Bond Market Review and Outlook

By James Balfour, CFA, VP, Senior Global Economist

KEY TAKEAWAYS

- The transition to developed economies as the engine of global growth accelerated in 2015, roiling financial markets.
- Headwinds to a global economic expansion remain with falling commodity prices and a stronger US dollar, but we think the majority of the move is behind us.
- Developed market economies should transition to a slow, self-sustaining recovery and drive global growth in 2016.

For some time, the global credit cycle has favored developed over emerging economies. The one-two punch of China shifting to a less commodity-intensive growth model and the Federal Reserve (the Fed) tightening monetary policy dramatically accelerated this transition. Major developed economies should prove resilient and ultimately emerge as the new engines of global growth for the remainder of this cycle.

Headwinds to the global economy certainly remain. Commodity prices may be pressured in the short run, but we think oil prices should rebound by the end of 2016. The US dollar may also continue to appreciate modestly as monetary policy divergence continues. However, we think the most dramatic moves are behind us. While some claim widening credit spreads could signal an imminent recession, we see little evidence to support that outcome. Instead, we expect 2016 to be a year of transition and recovery. In an environment of lower commodity prices and higher interest rates, countries that have been deleveraging since the Great Recession, notably the US, Europe and Japan, should eventually drive global growth. It may not feel like a robust global expansion, but we believe a slow, steady, self-sustaining recovery is in the cards for developed markets. We expand on our outlook below.

China

We do not think China will have a hard landing, but its economic transition has already created a hard landing for those countries dependent on its prior investment-driven growth model. We expect a managed transition from investment to consumption but not a game-changing policy response. The economy will follow an L-shaped recovery path; it won't be V-shaped. Financial conditions will also remain tight.

Emerging Markets

Debt growth was most excessive among the emerging market darlings known as the BRICs (Brazil, Russia, India and China). The boom years are over, government budgets are shrinking, and credit conditions will continue to tighten. The ending of recessions in Brazil and Russia will boost the headline growth rate for emerging markets, but future adjustments will be drawn out and painful. Structural reforms could help reorient economies toward new growth drivers. Meaningful change is on the horizon, but it requires a political response that is typically driven by major economic disappointments.

Japan

Japan is reforming its economy in slow motion. Prime Minister Abe introduced "three new arrows," part fiscal stimulus and part micro reforms intended to boost long-term productivity by raising birth rates and expanding the labor force. However, tax and welfare reforms have lost momentum, and medical and pension system reforms to address the rising costs of an aging population have stalled. Corporations have continued to hoard profits and add little debt to balance sheets. The goal of 2% inflation also remains elusive. The central bank may not be able to take its foot off the monetary gas pedal for a while.

Europe

European growth finally gained traction as fiscal austerity and bank stress tests moved into the rear-view mirror. Expanding bank credit, lower oil prices, lower interest rates, a weaker currency and quantitative easing boosted activity and eased financial conditions. The biggest boost to growth has passed, and growth should downshift modestly in 2016. The European Union's complex political system is its Achilles heel. Political risks will escalate with each additional year that growth proves insufficient to restore jobs lost in the downturn. Still, fiscal and monetary policies remain supportive, and conditions for a continued recovery remain intact.

US

The US economic expansion is expected to continue. However, slowing global growth will pressure the financial markets; call it a profit recession. Much of the pressure on corporate profits has resulted from weakening global growth, but the energy sector has weighed heavily on profits as well. Falling commodity prices, a global inventory correction in manufacturing, weaker exports and stronger dollar are symptoms of slowing global demand. Credit spreads have widened substantially, causing investors to wonder if a recession is near. Yet, the domestic US economy has been resilient. Job growth remains well above what is considered sustainable and is far from contracting—a requirement for a recession. Domestic consumption is a key for continued growth. Rising wages and employment and low gasoline prices, inflation and interest rates encourage consumer spending. With vastly improved household and corporate balance sheets, deleveraging is done. Moving into 2016, federal government spending is set to rise as well, lending additional economic support.

Fourth Quarter Review

By Craig Burelle, VP, Global Research Analyst

INDEX RETURNS BY SECTOR
as of December 31, 2015

INDEX				
US BROAD MARKET	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US AGGREGATE BOND	-0.32	-0.57	0.65	0.55
BARCLAYS US GOVERNMENT/CREDIT	-0.43	-0.74	0.44	0.15
S&P 500®	-1.58	7.04	0.15	1.38

In a quarter marked by the first Fed rate hike since June 2006, most US investment grade fixed income benchmarks posted modest losses, while high yield indices faced additional challenges. Higher-quality corporates and securitized assets, which represent 26.9% and 23.5% of the US Aggregate Index, respectively, helped the Index earn an excess return over like-duration Treasurys. Similarly, the US Government/Credit Index, with a weight of 35.2% to high-credit-quality corporates, earned an excess return over US Treasurys.

US GOVERNMENTS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US TREASURYS	-0.16	-0.94	0.81	0.84
3-MONTH T-BILLS	0.03	0.03	0.06	0.07
2-YEAR TREASURY	-0.10	-0.48	-0.20	0.41
5-YEAR TREASURY	-0.31	-1.38	0.34	1.31
10-YEAR TREASURY	-0.31	-1.44	1.43	0.91
30-YEAR TREASURY	-0.19	-2.08	2.92	-3.17
BARCLAYS US TIPS	-0.79	-0.64	-1.78	-1.44
BARCLAYS US AGENCY	-0.27	-0.64	0.42	1.01

The market implied probability of a Fed rate hike leapt higher in early November after the October US nonfarm payroll report indicated new job growth significantly higher than consensus expectations. The probability of a 25 basis point rate hike in December rose from 50% in late October to 74% by late November. Speeches given by Chair Yellen and other Federal Open Market Committee (FOMC) officials have indicated an initial rate hike for some time. Yields across the curve rose, but overall, the yield curve flattened. Rate hike expectations drove shorter-maturity yields up, while a lower inflation outlook and expected terminal federal funds rate capped longer-term yields. Most of the yield rise this quarter took place throughout October as investors discounted the first federal funds rate hike. Markets now appear to expect the Fed to tighten more slowly than in past cycles.

US MUNICIPALS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US MUNICIPALS	0.70	1.50	3.18	3.30

The municipal index is an investment grade benchmark, with the majority of securities rated AAA and AA. As corporate credit concerns mounted throughout the quarter, municipals provided yield and shelter from the volatility. The municipal bond index was the top-performing US fixed income asset class for the fourth quarter, and performance was actually led by the lowest-credit-quality A and BBB securities.

US SECURITIZED	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS MBS	-0.03	-0.10	1.20	1.51
BARCLAYS ABS	-0.19	-0.57	0.17	1.25
BARCLAYS CMBS	-0.89	-1.24	0.28	0.97

During October, the yield to worst on each securitized index initially spiked higher along with Treasury yields, and much like the US 2-year yield, securitized yields rose through quarter-end. Excess returns over like-duration Treasurys were slightly negative for ABS and CMBS indices. However, the MBS index posted a positive excess return of 61 basis points. In addition to raising rates, the Fed maintained its policy of reinvesting principal payments from matured agency MBS and debt into agency MBS.

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 December 31, 2015

INDEX CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US INVESTMENT GRADE	-0.78	-0.58	0.24	-0.68
AAA	0.17	0.51	2.91	0.43
AA	-0.31	-0.01	1.38	0.92
A	-0.40	-0.11	1.42	0.60
BBB	-1.27	-1.19	-1.20	-2.25
BARCLAYS EUROPEAN INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-0.82	1.30	1.03	-0.56
AAA	-0.80	1.08	2.24	-0.50
AA	-0.80	0.99	1.39	-0.59
A	-0.74	1.24	1.29	-0.38
BBB	-0.90	1.44	0.69	-0.70
BARCLAYS STERLING INVESTMENT GRADE *(LOCAL CURRENCY RETURNS)*	-0.94	0.97	1.60	0.70
AAA	-1.13	-0.00	2.37	1.39
AA	-1.00	0.48	1.33	-0.18
A	-0.99	0.89	1.76	0.80
BBB	-0.88	1.16	1.49	0.78

Rising US Treasury yields in the belly of the yield curve (5- to 10-year maturities) limited investment grade corporate returns in the quarter. AAA-rated US corporates earned the highest return, but at just 1.6% of the index, the universe is small. The Barclays US Investment Grade Index experienced a series of credit rating downgrades, with the weight of A-rated securities falling 3.7% and BBB-rated securities rising 3.1%. Deteriorating credit quality led to higher yields, which produced negative returns for some securities in the index. During the quarter, option-adjusted spreads (OAS) on the US Corporate, Euro-Aggregate and Sterling Aggregate indices tightened, though spreads widened for the majority of 2015. Additional European Central Bank (ECB) easing provided a tailwind for the Euro-Aggregate, and the Bank of England continued to hold its policy rate steady, which supported UK corporate credit.

CORPORATES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD	-2.52	-2.07	-6.82	-4.47
BB	-1.88	-0.15	-3.24	-1.00
B	-2.46	-1.99	-7.50	-4.72
CCC	-4.46	-7.51	-14.26	-12.11
BARCLAYS PAN-EURO HIGH YIELD *(LOCAL CURRENCY RETURNS)*	-2.58	1.54	-0.75	2.92
BB	-1.98	2.24	0.41	3.05
B	-3.79	-0.37	-4.04	2.29
CCC	-3.25	0.61	-0.23	2.61

Though the path for US rate increases should be gradual, uncertainty about the impact from higher rates and access to corporate credit markets created angst among high yield investors. The distribution of US high yield total returns was uneven. The communications, financials and technology sectors posted positive performance, but commodity-related and interest-rate-sensitive sectors like utilities and energy suffered. Specifically, US energy companies tumbled over 13%, falling along with the 18% decline in West Texas Intermediate (WTI) crude oil. A fractional 0.7% weight to the energy sector and additional monetary stimulus from the ECB propelled the Pan-European High Yield Index to positive performance, and the index's OAS tightened by 9 basis points.

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 December 31, 2015

INDEX				
BANK LOANS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
BARCLAYS US HIGH YIELD LOANS	-1.08	-2.23	-3.67	-0.82
BB	-0.02	-0.04	0.25	3.48
B	-1.28	-2.39	-3.59	-0.26
CCC	-3.14	-7.10	-8.05	-5.28

Once again, weakness in US high yield corporates bled into the US high yield loan market. In rising rate environments, floating-rate coupons typically buoy the price of high yield loans relative to traditional fixed-coupon bonds. However this quarter, US high yield loans underperformed traditional high yield corporates as technical pressures reduced liquidity and created pricing inefficiencies.

DEVELOPED COUNTRIES	1 MONTH	3 MONTH	6 MONTH	1 YEAR
CITIGROUP WGBI *(LOCAL CURRENCY RETURNS)*	-0.29	0.01	1.90	1.28
CITIGROUP NON-USD WGBI	-0.36	0.48	2.46	1.52
UNITED STATES	-0.16	-0.92	0.79	0.81
CANADA	1.24	0.72	1.75	3.71
JAPAN	0.75	1.18	2.07	1.25
AUSTRALIA	0.42	-0.53	2.13	2.55
UNITED KINGDOM	-1.12	-1.33	1.94	0.45
EUROPEAN GBI	-1.00	0.47	3.03	1.65
FRANCE	-1.18	-0.01	1.94	0.49
GERMANY	-1.02	-0.35	1.41	0.37
IRELAND	-0.68	0.61	3.15	1.66
ITALY	-0.71	1.66	5.84	4.92
SPAIN	-1.15	1.24	4.09	1.70

Global growth and inflation are expected to accelerate only slightly over the coming two years. This suggests policy rates will remain low in the near term. Sustained low-rate environments can be favorable for developed market government bonds in local currency terms, which has been the case for several years. The Fed was the first central bank to successfully lift rates off the zero bound, a positive for the global economy. Conversely, the ECB has increased monetary stimulus, and the Bank of Japan (BOJ) is maintaining its monetary policy with a bias to ease further should economic conditions deteriorate. A slowly hiking Fed paired with an easing ECB and an ultra-accommodative BOJ should create an environment in which even the lowest-yielding countries, like Japan, can produce positive returns.

EMERGING MARKET BONDS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
JP MORGAN EMBIG *(SOVEREIGN/QUASI-SOVEREIGN, USD)*	-1.50	1.55	-0.52	1.23
JP MORGAN CEMBI BROAD DIVERSIFIED *(CORPORATES, USD)*	-1.23	0.45	-2.32	1.30
JP MORGAN GBI-EM GLOBAL DIVERSIFIED *(GOVERNMENTS, LOCAL CURRENCY)*	-0.71	1.56	1.00	3.28

Emerging market government bonds were among the top-performing global asset classes. This performance was impressive relative to other risk assets given the inherent risks from China's growth slowdown, continued commodity price weakness and a strong US dollar. This quarter, country-specific risk drove returns. For example, Turkish assets in the EMBIG and CEMBI performed well on investor hope for political continuity within the AK Parti. With the economy slowing but still growing, Chinese sovereign bonds in the EMBIG and CEMBI also earned positive returns. In Brazil, the appointment of a new finance minister focused on structural reforms was well received by investors, but the continued drag from falling commodity prices limited total returns for the country.

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INDEX				
CURRENCY MARKETS	1 MONTH	3 MONTH	6 MONTH	1 YEAR
DOLLAR BLOC				
CANADIAN DOLLAR	-3.45	-3.80	-9.72	-16.03
AUSTRALIAN DOLLAR	0.82	3.82	-5.46	-10.87
NEW ZEALAND DOLLAR	3.75	6.75	0.98	-12.39
WESTERN EUROPE				
EURO	2.81	-2.82	-2.56	-10.22
NORWEGIAN KRONE	-1.64	-3.70	-11.19	-15.73
SWEDISH KRONA	3.39	-0.84	-1.82	-7.51
SWISS FRANC	2.68	-2.87	-6.65	-0.78
BRITISH POUND	-2.13	-2.59	-6.21	-5.40
EMERGING EUROPE & AFRICA				
CZECH KORUNA	2.89	-2.18	-1.62	-8.08
HUNGARIAN FORINT	1.31	-3.44	-2.69	-9.92
POLISH ZLOTY	3.02	-3.16	-4.14	-9.67
RUSSIAN RUBLE	-8.41	-9.87	-23.69	-16.25
SOUTH AFRICAN RAND	-6.60	-10.43	-21.33	-25.20
TURKISH NEW LIRA	-0.12	3.72	-8.08	-19.96
ASIA				
JAPANESE YEN	2.40	-0.28	1.90	-0.37
CHINESE RENMINBI	-1.47	-2.12	-4.51	-4.44
INDONESIAN RUPIAH	0.43	6.27	-3.26	-10.15
MALAYSIAN RINGGIT	-0.80	2.34	-12.13	-18.56
PHILIPPINE PESO	0.65	-0.38	-3.83	-4.66
SINGAPORE DOLLAR	-0.54	0.27	-5.01	-6.56
SOUTH KOREAN WON	-1.46	0.88	-5.07	-7.16
LATIN AMERICA				
ARGENTINE PESO	-25.09	-27.17	-29.73	-34.54
BRAZILIAN REAL	-2.36	-0.34	-21.66	-32.90
CHILEAN PESO	0.36	-1.72	-9.81	-14.42
COLOMBIAN PESO	-0.89	-2.74	-17.91	-25.14
MEXICAN PESO	-3.67	-1.68	-8.53	-14.27
PERUVIAN NEW SOL	-1.13	-5.29	-6.87	-12.73

The ECB increased monetary stimulus and the Fed raised the federal funds rate, but investors widely expected both moves and priced them into markets. However, markets were initially disappointed by the magnitude of additional easing from the ECB, which caused the euro to rally relative to the US dollar. By quarter-end, the US dollar still appreciated relative to the euro, and monetary policy divergence remained intact. In emerging markets, the Chinese renminbi slowly weakened, indicating sharp devaluations, like the one in the third quarter, are not the only option for the People's Bank of China. Idiosyncratic themes related to political change, interest rates and commodity prices dictated returns across emerging market currencies.

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Disclosure

All data as of December 31, 2015, unless otherwise noted.

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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.

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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