Morgan Stanley

INVESTMENT MANAGEMENT

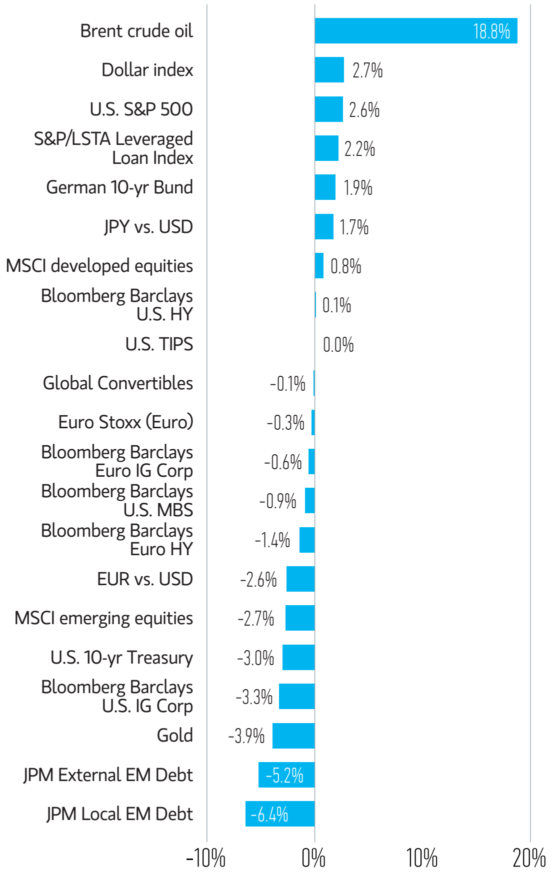
Global Fixed Income Bulletin

The Macro Trends Which Matter

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JULY 2018

The main trends in asset performance year-to-date have been generally weak risky asset returns, outperformance by U.S. assets and the USD, weakness in emerging markets (EM) and higher oil prices. Most of these have been driven by several macroeconomic trends (a) disappointment about a slowdown in some economic data and concerns about a trade war, (b) economic and monetary policy divergence between the U.S. and the rest of the world and (c) increased risks in EM. We think understanding these trends will be key for understanding asset price performance for the rest of the year.

DISPLAY 1
Asset Performance Year-to-Date



Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of June 30, 2018. 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 6 and 7 for index definitions.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)

Source: Bloomberg. Data as of June 30, 2018. Note: Positive change means appreciation of the currency against the USD.

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spreads

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)	
United States	2.86	0		
United Kingdom	1.28	+5	-158	+5
Germany	0.30	-4	-256	-4
Japan	0.04	0	-282	-1
Australia	2.63	-4	-23	-4
Canada	2.17	-8	-69	-8
New Zealand	2.72	0	-14	0
EUROPE			(Spread over Bunds)	
France	0.67	0	36	+4
Greece	3.96	-63	366	-59
Italy	2.68	-11	238	-7
Portugal	1.79	-19	149	-16
Spain	1.32	-18	102	-14
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			387	+22
EM Local Yields	6.64	+15		
EM Corporate Spreads			302	+18
Brazil	9.84	+34	326	+27
Colombia	6.41	+6	197	-8
Hungary	2.64	+60	145	+7
Indonesia	8.03	+73	218	+18
Malaysia	4.23	+1	166	+22
Mexico	7.65	-16	281	-7
Peru	5.65	-7	166	-2
Philippines	5.92	+44	132	+9
Poland	2.60	+1	76	-7
Russia	7.49	+36	217	-4
South Africa	9.39	+21	312	+35
Turkey	17.00	+216	415	+25
Venezuela	–	–	5011	+446
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			123	+8
EUR IG			122	+4
U.S. HY			363	+1
EUR HY			391	+24
SECURITIZED				
Agency MBS			79	+1
U.S. BBB CMBS			293	-8

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of June 30, 2018.

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Fixed Income Outlook

Slowing growth data has been concentrated in the manufacturing sector. Much of this slowdown has occurred in manufacturing purchasing manager indexes (PMIs) and in most countries has occurred from very heady levels reached in early 2018. Data for the broader economies have generally been more robust, and consensus gross domestic product (GDP) forecasts continue to be revised higher. Most economic forecasters see trend or above trend growth in 2018 and 2019 which is what current PMI levels are consistent with. Markets remain anxious, however, about the sustainability of such growth. Despite signs of a stabilization in PMIs outside of the U.S., markets are concerned that the global economy has passed an inflection point and is unlikely to do as well as it did in 2017. Trade conflict, political populism, tighter U.S. monetary policy and the end of quantitative easing (QE) have taken their toll on business and investor confidence. That said, while the imposition of punitive, growth sapping tariffs remain a risk, the most recent activity data have started to surprise on the upside. Our base case remains that the global economy remains resilient and downside risks remain small. This should provide a supportive backdrop for a recovery in corporate and EM markets.

However, we also know too strong growth can cause its own problems and the chief one at present is the tensions that U.S. economic outperformance is causing, especially for EM. It has been the worst start to the year for EM currencies in the last 30 years, and the concern is that weaker currencies, poor policies, higher U.S. rates and a tariff war could lead to a broader systemic risk event. While flows to EM markets are still positive for the year as a whole, there were large, retail-led outflows in June. Of key concern is evidence of the Chinese economy slowing, given its size and importance to the global economy. Our current assessment is still that emerging economy fundamentals are a lot better than they were in 2013 (and 2015 when the global industrial sector slowed significantly), so the potential impact of higher U.S. rates is lower now. We are also encouraged by proactive policy responses in many EM economies (rate hikes in Indonesia and Mexico) which have come under market pressure. Nonetheless, an accelerating tariff conflict and a disorderly Chinese slowdown remain key risks for our otherwise constructive outlook.

Sideways movement in developed country government bond markets masks some important monetary policy developments in June. The European Central Bank (ECB) confirmed the end of QE in 2018 but also committed to not raising rates before September 2019, a more dovish outcome than expected. On the other hand, the Federal Open Market Committee (FOMC) raised rates as expected but also communicated a slightly more hawkish stance. While the U.S. Federal Reserve's (Fed's) gentle pace of tightening has meant longer dated U.S. Treasury yields have risen slowly, the trend of policy divergence between the U.S. and other economies has been reinforced, which has been the recipe for a stronger USD.

Credit markets (particularly euro) continued to have a horrid time even as euro sovereign bond markets calmed down. Italian political risks have not been resolved, and hence further volatility seems likely, but it appears the Italian government has backed away from its most extreme anti-European Union (EU) and fiscal expansion rhetoric. In addition, mergers and acquisitions (M&A) has weighed on corporate credit markets, by generating additional supply and increasing leverage but, with recessionary risk remaining remote and valuations more attractive, we remain constructive, especially on financials.

EM are likely to remain under pressure given ongoing trade war concerns and idiosyncratic risks. However, the robust policy response from many countries and cheaper valuations are making many markets look attractive.

	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	While May was a systemic sell-off across risky assets, in June, markets began sorting through the idiosyncratic risks. Fears of risk contagion to euro peripheries began to subside, and Spanish and Portuguese spreads tightened by roughly 20 basis points. Ten-year U.S. Treasury yields ended the month flat, with yields declining in the second half of the month as trade war noise picked up. The U.S. Treasury 2s10s curve flattened by 10 basis points.[1]	With better inflation and economic data, market pricing and the Fed's own expectation for Fed hikes in 2018 has been creeping up. As for U.S. Treasury 10-year yields, we still think 3 percent is a reasonable guess as to its current "fair value." We have been relatively neutral on the USD, and are in wait-and-see mode, focusing on dollar-neutral FX pairs. We believe volatility in Italy will continue, likely resuming in the fall as the Italian government's fiscal expansion plans are likely to lead to further clashes with Italian institutions and the EU.
Emerging Market (EM) Rate/FX	EM assets had a rough second quarter, as the tail risks regarding trade wars are becoming more prominent, amid a strengthening USD and a marginally more hawkish Fed. Idiosyncratic EM volatility has increased, notably in Brazil, Argentina and Turkey. The sharp depreciation of the renminbi last June also weighed on market sentiment. Investors (primarily retail) withdrew assets from hard currency strategies (-$0.5 billion), while local currency strategy assets were roughly flat during the month.[2] In Argentina, the government and the International Monetary Fund (IMF) reached a standby agreement of USD 50 billion, for 36 months, plus USD 5.6 billion from multilaterals, which was above market expectations.[3] Turkey hiked its policy rate by another 125 basis points to 17.75 percent against market expectations of no change (highest analyst estimates of 100 basis points).[4] Surprisingly, Mexican assets have been well behaved considering the external environment and the presidential election.	We believe many trade measures will likely become effective before any progress in trade talks is realized. As a result, we should see a negative, though marginal impact on GDP and trade flows for targeted countries, but more importantly, an overall deterioration in business and consumer confidence. On the positive side, the EM policy response has been more proactive as of late, with many economies deemed as vulnerable reacting more forcefully to market turbulence. Furthermore, the sharp sell-off we witnessed in the 2Q18 appears to be overdone in countries with improving fundamentals (such as South Africa and Indonesia), thus offering attractive entry points should we see a de-escalation in trade-war rhetoric.

[1] Source: Bloomberg. Data as of June 30, 2018.
[2] Source: JP Morgan. Data as of June 30, 2018.
[3] Source: IMF. Data as of June 30, 2018.
[4] Source: Bloomberg. Data as of June 30, 2018.

	MONTHLY REVIEW	OUTLOOK
Credit	Both the U.S. and European corporate credit spreads made new year-to-date highs in June, as both markets ended the month with a noticeably weaker tone. Supply remained elevated in June, as has been the case all year. This was primarily due to large deals from Walmart and Bayer, each funding recent M&A transactions. Amazon's disruption of traditional business models continued in June with its acquisition of online pharmacy PillPack for $1 billion. Spreads of more traditional brick-and-mortar pharmacy chains like CVS and Walgreens moved wider on the news, though it will take some time to fully understand how Amazon's presence will disrupt these long-standing business models.	Sitting at the midpoint of the year, it is fair to say the credit markets have not behaved as expected thus far in 2018. However, spreads now sit at levels that are very attractive for nonrecessionary environments (our base case). We continue to have a strong bias for financials given their robust fundamentals and strong regulatory oversight. We remain cautious on many parts of the nonfinancial markets given weaker fundamentals, elevated supply and widespread technology and disruption risk.
Securitized	Rates-sensitive securitized assets were essentially flat during the month, while credit-sensitive securitized assets overall continued to generate positive returns, primarily driven by income. Home prices continued to rise, but home affordability is becoming more challenging as home prices rise and mortgage rates have increased as well. Commercial mortgage-backed securities (CMBS) spreads widened 5-10 basis points in June, but CMBS, which has significantly underperformed over the past couple years, has performed meaningfully better in 2018 year to date.	Rising home prices should be positive for seasoned loans, but could be more problematic for newly originated loans. We still find attractive value in nonagency residential mortgage-backed securities (RMBS), but we are beginning to become more cautious given the spread tightening over the past few years. We remain very cautious on CMBS collateralized by retail properties, but we remain constructive on CMBS backed by residential properties, office buildings, industrial properties and distribution centers. In European mortgage-backed securities (MBS), we see the recent spread widening as a potential investment opportunity. We remain negative on Italy, but we believe that Spain, Portugal, the Netherlands, Germany and the U.K. continue to offer attractive MBS opportunities.

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Risk Considerations

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

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

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

Spain 10-Year Government Bonds—Spain 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 domestic or euro domestic markets by issuers around the world.

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

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

U.K. 10YR 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

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the accepted conventions within each market. Generally, the benchmark bond is the latest issue within the given maturity band; consideration is also given to yield, liquidity, issue size and coupon.

German 10YR bonds—Germany Benchmark 10-Year Datastream Government Index; **Japan 10YR 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 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 **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 (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 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 **ICE BofAML United States 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.

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

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

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

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

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

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

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

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

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

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