Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Bad Politics, Good Economies

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | SEPTEMBER 2017

Summary

With economic fundamentals and monetary policy stable, political noise has become the main source of market volatility. In the case of the debt ceiling and North Korea, we think political noise could continue to generate volatility, but it will remain just that — noise. At the same time, the environment should continue to support carry — fundamentals are improving yet there's little pressure for monetary policy to tighten rapidly due to undershooting of inflation. Nevertheless, given strong price appreciation for the past eight months, we think taking some profits on risky assets across the board is reasonable.

DEVELOPED MARKET (DM) RATE/FOREIGN CURRENCY (FX): Geopolitical noise and risk-off sentiments led risk-free yields to decrease across DM. U.S. Treasury 10-year yields fell 18 basis points as did German 10-year yields, while European periphery spreads widened. The dollar continued to weaken. Euro-linked currencies, such as Swedish krona and Norwegian krone, were the best performers amongst developed market currencies.

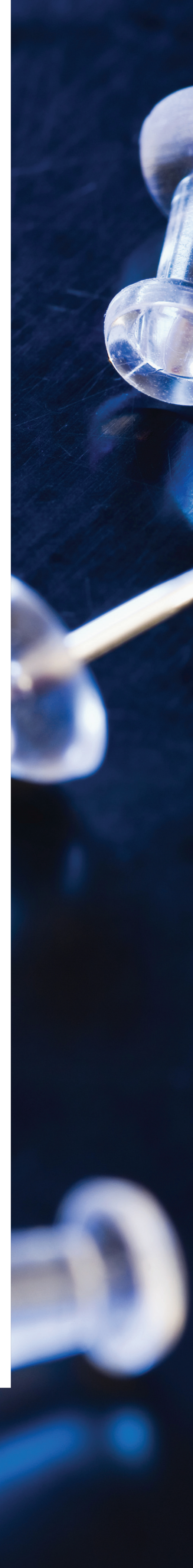
We believe higher U.S. Treasury yields will depend on higher U.S. inflation. Until then, they are likely to remain in a range and the yield curve will continue to flatten. We do expect the U.S. Federal Reserve (Fed) to announce its balance sheet reduction in September and hike rates in December, although the probability of the latter has been steadily decreasing. In currencies, we think the dollar's travails will not abate as long as dovish U.S. rate expectations persist and the non-U.S. global economy performs well.

EMERGING MARKET (EM) RATE/FX: EM fixed income asset returns were positive in the month with higher-yielding assets outperforming investment-grade credits, currencies strengthening versus the U.S. dollar and sovereigns outperforming corporates within dollar-denominated debt. U.S. President Donald Trump's political rally rhetoric created headwinds for Mexican assets as he reiterated threats to withdraw the U.S. from North American Free Trade Agreement (NAFTA). The U.S. administration announced additional sanctions on the Venezuelan government. However, trading in most of the existing outstanding debt is still permitted.

We remain optimistic about the prospects for EM fixed income in 2017 as country fundamentals and the macro environment remain supportive, with those countries that rely most on global trade potentially challenged. The various factors both pushing and pulling investors into EM fixed income remain in place: DM yields remain very low, economic data in EM appears to be recovering, EM real rate differentials with the U.S. and European yields are at multiyear highs and Fed rate hikes are likely to remain gradual.

CREDIT: In both European and U.S. investment-grade credit markets, spreads widened and was broad-based, impacting all rating categories and sectors, a phenomenon we have not seen in some time. Across markets, higher-beta credits and lower-rated issues underperformed.

Our overall stance on credit remains largely unchanged, as spreads have not moved drastically enough to warrant a re-evaluation of risk. We remain long risk and carry and have continued to moderately de-risk



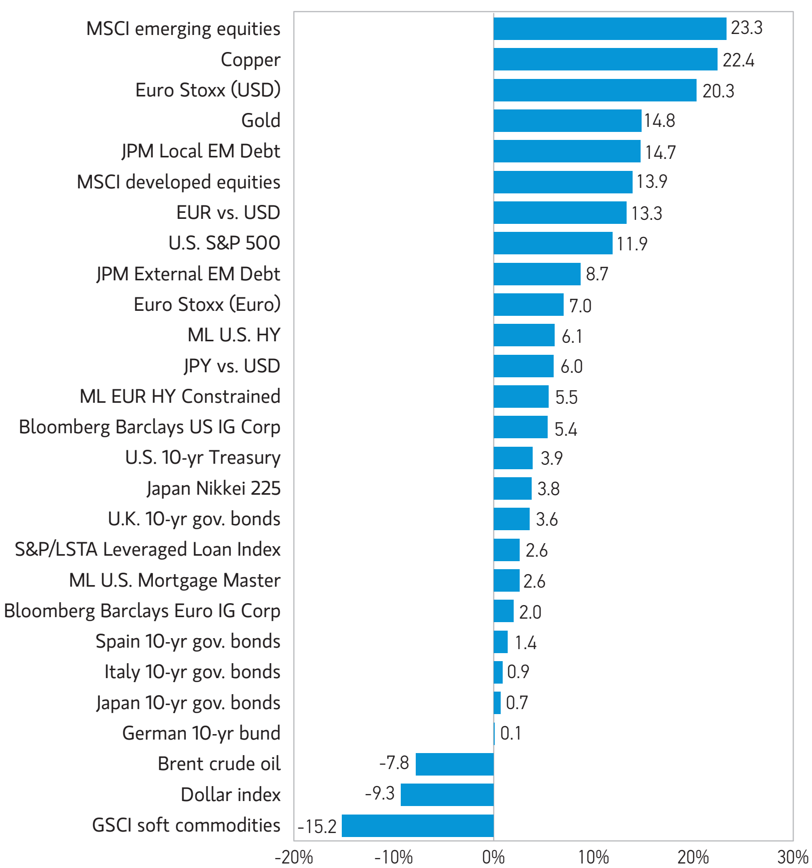
portfolios to reflect tighter valuations and more balanced upside/downside. We anticipate, however, that if equities continue to trade weaker, we may see a re-allocation into convertible bonds in the coming months, as convertibles have historically provided comparable returns to stocks with far less volatility.[1]

SECURITIZED: Agency mortgage-backed securities (MBS) continued to perform in line with expectations, while credit-related securitized assets maintained their trend outperformance. Retail shopping centers remain a major area of concern. Mall vacancy rates inched up 0.2 percent to 8.1 percent during the second quarter of 2017, and the leasing of vacant retail space fell to the lowest rate since 2011 during the quarter.[2]

After the significant tightening of credit spreads over the past year, we are becoming more cautious on credit-sensitive securitized assets. We remain positive on European securitized credit opportunities. Home prices have been steadily improving across Europe over the last couple years, buoyed by historically low mortgage rates and the improving economies. The buoyancy of the global economy keeps us long.

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of August 31, 2017. 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 12 and 13 for index definitions.**

DISPLAY 2

Major Monthly Changes in 10-Year Yields and Spreads

	RATES		CURRENCY
DM	**LEVEL**	**CHANGE (BPS)**	**CHANGE (%)**
United States	2.12	-18	
United Kingdom	1.03	-20	-2.16
Germany	0.36	-18	0.57
Japan	0.01	-7	0.25
EM Spreads			
EM External	320	-3	
EM Local Yields	6.08		
EM Corporate	251	3	
Credit Spreads			
U.S. IG	110	8	
EUR IG	99	7	
U.S. HY	378	26	
EUR HY	266	18	
Securitized Spreads			
Agency MBS	12	-1	
U.S. BBB CMBS	350	-15	

Source: Bloomberg, JP Morgan. Data as of August 31, 2017.

[1] Source: Thomson Reuters Focus Index. Data as of August 31, 2017. This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure page for more information.

[2] Source: REIS Inc. Data as of August 31st, 2017.

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Fixed Income Outlook

The market prepared itself for significant monetary announcements in August, but Jackson Hole proved to be uneventful. Central bankers did not see the need to announce or make changes to current policy. With economic fundamentals and monetary policy stable, political noise has become the main source of market volatility. North Korea missile tests and the U.S. debt ceiling impasses created jitters in the markets, with the VIX spiking mid-month, but did not result in a sustained sell-off in August. So despite solid economic fundamentals, 10-year U.S. Treasuries and bund yields trended down, hitting lows for the year. Risky credit assets underperformed as spreads widened on the month.

On the debt ceiling, recent political maneuvers have significantly reduced the risk of the U.S. experiencing a technical default in the near term; the issue looks to have been postponed until the end of the year or more likely into early next year. We want to highlight that a government shutdown, which had occurred in 2011 and 2013, is not the same as a default on Treasuries.

On North Korea, the lack of a good military solution and North Korea leader Kim's strong resolve to develop nuclear capabilities as a deterrent means the U.S. might ultimately have to accept North Korea as a nuclear power. Using Cold War logic, the U.S. will focus on containment, but we don't think it will escalate to war. In this case, we think political noise could continue to generate volatility spikes, but they will remain just that — noise. At the same time, economic fundamentals continue to improve. Second quarter gross domestic product (GDP) data shows a rebound from the first quarter for major economies, with the U.S. hitting 3.0 percent growth.

Looking back on the past few months, we've enjoyed a particularly good environment for risky assets, a so-called "goldilocks period" — fundamentals are improving yet there's little pressure for monetary policy to appreciably tighten due to undershooting of inflation. We do not see major disruptions to this environment which has been so supportive for carry. We think a Fed hike in December is likely (but with lower probability than last month or the month before that) but we do not think that the Fed will hike aggressively thereafter, and that the terminal rate could be closer to 2 percent than the 3 percent projected by the Fed. Nevertheless, given the very strong price appreciation for the past 8 months, from a risk-reward standpoint, we think taking some profits on risky credit assets is reasonable.

The reasonably rapid fall in the dollar over the past few months, particularly against European currencies, may be reaching its limits absent more significant changes in interest rates. But, there is no doubt that U.S. rate differentials have been narrowing against the rest of the world (in general) and until sentiment and data shift back in favor of higher U.S. rates and yields, the dollar is likely to remain under pressure. We continue to like EM currencies versus the U.S. dollar. Euro strength is undoubtedly complicated monetary policy for the European Central Bank (ECB), but there may be little they can do about it as it reflects fundamental improvements both in data and in sentiment in Europe relative to the U.S. We also may be seeing the final death throes of the "Trump trade."

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Developed Market

Monthly Review

Geopolitical noise and risk-off sentiments led risk-free yields to decrease across developed markets. U.S. Treasury 10-year yields fell 18 basis points. German 10-year yields fell 18 basis points, while European periphery spreads widened.[3] Greek 10-year yields increased by 14 basis points while Spanish yields increased by 6 basis points.[4]

The dollar continued to weaken. Euro-linked currencies, such as Swedish krona and Norwegian krone, were the best performers in DM. EM currencies also outperformed. Oil prices were basically unchanged on the month.[5]

In the U.S., the annual Jackson Hole meeting of central bankers was relatively uneventful. Chair Yellen spoke on how financial regulation has made the system safer after the crisis, but some rollbacks or changes could be considered. In terms of data, GDP was revised higher for the second quarter to 3.0 percent, above 2.7 percent previously. Labor markets continued to grind tighter while inflation has stayed at around 1.7 percent year-on-year.

In the eurozone, the ECB gave little new details about future policy in August. Members of the ECB had commented that the ECB would wait until the fall to offer guidance on policy. The next meeting is September 7th. In August, activity continued to be strong; Purchasing Managers Index (PMI) strengthened to 57.4, versus 57.0 previously.

In the U.K., the Bank of England (BoE) kept rates unchanged at its August meeting. On Brexit, certain members of May's government have floated the idea of a transition arrangement, aimed to help phase in the exit from the European Union (EU). Negotiations have stalled over the issue of the liabilities to be paid by the U.K. upon exit, which the EU has estimated to be €50 billion. Inflation seems to be plateauing, with headline inflation at 2.6 percent year-on-year, flat from last month.

In Japan, second quarter GDP was strong, at 2.0 percent year-on-year, versus 1.5 percent in the last quarter. Core inflation has been improving, with most recent print at -0.1 percent, up from -0.2 previously.[6] However, the focus has been on elections as Abe nears the end of his term. Though there's high likelihood that Abe will be re-elected, if he is not, the continuation of Abenomics would come into question.

DISPLAY 3

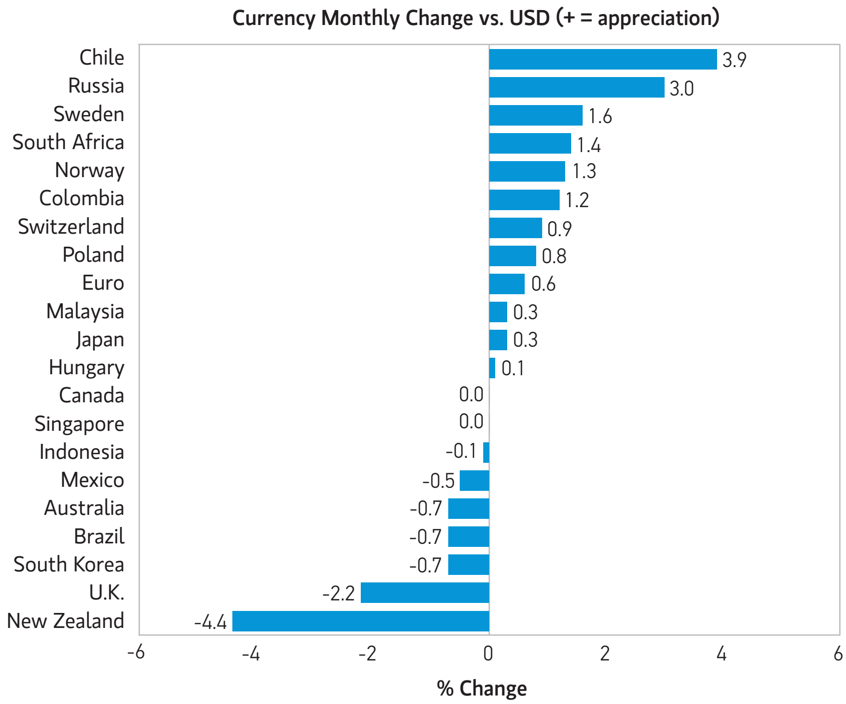
Government Bond Yields for Major Economies

COUNTRY	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR SPREAD (BPS)	MONTH CHANGE (BPS)	2S - 10S YIELD CURVE (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)			
United States	2.12	-18			79	-15
United Kingdom	1.03	-20	-108	-2	86	-10
Germany	0.36	-18	-176	0	109	-14
Japan	0.01	-7	-211	10	17	-3
Australia	2.71	4	60	21	83	-6
Canada	1.85	-21	-27	-3	57	-17
New Zealand	2.90	-8	79	10	87	-2
Europe			(Spread over Bunds)			
Belgium	0.67	-16	31	2	123	-9
France	0.66	-14	30	4	118	-6
Germany	0.36	-18			109	-14
Greece	5.54	14	518	33	240	45
Ireland	0.69	-15	33	3	121	-9
Italy	2.05	-5	168	13	223	-7
Netherlands	0.49	-16	13	2	119	-11
Portugal	2.83	-5	247	13	283	7
Spain	1.56	6	120	24	191	9
Denmark	0.50	-17	14	1	114	-11
Norway	1.54	-13	118	5	95	-9
Sweden	0.80	6	44	25	148	7
Switzerland	-0.14	-19	-50	0	69	-12

Source: Bloomberg, Data as of August 31, 2017

[3] Source: Bloomberg. Data as of August 31, 2017.
[4] Source: Bloomberg. Data as of August 31, 2017.
[5] Source: Bloomberg. Data as of August 31, 2017.
[6] Source: Bloomberg. Data as of August 31, 2017.

DISPLAY 4
Currency Monthly Changes Versus U.S. Dollar



Source: Bloomberg. Data as of August 31, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

Outlook

We believe higher U.S. Treasury yields will depend on higher U.S. inflation. Until then, they are likely to be depressed and the yield curve will continue to flatten. If inflation does rise, we believe that U.S. Treasury 10-year yields may end the year close to 2.60 percent and the 2-year to 10-year yield curve will be near 80 basis points. We do expect the Fed to announce its balance sheet reduction in September and hike rates in December. Of course, this is very dependent on economic data.

We believe the ECB as well as the performance of German government bonds hold the key to performance across global treasury markets. In the remainder of 2017, German bonds will not only respond to economic conditions, but also to a pre-planned exit of quantitative easing (QE) and the possibility of less negative interest rates in 2018. As such, we believe German yields could rise toward year-end. However, continued flare-ups in political risks could weigh on yields. Peripheral European bonds are likely to remain well bid and narrow in spread with Germany, provided that economic and political risks remain tame.

In other DMs, we expect Japanese Government Bond (JGB) yields to remain low but talk of exiting yield curve control may push 10-year JGBs slightly above 0.10 percent. We believe being overweight Australian government bonds is a good hedge to the risk of a deeper than expected slowing in China.

In terms of currencies, the U.S. dollar is likely to move sideways in the months ahead as growth around the world matches or exceeds that in the U.S. In many ways, the dollar, particularly against the euro, has fallen much farther than justified by relative rate or growth differentials. The unexpected strength in the euro has more to do with expectations of a dovish Fed and a hawkish ECB, expectations which could easily not be realized. Europe in general has been strengthening, and we are positive on euro-linked currencies such as Swedish kroner, Czech koruna and Polish zloty. EM currencies look interesting in a more robust global growth world and we think can outperform versus the U.S. and Australian dollars. However, for certain EM currencies, Trump's protectionist agenda will remain a source of volatility.

Emerging Markets

Monthly Review

EM fixed income asset returns were positive in the month with higher-yielding assets outperforming investment-grade credits, currencies strengthening versus the U.S. dollar, and sovereigns outperforming corporates within dollar-denominated debt. EM fixed income strategies continued to gain assets with investors, allocating $5.4 billion across hard currency, local currency and blended strategies, bringing the year-to-date total to $75.5 billion.[7] Commodity prices rose in the month, mitigating year-to-date losses for oil and coal while strengthening gains in hard commodities such as gold, silver, palladium and platinum. Gold and copper prices were some of the strongest performers for the month and the year as investors used investments in gold as

[7] Source: JP Morgan. Data as of August 31, 2017.

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DISPLAY 5

Major Economic Data Releases

COUNTRY			LATEST	CONSENSUS	PREVIOUS	AS OF
U.S.	Labor	Non-farm Payrolls ('000s)	209	180	231	7/31/2017
		Unemployment rate (%)	4.3	4.3	4.4	7/31/2017
		Participation rate (%)	62.9		62.8	7/31/2017
		Average Hourly Earnings (%YoY)	2.4		2.4	7/31/2017
	Activity	ISM Manufacturing	56.3	56.5	57.8	7/31/2017
		GDP (%QoQ, saar)	3	2.7	1.2	6/30/2017
		GDP (%YoY)	2.2		2	6/30/2017
	Inflation	CPI (%YoY)	1.7	1.8	1.6	7/31/2017
		Core CPI (%YoY)	1.7	1.7	1.7	7/31/2017
Euro Area	Labor	Unemployment rate (%)	9.1	9.1	9.1	7/31/2017
	Activity	PMI Manufacturing	57.4	57	57	8/31/2017
		GDP (%QoQ)	0.6	0.6	0.5	6/30/2017
		GDP (%YoY)	2.2	2.1	1.9	6/30/2017
	Inflation	CPI (%YoY)	1.3	1.3	1.3	7/31/2017
		Core CPI (%YoY)	1.2	1.2	1.1	7/31/2017
U.K.	Labor	Unemployment rate (%)	4.4	4.5	4.5	6/30/2017
		Average Weekly Earnings (%)	2.1	1.8	1.9	6/30/2017
	Activity	PMI Manufacturing	55.1	54.5	54.2	7/31/2017
		GDP (%QoQ)	0.3	0.3	0.2	6/30/2017
		GDP (%YoY)	1.7	1.7	2	6/30/2017
	Inflation	CPI (%YoY)	2.6	2.7	2.6	7/31/2017
		Core CPI (%YoY)	2.4	2.5	2.4	7/31/2017
Japan	Activity	PMI Manufacturing	52.1		52	7/31/2017
		GDP (%QoQ, saar)	4	2.5	1.5	6/30/2017
		GDP (%YoY)	2		1.5	6/30/2017
	Inflation	CPI (%YoY)	0.4	0.4	0.4	7/31/2017
		Core CPI (ex food and energy, %YoY)	-0.1		-0.2	7/31/2017

Source: Bloomberg. Data as of August 31, 2017.

a hedge against geopolitical risks and copper is seen as a leading indicator of global demand. Political volatility flared in the month as tensions on the Korean peninsula continued to provoke responses from North Korea, the U.S. and South Korea, while threatening to further involve China to help resolve the impasse.

Several Central Banks continued to cut rates to spur economic growth amid well-behaved inflation. The Bank of Indonesia cut rates 25 basis points to 4.5 percent as core inflation remained well-contained and activity measures were within the lower bounds of expectations. The Reserve Bank of India also cut rates 25 basis points to 5.75 percent as inflation remained at multiyear lows. Colombia's Central Bank (BanRep) also cut policy rates 25 basis points, and also signaled a pause in the cutting cycle, with the market pricing in cuts in the first half of 2018. Better economic data in China boosted the outlook for growth in the second half of the year. PMI data slowed from recent highs but remained in expansionary territory. Continued spending on infrastructure by the Chinese government, a slower-than-expected adjustment in the property market, and stronger labor markets in Europe and the U.S. likely aided exports for the country, contributing to the strong first half growth. The growth in China has been a critical component of commodity demand and a key support for commodity prices as supply imbalances correct. These rate cuts stood in contrast to the Czech National Bank (CNB) which hiked rates 20 basis points to cool inflation. The CNB lifted policy rates from 0 percent and was the first bank hike in Europe this year.

EXTERNAL: EM external sovereign and quasi-sovereign debt returned 1.73 percent in the month, bringing year-to-date performance to 8.74 percent, as measured by the JP Morgan EMBI

Global Index.[8] Higher-yielding, lower-rated credits outperformed lower-yielding, higher-rated credits in the month. Bonds from El Salvador, Argentina, Iraq, Ghana and Jamaica outperformed the broader market, while those from Venezuela, Namibia, Lebanon, Latvia and Serbia lagged.

DOMESTIC: EM domestic debt returned 1.79 percent in the month, bringing year-to-date performance to 14.67 percent as measured by the JP Morgan GBI-EM Global Diversified Index.[9] EM currencies strengthened 0.85 percent versus the U.S. dollar and EM bonds returned 0.93 percent in local terms.[10] Within the domestic debt universe, bonds from Russia, Chile, Colombia, Turkey, South Africa and Indonesia outperformed. Conversely, bonds from the Philippines, Argentina, Romania, Brazil, Mexico and Czech Republic lagged the broader market.

CORPORATE: EM corporate debt returned 0.79 percent in the month, as measured by the JP Morgan CEMBI Broad Diversified Index.[11] Higher-yielding, lower-quality companies outperformed higher-rated companies in the month. From a regional perspective, companies in Africa (Nigeria), Latin America (Brazil, Jamaica and Mexico), and Europe (Ukraine and Kazakhstan) led the market, while those from Asia (Macau, Singapore and Thailand) and the Middle East (Saudi Arabia, Bahrain and United Arab Emirates) lagged. From a sector perspective, companies in transport, oil & gas, metals & mining, infrastructure, real estate, diversified and utilities sectors outperformed the broader market, while those in the consumer, financial, pulp & paper and technology, media and telecommunications (TMT) sectors lagged.

DISPLAY 6
EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	265	+2	8.9	-7
Colombia	195	+1	6.5	-8
Hungary	105	-7	1.8	-17
Indonesia	187	+5	7.0	-28
Malaysia	139	+4	3.9	-8
Mexico	244	+7	7.0	+1
Peru	153	+1	5.5	-8
Philippines	102	+9	4.9	+5
Poland	57	-8	2.7	-8
Russia	180	-1	7.6	-18
South Africa	264	-8	9.3	-3
Turkey	277	-3	10.6	+5
Venezuela	3125	+148	-	-

Source: JP Morgan. Data as of August 31, 2017.

Outlook

From a fundamental perspective, EM economies, in aggregate, have continued to improve. The EM/DM growth differential appears to be recovering in favor of EM as the negative growth impacts from Brazil and Russia lessen. China's growth slowdown is likely to continue in the medium-term, with better-than-expected short-term growth likely to be challenged by policy-induced tightening in financial conditions. In the U.S., reflation hopes are now centered solely on the passage of fiscal reform, which if successfully executed, could be reflected in stronger U.S. growth in 2018. Volatility has remained low as investor concerns have been offset by global central bank liquidity, despite U.S. Fed rate hikes and talk of balance sheet reduction. This positive fundamental outlook could be threatened by a variety of factors including: a sharp return of volatility, monetary policy missteps or a flare-up in geopolitical tensions. De-globalization risks are likely to intensify in the short term as NAFTA renegotiation talks approach a crucial stage, but we remain constructive on the final outcome. A U.S. withdrawal from the agreement would be economically self-defeating, causing severe disruptions in the existing value chains of key U.S. industries. Moreover, the political gain from exiting NAFTA does not appear

8 Source: JP Morgan. Data as of August 31, 2017.
9 Source: JP Morgan. Data as of August 31, 2017.
10 Source: JP Morgan. Data as of August 31, 2017.
11 Source: JP Morgan. Data as of August 31, 2017.

to be clear-cut, since there are segments of the President's support base that stand to lose significantly from such a decision (for example, states with strong agricultural sectors).

We remain optimistic about the prospects for EM fixed income in 2017 as country fundamentals and the macro environment remain supportive, with those countries that rely most on global trade potentially challenged. The various factors both pushing and pulling investors into EM fixed income remain in place: DM yields remain very low, economic data in EM appears to be recovering, Fed rate hikes are likely to remain gradual, U.S. protectionist inclinations have diminished and concerns of a sharp slowdown in China have eased. We believe that EM assets should be able to weather Fed rate hikes if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty from undue Fed hawkishness, or Chinese policy tightening triggering a sharper-than-expected growth downturn. We are also cognizant of potential geopolitical risks which may flare up and trigger spikes in volatility. However, we anticipate such events will be transitory and idiosyncratic to specific countries, rather than systemic.

DISPLAY 7
Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	**110**	**+8**	**99**	**+7**
Industrial Basic Industry	134	+5	90	+7
Industrial Capital Goods	88	+8	83	+7
Industrial Consumer Cyclicals	105	+9	107	+7
Industrial Consumer Noncyclicals	99	+12	90	+10
Industrial Energy	147	+11	101	+6
Industrial Technology	91	+7	71	+5
Industrial Transportation	105	+8	88	+6
Industrial Communications	153	+14	108	+10
Industrial Other	91	+1	120	+4
Utility Electric	104	+4	92	+7
Utility Natural Gas	113	+6	95	+6
Utility Other	114	-7	98	+5
Financial Inst. Banking	96	+5	91	+7
Financial Inst. Brokerage	104	+1	95	+3
Financial Inst. Finance Companies	106	+7	84	+3
Financial Inst. Insurance	114	+8	175	+13
Financial Inst. REITS	126	+2	107	+4
Financial Inst. Other	112	+9	129	+6

Source: Bloomberg Barclays. Data as of August 31, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

Credit

Monthly Review

After four consecutive months of strong performance and tighter spreads, global credit markets underperformed in August as political risks created international market unrest. While global equity indices where roughly unchanged over the month in the United States and Europe, increased uncertainty and market volatility was captured through movements in the VIX. After trading in a relatively tight band for most of the year, the VIX touched 2017 highs during the month. In credit markets we saw a flight to quality, as lower-rated bonds underperformed. Spreads in the United States and Europe widened throughout August.

In the United States, markets became increasingly focused on fiscal challenges brewing in Washington. Specifically, Congress needs to pass a budget for the new fiscal year by the end of September. If this is not achieved by the deadline, a partial federal government shutdown will ensue, the potential for which rattled markets in August. Additionally, Congress must soon pass an increase in the debt ceiling, without which there is the potential for a ratings downgrade. The uncertainty surrounding both domestic U.S. issues weighed on sentiment over the month, and may continue to destabilize markets until a resolution is reached. Within the U.S., specifically, negative headlines were exacerbated by weak technicals and

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tight valuations, as new issue volumes reached historic records for August and spreads entered the month at year-to-date lows. European headlines focused on upcoming Italian and German elections, as continued uncertainty weighed on market sentiment.

In both European and U.S. investment-grade credit markets, spread widening was broad-based, and impacted all rating categories and sectors, a phenomenon we have not seen in some time. Across markets, higher-beta credits and lower-rated issues underperformed. As a result, sectors such as subordinated financials, energy and communications underperformed over the course of the month. Interestingly, European high-yield reported stronger excess returns lower down the risk spectrum, an unusual occurrence during a risk-off month. In the U.S., high-yield followed the same performance pattern as investment-grade, as higher-beta credits underperformed higher-rated bonds. Convertibles performance was weak during August as well, as underlying equities around the world had mixed results. We anticipate, however, that if equities continue to trade weaker, we may see a re-allocation into convertible bonds in the coming months, as convertibles have historically provided comparable returns to stocks with far less volatility.

Most notably on the news front in August was Teva's weak earnings announcement, which sent spreads 50 basis points wider and resulted in a ratings downgrade to BBB- by two agencies, reminding the market that idiosyncratic risk still exists.[12] In addition, Amazon issued $16 billion in debt in August, to finance its acquisition of Whole Foods.[13] This remains notable as it is the largest acquisition in Amazon's history, and gives the company direct access to the grocery industry, where online shopping has just 3 percent market share. We remain very constructive on the Amazon story, and believe the deal was priced attractively given the forward outlook on the company.

Outlook

While there has been a clear shift in sentiment within the market as a result of looming international and domestic political risks, our overall stance on credit remains largely unchanged, as spreads have not moved drastically enough to warrant a re-evaluation of risk. We still anticipate that spreads will grind tighter into year-end. Technicals remain generally supportive of credit, though tested by high hedging costs. Fundamentals remain stretched for many non-financials, while fundamentals for financial issuers remain strong. We remain long risk and carry and have continued to de-risk portfolios to reflect tighter valuations and more balanced upside/downside potential. We continue to seek opportunities in high-yield bonds, convertible bonds and investment-grade corporates that present unique spread dynamics. As we head into September, we are vigilant of global political headlines, and will continue to monitor their potential impact on credit markets.

Securitized Products

Monthly Review

Agency MBS continued to perform in line with expectations in July, while credit-related securitized assets maintained their outperformance of 2017. Nominal spreads on current coupon agency MBS were unchanged in August at 91 basis points above interpolated Treasuries, while option-adjusted spreads (OAS) tightened 1 basis point to 12 basis points above interpolated Treasuries as volatility and prepayment concerns remain subdued.[14] The Fed purchased approximately $25 billion agency MBS in August in order to maintain its agency MBS portfolio at $1.75 trillion; however, the Federal Open Market Committee (FOMC) statement from the July meeting suggested that the Fed could begin to taper its MBS reinvestments "relatively soon." The Fed purchased almost $400 billion agency residential mortgage-backed securities (RMBS) in 2016, and is on pace for over $300 billion in 2017, but we believe that ending or slowing this reinvestment could have a significant negative impact on agency MBS.[15]

Non-agency MBS spreads tightened slightly in August, continuing the strong gains of 2017, and cash flow and credit performance continues to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. Home prices are up 43.7 percent nationally from the lows in 2012, and are now up 4.3 percent from the pre-crisis peak in July 2006. With unemployment low, the economy slowly improving, and homes remaining generally affordable at current mortgage rates, we expect mortgage credit performance to continue to improve.

Commercial mortgage-backed securities (CMBS) performance continues to diverge depending on different collateral compositions. Since the beginning of the year, spreads on CMBX 6 BBB- (2012 vintage), which has 35 percent retail exposure, are wider by 221 basis points, while spreads on CMBX 9 BBB- (2015 vintage), which has only 26 percent retail exposure are tighter by 14 basis points.[16] The increasing announcements of retail store closings and poor retail earnings are

[12] Source: Bloomberg. Data as of August 31, 2017.

[13] Source: Bloomberg. Data as of August 31, 2017.

[14] Source: Yield Book. Data as of August 31, 2017.

[15] Source: Federal Reserve Bank of New York. Data as of August 31, 2017.

[16] Source: Markit. Data as of August 31, 2017.

DISPLAY 8

Key Data for Non-Agency MBS

		LATEST	PREVIOUS	UNIT	CHANGE OVER 1 YEAR	UNIT	AS OF
Prices	National Home Prices	0.36	0.3	% MoM	5.8	% YoY	6/30/2017
	Existing Home Sales	5.4	5.51	MM homes			7/31/2017
	Existing Home Sales	-1.3	-1.96	% MoM	2.1	% YoY	7/31/2017
Inventory	Housing Inventory	-0.5		% MoM	-7.1	% YoY	
	Housing Inventory	4.2	4.2	Months supply	4.8	Level last yr	7/31/2017
Defaults	New Defaults	0.62	0.6	% annualized	0.66	Level last yr	7/1/2017

Source: Bloomberg. Data as of August 31, 2017.

causing credit concerns for many retail properties. Non-agency CMBS issuance totaled roughly $11 billion in August, roughly on average pace for the year, and lifting the 2017 year-to-date total to $53 billion for the first eight months of 2017.[17] We expect non-agency CMBS issuance to slow in the 4th quarter, but still expect roughly $60-70 billion in total new issuance volumes for 2017.

Fundamentally, CMBS performance remains on reasonably solid ground, although there are some areas of concern. Commercial real estate prices rose 0.3 percent in July, and are now down only 0.6 percent in 2017 and essentially flat over the past 12 months. After several years of 10+ percent annual increases, commercial real estate prices have flattened over the past year, but we do not expect price changes to turn materially negative given the continued strength of the U.S. economy. Although retail-oriented CMBS has been hardest hit, non-agency CMBS more broadly has been one of the worst performing credit sectors over the last couple years, lagging most of the tightening seen in other credit sectors. While we do see some signs of concern, overall we believe CMBS represents one of the more attractive credit sectors from a relative value perspective.

European MBS spreads continued to tighten in August, and are now 30 to 70 basis points tighter in 2017.[18] Low interest rates and moderate signs of economic growth in Europe seem to be outweighing any material concerns over Brexit fallout. The ECB continued asset-backed securities (ABS) purchases in July, increasing their portfolio by €0.5 billion to €24.6 billion of European ABS as the end of July 2017.[19] European ABS issuance slowed in August with just €3.0 billion issued for a 2017 total issuance volume of €50.3 billion, less than the €56.1 billion during the first eight months of 2016.[20] We expect securitized issuance to remain relatively light in 2017 given regulatory constraints.

Outlook

After the significant tightening of credit spreads over the past year, we are becoming more cautious on credit-sensitive securitized assets. While we believe that most real estate and consumer credit conditions remain positive, credit spreads in many securitized sectors have tightened to levels not seen since before the financial crisis. Across most securitized markets, with the exception of a few subsectors of the CMBS market, we do not foresee any significant near-term credit concerns, but we have concerns about whether risk premiums (credit spreads) are sufficient compensation for even low fundamental risk levels at current valuations in many sectors. We continue to see a number of idiosyncratic credit opportunities that offer attractive value, but more broadly, we are finding credit-oriented securitized products to be relatively expensive versus historical levels.

Although we are reducing our credit outlook, we are still maintaining a credit bias in our portfolios given the broad strength of fundamental real estate and asset-backed conditions. The U.S. economy continues to grow slowly, averaging roughly 2 percent GDP growth over the last few years. Despite the recovery of home prices over the past several years, homes remain historically

[17] Source: Bank America. Data as of August 31, 2017.

[18] Source: JP Morgan. Data as of August 31, 2017.

[19] Source: European Central Bank. Data as of August 31, 2017.

[20] Source: Deutsche Bank. Data as of August 31, 2017.

affordable on a national level when comparing median incomes to the cost of owning a median-priced home at current mortgage rates. Consumer spending has been slowly increasing, benefitting many sectors of commercial real estate, although traditional shopping malls continue to suffer from store closings as many national retailers face increasing competition from on-line shopping. For U.S. credit-oriented securitized products, we continue to favor legacy non-agency RMBS, seasoned non-retail CMBS and non-traditional U.S. ABS.

We also remain cautious on agency MBS. While the relative value of agency MBS has improved given its recent underperformance versus other securitized assets, agency MBS remains expensive by historical comparison and potentially faces significant supply headwinds as the Fed begins to slow its agency MBS reinvestments and lets its $1.75 trillion portfolio run off. The Fed has been the largest buyer of agency MBS over the past 8 years, and net market float of agency MBS should increase as the Fed slows its purchases. We believe agency MBS spreads, which are near the tightest levels over the past 10 years on a nominal spread basis for current coupon MBS, could widen to more historically normal levels as the Fed slows its purchases. On the positive side, interest rate volatility remains subdued, and agency MBS should continue to perform reasonably well from a fundamental carry perspective if interest rates remain range-bound.

We remain positive on European securitized credit opportunities. The ECB and BoE continue to provide accommodative interest rate policies which are beneficial to residential and commercial real estate values and consumer balance sheets. Home prices have been steadily improving across Europe over the last couple of years, buoyed by historically low mortgage rates and the improving economies. We remain cautious on recently originated U.K. residential loans and London-based commercial real estate properties, due to Brexit concerns, but we still like very seasoned (10-years or more) U.K. RMBS. We also find attractive relative value in seasoned peripheral RMBS, which are benefiting from rising home prices, and attractive value in non-U.K. CMBS which are generally performing well as the European economies strengthen and which could selectively benefit from potential Brexit-related relocation of London financial personnel.

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

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

Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care.

The **JP Morgan Emerging Markets Bond Index Global (EMBI Global)** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans and eurobonds with an outstanding face value of at least $500 million.

The **JP Morgan CEMBI Broad Diversified Index** is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

The **JP Morgan GBI-EM Global Diversified Index** is a market capitalization weighted, liquid global benchmark for U.S.-dollar corporate emerging market bonds representing Asia, Latin America, Europe and the Middle East/Africa.

The **ISM Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production

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inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The **Bloomberg Barclays U.S. Mortgage Backed Securities (MBS)** Index tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA) and Freddie Mac (FHLMC). The index is constructed by grouping individual TBA-deliverable MBS pools into aggregates or generics based on program, coupon and vintage. Introduced in 1985, the GNMA, FHLMC and FNMA fixed-rate indexes for 30- and 15-year securities were backdated to January 1976, May 1977 and November 1982, respectively. In April 2007, agency hybrid adjustable-rate mortgage (ARM) pass-through securities were added to the index.

The **Nikkei 225 Index (Japan Nikkei 225)** is a price-weighted index of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

The **U.S. Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies.

Italy 10YR govt bonds — Italy Benchmark 10-Year Datastream Government Index.

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

Spain 10YR govt bonds — Spain Benchmark 10-Year Datastream Government Index.

The **BofA Merrill Lynch European Currency High-Yield Constrained Index (ML Euro HY constrained)** is designed to track the performance of euro- and British pound sterling-denominated below investment-grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world.

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

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

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

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

The **BofA Merrill Lynch U.S. Mortgage-Backed Securities (ML U.S. Mortgage Master) Index** tracks the performance of U.S. dollar-denominated, fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market.

The **S&P/LSTA U.S. Leveraged Loan 100 Index (S&P/LSTA Leveraged Loan Index)** is designed to reflect the performance of the largest facilities in the leveraged loan market.

The **Bloomberg Barclays Euro Aggregate Corporate Index (Barclays Euro IG Corporate)** is an index designed to reflect the performance of the euro-denominated investment-grade corporate bond market.

The **Bloomberg Barclays U.S. Corporate Index (Barclays U.S. IG Corp)** is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable, corporate bond market.

The **Bank of America Merrill Lynch United States High Yield Master II Constrained Index (Merrill Lynch U.S. High Yield)** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred-interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default.

JPY vs. USD — Japanese Yen total return versus USD.

Euro vs. USD — Euro total return versus USD.

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

The **MSCI AC Asia ex-Japan Index (MSCI Asia ex-Japan)** captures large- and mid-cap representation across two of three Developed Markets countries (excluding Japan) and eight Emerging Markets countries in Asia.

The **S&P GSCI Softs (GSCI soft commodities) Index** is a sub-index of the S&P GSCI that measures the performance of only the soft commodities, weighted on a world production basis. In 2012, the S&P GSCI Softs Index included the following commodities: coffee, sugar, cocoa and cotton.

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

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

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

The S&P GSCI Copper Index **(Copper),** a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark for investment performance in the copper commodity market.

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CRC 1891703 Exp. 09/31/2018 IM: 9027084 CS 9027094 Lit-Link: FIBULLETIN 09/17