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FIXED INCOME VIEWPOINTS

SUMMARY:

US Treasuries have rallied sharply in early 2016, benefiting from volatility in global risk assets amid concerns about China's ability to concurrently stem capital outflows, support the yuan, and loosen monetary policy; less robust domestic data; and ongoing weakness in commodity prices. Inflation expectations have markedly fallen, with 10-year breakeven spreads their lowest since the global financial crisis. Against this backdrop, a Fed rate hike in March appears increasingly unlikely.

German sovereigns similarly benefited from the risk-averse environment. Core European rates received an additional tailwind from European Central Bank (ECB) President Draghi's comments that "conditions have worsened" since the governing council met in December, implying that additional stimulus will be forthcoming when the ECB convenes in March. Meanwhile, the yield on Japanese 10-year notes approached 0% after the Bank of Japan (BoJ) instituted negative interest rates on certain bank reserves. While most balances are not presently subject to sub-0% rates, the new tiered rate structure provides the BoJ with a flexible tool for calibrating future monetary policy.

Corporate credit spreads have broadly widened, with commodity producers bearing the brunt. Within investment grade, recent weakness has led to price dislocations for some industrials that are not justified by fundamentals. High yield opportunities can be found in high-quality energy and lower-rated, non-commodity issues that have been unjustly penalized. With less energy exposure, bank loans and European high yield are attractive options for diversifying US high yield bond exposure.

Dollar-denominated sovereigns merit the highest-conviction outlook within the emerging markets (EM) opportunity set, providing attractive yields versus US investment-grade credit and better liquidity than EM corporate bonds. Rates are attractive in certain local currency EM sovereign markets, but commodity prices need to stabilize for currencies to sustainably rebound; recent signs of waning dollar strength are encouraging for the sector.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: The sector offers relative safety and decent income at a reasonable price. Late credit-cycle dynamics, combined with crowded investor positioning in financials, have created price dislocations in some lower-quality industrial sectors. We see relative value opportunities in some midstream energy companies and other commodity-related names that have the wherewithal to maintain their investment-grade ratings. Real estate investment trusts also offer value.

EURO CORPORATES: A continued collapse in oil prices, global financial market volatility, and concerns over the Chinese economic slowdown caused significant widening in all spread products. Weak bank earnings and concerns over non-performing loans added to the soft tone. European high-grade corporates held up relatively well, though, partially aided by a dovish ECB meeting that indicated further monetary easing will be delivered in March. The short-term outlook and risk sentiment remain fragile. However, with the significant reversal in spreads, the market appears to be already pricing in a lot of the risks.

US HIGH YIELD: The 2016 default outlook is rising given energy price deterioration and stress in the metals space. We are also expecting a meaningful amount of exchange offers as well as substantial "fallen angel" supply over the next 12 months as issuers lose their investment-grade ratings. Even so, we continue to find interesting ideas away from commodities and even within the highest-quality energy universe. A rally could transpire toward the second half of 2016, as valuations at some point will become too compelling to resist. However, the market still needs to work through several near-term headwinds.

EURO HIGH YIELD: Technical support, sound fundamentals, and expectations of additional ECB support are some of the reasons the market has not seen a significant sell-off or larger investor redemptions despite weaker performance in December and January. New issuance has been below average in a cautious environment, and we continue to wait for a reasonable primary market calendar to start up. We expect this to help move the market back into balance. The sector is expected to continue to outperform US high yield (on a currency hedged basis) in the near- to mid-term.

BANK LOANS: Spreads have widened in response to the increase in high yield spreads as well as weaker technicals, with continued retail mutual fund outflows and lower collateralized loan obligation issuance. However, the fundamental picture remains intact. Loans should continue to benefit from their lower commodity exposure than US high yield and a minimal near-term maturity profile. Default rate expectations have increased but should diverge from the US high yield bond market, with loan defaults staying significantly lower.

AGENCY MORTGAGE-BACKED SECURITIES: The sector has cheapened versus Treasuries but continues to outperform the broader credit markets and provide a source of liquidity for investors. Valuations are near their widest levels of the last two years, and the low yield levels on Treasuries have increased the directional bias of spreads (MBS spreads have moved in the opposite direction of Treasury yields). We maintain a neutral outlook for the sector.

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EM DOLLAR SOVEREIGN: The sector recovered quickly from stressed levels in mid-January. Signs that US dollar strength may be waning and potentially stabilizing commodities prices are grounds for optimism. But until there is more clarity around Chinese monetary policy, spread tightening will be limited. Still, the sector offers attractive yields, keeping the outlook relatively positive. We remain focused on higher-quality countries that are implementing reforms or that the market has unfairly punished.

EM CORPORATES: Our outlook for the EM corporate sector remains cautious. Negative returns in December and January have made absolute valuations more attractive, but relative value is less compelling. Illiquidity in this sector relative to other global fixed income alternatives raises the bar on a valuation- or fundamental-centered thesis for adding exposure. Valuations for investment-grade quasi-sovereigns remain attractive relative to investment-grade EM corporates, and state-supported firms also offer better liquidity.

EM LOCAL: Yields fell over the past month, led by Brazil, Indonesia, South Africa, Hungary, and Romania. EM currencies are grappling with conflicting forces. A recent pullback in US dollar strength is should be positive, but commodity prices need to stabilize for EM currencies to meaningfully appreciate. The threat of a Chinese yuan devaluation is also weighing on EM currencies. We maintain a neutral outlook for local rates, favoring countries with attractive yields and the ability to manage monetary policy proactively. We remain cautious on EM currencies, preferring those countries experiencing relatively strong growth and those that are implementing economic reforms that should encourage long-term growth.

DEVELOPED SOVEREIGN MARKETS:

US: Negative sentiment in global risk markets, commodity price volatility, uncertainty regarding a Chinese yuan devaluation, and continued disappointing US economic data have led to a sharp flight-to-quality rally in Treasuries over the past month. Economic data need to improve, and both deflation and general risk fears need to calm for yields to break their bullish trend. Retracements to higher yields are possible, particularly with a large fear premium currently priced into the market, but sell-offs may be shallow until the macro landscape improves.

EUROZONE: In January, the ECB alluded to additional easing measures, and the market is pricing in a 10 to 20 basis point cut in the deposit rate. It is unclear whether this action is necessary. Consensus growth expectations have declined slightly over the past month (to 1.6% for 2016), but high-frequency data indicate that growth continues at a moderate and steady pace. Still, lack of inflation means that rate hikes are unlikely for at least three years. Negative deposit rates, quantitative easing, and associated negative net supply should keep German bund yields well below fair value, with the 10-year expected to remain in a 0.2% to 0.9% range over the next six to 12 months.

JAPAN: Core inflation remains weak. An increase in core-core inflation (prices excluding fresh food and energy) has been more encouraging. However, of concern for the BoJ is that spring wage negotiations disappoint, with muted wage demands from unions. In addition, inflation expectations have ticked lower in the wake of lower oil prices. In late January, the BoJ introduced a tiered deposit rate system, with marginal deposits remunerated at -0.10%. The effectiveness of negative rates is questionable, as it appears that a very limited amount of liquidity will be subject to negative deposit rates; the majority of deposits will be remunerated at 0%. The central bank's next policy easing step likely entails an increase in the deposits subject to the -0.10% rate.

UK: The market's expectations for the first Bank of England (BoE) interest rate hike have moved from late 2016 into early 2018. This profound change has been driven by a combination of softer data and an increase in global risk aversion. In addition, the market views "Brexit" risk as not only keeping the BoE on hold but also prone to cut interest rates should Brexit actually occur; the rationale being that a UK withdrawal from the European Union would disrupt economic growth. This has driven a marked bull steepening in the UK yield curve, with gilts only modestly underperforming US Treasuries in the significant rally that has evolved since the start of the year.

CANADA: Fourth-quarter 2015 growth looks to have stalled, and GDP expectations for 2016 have been rightly ratcheted lower. Renewed oil price declines pose downside risks to the outlook. Inflation has remained contained, giving the Bank of Canada (BoC) some welcome monetary policy flexibility. While we expect policy rates to remain on hold for an extended period, the BoC could deliver further easing if growth disappoints. Canadian government bond yields are likely to remain range-bound versus their US counterparts, with a bias to outperform should we transition to a rising rate environment.

AUSTRALIA: Recent domestic data has been more encouraging despite the significant ongoing drag from mining investment. The labor market has not given back the outsized job gains of recent months, and confidence indicators have been stable. However, signs that housing activity may be rolling over and the deterioration in the trade balance bear watching. The Reserve Bank of Australia appears comfortably on hold in the near term, but downside risks from China and weak commodities prices will continue to dampen expectations for a stronger recovery.

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