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August 2015

FIXED INCOME MARKETS COMMENTARY

SUMMARY:

The U.S. Treasury yield curve substantially flattened over the past month. Longer-term yields fell in response to renewed commodity price weakness, dollar strength, and concerns about global growth. However, short-term yields rose slightly as the Fed appeared to lower the bar for a rate hike, stating in late July that only "some further improvement in the labor market" is needed to justify liftoff.

In Europe, peripheral sovereigns rallied after a bailout agreement between Greece and its international creditors alleviated worries of a near-term Greek exit from the eurozone. German bund yields declined with commodity prices but remained well above their April lows. Japanese government bond yields remained relatively stable at low levels as the Bank of Japan (BOJ) remained committed to open-ended asset purchases until its 2% inflation target is reached.

U.S. investment-grade corporate spreads climbed to their widest level in nearly three years amid heavy new issuance driven by takeover activity. The downdraft in commodity prices and industry outflows pressured U.S. high yield spreads wider. However, European corporate spreads tightened as the Greek debt agreement bolstered risk appetite.

Dollar-denominated emerging markets (EM) credit saw spreads widen in response to the commodity price drop, idiosyncratic events in countries such as Brazil, and liquidity concerns. Although yields are compelling in certain countries, a rising dollar has continued to weigh on performance of EM government bonds issued in local currencies.

SPREAD SECTORS:

U.S. INVESTMENT-GRADE CORPORATES: Late-cycle corporate behavior is offset by attractive value relative to other credit sectors and steep credit curves following recent weakness stemming from heavy supply and tumbling commodity prices.

EURO CORPORATES: The European economic backdrop remains sanguine, reflected in second-quarter earnings which have shown continued recovery. Valuations remain significantly wider than the tights seen before the German bund sell-off in April, and euro corporates have lagged the post-Greece rally in peripheral sovereigns. However, recent outperformance versus U.S. corporates could constrain further spread tightening.

U.S. HIGH YIELD: Overall valuations and market yields are getting more interesting but are skewed to a degree by the energy and metals and mining industries. Volatility is still likely given the energy sector's impact, and we are moving into a seasonally more volatile period of the year. Spread levels are still implying a higher default rate than we are currently expecting.

EURO HIGH YIELD: The European market looks less attractive versus U.S. high yield than a month ago due to the latter's underperformance. Opportunities remain in individual names, but with the euro high yield primary market now shut for summer, accessing bonds in size will be more challenging.

BANK LOANS: Loan spreads have been pulled a bit wider given the move in U.S. high yield bond spreads. However, the asset class has benefited from a materially lower exposure to commodities, and it still provides some measure of protection against rising interest rates.

AGENCY MBS: The recent cheapening in the sector has left valuations more attractive relative to Treasuries and near levels where mortgages historically traded without support from the Federal Reserve. A pickup in seasonal supply and views on the future pace of Fed tightening will remain a focus for investors.

EM DOLLAR SOVEREIGN: Sovereigns are relatively rich versus U.S. investment-grade assets and higher-quality high yield bonds. The sector is likely to see at least temporary weakness when Fed liftoff occurs. However, this should generate an opportunity to reinvest at better valuations, as we see momentum in some markets for positive structural reforms.

EM CORPORATES: Although performance has weakened recently, EM corporates have outperformed dollar sovereigns and U.S. high yield corporates year-to-date. We are cautious on the sector in the near term, as the recent sell-off is warranted by fundamental deterioration in underlying credits, a sluggish macro backdrop, and weakness in commodity prices. In addition, Fed liftoff will likely create headwinds due to liquidity concerns.

EM LOCAL: We remain positive on the sector relative to global developed market debt. But overall growth rates remain subdued in developing markets at the headline level. Until the Fed hiking cycle commences, EM currencies will remain challenged.

DEVELOPED SOVEREIGN MARKETS:

U.S.: The Fed has lowered the bar for liftoff this year, and current market probabilities suggest that a September rate hike is about a 50% chance. U.S. data has been just good enough to justify a rate hike even as commodity prices collapsed and global growth remains weak. While the long end of the curve is being led lower by commodities, we expect yields in general to move higher as the Fed commences tightening.

EUROZONE: The eurozone growth and inflation outlook are improving. It is uncertain how Greece will affect the eurozone recovery in the second half of the year. Although the direct linkages are small, there could still be some impact. Monetary policy will remain accommodative for the foreseeable future. Quantitative easing is expected to end in late 2016, but no rate hikes are likely before mid-2018.

JAPAN: Core inflation continues to undershoot, dragged lower by energy prices. Second-quarter growth remained disappointing, but there are signs of recovery, with higher wages feeding through into consumption and the business outlook improving. The BOJ appears to be on hold for now with additional stimulus.

UK: A start to the hiking cycle in the first quarter of 2016 now seems likely. The Bank of England (BOE) has been prudently laying out expectations for a gradual and shallow hiking cycle of perhaps 150 basis points. As wages start to rise, hawkish dissenters in the BOE are growing although inflation pressures are muted given a strong British pound and lower oil prices.

CANADA: Second-quarter growth may well be negative, suggesting a technical recession and disappointing the Bank of Canada's (BOC's) expectation of a rebound. Having cut rates further in July, the BOC is likely to remain on hold for an extended period, looking for a delayed pickup in growth in the second half of 2015. There is some political uncertainty risk approaching the October federal election.

AUSTRALIA: The Reserve Bank of Australia appears comfortable with the current degree of monetary stimulus, with currency weakness also helping with the adjustment. However, soft Chinese growth and renewed weakness in commodities pose downside risks to the economic outlook.

IMPORTANT INFORMATION

Unless indicated otherwise the source of all market data is Thomson Datastream.

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