Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Tariffs, Tariffs, Tariffs: Waiting (Anxiously) for Clarity

MACRO INSIGHT | BROAD MARKETS FIXED INCOME TEAM | April 2025

As this is a monthly bulletin, we will reflect on the events of March but also discuss the market movements that transpired in the first few days of April, particularly following President Donald Trump's "Liberation Day."

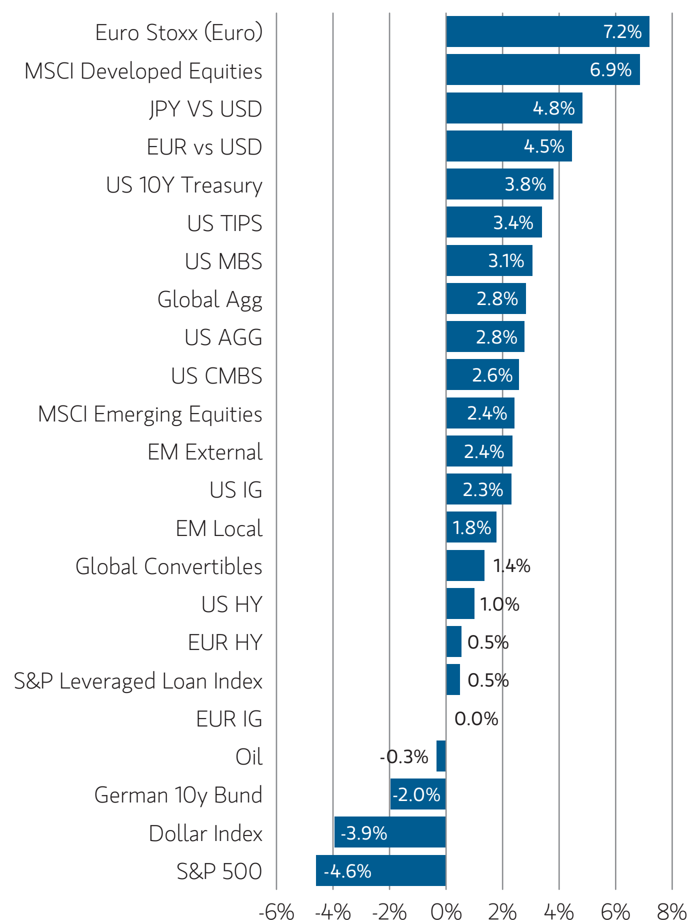
March proved to be a challenging month for fixed-income investors, as global yields increased broadly and risk assets sold off.

Developed market yields climbed worldwide, with the most notable increases occurring in Europe. This surge was driven by Germany's approval of a fiscal reform package that will inject hundreds of millions of Euros into the economy. The 10-year bund yield rose more than 30 basis points (bps) following the announcement. Yields in other regions also rose, with the UK up by 19 bps, Japan by 11 bps, Australia by 9 bps, and New Zealand by 8 bps. Yield curves predominantly bear steepened throughout the month, with the 2s10s spread in the U.S. steepening by 10 bps and the 10s30s spread steepening by 9 bps.

Emerging market (EM) government bond yields were mixed. In Brazil, Mexico, and Thailand, 10-year yields fell by 18, 14, and 10 bps, respectively, while yields in Hungary rose by nearly 60 bps, with increases of 9 bps in Indonesia and 8 bps in South Africa. The U.S. dollar declined by more than 3% against a basket of other currencies, notably falling 4.3% against the Euro, 7.3% against the Swedish Krona, and 7.1% against the Norwegian Krone.[1]

DISPLAY 1

Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of March 31, 2025. 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 8-9 for index definitions.

[1] Source: Bloomberg, as of March 30, 2025.

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Emerging market external spreads widened, with high-yield spreads widening by 36 bps and investment-grade spreads widening by 6 bps. EM corporate spreads also expanded, with spreads in both U.S. and Euro Investment Grade (IG) corporates widening by 7 bps. Meanwhile, U.S. high-yield spreads widened by 67 bps, and Euro high-yield spreads widened by 50 bps. The 30-year U.S. mortgage rate fell by 17 bps to 6.77%. Both agency mortgage spreads and securitized credit spreads also widened over the month.[2]

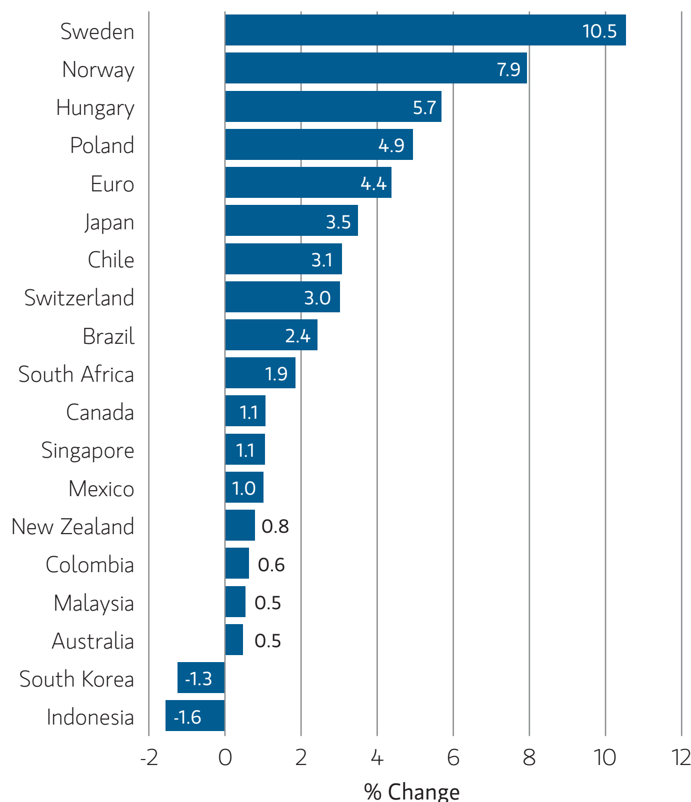
April Overview Market Comments

On April 2, the Trump administration announced a new set of tariff measures, introducing a base global tariff rate of 10%, with higher rates for specific regions: 20% for Europe, 24% for Japan, and an additional 34% for China (bringing the total for this year to 54%). These rates were

DISPLAY 2

Currency Monthly Changes versus USD

(+ = appreciation)



Note: Positive change means appreciation of the currency against the USD.
Source: Bloomberg. Data as March 31, 2025.

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	4.21	0		
United Kingdom	4.68	19	47	20
Germany	2.74	33	-147	33
Japan	1.49	11	-272	11
Australia	4.38	9	18	9
Canada	2.97	7	-124	7
New Zealand	4.49	8	28	8
EUROPE			(SPREAD OVER BUNDS)	
France	3.45	31	72	-2
Greece	3.56	30	82	-3
Italy	3.87	33	113	0
Portugal	3.26	32	52	-1
Spain	3.37	33	63	-1
EM	**10-YR LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			317	18
EM Corporate Spreads			226	15
EM Local Yields	6.28	-3		
			(SPREAD OVER USTS)	
Brazil	15.08	-18	1087	-18
Colombia	12.25	81	805	81
Hungary	7.23	57	302	58
Indonesia	6.99	9	278	9
Malaysia	3.77	-1	-43	-1
Mexico	9.35	-14	514	-13
Peru	6.69	31	248	31
Poland	5.72	-3	151	-3
South Africa	10.61	8	640	8
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			94	7
EUR IG			98	7
U.S. HY			347	67
EUR HY			334	50
SECURITIZED				
Agency MBS			144	12
U.S. BBB CMBS			600	17

Positive Neutral Negative

Source: Bloomberg, JPMorgan. Data as of March 31, 2025.

[2] Source: Bloomberg, as of March 31, 2025.

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determined by each country's bilateral goods trade deficit with the U.S., rather than their current tariff rates on U.S. goods. Estimates suggest that the latest measures raise the effective tariff rate to between 18% and 23%, a significant increase from the 2-3% at the beginning of the year, marking the highest levels since the early 1900s.

U.S. officials have indicated that there may be room for reducing these tariffs if trading partners refrain from retaliation or make concessions in other areas. The White House has stated that "reciprocal tariffs will remain in effect until President Trump determines that the threat posed by the trade deficit and underlying non-reciprocal treatment has been satisfied, resolved, or mitigated." The global response to the latest round of U.S. tariffs will be closely monitored, although it remains unclear how policymakers will react. We anticipate that most countries will either seek to negotiate with the U.S. without retaliation or implement retaliatory measures without initially escalating tensions. However, the timeline for these negotiations remains uncertain.

Domestically, governments may also aim to mitigate the growth impact through fiscal policy. For instance, Spain has already announced a €14.1 billion tariff support plan, and Germany significantly increased its fiscal capacity in March to respond to U.S. policy changes. These tariffs are expected to negatively affect growth both globally and particularly in the U.S., where growth had been exceptionally strong until now. The implicit tax increase in the U.S. is projected to exceed 2.5% of GDP, representing the largest tax increase in decades, even before considering retaliatory actions or any other U.S. policy responses.

This situation is expected to exert upward pressure on inflation in the U.S., while likely serving as a deflationary impulse elsewhere unless significant retaliatory tariffs are enacted, and exchange rates depreciate substantially. For European and other central banks, this combination of factors strengthens the case for further easing. In the U.S., with a mix of weak growth and rising inflation, the Federal Reserve will face a more challenging position, ultimately needing to weigh which shock is more detrimental.

Fixed Income Outlook

Reversing the adage, this March came in like a lamb and went out like a lion for financial markets. Any discussion of the outlook for economies, monetary and fiscal policies, and interest rates must now incorporate the epochal "Liberation Day," the Trump administration's tariff announcement day on April 2. As widely covered in the media, the magnitude was much worse than expected, as President Trump increased prospective tariffs to rates that could surpass those last seen in the early 1900s. Even fairly hawkish analysts expected average U.S. tariff rates to increase to only 11% (up from 2024's 2%-3% level). Taking Trump's numbers at face value, the U.S. average tariff rate will rise to the mid-20% level, and could go higher if retaliation becomes widespread. China, as anticipated, has already retaliated, raising tariffs 34% on all U.S. imports and restricting exports of rare earth metals. Of course, the less bearish interpretation is that these measures are a gambit by the U.S. administration to negotiate tariffs down in return for easier access for U.S. goods and/or other favors.

The tariffs as currently envisioned by the U.S. administration will likely be a significant blow to U.S. and global growth as well as seriously inflationary, at least for the U.S., potentially generating a stagflationary outcome. In response, a range of policy actions—including monetary and fiscal policy easing, retaliatory trade actions, negotiating down tariffs, and appeasement—are likely to follow. Unfortunately, regardless of policy response, given the level of deterioration in both risk sentiment and confidence in U.S. policymaking, a 2025 global recession appears much more probable.

To avert such a negative 2025 outcome, policies need to change quickly. This may be possible in Europe and Japan, and to a lesser extent in Asia, where fiscal policy can be eased aggressively—but not so much in the U.S. At current tariff levels, duties collected would be over 3% of gross domestic product (GDP).[3] The previous highest tariff revenue collected was 0.5% of GDP in the mid-1930s.[4] Why is it so much higher now? Globalization. Global trade is much bigger now than in the 1930s, and imports are a much larger percentage of the economy. Indeed, U.S. imports top $3 trillion per year.[5] As a reminder, tariffs are a tax on U.S. consumers and corporations, and this would represent the largest tax increase since the 1960s. We believe the implications of this fiscal contraction are ominous and would result in a draconian tightening of fiscal policy. Estimates suggest a GDP reduction of 1%-2% of GDP, which would take the economic growth rate to zero or below.[6] The disposition of U.S. tariff revenue,

[3] Source: Minack Advisors April 3, 2025.

[4] Source: Minack Advisors April 3, 2025.

[5] Source: Deutsche Bank Research April 2025.

[6] Source: Deutsche Bank Research April 2025.

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ignoring the inflationary implications, will be critical to the U.S. economic outlook. Unfortunately, changes in fiscal policy are at the mercy of the U.S. Congress, which is stuck in a budget resolution process that will likely take until the end of summer to resolve. If tariff revenue was recycled back to the household and corporate sectors, the negative macroeconomic effects could be somewhat mitigated and reduce the probability of recession.

What about monetary policy? The inflation implications of the stated tariff structure are anticipated to put upward pressure on prices and complicate the Federal Reserve's (Fed) job. Estimates for core consumer price index (CPI) run from 3.5% to 5% for 2025 and, as Chairman Jerome Powell said on April 4, the Fed needs to make sure the seemingly one-off price hikes do not feed permanently into inflation, reducing the Fed's ability to ease policy at least in the short term. Moreover, Institute for Supply Management (ISM) business surveys already show signs of incipient inflationary pressures at the corporate level with falling orders—evidence of stagflation already building. So, while it is reasonable to expect the Fed to cut interest rates if the economy weakens substantially, a more modest weakening will likely not catalyze a rate move in our view. We expect the Fed to sit on the sidelines until more is known, which is unlikely before June at the earliest. Any rate cuts are likely to occur in the second half of the year.

This stagflationary dynamic looks worse in the U.S. than the rest of the world. The economic growth hit is global, but the inflationary impact is predominantly in the U.S. While U.S. growth could possibly be negative in the first and second quarters, inflation will likely be rising significantly. One indirect positive recent development is that energy prices have fallen substantially, which benefits U.S. consumers (and companies) by cushioning some of the inflationary shock of tariffs.

The rest of the world will also experience a growth shock. But the EU, Japan and China are large economies with fiscal space to respond to economic weakness by deploying aggressive fiscal easing, especially in the EU, in the months ahead. And, even if easing is not deployed immediately, expectations of a policy shift are likely to bolster confidence at both the household and corporate levels, supporting growth.

The bottom line is that we believe recession risk has risen everywhere. The good news is that global economic fundamentals were solid coming into this year. This should help cushion the shock. Indeed, the U.S. may avoid a recession, but danger signs abound. Retaliation poses a downside risk, as do further big drops in business sentiment and concomitant deterioration in labor markets. In addition to solid fundamentals, policy easing, potentially aggressively, in much of the world could also provide an offset. Unfortunately, the U.S., the epicenter of the shock, is in the least favorable position to handle the shock given the logjams on fiscal policy and the Fed frozen (at least for now) by the potential rise in inflation.

Government bond yields have been well supported. U.S. Treasury bonds resumed their bull market, while the bear market that emerged in European bonds in March has flipped to a bull market. Yields have fallen meaningfully in the space of a few weeks. How much further they fall will depend on incoming news on tariffs, non-tariff policy responses and the performance of equities. So far, government bonds have rallied as equities have fallen (performing their diversifying function). For many U.S. equity sectors, the drop from peak to current levels has been substantial, suggesting the end might be near if the bad news ends. This would also suggest the 3.75% level in the 10-year U.S. Treasury yield, near the 2024 low, will likely be hard to break unless we get more bad news (such as U.S. fiscal policy tightening, tariff escalation). We are modestly overweight interest rate risk and modestly overweight credit exposure, but keeping risk exposures low by historical standards.

Credit spreads, already beginning to widen in March, have followed equities' lead and are now underperforming at an accelerated pace. While continued pressure is likely given the tariff news, credit fundamentals were quite strong coming into the event, even if valuations were on the high side. While economies are slowing, the absence of private sector imbalances have made them well placed to absorb some of the shock. For example, the share of BBB- issuers in investment grade credit indexes is at a historical low.[7] All-in yields on U.S. investment grade corporate bonds are still around 5%-5.5%, an attractive nominal and real yield as long as inflation returns, even if slowly, back to recent levels. Lastly, corporate behavior tends to become more conservative during tumultuous periods, which usually benefits creditors. This suggests that spreads may not widen to the wides we have seen in previous recessionary periods. At some point, with some differentiation among sectors, we expect corporate bonds to be a more attractive buy. Euro investment grade exposure is preferred at the margin,

[7] Source: JPMorgan Research, as of March 31, 2025.

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given the EU's greater flexibility on monetary and fiscal policy to respond to the tariff shock. The high yield market is more vulnerable, but we also do not anticipate a widening to usual recessionary levels. And, there is always the chance that, per most investors' expectations, the current proposed tariff rates will be negotiated down over the next few months. Nonetheless, damage has been done already and the outlook is less positive than before given the tremendous uncertainty created by the U.S. administration's economic agenda.

Securitized credit and U.S. agency mortgage-backed securities (MBS) have been less ruffled by recent volatility than other sectors and remain our favorite overweight. However, the recent outperformance of this sector compared to corporate credit has marginally reduced its relative value. That said, securitized credit does not face the same issues as the U.S. corporate sector during this period of heightened economic uncertainty. Amid the current noise and uncertainty in the world, we believe this sector can continue to perform well.

In currency markets, also somewhat paradoxically, the U.S. dollar weakened in response to Trump's tariff unveiling. The U.S. implementation of tariffs was supposed to be dollar-positive, as it would encourage other countries to let their currencies depreciate to offset their effects. The opposite seems to be happening. Countries like China are digging in their heels and have resisted currency depreciation, looking for fiscal policy to offset tariff effects, while Europe, contrary to the naysayers, has now announced plans for historically unprecedented fiscal expansion. These policy mixes have, at least for now, undermined the dollar, as U.S. policy seems to be going in the other direction, that is, tighter fiscal policy and easier monetary policy. How long this is likely to last is unknown and depends on policy implementation around the world. Certainly, we have become less convinced about the direction of currencies and prefer to sit on the sidelines during this transitional period.

Developed Market Rate/Foreign Currency

MONTHLY REVIEW

After initially rising, developed market interest rates declined in March due to weakness in risky asset markets as tariff concerns increased. Economic data—particularly soft data—showed a weakening in sentiment amongst both consumers and firms, alongside higher inflation expectations, especially in the U.S. At the March FOMC meeting the Fed lowered its projections for growth and raised those for inflation, but also stressed that economic uncertainty has increased due to policy unknowns. Hard data, including the payrolls report for February and retail sales were less downbeat. However, markets remained focused on the downside risks to growth posed by policy uncertainty, a fall in public sector employment, and deteriorating confidence.

In the Eurozone, the CDU/CSU and SPD parties shocked markets by agreeing to a far larger-than-expected EUR 1,000bn infrastructure and defence bill, and then successfully pushing the bill through the German parliament and amending the debt brake (which limits the government's ability to run fiscal deficits). This caused 10y German Bund yields to rise around 30 bps on the day announced, the largest one day move in more than two decades. However, European risky assets outperformed the U.S. considerably, reflecting increased optimism about the boost to growth from the fiscal expansion. The Bund market did rebound, as global growth and risk concerns supported government bond markets, but lagged the rally in U.S. Treasurys in spite of the inflation outlook in the Eurozone being more benign than the U.S. In Japan, yields rose for most of the month as data continued to point to stronger inflation dynamics and resilient growth, but pulled back into month-end as global growth and trade concerns increased.

In foreign exchange markets, the U.S. Dollar continued to weaken due to narrowing interest rate differentials and subdued U.S. equity market performance. The best-performing developed market currencies were the Norwegian and Swedish Krones, which benefited from the improvement in risk sentiment in Europe.

OUTLOOK

We are overweight duration in DM markets, aside from Japan, and retain curve steepening exposures in U.S. Treasuries and Bunds. Short maturity bonds have more potential to rally if the growth outlook deteriorates, as central banks could cut more aggressively if growth slows, helping to steepen the curve. Cross-market, we remain overweight duration in New Zealand and the UK versus the U.S. and Australia, as we think central banks in the former group have more room to cut rates than currently priced. In Japan, we recently increased the size of our underweight in duration given positive wage and price developments and remain long inflation breakevens. We continue to favour the Australian and U.S. dollars versus Canadian, and also maintain a positive view on the yen against various currencies including the Korean won and U.S. dollar.

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Emerging Market Rate/Foreign Currency

MONTHLY REVIEW

Emerging markets debt (EMD) performance was mixed for the month of March. EM currencies generally rallied as the USD dollar, while still strong in absolute terms, weakened for most of the period. Continuing themes from February, U.S. foreign policy was volatile and consumer confidence remained uncertain. Sovereign credit spreads widened but despite the fall in U.S. Treasury rates, the sovereign credit segment of the asset class had negative performance. Ecuador sovereign credit sold off following an unexpectedly close first round Presidential election. Corporate credit spreads also widened but were muted compared to sovereign credit and the fall in U.S. Treasury rates boosted performance. Following an initial postponement of 25% tariffs on products from Mexico and Canada, tariffs went into effect, but then were postponed once again. In Turkey, President Erdogan arrested the mayor of Istanbul, his main opposition, which raised concern regarding the future of orthodox monetary policy. The lira sharply sold off before the central bank steeped in and intervened. Flows for the asset class turned negative for both hard and local currency funds.

OUTLOOK

Emerging markets debt remains an attractive asset class especially when focusing on country fundamentals and countries with idiosyncratic risk. Concerns about U.S. foreign policy and tariff uncertainty remain causing volatility in global markets. We continue to monitor the potential impacts that tariffs might have at the individual country level and focus on individual countries' policy reactions. A number of developed markets and emerging markets central banks cut rates during the month—opportunity remains in the local rates segments of the market. Finding investment opportunities in countries that are more removed or less sensitive to broader global volatility can provide diversification and additional value.

Corporate Credit

MONTHLY REVIEW

In March, European and U.S. investment grade spreads widened by 7 bps as the market grappled with tariff and trade war uncertainty following new European fiscal announcements. Chancellor Friedrich Merz's spending measures, including a €500bn infrastructure fund, marked a significant departure from Germany's fiscal conservatism, while the European Commission announced an additional €800bn for defence. Tariff uncertainty persisted, with 25% tariffs on aluminium and steel, and threats of 200% tariffs on European wines and spirits. Central banks were also in focus, with the ECB cutting rates by 25 bps and President Christine Lagarde adopting a cautious tone. The Bank of England held rates unchanged with a hawkish vote split, and the FOMC meeting highlighted uncertainty with mixed economic projections. Economic data showed mixed results, with German ZEW (economic indicator index) expectations surging, PMI data being mixed, and U.S. survey data indicating stagflationary concerns. Inflation trends were notable, as European headline HICP decreased and U.S. Core CPI was softer than expected. Corporate earnings met expectations, with strong margins and stable leverage. Finally, technical factors remained supportive, though inflows slowed, and primary issuance was at the lower end of expectations.

Performance in the U.S. and global high yield markets turned negative in March amid high volatility, wider spreads and a further decline in U.S. Treasury yields. The Fed's March decision to hold its key policy rate steady was virtually a non-event and the projection of two rate cuts later this year was quickly overshadowed by growing expectations for a greater number of reductions as concern mounted over an expanded scope of tariffs and the potentially dire near-term economic consequences. Amid the volatility, the high yield market remained orderly and relatively well bid, with healthy March issuance volume that was generally well received by a receptive investor base. The lower-rated segment of the high yield market broadly underperformed on an absolute and relative basis, with the average spread differential between the single-B and CCC segments ending the quarter at nearly 550 bps, relative to a January-end level of just over 400 bps.[8]

Global convertible bonds generated negative returns along with other risk assets in March. Challenging performance in the asset class was primarily driven by performance of the U.S. portion, which was most negatively impacted by concerns around tariffs and their potential consequences. Ultimately, global convertible bonds largely outperformed global equities while underperforming global bonds. New issuance continued its momentum from February with March seeing the largest amount of issuance since May 2024. While volume in the primary market was primarily driven by U.S. issuers, both Europe and Asia ex-Japan had healthy monthly issuance as well. In total, $13.3 billion priced during the month bringing the year-to-date total issuance to $22.8 billion.[9]

[8] Source: MSIM, Bloomberg, as of April 1, 2025.

[9] Source: Bank of America, April 1, 2025.

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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, supported by corporate strategy that is low risk. 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 continue to be cautious on the high yield market as we begin the second quarter. This outlook includes the dynamic and uncertain evolution of trade, immigration and tax policy, the expectation for stickier inflation, slowing economic growth with an increased probability of recession, and elevated volatility. Yields remain historically attractive and the average spread in the high yield market, while more than 95 bps above post-Global Financial Crisis lows reached in January, remains susceptible to further widening. 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 caution is warranted and expect more comprehensive price realization, particularly in the lower-rated and more challenged segments of leveraged credit.

We continue to remain constructive on the global convertible bond market as we begin the second quarter. Convertible bonds maintained their balanced profile and generated positive total returns during what was a volatile first quarter. Given its bond floor feature, we believe the asset class will remain an attractive place to allocate capital in what we believe will be a volatile environment going forward. Finally, we believe primary issuance will pick up despite a disappointing first quarter. Corporations will need to continue balancing their financing needs with relatively high interest rates as well as the evolving monetary policies from global central banks.

Securitized Products

MONTHLY REVIEW

Current coupon Agency MBS spreads widened materially in March in sympathy with other fixed income markets; spreads widened 12 bps in March to 144 bps above U.S. Treasuries. Agency MBS spreads remain wide, both relative to other core fixed income sectors and from a historical perspective. The Fed's MBS holdings shrank by $14.0 billion in March to $2.18 trillion and are now down $514.7 billion from its peak in 2022. U.S. Banks holdings rose slightly in March to $2.67 trillion; bank MBS holdings are still down $334 billion since early 2022.[10] After several months of spreads grinding tighter, securitized credit spreads widened in sympathy with agency MBS and with the broader market turmoil in March. March continued the previous two months' pattern of heavy issuance; this supply was well absorbed, but spreads were often wider than IPT due to market volatility and general wider spreads.

OUTLOOK

We expect U.S. Agency MBS spreads to tighten as we expect inflows from relative value investors and banks due to the attractive return profile of this sector versus other core fixed income sectors. We expect securitized credit spreads to widen slightly from current levels should Agency MBS spreads remain at these levels as they are still trading relatively tight to Agency MBS spreads. We believe that returns will result primarily from cashflow carry in the coming months as we enter April with attractive yields. 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 asset-backed securities (ABS), particularly involving lower income borrowers. Commercial real estate also remains challenged by current financing rates. Residential mortgage credit opportunities remain our favorite sector currently 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 continue to remain attractive versus investment-grade corporate spreads and versus historical Agency MBS spreads.

[10] Source: Bloomberg, as of March 31, 2025.

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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.

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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 **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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