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FIXED INCOME VIEWPOINTS

SUMMARY:

US Treasury yields have spiked following the November election as inflation expectations have risen, lifted by the potential for fiscal stimulus into an economy already near full employment. Treasury yields appear biased to the upside. But the market may be overestimating a full-scale regime change to higher yields given still-low global yields, uncertainty about the new administration's economic policies, and structural headwinds to higher global growth and inflation.

Despite concerns about tapering asset purchases, the European Central Bank will likely continue quantitative easing (QE) through the end of 2017—or later—given below-target inflation and abundant eurozone political risks. ECB rate hikes are probably several years away. Against a divergent central bank policy backdrop, the yield spread between 10-year US Treasuries and equivalent German bunds has climbed to multi-decade highs.

The Japanese yield curve has remained relatively stable, as negative deposit rates anchor the front of the curve and the Bank of Japan targets a 0% 10-year yield. Although inflation remains absent, the BoJ will likely remain on hold with additional stimulus measures for the foreseeable future.

The potential for increased infrastructure spending and tax reform appears to have lengthened the runway for the US credit cycle, benefiting investment-grade and high yield corporate bonds. European high yield corporate valuations have improved versus their US counterparts, but elevated eurozone political risks could create volatility. Political uncertainty is also a headwind for investment-grade Euro corporates.

Valuations for hard currency emerging market (EM) sovereigns have risen to attractive levels following weakness stemming from US policy concerns. Valuations for EM corporates are less compelling given the sector's weaker liquidity profile, which restrained spread widening compared with more-liquid sovereign debt. There should be opportunities to add to EM local currency bonds, but US Treasury yields and the dollar need to stabilize.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Although the credit and profit cycles are protracted, potential fiscal policy support may have extended the runway for corporate issuers. Higher oil and commodity prices are also positive for the sector. Valuations are fair at current levels, and technicals remain supportive. Our enthusiasm is tempered by a lack of spread dispersion between issuers, risk of fund outflows in a rising rate environment, and policy uncertainty.

EURO CORPORATES: The market has experienced significant weakness on mounting concerns over European political risk. Rising government bond yields are also leading to fears over future outflows from the asset class if absolute returns turn negative, and credit spreads do not offer compelling value relative to fundamentals. Still, corporate bond purchases by the ECB remain a strong positive technical force for European credit.

US HIGH YIELD: The OPEC agreement has lifted oil prices, benefiting the sector. However, it will be important to watch whether participants follow through on production cuts, and increased US shale production could drive prices lower in the second half of 2017. The potential for increased infrastructure spending has raised expectations for metal prices, and we have increased confidence in a lower high yield default rate next year. Seasonal trends are positive, as the high yield market has historically performed well early in the year. We are still finding opportunities in metals and mining, select subsectors of the energy sector, lower-quality non-commodity firms, and shorter-maturity "fallen angels" securities.

EURO HIGH YIELD: With US high yield spreads tightening and European high yield spreads widening in November, relative value has improved adjusting for ratings and duration differences between the two markets. Positive technical pressure is building on lower new issuance expected into year-end combined with continued investor demand for yield. However, there is also increased investor uncertainty and weaker investor sentiment amid increasing European political risks.

BANK LOANS: We maintain a constructive outlook given a meaningfully lower default rate versus the US high yield bond market. The asset class his historically performed well during periods of rising rates, and there is also potential for a late 2016 or early 2017 coupon increase as LIBOR is near the 1% floor of many loans. Technicals are currently supportive with demand outpacing supply amid strong collateralized loan obligation issuance and positive retail flow activity. These positive factors are balanced with increased market re-pricing activity and corporate credit being late in the cycle.

AGENCY MORTGAGE-BACKED SECURITIES: Our outlook for the sector has improved as MBS are now fairly valued versus Treasuries after cheapening in November amid the sharp move higher in longer-term Treasury rates. Technicals appear more balanced, but policy risk from the Fed and Washington has increased following the US election.

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EM DOLLAR SOVEREIGNS: The sudden US rate move has repriced EM sovereigns and quasi-sovereigns to relatively cheap valuations levels compared with US investment grade, high yield, and EM corporate issuers. Increased clarity on who will serve in President Trump's Cabinet could justify a more positive outlook for the asset class depending on his choices. While meaningful spread compression is unlikely, the sector is a source of attractive carry, and select issuers within the sector offer value.

EM CORPORATES: In a period of ETF-driven outflows from EM bond markets, EM corporate spreads have actually benefited from the sector's illiquidity, with fairly moderate spread volatility compared with more-liquid EM sovereigns. Near-term caution remains warranted, as EM assets have underperformed following every unwind of quantitative easing and zero interest rate policy since 2012. Returns will likely be coupon-driven, with modest potential for spread tightening.

EM LOCAL: Near-term risks have crystallized—notably political risks in developed markets and a renewed focus on the Fed tightening cycle. However, volatility stemming from the US election and a December Fed rate hike could prove to be an opportunity. Over the medium term, external rebalancing in emerging countries and attractive real yields versus developed market support EM local bond markets. The trends in the US dollar—and relatedly, commodity prices—remain key drivers of performance.

DEVELOPED SOVEREIGN MARKETS:

US: Economic data has recently been positive, and leading indicators continue to suggest that domestic growth will remain around current levels in the near term. Inflation expectations can continue to firm as headline inflation moves higher into 2017. Expectations for fiscal expansion under a Trump administration and the contours of a Fed monetary response to increased fiscal stimulus will keep higher rates a concern for investors. However, the market may be overestimating the new administration's ability to deliver proposed fiscal policy initiatives.

EUROZONE: The ECB will remain dovish for some time even if it tapers QE. The market is now pricing in hikes to start in mid-2019, which seems reasonable. European growth has improved, but inflation remains well below the ECB's target. Upward pressure from higher US Treasury yields is balanced with risk aversion around the numerous European political events in 2017. These include national elections in Germany, France, and the Netherlands, and possibly another Italian vote.

JAPAN: The Japanese economy looks slightly better, in part driven by external tailwinds and government support. The BoJ will likely remain on hold for the foreseeable future given improving growth and the unpopularity of further easing. The Japanese curve should remain relatively stable as the BoJ defends the front end and 10-year points. A constructive backdrop for risk has provided some respite on yen strength, but a slowdown in global growth could contribute to further strengthening.

UK: The Chancellor's Autumn Statement confirmed larger deficits, but net new fiscal stimulus will be very limited. Stronger economic data continues as the initial post-Brexit shock continues to fade. The Bank of England (BoE) now has a neutral bias, and further easing would more likely be a rate cut rather than any extension of QE. The BoE will keep a very wary eye on the extent and persistency of the inflation target overshoot expected next year. UK gilts continue to look highly vulnerable awaiting the triggering of Article 50 for Britain to exit the European Union.

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