Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

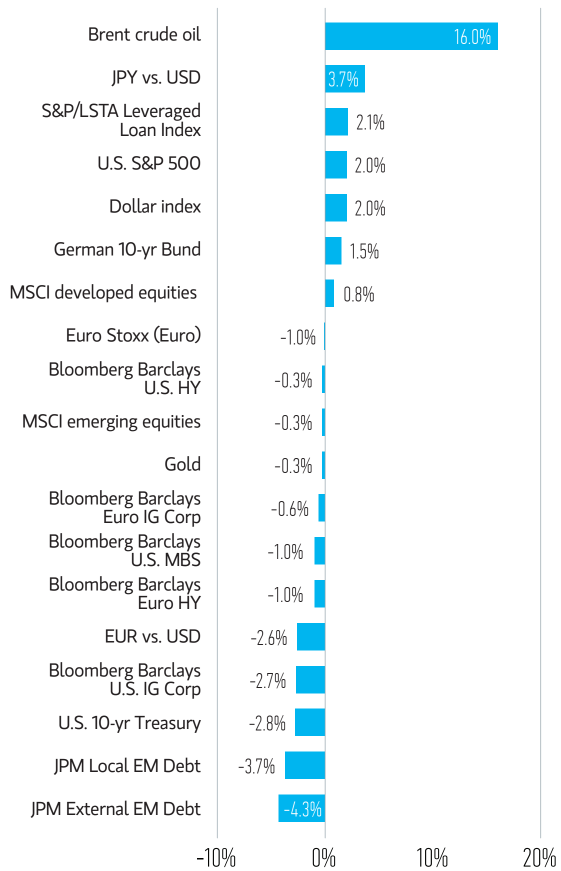
A Bumpy Ride

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JUNE 2018

May was a schizophrenic month for financial markets, with both bouts of "risk on" and "risk off," sometimes simultaneously. Equities and commodities did well, but credit and emerging markets suffered. Government bonds benefited from safe-haven demand but were also negatively affected by stronger inflation prints and still-robust U.S. growth data (growth data being much more mixed outside of the U.S.). All of which suggest central banks will continue to normalize monetary policy. Much of the increased stress stemmed from political risks—the Italian coalition government, elections in emerging markets, trade war concerns—and these are likely to persist over the coming months as tensions have not been resolved. However, the positive global growth picture remains intact and means we remain positive on credit and spread product. Admittedly, expectations of higher volatility make many "carry trades" less attractive, but the recent bout of risk aversion has also made valuations more compelling.

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of May 31, 2018. 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 6 and 7 for index definitions.

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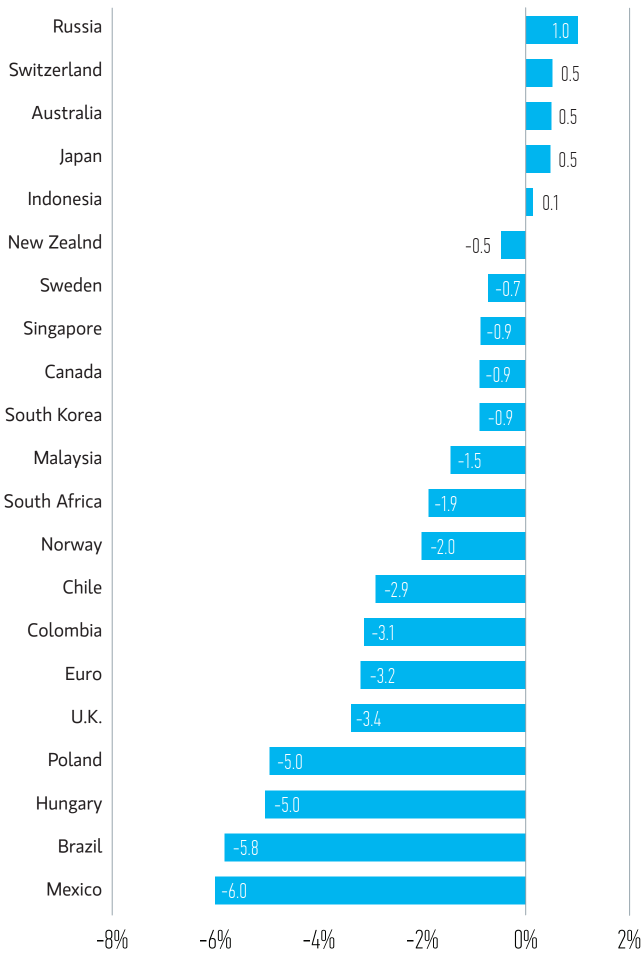
DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of May 31, 2018. Note: Positive change means appreciation of the currency against the U.S. dollar.

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spreads

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)	
United States	2.86	-9		
United Kingdom	1.23	-19	-163	-9
Germany	0.34	-22	-252	-12
Japan	0.04	-2	-282	+8
Australia	2.67	-10	-19	0
Canada	2.24	-6	-61	+3
New Zealand	2.72	0	-14	+9
EUROPE			(Spread over Bunds)	
France	0.67	-12	33	+10
Greece	4.59	+72	424	+94
Italy	2.79	+101	245	+123
Portugal	1.98	+31	164	+52
Spain	1.50	+22	116	+44
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			365	+32
EM Local Yields	6.49	+29		
EM Corporate Spreads			284	+39
Brazil	9.50	+121	299	+57
Colombia	6.35	+23	205	+23
Hungary	2.04	+47	138	+23
Indonesia	7.30	+25	200	+18
Malaysia	4.22	+2	144	+22
Mexico	7.82	+31	288	+25
Peru	5.72	+41	168	+16
Philippines	5.48	+18	123	+20
Poland	2.59	+13	83	+24
Russia	7.13	+7	221	+18
South Africa	9.19	+42	277	+23
Turkey	14.84	+204	390	+71
Venezuela	–	–	4565	+221
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			115	+7
EUR IG			118	+26
U.S. HY			362	+24
EUR HY			367	+75
SECURITIZED				
Agency MBS			78	+2
U.S. BBB CMBS			301	+3

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of May 31, 2018.

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Fixed Income Outlook

May was a rather schizophrenic month for financial markets, with bouts of both “risk on” and “risk off,” sometimes almost simultaneously. Developed market (DM) equity markets and commodities continued to make gains, supported by positive economic data and still-accommodative monetary policy, but credit markets and emerging markets (EM) suffered, partly due to idiosyncratic political risk events, but also by the sharp move higher in U.S. yields in the beginning of the month. In particular, concern about the anti-European Union (EU) stance of the new Italian coalition government has led to an ongoing bout of euro sovereign stress, and there are concerns about the presidential elections in Mexico and Brazil, and, let’s not forget, the threat of a trade war between the U.S. and its trading partners. All compounded by less-than-robust data prints outside of the U.S. This has led to a safe-haven bid for risk-free government bonds, with Bund yields falling to levels not seen since last year. However, government bonds are at risk from continued strong growth and rising inflationary pressures, with strong money prints reported in both Europe and the U.S.

Going forward, the most likely outcome is still that central banks normalize policy very slowly, as inflation is still recovering rather than overshooting and risks to the growth outlook abound. While a range of political risks are likely to persist, the positive global growth backdrop continues, meaning we remain positive on credit and EM, and unenthusiastic about DM government bonds, with a few notable exceptions.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	Volatility in emerging markets and European periphery brought back demand for safe havens in May. German 10-year yields decreased 22 basis points, outperforming U.S. Treasuries as political risks in Italy and Spain roiled the euro markets.[1] Negative headlines also helped to boost the dollar broadly.	We believe the U.S. Federal Reserve (Fed) must see a sustained rise in core personal consumption expenditures (PCE) price index before revising upward their policy outlook and will allow for a moderate inflation overshoot. For now, three hikes in 2018 still look most likely. For the 10-year U.S. Treasury, we think 3 percent is a reasonable area for it to trade in this environment. In May, we saw that 10-year rates hitting 3 percent started to create tighter financial conditions, which can lead to problems, especially in vulnerable EM countries, which then serves as a cap to Treasury yields. In terms of currencies, given the stronger dollar trend we've witnessed, the dollar's short-term outlook is more muddled. As such, we have been relatively neutral on the U.S. dollar and focused on more dollar-neutral FX positioning.
Emerging Market (EM) Rate/FX	EM fixed income assets continued to trade down in the month as ongoing U.S. dollar strength exacerbated EM currency weakness. Investors rotated into hard currency strategies (+$3 billion), away from local currency strategies (-$3 billion) in the month.[2] Turkey's central bank (CBRT) raised the Late Liquidity Window rate, which it has been using as its effective policy rate, by 300 basis points in an emergency meeting to counteract a rapid depreciation of Turkish lira. Meanwhile, in Argentina, the central bank (BCRA) tried to stabilize the Argentine peso (ARS) by hiking rates to 40 percent from 30.25 percent.	Despite the recent stumble in performance, we keep a constructive outlook for EM economies throughout the rest of the year. Commodity prices should remain supported while global inflationary pressures are still low. In addition, the current bout of dollar appreciation could reverse, and the U.S. dollar looks a bit overvalued. Finally, though domestic politics in key EM economies may add to heightened volatility, we think these events will remain confined to specific countries, without systemic impact on the broad EM world.

[1] Source: Bloomberg. Data as of May 31, 2018.

[2] Source: Bloomberg. Data as of May 31, 2018.

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	MONTHLY REVIEW	OUTLOOK
Credit	Both U.S. and European corporate credit indexes sold off and ended May at the widest spreads year-to-date. The performance of U.S. banks was decent, but European banks performed poorly in May. Unsurprisingly, Italian banks led bank weakness. Away from financials, other notable underperforming sectors in May included metals, attributable to EM weakness in May, and communications, as mergers and acquisitions (M&A) headlines continue to weigh down the sector.	Looking ahead, we believe a key issue is whether or not the market loses confidence in Italy and the extent to which this weighs on European and global economic growth. Our decision to remain modestly long credit is predicated on the assumption that any growth slowdowns are transitory and that global economic growth remains on a reasonable upward trajectory. In fact, valuations look significantly more attractive now. Signs of a more protracted slowdown would force us to revisit our thesis.
Securitized	With volatility in the rates market in May, rates-sensitive securitized assets performed reasonably well and reversed some of their previous losses, as fears about continued mortgage duration extension abated. Credit-sensitive securitized assets overall continued to perform well, as spreads were mixed but largely unchanged during the month and high carry continued to generate attractive returns. European mortgage-backed securities (MBS) spreads widened meaningfully in May, reacting to the political uncertainties in Italy, but most European MBS spreads still remain tighter for the year.	The combination of increasing home prices and higher interest rates is beginning to have a more material impact on housing affordability. We still find attractive value in non-agency residential mortgage-backed securities (RMBS), as the cash flow yields of non-agency RMBS remain compelling, but we are beginning to become more cautious given the spread tightening over the past few years. In European MBS, we see the May spread widening as a potential investment opportunity. We remain negative on Italy, but we believe that Spain, Portugal, the Netherlands, Germany and the U.K. continue to look attractive.

Risk Considerations

Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest rate environment, the portfolio may generate less income. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

DEFINITIONS

R* is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate.

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 10-Year Government Bonds—Italy Benchmark 10-Year Datastream Government Index.

The **MSCI World Index (MSCI developed equities)** captures large and mid-cap representation across 23 developed market (DM) countries.

Spain 10-Year Government Bonds—Spain Benchmark 10-Year Datastream Government Index.

The **ICE BofAML European Currency High-Yield Constrained Index (ICE BofAML 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

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those countries that are accessible by most of the international investor base (excludes China and India as of September 2013).

U.K. 10YR government bonds—U.K. Benchmark 10-Year Datastream Government Index. For the following Datastream government bond indexes, benchmark indexes are based on single bonds. The bond chosen for each series is the most representative bond available for the given maturity band at each point in time. Benchmarks are selected according to the accepted conventions within each market. Generally, the benchmark bond is the latest issue within the given maturity band; consideration is also given to yield, liquidity, issue size and coupon.

German 10YR bonds—Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR government bonds**—Japan Benchmark 10-Year Datastream Government Index; and **10YR U.S. Treasury**—U.S. Benchmark 10-Year Datastream Government Index.

The **ICE BofAML U.S. Mortgage-Backed Securities (ICE BofAML 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 (Bloomberg 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 (Bloomberg Barclays U.S. IG Corp)** is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market.

The **ICE BofAML United States High Yield Master II Constrained Index (ICE BofAML 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 U.S. dollar.

Euro vs. USD—Euro total return versus U.S. dollar.

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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