.

We think the optimistic case for China's debt growth makes some sense, but we remain wary of the pace of new credit creation and the sustainability of existing debt. New credit is primarily flowing to infrastructure and real estate (which offers banks the security of collateralized lending). Much of the existing debt stock is held in the corporate sector. The bulk of this corporate debt was accumulated by state-owned enterprises (SOEs) controlled by local governments in sectors such as coal, steel and shipbuilding that are now burdened by excess capacity, weak profitability and declining efficiency.

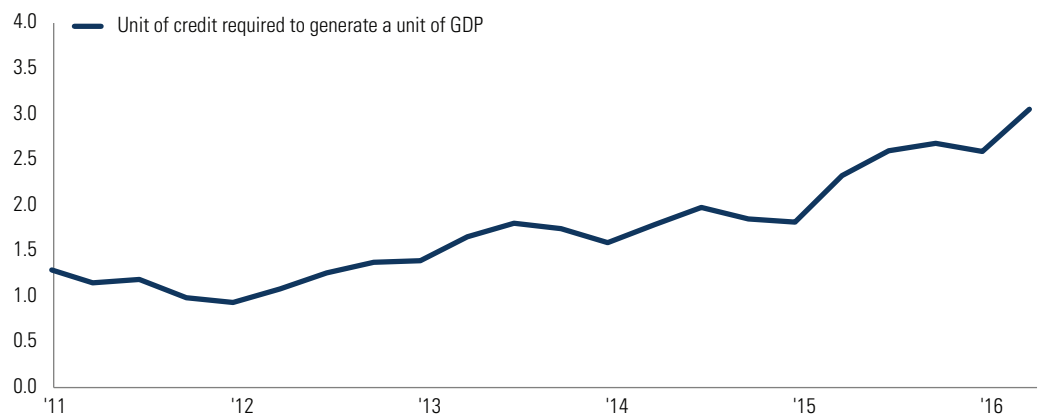
Looking ahead, we think the growth of non-performing loans in excess-capacity sectors will increase pressure on the banking system, eventually requiring recapitalization. In our view, the most likely scenario is a relatively large recapitalization equivalent to around 30% of GDP, but through a process that is relatively benign and opaque. Much of the existing debt is owed by government-linked companies to government-linked banks. We think the government will need to inject capital, and some non-performing assets are likely to get shuffled around and adjusted in ways that buy time and limit stress in the banking system.

We think the best-case scenario (but also the least likely) is that policymakers enact reforms targeted at the local SOEs and shadow lenders and direct new credit to projects that increase potential growth. In that scenario, we think the need for recapitalization could be significantly smaller, perhaps equivalent to 10% of GDP.

The risk scenario is that new credit is directed to unproductive investment and capital outflows create a funding crisis that requires a bigger recapitalization. While not our base case, this is the scenario we watch for when looking to China for potential signs of disruptive change.

China's Credit Growth is Becoming Less Efficient at Driving Economic Growth

China Property Prices (loan increment/GDP increment)



Source: HSBC. As of 1Q16.

The Policy Conundrum: Time for the Helicopters?

The conundrum for policymakers looms ever larger: monetary policy options are limited and increasingly disruptive; most countries have little capacity or appetite for fiscal stimulus; coordinated fiscal and monetary policy could be effective but puts central bank credibility at risk.

Wherever possible, central bankers appear to be sitting in wait-and-see mode rather than risk a move that might do more harm than good. Even the Bank of England (BoE) decided to sit tight at its July 14 meeting rather than respond preemptively to the expected Brexit-related weakness. Policy inaction is unlikely to last much longer.

- In **Japan**, we expect yen appreciation and the associated downward pressure on growth and inflation to prompt further easing by the Bank of Japan (BoJ) at its July 29 meeting. Japanese Prime Minister Shinzo Abe's convincing victory in the July upper house elections also paves the way for new fiscal stimulus.
- In the **UK**, we expect the BoE to cut interest rates from 50 basis points to 25 basis points in August, with a strong possibility of asset purchases. The UK may look to ease some of the fiscal tightening that likely contributed to Brexit, but we see little scope for major stimulus.
- In the **Eurozone**, we expect the European Central Bank (ECB) to cut rates in September, but only by 10 basis points. We think the ECB remains more focused on asset purchases. Declining rates and limited issuance mean that fewer government bonds are eligible for ECB purchase, so we think the ECB is very likely to announce changes to its current program. With the exception of Germany (where stimulus appears unlikely) we see little scope for fiscal easing. France, Spain and other countries are on track to miss EU deficit targets and are under pressure to tighten rather than loosen fiscal policy.
- In the **US**, we think the Fed will probably remain on hold until December or later. Whenever markets begin to anticipate a rate increase, US financial conditions tighten and the Fed is forced back into wait-and-see mode. The Fed now appears to be focused on lowering long-term projections for rate hikes, which might allow short-term rates to rise. However, the flattening in the US yield curve adds to the sense that the economy may be drawing closer to recession. Both US presidential candidates favor some form of fiscal expansion, but that will take time and we see no potential for fiscal stimulus ahead of the election.

Japan's expected shift to fiscal easing provides the starkest illustration of the policy conundrum. Previously, BoJ easing was paired with fiscal tightening (via the consumption tax hike). Pairing monetary easing with fiscal stimulus is a fundamental change, but we expect Japanese policymakers to make this combination implicit rather than explicit (i.e., new fiscal measures followed closely by the announcement of new JGB purchases by the BoJ, without explicitly tying the two policies together).

The conundrum for Japan is whether implicit monetary and fiscal coordination will be enough to offset Japan's structural headwinds, including high savings, the yen's status as a safe haven currency and aging demographics that have reduced the country's growth potential. The alternative is some form of "helicopter money", where the central bank permanently increases the money supply with the explicit purpose of financing fiscal stimulus. Considering the extent of BoJ asset purchases, a case can be made that the BoJ is already monetizing Japan's debt, and that being explicit about helicopter money would provide a stronger signaling effect.

Helicopter money might boost growth and inflation, but also carries significant risk for the financial system. Investors would likely question the BoJ's ability to avoid becoming permanently subordinated to fiscal policymakers, which could lead to higher risk premiums on Japanese government bonds (JGBs). Japanese banks have added duration risk to capture more yield in an environment of low net interest margins, and could face significant challenges if long-term JGB yields rise.

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Investment Themes

From an investment perspective, we think the macro backdrop suggests three main themes.

First, we think the pressure on the US corporate sector to raise wages while maintaining earnings is negative for US corporate credit. As we have discussed previously, we think the corporate sector is in the late phase of the cycle. This is when companies tend to reach for earnings by adding leverage, credit spreads are often more volatile and total returns on corporate bonds tend to be lower compared to other phases of the cycle. In a traditional cycle, the Fed would be raising rates to prevent an overheating economy from creating persistent wage inflation. Rate hikes would lead to defaults by weaker companies with too much debt and not enough earnings to afford higher rates. Slow growth has extended the cycle and kept the Fed from “taking away the punch bowl”, but at this stage we think leverage has increased and corporate fundamentals have deteriorated to the point that corporate bond spreads no longer offer attractive compensation for the risk. Our strategy is to be somewhat underweight US corporate bonds relative to benchmarks while maintaining exposure to specific issuers where we see strong or improving credit fundamentals.

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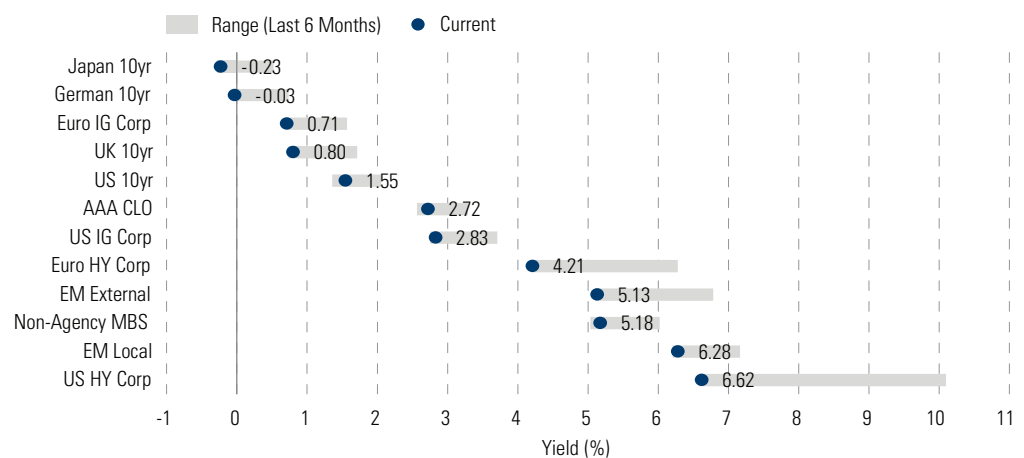
We think broad exposure to securitized sectors offers reasonably attractive carry and limited exposure to global macro factors and the US corporate credit cycle.

Second, we think diversified exposure to emerging market and securitized bonds offers the most attractive combination of yield and fundamentals. In emerging markets, we see value in specific countries with improving stories and attractive valuations. Venezuela, for example, has fundamental challenges but should benefit from the recent improvement in oil prices and has demonstrated strong willingness to continue servicing its debt. Another example is the Dominican Republic, a net oil importer with low debt-to-GDP. Thematic underweights include central and eastern European countries, which we think are overvalued and exposed to Brexit. We are also underweight China SOEs and hold credit default swap protection as a hedge against China stress scenarios. In securitized sectors, we favor diversified exposure across different segments of the market including non-agency residential mortgages and high-quality CLOs and student-loan asset-backed securities. We think broad exposure to securitized sectors offers reasonably attractive carry and limited exposure to global macro factors and the US corporate credit cycle.

Relative value positioning allows us to express macro-thematic views with more diversification and limited directional risk.

Third, we are negative on US and Japanese interest rates and prefer relative value as a strategy for positioning around global macro themes. Our strategy is to be somewhat underweight US and Japanese rates, where we see little value versus the risk given the potential for rate hikes in the US and further easing in Japan. Relative value positioning allows us to express macro-thematic views with more diversification and limited directional risk.

The Global Yield Spectrum: Steep Decline in JGB Yields Dragging Global Yields Lower



Barclays, JP Morgan, Bloomberg. As of July 17, 2016.

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