bond market review & outlook

By Rick Harrell, Vice President, Macro Strategies

fourth quarter 2013

After months of anxiety among investors, the Federal Reserve (the Fed) took a first step toward exiting its third quantitative easing (QE) program. However, the Fed has made it clear that the federal funds target rate will remain at zero long after tapering is complete. This forward guidance has become the tool of choice, a policy shift that will be reinforced by incoming Fed Chair, Janet Yellen. Investors have now had months to prepare for a reduction in QE, and when tapering was announced in December (earlier than many had expected), markets barely took notice. Importantly, the US economy appears to be approaching "escape velocity." So, a gradual removal of excessive monetary stimulus ought to be welcome news, and the fourth quarter's well-behaved bond market supports that case. Government bonds suffered minor losses as yields rose incrementally, while corporate credit performed well. In fact, both US and European credit spreads tightened to levels not seen since 2007. Even emerging market sovereign credit had a relatively decent fourth quarter, but the asset class was still negative for the year and a notable outlier among the credit sectors.

2013: THE YEAR OF INFLECTION

In 2013, the end of household deleveraging was a significant turning point for the US economy. Aggregate household liabilities rose for the first time since 2009, and there are early signs that consumer spending is making a comeback. As equity prices and home values rebounded, it was only a matter of time before household net worth was restored and the wealth effect kicked in, causing consumers to borrow and spend. And with most of the fiscal drag from the sequester behind us, the US now appears to be poised for stronger growth, more than at any other time since the Great Recession.

Japan has continued to pull itself out of deflation, but "Abenomics" appears, at least initially, to be incrementally successful. However, wage growth and labor market reforms will need to materialize before Japan can achieve its escape velocity. In Europe, multiple signs of a sustainable (albeit muted) recovery have been emerging. Ireland successfully exited its sovereign bailout program, unemployment rates in the peripheral economies have stopped rising or have begun to fall, and industrial activity seems to be picking up across the region on the back of solid export growth. Improving global growth, low inflation and still highly accommodative monetary policy created a positive environment for global credit, especially high yield and equity-linked assets, in 2013.

WHAT'S IN STORE FOR 2014?

Overall, we expect fixed income returns to be lackluster in 2014. There is not much juice left to squeeze from corporate credit markets where spreads are currently razor thin. However, high yield and floating-rate products, such as bank loans, are likely to repeat 2013's strong performance. As a consequence of the US leading a global economic acceleration in 2013, US Treasurys were the worst performing developed government bond market for the year. We expect government bonds will be flat in 2014, if not slightly negative, and non-US government bonds, especially those in peripheral Europe, should outperform US Treasurys. Emerging market (EM) sovereigns could make a comeback in 2014. The discount of EM sovereigns to corporate credit is presently at a four-year high. But, investors will need to be selective in this space, since many developing countries have experienced deteriorating fundamentals as a result of sliding commodity prices.

We believe the key risk going into 2014 is the "upside" growth scenario. Should the economy gallop ahead too quickly and inflation move higher, the markets will test the Fed's forward guidance, and we could see a repeat of last summer's bond market rout. Otherwise, in an environment of stronger global growth and dovish central bank policy, risk assets should perform well.

FOURTH QUARTER REVIEW

RETURNS BY SECTOR[1] *as of December 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Broad Market				
Aggregate	(0.57)	(0.14)	0.43	(2.02)
Government/Credit	(0.62)	(0.03)	0.33	(2.35)
S&P 500®	2.53	10.51	16.31	32.39

With the exception of Treasurys, US fixed income performance was stronger in the fourth quarter than in the second or third quarters of 2013. On December 18, the Federal Open Market Committee (FOMC) announced that it would decrease its monthly asset purchases to $35 billion for agency mortgage-backed securities (MBS) and $40 billion for longer-term Treasury securities beginning in January. The $10 billion taper, $5 billion to each asset class, signaled an eventual end to quantitative easing, but the message that day also reinforced forward guidance on low rates. US high yield and investment grade spreads rallied to six-year lows on the taper announcement, and the US Treasury curve steepened as yields on longer maturities moved higher while the front end remained anchored.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Governments				
US Treasurys	(0.91)	(0.75)	(0.65)	(2.75)
3-month T-bills	0.01	0.01	0.04	0.08
2-year Treasury	(0.11)	0.08	0.30	0.30
5-year Treasury	(1.48)	(0.91)	(0.22)	(2.47)
10-year Treasury	(2.01)	(2.44)	(3.09)	(7.81)
30-year Treasury	(1.99)	(3.56)	(6.61)	(15.03)
US TIPS	(1.47)	(2.00)	(1.31)	(8.61)
US Agency	(0.56)	(0.17)	0.11	(1.38)

While FOMC purchases supported longer-term government securities, it was not enough to generate positive returns for the quarter. The 30-year maturity suffered the largest loss this quarter, followed by the 10-year and 5-year. The FOMC's forward guidance held the front end of the yield curve down, but yields on short maturities still rose marginally. Even with the incremental rise in yields, 3-month and 2-year Treasury bills posted positive returns for the quarter and the year. Every other US government segment, including Treasury inflation-protected securities (TIPS) and agencies, had a negative total return for the quarter and the year.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Municipals	(0.26)	0.32	0.14	(2.55)

Municipal bonds earned positive returns across the vast majority of benchmark indices during the fourth quarter. Only one of the lower 48 states, Wyoming, posted a negative return over that period. The poor performance of the Puerto Rico index is notable, as it lost over 5% for the quarter. A significant debt burden and unfunded retiree obligations spooked investors, and increased uncertainty about Puerto Rico's ability to access the debt market exacerbated those fears over the past quarter. For the year, US municipal bond performance resembled the return profile of Treasurys, with the longer-maturity buckets suffering losses.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Securitized				
MBS: Mortgage-Backed	(0.47)	(0.42)	0.61	(1.41)
ABS: Asset-Backed	(0.22)	0.32	0.48	(0.27)
CMBS: Commercial Mortgages	(0.29)	0.53	1.56	0.23

The inevitability of a taper to MBS purchases combined with uncertainty about its timing kept securitized asset investors cautious throughout the quarter. Although the total return was negative, US MBS provided a positive excess return over duration-matched Treasurys in the fourth quarter. Over the same period, ABS and CMBS indices fared better, posting positive total returns and outperforming Treasurys of comparable duration.

[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 December 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US Investment Grade	(0.16)	1.11	1.94	(1.53)
AAA	(0.45)	(0.03)	(0.14)	(4.69)
AA	(0.44)	0.26	0.75	(2.42)
A	(0.26)	0.86	1.76	(1.86)
BBB	0.01	1.59	2.43	(0.93)
European Investment Grade *(local currency returns)*	(0.43)	0.96	2.28	2.37
AAA	(1.09)	0.02	0.21	(1.61)
AA	(0.62)	0.08	0.84	0.23
A	(0.52)	0.48	1.61	1.34
BBB	(0.27)	1.71	3.43	4.21
Sterling Investment Grade	(0.88)	0.22	2.86	1.64
AAA	(0.98)	(0.71)	1.30	(1.71)
AA	(0.88)	(0.53)	1.31	(0.65)
A	(0.97)	(0.26)	2.32	0.40
BBB	(0.77)	0.93	3.80	3.71

Performance in the global investment grade corporate space was generally negative during December. But over the entire fourth quarter, returns were mixed, with Europe outperforming the UK and US. With the exception of AAA rated bonds, US corporates had a positive quarter but suffered losses for the year. In Europe and the UK, risk-takers were rewarded for holding the lowest-rated investment grade debt, BBB quality, during the fourth quarter and the year. Annual returns in the US were modestly negative in the BBB quality segment, but in Europe and the UK, the return for BBB debt was around 4%.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US High Yield	0.54	3.58	5.95	7.44
BB	0.36	3.16	4.99	5.05
B	0.52	3.59	6.00	7.27
CCC	0.94	4.27	8.10	13.82
Pan-Euro High Yield *(local currency returns)*	0.66	4.00	8.18	9.90
BB	0.57	3.85	7.48	9.10
B	0.81	4.12	9.13	10.67
CCC	1.16	4.22	9.93	13.17

High yield has been the shining star of fixed income markets all year. The search for yield continued during the fourth quarter, as investors accepted lower credit quality for higher yielding securities. The return profile among high yield corporates is generally similar to investment grade, increasingly positive returns as credit quality declines. The lowest quality bucket was the top-performing group in our fixed income universe, returning more than 13% in the US and Europe.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Bank Loans				
US High Yield	0.49	1.73	2.92	5.39
BB	0.40	0.98	2.00	3.27
B	0.59	2.08	3.34	5.95
CCC	1.77	3.07	1.19	6.90

Bank loans have been a source of positive total return and stability throughout the year. In December, annual retail loan fund inflows hit $60 billion, which is more than three times the previous annual record of $17.9 billion. Bank loan investors that moved down the quality spectrum in search of higher yields were rewarded, as CCC rated debt outperformed for the quarter and year.

RETURNS BY SECTOR[1] *as of December 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Developed Countries				
World Government Bond Index (WGBI) *(local currency returns)*	(0.67)	0.12	0.85	0.19
Non-USD WGBI	(0.60)	0.46	1.47	1.38
United States	(0.87)	(0.72)	(0.64)	(2.65)
Canada	(0.60)	(0.20)	(0.33)	(2.28)
European GBI	(0.58)	1.14	2.09	2.22
France	(0.93)	0.33	0.84	(0.50)
Germany	(1.13)	(0.72)	(0.73)	(2.24)
Ireland	0.72	4.00	5.94	11.33
Italy	0.02	3.70	5.16	7.30
Spain	0.20	1.94	5.48	11.05
United Kingdom	(1.20)	(1.44)	(0.96)	(4.09)
Japan	(0.57)	0.19	1.56	2.21
Australia	0.45	(0.35)	0.31	0.10

The global economy is in a synchronized expansion led by the United States and assisted by Europe and Japan. Although the economic direction of these countries is similar, asset performance still varies. The government bond markets that provided positive returns this quarter had higher yields and greater credit risk than investments traditionally considered "safe havens." Even though the underlying economies are expanding, risky government bond markets can still rally if credit quality is improving. Perceived safe-haven countries like the US, UK and Germany, where interest rates bottomed and growth is accelerating, experienced losses in their government bond markets.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Emerging Market Bonds				
Emerging Market Government (EMBIG) *(Sovereign/Quasi-Sovereign, USD)*	0.58	0.91	1.79	(6.58)
Corporate Emerging Market Bond (CEMBI) *(Corporates, USD)*	0.17	1.96	3.02	(0.60)
Emerging Market Government (GBI-EM) *(Governments, local currency)*	0.44	0.50	1.20	(0.28)

A second consecutive positive quarter for emerging markets boosted the six-month return for each index, but the asset class still had negative returns for the year. Investors that sought high yield in emerging markets were not rewarded like those in bank loans, global corporates or developed market high yield and sovereign securities. On a total return basis, these indices have not fully recovered from the taper talk selloff that began in May. According to JP Morgan, inflows to dedicated EM fixed income concluded the year at +$10 billion, down from a record +$98 billion in 2012.

RETURNS BY SECTOR[1] *as of December 31, 2013*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Currency Markets[2]				
Dollar Bloc				
Canadian Dollar	(0.08)	(2.96)	(0.98)	(6.61)
Australian Dollar	(2.10)	(4.29)	(2.42)	(14.21)
New Zealand Dollar	1.11	(1.04)	6.15	(0.89)
Western Europe				
Euro	1.12	1.60	5.63	4.17
Norwegian Krone	0.92	(0.94)	(0.02)	(8.34)
Swedish Krona	1.71	(0.13)	4.07	1.01
Swiss Franc	1.49	1.34	5.83	2.52
British Pound	1.15	2.29	8.83	1.86
Emerging Europe & Africa				
Czech Koruna	1.25	(4.54)	0.51	(4.41)
Hungarian Forint	2.59	1.68	4.90	2.13
Polish Zloty	2.35	3.25	9.98	2.34
Russian Ruble	0.76	(1.46)	(0.09)	(7.13)
South African Rand	(3.03)	(4.43)	(5.83)	(19.24)
Turkish New Lira	(6.01)	(6.04)	(10.25)	(16.97)
Asia				
Japanese Yen	(2.73)	(6.69)	(5.86)	(17.62)
Chinese Renminbi	0.66	1.10	1.37	2.91
Indonesian Rupiah	(1.69)	(6.29)	(17.80)	(19.54)
Malaysian Ringgit	(1.58)	(0.49)	(3.52)	(6.65)
Philippine Peso	(1.43)	(2.07)	(2.84)	(7.64)
Singapore Dollar	(0.59)	(0.57)	0.39	(3.26)
South Korean Won	0.80	2.37	8.79	1.39
Latin America				
Argentine Peso	(5.81)	(11.17)	(17.38)	(24.61)
Brazilian Real	(1.10)	(6.14)	(5.52)	(13.15)
Chilean Peso	1.30	(3.95)	(3.24)	(8.80)
Colombian Peso	0.10	(1.22)	(0.35)	(8.42)
Mexican Peso	0.56	0.42	(0.81)	(1.41)
Peruvian New Sol	0.10	(0.42)	(0.51)	(8.77)

The US Dollar Index (DXY), which measures US dollar performance versus six developed market currencies, was up 0.02% for the quarter. Within the DXY, the euro, British pound and the Swiss franc appreciated versus the US dollar, and the yen, Canadian dollar and Swedish krona fell. The DXY index dramatically understates US dollar strength against emerging market currencies, which sold off significantly during the fourth quarter. Several currencies in Asia, Latin America and emerging Europe suffered losses between 2% and 10% for the quarter. A few bright spots included the Chinese renminbi and Korean won, which bested the dollar for small gains, and in emerging Europe, Hungary and Poland also appreciated.

[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.

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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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