Morgan Stanley

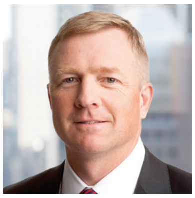
INVESTMENT MANAGEMENT

Forward Thinking

Navigating the Curve

INVESTMENT INSIGHT | FIXED INCOME TEAM | MARCH 2023

Today's bond market offers investors a rare set of opportunities to suit a wide range of portfolio objectives. Rates have risen across the yield curve in many markets, but the short end has increased more. Our investment managers outline strategies for seeking higher current income or capital appreciation during this unusual yield curve inversion, with more attractive choices than we have seen in over a decade.



ANDREW N. SVEEN, CFA
Head of Floating-Rate Loans
Portfolio Manager

FLOATING-RATE LOANS | HIGH YIELD BONDS | BROAD MARKETS FIXED INCOME

1 **The heavy emphasis on current-pay income is a distinguishing feature of the loan asset class**

2 **A "higher-for-longer" rate environment should bolster yield prospects on floating-rate loans**

3 **With uncertainty waning, a "soft" landing for the global economy would be tailwind for credit markets**

In senior loans there's simply no convexity required for above average returns

"Capital markets may see a mixed outlook in the face of easing inflation, uncertain recession risks and peaking interest rates. Although the loan market will contend with these factors too, a key distinction is that most bonds require falling interest rates for stronger gains. By comparison, most loan return prospects lie in current-pay income, which would be buoyed by a *higher-for-longer* rate environment. Loans are also distinguished by a zero-duration profile, which offers balance with the rest of a clients' *fixed* income portfolio.

At present, default and distress levels remain relatively benign, with the former at 1% and only 6% of the market priced at less than $80.[1] A resilient economy and an average Morningstar LSTA US Leveraged Loan Index price of $95 should act as cushions."

Note: The returns referred to in this document are those of representative indexes and are not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

[1] Leveraged Commentary & Data (LCD). As of February 23, 2023.

JEFFREY D. MUELLER
Co-Head of High Yield Portfolio Manager

FLOATING-RATE LOANS | **HIGH YIELD BONDS** | BROAD MARKETS FIXED INCOME

1 **Yields are hovering near decade-long highs across U.S. and European high-yield**

2 **Average bond prices remain significantly below par, offering attractive upside potential**

3 **We believe that elevated yields provide significant compensation for increased volatility**

Higher yields signal attractive entry point

"Central bank activity remains a key driver of risk appetite in our markets and will be a determinant in overall yield levels available. As a result, we are closely watching monetary policy and foresee potential for a *higher-for-longer* environment ahead. Historically, starting yields have been a great guide to forward-looking total returns—we believe that this is likely the case once again. Indeed, strengthening investor appetite in early 2023 indicates that today's higher yields are proving an attractive entry point."

RICHARD FORD
Co-Head of Broad Markets Fixed Income Portfolio Manager

FLOATING-RATE LOANS | HIGH YIELD BONDS | **BROAD MARKETS FIXED INCOME**

1 **High quality fixed income is finally delivering yields not seen in over a decade**

2 **Long-maturity corporates are trading at significant discounts to par**

3 **High-quality, core fixed income may hedge against recession risk**

High quality bonds offer value and downside risk mitigation in an uncertain world

"We think high-quality, core fixed income duration, with high starting yields and strong balance sheet fundamentals, should serve as a strong hedge against risks, while delivering levels of income not seen since the 2008 crisis. We see wider dispersion in credit spreads in 2023 offering opportunities for relative-value strategies via active sector, industry and security positioning. We particularly favour high-grade non-cyclical corporates and high quality systemically-important banks. We continue to like securitised assets that are backed by still-strong U.S. consumers which benefit from attractive valuations for their robust credit quality."

Investor Implications

GOOD ENTRY POINTS

Last year's rout in fixed income markets has left starting yields sitting at, or close to, historic highs. From current levels, we see an opportunity to earn respectable income and capital appreciation across the duration spectrum from floating-rate loans to high yield bonds and longer duration investment grade securities.

ALWAYS ACTIVE

While opportunities are emerging, an active approach is warranted for navigating fixed income in the current market conditions. Whether in sovereign debt, corporate bonds or structured securities, we believe that capitalizing on opportunities will require a combination of skilled expertise, careful risk management and the nimbleness and flexibility to adjust positions as market conditions change.

SWEET SPOTS

No two investors will seek to capitalize on the curve in the exact same way. However, broad opportunities exist across several fixed income sectors. This should grant each investor a degree of choice as they seek the sweet spot that best serves their unique aims, objectives and risk tolerance to complement their portfolio.

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Source of all data: Morgan Stanley Investment Management, as of February 23, 2023, unless otherwise specified.

IMPORTANT INFORMATION & DISCLOSURE

INDEX DEFINITIONS
Morningstar LSTA US Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

DEFINITIONS
Convexity measures the sensitivity of a bond's duration to changes in yield.

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 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. Floating-Rate Loans: An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There can be no assurance that the liquidation of collateral securing an investment will satisfy the issuer's obligation in the event of nonpayment or that collateral can be readily liquidated. The ability to realize the benefits of any collateral may be delayed or limited. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher rated investments.

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