Bond Market Review and Outlook

By Laura Sarlo, VP, Senior Sovereign Analyst

KEY TAKEAWAYS

- Monetary policy divergence has gained momentum; key central banks continue to ease while the US prepares to tighten.
- Persistent broad global disinflation continues to cap yields, hamstringing policymakers as they are squeezed between stimulating growth and a stronger US dollar.
- We expect central bank actions from the Fed, ECB and PBOC will continue to overshadow market fundamentals.

Key central banks, most notably the European Central Bank (ECB), pursued highly accommodative monetary policies during the quarter, in sharp relief to the US, where the Federal Reserve (the Fed) prepared markets for rising rates later this year. Ahead of a potential US policy shift, many commodity-sensitive and emerging market (EM) central banks eased further, seeking to boost sluggish growth.

Dancing with the Fed

During the quarter, markets focused on how the Fed would balance its dual mandate amid conflicting economic indicators. While US labor market conditions improved, global disinflation and falling commodity prices kept the central bank's 2% inflation target at a distance. Though the Fed deleted "patient" from its March statement, implicitly making a June rate hike possible, the comments struck a more dovish tone than other recent statements. Markets have now largely turned their attention to the Fed's September meeting.

Ongoing global disinflation, slow EM growth and broad US dollar strength appeared to influence market expectations for a later Fed liftoff, serving to anchor US Treasury yields. Growth and price levels continued their downtrend in China, the world's second-largest economy and arguably its key commodity consumer. Premier Li Keqiang reduced the government's official growth target from 7.5% to 7 %, the first such cut since 2012. Sluggish global activity and further commodity price declines also weighed on commodity-producing economies, notably Australia, Canada and key emerging markets. Many central banks have surprised with renewed monetary policy easing to protect export competitiveness and boost growth ahead of tighter US monetary policy. However, room for EM rate cuts was curtailed by concern that currency weakness would translate into higher inflation and credit risk premia. Corporate emerging market bond spreads widened modestly later in the quarter, with markets concerned that continued dollar strength could increase in debt servicing burdens for overleveraged EM corporates.

The Gravitational Pull of ECB QE

At long last, the European Central Bank (ECB) undertook a key step markets have been waiting for and began buying sovereign bonds. Targeting a balance sheet expansion of €1 trillion, the ECB Governing Council increased the pace of its balance sheet expansion from about €10 billion per month to €60 billion per month and committed to such a pace until at least September 2016. Sovereign bonds should make up roughly two-thirds of the ECB's monthly bond purchases, exceeding estimates of net new government bond issuance and igniting anticipation that high-quality euro area government bonds will become scarce. The size and structure of expected purchases, combined with already low and even negative yields in "core" euro area bond markets, is driving investors further out the maturity spectrum and lower in credit quality. During the quarter, the sharp rally and curve flattening in euro area sovereign and corporate bond markets stood in contrast to improved underlying economic activity and rising expectations for European growth and inflation over the coming year, factors that should theoretically have pushed yields higher and curves steeper.

Neighboring European economies continued to feel the euro area's economic and policy gravitational pull during the first quarter. Although the UK has been experiencing solid economic expansion, global energy disinflation and the British pound's relative strength against the euro stayed expectations that the Bank of England would need to begin any pronounced policy tightening cycle in the near term. Just ahead of the ECB's January quantitative easing (QE) announcement, the Swiss National Bank abandoned its unilateral policy of pegging the Swiss franc against the euro. The value of the Swiss franc surged sharply as a result, and the stronger currency undermined Switzerland's growth outlook. Combined with the adoption of more deeply negative deposit rates, Swiss government bond yields moved negative across the maturity spectrum out to ten years. Other developed European economies also struggled with low inflation and the ripple effects from ECB policy. Sweden cut policy rates into negative territory and initiated QE bond purchases. To maintain its peg to the euro (a key tenet of monetary policy for three decades), Denmark cut its CD rate to from -0.05% to -0.75%, suspended government bond issuance to discourage capital inflows, and sharply increased its pace of foreign exchange reserve accumulation. ECB effects rippled through the regional emerging markets as well. Poland, Romania and Turkey all cut rates during the quarter as lackluster growth and softening inflation created space for central banks to lower rates further.

Gauging the Ripple Effects

Central bank action appears set to critically shape financial markets this year at the expense of fundamentals. Market participants remain fixated on predicting the actions of the Fed, ECB and People's Bank of China (PBOC), with many other economies potentially caught up in these cross-currents.

Looking ahead, Europe is sailing with the wind. Improving growth and continued easing should continue to drive investors out the maturity spectrum, down in quality and into European stocks and foreign bonds, including US fixed income. As we've noted before, investors should remember the global nature of modern financial markets. A significant portion of the outstanding stock of US Treasurys is owned by foreigners, and developments around the globe matter for US yields.

Europe's economic recovery should be welcome development for China's export sector and may help ease the country's economic downshift to a "new normal." While China seems to have accepted structurally slower growth, continued stimulus will be used to stave off too much economic downside. Emerging markets are likely to remain squeezed by a slower China and the stronger US dollar. If China surprises to the upside, or if the Fed delays rate hikes further into the future, risky assets like EM should be primary beneficiaries.

First Quarter Review

By Craig Burelle, VP, Global Research Analyst

RETURNS BY SECTOR[1]
as of March 31, 2015

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US BROAD MARKET				
AGGREGATE	0.46	1.61	3.43	5.72
GOVERNMENT/CREDIT	0.50	1.84	3.69	5.86
S&P 500	-1.58	0.95	4.44	12.73

Broad US fixed income indices ebbed and flowed with US Treasurys throughout the first quarter. As Treasurys rallied in January, US government and credit indices followed, but the relationship worked both ways. When markets became fixated on the first fed funds rate hike and the rate path thereafter, broad indices followed Treasurys lower and relinquished some of their early gains. Volatility eased in mid-March after the FOMC lowered its economic projections, including the expected path for the fed funds rate. Despite the volatility, broad US credit indices posted solid gains by quarter-end.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US GOVERNMENTS				
US TREASURYS	0.63	1.64	3.60	5.36
3-MONTH T-BILLS	0.00	0.01	0.01	0.04
2-YEAR TREASURY	0.22	0.50	0.67	0.97
5-YEAR TREASURY	0.76	1.74	2.90	3.92
10-YEAR TREASURY	0.80	2.60	6.27	9.91
30-YEAR TREASURY	1.42	5.05	15.62	25.73
US TIPS	-0.47	1.42	1.40	3.11
US AGENCY	0.43	1.17	2.34	3.73

Two distinct macro events, the ECB's QE announcement and a nearly 10% decline in the price of West Texas Intermediate crude oil (WTI), impacted the US Treasury market during January. The oil price plunge put additional downward pressure on an already weak inflation outlook, while the ECB's commitment to easing perpetuated a global rally in developed market government bonds. The Treasury market was also supported by international investors seeking exposure to the strengthening US dollar, which rose 5% in January and over 9% in the first quarter. Treasury market gains were nearly erased in February due to market concerns of earlier-than-expected Fed tightening. However as the March FOMC meeting approached, Treasurys began to recover as fear abated. By quarter-end, expectations for imminent Fed policy tightening waned, cementing the Treasury rally.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US MUNICIPALS	0.29	1.01	2.40	6.62

Municipal bonds followed a pattern similar to US Treasurys throughout the quarter. However, the Municipal index underperformed the Treasury index even though the Municipals had longer duration. Total returns were just about evenly distributed across credit qualities, sectors and states. Top performers had longer duration and a very low weight in the total index. From a credit quality perspective, the BBB-rated segment outperformed the Municipal index by 75 basis points but represented just under 5% of the total index. At the state level, Wyoming and North Dakota led, but both states combined represented less than 1% of the total index.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
US SECURITIZED				
MBS: MORTGAGE-BACKED	0.37	1.06	2.86	5.53
ABS: ASSET-BACKED	0.41	0.90	1.45	2.24
CMBS: COMMERCIAL MORTGAGES	0.63	1.77	3.24	4.35

Much like the US Treasury and Municipal indices, the highest US securitized asset returns were earned by securities with the longest duration. Over the quarter, duration and the option-adjusted spread (OAS) for CMBS and ABS indices remained stable. US MBS duration declined from 4.3 years to 3.5 years during the quarter, and OAS declined 7 basis points. US MBS underperformed similar duration Treasurys for the period, while CMBS and ABS earned positive excess returns over 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
as of March 31, 2015

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
CORPORATES				
US INVESTMENT GRADE	0.32	2.32	4.12	6.81
AAA	0.61	2.18	5.43	8.46
AA	0.27	2.03	4.06	6.19
A	0.35	2.21	4.46	6.89
BBB	0.29	2.49	3.75	6.82
EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-0.14	1.36	2.93	7.34
AAA	0.25	2.90	6.33	14.10
AA	-0.07	0.86	2.27	6.60
A	-0.13	1.13	2.84	7.23
BBB	-0.18	1.73	3.19	7.59
STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	1.15	3.45	8.06	13.74
AAA	2.90	5.23	13.99	23.24
AA	1.45	3.04	8.29	13.87
A	1.23	3.59	8.58	14.64
BBB	0.98	3.35	7.37	12.59

Globally, investment grade performance was driven by the A and BBB credit quality segments, which are the primary components of the underlying indices. Approximately 90% of the US and European Aggregate indices are composed of A and BBB rated credits, evenly split between the two ratings. The Sterling Aggregate index is comparable, but the weights of A and BBB quality securities are not quite as pronounced at 30% and 29%, respectively. With the longest duration of 8.3 years, the Sterling Aggregate index outperformed both the US and European indices. The US index, with duration of 7.5 years, earned a higher return than the similarly weighted European index, which had duration of 5.1 years. OAS on the Sterling and US indices moved modestly lower during the period. Energy-related corporate bonds in the US index earned positive returns despite continued weakness in oil prices.

CORPORATES				
US HIGH YIELD	-0.55	2.52	1.49	2.00
BB	-0.46	2.69	3.61	4.93
B	-0.54	2.64	1.07	1.36
CCC	-0.77	2.01	-1.98	-2.36
PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	0.16	4.69	5.72	8.47
BB	-0.03	4.10	5.78	10.10
B	0.58	6.30	6.56	7.13
CCC	0.25	4.45	2.11	2.33

During the first quarter, concern over the liftoff date and path of the fed funds rate impacted US market sentiment. In a rising interest rate environment, high yield's relatively low duration should provide a better total return cushion than investment grade. Since initial rate hikes are typically correlated with a stronger economy, high yield could benefit from stronger company profits that can lead to credit improvement and tighter spreads. The same fundamental dynamic holds in the European market. But the ECB has made a low-rate promise and is not likely to tighten monetary policy until mid-2016 at the earliest. The ECB commitment, paired with fundamental economic improvement in the euro zone, created a favorable environment for Pan-European high yield during the quarter.

RETURNS BY SECTOR
as of March 31, 2015

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
BANK LOANS				
US HIGH YIELD	0.34	2.31	1.84	2.74
BB	0.47	2.43	3.21	3.61
B	0.69	2.60	2.32	3.23
CCC	0.59	2.18	1.02	6.02

Although bank loans characteristics are materially different than high yield bonds, the same performance drivers tend to impact both asset classes, which was helpful last quarter. The High Yield Loan index is composed of floating-rate instruments, and therefore has no duration. Despite no contribution from duration, total returns were nearly in line with US high yield corporates for the quarter. As the Fed enters the early stages of a tightening cycle, high yield company fundamentals could continue to improve with the accelerating economy.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
DEVELOPED COUNTRIES				
WORLD GOVERNMENT BOND INDEX (WGBI) *(LOCAL CURRENCY RETURNS)*	0.77	2.11	4.88	8.47
NON-USD WGBI	0.84	2.36	5.49	9.85
UNITED STATES	0.61	1.60	3.54	5.24
CANADA	-0.41	3.41	6.07	8.69
JAPAN	0.13	-0.54	1.95	3.43
AUSTRALIA	0.87	3.28	8.26	13.31
UNITED KINGDOM	2.20	2.35	9.28	15.00
EUROPEAN GBI	1.24	4.31	7.20	13.70
FRANCE	1.32	3.96	6.94	13.21
GERMANY	1.55	3.66	6.53	11.46
IRELAND	0.90	3.12	4.80	12.70
ITALY	1.04	5.70	8.45	15.82
SPAIN	0.96	3.95	6.82	14.39

Developed country government bond markets continued to perform well in local currency terms, but when converted to US dollars, returns were negatively impacted. Nevertheless, easy monetary policy from central banks and persistently low inflation remained key catalysts for global government bonds. The ECB announcement of sovereign QE program fueled the ongoing rally in European core and peripheral country bonds, but it wasn't just the ECB. The majority of central banks around the world eased policy to stimulate growth and inflation, while very few central banks considered tighter policy.

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
EMERGING MARKET BONDS				
EMERGING MARKET GOVERNMENT (EMBIG) *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	0.46	2.06	0.38	4.08
CORPORATE EMERGING MARKET BOND (CEMBI BROAD DIVERSIFIED) *(CORPORATES, USD)*	0.51	2.36	1.12	4.52
EMERGING MARKET GOVERNMENT (GBI-EM GLOBAL DIVERSIFIED) *(GOVERNMENTS, LOCAL CURRENCY)*	-0.14	2.53	4.74	8.97

US-dollar-denominated emerging market indices took part in the global bond rally, which was driven by internationally low inflation and accommodative monetary policy. Emerging market government and corporate bonds provided a higher yield than nearly all developed market bonds, and when owned via the EMBI and or CEMBI, US-based investors assumed no foreign currency risk. The EMBI and CEMBI rallied steadily throughout the quarter, assisted by Russian bonds, which represented a significant drag in the prior quarter. The GBI-EM index provided an even higher yield than EMBI and CEMBI, but the local currency component of the index introduced additional links to each constituent country's economic situation. The GBI-EM still rallied in local currency terms despite high inflation and low growth, which plagued several emerging markets during the quarter.

RETURNS BY SECTOR
as of March 31, 2015

INDEX	1 MONTH	3 MONTH	6 MONTH	12 MONTH
CURRENCY MARKETS[2]				
DOLLAR BLOC				
CANADIAN DOLLAR	-1.35	-8.40	-11.73	-12.90
AUSTRALIAN DOLLAR	-2.57	-6.95	-13.03	-17.89
NEW ZEALAND DOLLAR	-1.24	-4.19	-4.33	-13.77
WESTERN EUROPE				
EURO	-4.15	-11.30	-15.04	-22.06
NORWEGIAN KRONE	-4.90	-7.55	-20.28	-25.71
SWEDISH KRONA	-3.41	-9.55	-16.42	-25.01
SWISS FRANC	-1.89	2.22	-1.81	-9.06
BRITISH POUND	-4.02	-4.87	-8.60	-11.07
EMERGING EUROPE & AFRICA				
CZECH KORUNA	-4.30	-10.97	-15.22	-22.37
HUNGARIAN FORINT	-3.43	-6.55	-12.11	-20.28
POLISH ZLOTY	-2.42	-6.67	-12.82	-20.32
RUSSIAN RUBLE	6.13	4.38	-31.94	-39.55
SOUTH AFRICAN RAND	-3.90	-4.63	-6.98	-13.19
TURKISH NEW LIRA	-3.44	-10.11	-12.29	-17.59
ASIA				
JAPANESE YEN	-0.42	-0.29	-8.72	-14.07
CHINESE RENMINBI	1.12	0.09	-0.97	0.28
INDONESIAN RUPIAH	-1.09	-5.25	-6.78	-13.10
MALAYSIAN RINGGIT	-2.68	-5.57	-11.42	-11.85
PHILIPPINE PESO	-1.35	0.04	0.59	0.26
SINGAPORE DOLLAR	-0.68	-3.41	-7.03	-8.37
SOUTH KOREAN WON	-1.05	-1.69	-4.91	-4.05
LATIN AMERICA				
ARGENTINE PESO	-1.06	-4.01	-4.44	-9.25
BRAZILIAN REAL	-11.12	-16.86	-23.46	-28.93
CHILEAN PESO	-1.22	-3.01	-4.31	-12.13
COLOMBIAN PESO	-3.85	-8.58	-22.11	-24.17
MEXICAN PESO	-2.05	-3.35	-12.02	-14.45
PERUVIAN NEW SOL	-0.10	-3.78	-6.66	-9.30

Central banks, politics or persistent weakness in commodity prices impacted each currency to some degree. Idiosyncratic macro factors prompted weakness in the vast majority of foreign currencies, especially relative to the US dollar. The dollar remained bolstered by a Fed seeking to normalize monetary policy in 2015, while other central banks around the world have been easing. The ECB's sovereign QE prompted a steady selloff in the euro-US dollar exchange rate that took the pair from 1.21 to a low of 1.05 by mid-March. The US dollar also rallied versus nearly all major emerging and developed market currencies. Unrelenting weakness in commodity prices kept downward pressure on the currencies of commodity-exporting countries like Brazil, Colombia, Canada and Norway.

Past performance is no guarantee of future results.

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

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Disclosure

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 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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