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FIXED INCOME VIEWPOINTS

SUMMARY:

10-year U.S. Treasury yields touched all-time lows as the UK's vote to depart the European Union (EU) and mixed labor market data have led the market to push back the timeline for the next Fed rate hike. Amid economic uncertainty caused by the Brexit vote, sovereign yields across Europe are increasingly negative. The European Central Bank (ECB) will likely extend quantitative easing and could loosen purchase restrictions as it faces a shrinking supply of eligible government bonds. However, the market may be expecting more than the ECB will deliver.

In Japan, 20-year government bond yields dropped below zero for the first time. In the face of weak growth and falling inflation, investors are expecting the Abe government to announce substantial fiscal stimulus, while the Bank of Japan will likely announce further rate cuts and an expansion of asset purchases.

Although technicals remain strong and select bonds offer value, U.S. corporate fundamentals continue to deteriorate. Brexit will hinder European growth, but central bank policy responses should lend support to European credit markets. Brexit concerns may also lead to mispriced opportunities in the sterling corporate market.

A "lower-for-longer" interest rate environment and stabilizing fundamentals in several major countries are supportive of emerging markets (EM) bonds and currencies. Renewed concerns about China or a sudden spike in global rates are key risks to EM assets.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: We are at or near the end of the credit and profit cycle, and valuations are generally unattractive. Rising leverage is not reflected in valuations, which are closer to mid-cycle. We remain defensively positioned, with a bias toward lower-beta names, while waiting for wider spreads and increased volatility to deploy risk. We see industrials as more attractive than banks.

EURO CORPORATES: European growth will be negatively impacted by Brexit, and a protracted period of uncertainty is expected as the UK determines the path for withdrawing from the EU. There are also risks of strengthening secessionist movements in other European countries. Following significant recovery from initial Brexit widening, spreads offer little compensation for increased uncertainty. The ECB's corporate bond purchases are likely to contain—but not prevent—spread widening on the return of meaningful risk aversion.

US HIGH YIELD: We are preparing for lower energy prices, an elevated 2016 default rate, low recovery rates for companies that do default, uncertainty surrounding Brexit impacts and November U.S. elections, and corporate credit being late in the cycle. However, this is balanced by strong demand for income in a low rate environment. We are still finding opportunities fallen-angel securities, shorter-maturity bonds, and select new issues.

EURO HIGH YIELD: Positive factors include an increasingly supportive ECB and Bank of England (BoE), technical pressure due to inflows into the asset class for the year and reduced primary market deal flow, and solid core fundamentals. However, there is more uncertainty and weaker investor sentiment following the UK referendum. We expect the overall market to slide sideways, but higher volatility is likely in the third quarter. Uncertainty is amplified in the sterling-denominated part of the market following the Brexit vote.

BANK LOANS: We remain positive on the sector given a meaningfully lower default rate than the high yield bond market, the majority of the loan market is trading below par value, and there is potential for a late 2016 or early 2017 coupon increase if rates rise. Technicals are also supportive, with low supply. We are still finding opportunities in non-commodity lower quality issues, shorter-maturity loans, and select new issues.

AGENCY MORTGAGE-BACKED SECURITIES: The macro backdrop continues to dominate agency mortgage-backed securities (MBS) fundamentals as valuations continue to react directionally with moves in interest rates. The market's expectations for a more dovish policy path from the Fed push any concerns surrounding tapering of MBS reinvestments further into the future. Continued strength in housing keeps supply expectations elevated, but liquidity and attractive relative valuations versus other sectors have offset some of the supply concerns. Our focus remains on relative value within the sector.

EM DOLLAR SOVEREIGNS: The sector is likely to see strong, steady inflows stemming from depressed yields in developed markets. Technicals are also strong given limited supply and light dealer positioning. Fundamentals are stabilizing or improving in several key markets, and improvement in Brazil's fiscal and political situation will support the better tone toward EM assets more broadly. We continue to favor Brazil and Latin America generally, as valuations for European markets have been stretched by the ECB's highly accommodative monetary policy.

EM CORPORATES: We expect EM corporate returns will be coupon driven, with modest potential for spread tightening if technicals continue to dominate. Increased corporate leverage

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and supply will contain upside from current levels. While carry remains attractive versus negative-yielding government bonds and higher-volatility equities, valuations are stretched when factoring in the sector's weaker investor sponsorship and trading liquidity. EM corporate defaults have risen to record levels in the first half of 2016, driven by idiosyncratic stories. We are favoring companies in Brazil, Mexico, Indonesia, Argentina, and China, particularly consumer and media and telecom names and bonds with BBB and BB ratings.

EM LOCAL: Spreads relative to U.S. Treasury yields were stable over the past month as EM local yields rallied largely in line with the decline in U.S. Treasury yields. The fall in yields makes the universe less attractive in an absolute sense. In relative terms, however, select EM local yields look attractive to developed markets, which are looking even more stretched historically. EM currencies performed relatively well during June considering the volatility driven by the weak U.S. May payroll data, Fed policy uncertainty, and the UK's EU referendum. Flows into the asset class have picked up and are likely to persist provided that the Fed remains on hold.

DEVELOPED SOVEREIGN MARKETS:

US: Brexit has introduced an uncertainty premium into global rates that is unlikely to unwind fully in the near term. U.S. growth data may show a bounce in the second quarter, but investors will reserve judgment as political uncertainty will cloud the economic landscape in the third quarter. The Federal Open Market Committee has likely gone on a pause with tightening through at least the third quarter. And with other global central banks taking action, yields should remain low. We continue to favor yield curve flatteners.

EUROZONE: We expect 10-year bund yields to remain in a -0.2% to 0.5% range for the next six to 12 months. Negative policy rates, QE, and associated negative net supply should keep bund yields anchored. Valuations are stretched on a long-term, fundamental basis. Fair value for German bund yields is closer to 2% than 0%. Negative risks for bunds include eurozone growth maintaining its current pace, the Fed hiking more quickly than the market expects, a continued rebound in oil prices, and the ECB holding rates steady or tapering QE.

JAPAN: A temporary improvement in global growth should make Japan's economy look a little better. However, a strong yen will weigh on corporate profits, which will likely keep capex subdued. The strong yen also keeps the outlook for inflation restrained. Following a decisive victory for the Liberal Democratic party in upper house elections, the market is now expecting the Abe government to announce a fiscal stimulus package of between ¥10 to ¥15 trillion. The real amount is more likely to be ¥5 to ¥10 trillion. The Bank of Japan is likely cut rates by another 20 basis points and increase its ETF purchases to weaken the yen.

UK: The economic downswing is now kicking in post Brexit. The BoE is likely to cut interest rates close to zero over the next two policy meetings and present a case for the resumption of quantitative easing. Early signs of fallout in commercial property exacerbate tensions around liquidity (i.e., gating of certain real estate investment funds) and uncertainty of foreign sponsorship. The pound is taking the strain as Britain's very large current account deficit will also be a drag on growth and reflect the possibility of lower investment.

CANADA: A subdued growth outlook is expected to keep the Bank of Canada on hold for an extended period. Global political uncertainty could further weigh on business investment. Canadian assets will continue to be sensitive to oil price developments. Our expectation of lower oil prices suggests yields will be constrained at low levels. Canadian bond yields are very rich by any historical measure. But with an external environment of similarly low core yields, there are few triggers that could reverse this dynamic.

AUSTRALIA: Political uncertainty from the close election result suggests some risk of slippage on fiscal targets. Standard & Poor's has placed Australia's AAA rating on negative outlook; if delivered, a downgrade could weigh on longer-dated bonds. The Reserve Bank of Australia is expected to deliver a rate cut next month, but the next CPI print ahead of that meeting will be crucial. Australian bonds have fully priced in the next rate cut. The curve has also flattened tremendously, creating less scope for a further rally. But the level of Australian yields continues to look attractive in a global context.

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