Morgan Stanley

INVESTMENT MANAGEMENT

Allocating Fixed Income Assets Through the Great Unknown

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Our planet is facing a health crisis on a scale that we have not witnessed for close to a century. What began as an epidemic in part of China has expanded to a global pandemic. As a fuller appreciation of the severity of the crisis reached Western Europe and the United States, markets reacted severely. In short order, the pandemic and resultant quarantine led to a run on our financial systems as investors simultaneously tried to de-risk portfolios and move to cash. The outcome has been volatility and illiquidity not seen since 2008, if not the Great Depression.

If there is a silver lining to this crisis, it is that it is occurring only a dozen years beyond 2008. Many of the monetary and fiscal responses that were developed in response to the Global Financial Crisis (GFC) are well known to policymakers. Central banks responded to the 2020 crisis with breathtaking speed and magnitude. Fiscal policy has followed not far behind, with a fiscal package larger (as a percentage of GDP) than 2008 and perhaps as large as or larger than the Great Depression.

While winter turns to spring in the northern hemisphere, not all is spring-like yet. Challenges remain in parts of the money markets. The length of the virus-required quarantine, and resultant declines in economic activity are still unknown. The impact on the profitability of companies and industries as well as the support they will receive is also unknown.

Identifying Opportunities

It is against this uncertain backdrop that we invest today. Once we have the benefit of time and history, we will be able to look back on the crisis of 2020. What will we see? Our best thinking and how we are positioning portfolios follows:

Short to Medium Term Opportunity: Invest Alongside Central Banks

The Federal Reserve has launched an alphabet of programs supporting a range of financial assets in the fixed income markets. In general, history tells us that we want to buy what the Fed (and other central banks) are buying.

Exhibit 1: The Fed to the Rescue

The Fed Can Buy:	The Fed Cannot (Yet) Buy:
• Treasuries • Agency RMBS / CMBS • Money Market Securities (CP, CDs) • ABS: New Issue AAA, backed by eligible collateral • Secondary market CMBS • Investment-grade Corporates: 5 years and shorter, plus ETFs • Fallen angels • HY ETFs • Leveraged Loans / CLOs	• Non-agency MBS • Secondary market ABS • ABS rated below AAA • New issue CMBS • Equities • Non-US Governments / EMD

Source: Federal Reserve, Barclays, and Morgan Stanley Investment Management, as of April 13, 2020. This information may change without notice as circumstances or market conditions change.

The investment grade corporate bond market was one of the areas hardest hit by the deleveraging that occurred. High quality bond prices, measured by indexes and ETFs, declined by approximately 20%, resulting in yield spreads increasing by nearly 300 basis points (bps). The magnitude of the price decline was very similar to what we witnessed in late 2008 after the failure of Lehman Brothers.

The IG corporate market is one area we are focused on adding to in portfolios. The Fed is supporting this market by purchasing corporate bonds of U.S. issuers in the primary and secondary market. This is new ground for the Fed. Furthermore, the Fed will also purchase exchange-traded funds (ETF) that investment in the IG corporate market. We have purchased IG corporate ETFs for the first time and see this as a means of gaining access to the U.S. corporate market with the liquidity provided by ETFs.

We also have been active in participating in IG corporate new issues. While many parts of the fixed income market were still frozen, the IG new issue market re-opened to the largest U.S. banks and high quality non-financial issuers. We have purchased a number of such new issues, favoring sectors including banks, cable and telecom, technology and selected food and general merchandise retailers.

The IG corporate market will have its share of challenges. Many industries will be effectively shuttered for a lengthy period with little revenue and potentially large losses. Most will receive governmental support, however of currently unknown size and type. In addition, the rating agencies are likely to downgrade many companies across a swathe of industries. Currently we are much more cautious on a range of industries including gaming, lodging and leisure, autos, airlines, retail, restaurants, basic industries and many parts of the energy sector.

While we are constructive on investment grade corporate bonds, we are less sanguine on high yield corporate bonds broadly. Certainly, high yield valuations changed dramatically over March with spreads exceeding 1,000 bps. Historically, when yield spreads reached these levels, the high yield market had positive returns in the year ahead. However, this time may be different. The sudden stop of economic activity will hit companies with highly leveraged balance sheets hard. Also, the high yield market has a fair concentration of companies in the industries facing the biggest challenges. Expectations for defaults in the high yield market have risen to 12% and may rise further.[1] Additionally we have concerns whether fears of moral hazard may limit the support received by high yield companies owned by private equity. In spite of this, the Fed's announcement that they will be investing in High Yield ETFs will be supportive to the high yield market.

We are very selective in adding high yield exposure and are focusing on the bonds the Fed is likely to buy – fallen angels. Unlike in investment grade, where we have been willing to buy broad exposure, in high yield we believe that such a strategy will be less successful. Instead, we intend to add exposure to some of the large fallen angels that have and will likely be downgraded from investment grade. We also anticipate adding to relatively strong BB credits (some of which previously were on their way to investment grade), especially those in industries less impacted by the current economic environment.

Exhibit 2: U.S. Credit Spreads Look Attractive

5yr Spread Implied Cumulative Default Rates, based on recovery assumptions

			Implied 5yr Cumulative Default Rate			Actual Average 5yr Cumulative Default Rates	
		5yr Spread	0% Recovery	20% Recovery	40% Recovery	Worst	Average
USD	IG ALL	218	10.3%	12.8%	16.6%	2.4%	0.9%
	AA	128	6.2%	7.7%	10.1%	0.5%	0.2%
	A	180	8.6%	10.7%	14.0%	1.3%	0.4%
	BBB	264	12.4%	15.2%	19.7%	4.2%	1.6%
	HY ALL	880	35.6%	42.3%	52.0%	30.9%	17.0%
	BB	654	27.9%	33.6%	42.0%	17.3%	8.0%
	B	856	34.8%	41.4%	51.0%	38.4%	19.2%
	CCC	1704	57.3%	65.5%	75.8%	72.5%	51.1%

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
Source: Morgan Stanley Investment Management, S&P, Moody's, Bloomberg, data as of March 31, 2020. Implied 5-Year rate is a forward-looking measure of expected defaults; actual default rate is for the 5-year period ending March 31, 2020.

[1] Source: MSIM Global Fixed Income Team as of 3/31/2020.

Medium Term Opportunity: High Quality Securitized Credit

The securitized credit market has been our favored sector in recent years. These securities are backed by cash flows, often from consumers, and are generally secured by assets. The thesis for owning securitized credit was premised on the strength of the U.S. consumer, including income, employment, savings rate and reduced indebtedness. The economic crisis resulting from this virus risks undermining many of those building blocks. Furthermore, deleveraging in this market impacted prices dramatically as margin calls and liquidations have been overwhelming at times. Thankfully, we believe that much of that activity is behind us. Indeed, we now see new capital entering the market to take advantage of the dislocations.

Our focus is on bonds backed by hard assets, such as residential mortgages. Many of the fiscal programs that were established support homeowners, including support for payroll/income as well as latitude to defer mortgage payments. While we have meaningful concerns over parts of the commercial mortgage backed securities market, we see value in selected securities backed by high quality office buildings. Our return to work may be a new normal, but we expect that Class A offices in the central business districts in major cities will retain their value.

The securitized credit market also permits investors the ability to invest across the ratings spectrum as well as across subsectors of the market. In general we favor adding to more highly rated securitized investments. We are generally financing such purchases by reductions in agency mortgage-backed securities. While agency MBS are being purchased by the Fed, we believe their attractiveness was somewhat fleeting. The return of liquidity to the agency MBS market led prices improving meaningfully. While agency MBS (especially mortgage pools) look attractive on an absolute basis, we find less value relative to high quality corporate bonds and securitized credit.

Idiosyncratic Opportunity: Loans and Convertible Bonds

The other part of the broader leveraged finance market where we expect to find opportunities is in leveraged loans. Leveraged loans have been impacted in a similar manner to high yield corporate bonds. However, even in a world of reduced covenants, having some covenant protection and being senior and/or secured should be helpful to return potential and to recoveries in the event of default.

In the convertible market, opportunities exist as many converts are now priced at deep price discounts and therefore offer the potential for both yield and a valuable option for credit holders on the equity market. The average convertible bonds currently trades at a discount to the sum of its parts, with many names more severely dislocated.[2] The convertible market has a relatively high weight to the tech sector which has sold off as investors raced to cash but has the highest growth rate among sectors and we believe has a lower risk going forward to overhang from the virus.

Not (Yet) an Opportunity: Emerging Market Debt

The situation in emerging markets today is more balanced. We have to be mindful that some emerging markets countries do not have the healthcare or social services infrastructure that exists in many developed markets countries. In some cases, the ability of fiscal and monetary policy to respond in EM countries may also be limited. While the Fed has instituted swap lines with a number of DM central banks, it has been reluctant to implement the same arrangements with EM central banks.

The market is aware of these challenges. Yields on virtually all emerging markets debt has increased dramatically. We do expect there to be opportunities in emerging markets debt. We favor USD-denominated bonds from Mexico, Brazil and Indonesia, among others. We also continue to be constructive on local currency bonds in those countries, albeit hedged to USD. We expect that the central banks in those countries will continue to behave like their DM-brethren and reduce interest rates. That will likely be beneficial to the return on their local-currency bonds. It may, however, continue to pressure their currencies, as FX becomes the method of equilibrium across markets. For now, we have eliminated virtually all EM currency exposure across multi-sector fixed income portfolios.

We do expect to find opportunities in EM corporates. Many of the corporations in emerging markets countries are government related, which lends additional credit support. Furthermore, many companies are in essential industries, like utilities that are part of the infrastructure of those countries. Finally, there is a large EM corporate market in China. While China was impacted first by the virus, it is now recovering. We anticipate finding opportunities to add EM corporate exposure of Chinese companies.

We Believe Dynamic Allocation Among Fixed Income Sectors Will Prove Paramount as the Crisis Evolves

In summary, we see a historic crisis met with an epic response. An uncertain future has increased volatility and yields on many credit sensitive fixed income securities. We do not expect the recovery to be quick and anticipate the risk of further declines in the most risky assets. That means focusing our portfolios on higher quality bonds across sectors, including selected government bonds, investment grade corporates, fallen angels and securitized assets. We ultimately

[2] Sources: MSIM Global Fixed Income Team, Thompson Reuters Convertible Global Focus Index, as of 3/31/2020

expect there to be a recovery in the most credit risky sectors, such as high yield corporate bonds, leveraged loans, convertible bonds and emerging market debt. However, the recovery in such sectors may be bumpier. For now, we will maintain modest exposures to such areas and rely on strong security selection to identify what we believe are the winners.

RISK CONSIDERATIONS

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 this portfolio. Please be aware that this portfolio may be subject to certain additional risks. **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. **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. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Distressed and defaulted securities** are speculative and involve substantial risks in addition to the risks of investing in junk bonds. The Portfolio will generally not receive interest payments on the distressed securities and the principal may also be at risk. These securities may present a substantial risk of default or may be in default at the time of investment, requiring the portfolio to incur additional costs. **Preferred securities** are subject to interest rate risk and generally decreases in value if interest rates rise and increase in value if interest rates fall. **Mezzanine investments** are subordinated debt securities, thus they carry the risk that the issuer will not be able to meet its obligations and they may lose value. **Foreign securities** are subject to currency, political, economic and market risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. In general, **equity securities**' values also fluctuate in response to activities specific to a company. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk).

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