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fixed income



BNY MELLON

Which way next?

- 1 Which way next?
- 7 Coming up.... more regulation
- 10 Across the universe
- 22 Twin pressures

Despite ongoing volatility, global monetary policy divergence and market uncertainty, many investment managers continue to see strong potential and strategic value in fixed income over the year ahead.

After months of speculation on when the US Federal Reserve (Fed) would raise interest rates, the end of 2015 at last saw a modest, if decisive shift. In December the Fed raised rates by 0.25 percentage points – its first increase since 2006¹ – setting rates on what many predict will be an upward trend with potentially unpredictable outcomes.

While initial market reaction to the change was muted, policymakers and investors must now confront the likelihood of further rises in US rates, while other countries and regions continue on a more accommodative policy path. Central bank divergence and a range of other influencing factors will be key to where to find value in fixed income through 2016, according to managers from across BNY Mellon.

Slowing economic momentum in major developing markets such as China and Brazil is of significant concern, with combined outflows from emerging market (EM) debt and equities by foreign investors amounting to US\$46bn in the second half of 2015 – according to estimates from the Institute of International Finance.²

Despite this somewhat unsettled environment, the global debt market and fixed income investment sectors continue to register healthy growth. Current market uncertainty has also broadened the appeal of flexible fixed income mandates which can adapt to suit changing conditions.

Against this backdrop, BNY Mellon investment boutiques including Standish*, Newton, Alcentra, Insight Investment and Mellon Capital, outline the prospects facing the fixed income market in the year ahead, assessing what investors might expect and where the current opportunities lie.

*BNY Mellon Investment Management EMEA Limited is the distributor of the capabilities of its investment managers in Europe, Middle East, Africa and Latin America. Investment managers are appointed by BNY Mellon Investment Management EMEA Limited or affiliated fund operating companies to undertake portfolio management services in respect of the products and services provided by BNY Mellon Investment Management EMEA Limited or the fund operating companies. These products and services are governed by bilateral contracts entered into by BNY Mellon Investment Management EMEA Limited and its clients or by the Prospectus and associated documents related to the funds.

¹ BBC. US Fed raises interest rates by 0.25%. 16 December 2015.

² FT. Emerging market portfolio flows at weakest level since global financial crisis. 04 January 2016.

Market divergence

Fixed income investors entered 2016 facing mixed prospects amid renewed global stock market uncertainty as well as increasingly divergent central bank monetary policies. In January, turbulent equity markets prompted a shift to 'haven' investments, which saw a global brewing company attract a record US\$110bn of demand for a new A-rated bond deal, demonstrating the appeal of investment grade debt³ in uncertain times.

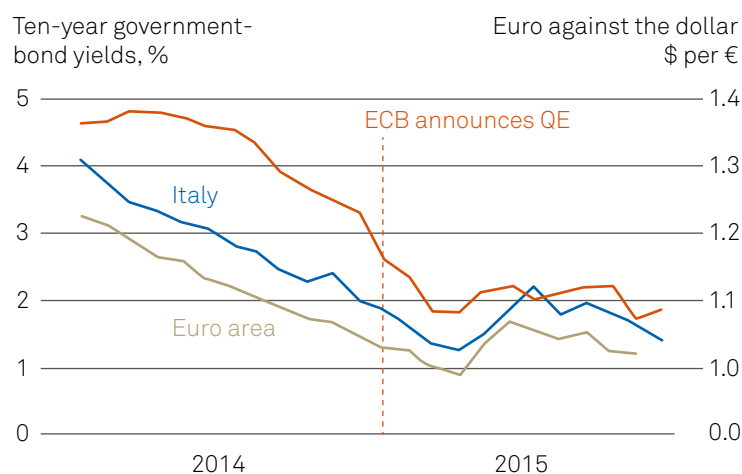
At a macro level, central bank monetary policy continues to dominate the fixed income agenda. After years of quantitative easing (QE) across major markets the US's Federal Reserve (the Fed) raised rates, signalling its intent to normalise markets.

Newton Investment Management sees ongoing Fed rate activity – together with the outcome of economic developments in China and the high yield market – as the key story to watch in 2016.

Commenting on the importance of rate moves in 2016, Newton head of fixed income, Paul Brain, says: "US Fed activity will undoubtedly influence bond markets. The US has the biggest bond market in the world and it is the market that prices all the others. Now that the Fed has started to raise rates it will likely want to continue but the fact that the economic cycle is already long in the tooth and that we have seen significant problems with the energy sector, investment is likely to slow. Once the consumer has spent its wage and energy windfalls, the US economy could be slowing once more. This suggests any further rate rises could be modest and that rates might have peaked by the middle of the year."

While the Fed looks to normalise its economy and draw back from the unconventional monetary policy of recent years, the European Central Bank (ECB) and Bank of Japan (BoJ) remain committed to sustaining their

QUANTIFYING QUANTITATIVE EASING



Source: Thomson Reuters as at 31 December 2015.

own QE policies while China has been intervening to support its own nascent capital markets, all of which could have unpredictable consequences for fixed income markets.

Commenting, Standish sovereign analyst Rowena Macfarlane says: "We believe the theme of divergence between the ECB and the Fed will continue to remain strong, with Eurozone inflation prints, market-based measures of inflation expectations, Fed actions and EUR/USD levels set to be important data points for European markets in coming months."

According to Newton's Brain, the divergence of monetary policy expectations between the US and Europe was reflected in the performance of the two regions' respective bond markets last year. He points out that sub-five-year German bund yields declined in 2015⁴ and 'peripheral' European sovereign bonds rallied, aided by further ECB stimulus. In contrast, US government borrowing costs rose across the maturity spectrum and at the front end in particular, in response to the Fed's December rate hike.⁵



The theme of divergence between the ECB and the Fed will continue to remain strong, with Eurozone inflation prints, market-based measures of inflation expectations, Fed actions and EUR/USD levels set to be important data points

Rowena Macfarlane, Standish



3 FT. AB InBev bond attracts \$110bn as investors rush to havens. 14 January 2016.

4 Bloomberg Business. German bonds decline with 10 year yield reaching 1%. 10 June 2015.

5 The New York Times. Why the Fed raised interest rates. 16 December 2015.

US strength

From a geographic perspective, the sustained strength of US economic recovery was one of the high points for global markets last year and provides at least some grounds for optimism among fixed income investors in 2016.

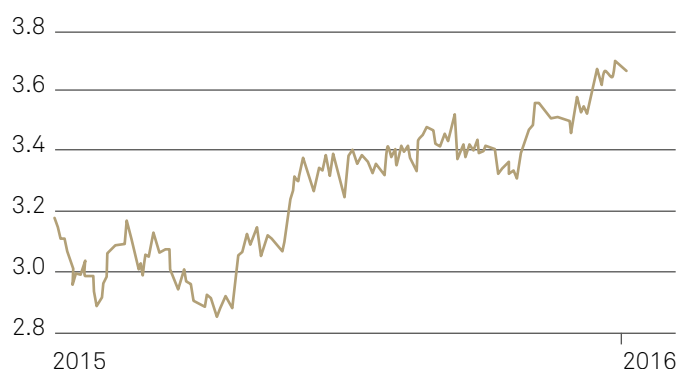
US employment levels are an important economic bellwether for the domestic market as well as an influencing factor on interest rate moves and they started the year in comparatively good health. According to Standish managing director for US rates and securitised strategies, Robert Bayston, the US labour market is currently near the Fed's estimate of full employment and near-term inflation is likely to be held down by the recent decline in commodity prices and the dollar strength of the past year.

He adds: "Our outlook for US and global growth for 2016 is little changed from 2015. Slowly improving inflation and a trend of tighter financial conditions will likely result in a cautious Fed, though markets appear to be somewhat pessimistic on rate hike expectations and we would expect these to rise somewhat in 2016."

Insight Investment head of global fixed income bonds, Isobel Lee, also anticipates further US rate rises in 2016, pointing out the market may be underestimating the potential for upward movements in rates and this could hold value opportunities for investors. "The Federal Reserve successfully achieved 'lift-off' in policy rates late last year. Although well-received, the committee is, on average, forecasting four rate hikes this year, while the market is still pricing in only two. The prospect of another hike in March is being materially underestimated and may present valuable opportunities. We continue to position for further yield curve flattening and for long-term inflation expectations to improve."

BANK OF AMERICA MERRILL LYNCH US CORPORATE BOND INDEX

Yield to worst (%)



Source: Bank of America Merrill Lynch, Eric Platt/FT as at 6 January 2016. Yield to worst = the lowest potential yield that can be received on a bond without the issuer defaulting.



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The prospect of another Fed rate hike in March is being materially underestimated and may present valuable opportunities

Isobel Lee, Insight Investment

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Global outlook

According to Newton's Brain, the global economic outlook for both developed and emerging economies remains mixed, particularly over the first half of the year. However, he believes the second half of the year will be a positive for fixed income investors, leading to a relatively good year for bonds.

Brain expects US interest rates will peak at 1% and may come back down as the year progresses. Europe, he says, is an easier story as the ECB has indicated it will continue to do what it needs to support the economy. For the UK, Europe's ongoing recovery will be good news, he notes, adding UK unemployment continues to fall. However, when and if the Bank of England moves rates is difficult to predict, he adds, pointing out it is likely to happen just when the US monetary policy stance goes into reverse. "The UK may miss its chance this year," says Brain.

In January, Bank of England governor Mark Carney ruled out any immediate rise in rates in what was described as a "fairly elegant swerve" from comments in July last year suggesting a modest rise might indeed be imminent.⁶

Vassilis Dagioglu, head of global asset allocation at Mellon Capital, says central bank action is likely to be a factor driving potential spikes in uncertainty. He notes any outsized movement in major market interest rates could trigger a ripple effect across asset prices.

"Divergence in monetary policies is expected to drive up the US dollar versus the euro and the yen and consequently boost shares of eurozone and Japanese companies relative to US shares," he says. "Meanwhile, in commodities, a strong US dollar could encourage producers to maintain increased output to service their dollar-denominated debt and government deficits, which in turn would push up supply and drive down pricing." Still, he adds, the reality for the year ahead is more likely a divergent world with different rates of growth and hence a variety of approaches to interest-rate policy.

While many are watching China carefully and certainly the start to 2016

was not a stellar one, Brain is more sanguine about the Asian giant. "China is no disaster; it is an economy that is transitioning and that will take a long time; consequently there will be periods of volatility and short term noise. It is worth bearing in mind that its current growth forecast of about 4-5% is still well above that forecast for some of the major developed markets," he adds.

Dagioglu also takes a nuanced view on China, noting the Chinese authorities have focused on a smooth transition, intervening when necessary. At the same time he believes the impact of the country's slowing growth on the world's developed markets "has been overstated". "The exposure of the corporate sector in the US or Europe or Japan to China is limited. Generally speaking, China accounts for less than 20% of total revenue for the broad equity indices in those regions."⁷

With respect to other emerging markets, in particular Latin America, Brain remains cautious. However, he does expect bad news will emanate from Venezuela and any sovereign defaults in the region are likely to have a contagion effect on the continent.

Other investment managers remain broadly optimistic about global economic prospects in 2016. Standish director of emerging markets, Javier Murcio, anticipates world GDP growth will show a modest increase in 2016 – with the International Monetary Fund (IMF) forecasting a rise from 3.1% last year to 3.6%⁸ as developed economies generally continue near current growth levels.

Murcio also expects to see emerging Asian countries continue to slow gradually and Latin American commodity exporters and Russia benefiting from positive base effects after a disappointing 2015.

Commenting on developed market prospects, Murcio remains unfazed by likely divergence in monetary policies and says: "In the developed economies including the US, Europe and Japan, consumer strength supported by improving labour markets and lower energy costs continues to drive growth, particularly in the services sectors.

"Despite likely diverging monetary policies in 2016, modest above trend growth should be supported throughout developed economies by ongoing high levels of monetary policy accommodation. The structural slowing of the Chinese economy continues to dominate the outlook for non-Japan Asia as well as most EM commodity exporters. While at current commodity price levels, we expect positive base effects to the growth of those countries most negatively impacted, managing the Chinese slowdown presents downside risks to our growth outlooks."

Geopolitical risk

In an increasingly unpredictable world, geopolitical risk remains an ever present threat to global markets. Last year saw renewed conflict break out in the Middle East, numerous terror related incidents across the globe and Russia become increasingly isolated from the west.

While these problems remain, Newton's Brain is also concerned about more prosaic political developments ahead such as the forthcoming US and German elections and a potential UK referendum on EU membership. He points to increasingly polarised electorates in both the US and Europe which threaten to delay investment or even create political logjam.

Commenting, he says: "We have seen a shift in the market – with a greater degree of underlying risk coming from politics. There is a long list of elections coming up and political polarisation and uncertain election outcomes could become an issue. We have recently seen inconclusive Spanish elections and the current state of politics in Portugal could also create problems.

"We seem to be moving away from widespread support for the centrist political parties to either end of the spectrum, without either left or right winning through strongly. That said, the good news is that while markets worry about political outcomes they are not as driven by those concerns as they are by low interest rates and the search for returns."

6 FT. Carney to wait and see after 'elegant swerve'. 20 January 2016.

7 BACI International Trade Database, European Central Bank as of November, 2015

8 BBC. The economic outlook for 2016. 06 January 2016.

According to Brain, such political factors are not “game changers” yet but they are concerns.

“Any in-out UK referendum on EU membership would be something for us to worry about, whatever the outcome. As we saw with the Scottish independence referendum in 2014, these events can delay investment, create uncertainty and lead to investors charging a premium for investing in that country,” he adds.

Inflationary trends

Sustained downward pressure on global oil and commodity prices has been just one factor driving inflation down to record lows in recent months, with little sign of upward inflationary trends returning any time soon. Oil prices had dropped from more than US\$100 per barrel in June of 2014 to less than US\$30 per barrel by mid-January 2016.⁹ While this may seem a boon for consumers and many industries, it also contributed to market volatility in the opening weeks of 2016. “Insofar as it’s possible to identify a trigger for the troubles,” says BNY Mellon IM strategist in Asia Simon Cox, “it may have been the International Energy Agency’s warning that the oil market might ‘drown in oversupply’. The oil price seems to have supplanted the Vix as a ‘fear gauge’ for the global economy. When it drops, risk assets seem to follow.”

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Any in-out UK referendum on EU membership would be something for us to worry about, whatever the outcome

Paul Brain, Newton

However, some managers remain hopeful that signs of a broader economic recovery in the US and Europe may help ease deflationary pressures throughout 2016. According to Brain: “US wage inflation looks set to rise in the first half of the year and other rising domestic costs such as shelter and housing could also bring a positive influence on inflation.”

Insight Investment believes inaccurate forecasting of US inflation could offer hidden market benefits, driving new investment opportunities. Commenting on the inflationary outlook for 2016 and its likely impact, its senior portfolio manager David Hooker says: “The market continues to underprice US inflation over the long term. Further falls in oil prices, which are entirely possible, may present opportunities for us to add to this stance.”

Liquidity concerns

The outlook for global market liquidity in 2016 looks uncertain, with some commentators in markets such as the UK warning a decline in bond liquidity could pose a wider threat to financial stability.¹⁰

Newton’s fixed income team is among those wary of current liquidity conditions. It adds that with interest rates rising in the US and ongoing pressure on US energy companies as a result of the

subdued oil price, a major credit sell off remains a threat.

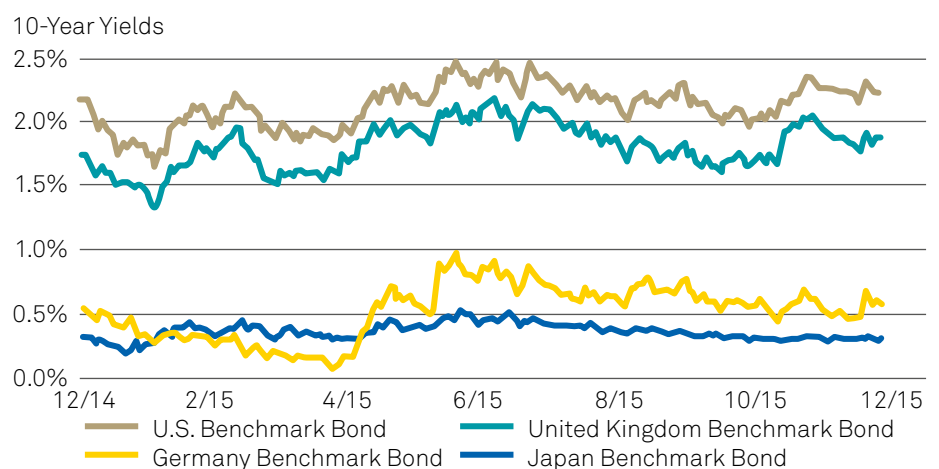
Commenting, Newton’s Brain adds that recent institutional mutual fund outflows are a worry in light of problematic liquidity conditions, though he points out that retail investors have remained bond buyers. As retail investors are more influenced by prices, Brain believes the next few months will illuminate whether retail investors are ‘running scared’ and reversing their position.

The quest for yield

From a yield perspective, the year started with the yield curve of US Treasuries flattening and the difference between shorter- and longer-term bond yields narrowing sharply.¹¹ But opinion on the yield forecast for 2016 remains divided.

Commenting on the yield outlook for 2016, Brain says: “In the bond space, our view is that yields will most likely stay low. We don’t expect policymakers to give up on attempting to stimulate new demand by maintaining low interest rates and inflation will be subdued so there could be limited upward pressure on government bond yields. In this environment profit margins will be challenged, perhaps putting upward pressure on corporate bond yields.”

GLOBAL FIXED INCOME: ONGOING ECB STIMULUS COULD SUPPORT YIELDS



Source: Factset. Data as of 10 December 2015.

9 The Guardian. Big fall in US share price as oil price dips. 14 January 2015.

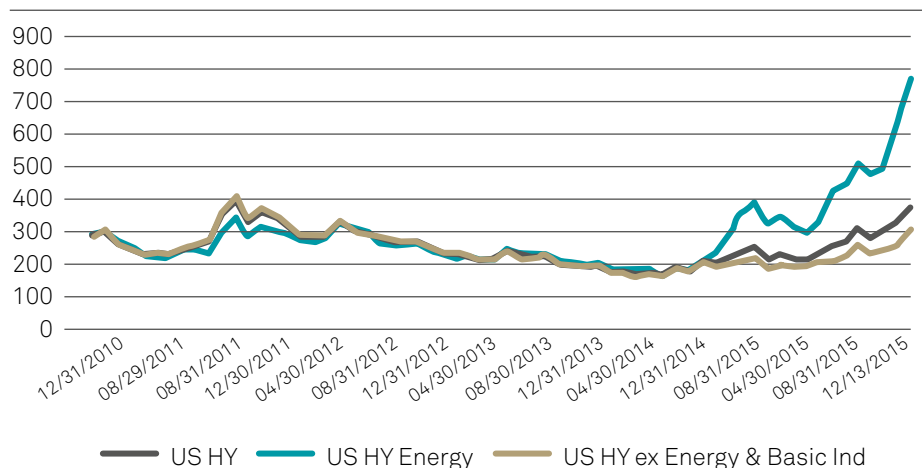
10 FT. Senior MP warns Bank of England on bond market liquidity. 15 November 2015.

11 FT. US bond yields sound warning on economy. 07 January 2016.

Risk and return

As the hunt for income intensifies, risk assets finally appear to be compensating investors with higher yields. According to Bloomberg figures the option adjusted spreads (OAS)¹² of US high yield over Treasuries in 2014 was 483bps, widening to 660bps by the end of 2015 and by mid-January 2016 it had stretched to 755bps. (For US high yield energy it was even wider jumping from 729bps over Treasuries in 2014 to 1526bps by mid-January 2016.)

US HIGH YIELD ENERGY SECTOR SPREADS



Source: Barclays High Yield Corporate Index, Bloomberg as at 22 January 2016.

01/22/2016 OAS	End 2015	End 2014
US HY ALL	660	483
US HY Energy	1296	729
US HY Ex- Energy & Metal & Mining	535	429

Source: Bloomberg as at 22 January 2016.

Investment grade OAS have also widened since 2014, albeit by a lesser amount. Bloomberg figures show US investment grade corporates offered yields of 131bps over Treasuries by the end of 2014 – widening to 181bps by mid-January 2016.

In recent years, the global loans market has been a significant beneficiary of the hunt for yield and a decline in traditional bank lending which followed the 2008 financial crisis, has created new opportunities to construct higher yield loans fund which can help fill this gap.

Commenting on the market outlook for the sector, Alcentra chief investment officer Paul Hatfield says the supply and demand scenario and market technical outcomes are hard to predict though he believes volatility will play an important role in the months ahead.

“Volatility will be the name of the game this year, whether that comes from continued economic problems in China, unrest in the Middle East or the impact of the low oil price and commodities generally on emerging markets and on the US. Geopolitical risk is always going to be there. Unfortunately there is nothing you can really do about that other than remain vigilant,” he says.

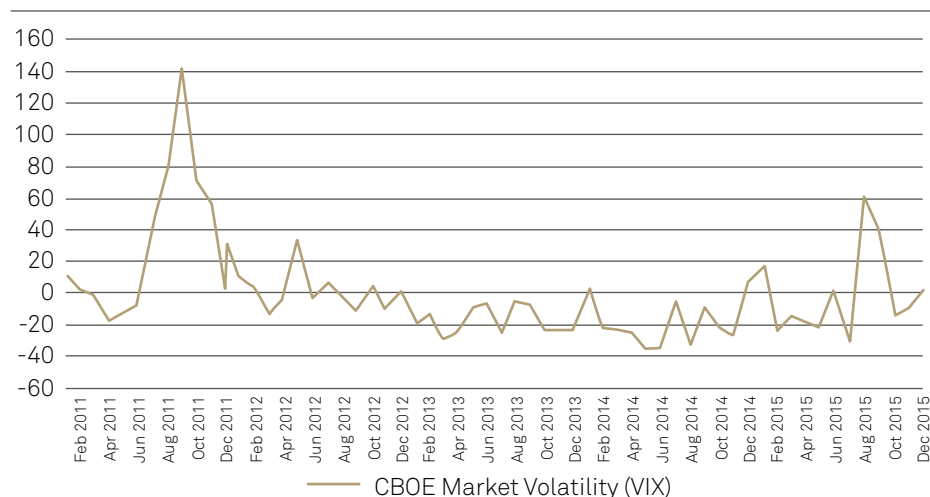
Turbulence heightens liquidity premiums

While it is not uncommon for investors to experience periods of limited liquidity, this challenge has become more pronounced and has exacerbated risk off sentiment during recent periods of market stress, according to Boston-based investment manager Standish. Regulatory changes have significantly reduced the size of dealer balance sheets and dealers have become less likely to step in and fill a liquidity vacuum. As a result, dealers tend to act more as agents, brokering trades directly between buyers and sellers, rather than warehousing inventory. During times of market stress or when sectors/issuers move out of favour, it is now more likely for liquidity to evaporate; leading prices lower more quickly than Standish has seen historically.

A good measure of this is the Bank of America Liquidity Stress Index. This index is a measure of funding stress in the global financial system, measured by the spread-based relationship in rates, credit and currencies. The indices' steady march higher throughout 2015 is representative of how Standish believes trading liquidity developed. Limited market depth has made daily liquidity and low spread volatility less common. The trading challenge is manifest via a feedback loop where dealers quote bonds on a spread basis relative to Treasuries and then on absolute price (representative of the high yield market) at the first sign of weakness. However, Standish does not anticipate the recent liquidity weakness to reverse near term. It sees value in spread sectors, but is cautious to evaluate the liquidity premium to both transact and to compensate investors for potentially longer holding periods. While tactical trades will become more difficult, Standish also believes that there should be strong buying opportunities over time.

¹² OAS is calculated with a stochastic interest rate model. The zero-coupon rate curve is calculated and a security is valued by discounting cash flows of the security using multiple interest rate scenarios, then averaging overall scenarios. The OAS is the constant shift to zero-coupon interest rates in all scenarios that is required to ensure the model value (the average value over all scenarios) of the bond equals the market price of the bond.

VOLATILE CONDITIONS PERSIST: VIX INDEX JANUARY 2011-16



Source: Vix/Bloomberg Business as at 11 January 2016.

“This credit cycle is quite long in the tooth, but the economic background is one of low growth rates, low inflation with very slow and steady improvement against the decline in China and heightened geopolitical risk.

“The falling oil price is good for some markets, like Europe, but not for others, like the US. Looking at the global prospects for 2016, Europe as a whole is looking like a good bet because it will be more stable than some other developed markets,” Hatfield adds.

Default outlook

Looking ahead, a growing number of investment managers point to signs of stress across parts of the fixed income sector – noticeably in high yield.

In January, credit rating agency Standard & Poor’s said the health of indebted companies had deteriorated at its fastest pace since 2009¹³, in the immediate aftermath of the global financial crisis.

The default rate on high yield bonds was 2.8% in 2015, compared with a weighted average of 3.7%, according to a Bloomberg story citing New York University Professor Edward Altman, developer of the “Z-Score” method for predicting bankruptcies.¹⁴ Altman predicts default rates will rise this year.

For all this, though most agree talk of an impending crisis is premature.

According to Brain: “There are a number of factors that lead to higher defaults in

a slow growth environment. It is not just about a particular sector coming under pressure it is the fact that the current economic cycle is long and tired.

“A good early warning sign is the amount of bonds which are distressed. The more distressed bonds you get the greater the chance that some of them will go bust because they can’t afford to pay the interest rate. The number of bonds distressed at 10-20% is quite high and has been rising steadily. That said – and despite our ongoing concerns about high yield and potential mutual fund and exchange traded fund outflows – dysfunctional markets can occur and we

HISTORICAL DEFAULTS AND OUTLOOK

Year	US Default Rate	US Loss Rate	European Default Rate	European Loss Rate
Actual 2013	2.0%	1.7%	2.8%	1.9%
Actual 2014	3.0%	—	3.4%	—
Est. 2015	1%-2%	—	0.5%-1.5%	—
Est. 2016	1%-3%	—	1%-3%	—

Source: Credit Suisse Leveraged Finance Default Review, as at 14 October 2015.

don’t believe we are seeing a systemic 2008-type credit crisis unfolding.”

While Hatfield shares concerns about specific debt market developments and possible defaults in the energy, mining and retail sectors, he also believes comparisons with the current market and pre-crisis conditions are overstated.

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The US default rate has ticked up slightly in recent months. But market conditions are not like 2006/7 where we were right at the top of the bull market in every sector and both the credit cycle and the economic cycle were overheating

Paul Hatfield, Alcentra

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“As far as defaults are concerned, these could increase in areas such as the energy sector, mining and retail and the US default rate has ticked up slightly in recent months. But market conditions are not like 2006/7 where we were right at the top of the bull market in every sector and both the credit cycle and the economic cycle were overheating,” he concludes.

¹³ FT. Credit health of indebted groups falls at fastest pace since 2009, S&P warns. 13 January 2016.

¹⁴ Bloomberg. NYU’s Altman Says U.S. Defaults to Climb, Recession More Likely. 25 January 2016.

Coming up... more regulations

Regulations and policy changes became an everyday feature of markets following the global economic crisis but as in many aspects of financial services, for fixed income investments, their influences are far from over.

Increased bond trading transparency is one of the goals targeted by Europe's second-phase Markets in Financial Instruments Directive (Mifid II). Due for implementation in 2018, Mifid II will require spread information to be published – pre-trade – for bonds deemed sufficiently liquid. The work involved in obtaining transaction and reference data for each instrument before the number-crunching to determine issue liquidity can even begin, is such that investment firms, trading venues and supervisors need to begin this year to rebuild their transaction and reference data reporting systems.

According to the European Securities and Markets Authority (ESMA), under the Mifid II requirements some 2,600 bonds, mostly government debt, out of the 50,000 traded in the EU will face greater, pre-trade transparency.¹ Effectively under the planned regulations, bonds deemed to be liquid have to conform to 'real time' transparency obligations. Exemptions are available for trades which are of a certain size. As such Mifid's requirements to publish bid/offer spread information, should affect just 5% of the EU market. Nonetheless, there have been harsh critics, most of which concern what the initiative will do to market liquidity.

Steven Maijoor, ESMA chair, believes protecting the liquidity of the bond market is paramount but says introducing greater transparency to EU fixed income trading is a matter of carefully calibrating liquidity thresholds. "Transparency applied indiscriminately to illiquid instruments can be extremely damaging, resulting in difficulties in executing trades and the thinning of already thin markets. However, I am not

aware of any liquid market which is not also reasonably transparent." As such, Maijoor says, ESMA's rules on bond liquidity and transparency, which are the result of two years' work where bond data was "put under the microscope" represents in his opinion, "the best technical approach permitted within the construct of Mifid II."

Improving liquidity

In addition to Mifid II, there are also plans to revise the EU prospectus regulations. As part of the action plan for Capital Markets Union, the European Commission proposes to overhaul the existing regime to improve access to finance for companies as well as to simplify information for investors.

As part of this the intention is to remove the distinction between retail and wholesale denominations for debt securities. The latter can be offered without a prospectus provided the amount issued, per unit, is above €100,000. As such most investment-grade issuers are incentivised to issue in large denominations in order to avoid the existing prospectus burden. The removal of this threshold could consequently create greater secondary market liquidity by creating a deeper market, while retail investors would also have access to a broader investment choice, according to the Commission.²

Other prospectus amendments that could impact fixed income liquidity include: lighter-touch requirements for smaller companies; allowing the creation of shorter and clearer prospectuses to provide better investor information; and simplifying secondary issuance through the use of a new, simplified prospectus for those already listed on a public market who want to do further capital raisings.³

PRIIPS' KID

However, while amendments to prospectuses may aid corporate bond issuance across Europe, amendments to another disclosure regime – due to

be enacted from December 2016 – may impact it negatively. EU policymakers have been progressing Packaged Retail and Insurance-based Investment Products (Priips) regulations, much of which deal with disclosure documents similar to the existing Ucits key investor information documents (Kiid).

Under the existing Priip proposals companies have to issue a single-i KID (key information documents) for all types of investment products. (While eventually the KID will replace the Kiid, until 1 January 2019 Priips will not apply to Ucits funds. The UK's non-Ucits funds may have to adhere to Priips earlier.)

The new Priips pre-contract disclosure document will contain, in broad terms, certain standardised information such as the nature and main features of the product, its risk and reward profile and costs. It is this aspect of the forthcoming regulation that is creating some concern with respect to fixed income instruments.

Cost information

The cost section of the KID aims to aid consumers in understanding what the costs of a Priip will or could be and what effect they may have on the possible return.

As such the current draft rules require providers to present transaction costs – highlighting the difference between the value of an asset at the point at which the order is initiated and the price at which the Priip transacts in that asset. In other words they are expected to point out the difference between an asset's arrival and its execution price multiplied by the quantity traded.

The difference between the pre-sale price and that at which an asset is bought can be wide and in the case of fixed income, be highly influenced and exacerbated in low liquid, high volatility environment.

This in turn may not just be off-putting to investors when they see the implied price move but can add to confusion and consequently, aversion.

¹ ESMA.europa.eu. Steven Maijoor speech 10 December 2015.

² Europa.eu/rapid/press-release_MEMO-15-6198_en.htm

³ Europa.eu/rapid/press-release_IP-15-6196_en.htm

Perceived threats to bond markets in 2016

Threats	Alcentra	Insight	Mellon Capital	Newton	Standish
Inflation					
Liquidity shock					
Geopolitical events					
Volatility					
Interest rate rise					
Energy and commodity prices					

KEY Very low Low Neutral High Very high

VARIANCE OF BEST PERFORMERS

	BEST ← —————→ WORST			
2015	Govt 1.7	EM 0.9	IG 0.1	HY -2.1
2014	Govt 8.7	IG 8.0	EM 7.9	HY 2.7
2013	HY 7.3	IG 0.2	Govt -0.2	EM -4.5
2012	EM 22.1	HY 18.7	IG 13.3	Govt 4.6
2011	GOVT 6.3	IG 5.1	EM 4.6	HY 2.9
2010	EM 15.2	HY 14.9	IG 7.5	Govt 3.9
2009	HY 59.7	EM 35.7	IG 16.1	Govt 1.2
2008	Govt 11.7	IG -3.4	EM -16.1	HY -27.0
2007	Govt 6.4	EM 5.6	IG 3.8	HY 2.5
2006	EM 12.1	HY 10.2	IG 3.3	Govt 2.8
2005	EM 14.4	Govt 6.5	IG 5.2	HY 4.9
2004	EM 16.2	HY 14.7	IG 8.7	Govt 8.0
2003	EM 36.1	HY 30.6	IG 8.7	Govt 4.4
2002	EM 13.8	Govt 10.7	IG 10.7	HY 1.6
2001	IG 10.0	Govt 7.3	HY 4.7	EM -0.6
2000	EM 13.4	Govt 10.2	IG 8.5	HY -6.2
1999	EM 24.9	HY 3.1	IG 1.7	Govt 1.3
1998	Govt 13.0	IG 10.8	HY 5.0	EM -15.1
1997	EM 17.9	HY 14.6	Govt 12.0	IG 10.4
1996	EM 36.3	HY 11.9	Govt 9.0	IG 3.4

KEY Govt Government IG Investment grade corporate EM Emerging market sovereign HY High yield corporate

Source: Newton, Merrill Lynch Indices Hedged into Sterling, end December 2015.

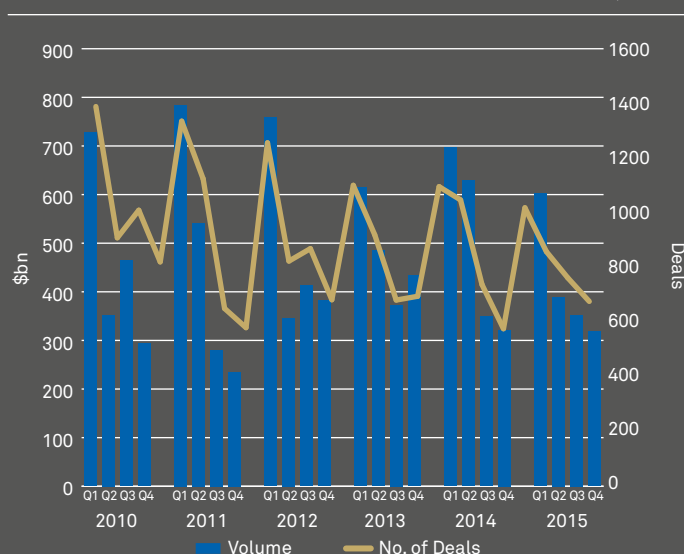
Economics and interest rates

(expectations and forecasts for 2016)

ALCENTRA	INSIGHT INVESTMENT	MELLON CAPITAL
Growth: from 0.5% to 1.0% across EU, 1.5% to 2.0% in the UK and 2.0% to 2.5% for the US.	Growth: from 1.9% (2015 forecast) to 2.5% (2016 forecast) across Europe, from 2.6% (2015 forecast) to 2.2% (2016 forecast) in the UK, and 2.4% (2015 forecast) to 2.6% (2016 forecast) in the US.	Growth: 1.8% across EU, 2.3% in the UK and US.
Inflation: 0% across EU, 0.25% in the UK and 0.25% to 0.5% in the US.	Inflation: consumer prices expected to be around 1.0% in 2016 in the EU, 1.5% in the UK and around 2.0% in the US.	Inflation: 0.7% across EU, 1.6% in the UK and 1.6% in the US.
Official interest rates in the EU and UK very unlikely to rise with US rates likely to rise slightly but not steeply.	No change in EU interest rates expected, with a gradual US rate rise likely during the next 12 months and a small rise probable in the UK.	No change in EU interest rates expected, with rates likely to rise in both the UK and US in the next 12 months.
Keys to bond valuations include: the pace of Fed increases in rates, inflation staying low, defaults have been low but likely to accelerate in 2016.	Keys to bond valuations include: the under-pricing of the pace of US rate hikes by markets, likely policy normalisation, potential risks surrounding the promised UK referendum on European Union membership. China's growth prospects and geopolitical risk remain potentially influencing factors.	Keys to bond valuations include: continued supply issues, interest rate risk, credit risk, the oil price impact on inflation and the potential for an increase in default risk as well as slowing Chinese and global growth concerns.

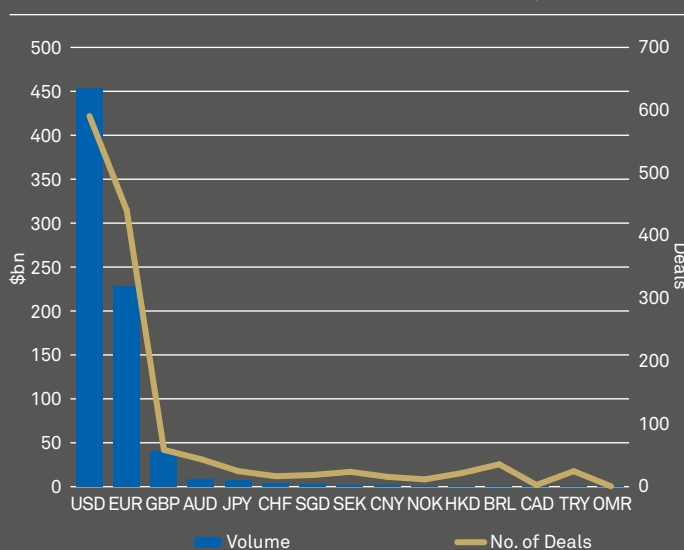
NEWTON	STANDISH
Growth: 1% to 1.5% across EU, 1.5 to 2.5% in the UK and 1.5% to 2.5% in the US.	Growth: 1.7% across EU, 2.0% in the UK and 2.2% in the US.
Inflation: 0.75% across EU, 1.5 to 2% in the UK and US.	Inflation: 0.7% across EU, 1.3% in the UK and US.
Official interest rates in the EU considered very unlikely to rise, while rates in the US are expected to rise over the next 12 months. UK rates likely to see no change or even fall over this period.	Official interest rates in the US and UK are likely to rise while rates in the EU are likely to fall.
Keys to bond valuations include: likely Fed rate rises in early part of 2016 and the potential for a rise in defaults in the energy sector. This could lead to a tightening of monetary conditions that slow the economy in the second half of the year and provide a more bullish environment for bonds.	Keys to bond valuations include: China's management of its slowing and shifting growth profile, currency depreciation and related effects on commodity prices and global disinflation. Liquidity and associated bouts of volatility also key to markets in 2016.

INTERNATIONAL EUROPEAN DEBT CAPITAL MARKETS VOLUME Q4 2015



Source: Dealogic. As at 31 December 2015.

TOP 15 INTERNATIONAL DCM VOLUME BY CURRENCY Q4 2015



Source: Dealogic. As at 31 December 2015.

A night sky filled with stars and a blue circle containing the text "Across the universe". The sky transitions from a deep blue at the top to a warm orange glow near the horizon. In the bottom left corner, the dark silhouette of a tree is visible against the horizon.

Across the universe

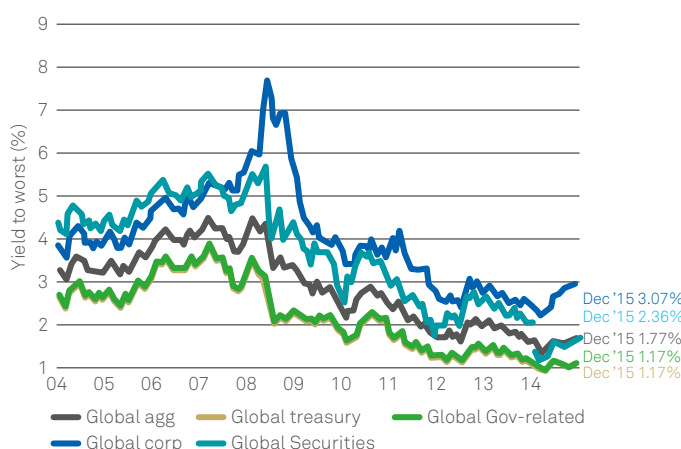
Global fixed income markets started 2016 amid renewed nervousness on China's stock exchanges and other international equity markets as turbulence encouraged many investors to shelter in traditional so-called 'haven' assets. Meanwhile the appeal of alternative bonds continues to grow in what appears an increasingly uncertain market backdrop.

Indecision over future interest rates, tightening market regulation, renewed volatility, the upcoming US election and diverging monetary policy all look set to influence market fortunes in the months ahead in what could be a highly unpredictable year. These factors could prompt uneven returns and patches of volatility but could also create pockets of value and opportunity – leading many pundits to highlight the virtues of flexible mandates.

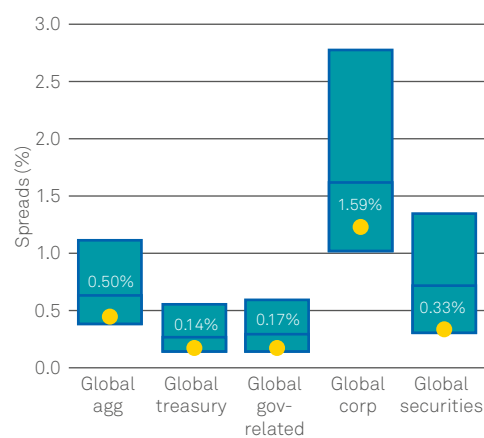
So how are these conditions most likely to affect fixed income investors in the months ahead? Here, managers from BNY Mellon investment boutiques outline some of the key sectoral opportunities and challenges likely to face them throughout 2016.

GLOBAL FIXED INCOME

	1 month (%)	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	7 years (%)	10 years (%)	Duration
Global aggregate (\$USD hedged)	-0.27	0.10	1.02	1.02	2.77	3.87	4.15	4.36	
Global aggregate (unhedged)	0.53	-0.92	-3.15	-3.15	-1.74	0.90	2.39	3.74	6.50
Global treasury (unhedged)	0.94	-1.04	-3.29	-3.29	-2.81	-0.12	1.11	3.44	7.49
Global govt-related (unhedged)	0.91	-1.06	-3.66	-3.66	-2.98	-0.23	1.12	3.39	7.32
Global corporates (unhedged)	-0.31	-0.82	-3.56	-3.56	-0.06	2.98	5.56	4.32	6.28
Global securitised (unhedged)	0.28	-0.58	-0.51	-0.51	1.04	2.64	3.60	4.45	4.52



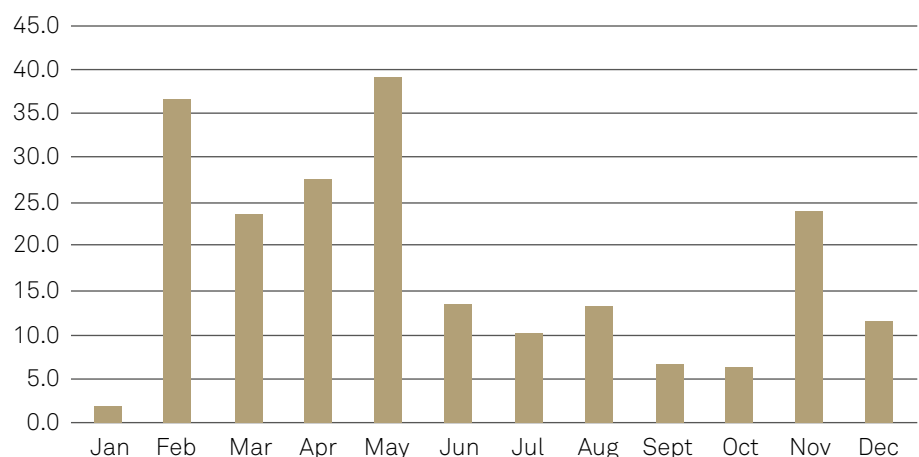
Source: Barclays Capital and Bloomberg.
Data as at 31 December 2015.



KEY

10 Year Max
Current
10 Year Average
10 Year Min

2016 FED MATURITY SCHEDULE OF TREASURY HOLDINGS (IN BILLIONS)



Source: Federal Reserve as at end December 2015.

Duration

Duration is an important tool in the armoury of bond investors and uncertainty over the timing and level of commitment to interest rate rises across major global markets divided opinion on the correct levels which should be applied to portfolios through much of 2015. This may be the case over the first half of 2016 as well.

A number of bond managers increased duration last year in response to delays in US and UK interest rate rises¹ but risked upsetting investors who continued to favour short-duration strategies. Newton was among those opting to keep its duration at relatively low levels, keeping one eye on potential risks ahead across the sector and it looks set to maintain this approach in 2016.

Commenting on the usefulness of duration in portfolio positioning, Newton head of fixed income, Paul Brain, says: "We do have some duration because it is possible – even in a rising interest rate environment – to find bonds that will go up in value and to have positioning that will benefit from rising interest rates such as in long 30-year bonds.

"Our duration position allows us to invest and seek value in other markets that are perhaps not so directly influenced by the Fed rate rise – such

as Europe – and some other selected geographic markets. Overall, while our duration is quite low because of ongoing concerns about the high yield market and China, we do still have a positive duration stance."

Standish's outlook on duration is mixed. Commenting, its deputy chief investment officer and managing director of global fixed income, Raman Srivastava says: "Not all duration is created equal. Within developed markets, traditional government related duration may benefit from continued low growth, low inflation and accommodative central bank policy in places such as Australia, Canada and parts of Europe.

"In addition, given the rapid decline in commodity prices, longer dated global inflation-linked securities have underperformed significantly taking market inflation expectations over the coming years to incredibly low levels. While we don't think inflation will rise materially, we think the sell-off in global

BUT: In an uncertain market environment, some long duration bond strategies could be vulnerable to any sudden shift in interest rates or movement in US Treasury yields.

A passive approach

While fixed income portfolios are most commonly actively managed, in certain instances investors and their managers find it preferable to adopt a passive approach.

Mellon Capital Management managing director, head of fixed income portfolio management, Paul Benson, says: "One of the biggest benefits of passive investing is the lower management fee it offers compared to active funds. Fixed income indexing nearly always requires some degree of sampling or optimisation given that the vast universe of bonds may be difficult to fully replicate.

"A passive manager may hold a representative sample of securities by stratified sampling – a common approach used to capture characteristics of a universe. Low turnover is therefore another benefit as passive investing typically calls for trading only when the benchmark rebalances and makes meaningful changes to its composition. In today's low yielding environment this cost saving is hardly trivial, particularly in less-liquid segments of the bond market."

According to Benson, growth in exchange-traded bond funds (ETFs) continues apace. Widespread market adoption of this trading vehicle has given rise to further advances in transparency (price discovery) as well as liquidity.

"By themselves, ETFs may not provide an optimal cost-effective benchmark tracking vehicle, particularly for illiquid market segments such as high yield or corporates. However, by combining an intelligent stratified sampling process with the use of ETFs and other market completion tools, one can build passive bond portfolios that track illiquid or difficult-to-trade benchmarks very well, with the added benefit of lower management fees," he adds.

inflation linkers has been excessive and opportunities exist here.”

Currency

From a currency perspective, monetary policy divergence between the US and much of the rest of the world is also likely to remain a key driver of markets in 2016, according to Insight Investment. Last year, illiquid foreign exchange markets provided significant headwinds for currency traders and the hunt for liquidity looks set to intensify in the months ahead.² Ongoing efforts by the Chinese government to devalue and internationalise its renminbi currency could also have significant impacts on wider currency markets in 2016 and trigger further market volatility.³

Commenting on this theme, Standish says: “We believe renminbi depreciation should remain a dominant theme through 2016. Chinese authorities are moving ahead with currency reforms and related adjustments to achieve their goal of a “clean float” in one to two

years’ time. Therefore currency market pressure will likely persist. While the regime shift is underway, the need for FX intervention will remain high. The real question for 2016 is the degree to which the authorities will tolerate a weakening of the CNY. We believe that a carefully nuanced and well communicated message will be necessary to limit the risk of capital account volatility, FX reserve losses as well as potential pressures on domestic interest rates.”

Against this backdrop, Newton’s stance on currency has shifted since last year, when Brain favoured the US dollar relative to the yen, euro and sterling. While still positive on the dollar, Brain is now increasingly bullish on the euro and inclined to go short Asian currencies.

“We like the euro, though not aggressively so because the European Central Bank’s (ECB) QE programme tends to undermine the currency. In terms of relative growth, we think Europe is going to do better than expectations and therefore better than some of the

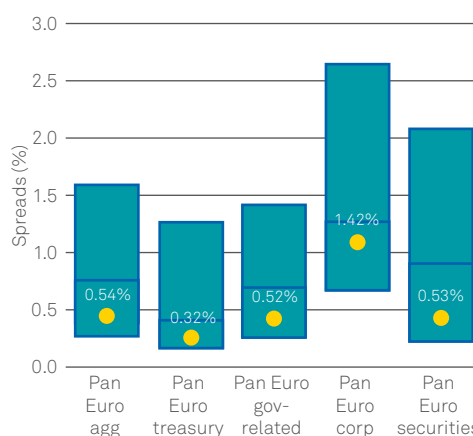
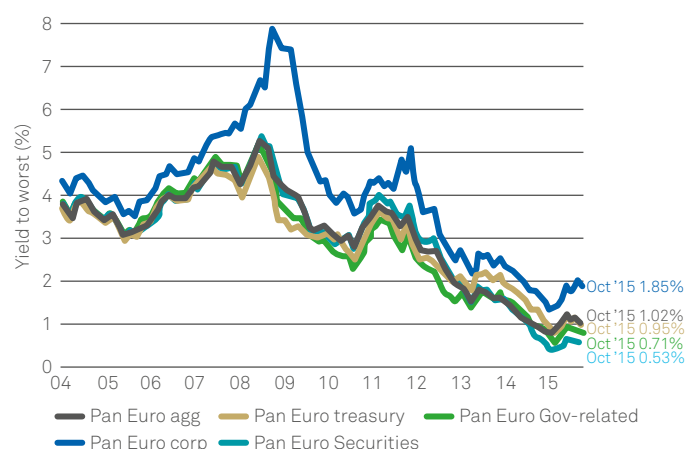
other global economies like emerging markets. At the moment we are long the dollar and the euro, which we think is significantly undervalued against Asia,” Brain says.

BUT: From a currency perspective, divergent global monetary policy has made some markets harder to call and has, in some cases, significantly impacted returns. Commenting, Insight Investment warns of the risk inherent in the uncertainty of central bank activity in Europe and other markets, pointing to increasingly erratic and uncertain pricing, following recent ECB activity.

“With risks looking unrewarded we substantially reduced positioning into year-end in 2015. We still have a long US dollar bias which will continue to be a theme in 2016,” adds Insight’s head of currency, Paul Lambert.

EUROPEAN FIXED INCOME

	1 month (%)	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	7 years (%)	10 years (%)	Duration
Pan Euro aggregate (\$USD hedged)	0.65	0.79	1.32	3.64	5.08	5.08	5.93	4.80	
Pan Euro aggregate (unhedged)	0.15	0.40	-5.83	-6.94	0.29	1.22	4.36	3.85	6.96
Pan Euro treasury (unhedged)	0.18	0.77	-5.15	-5.71	0.96	1.56	4.31	4.15	7.86
Pan Euro govt-related (unhedged)	-0.16	0.15	-6.93	-8.92	-1.16	0.24	3.53	3.41	5.83
Pan Euro corporates (unhedged)	0.77	-0.61	-7.01	-8.45	-0.21	1.25	5.46	3.33	5.61
Pan Euro securitised (unhedged)	0.40	0.09	2.19	2.85	4.34	5.12	5.77	4.42	4.84



Source: Barclays Capital and Bloomberg.
Data as at 31 October 2015.

² FT. Currency markets face liquidity challenge. 21 December 2015.

³ The Guardian. The perils of China’s currency devaluation. 13 January 2016.

Sovereign government debt

Nervousness in global equity markets saw fresh inflows to US Treasuries, German bunds and UK gilts at the start of the year, with an initial rise in yields – attributed to renewed central bank reserve liquidation – surprising many managers.⁴

In 2015 the Barclays US Treasury index registered a total return for the year of 0.84%. The bank's long-dated Treasury index was down 1.25%, while for the UK the Barclays Sterling Aggregate index gained 5%.⁵

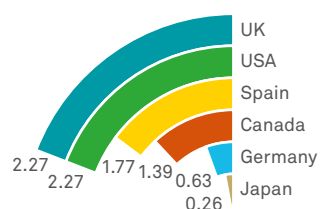
A range of factors looks set to influence sovereign government debt markets in the months ahead, with further Fed activity and policy divergence between the US and UK markets and Continental Europe and Japan anticipated in what some analysts are describing as the "Great divergence".⁶

Liquidity remains a concern and the UK's Treasury Select Committee recently asked the Bank of England for a thorough assessment of current bond liquidity issues.⁷ In a volatile global economic climate, the International Monetary Fund (IMF) has also warned that "a sudden rise in global risk aversion" could drive investors to sell riskier assets and shelter in safer ones such as UK gilts, US Treasuries and German bunds.⁸

The market has already seen some unusual indicators in 2016. In January

DEVELOPED MARKETS

10-Year Govt. Bond Yields (%)



Source: Bloomberg. Data as of 31 December 2015.

this year German bund yields hit record lows following remarks made by the head of the ECB, Mario Draghi, on its European stimulus plan.⁹

In terms of the strongest sovereign debt markets for 2016, Newton's Brain believes the US Treasury market will be the strongest in the second half of the year with rates peaking at that point as domestic wages rise and investment slows.

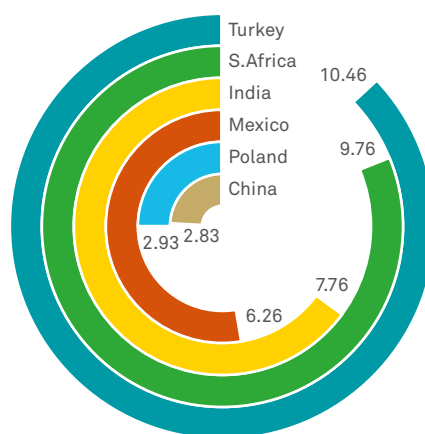
Commenting on the yield outlook for government debt in the US and UK, Insight Investment head of UK and global fixed income, Andrew Wickham says: "We expect to see higher yields in a year's time in sovereign markets, particularly the US. These yield rises will not be dramatic, but given the starting point in terms of current low bond yields they are enough to push returns into negative territory for the year as a whole.

"That doesn't mean all markets look bad. But it certainly means among the G4 countries we are not looking at positive returns this year. We think yields in Germany will be higher in a year's time, despite the ongoing QE programme. In terms of positioning, there is a bias to be short duration and net short versus indices."

BNY Mellon investment boutique Mellon Capital currently favours US sovereigns. Commenting, Paul Benson

EMERGING MARKETS

10-Year Govt. Bond Yields (%)



Source: Bloomberg. Data as of 31 December 2015.

says: "Among sovereign bonds, we prefer US bonds as the term premium in the US remains high relative to other global bond markets. Conversely, German and Canadian bonds are unattractive to us. In Germany the term premium is compressed relative to other developed bond markets, while Canadian yields have fallen as the drop in oil prices has lowered the inflation outlook."

BUT: According to Newton's fixed income team, front-end Treasuries look set to remain particularly vulnerable to further monetary policy tightening by the Fed, though it adds continued curve flattening and persistent lacklustre global growth warrant intermediate to long-dated US exposure.

Persistent low inflation in Europe also remains a concern for the ECB, with some other major markets and central banks experiencing similar conditions.¹⁰

From a gilt market perspective, Insight Investment also sees some potential market downside from ongoing uncertainty over the UK's mooted EU membership referendum.

Commenting, Wickham says: "The prospect of Brexit is a non-trivial risk that may be difficult to manage. In the event of a vote to exit the EU currency could be impacted. While we would not expect the Bank of England to increase interest rates to protect the currency, a steeper yield curve seems the most likely outcome, with the 10 year part of the curve the most likely to attract selling flows if people were to feel the UK needed some extra risk premium. It is not a risk we can actively position for today but one we think we will need to manage as we go through the next couple of quarters and should support the case to be short UK government bonds."

4 FT. Reserve selling lifts safer government bond yields. January 12, 2016.

5 Barclays/FT. Market performance for 2015 in figures. 01 January 2016.

6 FT. Markets Outlook 2016: policy divergence looms over bond traders. 03 December 2016.

7 Investment Week. Tyrie writes to Carney on gilt market liquidity concerns. 16 November 2015.

8 BBC. IMF downgrades global forecast. 19 January 2016.

9 FT. Short-term bund yields hit fresh lows, 27 January 2016.

10 Wall Street Journal. Low inflation is still main concern, says ECB vice president Constancio. 11 November 2015.

Corporate credit

Investors hope the fortunes of the investment grade credit market will improve after a year of mixed performance in 2015. While the supply of new investment grade corporate debt hit record levels last year¹¹ the wave of new supply increased borrowing costs and weighed on returns.

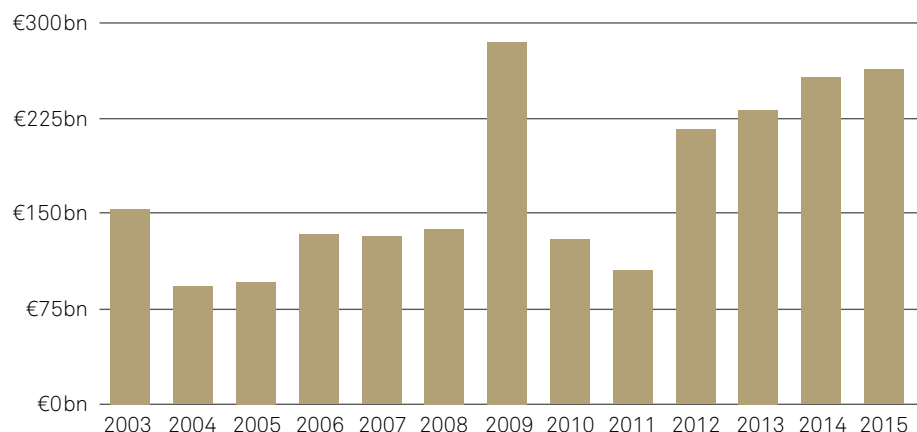
Nevertheless, despite a rise in underlying gilt yields, 2015 saw sterling investment-grade credit produce modest positive returns as spreads narrowed amid improving risk sentiment. Consequently some managers see at least some positives and strategic value in the sector. Last year ended with yields on investment grade bonds reaching a four year high of 3.71%¹² and this year started brightly with multi-million US debt issues by Walt Disney Co., Ford Motor Co. and Deere & Co.¹³

Commenting on the prospects for the sector, Newton's Brain says: "In investment grade we are seeing less shareholder friendly activity from corporates so the current market is actively quite supportive for the sector, though you do have the underlying worry of higher short-term rates and, more importantly, the concern about downgrades."

Insight Investment also continues to favour investment grade, believing it offers good value in the current market and holds limited scope for bond defaults. According to the group: "Investment grade corporate bond spreads provide compelling compensation for the fundamental risk of default, and we consider them cheap on a strategic basis. We expect the default environment to remain benign - although they will increase in high yield energy sectors- as cash generation remains robust," it adds.

Insight believes US credit remains the most attractive market by region – citing credit spreads that are still wider than equivalent UK and European investment

INVESTMENT GRADE CORPORATE ISSUANCE SINCE 2003



Source: Dealogic/Credit Market Daily as at end December 2015.

grade bonds. Insight adds that credit curves look particularly steep, which presents attractive value at long-dated maturities.

Commenting on growing opportunities in the emerging market corporate debt sector, Insight Investment's head of emerging market fixed income, Colm McDonagh, adds: "While the EM corporate index has performed reasonably well in recent months, there is a huge dispersion underlying many of the corporate exposures within it, particularly among oil and gas and other commodity issuers. In some of these cases there are particularly attractive recovery opportunities we feel may now be worth applying in portfolios."

Mellon Capital is also maintaining a positive outlook on investment grade credit, with some bright spots even within the energy sector. Benson says: "Within the investment grade segment, we find the BBB-rated sector to be the most attractive from an absolute return perspective as well as on a risk-adjusted return basis. Plus, we expect earnings growth ex-energy to improve in 2016. Within the investment grade energy sector, we favour select integrated energy companies that are not highly levered, where we believe the default risk is minimal."

BUT: Some concerns remain on how investment grade will respond to second and third round effects of lower commodity prices, particularly oil. Modest levels of return in the sector also appear to be encouraging investors to move beyond investment grade exposure into higher risk, higher return assets, driving significant growth in sub-investment grade issuance.

According to Standish's managing director of global fixed income, Raman Srivastava, two main concerns in credit are liquidity and defaults. He believes liquidity difficulties in credit markets will likely remain over the course of 2016 and defaults are likely to rise through the year. The latter, he says, is most likely within the energy space and high yield. "We believe these issues will present tremendous challenges in 2016. In our view, the backdrop of continued low growth and disinflationary pressures amid liquidity concerns and higher defaults in credit will create a fairly difficult environment for fixed income heading into this year."

11 FT. Corporate debt frenzy leaves investment-grade market cold. 11 August 2015.

12 Ibid.
13 Ibid.

It should be difficult for EM in the first half of the year as concerns over China linger, commodity prices stay weak, higher US rates lead to an outflow of assets and the benefits of competitive devaluations unwind

Colm McDonagh, Insight Investment

Emerging market debt

Emerging markets endured a rollercoaster ride in 2015 with China leading the way in the volatility stakes amid slowing economic growth and pronounced stock market turbulence.

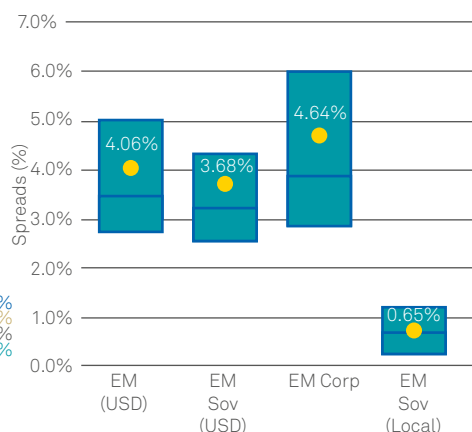
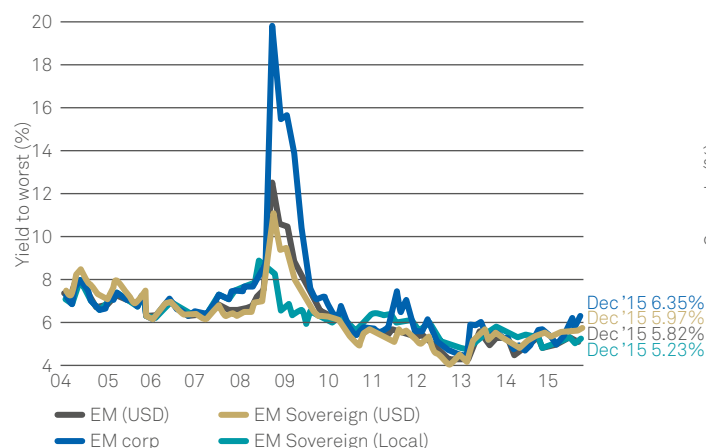
Other major emerging markets, including Brazil and South Africa, also hit challenging political and economic problems that affected bond markets, with the latter ending up with three different finance ministers in just one week in December after a series of sudden government reshuffles.¹⁴

Commenting on recent market developments across the sector and likely strategies to maximise returns, Insight Investment's McDonagh says: "Emerging markets have been subject to a plethora of negative and positive news, such as the political progress in Argentina and economic and political turmoil in Brazil and South Africa. This has made stock and sector selection, or 'dodging the bullets', of prime importance. However, we do see selective value and corporate investment grade trades at attractive yields."

Pointing to an economic rebalancing underway in emerging markets influenced by Chinese economic change, McDonagh says it is a much bigger deal for emerging market economies than the global financial crisis of 2008. "This means that the economic models of EM countries need to change. We think this rebalancing will reach an inflection point, based on moves we

EMERGING MARKET DEBT

	1 month (%)	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	7 years (%)	10 years (%)	Duration
EM \$USD aggregate	-1.40	0.98	1.29	1.29	0.57	5.12	9.96	6.72	5.49
EM sovereign (unhedged)	-1.19	1.32	1.50	1.50	0.74	5.57	9.67	7.03	6.82
EM corporate (unhedged)	-1.69	-0.06	-0.32	-0.32	0.56	3.94	11.09	5.84	4.39
EM local currency (unhedged)	-1.09	1.03	-10.38	-10.38	-5.60	-0.59	3.59	—	5.33



Source: Barclays Capital and Bloomberg.
Data as of 31 December 2015.

have recently seen in commodity and currency markets.

“As a result there will be an opportunity this year for local rates and currency and selected countries to offer significant opportunity. It is fair to say some of the biggest adjustments we have seen so far, particularly in some of the commodity-driven currencies, have returned positives, which we think will lead through to attractive long-only opportunities in 2016,” he says.

Managers on Standish’s emerging market debt local currency team also say they find emerging markets local duration attractive but are cautious in the face of continued market volatility.

“We continue to believe that emerging-markets local rates will perform better than currencies in the current global environment, which is characterised by sluggish growth and low inflation,” they add.

Developments in China have overshadowed many events in the wider Asian region but even here the prospects are far from bleak. Commenting on the market, Standish Asia head of credit strategy, Asian fixed income, Sarah Percy-Dove, says: “Broadly we remain

quite constructive on China, even though we currently expect below consensus economic performance in 2016, based on valuations.”

According to Percy-Dove, defaults are, and are likely to remain, low as China’s onshore bond markets continue to grow rapidly and provide a lower cost source of funding for many Chinese

corporates. She believes liquidity access will ensure defaults remain muted in the medium term. “This also means new issuance in the region will grow at a somewhat slower pace, as many of the Chinese USD issuers are tapping the local market instead of re/financing in USD. This technically should help support bond prices though,” she adds.

BUT: Emerging markets are frequently subject to periods of volatility and market unpredictability with geopolitical events just one factor capable of triggering bouts of market turbulence. Newton points to the potential for specific ratings downgrades in the months ahead. “Faltering growth models and the spectre of ratings downgrades (including in Brazil, Turkey and South Africa) represent continuing headwinds to some large emerging-market sovereign constituents and headline spreads over the medium term,” says Brain.

McDonagh adds: “It should be difficult for EM in the first half of the year as concerns over China linger, commodity prices stay weak, higher US rates lead to an outflow of assets and the benefits of competitive devaluations unwind. Things should improve in the second half of the year as it becomes more obvious China is stabilising and the Fed is taking a softly-softly approach to rate increases and hasn’t made a policy mistake,”

Commenting, Brain adds: “One concern is that there has been a lot of US dollar issuance by emerging market countries, mainly in Asia. Not the countries themselves but the companies and quasi-government institutions that may not be able to pay back those dollars if their respective currencies continue to devalue. All of these organisations have issued a lot of debt.”

US municipal bonds

Healthy demand and a stable credit outlook are driving optimism in the US municipal bond market, according to a wide range of market analysts.¹⁵ In a positive start to the year, January saw Chicago City Council approve US\$2.65bn of bonds requested by the City mayor to trim adjustable-rate debt from its portfolio and raise money for capital improvements.¹⁶

As the 'muni' market evolves, sub-sectors such as municipal high yield bonds look to be increasingly attractive to investors.

According to Standish's municipal bond team: "Municipal bond valuations have richened dramatically since the opening of the New Year, after being a top performing fixed income asset class last year. Municipal yields versus Treasuries and corporate bonds are historically low. That said, we believe municipal

bonds are a "safe haven" fixed income investment with attractive after tax yields, and relatively low volatility."

Standish points out that historically, municipal high-yield bond valuations have moved largely in concert with corporate high yield but in this recent bout of volatility, muni high yield has been spared. In fact, they say, in the second half of 2015, correlation has been the converse.

On the plus side, commodity prices have very little direct impact on the creditworthiness of the largest muni high yield sectors, the team says. "While some credits within the industrial development subsector can be hurt by the decline in commodities, other sectors such as airlines, toll roads and tobacco will directly or indirectly benefit. An estimated 65% of muni high yield is not energy related."

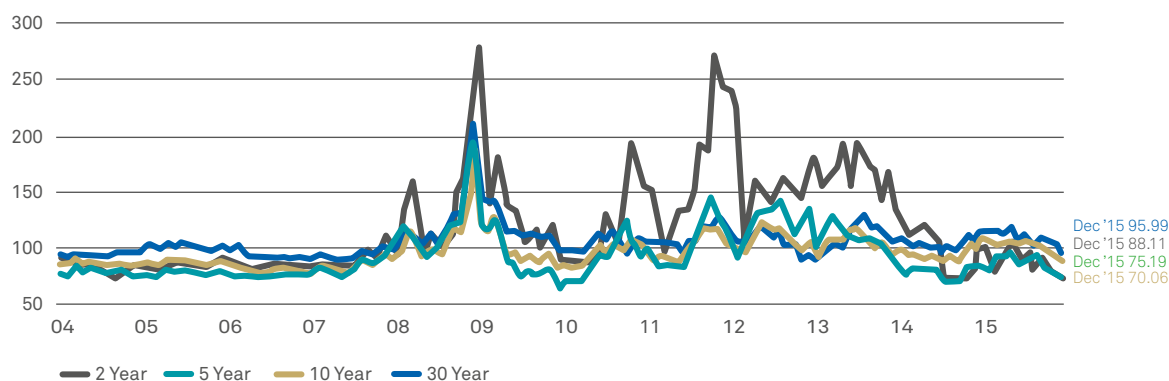
BUT: Standish points out a combination of favourable technical and fundamental factors have supported muni high yield valuations and as such relatively small changes in conditions could tip the market's fragile balance. "We feel a normalisation of the historical relationship between muni and corporate high yield would likely manifest itself in a significant cheapening of the muni high yield market, therefore creating an attractive buying opportunity," it adds.

Municipal bond valuations have richened dramatically since the opening of the New Year, after being the top performing fixed income asset class last year

Standish's municipal bond team

US MUNICIPALS

	1 month (%)	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	7 years (%)	10 years (%)
U.S. Municipals	0.70	1.50	3.30	3.30	3.16	5.35	5.96	4.72
Municipals (1 Year)	-0.02	-0.04	0.61	0.61	0.66	0.88	1.29	2.11
Municipals (3 Year)	-0.06	-0.01	1.18	1.18	1.24	1.81	2.37	3.01
Municipals (5 Year)	0.20	0.66	2.43	2.43	2.14	3.25	3.85	4.12
Municipals (10 Year)	0.80	1.60	3.76	3.76	3.34	5.55	5.94	5.20
Municipals (20 Year)	1.40	2.12	3.93	3.93	3.94	7.08	7.79	5.39



Source: Barclays Capital and Bloomberg.
Data as of 31 December 2015.

¹⁵ Reuters. US municipal bonds on solid footing heading into 2016. 23 December 2016.

¹⁶ Reuters. Chicago City Council committee advances \$2.65 bln bonds. 11 January 2016.

Inflation-linked bonds

With deflation fears fading and some analysts predicting a modest rise in inflation in 2016 and beyond¹⁷ the prospects for inflation-linked government debt could at last be improving after years of subdued inflationary pressures.

Standish's Srivastava says 2015 saw disinflationary pressures emanating mainly from China, but also pronounced across emerging markets and parts of the developed world. "We expect this trend to continue into 2016, at least into the first quarter in global financial markets. In our view, disinflationary pressures are one reason interest rates should remain contained. We believe inflation, or lack thereof, will limit the amount of tightening from some developed markets central banks, such as the Fed," he adds.

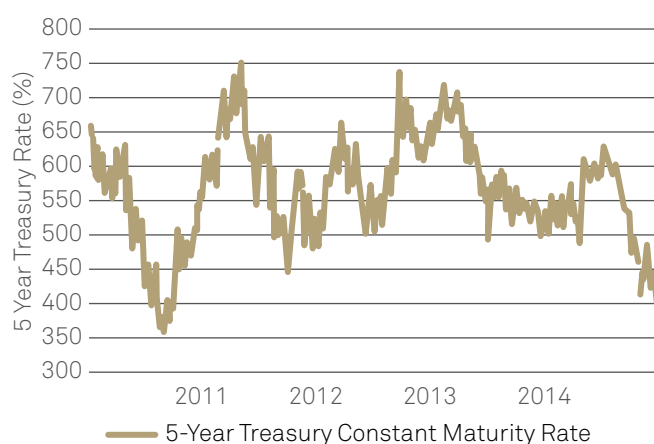
Still, Newton's Brain continues to see value in holding inflation-linked securities within fixed income portfolios. "US inflation-linked securities are a cheap insurance against the central banks being too slow. Given how far the oil price has fallen, where it is headed and also long-term deflation trends are still pretty strong, if the central banks are a little too slow in raising rates then the expectations will rise. So we do have US inflation-linked securities," he says.

Commenting in Newton's latest world bond market commentary, Brain adds: "With inflation expectations still depressed, diversification in inflation-linked issuance (US Treasury Inflation-Protected Securities) remains appropriate amid steady (c. +2%) private-sector wage growth and continuing geopolitical risks in the Middle East – particularly given the sensitive base

effects of imported inflation following 18 months of sharp energy price declines."

BUT: Any further slump in energy prices could derail drivers of upward inflationary pressure. The Chinese economic picture also remains far from clear and could yet have a major impact on the global economic and inflationary picture. Last year China registered its slowest growth rate in 25 years¹⁸ and while the 6.9% level was well above that of many other countries, Chinese officials also warned of a tougher year ahead in 2016.¹⁹

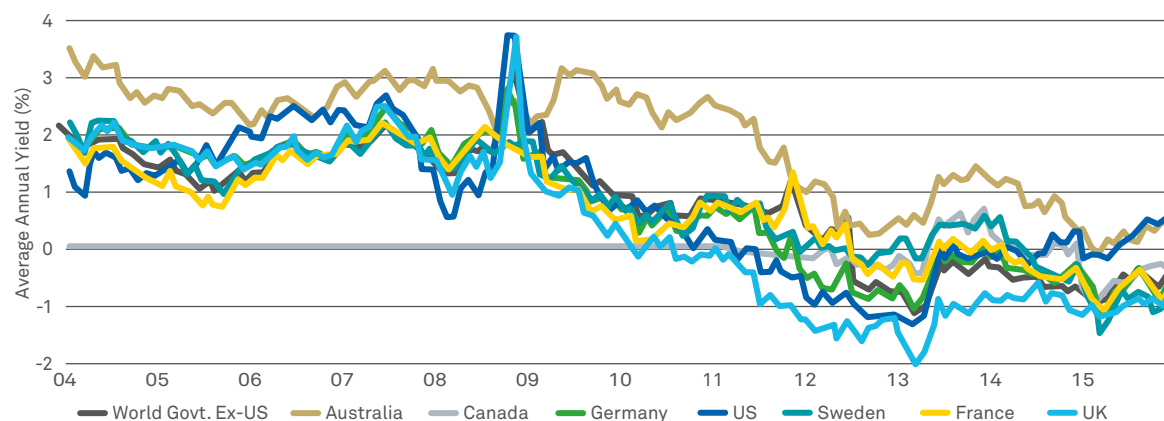
5-YEAR TREASURY INFLATION INDEXED SECURITY, CONSTANT MATURITY



Source: research.stlouisfed.org as at 16 December 2015.

GLOBAL LINKERS/TIPS

	1 month (%)	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	7 years (%)	10 years (%)
World Govt. Ex-US (1-10 Years)	-0.08	-2.14	-7.23	-7.23	-5.13	-1.22	1.12	2.51
US (1-10 Years)	-0.60	-0.72	-0.53	-0.53	-1.79	1.65	3.46	3.51
Australia (1-10 Years)	0.03	-0.16	1.63	1.63	3.02	6.07	5.82	5.73
Canada (1-10 Years)	0.54	0.07	3.54	3.54	1.27	1.64	1.17	0.82
France (1-10 Years)	-1.92	0.15	1.02	1.02	0.27	2.70	3.26	3.17
Germany (1-10 Years)	-1.73	0.29	0.05	0.06	-0.78	2.05	2.92	–
Sweden (1-10 Years)	-1.46	-0.21	2.05	2.06	0.88	2.35	2.80	3.06
UK (1-10 Years)	-1.47	-1.26	-2.07	-2.07	0.58	3.03	4.79	4.62



Source: Barclays Capital and Bloomberg.
Data as of 31 December 2015.

17 FT. Markets outlook 2016: Return of inflation could define bonds. 02 December 2015.

18 Wall Street Journal. China's Economic Growth in 2015 Is Slowest in 25 Years. 19 January 2016.

19 Ibid.

Asset backed securities

Mixed messages from European Central Bank (ECB) president Mario Draghi on the scale of asset backed securities (ABS) purchases²⁰ under its QE programme seem to have tempered hopes European QE will bring a major new boost to this sector in 2016.

Nevertheless, the ECB continues to buy ABS and demand for these products is also now coming from a range of European pension funds increasingly comfortable with their exposure to the asset class.²¹

According to Insight Investment, the ABS market continues to present strong absolute and relative value, after a challenging year arguably strengthened their investment case.

“The assets’ fundamental security and credit risk are disproportionately compensated by the returns available, making ABS one of the most compelling fixed income asset classes in our view,” Insight states.

“The shorter-term technical picture has also improved with net supply on the decrease and the environment unsupportive of secondary selling and primary issuance. In the short-term, this leaves ABS markets looking fundamentally and tactically strong compared to other areas of credit.”

Insight highlights particular value in the UK mortgage market, global collateralised loan obligations (CLOs) and the US single family rental (SFR) market. With all three offering security in AAA and AA tranches in particular.

BUT: Wider market volatility may continue to weigh on pricing in the ABS sector.

Loans

Regulatory change and increasingly stringent capital adequacy requirements continue to constrict the supply of bank lending to small and medium sized enterprises, creating growing opportunities for asset managers to service the sector.

This market is a key focus for Alcentra and its chief investment officer Paul Hatfield describes one of its key strengths as resilience in volatile markets. “Direct lending is relatively resistant to volatility because it is relatively illiquid and you can take each loan on its merits,” he says.

From a geographic perspective, Hatfield believes the European loans sector currently looks particularly attractive, with defaults rising marginally in stressed sectors in the US, such as energy, metals, mining and retail.

“The European loans market did well in 2015 and looks set to offer a degree of ‘haven’ stability and reasonable returns without some of the volatility we are seeing in the US,” adds Hatfield.

Insight Investment is also broadly upbeat on prospects for the European loans market, pointing to strong demand and healthy mergers and acquisition (M&A) activity, but does advocate a tactical approach to the market.

Commenting, it says: “Looking into 2016 we are moderately positive on the European leveraged loan market on a long-term strategic basis. However, we do believe tactical caution in the near term is important. Demand is looking strong, with the market more than capable of absorbing abundant volumes of recent supply. This is unlikely to evaporate with more than 15 collateralised loan obligations (CLOs) in the ‘ramp-up’ phase looking to enter the market in 2016.



The assets’ fundamental security and credit risk are disproportionately compensated by the impressive returns available, making ABS one of the most compelling fixed income asset classes in our view

Insight Investment



“Supply is also likely to be plentiful, particularly as M&A activity continues to be a key driver, and US names continue to prefer issuing in the European market. Importantly, market volatility currently provides investors with bargaining power to push back on unattractive pricing and structures in the primary market.”

BUT: Defaults could increase in areas such as the energy sector, mining and retail – particularly in the US. Insight cautions the wider loans environment also remains challenging, with tightening liquidity a potential issue. “Negative newsflow, particularly surrounding the US sub-investment market, may continue to weigh on sentiment. Liquidity issues and the impact of divergent monetary policy also present some uncertainty. However, we believe the market still offers compelling value for diligent, selective and cautious investors,” it concludes.

²⁰ BloombergBusiness. Draghi’s Asset-Backed Revival Forecasts Tempered for 2016. 03 December 2015.

²¹ FT. Pensions return to asset-backed securities. 01 October 2015.

Life in the fast lane: AT1 bonds in focus

The hunt for yield has led to the development and popularity of a growing range of more complex – and potentially riskier debt instruments.

These include contingent convertible instruments and so-called additional tier 1 (AT1) bonds which have come under the spotlight after a turbulent start to 2016.

Numerous European banks have launched AT1 debt over the past two years to meet growing capital adequacy and regulatory requirements. The bonds convert to equity or are written down should the underlying issuer hit difficulties²² and issuers are permitted to defer the coupon on the investment in some cases.

While the attractiveness of AT1s lies in their high coupons – with bonds returning almost 7% last year²³ – some experts argue they have yet to be tested in periods of extreme market stress. The European Banking

Authority has also previously warned a coupon deferral could be imminent.²⁴

With the AT1 market set to reach US\$200bn, both investors and market analysts have become increasingly concerned about the plunging values of some bonds in the market, the prospect of coupon deferral and the possible weakness of underlying issuers – including some European banks.

As yet, these fears have proved unfounded but turbulent market conditions in late 2015 and early 2016 saw sharp falls in prices for some AT1s, with some trading substantially below their issuance price²⁵, prompting considerable investor nervousness within the sector.

As a highly specialised investment, suitable only for more sophisticated investors, AT1s illustrate just one of the potential risk/return and product choices facing investors aggressively chasing returns in a low yielding environment.

22 FT. Bank bond losses put focus on regulators. 20 January 2016.

23 FT. Deutsche's riskiest bonds in spotlight.

24 FT. Bank bond losses put focus on regulators. 20 January 2016.

25 FT. Deutsche's riskiest bonds in spotlight.

Twin pressures

Falling prices and growing defaults presented key challenges to the high yield market last year – particularly in the US. However, beyond the headlines US high yield may present investors with some attractive opportunities through 2016, according to Alcentra managing director Chris Barris.

In a yield hungry, low interest rate environment high yield bonds have seen major investor inflows in recent years. But after a strong period of growth, market events and added volatility gave some investors pause for thought.

In December last year prices on high yield bonds fell to their lowest level in six years¹ with some investors registering their worst losses since 2008² and inflows to the sector punctuated by major outflows. Weakening global economic data and spiralling problems in specific industrial sectors exposed to high yield, such as US energy (see shale energy sidebar on page 24), also dented investor confidence.

To compound worries, December saw a US investment house freeze redemptions from its high yield fund while another player liquidated its entire portfolio.³

After an uneven start to 2016, during which three corporate issuers bypassed public bond sales⁴, many investors are hoping the market will soon stabilise. Some of the more established players in the market – such as specialist BNY Mellon investment manager Alcentra – believe the US high yield sector can navigate the current headwinds to present some strong opportunities to fixed income investors in 2016.

Alcentra managing director and head of high yield, Chris Barris, believes current problems are reflective of a typical high yield cycle, that the picture continues to evolve and the sector can still offer some compelling investment opportunities. He points out that in 2015 the US high yield market recorded only the sixth occasion when it had delivered negative returns in some 33 years.

An evolving cycle

Commenting on the current health of the sector Barris, adds: “With yields up to 9.5% available we believe the US high yield market is becoming increasingly more interesting and opportunistic. We recognise the high yield cycle is evolving. Some sectors are facing secular and cyclical challenges and central bank activity is diverging, all of which is leading to elevated volatility and mixed sentiment.

“That said, away from the challenged sectors, the longer term risk/return relationship is leaning favourably for credit managers, given the consensus, economic forecast and an accommodative US Federal Reserve. We believe US high yield will give mid-single digit returns this year but active management should perform better and we think it will look good against equities and emerging markets by year end.”

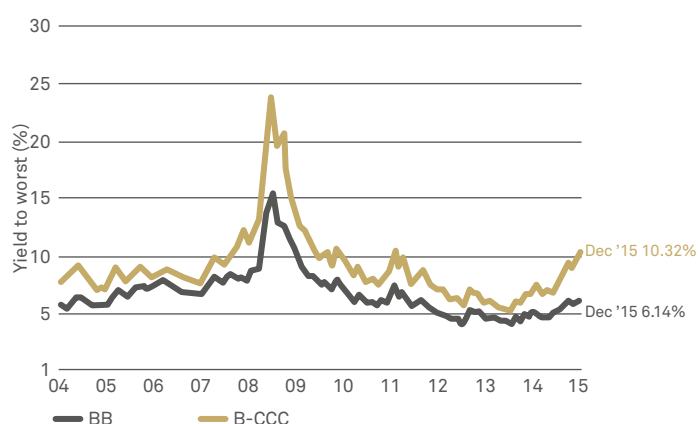
Barris believes the key challenges facing the market have been the commodities downturn – whose impact on US energy sector has been acute – and the slowdown in China, which is impacting US industrials, transportation and other industries that rely on Chinese demand.

Market volatility

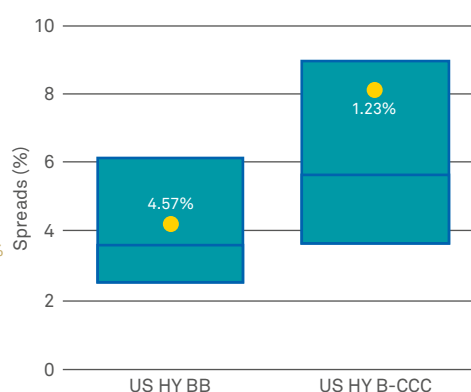
Commenting on recent market volatility and the outlook for US high yield in the months ahead he believes it will remain elevated in the US high yield sector in the short run. “However, valuations are becoming more interesting in that there are

US HIGH YIELD

	1 month (%)	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	7 years (%)	10 years (%)	Duration
U.S. High Yield	-2.52	-2.06	-4.47	-4.47	1.69	5.04	12.84	6.69	4.26
High Yield (BB)	-1.88	-0.15	-1.00	-1.00	3.10	6.05	12.25	7.57	4.67
High Yield (B-CCC)	-2.80	-3.24	-7.42	-7.42	0.33	4.24	12.88	6.22	4.16



Source: Bloomberg 31 December 2014.



1 Bloomberg Business. Junk bonds are tanking and Icahn says meltdown 'just beginning.' 14 December 2015.

2 Ibid.

3 Bloomberg Business. Third Avenue Ripples Hit Credit Across Globe as Risk Rises. 14 December 2015.

4 Reuters. RPT-US high-yield bond market stumbles out of the gate. 07 January 2016.

certain sectors and pockets of the high yield universe where earnings are fine and leverage is reasonable, liquidity is good, default risk is low and that should result in some very attractive opportunities,” he says.

Barris believes attractive potential lies in the high yield telecoms sector where earnings remain decent and credit statistics are currently comfortable. He also sees strong potential in some segments of the packaging industry and the financial sector.

Commenting, he says: “On the financial side there are a series of opportunities we would characterise as “rising stars” in the non-bank financial space that have recently improved their balance sheets and are yielding somewhere in the 7% area that for higher quality investors look quite attractive. We think these are interesting buying opportunities.”

According to Barris, the US high yield market has seen a reduction in overall liquidity, partly driven by regulatory shifts and increased market volatility which has encouraged a tactical shift by investment managers.

“While there has been a degradation in liquidity in the market, we made adjustments to this new world several years ago.” Investment managers have diversified portfolios with many targeting larger, more liquid issuers. “For us, it has allowed us to transact and address and meet liquidity requirements.”

Despite the negative press surrounding the US high yield sector in recent months, Barris continues to see healthy demand and says that while some retail clients have fallen away, institutional investors are showing renewed interest in the market.

Explaining this recent trend, he adds: “In terms of retail demand, the underlying mutual funds will also be affected by the broader sentiment on risk. We saw a reduction in retail demand at the end of the year and that was partly due to the movement in oil prices but also partly due to some year-end tax issues.

“What we have seen more recently is that institutional buyers and pensions and insurance accounts are looking at the sector as a real opportunity. More and more of the longer term investors are looking at this market with interest.”

“
We believe US high yield will give mid-single digit returns this year but active management should perform better and we think it will look good against equities and emerging markets by year end.

Chris Barris, Alcentra

5 FT. Harsh realities finally push US champions of shale oil into retreat. 01 November 2015.

6 The Wall Street Journal. Oil Plunge Sparks Bankruptcy Concerns. 11 January 2015.

7 CNBC. Oil companies brace for big wave of debt defaults. 21 November 2015.

Running out of gas? The US shale energy story

The US shale energy revolution of the last decade has had a dramatic impact on global oil and gas supply but now faces some serious challenges, with potentially major impacts on the credit sector.

Of the nearly five million barrels per day (b/d) in net global crude oil supply added between 2009 and 2014, 3.3 million b/d alone was from the US, according to US Energy Information Administration statistics.⁵

However, the rapid growth of the US shale energy sector is proving a double edged sword. The sector has been heavily funded by debt – including major tranches of high yield issuance – and a global slump in oil prices has hit both producers and developers hard.

Now it is starting to hurt investors. In January the cost of oil dipped below US\$30 a barrel, with some analysts suggesting a third or more of US oil producers – already heavily dependent on debt – could face bankruptcy or restructuring by mid 2017.⁶

Against a backdrop of accelerating default rates in the sector, concerns are growing for high yield and other debt associated with the shale energy sector, with credit rating agency Moody's forecasting the default rate will continue to increase in 2016.⁷


Newton Investment Management is among those managers keeping a watchful eye on developments in the sector. Its head of fixed income, Paul Brain, warns further declines in the high yield market are likely as defaults occur and investment grade companies are downgraded into the high yield sector. Once this has occurred and the oil price has found a floor then there will be some significant opportunities to invest in those companies that are able to survive, he adds.

“The good thing about the commodities sector is that you can take out supply and if companies go bust they stop producing. The commodity story is basically one of oversupply. The oil price at the time made US shale gas viable through technology changes. Demand was going up but supply was going up faster,” he says.

“This year we are hopeful the supply/demand imbalance should sort itself out. By the end of 2016 we might look to see a positive inflation effect from commodity prices, not because they are rising but because they have stopped falling.”

While the current state of the sector worries many investors in its existing debt, some commentators, including US-based investment manager Siguler Guff, see longer term potential in more specialised structures and believe the issues currently impacting shale energy producers could ultimately create new opportunities for distressed debt investors, should sectoral defaults continue to rise.

about BNY Mellon



BNY Mellon's multi-boutique model encompasses the skills of 12 specialised investment managers. Each is solely focused on investment management and each has its own unique investment philosophy and process.



Located in London, New York and Boston, Alcentra is a global asset management firm focused on sub-investment grade debt capital markets in Europe and the US.



Insight is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.



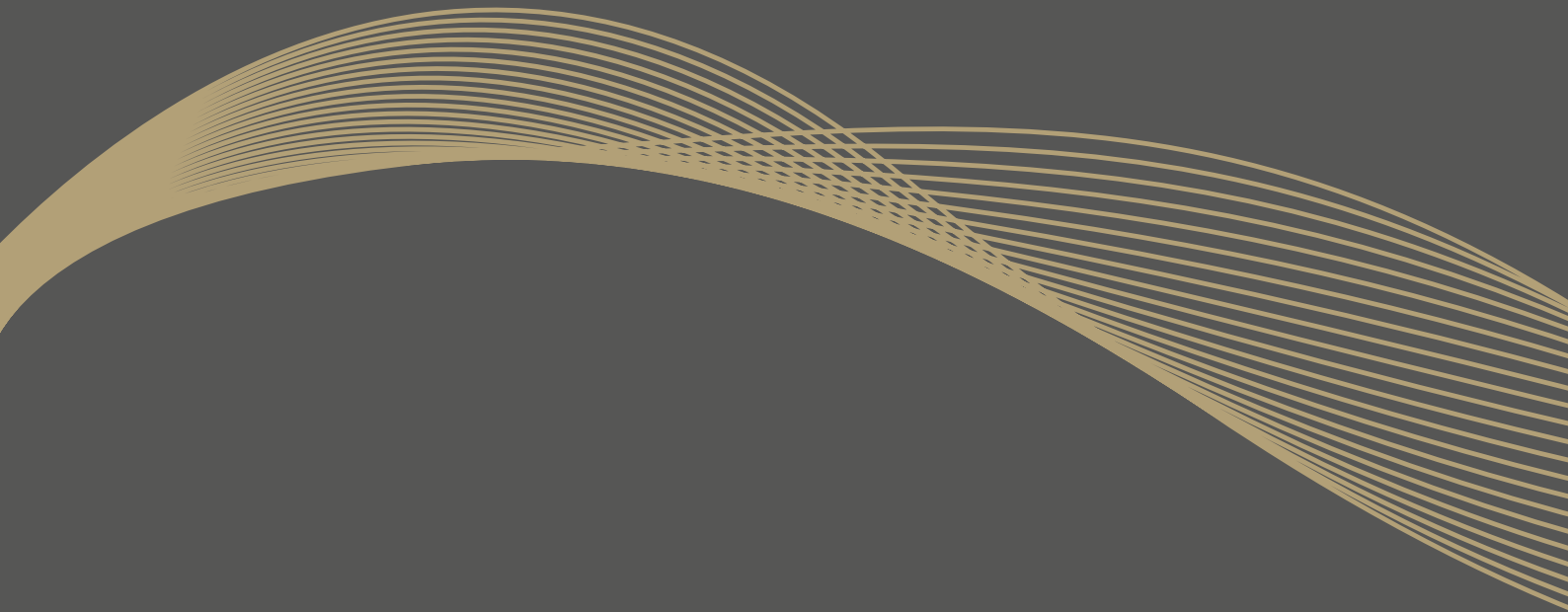
Mellon Capital Management Corporation offers investment capabilities ranging from indexing to alternatives with the infrastructure and skill to transact in all liquid asset classes and securities.



Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies.



Headquartered in Boston, Massachusetts, Standish is a specialist investment manager dedicated exclusively to active fixed income and credit solutions, with a strong emphasis on fundamental credit research.



Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested.

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