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FIXED INCOME VIEWPOINTS

SUMMARY:

U.S. Treasury yields were lifted in August by a strong July employment report and seemingly more hawkish comments from Fed officials. These included statements from Fed Chair Yellen, who said at the central bank's annual Jackson Hole Summit that the case for a rate increase "has strengthened in recent months." The Fed appears likely to hike once this year, which suggests modestly higher yields and a continued curve flattening trend.

The eurozone yield curve appears likely to steepen, with the front end anchored by negative deposit rates. Although the easing cycle appears to be nearing an end, the European Central Bank (ECB) will still likely extend quantitative easing (QE) beyond March 2017 and loosen the restrictions on the bonds eligible for purchase. However, another rate cut has become less likely.

The Bank of Japan's comprehensive assessment of monetary policy at its September meeting will likely endorse the BoJ's negative interest rate policy, providing Governor Kuroda with license to further cut rates. Amid concerns about the associated risks for the financial system, policymakers will also make efforts to steepen the yield curve.

Strong technicals in the U.S. investment-grade corporate market have overshadowed weakening fundamentals, creating a risk of spread widening if technical conditions suddenly shift. Fundamentals for European corporates are better, but valuations offer little compensation for risk. Bank loans are attractive as the Fed tightening cycle progresses, while high yield bonds offer pockets of opportunity.

Emerging credit markets have extended their impressive year-to-date rally, but an expected surge in dollar-denominated sovereign supply could temper near-term gains. EM local rates are attractive in some countries, particularly those with high real yields and potential for rate cuts. The path of the U.S. dollar and commodity prices remain key drivers for EM currency performance.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: In a market driven by technicals rather than fundamentals, we are cautious given that technical conditions can change swiftly. Valuations are unattractive relative to fundamentals and risks, with credit spreads near their tightest levels on the year. Positioned for slowing U.S. profit and earnings growth, we maintain a bias toward defensive sectors, such as pharmaceuticals, healthcare, and utilities.

EURO CORPORATES: Spread tightening induced by the ECB's corporate bond purchase program is leading to growing divergence between valuations and fundamentals. Yields have drifted to new all-time lows, and the broad compression of spreads leaves limited room for outperformance from securities trading at wider levels. Credit spreads, which are at year-to-date tights, offer little compensation in the face of a number of economic and political risks. These include potential disappointment with further ECB easing, Spain's inability to form a coalition government, the Italian referendum on constitutional reform, the timing of a rate rise in the U.S., and the looming U.S. election.

US HIGH YIELD: The risks of lower energy prices, low recovery rates, an elevated 2016 default rate, and a late-stage credit cycle are balanced by exceptionally strong demand for income in a low rate environment. In addition, the recent rebound in crude prices and aggressive oil price hedging by energy producers may keep the 2017 default rate from rising as much as expected. We continue to see opportunities in short-term, "fallen angel" securities and select new issues. Lower-quality, non-commodity bonds also offer areas of opportunity; spreads in this market segment widened in tandem with the energy sector but have lagged during the subsequent energy rally.

EURO HIGH YIELD: The ECB and Bank of England (BoE) have been highly supportive, and uncertainty and weaker investor sentiment following the UK Brexit referendum has eased. A lack of new issue supply coupled with growing investor cash balances has helped drive spreads tighter. Risks include valuations reaching unreasonable levels as a result of central bank actions, leading to an eventual correction. In addition, if an expected busy new issue calendar following the summer holidays doesn't materialize, investors with elevated cash levels to put to work could stretch valuations, causing increased market volatility.

BANK LOANS: Technicals are supportive; although retail fund flows remain muted, supply is low and a decent amount of collateralized loan obligation (CLO) volume provides demand. With less exposure to energy and commodity issuers, the default rate for loans remains muted as defaults in the U.S. high yield market are rising. With their low duration, loans are an attractive sector as the Fed rate hiking cycle progresses. Additionally, coupons could begin to reprice higher in late 2016 or early 2017, as London interbank offered rates have increased and now exceed some loans' LIBOR floor levels.

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AGENCY MORTGAGE-BACKED SECURITIES: Valuations are less compelling versus Treasuries but remain attractive relative to other spread sectors. MBS have benefited from a narrow trading range in Treasury rates. We expect MBS spreads to lag in any retracement to lower Treasury yields; conversely, potential hedging needs could weigh on spreads on a further break higher in the trading range for Treasury rates. Our focus remains on relative value opportunities within the sector.

EM DOLLAR SOVEREIGNS: We expect spreads to grind tighter, supported by investor demand for yield in a low global rate environment even in the face of U.S. rates drifting higher. Improvement in Brazil's economic troubles should support the better tone toward emerging markets more broadly. However, the Fed moving earlier or faster than expected could undermine short-term flow support. U.S. elections and China policy also present tail risks for the asset class. We remain focused on idiosyncratic themes and favor Brazil – and Latin America more generally – over emerging Europe, where valuations have been stretched by high accommodative monetary policy.

EM CORPORATES: Sector returns will be coupon driven, with modest potential for spread tightening, if technicals continue to dominate. Increased corporate leverage and supply will likely contain upside from current valuation 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 liquidity. We continue to favor BBB and BB rated bonds and prefer media and telecom and consumer product companies over energy producers and financials. Favored countries include Brazil, Mexico, Indonesia, Argentina, and China.

EM LOCAL: Divergence in inflation trends in emerging countries supports a number of markets where inflation is turning lower, which reduces the pressure on central banks to raise rates. Mexico, Brazil, India, and Indonesia are among the more interesting markets for local rates. A stable growth gap between emerging and developed countries supports EM currencies, as does improving current accounts and relatively high real yields in several countries. The path of the U.S. dollar – and, relatedly, commodity prices – are key to sector performance.

DEVELOPED SOVEREIGN MARKETS:

US: Economic data recently have been mixed, but leading indicators continue to suggest a bounce in growth in the second half of 2016.Financial conditions remain easy, and data that has been generally consistent with expectations keeps the next Federal Open Market Committee hike in the market narrative. Treasury yields may move modestly higher as markets contemplate the next Fed hike, led by the front end of the curve. But global central bank easing should keep term premiums low and yields ultimately contained. We continue to expect flattening of the Treasury yield curve, although there could be bouts of steepening.

EUROZONE: Another ECB rate cut is unlikely unless the euro strengthens or there is a significant sell-off in front-end European yields. The ECB is reluctant to cut further because of the impact on banks. An extension of QE and some easing of purchase restrictions are more likely than additional rate cuts. Due to disagreements within the Governing Council, any decisions on policy could be delayed until December.

The eurozone periphery is becoming less attractive, as there appear to be few positive catalysts for further spread compression. Meanwhile, there are approaching political risk events in Italy and Spain.

JAPAN: In the short term, global growth improvement could put upward pressure on global rates, including Japan. The BoJ appears poised to cut its base rate to -0.20%. Additional monetary policy initiatives will put downward pressure on the front of the Japanese yield curve, while a weaker yen and the BoJ's preference for a steeper curve should keep the long end from declining further. The yen should weaken due to monetary policy divergence. However, a large current account surplus and a weaker risk environment will probably continue to inhibit substantial yen weakening.

UK: The initial business shock over the Brexit vote has diminished, and the BoE's delivery of promised monetary easing has driven gilt yields to new all-time lows. The housing market has slowed, but purchasing managers' indexes (PMI) and trade reports have quickly rebounded. However, harder data will need to be scrutinized to gauge the full impact on the economy. Prime Minister May has affirmed no triggering of Article 50 before year-end, and significant political events in several European countries will delay Brexit negotiations. The next step is the fiscal response, with much speculation over infrastructure spending. The fiscal outcome will probably define the gilt market over the next 12 months, and an aggressive fiscal easing would likely mark the bottom in yields and a steeper curve.

CANADA: Second-quarter growth was strongly negative, as expected, impacted by the Alberta wildfires. A subdued growth outlook is expected to keep the Bank of Canada on hold for an extended period. Global political uncertainty could weigh on business investment further, and Canadian assets will continue to be sensitive to oil price developments.

AUSTRALIA: The Australian yield curve has flattened tremendously, implying less potential for a further rally. No further near-term action from the Reserve Bank of Australia is expected. While the RBA retained a mild easing bias, we do not foresee any more rate cuts this cycle. However, recent growth indicators bear monitoring: if soft retail sales and PMI are the start of a more negative trend, further easing would be more likely. China developments will also be important for the Australian growth outlook.

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