Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

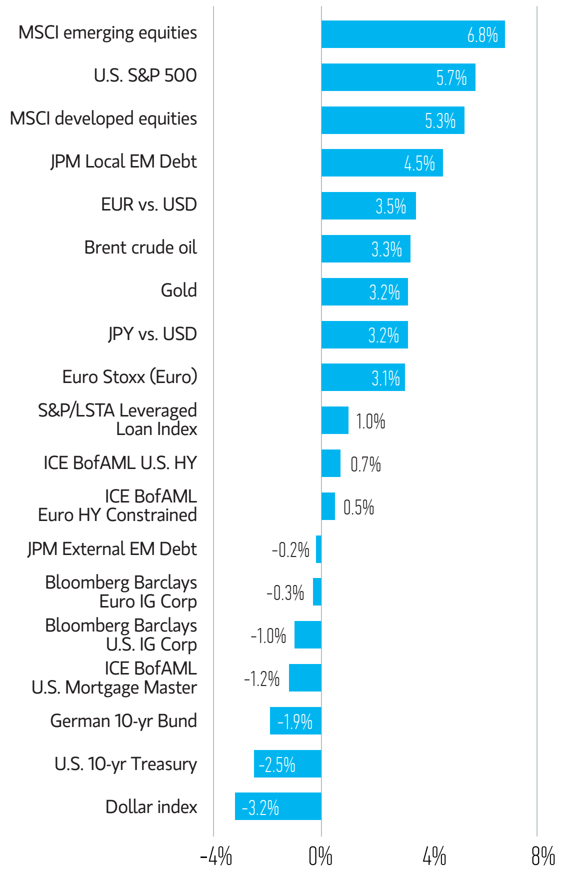
Finding a New Range and Speed of Adjustment

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

The increase in market volatility since the release of the January U.S. labor market data suggests that the low-rate, low-volatility environment is being challenged and probably coming to an end. Last year we began to argue that the world was moving into a synchronized economic upswing that was truncating downside (disinflationary) risks and pushing growth and inflation outside of their post-crisis ranges. This normalization of economic performance meaning steady, strong growth, rather than the start/stop behavior we have experienced over the past 10 years, means markets should "normalize" as well: more volatility and higher yields. Low and falling inflation last year muted if not negated this effect. 2018 is unlikely to be so lucky. As we saw in January, this means higher yields, nominal and real, as growth and inflation expectations do not mean revert as they have since the end of the global financial crisis.

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of January 31, 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 for index definitions.

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As a result of these forces, yields in developed markets are likely to spend time searching for a new, most likely higher, range as this economic expansion continues. For nongovernment bond markets, there will be tension between higher volatility negatively affecting valuations and positive fundamentals in terms of corporate/EM cash flow and economic momentum. As always, how central banks react to this changing economic and market performance landscape will determine how this tension is resolved. What new yield range is established and how fast yields adjust will be key to bond market performance in the period ahead. In this transition period, hold on to your hats!

	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	Strong growth numbers, rising economic prospects driven by fiscal stimulus and central banks tilting toward tightening all coalesced in January, contributing to rising risk-free yields around the world. The dollar declined versus major currencies as following strong risk-on sentiments. EM currencies outperformed.	We expect three rate hikes in 2018, which is the same as the Fed's forecast, but the market is pricing in only two. The risk for 2018 is if the Fed hikes rates faster than its current forecast (i.e., a fourth hike in 2018), not if they hike slower. However, unless R* rises significantly, driven by strong business investment and rising productivity, we believe that 3 percent may be the upper bound for where 10-year yields settle.
Emerging Market (EM) Rate/FX	Following a strong year for EM fixed income assets, returns were mixed in January. Dollar-denominated corporates outperformed sovereigns, as longer-duration assets faced the headwinds of rising U.S. Treasury yields. The U.S. dollar weakened as EM currencies strengthened 3.57 percent versus the dollar, essentially tracking the euro.[1] Flows into the EM asset class were robust, posting a record start to the year.	We see the EM/DM growth differential rising even further in favor of EM in 2018, potentially boosting inflows into EM. The steady decline in the dollar index, coupled with a pickup in trade-intensive global business investment, should further contribute to our constructive outlook. A faster Fed hiking path and trade protectionism remain the key risks. Though we expect some trade measures against China, our base-case scenario is that they will be moderate and limited to specific sectors (intellectual property, for example).

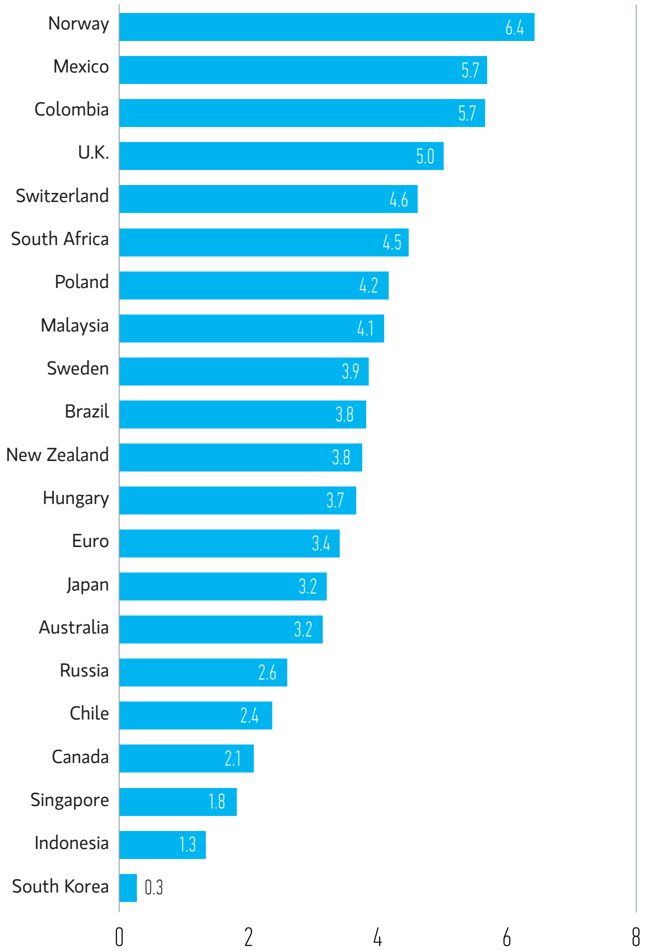
[1] Source: JP Morgan. Data as of January 31, 2018.

	MONTHLY REVIEW	OUTLOOK
Credit	The U.S. and European corporate indices snapped tighter in January, generating excess returns of nearly 1 percent and helping to offset negative total returns due to rising interest rates. Spreads for the major indices ended January at levels not witnessed since 2007. After a stellar 2017 subordinated financials once again led the way tighter in Europe, though the strength was widespread.	We find much greater comfort investing in financials over nonfinancials, a key area of our focus for the past several years. Higher interest rates, continued loan growth and cost containment helped boost interest income. Looking forward, the banks all expect a boost to profitability from lower future tax rates, though most excess cash is expected to be directed toward shareholders in the form of stock buy backs and dividends.
Securitized	Credit-sensitive securitized assets continued to perform well in January, while more rates-sensitive securitized assets underperformed as interest rates increased in January. Agency MBS, which is the most rates sensitive, had the worst performance among securitized assets in January.	Our investment thesis remains largely unchanged for February: We remain generally constructive on securitized credit opportunities and cautious on more rates-sensitive securitized assets. U.S. CMBS remains the highest-yielding securitized asset classes, but also the sector with perhaps the greatest risks. We expect commercial real estate valuations to remain flat for 2018 as property performance is unlikely to improve materially from current levels. Within CMBS, we still like residential-related sectors like single-family rental and multifamily housing.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of January 31, 2018. Note: Positive change means appreciation of the currency against the U.S. dollar.

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spread

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)	
United States	2.71	30		
United Kingdom	1.51	32	-120	2
Germany	0.70	27	-201	-3
Japan	0.09	4	-262	-26
Australia	2.81	18	11	-12
Canada	2.29	24	-42	-6
New Zealand	2.90	18	19	-12
EUROPE			(Spread over Bunds)	
France	0.97	18	27	-9
Greece	3.74	-38	304	-65
Italy	2.03	1	133	-26
Portugal	1.97	2	127	-25
Spain	1.43	-14	73	-41
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			290	-19
EM Local Yields	6.21	-5		
EM Corporate Spreads			204	-19
Brazil	8.73	-28	217	-15
Colombia	6.24	-2	153	-20
Hungary	1.47	+21	79	-7
Indonesia	6.54	-10	152	-14
Malaysia	4.00	+10	101	-7
Mexico	7.63	-4	223	-22
Peru	4.79	-45	119	-17
Philippines	4.74	-10	84	-11
Poland	2.76	+6	41	-4
Russia	7.05	-24	156	-23
South Africa	9.17	-14	219	-36
Turkey	11.71	-23	277	-14
Venezuela	–	–	4660	-194
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			86	-7
EUR IG			74	-12
U.S. HY			319	-24
EUR HY			250	-27
SECURITIZED				
Agency MBS			73	+4
U.S. BBB CMBS			299	-31

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of January 31, 2018.

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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.

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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 **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 **BofA Merrill Lynch European Currency High-Yield Constrained Index (ML Euro HY constrained)** is designed to track the performance of euro- and British pound sterling-denominated below investment-grade corporate debt publicly issued in the eurobond, sterling domestic or euro domestic markets by issuers around the world.

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

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

U.K. 10YR 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.

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 **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 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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