Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

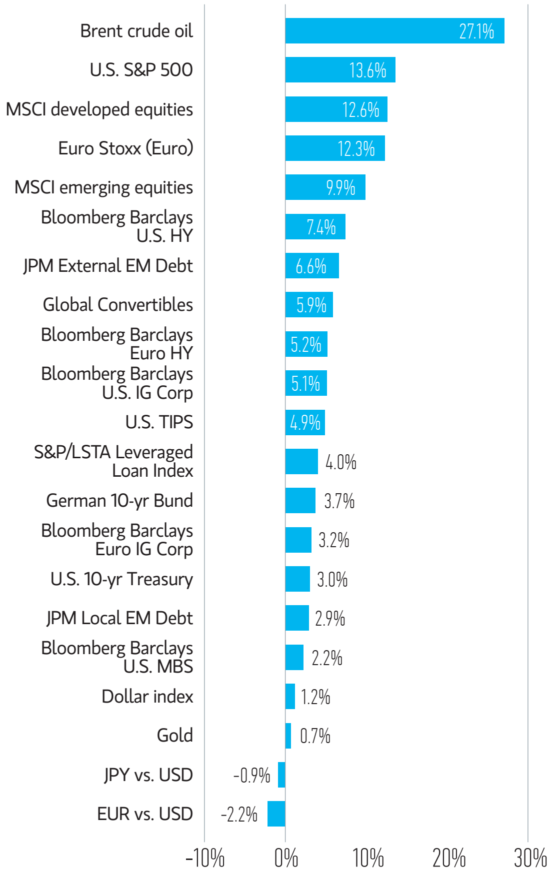
Goldilocks Redux?

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | APRIL 2019

Our worries that the rally in risk assets would struggle without concrete improvement in economic fundamentals proved partly true. Government bonds rallied massively as more central banks turned dovish and economic data did not inspire. However, despite this headwind of lower government bond yields implying concern about the economic future, risk assets held up well: investment grade spreads narrowed while high yield marginally underperformed. Optimism that an easier/lower path of monetary policy in 2019 and lower real short- and long-term yields will support economies and lengthen the business cycle, despite continued generally disappointing data, abounds. Not incorrectly in our view!

DISPLAY 1

Asset Performance Year-to-Date

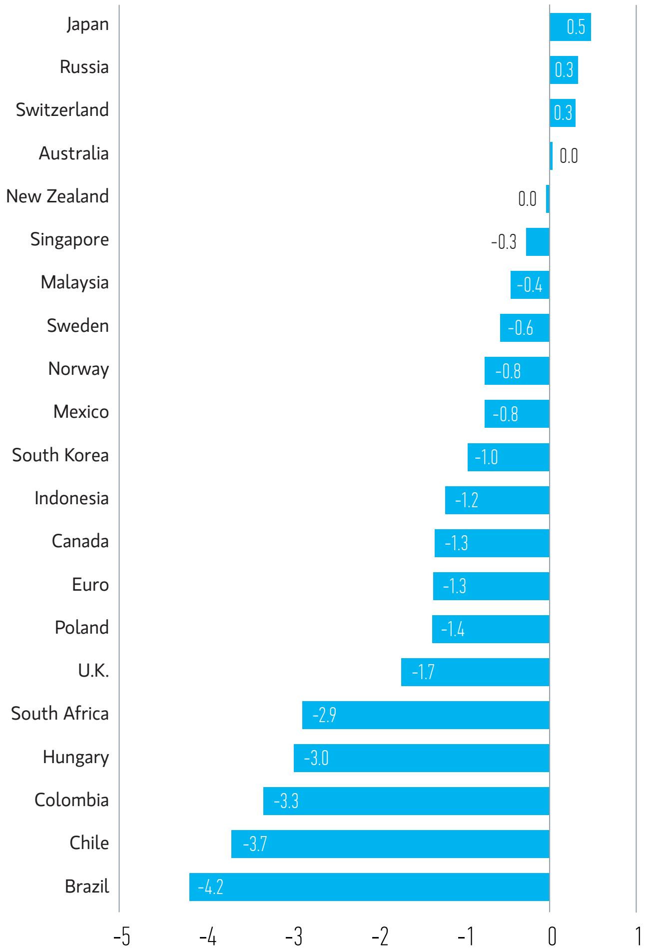


Note: USD-based performance. Source: Thomson Reuters Datastream. Data as of March 31, 2019. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 6 and 7 for index definitions.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of March 31, 2019. Note: Positive change means appreciation of the currency against the USD.

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spreads

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(Spread over USTs)	
United States	2.41	-31		
United Kingdom	1.00	-30	-141	+1
Germany	-0.07	-25	-248	+6
Japan	-0.08	-6	-249	+25
Australia	1.78	-33	-63	-2
Canada	1.62	-33	-79	-2
New Zealand	1.81	-36	-60	-5
EUROPE			(Spread over Bunds)	
France	0.32	-25	39	0
Greece	3.74	+7	381	+32
Italy	2.49	-26	256	-1
Portugal	1.25	-22	132	+3
Spain	1.10	-8	117	+18
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			371	+12
EM Local Yields	6.15	-9		
EM Corporate Spreads			298	+12
Brazil	8.20	+4	248	+18
Colombia	6.16	-25	184	-2
Hungary	1.82	-28	116	+9
Indonesia	7.74	-18	196	+3
Malaysia	3.80	-18	131	+5
Mexico	8.13	-20	308	-8
Peru	5.36	-24	130	-1
Philippines	5.34	-23	90	+4
Poland	2.28	-9	57	+8
Russia	8.07	-2	227	+19
South Africa	9.40	-9	315	+31
Turkey	19.55	+404	495	+95
Venezuela	–	–	5224	-79
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			119	-2
EUR IG			123	-5
U.S. HY			391	+12
EUR HY			376	+1
SECURITIZED				
Agency MBS			77	-9
U.S. BBB CMBS			268	+2

Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of March 31, 2019.

The views and opinions expressed are those of the Portfolio Management team as of April 2019 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**

Fixed Income Outlook

Reduced concerns about overly aggressive U.S. Federal Reserve (Fed) tightening and withdrawal of stimulus from other central banks are now consensus. To be fair, only the Fed has definitely said they have no plans to ease—they view themselves as being truly on hold. This to us is the conundrum. Market pricing of the Fed looks a tad optimistic (or pessimistic if you're thinking about the economy), meaning too high a probability is being attached to the Fed actually cutting rates. That makes us cautious about the direction of yields and worried that some upward adjustment is coming. On the other hand, clear global central bank concern about economic weakness and desultory inflation behavior suggests optimism that rates will stay low indefinitely, implying lower long-term yields. What is unambiguous is that this combo is good for risk assets. We're constructive on corporate credit, emerging markets and securitized debt, but not as bullish as we were the beginning of the year.

By contrast, we think the outlook for developed economy government bonds is more challenging and are modestly underweight duration, even though central banks have pivoted towards a more dovish stance. These paradoxes can be partly explained by what financial markets have already priced in, and by our expectations for the global economy going forward.

While there can be no doubting that central banks, concerned about the slowing global economy and facing little pressure to tighten policy due to weak inflationary pressures, have become more dovish, we think this is now generally in the price, and sometimes even more than that. While we agree the Fed may not raise rates further in 2019, the market is pricing in rate cuts. In euro, the European Central Bank (ECB) has pushed out its guidance on rate hikes into next year, but the market is not pricing increases until 2021. With valuations already rich, and carry declining due to flattening yield curves, the return outlook for high quality government bonds has become relatively unattractive unless one believes rate cuts are coming.

However, the accommodative monetary policy shift will still provide a supportive environment for emerging markets and corporate credit. In addition to monetary policy, Chinese fiscal and other economic stimulus measures should help buoy the global economy given China's importance as a source of external demand in many developing and European economies. From a technical perspective, the ongoing lack of market volatility makes carry trades attractive. A further source of positive impetus could be a resolution of the U.S.-China trade dispute. While the current economic data is still not strong, the trajectory is positive.

We also remain positive on securitized product given the health of the household sector in developed economies and accommodative monetary policy. While the temporary inversion of the U.S. yield curve rekindled discussion of an approaching U.S. recession, the curve has since re-steepened and it has also been pointed out that the time from curve inversion to recession has been long and variable.

Significant risks still persist, notably from trade and Brexit, and many of last year's idiosyncratic emerging market risks have not disappeared either. However, the main reason we are less bullish on risky assets than we were a few months ago is due to valuations being less attractive following the strong performance in the first quarter of the year. We have therefore taken steps to de-risk portfolios, taking advantage of strong market conditions which are consistent with inflows into credit product.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In March, risk asset returns lost momentum as government bonds rallied but, we would argue, did better than anticipated as a result of stronger market confidence in the central bank pivot to a more dovish policy stance. Sovereign bond yields across the developed markets saw significant declines over the month, with yields hitting multiyear lows. Central banks became even less hawkish as they responded to ongoing weakness in the global economy, in addition to weak inflationary pressures. The Fed pivoted to a much more dovish stance, projecting no rate hikes for the remainder of 2019. The USD modestly weakened during March, particularly against the EUR, JPY and GBP. The ECB announced new stimulus in the form of a long- term loans program for banks, which removed a funding risk from when the current programs expire.	Recent speeches from the Fed policymakers give us further confidence that the Fed is committed to being "patient" and "flexible" regarding future rate hikes. At this point it is not likely the Fed will hike rates again in 2019, but it may also not cut as much as the market currently prices. We expect Bank of Japan (BoJ) policy to remain easy along with other major central bank policies, but the BoJ may be uncomfortable with 10-year JGB yields falling below -0.10%. In terms of currencies, we expect the USD to weaken modestly in 2019.
Emerging Market (EM) Rate/FX	EM fixed income asset returns were mixed in the month as EM currencies weakened versus the USD, while local bond performance and external debt returns were positive. Within the hard currency segment, investment grade outperformed high yield as U.S. Treasury yields fell in the period, and sovereigns outperformed corporates.[1] Commodity prices were also mixed in the period, with continued strength in oil prices, while precious metals and agricultural commodity prices declined.[2] Investment flows continued their positive momentum with $16 billion flowing into EM fixed income funds during the month, according to JP Morgan. The inflows were roughly split between institutional and retail flows, primarily in favor of hard currency strategies, followed by local currency and then blended.	Despite recent softness in global growth and potentially market-disruptive events (in the near term, most notably Brexit), our outlook for EM debt remains constructive due to several factors. Firstly, global monetary policy has decidedly turned accommodative, as emphasized by the recent dovish turn by the Fed, and an easing bias by the ECB. In addition, China continues to provide significant stimulus via monetary easing (through reserve requirement ratio (RRR) cuts and enlarged liquidity facilities) and fiscal expansion (via tax cuts and increased infrastructure spending by local governments). Thirdly, the U.S.-China trade conflict, a major source of uncertainty last year, appears to be heading toward a provisionary agreement in the next few months, potentially boosting sentiment for risky assets in the near term.

[1] JP Morgan, as of March 31, 2019.

[2] JP Morgan, Bloomberg, as of March 31, 2019.

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	MONTHLY REVIEW	OUTLOOK
Credit	Despite the precipitous drop in government bond yields and mixed economic data, the rally in corporate bonds barely paused, enabling the year-to-date rally to continue. The Bloomberg Barclays U.S. Corporate Index narrowed by 1 basis point in March to end the month at 119 basis points over government bonds. European investment grade performed even better in March, closing the gap on year-to-date performance versus the U.S. spreads with the Bloomberg Barclays Euro-Aggregate Corporate Index tightening by 6 basis points to end March at 121 basis points relative to government bonds. The U.S. high yield market continued to rally in March, and the Bloomberg Barclays U.S. High Yield Index produced total returns of +0.94 percent.[3] Spreads widened 14 basis points to end the month at 414 basis points, while yields decreased by 11 basis points to 6.43 percent.[4]	Credit markets had a lot to digest in March. Economic data continued to come in mixed, especially outside the U.S., but seemed to indicate that the worst of the slowdown is now behind us. Our bias to position portfolios long risk coming into 2019 has been, and should continue to be, rewarded.
Securitized	Mortgage and securitized markets are off to a good start in 2019, benefitting from both rallying interest rates and tightening spreads. We believe that fundamental credit conditions will remain positive and that credit-sensitive mortgage and securitized assets will continue to perform well. From a fundamental perspective, we believe the U.S. economy is strong with healthy consumer and real estate market conditions, and we remain overweight credit-oriented securitized investments. We are underweight agency mortgage-backed securities (MBS) due to potential supply headwinds that the sector could face as the Fed has ended its MBS purchases and U.S. banks could potentially reduce their agency MBS holdings if their risk-based capital requirements are eased.	We continue to expect a benign rate volatility environment for 2019 which should benefit agency MBS in 2019, but some of this upside could be offset by the supply pressure from the Fed balance sheet runoff. Overall, we expect agency MBS to continue to outperform Treasuries but underperform credit-oriented securitized opportunities. In light of this strong performance and as first mentioned last month, we continue to take steps to de-risk most portfolios by trimming a mixture of subordinated financials, BBB non-financials, high yield and convertible bonds. We still find credit attractive at these levels but we believe the bulk of capital gains for the year are likely behind us.

[3] Bloomberg Barclays, as of March 31, 2019.

[4] Bloomberg Barclays, as of March 31, 2019.

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

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

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

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

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

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

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

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

The **Hang Seng Index** includes the largest and most liquid stocks listed on the Main Board of the Stock Exchange of Hong Kong.

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

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

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

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

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

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

The **JP Morgan CEMBI Broad Diversified Index** is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging markets entities.

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

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that includes only those countries that are accessible by most of the international investor base (excludes China and India as of September 2013).

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

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

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

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

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

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

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

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

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

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector.

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

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

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

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

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

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

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

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