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FIXED INCOME VIEWPOINTS

SUMMARY:

Reversing a portion of its longer-term trend, the Treasury yield curve has recently steepened as the Fed held off on raising rates, the Bank of Japan (BoJ) shifted its monetary policy framework to manipulate a steeper domestic curve, and European investors have begun to consider what a possible tapering of European Central Bank (ECB) asset purchases may look like. Recent U.S. economic data appears sufficient for a Fed rate hike in December, but an extended pause will likely follow.

The ECB took no action to extend its quantitative easing (QE) program, raising questions about its duration. Officials are likely to announce an extension by year-end, though this could be accompanied by a reduction in the size of monthly bond purchases. The ECB could also make modest adjustments to its rules for QE, which could impact eurozone countries differently depending on the details.

Facing domestic criticism of its negative interest rate policy, the BoJ altered its policy to begin targeting a 0% 10-year Japanese government bond yield rather than a set amount of asset purchases. Although broader impacts are uncertain, this move has potential to slow increases in global yields and dampen volatility in global curves.

Fundamentals are deteriorating in investment-grade corporate markets, particularly in the U.S., although technicals remain firm. U.S. high yield valuations have richened amid unrelenting demand for income, while a recent sell-off has cheapened European high yield valuations somewhat. Bank loans remain attractive for risk-adjusted yield, with the rise in LIBOR creating potential for near-term coupon increases. Valuations for agency mortgage-backed securities (MBS) have become less appealing, with performance dependent on continued low market volatility.

Technical conditions remain supportive of emerging markets (EM) credit as fundamentals improve in some major markets. However, future returns are likely to be coupon-driven given the extent of the recent rally. Potential near-term volatility could create opportunities in EM local markets with attractive real yields and declining inflation pressures. Key risks for the sector include a sharp move higher in global rates or further dollar strength as a U.S. rate hike approaches.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Credit spreads have held relatively steady as heavy supply continues to be met with strong inflows into the sector. However, credit fundamentals continue to steadily deteriorate, with leverage continuing to tick up for non-financial companies. The reported OPEC output cut decision has reduced downside risk, but credit quality and valuation concerns remain for many issuers. Limited differentiation in spreads at the issuer level limits relative value opportunities, although certain midstream energy names and real estate investment trusts offer value.

EURO CORPORATES: The ECB's bond buying has led to spread tightening and growing divergence between valuations and fundamentals. Fear that QE will not be expanded or extended beyond March 2017 has caused some weakness in the market, providing an indication of what may happen when asset purchases are eventually tapered. The closely-watched September FOMC and BoJ meetings proved to be innocuous, but other risks remain. These include the December Italian constitutional referendum, Spanish and U.S. elections, the potential for a "hard" Brexit, and negative newsflow related to the health of the European banking system.

US HIGH YIELD: Commodity prices remain a key driver of the sector. As such, the OPEC agreement has added to positive sentiment, although it will be important to watch whether the cartel follows through on the supply agreement. Energy and metals issuers continue to dominate default activity, but the increase in oil prices may have extended the life of some troubled companies. Inflows into the asset class should keep capital markets open for high yield issuers, allowing them to extend maturities and lower the cost of debt. Valuations have notably tightened since the end of 2015 and appear to be inside of fair value with respect to a default rate of about 3.5%.

EURO HIGH YIELD: Corporate bond purchases by the ECB and Bank of England (BoE) continue to indirectly support the European high yield market. September was one of the busiest months for new issues in the European market's history, and spreads widened as a result. The recent sell-off in European high yield while the U.S. market continued to rally sets the stage for potential outperformance by the European market in the fourth quarter. With the European new issue market ramping up, we are looking for opportunities to take advantage of more complex credit stories and capital structures that offer more attractive valuations.

BANK LOANS: The loan default rate should remain meaningfully lower than the high yield bond market due to less commodity exposure. 3-month USD LIBOR now exceeds 0.75% for the first time since 2009. With this key rate nearing the 100 basis point LIBOR floors of most loans, this paves the way for the floating rate coupons on loans to reset higher, increasing current income for investors and likely attracting

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additional flows into the asset class. In an environment of low rates and elevated macro uncertainty, loans screen as a compelling option for investors looking to add risk-adjusted yield in a low-duration asset.

AGENCY MORTGAGE-BACKED SECURITIES: Valuations are less appealing with volatility-adjusted spreads in negative territory, but technical trends have remained supportive. Any repricing of the current low levels of term premium in the back end of the curve should temper foreign and domestic bank demand for MBS. Performance is increasingly dependent on market volatility remaining low to support current spread levels.

EM DOLLAR SOVEREIGNS: Absolute returns for the sector are likely to exceed those of developed government bond markets over the next year, but a surge in supply may limit near-term gains. Fundamentals are stabilizing or improving in several key markets over the next year, but a surge in supply may limit near-term gains. Continued fiscal progress in Brazil will support the improved tone towards emerging markets more broadly. A building property bubble in China is a longer-term risk. We continue to have higher conviction on Brazil—and Latin America more generally—than on emerging Europe, where valuations have been stretched by the ECB's accommodative policies.

EM CORPORATES: The current rally is the sector's largest and second longest in the post-global financial crisis period. While yields remain attractive versus negative-yielding government bonds in many countries, valuations are stretched when factoring in the sector's lower liquidity and weaker institutional sponsorship. Returns will likely be coupon-driven, with modest potential for additional spread tightening.

EM LOCAL: Potential near-term volatility around the U.S. election and December Fed rate hike could prove to be an opportunity. A mild upside move in core yields is manageable, but a notably higher or steeper term structure in the U.S., Europe, and Japan would pressure EM local rates higher. External rebalancing and higher real yields versus developed markets support EM local markets on a medium-term basis. Divergence of inflation in EM countries supports a few markets—notably Brazil, Russia, Colombia, and Hungary—into year-end. The growth differential between emerging and developed markets also appears to be widening again, providing support for EM currencies.

DEVELOPED SOVEREIGN MARKETS:

US: Treasury yields may move modestly higher as markets contemplate the next Fed rate hike, led by the front end. Global central bank actions and communications may add some volatility to rates, but accumulated accommodation should keep term premiums low and Treasury yields ultimately contained. Economic data appears to be just strong enough to justify a Federal Open Market Committee rate hike in December. However, the Fed will likely go an extended pause after that move.

EUROZONE: Although debate among the governing council will be fierce, the ECB will likely extend its QE program beyond March 2017. Given the challenges of finding enough German bunds to buy, the ECB may also announce a reduction in the amount of monthly bond purchases. Officials could also implicitly relax the capital key (rules that force the ECB to buy debt in proportion to the size of each eurozone economy) or allow some buying of bonds yielding less than the deposit rate. Removal of the deposit rate floor would be positive for German bunds, while an alteration of capital key constraints would benefit peripheral countries at the expense of Germany.

JAPAN: Economic growth data appears to be improving slightly, lifted by global developments. However, a stronger yen continues to be a domestic headwind that is weighing on corporate profits and investments. The inflation outlook remains subdued due to the strong yen. The labor market is tight, but this is only slowly transmitting to wage pressures. The BoJ will likely remain on hold at its upcoming meeting. However, a 10 basis point cut in the deposit rate is possible, as the central bank likes to surprise the markets.

UK: Attention is turning to the UK's fiscal position and the degree of fiscal stimulus that will accompany the growing political rhetoric. Stronger economic data continues as the initial post-Brexit shock continues to fade. The stronger data is casting doubt on both the justification for and the degree of monetary easing already delivered by the BoE—as well as the expectations for more. Prime Minister May has been overtly critical of BoE policy and the negative consequences of QE. This is adding to near-term uncertainty in a sovereign market that offers an overall lack of empirical value, with poor real yields.

CANADA: Growth is rebounding from the Alberta wildfire disruptions in the second quarter. But the trend remains subdued, which is expected to keep the Bank of Canada on hold for an extended period.

Canadian assets continue to be sensitive to oil price developments. The recent gains in oil prices remove some of the tail risks to the economy. Canadian bonds yields are very rich by any historical measure.

But in an external environment of similarly low core yields, there are few triggers to reverse this dynamic.

AUSTRALIA: No further near-term action from the Reserve Bank of Australia is expected. While officials have retained a mild easing bias, we do not foresee any more rate cuts this cycle. The third-quarter inflation print at the end of October will be important for determining the direction of policy. A material undershoot could result in the delivery of an additional (and likely final) rate cut. Chinese economic developments will remain important to the Australian growth outlook. The outright level of Australian yields continues to look attractive in a global context.

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