Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

A Tantrum, or the Return to Fair Value?

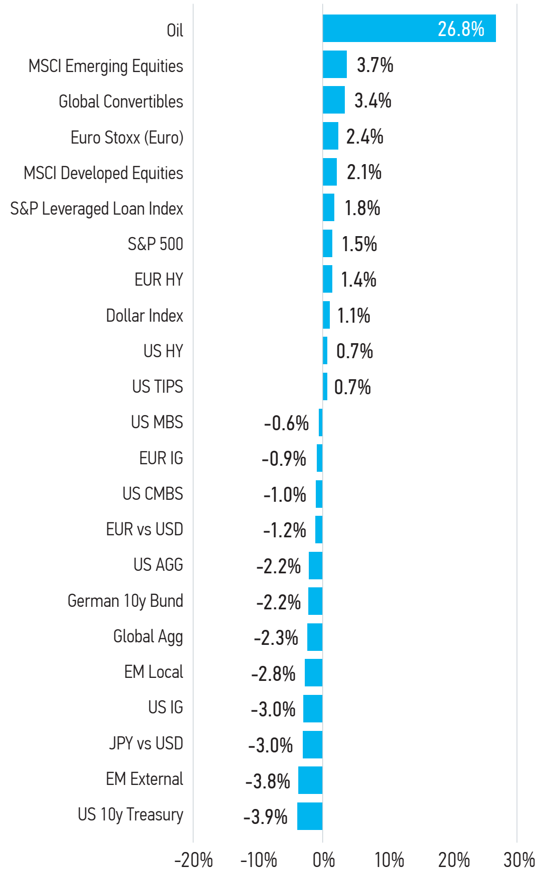
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | MARCH 2021

It does not seem so long ago that discussions about the economy and markets were all about central banks keeping policy easy; that interest rates and inflation would stay low; and that it would be a long time before economies got back to full employment. Such sentiment made sense back in January when it was unclear how much additional U.S. monetary and fiscal easing there would be or could be. Indeed, on the fundamental side, the pace of mass vaccinations was unclear; Europe was in a hard lockdown of unknown duration; Chinese growth seemed to be peaking; and consumer spending and industrial production were slowing in much of the world. Now, there might be too much stimulus, too much inflation, too strong growth. How the tide has turned!

In fact, the movement in government bond yields so far this year has prompted the use of the word “tantrum.” This harks back to the 2013 “taper tantrum” episode in the U.S. when the Fed discussed tapering their quantitative easing (QE) program, setting off a chain reaction of higher yields, wider credit spreads and weaker equities. When it became clear that the Fed was not going to suddenly end QE or tighten policy, and the economy was not going to weaken, credit spreads recovered, yields fell and equities rallied. Is what is happening today analogous to what happened in 2013?

We think not. While volatility has increased sharply, the sell-off in government bonds has been sudden but fairly orderly and, so far, not overly impactful on credit (or maybe even equities given both of their valuation levels). The sell-off in government bonds is most likely explained by a pricing-to-market phenomenon. What this means is that given the information flow on the pandemic, vaccination rates, policy actions, growth dynamics and the pricing of other assets such as credit and equities, government bond yields were just too low, relatively speaking. The rise of the U.S. Treasury 10-year bond yield to 1.50% takes it back to where it was pre-pandemic in February 2020. This equilibration of yields/expected

DISPLAY 1
Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of February 28, 2021. 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.

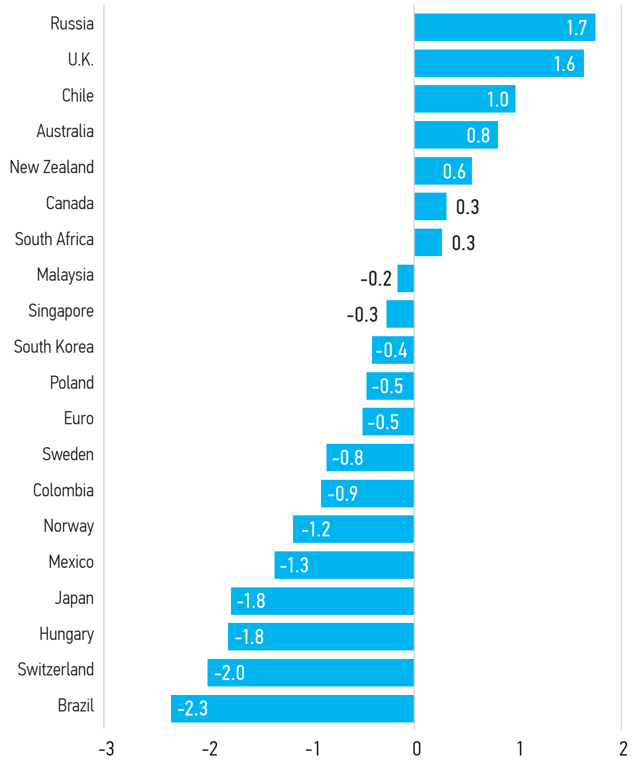
returns across asset classes is not something to worry about in terms of it impacting the prospects for credit spreads, for example. Only if yields rise "too far," meaning moving into a more restrictive range, might someone question the increased growth forecasts for economies around the world. We are simply not there yet. We would side on the justified optimism explaining the rise in yields, rather than seeing it as unwarranted.

The pace of yield increases has been sharp. This is likely to cause market indigestion, adjustment of risk positions amongst market participants and worry about the future, but it is unlikely to derail the economy. The amount of fiscal policy thrown and likely to be thrown at the U.S. economy is unprecedented. The fiscal packages just from December 2020 and those likely to be adopted in 2021 might reach 20% plus of GDP. Modest rises in rates are unlikely to cause problems, unless it gets out of hand. In our minds, that means U.S. Treasury yields will exceed 2% quickly, which is premature given the still weak state of labor markets. But, if the pace of the sell-off slows down, there is no reason to worry about higher yields derailing an economy likely to be on fiscal steroids this year, and potentially next year as well.

The implications of this scenario are somewhat straightforward; unless tantrum-like conditions materialize, which we think will not happen, interest rate/duration risk will continue to be a headwind for bond market performance. Stronger growth is good for corporate bottom lines and can be for their balance sheets as well. But, heightened volatility matters as well, hurting risky assets, so we are cautious about adding risk to portfolios in the short term. We remain positioned to potentially benefit from credit-sensitive assets outperforming government bonds and continue to believe duration will be a headwind to performance throughout 2021.

DISPLAY 2
Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Note: Positive change means appreciation of the currency against the USD. Source: Bloomberg. Data as of February 28, 2021.

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	1.40	+34		
United Kingdom	0.82	+49	-58	+15
Germany	-0.26	+26	-166	-8
Japan	0.16	+11	-124	-23
Australia	1.92	+78	51	+44
Canada	1.36	+47	-5	+13
New Zealand	1.90	+78	50	+44
EUROPE			(Spread over Bunds)	
France	-0.01	+27	25	+1
Greece	1.11	+43	137	+17
Italy	0.76	+12	102	-14
Portugal	0.32	+28	58	+2
Spain	0.42	+33	68	+7
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			383	-17
EM Local Yields	4.76	+15		
EM Corporate Spreads			351	-27
Brazil	7.27	+99	294	+6
Colombia	5.57	+47	238	+15
Hungary	2.09	+48	100	+1
Indonesia	6.65	+41	165	+14
Mexico	6.10	+48	221	+9
Peru	4.24	+49	133	+28
Philippines	3.48	-13	109	+11
Poland	0.92	+33	8	-12
Russia	6.49	+52	167	+10
South Africa	9.81	+16	381	+1
Turkey	13.53	+22	447	+3
Venezuela	–	–	19296	-1223
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			90	-7
EUR IG			89	-4
U.S. HY			326	-36
EUR HY			311	-32
SECURITIZED				
Agency MBS			77	+8
U.S. BBB CMBS			356	-51

Positive Neutral Negative

Source: Bloomberg, JPMorgan. Data as of February 28, 2021.

Fixed Income Outlook

It's all about the economy. I think it was James Carville, former President Clinton's campaign chief, who said something along those lines, maybe using more colorful language. But the sentiment is correct. The outlook for fixed income, more than ever, is about the trajectory of the economy and policymakers attitude towards it. Until recently, meaning February, the outlook for rates was for a slow grind higher, justified by improved economic conditions with central bank policies limiting rises either through QE, forward-based guidance, or even rate adjustments (those these were least likely to occur). Any surprising weakness would be met by more stimulus, probably fiscal, though stimulus nonetheless.

To put it simply, there has been too much "good" news to justify the level of yields coming into this year, or even at the end of January (or probably February as well). Initially, the January sell-off was led by inflation expectations rising. Not a terrible concern, given the low starting point, and even welcomed by central banks and equity and credit markets. But, by the middle of February the narrative changed. Now real yields began to rise, which directly impact financial conditions, tightening them, and impacting the real economy. If real yields are rising simply because growth expectations are increasing, this can also be undisruptive and does not necessarily warrant worry on the part of the Fed or financial markets: a faster growing economy naturally causes longer-term real rates to rise. But, this benign view of rate/yield moves was challenged by the market's abruptly changing its forecast for Fed policy. By the end of February, the market had brought forward almost 40 basis points (bps) of rate hikes into 2023, something not in the Fed forecast and opposite of what Fed communications suggested, i.e., no rate hikes until 2024.This hike in short rate expectations is in direct opposition to the Fed's own forecast and does have harmful effects, e.g., undermining risky asset prices, and is unwelcomed by risk markets and the Fed, given the distance the economy is away from its inflation/labor market goals and continued economic uncertainty.

Indeed, market forecasts of U.S. Q1 growth were probably in the 1%-2% range in late 2020. By February, expectations moved to the 3%-4% range (so much for a Q1 slowdown), with commensurate increases in growth expectations for 2021 and 2022. Without any worrisome signs that inflation is rising "too rapidly", the Fed has not seen it necessary to push back against the rise in yields and adjustments to Fed policy forecasts.

What is also remarkable is the global nature of the yield sell-off. Not only have yields risen strongly in the United States, generating one of the worst starts to Treasuries in history, but even more so in countries like Canada, Australia and the UK, suggesting the historically unprecedented fiscal expansion in the U.S. would pull ALL countries up, increasing global growth. Rate expectations are changing everywhere and there has been no place to hide, duration wise. Emerging markets have performed idiosyncratically; some outperforming DM, some underperforming. We expect this kind of pattern to continue. Credit and emerging market spreads have been very resilient despite the back up in yields. We view a material widening of spreads as a buying opportunity.

The big question is: Do we have too much of a good thing? Is policy too easy? Central banks say no. Markets say yes, at least in terms of when it expects the Fed to raise rates. Basically the market believes the Fed will relent and tighten policy sooner than they are saying. But, according to the Fed and the ECB (and most other central banks), economies are far from achieving the inflation/labor market/growth targets necessary to tighten policy. Chairman Powell reiterated this in his comments the first week of March. He said, to paraphrase, current policy is appropriate despite the outlook improving and the bond market becoming more volatile and bringing forward the first rate hikes. No changes in monetary policy. Markets are on their own.

Thus, given the continuation of strongly pro-cyclical policies in 2021 and beyond, high savings rates, mass vaccinations, the synchronized nature of the global business cycle and the relatively low level of nominal and real yields, we believe fixed income asset allocation should continue to be oriented towards cyclical assets and away from high quality/high interest rate sensitive bonds. That said, there are levels at which government bonds are a buy. It's just that we do not know where that is, yet. As always, it is conditional on the state of the economy and the central bank's view as to its appropriateness. However, discrimination remains key given valuation levels and the parlous state of markets. Given the very strong macro outlook, a movement to generally reduce credit quality; reduce interest rate sensitivity (maybe not immediately given the velocity of the recent sell off); overweight emerging markets and look for reasonable risk premium seems appropriate. We believe the market's concern with the economy being too strong and/or the Fed's indifference to higher yields is wrong, given the current state of knowledge. Worries about the economy being too strong to contain higher inflation are likely to be overblown.

	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In February, yields moved significantly higher across the developed markets as the pace of vaccine rollouts accelerated and infection rates continued to drop, causing growth and inflation expectations to increase. The majority of the rise in yields was due to higher real yields rather than higher inflation expectations. Central banks across the developed markets reiterated their dovishness and willingness to provide continued support.	We expect a strong, synchronized global economic recovery this year as COVID-related restrictions are lifted and pent-up demand boosts the recovery in consumption. Expansionary fiscal policy, especially in the U.S., is expected to stimulate growth further and central banks are expected to remain accommodative as output gaps are thought to be still large, economic risks are still skewed to the downside and the rise in inflation is expected to be temporary. While we do not expect a dramatic sell-off in government bond markets, we think the risk is skewed to yields rising, as valuations are still rich relative to history and there is potential for additional term premia to be priced into the long-end of the yield curve. Central banks in general have not expressed concern, either overtly or through back channels, about the rise in yields, presumably because it has not yet led to an unwarranted tightening of financial conditions.
Emerging Market (EM) Rate/FX	EM debt posted negative returns in February across the board, i.e., in both local and hard currency bonds. From a sector perspective, companies in the Infrastructure, Real Estate, Financial and Consumer segments led the market, while those in the Pulp & Paper, Oil & Gas, and Diversified sectors underperformed.	Despite a challenging year for EM debt so far, we still hold a constructive view on the asset class for the rest of 2021. A global backdrop of steady monetary policy accommodation, an ongoing rollout of multiple vaccines in the developed world (and increasingly, in parts of EM), and expectations of looser fiscal policy in the U.S. should be supportive for the emerging market asset class. Excessive optimism about reduced trade frictions under the Biden administration (particularly in U.S.-China relations) could challenge our positive scenarios for global trade and growth, and thus negatively impact the performance of growth-sensitive EM assets.

	MONTHLY REVIEW	**OUTLOOK**
Credit	Spreads were tighter over the month, driven mainly by expectations of a booming economic rebound, additional fiscal stimulus, and fourth quarter earnings results that exceeded expectations.	We see credit being supported by expectations of an economic rebound in 2021. Our base case reflects the consensus view that COVID-19 is transitory and continued positive support from monetary and fiscal policy will likely drive spreads tighter in the medium term. We expect an overshoot in H1 2021 with a likely correction in H2 as M&A increases. However, questions are asked over the level of QE in 2022 and the fear of missing out turning into fear of owning valuations that look historically expensive.
Securitized Products	Rising rates and the underperformance of agency MBS were the dominant themes in February, while securitized credit continued to perform well. Fears of slowing prepayments and duration extension outweighed continued Fed support for the agency MBS market. U.S. ABS and RMBS spreads were generally unchanged, while European RMBS spreads were slightly tighter. U.S. CMBS spreads were mixed with lower rated classes outperforming.	We expect continued strong performance in the coming months. We have shifted from a negative to a neutral outlook on agency MBS given its cheapening year to date. U.S. non-agency RMBS still offer reasonably attractive relative value. U.S. ABS continues to have a mixed outlook for 2021, with traditional consumer ABS being expensive while the COVID-challenged sectors offer greater recovery potential. Some CMBS sectors offer attractive value opportunities but others have potential credit problems. Multifamily housing (apartments) and office buildings could face challenges if there are fundamental shifts in how people want to live and work in the post-pandemic world. European markets are experiencing similar sector-specific performance dynamics.

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Risk Considerations

Diversification neither assures a profit nor guarantees against loss in a declining market.

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio. **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 a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. 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, and 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. **Basis point:** One basis point = 0.01%.

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. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

The **Bloomberg Barclays U.S. Corporate Index** 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.

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 **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-

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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.

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).

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.

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.

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 **Russell 2000® Index** is an index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

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.

The **Thomson Reuters Convertible Global Focus USD Hedged Index** is a market weighted index with a minimum size for inclusion of $500 million (U.S.), 200 million euro (Europe), 22 billion yen, and $275 million (Other) of convertible bonds with an equity link.

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.

The **Chicago Board Options Exchange (CBOE) Market Volatility (VIX) Index** shows the market's expectation of 30-day volatility.

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