Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Moving Past the French Election

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

Outlook

- With key French elections behind us, term premium in European risk-free rates, which had been excessively low, should rise barring any other global shocks. We reduced our duration underweight going into the second quarter but, as political risks faded, we have since begun to shorten duration once again. In the U.S., leading indicators and surveys have been strong and, as such, we expect second-quarter growth to accelerate from a weak first quarter. If this materializes, we believe the Fed would be on track to hike twice more this year, likely starting in June.
- In the U.S., we believe the proposed tax plan and regulatory changes have the right ingredients to lift growth, though it is very likely the time frame for tax reform will be slow. If volatility increases due to uncertainties in the fiscal debate, we see it as an opportunity to position for upside surprises later in the year and into 2018.
- We think that steeper developed market yield curves warrant the shortening of duration exposures and an overweight to higher-yielding currencies/countries that have attractive characteristics. For EM growth, the benefit of higher U.S. growth is likely to be offset partly by the risks of a potentially more protectionist U.S. trade agenda. Fairly closed economies enjoying limited current account deficits, such as India, are likely to remain rather uncorrelated to global financial conditions and should continue to perform well. The Mexican peso will likely remain the main shock absorber to U.S. trade protectionism shocks, though we believe a renegotiation of NAFTA is the most likely scenario, and Mexico is otherwise on an improving trend.
- In U.S. credit markets, we anticipate a continued grind tighter in spreads toward cycle lows. In investment grade, we remain constructive on financials with a bias toward subordinated debt, marginally constructive on BBB non-financials, and we remain less constructive on A-rated non-financial risk. We continue to seek opportunities in the high-yield and convertible bond markets, which are sectors that tend to perform better in the latter stages of the business cycle.
- We continue to underweight agency MBS due to their historically tight nominal and option-adjusted spreads as well as the increasing risk that the Fed may decide to discontinue the reinvestment of MBS paydowns.

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After a quarter of rising market optimism, the markets began focusing more on political risks in April. For much of the month, investors reduced risk in anticipation of a close French election, with the risk of Marine Le Pen becoming president. U.S. Treasuries and bunds yields declined while French and periphery spreads, as well as corporate spreads, widened. However, centrist candidate Macron won the first round and is likely to win the final round, polling with a 20 percent lead over Le Pen. The market-friendly outcome led markets to reverse in the last week of April; yields rose, spreads tightened.

We had reduced risk into April in anticipation of political risks. With the key bottleneck of French elections behind us, term premium in European risk-free rates, which had been excessively low, should rise. Fundamental-wise, the Euro Area inflation and growth have been improving while the European Central Bank (ECB) has indicated it will be gradual in reducing monetary accommodation, which should support growth and higher yields. We used the good outcome of the French elections as an opportunity to reduce interest rate risk.

In the U.S., market optimism has been cooling. Q1 gross domestic product (GDP) in the U.S. was weakened, driven by lower personal consumption. To be clear, first-quarter weakness has been a pattern for the past few years, so we would not read too much into it. As such, we expect payback in growth in the second quarter from consumption and inventories. Leading indicators and confidence surveys have been strong. Notably, business investment, a weak link in this recovery/expansion began to recover in Q1, contributing positively to growth. Importantly, capex surveys indicate it should stay strong in Q2. We believe the Federal Reserve (Fed) is on track to hike twice more this year, likely starting in June. Markets currently price a 60 percent chance of a June hike (prior to employment data release on May 5).

The new U.S. administration has found it challenging to deliver on campaign promises bringing in to question the reflation optimism that has been driving the strength in financial assets. Reflation hopes are centered on the passage of fiscal reform, which if successfully executed could be reflected in stronger U.S. growth for the second and third quarters. The Trump administration released an ambitious tax plan in April. Key points include reducing the personal tax rate brackets to 3, eliminating most deductions except mortgage interest and charity, reducing the corporate tax rate to 15 percent, and moving to a territorial-based corporate tax system. Given the realities of Washington and a renewed focus on health care reform, it might not be until 2018 that tax legislation is actually passed.

The Trump agenda has also focused on regulatory reform as a means to raise growth and employment. Lowering corporate tax rates can bolster U.S. tax competitiveness and incentivize more capex, one of the key missing ingredients to a stronger economy. Reducing the top personal income bracket aids small business owners, who will then be better positioned to hire more workers. Since these firms have historically been the primary source of job growth, reforming this piece of the tax code could stimulate job creation in many parts of the country that have been relatively starved of jobs and income. Regulatory changes are another form of stimulus and President Trump continues to appoint people to reduce the regulatory burden wherever possible. For instance, new regulators will likely ease compliance requirements for Dodd-Frank, which could allow smaller banks to ease credit lending standards. We believe the tax plan and regulatory changes have the right ingredients to lift growth though it is very likely the time frame for tax reform will be slow. If volatility increases due to uncertainties in the U.S. fiscal debate, and pessimism holds sway, we would see this as an opportunity to position for growth upside into 2018.

Developed Market Interest Rates and Currency Outlook

Without a realization of better economic data, we see 10-year yields trading within the ranges established this year. Better-than-expected growth, which hinges partly on the new policy mix under Trump, would drive "fair value" higher, though conversely, disappointments would drive rates lower. We have reduced our duration underweight going into Q2 but as political risks fade, we have gotten shorter in duration since the first round of the French elections.

Headline inflation rose in the Euro Area though political risks pushed down core Euro Area yields. However, in the first quarter, improving growth and inflation dynamics could raise market expectations of ECB tapering, which would increase risk premium and steepen yield curves. We are thus slightly negative on eurozone interest rate risk on valuation grounds and improving economic performance. In peripheral eurozone, populist political risks have pushed spreads higher and have led to what we consider to be mispricings relative to economic and political fundamentals, such as in Spain and Portugal.

In terms of currencies, the U.S. dollar is likely to move sideways in the months ahead as growth around the world matches or exceeds that in the U.S. It is likely to rise against select currencies where valuation and interest rate dynamics are supportive. We have overweight exposure to the Swedish kroner, Brazilian real, Mexican peso, Indonesian rupiah, Indian rupee and the Russian ruble and underweights in the U.S., Canadian and Australian dollars. Increasing global skepticism around monetary policy effectiveness will likely make it difficult for Sweden's Riksbank to ease further, while economic growth is at an above-trend pace. Emerging market currencies also look interesting in a more robust global growth world. However, Trump's protectionist agenda will remain a source of volatility. The upcoming general election in the U.K. has changed the balance of risks around

Brexit, since supporters of soft Brexit could gain power in government. This is positive for the pound and, as such, we exited our underweight in the Pound as a result.

Emerging Markets Outlook

Looking forward, we remain of the view that developed market (DM) yields will continue to support the "right" carry opportunities, a strategy of borrowing at a low interest rate and investing in a higher return asset, and that the improving macroeconomic backdrop will be an ongoing "push" factor of inflows into higher-yielding assets, including emerging markets (EM) fixed income. For global growth, the benefit of higher U.S. growth is likely to be offset partly by the extent of a potentially more protectionist U.S. trade agenda. However, the net effect will not be known for a while, with Mexico and China remaining in focus. What seems to be a little clearer is, despite the tension, is that cooperation between the new president and the more traditional trade-friendly wing of the Republican Party will likely temper the protectionist agenda. Consequently, NAFTA repudiation fears have declined as renegotiation seems more likely. The EM/DM growth differential has stabilized and appears to be recovering in favor of EM as the negative growth impacts from Brazil and Russia lessen. China's growth slowdown is likely to continue in the medium term, with better-than-expected short-term growth likely to be shortly challenged by a tightening in financial conditions.

Against this backdrop, there will be winners and losers in emerging markets. An overvalued U.S. dollar with downside potential combined with higher commodity prices should support commodity-exporting countries that still benefit from improving fundamentals and a significantly undervalued exchange rate, while commodity-importing countries that run large current account deficits are likely to underperform despite attractive carry cushions. Fairly closed economies enjoying limited current account deficits, such as India, are likely to remain rather uncorrelated to global financial conditions. The Mexican peso will likely remain the main shock absorber to negative U.S. trade protectionism. Gradual clarity on NAFTA has allowed the peso to recover from its weakest levels, but uncertainty remains.

We think that steeper DM yield curves warrant the shortening of duration exposures with a focus on higher-yielding currencies/countries that have attractive characteristics, given the change in global growth and trade outlook post the U.S. elections. We remain optimistic about the prospects for EM fixed income spreads for 2017 as country fundamentals and the macroenvironment remain supportive, with those countries that rely most on global trade potentially challenged. The various factors both pushing and pulling investors into EM fixed income remain in place: developed market yields remain very low, economic data in EM appears to be recovering, Fed rate hikes are likely to remain gradual, U.S. protectionism fears have eased, and concerns of a sharp slowdown in China have diminished. We believe that EM assets could well absorb multiple Fed rate hikes in 2017 if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty from Trump or Fed hawkishness, and European elections also pose potential downside risks.

Credit Outlook

Credit markets were strong around the globe in the month of April despite intra-month rate volatility, equity volatility and headline risks. The U.S. and European investment-grade and high-yield markets posted good results for the month, as President Trump's tax reform, the market-friendly outcome of the first round of the French election both, and strong earnings across the globe bolstered equity markets and led credit higher.

In U.S. credit markets, we anticipate a continued grind tighter toward cycle lows, as spreads are poised to continue to perform from current levels, technicals are generally supportive of the asset class and fundamentals are stable. In investment grade, we remain constructive on financials with a bias toward subordinated debt, we remain marginally constructive on BBB non-financials, and we remain less constructive on A-rated non-financial risk. We continue to seek opportunities in the high-yield and convertible bond markets, which are sectors that tend to perform better in the latter stages of the business cycle. In Europe, we expect that European investment-grade and high-yield credit will be well supported by ECB and Bank of England (BoE) corporate bond purchases. We anticipate that the ECB will continue to maintain its current policy mix of an easing bias via quantitative easing and a negative deposit rate to target higher inflation and a weaker currency. Political uncertainties remain the major risk to our constructive views, as we await political outcomes in Italy, France and Germany in 2017. In the U.S., political headlines continue to loom as we await further policy changes and clarifications under the new Trump administration.

Securitized Outlook

Our outlook remains largely unchanged from March: we remain overweight mortgage credit opportunities and underweight more rates-based risks of agency mortgage-backed securities (MBS). Agency MBS have performed reasonably well over the last few months as the market volatility has subsided and interest rates seem to have settled into a new range. If rates remain range-bound, both prepayment and extension risks would likely be relatively subdued, and agency MBS could outperform. However, we believe that interest volatility will likely increase as the Fed continues their interest rate hikes, and that this potential increase in volatility could cause agency MBS to underperform similar to their performance this past November and December. Although agency MBS is one

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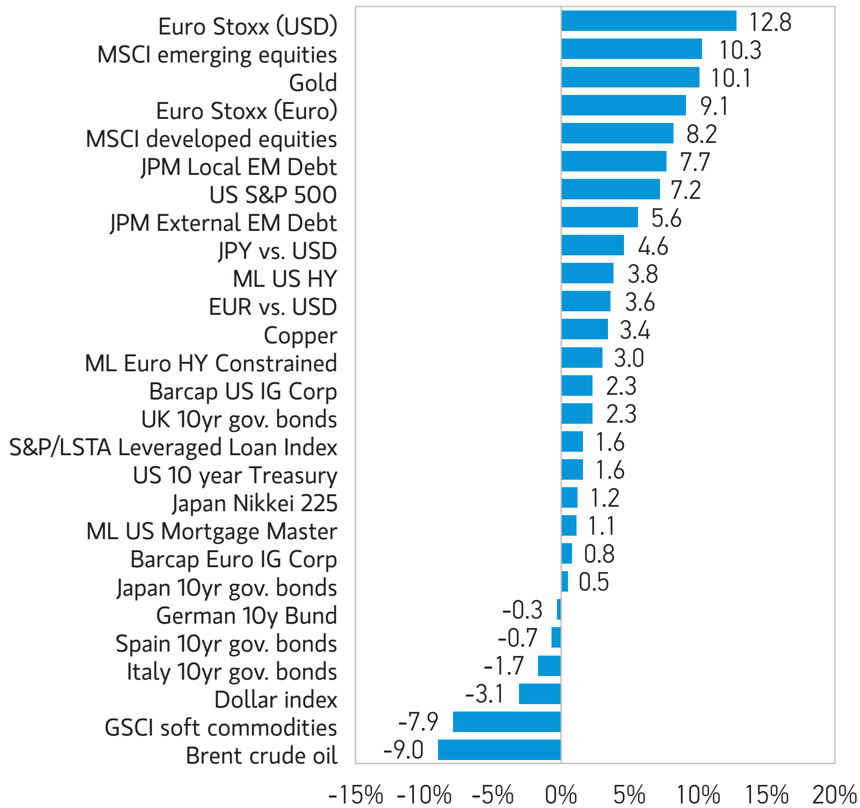
of the few securitized sectors that have not experienced material spread tightening over the past couple years, we remain cautious given both the currently marginal overall value opportunity and the potentially negative supply-demand dynamic if the Fed ends their portfolio reinvestment. Additionally, agency MBS have experienced mediocre returns over the past two years, and 2017 is off to a modest start relative to other asset classes, and thus we do not expect to see material increases in demand unless the sector cheapens and the value opportunity improves.

Non-agency MBS remains one of the more stable and attractive fixed income asset classes in our opinion. Given the attractive carry, improving fundamentals and shrinking net supply, we remain overweight the non-agency MBS sector. Non-agency MBS spreads have tightened roughly 50 basis points (bps) in 2017, but we remain positive given the still-attractive carry and improving fundamental conditions. Overall, we remain positive on the U.S. housing market given the modest strength of the economy, continued low mortgage rates and above-average home affordability. From a supply perspective, we project outstanding non-agency MBS to decline by $60-$70 billion in 2017, while new securitizations are projected to only amount to $25-$30 billion.

DISPLAY 1

Asset Performance Year-to-Date

Data as of 4/28/2017



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of April 28, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 11 and 12 for index definitions.

The commercial mortgage-backed securities (CMBS) market has become a tale of two markets, where securities with significant retail exposure have performed poorly while all other CMBS collateral types have been performing well. The numerous recent announcements of retail store closings have raised concerns over the future viability of many shopping malls, and CMBS, with significant retail exposure, has come under pressure as a result this year. While we believe that many malls will fail; possibly as much as 20 percent of all traditional indoor shopping malls, we also believe that most malls will remain profitable and will not represent a significant credit risk. Additionally, we believe that local population demographics, property-specific store composition, regional competition from other malls and the financial strength of the property sponsor are the primary determinants of which malls are most likely to succeed. The increasing distress in this market represents both a significant risk and a significant opportunity, and we believe that careful security selection can prove to be beneficial. Non-retail CMBS, namely securitizations backed by hotels, office buildings, industrial facilities and multifamily rental apartments, have generally been performing well with improving occupancy rates, rental rates, net-operating incomes and corresponding rising property valuations. The pace of commercial real estate price appreciation has slowed over the past year, but the trajectory remains positive for these property types. We remain positive on these asset classes, given the overall strength of the economy and stability of rates. CMBS supply has been moderate—supported by the refinancing of large number 2007-vintage loans but also somewhat constrained by the new CMBS risk-retention securitization requirements. Beginning in 2017, the issuers of CMBS securitizations are required to retain a 5 percent position in their deals. This requirement seems to have limited some of the potential CMBS securitization volumes.

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In Europe, we maintain a moderate overweight outlook for MBS and CMBS. Spreads remain tighter than pre-Brexit levels; although, we believe fundamental conditions have more uncertainty in the wake of the Brexit vote and given the political uncertainty in other parts of Europe. Overall, we remain positive on the sector given the belief that the ECB and BoE will continue to keep interest rates low for the foreseeable future, and that both the European economies, and more importantly the respective real estate markets, will benefit from these accommodative policies. Home prices were higher across nearly all of Europe for the second straight year, strengthened by low mortgage rates and slowly improving economies. New residential mortgage-backed security (RMBS) and CMBS issuance remains disappointingly light in Europe, but we are still finding a number of attractive seasoned opportunities. As long as the fundamental conditions remain positive with low rates and rising real estate prices, we continue to like the European RMBS and CMBS markets despite the political risks.

Market Summary

In much of April, yields fell across the developed markets as market optimism faded and worries of political risks increased.[1] Yields hit a low point right before French first-round elections, but then rebounded as Emmanuel Macron garnered the most votes. The dollar weakened against major currencies.

Over the month, 10-year U.S. Treasury yields were down 11 bps, while the 2s/10s curve flattened by 10 bps.[2] Germany's 10-year yield decreased 1 bp, while the two-year yield increased 1 bp.[3] Ten-year yields in Italy and Spain decreased 4 bps and 2 bps, respectively.[4] A good French election outcome led the riskiest periphery yields to decline. Portuguese 10-year yields decreased 43 bps. Greece's 10-year government yield decreased by 64 bps.[5] The Japanese government bond (JGB) 10-year yield decreased by 5 bps.[6]

Despite Fed tightening, the dollar generally weakened. The euro appreciated by 2.3 percent. The British pound appreciated by 3.2 percent, the biggest winner in the month, triggered by Theresa May's announcement early general elections. The Japanese yen was close to flat, declining 0.1 percent.[7] Talk from the Trump administration of reviving NAFTA renegotiations led the Canadian dollar to decline 2.5 percent, the biggest loser for the month. Crude oil (Brent) prices dropped to $52 from $53.[8]

Developed Markets

In the U.S., the Fed released minutes to the March meeting. In the meeting notes, most members judged that phasing out or ending reinvestment of the Fed's balance sheet is likely appropriate later this year. Data releases were weaker in April than the highs in March. March non-farm payrolls increased 98,000 versus expectations of 180,000.[9] The unemployment rate ticked down to 4.5 percent, below consensus of 4.7 percent, as the participation rate stayed at 63.0 percent. Average hourly earnings decreased to 2.7 percent from 2.8 percent previously.[10] The ISM manufacturing index decreased to 57.2 in March, in line with expectations of 57.2. GDP for the first quarter of 2017 was 0.7 percent (quarter-on-quarter annualized), below consensus forecast of 1 percent. Headline CPI decreased to 2.4 percent from 2.7 percent. Core CPI was 2.0 percent for March.[11]

In the eurozone, the ECB kept policy unchanged at the April meeting. ECB President Mario Draghi continues to note that downside risks have further diminished, though the risks to growth are not yet balanced. However, he expects to keep interest rates near present levels for an extended period. In terms of survey data, eurozone manufacturing PMI came in at 56.8 in March, above previous and market expectations.[12] Eurozone inflation was 1.5 percent for March, down from last month.[13]

In the U.K., Prime Minister Theresa May called for early general elections on June 8th. May would like the chance to consolidate her support in Parliament during Brexit negotiations. In terms of data, headline CPI inflation was 2.3 percent year-over-year in March, unchanged from previously and in line with consensus.[14] Core inflation was 1.8 percent, weaker than expectations of 1.9 percent. The unemployment rate's three-month average stayed at 4.7 percent in February. U.K. manufacturing PMI was 54.2 percent in March, below 54.5 in February and consensus expectations.[15]

In Japan, the Bank of Japan (BoJ) kept monetary policy unchanged in the April meeting. The BoJ has increased its assessment of current activity and it forecasts for 2017. The Shunto, spring wage negotiations, led to a 2.02 percent rise in wages, which is slightly above 2016 results of 2 percent. However, it notes downside risks to prices. In terms of data, manufacturing PMI was 52.4 for March, down from 53.3 in February. The March core national CPI (ex-food and energy) was down 0.1 percent, down from February and below consensus of flat.[16]

1 Source: Bloomberg. Data as of April 28, 2017.
2 Source: Bloomberg. Data as of April 28, 2017.
3 Source: Bloomberg. Data as of April 28, 2017.
4 Source: Bloomberg. Data as of April 28, 2017.
5 Source: Bloomberg. Data as of April 28, 2017.
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13 Source: Bloomberg. Data as of April 28, 2017.
14 Source: Bloomberg. Data as of April 28, 2017.
15 Source: Bloomberg. Data as of April 28, 2017.
16 Source: Bloomberg. Data as of April 28, 2017.

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Emerging Markets

The improving macroeconomic environment for EM generated another good month of relative performance. Limited supply from EM issuers and a drop in U.S. Treasury yields also contributed to the favorable backdrop for EM fixed income assets. EM currencies took a breather as the U.S. dollar strengthened and investors took profits on some of the stronger-performing currencies such as the Russian ruble, Colombian peso, Brazilian real and Mexican peso. Local bonds, however, performed well as several central banks, including Russia, Brazil, Colombia and Chile, cut interest rates in support of economic growth as muted inflation and currency strength provided room for monetary easing. Turkey's central bank also tightened monetary conditions by hiking liquidity window rates by 50 bps, brining average borrowing costs up by 25 bps.

South African assets ended the month higher despite a rocky start. A cabinet shuffle by President Zuma put the government's fiscal discipline into question, and rating agencies took notice as S&P downgraded the country's foreign currency rating to BB+ and local currency rating to BBB-, while Fitch cut both the sovereign's foreign and local currency ratings to BB+. With two out of three ratings agencies rating the country's debt at below investment grade, the country's foreign currency debt was removed from investment-grade indexes resulting in forced selling by ratings-sensitive investors. In other ratings actions, El Salvador's foreign currency rating was cut by S&P (CCC-) and Fitch (CCC), respectively, after the country missed a bond payment to a local pension fund.

In Latin America, there was unrest in Venezuela and Paraguay, and a conclusion to the hotly contested presidential election in Ecuador in which the left-leaning candidate Lenin Moreno won. Anti-government protestors took to the streets once again in Venezuela, demonstrating against the country's slide towards authoritarianism. The rolling protests occurred throughout the month and have resulted in at least nine deaths. In Emerging Europe, Turkey's government held a constitutional referendum in which voters narrowly approved a move to a presidential system. The next steps are for the results to be approved, after which the following constitutional amendments will take effect: The President can be affiliated with a political party, military courts will be eliminated, and the members of the High Council of Judges and Prosecutors will be reappointed within 30 days. This election result further consolidates power in the hands of President Erdogan.

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	1.65	-10	2.11	-13	2.58	-13
Belgium	-0.55	-5	-0.16	-7	0.78	-7
Canada	0.72	-3	1.01	-11	1.55	-8
Denmark	-0.58	1	-0.26	-3	0.61	0
France	-0.46	-17	-0.10	-22	0.84	-13
Germany	-0.73	1	-0.39	-1	0.32	-1
Ireland	-0.43	-8	0.17	-10	0.85	-14
Italy	-0.08	-5	1.05	-6	2.28	-4
Japan	-0.21	-2	-0.15	-4	0.02	-5
Netherlands	-0.64	-1	-0.32	-5	0.55	-3
New Zealand	2.08	-6	2.43	-5	3.04	-15
Norway	0.65	-39	0.97	-36	1.63	-1
Portugal	0.43	-19	2.02	-26	3.55	-43
Spain	-0.26	-9	0.44	-6	1.65	-2
Sweden	-0.65	-5	-0.07	-2	0.59	-2
Switzerland	-0.85	1	-0.55	-1	-0.11	-2
United Kingdom	0.08	-5	0.50	-6	1.09	-5
United States	1.26	1	1.81	-11	2.28	-11

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

External

EM external sovereign and quasi-sovereign debt returned 1.63 percent in the month, bringing year-to-date performance to 5.60 percent, as measured by the JP Morgan EMBI Global Index.[17] Higher-yielding, lower-rated credits outperformed lower-yielding, higher-rated credits in the month. Bonds from Venezuela, Argentina, Cote

[17] Source: JP Morgan. Data as of April 28, 2017.

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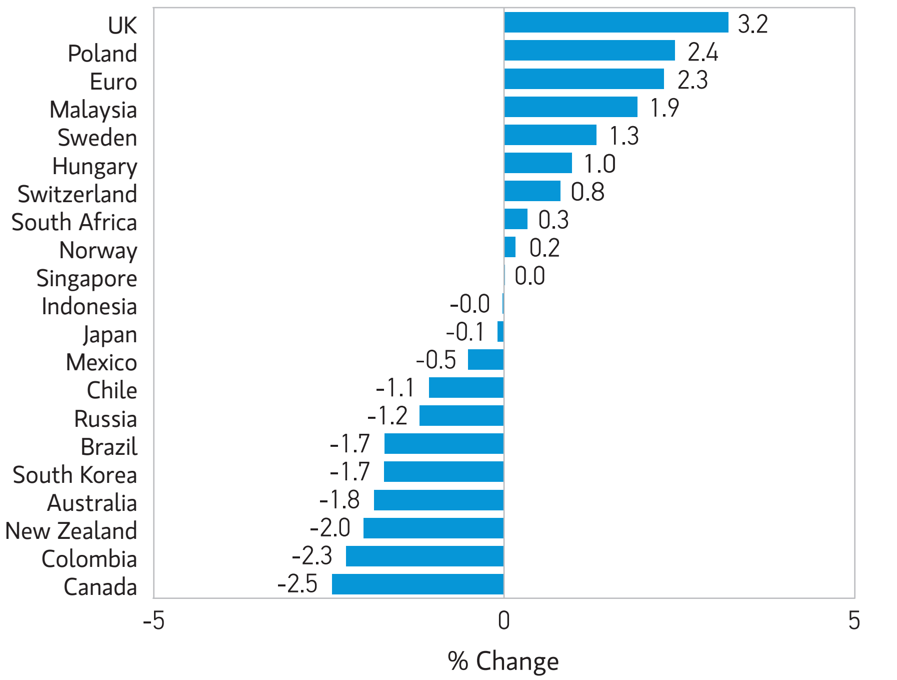
DISPLAY 3

Currency Monthly Changes Versus U.S. Dollar

Currency Monthly Change vs. USD (+ = appreciation)



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

D'Ivoire, Turkey, Zambia, Nigeria, Ukraine and Dominican Republic outperformed the broader market. Conversely, bonds from Bolivia, El Salvador, Trinidad and Tobago, Latvia, China, Indonesia and India underperformed the broader market in the month.

Domestic

EM domestic debt returned 1.17 percent in the month, bringing year-to-date performance to 7.75 percent, as measured by the JP Morgan GBI-EM Global Diversified Index.[18] EM currencies strengthened 0.22 percent versus the U.S. dollar and EM bonds returned 0.95 percent in local terms.[19] Currency performance versus the U.S. dollar weighed on bond performance for Colombia, Russia, Mexico, Thailand, Brazil, Chile and Argentina, while contributing to Euro-linked currencies from Turkey, Czech Republic, Poland, Romania and Hungary. Bonds from Hungary, Indonesia and the Philippines also underperformed the broader market. Conversely, bonds from Turkey, Argentina, Malaysia, Czech Republic, Poland, Romania, Peru and South Africa outperformed the broader market in the period.

Corporate

EM corporate debt returned 1.12 percent in the month, as measured by the JP Morgan CEMBI Broad Diversified Index.[20] Higher-yielding, lower-quality companies outperformed higher-rated companies in the month. From a regional perspective, companies in Latin America (Jamaica, Argentina and Peru), Europe (Croatia) and Africa (Nigeria and South Africa) led the market, while those in the Asia (China, South Korea and The Philippines) and the Middle East (UAE) lagged. From a sector perspective, companies in the Infrastructure, TMT, Consumer and Utilities sectors outperformed the broader market, while those in the Diversified sectors lagged.

Corporate Investment-Grade Credit

Investment-grade corporate bonds ended the month largely unchanged, despite significant movement in the equity and government bond markets. Equities rallied during the course of the month, especially bolstered by Trump's tax proposal at the close of the month. The S&P 500 ended the month up 1 percent.[21] Despite these broader market moves, the U.S. IG Corporate index tightened only 2 bps to close at 116 bps over Treasuries, and posted an excess return of 23 bps.[22] Within investment grade, as we have seen in previous months, sector dispersion was low. Financials marginally outperformed (3 bps tighter), but there were no notable sector moves across the investment-grade universe.[23] On a year-to-date basis, investment-grade spreads are 7 bps tighter for an excess return of 61 bps.[24] At the current level of 116 bps, the IG index is trading exactly at its long-term median.[25]

Throughout the month in investment grade, the markets paid close attention to developments in Washington. President Trump's proposed tax reform may have potential impacts on the corporate bond market, as lowering the corporate tax rate

[18] Source: JP Morgan. Data as of April 28, 2017.

[19] Source: JP Morgan. Data as of April 28, 2017.

[20] Source: JP Morgan. Data as of April 28, 2017.

[21] Source: Bloomberg Barclays. Data as of April 30, 2017.

[22] Source: Bloomberg Barclays. Data as of April 30, 2017.

[23] Source: Bloomberg Barclays. Data as of April 30, 2017.

[24] Source: Bloomberg Barclays. Data as of April 30, 2017.

[25] Source: Bloomberg Barclays. Data as of April 30, 2017.

to 15 percent would support many U.S. corporations, and the tax proposal would potentially repatriate overseas cash. The replacement of the border adjustment tax in favor of a territorial tax system was strongly opposed by the retail, auto and other import-heavy industries, and may negatively impact these sectors. On the idiosyncratic news front, most U.S. banks have announced strong 1Q17 earnings, as we are starting to see the earnings benefits of higher rates. We remain constructive on U.S. banks and expect them to outperform non-financials through the end of the year. We anticipate that telecom mergers-and-acquisitions (M&A) speculation will increase in the coming months as companies look to fill out their product portfolios and expand their access to wireless spectrum.

Investment-grade supply was $60 billion in April, well below the prior four-year April average ($90 billion).[26] Year-to-date, $432 billion has been issued, slightly ahead of the 2016 pace from January-April.[27] New bonds issued in April tightened a weighted average of 6 bps between issuance and the last day of the month.[28]

European investment grade outperformed U.S. investment grade in April despite rate volatility, as a 2 percent rally in European equities created a strong risk-on tone in European credit markets.[29] European investment-grade spreads tightened 7 bps in April.[30] Most of this spread tightening occurred after the outcome of the first round of the French presidential elections. Strong European economic data and a strong start to the earnings season also supported European credit markets. Over the course of the month, subordinated financials, longer maturity bonds and bonds lower down the risk spectrum outperformed. French names outperformed during the month, with sectors dominated by French names (such as Utilities) outperforming. Utilities (10 bps tighter) outperformed Financials (7 bps tighter) and Industrials (7 bps tighter).[31] Within financials, Tier 2 banks and insurance bonds saw strong demand post the first round of the French presidential elections. Corporate hybrids also had a good month, as they saw strong demand from investors. Like in the U.S., European corporates are trading in line with long-term medians.[32]

Euro-denominated investment-grade new issue supply was light in April (driven mainly by calendar effects), which further helped spread compression. In the European investment-grade market, gross issuance totaled €22.8 billion (€15.8 billion in financials and €7 billion in non-financials).[33] Sterling investment-grade gross issuance was strong at £4.6 billion (£1.9 billion financials, £2.8 billion non-financials). Despite the CBPs official end, issuance swung back toward the non-financial sector in April. April's issuance brings the year-to-date figure to £19.3 billion in the sterling space.

DISPLAY 4

EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	264	-16	9.6	-27
Colombia	192	-10	6.5	-32
Hungary	138	-9	2.1	-15
Indonesia	190	-8	7.3	-44
Malaysia	142	12	4.1	11
Mexico	255	-20	7.1	-34
Peru	146	-6	5.9	-33
Philippines	98	0	5.0	9
Poland	86	-2	2.9	-24
Russia	161	-1	7.9	-34
South Africa	269	27	9.4	8
Turkey	314	-18	10.9	16
Venezuela	2377	327	–	–

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

Corporate High Yield

The U.S. high-yield market produced total returns of +1.15 percent in April.[34] With the decline in interest rates, high yield posted an excess return of 0.62 percent.[35] Higher-

[26] Source: JPMorgan. Data as of April 30, 2017.
[27] Source: JPMorgan. Data as of April 30, 2017.
[28] Source: JPMorgan. Data as of April 30, 2017.
[29] Source: Bloomberg Barclays. Data as of April 30, 2017.
[30] Source: Bloomberg Barclays. Data as of April 30, 2017.
[31] Source: Bloomberg Barclays. Data as of April 30, 2017.
[32] Source: Bloomberg Barclays. Data as of April 30, 2017.
[33] Source: Bloomberg Barclays. Data as of April 30, 2017.
[34] Source: Bloomberg Barclays. Data as of April 30, 2017.
[35] Source: Bloomberg Barclays. Data as of April 30, 2017.

DISPLAY 5
Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	116	-2	111	-7
Industrial Basic Industry	146	-2	98	-5
Industrial Capital Goods	90	-2	88	-5
Industrial Consumer Cyclicals	109	+0	103	-7
Industrial Consumer Non-Cyclicals	104	-2	95	-6
Industrial Energy	143	-4	110	-8
Industrial Technology	96	-3	79	-4
Industrial Transportation	111	-2	101	-5
Industrial Communications	153	-2	115	-8
Industrial Other	100	-2	136	-7
Utility Electric	115	+0	107	-9
Utility Natural Gas	118	-3	108	-10
Utility Other	137	-1	103	-4
Financial Inst. Banking	106	-2	108	-6
Financial Inst. Brokerage	116	-4	108	-6
Financial Inst. Finance Companies	114	-5	94	-4
Financial Inst. Insurance	120	-3	215	-15
Financial Inst. REITS	136	-1	122	-11
Financial Inst. Other	0	+0	153	-9

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

quality high yield bonds outperformed lower-quality risk in April. The BB index gained +1.35 percent, the B index gained +1.13 percent and the CCC index gained +66 bps over the course of the month.[36] Excess returns for BB-rated, B-rated, and CCC-rated indexes were +76 bps, +61 bps and +23 bps, respectively.[37] The yield on the high-yield index currently stands at 5.63 percent.[38] Over the course of the month, the high-yield primary market priced $16.2 billion in USD-denominated bonds.[39]

Despite some intra-month volatility, April was a positive month for European high-yield credit. This strength was derived from receding systemic risk over the course of the month. The market-supportive outcome of the first round of the French presidential election led markets higher at the end of the month. In addition, continued supportive rhetoric from central banks, and indications from the governing council that its easy monetary policy is likely to continue further bolstered the high-yield market. The month of April also saw supportive economic data releases and a strong start to the first-quarter earnings season, particularly among banks, which further fuelled the positive sentiment in the market. European high yield saw a number of weeks of negative fund flows early in the month, but this reversed after the result of the presidential election, and mutual funds reported positive flows in the last week of the month. This strong demand saw risk premiums fall sharply and the European High Yield market reported strong excess returns of 1.1 percent for April, with the majority of this return generated in the final week of the month.[40]

Securitized Products

Agency MBS performed modestly in April, while credit-related securitized assets overall continued to perform well. Nominal spreads on current coupon agency MBS tightened two bps in April to 97 bps above interpolated Treasuries; while the option-adjusted spreads (OAS) decreased one bp to 14 bps above interpolated Treasuries.[41] The Bloomberg Barclays Capital U.S. MBS Index was up 0.67 percent in April and finished the first four months of 2017 up 1.14 percent.[42] The Fed purchased approximately $22 billion agency MBS in April in order to maintain their agency MBS portfolio at $1.75 trillion; however, several Fed governors have recently recommended ending the Fed's MBS reinvestment program, and we believe this could happen as soon as the fourth quarter of 2017. The Fed purchased

[36] Source: Bloomberg Barclays. Data as of April 30, 2017.

[37] Source: Bloomberg Barclays. Data as of April 30, 2017.

[38] Source: Bloomberg Barclays. Data as of April 30, 2017.

[39] Source: Bloomberg Barclays. Data as of April 30, 2017.

[40] Source: Bloomberg Barclays. Data as of April 30, 2017.

[41] Source: Yield Book. Data as of April 28, 2017.

[42] Source: Barclays. Data as of April 28, 2017.

almost $400 billion agency RMBS in 2016, and we believe that ending this reinvestment could have a significant negative impact on agency MBS.[43]

Non-agency MBS spreads continued their tightening trend in April, as cash flow and credit performance continued to improve. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.2 percent in February and are up 5.8 percent over the past year.[44] In fact, home prices are up 38 percent nationally from the lows in 2012, and have now surpassed pre-crisis peak levels from July 2006 to set new highs. Existing home sales increased 4.4 percent in March from February, setting a 10-year high with an annualized rate of 5.71 million homes sold, and up 5.9 percent from one year ago.[45] Housing inventory increased slightly, but is still lower year-on-year for the 22nd consecutive month and is down 5.8 percent from a year ago. New defaults were essentially unchanged at a 0.75 percent annual rate in March and are down from the 0.77 percent level in March 2016 and near the lowest levels over the past 10 years.[46] With unemployment low, the economy slowly improving, and home prices still recovering from the mortgage crisis almost 10 years ago, we expect mortgage credit performance to continue to improve.

CMBS performance continues to diverge depending on different collateral compositions. For example, since the beginning of the year, spreads on CMBX six BBB-rated issues (2012 vintage), which have 37 percent retail exposure, are wider by 133 bps, while spreads on CMBX nine BBB-rated issues (2015 vintage), which have only 24 percent retail exposure, are tighter by 30 bps. CMBS deals backed higher concentrations of retail properties actually performed better in April but have still substantially underperformed on the year. The increasing announcements of retail store closings and poor retail earnings are causing credit concerns for many retail properties. New non-agency CMBS issuance slowed in April with only $4 billion in issuance during the month, lifting the 2017 year-to-date total to $16.8 billion. We still anticipate $50 billion to $60 billion in new issuance volumes this year, and year-to-date issuance is currently on pace for the low end of this range. New risk retention regulations that took effect January 1, 2017, are appearing to have a meaningful effect of dampening new CMBS issuance.[47]

Fundamentally, CMBS performance remains on reasonably solid ground. Commercial real estate prices fell 0.4 percent in March and have now been essentially flat for the past six months, but prices are up 3.2 percent over the past 12 months. After several years of 10+ percent annual increases, the pace of commercial real estate price increases is slowing, but the trajectory remains positive. Commercial real estate prices are 26.2 percent above the previous peak in August 2007.[48] Hotel occupancy rates have been essentially flat year-over-year, but remain near the highest levels seen over the past 15 years, and are up more than 5 percent from 2011.[49] Even the retail sectors had positive news in April with Simon Property Group (SPG), the largest U.S. mall operator, announcing positive earnings for Q1 2017 with same-store net operating income (NOI) up 3.8 percent and store occupancy rates remaining unchanged from a year ago at 95.6 percent.[50] With CMBS issuance beginning to slow this year and expected so slow more sharply in 2018, and with underlying real estate fundamental conditions remaining strong (other than retail shopping centers), we expect CMBS to perform well for the remainder of 2017.

European MBS spreads continued their tightening trend in April and are now 20 to 50 bps tighter in 2017.[51] Low interest rates and early signs of economic growth seem to be outweighing any material concerns over Brexit fallout. ECB asset-backed security (ABS) purchases remain slow due to limited supply, and the ECB portfolio increased by only €0.2 billion European ABS in April. The ECB holds €24.3 billion of European ABS as of April 21, 2017.[52]

[43] Source: Federal Reserve Bank of New York. Data as of April 28, 2017.

[44] Source: S&P Case-Shiller U.S. National Home Price Index. Data as of April 28, 2017.

[45] Source: National Association of Realtors. Data as of April 28, 2017.

[46] Source: S&P/Experian First Mortgage Default Index. Data as of April 28, 2017.

[47] Source: Deutsche Bank. Data as of April 28, 2017.

[48] Source: Green Street. Data as of April 28, 2017.

[49] Source: Statistica.com. Data as of April 28, 2017.

[50] Source: Bloomberg. Data as of April 28, 2017.

[51] Source: Deutsche Bank. Data as of April 28, 2017.

[52] Source: European Central Bank. Data as of April 28, 2017.

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Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations** (CMOs), it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

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

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

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

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

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

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

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

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

The **Nikkei 225 Index (Japan Nikkei 225)** is a price-weighted index of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The **U.S. Dollar Index (DXY)** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. **Italy 10YR govt bonds**—Italy Benchmark 10-Year Datastream Government Index. The **MSCI World Index (MSCI developed equities)** captures large and mid-cap representation across 23 Developed Markets (DM) countries. **Spain 10YR govt bonds**—Spain Benchmark 10-Year Datastream Government Index. The **BofA Merrill Lynch European Currency High-Yield Constrained Index (ML Euro HY constrained)** is designed to track the performance of euro- and British pound sterling-denominated below investment-grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world. The **S&P 500® Index (U.S. S&P 500)** measures the performance of the large-cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy. The **JPMorgan Government Bond Index Emerging Markets (JPM External EM Debt)** tracks local currency bonds issued by Emerging Market governments. The index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (excludes China and India as of September 2013). **U.K. 10YR govt bonds**—U.K. Benchmark 10-Year Datastream Government Index. For the following Datastream government bond indexes, benchmark indexes are based on single bonds. The bond chosen for each series is the most representative bond available for the given maturity band at each point in time. Benchmarks are selected according to the accepted conventions within each market. Generally, the benchmark bond is the latest issue within the given maturity band; consideration is also given to yield, liquidity, issue size and coupon. **German 10YR bonds**—Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR govt bonds**—Japan Benchmark 10-Year Datastream Government Index; and **10YR U.S. Treasury**—U.S. Benchmark 10-Year Datastream Government Index.

The **BofA Merrill Lynch U.S. Mortgage-Backed Securities (ML U.S. Mortgage Master) Index** tracks the performance of U.S. dollar-denominated, fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The **S&P/LSTA U.S. Leveraged Loan 100 Index (S&P/LSTA Leveraged Loan Index)** is designed to reflect the performance of the largest facilities in the leveraged loan market. The **Bloomberg Barclays Euro Aggregate Corporate Index (Barclays Euro IG Corporate)** is an index designed to reflect the performance of the euro-denominated investment-grade corporate bond market. The **Bloomberg Barclays U.S. Corporate Index (Barclays U.S. IG Corp)** is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable, corporate bond market. The **Bank of America Merrill Lynch United States High Yield Master II Constrained Index (Merrill Lynch U.S. High Yield)** is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred-interest bonds and payment-in-kind securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default. **JPY vs. USD**—Japanese Yen total return versus USD. **Euro vs. USD**—Euro total return versus USD. **MSCI Emerging Markets Index (MSCI emerging equities)** captures large- and mid-cap representation across 23 Emerging Markets (EM) countries. The **MSCI AC Asia ex-Japan Index (MSCI Asia ex-Japan)** captures large- and mid-cap representation across two of three Developed Markets countries (excluding Japan) and eight Emerging Markets countries in Asia. The **S&P GSCI Softs (GSCI soft commodities) Index** is a sub-index of the S&P GSCI that measures the performance of only the soft commodities, weighted on a world production basis. In 2012, the S&P GSCI Softs Index included the following commodities: coffee, sugar, cocoa and cotton. The **Dow Jones Commodity Index Gold (Gold)** is designed to track the gold market through futures contracts. The **JPMorgan Government Bond Index—Emerging Markets (JPM local EM debt)** tracks local currency bonds issued by Emerging Market governments. The index is positioned as the investable benchmark that includes only those countries that are accessible by most of the international investor base (excludes China and India as of September 2013). The ICE Brent Crude futures contract **(Brent crude oil)** is a deliverable contract based on EFP delivery with an option to cash settle. The **S&P GSCI Copper Index (Copper)**, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark for investment performance in the copper commodity market.

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