Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Where Has the Volatility Gone?

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JUNE 2017

Summary

"Sell in May and go away" may be the market aphorism but if followed, turned out to be wrong this May! Yet, despite political noise from the U.S. and Brazil, no substantial risk event surfaced and risky assets ended the month higher, much to the consternation of those who reduced risk. This means that markets should be well supported into the summer as cash positions remain high and the "buy the dip" mentality persists. Although politics continue to be a source of volatility so far, it has remained a distraction rather than a problem. Indeed, low levels of volatility should continue over the summer as the trends in data and policy look well established.

DEVELOPED MARKET RATE/FX: In much of May, yields fell across developed markets (DM), driven by increased political noise around the FBI investigation into the Trump administration's ties with Russia and weaker-than-expected U.S. data. The political noise also weakened the dollar against major currencies.

We do not see any obvious catalysts to drive government bond yields meaningfully higher, at least in the short term. That said, from a longer-term perspective, U.S. and eurozone core government yields look too low. We prefer some of the peripheral eurozone countries, such as Portugal and Spain, which have benefited from economic reflation. Australian government yields also look relatively attractive given the risk profile of the Australian economy and headwinds for China.

EMERGING MARKET RATE/FX: Despite idiosyncratic setbacks, emerging market (EM) fixed income assets posted broadly positive performances in the month and investors continue to increase exposure to the asset class. Political events in Brazil weighed heavily on asset prices before stabilizing towards the end of the month. Chinese fiscal and monetary policy tightening, combined with large inventories, led to the sharp reversal in certain commodity prices, such as iron ore.

We remain optimistic about EM fixed income spreads for 2017 as country fundamentals and the macro environment remain supportive, with those countries that rely most on global trade potentially challenged. We like Brazil and Mexico bonds. Key risks are Trump's protectionist policies, a hawkish U.S. Federal Reserve (Fed), or Chinese policy tightening triggering a sharper-than-expected growth downturn. China's growth slowdown is likely to continue in the medium term, though CNY weakness looks less likely given the political and geopolitical backdrop.

CREDIT: Despite political headlines throughout the month of May, credit markets traded well across the credit spectrum in both the U.S. and Europe, as strong technicals helped credit spreads narrow modestly in both the investment-grade and high-yield markets. The VIX ended at its lowest monthly level since before the financial crisis.

In U.S. credit markets, we anticipate a continued grind tighter in spreads toward cycle lows despite growing leverage in many industries. We continue to seek opportunities in the high-yield and convertible bond markets, sectors that typically perform better in the latter stages of the business cycle. In investment-grade, we remain constructive on financials with a bias toward subordinated debt, marginally constructive on BBB nonfinancials, and we remain less constructive on A-rated nonfinancial risk.

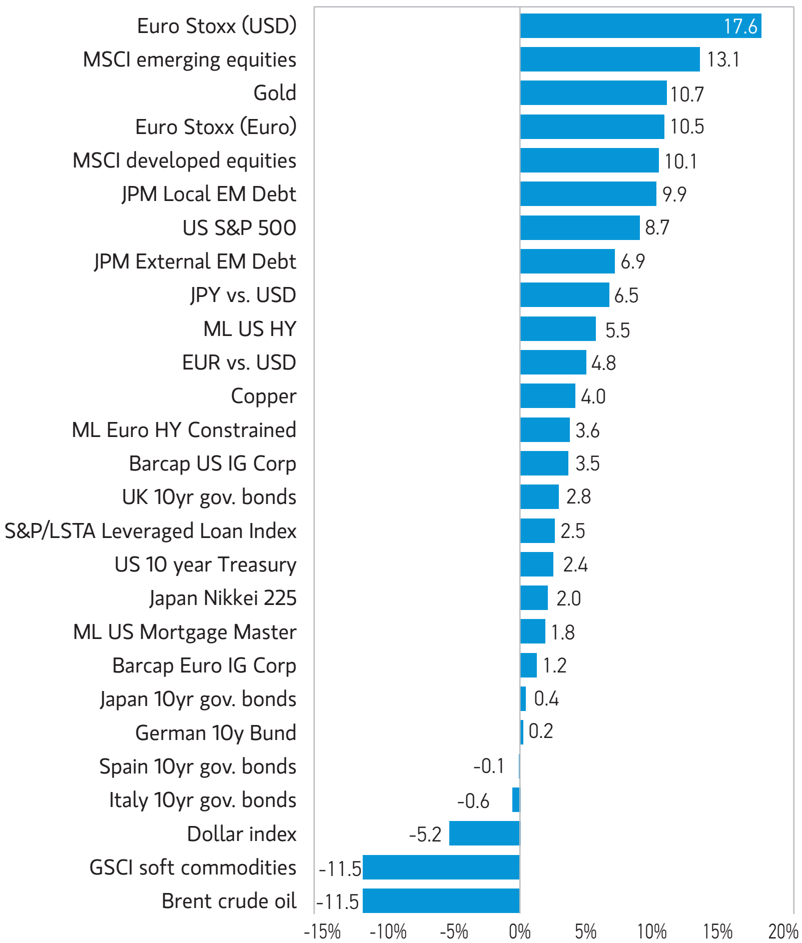
SECURITIZED: Agency mortgage-backed securities (MBS) performed well in May, while credit-related securitized assets also saw continued gains. Commercial mortgage-backed securities (CMBS) performance continues to diverge depending on different collateral compositions, with those with higher retail concentrations underperforming.

We remain positive on mortgage credit opportunities and are less constructive on the more rates-based risks of agency MBS. In Europe, we have been very positive on the outlook for MBS and CMBS, but the valuation of the assets makes us less favorable now. Spreads are now significantly tighter than pre-Brexit levels.

DISPLAY 1

Asset Performance Year-to-Date

Data as of 5/31/2017



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of May 31, 2017. 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 13 and 14 for index definitions.

DISPLAY 2

Major Monthly Changes in 10-Year Yields and Spreads

	RATES		CURRENCY
DM	**LEVEL**	**CHANGE (BPS)**	**CHANGE (%)**
United States	2.20	-8	
United Kingdom	1.05	-4	-0.47
Germany	0.30	-1	3.20
Japan	0.05	3	0.64
EM Spreads			
EM External	322	1	
EM Local Yields	6		
EM Corporate	258	5	
Credit Spreads			
U.S. IG	113	-3	
EUR IG	109	-2	
U.S. HY	363	-8	
EUR HY	290	-26	
Securitized Spreads			
Agency MBS	15	1	
U.S. BBB CMBS	373	-12	

Source: Bloomberg, JP Morgan. Data as of May 31, 2017.

The views and opinions expressed are those of the portfolio management team as of May 2017, and are subject to change based on market, economic, and other conditions. **Past performance is not indicative of future results.**

Fixed Income Outlook

"Sell in May and go away," may be the market aphorism but, if followed, turned out to be the wrong decision last month. Political noise, both from the Trump administration and Brazil, did give markets a chance to sell off, but there was no follow-through and most markets recovered. The new U.S. administration has found it challenging to deliver on campaign promises, bringing into question the reflation-related optimism that had led government bond yields higher. Curiously, less Trump optimism has not been hurting the continued bull run in credit and equities.

In any case, the volatility spike in May proved to be brief, with the VIX hitting below 10 near the end of the month.[1] That said, large market gains on risky assets, significant falls in government bond yields and the U.S. dollar (essentially unwinding the Trump trade), and continued low volatility are making investors uneasy.

Much of the rally in nongovernment bonds this year has been supported by good fundamentals, which continued to be solid in May. Europe, in particular, had better growth and inflation while in the U.S., data seemed to have peaked in March but remain in positive territory. We expect stronger economic growth performance in Q2 and Q3 after a weak Q1. Given the benign economic data, market pricing for a Fed hike in June is now above 80 percent.[2] We believe the market can handle the two to three hikes telegraphed for this year, since real rates remain low — meaning policy remains accommodative for economic growth.

In the past 12 months, most meaningful spikes in volatility can be attributed to political events. Each politics-related volatility spike has so far been short-lived and has resulted in higher asset prices. Perhaps the pattern is that investors de-risk ahead of the event and then re-invest after the event — a strategy that has worked well over the past 12 months … but why? This is likely because economic fundamentals have been reasonably strong, central bank policies have been accommodative, and cash levels in portfolios have been high. Unlike previous periods of high asset prices, this time skepticism abounds and cash levels remain high supporting the idea that markets are not irrationally priced.

More political noise is on the horizon, with ongoing testimonies related to the FBI investigation into alleged Trump administration ties with Russia, as well as French legislative elections and this week's U.K. general election. Politics are noise, fundamentals are real. Our strategy is to trade the noise, but invest with the fundamentals. We look at political noise as opportunities to buy assets with positive long-term fundamentals.

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[1] Source: Bloomberg. Data as of May 31, 2017.

[2] Source: Bloomberg. Data as of May 31, 2017.

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Developed Market

Monthly Review

Yields fell across the DM during much of May. Over the month, 10-year U.S. Treasury yields were down 8 basis points.[3] In the eurozone, Greece and Portugal spreads tightened more than those of the core eurozone countries, with Portugal yields down 49 basis points on the month due to good data releases.[4] Australia and New Zealand yields decreased by 19 basis points and 27 basis points, respectively, driven by worries around the Chinese economy and effects on commodity prices.[5]

The dollar generally weakened against most EM and DM currencies. Strong growth in Europe led to outperformance in its currencies. The euro appreciated by 3.2 percent, while Hungary was the biggest gainer, at 4.7 percent.[6]

In the U.S., the Fed kept policy unchanged at the May meeting. The committee looked through weaker GDP data in the first quarter and believes fundamentals remain solid. Activity and inflation data continue to be slightly weaker in May, after reaching a peak in March. ISM manufacturing was 55 in April versus 57 previously, though it is still in expansion. The labor market continues to be strong. April nonfarm payrolls surprised to the upside, increasing 211,000 versus expectations of 190,000.[7] This should support the Fed's case for tightening monetary policy in upcoming months.

DISPLAY 3

Government Bond Yields for Major Economies

COUNTRY	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR SPREAD LEVEL (%)	MONTH CHANGE (BPS)	2S - 10S YIELD CURVE (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)			
United States	2.20	-8			92	-10
United Kingdom	1.05	-4	-116	4	92	-10
Germany	0.30	-1	-190	6	102	-3
Japan	0.05	3	-215	11	21	-2
Australia	2.39	-19	18	-11	84	-8
Canada	1.42	-13	-79	-5	72	-10
New Zealand	2.78	-27	58	-19	86	-11
Europe			(Spread over Bunds)			
Belgium	0.66	-12	35	-11	123	-10
France	0.73	-10	43	-9	124	-5
Germany	0.30	-1			102	-3
Greece	6.09	-25	579	-24	17	21
Ireland	0.78	-7	48	-6	121	-7
Italy	2.20	-8	190	-7	237	1
Netherlands	0.52	-3	21	-2	117	-2
Portugal	3.06	-49	276	-47	279	-33
Spain	1.55	-10	125	-8	183	-8
Denmark	0.57	-3	27	-2	114	-4
Norway	1.51	-12	121	-11	93	-5
Sweden	0.47	-11	17	-10	118	-5
Switzerland	-0.17	-6	-47	-4	73	-1

Source: Bloomberg, data as of May 31, 2017

In the eurozone, data continues to be on an uptrend. PMI manufacturing in May remained unchanged from the previous month, at 57. Inflation is also stronger, with core CPI at 1.2 percent in April, up from 0.7 percent previously. Despite strong data, European Central Bank (ECB) President Mario Draghi continues to strike a dovish tone. In the month, he commented that monetary accommodation is still appropriate, given the lack of firmness in domestic inflation. In France, Emmanuel Macron won the presidential election run-off, which was market-friendly. The focus will be on legislative elections in June, which will determine Macron's legislative agenda as president.

In the U.K., the Bank of England (BOE) left monetary policy unchanged at its May meeting. Recent data remains strong with inflation hitting 2.7 percent in April, rising from 2.3 percent.[8] If the inflation overshoot persists, the Monetary Policy Committee (MPC) mentioned that policy might need to be tighter than the dovish path currently anticipated.

[3] Source: Bloomberg. Data as of May 31, 2017.
[4] Source: Bloomberg. Data as of May 31, 2017.
[5] Source: Bloomberg. Data as of May 31, 2017.
[6] Source: Bloomberg. Data as of May 31, 2017.
[7] Source: Bloomberg. Data as of May 31, 2017.
[8] Source: Bloomberg. Data as of May 31, 2017.

DISPLAY 4

Major Economic Data Releases

COUNTRY			LATEST	CONSENSUS	PREVIOUS	AS OF
U.S.	Labor	Non-farm Payrolls (1000s)	138	182	174	5/31/2017
		Unemployment rate (%)	4.3	4.4	4.4	5/31/2017
		Participation rate (%)	62.7		62.9	5/31/2017
		Average Hourly Earnings (%YoY)	2.4		2.4	5/31/2017
	Activity	ISM Manufacturing	55	55	55	5/31/2017
		GDP (%QoQ, saar)	1.2	0.9	2.1	3/31/2017
		GDP (%YoY)	2		2	3/31/2017
	Inflation	CPI (%YoY)	2.2	2.3	2.4	4/30/2017
		Core CPI (%YoY)	1.9	2	2	4/30/2017
Euro Area	Labor	Unemployment rate (%)	9.3	9.4	9.4	4/30/2017
	Activity	PMI Manufacturing	57	57	57	5/31/2017
		GDP (%QoQ)	0.5	0.5	0.5	3/31/2017
		GDP (%YoY)	1.7	1.7	1.8	3/31/2017
	Inflation	CPI (%YoY)	1.9	1.9	1.5	4/30/2017
		Core CPI (%YoY)	1.2	1.2	0.7	4/30/2017
U.K.	Labor	Unemployment rate (%)	4.6	4.7	4.7	3/31/2017
		Average Weekly Earnings (%)	2.4	2.4	2.3	3/31/2017
	Activity	PMI Manufacturing	57	57	57	5/31/2017
		GDP (%QoQ)	0.2	0.3	0.7	3/31/2017
		GDP (%YoY)	2	2.1	1.9	3/31/2017
	Inflation	CPI (%YoY)	2.7	2.6	2.3	4/30/2017
		Core CPI (%YoY)	2.4	2.3	1.8	4/30/2017
Japan	Activity	PMI Manufacturing	52.7		52	4/30/2017
		GDP (%QoQ, saar)	2.2	2.4	1.4	3/31/2017
		GDP (%YoY)	1.6		1.7	3/31/2017
	Inflation	CPI (%YoY)	0.4	0.4	0.2	4/30/2017
		Core CPI (ex food and energy, %YoY))	-0.3		-0.3	4/30/2017

Source: Bloomberg, data as of May 31, 2017

In Japan, growth continues to be stable, while inflation has ticked up, hitting 0.4 percent in April.[9]

Outlook

Without a realization of better economic data, we see 10-year yields trading within the ranges established this year. Better-than-expected growth, which hinges partly on the new policy mix under Trump, would drive "fair value" higher, though conversely, disappointments would drive rates lower. We have reduced our duration underweight going into Q2 but if political risks fade, we look to get shorter in duration.

In the first quarter, improving growth and inflation dynamics has raised market expectations of ECB tapering, which would increase risk premium and steepen yield curves in the euro area. We are slightly negative on eurozone interest rate risk on valuation grounds and improving economic performance. Peripheral eurozone has benefited from economic reflation in the area. We are most constructive on Portugal and Spain, which could see spread compression.

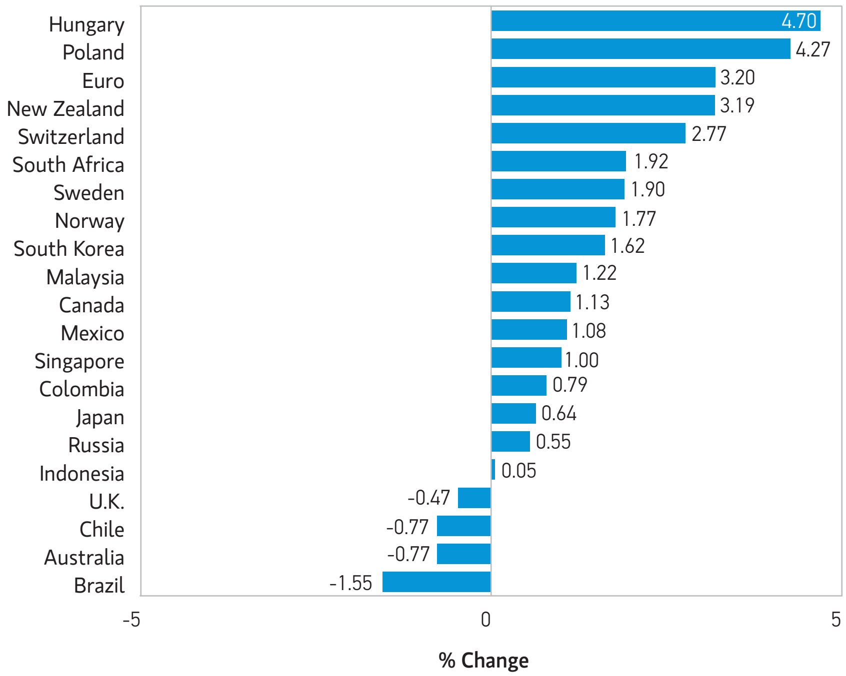
Policy to tighten financial conditions in China could produce negative economic reverberations elsewhere in the world, particularly EM. We see Australian rates as a good hedge against negative China risks.

In terms of currencies, the U.S. dollar is likely to move sideways in the months ahead as growth around the world matches or exceeds that in the U.S. Europe has been strengthening, and we are positive on euro-linked currencies such as Swedish kroner, Czech koruna and Polish zloty. EM currencies look interesting in a more robust global growth world. We like the Brazilian real, Mexican peso, Indonesian rupiah

[9] Source: Bloomberg. Data as of May 31, 2017.

DISPLAY 5

Currency Monthly Changes Versus U.S. Dollar



Source: Bloomberg. Data as of May 31, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

and Indian rupee, which we think can outperform versus the U.S. and Australian dollars. However, for these EM currencies, Trump's protectionist agenda will remain a source of volatility.

Emerging Markets

Monthly Review

Despite idiosyncratic setbacks, EMs fixed income assets posted broadly positive performance in the month. Investors continued to increase exposure to the asset class, adding $9.0 billion across hard currency, local currency and blended strategies, bringing the year-to-date total to $41.1 billion (compared to a total of $43 billion in 2016).[10] Idiosyncratic political events, in South Africa and Brazil among others, drove asset price volatility intra-month after markets priced out the French election risk. EM domestic debt outperformed external sovereign and corporate debt as EM currencies strengthened versus the U.S. dollar. Many commodity prices, particularly iron ore, weakened over the month.

Commodity prices erased much of their upswing as supplies began to build and demand growth forecasts cooled. However, while lower commodity prices could impede the fiscal plans for exporting nations, importing nations could benefit from lower commodity-linked inflation. After rallying 81 percent in 2016, prices for iron ore continued to weaken in 2017, and in April touched lows not seen since last October. Chinese economic tightening, which lowered the outlook for demand, combined with stockpiled supply, led to the sharp reversal in commodity prices.

At the most recent Organization of Petroleum Exporting Countries (OPEC) meeting, ministers agreed to extend the production cuts agreement in place by nine months. However, oil prices fell as the move did not satisfy investors who were hoping for deeper cuts or a longer duration of cuts to offset the threat of U.S. shale oil production growth. This view was supported by subsequent comments from Rosneft CEO Igor Sechin who stated that OPEC cuts could be "largely balanced out by an increase in U.S. shale oil production by the middle of 2018." With upside supply potential pitted against uncertain demand growth, oil prices have remained capped around $50/barrel for Brent. Highlighting the uncertainty of oil prices, Russian economy minister Maxim Oreshkin conveyed that "All macroeconomic policy is now based on the assumption of [an] oil price of $40."

Political events in Brazil weighed heavily on asset prices before stabilizing towards the end of the month. Allegations emerged that President Michel Temer was involved in covering up bribes to former speaker of the lower house, Eduardo Cunha. As a result, there were calls for Temer's resignation, to which he issued a sharp rebuke. As it stands, the President will likely remain in power depending on an electoral tribunal ruling expected in June, though his mandate is likely impaired to the point where the necessary social security and labor reforms are now in question. Investors quickly sold assets as they factored in the lower probability of social security reforms, which are critical to reigning in costs for the government and limiting its debt trajectory. While the politics have driven volatility, the Brazilian economy is in better shape than when the investigations began in 2015, lending support to assets in the country.

In South Africa, assets were supported by reports that the ruling ANC party would

[10] Source: Standard Charter. Data as of May 31, 2017.

DISPLAY 6

EM External/Local Changes

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	282	+23	9.9	+25
Colombia	203	+8	6.1	-5
Hungary	132	-1	1.9	-16
Indonesia	195	-1	7.2	-7
Malaysia	145	-2	3.9	-7
Mexico	255	+1	7.4	+11
Peru	145	+1	5.7	-6
Philippines	107	+5	5.0	-4
Poland	74	-14	2.7	-17
Russia	165	+4	7.7	+7
South Africa	261	-6	9.2	-2
Turkey	287	+4	10.4	-16
Venezuela	2228	+77	-	-

Source: JP Morgan. Data as of May 31, 2017.

discuss the removal of President Jacob Zuma, which proved to be premature. In the face of continued violent street protests Venezuela's President Nicolas Maduro called for a Constitutional Assembly to rewrite the constitution. The move was viewed as an attempt by the president to consolidate power, despite the potential for increasing divisions within the government as the current constitution was part of the former President Hugo Chavez's legacy.

EXTERNAL: EM external sovereign and quasi-sovereign debt returned 0.83 percent in the month, bringing year-to-date performance to 6.47 percent, as measured by the JP Morgan EMBI Global Index.[11] Higher-yielding, lower-rated credits underperformed lower-yielding, higher-rated credits in the month. Despite weaker energy prices, bonds from Ghana, Iraq, Ukraine, Senegal, Jamaica, Gabon, Zambia, Angola, and El Salvador outperformed the broader market. Conversely, bonds from Belize, Brazil, Egypt, Lebanon, Ecuador, Guatemala and Venezuela underperformed the broader market in the month.

DOMESTIC: EM domestic debt returned 1.96 percent in the month, bringing year-to-date performance to 9.86 percent as measured by the JP Morgan GBI-EM Global Diversified Index.[12] EM currencies strengthened 1.21 percent versus the U.S. dollar and EM bonds returned 0.74 percent in local terms.[13] Currency performance versus the U.S. dollar weighed on bond performance for Argentina, Brazil, Chile, and Peru, while contributing to the outperformance of euro-linked currencies from Czech Republic, Hungary, Poland and Romania. Bonds from Russia, the Philippines, Indonesia, Mexico, Turkey and Colombia also underperformed the broader market, while bonds from South Africa, Malaysia and Thailand also outperformed the broader market in the period.

CORPORATE: EM corporate debt returned 0.64 percent in the month, as measured by the JP Morgan CEMBI Broad Diversified Index.[14] Higher-yielding, lower-quality companies underperformed higher-rated companies in the month. From a regional perspective, companies in Africa (South Africa), Middle East (Israel), Latin America (Jamaica and Mexico), and Europe (Czech Republic, Poland, Turkey and Russia) led the market, while those in Asia-Pacific (Hong Kong and India) lagged. From a sector perspective, companies in the utilities, oil and gas, consumer, diversified, infrastructure and financial sectors outperformed the broader market, while those in the industrial, and metals and mining sectors lagged.

Outlook

Looking forward, we continue to believe that DM yields will continue to support the "right" carry opportunities, a strategy of borrowing at a low interest rate and investing in a higher return asset, and that the improving macroeconomic backdrop will be an ongoing "push" factor leading to inflows into higher yielding assets, including EM fixed income. For global growth, the benefit of higher U.S. growth is likely to be offset partly by the extent of a potentially more protectionist U.S. trade agenda. So far the President's pre-election rhetoric has not been followed up with action. However, the net effect will not be known

[11] Source: JP Morgan. Data as of May 31, 2017.

[12] Source: JP Morgan. Data as of May 31, 2017.

[13] Source: JP Morgan. Data as of May 31, 2017

[14] Source: JP Morgan. Data as of May 31, 2017

for a while, with Mexico and China remaining in focus. What seems to be a little clearer is, despite the tension, that cooperation between the new president and the more traditional trade-friendly wing of the Republican Party will likely temper the protectionist agenda. Consequently, North American Free Trade Agreement (NAFTA) repudiation fears have declined as renegotiation seems more likely. The EM/DM growth differential has stabilized and appears to be recovering 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 better-than-expected short-term growth likely to be soon challenged by a tightening in financial conditions. CNY weakness looks less likely given the political and geopolitical backdrop.

Against this backdrop, there will be winners and losers in EMs. Stabilizing commodity prices should support commodity-exporting countries that still benefit from improving fundamentals and a significantly undervalued exchange rate, while commodity-importing countries that run large current account deficits are likely to underperform despite attractive carry cushions. Fairly closed economies enjoying limited current account deficits, such as India, are likely to remain rather uncorrelated to global financial conditions. The Mexican peso will likely remain the main shock absorber against negative U.S. trade protectionism, while the market is shifting its focus to the Mexican political outlook. Gradual clarity on NAFTA has allowed the peso to recover from its weakest levels, but uncertainty remains.

We think that (eventual) steeper DM yield curves warrant the shortening of duration exposures with a focus on higher-yielding currencies/countries that have attractive characteristics given the change in global growth outlook. We remain optimistic about the prospects for EM fixed income spreads for 2017 as country fundamentals and the macro environment remain supportive, with those countries that rely most on global trade potentially challenged. The various factors both pushing and pulling investors into EM fixed income remain in place: DM yields remain very low, economic data in EM appears to be recovering, Fed rate hikes are likely to remain gradual, U.S. protectionism fears have eased, and concerns of a sharp slowdown in China have diminished. We believe that EM assets could well absorb multiple Fed rate hikes in 2017 if driven by increasing U.S. growth and not inflation; however, assets remain vulnerable to spikes in U.S. policy uncertainty from Trump or Fed hawkishness, and Chinese policy tightening triggering a sharper-than-expected growth downturn.

Credit

Monthly Review

CORPORATE INVESTMENT-GRADE

Credit markets traded well across the ratings spectrum in both the U.S and Europe as strong technicals helped credit spreads narrow modestly in both the investment-grade and high-yield markets. Lower-rated credit outperformed throughout the month in all markets, and supply remained robust. Absent an unexpected macroeconomic shock or political surprise, we anticipate the current grind tighter to persist in June.

Despite the potential for volatility due to the French presidential election and the risk of instability in the eurozone, U.S. investment-grade markets were reasonably quiet and supportive of risky assets. Following Macron's strong victory, the market found itself in a familiar position during the remainder of the month: an environment characterized by decent economic data, low inflation, accommodative monetary policy, and reasonably low geopolitical volatility. The VIX closed at 10.4 in May, the lowest monthly closing level since before the financial crisis.[15] The U.S. dollar investment-grade corporate index tightened 3 basis points to 113 basis points in May, the lowest monthly level seen since September, 2014.[16] In the investment-grade market, financials outperformed in May, particularly in Europe where subordinated financials and insurance bonds continued the rally we saw in April. In the U.S., autos were one of the few underperforming sectors, as spreads widened 3 basis points in the month, as the sector continues its cyclical adjustment.[17] On a year-to-date basis, investment-grade spreads are 10 basis points tighter in the U.S. and 15 basis points tighter in Europe, and financials have outperformed in both markets (13 basis points tighter in the U.S. and 22 basis points tighter in Europe).[18] Issuance in the U.S. investment-grade market was surprisingly heavy in May, with total issuance reaching $150 billion over the course of the month.[19] Despite higher-than-expected issuance, new issue concessions in the U.S. market were nearly nonexistent on the majority of deals, and negative on others, with the average concession for the month at 2 basis points.[20] Given the current tight state of valuations, this is particularly remarkable. Technicals in the U.S. investment-grade market remain strong, supported by macroeconomic conditions and continued favorable interest rate differentials.

European investment-grade spreads tightened in the month of May by 3 basis points to close at 109 basis points,

[15] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[16] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[17] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[18] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[19] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[20] Source: BAML. Data as of May 31, 2017.

DISPLAY 7

Credit Sector Changes

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	**113**	**-3**	**109**	**-2**
Industrial Basic Industry	142	-4	98	+0
Industrial Capital Goods	88	-2	87	-1
Industrial Consumer Cyclicals	108	-1	103	+0
Industrial Consumer Non-Cyclicals	101	-3	95	+0
Industrial Energy	140	-3	109	-1
Industrial Technology	94	-2	81	+2
Industrial Transportation	108	-3	98	-3
Industrial Communications	147	-6	115	+0
Industrial Other	95	-5	130	-6
Utility Electric	112	-3	106	-1
Utility Natural Gas	118	+0	105	-3
Utility Other	138	+1	100	-3
Financial Inst. Banking	104	-2	103	-5
Financial Inst. Brokerage	114	-2	108	+0
Financial Inst. Finance Companies	109	-5	96	+2
Financial Inst. Insurance	116	-4	207	-8
Financial Inst. REITS	133	-3	116	-6
Financial Inst. Other			146	-7

Source: Bloomberg Barclays. Data as of May 31, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment.

reaching the tights of the last two years.[21] Most of the spread tightening occurred after the market friendly outcome of the French presidential election. French names outperformed during the month, with the positive implications for the European project supporting the move in financials. Financials were 6 basis points tighter, outperforming utilities (1 basis point tighter) and industrials (flat on the month).[22] Bonds that are lower down the risk spectrum and corporate hybrids outperformed in May. In the European investment-grade market gross issuance totaled €69.4Bn (€29.6Bn in financials and €39.8Bn in nonfinancials), the largest issuance month of the year so far.[23] Sterling investment-grade gross issuance was strong at £5.1Bn (£1.6Bn financials, £3.5Bn nonfinancials).[24] May's issuance brings the YTD figure to £24.3Bn in the sterling space.[25] We expect a continued grind tighter in European investment-grade as we anticipate that major central banks will retain a bias toward accommodative monetary policy. We expect the ECB to continue to maintain its current policy mix of an easing bias via quantitative easing and a negative deposit rate to target higher inflation and a weaker currency. Despite this supportive landscape; however, we are cognizant that political risk still remains elevated in Europe as elections loom in Italy, France and Germany.

CORPORATE HIGH-YIELD

The U.S. high-yield market produced total returns of +0.87 percent in May.[26] Excess returns for the asset class were +0.48 percent during the month, as 5-year and 10-year Treasuries were down 7 basis points and 9 basis points, respectively.[27] Bonds further down the credit spectrum outperformed during the month, highlighting the strength in the high-yield asset class in May. The CCC-index returned +1.64 percent, the B-index returned +0.7 percent, and the BB-index gained +0.83 percent over the period.[28] Within the high-yield market, most sectors performed strongly in May. The best performing sectors were pharmaceuticals (+6.3 percent), banking (+1.91 percent), health care (+1.87 percent), wireless (+1.74 percent), and paper (+1.71 percent).[29] The high-yield new issue market remained robust in

[21] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[22] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[23] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[24] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[25] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[26] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[27] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[28] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[29] Source: Bloomberg Barclay's. Data as of May 31, 2017.

May, pricing $26.4 billion over the course of the month.[30]

May was another positive month for the European high-yield market, with the benchmark returning nearly 1 percent during the month.[31] That marks the fifth out of the past six month where returns have been positive. Spreads tightened following the final outcome of the French election early in the month, and then remained range bound during the rest of May. Macroeconomic data remained positive during the month, with European economic releases continuing to surprise to the upside. Fundamentals remain supportive, with default rates tracking at historically low levels, and first-quarter earnings largely beating expectations. Volatility was supressed across the European high-yield market, at seen throughout the broader financial markets. A key driver of performance in the European high-yield market remains the technical support of strong demand and low supply. May saw the largest net inflows into high-yield mutual funds this year, while net issuance in the primary market, particularly in the industrial sectors, has been very low, creating a strong technical environment. We expect the European high-yield market to remain well supported, as the ECB seems likely to retain their easing bias, and there seems little reason for the technical situation to change in the near term.

Outlook

We believe that spreads are poised to perform from current valuations across the U.S. and European credit spectrum, and if the present macroeconomic backdrop persists, we expect a continued grind tighter in June. Fundamentals, while stretched for many nonfinancials, do not seem to be deteriorating further, and should continue to create a positive backdrop for credit. Technicals remain strong across credit markets, as accommodative monetary policy continues to support spread products. As in the case of previous months, the greatest risk to our view remains political, as uncertainty remains in Europe and the U.S., and we continue to actively monitor this risk and its many implications for credit in June.

Securitized Products

Monthly Review

Agency MBS performed well in May, while credit-related securitized assets also saw continued gains. Nominal spreads on current coupon agency MBS tightened 2 basis points in May to 95 basis points above interpolated Treasuries, while the option-adjusted spreads (OAS) increased 1 basis point to 15 basis points above interpolated Treasuries as volatility declined.[32] The Bloomberg Barclays Capital U.S. MBS Index was up 0.61 percent in May, and finished the first five months up 1.75 percent for the year.[33] The Fed purchased approximately $28 billion agency MBS in May in order to maintain its agency MBS portfolio at $1.75 trillion. However, several Fed governors have recently recommended the end to the Fed's MBS reinvestment program, and we believe this could happen as soon as fourth-quarter 2017. The Fed purchased almost $400 billion agency residential mortgage-backed securities (RMBS) in 2016, and are on pace for over $300 billion in 2017, but we believe that ending this reinvestment could have a significant negative impact on agency MBS.[34]

Non-agency MBS spreads continued their tightening trend in May as cash flow and credit performance continued to improve. Home prices are up 40 percent nationally from the lows in 2012, and have now surpassed pre-crisis peak levels from July 2006 to set new highs. Despite the recent increases in home prices, U.S. homes remain affordable from a historical perspective. Mortgage performance also remains strong. New defaults declined to a 0.69 percent annual rate in April, down from the 0.75 percent level in March 2017 and near the lowest levels over the past 10 years.[35] With unemployment low, the economy slowly improving and home prices still recovering from the mortgage crisis almost 10 years ago, we expect continued improvement of mortgage credit performance.

CMBS performance continues to diverge depending on different collateral compositions. Since the beginning of the year, spreads on CMBX 6 BBB- (2012 vintage), which has 37 percent retail exposure, are wider by 133 basis points, while spreads on CMBX 9 BBB- (2015 vintage), which has only 24 percent retail exposure are tighter by 31 basis points. The increasing announcements of retail store closings and poor retail earnings are causing credit concerns for many retail properties. New non-agency CMBS issuance increased in May with roughly $8 billion in issuance during the month, lifting the 2017 year-to-date total to $25 billion. We still anticipate $50 billion to $60 billion in new issuance volumes this year, and year-to-date issuance is now on pace for the upper end of this range. New risk retention regulations that took effect January 1, 2017, are appearing to have a meaningful effect of dampening new CMBS issuance.[36]

European MBS spreads continued their tightening trend in May, and are now 30 to 50 basis points tighter in 2017. Low interest rates and early signs of economic growth seem to be outweighing any material concerns over Brexit fallout. ECB asset-backed securities (ABS) purchases slowed in April due to limited supply, and the ECB portfolio actually

[30] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[31] Source: Bloomberg Barclay's. Data as of May 31, 2017.

[32] Source: Yield Book. Data as of May 31, 2017.

[33] Source: Barclays. Data as of May 31, 2017.

[34] Source: Federal Reserve Bank of New York. Data as of May 31, 2017.

[35] Source: S&P/Experian First Mortgage Default Index. Data as of May 31, 2017.

[36] Source: Deutsche Bank. Data as of May 31, 2017.

DISPLAY 8

Key Data for Non-Agency MBS

		LATEST	PREVIOUS	UNIT	CHANGE OVER 1 YEAR	UNIT	AS OF
Prices	National Home Prices	0.32	0.4	% MoM	5.8	% YoY	3/31/2017
	Existing Home Sales	5.6	5.7	Million homes			4/30/2017
	Existing Home Sales	-2.3	4.2	% MoM	1.6	% YoY	4/30/2017
Inventory	Housing Inventory	7.2		% MoM	-9.0	% YoY	
	Housing Inventory (months supply)	4.2	3.8	Months supply	4.6	Level last year	4/30/2017
Defaults	New Defaults	0.69	0.75	% annualized	0.69	Level last year	4/1/2017
Prices	Commercial Property Prices	0	0	% MoM	2.3	% YoY	4/30/2017
Occupancy	Hotel Occupancy Rates	68	66	% occupied			3/31/2017
	National Office Vacancy Rates	13	12.9	% occupied			3/31/2017
Rent	Office Rent Growth				4.90	% YoY	3/31/2017

Source: JP Morgan. Data as of May 31, 2017.

decreased by €0.4 billion European ABS during the month.

Outlook

Despite the significant tightening of credit spreads in 2017, our outlook remains largely unchanged: we remain positive on mortgage credit opportunities and negative on more rates-based risks of agency MBS. We remain cautious on agency MBS due to their historically tight nominal and OAS, and due to the increasing risk that the Fed may decide to discontinue the reinvestment of MBS pay downs in their $1.75 trillion agency MBS portfolio sometime in the near future. Without the Fed's purchases, this additional MBS supply would need to be absorbed by other investors and spreads may need to widen to encourage other investors to add to their agency MBS positions. Additionally, agency MBS have experienced mediocre returns over past two years, and 2017 is off to a modest start relative to other asset classes. We do not expect to see material increases in demand unless the sector cheapens and the value opportunity improves.

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 continue to like the non-agency MBS sector. Non-agency MBS spreads have tightened by 60-100 basis points in 2017, but they remain our preferred sector given the still-attractive carry and improving fundamental conditions. We remain positive on the U.S. housing market based on the modest strength of the economy, continued low mortgage rates and above-average home affordability. From a supply perspective, we project outstanding non-agency MBS to decline by more than 10 percent, or roughly $60 billion in 2017, while new securitizations are projected to reach just $15 billion-$20 billion.

The CMBS market has become a tale of two markets, where securities with significant retail exposure have performed poorly, while all other CMBS collateral types have been performing well. The numerous recent announcements of retail store closings have raised concerns over the future viability of many shopping malls, and CMBS with significant retail exposure has come under pressure as a result this year. While we believe that many malls will fail, possibly as much as 20 percent of all traditional indoor shopping malls, we also believe that most malls will remain profitable and will not represent a significant credit risk.

The increasing distress in this market represents both a significant risk and a significant opportunity, and we believe that careful security selection can prove to be beneficial. Nonretail-oriented CMBS, namely securitizations backed by hotels, office buildings, industrial facilities, and multifamily rental apartments, have generally been performing well with improving metrics. The pace of commercial real estate price appreciation has slowed over the past year, but the trajectory remains positive

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for these property types. We remain positive on these asset classes given the overall strength of the economy and stability of rates. CMBS supply has been moderate, supported by the refinancing of large number 2007-vintage loans but also somewhat constrained by the new CMBS risk-retention securitization requirements. Beginning in 2017, the issuers of CMBS securitizations are required to retain a 5 percent position in their deals. This requirement seems to have limited some of the potential CMBS securitization volumes.

In Europe, although we still like securitized assets, we have reduced positions now that spreads are significantly tighter than pre-Brexit levels. Overall, we remain positive on the sector given the belief that the ECB and BOE will continue to keep interest rates low for the foreseeable future, and that the European economies, and more importantly, the respective real estate markets will all benefit from these accommodative policies. Home prices were higher across nearly all of Europe for second consecutive year in 2016, strengthened by low mortgage rates and slowly improving economies.

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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.

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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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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.

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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). **U.K. 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 bonds** — 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 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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