Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Understanding the "Known Unknowns"

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

Outlook

- Despite uncertainties surrounding the timing and exact specification of the Trump administration's policies, we see the possibility of real reforms and actions (e.g., tax and spending) that could sustain positive economic momentum in the U.S. With unemployment low and wages rising, albeit gradually, inflation should continue to move higher. This will allow the Fed to continue to raise interest rates. However, the pace is not likely to increase unless one of two conditions is met: (1) inflation accelerates; and (2) fiscal policy becomes much more expansionary. In the interim, the probability of recession has fallen with the price of more economic variability down the road: The old-fashioned business cycle may be coming back!
- For the first time since 2013, we are witnessing several bond bearish forces arriving simultaneously: improving economic data/rising inflation, both in the U.S. and the rest of the world, less easy monetary policy, easier fiscal policy and rising risk premiums. Basically, a reversal of all the factors that powered yields lower over the last several years. We remain modestly underweight overall duration to help protect portfolios from further improvements in growth and inflation.
- We still expect the EM/DM growth differential to recover during 2017 in favor of EM as the negative growth impacts from Brazil and Russia lessen. On Mexico, post the U.S. elections, we note that the Mexican peso is now the most undervalued currency in EM and is pricing in a fairly severe slowdown in Mexican growth and worsening in the funding of the current account deficit. The currency could outperform if these risks lessen. We believe that EM assets could well absorb Fed rate hikes in 2017 if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty.
- We anticipate that the U.S. credit market will continue to benefit from rising equity prices, supportive data, positive earnings, rising interest rates and growth optimism in the coming month. Technical factors, in terms of issuance are also likely to be supportive of spreads.

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

After the U.S. elections, global fixed income markets priced in a significant relaxation in U.S. fiscal policy that may boost economic growth, strengthen the U.S. dollar (USD) and further steepen yield curves. For much of January, markets looked toward the first few days of the Trump presidency for possible clues about his economic agenda. The market is grappling with many "known unknowns". After all, Trump is embarking on complex tax reform, working with a House with perhaps different priorities and less tolerance for deficit spending. In addition, with a slogan of "America First" in Trump's inauguration speech, Trump's administration soon revived the threat of renegotiating NAFTA and other trade agreements. As uncertainties gathered around tax policy and protectionism, market optimism became more subdued.

As Trump euphoria tempered, so did the dollar, which reversed approximately half of its gain following the election. U.S. Treasury yields declined in January as well. However, the positive activity and inflation momentum, which had started before the U.S. election and are partly driven by base effects of rising oil prices, carried into January and helped to push up yields globally. European bonds, which had outperformed U.S. Treasuries in December, underperformed in January as inflation surprised to the upside.

Despite the uncertainties, we still see real reforms in the pipeline that could sustain the positive economic momentum. Looser regulation in the U.S. could increase banks' propensity to lend. Lowering the corporate tax rate will make America, on margin, a more appealing destination for investment and production. Allowance for capital expenditure deductibility creates more incentive for business investment, which has been lacking in the current recovery. The prospect of these changes could lift the "animal spirits" of the U.S. economy. Though eventually, as the economy runs hot, recession risks would also increase. In essence, the U.S. will experience a typical business cycle, rather than the muted cycle that's characterized the post-crisis period.

If fiscal policy delivers, monetary policy is likely to respond to the fiscal impulse and its effect on inflation. If the U.S. labor market is tight, additional stimulus is likely to generate more wage and inflation pressures, and the Federal Reserve (Fed) will feel more compelled to hike rates faster. However, the underemployment rate (U-6) remains elevated compared to its history, suggesting that possible slack remains and wage pressure may be less pressing. In this case, there is more upside for growth before the Fed feels compelled to tighten more aggressively. Since the upside case is not currently priced in the markets, we see the possibility that curves will steepen and long-end yields rise further later this year.

In the meanwhile, to navigate the higher uncertainties regarding Trump's macro and micro policies and their interactions with monetary policy, we think it is appropriate to emphasize investments in idiosyncratic areas, less sensitive to conventional macroeconomic and policy dynamics. For example, Brexit news flow will likely drive U.K. asset prices and is relatively uncorrelated to the U.S. rate cycle. Though, it will be more dependent on negotiations between Europe and the Theresa May government, which has opted for a more hardline, clean Brexit. Similarly, in emerging market (EM) countries, we are focused on countries that trade on more localized developments, such as Argentina, Venezuela and Ukraine. In corporate debt markets, we favor subordinated financials, which could benefit from improved bank profitability if growth improves or regulatory burdens relax. In the securitized area, we have been, and continue to favor credit-sensitive mortgage sectors over agencies, which tend to be much more rate sensitive.

Developed Market Interest Rates and Currency Outlook

In 2017, we may see for the first time since 2013, a combination of bond bearish factors. However, 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, would drive "fair value" higher. We remain modestly underweight overall duration to help protect portfolios from further improvements in growth and inflation.

We expect continued European Central Bank (ECB) purchases to pressure euro periphery real yields lower, in order to bring about the necessary financial and economic rebalancing to increase inflation expectations. Based on this view, we continue to like inflation-protected bonds in Italy and Spain and are slightly negative on eurozone duration. In core euro area, improving growth and inflation dynamics could raise market expectations of ECB tapering, which would increase risk premium and steepen the curves.

In terms of currencies, the U.S. dollar is likely to remain strong in 2017, driven by widening short-term interest rate differentials with the rest of the world and a relatively more expansionary fiscal policy. We have exposure to where we see value, including the Swedish kroner. Increasing global skepticism around monetary policy effectiveness will likely make it difficult for Riksbank ease further, while economic growth is at an above trend pace. Emerging market currencies also look interesting in a more robust global growth world. The wildcard remains Trump's protectionist agenda, which would include complaints about a too strong dollar, upsetting the dollar bullish view.

EM Outlook

While it is still too early to know the exact contours of the next U.S. administration's fiscal, trade and immigration policies, the market hasn't waited to re-price not only the global fixed income outlook, but

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also the outlook for countries in EM likely to be the most affected, such as Mexico. The impact on China is still a question mark.

For global growth, the beneficial impact of higher U.S. growth is likely to be offset partly by the extent of the new president's potentially protectionist trade agenda. The net effect won't be known for a while, but Mexico and China will remain a key focus, with joint cooperation between the new president and the more traditional trade-friendly wing of the Republican Party potentially reducing the impact, especially if stronger U.S. economic growth takes on more importance as a goal than fulfilling populist campaign promises that risk damaging the U.S. economic outlook. We still expect the EM/developed market (DM) growth differential to recover during 2017 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 short-term growth prospects reliant on continued fiscal and monetary policy support. Recent data out of China has been suggesting resilience, but we believe we could see growth slowdown again at the end of Q1/Q2 2017. However, we continue to believe that China has ample policy buffers in 2017 to offset a too rapid deceleration in economic growth.

On Mexico, post the U.S. elections, we note that the Mexican peso is now the most undervalued currency in EM and is pricing in a fairly severe slowdown in Mexican growth and worsening in the funding of the current account deficit. We are cautiously bullish on the Mexican Peso since it has already significantly priced in risks, and could outperform if risks are less than expected. On the rates side, the central bank (Banxico) has clearly signaled it doesn't want to overreact with tightening. It has already prudently hiked 50 basis points (bps) in mid-November and 50 bps following the Fed hike in December. However, ongoing FX weakness and higher fuel prices fuel inflation pressures, which will likely mean that Banxico will have to hike more than the FOMC in 2017 despite the negative implications for economic growth. Weakening growth should help contain incipient inflationary pressures.

We expect historically low DM yields to still support the "right" carry opportunities and spreads as we expect an ongoing "push" factor of inflows into higher-yielding assets, including select EM fixed income. We believe that the various factors both pushing and pulling investors into EM fixed income remain in place: Developed market yields remain very low, economic data in EM appear to have stabilized, fears of multiple Fed rate hikes have subsided (although two to three interest rate hikes during 2017 are more likely than one) and concerns of a sharp slowdown in China have diminished. We believe that EM assets could well absorb Fed rate hikes in 2017 if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty.

Credit Outlook

We anticipate that the U.S. credit market will continue to benefit from rising equity prices, supportive data, positive earnings, rising interest rates and growth optimism in the coming month. In Europe, we believe that major central banks will retain a bias to accommodative monetary policy, which will continue to support European credit. As we head into February, we remain focused on political agendas and their implications for corporate credit and, barring unforeseen circumstances, anticipate a continued move tighter across global credit next month.

On the news front, investment-grade credit was fairly active over the month. M&A rumors resurfaced in the media space. Continued headlines in the pharmaceuticals space regarding patent rulings and drug pricing impacted names in the investment-grade universe. We anticipate volatility in the pharmaceutical and media space to continue in coming months. In the media/cable/telecom sector, we expect continued consolidation as the industry determines how best to deliver content to consumers. In the pharmaceutical space, focus on drug pricing and competition will remain, and plans to change Obamacare will continue to dominate headlines. In the face of pharma volatility we favor generic manufacturers over more branded players.

Moving further into February, issuance will remain a dominant theme in the U.S. investment-grade market and will be a key determinant of spread directionality. Specifically, if issuance tapers off toward $100 billion, as expectations currently dictate, this will be positive for the market and we may see spreads move modestly tighter. In addition, how corporates deal with improved cash flow (our forecast) will also be important. Additional leverage would be viewed negatively as existing leverage is already high by historical standards.

Securitized Outlook

We remain underweight agency mortgage-backed securities (MBS), given the historically low nominal spreads and low option-adjusted spreads and increased volatility over the last few months. Duration-extension risk has replaced prepayment risk as mortgage rates increased 50 basis points over the past year. Agency MBS have had mediocre returns over past two years and the 2017 outlook is not particularly positive, given the interest rate backdrop of two to three potential Federal Open Market Committee (FOMC) rate hikes this year. Agency MBS nominal spreads and option-adjusted spreads (OAS) are currently near the wide end of their two-year range, but the risk environment and volatility have also elevated. We are also cautious regarding agency MBS given the potential for the Fed to end their MBS portfolio reinvestment, which could cause a material spike in net MBS supply in the market.

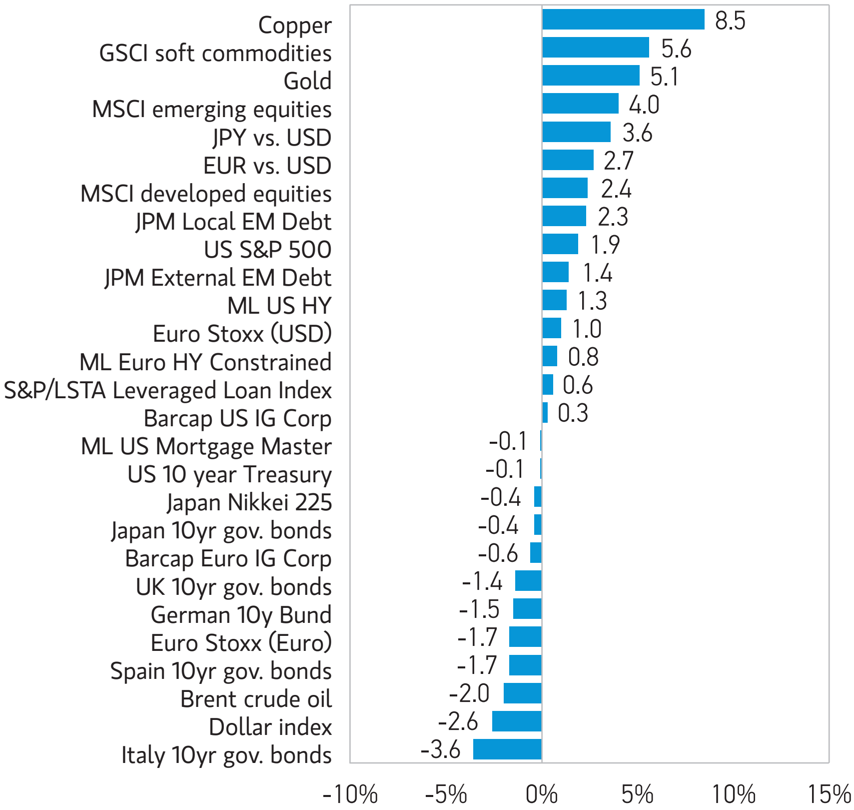
Non-agency MBS remains one of the more stable and attractive fixed income asset classes in our opinion. Given the attractive carry, improving fundamentals and shrinking net supply, we remain overweight the non-agency MBS sector. Non-agency MBS spreads have tightened roughly 50 bps over the past year, but we remain positive given the still attractive carry and improving fundamental conditions. We remain positive on the U.S. housing market given the modest strength of the economy, continued low mortgage rates and above-average home affordability. From a supply perspective, we project outstanding non-agency MBS to decline by $60 billion to $70 billion in 2017, while new securitizations are projected to only amount to $25-$30 billion.

We remain cautiously overweight commercial mortgage-backed securities (CMBS). Although CMBS performed very well in January, overall the sector has lagged the performance of other credit sectors over the past year. We believe that AAA CMBS offer "fair value," while BBB CMBS remains attractive relative to other comparably rated sectors. Investor sponsorship for the CMBS sector has been improving over the past few months and supply is subsiding. We expect that commercial real estate fundamental conditions will remain strong. While we remain overweight, we are limiting our overweight to a manageable level depending on portfolio risk profiles, given the increased volatility and mark-to-market risk in this sector.

In Europe, we have decreased our strong overweight positioning to a more moderate overweight outlook for MBS and CMBS. Spreads are now tighter than pre-Brexit levels, even though we believe fundamental conditions have more uncertainty in the wake of the Brexit vote. Overall, we remain positive on the sector given the belief that the ECB and Bank of England (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. New residential mortgage-backed security (RMBS) and CMBS issuance remains disappointingly light in Europe, but we are still finding a 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.

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of January 31, 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 11 and 12 for index definitions.

Market Summary

In January, yields rose in developed markets, led by Euro Area, which had lagged the U.S. yield rise last month.[1] The dollar weakened versus global currencies, giving back some of the sharp rise after Trump's election.

Over the month, 10-year U.S. Treasury yields rose 1 bp, while the 2s/10s curve flattened by 1 bp.[2] Germany's 10-year yield increased 23 bps, while the two-year yield increased 7 bps.[3] Ten-year yields in Spain, Italy and Portugal increased from 21 to 45 bps.[4] Greece's 10-year government yields underperformed the Euro periphery, rising by 71 bps, as negotiations with Euro Area institutions during bailout reviews stalled.[5] The Japanese government bond (JGB) 10-year yield increased by 4 bps.[6]

[1] Source: Bloomberg. Data as of January 31, 2017.
[2] Source: Bloomberg. Data as of January 31, 2017.
[3] Source: Bloomberg. Data as of January 31, 2017.
[4] Source: Bloomberg. Data as of January 31, 2017.
[5] Source: Bloomberg. Data as of January 31, 2017.
[6] Source: Bloomberg. Data as of January 31, 2017.

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The dollar weakened against most currencies. The euro appreciated by 2.7 percent. The British pound appreciated by 1.9 percent. The Japanese yen appreciated by 3.7 percent for the month.[7] The Mexican peso depreciated 0.5 percent as President Donald Trump revived the issue of NAFTA renegotiation, the only loser for the month. Crude oil (Brent) prices decreased in the month from $56 to $55.[8] The New Zealand and Australian dollars were the biggest winners for the month, benefitting from the reflation of commodity prices.

Developed Markets

In the U.S., the Fed kept policy unchanged as expected. Economic data was good in January, continuing the global reflationary trend. December nonfarm payrolls increased 156,000 versus expectations of 175,000.[9] The unemployment rate ticked up to 4.7 percent, in line with consensus, as the participation rate increased to 62.7 percent. Average hourly earnings rose to 2.9 percent from 2.5 percent previously.[10] The ISM manufacturing index increased to 54.7 in December, above expectations of 53.8. Gross domestic product (GDP) figures for the fourth quarter was 1.9 percent quarter-on-quarter, below consensus expectations of 2.2 percent. This brings 2016 yearly growth to 1.9 percent. Headline CPI rose to 2.1 percent from 1.7 percent, and core CPI was 2.2 percent for December.[11]

In the Eurozone, ECB kept rates unchanged at the meeting. The committee highlighted that growth has firmed in recent months, but that it has not firmed enough for the ECB to consider adjusting its asset purchase program. In terms of survey data, Eurozone manufacturing PMI came in at 55.1 in December, an improvement from November and above market expectations of 54.8.[12] Eurozone GDP for fourth-quarter 2016 was 0.5 percent, above consensus. This brings 2016 annual growth to 1.8 percent, above consensus of 1.7 percent. Eurozone inflation was 1.1 percent for December, up from 0.6 percent previously.[13]

In the U.K., the BoE kept policy unchanged at the January meeting. The BoE remains neutral in its outlook of future policy direction, since it is ready to support aggregate demand and containing rising inflation. It expects inflation to peak at 2.75 percent in mid-2018 and ending at 2.36 percent in 2020. This is slightly lower than November forecasts since the BoE is expecting greater slack in the economy. In terms of data, headline CPI inflation was 1.6 percent year-over-year in December, up from previously and beating consensus of 1.4 percent.[14] The unemployment rate's three-month average stayed at 4.8 percent in November. GDP figures for the fourth quarter were 0.6 percent, above consensus expectations of 0.5 percent. This brings annual 2016 growth to 2.2 percent. U.K. manufacturing PMI was 56.1 percent in December, up from 53.5 in November and consensus expectations of 53.3.[15]

DISPLAY 2

Government Bond Yields for Major Economies

COUNTRY	2YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	5YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)
Australia	1.78	-5	2.21	-11	2.71	-5
Belgium	-0.45	22	0.01	41	0.98	45
Canada	0.77	2	1.12	0	1.76	4
Denmark	-0.55	-2	-0.15	12	0.46	13
France	-0.48	17	0.14	27	1.04	35
Germany	-0.70	7	-0.40	13	0.44	23
Ireland	-0.44	9	0.43	54	1.18	42
Italy	0.04	22	0.93	33	2.26	45
Japan	-0.19	-1	-0.09	2	0.09	4
Netherlands	-0.64	9	-0.19	17	0.58	22
New Zealand	2.31	5	2.71	4	3.37	4
Norway	0.69	-5	1.07	-1	1.72	7
Portugal	0.07	3	2.13	26	4.19	43
Spain	-0.25	3	0.35	8	1.60	21
Sweden	-0.53	9	0.09	21	0.74	18
Switzerland	-0.87	9	-0.54	13	-0.06	13
United Kingdom	0.14	5	0.62	13	1.42	18
United States	1.20	2	1.91	-1	2.45	1

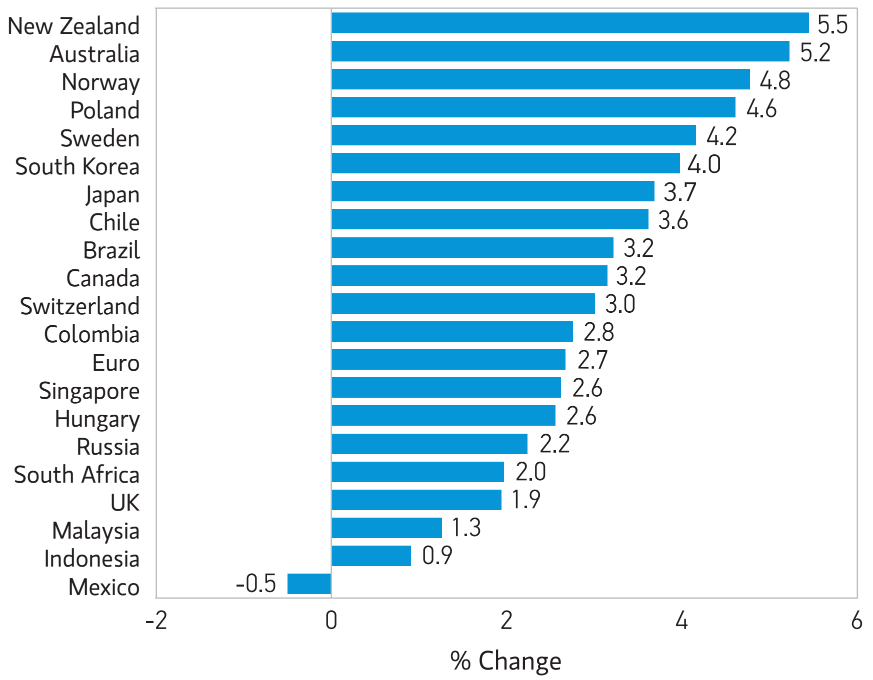
Source: Bloomberg LP. Data as of January 31, 2017.

[7] Source: Bloomberg. Data as of January 31, 2017.
[8] Source: Bloomberg. Data as of January 31, 2017.
[9] Source: Bloomberg. Data as of January 31, 2017.
[10] Source: Bloomberg. Data as of January 31, 2017.
[11] Source: Bloomberg. Data as of January 31, 2017.
[12] Source: Bloomberg. Data as of January 31, 2017.
[13] Source: Bloomberg. Data as of January 31, 2017.
[14] Source: Bloomberg. Data as of January 31, 2017.
[15] Source: Bloomberg. Data as of January 31, 2017.

DISPLAY 3

Currency Monthly Changes Versus U.S. Dollar

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of January 31, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

In Japan, the BoJ kept monetary policy unchanged. In terms of data, manufacturing PMI was 52.4 for December, up from 51.3 in November. The December core national CPI (ex-food and energy) was flat, down from November but above the consensus expectation of -0.1 percent.[16]

Emerging Markets

Global risk sentiment improved in January as better growth and inflation dynamics took hold in EM, the USD rally faded, and interest rate volatility subsided in developed markets despite an increase in political uncertainty. EM fixed income assets benefitted from the more stable fundamental backdrop as investors continued to be positioned lightly in EM. Many issuers came to market early to avoid the expected volatility generated by the new Donald Trump presidential administration. Despite the potential for political and trade changes stemming from the new U.S. administration, economic growth in EM is expected to rebound this year as growth in Brazil and Russia recovers. Commodity prices have been stable enough to allow exporting nations to consolidate their fiscal positions, while moderate inflation should continue to provide room for central banks to cut interest rates.

There was divergence in policy actions as some central banks were able to cut rates given currency and inflation stability, while others were forced to respond to weakening currencies. Before partially recovering, late-in-the-month assets in Mexico were pressured amid growing concerns of a more protectionist U.S. trade agenda and the potentially negative impacts of lower exports and foreign direct investment on the Mexican economy. The Mexican Foreign Exchange Commission intervened in the currency market to stabilize the sell-off in the peso and provide liquidity. Also under pressure were Turkish assets as the commodity-importing country continued to combat the challenges of political change, terrorism, a weak economy, and the need to fund a current account deficit while battling a weak lira, which hit a 4-year low. In order to aid economic growth Chile's central bank cut rates by 25 bps to 3.25 percent, as expected by the market. Despite cutting rates in the previous meeting, Colombia's central bank unexpectedly held rates steady in its last meeting over concerns of inflation following a recent VAT hike and global volatility. Colombia's foreign credit rating was affirmed at BBB by S&P, and the outlook was kept at negative as the agency awaits the results of fiscal and external adjustments. In a tightening move, China's PBOC 6- and 12-month rates +10 bps to 2.95 percent and 3.10 percent, respectively.[17] China's stimulative policies in 2016 produced economic growth of 6.8 percent as leaders try to manage the economy's transition from an export to a consumption model.

External

EM external sovereign and quasi-sovereign debt returned 1.44 percent in the month, as measured by the JP Morgan EMBI Global Index.[18] Lower-rated, higher-yielding bonds, outpaced investment-grade bonds over the month. Bonds from more idiosyncratically-driven countries such as Costa Rica, Dominican Republic, Brazil, Malaysia and Uruguay outperformed the broader market, as did commodity-related credits such as Venezuela, Ecuador and Mongolia. Conversely, bonds from El Salvador, Gabon, Ghana, Argentina, Latvia, Senegal, Angola and Armenia underperformed the broader market in the month.

Domestic

EM domestic debt returned 2.25 percent in the month, as measured by the JP Morgan GBI-EM Global Diversified

[16] Source: Bloomberg. Data as of January 31, 2017.

[17] Source: Bloomberg. Data as of January 31, 2017.

[18] Source: JP Morgan. Data as of January 31, 2017.

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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	291	-39	10.4	-67
Colombia	209	-16	6.7	-22
Hungary	161	-7	2.2	24
Indonesia	220	-17	7.8	-19
Malaysia	152	-45	4.0	-14
Mexico	296	0	7.5	1
Peru	159	-11	6.1	-35
Philippines	104	-6	5.3	-22
Poland	106	-4	3.2	11
Russia	176	-10	8.1	-18
South Africa	263	-13	9.3	-8
Turkey	353	-7	10.8	-13
Venezuela	2056	-112	–	–

Source: JP Morgan. Data as of January 31, 2017.

Index. EM currencies strengthened 1.15 percent versus the U.S. dollar and EM bonds returned 1.11 percent in local terms.[19] Currency performance versus the U.S. dollar weighed heavily on bond performance for Turkey, Mexico and the Philippines. Bonds from Hungary and Thailand also underperformed the broader market. Conversely, bonds from Brazil, Peru, Colombia, Poland, Chile and Russia outperformed the broader market in the period.

Corporate

EM corporate debt returned 1.24 percent in the month, as measured by the JP Morgan CEMBI Broad Diversified Index.[20] Higher-yielding, lower-quality companies outperformed higher-rated companies in the month. From a regional perspective, companies in Africa (South Africa) and Latin America (Brazil, Kazakhstan, Peru and Guatemala) led the market, while those in Asia (South Korea, Malaysia, Thailand and Singapore), the Middle East (Israel and Oman), and Europe (Croatia) lagged. From a sector perspective, companies in the metals and mining, industrial, oil and gas, TMT, and financial sectors outperformed the broader market, while those in the infrastructure, transport, consumer, diversified, and real estate sectors lagged.

Corporate Investment Grade Credit

Global credit markets continued to benefit from Trump optimism in the month of January amid rising equity prices, good data and earnings reports, rising interest rates, and rising expectations for nominal growth. Technicals continued to support markets in the U.S. and Europe, as global investment-grade and high-yield markets posted positive returns.

The main focus of the U.S. investment-grade market in January was the impressive, and unexpected, pace of issuance over the month. During the course of January, U.S. investment-grade supply reached $176 billion, the most on record for any calendar month.[21] Interestingly, only two transactions were M&A related, totaling $1.65 billion, which is atypical of months with higher-than-average primary market volumes.[22] Issuance was robust for both financials and nonfinancials ($93 billion versus $82 billion).[23] In spite of record issuance volumes, performance of new issues was strong, and concessions over the month averaged 3 bps, down from 5 bps in December.[24]

U.S. corporates tightened in January despite issuance volumes, ending the month two bps tighter.[25] Financials and BBB-rated nonfinancials were the outperformers over the month. In addition, the energy and metals sectors continued to perform well as a result of the higher-beta rally and the weaker dollar. The pace of tightening, however, decelerated in January after the Trump rally we saw in December, as the market continues to digest post-campaign expectations and observes the real impact the new administration's actions will have on the markets and the economy. Volatility was down over the month, as indicated by the VIX, which ended the month at 12, representing a 15 percent drop over the course of January.[26] Rates volatility remained elevated in January as the United States 10-year Treasury traded in a 25-bp range (2.30 percent to 2.55 percent) over the month.[27]

Technicals in the U.S. credit markets continue to be strong, and should continue to support spreads with a bias toward tightening, as we continue to grind toward cycle lows seen in 2014. We remain focused on the

19 Source: JP Morgan. Data as of January 31, 2017.
20 Source: JP Morgan. Data as of January 31, 2017.
21 Source: BAML. Data as of January 31, 2017.
22 Source: BAML. Data as of January 31, 2017.
23 Source: BAML. Data as of January 31, 2017.
24 Source: BAML. Data as of January 31, 2017.
25 Source: Bloomberg Barclays. Data as of January 31, 2017.
26 Source: Bloomberg. Data as of January 31, 2017.
27 Source: Bloomberg. Data as of January 31, 2017.

quality of corporate earnings and their implications on leverage, and monitor consequences from announced or proposed government policies.

The European investment-grade market tightened in the month of January by four bps.[28] Despite heavy supply during the start of the month, spreads marginally tightened in January with the market focused on the positive momentum for the U.S. economy following Trump's victory. In Europe, the notable outperformance in the month came from subordinated bank bonds. Corporate hybrids and bonds lower down the risk spectrum outperformed. In the European investment-grade market, new issue volume was strong in January, despite the magnitude of primary market activity in U.S. investment grade. Over the course of the month we saw €57.2 billion in investment-grade corporate issuance.[29] Sterling investment-grade issuance was busy in January as well at £5.2 billion, led by financials (£3.6Bn), while nonfinancial issuance was less robust (£1.6Bn).[30] Following the "No" vote in the Italian referendum, political risk remains elevated in Europe (with Dutch French and German elections to follow in 2017). Investment-grade and high-yield credit should be well supported by the ECB and BoE corporate bond (nonfinancials) purchases, subject to the global economy avoiding recession and default rates remaining low. We believe that Trump's victory is positive for financials (less regulation) and the basic materials (fiscal spend) sectors. Demand for short maturities remains high.

Corporate High Yield

The U.S. high-yield market generated 1.45 percent in total returns in January. As we saw in investment-grade, higher-beta credit outperformed: BB-rated credit gained 0.88 percent, B-rated credit gained 1.18 percent, and CCC-rated credit gained 2.30 percent on an excess returns basis.[31] Most sectors in the high-yield universe were up in January. The best performing sectors were commodity-focused, higher-beta sectors: oil field services (+4.4 percent), electric (+2.90 percent), midstream (+2.28 percent), and chemicals (+2.23 percent).[32] New issuance remained robust in high yield over the course of January as the market priced a total of $18.8 billion is USD-denominated bonds over the month.[33]

European high yield followed a strong end of 2016 with a good start to 2017, with a total return of 0.72 percent during the month.[34] While the return form government bonds was negative, and German yields ended the month higher, this was more than offset by returns from lower spreads, which tightened by 15 bps over the month.[35] CCC-rated bonds outperformed on idiosyncratic strength, while BB-rated and B-rated credits traded more or less in line with the market. Issuance was relatively depressed with only €5 billion of bonds issued, which, given the ongoing strong demand for higher yielding assets, resulted in a supportive technical backdrop.[36] Yields ended the month slightly higher than the record low level of 3.3 percent seen mid-month, but remain low on a historical basis.[37] While the absolute level of yield is low, we believe that European high yield offers the potential for positive returns relative to other European fixed income asset classes, particularly against a backdrop of rising government bond yields, given the higher level of income generated by the asset class and lower interest rate sensitivity.

Securitized Products

Agency MBS underperformed in January while credit-related securitized assets performed very well. Fears over higher rates and corresponding potential further duration extension combined with concerns about the Fed possibly ending the reinvestment of their MBS portfolio caused agency MBS to perform poorly in January. Nominal spreads on current coupon agency MBS widened seven bps to 98 basis points above interpolated Treasuries and option-adjusted spreads (OAS) also widened nine bps to nine bps above interpolated Treasuries.[38] The Bloomberg Barclays Capital U.S. MBS Index was down 0.03 percent in January as the wider spreads offset any positive carry during the month.[39] The Fed purchased approximately $34 billion Agency MBS in January in order to maintain their agency MBS portfolio at $1.75 trillion, however several Fed governors recently floated the idea of ending their portfolio reinvestment. The Fed purchased over $400 billion Agency RMBS in 2016, and we believe that ending this reinvestment could have a significant negative impact on agency MBS.[40]

Non-agency MBS spreads tightened in January as cash flow and credit performance continued to improve. Non-agency MBS spreads are trading at their tightest levels since 2014 for most securities. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.2 percent in November, and are up 5.6 percent over the past year.[41] Home prices are up 38 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 decreased 2.8

[28] Source: Bloomberg Barclays. Data as of January 31, 2017.

[29] Source: Bloomberg Barclays. Data as of January 31, 2017.

[30] Source: Bloomberg Barclays. Data as of January 31, 2017.

[31] Source: Bloomberg Barclays. Data as of January 31, 2017

[32] Source: Bloomberg Barclays. Data as of January 31, 2017

[33] Source: Bloomberg Barclays. Data as of January 31, 2017

[34] Source: Bloomberg Barclays. Data as of January 31, 2017.

[35] Source: Bloomberg Barclays. Data as of January 31, 2017.

[36] Source: Bloomberg Barclays. Data as of January 31, 2017.

[37] Source: Bloomberg Barclays. Data as of January 31, 2017.

[38] Source: Yield Book. Data as of January 31, 2017.

[39] Source: Barclays. Data as of January 31, 2017.

[40] Source: Federal Reserve Bank of New York. Data as of January 31, 2017.

[41] Source: S&P Case-Shiller U.S. National Home Price Index. Data as of January 31, 2017.

DISPLAY 5

Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	121	-2	120	-3
Industrial Basic Industry	154	-11	103	-9
Industrial Capital Goods	95	-3	93	-3
Industrial Consumer Cyclicals	115	+0	110	-4
Industrial Consumer Non Cyclicals	110	+0	101	-1
Industrial Energy	141	-7	118	-4
Industrial Technology	104	+1	79	-2
Industrial Transportation	113	+1	104	-2
Industrial Communications	157	+4	124	+0
Industrial Other	112	-2	148	-14
Utility Electric	113	-2	117	-3
Utility Natural Gas	123	-4	113	-1
Utility Other	141	-1	100	+1
Financial Inst. Banking	114	+0	117	-3
Financial Inst. Brokerage	131	-6	115	-9
Financial Inst. Finance Companies	132	-11	97	-2
Financial Inst. Insurance	126	-4	247	-10
Financial Inst. REITS	139	-6	138	-3
Financial Inst. Other	160	-8	158	-6

Source: Bloomberg Barclays. Data as of January 31, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

percent in December from November but were up 0.7 percent from December 2015.[42] In 2016 home sales totaled 5.45 million homes, the highest annual level since 2006. Housing inventory declined for the 19th consecutive month, and is now down 6.3 percent from a year ago. Unsold inventory is a 3.6 month supply at current sales pace, the lowest levels since the National Association of Realtors began tracking this data in 1999. New home sales also slowed in December, declining 10.4 percent from November and down 0.4 percent from December 2015.[43] For 2016 in total, an estimated 563,000 new homes were sold, up 12.2 percent from 2015. Despite the recent increases in home prices, U.S. homes remain affordable from a historical perspective. Mortgage performance also remains strong. New defaults were essentially unchanged at a 0.7 percent annual rate in December, but defaults are down from the 0.8 percent level in December 2015 and at the lowest levels over the past 10 years.[44] 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.

CMBS spreads also tightened significantly in January with AAA CMBS roughly 5 to 10 bps tighter and BBB CMBS 40-60 bps tighter.[45] AAA CMBS has been steadily tightening over the last nine months, while BBB CMBS had underperformed most other credit assets over the last two years but now appears to be seeing increasing demand. New non-agency CMBS issuance was surprisingly light in January with only two deals totaling $1.7 billion pricing. While over $100 million of 2007 vintage deals will be reaching their maturity and likely needing to be refinanced this year, we anticipate only $50 million to $60 million of non-agency CMBS issuance in 2017. New regulations that took effect January 1, 2017 now require issuers to retain a 5 percent ownership of new CMBS securitizations, which we believe will dampen some issuance as some originators seek alternative financing forms. Even with our more modest 2017 origination projections, January's issuance volumes were still less than half of the expected monthly volumes for this coming year. We saw roughly $70 billion in total non-agency CMBS issuance in 2016.[46]

Fundamentally, CMBS performance remains on solid grounds. Commercial real estate prices were flat in December, but are up 3.3 percent over the past 12 months. After several years of 10+ percent annual increases, the pace of commercial real estate price increases is slowing, but the trajectory remains positive. Commercial real estate prices are 26.7 percent above the previous peak in August 2007.[47] Hotel occupancy

[42] Source: National Association of Realtors. Data as of January 31, 2017.

[43] Source: U.S. Census Bureau and HUD. Data as of January 31, 2017.

[44] Source: S&P/Experian First Mortgage Default Index. Data as of January 31, 2017.

[45] Source: Barclays. Data as of January 31, 2017.

[46] Source: Deutsche Bank. Data as of January 31, 2017.

[47] Source: Green Street. Data as of January 31, 2017.

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

rates increased slightly in November from November 2015. Overall 2016 hotel occupancy rates remain near the highest levels seen over the past 15 years, and are up more than 5 percent from 2011.[48] National office vacancy rates decreased to 12.9 percent in Q4 2016, the lowest level seen since Q1 2008.[49] Multi-family vacancy rates increased by 0.2 percent in Q3 2016 to 4.5 percent, but multifamily vacancy rates remain near the lowest levels seen over the past 13 years.[50] Multifamily asset values rose 10 percent year-to-date through Q3 2016, more than double the increase for all real estate.[51] With CMBS issuance beginning to slow this year and expected so slow more sharply in 2018, and with underlying real estate fundamental conditions remaining strong, we expect CMBS to perform well in 2017.

European MBS spreads tightened 10 to 20 bps in January and remain meaningfully tighter than pre-Brexit levels.[52] ECB ABS purchases remain slow due to limited supply, and the ECB portfolio increased by only €0.3 billion European ABS in December. The ECB holds €22.8 billion of European ABS as of the end of 2016.[53] European ABS issuance totaled €91 billion in 2016, up from €79 billion in 2015.[54] We expect securitized issuance to remain relatively light in 2017 given regulatory constraints.

[48] Source: Statistica.com. Data as of January 31, 2017.

[49] Source: CBRE. Data as of January 31, 2017.

[50] Source: CBRE. Data as of January 31, 2017.

[51] Source: RCA/Moody's Commercial Property Price Index. Data as of January 31, 2017.

[52] Source: Deutsche Bank. Data as of January 31, 2017.

[53] Source: European Central Bank. Data as of January 31, 2017.

[54] Source: Deutsche Bank. Data as of January 31, 2017.

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.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

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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 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.

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 bunds**—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

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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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