Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Central Banks Talk Normalization

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JULY 2017

Summary

While the first half of 2017 was about reflation, a unique aspect of the second half stems from central bank policies to remove accommodation, which is creating unknown risk factors. The U.S. Federal Reserve (Fed) remains above the U.S. Treasury market in terms of rate expectations. The primary reason for the divergence is that inflation has been declining. The success of these planned policy moves will mainly depend on how global economic and financial conditions evolve. Our base case is that the normalization process will be orderly, supporting risky assets. The main risk will be a policy error in China.

DEVELOPED MARKET (DM) RATE/FOREIGN CURRENCY (FX): Yields in DM rose in June, led by Europe. Germany 10-yr yields rose 16 basis points (bps), while the periphery spreads to bunds tightened as a result of good data and more hawkish European Central Bank (ECB) comments. In the U.S., the Fed raised rates by 25 bps at its June meeting.

We believe the ECB as well as the performance of bunds holds the key to performance across global treasury markets, with higher bunds leading the rest upward. In addition, higher U.S. Treasury yields will depend on higher U.S. inflation. If inflation improves, we believe that U.S. Treasury 10-year yields may end the year close to 2.60 percent.

EMERGING MARKET (EM) RATE/FX: EM fixed income asset returns were mixed in June with investment-grade assets outperforming high-yield, currencies weakening versus the U.S. dollar, and corporates outperforming sovereigns within dollar-denominated debt.

We believe that DM yields will continue to support the "right" carry opportunities. We think that (eventual) steeper DM yield curves warrant the shortening of duration exposures with a focus on attractive higher-yielding currencies/countries.

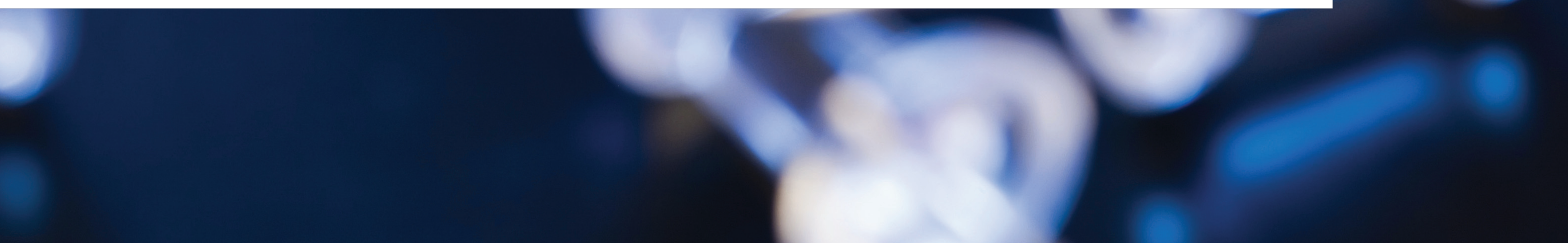
CREDIT: Investment-grade corporate spreads are now at the tightest level in nearly three years, returning to post-crisis lows of July 2014. In Europe, the restructuring of weak banks in Spain and Italy were viewed as positive, as they bailed in subordinated bondholders while protecting senior bondholders. Financials outperformed other sectors.

We are slightly more constructive on the U.S. market compared to the European market, mostly due to relative valuation. Given current valuations, we do not expect a drastic move tighter in spreads; however, spreads may continue to grind tighter if the current backdrop persists.

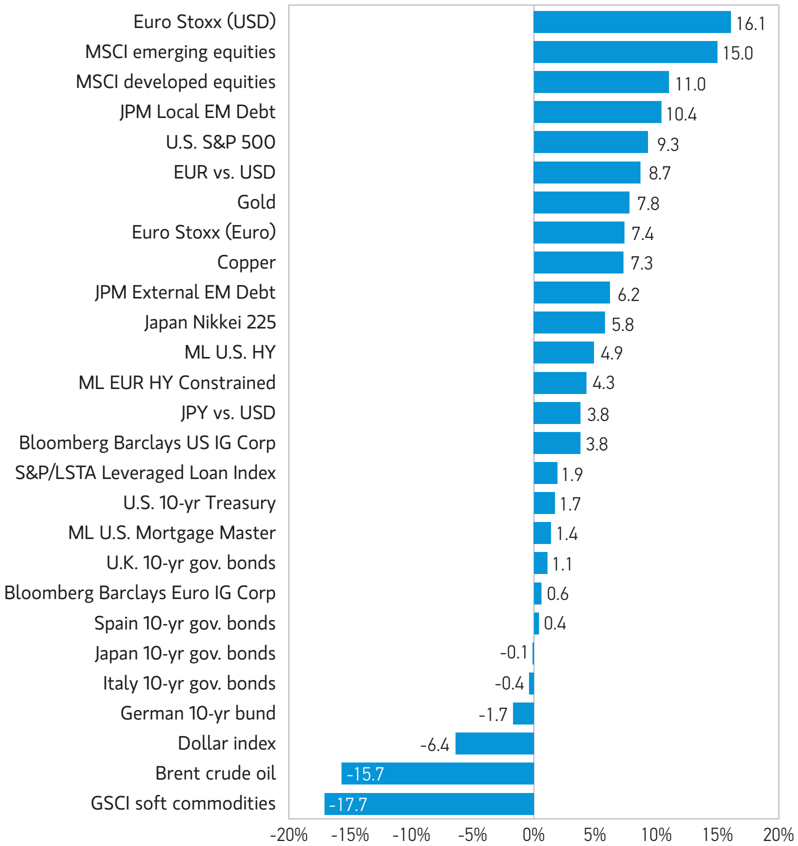
SECURITIZED: Agency mortgage-backed securities (MBS) had a mixed performance in June, positive relative to U.S. Treasuries but still negative on an absolute basis, while credit-related securitized assets saw continued gains from spread tightening and lower rates-oriented risk exposure.

The Fed is on pace to purchase over $300 billion agency MBS in 2017, and we believe that ending this reinvestment could have a significant negative impact on agency MBS. The increasing distress in the retail commercial mortgage-backed securities (CMBS) market represents both a significant risk and a significant opportunity. We believe that careful security selection can prove to be particularly beneficial in this market.

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



DISPLAY 1
Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of June 30, 2017. 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 pages 12 and 13 for index definitions.

DISPLAY 2
Major Monthly Changes in 10-Year Yields and Spreads

	RATES		CURRENCY
DM	**LEVEL**	**CHANGE (BPS)**	**CHANGE (%)**
United States	2.30	10	
United Kingdom	1.26	21	1.05
Germany	0.47	16	1.62
Japan	0.09	4	-1.43
EM Spreads			
EM External	327	5	
EM Local Yields	6		
EM Corporate	254	-4	
Credit Spreads			
U.S. IG	109	-4	
EUR IG	102	-7	
U.S. HY	364	1	
EUR HY	276	-14	
Securitized Spreads			
Agency MBS	15	1	
U.S. BBB CMBS	376	3	

Source: Bloomberg, JP Morgan. Data as of June 30, 2017.

Fixed Income Outlook

June could be a turning point in the market narrative. While the first half of the year was about reflation, looking forward, a unique aspect of the second half stems from central bank polices to remove accommodation, which is creating unknown risk factors. Data in the U.S. continued to cool in June, leading to the question of whether the economy had peaked. Nevertheless, these pockets of worries failed to seriously dent market confidence. June was another good month for risky assets, with the S&P 500 steadily climbing higher and credit spreads grinding lower.

The Fed and the treasury market have diverged greatly in terms of rate expectations. The Fed is forecasting another 25 bps hike by the end of the year, while the U.S. Treasury market only gives that about a 50 percent chance. This divergence grows as we move out to 2018 and beyond. For instance, the market is only pricing in one 25 bps rate hike by the Fed while the central bank is indicating three hikes. This will impact U.S. Treasury performance in 2H17.

The primary reason for the divergence is that inflation has been declining, core personal consumption expenditures inflation (PCE) is at 1.4 percent, well below the Fed's 2.0 percent target. We believe the market is too pessimistic about future inflation, as shown by pricing of breakevens, and could be underappreciating the odds that it could surprise to the upside. If inflation rises, U.S. Treasury yields will follow.

Furthermore, we've observed that global trends have been depressing 10-yr U.S. yields in 2017. Very easy monetary policy by the ECB and Bank of Japan (BoJ) worked to keep yields in these countries low, dragging down U.S. yields. This may be reversing as other central banks begin policy normalization. Though the U.S. data weakened recently, data elsewhere in the world remained strong. Europe continues to outperform, with improving Purchasing Manager's Index (PMI) and inflation in June. This has led to a more hawkish tilt in language from the ECB, which led bund yields to jump. In June, ECB hawkishness, rather than Fed tightening, was a bigger driver for higher U.S. yields.

The market awaits the timing of when the Fed will start reducing its balance sheet and if they will follow through with another rate hike. The Bank of England (BoE) is also at risk of increasing policy rates as there were several dissentions in the last Monetary Policy Committee (MPC) vote to keeps rates unchanged. There are also uncertainties over the BoJ's yield curve control policy to keep 10-year Japanese Government Bonds (JGBs) near zero bps. Finally, we will learn more about the ECBs plan to normalize policy rates and exit its asset purchase program. The significance of this is that 2H17 represents the first period since the crisis that major global central banks are making a coordinated move to end excessive policy accommodation.

In our base case, we assume that these events will proceed in an orderly fashion in 2H17. We neither expect inflation rates to spike nor do we believe bond yields will rise excessively, although they may still rise modestly. We largely believe that economic conditions globally will remain in what we refer to as a benign positive environment. As a result, we still see opportunities in carry strategies. Select EMs and overweight positions in EM FX both look attractive. China may slow further, which will keep bond yields in countries like Australia and New Zealand low and their currencies weak.

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The success and application of these policies moves will mainly depend on how global economic and financial conditions evolve. Clearly, it is more likely that the market will see an end of easy policies as long as data is robust. Outside of standard economic dynamics, it will be critical to observe if China will be able to reduce leverage and slow their economy in an orderly manner. Commodity prices will also be another key factor, oil prices in particular. However, much of the industry has rebalanced towards a lower oil regime, which increases their resilience in the face of another price decline.

The primary risk factor stems from China. If China slows its economy and delivers in a disorderly fashion, that will have great spillover effects around the global economy. Geopolitical risks in the Middle East and North Korea are ever present, but look seemingly contained from the perspective of the markets. A surprise move higher in inflation would cause yields and policy rate expectations to move higher. The risk would be that the low yield environment that has helped carry strategies' performances could be dismantled. These are not our base case events, but they do present a risk to our outlook.

DISPLAY 3

Government Bond Yields for Major Economies

COUNTRY	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR SPREAD (BPS)	MONTH CHANGE (BPS)	2S - 10S YIELD CURVE (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)			
United States	2.30	10			92	0
United Kingdom	1.26	21	-105	11	90	-2
Germany	0.47	16	-184	6	104	2
Japan	0.09	4	-222	-6	21	0
Australia	2.60	21	29	11	87	3
Canada	1.76	35	-54	25	66	-6
New Zealand	2.98	20	68	10	91	6
Europe			(Spread over Bunds)			
Belgium	0.80	14	34	-2	127	4
France	0.82	8	35	-8	119	-5
Germany	0.47	16			104	2
Greece	5.42	-67	496	-83	158	141
Ireland	0.90	12	43	-4	122	1
Italy	2.16	-4	169	-21	227	-10
Netherlands	0.66	14	19	-2	122	5
Portugal	3.03	-3	256	-20	289	10
Spain	1.54	-1	107	-18	180	-3
Denmark	0.67	10	20	-6	121	7
Norway	1.65	14	118	-2	103	10
Sweden	0.66	19	19	2	129	10
Switzerland	-0.02	15	-49	-2	78	4

Source: Bloomberg. Data as of June 30, 2017.

Developed Market

Monthly Review

Yields in DM rose in June, led by Europe. Over the month, 10-year U.S. Treasury yields were up 10 bps.[1] In the eurozone, Germany 10-year yields rose 16 bps, while the periphery spreads to bunds tightened as a result of good data and more hawkish ECB comments.[2] Canadian yields increased by 35 bps as the central bank gave indications it might normalize policy soon.[3]

The dollar generally weakened. On the back of rate hikes by the Fed, markets began to price in more chances of hikes in the dollar bloc, such as Canada, Australia and New Zealand. These currencies were the top gainers for the month. Oil fell to lows of around $42 mid-month, before recovering.[4] This led commodity currencies, such as the Russian ruble and Colombian peso, lower.

In the U.S., the Fed raised rates by 25 bps at its June meeting. The projection of the Fed Fund Rate, or the "dots," remained relatively unchanged from the last projection, with the terminal rate still at 3 percent. The committee also outlined the plan for balance sheet run-offs. Run-offs for U.S. Treasuries will start at $6 billion, increasing by 6 billion every three months until reaching $30 billion. Runoffs for mortgage securities will start at $4 billion, and increase by 4 billion every three months until reaching $20 billion. The exactness of the plan was a hawkish surprise to the market. However, securities in the Fed's balance

[1] Source: Bloomberg. Data as of June 30, 2017.
[2] Source: Bloomberg. Data as of June 30, 2017.
[3] Source: Bloomberg. Data as of June 30, 2017.
[4] Source: Bloomberg. Data as of June 30, 2017.

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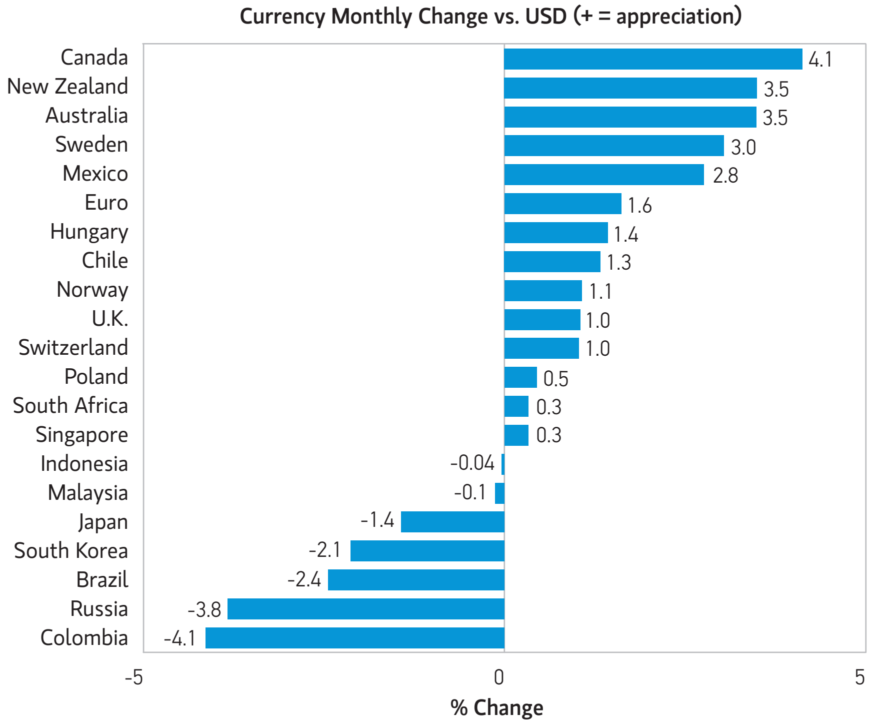
DISPLAY 4
Currency Monthly Changes Versus U.S. Dollar



Source: Bloomberg. Data as of June 30, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

sheet that mature next year should be less than the run-offs allowed by the Fed. In addition, the Fed looked through the weak inflation print on the month, which saw core consumer price index inflation (CPI) hit 1.7 percent, decreasing from 1.9 percent previously. Fed Chair Janet Yellen believed that weak core inflation was mainly driven by idiosyncratic price pressure, such as in health care and mobile prices, rather than suggesting general weakness.

In the eurozone, the ECB left policy unchanged at its meeting. President Mario Draghi affirmed that tail risks of deflation have disappeared but maintained that rates will remain low until well past the end of asset purchases. In a speech later in the month, Draghi reiterated that deflation risk was gone and argued that the ECB might change policy as economic conditions improve to keep the level of policy support unchanged. This was perceived as hawkish by the markets. Data continues to be on an uptrend. PMI manufacturing in June increased to 57.3 from 57. Finally, in France, President Emmanuel Macron's party was able to secure a solid majority in legislative elections, which improves the outlook for structural reform in the country.

In the U.K., the snap election led to a hung parliament, where the Conservative Party took the most seats but lost its parliamentary majority. Younger voters increased their turnout and saw the election as a chance to vote for a softer Brexit. Though Prime Minister Theresa May was able to form a government with the support of Northern Ireland parties, this was a personal blow, as she hoped to increase her bargaining power in the Brexit negotiations. In terms of data, inflation hit 2.9 percent in May, an increase from 2.7 percent previously.[5]

In Japan, the BoJ kept policy unchanged at its June meeting. First quarter growth was revised down to 1.0 percent quarter-on-quarter, from 2.4 percent, driven mainly by inventories.[6]

Outlook

We believe higher U.S. Treasury yields will depend on higher U.S. inflation. Until then, they are likely to remain in a range and the yield curve will flatten. If inflation improves, we believe that U.S. Treasury 10-year yields may end the year close to 2.60 percent and the 2-year to 10-year yield curve will be near 80 bps. We do expect the Fed to start reducing its balance sheet in October and hike rates in December. Of course, this is highly dependent on the outcome for economic data releases.

We believe the ECB as well as the performance of bunds hold the key to performance across global treasury markets. Our analysis indicates that bunds are leading while other global treasuries are following. In 2H17 bunds will not only respond to economic conditions, but also to be a pre-planned exit of quantitative easing (QE) and negative interest rates in 2018. We believe bund yields will rise towards year-end. As a result, we are less favorable on U.S. and German duration, as we believe yields will rise, albeit slowly.

Peripheral European bonds are likely to remain well bid and narrow in spread with Germany, providing that economic and political risks remain tame. In the U.K. we see opportunities

[5] Source: Bloomberg. Data as of June 30, 2017.
[6] Source: Bloomberg. Data as of June 30, 2017.

DISPLAY 5

Major Economic Data Releases

COUNTRY			LATEST	CONSENSUS	PREVIOUS	AS OF
U.S.	Labor	Non-farm Payrolls (1000s)	138	182	174	5/31/2017
		Unemployment rate (%)	4.3	4.4	4.4	5/31/2017
		Participation rate (%)	62.7		62.9	5/31/2017
		Average Hourly Earnings (%YoY)	2.4		2.4	5/31/2017
	Activity	ISM Manufacturing	55	55	55	5/31/2017
		GDP (%QoQ, saar)	1.2	1.2	2.1	3/31/2017
		GDP (%YoY)	2		2	3/31/2017
	Inflation	CPI (%YoY)	1.9	2	2.2	5/31/2017
		Core CPI (%YoY)	1.7	1.9	1.9	5/31/2017
Euro Area	Labor	Unemployment rate (%)	9.3	9.4	9.4	4/30/2017
	Activity	PMI Manufacturing	57.3	57	57	6/30/2017
		GDP (%QoQ)	0.6	0.5	0.5	3/31/2017
		GDP (%YoY)	1.9	1.7	1.8	3/31/2017
	Inflation	CPI (%YoY)	1.9	1.9	1.5	4/30/2017
		Core CPI (%YoY)	1.2	1.2	0.7	4/30/2017
U.K.	Labor	Unemployment rate (%)	4.6	4.6	4.6	4/30/2017
		Average Weekly Earnings (%)	2.1	2.4	2.3	4/30/2017
	Activity	PMI Manufacturing	57	57	57	5/31/2017
		GDP (%QoQ)	0.2	0.2	0.7	3/31/2017
		GDP (%YoY)	2	2	1.9	3/31/2017
	Inflation	CPI (%YoY)	2.9	2.7	2.7	5/31/2017
		Core CPI (%YoY)	2.6	2.4	2.4	5/31/2017
Japan	Activity	PMI Manufacturing	52.7		52	4/30/2017
		GDP (%QoQ, saar)	1	2.4	1.4	3/31/2017
		GDP (%YoY)	1.3		1.6	3/31/2017
	Inflation	CPI (%YoY)	0.4	0.4	0.2	4/30/2017
		Core CPI (ex food and energy, %YoY)	-0.3		-0.3	4/30/2017

Source: Bloomberg. Data as of June 30, 2017.

to be underweight gilts as inflation expectations may continue from prior weak currency effects.

In other DM, we expect JGB yields to remain low but talk of exiting yield curve control may push 10-year JGBs slightly above 0.10 percent. We believe being overweight Australian government bonds is a good hedge to the risk of a deeper than expected slowing in China.

In terms of currencies, the U.S. dollar is likely to move sideways in the months ahead as growth around the world matches or exceeds that in the U.S. Europe has been strengthening, and we are positive on euro-linked currencies such as Swedish kroner, Czech koruna and Polish zloty. EM currencies look interesting in a more robust global growth world. We like the Brazilian real, Mexican peso, Indonesian rupiah and Indian rupee, which we think can outperform versus the U.S. and Australian dollars. However, for these EM currencies, President Trump's protectionist agenda will remain a source of volatility.

Emerging Markets

Monthly Review

EM fixed income asset returns were mixed in the period, with investment-grade assets outperforming high-yield, currencies weakening versus the U.S. dollar, and corporates outperforming sovereigns within dollar-denominated debt. Despite the muted performance, investors continued to increase exposure to the asset class, adding $23 billion across hard currency, local currency and blended strategies, bringing the year-to-date total to $64.3 billion (compared to a total of $43 billion in 2016). The fundamental and global financial backdrop remained supportive for EM assets as policy rates gradually tightened, inflation remains subdued, volatility has remained low and EM growth has been resilient. Despite the favorable backdrop, political risks increased in select countries such as Venezuela and Qatar. However, we believe contagion risks from these events remain low.

The political conflict between Qatar and its neighbors escalated in the period as four Arab nations (Saudi Arabia, Egypt, United Arab Emirates and Bahrain) moved to isolate their smaller neighbor physically and politically. The group of four accused Qatar of supporting terror groups and maintaining close relations with Iran. Qatar is of economic and strategic importance as it hosts roughly 10,000 American troops and is the world's biggest exporter of liquefied natural gas. In Brazil, embattled President Michel Temer fought the corruption allegations against him while working to pass a labor bill to overhaul the country's labor laws and strengthen economic performance. Surveys suggest that Temer retains the required support among lawmakers in the lower house to avoid the case being sent to the Supreme Court, which could provide a measure of political stability. The humanitarian and political situation in Venezuela continued to deteriorate as violence escalated on either side. Anti-government actors used a police helicopter to attack the Supreme Court before opening fire on the Interior Ministry. Protestors suffered fatalities in clashes against police and pro-government militias. In Romania, the political crisis affecting the ruling Social Democratic Party (PSD) party was quickly resolved, resulting in the removal of Prime Minister Sorin Grindeanu, and the appointment of his replacement, Mihai Tudose, a close ally to PSD's leader Liviu Dragnea. In Argentina, former president Cristina Fernandez de Kirchner announced she would compete for the Senate in elections to be held on October 22, raising investors' concerns of a return to populism.

Several central banks across EM adjusted policy rates, while those from Turkey, Indonesia and Argentina held steady. The Central Bank of Russia cut rates by 25 bps as policymakers took a dovish tone with food prices driving headline inflation while core rates were expected to fall going forward. In Colombia, the central bank cut rates by 50 bps, versus the 25 bps expected by the market. Banxico, Mexico's Central Bank, followed the Fed with a hike of 25 bps, which was in line with market expectations. However, there was dissention within the board with one member voting against hiking rates. In Brazil, the National Monetary Council lowered inflation targets for 2019 and 2020, to 4.25 percent and 4.00 percent, respectively, taking advantage of the benign inflationary backdrop and to bring the targets closer in line with regional peers.

Outlook

EXTERNAL: EM external sovereign and quasi-sovereign debt returned -0.26 percent in the month, bringing year-to-date performance to 6.20 percent, as measured by the JP Morgan EMBI Global Index.[7] Higher-yielding, lower-rated credits underperformed lower-yielding, higher-rated credits in the month. Smaller, and/or, less-correlated and more idiosyncratically-driven countries outperformed in the month with Uruguay, El Salvador, Pakistan, Namibia, Belize, Vietnam and Paraguay leading the way. Higher-yielding and primarily commodity exporting countries, such as Venezuela, Iraq, Argentina, Azerbaijan, Gabon, Mongolia, South Africa, Zambia and Kazakhstan lagged the broader market during the month.

DISPLAY 6

EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	284	+2	9.7	-27
Colombia	200	-3	6.3	+19
Hungary	123	-9	1.9	-4
Indonesia	195	+0	7.1	-9
Malaysia	132	-13	3.9	-1
Mexico	255	+0	6.9	-47
Peru	145	+0	5.6	-9
Philippines	95	-12	4.8	-19
Poland	62	-12	2.7	+3
Russia	176	+11	7.8	+5
South Africa	279	+18	9.4	+22
Turkey	293	+6	10.4	+3
Venezuela	2464	+236	-	-

Source: JP Morgan. Data as of June 30, 2017.

[7] Source: JP Morgan. Data as of June 30, 2017.

DOMESTIC: EM domestic debt returned 0.46 percent in the month, bringing year-to-date performance to 10.36 percent as measured by the JP Morgan GBI-EM Global Diversified Index.[8] EM currencies weakened -0.21 percent versus the U.S. dollar and EM bonds returned 0.67 percent in local terms.[9] Currency performance versus the U.S. dollar weighed on bond performance for the Philippines, Colombia, Russia, Argentina and Brazil, while contributing to the outperformance of euro-linked currencies from Romania, Hungary, Czech Republic and Mexico. Bonds from Colombia, Russia, Brazil, South Africa, Malaysia, Chile and the Philippines underperformed the broader market, while bonds from Mexico, Peru, Hungary, Romania, Thailand, Turkey, Indonesia, Czech Republic and Poland outperformed the broader market in the period.

CORPORATE: EM corporate debt returned 0.20 percent in the month as measured by the JP Morgan CEMBI Broad Diversified Index.[10] Higher-yielding, lower-quality companies lagged higher-rated companies in the month. From a regional perspective, companies in Latin America (Chile, Mexico, Peru) and Asia (Macau, Malaysia, India, Indonesia) led the market, while those in the Europe (Croatia, Russia), Africa (South Africa) and the Middle East (Qatar) lagged. From a sector perspective, companies in the transport, pulp and paper, consumer, industrial, and utilities sectors outperformed the broader market, while those in the oil and gas, real estate, infrastructure, financial, and technology, media and telecom (TMT) sectors lagged.

Outlook

From a fundamental perspective, EM economies, in aggregate, have continued to improve. The EM/DM growth differential has stabilized and appears to be recovering in favor of EM as the negative growth impacts from Brazil and Russia lessen. China's growth slowdown is likely to continue in the medium term, with better-than-expected short-term growth likely to be challenged by policy-induced tightening in financial conditions. In the U.S., reflation hopes are now centered solely on the passage of fiscal reform, which if successfully executed, could be reflected in stronger U.S. growth in 2018. Volatility has remained low as investor concerns have been offset by global central bank liquidity, despite Fed rate hikes and talk of balance sheet reduction. This positive fundamental outlook could be threatened by a variety of factors including: a sharp return of volatility, monetary policy missteps, or a flare-up in geopolitical tensions as governments adapt to the new political fault lines drawn by shifting U.S. priorities. However, a turn towards de-globalization, particularly stemming from the U.S., seems less likely as North American Free Trade Agreement (NAFTA) repudiation fears have declined as renegotiation has become the preferred strategy.

Looking forward, we believe that DM yields will continue to support the "right" carry opportunities, a strategy of borrowing at a low interest rate and investing in a higher return asset, and that the improving macroeconomic backdrop will be an ongoing "pull" factor leading to inflows into higher yielding assets, including EM fixed income. We think that (eventual) steeper DM yield curves warrant the shortening of duration exposures with a focus on higher-yielding currencies/countries that have attractive characteristics, given the change in global growth outlook. We remain optimistic about the prospects for EM fixed income spreads for 2017 as country fundamentals and the macro environment remain supportive, with those countries that rely most on global trade potentially challenged. The various factors both pushing and pulling investors into EM fixed income remain in place: DM yields remain very low, economic data in EM appears to be recovering, Fed rate hikes are likely to remain gradual, U.S. protectionist inclinations have diminished and concerns of a sharp slowdown in China have eased. We believe that EM assets should be able to weather Fed rate hikes if driven by increasing U.S. growth and not inflation. However, assets remain vulnerable to spikes in U.S. policy uncertainty from undue Fed hawkishness, or Chinese policy tightening triggering a sharper-than-expected growth downturn.

Credit

Monthly Review

CORPORATE INVESTMENT-GRADE

The investment-grade credit market continued to perform well in June, with credit spreads grinding tighter over the month. Investment-grade corporate spreads are now at the tightest level in nearly three years, returning to post-crisis lows of July 2014. On a year-to-date basis, investment-grade spreads are 14 bps points tighter in the U.S., for an excess return of 1.55 percent.[11]

The most notable news items in June included the acquisition of Whole Foods and the U.S. bank stress tests. The acquisition of Whole Foods marked the first instance in which Amazon moved to brick and mortar retail. The headlines caused volatility in the supermarket and retail sectors, and positively impacted Whole Foods bonds. All 34 banks passed the Fed's 2017 stress tests, so no banks need to raise additional capital, as balance sheets remain strong and capital levels remain high. A reduction in oil prices was a significant headline in June, although the market viewed

[8] Source: JP Morgan. Data as of June 30, 2017.

[9] Source: JP Morgan. Data as of June 30, 2017.

[10] Source: JP Morgan. Data as of June 30, 2017.

[11] Source: Bloomberg Barclays. Data as of June 30, 2017.

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this as supply side-driven, and therefore, sector-specific.

The backdrop for the market remained benign with volatility, as measured by the VIX index, remaining in a narrow range and just above historic lows. U.S. investment-grade credit tightened 4 bps in June to close at 109 bps.[12] Within investment-grade, longer duration corporates outperformed short and intermediate bonds in June. Financials tightened, but underperformed nonfinancials, as the pace of tightening in the senior bank space was noticeably slower. Subordinated bank credit issued by insurance companies outperformed, continuing the year-to-date trend we have seen in 2017. Within nonfinancials, energy was the notable underperformer, as spreads widened in sympathy with softness in oil prices.

Issuance remained strong in June, pricing a total of $88.4 billion, 3 percent ahead of June 2016's total.[13] Issuance volumes were in line with street expectations as volumes tapered off post the Fed's rate hike in the middle of the month. Mergers and acquisitions (M&A) accounted for $16.5 billion of supply in June, comprising 19 percent of the month's total.[14] Industrial supply accounted for 47 percent of total primary supply in the month, while financial supply accounted for 38 percent of total volumes.[15]

The European investment-grade market traded better as corporate spreads ended the month 5 bps tighter at 103 bps.[16] The restructuring of weak banks in Spain (Popular) and Italy (Veneto/Vicenza) was viewed as reducing systemic risk for the banking system and larger banks, as they bailed in subordinated bondholders while protecting senior creditors. Increased hawkish rhetoric from central bank comments also dominated news in the month as comments suggested that the policy debate is on the path to a normalization of monetary policy while maintaining a growth bias. Financials outperformed other sectors, specifically lower-rated senior paper. French names continued to outperform in June.

DISPLAY 7

Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	**109**	**-4**	**102**	**-7**
Industrial Basic Industry	139	-3	91	-7
Industrial Capital Goods	86	-2	84	-3
Industrial Consumer Cyclicals	103	-5	102	-1
Industrial Consumer Noncyclicals	95	-6	89	-6
Industrial Energy	144	+4	104	-5
Industrial Technology	90	-4	79	-2
Industrial Transportation	102	-6	90	-8
Industrial Communications	141	-6	111	-4
Industrial Other	90	-5	124	-6
Utility Electric	109	-3	94	-12
Utility Natural Gas	116	-2	97	-8
Utility Other	129	-9	100	+0
Financial Inst. Banking	98	-6	94	-9
Financial Inst. Brokerage	109	-5	100	-8
Financial Inst. Finance Companies	102	-7	90	-6
Financial Inst. Insurance	112	-4	186	-21
Financial Inst. REITS	132	-1	110	-6
Financial Inst. Other			134	-12

Source: Bloomberg Barclays. Data as of Jun 30, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

CORPORATE HIGH-YIELD

The United States high-yield market produced total returns of +0.14 percent last month, and excess returns of 0.35 percent.[17] Higher-quality high-yield outperformed during the month as the BB-index gained +47 bps, the B-index was down 12 bps, and the CCC-index was down 45 bps.[18] Sector performance was mixed in June, as oil field services, independent, supermarkets, midstream and wirelines were the worst performers.[19] Leisure, banking, finance companies, transportation services and home construction were the best performers in June.[20]

[12] Source: Bloomberg Barclays. Data as of June 30, 2017.

[13] Source: Bloomberg Barclays. Data as of June 30, 2017.

[14] Source: Bloomberg Barclays. Data as of June 30, 2017.

[15] Source: Bloomberg Barclays. Data as of June 30, 2017.

[16] Source: Bloomberg Barclays. Data as of June 30, 2017.

[17] Source: Bloomberg Barclays. Data as of June 30, 2017.

[18] Source: Bloomberg Barclays. Data as of June 30, 2017.

[19] Source: Bloomberg Barclays. Data as of June 30, 2017.

[20] Source: Bloomberg Barclays. Data as of June 30, 2017.

The European high-yield market closed the month 20 bps tighter, although yields were flat month on month, reflecting the weakness in risk-free assets in the final week of June.[21] This weakness followed comments made by Mario Draghi at the ECB's annual conference that the market interpreted as being more hawkish than his previous position. The consequent selloff in government bonds was reflected in other markets, with volatility increasing and riskier asset prices declining in the final week of the quarter. BB-rated bonds outperformed, despite their greater interest rate sensitivity. In many cases these BB-rated securities were the subordinated corporate hybrid bonds of investment-grade companies. Subordinated bonds from financial issuers also did well during the month, as actions taken by weak Spanish and Italian banks reduced the perceived view of systemic risk within the banking system. In the primary high-yield market, net supply increased during the month as issuers looked to take advantage of attractive funding conditions to lock in historically low yields.

Outlook

We entered 2017 expecting an investment-grade corporate bond market characterized by competing tensions between fundamentals, valuation and technicals. Beneath the surface, we saw divergences between these factors across financials and nonfinancials and between the U.S. and Europe. Now, at the midpoint of the year, many of these tensions remain the same. As we weigh and sum them, we find ourselves still constructive on the investment-grade corporate market, with somewhat better (or at least not worse) fundamentals, but facing somewhat more expensive valuations. After being very constructive, we are now modestly constructive.

Overall, we are slightly more constructive on the U.S. market compared to the euro market. This is mostly due to relative valuation. In terms of fundamentals, U.S. banking and other financials remain very strong with high capital levels and improving profitability. We have been concerned about the pace of leveraging of U.S. industrials, though this trend has ameliorated in 2017 due to a pause in M&A and share buybacks combined with improving corporate earnings.

In Europe, the debt-equity cycle is much less advanced and the pressure on leverage is much lower. At a macro level, the election of Macron in France removes the risk of an anti-European Union project government. Macron has been elected on a platform promising structural reform (particularly labour reform) which is pro-growth and viewed as a market positive.

In summary, while spreads are trading inside long term median levels, we remain cautiously optimistic about investment-grade credit. Technicals remain supportive and fundamentals do not seem to be deteriorating further, though they remain stretched for many nonfinancials. Financial fundamentals remain strong, and continue to improve. As a result of current valuations, we do not expect a drastic move tighter in spreads; however, we anticipate that spreads will continue to grind tighter if the current backdrop persists. In portfolios, broadly speaking, we favor long risk-and-carry to take advantage of the current environment of modest, slow spread tightening, but want to de-risk where appropriate to reflect tighter valuations and less favorable fundamentals.

Securitized Products

Monthly Review

Agency MBS had a mixed performance in June, positive relative to U.S. Treasuries but still negative on an absolute basis, while credit-related securitized assets saw continued gains from spread tightening and lower rates-oriented risk exposure. Nominal spreads on current coupon agency MBS tightened 2 bps in June to 93 bps above interpolated treasuries, while the option-adjusted spreads (OAS) increased 4 bps to 19 bps above interpolated treasuries as volatility and prepayment concerns declined.[22] The Bloomberg Barclays Capital U.S. MBS Index was down 0.41 percent in June, but finished up 0.87 percent in the second quarter and up 1.34 percent through the first half of 2017.[23] The Fed purchased approximately $27 billion agency MBS in June in order to maintain their agency MBS portfolio at $1.75 trillion, however the minutes from the last two Fed meetings indicate that they may begin to taper their agency MBS reinvestments sometime later this year.

Non-agency MBS spreads continued their tightening trend in June as cash flow and credit performance continued to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.9 percent in April, and are up 5.5 percent over the past year.[24] Home prices are up 41 percent nationally from the lows in 2012, and have now surpassed pre-crisis peak levels from July 2006 to set new highs. Existing home sales increased 1.1 percent in May from April 2017 and 2.7 percent from May 2016, and are very near the 10-year highs.[25] Mortgage performance also remains strong. New defaults declined to a 0.64 percent annual rate in May, down from the 0.69 percent level in April 2017 and near the lowest levels over the past 10 years.8 With unemployment low, the economy slowly improving and home prices still recovering from the mortgage crisis almost 10 years ago, we expect mortgage credit performance to continue to improve.

[21] Source: Bloomberg Barclays. Data as of June 30, 2017.
[22] Suroce: Yield Book. Data as of June 30, 2017.
[23] Source: Barclays. Data as of June 30, 2017.
[24] Source: S&P Case-Shiller U.S. National Home Price Index. Data as of June 30, 2017.
[25] Source: National Association of Realtors. Data as of June 30, 2017.

DISPLAY 8
Key Data for Non-Agency MBS

		LATEST	PREVIOUS	UNIT	CHANGE OVER 1 YEAR	UNIT	AS OF
Prices	National Home Prices	0.16	0.25	% MoM	5.5	% YoY	4/30/2017
	Existing Home Sales	5.6	5.56	MM homes			5/31/2017
	Existing Home Sales	1.1	-2.5	% MoM	2.7	% YoY	5/31/2017
Inventory	Housing Inventory	2.1		% MoM	-8.4	% YoY	
	Housing Inventory (months supply)	4.2	4.1	Months supply	4.7	Level last year	5/31/2017
Defaults	New Defaults	0.64	0.69	% annualized	0.63	Level last year	5/1/2017

Source: Bloomberg. Data as of Jun 30, 2017.

CMBS performance continues to diverge depending on different collateral compositions. Since the beginning of the year, spreads on CMBX 6 BBB- (2012 vintage), which has 35 percent retail exposure, are wider by 153 bps, while spreads on CMBX 9 BBB- (2015 vintage), which has only 26 percent retail exposure are tighter by 12 bps.[9] The increasing announcements of retail store closings and poor retail earnings are causing credit concerns for many retail properties. New non-agency CMBS issuance increased in June with roughly $13 billion in issuance during the month, lifting the 2017 year-to-date total to $36 billion for the half of 2017.[10] We expect non-agency CMBS issuance to slow slightly in the second half of the year, and still expect roughly $60 billion in total new issuance volumes for all of 2017. New risk retention regulations that took effect January 1, 2017, are appearing to have a meaningful effect of dampening new CMBS issuance.

Fundamentally, CMBS performance remains on reasonably solid ground, although there are some signs of concern. Commercial real estate prices fell 0.4 percent in May, and are now down 0.8 percent in 2017, but prices are still up 0.7 percent over the past 12 months. After several years of 10+ percent annual increases, commercial real estate prices have flattened over the past year, but we do not expect price changes to turn materially negative given the continued strength of the U.S. economy. Office rent growth was up 4.9 percent year-on-year in the first-quarter of 2017.[13] Multifamily vacancy rates remain near the lowest levels seen over the past 13 years.[14] Non-agency CMBS has been one of the worst performing credit sectors in 2017, lagging most of the tightening seen in other credit sectors. While we do see some signs of concern, overall we believe CMBS represents one of the more attractive credit sectors from a relative value perspective.

European MBS spreads continued their tightening trend in June, and are now 30 to 60 bps tighter in 2017.[15] Low interest rates and moderate signs of economic growth seem to be outweighing any material concerns over Brexit fallout.

ECB asset-backed securities (ABS) purchases remained slow in May, and the ECB portfolio decreased for the second consecutive month, this time declining by €0.1 billion European ABS during the month. The ECB held €23.7 billion of European ABS at the end of May 2017.[16] European ABS issuance increased in June with €9.6 billion issued for a 2017 total issuance volume of €40.8 billion, less than the €43.4 billion during the first half of 2016.[17] We expect securitized issuance to remain relatively light in 2017 given regulatory constraints.

Outlook

Despite the significant tightening of credit spreads in the first half of 2017, our outlook for the second half of the year remains largely unchanged: we favor mortgage credit opportunities and are negative on more rates-based risks of agency MBS. The Fed purchased nearly $400 billion agency MBS in 2016, and have purchased $158 billion agency MBS through the first six months of 2017 (on pace for over $300 billion purchases for all of 2017) in order to maintain their portfolio at $1.75 trillion. Without the Fed's purchases, this additional MBS supply would need to be absorbed by other investors and spreads may need to widen to encourage other investors to add to their agency MBS positions. Agency MBS have performed reasonably well year-to-date as the market volatility of rates has been relatively mild. If rates remain rangebound, both prepayment and extension risks would likely remain subdued, and agency MBS could outperform. However, we believe that interest rate volatility will likely increase as the Fed continues its interest rate hikes and implements its balance sheet reduction plans—this potential increase in volatility could cause agency MBS to underperform similar to their performance at the end of 2017, after the U.S. elections. Although agency MBS is one of the few securitized sectors that has not experienced material spread tightening over the past couple of years, we remain cautious given both

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the currently marginal overall value opportunity and the potentially negative supply-demand dynamic if the Fed ends its portfolio reinvestment.

Despite their spread tightening during the first half of the year, non-agency residential mortgage-backed securities (RMBS) remains one of the more stable and attractive fixed income asset classes in our opinion. Non-agency MBS spreads have tightened 60-100 bps in 2017, but credit risk continues to decline given the strengthening of the housing market and continued seasoning of this primarily pre-crisis market. Additionally, cash flow dynamics are improving as prepayments on non-agency RMBS are increasing now that home prices are back above originally underwritten levels. Unlike agency MBS where faster prepayments on the largely above-par-priced market are generally negative, increasing prepayments on non-agency RMBS are generally positive since the bulk of the legacy non-agency RMBS market still trades at a meaningful discount to par.

The CMBS market has become a tale of two markets, where securities with significant retail exposure have performed poorly during the first half of 2017, while nearly all other CMBS collateral types have been performing reasonably well. The numerous recent announcements of retail store closings have raised concerns over the future viability of many shopping malls, and CMBS with significant retail exposure has come under pressure as a result this year. While we believe that many malls will fail—possibly as much as 25 percent of all traditional indoor shopping malls—we also believe that most malls will remain profitable and will not represent a significant credit risk. We believe that local population demographics, property-specific store composition, regional competition from other malls and the financial strength of the property sponsor are the key determinants of which malls are most likely to succeed. The increasing distress in this part of the CMBS market represents both a significant risk and a significant opportunity, and we believe that careful security selection can prove to be particularly beneficial in this market.

Non-retail-oriented CMBS have generally been performing well with improving occupancy rates, rental rates, net-operating incomes and corresponding rising property valuations. Commercial real estate prices have largely been flat over the past year, but we believe the underlying fundamental market conditions remain positive in many of these CMBS sectors given the overall strength of the economy and stability of rates. CMBS supply has been moderate—supported by the refinancing of a large number of 2007-vintage loans but also somewhat constrained by the new CMBS risk-retention securitization requirements. Beginning in 2017, issuers of CMBS securitizations are now required to retain a 5 percent position in their deals. This requirement seems to have limited some of the potential CMBS securitization volumes.

In Europe, we are now moderately positive in outlook for MBS and CMBS, after having been strongly positive. Spreads are now significantly tighter than pre-Brexit levels, even though we believe fundamental conditions have more uncertainty in the wake of the Brexit vote and given the political uncertainty in other parts of Europe. Overall, we remain positive on the European securitized opportunities given the belief that the ECB and BoE will continue to keep interest rates low for the foreseeable future, and that both the European economies, and more importantly the respective real estate markets, will benefit from these accommodative policies. Home prices were higher across nearly all of Europe for the second straight year in 2016, strengthened by low mortgage rates and slowly improving economic activity. New RMBS and CMBS issuance remains disappointingly light in Europe, but we are still finding a limited number of attractive, seasoned opportunities. As long as the fundamental conditions remain positive with low rates and rising real estate prices, we continue to like the European RMBS and CMBS markets despite the political risks.

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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 market 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.

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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 10YR govt 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 10YR govt 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 Market 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).

U.K. 10YR govt 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 10YR bonds — Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR govt bonds** — Japan Benchmark 10-Year Datastream Government Index; and **10YR 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 (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 sub-index 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 Market 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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