NATIXIS ASSET MANAGEMENT

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Review of year 2015 in fixed income markets

HIGHLIGHTS

- **Fed status quo fuelled currency war with many central banks embarking onto monetary easing**
- **After months of uncertainty about the timing, Fed lifts rates from zero in December**
- **Despite bouts of volatility, bond yields made a round trip in 2015**
- **Peripheral bond spreads failed to perform amid political risk**
- **Credit hit by specific risk and increased issuance**
- **Emerging debt markets jolted by commodity price drop and China, Brazil woes**

In this note, we look back at year 2015 in global fixed income markets. The long-standing zero interest rate policy in the US eventually ended in December, but delays to Fed lift-off framed global central banking into a de facto currency war throughout 2015. Interest rates have been cut to deeply negative levels in many jurisdictions. Bond yields have remained under pressure of quantitative easing purchases in several regions. Ten-year bond yields in G4 space ended the year moderately higher than last year-end's historical lows. In euro sovereign bond markets, Italy was the star performer but spread compression largely undershot consensus expectations. Credit markets have suffered from specific issues in the automotive industry and the broad decline in commodity prices. US speculative-grade bond markets suffered from heavy exposure to the energy sector amid collapsing oil prices. In turn, dislocations in currency swap bases resulted in significant foreign borrowing in investment-grade euro markets adding to upward pressure on credit premiums. In emerging debt space, slowing Chinese demand for commodity products, political backlash in Brazil or South Africa and geopolitical tensions between Russia and Turkey all took a toll on foreign-currency spreads. Currency weakness and rising inflation in South America caused policy rate tightening and local-currency markets underperformance.

In terms of performance, euro-centric fixed income aggregate portfolios returned just under 2% in 2015. Corporate credit underperformed sovereign by fully 2% and other asset classes bought by the European Central Bank (covered, agency) by around 1%. Index-linked bonds (3%) outperformed the broader market despite falling inflation thanks to Italian spreads. Diversification paid off with stellar returns from euro convertible bonds (9%) and high-yielding speculative grade (5-6%). Hard-currency emerging markets returned 2% in euro-hedged terms.

December lift-off caps year of uncertainty regarding Fed policy

Uncertainty about Fed lift-off timing has had considerable bearing in US and foreign financial markets. The Fed's 'data-dependence' was certainly difficult to understand for most market participants. It seems as though the Fed had no clear strategy to begin policy firming and relied disproportionately on incoming data rather than a risk assessment to the US growth and inflation outlook. The sharp slowdown early on in 2015 added to market anxiety even as US policy makers pointed at transitory factors impacting activity including weather-related disruptions, collapse in oil extraction investment and labour disputes in West Coast ports. However, US dollar strength was the underlying concern prompting FOMC participants to adjust their rate forecasts lower. With hindsight, the dot chart was the Fed's instrument to stem dollar strength and, in fact, it turned out to be quite effective. The broad dollar value (DXY index) indeed has remained within a narrow 6% range from March onwards. Nevertheless, at the June Fed meeting, 10 of 17 FOMC members envisaged raising interest rates at least twice in 2015. Against this backdrop, the September decision to maintain status quo ignited a bout of volatility in financial markets. The reasons given for status quo indeed looked out of line with the Fed's dual mandate of sustainable employment and price stability. The FOMC pointed to adverse developments in emerging markets and China, in particular, following an equity rout and the surprise CNY devaluation in August as the chief reason to hold fire. To make matters worse, the Fed indicated that the US economy had proven stronger than expected in the summer period. To be fair, at the time of the September FOMC, there was a risk of government shutdown looming in October. In October, the FOMC instead stressed its dual mandate making an explicit reference to the December meeting for possible lift-off date. In sum, the lack of consistency in the Fed's arguments has been a source of uncertainty and contributed to shape other Central banks' policies.

- **Currency war as the flipside of Fed inaction**

Monetary status quo in the US encouraged a race to the bottom in foreign exchange markets. Outsized quantitative easing by the Bank of Japan (80Tr yen per annum) was used to depreciate the yen exchange rate to about 120 yen to the dollar. The European Central Bank expanded its asset purchase program to government bonds, agency bonds and supranational debt securities. In March 2015, the Euro-system thus committed to buy bonds at a €60bn clip per month until September 2016 in a bid to promote higher inflation. Core inflation increased from March lows at 0.6%yoy to about 1% by year-end. The country allocation rule is the ECB's capital key. The Bundesbank hence gets the lion's share with public-sector bond purchases in excess of €10bn each month. The deadline for the quantitative easing program was later pushed forward to March 2017 along with a further cut in the deposit rate (-10bps to -0.30% in December). On the currency front, the euro has fallen to a 2015 low at $1.05 in March from over $1.20 at the start of the year.

- **Scandinavian banks pushed into further easing by ECB accommodation**

In turn, ECB monetary easing prompted Scandinavian Central Banks to adopt extremely aggressive policy stances. Denmark defended its peg to the euro by doubling up reserves in January-February and cutting rates on certificates of deposit to as low as -0.75% in several steps. Sweden put its repo rates in deeply negative territory (down to -0.35%) and embraced quantitative easing at a time when economic growth hovered about 3% per annum. Norway decreased rates to stem currency appreciation despite inflation edging higher, flat unemployment rate and considerable fiscal leeway.

In Switzerland, the SNB was faced with a different challenge. The decision to peg the CHF to the EUR at €1.20 in 2012 forced the Central bank to purchase considerable amounts of foreign-denominated bonds, mostly French OATs and German Bunds. The SNB's balance-sheet increased to nearly 95% of the Swiss GDP, with disproportionate EUR exposure on the asset side funded by the provision of bank reserves at a negative rate of -0.75%. In fact the SNB has no repo operations with the local banking sector and is rather the choice counterparty of the World's excess demand for safe-haven CHF. BoJ effort to depreciate the yen had indeed left the Swiss franc as the sole safe haven in currency markets. Eventually sustaining a balance sheet this large was unsustainable and the SNB decided to abandon the €1.20 peg in early January. The ensuing jump in the CHF exchange rate brought the EUR near parity before stabilizing about 1.08.

Currency warfare was also evident in rate cuts in Australia (-25bps to 2%), New Zealand (-100bps to 2.5%) and Canada (-50bps to 0.50%). Indeed lower commodity prices (metals in Australia, dairy prices in New Zealand, oil in Canada) had resulted in a sharp decline in investment spending and deterioration in the terms of trade. Rate cuts aimed essentially at correcting upward pressure on real effective exchange rates. However, looking ahead, such accommodative policies carry risks to financial stability given sustained demand for housing investment in particular.

- **Surprise devaluation in China derail emerging markets**

Elsewhere across emerging markets, China's devaluation in August entailed a major surprise to markets. Lower GDP and growth expectations had led to a sharp correction in equity markets and significant capital outflows through summer (estimated at the equivalent of more than $100bn a month). The PBoC had no choice but to devalue. In a related effort, the Chinese Central Bank decided to combat the resulting tightening of domestic monetary conditions by cutting rates to 4.35% (from over 5.60% in 2014) and reducing banks' reserve requirement ratio to 17.50%. Other Asian central banks followed the steps of the PBoC with monetary accommodation.

In Latin America, inflation pressures led monetary authorities to raise interest rates in a number of countries (Colombia, Chile, Peru notably). Brazil is stuck in stagflation. Inflation remains persistently above target despite recession and efforts to rein in public finances. In Eastern Europe, Poland cut rates due to both persistent deflationary pressure and ECB outsized easing. Russia's monetary policy was complicated by elevated volatility on the rouble stemming from downward pressure on oil prices.

Treasury and Bund markets

- **World yields moving sideways**

Ten-year yields in major markets have shown some volatility but failed to creep higher as expected by a broad consensus at the start of 2015. The US 10-year note yield ended the year about 2.20%

essentially unchanged from last year's close. Bearish positioning from late 2014 and signs of weaker growth in the winter period sent US bond yields to a yearly low at 1.64% at the end of January. The ensuing economic rebound propelled yields briefly above 2.40% in June-July before reverting to about 2.20%. The yield curve generally flattened as policy tightening was gradually priced into short-dated bonds. Two-year yields hence crept higher to end 2015 just under 1%. Market expectations however remain out of line with FOMC projections for the likely path of Fed Funds rates in years to come. As concerns the back-end of the curve, 10s30s spreads increased sharply between March and May (80bps), and rallied through summer amid an equity rout and resumed rising until October (85bps peak) when the Fed finally signalled that an interest rate hike was likely in December. The 10s30s spread reverted to the 70bp area at year-end.

In the euro area, the announcement of sovereign bond-buying by the ECB on January 22nd, 2015 triggered a straight-line rally in 10-year Bund yields from 0.60% at the start of the year to less than 0.10% in mid-April. At around €50bn per month, the size of purchases for public-sector bonds (including agency and supranational debt) was indeed very large compared with borrowing needs (or equivalently net bond issuance). The actual start date of ECB purchases was March 9, 2015. The implementation initially push bond yields lower to levels near 0%. Long-run investors had fled the bond market leaving futures trading in the hands of high-frequency algorithm traders, trend-followers and other CTA accounts. The dearth of final buyers finally triggered sharp upward corrections in Bund yields from 0.16% to 0.72% in April-May and 0.48% to 1% in June. The downtrend in yields resumed in the second half of the year but volatility remained much larger than in the first quarter. The reason for persistent yield volatility is likely the interplay between the Bundesbank approach to QE and sensitivity of yields to US developments. The ban on purchases of bonds yielding less than the deposit rate was a significant constraint for the Bundesbank. Given deeply negative yields out to 3-4 years, a significant chunk of the market was ineligible to QE. The German central bank has consistently sought to minimize duration for a given level of yield. This action tended to steepen the curve in bear market phases and to flatten the term structure when yields were falling. Furthermore, the low average maturity of Bundesbank bond purchases (around 6 years) did insulate euro yields from foreign influence up to 5 years maturity but not beyond that point. Hence, the correlation of forward euro yields to US rates has indeed increased despite ECB accommodation.

- **Euro sovereign core spreads stable through 2015**

In euro sovereign space, spreads have ended the year just about where they started it. Yearly tights were hit at the start of QE in March, highs were seen in July. Excluding Portugal, the spread on sovereign bonds declined modestly from 46bps to 41bps by year-end 2015. In core bond markets, there was little movement in spreads overall. Growth has been weak in Austria and Finland while the unfolding recovery in the Netherlands' economy was reflected in a rating upgrade back to AAA (S&P). In France, 10-year OAT spreads hovered about 30-40bps through most of the year hitting a high point at 48bps at the climax of the summer Greek crisis. Belgium traded along the same lines despite uncertain economic growth and some fiscal slippage.

- **Politics spark summer volatility in peripheral markets**

At the start of the year, consensus was for outsized performance from peripheral bonds against core markets was widespread and thus proven wrong. In positioning surveys, nearly 80% of euro final investors had long exposure to Italian, Spanish and Portuguese bonds vs. lower-risk core debt. The long consensus certainly hindered peripheral performance this year.

In the weeks prior to the implementation of QE, peripheral bond spreads rallied and hit its 2015 tightest level days after the first ECB purchases. Italian BTPs were trading about 88bps vs. German Bunds on March 12th from over 130bps on December 31st, 2014. The performance of Spanish Bonos was more volatile throughout the year for three reasons: local bank selling, political risk and the Treasury's preference for long-term syndicated bond issuance. Spanish banks have been the marginal seller in the Bonos market through July. Local banks sold more than €30bn worth of Spanish bonds in the 10 months to October 2015 in a bid to seclude their link to sovereign debt and manage their balance sheet. Heavy bank selling has hence overshadowed underlying improvement in Spain's economic growth and public finances. On the political front, many investors were drawing comparisons between Podèmos and Greece's left-party Syriza, which came to power in January 2015. As the new government in Greece refused to comply with earlier commitments to Europe, tensions arose between Greece and its international creditors in the second quarter of 2015. Foreign funding was cut and a banking crisis developed forcing a temporary shutdown of Greek banks and daily limits to cash withdrawals. Eventually, a deal was reached on July 13th and new elections (won by Alexis Tsipras) were held in Greece. Risk aversion and volatility in markets amid Greece's crisis sent Spanish and Italian spreads higher to the 160bp area by mid-July. A new bout of volatility occurred around Catalan elections in Spain and Portugal's general elections in late September. Portugal's elections turned out to be inconclusive with the right-wing incumbent party failing to retain majority. The socialist party in turn managed to form a government with centre and far-left parties after weeks of negotiations.

- **Euro area Treasuries adjust issuance to ECB bond purchases**

As concerns bond issuance, market conditions allowed debt agencies (most notably Spain and Italy) to increase the duration of their debt sold to the market. This contributed to keep yield spreads wider for some time despite a tendency of national Central Banks (NCBs) to buy long-dated securities. In essence, while the amount purchased by each NCB is limited by its capital share in the ECB, duration is not. Whilst Euro-system bond purchases had average maturities of about 8 years in aggregate, the average in peripheral countries was at least one year longer (Italy 9.3 years, Spain 9.7, Portugal 10.6 and Ireland 9.3 for the March-November 2015 period).

Credit markets hit by idiosyncratic risk

In the euro area, in spite of a pickup in growth and enhanced monetary easing, corporate bonds had a rough ride in 2015. Corporate credit is the only euro asset class to post negative total returns in 2015. Unsecured bond spreads to Bunds went up from 88bps at the end of last year to about 135bps. The underperformance of euro private debt markets appears traceable to supply conditions, idiosyncratic risks and asset allocation flows.

- **New corporate issuance trends**

On the issuance side, increased borrowing by non-resident institutions (US corporations) has surprised market participants. Lower interest rates and a favourable basis in currency swap markets have provided incentives for US borrowers to tap euro bond markets (foreign borrowing has represented up to 30% of euro-denominated issuance this year). A significant number of new issuers have hence used better terms in euro markets than in dollar markets to expand their investor base. The 5-year euro-dollar currency swap basis was indeed as low as -38bps in March and made new lows in November (-45bps). In total net bond issuance increased to €160bn from €70bn last year. In the financial sector, net euro issuance was positive for the first time since 2009. Furthermore, borrowers continue to lengthen the maturity of their debt. Over the past two years bonds with maturities at issuance beyond 7 years have accounted for about 30% of the market double the 2008-2011 average. The maturity distribution caused some steepening in the term structure of corporate bond spreads.

- **Idiosyncratic events causing outflows from credit**

On a sector basis, the materials group has considerably underperformed the broader credit market mainly due to continued weakness in commodity prices. The average sector spread on investment grade names topped the 200bp mark (on Bloomberg OAS indices). Some specific credit stories also impacted the sector performance. The automotive sector also underperformed markedly last autumn in the wake of the emission scandal.

Inflows into euro investment grade funds have reversed after April as equity market performance turned sour and many investment funds based in the euro area diversified away from euro-denominated assets selling both public and private debt instruments (government bonds, covered, agency) to the ECB and purchasing foreign bonds instead. In fact, excess supply of euro-denominated corporate bonds appeared at a time when euro investor demand for US assets emerged. Despite enhanced eligibility of private debt instruments as part of the agency debt purchases, corporate spreads have failed to match performance of euro sovereign bonds.

- **Covered debt valuation realignment**

As regards covered bond markets, the trend has been consistently for wider spreads from tight levels. The pace of ECB purchases slowed from nearly €3bn a week in March to less than €2bn since October. Bank demand linked to liquidity buffers may have slowed as well. Furthermore, a supply glut in September added to upward pressure on spreads although net issuance was covered debt negative for the whole year. Despite high ratings and low spread volatility, outsized monetary easing in several jurisdictions has fanned fears of potentially destabilizing housing bubbles. Bond issued by financial institutions based in Canada, Australia or Scandinavian countries are not eligible to the ECB's CBPP3 and collateral value looking out a few years may be questionable after sharp rises in house prices in recent years. In all, covered bond spreads have increased by 16bps last year to 51bps by year-end.

- **US high yield woes impact European speculative-grade markets**

In high yield space, default rates in Europe remain low (2.5% over the 12 months to November 2015) but spreads have been under pressure from US high yield outflows. The spread on European high yield bonds started falling in the risk rally up to the beginning of March hitting a low at 320bps before widening out above 400bps in July and then again in late September to 480bps on credit-specific issues. However, despite around 70bps of widening, the asset class did outperform core investment grade bonds in 2015 (sovereign, covered, agency, IG corporate debt). US speculative-grade is heavily skewed towards the energy sector (15-20% of market size) for which spreads has averaged about 925bps (Bloomberg indices vs. UST) through October 2015 before renewed weakness in oil prices sent yield gaps beyond 1300bps. The default rate in US high yield is now creeping higher (3.7% in November). Furthermore, distressed funds in the USD markets had to shut down unveiling liquidity risk in lower-rated bond markets. The US high yield asset class had thus been sold by asset allocators.

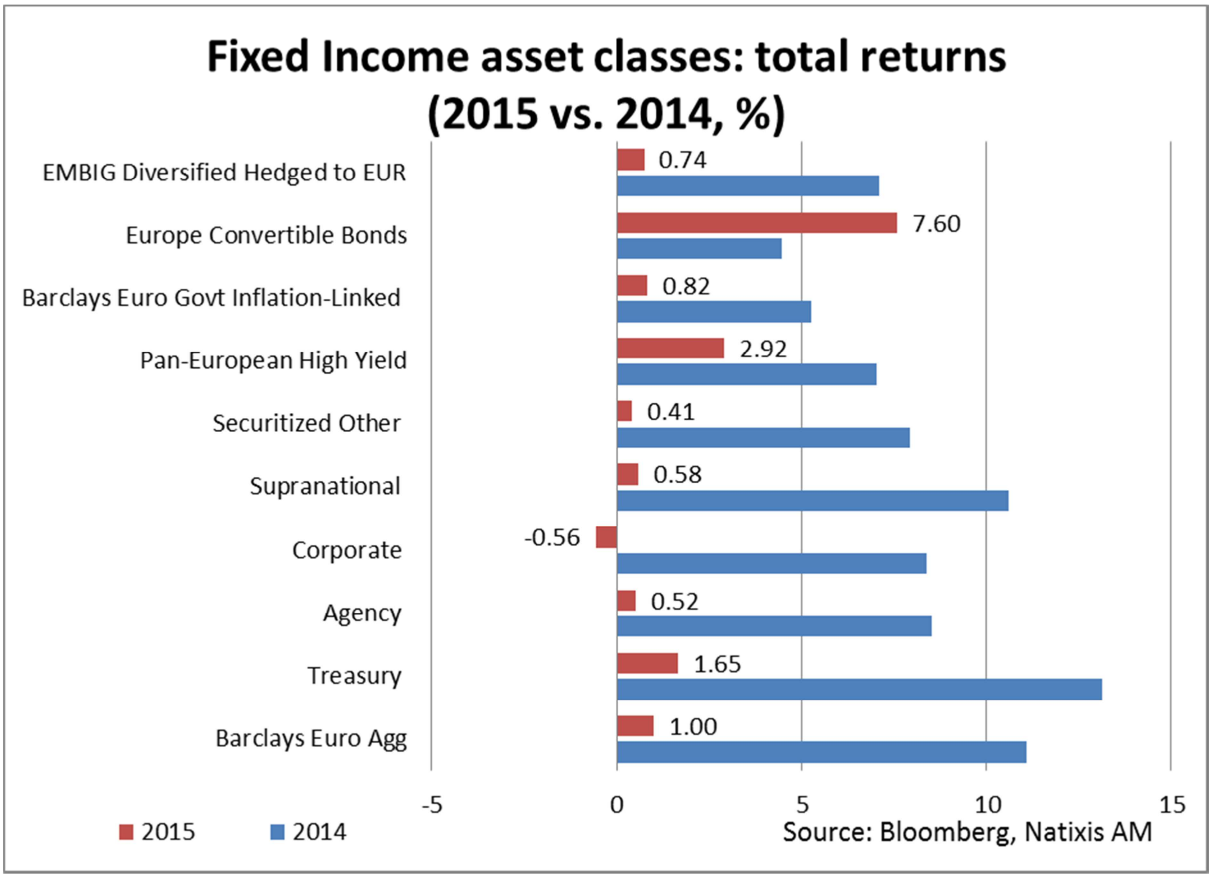
Political risks and commodity rout take a toll on emerging bonds

Lastly, in emerging bond markets, the year was full of surprises. Overall the spread on dollardenominated debt increased from 350bps at the start of the year to a peak at 425bps by year-end. The bearish consensus on Russia was proven wrong. The Russian spread nearly halved in 2015 dipping from over 500bps in January to the 300bp area in December. Last year's Russian rouble massive devaluation indeed cushioned the fall in oil prices although domestic demand did collapse. It remains to be seen if long-standing oil weakness end up putting pressure on spreads yet again. In Africa, the commodity bear market took a toll on external credit. Foreign reserves have decreased significantly across the region. Turkey muddled through despite elections and Syria's refugee crisis. Turkish spreads on USD debt nevertheless increased late last year amid tensions with Russia after the downing of a Russian aircraft. In Latin America, a perfect storm developed in Brazil. Political scandals, a worsening recession and stubbornly high inflation resulted in sharp sell-offs in currency (BRL traded above 4 against the US dollar) and spreads. Brazil was thus downgraded to junk by two agencies in 2015. The impeachment procedure against President Rousseff has been invalidated for now but the issue is still pending. Spreads on external debt went up to end the year near 600bps. In China, growth expectations finally caught up with reality. As private capital outflows intensified in August, the PBoC had no choice by to devalue and embark into monetary easing. Authorities took further steps to reignite lending and durable consumption in the fall. This triggered some monetary adjustments in the region.

Conclusions

Delayed Fed lift-off contributed to the development of a currency war through 2015. Easing measures have been implemented across the developed world. As a consequence, bond yields have been little changed. Consensus for peripheral outperformance turned out to restrain their performance in 2015. The outlook may be for a resumption of spread narrowing in 2016. Valuations in credit have cheapened especially in sectors linked to commodities. Central bank activism may have long-run negative consequences on financial stability. The widening in covered bond spreads may be a first sign of downside risks on underlying real estate collateral.

As at January 5th, 2016.



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