Morgan Stanley

US Credit Strategy
Morgan Stanley Research
North America

IACPM Webinar – 2023 US Credit Outlook

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Morgan Stanley & Co. LLC

Executive Summary

Soft landing for growth, but not for earnings...

- Our economists expect global growth to step down to 2.2%Y in 2023, below the 3%Y threshold for a recession. The US narrowly avoids a recession but cumulative effects of Fed tightening result in muted 0.5%Y GDP growth in 2023, followed by subdued <1%Y growth in 2024. The euro area and UK enter a recession and recovery in 2024 is tepid.
- Earnings and margin risks loom large in both the US and Europe. For December 2023, we are 16% and 14% below bottom-up consensus in the US and Europe, respectively.

…inflation eases at a gradual pace

- Inflation should decline from its peak this year with base effects of commodity prices, and modest supply chain normalization.
- Labor hoarding and rental inflation are likely to keep core CPI above the Fed's target in 2023. Unemployment rises slowly to 4.3% by year-end.
- Policy rates in most developed markets peak in 1Q. Our economists expect the Fed to pause at 4.50-4.75%, but the pause lasts for almost the entire year.

Healthy yields and strong fundamentals limit downside for IG even in a recession, leveraged credit more exposed

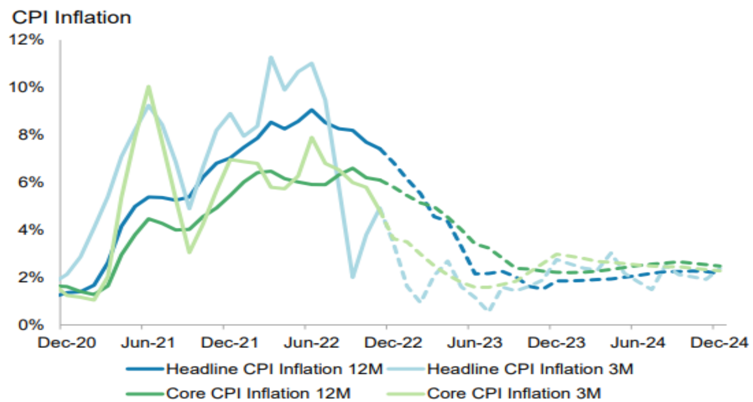
- We expect IG spreads to trade in a range, delivering marginally positive excess returns. Locally, spreads are at the tight end of this range and should drift wider in early 2023 on earnings fears. However, the downside for IG is more muted and better defined than growth-sensitive assets. Regionally, we favor Europe and Asia over the US.
- In the US, we like (1) long-duration, low-dollar bonds, (2) a quality barbell of single As with low BBBs, and (3) Banks/Energy across sectors.

Add some upside convexity in HY while staying defensive in leveraged loans

- We forecast ~125bp widening in US HY, resulting in negative excess returns and 5% total returns. We favor a barbell of BBB/BB for income and deep discount, and higher-beta paper to enhance convexity.
- We prefer staying up in quality within leveraged loans; B2s look attractive. Sector-wise, we are cautious on Healthcare, Retail and Consumer Staples within the loan complex. We retain our overweight for HY Energy.

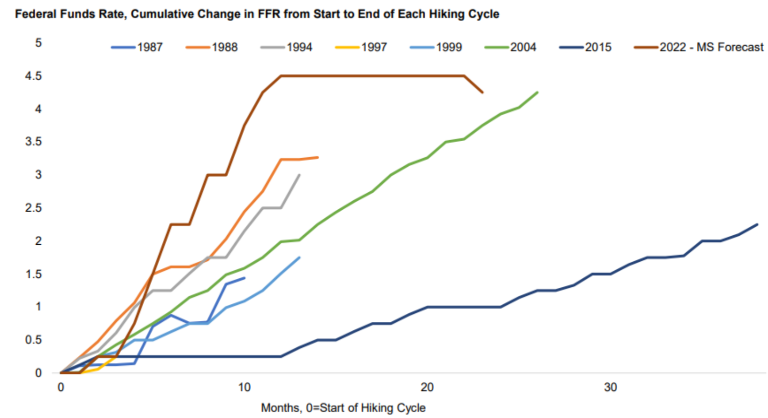
Inflation Has Peaked, but the Path to 2% Is Slow; Unemployment Rises Slowly

Inflation expected to decelerate sharply over the coming months but remain above target…



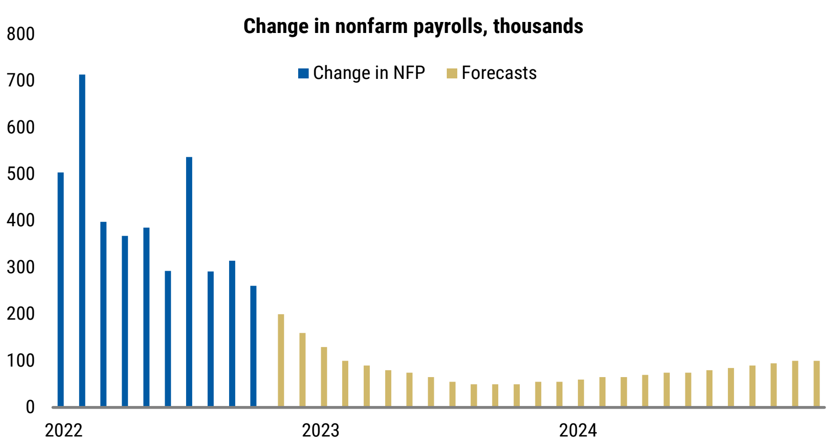
Source: Bureau of Labor Statistics, Morgan Stanley Research

…leading to Fed cuts in December



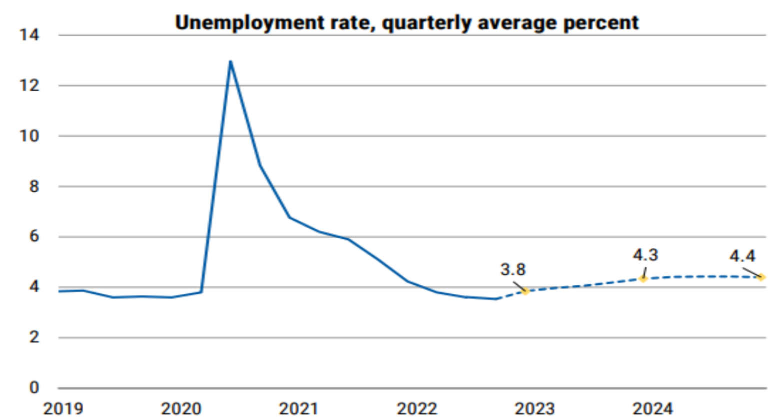
Source: Morgan Stanley Research

Payrolls to trend below 100k by the middle of 2023



Source: Bureau of Labor Statistics, Morgan Stanley Research forecasts

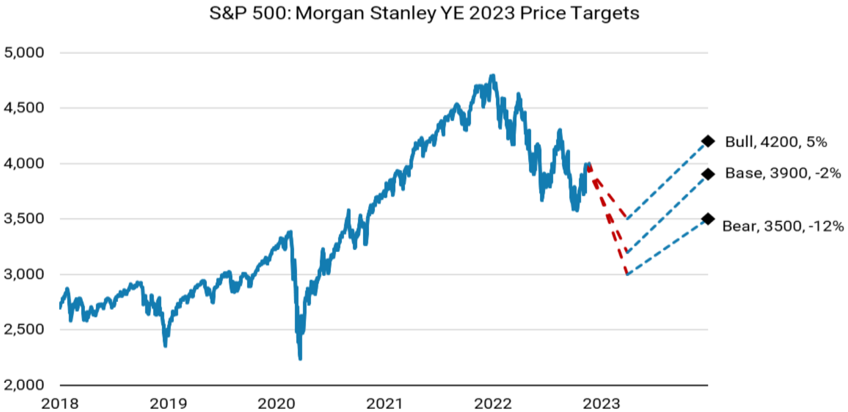
A tight labor market means the unemployment rate rises slowly



Source: Bloomberg, Morgan Stanley Research

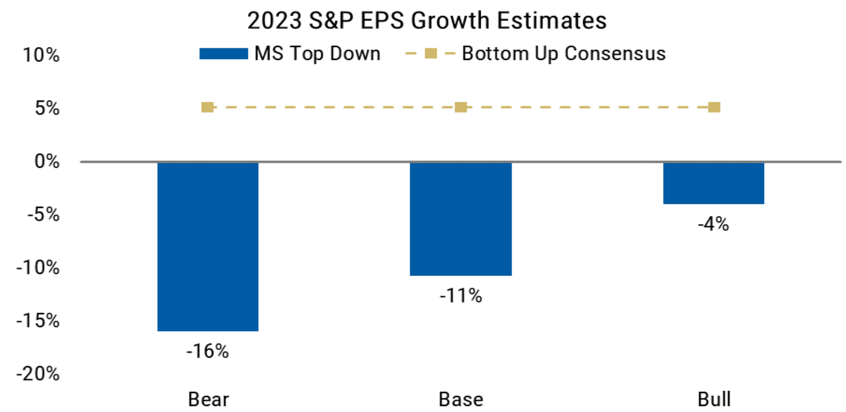
US Equities – Material Earnings Downside, But Likely Front-Loaded

2023 SPX price target is in line with current levels, but the path will likely be volatile



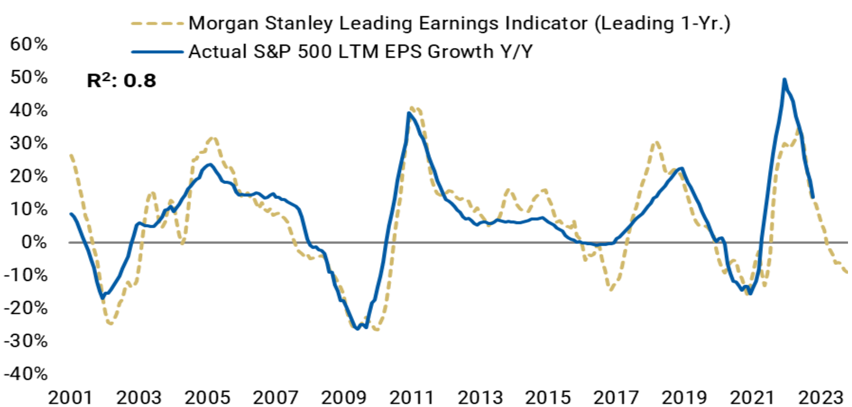
Source: Bloomberg, Morgan Stanley Research forecasts

We see the S&P 500 discounting 2023 earnings risk some time in the first quarter of next year…



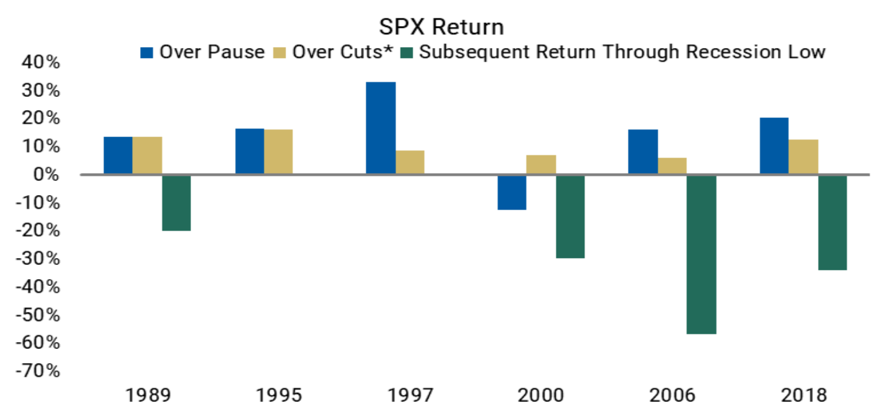
Source: Bloomberg, Morgan Stanley Research forecasts

…as Morgan Stanley's leading earnings indicator points to significant downside to EPS growth ahead



Source: FactSet, Bloomberg, Morgan Stanley Research; Note: Inputs: ISM Mfg. PMI, Conference Board Consumer Confidence, housing starts, credit spreads. Weightings float over time based on rolling correlation of a given factor versus EPS growth.

Fed pause tends to be positive for stocks, while cuts are negative when coinciding with recessions



Source: Bloomberg, Morgan Stanley Research; Note: *Either through end of cuts mid cycle or market peak immediately preceding recession/during cuts.

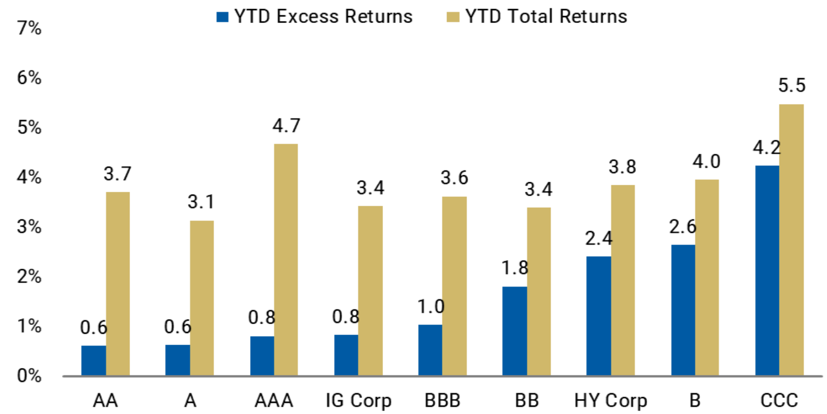
2023 US Credit Strategy Forecasts

Key credit forecasts through end-2023

	Current	Bull	Base	Bear
Index Spread (bp)				
IG	124	125	**155**	210
HY	407	400	**575**	700
Loans	523	500	**700**	850
Excess Return				
IG		1.1%	**-0.9%**	-4.4%
HY		3.7%	**-3.5%**	-9.0%
Loans		5.5%	**-0.7%**	-6.7%
Total Return				
IG		-	**4.6%**	-
HY		-	**3.8%**	-
Loans		-	**3.9%**	-
Defaults - 12M				
HY	1.4%	3.0%	**4.0%**	6.0%
Loans	0.8%	2.0%	**3.0%**	6.0%
2023 Full Year Gross Issuance ($bn)				
IG		-	**1,250-1,450**	-
HY		-	**175-200**	-
Loans		-	**250-275**	-

Source: Bloomberg, PitchBook LCD, Dealogic, Moody's, Morgan Stanley Research forecasts; Note: Pricing as of Jan 13, 2023.

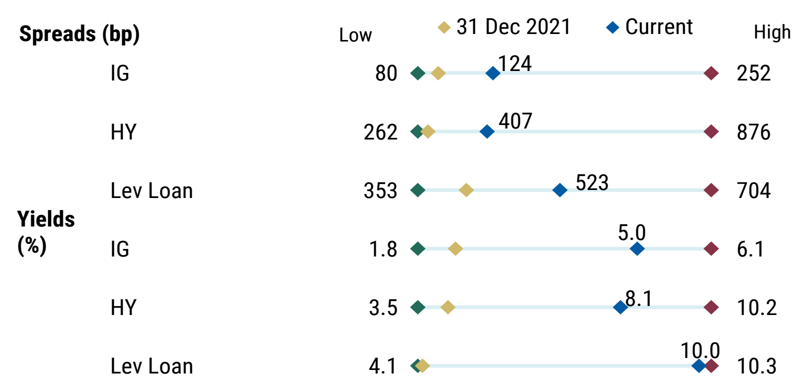
Credit markets off to a strong start in 2023 after poor performance in 2022…



Source: Bloomberg. Morgan Stanley Research

…but growth risks are not fully priced in yet, particularly for leveraged credit

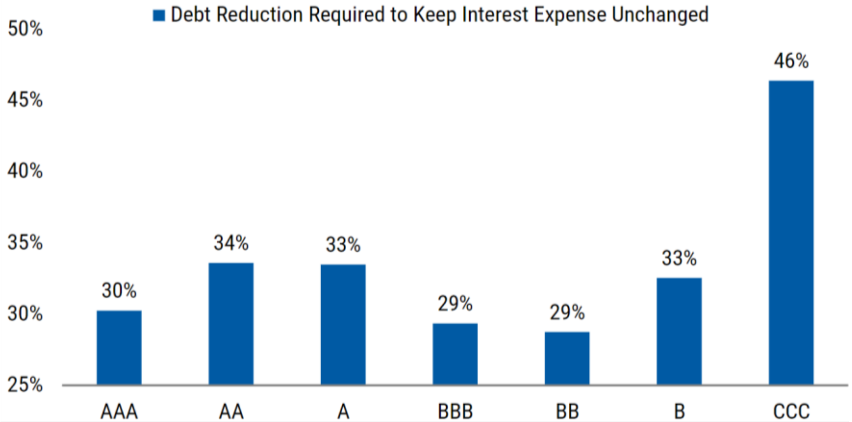
US Credit Spread & Yield Ranges (2011 - Current*)



Source: Bloomberg, Morgan Stanley Research

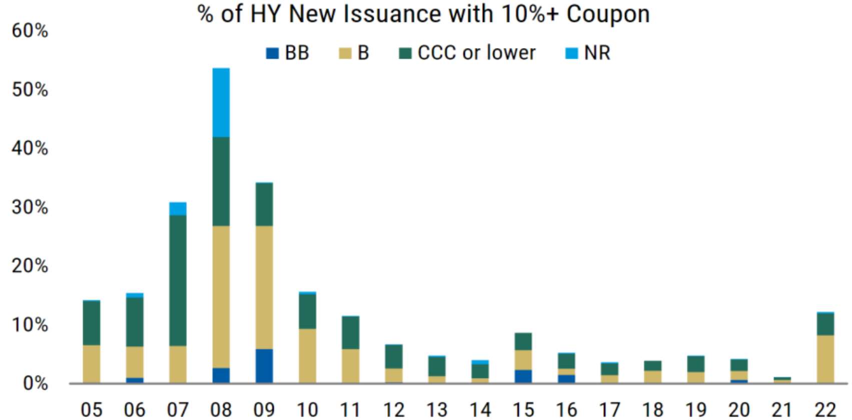
Corporate Finance in a Higher Yield Regime

Achieving a sustainable capital structure will require lower leverage in a higher rates environment



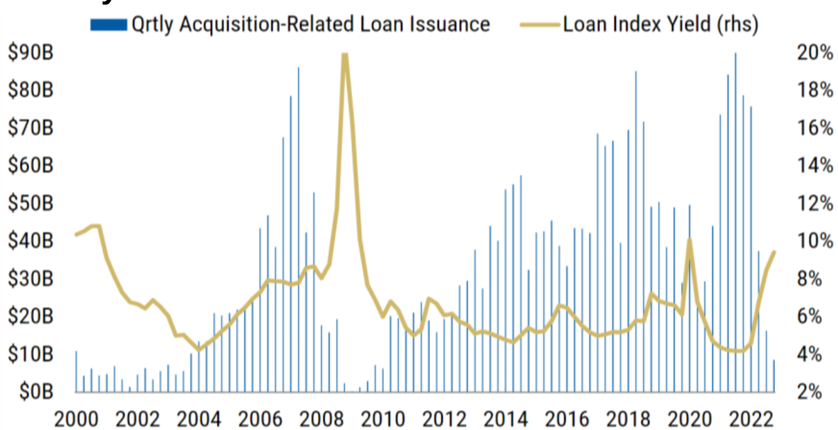
Source: ICE, Bloomberg, Morgan Stanley Research

Double-digit coupons pose a challenge but have proven to be feasible pre-GFC



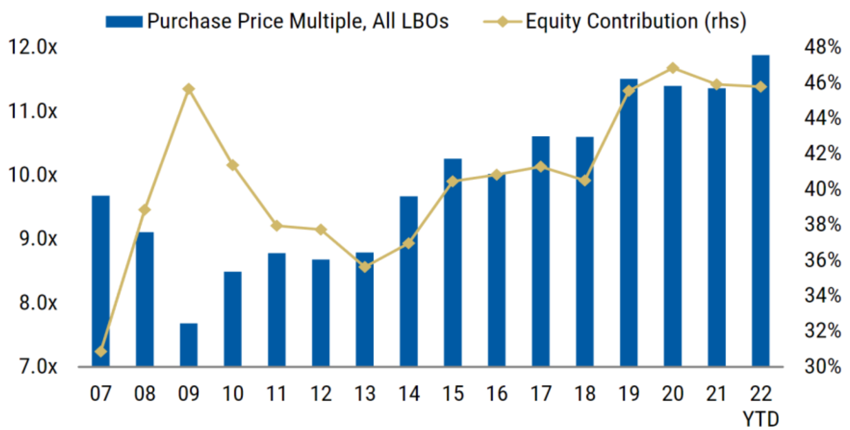
Source: PitchBook LCD, Morgan Stanley Research

Higher financing rates have weighed on acquisition activity more than usual – due to the macro outlook



Source: PitchBook LCD, Morgan Stanley Research

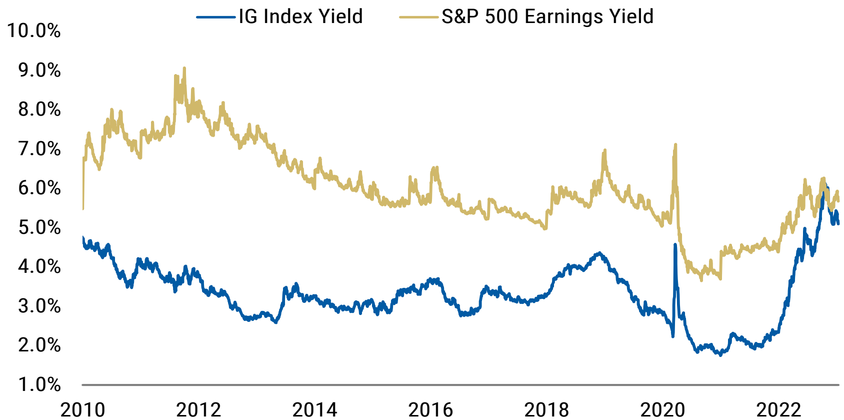
Large equity contributions lifted purchase multiples in 2021-22 – expect lower multiples this year



Source: PitchBook LCD, Morgan Stanley Research

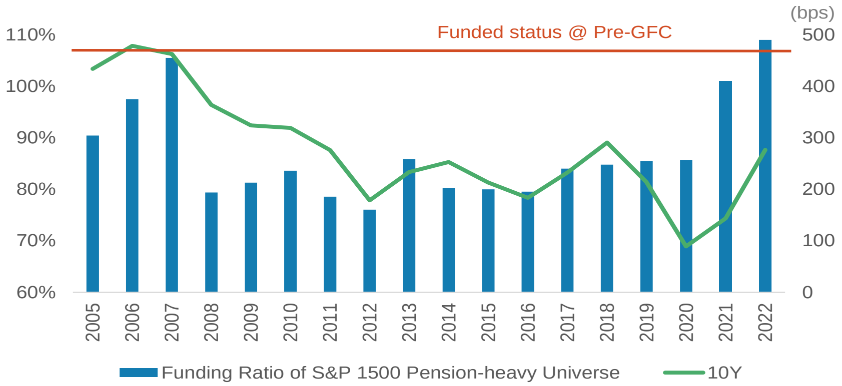
High-Quality Credit to Be a Big Beneficiary of Asset Allocation Shifts

Quality income in IG should attract more domestic demand…



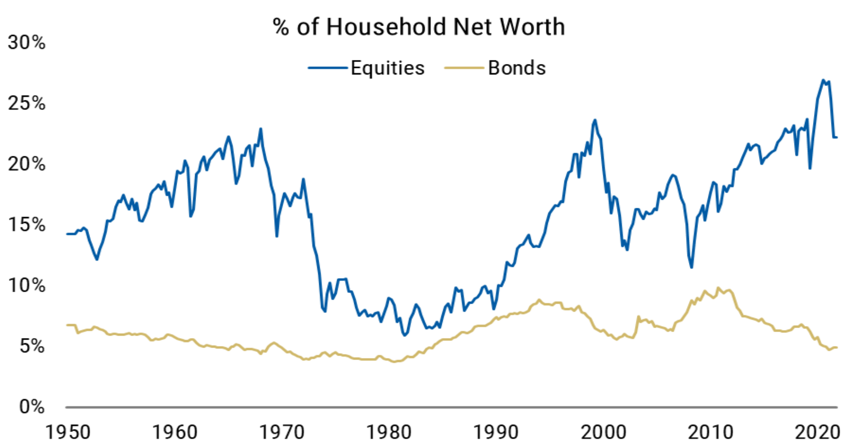
Source: Bloomberg, Morgan Stanley Research

… given elevated pension funded ratios…



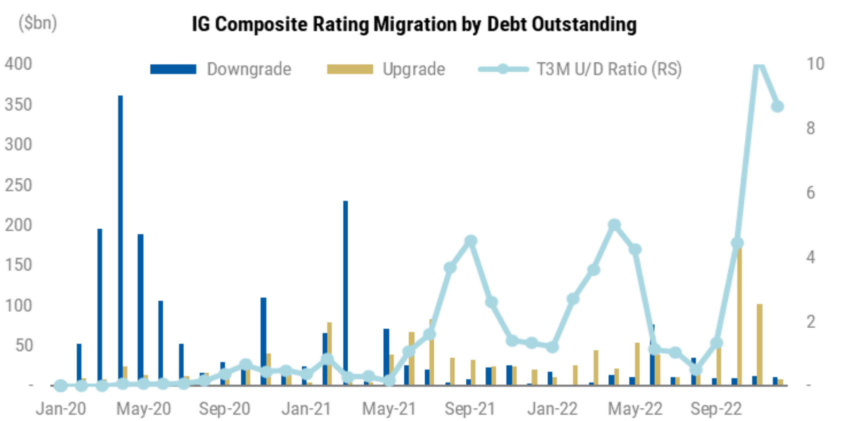
Source: Bloomberg, FactSet, Morgan Stanley Research

…and the under-allocation to bonds by households



Source: Bloomberg, Morgan Stanley Research

Fundamentals remain strong; upgrades outpacing downgrades

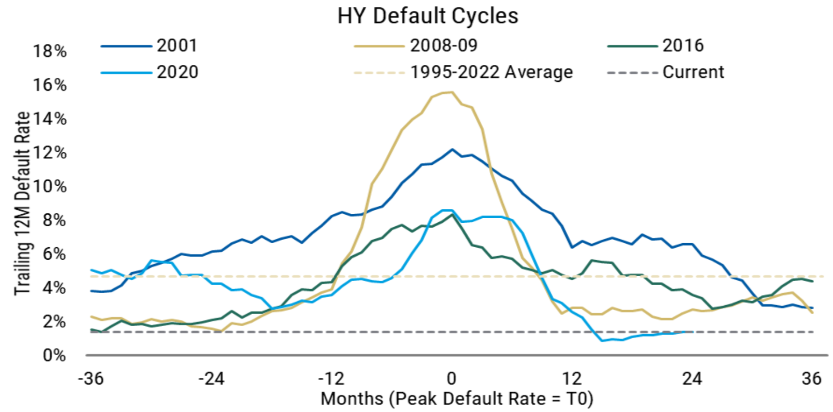


Source: Bloomberg, Morgan Stanley Research

Default Cycle – Flatter but Longer

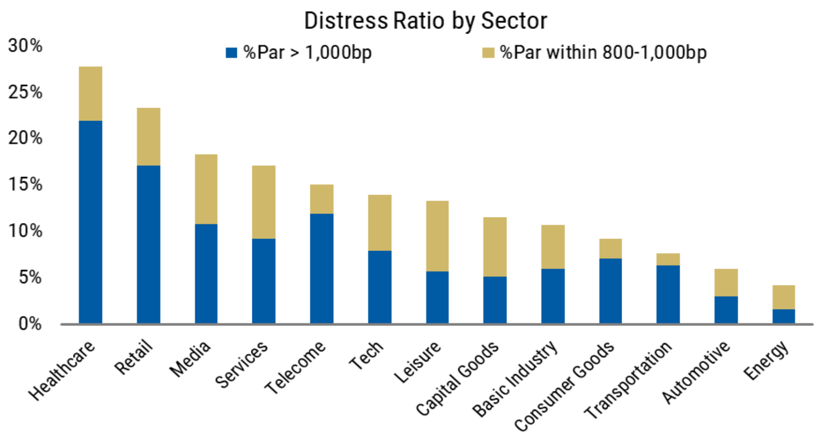
- We expect default rates to **push above historical averages** in 2023, but the lack of a clear sector problem and extended maturity walls should keep defaults inside recession peaks.
- With **maturities coming into focus** in late 2023/2024, still elevated policy rates and potentially sluggish earnings growth create a set-up for a gradual cascade of defaults.
- Solving for an **early 2000-style cycle**, where default rates could remain above average for some time beyond 2023.

We expect a flatter but potentially longer-lasting distress/default cycle



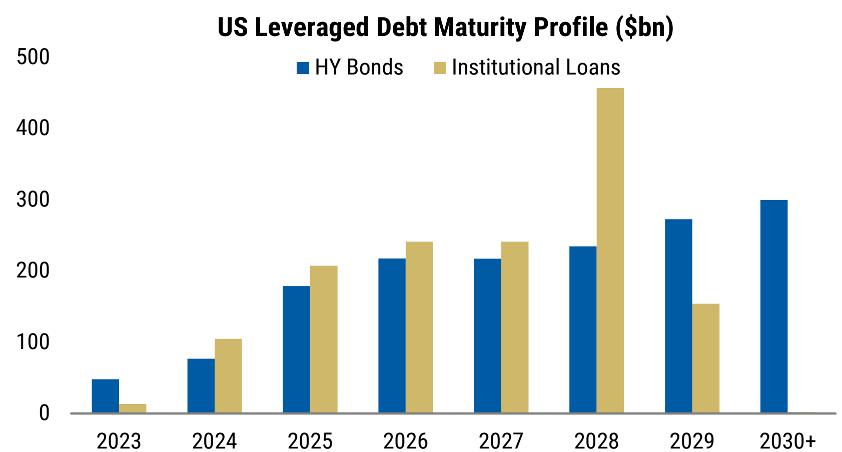
Source: Bloomberg, Moody's, Morgan Stanley Research

Distress is evenly distributed without a clearly defined problem sector



Source: ICE, Morgan Stanley Research

Refinancing channel less impactful due to termed-out maturities

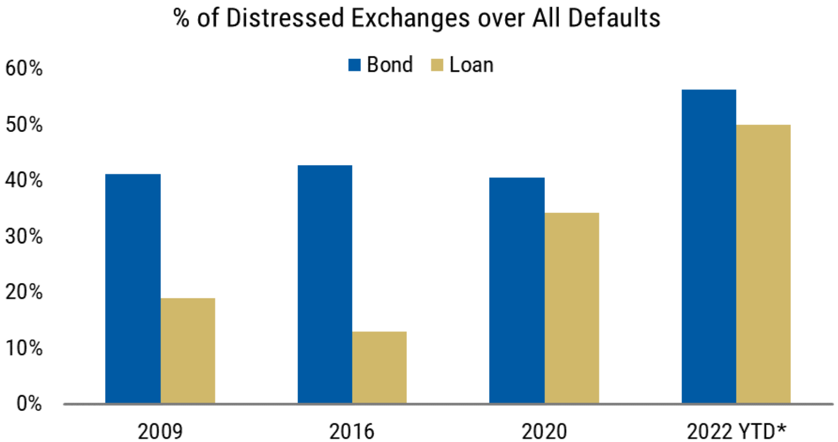


Source: PitchBook LCD, Morgan Stanley Research

Extensions and Distressed Exchanges to Play Bigger Role?

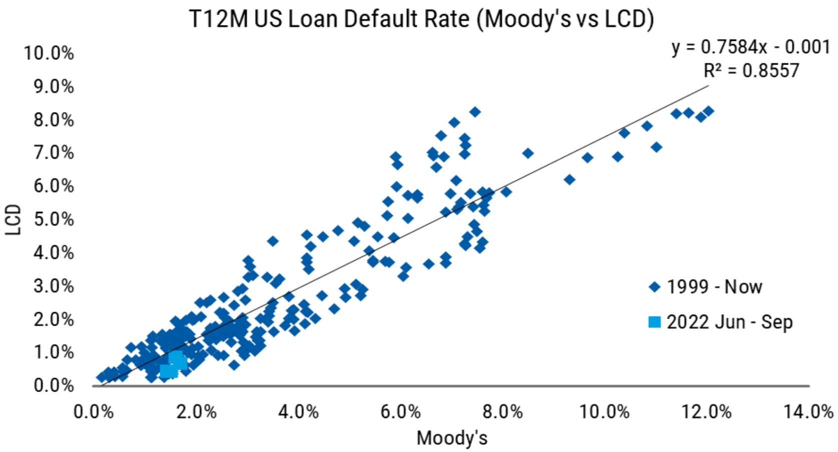
- We expect credit events to skew toward **restructurings and liability-management** exercises (vs. bankruptcy filings), due to (1) weak documentation and (2) the ability and incentive for sponsors to engage in more aggressive actions to **preserve equity in portcos.**
- Distressed exchanges have been the **most prevalent form** of default in 2022.
- Rising occurrence of DE may keep default rates in check, but raises the risk of a protracted distressed cycle.
- Recovery prospects could vary for different groups of creditors; creditor-on-creditor tension adds another layer of uncertainty.

Distressed exchanges have been gaining in popularity, especially within the leveraged loan market



Source: Bloomberg, Moody's, PitchBook LCD, Morgan Stanley Research; Note: *2022 YTD defaults are based on both Moody's and S&P. Historical defaults are exclusively from Moody's.

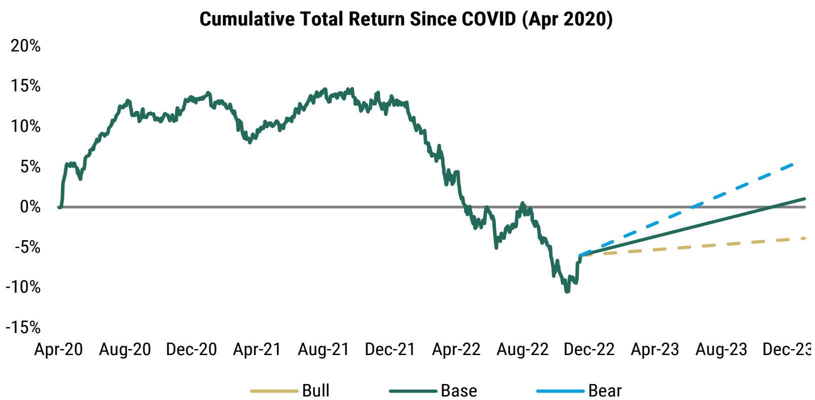
LCD's default measure may understate the broader loan default picture in this cycle



Source: Moody's, PitchBook LCD, Morgan Stanley Research

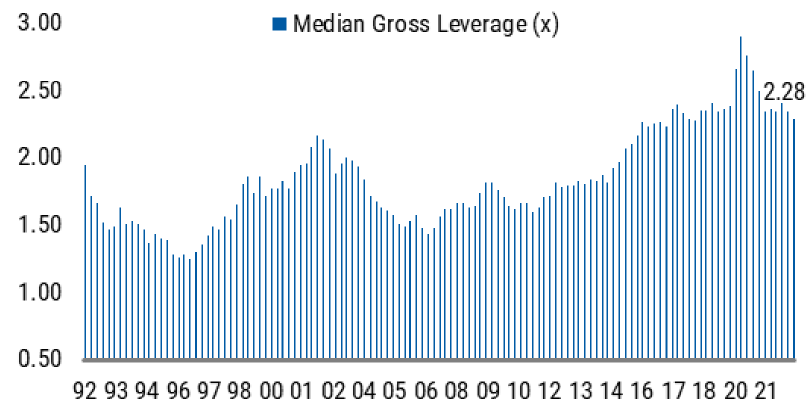
Investment Grade | Look for Income in IG in 2023

Strong total returns expected across a range of economic scenarios



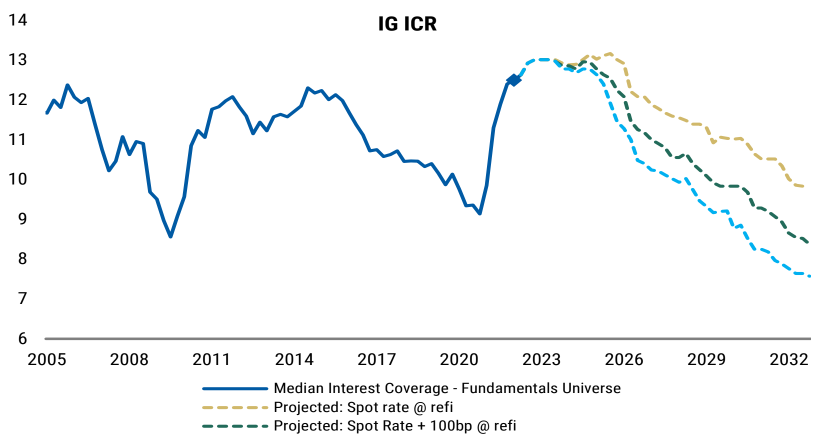
Source: Bloomberg, Morgan Stanley Research forecasts

Fundamentals remain healthy



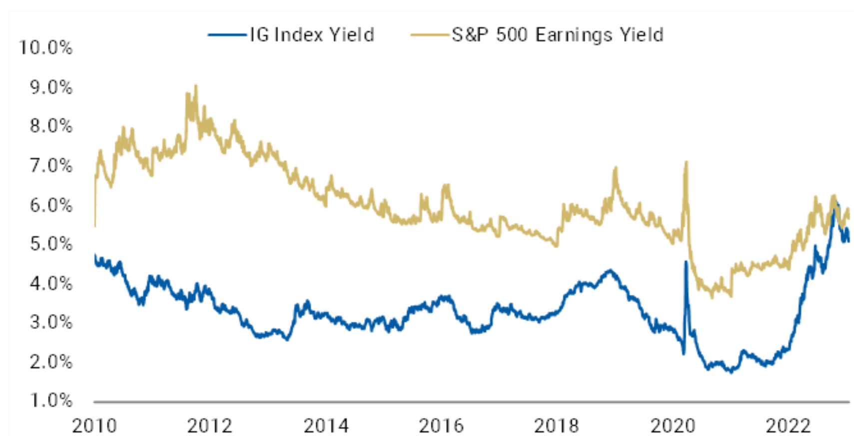
Source: Bloomberg, Morgan Stanley Research

Interest coverage ratios not expected to deteriorate in the near term



Source: Bloomberg, Morgan Stanley Research

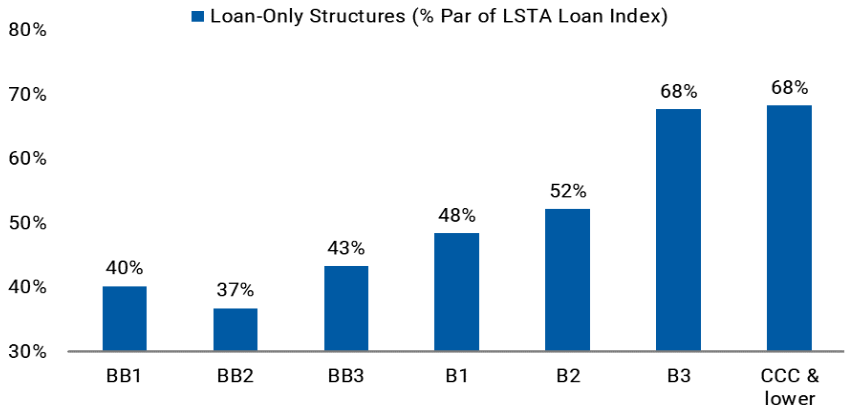
IG provides attractive yields compared to equities



Source: Bloomberg, Morgan Stanley Research

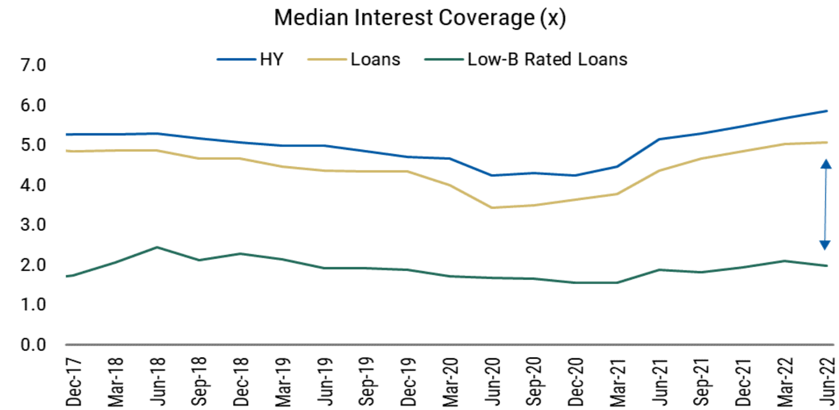
Downgrade Risks Are More Imminent, Particularly for Loans

Higher concentration of loan-only capital structures down the rating spectrum



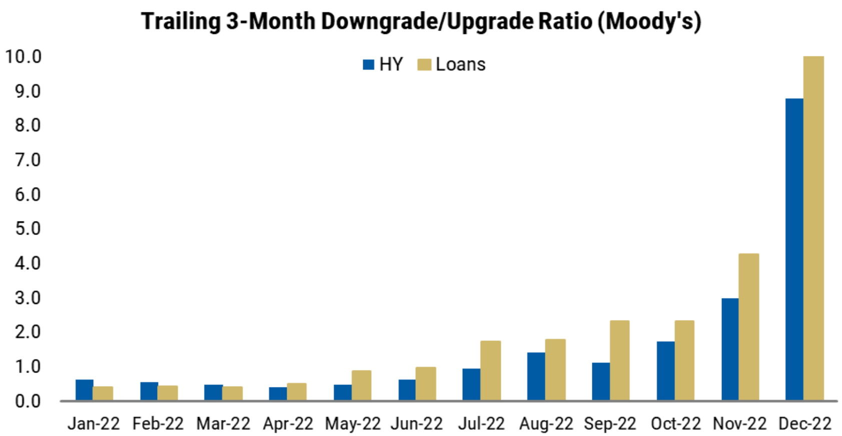
Source: ICE, PitchBook LCD, Morgan Stanley Research; Note: We use index-eligible loans and bonds to define 'loan-only' structures. Composite ratings shown and defined as the lower of S&P facility and Moody's CFR.

Affordability squeeze has been more measured than feared, but we expect tiering to intensify



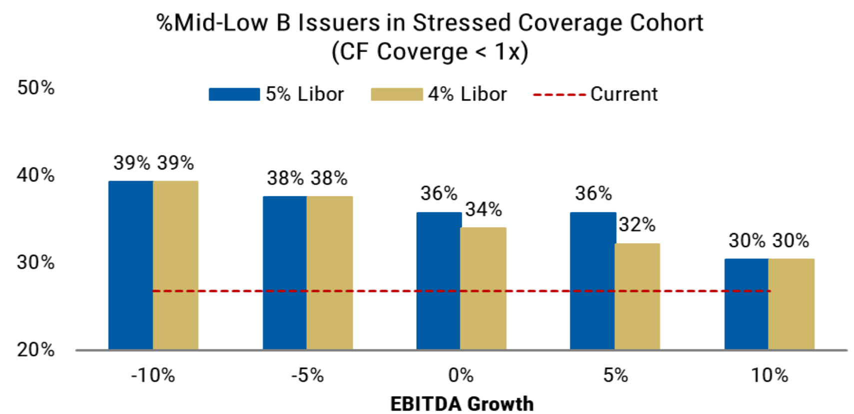
Source: S&P Capital IQ, Bloomberg, Morgan Stanley Research

Downgrade momentum has been stronger and more persistent within the loan market compared to HY



Source: Bloomberg, PitchBook LCD, Morgan Stanley Research

A third of mid-to-low single B companies may fall below 1x coverage under 4% Libor + 0% EBITDA growth



Source: LCD, Bloomberg, S&P Capital IQ, Source: Bloomberg, Morgan Stanley Research; Note: 4% Libor corresponds to a 300bp rate hike from 1% Libor as of March 31, 2022.

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Overweight/Buy	**1352**	**37%**	**278**	**42%**	**21%**	**593**	**38%**
Equal-weight/Hold	**1659**	**45%**	**309**	**46%**	**19%**	**735**	**47%**
Not-Rated/Hold	**3**	**0%**	**0**	**0%**	**0%**	**0**	**0%**
Underweight/Sell	**651**	**18%**	**82**	**12%**	**13%**	**224**	**14%**
Total	**3,665**		**669**			**1552**	

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