

The Credit Report

Fixed Income Strategy

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INVESTMENT THESIS

Investment Grade

Maturity Range: Focus on 3 years to 7 years, but as 10-year Treasury yields approach 3% look at 10+ year corporates.

Duration: 4.2 years

Ratings: We like a down-in-quality trade, focusing on BBB-rated issuers. Food & Beverage, Base Metal Miners, Energy and Financial fixed-to-float preferreds stand out.

High Yield

Maturity Range: 2 years to 7 years. As 10-year Treasury yields approach 3% look at 7+ year high yield issues.

Duration: 2.7 years

Ratings: Focus on BBs and upper-tier Bs and leveraged loans

Preferreds

We like issues that are fixed-to-float. Focus on deals that have higher fixed coupons with back-end floating rates in the 300-400bp range.

Emerging Markets

Focus on US dollar over local currency; within Latin America we believe Mexico, Peru, and Colombia stand out from their regional peers on a macro fundamental basis, and with Eastern Europe we would focus on Hungary and Romania.

Winter Is Coming, but We Might as Well Enjoy Summer While it's Here

- A weak first quarter, the ongoing conflict in Eastern Ukraine, the Israeli offensive in Gaza, the commercial paper default by Espirito Santo International and a slightly less dovish Fed have all recently led to varying degrees of weakness in risk assets. Is there more to this recent weakness than profit taking?
- We believe the answer is no. The geopolitical issues are unlikely to affect growth or earnings, US economic growth should rebound in 2Q from the dismal 1Q reading and corporate fundamentals remain relatively strong.
- Investment grade (IG) credit has been remarkably stable over the last month and we expect this range-bound pattern will persist, barring a sudden rise in interest rates. However, at current spread levels investors have little cushion to offset the negative effect of rising rates, which will eat into total returns.
- The sell-off in high yield (HY) has been painful, but it is important to put it in context. We have seen six periods where spreads have widened since May of last year; this one is the second biggest in spread terms and the third biggest in dollar price, and although it may not be done yet it is also the third longest.
- However, with the dollar price heading toward a 103 handle, and spreads on the index back above 400bp, valuations are slightly more attractive and we believe investors will start looking to put money back to work in HY over the coming weeks.

Please note that *The Credit Report* is being retired. This will be the last edition of this report.

Winter Is Coming, but We Might as Well Enjoy Summer While it's Here

By Jonathan Mackay, Managing Director
Morgan Stanley Wealth Management

In the HBO series *Game of Thrones*, one of the characters, Ned Stark, frequently reminds his family and friends of his family mantra; “winter is coming.” The Starks live in the north of the country and the words are meant to remind them to prepare for harder times ahead. This cautious but ultimately pessimistic way of thinking seems to be commonplace among investors and in news headlines these days. As my colleague Dan Skelly often says, “this is one of the most unloved rallies in the equity market we have ever seen.”

The pessimism isn't coming out of nowhere; the scars from the Great Recession are fading but still relatively fresh, the Euro Zone is only just emerging from their sovereign debt crisis and a broad swath of emerging market economies are slowing. With a backdrop like that it's no wonder investors are susceptible to negative headlines. A weak first quarter, the ongoing conflict in Eastern Ukraine, the Israeli offensive in Gaza, the commercial paper default by Espirito Santo International and a slightly less dovish Fed have all recently led to varying degrees of weakness in risk assets. Is there more to this recent weakness than profit taking?

Maybe I've spent too much time in the sun this summer, or the summer shandies have warped my senses, but to me it feels like winter is a long way off. The conflicts in Eastern Europe and the Middle East are concerning from a human perspective, but it appears unlikely either will materially affect US growth or corporate earnings. Speaking of growth, Morgan Stanley & Co.'s (MS & Co.) US Economics team is currently tracking second quarter GDP at 3.3%. The first estimate comes out on 7/30 and consensus is currently tracking at 2.9%; the possibility of an upside surprise exists. Last, corporate fundamentals remain fairly strong with earnings growing, net leverage below trend, the cost of debt is near all time-lows, and companies aren't being overly aggressive with capital spending.

All this leads us to the view that a major sell-off in credit is currently unlikely and this recent correction is more likely repositioning, and profit taking will be fairly shallow and short-lived.

Investment Grade Credit

Investment grade credit has benefited from both the “up-in-quality” trade over the past month and the rally in long-end rates. The spread on the Citi BIG Corporate Index is only wider by 1bp since the beginning of July and is only 3bp off the post-crisis low of 96bp hit earlier this month. The Treasury yield curve bull

flattened (long rates rallied more than short rates), which added to the total return of IG credit given its long duration profile. IG credit has been remarkably stable since the middle of March, trading within a very tight 10bp range (see Fig 1). We expect this range-bound pattern will persist, barring a sudden rise in interest rates.

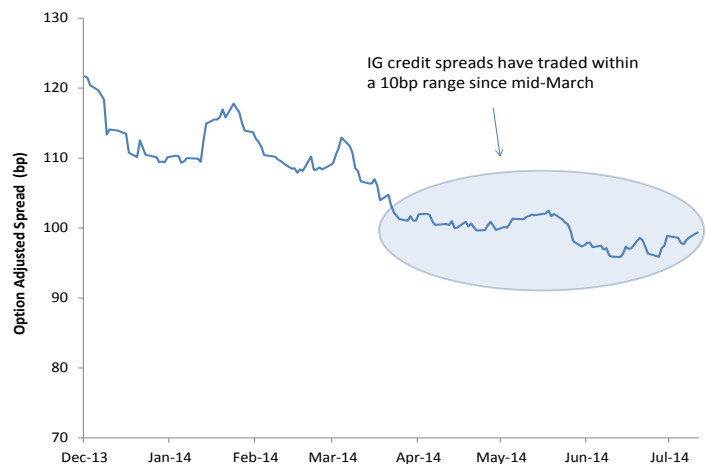
As we discussed earlier, we believe this rally in rates may be short-lived and thus we expect the 10-year Treasury to gradually move back up toward 2.60%/2.80% over the coming months. At current spread levels, investors have little cushion to offset the negative effect of rising rates, which will eat into total returns.

So how do you play IG at the current stage of this cycle? We believe picking the right maturities and sectors that might benefit from rising rates and inflation will be key ingredients to investors outperforming the broader market over the next 6-12 months.

We continue to see value in the 3-7 year maturity bucket, as it has a shorter-duration profile than the overall market and will likely be less sensitive to investor flows versus very short maturities. We also believe investors should be looking to add duration as rates rise toward 3% on the 10-year, based on our view that the yield curve will “bear flatten” (short rates rising further than long rates) as we move toward the first Fed rate hikes.

From a sector perspective, inflation can eat into corporate margins unless companies can feed rising input costs through to their end markets. Food & Beverage, Base Metal Mining companies and Energy companies all generally fit into this category. Financials may also benefit from rising rates as higher yields expand their net interest margins. Within Financials we continue to prefer moving down the capital structure into fixed-to-float preferreds versus buying senior bonds.

Fig 1. Relative Stability in Investment Grade Credit Spreads



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Consider

- Financials – Fixed-to-Float Preferreds
- Food & Beverage
- Energy
- Base Metals Mining

High Yield Credit

It has been a volatile month for HY investors. The Citi High Yield Market Index hit a post-crisis low in spread terms of 361bp on June 23; it also hit an all-time low yield of 4.90%. However, the good times could not be sustained. Spreads have widened 46bp and the yield on the index is higher by more than 0.5%. From a total return perspective, the index has lost 0.80% in that period and is now trailing IG credit in year-to-date return by more than 115bp.

The sell-off has been painful, but in our opinion it is more likely investors have been taking profits and perhaps setting money aside for new issues once the blackout period around earnings season ends. Another factor that probably didn't help was the market has been trading at a dollar price above the average call price of the market, which can limit price upside. The price of the index is now trading right in-line with the average call price at 104. Finally, the length and depth of this sell-off is not that severe relative to other periods of weakness since last summer (see Fig 2). We have seen 6 periods where spreads have widened since May of last year; this one is the second biggest in spread terms and the third biggest in dollar price, and although it may not be done yet it also the third longest. However, with the dollar price heading toward a 103 handle and spreads on the index back above 400bp, valuations appear slightly more attractive and we believe investors will start looking to put money back to work in HY over the coming weeks.

The late innings of the credit cycle are essentially clipping-your-coupon innings. Price upside is limited for the broader market, but can be found in individual issues and investors are getting a higher income stream than IG can offer. However, it should be noted that when the cycle turns it can happen very quickly, as it did in late '01 and late '07. Based on this, we continue to favor BB and single-B rated HY issues over CCCs.

Fig 2. Comparing HY Spread Widening Episodes

Widen	Dates	Duration (Days)	Spread (bp)			Price (\$)		
			Start	End	Change	Start	End	Change
1	5/9/13-6/25/13	34	433	543	110	107.72	100.93	6.79
2	7/23/13-8/27/13	26	463	492	29	104.25	101.81	2.44
3	9/19/13-9/30/13	8	463	492	29	102.85	102.10	0.75
4	1/22/14-2/4/14	10	401	446	45	104.30	103.37	0.93
5	3/5/14-3/14/14	8	398	419	21	105.03	104.42	0.61
6	6/23/14-current	21	361	407	46	105.69	104.24	1.46

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Consider

- Leveraged Loans
- Base Metal Miners
- Energy
- Food & Beverage

Emerging Markets

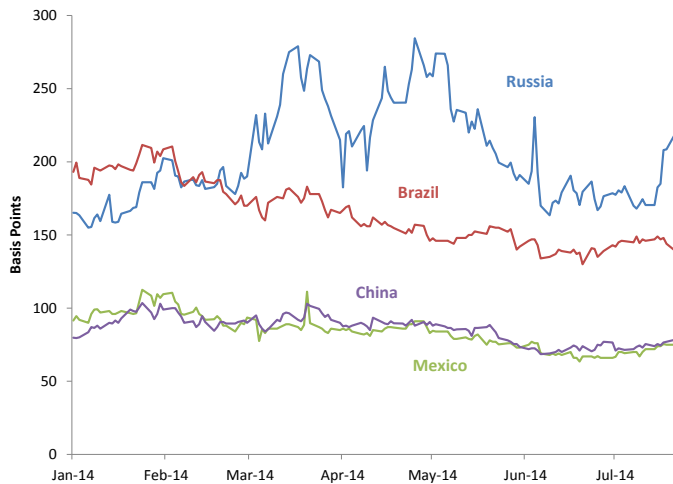
There have been two big stories in EM credit over the past two months—one is obviously the situation in Ukraine/Russia—but the other is the remarkable resilience of EM spreads. Outside of widening in Russia, other major EM countries have either rallied or traded sideways (see Fig 3). This could just be money moving out of Russia and into other credits, but it also goes to show how the benign backdrop of lower rates in the US and lower market volatility has allowed EM credits to continue rallying despite weaker growth and in some countries higher inflation.

For Russia, sanctions will reduce access to external funding markets, putting downward pressure on the RUB and upward pressure on rates, and the increased uncertainty could hit consumption and investment, creating downside risks to growth. It is very difficult to determine how Russia will respond to the sanctions, and the outcome seems somewhat binary. If they comply with G7 requests, most notably aiding a ceasefire in eastern Ukraine and sealing the border, sanctions may be removed or eased and growth may improve. In the event of continued non-compliance with the demand that Russia stops destabilizing Ukraine, further sanctions may be enacted on other energy or

finance companies, further damaging confidence and growth. We do not expect a sustained spillover into broader EM for now. Investors are likely to move their funds away from Russia and into other regions (i.e., Latin America).

Outside of geopolitical tensions, the benign rate backdrop in the US is unlikely to last for long and as such, the vulnerabilities remain high for EM economies. Broadly for EM debt, we see more downside potential than upside over the next 6-12 months and believe investors should approach the asset class looking for idiosyncratic opportunities in individual countries and credits within those countries. We also continue to favor US dollar-based EM investing over local currency investing.

Fig 3. Select Sovereign Credit Default Swaps 5-Year USD



Source: Bloomberg. Data as of 7/22/14.

Consider

- We remain overweight Mexico, Peru and Columbia in LatAm, and favor Hungary and Romania in the CEE region.

The Economy & Interest Rates

By Kevin Flanagan, Managing Director
Morgan Stanley Wealth Management

If I Should Fall Behind

What a difference a few months make. Following Fed Chair Yellen's first presser at the March FOMC meeting (considerable period = 6 months), the money and bond markets began to discount the potential for the first rate hike coming sooner than expected, perhaps spring of 2015. Since then, the collective market has let the 'Fed lift-off' date drift back with a June/September 2015 timetable representing more of a consensus. For the record, we are in the 2H15 camp. Taking it one step

further, in a recent survey, MS & Co.'s economics team noted that "more than 1 in 4 see rate hikes coming after 2015." In our travels throughout the country thus far in 2014, the notion the Fed could wait that long and potentially fall behind the curve receives scant attention. Against that backdrop, we thought it was worth exploring.

Clearly, the US economy has dug an even deeper hole than the one we wrote about in our May Basis Points, *Fixing a Hole*. In their final revision, the BEA reported that Q1 real GDP sunk -2.9%, the weakest showing in five years. Weather has been the much ballyhooed culprit for that result, but obviously there was more at work, specifically, the volatile inventories and net exports components. Large swings in these two components appear to be behind the +3.4% pace of growth for 2H13 which, in and of itself, was too strong a number. Thus, some payback was warranted. While MS & Co.'s Q2 real GDP tracking estimate looks for a solid +3.3% rebound, growth for the entire year probably won't be much better than last year's +1.9%.

That's not to say there haven't been positive surprises—there have, namely labor market activity. Total nonfarm payrolls rose by +288,000 in June, pushing the monthly average thus far this year up to +231,000, a visible uptick from the 2013 tally of +194,000. The unemployment rate has now dropped -0.6pp this year down to 6.1%, the lowest reading since July 2008. The one notable outlier, though, is the seemingly non-existent momentum for wages, as the year/year increase remains mired around the +2.0% threshold (more on that in a moment).

Another surprising story to some degree has been the pickup in broader inflation measures. While we do not envision an 'inflation bogeyman' here in the US, the discussion no longer includes the mention of deflation and/or disinflation. To provide some perspective, the year/year rate for overall CPI has risen from +1.1% to 2.1% just within the last three months. For those who wish to exclude Food & Energy, the increase for the same time period goes from +1.6% to +2.0%. For the record, the Fed's preferred measure, the core PCE deflator, has moved up +0.4pp to +1.5%.

This upward trajectory seems to be the path of least resistance at this stage and begs the question, what if the annual rate eclipses the Fed's comfort zone or threshold of somewhere between +2.0% to +2.5%? The answer could very well lie in the trend for wages. We believe the Yellen-led Fed will place more of a priority on improving wages at the expense of broader inflation. In fact, at the June FOMC presser, Ms. Yellen referred to the aforementioned run-up as "noise."

Market Data as of 7/22/2014

<p>Investment Grade Spreads by Rating (Option Adjusted Spread)</p> <p>Source: Morgan Stanley Wealth Management Fixed Income Strategy; Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved.</p>	<p>High Yield Spreads by Rating (Spread to Worst)</p> <p>Source: Morgan Stanley Wealth Management Fixed Income Strategy; Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved.</p>															
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<p>Investment Grade Yield by Maturity (YTW)</p> <p>Source: Morgan Stanley Wealth Management Fixed Income Strategy; Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved.</p>	<p>Average Monthly Credit Issuance 2012-2014</p> <p>Source: Morgan Stanley Wealth Management Fixed Income Strategy and Bloomberg.</p>															
<p>Source: Morgan Stanley Wealth Management Fixed Income Strategy; Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved.</p>	<p>Source: Morgan Stanley Wealth Management Fixed Income Strategy and Bloomberg.</p>															
<p>Moody's Rating Trend</p> <p>Source: Morgan Stanley Wealth Management Fixed Income Strategy and Bloomberg.</p>	<p>Total Returns for Investment Grade and High Yield</p> <table border="1"> <thead> <tr> <th>Year</th> <th>Citi BIG US Corporate Index</th> <th>Citi High Yield Market Index</th> </tr> </thead> <tbody> <tr> <td>2011</td> <td>8.26%</td> <td>5.52%</td> </tr> <tr> <td>2012</td> <td>9.97%</td> <td>15.17%</td> </tr> <tr> <td>2013</td> <td>-1.52%</td> <td>7.22%</td> </tr> <tr> <td>YTD</td> <td>5.84%</td> <td>4.69%</td> </tr> </tbody> </table> <p>Source: Morgan Stanley Wealth Management Fixed Income Strategy; Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved.</p>	Year	Citi BIG US Corporate Index	Citi High Yield Market Index	2011	8.26%	5.52%	2012	9.97%	15.17%	2013	-1.52%	7.22%	YTD	5.84%	4.69%
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Fixed Income Risk Considerations

Floating-rate Securities - The initial interest rate on a floating-rate security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk.

Call Risk - Some securities may be callable. If the security is called, the investor bears the risk of reinvesting the proceeds at a lower rate of return.

Credit Risk - The risk that the issuer might be unable to pay interest and/or principal on a timely basis. Widely recognized rating agencies, such as Moody's Investor Services and Standard & Poor's, offer their assessment of an issuer's creditworthiness. U.S. Treasury securities are considered the "safest" investment as they are backed by the "full faith and credit" of the U.S. Government. On the other end of the scale, high yield corporate bonds are considered to have the greatest credit risk.

Duration Risk - Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

Interest Rate Risk - The risk that the market value of securities might rise or fall, primarily due to changes in prevailing interest rates. All fixed income securities are susceptible to fluctuations in interest rates; generally, if interest rates rise, bond prices will fall, and vice versa.

Prepayment Risk - In a CMO or MBS, the risk that an investor's principal will be returned sooner than originally expected, due to principal prepayments made by homeowners on the underlying mortgage loans.

Reinvestment Risk - The risk that the income stream from the investment may be reinvested at a lower interest rate. This risk is especially evident during periods of falling interest rates where coupon payments are reinvested at a lower rate than the current instrument.

Secondary Market Risk - While a secondary market exists for most fixed income securities, there is no guarantee that a secondary market will exist for a particular fixed income security. Furthermore, if a security is sold prior to maturity, the price received may be more or less than face value, or the amount of the original investment.

Index data is based on index total return - Fixed income securities, including municipal bonds, are subject to certain risks including interest rate risk, credit risk, reinvestment and valuation risks. The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Information provided herein has been obtained from outside sources that are deemed to be reliable. However, Morgan Stanley Wealth Management has not independently verified them and we make no guarantees, express or implied, as to their accuracy or completeness or as to whether they are current. Past performance is not a guarantee of future performance. The indices are unmanaged and are shown for illustrative purposes only and do not represent the performance of any specific investment. Investors cannot invest directly in an index.

Index Definitions

The Citi US BIG Corporate Index is designed to track the performance of US dollar denominated US and non-US corporate bonds. It excludes US government guaranteed and non-US sovereign and provincial securities. Bonds must have a fixed coupon, a minimum of one year to maturity and be rated a minimum of BBB-/Baa3 by both S&P and Moody's.

The Citi Emerging Market Sovereign Bond Index designed to track the performance of US dollar denominated Emerging Market sovereign and quasi-sovereign bonds. Bonds must have a fixed coupon, and a minimum of one year to maturity.

The Citi High Yield Market Index is designed to capture the performance of below investment grade debt issued by corporates domiciled in the United States or Canada. Bonds must have a fixed coupon, a minimum of one year to maturity and be rated a maximum of BB+/Ba1 by both S&P and Moody's.

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