

### Global Fixed Income Bulletin

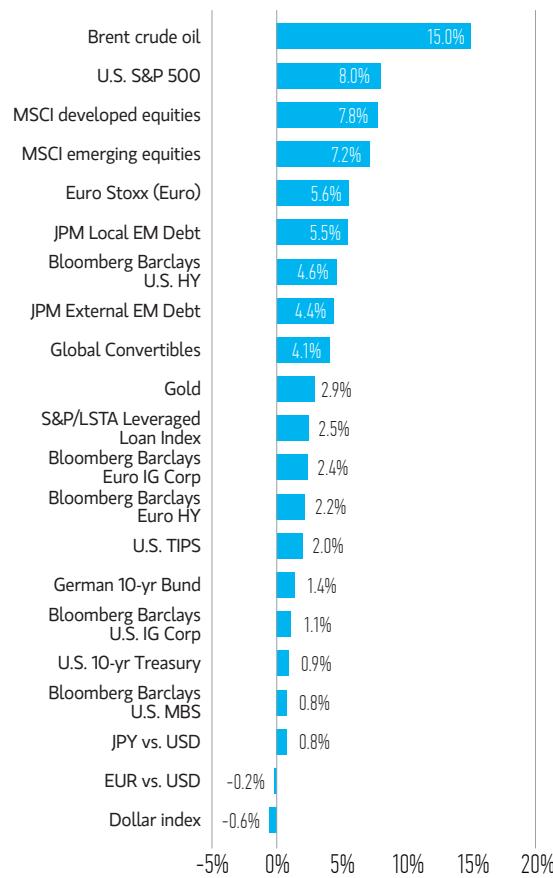
# Why It's Different This Time

**FIXED INCOME** | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | FEBRUARY 2019

After a disappointing 2018 and a somewhat traumatic December, January was a welcome surprise for most investors. The strong performance of nearly all assets in January was truly astounding given the events at the end of last year. Equally important was the fact that government bonds rallied alongside risk assets. The very strong January performance naturally lends itself to a feeling of *déjà vu*. Didn't we see this movie last year? A great January followed by, well, we know what happened the remainder of the year. Not surprisingly, market participants are a little skeptical that these good times can last. Moreover, many issues generating problems in 2018 have not gone away (Brexit, populist politics more generally, U.S.-China trade tensions). How are things different? We think there are two main differences.

First, central banks have changed their tune. They have noticed the deceleration in economic activity and become considerably more dovish. Second, valuations outside government bonds are a lot more attractive than they were a year ago, even if they are not as cheap as they were a month ago. We remain committed to be long risk assets, notably in corporate credit and emerging markets. We will keep a close eye on political developments to make sure fundamentals are not derailed. The dramatic shift in U.S. Federal Reserve (Fed) communication means we no longer expect U.S. and core eurozone government bond yields to move much higher. Hence, we have shifted to a neutral overall stance on duration, although we also see potential for variation in performance across countries.

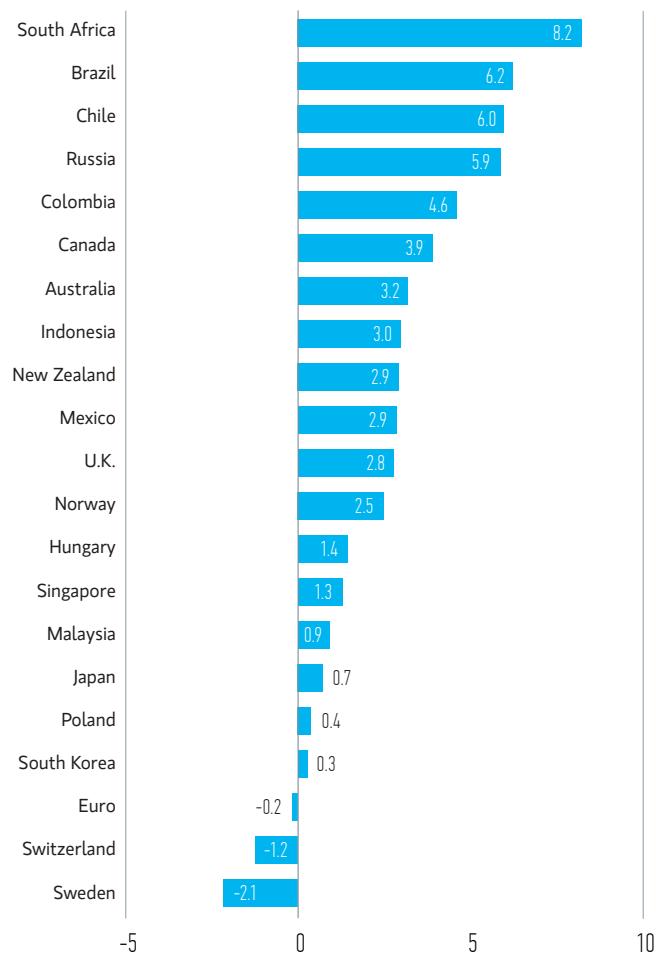
### DISPLAY 1 Asset Performance Year-to-Date



Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of Jan 31, 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 January 31, 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<br>YIELD<br>LEVEL (%) | MONTH<br>CHANGE<br>(BPS) | 10-YR<br>SPREAD<br>(BPS) | MONTH<br>CHANGE<br>(BPS) |
|----------------------|-----------------------------|--------------------------|--------------------------|--------------------------|
| (Spread over USTs)   |                             |                          |                          |                          |
| United States        | 2.63                        | -5                       |                          |                          |
| United Kingdom       | 1.22                        | -6                       | -141                     | 0                        |
| Germany              | 0.15                        | -9                       | -248                     | -4                       |
| Japan                | 0.01                        | 0                        | -262                     | +6                       |
| Australia            | 2.24                        | -8                       | -39                      | -2                       |
| Canada               | 1.88                        | -9                       | -75                      | -3                       |
| New Zealand          | 2.26                        | -11                      | -37                      | -5                       |
| (Spread over Bunds)  |                             |                          |                          |                          |
| France               | 0.55                        | -16                      | 41                       | -6                       |
| Greece               | 3.87                        | -52                      | 372                      | -43                      |
| Italy                | 2.59                        | -15                      | 244                      | -6                       |
| Portugal             | 1.62                        | -10                      | 147                      | -1                       |
| Spain                | 1.20                        | -22                      | 105                      | -13                      |
| EM                   | INDEX<br>LOCAL<br>YIELD (%) | MTD<br>CHANGE<br>(BPS)   | USD<br>SPREAD<br>(BPS)   | MTD<br>CHANGE<br>(BPS)   |
| EM External Spreads  |                             |                          | 376                      | -57                      |
| EM Local Yields      | 6.22                        | -16                      |                          |                          |
| EM Corporate Spreads |                             |                          | 309                      | -43                      |
| Brazil               | 7.76                        | -39                      | 235                      | -38                      |
| Colombia             | 6.41                        | -10                      | 191                      | -37                      |
| Hungary              | 2.07                        | -14                      | 127                      | -21                      |
| Indonesia            | 8.10                        | -6                       | 196                      | -41                      |
| Malaysia             | 4.04                        | -6                       | 139                      | -22                      |
| Mexico               | 8.47                        | -25                      | 330                      | -27                      |
| Peru                 | 5.61                        | -12                      | 145                      | -23                      |
| Philippines          | 5.74                        | -56                      | 101                      | -19                      |
| Poland               | 2.20                        | -7                       | 67                       | -14                      |
| Russia               | 7.94                        | -48                      | 219                      | -35                      |
| South Africa         | 9.30                        | -29                      | 296                      | -65                      |
| Turkey               | 14.81                       | -206                     | 393                      | -36                      |
| Venezuela            | —                           | —                        | 4770                     | -2075                    |
| CREDIT               |                             | SPREAD<br>(BPS)          | MTD<br>CHANGE<br>(BPS)   |                          |
| U.S. IG              |                             | 128                      | -25                      |                          |
| EUR IG               |                             | 142                      | -10                      |                          |
| U.S. HY              |                             | 423                      | -103                     |                          |
| EUR HY               |                             | 434                      | -60                      |                          |
| SECURITIZED          |                             |                          |                          |                          |
| Agency MBS           |                             | 83                       | -6                       |                          |
| U.S. BBB CMBS        |                             | 287                      | -14                      |                          |

Positive    Neutral    Negative

Source: Bloomberg, JP Morgan. Data as of January 31, 2019.

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# Fixed Income Outlook

What a difference a month makes. The extremely adverse market conditions in December were replaced by very supportive ones in January. Not only did the S&P 500 enjoy its best return month since October 2015, practically all asset classes delivered positive returns. The most obvious explanation for the turnaround is the change in tone from the Fed, who at their January meeting communicated that after raising rates for eight straight quarters, they may not raise interest rates at all in 2019. This significantly reduces the risks of a "hard landing" to the U.S. economy due to the Fed overtightening.

The rally in many risky assets, e.g., small cap equities, pre-dated the Fed statements. It would appear that many investors agreed with us that valuations were discounting an economic outcome that was far more severe than was likely to occur, and many assets had become too cheap unless a recession was imminent. Nonetheless, the shift in Fed tone was very important. It helped to reduce concerns that the Fed would tighten policy too far too quickly, and fits with a broader theme of central banks moderating or outright reversing their tightening policies. Subdued inflation in all the major economies means that central banks are under little pressure to tighten policy quickly or to tighten at all. For example, the U.S. labor market reports for December and January both reported very healthy increases in employment. However, wage growth did not accelerate and the unemployment rate decreased as more workers joined the labor force. This suggests there is more slack in the U.S. economy and the Fed can be "patient."

On the whole, economic data released in January disappointed, with three notable trends. First, the survey "soft" data tended to be weaker than the actual "hard" economic data releases. Given soft data tends to be less volatile than the hard data, and hence a better indicator of underlying economic trends, it may be flagging economic weakness that will soon become evident. Second, U.S. economic data have been considerably better, relative to expectations, than data for other economies, notably Europe. Third, the weak data have primarily been associated with trade, manufacturing and investment. Household consumption has generally remained strong as unemployment is low and wage growth has been rising, albeit modestly. Generally, the fixed investment and manufacturing sectors, which are typically more volatile, drive the business cycle. If they continue to slow, it could cause a broader economic slowdown. However, with

household income growth solid in both the United States and Europe, a recession or even higher probabilities of recession look unlikely.

The shift in central bank policy expectations is important for our outlook on yields. We no longer think that the Fed and other central banks will tighten policy over the coming months. As a result, we have turned neutral on duration. However, we expect some variation in performance across markets. We think Australian rates have the most potential to stay low or fall further, while we expect Canadian yields to rise more than in the U.S. In Europe, we think U.K. yields can rise considerably given the tight labor market once a resolution for Brexit is found.

We expect credit spreads to tighten across markets. Absent a recession we believe, default rates are likely to stay low, company earnings will continue to grow and liquidity should return to the market. We think concerns about high yield markets being swamped by a deluge of downgraded BBB companies are overstated, as continued earnings growth will give them time to manage their debt profiles lower. However, while we continue to position portfolios for long risk, we are taking advantage of the more supportive conditions to incrementally sell positions we feel are vulnerable to a deterioration in fundamentals.

The emerging market (EM) debt outlook we envisioned at the end of last year has materialized, for the most part, in the first month of 2019. At the time, we argued that attractive valuations, a backdrop of moderate global growth and subdued inflation, coupled with a dovish Fed and USD weakness would support EM debt assets in 2019. The strong year-to-date performance inevitably raises questions about the sustainability of the rally. We remain cautiously optimistic on EM fixed income, as the underlying premises of our investment thesis still apply, though valuations have become less enticing.

In securitized and mortgage markets, we still believe the U.S. economy remains strong with healthy consumer and real estate market conditions, and we remain overweight credit-oriented securitized investments. We remain underweight agency mortgage-backed securities (MBS) due to continued supply-demand concerns 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 ease.

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## MONTHLY REVIEW

## OUTLOOK

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

U.S., UK, and German 10-year yields continued to fall in January by six, six, and nine basis points, respectively.<sup>1</sup> Fed Chairman Jerome Powell appeased investors early in the month, signaling to markets that the Fed will be patient with the timing of future rate hikes. Powell's tone set the stage for the rest of the month, quelling fears of tighter monetary policy. The two-year to 10-year spread remained relatively unchanged compared to levels seen at the end of December at approximately 17 basis points, and the USD saw broad-based declines against developed market (DM) and EM currencies.<sup>2</sup>

In Europe, growth data continued to come in weaker than expected, particularly in Germany and Italy. The European Central Bank's (ECB's) view remains that the economic weakness is likely to be transitory, and points to strong labor market data as a source of growth and inflation going forward. However, they acknowledge things are not progressing as they envisioned and there are at least as much downside risk as upside. It seems increasingly unlikely the ECB will manage to raise interest rates this year; more targeted easing is very possible.

The U.K. continues to be driven by Brexit uncertainty. The risk of a "no-deal" exit is increasing, as the planned 29 March exit date approaches, but it seems increasingly likely Parliament will force Prime Minister Theresa May to ask for an extension so that the exit can be negotiated in an orderly manner.

**Emerging  
Market (EM)  
Rate/FX**

EM fixed income assets rebounded in January following a volatile 2018. Domestic debt led the way, driven by currency strength versus the USD and local bond performance. Within hard-currency assets, high yield outperformed investment grade, and sovereigns outperformed corporates. An improvement in EM sentiment was driven by attractive valuations, optimism around U.S.-China trade talks, the easing measures announced by the People's Bank of China (PBoC) in December, and a growing perception that the U.S. Fed hiking cycle may be over. Commodity prices also rose, with double-digit returns registered for crude oil, followed by agricultural commodities and metals. Investment flows were positive, primarily into hard currency, followed by local currency and blended strategies. Issuers took advantage of the favorable market backdrop to issue, with a variety of sovereign, quasi-sovereign, and corporate deals priced during the month.

U.S. growth is expected to moderate this year, yet remain above potential. Even though the U.S. yield curve remains very flat, it has yet to invert. This is helping to push expectations of the next U.S. recession well into 2020 or beyond. Fed policymakers stated that they will be patient and will likely keep rates on hold for at least the next few quarters, and the next rate move would not necessarily be a hike. Corporate earnings, U.S.-China trade negotiations, the debt ceiling, and the possibility of a renewed government shutdown are likely to drive the macroeconomic outlook. Key issues will be if the economic performance of the U.S. and other countries continues to diverge and if the weaker trend in the "soft" economic survey data is confirmed in the actual "hard" economic data releases. We believe the U.S. 10-year Treasury yield is likely to trade between 2.65% and 3% for the next several months.

The EM debt outlook we envisioned at the end of last year materialized, for the most part, in the first month of 2019. At the time, we argued that attractive valuations, a backdrop of moderate global growth and subdued inflation, coupled with a dovish Fed and USD weakness, would support EM debt assets in 2019. The strong year-to-date performance inevitably raises questions about the sustainability of the rally. We remain cautiously optimistic on EM fixed income, as the underlying premises of our investment thesis still apply, though valuations have become less attractive.

<sup>1</sup> Source: Bloomberg, as of January 31, 2019.

<sup>2</sup> Source: Bloomberg, as of January 31, 2019.

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## MONTHLY REVIEW

## Credit

Global investment grade spreads rallied strongly in January, recouping all of December's underperformance. While economic data and corporate earnings have been weak in spots and unremarkable in others, spreads were simply too wide at the start of January for a nonrecessionary environment. The Bloomberg Barclays U.S. Corporate Index narrowed by 26 basis points in January to end the month at 127 basis points over government bonds, with financials and BBB nonfinancial credits leading the market tighter. As measured by excess returns versus government bonds, the U.S. Investment Grade index generated an excess return of +1.83% for the month. European investment grade lagged the U.S. market but spreads also narrowed in January. Spreads on the Bloomberg Barclays Euro-Aggregate Corporate Index tightened by 10 basis points to end January at 141 basis points relative to government bonds.

## OUTLOOK

As discussed last month, with confirmation that a recession is not imminent, we expect credit spreads to tighten. Absent a recession, default rates are likely to stay low, company earnings will continue to grow and liquidity should return to the market. Continued earnings growth will give BBB companies time to manage their debt profiles lower and we see the risks on the number of expected downgrades to BB as overstated. We continue to position portfolios long risk to take advantage of these conditions though we have been incrementally de-risking portfolios on the heels of this rally. We do not expect spreads to retest cycle lows given the age of the business cycle, and the lower average quality of the market and questionable technicals pose risks. Sector and issuer selection will be key decisions in 2019 as technology and behavioral change are evolving rapidly and are disruptive for many traditional industry business models. These concerns will keep us cautious and more tactical.

## Securitized

After several months of a risk-off environment, mortgage and securitized markets stabilized in January. Mortgage and securitized spreads were slightly tighter, but did not experience the more significant rebound that occurred in many other credit sectors in January. Returns in January came from a combination of interest rate movements, spread changes and cash flow carry. Both agency MBS and credit-sensitive sectors had similar aggregate performances in January, but for different reasons. Rate movements largely propelled agency MBS performance while carry dominated credit-oriented asset returns. Fundamental securitized credit conditions remain sound with low default rates, healthy consumer balance sheets and stable housing markets.

Mortgage and securitized markets are off to a decent start in 2019, although lagging behind the bounce in many other markets. From a fundamental perspective, we still believe the U.S. economy remains strong with healthy consumer and real estate market conditions, and we remain overweight credit-oriented securitized investments. We remain underweight agency MBS due to continued supply-demand concerns 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 ease. Agency MBS spreads tightened in January after the Fed's statement, which indicated a willingness to potentially change its balance sheet normalization plans. We believe the Fed will continue to unwind its balance sheet in the absence of severe economic distress, and the excess supply of agency MBS will continue to put pressure on MBS spreads.

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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.

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The **S&P 500® Index (U.S. S&P 500)** measures the performance of the large-cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy.

The **JPMorgan Government Bond Index Emerging Markets (JPM External EM Debt)** tracks local currency bonds issued by emerging market governments. The index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (excludes China and India as of September 2013).

**U.K. 10YR government bonds**—U.K. Benchmark 10-Year Datastream Government Index. For the following Datastream government bond indexes, benchmark indexes are based on single bonds. The bond chosen for each series is the most representative bond available for the given maturity band at each point in time. Benchmarks are selected according to the accepted conventions within each market. Generally, the benchmark bond is the latest issue within the given maturity band; consideration is also given to yield, liquidity, issue size and coupon.

**German 10YR bonds**—Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR government bonds**—Japan Benchmark 10-Year Datastream Government Index; and **10YR U.S. Treasury**—U.S. Benchmark 10-Year Datastream Government Index.

The **ICE BofAML U.S. Mortgage-Backed Securities (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 market 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.

The **Thomson Reuters Convertible Global Focus USD Hedged Index** is a

market weighted index with a minimum size for inclusion of \$500 million (US), 200 million euro (Europe), 22 billion yen, and \$275 million (Other) of convertible bonds with an equity link.

The **MSCI All Country World Index (ACWI, MSCI global equities)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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