

### Global Fixed Income Bulletin

# Bright Skies in Q1, Some Clouds Ahead

**FIXED INCOME** | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | APRIL 2017

## Outlook

- In light of the many foreseeable political risks, we are more cautious in our outlook for the second quarter. If drivers of higher rates in Q1, namely rebounding inflation and U.S. fiscal optimism pause, the main risk is that U.S. rates might tilt lower. That said, government bond yields in much of the world rallied in Q1, taking them to the bottom of perceived trading ranges, potentially reflecting much reduced optimism that the world can break out of its long-term "secular stagnation."
- The Federal Reserve's current strategy seems to be to raise rates opportunistically, picking moments that would be minimally disruptive to financial markets. The implication for fixed income investing is to build a portfolio that will out-carry and out-tighten the pace of rate hikes. Picking the right carry opportunities, ones that offer the best risk-adjusted return, will be a key component of outperformance potential.
- We remain optimistic about the prospects for emerging market (EM) fixed income as country fundamentals and the macro environment remain supportive. Differentiation remains key. Those countries that are heavily reliant on global trade could be potentially challenged given pressures on globalization. On the other hand, commodity exporting countries could still benefit from improving fundamentals, higher commodity prices and undervalued exchange rates, while commodity importing countries that run large current account deficits are likely to underperform despite attractive carry cushions.
- In corporate credit, we expect continued tightening across credit assets. In the U.S. we expect that continued robust demand for the investment-grade (IG) and high-yield (HY) asset classes will lead spreads tighter. In Europe we envision that both IG and HY should be well supported by the European Central Bank (ECB) and Bank of England (BoE) corporate bond (nonfinancials) purchases.
- We continue to underweight agency mortgage-backed securities (MBS) due to their historically tight nominal and option-adjusted spreads, as well as the increasing risk that the Fed may decide to discontinue the reinvestment of MBS paydowns.

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First-quarter 2017 was marked by an upsurge in global economic sentiment and inflation, which continued to have legs in March. PMIs and other soft data surveys continue to be at near-term highs. Base effects from an oil price rebound drove inflation higher, with U.S. headline inflation hitting 2.7 percent. Going forward, as these effects reduce, the headline should converge towards the core, which sits at around 2 percent.

Good fundamentals and calm markets created an opportunity for the Fed to hike rates. At the beginning of the month, market pricing for a hike was roughly 50:50. However, public comments by Federal Open Market Committee (FOMC) members during the first week of March quickly pushed up market expectations. With unemployment below 5 percent and headline inflation above 2 percent, economic fundamentals provided a good case for tightening. In anticipation of the hike, 10-year yields rose briefly above 2.6 percent, breaking out of its recent range.

Market reaction to the Fed hike was surprisingly benign. While markets feared that the Fed's reaction function was turning hawkish, the central bank struck a more dovish tone at the meeting. The FOMC's projection of the future rate path stayed relatively unchanged. The terminal rate stayed around 3 percent while the committee on average still projects a total of three hikes for 2017, unchanged from the last projection. If one assumes an inflation rate of 2 percent at the end of the cycle, the real terminal fed funds rate would be around 1 percent, which is lower than the historical average. With the latest hike, the real fed funds rate is still negative, and therefore, represents relatively easy monetary conditions. In other words, we believe the Fed is still in the process of removing excess accommodation, and is not yet interested in adopting an outright restrictive monetary stance. As a result, financial conditions eased in the aftermath; equities rose, the trade-weighted dollar declined, and spreads compressed.

The Fed's current strategy seems to be to raise rates opportunistically, picking moments that would be minimally disruptive to financial markets. The implication for fixed income investing is to build a portfolio that will out-carry and out-tighten the pace of rate hikes. Picking the right carry opportunities, ones that offer the opportunity for the best risk-adjusted return, will be an important source of outperformance.

While the first quarter was driven by global reflation, the upcoming quarter could present more risks, particularly political. The U.K. has formally triggered Article 50 to negotiate an exit from the EU, which could turn contentious. French elections present another event risk. The large number of first-round presidential candidates, revealing political fragmentation among voters, could counteract each other, helping Marine Le Pen.

Finally, there is fiscal policy in the U.S. Much of the market rhetoric in March was dominated by developments in Washington DC. In particular, the Trump administration's failure to pass health care reform generated market concern over the administration's ability to enact other reforms, namely tax policy. However, the silver lining is that Washington, in theory, will not be bogged down by debates over health care, which means that tax policy, for which the president will likely take the lead, could be pushed forward in the legislative agenda. On the other hand, the complexity of tax policy could mean that reform momentum might stall, though we believe some form of tax reform will pass eventually. In light of the many foreseeable political risks, we are more cautious in our near-term outlook. If drivers of higher rates in Q1, namely rebounding inflation and fiscal optimism, pause in Q2, the main risk is that U.S. rates could tilt lower. That said, yields have already moved to the bottom of their recent range.

## Developed Market Interest Rates and Currency Outlook

Yields normalized considerably in Q1. However, without a realization of better economic data, we see 10-years trading within the ranges established this year. Better-than-expected growth, which hinges partly on the new policy mix under Trump, would drive "fair value" higher, though conversely, disappointments would drive rates lower. In light of our riskier outlook for Q2, we look to reduce our duration underweight on moves to lower yields.

We expect continued ECB purchases to pressure euro periphery real yields lower, in order to bring about the necessary financial and economic rebalancing to increase inflation expectations. Based on this view, we continue to like inflation-protected bonds in Italy and Spain and are slightly negative on eurozone duration on valuation grounds and improving economic performance. In the core euro area, improving growth and inflation dynamics could raise market expectations of ECB tapering, which would increase risk premium and steepen yield curves. Populist political risks have pushed eurozone spreads higher and have led to what we consider to be mispricings relative to economic and political fundamentals, such as in Spain and Portugal.

In terms of currencies, the U.S. dollar is likely to remain firm in 2017, driven by widening short-term interest rate differentials with the rest of the world and a relatively more expansionary fiscal policy. We have exposure to where we see value, including the Swedish kroner, Brazilian real, Mexican peso, Indonesian rupiah and the Russian ruble. Increasing global skepticism around monetary policy effectiveness will likely make it difficult for Sweden's Riksbank to ease further, while economic growth is at an above-trend pace. Emerging market currencies also look interesting in a more robust global growth world. The wild card remains Trump's protectionist agenda,

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which would include complaints about a too strong dollar, upsetting the currency's bullish view.

## Emerging Markets Outlook

The new U.S. administration has found it challenging to deliver on pre-inauguration hopes for policies that would support reflation. With reflation hopes centered on the passage of fiscal reform, we expect stronger growth in Q2 and Q3 in the U.S. than in Q1.

In a historical context, we would still expect overall low DM yields to support the "right" carry opportunities as we expect an ongoing push-factor of inflows into higher yielding assets, including select EM fixed income. For global growth, the beneficial impact of higher U.S. growth is likely to be partly offset by the extent of the new president's potentially protectionist trade agenda. The net effect won't be known for a while, but Mexico and China will remain a key focus, with joint cooperation between Trump and the more traditional trade-friendly wing of the Republican wing potentially reducing the protectionist impact. NAFTA repudiation fears have declined as renegotiation seems more likely. The EM/DM growth differential has stabilized and appears to be recovering in favor of EM as the negative growth impacts from Brazil and Russia lessen. China's growth slowdown is likely to continue in the medium term, with better-than-expected short-term growth reliant on continued fiscal and monetary policy support.

Against this backdrop, there will be winners and losers in EM. An overvalued U.S. dollar with downside potential, combined with higher commodity prices, should support commodity exporting countries that still benefit from improving fundamentals and a significantly undervalued exchange rate. In contrast, commodity importing countries that run large current account deficits are

likely to underperform despite attractive carry cushions. Fairly closed economies enjoying limited current account deficits, such as India, are likely to remain rather uncorrelated to global financial conditions. The Mexican peso will remain the main shock absorber to negative U.S. trade protectionism. Gradual clarity on NAFTA has allowed the peso to recover from its weakest levels; indeed, the peso was the strongest currency in the world in Q1: An example of the power of undervaluation when negative momentum stops.

We remain optimistic about the prospects for EM fixed income as country fundamentals and the macro environment remain supportive, with those countries relying the most on global trade potentially challenged. The various factors both pushing and pulling investors into EM fixed income remain in place: Developed market yields remain very low, economic data in EM appears to be recovering, Fed rate hikes are likely to remain gradual, U.S. protectionism fears have eased and concerns of a sharp slowdown in China have diminished. We believe that EM assets could well absorb multiple Fed rate hikes in 2017 if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty from Trump or Fed hawkishness, while European elections also pose potential downside risks.

## Credit Outlook

In March, the Trump administration's push for health care reform was a dominant theme. While the failure of the administration to pass health care reform has little direct impact on the corporate bond market, the implications of this failure on the type and magnitude of tax reform has a potentially significant impact. Specifically, if the administration had succeeded in passing the health care reform, the market may have had greater confidence in its ability to pass a

comprehensive tax reform which could include changes to the overall tax rate, allowances for cash repatriation, border adjustments, and tax treatment of corporate interest expense—which we will closely watch in the upcoming months.

As low global yields, high cash balances and government support of credit markets persist around the globe, we expect continued tightening across credit assets. In the U.S. we expect that continued robust demand for the investment-grade (IG) and high-yield (HY) asset classes will lead spreads tighter. In Europe we envision that both IG and HY should be well supported by the ECB and BOE corporate bond (nonfinancials) purchases. While political volatility is currently the most prominent risk in global credit, we anticipate that technicals will continue to drive spreads and support credit in the upcoming quarter. We continue to remain long risk and carry, but have de-risked in anticipation of increased volatility in the second quarter as Brexit, French elections and continued U.S. political headlines loom.

## Securitized Outlook

Overall, our outlook for the securitized asset class remains largely unchanged from March: We remain overweight mortgage credit opportunities and underweight more rates-based risks of agency MBS. We continue to underweight agency MBS due to their historically tight nominal and option-adjusted spreads, as well as the increasing risk that the Fed may decide to discontinue the reinvestment of MBS paydowns in their \$1.75 trillion agency MBS portfolio sometime in the near future. The Fed purchased nearly \$400 billion agency MBS in 2016 in order to maintain its portfolio at \$1.75 trillion, and we expect the bank to purchase roughly \$250 billion agency MBS in 2017.<sup>1</sup> Without the Fed's purchases, this additional MBS supply would need

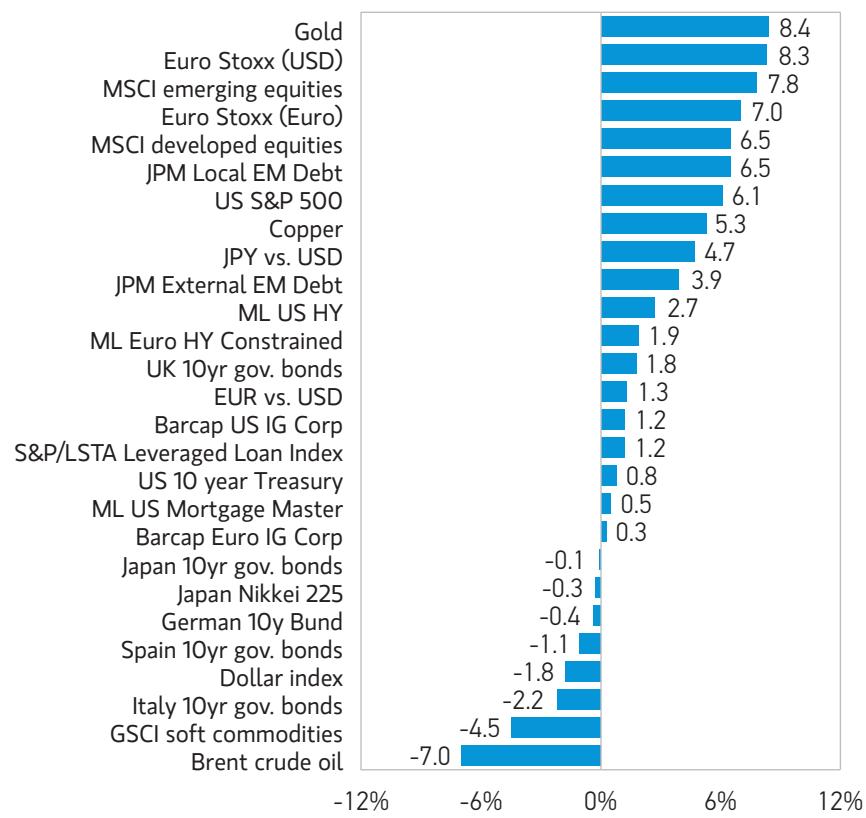
<sup>1</sup>Source: Federal Reserve. Data as of March 31, 2017.

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to be absorbed by other investors, and spreads may need to widen to encourage investors to add to their agency MBS positions. Agency MBS have performed reasonably well over the last few months as the market volatility has subsided and interest rates seem to have settled into a new range. If rates remain range-bound, both prepayment and extension risks would likely be relatively subdued, and agency MBS could outperform. However, we believe that interest volatility will likely increase as the Fed continues its interest rate hikes, and that this potential increase in volatility could cause agency MBS to underperform, similar to their performance last November and December. Although agency MBS is one of the few securitized sectors that have not experienced material spread tightening over the past couple years, we remain cautious given both the currently marginal overall value opportunity and the potentially negative supply-demand dynamic if the Fed ends their reinvestment. Additionally, agency MBS have experienced mediocre returns over past two years, and 2017 is off to a modest start relative to other asset classes, and thus we do not expect to see material increases in demand unless the sector cheapens and the value opportunity improves.

Non-agency MBS remains one of the more stable and attractive fixed income asset classes in our opinion. Given the attractive carry, improving fundamentals and shrinking net supply, we remain overweight the sector. Non-agency MBS spreads have tightened roughly 75-100 basis points over the past year, but we remain positive given the still-attractive carry and improving fundamental conditions. Further, we remain positive on the U.S. housing market given the modest strength of the economy, continued low mortgage rates and above-average home affordability. From a supply perspective, we project outstanding non-agency MBS to decline by \$60 billion to \$70 billion in 2017, while new securitizations are projected at just \$25 billion to \$30 billion.

## DISPLAY 1 Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of March 31, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See pages 12 and 13 for index definitions.

We remain cautiously overweight the U.S. commercial mortgage-backed securities market (CMBS), which currently offer some of the highest yield opportunities within fixed income. In addition, most underlying real estate sectors are performing well with record-high occupancy rates and increasing rental rates. This is particularly true for multifamily housing, hotels and office buildings. However, we are much more cautious on retail shopping centers given the seemingly endless announcements of store closings by major national retailers. Individual security selection is extremely critical in this environment as wider spreads create value opportunities, but property-specific credit problems could

create potential landmines. Overall, we expect that commercial real estate fundamental conditions will remain strong. We remain positive on the office, hotel, industrial and multifamily housing sectors of the CMBS market, but we are very cautious on retail shopping centers.

In Europe, we have decreased our strong overweight positioning to a more moderate overweight outlook for MBS and CMBS. Spreads are now tighter than pre-Brexit levels; although, we believe fundamental conditions have more uncertainty in the wake of the Brexit vote. Overall, we remain positive on the sector given the belief that the ECB and BoE will continue to keep interest

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**DISPLAY 2**  
**Government Bond Yields for Major Economies**

COUNTRY	2YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	5YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)
Australia	1.75	-6	2.24	-1	2.70	-2
Belgium	-0.50	6	-0.09	12	0.85	14
Canada	0.75	-1	1.12	0	1.63	-1
Denmark	-0.59	7	-0.23	15	0.60	10
France	-0.29	24	0.13	10	0.97	8
Germany	-0.74	16	-0.38	19	0.33	12
Ireland	-0.35	10	0.26	8	1.00	11
Italy	-0.03	-2	1.11	28	2.32	23
Japan	-0.19	8	-0.12	2	0.07	1
Netherlands	-0.63	18	-0.27	13	0.58	10
New Zealand	2.14	-3	2.48	-10	3.19	-4
Norway	0.61	-32	0.94	-17	1.64	-7
Portugal	0.62	60	2.28	46	3.98	10
Spain	-0.17	-4	0.50	0	1.67	1
Sweden	-0.60	6	-0.05	10	0.61	7
Switzerland	-0.86	10	-0.54	16	-0.09	14
United Kingdom	0.13	3	0.56	1	1.14	-1
United States	1.25	-1	1.92	-1	2.39	0

Source: Bloomberg LP. Data as of March 31, 2017.

rates low for the foreseeable future, and that both the European economies, and more importantly the respective real estate markets, will benefit from these accommodative policies. New residential mortgage-backed security (RMBS) and CMBS issuance within Europe remains disappointingly light, but we are still finding a number of attractive seasoned opportunities. As long as the fundamental conditions remain positive

with low rates and rising real estate prices, we continue to like the European RMBS and CMBS markets despite the potential political risks.

### Market Summary

In March, yield changes across developed markets were mixed.<sup>2</sup> Yields rose as markets priced in odds of a Fed hike. However, dovish messaging from the Fed at the FOMC meeting led yields

lower, giving back most of their rise for the month. The dollar weakened against major currencies.

Over the month, 10-year U.S. Treasury yields were unchanged, while the 2s/10s curve flattened by 1 bp.<sup>3</sup> Germany's 10-year yield increased 12 bps, while the two-year yield increased 16 bps.<sup>4</sup> Ten-year yields in Italy and Portugal increased 23 bps and 10 bps, respectively.<sup>5</sup> Spanish 10-year yields increased 1 bps. Greece's 10-year government yield outperformed the euro periphery, decreasing by 16 bps.<sup>6</sup> The Japanese government bond (JGB) 10-year yield increased by 1 bp.<sup>7</sup>

Despite Fed tightening, the dollar generally weakened. The euro appreciated by 0.7 percent. The British pound appreciated by 1.4 percent. The Japanese yen appreciated by 1.2 percent.<sup>8</sup> The Mexican peso appreciated 7.4 percent, the biggest winner in the month. The New Zealand dollar was the biggest loser as dairy prices declined, leading the trade balance to surprise on the weak side. Crude oil (Brent) prices dropped to \$53 from \$56.<sup>9</sup>

### Developed Markets

In the U.S., the Fed raised rates by 25 bps at the March meeting. The Summary of Economic Projections show the total rate increases this year and next, which are unchanged from the previous projection. Data continued to be strong in March. February non-farm payrolls increased 235,000 versus expectations of 200,000.<sup>10</sup> The unemployment rate ticked down to 4.7 percent, in line with consensus, as the participation rate increased to 63.0 percent. Average hourly earnings increased to 2.8 percent from 2.6 percent previously.<sup>11</sup> The ISM manufacturing index increased to 57.7 in February, above expectations of 56.2. Gross domestic

<sup>2</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>3</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>4</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>5</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>6</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>7</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>8</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>9</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>10</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>11</sup> Source: Bloomberg. Data as of March 31, 2017.

product (GDP) figures for the fourth quarter were revised up to 2.1 percent, above consensus forecast of 2 percent. This brings 2016 yearly growth to 3.5 percent. Headline CPI rose to 2.7 percent from 2.5 percent, driven mostly by base effects from rising oil prices. Core CPI was 2.2 percent for February.<sup>12</sup>

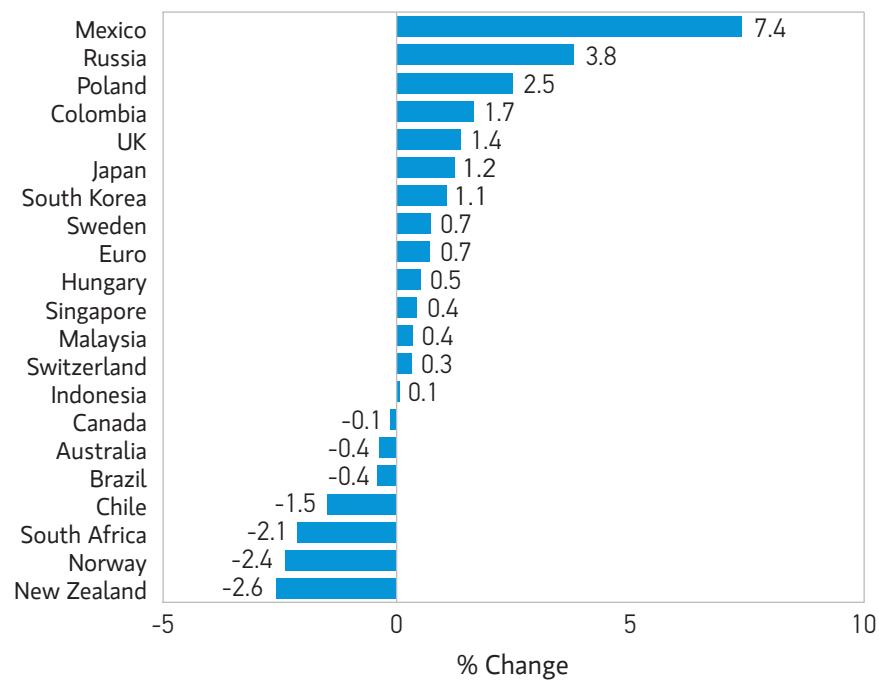
In the eurozone, the ECB kept policy unchanged at the March meeting, which was in line with expectations. ECB President Mario Draghi noted that downside risks to rates and growth had diminished. However, the committee would like to see signs of a self-sustaining price recovery before withdrawing accommodation. In terms of survey data, eurozone manufacturing PMI came in at 55.4 in February, in line with January and slightly below market expectations of 55.5.<sup>13</sup> The final eurozone GDP for fourth-quarter 2016 was 0.4 percent quarter-on-quarter. This brings 2016 annual growth to 1.7 percent. Eurozone inflation was 2.0 percent for February, flat from last month.<sup>14</sup>

In the U.K., the BoE kept policy unchanged at the March meeting, with one member dissenting in favor of higher rates. The statement noted that some members see a reduction in policy support as warranted if there's a little further upside in growth or inflation. U.K. Prime Minister Theresa May formally triggered Article 50 to exit the EU, though offered little additional details about the U.K.'s negotiation strategy. In terms of data, headline CPI inflation was 2.3 percent year-over-year in February, up from previously and above consensus of 2.1 percent.<sup>15</sup> Core inflation was 2 percent, above consensus of 1.7 percent. The unemployment rate's three-month average ticked down to 4.7 percent in January. Final GDP figures for the fourth quarter stayed at 0.7 percent,

### DISPLAY 3

#### Currency Monthly Changes Versus U.S. Dollar

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of March 31, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

in line with expectations. This brings annual 2016 growth to 1.9 percent. U.K. manufacturing PMI was 54.6 percent in February, below 55.7 in January and consensus expectations.<sup>16</sup>

In Japan, the Bank of Japan (BoJ) kept monetary policy unchanged in the March meeting. Governor Kuroda reaffirmed the 10-year yield target. In terms of data, manufacturing PMI was 53.3 for February, down from 53.5 in January. Final fourth quarter GDP was 0.3 percent quarter-on-quarter, below expectations of 0.4 percent. This brings 2016 growth to 1.2 percent. The January core national CPI (ex-food and energy) was 0.2 percent, up from December and in line with consensus.<sup>17</sup>

### Emerging Markets

EM fixed income assets registered another strong month of performance to end the first quarter on a positive note. Investors continued to increase exposure to the asset class on a brightening outlook for EM fundamentals and a stable global macro backdrop offsetting the emergence of idiosyncratic developments in select countries. The reduction of protectionist concerns about the new U.S. administration aided assets in Asia and Mexico. A total of \$6.4 billion went to hard currency, local currency and blended strategies during the month to bring the year-to-date total to \$17 billion, compared to a total of \$43 billion in 2016.<sup>18</sup> U.S. Treasury yields and the U.S.

<sup>12</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>13</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>14</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>15</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>16</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>17</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>18</sup> Source: Standard Charter. Data as of March 31, 2017.

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dollar remained contained in spite of the Fed's decision to hike policy rates 25 bps.<sup>19</sup> This provided a catalyst for local currency debt to outperform, driven by local bond performance and currency appreciation versus the U.S. dollar. Within dollar-denominated debt, sovereign investment grade credits outperformed higher-yielding credits, while higher-rated companies underperformed high yield.

Growth in the developed world continued to show signs of resiliency, as did EM economic data, including China. Mexico's central bank, Banxico, followed the Fed by also hiking rates by 25 bps, while China's central bank (the PBOC), continued to hike its policy rates aimed at slowing credit growth. Conversely, other central banks (including Colombia and Russia) continued to—and still have room to—cut interest rates to support growth. The Russian central bank (CBR) cut policy rates 25 bps and in its statement remained cautious on the trajectory of future interest rate cuts. The market is expecting additional cuts of 75–100 bps through the rest of the year.

In Latin America, Venezuelan assets came under renewed pressure after the country's Supreme Court invalidated the opposition-controlled National Assembly, further moving that country towards a dictatorship. However, the government encouraged the court to quickly reverse this decision in reaction to condemnations from within the Chavismo Party and from regional governments. The Venezuelan leadership has shown willingness and ability to pay, despite the challenges of maintaining social spending in the face of lower oil revenues. In Brazil, the anti-corruption investigations continued as authorities launched a new probe focused on Brazilian meat producers. The newly launched probes, named "Weak Flesh" and "Cold Meats," involve bribery schemes implicating agricultural inspectors and

the approvals granted for the sale and export of tainted/spoiled meat. The actions weighed on bond and stock prices for companies in the processed food and beef sector. Several countries moved quickly to ban protein imports from Brazil broadly or at least from specific plants involved in the initial investigation. It wasn't all bad news from Brazil, however, as Moody's revised the outlook for the country's Ba2 rating to stable from negative.

In other ratings action, Fitch Ratings affirmed Colombia at BBB and revised the outlook to stable from negative. The decision was based on a "reduction in macroeconomic imbalances as a result of the sharp reduction in the current account deficit," driven in part by the passage of the tax reform in December. Russia's credit rating outlook was raised to positive by S&P Global Ratings based on higher economic growth and fiscal discipline. Politics once again took center stage in South Africa as President Jacob Zuma announced a cabinet reshuffle of nine ministers and six deputy ministers, including finance minister Pravin Gordhan, who was favored by the market as a positive force for fiscal discipline and a check on the spending tendencies of the government. Gordhan's removal could also allow greater access to patronage resources for the president to dole out. The reshuffle triggered a ratings downgrade by S&P (to BB+ from BBB-, which occurred in early April) and could prompt further warnings by the other major ratings agencies. The reshuffle weighed on South African asset prices, especially the currency (ZAR: rand).

### External

EM external sovereign and quasi-sovereign debt returned 0.35 percent in the month, bringing year-to-date performance to 3.90 percent, as measured by the JP Morgan EMBI

Global Index.<sup>20</sup> Bonds from Belize, Mozambique, Paraguay, Oman, Cameroon, and Angola, outperformed the broader market. Conversely, bonds from Venezuela, Ecuador, Bolivia, South Africa, Ivory Coast, Malaysia, Zambia and Azerbaijan underperformed the broader market in the month.

### Domestic

EM domestic debt returned 2.31 percent in the month, bringing year-to-date performance to 6.5 percent as measured by the JP Morgan GBI-EM Global Diversified Index.<sup>21</sup> EM currencies strengthened 0.91 percent versus the U.S. dollar and EM bonds returned 1.40 percent in local terms.<sup>22</sup> Currency performance versus the U.S. dollar weighed heavily on bond performance for South Africa, Chile, Brazil and Turkey. Bonds from the Philippines, Malaysia, Romania, Hungary and Thailand also underperformed the broader market. Conversely, bonds from Mexico, Russia, Poland, Peru, Indonesia and Colombia outperformed the broader market in the period.

### Corporate

EM corporate debt returned 0.32 percent in the month, as measured by the JP Morgan CEMBI Broad Diversified Index.<sup>23</sup> Higher-yielding, lower-quality companies outperformed higher-rated companies in the month. From a regional perspective, companies in Africa (Nigeria), Latin America (El Salvador, Argentina) and Europe (Kazakhstan) led the market, while those in Asia (South Korea) and the Middle East (Egypt) lagged. From a sector perspective, companies in the Oil and Gas, Industrial, Real Estate, Utilities, and Financial sectors outperformed the broader market, while those in the Consumer, Metals and Mining, TMT and Infrastructure sectors lagged.

<sup>19</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>20</sup> Source: JP Morgan. Data as of March 31, 2017.

<sup>21</sup> Source: JP Morgan. Data as of March 31, 2017.

<sup>22</sup> Source: JP Morgan. Data as of March 31, 2017.

<sup>23</sup> Source: JP Morgan. Data as of March 31, 2017.

## Corporate Investment-Grade Credit

With the exception of European high grade, global credit markets were marginally weaker in March, though market activity was relatively muted throughout the period. Technicals continue to be the dominant driver of spread directionality in the United States and Europe as low global yields and government support continue to control the price action in the United States and European IG and HY markets. Despite our bias to anticipate a further tightening in global credit in the coming quarter, we are cognizant of potential political headlines in Europe and the United States, and consider political volatility, and its many market implications, as the major risk to our view.

March was a quiet month in the U.S. IG market. Treasuries ended the month unchanged, and U.S. equities were largely unchanged to slightly weaker. Volatility (as measured by the VIX index) in the United States remained in a narrow range throughout March, and ended the month roughly unchanged at 12.<sup>24</sup> Corporate spreads in the U.S. were weaker during the month, widening by 3 bps relative to Treasuries, to end the month at 118 bps.<sup>25</sup> On an excess returns basis, the U.S. corporate index returned (0.15 percent) during the period.<sup>26</sup> Similar to our observations in February, there was little dispersion across sectors in March, although long corporates marginally underperformed.

In addition to macro drivers, idiosyncratic developments continued to be at the forefront of the U.S. IG market throughout the month. Specifically, an energy firm announced a \$13.3 billion asset sale. This further exemplifies that energy companies are focused on strengthening their balance sheets after the volatility in early 2016. In addition, a bankruptcy has weighed on the U.S. utility sector, specifically on

### DISPLAY 4 EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	264	-16	9.6	-27
Colombia	192	-10	6.5	-32
Hungary	138	-9	2.1	-15
Indonesia	190	-8	7.3	-44
Malaysia	142	12	4.1	11
Mexico	255	-20	7.1	-34
Peru	146	-6	5.9	-33
Philippines	98	0	5.0	9
Poland	86	-2	2.9	-24
Russia	161	-1	7.9	-34
South Africa	269	27	9.4	8
Turkey	314	-18	10.9	16
Venezuela	2377	327	—	—

Source: JP Morgan. Data as of March 31, 2017.

names that are in the midst of large nuclear construction projects. Particularly, market participants have raised questions about the viability of these projects and the future of nuclear development in the United States.

The U.S. IG primary market continued to exhibit strength in the month of March. Supply totaled \$118 billion during the month, bringing the quarterly total to \$371 billion.<sup>27</sup> Performance of new issues was modest during the month, as new bonds tightened a weighted average of 3 bps between issuance and the last day of the month.<sup>28</sup> Concessions remained very low in March, at 2.1 bps, and oversubscription levels remained consistent, at 3.1x during the month, in line with previous months.<sup>29</sup> As we head into April, we anticipate that spreads will continue to grind tighter

toward the cycle lows of 2014, fueled mainly by persistently strong technicals. Investors continue to look for attractive yield as government yields remain low.

European IG spreads tightened versus Bunds in the month of March by 6 bps.<sup>30</sup> The market benefited from positive global economic data, the more stable political expectations in the French election, a rally in European equity markets and low volatility. Europe outperformed the U.S. when questions over Trump's ability to implement his stated growth strategy raised concerns following the abandonment of health care reform. Notable outperformance in the month came from subordinated financials and corporate hybrids. Financials (9 bps tighter) outperformed relative to Utilities

<sup>24</sup> Source: Bloomberg. Data as of March 31, 2017.

<sup>25</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>26</sup> Source: Bloomberg Barclays. Data as of

March 31, 2017.

<sup>27</sup> Source: JPMorgan. Data as of March 31, 2017.

<sup>28</sup> Source: JPMorgan. Data as of March 31, 2017.

<sup>29</sup> Source: BAML. Data as of March 31, 2017.

<sup>30</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

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**DISPLAY 5**  
**Credit Sector Changes**

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	118	+3	118	-6
Industrial Basic Industry	148	+6	103	+1
Industrial Capital Goods	92	+3	93	-2
Industrial Consumer Cyclicals	109	+3	110	-1
Industrial Consumer Non-Cyclicals	106	+2	101	-3
Industrial Energy	147	+8	118	-3
Industrial Technology	99	+2	83	+0
Industrial Transportation	113	+2	106	-4
Industrial Communications	155	+1	123	-4
Industrial Other	102	-4	143	-7
Utility Electric	115	+4	116	-7
Utility Natural Gas	121	+2	118	-5
Utility Other	138	+3	107	-3
Financial Inst. Banking	108	+3	114	-8
Financial Inst. Brokerage	120	-2	114	-1
Financial Inst. Finance Companies	119	+5	98	+0
Financial Inst. Insurance	123	+2	230	-19
Financial Inst. REITS	137	+3	133	-4
Financial Inst. Other	150	-1	162	+0

Source: Bloomberg Barclays. Data as of March 31, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

(5 bps tighter) and Industrials (3 bps tighter). The best-performing sectors were Insurance, Banking and Electric. Metals and Mining, Chemicals, and Tobacco underperformed the broader market. Longer maturity bonds outperformed as the credit curve flattened. Lower-quality BBB-rated credits outperformed single A and higher-rated credits. Additionally,

tighter swap spreads had a notable impact on the market during the month. Five-year swap spreads tightened 8 bps to close the month at +57 bps, causing high-quality corporates to underperform versus swaps but tighten relative to governments. In the European investment grade market, gross issuance totaled €68.3 billion (€25.9 billion in financials and €42.4 billion in

nonfinancials),<sup>31</sup> a pick up from February, driven mainly by several large multi-tranche deals in the nonfinancials space.

We saw increased issuance from U.S. issuers issuing in EUR in March. Sterling investment grade gross issuance was strong at £4.3 billion (£3.5 billion financials, £0.8 billion nonfinancials), spread evenly across the month, bringing the year-to-date figure to £14.2 billion.<sup>32</sup> Year-to-date issuance has been dominated by higher quality issuers, with BBB-rated credits making up only 12 percent of sterling IG supply.<sup>33</sup> Both primary and secondary issues performed well as the CBPS and maturing bonds kept net sterling issuance fairly benign. We continue to expect major central banks to retain a bias to accommodative monetary policy. We expect the ECB to maintain its current policy mix of an easing bias via quantitative easing and a negative deposit rate to target higher inflation and a weaker currency. Political risk remains elevated in Europe with Dutch, French and German elections to come in 2017; however, we expect European investment grade technicals to continue supporting the asset class in April.

### Corporate High Yield

The U.S. high-yield market produced total returns of -0.22 percent last month, and excess returns of -0.25 percent.<sup>34</sup> Higher-quality bonds outperformed the broader high-yield market, which is a reversal of the trend we had seen throughout the rest of the first quarter, during which lower-quality credit consistently outperformed. The worst-performing HY sectors in March were Pharmaceuticals (-2.95 percent), Retailers (-1.00 percent), Oil Field Services (-0.78 percent), and Wirelines (-0.73 percent).<sup>35</sup> The best-performing sectors were Electric (+70 bps), Transportation Services (+33 bps), Technology (+25 bps), Paper (+23 bps), and Home Construction (+19 bps).<sup>36</sup>

<sup>31</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>32</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>33</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>34</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>35</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>36</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

During the month of March, the HY primary market priced \$42.6 billion in USD-denominated bonds.<sup>37</sup>

The European HY market reported a small negative total return in March after two months of very strong performance. European economic performance remained robust, and forward-looking indicators suggest that this should continue to be the case. Default rates continue to be very low, offering a benign fundamental backdrop for investing in high yield. Issuance levels in the primary market surged during March after a relatively slow start to the year. High levels of cash, and the need for higher-yielding assets, meant that the demand for new issues was strong, syndicate books were very well subscribed, and many new issues were priced with historically low coupons. To highlight the strong technical in the HY primary market it is particularly notable that March saw the issuance of a bond with the lowest-ever coupon for a Euro-denominated sub-investment grade bond. Flows into high yield started to slow in March, culminating with three sequential weeks of outflows during the final weeks of the month. Yields increased moderately, ending the month 11 bps higher at 3.3 percent. Given our expectation for a continued demand for higher-yielding assets, we believe that European HY can continue to generate decent excess returns, and is likely to perform well, relative to other fixed income assets in coming months.

## Securitized Products

Agency MBS performed modestly in March, while credit-related securitized assets overall continued to perform well. Fears over higher rates and corresponding potential for a further extension for agency MBS have subsided for now as interest

rates appear to have stabilized in a new trading range. Nominal spreads on current coupon agency MBS remained unchanged at 99 bps above interpolated Treasuries, while the option-adjusted spreads (OAS) increased five basis points to 15 bps above interpolated Treasuries.<sup>38</sup> The Bloomberg Barclays Capital U.S. MBS Index was up 0.03 percent in March, and finished the first quarter up 0.47 percent for the year.<sup>39</sup> The Fed purchased approximately \$24 billion agency MBS in March in order to maintain its agency MBS portfolio at \$1.75 trillion; however, discussions around ending this reinvestment program are becoming more frequent. The Fed purchased almost \$400 billion agency RMBS in 2016, and we believe that ending this reinvestment could have a significant negative impact on agency MBS.<sup>40</sup>

Non-agency MBS spreads continued their tightening trend in March as cash flow and credit performance continued to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.2 percent in January, and are up 5.9 percent over the past year.<sup>41</sup> Home prices are up 38 percent nationally from the lows in 2012, and have now surpassed pre-crisis peak levels from July 2006 to set new highs. Existing home sales declined 3.7 percent in February from January's record levels, but sales remain 5.4 percent above February 2016 with an annualized rate of 5.48 million units sold.<sup>42</sup> New home sales increased in February, up 6.1 percent from January and up 12.8 percent from February 2016.<sup>43</sup> Despite the recent increases in home prices, with unemployment low, the economy slowly improving, and home prices still recovering from the mortgage crisis almost 10 years ago, we expect mortgage credit performance to continue to improve.

CMBS performance began to significantly diverge in March, with collateral composition having a more substantial impact than usual on pricing. Retail exposure was particularly punished, with BBB-rated securities collateralized by meaningful retail exposure trading 25-50 basis points wider during the month, while deals with more limited retail exposure actually tightening during the month. CMBS deals backed by office buildings, hotels, industrial buildings and multifamily rental properties are seeing strong demand, while CMBS deals with meaningful retail shopping center exposures are under significant selling pressure. The increasing announcements of retail store closings and poor retail earnings are causing credit concerns for many retail properties. New non-agency CMBS issuance increased materially in March with nearly \$9 billion in issuance during the month, lifting the 2017 year-to-date total to nearly \$13 billion. We still anticipate \$50 billion to \$60 billion in new issuance volumes this year, but the market is currently well below this issuance pace. New risk retention regulations that took effect January 1 are appearing to have a meaningful effect of dampening new CMBS issuance.<sup>44</sup>

Fundamentally, CMBS performance remains on solid ground. Commercial real estate prices were flat again in February, and have now been flat each of the past three months, but prices are up 2.2 percent over the past 12 months. After several years of 10 percent-plus annual increases, the pace of commercial real estate price increases is slowing, but the trajectory remains positive. Commercial real estate prices are 26.7 percent above the previous peak in August 2007.<sup>45</sup> With CMBS issuance beginning to slow this year and expected to slow more sharply

<sup>37</sup> Source: Bloomberg Barclays. Data as of March 31, 2017.

<sup>38</sup> Source: Yield Book. Data as of March 31, 2017.

<sup>39</sup> Source: Barclays. Data as of March 31, 2017.

<sup>40</sup> Source: Federal Reserve Bank of New York.

Data as of March 31, 2017.

<sup>41</sup> Source: S&P Case-Shiller U.S. National Home Price Index. Data as of March 31, 2017.

<sup>42</sup> Source: National Association of Realtors. Data as of March 31, 2017.

<sup>43</sup> Source: U.S. Census Bureau and HUD. Data as of March 31, 2017.

<sup>44</sup> Source: Deutsche Bank. Data as of March 31, 2017.

<sup>45</sup> Source: Green Street. Data as of March 31, 2017.

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in 2018—and with underlying real estate fundamental conditions remaining strong (other than retail shopping centers)—we expect CMBS to perform well in 2017.

European MBS spreads continued their tightening trend in March, and are now 5 to 25 basis points tighter in 2017.<sup>46</sup> Low

interest rates and early signs of economic growth seem to be outweighing any material concerns over Brexit fallout. ECB ABS purchases remain slow due to limited supply, and the ECB portfolio increased by only €0.1 billion European ABS in February. The ECB holds €23.5 billion

of European ABS as of February 2017.<sup>47</sup> European ABS has totaled €13.7 billion through the first three months of 2017, less than the €15.4 billion during the same period last year.<sup>48</sup> We expect securitized issuance to remain relatively light in 2017, given regulatory constraints.

<sup>46</sup> Source: Deutsche Bank. Data as of March 31, 2017.

<sup>47</sup> Source: European Central Bank. Data as of March 31, 2017.

<sup>48</sup> Source: Deutsche Bank. Data as of March 31, 2017.

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The **National Association of Realtors Home Affordability Index** compares the median income to the cost of the median home.

**Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector.

**Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

The **JP Morgan Emerging Markets Bond Index Global (EMBI Global)** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans and eurobonds with an outstanding face value of at least \$500 million.

The **JP Morgan CEMBI Broad Diversified Index** is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

The **JP Morgan GBI-EM Global Diversified Index** is a market capitalization weighted, liquid global benchmark for U.S.-dollar corporate emerging market bonds representing Asia, Latin America, Europe and the Middle East/Africa.

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The **ISM Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index** tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. Introduced in 1985, the GNMA, FHLMC and FNMA fixed-rate indexes for 30- and 15-year securities were backdated to January 1976, May 1977, and November 1982, respectively. In April 2007, agency hybrid adjustable-rate mortgage (ARM) pass-through securities were added to the index.

The **Nikkei 225 Index (Japan Nikkei 225)** is a price-weighted index of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The **U.S. Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. **Italy 10YR govt bonds**—Italy Benchmark 10-Year Datastream Government Index. The **MSCI World Index (MSCI developed equities)** captures large and mid-cap representation across 23 Developed Markets (DM) countries. **Spain 10YR govt bonds**—Spain Benchmark 10-Year Datastream Government Index. The **BofA Merrill Lynch European Currency High-Yield Constrained Index (ML Euro HY constrained)** is designed to track the performance of euro- and British pound sterling-denominated below investment-grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world. The **S&P 500® Index (U.S. S&P 500)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The **JPMorgan Government Bond Index Emerging Markets (JPM External EM Debt)** tracks local currency bonds issued by Emerging Market governments. The Index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (Excludes China and India as of September 2013). **U.K. 10YR govt bonds**—U.K. Benchmark 10-Year Datastream Government Index. For the following Datastream government bond indexes, benchmark indexes are based on single bonds. The bond chosen for each series is the most representative bond available for the given maturity band at each point in time. Benchmarks are selected according to the accepted conventions within each market. Generally, the benchmark bond is the latest issue within the given maturity band; consideration is also given to yield, liquidity, issue size and coupon. **German 10YR bunds**—Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR govt bonds**—Japan Benchmark 10-Year Datastream Government Index; and **10YR U.S. Treasury**—U.S. Benchmark 10-Year Datastream Government Index.

The **BofA Merrill Lynch U.S. Mortgage Backed Securities (ML U.S. Mortgage Master) Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The **S&P/LSTA U.S. Leveraged Loan 100 Index (S&P/LSTA Leveraged Loan Index)** is designed to reflect the performance of the largest facilities in the leveraged loan market. The **Bloomberg Barclays Euro Aggregate Corporate Index (Barclays Euro IG Corporate)** is an index designed to reflect the performance of the

euro-denominated investment-grade corporate bond market. The **Bloomberg Barclays U.S. Corporate Index (Barclays U.S. IG Corp)** is a broad-based benchmark that measures the investment-grade, fixed rate, taxable, corporate bond market. The **Bank of America Merrill Lynch United States High Yield Master II Constrained Index (Merrill Lynch U.S. High Yield)** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default. **JPY vs USD**—Japanese Yen Total return versus USD. **Euro vs USD**—Euro Total return versus USD. **MSCI Emerging Markets Index (MSCI emerging equities)** captures large- and mid-cap representation across 23 Emerging Markets (EM) countries. The **MSCI AC Asia ex-Japan Index (MSCI Asia ex-Japan)** captures large- and mid-cap representation across two of three Developed Markets countries (excluding Japan) and eight Emerging Markets countries in Asia. The **S&P GSCI Softs (GSCI soft commodities) Index** is a sub-index of the S&P GSCI that measures the performance of only the soft commodities, weighted on a world production basis. In 2012, the S&P GSCI Softs index included the following commodities: coffee, sugar, cocoa and cotton. The **Dow Jones Commodity Index Gold (Gold)** is designed to track the gold market through futures contracts. The **JPMorgan Government Bond Index—Emerging Markets (JPM local EM debt)** tracks local currency bonds issued by Emerging Market governments. The Index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (Excludes China and India as of September 2013). The ICE Brent Crude futures contract (**Brent crude oil**) is a deliverable contract based on EFP delivery with an option to cash settle. The **S&P GSCI Copper Index (Copper)**, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark for investment performance in the copper commodity market.

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