Finding opportunity in a low-return world

2016 investment outlook: Fixed Income

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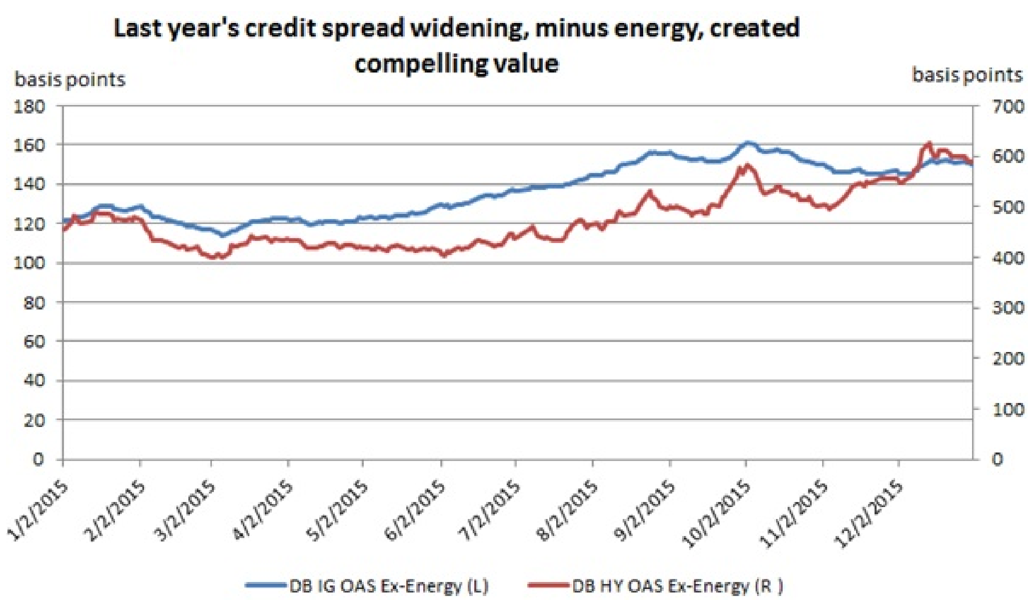
Returns from the major fixed income and equity markets were low in 2015. Most European equity markets generated small positive returns while the US market finished the year close to flat. Fixed income did little better with the Barclays US Aggregate Bond Index up 0.55% and the Barclays Euro Aggregate Bond Index up 1.00%.[1] These returns are disappointing relative to most investors' historical return expectations. While we expect 2016 may be somewhat better than 2015, returns are likely to be relatively low across most traditional asset classes, in our view. Global deflation, low nominal growth, Federal Reserve rate hikes, and profit margins that are unlikely to expand from current levels argue for low returns in 2016.

In a low-return world, fixed income is likely to offer some compelling investment opportunities in 2016, in our view, with lower overall volatility than many other asset classes. While the Fed has begun to raise rates, and will likely hike them further in 2016, increases in longer-term bond yields should remain restrained due to global deflationary pressure and slower potential growth in the US and Europe. If the yield curve flattens, longer-maturity bonds may still be able to generate reasonable returns despite rate increases at the short end.

Credit looks compelling

Within fixed income asset classes, there are compelling opportunities within credit. As we anticipated this time last year, 2015 was a tough year for credit due to an increase in volatility, depressed corporate earnings and energy prices. Credit spreads widened out across investment grade and high yield, overshooting our expectations and getting to levels that offer compelling value. Today, we are still cautious on commodity sectors, but favor investment grade and high yield debt of corporate issuers that are focused on the US and European economies. Credit spreads are currently at levels normally associated with recession, but we believe that growth in Europe and the US will be solid in 2016. Yield spreads have been dragged out to current levels by large amounts of issuance and credit stress in the commodity sectors, and offer opportunity in our view. We slightly favor European credits over the US, as the European Central Bank continues to be supportive and Europe is earlier in the economic and credit cycle than the US.



Source: Deutsche Bank, Jan. 2, 2015, to Dec. 31, 2015. The blue line is the Deutsche Bank Credit Strategy Dm USD IG Ex-Energy OAS Index, which represents the market-value weighted, average option-adjusted spread of developed market USD investment grade (ex-energy) corporate bonds. The red line is the Deutsche Bank Credit Strategy Dm USD HY Ex-Energy OAS Index, which represents the market-value weighted, average option-adjusted spread of developed market USD high yield (ex-energy) corporate bonds. The option-adjusted spreads take into account embedded options. Past performance is no guarantee of future results. An investor cannot invest directly in an index.

Select opportunities emerge in EM

As we noted in 2015, we have been cautious on emerging markets (EM) due to the substantial amount of domestic debt built up since the Global Financial Crisis. Dealing with this debt build-up continues to be a headwind for EM going forward. That being said, adjustment has begun, particularly in currencies, and some opportunities are likely to present themselves in 2016 in currency. Country and issuer selection in 2016 is likely to be the key to EM performance, in our view.

One area of EM where we believe adjustment has only just started is Asia. As a region, Asia has seen increases in debt in recent years, and now suffers from slowing growth and disinflationary pressures. This is a difficult macro mix and requires much easier policy. We anticipate easier policy in Asia and associated currency weakness in 2016. China is a clear example of this, but we anticipate these trends will impact most Asian currencies. We see a benefit to being short in Asian currencies, which could generate returns while helping to buffer investors' portfolios in the event of an economic "hard landing" in China that impacts global risk assets.

Return potential for 2016

In a world of lower return expectations, we believe fixed income has the potential to generate relatively attractive returns. Corporate bonds issued by US and European domestic companies offer a compelling opportunity, and paired with an underweight in Asia fixed income, should provide a solid foundation for a global fixed income portfolio in 2016 that can generate solid income and return, in our view.

[1] Source: Barclays Live as of Dec. 31, 2015

Important information

The Barclays US Aggregate Bond Index is an unmanaged index considered representative of the US investment-grade, fixed-rate bond market.

The Barclays Euro Aggregate Bond Index is an unmanaged index considered representative of the euro-denominated, investment-grade, fixed-rate bond market.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another.

A basis point is one hundredth of a percentage point.

A hard landing refers to a sharp economic slowdown down after a period of quick growth.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Short sales may cause an investor to repurchase a security at a higher price, causing a loss. As there is no limit on how much the price of the security can increase, exposure to potential loss is unlimited.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

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