

Weekly Commentary



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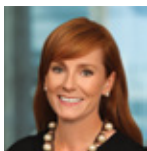
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Key points

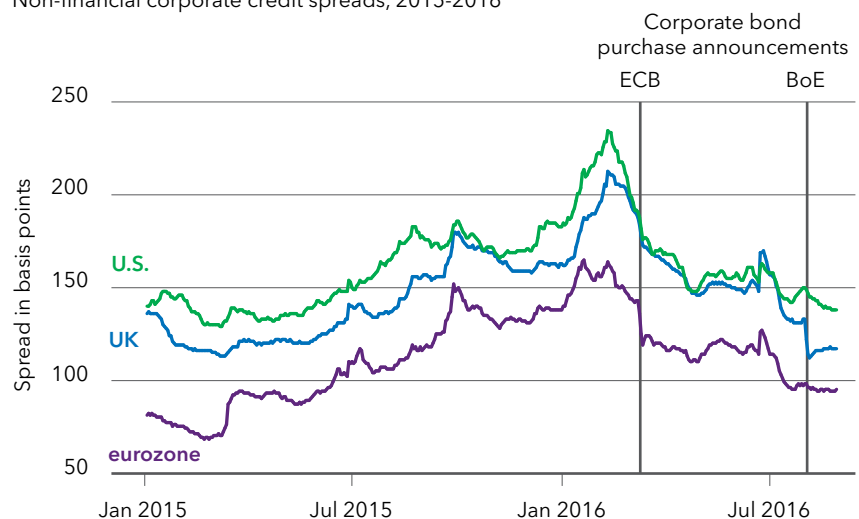
- 1 We see global corporate bond spreads tightening further, driven by European Central Bank (ECB) asset purchases.
- 2 A September U.S. interest rate increase looks less likely after weaker-than-expected U.S. jobs numbers last month.
- 3 The ECB could announce an extension of its quantitative easing (QE) program this week or may wait longer before doing so.

1 A boon for corporate bonds

The ECB and Bank of England (BoE) both started buying non-financial corporate bonds this year, driving down corporate credit spreads globally. We see more spread compression ahead, based on our expectations for the ECB to extend its asset purchases.

Chart of the week

Non-financial corporate credit spreads, 2015-2016



Sources: BlackRock Investment Institute and Barclays, September 2016.

Notes: The lines show the option-adjusted spreads for each economy's Barclays corporate industrials index. Corporate bonds are investment grade. Option-adjusted spreads represent the difference in yields between corporate bonds and equivalent government bonds. ECB stands for the European Central Bank, BoE for the Bank of England.

Spreads are the difference in yields between corporate bonds and their government counterparts. The chart above shows how eurozone, U.S. and UK non-financial corporate credit spreads have shrunk. Stubbornly low eurozone inflation expectations should push the ECB to extend its stimulus beyond March 2017.

The ECB's only way forward: keep easing

Further ECB monetary easing measures could come as early as this week. We see an extension of the March end point for the ECB's QE program as more likely than an increase in the size of monthly purchases or a lowering of interest rates below the current -0.40% deposit rate.

A longer QE program would require the ECB to relax its self-imposed asset purchasing rules to ensure it has enough eligible bonds to buy. A rule change could increase the percentage of any single bond the ECB can buy, broaden the composition of sovereign bonds bought, expand the universe of eligible corporate bonds or even expand the program to include stock purchases - a radical move we see as unlikely at this stage.

Any QE-program change would likely result in price changes for asset classes affected by the rule relaxations. Bottom line: Ongoing strong central bank demand should support European and global bond prices, though selectivity is key. We see opportunities in eurozone peripheral government bonds. We also like selected European corporate bonds, such as those of technology and pharmaceutical firms. We are overweight U.S. credit with a preference for investment-grade bonds.

2 Week in review

- Weaker-than-expected U.S. non-farm payroll growth in August lowered expectations of a September U.S. interest rate increase.
- Oil prices fell, as a weekly report showed a rise in U.S. crude stockpiles. A key U.S. inflation gauge rose for another month.
- Economic indicators highlighted disparities in growth. Purchasing managers index (PMI) manufacturing readings for the UK and China beat expectations, while U.S. data disappointed.

Global snapshot

Weekly and 12-month performance of selected assets

EQUITIES	WEEK	YTD	12 MONTHS	DIV. YIELD
U.S. Large Caps	0.5%	6.7%	11.9%	2.1%
U.S. Small Caps	1.1%	11.3%	10.9%	1.4%
Non-U.S. World	0.3%	5.9%	7.1%	3.1%
Non-U.S. Developed	0.5%	2.0%	4.1%	3.4%
Japan	0.8%	1.1%	7.0%	2.3%
Emerging	-0.1%	15.4%	15.8%	2.5%
Asia ex-Japan	0.2%	11.1%	16.2%	2.5%

BONDS	WEEK	YTD	12 MONTHS	YIELD
U.S. Treasuries	0.2%	5.0%	5.0%	1.6%
U.S. TIPS	0.3%	6.6%	5.8%	1.6%
U.S. Investment Grade	0.2%	9.2%	9.4%	2.8%
U.S. High Yield	0.1%	14.4%	9.1%	6.3%
U.S. Municipals	-0.2%	4.3%	6.7%	1.7%
Non-U.S. Developed	-2.2%	11.6%	10.5%	0.5%
EM \$ Bonds	-0.2%	14.2%	14.6%	5.0%

COMMODITIES	WEEK	YTD	12 MONTHS	LEVEL
Brent Crude Oil	-6.2%	25.6%	-7.3%	\$46.83
Gold	0.3%	24.8%	16.7%	\$1,325
Copper	0.3%	-1.7%	-9.6%	\$4,627

CURRENCIES	WEEK	YTD	12 MONTHS	LEVEL
Euro/USD	-0.4%	2.7%	-0.7%	1.12
USD/¥en	2.0%	-13.5%	-13.5%	103.92
Pound/USD	1.2%	-9.8%	-13.2%	1.33

Source: Bloomberg. As of Sept. 2, 2016. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; Non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI Indexes; U.S. Treasuries by the Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Barclays U.S. Corporate Index; U.S. high yield by the Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Barclays Municipal Bond Index; non-U.S. developed bonds by the Barclays Global Aggregate ex USD; and emerging market \$ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

Sept. 6	August U.S. services PMI; eurozone Q2 gross domestic product (GDP)
Sept. 7	U.S. Beige Book; Germany July industrial production
Sept. 8	ECB monetary policy meeting
Sept. 9	China August Consumer Price Index (CPI), Producer Price Index (PPI)

The main event this week: the ECB's monetary policy meeting on Thursday. We expect the central bank will eventually announce an extension of its QE program beyond the current March 2017 end date, a move that would require a program rule change of some sort. A wait-and-see approach is also possible, given calmer financial market conditions that include a bounce-back in European bank equity prices. Elsewhere, China's inflation data may provide further signs nominal growth in the world's second-largest economy is improving, including a further moderation in wholesale price deflation and an additional CPI pick-up.

Asset class views

Views from a U.S. dollar perspective over a three-month horizon

ASSET CLASS		VIEW	COMMENTS
EQUITIES	U.S.	–	Consumption and labor markets are strong, but valuations are elevated. Further gains require a meaningful improvement in earnings. We like dividend growers and quality stocks.
	Europe	▼	ECB stimulus is supportive, but post-Brexit uncertainty challenges already poor profits. A weak pound helps UK exporters; we are cautious on UK domestic stocks and European banks.
	Japan	–	Attractive valuations and better corporate governance are not enough to offset a soft economy and rising yen. The BoJ is nearing the limits of monetary policy; structural reforms are needed.
	EM	▲	A stable U.S. dollar, economic reform momentum, and improving corporate fundamentals support the asset class. We see further room for inflows given reasonable valuations and light investor positioning.
	Asia ex-Japan	▲	Financial sector reform and rising current account surpluses are encouraging. China's economic transition is ongoing, but we believe lower growth rates are priced in. We like India and ASEAN markets.
FIXED INCOME	U.S. Treasuries	–	A Fed on hold and easy global monetary policy offer support near term. Long-maturity bonds have a structural bid amid low rates and are diversifiers.
	U.S. Municipals	▲	We favor munis for their tax-exempt income, low volatility and strong demand from investors seeking stability and yield. We prefer bonds tied to specific revenue streams.
	U.S. Credit	▲	We generally prefer investment-grade bonds. Yields offer compensation for the risks entailed, such as rising corporate leverage.
	DM ex-U.S. Fixed Income	–	The ECB and BoE corporate QE programs could push credit spreads tighter, but we are turning more cautious. We like tech and pharma corporate debt, and selected sovereigns in the eurozone's periphery.
	EM Debt	▲	We prefer high yield hard-currency debt, but are cautious on commodity exporters. We like local-currency debt in Brazil, India and Indonesia for those who can stomach volatility.
COMMODITIES	Commodities	–	Commodity markets are oversupplied. Oil fundamentals have improved, but we see much of this as priced in. We like gold as a portfolio diversifier.

▲ Overweight – Neutral ▼ Underweight

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