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Fixed Income Focus
July 2016

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Corporate bonds and inflation.

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ECB stimulus is boosting the US corporate bond market

- **A new European Central Bank (ECB) monetary policy tool is having ramifications far beyond its borders.**
- **The Corporate Sector Purchase Programme (CSPP) has tightened spreads not only for European corporate bonds, but also for US corporate bonds.**
- **Despite these tighter spreads, the programme's added demand in the market may ensure that corporate bonds remain attractive to many investors.**

In this issue:

- How European monetary policy is affecting corporate bonds beyond its borders
- How deleveraging could push inflation higher

In today's global markets, a policy action in one region can often have ramifications beyond its borders. The current quantitative easing programme of the ECB, which has the central bank buying corporate bonds, has implications beyond its own continent. Although its primary goal is to stimulate European economies, it could result in an attractive investing opportunity for US corporate bond investors over the intermediate investment horizon.

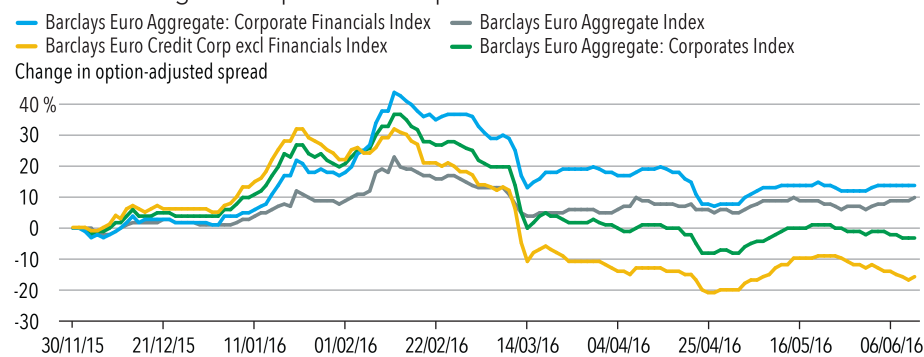
The ECB's newest policy tool

As a result of low inflation and slow growth in the Eurozone, the ECB has been pursuing two paths to stimulate economic activity and inflation. First, deposit rates – the interest rates European banks earn on overnight deposits within the Eurosystem – have been cut into negative territory and are currently at a negative 0.4% rate. Second, on 10 March the ECB announced additional quantitative easing in the form of a CSPP.

This action is intended to inject liquidity into the Eurosystem by buying corporate bonds. The desired effect is to pull down corporate lending rates and encourage corporate activity, and thus overall economic activity and employment. While the economic and employment effects are yet to be determined, this action has certainly had an effect on the corporate bond market.

European bond spreads have fallen

When the ECB's new programme was announced in mid-March it had a dramatic effect on the region's corporate bond spreads.



Source: Barclays

There had been a significant decline in corporate bond prices through the first two months of 2016. Yet the combination of investors recognising value at lower prices (higher yields) and the announcement of the CSPP has caused a dramatic reversal in corporate bond risk-taking in anticipation of the initiation of the CSPP on 8 June.

The CSPP added an additional €20 billion to the original Asset Purchase Programme (APP). With its announcement, corporate bond prices began a dramatic rise as the yield spread to government bonds moved dramatically lower over the ensuing weeks. This price rise was not just limited to European corporate bonds, but affected US corporate bonds as well. While this may not sound logical on the surface, the link is clear.

The programme's broader implications

First, many US corporations have European subsidiaries and routinely opt to issue eurobonds for liability, market access or yield reasons. Second, many euro-area corporations issue in the US for the same reasons. Given that the ECB has established a buying programme, both of these groups will likely prefer to issue eurobonds at significantly lower yields.

A combination of lower sovereign rates and tighter credit spreads will result in a lower coupon versus what could be achieved in the US.

Second, global investors have the option of buying eurobonds or US bonds. These investors will look for relative value in the same issuer; as the ECB buys the eurobond issuance, global investors will likely buy the US issuance. That demand has and will pull spreads down, increasing bond prices.

Lastly, as companies preferentially issue in eurobonds, the US market may see a short-term reduction in corporate bond issuance. This decrease in net supply could create a modest scarcity premium in select issuers or industries. Companies that routinely issue in the US include Caterpillar, Coca-Cola, Merck and PACCAR Financial. Some large euro-area companies that routinely issue in the US are Anheuser-Busch Inbev, Bayer, BMW, Deutsche Telekom, Nestlé, Roche, Sanofi, Shell, Telecom Italia, Unilever and Volkswagen.

> "As companies preferentially issue in eurobonds, the US market may see a short-term reduction in corporate bond issuance."

Corporate bonds may remain attractive

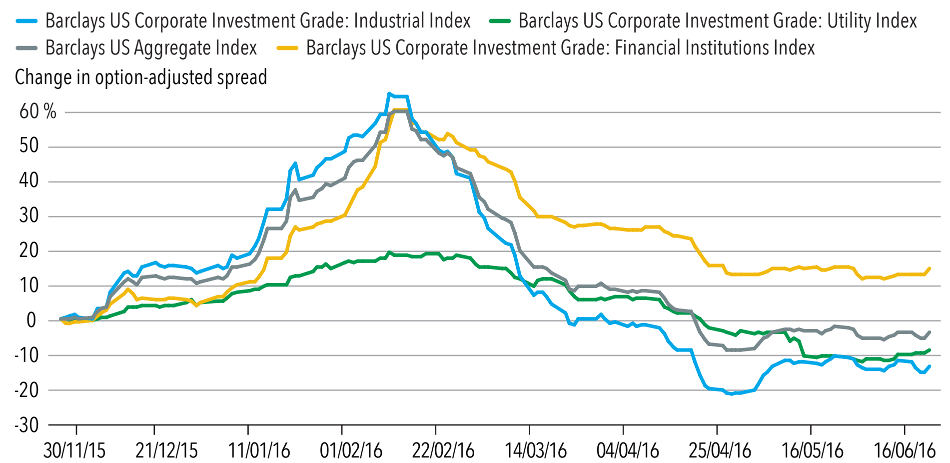
As is historically the case, at this point in the current business cycle, companies will have increased leverage on their balance sheets and should require a higher risk premium. Credit spreads, currently averaging about 150 basis points, seem to somewhat reflect this increase in leverage and are well off the lows of approximately 90 bps at their tightest.

However, the CSPP has added a new level of demand for corporate bonds that

make them attractive to investors with a short- to intermediate-term investment horizon. While the formal programme extends only to March 2017, much like QE in the US, the CSPP could have more lasting effects on supply and demand, anchoring yields at low levels to stimulate the Eurozone economy. As a result, corporate bonds may offer value for the sophisticated investor for some time.

US corporate bond spreads have also fallen

The ECB's programme had a significant effect on the US fixed-income market.



Source: Barclays

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To deleverage, monetary policymakers may embrace inflation

- **US inflation has been extremely low since the financial crisis.**
- **Deleveraging forces threaten to reverse that trend, however, as economic growth and debt creation are likely to remain at low levels.**
- **Treasury Inflation-Protected Securities (TIPS) can help investors avoid some of the risk that rising prices pose to their portfolio.**

Most millennials (the generation born between 1982 and 1994) have never used a fax machine and struggle to imagine life before the internet. Inflation is also foreign to this generation. It has been remarkably low in recent years: as the chart on page 4 shows, the US Consumer Price Index (CPI) flirted with deflation for much of 2015 and remains barely above 1% on a year-on-year basis thus far in 2016.

The collapse in oil prices and the strength of the US dollar were powerful deflationary forces in 2014 and 2015. Yet the lack of wage growth in an environment where the national unemployment rate has fallen from 10% just after the financial crisis to 5% lately is a bigger concern for monetary authorities.

Low inflation is of particular concern in a world of high debt. Since the global financial crisis of 2008, debt levels have continued to rise globally. The Bank for International Settlements estimates that the debt-to-GDP ratio for advanced economies overall increased from 253% in 2007 to 266% in 2015.

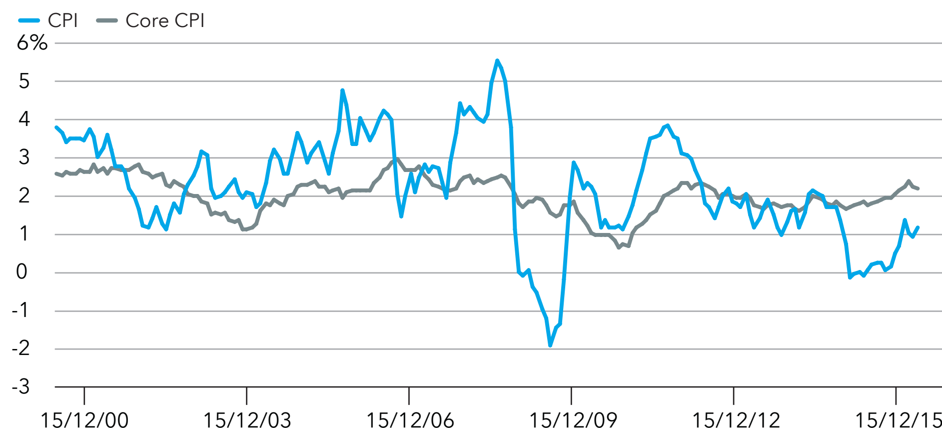
Three forces for deleveraging
In order to deleverage, economies essentially need three ingredients: real gross domestic product growth, slower debt creation, and inflation. In an ideal world, all three factors would contribute to the deleveraging process.

Unfortunately, that is not always how deleveraging works out in practice. In recent years, the contribution from real GDP growth to deleveraging has been modest as the main drivers of long-term growth – workforce and productivity growth – are proving less supportive. In ageing societies facing low productivity growth, real GDP growth is an unlikely driver of deleveraging.

What about slower debt creation then? Private sector debt has certainly fallen relative to GDP, but public sector debt has more than offset that decline. The BIS estimates that public sector debt in advanced economies grew from 75% of GDP in 2007 to 105% in 2015.

Rising inflation is edging nearer to expectations

With energy prices stabilising, the US Consumer Price Index (CPI) is slowly closing in on core CPI.



Source: Bureau of Labor statistics

"In this economic policy environment, Treasury Inflation-Protected Securities are appealing to protect the long-term purchasing power of a diversified portfolio."

Furthermore, the backlash triggered by austerity programmes in Europe and the subsequent rise of populist political movements promising generous fiscal policies suggest that reining in public debt is politically difficult. As a result, slower debt creation is also unlikely to be a big contributor to deleveraging.

In this environment, maintaining some inflation in the system is important for long-term debt sustainability. Japan's experience shows how low inflation, or outright deflation, makes it difficult to curtail the public debt burden. According to the Organisation for Economic Co-operation and Development (OECD), Japan's public debt increased from 100% of GDP in 1996 to 246% in 2014. This backdrop explains why fighting deflation risks is such a critical economic policy issue for much of the developed world. In particular, monetary authorities have implemented a range of innovative policy tools (including quantitative easing, forward guidance and negative interest rates) to maintain inflation in positive territory.

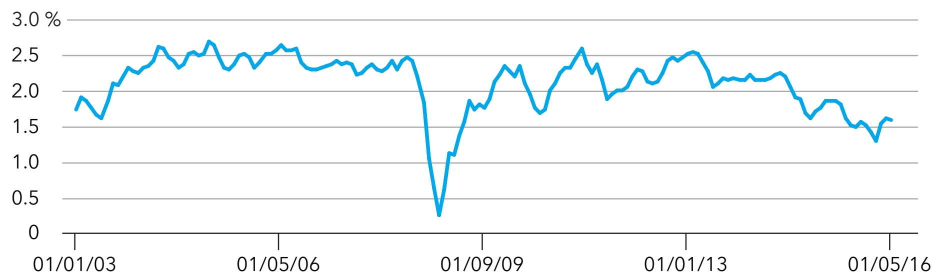
Investors can protect themselves if inflation rises
With the other possible means of deleveraging mostly out of the running, sustaining inflation well into positive territory is a focus for policymakers in the developed world. In this economic policy environment, TIPS are appealing to protect the long-term purchasing power of a diversified portfolio. After the recent deflation scare triggered by the oil price collapse, the cost of inflation protection has fallen and looks relatively cheap from a historical perspective. The chart below shows the market's expectation for US inflation over the next 10 years; the current valuation implies an average inflation rate of only 1.5% over this period.

Apart from the market dislocation that followed the collapse of Lehman Brothers in 2008, TIPS have not been as attractive relative to nominal bonds for many years. Against this cheap valuation, the chart on page 3 shows that core inflation (which excludes food and energy) has been remarkably stable and is actually trending up. An environment in which oil prices are stabilising provides the potential for TIPS to remain well supported. Energy prices have had a significant influence on both TIPS and corporate spreads in recent years. While both TIPS and corporate bonds benefit from a stabilisation in energy prices, TIPS may offer better fundamental value given the significant releveraging taking place at many companies.

For these reasons, TIPS appear to be an appealing investment to protect the long-term purchasing power of a diversified portfolio. This point seems especially compelling against a backdrop where the debt dynamics and monetary policy framework are raising questions on the inflation trajectory in advanced economies. In addition, the recent deflation scare has brought TIPS to an attractive valuation from an historical perspective and relative to competing fixed-income alternatives.

10-year breakeven inflation rates remain low

With core CPI around 2%, Treasury Inflation-Protected Securities look cheap at current breakeven levels.

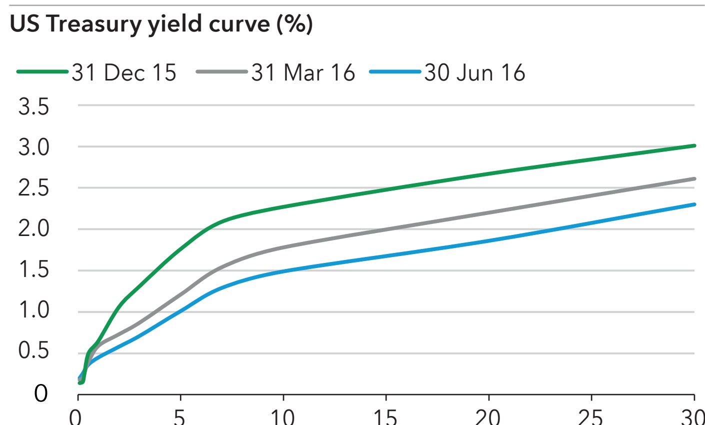


Source: Federal Reserve Bank of St. Louis
The breakeven inflation rate represents a measure of expected inflation derived from 10-Year Treasury Constant Maturity Securities and 10-Year Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 10 years, on average.

Markets at a glance (as at 30 June 2016)

US Treasury yields (%)	Month end[1]	Quarter end[2]	Year end[3]
3-Month	0.26	0.21	0.16
2-Year	0.58	0.73	1.06
5-Year	1.01	1.21	1.76
10-Year	1.49	1.78	2.27
30-Year	2.30	2.61	3.01
2- to 10-Year Spread (bps)	91	105	121
2- to 30-Year Spread (bps)	172	188	195

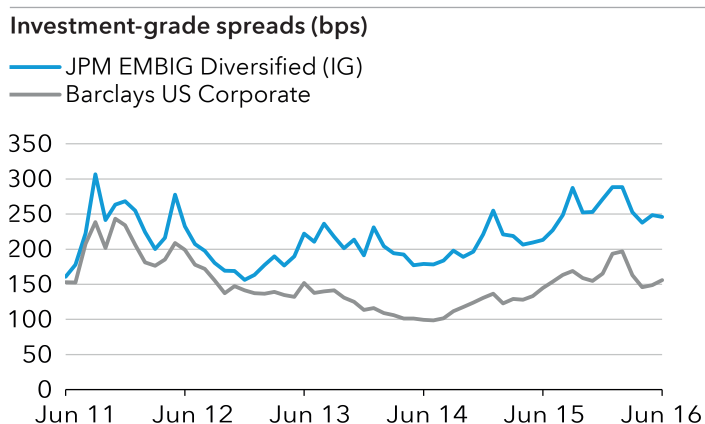
US Treasury yield curve (%)



Sources: Datastream, Federal Reserve

Spreads (bps)	Month end[1]	Quarter end[2]	Year end[3]
Barclays US Corporate	156	163	165
Barclays US High Yield Corporate	594	656	660
JPM EMBIG Diversified (IG)	246	253	271
JPM EMBIG Diversified (HY)	590	621	627
JPM EMBIG Diversified	388	406	409

Investment-grade spreads (bps)



Sources: Barclays, RIMES

Yields (%)	Month end[1]	Quarter end[2]	Year end[3]
UK 10-year Government Bond	1.02	1.42	1.96
Germany 10-year Government Bond	-0.13	0.16	0.63
Japan 10-year Government Bond	-0.23	-0.04	0.25
Barclays US Corporate	2.88	3.21	3.67
GBI-EM Global Diversified	6.33	6.51	7.13

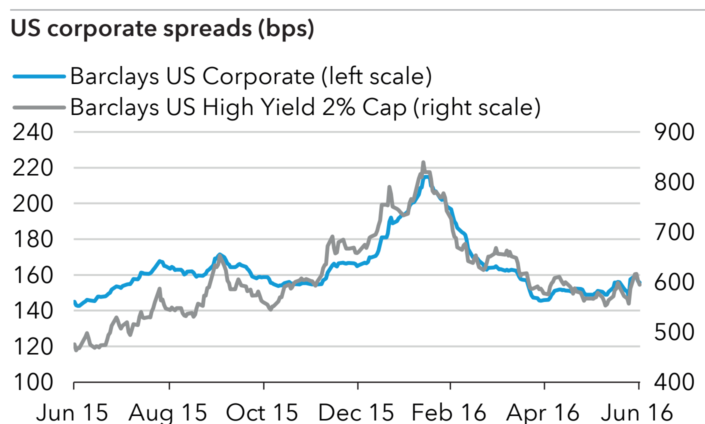
Exchange rates (% change vs. USD)[4]	1 month	3 months	YTD
British pound	-8.16	-6.99	-9.30
Swiss franc	2.05	-1.70	2.75
Euro	-0.21	-2.51	2.27
Japanese yen	8.11	9.56	17.26

Currency contribution (%)			
JPM GBI-EM Global Diversified	3.54	-0.47	5.69

Fixed-income index returns[4]			
Barclays US Aggregate	1.80	2.21	5.31
Barclays Global Aggregate	2.92	2.89	8.96

Sources: Barclays, Datastream, Federal Reserve, RIMES

US corporate spreads (bps)



Source: Barclays

1. Month-end: 30 June 2016
2. Quarter-end: 31 March 2016
3. Year-end: 31 December 2015
4. As at 30 June 2016

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