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MARKET INSIGHTS

US CORPORATE BONDS CONTINUE TO THRIVE

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US CORPORATE BONDS DISPLAY STEEL

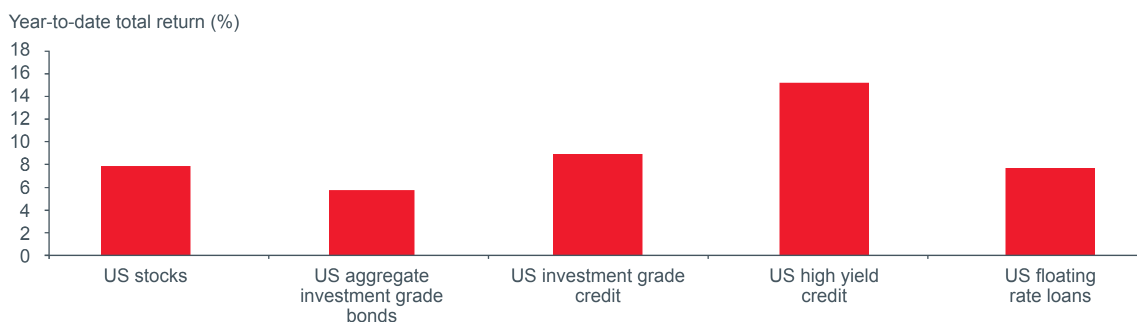
Investors have historically perceived US investment grade ("IG") fixed income bonds to offer relative safety amid global uncertainty. Starved of yield and pining for quality, a high level of uncertainty in the global marketplace should keep investors' portfolios more conservatively positioned. The day after Brexit, a broad range of US quality bond indexes gained while preferred securities, US high yield and the S&P 500 fell, reflecting a flight to quality. The relative calm in US IG bond prices versus other riskier assets post the US elections is another case in point as markets digested an unexpected Trump win.

During the year, demand for fixed rate returns further accelerated against the backdrop of global government debt yields hitting record lows.

Corporate bond yields remain attractive to investors searching for fixed returns at a time when some USD12 trillion of global debt, concentrated in Japan and Europe, trades at a negative rate.

The S&P 500 Bond Index, which is designed to be a corporate-bond counterpart to the S&P 500, was up 8.1% year-to-date and offers a 2.9% yield, 137bps above the 10-year Treasury yield[1].

Fig.1. Year-to-date US bonds' returns have been competitive compared to US equities



Source: Morningstar Direct, as at 30 September 2016. As measured by the QTD and YTD total returns of the following indices: S&P 500 Index, Barclays US Aggregate Index, Barclays US Credit Index, Bank of America Merrill Lynch US High Yield Index and the S&P/LSTA Leveraged Loan Index. Indices are unmanaged and cannot be invested in directly. The index returns shown do not include any transaction costs, management fees, or other costs. The indices provided in this chart represent the investment environment existing during the time periods shown. The information provided is for comparison purposes only to reflect general market conditions. Index returns represent past performance and are not indicative of any specific investment. Past performance of the indices is no guarantee of future results.

[1]Bloomberg, S&P Dow Jones Indices, as at 30 September 2016. S&P 500 Bond Index (SP500BDT), 10 Year US Treasury Yield (USGG10YR).

FUNDAMENTALS REMAIN STABLE

US corporate fundamentals remain stable. In particular for IG issuers, the pace of balance sheet deterioration has slowed; leverage has stabilised[2] and earnings – particularly for domestically-focused companies – remain constructive. In light of our expectations for moderate US economic growth, we do not expect material balance sheet deterioration, but corporate leverage could rise if growth surprises to the downside.

In an ongoing effort to spur economic growth and encourage inflation, global central banks remained accommodative. The data-dependent Fed and the European Central Bank ("ECB") both opted to prolong current policy rates, and the Bank of Japan ("BoJ") surprised the markets with an announcement that it added yield curve control to its unconventional policy objectives.

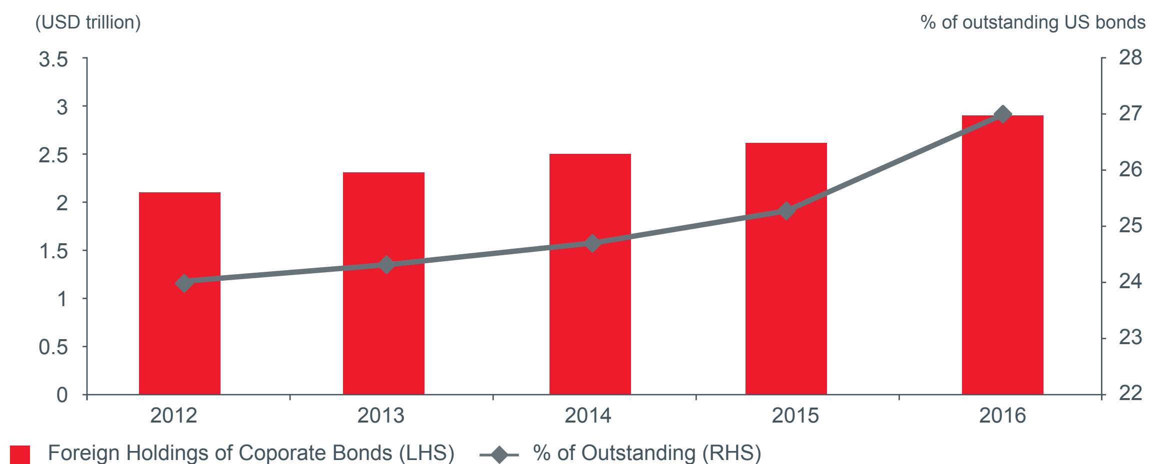
As evidenced by global bond yields, the Fed, BoJ and ECB were certainly not alone in maintaining policy accommodations; by market value, over 36% of global developed sovereign bonds have a negative yield-to-maturity[3].

Therefore strong demand continues to offset stable fundamentals and fairer valuations. USD fixed income should be supported by incremental demand from yield-seeking global and domestic investors. With US economic growth comparing favourably to other developed economies and with US bonds accounting for nearly 80% of the yield available to global IG bond investors[4], it's no surprise that foreign ownership of US corporate bonds has sharply increased[5].

While the USD5.9 trillion US IG corporate bond market represents only 12% of that global market, it is now responsible for 33% of its total (effective) yield payment. In other words, nearly one in three (global) dollars paid out in the global IG broad market is paid to investors in the US IG corporate bond market. According to recent data from the US Treasury, foreign investors have already picked up USD146 billion in US corporate bonds in the 12 months ended July.

Until these positive dynamics unwind, our baseline expectation is for stable demand to persist. However, one factor that may thwart a significant rise in foreign bond purchases is the rising costs of currency hedging.

Fig.2. Foreign holdings of US corporate bonds have been on the rise



Source: Barclays Research and Federal Reserve. Based on 2Q16 data, the latest available as at 30 September 2016.

[2]Barclays. Credit Research. In Demand, as at 30 September 2016. [3]Bloomberg. Based on the index weights of holdings within the Bloomberg Global Sovereign Bond Index with negative yield-to-maturities, as at 30 September 2016. [4]Bloomberg and Bank of America Merrill Lynch. Based on the Bank of America Merrill Lynch Global Corporate Bond Index (G0BC) and the Bank of America Merrill Lynch US Corporate Bond Index (C0A0), their respective yields, market values and weights. See disclosures for full descriptions. [5]Bloomberg and Bank of America Merrill Lynch. Based on the yield-to-maturities and weights of the Bank of America Merrill Lynch Global Corporate Bond Index (G0BC) and the Bank of America Merrill Lynch US Corporate Bond Index (C0A0), as at 30 September 2016. Index definitions provided in the disclosures.

MIXED US ECONOMIC DATA

Monetary policies aside, US economic data remained mixed. The Labour Market Conditions Index, designed to capture aggregate expansion and contraction of the labour market, slipped into shallow negative territory. Below an improved headline unemployment figure of 4.9%, wage growth failed to accelerate, contributing to depressed inflation measures.

However, modestly rising home prices and steady consumer spending continued to offer ballast to the domestic economy.

US GDP grew at an estimated annualised pace of 1.4% during the second quarter, which, at the least, did not create a headwind for fixed income assets[6].

MODERATING GLOBAL RISKS

Relative to the beginning of the year, the markets' perception of global risks materially subsided, contributing to historically low volatility[7]. Near the end of Q2, sentiment weakened ahead of the UK referendum vote when investors feared the result would usher in global growth headwinds.

However, following the ECB and Bank of England's assurance that they would attempt to cushion potential consequences with more easing, risk-on behaviour resumed as resolution was kicked down the road.

Arguably, the markets have also become more comfortable with sensitive oil prices, an unexpected US presidential election outcome and currency market fluctuations.

LOOKING AHEAD

The pace of US growth is attractive relative to that of global expansion as we expect the US economy to continue growing at a pace of about 2%, a rate that is relatively in line with the economists' average expectations. Ongoing improvements in the labour and housing markets, an overall healthy consumer base, and still-supportive monetary policies should underpin resilient growth.

Nonetheless, we think that amid ongoing global uncertainty, it will be difficult for the US Fed to significantly raise interest rates. Therefore a benign interest rate environment coupled with modest domestic expansion should, at the least, not pose a headwind to corporate fundamentals of US IG issuers.

[6]BEA. Based on the third estimate of Q2 2016 GDP, as at 29 September 2016. [7]Bloomberg. Based on the daily mid-price of the Bank of America Merrill Lynch MOVE measure and the CBOE VIX measure as at 30 September 2016, both of which are below their respective 5-year averages.

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