Global Fixed Income Weekly

Executive Summary

- The outcome of the G20 meeting between US President Donald Trump and Chinese President Xi Jinping was perceived favorably by markets. There was no de-escalation or substantive progress on key negotiation items including dispute resolution, but both sides agreed to postpone the imposition of additional tariffs during negotiations.

- European risk assets and rates were buoyed by expectations for prolonged monetary policy accommodation following IMF Director Christine Lagarde’s nomination for the European Central Bank (ECB) presidency. In Germany, the 10-year sovereign bond yield is close to -40bps, in line with the regions policy rate, while Italy’s equivalent maturity sovereign bond yield dropped below that of the US for the first time since February.

- We remain overweight spread sectors including corporate and securitized credit given ongoing growth and accommodative central bank policy, and we think recent Agency mortgage backed security (MBS) underperformance presents an opening to add tactical overweight exposure.

Macro Commentary and Strategy

Duration: We are underweight UK rates. We are also modestly underweight US rates.

- The US economy added 224,000 jobs in June, far exceeding consensus expectations for a 160,000 rise. The unemployment rate rose by 10bps to 3.7%, though this is partly attributable to an equivalent magnitude rise in the labor force participation rate. Average hourly earnings increased 3.14% year-over-year and 0.2% on the month.

- Elsewhere on the data front, the ISM manufacturing and non-manufacturing indexes decreased -0.4 and -1.8 points, respectively, to 51.7 and 55.1 in June. The composition of the manufacturing report was somewhat firmer than the headline reading, with an increase in the production and employment subcomponents. On the non-manufacturing side, business activity, new orders and employment components moderated but levels remain firm, suggesting healthy service-sector growth.

- We remain underweight UK rates as we think market-implied pricing for the Bank of England (BoE) policy is overly dovish and at odds with macro indicators including low unemployment, firming wages and around-trend growth. In a speech this week, BoE Governor Mark Carney expressed “greater confidence” in first quarter activity softness being driven by “weather, not the economic climate”. He also acknowledged “mixed” international data and trade uncertainty but considered the impact on the UK economy “to be modest”.

Chart of the Week: The US has spent a declining amount of time in recession

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Chart of the Week: The US has spent a declining amount of time in recession
Country: We are overweight rates in Australia and New Zealand versus other developed market (DM).

- European Union leaders nominated IMF Director Christine Lagarde to succeed outgoing ECB President Mario Draghi when his term ends this October. The nomination suggests policy continuity in the Euro area, given Lagarde’s support for unconventional easing to address persistently low inflation in the region. She is also an advocate for structural reform and has called for further fiscal and financial integration.

- We used the resultant rally in European rates as an opportunity to scale back overweight relative value exposures. Elsewhere, we remain overweight rates in Australia versus other DMs including the UK and Norway.

Currency: We are overweight the euro and US dollar, while overweight select emerging market (EM) currencies.

- We recently scaled back our overweight position in the Norwegian krona following appreciation in response to tighter monetary policy. Elsewhere, we remain underweight the US dollar versus other DM currencies and versus select EM currencies.

Cross Macro: We hold relative value positions across rates, currencies and credit.

- We are overweight European credit versus rates in France and Spain (versus Germany). We expect performance in both European rate markets to mean revert following recent outperformance relative to European credit. In addition, we think political uncertainty may weigh on Spanish rates in the near-term, while we are cautious around France’s fiscal outlook.

Sovereign 10-Year Yield Levels

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<table>
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<tr>
<th>Country</th>
<th>Range (Last 12 Months)</th>
<th>Current</th>
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<tbody>
<tr>
<td>US</td>
<td>1.97</td>
<td>1.97</td>
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<tr>
<td>Italy</td>
<td>1.70</td>
<td>1.70</td>
</tr>
<tr>
<td>Canada</td>
<td>1.50</td>
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<tr>
<td>UK</td>
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<tr>
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<td>France</td>
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<td>0.30</td>
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<td>-0.16</td>
<td>-0.16</td>
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<tr>
<td>Netherlands</td>
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<tr>
<td>Germany</td>
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<td>-0.39</td>
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<tr>
<td>Switzerland</td>
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Source: Bloomberg, GSAM. As of July 5, 2019.

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Investment Commentary
July 5, 2019

Sector Commentary and Strategy

Agency MBS: We are tactically overweight.

- Agency MBS spreads have widened in 2019 in response to challenging supply-demand dynamics, given the US Federal Reserve’s (Fed) balance sheet runoff. More recently, the sector has underperformed on rising refinance concerns. We think the sector screens cheap relative to our assessment of associated refinancing risks and we have added tactical overweight exposure.

Non-Agency MBS/ABS: We are overweight.

- The US housing sector appears to be stabilizing following late-2018 weakness. Existing and new home sales growth remains negative but the monthly pace of declines has moderated. Homebuilder sentiment and housing affordability has improved, while mortgage delinquency rates continue to trend downwards.

Investment Grade Corporates: We are overweight.

- While we are mindful of a deterioration in credit quality within the US investment grade corporate credit market, we think the BBB-rated portion of the sector offers attractive carry and roll opportunities. Moreover, we have observed a bifurcation of capital management behaviors between issuers at the opposite ends of the credit spectrum.

- Higher quality (AA- or A-rated) borrowers have been more willing to use cash for equity-friendly activities such as share buybacks and dividend payments, as well as mergers and acquisitions activity. In contrast, BBB-rated issuers have engaged in credit-friendly actions such as proactive debt reduction.

High Yield & Bank Loans: We are overweight.

- US high yield has benefited from supportive supply-demand dynamics in recent months. Year-to-date new issuance is almost flat. Moreover, as most primary market activity is dominated by refinancing activity, net new supply may turn negative in the coming quarters. Investor demand for the asset class has increased in response to expectations for Fed policy easing which is expected to elongate the US expansion (see “Chart of the Week”).

Emerging Markets: We are neutral to slightly overweight external emerging market debt (EMD) in multi-sector fixed income portfolios and see value in both external and corporate debt in dedicated EMD portfolios. Across local currency debt, we continue to identify idiosyncratic opportunities.

- Easier global financial conditions (largely due to lower US rates) alongside reduced political uncertainty has recently alleviated downward pressure on Turkish assets, though medium- to long-term concerns around its macroeconomic outlook remain unchanged.

Sector Spreads

![Investment Grade Spreads Chart]

![High Yield and Emerging Market Spreads Chart]

Source: Bloomberg, Barclays, J.P. Morgan, as of July 5, 2019.

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