GLOBAL CREDIT STRATEGY: Orderly reflation

"We expect rates to move higher in 2017, which the credit markets should be able to digest in an orderly fashion – especially with a big negative supply shock in U.S. credit."

– Hans Mikkelsen, head of U.S. High Grade Credit Strategy

Our view

Power shift

With populism on the rise, the era of negative fixed-income yields is likely nearing the end. Although not our baseline, a disorderly rates move would heighten the risks of outflows from corporate bond funds, of emerging market weakness and of concerns about debt sustainability.

The diet begins

We are saying goodbye to an extraordinary year; 2016 was an embarrassment of riches for credit investors, especially in the U.S. Our return forecasts for 2017 make for somewhat sober reading, as we foresee low, single-digit gains. Look for total returns of 3.5 to 4.5 percent for U.S. high-grade bonds and 4 percent to 5 percent for U.S. high yield.

A flatter world

Total returns will likely be virtually unchanged for European high-grade bonds and just 1.5 to 2 percent for European high yield. Asia, which has its lowest net supply since 2011, will likely see high-grade total returns of around 1 percent and high-yield gains of 2.4 percent. In emerging markets, we anticipate total returns of 1.3 percent for corporate bonds and 1.9 percent for high-yield issues.

Key calls

- **U.S.** – We continue to like 30-year corporate bonds, which could generate total returns of 8 to 9 percent. We are overweight banks and energy. In the high-yield arena, we prefer short-duration single Bs. And we like companies that generate most of their revenue from inside the country – and those that have grown organically rather than through deals.

- **Europe** – In a populist era, we prefer domestic credits (such as retail, telecoms, utilities, insurance and banks) to exporters. We favor Spanish credits over Italian ones and would keep a close eye on France. In high yield, we're cautious about Italy, favor floating-rate notes over fixed bonds and like short-dated, high-coupon bonds with tender potential.

- **Asia** – High-yield bonds are preferable to investment-grade debt. We are overweight China, Hong Kong and Indonesia; underweight Korea, Thailand and Malaysia. And we see better value in BBs over Bs.

- **Emerging markets** – In corporates, we are overweight Latin America, given the region's relatively attractive spreads and expected improvement in growth. We are underweight Asia, where valuations are tight, and market weight for Eastern Europe, the Middle East and Africa (EEMEA).