Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Fear and Hope: Soft vs Hard Landings

GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | JUNE 2022

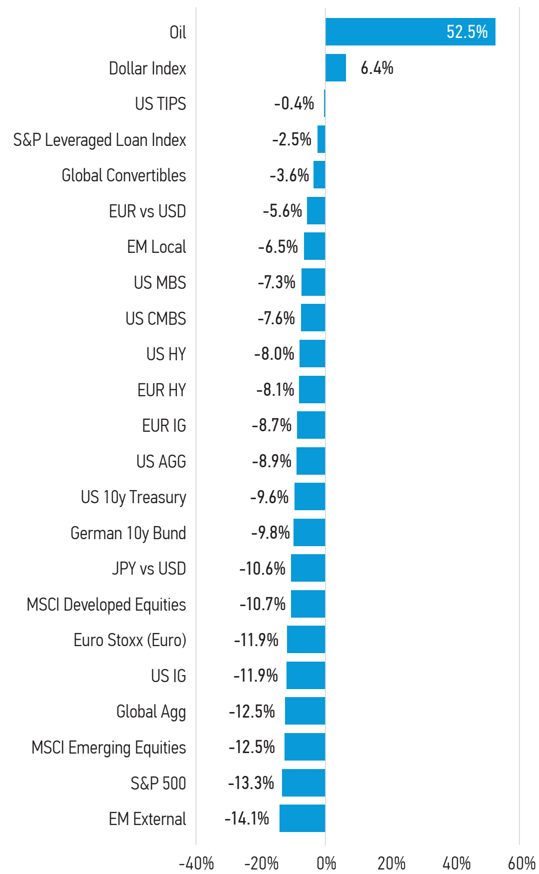
Markets continue to be buffeted by high levels of volatility driven by shifting fears of recession and inflation. This roller coaster of a month resulted in very diverse financial market performance. In the U.S., the month started off where April ended: higher yields, wider credit spreads, weaker equities as inflation fed tightening fears dominated. But by mid-month, slowdown fears (growth surprises became negative) increased, which pushed yields lower across U.S. Treasuries, reduced rate hike expectations by about 25 basis points (bps) and helped equities rebound. By the end of May, U.S. Treasury 10-year yields were down about 9 bps and the S&P 500 equity index essentially unchanged, after being down almost 6% mid-month. With a more dovish U.S. Federal Reserve (Fed) outlook (on the back of growth fears) the U.S. yield curve steepened.

Price action in the rest of the world's bond markets was not so benign. Yields in Europe rose significantly with German 10-year yields up 18 bps. It was quite noticeable that in countries where monetary policy hawkishness weakened to some degree, bond markets did OK; but in those countries where central bank hawkishness was maintained or intensified, bond yields continued to rise over the month.

Inflation data continue to show little signs of slowing sufficiently for central banks to relent on hiking plans. Fed rhetoric remains one of "expeditiously" getting rates normalized while, for example, European Central Bank (ECB) members continue to harp on the need to quickly exit negative interest rate policy. As such, May was unusual in that U.S. rate expectations softened (taking out one anticipated rate hike)

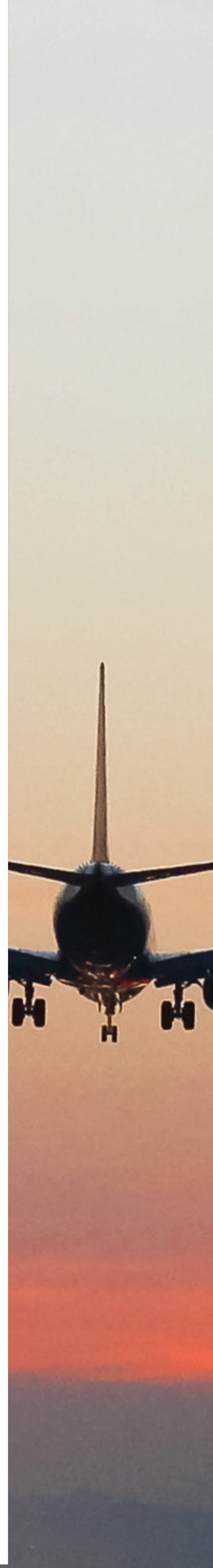
DISPLAY 1

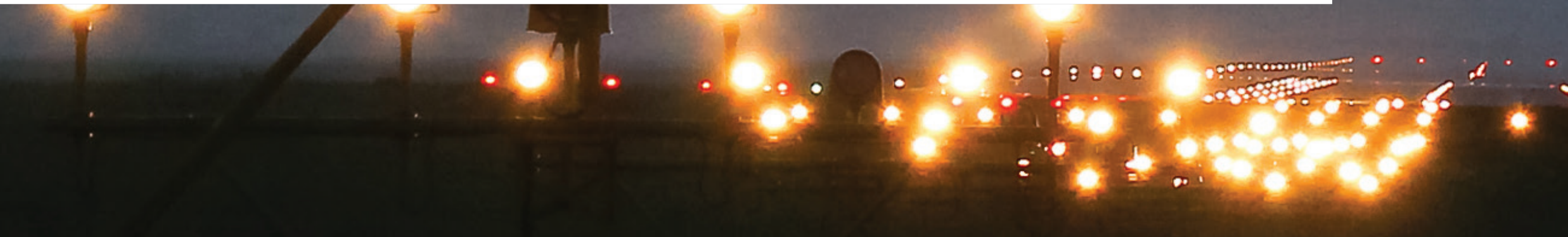
Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of May 31, 2022. 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 6-7 for index definitions.

The views and opinions expressed are those of the Portfolio Management team as of June 2022 and are subject to change based on market, economic and other conditions. **Past performance is not indicative of future results.**





relative to those in the rest of the world. The Bank of Canada was particularly forceful in its comments about the need to do "whatever it takes" to get inflation down sooner rather than later.

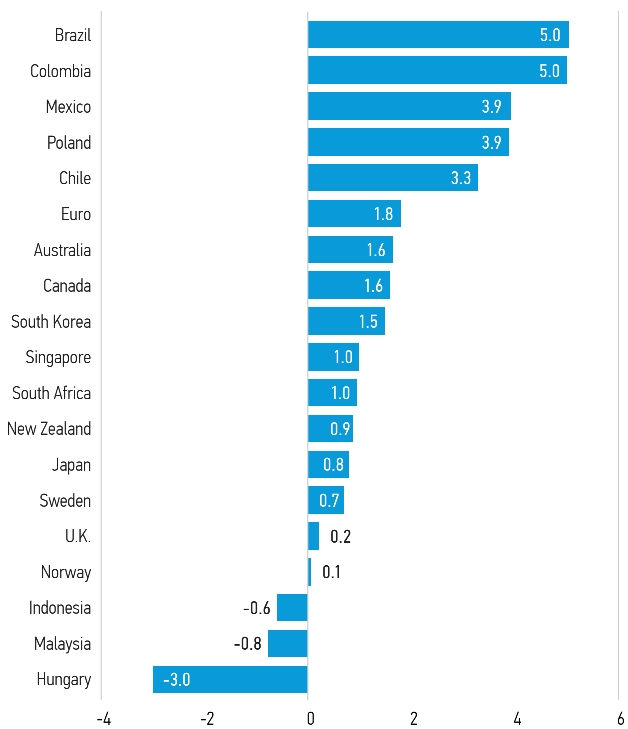
Perceptions that inflation had peaked, economies were slowing, and the Fed was unlikely to raise rates by more than priced into yield curves gave a fillip to markets, especially once U.S. Treasury yields moved over 3% on May 5, a level perceived to be a bridge too far (for the health of the economy). The mid May rally in U.S. yields was somewhat anomalous, suggesting it is unlikely to continue. During the month, real yields rose as nominal yields fell, implying a decline in inflation expectations. Nominal and real yields are usually highly positively correlated. It is also counterintuitive given the upward pressure seen in commodity prices (particularly oil and food) to think inflation expectations should improve so significantly. As such, we were not surprised that the rally in 10-year U.S. Treasuries ran out of steam around the 2.75% level.

These relative central bank assessments drove fixed income returns. U.S. Treasuries and U.S. dollar bonds eked out positive returns for the month, while in general, fixed income returns were negative outside the U.S. High yield corporates continued to sell off, not benefiting as much from an easing of Fed hawkishness. Indeed, while anticipating lower short rates is good for bonds, higher real yields and lower inflation is not for lower quality issuers. Euro-denominated corporate bonds (both IG and HY) put in a very poor performance on the back of increased ECB hawkishness, higher yields and poor inflation data.

DISPLAY 2

Currency Monthly Changes Versus U.S. Dollar

(+ = appreciation)



Note: Positive change means appreciation of the currency against the USD.
Source: Bloomberg. Data as of May 31, 2022.

Emerging market debt (EMD) returns were very diverse in May. External markets underperformed as spreads did not recover as well as credit markets. However, local markets did well, putting in one of the better returns across asset classes as EM currencies strengthened on the back of optimism that peak Fed funds rates were discounted. Another key differentiator has been external conditions whereby commodity exporters have generally benefited from high and rising commodity prices while commodity importers are suffering worsening trade balances.

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	2.84	-9		
United Kingdom	2.10	+20	-74	+29
Germany	1.12	+18	-172	+27
Japan	0.24	+1	-260	+10
Australia	3.35	+23	51	+32
Canada	2.89	+2	5	+11
New Zealand	3.61	+101	77	+110
EUROPE			(Spread over Bunds)	
France	1.64	+18	52	-1
Greece	3.58	+24	246	+5
Italy	3.12	+35	200	+16
Portugal	2.26	+24	114	+6
Spain	2.23	+25	110	+7
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			323	+3
EM Corporate Spreads			266	+8
EM Local Yields	5.89	+32		
Brazil	12.80	+29	300	-6
Colombia	10.92	+79	331	-43
Hungary	7.09	+15	202	+14
Indonesia	6.95	+4	154	-9
Mexico	4.20	-27	60	-6
Peru	8.76	-34	219	-27
Philippines	7.48	-36	154	-26
Poland	6.26	+59	115	-19
Russia	6.67	+8	11	+4
South Africa	10.43	-2	384	-5
Turkey	21.58	+114	584	+70
Venezuela	–	–	26059	-4420
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			130	-5
EUR IG			162	+11
U.S. HY			406	+27
EUR HY			472	+25
SECURITIZED				
Agency MBS			118	-3
U.S. BBB CMBS			377	+39

Positive Neutral Negative

Source: Bloomberg, JPMorgan. Data as of May 31, 2022.

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Fixed Income Outlook

Unfortunately, volatility is unlikely to go away. Even though most of the bear market in rates is likely behind us, upward pressure from high (even if falling) inflation and rate hikes will keep bond yields elevated. Central banks are highly likely to deliver what is priced into yield curves. Chairman Powell has reiterated multiple times the need to "normalize" rates "expeditiously." We take that to mean moving the Fed funds rate to a minimum of 2.5% this year with risks skewed higher. Once the Fed gets rates to the 2.5-2.75% zone, the pace of rate hikes is likely to slow but continue. The extent of the move beyond "normal" will be highly data dependent, meaning how the economy is performing in late summer and early fall. If growth continues to slow; labor markets loosen, softening wage growth. Most importantly, if inflation is moving lower, the Fed can slow the pace of tightening, protecting economic growth. However, it is not clear at all if these conditions will be met. Thus, the concern remains that the probability of the Fed lifting its terminal rate forecast at the June Federal Open Market Committee (FOMC) meeting is significant, which could easily upset markets.

Central banks in general remain on a hawkish trajectory, even those in countries that have already experienced significant rate hikes. New Zealand's central bank, one of the first to raise rates last year, was expected to announce a slowing or ending of its hiking cycle. Instead, it doubled down, saying overdoing it (in terms of rate hikes) was less risky than doing too little. Similar sentiments appear to be becoming the majority sentiment at the ECB where inflation has continued to surprise to the upside while economic growth has NOT taken as big a hit as was expected pre-Russian invasion of the Ukraine. Expect more hawkish rhetoric and actions by central banks.

Central banks are not acting without reason. May data for business confidence, labor markets and consumer spending was resilient. Yes, in some cases like the U.S. Institute for Supply Management (ISM) data, results were weaker than expected, but they remain at robust levels and, we believe, are likely to stay firm as strong labor markets, strong income generation, healthy balance sheets and high savings keep service sector spending strong. It is difficult to see meaningful falls in inflation with economic fundamentals so solid. While goods producing sectors have peaked in terms of growth, services still have upside potential. We remain more wary of inflation than recession.

The ending of Covid restrictions (at least for now) in China should also be a positive for the global economy with demand effects outweighing supply side improvements. If so, this will be another reason to expect commodity prices to remain firm, increasing the difficulty of central banks to bring down inflation, especially with household and corporate fundamentals so strong.

The outlook for corporate bonds is mixed. The simple metric is: hard landing bad; soft landing good. While we wait to see which one wins out, spreads should remain in recent ranges (+120 – 150 bps on U.S. IG index, somewhat higher on high yield, +350 – 550 bps). Volatility amongst companies and sectors is likely to remain high as companies navigate high inflation and supply/input challenges (and of course ongoing corporate disruption). Recent spread widening in April/May took spreads into recession-like territory (+150 bps). This proved too wide given continued economic resilience and higher absolute yields. On the other hand, corporate results are unlikely to improve significantly, leaving IG spreads stuck between where they began the year and May wides. We still like credit for their carry, see opportunities in idiosyncratic situations whereby some companies have been unduly punished in the April/May sell off.

Emerging Markets (EM) was a tale of two markets in May. Local outperformed with external lagging significantly. Local returns were boosted by strong EM FX performance. Lower rated external EM continues to struggle with high energy and food inflation, undermining fiscal balances and economic growth. With several frontier economies on the verge of or restructuring, risk remains there as well. Countries that benefit from high oil and food prices have performed well. Country level analysis will be vital to uncover value as we expect markets to place an emphasis on differentiation amongst countries and credits. EM is likely to struggle as long as Developed Markets (DM) central banks remain on their current hawkish trajectory and inflation stays high. EM external looks reasonably attractive but lacks a catalyst to spark a rally.

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	MONTHLY REVIEW	OUTLOOK
Developed Market Rate/ Foreign Currency	Broadly, the move in DM rates was mixed, occurring on a country-by-country basis. Central bank policy and indications from policy members drove much of the monthly moves, with a more dovish Fed bringing down most U.S. rates, while surprisingly hawkish sentiment from the ECB, Bank of England (BoE), and Reserve Bank of Australia (RBA) led to selloffs elsewhere. Markets started pricing in more growth/recession concerns, leading risk assets to sell off and causing a more typical negative correlation between risk assets and U.S. Treasuries to appear, with Treasuries attractive as a safe haven asset.[1]	Central banks are still forced to navigate a tough situation to achieve a soft landing that will cool inflation without pushing the economy into a recession. While the slight decline in U.S. Consumer Price Index (CPI) may indicate that the economy has pushed past the peak, the key will be how long, and how high, inflation will remain.
Emerging Market Rate/ Foreign Currency	EMD segments were mixed in May with the local index achieving positive returns primarily due to broad currency strength, while average spreads on the hard currency indices—both sovereign and corporate—widened, leading to muted performance. Outflows continued from the asset class as a whole and across both local and hard currency funds.[2]	Valuations appear to be compensating investors well at these levels while areas of opportunity remain. Inflationary pressures will likely continue for both developed and emerging markets in the near term as energy and food prices remain elevated. As such, Fed tightening remains a notable concern, but markets appear to be appropriately pricing in that risk. Country-level analysis will be critical in uncovering pockets of opportunity within this diverse universe.

[1] Source: Bloomberg. Data as of May 31, 2022.
[2] Source: Bloomberg. Data as of May 31, 2022.

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	MONTHLY REVIEW	OUTLOOK
Corporate Credit	For much of the month, continued concern over the impact of inflation, interest rates and tightening liquidity on corporate and consumer health weighed on risk sentiment.[3] As such, corporate credit sectors underperformed. Investment grade credit spreads widened slightly in May, with Europe notably underperforming the U.S. The high yield market experienced pronounced weakness for the balance of May before rallying aggressively in the final days of the month. Global convertibles fell again in May as well, underperforming both equities and bonds.[4] The senior corporate loan market also sank in May.[5]	Looking forward we see spreads rangebound. Markets are supported by more attractive valuations and strong corporate results, yet constrained by continued macro uncertainties, and weak technicals given the lack of demand while market volatility remains high. We are cautious on the high yield market. The high yield market experienced significant pockets of volatility this year and there is little to suggest the environment for high yield will become materially more supportive over the near term. While we have continued conviction in the loan market's relatively healthy credit picture, the geopolitical situation in Europe clouds the outlook.
Securitized Products	Recession fears caused securitized credit spreads to widen further in May while government-guaranteed agency MBS tightened. Agency MBS bounced back and outperformed both U.S. Treasuries and credit assets in May, however, Agency MBS spreads are still materially wider than pre-pandemic levels as the market is pricing in the end of quantitative easing and likely the beginning of quantitative tightening. U.S. non-agency Residential Mortgage-Backed Securities (RMBS) spreads widened further across nearly all residential sectors over the month. U.S. ABS spreads were also wider in May, but fundamental credit performance remains strong.[6]	We believe the securitized market still offers a unique combination of low durations, attractive yields, and solid credit fundamentals. We remain constructive on securitized credit and believe sector and security selection will become more important in the coming years if the economy softens. We remain cautious on agency MBS and interest rate risk.

[3] Source: Bloomberg U.S. Corporate High Yield Index. Data as of May 31, 2022.

[4] Source: Refinitiv Global Convertibles Focus Index. Data as of May 31, 2022.

[5] Source: S&P/LSTA Leveraged Loan Index. Data as of May 31, 2022.

[6] Source: Bloomberg, as of May 31, 2022.

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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: O=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 U.S. 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 U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The **Bloomberg U.S. 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 U.S. Treasury**—U.S. 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 U.S. Mortgage-Backed Securities (ICE BofAML U.S. Mortgage Master) Index** tracks the performance of U.S. dollar-denominated, fixed-rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. domestic market.

The **ICE BofAML U.S. High Yield Master II Constrained Index (ICE BofAML U.S. 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.

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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 U.S.-denominated corporate bonds issued by emerging markets entities.

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 U.S. 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 U.S.-dollar corporate emerging market bonds representing Asia, Latin America, Europe and the Middle East/Africa.

JPY vs. USD—Japanese yen total return versus U.S. dollar.

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 U.S. 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 (U.S.), 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 (U.S. S&P 500)** measures the performance of the large-cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy.

S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index seeks to measure the value of residential real estate in 20 major U.S. 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 U.S. 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 (U.S.), 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 **U.S. 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 U.S. 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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CRC 4790790 Exp. 6/30/2023 Lit-Link: FIBULLETIN-0622 10235040_KC_0622