Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

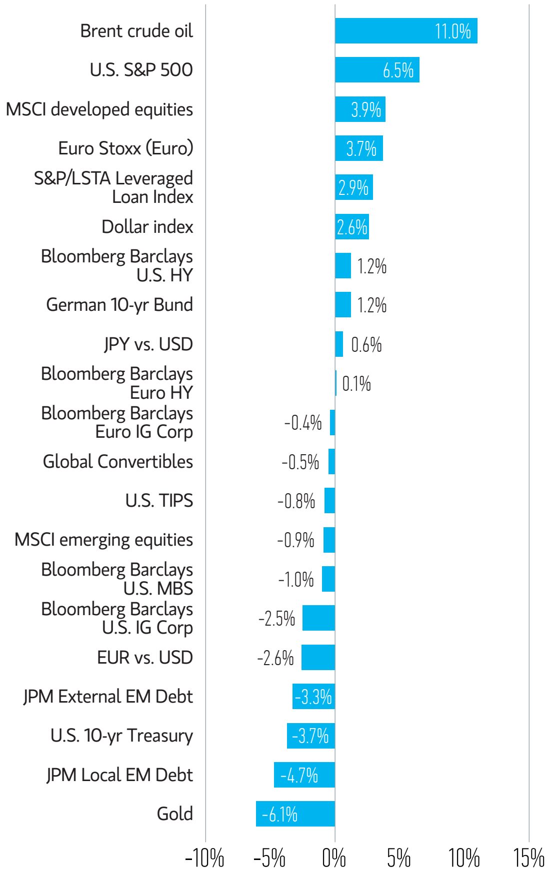
Awaiting ‘Peak’ Trade Noise

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

It seems that the news cycle has been as important as fundamentals in pricing financial assets. But, there comes a time when valuations get stretched too far and even though there has not been an improvement in the news flow/fundamentals, markets can rally. July was such a month. Risky assets rallied and risk free assets sold off. However, eventually prices cannot keep going up unless fundamentals improve and/or risks decline. August is looking like a critical juncture for both trade talks and the Italian budget. In other words, volatility may return. Our current strategy is to remain somewhat cautious, do not chase higher prices (lower yields) and wait for prices to reach attractive levels. We believe both economic and technical pressures point to higher U.S. Treasury yields, though we remain of the belief 10-year maturities will struggle to sustain yields much over 3% unless the rest of the global economy improves.

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of July 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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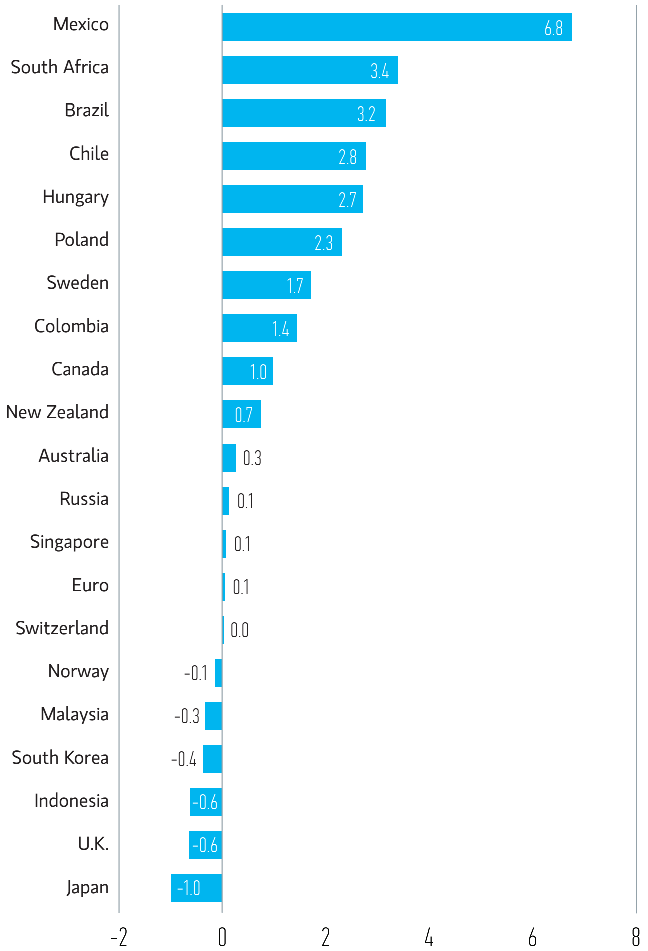
DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of July 31, 2018. Note: Positive change means appreciation of the currency against the USD.

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	2.96	+10		
United Kingdom	1.33	+5	-163	-5
Germany	0.44	+14	-252	+4
Japan	0.06	+3	-290	-7
Australia	2.65	+2	-31	-8
Canada	2.31	+14	-65	+4
New Zealand	2.72	0	-24	-10
EUROPE			(Spread over Bunds)	
France	0.73	+7	29	-7
Greece	3.96	0	352	-14
Italy	2.72	+4	228	-10
Portugal	1.74	-5	130	-19
Spain	1.40	+8	96	-6
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			352	-35
EM Local Yields	6.56	-8		
EM Corporate Spreads			270	-32
Brazil	9.45	-39	263	-63
Colombia	6.55	+14	177	-20
Hungary	2.36	-28	110	-35
Indonesia	7.95	-8	182	-36
Malaysia	4.08	-15	130	-36
Mexico	7.80	+15	274	-7
Peru	5.53	-12	143	-23
Philippines	5.92	-1	102	-30
Poland	2.57	-3	58	-18
Russia	7.53	+5	188	-29
South Africa	9.17	-22	273	-39
Turkey	19.17	+217	432	+17
Venezuela	–	–	5086	+75
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			109	-14
EUR IG			110	-12
U.S. HY			336	-27
EUR HY			343	-48
SECURITIZED				
Agency MBS			77	-2
U.S. BBB CMBS			275	-18

Positive Neutral Negative

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

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Fixed Income Outlook

In July, no bad news was good news. Data rebounded from a dip in the second quarter and, in general, surprised positively in July. Over 80% of the S&P 500 earnings beat analyst expectations. With underlying economic momentum still strong, the lack of distracting negative headlines meant that markets saw broad improvement across risk assets and regions. For instance, investment grade spreads, which hit a peak at the end of June, had recouped half of the year's rise by the end of July.

In a busy central bank calendar, it was the Bank of Japan (BoJ) which surprised the most. Having pegged 10-year Japanese Government Bond (JGB) yields at zero, the BoJ raised the band for policy rate fluctuations from +/- 10 basis points (bps) to +/- 20 bps. We believe this is a significant shift in policy. The BoJ will still act against sharp spikes in JGBs, but it will bring more volatility and allow JGB yields to drift higher in the medium term, which should ripple through risk-free yields around the world.

While July heralded a welcomed lull in the litany of shocks the global economy and bond market have faced, headwinds remain. In particular, the global trade war temperature keeps rising, risking distracting markets and businesses from an otherwise very good economic outlook. As such, it has become as important to forecast the political news cycle to understand market performance and to perform the Herculean task of handicapping the outcome AND the implications of the outcome for economic and financial market performance. The U.S. Trade Representative will hear public comments on the proposed list of $200 billion goods, and will reach a decision after August 31. Depending on the Chinese reaction, we believe that August-end could be "peak" trade noise, with a reduction of uncertainty possible in September. We are in wait-and-see mode.

In addition, Italy, which has been the main source of volatility for Europe, will start its budget debate, with October 15 as the deadline for passing the budget. Since the populist coalition believes it has a mandate to challenge European Union (EU) fiscal austerity, we believe volatility could rise in August. However, any sharp sell-off is likely to be a buying opportunity as the populist government has shown before that it is still responsive to market and international pressure and will relent.

July showed that valuations matter: even without much better news/data, markets can rally. Our strategy remains being fairly conservative with risk taking and waiting for either news/data to improve and/or valuations to get better. With the U.S. economy in good shape (at least for now), the U.S. Federal Reserve (Fed) continuing to raise rates, the BoJ adjusting yields higher, and European Central Bank (ECB) poised to end quantitative easing (QE), upward pressure on developed country bond markets should continue. But, 10-year U.S. Treasury yields substantially over 3% probably represent a buying opportunity, all else equal.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In July, risk appetite returned to markets. Ten-year JGB yields experienced a sharp increase in the month as the BoJ adjusted its yield curve control policy. This led to higher yields around the world towards the end of the month. The BoJ announced that the band around the 0 percent yield target will widen from +/- 10 bps to +/- 20 bps, to give more flexibility in adjusting the 10-year rate. Ten-year U.S. Treasury yields ended the month up 10 bps. The 2s10s curve flattened by 4 bps, ending the month at 29 bps.[1] European yields generally also rose.	A wider band for JGB trading as the BoJ adjusts the yield curve control policy should introduce more volatility and upward pull for risk-free rates. It is very possible markets test the 3 percent level in 10-year U.S. Treasuries again, though we look for overshoots as a buying opportunity. A sustained move higher in yields will require R*, i.e., estimated neutral policy rate, to rise significantly, driven by strong business investment, a falling savings rate and rising productivity.
Emerging Market (EM) Rate/FX	EM fixed income asset prices rallied in the month after a challenging second quarter. Within the dollar-denominated space, sovereigns outperformed corporates and dollar-denominated debt outpaced local. Higher-yielding, lower-rated credits outperformed in the month as risk appetite improved on cooling trade tensions between the U.S. and the EU. Investors (primarily retail) withdrew assets from local currency strategies (-$1.4 billion), while hard currency strategies gained +0.6 billion in the month. Energy and metal prices fell over the month, while prices for agricultural commodities, such as wheat, corn, soybeans and cotton, strengthened.	Tail risks regarding trade wars are becoming more prominent. Though EM economies are exposed differently to a trend towards more protectionism, a worsening global trade picture should weigh on global growth and have negative implications for all risky assets, and EM in particular. On the positive side, the EM policy response has been more proactive as of late, with many economies deemed as vulnerable reacting more forcefully to market turbulence. The sharp sell-off we witnessed in the second quarter appears to be overdone in countries with improving fundamentals (such as South Africa and Indonesia), thus offering attractive entry points should we see a de-escalation in trade war rhetoric.

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

	MONTHLY REVIEW	OUTLOOK
Credit	Global credit markets rallied strongly in July, turning in their best performance in many months. The Bloomberg Barclays U.S. Investment-Grade Corporate Bond Index tightened by 14 bps in July to end the month at 109 bps, with lower quality and longer maturity bonds outperforming the broader market.	As we wrote last month, valuations in the investment grade markets had reached levels in June that priced in a lot of bad news. We believed that spreads in the 120 bps range (where they started July) were only really justifiable if we experienced a material economic slowdown. We believe credit remains well positioned to perform well in the second half of 2018. The fundamental backdrop looks increasingly benign, given strong economic data and the easing of both trade and political concerns relative to the first half of 2018.
Securitized	Mortgage and securitized markets were relatively quiet and performance was generally flat in July. Non-agency residential mortgage-backed securities (RMBS) spreads were slightly wider in July, but income continued to generate positive returns for the sector during the month. Home prices continued to perform well, but home affordability is becoming more challenging as home prices rise and mortgage rates have increased as well. European mortgage-backed securities (MBS) spreads widened again in July as political uncertainties continue to unsettle the markets once again.	Our investment thesis remains largely unchanged for August: We remain generally constructive on securitized credit opportunities and cautious on U.S. agency MBS. Despite some of the global economic risks and uncertainties from growing protectionism, we believe the U.S. economy remains strong, and consumer and real estate fundamentals continue to improve. As the commercial mortgage-backed securities (CMBS) credit curve continues to flatten, we have been migrating up in credit. At current spread levels, we believe most AAA CMBS offer compelling value relative to other high-quality asset classes, while spreads on lower-rated CMBS continue to vary significantly based on underlying collateral composition. In European MBS, we remain negative on Italy, but we believe that Spain, Portugal, the Netherlands, Germany and the U.K., which continue to offer attractive MBS opportunities.

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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 **Bloomberg Barclays Global Aggregate Corporate Index** is the corporate component of the Barclays Global Aggregate index, which provides a broad-based measure of the global investment-grade fixed income markets.

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

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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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