Bond Market Review and Outlook

By Rick Harrell, Senior Sovereign Analyst

KEY TAKEAWAYS

- Fourth-quarter market volatility was driven by falling oil prices and a strengthening US dollar.
- Diverging monetary policies seem set to continue in 2015.
- Cheaper oil should be a net positive for global GDP next year, but benefits will not be evenly distributed.

The US economy continues to accelerate in contrast to stagnant or slowing growth in Europe, Japan and many emerging economies. The global monetary policy divergence that has been developing since 2013 seems at its most extreme yet. These diverging dynamics have reinforced the US dollar's strength and continue to drive markets.

Global growth expectations were continually cut throughout 2014 as China and Japan disappointed and European growth remained uninspiring. With growth still faltering, many central banks have been ramping up efforts to stimulate their economies through easy monetary policy. The Bank of Japan (BoJ) stepped up its already aggressive quantitative easing (QE) program, and the European Central Bank (ECB) is closer than ever to expanding its balance sheet with sovereign QE. In contrast, the Federal Reserve (the Fed) concluded its third round of QE in October due to the steady improvement in the US economy. The US labor market is beginning to firm, and early signs of accelerating wage inflation are emerging. Share buybacks and dividend payouts are also increasing—indicators that the US is moving into the later stages of its credit cycle. However, corporate profits should ramp up and prolong this phase of the credit cycle. While the Fed could delay interest rate hikes if inflation surprises to the downside because of lower oil prices, the US will likely be the first major developed economy to see higher policy rates next year. Diverging monetary policies seem set to continue in 2015.

All About the US Dollar and Oil

On the back of the improving US economy, the dollar galloped ahead again in the fourth quarter, putting every other currency return in negative territory. Coincident with dollar strength, the drop in oil prices intensified and wreaked havoc on energy-linked assets. By mid-December, oil's tumble had put the Russian ruble into free fall, sparking a wave of contagion that hit risk assets.

While US energy-related names underperformed significantly, the rise in volatility from the abrupt rout in oil caused credit spreads to widen across the entire industrial spectrum, with nearly all sectors posting negative excess returns. In the fourth quarter alone, US investment grade and high yield gave back over 100 and 200 basis points in performance, respectively, and ended the year with negative excess returns. Residential mortgage-backed securities (RMBS) and securitized commercial mortgaged-backed securities (CMBS) were safe havens amid the broader credit weakness and did not see spreads widen. European corporates outperformed their US counterparts amid speculation that corporate bonds will be on the ECB's menu of bond purchases.

Developed market yield curves flattened relentlessly throughout 2014, and the trend only intensified in the fourth quarter. For example, yields on 2-year US Treasurys reached new cyclical highs, reflecting the US economy's steady improvement. But the longer end of the curve, more influenced by global developments and concerns about slower secular growth, marched lower the entire year. Additionally, market-based measures of inflation expectations followed oil lower. In fact, Germany's five-year breakeven inflation rate has recently been negative, implying that market participants expect the euro zone to register negative rates of inflation soon. All of this enabled long duration bonds to do well. Unsurprisingly, longer-maturity bonds were the top-performing fixed income sector for the quarter and year. In the US, 30-year Treasurys delivered a double-digit return in fourth quarter alone.

Cheaper Oil Should be Positive for Global Growth, but a Strong US Dollar is a Key Risk for Emerging Markets

Looking ahead, the decline in oil prices should stimulate global growth. There will be winners and losers from lower oil prices as economic gains are redistributed from oil producers to oil consumers. The obvious losers are oil-exporting nations such as Russia, Venezuela and Nigeria, while the US, Western Europe and most of Asia stand to benefit. With global central banks (excluding the Fed) maintaining monetary stimulus amid low inflation and better growth, investor risk appetite should remain strong. But excessive US-dollar appreciation is a key risk going into 2015 as it will be a headwind for emerging markets (EM), particularly in the private sector where US dollar leverage is high. If asset-liability mismatches arise from large currency swings, default risks will rise, and broader contagion emanating from EM cannot be ruled out. On balance, however, the share of global GDP that prospers from lower oil should far exceed the share that doesn't. If crude oil prices remain low, there is good reason to be optimistic about improving global growth in 2015.

Fourth Quarter Review

RETURNS BY SECTOR[1]
as of December 31, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US BROAD MARKET				
AGGREGATE	0.09	1.79	1.96	5.97
GOVERNMENT/CREDIT	0.08	1.82	1.99	6.01
S&P 500	(0.25)	4.93	6.12	13.69

Volatility in the US Treasury and stock markets spiked on two occasions during the fourth quarter. Markets were driven by several macroeconomic factors, including uncertainty over the pace of future fed funds rate hikes and oil prices plummeting nearly 40%. On average, volatility was higher during the fourth quarter than in the first three quarters of the year, but the spikes responsible for that higher average were short lived. The majority of fixed income indices earned positive total returns for the quarter, but US Treasury inflation-protected securities (TIPS) and high yield indices declined. Longer-duration investment grade indices provided the highest total returns for the quarter.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US GOVERNMENTS				
US TREASURYS	0.14	1.93	2.28	5.05
3-MONTH T-BILLS	(0.00)	0.00	0.02	0.05
2-YEAR TREASURY	(0.22)	0.17	0.21	0.66
5-YEAR TREASURY	(0.47)	1.14	0.95	2.89
10-YEAR TREASURY	0.38	3.57	4.34	10.74
30-YEAR TREASURY	3.47	10.06	13.72	29.38
US TIPS	(1.13)	(0.03)	(2.07)	3.64
US AGENCY	0.01	1.16	1.34	3.58

Yields on short-dated maturities, ranging from six months to three years, rose during the quarter as investors prepared for a fed funds rate hike in 2015. Conversely, the long end of the US yield curve rallied, sending yields on 5-, 7-, 10- and 30-year Treasurys lower. The 30-year yield fell by 44 basis points and the 10-year fell by more than 30 basis points. As a result of foreign central bank easing, the world's risk-free asset, the US Treasury, provided additional yield over government bonds from Italy, Spain, Germany and Japan in an appreciating currency. Another driver of US Treasury performance was the unrelenting decline of US inflation expectations, which is positive for nominal Treasurys but unfavorable for TIPS.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US MUNICIPALS	0.50	1.37	2.88	9.05

The US Municipal Bond index provided a positive return during each quarter of 2014 but failed to outperform the US Treasury index in the fourth quarter as it had in the previous three periods. Though municipal bonds underperformed US Treasurys in the fourth quarter, the index handily outperformed over the past 12 months. Longer-duration segments of the municipal index provided the highest total returns. The long bond segment of the municipal index returned 2.36% for the period and had a duration of 9.85 years, versus the aggregate municipal index return of 1.37% with a duration of 6.1 years.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US SECURITIZED				
MBS: MORTGAGE-BACKED	0.15	1.79	1.97	6.08
ABS: ASSET-BACKED	(0.22)	0.55	0.56	1.88
CMBS: COMMERCIAL MORTGAGES	(0.15)	1.45	1.21	3.86

Much like the US Treasury and Municipal indices, US securitized assets with the longest duration realized the highest returns. The US MBS index had a duration of 4.34 years and led the group during the quarter, followed closely by the CMBS index, which had a similar duration of 4.29 years. Option-adjusted spreads (OAS) on all three securitized benchmarks tightened marginally over the quarter, which contributed to the outperformance of each index over duration-matched US Treasurys.

[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 December 31, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
CORPORATES				
US INVESTMENT GRADE	0.06	1.77	1.69	7.46
AAA	0.73	3.18	3.65	9.78
AA	0.25	1.98	2.17	6.35
A	0.29	2.20	2.18	7.23
BBB	(0.25)	1.22	1.01	7.89
EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	0.55	1.55	3.42	8.40
AAA	1.37	3.34	7.13	14.92
AA	0.62	1.40	3.39	7.80
A	0.63	1.69	3.74	8.30
BBB	0.43	1.44	3.06	8.61
STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	1.38	4.46	7.53	12.51
AAA	2.34	8.32	14.49	19.36
AA	1.59	5.09	8.76	12.97
A	1.58	4.82	8.40	12.89
BBB	1.11	3.88	6.21	11.89

The higher-duration profile of investment grade corporate bond indices drove outperformance relative to high yield corporates during the quarter. Although the OAS on US and Sterling investment grade indices rose 19 and 16 basis points, respectively, the indices, particularly Sterling, still earned the some of the highest total returns outside of long duration US Treasurys. The AAA segment of the Sterling index had a duration of 14.3 years, which led to a strong return relative to the shorter-duration, lower-rated segments within the same index. The OAS on the Euro-Aggregate index had tightened nearly six basis points by mid-November but finished the quarter only two basis points tighter. Speculation about additional easing from the ECB in 2015 kept downward pressure on the Euro-Aggregate OAS.

The table above shows total returns in local currency terms, so the effect of euro and pound volatility versus the US dollar is not captured. During the fourth quarter, the euro fell 4.2% and the pound fell 3.9%. In US-dollar terms, the Euro-Aggregate index produced a negative return, while the Sterling Aggregate index returned 0.54%.

CORPORATES				
US HIGH YIELD	(1.45)	(1.00)	(2.85)	2.45
BB	(0.63)	0.90	(0.46)	5.37
B	(1.63)	(1.52)	(3.36)	1.47
CCC	(3.00)	(3.91)	(6.54)	(1.11)
PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	0.36	0.99	0.93	7.02
BB	0.57	1.62	2.75	9.03
B	0.17	0.24	(1.36)	3.94
CCC	(1.12)	(2.24)	(4.59)	2.71

US and Pan-European high yield OAS spiked in October and December along with stock market volatility. But the Chicago Board Options Exchange Volatility Index (VIX), a broad measure of market volatility, has retreated, while high yield spreads remain elevated. Since July, the OAS levels on both US and Pan-European indices have widened. Over the fourth quarter, yields on the US and Pan-European indices rose 48 and 7 basis points, respectively. The BB segment of both high yield indices earned a positive return that outpaced each respective aggregate index, but only the US BB segment had a materially higher duration than the aggregate index. The Pan-European high yield index duration of 3.86 is nearly the same as its BB component at 3.88 years.

RETURNS BY SECTOR[1]
as of December 31, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
BANK LOANS				
US HIGH YIELD	(1.31)	(0.46)	(0.97)	1.54
BB	(0.58)	0.76	0.31	1.47
B	(1.25)	(0.27)	(0.48)	1.81
CCC	(1.12)	(1.14)	0.92	6.27

Though bank loans have materially different characteristics relative to high yield, the performance of high yield corporates tends to spill over into the bank loan space. Similar to US high yield corporates, the BB segment of the bank loan index earned a positive return, while the aggregate index did not. Bank loans are floating-rate instruments and therefore do not have duration. The higher credit quality of BB-rated bank loans relative to other segments of the index drove the index's outperformance.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
DEVELOPED COUNTRIES				
WORLD GOVERNMENT BOND INDEX (WGBI) *(LOCAL CURRENCY RETURNS)*	0.85	2.71	4.31	8.47
NON-USD WGBI	1.16	3.06	5.16	9.93
UNITED STATES	0.15	1.90	2.24	4.92
CANADA	0.55	2.58	3.48	7.46
JAPAN	1.22	2.50	3.15	4.86
AUSTRALIA	1.86	4.82	5.91	11.13
UNITED KINGDOM	1.93	6.77	11.05	14.92
EUROPEAN GBI	1.10	2.77	5.78	13.18
FRANCE	0.93	2.87	5.64	12.07
GERMANY	1.21	2.78	5.20	10.33
IRELAND	0.51	1.63	4.86	13.89
ITALY	0.99	2.60	5.85	15.37
SPAIN	1.59	2.76	6.50	16.64

Developed country government bonds continue to perform well in local currency terms as easy monetary policy from central banks remains a tailwind. The ECB is widely expected to ease policy further in 2015, which fueled the fourth-quarter rally in European core and peripheral country bonds. A surprise announcement by the BoJ on October 31, 2014, outlined plans to expand the country's monetary base by an additional 10 trillion yen per year, bringing the total target to 80 trillion yen per annum. Since that announcement, the 10-year Japan government bond yield fell 13 basis points from 0.45% to 0.32%. The Fed and Bank of England are on the opposite side of the monetary policy spectrum relative to the ECB and BoJ, with rate hikes seemingly on the horizon in 2015. However, policy rates in the US and UK should remain historically low even after the first rate hikes.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
EMERGING MARKET BONDS				
EMERGING MARKET GOVERNMENT (EMBIG) *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	(2.87)	(1.65)	(3.27)	5.53
CORPORATE EMERGING MARKET BOND (CEMBI) *(CORPORATES, USD)*	(1.93)	(1.21)	(1.30)	4.96
EMERGING MARKET GOVERNMENT (GBI-EM) *(GOVERNMENTS, LOCAL CURRENCY)*	(1.21)	2.16	2.68	8.18

Both government and corporate emerging market sovereign debt struggled for the second consecutive quarter, but performance was skewed by losses in high yield securities and specific countries with relatively large weights in the indices. Russian and Venezuelan securities, which have a 7.9% and 4.8% weight within the EMBIG, fell by 9.8% and 28.8%, respectively, during the quarter. A similar return skew was also present in the CEMBI Broad Diversified, where Brazilian and Russian corporates compose 4.9% and 4.3% of the index, respectively. The Brazilian component lost nearly 5.0%, while Russia fell 13.3%. Aside from sizable losses in selected countries, bright spots kept aggregate index losses small. Turkey, for example, was up 6.5% in the EMBIG and 2.8% in the CEMBI. The GBI-EM earned a positive return in local currency terms each quarter in 2014. Russia was a drag on that index, but carry from high-yielding local debt in other countries more than offset the losses.

RETURNS BY SECTOR[1]
as of December 31, 2014

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
CURRENCY MARKETS[2]				
DOLLAR BLOC				
CANADIAN DOLLAR	(1.76)	(3.64)	(8.17)	(8.59)
AUSTRALIAN DOLLAR	(3.89)	(6.54)	(13.34)	(8.32)
NEW ZEALAND DOLLAR	(0.56)	(0.14)	(10.97)	(5.08)
WESTERN EUROPE				
EURO	(2.84)	(4.22)	(11.64)	(11.97)
NORWEGIAN KRONE	(5.66)	(13.77)	(17.70)	(18.53)
SWEDISH KRONA	(4.56)	(7.60)	(14.39)	(17.54)
SWISS FRANC	(2.92)	(3.94)	(10.81)	(10.20)
BRITISH POUND	(0.43)	(3.92)	(8.94)	(5.92)
EMERGING EUROPE & AFRICA				
CZECH KORUNA	(2.95)	(4.78)	(12.32)	(13.00)
HUNGARIAN FORINT	(5.91)	(5.95)	(13.54)	(17.34)
POLISH ZLOTY	(5.20)	(6.59)	(14.28)	(14.69)
RUSSIAN RUBLE	(18.55)	(34.80)	(44.05)	(45.88)
SOUTH AFRICAN RAND	(4.39)	(2.47)	(8.06)	(9.32)
TURKISH NEW LIRA	(4.92)	(2.43)	(9.27)	(8.00)
ASIA				
JAPANESE YEN	(0.96)	(8.46)	(15.40)	(12.08)
CHINESE RENMINBI	(0.97)	(1.07)	(0.04)	(2.44)
INDONESIAN RUPIAH	(1.47)	(1.61)	(4.14)	(1.75)
MALAYSIAN RINGGIT	(3.26)	(6.20)	(8.19)	(6.34)
PHILIPPINE PESO	0.43	0.55	(2.38)	(0.73)
SINGAPORE DOLLAR	(1.59)	(3.75)	(5.95)	(4.72)
SOUTH KOREAN WON	1.57	(3.28)	(7.25)	(3.77)
LATIN AMERICA				
ARGENTINE PESO	0.69	(0.44)	(3.93)	(22.98)
BRAZILIAN REAL	(3.47)	(7.93)	(16.68)	(11.12)
CHILEAN PESO	0.30	(1.34)	(8.82)	(13.36)
COLOMBIAN PESO	(6.71)	(14.80)	(21.00)	(18.81)
MEXICAN PESO	(5.57)	(8.97)	(12.09)	(11.62)
PERUVIAN NEW SOL	(1.90)	(2.99)	(6.07)	(6.14)

Diverging monetary policy has created a dominant US-dollar rally that weakened every other currency in the world over the past 12 months. The US dollar index (DXY), which is heavily weighted toward euro, rallied another 5.0% in the fourth quarter after a third-quarter gain of 7.8%. Additionally, geopolitical risks remained, which affected those countries directly involved, namely Russia, and also neighboring countries like Poland, Hungry and the Czech Republic. The currencies of commodity-exporting countries depreciated throughout the quarter as copper, iron ore and crude oil fell precipitously. The Japanese yen also fell 8.5% on the central bank's announcement of additional monetary easing.

[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. 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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