Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

The Long and Winding Road

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | MAY 2020

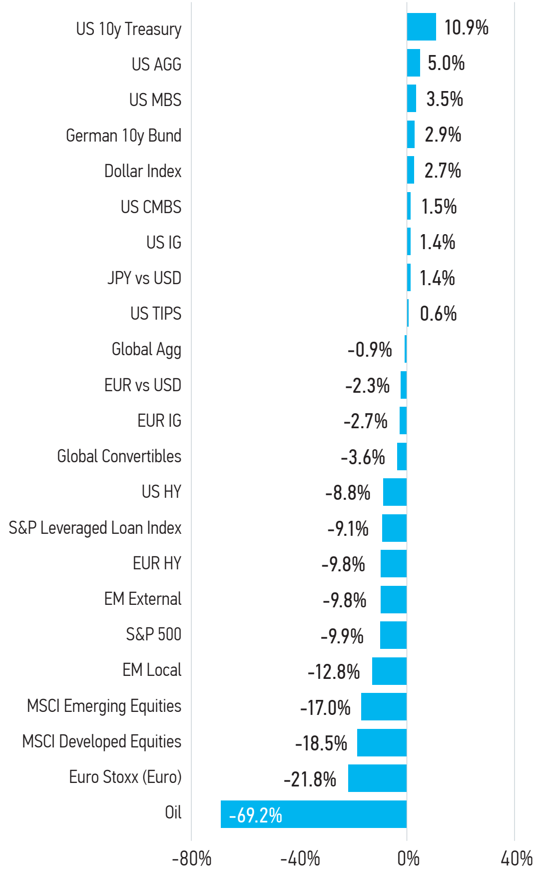
The calamitous events of March quickly receded into memory as markets recovered dramatically in April. In fact, we had 18 months' worth of bear/bull markets (credit and equities) compressed into those fateful weeks, beginning in mid-March. The S&P 500 was up 13%, its best month since January 1987, while the Bloomberg Barclays US Corporate Index returned 5.2%. We had some of the best days and weeks and some of the very worst all in March/April. Interest rate volatility collapsed and is now close to pre-crisis levels. Yet the world also experienced the worst economic data ever seen, at least over such a short period of time. Every data release in Europe and the U.S. was worse and worse, more often than not exceeding already depressed forecasts/expectations. Yet markets rallied.

Policies responded: monetary policy, fiscal policy and, just as importantly, health policy responded (or showed strong signs of working). On all three fronts, policy actions were unprecedented. The U.S. Federal Reserve (the Fed) added over $3 trillion to its balance sheet in a matter of weeks. The U.S. Congress passed unprecedentedly large fiscal support packages designed for direct income support and credit support for the corporate sector, partnering with the Fed and banking sector to distribute trillions of dollars of support. In fact, estimates have been made that, as a result of all the policy actions in the U.S., national income (as defined in GDP accounts) will actually be up this year. As with any war—and this is a war with a virus—overwhelming firepower frequently wins the day. And, so far policymakers seem to be winning.

Our commentary title last month, "The End of the Beginning," seems very appropriate. The economic policy war has been won, in that enough support and confidence has been injected into the economy at large

DISPLAY 1

Asset Performance Year-to-Date



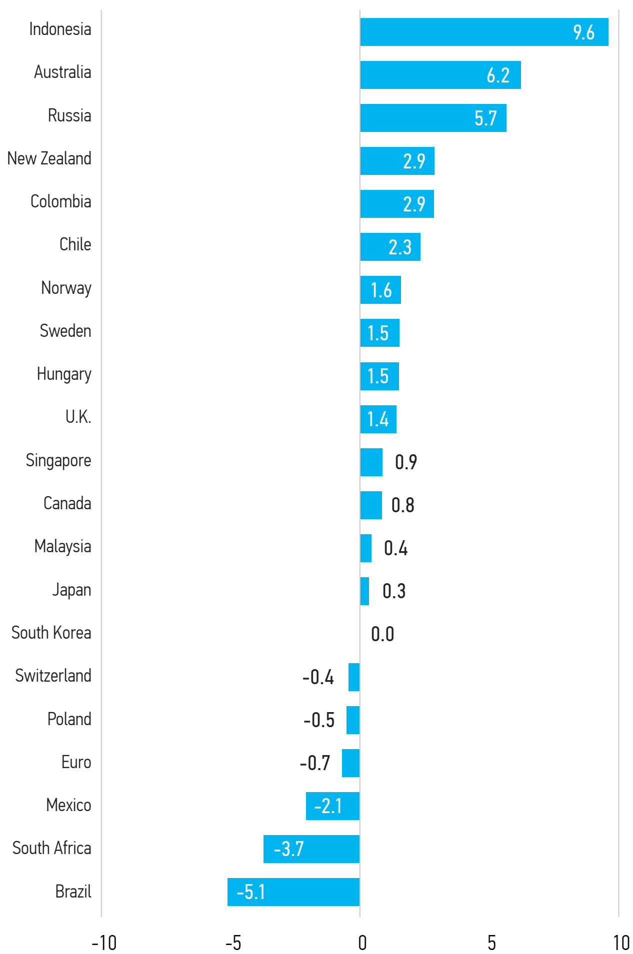
Note: USD-based performance. Source: Bloomberg. Data as of April 30, 2020. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 11 and 12 for index definitions.

to give health policy a chance to slow infection rates to low enough levels to reopen economies. The good news is that this is happening and will likely support asset prices. The bad or uncomfortable news is that we do not know if it will work in North America, Europe and in many emerging countries. First-in-first-out China may provide some clues as to what to expect in terms of recovery patterns. So far the evidence points to sluggish (though potentially bottoming) behavior in the services sector (amid soft consumption), and a more convincing rebound in manufacturing, recently tempered by weak export data (due to falling external demand). The potential for a second wave of infections could also jeopardize a more decisive recovery in economic activity and needs to be monitored. Given all the imponderables surrounding the near future, but taking into account the progress made, cautious optimism is warranted. While we may indeed be on a "long and winding road" the longer your investment horizon, we believe the more confident you should be.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of April 30, 2020. 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	0.64	-3		
United Kingdom	0.23	-13	-41	-9
Germany	-0.59	-12	-123	-8
Japan	-0.03	-5	-67	-2
Australia	0.89	+13	25	+16
Canada	0.55	-15	-9	-12
New Zealand	0.88	-21	24	-17
EUROPE			(Spread over Bunds)	
France	-0.11	-10	48	+2
Greece	2.17	+49	275	+60
Italy	1.76	+24	235	+36
Portugal	0.82	-5	140	+6
Spain	0.72	+5	131	+16
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			557	-20
EM Local Yields	4.94	-43		
EM Corporate Spreads			537	-62
Brazil	5.97	-34	422	+37
Colombia	6.37	-49	395	+17
Hungary	1.74	-14	228	-25
Indonesia	7.86	-13	309	-12
Mexico	6.64	-55	410	+61
Peru	4.72	-32	200	+5
Philippines	4.89	0	181	-36
Poland	1.03	-29	103	-2
Russia	5.86	-75	263	-20
South Africa	10.73	-48	617	-29
Turkey	10.78	-186	677	-44
Venezuela	–	–	18439	+1972
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			202	-70
EUR IG			186	-53
U.S. HY			744	-136
EUR HY			636	-142
SECURITIZED				
Agency MBS			108	-16
U.S. BBB CMBS			830	+143

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of April 30, 2020.

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Fixed Income Outlook

After the roller coaster and depressing series of events in March, April was a welcome relief. Policy actions were of unprecedented size and structure, showing a degree of coordination (if indirect) of monetary and fiscal policy not seen since the 1940s, helping money markets, government bonds and credit markets to stabilize. Risky assets rebounded and, importantly, government bond yields fell. A synchronized collapse in global economic activity corresponded with a synchronized policy response with implicit messages: "we will do whatever it takes" and "failure is not an option," wartime slogans appropriate for today's COVID-19 war.

As the news flow improved, we could characterize unprecedented weakness in economic data and negative oil prices as positive, in the perverse sense that what is at zero can only go up. The combination of massive policy actions on monetary/fiscal/health fronts with the sense -- and it is only a hunch -- that economic activity is reaching a bottom in April/May is leading to better asset market performance. We believe that government bond yields (in general, maybe not for every country) in developed markets, equities and oil bottomed in March/April, and employment will bottom in May. But, where do we go from here after the strong April rallies?

We expect QE to continue in an unlimited way in the coming months across developed markets, even if at a reduced pace given the frenetic interventions in March and April. It is still too soon to be able to tell the ultimate impact that the coronavirus will have on the economy and global markets. Will reopenings cause a second wave of infections? Will travel and leisure activities return to "normal"? What shape or contour will the economic recovery have? V shaped? Not likely, unless there is a miracle healthcare development, given the severe disruptions to the global economy and persistent impact on consumer behavior. Will it be a checkmark recovery, with rebound not as sharp as downturn? Or could it be an L, or a W? We do not know. We do believe risk-free government bond yields will remain low, an unlikely source of return going forward, and that inflation will not be an issue. Because of this, we believe central banks will continue to be accommodative indefinitely, or even expand stimulus to new heights.

A consolidation of the improved risk sentiment observed during April may benefit risky assets. For instance, while the economic and health outlooks look a lot better now, and volatility has retreated, government bond prices and investment grade spreads generally reflect that; that is, a short, sharp recession but no depression. In order to see further compression of corporate bond spreads, whether investment grade or high yield, the economy will need to emerge from lockdown in an orderly fashion. Government support of incomes at their recent pace is probably unsustainable past the summer. The Fed's TALF program is expected to terminate at the end of September, for example. This of course does not mean programs and support cannot be renewed or expanded, it is just that the medium term cost in terms of debt, lost productivity, lost income and lower future living standards (hopefully only relative to previous expectations) are potentially very high. Therefore, while spreads are still wide of pre-crisis levels, a relatively large amount of near-term optimism is discounted.

Two sectors underperformed in the April rebound. Emerging Market (EM) debt and securitized credit. The simple reason is that neither benefitted directly from all of the monetary and fiscal support policies announced and implemented in March and April. Therefore, attractive valuations, stabilization in commodity prices, and progress on funding/debt relief initiatives directly targeting EM economies could combine to provide a boost to EM debt in the near term.

Securitized credit also failed to rebound as much as developed market credit (or agency mortgage backed securities) for the same reason as EM. For this reason we believe there is more room for securitized credit to catch up to corporate credit in the months ahead as there is more room for spreads to compress as economies come off the floor, so to speak. New issuance remains very light and secondary selling has slowed substantially, while demand appears to be steadily increasing. Spreads are unlikely to quickly return to pre-COVID-19 levels (but neither are credit spreads in general) given the elevated economic risks from the virus, but we expect spreads to continue to tighten in from current levels.

While we remain optimistic that the worst is over, so do financial markets, meaning that a second wave of infections requiring a second wave of lockdowns could be deleterious to risky assets. China did not relax its lockdown until it had essentially defeated the virus, and even now social distancing measures and travel restrictions remain in place. Europe and the U.S. are attempting to relax lockdowns while still trying to reduce infections, a much harder battle. Sweden is conducting an experiment of not locking down the economy and absorbing the infection costs with only a focus on social distancing. Is this a harbinger that unlocking economies before the virus is well under control is possible? As every country has its own social norms and is experiencing different infection and mortality rates, we must be careful about generalizing the experience(s) of one country to others. We will know more over time and our investment strategy will adjust to changing facts and valuations.

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	MONTHLY REVIEW	OUTLOOK
Developed Markets	In April, market conditions seemingly began to revert to more "normal" levels as massive government stimulus measures began to work across the developed markets, mainly in the United States. The VIX fell by 19 percentage points after reaching as high as 83 in March.[1] Over the month, changes in developed market government 10-year bond yields were mixed. Central bank action remained the driver, with yields falling more where central bank easing was more aggressive and not doing as well where they were less aggressive.	Overall, we expect continued monetary policy accommodation across developed markets in the coming months. Having eased aggressively in March and seen market conditions stabilize, it is understandable that most central banks waited to see if further accommodative measures are necessary. This will depend on market conditions and developments in the underlying economy. But, with (upward) inflationary pressures very weak and economies hit by a severe exogenous shock, there is every reason to believe central banks will be ready to ease further, although most will have to do so via unconventional policy measures (e.g. QE and liquidity provision measures) given policy rates in most DM economies are already at the lower bound.
Emerging Markets	EM assets rallied in April as the impact of monetary and fiscal stimulus from global authorities worked its way through financial markets. EM dollar-denominated corporates led the way in performance, driven by the high yield segment, as well the industrial, consumer, and metals and mining sectors. Domestic debt followed corporates as local bonds rallied and EM currencies strengthened versus the U.S. dollar. Dollar-denominated sovereigns brought up the rear as Latin American countries lagged.[2]	Following the incipient stabilization observed in April, market attention will focus on the gradual easing of lockdown measures in the developed world. First-in-first-out China may provide some clues as to what to expect in terms of recovery patterns: so far the evidence points to sluggish (though potentially bottoming) behavior in the services sector and a more convincing rebound in manufacturing, recently tempered by weak export data. The potential for a second wave of infections could also jeopardize a more decisive recovery in economic activity and needs to be monitored.

[1] Source: Bloomberg, as of 4/30/2020

[2] Source: JP Morgan, as of 4/30/2020

	MONTHLY REVIEW	OUTLOOK
Credit	The key driver of credit spreads in April was a more optimistic expectation for markets as the coronavirus debate moved to strategies to exit the lockdown and the policy response intensified with additional liquidity support for corporates and fiscal grants for labor furloughed as a result of the "shuttering." The month can be broadly split into two stages, an initial rally from the wide spreads of March, followed by a consolidation toward month-end when spreads rebounded to levels seen in February 2016, when oil was last below $30 per barrel and the base case expectation was for a demand driven recession.[3]	We frame the outlook for credit a simple question: Is now the time to buy? Fundamentals have consolidated, with the optimists citing advances in the path to a vaccine and plans to exit lockdown with the economy supported by the level of policy stimulus/support, while pessimists focus on the risk of reinfection and the economic cost seen in the current weak economic data. Valuations seem to be fair for the current backdrop.
Securitized Products	The securitized market partially rebounded in April, with spreads tightening to varying degrees, although remaining materially wider across all sectors than pre-COVID-19 levels. There was a clear tiering of recovery, with higher-quality assets and securities receiving support from the Fed and recovering most significantly, while more credit-sensitive securities languished. Fundamental credit conditions remain challenged, with U.S. jobless claims over the last six weeks totaling over 30 million.[4]	We expect to see spreads continue to tighten across most securitized sectors in May. New issuance remains very light and secondary selling has slowed substantially, while demand appears to be steadily increasing. Spreads are unlikely to return to pre-COVID-19 levels given the elevated economic risks from the virus, but we expect spreads to continue to tighten in from current levels. We believe the current market environment represents an attractive investment opportunity, as we believe that current spreads overcompensate for actual credit risks.

[3] Source: Bloomberg, as of 4/30/2020

[4] Source: Bloomberg, as of 4/30/2020

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

MONTHLY REVIEW

In April, market conditions seemingly began to revert to more "normal" levels as massive government stimulus measures began to work across the developed markets, mainly in the United States. The VIX fell by 19 percentage points after reaching as high as 83 in March.[5] Over the course of the month, changes in developed market government 10-year bond yields were mixed. Central bank action remained the driver, with yields falling more where central bank easing was more aggressive (e.g., New Zealand, where the Reserve Bank of New Zealand surprised with the size of its QE purchases), and not doing as well where they were less aggressive (e.g., Australia, where the RBA's yield curve control provided little support for long maturity bonds). Yields also rose amongst lower credit rated euro sovereigns (Greece, Italy, Spain, Portugal), as credit spreads widened due to the increased burden from the COVID crisis and lack of joint fiscal response. U.S. 10-year inflation break-evens widened, ending the month at 1.07%,[6] although some of the recovery was most likely due to Fed buying rather than a recovery in inflation expectations. From a currency perspective, the USD weakened most against G10, and AUD saw the largest gain across the G10, consistent with the broader risk-on tone. On the whole, almost all central banks cut rates and launched QE in March. Now they are waiting to see if and how they need to provide more support to the markets.

The Fed held its April meeting and emphasized its extreme actions were necessary to support credit flowing through the economy, both for businesses and consumers. The Fed reiterated that it would use its "full range of tools" to ensure this. Markets were disappointed that the Fed did not provide more concrete forward guidance on rates, and only stated that policy levels are appropriate for now and it will not be in any hurry to hike interest rates. Fed Chairman Jerome Powell signaled that they are willing to expand the scope of their market support facilities if necessary. Regarding inflation, the Fed sees neither a risk to inflation or deflation, and maintained policy actions to reach their stated 2% inflation target.[7]

The only new policy measures announced at the European Central Bank's (ECB) April meeting was a new liquidity program (PELTRO) for banks, and more generous terms on the existing TLTRO III. With the TLTRO III lending facility, banks will be able to borrow at -50bp from May 2020 to July 2021. Similar to the Fed, the ECB pledged to be flexible in its policy response.[8]

In Japan, the central bank left rates unchanged but announced its plan to increase its CP and corporate bond purchase programs as well as expand its collateral and bank subsidies in order to make lending programs more attractive. Additionally, the Bank of Japan (BoJ) announced that it would eliminate the ¥80 trillion limit on JGB purchases, essentially signaling that its JGB purchases are unlimited.[9] The BoJ also reiterated its pledge to do whatever is needed to ensure stability and keep monetary policy accommodative.

In New Zealand, Finance Minister Grant Robertson stated that the policy response in New Zealand appears to be working well, given that liquidity levels have rebounded and bond markets are functioning well. The Reserve Bank of New Zealand's next policy meeting is on May 13, and it is expected to announce additional packages and potentially more stimulus to help the economy recover. In Australia, no further central bank support was announced in April, as bank officials feel their previously announced support measures, including the yield curve control policy, are working and adequate for the time being.

OUTLOOK

Overall, we expect continued monetary policy accommodation across developed markets in the coming months. Having eased aggressively in March and seen market conditions stabilize, it is understandable that most central banks waited to see if further accommodative measures are necessary. This will depend on market conditions and developments in the underlying economy. But, with (upward) inflationary pressures very weak and economies hit by a severe exogenous shock, there is every reason to believe central banks will be ready to ease further, although most will have to do so via unconventional policy measures (e.g., QE and liquidity provision measures) given policy rates in most DM economies are already at the lower bound.

This will help to keep government bond yields at very low levels, although concerns about increased issuance (especially at the long-end of the curve) and potential ratings downgrades (for euro sovereigns) could lead to upward pressure. While better than expected economic data may also push yields higher, this is likely to come mainly from a rise in interest rate risk premia, rather than higher central bank rate expectations, and hence we expect will be relatively modest.

[5] Source: Bloomberg, as of 4/30/2020
[6] Source: Bloomberg, as of 4/30/2020
[7] Source: The Federal Reserve, as of 4/30/2020
[8] Source: The European Central Bank, as of 4/30/2020
[9] Source: Bloomberg, as of 4/30/2020

Emerging Market (EM) Rate/FX

MONTHLY REVIEW

EM assets rallied in April as the impact of monetary and fiscal stimulus from global authorities worked its way through financial markets. EM dollar-denominated corporates led the way in performance, driven by the high yield segment, as well the industrial, consumer, and metals and mining sectors. Domestic debt followed corporates as local bonds rallied and EM currencies strengthened versus the U.S. dollar. Dollar-denominated sovereigns brought up the rear as Latin America countries lagged.[10] Oil prices recovered after futures briefly turned negative in April, as U.S. storage facilities hit capacity. Despite the recovery, the performance of weaker oil credits remained challenged. Idiosyncratic issues and the default process also weighed on sovereign performance, especially in Suriname, Zambia, Lebanon, Mozambique, Belize, Ecuador, and Argentina. Commodity prices were mixed as agricultural commodities were generally weaker, while metal prices strengthened and energy prices ranged from flat to weaker.[11]

The economic problems exacerbated by the COVID-19 crisis and lower energy prices have led to several issuers trading at wide spreads as investors price in some level of restructuring or default. Commodity-related credits such as Ecuador, Angola, Iraq and Zambia were included in that group, as were those with idiosyncratic issues such as Sri Lanka, Lebanon, and Argentina. In Ecuador, the government issued the consent solicitation to postpone a three-month deferral of coupon payments to provide time for a new agreement with the IMF.[12] In our view, authorities are trying to avoid a default because they need continued access to external financing to navigate the crisis. Nevertheless, Ecuador will need further relief going forward. The IMF approved loans to Costa Rica and the Dominican Republic to support health expenditures and relief measures. It also approved a loan to Nigeria to support the economy given the severe impact of the COVID-19 shock and sharp fall in oil prices.

Elsewhere in Latin America, authorities continued to cut rates and enacted fiscal easing. Chile's government announced an additional $5bn package to support economic growth. In Costa Rica, the Minister of Finance requested the Congress to waive the fiscal rule. In Peru, the Congress deliberated over a bill that would allow pensioners to withdraw from their pension funds, up to 25% of workers' accounts. Central banks in Chile, Mexico, and Colombia continued to cut rates as inflation eased and growth weakened. Rating agencies have been quick to act in adjusting ratings to the new economic outlook. Fitch downgraded both Colombia and Mexico to BBB-.[13]

In Europe, the Ukrainian Parliament passed a key land reform bill, which was required to unlock $8bn worth of IMF financing. Central banks in Poland, Russia, and Turkey also cut interest rates to counteract COVID-19 weakness. The National Bank of Hungary (NBH) announced a quantitative easing program. The Polish government announced a new set of support measures ("Financial Shield" program), worth about 4.3% of GDP, to provide financing to non-financial firms.[14]

In South Africa, the government announced a ZAR500bn (10% of GDP) fiscal support package targeting businesses, unemployment, and low-income individuals to combat economic weakness. South Africa could request access to an IMF's Rapid Financing Instrument (RFI) of $2.1bn (50% of its quota), or loans from the World Bank or the African Development Bank. Central banks in the Philippines and China cut interest rates and/or reserve requirements during this period. The Indonesian government also announced a coronavirus relief package comprising 2.4% of GDP, taking the expected fiscal deficit this year to 5.1% of GDP. As this figure exceeds the 3% fiscal deficit limit, President Jokowi issued an emergency law easing the cap for the 2020-22 period.[15]

OUTLOOK

Following the incipient stabilization observed in April, market attention will focus on the gradual easing of lockdown measures in the developed world. First-in-first-out China may provide some clues as to what to expect in terms of recovery patterns; so far the evidence points to sluggish (though potentially bottoming) behavior in the services sector and a more convincing rebound in manufacturing, recently tempered by weak export data. The potential for a second wave of infections could also jeopardize a more decisive recovery in economic activity and needs to be monitored. In any event, the market is already primed for very weak economic data releases in the months ahead, and we believe that confirmation of those subdued expectations is unlikely to severely disrupt market sentiment. Most EM economies, particularly Latin America, are still in severe lockdown mode (with mild improvements in the last week), with attention focused on governments' efforts to flatten the infection curve and limit death rates, and on announcements of fiscal and monetary relief measures. In this regard, EM policy action has been very proactive, which should somehow contain the heavy economic cost of the pandemic, but at the expense of worsening debt trajectories.

[10] Source: JP Morgan, as of 4/30/2020
[11] Source: Bloomberg, as of 4/30/2020
[12] Source: Bloomberg, as of 4/30/2020
[13] Source: Bloomberg, as of 4/30/2020
[14] Source: Bloomberg, as of 4/30/2020
[15] Source: Bloomberg, as of 4/30/2020

A consolidation of the improved risk sentiment observed during April may benefit risky assets. This is even more so for EM debt, which bore the brunt of asset underperformance in March, and has not been a direct beneficiary of very generous relief policies announced by governments in the developed world. Therefore, attractive valuations, a stabilization in commodity prices, and progress on funding/debt relief initiatives directly targeting EM economies could combine to provide a boost to EM debt in the near term. We find value in hard currency EM debt, as well as duration in several countries, ranging from low yielders (such as Hungary) to high-yielders running prudent fiscal policies and with ample room for monetary policy easing (Mexico and Russia). We are more cautious on EM FX in the near term, despite screening extremely cheap, as EM authorities generally see weaker currencies as part of the response to the COVID-19 shock. Finally, we continue to monitor idiosyncratic stories including possible IMF program financing to Ukraine, Lebanon, or South Africa, heightened volatility in Brazil after recent Cabinet changes, as well as the outcome of Argentina's debt restructuring.

Credit

MONTHLY REVIEW

The key driver of credit spreads in April was a more optimistic expectation for markets as the coronavirus debate moved to strategies to exit the lockdown and the policy response intensified with additional liquidity support for corporates and fiscal grants for labor furloughed as a result of the "shuttering." The month can be broadly split into two stages, an initial rally from the wide spreads of March, followed by a consolidation toward month end when spreads rebounded to levels seen in February 2016 when oil was last below $30 per barrel and the base case expectation was for a demand driven recession.[16]

BBB-rated names outperformed higher rated securities in the U.S. Investment grade credit, as represented by the Bloomberg Barclays U.S. Corporate Index, closed 83 basis points (bps) tighter in April to end the month at 202 bps over government bonds. Financials (69 bps tighter) underperformed non-financials (89 bps tighter) in the month. In comparison to government bonds, the Index generated a positive excess return of 4.69%. European IG, represented by the Bloomberg Barclays Pan-European Aggregate Corporate Index, underperformed the U.S. market in April, closing 55 bps tighter at 186 bps. Financials closed 63 bps tighter, outperforming non financials (48 bps tighter). The Index generated a positive excess return of 3.26% versus government bonds.[17]

High-yield bonds rebounded sharply in April as unprecedented fiscal and monetary measures began to flow through the system. The Fed expanded the scope of its corporate credit facilities to include fallen angels and HY ETFs amid record new issue supply. Spreads ended the month 136 bps tighter, at 744 bps, and yields tightened 139 bps to end the month at 8.05%. Despite the strong performance in April, spreads are still 408 bps wider YTD.[18]

Within most sectors of the Bloomberg Barclays U.S. Corporate High Yield Index, returns were positive. Exploration & Production and Midstream were far and away the best performers, up 27.60% and 20.09% respectively, as commodity prices bounced back from multi-decade lows. Lodging and Restaurants were also up over the month, returning 6.93% and 5.99%. Meanwhile, the worst performing sectors were transportation services (-8.25%), aerospace/defense (-2.95%), finance companies (-1.13%) and oil field services (-1.06%).[19]

From a ratings perspective, higher quality bonds significantly outperformed. BB rated bonds were up +6.49%, while B rated credits were up +3.20% and CCCs were barely positive at 0.46%. High yield issuance surged in April and the market priced $37.3Bn across 55 new issues. YTD supply is now up 34% YoY. This was absorbed well by the market which simultaneously saw record inflows of $21.3Bn.[20]

Default activity rose sharply over the month as 19 companies filed for bankruptcy or missed an interest payment, affecting $24.0bn of bonds and $11.7bn of loans. It was the fifth largest monthly default volume on record. The par-weighted U.S. high-yield default rate jumped to a ten-year-high of 4.71%, which is up 208 bps from the start of the year. Notably, the Energy sector has accounted for 39% of total volume of defaults over the last year. As a result, the LTM par-weighted high-yield default rate ex-Energy is a more modest 3.55%.[21]

We expect to see a meaningful increase in overall high yield market defaults in the coming year due to a significantly weaker economy stemming from the COVID-19 outbreak, as well as stress in the Energy sector. Current street estimates vary between 8% and 12%,[22] but we expect all to be heavily concentrated in Energy and Coronavirus impacted sectors, thus getting sector positioning right will be critical for performance over the coming months.

Global convertibles rebounded with other risk assets in April, after two

[16] Source: Bloomberg, as of 4/30/2020

[17] Source: Bloomberg Barclays, as of 4/30/2020

[18] Source: Bloomberg Barclays, as of 4/30/2020

[19] Source: Bloomberg Barclays, as of 4/30/2020

[20] Source: Bloomberg, as of 4/30/2020

[21] Source: Bloomberg, as of 4/30/2020

[22] Source: Bloomberg, as of 4/30/2020

down months, due to the impact of embedded equity option valuation from improving trends with the coronavirus. MSCI Global equities were up the most since October, 2011, rising 10.58% in the month while the Bloomberg Barclays Global Credit index rose 4.01% and the Reuters Global Convertibles index rebounded 6.22%. Convertibles performance was driven by cyclical equity sectors, as technology, communications and consumer discretionary all returned between 12% and 17% in the month. Convertible supply continued apace with $16.5bn in new deals, led by $13.5bn from U.S. issuers, the highest monthly volume since May, 2008. Supply came primarily from cash-starved firms in the retail and travel sub-sectors, along with continued issuance from the technology sector. Unsurprisingly, market sentiment remains cautious with managers' underweight Europe and Asia and overweight the U.S., while also being underweight Energy and financials and remaining overweight technology.[23]

OUTLOOK

We frame the outlook for credit with the simple question: Is now the time to buy? Fundamentals have consolidated with the optimists citing advances in the path to a vaccine and plans to exit lockdown with the economy supported by the level of policy stimulus/support while pessimists focus on the risk of reinfection and the economic cost seen in the current weak economic data. Valuations seem to be fair for the current backdrop, having moved to the levels of February 2016 when the economy last saw weak commodity prices. We have a constructive medium term bias, viewing the policy support as truncating the downside risk (central banks will do whatever it takes), but in the short term expect news headlines and the technical of continued high supply to potentially create some volatility. However, central bank buying should not be underestimated as the stock and flow effects supporting credit and anecdotal data continues to imply strong demand for credit. In summary we believe this was the year to sell in February and go away, we see May as an opportunity to add credit.

Credit markets having initially focused on the risks of defaults and downgrades are now also focusing on the changes coronavirus will have on corporates. Supply chains will likely be diversified (industries less efficient, margins lower), workers will be more likely to work from home (will we need less office space?), online retail will accelerate, how will business and personal travel change (demand for airlines and hotels?), technology use increases (there are winners) and many other themes. We are looking to social disruption alongside technology disruption as key drivers of credit performance over the remainder of 2020.

Securitized

MONTHLY REVIEW

The securitized market partially rebounded in April, with spreads tightening to varying degrees, although remaining materially wider than pre-COVID-19 levels across all sectors. There was a clear tiering of recovery, with higher quality assets and securities receiving support from the Fed and recovering most significantly, while more credit sensitive securities languished. Fundamental credit conditions remain challenged with U.S. jobless claims over the last 6 weeks totaling over 30 million.[24] While an enormous amount of both fiscal and monetary stimulus has been put in place over the past six weeks, the broad economic shutdown and corresponding surge in unemployment will still likely lead to a spike in delinquencies and defaults across most securitized sectors. While this projected surge in delinquencies and defaults is concerning, we believe that the majority of the securitized markets have been structured in the post-Financial Crisis era to withstand substantial default and loss levels, and should ultimately be unimpaired from a fundamental credit perspective. The April remittance reports, which reflect March borrower payments, showed very minimal change in credit performance, but we expect to see more of an impact in the May remittances (April borrower payments).[25] We expect spreads to tighten further in the coming months as the actual delinquencies and defaults coming in lessen some of the market fears, but we expect securitized credit spreads to remain well above February spread levels as risk conditions will likely remain elevated for a while.

Agency MBS continued to perform well in April, with continued strong buying by the Fed, which purchased nearly $600 billion agency MBS over a six-week period from mid-March until the end of April.[26] 30-year mortgage rates fell 27 basis points in April to 3.23%,[27] the lowest rate in U.S. history, helping support home affordability, but also increasing mortgage financing risk for agency MBS. Despite this, we expect mortgage prepayments to remain relatively muted as the business disruptions and inefficiencies from the work-from-home environment slow refinance activity.

U.S. non-agency RMBS spreads tightened in April, but still lagged behind the spread tightening in the ABS and CMBS markets. New issuance remains very light, as spreads will likely need to tighten further to increase supply given current spreads represent uneconomic financing levels for new loan origination.

[23] Source: MSCI, Bloomberg Barclays, Thomson Reuters, as of 4/30/2020
[24] Source: Bloomberg, as of 4/30/2020
[25] Source: Bloomberg, as of 4/30/2020
[26] Source: The Federal Reserve, as of 4/30/2020
[27] Source: Bloomberg, as of 4/30/2020

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Investors are still waiting to see the impact of both the spike in jobless claims and the impact of the mortgage forbearance program.

U.S. ABS spreads also tightened April, both among higher quality auto and credit card ABS, as well as more credit-sensitive sectors such as consumer loans and aircraft ABS. The more-vulnerable ABS sectors continue to trade at substantially wider spreads, but are finally seeing a small increase in demand.[28]

U.S. CMBS spreads also tightened in April, and AAA CMBS spreads are now only 50-100 basis point wider than pre-COVID-19 levels, on average. The inclusion of secondary CMBS in the TALF program should give a significant boost to AAA CMBS demand. We anticipate continued fundamental stress for both hotels and shopping centers for the remainder of 2020. Office and residential-related CMBS should also see some stress, but overall we expect significantly better credit performance in these sectors.[29]

European RMBS spreads also tightened in April, as limited supply and increasing demand helped push spreads tighter. Overall, we find better relative value in most U.S. sectors over European securitized sectors.

OUTLOOK

We expect to see spreads continue to tighten across most securitized sectors in May. New issuance remains very light and secondary selling has slowed substantially, while demand appears to be steadily increasing. Spreads are unlikely to return to pre-COVID-19 levels given the elevated economic risks from the virus, but we expect spreads to continue to tighten in from current levels. We believe the current market environment represents an attractive investment opportunity, as we believe that current spreads overcompensate for actual credit risks. We will be closely watching delinquency and defaults levels in the coming months, but generally, we believe that structural credit protections on most securities will be sufficient to withstand this expected surge in delinquencies and defaults. We are focused on increasing exposure to sectors that we believe will be more resilient to the economic impacts from coronavirus, namely residential real estate related securities, auto loan ABS, and CMBS collateralized by office buildings, residential properties, and warehouse or logistics centers. We are looking to reduce exposure to unsecured consumer loans, small business loans, hotels, shopping centers and airplanes. For opportunistic portfolios, senior securities in some of these troubled sectors could represent an attractive opportunity given the substantial levels of structural credit support and the significantly reduced prices. Mark-to-market risks will likely remain high for these securities, but we believe the structural credit protections can help protect against substantial levels of defaults and that many of these securities will be fine from a fundamental credit perspective. Agency MBS seems to offer fair value at current levels, but we generally favor credit-related securitized opportunities at current valuations.

[28] Source: JP Morgan, as of 4/30/2020

[29] Source: Bank of America, as of 4/30/2020

Risk Considerations

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, 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. 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. 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.

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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.

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 **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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