bond market review & outlook

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third quarter
2014

The US economy diverged from many of the world's economies in the third quarter as it continued to lead global growth. US monetary policy, interest rates, currency and credit market performance are veering the most from those in Europe, Japan, Latin America and China, where growth has disappointed recently. A look at the US dollar can provide some insight into how this divergence is impacting the fixed income markets.

KEY TAKEAWAYS

- A strong US dollar can help cap inflation and delay interest rate hikes, benefiting bond investors.
- Look for global growth to firm in 2015 as the US economy strengthens and other countries ease monetary policy.
- Credit valuations are full, but rising profits can keep leverage in check and prolong the cycle.

HEAVY LIFTING FROM A STRONG DOLLAR

The US dollar was the standout performer for the quarter, driven by many of the same factors that affect fixed income performance—for example, monetary policy and changes in interest rates. As the Federal Reserve (the Fed) ends quantitative easing, the European Central Bank (ECB) is just getting started. The ECB signaled that it would like to grow its balance sheet by about €1 trillion. These diverging policies have led to a rapid rise in the dollar versus the euro. But the dollar has not only appreciated against the euro. It has made a broad move higher against many developed and emerging market currencies as central banks cut interest rates in an effort to stimulate demand.

The dollar has been gaining from the rise in US interest rates, especially at the front end of the curve, where 2- and 5-year Treasury yields have achieved new highs for the year. European yields have plunged as the economy continues to stagnate and deflation risks increase. Yields on 10-year German bunds have dropped below 1.0% while German 2-year yields have gone negative. It is hard to believe, but the US is looking more and more like a global high yielder even with the 10-year Treasury around 2.5%.

The US economy and interest rate profile can benefit from a stronger dollar at this point. First, a rising dollar can help keep a lid on import prices, especially commodity prices, so input costs are lower. And with a strong dollar helping contain inflationary pressures, the Fed can increase rates more slowly than it otherwise would in a rising growth environment. Investors have already seen this effect begin to play out—US fixed income markets benefited from lower yields to a great extent this year, thanks largely to a stronger dollar and deflationary pressures imported from Europe.

LOOKING FOR GROWTH, EYEING RISKS

Competitive devaluations are a theme we have highlighted all year. In a demand-deficient world, and with interest rates presently at the zero bound, currency devaluation is another important policy lever. We think weaker currencies, more stimulative monetary policy from China, Europe and others, and a stronger US economy will finally give global growth a more substantial lift in 2015.

Credit markets could use a period of stronger growth to feed better corporate earnings. Credit valuations are full, but a jump in profits can keep leverage in check and prolong the cycle. We have seen some spread widening recently in high yield and investment grade credits, but we expect earnings to rise and view this as more of a buying opportunity.

Investors should be aware that dollar bull markets can come with a downside in that they generally coincide with significant economic and financial pressure in another region of the world. We see risk premiums rising in a few commodity- and emerging-market-related asset prices, but nothing alarming at this point.

RETURNS BY SECTOR[1] *as of September 30, 2014*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Broad Market				
Aggregate	(0.68)	0.17	2.21	3.96
Government/Credit	(0.90)	0.17	2.10	4.08
S&P 500®	(1.40)	1.13	6.42	19.73

Year-to-date strength in high grade US fixed income markets carried over into the third quarter despite a rise in US Treasury volatility. Longer duration fixed income indices tended to outperform those with shorter duration again this quarter. While total returns were mixed, most US corporate credit indices failed to produce positive excess returns during the period.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Governments				
US Treasurys	(0.55)	0.34	1.70	2.28
3-month T-bills	0.00	0.01	0.03	0.06
2-year Treasury	(0.08)	0.04	0.30	0.56
5-year Treasury	(0.54)	(0.19)	0.99	0.81
10-year Treasury	(1.23)	0.75	3.43	4.32
30-year Treasury	(2.12)	3.33	8.74	13.37
US TIPS	(2.50)	(2.04)	1.69	1.59
US Agency	(0.29)	0.19	1.37	2.22

Though US Treasury volatility increased during the third quarter, performance remained broadly positive. More hawkish language from the Federal Open Market Committee (FOMC) caused the yield on shorter maturities to rise, but the yield on 10-year maturities remained flat while the 30-year yield declined by 18 basis points. There is potential for increased rate volatility as the market grapples with the date and pace of future rate hikes, but FOMC decisions remain data dependent, and inflation has been tame. Inflation expectations, as measured by break-even rates on Treasury inflation-protected securities (TIPS), steadily declined throughout the quarter. As a result, the US TIPS index produced a negative total return for the period.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Municipals	0.10	1.49	4.12	7.93

Municipal bonds have performed well over the last three quarters on the back of low-to-moderate US Treasury volatility. Municipal bonds generally offer high grade investors better yields than they could earn on Treasurys. During this quarter, municipal bonds with the longest duration offered the highest total returns. From a sector stand point, industrial development & pollution control bonds were the top performer, besting the broad municipal index by over 60 basis points. At the state level, New York and California, which represent more than one third of broad index assets, outperformed the municipal benchmark by over 20 basis points each.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US Securitized				
MBS: Mortgage-Backed	(0.16)	0.18	2.59	3.78
ABS: Asset-Backed	(0.15)	0.01	0.78	1.65
CMBS: Commercial Mortgages	(0.52)	(0.23)	1.08	2.93

As the third quarter began, option-adjusted spreads on all three major securitized benchmarks began to steadily trend higher. During September, CMBS and ABS spreads continued to rise, while the longer duration US MBS index managed to tighten by six basis points. Although total returns were generally positive, each of the indices underperformed duration-matched US Treasurys for the quarter.

[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).*

RETURNS BY SECTOR[1] *as of September 30, 2014*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US Investment Grade	(1.44)	(0.08)	2.58	6.77
AAA	(1.26)	0.45	2.87	6.37
AA	(1.00)	0.18	2.05	4.56
A	(1.36)	(0.02)	2.33	5.83
BBB	(1.63)	(0.21)	2.96	8.28
European Investment Grade *(local currency returns)*	0.18	1.84	4.28	7.76
AAA	0.14	3.66	7.31	11.23
AA	0.31	1.96	4.23	6.40
A	0.23	2.02	4.27	7.02
BBB	0.08	1.60	4.27	8.91
Sterling Investment Grade	(0.54)	2.93	5.25	7.94
AAA	(0.87)	5.70	8.11	9.41
AA	(0.47)	3.49	5.15	6.92
A	(0.60)	3.41	5.57	7.41
BBB	(0.48)	2.24	4.87	8.70

Option-adjusted spreads on US Corporate Investment Grade and Sterling Aggregate Corporate indices bottomed in mid- to late June and rose through the third quarter. Relative to US Corporates, the rise in Sterling Corporate spreads was smaller and less meaningful to total returns. Additional easing measures announced by Mario Draghi and the ECB Governing Council helped push the Euro-Aggregate Corporate index to a new spread low of 89 basis points in early September. AAA-rated securities in each of the three indices had the highest duration and posted the highest total returns for the third quarter. At the sector level, utility companies were a standout segment of the US corporate index, while energy lagged on continued oil price declines. The technology sector of the Euro-Aggregate index was the top performer, while financials, although positive, lagged the broad index return for the quarter. In the Sterling Aggregate Corporate index, utilities were the top sector, while technology provided a positive return but lagged the aggregate index.

The table above shows total returns in local currency terms, so the effect of euro and pound volatility during the quarter is not captured. Over the past three months, those currencies came under considerable pressure versus the US dollar, falling 6.82% and 4.56%, respectively. In US dollar terms, the Euro- and Sterling Aggregate indices would have produced negative returns.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Corporates				
US High Yield	(2.09)	(1.87)	0.49	7.20
BB	(1.93)	(1.34)	1.28	7.73
B	(1.97)	(1.86)	0.29	6.74
CCC	(2.72)	(2.74)	(0.39)	7.30
Pan-Euro High Yield *(local currency returns)*	(0.53)	(0.06)	2.61	10.21
BB	0.23	1.12	4.09	11.43
B	(1.62)	(1.60)	0.54	7.96
CCC	(2.62)	(2.40)	0.21	9.50

A less dovish message from FOMC participants caused investors to reassess the future path of federal funds rate hikes, which introduced volatility to the markets. As the Chicago Board Options Exchange Volatility Index (VIX), a broad measure of market volatility, began to rise in July, high yield spreads in Europe and the US also rose. Market volatility and spread widening cooled through August but returned in September. Susceptibility to market volatility and the short duration nature of high yield securities negatively impacted high yield performance this quarter.

RETURNS BY SECTOR[1] *as of September 30, 2014*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Bank Loans				
US High Yield	(0.66)	(0.51)	0.88	3.77
BB	(0.57)	(0.45)	0.38	1.69
B	(0.51)	(0.21)	0.89	4.21
CCC	0.43	2.08	4.95	10.80

The High Yield Loan index total return ebbed and flowed with market volatility throughout the quarter. The index posted a small loss for the month of July, rallied 26 basis points in August, but fell 66 basis points in September. Poor performance in high yield bond indices spilled over into high yield loans, even though the assets have different characteristics. A positive catalyst for the bank loan index is the near absence of default risk over the next twelve months as a minor 0.12% of index value matures.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Developed Countries				
World Government Bond Index (WGBI) *(local currency returns)*	(0.19)	1.56	3.43	5.73
Non-USD WGBI	(0.05)	2.04	4.13	7.16
United States	(0.54)	0.33	1.65	2.22
Canada	(0.70)	0.88	2.47	4.54
European GBI	0.08	2.93	6.07	11.39
France	(0.26)	2.69	5.86	9.30
Germany	(0.17)	2.36	4.63	6.57
Ireland	0.73	3.17	7.54	16.54
Italy	0.59	3.16	6.79	16.61
Spain	0.37	3.64	7.08	15.71
United Kingdom	(0.69)	4.01	5.23	6.09
Japan	0.08	0.63	1.44	2.49
Australia	(0.50)	1.04	4.66	5.65

Global bonds within the WGBI earned positive total returns in local currency terms during the quarter. The ECB announced additional measures to ease financial conditions and offered a glimpse into potential asset purchase programs to be used as a means of easing further. Sovereign quantitative easing is unlikely, but peripheral sovereign debt in the euro zone continued to rally. Economic growth in the UK has been increasing, and market participants expect a Bank of England rate hike by March 2015, but UK gilts still earned a positive total return this quarter. Japan government bonds managed to rally during the quarter, but there were no major shifts in monetary policy, nor are any expected through year-end. Local currency global fixed income returns were strong for the quarter, but foreign currencies were weak. For a US-dollar-based investor, the positive returns of global fixed income would have been overshadowed by weakness in foreign exchange.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Emerging Market Bonds				
Emerging Market Government (EMBIG) *(Sovereign/Quasi-Sovereign, USD)*	(2.41)	(1.65)	3.69	8.28
Corporate Emerging Market Bond (CEMBI) *(Corporates, USD)*	(0.86)	(0.09)	3.36	8.33
Emerging Market Government (GBI-EM) *(Governments, local currency)*	(0.66)	0.51	4.04	6.42

As market volatility rose through July, high yield emerging market assets were negatively impacted, much like US and European high yield indices. Spreads widened on EMBIG and CEMBI US-dollar-denominated benchmarks as yields on the underlying bonds began to rise. The GBI-EM yield also rose during the quarter. However, the high income nature of securities within the index fueled its outperformance versus the EMBIG and CEMBI, which yielded 5.7% and 5.3%, respectively, compared to 6.8% for GBI-EM. Political tension between Russia and Ukraine also impacted the performance of each index. Ukraine represents a negligible 1.9% of the EMBIG and 0.76% of the CEMBI, but Russia represents approximately 8.5% of the EMBIG, 4.9% of the CEMBI, and 7.2% of the GBI-EM.

RETURNS BY SECTOR[1] *as of September 30, 2014*

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
Currency Markets[2]				
Dollar Bloc				
Canadian Dollar	(2.86)	(4.71)	(1.32)	(7.94)
Australian Dollar	(6.34)	(7.27)	(5.58)	(6.12)
New Zealand Dollar	(6.63)	(10.85)	(9.87)	(5.93)
Western Europe				
Euro	(3.82)	(7.75)	(8.26)	(6.62)
Norwegian Krone	(3.56)	(4.56)	(6.81)	(6.41)
Swedish Krona	(3.08)	(7.35)	(10.27)	(10.87)
Swiss Franc	(3.86)	(7.15)	(7.38)	(5.26)
British Pound	(2.32)	(5.22)	(2.69)	0.17
Emerging Europe & Africa				
Czech Koruna	(2.99)	(7.92)	(8.43)	(12.78)
Hungarian Forint	(2.56)	(8.07)	(9.30)	(10.64)
Polish Zloty	(3.16)	(8.24)	(8.60)	(5.71)
Russian Ruble	(6.27)	(14.19)	(11.18)	(18.21)
South African Rand	(5.48)	(5.74)	(6.68)	(11.14)
Turkish New Lira	(5.06)	(7.01)	(6.04)	(11.40)
Asia				
Japanese Yen	(5.07)	(7.59)	(5.85)	(10.38)
Chinese Renminbi	0.07	1.04	1.27	(0.30)
Indonesian Rupiah	(4.09)	(2.57)	(6.79)	(6.42)
Malaysian Ringgit	(3.92)	(2.12)	(0.49)	(0.64)
Philippine Peso	(3.06)	(2.91)	(0.33)	(3.31)
Singapore Dollar	(2.12)	(2.29)	(1.43)	(1.57)
South Korean Won	(3.92)	(4.11)	0.90	1.84
Latin America				
Argentine Peso	(0.29)	(3.50)	(5.04)	(31.28)
Brazilian Real	(8.62)	(9.51)	(7.15)	(9.40)
Chilean Peso	(1.81)	(7.58)	(8.16)	(15.65)
Colombian Peso	(5.15)	(7.28)	(2.65)	(5.87)
Mexican Peso	(2.56)	(3.43)	(2.76)	(2.51)
Peruvian New Sol	(1.57)	(3.18)	(2.83)	(3.65)

After essentially flat performance over the past three quarters, the US dollar index (DXY) rallied for a massive 7.78% gain. Most of the DXY move can be explained by diverging monetary policies and interest rates in the US and Europe. The Fed is growing less dovish and winding down asset purchases, just as the Governing Council at the ECB is discussing potential asset purchase programs that could expand the balance sheet by €1 trillion. While the euro represents 57.6% of the DXY index, Japanese yen, the second highest weight, represents a still substantial 13.6%. The Bank of Japan did not adjust the current policy mix this quarter, but the yen still tumbled 7% lower versus the US dollar. Emerging market currencies also depreciated throughout the period. Eastern European currencies were particularly pressured as a result of political tensions. In Latin America, declining economic fundamentals were a key driver of weakness. Emerging Asian currencies declined the least, and the Chinese renminbi managed to appreciate versus the US dollar.

[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 *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 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 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). 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*, also known as the bank 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.*

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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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