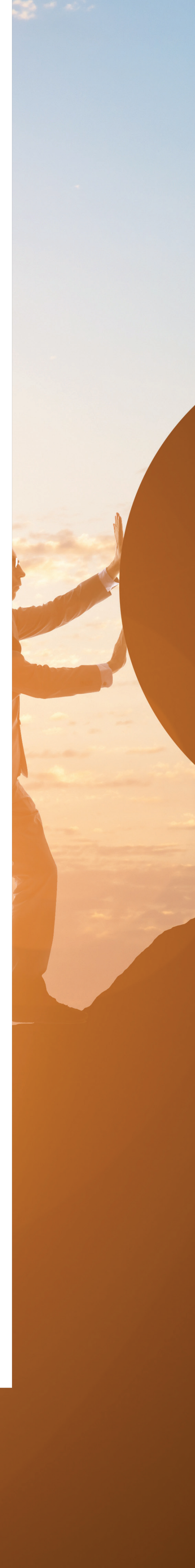
Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Central Banks Poised to Keep the Expansion Rolling

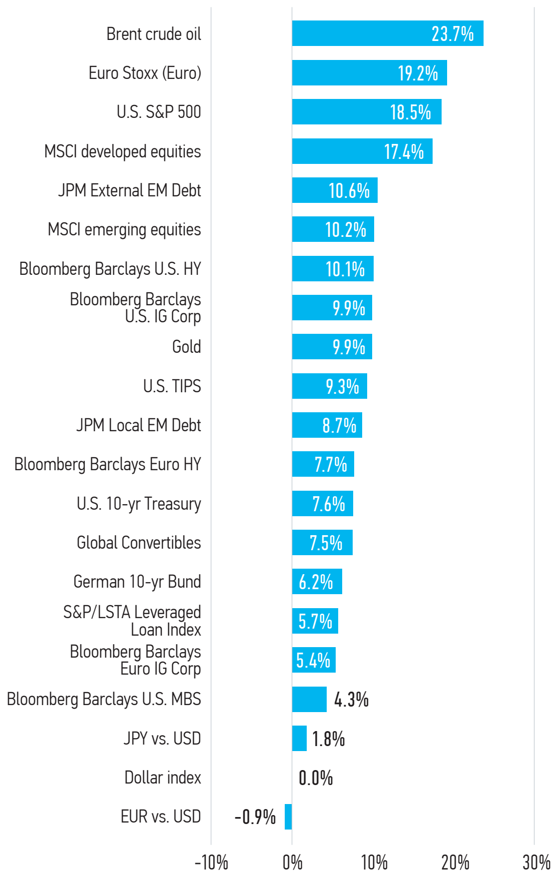
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JULY 2019



What an extraordinary month June was. Virtually every financial asset generated a positive return. This is a very rare occurrence and even more extraordinary as it occurred with economic data deteriorating and disappointing across the globe. What gives? Central banks are what gives. The European Central Bank (ECB) and the U.S. Federal reserve (Fed) independently signaled their willingness to do a *volte face* and emphasize downside economic risks, significantly changing the likely direction of monetary policy. When it was hard to out-dove markets, these two central banks did it. And guess what? Financial markets loved it. Despite weak data, something credit and equities should not have liked, markets rallied. All of them, almost indiscriminately. Even the dollar took a tumble as risk premium vanished, as well as the U.S. yield advantage. By suggesting monetary easing was imminent BEFORE a recession hit (or was about to hit) these two central banks hit the sweet spot: what we mean by that is that their surprising dovishness did not panic markets (e.g., well, if the Fed is that worried maybe so should I). Instead, the cavalry was coming, in time to save the day.

We cannot emphasize enough the unusualness of this market performance. It is emblematic of a market unprepared for the cavalry to arrive and underinvested in everything. It also did not hurt that Presidents Trump and Xi managed to call a truce on their trade dispute. Now the hard part: The Fed and the ECB have to deliver. And, after they do, it has to work! Just because policy rates, yields and spreads go down doesn't mean the economy must do better. This is not physics. What has to happen is that spending goes up. And this means companies have to reverse their declining investment plans and keep hiring, and consumers have to keep spending, and the trade war cannot heat up again, and we can't have a hard Brexit. A long list. It is unclear how far yields and spreads will have to fall to trigger a stabilization and rebound in business confidence and spending. What we are sure about is that central banks, even if their policy tool box is getting threadbare, will go out guns blazing, meaning they will do all in their power to insure this expansion does not end this year or next. So far we agree with that prognosis given their abrupt change of mind.

DISPLAY 1
Asset Performance Year-to-Date

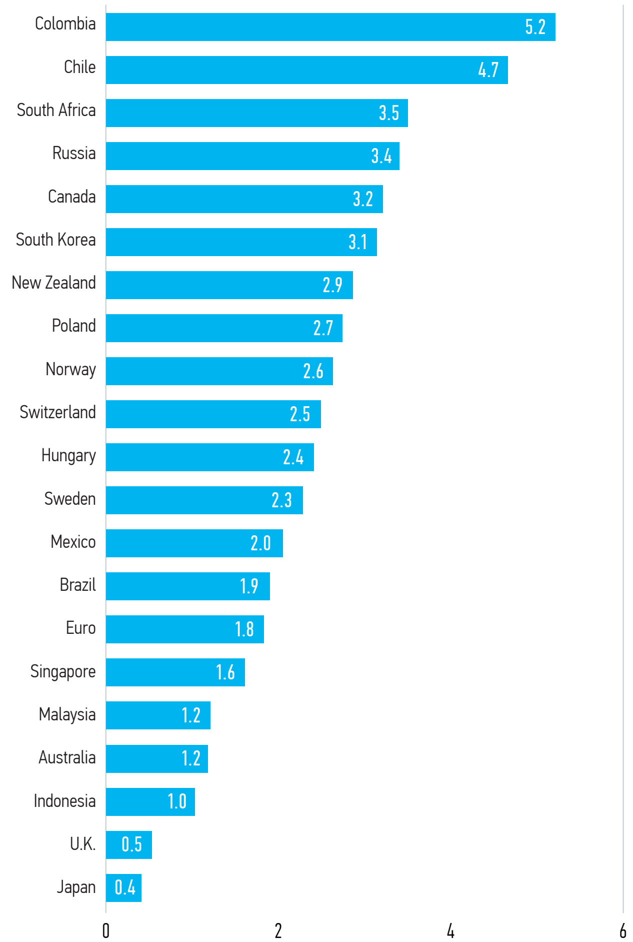


Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of June 30, 2019. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 6 and 7 for index definitions.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data, as of June 30, 2019. Note: Positive change means appreciation of the currency against the USD

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spreads

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)	
United States	2.01	-12		
United Kingdom	0.83	-5	-117	+7
Germany	-0.33	-13	-233	-1
Japan	-0.16	-6	-216	+6
Australia	1.32	-14	-68	-2
Canada	1.47	-2	-54	+10
New Zealand	1.57	-14	-44	-2
EUROPE			(Spread over Bunds)	
France	-0.01	-22	32	-9
Greece	2.45	-46	278	-34
Italy	2.10	-57	243	-44
Portugal	0.48	-33	80	-21
Spain	0.40	-32	72	-20
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			364	-27
EM Local Yields	5.71	-35		
EM Corporate Spreads			292	-27
Brazil	6.88	-78	232	-35
Colombia	5.77	-40	181	-31
Hungary	1.63	-19	90	-30
Indonesia	7.46	-62	187	-25
Malaysia	3.63	-16	128	-6
Mexico	7.59	-55	329	0
Peru	4.85	-35	124	-24
Philippines	4.87	-21	79	-19
Poland	2.07	-13	39	-27
Russia	7.28	-41	206	-21
South Africa	9.21	-18	283	-43
Turkey	16.92	-318	478	-69
Venezuela	–	–	8867	+3289
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			115	-13
EUR IG			112	-16
U.S. HY			377	-56
EUR HY			307	-98
SECURITIZED				
Agency MBS			79	-6
U.S. BBB CMBS			253	+5

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of June 30, 2019

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Fixed Income Outlook

Our hope that central banks around the world would realize the precarious situation the global economy was headed towards was rewarded. With the ECB and Fed signaling ease, and the Reserve Bank of Australia cutting rates, we are more confident that market pricing of credit and government bonds, both developed and emerging, is not wrong. Anticipating good things happening, yes, but the probability of those good things happening is now much higher than in May.

But, here's the caveat. Central banks need to deliver. And not in a drip feed way. They need to impress. Can they do it? Of course. Will they? We will have to wait and see. We are cautiously optimistic. Global manufacturing business surveys have fallen for fourteen months in a row. This needs to stop. Will it? Not sure. Global trade disputes layered onto other more mundane issues such as China's rebalancing of its economy and fostering deleveraging make it a challenge. Cutting rates, additional quantitative easing all help (we think!), but you can't force companies and households to borrow. That takes renewed confidence about the future. If these trade disputes go on and on, there will be no reason for companies to unleash their "animal spirits." What do we need to look out for? On the bullish side, we need to see business confidence improve. On the bearish side, the reverse! In the 2015 slowdown, the service sector held up well, buoyed by a strong consumer. The spillover from manufacturing to non- manufacturing did not happen. We need to see the same now. If the service sector slows, we might see firms reducing employment, undercutting household confidence and initiating a negative spiral of slower growth, slower hiring, etc.

Surprisingly, to us at least, we have not changed our views on the merits of various markets around the world or sector positioning. This is primarily due to the fact that our views on the likelihood of central banks delivering easier policy have become more confident. Diversified overweight positions in Australia, New Zealand, Spain and Greece, still look good. More modest overweights in investment grade and high yield also make sense given the likelihood that central banks, at a minimum, should be able to stave off recession. Yes, spreads are tighter, but with government bond yields quickly evaporating around the world, credit markets are big enough to take their place. Securitized credit still looks like a relatively safe harbor in a fragile, volatile and uncertain world, and thus is our large overweight.

Emerging markets also benefit from the change of direction of developed country monetary policy. While a weaker global economy and reductions in global trade volume are not good, significantly easier financial conditions alongside a weaker dollar provide a very decent backdrop. Of course, local fundamentals remain important. As usual, we prefer countries with steep yield curves and decent fundamentals. This leads to a natural differentiator among countries. To repeat our usual mantra: the right fundamentals at the right price. Mexican and Brazilian rates along with Indonesia are some of our current favorites. In a world increasingly starved of yield, and we mean any yield, emerging markets stand out as places where there still is nominal and real yield. This should lead to continued good performance.

Looking to the future, nimbleness is going to be necessary to navigate increasingly complicated markets. With monetary policy on the move, markets anticipating (rightly or wrongly) big policy moves, trade disputes ever present and elections coming up, investors are going to have to make key decisions about what tradeoffs central banks will make with regard to forestalling recession pressures by preemptive moves (nowadays called "insurance" cuts) and acting too cautiously, letting recessionary forces become too strong to stop.

	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In June, investors centered their attention on global central bank meetings and trade negotiations, as both the highly anticipated June Federal Open Market Committee (FOMC) and the G20 summit were held. While volatility was subdued during the month, the 10-year Treasury fell below 2% for the first time since 2016. Other developed market bonds followed suit as yields continued to fall across the globe, particularly in countries like Spain and Italy. Central banks across the developed markets placed an emphasis on accommodative monetary policy, led by the FOMC and ECB over the course of the month.	U.S. growth is likely to be lower for the remainder of 2019, although stabilizing via easier monetary policy. Central banks have become more accommodative, particularly in the U.S. and eurozone, and we expect that to continue as uncertainty in the geopolitical and economic landscape remains prevalent. We currently see three major risks to the outlook: Brexit, U.S./China trade disputes and the U.S. presidential elections. Recent speeches from the Fed policymakers give us further confidence that the Fed is committed to being flexible regarding future monetary rate policy. With that being said, at this point we believe multiple "insurance" rate cuts may be warranted over the next twelve months to help lengthen the economic cycle and avoid a recession. And with inflation below the Fed's target level, it's difficult to see why it would not want to do this. In the shorter term, we believe that the U.S. 10-Year Treasury yield is likely to spend a majority of the time between 1.75 and 2.25% for the next several months.
Emerging Market (EM) Rate/FX	A dovish Fed statement and a pause in trade tension escalation helped EM fixed income asset prices post strong gains in the month. The strong month brought year-to-date total returns to the high single/low double-digit range. Within hard currency assets, the high yield segment outperformed the investment grade segment, and sovereigns outperformed corporates, as falling U.S. Treasury yields aided longer-duration assets. EM domestic debt led the way in the month, with a mix of currency strength and local bond performance helping close the YTD performance gap with dollar-denominated debt. Commodity prices were broadly stronger in the period, with oil prices rebounding almost 10% as supply stocks fell and OPEC announced that they would extend their production cuts. Metal prices continued to see strength with supply disruptions supporting the price of iron ore, and gold continuing to gain favor with investors, in part as an alternative to negative yielding government debt. Soft commodities also performed well as coffee, sugar, wheat and soybean prices rose while cotton and cattle prices continued to weaken.	Though downward growth revisions have increased, primarily in Asia and in key Latin American economies (Brazil and Mexico), dovish central banks in developed economies, as well as subdued domestic inflationary backdrops, should allow EM central banks to maintain monetary stimulus. Furthermore, some countries with prudent fiscal frameworks could support dwindling growth via more active fiscal policy. We also remain optimistic on structural reforms in several EM countries. For example, we expect a successful social security reform in Brazil that, despite some dilution, will achieve sizable savings in the next 10 years, and improve the country's debt dynamics. Policy continuity in countries such as India and Indonesia (and, also in the Philippines, after local election that favored incumbent President Duterte) should also be supportive of economic growth and reforms. On the negative side, the failure of global trade to pick up and/or a more pronounced slowdown in China's activity could be detrimental to trade-intensive EM economies. Finally, presidential elections in Argentina could add to volatility, though the latest political developments and the FX stability have contributed to improving the reelection odds of market-friendly President Macri.

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	MONTHLY REVIEW	OUTLOOK
Credit	Corporate bonds performed well in June, as risk appetite returned on the back of hopes for U.S.-China progress. Spreads tightened in June as quickly as they widened in May amid dovish turns by the Fed and ECB as well as U.S.-China trade optimism. The Bloomberg Barclays U.S. Corporate Index closed 14 basis points (bps) tighter in June to end the month at 114 bps over government bonds, with longer dated and LT2 financial credits outperforming.[1] High yield spreads tightened 56bps to end the month at 377 and yields fell 70bps to 5.87%.[2] U.S. Investment Grade Index generated an excess return of +2.45% in June with YTD returns of +3.91% while high yield returned 2.28% in June, bringing total YTD returns to 9.94%.[3]	Our strategy has been to take profits on long-held positions as spreads move below the long-run average and that triggered profit-taking in the month but we remain net long risk looking to be tactical over the coming quarter. While valuations got richer following strong performance in the first half of 2019, the risks of recession remain. Uncertainty around global trade and weaker growth make the short-term outlook for corporate earnings less clear. Our base case does not call for a recession; rather, we expect continued low global growth and low inflation, supported by low real rates and easy financial conditions. We are carefully monitoring the incoming economic data (with heightened focus on employment trends) as well as comments from central banks to see if the central bank economic put (such as another quantitative easing program in Europe) will be rekindled, which would likely quickly reinforce market confidence.
Securitized	The Bloomberg Barclays U.S. MBS Index was up 0.72% in June but underperformed the Bloomberg Barclays U.S. Treasury Index which was up 0.92%, as MBS durations shortened as interest rates declined.[4] Current coupon agency mortgage backed securities (MBS) nominal spreads widened 2 bps in June to 87 bps above interpolated U.S. Treasuries.[5] The duration of the Bloomberg Barclays U.S. MBS Index shortened by nearly a quarter of a year to 3.15 years during June, as mortgage prepayment speeds are expected to accelerate as a result of lower mortgage rates.[6] National mortgage rates were 23 bps lower in June, ending at 3.80%, down 103 bps from November.[7] Lower coupon agency MBS outperformed higher coupon MBS as prepayment concerns have a greater negative impact on the higher coupon MBS. The Fed MBS portfolio shrank by $23 billion during June to $1.533 trillion and is now $104 billion lower year-to-date.[8]	While we are becoming more cautious on both interest rate risk and credit risk at current levels, we still believe that securitized fundamental credit conditions will remain positive and that credit-sensitive mortgage and securitized assets will continue to perform well. We have reduced our underweight in agency MBS given its underperformance year-to-date makes it now more attractive on a risk-adjusted basis, even if we still have concerns about faster prepayments and supply pressure from the Fed. We remain moderately positive on residential mortgage-backed securities (RMBS) as we are positive on the U.S. housing market and residential credit conditions. We have reduced our positioning in commercial mortgage-backed securities (CMBS), but we believe the CMBS market remains very idiosyncratic in terms of its opportunity set and risk profile. In U.S. asset-backed securities (ABS), we continue to have a positive outlook on consumer credit sectors, as consumer balance sheets are in good shape due to low unemployment, increasing wages, higher savings rates, and consumer confidence levels that remain high by historical comparison. Total consumer debt remains at a reasonable level, interest rates remain historically low and credit card utilization rates are near the lowest levels in 20 years. In European RMBS, we are constructive on residential real estate credit conditions, despite the volatile political environment.

[1] Source: Bloomberg Barclays, data as of June 30, 2019

[2] Source: Bloomberg Barclays, data as of June 30, 2019

[3] Source: Bloomberg Barclays, data as of June 30, 2019

[4] Source: Bloomberg, as of June 30, 2019

[5] Source: JP Morgan, as of June 30, 2019

[6] Source: Bloomberg, as of June 30, 2019

[7] Source: Bloomberg, as of June 30, 2019

[8] Source: Federal Reserve Bank of New York, as of June 30, 2019

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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.

DEFINITIONS

R* is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate.

INDEX DEFINITIONS

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

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

The **Bloomberg Barclays Global Aggregate Corporate Index** is the corporate component of the Barclays Global Aggregate index, which provides a broad-based measure of the global investment-grade fixed income markets.

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

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

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

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

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

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

The **Hang Seng Index** includes the largest and most liquid stocks listed on the Main Board of the Stock Exchange of Hong Kong.

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

The **ICE BofAML European Currency High-Yield Constrained Index (ICE BofAML Euro HY constrained)** is designed to track the performance of euro- and British pound sterling-denominated below investment-grade corporate debt publicly issued in the eurobond, sterling

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

The **ICE BofAML U.S. High Yield Master II Constrained Index (ICE BofAML U.S. High Yield)** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred-interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default domestic or euro domestic markets by issuers around the world.

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

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

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

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

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

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

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

JPY vs. USD—Japanese yen total return versus U.S. dollar.

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

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

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

The **MSCI All Country World Index (ACWI, MSCI global equities)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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

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

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

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

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

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

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

Spain 10-Year Government Bonds—Spain Benchmark 10-Year Datastream Government Index.

The **Thomson Reuters Convertible Global Focus USD Hedged Index** is a market weighted index with a minimum size for inclusion of $500 million (US), 200 million euro (Europe), 22 billion yen, and $275 million (Other) of convertible bonds with an equity link.

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

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

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