FIXED INCOME
OUTLOOK 2016

SWIMMING AGAINST THE FLOOD OF GLOBAL LIQUIDITY

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- Global monetary policy stimulus is pushing all central banks downstream. For better or worse, the global economies are interdependent.
- Global QE will continue to increase, supporting credit and risk assets. Defaults are rising but should be limited, concentrated in the commodities segment.
- US rates will rise above current levels, but the effects of global QE will limit the increase.
- Emerging markets will become more attractive, but investors are fearful to jump in. We expect a rebound in investor sentiment later in 2016.
- In Europe and Japan, earnings are benefitting from weaker currencies against the dollar. However, low yields are pushing investors toward the US market.

We are now near the end of 2015, and the global fixed income markets continue to be under pressure. Global central banks have released a torrent of accommodative monetary policy in an effort to stimulate lackluster growth and to avoid the trappings of deflation. Quantitative easing (QE) is pushing all central banks downstream toward zero rates while the US Federal Reserve struggles to move upstream toward higher ground.

The US economy has not yet achieved the underlying economic strength the Fed needs to fight against the effects of global QE. In the coming months, we believe the Fed will finally start to make progress, but the currents will be too strong to fully overcome by the end of 2016. This will result in policy rates moving above current levels but well shy of their forecasts.

What's more, several factors could erase any headway: interim credit market volatility, a midcycle economic slowdown, currency headwinds, a collapse in commodities segments, and heightened geopolitical and terrorism risks.

For better or worse, the global economies are interdependent, and capital markets have become more connected – just look at the impact of the strong dollar over the past 18 months. During the financial crisis and initial recovery, the US was the beneficiary of the more favorable global climate. Now it must transfer some of its strength to allow other central banks to fight weakness in many pockets of the world.

The path toward US interest rate normalization will not be easy nor smooth. At best, it will be a long and slow process where we see a gradual flattening of the yield curve but ongoing low global interest rates. This will support fixed income assets but result in very low return outcomes for a prolonged period.

Developed market investment grade takes a slow, bumpy ride

Investment grade fixed income is at the center of global monetary policy actions. While the US economy continues to heal, with unemployment levels now ready to breach 5%, Europe appears to be embarking on an expansion of its QE program and Japan is on the brink of another recession. In a connected global capital market, it's difficult to see an outcome where US Treasuries can break away from other "risk-free" sovereign bonds. And the Fed's ability to increase short-term rates will be constrained by the potential impact on the currency markets that may filter into the real economy. Unless we see a meaningful shift in December, investment grade fixed income markets will finish 2015 pretty much where they began, with a somewhat bumpy ride in between.

Spreads have widened as a wave of new-issue supply overtook the market at every turn and fundamentals deteriorated as a result. Unable to boost organic earnings from top-line growth, companies are increasingly turning to financial engineering or strategic acquisitions by leveraging their balance sheets in an effort to boost growth.

In Europe and Japan, earnings are benefitting from weaker currencies versus the US dollar, and ongoing QE should support credit spreads. However, low absolute yields are pushing investors toward the US market, where yields are relatively higher. Also, credit spread risk in investment grade appears more attractive than duration risk in the year ahead.

Rather than offering broad-based opportunities, market volatility will result in selective assets and securities that offer value. But the time to capture them is shifting quickly, so investors will need to be nimble and trade on these opportunities to generate excess returns.

The emerging markets are enticing, but investors are fearful to jump in

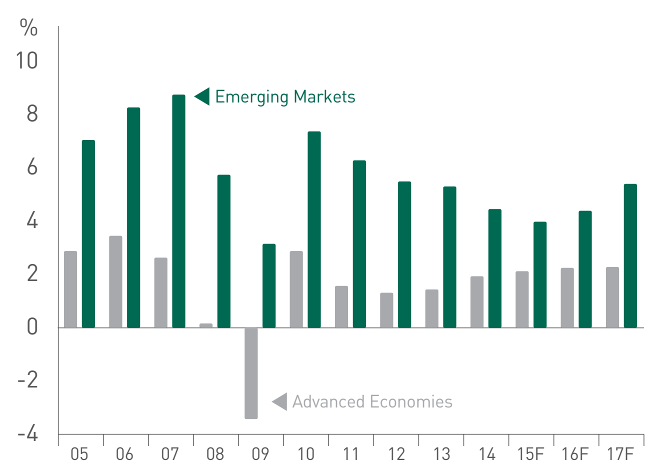
The first half of 2015 featured a strong rally that was overwhelmed by fear in the second half. This fear was the result of renewed China growth concerns, another leg down in commodities prices, and Fed uncertainty. Ongoing dollar strength meant that hard currency segments showed greater resilience while local currency bonds sought bottom. Market liquidity conditions were also poor, pushing the market toward a buy-and-hold approach. But we expect that lower supply, which has been concentrated by Asian issuers, will support market technicals in the near term.

We have also seen meaningful dispersion within emerging markets (EM) that will continue as a longer-term trend. Despite the concerns about China, Asia credit was a standout performer, while Brazil plunged to new lows. But at some level, return outcomes defied fundamentals: Russia was a top outperformer despite downgrades, and "basket case" countries Argentina, Venezuela, and Ukraine also outperformed traditional safe havens.

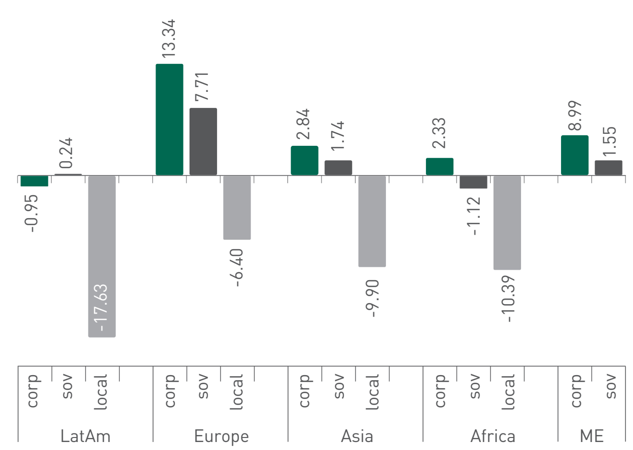
In 2016, the ongoing global central bank policy easing should dampen the negative impact from any US Fed monetary tightening, and the magnitude of the negative currency trends should decline. While overall EM growth

Emerging markets: focus on headline growth disguises regional & asset class variances

Growth Differential Maintained Despite Headwinds



Regional Total Returns YTD



Source: IMF World Economic Outlook Database, JPM CEMBIBD, EMBIGD, GBI-EMGD indices, Bloomberg, 31 October 2015. Any opinions, projections, forecasts and forward-looking statements presented are valid only as of the date indicated and are subject to change.

levels will remain low, they should rebound from 2015's lows as less negative growth in Russia and Brazil, along with strong growth in India, offsets the slowdown in China.

Across broad patches of EM, we continue to see weaker manufacturing and export segments (despite the beneficial impact of local currency depreciation) offset by stronger consumption, particularly of services.

We expect ongoing volatility and an abundance of caution during the first half of 2016, but an eventual rebound either later in the year or in 2017. Fundamentals will be secondary to technicals and sentiment in the near term, but EM debt remains an attractive component of global fixed income and should perform well relative to its developed market counterparts over the longer term.

Oil and money flows drive leveraged finance

In an asset class where fundamental drivers should have an outsize impact on performance outcomes, technical trends dominated the market in 2015. Despite minimal default rates, US spreads widened substantially during the second half of the year on concerns about the energy segment and the challenging demand technical environment for loans. The standout performer has been European credit, and loans in particular, due to much more favorable technicals and despite less favorable fundamentals and valuations through much of the year. It's yet another reminder that in the short term, it's difficult to swim against the current of liquidity flows.

In 2016, we expect some headwinds from a deterioration in fundamentals. Earnings disappointments have risen and default rates are poised to pick up as the full carnage in commodities takes hold. But valuations already reflect this outcome, and while we do not expect much spread tightening, the market should be poised to deliver substantially improved returns that approximate coupons. Still, we expect periods of volatility in both directions.

On the surface, US loans appear to be the most attractive risk-adjusted asset class, but they currently face stiff technical headwinds. These are due to ongoing retail outflows and a difficult collateralized loan obligation (CLO) formation environment, which will not get any easier with the phase-in of US risk-retention requirements at the end of 2016. But the Fed's rate normalization process, once it finally begins, should help by halting retail outflows, if not necessarily resulting in meaningful inflows.

For US high yield, market sentiment for 2016 will be dictated by the path of oil prices. If pricing levels rebound toward a sustainable level in the mid-$50 to $60 level per barrel, renewed optimism and investor demand would support the asset class. Should oil remain near current depressed levels and supply fail to contract as anticipated, we would see ongoing aversion to high yield despite the fact that energy is representing an increasingly smaller segment of the broader market.

In Europe, a decidedly different trend appears to be taking shape. The European leveraged finance market has been experiencing weaker fundamentals, with higher defaults and macroeconomic challenges. However, the fundamental trends are improving and the gap between Europe and the US has been narrowing. The lack of supply in the European market, combined with ongoing and potential expansion of QE, is also providing strong support to risk assets. While valuations are inferior and should result in lower return expectations relative to the US market, the other factors should allow for a less volatile return outcome for 2016, so it will be difficult to underweight Europe on a currency-hedged basis.

Despite the challenges across leveraged finance as we get deeper into the credit cycle, the asset classes appear to be poised to produce some of the best returns based on near-coupon expectations. Unfortunately, this market rarely produces coupon returns, so we expect returns to be several percentage points above or below coupon yields.

Seek incremental alpha when returns are low

In many ways, 2015 is shaping up to be a lost year for fixed income, and many components of our 2016 outlook continue to remain in place. The downward volatility in credit assets during the second half of the year in particular has resulted in favorable valuations even amid declining fundamentals and expectations of rising global defaults. Global QE will continue to increase over the next year as the European Central Bank expands its current program, the Bank of Japan faces another recession, and the People's Bank of China attempts to smoothly navigate its economic transition. The resulting effect should be ongoing support of credit and risk assets and a benign default environment concentrated within the commodities segment and idiosyncratic business situations.

It boils down to this: We are in a multi-year period of low fixed income beta return expectations, so investors will need to get the most out of their portfolios by seeking incremental alpha and adopting a more flexible, nimble approach.

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