Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

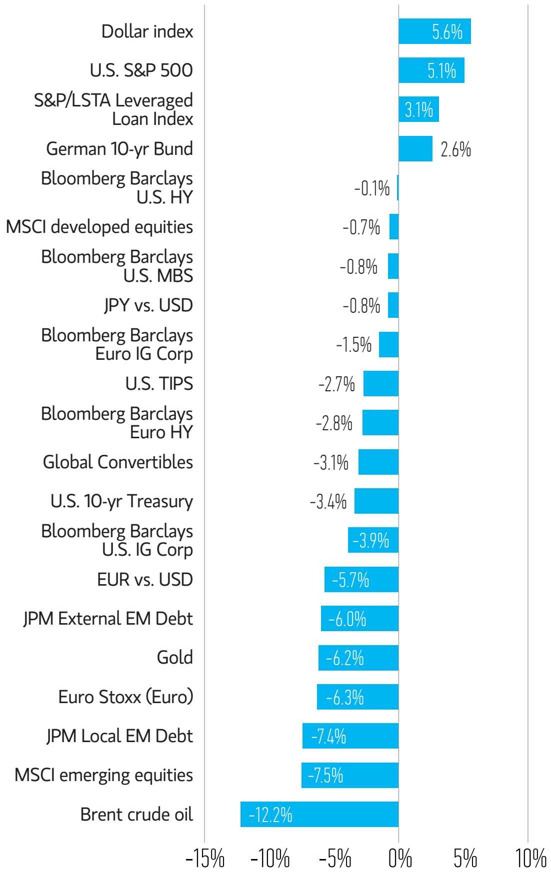
November's Blues

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

Another tumultuous month saw major developed market rates rally with the U.S. Treasury yields dropping 16 basis points (bps) with the yield curve flattening further. Emerging market (EM) performance was mixed with local currency debt generating positive returns while hard currency debt ended in negative territory. But, alas as the weather has continued to cool, so too have the markets. Global credit underperformed government bonds as spreads, including both high-yield and investment grade, widened in November; both macroeconomic sentiment changes and concerns about microeconomic fundamentals contributed. e.g., the 20 percent drop in Brent crude did not help the energy sector. European corporate bond performance was notable as it continued its penchant to underperform U.S. credit. Securitized credit spreads also widened in sympathy with corporate bonds although there were less obvious catalysts.

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of November 30, 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

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	2.99	-16		
United Kingdom	1.36	-7	-162	+8
Germany	0.31	-7	-267	+8
Japan	0.09	-4	-290	+12
Australia	2.59	-3	-40	+12
Canada	2.27	-23	-72	-7
New Zealand	2.72	0	-27	+16
EUROPE			(Spread over Bunds)	
France	0.68	-7	37	+1
Greece	4.27	+3	395	+10
Italy	3.21	-21	290	-14
Portugal	1.83	-5	151	+3
Spain	1.50	-5	119	+3
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			418	+27
EM Local Yields	6.56	-18		
EM Corporate Spreads			327	+27
Brazil	8.55	-12	265	+9
Colombia	6.72	-14	210	+24
Hungary	2.32	-41	142	+21
Indonesia	8.09	-53	222	+6
Malaysia	4.16	+3	147	+14
Mexico	9.24	+39	347	+40
Peru	5.75	-22	162	+10
Philippines	6.33	-29	110	-3
Poland	2.46	-12	72	+10
Russia	8.42	+6	239	+19
South Africa	9.57	-40	353	+10
Turkey	16.98	-244	463	+21
Venezuela	-	-	6255	+452
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			137	+19
EUR IG			149	+21
U.S. HY			418	+47
EUR HY			469	+72
SECURITIZED				
Agency MBS			95	+2
U.S. BBB CMBS			268	+14

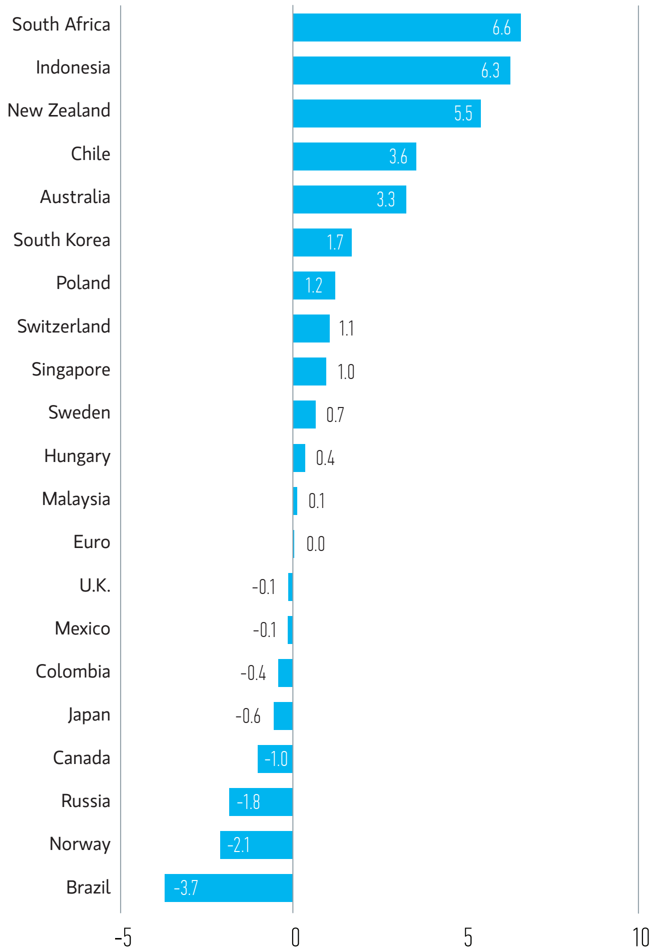
Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of November 30, 2018.

DISPLAY 3

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of November 30, 2018. Note: Positive change means appreciation of the currency against the USD.

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Fixed Income Outlook

As we enter 2019, two specific challenges face the two largest economies in the world. First, will U.S. financial markets have a soft, bumpy or hard landing following the likely peak of growth and earnings that were reached in 2018? Second, will stimulus policies in China stabilize growth conditions? Resolutions for both will be the key drivers for U.S. economy's financial asset prices in the months ahead.

U.S. fiscal policy was the major story this year. It energized the U.S. economy just as the rest of the world began to slow down. This divergence has been the major driver of asset markets. Loose fiscal policy, stronger than expected growth and higher than expected rates propelled the dollar higher, again higher than the market anticipated. The adrenaline shot the U.S. economy received in 2018 should weaken significantly in 2019, slowing the economy, reducing inflation risk and reducing the probability of ever higher short term rates. While a slower economy is good for risk free rates and reduced inflationary pressures, the impact on credit and earnings is more ambivalent. It will depend on how much the economy slows; how weak the equity market gets and how high inflation goes.

Context is important. We believe that tax reform and deregulation spurred business investment and a capital deepening that catalyzed a reversal in the falling trend in productivity. The rise in productivity may have a longer lasting impact that may lead to higher potential growth. The initial impulse was recorded in 2018 with U.S. gross domestic product (GDP) growing at 3 percent versus original consensus estimates of around 2 percent, which proved too low. Consensus expectation is for growth to slow to 2.6 percent in 2019, and to slow further to 1.8 percent in 2020, a level we think is about equal to potential growth. Our base case is that the U.S. Federal Reserve (Fed) will engineer a soft landing by not hiking too much, likely ending the rate hiking cycle at 3 percent in June 2019.

Credit asset performance will be impacted by post peak dynamics in growth and earnings. It needs to be recognized that this asset class is more vulnerable than usual at this point in an economic cycle due to high levels of leverage in the post quantitative easing (QE) era. That said, interest coverage is very strong at an aggregate level and should pose no systemic risk to the economy. Although a recession is not our base case scenario in the next couple of years, risk premia has risen and will likely rise further, adjusting spreads wider to reflect the increased weighting of this risk. But, this also assumes static behavior in the corporate sector. We should not assume solidly performing companies will do nothing if credit conditions deteriorate further. How soon, how deep, how long a slowdown might materialize are therefore questions that need to be reconciled. We believe a soft landing scenario will benefit credit assets as we move along in 2019.

As previously mentioned, the outlook for the Chinese economy could be crucial for the performance of the global economy in 2019. Weakness in China this year has been due in no small measure to the significant policy tightening in 2017/early 2018. In 2017 China increased short rates by over 200 bps, pushing the renminbi up by 7 percent, as Chinese policymakers attempted to slowly deleverage the economy. But, the unanticipated escalation of U.S. trade tensions in conjunction with previous tightening moves has resulted in a significant reduction in the Chinese contribution to global growth, which was certainly felt in Europe.

In response to this unwanted slowdown (with the risk of more due to ongoing trade tensions), China has engaged in aggressive easing, such as lowering short term rates by more than 200 bps in 2018 and cutting the required reserve ratio (RRR) by 250 bps. The good news is that there are signs of the stimulus working. Since easing policies tend to work with a lag, we hopefully will see further stabilization of the economy as we move into 2019, offsetting negative effects of U.S. tariffs. Chinese economic and asset price stability will be supportive of global asset prices especially, but not only confined to, EM.

In conclusion, we see market uncertainty revolving around whether or not the end of the Fed tightening cycle will produce a soft, bumpy or hard landing,and whether or not China's stimulus policies enacted in 2018 (and likely continuing into 2019) will stabilize their economy in 2019. Additional considerations reside with Europe and Brexit, political risks that are difficult to price. Risk premia are on the rise, pushing asset prices below fundamental valuations in a non-uniform manner, making investment opportunities more idiosyncratic than systematic. We remain optimistic that absent any signs of economic deterioration a soft landing, supportive of asset prices is the most likely scenario for 2019.

	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In November, we saw DM yields moving lower where U.S. 10-year Treasury and German Bunds fell 16 bps and 7 bps respectively. U.K. rates also experienced big moves where 10-year gilt yields fell 7 bps but 30-year bond yields rose 22 bps amidst new Brexit developments. Italian bonds yields rallied 13-22 bps across the curve while Portugal fell 2-8 bps. The U.S. yield curve flattened further with the U.S. Treasury 2s10s spread tightening 7 bps this month to 20 bps.[1]	U.S. growth is likely to be lower in 2019 as the fiscal impulse wears off and the lagged effect of higher rates bite. Recent speeches from the Fed policymakers give us further confidence that they are cognizant of the risk of over tightening and the need to move (at some point in the near future) to a more data dependent policy. The Fed wants to contain inflation risk; it does not want to cause a hard landing/recession. It is therefore likely that the market may also acknowledge that the peak in U.S. Treasury 10-year yield is likely to be below 3.50 percent. A longer term risk is a wider band for Japan Government Bonds (JGB) yields, as the Bank of Japan (BoJ) adjusts the yield curve control policy. This could introduce more volatility and create an upward push for risk-free rates. But, for now, the BoJ does not appear to be in a rush. Ultimately, we see market uncertainty revolving around whether or not the end of the Fed tightening cycle will produce a soft, bumpy or hard landing, and whether or not China's stimulus policies enacted in 2018 (and likely continuing into 2019) will stabilize their economy in 2019. Additional considerations reside with Europe and Brexit, political risks that are difficult to value. Risk premia are on the rise, pushing asset prices below fundamental valuations in a non-uniform manner, making investment opportunities more idiosyncratic than systematic. We remain optimistic that absent any signs of economic deterioration a soft landing, supportive of asset prices is the most likely scenario for 2019.
Emerging Market (EM) Rate/FX	EM fixed income asset performance was mixed in the month with local currency debt posting positive returns while hard currency debt returns ended in negative territory. While not calling for a recession in the near future, global growth estimates have been reduced as data has underperformed optimism. The outlook for global growth has been overshadowed by the risks arising from trade disputes initiated by the U.S. and the implications for global trade. Despite an improved outlook for North American trade via the signing of the North American Free Trade Agreement's (NAFTA's) replacement, United States-Mexico-Canada Agreement (USMCA), there remains an ongoing dispute between the U.S. and China. The Asia-Pacific Economic Cooperation (APEC) summit ended in disarray after the U.S. and China failed to agree on a joint statement, reflecting tensions due to the ongoing trade war. This is the first time since the summit began in 1993 that no joint statement was issued. Political risk in Europe increased during the period as Russia seized three naval vessels from Ukraine, prompting the imposition of martial law in Ukraine.	After a challenging year for EM fixed income, we hold a constructive outlook for 2019, driven by attractive valuations, a benign global backdrop of moderate growth/subdued inflation and a Fed that is likely approaching the end of its tightening cycle. We believe these factors and growing twin deficits in the U.S. limit the scope for material U.S. Dollar (USD) appreciation. Our historical analysis indicates that EM fixed income tends to outperform when EM economies are closing negative output gaps and converging toward potential growth.

[1] Source: Bloomberg. Data as of November 30, 2018.

	MONTHLY REVIEW	OUTLOOK
Credit	Global investment grade spreads widened in November, firmly establishing new year-to-date wides. The Bloomberg Barclays U.S. Corporate Index widened by 19 bps in November to end the month at 137 bps over government bonds, with financials leading the market wider. Spreads in the U.S. are now wider than they have been since the 3rd quarter of 2016. For the year, U.S. investment grade corporates are 44 bps wider on average. In Europe, the Bloomberg Barclays Euro-Aggregate Corporate Index moved 21 bps wider to end the month at 149 bps relative to governments. European corporate bonds continue to underperform U.S. investment grade as European investment grade corporates are 63 bps wider for the year.[2] One would have to look back to the energy crisis in early 2016 to find similarly wide spreads in the European investment grade market. As in prior months the drivers of credit remain macroeconomic worries and concerns about company fundamentals (especially leverage in BBB credit). Compounding these worries are poor technicals headed into year end, the most notable symptom being limited risk appetite in the dealer community.	Looking forward to 2019 the dangers cited are known, credible and well debated (and arguably in the price). The opportunity is that the recession does not arrive again and global growth stabilizes. In this scenario the increased systemic risk premium is unjustified as default rates stay low, company earnings continue to grow, higher yields stimulate demand for fixed income credit and confidence in the market increases liquidity.
Securitized	Widening securitized credit spreads and rallying risk free interest rates were the primary market themes in November. Securitized credit spreads had been resilient to spread widening for most of 2018, as spreads in corporate sectors and EM drifted wider. However, securitized credit spreads could not with stand the pressures coming from other sectors and have now widened for two consecutive months. Fundamental securitized credit conditions remain sounds with low default rates, healthy consumer balance sheets and stable housing markets, but increasing volatility, greater concerns over the future health of the U.S. economy, widening spreads in other credit sectors are combining to put pressure on securitized credit spreads. Agency mortgage-backed securities (MBS) outperformed credit-sensitive securitized for the first time this year, as their agency MBS spreads were essentially unchanged.	We are becoming a little more cautious on securitized credit assets. While we believe the fundamental credit environment remains positive, volatility has increased and credit spreads have now widened for two straight months. We do not anticipate any near-term deterioration of credit performance in the form of increased delinquencies or defaults, but we believe that credit spreads could continue to widen as the market's appetite for risk appears to be weakening.

[2] Source: Bloomberg Barclays. Data as of November 30, 2018.

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).

U.K. 10YR government bonds—U.K. Benchmark 10-Year Datastream Government Index. For the following Datastream government bond

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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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