



## SECTOR PULSE

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Fixed Income Newsletter

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Although volatility across fixed income sectors has been remarkably low this year, a variety of risk factors lead us to believe that volatility will increase in 2018. Markets have thus far shrugged off risks, including North Korean nuclear tests as well as expected actions by many developed market central banks to unwind their ultra-accommodative monetary policies, but we think that is unlikely to persist through next year. As a result, we favor meaningful allocations to liquid sectors such as high-quality developed market sovereign debt to facilitate tactical portfolio shifts in response to a risk event.

### STEADY GROWTH, SUBDUED INFLATION

In the second half of 2017, the global economy showed strong growth and

## VOLATILITY POISED TO INCREASE AFTER QUIET 2017

### KEY TAKEAWAYS

- Although markets have thus far shrugged off risks, including North Korean nuclear tests as well as expected actions by many developed market central banks to unwind their ultra-accommodative monetary policies, we think that is unlikely to persist through 2018.
- The potential risks that could shake up fixed income markets include a surprise in developed market politics, a breakdown in the NAFTA negotiations, escalating geopolitical tensions, and an abrupt slowdown in the Chinese economy.
- With some major developed market central banks beginning to scale back their extremely accommodative monetary policies, there is the potential for increased volatility if markets misjudge the speed or timing of the normalization process.
- We believe maintaining meaningful allocations to liquid sectors allows us tactical flexibility should volatility create pricing dislocations and more favorable valuations in credit sectors.

continued subdued, though moderating, inflation. Despite geopolitical and economic risks, volatility remained low, with global developed market government debt trading in a relatively narrow range for much of the year.

In 2017 through late November, the yield on the 10-year U.S. Treasury note generally stayed between 2.10% and 2.60%, a tight 50 basis point (bp) range. This was in contrast with 2016, when the range was 115 bp (from 1.40% to 2.55%). The 10-year bund yield has largely traded between 0.20% and 0.60% this year, with the 40 bp range contrasting with last year's 75 bp range from -0.15% to 0.60%. The Bank of Japan (BoJ) in 2017 targeted a 0% yield on the 10-year Japanese

government bond, keeping yields generally within a 10 bp range this year versus last year's 55 bp range (-0.30% to 0.25%).<sup>1</sup> Low rate volatility has been a consistent theme across developed markets in 2017.

In credit sectors, the lack of market volatility and strong equity markets helped credit spreads grind steadily tighter through much of 2017. European high yield spreads compressed so much that the yield in the sector, as measured by the J.P. Morgan European Currency High Yield Index, reached 3.00% at the end of October compared with an average yield since 1999 of 8.78%. Credit spreads on U.S. high yield bonds and U.S. investment-grade corporate debt reached their

<sup>1</sup>Source for yield data: Barclays Live

narrowest levels in 10 years late in 2017. Although spreads widened somewhat in November, money subsequently flowed back into both high yield and investment-grade credit to take advantage of the widening, supporting the sectors.

#### RANGE OF RISKS THAT COULD ESCALATE

There are several potential risks that could shake up global fixed income markets. A surprise in developed market politics, such as a failure to enact tax reform legislation in the U.S., tumultuous Brexit negotiations between the UK and the European Union, or a renewed move toward Catalanian succession from Spain, could trigger more volatility in credit sectors, as could a breakdown in the North American Free Trade Agreement (NAFTA). Of course, geopolitical risks on the Korean Peninsula and in the Middle East could re-escalate, with conflict in the Middle East likely impacting oil prices. Also, while we still anticipate that China will be able to manage its transition to an economy focused on domestic consumption rather than exports, an abrupt Chinese slowdown would impact global markets through a variety of channels.

#### DEVELOPED MARKET MONETARY POLICY NORMALIZATION

With some major developed market central banks beginning to scale back their extremely accommodative monetary policies, there is the potential for increased volatility if markets misjudge the speed or timing of the normalization process. Although we anticipate that the Federal Reserve will continue to gradually raise rates as it slows reinvestment in its bond holdings, a faster-than-expected pace of tightening, which is plausible, would likely jolt markets.

Similarly, although the European Central Bank (ECB) has committed to buying bonds at least through September 2018 while slowing the pace of its purchases, a more abrupt slowdown, though unlikely, would create volatility, should it occur. Although it seems a low probability that the BoJ will be able to ease back on its quantitative easing in 2018, given Japan's persistently low inflation, a sudden bounce in inflation expectations or changes in BoJ yield curve control would accelerate an eventual move toward tapering.

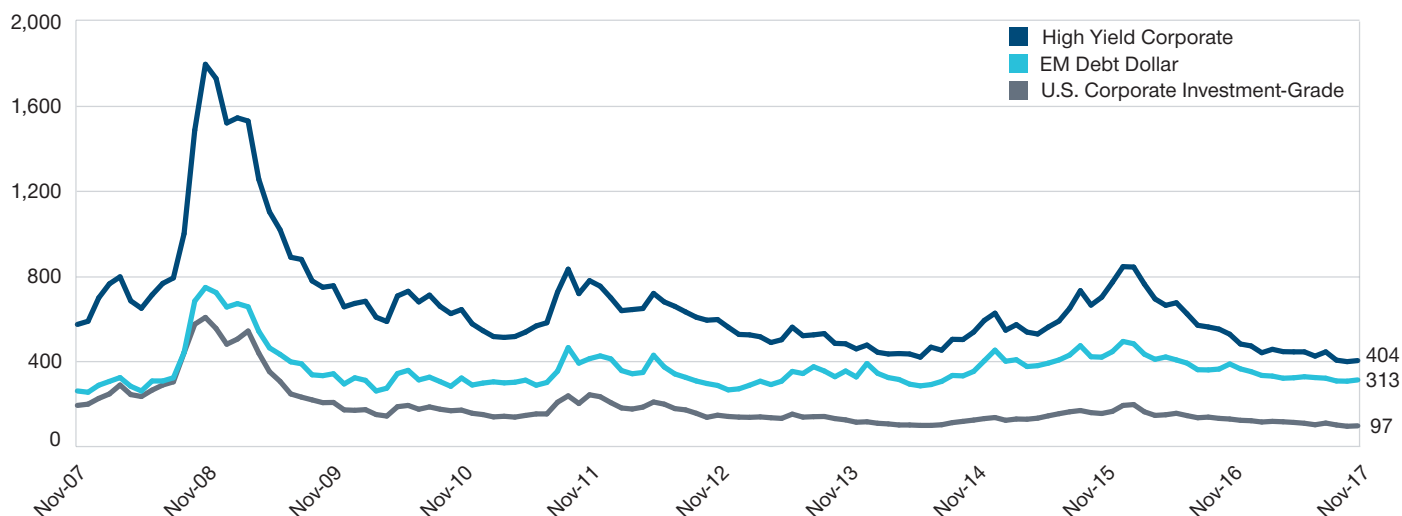
#### FOCUS ON DEVELOPED MARKET SOVEREIGNS, EMERGING MARKET LOCAL DEBT

In the current environment of elevated valuations across nearly all fixed income sectors, we have maintained sizable allocations to liquid high-quality segments, including developed market government bonds and agency mortgage-backed securities. We also favor locally denominated emerging market debt, which we believe can offer the opportunity to benefit from monetary easing in countries such as Brazil that are lowering rates, as well as exposure to some emerging market currencies that appear poised to gain against the U.S. dollar.

We believe maintaining liquidity allows us tactical flexibility should volatility create pricing dislocations and more favorable valuations in credit sectors. While holding liquidity entails a cost, that cost is currently low given tight credit spreads. Although the timing and magnitude of risk events are difficult to predict, history shows that the value of liquidity can increase dramatically around heightened volatility.

#### Yield Spreads Over Treasuries (basis points)

November 30, 2007–November 30, 2017



Sources: High Yield Corporate—J.P. Morgan Global High Yield Index, EM Debt Dollar—J.P. Morgan Emerging Markets Bond Index Global, U.S. Corporate Investment-Grade—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index.\*

Source for Bloomberg Barclays index data: Bloomberg Index Services Ltd. Copyright 2017, Bloomberg Index Services Ltd. Used with permission.

Yield spreads over Treasuries are the calculated spreads between a computed option-adjusted spread index of all bonds in a given rating category and a spot Treasury curve.

\*Option-adjusted spread for the Bloomberg Barclays U.S. Corporate Investment Grade Bond Index as of November 30, 2017. Spread-to-worst for the J.P. Morgan Global High Yield Index as of November 30, 2017.

## Relative Value Short-Term Outlook

## Sector Returns

(As of November 30, 2017)\*\*

Sector	Driver	One-Mo. Return	YTD Return	One-Yr. Return
U.S. Treasuries	Decent strength in the economy, the Fed continuing on a path of gradual rate hikes, and tax reform momentum suggest higher yields. We expect the yield curve to flatten as interest rates on the short end are pressured higher.	-0.14%	2.00%	1.89%
U.S. Treasury Inflation Protected Securities (TIPS)	We expect to see higher breakevens as inflation data appear to have bottomed and are firming.	0.13	2.07	1.97
Global Sovereign ex-U.S. <sup>†</sup>	We expect developed market yields to increase through time as global growth continues to surprise to the upside. The improving European economy and gradually rising inflation are convincing the ECB to slowly normalize monetary policy. Meanwhile, the BOJ remains highly accommodative despite positive economic data, and the UK will need to raise interest rates, albeit gradually, as long as political uncertainty associated with Brexit remains under control.	2.12	10.22	9.16
U.S. Municipals	Municipal yield ratios versus Treasuries remain rich in the short and intermediate section of the curve. Despite tax reform uncertainty, the path of Treasury rates will likely be the main driver of realtive value going forward.	-0.54	4.36	5.58
Mortgage-Backed Securities (MBS)	We think the outlook for agency MBS has become less favorable, as an increase in interest rate volatility and a less supportive technical backdrop could be a drag on performance moving forward.	-0.14	2.14	2.14
Commercial Mortgage-Backed Securities (CMBS)	In our view, the CMBS sector continues to look attractive as recent robust issuance has been well received, and strong demand for the remaining 2017 calendar is expected.	-0.33	3.06	2.64
Asset-Backed Securities (ABS)	We view the ABS sector as benefiting from strong consumer fundamentals and continuing to provide a relative safe haven if interest rate volatility continues to increase.	-0.09	1.53	1.38
Global Investment-Grade Corporate	Investment-grade corporate spreads have widened recently with rich valuations and uncertainty around U.S. tax policy and the extent of Fed tightening.	-0.15	5.46	6.16
Global High Yield Corporate	Despite investor demand for yield, high yield corporate spreads widened recently as valuations screened rich amid uncertainty around U.S. tax policy and the extent of Fed tightening. Volatile commodity prices, outflows, weakness in equities, and corporate credit being late in the cycle could also place upward pressure on yields.	-0.04	7.86	10.10
Bank Loans	Bank loans, with their floating rate feature, appeal to investors seeking shelter from rising interest rates. Solid fundamentals, low commodity exposure, low default rate expectations, and continued strong demand lead us to be constructive on the sector, but a reversal in technicals is a key risk.	0.16	3.89	5.14
Emerging Markets (EM) Dollar Sovereigns	We are cautious on emerging markets as the Fed may need to tighten further, with three to four hikes expected in 2018 amid higher inflation and tight labor markets. In addition, we are selective in the sector due to rising idiosyncratic risks (i.e., Mexico, South Africa, Turkey, and Russia).	-0.27	8.63	10.20
EM Corporates	Despite a supportive technical backdrop, we are cautious in the near term given the extent of the sector's rally, weaker liquidity profile, and little buffer for idiosyncratic shocks.	0.03	7.62	8.46
EM Local	Although we continue to favor countries that could cut interest rates or offer high real yields, idiosyncratic risks in the sector and the potential for additional Fed tightening lead us to be cautious.	1.68	12.93	15.04

Sources: T. Rowe Price, Bloomberg Barclays, J.P. Morgan, and S&P/LSTA.

\*\*U.S. Treasuries—Bloomberg Barclays U.S. Treasury Index, U.S. TIPS—Bloomberg Barclays U.S. TIPS Index, Global Sovereign ex-U.S.—Bloomberg Barclays Global Aggregate ex-U.S. Index, U.S. Municipals—Bloomberg Barclays Municipal Bond Index, MBS—Bloomberg Barclays U.S. MBS Index, CMBS—Bloomberg Barclays U.S. CMBS Index: ERISA Eligible, ABS—Bloomberg Barclays Asset Backed Index, Global Investment-Grade Corporate—Bloomberg Barclays U.S. Corporate Investment Grade Bond Index, Global High Yield Corporate—J.P. Morgan Global High Yield Index, Bank Loans—S&P/LSTA Performing Loans Index, EM Debt Sovereigns—J.P. Morgan Emerging Markets Bond Index Global, EM Corporates—J.P. Morgan CEMBI Broad Diversified, EM Local—J.P. Morgan Global Bond Index—Emerging Market Global Diversified.

<sup>†</sup>European corporates are included in this sector.

**Past performance is not a reliable indicator of future performance.**

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