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FIXED INCOME VIEWPOINTS

SUMMARY:

After dropping sharply following the UK's Brexit vote, stronger employment data has applied some upward pressure on U.S. Treasury yields. The Fed is expected to be patient with rate hikes, but stronger economic readings could pull investors' expectations forward, with the front of the curve looking most vulnerable. The long end is supported by other central banks leaning toward additional easing.

The European Central Bank has signaled openness to further monetary stimulus if needed. As the Bank of England (BoE) launches aggressive stimulus measures in the aftermath of Brexit, the ECB will likely extend its quantitative easing (QE) program and could adjust its parameters. It may also cut deposit rates further into negative territory.

The Bank of Japan (BoJ) disappointed markets in July, doubling its ETF purchases but not cutting the policy rate or further expanding the monetary base. The government's fiscal stimulus announcement likewise underwhelmed. Investors are anticipating action at the BoJ's September meeting, when the central bank will perform a comprehensive assessment of monetary policy.

Powerful technical forces continue to overwhelm shaky fundamentals in the U.S. investment-grade corporate market as investors search for yield, while the ECB's corporate bond purchases dominate European credit markets. Strong investor demand in a low rate environment has fueled impressive performance for high yield debt, where select opportunities are still available.

Low developed market rates are providing a technical tailwind for emerging markets (EM) bonds. EM credit returns will likely be coupon-driven, with limited potential for additional spread tightening. EM local rates are attractive relative to developed market counterparts; the outlook for the Fed – and the associated impact on the U.S. dollar and commodity prices – will heavily influence results for the sector.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: We believe we are near the end of the credit and profit cycles. Valuations are less attractive than they were earlier in the year. Spreads have tightened for both industrials and financials, as strong technicals have overwhelmed deteriorating fundamentals. Leverage is high, while valuations are more appropriate for the middle of the credit cycle. We are therefore positioned defensively within the sector, favoring higher-quality, lower-beta bonds.

EURO CORPORATES: Expectations for accommodative central bank policies are dominating other market catalysts, as European growth is likely to be negatively impacted by Brexit. The ECB's corporate bond-buying program continues to provide strong technical support. Spreads are close to their tightest levels of the year and offer little compensation for risks. The ECB's bond purchases are likely to contain – but not prevent – spread widening should there be a return of meaningful risk aversion.

US HIGH YIELD: Along with company-specific events, the factors driving the market include oil and commodity prices, default rate expectations, and central bank actions. We are positioned for lower energy prices, an elevated 2016 default rate combined with low recovery rates, and corporate credit being late in the cycle. There is also lingering uncertainty surrounding Brexit impacts as well as U.S. elections. These risks are balanced by exceptionally large technical demand for income in a low rate environment. We continue to find opportunities in "fallen angel" bonds that have been downgraded from investment grade, shorter-maturity debt, and select new issues.

EURO HIGH YIELD: The ECB and BoE are increasingly supportive, and positive technical pressure persists due to net inflows into the asset class on the year accompanied by reduced primary market issuance. Valuations are roughly fair versus U.S. high yield after adjusting for ratings and duration differences. There is greater uncertainty and weaker investor sentiment following the UK referendum, but core fundamentals remain in place. Value remains, but our focus is on undervalued, core longer-term value stories and yield-to-call paper where coupons can be clipped for longer amid disruptions to capital markets.

BANK LOANS: The sector benefits from a meaningfully lower default rate and lower commodity exposure than the U.S. high yield bond market. Moreover, there is potential for a late 2016 or early 2017 coupon increase thanks to bank loans' floating rate characteristics. However, the positive outlook is balanced by uncertainty surrounding European Brexit impacts and upcoming U.S. elections. We are still finding opportunities in non-commodity lower quality issues, shorter-maturity loans, and select new issues.

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AGENCY MORTGAGE-BACKED SECURITIES:
The market's expectation for a more dovish policy path from the Fed continues to push risk of an earlier end to reinvestments of principal payments on the Fed's MBS holdings into the future. A lower, but narrower, trading range for interest rates continues to support high-quality and liquid sources of income, like MBS. Strength in the U.S. housing market has kept supply expectations elevated, but continued robust overseas demand tempers supply concerns. Valuations continue to look fair versus Treasuries and more attractive relative to competing spread sectors. Our focus remains on relative value opportunities within the sector.

EM DOLLAR SOVEREIGNS: Absolute returns are likely to exceed those in developed government bond markets, and additional yield carry should lead investment-grade EM sovereigns to outpace U.S. and European investment-grade corporate bonds. High yield EM bonds are slightly cheap versus U.S. high yield bonds, having fractionally lagged in the recent credit rally. Improvement in Brazil's political and fiscal situation will support the better tone toward EM assets more broadly. We are mindful of China foreign exchange policy and related outflow fears. A broader developed market rate reversal would also test global trading liquidity and potentially trigger outflows from ETFs invested in emerging markets.

EM CORPORATES: EM corporate defaults reached record levels in the first half of 2016, driven by idiosyncratic stories, but technicals currently outweigh fundamentals. From a technical perspective, EM corporates should continue to benefit from fund inflows in the quarter ahead combined with modest net supply out of Russia (due to sanctions), China (onshore refinancing of external corporate debt), and Brazil (corporate deleveraging). Favored markets include Brazil, Mexico, Indonesia, Argentina, and China. We prefer consumer, media, and telecom names, with a focus on higher-quality bonds. We are cautious on Turkey, Gulf Cooperation Council countries, and frontier markets, as well as lower-quality bonds.

EM LOCAL: Valuations versus developed market bonds are still attractive. EM local bonds should be able to tolerate a mildly upward bias in U.S. Treasury yields. However, a large developed market sell-off, while not our base case, would undermine the asset class. A stable economic growth gap between emerging and developed markets supports EM currencies. The path of the U.S. dollar – and relatedly, commodity prices – is key for the sector. The outlook for the Fed will be the primary driver of the dollar and overall sector performance.

DEVELOPED SOVEREIGN MARKETS:

US: Most economic indicators have surprised positively in the past six to eight weeks. Weak second-quarter GDP growth was the notable exception, but leading indicators are suggestive of a third-quarter bounce in economic growth. While a rate hike in September seems unlikely, improving economic data has the potential to bring the next Fed rate hike into view. But with global central banks in full easing mode, the term premium is likely to remain low. The Brexit uncertainty premium has been largely removed, but markets will transition to U.S. election uncertainty as the summer ends. We continue to maintain a flattening bias along the U.S. yield curve.

EUROZONE: The ECB's QE program will need to be extended beyond March 2017; this will probably be announced in September but may be delayed to December. The key question is how the ECB tweaks the parameters. Removal of the deposit rate floor would be positive for German bunds, but a removal of the capital key constraint would be bund negative, as it would allow the ECB to buy larger quantities of other member states' bonds. The ECB could also cut its deposit rate another 10 bps to -0.5% if oil prices remain weak. If there is a cut, it is likely to be the last. The market is pricing in a 10 bps cut this year and another 10 bps cut next year. The lack of inflationary pressure means that rate hikes are unlikely for at least three years. Within Europe, we prefer peripheral markets such as Slovenia, Italy, and Cyprus.

JAPAN: Improved global data flow will likely put some upward pressure on global rates (Japan included).

The Japanese yield curve is likely to have a flattening bias as strong external accounts and inadequate BoJ action keep upward pressure on the yen. All else being equal, a stronger yen implies a flatter curve.

Rampant speculation about the BoJ's next move is likely to reappear in early September and to change yield curve dynamics as the market prices in the possibility of a rate cut. Valuations are supportive of the front end of the curve, as no cuts are priced in for the September policy meeting.

UK: Anticipation and delivery of monetary easing have driven gilt yields to new all-time lows. A 0.25% rate cut, £60 billion in additional gilt asset purchases, a £10 billion corporate bond purchasing program, and important technical changes to increase the potential of looser monetary policy feeding into the real economy are the fulfilment of the BoE's promise to respond to downside economic risks following Brexit. Further easing seems likely, including moving interest rates near the zero bound.

Harder economic data will be scrutinized for its validation (or not) of the very sharp weakening in purchasing managers' index readings since the Brexit vote.

CANADA: A subdued growth outlook is expected to keep the Bank of Canada on hold for an extended period, but Canadian bonds yields are very rich by any historical measure. However, with an external environment of similarly low core yields, there are few triggers that could reverse this situation. Our expectation of lower oil prices also suggests yields will be constrained.

AUSTRALIA: Political uncertainty from the close election result suggests some risk of slippage on fiscal targets. As expected, the Reserve Bank of Australia has delivered a rate cut this month. We expect this to be the trough of the cycle. Scope is very limited scope for Australian bonds to price in further rate cuts from here. The curve has also flattened tremendously, which means less scope for a further rally.

Still, the level of Australian yields continues to look attractive in a global context.

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