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FIXED INCOME SECTOR PULSE

MARCH 2015

SUMMARY:

US Treasury yields have climbed from their 2015 lows as continued strong job growth overshadows otherwise lackluster domestic data. Yields should be headed higher with rate hikes looming later this year, but international demand amid a scarcity of global yield and potential weakness in risk assets are restraining factors.

The European Central Bank's ('ECB')long-awaited asset purchase programme has driven eurozone yields to unprecedented low levels. Although demand for bonds will far outstrip supply as quantitative easing (QE) commences, risk for investors is high—particularly if the ECB succeeds in stimulating growth and inflation. Japanese government yields have stabilised following a spate of unusual volatility. The Bank of Japan's ('BoJ') large-scale asset purchases support low yields despite long-term fiscal concerns. With inflation undershooting the BoJ's target by a wide margin, expanded stimulus is possible later this year.

Within credit markets, security selection remains a central theme as top-down sector opportunities remain limited. Fundamentals are on a slow downtrend for investment-grade corporates (ex financials), but investor demand for high-quality credit shows no sign of abating. High yield bonds have rallied as oil prices steadied somewhat, but valuations remain attractive given a muted default outlook for 2015.

Emerging markets (EM) credit offers compelling valuations, but idiosyncratic risks abound. EM local rates remain attractive relative to developed market sovereigns, but currencies will remain a headwind until dollar strength subsides.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: A rebound in higher-beta commodity-related sectors, combined with a solid technical backdrop, has supported spreads over the past month. T. Rowe Price credit analysts continue to find opportunity in subordinated European bank paper, lower-beta industrials, and select energy-related credits.

EUROPEAN CORPORATES: Credit spreads tightened further as Athens and European officials negotiated an extension of Greece's bailout, Ukraine and Russia agreed to a truce, and the market interpreted Fed Chair Yellen's testimony to Congress as dovish. Corporates continued to anticipate the positive effect of ECB QE which commences in March and provides indirect support to the corporate sector.

US HIGH YIELD: Overall valuations and market yields are still interesting but not as attractive as in early January. Volatility is still likely given the impact of energy prices. Spread levels are still implying a slightly higher default rate than we are currently expecting. We continue to see a relatively muted default outlook through 2015. If oil prices remain low for a more extended period of time, we believe there will be a material impact on the 2016 default rate.

EURO HIGH YIELD: Flows into the asset class have outstripped the record issuance seen year-to-date, leaving high cash balances in the market despite spread tightening. February was one of—if not the—strongest months for market inflows in the past five years. This was reflected in the best year-to-date returns for the market since 2012, with February the strongest month since October 2013. At a macro level, low default rates and indirectly supportive QE bolster the asset class.

BANK LOANS: Loans still appear to offer a more defensive way to play solid high yield fundamentals with lower volatility, although valuations are not as cheap as in early January. Loans have benefited from a materially lower exposure to commodities sectors than high yield bonds. There are still discounts to be found, as roughly 60% of the market still trades below par. But those discounts are starting to disappear as a lean new issue calendar and significant paydowns support the secondary market.

AGENCY MBS: Performance remains largely directional with the moves in US interest rates. The sector continues to underperform into a flatter curve and lower yields, while outperforming into a modestly steeper curve and higher rates. The retracement higher in yields over the last five weeks has been fundamentally supportive for the sector, easing concerns that an extended refinance wave and elevated prepayments would hurt performance at higher dollar prices.

EM DOLLAR SOVEREIGN: Emerging sovereigns are attractive versus US credit in both the high yield and investment-grade spaces but are increasingly idiosyncratic (Russia, Brazil, Venezuela, and oil-related names in general). Commodity price and currency moves will likely claim victims, and Fed liftoff may challenge less-liquid markets.

EM CORPORATES: Valuations are attractive relative to US credit across the rating spectrum. Relative to EM sovereigns, valuations are more neutral and nuanced. Commodity price weakness has a mixed impact on issuers but is generally a headwind to spread compression. Our enthusiasm is tempered by poor liquidity, particularly in the high yield area of the market.

EM LOCAL: Local bonds valuations look relatively cheap to developed market sovereigns (though less so versus US Treasuries) but are looking fairly expensive versus dollar-denominated EM sovereigns. Flows have improved modestly but remain low. Inflows are not expected to pick up notably until the strong US dollar bid steadies. Valuations are globally attractive but are also increasingly varied. Growth rates remain subdued in emerging markets. Until they pick up, EM currencies will remain under a cloud.

DEVELOPED SOVEREIGN MARKETS:

US: Stronger inflation expectations, firmer risk markets, better data in Europe, and good US job growth have overwhelmed otherwise lackluster domestic data and led yields higher. Stronger labour market readings and stable inflation expectations have let the Fed win back the narrative and bring the rate hike debate back into focus. The likely depth of any sell-off, however, is restrained by continued pressure on term premiums from soft global economic conditions, the resulting scarcity of global yield, and US economic data (ex labour markets) that has recently downshifted.

EUROZONE: The ECB has launched a more aggressive programme of sovereign QE, both in size and scope (i.e., including longer-dated bonds). The growth and inflation outlooks are expected to improve later this year, but monetary policy is likely to remain accommodative for the foreseeable future. Sovereign bond purchases should constrain yields at low levels. Yet valuations are extremely expensive.

JAPAN: Core inflation continues to undershoot, dragged lower by energy prices. The BoJ has downwardly revised its near-term inflation outlook but is still optimistic of achieving its target within two years. Fourth-quarter growth was a little weaker than expected after a very weak third quarter.

UK: The domestic economy has remained relatively robust, and there are signs of an initial pickup in wages. The market is still pricing in the first rate hike from the BoE in 2016, though this has been brought forward. Event risk is high with the general election in May. The outcome, and resultant impact on fiscal and monetary policy, is highly uncertain.

CANADA: Although current growth has been reasonable and inflation close to target, the Bank of Canada (BoC) has shown itself to be more concerned about downside growth risks following the sharp decline in oil prices. The BoC delivered a surprise rate cut in January and looks likely to maintain a dovish bias. Although the market is expensive, an easing bias could keep the market better supported even in the face of rising US yields.

AUSTRALIA: The Reserve Bank of Australia (RBA) has also opportunistically cut rates, taking advantage of the benign inflation environment and trend of easing monetary policy globally. Growth risks are to the downside given an ongoing decline in commodity prices and terms of trade. A further rate cut is possible, and the RBA is likely to remain accommodative for a considerable period.

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