Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Is 2025 (finally) the Year of the Bond?

MACRO INSIGHT | BROAD MARKETS FIXED INCOME TEAM | January 2025

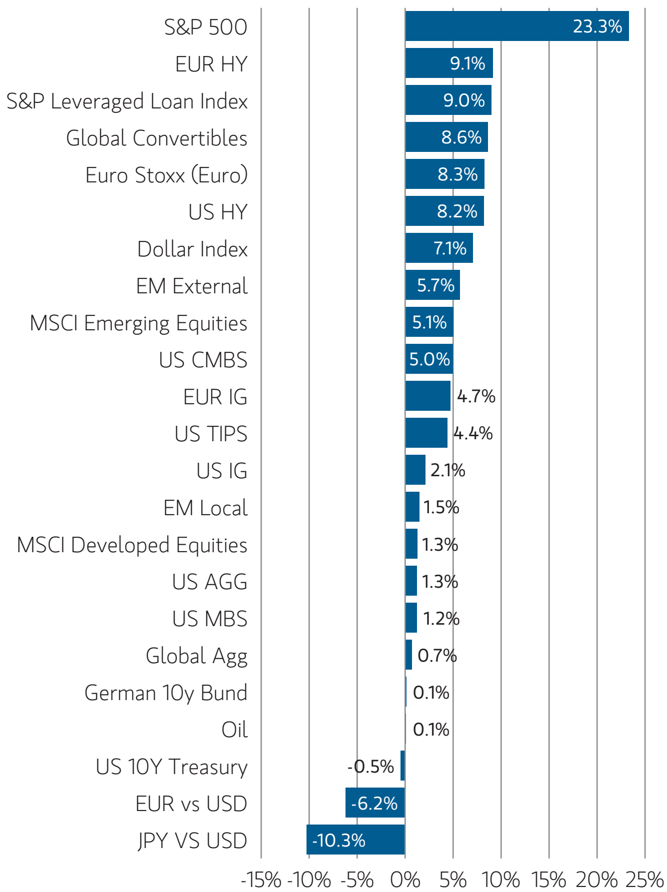
December proved to be an eventful month in the bond market, influenced heavily by a hawkish Federal Reserve (Fed) meeting and persistent global inflation trends that underwhelmed expectations. Global government bond yields experienced notable increases across both developed and emerging markets. In the U.S., the 10-year Treasury yield rose by 40 basis points (bps), contributing to a significant steepening of the yield curve with the 2s/10s spread (the difference between 2- and 10-year yields) widening by 31 bps.[1] In Europe, the trend was similar, with Germany's 10-year yield climbing 28 bps, while the U.K. yield saw an increase of 33 bps. Emerging markets also felt the impact, with Mexico's yields rising by 42 bps and Brazil experiencing a substantial jump of 175 bps. China and Thailand were two of the only countries that saw their 10-year yield decline over the month with yields falling by 36 bps in China and 4 bps in Thailand.

The U.S. dollar strengthened throughout the month, gaining 2.6% against a basket of other currencies.[2] Notably, it outperformed the New Zealand dollar by 5.4%, the Australian dollar by 5%, and the Japanese yen by 4.7%.

Regarding spread sectors, the U.S. corporate market saw a 21 bps widening in high yield spreads and a slight increase of 2 bps in investment grade spreads. Conversely,

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of December 31, 2024. 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 9-10 for index definitions.

[1] Source for all global government bond yields: Bloomberg L.P. Data as of 12/31/2024.

[2] Source for currency data: Bloomberg L.P. Data as of 12/31/2024.

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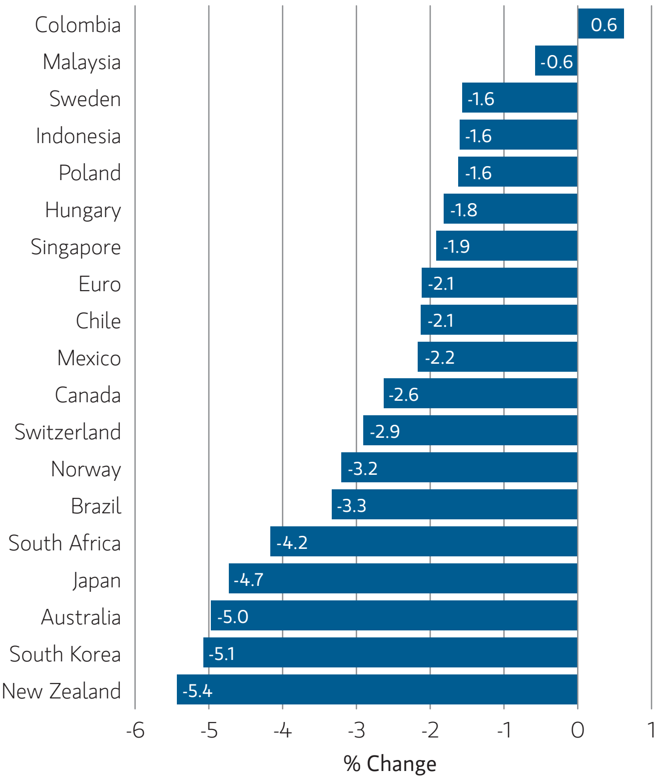
European high yield spreads tightened by 22 bps, while investment grade corporate spreads narrowed by 6 bps.[3] Meanwhile, securitized credit spreads remained mostly stable. Agency mortgage-backed spreads experienced marginal tightening.

Overall, December highlighted significant volatility and adjustments in both the bond and currency markets, setting the stage for further developments in the new year.

DISPLAY 2

Currency Monthly Changes versus USD

(+ = appreciation)



Note: Positive change means appreciation of the currency against the USD. Source: Bloomberg. Data as December 31, 2024.

DISPLAY 3

Major Monthly Changes in 10-Year Yields and Spreads

COUNTRY	10-YR YIELD LEVEL (%)	MONTH CHANGE (BPS)	10-YR SPREAD (BPS)	MONTH CHANGE (BPS)
			(SPREAD OVER USTS)	
United States	4.57	40		
United Kingdom	4.57	33	0	-7
Germany	2.37	28	-220	-12
Japan	1.10	5	-347	-35
Australia	4.36	2	-21	-38
Canada	3.23	14	-134	-26
New Zealand	4.41	3	-16	-37
EUROPE			(SPREAD OVER BUNDS)	
France	3.20	30	83	2
Greece	3.22	31	85	3
Italy	3.52	25	116	-3
Portugal	2.85	31	48	3
Spain	3.06	27	69	-1
EM	**10-YR LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			295	-7
EM Corporate Spreads			206	-4
EM Local Yields	6.37	9		
			(SPREAD OVER USTS)	
Brazil	15.16	175	1059	135
Colombia	11.88	100	731	59
Hungary	6.56	20	199	-20
Indonesia	6.97	11	240	-29
Malaysia	3.81	1	-76	-39
Mexico	10.42	42	585	2
Peru	6.63	7	206	-34
Poland	5.88	37	131	-3
South Africa	10.31	18	575	-22
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			80	2
EUR IG			102	-6
U.S. HY			287	21
EUR HY			309	-22
SECURITIZED				
Agency MBS			135	-3
U.S. BBB CMBS			628	-18

Positive Neutral Negative

Source: Bloomberg, JPMorgan. Data as of December 31, 2024.

[3] Source: Bloomberg L.P. Data as of 12/31/2024.

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Fixed Income Outlook

Bond market volatility returned in December, with yields rising worldwide. Moreover, credit spreads widened as well, albeit less aggressively than yields. All was not completely lost, as securitized credit spreads tightened modestly. At the extreme end, Brazilian yields were up well over 100 bps in December alone as the central bank hiked its policy rate 100 bps. December's poor performance weighed significantly on 2024 returns overall. For the year, the U.S. aggregate bond index returned 1.25% while the global aggregate bond index (hedged to U.S. dollars) returned 3.4%, both significantly underperforming cash and underperforming expectations. High yield corporate debt bucked the trend as returns comfortably exceeded cash.[4]

This result is highly unusual given that developed market central banks began their long-awaited easing cycles. In fact, since the Fed began to lower interest rates in September, 10-year U.S. Treasury yields have risen to just under 90 bps. Of course, what happened is that economic data once again proved unfriendly just as the Fed became more optimistic about inflation and pessimistic about growth and unemployment. Indeed, the U.S. unemployment rate peaked as the Fed began to cut interest rates. Bad luck or bad analysis/forecasting? The answer is important as it portends what may lie ahead.

Prognostications for 2025 are likely to be challenging to hold with confidence. The last five years have been replete with surprises. First was 2020, when the pandemic changed everything by the end of the first quarter; 2021 saw an inflation surge few had forecast; then "transitory" inflation turned out to be anything but, causing 2022 to introduce the most aggressive tightening cycle in decades; 2023 brought on recession worries/forecasts, which also proved to be not just off the mark but the diametric opposite to what actually happened; and 2024 delivered continued good news on the economy, with no slowdown in U.S. growth and spectacular U.S. equity returns. So, what can we expect for 2025?

The big day is 20 January, President-elect Trump's inauguration. He has promised a slew of decisions on the first day of office. While we do not know the extent of his actions, we do know his policy agenda, whether implemented on day one through executive orders or over the course of 2025 through legislative action. We have already seen Trump's social media posts regarding tariffs on China, Canada and Mexico. It is still unknown to what extent deals will be struck with these countries or with the rest of the world. So, uncertainty reigns on this front. How this plays out is likely to be important for the evolution of economies and potentially monetary policy. Fed Chairman Powell alluded to such in his December press conference where he stated that some Federal Open Market Committee members were already incorporating their views on the economic impact of potential Trump policies into their monetary policy outlooks.

What about monetary policy? The outlook for growth and inflation are key. Most developed market central banks began cutting interest rates in 2024, with the Fed and European Central Bank (ECB) each cutting rates 100bp on the back of lower inflation. Moreover, they have signalled further rate cuts in 2025. But a major complicating factor for both the Fed and ECB is that inflation remains above target, improvements have been spotty in the last few months and increased price pressures are likely to be in the pipeline, not least coming from higher tariff threats. Last year, the market proved too dovish about rate cuts. Will 2025 be different? Market and central bank forecasts are much more in line now than they have been in recent years, so that is something. But given the likely recovery in non-U.S. global economic growth and the ongoing resilience of the U.S. economy (led by a vibrant household sector and increasingly confident corporate sector), the outlook for rate cuts is uncertain. Importantly, is monetary policy tight? The performance of equities, house prices and resiliency of growth and inflation would suggest not. Moreover, we know that there will be changes to U.S. trade/fiscal/immigration/regulatory policies in 2025. We just do not know how extensive and how much other countries will retaliate. This further muddies the water when it comes to predicting rate cuts around the world in 2025.

It is distinctly possible that current levels of developed market yields around the world are close to fair value. If the Fed and ECB do not cut rates at least 50 bps more in 2025, it is difficult for bonds to rally. With fiscal policy likely to remain loose around the world and inflation sticky (even if continuing to drift lower), the term premium on bonds could continue to rise. Indeed, one of the major contributing factors to higher bond yields in December was the rise in risk premiums on longer-maturity government bonds. However, risk premiums are still below long-term averages and are still likely to move higher—the timing and extent of which remain distinctly uncertain. It is very possible that U.S. Treasury yields remain in a broad 4%-5% range in 2025, which, if it did happen, would be a big positive after 2024's mediocre performance.

[4] Source: Bloomberg, as of 12/31/2024.

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Other developed country bond markets look better positioned than the U.S. Treasury market, but that is faint praise as many issues facing the U.S. are also present in other countries. Indeed, German and Canadian government bonds have performed very well in 2024 with respect to U.S. Treasurys. We are more optimistic that these markets will likely be better supported in 2025. The U.K. gilt market remains interesting to us, as it appears to have similar growth (low) prospects as the eurozone but with yields and policy rates closer to those in the U.S. This may present an opportunity in 2025. Will 2025 finally be the year for strong bond returns (outside of high yield)?

As a starting point, longer-maturity U.S. Treasury yields are higher now than they were at the beginning of 2024. And, if yields do drift higher, the extra starting yield will offset some of that. We remain hopeful that bonds can beat cash in 2025, but this will require central banks to continue to cut interest rates. This looks likely but, and it is an important but, recent trends in growth and inflation (and Trumpian policy implementation) have increased the probability of rates not being cut in 2025. On the other hand, we believe bond returns are likely to be stronger in absolute terms compared to 2024, at least for investment grade. With the yield on the U.S. high yield index hovering around 7%, the potential to generate 8%-plus returns in 2025 will be challenging, although far from impossible. When all is said and done, we believe being long duration risk in portfolios still does not look overly appealing. While markets are in a better place than in 2024 with regard to expectations on monetary policy and the economy (no recession priced; no material increases in unemployment rates expected; better growth outside of the U.S. beginning; and continued Chinese economic stimulus), upside surprises to growth and inflation are still possible.

Credit markets are likely to continue to perform well. Absolute yields, solid U.S. economic data, strong corporate fundamentals, central bank policy support and expectations of more easing are supportive of the sector. Trump/Republican party policies (deregulation/tax cuts) should be also helpful. However, the longer-term impact of Republican policies is less clear. Greater opportunities and more regulatory leeway typically led to riskier behaviour and greater leverage, which is not usually positive for creditors. With credit spreads on the tighter side (expensive by historical standards but not overvalued), it will be difficult to significantly outperform. We are more confident on absolute performance than relative to other sectors or asset classes. Combining fundamentals/technicals and valuation, a very selective strategy seems appropriate. We remain focused on avoiding companies and industries at risk (either from idiosyncratic underperformance, secular challenges or from increased management aggressiveness) while building as much yield as is reasonable into the portfolio without jeopardizing returns from credit losses or spread widening and without taking undue risks. Given current spread levels, it is challenging to be confident that spreads can tighten meaningfully further from here, although it's not impossible, as fundamentals at both the macro and sector levels remain strong. We still identify better opportunities in U.S. names and European banks in euro-denominated bonds.

At risk of sounding like a broken record, we continue to find the best opportunities in securitized credit, both in agency and non-agency securities. Amid the current noise and uncertainty in the world, we believe this sector can continue to perform well. U.S. households with prime credit ratings maintain strong balance sheets, which should continue to support consumer credit and ancillary structures, especially as housing prices remain firm and the unemployment rate stays low. Changes in U.S. tax policy should also be supportive. In the agency sector, higher coupon securities continue to be attractive compared to investment grade corporates and other agency coupon structures, and we believe they are likely to outperform U.S. Treasury securities. Selective asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) also remain attractive, though it is prudent to be highly selective when investing in commercial office-backed securities.

Emerging market (EM) bonds are likely to remain unloved during the early stages of the Trump-led Republican government. Stronger U.S. growth, combined with higher interest rates for a longer period and weaker global trade linkages, are not typically conducive to strong EM performance. Nevertheless, we believe that countries with solid economic outlooks, decent growth, falling inflation, high real yields and central banks willing and able to cut interest rates—despite policy changes in the U.S.—are likely to perform well. Country and security selection remain critical. We continue to avoid Brazilian bonds as fiscal and monetary risks remain unresolved. Indeed, the Brazilian central bank has been resolutely hawkish in hiking interest rates but to no avail so far. At some point in 2025, we believe Brazilian local bonds are likely to be more attractive. We think some of the higher-yielding countries with weaker trade linkages to the U.S., like Egypt, are likely to perform relatively better.

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In currency markets, the dollar remains firm, and this is unlikely to change near term. While the dollar appears stretched compared to its historical levels, its fundamental support remains robust and most other currencies around the world look significantly more challenged. Easier fiscal policy, tighter monetary policy (relative to prior expectations), trade wars and stronger U.S. growth all bode well for the dollar. However, one caveat to this optimistic narrative could be a deterioration in the U.S. labour market. This would incentivize the Fed to become more aggressive in cutting interest rates given its dual mandate. Otherwise, the U.S. economy continues to excel in terms of growth, productivity, profit results and yield levels. It will be challenging for other countries to generate the kind of fundamental support that the U.S. dollar enjoys, especially with a Republican administration focused on implementing a higher tariff strategy. It seems likely that something needs to go wrong on the U.S. side to cause the dollar to fall. But, with tariffs imminent, this is difficult to see. We believe avoiding underweight U.S. dollar positions versus other developed market currencies makes sense. That said, we also believe more idiosyncratic positions in selective EM currencies do have merit—selectivity being the key word.

Developed Market Rate/Foreign Currency

MONTHLY REVIEW

Developed market (DM) interest rates rose in December, and yield curves continued to steepen, in spite of inflation and labour market data printing largely in line with expectations. The reason for the sell-off was a more hawkish FOMC meeting than the market was expecting, despite delivering on a widely expected 25 bps cut. Official estimates of the rate path and long-run neutral rate were revised significantly higher in the Summary of Economic Projections, and Chairman Powell reinforced the more hawkish message at the press conference. Longer-maturity bonds underperformed short-maturity bonds as term premium also expanded.

In the euro area, economic data showed some signs of stabilisation after the deterioration observed in November. While sentiment in German and French manufacturing continued to worsen, the euro area services PMI returned to expansion territory. The European Central Bank (ECB) reduced its policy rate by a further 25 bps at its December meeting, with communication suggesting a perception of further downside risks to growth.

In foreign exchange markets, the U.S. dollar continued to appreciate against all other G10 currencies in December, as stronger U.S. growth and Fed hawkishness led to a further widening in rate differentials between the U.S. and global peers. The dollar index reached levels not seen since 2022 as markets began to also consider the outlook for global trade under the incoming Trump administration. The Antipodean currencies traded the most poorly, along with the Japanese yen, which weakened due to the Bank of Japan being more dovish than expected at its December meeting.

OUTLOOK

We are neutral on duration in DM markets overall, aside from Japan, and retain curve steepening exposures, particularly in the U.S. Cross-market. We remain underweight U.S. duration vs the U.K. and New Zealand. While Fed expectations and UST valuations seem more reasonable after the recent sell-off, U.S. economic growth remains robust, and inflationary pressures—particularly in services sectors—remain elevated. We remain underweight JGBs, and long Japanese inflation breakevens, given we think Japanese inflation is moving structurally higher and will result in the BoJ raising interest rates higher than the market currently prices. We remain positive on the Australian dollar and U.S. dollar versus the Canadian dollar, and also favour the yen over the euro.

Emerging Market Rate/Foreign Currency

MONTHLY REVIEW

Performance was disappointing for EMD markets as EM currencies broadly sold off and sovereign and corporate credit were negatively impacted by the rise in U.S. Treasury yields for the month. The U.S. Presidential election was top of mind for global investors. Following the Fed's first rate cut of this cycle in September, October was marked with uncertainty in anticipation of the election—U.S. Treasury yields increased and the dollar strengthened. The market responded to the Trump election victory with increased volatility and, although it cut rates at its December meeting, the Fed's less dovish tone coming out of the meeting grabbed investors' attention and rates continued to rise along with the U.S. dollar. In the Middle East, geopolitical uncertainty increased as the Assad regime in Syria fell after four decades of ruling. The fall of the regime was partially a consequence of a weaker Iran. Alliances and centers of power in the region have the potential to shift also due to the ongoing war in the region. South Korea President Yoon Suk Yeol briefly imposed martial law to "protect the country from anti-state forces," and likely as a result of the President's political troubles and lack of influence after the opposition won the general election earlier this year. Yoon and acting President Han Duck-soo were both impeached by Parliament creating political ambiguity, but the Constitutional Court still must determine if impeachment is legal.

Performance for the underlying EMD risk factors was negative. The EM corporate index was down the least as spreads compressed, but the rise in U.S. Treasury yields dominated performance. The USD-denominated EMD sovereign index also saw spreads compress, to a lesser degree than corporates, but U.S. Treasury yields were a similar drag on performance. Finally, the local segment of the asset class suffered most as currencies sold off and local rates rose, albeit less than U.S. Treasury yields. Outflows continued with approximately -$15.8 billion net going out of dedicated-EMD funds globally during the quarter with -$11.6 billion from hard currency funds and -$4.2 billion from local currency funds.

OUTLOOK

The U.S. Fed cut rates at its December meeting which was largely expected. However, the shift in tone and outlook for future cuts in 2025 turned more restrictive than it was just a few months ago. EM central banks will continue to watch the actions of the Fed as they navigate future rate cuts. Real yields differential widened between EM and DM as the number of rate cuts moderated across

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emerging markets, but developed markets continued on their cutting cycle. Emerging markets inflation continued to come down, although at a slower rate, and the market stays cautious in anticipation of global policies that could trigger an uptick in inflation. While U.S. politics are often not directly related to emerging markets, policies can have spillover effects. As the next administration comes into office, foreign policy and trade policy will begin to take shape—we will monitor how this may impact countries at an individual level. Geopolitical tensions increased during the quarter. The fall of the Assad regime along with the conflict that has expanded beyond Israel and Hamas may open the potential for a shift in the centers of influence and shift in alliances in the region. Given the uncertain macro backdrop, we continue to place an emphasis on differentiation amongst countries and credits in order to uncover value.

Corporate Credit

MONTHLY REVIEW

December saw European investment grade credit spreads tighten, driven by strong technicals, while government bond yields moved higher. Both the ECB and the Fed cut interest rates by 25 bps, with the ECB lowering rates to support economic growth, and the Fed signalling a more cautious approach. Separately in France, the government of Michel Barnier fell, with the first successful no-confidence vote since 1962. During what was a quiet month for corporate news flow, rumours of a merger between Honda and Nissan surfaced, leading to substantial tightening in Nissan's credit spreads. Meanwhile, the publication OFWAT's 'Final Determinations' was seen as broadly positive for the struggling UK water sector. Primary issuance was seasonally light and came in the middle of the expected range at EUR 5bn. Inflows into the asset class continued at a strong pace with investors continuing to reach for the "all-in" yield offered by IG credit.

Performance in the U.S. and global high yield markets weakened in December amid modestly wider spreads and sharply higher U.S. Treasury yields. The increase in base rates coupled with wider spreads left the average yield in U.S. high yield at a four-month high at year-end.[5] The lowest quality segments again generally outperformed for the one-month period, while the higher quality, longer duration BB-segment underperformed as U.S. Treasury yields rose. Finally, December was an active month for default and distressed exchange activity in leveraged credit; however, most of the volume was attributable to a single mass media provider.

Global convertible bonds sold off with other risk assets in December. The Federal Reserve's December reduction in short-term rates was fully anticipated; however, commentary regarding a more cautious path forward was viewed as hawkish, which caused U.S. equity markets to sell off and U.S. treasury yields to climb. Ultimately, global convertible bonds outperformed global equities and bonds during the month. New issuance was strong again in December, with the U.S. accounting for a large majority of new paper during the month. The asset class also continued to see crypto-related issuers come to market again during the month. In total, $12.0 billion priced in December, bringing total issuance in 2024 to $119 billion.

OUTLOOK

Looking forward our base case remains constructive for credit supported by expectations of a "soft landing", fiscal policy that remains supportive of growth/employment/consumption, and strong corporate fundamentals. This is additionally supported by a generally low risk corporate strategy. Manageable net issuance coupled with strong demand for the "all-in" yield offered by IG credit is expected to create a supportive technical dynamic. When looking at credit spreads, we view the market as offering some value but see carry as the main driver of return, with additional gains coming from sector and, increasingly, security selection. Given the uncertain medium term fundamental backdrop, we have less confidence in material spread tightening.

We enter 2025 with a relatively balanced view for the high yield market. This outlook includes the expectation for episodic volatility, and the sober realization that, while yields remain historically attractive, on a spread-basis the high yield market is priced nearly to perfection. We come to this conclusion after a thorough analysis of factors including the evolving monetary policy of global central banks, U.S. and global economic growth, consumer health, the fundamentals of high yield issuers, technical conditions, and valuations. Ultimately, we believe that, on average, the yield provides attractive compensation for the underlying credit risk, but reaching for risk in lower-rated credits will be punitively rewarded.

We remain constructive on the global convertible bond market as we enter 2025. Technicals are strong, as convertible bonds have maintained a balanced profile, interest rates remain relatively high, equity valuations increased in 2024, and corporations continue to have financing needs. New convertible bond issuance was strong in 2024 and we expect that to continue as global central banks continue to modestly cut interest rates and

[5] Source: Morgan Stanley Investment Management, ICE Data Indices. Data as of 1/2/2025.

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bonds issued during the Covid-19 pandemic mature. Finally, volatility should pick up in the new year as geopolitical tensions and regional tensions remain present and markets digest the policies of the incoming Trump administration.

Securitized Products

MONTHLY REVIEW

In December, U.S. agency MBS spreads tightened by 3 bps and are now approximately 4 bps wider year-to-date at +135 bps compared to U.S. Treasuries. Given the significant tightening in other credit sectors, agency MBS continues to be one of the few areas in fixed income with attractive valuations. The Fed's MBS holdings shrank by $3.5 billion in December to $2.237 trillion and are now down $459 billion from its peak in 2022. After a prolonged period of monthly increases, U.S. banks' MBS holdings fell slightly by $7 billion to $2.643 trillion in December; bank MBS holdings are still down roughly $329 billion since early 2022. Securitized credit spreads were little changed in December. Securitized issuance remained slow in December, as the holiday season continued, with many issuers opting to enter the market before the election; this supply was well absorbed and met with strong demand. Year-to-date, securitized credit has outperformed most other sectors of comparable credit quality due to its high cash flow carry and lower interest rate duration.

OUTLOOK

We expect U.S. agency MBS spreads to tighten as flows from cash and cash alternatives should move to the attractive return profile of this sector. We also expect securitized credit spreads to tighten in line with agency MBS spreads. Securitized credit sectors were among the best performing sectors in 2024, and we expect this to continue into 2025. We believe that returns will result primarily from cashflow carry in the coming months as we enter the year with higher yields, but will also get an added boost from tighter spreads due to increased demand. We still believe that current rate levels remain stressful for many borrowers and will continue to erode household balance sheets, causing stress for some consumer ABS, particularly involving lower income borrowers. Commercial real estate also remains challenged by current financing rates. Residential mortgage credit opportunities remain our favorite sector and is the one sector where we remain comfortable going down the credit spectrum, as we remain more cautious regarding lower rated ABS and CMBS. We remain positive on Agency MBS valuations as they remain attractive versus investment-grade corporate spreads and versus historical agency MBS spreads.

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Risk Considerations

Diversification neither assures a profit nor guarantees against loss in a declining market.

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g., natural disasters, health crises, terrorism, conflicts, and social unrest) that affect markets, countries, companies, or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g., portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio. **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 a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. 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, and correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **collateralized mortgage obligations (CMOs)**, it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third-party guarantees are insufficient to make payments, the portfolio could sustain a loss.

DEFINITIONS

Basis point (bp): One basis point = 0.01%.

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.

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

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

The **Bloomberg US Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging market debt.

The **Bloomberg US Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

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

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

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

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

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

The **ICE BofAML US High Yield Master II Constrained Index (ICE BofAML US 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.

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

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

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

The **JPMorgan Government Bond Index**—emerging markets **(JPM local EM debt)** tracks local currency bonds issued by emerging

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

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

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

JPY vs. USD—Japanese yen total return versus US dollar.

The **Markit ITraxx Europe Index** comprises 125 equally weighted credit default swaps on investment grade European corporate entities, distributed among 4 sub-indices: Financials (Senior & Subordinated), Non-Financials and HiVol.

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

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

The **MSCI All Country World Index (ACWI, MSCI global equities)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in US dollars and assumes reinvestment of net dividends.

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

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

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

The **Refinitiv Convertible Global Focus USD Hedged Index** is a market weighted index with a minimum size for inclusion of $500 million (US), 200 million (Europe), 22 billion Yen, and $275 million (Other) of Convertible Bonds with an Equity Link.

The **Russell 2000® Index** is an index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

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

S&P CoreLogic Case-Shiller US National Home Price NSA Index seeks to measure the value of residential real estate in 20 major US metropolitan areas: Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Detroit, Las Vegas, Los Angeles, Miami, Minneapolis, New York, Phoenix, Portland, San Diego, San Francisco, Seattle, Tampa and Washington, D.C.

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

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

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

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

The **Thomson Reuters Convertible Global Focus USD Hedged Index** is a market weighted index with a minimum size for inclusion of $500 million (US), 200 million euro (Europe), 22 billion yen, and $275 million (Other) of convertible bonds with an equity link.

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

The **US 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 US trade partners' currencies.

The **Chicago Board Options Exchange (CBOE) Market Volatility (VIX) Index** shows the market's expectation of 30-day volatility.

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