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June 2015

FIXED INCOME SECTOR PULSE

SUMMARY:

US Treasury yields have climbed to their highest level of the year, driven by turbulence in European rates, a resumption of strong US employment growth following a March lull, and record corporate bond supply. The Fed maintains its sights on 2015 rate liftoff, with subsequent rate hikes to be gradual and wholly data dependent.

Eurozone sovereigns have been volatile as a better growth and inflation outlook vies with uncertainty around debt negotiations with Greece. The sell-off in German bunds is looking overextended in the near term. But longer term, rates in core European markets remain unjustifiably low. Japanese government bonds have enjoyed relative stability compared with US and European counterparts. The Bank of Japan (BOJ) may increase stimulus efforts, but a near-term change in policy has become less likely given some recently encouraging economic data and concerns about an overly weak yen.

Heavy supply continues to dominate the US investment-grade corporate market, helping improve valuations. Strengthening fundamentals and solid technicals are supportive of European corporates, though valuations are uninspiring. In high yield, carefully selected energy names provide opportunities.

Following a strong rally, emerging markets (EM) credit offers less valuation cushion should Fed tightening or country-specific events spur risk aversion. Select EM local currency bonds look attractive versus developed market sovereign debt following a backup in rates, but foreign exchange risk remains high ahead of Fed tightening.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Overall spreads have widened from their cycle tights due to a combination of idiosyncratic events and Treasury yield curve steepening. Heavy supply has dominated the market, pushing spreads wider, as merger and acquisition activity continues to be brisk. Our analysts continue to find opportunity in select financials and lower-beta industrial sectors, such as airlines and healthcare.

EURO CORPORATES: The market continues to demonstrate resilience in the face of significant volatility in sovereign markets. The medium-term outlook is for range-bound trading. European Central Bank (ECB) quantitative easing (QE) remains a strong positive technical driver, and the economic recovery in Europe is starting to feed through into corporate earnings, leading to improving fundamentals. Valuations, however, remain unexciting.

US HIGH YIELD: Spreads have held in well despite Treasury market volatility, though they have widened a bit in early June. The main performance driver of the market continues to be commodity prices given the large weight of energy and metals sectors. Spread levels are still implying a higher default rate than we are currently expecting.

EURO HIGH YIELD: Industry inflows continued into European high yield funds through May, which, combined with lower new issuance, was supportive of the sector. With QE, industry inflows, and a positive tone, positive performance could continue despite overall valuations looking less compelling.

BANK LOANS: The fundamental picture remains intact, with low forward default expectations and a minimal near-term maturity profile. The largest market drivers today are technical in nature and include solid collateralized loan obligation issuance, a light new issue calendar, a meaningful amount of straight paydowns, and a recovering inflow picture.

AGENCY MBS: The sector tracked Treasuries in May but recorded modest outperformance versus the broader credit market. Tighter spreads, more balanced technicals, uncertainty over the path of Fed policy, and persistent volatility in the rates market provide little catalyst for significant spread tightening going forward.

EM DOLLAR SOVEREIGN: The sector is at best fairly valued relative to US investment-grade and high yield corporates. External sovereigns are likely to see at least transitional weakness when the Fed lifts off. However, this should generate an opportunity to reinvest at better yield levels, as we see momentum in some markets for economic and political reform.

EM CORPORATES: The corporate sector has outperformed EM dollar sovereigns and US high yield year to date. Fed rate hikes will likely challenge liquidity in the sector, which leaves us cautious while also anticipating opportunities to buy at more compelling valuations. Within the sector, we continue to have a preference for investment-grade over high-yield names.

EM LOCAL: The sector is becoming more attractive in absolute terms after the recent backup in local rates. It also remains attractive relative to global developed market debt. EM local continues to cheapen versus external EM debt but has not yet reached extremely oversold levels. We are cautiously optimistic on duration with the recent rise in local rates. However, until global growth picks up and ahead of a Fed hiking cycle, EM currencies will continue to face headwinds.

DEVELOPED SOVEREIGN MARKETS:

US: To the extent global data remains firm, the dollar stays away from its recent highs, and domestic data does not significantly disappoint, the Federal Open Market Committee (FOMC) remains on track for a third-quarter rate liftoff. As such, yields may remain on an uncertain path until either the data becomes more convincing or the FOMC signals a push back of liftoff into the fourth quarter or later.

EUROZONE: The recent sell-off has returned German bund yields to around fair value on a short-term outlook. ECB QE should be supportive over the next two months, as investor positioning is more balanced and net supply turns negative. But valuations remain very expensive on a long-term, fundamental basis.

JAPAN: Recent economic data has been relatively encouraging, including an upward revision to first-quarter GDP growth. Although inflation continues to undershoot due to the decline in energy prices, it should begin to pick up in the second half of 2015. The BOJ may further ease if inflation fails to rise, but no policy changes are expected before October. It is now possible that the BOJ leaves policy as is.

UK: A Conservative majority in the new government allows a policy of fiscal tightening to be enacted over the course of the next five years. After a weaker-than-expected first quarter, the economy is expected to perform relatively well this year. The market is not expecting the Bank of England to begin raising rates until the first quarter of 2016. We continue to expect only a modest hiking cycle, given the interest rate sensitivity of the economy.

CANADA: Weak growth and below-target inflation support the Bank of Canada's (BOC) on-hold stance, though further data disappointment may reopen the possibility for another rate cut. The market remains very expensive on a historic real yield basis, but with the BOC likely to remain on an extended pause, there is scope for yields to be more resilient when the Fed begins raising rates.

AUSTRALIA: The growth outlook remains dreary given little improvement in non-mining investment. Accordingly, the Reserve Bank of Australia is likely to remain accommodative for a considerable period. Stabilization in commodity prices will help ease growth concerns and alleviate the pressure for further policy action in the near term.

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