Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Central Bankers Debate Policy

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | SEPTEMBER 2016

Outlook

- We believe the upcoming months, including a full calendar of central bank policy meetings in September, will be key to watch as central banks reconsider their thinking, potentially shaking up the lull in sovereign bond markets. Markets have been predicting more of the same over the next few months, and there is some chance expectations will not be met, in a bearish way. However, adjustments will likely only result in a correction in government bond markets, as we maintain that the trend in central bank policy will be supportive of spread products and carry strategies. But we are careful with our duration and do not want to be too long, given how far yields have fallen and how optimistic markets have been on monetary policy.
- With moderate global growth and low inflation the most likely path forward and emerging market (EM) fundamentals stabilizing-to-turning, we believe EM debt should perform reasonably well.
- We continue to monitor signs that the credit cycle is maturing. However, we believe the strong technical backdrop afforded by easy central bank policy will continue to dominate the global fixed income markets going forward. Investors seeking returns will continue to buy global credit, while U.S. credit will likely outperform, as relatively attractive yields in the country will continue to attract foreign buyers.

Sovereign bond markets traded in a tight range in August as observers waited for the Jackson Hole, Wyoming, meeting for possible insights into central bank policy. The monthly trading range for 10-year U.S. Treasuries was around 18 basis points (bps), the tightest since 2006. S&P 500 daily returns stayed within plus/minus 1 percent. Many spread products did very well in the calm. Investment-grade (IG) and high-yield (HY) tightened to new lows, led by energy-sensitive sectors on the back of rising oil prices.

The direction-less sovereign market reflects increasing policy uncertainty among central bankers. While we do not believe the debate is yet settled, we believe central bankers' reaction

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The views and opinions expressed are those of the portfolio management team as of September 2016, and are subject to change based on market, economic, and other conditions. **Past performance is not indicative of future results.**

functions are changing. For one, central bankers within the Bank of Japan (BoJ) and European Central Bank (ECB) are more wary of using negative interest rates, which carry costs for financial corporations and savers. Moreover, in her Jackson Hole speech, Janet Yellen, chair of the U.S. Federal Reserve Board (Fed), seemed open to the debates within the Federal Open Market Committee (FOMC) for new monetary tools, including moving the inflation target to 3 percent. To us, this sounds like the Fed is more willing to allow inflation to overshoot for a significant period of time to boost inflation expectations. This means holding rates lower for longer, despite improving data.

In terms of implications for asset prices, we believe we are still in an environment where central bank policy will be accommodative and will continue to pursue their goals of asset reflation. Of course, we expect that there may be slight variation from country to country. For instance, Japan and Europe will maintain a negative rate policy and continue to expand on quantitative easing (QE) as a means of asset support. The Fed will likely hike rates, albeit at a very slow pace. The U.K. will keep rates low and continue its QE program as well. Putting it all together, there is little tolerance in the central bank community to allow interest rates to rise in a disruptive manner that will negatively impact asset prices or business confidence. As mentioned, we believe there is growing sentiment among central bankers that inflation expectations are too low and need to be higher. This should support a steepening of yield curves, which is largely a stimulus for risky asset prices.

Thus, we have an environment in which carry strategies and spread products should do well. Our preference is to own spread products that have a lower correlation to interest movements. Asset classes such as HY and securitized products stand to do well in just such an environment in our opinion. In many cases, the underlying fundamentals of the sectors within these asset classes are strong, but trade cheap relative to their fundamentals. In HY, sectors such as paper, packaging and homebuilding offer attractive yields with good fundamental backing. Similarly, non-agency mortgage and commercial mortgage-backed securities (CMBS), which is largely a domestic U.S. story with the backing of strong fundamentals from rising commercial and residential real estate prices, also look attractive.

A quiet August 2016 was welcomed in light of volatile Augusts in the past few years. However, we believe the upcoming months, including a full calendar of central bank policy meetings in September, will be key to watch as central banks reconsider their thinking, potentially shaking up the lull in sovereign bond markets.

Interest Rates & Currency Outlook

Given the relative lethargy of the global economy and ongoing uncertainties around the impact of Brexit, we expect the Fed to do all it can to implement a "dovish" hiking path. In our opinion, longer-maturity Treasuries are shaped more by technical forces related to global risk premia, which we think could reverse and drive yields higher. In light of these forces and market realities, we remain modestly underweight U.S. duration although overweight elsewhere, such as in EM. We also believe that current market pricing of inflation through Treasury Inflation-Protected Securities (TIPS) underestimates the potential for higher inflation.

We expect continued 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 remain essentially neutral on eurozone duration. The ECB is likely to adopt an even easier monetary policy, if only by extending the time frame of QE.

We expect that a China-related commodity-based slowdown and slow growth should contribute toward an easy monetary policy in Australia and New Zealand. Given the ongoing weakness in dairy prices, we believe New Zealand government bonds should outperform and continue to be overweight this market. EM assets remain attractive in this low-yielding, easy money world. Central European bonds remain attractive, while we are tactically positive on Brazil and Mexico.

In terms of currency positioning, we see a weaker dollar in the near future, given a dovish Fed—although the dollar could strengthen in a risk-off scenario. We have exposure to where we see value, including the Polish Zloty, Norwegian kroner and Russian ruble. We are underweight the British pound in anticipation of deteriorating growth caused by Brexit uncertainties.

EM Outlook

Even though EM fixed income has posted strong year-to-date returns, we remain optimistic about its prospects for the remainder of the year as developed market yields remain very low, economic data in EM appears to have stabilized, fears of multiple Fed rate hikes have subsided, and concerns of a sharp slowdown in China have diminished. While one more Fed hike is likely by year-end, overall supportive developed market monetary policies, combined with lower China fears, will likely remain the positive drivers of asset price performance for the remainder of the year. Relative yields and valuations remain attractive in EM, but for a longer-lasting rally to take hold, we need to see a more sustained turn in EM economic fundamentals, an oil price range of $40-50/per barrel, a stable U.S. dollar and range-bound developed market rates.

We believe that EM assets could absorb one to two growth-induced Fed rate hikes in 2016, but assets would remain vulnerable to rate hikes driven by a surge in inflation. However, the inflationary environment should remain relatively benign for the world as a whole, especially post-Brexit and with unresolved China vulnerability. Broadly, we expect a modest rebound in EM growth for the rest of 2016 and 2017, as the negative 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. In our opinion, the gradual shift toward managing the Renminbi against a basket of currencies reduces the risk of an abrupt devaluation, while China is the president of the G20 this year.

Looking ahead, we believe emerging markets fixed income (EMFI) should remain supported by better economic growth prospects and still-lax monetary policy. Despite a narrowing of the EM/developed market (DM) growth differential and a weakening of fundamentals following the 2008 global financial crisis, EM economies, in our opinion, are still in better health than they were 10 to 15 years ago. EM economies are supported by generally lower levels of external debt as a percentage of gross domestic product (GDP), freely floating exchange rates, relatively large buffers in the form of foreign currency reserves, and growing local debt markets supported by generally robust and well-capitalized banking systems. These factors limit the risks of external funding pressures inflicting severe damage on their economies. With many in the market forecasting moderate global growth and low inflation, and EM fundamentals stabilizing-to-turning, we believe EM debt should perform reasonably well for investors looking for diversification, yield/carry and total return potential.

Credit Outlook

As we head into year-end, we continue to monitor signs that the credit cycle is maturing and attempt to balance the potential negatives of a late-cycle credit environment with unprecedented central bank support. In the near term, it seems likely that the technicals will outpace any potential late-cycle risks; however, we are cognizant of the potential for a credit repricing if policy support diminishes or the market loses faith in the strength of corporate credit in the face of a late-cycle environment. Additionally, as we head into the end of 2016 and into early 2017, we remain cautious about Italy's constitutional reform referendum and the U.S. election. Both pose political and policy uncertainty, and are pockets of potential volatility for global credit markets.

In the interim, September is poised to be a much more active month than August from a macroeconomic perspective. Specifically, during the first three weeks of September, U.S. employment data will be reported and ECB, Bank of England (BoE), Fed and BoJ meetings will take place. Despite the heavy macroeconomic calendar in September, we continue to believe that the strong technical backdrop afforded by easy central bank policy will continue to dominate the global fixed income markets going forward. We expect investors seeking returns will continue to buy global credit, and U.S. credit will likely outperform, as relatively attractive yields in the U.S. will continue to attract foreign buyers. Significant supply expectations in U.S. IG and HY markets will present an attractive opportunity to accumulate credit risk throughout September. As such, we continue to believe that a robust technical environment remains the dominant theme across global credit, and credit remains an attractive asset class in a slow economic growth, low-yielding environment.

Securitized Outlook

We remain significantly underweight agency mortgage-backed securities (MBS) given the historically low nominal spreads and low option-adjusted spreads (OAS), combined with near record low mortgage rates which should meaningfully increase prepayment risks and option costs. However, agency MBS have performed reasonably well in 2016, given the increased demand for liquid and high credit quality spread products. Despite good performance over the past few years as rates volatility has remained relatively low, we believe that agency MBS appears to be expensive from a historical spread and yield perspective and that the downside risk significantly outweighs the upside potential and outweigh the current carry. Additionally, we believe credit-sensitive mortgage securities currently offer better risk-adjusted return profiles and cash flow carry. Although we remain underweight agency MBS, we also believe agency MBS can complement a more credit-sensitive MBS portfolio, given the liquidity and diversification benefits of agency MBS.

We believe that non-agency MBS remains one of the more stable and attractive fixed income asset classes. Given the attractive carry, improving fundamentals and shrinking net supply, we remain overweight the sector. Non-agency MBS offers spreads of 200-250 bps above U.S. Treasuries for IG bonds, and 250-300 bps above for senior non-IG bonds on a loss-adjusted basis. We remain positive on the U.S. housing market, given the modest strength of the U.S. 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 2016, while new securitizations are projected to only amount to $20 billion to $30 billion.

We remain cautiously overweight CMBS. We expect that commercial real estate fundamental conditions will continue to improve as the U.S. economy strengthens, and we believe CMBS is poised to perform well as a result. However, we have some concerns over supply/demand dynamics, given the recent spread volatility and given our expectations of future increases in new origination and issuance. However, we also have concerns over late 2015 and 2016 vintage origination CMBS due to the substantial increase in property values over the last few years and favor more seasoned CMBS issues, which have benefited from recent property price appreciation. For more recent issuances, we favor

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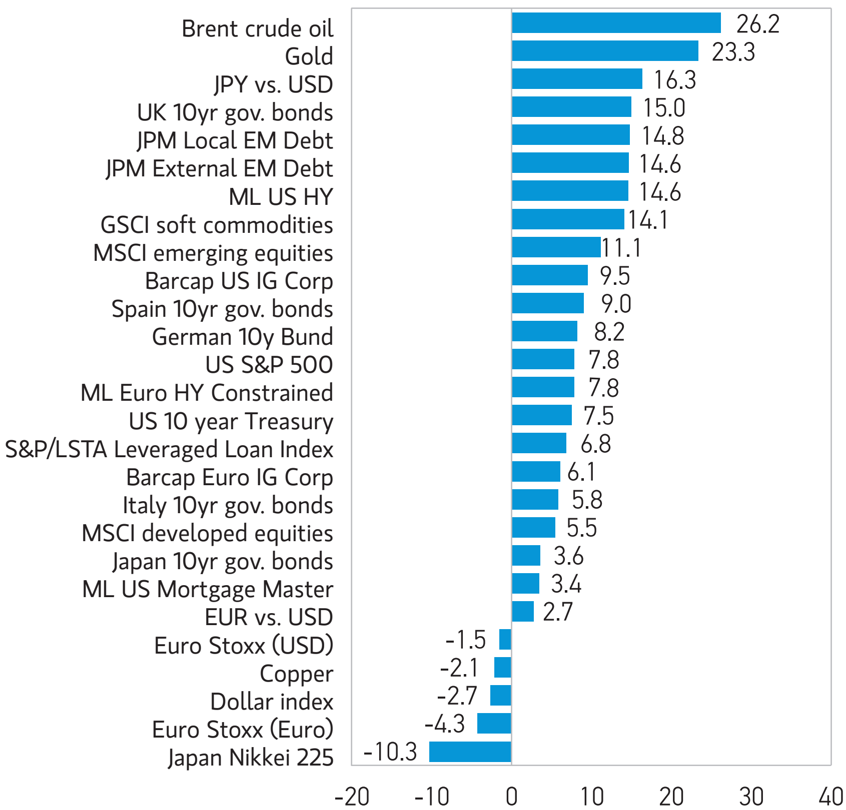
moving up the capital structure to benefit from increased structural credit protection while still receiving attractive spreads resulting from recent spread widening. Although we expect continued volatility in CMBS in 2016, we believe that CMBS offers attractive yields and should continue to benefit from improving fundamental market conditions. While we remain overweight, we are limiting our overweight to a manageable level depending on portfolio risk profiles, given the increased volatility and mark-to-market risk in this sector.

In Europe, although spreads have now tightened back to pre-Brexit levels, they remain wider on the year for most non-ECB eligible assets. We believe U.K. RMBS remains one of the most attractive asset classes. Although the Brexit vote raises the potential for a recession in the U.K., we still like the very seasoned U.K. RMBS with borrowers that continued to pay during the financial crisis. These borrowers have proven themselves to be more resilient to economic stress and home price declines, and the securities on these seasoned deals have benefited from deleveraging and increased credit structural protection. Additionally, the BoE is now projected to cut rates, which should increase refinancing activity and improve home affordability. In mainland Europe, the ECB restated its commitment to keeping interest rates low for a sustained period of time and to provide additional stimulus. Many European real estate markets are still recovering from the financial crisis, particularly in peripheral Europe where real estate prices remain well below their peaks, and the ECB stimulus should help to reflate real estate prices. With improving fundamental conditions and wider spread levels, we continue to like the European RMBS and CMBS markets.

DISPLAY 1

Asset Performance Year-to-Date

Returns through 8/31/2016



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of August 31, 2016. 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 page 14 for index definitions.

Market Summary

In August, yields in the U.S., U.K. and Europe rose following the lead of Japanese government bonds and as perceptions of global risk receded.[1] The dollar gained versus global currencies as the market increased its expectations of a near-term rate hike.

Over the month, 10-year U.S. Treasury yields rose 13 bps while the 2s10s curve flattened by 2 bps.[1] Germany's 10-year yield increased 5 bps, while the country's two-year yield increased 1 bp.[1] The 10-year yields of Ireland, Italy and Spain were close to flat on the month,[1] Portugal's 10-year yield which increased 11 bps, selling off after rumors that rating agency DBRS is reviewing for downgrade. Greece's 10-year government yields decreased by 6 bps.[1] And the Japanese government bond (JGB) 10-year yield increased by 13 bps,[1] while the 30-year yield continued to rebound in August, rising 17 bps in the month, ending at 43 bps.

In August, the dollar strengthened strongly after Jackson Hole meetings suggested that a more hawkish hiking path might be possible. The euro lost 0.1 percent, while the British pound depreciated by 0.7 percent. The Japanese yen depreciated by 1.3 percent for the month.[1] Crude oil (Brent) prices increased in the month from $42 to $47.[1] As a result, the Norwegian Kroner and Russian ruble gained 1.4 percent and 0.8 percent, respectively.[1]

[1] Source: Bloomberg. Data as of August 31, 2016.

Developed Markets

In the U.S., FOMC members met at the Jackson Hole Symposium to discuss monetary policy. In her speech, Janet Yellen mentioned that the case for a rate hike has strengthened, however the actual decision will continue to be data-dependent. Vice Chair Stanley Fischer remarked that he saw one to two hikes as possible this year, which the market viewed as a hawkish signal. Economic data continued to be strong for the month. July nonfarm payrolls posted a strong positive surprise, increasing 255,000 versus expectations of 180,000, although June nonfarm payrolls were revised lower to 271,000 from 287,000.[2] The unemployment rate ticked up to 4.9 percent, above consensus of 4.8 percent, as the participation rate increased 0.1 to 62.8 percent. Average hourly earnings rose 2.6 percent.[2] ISM manufacturing index decreased to 52.6 in July, a bit below expectations of 53. GDP figures for the second quarter were revised 0.1 lower to 1.1 percent quarter-on-quarter, in line with consensus. Headline CPI was 0.8 percent and core CPI was 2.2 percent for July.[2]

In the eurozone, the ECB released minutes to the July meeting, which was balanced in tone. The ECB acknowledged the risks likely to impact general outlook due to Brexit and emphasized its readiness to act. In terms of survey data, eurozone manufacturing PMI came in at 52 in July, below June, and slightly above expectations of 51.9.[2] Eurozone GDP for second-quarter 2016 was unrevised at 0.3 percent quarter-on-quarter, in line with consensus. Eurozone inflation was 0.2 percent for July, up from 0.1 in June.[2]

In the U.K., the BoE voted to cut the Bank Rate by 25 bps to 0.25 percent and to start asset purchases over the next 18 months, in reaction to possible negative economic effects from Brexit. The BoE will purchase £60 billion of gilts over 6 months and £10 of corporate bonds over 18 months. The QE program was a dovish surprise to the markets.

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	1.44	-7	1.51	-3	1.82	-5
Belgium	-0.59	-2	-0.43	4	0.18	5
Canada	0.58	4	0.67	7	1.02	0
Denmark	-0.53	-5	-0.32	-1	0.04	-2
France	-0.57	-3	-0.38	1	0.18	8
Germany	-0.62	1	-0.5	3	-0.07	5
Ireland	-0.37	-59	-0.14	-2	0.43	1
Italy	-0.09	-3	0.25	-4	1.15	-2
Japan	-0.2	5	-0.17	9	-0.06	13
Netherlands	-0.6	-1	-0.42	5	0.04	6
New Zealand	1.81	-1	1.82	-6	2.24	3
Norway	0.54	-32	0.58	-60	1.08	11
Portugal	0.53	7	1.9	18	3.04	11
Spain	-0.18	-2	0.14	-4	1.01	-1
Sweden	-0.64	3	-0.36	2	0.11	0
Switzerland	-0.86	-2	-0.78	12	-0.48	9
United Kingdom	0.14	3	0.21	-6	0.64	-4
United States	0.81	15	1.2	17	1.58	13

Source: Bloomberg LP. Data as of August 31, 2016.

The BoE also launched a term funding scheme to provide liquidity to banks, which should help sector earnings in light of lower rates. In terms of data, headline CPI inflation was 0.6 in July, up from June and above consensus of 0.5 percent.[2] The unemployment rate's three-month average stayed at 4.9 percent in June. GDP figures for the second quarter were unrevised at 0.6 percent quarter-on-quarter, in line with consensus. U.K. manufacturing PMI decreased for a second month to 48.2 in July, from 49.1 in June, below expectations of 49.1.[2]

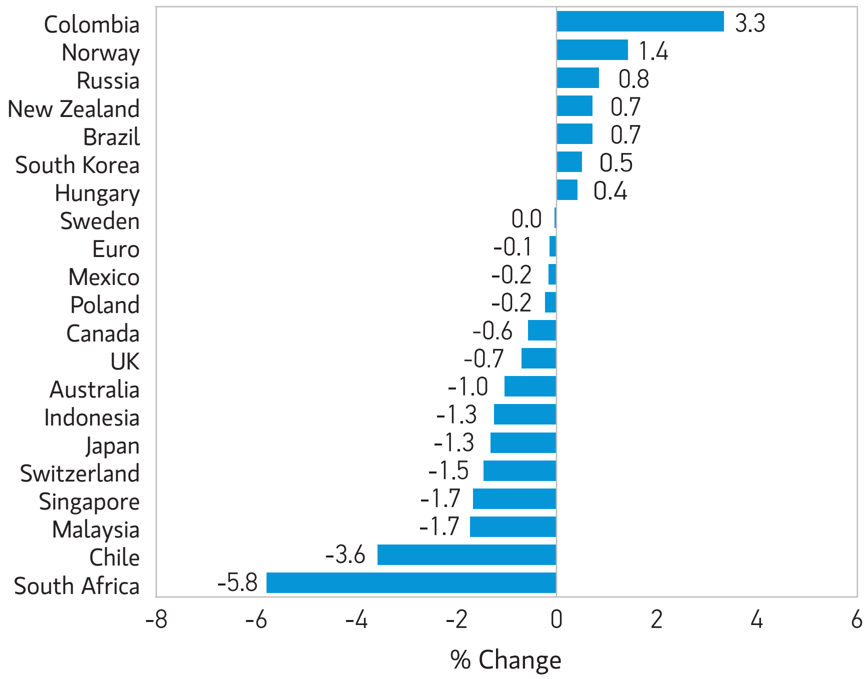
In Japan, BoJ Governor Haruhiko Kuroda spoke at Jackson Hole, reiterating that the bank has policy tools for additional easing if necessary. Kuroda mentioned that more quantitative easing or negative rates continue to be available policy tools. However, he admits that inflation expectations might be anchored to historical inflation and therefore stickier than previously realized. On the data front, manufacturing PMI was 49.5 for August, down from 49.6 in July. The second-quarter GDP figure was 0.2 quarter-to-quarter, below expectations of 0.7 percent and below previous quarter's 2 percent. The July core

[2] Source: Bloomberg. Data as of August 31, 2016.

DISPLAY 3

Currency Monthly Changes versus U.S. Dollar

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of August 31, 2016. Note: Positive change means appreciation of the currency against the U.S. dollar.

national CPI (ex-Food & Energy) came in at 0.5 percent, down from 0.7 in June and below consensus of 0.7 percent.[3]

Emerging Markets

EMFI assets posted positive performance in the month, with dollar-denominated sovereign and corporate debt outperforming domestic debt as EM currencies generally weakened versus the U.S. dollar in the latter half of the month. Despite slightly more hawkish comments coming out of the Jackson Hole meeting, global monetary policy remained supportive of fixed income. Investors continued their search for higher-yielding assets, leading to over $7 billion of inflows into EMFI during the month and driving expectations of $40 billion by year-end.[4] Aside from attractive yields, EM economic growth appears to be stabilizing and higher-frequency data points to a potential rebound dependent on a stable U.S. dollar, commodity prices and inflation.

Political events drove spikes in volatility throughout the month, most notably in South Africa where assets suffered after political infighting at the ruling African National Congress (ANC) that threatened to ensnare Finance Minister Pravin Gordhan. Gordhan received warning that he might face charges in relation to his oversight of the South African Revenue Service. The move followed a poor showing by the ANC in municipal elections, which further eroded President Zuma's powerbase. The political maneuvering further darkened the outlook for the country's credit rating, which is scheduled for review later in the year. In Europe, tensions briefly flared between Ukraine and Russia after an attempted assassination of the leader of the "Luhansk People's Republic," in which two Russian service members were killed. Russian leaders blamed Ukrainian agents for the attack and bolstered troop and air defense positions in the Crimea region while casualties mounted.

In Latin America, Brazil's impeachment trial of former President Dilma Rousseff concluded as the Senate voted 61-20 for impeachment, well above the minimum threshold of 54 votes. Acting President Michel Temer was sworn into the top office and attention quickly turned to the fiscal reform agenda, which has so far been disappointing. The government of Colombia signed a peace deal with the FARC rebels, which will end the 52-year war if approved by the Colombian population. Concerns of Mexico's economic health surfaced as S&P Ratings Agency lowered the outlook for the country's BBB+ rating to negative. The downgrade mainly reflects fiscal concerns and the rapid deterioration of the country's debt/GDP level. The debt dynamics are partially the result of the government's overestimation of economic growth and the resulting overspending from a fiscal perspective. While this has been negative for the trajectory of Mexico's level of debt, the absolute level of debt still remains at manageable levels (estimated 45 percent/GDP for 2016). To stabilize the debt to GDP level, the government must deliver on its commitment for a primary budget surplus in 2017.

In more positive news, India's goods and services tax (GST) constitutional amendment passed the upper house. The GST measure creates a single uniform tax for goods and services across the country and is expected to boost efficiency and total factor productivity in the medium term as well as widen the tax base. However, implementation of the GST will take time.

External

EM external sovereign and quasi-sovereign debt returned 1.80 percent in the month, bringing year-to-date performance to 14.65 percent, as measured by the JP Morgan EMBI Global Index.[5] Lower-rated, higher-yielding, and many smaller and less-liquid assets outpaced IG bonds in the month. An increase in energy prices supported assets from oil-exporting

[3] Source: Bloomberg. Data as of August 31, 2016.
[4] Source: JP Morgan. Data as of August 31, 2016.
[5] Source: JP Morgan. Data as of August 31, 2016.

nations as bonds from Zambia, Iraq, Ghana, Angola, Senegal, Gabon, Ivory Coast and Venezuela led the market, while bonds from Mongolia, South Africa, Chile and Honduras lagged with negative performance. Mongolian debt prices fell -7.7 percent, which prompted Finance Minister Choijilsuren Battogtokh to declare a state of "economic crisis." Economic growth is expected to slow to 1.3 percent, while Mongolia's fiscal deficit is projected to reach 21.1 percent of GDP.[6] The government announced the formation of a task force that will make recommendations to address the problem. Meanwhile, the S&P rating agency changed its outlook for the country's rating to negative from neutral.

DISPLAY 4

EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	315	-31	11.7	3
Colombia	232	-38	7.3	-12
Hungary	175	-36	2.1	2
Indonesia	234	-20	7.3	13
Malaysia	207	-19	3.5	0
Mexico	258	-36	5.9	-8
Peru	162	-32	5.8	2
Philippines	93	-8	4.3	-12
Poland	83	-15	2.3	-9
Russia	220	-27	8.3	-25
South Africa	312	5	9.4	40
Turkey	313	-27	9.4	2
Venezuela	2456	-54	–	–

Source: JP Morgan. Data as of August 31, 2016.

Domestic

EM domestic debt returned 0.04 percent in the month, bringing year-to-date (YTD) performance to 14.75 percent, as measured by the JP Morgan GBI-EM Global Diversified Index.[5] EM currencies weakened -0.29 percent versus the U.S. dollar and EM bonds returned 0.33 percent in local terms.[5] Currency performance versus the U.S. dollar was the swing factor for many countries as bonds from Colombia, Russia, the Philippines and Brazil outperformed the broader market. Bonds from South Africa, Chile and Indonesia underperformed as currency weakness versus the USD exacerbated weak local bond performance.

Corporate

EM corporate debt returned 1.32 percent in the month, bringing YTD performance to 10.95 percent, as measured by the JP Morgan CEMBI Broad Diversified Index.[5] Higher-yielding, lower-quality companies outperformed higher-rated companies over the month. Performance was broad-based from a regional perspective with only Asia lagging the broader market, driven by weaker performance from companies in Macau, Hong Kong and Taiwan. Companies in Europe, including Kazakhstan, Poland and Turkey led the market, as did those from Latin America (Brazil, Argentina and Colombia). From a sector perspective, companies in the Transport, Oil & Gas, Metals & Mining, Infrastructure, Industrial and TMT sectors outperformed the broader market, while those in the Pulp & Paper, Utilities and Real Estate sectors lagged.

Corporate Credit

The month of August was characterized by spread tightening across credit markets, as a strong technical backdrop continued to drive credit spreads tighter across the globe. The BoE announced quantitative easing expansion and a corporate bond purchase program, which accelerated foreign buying in the U.S. and led to an outperformance in U.S. credit throughout the month of August.

U.S. IG outperformed European IG credit on an excess returns basis (0.82 percent versus 0.49 percent, respectively) in August.[7] Specifically, U.S. industrials most notably outperformed European counterparts, with U.S. industrials generating a 0.9 percent excess return, while European industrials produced 0.29 percent in excess returns.[7] The outperformance of U.S. IG credit versus European IG credit highlights strong foreign buying within the U.S. credit market as QE efforts and sustained low global yields attract overseas investors into the U.S. credit market. Across the U.S. and European credit markets, lower-rated credits and subordinated debt continued to outperform in August, further highlighting the bullish sentiment in global IG credit.

U.S. IG issuers brought a record $100 billion in supply to market in August, as demand for U.S. credit rose and borrowing costs remained suppressed.[8] Supply expectations remain elevated in the U.S. going into year-end, and

[6] Source: Bloomberg. Data as of August 31, 2016.

[7] Source: Barclays. Data as of August 31, 2016.

[8] Source: BAML. Data as of August 29, 2016.

issuance will likely remain the dominant theme for the U.S. credit market in September. Specifically, in U.S. IG credit, supply forecasts are $120 billion for September, as issuers pull supply forward in the face of tight spreads and low Treasury yields. Additionally, we anticipate issuers will term out short-term debt ahead of the October 14 money market reform deadline.[8] Absent unforeseen macroeconomic headlines, it remains likely that despite elevated issuance levels, the secondary IG market will continue to perform as a result of the supportive technical backdrop for U.S. credit. European issuance closed at €19.6 billion in August, led by nonfinancials (€12.1 billion).[9] Consensus estimates for September are calling for €60 billion in primary supply in the European market, which is in line with 2015.[9]

The U.S. High-Yield Index produced total return of 2.09 percent last month, and excess returns of 2.53 percent.[10] Within the U.S. HY complex, lower quality credit outperformed, with CCC-rated bonds generating a total return of 3.29 percent, while B-rated issuers generated a total return of 1.48 percent.[10] All U.S. HY sectors were positive last month, as positive mutual fund flows, positive ETF flows, and general market stability supported the HY market throughout the period. Given the strong secondary backdrop, the U.S. HY market priced $16.6 billion in USD-denominated debt in August.[10] The European HY market delivered a 1.77 percent total return in August, and so underperformed the U.S. HY market.[10] Energy and consumer cyclicals continue to be the top performers in both the U.S. and European HY markets, as spreads on higher-beta credits remain most attractive in the current low-yield environment. The European HY market priced €2.3 billion worth of bonds in August and saw no USD issuance from European companies.[10] Global HY continues to perform well across the U.S. and Europe as a supportive technical backdrop continues to drive yields lower.

DISPLAY 5

Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	135	-10	108	-6
Industrial Basic Industry	190	-7	105	-6
Industrial Capital Goods	102	-6	81	-2
Industrial Consumer Cyclicals	120	-6	98	0
Industrial Consumer Non Cyclicals	113	-3	86	-1
Industrial Energy	193	-28	105	-6
Industrial Technology	122	-13	70	0
Industrial Transportation	126	-5	85	-1
Industrial Communications	158	-8	104	-4
Industrial Other	117	-5	136	-11
Utility Electric	129	-6	99	-3
Utility Natural Gas	144	-5	91	0
Utility Other	153	-4	80	-3
Financial Inst. Banking	122	-9	107	-12
Financial Inst. Brokerage	148	-12	108	-13
Financial Inst. Finance Companies	159	-7	88	-3
Financial Inst. Insurance	150	-9	252	-19
Financial Inst. REITS	160	-10	112	-1
Financial Inst. Other	181	-67	156	-12

Source: Barclays. Data as of August 31, 2016. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

Securitized Products

Mortgage credit markets had another strong month and more rates-sensitive agency markets were moderately positive. Agency MBS marginally outperformed their duration equivalent Treasuries as nominal spreads on current coupon MBS tightened three to 100 bps above duration equivalent Treasuries, while OAS widened six to eight bps over equal duration Treasuries.[11] The Bloomberg Barclays U.S. Mortgage Index was up 0.15 percent in August and has now returned 3.47 percent year-to-date.[12] The U.S. Treasury curve flattened slightly again in August as the 10-year Treasury rate increased 13 bps, while the 2-year Treasury rate increased by 15 bps.[13] While 30-year mortgage rates increased four bps to 3.40 percent, rates are still near record lows.[14] Finally, the Fed continues to reinvest paydowns

[9] Source: Barclays. Data as of September 1, 2016.
[10] Source: Barclays. Data as of September 1, 2016.
[11] Source: Yield Book. Data as of August 31, 2016.
[12] Source: Barclays. Data as of August 31, 2016.
[13] Source: Bloomberg. Data as of August 31, 2016.
[14] Source: Bankrate.com. Data as of August 31, 2016.

at roughly $25 billion per month and maintain its agency MBS portfolio at approximately $1.75 trillion.[15]

Non-agency MBS spreads tightened roughly 10 bps, and cash flow performance continued to improve as well. Non-agency MBS spreads are now at the tightest levels in 2016 and have returned to second-quarter 2015 levels. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 1.0 percent in June, and are up 5.1 percent over the past year.[16] Home prices are up 36 percent nationally from the lows in 2012, and are now only 1 percent below the peak from July 2006. While existing home sales fell 3.2 percent in July and were down 1.6 percent from July 2015, home sales levels remain near historical highs.[17] New home sales were up 12.4 percent in July from June and up 31.3 percent from July 2015.[18] With the unemployment rate at 5 percent and with U.S. GDP growing slowly, U.S. homes remain affordable from a historical perspective. In fact, the National Association of Realtors Home Affordability Index, which compares the median income to the cost of the median home, shows affordability to be roughly 15 percent above the 15-year average home affordability. The median monthly mortgage payment was 16.3 percent of median income in June, up 15.7 percent in May and slightly higher than the June 2015 level of 16.1 percent.[19] Mortgage performance also remains strong. New defaults were essentially unchanged at a 0.66 percent annual rate in July, but defaults are down from the 0.80 percent level in July 2015.[20] We expect continued improvement in mortgage credit performance amid an environment of low unemployment low, a slowly improving economy and home prices that are still recovering from the mortgage crisis almost 10 years ago.

CMBS spreads were mixed in August with cash CMBS 5-10 bps tighter, and synthetic CMBX slightly wider during the month. CMBS performance in 2016 has varied depending on positioning in the capital structure. AAA-rated CMBS are 25-30 bps tighter in 2016, while BBB CMBS are 40-75 bps wider for the year.[21] New CMBS issuance increased in July with $7 billion in total issuance during the month. Year-to-date issuance remains lighter than initially anticipated with roughly $39 billion issued through the first eight months of the year. We are on pace for $55 billion to $60 billion in issuance in 2016, which would be roughly half of the issuance that was initially anticipated for the year.[22] CMBS spreads are wider in aggregate in 2015 and 2016, and the financing efficiency of commercial mortgage securitization has been reduced as a result. Fundamentally, CMBS performance remains on solid ground. Commercial real estate prices were essentially flat in July, but are up 6.3 percent over the course past 12 months. After several years of 10-plus percent annual increases, the pace of commercial real estate price increases is slowing, but the trajectory remains positive. Commercial real estate prices are 25.8 percent above the previous peak in August 2007.[23] Retail sales were flat in July but are up 2.3 percent from July 2015. Total retail sales over the past three months were up 2.5 percent from the same three-month period in 2015.[24] Personal income increased 0.4 percent and personal spending rose 0.3 percent in July, helping support the retail sectors of CMBS.[25] Consumer confidence surged to a 12-month high in August, with The Conference Board Index reporting on Americans' views of the economy and labor market rising from 96.7 to 101.1, while the University of Michigan Consumer Sentiment index was essentially unchanged at 89.8.[26] Hotel occupancy rates in July were slightly lower at 74.4 percent versus July 2015 at 75.3 percent, but occupancy rates remain near the highest levels seen over the past 15 years, and are up 4.5 percent from 2011.[27] National office vacancy rates decreased to 13 percent in second-quarter 2016, the lowest level seen since the first quarter of 2008.[28] Multifamily vacancy rates decreased in second-quarter 2016, and are very near the lowest levels seen over the past 13 years.[29] While price volatility and supply-demand dynamics for CMBS continue to cause some concerns, the fundamental real estate market conditions underlying CMBS market appear to be stable.

European MBS spreads were 15-30 bps tighter for non-ECB eligible assets in August and have now reverted back to pre-Brexit levels.[30] ECB eligible ABS spreads were unchanged in August and are 5-15 bps tighter in 2016. ECB ABS purchases remain slow with the ECB adding roughly €850 million European ABS in July, bringing the net ECB holdings to €20.4 billion of European ABS.[31] European ABS issuance was moderate in August, with roughly €7.2 billion in new securitizations during the month. The 2016 year-to-date securitization issuance totals €54.2 billion, behind the 2015 level of €55.4 billion through August 2015.[30]

[15] Source: Federal Reserve Bank of New York. Data as of August 31, 2016.

[16] Source: S&P Case-Shiller U.S. National Home Price Index. Data as of August 31, 2016.

[17] Source: National Association of Realtors. Data as of August 31, 2016.

[18] Source: US Census Bureau and HUD. Data as of August 31, 2016.

[19] Source: National Association of Realtors. Data as of August 31, 2016.

[20] Source: S&P/Experian First Mortgage Default Index. Data as of August 31, 2016.

[21] Source: Barclays. Data as of August 31, 2016.

[22] Source: Deutsche Bank. Data as of August 31, 2016.

[23] Source: Green Street. Data as of August 31, 2016.

[24] Source: U.S. Department of Commerce. Data as of August 31, 2016.

[25] Source: Bureau of Economic Analysis. Data as of August 31, 2016..

[26] Source: The Confidence Board and University of Michigan. Data as of August 31, 2016.

[27] Source: Statistica.com. Data as of August 31, 2016.

[28] Source: CBRE. Data as of August 31, 2016.40 Source: National Association of Realtors. Data as of August 31, 2016.

[29] Source: U.S. Census Bureau and National Association of Home Builders. Data as of August 31, 2016.

[30] Source: Deutsche Bank. Data as of August 31, 2016.

[31] Source: European Central Bank. Data as of August 31, 2016.

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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 **J.P. 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

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diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The **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 US 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). **UK 10YR govt bonds**—UK 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 **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 **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. 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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