Morgan Stanley

INVESTMENT MANAGEMENT

Fixed Income Newsletter

Preferred Market Update

FIXED INCOME MANAGED SOLUTIONS | MARKET INSIGHT | APRIL 2023

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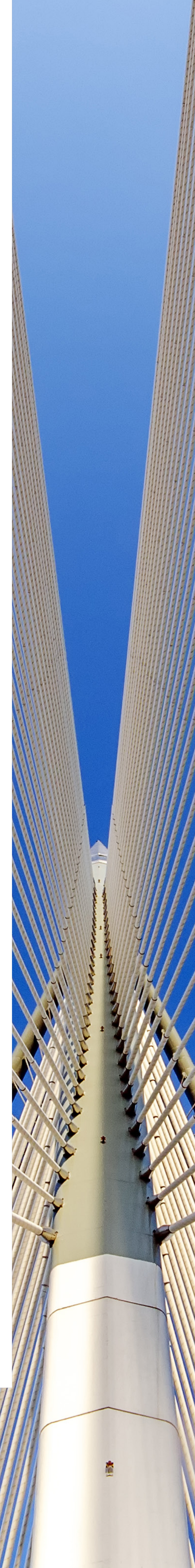
Regional bank failures delivered the strongest shock to the financial sector since 2008, sending preferred indices lower in March. With 86% of market weight in financials, the ICE Preferred BofA Index declined 3.3% to end the first quarter up 3.3%. Index performance varied widely based on exposure to troubled issuers. The $1000 par High Yield index dropped 8.9% to finish Q1 down 3.46%, while the USD Contingent Convertibles index declined 13.7% to end the quarter down 11.05%.[1] In this month's note, we address recent developments and the outlook for the sector.

Rapid deposit flight led regulators to take over a venture capital-focused regional bank, while a New York lender was placed in receivership that weekend. A week later, Swiss regulators forced a bank merger, writing down the contingent convertibles for the largest constituent in the USD index. The swift value destruction shocked investors, and they quickly turned their attention to broader implications, sending preferred spreads in March to the widest levels since the summer of 2020.

We believe there are two concerns for regional banks: the liquidity risk, and the intermediate impact of the recent episode on future profitability. We believe policymakers can address the first issue through lending programs, changes in deposit



[1] Source: Bloomberg as of March 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.

insurance and capital requirements. But higher borrowing costs could linger for regional banks, which makes for a more challenging operating environment.

Policy changes may already be having a positive impact. In a joint statement, the Treasury, Federal Reserve and FDIC guaranteed deposits of the two failed banks, giving depositors immediate access to their funds. This action may have set a precedent for how regional bank failures might be handled going forward. If that is the case, it may have also expanded the implicit deposit guarantee beyond systemically important banks. The FDIC is putting forward proposals on May 1st that include changes to deposit insurance.

Separately, the Fed established the Bank Term Funding Program (BTFP). Borrowing rates are slightly lower than the Fed discount window, but the main feature is the ability for banks to access liquidity with securities valued at par, to avoid liquidating portfolios and realizing losses. Combined borrowing at the Fed window and BTFP exceeded 160 billion the first week of the program but has since declined marginally through the week ending 3/29.[2] Based on public disclosures, three banks account for most borrowing, indicating limited stress beyond those institutions.

However regional banks are not out of the woods, as higher borrowing costs and increased capital requirements could weigh on profitability. On the regulatory side, we could see liquidity coverage ratio extended to regional banks and annual stress test assumptions updated to better account for interest rate and liquidity risk. Regulators were already considering extending “Total Loss Absorbing Capital”, or TLAC, requirements to the regional banks at the start of the year, and that likelihood has only increased. Banks may need to compete more aggressively for deposits and move to lock in longer-term funding through CDs, the Federal Home Loan Bank and bond issuance. The net effect, in our view, is lower profitability.

DISPLAY 1

Returns

INDEX	MTD	QTD	YTD	2022
BofA Fixed Rate Preferred Index	-3.32	3.34	3.34	-14.60
25 Par Preferreds	-5.58	4.42	4.42	-20.71
1000 Par IG	-2.52	1.10	1.10	-10.18
1000 Par HY	-8.90	-3.46	-3.46	-14.12
USD CoCo	-13.67	-11.05	-11.05	-11.29
US High Yield	1.13	3.72	3.72	-11.22
US Corporate	2.56	3.45	3.45	-15.44
5-10yr. Financials	1.96	3.57	3.57	-15.35

Metrics

INDEX	CY	YTW	YTM	OAS	EFF. DUR.
BofA Fixed Rate Preferred Index	5.89	6.96	7.17	229	5.15
25 Par Preferreds	6.74	7.26	7.42	221	7.64
1000 Par IG	5.65	7.40	7.66	302	3.09
1000 Par HY	6.82	8.93	9.02	459	2.71
USD CoCo	8.31	8.94	8.95	479	1.95
US High Yield	6.71	8.79	8.82	483	3.83
US Corporate	4.18	5.38	5.40	150	6.81
5-10yr. Financials	4.19	5.64	5.69	197	6.17

Source: Bloomberg, as of March 31, 2023.

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First quarter results will be the most anticipated since the financial crisis, in our opinion, with a particular focus on deposit costs and flows. Lending standards were already increasing before the recent episode, and we expect banks to continue tightening purse strings. Regional bank portfolios skew toward commercial real estate, which could come into closer focus as well. Earnings expectations could come down considerably as net interest margin compresses. As credit investors, we tend to focus on asset quality, but higher earnings volatility and deposit tail risk has made net interest margin top of mind for all.

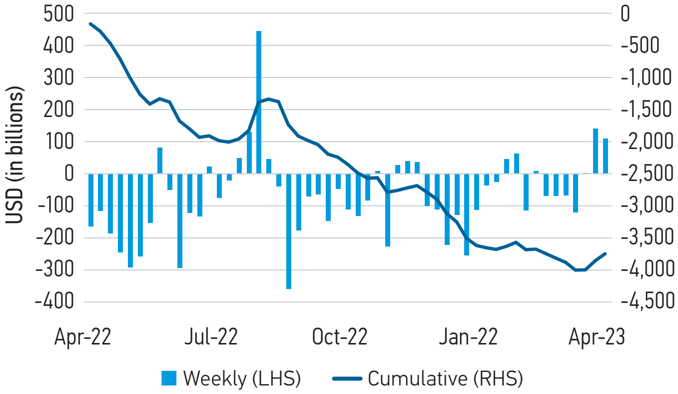
While we recognize the challenges for regional banks, portfolio decisions come down to what is in the price. Many securities are priced for a worse outcome than operational headwinds, in our view. As an example, in early summer 2020, markets reopened after the onset of COVID, and we saw a group of regional banks issue 1000 par preferreds. That vintage trades at wider spreads today, which is overdone, in our opinion.

To the extent banking stress is an unintended consequence of rapidly tightening financial conditions, that is something policymakers can adjust, and forward rate expectations are already resetting lower. Monetary and fiscal policy played a large role in the rapid balance sheet expansion for U.S. banks

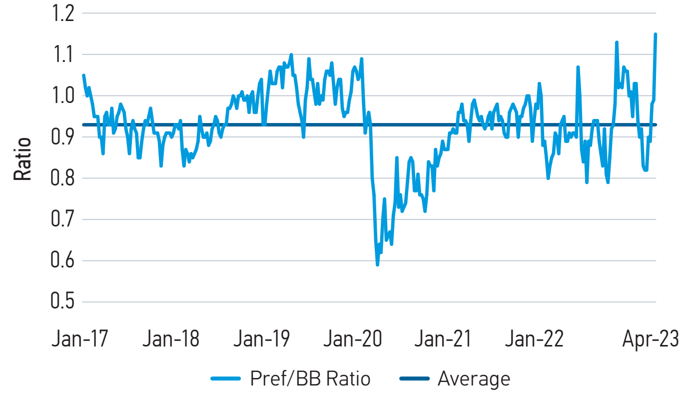
[2] Source: FederalReserve.gov

DISPLAY 2

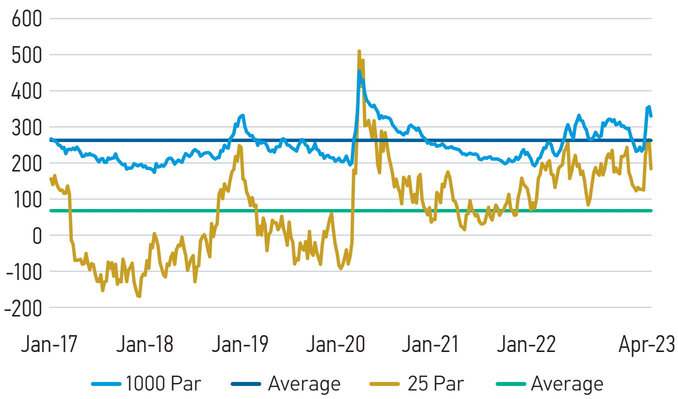
Preferred ETF Flows



Ratio of 1000 Par to BB High Yield OAS

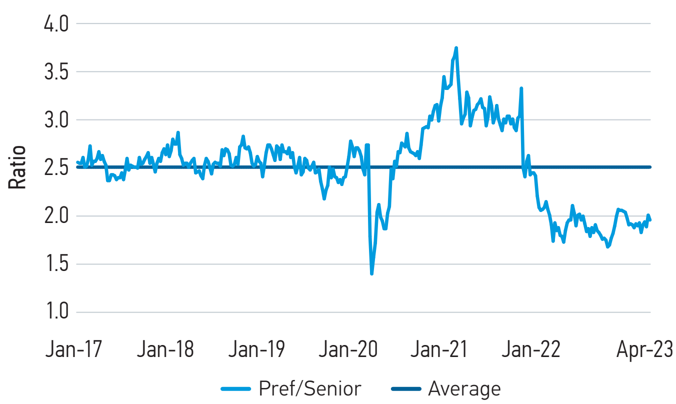


25 and 1000 Par OAS

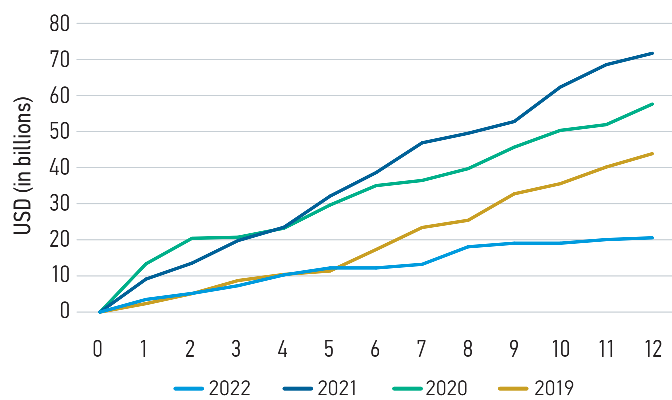


Yield to Worst: 1000 Par and 25 Par

Ratio of 1000 Par to Senior Financial OAS



Cumulative U.S. Preferred Issuance



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

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during 2021 that helped bring us here. While banks are now competing for deposits, it was only two years ago large banks were forced to issue preferreds to meet supplementary leverage ratio requirements as deposits flooded in. The Federal Reserve was established over a century ago largely in response to bank runs, and while recent high-velocity deposit flight is a modern-era tail risk, we believe fractional reserve banking is here to stay and liquidity issues can be contained through existing and additional measures, if necessary.

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 I CE B ofAML 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 (COAO)** 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.

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