Fixed Income: Where Are the Opportunities Now?

Mark Foust, Senior Product Specialist, Fixed Income

Over the last three months, financial markets have seen a significant uptick in volatility. Much of the turmoil has come on the back of U.S. President Trump's unexpected victory in November. Following the election, equity markets soared and interest rates rose as investors recalibrated their expectations to factor in a Trump-driven U.S. economy, including better economic growth and higher inflation.

In the days since his inauguration, there has been growing uncertainty over the direction of President Trump's economic and foreign trade policies. However, equity markets have continued to rally, interest rates are nearly unchanged, and volatility has subsided as shown in the tables below.

2017 YTD RETURNS as of 2/10/2017

S&P 500	+3.7%
Russell 2000	+2.4%
MSCI EAFE	+3.5%
U.S. Treasuries	+0.5%
High Yield	+2.0%
Emerging Markets Debt	+2.7%

Source: Bloomberg, JP Morgan, Barclays

U.S. TREASURY YIELDS as of 2/10/2017

	12/31/2016	2/10/2017	Change
Two-year	1.20%	1.20%	---
Five-year	1.93%	1.89%	-0.04%
Ten-year	2.45%	2.41%	-0.04%

Source: Bloomberg

SPREADS as of 2/10/2017

	12/31/2016	2/10/2017	Change
Investment Grade	+127	+125	-2
High Yield	+442	+411	-31
Emerging Markets Debt	+342	+315	-27

Source: JP Morgan, Barclays

Identifying key positive and negative drivers for returns in the markets can be challenging amid the noise of the current political environment, leading many to wonder where opportunity currently exists. Within the fixed income markets, we feel the credit-related sectors are well-positioned to outperform over the next twelve months. Our outlook is based on the following key factors:

- Moderate Global Growth. It is our belief that modest economic growth will continue in the U.S., similar to what we have seen over the last seven years. We are in alignment with the markets that inflation will rise, but we expect

Mark Foust

Mr. Foust is responsible for providing ongoing communication and in-depth portfolio insight regarding our fixed income strategies. Mr. Foust is responsible for understanding and communicating portfolio positioning and buy/sell rationale, attribution analysis and serving as a representative for senior investment professionals. Prior to joining DuPont Capital in 2009, Mr. Foust was Executive Director, Fixed Income Portfolio Specialist for Morgan Stanley/ Miller, Anderson & Sherrard. Previously, Mr. Foust was Senior Vice President, Taxable Fixed Income Sales with Prudential Securities, Vice President, Taxable Fixed Income Sales with Smith Barney, and Vice President, Taxable Fixed Income Sales with Merrill Lynch. Mr. Foust joined the financial services industry in 1985.

We expect credit-related sectors will outperform other fixed income sectors due to expectations for moderate global growth and a relative yield advantage.

ONE RIGHTER PARKWAY • SUITE 3200 • WILMINGTON, DE 19803 • (302) 477-6000

levels will remain right at or only slightly above the Fed's 2% target. Global economies also appear to be in decent shape with solid fourth quarter growth in China and improved growth in Europe. Under this moderate global growth scenario, high yield and emerging markets debt should maintain a positive trajectory, and spreads will likely tighten slightly.

- **Income Generation.** High yield and emerging markets debt remain attractive relative to other areas of the market with yields close to 6%. In comparison, most other fixed income segments are yielding below 3% despite the rise in rates during the fourth quarter of 2016. Spreads may tighten slightly, but the bulk of the return generated by these segments will likely be income driven. Investment grade corporates also have the potential to outperform the broader fixed income market. New issuance has been heavy as companies move to raise additional capital while rates remain favorable. Despite the push to cash in on what remains of the low rate environment, some of the new debt is being issued at attractive levels. However, investors should be selective in the investments they choose.

While we are optimistic that these credit-related sectors have the potential to deliver attractive returns in the short to mid-term, we are cautious of underlying risks. In particular, we are closely monitoring developments related to the Trump administration's policy decisions. The market has already priced in the successful implementation of his proposed policies including deregulation and corporate tax reform. If President Trump is unable to deliver on the expected reforms, or his administration enacts trade protectionist policies, a U.S. recession could ensue towards the end of 2017 or in the first half of 2018. In this scenario, exposure to all credit strategies would be detrimental as Treasury rates would decline and credit spreads would widen significantly.

As the administration's policies materialize, we stand prepared to adjust portfolio exposures as appropriate. If the moderate growth trend appears to be in danger, a reduction in the aforementioned areas would be warranted.

To view our latest research papers and publications, please visit us online http://dupontcapital.com/insights/