Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Pricing in Trump

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

Outlook

- In 2017, we may see for the first time since 2013 a combination of bearish factors for bonds: improving economic data/rising inflation, less easy monetary policy and rising risk premiums. As forces dragging down term premium dissipate, we could shift towards a regime where Treasury prices are driven more by fundamentals than technicals. If so, yields could have more room to rise—our longer-term fundamental "fair value" estimate would put yields at around 3 percent. Historically, rising rates have been associated with spread tightening. Better growth prospects could outweigh the rise in risk-free yields and USD, which is bullish for risky U.S. assets. We think cyclically sensitive sectors in credit and securitized could do well, with underweights in U.S. rates continuing to act as a good hedge.
- We expect historically low developed market (DM) yields to still support the "right" carry opportunities and spreads in EM. We also expect an ongoing "push" factor of inflows into higher-yielding assets, including select emerging market (EM) fixed income. Given that the "Trump Tantrum" has not been EM-specific, we believe that the various factors both pushing and pulling investors into EM fixed income remain in place. However, assets remain vulnerable to spikes in U.S. policy uncertainty and the Trump Tantrum will likely somewhat delay rate-cutting cycles in Russia, Indonesia and Colombia.
- Pro-growth rhetoric, higher inflation expectations and continued demand for U.S. credit should create a bullish environment for U.S. credit. We anticipate the divergence between the U.S. and European markets to continue in December and 2017.

The election of Donald Trump dominated market attention for November. The market was clearly not positioned for his win. But what was a further surprise was the direction of market reaction, which quickly shifted towards risk-on mode after the election. Sell the rumor, buy the fact indeed. U.S. Treasuries yields dropped around 15 basis points (bps) on the eve of the election but had rebounded by the next day, ending the month

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up more than 50 bps. Odds of Federal Reserve (Fed) hikes increased, driving the trade-weighted dollar to a new peak.

It is worth noting that the market narrative has completely changed. A month ago, 2 percent represented a very bearish forecast for the 10-year Treasury. The story of low growth and low returns, in other words, secular stagnation, was widely circulated and was even acknowledged by the Fed. Now, markets are focusing on higher growth and higher inflation. Since the Republicans control both the executive and legislative branch, chances of infrastructure spending and tax cuts now look much more likely than the previous base case—a Hillary Clinton presidency with a divided Congress. If Trump focuses on business-friendly reforms, such as a corporate tax cut, business confidence and capital expenditure could rebound, boosting productivity and growth. On the other hand, EM markets have not ignored the protectionist aspect of Trump's rhetoric—spreads have widened and currencies such as the Mexican peso have sold off. If Trump follows through on his protectionist promises, the outlook is more ambiguous for global growth but, in either scenario, U.S. inflation should increase.

We could be entering a period of not only higher growth and higher inflation, but also higher volatility. We see plenty of political risk events ahead—aftermath of the Italian referendum as well as elections in Netherlands, France and Germany. 2016 has shown that people who are dissatisfied with the current order could actually be a silent majority. Thus, we think more shocks, such as from politics, could be a source of potential volatility ahead.

Treasuries, as well as the stock market and other risky U.S. assets, have been re-pricing to reflect these changing fundamental outlooks. Global fundamentals with regard to growth and to a lesser degree inflation were on an uptrend before the U.S. election. It is also worth noting that current U.S. Treasury levels are still roughly unchanged from a year ago, even as most risky assets have hit new highs on the year. Most of the decline in yields this year has been driven by declining term premium, as central bank and foreign buying increased demand for treasuries. As USD hedging costs rise, U.S. Treasuries are now less attractive to foreign buyers after hedging back to local currency. As these forces dragging down term premium dissipate, we could shift towards a regime where Treasury prices are driven more by fundamentals than technicals. If so, yields could have more room to rise—our longer-term fundamental "fair value" estimate would put yields at around 3 percent.

Historically, rising rates have been associated with spread tightening. Better growth prospects could outweigh the rise in risk-free yields and USD, which is bullish for risky U.S. assets. U.S. credit and high-yield spreads did, in fact, tighten in the month. Going forward, financials should do well as curves steepen. More growth-friendly policies and perhaps lighter regulatory burden would likely make bank lending more profitable. In summary, we think cyclically sensitive sectors in credit and securitized could do well, with underweights in U.S. rates continuing to act as a good hedge.

Interest Rates and Currency Outlook

In 2017, we may see for the first time since 2013 a combination of bearish factors for higher-yielding bonds: improving economic data/rising inflation (more coordinated globally than we have seen recently), less easy monetary policy and rising risk premiums. Basically, it is a reversal of all that powered yields lower over the last several years. However, given the Fed's desire to allow inflation expectations to rise, we expect the Fed could continue to implement a "dovish" hike, which would not derail possible continuation in the U.S. and global expansion. Expectations of two or three 2017 rate hikes are reasonable. In this world, we think longer-maturity Treasuries should continue to underperform. As such, we remain underweight U.S. duration. We also believe that current market pricing of inflation through Treasury Inflation-Protected Securities underestimates the potential for higher inflation.

We expect continued European Central Bank (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 are slightly negative on Eurozone duration, although we do not expect longer-maturity core Eurozone yields to break out of recent ranges.

In our opinion, EM assets remain attractive as fundamentals within many EM countries seem to be improving. Central European bonds are attractive, as are Indonesia and Argentina. We are tactically positive on Brazil, pending confirmation that political change will result in lasting reform.

In terms of currency positioning, we have exposure to where we see value, including the Norwegian kroner. Norway has been one of the only G10 countries to experience above-target inflation, while the currency has depreciated quite a lot in the past few years. We are underweight the Japanese yen due to rising U.S.-Japan rate differential and diverging central bank policy.

EM Outlook

After the U.S. elections, global fixed income markets are pricing in a significant relaxation in U.S. fiscal policy that may boost economic growth, strengthen the USD and, as a result, supercharge the DM yield curve steepening trend that was already underway pre-election. While it is still too early to know the exact contours of the next U.S. administration's fiscal, trade and immigration policies, the market hasn't waited to reprice not only the global fixed income outlook, but also the outlook for countries in EM likely to be the most affected, such as Mexico. However, market reactions since the elections also suggest that position unwinds were an important driver of asset prices.

For global growth, the beneficial impact of higher U.S. growth is likely to be offset partly by the extent of the new president's potentially protectionist trade agenda. The net effect won't be known for a while, but Mexico and China will remain a key focus, with joint cooperation between the new president and the more traditional trade-friendly wing of the Republican Party potentially reducing the impact, especially if stronger U.S. economic growth takes on more importance as a goal than fulfilling populist campaign promises that risk damaging the U.S. economic outlook. We still expect the EM/DM growth differential to recover during 2017 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 short-term growth prospects reliant on continued fiscal and monetary policy support. Recent data out of China has been suggesting resilience, but we believe we could be in for another growth slowdown at the end of Q1/Q2 2017. However, we continue to believe that China has ample policy buffers in 2017 to offset any too rapid deceleration in economic growth.

We expect historically low DM yields to still support the "right" carry opportunities and spreads as we expect an ongoing "push" factor of inflows into higher-yielding assets, including select EM fixed income. Given that the "Trump Tantrum" has not been EM-specific, we believe that 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 appear to have stabilized, fears of multiple Fed rate hikes have subsided (although two interest rate hikes next year are more likely than one) and concerns of a sharp slowdown in China have diminished. We believe that EM assets could well absorb a Fed rate hike in December if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty and the Trump Tantrum will likely somewhat delay rate-cutting cycles in Russia, Indonesia and Colombia.

Credit Outlook

As we head into the last month of 2016, economic growth rhetoric, interest rates, political uncertainty in Europe and inflation expectations will continue to dominate the U.S. and European investment-grade and high-yield markets. Pro-growth rhetoric, higher inflation expectations and continued demand for U.S. credit created a bullish environment for U.S. credit in November. We anticipate an outperformance in the U.S. as we close out 2016, as pro-growth sentiment, higher inflation expectations, a supportive technical environment and an anticipation of reduced regulation fuels positive sentiment in the U.S. credit markets. In Europe, we anticipate continued slow-growth expectations and political uncertainty in Italy to dictate credit performance in both investment grade and high yield. We anticipate the divergence between the U.S. and European markets to continue in December and in 2017, as increasingly favorable macroeconomic, fundamental and technical backdrop in the U.S. creates a more bullish environment for U.S. credit relative to European credit.

Securitized Outlook

We remain underweight agency mortgage-backed securities (MBS) given the historically low nominal spreads and low option-adjusted spreads and increased volatility over the last month. Duration-extension risk has replaced prepayment risk as mortgage rates increased 47 bps in November. Agency MBS gave back roughly half of their gains in November and year-to-date returns now look mediocre. While agency MBS have reasonably performed well over the past few years as rates volatility has remained relatively low, we believe agency MBS appear expensive from a historical spread and option-adjusted spreads (OAS) perspective, and we believe their risks have increased over the past month given the increased volatility and duration-extension risk. Additionally, we believe credit-sensitive mortgage securities currently offer better risk-adjusted return profiles and cash flow carry.

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 offers spreads of 150-225 bps above Treasuries for investment-grade bonds and 225-275 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 non-agency MBS to decline by $70 -$80 billion in 2016, while new securitizations are projected to only amount to $30-$40 billion.

We remain cautiously overweight commercial mortgage-backed securities (CMBS). AAA CMBS has performed well in 2016, and we believe now offers only fair value versus other asset classes. BBB CMBS has underperformed most credit sectors in 2016, and sponsorship for the sector still feels soft, but we expect that commercial real estate fundamental conditions will remain strong as long as unemployment remains low and the U.S. economy continues its moderate growth. We believe credit-sensitive CMBS are poised to perform well as a result of these healthy economic conditions, 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

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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. Although we expect continued volatility in CMBS in December and into 2017, we still believe that CMBS offers attractive yields and should continue to benefit from improving fundamental market conditions.

In Europe, we have decreased our strong overweight positioning to a more moderate overweight outlook for MBS and CMBS. Spreads are now tighter than pre-Brexit levels, even though we believe fundamental conditions have more uncertainty in the wake of the Brexit vote. Overall, we remain positive on the sector given the belief that the ECB and Bank of England (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. 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.

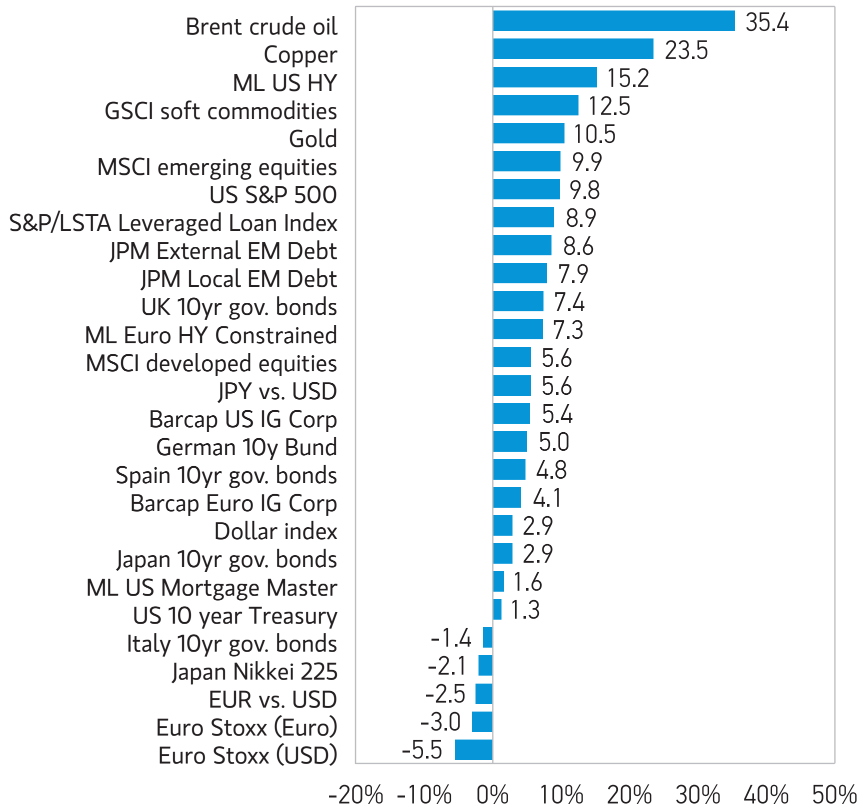
Market Summary

In November, yields in developed markets rose rapidly and curves generally steepened, led by the U.S.[1] The dollar strengthened versus global currencies, as the market continues to price in a potentially faster rate of Fed rate hikes.

DISPLAY 1

Asset Performance Year-to-Date

Returns through 11/30/2016



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of November 30, 2016. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See page 14 for index definitions.

Over the month, 10-year U.S. Treasury yields rose 56 bps, while the 2s/10s curve steepened by 28 bps.[2] Germany's 10-year yield increased 11 bps, while the two-year yield decreased 11 bps.[3] 10-year yields in Spain, Italy and Portugal increased from 33 to 39 bps.[4] Greece's 10-year government yields outperformed, decreasing by 171 bps, as successful bailout reviews make debt relief look increasingly likely.[5] Japanese government bond 10-year yield increased by 7 bps.[6]

The dollar strengthened against most currencies. The euro depreciated by 3.6 percent. The British pound appreciated by 2.2 percent, the only winner in the month against the dollar. The Japanese yen depreciated by 8.4 percent for the month, the biggest loser in the month.[7] Mexican peso lost 8.3 percent as Donald Trump's election put shadows over the country's trade outlook.

[1] Source: Bloomberg. Data as of November 30, 2016.
[2] Source: Bloomberg. Data as of November 30, 2016.
[3] Source: Bloomberg. Data as of November 30, 2016.
[4] Source: Bloomberg. Data as of November 30, 2016.
[5] Source: Bloomberg. Data as of November 30, 2016.
[6] Source: Bloomberg. Data as of November 30, 2016.
[7] Source: Bloomberg. Data as of November 30, 2016.

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Developed Markets

In the U.S., the Federal Open Market Committee kept rates unchanged at the November meeting. In the release of the meeting minutes, members saw a rate rise relatively soon. Data was relatively good in November. October nonfarm payrolls increased 161,000 versus expectations of 173,000, although September nonfarm payrolls were revised higher to 191,000 from 156,000.[8] The unemployment rate ticked down to 4.9 percent, in line with consensus, as the participation rate decreased to 62.8 percent. Average hourly earnings rose to 2.8 percent from 2.7 percent.[9] ISM manufacturing index increased to 51.9 in October, above expectations of 51.7. Gross domestic product (GDP) figures for third quarter were revised higher to 3.2 percent from 2.9 percent quarter-on-quarter, above consensus expectations of 3.0 percent. Headline CPI rose to 1.6 percent from 1.5 percent, and core CPI was 2.1 percent for October.[10]

In the Eurozone, ECB President Mario Draghi commented that a decision about possible extension and size of asset purchases will be made at the December meeting. In terms of survey data, Eurozone manufacturing PMI came in at 53.5 in October, in line with September but above expectations of 53.3.[11] Eurozone GDP for third-quarter 2016 was unrevised at 0.3 percent quarter-on-quarter, in line with consensus. Eurozone inflation was 0.5 percent for October, up from 0.4 percent previously.[12]

In the U.K., the BoE kept policy unchanged at the November meeting. The committee noted that the inflation overshoot has been larger than expected, driven by the weaker sterling. It emphasized its limit on tolerance for inflation overshoot. In terms of data, headline CPI inflation was 0.9 percent year-over-year in October, down from previously and below consensus of 1.1 percent.[13] The unemployment rate's three-month average ticked down to 4.8 percent in September. GDP figures for the third quarter stayed at 0.5 percent quarter-on-quarter, in line with consensus. U.K. manufacturing PMI was 54.3 percent in October, down from 55.5 in September and below consensus expectations of 54.5.[14]

In Japan, the BoJ continues to target purchases around the yield curve. On the data front, manufacturing PMI was 51.1 for November, down from 51.4 in October. The October core national CPI (ex-Food & Energy) was 0.2 percent, up from September and above the consensus expectation of 0.1 percent.[15]

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	1.76	12	2.25	30	2.72	38
Belgium	-0.66	-3	-0.31	1	0.63	24
Canada	0.70	16	1.01	32	1.59	39
Denmark	-0.53	-8	-0.18	0	0.40	11
France	-0.62	-3	-0.08	19	0.75	29
Germany	-0.73	-11	-0.43	-3	0.28	11
Ireland	-0.54	-42	-0.02	6	0.88	24
Italy	0.05	5	0.89	24	1.99	33
Japan	-0.16	8	-0.09	10	0.03	7
Netherlands	-0.69	-9	-0.29	3	0.43	16
New Zealand	2.14	14	2.49	30	3.13	42
Norway	0.63	-31	0.77	-34	1.67	28
Portugal	0.34	-3	2.25	38	3.71	39
Spain	-0.12	5	0.48	31	1.55	35
Sweden	-0.71	3	-0.15	19	0.54	28
Switzerland	-0.92	-3	-0.66	8	-0.13	27
United Kingdom	0.13	-14	0.61	2	1.42	17
United States	1.11	27	1.84	54	2.38	56

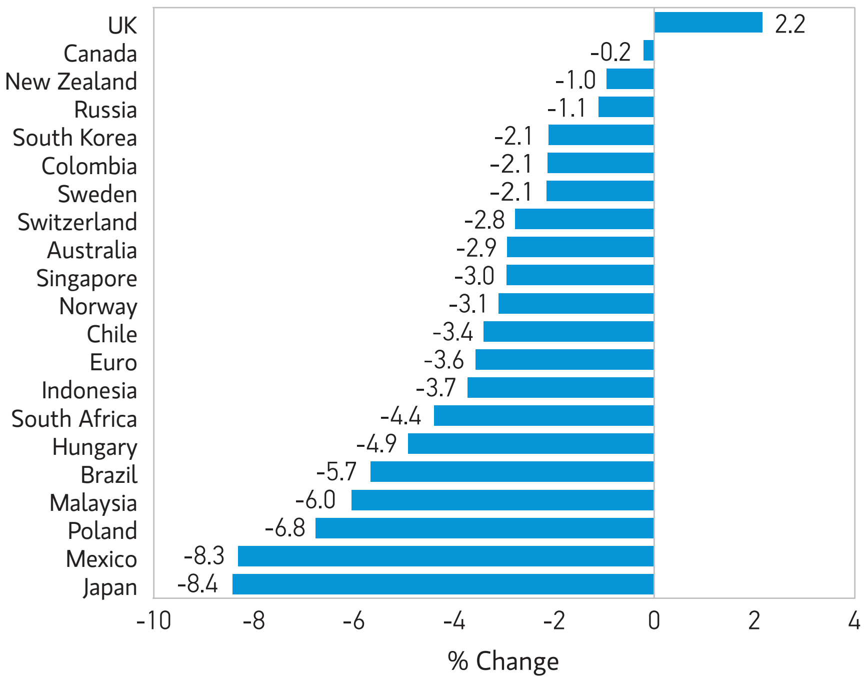
Source: Bloomberg LP. Data as of November 30, 2016.

[8] Source: Bloomberg. Data as of November 30, 2016.
[9] Source: Bloomberg. Data as of November 30, 2016.
[10] Source: Bloomberg. Data as of November 30, 2016.
[11] Source: Bloomberg. Data as of November 30, 2016.
[12] Source: Bloomberg. Data as of November 30, 2016.
[13] Source: Bloomberg. Data as of November 30, 2016.
[14] Source: Bloomberg. Data as of November 30, 2016.
[15] Source: Bloomberg. Data as of November 30, 2016.

DISPLAY 3

Currency Monthly Changes versus U.S. Dollar

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of November 30, 2016. Note: Positive change means appreciation of the currency against the U.S. dollar.

Emerging Markets

EM fixed income assets came under pressure during the month of November, applying a brake on what was a strong year for the asset class. Weighing on performance were rising 10-year U.S. Treasury yields and asset flows which turned negative for the asset class. In addition, the unexpected victory of Donald Trump in the U.S. presidential elections triggered an initial sell-off in risk assets before investors focused on the potential benefits for the U.S. economy. Commodity prices rose over the month, in part due to higher expectations for global growth as well as an Organization of the Petroleum Exporting Countries (OPEC) meeting held at the end of the month. The meeting resulted in OPEC's first deal to cut oil output in eight years and brought oil prices above $50/per barrel, while reducing downside risks.

Political uncertainty rebounded in Brazil as President Michel Temer lost key aide Geddel Vieira Lima. Lima was forced to step down after he and the president were accused of pressuring for the construction of a building in which Lima held a stake in. The news is not expected to lead to an impeachment but investors are concerned that it could hinder the government's reform agenda.

A revised peace deal between the Colombian government and FARC rebels was ratified by Congress with a vote of 130-0, as the opposition party abstained from voting. The accord was revised to consider the objections of the populous who voted against the original deal in October. The rebels will be required to move to transitional zones in five days and hand over all weapons to the United Nations within 150 days. The new deal still does not require jail sentences for former fighters, and instead restricts their movements to a particular area, and allows them 10 congressional seats between 2018 and 2026. Importantly, focus can now shift towards passing a fiscal reform bill that will be key to the country avoiding a credit rating downgrade.

In South Africa, President Jacob Zuma's political career survived as the ANC rejected calls to ask for his resignation. The President has shown great staying power as his influence was reduced after he lost his most recent political battle with Finance Minister Gordhan. Mexico's central bank (Banxico) responded to continued currency weakness post-U.S. elections with an interest rate hike of 50 bps to bring the overnight rate to 5.25 percent as the market expected. Banxico will also lose its Governor, Agustin Cartens, as he announced he would be stepping down next year to head the Bank of International Settlements.

External

EM external sovereign and quasi-sovereign debt returned -4.17 percent in the month, reducing year-to-date performance to 8.63 percent, as measured by the JP Morgan EMBI Global Index.[16] On a relative basis lower-rated, higher-yielding bonds outpaced investment-grade bonds, which were weighed down by rising U.S. Treasury yields. Bonds from smaller, less-correlated countries such as Belarus, Pakistan, Egypt, Senegal and Serbia outperformed the broader market, as did oil-related credits such as Bolivia, Venezuela, Iraq, Ecuador, Russia and Nigeria as Brent oil prices rose 12 percent in the month.[17] Bonds from Latin American countries such as Belize,

[16] Source: JP Morgan. Data as of November 30, 2016.

[17] Source: Bloomberg. Data as of November 30, 2016.

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El Salvador, Argentina, Guatemala, Uruguay, Paraguay, Mexico and Peru underperformed the most in the month.

Domestic

EM domestic debt returned -0.85 percent in the month, bringing year-to-date performance to 16.08 percent, as measured by the JP Morgan GBI-EM Global Diversified Index.[18] EM currencies weakened -0.54 percent versus the U.S. dollar, and EM bonds returned -0.30 percent in local terms. Currency performance versus the U.S. dollar weighed heavily on bond performance for Colombia, Romania, Turkey, Poland, Hungary and Malaysia, while assets in Brazil, South Africa, Mexico, Peru and Chile outperformed the broader market in the period.

Corporate

EM corporate debt returned -0.01 percent in the month, bringing year-to-date performance to 11.10 percent, as measured by the JP Morgan CEMBI Broad Diversified Index.[19] Higher-yielding, lower-quality companies outperformed higher-rated companies. From a regional perspective, companies in Africa (Nigeria) and Latin America (Brazil, Jamaica) outperformed, while those in the Middle East (Israel), Asia (S. Korea, China, Hong Kong and Thailand) and Europe (Czech Republic, Russia) underperformed. From a sector perspective, companies in the Metals & Mining, Transport, Infrastructure and Industrial sectors outperformed the broader market, while those in the Consumer, Real Estate, Diversified and Utilities sectors lagged.

DISPLAY 4

EM External and Local Spread Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	338	22	11.3	30
Colombia	252	15	7.2	5
Hungary	156	4	2.2	22
Indonesia	229	-3	8.2	76
Malaysia	210	18	4.4	78
Mexico	330	37	7.3	92
Peru	173	18	6.4	58
Philippines	107	-4	5.5	75
Poland	90	5	3.0	43
Russia	206	-19	8.7	19
South Africa	293	11	9.5	36
Turkey	365	38	10.7	104
Venezuela	2343	27	–	–

Source: JP Morgan. Data as of November 30, 2016.

Corporate Credit

Financial market conditions in the U.S. changed rapidly as investors priced in the inflationary impact of anticipated fiscal stimulus, reduced trade and a more aggressive Fed. In contrast, European credit markets traded lower in November as growth concerns relative to the U.S., concerns over Italian political uncertainty and wider swap spreads weighed on European credit markets.

Within investment grade, the U.S. outperformed Europe on an excess returns basis and on a spread basis, as the Trump election brightened the economic outlook and the narrative in the market changed from slow growth and low inflation to higher growth and rising inflation. The potential for faster real GDP growth due to a greater likelihood of pro-growth policies that may stem from the fiscal side as well as regulatory reforms has led markets higher since the election. Specifically, pro-growth policies may come in the form of faster government outlays, lower taxes (reduction of marginal income tax rates, lower capital gains tax rate and reduced corporate tax rate) and less regulatory oversight. The potential for a loosening of Dodd-Frank regulations and the reduction of other business regulations has also been supportive of financial markets. Additionally, Trump's stated plans to increase both public infrastructure and defense spending have the potential to accelerate the pace of economic growth from its current slow trend rate. Lastly, corporate pricing power should improve in response to stronger aggregate demand.

These macroeconomic factors fueled the bullish sentiment in the U.S. investment-grade (IG) market in November. In addition, technicals remained supportive of U.S. IG during the month, as the increase in yields incentivized demand from yield-sensitive investors. U.S. IG returned 0.52 percent on an excess returns basis in November and spreads were 3 bps tighter in November,

[18] Source: JP Morgan. Data as of November 30, 2016.

[19] Source: JP Morgan. Data as of November 30, 2016.

ending the month at 124 bps.[20] During November, financials outperformed industrials, as financials tightened 5 bps in November, while industrials tightened 4 bps.[21] Most notably, financial risk further down the capital structure outperformed the rest of the market (13 bps tighter over the month), as the market priced in a reversal of regulations under a Trump presidency.[22]

European IG returned -0.85 percent on an excess returns basis in November, underperforming U.S. IG.[23] European IG spreads widened in November by 17 bps, ending the month at 125 bps.[24] Interestingly, this marks the first time since the sovereign crisis in 2011 that European 7- to 10-year corporate bond spreads exceed U.S. spreads.[25] Like in the U.S., financials outperformed industrials in the European IG market. Financials were 15 bps wider in November, while industrials were 18 bps wider during the month.[26]

The divergence between the U.S. and European IG credit market will likely remain a persistent theme going into year-end and into 2017. Pro-growth sentiment in the U.S. may fuel much of this performance disparity. In addition, the U.S. will likely continue to benefit from foreign demand due to comparatively higher U.S. interest rates. Additionally, if U.S. corporations are allowed to bring overseas cash back to the U.S. at a favorable tax rate, this may diminish issuance requirements and would create an even stronger technical for U.S. bonds as net issuance will be lower. In contrast, a less favorable yield environment and lower-growth expectations in Europe may result in continued underperformance of European IG relative to the U.S.

DISPLAY 5

Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	129	-3	126	+17
Industrial Basic Industry	172	-4	117	+15
Industrial Capital Goods	99	-3	98	+19
Industrial Consumer Cyclicals	120	-1	117	+18
Industrial Consumer Non Cyclicals	114	-1	101	+16
Industrial Energy	169	-4	130	+21
Industrial Technology	112	-6	81	+11
Industrial Transportation	117	-4	107	+21
Industrial Communications	159	-3	126	+17
Industrial Other	114	-2	166	+30
Utility Electric	120	-4	126	+25
Utility Natural Gas	132	-3	117	+24
Utility Other	144	-16	97	+15
Financial Inst. Banking	118	-4	123	+14
Financial Inst. Brokerage	140	-4	123	+8
Financial Inst. Finance Companies	150	-9	98	+9
Financial Inst. Insurance	136	-6	270	+19
Financial Inst. REITS	144	-4	140	+26
Financial Inst. Other	164	+0	162	+15

Source: Bloomberg Barclays. Data as of November 30, 2016. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

The U.S. high-yield market posted -0.47 percent in total returns in November and 1.28 percent in excess returns during the month.[27] CCC-rated credit outperformed on an excess returns basis, followed by B-rated risk, and BB-rated bonds (1.56 percent, 1.5 percent and 1.02 percent, respectively).[28] Like IG, European high yield underperformed U.S. high yield in November. In Europe, high yield delivered a -0.81 percent total return in November.[29] In both the U.S. and

20 Source: Bloomberg Barclay's. Data as of November 30, 2016.

21 Source: Bloomberg Barclay's. Data as of November 30, 2016.

22 Source: Bloomberg Barclay's. Data as of November 30, 2016.

23 Source: Bloomberg Barclay's. Data as of November 30, 2016.

24 Source: Bloomberg Barclay's. Data as of November 30, 2016.

25 Source: BAML. Data as of November 30, 2016.

26 Source: Bloomberg Barclay's. Data as of November 30, 2016.

27 Source: Bloomberg Barclay's. Data as of November 30, 2016.

28 Source: Bloomberg Barclay's. Data as of November 30, 2016.

29 Source: Bloomberg Barclay's. Data as of November 30, 2016.

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Europe, higher-beta credit outperformed the broader high-yield market. In Europe, top-performing sectors included consumer cyclical services (0.72 percent) and transportation services (0.66 percent).[30] In the U.S., energy and metals mining continued to outperform the broader high-yield market as commodity prices rebounded from their mid-November lows. High-yield sectors in the U.S. that are most advantageously positioned for growth-positive policy shifts also outperformed in November.

Issuance in November was active across global credit markets despite increased market volatility and higher rates. In the U.S., investment-grade issuance totaled $75 billion.[31] In high yield, the U.S. market priced a total of $15 billion.[32] In Europe, the high-yield market issued €3.4 billion in November.[33]

Securitized Products

Agency MBS took center stage in November as interest rates moved substantially higher and mortgage duration extension became a meaningful concern. Agency MBS had been very stable for most of the year, with minimal spread volatility and relatively little duration volatility. Matching 10-year U.S. Treasury rises, mortgage rates increased 47 bps to 3.98 percent.[34] Higher mortgage rates are expected to decrease mortgage prepayment speeds, and as a result, the duration of the Bloomberg Barclays U.S. Mortgage Index extended 1.35 years from 3.18 years to 4.53 years.[35] Nominal spreads on current coupon agency MBS were slightly tighter at 95 bps above interpolated Treasuries, and OAS were unchanged at 4 bps above interpolated Treasuries, but Agency MBS still underperformed significantly during the month as a result of the duration extension combined with the interest rate increases.[36] The Bloomberg Barclays U.S. MBS Index was down 1.77 percent in November as interest rates rose during the month and the Index duration extended, but the Index has still returned 1.69 percent year-to-date.[37] The Fed decreased their agency MBS purchases slightly this month to roughly $38 billion, but these purchase volumes are still well above the annual monthly average to compensate for the recent increase in prepayments. While we expect Fed purchases to slow in coming months as higher rates lead to slower paydowns, the Fed continues to maintain their agency MBS portfolio at approximately $1.75 trillion.[38]

Non-agency MBS spreads tightened in November as cash flow and credit performance continued to improve, and non-agency MBS spreads are at their tightest levels since 2014 for most securities. Fundamental U.S. housing market and mortgage market conditions remain positive. National home prices were up 0.4 percent in September and are up 5.5 percent over the past year.[39] Nationally, home prices are up 38 percent from the lows in 2012 and have now surpassed pre-crisis peak levels from July 2006 to set new highs. Existing home sales rose 2.0 percent in October and are up 5.9 percent from October 2015.[40] October home sales marked the highest annualized levels since February 2007. Housing inventory declined for the 17th consecutive month, falling 0.5 percent in October and 4.3 percent from a year ago. Unsold inventory is a 4.3 month supply at current sales pace, down from 4.4 months in September. New home sales decreased 1.9 percent in October from September but are up 17.8 percent from October 2015.[41] Despite recent increases in home prices, U.S. homes remain affordable from a historical perspective. In fact, the National Association of Realtors Home Affordability Index, which compares the median income to the cost of the median home, shows affordability to be roughly 15 percent above the 15-year average home affordability.

CMBS spreads also tightened in November with AAA-rated CMBS roughly three bps tighter and BBB-rated CMBS 20-25 bps tighter. Year-to-date in 2016, CMBS performance has sharply diverged based on position in the capital structure, with AAA-rated CMBS 25-30 bps tighter while BBB are 50-75 wider for the year.[42] New non-agency CMBS issuance decreased in November with roughly $8 billion in total issuance during the month. Year-to-date issuance is roughly $63 billion through the first 11 months of the year, and we are on pace for $70-$75 billion in issuance in 2016, which would be about 70 percent of the issuance that was initially anticipated for the year.[43] Fundamentally, CMBS performance remains on solid grounds. Commercial real estate prices were flat in October, but are up 4.7 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 26.3 percent above the previous peak in August 2007.[44]

[30] Source: Bloomberg Barclay's. Data as of November 30, 2016.

[31] Source: Bloomberg Barclay's. Data as of November 30, 2016.

[32] Source: Bloomberg Barclay's. Data as of November 30, 2016.

[33] Source: Bloomberg Barclay's. Data as of November 30, 2016.

[34] Bloomberg and Bankrate.com, as of November 30, 2016.

[35] Bloomberg Barclays, as of November 30, 2016.

[36] Yield Book, as of November 30, 2016.

[37] Bloomberg Barclays, as of November 30, 2016.

[38] Federal Reserve Bank of New York, as of November 30, 2016.

[39] S&P Case-Shiller U.S. National Home Price Index, as of November 30, 2016.

[40] National Association of Realtors, as of November 30, 2016.

[41] U.S. Census Bureau and HUD, as of November 30, 2016.

[42] Bloomberg Barclays, as of November 30, 2016.

[43] Deutsche Bank, as of November 30, 2016.

[44] Green Street, as of November 30, 2016.

European MBS spreads were slightly wider in November, after tightening substantially the past four months, and remain meaningfully tighter than pre-Brexit levels.[45] ECB asset-backed securities (ABS) purchases remain slow due to limited supply, and the ECB portfolio increased by only €0.6 billion European ABS in October. The ECB holds €21.2 billion of European ABS as of the end of October.[46] European ABS issuance decreased in November but remains ahead of 2015 pace.[47] RMBS, ABS and CDO issuance are all ahead of 2015 volumes, while CMBS issuance has been much lower this year.

[45] Deutsche Bank, as of November 30, 2016.

[46] European Central Bank, as of November 30, 2016.

[47] Deutsche Bank, as of November 30, 2016.

INDEX DEFINITIONS

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

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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.

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). **UK 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 bunds**—Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR govt bonds**—Japan Benchmark 10-Year Datastream Government Index; and **10YR U.S. Treasury**—U.S. Benchmark 10-Year Datastream Government Index.

The **BofA Merrill Lynch U.S. Mortgage Backed Securities (ML U.S. Mortgage Master) Index** tracks the performance of U.S. dollar-denominated fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market. The **S&P/LSTA U.S. Leveraged Loan 100 Index (S&P/LSTA Leveraged Loan Index)** is designed to reflect the performance of the largest facilities in the leveraged loan market. The **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 subindex 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 subindex 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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