

### Global Fixed Income Bulletin

# What Can Derail the Carry Trade?

**FIXED INCOME** | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | DECEMBER 2017

## Summary

In this Goldilocks environment of robust growth, modest inflation and loose financial conditions, it's difficult to see why fixed income investors should not continue to be overweight nongovernment bonds to help enhance yield. Strong 2017 returns do mean future returns are likely to be lower than this year, but the environment remains highly supportive of the continued outperformance of riskier fixed income. The greatest risk to this scenario is that central banks surprise the market and tighten monetary policy significantly more than what is currently discounted in financial markets. This situation remains a low-probability event in our minds. The bottom line is that while markets have run a long way, and future returns are likely to be more modest, the current environment is likely to continue, i.e., the 2017 strategy should continue to work in 2018.

**DEVELOPED MARKET (DM) RATE/FOREIGN CURRENCY (FX):** Progress on tax reform and the rising odds of a December rate hike led U.S. yields to rise throughout the month and the yield curve to flatten. Reversing the trend for the last two months, the dollar declined versus major currencies as risk-on sentiments resumed.

We expect the U.S. Federal Reserve (Fed) to hike rates in December. A more assertive Fed, better growth and increasing odds for tax reform would likely push long-term yields modestly higher. In addition, we see some scope for inflation to rise in 2018 following the strength in growth this year. As a result we are also positive on U.S. TIPs. In terms of currencies, after a short bout of risk-off and dollar strength, risk appetite seems to be returning. We therefore think moving toward a dollar underweight makes sense again.

**EMERGING MARKET (EM) RATE/FX:** EM performance was mixed in November. Despite rising U.S. Treasury yields, the domestic and corporate debt indices generated a positive return, while the sovereign external debt market was weighed down by Venezuela's restructuring announcement.

We remain optimistic about the prospects for EM fixed income as we move toward 2018, as country fundamentals and the macroeconomic environment remain supportive. We are also cognizant of potential geopolitical risks. However, we anticipate such events will be transitory and idiosyncratic to specific countries, rather than systemic. De-globalization risks may intensify as North American Free Trade Agreement (NAFTA) renegotiation talks stretch into 2018, but we remain optimistic about the final outcome.

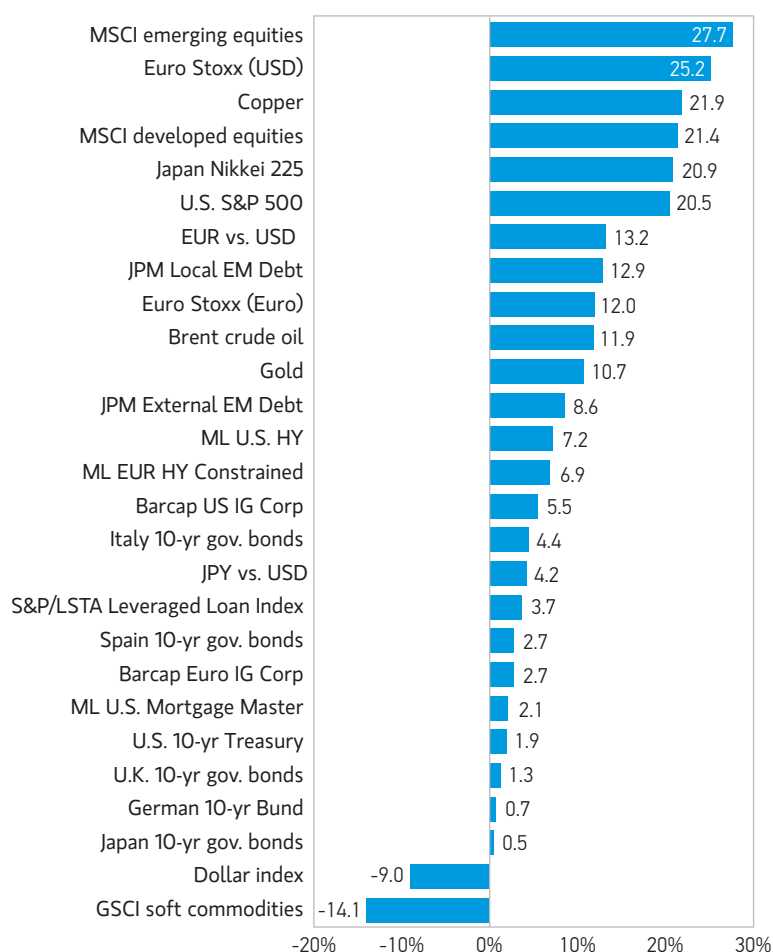
**CREDIT:** Global Credit indices were little changed in November and remained within a few basis points of post-crisis lows. Investors experienced more dispersion and volatility across ratings and sectors than has been seen for some time. The resurgence of idiosyncratic risk is yet another sign that markets are continuing to normalize.

While there are certainly both positive and negative forces acting on the market, we continue to see opportunity for spreads to tighten a modest amount over the near and medium terms. Credit spreads are near post-crisis lows but remain wider than previous cycles, while improving economic growth should help ensure stable fundamentals. We do believe the majority of beta-driven compression is past us at this point in the cycle, so we find ourselves focusing much more on alpha-generating opportunities arising from renewed idiosyncratic volatility.

The views and opinions expressed are those of the Portfolio Management team as of November 2017 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**

**SECURITIZED:** Agency mortgage-backed securities (MBS) underperformed slightly in November, while credit-sensitive securitized assets continued to outperform. Nonagency MBS spreads were essentially unchanged in November, while cash flow and credit performance continued to improve.

As 2017 comes to a close, we expect continued outperformance by securitized assets. While we do not expect further spread tightening, the fundamental conditions in the securitized markets remain very positive, and the cash flow-based carry of securitized assets should continue to generate compelling returns. The biggest risk we see in the near term is a potential shock in interest rates. If interest rates were to rise more than 100 basis points, these higher rates could create some problems for affordability and refinance-ability.

**DISPLAY 1****Asset Performance Year-to-Date**

Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of November 30, 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**

DM	RATES		CURRENCY
	LEVEL	CHANGE (BPS)	CHANGE (%)
United States	2.41	3	
United Kingdom	1.33	0	1.82
Germany	0.37	0	2.22
Japan	0.04	-3	0.98
<b>EM</b>			
EM External Spreads	311	6	
EM Local Yields	626	4	
EM Corporate Spreads	225	0	
<b>Credit Spreads</b>			
U.S. IG	97	2	
EUR IG	88	1	
U.S. HY	344	6	
EUR HY	269	39	
<b>Securitized Spreads</b>			
Agency MBS	12	1	
U.S. BBB CMBS	334	0	

Source: Bloomberg, JP Morgan. Data as of November 30, 2017.

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## Fixed Income Outlook

A quick look at asset performance year-to-date, *Display 1*, reveals what a kind year it has been for investors, with nearly all asset classes delivering strong positive returns. The unattractive corollary of this is that expected future returns look lower as valuations are now demanding. However, this is not necessarily the case, as the macroeconomic environment remains remarkably benign, meaning richer valuations become justifiable. On the economic growth side, DM surprise indicators are at their highest level since 2010, having trended steadily higher since June; the EM indicator has lagged behind but remains in positive territory. At the same time, inflation remains subdued, especially on core measures, and tighter labor markets have yet to translate into accelerating wage growth, which turns central banks hawkish. Admittedly many of the major central banks (the Fed, the Bank of England Monetary Policy Committee (MPC), the Bank of Canada (BoC), the Reserve Bank of Australia (RBA)) have shifted to reducing the amount of accommodation they are providing to the economy, but the pace of withdrawal is glacial in comparison to previous tightening cycles.

In this Goldilocks environment of robust growth, modest inflation and loose financial conditions, it's difficult to see why fixed income investors

should not continue to be overweight non-government bonds to help enhance yield. Strong 2017 returns do mean future returns are likely to be lower than this year, but the environment remains highly supportive of continued outperformance of riskier fixed income. However, in the current low-volatility environment the break-even spread widening required to offset the negative carry from being short means it is not easy to sit underweight spread product just because valuations look rich in comparison to recent years.

History does show that attractive carry trades can reverse very quickly when hit by a macroeconomic shock. However, with the global economy growing steadily, and monetary policies on autopilot, it is at present difficult to identify any risk events and imbalances that could be worrisome. A tightening of global monetary conditions poses the biggest risk to this very benign scenario but also has a low probability of happening. Moreover, monetary policy could quickly turn if the macroeconomic outlook becomes troubled. There is a risk that central banks could surprise the market by raising rates faster than expected, but a large and disorderly sell-off in treasuries seems unlikely.

So even though markets have performed well for almost two years, current fundamentals and risk scenarios indicate this trend is likely to continue, with more modest returns, in 2018.

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	MONTHLY REVIEW OUTLOOK

## Developed Market

### Monthly Review

Progress on tax reform and the rising odds of a December rate hike led U.S. yields to rise throughout the month. 10-year yields rose 3 basis points while the curve flattened by 15 basis points. German 10-year yields were unchanged for the month.<sup>1</sup> Australia and New Zealand were the top performers, tightening by 17 and 20 basis points, respectively.<sup>2</sup>

Reversing the trend for the last two months, the dollar declined versus major currencies as risk-on sentiments resumed. EM currencies outperformed. The euro strengthened by 2.2 percent while the Polish zloty strengthened by 3.1 percent.<sup>3</sup>

In the U.S., the Federal Open Market Committee (FOMC) left policy unchanged at its November meeting. The main change the committee made was upgrading growth assessment to “solid” from “rising moderately.” Minutes to the meeting also mentioned that many participants thought another rate hike was warranted if conditions remain the same. In terms of data, inflation, as measured through the Consumer Price Index (CPI), rose 0.01 to 1.8 percent, the first uptick in six months. Growth was revised up to 3.3 percent quarter-on-quarter from 3.0 percent for the third quarter.

In the Eurozone, monetary policy was relatively quiet. On the political front, negotiations for the German governing coalition broke down. The next steps could involve either a minority government headed by Merkel, another

### 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	2.41	● 3			63	-15
United Kingdom	1.33	● 0	-108	● -3	81	-6
Germany	0.37	● 0	-204	● -3	105	-6
Japan	0.04	● -3	-237	● -6	20	-4
Australia	2.50	● -17	9	● -20	76	-8
Canada	1.89	● -6	-52	● -9	46	-10
New Zealand	2.72	● -20	31	● -23	80	-11
			(Spread over Bunds)			
Europe						
Belgium	0.57	● -4	20	● -4	115	-8
France	0.68	● -7	32	● -8	125	-10
Germany	0.37	● 0			105	-6
Greece	5.45	● -2	508	● -2	266	30
Ireland	0.59	● 1	22	● 0	113	-1
Italy	1.75	● -8	138	● -8	209	-1
Netherlands	0.46	● -1	10	● -1	116	-4
Portugal	1.87	● -20	151	● -21	211	-10
Spain	1.45	● -2	108	● -2	178	-2
Denmark	0.44	● -3	7	● -4	95	-13
Norway	1.50	● -11	114	● -12	100	-8
Sweden	0.74	● -6	37	● -6	157	0
Switzerland	-0.12	● -4	-48	● -4	75	-2

Source: Bloomberg, Data as of November 30, 2017

grand coalition between CDU/CSU and the SPD, or new elections. In October, core inflation slid from 1.1 percent to 0.9 percent.<sup>4</sup>

In the U.K., the Bank of England (BoE) raised rates by 25 basis points to 0.50

percent. The BoE had first indicated the possibility of a hike in its September meeting, given strong inflation. It expects another two hikes over the next three years. Core inflation stayed at 3.0 percent in October.

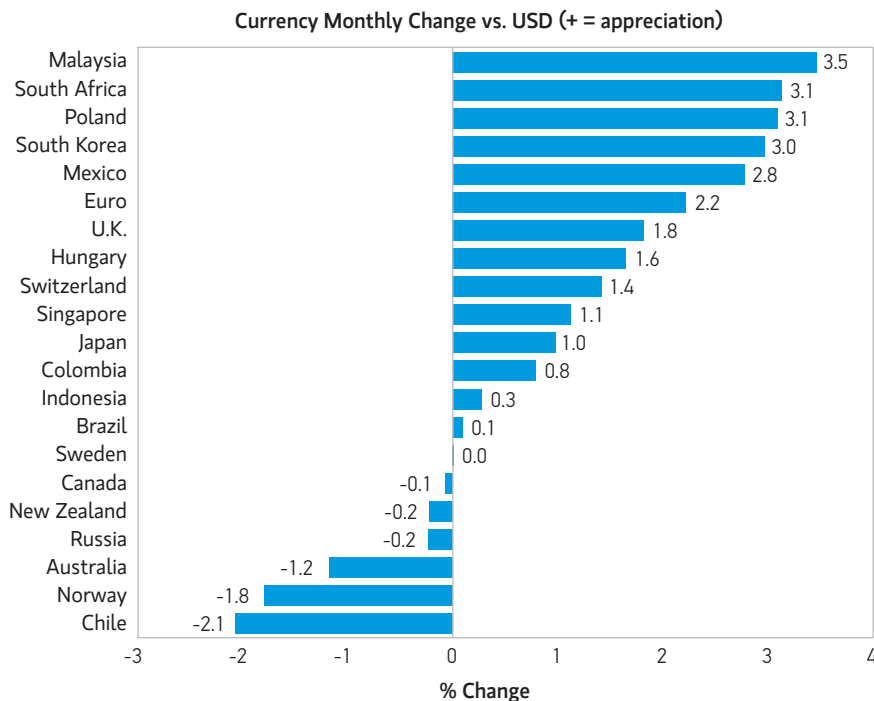
<sup>1</sup> Source: Bloomberg. Data as of November 30, 2017.

<sup>2</sup> Source: Bloomberg. Data as of November 30, 2017.

<sup>3</sup> Source: Bloomberg. Data as of November 30, 2017.

<sup>4</sup> Source: Bloomberg. Data as of October 31, 2017.

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**DISPLAY 4****Currency Monthly Changes Versus U.S. Dollar**

Source: Bloomberg. Data as of November 30, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

**Outlook**

Though U.S. inflation could stay muted, we believe the Fed will continue to hike rates as long as growth dynamics remain solid. Market expectations may be too relaxed about the Fed's willingness to keep hiking while inflation remains below target. We expect the Fed to hike rates in December. A more assertive Fed, better growth and increasing odds for tax reform would likely pressure long-term yields modestly higher. In addition, we see some opportunity for inflation to rise in 2018 following the growth strength this year, though we do not see a dramatic upswing and are positive on U.S. Treasury Inflation Protected Securities (TIPS).

The European Central Bank (ECB) and the performance of German government bonds could also impact global treasury markets. In the remainder of 2017,

German bonds will likely not only respond to economic conditions but also to the planned tapering of monthly ECB purchases. As such, we believe German yields could rise toward year's end but offer poor risk/reward nonetheless. Peripheral European bonds are likely to remain well bid and narrow in spread with Germany.

In other DMs, we expect Japanese Government Bond (JGB) yields to remain low, but talk of modifying yield curve control may push 10-year JGBs slightly above 0.10 percent. We believe being overweight Australian government bonds make sense given their economic prospects and as a hedge to a weaker-than-expected China.

In terms of currencies, after a short bout of risk-off and dollar strength, risk appetite seems to be returning. We therefore think moving toward a

dollar underweight makes sense again. EM currencies struggled recently and we see opportunities to re-enter certain of these positions. We continue to be relatively medium-term bullish on the fundamentals underlying these currencies. We remain positive on euro-linked currencies such as the Polish zloty.

**Emerging Markets****Monthly Review**

EM performance was mixed in November. Despite rising U.S. Treasury yields, the domestic and corporate debt indices generated a positive return, while the sovereign external debt market was weighed down by Venezuela's restructuring announcement. Energy prices rose, with prices for Brent oil climbing over 3 percent, lending support to bond prices for oil & gas companies and energy-exporting countries. Soft commodity prices also rose, with soybeans, wheat and corn leading the way. With one month remaining in the calendar year, the market remains alert to the potential for volatility stemming from ongoing political risks, such as tensions with North Korea, NAFTA negotiations, U.S. tax package progress, Brazil's pension reform vote, central bank meetings and the South Africa African National Congress (ANC) elective conference. However, the global backdrop remains supportive: EM growth is recovering, inflation is generally low and major central banks remain accommodative despite gradual policy normalization. EM fixed income assets have performed well year-to-date and investors are being selective on the basis of fundamentals and valuations, which could trigger a move to lock in gains should any risks materialize.

Potentially impacting consumer prices, business investment and trade dynamics in general, NAFTA negotiations between the U.S., Canada and Mexico continued with little progress being

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## DISPLAY 5

## Major Economic Data Releases

COUNTRY			LATEST CONSENSUS PREVIOUS			AS OF
U.S.	Labor	Non-farm Payrolls ('000s)	261	313	18	10/31/2017
		Unemployment rate (%)	4.1	4.2	4.2	10/31/2017
		Participation rate (%)	62.7		63.1	10/31/2017
		Average Hourly Earnings (%YoY)	2.3		2.5	10/31/2017
	Activity	ISM Manufacturing	58	58	59	11/30/2017
		GDP (%QoQ, saar)	3.3		3.1	9/30/2017
		GDP (%YoY)	2.3		2.2	9/30/2017
		Inflation CPI (%YoY)	2	2	2.2	10/31/2017
		Core CPI (%YoY)	1.8	1.7	1.7	10/31/2017
Euro Area	Labor	Unemployment rate (%)	8.8	8.9	8.9	10/31/2017
	Activity	PMI Manufacturing	60.1	60	59	11/30/2017
		GDP (%QoQ)	0.6	0.6	0.7	9/30/2017
		GDP (%YoY)	2.5	2.5	2.3	9/30/2017
		Inflation CPI (%YoY)	1.4	1.4	1.5	10/31/2017
U.K.	Labor	Unemployment rate (%)	4.3	4.3	4.3	9/30/2017
		Average Weekly Earnings (%)	2.2	2.1	2.3	9/30/2017
	Activity	PMI Manufacturing	58	57	57	11/30/2017
		GDP (%QoQ)	0.4	0.4	0.3	9/30/2017
		GDP (%YoY)	1.5	1.5	1.5	9/30/2017
		Inflation CPI (%YoY)	3	3.1	3	10/31/2017
		Core CPI (%YoY)	2.7	2.8	2.7	10/31/2017
Japan	Activity	PMI Manufacturing	52.8		53	10/31/2017
		GDP (%QoQ, saar)	1.4	1.5	2.6	9/30/2017
		GDP (%YoY)	1.7		1.4	9/30/2017
		Inflation CPI (%YoY)	0.2	0.2	0.7	10/31/2017
		Core CPI (ex food and energy, %YoY)	0		0	10/31/2017

Source: Bloomberg. Data as of November 30, 2017.

made to close chapters in the fifth round of talks. Mexico's CPI ticked up slightly above expectations in October, though both headline and core inflation appear to have peaked in August. In Venezuela, assets suffered after the government announced it would seek a debt restructuring. The state-owned oil company, PDVSA (Petroleos de Venezuela SA), made a \$1.2 billion amortization payment of bonds maturing on November 2, 2017; however, \$200 million in sovereign Venezuela bonds due in 2019 and 2024 coupon payments were not made on time or within the grace period. The subsequent creditor meeting concluded with no solution. ISDA (International Swaps and Derivatives Association) declared that Venezuela's delayed payments were a "credit event" and credit default swaps would be triggered. However, Venezuelan and PDVSA bonds continue to trade with accrued interest as the country made the delayed payments and cured the default before bond holders took any legal action.

In South Africa, Standard & Poor's lowered the country's local currency rating one notch to BB+ and its foreign currency rating to BB, while Moody's held credit ratings steady but put them on review for possible downgrade. This was a better-than-expected result as the market was expecting more severe cuts to the credit ratings, potentially pushing all the country's local currency debt ratings to sub-investment grade. Moody's upgraded India's long-term foreign currency credit rating to Baa2 stable, up from Baa3 positive, based on expectations of continued economic and institutional reform progress, which should foster sustainable growth.

As expected, the Bank of Korea raised policy rates 25 basis points to 1.50 percent, the first hike since June 2011. The hike was to prevent financial imbalances and was viewed

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as a dovish hike by the market as it was not unanimous and didn't signal further hikes in their communication statement. The BCRA (Banco Central de la Republica Argentina), in Argentina, once again surprised the market by hiking the policy rate by 100 basis points to 28.75 percent. In Hungary, the National Bank of Hungary reiterated to the market its intention to flatten the yield curve with unconventional policy tools, announcing a mortgage bond purchase program and unconditional interest swaps targeting the 5-year and 10-year sector. Turkey's central bank was caught between the market, which expects higher interest rates to stop a slide in the value of the lira, and President Erdogan, who urged lower rates to boost growth. The central bank pushed borrowers to an overnight borrowing window that was, in effect, a 25 basis points hike in rates. In Colombia, the central bank (BanRep) cut policy rates 25 basis points, in a surprise to the market.

**EXTERNAL:** EM external sovereign and quasi-sovereign debt returned -0.27 percent in the month, bringing year-to-date performance to 8.63 percent, as measured by the JP Morgan EMBI Global Index. Bonds from high-yielding, lower-rated countries underperformed lower-yielding, higher-rated countries as Venezuelan bonds weighed on market performance. Bonds from energy exporters such as Angola, Ecuador, Gabon, Iraq and Cote D'Ivoire outperformed the broader market, as did bonds from Mexico, Trinidad & Tobago and Uruguay. Conversely, bonds from Venezuela, Lebanon, Belize, Jordan, Sri Lanka, Honduras, China, Jamaica, Turkey and Pakistan lagged the broader market.<sup>5</sup>

**DOMESTIC:** EM domestic debt returned 1.68 percent in the month, bringing year-to-date performance to 12.93 percent as measured by the JP Morgan GBI-EM Global Diversified Index. EM

## DISPLAY 6

### EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	234	 -3	9.1	+26
Colombia	176	 -7	6.2	-19
Hungary	87	 -8	1.3	-13
Indonesia	168	 +5	6.8	-26
Malaysia	109	 +0	3.9	-6
Mexico	232	 -15	7.3	+5
Peru	133	 -3	5.3	-13
Philippines	93	 +1	4.8	0
Poland	45	 -3	2.7	-6
Russia	176	 -6	7.4	-5
South Africa	280	 -8	9.9	+22
Turkey	311	 +8	12.6	+77
Venezuela	4717	 +1546	—	—

Source: JP Morgan. Data as of November 30, 2017.

currencies strengthened 1.36 percent versus the USD and EM bonds returned 0.32 percent. Within the domestic debt universe, bonds from Malaysia, Poland, Mexico, the Philippines and South Africa outperformed. Conversely, bonds from Turkey, Chile, Romania, Brazil and Russia lagged the broader market.<sup>6</sup>

**CORPORATE:** EM corporate debt returned 0.03 percent in the month, as measured by the JP Morgan CEMBI Broad Diversified Index. Higher-yielding, lower-quality companies outperformed higher-rated companies in the month. From a regional perspective, companies in Africa (South Africa, Nigeria), Europe (Czech Republic, Kazakhstan, Russia, Ukraine) and Latin America (Mexico, Panama, Colombia) led the market, while those from the Middle East (Israel, Bahrain) and Asia (Taiwan, Hong Kong, Malaysia) lagged.<sup>7</sup>

## 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, as the government emphasizes the quality of growth over rapidity.

Volatility has remained low as investor concerns have been offset by global central bank liquidity and an improved outlook for global growth, despite U.S. Fed rate hikes and anticipated 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. Deglobalization

<sup>5</sup> Source: JP Morgan. Data as of November 30, 2017.

<sup>6</sup> Source: JP Morgan. Data as of November 30, 2017.

<sup>7</sup> Source: JP Morgan. Data as of November 30, 2017.

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risks may intensify as NAFTA renegotiation talks stretch into 2018, but we remain optimistic about the final outcome. 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 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 as we move toward 2018 as country fundamentals and the macroeconomic environment remain supportive. 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 may 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.

## Credit

### Monthly Review

Global Credit indices were little changed in November and remained within a few basis points of post-crisis lows. Macroeconomic conditions remained favorable for the asset

### DISPLAY 7 Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	97	+2	88	+1
Industrial Basic Industry	116	-1	80	+3
Industrial Capital Goods	79	+3	76	+3
Industrial Consumer Cyclical	90	+1	87	+2
Industrial Consumer Noncyclicals	91	+4	83	+5
Industrial Energy	125	+5	82	+2
Industrial Technology	83	+7	61	+1
Industrial Transportation	88	-1	80	0
Industrial Communications	140	+4	97	+4
Industrial Other	84	-1	111	+2
Utility Electric	93	0	79	+2
Utility Natural Gas	98	-1	86	+3
Utility Other	102	-2	83	+1
Financial Inst. Banking	81	0	83	-3
Financial Inst. Brokerage	92	-1	84	-1
Financial Inst. Finance Companies	99	+7	81	+3
Financial Inst. Insurance	103	+1	142	-7
Financial Inst. REITS	112	0	97	+5
Financial Inst. Other	99	-1	136	+17

Source: Bloomberg Barclays. Data as of November 30, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

class. Economic data continued to be strong, and outside of some weakness in Europe, the major equity indices performed well.

The U.S. and European corporate indices moved sideways in November, generating excess returns close to zero for the month on minimal spread movement. However, while the topline numbers would suggest all was calm during the month, investors experienced

more dispersion and volatility across ratings and sectors than has been seen for some time. Merger and acquisition (M&A) rumors and weak earnings drove several credits and subsectors wider. The resurgence of idiosyncratic risk is another sign that markets continue to normalize after years of heavy central bank intervention, which tamped down volatility. Our expectation is that idiosyncratic risk

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is here to stay, and while this can be a threat to credit returns, it also creates opportunities for actively managed portfolios. Heading into year's end, we find ourselves seeking alpha generating opportunities that arise from renewed idiosyncratic volatility, while simultaneously looking to opportunistically trim beta from portfolios.

In the U.S., several industrial subsectors held firm, but weakness in communications, consumer non-cyclicals, energy and technology drove nonfinancials wider. Spreads were better behaved in the utility and financial sectors, which generated modestly positive excess returns. Trends in Europe were similar to those in the U.S. Several industrial and utility subsectors underperformed, driving nonfinancials wider, despite some other subsectors holding firm. Financials remained the bright spot in Europe, with banks and insurance credits continuing to tighten relative to treasuries and generate strong excess returns.

On the news front, roughly one year after the proposed takeover of Time Warner by AT&T was announced and just a month before the deal was first expected to close, the U.S. Department of Justice (DoJ) sued to stop it from happening. The DoJ's primary concern is that the combined company will have too much distribution power over valuable content. The prior administration approved a very similar deal with Comcast and NBC Universal, but given the new administration's preference for less regulation and government intervention, this path was not offered to AT&T. AT&T appears ready for a legal battle, though we wouldn't be surprised to see an out-of-court settlement where AT&T agrees to divest some content assets.

Regulatory pushback against one large merger didn't discourage a potential

large takeover in the technology space, as Broadcom approached Qualcomm. This would be the largest-ever acquisition in the technology sector and as proposed would be largely financed with cash. If the deal were to go through under these terms, the combined entity would need to issue a significant amount of debt, which would likely lead to downgrades to "low investment grade" or even "high-yield" by one or more rating agency.

Understandably, bonds spreads from both Qualcomm and Broadcom widened on the news. Qualcomm has since rejected the offer, citing unattractive valuation and significant regulatory hurdles. Both companies are also still in the process of closing their own recent acquisitions, which have been delayed for regulatory reasons. Recent headlines suggest Broadcom is willing to go hostile with its offer so we suspect additional chapters to this story will be written in the months ahead.

Global high-yield and convertible bonds posted slightly weaker performance in November, consistent with results in investment grade. In high-yield, weakness in communications and consumer non-cyclicals overshadowed rather benign performance across most other sectors. Global convertibles fell modestly in November, dragged down by slightly negative credit returns and mixed global equity performance.

## Outlook

With 2017 quickly coming to a close, we expect spreads to remain range-bound for the next several weeks as investors begin to focus on opportunities in 2018. Investors have a lot to digest, including record equity performance, higher government bond yields, improving global economic growth, tightening monetary policy, likely U.S. tax reform and ever-present domestic and international political risk.

While there are certainly both positive and negative forces acting on the market, we continue to see opportunity for spreads to tighten a modest amount over the near and medium terms. Credit spreads are near post-crisis lows but remain wider than previous cycles, while improving economic growth should help ensure stable fundamentals. We do believe the majority of beta-driven compression is past us at this point in the cycle, so we find ourselves focusing much more on performance generating opportunities arising from renewed idiosyncratic volatility.

## Securitized Products

### Monthly Review

Agency MBS underperformed slightly in November, while credit-sensitive securitized assets continued to outperform. Nominal spreads on current coupon agency MBS tightened 3 basis points in November to 77 basis points above interpolated treasuries, while the option-adjusted spread (OAS) widened 1 basis point to 12 basis points above interpolated treasuries.<sup>8</sup> The Mortgage Index is up 2.14 percent through the first 11 months of 2017, outperforming the Treasury Index, which is up 2.00 percent year-to-date.<sup>9</sup> The Fed purchased approximately \$22 billion agency MBS in November, and its agency MBS holdings remained at \$1.77 trillion. Despite plans to implement "balance sheet normalization" beginning in October, the Fed's agency MBS holdings are unchanged over the past two months.<sup>10</sup> We still expect the Fed to begin reducing its MBS purchases in the coming months, and that slowing its reinvestments will likely have a meaningful negative impact on agency MBS.

Nonagency MBS spreads were essentially unchanged in November, while cash flow and credit performance

<sup>8</sup> Source: Yield Book. Data as of November 30, 2017.

<sup>9</sup> Source: Bloomberg Barclays. Data as of November 30, 2017.

<sup>10</sup> Source: Federal Reserve Bank of New York. Data as of November 30, 2017.

## DISPLAY 8

## Housing Sector Changes

		LATEST	PREVIOUS	UNIT	CHANGE OVER 1 YEAR	AS OF
Prices	National Home Prices	● 0.72	0.66	% MoM	● 6.2	% YoY 9/30/2017
	Existing Home Sales	● 5.5	5.37	MM homes		10/31/2017
	Existing Home Sales	● 2.1	0.37	% MoM	● -0.9	% YoY 10/31/2017
Inventory	Housing Inventory	● -3.2		% MoM	● -10.4	% YoY
	Housing Inventory (months supply)	● 3.9	4.2	Months supply	4.4	Level last yr 10/31/2017
Defaults	New Defaults	● 0.67	0.66	% annualized	0.70	Level last yr 10/1/2017

continued to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices are up 6.2 percent over the past year, the biggest yearly increase since 2014.<sup>11</sup> Home prices are up 45.9 percent nationally from the lows in 2012 and are now up 6.0 percent above the precrisis peak in July 2006. Mortgage performance also remains strong. New mortgage defaults increased slightly to a 0.67 percent annual default rate in September, but remain near the lowest levels over the past 10 years.<sup>12</sup> 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 based on collateral type, with CMBS backed by retail properties trading poorly and CMBS backed by most other collateral types generally performing well. In aggregate, CMBS spreads tightened in November, and AAA CMBS are roughly 20 basis points tighter on the year, while BBB-CMBS are roughly 50-60 basis points tighter year-to-date. Nonagency CMBS issuance totaled roughly \$8 billion in November, lifting the 2017 year-to-date total to \$79 billion for the first 11 months of 2017.<sup>13</sup> We expect CMBS

new issuance to slow meaningfully in 2018 as fewer CMBS deals are maturing from the significantly smaller 2008-vintage CMBS origination.

Fundamentally, CMBS performance remains on reasonably solid ground, although there are some areas of concern. Commercial real estate prices fell 1.1 percent in October and are 0.9 percent lower in 2017.<sup>14</sup> 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. National office vacancy rates declined 0.1 percent to 12.9 percent in Q3 2017, essentially the lowest vacancy levels seen since Q1 2008.<sup>15</sup> We remain positive on seasoned CMBS and newly issued CMBS backed by office buildings, residential properties and industrial properties.

European MBS spreads were largely unchanged in November but remain 30 to 100 basis points tighter in 2017.<sup>16</sup> Low interest rates and moderate signs of economic growth in Europe seem to be outweighing any material concerns over Brexit fallout. The ECB increased its asset-backed securities (ABS) purchases again in October, and their ABS portfolio increased by €0.6 billion to €24.7 billion of European ABS as of the end of October 2017.<sup>17</sup>

## Outlook

As 2017 comes to a close, we expect continued outperformance by securitized assets. While we do not expect further spread tightening, the fundamental conditions in the securitized markets remain very positive, and the cash flow-based carry of securitized assets should continue to generate compelling returns. Home prices continue to rise, consumer confidence and consumer balance sheets are improving, interest rates remain historically low and stable, and despite the political gridlock in D.C., the lending environment is beginning to improve with easing regulatory enforcement and expanding lending guidelines. These conditions bode well for further improvements in credit performance. We expect to see residential mortgage delinquencies and defaults continue to decline, commercial mortgage refinancing rates continue to increase (with probable exception of retail shopping centers) and consumer-oriented ABS assets continue to perform well. While spreads have tightened over the past year, most credit-related securitized spreads remain meaningfully wider than precrisis levels and are still wider than similarly rated corporate credit investments. We expect securitized assets to continue to generate attractive absolute and relative carry-

<sup>11</sup> Source: S&P Case-Shiller National Home Price Index. Data as of November 30, 2017.

<sup>12</sup> Source: S&P Experian First Mortgage Default Index. Data as of November 30, 2017.

<sup>13</sup> Source: Bank America. Data as of November 30, 2017.

<sup>14</sup> Source: Green Street. Data as of November 30, 2017.

<sup>15</sup> Source: CBRE. Data as of November 30, 2017.

<sup>16</sup> Source: JPMorgan. Data as of November 30, 2017.

<sup>17</sup> Source: European Central Bank. Data as of November 30, 2017.

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based returns in December and into 2018 as well.

What concerns us? The biggest risk we see in the near term is a potential shock in interest rates. The Fed will likely raise short-term interest rates another 25 basis points in December, and simultaneously, the Fed has embarked on its “balance sheet normalization,” effectively an unwind of its quantitative easing policies by slowing the pace of reinvestment of MBS and treasuries and letting its portfolio slowly decline. The markets seem to be largely ignoring this potential risk, as longer-term interest rates have hardly reacted to the Fed rate hikes over the past two years or to the announcement of its balance sheet normalization plans. We believe securitized markets can easily withstand a 50-100 basis point interest rate increase, but if interest rates were to rise more than 100 basis points, these higher rates could create some problems for affordability and refinance-ability.

In terms of relative value, we still favor a credit-oriented portfolio composed of non-agency RMBS, CMBS backed by non-retail properties and select nontraditional ABS over more rates-related risk assets such as agency MBS. Nonagency MBS should continue to

benefit from improving cash flows as defaults decline and voluntary prepayments increase. Spreads will not likely tighten much further from current levels, but nonagency MBS yields still offer compelling relative value, and risk profiles continue to improve with rising home prices. Most nonretail CMBS sectors continue to perform well from a fundamental value perspective, with record-high occupancy rates and increasing rental rates. Retail-related CMBS continues to suffer from store closings, causing rising vacancy rates and weaker leasing rates. We also have some concerns about current valuations on some hotel and office properties, but we remain optimistic about housing-related CMBS. In nontraditional ABS, we continue to like housing-related ABS and subprime auto ABS, and we have been cautiously adding consumer loan ABS and aircraft lease ABS.

Agency MBS remains our least compelling sector. Agency MBS nominal spreads are at the tightest levels in more than 20 years, and the Fed is just beginning to reduce its \$1.77 trillion agency MBS portfolio. Agency MBS option-adjusted spreads (OAS) are at more historically normal levels, but these OAS valuations are predicated on

continued low interest rate volatility and low prepayment volatility. We believe that volatility will likely increase in 2018 as the Fed continues its rate hike program and advances its balance sheet reduction goals.

In Europe, we continue to favor seasoned U.K. residential mortgage-backed securities (RMBS) and seasoned peripheral Eurozone RMBS. Home prices have been steadily climbing throughout Europe over the past few years, supported by accommodative ECB policies like low interest rates and asset purchases. Many European housing markets remain below precrisis levels and have more room to recover. In the U.K., while we have significant concerns about the impact of Brexit on the U.K. economy and housing markets, we also believe that very seasoned (~10 years or more) U.K. RMBS will continue to perform well and should benefit from de-levering capital structures (increasing structural credit support levels). We believe the current risk premiums (spreads) that we receive on many of these seasoned U.K. RMBS overstate the actual risks on these seasoned securities. We continue to have an overweight to this sector.

## Risk Considerations

**Fixed income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In the current rising interest rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. Longer-term securities may be more sensitive to interest rate changes. In a declining interest rate environment, the portfolio may generate less income. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

## INDEX DEFINITIONS

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

The **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 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 10-Year Government Bonds** — Italy Benchmark 10-Year Datastream Government Index.

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

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

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

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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 U.S. dollar.

**Euro vs. USD** — Euro total return versus U.S. dollar.

**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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