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FIXED INCOME SECTOR PULSE

APRIL 2015

SUMMARY:

10-year US Treasury yields have traded in a range around 2%, as concerns about rate hikes by a less "patient" Fed have been counterbalanced by recent softness in domestic economic readings and strong demand from yield-starved international investors. The European Central Bank (ECB) commenced its much-anticipated sovereign bond purchase program, driving yields across the region to unprecedented lows. With economic data showing hints of improvement, eurozone duration looks increasingly risky. Japanese growth and inflation data have disappointed, increasing the likelihood of additional stimulus measures this year. Amid thin liquidity in the government bond market, efforts may be expanded to a wider range of asset purchases.

Investors have easily taken down heavy supply of investment-grade corporate debt despite signs the credit cycle may be nearing its late stages. Commodity prices remain an area of concern for the US high yield market, but energy-related dislocations have created opportunities to take advantage of industry consolidation and fundamentally sound credits. European high yield has been stable against a supportive macro backdrop.

Emerging markets credit remains attractive relative to comparable developed market debt. But volatility may arise from a tighter Fed, an oil supply glut, and rising defaults in certain pockets of the market. Although performance can be volatile, EM local currency bonds remain a compelling alternative to global sovereigns and could benefit from a reprieve in pervasive dollar strength.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Higher-beta commodity-related sectors and steeper credit curves amid falling Treasury yields have been contributing to increased volatility and wider spreads. Non-financial credit fundamentals have likely peaked for this cycle, leaving technicals as the primary support for valuations. T. Rowe Price credit analysts continue to find opportunity in select financials and lower-beta sectors.

EUROPEAN CORPORATES: Spreads widened last month as the ECB finally began its long-awaited bond buying program. Underperformance relative to government bonds was principally due to corporates lagging the continued strong performance of sovereigns rather than falling corporate bond prices. Although valuations are unexciting, euro corporates still offer reasonable yield pickup versus peripheral European sovereigns.

US HIGH YIELD: The main performance driver of the market continues to be commodity prices given the size of the sector and its large impact on the market. Spread levels are still implying a higher default rate than we are currently expecting. If oil prices remain low for a more extended period of time, we will need to evaluate the impact to our 2016 default outlook.

EURO HIGH YIELD: A supportive macro backdrop and accommodative central bank policies have continued to result in a stable environment for the asset class. This resulted in European high yield outperforming other global high yield markets last month as continued inflows to the asset class were readily absorbed. With QE, investor inflows, and a positive tone, strong performance is expected to continue despite valuations looking less compelling on a spread and yield basis.

BANK LOANS: The largest current market drivers are technical in nature, with strong collateralised loan obligation issuance, a light new issue calendar, and a meaningful amount of paydowns. The asset class has also benefited from a materially lower exposure to commodities than the high yield bond market. There are still some discounts to be found, but dollar prices have grinded higher, with light new issuance in March reducing the discounted opportunity set.

AGENCY MBS: The directionality between rates and spreads persists, with the move to lower Treasury yields widening mortgage spreads into the rally. The market's attention on the timing of eventual Fed tightening has longer-term implications, but near-term technicals appear supportive, and concerns over a spike in refinancing activity have eased.

EM DOLLAR SOVEREIGN: Emerging market sovereigns are attractive versus developed market assets (both high yield and investment grade) but are increasingly idiosyncratic—Russia, Brazil, Venezuela, and other oil-related names, in particular. Commodity price and currency moves will claim victims, and Fed liftoff may challenge less-liquid markets.

EM CORPORATES: Valuations are attractive versus US investment grade and high yield across the rating spectrum. This now applies to single B rated bonds as well. Commodity price weakness has a mixed impact on issuers but is generally a headwind to spread compression. Our enthusiasm is tempered by poor liquidity, particularly in the high yield area of the market.

EM LOCAL: Yield spreads have widened over the past month as US Treasuries rallied. Some stability in emerging currencies has been helpful following a period where the competing trends of weakening currency and strong bond performance have been extended. Flows have improved modestly but are likely to remain low; inflows are not expected to pick up notably until the US dollar bid steadies. Valuations are globally attractive but increasingly bifurcated. Until growth rates pick up in emerging markets, currencies will remain under a cloud.

DEVELOPED SOVEREIGN MARKETS:

US: A dovish March Federal Open Market Committee (FOMC) policy statement, weak first-quarter economic data, and a surprisingly poor March jobs report moved 10-year rates from the upper end of their 1.75% to 2.25% range in early March to near the bottom by early April. The market has nearly priced out the possibility of a 2015 rate hike, while even the dovish FOMC sees two rate increases this year. Weak economic data and debate about the potential hiking cycle have dominated the market's attention. A range-bound 10-year yield is likely to continue in the near term.

EUROZONE: The ECB has launched an aggressive program of sovereign quantitative easing (QE), buying two times the expected net issuance in 2015-2016 across the curve. The growth and inflation outlooks are already improving, but monetary policy is likely to remain accommodative for the foreseeable future. Negative yields in the front end have pushed demand further out the curve. Sovereign bond QE should constrain yields at low levels. However, valuations are extremely expensive.

JAPAN: Core inflation continues to undershoot, dragged lower by weaker energy prices. Fourth-quarter growth was revised lower due to weaker-than-expected business investment and inventories, and exports remain soft. The Bank of Japan's bond purchase program continues to support low yields.

UK: Benign inflation and concern about the drag from a weak eurozone has seen market pricing push back the timing of rate hikes; the Bank of England has validated that the first move will not come until late 2015 or early 2016. We continue to expect only a modest hiking cycle given the interest rate sensitivity of the economy. A general election in May could see a potentially messy result.

CANADA: The market is very expensive by any historical measure, but an easing bias and threat of a further rate cut could keep the market better supported even in the face of rising US yields.

AUSTRALIA: There are downside growth risks given an ongoing decline in commodity prices and terms of trade. A further rate cut is possible, and the Reserve Bank of Australia is likely to remain accommodative for a considerable period.

IMPORTANT INFORMATION

The views contained herein are as of 8 April and may have changed since that time. Unless indicated otherwise the source of all market data is Thomson Datastream.

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