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April 2016

FIXED INCOME VIEWPOINTS

SUMMARY:

US Treasury yields rose in early March following a strong government employment report, which brought Federal Reserve rate hikes back into focus. However, Treasury yields later retraced most of this move as the Fed's communications turned more dovish, citing concerns about elevated global risks. While nominal Treasuries produced flat returns in March, US Treasury inflation protected securities generated their strongest monthly returns in over a year, benefiting from the rebound in oil prices and a firmer core inflation reading.

The European Central Bank exceeded market expectations with aggressive easing measures that included increasing its monthly asset purchases by €20 billion to €80 billion and, surprisingly, broadening the program to include nonbank investment-grade euro corporate debt. The ECB also cut the key repo rate to 0%, lowering the deposit rate further into negative territory, and launched four new targeted longer-term refinancing operations (TLTROs) with attractive terms. Yields on peripheral eurozone sovereigns compressed versus extremely low-yielding German bunds.

The Bank of Japan made no substantive monetary policy changes at its March meeting. However, the BoJ downgraded its assessment of the economy, suggesting that it could expand its quantitative and qualitative easing program at its April 27-28 meeting—particularly if the yen maintains its strength. Yields on 10-year Japanese government bonds hovered below 0%.

Corporate credit spreads markedly tightened in March as the market priced in fewer Fed rate hikes in 2016, the ECB ramped up its stimulus efforts, oil prices bounced, and global equities recouped losses suffered earlier in the year. Euro corporates are benefiting from strong technical support due to the ECB's impending asset purchase program. Demand for US investment-grade corporates remains strong, with valuations fair versus longer-run averages. In high yield, there are opportunities in high-quality energy and lower-rated non-commodity names.

With the recent risk rally, valuations for dollar-denominated emerging markets sovereigns have become less compelling, and increased supply could restrain further spread tightening. The outlook for EM corporates remains cautious due to poor liquidity and stretched relative valuations. EM local currency bonds offer a still-significant yield advantage over high-quality global sovereigns. However, currencies could be volatile if concerns about Fed tightening and Chinese growth resurface.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Overall relative value is fair versus longer-run averages after the recent rally, which was one of the largest monthly tightening moves since 2011.The strong performance across lower-quality industrials has reduced opportunities relative to other credit sectors. However, US investment-grade corporates continue to offer relative safety and income at a reasonable price.

EURO CORPORATES: The ECB positively surprised the market with the expansion of quantitative easing (QE) to include nonbank high-grade euro corporates and the introduction of four additional targeted longer-term refinancing operations with very easy conditions. In addition, it signalled that further rate cuts would be unlikely—a positive announcement for banks given the current focus on the impact of negative rates on bank earnings. Although spreads have reacted very positively, the prospect of a large, price-insensitive buyer in the form of the ECB leaves room for further modest spread tightening.

US HIGH YIELD: The market has quickly absorbed a vast amount of "fallen angel" paper, with year-to-date totals already near the record high of $150 billion in 2009.[1] The fact that many of these companies have split credit ratings helped, as it resulted in strong demand from both high yield and investment-grade investors looking for paper. A large positive turn in flows and very low dealer inventories also contributed to spread tightening. Although fundamentals outside of the commodities space are fairly intact, commodity prices continue to be a large driver of the market.

EURO HIGH YIELD: Technical conditions in the market remain positive, with strong investor inflows into the asset class and a significant lack of new primary market deals. Year to date, there have been less than €4 billion of deals; on a trailing twelve-month basis, this represents the lowest issuance totals in over two years. The latest stimulus measures from the ECB add to the sector's reasonably supportive long-term fundamentals. The ECB's corporate bond purchases, while not directly affecting euro high yield, should benefit the market as crossover investors will likely buy more BB rated debt. It also improves overall risk appetite, enabling the sluggish primary market to reopen.

BANK LOANS: Spreads have tightened over the past month alongside the rebound in the high yield bond market, but there still remains a material amount of paper trading below par value. Technicals, including collateralized loan obligation performance and issuance, are key market drivers to watch.

[1] Source: J.P. Morgan.

Default rate expectations have increased but should remain modest and lower than US high yield in 2016 given lower commodity exposure and a minimal near-term maturity profile.

AGENCY MORTGAGE-BACKED SECURITIES: MBS traded in a narrow range for most of March and posted small gains versus Treasuries, with coupon income offsetting a modest widening in spreads. Fundamentals remain constructive as prepayment concerns continue to ease despite still lower levels in consumer borrowing rates. A dovish Fed and the start of the new quarter should continue to be supportive of valuations, but some concerns exist relating to seasonal strength in housing and how well supply will be absorbed by investors with yields at low levels.

EM DOLLAR SOVEREIGN: Richer valuations and less supportive technical conditions (e.g., lower cash balances among asset managers, fewer short positions in commodities, and smaller long positions in the US dollar) argue for more caution, particularly as supply is likely to pick up. Fundamentals are widely mixed across the opportunity set. There is potential long-term upside in several markets (Argentina, Brazil, and Mexico) and decent reform prospects in others (Indonesia and Sri Lanka). There are election hurdles in countries such as Peru, Serbia, and the Philippines. Some commodity producers, such as Mongolia and Ghana, are feeling stress, and political uncertainties in Turkey make us cautious there.

EM CORPORATES: Our outlook for the sector remains cautious. Illiquidity in EM corporates relative to other fixed income alternatives puts a higher bar on a valuation or fundamental centered thesis for adding to exposures. In addition, strong absolute performance has further stretched relative value. We maintain a preference for higher-rated credit—specifically, BBB and BB rated bonds.

EM LOCAL: Larger markets continue to drive gains in the sector, notably Brazil and also Colombia. At the headline level, valuations are less attractive, although yields are still somewhat wide to US Treasuries. March was a very strong month for EM currencies, particularly some of those that had been the weakest. Recent price action looks likely to retrace or consolidate after the recent run up. A more volatile trading range appears likely. A more cautious Fed and a possible bottom in commodity prices are clearly supportive for emerging markets. The reemergence of concerns about Fed tightening and Chinese growth remain central risks.

DEVELOPED SOVEREIGN MARKETS:

US: Domestic economic data, risk assets, and inflation expectations continue to improve, but Treasury yields have been unable to rise. A surprisingly dovish Federal Open Market Committee, a declining dollar, and QE from abroad are applying downward pressure to yields, causing Treasury valuations to become increasingly unattractive.

EUROZONE: The ECB remains engaged in an aggressive program of sovereign QE, buying two times net issuance. It does not buy bonds yielding below the deposit rate (now -0.4%). Currently yields are below the deposit rate out to the four-year maturity, so ECB buying should result in flatter yield curves. The QE program will probably be extended beyond its current end date of March 2017. The ECB could cut its deposit rate by another 10 basis points, but it is unlikely to go much further into negative territory. A lack of inflation means that rate hikes will probably not happen for at least three years.

JAPAN: Inflation continues to roll over—a tendency that looks set to continue on the back of the recent appreciation in the Japanese yen and muted wage pressure in the spring wage negotiations with unions. Loss of economic momentum continues, with some divergence across manufacturing and services (the former being weaker than the latter). Growth will likely be supported by additional fiscal initiatives prior to the midyear upper house elections. We expect additional easing by the BoJ through additional reduction of the interest rate paid on commercial banks' deposits at the central bank and likely through expansion of the qualitative easing program (e.g., ETF purchases).

UK: With barely one interest rate rise priced in by 2019, "Brexit" jitters continue to cast a pall over the market and underpin gilt yields near record lows. With consumer confidence soft and the housing market showing signs of cooling—at least at the top end—the Bank of England will continue to be comfortable with a softer British pound. The referendum on 23 June remains the key focus and is dampening consumer and business confidence. Meanwhile, Moody's has flagged downside risk to the UK's sovereign rating should Brexit become a reality.

CANADA: The Bank of Canada left rates on hold in March, and the government's fiscal stimulus will stay the central bank's hand on delivering any further monetary easing. Recent stability in oil prices has made the economic outlook less gloomy, but a period of below-trend growth still appears likely. Canadian government bonds traded in line with US Treasuries over the past month but are likely to marginally outperform Treasuries in a rising US yield environment.

AUSTRALIA: Recent domestic data has been more encouraging. But with inflation close to the lower end of its target band, the Reserve Bank of Australia has indicated scope for further easing should inflation remain low— the first-quarter CPI print in April will be critical to the RBA's decision. The Australian dollar has rallied on improved risk sentiment and a better tone for commodities. If this extends further, the RBA is more likely to contemplate easing again. The market appears appropriately priced for now, with some probability of easing over the next year.

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