Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

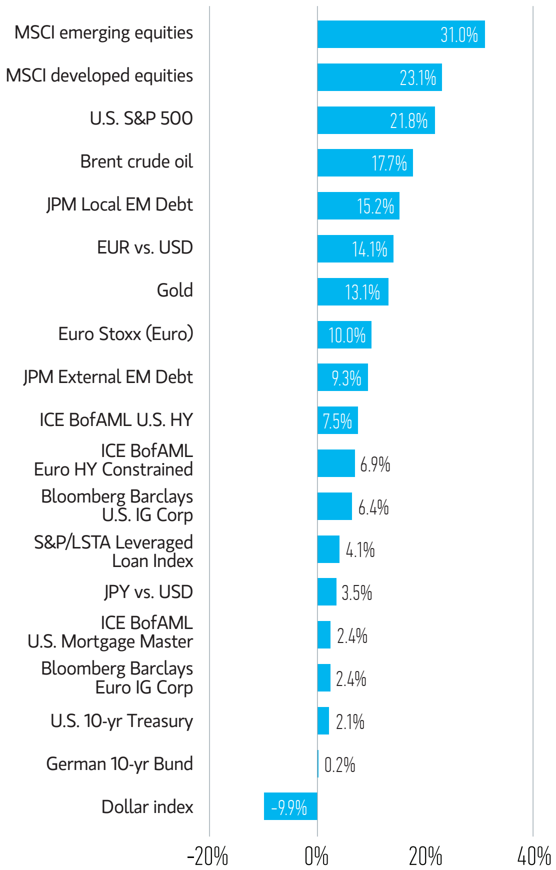
2018 – A Focus on Alpha

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

As the new year begins, it's difficult to see what will disrupt this not-too-hot, not-too-cold environment: growth continues to surprise on the upside, but inflationary pressures remain dormant, implying the unusually slow pace of central bank policy normalization will continue. There is also a notable lack of enthusiasm among investors. Cash allocations are high, market commentary focuses on how expensive markets are and how risks are growing. A buy the dip mentality frequently means one will likely not materialize! However, market skepticism about value and the ability of indexes to drive returns does have validity. In this positive macroeconomic, somewhat high valuation world, alpha/issuer selection is likely to be a far bigger driver of performance than just being long risk. Indeed, given their greater diversity of macroeconomic situations, emerging markets may be an attractive space to look for alpha opportunities.

DISPLAY 1

Asset Performance Year-to-Date



Note: U.S. dollar-based performance. Source: Thomson Reuters Datastream. Data as of December 30, 2017. The indexes are provided for illustrative purposes only and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See pages 11 and 12 for index definitions.

DISPLAY 2

Major Yearly Changes in 10-Year Yields and Spread

COUNTRY	10-YR YIELD LEVEL (%)	YEAR CHANGE (BPS)	10-YR SPREAD (BPS)	YEAR CHANGE (BPS)
			(Spread over USTs)	
United States	2.41	-7		
United Kingdom	1.19	-4	-122	2
Germany	0.43	25	-198	32
Japan	0.05	1	-236	8
Australia	2.63	-15	22	-8
Canada	2.05	33	-36	39
New Zealand	2.72	-66	32	-59
EUROPE			(Spread over Bunds)	
France	0.79	13	36	-12
Greece	4.12	-300	369	-325
Italy	2.02	22	159	-3
Portugal	1.94	-181	152	-206
Spain	1.57	24	114	-1
EM	**INDEX LOCAL YIELD (%)**	**YTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**YTD CHANGE (BPS)**
EM External Spreads			311	6
EM Local Yields	6.26	-616		
EM Corporate Spreads			225	0
Brazil	9.02	-208	232	-98
Colombia	6.26	-69	173	-52
Hungary	1.26	-69	86	-82
Indonesia	6.63	-139	166	-71
Malaysia	3.90	-28	108	-89
Mexico	7.67	+16	245	-51
Peru	5.24	-126	136	-34
Philippines	4.84	-63	95	-15
Poland	2.69	-35	45	-65
Russia	7.29	-95	179	-7
South Africa	9.31	-3	255	-21
Turkey	11.95	+104	291	-69
Venezuela	–	–	4854	+2686
CREDIT			**SPREAD (BPS)**	**YTD CHANGE (BPS)**
U.S. IG			93	-30
EUR IG			86	-37
U.S. HY			343	-61
EUR HY			277	-95
SECURITIZED				
Agency MBS			69	-20
U.S. BBB CMBS			330	-79

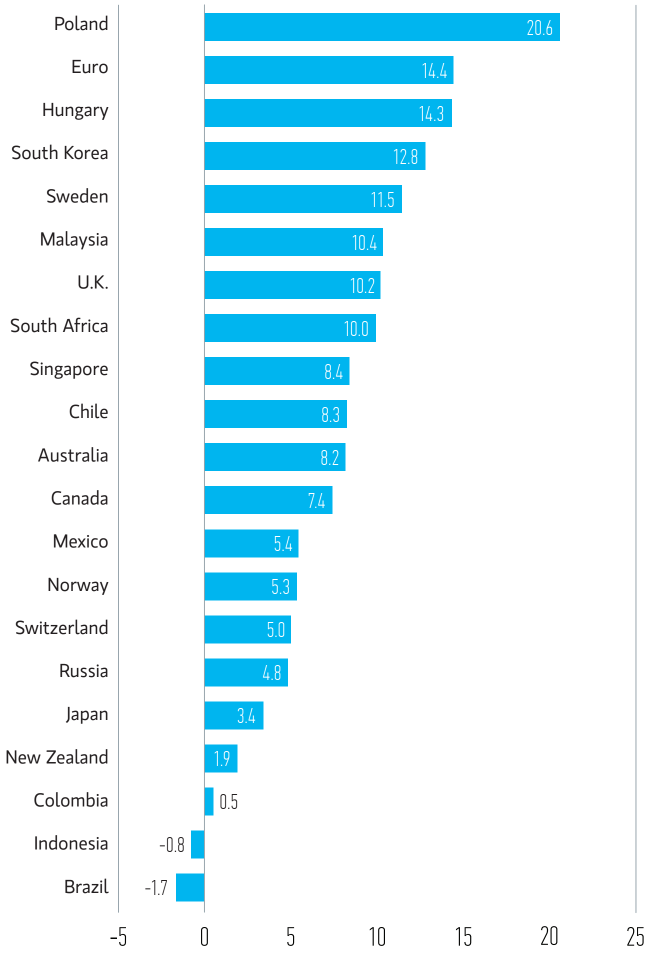
Positive Neutral Negative

Source: Bloomberg, JP Morgan. Data as of December 29, 2017.

DISPLAY 3

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Source: Bloomberg. Data as of December 29, 2017. Note: Positive change means appreciation of the currency against the U.S. dollar.

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Fixed Income Outlook

Will 2018 be as good to investors as 2017? Most assets performed well last year as the combination of sustained economic expansion and continued easy financial conditions buoyed risky assets. As the new year begins, it's difficult to see what will disrupt this not-too-hot, not-too-cold environment: growth continues to surprise on the upside, but inflationary pressures remain dormant, implying the unusually slow pace of central bank policy normalization will continue. There is also a notable lack of excitement among investors. Cash allocations are high, market commentary focuses on how expensive markets are and how risks are growing. A buy the dip mentality frequently means one will likely not materialize! However, market skepticism about value and the ability of indexes to drive returns does have validity. In this positive macroeconomic, somewhat high valuation world, alpha/issuer selection is likely to be a far bigger driver of performance than just being long risk.

There are always things to worry about, from central bank policy surprises to geopolitical explosions. We believe one of the key risks, if not maybe the most important risk, for 2018 is not so much the macroeconomic picture turns unfavorable, but that the market's demanding expectations are not met. Central banks may still normalize policy very slowly in comparison to previous cycles, but it won't take much to exceed current market pricing, e.g., if the Fed raises rates more than twice, if the European Central Bank (ECB) ends quantitative easing (QE) in September, or if the Bank of Japan (BoJ) shifts at all on its yield curve control policy. With the composition of the Federal Open Market Committee (FOMC) still in flux, U.S. President Donald Trump has several more appointments to make. Given current valuations, the skew in potential outcomes for government bond markets is towards yields moving meaningfully higher rather than lower. Therefore, even if one's central scenario is not very different from what the market expects, we believe it makes sense to position for higher yields.

In spread product, the concern is that even a benign economic outlook may not be enough to drive outperformance given the spread compression that has already happened. One will need to be far more selective in where one takes spread risk to help both eke out higher returns and minimize potential losses in a sell-off. Alpha/issuer selection is likely to be a far bigger driver of performance than just being long beta/carry. Given the greater diversity of macroeconomic situations, emerging markets may be an attractive space to look for alpha opportunities.

	OUTLOOK
Developed Markets/FX	The initial conditions in the market suggest that the 10-Year U.S. Treasury is likely to stay in a range between 2% and 3%. We do not expect the U.S. Federal Reserve (Fed) message/policy to be very different under Fed chair nominee Jerome Powell, at least until more data is collected about the performance of the economy following recent rate hikes. We are most positive on European peripheries and Australia rates, while slightly bearish on German bunds and Japanese government bonds. We are neutral on the dollar.
Emerging Markets/FX	In the near-term, we currently advocate a cautious approach to the asset class in view of the sizable outperformance last year, rising 10-Year U.S. yields, and a host of geopolitical tail risks as local political factors. We therefore prefer idiosyncratic stories with high carry, and/or undervalued. Within the idiosyncratic stories, we like reform-minded countries such as India and Indonesia, those with ongoing disinflation and tight monetary policies (Russia) and still others with activist central banks (in particular, Hungary). However, we choose to avoid low-yielders such as Thailand and Czech Republic, or countries with deteriorating fundamentals, such as Colombia.
Credit	While spreads have reached post-crisis lows, they remain wide of previous late cycle periods and should remain supported by improving economic growth and corporate earnings. We believe the majority of beta-driven compression is now behind us and expect 2018 to be defined by alpha-generating opportunities. On the nonfinancial side, we find ourselves more focused on rising idiosyncratic risk, driven by mergers and acquisitions (M&A) and disruption risks, which we worry is not properly priced into many credits. We find much greater comfort investing in financials. Especially in Europe, we find regulators and central banks continue to de-risk the sector, encouraging banks to hold more capital and better assets. We are happy to hold modest amounts of high-yield and convertible bonds, though we expect to gradually reduce this exposure in 2018.
Securitized	We enter 2018 with another positive outlook for the securitized markets based on attractive carry and improving credit conditions. We do not expect to match 2017 returns, but we still expect attractive absolute and relative returns for 2018 based on the cash flow-based carry opportunities. Some of our favored sectors are: non-agency residential mortgage-backed securities (RMBS), residential-related commercial mortgage-backed securities (CMBS), esoteric asset-backed securities (ABS) and seasoned peripheral European and U.K. RMBS. We are less positive on agency mortgage-backed securities (MBS), retail-, and hotel-backed CMBS.

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Developed Market
2018 Outlook

U.S.

We expect three rate hikes in 2018, which is the same as the Fed's forecast, but the market is pricing in only two. The risk for 2018 is if the Fed hikes rates faster than its current forecast (i.e., a fourth hike in 2018), not if they hike slower. However, the Fed will need to see what impact its tightening to date has had and the fact that wherever R*, happens to be, the Fed is closer to it!

We do not expect Fed policy to be very different under Jerome Powell, at least until more data on the economy becomes available later in the year. For market stability confidence reasons, Powell needs to show continuity with outgoing Fed chair Janet Yellen for at least the first few meetings. Initial conditions in the market suggest that the 10-Year U.S. Treasury is likely to stay in a range between 2% and 3%.

The dollar is being pulled in different directions and we are neutral in wait of a clear trend. A more active Fed and rising interest rate differential with the rest of the world is bullish for the dollar, but better relative growth across the world is bearish.

EURO AREA

The strength of the eurozone's economic recovery, and growing evidence of rising underlying inflation, means it is increasingly likely that the ECB will end its QE program in September or shortly thereafter. The move to policy normalization should cause German yields to rise towards year-end, but the depletion of the duration/collateral pool and ECB reinvestment should cap a large rise.

Given the spread compression since the French presidential election, and its worse fiscal fundamentals, we are bearish on France versus Germany. However, we are more bullish on the peripheral euro sovereigns such as Portugal and Greece. While we expect less dramatic tightening in Portugal than we had in 2017, improving fundamentals and relatively high carry continue to make the periphery attractive to us. Italian elections in March pose a clear threat to the spread tightening trend, not only for BTPs (Buoni del Tesoro Poliennali or Italian Treasury bonds) but also for other euro sovereigns—but could also provide attractive trading opportunities if spreads widen more than is fundamentally warranted.

U.K.

The outlook for U.K. rates is complicated by the continued political uncertainties from Brexit. While the Bank of England (BoE) is clearly biased to continue raising rates if the economy remains resilient and the labor market tightens as it expects, political developments could rapidly change the outlook. Many key issues regarding the U.K.'s exit from the European Union (EU) are expected to be negotiated this year, and British politics remain uncharacteristically unstable, so major political risk remains. Gilts already have an unusually large risk premium priced into them (yields on the low side), so have potential to sell off significantly in response to a positive risk event, but we do not expect them to be a driver of global rates markets as they were in 2016.

JAPAN

We expect JGB yields to remain low, but this is very much in the price already. The extreme flatness of the curve suggests investors expect the BoJ's current yield curve control policy to remain in place for an extended time. Any speculation that the policy could change, possibly due to evidence of rising inflationary pressures, could cause a notable repricing. Given the extent to which Japanese investors have turned to foreign fixed income markets for yield pick-up, even modestly higher domestic rates could have a significant impact on global rates.

CANADA/AUSTRALIA/NEW ZEALAND

The economies in Canada, Australia and New Zealand have been steadily improving, supported by global growth and rising commodity prices. However, in each country, high household leverage and slowing house price inflation have made their central banks more cautious. We like being overweight Australian government bonds and underweight the currency, given the economic prospects and as a hedge, potentially, to a weaker-than-expected China.

NORWAY/SWEDEN

With little slack and inflation approaching 2%, we think Sweden should be very close to a rate normalization cycle. However, the Riksbank is very sensitive to FX strength (in an almost hysterical fashion) and lower imported inflation, which has led it to maintain a dovish bias. In contrast, despite relatively low inflation, the Norgesbank has become more hawkish out of financial stability concerns, as household leverage is among the highest in the developed world. We see reasons for both NOK (Norwegian krone) and SEK (Swedish krona) to strengthen versus the euro.

Emerging Markets
2018 Outlook

We believe the main question for investors in EM is which EM asset class will outperform, and under what external scenario. Subsequently, within the asset class, the right assets have to be identified that are likely to perform, given the external macroeconomic scenario and the fundamentals of the sovereign or corporate in question. Amid the current themes driving EM fixed income investments, it is, in our view, important to be flexible and have the ability to reallocate to the asset class that is likely to perform the best. For example, a backdrop of broad U.S. dollar weakness should benefit EM fixed income across the board: local currency debt should outperform via EMFX

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appreciation and returns from duration, as FX appreciation contributes to disinflation. Similarly, dollar weakness reduces the cost of servicing hard currency debt, which should benefit EM sovereign/corporate spreads, particularly those of countries and companies with high USD debt stocks. Meanwhile, a combination of disinflation and steep domestic yield curves might argue for duration exposure in certain countries where inflation expectations are well-anchored.

Our view remains constructive overall on the asset class in the medium term, on the back of supportive global fundamentals (most notably, a synchronized global expansion, dollar weakness and global trade expansion amid subdued inflationary pressures in advanced economies), EM idiosyncratic fundamentals, still attractive yields compared to alternatives in developed markets, and some room for valuations to tighten further. Notwithstanding our benign medium-term view, we currently advocate a cautious approach to the asset class in view of the sizable outperformance last year, moderately higher 10-Year U.S. Treasury yields driven by the successful passage of the tax package, electoral contests in key EM economies, and a host of tail risks, including geopolitics and the U.S. government's potential anti-trade initiatives (particularly, a bad outcome on the North American Free Trade Agreement (NAFTA) renegotiation and/or measures impacting U.S.-China trade relations).

We therefore prefer a more selective allocation to EM currencies in the near term, preferring idiosyncratic stories with high carry, such as Egypt, Indonesia and Russia, and undervalued currencies including Malaysia. In local rates, we like overweight duration exposure to reform-minded countries with attractive yields, such as India and Indonesia, those with ongoing disinflation and tight monetary policies (Russia), and still others with activist central banks (in particular Hungary, as monetary authorities introduce measures to flatten the local yield curve). However, we choose to avoid low-yielders, such as Thailand and Czech Republic, or countries with deteriorating fundamentals, such as Colombia. Regarding sovereign spreads, we think valuations have some further room to tighten, and we are biased in favor of countries with ongoing reform agendas and/or high yields such as Indonesia, Argentina and Ukraine, and avoiding low- yielders (such as Chile), or deteriorating macro/political stories (Colombia and Turkey).

Within EM corporates we remain overweight higher-yielding, lower-rated credits as the default cycle has bottomed and we should begin to see the ratio of ratings upgrades to downgrades rise in the near future. Within this high-yield segment we are favoring idiosyncratic stories in countries with stable-to-improving fundamentals, while within investment-grade credits we have focused on lower-rated companies within the 7- to 10-year segment of the yield curve, as well as perpetuals with punitive step-up provisions. Within Asia, we favor China via higher-quality state-owned enterprises (SOEs) and new economy companies, as well as India (oil and gas, and clean energy plays) and Indonesia (property and technology, media and telecommunications). Within Latin America, we favor Argentina (reform story offers attractive risk/reward as the country re-enters the global capital markets) and Brazil (oil and gas SOE, financials and local champions in core sectors such as proteins).

Credit

2018 Outlook

Every December our team of portfolio managers, traders and analysts sit down to discuss our credit outlook for the upcoming year. Coming to a consensus has been a relatively easy task for a while now. With the exception of 2014 (more on this later), spreads have begun each January above long-term medians and well wide of typical late cycle lows. Pairing these attractive valuations with a multiyear backdrop of aggressive central bank intervention and gradually normalizing economies, it did not take much for our team to reach a bullish consensus and agree to position portfolios overweight credit.

Indeed, 2017 was another strong year for investment-grade credit, driven by continued economic improvement, accommodative monetary policy and low volatility. Spreads tightened across every major sector in 2017, though the best-performing sectors were basic industry and energy. Spreads in these sectors continued to normalize after significant underperformance in early 2016. European investment-grade performed even better than U.S. corporates, narrowing by 37 basis points relative to governments. As with the U.S., every sector outperformed governments, though subordinated bank and insurance paper vastly outperformed the broader European market.

Circumstances were very different when our team met this past December. Spreads now sit firmly at post-crisis lows, the U.S. economic expansion is nearly 10 years old and excess global monetary accommodation is gradually being withdrawn. At the same time, global equities have had record performance, government bond yields continue to normalize and corporate fundamentals have remained relatively stable. Sitting around the table, our team discussed these and a range of other factors expected to have positive and negative influences on the market in 2018. Our discussions concluded with our team remaining constructive on credit, but holding more modest expectations and nuanced views of the asset class looking forward.

Our thesis for 2018 is that while spreads have reached post-crisis lows, they remain wide of previous late-cycle periods and should remain supported by improving economic growth and stable fundamentals. We do not expect the gradual removal of accommodation to have an outsized negative impact on our markets, but we do expect volatility to increase as central bank intervention declines. As a result of these circumstances, we believe the majority of beta-driven compression is now behind us and expect 2018 to be defined by alpha-generating opportunities arising from renewed idiosyncratic volatility. In the sections ahead, we will more closely examine our outlook for market fundamentals, technicals and valuations that led us to this conclusion.

When examining fundamentals, we believe it remains appropriate to evaluate nonfinancials independently from financials, given that many of their primary drivers are different. On the nonfinancial side, we find ourselves cautiously positioning portfolios among a majority of companies with high but stable levels of leverage. This in and of itself does not overly concern us, though we are mindful that these levels of leverage are quite high relative to previous late-expansionary periods. We find ourselves more focused on rising idiosyncratic risk and sector/issuer dispersion, driven by M&A and disruption risks, and which we are concerned were not properly priced into many credits. Looking ahead, we are carefully considering how technological advancement may impact the companies and sectors in which we invest, how the growth of the online economy will impact brick and mortar businesses and how the rising popularity of renewable energy could impact traditional energy and utility companies. We also remain wary of aggressive M&A that can cause companies to overextend and exposure themselves to heightened execution risk. Long positions within nonfinancials are still possible, but only when we believe valuations compensate us for these and other risks.

We find much greater comfort investing in financials, a key area of our focus for the past several years. This sector remains supported by global policy initiatives that aim to reduce systemic business risk and encourage business models to become more transactionally-oriented. Our view is to become a bit more nuanced when looking within specific regions and subsectors. For example, in the U.S., we find that de-risking has been largely completed by the largest institutions and, as a result, we do not expect to witness continued improvement in credit quality. That said, fundamentals in the U.S. financial system remain very strong and a heavy regulatory presence remains. In Europe, we find regulators and central banks continue to de-risk the sector, encouraging banks to hold more capital and better assets. Outside of the banking sector, we remain favorably oriented towards insurance companies. Their traditionally strong balance sheets and high capital levels have been buoyed by strong equity markets and improving pricing environments.

Looking at valuations, we believe the spread on the U.S. investment-grade corporate index is no longer cheap but also does not strike us as particularly expensive. Investors should continue to earn relatively attractive excess returns in an environment where spreads remain range-bound or narrow slightly. We are responding to these conditions by gradually reducing risk in portfolios but continuing to position accounts modestly overweight risk. While our conviction level isn't as high as past years, we find ourselves reluctant to get too defensive too soon. If precedents are any guide, credit may actually get more expensive before the business cycle ends—and given the level of spreads today, the cost of being underweight in this situation would be very costly. In the absence of particularly expensive valuations, rather than rapidly shedding risk with no major negative catalysts on the horizon, we believe following a path of gradual de-risking is most appropriate.

As for the drivers of returns in the year head, as mentioned earlier, we expect returns to be driven more by idiosyncratic risk than beta-driven compression. Given our differing views on financials relative to nonfinancials, we continue to position portfolios overweight the former and underweight the latter. Where permitted, we are happy to hold modest amounts of high-yield and convertible bonds, though we expect to gradually reduce this exposure early in 2018.

After the equity rally in 2017, stocks are not as straightforward to predict looking ahead. However, the backdrop for convertibles heading into 2018 consists of tightening monetary conditions, improving economic growth and rising rates, all of which are net beneficial to asset class performance relative to both bonds and stocks in our opinion. Further, we expect an eventual return to volatility after a year where global equities had the second lowest volatility in the past century.[1] We therefore expect a solid year for convertibles in 2018 with improved performance relative to stocks in particular. Issuance is poised to rise as well, as we expect both higher equity prices and higher rates should bring supply to the market.

Securitized Products
2018 Outlook

We enter 2018 with another positive outlook for the securitized markets based on attractive carry and improving credit conditions. We do not expect to match 2017 returns, but we still project attractive absolute and relative returns for 2018 based on the cash flow-based carry opportunities in the securitized markets.

Agency MBS remains one of our primary concerns in 2018. We enter

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

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the new year with nominal spreads on agency MBS at the tightest levels in more than 20 years and with the Fed just beginning to unwind its $1.75 trillion holdings of agency MBS. The Fed owns over 30% of the agency MBS market, and we believe spreads may need to widen to attract investors to fill the expected Fed void.[2] We also have concerns over possible increases in interest rate volatility as the Fed continues to raise rates and reduces its balance sheet holdings. We remain underweight agency MBS relative to more credit-sensitive securitized products, but are neutral on agency MBS relative to U.S. Treasuries.

U.S. non-agency RMBS continue to offer compelling value given their attractive yields, improving housing market conditions and declining non-agency RMBS supply. Although non-agency RMBS spreads are tighter over the past year, non-agency yields are only marginally lower due to rising interest rates and improving non-agency cash flow projections. Non-agency prepayment speeds have increased since more homeowners are now able to refinance as home prices are back above original levels in most areas. Much of the legacy non-agency RMBS market still trades at sub-par prices, and faster prepayments should have a positive impact on performance.

We expect home prices to continue to rise in 2018, although probably closer to 3%-4% rather than the 5%-6% average annual pace of the last five years.[3] In part, this is due to the current supply-demand imbalance. New household formation has outpaced new home building over the past several years leading to record low housing inventories in 2017. Housing supply is not quickly fixable given the relatively long production timelines for new homes. We expect new tax policy to have a marginally negative impact on home prices on a national level due to decreased deductibility of mortgage interest. But regional impacts could be more substantial as changes in the deductibility of state and local income taxes could harm affordability in northeast and west coast states.

The supply-demand dynamic in non-agency RMBS remains positive as the nearly $500 billion non-agency RMBS market continues to shrink at roughly 10% per year as new origination and securitization on non-agency mortgages remains minimal. Regulatory lending constraints, less efficient securitization capital structures and memories of painful mortgage legal settlements continue to discourage many lenders from more aggressively originating loans outside of Government-Sponsored Enterprises (GSE) guidelines. Despite the declining supply, we expect demand for non-agency RMBS to remain strong as investors try to replace portfolio run-off from portfolio paydowns. If demand remains steady or improves given the positive fundamental outlook, prices could continue to move higher as a function of this shrinking supply.

U.S. CMBS remains the highest yielding securitized asset classes, but also the sector with perhaps the greatest risks. AAA-rated CMBS performed well in 2017, tightening roughly 25 basis points. At current level, we believe most AAA CMBS offer fair value relative to other asset classes. Spreads on lower-rated CMBS vary significantly based on underlying collateral composition. Fundamental conditions are running at near peak levels across all commercial real estate sectors, with record high occupancy rates for hotels, office space and multifamily housing. Rental rates have also increased in these sectors which has further bolstered revenues and net operating income levels.

The primary exception to these optimal market conditions is the retail shopping sector. Store closings are increasing and vacancy rates are rising at many shopping centers. Even for shopping malls where vacancy rates have remained low, refinancing their debt has become more challenging as market fears have constrained lending in this sector. While we do not see increased default risk being an immediate problem for retail properties, we expect loan maturities to heighten default risks due to this difficult lending environment and declining future prospects for these malls.

Overall, we find CMBS valuations to be attractive, but the risks to remain elevated as well. In terms of specific CMBS subsectors, we still like residential related sectors like single-family rental and multifamily housing. We also like large single-asset deals and seasoned conduit deals. However, we remain very cautious on shopping centers given weakness in the brick-and-mortar retail sectors, and we are cautious on recent-origination hotel loans given sharp increases in valuations over the past few years.

In U.S. ABS, we continue to find minimal value in traditional credit card and auto ABS at current spread levels, but we continue to see attractive opportunities in more esoteric ABS sectors, such as consumer loans, aircraft leases, subprime auto loans and servicer advances securitizations. Consumer balance sheets are improving due to low unemployment and increasing wages. Total consumer debt remains at reasonable levels as interest rates remain low and credit card utilization rates are at lowest levels in nearly 20 years. Student loan debt continues to rise and could cause increased stress for some consumers, but overall, we remain positive on consumer credit. Additionally, ABS securitizations in the post-financial crisis era are generally being structured with very robust levels of credit protection, designed to withstand very high default levels.

[2] Source: Federal Reserve. Data as of December 31, 2017.

[3] Source: Bloomberg, S&P Case-Shiller. Data as of December 31, 2017.

Security selection remains critical in the more esoteric ABS sectors, but we believe these sectors offer attractive relative value as we enter 2018.

Despite the strong performance of European securitized markets in 2017, we continue to see attractive opportunities in U.K., Spanish, Portuguese and Greek RMBS. Spreads have tightened considerably over the past year, but remain attractive relative to many U.S. securitized markets and relative to ECB-eligible ABS and corporate bonds. We particularly favor very seasoned (10+ years) loans in U.K. RMBS given the proven credit worthiness of the borrower, and the housing market cushion from the home price increases over the last 10 years. Low mortgage rates are also having a positive effect on home prices throughout Europe, and the 10-year seasoned loans have proven their credit worthiness, with the borrowers having made consistent payments through more difficult economic times.

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.

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DEFINITIONS

Alpha is the excess return or value added (positive or negative) of the portfolio's return relative to the return of the benchmark. **Beta** is a measure of the relative volatility of a security or portfolio to the market's upward or downward movements. A beta greater than 1.0 identifies an issue or fund that will move more than the market, while a beta less than 1.0 identifies an issue or fund that will move less than the market. The Beta of the Market is always equal to 1. **Carry** is defined as the difference between a yield of a bond and interest on overnight cash. **Duration** is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. **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. **Spread** is the difference between the quoted rates of return or yield on two different investments, usually of different credit qualities but similar maturities. It is often the indication of the risk premium for one investment vehicle over another

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 **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).

U.K. 10-Year 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 10-Year bonds — Germany Benchmark 10-Year Datastream Government Index; **Japan 10-YR government bonds** — Japan Benchmark 10-Year Datastream Government Index; and **10-YR 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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CRC 1984115 Exp. 12/31/2018 9125343_KC_0118 Lit-Link: FIBULLETIN 01/18