Market Insight

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Despite Noise, Macro Factors Will Drive Fixed Income Markets

All eyes in bond land have been focused on Newport Beach, California, since Bill Gross on September 26 announced he was departing for another firm after 40 years at the helm of PIMCO. Given Gross's position as the highly visible CIO of the world's largest bond manager, the market's fixation on his decision — and the impact it may have on fixed income dynamics as PIMCO contends both with fund outflows as well as with potential adjustments to its portfolio positioning — is understandable. And while all this makes for interesting bond desk chatter, fixed income markets continue to be driven primarily by much more impactful fundamental and technical factors, both on the western front and well east of PIMCO HQ.

In this special report, we consider each of the major global fixed income segments in the context of these broader factors, highlighting any technical noise and disruptions that may result from the change in leadership at PIMCO. Our discussion is anchored by three key investment premises:

- Broad macro conditions remain the main driver of fixed income markets; any market distortions caused by the flow of assets among fixed income managers will be the exception and not the rule.
- While the market is rightfully concerned about the beginning of a Fed tightening cycle, the extent of rate hikes is likely to undershoot the Fed's expectations as represented by its now-notorious "dot plot".
- While economic strength in the U.S. persists, the largest downside risks will continue to come from abroad, particularly Europe.

Global Interest Rates

Macro backdrop. U.S. economic data continues to surprise to the upside. Though each upbeat data point out of the U.S. going forward has the potential to draw forward market expectations of the Fed's timing, we continue to believe the central bank will hold off on its initial fed funds rate hike until mid-2015, at which point it will steadily raise rates over time to the 2.0-2.5% range before taking a breather. While the U.S. economy is exhibiting the type of cyclical strength that should bias short-term rates higher and the dollar stronger, the Fed's consistently dovish messaging — relative to its more-hawkish "dot plot", which depicts the interest rate projections of individual FOMC members — is stifling the rate move, as broader structural factors are keeping inflation readings below target. For example, while September nonfarm payrolls came in stronger than expected and were accompanied by upward revisions to July and August, wage growth remains moribund, as evidenced by flat average hourly earnings in the latest reading.

Furthermore, slowing growth and inflation abroad is inducing very easy central bank policy; the ECB and BOJ are locked into more, not less, accommodation for the foreseeable future, and Chinese liquidity remains additive. The U.S. economy is not fully immune from these growth and liquidity dynamics, and the rise in the dollar will have some restraining effect on inflation and on net exports. In addition, money flowing into the U.S. from foreign reserve managers is creating demand for Treasuries that is fairly insensitive to changes in the U.S. domestic economy and contributing to the currency appreciation.

While the U.S. yield curve is poised to flatten as we enter into this tightening cycle, the yield on the ten year is unlikely to move meaningfully beyond the 3% level even as short-term rates rise. Further support for U.S. rates will be provided by a strong U.S. dollar and yield that handily eclipses that of global alternatives like German bunds and Japanese government bonds.

Potential PIMCO impact. PIMCO has been a steady seller of volatility in the interest rates markets, and any material change in strategy could impact swap market supply/demand dynamics and promote some uptick in

interest rate volatility. PIMCO also has been engaged on the short end of the yield curve in a steepening trade through the eurodollar market versus longer term Treasuries and futures, and any unwind could foster additional support for a flatter U.S. yield curve. In addition, the U.S. TIPS market has already weakened significantly in recent weeks, and the potential for further technical pressure remains high.

Looking abroad, PIMCO maintains sizeable positions in peripheral European issues. Though the ECB's September announcement of an asset-purchase program provided some relief, its relatively small scope suggests it may not be enough to reverse the persistent disinflationary trends and stagnant growth across the euro zone. Further economic deterioration combined with the unwind of a large position could lead to spread widening in the region.

Investment outlook. In the U.S., we maintain a negative duration posture both strategically and tactically. Outside of the U.S., we remain underweight peripheral Europe. In terms of currencies, we remain overweight the U.S. dollar versus other developed market currencies and continue to be quite defensive in emerging market currencies given the downturn in commodity markets.

Investment Grade Corporates

Macro backdrop. The positive outlook for the U.S. economy is supportive of both risk appetites and corporate spreads. Fundamentals for corporate issuers remain broadly positive, with some ebb and flow as positive economic conditions are reflected in improved revenue and EBITDA while also inspiring an uptick in shareholder-friendly activity by increasingly confident managements. That said, many investment grade corporate issuers have global footprints and thus are likely to be impacted by widespread economic weakness beyond domestic borders. For instance, the recent decline in commodity prices has not been kind to commodity-sensitive industries, as evidenced by widening spreads in metals and energy of late. Interest rate volatility could also inspire technical pressure for investment grade corporates in the coming months.

Potential PIMCO impact: Given PIMCO's size, it typically has had a preference for more liquid instruments such as index credit default swaps (IG CDX), larger cap issuers and intermediate maturity financial paper. These areas would be the most likely to see volatility should any portfolio repositioning occur.

Investment outlook. Widening in recent weeks to early-2014 levels, corporate spreads currently are fairly valued. Generally speaking, we prefer market segments that are more U.S.-centric given the aforementioned multinational nature of many investment grade corporate issuers. Banks may be particularly susceptible to international volatility, which tends to transmit more quickly through financial concerns than industrial companies. Shorter-dated corporates may be somewhat insulated from any tumult, however, given their reduced sensitivity to changes in market technicals and a credit cycle that has yet to peak. Technical conditions related to recent heavy new issuance should ease as the market heads into earnings season, but the calendar will still be active. Carry or yield is expected to remain the primary driver of excess returns in this space.

High Yield Corporates

Macro backdrop. The high yield market in September suffered from a glut of new-issue supply. Having overestimated demand for high yield paper, bankers were forced to reprice new issues and the secondary market also suffered. By month-end, however, supply had cleared or been postponed, and the market found its equilibrium, albeit at wider levels. Higher-quality issues outperformed lower-quality ones in the recovery, leaving BB returns outpacing CCC returns for the year. Commodity-related sectors — including metals and mining, oil field services and independent energy — have underperformed.

Corporate fundamentals generally remain in good shape, with both revenue and EBITDA picking up over the last several quarters. While we have seen a modest increase in leveraging transactions, leverage has actually declined in recent quarters due to the improvement in earnings.

Potential PIMCO impact. We expect the impact on the high yield market to be modest, with any uptick in volatility concentrated among the largest issuers.

Investment outlook. The market has found firmer footing so far in October, with supply-related pressures from September abating. While interest rate volatility and the potential for risk aversion are wildcards in the coming weeks, the high yield market appears positioned for an attractive total return opportunity through early 2015. With improving economic data and still-solid credit fundamentals, spreads and yields are appealing at current levels, and the typical fourth quarter pattern of high coupon income and reduced supply further buoys the market. Moreover, many high yield issuers should benefit from the U.S. focus of their businesses as global economic growth increasingly diverges.

Mortgages

Macro backdrop. We are constructive on mortgages. The housing recovery still has plenty of room to run, with housing starts recently hitting a multiyear high, and the inherent refinancing risk implied in mortgage pricing assumes more pre-payment risk than we believe exists. Also, the supply and demand dynamic remains favorable for mortgages in the near term. Gross issuance is extremely low year-over-year, especially given reinvestment activity within the Fed's portfolios, which the central bank has stated will likely continue through most if not all of 2015. As such, we expect agency mortgages to be well supported in the coming months.

CMBS and non-agency mortgages remained stable over the course of September, displaying resilience against the more volatile macro backdrop. While the robust new-issue pipeline of securitized assets may be met with lackluster demand in response to increased volatility in other risk markets, the low overall supply of net new mortgages, strong fundamentals and attractive valuations should together provide support for these sectors of the market.

Potential PIMCO impact. PIMCO has maintained significant underweights to mortgage securities; a transition of these funds to managers with a more neutral or positive bias to the sector would introduce significant marginal demand to the mortgage market. That said, we have seen little in the way of realized price volatility in the large and very liquid market for mortgage products.

Investment outlook. We are constructive on agency mortgages while acknowledging the potential for interest rate volatility and spotty demand outside of the Fed. While valuations aren't cheap, agency mortgages provide attractive carry with little exposure to volatilities stemming from international markets. We also continue to favor non-agency mortgages and CMBS, which stand to benefit from the ongoing improvement in U.S. real estate market dynamics. There will, however, be a premium on security selection going forward.

Emerging Markets

Macro backdrop. Growth and inflation across emerging markets is divergent, but we see higher probability of downside surprises given weak demand from the G-3 and weak global trade in general. Though uncertainty around the Fed's tightening path is a cause for concern and weaker commodity prices are a risk, global liquidity conditions are generally supportive of emerging markets. As such, flows are not leaving the asset class but are being circulated within it. For example, tensions between Russia and Ukraine are redirecting flows away from Central Europe and toward Latin America and Asia.

Potential PIMCO impact. We expect little PIMCO-related impact, as macro and political factors within individual countries will likely play a more dominant role across the emerging market complex.

Investment outlook. We continue to favor corporates over sovereigns, with a bias for hard-currency issues over local-currency paper.

Conclusion

While the recent news from PIMCO does have the ability to influence certain sectors of the market, we fully expect macroeconomics and broader technical factors to be the dominant forces in fixed income. Any change in market dynamics caused by portfolio transitions among fixed income managers not only will be an exception to the rule, but also a potential tactical investment opportunity on which to capitalize.

While the U.S. economic outlook continues to improve, a broad array of challenges are impeding recovery elsewhere. These weak global economic conditions combined with the rock-bottom U.S. labor market participation rates, a stronger U.S. dollar and the absence of any domestic wage pressures will allow the Fed to remain "exceptionally patient" as it moves to raise interest rates. As such, changes in U.S. monetary policy will be gradual, and we believe the extent of federal funds rate hikes will most likely undershoot even the central bank's own expectations. Moreover, inflationary pressures outside U.S. borders are benign, and the net level of global monetary accommodation remains positive.

However, while strength in the U.S. is a tailwind for U.S. spread assets, lack of attention to global concerns may leave one exposed to bouts of episodic volatility and the large downside risks that are likely to emerge from beyond our borders, particularly from Europe, where inflation is trending near zero. While technical pressures emanating from the big bond manager in California bear watching, immunizing portfolios against the potential tail risks looming farther east is our prescribed course for navigating the fixed income landscape.

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