Morgan Stanley

INVESTMENT MANAGEMENT

Global Fixed Income Bulletin

Welcome to the Brave New World!

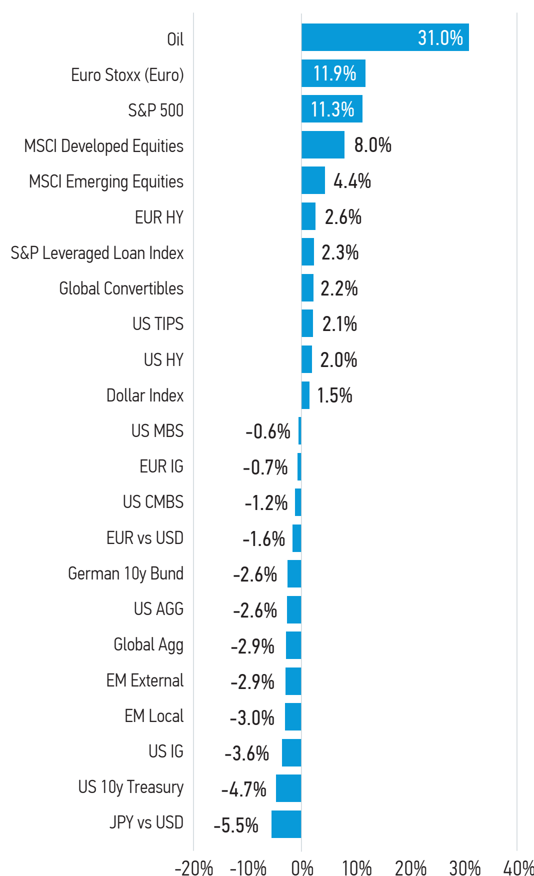
FIXED INCOME | GLOBAL FIXED INCOME TEAM | MACRO INSIGHT | MAY 2021

April delivered surprising fixed income results. After rising significantly in March, U.S. Treasuries and most other developed market government bond yields fell measurably, despite solid, surprisingly strong economic data (economic surprise indexes continue to be "surprised" with positive economic data), aggressive U.S. fiscal expansion plans, and good news on the pandemic front. European yields rose significantly, a very unusual occurrence given the behavior of U.S. Treasuries and relatively weak European economic data; and emerging markets were as usual fairly diverse in their performance, driven mostly by local idiosyncratic factors, with external markets outperforming and with local markets supported by the U.S. Treasury rally tailwind.

The rise in European yields was surprising as it bucked the rally in the U.S. and went against the European Central Bank's (ECB) stepped up Quantitative Easing (QE) buying and dovish communication. On the other hand, negative EU Q1 GDP growth was already well known, while the vaccination program accelerated and optimism prevailed about the ability of Europe to exit lockdown in Q2. German 10-year bonds ended the month near their year highs, with most other Euro markets performing worse.

Contrary to the underperformance of European peripheral bond markets, Euro and U.S. credit markets, investment grade, and high yield, fared well once again, with credit spreads tightening over the month. Outperformance of high yield was notable, with spreads tightening by double digit basis points (bps). Outperformance was supported by the search for yield, growing economic optimism, higher equities

DISPLAY 1
Asset Performance Year-to-Date



Note: USD-based performance. Source: Bloomberg. Data as of April 30, 2021. 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 and 7 for index definitions.

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and, most importantly, falling real yields. Notably, spread compression between higher- and lower-quality rating buckets dissipated, despite all the good news, with CCC bonds only marginally outperforming BB- and B-rated sectors.

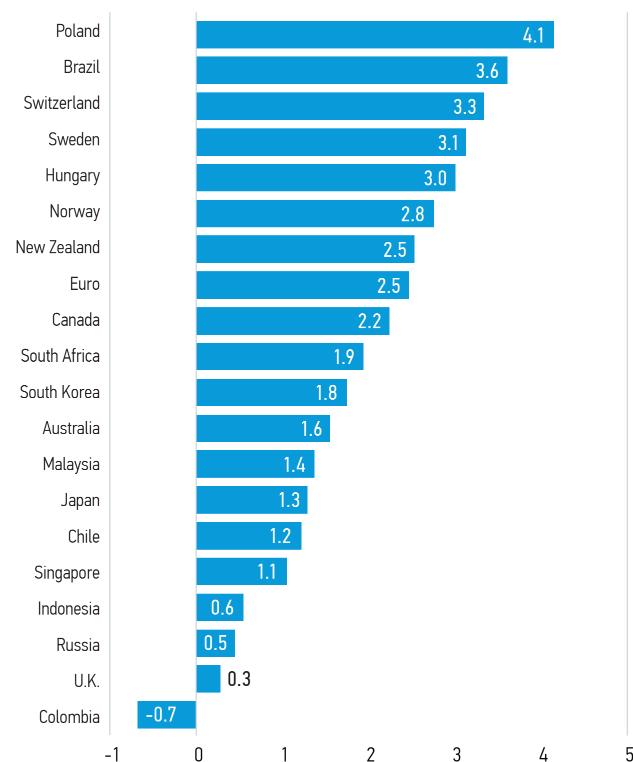
The key driver for lower yields and stronger risk markets was a market recalibration of likely Fed policy. During April, the Fed continued to aggressively push its dovish narrative, laying out the case for no change in either QE or rates until late 2023 at the earliest. Given the market's opposite view in March, when it had priced the Fed to be raising rates in 2022, there was ample room for yields to fall if the market decided to move closer to the Fed narrative, which it did. This led to a fall in real yields matching the fall in nominal yields, a testament to the Fed's ability to convince the financial markets that it was serious about keeping real yields low in support of a "boomy" economy in order to get unemployment back to pre-pandemic levels with, of course, the requisite equitable distribution across population cohorts.

A renewed confidence in the Fed's willingness and ability to keep nominal, but most importantly real, yields low has important implications for investment strategy. While yields are likely to go higher medium term (i.e., the Fed and fiscal policy will likely succeed in lowering unemployment and raising inflation and growth), the near-term outlook is a lot murkier. In fact, we would not be surprised if government bond yields as well as credit spreads settle into a range with little momentum either way. While investors are not well compensated for taking duration/interest rate risk currently, volatility in rates is not likely to be an impediment to returns in the months ahead: Low yields will! We remain positioned to benefit from credit-sensitive assets outperforming during the upcoming anticipated economic boom.

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 April 30, 2021.

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	1.63	-11		
United Kingdom	0.84	0	-78	+11
Germany	-0.20	+9	-183	+20
Japan	0.10	0	-153	+12
Australia	1.75	-4	12	+7
Canada	1.55	-1	-8	+10
New Zealand	1.65	-16	2	-5
EUROPE			(Spread over Bunds)	
France	0.16	+20	36	+11
Greece	0.99	+12	120	+3
Italy	0.90	+24	111	+15
Portugal	0.48	+25	68	+16
Spain	0.48	+14	68	+5
EM	**INDEX LOCAL YIELD (%)**	**MTD CHANGE (BPS)**	**USD SPREAD (BPS)**	**MTD CHANGE (BPS)**
EM External Spreads			383	-17
EM Local Yields	4.76	+15		
EM Corporate Spreads			351	-27
Brazil	7.92	-20	277	-13
Colombia	6.48	-4	234	+12
Hungary	2.00	-13	99	+5
Indonesia	6.52	-20	146	0
Mexico	6.82	+7	205	-1
Peru	5.22	+43	138	+13
Philippines	4.19	+32	93	-6
Poland	1.02	+9	19	+7
Russia	6.76	+2	159	-12
South Africa	10.13	-17	338	-22
Turkey	17.73	-63	499	-41
Venezuela	–	–	18611	-767
CREDIT			**SPREAD (BPS)**	**MTD CHANGE (BPS)**
U.S. IG			88	-3
EUR IG			84	-6
U.S. HY			291	-19
EUR HY			291	-18
SECURITIZED				
Agency MBS			60	-10
U.S. BBB CMBS			305	-31

Positive Neutral Negative

Source: Bloomberg, JPMorgan. Data as of April 30, 2021.

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Fixed Income Outlook

In April, the markets saw continued support for risk assets, with additional fiscal announcements in the U.S. and continued monetary support from the ECB and the Fed, both maintaining it was too early to be considering tapering. Through the month, there was improving economic data with coronavirus cases falling in developed markets and economies focused on reopening. This was further aided by the rally in commodity prices, driven by the containment of oil supply and the strengthening in demand for metals to support infrastructure spending plans.

While the performance of U.S. Treasuries (and the government bonds of other English speaking countries) was a bit of a surprise given the data/information flow, valuations and market technicals were positioned the other way (i.e., for yields to fall). At the beginning of the month, the market was pricing in a relatively aggressive Fed tightening cycle, and with the market positioned commensurately short interest rate risk, maybe it was not too surprising we had a counter-trend rally. But, there is more to it than that. The Fed is on a mission to communicate/educate its new monetary operating strategy, Flexible Average Inflation Targeting (FAIT). In March, markets questioned whether or not the Fed would actually implement it. By the end of April, the market has moved its forecasts towards the Fed's view, even if it is not entirely convinced, given its obsession with near term inflation risks. Contrary to our worries in early April that the market would price in even earlier rate hikes, undermining growth optimism, the opposite occurred. Potential bear market averted. Keep an eye on real yields. They remain a key indicator of value and risk premium.

Looking further out, we see inflation concerns as overdone. This does not mean inflation will not be higher in 18 months or that the Fed will not be talking about or even raising rates. It does mean, as of now, these pressures are likely to be relatively contained, or transitory in nature. Analysts are forecasting very high year-over-year inflation prints, on both headline and core inflation measures, over the rest of the year. But these are not expected to persist, as they are driven by base effects (many prices, especially for commodities, collapsed last year but have now normalized and won't rebound to the same extent again), the reversal of temporary tax cuts and other anomalies like changes in the timing of seasonal sales. But with employment and labor market participation rates still well below pre-pandemic levels there is likely to be a long road before we see wage pressures materialize that would jeopardize the Fed's inflation mandate. Admittedly, there is a lot of labor market churn going on as workers change jobs, moving from declining sectors to growing ones, which could put upward pressure on wages and appear inflationary. However, we would advise caution and not read too much into this. What is happening is natural and part of the dynamic capitalist process and is not inherently inflationary. As the Fed has communicated, we are likely to see a temporary rise in inflation due to the economic healing process. But, this is transitory, not "troubling," in their parlance. This seems a reasonable view to have at the moment but needs careful watching.

Importantly, with the Fed desiring a higher inflation rate (remember FAIT), we do not see the usual cyclical upswing in Fed-induced real interest rates (the usual cause of bear markets in fixed income) happening for a long time. While cyclical strength, combined with easy monetary and fiscal policy, will keep the economy strong, underlying structural forces (digitalization, productivity gains) are likely to help contain any inflationary impulse that does occur. On the other hand, it is also unlikely U.S. yields, or for that matter global yields, fall meaningfully from current levels absent a large new shock, such as a resurgence in the pandemic or financial incident. Yields are likely to remain range bound for now, good for risky assets, good for falling volatility.

In terms of strategy, the combination of falling real yields, healthy household balance sheets, fiscal expansion, strong, but maybe moderating growth, gently rising inflation expectations, and a rapidly healing labor market augers well for cyclical assets. We remain constructive on credit, both corporate and securitized housing, despite somewhat lofty valuations by historical standards, and hold lower-than-average credit quality, and are overweight external emerging markets. However, the spread or return compression between higher and lower rated high yield bonds looks nearly complete. Down-in-quality moves into CCC rated bonds are likely to lead to much smaller capital gains opportunities going forward. That said, the economic environment is so good, it is also hard to see default risks increasing in the next 12 months, so remaining overweight lower quality bonds still makes sense to us in order to capture the additional yield potential. Significant risk taking should be confined to idiosyncratic opportunities where risk premiums are elevated. The danger, of course, is that this usually only occurs when something goes wrong and risks have risen! Good research; bottom-up analysis remains key. Caveat emptor.

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	MONTHLY REVIEW	OUTLOOK
Developed Market (DM) Rate/Foreign Currency (FX)	In April, most developed-market government bond yields fell, or plateaued, in spite of continued strong economic data. Mass vaccinations forged ahead and economic reopenings in several developed market countries began as coronavirus cases remained at manageable levels. After lagging the U.S. and U.K.'s initial vaccine rollout, Europe has begun to accelerate its rate of vaccination, and coronavirus cases appear to be declining after additional lockdowns were imposed in the region.	Recent data and information flow continue to imply 2021 economic growth will be very strong. Falling infection rates, vaccine rollouts, strong efficacy results, massive U.S. fiscal stimulus, high savings rates, economic reopenings and dovish central banks are buttressing a very positive outlook for economies. With the $1.9 trillion support/stimulus package being implemented, U.S. fiscal policy is on a trajectory to significantly improve 2021/2022 growth globally, not just in the U.S. While we do not expect a dramatic sell-off in government bond markets, we think the risk is skewed to yields rising, as valuations are still rich relative to history and there is potential for additional term premia to be priced across the yield curve. Central banks in general have not expressed significant concern about the rise in yields, presumably because it has not yet led to an unwarranted tightening of financial conditions. We expect significantly higher inflation in 2021, but for it to be transitory, and for central banks not to respond to it.
Emerging Market (EM) Rate/FX	EM debt posted positive returns in April across the board, i.e., in both local and hard currency bonds. From a sector perspective, companies in Oil & Gas, Television, Media and Telecom, Metals & Mining, Industrial led the market, while those in the Financial, Consumer, Utilities, Infrastructure, Pulp and Paper underperformed.	We remain constructive on EM Fixed Income assets on the back of steady monetary policy accommodation and rapid progress on vaccine rollouts in the developed world, and looser fiscal policy in the U.S. boosting commodity prices and growth in the rest of the world. The slower deployment of vaccines in several EM countries makes them more vulnerable to new virus strains, leading to tighter lockdown measures in the near term, weighing on growth and already fragile fiscal accounts. Potential disappointments of optimistic expectations about Biden policies vis-à-vis growth and trade could negatively impact the performance of growth-sensitive assets. Finally, reemergence of geopolitical risks (as evidenced by recent escalation in U.S.-Russia and U.S.-China tensions) could also disrupt our relatively benign outlook for EM.

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	MONTHLY REVIEW	OUTLOOK
Credit	Credit spreads tightened over the month across both Euro and U.S. Investment Grade (IG). Credit markets also benefitted from higher equities and lower volatility in the month. Sector and corporate news in the month was dominated by Q1 earnings reports, where results in most cases exceeded increased expectations. Spreads also tightened due to improving economic data, with coronavirus cases falling in developed markets and economies focused on reopening. This was further aided by the rally in commodity prices, driven by the containment of oil supply and the strengthening in demand for metals to support infrastructure spending plans.	We see credit being supported by expectations of an economic rebound in 2021 as well as continued positive support from monetary and fiscal policy as rates stay accommodative and QE strong. We expect continued strength with a potential price overshoot in the first half of the year, with a correction in the second half as M&A increases, questions are asked over the level of QE in 2022, and as fear of missing out buying activity turns to fear of owning valuations that look historically expensive.
Securitized Products	Interest rates stabilized in April and spreads continued to tighten on both U.S. agency mortgage-backed securities (MBS) and credit-oriented securitized products. U.S. non-agency residential mortgage-backed securities (RMBS) and Commercial mortgage-backed securities (CMBS) spreads were largely unchanged in April. However, U.S. asset-backed securities (ABS) spreads continued to grind tighter as did European RMBS spreads, which tightened as both new issuance and secondary trading volumes were low.	We continue to have a positive outlook on residential and consumer credit sectors and a more cautious view on CMBS. We believe agency MBS now looks expensive on a historical level basis and a risk-adjusted basis. U.S. non-agency RMBS have largely recovered to pre-pandemic levels, but still offer reasonably attractive relative value. U.S. ABS continues to have mixed outlook for 2021, with traditional consumer ABS (credit cards and auto loans) looking relatively expensive while the more COVID-challenged ABS sectors continue to offer much greater recovery potential. CMBS valuations remain very idiosyncratic, with some attractive value opportunities and some potential credit problems as well.

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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

R* is the real short term interest rate that would occur when the economy is at equilibrium, meaning that unemployment is at the neutral rate and inflation is at the target rate. **Basis point:** 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.

The **Bloomberg Barclays Euro Aggregate Corporate Index (Bloomberg Barclays Euro IG Corporate)** is an index designed to reflect the performance of the euro-denominated investment-grade corporate bond market.

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 **Bloomberg Barclays U.S. Corporate Index (Bloomberg Barclays U.S. IG Corp)** is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market.

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

The **Bloomberg Barclays 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

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securities. Its securities have maturities of one year or more and a credit rating lower than BBB-/Baa3, but are not in default.

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 **National Association of Realtors Home Affordability Index** compares the median income to the cost of the median home.

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 **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.

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 3592355 Exp. 5/31/2022 10028733_KC_0521 Lit-Link: FIBULLETIN-0521