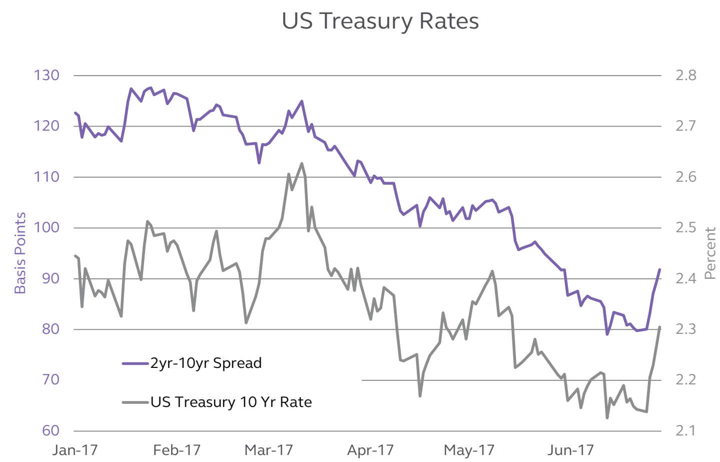
Highlights

The US Treasury market was apathetic during the 2nd quarter. Rates exhibited little direction and volatility trended lower during the quarter as the 10 yr traded within the range of 2.12%-2.41%. Compared to the previous quarter, the yield curve showed a slight flattening shift with 2 yr bonds up 13 bps and the 10 yr down 8 bps. Though changes in the shape of the curve were modest, they were tightly correlated with direction, steepening the term structure when rates rose and flattening as rates fell.

The range-bound activity in Treasury bonds was in reaction to relative weak economic performance and low inflation. The estimate for real GDP growth in the 2nd quarter of 2017 is even weaker than the 1.4% posted in the 1st quarter; though the economy continued to create jobs as evidenced by non-farm payrolls increasing an average of 190K per month over the quarter and the unemployment rate falling to 4.4%. While these levels might appear unsustainable over time to many, including the FOMC, the friction caused by tight labor conditions has yet to manifest itself into wage gains significant enough to create inflation concerns.

The Fed's key inflation measure, core PCE, is well below the 2% target at 1.4%. Seeing weaker economic and inflation numbers as transitory, at its June meeting, the FOMC chose to raise the federal funds rate another 0.25% and outlined a plan for gradual tapering of quantitative easing (QE) measures targeted to begin this year. The Trump administration and the legislature are grappling with healthcare reform legislation, delaying the anticipated reflationary initiatives such as infrastructure spending and tax cuts. This turned out to be a good concoction for bond market participants.



Source: Bloomberg

Outlook

We believe the factors shift in the second half of this year; growth should rebound to around 2.3% applying modest upward pressure on interest rates and core PCE is likely to remain below the Fed's 2% target. Despite benign inflation expectations, we believe these conditions will provide sufficient data for the FOMC to see their way clear to a third rate hike for 2017, likely in December.

Political events will continue to have a significant impact on the bond market. If congress can overcome the health care reform issues to focus on fulfilling pro-growth policy initiatives, we would expect US Treasury yields to move to higher levels.

Mark Kummerer, CFA
Sr. Portfolio Manager

Please see Disclosures for important information.

Highlights

The Bloomberg Barclays Corporate Investment Grade Credit Index posted a total return of 2.54% and an excess return of 1.12% over US Treasury bonds for the 2nd quarter of 2017. Despite headwinds throughout the quarter, including falling oil prices, softer US macroeconomic data, a relatively aggressive Fed, and continued geopolitical risks, investment grade Corporates remained resilient and continued to see performance driven by strong demand technicals. In particular, both domestic and international flows into Corporates continued to be strongly positive and investors need to put cash to work.

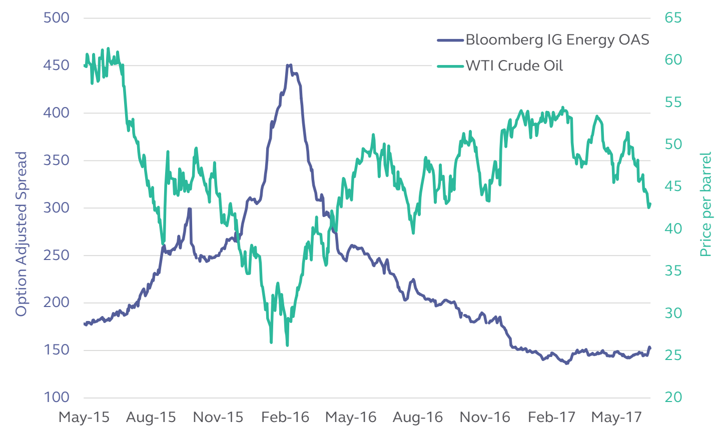
Despite crude oil falling almost 10% throughout the quarter on oversupply concerns, spreads within the Energy subset of the Index ended the quarter flat. Marginal fundamental improvements within the Energy sector since 2016 have indeed been a positive; although strong overall demand for credit has been the main driver of performance. Retail and retail REITs continue to struggle with secular shifts as the consumer changes and industry adapts, while spread volatility for the sector has also been muted (barring such headline names as Kohls and Macys.) These are both examples of how positive technicals and low volatility affected even out-of-favor sectors as investor appetite for increased yield remained strong during the quarter.

After posting an unexpected quarterly record for new issuance, $390B, in the 1st quarter, the trend of robust issuance pricing continued as positive market conditions persisted and 2nd quarter issuance was $328B. Issuers were optimistic as rates stayed low and timing of potential overseas cash repatriation remained unclear. The first half of 2017 saw a 148% increase in floating rate issuance versus the previous year as investor concern over tight monetary policy and expected rate hikes persisted. Flattening of the yield curve during the quarter demonstrated investors' demand for rate protection given current policy. New issue concessions continue to compress, with multiple new deals in the 2nd quarter pricing tighter than their secondary issues.

Outlook

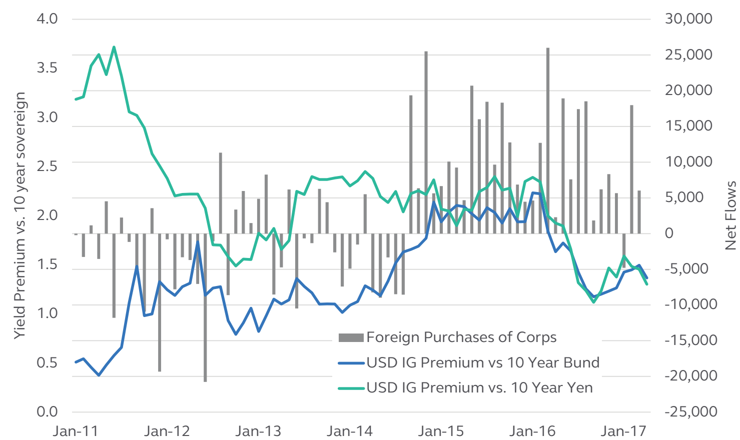
We remain relatively constructive on credit risk as the positive technical backdrop persists; however we are closely monitoring softer economic data as well as central bank policy. With spreads on investment grade bonds nearing historical tights, potential for positive excess returns is becoming more limited. Despite valuations being compressed, we expect continued global demand for US credit given the yield advantage relative to the global low-yield environment. In addition, lack of M&A activity in the pipeline, combined with pre-funding due diligence, lead us to expect issuance to taper off to end the year near the 2016 level, providing a favorable technical backdrop.

Oil Prices vs. Energy Spreads



Source: Bloomberg

Foreign Buyers vs. Cross-Currency Hedge



Source: Bloomberg, US Treasury

Dan Kang, CFA
Head of Credit

Please see Disclosures for important information.

Mortgage-Backed Securities (MBS)

Morley
CAPITAL MANAGEMENT

Highlights

The Bloomberg Barclays US Agency MBS Index posted total and excess returns of 0.87% and -0.04% during the 2nd quarter. 30 yr bonds outperformed 15 yr bonds on a total return basis (0.92% vs 0.62%) as the yield curve flattened, though excess returns between the sectors were comparable. Option-adjusted spreads widened by 5 bps as a result of wider nominal spreads and a decline in implied volatilities to near historic lows.

The prepay environment for MBS investors has been benign as 70% of outstanding MBS lack an economic incentive to refinance and the remaining 30% have a high degree of burnout. The MBA Refinance Index which measures the number of refinance applications submitted, has hovered between 1100-1500 YTD and aggregate prepay speeds have converged around 10%-12% across products.

The FOMC outlined its plan for balance sheet normalization at its June meeting. With the goal of minimizing market disruptions, the Fed set initial MBS runoff caps of $4B/month, rising by $4B at 3 month intervals until reaching $20B/month. MBS investors took the news in stride given the relatively gradual pace of runoff relative to the Fed's current MBS portfolio size of $1.77T.

Assuming an October effective date, the Fed's paydown runoff will result in a relatively modest $12B incremental MBS supply to private investors this year, building to $120B over the first 12 months and $240B per year thereafter. The market's ability to absorb this extra supply will depend on factors impacting long term rates and consequently, MBS supply. These include the scale and pace at which other foreign central banks reduce QE bond purchases, the level at which global yields recalibrate, and changes in relative values across US spread sectors given more competitive yields overseas.

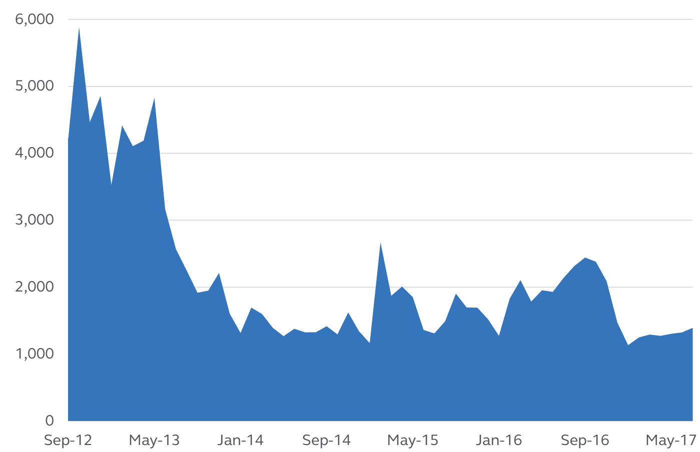
Gross issuance of Agency MBS declined by $23B to $299B in the 2nd quarter, while net issuance plunged by $47B to $52B. The decline in issuance was driven by significantly lower production of MBS with shorter weighted average maturities (WAM), 15yr/20yr/ARM, which tend to be primarily refinancing products. The net outstanding balance of these products declined by a combined $15B during the quarter.

Outlook

While higher rates may dampen MBS origination, regulatory rollbacks could potentially boost supply. On June 12th, the US Treasury released a report with proposed changes to financial regulations including easing mortgage origination, reporting and servicing requirements along with less stringent bank capital requirements. Many of the proposed changes can be done via regulatory rule-making, bypassing the political gridlock delaying other initiatives. To the extent these changes boost housing market activity and purchase originations, 30 yr and Ginnie Mae securities would be most impacted; though these securities would be most affected by the Fed's balance sheet normalization process given the composition of the Fed's MBS holdings.

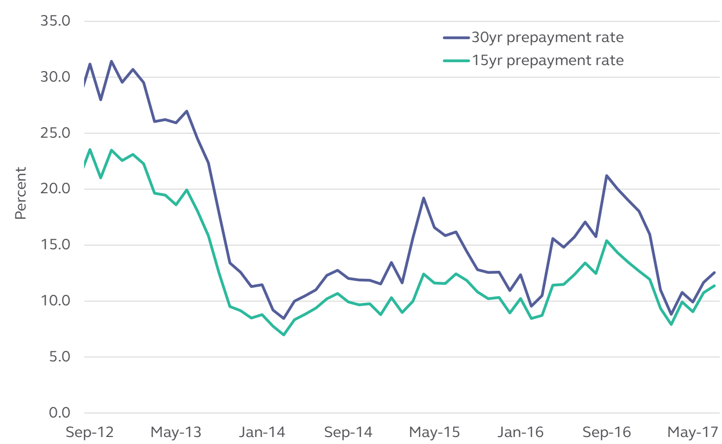
The MBS basis may widen by 10-15 bps over the medium term as supply/demand technicals shift and markets transition through a new era of waning central bank support. We would view this as an opportunity to add incremental exposure, particularly in seasoned/shorter WAM passthroughs and CMOs to the extent that they cheapen along with other MBS sectors bearing more direct policy risk exposures.

MBA Refi Index



Source: Mortgage Bankers Association

Aggregate Prepayment Rates



Source: Mortgage Bankers Association

Perpetua Phillips
Sr. Portfolio Manager

Morley Capital Management

Highlights

The Bloomberg Barclays AAA Asset-Backed Securities Index posted total and excess returns of 0.56% and 0.30%, respectively, for the 2nd quarter. New issuance volume in the 2nd quarter surpassed the 1st quarter by close to 25%, with $68.2B in bonds coming to market. Other ABS volumes increased by 64% and Credit Cards by 40%.

Despite a slight down-tick in new car sales, Auto ABS issuance continues to dominate new issuance, with over 42% of all volume. Overall, new car sales have been running below 17M units on an annualized basis versus 17.6M sold in 2016. Additionally, close to 4M vehicles are coming off-lease this year, pressuring used car prices, and dealer inventories are at high levels.

Total consumer debt outstanding, reaching $12.73T, has surpassed pre-crisis highs; credit card debt, however, is 11% lower than pre-crisis levels. Credit Card ABS has experienced over 103% YOY growth in issuance, mostly due to $60B of paper maturing this year versus approximately $34B last year. As a result of maintaining seasoned accounts, master trust credit metrics continue to be cleaner than sponsors' portfolio metrics.

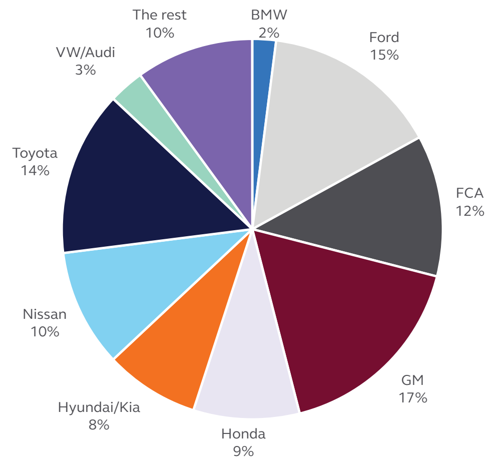
Outlook

Spreads have tightened approximately 10 bps YTD across sub-sectors, excluding Auto Lease paper. Although residual values are a primary concern, Auto Lease ABS benefit from strong structural features, including double-digit credit enhancement. Recent new auto lease deals have offered attractive concessions to prime auto loans, more than off-setting the residual value risk.

Given a strong economic backdrop, the uptick in delinquencies, especially in the auto sector has been of concern. Loosening credit metrics, including lending to deep subprime borrowers, is one explanation for some of the worst performance experienced. However, there may be a broader affordability issue given the high average transaction prices for cars which exceeded $32,000. From 2008-2015, 6.8M rental households were added and 1M owner households were lost, diminishing the impact of home prices appreciating 38% from the lows.

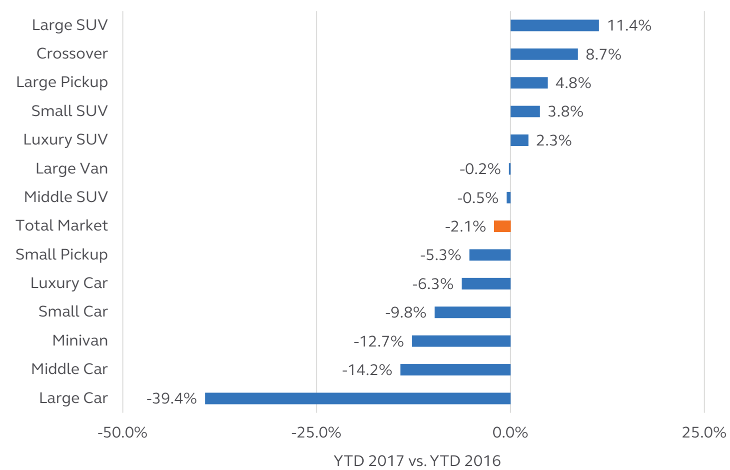
2-year swap rates declined from over 35 bps in the 1st quarter to 24 bps today. The spread compression in both credit spreads and swap spreads have made many on-the-run ABS bonds less attractive than Corporates. 1-month LIBOR continues to rise, 1.22%, providing an attractive absolute yield for some new issue floater bonds. The off-the-run ABS sectors still provide an attractive pickup to Treasury bonds.

2017 Vehicle Sales in US



Source: Consumer ABS Weekly

Auto Sales by Segment



Source: Autodata, Morgan Stanley Research

Rupa Raman, CFA
Head of Structured Credit

Highlights

The Bloomberg Barclays AAA Commercial Mortgage Backed Securities Index posted total and excess returns of 0.92% and 0.32%, respectively, for the 2nd quarter. Total private label issuance reached $36B YTD, higher than the $27B reached in the first half of 2016. Agency CMBS issuance was also higher than 2016 with close to $68B in new issuance for the first half.

As lenders have continued to increase commercial real estate (CRE) exposure, only 11% of all CRE loans have been securitized via the CMBS market. Outstanding loans in the conduit CMBS market are down to $335B, with only $57B in legacy bonds remaining.

Moody's/RCA Commercial Property Price Indices are up 7% YOY, 23% above the pre-crisis peak, and have recovered 159% from peak-to-trough losses. Price appreciation has been much faster and stronger than residential real estate. However, price appreciation has been growing faster in residential real estate than commercial in the last 6 months.

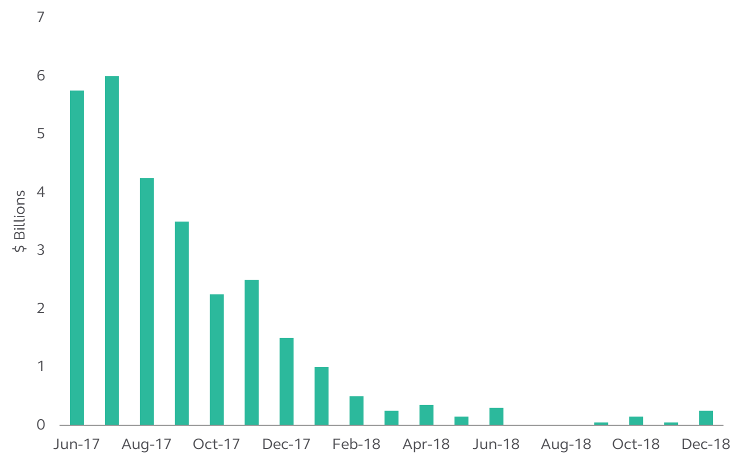
Outlook

Multi-family rent growth has slowed for the past five quarters. The growth rate for the 4th quarter of 2015 was 5.8% and the growth rate for the 1st quarter of 2017 stalled at 3%. With new apartments coming online, the market is starting to see discounted offerings. Given a recovery of 243% from peak-to-trough prices in multi-family, rental growth is essential to maintain valuations.

The supply/demand imbalance continues to keep spread widening contained; however, some new deals have had more difficulty getting executed than others. Consequently, there have been material concessions of close to 10 bps for the A1 notes. Absolute yield buyers continue to buy lower down in the capital structure; though, given the downside of CRE price growth slowing and underlying cash flows getting strained, the front-pay notes offer a more compelling trade.

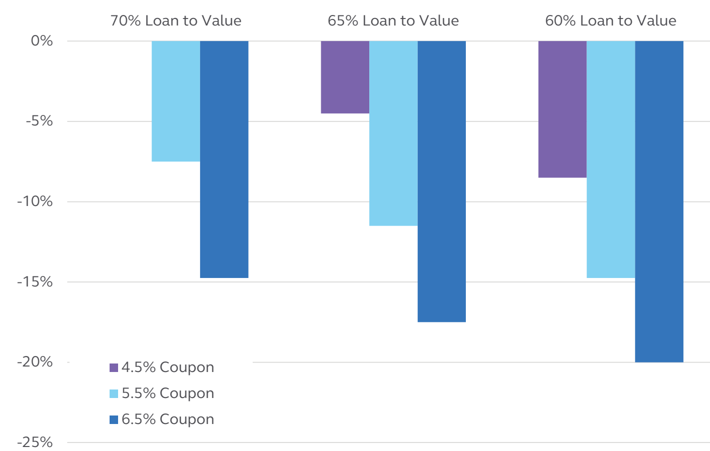
Retail headlines continue to dominate the credit concern in CMBS with new deals having much less retail exposure than prior years. The latter half of 2017 will have a handful of weak malls maturing in CMBS that may find it difficult to refinance. Malls that have liquidated this year have experienced severities in excess of 70% posing extension risk to A2 notes with weak malls as target loans.

Legacy CMBS Maturities



Source: Deutsche Bank, Intex, excludes defeased loans

CRE Transaction Volumes



Source: Morgan Stanley CRE Tracker

Rupa Raman, CFA
Head of Structured Credit

Disclosures

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The Bloomberg Barclays US Corporate Investment Grade Index is a component of the Bloomberg Barclays US Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg Barclays U.S. Aggregate Index.

The Bloomberg Barclays US Agency 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 Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

The Moody's/RCA Commercial Property Price Index (CPPI) measures United States commericial real estate prices.

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