Morgan Stanley

INVESTMENT MANAGEMENT

Fixed Income Newsletter

Preferred Market Update

FIXED INCOME MANAGED SOLUTIONS | MARKET INSIGHT | NOVEMBER 2022

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Preferred yields hit new highs in October, with the BofA Fixed Rate Preferred Index finishing the month above 7% yield to worst, the best since the Global Financial Crisis. The 10-year Treasury rose 24 basis points (bps) to 4.04%, declining from a peak above 4.2% after the mini-budget reversal in the UK helped calm global markets. Investment Grade corporate credit spreads charted a similar path, recovering at month end to finish close to unchanged in October. Contingent convertibles outperformed, rising 1.4%, as the restructuring plans for a large European investment bank became clearer for investors. More rate-sensitive $25 par securities underperformed, dropping 5%, while $1000 par IG preferreds declined 62 bps. In the primary market, preferred issuers remained on the sidelines, while senior supply underwhelmed following third quarter results for financial institutions.

The 4%+ monthly divergence in $25 par and $1000 par returns is less remarkable now that it has happened so often this year—in April, May, August and now October. Before 2022, a 4% monthly difference had not happened once in the previous 10 years. Rate volatility has been a feature of 2022 performance,

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and it is worth reiterating that it has largely accounted for preferred total returns this year. Taking the $25 par index through month-end, prices have declined 24.8%, which netted against 3.78% income, produced a total return of -21.05%. It's the worst year since the financial crisis by a wide margin, but only 6.23% of that is excess return, or due to non-rates factors.

Strictly based on credit spreads, IG corporate bonds have held up well given macro headwinds, and preferreds have arguably outperformed senior bonds. The option adjusted spread, OAS, has widened 146 bps for the $25 par index and 93 bps in $1000 par, which compares with 80 bps in IG financials. While preferred spreads are wide of 10 year averages, they are hardly distressed. Corporate fundamentals remain strong, in our opinion, and preferreds have been supported by a lack of new issue supply, which is down roughly 80% in the U.S. market. With index yields nearing 8%, issuers are understandably reluctant to price new bonds in the market.

We don't anticipate the environment changing in the near term, which could keep new issue supply muted next year. Even with a sharp credit rally, few securities are hitting first call in 2023, as 2018 was a relatively light year for supply. Bank balance sheets are now flat to declining, reducing the need for additional tier 1 capital. Some financial issuers have recently called floating rate securities, but without replacement, as the constraining capital requirement has shifted from SLR to CET1 for large banks. With 3-month Libor above 4% and the average back end spread above 300 bps for 1000 par preferreds, floating rate preferreds are no longer cheap capital for issuers.

Fundamentals remain strong for financial institutions, as higher rates fuel revenue growth. Third quarter earnings had a few surprises, but the relative beneficiaries of the current environment are traditional banks that can fully benefit from higher net interest income. Deposits are now declining across the banking sector as the Fed withdraws liquidity, and we believe larger banks did a better job of holding on to customer funds, contributing to positive margin and interest income outlooks in some cases. For capital markets, revenues declined year over year across investment banking segments as weakness in underwriting continued. Fixed income trading helped offset lower equity trading volumes. Elevated activity during COVID makes for difficult revenue comparisons in certain business segments, but importantly, we saw scant evidence of credit deterioration in loan books.

Taken together, we believe preferred credit spreads could continue trading near current levels. Tight financial conditions could keep economic growth muted, but strong consumer balance sheets should help limit credit losses. Interest rates have started to stabilize as policy rates approach terminal estimates and financial stability concerns subside. A sharp recovery may not be in the imminent future, but attractive total returns don't require a rebound in risk assets or a policy pivot. Preferred investors are now collecting the highest yields post Global Financial Crisis while they wait for a broader recovery.

DISPLAY 1

Returns

INDEX	1W	MTD	QTD	YTD	2021
BofA Fixed Rate Preferred Index	-0.15	-1.99	-1.99	-16.44	2.24
25 Par Preferreds	-0.59	-5.05	-5.05	-21.05	3.27
1000 Par IG	0.35	-0.62	-0.62	-13.60	2.46
1000 Par HY	0.29	-0.91	-0.91	-16.16	6.33
USD CoCo	0.15	1.40	1.40	-16.12	4.05
US High Yield	-0.41	2.85	2.85	-12.19	5.36
US Corporate	-0.25	-1.11	-1.11	-19.24	-0.95
5-10yr. Financials	-0.30	-1.14	-1.14	-19.40	-1.42

Metrics

INDEX	CY	YTW	YTM	OAS	EFF. DUR.
BofA Fixed Rate Preferred Index	6.05	7.20	7.39	227	5.78
25 Par Preferreds	6.87	7.36	7.43	227	8.42
1000 Par IG	5.78	7.65	7.93	288	3.39
1000 Par HY	6.51	8.56	8.74	390	3.09
USD CoCo	7.20	9.12	9.24	415	2.27
US High Yield	6.73	9.06	9.08	461	4.13
US Corporate	4.30	5.98	5.99	164	6.71
5-10yr. Financials	4.28	6.37	6.38	221	6.20

Source: Bloomberg, as of October 31, 2022.

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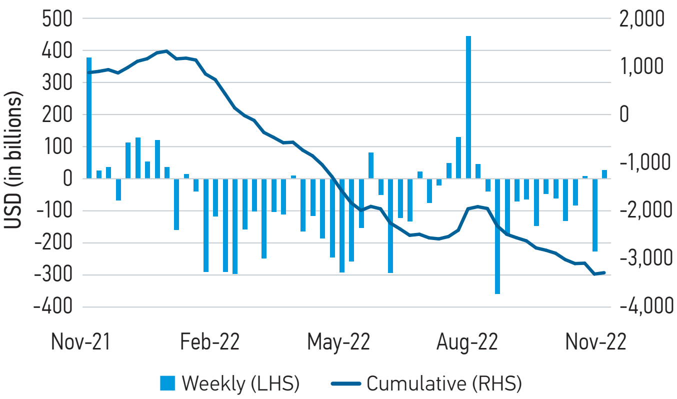
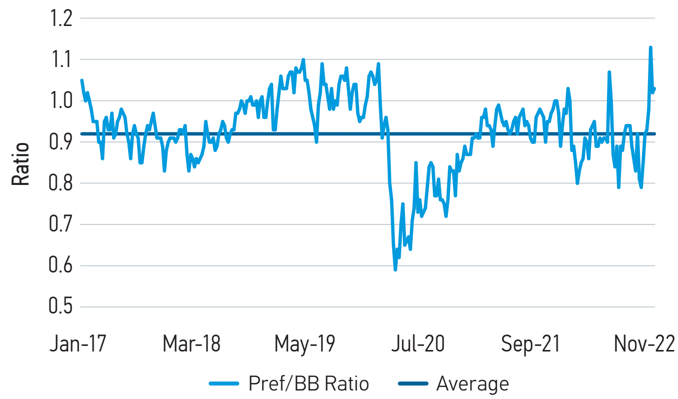
DISPLAY 2

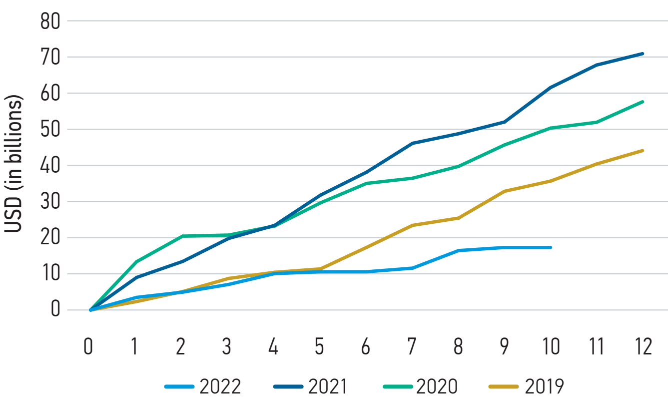
Preferred ETF Flows



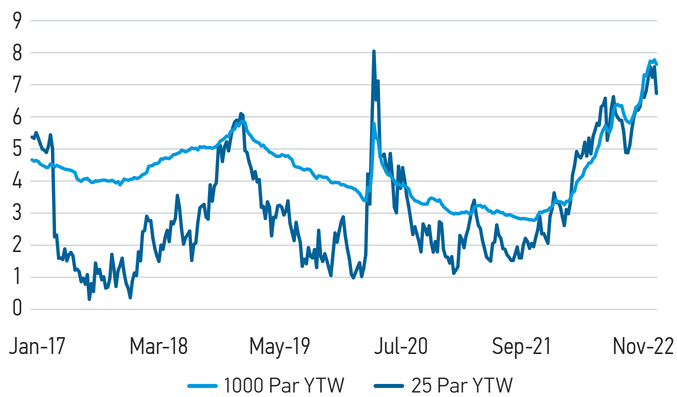
Ratio of 1000 Par to BB High Yield OAS



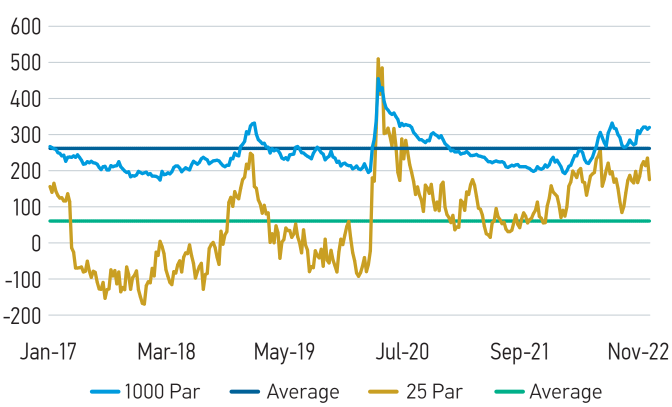
Cumulative U.S. Preferred Issuance



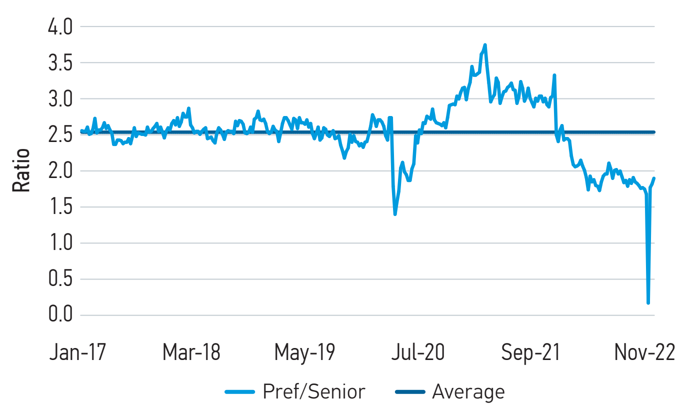
Yield to Worst: 1000 Par and 25 Par



25 and 1000 Par OAS



Ratio of 1000 Par to Senior Financial OAS



All chart data from Bloomberg as October 31, 2022. **Past performance is no guarantee of future results.**
All performance data from Bloomberg as of October 31, 2022

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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. **Municipal securities** are subject to early redemption risk and sensitive to tax, legislative and political changes. **Taxability Risk:** Changes in tax laws or adverse determinations by the Internal Revenue Service ("IRS") may make the income from some municipal obligations taxable. By investing in investment company securities, the portfolio is subject to the underlying risks of that investment company's portfolio securities. In addition to the Portfolio's fees and expenses, the Portfolio generally would bear its share of the investment company's fees and expenses. **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. In addition to the risks associated with common stocks, investments in convertible securities are subject to the risks associated with fixed-income securities, namely credit, price and interest-rate risks. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk.

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 **iBoxx Contingent Convertible Indices** represent the developed and emerging market Contingent Convertible (CoCo) fixed income market for EUR, GBP and USD denominated bonds.

The **Bloomberg U.S. Corporate 1-3 Year Index** measures the investment grade, fixed-rate, taxable corporate bond market with 1-3 year maturities.

The **CIPS/Markit UK Manufacturing Purchasing Managers' Index (PMI)** is a composite index based on five of the individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment - 0.2, Suppliers' Delivery Times - 0.15, Stock of Items Purchased - 0.1, with the Delivery Times Index inverted so that it moves in a comparable direction.

The **Citigroup Economic Surprise Indices** are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating consensus.

The **ICE BofAML Contingent Capital Index** tracks the performance of investment grade and below investment grade contingent capital debt publicly issued in the major domestic and Eurobond markets.

The **ICE BofAML Core Plus Fixed Rate Preferred Securities Index** tracks the performance of fixed-rate US dollar-denominated preferred, U.S.-domiciled securities.

The **ICE BofAML Eurodollar Banking Index** is a subset of ICE BofAML Eurodollar Index including all securities of Bank Issuers and tracks the performance of US dollar denominated investment grade quasi-government, corporate, securitized and collateralized debt publicly issued in the eurobond markets.

The **ICE BofAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate, U.S. dollar denominated, investment-grade preferred securities in the U.S. domestic market.

The **ICE BofAML U.S. All Capital Securities Index** is a subset of the ICE BofA Merrill Lynch U.S. Corporate Index including all fixed-to-floating rate, perpetual callable and capital securities.

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

The **ICE BofAML U.S. Corporate Index (C0A0)** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market.

The **ICE BofAML U.S. Corporate BB Index** is a subset of the ICE BofAML US High Yield Master II Index tracking the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating BB.

The **ICE BofAML U.S. Corporate B Index** is a subset of the ICE BofAML US High Yield Master II Index tracking the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating B.

The **ICE BofAML U.S. Corporate C Index** is a subset of the ICE BofAML US High Yield Master II Index tracking the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market. This subset includes all securities with a given investment grade rating CCC or below.

The **ICE BofAML U.S. High Yield Institutional Capital Securities Index** (HIPS) tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issues in the US domestic market.

The **ICE BofAML U.S. Investment Grade Institutional Capital Securities Index** (CIPS) tracks the performance of US dollar denominated investment grade hybrid capital corporate and preferred securities publicly issued in the US domestic market.

KBW Bank index measures the performance of leading banks and institutions that are engaged in banking activities.

Current yield is a measure that looks at the current price of a bond instead of its face value and represents the return an investor would expect if he or she purchased the bond and held it for a year. Calculated by dividing the Annual Cash Inflows / Market Price.

Effective duration takes into account that expected cash flows will fluctuate as interest rates change.

Option Adjusted Spread is a measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst would use the Treasury securities yield for the risk-free rate. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond.

Yield-To-Maturity is the rate of return anticipated on a bond if it is held until the maturity date.

Yield-To-Worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting. The yield to worst is calculated by making worst-case scenario assumptions on the issue by calculating the returns that would be received if provisions, including prepayment, call or sinking fund, are used by the issuer.

IMPORTANT DISCLOSURES

One basis point = 0.01%

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's relevant offering document.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index.

A minimum asset level is required. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

For important information about the investment managers, please refer to Form ADV Part 2.

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