

Global Fixed Income Bulletin

Global Reflation Continues

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

Outlook

- In the near-term, we believe upward pressure on rates from better growth and loosening fiscal policy could be balanced by uncertainty around the Trump agenda and political risks events in Europe, keeping risk-free rates in a range. In this environment, we think focusing on yield enhancement strategies makes sense.
- Without a realization of better economic data, we see current levels for 10-year U.S. Treasuries as approximately fair. Better-than-expected growth, which hinges partly on the new policy mix under Trump, would drive "fair value" higher. We expect economies to continue to perform well in 2017 and will look to position for further rises in risk-free yields later in the year as the direction of regulatory reform and fiscal stimulus become clearer.
- Geopolitical tail risks, such as a reversal of the U.S.' one China policy and lack of support of NATO has been much reduced, as well as the most pessimistic scenarios of a sharp trade protectionist escalation. However, a renewed push towards trade protectionism or a 20 percent border-adjustment tariff would have a material impact on the USD and EM outlook, with Mexico and EM Asia likely to bear the brunt of any negative reaction.
- On Mexico, despite a near 10 percent appreciation since its peak, we note that the Mexican peso remains the most undervalued currency in EM and is still pricing in a significant risk premium with regards to protectionist policies out of the U.S.
- We expect that barring any news to the contrary, U.S. investment-grade and high-yield credit should continue to tighten as technicals remain supportive of the asset classes and macro fundamentals stay firm. In Europe, if anti-euro risks fade with European elections, we believe spreads still have the potential to tighten further.
- We remain cautiously overweight CMBS. Most sectors of the CMBS market are performing well with record high occupancy rates and increasing rental rate but remain wary of retail shopping centers.

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Since the last quarter of 2016, global activity has steadily picked up. This trend continued into February. In the month, global manufacturing PMI and U.S. ISM hit two-year highs. Stronger economic growth and the base effect of higher commodity prices boosting headline inflation have led the Federal Reserve (Fed) to consider pulling forward its rate hikes for this year, including a possible 25 basis point (bp) hike in March. Equities outperformed in the month, and spread products, such as U.S. investment-grade spreads and local emerging markets spreads, tightened. On the other hand, rising inflation has been more ambiguous for risk-free rates. Ten-year yields traded in a narrow range, as fixed income markets continued to digest global reflationary trends, the Fed's reaction function, Trump's economic agenda and political risks in the euro area.

As activity data rebounds in the U.S., questions arise about the remaining slack in the economy and implications for Fed policy. A threat for risky assets now would be for the Fed to turn more hawkish than market expectations. In this regard, the February jobs report was positive for risk sentiment. Though the unemployment rate ticked up in February, this was largely due to the fact that 584,000 people joined the labor force, driving labor force participation up to 62.9 percent. At the same time, growth in average hourly earnings declined. The data suggests that additional slack may remain in the U.S. labor market, what Chair Yellen has often cited as the "shadow labor force." If previously discouraged workers rejoin the labor force, the additional pool of available workers should dampen wage pressures, keeping labor costs in check and corporate profit margins high. The absence of pressing domestic inflation also means the Fed can be more patient in the pace of rate hikes. Accommodative rates, improving economic confidence and high corporate margins are a positive mix for risky assets and the current business expansion. Regardless, we do not think the Fed is ready to "take away the punch bowl."

The other big question for rates is the timing of fiscal stimulus and upcoming political events. Trump has signed an executive order for federal regulatory agencies to actively reduce the regulatory burden. This has the potential to free up businesses to invest more and, probably most importantly, increase bank credit flow to small- and medium-sized businesses (SMEs), which still has not recovered to pre-crisis levels. However, on the tax and infrastructure policy front, it seems that markets are unlikely to get clear signals until the second half of 2017 given the heavy legislative agenda with regard to health care, immigration and military spending.

The success of Trump's economic agenda will depend on how the Fed responds to his plans and the actual evolution of the economy. President Trump will replace three and up to five Fed governors, including most likely the chair and vice chair in the next 18 months. The future composition and leanings of this "new" Fed will potentially have significant changes in monetary and regulatory policy. This uncertainty is unlikely to diminish until well into 2017 as Chairwoman Yellen's term does not end until January 2018. Europe is an additional source of risk as most core euro area countries face elections this year, including Netherlands, France, Germany and possibly Italy. News around the French election continues to be noisy and this could cast a shadow on risk appetite for the next few months.

In the near-term, we believe upward pressure on rates from better growth and loosening fiscal policy could be balanced by uncertainty around the Trump agenda and political risks events in Europe, keeping risk-free rates in a range. In this environment, we think focusing on yield enhancement strategies makes sense. In many sectors, spreads have tightened significantly. However, local emerging markets (EM), which continue to benefit from improving commodity prices and

reform momentum, and commercial mortgage-backed securities (CMBS) are areas where we see pockets of value. Looking forward, we look to position for possible rises in risk-free yields later in the year as the direction of regulatory reform and fiscal stimulus become clearer.

Developed Market Interest Rates and Currency Outlook

For the first time since 2013, we are witnessing several bond bearish forces arriving simultaneously: improving economic data/rising inflation, both in the U.S. and the rest of the world, less easy monetary policy, easier fiscal policy and rising risk premiums. Basically, a reversal of all the factors that powered yields lower over the last several years. However, without a realization of better economic data, we see current levels for the ten years as approximately fair. Better-than-expected growth, which hinges partly on the new policy mix under Trump, would drive "fair value" higher. We remain modestly underweight overall duration to help protect portfolios from further improvements in growth and inflation.

We expect continued European Central Bank (ECB) purchases to pressure euro periphery real yields lower, in order to bring about the necessary financial and economic rebalancing to increase inflation expectations. Based on this view, we continue to like inflation-protected bonds in Italy and Spain and are slightly negative on eurozone duration. In core euro area, improving growth and inflation dynamics could raise market expectations of ECB tapering, which would increase risk premium and steepen the curves. Populist political risks have pushed euro area spreads higher and have led to what we consider to be mispricings relative to economic and political fundamentals, such as in Spain and Portugal.

In terms of currencies, the U.S. dollar is likely to remain strong in 2017, driven by widening short-term interest rate differentials with the rest of the world

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and a relatively more expansionary fiscal policy. We have exposure to where we see value, including the Swedish kroner and the Russian ruble. Increasing global skepticism around monetary policy effectiveness will likely make it difficult for Riksbank ease further, while economic growth is at an above trend pace. We are bearish the British pound since we expect Brexit uncertainties will put headwinds on growth, leading the Bank of England (BoE) to stay dovish. Emerging market currencies also look interesting in a more robust global growth world. The wildcard remains Trump's protectionist agenda, which would include complaints about a too strong dollar, upsetting the dollar bullish view.

Emerging Markets Outlook

Global growth has shown improved signs of strength over the last few months as the prospect for reflationary policies under a new U.S. administration has buoyed 'animal spirits' and global confidence indicators. We are still awaiting details of the likely timing and amount of relaxation of U.S. fiscal policy that may underpin the recently sharp improvement in confidence. Meanwhile, geopolitical tail risks such as a reversal of the U.S.' one China policy and lack of support of NATO has clearly been much reduced, as well as the most pessimistic scenarios of a sharp trade protectionist escalation by labelling China as a currency manipulator and a repudiation of NAFTA. Markets have cheered this reduction in tail risks, but details in terms of actual policies have been scant and a renewed push toward trade protectionism or a 20 percent border-adjustment tariff would have a material impact on the USD and EM outlook, with Mexico and EM Asia likely to bear the brunt of any negative reaction.

For global growth, the beneficial impact of higher U.S. growth is still likely to be offset partly by the extent of the new president's

potentially protectionist trade agenda. The net effect won't be known for a while, but Mexico and EM Asia will remain a key focus, with joint cooperation between the new president and the more traditional trade-friendly wing of the Republican Party potentially reducing the impact, especially if stronger U.S. economic growth takes on more importance as a goal than fulfilling populist campaign promises that risk damaging the U.S. economic outlook. We still expect the EM/developed market (DM) growth differential to recover during 2017 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 short-term growth prospects reliant on continued fiscal and monetary policy support. Recent data out of China has been suggesting resilience, but we believe we could see growth slowdown again at the end of first-quarter/second-quarter 2017. However, we continue to believe that China has ample policy buffers in 2017 to offset a too rapid deceleration in economic growth.

On Mexico, despite a near 10 percent appreciation since its peak weakness two days before the U.S. presidential inauguration January 20, we note that the Mexican peso remains the most undervalued currency in EM and is still pricing in a significant risk premium with regards to protectionist policies out of the U.S. For EM Asia, most exchange rates have rallied back to pre-U.S. elections levels, or stronger, and are, in our view, relatively more vulnerable to a re-assessment of border-adjustment tariff implementation probabilities or a stronger USD on the back of a more hawkish Fed. On the rates side, the central bank (Banxico) has clearly signaled it doesn't want to overreact with tightening and after another prudent 50-bp hike in early February we believe it will now be in a position to follow the Fed, especially after announcing a \$20 billion foreign exchange (FX) swap program to reduce MXN tail risk.

We expect historically low DM yields to still support the "right" carry opportunities (pre-dominantly commodity exporters, which are seeing a sharp improvement in their terms-of-trade) and spreads as we expect an ongoing "push" factor of inflows into higher-yielding assets, including select EM fixed income. We believe that the various factors both pushing and pulling investors into EM fixed income remain in place: DM yields remain historically low, economic data in EM appear to be recovering, and fears of multiple Fed rate hikes are tempered by the better global growth outlook (although three interest rate hikes during 2017 are more likely than one or two) and concerns of a sharp slowdown in China have diminished. We believe that EM assets could well absorb Fed rate hikes in 2017 if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty and any suggestions that Fed is falling behind the curve and has to change toward a more hawkish reaction function.

Credit Outlook

February was a strong month for risk assets. The tone in global credit markets was largely set by equities, which had a strong month in both the U.S. and Europe. In the US, the S&P 500 was up approximately 5 percent, and European equity indices were up approximately 2 percent.¹ Volatility remained in a narrow range in February, as the VIX ended the month unchanged at 12.² Strong technicals continued to dominate the credit market rhetoric over the month as investors persist in their hunt for yield. In February, U.S. investment grade outperformed European investment grade, while both U.S. and European high-yield markets had a strong month.

We expect that barring any news to the contrary, U.S. investment-grade and high-yield credit should continue to

¹ Source: Bloomberg. Data as of February 28, 2017.

² Source: Bloomberg. Data as of February 28, 2017.

tighten as technicals remain supportive of the asset classes. In the U.S. we continue to monitor the quality of corporate earnings, primary market supply, and implications from announced or proposed government policies. In Europe, we anticipate that central banks will remain accommodative, and therefore supportive of European credit. As March continues, we remain focused on political agendas, corporate earnings and primary market activity across global credit markets. If anti-euro risks faded in Europe with European elections, we believe spreads have the potential to tighten further.

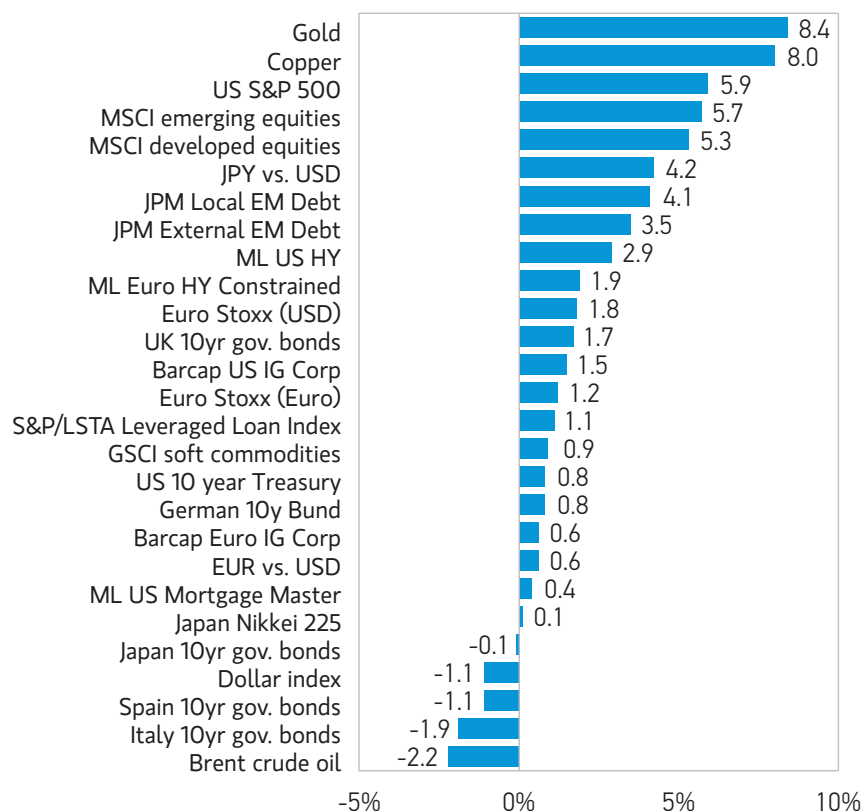
Securitized Outlook

We remain underweight agency mortgage-backed securities (MBS), given the historically low nominal spreads and low option-adjusted spreads. The post-election duration-extension risks have subsided for now as interest rates appear to have found a new trading range and MBS duration extension has already been significantly realized over the past few months. Agency MBS have had mediocre returns over the past two years, and 2017 is off to a modest start relative to other asset classes. Additionally, the outlook for the remainder of 2017 is not particularly positive, given the interest rate backdrop of two to three potential Federal Open Market Committee (FOMC) rate hikes this year. Agency MBS nominal spreads and option-adjusted spreads (OAS) are currently near the wide end of their two-year range, but the risk environment and volatility have also elevated. We are also cautious regarding agency MBS given the potential for the Fed to end their MBS portfolio reinvestment, which could cause a material spike in net MBS supply in the market.

Non-agency MBS remains one of the more stable and attractive fixed income asset classes in our opinion. Given the attractive carry, improving fundamentals

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. **Source:** Thomson Reuters Datastream. **Data as of February 28, 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 11 and 12 for index definitions.

and shrinking net supply, we remain overweight the non-agency MBS sector. Non-agency MBS spreads have tightened roughly 75-100 bps over the past year, but we remain positive given the still attractive carry and improving fundamental conditions.³ We remain positive on the U.S. housing market given the modest strength of the economy, continued low mortgage rates and above-average home affordability. From a supply perspective, we project outstanding non-agency MBS to decline by \$60 billion to \$70 billion in 2017, while new securitizations are projected to only amount to \$25-\$30 billion.⁴

We remain cautiously overweight CMBS. Most sectors of the CMBS market are performing well with record high occupancy rates and increasing rental rates, especially multi-family housing, hotels and office buildings. We are much more cautious on retail shopping centers given the seemingly endless announcements of store closings by major national retailers. Individual security selection is extremely critical in this environment as wider spreads create value opportunities but property-specific credit problems could create potential landmines. We believe that AAA CMBS generally offer "fair value" and should

³ Source: MSIM. Data as of February 28, 2016.

⁴ Source: MSIM. Data as of February 28, 2016.

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largely be insulated from current credit concerns, but BBB CMBS performance will be extremely idiosyncratic with some very attractive yield opportunities alongside some greater risk concerns. Investor sponsorship for the CMBS sector has been improving over the past few months and supply is subsiding. Overall, we expect that commercial real estate fundamental conditions will remain strong with an improving economy, low unemployment, rising wages and increasing business spending. While we remain overweight, we are limiting our overweight to a manageable level depending on portfolio risk profiles and market opportunities.

In Europe, we have decreased our strong overweight positioning to a more moderate overweight outlook for MBS and CMBS. Spreads are now tighter than pre-Brexit levels, even though we believe fundamental conditions have more uncertainty in the wake of the Brexit vote. Overall, we remain positive on the sector given the belief that the ECB and BoE will continue to keep interest rates low for the foreseeable future, and that both the European economies and more importantly the respective real estate markets, will benefit from these accommodative policies. New residential mortgage-backed security (RMBS) and CMBS issuance remains disappointingly light in Europe, but we are still finding a number of attractive seasoned opportunities. As long as the fundamental conditions remain positive with low rates and rising real estate prices, we continue to like the European RMBS and CMBS markets.

Market Summary

In February, yields declined across developed markets.⁵ The dollar weakened versus many EM currencies but gained versus most developed market currencies.

Over the month, 10-year U.S. Treasury yields declined 11 bps, while the 2s/10s curve flattened by 9 bps.⁶ Germany's 10-year yield decreased 23 bps, while the two-year yield decreased 20 bps.⁷ Ten-year yields in Italy and Portugal decreased 18 and 31 bps, respectively.⁸ Spanish 10-year yields increased 5 bps. Greece's 10-year government yields outperformed the euro periphery, decreasing by 67 bps, as the tone in euro area bailout negotiations improved.⁹ The Japanese government bond (JGB) 10-year yield decreased by 3 bps.¹⁰

The dollar strengthened in February. The euro depreciated by 2.0 percent. The British pound depreciated by 1.6 percent. The Japanese yen was roughly flat for the month.¹¹ The Mexican peso appreciated 3.6 percent, the biggest winner in the month, as the Mexican central bank took steps to support the currency. Crude oil (Brent) prices stayed at \$55.¹²

Developed Markets

In the U.S., the Fed released the FOMC minutes and was fairly neutral in tone. Participants saw a hike as fairly soon if the data evolves along expectations but gave little signals about a March hike. However, later comments by Fed Governors Williams and Dudley suggested that current data may warrant a rate hike relatively soon, pushing up market pricing of a March hike. February non-farm payrolls increased 277,000 versus expectations of 180,000.¹³ The unemployment rate ticked up to 4.8

percent, 0.1 percent above consensus, as the participation rate increased to 62.9 percent. Average hourly earnings declined to 2.5 percent from 2.8 percent previously.¹⁴ The ISM manufacturing index increased to 56.0 in January, above expectations of 55. Gross domestic product (GDP) figures for the fourth quarter were unrevised at 1.9 percent quarter-on-quarter, below consensus expectations of 2.1 percent. This brings 2016 yearly growth to 1.9 percent. Headline CPI rose to 2.5 percent from 2.1 percent, driven mostly by base effects from rising oil prices. Core CPI was 2.3 percent for January.¹⁵

In the eurozone, the ECB published minutes to the January meeting. The committee clarified operational issues surrounding quantitative easing (QE). Central banks can buy bonds below the deposit rate or deviate temporarily from the capital key, though priority should be given to assets with yields above the deposit rate. In terms of survey data, eurozone manufacturing PMI came in at 55.2 in January, in line with December and above market expectations of 55.1.¹⁶ Eurozone GDP for fourth-quarter 2016 was revised down to 0.4 percent quarter-on-quarter, below consensus of 0.5. This brings 2016 annual growth to 1.7 percent. Eurozone inflation was 1.8 percent for January, up from 1.1 percent previously.¹⁷

In the U.K., the BoE kept policy unchanged at the February meeting and was neutral in tone. The MPC indicates it will trade off containing above-target inflation with support for a slowing economy. In terms of data, headline CPI inflation was 1.8 percent year-over-year in January, up from previously but below consensus of 1.9 percent.¹⁸ Core inflation was 1.6 percent, below consensus of 1.7

⁵ Source: Bloomberg. Data as of February 28, 2017.

⁶ Source: Bloomberg. Data as of February 28, 2017.

⁷ Source: Bloomberg. Data as of February 28, 2017.

⁸ Source: Bloomberg. Data as of February 28, 2017.

⁹ Source: Bloomberg. Data as of February 28, 2017.

¹⁰ Source: Bloomberg. Data as of February 28, 2017.

¹¹ Source: Bloomberg. Data as of February 28, 2017.

¹² Source: Bloomberg. Data as of February 28, 2017.

¹³ Source: Bloomberg. Data as of February 28, 2017.

¹⁴ Source: Bloomberg. Data as of February 28, 2017.

¹⁵ Source: Bloomberg. Data as of February 28, 2017.

¹⁶ Source: Bloomberg. Data as of February 28, 2017.

¹⁷ Source: Bloomberg. Data as of February 28, 2017.

¹⁸ Source: Bloomberg. Data as of February 28, 2017.

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percent. The unemployment rate's three-month average stayed at 4.8 percent in December. GDP figures for the fourth quarter were revised higher to 0.7 percent, above consensus expectations of 0.6 percent. This brings annual 2016 growth to 2.0 percent. U.K. manufacturing PMI was 55.9 percent in January, below 56.1 in December but in line with consensus.¹⁹

In Japan, the Bank of Japan (BoJ) kept monetary policy unchanged. In terms of data, manufacturing PMI was 52.7 for January, up from 52.4 in December. Fourth quarter GDP was 0.2 percent quarter-on-quarter, below expectation of 0.3 percent. This brings 2016 growth to 1.0 percent. The December core national CPI (ex-food and energy) was flat, down from November but above the consensus expectation of -0.1 percent.²⁰

Emerging Markets

EM fixed income asset prices rose over the month as the U.S. dollar weakened and U.S. Treasury yields fell modestly. Investors focused their attention on asset "reflation" (i.e., potentially rising inflation expectations) and strengthening commodity prices, while sidelining serious concerns about potential changes to U.S. trade policies. With uncertainty regarding potential policy proposals from the U.S. administration and how that will impact trade flows, foreign direct investment, and inflation dynamics, investors have, and should continue to, focused on fundamentals and idiosyncratic stories to drive performance.

Central bank actions took center stage in the month. Mexico's central bank (Banxico) announced a new policy for its currency interventions in which it will provide non-deliverable forwards, which will settle in MXN (Mexican peso) and will increase the bank's ability to manage its currency without draining FX reserves. This followed Banxico's rate hike of +50 bps, which was higher than

DISPLAY 2

Government Bond Yields for Major Economies

COUNTRY	2YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	5YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)
Australia	1.81	3	2.25	4	2.72	1
Belgium	-0.57	-11	-0.21	-23	0.71	-28
Canada	0.74	-3	1.09	-3	1.62	-14
Denmark	-0.66	-11	-0.38	-23	0.50	4
France	-0.52	-4	0.02	-12	0.88	-15
Germany	-0.90	-20	-0.57	-17	0.20	-23
Ireland	-0.45	0	0.17	-26	0.89	-29
Italy	-0.02	-6	0.83	-10	2.08	-18
Japan	-0.26	-7	-0.14	-5	0.06	-3
Netherlands	-0.82	-17	-0.41	-21	0.48	-10
New Zealand	2.17	-14	2.58	-14	3.23	-14
Norway	0.63	-15	0.95	32	1.71	-1
Portugal	0.02	-5	1.82	-31	3.88	-31
Spain	-0.13	13	0.49	15	1.64	4
Sweden	-0.66	-13	-0.15	-24	0.53	-21
Switzerland	-0.96	-9	-0.70	-16	-0.23	-17
United Kingdom	0.09	-5	0.54	-8	1.14	-28
United States	1.18	-2	1.85	-7	2.35	-11

Source: Bloomberg LP. Data as of February 28, 2017.

the market's expectation of a +25 bps hike as the bank continued to battle a weak currency which has been contributing to higher inflation. The Bank of Indonesia held policy rates steady at 4.75 percent in its last meeting, as did the central bank of Argentina (BCRA), which held its policy rate at 24.75 percent. In India, the central bank (RBI) held rates steady, surprising investors who were expecting a rate cut. The RBI rate committee expressed concerns about persistent inflation, signaling an end to their easing cycle.

China's currency reserves fell moderately, down \$12.3 billion, touching \$2.998 trillion, its lowest level since February 2011.²¹ While the level of reserves may have sparked headlines, the actual pace of reserve losses has slowed. Investors continue to watch the level of reserves as a measure of China's ability to manage its economy's transition to a slower-growth path and its ability to confront tail-risk events that could possibly occur. The IMF announced support for the Mongolian government via a three-year Extended Fund Facility for about \$440 million,

¹⁹ Source: Bloomberg. Data as of February 28, 2017.

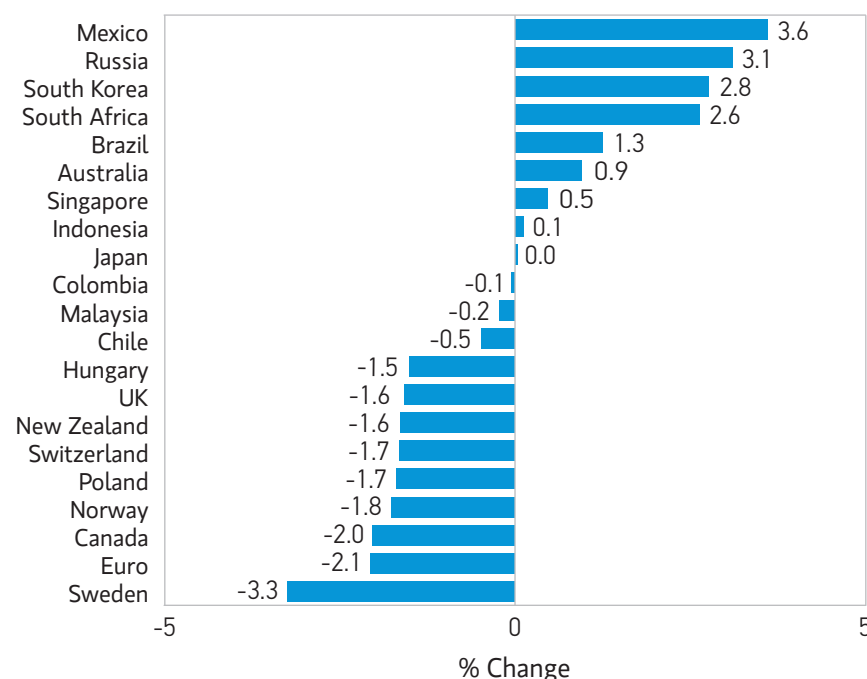
²⁰ Source: Bloomberg. Data as of February 28, 2017.

²¹ Source: Bloomberg. Data as of February 28, 2017.

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DISPLAY 3**Currency Monthly Changes Versus U.S. Dollar**

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of February 28, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

which will help as the government consolidates its fiscal situation after running large deficits following the drop in commodity prices over the last several years. In Ecuador, ruling party government candidate Lenin Moreno failed to achieve victory in the first round of presidential elections, forcing a second round runoff vote against conservative banker (and market favorite) Guillermo Lasso, set for April.

External

EM external sovereign and quasi-sovereign debt returned 2.08% in the month, bringing year-to-date performance to 3.54%, as measured by the JP Morgan EMBI Global Index.²² The performance of lower-rated, higher-

yielding bonds was roughly similar to investment-grade bonds over the month. Bonds from smaller, more idiosyncratic stories, such as Egypt and Ethiopia, as well as commodity-exporting nations such as: Mongolia, Iraq, Zambia, Belize, Angola and Gabon outperformed the broader market. Conversely, bonds from Mozambique, Suriname, Ghana, Latvia, Slovakia, Armenia, Lithuania, Serbia and Croatia underperformed the broader market in the month.

Domestic

EM domestic debt returned 1.80% in the month, bringing year-to-date performance to 4.09% as measured by the JP Morgan GBI-EM Global Diversified Index.²³ EM currencies

strengthened 1.11 percent versus the US dollar and EM bonds returned 0.70% in local terms.²⁴ Currency performance versus the U.S. dollar weighed heavily on bond performance for Romania, Hungary, Poland, Chile, Colombia and Malaysia. Bonds from Peru, Indonesia and Thailand also underperformed the broader market. Conversely, bonds from Turkey, Mexico, South Africa, Brazil Russia and the Philippines outperformed the broader market in the period.

Corporate

EM corporate debt returned 1.39% in the month, as measured by the JP Morgan CEMBI Broad Diversified Index.²⁵ Higher-yielding, lower-quality companies outperformed higher-rated companies in the month. From a regional perspective companies in Latin America (Mexico, Brazil, Guatemala and Chile), Africa (Nigeria and South Africa), and Europe (Czech Republic and Poland) led the market, while those in the Middle East (Israel) and Asia (Malaysia and Hong Kong) lagged. From a sector perspective, companies in the Metals & Mining, Industrial, Infrastructure, Consumer, and Oil & Gas sectors outperformed the broader market, while those in the Utilities, Transport, TMT, and Diversified sectors lagged.

Corporate Investment-Grade Credit

U.S. investment-grade corporate spreads tightened by 5 bps to end the month at 115 bps over U.S. Treasuries.²⁶ BBB-rated credit and financials outperformed the broader index, though the level of dispersion across sectors was low. Energy underperformed the broader index in February, a meaningful deviation from the last several months when the energy sector outperformed. Despite underperformance, energy still generated positive excess returns. With dispersion across industries and sectors low, the key theme year-to-date

²² Source: JP Morgan. Data as of February 28, 2017.

²³ Source: JP Morgan. Data as of February 28, 2017.

²⁴ Source: JP Morgan. Data as of February 28, 2017.

²⁵ Source: JP Morgan. Data as of February 28, 2017.

²⁶ Source: Bloomberg Barclays. Data as of February 28, 2017.

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in the U.S. investment-grade market has been the resurgence of idiosyncratic risk. Over the course of the month, we saw earnings related volatility in a number of names. Failed M&A transaction headlines dominated the news flow in February. Technicals in the U.S. investment-grade market continue to be supportive of the asset class. Issuance declined materially from January's record pace; however, issuance still totaled close to \$100 billion.²⁷ The decline in absolute issuance was a positive technical for the market as the dealer community and investors had to absorb less supply. New issues performed well in February, as new bonds tightened a weighted average of 10 bps between issuance and the last day of the month.²⁸ On a year-to-date basis, supply is running more than 20 percent above last year's pace.²⁹ Due to the smaller M&A backlog, however, we may see the pace of issuance decline in the coming months. Concessions for new issues were low in February, as new issues were met by large demand. We anticipate a continued grind toward the cycle lows we saw in 2014 (100 bps) in U.S. investment-grade credit, and continue to position ourselves overweight credit, particularly in the financial sector.

Unlike the U.S., the European investment-grade credit was unable to generate positive excess returns due to the widening of European swap spreads. European investment-grade spreads widened in the month of February by 4 bps; however, due to sharply falling benchmark yields the asset class still posted positive total returns in the month.³⁰ The notable underperformance in the month came from French corporates as the uncertainty around the upcoming elections weighed on sentiment. Utilities (8 bps wider) underperformed relative to Industrials

DISPLAY 4**EM External and Local Spread Changes**

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	280	-11	9.9	-58
Colombia	202	-7	6.8	8
Hungary	147	-14	2.2	7
Indonesia	198	-22	7.8	-8
Malaysia	130	-22	4.0	-2
Mexico	275	-21	7.5	-3
Peru	152	-7	6.2	10
Philippines	98	-6	4.9	-32
Poland	88	-18	3.1	-2
Russia	162	-14	8.3	20
South Africa	242	-21	9.3	0
Turkey	332	-21	10.7	-7
Venezuela	2050	-6	—	—

Source: JP Morgan. Data as of February 28, 2017.

(2 bps wider) and Financials (6 bps wider). In terms of sectors, notable underperformance came from Utilities and Natural Gas, while the Metals and Mining sector outperformed. Short maturity bonds (1-3 year) outperformed in February, as demand for positive yielding short-term paper persisted. In contrast, 7-10 year maturities traded weaker over the month. Gross issuance totaled €38.9 billion (18.5 billion in financials and 20.4 billion in non-financials) in February, a slowdown from January, driven mainly by a reduction in issuance in the financials space.³¹ Sterling investment-grade gross issuance was strong at £4.5 billion (£3.2 billion financials, £1.3 billion non-financials),

bringing the year-to-date figure to £9.7 billion.³² Both primary and secondary issues performed well as the CBPS kept net sterling issuance fairly benign.

Corporate High Yield

Similar to the investment-grade market, the U.S. high-yield market was strong over the course of February. The high-yield market generated total returns of 1.46% in February.³³ Excess returns were 1.12% for the month as 5-year and 10-year U.S. Treasuries were down 3 bps and 5 bps, respectively.³⁴ Lower-rated high yield outperformed the broader market. CCC-rated bonds outperformed B-rated and BB-rated credit (67 bps tighter, 18 bps tighter, and 13 bps tighter,

²⁷ Source: BAML. Data as of February 28, 2017.

²⁸ Source: JPMorgan. Data as of February 28, 2017.

²⁹ Source: JPMorgan. Data as of February 28, 2017.

³⁰ Source: Bloomberg Barclays. Data as of

February 28, 2017.

³¹ Source: Bloomberg Barclays. Data as of February 28, 2017.

³² Source: Bloomberg Barclays. Data as of February 28, 2017.

³³ Source: Bloomberg Barclays. Data as of February 28, 2017.

³⁴ Source: Bloomberg Barclays. Data as of February 28, 2017.

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DISPLAY 5

Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	115	-6	124	+4
Industrial Basic Industry	142	-12	102	-1
Industrial Capital Goods	89	-6	95	+2
Industrial Consumer Cyclicals	106	-9	111	+1
Industrial Consumer Non Cyclicals	104	-6	104	+3
Industrial Energy	139	-2	121	+3
Industrial Technology	97	-7	83	+4
Industrial Transportation	111	-2	110	+6
Industrial Communications	154	-3	127	+3
Industrial Other	106	-6	150	+2
Utility Electric	111	-2	123	+6
Utility Natural Gas	119	-4	123	+10
Utility Other	135	-6	110	+10
Financial Inst. Banking	105	-9	122	+5
Financial Inst. Brokerage	122	-9	115	+0
Financial Inst. Finance Companies	114	-18	98	+1
Financial Inst. Insurance	121	-5	249	+2
Financial Inst. REITS	134	-5	137	-1
Financial Inst. Other	151	-9	162	+4

Source: Bloomberg Barclays. Data as of February 28, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

respectively).³⁵ The current yield on the asset class is presently at 5.58 percent.³⁶ The best performing high-yield sectors were pharmaceuticals, transportation services, healthcare, and cable satellite (5.27%, 2.96%, 2.66%, and 2.66% percent, respectively).³⁷ The worst performing sectors over the course of the month were retailers, independent,

consumer products, and supermarkets (+67 bps, +61 bps, +59 bps, +56 bps and +30 bps, respectively).³⁸ The U.S. high-yield market priced 32 new issues for \$17.9 billion during the course of the month.³⁹

February was another strong month for the European high-yield market, which

returned 1.22%.⁴⁰ The compression between investment grade and high yield that we have seen in previous months continued throughout February. Demand for high yield remained strong against a backdrop of very low yields in the broad fixed income markets, while supply remained relatively muted. The syndicated loan market continues to be the favoured supplier of long term leverage capital, given low margins and attractive covenant packages. As a result, new issuance in the high yield bond market continues to underwhelm. Given the rally in the government bond market, the higher quality BB-part of the market outperformed during the month given its greater duration and higher rate sensitivity. In contrast, the underperformance of the CCC-rated part of the market was driven by more idiosyncratic events. We anticipate that both the European investment-grade and high-yield credit markets should continue to be well supported by the ECB and BoE corporate bond purchases, subject to the global economy avoiding recession and default rates remaining low.

Securitized Products

Agency MBS performed modestly in February while credit-related securitized assets overall continued to perform well. Fears over higher rates and corresponding potential further duration extension for agency MBS have subsided for now as interest rates appear to have stabilized in a new trading range, but concerns about the Fed possibly ending the reinvestment of their MBS portfolio caused agency MBS to continue to slightly underperform in February. Nominal spreads on current coupon agency MBS widened one basis point to 99 bps above interpolated Treasuries and option-adjusted spreads (OAS) also widened one basis point to 10 bps above

³⁵ Source: Bloomberg Barclays. Data as of February 28, 2017.

³⁶ Source: Bloomberg Barclays. Data as of February 28, 2017.

³⁷ Source: Bloomberg Barclays. Data as of February 28, 2017.

³⁸ Source: Bloomberg Barclays. Data as of February 28, 2017.

³⁹ Source: Bloomberg Barclays. Data as of February 28, 2017.

⁴⁰ Source: Bloomberg Barclays. Data as of February 28, 2017.

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interpolated Treasuries.⁴¹ The Bloomberg Barclays Capital U.S. MBS Index was up 0.47% in February as lower interest rates outweighed the negative effects of wider spreads during the month.⁴² The Fed purchased approximately \$30 billion agency MBS in February in order to maintain their agency MBS portfolio at \$1.75 trillion, however discussions around ending their reinvestment program are becoming more frequent. The Fed purchased almost \$400 billion agency RMBS in 2016, and we believe that ending this reinvestment could have a significant negative impact on agency MBS.⁴³

Non-agency MBS spreads continued their tightening trend in February as cash flow and credit performance continued to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. Despite the recent increases in home prices, U.S. homes remain affordable from a historical perspective. Mortgage performance also remains strong. New defaults were essentially unchanged at a 0.7% annual rate in January, but defaults are down from the 0.8% level in January 2016 and at the lowest levels over the past 10 years.⁴⁴ With unemployment low, the economy slowly improving, and home prices still recovering from the mortgage crisis almost 10 years ago, we expect mortgage credit performance to continue to improve.

CMBS spreads gave back some of their spread tightening from January with AAA CMBS roughly 2 to 5 bps wider and BBB CMBS 10-25 bps wider in February.⁴⁵ AAA CMBS had been steadily tightening over the last nine months, but may now be running up against tightening limits. BBB CMBS performance is beginning to diverge sharply based on the underlying loans. CMBS deals backed by office buildings, hotels, industrial buildings and multi-family rental properties are seeing strong demand, while CMBS deals with meaningful retail shopping center exposures are under significant selling pressure. The increasing announcements of retail store closings and poor retail earnings are causing credit concerns for many retail properties. New non-agency CMBS issuance continues to be light, with just over \$2 billion of deals pricing in February and still less than \$4 billion so far for 2017. We still anticipate \$50 billion to \$60 billion in new issuance volumes this year, but the market is currently well below this issuance pace. New risk retention regulations that took effect January 1, 2017 are appearing to have a meaningful effect of dampening new CMBS issuance.⁴⁶

Fundamentally, CMBS performance remains on solid grounds. Commercial real estate prices were flat in January, but are up 3.0 percent over the past 12 months. After several years of 10+ percent annual increases, the pace of commercial real estate price increases

is slowing, but the trajectory remains positive. Commercial real estate prices are 26.7 percent above the previous peak in August 2007.⁴⁷ Hotel occupancy rates were flat year-over-year, but remain near the highest levels seen over the past 15 years, and are up more than 5 percent from 2011.⁴⁸ National office vacancy rates decreased to 12.9% in fourth-quarter 2016, the lowest level seen since first-quarter 2008.⁴⁹ Multi-family vacancy rates increased by 0.2% in Q3 2016 to 4.5 percent, but multi-family vacancy rates remain near the lowest levels seen over the past 13 years.⁵⁰ Multi-family asset values rose 10 percent year-to-date through third-quarter 2016, more than double the increase for all real estate.⁵¹ With CMBS issuance beginning to slow this year and expected to slow more sharply in 2018, and with underlying real estate fundamental conditions remaining strong (other than retail shopping centers), we expect CMBS to perform well in 2017.

European MBS spreads tightened 10 to 15 bps in February and remain meaningfully tighter than pre-Brexit levels.⁵² ECB ABS purchases remain slow due to limited supply, and the ECB portfolio increased by only €0.5 billion European ABS in January. The ECB holds €23.4 billion of European ABS as of January 2017.⁵³ European ABS issuance totaled €91 billion in 2016, up from €79 billion in 2015.⁵⁴ We expect securitized issuance to remain relatively light in 2017 given regulatory constraints.

⁴¹ Source: Yield Book. Data as of January 31, 2017.

⁴² Source: Barclays. Data as of January 31, 2017.

⁴³ Source: Federal Reserve Bank of New York. Data as of January 31, 2017.

⁴⁴ Source: S&P/Experian First Mortgage Default Index. Data as of January 31, 2017.

⁴⁵ Source: Barclays. Data as of January 31, 2017.

⁴⁶ Source: Deutsche Bank. Data as of January 31, 2017.

⁴⁷ Source: Green Street. Data as of January 31, 2017.

⁴⁸ Source: Statista.com. Data as of January 31, 2017.

⁴⁹ Source: CBRE. Data as of January 31, 2017.

⁵⁰ Source: CBRE. Data as of January 31, 2017.

⁵¹ Source: RCA/Moody's Commercial Property

Price Index. Data as of January 31, 2017.

⁵² Source: Deutsche Bank. Data as of January 31, 2017.

⁵³ Source: European Central Bank. Data as of January 31, 2017.

⁵⁴ Source: Deutsche Bank. Data as of January 31, 2017.

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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.

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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.

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The **ISM Manufacturing Index** is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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

The **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 bunds**—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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