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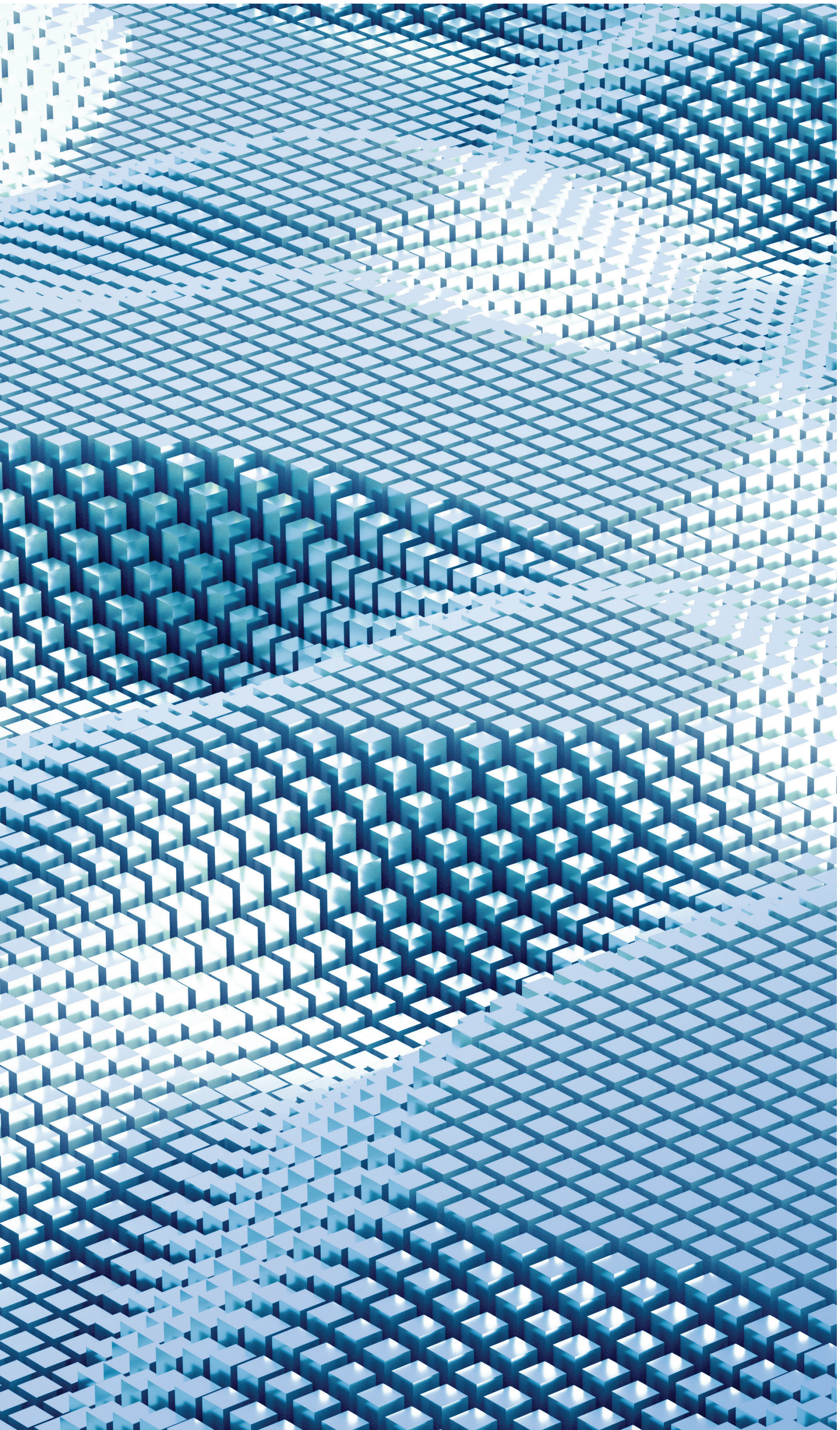

2021 Market Outlook

2021 Credit Outlook: Buy the vaccine reflation, sell expectations of a policy reversal

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"Buy the rumour, sell the fact" has passed into investing folklore to reflect the concept that markets do not price current conditions, but are efficient at pricing in expectations. As 2020 ended, the real economy weakened as we navigated a second lockdown in many developed markets. However, markets are ignoring current conditions and rallying based on expectations for 2021. Vaccine hopes plus easy monetary policy and additional fiscal stimulus are all ingredients for the expected "turbocharged" reflation over the coming months, supporting tighter credit spreads in the first quarter. Later in 2021, we expect markets to focus on what economic conditions will look like following the rebound and whether the value offered is reasonable. Questions over the sustainability of easy policy, political risk, corporate strategy, environmental and other regulatory changes, and unknown unknowns have the potential to "overshoot" to the upside in the first half of 2021 and disappoint in the second half of the year.

We expect the global economy is primed for a strong 2021, with Central Banks happy to run easy policy even when inflation starts to rise, politicians committed to growth policies (austerity was not deemed a success in most cases) and corporates focused on investment to take advantage of the fiscal drive and low cost of debt. In contrast, markets are expected to price out the "overshoot," believing markets need to price a "fair" risk premium for the multiple uncertainties they face. We do not expect a significant backup in spreads, merely a correction with spreads closing 2021 not dissimilar to the level they started the year.

2020 Valuations level set expectations for 2021

While investment grade credit spreads finished 2020 broadly unchanged, giving investors a small excess return inline with consensus expectations at the start of the year, the path has been contrary to expectations. The year can be summarized as one of surprises, the largest of which was not necessarily the pandemic, but rather the speed of the recovery.

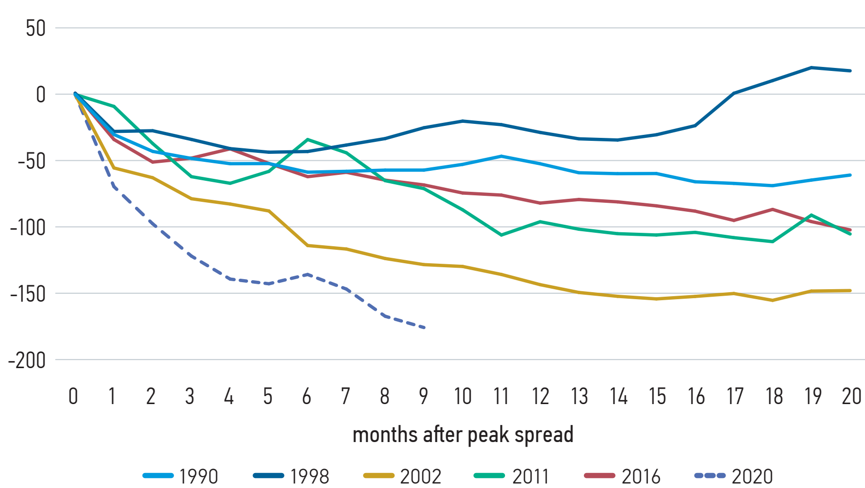
Historically, a business downturn is followed by phases of repair and recovery, before the business cycle reverts to expansion and credit spreads rebound to pre-recessionary levels over many months. The rally in credit spreads since April 2020 surprised market participants, but in hindsight can be explained by three factors:

1. The belief that coronavirus is a transitory natural disaster and not the result of excesses in the financial system;
2. That public sector support is both strong and has the capacity to be extended as necessary; and
3. That heavy investor demand for risk assets, whether responding to the value opportunity or simply the fear of missing out, drove credit markets higher.

DISPLAY 1

An unprecedented recovery in U.S. Investment Grade

Spread change following peak recession or stress event, excluding 2008
Monthly Data as of October 30, 2020



Represents components of the **Bloomberg Barclays U.S. Corporate Index**. The indices are for illustrative purposes only. **Past performance is no guarantee of future results.** See Disclosure page for index definition.

Source: Bloomberg, MSIM, November 2020

Comparing current valuations to history

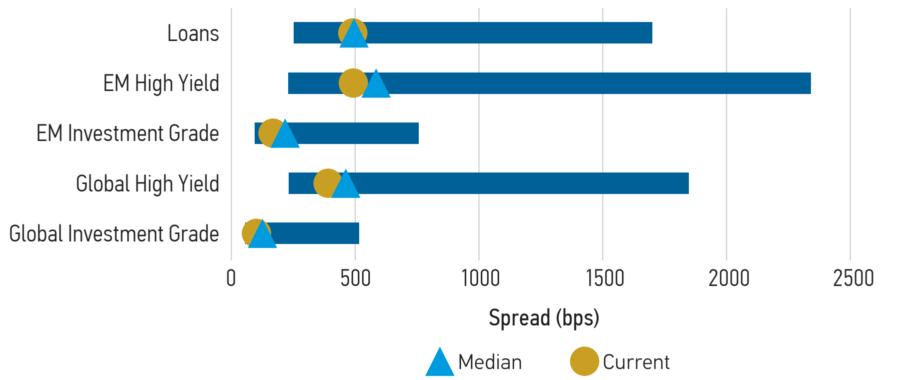
Level setting valuations relative to history is a useful barometer to anchor the investment debate. To quote another old adage, "there are no good or bad investments, but good or bad valuations" should be ignored at one's peril. Changes in the index composition and any paradigm shift in the investment backdrop are also important when comparing levels.

The investment grade index has seen both an increasing weight to BBB issuers and an extending maturity in recent years, increasing the risk profile of the index. Given the higher maturities and lower credit ratings prevailing in the US investment grade market compared with 2010, it could be argued that today's spreads are more expensive than at first glance.

Considering valuations more broadly, while developed market investment grade spreads have rebounded to levels close to the start of the year, high yield and emerging market corporates remain wider. The widening in all markets reflects the COVID-sensitive sectors and issuers that have understandably yet to rally fully, ensuring the credit market starts 2021 more bifurcated than normal.

DISPLAY 2

Current valuations to history (2001 to 2020)



Loans: **Credit Suisse Leveraged Loan Index.** EM High Yield: **J.P. Morgan CEMBI Broad Diversified High Yield Index.** EM Investment Grade: **J.P. Morgan CEMBI Broad Diversified Investment Grade Index.** Global High Yield: **Bloomberg Barclays Global High Yield Corporate Index.** Global Investment Grade: **Bloomberg Barclays Global Aggregate Corporate Index.** The indices are for illustrative purposes only. **Past performance is no guarantee of future results.** See Disclosure page for index definitions.

Source: Current spread levels as of December 23, 2020.

First Half 2021: Credit markets to "overshoot"

We believe credit markets are set to "overshoot" in the first half of 2021, supported by vaccine-fueled reflating economies, strong demand, and supportive action by monetary and fiscal policy makers. Companies dealing with the aftermath of 2020 will likely be conservative in their strategy, allowing leverage to fall if profitability rebounds, thus helping bondholders. We expect marginal news will be constructive with a fiscal package in the U.S., Central Banks continuing to target pro-growth policies and economic data expected to confirm the economic recovery. Demand for yield is expected to remain strong against this backdrop, with the focus on higher yielding sectors of the credit market as well as the coronavirus-impacted basket of companies. In contrast, supply is expected to fall in 2021 following the record issuance in many credit markets in 2020 as companies behaved rationally and accessed "emergency" liquidity to help ensure their survival in times of uncertainty.

Second Half 2021: Markets to focus on the risks post-coronavirus

Once the vaccine is distributed and government restrictions relating to COVID-19 are banished to history, we believe markets will focus on the risks for 2022. Key issues include:

- How the debt raised in 2020 will be repaid,
- The shift in political agendas,
- The challenges to create employment,
- The amount of regulation,
- The terms of international trade, and
- The benefits of globalization versus protectionism.

Companies will consider all stakeholders but in all likelihood shareholders will demand a focus on returns, possibly through an increase in debt. Central Banks will need to consider not just the current policy mix but also their forward guidance, not an easy task if inflation starts to rise as a result of the excess liquidity and stimulus in the system.

Key Credit Themes for 2021

1. INVESTMENT GRADE WILL BE THE NEW "SAFE HAVEN"

With developed market government bonds offering low or negative real yields (in some cases low or negative absolute yields), investment grade credit is becoming the new haven asset for some investors.

Investing where governments have implemented direct support programs was a feature of 2020. In Europe, the ECB now owns a significant portion of the non-bank IG market and this is set to increase in 2021 with the "stock" and "flow" effects supporting tighter spreads. In H2 2021, the size of the program and the policy for 2022 will be debated, but in the short term the expected 6 to 8bn euro monthly purchases in 2021 should be a technical driver of the "overshoot" in valuations.

2. LARGE SCALE M&A TRANSACTIONS WILL BE LESS FREQUENT

M&A is a topic much discussed amongst credit investors. Expectations for large scale transactions in 2021 are not high due to the uncertainty in the economic backdrop as well as the valuations placed on companies. Portfolio rebalancing where underperforming or non-strategic divisions are sold seems more likely given the large pools of capital looking to be invested by private equity and the focus of management to unlock value by rationalizing the corporate structure.

3. EXPECT THE INCREASE IN BBB ISSUERS TO CONTINUE

We expect the increase in BBB issuers to continue as companies focus on their optimal financing structure, and conclude that with a low cost of debt, more leverage is optimal with mid- to high-BBB the most efficient rating. In addition, low rates are triggering liability management exercises (LME) where companies lock in long-dated borrowing at the current low rates, offset by buying back short-dated debt at a small premium, a positive both for short-dated debt as well as credit in general as refinancing risk is reduced. We expect this trend to continue in 2021, supporting tighter spreads.

4. SOCIAL DISRUPTION WILL CHANGE INDUSTRY DYNAMICS

Features of the credit markets in 2020 were "technology disruption" and "sustainable responsibility." In 2021, we expect a focus on "social disruption." The pandemic has driven a greater use of technology, more home working and an increased focus on personal well-being. Business travel-related industries may see less activity as meetings using new technologies are seen to be an efficient substitute. Flexible working has not harmed productivity. More flexible work practices will cut demand for offices and related services including transport. Corporates who have relied on "just-in-time" inventory or finance are re-assessing whether a more conservative and diversified operating plan is preferable, even if costs rise a little. Active selection of who one lends money to is paramount in a rapidly changing and uncertain world.

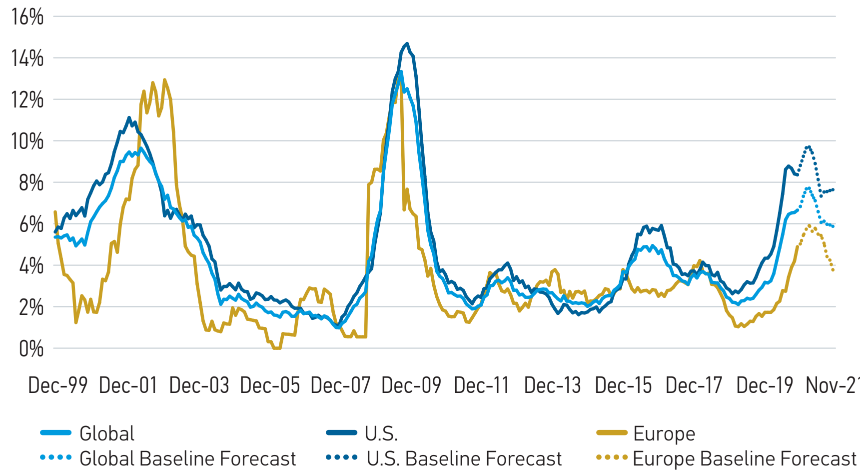
5. SUSTAINABLE RESPONSIBILITY WILL EXPAND IN 2021

The desire of investors that corporations be responsible for all stakeholders including workers and the environment is not new, but the demands for accountability and change have accelerated. Investors want companies to demonstrate social responsibility, or they risk being excluded from the investable

DISPLAY 3

Moody's Default Rates

Trailing 12-Month Default Rates and Baseline Forecasts
Data as of October 31, 2020



Source: Moody's, Morgan Stanley Investment Management

Past performance is no guarantee of future results.

opportunity set. Management have responded by altering business plans and updating stakeholders on their key performance targets, allowing the current business and also the rate of change to be considered (momentum). Active credit investors will likely demand more from management in 2021 via engagement, driving companies marginally to increase costs for the benefit of society (companies will hope these costs are offset by the impact of technology), and we believe markets will respond by rewarding good actors both for the lower business risk and the strong technical demand for those issuers. 2021 should be a year where the focus rotates from the COVID recovery basket of corporates to well-respected ESG companies that are "best in class," with low business risk and strong franchises.

See our Fixed Income ESG Outlook, [A Sustainable Future? 5 Sustainable Investing Themes That Will Define 2021] for further reading.

6. HIGH YIELD WILL BENEFIT FROM LOW DEFAULT RATES IN 2021

The rebound in high yield credit markets mirrored investment grade in 2020, mainly driven by default rates not rising as feared as a result of the economic slowdown. Consensus forecasts for high yield defaults in the second quarter of 2020 were consistent with previous recessions at or above 10%. This expectation has fallen as a combination of fiscal support programs and Federal Reserve policy actions to buy high yield via ETFs drove investor confidence, creating demand that allowed even the most COVID-impacted companies and sectors to access the capital markets and raise liquidity. This resulted in a change in default expectations, with current expectations of peak U.S. defaults of around 7%, and 5% to 6% in Europe. We expect a number of delayed restructurings to impact the 2021 data. By the second half of 2021, we expect defaults to have normalized in the 2% to 3% region, a positive driver for high yield spreads.

The changing composition of the high yield index is supportive of lower spreads relative to history. 2020 saw a number of fallen angels enter the high yield benchmark, improving the overall credit quality of the market. Investment grade issuers in sectors like Energy, Autos, Transport and Leisure that were directly impacted by the slowdown have increased the portion of BBs in 2020. European high yield has also seen an increase in the quantity of secured debt, a factor cited for the higher recovery rate in 2020, which also supports lower credit spreads into 2021.

7. HIGH YIELD AND LOANS WILL BENEFIT FROM COMPRESSION IN THE FIRST HALF OF 2021

The Fed's decision to purchase high yield in 2020 through ETFs (support for the asset class without discrimination on an issuer's credit quality) resulted in increased market confidence, allowing most issuers to access liquidity. While compression has occurred in many sectors, opportunities exist in 2021 in higher quality issuers from "bad neighbourhoods" and asset classes like Loans that did not benefit from direct support. Improving economic conditions coupled with the search for yield should see these areas outperform in H1 2021. In this environment, active issuer selection is expected to be a core driver of high yield returns in 2021.

8. INVESTMENT GRADE COMPANIES WILL CONTINUE TO BUY HIGH YIELD COMPANIES

As markets normalise and uncertainty reduces, companies have to decide where to spend cash raised/saved in 2020. We have already seen M&A in Energy with investment grade companies buying smaller high yield companies distressed by the current economic conditions. We expect more activity in 2021, driven by continued low borrowing costs.

9. CLO (COLLATERALISED LOAN OBLIGATIONS) DEMAND TO REMAIN STRONG

The search for yield will not be restricted to vanilla credit. Structured corporate credit is expected to benefit from the same underlying themes of improving fundamentals and strong demand, creating an additional technical buyer of the underlying Loan asset. Credit compression is a characteristic of markets when the "tide is rising," driving the liquidity risk premium lower, a supportive backdrop for CLO creation.

10. EMERGING MARKET (EM) CORPORATES TO OUTPERFORM DEVELOPED MARKET CORPORATES IN 2021

EM Corporates underperformed developed markets in 2020, providing the opportunity to play catch-up in 2021. The lack of direct central bank buying of corporates hindered the recovery in 2020, but we believe the stars are aligned for the fundamentals to improve and the technicals to be strong. Factors supporting the markets include: a rebound in global growth weighted to manufacturing, better population demographics in emerging economies making coronavirus less impactful, targeted lower leverage in China in both real estate (Three Red Lines policy) and state- controlled companies, and pro-growth monetary policy in many regions. Flows confirm the trend, with recent inflows signaling a strong technical driven by demand for early 2021.

Active selection across the broad EM corporate complex favours China Property, Indian Utilities and Indonesian corporates in Asia as well as Commodity producers and Consumer nondiscretionary in Latin America. In the Middle East, we see opportunities in Utilities that represent the infrastructure for society.

11. CONVERTIBLES OFFER ATTRACTIVE RETURNS

The risk profile of convertible bonds offer an attractive risk-return profile late in the business cycle. The downside is mitigated by the fixed income structure, and the upside potential driven by equity prices. Convertibles outperformed in 2020 as a rise in volatility boosted option-based returns. We expect continued strong performance from convertibles as economic recovery should benefit risk assets, but ongoing uncertainties keep volatility elevated. Issuance in 2020 was at record levels, focused on both the COVID recovery issuers who needed funding and the work from home beneficiaries, such as technology companies, that have not often issued in the public debt market. Both segments offer interesting risk opportunities in a diversified credit portfolio. Finally, the recent surge in supply has not yet been matched by offsetting demand, making convertible valuations, in our view, fair to relatively cheap.

12. 2021 IS NOT THE START OF A "NEW NORMAL" FOR CREDIT SPREADS, AS SEEN IN JAPAN

Low rates, negative real yields, low growth, and banks encouraged to lend are all part of the "new normal" post the financial crisis that caused credit spreads to tighten in Japan where markets are in a new regime. While some of the conditions in Japan are impacting markets and society in the U.S. and Europe, we do not expect a parallel experience. Demographics and cultures are different, supply of debt is expected to be higher with continued transfer of risk away from the banks to the public market and corporate strategy has marginally differing priorities. Whilst a new era of lower credit volatility seems possible, the experience seen in recent years in Japan is less likely.

Expect beta to lead performance in first half 2021, with high quality credit outperforming in the second half

The credit team believes that the first half of 2021 will be positive for excess returns across credit sectors, driven by continued compression and the COVID-sensitive basket outperforming. Comparing developed markets versus emerging, the preference is for emerging corporates; comparing investment grade to high yield, the preference is for high yield. In the second half of 2021, when valuations are expected to have overshot "fair value," we see opportunities to rotate into "premier" higher quality credits to help protect value.

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Bloomberg Barclays Global High Yield Corporate Index provides a broad-based measure of the global corporate high-yield fixed income markets.

The **Bloomberg Barclays Global Aggregate Corporate Index** is the corporate component of the Barclays Global Aggregate index, which provides a broad-based measure of the global investment-grade fixed income markets.

The **Credit Suisse First Boston (CFSB) Leveraged Loan Index** is a market value-weighted index designed to represent the investable universe of the U.S. dollar-denominated leveraged loan market.

The **JPMorgan CEMBI Broad Diversified High Yield Index** is a global, liquid corporate emerging-markets benchmark that tracks U.S.-denominated, high yield corporate bonds issued by emerging-markets entities.

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