Morgan Stanley

INVESTMENT MANAGEMENT

Fixed Income Newsletter

Preferred Market Update

FIXED INCOME MANAGED SOLUTIONS | MARKET INSIGHT | JANUARY 2023

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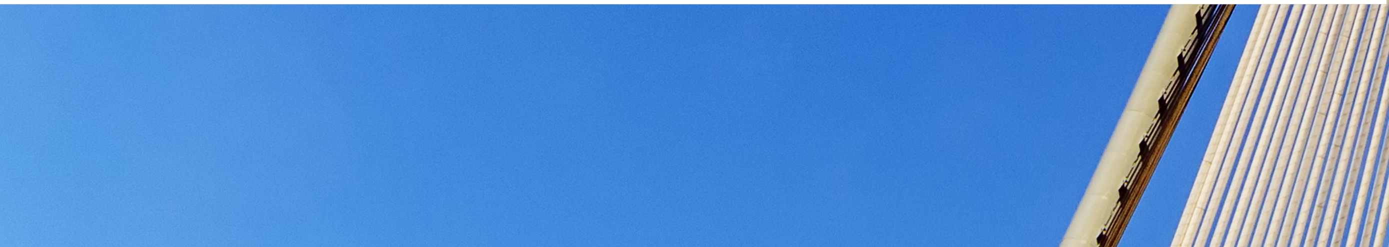
Preferreds roared back in January as investor demand for income and subsiding economic concerns led to a broad rally in credit. Combined with the end of 2022 tax loss harvesting and a 37 basis point decline in the 10 year Treasury rate, ICE BoA Fixed Rate Preferred Index, rose over 9% in the month. The $25 par market reversed December underperformance and more, jumping 13% in January. $1000 par Investment Grade (IG) spreads moved tighter throughout the month, with the index finishing 5% higher.[1] Thematically, results for financial institutions continued to suggest peaking, but still resilient, fundamentals.

The blistering start for preferreds in 2023 is as much about last year as this one. We observed portions of the preferreds market lag in Q4 despite financials outperformance in senior bonds, and suspected tax loss harvesting was weighing on the market. In hindsight, we believe a historically weak 2022 may have contributed to a pronounced January effect as retail preferreds led the market higher.

Fundamentals and the economic outlook remain favorable for preferred issuers, in our view, which was also largely the case four weeks ago. But the investor debate has shifted from hard versus soft landing, to whether recession occurs at all in 2023.

[1] Source: Bloomberg as of January 31, 2023.

Past performance is no guarantee of future results. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. See Disclosure section for index definitions.



The main factor contributing to the shift is the continued strength in the labor market. Combined with declining inflation, yield buyers have been more comfortable stepping into the market for historically high yields.

High yield-rated preferreds outperformed in January as credit spreads rallied and earnings results allayed investor fears in a couple of idiosyncratic cases. The two top performing issuers in $1000 par both saw their equity prices jump over 10% following earnings. In the first, an auto lender confirmed net interest margin guidance for the year, among other positive factors. For the other, a venture capital-linked bank, deposit declines slowed from the prior quarter's pace, allowing spreads to compress closer to senior bond levels.[2] As we have commented previously, net charge offs are trending higher for financials, but new information in Q4 earnings did nothing to shift our expectations for losses this year in-line with historical averages.

Results were generally solid, if unremarkable, for financials. Lending standards are tightening, and commercial loan growth is slowing, while consumer card spending is decelerating as balances rise. For the largest banks, overall loan growth remained positive, but net interest income outlooks implied a slowdown from the Q4 run rate as net interest margins decline with increasing deposit costs. Focus categories such as commercial real estate, auto lending, and consumer finance didn't reveal alarming trends in asset quality, but some auto insurers had difficult quarters, which we believe could precede future downgrades.

The primary market was quiet again in January. A 65 million $25 par REIT was the lone deal before a regional bank decided to try the $1000 par market the first week of February.[3] Refinancing a Libor-based security with a coupon over 8%, the 1.5 billion deal carried a 6.25% coupon with a 7-year call and 280 basis point back-end. As the market continues to rally, we could see more issuers come the market later this year. As one example, a card issuer opted for a subordinated bond in January, after indicating the potential for a preferred issue on its earnings call. We would not be surprised to see other card issuers follow suit and optimize their capital structures with preferreds as the market improves.

The lack of supply is a positive technical, but it can also indicate how issuers view market conditions. Back in November, a GSIB bank tendered for 1.5 billion in preferreds across $25 and $1000 par, with investors only agreeing to part with approximately $700 million. December had no supply at all outside of a $25 par insurance issue. In January, another GSIB bank elected to skip the call on a security with an above-market 406 basis point back-end spread, instead of refinancing. The implication is issuers could be anticipating a better environment than the current one to issue securities. While spreads are tighter year to date, valuations are reasonable and demand is strong, and we believe investors hoping to buy the dip may get limited opportunities this year.

DISPLAY 1

Returns

INDEX	MTD	QTD	YTD	2022
BofA Fixed Rate Preferred Index	9.25	9.25	9.25	-14.60
25 Par Preferreds	13.72	13.72	13.72	-20.71
1000 Par IG	4.98	4.98	4.98	-10.19
1000 Par HY	8.06	8.06	8.06	-14.12
USD CoCo	4.87	4.87	4.87	-11.31
US High Yield	3.91	3.91	3.91	-11.22
US Corporate	3.89	3.89	3.89	-15.45
5-10yr. Financials	4.55	4.55	4.55	-15.35

Metrics

INDEX	CY	YTW	YTM	OAS	EFF. DUR.
BofA Fixed Rate Preferred Index	5.46	5.66	6.39	123	5.05
25 Par Preferreds	6.01	5.62	6.05	98	7.05
1000 Par IG	5.34	6.24	7.07	218	3.51
1000 Par HY	5.93	7.32	7.88	312	3.32
USD CoCo	6.61	7.27	7.80	300	2.66
US High Yield	6.41	7.76	7.83	394	3.86
US Corporate	4.03	4.92	4.95	121	7.06
5-10yr. Financials	4.03	5.05	5.12	160	6.27

Source: Bloomberg, as of January 31, 2023.

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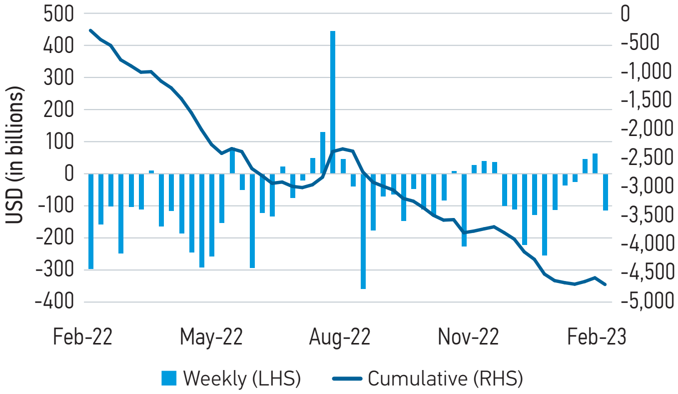
[2] Source: Bloomberg, as of January 31, 2023.

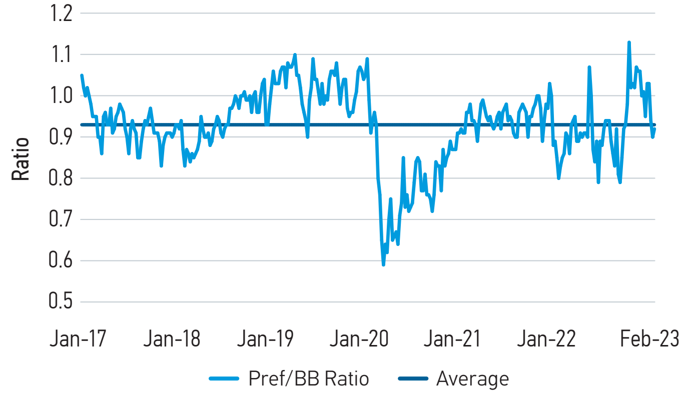
[3] Source: Bloomberg, as of January 31, 2023.

DISPLAY 2

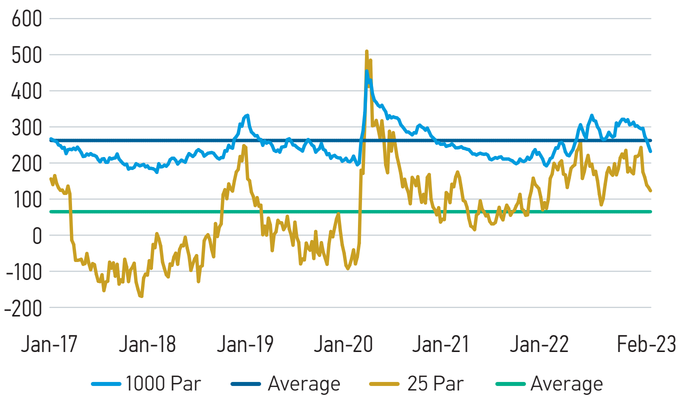
Preferred ETF Flows



Ratio of 1000 Par to BB High Yield OAS

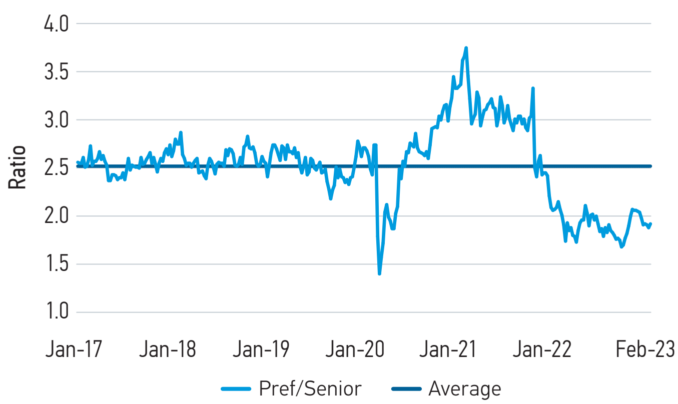


25 and 1000 Par OAS

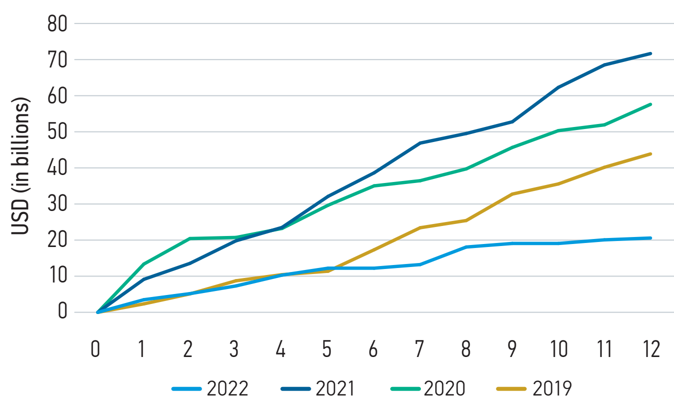


Yield to Worst: 1000 Par and 25 Par

Ratio of 1000 Par to Senior Financial OAS



Cumulative U.S. Preferred Issuance



All chart data from Bloomberg as January 31, 2023. **Past performance is no guarantee of future results.**
All performance data from Bloomberg as of January 31, 2023.

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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%

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