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November 2015

FIXED INCOME VIEWPOINTS

SUMMARY:

U.S. Treasury yields climbed after the Federal Open Market Committee issued a more hawkish post-meeting policy statement on 28 October. Seemingly less concerned about international turmoil impairing domestic growth, the FOMC's statement specifically referenced the 15-16 December meeting as a possibility for a rate hike.

In contrast, European Central Bank President Mario Draghi affirmed that more monetary stimulus could be forthcoming at the ECB's 3 December policy meeting given downside risks to growth and inflation. This dovish stance, coupled with aggressive rate cuts by the People's Bank of China, helped risk assets rebound from their third-quarter sell-off. Meanwhile, the Bank of Japan (BoJ) made no changes to its already large stimulus program while advising that it is prepared to undertake additional easing measures, if needed. Japanese government bonds had little reaction to the news, remaining at low yield levels.

Corporate credit sectors rebounded strongly last month with the upturn in investor sentiment. Although profits may have peaked and leverage has risen, valuations for U.S. investment-grade corporate bonds are attractive. Slow growth and ECB stimulus continue to support European high-grade corporates. Defaults are set to rise in the U.S. high yield market, though largely confined to troubled commodity sectors. With lower energy exposures, bank loans and European high yield bonds should face fewer performance headwinds.

Caution is warranted for emerging markets (EM) credit with Fed rate hikes in view, but volatility should create attractive entry points. Valuations for EM local currency bonds are less compelling with the recent increase in Treasury yields, and currencies remain vulnerable ahead of a Fed tightening move. Stronger global growth in 2016 could provide a positive catalyst for beleaguered EM local assets.

SPREAD SECTORS:

U.S. INVESTMENT-GRADE CORPORATES: Late-cycle corporate behavior is offset by steep credit curves and attractive relative value. Moreover, the technical backdrop has become more favorable; the market has grown less enthusiastic about taking down megadeals, and the additional capital that banks must raise to meet total loss-absorbing capacity regulations will be less onerous than previously anticipated. We favor lower-rated, non-commodity industrials, such as airlines, health care, and pharmaceutical names. In financials, senior bank paper and real estate investment trusts are top investment themes.

EURO CORPORATES: The European high-grade market performed well in October as emerging markets assets and commodities prices stabilized. In addition, very dovish ECB communications provided strong hints of additional central bank stimulus at the next policy meeting in December. While ECB action is unlikely to lead to significant spread tightening, the fundamental backdrop of low inflation, high unemployment, and a measured economic recovery is positive for high-quality European bonds. Additionally, a rally in core and peripheral government bonds has improved relative valuations.

U.S. HIGH YIELD: The 2016 default outlook is rising given energy price deterioration over the past year and continued stress in the metals space. We are also expecting a meaningful amount of "fallen angel" supply over the next 12 months as more companies lose their investment-grade credit ratings. Although fundamentals outside of the commodities space are fairly intact, commodity prices continue to be a large driver of the market given the size of the energy complex and its impact on performance of the overall sector. Volatility is still likely given concerns about energy producers, equity market turbulence, and the potential for further downgrades.

EURO HIGH YIELD: October saw the market bounce back vigorously, recovering the spread widening seen in September. European high yield spreads had widened in line with U.S. high yield, but the European market does not face the same negative headwinds that the U.S. market currently does. Over the mid to longer term, performance should be governed by market fundamentals, which are still sound. As such, European high yield still looks oversold versus its U.S. counterpart.

BANK LOANS: Floating rate loans offer a more defensive way to play decent high yield fundamentals, but with lower volatility. Spreads have widened in response to the move in high yield spreads, and there are now a meaningful amount of loans trading below par. Still, the asset class has benefited from materially lower exposure to commodities and CCC rated issues than the U.S. high yield bond market. And loans still provide some measure of protection against rising interest rates.

AGENCY MORTGAGE-BACKED SECURITIES: We maintain a neutral outlook for the sector with spreads at the tighter end of their narrow trading range. Fundamentals remain constructive, duration-hedged carry is attractive, relative liquidity is favorable, and seasonal net supply trends are supportive. Risks remain tied to the potential implications for future tapering of reinvestments by the Fed and headline risk surrounding housing policy.

EM DOLLAR SOVEREIGN: After a strong rally following the September China-driven global growth panic, the sector is broadly at fair value versus U.S. investment-grade and high yield corporates. Market technicals—namely, limited supply, high cash balances, and large repayments—are supportive. Yet some consolidation is likely ahead of Fed rate hikes. An

idiosyncratic event in Brazil remains the greatest risk to the near-term outlook but would likely provide attractive entry points for adding risk exposure.

EM CORPORATES: We maintain a relatively low conviction on the sector as the recent rally appears to be unwarranted given fundamental deterioration in underlying credits, a weak macro backdrop, and low commodity prices. A December Fed rate hike may provide opportunities to reenter positions amid likely dislocations. Illiquidity in EM corporates relative to other fixed income alternatives demands a higher bar on a valuation- or fundamental-centered thesis for adding exposure.

EM LOCAL: Yield spreads versus U.S. Treasuries retraced tighter over the past month, approaching fair value after being toward the top of their four-year range. Rolling underperformance versus global sovereign bonds has stabilized; since the end of September, EM local has held its own versus major developed markets. The interest rate outlook is more neutral following the recent rally, and we have been rotating out of markets with low yields. We remain cautious with EM currency exposures ahead of the December Fed meeting given the potential for U.S. dollar strength and exchange rate volatility.

DEVELOPED SOVEREIGN MARKETS:

U.S.: Domestic data remains mixed, but it appears sufficient to put the FOMC on track for rate liftoff in December. Subdued global growth conditions and a renewed dovish turn by other major central banks continue to exert gravity on U.S. yields, counterbalancing the likely effects from tighter Fed policy. Longer-term yields may remain capped, but we expect the intermediate section of the curve to exhibit weakness as FOMC rate hike probabilities for December now exceed 50%.

EUROZONE: The growth and inflation outlooks are stable, but momentum has waned. The ECB will probably become more accommodative in 2016 amid worries about the impact of the emerging markets slowdown on the eurozone's recovery. We are not expecting rate hikes by the ECB for at least the next three years. Although valuations for German bunds are highly stretched on a long-term, fundamental basis, we expect yields to remain in a tight range over the next 6 to 12 months given quantitative easing (QE) and associated negative net supply.

JAPAN: Core inflation remains weak, dragged lower by energy prices, and third-quarter gross domestic product looks to be only slightly better than disappointing second-quarter growth numbers. There are some signs of domestic recovery, but external factors are a drag on growth. The BoJ has lowered its inflation outlook and pushed back its expected timeline for hitting the 2% inflation target until the second half of fiscal year 2016. Nonetheless, the BoJ left policy unchanged in October and was relatively hawkish, creating uncertainty for further policy action.

UK: Market expectations for the first Bank of England (BoE) interest rate hike had been pushed out as far as the first quarter of 2017. More recently, Fed hawkishness has pulled expectations for a rate hike forward to the third quarter of 2016. The BoE has concerns about weaker global growth weighing on an otherwise firm domestic outlook. Deflationary concerns, with consumer prices falling 0.1% year-over-year in September, and an affirmation by the BoE that it will continue to maintain its QE stock should underpin longer-term gilt prices. However, the front end of the gilt curve remains vulnerable to more hawkish Fed communications.

CANADA: Growth indicators have improved and show a recovery after the technical recession in the first half of 2015. Nonetheless, continued low oil prices pose downside risks to the outlook. While the market remains very expensive on a historic real yield basis, with the Bank of Canada likely to remain on hold for an extended period, there is scope for yields to be more resilient when the Fed begins raising rates. However, the risk of easier fiscal policy from the new Liberal government may weigh on the long end of the curve.

AUSTRALIA: Net exports have continued to rebound, but soft Chinese growth and renewed weakness in commodities pose downside risks. Despite soft inflation, the Reserve Bank appears comfortable with the current degree of monetary stimulus, and currency weakness is helping with the adjustment. Scope exists for further easing should data disappoint. The market is pricing in one more rate cut next year, which seems fair.

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