Bond Market Review and Outlook

By James Balfour, CFA, VP, Senior Global Economist

KEY TAKEAWAYS

- The global credit cycle favors developed over emerging markets, but the shift has accelerated recently, causing tumult.
- Volatility was likely to develop as the global growth baton passed from emerging to developed markets.
- We believe developed economy fundamentals are stronger than markets may indicate.
- We view falling asset prices as creating opportunities, but investors will need to carefully balance value and risk.

Risk assets suffered this quarter amid notable market volatility, as oil prices declined over $15 a barrel and concerns about the economic health of China and emerging markets (EM) escalated. The uncertain global outlook swayed the Federal Reserve (the Fed) to leave interest rates unchanged in September, and the central bank questioned "whether or not there might be a risk of a more abrupt slowdown" in China.[1]

As might be expected, long duration assets within the major government bond markets outperformed in this environment, while riskier assets such as emerging markets, EM currencies, high yield bonds and equities declined as many investors shed risk. Market volatility was largely set off by the sharper-than-expected slowdown in Chinese infrastructure spending and exacerbated by a Fed on the cusp of raising rates. But more than just reduced investment spending in the Middle Kingdom has been roiling the markets. Knock-on effects of China's fumbling policy response and the implications for emerging market growth and commodity prices have all contributed.

Passing the Baton from EM to DM

Since 2012, the global credit cycle has favored developed over emerging markets. This shift has started to accelerate recently, causing tumult in fixed income markets. Most developed markets, notably the US, UK, Europe and Japan, have been deleveraging since the financial crisis and are now in favorable parts of the credit cycle. Growth may not be overly impressive, but headwinds from inflation and wage growth remain muted. On the other hand, China and other emerging economies have gotten a boost from exceptionally easy financial conditions in developed markets. The rapid credit growth of past years appears to finally be reaching its zenith, and the relative growth advantage of emerging markets has begun to fade.

With the boom in global trade and commodities behind us, we are transitioning to new growth drivers. Going forward, we expect US dollar strength to continue, while the US and other advanced economies continue their slow, and at times halting, recoveries from the financial crisis. Some good news: we don't think the world is on the brink of another crisis. Interest rates are close to record lows in emerging markets and may go even lower. EM growth should stabilize, likely at a slower pace at least until these countries embrace reforms to open new avenues for growth.

[1] *Janet Yellen (Chair, Board of Governors of the Federal Reserve System), press conference, 9/17/2015.*

The DM Growth Engine

Market prices seem to be adjusting to the new reality of lower EM growth and commodity prices. Some of this adjustment has directly hit developed markets, not only mining and energy earnings but also manufacturers and export-oriented firms. Typical of when risk appetites wane, markets appear to be expecting widespread stress across developed economies. We do not believe the deterioration in underlying fundamental values will be so extensive. The pace of credit rating agency downgrades may increase, but we believe corporate health is relatively strong and defaults will remain low.

Volatility was likely to develop as the baton passed from emerging to developed markets. We believe major developed economies have several years before the credit cycle progresses, with consumers the most likely candidates to borrow and spend in the meantime. As we see it, China finally seems willing to absorb a sharper economic adjustment while allowing credit growth to slow and relinquishing its current role as the world's growth engine. Any future stimulus will probably be defensive in nature. EM valuations will likely adjust lower as developed economies become the primary drivers of global growth. However, near record-low interest rates across emerging and developed markets should help to smooth the transition. We view falling asset prices as creating opportunities, but investors will need to carefully balance value and risk.

Third Quarter Review

By Craig Burelle, VP, Global Research Analyst

INDEX RETURNS BY SECTOR
as of September 30, 2015

INDEX				
US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US AGGREGATE BOND	0.68	1.23	-0.47	2.94
BARCLAYS GOVERNMENT/CREDIT	0.70	1.20	-0.92	2.73
S&P 500®	-2.47	-6.44	-6.18	-0.61

Fixed income performance was not broadly negative during the third quarter, but very few indices made strong gains. Generally, highly leveraged companies that operate within the metals and mining and energy sectors dragged on index returns. A late-quarter spike in volatility supported lower-risk US Government and Treasury index returns, which rallied further after the Federal Open Market Committee (FOMC) voted against raising the federal funds rate in September.

US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US TREASURYS	0.88	1.76	0.15	3.76
3-MONTH T-BILLS	0.02	0.03	0.04	0.05
2-YEAR TREASURY	0.28	0.29	0.39	1.06
5-YEAR TREASURY	1.04	1.74	0.98	3.90
10-YEAR TREASURY	1.44	2.92	-0.21	6.05
30-YEAR TREASURY	1.34	5.10	-5.87	8.83
BARCLAYS US TIPS	-0.59	-1.15	-2.20	-0.83
BARCLAYS US AGENCY	0.56	1.06	0.49	2.84

Upward pressure on US Treasury yields, prompted by rising global government rates, dissipated in the third quarter. Yields on European government bonds, in particular, began to settle into new, slightly higher trading ranges. As the quarter progressed, yields at the front end of the US yield curve, like the 2-year maturity, drifted modestly higher as investors discounted the risk of a September Fed rate hike. Conversely, yields on 5-, 10- and 30-year maturities inched lower and continued declining after the FOMC meeting. One factor in the FOMC decision was declining market-based measures of inflation compensation partially reflected by lower energy prices. A lack of inflationary pressure led US TIPS, an asset class that seeks to protect against inflation, to underperform.

US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US MUNICIPALS	0.72	1.65	0.75	3.16

Municipal securities, while backed by creditworthiness of US state and local governments, provide a spread over US Treasurys of similar duration. The municipal index typically moves in sync with the broad US Treasury index and did so this quarter, with total returns broadly positive across sectors. The education and transportation sectors were among the top performers, along with index-heavy states like Texas, California and Florida. The municipal index continued to rally after the FOMC left the federal funds target rate unchanged.

US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS MBS	0.58	1.30	0.55	3.43
BARCLAYS ABS	0.45	0.74	0.92	2.38
BARCLAYS CMBS	1.22	1.54	0.47	3.72

The FOMC decision also positively impacted high-quality US securitized assets. Option-adjusted spreads (OAS) on the US MBS and CMBS indices widened steadily as investors anticipated the beginning of a rate tightening cycle. After the decision to maintain rates, OAS tightened as the indices rallied to generate positive total returns. The ABS index had the lowest duration of the securitized benchmarks and consequently rallied less as US Treasury yields fell.

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

All returns in US dollars, unless noted. ***Past Performance is no guarantee of future results.***

INDEX RETURNS BY SECTOR
as of September 30, 2015

INDEX CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US INVESTMENT GRADE	0.75	0.83	-2.36	1.66
AAA	1.22	2.39	-2.21	3.11
AA	0.93	1.39	-1.08	2.93
A	0.95	1.54	-1.47	2.92
BBB	0.49	-0.02	-3.48	0.13
BARCLAYS EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-0.70	-0.26	-3.16	-0.31
AAA	0.64	1.14	-4.34	1.72
AA	-0.04	0.40	-2.39	-0.18
A	-0.39	0.05	-2.70	0.06
BBB	-1.18	-0.74	-3.77	-0.70
BARCLAYS STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-0.05	0.62	-3.60	4.18
AAA	1.12	2.37	-3.65	9.83
AA	0.37	0.85	-3.59	4.40
A	0.19	0.86	-3.55	4.72
BBB	-0.36	0.32	-3.61	3.49

Flattening government yield curves in the United States, Europe and the United Kingdom supported investment grade corporate indices. The rally in long maturities across each curve provided a positive fundamental backdrop for long duration corporate bond prices. Returns were broadly positive across sectors in the US Corporate index, with the exception of energy. The energy sector, which represents 10.3% of the US index, came under significant selling pressure as oil prices failed to recover. European sector performance was mixed, with technology and transportation posting positive total returns and consumer cyclicals and industrials dragging on total returns. The Sterling Aggregate had the longest duration of the three corporate bond indices and benefited most from flattening curves; sector performance was also positive and well balanced.

CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD	-2.60	-4.86	-4.85	-3.43
BB	-2.08	-3.10	-3.46	0.03
B	-3.04	-5.62	-5.28	-4.26
CCC	-2.67	-7.29	-6.84	-8.68
BARCLAYS PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	-2.03	-2.26	-3.18	2.36
BB	-1.96	-1.79	-3.18	2.41
B	-2.62	-3.68	-3.41	2.92
CCC	-0.25	-0.84	-2.36	-0.29

High yield corporates in the United States and Europe struggled this quarter. Positive macroeconomic factors like European Central Bank (ECB) quantitative easing (QE) and delayed FOMC tightening did not stop OAS from steadily leaking wider. Total returns were broadly negative across all major sectors of the Pan-Euro and US indices. However, the distribution of losses was uneven. Falling crude prices negatively impacted the energy sector, which includes highly levered oil companies that borrowed to fund projects that are now becoming unprofitable. Energy companies represented a 12.5% weight in the US high yield index and tumbled over 15.9% in the quarter. Losses in the Pan-Euro high yield energy sector were nearly as substantial, but energy represents less than 1.0% of the index, which explains some of the outperformance relative to US high yield.

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

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INDEX RETURNS BY SECTOR
as of September 30, 2015

INDEX				
BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD LOANS	-0.76	-1.48	-0.86	0.97
BB	0.00	0.29	1.06	4.31
B	-1.02	-1.23	-0.40	1.91
CCC	0.11	-1.02	-0.22	0.79

Broad weakness in the vast majority of US high yield sectors bled through to bank loans. The worst performing sector within the US high yield loan index was energy, which fell 15.9%. While the magnitude of energy's decline was comparable to high yield bonds, the loan index was less affected because of the energy sector's lower 3.8% index weight.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI *(LOCAL CURRENCY RETURNS)*	0.79	1.89	-0.83	4.01
CITIGROUP NON-USD WGBI	0.76	1.97	-1.29	4.13
UNITED STATES	0.85	1.73	0.14	3.68
CANADA	-0.05	1.02	-0.42	5.63
JAPAN	0.36	0.87	0.61	2.57
AUSTRALIA	0.34	2.68	-0.17	8.07
UNITED KINGDOM	1.29	3.32	-0.53	8.70
EUROPEAN GBI	1.03	2.55	-3.01	3.98
FRANCE	1.02	1.94	-3.33	3.38
GERMANY	0.81	1.77	-2.83	3.52
IRELAND	0.84	2.52	-2.01	2.69
ITALY	1.30	4.11	-2.36	5.89
SPAIN	1.02	2.82	-3.36	3.23

Pro-growth statements with a dovish tilt from central bankers did not soothe all risk assets, but they did have a positive impact on developed market government bonds in local currency terms. ECB Chairman Draghi reminded markets of the central bank's willingness to do whatever it takes to preserve the euro zone. Draghi increased the issue share limit for QE purchases of individual government bonds to 33.0% from 25.0% and stated the ECB can adjust size and duration of QE if needed. Additionally, Bank of Japan (BOJ) Governor Kuroda reiterated willingness to adjust policy as appropriate to achieve a stable 2.0% inflation rate. As mentioned previously, the Fed refrained from raising its target rate. With rate hike expectations around the globe pushed out, most developed market yield curves flattened, as securities with long maturities rallied.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	-1.38	-2.04	-2.33	-1.96
JP MORGAN CEMBI BROAD DIVERSIFIED *(CORPORATES, USD)*	-1.18	-2.76	-1.48	-0.38
JP MORGAN GBI-EM GLOBAL DIVERSIFIED *(GOVERNMENTS, LOCAL CURRENCY)*	-0.35	-0.55	-0.81	3.89

The decline of China's economic growth rate, the strong US dollar and the relentless commodity selloff wreaked havoc on most emerging markets. There were pockets of positive performance, but the asset class was generally weaker for the quarter. Commodity importers and countries with more diversified export bases fared better than commodity exporters. Commodity-driven economies primarily exporting to China, like Brazil, drove the most negative returns. Despite the macroeconomic headwinds, emerging market sovereigns and US-dollar-pay corporates still outperformed US high yield by a wide margin. The GBI-EM index, assisted by high yielding local currency government bonds, suffered an even smaller loss for the quarter.

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INDEX RETURNS BY SECTOR

as of September 30, 2015

INDEX				
CURRENCY MARKETS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
DOLLAR BLOC				
CANADIAN DOLLAR	-1.30	-6.15	-4.71	-15.89
AUSTRALIAN DOLLAR	-1.34	-8.94	-7.74	-19.77
NEW ZEALAND DOLLAR	0.93	-5.41	-14.34	-18.05
WESTERN EUROPE				
EURO	-0.30	0.27	4.16	-11.51
NORWEGIAN KRONE	-2.77	-7.78	-5.34	-24.54
SWEDISH KRONA	1.23	-0.99	3.12	-13.81
SWISS FRANC	-0.62	-3.88	-0.06	-1.87
BRITISH POUND	-1.41	-3.72	2.09	-6.69
EMERGING EUROPE & AFRICA				
CZECH KORUNA	-0.87	0.58	5.54	-10.52
HUNGARIAN FORINT	-0.33	0.77	-0.17	-12.26
POLISH ZLOTY	-0.62	-1.02	-0.05	-12.87
RUSSIAN RUBLE	-1.74	-15.33	-10.98	-39.41
SOUTH AFRICAN RAND	-4.15	-12.17	-12.43	-18.55
TURKISH NEW LIRA	-3.66	-11.37	-14.15	-24.70
ASIA				
JAPANESE YEN	1.13	2.19	0.21	-8.53
CHINESE RENMINBI	0.36	-2.44	-2.46	-3.41
INDONESIAN RUPIAH	-4.00	-8.97	-10.78	-16.82
MALAYSIAN RINGGIT	-4.61	-14.15	-15.73	-25.36
PHILIPPINE PESO	0.12	-3.46	-4.34	-3.77
SINGAPORE DOLLAR	-0.74	-5.27	-3.52	-10.30
SOUTH KOREAN WON	-0.21	-5.90	-6.39	-10.98
LATIN AMERICA				
ARGENTINE PESO	-1.30	-3.52	-6.37	-10.52
BRAZILIAN REAL	-8.28	-21.39	-19.02	-38.01
CHILEAN PESO	-0.63	-8.22	-10.21	-14.08
COLOMBIAN PESO	-1.13	-15.59	-15.80	-34.42
MEXICAN PESO	-0.99	-6.97	-9.78	-20.62
PERUVIAN NEW SOL	0.10	-1.67	-4.23	-10.61

The US dollar rallied versus its major trading partners with the exception of the Japanese yen and euro. Monetary policy divergences and macroeconomic headwinds continued to pressure foreign exchange markets. The strong US dollar environment prevailed again despite the Fed's decision to delay its first rate hike. Currencies of commodity exporters, whether emerging or developed, underperformed because commodity prices continued to decline. China took steps to allow the renminbi to find a more market-oriented level, which caused an abrupt 2.5% decline in the currency relative to the US dollar. The yen and euro remained stable relative to other currencies as the BOJ and ECB remained committed to existing expansionary policies.

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

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Disclosure

All data as of September 30, 2015, unless otherwise noted.

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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 prefunded 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 Bond Index *is a broad-based benchmark that measures the investment grade, euro-denominated, fixed-rate corporate bond market. Inclusion is based on the currency denomination of a bond and not the country of risk of the issuer. The Euro Corporate Index is a subset of Barclays broader-based flagship indices, such as the Euro Aggregate and the multi-currency Global Aggregate Index.*

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). 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.*

Barclays US High-Yield Loans Index*, also known as the Bank Loan Index, provides broad and comprehensive total return metrics of the universe of syndicated term loans. To be included in the index, a bank loan must be dollar denominated, have at least $150 million funded loan, 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 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.*

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