Bond Market Observations

March 2016

"One lesson is that we should get used to periods of higher volatility. At very low levels of interest rates, asset prices tend to show higher volatility …"

—Mario Draghi, President, European Central Bank

Opportunities in the Midst of Varying Policies

- Global central bank policies continue to surprise with explicit expansion of monetary policies in China, Japan and Europe.
- Meanwhile, the Federal Reserve continues towards tightening, but lowers expectations.
- Near-term, we see opportunities to capitalize on positive market sentiment.
- We are cautious medium-term as fundamentals remain challenged.

"Government officials are prioritizing support for near-term GDP growth over longer-term structural reform."

China Prioritizes Growth

A surprise cut by the People's Bank of China to banks' Reserve Requirement Ratio in February signaled the beginning of more aggressive policy easing. Government officials are apparently prioritizing support for near-term GDP growth over longer-term structural reform. The focus on pro-cyclical policies to promote economic expansion will likely come at the expense of rising financial risks and the potential loss of credibility. The Government's key political milestone of doubling per-capita incomes by 2020 (from their 2010 level) requires a minimum of 6.5% growth going forward. Therefore, greater central bank stimulus is expected as domestic economic momentum wanes. Unless G3 central bank stimulus plans provide a significant boost to global demand, this will be associated with additional easing in China.

Japan Implements Negative Rates

In another surprise move, the Bank of Japan (BoJ) ventured into uncharted territory for that country in January, applying a rate of negative 0.1% to bank excess reserves. They also communicated a dovish bias via the potential for further cuts and the elimination of the lower yield limit on Japanese government bond purchases. The goal: reviving the economy by stimulating consumption and investment through lower bond yields and a weaker currency. However, the introduction of negative rates has not gone smoothly given implication difficulties at financial institutions. Following the poor reception of negative rates by the markets, the BoJ de-emphasized negative rates as a policy tool during their March meeting. However, further stimulus may be feasible through equity purchases or by expansion of the monetary base given the BoJ's downgraded forecast for inflation expectations.

Europe Fights Deflation…

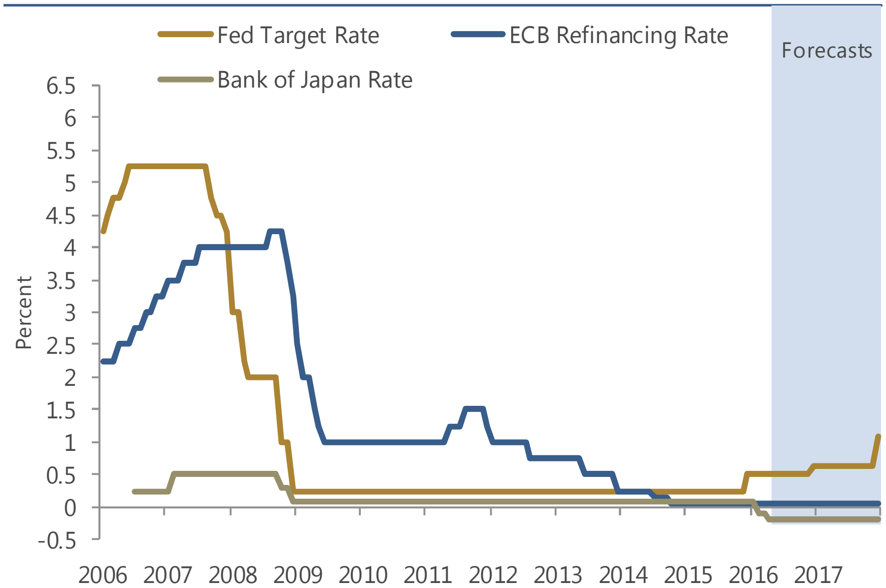
This month, the European Central Bank (ECB) exceeded market expectations and engaged in further expansion of monetary policy, citing downside risks to Eurozone inflation given weaker global conditions. The monetary easing package had four main components: a 10 basis point bank deposit rate cut, a new bank lending (LTRO) program, an increase in the scale of quantitative easing (QE) by purchasing an additional €20 billion per month, and an expansion of the scope of QE purchases to include non-bank, investment grade corporate bonds. It appears that Draghi has 'thrown the kitchen sink' at the lack of growth and inflation in the region. Additional easing may be harder to come by as the ECB has set a higher bar for any future monetary easing and the effectiveness of any further stimulus remains a concern.

...And The Fed Takes A Dovish Tone

"While the Fed remains on a path towards a higher Fed Funds rate, their tone indicated more caution on the outlook."

Since the January FOMC meeting, the state of the global financial markets has improved on the back of policy accommodation elsewhere in the world: U.S. financial conditions have eased, both survey and market-based inflation expectations have risen, the dollar has weakened, and global volatility has subsided. U.S. domestic fundamentals have been improving, including strength in the labor market as the unemployment rate has dropped below 5% and inflation is beginning to trend upwards towards the Fed's 2% target. However, Fed officials remain concerned about the global economic backdrop and acknowledge that global financial developments pose risks to the U.S. economy. While the Fed remains on a path towards a higher Fed Funds rate, their tone indicated more caution on the outlook. They lowered their GDP growth forecasts as well as their projections for the number of rate hikes in 2016 from four hikes at the December meeting, down to two hikes at the March meeting.

Central Bank Rates and Market Forecasts



Source: Thomson Reuters Datastream, market forecasts as of March 2016

Greater Opportunities Near-Term

Policy easing announcements around most of the world have provided markets with a basis for re-asserting a rally in risk assets. With a lower tail risk to global growth, monetary policy has effectively put a floor under commodities. This has not only lifted the prices of the commodities themselves, but also aided the fixed income returns of sovereigns, quasi-governments and corporates that rely on commodity production. In addition, expanded ECB buying of both sovereign and corporate debt has caused European peripheral sovereigns and credit to rally. This increased appetite for risk assets has spilled over to U.S. markets, with investment grade corporates and high yield spreads retracing the early 2016 move wider.

Sustained Medium-Term Caution on Risk Markets

"While we are taking advantage of opportunities, we remain cautious on spread sectors over a longer holding period."

We believe that increased monetary policy injections in Japan, China and Europe create near-term investment opportunities. However, over the medium-term we continue to see the risk to the global outlook as skewed toward the downside. For example, further easing out of China had a minimal impact to our macroeconomic or foreign exchange view on the country and the region more broadly. The government's focus on growth reinforces our 'long-landing' scenario as policy efforts imply greater fiscal spending. With that, we expect further Renmimbi weakness to sustain countercyclical support for the economy. As Renmimbi depreciation has been a precursor to spread volatility around the globe over the last year, we remain concerned that the near-term stability in spreads may again come under pressure over the medium-term.

Implementation Opportunities

Portfolio risk budgets remain near the lower end of their respective ranges with room to add risk given the improvement in our near-term view. While we are taking advantage of opportunities, we remain cautious on spread sectors over a longer holding period. Increased corporate leverage and the declining trend of revenues tell us that we are in the later stage of the credit cycle. In our corporate allocation, we have been looking to move up the quality spectrum. We remain cautious on commodity related sectors as the structural causes of the slowdown in China remain intact. We have been de-risking our high yield allocation in portfolios, expecting to see an increase in the number of issuers downgraded to high yield, an increase in defaults and lower recovery rates within commodity related sectors. Within emerging markets we see some value in pockets of local currency bonds as well as U.S dollar denominated credit. However, we believe emerging market, commodity related names should continue to experience high volatility.

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