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FIXED INCOME VIEWPOINTS

SUMMARY:

U.S. Treasury yields rose in December, primarily toward the front of the curve, as the Federal Reserve raised its target range for the fed funds rate to 0.25% to 0.50%. The widely expected rate hike was its first since June 2006. Yields fell, however, in the opening days of 2016 as plunging Chinese share prices, a depreciating yuan, and a continued decline in oil prices drove investors into safe-haven assets.

European sovereign yields initially jumped, but later pulled back amid global concerns, after the European Central Bank disappointed investors who were expecting a more aggressive monetary policy expansion. At its early December meeting, the ECB cut its deposit rate by 10 basis points to -0.30% and extended its asset purchase program by six months to at least March 2017.

Japanese government bond yields steadily declined, nearing record-low levels reached last January, as the Bank of Japan made modest adjustments to its quantitative easing (QE) program. The BoJ maintained its asset purchases at ¥80 trillion per year but extended the average maturity of its government bond holdings to seven to 12 years.

With spreads widening slightly over the past month, valuations for U.S. investment-grade corporate bonds remain attractive versus Treasuries and other credit sectors. Weak commodity prices have continued to weigh on the high yield market, and select higher-quality energy bonds are beginning to pique interest at current valuation levels. European corporates remain supported by highly accommodative ECB monetary policy and slow, but stable, domestic growth.

Emerging markets (EM) sovereign and corporate credit may appear cheap relative to similarly rated U.S. credit, but the sectors' liquidity constraints, along with fundamental concerns in some major countries, warrant higher risk premiums. EM local currency yields are attractive versus developed markets sovereigns, but are less so versus hard-currency EM sovereigns and U.S. high yield credit. Currencies remain a pressure point as the Fed begins tightening.

SPREAD SECTORS:

U.S. INVESTMENT-GRADE CORPORATES: Although we are in the late stages of the U.S. corporate credit cycle, valuations are attractive relative to Treasuries and other credit sectors, particularly in light of a low risk of economic recession in the near term. Airlines and health care are two areas of interest. We are also seeing value in certain beaten-down energy-related names that have ample assets, strong management teams, and the willingness to cut dividends or raise capital.

EURO CORPORATES: The fundamental backdrop of low inflation, elevated unemployment, and a measured economic recovery remains a positive one for European investment-grade bonds. On the downside, the market is vulnerable to erratic supply pressures and idiosyncratic risks, as well as generic global risk-off factors. Indeed, moderate spread widening over the past month was largely the result of distressing China headlines, the continued oil price collapse, and rising tensions in the Middle East.

U.S. HIGH YIELD: The risk-averse environment continued in December and into early January. There has been significant decompression between credit-rating tiers, as lower-quality bonds lagged higher-quality issues. Overall valuations and market yields are still heavily skewed by two industries—energy and metals/mining—but are starting to get more interesting. We are beginning to find some value both within and away from commodities. Higher-quality energy and lower-rated non-commodity names that the market has unfairly punished provide opportunities.

EURO HIGH YIELD: European high yield demand remained robust in 2015, as evidenced by significant investor inflows into the asset class. Despite tight spreads versus the U.S. high yield sector (European high yield is almost 200 basis points tighter), positive fundamental trends remain in place, as does technical support. Against this supportive backdrop and with lower energy exposure, European high yield could continue to outperform U.S. high yield in the near- to mid-term (on a currency-hedged basis).

BANK LOANS: Loan spreads have widened in response to the move in high yield bond spreads as well as weaker technicals, including lower collateralized loan obligation issuance and meaningful new issue supply. Many loans are now trading below par. Lower quality continues to lag higher quality from a performance standpoint. However, the asset class has benefited from a materially lower exposure to commodities and lower CCC exposure than U.S. high yield. Loans also still provide some measure of protection against rising interest rates due to their floating rate coupons.

AGENCY MORTGAGE-BACKED SECURITIES: We maintain a neutral outlook for the sector as valuations remain fair versus Treasuries. Stable fundamentals, favorable liquidity, and positive near-term technicals underpin agency MBS. Some uncertainty regarding the pace of Fed tightening and the corresponding decision regarding the timing of tapering reinvestment of MBS principal payments remain a longer-term risk to the sector. But this is most likely a 2017 event.

EM DOLLAR SOVEREIGN: The sector is modestly cheap relative to U.S. credit markets. However, impaired liquidity and concerns about the fundamental story justify a higher risk premium. Brazil and Mexico are countries where we may look to add risk. The Fed has managed its communications well thus far, and the widely expected December rate hike had little impact on emerging market assets. Macro concerns are now more focused on China, commodity prices, and their linkage to emerging markets currencies and monetary policies.

EM CORPORATES: Our outlook for the sector remains circumspect. Negative returns in December have made absolute valuations more attractive, but relative value is less compelling. Illiquidity in EM corporates relative to other fixed income alternatives puts a higher bar on a valuation- or fundamental-centered thesis for adding to positions. Some of the more attractive names reside in Mexico, China, Indonesia, Philippines, and—increasingly—Brazil.

EM LOCAL: Sector-level spreads widened over the past month versus U.S. Treasuries, largely on higher yields in South Africa and Brazil. Local yields are nearly two standard deviations cheap relative to recent history. This creates opportunities to selectively add to currency-hedged positions. Following Fed rate liftoff, the market's attention has shifted to China and associated growth and commodity risks. Further pressure on currencies also remains a key risk. Encouragingly, the breadth of U.S. dollar strength has recently eased.

DEVELOPED SOVEREIGN MARKETS:

U.S.: A well-managed "liftoff" by the Federal Open Market Committee and general risk-off sentiment have led to relatively contained 10-year yields in December and early January. Aside from strong employment reports, domestic economic data continues to generally disappoint, and still-shaky global economic conditions have also helped keep a lid on longer-end yields. Stronger economic data is required to validate the Fed's interest rate outlook, which encompasses more rate hikes than the market expects.

EUROZONE: The ECB extended its aggressive program of sovereign QE by six months until March 2017. Asset purchases are likely to be tapered after that date. The December ECB announcement, which disappointed the market, suggests that hawks have regained influence at the central bank. Still, the ECB's deposit rate is -0.3%, and an absence of inflation means that rate hikes are unlikely to happen for at least three years. Negative rates, QE, and associated negative net supply will likely keep benchmark German bund yields suppressed at levels below fair value.

JAPAN: Core inflation continues to undershoot the Bank of Japan's 2% target. However, there have been more encouraging developments in measures of "core-core" inflation (excluding fresh food and energy). Signs of a moderate economic recovery continue. In line with global developments, the outlook for the manufacturing sector has softened a little, while the service sector outlook remains steady. Growth will be supported by fiscal initiatives prior to the 2016 upper house elections, and the BoJ is unlikely to further ease monetary policy until then. External developments present the greatest risks for the growth outlook.

UK: The first quarter of 2016 leaves behind much of the technical support gilts benefited from toward the end of 2015. However, a large redemption in January and a duration-light issuance calendar may yet allow the market to maintain stability. Objectively, a near "priced for perfection" outlook for UK interest rates leaves gilts looking stretched against U.S. Treasuries. However, gilts are also being indirectly supported by a still-aggressive ECB monetary policy. "Brexit" will be a big focus for the gilt market in 2016, with a referendum on European Union membership expected to be held around mid-year.

CANADA: More recent growth indicators show that third-quarter economic strength has not been sustained. Renewed oil price declines pose downside risks to the outlook. The Bank of Canada is likely to remain on hold for an extended period—in stark contrast with expected further tightening by the Fed.

AUSTRALIA: Recent domestic data has been more encouraging, with consumption and net exports offsetting the significant ongoing drag from mining investment. The Australian dollar has remained surprisingly resilient despite increased Chinese growth concerns and further weakness in commodity prices. Should this divergence persist, the Reserve Bank of Australia may have to deliver another dose of monetary policy easing.

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