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FIXED INCOME VIEWPOINTS

SUMMARY:

The US Treasury yield curve has aggressively steepened, with term premiums rising as the market has priced in higher growth, inflation, and deficit spending under a Trump administration. With inflation expectations rising and headline inflation firming, Treasury inflation protected securities (TIPS) continue to offer some value.

European yields have risen in sympathy with US yields. European investors have priced out additional European Central Bank rate cuts, and many expect the ECB to slightly taper its assets purchases when it announces an extension of the quantitative easing (QE) program beyond March 2017. However, tighter global financial conditions could convince the ECB to maintain a dovish bias. The Italian constitutional referendum on 4 December is also a potential risk event.

The Bank of Japan has begun targeting a 0% 10-year sovereign yield, which has markedly reduced trading volumes of Japanese government bonds, while allowing some steepening of the yield curve. The BoJ has pushed back its forecasts for reaching its 2% inflation target into fiscal 2018 but appears to be on hold with additional rate cuts given the unpopularity of negative interest rate policy in Japan.

Credit markets have reacted positively to the US election outcome, but volatility is likely to reappear. Increased infrastructure spending and tax cuts could extend the economic cycle for US investment-grade and high yield companies. However, certain industries – such as health care – are at risk of changes in government policy; others – such as financials and energy producers – could benefit from a reduced regulatory burden.

The rapid increase in US rates and potential for protectionist trade policies have created headwinds for emerging markets following a stretch of strong performance. However, some countries are more affected than others, and volatility should create buying opportunities. Dollar strength and commodity prices remain key risks.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Technicals have been highly supportive but are more likely to weaken than strengthen further. Credit fundamentals are peaking, and balanced sheets appear stretched.

However, the potential for lower corporate tax rates, a reduced regulatory burden, and increased fiscal stimulus under a Trump administration could extend the economic cycle, supporting fundamentals in the sector. Little market dispersion in valuations limits the amount of relative value opportunities. However, our analysts are finding select opportunities in areas such as bank, midstream energy, and real estate investment trusts..

EURO CORPORATES: Near-term risks include uncertainty about the ramifications of the US election outcome and the 4 December Italian constitutional referendum. The ECB's corporate bond purchasing program has induced spread tightening and led to growing divergence between valuations and fundamentals. Potential tapering of QE by the ECB may reduce current strong technical support.

US HIGH YIELD: Commodity prices remain a key driver of the high yield market given that energy and metals producers represent a large component of the overall market. We continue to expect lower energy prices in 2017. However, the possibility of an OPEC supply agreement balances some of the risks. An increase in infrastructure spending and tax cuts could extend the US business cycle, supporting fundamentals for high yield companies. However, this may be offset by greater uncertainty and related volatility. High yield credits that stand to benefit from infrastructure spending, such as certain metals and energy issuers, have become more attractive. Hospital operators could come under pressure with potential changes in healthcare policy under the Trump administration.

EURO HIGH YIELD: Asset purchases and accommodative monetary policy from the ECB and Bank of England continue to provide indirect support for the market. European high yield outperformed the US high yield market in October – a trend that could continue over the fourth quarter. The new issue market has opened up, creating opportunities to invest in more complex credits and structures. The market is subject to uncertainty and weaker investor sentiment related to the UK referendum and Brexit negotiations.

BANK LOANS: There is potential for a coupon increase in late 2016 or early 2017 as 3-month LIBOR has now risen above the first floor level for some loans of 75 basis points. Although credit markets have generally reacted positively to the US election results, uncertainty around economic policy could generate volatility in loans and other credit sectors. Historical performance data demonstrates that floating rate loans can perform well during environments of rising rates and higher inflation. We continue to find opportunities in lower-quality non-commodity issuers, shorter-maturity loans, certain energy credits, and select new issues.

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AGENCY MORTGAGE-BACKED SECURITIES:
VValuations continue to screen rich to Treasuries, but remain attractive versus competing spread sectors. The technical trends are beginning to look less constructive, carry has eroded with hedging costs increasing due to higher market volatility, and housing policy risks are rising. Prepayment risk has eased, but extension risk has become more of a concern with a move higher in rates.

EM DOLLAR SOVEREIGNS: A sharp move higher in US yields and the potential for protectionist trade policies from the incoming Trump administration have led to weaker technical support following several weeks of steady inflows into the asset class. Dislocations could create opportunities to selectively add to securities that have sold off more than fundamentals warrant. Mexico remains the most vulnerable market to US policy changes given the countries' close economic ties. We are less concerned about the outlook for Asia, as it is more closely linked to China than the US, although shifting alliances in the region add a degree of political risk. Russia is the most likely beneficiary of a Trump victory, as increased US isolationism could allow Russia to exert greater influence in Eastern Europe and the Middle East.

EM CORPORATES: Near-term caution is warranted with the rise in global rates as EM assets have underperformed following every unwind of QE and zero interest rate policy since 2012, exemplified by the 2013 "taper tantrum". While the sector remains attractive relative to negative-yielding developed market government bonds and higher-volatility equities, valuations are stretched when factoring in the sector's weaker institutional sponsorship and liquidity. We continue to favor companies in countries such as Brazil, Indonesia, Argentina, and China. Volatility in Mexico stemming from the US election results could create buying opportunities.

EM LOCAL: Yields have risen from their lows with the increase in US Treasury rates. In the near-term, political risks – most notably in developed markets – and the Fed's policy path will influence local yields. Over the medium term, improving external balances and deflationary pressures in some regions support certain markets. Although there could be another leg higher for the US dollar rally in the near term, we believe that much of the appreciation in the dollar has already occurred. In addition to further dollar strength, commodity prices remain a key risk.

DEVELOPED SOVEREIGN MARKETS:

US: Economic data recently has been mostly positive, and leading indicators continue to suggest a near-term bounce in growth. Financial conditions remain easy, and data consistent with expectations keeps a December Federal Open Market Committee (FOMC) rate hike in the market narrative. However, increased political uncertainty following the US election will make it a difficult decision. Having already experienced a sharp bear steepening of the curve, Treasury yields may move modestly higher as markets contemplate the next phase of global central bank policies.

EUROZONE: We expect a "dovish taper" when the ECB extends its QE program beyond March 2017 – this decision will likely be announced in December. Although low conviction, our expectations are that the timeframe for asset purchases is extended by six months, the pace is slightly reduced, and some parameters are tweaked to account for a scarcity of German bunds. Additional rate cuts have been priced-out, which we believe is correct, However, lack of inflationary pressure implies that rate hikes will not happen in Europe for at least three years.

JAPAN: The BoJ has shown no urgency to proactively cut rates to push inflation higher. As such, we expect the BoJ to remain on hold at its upcoming meetings given improving growth and unpopularity of further easing. The Japanese curve has shifted higher but has remained relatively stable as the BoJ defends both the front end and 10-year point. A constructive backdrop for risk likely provides some respite on yen strength. This will likely put pressure on the curve to steepen.

UK: Attention has turned to the degree of fiscal stimulus that will be delivered by the government, which will release its Autumn Statement on 23 November. Stronger economic data continues as the initial post-Brexit shock continues to fade. The stronger data has caused the Bank of England to abandon the prospect of another rate cut with higher GDP and consumer price inflation forecasts (the latter closing on 3% during the two-year forecast period). After Prime Minister May's criticism of QE, the higher growth and inflation forecasts cast significant doubt over the extension of the program beyond its scheduled completion in early 2017.

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