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July 2015

FIXED INCOME MARKETS UPDATE

SUMMARY:

Treasuries were volatile, as stronger U.S. economic data, a seemingly imminent Fed rate hike, and weakness in German bunds prompted a sharp selloff in rates in early June. More recently, concerns about a Greek exit from the euro, a drop in oil prices, and a dramatic correction in Chinese stocks stimulated demand for Treasuries, driving yields lower.

Eurozone sovereign yields spiked after European Central Bank President Mario Draghi warned investors to "get used to periods of higher volatility." An impasse in Greek debt negotiations subsequently benefited safe-haven German bunds while suppressing demand for peripheral sovereigns. Japanese government bond yields remained relatively stable at low levels as global investors turned to Asian fixed income markets for a refuge from interest rate volatility.

Heavy supply, driven by a boom in mergers and acquisitions (M&A), has pressured U.S investment-grade corporate spreads wider and credit curves steeper. Fundamentals for U.S. high yield issuers are solid away from commodities producers, and strategic M&A has generally been positive for the below investment-grade sector. Concerns about Greece weighed on European corporates.

Emerging markets (EM) credit performance has been resilient in the face of numerous macro headwinds; Fed-induced weakness and liquidity challenges could lead to better entry points later this year. EM local currency bonds compare favorably with developed market sovereigns from a rates perspective, and certain currencies look attractive after recent weakness. But dollar strength remains a risk ahead of Fed tightening.

SPREAD SECTORS:

U.S. INVESTMENT-GRADE CORPORATES: While non-financial credit fundamentals may have peaked for the cycle, improved valuations and steeper credit curves remain supportive of demand. Following recent weakness, U.S. investment-grade corporates offer more compelling value relative to other credit sectors than they have for some time.

EURO CORPORATES: Spreads widened dramatically on expectation of a Greek default and the possibility of Greece leaving the euro. Away from these headlines, the growth outlook in Europe has improved, benefiting corporate fundamentals.

U.S. HIGH YIELD: The main driver of the market continues to be commodity prices given the size of the energy sector and its impact on the market. However, meaningful ETF outflows were an additional factor over the past month. Credit spread levels are still implying a higher default rate than we are currently expecting.

EURO HIGH YIELD: Market concerns and volatility triggered by Greece increased investor caution in the second half of June. Lack of supply in the primary market pipeline was matched with market outflows beginning around mid-month. Through not significant, industry outflows were material and suggestive of profit-taking. However, year-to-date inflows to the market remain at record levels. Away from Greece, fundamentals remain good to strong.

BANK LOANS: The sector continues to benefit from materially lower exposure to commodities than the U.S. high yield bond market. The fundamental picture remains intact, with low forward default expectations and a minimal near-term maturity profile. Loans continue to provide some measure of protection against rising interest rates, and the percentage of loans trading at a premium has recently declined.

AGENCY MBS: We maintain a neutral outlook for the sector as positives from expectations for Fed reinvestments to continue into late 2016 and lower refinance activity compete against less supportive seasonal trends, extending durations leading to a weaker carry profile, and elevated interest rate volatility.

EM DOLLAR SOVEREIGN: Sovereigns are relatively rich versus U.S. corporate assets in both the investment-grade and high yield spaces. The sector is likely to see at least temporary weakness when the Fed decides to raise rates, which should create opportunities. Within the sector, we continue to look to upgrade liquidity.

EM CORPORATES: The EM corporate sector has performed well year-to-date versus EM dollar sovereigns and U.S. high yield corporates. Fed rates hikes will challenge the sector amid liquidity concerns, which leaves us cautious while also anticipating opportunities to add to the sector during periods of weakness. We continue to prefer higher-quality credits over lower-rated names.

EM LOCAL: The absolute level of yields is attractive, and valuations remain positive relative to global developed market sovereign debt. Valuations are stable versus EM dollar sovereigns, but not particularly compelling. Overall growth rates remain subdued at the headline level across developing markets. EM currencies will continue to be challenged until growth picks up and ahead of a Fed hiking cycle.

DEVELOPED SOVEREIGN MARKETS:

U.S.: Once the situation in Greece has greater clarity, improving economic data should keep yields moving higher near term. The curve should also stay in steepening mode until the Federal Open Market Committee signals liftoff, which is unlikely to occur this month, but may happen this quarter.

EUROZONE: The European Central Bank remains committed to an aggressive program of sovereign quantitative easing (QE), buying two times expected net issuance in 2015-2016 across the curve. The growth and inflation outlooks are improving, but monetary policy will remain accommodative for the foreseeable future. QE is expected to end in late 2016, but no rate hikes are likely until at least mid-2018.

JAPAN: First-quarter growth was disappointing, but there are signs of recovery, with higher wages feeding through into consumption and the business outlook improving. The Bank of Japan appears to be on hold, and any additional easing will likely be symbolic. The government has released a new medium-term fiscal plan to balance the primary deficit by 2020. The optimistic plan focuses on growth rather than consolidation.

UK: A stable government with a tight fiscal mandate is now in place. After a weaker-than-expected first quarter, the economy is expected to perform relatively well this year. With the Bank of England implying not enough was priced into the interest rate curve in terms of rate hikes, the timing of the first rate hike will come back into focus. And with a fiscally conservative government in place, the current pricing of early next year might prove accurate.

CANADA: Second-quarter growth has gotten off to a weak start and looks unlikely to meet the Bank of Canada's (BOC's) expectation of a decent rebound from the first-quarter contraction. The prospects of another rate cut have risen. The market remains very expensive on a historic real yield basis, but with the BOC likely to remain accommodative, there is scope for yields to be more resilient when the Fed begins raising rates.

AUSTRALIA: The growth outlook remains sober given little improvement in non-mining investment, China growth concerns, and the decline in commodity prices; this should keep the monetary stance stimulative. Reflationary efforts from China and stabilization in commodity prices could be supportive for growth prospects.

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