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FIXED INCOME VIEWPOINTS

SUMMARY:

The US Treasury yield curve flattened over the past month as short-term yields rose on repricing of Federal Reserve rate hike expectations while long-end yields held steady. Minutes from the Fed's April policy meeting explicitly mentioned the potential for a June rate increase if incoming growth, employment, and inflation data were consistent with the central bank's objectives.

German bunds rallied, with 10-year yields approaching all-time lows near 0%. The European Central Bank (ECB) kept policy on hold as it monitors the effects of negative deposit rates, an impending corporate bond purchase program, and new targeted longer-term refinancing operations.

Meanwhile, yields on 10-year Japanese government bonds hovered in negative territory as domestic economic data remained soft. As expected, Prime Minister Abe postponed the value-added-tax increase scheduled for next year out of concern that it will derail an already struggling economy. However, Abe failed to deliver on hopes for large-scale fiscal stimulus.

The high yield credit rally continued, while investment-grade corporates gave back some gains amid record-setting new issuance. Fundamentals for US investment-grade corporates are deteriorating, although demand remains robust. The ECB's corporate bond purchases, scheduled to launch on 8 June, should help dampen volatility for European corporates. It is harder to find value in the high yield bond market following recent strong performance. Lower energy exposure, strengthening technicals, and low sensitivity to rising rates make a case for bank loans.

A more defensive stance seems appropriate in emerging market (EM) credit heading into a seasonally challenging period for liquidity with several potential macro risk triggers on the horizon. There should be opportunities to add risk at more compelling valuations later in the year. Likewise, lower-beta positions are favored in EM local currency markets for now, while looking to selectively add to duration and currency exposures on weakness.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: The sector's risk/reward profile has deteriorated amid late-cycle credit dynamics combined with crowded investor positioning in financials. Relative value is fair after the recent rally, while technicals remain supportive. Within the sector, we still favor industrials over bank paper. Real estate investment trusts and midstream energy names also offer value. In general, we are defensively positioned and are waiting for increased volatility and wider spreads to deploy risk.

EURO CORPORATES: Spreads have recently drifted wider from their year-to-date lows as new issuance remains very elevated ahead of the start of the ECB's corporate sector purchase programme (CSPP). The short-term outlook is very uncertain given imminent risks of "Brexit" and Spanish elections in late June. The CSPP, although largely priced in, remains a very strong technical driver. In the absence of generic risk-factors, there is room for spreads to tighten further as the ECB's bond purchases begin. Similarly, if risk assets weaken, the CSPP should help contain spread widening relative to other credit sectors.

US HIGH YIELD: After a weak start to May, the high yield rally continued as asset managers looked to put cash to work with limited inventory available. Higher energy prices also drove sector-level spreads tighter given the sector's large exposure to energy producers. Valuations are not as attractive following the strong year-to-date rally, and defaults have picked up with recovery rates coming in much lower this cycle than in previous default upturns. Although fundamentals outside of the commodities space remain fairly intact, commodity prices continue to be a large driver of the market.

EURO HIGH YIELD: With central bank policies, credit cycles, and default cycles at very different stages for US versus European high yield, we expect the European market to be less volatile. Sound fundamentals in Europe continue to be supported by active ECB actions such as CSPP, which will likely drive investment-grade participants into the high yield market. European high yield should be a beneficiary if the UK votes to remain in the European Union later this month.

BANK LOANS: Valuations are not as attractive as they were in February, but there are still a fair number of loans priced below par value. Technicals—including collateralized loan obligation (CLO) issuance, retail fund flows, and new loan issuance—are major performance drivers currently, with new issue supply presently constrained. Strong technicals could also drive a repricing wave. The asset class still offers a materially lower exposure to commodities and CCC rated issuers than the US high yield bond market, and it still provides some measure of protection against rising interest rates.

AGENCY MORTGAGE-BACKED SECURITIES: Agency MBS continued to trade in a narrow range and posted small gains versus Treasuries as carry at the back end of the curve and spread tightening toward the front of the mortgage curve were the main contributors to performance in May. Prepayment concerns still linger with the prevailing low levels in consumer borrowing rates. Additionally, the technical backdrop continues to be a bit uncertain with investors focused on the cross currents between higher seasonal net supply and increased demand from banks and overseas investors.

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EM DOLLAR SOVEREIGNS: Sovereign spreads have rallied year to date but still appear attractive versus their post-crisis averages. However, numerous global macro risks heading into a seasonally less-liquid period for fixed income leave us cautious with risk exposures. We expect opportunities to add risk at more compelling spread levels. We remain focused on countries with positive idiosyncratic themes, such as Brazil.

EM CORPORATES: We maintain a cautious outlook on EM corporates. Even more challenging liquidity in the sector relative to other fixed income alternatives puts a higher bar on a valuation or fundamental centered thesis for adding risk. Moreover, strong absolute returns have stretched relative value even further versus the US high yield market. We maintain a preference for BBB credit, which offer a better risk/reward tradeoff than higher- or lower-rated debt. Valuations for BB rated EM corporates appear very rich relative to similarly rated US credit.

EM LOCAL: Spreads versus US Treasuries were stable over the past month, with benchmark yields rising moderately along with five-year US Treasury yields. Most markets were fairly flat on the month in yield terms. Of note were some idiosyncratic movers, as Mexico, South Africa, and Thailand saw yields rise in line with or more than those in the US Treasury market. The rise in absolute yields makes the universe more attractive than it was previously.

Meanwhile, EM currencies performed poorly in May. In Asia, the Malaysian ringgit and South Korean won underperformed, but the Philippine peso outperformed as political uncertainty eased following the May presidential election. Emerging European currencies fell across the board. The South African rand underperformed and now looks notably cheap based on longer-term metrics. Latin American currencies were the worst performers. A more hawkish Fed may create opportunities to add to FX and rates positions if valuations cheapen. With volatility expected, lower-beta positions are preferred.

DEVELOPED SOVEREIGN MARKETS:

US: Notwithstanding a recent slowdown in employment growth, economic data has generally been improving and looks to continue to recover after a poor first quarter. The pace of growth will likely remain relatively tepid, but stabilization in output should allow the Fed to hike again this year. This should lead to higher US yields as the year progresses, at least at the front end and intermediate portions of the curve. However, a Fed misstep in concert with weakness from abroad or a sustained slowdown in payroll growth are downside risks that could pull yields lower.

EUROZONE: The ECB's quantitative easing (QE) is pressuring yield curves flatter. The central bank will probably extend the QE programme beyond March 2017; this decision will probably be announced in September but may be delayed until December. The ECB could also cut its depo rate by another 10 basis points to -0.5% if oil prices fall, but it is unlikely to act with oil at $50 per barrel. If there is a cut, it will likely probably mark the bottom for rates barring another recession. Even so, lack of inflationary pressure means rate hikes are unlikely for at least three years.

JAPAN: Inflation continues to roll over—a tendency that looks to continue on back of the yen appreciation and slowing economic momentum—and the recent earthquakes have aggravated the economic slowdown. The value added tax increase scheduled for next April was postponed by 2½ years, as was widely expected. Despite Prime Minister Abe's recent speech that indicated no urgency to ease fiscal policy, the market is expecting a supplementary budget of between ¥5 and ¥10 trillion. We expect additional monetary easing by the Bank of Japan through further lowering the deposit rate and expanding the qualitative easing program via additional ETF purchases. The timing of additional easing is uncertain, however; the general unpopularity of negative rates is probably the largest obstacle prior to the upper house elections in July.

UK: Opinion polls suggested reduced risk of Brexit for much of the past month, only to reverse course again moving into June as the "Remain" lead whittled away to a 50:50 coin toss; correspondingly, a two week sell-off in the gilt market was reversed in short order. Economic data continues to be mixed, with evidence that Brexit concerns are weighing on business and consumer confidence. The 23 June referendum on EU membership will be the market's overriding focus, and risk premia are likely to remain elevated, compressing UK interest rate expectations and gilt yields.

CANADA: The recent tragic wildfires in Alberta have dampened the growth outlook, but the Bank of Canada (BoC) expects the impact to be somewhat transitory. Interest rates remain extremely low and accommodative, and we have been seeing stronger activity in consumption and housing construction. Additionally, the recent budget was mildly stimulative, with infrastructure spending set to add modestly to growth over coming years. The BoC remains comfortably on hold with policy for now, and absent a relapse in the oil price, we do not expect further easing in this cycle.

AUSTRALIA: Australian bonds have enjoyed a sharp rally with the Reserve Bank of Australia unexpectedly cutting rates in May and maintaining dovish tone. Further easing looks likely, particularly if the next inflation print also disappoints on the low side. However, with another cut fully priced, the scope for further outright gains is limited. Additionally, the Australian curve is fairly flat out to the five-year maturity, offering limited roll-down return potential.

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