Bond Market Review and Outlook

By Craig Burelle, VP, Macro Analyst

KEY TAKEAWAYS

- Growth and inflation have improved modestly, but fundamentals don't suggest a sharp rate rise in 2017.
- Longer term, yields can move higher as inflation picks up, but the transition will likely be slow and uneven.
- Recent economic developments have been credit positive, and US corporate profits have resumed year-over-year growth, an important tailwind for credit.

Markets were in reflation mode during the final weeks of 2016, sending the 10-year US Treasury yield to its highest level in more than two years. While economic indicators have shown modest improvement, most of the rise in yields is built on lofty expectations. In the coming years, we think a strengthening macro backdrop may support modestly higher yields.

The Bond Bull May Not Have Much Further to Run

The bond bull market, unleashed after former Federal Reserve Chairman Paul Volcker broke the back of inflation in the early 1980s, pushed US interest rates to record lows in 2016. Over the course of that multi-year rally, there were several head fakes when 10-year yields rose 200 basis points or more over several quarters. Those shocks proved temporary and the long-term trend remained intact as rates reversed and eventually made new lows. After printing an all-time closing low of 1.36% in mid-2016, the US 10-year yield has risen more than 100 basis points, causing investors to question whether this is the end or just another shock. A mix of economic indicators and the potential for significant pro-business legislation in the US lead us to believe the low in US interest rates is most likely behind us.

The Economic Backdrop is Slowly Improving

The threat of global deflation has diminished during the past few quarters. Two of the world's largest economies, the aggregate euro zone countries and Japan, appear to have emerged from price deflation. Euro zone headline inflation has steadily risen from negative territory last April to positive 1.1% in December. In Japan, the Bank of Japan is determined to reach a 2.0% inflation target and has made some progress recently. The latest read on headline inflation in Japan indicated a 0.50% rise in November, which is a significant increase relative to the -0.50% decline last September. China's economy has been slowing, but at a moderate enough pace to keep fears of a hard landing and deflationary impulse at bay.

Headline inflation in China is just above the 2.0% threshold and has risen over the past three months. The rally in oil prices began to support inflation indicators toward the end of 2016 and provides some evidence that reflation is beginning to take hold. The real rate of interest, that is the nominal bond yield minus the year-over-year percentage change of headline inflation, declined throughout the multi-decade US Treasury bond rally along with the absolute level of rates and inflation. During the 35-year bull market, the 10-year real rate averaged 3.10%, but it averaged only 0.77% over the past 5 years. With inflation slowly picking up, it seems likely that nominal yields can continue moving higher to provide a real rate more in sync with the long-term average, but the transition will likely be slow and uneven.

Domestic economic fundamentals and expectations provide further evidence that modestly higher bond yields can be sustained in the years ahead. By most standards, the US economy is at or very close to full employment and core Personal Consumption Expenditures, the Fed's chosen inflation measure, is fairly close to target. The pace of fed funds rate hikes should increase from one hike in 2016 to two hikes in 2017 based on the continued progress of those indicators. Although speculation until signed into law, corporate tax cuts and fiscal stimulus at full employment could put additional upward pressure on inflation, but probably not until 2018. With inflation expected to pick up over the long term, it is reasonable to assume that a greater inflation premium than seen in recent years could be priced into bond yields. However, we believe a majority of the adjustment has already been built in to US Treasury yields and expect the 10-year to rise by less than 20 basis points during 2017.

What Are the Implications For Fixed Income?

Ultimately, the performance of most fixed income asset classes will depend on the pace at which US Treasury yields rise; we do not believe fundamentals dictate a sharp rise in 2017. Economic developments over recent months have been credit positive as slightly higher inflation and decent GDP growth are set to boost top-line revenue, though the rise in yields has partially offset those positive trends. US high yield credit stands to benefit the most from a modest cyclical pickup and further credit repair within the energy sector, which should keep a lid on default rates. US high yield loans, which have floating interest rates and zero duration, also stand to benefit from an improving economic backdrop and are uniquely isolated from rising rates. In addition to higher GDP growth, US corporate profits have resumed year-over-year growth and we expect that to continue in future quarters, an important tailwind for corporate credit.

Fourth Quarter Review

By Craig Burelle, VP, Macro Analyst

INDEX RETURNS BY SECTOR
as of December 31, 2016

INDEX				
US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BBG BARC US AGGREGATE BOND	0.14	-2.98	-2.53	2.65
BBG BARC US GOVERNMENT/CREDIT	0.21	-3.39	-3.00	3.05
S&P 500®	1.98	3.82	7.82	11.96

Many fixed income assets classes struggled during the fourth quarter as the US Treasury yield curve steepened, led by maturities in the five- to ten-year segment. Longer-duration benchmark indices like the US Government/ Credit underperformed shorter-duration indices over the period. Risk appetite was strong during the quarter, and many credit spreads tightened while US equities rallied. However, a nearly 100 basis point rise in the belly of the curve pushed total returns into negative territory for intermediate- and long-duration benchmarks.

US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BBG BARC US TREASURYS	-0.11	-3.84	-4.11	1.04
3-MONTH T-BILLS	0.04	0.09	0.19	0.35
2-YEAR TREASURY	-0.02	-0.56	-0.68	0.64
5-YEAR TREASURY	-0.20	-3.34	-3.71	0.48
10-YEAR TREASURY	-0.38	-6.81	-7.51	-0.16
30-YEAR TREASURY	-0.40	-13.75	-13.64	0.88
BBG BARC US TIPS	-0.10	-2.41	-1.47	4.68
BBG BARC US AGENCY	-0.13	-1.96	-1.83	1.39

The steepening US yield curve defined fixed income performance for the quarter as the impact from global monetary policy divergence intensified. Many developed market central banks like the European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England (BOE) are still actively managing quantitative easing (QE) programs while the Federal Reserve (Fed) is the only major central bank hiking short-term interest rates. In the beginning of the quarter, US yields moved higher in anticipation of rate hikes in 2017 and 2018 as well higher inflation and slightly higher US GDP growth. After the presidential election, Treasury yields continued higher fueled by expectations for pro-business reform and corporate tax cuts that could increase aggregate demand and lead to increased inflation over the next few years.

US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BBG BARC US MUNICIPALS	1.17	-3.62	-3.91	0.25

Municipal bonds were not immune from the US Treasury bond selloff but did recover some losses by quarter-end. The municipal benchmark is predominantly driven by three states, California, New York and Texas, which collectively represent over 42.2% of the index. Other than New Jersey, which declined over 5.1%, most states performed roughly in line with the aggregate index total return. AAA-rated states were the top-performing credit quality but only outperformed the overall index by around 30 basis points.

US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BBG BARC MBS	-0.00	-1.97	-1.39	1.67
BBG BARC ABS	-0.15	-0.70	-0.50	2.03
BBG BARC CMBS	-0.41	-3.03	-2.46	3.32

Yields on each of the three securitized asset benchmarks moved higher throughout the quarter, but like Treasurys, much of the rise took place post US presidential election. Spreads on the US MBS and ABS indices moved a bit wider while the CMBS index spread tightened by nine basis points. The ABS and CMBS indices posted modest excess returns over duration-matched Treasurys while US MBS posted a negative excess return for the quarter.

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

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INDEX RETURNS BY SECTOR
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INDEX CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BBG BARC US INVESTMENT GRADE	0.67	-2.83	-1.46	6.11
AAA	0.47	-4.90	-4.39	3.39
AA	0.44	-3.00	-2.53	3.60
A	0.55	-3.11	-2.24	4.65
BBB	0.83	-2.48	-0.47	8.04
BBG BARC EUROPEAN INVESTMENT GRADE -*LOCAL CURRENCY RETURNS*	0.63	-1.20	0.63	4.73
AAA	0.67	-3.36	-1.46	5.67
AA	0.38	-1.43	-0.27	3.97
A	0.49	-1.28	0.40	4.27
BBB	0.81	-1.04	1.04	5.26
BBG BARC STERLING INVESTMENT GRADE -*LOCAL CURRENCY RETURNS*	2.37	-2.34	3.92	12.27
AAA	2.87	-4.95	0.58	17.41
AA	2.10	-2.37	2.52	12.47
A	2.65	-2.81	3.69	12.82
BBB	2.21	-1.90	4.46	11.69

US investment grade corporate spreads continued to narrow during the quarter, although index yield rose along with Treasury yields. Total returns were negative across all sectors, but higher crude oil prices helped the energy sector outperform the aggregate index. The financial sector also outperformed as higher US interest rates began to brighten the outlook for bank profitability. Similarly in Europe, investment grade corporates sold off as government bond yields moved higher, albeit by a smaller magnitude than in the US. The financial sector was also a top performer in Europe as government bond yields moved out of negative territory. Performance within the Sterling Aggregate mirrored both the US and Euro-Agg indices as energy and financials outperformed; however, all sectors posted negative total returns. Year–to-date total returns are still solidly positive for investment grade corporates despite fourth-quarter declines. All three indices also provided strong excess returns over the past 12 months.

CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BBG BARC US HIGH YIELD	1.85	1.75	7.40	17.13
BB	1.19	0.43	4.81	12.78
B	1.97	2.01	7.82	15.81
CCC	3.30	4.70	13.29	31.46
BBG BARC PAN-EURO HIGH YIELD -*LOCAL CURRENCY RETURNS*	1.84	2.20	5.23	6.48
BB	1.69	1.52	4.41	6.14
B	2.10	3.47	6.74	6.99
CCC	2.96	5.80	9.82	9.67

US high yield was a bright spot in global fixed income during the quarter and built on already impressive year-to-date total returns. A further rally in crude oil prices fostered credit repair within the energy sector and related industries, which were performance leaders during the quarter. US high yield spreads tightened over 70 basis points during the quarter and could go tighter still as credit stands to benefit from a pick-up in the domestic economy. The Pan-European High Yield index, which has almost no exposure to the energy sector, performed about in line with US high yield for the quarter. Credit risk appetite remained high as lower-quality securities continued to outperform within each index, but opportunities in that space are limited. CCC-rated securities represent just 15.6% and 5.9% of US High Yield and Pan-European High Yield, respectively.

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BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
S&P/LSTA LEVERAGED LOAN	1.16	2.26	5.41	10.16
BB	0.82	1.35	3.63	7.33
B	1.09	2.18	5.69	10.80
CCC	4.32	8.81	17.6	29.05

We have noted in the past that 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 -most notably the floating rate characteristic of bank loans. That relationship held throughout the quarter as the high yield loan index posted total returns with a bit greater than the high yield corporate index. The bank loan index should continue to benefit from the recovery in US corporate profits as well as a slight uptick in domestic GDP.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI *-LOCAL CURRENCY RETURNS*	0.10	-3.05	-3.26	2.97
CITIGROUP NON-USD WGBI	0.21	-2.66	-2.84	3.95
UNITED STATES	-0.11	-3.79	-4.09	1.03
CANADA	-0.80	-3.87	-3.37	-0.34
JAPAN	-0.72	-1.78	-3.93	3.65
AUSTRALIA	-0.21	-4.06	-3.29	2.52
UNITED KINGDOM	2.02	-3.70	-1.27	10.94
EUROPEAN GBI	0.64	-3.02	-2.37	3.20
FRANCE	0.22	-3.42	-3.22	3.66
GERMANY	0.26	-2.48	-2.65	3.92
IRELAND	0.62	-1.77	-0.68	3.56
ITALY	1.34	-3.30	-2.20	0.76
SPAIN	1.15	-2.83	-0.68	4.19

After rallying throughout the earlier part of 2016 most global government bond yields are now close to one year highs. The strong rally began to plateau during the third quarter and suffered a larger setback during the fourth quarter. It has become clearer that policy makers' foray into negative interest rates impaired financial sector health, and now that rates have moved up a bit, the entire system should remain healthier. Some countries have a higher beta to US yields than others; however, most yield curves steepened over the fourth quarter, albeit at varying degrees. The rise in yields, although positive for the financial sector, is responsible for the WGBI's weak performance. Global economic growth and inflation are not expected to accelerate rapidly over the next 12 months, therefore, further curve steepening from here is less likely than it was 6 months ago. After bearing the brunt of two consecutive tough quarters, most developed market government bonds still show positive 12-month total returns.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG *-SOVEREIGN/QUASI-SOVEREIGN, USD*	1.44	-4.21	-0.64	10.19
JP MORGAN CEMBI BROAD DIVERSIFIED *-CORPORATES, USD*	0.78	-1.32	1.72	9.65
JP MORGAN GBI-EM GLOBAL DIVERSIFIED *-GOVERNMENTS, LOCAL CURRENCY*	0.96	-1.40	0.94	9.35

Emerging markets have been top performers this year, but the fourth quarter presented the asset class with several challenges. First, EM indices tend to have a strong negative correlation to UST yields, declining when US yields rise. In addition to technical factors, investors feared many emerging countries could face greater political risk as the incoming US presidential administration develops new foreign policy frameworks. Finally, the US dollar rally reaccelerated during the quarter, dealing a blow to local currency assets in particular. Though the quarter was difficult, it wasn't enough to tarnish emerging markets' strong 12-month performance.

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CURRENCY MARKETS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
DOLLAR BLOC				
CANADIAN DOLLAR	-0.03	-2.34	-3.85	2.96
AUSTRALIAN DOLLAR	-2.40	-5.95	-3.26	-1.07
NEW ZEALAND DOLLAR	-2.10	-4.83	-2.80	1.51
WESTERN EUROPE				
EURO	-0.68	-6.39	-5.30	-3.18
NORWEGIAN KRONE	-1.34	-7.59	-3.21	2.34
SWEDISH KRONA	1.37	-5.84	-7.10	-7.30
SWISS FRANC	-0.17	-4.67	-4.22	-1.66
BRITISH POUND	-1.33	-4.87	-7.29	-16.26
EMERGING EUROPE & AFRICA				
CZECH KORUNA	-0.60	-6.43	-5.09	-3.20
HUNGARIAN FORINT	0.36	-6.80	-3.44	-1.33
POLISH ZLOTY	0.44	-8.70	-5.86	-6.31
RUSSIAN RUBLE	4.18	2.18	3.80	17.85
SOUTH AFRICAN RAND	2.58	-0.13	7.18	12.58
TURKISH NEW LIRA	-2.44	-14.86	-18.33	-17.21
ASIA				
JAPANESE YEN	-2.14	-13.35	-11.76	2.79
CHINESE RENMINBI	-0.80	-3.93	-4.28	-6.50
INDONESIAN RUPIAH	0.61	-3.20	-1.95	2.34
MALAYSIAN RINGGIT	-0.45	-7.75	-10.20	-4.28
PHILIPPINE PESO	0.15	-2.28	-4.92	-5.43
SINGAPORE DOLLAR	-0.93	-5.79	-6.88	-1.96
SOUTH KOREAN WON	-3.06	-8.68	-4.48	-2.55
LATIN AMERICA				
ARGENTINE PESO	-0.05	-3.61	-5.26	-18.57
BRAZILIAN REAL	4.01	0.22	-1.30	21.68
CHILEAN PESO	0.57	-1.95	-1.07	5.70
COLOMBIAN PESO	2.39	-4.00	-2.72	5.75
MEXICAN PESO	-0.74	-6.47	-11.80	-16.98
PERUVIAN NEW SOL	1.71	0.82	-2.02	1.73

A combination of actively diverging monetary policies and concern about the future of global trade led to a resurgence of the US dollar. During the quarter, the monetary policy divergence theme became more of a reality, sending the US dollar and foreign currencies in opposite directions. As the ECB, BOJ and BOE continue with QE programs, the Fed may very well be the only major central bank hiking rates during 2017. The dollar had traded firm early in the fourth quarter but shot even higher following the US presidential election. In addition to interest rate differentials, investors have to consider potential fiscal policies regarding trade, repatriation of overseas cash and corporate tax cuts. What the new pro business presidential administration will actually be able to accomplish is still unknown, but until concrete evidence emerges, investors may prefer to hold US dollars.

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Disclosure

All data as of December 31, 2016, unless otherwise noted.

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Index Definitions

***Bloomberg 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.*

***Bloomberg 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.*

***Bloomberg 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.*

***Bloomberg 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.*

***Bloomberg 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.*

***Bloomberg 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.*

***Bloomberg Barclays Mortgage-Backed Securities -MBS Index** is a component of the Bloomberg Barclays 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.*

Bloomberg Barclays Asset-Backed Securities -ABS Index *is a component of the Bloomberg 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.*

Bloomberg Barclays Commercial Mortgage-Backed Securities -CMBS ERISA-Eligible Index *is a component of the Bloomberg Barclays US Aggregate Index and the ERISA-eligible component of the Bloomberg 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.*

Bloomberg 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.*

Bloomberg 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.*

Bloomberg 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.*

Bloomberg 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.*

Bloomberg 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.*

S&P/LSTA Leveraged Loan Index*, is a market value-weighted index designed to measure the performance of the US leveraged loan market based upon market weightings, spreads and interest payments.*

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.*