Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

It's complicated ...

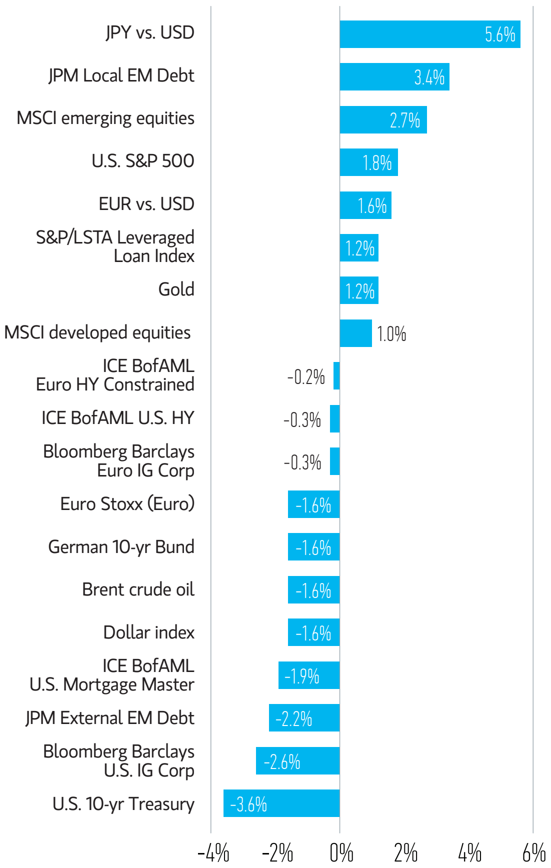
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | MARCH 2018

The market outlook feels more complex than it did a month ago. The economic backdrop remains very positive, but growth surprises have moderated and become more varied across economies, with the strongest growth trajectory still being in the U.S. The path to higher growth is undoubtedly one that will be bumpier. We still think the most likely path is for interest rates to go higher, but not equally across markets. The risks are skewed to the market underpricing Federal Reserve (Fed) rate hikes; underappreciating potential Bank of England (BoE) tightening, while the European Central Bank (ECB) could signal this month that it is in no hurry to normalize policy. Valuations also come into play, with U.S. Treasuries still demandingly priced, while German bunds are anchored by very low policy rates and quantitative easing (QE) induced scarcity.

The increase in risky asset volatility is also a challenge for spread product. The positive economic outlook continues to provide fundamental support, but higher volatility undermines risk-adjusted return expectations when valuations already look demanding versus history. Our bias is still to think that positive growth fundamentals will prevail, but the ride is likely to be bumpier than it was over the last year. Sharpe ratios will likely deteriorate.

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of February 28, 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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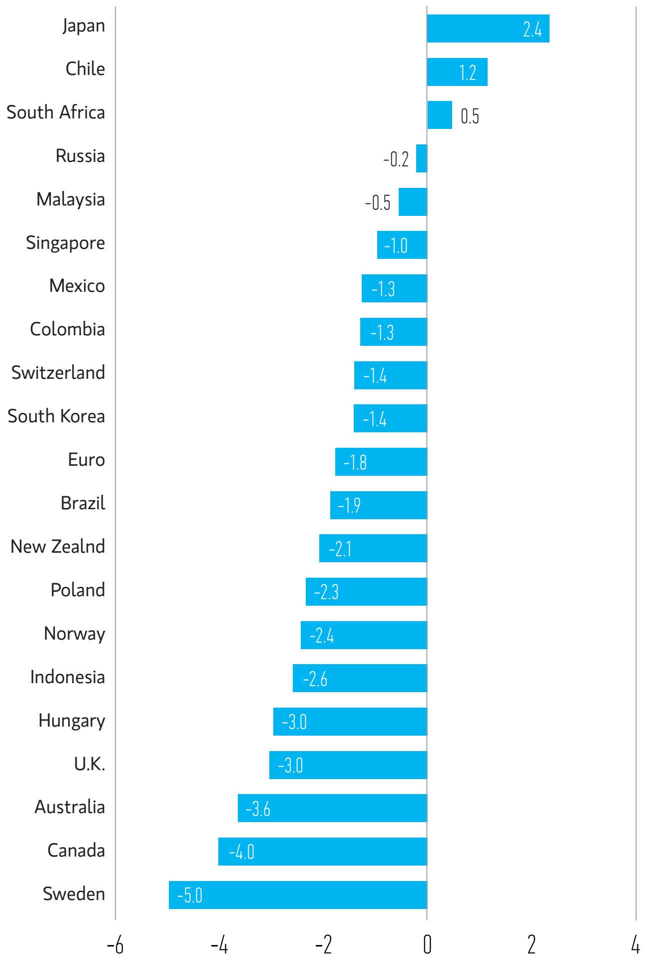
DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of February 28, 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	+16		
United Kingdom	1.50	-1	-136	-16
Germany	0.66	-4	-220	-20
Japan	0.05	-3	-281	-19
Australia	2.81	0	-5	-16
Canada	2.24	-5	-63	-21
New Zealand	2.94	+4	8	-11
EUROPE			(Spread over Bunds)	
France	0.92	-5	26	-1
Greece	4.41	+67	376	+71
Italy	1.97	-5	132	-1
Portugal	1.99	+3	134	+7
Spain	1.54	+11	88	+15
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			309	+19
EM Local Yields	6.25	+3		
EM Corporate Spreads			219	+16
Brazil	8.49	-24	226	+9
Colombia	6.42	+18	178	+25
Hungary	1.67	+20	99	+20
Indonesia	6.91	+37	170	+18
Malaysia	4.04	+4	108	+7
Mexico	7.69	+6	238	+15
Peru	4.94	+15	137	+18
Philippines	4.86	+12	102	+18
Poland	2.63	-12	55	+14
Russia	6.81	-24	152	-4
South Africa	8.75	-42	229	+10
Turkey	11.92	+21	297	+20
Venezuela	–	–	4625	-35
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			96	+10
EUR IG			80	+6
U.S. HY			319	-24
EUR HY			250	-27
SECURITIZED				
Agency MBS			78	+5
U.S. BBB CMBS			299	-31

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of February 28, 2018.

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Fixed Income Outlook

The outlook for interest rates feels more complicated than it did a month ago. On the fundamental macroeconomic side, some of the positive momentum in the global growth picture has moderated, with growth indicators no longer surprising to the upside. In addition, global equities experienced their worst month in two years. This says almost as much about how steady equity markets have been in recent times as it does about the size of last month's sell-off, but both suggest there could be increased demand for fixed income as a risk-hedging instrument. At the same time, the growth outlook remains very solid, and there are concerns that inflationary pressures are building, so the trend toward tighter monetary policy remains in place.

The picture has also become more varied across economies. The strong U.S. economic data and Fed communication mean a March rate hike is now priced with close to certainty, and the debate is moving on to if the Fed might raise rates four times in 2018 and/or more than twice in 2019. In the U.K., tight labor market conditions suggest the Monetary Policy Committee (MPC) may raise rates twice this year but weaker growth data is also supporting long maturity bonds. In euro, growth remains strong, but it may not be enough to convince the ECB to raise rates before well into 2019. The Bank of Japan (BoJ) has also made comments about moderating its easy stance, but the time horizon is still too long to impact JGB performance. The end result is that we may see continued divergence between markets, with U.S. rates looking more vulnerable than most other markets.

The weakness and increased volatility in equity markets has also negatively impacted credit and sovereign spreads. While solid macroeconomic fundamentals continue to provide support, the question is if spread product can withstand a significant increase in risk premium, given current spread levels. At the very least, higher rate volatility makes carry trades harder to hold, and cheaper equity valuations make it a more attractive asset for risk-seeking investors. Our bias remains to be long spread product, but we recognize the ride is likely to be more bumpy going forward.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	Global rates were volatile in February. After peaking at 2.95 percent in the middle of the month, 10-year U.S. yields ended the month up 16 basis points. However, rising yields were limited to the U.S., where economic data and inflation continues to surprise positively and the odds of more frequent Fed hikes continue to rise. The dollar rose versus major currencies as risk sentiments reversed from the euphoria of January, except versus the yen which strengthened against everyone.	The risk for 2018 is the Fed hikes rates faster than expected. As of now, we still lean toward three hikes. Given the debate around R*, with some Fed members putting forth that we might be close to it already, we believe the Fed will proceed with caution, lest they overtighten. Unless R* rises, driven by strong business investment, falling saving and rising productivity, we believe that, for now, 3 percent may be the upper bound for 10-year U.S. Treasury yields.
Emerging Market (EM) Rate/FX	EM fixed income asset performance was negative in February. Dollar-denominated corporates and local currency sovereigns outperformed dollar-denominated sovereign and quasi-sovereign credits on a relative basis as assets faced the headwinds of rising U.S. Treasury yields and the prospects of additional Fed rate hikes, softening commodity prices, and a strengthening U.S. dollar.	We see the EM/DM growth differential rising even further in favor of EM in 2018, potentially boosting inflows into EM. Though the downward trend in the dollar index came to a halt in February, we see the recent strength as a temporary phenomenon. 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. Moreover, though we expect some trade measures against China, our base case scenario is that they will be moderate and limited to specific sectors (intellectual property, for example).

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	MONTHLY REVIEW	OUTLOOK
Credit	What a difference one month makes! The U.S. and European corporate indexes reversed their move from January, generating negative excess returns, with spreads widening by 8 basis points in the U.S. European investment grade was 5 basis points wider. One of the concerns driving the credit markets was a technical pressure driven by a handful of large sell orders of short-dated credit, driven by U.S. tax reform and repatriation. While the short maturity part of the index did indeed widen more than the rest of the credit curve, the market was able to orderly absorb the large liquidations that have occurred.	As much as the January exuberance was surprising, the magnitude of February's correction was unpleasant. But in many ways, these moves represent a necessary and healthy adjustment of markets to the new regime. The market needs to adapt to the higher level of risk premia and new trading ranges. Longer term, growth should continue to improve, rates should move higher, and central banks are unlikely to materially slow the economy, except by accident. This should be good for corporate earnings and spreads.
Securitized	Credit-sensitive securitized assets continued to perform well in February, while more rates-sensitive securitized assets underperformed as interest rates increased again in February. Agency mortgage-backed securities (MBS), which is the most rate-sensitive and least credit-sensitive asset class within the securitized world, again had the worst performance among securitized assets in February.	Our investment thesis remains largely unchanged for March: We remain generally constructive on securitized credit opportunities and cautious on more rates-sensitive securitized assets. U.S. commercial mortgage-backed securities (CMBS) remain the highest-yielding securitized asset classes, but also the sector with perhaps the greatest risks. We are continuing to trim our more vulnerable CMBS exposures, such as shopping centers, and add to more residential-related exposures.

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 **JP Morgan 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 **JP Morgan 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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