INVESTMENT MANAGEMENT

Morgan Stanley

COMMENTARY | DECEMBER 2015

Global Fixed Income Bulletin

Central Banks Lead the Market

Outlook

- Asset performance in November was dominated by Federal Reserve (Fed) and European Central Bank (ECB) polices, or the anticipation there of. Asset performance and economic health should be viewed through the lens of financial conditions—a central banks scorecard of policy actions. Financial conditions globally became easier in November and global asset prices broadly improved as a result.
- We expect U.S. rates to rise in line with current forwards, but with a bearish bias. Since we expect the Fed to follow a dovish hiking path, we believe that any aggressive market re-pricing of short-term U.S. Treasuries could be disappointed. In light of this, we remain underweight U.S. duration.
- Broadly, we expect a rebound in emerging markets (EM) growth in 2016 and 2017 as the negative impact from Brazil and Russian lessens. In China, we continue to believe that the country will avoid a hard landing. We expect further stimulus in the form of additional, most likely quarterly, interest rate/required reserve ratios (RRR)[1] cuts, infrastructure spending, and easing of credit conditions. Following the much-anticipated inclusion of the yuan (CNY) in the International Monetary Fund's (IMF) special drawing rights (SDR)[2] in early December, we believe that Chinese economic policy makers may widen the trading band but continue to hold the CNY relatively stable against the USD over the medium-term to avoid talk of Chinese "currency wars."
- Current credit spreads are above the long-run averages across markets, and in the U.S. are over one standard deviation above long-term averages. The market seems to be pricing in a more stressed economic backdrop than is our base case for continued positive, but below par, growth, combined with abundant central bank liquidity. As such we feel that current valuations offer an attractive investment opportunity, with the potential positive excess returns as spreads recompress to levels more appropriate to the risks we observe.
- We believe non-agency mortgage-backed securities (MBS) remain one of the more stable and attractive fixed income asset classes. We remain positive on the U.S. housing market given the strength of the U.S. economy, continued low mortgage rates, and above-average home affordability. We are cautiously overweight commercial mortgage-backed securities (CMBS). Currently, we favor seasoned CMBS issues over 2015-vintage originations. Seasoned CMBS have improved credit conditions due to this property price appreciation, over newly originated deals which may have somewhat inflated property valuations as part of its underwriting.

November was a month where price-actions for assets were largely dominated by well-advertised and anticipated central bank events from both the Fed and the ECB. The Fed is expected to hike rates at the December FOMC meeting and the ECB is expected to add additional policy stimulus. As a result, U.S. yields rose and the USD strengthened while European government bond yields fell and the euro weakened.

What is perhaps more important is that despite an anticipated rate hike from the Fed and a strengthening USD, risk asset prices such as equities rose and credit spreads were

[1] The **Required Reserve Ratio (RRR)** is the fraction of deposits that regulators, in this case, the Federal Reserve, require a bank to hold in reserves and not loan out.

[2] **Special drawing rights (SDR)** are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund.

The views and opinions expressed are those of the portfolio management team as of December 2015, and are subject to change based on market, economic, and other conditions. **Past performance is not indicative of future results.**

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stable to tighter. In terms of financial conditions, improvement in equities and credit spreads was sufficiently strong enough to offset the rise in yields and in the USD such that U.S. financial conditions did not tighten and, in fact, eased a little bit. This suggests that the market is not worried about the first rate hike in nine years and expectations are that the Fed will hike rates very slowly.

In Europe, the markets well anticipated and priced in a substantial easing from the ECB the first week of December. This dominated price action as the euro weakened, core yields fell and peripheral spreads tightened. Additionally, riskier assets also improved as equity and credit spreads performed well. This added up on all counts to a substantial easing of financial conditions across the Eurozone. The question then for the markets in the months ahead is if the boost provided by ECB policy stimulus will be sustainable and enough to negate disinflationary fears.

Emerging markets were wobbly in the face of the policy moves from the Fed and ECB. Perhaps more important to emerging markets was performance from China. The Chinese economy has shown some signs of stability as officials continued to support easier policies. Some markets, such as Australia and New Zealand, were beneficiaries of the recent stability in China as economic data has rebounded a bit in those countries. We view this as only temporary, as China will likely continue to slow. The question, of course, is if the slowdown is orderly. Early indications are that it might be.

In summary, asset performance in November was dominated by central bank polices, or the anticipation there of. This has been a common theme throughout the crisis. Asset performance and economic health should, therefore, be viewed through the lens of financial conditions—a central bank's scorecard of policy actions. Financial conditions globally became easier in November and global asset prices broadly improved as a result.

Interest Rates & Currency Outlook

Economic data in the U.S. has stabilized since mid-October suggesting that spillover concerns from the turbulence created by China were misplaced. U.S. financial conditions have eased since August/September. The combination of October's improvement in U.S. data and the return of VIX (widely viewed as the financial market stress indicator) to normal levels has been sufficient to allow the Fed to signal that lift-off is likely in December. We expect U.S. rates to rise in line with current forwards, but with a bearish bias. Since we expect the Fed to follow a dovish hiking path, we believe that any aggressive market re-pricing of short-term U.S. Treasuries could be disappointed. In light of this, we remain modestly underweight U.S. duration with a bias towards being underweight intermediate and longer-maturity yields.

We expect continued ECB purchases to push euro periphery real yields lower, if not into negative territory, similar to what happened in the U.S., in order to bring about the necessary financial and economic rebalancing to increase inflation expectations. Based on this view, we continue to be overweight inflation-protected bonds in Italy and Spain and somewhat neutral on Euro Area duration.

We expect that a China-related commodity-based slowdown and slow growth should keep monetary policy in Australia and New Zealand easy. We believe that Australia and New Zealand government bonds should outperform, if not trade through, U.S. Treasuries in the next one to two years. We continue to be overweight these markets.

In terms of currency positioning, we see the trend towards a stronger U.S. dollar resuming as the Fed prepares to hike and thus remain overweight the currency. We have been underweight the euro in expectation of further easing from the ECB. On the back of moderate global growth, China slowdown, and dovish central banks, we have also been underweight commodity and Asian currencies.

EM Outlook

Over the next few months, the primary risks that we will continue to monitor include the path of Chinese economic growth, currency and monetary policy, the potential for rising U.S. interest rates, and the direction of commodity prices. We think that any volatility generated by the Fed lift-off could provide interesting entry opportunities for select EM assets as we think that the Fed will be very cautious with future hikes and that its rate hiking cycle will end well before its current expectations.

Broadly, we expect a rebound in EM growth in 2016 and 2017 as the negative impact from Brazil and Russian lessens. In China, we continue to believe that the country will avoid a hard landing, supported by higher frequency economic indicators pointing to an ongoing stabilization at a lower level of growth. We do believe, however, that "actual" Chinese economic growth will fall far short of the official targeted growth rate of 7 percent this year and approach 6 percent. Next year's likely target of 6.5 percent growth is also likely to be missed even though significant fiscal and monetary stimulus remains in the pipeline. With manufacturing PMI releases stabilizing at low levels, we expect further stimulus in the form of additional, most likely quarterly, interest rate/RRR cuts, infrastructure spending, and easing of credit conditions. Property prices continue to show signs of stabilization/recovery, which should continue to support growth. Following the much-anticipated inclusion of the CNY in the IMF's SDR in early December, we believe that Chinese economic policy makers may widen the trading band but continue to hold the CNY relatively stable against the USD over the medium term to avoid talk of Chinese "currency wars."

With challenges facing several EMs due to a difficult external growth and commodity price backdrop, their sovereign ratings are seen to be increasingly at risk. In particular, we monitor those countries on the cusp of losing their investment grade (IG) status, as it can result in a higher cost of financing. The fall from IG to high yield (HY) can impact a country's inclusion in key benchmark indices and also limits the ability of many institutional lenders to invest in the country as they often have credit rating restrictions. Given the general election outcome in Turkey, we now expect the country to hold on to its IG rating as long as it re-commits to fiscal discipline and avoids attempts to once again put into question central bank independence. Conversely, we continue to expect that Brazil, given the disappointment in terms of fiscal discipline and growth, will lose the second of its three IG ratings at some point before the end of the first quarter of 2016 unless there is a significant shift in policies or regime change. Moody's may very well downgrade Brazil by mid next year. Bucking the negative ratings trend, there are upgrade candidates in EM. Early next year for example, we expect Hungary to regain its first IG rating in five years, and the Philippines to be upgraded.

Despite a narrowing of the EM/developed markets (DM) growth differential and a weakening of fundamentals since the global financial crisis, EM economies are still in better health than they were 10 to 15 years ago with lower levels of external debt as a percentage of GDP, freely floating exchange rates, relatively large buffers in the form of foreign currency reserves, and growing local debt markets supported by generally robust and well-capitalized banking systems. In the absence of extremely attractive valuations and/or an improving fundamental outlook, EM economies must recommit to structural reforms to address economic challenges and restore widespread faith by the investment community. The election of reform-minded candidates, like those in Indonesia, India, and most recently Argentina, are steps in the right direction for these economies. For long-term investors, EM debt still offers attractive real yields for an IG asset, on average, providing carry and potential spread compression, which could provide a buffer should interest rates begin to rise in the U.S. With many in the market forecasting moderate growth and low inflation, we believe EM debt should perform well for investors looking for diversification, yield/carry, and total return potential (via yield and spread compression). We note that with valuations reaching extreme levels during the global sell-off in September, value is once again starting to emerge in some assets. Of note, local currency EM debt may have already adjusted sufficiently to compensate for the more challenging global environment in the year ahead.

Credit Outlook

On the macro front, the focus of the market remains the divergent direction of monetary policy. The market is increasingly pricing in the Fed announcing an increase in the fed funds rate at their December meeting, with much commentary from Fed board members indicating that economic conditions are strong enough to support such a move.

Not only is monetary policy diverging, but the differing economic outlook has also been a key driver of management behavior and risk appetite. After three or four years of positive economic growth, the U.S. economy has entered into a more mature stage of the credit cycle. Margins and earnings have peaked, equity multiples are high, and management have sought for alternative ways of rewarding shareholders. This has been achieved in part through debt-funded acquisition, share buybacks and elevated dividend payments. Global mergers and acquisitions (M&A) has reached a new peak of over $2.5 trillion[3], and the U.S. has seen the majority of this activity, as companies have sought to buy growth. Furthermore, U.S. share buybacks are close to their pre-crisis peak, and have exceeded free cash generation on an aggregate basis. This late cycle re-leveraging has resulted in weaker credit metrics and significantly higher volumes of bonds issued to the U.S. credit markets. The credit cycle in Europe is much less advanced, with the last leg of the sovereign crisis still fresh in management's consciousness and economic growth continuing to run below trend. Consequently, management risk appetite in Europe remains lower, credit metrics remain sound, and we have seen lower volumes of issuance in the primary market.

Credit spreads remain elevated relative to historical levels, particularly in the U.S. where late cycle corporate leveraging, active primary market issuance and the expectation of tighter monetary policy from the Fed lowering demand for fixed income assets have resulted in higher risk premiums. Credit spreads in Europe have been pulled wider in line with the U.S. market, despite more supportive technical and fundamental conditions. Current spreads are cheap to the long-run averages across markets, and in the U.S. are over one standard deviation above long-term averages. Historically, these levels of spreads have been associated with periods of economic recession or systemic stress. The market seems to be pricing in a more stressed economic backdrop than is our base case for continued positive, but below par, growth, combined with abundant central bank liquidity. As such, we feel that current valuations offer an attractive investment opportunity, with the potential positive excess returns as spreads recompress to levels more appropriate to the risks we observe.

[3] Source: Bloomberg. Data as of November 30, 2015.

Securitized Outlook

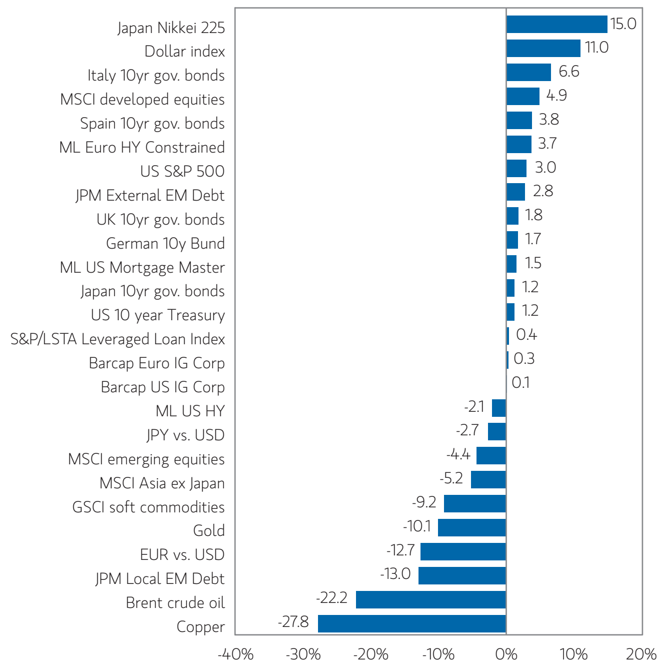
We remain slightly underweight Agency MBS. Agency MBS have performed reasonably well in 2015, but they remain expensive by historical measures. Mortgage rates and prepayment speeds have been range-bound, helping support the performance so far, but with the possibility of a Fed rate hike in the coming months, volatility and absolute rate levels could rise and MBS duration extension concerns could return. There is also the additional risk that the Fed could end their MBS purchase program, which is currently buying 25 to 30 percent of all new origination,[4] at some point in 2016. Although current MBS carry is moderately attractive, we believe the potential risks to supply and performance over the next six months possibly outweigh the benefits of this carry, and thus we remain underweight. We also believe that the current opportunities in more credit-sensitive securitized sectors, particularly non-agency MBS and CMBS, offer better risk-adjusted relative value than Agency MBS

Non-agency MBS remains one of the more stable and attractive fixed income asset classes. Given the attractive carry, improving fundamentals, and shrinking net supply, we remain overweight the non-agency MBS sector. Non-agency MBS offers spreads of 175 to 225 basis points (bps) above U.S. Treasuries for IG bonds, and 275 to 375 bps for non-IG bonds on a loss-adjusted basis.[5] We remain positive on the U.S. housing market given the strength of the U.S. economy, continued low mortgage rates, and above-average home affordability. From a supply perspective, we project outstanding non-agency MBS to decline by $60 billion to $70 billion this year, while new securitizations are projected to only amount to $40 to $50 billion in 2015.

We are cautiously overweight CMBS. We expect that commercial real estate fundamental conditions will continue to improve as the U.S. economy strengthens, and we believe CMBS is poised to perform well as a result, but we have some concerns over supply/demand dynamics given the recent spread volatility and our expectations of future increases in new origination and issuance. We also have some concerns over 2015-vintage origination CMBS due to the substantial increase in property values over the last few years. We favor seasoned CMBS issues, which have improved credit conditions due to recent property price appreciation, over newly originated deals which may have somewhat inflated property valuations as part of its underwriting. Although we expect continued volatility in CMBS towards the end of the year, we still believe that CMBS offers attractive relative value and should continue to benefit from improving fundamental market conditions.

In Europe, we believe the recent spread widening in UK and peripheral Europe represents an attractive buying opportunity. The fundamental conditions in both the UK and continental Europe are improving. The UK economy is gaining strength, which should benefit commercial and residential real estate prices. Within the European Union (EU), the ECB appears to be committed to its stimulus policies, which we believe will help reflate asset prices, similar to what the U.S. has experienced over the past six years. We expect to see increasing European ABS supply, but also improving fundamental conditions in Europe in 2016.

Display 1: **Asset Performance Year-to-Date**



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of November 30, 2015.

Market Summary

Global bond performance diverged as markets anticipate policy tightening in the U.S. and easing in the Euro Area. For the month, U.S. yields were higher, while U.K. and European yields ended the month lower. The dollar broadly rallied against the rest of the world.[6]

Over the month, 10-year U.S. Treasury yields increased by 6 bps while the 2s10s curve flattened by 14 bps. Ten-year German yields decreased by 4 bps, while 2-year German bund yields decreased by 10 bps. Ten-year yields in Ireland, Italy, Spain, and Portugal decreased by 6 to 22 bps.[7] Meanwhile, the Greek government successfully concluded its review to unlock the first tranche of bail-out payment. Greek 10-year government yields

[4] Source: Federal Reserve. Data as of November 30, 2015.

[5] Source: Credit Suisse. Data as of November 30, 2015.

[6] Source: Bloomberg. Data as of November 30, 2015.

[7] Source: Bloomberg. Data as of November 30, 2015.

decreased by around 36 bps on the month. Japanese government bond (JGB) 10-year yields were unchanged.[8]

In November, the dollar strength continued. The pound lost 2.4 percent against the dollar.[9] The euro was among the biggest losers in the month, losing around 4.0 percent. Hungarian forint and Polish zloty also lost 4.1 percent and 4.4 percent, respectively. The Japanese yen lost 2.0 percent against the dollar for the month.[10] Crude oil (Brent) prices dropped from $50 to $45.[11]

Developed Markets

In the U.S., the Fed released the minutes to the October meeting. In regards to the lift-off, most participants thought conditions for policy normalization could be met by the time of the next meeting. Some were concerned that a delay in policy firming would increase uncertainty in financial markets, increase the buildup of financial imbalances due to very low rates, or erode the Federal Open Market Committee's credibility. Moreover, the Committee noted that it should underscore at the time of the lift-off that the expected path, rather than the timing of increase, is more important for financial conditions. The minutes revealed that the Committee discussed the short-run equilibrium real interest rate, the rate that would result in the economy operating at full employment and price stability, and estimated it to be around zero. The long-run equilibrium is likely also lower compared to that of pre-financial crisis. The market, thus, expects the long-run nominal fed funds rate to likely be lower than it was in previous periods. In terms of data, October nonfarm payrolls increased 271,000 versus expectations of 185,000, and September nonfarm payrolls were revised lower to 137,000 from 142,000. The unemployment rate decreased from 5.1 percent to 5.0 percent, in line with consensus. Average hourly earnings rose 2.5 percent, above the previous print of 2.3 percent.[12] The ISM manufacturing index declined to 48.6 in November from 50.1 prior, below consensus expectations of 50.5. Q3 GDP was revised to 2.1 percent from 1.5 percent, in line with consensus expectations. Headline CPI was 0.2 percent and core CPI was 1.9 percent for October.[13]

In the Euro Area, the ECB published accounts of the October meeting, which was dovish and consistent with the tone of the October press conference. The Governing Council acknowledged that market expectations for easing had increased. Some in the Council argued for action in the October meeting while others wanted to avoid reaching premature conclusions from the latest data. Risks to growth were seen to be on the downside due to the outlook in emerging markets, though domestic demand has proved to be resilient. In terms of survey data, final Euro Area manufacturing PMI came in at 52.8 in November, above 52.3 in October, and above consensus expectations of 52.3.[14] The initial Q3 GDP print was 0.3 percent quarter-on-quarter, slightly below consensus expectations of 0.4 percent. Euro Area inflation was revised higher to 0.1 from flat in October.[15]

In the U.K., the Bank of England (BoE) voted 8-1 to keep monetary policy unchanged. The meeting gave little indication as to the timing of a possible lift-off. The Monetary Policy Committee (MPC) also published the November Inflation report. Growth was lowered by 0.1 to 2.7 percent and 2.5 percent for 2015 and 2016. It revised lower the near-term inflation but revised higher the 2-year and 3-year inflation to 2.06 percent and 2.22 percent, respectively. Finally, the MPC expects the unemployment rate to fall to 5.3 percent in Q4 of 2015 and then reach 5.2 percent by Q4 of 2016. In terms of data, headline CPI inflation was -0.1 in October, unchanged from September and in-line with consensus.[16] The unemployment rate, three-month average, ticked down to 5.3 percent in September from 5.4 percent in August. UK manufacturing PMI decreased to 52.7 in November, from 55.2 in October, below consensus expectations of 53.6.[17]

The Bank of Japan (BoJ) voted 8-1 to keep monetary policy and asset purchases unchanged in November. The BoJ maintained that the economy has continued to recover moderately. However, the BoJ made a change to its inflation expectation language, acknowledging that indicators recently show some relatively weak developments, though the long-term trend seems to be still rising. On the data front, manufacturing PMI was 52.8 for November, up from 52.4 in October. The October core national CPI (ex-Food & Energy) came in at 0.7 percent, down from 0.9 in September, and below consensus expectations of 0.8.[18]

[8] Source: Bloomberg. Data as of November 30, 2015.

[9] Source: Bloomberg. Data as of November 30, 2015.

[10] Source: Bloomberg. Data as of November 30, 2015.

[11] Source: Bloomberg. Data as of November 30, 2015.

[12] Source: Bloomberg. Data as of November 30, 2015.

[13] Source: Bloomberg. Data as of November 30, 2015.

[14] Source: Bloomberg. Data as of November 30, 2015.

[15] Source: Bloomberg. Data as of November 30, 2015.

[16] Source: Bloomberg. Data as of November 30, 2015.

[17] Source: Bloomberg. Data as of November 30, 2015.

[18] Source: Bloomberg. Data as of November 30, 2015.

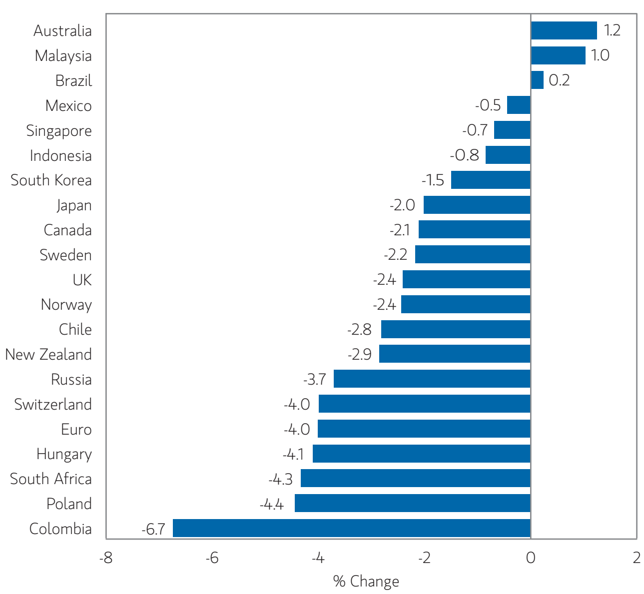
Display 2: **Government Bond Yields For Major Economies**

COUNTRY	2YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	5YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10YR YIELD LEVEL (%)	MONTH CHANGE (BPS)
Australia	2.01	27	2.31	24	2.86	25
Belgium	-0.34	-7	-0.06	-9	0.78	-3
Canada	0.63	6	0.91	3	1.57	3
Denmark	-0.58	-9	0.14	-16	0.74	-11
France	-0.33	-5	-0.01	-10	0.79	-8
Germany	-0.42	-10	-0.18	-10	0.47	-4
Ireland	-0.20	-2	0.11	-18	0.99	-12
Italy	-0.03	-6	0.37	-13	1.42	-6
Japan	-0.01	-1	0.04	0	0.31	0
Netherlands	-0.39	-9	-0.13	-9	0.63	-5
New Zealand	2.58	4	2.96	23	3.54	24
Norway	0.53	-9	0.62	-14	1.45	-14
Portugal	0.14	-19	1.01	-28	2.32	-22
Spain	-0.03	-6	0.50	-16	1.52	-15
Sweden	-0.47	-2	0.11	8	0.75	11
Switzerland	-1.10	-26	-0.98	-16	-0.36	-9
United Kingdom	0.60	-2	1.21	-6	1.83	-10
United States	0.93	21	1.64	13	2.21	6

Source: Bloomberg LP. Data as of November 30, 2015.

Display 3: **Currency Monthly Changes versus U.S. Dollar**

Currency Monthly Change vs. USD (+ = appreciation)



Source: Bloomberg LP. Data as of November 30, 2015. Note: Positive change means appreciation of the currency against the U.S. dollar.

Emerging Markets

Following a strong October rally, EM asset performance took a breather in November. Over the month, risky assets weakened and U.S. Treasury yields drifted higher as seasonally low liquidity exacerbated investor repositioning ahead of anticipated interest rate hikes by the Fed in December.

Sovereign spreads slightly tightened while domestic debt yields rose and corporate credit spreads widened over the month. EM fixed income investors continued to withdraw money from the asset class, removing roughly $6 billion in November, bringing the year-to-date total to an estimated $22 billion in outflows.[19]

Politics and policies took center stage over the month. In Argentina, voters elected the market-favored candidate Maurico Macri. The market hopes Macri will be able to tackle the monumental tasks of settling the outstanding debt dispute, liberalizing the exchange rate, addressing rampant inflation, and implementing the needed reforms to revitalize the Argentine economy. Croatian parliamentary elections raised hopes that a reformist coalition government would be formed as the third-largest party, MOST (a coalition of independents), performed better than expected. In Romania, after a large nightclub fire prompted protests, political pressure forced the resignation of Prime Minister Victor Ponta, after which a technocratic government was appointed by the President. Another reformist leader, Indian Prime Minister Narendra Modi, suffered one of his biggest setbacks since taking office with a defeat in a crucial state election, dealing a blow to his push for economic reforms. His opponents, led by incumbent Bihar Chief Minister Nitish Kumar, won 73 percent of seats in the state's 243-member assembly, with the Modi-led National Democratic Alliance taking 24 percent. Turkish elections brought back an outright majority to the ruling AKP party, reducing political uncertainty for the country as it faces ongoing economic and geopolitical challenges. Many central banks across EM held interest rates steady with the exception of Colombia and South Africa, which hiked rates 25 bps each. Indonesia's central bank reduced required reserve ratios to stimulate the economy without cutting interest rates, which could further weaken its currency which has already been under pressure.

[19] Source: Standard Chartered. Data as of November 30, 2015.

External

EM external sovereign and quasi-sovereign debt returned -0.06 percent in the month, measured by the JP Morgan EMBI Global Index, bringing year-to-date performance to 2.77 percent.[20] External sovereign and quasi-sovereign assets held in well compared to corporate and domestic debt as U.S. Treasury yields rose, leading to credit spreads tightening 3 basis points. Oil-related credits performed well as Venezuela, Kazakhstan, Angola and Ecuador outperformed the broader market. Malaysian bonds also performed well after the sovereign wealth fund, 1MDB, announced a planned asset sale which would provide a cash injection. Lower-yielding, higher-rated countries such as Chile, Indonesia, Turkey, Peru, and Mexico underperformed the broader market as U.S. Treasury yields rose in the period. Egyptian bonds underperformed the most in the period as investors priced in reduced tourism revenues after a Russian passenger plane leaving Egypt was brought down by a bomb planted by terrorists.

Domestic

EM domestic debt returned -2.16 percent in the quarter as measured by the JP Morgan GBI-EM Global Diversified Index.[21] EM currencies depreciated -2.35 percent versus the U.S. dollar and EM bonds returned 0.18 percent in local terms.[22] Colombia, South Africa, Poland, Romania and Hungary underperformed the broader market as currency weakness versus the U.S. dollar drove the negative performance. Colombian and South African domestic debt were also negatively impacted by central bank rate hikes. Domestic debt from Indonesia, Malaysia, the Philippines and Thailand outperformed the broader market, driven primarily by local bond returns as currency performance was mixed.

Corporate

EM corporate debt returned -0.52 percent in the month as measured by the JP Morgan CEMBI Broad Diversified Index.[23] As in other areas of EM debt, higher-yielding, lower-quality companies outperformed IG companies in the month on a relative basis. Regionally, companies in Europe and Asia outperformed those in Latin America, Africa and the Middle East. In particular, companies in Russia, Poland, Hungary, China, Singapore, and Taiwan outperformed the broader market while those in Brazil, Colombia, Mexico and Bahrain lagged. The Metals & Mining sector was the largest underperforming sector in the month while the Real Estate sector posted the strongest returns.

[20] Source: JP Morgan. Data as of November 30, 2015.

[21] Source: JP Morgan. Data as of November 30, 2015.

[22] Source: JP Morgan. Data as of November 30, 2015.

[23] Source: JP Morgan. Data as of November 30, 2015.

Display 4: **EM External and Local Spread Changes**

COUNTRY	USD SPREAD (BPS)	MTD CHANGE (BPS)	INDEX LOCAL YIELD (%)	MTD CHANGE (BPS)
Brazil	450	11	15.9	11
Colombia	286	3	8.1	37
Hungary	180	-5	2.7	6
Indonesia	323	15	8.7	-25
Malaysia	216	-68	4.0	2
Mexico	280	5	6.1	11
Peru	224	4	6.9	-4
Philippines	125	7	4.8	-7
Poland	91	2	2.2	0
Russia	273	-14	9.7	-18
South Africa	326	-6	8.9	24
Turkey	289	10	10.2	43
Venezuela	2605	-87	–	–

Source: JPM. Data as of November 30, 2015.

Corporate Credit

November was a moderately positive month for global risk markets continuing the positive momentum from October, and markets have now recovered much of the weakness of the 3rd quarter. Credit spreads were moderately tighter across the developed markets, and excess returns were positive. The one notable area of weakness in the fixed income markets was U.S. HY, where a large market exposure to commodity prices combined with sustained mutual fund and (exchanged traded funds) ETF redemptions to result in spreads giving back much of October's gains. EM stabilized in November, consolidating October's strong returns, despite weakness across the commodities complex. Crude oil prices fell back to the levels last seen in the summer, while metals fell to multi-year lows. Despite some weakness in the first half of the month, equity markets recovered in the second half to end the month largely unchanged. VIX followed a very similar pattern with volatility rising in first half of the month, but falling back to the bottom of the recent range by month end.

The global credit markets generated moderately positive excess returns, with the U.S. and Europe reporting 0.22 percent and 0.29 percent excess returns respectively, reflecting credit spreads that tightened by 2 to 3 bps. The financial sector materially outperformed the Industrial sector, both in the U.S. and Europe. This, in part, reflects the relatively lower volume of net issuance into the financial sector, while IG Industrial issuance continues to run at a record pace, both on a gross and net basis. In addition, the secular trend for banks continues to be one of de-risking, while corporate issuers, particularly in the U.S., are in a period of late cycle leveraging. Total returns in HY markets continued to diverge, with the U.S. HY market reporting materially negative total returns of -2.22 percent, while the Pan European HY index generated positive returns of 0.61 percent, in part reflecting the significantly higher exposure of the U.S. market to commodity sensitive issuers, and in part the continued search for yield in the face of further ECB monetary policy accommodation.

Display 5: **Credit Sector Changes**

SECTOR	USD SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)	EUR SPREAD LEVEL (BPS)	MONTH CHANGE (BPS)
Index Level	155	-4	130	-3
Industrial Basic Industry	268	+24	255	+7
Industrial Capital Goods	121	-6	111	-1
Industrial Consumer Cyclicals	140	-4	134	-3
Industrial Consumer Non Cyclicals	126	-7	107	-1
Industrial Energy	250	+3	125	-6
Industrial Technology	133	-5	92	-2
Industrial Transportation	146	-5	113	-2
Industrial Communications	184	-7	132	-2
Industrial Other	127	-5	158	+7
Utility Electric	145	-1	134	-1
Utility Natural Gas	150	-3	122	-1
Utility Other	161	-4	115	+0
Financial Inst. Banking	118	-10	109	-5
Financial Inst. Brokerage	151	-10	122	-9
Financial Inst. Finance Companies	125	-4	107	-5
Financial Inst. Insurance	155	-4	250	-6
Financial Inst. REITS	169	-5	161	+0
Financial Inst. Other	126	-9	164	+26

Source: Barclays Capital. Data as of November 30, 2015.

Securitized Products

Agency MBS underperformed U.S. Treasuries in November as the likelihood of a Fed rate hike and higher interest rates became more probable. Current coupon agency MBS were essentially unchanged in nominal spread at 100 bps above interpolated U.S. Treasuries.[24] Thirty-year fixed rate mortgage rates decreased 19 bps to finish at 3.82 percent in November.[25] The Fed purchased roughly $24 billion agency MBS over the past month, consistent with their forecast and with previous months' purchase volumes. The Fed's total MBS holdings remain at $1.75 trillion, or roughly one-third of the agency MBS market.[26]

Non-agency MBS prices were largely unchanged in November, after having declined in September and October. Fundamental market conditions underlying the non-agency MBS market remain very strong. Home prices rose 0.2 percent in September, and were up 5.5 percent year-on-year from September 2014.[27] Despite some mixed headlines, home sales data was very positive in October. October existing home sales were down 3 percent from the very strong September numbers, but remain 4 percent higher than October 2014.[28] New home sales in October increased 11 percent from September and were up 5 percent over October 2014.[29] The volume of outstanding homes for sale decreased 2.3 percent in October and is now 4.5 percent below a year ago. The 2.14 million available homes for sale represent a 4.8 months' supply, well below the historically normal equilibrium level associated with a stable housing market.[30] The U.S. homebuilder confidence index fell slightly in October, but remains near post-housing-crisis highs.[31] Fundamental mortgage performance remains positive. Mortgage defaults in October ticked up slightly from 0.76 percent to 0.81 percent, but remains down from 0.96 percent in October 2014 and well below the nearly 6 percent level in 2009.[32] We expect new defaults to remain low given the strength of the housing market, and we expect MBS cash flows to slowly increase as more borrowers are becoming eligible to refinance with rising home prices.

[24] Source: Bloomberg, Yield Book. Data as of November 30, 2015.

[25] Source: Bankrate.com. Data as of November 30, 2015.

[26] Source: Federal Reserve Bank of New York. Data as of November 30, 2015.

[27] Source: S&P Case-Shiller 20-City Index. Data as of November 30, 2015.

[28] Source: National Association of Realtors. Data as of November 30, 2015.

[29] Source: U.S. Census. Data as of November 30, 2015.

[30] Source: National Association of Realtors. Data as of November 30, 2015.

[31] Source: National Association of Home Builders. Data as of November 30, 2015.

[32] Source: S&P/Experian First Mortgage Default Index. Data as of November 30, 2015.

CMBS spreads widened again in November, marking the fourth straight month of spread widening. AAA-rated CMBS widened 0 to 5 bps on the month, while BBB spreads were 5 to 10 bps wider. BBB spreads are now 100 to 150 bps wider on the year. New issuance volumes decreased slightly to $8 billion in November, after exceeding $10 billion in October.[33] The CMBS market remains on-pace for the first $100+ billion issuance year since 2007. Fundamentally, the CMBS sector remains healthy. Retail sales continue to climb, with October numbers up 0.1 percent from September and up 1.7 percent from October 2014, but consumer confidence declined in October.[34] Hotel occupancy rates are at their highest levels in more than 15 years at over 65 percent occupancy so far in 2015.[35] For comparison, the previous credit cycle peak of 2004 to 2006 averaged roughly 63 percent occupancy. These high occupancy rates are boosting the performance of the hotel sector of CMBS. The improving economy and employment numbers are also helping reduce office space vacancies. National office vacancy rates fell to 0.1 percent to 13.4 percent in Q3 2015.[36] Office vacancy rates have either been flat or declined for 22 consecutive quarters. Industrial availability rates declined to 9.6 percent in Q3 2015, also having been flat or declined for 22 consecutive quarters.[37] Multifamily vacancy rates declined 0.2 percent from a year ago to 4.2 percent in Q3 2015.[38]

European ABS spreads tightened in November, particularly in the UK and non-core Europe. European spreads had widened over the past six months, but are beginning to see more demand at these wider levels. The ECB purchased only €600 million Euros of ABS in November, increasing their total ABS holdings to almost 15.2 billion euros.[39] European ABS issuance remained low in November, totaling €7.2 billion, and pushing the year-to-date total to €74.7 billion.[40] 2015 European ABS issuance is on pace to exceed 2014 and record the highest post-crisis annual ABS issuance.

[33] Source: Deutsche Bank. Data as of November 30, 2015.

[34] Source: U.S. Census and The Confidence Board. Data as of November 30, 2015.

[35] Source: Statistica.com. Data as of November 30, 2015.

[36] Source: CBRE. Data as of November 30, 2015.

[37] Source: CBRE. Data as of November 30, 2015.

[38] Source: CBRE Data as of November 30, 2015.

[39] Source: European Central Bank. Data as of November 30, 2015.

[40] Source: Deutsche Bank. Data as of November 30, 2015.

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The **Volatility Index (VIX)** is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30-day period. The VIX is quoted in percentage points and translates, roughly, to the expected movement in the S&P 500 index over the next 30-day period, which is then annualized.

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