

**Summary: In general, equities have outperformed bonds this year. For bonds it has been the second or third worst year of performance over the last decade. Part of that has been pay-back after a very strong year in 2014 which saw yields and credit spreads fall to very low levels. Part is also a reflection of a number of events that have created volatility in the markets – the Swiss currency move, Greece, oil prices and China. The European Central Bank (ECB) joined the quantitative easing (QE) party and Bunds sold off massively, contrary to how the market was positioned. And then there has been the “will-they, won’t they” story of the Federal Reserve (Fed). Just now it looks like we could experience a normal business cycle – the US is close to full capacity, monetary tightening will start soon, credit should outperform rates and eventually the cycle will peak.  I suspect it will be difficult to get great returns from bonds again in 2016. Although yields are a little higher than where they ended last year any additional income return might be lost by a more negative price return, especially in markets where rates go up (US and UK). Short duration is the way to play rising rates and in high yield any rise in defaults is likely to come after rates have gone up. So investors should be rewarded for taking credit risk. But key to all is what the Fed does, what inflation does and how the economy and the markets react.**

**Normal service resumes –**  I’m back. The last few weeks have been hectic with travel and other things but I have finally found some time to sit down and compose my thoughts on the outlook for markets as we get towards the end of the year. Returns to bond indices have been modest in 2015 despite central banks having either eased more (ECB, Swiss National Bank, Riksbank, Reserve Bank of Australia amongst others) or maintained a very accommodative stance (Fed, Bank of England, Bank of Japan and others). This reflects the very important fact that the contribution to total return from the income component has been constrained by low yields. If we take a representative global bond market index, comprised of high quality government and corporate bonds, the total return as of the 11th November was just 0.65% with that being comprised of a -1.6% price return and a 2.2% income return. Low initial yields and a tendency for yields to rise over the year, thereby generating negative price returns in most bond sectors, have made 2015 the second weakest year of the last ten for most bond sectors. With the Fed about to begin raising interest rates does that mean 2016 won’t be much better?

**ECB vs Fed –**Of the major bond market sectors, European high yield has been one of the best performers, followed closely by European inflation linked bonds and European peripheral government bonds. By contrast, US high yield, US investment grade and US inflation linked have all had negative total returns, year-to-date. This tells an interesting story about monetary policy. The ECB embarked on a large scale asset purchase programme in early 2015 and this has benefitted those sectors that had the highest yield at the time, as well as inflation linked assets given that the whole purpose of QE is to raise inflation. European break-even inflation rates now stand higher than they did at the beginning of the year, thus providing an outperformance relative to nominal government bonds. For the US the never-ending story has been about when the Fed will raise interest rates. On top of that the high yield sector has underperformed as a result of energy, while investment grade has seen spreads widen throughout the year because of the clear re-leveraging trend amongst American companies.

**Credit vs rates –** Most of the credit negative news came towards the end of summer following the decision of the People’s Bank of China to adjust its exchange rate setting mechanism, which many took as a willingness to see a weaker RMB. This came after a year-long slide in commodity prices and amid plenty of evidence that the shift in China’s development is resulting in a lower overall growth rate. However, credit has rallied strongly in Q4 as it has become clear that we are not on the verge of a global recession. Indeed, even in China, the relative growth of domestic demand (retail sales, housing) means that it is not all doom and gloom. Just as important, if not more, is the strength of the US economy. Last week’s employment report for October showed another 217,000 jobs created and a further decline in the unemployment rate to 5%. Moreover, there are now signs that the tightness in the labour market is pushing wages up, with average hourly earnings up 2.5% compared to a year before. Employment growth remains close to 2% on a year on year basis, GDP growth will average much more than 2% for the year as a whole and come the New Year inflation will move higher. So it makes little sense to keep the Fed Funds rate at 0.00%-0.25%. Unlike the situation in September, improved sentiment about the global economy as well as more stable markets should allow the Fed to begin raising rates next month.

**High yield performing again –**  We like to think that interest rates and credit spreads behave differently to each other depending on where we are in the economic cycle. As the US recovery accelerates into more of a late-cycle expansion the key characteristics would be a turn higher in inflation and monetary tightening. Rates will move higher but credit spreads might not move as much given the macro backdrop, at least in the first stage of the tightening cycle. This should mean a positive excess return from credit (total return relative to government bonds). Where we expect to see this playing out most obviously is in high yield. As Treasury yields rise in response to the start of the Fed tightening cycle, high yield spreads should narrow from their current 600 basis point level over Treasuries. This has already started with US high yield delivering a positive excess return of 2.8% this quarter.

**Will we get a 300bp tightening cycle? –** The biggest risk to US and global fixed income is that Fed rate hikes push both underlying yields and credit spreads wider because of the view, that is likely to unfold at some point, that the US is rapidly closing in on the peak of the business cycle. We don’t see that as the main scenario for the first part of 2016 or perhaps not even until much later, but that would change if the Fed were to raise more quickly than is currently priced in. Personally I can see the Fed Funds rate at between 2% and 3% sometime in 2017 and perhaps higher. Since the early 1980s, the average total move from trough to peak in the Fed Funds rate has been 325 basis points and tightening cycles have lasted between 1 and 3 years. If we are saying that the upcoming cycle is going to be shorter in duration and resulting in less of a rate adjustment, then there must be something that makes the Fed curtail its policy. That something needs to be a heightened chance of a recession coming from a sharp reduction in aggregate demand. Where might that come from? The household sector is less leveraged than it was prior to 2008 and has maintained a personal savings rate of close to 5%, so consumers might not respond too much to modestly higher interest rates. A rapid rise in inflation leading to a decline in real incomes might curtail domestic consumption but with a tight labour market the initial response could be higher wage growth, suggesting that the Fed would need to be more aggressive than current market pricing anyway. Household debt outstanding has hardly increased during this US economic expansion, while federal and non-financial corporate debt has risen rapidly in nominal terms and corporate debt remains only marginally less as a percentage of GDP than at its peak in early 2009. If a rate driven, debt induced shock to demand is going to trigger the next US recession, it might be that it comes from the corporate sector or it might mean that rates have to go up a lot more than is conventionally thought.

**Euro rates to stay low –** If inflation stays low, the Fed can be as gentle as the forward market suggests and take its time getting to the “new normal” terminal rate. The economy might not flinch too much from that and bond investors are likely to be rewarded for staying in credit. However, we might have to be prepared for a less benign scenario of higher rates and wider credit spreads in the US. But it is hard to be that bearish on Europe other than on the basis that there will be some spill over from a weaker US market if we see one. The ECB continues to suggest that QE will continue beyond September 2016. The euro area economy is nowhere near close to full employment with continued structural drags on growth from the financial sector and fiscal policy. Until recently the trend had still been one of de-leveraging. A measure of that is the face value of the European corporate bond market had been on a downward trend in the 2010-2013 period. There has been a growth in euro denominated corporate debt since the beginning of 2014 but quite a lot of that has been from non-European issuers taking advantage of low borrowing costs. Re-leveraging in Europe of European companies is way behind that in the US.

**Short duration credit –** So how to play the markets going into 2016? We think that generally we are still in the phase of the cycle that supports credit and that we will see in some areas the negative correlation of returns from a pure credit exposure to a pure rates exposures. That argues for a short duration approach to fixed income portfolios, focussed on credit spread but with limited duration exposure. Indeed, even if underlying yields and spreads both go higher, a portfolio of short maturity bonds will do better than the full market exposure. For the US versus Europe the divergence of monetary policy will remain a theme and the reflationary element to the euro story should play out in continued widening of European index-linked break-evens and excess returns from high yield. On emerging market debt, the story has been one of decent returns in hard currency debt this year despite the well-known growth and policy problems in emerging markets. Those headwinds won’t go away and we would be somewhat cautious on emerging market debt during a period of rising US rates. However, history suggests that any weakness associated with Fed tightening is limited and then emerging market spreads tend to narrow. The policy flexibility that the Chinese authorities have should underpin confidence that Chinese growth won’t slow much more and this in turn should reduce additional bearishness on commodities and other emerging market economies.

**Power, corruption and lies –** It’s become easy to be disillusioned with organised sport. Unfortunately it’s not that surprising when one hears news of cheating and bribery. It all goes against the natural emotional excitement of watching sporting competition. What if the winner has cheated, what if someone has paid someone to guarantee the result, what if you are being fleeced for the price of a ticket. And in my sport of choice the actual product has become so dull. Van Gaal’s United are like a bad Barcelona, Chelsea are more entertaining off the pitch than on it, Arsenal are inconsistent and Liverpool are just rubbish. Thank goodness for Jamie Vardy, Salford City FC and the super Owls beating Newcastle and then Arsenal in the League Cup. Next year there is even more money coming into the game, but that won’t guarantee excitement. If the money trickled down to grass roots it would help because England is not going to produce a Messi if 12-year olds have to play on mud. My son has given up football for now and is focussed on rowing but I can’t honestly say that watching an-eight speed by on the river at a head generates the same excitement as Dwight Yorke knocking in three against Arsenal back in the day. Maybe the Premier League can use some money to make the goal posts wider and higher – harder for the goalkeepers but Rooney might bag one now and again.

**Chris Iggo**

**CIO Fixed Income, AXA Investment Managers**

All data sourced by AXA IM as at 13 November 2015.