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May 2015

FIXED INCOME SECTOR PULSE

SUMMARY:

Sovereign yields spiked across Europe despite the European Central Bank's (ECB) ongoing government bond purchases, as rich valuations and an improving growth and inflation outlook triggered an unwinding of widely held quantitative easing (QE) trades. 10-year US Treasury yields climbed to their highest level this year, driven by the sharp selloff in German bunds and firming inflation expectations. Fed liftoff is on track to commence by September, but continued softness in US economic data could call the timeline into question and restrain a further rise in Treasury yields. Japanese government bond (JGB) yields followed global yields higher although Japanese economic data remains lackluster. The Bank of Japan (BOJ) is likely to add to stimulus efforts this year, though this may involve a wider range of asset purchases amid concerns about liquidity in the JGB market.

Investment-grade corporate fundamentals may be on a downtrend in the US, but there are still select opportunities in lower-beta industrials and European banks. US high yield corporate fundamentals remain solid outside of the commodities space, and technicals for bank loans are highly supportive. European high yield has been stable despite the high volatility in European rates, supported by highly accommodative ECB policy and signs of faster economic growth.

Emerging markets (EM) credit offers compelling valuations, but market liquidity is a risk in a rising rate environment. EM local currency bonds are attractive versus developed market sovereign debt, and some countries are seeing improvement in external balances. However, a resumption of dollar strength could lead to volatility in performance.

SPREAD SECTORS:

US INVESTMENT-GRADE CORPORATES: Overall market volatility remains low as spreads for commodity-related sectors continue to move tighter from their wides. Spreads have continued to perform well on the back of higher risk-free rates. Strong technicals are the primary support for valuations, as non-financial credit fundamentals appear to have peaked.

EUROPEAN CORPORATES: The medium-term picture is unchanged, as ECB QE remains a strong positive technical driver. In the short term, sovereign volatility may lead to an increase in risk aversion. The backup in periphery yields has also reduced the relative value of investment-grade euro corporates. But in the face of the recent dramatic sell-off in German bunds, corporates demonstrated their resilience with lower price declines.

US HIGH YIELD: Overall valuations and market yields are still interesting but not as attractive as earlier in the year. Volatility remains likely given the energy sector's impact on the market. However, spread levels are still implying a higher default rate than we are currently expecting. The default rate next year will depend on the direction of energy prices.

EURO HIGH YIELD: Supportive macro and central bank policies continued to result in a stable environment for the asset class. Inflows into European high yield assets continued, although at a more moderate pace than in March, which provided ample liquidity to soak up reduced supply in Europe. With QE, inflows, and a positive market tone, positive performance appears set to continue despite the sector looking less compelling on a spread and yield basis.

BANK LOANS: The sector is not quite as cheap as it was earlier in the year. The opportunity in discounted paper has thinned out with light new issuance pushing investors into the secondary market. Loans have benefited from a materially lower exposure to commodities than US high yield, strong collateralised loan obligation issuance, and a recovering inflow picture.

AGENCY MBS: Positive technicals, cheaper relative valuations, and continued directionality of performance (i.e., higher rates results in tighter spreads) led to a solid month for agency MBS in April. Attractive relative valuations and liquidity of the sector remains a focus for investors.

EM DOLLAR SOVEREIGN: The sector is attractive versus US credit in both the high yield and investment-grade spaces. But stories are increasingly idiosyncratic, and valuations are now off of their best levels. Fed liftoff may challenge less-liquid asset markets. Reform momentum has picked up with Brazil taking initial—but needed—steps towards macro adjustment.

EM CORPORATES: Valuations are attractive relative to developed credit within the BBB and BB rated market segments. The commodity price rebound has reduced tail risk of higher default rates in 2015. Our enthusiasm is tempered by poor liquidity, particularly in the high yield area of the market.

EM LOCAL: Spreads have been relatively stable over US Treasuries. The EM foreign exchange bounce on a weaker US dollar and higher euro has been supportive following an extended period where currencies hurt performance and bonds positively impacted performance. Local bonds remain relatively cheap compared with global bonds but are fairly valued versus dollar-denominated EM sovereigns and US high yield. Overall economic growth rates remain subdued in EM at the headline level. Until they pick up and ahead of a Fed hiking cycle, emerging currencies will remain a headwind.

DEVELOPED SOVEREIGN MARKETS:

US: Rising global yields and a bounce in inflation expectations (i.e., removal of deflation fear) add weight to potential bearish outcomes. Stronger data, particularly if it is global, will set the stage for Federal Open Market Committee (FOMC) liftoff and higher yields, but second-quarter economic data has yet to meet high expectations. A data-dependent FOMC needs stronger data to liftoff. Until that occurs, yields may struggle to maintain their current upward trajectory.

EUROZONE: Negative yields in the front end plus QE had pushed demand out the curve and suppressed yields. With the recent sharp sell-off, valuations are now more reasonable on a short-term basis but remain extremely expensive on a long-term fundamental basis. The growth and inflation outlook are improving, but monetary policy will remain accommodative for the foreseeable future. QE is expected to end as planned in September 2016, but no rate hikes are likely before 2018 or 2019.

JAPAN: Core inflation continues to undershoot, dragged lower by energy prices. First-quarter growth was disappointing, but there are signs of a recovery, with higher wages feeding through into consumption. The BOJ has pushed back its expectation of hitting the 2% inflation target until the first half of fiscal year 2016. The BOJ is likely to ease again in July or October, and the government is expected to release a new medium-term fiscal plan in the summer.

UK: With the Conservative party surprisingly winning an outright majority at the general election, the focus can switch back to the real economy. A more stable government with a tight fiscal mandate is now more likely. After a weaker-than-expected first quarter, the economy is expected to perform relatively well this year. The Bank of England has implied that not enough was priced into the interest rate curve in terms of rate hikes, and the timing of the first hike will come back into focus.

CANADA: The Bank of Canada (BOC) has adopted a more neutral stance recently, suggesting that growth will return to more normal levels after a front-loaded hit from the sharp decline in oil prices over the past few quarters. Rate cut expectations have largely been priced out. But with the BOC likely to remain on an extended pause, there is scope for yields to be more resilient than other markets when the Fed begins raising rates.

AUSTRALIA: The Reserve Bank of Australia has delivered a further rate cut, taking the policy rate to a new record low of 2.0%. The curve steepened on expectations that this will be the low for the cycle, but much depends on whether the expected rebound in consumer spending is sufficient to outweigh the drag from business investment. Reflationary efforts from China are also supportive for the growth outlook.

IMPORTANT INFORMATION

The views contained herein are as of12 May 2015 and may have changed since that time. Unless indicated otherwise the source of all market data is Thomson Datastream.

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