Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

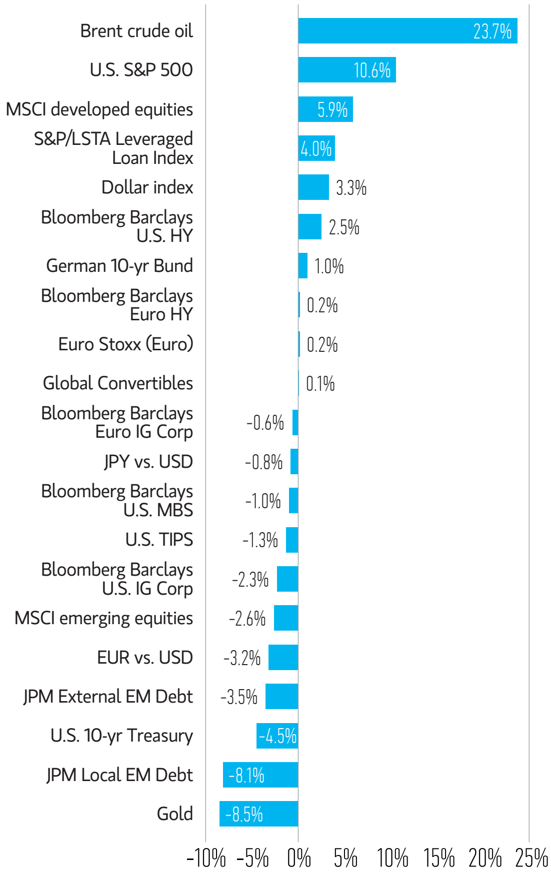
Too Much of a Good Thing?

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

A combination of strong U.S. economic data, heightened expectations of additional U.S. Federal Reserve (Fed) tightening and high valuations pushed yields upward. Fortunately, still modest inflationary pressures means the Fed is likely to continue its slow and steady pace of raising interest rates, which will not jeopardize the U.S. economy's solid economic growth. On the other hand, this pace of tightening is proving to be more problematic for the rest of the world, particularly emerging markets (EM). At present we believe the strong growth data, which is probably still good for the global economy in addition to the U.S., is not a threat to risky assets, although discrimination among EM remains key. While some may argue too much U.S. growth is no longer good for the global economy, too much of a good thing can sometimes be wonderful. We will see!

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of October 1, 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 pages 6 and 7 for index definitions.

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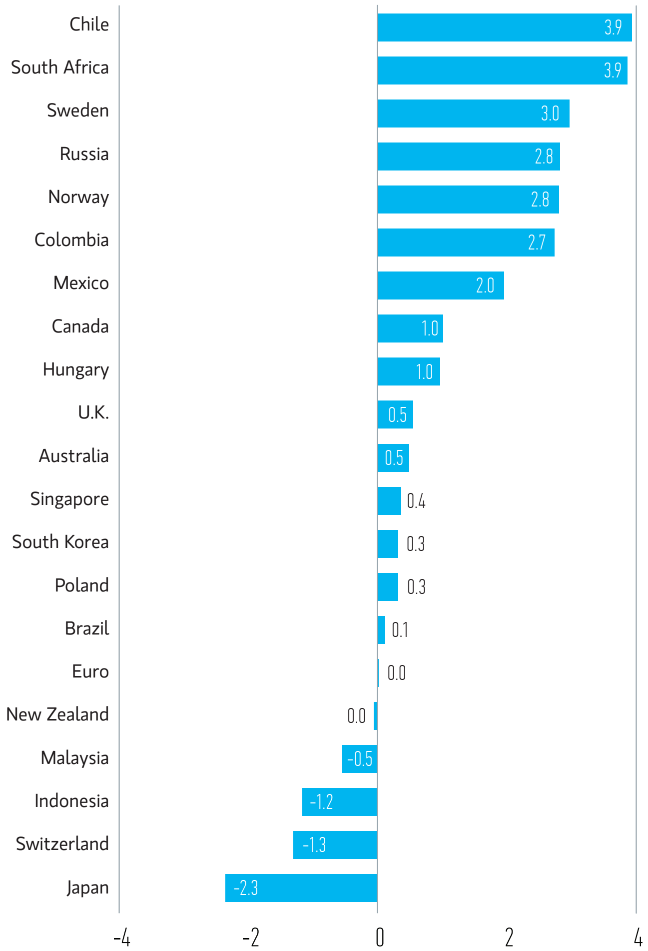
DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of September 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	3.06	+20		
United Kingdom	1.57	+15	-149	-5
Germany	0.47	+14	-259	-6
Japan	0.13	+2	-293	-18
Australia	2.67	+15	-39	-5
Canada	2.43	+20	-63	0
New Zealand	2.72	0	-34	-20
EUROPE			(Spread over Bunds)	
France	0.80	+12	33	-2
Greece	4.18	-22	371	-36
Italy	3.15	-9	268	-23
Portugal	1.88	-5	141	-19
Spain	1.50	+3	103	-12
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			360	-39
EM Local Yields	6.67	+2		
EM Corporate Spreads			286	-28
Brazil	10.07	-34	289	-48
Colombia	6.59	+4	168	-16
Hungary	2.62	+12	109	-15
Indonesia	8.17	-6	182	-9
Malaysia	4.07	+2	123	-13
Mexico	7.94	+2	256	-26
Peru	5.68	+17	133	-14
Philippines	6.44	+51	94	-15
Poland	2.62	+4	47	-16
Russia	8.25	-15	210	-25
South Africa	9.61	+5	297	-39
Turkey	20.04	-394	430	-168
Venezuela	–	–	5499	-308
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			106	-8
EUR IG			114	-5
U.S. HY			316	-22
EUR HY			329	-19
SECURITIZED				
Agency MBS			80	-1
U.S. BBB CMBS			252	-10

Positive Neutral Negative

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

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Fixed Income Outlook

The behavior/trend in U.S. Treasury (UST) yields remains the key focus of markets. Higher yields should not have been that surprising, as the Fed has been clearly communicating its intention to steadily raise interest rates, but the market had been reluctant to price in much in the way of rate hikes beyond 2019. However, recent strong growth data supports the case for additional hikes and a longer hiking cycle, e.g., the market is for the first time this cycle converging to the Fed's forecasts rather than the other way around. In addition, with interest rate term premium estimates still negative, there is potential for yields to rise through this channel as well. The correlated nature of global bond markets means higher UST yields are leading to higher yields everywhere, almost regardless of domestic fundamentals. Our view is the risks remain skewed to yields rising further from here, led by the U.S.

The Fed raising interest rates because the economy is doing better should not necessarily be a headwind for risky assets. The risk of over-tightening by the Fed seems small, particularly given that inflationary pressures remain subdued—meaning the pace can always be slowed, as has happened during the current tightening cycle. While there is growing evidence of tight labor markets pushing up wage inflation in both the U.S. and Europe, the pickup mainly supports the argument that monetary policy needs to be tightened rather than accelerating the pace of the measure. This should mean the impact on risky assets, in the U.S., is modest.

However, the concern is whether asset markets outside of the U.S. can cope with higher yields with the same resilience. After briefly converging, it appears the U.S. economy is once again outpacing the rest of the world. Europe is growing notably slower than in 2017, and is being dragged down by political and fiscal uncertainties in Italy. The key concern in EM is the resilience of China's economy, not helped by an acrimonious dialogue with the U.S. on trade.

On balance we think stronger U.S. growth and higher U.S. yields will not disrupt the global economy and financial markets. This is partly because strong U.S. growth (for now) is still good for the global economy, and also because there is a feedback loop to Fed policy if higher yields prove to be disruptive. That said, we believe discrimination needs to be used in EM, picking between countries that have better and worse fundamentals. The Italian situation also runs the risk of becoming far more disruptive even though there are few signs of contagion so far. And, last but not least, the burgeoning/escalating trade war with China needs to be monitored for more sinister effects.

Stronger growth may be too much of a good thing if it leads to excessive monetary policy tightening and too strong a dollar. But, as Mae West commented, too much of a good thing can also be wonderful.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In September, we saw risky assets bounce back from the August sell-off. U.S. Treasury yields rose on average 20 basis points across the curve, while German bunds sold off 7-15 basis points. The only exception was the Japanese Government Bond (JGB), where the bonds continued to be well-anchored. Japan yields ended up unchanged this month. Italian bonds reversed some of their previous month's losses by rallying more than 40 basis points on the front end of the curve, while interestingly the back end of the euro BTP's curve only rallied 10 basis points. The U.S. 2s10s curve remained a flattish 24 basis points this month.[1]	We believe the Fed is on the path of continuous, gradual rate hikes for 2019, allowing for only a moderate inflation overshoot. Recent meetings showed that the Fed reaffirmed its plan to hike three times in 2019 and the market is coming around to this view, given recent firming pressures in wages and business confidence raising the ante with regard to the appropriate terminal rate. As for U.S. 10-Year Treasury yields, we believe it will fall in the range of 3-3.5%. As we've previously noted, JGBs have served to anchor yields worldwide. A wider band for JGB trading, as the Bank of Japan (BoJ) adjusts the yield curve control policy, could introduce more volatility and upward pull for risk-free rates but, for now, the BoJ does not appear to be in a rush.
Emerging Market (EM) Rate/FX	Market sentiment improved in September as headwinds diminished with progress on North American trade talks, improved market technicals and valuations, which sparked investor attention. While year-to-date performance has been poor, there has been limited contagion and no substantial uptick in the outlook for defaults as this sell-off has been more idiosyncratically driven than systemic, in our opinion. Within the dollar-denominated space, sovereigns outperformed corporates during the month, while local debt generally outperformed dollar-denominated debt as EM currencies strengthened versus the U.S. dollar. Commodity prices gained over the month, with broad gains across energy, agriculture and metals, such as platinum and palladium. However, prices for aluminum, gold and silver fell in the period.	While we believe second- and third-quarter weakness in EM valuations has created market opportunities to add risk, we have become more selective as the outlook for EM fundamentals have become less certain. At a structural level, the world seems to be leaving global growth synchronicity behind and entering a new phase of diverging growth, as evidenced by still healthy growth in the U.S., stabilization in Europe and Japan, and, importantly, a more recent deceleration of activity in EM. Trade issues top the list of concerns, with U.S. and China locked in a seemingly protracted battle that could undermine growth expectations more broadly. Threats that the U.S. may consider expanding tariffs to the remaining $267 billion worth of U.S. imports from China could unleash another retaliatory round from the latter, thus weighing on global growth/market sentiment.[2] On the positive side, however, the announcement of a revamped North American Free Trade Agreement (NAFTA), the so-called United States-Mexico-Canada Agreement (USMCA), highlights the propensity for the U.S. to strike a deal and is an important step towards removing one large source of trade-related uncertainty, once national Congresses approve the tentative deal.

[1] Source: Bloomberg. Data as of September 30, 2018. [2] Source: JP Morgan. Data as of September 30, 2018.

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	MONTHLY REVIEW	OUTLOOK
Credit	Global investment grade spreads tightened in September, ending the quarter on a strong note. The Bloomberg Barclays U.S. Investment-Grade Corporate Bond Index tightened by 8 basis points in September to end the month at 106 basis points, with BBB-rated industrials leading the market.[3] Spreads in the U.S. are now tighter than at any point since April. For the year, the U.S. investment-grade corporates are 13 basis points wider. In Europe, the Bloomberg Barclays Euro-Aggregate Corporate Index moved 5 basis points tighter to end the month at 114 basis points.[4] Relative to the U.S., spreads in Europe have been more range-bound these past few months and remain 28 basis points wider for the year. Global convertibles delivered a small positive return in the month, pulled up by rising stocks and pulled back down by falling bonds. Returns were muted across major asset classes as MSCI Global Equities were up 26 basis points and Bloomberg Barclays Global Credit was down 32 basis points, while the Thomson Reuters Global Convertibles Focus Index performed in between, rising just 3 basis points.[5]	Looking ahead, we remain constructive on investment grade credit. Corporate earnings continue to be strong, heavy supply has been met with even stronger demand, and the macro backdrop continues to improve. Economic indicators remain robust, particularly in the U.S., while some key geopolitical concerns appear to be subsiding. The recent downward spiral from emerging markets has slowed and progress has been made in some ongoing trade disputes. Valuations, while off the widest levels, remain around long-term average levels. With the European Central Bank (ECB) stepping away from the corporate bond market, monetary policy tightening in the U.S., and Italian politics likely to remain volatile, we do not expect spreads to tighten rapidly from here. Rather, we expect spreads to grind tighter as we head into year-end, generating some attractive excess returns in the process.
Securitized	Rising interest rates, duration extension and tightening credit spreads were the primary themes in September. Absolute returns were dominated by the impact from higher rates, and credit-oriented securities meaningfully outperformed more rate-sensitive securities during the month. Market sentiment seemed to shift during September and strengthening U.S. economic data seem to be outweighing potential global economic weakness and trade tariff concerns. The Fed raised short-term rates another 25 basis points in September, and market expectations now have the Fed raising rates again in December and potentially a few more times in 2019.	Our investment thesis remains largely unchanged for October. We remain generally constructive on securitized credit opportunities and cautious on U.S. agency mortgage-backed securities (MBS). We remain underweight agency MBS due to concerns over rising rates and potential higher interest rate volatility, and also since the Fed continues to reduce its MBS purchases, and as a result, the tradable market supply is increasing. Agency MBS also still looks expensive from a historical spread perspective, and we believe spreads will likely need to widen to attract new investors to offset the Fed's reduced purchases. While we remain underweight agency MBS, we may begin to taper our underweight in the coming months if agency MBS continue to cheapen. We believe that most of the duration extension from higher interest rates and slowing prepayment speeds has already been realized. The Bloomberg Barclays U.S. MBS Index has already extended a full year in 2018, and we believe that we are nearing the end of the current rising rate cycle. While MBS could still face supply pressure from the diminished Fed MBS purchases, we believe that agency MBS carry could overcome moderate spread widening if interest rates stabilize.

[3] Source: Bloomberg Barclays. Data as of September 30, 2018.

[4] Source: Bloomberg Barclays. Data as of September 30, 2018.

[5] Source: Bloomberg Barclays. Data as of September 30, 2018.

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.

DEFINITIONS

R* is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate.

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).

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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 **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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