Fixed Income Perspectives

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It's Quiet...Is It Too Quiet?

Our semi-annual themes provide a framework for our investment decisions. Our holistic view of the economy and global monetary policy helps determine the overall risk budget and portfolio positioning to capitalize on relative value across sectors, while helping inform our bottom-up security selection process.

As we enter 2018, the macro environment remains supportive for the fixed income markets. However, full valuations, diminished monetary policy support and our focus on identifying risks that could drive downside volatility favor "selling into strength" as opposed to "buying on weakness." Across our platform of fixed income strategies, this will be our primary focus in the first half of 2018.

Investment Themes

Global Growth: Global growth will remain solid with all regions contributing positively, despite the ongoing economic transition in China.

U.S. Growth: Growth in the U.S. will remain robust, benefiting from deregulation and, to a lesser extent, corporate tax reform. Consumption growth will continue to be held back by income and wealth inequality.

Inflation: Inflation will remain below the Fed's target. Upward inflationary pressure from demographic shifts and labor skill shortages will likely increase. However, we believe this pressure will be offset by lingering disinflationary benefits from globalization within the tradable goods sector and the ongoing influence of technology.

Central Banks: The Fed's cautious pace of interest rate normalization and balance sheet reduction will continue, despite the change in Fed membership. The ECB and BOJ risk further asset price distortion by continuing to pursue expansionary monetary policies, but an aggressive pullback of accommodation risks market disruption.

Corporate Health: Strong nominal growth and corporate tax cuts within the U.S. will provide a continued tailwind to corporate earnings, which will allow companies to absorb modest labor cost increases. Higher earnings will facilitate growth in business investment, but limited consumption growth will continue to favor a return of capital to stakeholders over significantly expanded investment.

Multi-Sector Portfolio Strategy

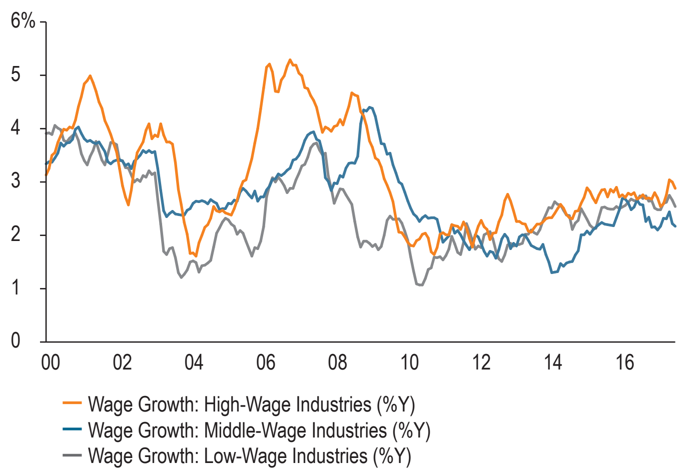
- Modestly overweight spread assets
- Overweight CLOs, which continue to provide attractive relative value
- Overweight non-agency RMBS and added exposure to credit risk transfer securities as hurricane-related concerns receded
- Security selection remains critical in CMBS as fundamentals have broadly plateaued
- While we remain constructive on corporate credit, current spread levels require a nimble, tactical approach
- Maintain slight overweight to select emerging markets, with a bias towards Latin American sovereigns
- Underweight agency RMBS, as we continue to believe the unwinding of the Fed's balance sheet skews risk to the downside
- Maintain shorter duration posture across portfolios

U.S. Growth to Keep Rolling…

As 2017 comes to a close, investors and analysts have stopped wondering when economic growth will at last pick up, but rather, if the economy may overheat. A supportive macro environment combined with uncomfortably low levels of volatility in 2017 led to strong returns in most asset classes. Business investment picked up and drove third quarter growth, while jobs remain copious as the unemployment rate has dropped to 4.1%, the lowest figure in more than a decade. Optimism has surged, as evidenced by business investment stemming from the passage of tax reform. Consumer optimism has also increased, as the University of Michigan's consumer-sentiment index reached its highest level since 2004.

We believe the U.S. will experience robust growth during the first half of 2018, benefiting from deregulation and to a lesser extent, corporate tax reform. As a result, the current economic expansion in the U.S., should it continue through 2018, will become the country's second-longest on record. With that said, we believe consumption growth will remain subdued. While we have seen consumption tick up lately, and subsequently household savings modestly slow, we believe income and wealth inequality will continue to temper the growth rate. Wage growth continues to struggle after dropping to 2.5% year-over-year and income inequality metrics continue to increase.

Figure 1: Wage Growth Disparity



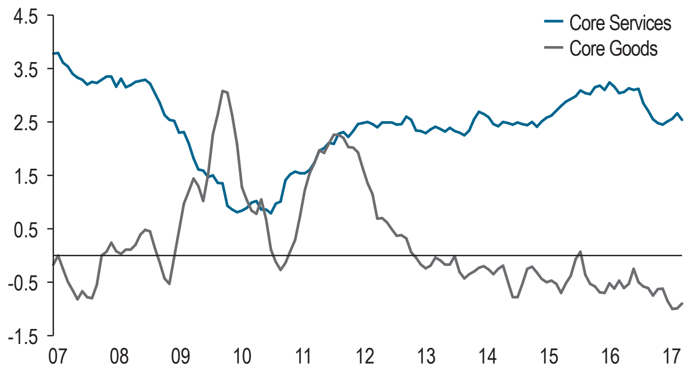
Source: Bureau of Labor Statistics, Morgan Stanley Research

From a corporate earnings perspective, we believe this limited consumption growth will continue to favor a return of capital to stakeholders over significantly expanded investment. However, we do expect higher earnings to facilitate growth in business investment. Broadly speaking, we believe corporate earnings will benefit from strong nominal growth and the passing of the tax bill in Washington, which should allow companies to absorb modest labor cost increases and have a modestly positive impact on GDP.

Shifting to monetary policy, we believe the Fed's cautious pace of interest rate normalization and balance sheet reduction will continue in the first half of 2018, despite changes in Fed membership.

Additionally, inflation should remain below the Fed's 2% target. The latest core inflation reading missed expectations, and recent "Fed speak" has brought into question the transitory nature of the current lower level of inflation. This has contributed to the flattening of the yield curve. Meanwhile, demographic shifts have caused upward inflationary pressure, specifically as millennials begin forming households and more baby boomers retire. In addition, labor skill shortages will likely increase. However, we believe this pressure will be offset by lingering disinflationary benefits from globalization within the tradable goods sector and the ongoing influence of technology.

Figure 2: Core Goods & Services CPI

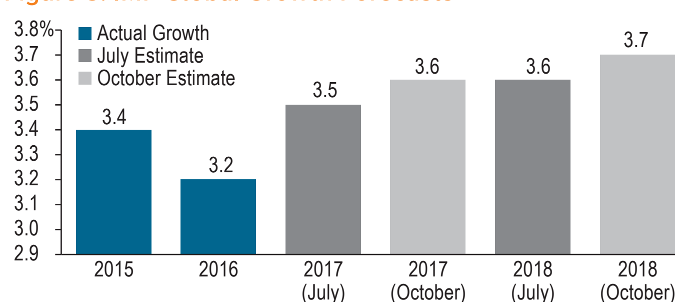


Source: Barclays Research as of December 17

… and the Global Economy is Just Starting

The same optimism exists outside of the United States, if not more so, as global growth projections continue to be revised upwards for both developed and emerging markets. The Eurozone has experienced a solid upward trend in growth over the last year, driven not only by Germany, but also by peripheral economies such as Spain and Italy. With that said, many of these countries are still way off their pre-crisis trends, indicating they have further room to run. Supporting this are the continued elevated global PMI levels, as well as Eurozone manufacturing PMI, which recently hit its highest level in 17 years. Furthermore, while the euro has strengthened recently, it is not enough to provide a major headwind to growth or corporate earnings, as business surveys continue to climb to new highs.

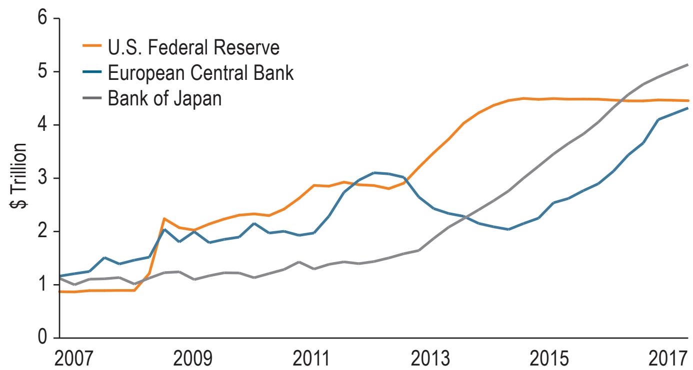
Figure 3: IMF Global Growth Forecasts



Source: International Monetary Fund, as of December 2017

Unlike the Fed, the European Central Bank continues to pursue expansionary monetary policies. The ECB is still adding to its balance sheet through 2018 and has promised not to raise rates before it ceases its quantitative easing program. The Bank of Japan also remains committed to its current accommodative policies and is targeting 0% for 10-year government bond yields in an effort to stimulate inflation. When you combine these commitments from global central banks, policy remains accommodative which can continue to support and in some cases distort asset prices. We are paying close attention to global central banks, as an unexpected pullback of accommodation could cause market disruption.

Figure 4: Central Bank Balance Sheets



Source: Bloomberg as of September 30, 2017

In addition to developed markets, we believe growth within emerging markets will remain solid through the first half of 2018, with all regions contributing positively despite the ongoing economic transition in China. While the level of debt in China causes some concern, it is important to note that China is still at a very early stage of development given how much of its population lives in urban areas. Additionally, Chinese activity accelerated in 2017, leading the People's Bank of China to tighten monetary policy. Elsewhere within emerging markets, momentum is taking hold. The supportive global growth backdrop and stable commodity prices will continue to lead to EM capital flows and anchor EM fundamentals. Idiosyncratic risks still exist, particularly in South Africa regarding its political landscape, turmoil in Venezuela, and concerns on how potential changes to NAFTA may affect Mexico.

Outlook & Positioning Going into the New Year

As we enter 2018, we expect the macro environment to broadly support fixed income markets. Even in the U.S., where the economic cycle is a step ahead, leading indicators suggest continued growth. Globally, PMIs continue to stay elevated and growth projections across all regions continue to be revised upward. With that said, a surprise uptick in inflation or hawkish central bank rhetoric are just two risks that could lead to volatility. With full valuations and diminishing monetary policy support, we move our focus to identifying risks that could cause volatility to re-surface and favor "selling into strength" as opposed to "buying on weakness." As a result, maintaining dry powder with the ability to stay nimble and execute on sound security selection becomes increasingly more important.

We begin the year modestly overweight risk, with a focus on securitized credit. Our largest overweight is to collateralized loan obligations ("CLOs") within our ABS allocation, which continue to provide attractive relative return opportunities, particularly if rates move higher. We also still like Non-Agency residential mortgages ("RMBS"), and have added some exposure to credit risk transfer securities ("CRTs") after hurricane-related concerns receded. While we maintain allocations to commercial mortgage-backed securities ("CMBS") due to continued momentum in commercial real estate prices, security selection remains key as fundamentals have broadly plateaued.

We remain constructive on corporate credit as the passage of tax cuts and increasing growth should provide a nice tailwind to credit fundamentals. Within investment grade, we are underweight from a market value standpoint, but hold an overweight to slightly riskier BBB-rated issuers.

We are maintaining a modest allocation to high yield corporates. However, with spreads for both high yield and investment grade corporates near post-crisis tights, a nimble, tactical approach is warranted and allocating to the right issuers is paramount. Additionally, we are maintaining a slight overweight to select emerging markets, with a bias towards Latin American sovereigns. We continue to believe the unwinding of the Fed's balance sheet skews risks to the downside for Agency RMBS and remain underweight. Finally, given our expectations for a move higher in interest rates, we maintain a short duration posture across our portfolios.

Figure 5: Investment Grade and High Yield Spreads

Source: Barclays Live as of December 2017

Past performance does not guarantee future results.

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