
Global Fixed Income Outlook

Seeking Equilibrium

Executive Summary

The macro environment remains supportive of assets geared to growth. Developed markets are leading a synchronized global expansion and financial conditions are easy, with strong equities and accessible credit. That said, we think markets might be complacent and we see inconsistencies that may find equilibrium in the coming months. US sentiment is running ahead of hard data, and rates are too low and financial conditions too loose for the projected policy tightening. We haven't seen much risk premium to reflect a tapering of quantitative easing (QE), political strains in Europe, or risks in China's financial sector. While we don't expect upheaval, we note that the credit cycle is mature, central bank policy is in flux and geopolitical risks are elevated. In a world of stretched valuations, we are currently focused on opportunities in undervalued emerging market currencies.

- **The global growth upswing has been synchronized and strong.** Our current activity index, which measures the growth signal from major high-frequency indicators, implies global growth is just above 4%. We think momentum is close to peaking, and while the US economy should keep strengthening, we expect more dispersion in global growth due to less accommodative monetary policy, the waning effects of China's fiscal stimulus and geopolitical concerns.
- **We see less symmetry in the global inflation outlook, due in part to dispersion in output gaps.** Last quarter (see "Reflation and Rising Rates") we noted that inflation is picking up, particularly in the US, but core measures remain weak in Europe and Japan. Wage growth is subdued, even where labor markets are tightest in Japan and Germany. We still see value in trades based on divergence in US and European rates.
- **The QE unwind is the next challenge for fixed income markets.** We believe the scale-back of large asset purchase programs that have suppressed volatility since the crisis poses risks of spillover to credit markets. We see the US Federal Reserve (Fed) taking steps to reduce its holdings of Treasuries and agency mortgages late this year, in line with its broader policy normalization. The European Central Bank (ECB) and Bank of Japan (BoJ) are likely to slow the pace of buying—despite remaining committed to policy easing—due to a scarcity of assets.
- **Political risk has increased, centered in Europe.** As discussed in our GSAM 2017 Outlook, the rise of nationalist politics poses a threat to the monetary union, irrespective of the outcome of the French elections. By the Italian elections in early 2018, we expect more risk premia in European sovereign debt ex-Germany. Meanwhile, the struggle to repeal the Affordable Care Act raises doubts about the broader pro-growth agenda in the US, and we think markets may be complacent about China's policy stability ahead of the 19th Congress.
- **We favor undervalued emerging market currencies.** Solid global growth, a stable trajectory of US interest rates, improved commodities markets and a reduced focus on President Donald Trump's trade proposals should help some more-volatile currencies rebound. Consistent with our expectation for more inflation and policy tightening in the US, we think US rates will rise, leading to steeper yield curves across major developed markets and weakness in agency mortgage markets.

Growth Outlook

The recent growth upswing has been strong, synchronized and beyond our expectations. Our global current activity index, which aims to provide a timely growth signal drawn from high-frequency data across the global economy, reflects growth just above 4%. This compares with around 2.5% based on quarterly GDP reports. We have revised up our forecasts for the largest developed economies, though we believe momentum is close to peaking. We still see dispersion in the inflation outlook. The US is the only major economy likely to see inflation close to target this year, and our low forecast for the Eurozone is our biggest departure from consensus. In the near term, we see emerging markets contributing to and benefiting from the global uplift. Over the longer term, we remain wary of a slump in Chinese growth or a debt-driven shock, and the consequences for connected economies. The key risks to our positive outlook are potential volatility stemming from geopolitical events—particularly in light of increased tensions with North Korea—or more-aggressive US policy tightening.

- **In the US we are looking for equilibrium between sky-high sentiment and hard data, and low rates and tighter Fed policy.** We think the qualitative and quantitative measures will converge around a modest pickup in growth, to roughly 2.2%. Growth may be stronger if the administration makes progress on tax reform, but we don't expect impacts from any pro-growth regulatory and fiscal policies before 2018, and we are watching for foreign policy- and trade developments that could destabilize the longer-term outlook. We see a disconnect in the persistence of low rates and easy financial conditions despite upward revisions in the Fed's policy projections. We expect US rates will adjust higher and we are watching for tightening in financial conditions as a potential risk to our Fed outlook. Our base case is for the Fed to raise interest rates two more times this year and start tapering its balance sheet, and the pace of hikes could accelerate in 2018.
- **In China we see activity slowing and risks from rising funding costs.** We expect growth to slow to 6.3% from 6.7% in 2016 as the effects of fiscal stimulus fade. Moderation in the property market due to credit tightening, and reduced demand for autos following the tax-cut expiry will likely weigh on domestic activity. We are encouraged by the National Congress' focus on reforms and central bank efforts to curb leverage by raising interest rates. However, the imbalance between credit- and economic expansion is concerning and rising funding costs may only add to pressure on heavily indebted state-owned enterprises and the financial system. China's relationship with the Trump administration and the leadership transition in November are key political uncertainties.
- **We see near-term growth improvements in the Eurozone but we do not expect core inflation to gather momentum.** We have revised up our 2017 growth forecast to 1.2% from 0.8% following positive data surprises; including a six-year high for the purchasing manager's index. However, despite the ECB's upward revisions of growth and inflation forecasts in March, we expect core inflation to remain around 1% to 2019. Unemployment remains in double digits, the improving trend has stalled in Italy and France and wages continue to stagnate. Renewed China demand helped exports in the first quarter, but we see headwinds from reduced trade with the UK. Moreover, uncertainty surrounding elections in France and Germany and political instability in Italy could weigh on sentiment.
- **Consumption and inflationary pressures in Japan remain weak.** A pickup in exports and housing investment has driven recent improvements in growth. The boost from housing appears to be fading, although continued gains in trade, the impact from last summer's fiscal stimulus and relatively loose financial conditions may help near-term momentum. Further out, we expect consumption to weaken despite low unemployment and increased labor force participation as wage growth remains subdued. We expect monetary policy to remain accommodative for the foreseeable future given the lack of domestically-generated inflationary pressures.
- **We expect lower UK consumption and uncertainty surrounding Brexit negotiations to weigh on investment.** We believe central bank and government actions following the referendum have helped to avert more negative economic outcomes. That said, survey data are weakening and falling retail sales suggest a decline in consumption, which has been a key driver of growth in recent years. We believe rising inflation will curb household spending power, and we expect weak investment due to uncertainty during the formal two-year negotiations to exit the European Union (EU). We think the Bank of England (BoE) will look through a temporary spike in inflation, providing expectations remain contained, and monetary policy is likely to remain on hold this year.

Political Risks and Realities

In Europe the stakes are particularly high given the rise of parties that would explicitly demand a breakup of the euro area or contest the union's terms.

We expect to see more risk priced into euro area markets ex-Germany by the time Italy goes to the polls in 2018.

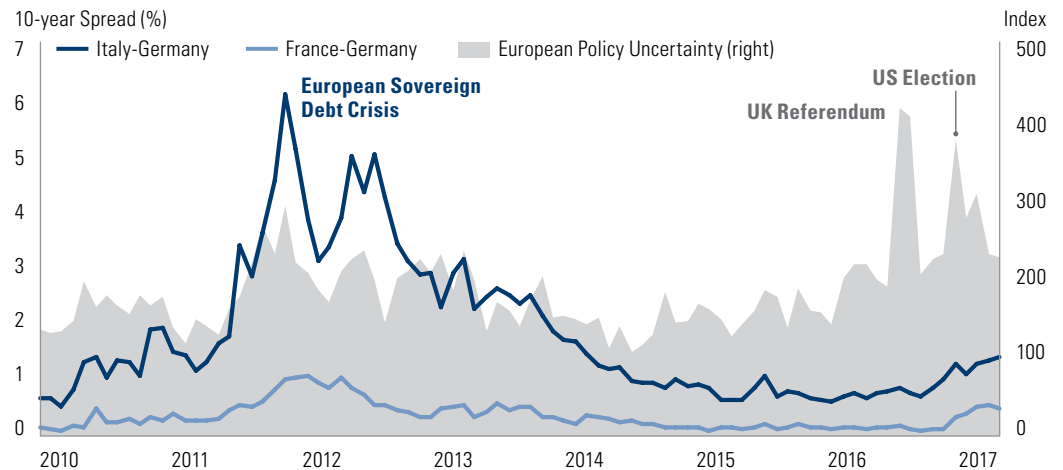
We think defensive trade should favor our overweight in euro area rates. We see the euro weakening relative to Nordic markets that we think are underestimating domestic growth.

Last quarter we discussed political risks, which we now see centering on imbalances in three regions. First is Europe, where we think the stakes are particularly high given the rise of parties that would explicitly demand a breakup of the euro area or contest the union's terms. Another is the US, where high expectations for reflationary policy—reflected in elevated stocks and sentiment—are confronting the challenges of delivering. And the third is China, as we think markets may be underpricing the risk of policy surprises ahead of November's 19th Congress (see p.6).

We have been concerned about the lack of premium in European sovereign markets despite tail risks arising from the populist influence in key elections, particularly the French presidential vote. So far sovereign markets have avoided a volatility spike, finding equilibrium in moderately wider spreads and declining political risk. Centrists prevailed in the Dutch election and the first round of France's vote and, at the time of writing, we think Emmanuel Macron will defeat Front National's Marine Le Pen in the second round on May 7. However, we don't think a Macron win could dispel the threat of Eurozone fragmentation over the longer term.

The rise of nationalism is the euro area's third major challenge since the 2011 sovereign debt crisis and the immigration surge in 2015. We expect to see more risk priced into euro area markets ex-Germany by the time Italy goes to the polls in 2018, as the anti-establishment Five Star Movement, which wants a referendum on euro membership, has become a close rival to the governing center-left Democratic Party. We have no position in Italy at this stage, though we think any defensive trade should favor our overweight in euro area rates. We are tactical on the euro, though we see it weakening relative to Nordic markets that we think are underestimating domestic growth.

European Markets Reflected Far More Risk in the 2011 Sovereign Debt Crisis



Source: Macrobond, "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com. As of March 31, 2017.

We see downside for the British pound, adding to pressure on inflation and consumer demand, and potential volatility over the two-year process of separation from the EU.

It is too early to gauge how the UK's exit from the EU may impact euro area politics, though we have views on the challenges for the UK economy. We see downside for the British pound, adding to pressure on inflation and consumer demand, and potential volatility over the two-year separation process. As a leading indicator we are watching talks on financial settlement—the UK payment to compensate liabilities to the EU—since strains over this agreement may imply more trouble ahead.

We think benefits to US corporate credit from the current tax reform proposals would be dispersed, and some sectors may be negatively impacted.

In the US, we expect equilibrium to come from convergence in elevated surveys and hard data, though it's still unclear how market expectations will respond to political realities. Much will depend on whether the Trump administration can deliver the pro-growth policies that resonated in the election campaign. Stocks have come off record highs since the rejection of the Republican plan to replace the Affordable Care Act, and progress on tax reform and deregulation could be restorative. However we think benefits to corporate credit from the current proposals would be dispersed, and some sectors may be negatively impacted. The factors that encourage more aggressive corporate behavior, such as mergers and acquisitions or shareholder-friendly actions, may undermine credit profiles. Moreover, we see potential for adverse economic and market impacts from any escalation in the more-aggressive aspects of the administration's foreign policy- or trade agenda (for more on this, see our February Macro Insights "Trade Showdown").

QE: The Quiet Exit

We think this year marks the peak of QE in the largest developed economies. The reasons are different but the most likely implications are similar: steeper yield curves and a risk of volatility as the biggest buyers withdraw from their markets.

Central banks in the largest developed economies are aiming for a low-key exit from the asset-purchase programs that have made them the biggest buyers in their respective markets since the financial crisis. We think this year marks the peak of QE, and over the next 12 months we expect to see various stages of balance sheet normalization for central banks in the US, Europe and possibly Japan. The reasons are different but the implications are similar: steeper yield curves and the risk of a spillover across fixed income markets as programs that have suppressed volatility and kept rates low for almost a decade unwind.

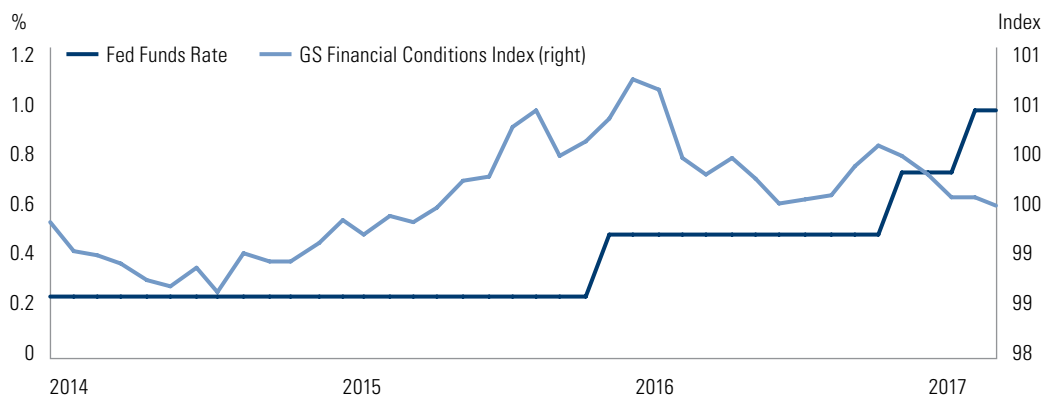
In the US, strengthening growth and inflation and concerns about market complacency are motivating the Fed to extend the process of policy normalization from interest rate hikes to balance sheet reduction. In the UK, despite the risks of a growth slowdown, we see upward pressure on UK rates as the near-term inflation outlook is too high to warrant additional BoE asset purchases. By contrast, in Europe and Japan stubbornly low inflation is driving policymakers to continue easing, but a scarcity of assets is forcing them to slow purchases. The pace they have set is unsustainable—the ECB is approaching the self-imposed limits of the capital key, which determines how much the ECB can buy in each member state's market. Moreover, the economic impact of QE is unclear and policymakers are increasingly concerned about central bank risk exposures.

Fed in Flux

Starting around year-end we believe the Fed will slow reinvestment of maturing Treasury and agency mortgage securities in its portfolio. We expect an upward adjustment in US rates and we see mortgage spreads widening.

We think the Fed will take incremental and well-telegraphed steps to shrink its balance sheet, in line with its gradual path of interest rate hikes. Similar to the Fed's projections, we see two further hikes this year and a likely acceleration in 2018. And starting around year-end we believe the Fed will slow reinvestment of maturing Treasury and agency mortgage securities in its \$4 trillion portfolio, rather than the more aggressive action of stopping altogether or selling. We expect US rates to adjust higher, steepening the Treasuries yield curve at the longer end, and we see mortgage spreads widening, as the market continues to underprice even this moderate scenario of Fed tightening.

Financial Conditions Are Easing Despite Fed Hikes



Source: Goldman Sachs US Financial Conditions Index. As of April 17, 2017.

So far credit spreads have tightened as agency mortgages have widened. Signs of a turn in that relationship could lead us to a more negative stance on credit and potentially a less-hawkish outlook on Fed policy.

We see two key risks as plans for the balance sheet evolve. A sharp adjustment in rates and agency yields could cause spillover to credit markets, driving financial conditions back to the overly tight levels that deterred the Fed from hiking in the recent past. So far financial conditions have remained surprisingly loose—with easy credit, strong equities and a firm dollar—despite the Fed’s more sobering speeches on policy normalization. As an indicator we are watching the correlation of credit and mortgage markets, which has been negative so far, with credit spreads tightening as agency mortgages have widened. Signs of a turn in that relationship could lead us to a more negative stance on credit and potentially a less-hawkish outlook on Fed policy.

The other key risk stems from uncertainty over Fed policy continuity. Fed Chair Janet Yellen’s tenure is up for renewal in early 2018 and President Trump has the option to nominate a replacement for her later this year. So far it is unclear whether he will, having abandoned his campaign-era criticisms of Yellen. Nevertheless, a change of leadership as the Fed unwinds its crisis-era policy could have significant implications, particularly if the new Chair favors a much more hawkish stance. Moreover, Yellen’s is only the most senior of several posts that will need to be filled over the coming year, which could shift the balance of views on the Board.

Can the BoJ Example Help the ECB?

We think the ECB will announce a further decline in asset purchases toward year-end, to take effect in 2018. We base this view on the dwindling pool of securities, rather than any progress on hitting the inflation target.

The ECB’s reduction in the pace of QE purchases to €60bn from €80bn per month has had limited market impact, with President Mario Draghi stressing the move shouldn’t be considered a tapering. We think the ECB will announce a further decline in asset purchases toward year-end, to take effect in 2018. We base this view on the dwindling pool of securities, rather than any progress on hitting the inflation target. Despite our outlook for somewhat stronger growth, we are not convinced by speculation that the ECB could first raise interest rates from the current -40bps, as we think inflation will remain too low next year to justify additional steps toward policy normalization.

Nor do we expect a rapid dispatch of the ECB’s QE program, given the risk of market instability. Our base case is for an incremental and well-communicated taper, possibly with additional measures to help curb market volatility, similar to the BoJ’s yield curve control framework.

The BoJ has made no formal pledge to reduce asset purchases, but Governor Haruhiko Kuroda has recently shown a greater willingness to discuss an exit from QE. The BoJ’s balance sheet is by far the most altered by the policy, as it now holds assets worth more than two-thirds of GDP. So far the BoJ has sufficient credibility on its commitment to tether the 10-year yield around zero to cut back on asset purchases, but it maintains a loose target to grow its holdings by around 80 trillion yen a year. The first step toward the exit might be to quietly let this guidance drop.

EM: Value in Currencies

We see opportunities in currencies that sold off in spite of solid fundamentals—such as positive current accounts, low debt and improved governance—as we believe they are best placed to gain from the global growth upswing that is now underway.

Emerging market currencies are coming back from four years of turbulence, bringing some of the best opportunities in today’s markets. In a field of stretched valuations after an unusually long credit cycle, we see a rare combination of value and improving fundamentals in parts of the developing world, and currencies generally remain undervalued relative to debt. Moreover, contrary to the traditional perception, we believe emerging markets may be less exposed than most developed markets to the epicenters of today’s political risks. In short, we favor markets that we believe can gain from growth in Europe and the US without foundering on their political problems.

This is not to say that political risk has disappeared from developing markets, as demonstrated by the volatility in the South African rand following the finance minister’s dismissal, and the Turkish lira’s response to President Recep Tayyip Erdogan’s victory in a controversial constitutional referendum. But these are idiosyncratic events with less potential to drive contagion.

The shocks over the past four years have been external and market-driven. Emerging market currencies collectively took the brunt of fears over rising US interest rates in 2013, followed by the commodities market downturn in 2014-15 and subsequent US dollar rally. These exogenous factors have since receded, leaving a substantial premium in emerging markets, especially in a developed-market environment of negative inflation-adjusted yields.

We believe central and eastern European currencies have the advantages of strong balance of payments and trade linkages to European growth, while not enmeshed in the euro's problems. We expect the Czech koruna to appreciate on the removal of the euro peg.

In Latin America, we think the Brazilian real can gain from a stabilizing macro-environment and we see value in the Mexican peso. We also see some benefit from the reduced focus on the protectionist aspects of President Trump's trade agenda.

We are positioned for weakness in Asian currencies most exposed to turmoil in China, such as the Taiwan, Singapore and Hong Kong dollars.

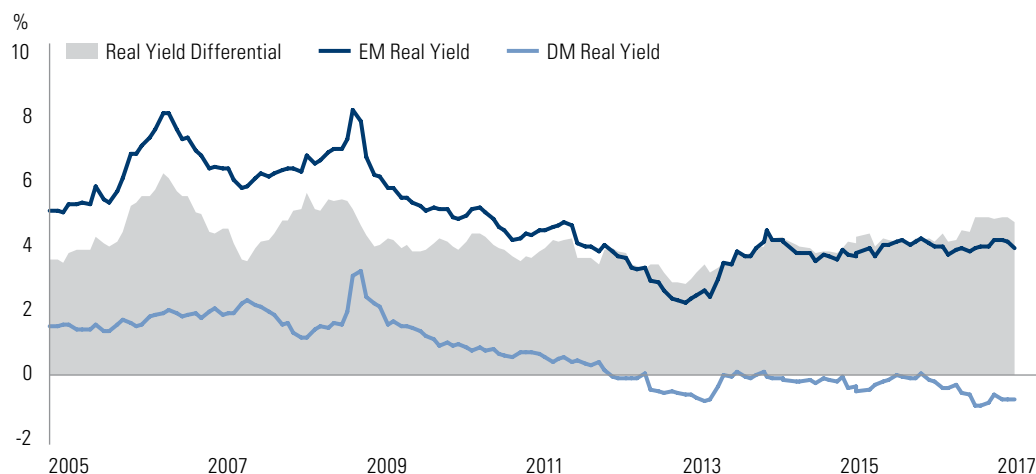
Dispersion in Recovery

In a diverse asset class, dispersion of performance is to be expected, and we see opportunities in the recovery from an indiscriminate downturn. We favor currencies that sold off in spite of their solid fundamentals—such as positive current accounts, low debt and improved governance—as we believe they are best placed to gain from the global growth upswing that is now underway.

From a regional perspective, we believe central and eastern European currencies have the advantages of strong balance of payments and trade linkages to European growth, while not enmeshed in the euro's problems. We also see a country-specific driver of appreciation in the removal of the Czech koruna's peg to the euro. In Latin America, we think the Brazilian real can gain from a stabilizing macro-environment. We also see some benefit to the region from the reduced focus on the protectionist aspects of President Trump's trade agenda. For instance, we see value in the Mexican peso, which recovered from its post-US election slump on the failure of the healthcare overhaul and the pivot to tax reform.

And we believe some currencies can benefit from execution risk on US domestic policy, as curbs on President Trump's reflationary policies may reduce the risk of more-aggressive Fed tightening. The relatively orderly pace of Fed policy tightening has been a tailwind for emerging market assets recently, though we see some near-term risk that market expectations have scaled back too much and we are watching the potential for tremors as they adjust higher.

Higher Inflation-Adjusted Yields in Emerging Markets Can Attract Investment Flows



Source: Barclays as of March 31, 2017

We still think the main risks within the developing world stem from China, and markets may be complacent. The economic slowdown is a long-term challenge but we have nearer-term concerns about the impact of rising funding costs on China's overleveraged companies. The senior debt of China's top five financial institutions is trading close to JP Morgan, which may reflect the likelihood of Chinese government support, but does not in our view compensate for a lack of transparency on the non-performing loans on Chinese bank balance sheets. As a result, we maintain conviction in our positioning for weakness in Asian currencies most exposed to market- or economic turmoil in China, such as the Taiwan, Singapore and Hong Kong dollars.

In summary, as of the second quarter of 2017 we believe the main risks to our outlook and positioning are: 1) the potential for a more hawkish turn in Fed policy, which could in turn refuel US dollar appreciation; 2) political risks in Europe—though we expect these to recede—and 3) geopolitical events, particularly given the escalation of tensions with North Korea. We will revisit our views on the risks and opportunities arising from these and other impactful developments in subsequent quarterly Outlooks. In the intervening months, our views and positioning surrounding key investment themes are covered in the Macro Insights and other publications on gsam.com.

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