

Global Fixed Income Bulletin

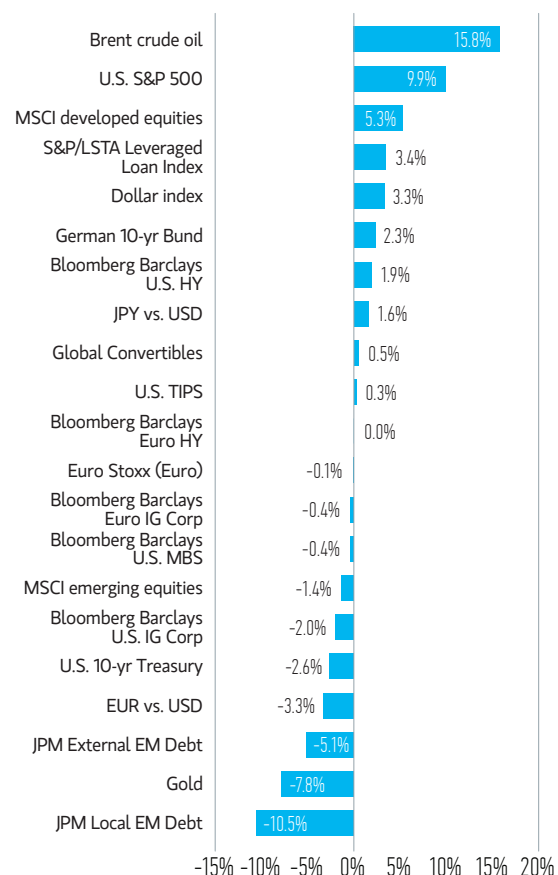
Is the Stress Systemic or Idiosyncratic?

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

A key issue for investors to address is if the stresses which affected markets in August were predominantly idiosyncratic in nature or if there are more sinister systemic issues at work. If they are mainly idiosyncratic, they are unlikely to derail an otherwise positive global economic environment, supporting risky assets and leading to increased upward pressure on government bond yields. However, if they are indicative of broader underlying tensions in the global economy (excessive leverage, tight financial conditions, deteriorating emerging markets) then the outlook is likely to be a lot more challenging and many “cheap” assets may actually be a “value trap.”

DISPLAY 1

Asset Performance Year-to-Date

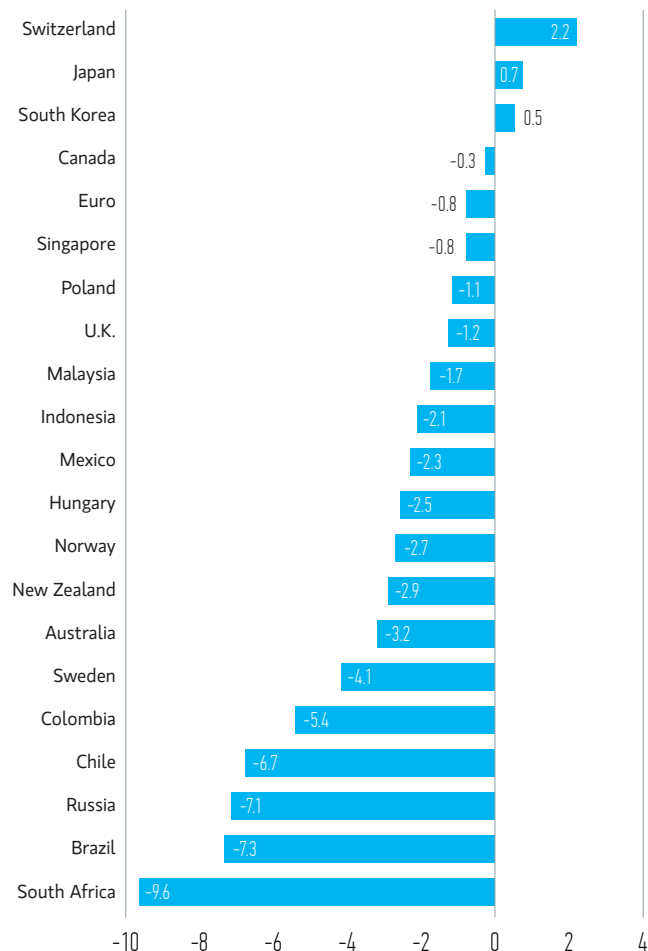


Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of August 31, 2018. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 6 and 7 for index definitions.

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DISPLAY 2**Currency Monthly Changes Versus U.S. Dollar**

(+ = appreciation)



Source: Bloomberg. Data as of August 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	2.86	-10		
United Kingdom	1.43	+10	-143	+20
Germany	0.33	-12	-253	-2
Japan	0.11	+5	-275	+14
Australia	2.52	-13	-34	-3
Canada	2.23	-8	-63	+2
New Zealand	2.72	0	-14	+10
EUROPE (Spread over Bunds)				
France	0.68	-5	36	+7
Greece	4.40	+44	408	+56
Italy	3.24	+52	291	+63
Portugal	1.92	+18	160	+30
Spain	1.47	+7	115	+19
EM	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)	USD SPREAD (BPS)	MTD CHANGE (BPS)
EM External Spreads			399	+47
EM Local Yields				
EM Corporate Spreads			314	+44
Brazil	10.41	+96	337	+74
Colombia	6.55	0	184	+7
Hungary	2.50	+14	124	+14
Indonesia	8.23	+29	191	+9
Malaysia	4.06	-3	136	+6
Mexico	7.93	+13	282	+8
Peru	5.52	-1	147	+4
Philippines	5.92	0	109	+7
Poland	2.57	0	63	+5
Russia	8.40	+87	235	+47
South Africa	9.55	+38	336	+63
Turkey	23.97	+480	598	+166
Venezuela	—	—	5807	+721
CREDIT			SPREAD (BPS)	MTD CHANGE (BPS)
U.S. IG			114	+5
EUR IG			119	+9
U.S. HY			338	+2
EUR HY			348	+5
SECURITIZED				
Agency MBS			81	+4
U.S. BBB CMBS			262	-13

Positive Neutral Negative

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

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Fixed Income Outlook

At first glance, most of last month's market stresses seem to be unrelated to each other. Turkey, Argentina and South Africa all have significant structural economic issues, all of which have been known about for some time. But they are representative of the emerging market (EM) asset class and therefore do set the tone for investor attitudes with regard to risk and reward. On the other hand, while significant within EM, we do not believe they are big enough to present a systemic risk to the global economy or markets. A more significant risk to the global economy would be a more severe slowdown in China which would have much more negative implications for the global economy, monetary policies and market performance.

EM stresses have not been the only source of risk and concern. In Europe, changing political dynamics in Italy have raised important fiscal issues for the Italian economy and asset prices and for the Eurozone as a whole. Italy is a large enough economy and has a large enough bond market to pose a systemic risk to the rest of the European Union (EU) and eurozone. The populist stance of the current Italian coalition government threatens to undermine the success the EU has had in reinvigorating the economy (not helped by the U.S. "America First" trade policies). The good news is that populist governments have a poor record at rebelling against EU hegemony, and the market pressure placed on the Italian government is likely to force it to more-or-less adhere to EU fiscal rules. The big risk is that the coalition government does not back down until the market forces it to, thus creating significant upside risks to yields. On the other hand, Italian risk premia are fairly high and if the government backs down and pursues more orthodox policies, Italian assets could rally.

Optimists would point out that the global economy remains in good shape, with not only the slowdown in economic activity from the beginning of the year abating, but seeing a re-invigoration of the U.S. economy. Corporate earnings remain robust, especially in the U.S., inflation is low, keeping central banks at bay (yes, even the U.S. Federal Reserve (Fed) has pursued a slow hiking trajectory belying the

level of nominal gross domestic product (GDP) and low unemployment rates), helping to keep equity and interest rate volatility low. While foreign currency (FX) volatility has picked up, due to the stresses in EM, it still remains low if looked at on a multiyear basis and at a G-10 level.

Unfortunately, this is not the whole story. Pessimists see stresses in EM as an inevitable consequence of tightening global liquidity conditions, especially U.S. dollar (USD) financing, which is likely to continue given the U.S. economy's robust performance. The year-to-date economic divergence between the U.S. and the rest of world has surprised markets and poses risks. One, the Fed could tighten more than the non-U.S. economy can bear, initiating a slowdown that will undermine asset prices, even U.S. ones, as negative feedback loops kick in. While the U.S. does not sit in isolation from the rest of the world, there is enough momentum in the U.S. economy to blunt, if not overwhelm, negative forces emanating from outside its borders. Two, the dollar could continue to rise, exacerbating inflationary concerns in EM, eliciting monetary tightening when economic conditions in many countries suggest stable to lower rates would be most appropriate. Eventually, the negative feedback loop to the U.S. economy would cause the Fed to moderate its tightening, but this could happen too late, and after much damage.

In the short term (i.e., next month or two), the negative sentiment and momentum send a bearish signal regardless if the stresses are fundamentally justified or not. Our tactical indicators advise caution because EM underperformance of the type we have recently experienced has historically been a reliable leading indicator of lower developed market government bond yields and wider credit spreads (all else equal). However, if the global economic data remain robust, and reduced central bank liquidity provision is less detrimental than feared, EM and other credit assets could start to look attractively priced. While it looks premature to rush in just yet, the summer sell-off may provide attractive buying opportunities before year-end.

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MONTHLY REVIEW

OUTLOOK

Developed Market (DM) Rate/Foreign Currency (FX)

In August, we saw risk-off sentiments in global markets following volatile headline news ranging from Italy to Brexit. Investors' flight to safety drove U.S. 10-Year Treasury and Germany Bund 10 basis points (bps) and 12 bps lower, respectively. On the other hand, Italy's spread continued to widen, moving another 52 bps this month on the uncertainty of their budget proposal near the end of September. Other peripheral countries, ranging from Greece to Portugal, sold off in response to general weaker risk appetite. U.K. 10-Year Treasury yields rose 10 bps amidst more headlines coming out of Brexit. U.S. 2s10s curve continued to flatten, moving another 6 bps to a new low of 23 bps.¹

We believe the Fed will allow for a moderate inflation overshoot, i.e., be patient with firming inflation data. The market seems to be coming around to this view that the Fed is not likely to hike aggressively in 2019 after Jay Powell's Jackson Hole speech, although recent firming pressures in wages and business confidence raises the ante with regard to the appropriate terminal rate. As for U.S. Treasury 10-Year yields, we still think 3 percent is a reasonable estimate as to its current equilibrium. As we've previously noted, Japanese Government Bonds (JGBs) have served to anchor yields worldwide. A wider band for JGB trading as the Bank of Japan (BoJ) adjusts the yield curve control policy could introduce more volatility and upward pull for risk-free rates but for now the BoJ does not appear to be in a rush. It is very possible we test 3 percent in U.S. Treasuries again, though we look for overshoots as a buying opportunity.

Emerging Market (EM) Rate/FX

Sentiment, weighed down by threats to global trade, and light summer liquidity provided the backdrop for a poor month of performance for EM fixed income assets. The reduction of global liquidity (the raising of policy rates and reduction of Fed balance sheet assets) has caused the market to focus on countries with external vulnerabilities, specifically those with twin deficits (current account and fiscal). This has led to pressure on assets, especially currencies, from Turkey, Argentina and South Africa. While the changing monetary policy landscape prompted a change in investor sentiment, most of these countries were facing their own idiosyncratic issues which left them vulnerable to shifts in risk appetites. While the asset price movements for those particular countries have fallen to distressed levels recorded in previous EM crisis periods, broader contagion has been limited, perhaps due to the absence this time around of any notable uptick in either actual or expected defaults. During the month, within the dollar-denominated space, corporates outperformed sovereigns, and overall, dollar-denominated debt outperformed local debt. Investors (primarily retail) withdrew assets from both local currency strategies (-\$0.4 billion) and hard currency strategies (-\$0.7 billion) in the month.² Energy and palladium prices rose over the month, while prices for other industrial metals and agricultural commodities such as wheat, corn, soybeans and cotton fell.

We keep a cautious view on EM debt, as a set of risks may adversely impact asset returns in the near term. Among global factors, trade issues seem to be top of the list, including the U.S. government acting on its threat to levy additional tariffs on China, which is likely to be met by Chinese retaliatory measures. Additionally, still unresolved U.S.-Canada trade issues involving the North American Free Trade Agreement (NAFTA) will contribute to heightened volatility, despite a tentative agreement signed between the U.S. and Mexico. A flattening U.S. yield curve, which some view as a reliable predictor of impending recession, may start to impact U.S. equities, thus raising fears on global growth and impacting EM assets. On the other hand, the latest high-frequency indicators coming out of Europe have surprised to the upside, which has helped to mitigate global growth concerns. We also keep an eye on China, as the government relies on multiple policy tools to deal with conflicting goals involving deleveraging, a soft activity slowdown, and FX stability amid a dwindling current account surplus and a trade spat with the U.S.

¹ Source: Bloomberg. Data as of August 31, 2018. ² Source: JP Morgan. Data as of August 31, 2018.

MONTHLY REVIEW

OUTLOOK

Credit

Global credit markets drifted weaker in August, after a strong rally in July. The Bloomberg Barclays U.S. Investment-Grade Corporate Bond Index had spreads widening by 5 bps in August to end the month at 114 bps, with BBBs and industrials leading the market down.³ In Europe, the spread of the Bloomberg Barclays Euro-Aggregate Corporate Index moved 9 bps wider to end the month at 119 bps.⁴ For the year, U.S. investment-grade corporate spreads are now 21 bps wider while the spread on the European Investment-Grade Corporate Index is 33 bps wider.

With spreads in the low 100s for U.S. and European credit, we believe credit valuations remain attractive in a nonrecessionary environment and have the potential to perform well in the last few months of 2018. While there will likely be continued volatility in EM, as well as continued trade disputes, the fundamental backdrop in the U.S. and Europe looks rather benign. Technicals will be an important factor from here and we'll be closely watching how the supply calendar and associated demand/in-flows may influence the market. With regard to positioning, we continue to position portfolios modestly overweight credit risk. Within investment grade, we continue to favor financials, given their robust fundamentals and strong regulatory oversight. We remain cautious on many parts of the nonfinancial markets due to weaker fundamentals, merger and acquisition (M&A) risks and widespread technology and disruption risks.

Securitized

In August, mortgage and securitized markets were relatively quiet, but performance was generally positive. Global economic weakness seems to be outweighing relatively strong U.S. economic numbers, driving interest rates lower, but the continued expectation of more Fed rate hikes is causing the curve to flatten further. Rates-sensitive securitized assets performed well in August, while credit-sensitive securitized assets overall continued to generate positive returns, primarily driven by cash flow carry.

Our investment thesis remains largely unchanged for September: we remain generally constructive on securitized credit opportunities and cautious on U.S. agency mortgage-backed securities (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 credit fundamentals continue to improve. We remain underweight agency MBS given that the Fed continues to reduce its MBS purchases, and as a result, the tradable market supply is increasing. Agency MBS also still looks expensive from a historical spread perspective, and we believe spreads will likely need to widen to attract new investors to offset the Fed's reduced purchases. We expect interest rate volatility to remain subdued for the remainder of 2018, and this reduced volatility could allow agency MBS to outperform other government guaranteed assets, but overall we still expect agency MBS to generally underperform the broader securitized investment universe given the lower carry and our concerns over increasing tradable supply.

³ Source: Bloomberg Barclays. Data as of August 31, 2018.

⁴ Source: Bloomberg Barclays. Data as of August 31, 2018.

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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.

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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 (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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