Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Just When You Thought It Was Safe to Go Back in the Water…

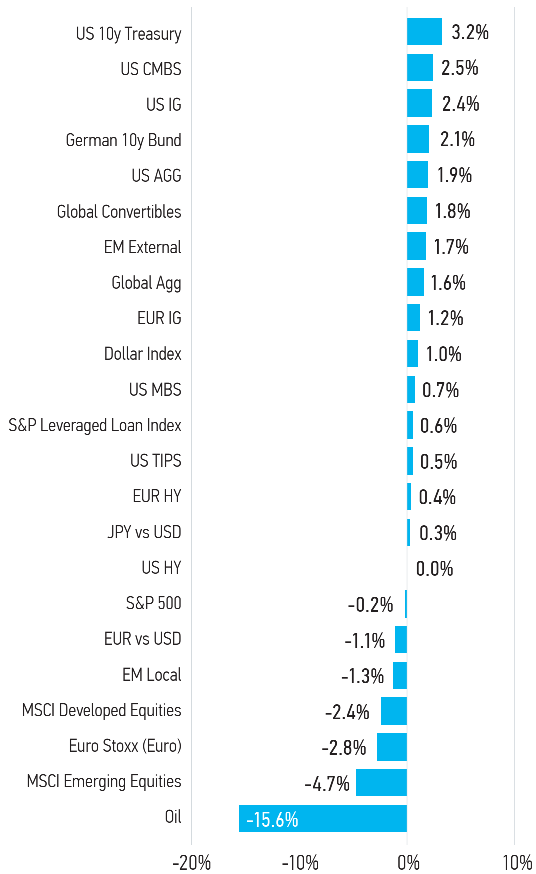
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | FEBRUARY 2020

Markets grappled with two conflicting forces in January. On the positive side we generally had upbeat economic data, supporting the reflation thesis that buoyed risk markets (credit and equities). On the other hand, we had the coronavirus outbreak in China, the scale of which did not fully become apparent until later in the month, undermining the thesis which had been driving markets. Given the magnitude of the potential risk stemming from the coronavirus outbreak, it was not surprising that downside economic concerns dominated the nascent economic data recovery, at least at first. But, what was remarkable was the subsequent ability of corporate bonds and equities to shrug off the potential economic effect of the crisis. US BBB rated-corporate bond spreads only widened modestly, with yields tracking the drop in U.S. Treasury yields. Even more impressively, euro-denominated BBB rated spreads were essentially unchanged![1]

This strong performance suggests confidence that the virus outbreak will be contained (certainly no pandemic) and economic data will rebound sharply after the inevitable deterioration in February (and possibly March). Economic risk even in the short term will be concentrated in China and Asia and possibly a few selective (unlucky) emerging countries. Underlying this thesis are two hypotheses: (1) this virus outbreak will behave similarly to previous episodes like SARS in 2002/2003, which did prove to be short lived on all fronts; and (2) the power of easy financial conditions. The second point is easier to accept than the first. A large drop in government bond yields and a move to anticipate/discount two Fed rate cuts no doubt cushioned the impact. The People's Bank of China (PBoC) has also moved quickly to boost liquidity conditions to ensure the smooth functioning of the Chinese financial system. However, be that as it may, the economic outlook for China is very uncertain; global growth will slow; trade will take longer to rebound, and markets have not generally cheapened. Buying the dip is proving problematic given how shallow the dip has been in many asset classes. A cautiously optimistic stance is warranted, but it's too early to sound the all clear. For now, being modestly bullish on medium term growth; modestly bullish on credit and emerging markets; and modestly bearish on rates seems appropriate.

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of January 31, 2020. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 6 and 7 for index definitions.

[1] Source: Bloomberg Barclays. Data as of January 31, 2020

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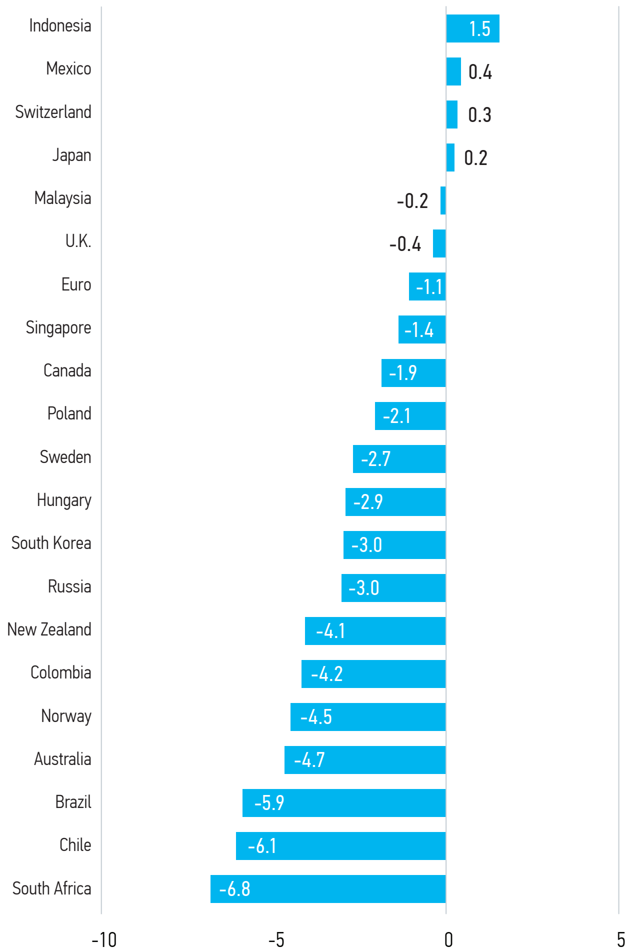
DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of January 31, 2020. Note: Positive change means appreciation of the currency against the USD.

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spreads

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)	
United States	1.51	-37		
United Kingdom	0.52	-34	-98	+3
Germany	-0.43	-25	-194	+12
Japan	-0.07	-6	-157	+32
Australia	0.95	-36	-55	+2
Canada	1.27	-37	-23	0
New Zealand	1.30	-34	-21	+4
EUROPE			(Spread over Bunds)	
France	-0.18	-29	26	-4
Greece	1.17	-28	161	-3
Italy	0.94	-48	137	-23
Portugal	0.27	-18	70	+7
Spain	0.24	-23	67	+2
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			297	+22
EM Local Yields	5.16	-17		
EM Corporate Spreads			272	+5
Brazil	6.03	-22	225	+11
Colombia	5.58	-38	176	+15
Hungary	1.28	+9	92	+11
Indonesia	6.91	-23	165	+24
Mexico	6.71	-23	187	+15
Peru	4.34	-18	96	+15
Philippines	4.15	-16	84	+15
Poland	1.89	0	40	+13
Russia	6.01	-11	150	+20
South Africa	9.47	-5	325	+31
Turkey	9.93	-177	372	-31
Venezuela	–	–	15706	+1414
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			102	+9
EUR IG			94	+1
U.S. HY			390	+54
EUR HY			329	+37
SECURITIZED				
Agency MBS			72	+2
U.S. BBB CMBS			249	-8

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of January 31, 2020.

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Fixed Income Outlook

Another year, another risk to the business cycle. It seems every year at least one new challenge arises that could derail this elongated business cycle. And each year the world escapes. Last year it was a trade war and lagged effects of U.S. monetary tightening. This year's challenge: Somewhat surprisingly, the financial market's dalliance with the R word (recession) proved fairly short lived, that is outside of China, Singapore, Thailand, commodity markets, and maybe Korea. It is possible that the outsized move in commodity prices relative to the move in non-Asian financial markets is not a global recession forecast but simply reflects the importance of Chinese demand.

Indeed, outside of developed country government bonds, commodity prices, and a few Asian equity markets you would be hard-pressed to believe a globally impactful medical catastrophe was unfolding in China. What gives? This strong relative performance suggests confidence that the virus outbreak will be contained and economic data will rebound sharply after the inevitable deterioration in February (which may also extend into March). Economic risks, even in the short term, will be concentrated in China and Asia and possibly a few select emerging countries. Underlying this thesis is two hypotheses: (1) the virus outbreak will behave similarly to previous episodes like SARS in 2002/2003 which proved to be short lived on all fronts; and (2) the power of easy financial conditions. The second point is easier to accept than the first. A large drop in government bond yields and a move to anticipate/discount two Fed rate cuts no doubt cushioned the impact, and the PBoC has moved quickly to boost liquidity conditions to ensure the smooth functioning of the Chinese financial system. The fact that the Fed had been cutting rates and has suggested in its communications that rate cuts were more likely than rate hikes built confidence that if data did deteriorate the Fed would react. Ironically, by communicating this, the market's moves may obviate the Fed's need to actually move. Regardless, a lot of uncertainty remains.

After their powerful rallies at the end of last year, bond and equity markets were ripe for a correction, making them vulnerable to bad news. The fact that the sell-off (or rally in government bonds) was relatively contained was impressive, although we must not forget that the crisis is not over in China or for the rest of the world. While there are signs that the virus is spreading at reduced rates, we do not know enough about its characteristics to be overly confident that the end is near. Given where valuations were at the beginning of the year; and the lagged improvement in real and sentiment data, the ability of the market to dismiss the event as a short term hiccup implies a strong belief in the global economy's likely reversion to its pre-virus trajectory, which was not all that great to begin with. It is a small leap of faith that the nascent recovery we were seeing will not be derailed significantly due to the coronavirus outbreak. While the most likely outcome is one of renewed economic vigor (strongly supported by easier financial conditions), this type of aggregate demand and supply shock may have surprising implications for future economic and financial market performance. In other words, do not be surprised by surprises over the next few weeks and months. Let's hope for the best.

Be that as it may, the economic outlook for China is very uncertain; global growth will slow; global trade will be slower to rebound, and markets have generally not cheapened. Buying the dip is problematic if there is not much of a dip to buy! Therefore we are not recommending any significant changes to our strategy. Medium term, meaning a horizon of at least one year, we are modestly bullish on the economy, modestly negative on rates, selectively negative on the dollar but not bullish on most G7 currencies and modestly positive but selective on credit and emerging markets. Per usual, our strategy continues to emphasize skepticism that the market can predict the future and we are willing to fade dramatic moves one way or the other in current market conditions. It's too early to sound the all clear.

	MONTHLY REVIEW	OUTLOOK
Developed Markets	Developed market sovereign bond yields rallied across the board in January as risk assets underperformed and markets shifted to a "risk off" sentiment. Geopolitical risks, such as escalation between the U.S. and Iran as well as the coronavirus outbreak weighed on investors. The yield on the 10 year U.S. Treasury fell 41 basis points over the month to 1.51%, with similar downward movements in Canada, Australia, and New Zealand, while Japan's 10 year equivalent bond fell by five basis points and 10 year Bunds rallied 25 basis points. 10-year breakeven inflation in the U.S. declined nearly 15 basis points, ending the month at 1.64.[2]	Global growth and inflation are likely to be stable to slightly higher in 2020. We believe central banks around the world will generally remain on hold, with further accommodation in the developed markets unlikely unless the growth outlook deteriorates significantly. Despite recent positive developments in areas such as Brexit and U.S./China trade negotiations, we believe geopolitical issues remain one of the bigger risks to the global economy, as well as weakness in the manufacturing and trade sectors undermining the consumer. In this context, we expect U.S. Treasury yields to remain below and around 2%. The U.S. election also introduces further uncertainty to the outlook, but not until the second half of 2020. Additionally, the coronavirus has been an unexpected and hard to quantify shock to the global growth outlook.
Emerging Markets	Emerging markets (EM) fixed income asset performance was mixed in the month as investors reduced risk on fears of the potential economic impact of the spreading coronavirus. Despite the positive momentum in the recent global economic data, it is likely to deteriorate going forward given the economic disruption to date. It is therefore not surprising U.S. Treasury yields fell, which aided longer-duration/higher-quality assets, and the U.S. dollar strengthened versus EM currencies. In this environment, within the dollar segment, Investment grade assets outpaced high yield and EM domestic debt posted negative performance as currency weakness outweighed local bond returns. Within dollar-denominated debt, return dispersion was wide and skewed to the positive side with only a handful of countries posting negative returns. This was in contrast to domestic debt, where dispersion was wide but returns were more balanced. According to data from JP Morgan, investors started the year by adding to their EM debt allocations, with hard currency strategies gaining twice the assets of local currency strategies. Growth fears weighed on commodity prices, which were broadly weaker, with the exception of gold.[3]	We remain cautious on EM debt in the near term, as the optimism post-US-China Phase 1 deal has proven short-lived, upstaged by the recent coronavirus outbreak. The true impact of the latter remains to be seen, but it is likely to weigh on Chinese growth in 1Q (estimates of downward growth revisions range from 0.2-0.8 percentage points), with spillovers to commodity exporters in EM as well as countries with trade linkages with China. Therefore, most asset classes whose outperformance was predicated on stronger global growth may continue to be challenged in the near term, most notably EMFX and equities, and also HY credit, with high-quality duration likely outperforming. In the medium term, however, experience from previous outbreaks points to V-shaped economic recoveries, which should limit the downside to risk assets in general. Finally, should growth decelerate more sharply, we expect support from central banks.

[2] Source: Bloomberg. Data as of January 31, 2020 [3] Source: JP Morgan. Data as of January 31, 2020

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	MONTHLY REVIEW	OUTLOOK
Credit	January saw corporate spreads wider in the U.S. and in Europe. The positive key drivers of credit spreads in January were (1) the signing of the US/China "phase one" trade deal (2) Middle East volatility following US/Iran escalation and subsequent de-escalation of risk (3) macro-economic data that continued to improve at the margin (4) corporate reporting that to date has exceeded expectations. However, these factors were overwhelmed by the outbreak of the coronavirus.	Overall credit markets remain orderly despite increased risk sentiment dominated by the coronavirus. Demand remains strong with new issues oversubscribed and trading well on break. While credit spreads widened in the first month of the year, valuations still remain expensive to long run average. Looking forward we expect 2020 to be a year of two halves with credit initially well supported by the improving economic backdrop, reduced political risk and strong demand with no let-up in the need for yield given the excess liquidity in the system.
Securitized Products	January looked a lot like 2019 overall in securitized markets, with interest rates rallying and credit spreads continuing to tighten further. Credit-oriented securitized assets performed well during the month, while agency MBS underperformed as lower rates increased prepayment concerns. U.S. real estate and consumer credit conditions remain healthy, with historically low unemployment, rising wages and healthy spending rates, and increasing home sales which are being supported by low mortgage rates.	We remain positive on mortgage and securitized sectors in 2020. Agency MBS has cheapened meaningfully over the past two years and now look attractive on a risk-adjusted relative value basis. Securitized credit opportunities also look attractive as fundamental credit conditions remain very positive for residential and consumer lending markets in both the U.S. and Europe.

Risk Considerations

Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. Certain **U.S. government securities** purchased by the strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **Public bank loans** are subject to liquidity risk and the credit risks of lower-rated securities. **High-yield securities (junk bonds)** are lower-rated securities that may have a higher degree of credit and liquidity risk. **Sovereign debt securities** are subject to default risk. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (**liquidity risk**). They are also subject to credit, market and interest rate risks. The **currency market** is highly volatile. Prices in these markets are influenced by, among other things, changing supply and demand for a particular currency; trade; fiscal, money and domestic or foreign exchange control programs and policies; and changes in domestic and foreign interest rates. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than the risks generally associated with foreign investments. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs),** it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

DEFINITIONS

INDEX DEFINITIONS

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

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

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

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

The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

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

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

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

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

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

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

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

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

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

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.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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