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FIXED INCOME VIEWPOINTS

SUMMARY:

U.S. Treasury yields remain near their lows for the year despite higher oil prices, firmer inflation expectations, and strength in risk assets. Soft domestic growth readings, low rates in Europe and Japan, and a dovish interpretation of the Fed's April policy statement have helped keep yields suppressed, with futures markets pricing in low odds of a June rate hike.

German bund yields have been locked in a range near all-time lows. As expected, the European Central Bank made no changes to monetary policy in April, but ECB officials revealed details of their corporate bond purchase program, set to start in June. The universe of eligible bonds was broader than anticipated.

The Bank of Japan remained on hold despite a stronger yen, disappointing investors who expected the BoJ to expand its asset purchases and push rates further into negative territory. With Japanese growth weakening and inflation low, further easing is probable in June or July. 10-year Japanese government bond yields remain below 0%.

Corporate credit spreads have tightened further on the year. Valuations for U.S. investment-grade corporates are uninspiring given deteriorating fundamentals, though select industrials offer value. Additional spread compression will be limited for euro corporates, but the ECB's bond buying should cushion volatility. The strong rally in high yield may be nearing an end, though there are still pockets of opportunity in higher-quality energy names and in the new issue market.

The rally in emerging markets (EM) credit has moderated. Political and downgrade risk have risen in some countries, while others are on a positive reform path. EM dollar sovereigns remain favored over EM corporates for their better liquidity. EM local rates have become less attractive, while volatility emanating from Fed policy and Chinese growth concerns should create opportunities to add to EM currency exposures on weakness.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Late credit cycle dynamics combined with crowded investor positioning in financials have reduced our conviction level for the sector. Relative value versus other global credit sectors is fair, at best, after the recent rally in risk assets, and valuations look rich in comparison with risk-free assets. It is questionable whether the strong technical backdrop, driven by foreign investor inflows, will be enough to keep credit spreads from widening.

EURO CORPORATES: Spreads tightened further as details of the ECB's Corporate Sector Purchase Program (CSPP) revealed that the scope for eligible bonds is larger than originally expected. The sector also benefited from general improvement in risk sentiment on stronger oil prices and reduced concerns over tighter Fed policy and decelerating Chinese growth. The impact of the ECB's CSPP may be largely priced in, leaving only modest room for further spread tightening. However, the prospect of a large, price-insensitive buyer remains a very strong technical driver for the market. This is likely to cushion financial market volatility stemming from next month's "Brexit" vote and Spanish elections.

US HIGH YIELD: The rally continued in April as sizable inflows into high yield ETFs, very low dealer inventories, and higher oil prices combined to drive spreads tighter. "Fallen angels" were also absorbed more easily than anticipated. Valuations are not as attractive post the strong rally, and defaults have picked up with recovery rates coming in much lower than in previous default cycles. Overall valuations and market yields are still skewed by two industries—energy and metals and mining—but we continue to find interesting investment ideas away from these areas and even within the highest-quality energy universe.

EURO HIGH YIELD: Primary market issuance picked up in April with the largest totals in a year, but the technical pressure on the market persists. Of the estimated €15 billion of new issuance, 70% were so-called Yankee issues (USD denominated) and were therefore avoided by many institutional investors who are focused only on bonds denominated in European currencies. Due to this dynamic, secondary market liquidity conditions remain difficult. Sound fundamentals continue to be indirectly supported by active ECB actions such as the CSPP, which will likely push investment-grade participants into the high yield market.

BANK LOANS: Loans still appear to offer a more defensive way to play decent high yield fundamentals (outside of the commodities sectors) with lower volatility. Valuations are not as attractive as they were in February, but there are still a fair amount of loans priced below par. Technicals— including collateralized loan obligation (CLO) issuance, retail fund flows, and new loan issuance—are keys to near-term performance.

AGENCY MORTGAGE-BACKED SECURITIES: Agency MBS traded in a narrow range for most of April and posted small gains versus Treasuries. Fundamentals have deteriorated slightly as prepayment concerns linger given still low levels in consumer borrowing rates. The technical backdrop remains mixed and a bit uncertain, with crosscurrents of expectations for a pickup in seasonal net supply and increased demand

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from both banks and overseas investors. However, cross-sector valuations versus credit sectors continue to look compelling.

EM DOLLAR SOVEREIGN: As expected, fuller valuations and less-supportive technical conditions have recently caused the rally to moderate, though Brazil idiosyncratic gains should continue as the presidential impeachment process progresses. We have turned more cautious on Russia and Turkey and have reduced risk accordingly. A rollover in commodities prices and downside U.S. growth concerns remain risks as well.

EM CORPORATES: We maintain a cautious outlook for the sector. Illiquidity in EM corporates relative to other fixed income alternatives puts a higher bar on a valuation or fundamental centered thesis for adding to exposures. Strong absolute performance has further stretched relative value versus U.S. high yield. We are focused on companies in countries with positive reform momentum—such as Indonesia, Mexico, and Argentina—which supports long-term growth and reduces sensitivity to global capital markets stress. In Brazil, the potential for a market-friendly leadership change underpins our improved outlook for the country's credit.

EM LOCAL: Spreads and yields were stable over the past month at the index level. However, there was a rise in idiosyncratic performance differences between markets. Fewer rallied—Brazil and Peru stood out in that regard—and a number sold off (notably some of the lower yield markets such as Thailand, Poland, and Hungary) as we saw higher yields and greater volatility in core markets during the month. At the headline level, valuations remain somewhat unattractive, although yield spreads versus Treasuries are still somewhat wide.

As expected, the recent strong performance from currencies has consolidated recently. A more dovish Fed and a bottoming of commodity prices are clearly supportive for EM currencies over the medium term, but a more volatile trading range remains likely. The reemergence of concerns about Fed tightening and Chinese growth remain central risks, although these events may also provide opportunities to add to exposures on weakness.

DEVELOPED SOVEREIGN MARKETS:

US: In a repeat of March, yields moved higher heading into the April Federal Open Market Committee (FOMC) meeting and subsequently rallied as the post-meeting policy statement maintained a dovish tone. Risk assets and inflation expectations remain relatively firm, particularly when viewed against their first-quarter lows. But economic data has stagnated recently, keeping the FOMC leaning dovish. A dovish bias from the Fed and other global central banks continues to pressure yields lower, but Treasury valuations are at unattractive levels.

EUROZONE: The ECB's sovereign purchases have been pressuring the yield curve flatter. The central bank's quantitative easing program will probably be extended beyond March 2017; this decision could be announced in June but may be delayed until September. The ECB could also cut its deposit rate by another 10 bps to -0.5%, but it is unlikely to go farther into negative territory barring a recession. Lack of inflation means rate hikes will likely not happen for at least three years. We expect bund yields to trade in a range between -0.1 and 0.6% over the next six to12 months.

JAPAN: Inflation continues to roll over, a trend that looks set to continue on the back of yen appreciation and weak growth. The loss of economic momentum continues, and the economic slowdown will be aggravated by the recent earthquake. Into 2016, growth will likely be supported by additional fiscal initiatives. We expect additional easing by the BoJ through an additional reduction of the interest rate paid on commercial banks' deposits at the central bank. There will also probably be an expansion of the qualitative easing program (i.e., ETF purchases). The timing of additional easing is uncertain; the general unpopularity of negative rates is probably the largest obstacle prior to the Upper House elections in July.

UK: Gilts gave back some of their year-to-date gains over the past month. The angst over "Brexit" risk subsided with the opinion polls seemingly reacting positively to U.S. President Obama's cautionary advice against the UK leaving the EU. The irony is that the economic data has been getting worse—the labour market shows signs of cooling, house prices are fading, retail sales are very soft, and PMI readings are weaker. Indeed, the market still prices in a 30% chance of a rate cut by spring 2017, with a single rate hike only priced in after 2020 according to the overnight indexed swap curve.

CANADA: Following a weak second half of 2015, growth looks to have returned to a healthier pace, with first-quarter GDP growth expected to rebound by 2.5% to 3%. Consumption has been resilient, and housing activity is buoyant, supported by low interest rates. The recently-announced budget is also modestly stimulative, though the investment spending plans are spread out over a number of years. The Bank of Canada remains comfortably on hold for now. Absent a relapse in the oil price, we do not expect further easing in this cycle.

AUSTRALIA: Overall growth data has continued to be relatively healthy in the face of the ongoing and significant drag from mining investment. Employment growth has been rather solid, keeping the unemployment rate broadly stable, and business confidence has been boosted by the weaker exchange rate and declining interest rates. However, the first-quarter CPI reading proved to be decisive for the Reserve Bank of Australia (RBA); core measures of inflation printed at around 1.5%, a multi-decade low and significantly undershooting the RBA's expectations and target range. The central bank duly delivered a rate cut in May, and further easing looks likely.

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