

GLOBAL FIXED INCOME: RUNNING ON EMPTY?

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Through the first nine months of the year, the global fixed income markets continued to defy the odds. Indeed, year-to-date, a variety of bond arenas have posted visible positive performances, continuing the trend that investors have been accustomed to for almost two years now. The more important question is whether this past performance can be maintained in the months ahead, or is the global bond market rally finally running on empty?

The [emerging market \(EM\)](#) debt space continued in the top spot, experiencing the best performance in the fixed income universe through the third quarter and building on the positive momentum that was seen for 2016. To be sure, EM local debt has produced a total return of +14.28% (J.P. Morgan Government Bond Index – Emerging Markets Global Diversified Index), after posting nearly +10% for all of last year. Interestingly, EM local debt performance has improved with each passing three-month period in 2017, starting in Q1 at +6.50% and posting a +10.36% total return through Q2. Some of the key reasons behind this performance have been fundamental improvements in EM countries combined with a less hostile U.S. rate setting. Although the [Federal Reserve \(Fed\)](#) lifted rates in March and June, as well as announcing balance sheet normalization in September, [U.S. Treasury \(UST\) 10-Year yields](#) (as of this writing) have actually fallen this year, helping support the EM local debt arena accordingly.

Total Returns

	Q3 2017 Year-to-Date	2016
2-Year U.S. Treasury Note	0.54%	0.63%
10-Year U.S. Treasury Note	2.41%	-0.14%
Barclays Aggregate	3.14%	2.65%
Investment-Grade Corporate	5.18%	6.11%
High-Yield Corporate Yield	7.00%	17.13%
Emerging Market US\$ Total Return	9.16%	9.64%
EM Local Debt	14.28%	9.94%

Source: Bloomberg, as of 10/13/17. Past performance is not indicative of future results.

The U.S. [corporate bond](#) market managed to come in on the plus side of the ledger as well through Q3, although in the case of [high yield \(HY\)](#) the return has not lived up to last year's experience. This should come as no surprise to fixed income investors, however, as calendar year 2016 represented a stellar display for both the [investment-grade \(IG\)](#) and HY sectors. To provide some perspective, as measured by the Barclays U.S. Corporate High-Yield Total Return Index Unhedged, HY produced a positive reading of 7.00% following a very robust increase of 17.13% in 2016. In the IG corporate market, according to the Barclays U.S. Aggregate Corporate Total Return Value Unhedged Index, the IG sector registered a gain of 5.18% after finishing 2016 with a positive performance of 6.11%.

Perhaps the biggest surprise in the fixed income arena has been in the interest-sensitive side, specifically the U.S. Treasury (UST) market. Despite the fact that the Fed has implemented two [rate hikes](#) this year, with one more expected in December, UST yields have not surged higher, or in the case of the 10-Year maturity, the yield has actually fallen 30 [basis points \(bps\)](#) from its pre-March [FOMC](#) high-water mark through quarter-end on September 30. The 2-Year yield, typically more sensitive to Fed rate hike developments, has risen by only about 10 bps during the aforementioned time frame. As

a result, these UST returns also managed to record positive showings of 0.54% and 2.41% for the 2-Year and 10-Year (utilizing the [Citi 2-Year](#) and [10-Year Treasury Benchmark On-the-Run Index](#)), respectively.

Conclusion

How do we finish 2017? As I've discussed in prior blog posts, geopolitical headlines, specifically as they pertain to North Korea, will unfortunately remain an influence, especially for [safe-haven](#) assets such as Treasuries. Obviously, the legislative session in Washington, D.C., will no doubt carry the potential to move fixed income yields in a visible way as well. To be sure, the tax reform/tax cut debate and budget negotiations are now on the "shot clock" if they are to be resolved before year-end. Or will those issues get pushed back as 2018 trading considerations? Don't forget that the Fed and other global central banks, as monetary policy makers, could be making Q4 headlines as well. Given the returns investors have witnessed thus far this year, the starting point going forward probably makes it difficult to build upon the Q3 year-to-date performance. In the opening weeks of Q4, returns have been either little changed or slightly negative, but more than two months are left in the period.

Unless otherwise noted, data source is Bloomberg, as of October 13, 2017.

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DEFINITIONS

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.

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

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.

10-year government bond yield : Yields on the 10 year government debt security.

Corporate Bonds : a debt security issued by a corporation.

High Yield : Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

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.

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.

Basis point : 1/100th of 1 percent.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Citi 2-Year Treasury Benchmark On-the-Run Index : Total return index for the Generic United States on-the-run 2-Year Treasury. Data is updated on the 1st day of the month for the last business day of the previous month and is final on that day. Index updates monthly subject to the existence of appropriate bonds for the specified period.

Citi 10-Year Treasury Benchmark On-the-Run Index : Total return index for the Generic United States on-the-run 10-Year Treasury. Data is updated on the 1st day of the month for the last business day of the previous month and is final on that day. Index updates monthly subject to the existence of appropriate bonds for the specified period.

Safe-haven : Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.