Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Where To From Here?

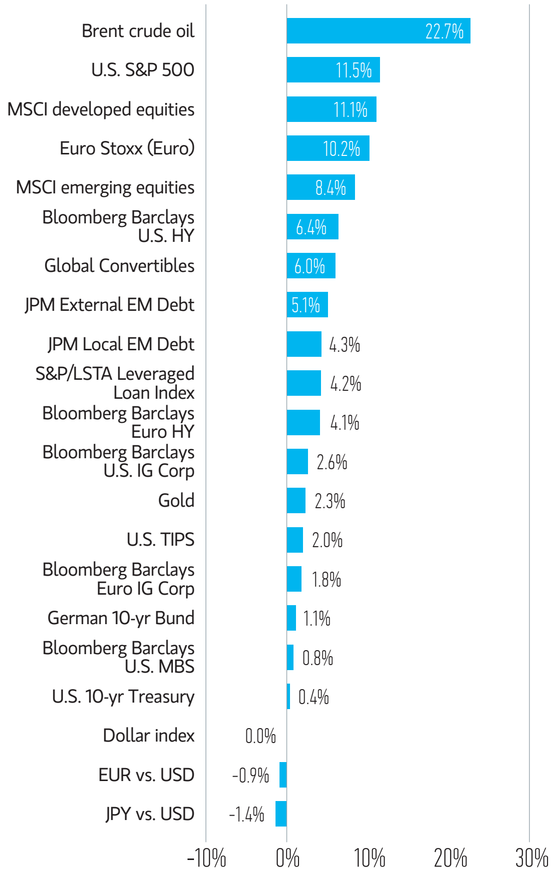
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | MARCH 2019

February proved to be a month of consolidation after January's remarkable comeback. Performance in government bonds varied: U.S. Treasury and German government bond yields modestly increased, while Australian and Spanish government yields decreased. Nongovernment sectors also consolidated their stellar January performance. This is not surprising as markets needed to digest the flow of news: central banks becoming more dovish; economic data still weakening while geopolitical risks centered on U.S.-China trade negotiations and Brexit continued to hang over markets. Growing optimism that both issues are likely to be resolved in market-/economy-friendly ways also helped the rally in risk markets continue. But, as we all know, the proof is in the pudding.

Asset prices cannot continue to rally unless fundamentals eventually move in a favorable direction. And on this front, ambiguity reigns. Industrial data is still weakening, albeit with modest signs that the worst may be past, but the lagged effects of previous monetary tightening, particularly in the United States, are still to be felt. That said, the U.S. Federal Reserve (Fed) must be relieved that financial conditions have eased, reducing pressure to be even more dovish. With risk assets having performed well and reasonable uncertainty remaining about the direction of economies and political negotiations, we have not increased our risk exposures and continue to remain neutral on overall interest rate positioning. We expect more clarity in the weeks and months ahead, and assuming prices are right, we will make adjustments.

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of February 28, 2019. 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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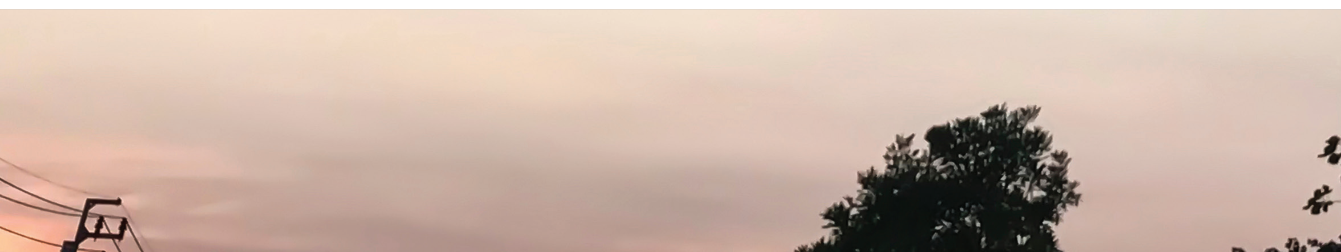

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)

Source: Bloomberg. Data as of February 28, 2019. 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	2.72	+9		
United Kingdom	1.30	+8	-141	0
Germany	0.18	+3	-253	-5
Japan	-0.02	-3	-274	-11
Australia	2.10	-14	-61	-23
Canada	1.94	+6	-77	-2
New Zealand	2.16	-10	-56	-18
EUROPE			(Spread over Bunds)	
France	0.57	+1	39	-2
Greece	3.66	-21	348	-24
Italy	2.75	+16	257	+13
Portugal	1.47	-15	129	-18
Spain	1.17	-2	99	-6
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			359	-17
EM Local Yields	6.24	+2		
EM Corporate Spreads			287	-22
Brazil	8.16	+40	230	-5
Colombia	6.41	0	186	-5
Hungary	2.10	+3	107	-20
Indonesia	7.91	-19	193	-3
Malaysia	3.98	-6	126	-13
Mexico	8.33	-14	316	-14
Peru	5.60	-1	131	-14
Philippines	5.57	-17	86	-15
Poland	2.37	+16	49	-18
Russia	8.09	+15	208	-11
South Africa	9.49	+18	284	-12
Turkey	15.50	+69	400	+7
Venezuela	–	–	5303	+533
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			121	-7
EUR IG			128	-14
U.S. HY			423	-103
EUR HY			434	-60
SECURITIZED				
Agency MBS			86	+3
U.S. BBB CMBS			287	-14

Positive Neutral Negative

Source: Bloomberg, J.P. Morgan. Data as of February 28, 2019.

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Fixed Income Outlook

While the generally benign market conditions of January continued into February, with risky assets performing well and government bond markets only modestly weaker, the outlook in March is more uncertain as valuations are not as cheap as they were, and the macro outlook remains uncertain. There is some evidence that the Chinese and eurozone economies are bottoming, but the evidence is at best mixed, with data relating to the manufacturing sector or to trade generally surprising to the downside, while labor market and consumer demand releases have been more positive. Q4 earnings releases were generally better than expected, but analysts have been revising down their forecasts.

Other macroeconomic risks, like Brexit, remain unresolved, and while there appears to be progress on the U.S. and China achieving a trade deal, the market is already discounting good news on this front. Similarly, subdued inflation means central banks are not under pressure to tighten monetary policy rapidly, if at all, but the market has already priced this in. The Fed is not priced to raise interest rates at all in 2019, and European Central Bank (ECB) rate hikes have also been pushed out into 2020. In fact, the ECB is expected to ease monetary conditions by providing new lending facilities to replace maturing targeted long-term refinancing operations (TLTRO) programs, but, given the market is already anticipating such measures, the impact on markets (in particular Italian banks and BTPs) may be modest if announced but severely negative if not.

So while the environment for risky assets is still positive, it is less so than it was before, and we have reduced our exposure to corporate credit and emerging markets (EM). We think the case for owning these asset classes is still positive: EM should be supported by the Chinese and eurozone economies bottoming, a potential China-U.S. trade deal as well as low inflation should keep developed economy central banks accommodative, and in turn enable developing economy central banks to run looser monetary policy than they otherwise would. Credit is supported by robust earnings reports, a potential renewal of TLTRO facilities by the ECB, and expectations of a U.S. recession being continually pushed out (aside from a flat yield curve, very few indicators suggest a recession is likely within the next 12-24 months). In securitized markets, we are more exposed to credit-oriented product and are underweight agency mortgage-backed securities (MBS) due to supply concerns from the Fed normalizing its balance sheet. However, we will need clearer evidence that the economic growth outlook is indeed improving for the risky asset rally to be sustained through the year, as well as the expectation that central banks will not tighten very quickly.

In government bond markets we have moved to a neutral stance. The market has already priced in the shift from gradual monetary policy normalization to being more accommodative, and with yield curves very flat (so that carry is modest) and valuations very rich relative to history, it is difficult to be bullish on the asset class. At the same time, the downside risks look limited if inflation remains subdued and developed economy government bonds play an important potential diversification[1] role in portfolios, doing well when most other assets do badly. One market where the outlook is particularly uncertain is the U.K. gilt market, where tightening labor market data would normally have caused the Bank of England (BoE) to raise rates several times already. However, uncertainty around Brexit has put monetary policy on ice. If the current political uncertainties can be resolved positively, then the market may have to price in a far faster pace of rate hikes.

[1] Diversification does not eliminate the risk of loss.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In February, risk assets rallied and investor sentiment continued to recover. Global 10-year yields rose in the U.S., U.K. and Germany, while yields fell in Australia, New Zealand and Japan. A slowdown in global growth remained a concern, despite a rebound in consumer confidence. The U.S. Dollar (USD) increased marginally against other G10 currencies, with the notable exception of sterling (GBP) which strengthened on expectations that the probability of a disorderly U.K. “no deal” exit from the European Union (EU) had decreased.	U.S. growth is likely to be lower, but not collapse, in 2019 as the fiscal impulse wears off and the lagged effect of higher rates bite. Recent speeches from Fed policymakers give us further confidence that they are cognizant of the risk of tightening monetary policy too far and the need to move (at some point in the near future) to a more data dependent policy. We don’t expect any substantial policy changes in the near future, given our outlook of a tame inflation path for the next 12 months. It is therefore likely that the market may also acknowledge that the peak in the U.S. Treasury 10-year yield is likely to be below 3.50 percent and the low likely above 2.50 percent. In the shorter term, despite the dip lower toward the end of December, we believe that the U.S. 10-Year Treasury yield is likely to spend a majority of the next few months between 2.60 and 3.00 percent.
Emerging Market (EM) Rate/FX	EM fixed income asset returns were mixed in February as EM currencies weakened versus the U.S. dollar, while local bond performance and external debt returns were positive. Within the hard currency segment, high yield outperformed investment grade, and corporates outperformed sovereigns. Optimism for the U.S.-China trade talks was supported by U.S. President Donald Trump’s announcement that the U.S. would delay the March 1st deadline for the implementation of additional tariffs. China’s government also signaled that it would increase commodity purchases from the U.S. Given the weaker inflation and external backdrop, many EM central banks have turned more dovish, which should allow for selective rate cuts to support economic growth.	We remain constructive EM debt over the coming weeks, predicated on several factors. Firstly, the latest high-frequency data in China and the eurozone suggest that activity may have already bottomed out. Secondly, the absence of global inflationary pressures combined with a moderation in growth is prompting central banks in the developed world to postpone or abandon plans for monetary policy normalization. Thirdly, the solid year-to-date performance of EM debt assets, which took place amid a largely stable dollar, should be buoyed in the future provided our expectation of USD weakness begins to materialize. Finally, the U.S.-China trade conflict, a major source of uncertainty last year, appears to be heading toward a provisionary agreement, boosting sentiment for risky assets in the near term.

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	MONTHLY REVIEW	OUTLOOK
Credit	The recovery of credit markets continued in February as global investment grade and high yield spreads continued to rally back from last quarter's weakness. Over the course of February markets digested 4Q earnings that were decent overall with few signs of material deterioration. Earnings before interest, tax, depreciation and amortization (EBITDA) grew at a slower pace, as has been expected, but remained sufficient to keep leverage broadly unchanged. These results, coupled with no meaningful negative surprises on the macroeconomic front, helped to allow the year-to-date rally to continue.	Fourth quarter earnings, which have been stable on balance, coupled with solid 4Q U.S. gross domestic product (GDP) data and improving sentiment, have helped to create a supportive environment for the credit markets. As we have been saying for some time, a near-term recession remains unlikely, defaults rates will remain low and earnings growth, while slowing, should support deleveraging where necessary. The Fed remains dovish and has recently discussed inflation targeting—a development that if adopted is likely to lower the likelihood of rate hikes even further. Outside the U.S., the ECB also remains dovish and is considering another round of TLTROs while China looks to relax policy as well. Easier monetary policy will help to extend the cycle, supporting the corporate sector.
Securitized	Mortgage and securitized markets performed relatively well in February, as interest rates drifted higher and credit spreads tightened across most sectors. Agency MBS outperformed Treasuries again in February as the stable rate environment and low volatility continues to minimize the embedded option cost and negative convexity of agency MBS. Credit-sensitive securitized sectors outperformed agency MBS as fundamental credit conditions remain supportive and higher yields/carry continue to drive outperformance.	Mortgage and securitized markets are off to a decent start in 2019, although lagging behind the bounce-back performance in many other markets that were hit harder in 2018. From a fundamental perspective, we believe the U.S. economy is strong with healthy consumer and real estate market conditions, and we remain overweight credit-oriented securitized investments. We are underweight agency MBS due to potential supply headwinds the sector could face as the Fed has ended its MBS purchases and U.S. banks could potentially reduce their agency MBS holdings if their risk-based capital requirements are eased. Agency MBS have performed reasonably well year to date, outperforming Treasuries, as interest rate volatility remains low and mortgage option costs are minimized as a result. We continue to expect a benign rate volatility environment for 2019, which should continue to benefit agency MBS in 2019, but this benefit could be offset by the supply pressure from the Fed balance sheet run-off. Overall, we expect agency MBS to continue to outperform Treasuries but underperform credit-oriented securitized opportunities.

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Risk Considerations

Fixed income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest rate environment, the portfolio may generate less income. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell **(liquidity risk)**. They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

DEFINITIONS

R* is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate.

INDEX DEFINITIONS

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

The **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 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 **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 **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.

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 **Dow Jones Commodity Index Gold (Gold)** is designed to track the gold market through futures contracts.

Euro vs. USD—Euro total return versus U.S. dollar.

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 **Hang Seng Index** includes the largest and most liquid stocks listed on the Main Board of the Stock Exchange of Hong Kong.

The **ICE Brent Crude futures contract (Brent crude oil)** is a deliverable contract based on EFP delivery with an option to cash settle.

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

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 **ICE BofAML U.S. 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 domestic or euro domestic markets by issuers around the world.

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.

Italy 10-Year Government Bonds—Italy Benchmark 10-Year Datastream Government Index.

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 **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).

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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).

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 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.

JPY vs. USD—Japanese yen total return versus U.S. dollar.

The **National Association of Realtors Home Affordability Index** compares the median income to the cost of the median home.

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 **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.

MSCI Emerging Markets Index (MSCI emerging equities) captures large- and mid-cap representation across 23 emerging markets (EM) countries.

The **MSCI World Index (MSCI developed equities)** captures large and mid-cap representation across 23 developed market (DM) countries.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector.

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 **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 **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.

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.

Spain 10-Year Government Bonds—Spain Benchmark 10-Year Datastream Government Index.

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.

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.

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