INVESTMENT MANAGEMENT

Morgan Stanley

COMMENTARY | AUGUST 2016

Global Fixed Income Bulletin

Policymakers to the Rescue

Outlook

- Brexit ushered in coordinated global central bank easing, which was unexpected, but should support risky asset prices and spread tightening going forward. We see sovereign yields trading in a range. Any normalization in term premia would push up yields but slow growth and political risks could continue to periodically drag down risk-free government bond yields. Policy easing and relatively stable risk-free rates make us positive on carry products. We remain modestly underweight U.S. duration although overweight elsewhere, particularly in emerging markets (EM).
- Although EM fixed income has posted strong year-to-date returns, we remain optimistic about its prospects for the remainder of the year as fears of a Federal Reserve (Fed) rate hike 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 decreased China fears will likely remain the main drivers of asset price performance in the third quarter of 2016.
- As a result of the conglomeration of easy central bank policy measures, we expect continued demand for credit. Specifically, we anticipate markets that benefit most from portfolio rebalancing efforts, such as higher-quality high yield (HY) and subordinated notes, to see ongoing demand. We continue to monitor developments in the energy market for indications of weak aggregate demands as well as political risks.
- We remain underweight Agency mortgage-backed securities (MBS) given the historically low nominal spreads and low option-adjusted spreads, combined with near record low mortgage rates, which should meaningfully increase prepayment risks and option costs. Instead, we favor non-agency MBS since we remain positive on the U.S. housing market. We remain cautiously overweight commercial mortgage backed securities (CMBS), limiting our position to a manageable level given the increased volatility and mark-to-market risk in this sector. We like very seasoned U.K. residential mortgage-backed security (RMBS), which have borrowers that continued to pay during the financial crisis. Rate-cutting by the Bank of England (BoE) should increase refinancing activity and improve home affordability.

Brexit-related worries clouded the beginning of July, but these cleared quickly as the month went on. Risk-free yields took a further leg down in the beginning of the month in reaction to Brexit, with U.S. Treasuries reaching a low of 1.35 at one point.[1] However, the shock period faded as the U.K. enters a long period of negotiations, which will, at least, be led by a prudent new Prime Minister, Theresa May. Brexit had the side benefit of ushering in additional central bank easing, which was unexpected and led to higher risky asset prices, tighter spreads and, somewhat surprisingly given the performance of risky assets, lower risk-free government bond yields.

Outside of the sovereign bonds market, investors seemed to shrug off Brexit fears as risk assets rallied further. The S&P 500, as well as U.S. High Yield and Emerging Markets local debt, hit the highs for the year. U.S. assets were supported by good data releases throughout the month, including payrolls, retail sales and ISM manufacturing. Outside of the U.S., the market was buoyed by expectations of central bank policy support. In fact, Brexit has created an environment for coordinated

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

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global easing, with the BoE, European Central Bank (ECB), and Bank of Japan (BoJ) all indicating their readiness to do more. We expect easy policy from the BoE during its August meeting, with a possibility that the bond buying program in the U.K. may be restarted. Similarly, the BoJ, although it disappointed elevated expectations by not cutting its deposit rate or increasing the scale of Japanese government bond (JGB) purchases did increase its equity ETF purchase program. It also indicated that policy is under review for the September meeting, after the government reveals its fiscal stimulus package. Additionally, the Fed implied it will continue to be measured in its approach to raising rates in the U.S., with weaker than expected GDP in the U.S. further dampening rate-rise expectations.

Attitudes toward fiscal policy are also evolving. Several central banks this year have hinted at some costs to unconventional monetary policy, including pressure on bank earnings and reduced returns to savers. Given these externalities and worries that we have reached the limits of the benefits from low rates, fiscal easing begins to look more attractive. In Japan, although the BoJ did not expand its bond purchasing programs at the July meeting, the market can look to the Abe government for fiscal stimulus. The Japanese Ministry of Finance is expected to deliver a fiscal package over the next few years, increasing spending next year by around 1 percent of GDP. This would be a sizable increase considering growth has averaged around 0.6 percent year-on-year for the last five years.[2] We anticipate more fiscal policy to complement easy monetary policy worldwide.

Given all of this, we see sovereign yields trading in a range. If fiscal policy becomes a bigger driver of markets, we could see some normalization of term premia, which has been the driver of lower yields and has been depressed by central bank asset purchases. In fact, yields on 10-year Japanese Government Bonds rebounded after the July BoJ meeting. However, slow global growth and the rise of populist, anti-globalization attitudes could continue to present risks to markets and to weigh on yields. On the other hand, this should be good news for carry products. Spreads should compress as investors reach for yield, with policymakers easing financial conditions to cushion against volatility.

Interest Rates & Currency Outlook

Given the relative weakness 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, particularly 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 euro-area duration. The ECB is likely to adopt an even easier monetary policy, if only by extending the time frame of quantitative easing (QE).

We expect that a China-related commodity-based slowdown and slow growth should keep monetary policy in Australia and New Zealand easy. 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, easing money world. Central European bonds remain attractive, despite their recent underperformance. We are tactically positive on Brazil and South Africa.

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

Although EM fixed income has posted strong year-to-date returns, we remain optimistic about its prospects as fears of a Fed rate hike 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 decreased China fears will likely remain the main drivers of asset price performance in the third quarter of 2016. We note that the stronger performance in June and July was mostly driven by an appetite for duration piqued by the potential for easing by the BoE and potentially laxer terms for the ECB's quantitative easing program. To see a continued rally with more-lasting effects we need to see a turn in EM economic fundamentals, an oil price range of $40 to $50 per barrel, a stable U.S. dollar and range-bound developed market rates.

We believe that EM assets could absorb one to two rate hikes in 2016, although they remain vulnerable to more hawkish surprises, especially if they do not reflect an upward assessment in U.S./global growth prospects, but instead incipient inflationary concerns. 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 impact from Brazil and Russia lessen. China's growth slowdown is likely to continue in the medium term, although we expect stability in the short term. And we are surprised we have not seen more of a growth rebound on the back of the aggressive policy response through

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

fiscal policy, required reserve ratio adjustments[3] and rate cuts. The stabilization of the U.S. dollar has provided the Renminbi a welcome respite and allowed the authorities to successfully manage the Chinese currency vis-à-vis the basket while allowing foreign exchange reserve losses to slow. We expect "official" growth to slow to 6.5 percent with "actual" growth at around 5 percent in 2016. 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.

Credit Outlook

We continue to expect higher-yielding markets to be supported by ongoing central bank action over the coming months. The ECB bought in excess of €13 billion of corporate bonds in the first seven weeks of the CSPP,[4] and we anticipate continued ECB activity in the market. As a result of the conglomeration of easy central bank policy measures, we expect continued demand for credit. Specifically, we anticipate markets that benefit most from portfolio rebalancing efforts, such as higher-quality high yield and subordinated notes, to see ongoing demand.

While we remain positive on credit due to the technical backdrop of the credit markets, we continue to monitor macroeconomic issues. Specifically, the price of oil has fallen 20 percent from its $50/barrel peak at the end of May. Given the trading correlation of risk assets with oil we witnessed earlier in the year, we continue to monitor developments in the energy market for indications of weak aggregate demand. Additionally, global political risks remain topical, as the Spanish government uncertainty, the U.S. presidential elections, the Italian referendum, and national elections in France, the Netherlands and Germany pose the potential for market volatility.

Despite these uncertainties, we believe that in the medium term the technical backdrop afforded by central bank policy will dominate asset prices in the fixed income markets. Yields remain suppressed by unconventional policy, and investors seeking returns are being forced to look for higher income from alternative assets. As such, we continue to believe that the higher carry earned by owning credit will continue to attract investors, and provide the backdrop for attractive returns in a low yielding, low economic-growth environment.

Securitized Outlook

We remain underweight Agency MBS given the historically low nominal spreads and low option-adjusted spreads, combined with near record low mortgage rates, which should meaningfully increase prepayment risks and option costs. Agency MBS have performed well in 2016 driven largely by increased demand for liquid and high credit quality spread products. While agency MBS have performed well 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 current carry. Additionally, we believe credit-sensitive mortgage securities currently offer better risk-adjusted return profiles and cash flow carry, especially given the spread widening across many sectors over the past year. While we believe agency MBS will continue to perform well in the near term, we do not find agency MBS to be attractive on a relative basis to credit-related MBS.

Nonagency 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 nonagency MBS sector. Nonagency MBS offers spreads of 200 to 250 basis points (bps) above Treasuries for investment grade bonds, and 275 to 300 bps for senior noninvestment grade 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 nonagency 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, but 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. We also have some concerns over late 2015 and 2016 vintage origination CMBS due to the substantial increase in property values over the last few years. We favor more seasoned CMBS issues, which have benefited from recent property price appreciation, over newly originated deals which may have somewhat inflated property valuations as part of their underwriting. For more recent issuances, we favor 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 still 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.

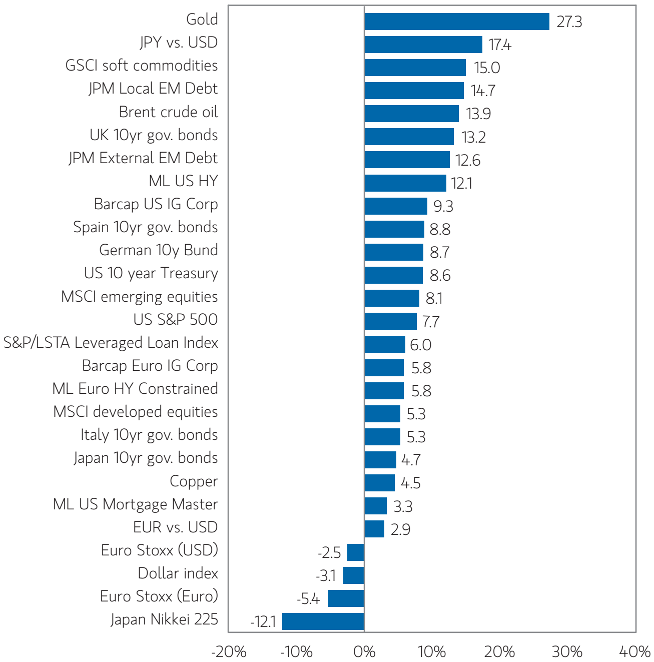
[3] The Required Reserve Ratio (RRR) is the fraction of deposits that regulators, in this case, the Federal Reserve, require a bank to hold in reserves and not loan out.

[4] Source: ECB. Data as of July 31, 2016.

In Europe, we believe the spread widening in the U.K. and peripheral Europe over the past year represents an attractive buying opportunity in 2016. 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 their 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 7/29/2016



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of July 31, 2016. The indices 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 10 for index definitions.

Market Summary

In July, yields in the U.S., U.K. and Europe in general fell due to risk-off ripples following the Brexit vote at the end of June.[5] Developed market currencies generally gained versus the U.S. dollar, but renewed declines in oil dragged down oil currencies.

Over the month, 10-year U.S. Treasury yields decreased by 2 bps while the 2s10s curve flattened by 5 bps.[6] Ten-year German yields increased 1 bps, while two-year German yields increased by 4 bps.[7] Ten-year yields in Ireland, Italy and Spain decreased by 9 to 14 bps.[8] Portugal ten-year yields decreased by 7 bps. Greek 10-year government yields increased by 14 bps.[9] Japanese government bond (JGB) 10-year yields increased by 3 bps.[10] Thirty-year JGB yields rebounded in July to 26 bps after hitting a low of 5 bps during the month.

In July, the dollar was on an uptrend during the month but lost some ground after the Federal Open Market Committee (FOMC) and BoJ meeting. The euro gained 0.6 percent while the British pound depreciated by 0.6 percent. The Japanese yen appreciated by 1.1 percent for the month, appreciating strongly following the BoJ meeting.[11] Crude oil (Brent) prices decreased the month from \$49 to \$42.[12] As a result, Canadian dollar, Norwegian Kroner, Mexican Peso and Russian Ruble all depreciated on the month.

Developed Markets

In the U.S., the FOMC kept monetary policy unchanged at the July meeting. Compared to the June meeting statement, the July statement added that risks to economic outlook have diminished. Economic data was very good for the month. June nonfarm payrolls posted a strong positive surprise, increasing 287,000 versus expectations of 180,000, although May nonfarm payrolls were revised lower to 11,000 from 38,000.[13] Despite favorable employment growth, the unemployment rate ticked up to 4.9 percent, above consensus of 4.8 percent, as the participation rate increased 0.1 to 62.7 percent. Average hourly earnings rose 2.6 percent.[14] Business confidence rose more than expected with ISM manufacturing index increasing to 53.2 in May, above consensus expectations of 51.3. Q2 GDP was 1.2 percent quarter-on-quarter, below consensus of 2.5 percent. Headline CPI was 1.0 percent and core CPI was 2.3 percent for June.[15]

[5] Source: Bloomberg. Data as of July 31, 2016.

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

[7] Source: Bloomberg. Data as of July 31, 2016.

[8] Source: Bloomberg. Data as of July 31, 2016.

[9] Source: Bloomberg. Data as of July 31, 2016.

[10] Source: Bloomberg. Data as of July 31, 2016.

[11] Source: Bloomberg. Data as of July 31, 2016.

[12] Source: Bloomberg. Data as of July 31, 2016.

[13] Source: Bloomberg. Data as of July 31, 2016.

[14] Source: Bloomberg. Data as of July 31, 2016.

[15] Source: Bloomberg. Data as of July 31, 2016.

In the euro area, the ECB left policy unchanged at the July meeting. ECB Governor Mario Draghi felt the need to gather more information about the effects of Brexit before evaluating current monetary policy. In terms of survey data, euro-area manufacturing PMI came in at 52.8 in June, in line with May, and slightly above consensus expectations of 52.6.[16] Euro-area GDP for Q2 2016 was 0.3 percent quarter-on-quarter, in line with consensus. Euro-area inflation was 0.1 percent for June, up from -0.1 in May.[17]

In the U.K., the BoE voted 8 to 1 to keep monetary policy unchanged. The market had expected a 25 bps rate cut; however, the Committee indicated that easing is expected at the August meeting, when new economic projections will also be released. In terms of data, headline CPI inflation was 0.5 in June, up from May and above consensus of 0.4 percent.[18] The unemployment rate, three-month average, ticked down to 4.9 percent in May. Q2 GDP was 0.6 percent quarter-on-quarter, above consensus of 0.5 percent. U.K. manufacturing PMI decreased sharply to 49.1 in June, from 52.1 in May, above consensus expectations of 48.7.[19]

In Japan, the BoJ decided at the July meeting to increase ETF purchases but kept interest rates and other asset purchases unchanged, disappointing markets. Bank Governor Kuroda acknowledged that business and consumer confidence have been declining. He has asked the staff to prepare a comprehensive assessment of policies necessary to achieve the 2 percent inflation target for the September meeting. On the data front, manufacturing PMI was 49.0 for July, up from 48.1 in June. The June core national CPI (ex-Food & Energy) came in at 0.4 percent, decreased from 0.6 in May, and in line with consensus.[20]

[16] Source: Bloomberg. Data as of July 31, 2016.

[17] Source: Bloomberg. Data as of July 31, 2016.

[18] Source: Bloomberg. Data as of July 31, 2016.

[19] Source: Bloomberg. Data as of July 31, 2016.

[20] Source: Bloomberg. Data as of July 31, 2016.

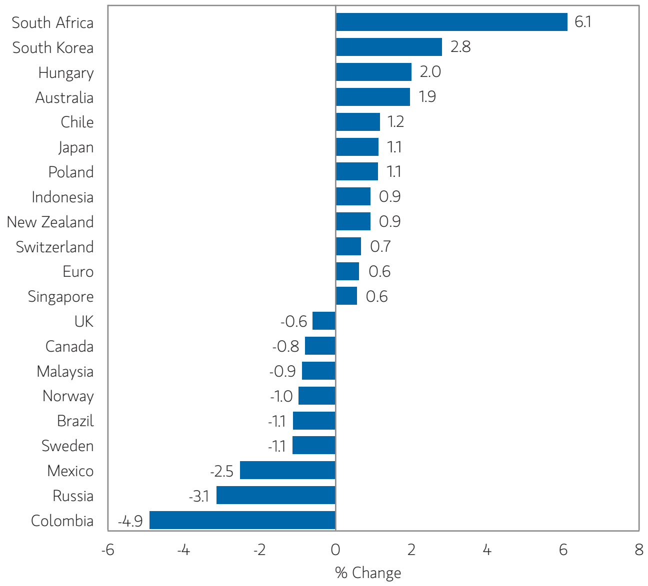
Display 2: **Government Bond Yields for Major Economies**

COUNTRY	2YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	5YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)
Australia	1.51	-8	1.55	-10	1.87	-11
Belgium	-0.57	1	-0.47	-7	0.12	-11
Canada	0.54	2	0.60	3	1.03	-3
Denmark	-0.48	8	-0.31	0	0.06	-4
France	-0.55	-1	-0.40	-5	0.10	-8
Germany	-0.63	4	-0.53	4	-0.12	1
Ireland	-0.44	-38	-0.12	-8	0.42	-11
Italy	-0.06	5	0.29	0	1.17	-9
Japan	-0.25	5	-0.27	4	-0.19	3
Netherlands	-0.59	1	-0.47	-5	-0.02	-10
New Zealand	1.82	-19	1.88	-15	2.21	-15
Norway	0.54	-32	0.49	-37	0.97	-4
Portugal	0.46	-12	1.72	-10	2.93	-7
Spain	-0.16	3	0.17	-1	1.02	-14
Sweden	-0.66	-4	-0.37	-9	0.10	-15
Switzerland	-0.84	23	-0.90	11	-0.56	1
United Kingdom	0.11	1	0.28	-7	0.69	-18
United States	0.66	7	1.02	2	1.45	-2

Source: Bloomberg LP. Data as of July 29, 2016.

Display 3: **Currency Monthly Changes versus U.S. Dollar**

Currency Monthly Change vs. USD (+ = appreciation)



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

Emerging Markets

Investment flows continued to aid EM fixed income assets while investors navigated the headwinds of an attempted coup in Turkey and softening energy prices. Global monetary policy has been supportive of carry trades as the Fed held interest rates steady and the ECB expanded the scope of its QE program. Investors were pushed by the ECB to search for assets offering a positive yield, while stabilizing fundamentals and relatively attractive valuations continued to pull investors to EM fixed income, resulting in inflows of $15 billion during the month. Against this backdrop, dollar-denominated investments outperformed domestic debt and higher-yielding, and often smaller, less-liquid investments outperformed lower-yielding, higher-rated assets.

Notably, on Friday, July 15, elements within the Turkish military attempted to overthrow the government of President Recep Tayyip Erdogan. The coup attempt turned out to be short-lived and unsuccessful, and the elected government quickly regained effective control by early Saturday morning. The government subsequently blamed the coup attempt on followers of U.S.-based cleric Fethullah Gulen. In response, the government announced a three-month state of emergency and arrested thousands of suspected coup participants, leading to a purge of over 50,000 people from their employment in the public and education sectors. All three major rating agencies were quick to react negatively to the coup attempt. Both Moody's and Fitch rate the country's external debt at Investment Grade but Moody's has scheduled a review for a possible downgrade. S&P downgraded the country to BB from BB+ within days of the coup attempt. As S&P already has Turkey below Investment Grade, the loss of an investment grade (IG) rating by either Moody's or Fitch would lead to the country's debt being removed from IG indices and could trigger forced selling by ratings-constrained investors.

The Central Banks of Brazil and Indonesia held policy rates steady, against market expectations, as did central banks from South Africa, Poland, Peru, Chile and South Korea. Malaysia's central bank cut rates against expectations while Hungary's announced nontraditional easing measures to support economic growth.

External

EM external sovereign and quasi-sovereign debt returned 1.56 percent in the month, bringing YTD performance to 12.62 percent, as measured by the JP Morgan EMBI Global Index.[21] Lower-rated, higher-yielding, and many smaller and less-liquid assets outpaced IG bonds in the month. Bonds from El Salvador, Venezuela, Egypt, Mongolia and Sri Lanka led the market, while bonds from Turkey, Angola, Iraq, Colombia, Russia and Azerbaijan lagged with negative performance.

[21] Source: JP Morgan. Data as of July 31, 2016.

Domestic

EM domestic debt returned 0.60 percent in the month as measured by the JP Morgan GBI-EM Global Diversified Index.[22] EM currencies weakened -0.31 percent versus the U.S. dollar and EM bonds returned 0.91 percent in local terms.[23] Currency performance versus the U.S. dollar was the swing factor for domestic debt performance as bonds from South Africa, Indonesia, Hungary, and Romania outperformed the broader market, while bonds from Colombia, Turkey, Russia, Mexico, Peru and Malaysia underperformed.

Corporate

EM corporate debt returned 1.58 percent in the month as measured by the JP Morgan CEMBI Broad Diversified Index.[24] Higher-yielding, lower-quality companies outperformed higher-rated companies over the month. Regionally, companies in Africa (South Africa) and Latin America (Jamaica, El Salvador, Brazil, Mexico) outperformed those in Europe (Turkey, Russia) and Asia (Malaysia, Taiwan, S. Korea, Singapore). From a sector perspective, companies in the Transport, Metals & Mining, TMT, Industrial and Consumer sectors outperformed the broader market, while those in the Diversified, Infrastructure and Financial sectors lagged.

Display 4: **EM External and Local Spread Changes**

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	346	-20	11.7	-22
Colombia	270	13	7.4	13
Hungary	211	-13	2.0	-31
Indonesia	254	-30	7.1	-45
Malaysia	226	-6	3.5	-23
Mexico	294	1	6.0	4
Peru	194	-6	5.8	-10
Philippines	101	-12	4.4	-29
Poland	98	-32	2.4	4
Russia	247	12	8.5	11
South Africa	307	-30	9.0	-20
Turkey	340	46	9.4	47
Venezuela	2510	-149	–	–

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

[22] Source: JP Morgan. Data as of July 31, 2016.

[23] Source: JP Morgan. Data as of July 31, 2016.

[24] Source: JP Morgan. Data as of July 31, 2016.

Corporate Credit

On the heels of the U.K. referendum-induced volatility in June, July proved to be a strong month for credit, as global markets focused on the broadly accommodative policies of central banks around the world. The ECB launched its corporate sector purchase program in June, and the program was a key driver of credit asset prices in July. The beneficial consequences of this program were particularly apparent in Europe, but have been seen in markets around the globe. While neither the BoE nor the BoJ announced significant easing to policy during the month, both are expected to extend their activities in their next meetings, further providing technical support to global markets. Equity markets had a strong month both in Europe and the U.S., and recovered their post-referendum weakness. The S&P 500 ended the month at an all-time high, while the FTSE 100 and the U.K.-focused FTSE 250 ended the month near the top of their year-to-date ranges. European bourses remain below the levels seen earlier in the year, but reported returns of between 3 and 5 percent in July.[25]

Improved global risk appetite benefitted global credit as the Barclays Global Aggregate Corporate Index generated total returns of 1.72 percent and excess returns of 1.17 percent in July.[26] European credit outperformed U.S. credit in July, given the extensive central bank buying program in Europe, with the European Corporate Aggregate Index generating excess returns of 1.58 percent, while the U.S. posted excess returns of 0.93 percent.[27] The Sterling Index was the strongest performer of the major investment grade indices, generating excess returns of 3.07 percent during the month.[28] Despite strong excess returns, however, this represents only a partial recovery of the losses the Sterling market experienced in the wake of the June referendum vote. The global HY market outperformed its IG peer, returning 4.16 percent.[29] U.S. and European HY returns were approximately in line.

Financial versus nonfinancial performance continued to decompress in July, as financial bonds moderately underperformed industrial bonds given weaker technicals and heightened credit concerns within the financial sector. This underperformance highlights the ECB's focus on industrials, further perpetuating the technical strength in the industrial space we highlighted in June. In addition to weaker technicals, the financial sector suffered from elevated uncertainty. Specifically, the Italian banks came under scrutiny, as Banca Monte Dei Paschi di Siena's credit quality suffered due to high levels of nonperforming loans and weak capitalization. The EBA's stress test further heightened uncertainty in the financial space; however, results of the test were benign as 50 out of 51 banks tested were deemed to have sufficient capital to remain solvent in the test's adverse scenario. Notably, Monte di Paschi failed the test; however, adverse market reaction was mitigated by the bank's plan to address asset quality and low capital levels. Despite the underperformance of financials in relation to industrials, the outperformance of subordinated debt compared to senior debt highlights the demand for yield and overall comfort with financial credit within the context of a strong credit market.

Display 5: **Credit Sector Changes**

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	145	-11	114	-23
Industrial Basic Industry	197	-18	111	-33
Industrial Capital Goods	108	-7	83	-18
Industrial Consumer Cyclicals	126	-11	98	-21
Industrial Consumer Non Cyclicals	116	-12	87	-19
Industrial Energy	221	-4	111	-23
Industrial Technology	135	-11	70	-24
Industrial Transportation	131	-12	86	-24
Industrial Communications	166	-16	108	-26
Industrial Other	122	-5	147	-30
Utility Electric	135	-5	102	-29
Utility Natural Gas	149	-7	91	-25
Utility Other	157	-8	83	-27
Financial Inst. Banking	131	-13	119	-21
Financial Inst. Brokerage	160	-8	121	-29
Financial Inst. Finance Companies	166	-13	91	-12
Financial Inst. Insurance	159	-11	271	-32
Financial Inst. REITS	170	-6	113	-29
Financial Inst. Other	248	+2	168	-29

Source: Barclays. Data as of July 31, 2016.

Securitized Products

Mortgage credit markets had their best month of the year in July, while more rates sensitive agency MBS were relatively steady during the month. Agency MBS generally performed in-line with their duration equivalent Treasuries with nominal spreads on current coupon MBS widening three bps to 103 bps above interpolated U.S. Treasuries, while option-adjusted spreads (OAS) tightened six bps to two bps over interpolated Treasuries.[30] The Barclays U.S. MBS Index has now returned 3.32 percent through the end of July, up 0.21 percent for the month of July.[31] The U.S. Treasury curve flattened in July as

[25] Source: Barclays. Data as of July 31, 2016.

[26] Source: Barclays. Data as of July 31, 2016.

[27] Source: Barclays. Data as of July 31, 2016.

[28] Source: Barclays. Data as of July 31, 2016.

[29] Source: Barclays. Data as of July 31, 2016.

[30] Source: Yield Book. Data as of July 31, 2016.

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

the 10-year Treasury rate decreased two bps while the two-year Treasury rate increased by seven bps.[32] Thirty-year mortgage rates decreased by 17 bps to 3.36 percent, near record low levels.[33] The Fed continues to reinvest pay downs and maintain their agency MBS portfolio at roughly $1.75 trillion.[34]

Non-agency MBS performed very well in July as spreads tightened roughly 20 bps and the non-agency MBS cash flow performance continued to improve as well. Non-agency MBS spreads are now at their tightest levels in 2016 and are back near Q2 2015 levels. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 1.2 percent in May, and are up 5.0 percent over the past year.[35] Home prices are up 35 percent nationally from the lows in 2012, and are now only 2 percent below the peak from July 2006. Existing home sales increased 1.1 percent in June from May home sales and are up 3.0 percent from June 2015, and are at the highest level since February 2007.[36] With the unemployment rate at 5 percent and with U.S. GDP growing slowly, U.S. homes remain very affordable from a historical perspective. 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 18 percent above the 15-year average home affordability. Mortgage performance also remains strong. New defaults were essentially unchanged at a 0.65 percent annual rate in June, but are down from 0.80 percent in June 2015.[37] With unemployment low, the economy slowly improving, and home prices still recovering from the mortgage crisis almost 10 years ago, we expect mortgage credit performance to continue to improve.

CMBS spreads tightened substantially in July as investors began to recognize that this sector has underperformed most credit sectors in 2016. AAA-rated CMBS tightened 10 bps in July, and have now reverted back to 2015 year-end levels, while BBB-rated classes tightened 50 bps in spread in July and are now roughly 25 bps wider for synthetic CMBX and 75 to 100 bps wider for cash CMBS in 2016.[38] New CMBS issuance increased marginally in July with $4 billion in total issuance during the month. Year-to-date issuance also remains lighter than expected with roughly $32 billion issued through the first seven months of the year. We continue to ratchet down our 2016 new CMBS issuance forecast from $100 billion to $120 billion at the start of the year, the amount needed to refinance the more than $100 billion CMBS loans scheduled to mature this year, down to $50 billion to $60 billion, as lenders are finding alternative buyers for CMBS securitizations.[39]

CMBS spreads are materially 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 increased 0.8 percent in June, and are up 6.6 percent over the course of 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 now 25.8 percent above the previous peak in August 2007.[40] Hotel occupancy rates in June were unchanged from June 2015 at 73.1 percent, but this is matching the highest levels seen over the past 15 years, and is up 4.5 percent from 2013 and up 8.1 percent from 2011.[41] National office vacancy rates decreased to 13.0 percent in Q2 2016, the lowest level seen since Q1 2008.[42] Multifamily vacancy rates increased slightly in Q1 2016, but are still near the lowest levels seen over the past 13 years.[43] While price volatility and supply-demand dynamics for CMBS continue to cause some concerns, the fundamental real estate market conditions underlying CMBS market appears to be solid.

European ABS spreads were largely unchanged in July after widening in June post-Brexit. Spreads are still roughly 25 to 50 bps wider post-Brexit, and are now 25 to 75 bps wider on the year for non-ECB eligible assets, particularly for U.K. RMBS.[44] ECB eligible ABS were unchanged in spread in July and are 5 to 15 bps tighter in 2016. ECB ABS purchases remain slow with the ECB adding roughly €500 million European ABS in June. The ECB holds €19.6 billion of European ABS.[45] European ABS issuance was slow again in July, with roughly €5.9 billion in new securitizations during the month. 2016 year-to-date securitization issuance totals €47.2 billion, behind the 2015 pace of €50.1 billion through July 2015.[46]

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32 Source: Bloomberg. Data as of July 31, 2016.

33 Source: Yield Book. Data as of July 31, 2016.

34 Source: Bankrate.com. Data as of July 31, 2016.

35 Source: Federal Reserve Bank of New York. Data as of July 31, 2016.

36 Source: S&P Case-Shiller U.S. National Home Price Index. Data as of July 31, 2016.

37 Source: National Association of Realtors. Data as of July 31, 2016.

38 Source: S&P/Experian First Mortgage Default Index. Data as of July 31, 2016.

39 Source: Deutsche Bank. Data as of July 31, 2016.

40 Source: Green Street. Data as of July 31, 2016.

41 Source: Statistica.com. Data as of July 31, 2016.

42 Source: CBRE. Data as of July 31, 2016.

43 Source: US Census Bureau and National Association of Home Builders. Data as of July 31, 2016.

44 Source: Deutsche Bank. Data as of July 31, 2016.

45 Source: European Central Bank. Data as of July 31, 2016.

46 Source: Deutsche Bank. Data as of July 31, 2016.

INDEX DEFINITIONS

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

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

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

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

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

The **Barclays US 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 indices 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 gov 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 (US 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 10 Yr govt bonds** - UK Benchmark 10 Year Datastream Government Index. For the following Datastream government bond indices, benchmark indices 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 10 YR bunds** - Germany Benchmark 10 Year Datastream Government Index; **Japan 10 Yr govt bonds** - Japan Benchmark 10 Year Datastream Government Index; and **10-year US Treasury** - US Benchmark 10-Year Datastream Government Index.

The **BofA Merrill Lynch US Mortgage Backed Securities (ML US Mortgage Master) Index** tracks the performance of US dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by US agencies in the US 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 US 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 US 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 2 of 3 Developed Markets countries (excluding Japan) and 8 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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