Bond Market Review and Outlook

By Craig Burelle, VP, Macro Analyst

KEY TAKEAWAYS

- The two-year horizon for economic activity looks neither shining bright nor gloomy and dark.
- Risk assets do not necessarily have to sell off as growth plods along.
- Coordinated monetary and fiscal policy efforts to spur growth could be next, but historically low interest rates are likely to persist.

Accommodative monetary policies helped make it a fairly calm summer in the markets. Volatility ticked up following the June Brexit vote but quickly faded. In September, a short-lived spike in global interest rates shook risk assets, but the damage was not sustained.

Muddle-Through Economics Aren't So Bad

The pace of economic growth in the United States is expected to increase for the third and fourth quarters of this year, but annually, the estimated 1.50% growth rate would be the slowest year-on-year change since the recovery began six years ago. The two-year horizon for economic activity looks neither shining bright nor gloomy and dark. Corporate profits should recover modestly and core inflation will likely remain just under 2.00%, the Federal Open Market Committee (FOMC) long-run objective. This slow economic expansion is potentially favorable for US credit markets, where investors can earn carry over US Treasurys. The FOMC will likely raise the federal funds rate by 25 basis points in December, but the path for rates thereafter is unlikely to be steep. Generally stable macroeconomic indicators suggest long rates, 10- to 30-year maturities, will remain historically low for the next few quarters. The FOMC's policy stance has allowed a pause in the US dollar bull market. Stability in the world's reserve currency continues to support emerging market securities and currencies that suffered during the dollar's ascent.

The outlook for global growth and inflation appears much like the US, with both indicators growing at a slow but steady annual rate for the forecast horizon. The gradual economic slowdown in China has been drag, and we wait to see which regions, countries or sectors can step up as a new global growth engine to fill the void. But risk assets do not necessarily have to sell off as growth plods along. Markets may have moved ahead of fundamentals since they appear to be pricing in positive outcomes that have yet to materialize; however, credit spreads may move sideways to modestly tighter as we wait for fundamentals to catch up.

Are Monetary Policymakers Out of Bullets?

Extraordinarily low—and in some cases negative—interest rates have not bolstered headline economic growth as many policymakers had hoped. Negative interest rates and steady but slow economic activity in Europe and Japan have given rise to a debate about available policy levers left to pull. Monetary policy has carried all the weight since the global financial crisis while fiscal austerity kept many governments on the sidelines. A transition to fiscal policy would in most cases require new government bond issuance. Speculation over this shift grew slightly hysterical during mid-September, causing a quick spike in global interest rates; by quarter-end, most global yields had returned to pre-spike levels. Developments and comments from officials regarding the use of fiscal policy could be a source of bond market volatility going forward, but is unlikely to present structural and lasting change. Some level of coordinated action between monetary and fiscal policymakers could be the next step. Monetary policies have become increasingly creative over the past few years, and that may continue. In any event, the fundamental economic backdrop suggests that a historically low global interest rate environment will likely persist.

Third Quarter Review

By Craig Burelle, VP, Macro Analyst

INDEX RETURNS BY SECTOR
as of September 30, 2016

INDEX				
US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US AGGREGATE BOND	-0.06	0.46	2.68	5.19
BARCLAYS US GOVERNMENT/CREDIT	-0.19	0.40	3.08	5.86
S&P 500®	0.02	3.85	6.40	15.43

Fixed income benchmarks increased year-to-date gains during the quarter while the S&P 500 Index hit an all-time high. Limited market volatility over the summer months and decent economic data supported credit markets. The FOMC may hike the federal funds rate by 25 basis points this December, but the economic environment is not robust enough to expect more than two hikes per year after that. Both the US Aggregate and US Government/Credit indices earned more than 60 basis points of excess return relative to like-duration US Treasurys.

US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US TREASURYS	-0.13	-0.28	1.81	4.09
3-MONTH T-BILLS	0.05	0.10	0.18	0.29
2-YEAR TREASURY	0.13	-0.13	0.38	0.72
5-YEAR TREASURY	0.28	-0.38	0.97	2.52
10-YEAR TREASURY	-0.22	-0.75	2.25	5.60
30-YEAR TREASURY	-2.00	0.13	7.37	14.53
BARCLAYS US TIPS	0.55	0.96	2.69	6.58
BARCLAYS US AGENCY	0.09	0.14	1.36	2.76

At the start of the first quarter, FOMC projections indicated four rate hikes during 2016. As of September 30, there have been no increases and only one 25 basis point hike is anticipated. The FOMC consistently lowered economic projections throughout the year, which removed some of the upward pressure on US Treasury yields. A low and slow federal funds rate path should prevent the long end of the yield curve from rising rapidly over the course of this tightening cycle. During the third quarter, short-end rates out to the 10-year maturity moved slightly higher while the 30-year maturity was nearly unchanged.

US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US MUNICIPALS	-0.50	-0.30	2.30	5.58

The Municipal index zigzagged between positive and negative territory throughout the quarter but finished in the red. A few states with large index weightings posted negative performance. California represents more than 17% of the index and returned -0.40%. New York is over 15% of the index and returned -0.28%. Texas represents nearly 10% percent of the index and returned -0.47%. Puerto Rico municipals were a top performer, popping nearly 4.5%, but the outsized gain had little impact on index performance.

US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS MBS	0.28	0.60	1.71	3.61
BARCLAYS ABS	0.26	0.20	1.37	2.16
BARCLAYS CMBS	-0.21	0.59	2.84	5.22

US securitized benchmarks bested like-duration Treasurys for the quarter as each of the three indices posted a positive excess return. The CMBS index led the securitized group with more than twice the duration of the US MBS index but only a fractional yield advantage of 7 basis points. The more cyclically tied ABS benchmark lagged but still posted a positive 26-basis-point excess return. The Federal Reserve (the Fed) still owns $1.7 trillion worth of mortgage-backed securities (MBS) and remains a powerful force in that market as principal payments from matured holdings are reinvested.

Data Sources: Barclays indices from Barclays Live; currency returns, JPMorgan and Citigroup indices from Bloomberg; and S&P 500 Index from FactSet.

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INDEX RETURNS BY SECTOR
as of September 30, 2016

INDEX				
CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US INVESTMENT GRADE	-0.25	1.41	5.03	8.56
AAA	-0.91	0.53	3.87	9.27
AA	-0.39	0.48	3.10	6.79
A	-0.41	0.90	3.97	7.89
BBB	-0.06	2.06	6.40	9.47
BARCLAYS EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-0.07	1.84	3.45	7.37
AAA	0.07	1.97	5.18	10.53
AA	0.06	1.18	2.60	6.52
A	-0.01	1.71	3.20	6.94
BBB	-0.16	2.11	3.81	7.90
BARCLAYS STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-1.52	6.41	11.42	16.08
AAA	-3.93	5.81	15.67	23.51
AA	-1.68	5.02	10.83	15.76
A	-1.80	6.69	12.29	17.12
BBB	-1.21	6.48	10.74	15.17

Investment grade corporates performed well globally during the quarter, led by the UK. After Brexit, the Bank of England (BOE) cut its benchmark lending rate by 25 basis points to ease the potential economic backlash from the country's decision to leave the European Union. The interest rate cut coincided with a rally across the UK gilts yield curve, led by the long end. At 8.7 years, the Sterling Aggregate index has the longest duration, followed by the US Corporate index at 7.5 years and the Euro-Aggregate at 5.4 years. Interest rates across the US yield curve rose during the quarter, but the short end of the curve moved most. The elevated duration component of the US Corporate index hampered total returns, but not drastically. The European Central Bank (ECB) continues to buy investment grade corporates, which is a positive technical for that market. The yield to worst on the Euro-Aggregate rallied to 0.66%, compared with 2.84% on the US Corporate index and 2.26% on the Sterling Aggregate Corporate index.

CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD	0.67	5.55	11.38	12.73
BB	0.35	4.36	8.12	12.13
B	0.53	5.70	10.80	11.26
CCC	1.77	8.20	21.00	16.12
BARCLAYS PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	-0.80	2.96	3.69	5.78
BB	-0.79	2.85	3.88	6.90
B	-0.82	3.17	3.06	3.02
CCC	-0.53	3.80	4.58	4.28

US high yield corporates were the leading domestic asset class during the quarter, aided by low market volatility throughout summer and consistently easy financial conditions. The US high yield option-adjusted spread, which was 480 basis points as of September 30, remains well above the 323-basis-point low of 2014. Commodity-related industry groups like metals and mining as well as energy showed leadership during the quarter and produced total returns greater than the overall index. Pan-European high yield continued to rally and the index reached an all-time low yield of 4.05%. Financial companies and banks, which represent just over 37% of the index, underperformed most other industries but still earned positive returns. Although historically low, the high yield indices still provide substantial yields relative to most other fixed income asset classes.

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INDEX				
BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD LOANS	0.93	3.30	6.47	5.96
BB	0.55	2.06	3.54	5.07
B	0.94	3.18	6.05	5.41
CCC	2.58	8.01	18.22	2.28

Performance in the high yield loan market is highly correlated with that of the high yield corporate bond market despite fundamental differences between the two asset classes. As a lower-beta proxy for high yield corporates, the high yield loan index posted total returns similar to the high yield corporate index, only less. The CCC credit quality segment provided a significantly higher return than B and BB qualities but represents just over 5% of the total index.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI *(LOCAL CURRENCY RETURNS)*	-0.14	-0.22	2.43	6.22
CITIGROUP NON-USD WGBI	-0.13	-0.18	2.73	7.30
UNITED STATES	-0.14	-0.31	1.79	4.04
CANADA	-0.03	0.52	2.52	4.41
JAPAN	0.02	-2.19	0.80	6.78
AUSTRALIA	-0.44	0.80	4.34	6.29
UNITED KINGDOM	-2.47	2.52	9.43	13.67
EUROPEAN GBI	0.20	0.67	2.89	6.92
FRANCE	0.27	0.21	3.12	7.32
GERMANY	0.25	-0.18	2.67	6.18
IRELAND	0.42	1.11	2.76	6.07
ITALY	-0.26	1.14	1.59	5.92
SPAIN	0.79	2.21	4.49	8.55

The developed market government bond rally plateaued during the third quarter, but losses were limited in most cases. A short-lived spike in global yields took place in mid-September as market participants digested the possibility of new fiscal policy developments. By quarter-end, most yields had settled near pre-spike levels. Japan and Germany had been performance leaders in past quarters, but they underperformed this quarter. The UK market led the group, supported by an interest rate cut at the BOE that resulted in lower rates across the yield curve. Spain and Italy also earned relatively high total returns for the quarter. Both short- and long-end rates on Spain's yield curve declined, but Italy's curve remained more anchored.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	0.34	3.73	9.34	16.82
JP MORGAN CEMBI BROAD DIVERSIFIED *(CORPORATES, USD)*	0.15	3.07	6.96	11.61
JP MORGAN GBI-EM GLOBAL DIVERSIFIED *(GOVERNMENTS, LOCAL CURRENCY)*	1.12	2.38	5.63	12.63

Emerging market fixed income was a bright spot in the global bond space during the quarter and now shows outstanding 12-month total returns. A vast majority of the EMBIG constituents were firmly in positive territory for the quarter, with only Mexico and Turkey posting modest losses. Within the CEMBI, Brazil corporates have been a dominant force, earning over 7% for the quarter and 27% in the past 12 months. The GBI-EM local currency government bond index lagged US-dollar-denominated indices, weighed down by relatively low returns in Eastern European countries Poland, Hungary and Romania. As an asset class, emerging markets have had positive inflows, which can be a favorable performance tailwind.

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CURRENCY MARKETS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
DOLLAR BLOC				
CANADIAN DOLLAR	-0.17	-1.55	-0.94	1.42
AUSTRALIAN DOLLAR	1.96	2.86	0.09	9.20
NEW ZEALAND DOLLAR	0.50	2.13	5.46	13.86
WESTERN EUROPE				
EURO	0.69	1.16	-1.27	0.52
NORWEGIAN KRONE	4.30	4.74	3.56	6.65
SWEDISH KRONA	-0.16	-1.33	-5.32	-2.38
SWISS FRANC	1.29	0.47	-0.99	0.20
BRITISH POUND	-1.26	-2.55	-9.67	-14.25
EMERGING EUROPE & AFRICA				
CZECH KORUNA	0.75	1.43	-1.17	1.20
HUNGARIAN FORINT	1.17	3.60	0.57	2.23
POLISH ZLOTY	2.22	3.12	-2.48	-0.63
RUSSIAN RUBLE	3.95	1.78	6.69	4.11
SOUTH AFRICAN RAND	7.35	7.32	7.61	0.96
TURKISH NEW LIRA	-1.40	-4.07	-6.09	0.86
ASIA				
JAPANESE YEN	2.05	1.83	11.07	18.28
CHINESE RENMINBI	0.11	-0.36	-3.27	-4.73
INDONESIAN RUPIAH	1.64	1.29	1.60	12.26
MALAYSIAN RINGGIT	-2.06	-2.52	-5.71	6.28
PHILIPPINE PESO	-4.02	-2.92	-5.01	-3.63
SINGAPORE DOLLAR	-0.05	-1.17	-1.08	4.34
SOUTH KOREAN WON	1.23	4.59	3.84	7.65
LATIN AMERICA				
ARGENTINE PESO	-2.45	-1.71	-3.94	-38.47
BRAZILIAN REAL	-1.07	-1.49	10.16	21.03
CHILEAN PESO	3.45	0.90	1.59	5.91
COLOMBIAN PESO	3.14	1.36	4.19	7.15
MEXICAN PESO	-3.10	-5.70	-10.86	-12.73
PERUVIAN NEW SOL	0.25	-2.90	-2.08	-4.43

Foreign exchange volatility was muted during the quarter as central banks largely sat on their hands assessing incoming macro data without making major policy adjustments. As a result, the US dollar was range bound along with other major currencies. A lack of catalysts to boost the US dollar has led to more idiosyncratic trade among individual currency pairs. Quarterly gains and losses were fairly muted across most currencies with only a few outliers. The Mexico peso hit all-time lows relative to the US dollar during the quarter but recovered some losses after the Bank of Mexico hiked the official overnight rate by 50 basis points late in the quarter. The South Africa rand was a standout leader for the quarter but showed only modest gains for the past 12 months. Brazilian real, on the other hand, showed a modest loss for the quarter but a substantial gain of more than 20% relative to the US dollar over the past year.

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Disclosure

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Index Definitions

Barclays US Aggregate Bond Index *represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the US investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.*

Barclays US Government/Credit Index *includes securities in the government and credit indices. The government index includes treasuries (i.e., public obligations of the US Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government). The credit index includes publicly issued US corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.*

Barclays US Treasury Index *includes public obligations of the US Treasury with at least one year until final maturity, excluding certain special issues such as state and local government series bonds (SLGs), US Treasury TIPS and STRIPS.*

Barclays US Treasury Inflation Protected Securities Index *consists of inflation-protection securities issued by the US Treasury that have at least one year to maturity and at least $250 million par amount outstanding.*

Barclays US Agency Index *includes agency securities that are publicly issued by US Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the US Government (such as USAID securities).*

Barclays US Municipal Index *is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index has four main sectors: general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and prerefunded bonds.*

Barclays Mortgage-Backed Securities (MBS) Index *is a component of the Barclays US Aggregate Index covering mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.*

Barclays Asset-Backed Securities (ABS) Index *is a component of the Barclays US Aggregate Index including pass-through, bullet and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. Constituents must have an average life of at least one year and a deal size of at least 500 million.*

Barclays Commercial Mortgage-Backed Securities (CMBS) ERISA-Eligible Index *is a component of the Barclays US Aggregate Index and the ERISA-eligible component of the Barclays CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption, is the only CMBS sector that is included in the US Aggregate Index.*

Barclays US Corporate Index *contains publicly issued US corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC-registered. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which include both US and non-US corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government.*

Barclays Euro-Aggregate Corporate Index *consists of bonds issued in the euro or the legacy currencies of the 16 sovereign countries participating in the European Monetary Union (EMU). All issues must be investment grade-rated, fixed-rate securities with at least one year remaining to maturity. The Euro-Aggregate Index excludes convertible securities, floating rate notes, perpetual notes, warrants, linked bonds, and structured products.*

Barclays Sterling Aggregate Corporate Index *is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate sterling-denominated bond market. Inclusion is based on the currency of the issue, not the domicile of the issuer. The index includes publically issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.*

Barclays US Corporate High-Yield Index *covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.*

Barclays Pan-European High-Yield Index *covers the universe of fixed-rate, sub-investment grade debt denominated in euros or other European currencies (except Swiss francs). Securities must be rated high-yield (Ba1/BB+ or lower) by at least two of the following rating agencies: Moody's, S&P, Fitch. Excludes emerging markets.*

Barclays US High-Yield Loans Index*, also known as the Bank Loan Index, provides broad and comprehensive total return metrics of the universe of syndicated term loans. To be included in the index, a bank loan must be dollar denominated, have at least $150 million funded loan, a minimum term of one year, and a minimum initial spread of LIBOR+125.*

Standard & Poor's 500 (S&P 500®) Index *is a market capitalization-weighted Index of approximately 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance. S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.*

Citigroup World Government Bond Index (WGBI) *measures the performance of fixed-rate, local currency, investment grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies. The WGBI provides a broad benchmark for the global sovereign fixed income market.*

JPMorgan Emerging Markets Bond Index Global (EMBIG) *tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds.*

JPMorgan Corporate Emerging Markets Bond Index (CEMBI Broad Diversified) *tracks total returns of US dollar-denominated debt instruments issued by corporate entities in emerging markets countries. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds.*

JPMorgan Government Bond Index—Emerging Markets (GBI-EM Global Diversified) *provides a comprehensive measure of local currency denominated, fixed rate, government debt issued in emerging markets.*