# bond market review & outlook

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first quarter 2014

## A SLOW START

The current economic picture continues to be one of a halting global expansion, with one step forward and one frozen step back. We believe 2014 should see sustainable and accelerating global growth. But we are frustrated that one-off events, like weather or geopolitical events, get blamed for keeping the expansion stuck in a low gear when more fundamental supply and demand imbalances are at play. While economists may be frustrated, in our view, bond investors should not be. This uneven economic dynamic coincides with very low inflation and should provide a solid tailwind for bond prices.

### KEY TAKEAWAYS

- The current economic picture continues to be one of a halting global expansion, but we believe 2014 should see sustainable and accelerating global growth.
- Every fixed income benchmark in this performance review earned a positive total return during the first quarter of 2014.

Who would have thought that the 30-year US Treasury would have returned 8.11% in the first quarter, while equities would underperform, delivering a 1.81% return for the S&P 500® Index? The 30-year Treasury was a standout performer for the quarter but was coming back from a very deep 2013 loss of -15.03%. Meanwhile, equities are consolidating their gains after a stellar 32.39% return in 2013. We are not taking the current year-to-date market performance as a sign that we are heading into the economic "ice age" where bonds outperform stocks on a sustained basis. However, we do believe it demonstrates the value of keeping higher interest rate expectations in check, and the benefit of bonds to portfolio diversification. The prevailing investor sentiment on the death of bonds was an exaggeration.

## DISINFLATION TAILWIND FOR DEVELOPED MARKETS

The dominant factor for developed bond markets is low, and sometimes falling, rates of inflation. This disinflation tailwind clearly signals that aggregate supply still exceeds demand on a global basis, which is why we only expect a very gradual rise in bond yields, even as economic growth accelerates.

Europe is grabbing the headlines for disinflation, with consumer prices slipping to a meager 0.5% in the last year. A strong euro is largely blamed for European disinflation, and policymakers are trying to talk the currency down with limited success. We would expect the European Central Bank (ECB) to ease monetary policy further in an effort to hit its 2.0% inflation target. European bond investors were rewarded during the quarter, particularly in the periphery where performance has continued to be very strong.

US Inflation has been low and relatively stable, around 1.1% for core personal consumption expenditure (PCE) measures, but that has not stopped the Federal Reserve (the Fed) from sounding slightly more hawkish. Long bond investors should benefit as the Fed winds down quantitative easing (QE) and moves forward rate hike expectations to the second quarter of 2015 while inflation remains low. We expect the long end of the yield curve to be much more stable and to flatten as the Fed continues on its path of policy normalization.

Japan has been getting some traction on raising its inflation rate, but mostly through a weak yen and higher import prices. Yen devaluation was critical in achieving higher rates of inflation and is a clear lesson for those countries battling undesirable disinflation trends, i.e., currency devaluation can be a useful monetary policy tool in a demand-deficient world.

## STAGFLATION HEADWIND IN SOME EMERGING MARKETS

Stagflation was a dominant fear in developed markets with the advent of unconventional monetary policies, but investors were looking in the wrong spot. A handful of emerging markets, like Russia, Brazil, India, Turkey, South Africa and Indonesia, are currently facing stagflation headwinds with high inflation and slow growth. Stagflation can seriously damage asset prices, usually resulting in underperformance of stocks, bonds and currencies. However, policymakers in these countries have been fighting back with orthodox monetary policy, raising interest rates and trying to curb demand to bring down inflation. Success in beating stagflation could deliver some reversal in the poor performance of asset prices, and that is something to look forward to.

## FIRST QUARTER REVIEW

**RETURNS BY SECTOR**[1] *as of March 31, 2014*

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **US Broad Market** | | | | |
| Aggregate | (0.17) | 1.84 | 1.70 | (0.10) |
| Government/Credit | (0.11) | 1.98 | 1.94 | (0.26) |
| S&P 500® | 0.84 | 1.81 | 12.51 | 21.86 |

Every fixed income benchmark in this performance review earned a positive total return during the first quarter of 2014. When bonds performed well as a whole in the recent past, the highest returns were skewed toward the lowest-quality bonds. Over the past quarter, higher-duration indices, like municipals and high grade corporates, performed in line with high yield indices, which have significantly less duration but greater credit risk.

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **US Governments** | | | | |
| US Treasurys | (0.29) | 1.34 | 0.58 | (1.26) |
| 3-month T-bills | 0.01 | 0.02 | 0.04 | 0.09 |
| 2-year Treasury | (0.09) | 0.19 | 0.26 | 0.40 |
| 5-year Treasury | (0.82) | 0.73 | (0.19) | (1.94) |
| 10-year Treasury | (0.34) | 3.38 | 0.86 | (4.39) |
| 30-year Treasury | 0.90 | 8.11 | 4.26 | (5.23) |
| US TIPS | (0.47) | 1.95 | (0.09) | (6.49) |
| US Agency | (0.17) | 1.02 | 0.85 | (0.44) |

US Treasurys rallied in the first quarter despite market consensus expectations for higher yields. According to Fed Chair Yellen's more hawkish-than-expected testimony on March 19, there is potential for a 1% federal funds rate in 2015. Yields spiked on that news, but even shorter maturities managed to earn positive returns. While it was not a particularly "risk-off" quarter, the Treasury market performed well as a whole. The 10- and 30-year yields fell by 31 basis points and 41 basis points and returned 3.38% and 8.11%, respectively. The 10-year Treasury bond outperformed US and European high yield. The 30-year Treasury was the top-performing asset in this review.

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **US Municipals** | 0.17 | 3.32 | 3.65 | 0.39 |

After posting a modest loss last quarter, municipal bonds bounced back and outperformed US and European corporates and the WGBI. A key story in this space was Puerto Rico. After being downgraded by all three major rating agencies in February, the Commonwealth came to market in March and successfully auctioned $3.5 billion of general obligation bonds with an 8% coupon due in 2035. Puerto Rico was a top performer in the index, returning over 8% for the quarter. The index's top-performing sector was industrial development/pollution control revenue, up 4.35%.

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **US Securitized** | | | | |
| MBS: Mortgage-Backed | (0.32) | 1.59 | 1.16 | 0.20 |
| ABS: Asset-Backed | (0.14) | 0.54 | 0.86 | 0.21 |
| CMBS: Commercial Mortgages | (0.10) | 1.29 | 1.83 | 1.39 |

If the Fed continues to purchase MBS at the same decreasing rate, QE will be complete by November of this year. US MBS earned the highest total return in the securitized space but did not provide a positive excess return over duration-matched Treasurys. CMBS and ABS indices posted positive total and excess returns for the quarter. Option-adjusted spreads continued to tighten throughout the quarter for all three indices.

[1] *All returns sourced from Barclays Indices except: currency returns (Bloomberg), World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P500 (FactSet and Ned Davis Research).*

**RETURNS BY SECTOR**[1] *as of March 31, 2014*

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **Corporates** | | | | |
| **US Investment Grade** | 0.07 | 2.94 | 4.08 | 1.47 |
| AAA | 0.07 | 3.42 | 3.39 | (0.67) |
| AA | (0.05) | 2.19 | 2.46 | (0.08) |
| A | (0.08) | 2.54 | 3.42 | 0.98 |
| BBB | 0.25 | 3.52 | 5.16 | 2.36 |
| **European Investment Grade** *(local currency returns)* | 0.42 | 2.36 | 3.34 | 4.21 |
| AAA | 0.51 | 3.63 | 3.65 | 1.29 |
| AA | 0.36 | 1.99 | 2.08 | 1.93 |
| A | 0.36 | 2.14 | 2.64 | 3.00 |
| BBB | 0.51 | 2.69 | 4.45 | 6.25 |
| **Sterling Investment Grade** | (0.24) | 2.33 | 2.56 | 2.20 |
| AAA | (0.06) | 1.92 | 1.20 | (0.55) |
| AA | (0.35) | 2.23 | 1.69 | 0.33 |
| A | (0.39) | 2.01 | 1.74 | 0.95 |
| BBB | (0.05) | 2.71 | 3.66 | 4.09 |

Total returns on US corporate bonds were strong during the first quarter, and option-adjusted spreads grinded toward seven-year lows. Investors were compensated for taking credit risk in lower-quality US investment grade bonds, but the performance of high-quality corporates with longer duration was nearly equivalent. In Europe, the highest-rated AAA bonds in the Euro-Aggregate Index had nearly twice the duration of BBB bonds and outperformed those lower-rated securities by nearly 100 basis points. European corporate spreads have been steadily grinding tighter since financial tension in the region eased during the fourth quarter of 2011. The effect of duration on returns was less profound in the Sterling Aggregate Index, where performance was more normally distributed relative to credit quality. The Sterling Aggregate Index option-adjusted spread was near a seven-year low set in mid-January.

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **Corporates** | | | | |
| **US High Yield** | 0.24 | 2.98 | 6.67 | 7.54 |
| BB | 0.14 | 3.11 | 6.37 | 6.24 |
| B | 0.22 | 2.75 | 6.44 | 7.29 |
| CCC | 0.55 | 3.31 | 7.72 | 11.14 |
| **Pan-Euro High Yield** *(local currency returns)* | 0.64 | 3.28 | 7.41 | 12.13 |
| BB | 0.55 | 3.08 | 7.05 | 11.04 |
| B | 0.68 | 3.13 | 7.38 | 12.68 |
| CCC | 1.15 | 4.84 | 9.27 | 17.60 |

US high yield was one of the top-performing US fixed income asset classes in the first quarter, second only to municipals. Similar to investment grade, US high yield performance was solid across all qualities, but the highest-rated securities nearly outperformed the lowest. The higher-quality sleeve of the index gained 3.11% while the lowest quality gained 3.31%, just a 20-basis-point difference. Returns in European high yield were more in line with the quality of the bonds, meaning investors were compensated for moving down in quality and accepting greater credit risk.

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **Bank Loans** | | | | |
| **US High Yield** | 0.32 | 1.12 | 2.86 | 4.26 |
| BB | 0.15 | 0.31 | 1.30 | 2.24 |
| B | 0.28 | 1.18 | 3.29 | 4.52 |
| CCC | 0.89 | 2.43 | 5.57 | 3.56 |

The Barclays US High Yield Loans Index posted its tenth consecutive quarterly gain; the last negative quarter was the third quarter of 2011. The electric segment in the utilities sector gained 2.92% and was the top performer. The consumer cyclical sector as a whole was positive for the quarter, but the restaurant segment finished down by -1.15%. Albeit a small piece of the index, low-quality bonds categorized as distressed gained 22.5% during the quarter and 48.3% over the last 12 months.

**RETURNS BY SECTOR**[1] *as of March 31, 2014*

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **Developed Countries** | | | | |
| **World Government Bond Index (WGBI)** *(local currency returns)* | 0.18 | 2.11 | 2.23 | 1.43 |
| Non-USD WGBI | 0.36 | 2.44 | 2.90 | 2.52 |
| United States | (0.27) | 1.29 | 0.56 | (1.21) |
| Canada | (0.31) | 2.23 | 2.03 | (0.32) |
| European GBI | 0.93 | 3.83 | 5.02 | 5.74 |
| France | 0.70 | 2.92 | 3.26 | 2.57 |
| Germany | 0.35 | 2.60 | 1.86 | (0.08) |
| Ireland | 0.77 | 4.20 | 8.37 | 11.44 |
| Italy | 1.42 | 5.29 | 9.19 | 12.89 |
| Spain | 1.74 | 6.00 | 8.06 | 14.57 |
| United Kingdom | 0.01 | 2.28 | 0.81 | (2.61) |
| Japan | (0.28) | 0.84 | 1.03 | 0.51 |
| Australia | (0.16) | 1.30 | 0.94 | 1.51 |

The returns of European peripheral bonds have been outstanding over the past three years, and the outperformance continued this quarter. Spanish and Italian government bonds led the pack, gaining 6.0% and 5.2%, but over the past three years, they have returned nearly 30% each. Spain and Italy were top performers, but Ireland and France also helped drive the WGBI's positive return. Yields on Irish, Spanish and Italian 10-year bonds have been approaching eight-and-a-half-year lows. Australia and the United States were up around 1.3% each, but they underperformed the broader WGBI, which was driven by European government bonds. The US economy is accelerating and QE is ending—both factors are likely to push US Treasurys higher. At the same time Europe's growth trajectory is less robust, and consequently, yields there should rise more gradually over the coming quarter.

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **Emerging Market Bonds** | | | | |
| **Emerging Market Government (EMBIG)** *(Sovereign/Quasi-Sovereign, USD)* | 1.26 | 3.48 | 4.43 | (1.05) |
| **Corporate Emerging Market Bond (CEMBI)** *(Corporates, USD)* | 0.67 | 2.79 | 4.80 | 1.24 |
| **Emerging Market Government (GBI-EM)** *(Governments, local currency)* | 1.14 | 1.78 | 2.29 | 0.33 |

During the first quarter, emerging market currencies were mixed, but most depreciated versus the US dollar. Weaker currencies put pressure on the GBI-EM Index, but it still managed a positive return. The EMBIG Index, denominated in US dollars, was the top performer as investors chose carry but shied away from currency risk. The CEMBI, also a US-dollar-pay index, outperformed the GBI-EM but underperformed the EMBIG Index. Emerging markets have had a difficult last 12 months, but value has been appearing in several areas of this asset class.

**RETURNS BY SECTOR**[1] *as of March 31, 2014*

| INDEX | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
|---|---|---|---|---|
| **Currency Markets**[2] | | | | |
| **Dollar Bloc** | | | | |
| Canadian Dollar | 0.13 | (3.86) | (6.71) | (7.93) |
| Australian Dollar | 3.81 | 3.89 | (0.57) | (11.09) |
| New Zealand Dollar | 3.27 | 5.47 | 4.37 | 3.49 |
| **Western Europe** | | | | |
| **Euro** | (0.24) | 0.19 | 1.79 | 7.41 |
| Norwegian Krone | 0.25 | 1.39 | 0.43 | (2.36) |
| Swedish Krona | (0.99) | (0.54) | (0.67) | 0.86 |
| Swiss Franc | (0.49) | 0.94 | 2.29 | 7.30 |
| British Pound | (0.50) | 0.63 | 2.94 | 9.63 |
| **Emerging Europe & Africa** | | | | |
| Czech Koruna | (0.69) | (0.23) | (4.76) | 0.70 |
| Hungarian Forint | 0.65 | (3.10) | (1.47) | 6.32 |
| Polish Zloty | (0.42) | (0.08) | 3.16 | 7.75 |
| Russian Ruble | 1.96 | (6.55) | (7.91) | (11.70) |
| South African Rand | 2.12 | (0.37) | (4.79) | (12.30) |
| Turkish New Lira | 3.06 | 0.35 | (5.71) | (15.43) |
| **Asia** | | | | |
| **Japanese Yen** | (1.39) | 2.01 | (4.80) | (8.73) |
| Chinese Renminbi | (1.16) | (2.62) | (1.55) | (0.11) |
| Indonesian Rupiah | 2.19 | 7.13 | 0.40 | (14.31) |
| Malaysian Ringgit | 0.38 | 0.34 | (0.15) | (5.23) |
| Philippine Peso | (0.40) | (0.94) | (2.99) | (8.94) |
| Singapore Dollar | 0.82 | 0.44 | (0.14) | (1.37) |
| South Korean Won | 0.27 | (1.40) | 0.93 | 4.38 |
| **Latin America** | | | | |
| Argentine Peso | (1.64) | (18.53) | (17.38) | (36.01) |
| Brazilian Real | 3.19 | 3.97 | (2.42) | (11.01) |
| Chilean Peso | 1.69 | (4.37) | (8.15) | (14.07) |
| Colombian Peso | 3.81 | (2.11) | (3.31) | (7.42) |
| Mexican Peso | 1.46 | (0.16) | 0.26 | (5.57) |
| Peruvian New Sol | (0.34) | (0.42) | (0.84) | (7.78) |

Foreign currency performance was mixed over the quarter, with many emerging market exchange rates depreciating versus the US dollar. Geopolitical tension and uncertainty over the Ukraine/Crimea situation pulled down the Russian ruble specifically. Depreciation in other EM currencies was fairly muted. During the quarter, China doubled the trading band on the US dollar/renminbi exchange rate from 1% to 2% in an effort to move toward a more free-floating currency regime. In developed currencies, Australia and New Zealand have rallied for strong gains, and the euro has held its gains, remaining around the 1.38 level. The US Dollar Index (DXY), which measures performance versus six developed market currencies, was essentially flat for the second straight quarter, up just 0.07%.

*[1]All returns sourced from Barclays Indices except: currency returns (Bloomberg), World Government Bond (Citigroup), Emerging Market Bond (JPMorganChase), and S&P 500 (FactSet and Ned Davis Research).*

*[2]Currency returns are relative to the US dollar.*

***Past performance is no guarantee of future results.***

*Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.*

## INDEX DEFINITIONS

***Barclays US Aggregate Bond Index*** *is a broad-based benchmark that measures the investment grade, US-dollar-denominated, fixed-rate taxable bond market including Treasurys, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS.*

***Barclays US Government/Credit Index*** *includes Treasurys (i.e., public obligations of the US Treasury that have remaining maturities of more than one year), government-related issues (i.e., agency, sovereign, supranational, and local authority debt), and corporates.*

***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 Potected Securities Index*** *is an unmanaged index that tracks inflation-protected securities issued by the US Treasury.*

***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*** *covers the US-dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.*

***Barclays US Securitized Index*** *consists of the US MBS Index, the Erisa-eligible CMBS Index, and the fixed-rate ABS Index. The US Mortgage-Backed Securities (MBS) Index covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The US CMBS Investment Grade Index measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300mn. The fixed-rate ABS Index includes securities backed by assets in three sectors: credit and charge card, auto and utility.*

***Barclays US Corporate Index*** *is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. It includes US-dollar-denominated securities publicly issued by US and non-US industrial, utility, and financial issuers that meet specified maturity, liquidity, and quality requirements.*

***Barclays Euro Corporate Index*** *tracks the fixed-rate, investment-grade euro-denominated corporate bond market. Inclusion is based on the currency of the issue, not the domicile of the issuer. The index includes publicly issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.*

***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 publicly issued securities from industrial, utility, and financial companies that meet specified maturity, liquidity and quality requirements.*

***Barclays US Corporate High-Yield Index*** *measures the market of US-dollar-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.*

***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). 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 Loan Index*** *covers syndicated term loans which are US-dollar denominated, with at least $150 million funded loans, 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 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 market for the US and most developed nation government bond markets. Countries must have a minimum rating of A3/A- by both Moodys' and S&P to enter the index and will be removed from the index if the ratings fall below Baa3/BBB-.*

***JPMorgan Emerging Markets Bond Index Global (EMBIG)*** *measures the market for US-dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities of qualifying emerging market countries.*

***JPMorgan Corporate Emerging Markets Bond Index (CEMBI)*** *is a market capitalization weighted index consisting of US-dollar-denominated emerging market corporate bonds.*

***JPMorgan Government Bond Index-Emerging Markets (GBI-EM)*** *tracks local currency bonds issued by emerging market governments.*

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