Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

How Big Are the Waves?

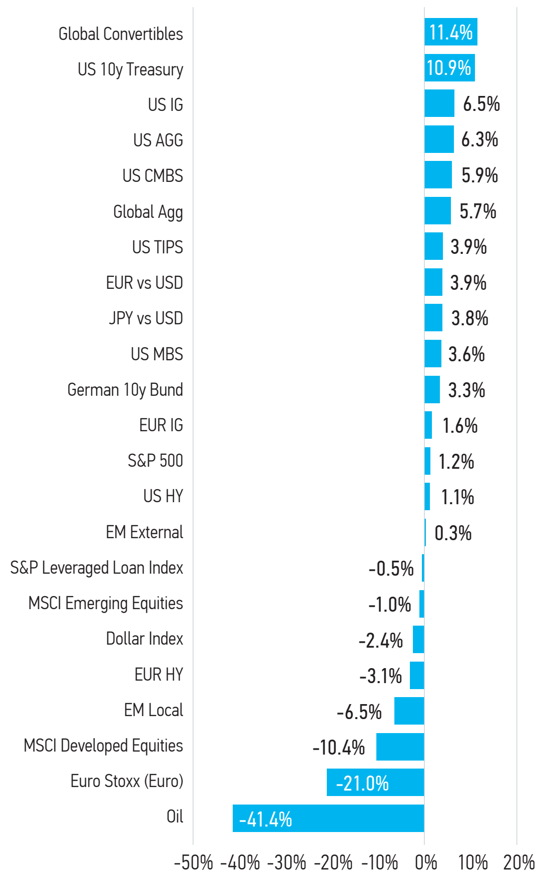
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | NOVEMBER 2020

October was an unusual month. Waves were coming from all directions and financial markets struggled to understand and react to all the possible scenarios and permutations. On one hand, bond yields rose significantly in the U.S. but fell in most other countries. In fact, U.S. Treasury yields rose the most in one month since September 2018. This is unusual: government bond yields across developed economies generally move in the same direction or at least do not diverge as dramatically as they did in October. We think this happened for two reasons: the probability of a Blue Wave (a sweep of the U.S. government by the Democratic Party) rose significantly; and the new COVID-19 wave hit and hit Europe particularly hard. While U.S. economic fortunes were generally considered to be positively affected by the net effect of these two forces, Europe's economic outlook dimmed. Not too surprisingly, despite equity market weakness, hope of a large U.S. fiscal package (in a Blue Wave scenario) and trust that the Fed would continue to provide unwavering accommodation supported credit and mortgage markets, whose spreads tightened. On the other hand, equities were hit by worries about capital gains tax increases and a deterioration in the regulatory environment. While in Europe, the effect of the COVID-19 wave was distinctly negative both in terms of growth and inflation.

Despite the likely end of U.S. electoral uncertainty, two big risks remain for the economy and bond markets. The first is the reduced likelihood of aggressive fiscal stimulus in 2021. There will be some, but will it be enough to keep economic growth strong? Fiscal policy is likely to net tighten next year even with the planned stimulus (not Blue Wave stimulus). This would follow the patterns of recent business cycles where fiscal policy was tightened prematurely, undercutting the recovery in growth, employment and inflation. Not a catastrophic outcome but not great either. Second is an extended lockdown/ restrictions due to a renewed wave of COVID-19

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of October 31, 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 6 and 7 for index definitions.

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infections. Hopefully, the European one will be short (it is so far not that extensive) and not too damaging, although the risk is that it exacerbates the strain health sectors are already under in the northern hemisphere from winter. We continue to believe any U.S. restrictions will be local and not too damaging, clearly dependent on health care systems not being overwhelmed.

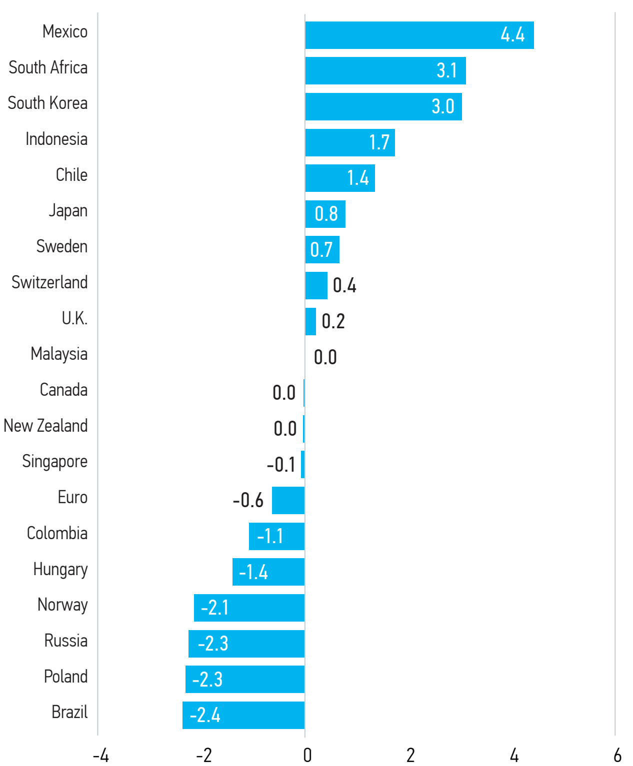
The good news is that monetary policy makers are still on the case. While the Fed has gone relatively quiet (not surprising given their big news in September and the November election) other central banks have been responding. Indeed, from the Fed leading the "easing" charge, leadership is shifting elsewhere. The ECB is expected to add to stimulus in December; the Bank of England expanded its QE programme in November; and the Reserve Bank of Australia lowered its yield targets and significantly expanded QE. These monetary policy backstops will only increase, if economic data disappoints for whatever reason, and, with inflation weak and U.S. fiscal policy unlikely to be on an overly aggressive trajectory into 2021, the Fed is likely to also join the party and increase accommodation further. And, of course, we cannot count on better therapeutics and vaccines which could significantly reduce health risks and boost the economy back to normal.

We remain comfortable with a modestly long risk position in portfolios. Looking into 2021, we still see economies improving as the economic data continue to come in better than expected, and assuming modest COVID-19 lockdowns. We remain positioned to benefit from riskier fixed income assets outperforming and government bond yields moving sideways.

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 October 31, 2020.

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	0.87	+19		
United Kingdom	0.26	+3	-61	-16
Germany	-0.63	-11	-150	-29
Japan	0.04	+3	-83	-16
Australia	0.83	+4	-5	-15
Canada	0.66	+10	-21	-9
New Zealand	0.53	+3	-34	-16
EUROPE			(Spread over Bunds)	
France	-0.34	-10	28	0
Greece	0.95	-8	158	+3
Italy	0.76	-11	139	0
Portugal	0.11	-16	73	-5
Spain	0.14	-11	76	-1
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	6.49	+43	318	-25
Colombia	5.39	+18	248	-18
Hungary	1.77	-4	106	-17
Indonesia	6.62	-27	190	-19
Mexico	6.20	+15	253	-26
Peru	4.12	-11	116	-19
Philippines	3.59	0	129	-15
Poland	0.62	-13	16	-10
Russia	5.79	-6	197	-10
South Africa	10.24	-1	451	-64
Turkey	14.27	+144	638	+9
Venezuela	–	–	18894	-2496
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			125	-11
EUR IG			116	-3
U.S. HY			509	-8
EUR HY			471	+14
SECURITIZED				
Agency MBS			78	-14
U.S. BBB CMBS			576	-25

Positive Neutral Negative

Source: Bloomberg, JPMorgan. Data as of October 31, 2020.

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Fixed Income Outlook

The U.S. election has come but not gone. As of now it looks like a split government: Democrats in the White House and House; Republicans in the Senate (probably). If this indeed holds, and we might not know for sure until the state of Georgia has its Senate runoff in January, we are getting something financial markets would seem to like: split government and no Blue Wave. But a second COVID-19 wave has appeared and intensified. New infections are rising rapidly, reaching a new global high, and while hospitalizations and mortality rates remain well below previous highs, they are increasing. This might necessitate exactly what the now unlikely Blue Wave will not deliver: a big fiscal stimulus package. Again, the outlook comes down to the course of the pandemic and how policymakers respond.

Economic risks have risen. Fiscal policy action in the U.S. is unlikely to be as large as the package previously under negotiation between Congress and the White House. Policy gridlock is possible. But, these risks still appear manageable. First, the U.S. is not locking down, at least as of yet. And, if a more stringent lockdown becomes necessary, it is likely to be the catalyst for another large bipartisan fiscal support package. Second, a vaccine looks increasingly likely to be approved soon, significantly improving the economic outlook for 2021 and beyond. Third, European economic weakness should not significantly impact the rest of the world. It is service sector led and designed to work/end before the holidays and thus likely to be relatively short. Fourth, we have to keep in mind that Asia is in a very good place with regard to the virus and the economic outlook. China, in particular, looks increasingly likely to return to "normal" by early next year. This will be supportive for the global economy and help further cushion the impact of a European downturn. Another bit of good news is that the southern hemisphere is moving into summer which should reduce health risks. This should help Latin America in particular. Virus cases are already on the decline in Brazil, Chile and Peru. Of course, a big risk, which cannot be dismissed, is that the type of lockdowns that are happening in Europe will happen in the U.S. and elsewhere.

Despite all the noise around the U.S. election and rising COVID-19 cases, we still remain medium term optimistic and are not changing our investment outlook. Economic growth in the fourth quarter is likely to be weaker than expected, but we expect a bigger bounce in 2021. A modestly bullish position with respect to credit and emerging markets looks sensible with a fairly neutral bias to interest rate risk (favoring countries running easiest monetary policies or those with the most commitment to ease further). Emerging markets in particular could be well placed to outperform in months ahead as they have not experienced a second COVID-19 wave (never exited the first!); China and seasonality are supportive; and a Democratic administration, if confirmed the winner, will be more internationalist and less anti-globalist.

This outlook is predicated on the idea that monetary policy globally will continue on its easing trajectory (pandemic is more deflationary than inflationary), keeping liquidity abundant and government yields low AND fiscal policymakers will ease further, although it may take some bad news on the COVID-19 front to act decisively. Moreover, the heavy sectoral impact of the pandemic strongly supports the case for further significant fiscal support. That said, we remain discriminating in our choice of assets and continue try to avoid the two tails of the risk spectrum: very high quality/low yielders and very low quality/high yielders, in both credit, securitized and sovereign markets.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In October, markets were in a "wait and see mode" as the U.S. election quickly approached, while a pickup in coronavirus cases was seen across the globe. Europe reimposed strict lockdowns in some countries to combat the spike in cases. Government bond yields rose in the U.S., Australia, Canada and New Zealand and generally fell across Europe. The 10-year Treasury yield increased by 19 basis points, which is the biggest increase seen since September 2018.	We expect central banks to extend accommodation further as economic risks remain skewed to the downside and inflation is no impediment to easing further, or is so low it compels central banks to ease. As a result, we expect government bond yields to remain at low levels, although there is potential for some differentiation as economic performance varies. 2020 was about policy that supported solvency to reduce the risk of longer-lasting credit impairment for corporations (QE) and individuals. Credit impairment needed to be addressed first because it would reduce the potential for stronger and faster recovery. 2021 is about stimulus and recovery. What was unknown was how this stimulus would be applied and by whom.
Emerging Market (EM) Rate/FX	Risk appetite returned during the month, given continued expectations of monetary and fiscal support for markets, expectations of a market friendly outcome to the U.S. elections, and better-than-expected Q3 corporate earnings. From a broad market perspective, Venezuela, Cote d'Ivoire, Kenya, Ghana and Belize were the best performers in October, while bonds in Sri Lanka, Argentina, Suriname, Zambia, Lebanon and Costa Rica were the worst performers. From a sector perspective, companies in the pulp and paper, metals & mining, industrial and real estate segments led the market, while those in the oil & gas, transport, consumer, and infrastructure business outperformed.	We remain cautiously optimistic on EM debt in the near term on the back of continued global monetary support and prospects of further fiscal policy accommodation. The U.S. presidential elections will play a major role in determining asset performance in the weeks ahead. However, stricter lockdown measures as the ones imposed in several countries in Europe, and increased odds that similar measures could be announced in the U.S. and other countries, could jeopardize our relatively constructive view on EM assets.

	MONTHLY REVIEW	OUTLOOK
Credit	Spreads were tighter on the month. The key drivers were continued expectations of monetary and fiscal support for markets as evidenced by ECB commentary, expectations of a Biden victory in the U.S. elections coupled with a possible "Blue Wave", positive Q3 corporate reporting relative to lowered expectations and continued strong demand for IG credit (including ECB QE purchases) in a month when supply slowed.	Looking forward, we see the remainder of the year as characterized by lower liquidity with market direction driven by the latest headline. Our base case reflects the consensus view that coronavirus is transitory and monetary policy is credit risk friendly. Overall, we expect monetary and fiscal stimulus to remain in place well into 2021, likely driving spreads tighter in the medium term.
Securitized Products	U.S. Agency mortgage-backed securities (MBS) performed well in October and securitized credit spreads continued to grind tighter in October. Mortgage prepayment speeds showed no signs of slowing as mortgage rates again hit new historic low again in October. U.S. asset-backed securities (ABS) spreads were generally unchanged or tighter. U.S. commercial mortgage-backed securities (CMBS) spreads tightened another 5-10 basis points in October. European RMBS spreads were largely unchanged in October, but have almost fully recovered to pre-COVID-19 levels.	Agency MBS now look marginally expensive, but should remain a relative safe haven given the expected Fed's purchases. 2.0 non-agency MBS look expensive, but attractive opportunities exist in other less traditional RMBS. We expect the U.S. housing market to remain stable and non-agency RMBS to continue to perform relatively well from a credit perspective. We expect auto loans, credit cards and consumer loans to continue to perform reasonably well. Delinquencies could rise if some of the stimulus measures are not extended or if further economic shutdowns develop. There is material upside to aircraft and small business loan ABS in an economic recovery. The outlook remains positive for multi-family, office and logistics CMBS, but we have concerns about properties in large cities. Hotel and shopping center CMBS are likely to remain very stressed. European markets are experiencing similar sector-specific performance dynamics to the U.S., but should remain well supported by the ECB's €1.35 trillion PEPP fund.

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. **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.

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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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