GLOBAL FIXED INCOME: THE 2016 FINAL GRADES ARE IN

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There is no doubt that 2016 proved to be rather volatile in the global fixed income arena. There certainly were many factors, headlines and events (plunging oil prices, Brexit, the U.S. presidential election, the Federal Reserve's (Fed) second rate hike, etc.) the collective bond market had to contend with, which most assuredly were integral for this roller-coaster ride.

If we cut through all the noise, a recurring theme seemed to be that, in terms of overall performance, 2015's losers became 2016's winners. Nowhere was this trend more evident than in the U.S. corporate bond market, as one of the worst-performing fixed income asset classes of 2015—high yield (HY)—became the top performer last year. As measured by the Barclays U.S. Corporate High Yield Total Return Index Unhedged, HY produced a reading of +17.13% in 2016, more than reversing the prior year's 4.47% decline. It should be noted that it didn't start out that way, as the HY sector was certainly going through its struggles to begin 2016. Indeed, the plunge in oil prices and the increased anxieties it produced regarding elevated default rates pushed HY spreads out to levels we hadn't seen in almost five years. As energy prices reversed course and the market's worst fears weren't realized as a result, investors viewed HY corporates as a rather attractive investment vehicle, with spreads finishing last year 430 basis points (bps) below their peak reading of early February. In the investment-grade (IG) corporate market, a similar pattern emerged. According to the Barclays U.S. Aggregate Corporate Total Return Value Unhedged Index , the IG sector finished 2016 with a positive performance of +6.11%, a rather noticeable improvement from the prior year's -0.68% reading.

Total Returns

	2015	2016
2-Year U.S. Treasury Note	0.44%	0.63%
10-Year U.S. Treasury Note	0.90%	-0.14%
Barclays Aggregate	0.55%	2.65%
Investment-Grade Corporate	-0.68%	6.11%
High-Yield Corporate	-4.47%	17.13%
Emerging Market US$ Total Return	1.05%	9.64%
EM Local Debt	-14.92%	9.94%

Source: Bloomberg, as of 1/06/2017. Past performance is not indicative of future results.

For definitions of indexes in the chart, visit our glossary.

The emerging market (EM) debt experience had the most noticeable reversal of fortunes, specifically in the local debt area. To be sure, EM local debt produced a total return just under +10% (J.P. Morgan Government Bond Index – Emerging Markets Global Diversified Index) last year, which represented a turnaround of nearly 25 points from the 2015 shortfall of -14.92%.

From the interest-sensitive side, U.S. Treasury market (UST) performance numbers varied depending upon where one sat on the yield curve. To illustrate, the UST 2- Year return came in on the plus side of the ledger, at +0.63%, compared to a negative showing of -0.14% for the UST 10-Year (utilizing the Citi 2-Year and 10-Year Treasury Benchmark On-the-Run Index). With respect to the UST 10-Year, this was a perfect example of the roller-coaster ride discussed earlier, as its total return in the days and weeks post-Brexit was solidly in the plus column, hovering around +8.0%.

Conclusion

So where are we headed in 2017? Given the different starting points between this year and 2016, it would not seem reasonable to expect duplicate performances from the HY, IG and EM local debt asset classes this year. However, that does not mean positive performances won't ultimately be realized, it's just that the magnitudes would more than likely be lower. Certainly, there are a lot of unknowns entering the equation as well (the new Trump administration, potential fiscal stimulus, eurozone elections and Fed policy, to name a few). So fasten your seat belt and get ready for another potentially volatile ride in fixed income land in 2017.

Unless otherwise noted, source is Bloomberg, as of 1/06/2017.

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DEFINITIONS

Brexit : an abbreviation of "British exit" that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Unio.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Corporate Bonds : a debt security issued by a corporation.

High Yield Corporate (Bond) : a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

Barclays U.S. Corporate High Yield Index : Covers the universe of fixed-rate, non-investment-grade corporate debt.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Basis point : 1/100th of 1 percent.

Investment Grade : A rating given to a municipal or corporate bond. It is a relatively favorable rating by either Moody's or Standard & Poor's indicating a higher chance an issuer performs interest and principal obligations as promised by the terms of the debt issuance.

Barclays US Agg Corporate Total Return Value Unhedged USD : The Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

Emerging market : Characterized by greater market access and less potential for operational risks when compared to frontier markets, which leads to a larger base of potentially eligible investors.

JP Morgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified : The JP Morgan GBI EM Global Diversified tracks the performance of local currency debt issued by emerging market governments, whose debt is accessible by most of the international investor base. The index incorporates a constrained market-capitalization methodology in which individual issuer exposures are capped at 10%, (with the excess distributed to smaller issuers) for greater diversification among issuing governments.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).