

### Global Fixed Income Bulletin

# 2017: Fiscal Trumps Monetary – A Year to Remember!

**FIXED INCOME** | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JANUARY 2017

## Outlook

- We believe the bond market is in the midst of a regime shift, turning away from an overdependence on central bank policy toward one driven by fiscal policy and fundamental economic valuations. At such times of regime shift, we anticipate active management will be even more valuable in helping generate returns. We think the winning characteristics for 2017 should include the following: carry, less rate-sensitive, and more credit, idiosyncratic and thematic exposures.
- In the U.S., we see possible upside growth surprise from new policy mix under Trump and remain moderately bearish on rates (some of the Trump effect is priced in). Inflation around the world could surprise markets to the upside, which is why we have a steepening bias for curves, such as in the Eurozone and Japan.
- In EM, we believe 2017 will be the year when we see more pronounced growth dividends from the recovery in commodity prices and gradual reform progress. We favor commodity exporters with high interest rates and undervalued currencies. Indonesia, Russia, Brazil and Colombia stand out. China is likely to be the major factor that can upset this recovery both in the form of lower commodity prices or by triggering a spike in risk aversion. Too fast a renminbi depreciation could trigger a series of negative developments.
- We have a constructive outlook on U.S. investment grade and high yield, while more cautious in Europe. Our fundamental view of credit is bifurcated between industrials and financials as we expect financial fundamentals to improve, while the fundamentals of non-financial credits remain stretched. In high yield, lower-rated parts of the market offer the potential for more attractive returns, given higher spreads and an improving macroeconomic background.
- Agency RMBS remain one of our primary concerns in 2017, due to the expectation of more Fed rate hikes and the prospect of higher mortgage rates. There is also the additional risk of the Fed ending their MBS reinvestment of pay downs as part of their MBS Purchase Program. U.S. non-agency RMBS continue to offer compelling value in our opinion, given their attractive yields, improving housing market conditions and declining non-agency RMBS supply. Overall, we find CMBS spreads/yields to be attractive, but recommend careful security selection and moderate CMBS exposure.

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The U.S. economic engine is primed to grow in our opinion. The drivetrain is fiscal stimulus and regulatory reform. The spark to get the cylinders moving has already been ignited: expectations have risen for more business investment, leading to gains in productivity, which can ultimately produce higher per capital incomes. Looking back, the U.S. economy has been sorely lacking in investment, leading to low productivity and wage growth. Moreover, the banking sector has been hamstrung by exceptionally low rates and a battery of rules and regulations preventing it from “greasing the wheels” of economy, particularly small and medium-size enterprises, the lifeblood of growth in many regions of the country. Of course, there are risks: geopolitical, protectionism and anti-immigration stand out. Investors need to be wary of the risks that the Trump administration might get sidetracked in addressing issues that reduce productivity (trade barriers and immigration issues stand out) rather than those that boost growth both in the short run (tax cuts, infrastructure spending) and in the long run (structural reform and deregulation). For now, markets are giving the benefit of the doubt to Trumponomics, but we must be cognizant of execution risks or retaliatory actions by countries feeling attacked by some of the future administration’s less savory policies. We see room for further improvement in risky assets and U.S. Treasury yields to rise under the assumption that the positives of Trump policy actions will dwarf the negatives, at least for 2017.

Some context here may help. Current consensus forecasts for U.S. gross domestic product (GDP) growth in the year ahead is 2.2 percent versus potential output of 1.5 percent, based on Consensus Economic data as of Dec. 31, 2016. If these forecasts come true, then 2017 will see growth run above its potential by 0.70 percent. In an optimistic scenario, growth may run at 3.0 percent, which is double its potential. In both cases, excess capacity in the economy is declining, and the economy

is running hot with the latter greater than the former. Inflation and wages are likely to continue to rise.

The reality is that the U.S. under President Donald Trump is going to embark on a policy of tax cuts and increased fiscal spending at a time when the economy is close to full employment. The Federal Reserve (Fed) is likely to respond to unexpected rises in inflation with more hawkish talk if not action. Wage growth in the January employment report was supportive of further rises in core inflation. It may be the 2018 hiking cycle which needs to be adjusted upwards by the market as the true size and impact of Trump’s policies become evident. However, there is risk that market expectations are running ahead of politics and that President Trump will not be able to execute his agenda as quickly as he would like. Indeed, even under optimistic scenarios, the major effects of tax and spending changes will not really hit the economy until 2018, although there is no doubt that the household and corporate sectors could begin to spend more in anticipation of the legislative changes.

Asset returns are highly dependent on the investing regime. Thus, we believe the market is in the midst of a regime shift turning away from an overdependence on central bank policy to drive performance and toward one driven by fundamental economic valuations and legislative actions. This shift will take some time, but it signals a return to more normal market conditions.

Managing interest rate risk will be critical during this transition period (2016 fourth-quarter bond market performance was among the worst in many years), and there will probably come a time in 2017 to buy duration (and sell risky assets) if and when markets become overly exuberant about the growth and inflation outlook. However, on the whole, we need to be less reliant on duration for returns (beta). Winning portfolio characteristics should

include the following: carry, reduced interest rate-sensitivity, and more credit, idiosyncratic and thematic exposures. Some examples of sectors within the fixed income market that fit our thematic criteria are: 1) commodity exporters in emerging markets (EM), 2) non-agency residential mortgage-backed securities (RMBS), and 3) high yield. We elaborate on these in asset-specific discussions below.

These are just some specific examples of investment opportunities in fixed income for 2017. In an environment of rising rates, fixed income could still add diversification to a portfolio. At such times of regime shift and uncertainty, we anticipate active management will be more valuable for returns in 2017, which can more nimbly manage duration and sift through idiosyncratic risks.

## 2017 Developed Markets Outlook

In the U.S., though the rise in long-end yields has been sharp, we see the moves as a realignment toward economic “fair value”. Term premium, which is normally positive, has only recently moved back to zero. Without a realization of better economic data, we see current levels for the 10 years as approximately fair. Better-than-expected growth, which hinges partly on the new policy mix under Trump, could drive our “fair value” higher. We say partly, because trends toward higher yields, higher wages and inflation, and better economic growth were already in place before Mr. Trump won the election. However, Fed policy is truly decoupling from the rest of the world, which could be a headwind for the economy and a negative for the bond market. Taking all of above into consideration, we remain modestly underweight duration to help protect portfolios from further improvements in growth and inflation. With still a significant amount of uncertainty around the Trump agenda, we do advocate maintaining a certain degree of flexibility in portfolio positioning to be able to adapt to unexpected developments.

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In other core developed markets, low growth and populist politics remain as headwinds. However, fiscal policy is easing globally and can complement easy monetary policy, which would be an improvement from 2016. Inflation could surprise markets to the upside, which is why we have a steepening bias for curves, such as in the Eurozone and Japan. In the U.K., fears that the economy weakens post triggering of Article 50 should keep policy accommodative. As a result, rates in the U.K. should remain range-bound and are likely to outperform USTs and bunds. The big risk for U.K. yields is continued weakness in the pound, triggering higher inflation and higher long-term bond yields.

In the Eurozone, plenty of political risk events are in store, with elections in Germany, France and the Netherlands, as well as the government reshuffling in Italy. However, mainstream parties will try to fend off rising antiestablishment candidates, which incentivizes additional fiscal easing. European Central Bank (ECB) purchases remain in place until at least the end of 2017. Barring political shocks, easy policy should support peripheral spreads in Spain, Italy and Greece. On that basis, we are modestly overweight these spreads. In core euro area, improving inflation dynamics could raise market expectations of ECB tapering, which would increase risk premium and steepen the curves.

In Japan, Bank of Japan (BoJ) is likely to maintain yield curve control policy. We don't expect BoJ to cut rates further due to the negative repercussions on financial sectors and the negative public reactions. Yield curve control allows the government to expand fiscal policy and fund itself at very low costs. The combined effect of stimulative monetary and fiscal policy should be positive on growth and inflation in 2017. Rising rates in the U.S. would exert a pull on yields elsewhere, making

it more difficult for the BoJ to keep JGB 10-year yields around 0 percent. Hence, we have a modest underweight in duration in Japan and expect curves to continue to steepen at the margin.

Australia and New Zealand should benefit from the global reflation and rising commodity prices, though the outlook gets more uncertain later in the year. Housing, which had absorbed a lot of excess capacity from the commodity bust in 2016, could start to cool and perhaps become a drag on growth. Central banks will probably continue to keep rates low, though fiscal policy, such as infrastructure planning in New Zealand, could do more of the work in stimulating the economy. In this outlook, the biggest risk still relates to China, which could slow as its own fiscal stimulus and property sector declines, dragging down commodity prices such as iron ore and coal, which had a phenomenal 2016, posting double-digit returns. We expect the Fed to be more hawkish than RBA and RBNZ, and on that basis, we expect the spread to 10-year U.S. Treasuries for both countries, Australia and New Zealand, to remain well-bid and might also turn negative for the first time since 1980s.

Similar to Australia and New Zealand, Canada benefits from rising oil prices and fiscal spending. For the larger non-oil economy, the biggest driver is actually U.S. industrial production, which has been on a cyclical uptrend. Over the medium term, if U.S. business investment improves with tax and regulatory reform, Canada should benefit as well. However, improving terms of trade could also continue to push up the Canadian dollar, presenting a drag for non-oil exports. Given these conflicting forces on an economy in nascent recovery, we expect monetary policy to remain dovish at the margin. Tightening mortgage rules could succeed in preventing further heating of the housing market, allowing the Bank

of Canada to maintain low rates and decreasing financial stability risks in the economy. We expect the interest rate differential with the U.S. to widen on the back of faster rising rates in the U.S. and thus are relatively bullish Canadian rates.

In terms of currency, the U.S. dollar should most likely remain strong in 2017, driven by widening short-term interest rate differential with the rest of the world as the Fed turns more hawkish. The U.S. two-year interest rate differential with German yields reached 208 basis points (bps), the widest since 2000, bolstering the U.S. dollar and causing the euro to fall below 1.04, its lowest point since 2003.<sup>1</sup> We think dollar strength manifests strongly against the yen, where the yield curve control policy keeps Japanese rates low and might lead imbalances to be distributed through currency deviation. We also like being underweight the euro versus the Swedish krona, as there are increasing signs that the Riksbank may start to become more hawkish in 2017. Increasing global skepticism around monetary policy effectiveness will likely make it difficult for Riksbank to resort to further easing, while economic growth is cruising at above trend pace. We think the Australian dollar and New Zealand dollar could experience further depreciation as any risks from China could derail the commodity price reflation that has benefitted these countries.

## 2017 EM Outlook

In terms of the outlook for major EM, we think that 2017 will be the year when we see more pronounced growth dividends from the recovery in commodity prices and gradual reform progress. Our view is primarily reliant on three factors: i) Global growth, which is expected to rise by 0.5 percent in 2017 to 3.5 percent, according to IMF estimates; ii) Rising commodity prices, which have been improving as China and global markets

<sup>1</sup> Source: Bloomberg. Data as of December 31, 2016.



have stabilized; and iii) Terms of trade. A great unknown for 2017 is U.S. trade and protection policies and how it may spill over to the emerging world. However, if it turns out less than feared, then EM can do very well in 2017 especially since fundamentals have already been improving. However, China, more so than the U.S., is likely to be the major factor that can upset this recovery both in the form of lower commodity prices or by triggering a spike in risk aversion.

Better terms of trade will likely benefit commodity exporters. In local EM bonds, we favor commodity exporters with high interest rates and undervalued currencies. Indonesia, Russia, Brazil and Colombia stand out as opportunities to invest in.

Turning first to Latin America, Mexico, despite its structural reform progress and fiscal discipline, is, somewhat ironically, likely to face the most uncertainty, given the incoming U.S. administration's anti-trade rhetoric. However, we think that Mexico, the U.S. and Canada will find enough common ground to avoid a trade war, though uncertainty will remain high. Brazil should finally see a year of modest growth, steadily declining inflation and a Central Bank likely to speed up the pace of cuts. On the political front, the Temer administration is focused on passing a pension reform seen as key to curb the country's unsustainable debt dynamics, amid a spreading Lava Jato probe. Further south, Argentina faces a challenging 2017 amid large financing requirements, a less benign environment for external borrowing, and critical midterm elections that limit the scope for meaningful fiscal adjustment. On the positive side, the economic activity should recover on declining inflation, a strong harvest and a subdued recovery of neighboring Brazil.

Changing to Europe, the Middle East and Africa, it seems geopolitics and refugee flows are as important drivers as the outlook for macro developments and the ECB's tapering plans. Central Europe

remains somewhat shielded from broader EM concerns, but the turn towards populist/nationalistic politics is eroding progress made on institution building and the investment outlook, particularly in Poland and Romania. Nevertheless, we think that 2017 will not see major changes for these economies, which will be driven by broader European themes, such as the ECB and Brexit. Russia should benefit from higher oil prices. In fact, the economy has already started growing in third-quarter 2016, and faster-than-expected disinflation will allow the Central Bank of Russia to resume its easing cycle in first-quarter 2017. Furthermore, Trump's friendly overtures towards the country increase odds of sanction relaxation by year-end. Turkey's room to maneuver is rapidly shrinking, given higher oil prices and its turn towards an increasingly authoritarian form of government, which means more heterodox policies in an increasingly less favorable EM environment. Any wholesale relaxation of fiscal policy, the only credible policy anchor left, would make the challenges facing Turkey all the more severe. On the other hand, Turkey may benefit from a stabilization of the crisis in Syria. South Africa could surprise positively next year in a scenario where a weakened President Zuma steps down and a more credible administration takes over. On the other hand, rating agencies may strip the sovereign from its investment-grade status, should political uncertainty persist.

Finally, shifting toward- Asia, local developments are likely to be dominated by the U.S. trade agenda and its impact on U.S./China relations and the Chinese yen versus the U.S. dollar. Currencies in the region are likely to depreciate further if the new U.S. government delivers on its protectionist stance. Hence, disruption of the trade channel will prevent non-Japan Asia from enjoying the benefits of an expected stronger U.S. growth. China's economic outlook remains another cloud combined with the potential of increased

tensions in maritime areas claimed by China and other countries. The outlook for the stronger stories of 2016, such as Indonesia, still looks relatively positive, and we see the country moving forward with its fiscal agenda, and monetary policy becoming more lax. India is likely to be one of the most unaffected EM countries from all the geopolitical crosscurrents, and 2017's market focus will be on the monetary reform implications, the implementation of the GST (some slippage is already seen), and the potential for further rate cuts by the RBI as inflation looks well under control. Finally, we think Malaysia will continue to use its large macro buffers to manage political tensions derived from the 1MDB scandal.

## 2017 Credit Outlook

Overall, we are optimistic about the prospects for U.S. investment-grade and high-yield credit as we enter the year with an improved macroeconomic environment, continued supportive technicals, improving fundamentals in key areas of the credit markets, and favorable valuations.

The macro environment should help U.S. credit as Washington introduces a strong pro-growth agenda with increased fiscal spending, tax reform and decreased regulation. It is not difficult to envision corporate spreads moving meaningfully tighter during 2017. Spreads could widen significantly (nearly 30 bps) before excess returns turn negative.

We believe that financials are particularly well-positioned to benefit from improved U.S. growth, higher yields, and the potential for a reduction in regulatory oversight under a Trump administration. This should allow for increased profitability, and allow banks to shore up their balance sheets and further improve liquidity profiles. A rollback of certain regulatory requirements should allow bank profitability to improve without meaningfully increasing risks. We must, however, remain mindful that

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the industry may potentially return to its riskier ways if banking regulation is altered in a more significant fashion. While this isn't our base case today, we may see a divergence in the performance of senior versus subordinated bank debt, as senior debt may tighten as profitability improves, while subordinated debt may lag as banks become riskier from a fundamental perspective.

Non-financial corporates present a very different set of risks versus financials. In the past few years, we have been concerned about the rise of leverage among non-financial companies. In particular, we have been worried about the level of leverage relative to our place in the business cycle. High leverage is typical of a downturn; however, we have historically not witnessed the current high levels of corporate leverage while still in an expansionary phase. As we look ahead, we are cognizant that higher EBITDA growth driven by a stronger U.S. economy could quickly alleviate our leverage concerns if management teams choose to direct excess cash flow to pay down debt. Irrespective of broader fundamental trends, our outlook is more positive toward certain growth and commodity sensitive sectors. In contrast, we are cautious on health care, given potential political scrutiny of drug pricing and the unknown future of the Affordable Care Act or potential replacement legislation. We further remain cautious on the auto sector, as auto sales have already reached cycle highs and there are significant unknowns regarding President-elect Trump's trade policy and its impact on the sector.

The technical backdrop for corporate credit is expected to remain positive in 2017. Foreign buying should continue to drive price action in U.S. investment grade, and may gain momentum as yields in the U.S. become increasingly attractive for yield-sensitive buyers. In

2016, net foreign purchases of U.S. corporate bonds totaled approximately \$450 billion.<sup>2</sup> By comparison, in 2010, foreign purchases of U.S. corporate bonds totaled approximately \$120 billion.<sup>3</sup> We anticipate that foreign demand will remain strong, as the yield advantage for U.S. credit compared to the yen and euro credit will likely continue to trend higher. The risk to this view is the potential for rising FX hedging costs to limit foreign demand. In addition, we expect that U.S. insurance companies and pension funds will likely become more active buyers in 2017, if higher corporate yields and equity prices compel this buyer base to rotate equity holdings into fixed income. On the other hand, we also anticipate lower net bond supply to further strengthen U.S. investment-grade technicals. Following the result of the U.S. election, the market anticipates a repatriation of trapped overseas cash at a favorable tax rate for U.S. corporations. While this is uncertain, a large shift of offshore funds back to the U.S. will likely lead to less issuance from U.S. companies in 2017. In addition, higher rates in the U.S., and prefunding of maturities at U.S. corporations, may further mute supply requirements in the U.S.

We are also bullish on U.S. high yield. This asset is less rate-sensitive and relies more on idiosyncratic factors and credit conditions to drive performance. In 2017, we expect default rates to fall and economic fundamentals to improve. We tend to believe the single B and triple CCC segments of the market are most appealing, largely because they are less sensitive to rates and more sensitive to pro-growth policies. Basic industries, manufacturing and food and beverage are areas we like.

For European credit, election politics and the reality of a Trump presidency, with an expected policy mix that might or might

not be executed, will drive risk appetite. Offsetting any market stress, central bank policy is expected to remain supportive with a bias to easy financial conditions and the provision of liquidity as required. Corporate profitability will remain challenged as low-growth limits top line revenue expansion and cost pressures remain; however, financials' profitability should increase if rates rise and regulatory reform is eased.

Following the spread widening in the fourth quarter, current valuations offer attractive opportunities, given expectations defaults will stay low, risk premiums will fall as political uncertainty diminishes and demand remains high. Current spreads are close to long-run averages in investment-grade credit, but as 2017 evolves, we expect both the positive technical impact of ECB purchases and a fundamental reduction in risk premium to move credit spreads through both long-run averages and fair value.

Our favored sector remains financials, where a combination of regulators driving industry risk reduction, rising rates improving profitability and abundant liquidity limiting defaults, fundamentally supports credit risk. Valuation in tier 2 subordinated securities look particularly attractive as the benefit of a must-pay coupon, with a defined maturity and an attractive spread offer the best risk-adjusted returns.

In industrials, we see risks of increased M&A as management is pressured by shareholders to increase returns. We expect opportunities in new issues that price at a discount to fund these deals. More broadly, we expect industrials to trade in a range as the support of ECB buying acts as a barrier to spread widening. In utilities, demand for infrastructure, like assets with the potential for well-defined cash flows, is expected to be positive. While

<sup>2</sup> Source: Goldman Sachs. Data as of December 31, 2016.

<sup>3</sup> Source: Goldman Sachs. Data as of December 31, 2016.

we like the fundamentals in the sector, we see best value in corporate hybrids, given valuations in senior bonds reflect the low-risk nature of the sector.

In European high yield, our analysis suggests that the lower-rated parts of the high-yield market offers the potential for more attractive returns, given higher spreads, our expectation for low default rates and the lower interest rate sensitivity of lower-rated credit. We also believe that subordination risk premium remains elevated, and corporate hybrids continue to offer value.

After an eventful 2016, we look forward to 2017 with a constructive outlook on U.S. investment grade and high yield, while more cautious in Europe. Our fundamental view of credit is bifurcated between industrials and financials, as we expect financial fundamentals to improve, while the fundamentals of non-financial credits remain stretched. We will remain vigilant to see exactly how changing financial regulation impacts bank credit risk, and will continue to monitor how non-financial companies choose to direct their anticipated higher profits. If valuations continue to remain favorable, we expect to maintain overweight credit positions entering 2017, and anticipate a positive landscape for U.S. investment-grade credit as we start the new year. In Europe, while 2017 is likely to see some volatility, we would expect buy & hold credit to generate positive excess returns in the year and would view any spread widening as an opportunity to add to credit positions.

## 2017 Securitized Outlook

We begin 2017 in a fairly similar position to the beginning of 2016, with the Fed having just raised rates by 25 bps, the U.S. economy growing modestly, and U.S. home prices up 5 percent over the past year.<sup>4</sup> Securitized credit conditions

still appear to be positive with rising real estate prices, low unemployment, improving wages and interest rates still low by historical comparison. Mortgage credit performance continues to be improving with declining delinquency and default rates and reasonably tight lending standards. Credit spreads are generally a little tighter than a year ago, with the exception of BBB commercial mortgage-backed securities (CMBS), but still appear to offer attractive value, and perhaps even less risk, than more rate-sensitive mortgage assets.

Agency RMBS remain one of our primary concerns in 2017. With mortgage rates roughly 60 bps higher since the U.S. election, agency MBS durations have extended considerably. Given the expectation of more Fed rate hikes in 2017 and the prospect of higher mortgage rates, we believe that the duration-extension risk persists in 2017. Rates volatility has been generally low for the past several years, effectively trading in a 50-100 basis point range, but there appears to be greater risk that we could break out of that range in 2017 causing material convexity issues. There is also the additional risk of the Fed ending their mortgage-backed securities (MBS) reinvestment of pay downs as part of their MBS Purchase Program.

The ramifications of this would likely involve MBS spread widening as new buyers would be needed to fill this void in the market. The dominant buyers of agency MBS in 2016 were the Fed, U.S. banks for regulatory capital purposes, and foreign investors, given relative yield opportunities.<sup>5</sup> Largely as a result of the Fed accumulating roughly 30 percent of the MBS market, nominal spreads on agency MBS are currently 90 bps above interpolated Treasuries, which is roughly 30 bps tighter than pre-crisis levels.<sup>6</sup> A potential loosening of regulatory constraints could curtail

U.S. bank buying since banks have been net purchasers primarily as a function of capital requirement needs. The stronger dollar currently makes nearly all U.S. assets less compelling to foreign investors, thus foreign buying of agency MBS could wane. Money manager market share of the agency MBS market has shrunk from 40 percent to 20 percent since the Fed began their purchase program, at least in part as a result of the tighter spreads.<sup>7</sup> We expect agency MBS spreads to need to widen about 20 to 30 bps for the broader money management community to increase their agency MBS positions enough to absorb the declining Fed MBS positions.

On the positive side, while MBS spreads may remain tight, yields are higher than they were at the beginning of 2016 due to higher rates and the extended duration. Another positive for agency MBS is the liquidity component. The \$5.5 trillion agency MBS market is among the most liquid markets in the world, with average daily trading volumes of over \$200 billion and very tight bid/ask spreads.<sup>8</sup> Even in the depths of the financial crisis and throughout other liquidity-challenged times, agency MBS have proven their liquidity value. With volatility expected to increase in 2017, this liquidity could prove to be very valuable. We also like some interest-only MBS securities, which should outperform if interest rates continue to rise and prepayments slow but, in general, this sector is currently fairly valued in our opinion, given recent demand for protection from higher rates. Overall, we are underweight agency MBS from a value perspective.

U.S. non-agency RMBS continue to offer compelling value, given their attractive yields, improving housing market conditions and declining non-agency RMBS supply. Although non-agency RMBS spreads are slightly tighter on the year, they still remain attractive relative

<sup>4</sup> Source: S&P Case-Shiller U.S. National Home Price Index. Data as of December 31, 2016.

<sup>5</sup> Source: Nomura. Data as of December 31, 2016.

<sup>6</sup> Source: Yield Book. Data as of December 31, 2016.

<sup>7</sup> Source: Nomura. Data as of December 31, 2016.

<sup>8</sup> Source: SIFMA. as of December 31, 2016.

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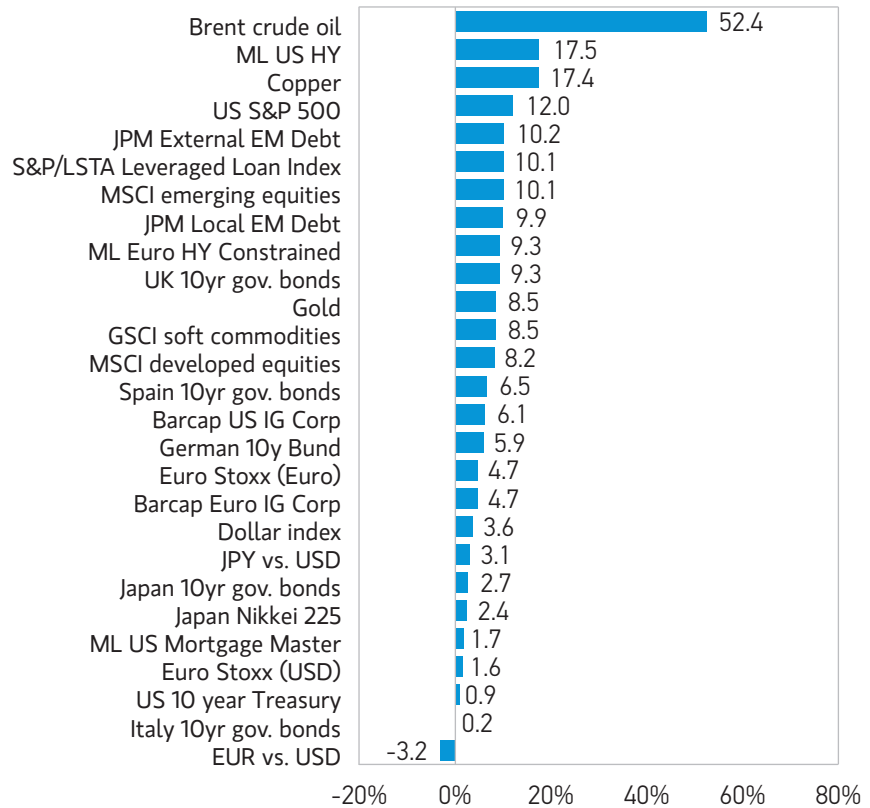
to similar risk asset classes, and the risks within the non-agency mortgage market appear to be declining. Mortgage delinquency and default rates continue to decline.<sup>9</sup> Additionally, prepayment speeds are accelerating as most home prices are no longer below their original value and as borrowers are more easily able to refinance. We believe that the improving cash flow dynamics of faster prepayments on predominantly discount-priced securities and reduced expected losses should continue to drive non-agency RMBS valuations higher in 2017. Finally, if demand remains steady or improves, given the positive fundamental outlook, prices could also move higher to reflect the shrinking supply, which continues to shrink at roughly 5 percent to 10 percent per year.<sup>10</sup> Thus, we remain overweight U.S. non-agency RMBS.

U.S. CMBS offers the conundrum of being among the highest yielding, securitized asset classes, but also the sector with perhaps the greatest risks. AAA-rated CMBS performed well in 2016, tightening roughly 25 bps, and currently offering “fair value”. BBB-rated CMBS spreads widened 50-100 bps over the course of 2016 and are nearly 200 bps wider over the past two years.<sup>11</sup> Commercial real estate valuations are at historic highs, roughly 25 percent higher than pre-crisis levels (for comparison, U.S. residential real estate prices have just returned to pre-crisis levels.<sup>12</sup> Fundamental conditions are running at near peak levels across all commercial real estate sectors, with record high-occupancy rates for hotels, office space and multi-family housing.<sup>13</sup>

The risk to the CMBS market is that these goldilocks conditions weaken and valuations readjust to more historically normal levels. We expect commercial real estate valuations to decline in 2017 as a function of higher interest rates and the

#### DISPLAY 1 Asset Performance in 2016

Returns through 1/3/2017



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of December 30, 2016. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See page 18 for index definitions.

stronger dollar reducing foreign buying. We also have concerns over retail shopping centers, given the recent weakness of many anchor tenants and the demographic shift to more online shopping. Financing for real estate purchases could also become more challenging in 2017, as new risk retention requirements for securitizations could restrict some lending. Given our concerns over potential property price declines in 2017, we favor seasoned, post-crisis CMBS (2012-2014 vintages), which have benefitted from recent property value appreciations

and are therefore less vulnerable to a potential retracing of property prices.

2017 CMBS issuance could also represent a challenge for the CMBS market in 2017. \$100+ billion of CMBS loans will be reaching their scheduled maturity in 2017 and will need to be refinanced.<sup>14</sup> The good news on the supply front is that supply is expected to drop sharply toward the end of 2017 and into 2018, as very few loans were originated in late 2007 and 2008 as the financial crisis escalated. Overall, we

<sup>9</sup> Source: S&P/Experian First Mortgage Default Index. Data as of December 31, 2016.

<sup>10</sup> Source: SIFMA. Data as of December 31, 2016.

<sup>11</sup> Source: Bank of America. Data as of December 31, 2016.

<sup>12</sup> Source: Green Street. Data as of December 31, 2016.

<sup>13</sup> Source: CBRE. Data as of December 31, 2016.

<sup>14</sup> Source: Bloomberg. Data as of December 31, 2016.

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**DISPLAY 2****Government Bond Yields for Major Economies for 2016**

COUNTRY	2YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	5YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)
Australia	1.83	-19	2.33	8	2.77	-12
Belgium	-0.67	-34	-0.40	-43	0.53	-44
Canada	0.75	27	1.11	38	1.72	33
Denmark	-0.54	-23	-0.27	-60	0.33	-64
France	-0.66	-35	-0.12	-21	0.69	-30
Germany	-0.77	-42	-0.53	-49	0.21	-42
Ireland	-0.66	-531	-0.12	-57	0.75	-40
Italy	-0.18	-15	0.60	10	1.82	22
Japan	-0.18	-17	-0.11	-14	0.05	-22
Netherlands	-0.74	-36	-0.37	-33	0.36	-44
New Zealand	2.26	-51	2.68	-32	3.33	-24
Norway	0.59	-354	0.74	-381	1.65	17
Portugal	0.04	-6	1.87	80	3.76	125
Spain	-0.28	-28	0.27	-41	1.38	-39
Sweden	-0.62	-18	-0.11	-42	0.56	-45
Switzerland	-0.96	-17	-0.67	-7	-0.19	-13
United Kingdom	0.08	-57	0.49	-86	1.24	-72
United States	1.19	14	1.93	17	2.44	17

Source: Bloomberg LP. Data as of December 30, 2016.

find CMBS spreads/yields to be attractive, but recommend careful security selection and moderate CMBS exposure. In terms of specific CMBS subsectors, we still like residential-related sectors like single-family rental and multi-family housing. We also like large, single-asset deals, and seasoned conduit deals. However, we remain cautious on shopping centers, given weakness in the brick-and-mortar retail sectors, and are cautious on recent-origination hotels, given sharp increases in valuations over the past few years.

In U.S. ABS, we continue to find minimal value in traditional credit card and auto ABS at current spread levels, but we continue to see opportunities in more esoteric ABS, such as aircraft, subprime auto and servicer advances securitizations. We remain cautious on student loans and non-collateralized consumer loans.

In the European securitized markets, we continue to see attractive opportunities in U.K., Spanish, Portuguese and Greek RMBS backed by seasoned pre-crisis

loans. Low mortgage rates are having a positive effect on home prices in these countries, and these now nearly 10-year seasoned loans have proven their credit worthiness with the borrowers having made consistent payments through more difficult economic times. Core European RMBS remain very expensive as the ECB continues to purchase these securities and push spreads tighter. European CMBS remains more challenging to source attractive opportunities as new issuance has been extremely constrained. More restrictive European regulations and capital requirements have made securitization a less efficient funding vehicle and thus dramatically reduced new issuance. Existing CMBS deals continue to perform well as part of the broader European real estate recovery, but sourcing new investment opportunities remains challenging.

**Market Summary: 2016 Review**

Over 2016, in core developed markets, yields decreased dramatically in the first three quarters, driven by more bearish economic outlooks, central bank easing and risk events.<sup>15</sup> However, yields were jolted up in the fourth quarter as these drivers diminished. The dollar made a similar U-turn, ending the year slightly higher than the beginning of the year.

Over the year, 10-year U.S. Treasury yields rose 17 bps, ending the year at 2.44 percent. The 2s/10s curve steepened 3 bps.<sup>16</sup> Dovish ECB policy led rates in euro area core countries to decrease, especially in the short-end. Germany's 10-year yield decreased 42 bps, ending at 0.21 percent, while the two-year yield decreased 42 bps as well.<sup>17</sup> Two-year German yields are now -0.77 percent, France is at -0.66 percent. Japanese government bond 10-year yield decreased by 22 bps.<sup>18</sup>

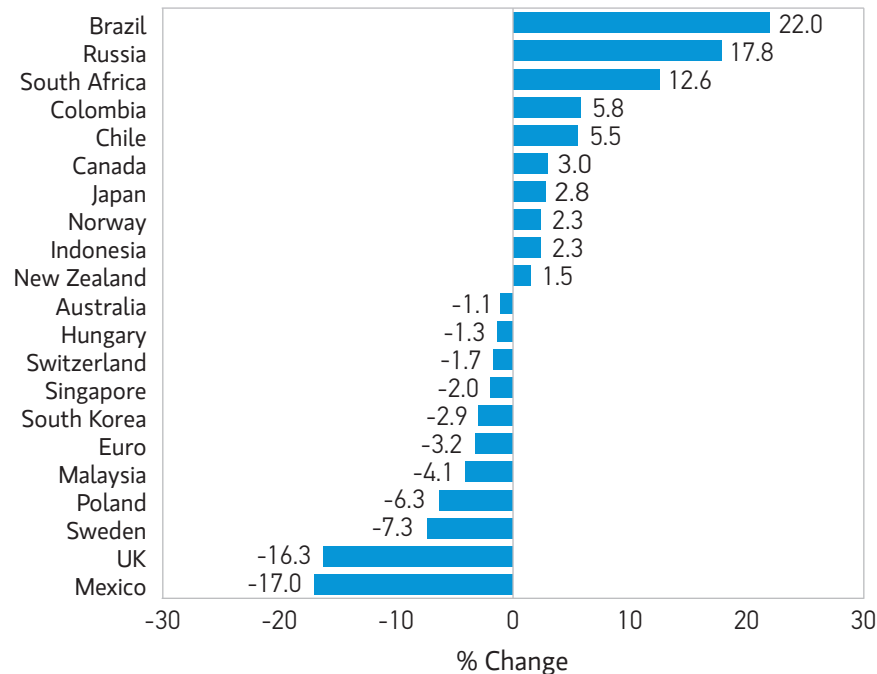
<sup>15</sup> Source: Bloomberg. Data as of December 30, 2016.<sup>17</sup> Source: Bloomberg. Data as of December 30, 2016.<sup>16</sup> Source: Bloomberg. Data as of December 30, 2016.<sup>18</sup> Source: Bloomberg. Data as of December 30, 2016.

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**DISPLAY 3****2016 Annual Changes Versus U.S. Dollar**

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of December 31, 2016. Note: Positive change means appreciation of the currency against the U.S. dollar.

Political risks drove the performance of Eurozone periphery bonds. 10-year yields in Spain decreased 39 bps as political risks subsided with the formation of a center-right government, breaking the deadlock after elections.<sup>19</sup> Greece's 10-year government yields decreased by 118 bps, as Greece cooperated with European institutions in passing structural reforms, increasing its odds of debt relief.<sup>20</sup> On the flip side, Italy yields increased 22 bps as political risks increased following the failed constitutional referendum and the resignation of Prime Minister Matteo Renzi. Portugal yields increased 125 bps, driven by perceptions of political and fiscal risks with the entry of leftist parties into the ruling coalition.

The dollar declined in the first half of the year as chances of Fed hikes in 2016 declined, but recovered in the second half. The trade-weighted dollar reached a new multi-year peak in December, following hawkish comments at the FOMC meeting. The euro depreciated by 3.2 percent, while the Japanese yen appreciated by 2.8 percent.<sup>21</sup> The British pound was one of the biggest losers following the Brexit vote, decreasing by 16.3 percent.<sup>22</sup> Commodity-linked currencies were the main winners versus the dollar in the year as commodities prices rebounded. Brent crude oil prices rose from \$37 to \$57, leading the Russian ruble to gain 17.8 percent.<sup>23</sup> Many currencies with the biggest gain, such as Brazil, Russia and

South Africa, had suffered the largest declines in 2015. The biggest loser was the Mexican peso, which declined 17 percent as Trump's election sparked fears of protectionist reprisal.<sup>24</sup>

**Developed Markets: 2016 Review**

The more things change, the more they stay the same. On the surface, the end of 2016 looks very similar to the end of 2015—U.S. Treasury yield at around 2.3 percent, markets pricing in 2-3 Fed hikes for the next year, oil prices around \$40 to \$50, with stock market slightly higher and investment-grade credit spreads tighter.<sup>25</sup> But this masks the extraordinary swings seen last year—in markets, economic policy and politics.

First, 2016 was a year of market pessimism and euphoria. Tightening financial conditions throughout late 2015 caused activity to decelerate in the beginning of 2016. On top of that, a hawkish Fed hiking path (as revealed through the Fed "dots") and a strong U.S. dollar put fears of global recession. Looking back, spread widening in high yield, driven by steep declines in one sector (energy), was perhaps misread by markets as general stress within the entire credit market, even the entire economy. Nevertheless, by February, markets had done much of the tightening before the Fed could.

The Fed then grew more dovish, bringing down projected rate hikes for 2016. In addition, many central banks elsewhere stepped up easing efforts in the first quarter. Concerted global easing worked: spreads declined, the U.S. dollar depreciated, Chinese devaluation fears subsided and oil prices troughed. This easing of financial conditions paved the way for an increase in activity globally in the second half of 2016. Even the U.K. bucked negative forecasts surrounding Brexit, since immediate monetary easing

<sup>19</sup> Source: Bloomberg. Data as of December 30, 2016.

<sup>20</sup> Source: Bloomberg. Data as of December 31, 2016.

<sup>21</sup> Source: Bloomberg. Data as of December 31, 2016.

<sup>22</sup> Source: Bloomberg. Data as of December 31, 2016.

<sup>23</sup> Source: Bloomberg. Data as of December 31, 2016.

<sup>24</sup> Source: Bloomberg. Data as of December 31, 2016.

<sup>25</sup> Source: Bloomberg. Data as of December 30, 2016.

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in its aftermath served to prop up activity, while more negative dynamics take longer to play out.

Excessive market bearishness set the stage for a big market rebound. February turned out to be a great buying opportunity for risky assets. The worst assets of 2015 became the best performing in 2016—energy-sensitive high yield, local EM. A strong dollar had increased financial stress on EM countries, which had significant dollar liabilities. Many were also commodity exporters, the prices of which were inversely related to the dollar. As dollar strength subsided, investors scrambled to catch up to the rally. However, even as risky assets shrugged off the multiple adverse shocks of 2016, the one asset class that did not were risk-free yields, which continued to grind lower. Central bank easing had pushed down term premium on risk-free rates, pushing yields lower than what fundamentals would suggest.

Market swings were caused by big swings in policy, moving from monetary policy dominance to fiscal policy. The Shanghai G20 meeting was the first marker of this change for the markets, where monetary policymakers tacitly ended competitive devaluation as an easing tool. This opened the door to questions about monetary policy efficacy, leading central banks to back off from extensions of unconventional monetary policy. The Fed Jackson Hole conference in late August drove the message home. At the meeting, policymakers intimated that flatter yield curves, driven by expectation of monetary easing, may be counterproductive. This set the stage for term premium normalization in risk-free rates during the last quarter of the year. Japan, arguably the country with most entrenched stagnation and, therefore, always the leader in monetary policy, introduced yield curve control in September instead of taking rates more negative. Since Japanese government yields now had an effective floor, yields in the rest of the world rebounded.

With retrenching monetary policy, the baton passed to fiscal expansion. In many instances, central bankers have urged this shift—Mario Draghi, President of the ECB, underscored the need for structural reform in the euro area, and Chairwoman Janet Yellen noted declining productivity and neutral rate within the U.S. Norway and Canada, hit by declining oil prices, were the first to start deficit spending. Japan and the U.K. followed in the fall. Attention shifted from monetary policymakers to central governments. Then, in November, the spotlight was cast onto the U.S., with the election of Donald Trump, who is promising a big fiscal stimulus in the form of tax cuts and infrastructure spending.

Fiscal policy allowed central bankers to pause in easing. The Fed delivered a much anticipated rate hike in December, followed by a hawkish projection for future fed hikes that surprised markets. 2017 hike projection rose from two hikes to three hikes. Chairwoman Yellen explained that committee members may have included expectations of fiscal policy.

Finally, political risk came to the forefront in 2016 and produced some of the biggest surprises of the year. Brexit, Trump election, but also political deadlock in Spain after multiple elections, the collapse of Renzi's government in Italy, wins in German state elections for the alternative right party. 2016 showed that developed market countries, even those assumed to have the strongest political institutions, are not immune to populist risk. Years of slow growth had spawned social dissatisfaction, which manifested in voting for “alternative” candidates, parties or causes. Moreover, political shock events this year have been very difficult to price. Except for assets directly affected by Brexit and Trump (such as the pound and Mexican peso), most risky assets have shrugged off political risk for now, contrary to investor expectations. Markets, and indeed most of the established observers, found it hard to read political trends, a phenomenon that could continue into 2017.

On the political and policy front, investors had to reassess many of their existing assumptions during 2016. However, the year also provided many opportunities for those who withstood the volatility.

## Emerging Markets: 2016 Review

EM fixed income assets traveled a bumpy road to reach high single-digit, low double-digit returns in 2016. EM was in the center of the turmoil to start the year, which was fueled by concerns over capital flight from China and continued weakness in global growth and commodity prices. Sentiment improved heading into February as a rebound was built on a mixture of attractive valuations and investor positioning, combined with strengthening commodity prices, an improving EM growth profile, an easing of China fears, as well as a weakening of the U.S. dollar and generally accommodative central bank policies. Investment flows into the asset class were driven by both pull factors, such as political and economic improvement within EM, as well as push factors, such as attractive relative valuations and investors fleeing the negative real yields offered by many global government bonds. These flows contributed to the favorable backdrop which provided an entry for new and returning issuers including Saudi Arabia, Oman and Argentina. The rise in developed market populism generated ballot surprises with implications for EM. The victory of Trump triggered a rotation to equities from bonds, and from emerging to U.S. markets, as the market became excited about the potential for stimulative policies and resulting higher growth and inflation. The populist surge in the U.S. and Western Europe was, for the most part, not mirrored in EM, which benefited from reform-minded leaders in India, Indonesia, Argentina and Brazil. Assets from these reform story countries, as well as those from energy exporting nations, led the rally for EM fixed income in 2016.

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**DISPLAY 4****EM External and Local Spread Changes**

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	330	-218	11.1	-493
Colombia	225	-92	6.9	-133
Hungary	168	-12	1.9	-87
Indonesia	237	-92	8.0	-89
Malaysia	197	-33	4.2	18
Mexico	296	-19	7.5	130
Peru	170	-70	6.5	-89
Philippines	110	-14	5.5	20
Poland	110	8	3.0	65
Russia	186	-104	8.2	-137
South Africa	276	-136	9.3	-68
Turkey	360	72	10.9	28
Venezuela	2168	-639	–	–

Source: JP Morgan. Data as of December 30, 2016.

There was a changing of the guard in many EM countries as the Philippines elected outspoken President Rodrigo Duterte, President Dilma Rousseff of Brazil was impeached and replaced by Vice President Michel Temer, Thailand's ruler of 70 years, King Bhumibol, passed away, and South Korea's President Park Geun-hye was impeached. EM credit ratings were under pressure during the year. Initially, energy-related countries and companies went through a round of downgrades as agencies adjusted their ratings to reflect the new revenue outlook, before attention was turned to politically driven issues in Brazil, Turkey and South Africa. Brazil completed its seven-year ratings roundtrip after Moody's stripped the country of its final investment-grade rating, while policymakers were distracted by the far-reaching corruption investigation, Lavo Jato, which continued to claim political and business leaders, including President Dilma Rousseff. Vice

President Michel Temer was elevated to acting president and made a strong start toward economic reforms despite popular protests and continued pressure from Lavo Jato-related allegations against his administration. An unsuccessful coup in Turkey provided President Recep Tayyip Erdogan an opportunity to consolidate power under an extended state of emergency. Turkey's weakened institutional strength, coupled with sluggish economic growth and external funding requirements, contributed to the loss of its investment-grade rating. In contrast, South Africa managed to maintain its investment-grade status through the end of the year despite political infighting involving President Jacob Zuma. In more positive news, Hungary's foreign currency credit rating was upgraded to investment grade on the back of stronger-than-expected economic performance and fiscal rectitude, which reduced external vulnerabilities. In

Colombia, the government ratified a peace deal with FARC rebels, which ended the 52-year civil war and provided President Santos the political capital necessary to enact fiscal reforms to solidify Colombia's investment-grade credit rating.

**Corporate Credit: 2016 Review**

Investment-grade and high-yield markets experienced volatility intra-year, but spreads performed well during 2016. This was partly helped by strong technicals that mitigated any spread widening throughout the period. The underperformance in January/February was driven by concerns that weak global aggregate demand, reflected by lower Chinese growth expectations, would lead to a continued fall in commodity prices and higher default rates. European credit spreads peaked at 167 bps on 11 February, which aligned closely with the trough in spot WTI prices. Oil prices had a bearing for credit in 2016, as the rise in defaults was primarily driven by oil and commodity companies in the U.S.

The subsequent rally was driven by global central banks responding with easy monetary policy that provided liquidity to the market, reducing expectations for defaults. In many cases, they created demand for credit assets. For example, the Peoples Bank of China (PBoC) increased liquidity in the market via social financing, the European Central Bank (ECB) increased their support for markets with the announcement that they would start purchasing corporate securities (CSPP).

Politics was a key driver of credit in 2016. In Europe, the surprise Brexit vote in June, where a lack of confidence in incumbent politicians highlighted the risk of popular politics changing the political landscape, resulted in a short-lived sell-off in risk markets. However, the central bank response of quantitative easing (QE) in Europe and a rate cut in the U.K. led to markets concluding this was not a systemic event causing spread to rally. In

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Q4, the U.S. election surprised, with a Trump victory that was initially perceived as negative for risk assets, but equities and U.S. credit quickly reversed and rallied as the market viewed his policy mix as pro-growth. In contrast, European credit underperformed as concerns over the result of the Italian referendum on senate reform reduced ECB QE cutting monthly purchases from EUR 80 billion to EUR 60 billion from April 2017, and perceived weakness in German and Italian banks drove sentiment.

U.S. investment-grade market ended the year at 123 bps, 42 bps tighter than where we started the year. Cyclicalities dominated price action in U.S. investment-grade credit in 2016, as higher beta credit outperformed lower beta, commodity-sensitive sectors outperformed, and credit curves flattened. BBB-rated credit outperformed the broader market, tightening 66 bps during 2016, while A-rated credit tightened 24 bps.<sup>26</sup> Longer-duration credit outperformed shorter-duration during the year. From a sector perspective, energy and materials outperformed as commodity prices rebounded from lows in mid-February. In contrast, consumer staples, financials and health care lagged the rally, but still ended the year tighter.

The new issue market remained robust throughout 2016, as new issue supply volume hit \$1,289 billion, up 2 percent from 2015 issuance.<sup>27</sup> With the exception of the volatile first two months performance of high-grade, new issue supply was strong in 2016, and primary market performance was positive. Following the v-shaped recovery in 1Q16, issuance remained robust through the rest of 2016. The pace of issuance, however, slowed, and the performance of new issues was mixed by the end of 4Q16, given record-setting issuance pace. As we saw in the secondary market, overseas

#### DISPLAY 5 Credit Sector Changes: 2016

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	123	-42	123	-11
Industrial Basic Industry	165	-147	112	-181
Industrial Capital Goods	98	-22	96	-17
Industrial Consumer Cyclical	115	-26	114	-18
Industrial Consumer Non Cyclical	110	-19	102	-7
Industrial Energy	148	-162	122	-31
Industrial Technology	103	-34	81	-8
Industrial Transportation	112	-38	106	-6
Industrial Communications	153	-40	124	-9
Industrial Other	114	-11	162	+7
Utility Electric	115	-34	120	-17
Utility Natural Gas	127	-30	114	-9
Utility Other	142	-24	99	-15
Financial Inst. Banking	114	-9	120	+10
Financial Inst. Brokerage	137	-19	124	-1
Financial Inst. Finance Companies	143	-15	99	+1
Financial Inst. Insurance	130	-28	257	+2
Financial Inst. REITS	145	-24	141	-22
Financial Inst. Other	168	+44	164	+0

Source: Bloomberg Barclays. Data as of December 30, 2016. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

investor participation supported primary markets throughout the year, and mitigated much of the periodic spread widening throughout the year.

The U.S. high-yield bond market took investors on one of the biggest roller coaster rides of the year. Beginning the year with one of the worst starts ever to a quarter, the U.S. high-yield market reached a low of -5.15 percent

on February 11 only to end 2016 with a return of 17.13 percent, the best performance for the asset class since 2009's record of 58.2 percent.<sup>28</sup> The market's strong overall performance in 2016 was driven by lower-tier credits and by the recovery in commodities. CCCs returned 31.46 percent, while Bs and BBs returned 15.81 percent and 12.78 percent, respectively. Despite enduring a rocky start to the year, high-yield energy credits

<sup>26</sup> Source: Bloomberg Barclays. Data as of December 31, 2016.

<sup>27</sup> Source: BAML. Data as of December 31, 2016.

<sup>28</sup> Source: Bloomberg Barclays. Data as of December 31, 2016.

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led the rally in higher beta, producing year-to-date returns of 32 percent.<sup>29</sup>

In 2016, high-yield new issuance totaled \$280 billion, which represented a modest decline from last year's \$293 billion.<sup>30</sup> While default activity was elevated in 2016, it was once again concentrated in the energy and metals and mining sectors, and more than half of the year's default volume occurred in the first quarter.<sup>31</sup> The commodity sectors alone accounted for nearly 70 percent of the year's total default volume.<sup>32</sup>

Similarly in European credit, spreads widened in the first quarter and over Brexit, but subsequently rallied to end the year tighter, generating positive excess returns in both IG and high yield. Investment-grade credit spreads were 9 bps tighter in the year closing at +124 bps, while high-yield spreads tightened 132 bps closing at +388 bps, reflecting the outperformance of lower-rated credit.

Within the European investment-grade and high-yield space, non-financials outperformed financials in 2016. Basic materials and energy, which had been weak in Q4 2015, rebounded in line with commodity prices. Industrials benefited from the technical demand created by the ECB's corporate bond purchase program (CSPP), which outweighed the risks of increased M&A. Financials, in contrast, underperformed in Q1, reflective of concerns that higher default rates and low/negative rates would lead to weaker profitability, with subordinated bonds most impacted.

Total supply in 2016 was broadly in line with expectation. Industrial net issuance was EUR 149 billion (gross: EUR 249 billion) as opposed to financial net issuance at EUR 6 billion (gross: EUR 245 billion), with maturities targeted

at the longer end, allowing corporate treasurers to lock in low yields. Demand, in contrast, was strong for shorter maturities with positive yields as a substitute for negative bank deposit rates.

### Securitized Products: 2016 Review

We began 2016 with a strong pro-credit bias and concerns over more interest rate-sensitive agency mortgage-backed securities (MBS) in a potential Fed-tightening and rising-rate market environment. This investment thesis was eventually proven, but only after a very challenging start to the year, similar to other asset classes. 2016 can be most easily summarized as four very distinct quarters, each with its own narrative and market impacts.

First-quarter 2016 was all about credit distress and challenging liquidity as equity indexes were down 10-plus percent intra-quarter, oil prices fell 20 percent to multi-year lows, U.S. Treasury rates fell 50-plus bps, credit spreads widened across nearly all fixed income asset classes, and market discussions revolved around a possible recession and growing liquidity concerns in the new regulatory environment.<sup>33</sup> The impact to the securitized market was a flight-to-quality with government-guaranteed agency MBS performing very well and mortgage credit spreads widening sharply. Additionally, BBB-rated CMBS and AAA-rated CMBS spreads widened 200-plus bps and 50 bps, respectively,<sup>34</sup> and non-agency RMBS spreads widened 50-100 bps during the quarter.<sup>35</sup>

Second-quarter 2016 began with the rates market stabilizing and securitized credit spreads partially recovering, but then Brexit came along and U.S. Treasury rates rallied to historic low levels and credit spreads again widened sharply.

Trading volumes were relatively light this time around, as most of the distressed selling took place in the first quarter, but mark-to-market impacts were still challenging. Among securitized sectors, U.K. and broader European RMBS were the most significantly affected, but U.S. RMBS and CMBS also saw further spread widening.

Third-quarter 2016 was the sea of tranquility. The absence of any bad news during the quarter allowed for a period of low volatility and significant credit spread tightening. With the exception of BBB-rated CMBS, nearly all securitized credit spreads ended the quarter tighter, reversing the effects of the first two quarters plus some. Agency RMBS continued to perform well with spreads at the tightest levels of the year, given that rates were now meaningfully off the lows of the years, and rates volatility was relatively low during the quarter.

Fourth-quarter 2016 reintroduced the risks of higher rates and the negative convexity of mortgages causing agency MBS to underperform. As rates sold off after the election, the duration of the Bloomberg Barclays U.S. Mortgage Index extended from 3.1 years to 4.8 years.<sup>36</sup> Duration extension risk (negative convexity) had largely been ignored in the agency MBS market for much of 2016, but was hit with full force in the fourth quarter causing agency MBS to underperform. However, credit-related MBS performed well, buoyed by expectations of improved U.S. economic growth and higher rates, which allowed spreads to tighten while still offering higher yields.

For 2016 in its entirety, credit-oriented MBS performed well and rates-sensitive mortgage sectors underperformed. The

<sup>29</sup> Source: Bloomberg Barclays. Data as of December 31, 2016.

<sup>30</sup> Source: JPMorgan. Data as of December 31, 2016.

<sup>31</sup> Source: JPMorgan. Data as of December 31, 2016.

<sup>32</sup> Source: JPMorgan. Data as of December 31, 2016.

<sup>33</sup> Source: Bloomberg. Data as of March 31, 2016.

<sup>34</sup> Source: Bank of America. Data as of March 31, 2016.

<sup>35</sup> Source: Amherst Securities. Data as of March 31, 2016.

<sup>36</sup> Source: Bloomberg Barclays. Data as of December 31, 2016.

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best performing credit sectors were non-agency RMBS (especially agency credit risk transfer securities) and residential-related CMBS (particularly multifamily and single-family rentals). Agency MBS generally performed the worst in 2016, with the exception of interest-only agency MBS, which benefited from the higher rates and the resulting slower-than-projected prepayment speeds. Rough performance numbers by sector in 2016 (return performance reflects MSIM investments from a representative portfolio, and not the broader market returns) are listed below:

#### DISPLAY 6 Securitized Sector Returns in 2016

SECURITIZED SECTOR	2016 RETURN
U.S. Agency RMBS—Pass-Throughs	1.5%
U.S. Agency RMBS—CMOs	7.7%
U.S. Non-Agency RMBS	6.8%
U.S. CMBS	5.4%
U.S. ABS	4.9%
European RMBS	5.2%
European CMBS	5.9%

The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See 15 and 16 for index definitions.

Source: MSIM. Data as of December 30, 2016. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

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There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline. Accordingly, you can lose money investing in a fixed income portfolio. Please be aware that a fixed income portfolio may be subject to certain additional risks.

**Fixed income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. Longer-term securities may be more sensitive to interest rate changes. In a declining interest rate environment, the portfolio may generate less income.

Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future.

**Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities.

**High-yield securities ("junk bonds")** are lower-rated securities that may have a higher degree of credit and liquidity risk.

**Sovereign debt securities** are subject to default risk.

**Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks.

The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates.

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Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging markets** countries are greater than the risks generally associated with foreign investments.

**Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks.

**Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations** (CMOs), it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

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#### INDEX DEFINITIONS

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

The **National Association of Realtors Home Affordability Index** compares the median income to the cost of the median home.

**Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector.

**Consumer Price Index (CPI)** is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

The **JP Morgan Emerging Markets Bond Index Global (EMBI Global)** tracks total returns for traded external debt instruments in the emerging markets and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans and eurobonds with an outstanding face value of at least \$500 million.

The **JP Morgan CEMBI Broad Diversified Index** is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

The **JP Morgan GBI-EM Global Diversified Index** is a market capitalization weighted, liquid global benchmark for U.S.-dollar corporate emerging markets bonds representing Asia, Latin America, Europe and the Middle East/Africa.

The **ISM Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The **Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index** tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. Introduced in 1985, the GNMA, FHLMC and FNMA fixed-rate indexes for 30- and 15-year securities were backdated to January 1976, May 1977 and November 1982, respectively. In April 2007, agency hybrid adjustable-rate mortgage (ARM) pass-through securities were added to the index.

The **Nikkei 225 Index (Japan Nikkei 225)** is a price-weighted index of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The **U.S. Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. **Italy 10-Year Government Bonds**—Italy Benchmark 10-Year Datastream Government Index. The **MSCI World Index (MSCI developed equities)** captures large- and mid-cap representation across 23 Developed Markets (DM) countries. **Spain 10-Year Government Bonds**—Spain Benchmark 10-Year Datastream Government Index. The **BofA Merrill Lynch European Currency High-Yield Constrained Index (ML Euro HY constrained)** is designed to track the performance of euro- and British pound sterling-denominated below investment-grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world. The **S&P 500® Index (U.S. S&P 500)** measures the performance of the large-cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy. The **JPMorgan Government Bond Index Emerging Markets (JPM External EM Debt)** tracks local currency bonds issued by Emerging Markets governments. The index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (excludes China and India as of September 2013). **UK 10-Year Government Bonds**—U.K. Benchmark 10-Year Datastream Government Index. For the following Datastream government bond indexes, benchmark indexes are based on single bonds. The bond chosen for each series is the most representative bond available for the given maturity band at each point in time. Benchmarks are selected according to the accepted conventions within each market. Generally, the benchmark bond is the latest issue within the given maturity band; consideration is also given to yield, liquidity, issue size and coupon. **German 10-Year Bonds**—Germany Benchmark 10-Year Datastream Government Index; **Japan 10-Year Government Bonds**—Japan Benchmark 10-Year Datastream Government Index; and **10-Year U.S. Treasury**—U.S. Benchmark 10-Year Datastream Government Index.

The **BofA Merrill Lynch U.S. Mortgage-Backed Securities (ML U.S. Mortgage Master) Index** tracks the performance of U.S. dollar-denominated fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The **S&P/LSTA U.S. Leveraged Loan 100 Index (S&P/LSTA Leveraged Loan Index)** is designed to reflect the performance of the largest facilities in the leveraged loan market. The **Bloomberg Barclays Euro Aggregate Corporate Index (Barclays Euro IG Corporate)** is an index designed to reflect the performance of the euro-denominated investment-grade corporate bond market. The **Bloomberg Barclays U.S. Corporate Index (Barclays U.S. IG Corp)** is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable, corporate bond market. The **Bank of America Merrill Lynch United States High Yield Master II Constrained Index**

The views and opinions expressed are those of the portfolio management team as of January 2017, and are subject to change based on market, economic, and other conditions. **Past performance is not indicative of future results.**

**(Merrill Lynch U.S. High Yield)** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default. **JPY vs. USD**—Japanese Yen Total Return versus USD. **Euro vs. USD**—Euro Total Return versus USD. **MSCI Emerging Markets Index (MSCI emerging equities)** captures large- and mid-cap representation across 23 Emerging Markets (EM) countries. The **MSCI AC Asia ex-Japan Index (MSCI Asia ex-Japan)** captures large- and mid-cap representation across two of three Developed Markets countries (excluding Japan) and eight Emerging Markets countries in Asia. The **S&P GSCI Softs (GSCI soft commodities) Index** is a subindex of the S&P GSCI that measures the performance of only the soft commodities, weighted on a world production basis. In 2012, the S&P GSCI Softs Index included the following commodities: coffee, sugar, cocoa and cotton. The **Dow Jones Commodity Index Gold (Gold)** is designed to track the gold market through futures contracts. The **JPMorgan Government Bond Index—Emerging Markets (JPM local EM debt)** tracks local currency bonds issued by Emerging Markets governments. The index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (excludes China and India as of September 2013). The ICE Brent Crude futures contract (**Brent crude oil**) is a deliverable contract based on EFP delivery with an option to cash settle. The **S&P GSCI Copper Index (Copper)**, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark for investment performance in the copper commodity market.

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