Bond Market Review and Outlook

By James Balfour, CFA, VP, Senior Global Economist

KEY TAKEAWAYS

- Global growth was not resilient enough to weather a hawkish Fed and stronger dollar.
- Recent central bank actions seem aimed at reducing currency volatility and give a nod to the benefits of a weaker US dollar.
- Our near-term outlook for risk assets is positive since recent policy shifts to stabilize the dollar encourage a smoother rebalancing of global growth.
- Currently, a more stable dollar happens to work to everyone's advantage, but how long this lasts is an open question.

Global markets became increasingly volatile during the first half of the quarter, intensifying with every down tick in the price of oil. Chatter about the odds of a US recession grew louder with financial indicators such as widening credit spreads drawing the most concern.

Weakness in US economic data was concentrated in energy, mining and related industries, with more modest weakness in the manufacturing sector. Global economic data was also weaker, with decelerating global trade flows and broad softness across the manufacturing sector. Some talk of a global recession remains, although this is more of a technical forecast driven by emerging markets (EMs) growing slower than normal on average.

How Did We Get Here?

To see how we got here, we need to rewind the tape a bit. The EM link is an important part of the story. In the decade following China's 2001 admission to the World Trade Organization, growth in world trade and EM economies soared, the US dollar steadily declined and commodities boomed. EM economies increased their leverage quite dramatically over this period, as they are prone to do when the dollar is falling, with Brazil, Russia, India and China leading the pack. The boom times were good. But when the dollar started to strengthen, the bust began to take shape, revealing imbalances in the commodity and EM debt markets. We soon witnessed the "taper tantrum," the start of the yuan devaluation, the free fall in commodity prices, tighter financial conditions across EMs and an ever-escalating dollar.

The Weight of the Dollar

The markets understood that "global economic and financial developments" were bound to keep the Federal Reserve (the Fed) from hiking too quickly, and that a steady diet of rate hikes would be doomed to fail. The strong dollar has been at the center of these developments. Through the lens of the strengthening dollar, we saw pressures build globally as the Fed set off to hike while the rest of the world was poised to ease, particularly the major central banks from the euro zone, Japan and China. And we saw the divergence across global business cycles. Commodities and EM debt are sensitive to the dollar. In this environment, we think a strengthening dollar will create tighter financial conditions across EM economies. It will also exacerbate any oil supply/demand mismatches and put pressure on China to devalue the yuan. More broadly, a tightening Fed constrains policies elsewhere in the world. The Fed isn't necessarily causing all of these problems. These imbalances already existed with policy makers around the world managing the process of rebalancing their economies as best they could. Fed hikes and a stronger dollar can only work to make these adjustments more difficult.

A Shanghai Accord

Ever since the G20 meetings in Shanghai, the tone from the major central banks seems to have changed ever so slightly. Recent comments have suggested an effort to achieve less currency volatility. Perhaps central bankers became more focused on the risks the strong dollar poses to global growth. Global financial stress points may have focused their minds. Call it what you will, but we have seen changes of late, including some forward guidance by central banks that all helped cool the dollar. After the March European Central Bank (ECB) meeting Mario Draghi said, "Also let's not forget that in the G20 in Shanghai all countries took a solemn agreement that basically they would avoid such [a currency] war."[1] He went on to say, "…we don't anticipate that it will be necessary to reduce rates further," a comment that attracted market attention and immediately put upward pressure on the euro. Next, the Bank of Japan (BOJ) took a pass on further easing and China drafted rules to levy a Tobin tax on foreign exchange transactions with an eye on slowing speculative activity. And most importantly, the Fed delivered a surprisingly dovish message when it removed two rate hikes from this year's forecast (the dots) and increased its emphasis on downside risks.

Looking Ahead

At this stage of the cycle, the main risks have been associated with the world's ability to adjust to the end of China's investment boom. We see the recent shift in policy toward a stable dollar as good news for risk assets as it addresses the immediate threats of a much stronger dollar and encourages a smoother transition in the rebalancing of global growth. Less upward pressure on the dollar should create easier financial conditions in emerging markets and result in a smaller yuan devaluation, more support for commodity prices and better conditions for global growth.

Whether coordinated or not, these stable dollar policies will ultimately prove to be temporary. Central bankers are well aware that the best global outcome will occur if each country works to maximize its own long-term economic growth. At the current juncture, a more stable dollar works to everyone's advantage. How long this lasts is an open question. A risk management approach is just what the doctor ordered. Perversely, the recent dovish stance by the Fed makes it more likely they will be able to hike in June. Slow and steady wins the race.

[1]*Introductory statement to the press conference (with Q&A), European Central Bank, 3/10/2016.*

First Quarter Review

By Craig Burelle, VP, Macro Analyst

INDEX RETURNS BY SECTOR
as of March 31, 2016

INDEX				
US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US AGGREGATE BOND	0.92	3.03	2.44	1.96
BARCLAYS US GOVERNMENT/CREDIT	1.17	3.47	2.70	1.75
S&P 500®	6.78	1.35	8.49	1.78

High-quality credit indices rallied during the first half of the quarter when volatility rose and risky assets like equities, commodities and high yield credit retreated. As oil bottomed and capital returned to markets, longer-duration high-quality credit indices surrendered some gains, while shorter-duration indices stabilized and held gains. In addition to a positive absolute return, the US Government Credit Index realized a modest excess return relative to like-duration Treasurys.

US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US TREASURYS	0.16	3.20	2.24	2.39
3-MONTH T-BILLS	0.05	0.08	0.11	0.14
2-YEAR TREASURY	0.17	0.82	0.33	0.72
5-YEAR TREASURY	0.17	2.96	1.54	2.53
10-YEAR TREASURY	-0.24	4.79	3.28	3.06
30-YEAR TREASURY	0.14	8.93	6.67	0.40
BARCLAYS US TIPS	1.80	4.46	3.79	1.51
BARCLAYS US AGENCY	0.20	2.04	1.39	1.88

Volatility quickly ratcheted higher as the year began, and investors flocked to the perceived safe haven of US Treasurys. On the first day of the year, federal funds futures markets priced a 51% probability that the next 25-basis-point Fed rate hike would occur in March. By mid-quarter, the probability of a March hike plummeted to 0 as market volatility tightened financial conditions. Treasurys rallied throughout the turmoil and held gains through quarter-end as the Fed reduced the expected number of rate hikes in 2016 from four to two. Fed expectations to maintain a lower fed funds rate for longer was the primary reason Treasurys with 10- and 30-year maturities outperformed.

US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US MUNICIPALS	0.32	1.67	3.20	3.98

Municipal bonds, similar to US Treasurys, are debt securities backed by the credit of a US state or local government. The municipal index provided a yield spread over US Treasurys throughout the quarter with a credit quality rating just two notches lower. Despite the yield advantage and slightly longer index duration, municipals underperformed US Treasurys.

US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS MBS	0.30	1.98	1.87	2.43
BARCLAYS ABS	0.12	1.36	0.78	1.71
BARCLAYS CMBS	1.25	3.61	2.32	2.80

Market volatility hampered investor demand for securitized new issuance, which caused new deals to be finalized near the wide end of recent spread ranges. The Fed continued to reinvest principal payments from its agency debt and agency MBS holdings into fresh agency MBS to maintain the dollar value of securitized assets on its balance sheet. Agency MBS rallied along with US Treasurys, while pro-cyclical ABS and CMBS participated in the credit market rally.

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 March 31, 2016

INDEX				
CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US INVESTMENT GRADE	2.77	3.97	3.37	0.92
AAA	1.69	4.67	5.20	2.88
AA	1.84	3.59	3.58	2.46
A	2.07	3.89	3.77	2.25
BBB	3.63	4.13	2.89	-0.69
BARCLAYS EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	1.40	2.46	3.80	0.52
AAA	0.51	3.96	5.08	0.52
AA	0.84	2.81	3.82	1.34
A	1.04	2.35	3.62	0.82
BBB	1.84	2.46	3.94	0.02
BARCLAYS STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	2.93	3.18	4.18	0.44
AAA	1.87	6.79	6.79	2.89
AA	2.19	3.95	4.45	0.70
A	2.95	3.38	4.30	0.59
BBB	3.10	2.80	4.00	0.24

US high-quality corporates trended steadily higher throughout the quarter despite choppy trading in other asset classes. The long duration of high-grade US corporates was a tailwind as the US yield curve flattened, led by declines in 10- to 30-year yields. Metals and mining corporates led the index and gained more than 11%, while financials, a 31% index weight, lagged the broader group. ECB Chairman Mario Draghi announced several monetary easing measures in March, including the new corporate sector purchase program (CSPP). Euro-denominated investment grade bonds issued by euro area non-bank corporations are eligible for regular ECB purchase under the program. Many European government bond curves flattened, assisting the advance of European high-quality corporates. Similarly, a flattening UK government bond curve supported the sterling investment grade index, which had a longer duration than the US and European indices.

CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD	4.44	3.35	1.22	-3.69
BB	3.45	3.86	3.71	0.13
B	3.60	2.46	0.41	-4.88
CCC	9.27	3.76	-4.04	-10.60
BARCLAYS PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	3.32	0.47	2.01	-1.23
BB	3.40	0.65	2.91	-0.36
B	3.00	0.33	-0.04	-3.45
CCC	3.96	-0.89	-0.29	-2.64

The first quarter rewarded buy-and-hold investors. After trading down by as much as 5% in early February, the Barclays US Corporate High Yield Index rallied through quarter-end to post strong returns across credit qualities. The index's option-adjusted spread widened to as much as 179 basis points, only to tighten late in the quarter and finish roughly unchanged. In Europe, additional monetary easing from the ECB may have lowered debt service costs for many euro zone sectors, but financials and insurance companies suffered due to the ultra-low rate environment and consistent yield curve flattening. Pan-european high yield industrials earned a positive return of 1.3% and represent over 72% of the index, but the drag from financials was great enough to pull the aggregate index return about flat for the quarter.

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 March 31, 2016

BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD LOANS	3.14	1.79	-0.47	-1.33
BB	1.84	1.52	1.48	2.56
B	3.54	1.83	-0.61	-1.01
CCC	4.97	-6.87	-13.48	-13.67

In a rising rate environment, the floating rate nature of US high yield loans would normally be a tailwind for the indices' performance. Although the Fed started its tightening cycle, the path to higher rates is no longer as steep as first thought. Consequently, US Treasury yields declined during the first quarter, which supported long duration securities but hampered US high yield loan returns. Despite a lack of support from duration, the US High Yield Loans Index earned a positive total return as financial conditions eased in the latter half of the quarter.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI *(LOCAL CURRENCY RETURNS)*	0.47	3.68	3.70	2.84
CITIGROUP NON-USD WGBI	0.63	3.95	4.45	3.10
UNITED STATES	0.15	3.15	2.21	2.35
CANADA	-0.20	1.12	1.84	1.41
JAPAN	1.10	4.69	5.93	6.58
AUSTRALIA	-0.42	2.42	1.87	1.70
UNITED KINGDOM	-0.08	5.28	3.87	3.32
EUROPEAN GBI	0.48	3.43	3.92	0.79
FRANCE	0.39	4.08	4.07	0.61
GERMANY	-0.29	3.79	3.42	0.50
IRELAND	0.68	2.59	3.22	1.15
ITALY	1.11	2.57	4.27	1.81
SPAIN	0.86	2.61	3.88	0.39

A long-term macro perspective may cause investors to conclude that developed market government bonds are unattractive since interest rates have never been so low. While such a conclusion is not necessarily false, investors who ignored developed market government bonds missed out on some of the best global market returns for the quarter. For example, the Japanese segment of the WGBI began the quarter with a yield-to-maturity of 37 basis points but later rallied to just 4 basis points and posted a 4.7% return. Even more extreme, the German segment of the WGBI started the quarter with a yield-to-maturity of 28 basis points but rallied through 0 to -6 basis points by quarter-end to post a 3.8% total return. A low rate environment does not always signal low returns.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	3.34	5.22	6.85	4.36
JP MORGAN CEMBI BROAD DIVERSIFIED *(CORPORATES, USD)*	3.20	3.89	4.35	2.81
JP MORGAN GBI-EM GLOBAL DIVERSIFIED *(GOVERNMENTS, LOCAL CURRENCY)*	2.50	5.00	6.63	5.77

Emerging market fixed income indices were among the top-performing asset classes for the quarter. The EMBIG, which has the longest duration of any listed emerging market benchmark, led the group as yield curves around the world flattened. Within the EMBIG, high-yielders Brazil and Indonesia were top performers. The CEMBI was not far behind but lagged since top-weighted countries, like China, posted relatively small gains. Although the GBI-EM Global Diversified Index had considerably lower duration than the EMBIG, total returns were not far behind. Once again, Brazil was a leading performer in the GBI-EM as the indictment of corrupt business men and former President Lula increased the probability of current President Rouseff's impeachment.

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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	4.12	6.42	2.38	-2.45
AUSTRALIAN DOLLAR	7.23	5.09	9.11	0.66
NEW ZEALAND DOLLAR	4.84	1.14	7.97	-7.51
WESTERN EUROPE				
EURO	4.66	4.77	1.82	6.05
NORWEGIAN KRONE	5.14	6.95	2.99	-2.51
SWEDISH KRONA	5.54	3.98	3.11	6.33
SWISS FRANC	3.81	4.19	1.20	1.13
BRITISH POUND	3.18	-2.55	-5.08	-3.09
EMERGING EUROPE & AFRICA				
CZECH KORUNA	4.76	4.68	2.39	8.07
HUNGARIAN FORINT	3.38	5.26	1.65	1.47
POLISH ZLOTY	7.28	5.23	1.90	1.85
RUSSIAN RUBLE	12.40	8.41	-2.29	-13.02
SOUTH AFRICAN RAND	7.48	4.75	-6.18	-17.84
TURKISH NEW LIRA	5.27	3.55	7.39	-7.80
ASIA				
JAPANESE YEN	0.11	6.80	6.49	6.72
CHINESE RENMINBI	1.52	0.62	-1.51	-3.93
INDONESIAN RUPIAH	1.03	4.15	10.68	-1.25
MALAYSIAN RINGGIT	7.78	10.12	12.71	-5.03
PHILIPPINE PESO	3.35	2.03	1.64	-2.76
SINGAPORE DOLLAR	4.32	5.20	5.48	1.77
SOUTH KOREAN WON	8.15	2.77	3.67	-2.95
LATIN AMERICA				
ARGENTINE PESO	7.70	-12.06	-35.95	-40.03
BRAZILIAN REAL	11.80	10.26	9.89	-11.01
CHILEAN PESO	4.24	6.13	4.30	-6.35
COLOMBIAN PESO	9.68	5.74	2.84	-13.41
MEXICAN PESO	4.96	-0.41	-2.09	-11.66
PERUVIAN NEW SOL	6.33	3.05	-2.40	-6.53

The US dollar retreated 4.1% as measured by the DXY index and 2.9% as measured by the broad trade-weighted US dollar index for several reasons. A dovish Fed cooled dollar strength and lifted most foreign currencies, including those of emerging markets. Notably in developed markets, the Japanese yen rallied more than 6%, even after the BOJ moved to negative bank deposit rates in late January. The euro also appreciated over 4% versus the dollar, despite the delivery of an additional easing package from the ECB. The oil price recovery and broad US dollar weakness also supported the currencies of commodity exporters, such as Canada, Russia and Norway.

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Disclosure

All data as of March 31, 2016, 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 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 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.*