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FIXED INCOME VIEWPOINTS

SUMMARY:

Treasury yields edged higher ahead of the Federal Open Market Committee's (FOMC's) September 16-17 policy meeting, as investors weighed whether the Fed would raise rates for the first time since 2006 with U.S. labor market conditions continuing to tighten. But Treasury yields tumbled and risk assets sold off after the Fed announced it would continue to hold rates near 0%, expressing concerns about global economic developments and tighter financial conditions.

German bund yields declined over the past month as safe-haven government debt rallied amid heightened risk aversion and renewed concerns about a slowdown in global growth. Subdued eurozone inflation data and indications that the currency bloc's growth momentum is ebbing also fueled demand for high-quality European government obligations. In Japan, 10-year government bond yields dipped to their lowest level in five months as core inflation in Japan fell back into negative territory. Growing expectations that the Bank of Japan (BoJ) will need to soon increase its stimulus efforts overshadowed a downgrade of Japan's sovereign credit rating by Standard & Poor's, citing weak economic growth and significant fiscal challenges.

Credit spreads in the U.S. investment-grade corporate market continued to widen as demand softened following the Fed's surprisingly dovish announcement, creating opportunities in financials and lower-rated, non-commodity industrials. High yield performance remained weak as investors broadly shed risk, but fundamentals remain firm outside of the commodity production industries. European corporates sold off across the quality spectrum but remain supported by highly accommodative monetary policy and improving domestic demand.

Valuations for dollar-denominated emerging markets (EM) bonds are increasingly attractive, but exogenous pressures, country-specific challenges, and constrained liquidity warrant caution for now. EM local currency bond valuations are compelling, with a significant yield advantage versus developed market sovereigns. However, currencies are expected to continue to be volatile until Fed policy uncertainty abates or global growth accelerates.

SPREAD SECTORS:

U.S. INVESTMENT-GRADE CORPORATES: With recent spread widening, U.S. high-grade corporates offer compelling value relative to other credit sectors. Financials offer decent spreads with less volatility, and BBB rated industrials—such as airlines and health care names—look attractive as spreads have decompressed across ratings tiers. We remain wary of energy- and commodity-related names, though, as there is potential for further downside risk.

EURO CORPORATES: The European market sold off due to a combination of generic factors affecting spread products. These included ongoing weakness in commodities prices and disappointment at Fed inaction, as well as numerous idiosyncratic stories. Despite recent turbulence, the underlying story for the sector is a euro area economy that is gaining momentum alongside supportive European Central Bank (ECB) monetary policy. Investment-grade European corporates now offer good value relative to peripheral eurozone sovereigns and some high-grade U.S. corporates.

U.S. HIGH YIELD: Overall valuations and market yields are getting more interesting but are heavily skewed by the energy and metals/mining industries. However, investor outflows from the asset class in an illiquid market have also contributed to recent broader price weakness. The market is now pricing in meaningful default activity in 2016, as well as the potential for several "fallen angels" to be downgraded from the investment-grade space. Fundamentals remain intact outside of the commodities space, but volatility is still likely given the impact from energy prices, equity market volatility, and thin liquidity. We have also entered a historically more volatile period of the year.

EURO HIGH YIELD: September saw the weakest performance for the sector since the peak of the eurozone debt crisis in late 2011. Unlike that period, performance was driven by events external to the market, as fundamentals have not changed. Europe remains in the early phase of the economic cycle, the ECB remains very supportive, second-quarter results for European high yield issuers were generally good, defaults are expected to remain low, and market technicals remain sound. As such, European high yield appears oversold compared with U.S. high yield.

BANK LOANS: Spreads have widened in response to the move in high yield bond spreads, and there are now a meaningful amount of loans trading below par value. The sector has benefited from a materially lower exposure to commodities and CCC rated credits than U.S. high yield, and loans still provide some measure of protection against rising interest rates.

AGENCY MORTGAGE-BACKED SECURITIES (MBS): Valuations look fair versus the Treasury curve, fundamentals are constructive, and technicals in the sector remain mixed. In the near term, mortgage investors will remain focused on the mixed messaging from the Fed surrounding the timing of rate "liftoff" and the potential implications for future tapering of its MBS reinvestments.

EM DOLLAR SOVEREIGN: China growth concerns will likely weigh on commodities exporters, capping the upside for the sector until fundamentals more convincingly turn; EM currency adjustments remain an important catalyst for improvements in external accounts. Technicals—namely, low supply and very negative investor sentiment—are favorable for the sector, as are valuations. In our view, a Fed rate hike has become less of a risk for emerging markets. On balance, it would actually be confirmation that the Fed is less concerned about the situation in China. However, that may come only after more fiscal stimulus from the Chinese government.

EM CORPORATES: We remain cautious on the sector, as the recent sell-off was warranted by fundamental deterioration in underlying credits, a challenging macro backdrop, and volatile commodity prices. But following recent weakness, we are looking to selectively add risk after reducing it a few months ago. Investment-grade quasi-sovereigns are an area of interest, having cheapened versus investment-grade EM corporates and offering superior liquidity.

EM LOCAL: Spreads versus similar-maturity U.S. Treasuries moved higher over the past month and are now near the top of their four-year range. Although the widening was modest, volatility was elevated. EM local has notably underperformed developed market sovereigns on a rolling basis; valuations are more neutral versus EM dollar sovereigns and U.S. high yield. Currencies remain weak and a source of volatility. We are waiting to get past a Fed rate hike or see stronger global growth to galvanize valuations. With regard to rates, we favor countries that have greater capacity to ease monetary policy in response to external and inflationary pressures; with currencies, we remain focused on countries with stronger growth and balance sheets.

DEVELOPED SOVEREIGN MARKETS:

U.S.: The FOMC signaled with its September decision to further delay a rate hike that global financial conditions are a concern, and these have only worsened since. U.S. data is now showing some minor signs of weakness as well. With risk aversion running high, the Treasury rally may be somewhat overextended. But in the absence of a positive catalyst to relax financial conditions, yields are expected to stay low in the near term.

EUROZONE: The market is now expecting an increase in the size or length of its quantitative easing (QE) program before year-end to combat low inflation, but the bar for additional easing is high. Policy is already highly stimulative, and hawks on the ECB governing council will be reluctant to respond more aggressively unless there are more tangible signs of weakness. In any event, the existing QE program and associated negative net supply should support low government bond yields into early 2016.

JAPAN: Recent data has generally been disappointing, and ongoing Chinese concerns will challenge the BoJ's more optimistic assumptions about growth and inflation. Further supportive action—both fiscal and monetary—are expected. The BoJ could ease further in late October or early 2016. Already owning a large share of Japanese government bonds, the BoJ may target other assets, such as corporate bonds or ETFs.

UK: Recent economic data have been softer; with the exception of construction, purchasing manager's index data have weakened. Although inflation remains subdued, wages have been rising, particularly for the private sector. The market appears to be underpricing a Bank of England (BoE) rate hike next year, with the first hike not priced in until the fourth quarter and only 25 bps of tightening expected in 2016. Although it is unlikely that the BoE will move ahead of the Fed, a U.S. rate hike is not a precondition for the BoE to move. Still, the pace of rate hikes will likely be slow and gradual.

CANADA: Growth indicators have improved and show a recovery after the technical recession experienced in the first half of 2015. Nonetheless, renewed oil price declines pose downside risks to the outlook. The Bank of Canada is likely to remain on hold for an extended period, but we do not see scope for further easing at this point.

AUSTRALIA: The growth outlook remains sober given little improvement in non-mining investment; this should keep the monetary stance stimulative. The Reserve Bank appears comfortable with the current degree of monetary stimulus, and currency weakness is helping with the adjustment. Net exports appear to be picking up despite commodity price pressures, and the pace of job growth is healthy. However, soft Chinese growth and renewed weakness in commodities pose downside risks.

JAPAN: Recent economic data has been disappointing, and the slowdown in China could further weigh on growth. Second-quarter economic growth was weaker than expected, and the bounceback in the current quarter appears muted. There is potential for additional fiscal or monetary easing, and the Bank of Japan may be forced to act more quickly if growth and inflation continue to undershoot.

UK: A conservative majority in the government allows tighter fiscal policy to be enacted over the next five years, which implies a shallower tightening of monetary policy. Economic data remains decent but has softened recently. Inflation pressures are muted due to a strong pound and lower oil prices. But with wages rising, the Bank of England is expected to raise rates in 2016 while emphasizing a slow and shallow tightening cycle.

CANADA: A negative second-quarter GDP reading marks a "technical" recession for Canada, with weakness concentrated in the commodities extraction sector. The Bank of Canada is likely to remain on hold for an extended period, looking for a delayed pick-up in growth in the second half of 2015. Renewed oil price declines pose downside risks to the outlook.

AUSTRALIA: The Reserve Bank appears comfortable with the current degree of monetary stimulus, with currency weakness also helping with the adjustment. However, another rate cut is possible given external threats to growth from China and renewed weakness in commodities.

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