

# UBS Asset Management Flash Commentary

## Update on December US Federal Reserve Meeting and US High Yield

- FOMC raises interest rates by 0.25%
- Market reaction muted
- Credit markets stabilized after recent volatility

### What Happened and Why?

The Federal Open Market Committee (FOMC) raised the target range for the federal funds rate by 25 basis points to 0.25–0.50%.

The market widely expected the increase, so the focus was on the language and the FOMC members' projections for future rate increases. Both of these were marginally more dovish than expected. The Fed is now using the term "gradual" to describe the likely path of monetary policy, and the distribution of the expected year-end target rate has drifted somewhat lower. Nonetheless, expectations for the long-run rate remained steady suggesting that gradual rate rises over the next few years could be replaced with faster rate hikes further down the line. The press conference was slightly less dovish, with Fed Chairperson Janet Yellen emphasizing again that even with rate rises, policy remains accommodative and that future decisions would be data dependent. The improvement in the labor market is now apparently taken as given, so the focus has switched to expected inflation.

This marks the first rate hike since June 2006, and also the first rate hike in an environment where the Fed balance sheet has expanded dramatically through quantitative easing. As a result, the Fed also had to expand special measures, such as reverse repos, to ensure that the fed funds rate will tend towards the mid-point of the target range.

### Market Reaction

US interest rates moved modestly higher following the release of the Fed statement. The yield on the 2-year Treasury moved 4 basis points higher to 1.00% reaching this level for the first time since 2010. The 10-year Treasury increased 1 basis point to 2.27%, reflecting a slight flattening of the yield curve. The odds of a fed funds increase at the March meeting are currently

approximately 40% based on implied fed funds futures contracts.

### Implications for our Multi Asset portfolios

The Federal Reserve's announcement today that it would begin to increase rates was well-telegraphed—thus avoiding a communication error. Initial market reaction has been muted, suggesting the Fed also effectively avoided a policy error. That error avoidance is important, in that it reduces the chance of near-term market volatility spikes or outsized asset price dislocations. It's also notable that today's Fed forecasts for growth and inflation did not come down markedly from previous forecasts, contrary to lower expectations issued recently by some market participants. In part, that reflects the Fed's confidence in the US economy, and its belief that the global concerns it articulated in September (i.e. China) have lessened.

Essentially, the Fed has left the door open to assuming a more hawkish stance (quicker tightening) or dovish stance (slower tightening or more easing) should forthcoming data deviate significantly and persistently from their forecasts necessary to support its objectives of maximum employment and 2% inflation. How the Fed chooses to exercise that flexibility may lead to bouts of volatility leading up to or immediately following its FOMC meetings in 2016.

Over the intermediate-term, we would expect today's move by the Fed to:

- Remain supportive for risk assets
- Have a benign impact on more rate-sensitive assets, including investment grade corporate credit and inflation-linked securities
- Have a slightly bearish impact on the US dollar, in the absence of a clear commitment to steady rate hikes going

forward. By implication, this puts more pressure on the European Central Bank and Bank of Japan to take more aggressive steps to depreciate their currencies, should they choose to do so as part of their easing efforts

- Cause us to reconsider our stance on emerging markets equities and debt—valuations are becoming increasingly attractive in our view, and while there are a number of fundamental challenges to consider, we believe the downside risk of missteps by the Fed has been mitigated

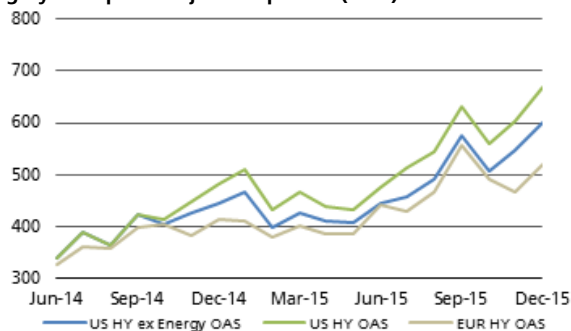
### Implications for High Yield Markets

Following last week's bout of volatility, the credit market appeared to stabilize this week. Spreads have continued to widen modestly, but trading activity appears more balanced and overall volumes are a little above average.

In terms of our outlook for credit, we have seen changes in the US High Yield market over the past several months. We now see a more pronounced deterioration in underlying credit fundamentals. Favorable leverage trends have reversed and a slowing global economy is likely to negatively impact earnings growth. We also expect a material uptick in defaults during 2016, predominantly in industries that have felt the effects of persistently low commodity prices.

High yield spreads have widened materially to reflect increased credit risk. We expect defaults to increase in 2016; however, default rates outside the commodity-related industries should remain below the historical averages. While the current level of spreads in US high yield is trading at recessionary levels, the Fed's outlook for moderate growth from today's meeting indicates that there is opportunity in high yield outside of the commodity sectors.

High yield option adjusted spreads (OAS)



Source: Barclays Capital PLC, Bank of America Merrill Lynch

In our US High Yield portfolios, we are cognizant of the prevailing liquidity risks and prefer to maintain modest cash balances (between 5-10%) and an overweight to investment grade credit. We also continue to hold material underweights in the energy and metals & mining industries relative to benchmarks. The yield-to-worst on the Bank of America Merrill Lynch US High Yield Cash Pay Constrained Index is currently around 8.75%. Despite significant spread widening in commodity-related sectors, we prefer reduced exposure based on our negative fundamental outlook for these sectors.

We remain constructive on EUR High Yield. The current yield-to-worst on the broad market is relatively attractive at 5.25%, as measured by the Bank of America Merrill Lynch EUR High Yield index. Moreover, the European Central Bank (ECB) remains poised to continue, and potentially expand stimulus efforts. A significant portion of the EUR high yield market (approximately 25%) is in the banking industry which should benefit from the ECB quantitative easing (QE) program. EUR high yield also has minimal exposure to metals & mining (less than 1%) and energy (approximately 5%). As a result, we would expect EUR HY to be less impacted by developments in commodities and potentially experience less volatility in the current environment.

We also favor Short Duration High Yield given greater clarity on the maturity profile. These portfolios also have more limited exposure to commodity sectors and lower interest rate sensitivity with a duration of around 1.5 years.

Asian High Yield has achieved positive returns year-to-date despite volatility in the broader market. The market has relatively limited exposure to oil and related commodities compared to US high yield and a current yield-to-worst of 7.60% as measured by the JPMorgan Asian Credit Non-Investment Grade Index. As we approach year-end, we have maintained higher liquidity in these portfolios and prefer higher quality bonds.

More broadly, the moderate growth and low inflation environment remains supportive for fixed income. While we would not be surprised to experience more bouts of volatility, credit sectors continue to benefit from the pervasive demand for income in a low rate environment.



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