Global Fixed Income Bulletin

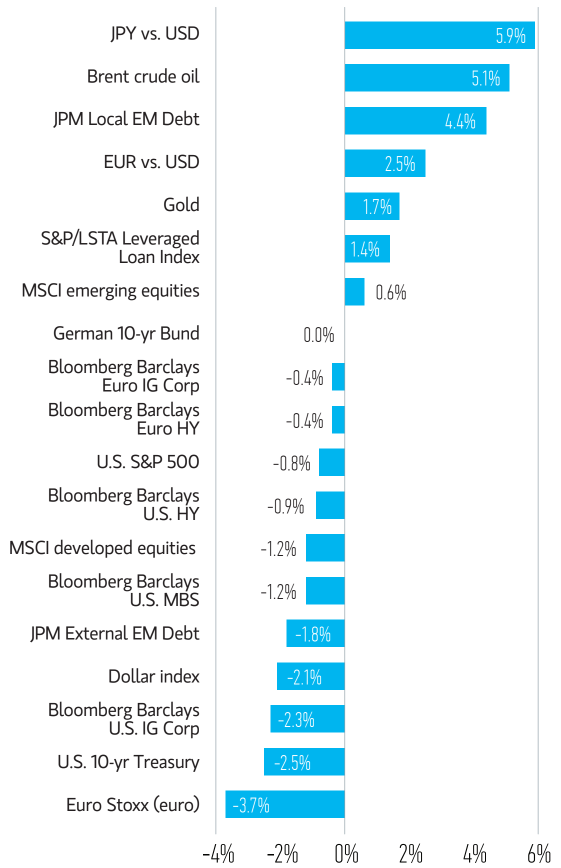
Goldilocks Meets the Three Bears

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

As much as January felt like Goldilocks' conditions for markets, it seems that March was a perfect storm of risks—trade war, rising short-term rates, FANG (Facebook, Amazon, Netflix and Alphabet) stocks. Investment-grade spreads were hit especially hard in the month, widening 13 basis points and unwinding a large portion of the tightening from 2017. This was in large part driven by technical forces. Among other forces, U.S. corporate repatriation pulled dollars from abroad, pushing up funding costs and the Libor-OIS (London Interbank Offered Rate-Overnight Index Swap) spread. Yields on short-term papers widened, dragging up the rest of investment-grade spreads. We view the recent spread widening in short-dated investment-grade paper as a good opportunity to add good carry for relatively low default risk. On trade, we believe that the administration will not be singularly focused on closing the trade deficit (the bear case) and, ultimately, will be satisfied if China makes real concessions in other economic or geopolitical areas (the bull case).

DISPLAY 1

Asset Performance Year-to-Date

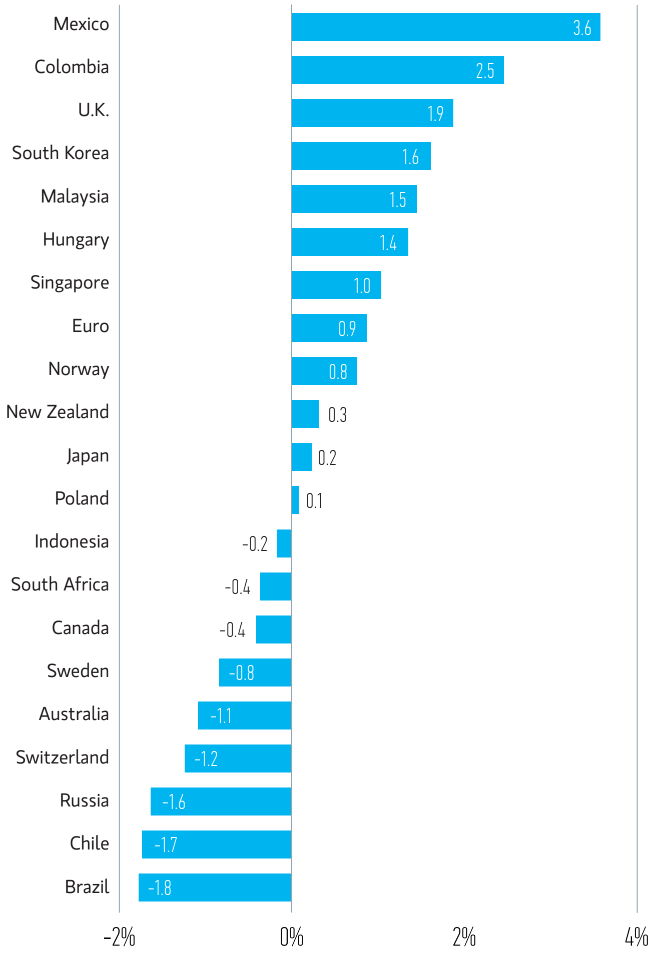


Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of March 31, 2018. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 12 and 13 for index definitions.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of March 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	2.74	-12		
United Kingdom	1.35	-15	-139	-3
Germany	0.50	-16	-224	-4
Japan	0.04	-1	-270	+11
Australia	2.60	-21	-14	-9
Canada	2.09	-14	-65	-2
New Zealand	2.72	-23	-2	-10
EUROPE			(Spread over Bunds)	
France	0.72	-20	22	-4
Greece	4.32	-9	382	+7
Italy	1.79	-19	129	-3
Portugal	1.61	-38	111	-22
Spain	1.16	-38	67	-22
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			323	+14
EM Local Yields	6.13	-12		
EM Corporate Spreads			241	+22
Brazil	8.23	-27	238	+12
Colombia	6.22	-21	180	+2
Hungary	1.51	-16	110	+11
Indonesia	6.84	-6	184	+14
Malaysia	3.98	-5	126	+18
Mexico	7.40	-29	252	+14
Peru	4.92	-1	156	+19
Philippines	5.08	+21	102	+0
Poland	2.47	-16	55	+0
Russia	6.79	-3	195	+43
South Africa	8.56	-19	250	+21
Turkey	12.80	+88	323	+26
Venezuela	–	–	4189	-436
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			109	+13
EUR IG			95	+15
U.S. HY			354	+18
EUR HY			311	+30
SECURITIZED				
Agency MBS			80	+2
U.S. BBB CMBS			305	-3

Positive Neutral Negative

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

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Fixed Income Outlook

It is April, but January already feels like a very long time ago. As much as January felt like Goldilocks' conditions for markets, it seems like March was a perfect storm of risks—trade war concerns, rising short-term rates, FANG stock issues. Investment-grade spreads were hit especially hard in the month, widening 13 basis points and unwinding a large portion of the tightening from 2017. In contrast, the S&P 500 is still up 14 percent from the end of 2016.[1]

Given relative stability in economic data and monetary policy, technical forces drove fixed income market trading in March. The first quarter saw large volumes of corporate issuance, on top of larger U.S. Treasury supply. Dealers had very limited scope to absorb the supply, given balance sheet and capital constraints. In addition, U.S. corporate repatriation pulled dollars from abroad, pushing up funding costs and the Libor-OIS spread. Yields on short-term papers widened, dragging up the rest of investment-grade spreads. On the demand side, rising U.S. Treasury rates led investors to rotate out of fixed income into equities, with total equities inflow in January reaching a record of $100 billion.[2] All of this led investment-grade and high-yield credit spreads to widen in the month.

On top of technical forces, trade war headlines kept risk appetite and dip buying in check. On trade, we believe that the administration will not be singularly focused on closing the trade deficit (the bear case) and, ultimately, will be satisfied if China makes real concessions in other economic (intellectual property, market access) or geopolitical areas (the bull case). Tariffs and other hardline threats are tools to push China to negotiate. Though he shares Trump's ideological focus on China, Robert Lighthizer is an experienced trade official who has worked to compile a large case file of Chinese anti-competitive practices (see his 100+ report on China and World Trade Organization (WTO) compliance), and will work to steer the administration toward rational trade actions that are grounded in evidence. In addition, Trump could potentially tie trade and geopolitics, softening on trade if China helps on North Korea. Given the upcoming midterm elections, the largely bipartisan agreement that China has been abusing WTO rules, and possible related issues surrounding a U.S.-North Korea summit, we do see more trade-related volatility in the near-term, though we believe the bull case will play out in the end.

Finally, to put all of the risks into perspective, economic fundamentals continue to be good. The U.S. ISM Manufacturing Index is still hovering around 60 indicating we're still in a strong expansion phase, corporate earnings are rising, while core inflation remains subdued. Credit default risks should remain low, supporting investment-grade and high-yield corporate bonds. In addition, emerging market (EM) local bonds and non-agency mortgages have been relatively calm in the storm, and we continue to see them as good places to weather additional volatility.

[1] Bloomberg Barclays. As of March 31, 2018.

[2] Wigglesworth, Ryan. "Equity fund inflows hit record as stock market sees best January since 1987". *Financial Times*. February 1, 2018.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	With a slew of negative trade headlines, global rates rallied in March. Ten-year U.S. Treasury yields ended the month down 12 basis points, ending the month at 2.74 percent while German 10-year yields fell 16 basis points. Euro-area periphery spreads mostly tightened, led by Portugal and Spain.[3] Italian spreads lagged the rest of the periphery due to inconclusive election results on March 4. The dollar was relatively flat versus other currencies. The Mexican peso was the biggest winner in the month, gaining 3.6 percent as the U.S. trade team made key concessions that made a North American Free Trade Agreement (NAFTA) deal look more likely. Trump's announcements targeting China's technology sector appear to be read more as the opening salvo towards a broad trade negotiation than the prelude to a full-blown trade war.	Unless trade tensions morph into a full blown anti-growth war, we believe the risk for 2018 is that the U.S. Federal Reserve (Fed) hikes rates faster than expected. For now, we are still expecting three hikes. Unless R* rises, driven by strong business investment, a falling savings rate and rising productivity, we believe that, for now, 3 percent may be the upper bound for 10-year U.S. Treasury yields. We see rising odds of a hike in the Yield Curve Control (YCC) target in Japan, perhaps early next year. We believe JGBs have acted as an important anchor for yields around the world, and any change in market expectation of YCC could be the next driver of higher yields.
Emerging Market (EM) Rate/FX	EM fixed income asset performance was mixed in March. Dollar-denominated and local currency sovereigns outperformed dollar-denominated corporate debt. In aggregate EM currencies strengthened 0.06% versus the U.S. dollar and EM bonds gained 0.94% in local terms, leading to a return of 1.00% for the index measured in U.S. dollars. At the aggregate level yields fell 8 basis points to 6.00% for EM domestic debt. Bonds from Mexico, Colombia, Hungary, Malaysia and South Africa outperformed the broader market. Conversely, bonds from Turkey, Russia, the Philippines, Brazil and Chile lagged as currency weakness versus the U.S. dollar weighed on performance. While war tensions on the Korean peninsula have temporarily ebbed, the prospects of a trade war, or at least a skirmish, increased with the U.S. administration announcing tariffs on Chinese imports, and China responding in kind. So far, overall, the rhetoric has been worse than the actual actions by either side.	We see the EM/DM growth differential rising even further in favor of EM in 2018, potentially boosting inflows into EM. Strengthening growth, U.S. twin deficits and valuation make significant dollar appreciation unlikely. While U.S. trade protectionist inclinations could be a source of volatility, we do not expect them to change the global narrative.

[3] Source: Bloomberg. Data as of March 31, 2018.

	MONTHLY REVIEW	OUTLOOK
Credit	Corporate indexes experienced extended weakness in March, with both the U.S. and European markets generating negative excess returns. Spreads have retraced much of their recent outperformance and have now widened back out to September 2017 levels. Investment-grade spreads widened across all sectors, with financials underperforming nonfinancials. In particular, subordinated financials and insurance bonds continued to underperform, after their stellar performance in late 2017.	March made it apparent that the market needs to adapt to the higher level of risk premia and new trading ranges. With a large supply to fund several merger and acquisition (M&A) transactions, the dispersion of concessions among deals was wide, and the modest performance relative to the large discounts indicated that we were still in a market searching for proper clearing levels. Additionally, the widening of the Libor-OIS spread developed into a negative tailwind for shorter-maturity assets, and the ripple effects were felt throughout the investment-grade market. As long-term investors, we view the recent spread widening in short-dated investment-grade paper as a good opportunity to add good carry for relatively low default risk.
Securitized	Securitized assets had a moderately good performance in March. Credit-sensitive securitized assets continued to perform well, with returns resulting primarily from carry rather than from spread tightening. Agency mortgage-backed securities (MBS) had its first positive return month in 2018 as interest rates reversed some of their 2018 increases and seem to have found a new range. The Fed purchased $20 billion to $30 billion MBS per month in 2017, but has reduced its purchases to $12 billion to $20 billion per month so far in 2018.	We remain generally constructive on securitized credit opportunities and cautious on more rate-sensitive securitized assets. Despite its underperformance year-to-date in 2018, agency MBS still looks expensive from a historical spread perspective, and we expect it to cheapen further as volatility increases and the largest buyer (the Fed) reduces its purchases. In addition, we continue to see attractive opportunities in U.K., Spanish, Portuguese and Greek residential mortgage-backed securities (RMBS).

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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.

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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 (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 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 (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 **ICE BofAML 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 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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