Bond Market Review and Outlook

By James Balfour, CFA, VP, Senior Global Economist

KEY TAKEAWAYS

- As US monetary policy begins to normalize, we expect its influence on global rates will reassert itself.
- While the US should weather a slow pace of tightening with a fair amount of grace, we hold some reservations about a Fed hiking cycle so broadly out of sync with the rest of the world.
- Low inflation pressures, easy monetary policy and unsynchronized global growth bode well for a longer global economic expansion.

Government bond yields in Europe bounced sharply higher after deflation fears subsided and the European Central Bank (ECB) launched its quantitative easing (QE) program. In a big unwind of the European gravitational pull on yields, this surge pushed bond yields higher across virtually all advanced economies. Going forward, we expect the US to increasingly drive global rates.

The US Moves Back into the Driver's Seat

Historically, the US has been the dominant driver of global interest rates, and as US monetary policy begins to normalize, we expect its influence on global rates will reassert itself. As the US gradually tightens monetary policy, we are likely to see modest upward pressure on the dollar. Volatility should creep back into the US bond market due to growing uncertainty around wage growth, inflation pressures and, ultimately, the path of the Federal Reserve's (the Fed's) rate hikes. As a result of rising policy rates and volatility, US bond yields should rise.

Our outlook currently favors international developed market government bonds over US Treasurys, and in credit, high yield over investment grade bonds. Spreads can modestly tighten as yields rise, so credit should continue to outperform Treasurys over the next year. Since we are getting later in the credit cycle, we also expect more frequent periods of market volatility and widening spreads, which could present buying opportunities.

While we think concerns about secular stagnation in the US are overblown, we sympathize with global fixed income investors who appear uncomfortable with the Fed starting to normalize interest rates. We expect the US to weather a slow pace of tightening with a fair amount of grace, but we hold some reservations about a hiking cycle that is broadly out of sync with the rest of the world. More than 20 central banks lowered interest rates this year, while only a handful hiked (notably Brazil, Iceland and Ukraine). The global disinflationary impulse has not fully run its course, and a tightening of US monetary policy will surely send some tremors throughout the world. We expect some surprises in the face of tighter Fed policy and less resilient global growth.

Global Rebalancing

Emerging economies have benefited from secular trends over the past decade, but the tide has reversed. The boom in global trade and commodities is behind us, and the world is coming to grips with China working to deleverage and restructure its economy. After several quarters of slowing, China's recent stimulus plans have not created the expected "pop" to growth, and the country continues to search for that elusive upturn in growth. The many economies that rode in China's wake will likely need to undergo several years of restructuring in order to thrive in the changing world economy. The easy money across developed markets is also waning, which will add pressure in places where credit boomed. Unlike recent years, growth prospects have begun to vary widely from country to country. On the whole, low inflation pressure, easy monetary policy and unsynchronized global growth should bode well for a longer global economic expansion. This provides emerging economies more time to adjust but also reduces the pressure for political reforms.

These dynamics make us most wary about emerging market (EM) government bonds and currency risk. We currently favor some EM corporate bonds with a higher risk premium, many of which are well into a credit cycle downturn. We expect additional value opportunities to materialize in the EM space as economies adjust to a more challenging, competitive global environment. Opportunities could emerge more quickly if China stumbles or global interest rates lurch higher. However, in the current environment, investors should remain patient as we expect opportunities will unfold gradually.

Second Quarter Review

By Craig Burelle, VP, Global Research Analyst

INDEX RETURNS BY SECTOR
as of June 30, 2015

INDEX				
US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US AGGREGATE BOND	-1.09	-1.68	-0.10	1.86
BARCLAYS GOVERNMENT/CREDIT	-1.23	-2.10	-0.30	1.69
S&P 500®	-1.94	0.28	1.23	7.42

Fixed income markets began the quarter on a quiet note but grew increasingly volatile in May and June. The US Treasury yield curve began to steepen in late April as global bond market investors repriced the path of ECB rate hikes, sparking a global bond selloff. The rise in longer-term Treasury yields pushed yields on the US Aggregate and Government/Credit indices higher. Since broad credit market yields rose marginally higher than like-duration Treasury yields, option-adjusted spread (OAS) widened modestly on each index.

US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US TREASURYS	-0.88	-1.58	0.03	2.31
3-MONTH T-BILLS	-0.00	0.01	0.01	0.03
2-YEAR TREASURY	0.01	0.10	0.60	0.82
5-YEAR TREASURY	-0.57	-0.75	0.97	1.93
10-YEAR TREASURY	-1.91	-3.04	-0.51	3.81
30-YEAR TREASURY	-4.69	-10.44	-5.92	6.99
BARCLAYS US TIPS	-0.97	-1.06	0.34	-1.73
BARCLAYS US AGENCY	-0.44	-0.56	0.60	1.95

The US Treasury market can be affected by factors besides domestic monetary and fiscal policy or economics. Spiking global government bond yields were a key force behind higher US Treasury rates in the second quarter. While global monetary policy remained broadly unchanged to easier, the vast majority of medium- to long-term government bond yields rose. As fixed income investors unwound long positions, the global bond market selloff intensified. International markets carried Treasury yields higher, though domestic inflation remained tame, GDP growth figures were weak, and the Fed stayed data dependent, signaling no imminent rate hike.

US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US MUNICIPALS	-0.09	-0.89	0.11	3.00

Although returns were negative, the Barclays US Municipals Index outperformed several other credit indices with similar duration. The longer duration of municipal bonds suggests returns should be highly sensitive to rising interest rates. However, an expanding economy should increase tax receipts, improving the credit quality of state governments. A stronger credit profile typically translates into higher bond prices, which would cushion some of the loss from rising rates.

US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS MBS	-0.76	-0.74	0.31	2.28
BARCLAYS ABS	-0.06	0.17	1.08	1.64
BARCLAYS CMBS	-1.02	-1.06	0.69	1.91

Securitized assets were not immune to the US yield curve's upward shift. The longer-duration profile of the MBS and CMBS indices at 4.5 years explains most of the total return deviation relative to ABS, which had a duration of 2.5 years. OAS on the MBS and CMBS indices finished the quarter marginally higher, while ABS OAS remained flat. The ABS index earned the highest positive excess return over US Treasurys, while the CMBS index excess return was negative.

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 June 30, 2015

INDEX CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US INVESTMENT GRADE	-1.84	-3.16	-0.92	0.75
AAA	-2.08	-4.49	-2.41	1.15
AA	-1.36	-2.43	-0.45	1.71
A	-1.69	-2.96	-0.81	1.35
BBB	-2.07	-3.47	-1.06	-0.06
BARCLAYS EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-1.97	-2.90	-1.58	1.79
AAA	-2.48	-5.42	-2.68	4.26
AA	-1.79	-2.79	-1.95	1.37
A	-1.87	-2.75	-1.65	2.03
BBB	-2.11	-3.05	-1.38	1.64
BARCLAYS STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-2.80	-4.19	-0.89	6.58
AAA	-3.50	-5.88	-0.95	13.40
AA	-2.88	-4.40	-1.49	7.13
A	-2.91	-4.38	-0.95	7.37
BBB	-2.68	-3.92	-0.70	5.47

Investment grade corporate bonds struggled during the quarter as yield curves in the US, Germany and UK steepened. The second-quarter spike in government bond yields created more volatility than any other period since 2013's "taper tantrum." The low yield and long maturity profile of investment grade corporates negatively impacted performance, with the higher credit quality profile doing little to support returns. With the longest duration of 7.9 years, the Sterling Aggregate index underperformed the United States and Europe, which have durations of 7.2 and 5.1 years, respectively. Excess returns for the second quarter were also negative as OAS widened.

CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD	-1.49	0.00	2.53	-0.40
BB	-1.47	-0.37	2.31	1.84
B	-1.43	0.36	3.01	-0.45
CCC	-1.61	0.49	2.50	-4.19
BARCLAYS PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	-1.49	-0.94	3.70	4.66
BB	-1.52	-1.41	2.62	5.45
B	-1.08	0.28	6.60	5.15
CCC	-3.53	-1.53	2.85	-1.87

The greater yield advantage and relatively lower duration of high yield corporates sheltered the indices from the sizable losses of investment grade. The magnitude of the government yield spike in Europe was greater than in the United States, which placed additional drag on Pan-Euro high yield total returns. However, the ECB remains committed to stimulative monetary policy until at least mid-2016. Easy monetary policy paired with fundamental economic improvement in the euro zone should provide a favorable backdrop, as long as government yields remain stable.

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INDEX RETURNS BY SECTOR
as of June 30, 2015

INDEX				
BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD LOANS	-0.43	0.63	2.96	1.96
BB	-0.02	0.77	3.22	3.54
B	-0.50	0.84	3.46	2.96
CCC	-0.54	0.80	3.00	3.95

The Barclays US High Yield Loans Index was less impacted by rising interest rates because it is composed of floating-rate instruments. Bank loans provide income without the duration risk of traditional bonds, which can be beneficial during a Fed tightening cycle. The CCC credit quality segment was a top performer during the quarter but represents a small fraction of the index. CCC-rated credits were also the top performer in high yield corporate indices. High yield loans and bonds tend to have similar performance drivers; however, less sensitivity to rising interest rates is currently a key advantage of bank loans.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI *(LOCAL CURRENCY RETURNS)*	-1.29	-2.67	-0.61	3.67
CITIGROUP NON-USD WGBI	-1.49	-3.20	-0.91	4.20
UNITED STATES	-0.87	-1.56	0.02	2.26
CANADA	-0.33	-1.43	1.93	5.47
JAPAN	-0.04	-0.26	-0.79	2.33
AUSTRALIA	-1.17	-2.77	0.41	6.35
UNITED KINGDOM	-1.88	-3.72	-1.46	9.44
EUROPEAN GBI	-2.57	-5.41	-1.34	4.36
FRANCE	-2.84	-5.18	-1.42	4.14
GERMANY	-2.11	-4.52	-1.03	4.12
IRELAND	-2.36	-4.42	-1.44	3.35
ITALY	-2.66	-6.22	-0.87	4.92
SPAIN	-2.46	-6.01	-2.30	4.06

The main event of the second quarter was the global bond market selloff led by euro zone core and peripheral bonds. What sparked the selloff that spread to nearly all government bond markets? Traditional catalysts for a bond rout seemed absent. Inflation, in particular, remained well below central bank targets in major markets like Europe, Japan and the United States. An implied message from Mario Draghi seems to have altered market expectations. Draghi's declaration that European QE has been effective prompted investors to reassess the timing of the first ECB rate hike. From mid-April through June, the expected number of months until an ECB rate hike collapsed from 56 to 25. With the expected liftoff for ECB rates more than halved, German bunds led global yields higher, causing investors to abandon deflationary concerns and consider global reinflation.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	-1.69	-0.29	1.76	-1.57
JP MORGAN CEMBI BROAD DIVERSIFIED *(CORPORATES, USD)*	-0.90	1.32	3.70	2.35
JP MORGAN GBI-EM GLOBAL DIVERSIFIED *(GOVERNMENTS, LOCAL CURRENCY)*	-0.41	-0.26	2.26	4.99

Emerging market sovereign bonds denominated in US dollars performed especially well considering the developed market bond rout. While EMBIG performance was particularly impressive given headwinds from the index's longer effective duration of 7.0 years, it underperformed the CEMBI, which had a lower effective duration at 4.9 years. Even with its yield advantage, the GBI-EM underperformed the CEMBI but was nearly in line with the EMBIG. The GBI-EM's high-yielding government bonds are subject to global market risk sentiment as well as domestic economic and political conditions, which can be volatile.

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INDEX RETURNS BY SECTOR
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INDEX				
CURRENCY MARKETS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
DOLLAR BLOC				
CANADIAN DOLLAR	-0.32	1.54	-6.99	-14.59
AUSTRALIAN DOLLAR	0.81	1.31	-5.72	-18.30
NEW ZEALAND DOLLAR	-4.81	-9.44	-13.24	-22.76
WESTERN EUROPE				
EURO	1.47	3.88	-7.86	-18.59
NORWEGIAN KRONE	-1.04	2.64	-5.11	-21.90
SWEDISH KRONA	2.79	4.15	-5.79	-19.35
SWISS FRANC	0.51	3.98	6.29	-5.21
BRITISH POUND	2.75	6.03	0.87	-8.15
EMERGING EUROPE & AFRICA				
CZECH KORUNA	2.00	4.94	-6.57	-18.08
HUNGARIAN FORINT	-0.41	-0.93	-7.42	-19.96
POLISH ZLOTY	-0.50	0.98	-5.76	-19.22
RUSSIAN RUBLE	-5.42	5.14	9.75	-38.60
SOUTH AFRICAN RAND	-0.13	-0.30	-4.92	-12.58
TURKISH NEW LIRA	-0.70	-3.14	-12.93	-21.00
ASIA				
JAPANESE YEN	1.35	-1.93	-2.22	-17.28
CHINESE RENMINBI	-0.05	-0.02	0.07	0.03
INDONESIAN RUPIAH	-0.86	-1.99	-7.13	-10.98
MALAYSIAN RINGGIT	-2.80	-1.85	-7.31	-14.90
PHILIPPINE PESO	-1.16	-0.90	-0.86	-3.22
SINGAPORE DOLLAR	0.03	1.85	-1.63	-7.48
SOUTH KOREAN WON	-0.65	-0.52	-2.20	-9.29
LATIN AMERICA				
ARGENTINE PESO	-1.05	-2.95	-6.84	-10.51
BRAZILIAN REAL	2.44	3.02	-14.35	-28.64
CHILEAN PESO	-3.31	-2.16	-5.11	-13.48
COLOMBIAN PESO	-2.83	-0.24	-8.81	-27.96
MEXICAN PESO	-2.29	-3.02	-6.27	-17.60
PERUVIAN NEW SOL	-0.72	-2.61	-6.29	-11.98

For the past year, US dollar appreciation has been assisted by steadily widening economic and monetary policy divergences between the United States and key trading partners, namely Europe and Japan. Because of a sluggish first quarter in the United States, growth and inflation data released during the second quarter indicated that economic divergences between the US, Europe and Japan had narrowed. In addition to economic developments pressuring the dollar, consensus expectations for the first federal funds rate hike were pushed out. A later start to the hiking cycle signaled a more dovish Fed, which translated into additional US dollar weakness. Although the gap may have narrowed, policy divergence should remain a driving force in currency markets.

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Disclosure

All data as of June 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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