MONTHLY COMMENTARY

Global Fixed Income

May 31, 2015

Developed-Market Bonds

Euro-zone bond yields ultimately increased in May despite core yields (German Bunds, French sovereigns) retreating in the back half of the month on "Grexit" fears and lower euro-zone inflation expectations. Market participants sold peripheral euro-zone bonds (Portugal, Spain, and Italy) aggressively in favor of core euro-zone sovereigns following Greece's brinksmanship negotiation tactics with official creditors. Mexican bond yields followed G3 yields higher during the month, although two-year Mexican rates fell in response to a nine-year low inflation print that removed domestically oriented pressures on the Bank of Mexico to begin a rate-hike cycle in 2015. South Africa's bonds underperformed major treasury markets after the country's tabulations revealed an underwhelming 1.3% annualized growth rate in the first quarter and a 12-year high unemployment rate of 26.4%. Rating agencies are clear in communicating that South Africa must achieve a timely return to better growth levels to offset persistent budget deficits and maintain its investment-grade rating. Polish sovereign debt also underperformed in the wake of a slightly surprising presidential win by opposition candidate Andrzej Duda. Investors feared that Mr. Duda's election may be a harbinger for broader political shifts toward anti-austerity and populism.

Developed-Market Currencies

In a reversal from April's trend, nearly all currencies fell against the U.S. dollar in May. Janet Yellen delivered a slightly hawkish speech that referenced a likely 2015 rate hike, which instantly reoriented currency markets toward a dollar rally. Late May Grexit fears further hurt the euro (down 2.0%) while the yen (down 3.6%) neared decade-low levels against the U.S. dollar. The International Monetary Fund joined a chorus of market participants urging the Bank of Japan (BoJ) to increase monetary stimulus efforts—days later, a soft 0.3% inflation print likely cemented a dovish shift at the BoJ. Most economically sensitive commodity prices fell in May on China slowdown fears and a strengthening U.S. dollar, weighing on the Australian dollar (down 3.2%), Malaysian ringgit (down 2.8%), Chilean peso (down 1.0%), and Norwegian krone (down 3.0%). New Zealand's dollar (down 6.7%) fell on poor employment, inflation, and wage pressure data that caused investors to position for an impending rate cut, as evidenced by the double-digit-bps fall in two-year rates. The British pound (down 0.3%) outperformed other European currencies, helped by the Conservative party's electoral win. The Polish zloty's fall this month (down 3.7%) occurred in tandem with a sell-off in the country's sovereign debt following the Andrzej Duda presidential election win.

Emerging Market Bonds and Currencies

Indonesian bonds and the rupiah (down 2.0%) underperformed on a weaker-than-expected gross domestic product report and uncertainty related to a disconnect between the central bank governor and Indonesia's vice president, who flatly

Yields higher, dollar stronger

Hawkish Federal Reserve rhetoric drove dollar strength in May

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contradicted each other in statements about interest rate paths. Hungary's forint (down 3.7%) fell against the euro after producer price levels coaxed a dovish statement from the central bank. Hungary's 10-year bond yield nearly touched 4% in early May before falling back below 3.5% at month end. Brazil's real (down 5.2%) fell in response to the lower house in parliament's approval of more generous pensions, which countered President Dilma Rousseff's austerity efforts. The Rousseff administration also froze nearly 70 billion reais of discretionary spending in May, which helped to lower growth expectations and sovereign bond yields.

Mortgages and Credit

European mortgages ineligible for purchase by the European Central Bank continued to underperform in May while investments sensitive to peripheral euro-zone risk appetite underperformed on Grexit contagion fears. High yield spreads contracted in both the U.S. and Europe while investment-grade spreads widened slightly. Investors shunned investment-grade credit as a source of interest-rate sensitivity in a rising rate environment.

Outlook

Ultra-supportive monetary policy, cheap energy, devalued currencies, and low interest rates should make 2015 a pivot year for global growth. The U.S. economy is already advancing at lift-off speed and we expect the European and Japanese economies to surprise to the upside once the impact of stimulus takes hold. Peripheral European currencies look attractive as an expression of a constructive European economic outlook that avoids direct exposure to quantitative easing. Despite our outlook for better developed market growth, we expect long-term safe-haven yields will remain capped on the upside as a result of the still formidable debt overhang, a benign global inflation environment, a low terminal level for G3 policy rates, and entrenched concerns of global economic fragility. In 2015, we believe select emerging market debt offers the most attractive source of yield and potential currency return among our investible universe.