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US Credit Strategy 2024 Outlook

All information as of January 12, 2024, unless otherwise indicated.

2024 Credit Outlook | **Key Takeaways**

- **A soft landing for growth, cooling inflation, and the start of policy easing:** We expect growth to decelerate next year but not approach recessionary territory. The Fed and ECB should start cutting in June and the Fed eases 300bp through end-2025, despite a soft landing. The Treasury curve disinverts fully by end-2024 on an expectation of policy normalization. The end of policy tightening and normalization in yield curves provide a good set-up for credit technicals.
- **Late-cycle market: More dispersion supports up in quality:** High grade balance sheets are well positioned to deal with higher rates for longer given termed-out maturities/healthy cash levels. But, for leveraged credit, we see quality turning worse as the full effect of rates continues to erode free cash flow and hurt margins/interest coverage. Slowing growth and rising single-stock/credit risk are also consistent with a late-cycle market. We expect to see more dispersion/tiering within leveraged credit.
- **Key Credit Forecasts:** Overall, we see a tricky set-up for the near term given a combination of fairly rich valuations, likelihood of higher supply, volatility in macro data, and potential disappointment from realized policy easing vs. what is priced in. Credit spreads are priced for a smoother soft landing (mid 1990s style) than our economists are penciling in. Valuations favor IG over HY, but we think quality compression *within* both assets is likely short term.
- **Key Credit Views: In IG**, we stick to the front end where carry and income remain reasonable. Long-end technicals should weaken on both the demand and supply fronts. **In leveraged credit**, we see a window for CCCs to outperform. Our preference for Loans over Bonds is more strategic. **In synthetics**, instead of index decompression, we prefer alternatives with less exposure to CCCs.

Macro Themes | What's Needed to Stick the Landing: Benign Growth, Falling Inflation

- **We see a "soft landing" for the US – not too hot, not too cold**

- **Our economists** expect growth to slow from 2.5% to 1.6% at end-2024. Growth continues to slow further in 2025 (1.4%) from the lagged impact of policy, tighter financial conditions, and consumer weakening.

- Labor market cools further but does not roll over. Less hiring but not a lot of layoffs mean that payrolls drop substantially but unemployment increases only modestly, from 3.9% to 4.1%.

Morgan Stanley growth, inflation, and policy forecasts

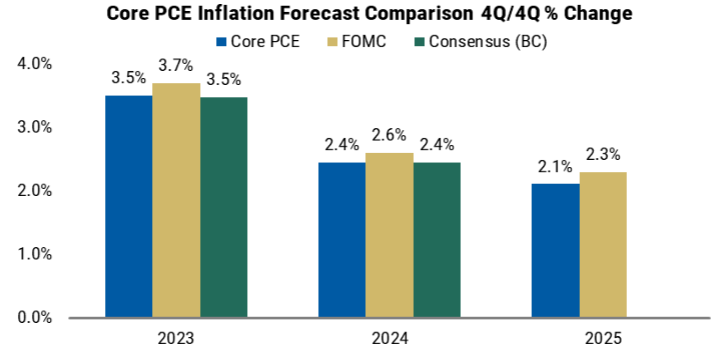
Region	GDP (%4Q/4Q)		Inflation (%Y4Q/4Q)		Policy Rate (%)	
	2023	*2024*	*2023*	*2024*	*YE23*	*YE24*
Global	2.9	2.9	2.8	2.5	-	-
US	2.5	1.6	3.4	2.4	5.375	4.375
Eurozone	0.0	1.0	3.1	2.1	4.00	3.00
Japan	2.1	1.0	3.2	2.7	-0.10	0.25
China	4.9	4.1	-0.1	1.5	1.80	1.60
India	6.0	6.7	5.1	5.3	6.50	6.00

Source: Morgan Stanley Research forecasts. Inflation numbers above reflect Core PCE for the US and CPI for the rest of the countries

Macro Themes | Inflation Cools, Rate Cuts Begin in June 2024

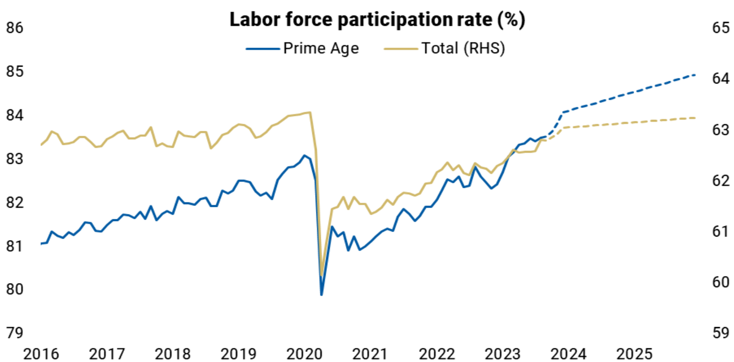
- We expect core inflation to keep cooling with core CPI at 2.5% by end-2024.
- Core goods deflation persists, while improving labor supply underpins our economists' call for wage disinflation, without a substantially weaker economy.
- The fed funds rate is below 3% by the end of 2025. This rapid pace of cuts in 2025 is an out-of-consensus call from our economics team.

In 2024, on a 4Q/4Q basis, our economists expect inflation at 2.4%



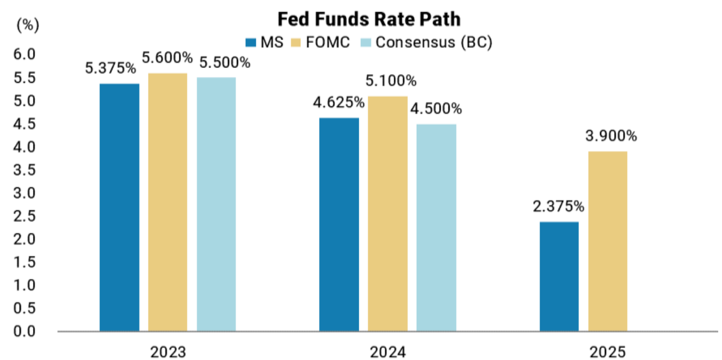
Source: Blue Chip, Federal Reserve Board, Bloomberg, Morgan Stanley Research forecasts; Note: FOMC Projection is from September 2023 Summary of Economic Projections, November 2023 Blue Chip survey

Labor supply should improve, keeping the soft landing narrative in place



Source: BLS, Morgan Stanley Research, Data as of Nov 15, 2023

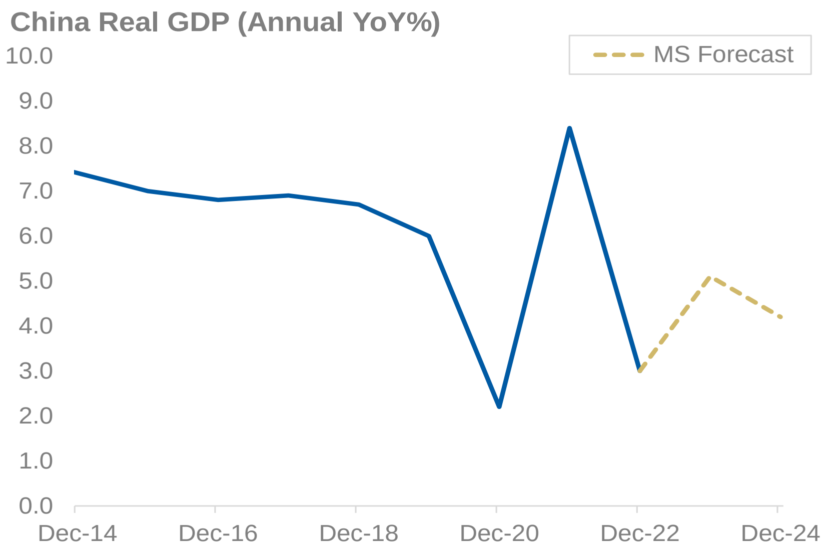
We think the Fed is done hiking, cuts start in June 2024, and expect more cuts than consensus in 2025

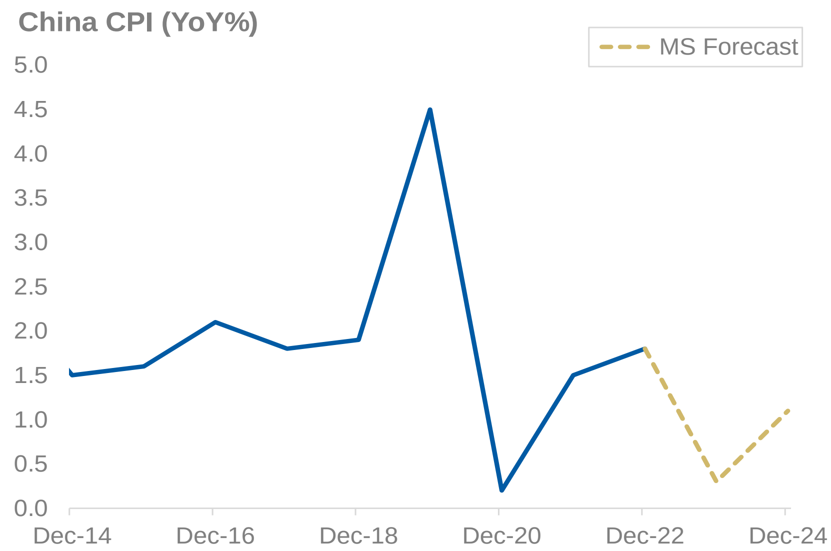


Source: Blue Chip, Federal Reserve Board, Bloomberg, Morgan Stanley Research forecasts; Note: FOMC Projection is from September 2023 Summary of Economic Projections, November 2023 Blue Chip survey

Macro Themes | We See a Bumpy Road to Reflation for China

- What's needed to stick the landing: China growth finds its footing
- Real GDP growth to improve to 4.2%Y in 2024, and inflation to rise gradually to 1.1%Y in 2024





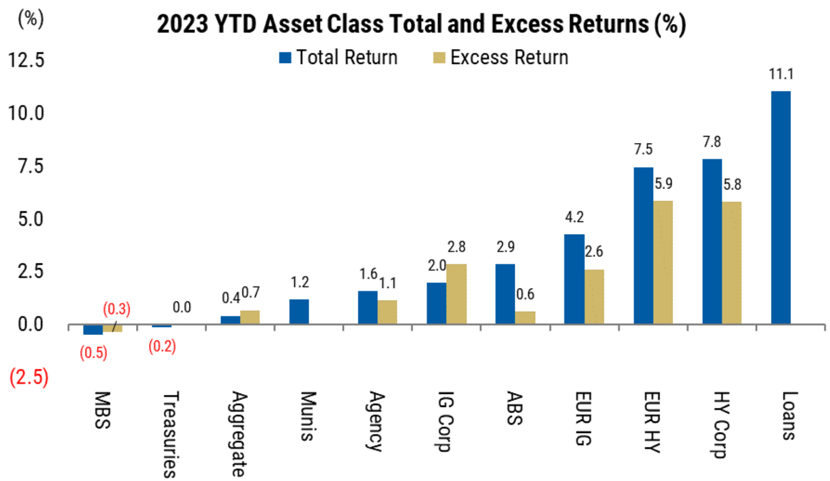
Source: Bloomberg, IMF, Morgan Stanley Research forecasts

Source: Bloomberg, IMF, Morgan Stanley Research forecasts; Note: CPI numbers are period averages.

Macro Themes | A Year of Corporate Credit Resilience

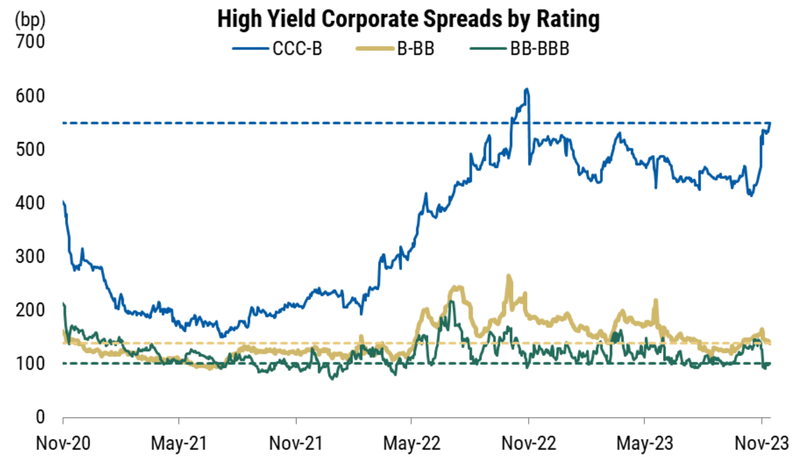
- Against an overhang of weak sentiment, excess returns were strong, and credit outperformed most other fixed income assets. Loans generated returns comparable to stocks (risk-adjusted), HY credit did better than EM, and IG outperformed Agency MBS.
- Valuations might be more compelling in other markets, but not excessively rich. Credit managers will find opportunities as dispersion rises through a slower growth environment.

Corporate credit outperformed broader fixed income assets in 2023...



Source: Bloomberg, Morgan Stanley Research; Note: Excess returns not available for SP500, RTY, Loans, and Munis; Data as of Nov 15, 2023

...with compression themes dominating (until recently)



Source: Bloomberg, Morgan Stanley Research forecasts, Data as of Nov 15, 2023

Forecast Summary | IG Spreads Sideways, More Widening in Leveraged Credit, Healthy Total Returns

Key Credit Forecasts Through 4Q24

	Current	Bull	Base	Bear
Index Spread (bp)				
IG	99	90	**125**	165
HY	334	325	**475**	600
Loans	455	400	**525**	675
Excess Return				
IG		1.6%	**-0.3%**	-3.7%
HY		3.0%	**-3.3%**	-8.8%
Loans		5.4%	**0.9%**	-5.0%
Total Return				
IG		-	**5.8%**	-
HY		-	**1.0%**	-
Loans		-	**6.2%**	-
Defaults - 12M				
HY	3.8%	3.0%	**4.25%**	6.0%
Loans	5.4%	3.0%	**4.75%**	7.0%
Full Year Gross Issuance ($bn)	**FY 2023**			
IG	1,283	-	**1,355**	-
HY	176	-	**230**	-
Loans	234	-	**290**	-

- HY spreads are trading at their 30th percentile over the past 20 years. Accounting for structural changes, these levels leave very little cushion.
- Spreads across rating cohorts are at YE 2021 tights, while CCCs have lagged. We see room for CCCs to catch up.
- Overall set-up of fundamentals, valuations, and technicals leaves us firmly up-in-quality. IG credit provides a sound source of income and price upside. In the bull case, IG spreads on the Bloomberg index hit their all-time tights through the mid-1990s.
- Expect a longer but flatter default cycle. We see defaults peaking at ~5.5% in loans and 5.0% in HY (in 2Q24) and then moderating gradually from there at 4.75% and 4.25%.
- Credit events could skew towards hard defaults/bankruptcies over time, while loan recoveries set lower than long-term averages, at around 45%.

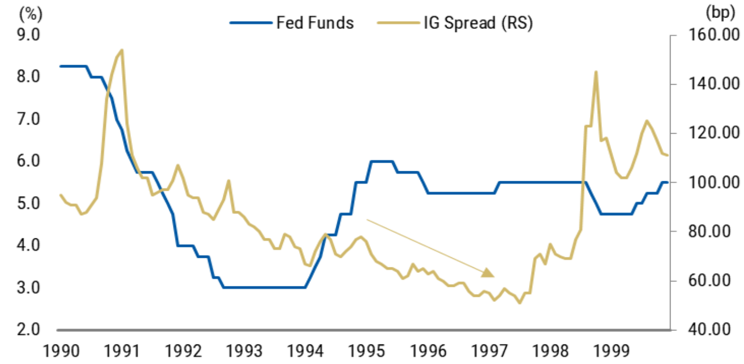
Source: Dealogic, PitchBook LCD, Bloomberg, Morgan Stanley Research estimates; Note: Pricing as of Jan 10, 2024; US IG (HY) and leveraged loan spreads forecast for the Bloomberg Barclays US Corporate IG (HY) Bond and PitchBook LSTA Leveraged Loan indices. Lev loan default rate includes hard defaults and distressed exchanges from Moody's. Current full year gross issuance figures are annualized.

The Bull and Bear Cases | Mid-1990s versus a Mild Recession

- **The Bull Case:** The 1994-95 rate-hiking cycle was characterized by a smooth soft landing. The economy managed to avoid a recession in a higher-for-longer environment after 18 months of hiking.

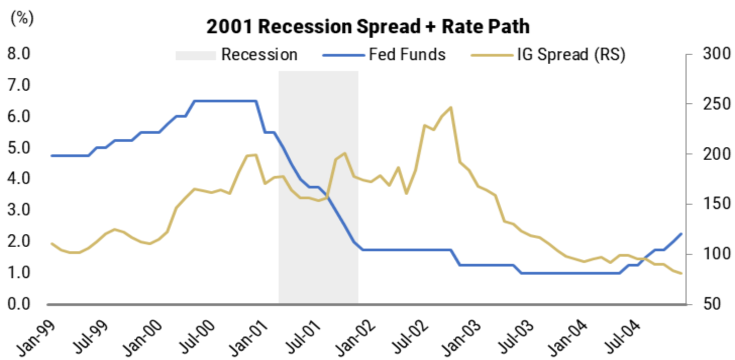
- **Bear Case: A Mild recession, but not Stagflation.** The recent example of a mild recession is the 2001 downturn. It followed a long expansion in the 1990s, which the Fed responded to with rate cuts. IG spreads did not spend much time north of 200bp.

IG spreads kept tightening through the rate-hiking cycle of the mid 1990s



Source: Morgan Stanley Research, Data as of Nov 15, 2023

Spreads vs. fed funds rate through the early 2000s



Source: BLS, Morgan Stanley Research, Data as of Nov 15, 2023

IG spread peaks through prior downturns

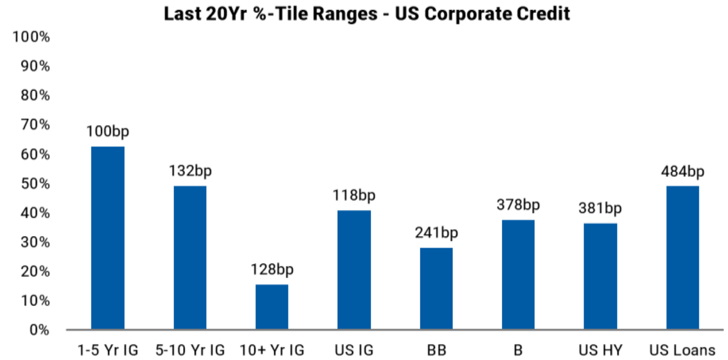
Previous Spread Peaks (bp)	IG Spread	A Spread	BBB Spread
Jul-68	148	151	189
Nov-70	207	216	280
Jan-75	177	193	293
Jun-80	183	208	290
Nov-82	254	327	376
Jul-86	225	249	289
Jan-91	151	147	251
Oct-01	201	187	266
Dec-08	607	588	732
Oct-11	243	228	287
Feb-16	197	149	261
Mar-20	272	211	353
Nov-23	121	104	149
Avg	239	238	322

Source: BLS, Morgan Stanley Research

Macro Themes | Debt Affordability Erodes Credit Quality

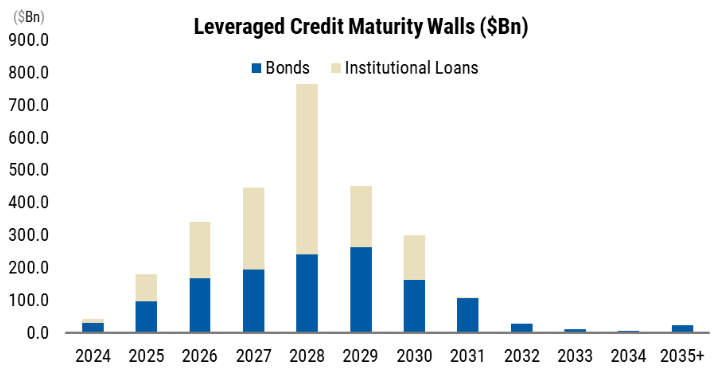
- The macro environment is not acutely challenging, but higher rates coupled with significant refinancing needs and an incremental hit to cost of funding will weigh on credit quality/ratings.
- Expect to see more dispersion and quality tiering.
- Risk/reward is less appealing than in IG – bull case comes with the challenge of higher rates, downside in the bear case is more non-linear.

HY spreads rich vs. history; loans and IG more reasonable except for the long end



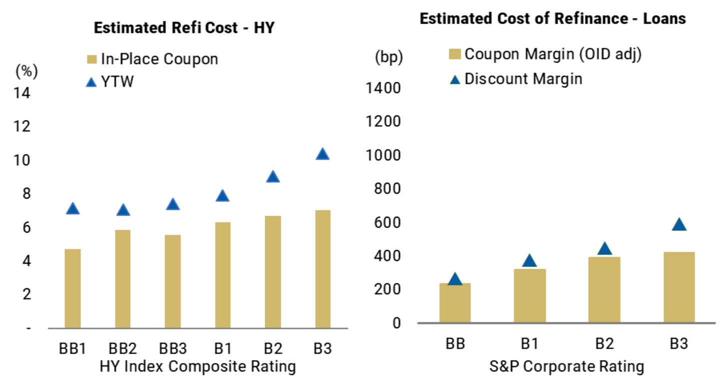
Source: Bloomberg, PitchBook LCD, Morgan Stanley Research; Note: for US Loans, we use spread-to-maturity from October 2008; Data as of Nov 15, 2023

Refi needs ramp up as 2025/26 maturities come into view...



Source: Moody's, PitchBook LCD, Morgan Stanley Research; Data as of Dec 31, 2023

...and HY issuers face a higher refi cost penalty



Source: Bloomberg, ICE, PitchBook LCD, Morgan Stanley Research; Data as of Nov 15, 2023

Macro Themes | Weaker Macro Helps Government Bonds Perform

- Rates were driven by the strength in the economy over the summer, i.e., “yields following growth”. We expect more emphasis on lower inflation and lower growth into 2024.

- Our rates strategists see the 10Y at 3.95% by end-2024 (65bp lower), and 30Y at 4.4% (40bp lower). Our Fed call remains for no more hikes, and the start of rate cuts in 2Q24, in line with market-implied OIS pricing.

Morgan Stanley government bond yield/spread forecasts – base cases

	2-Year		5-Year		10-Year		30-Year	
	2Q24	4Q24	2Q24	4Q24	2Q24	4Q24	2Q24	4Q24
US	4.40	3.70	4.15	3.85	4.20	3.95	4.50	4.40
Germany	2.10	1.60	1.90	1.70	2.10	1.80	2.45	2.30
Japan	0.15	0.20	0.45	0.55	0.85	0.90	1.70	1.75
UK	4.00	3.20	3.80	3.30	3.70	3.50	4.40	4.00
Australia	4.25	3.95	4.35	4.20	4.55	4.40	4.90	4.70
New Zealand	5.00	4.50	4.70	4.40	4.95	4.85	5.05	5.00
Canada	4.20	3.60	3.70	3.30	3.60	3.30	3.40	3.30
Austria*	15	10	40	35	55	45	60	50
Netherlands*	15	10	30	25	35	30	30	30
France*	10	10	45	40	60	55	100	95
Belgium*	15	15	50	45	70	65	110	105
Ireland*	5	5	45	40	55	50	75	70
Spain*	50	40	75	65	110	100	180	170
Italy*	100	85	160	145	210	190	230	220
Portugal*	20	10	50	40	85	75	145	145

Source: Morgan Stanley Research forecasts; Note: *Yield spread to Bunds in bp.

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In the US, near-term uncertainty gives way to an earnings recovery in 2024

Outlook for equity market earnings, valuations, and targets

						MS Top Down EPS Estimates			Bottom Up Consensus EPS Estimates		
	Current Price	MS Next 12M Price Target	MS Next 12M Price Target % to Current	Current P/E	MS Next 12M P/E Target	2023	2024	2025	2023	2024	2025
Bear	4,689	3,850	-18%	19.2x	16.5x	$206	$192	$234	$219	$245	$275
Growth						*-6%*	*-7%*	*22%*	*0%*	*11%*	*12%*
Base	4,689	4,500	-4%	19.2x	17.0x	$215	$229	$266	$219	$245	$275
Growth						*-2%*	*7%*	*16%*	*0%*	*11%*	*12%*
Bull	4,689	5,050	8%	19.2x	17.5x	$222	$251	$289	$219	$245	$275
Growth						*1%*	*13%*	*15%*	*0%*	*11%*	*12%*

Note: We use 2025 forward earnings to project our price target which takes into account our June earnings forecast (currently $266 base case). Source: Factset, Morgan Stanley Research estimates

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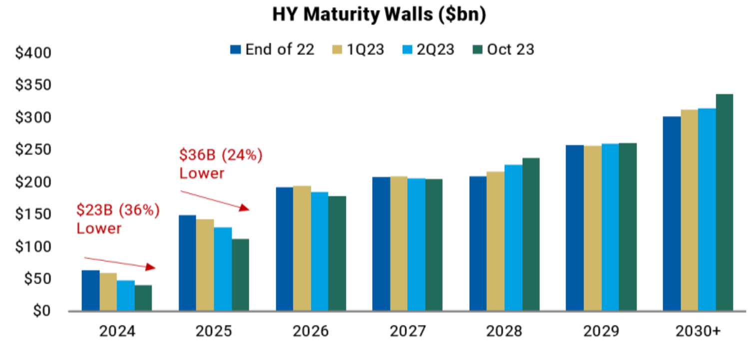
KEY THEMES

Key Themes | The Impact of Higher Rates

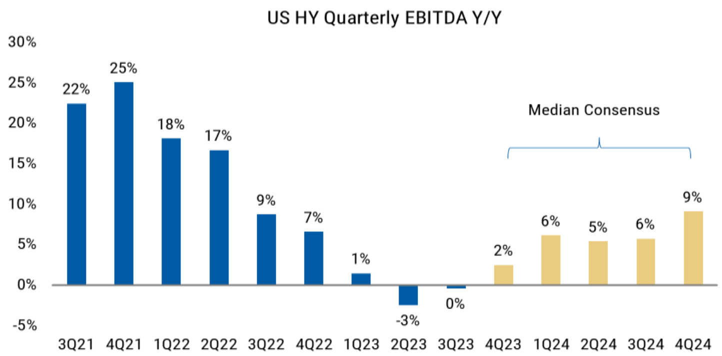
- 2024 maturities were addressed in 2023, but refinancing needs for 2025/2026 are high. We are more concerned about the impact of higher refi cost on credit quality rather than the capital availability.
- HY borrowers have not seen the same momentum of downgrades, but in-place fundamentals are clearly weakening.
- Looking forward, we think the feed-through of higher rates to sub-IG balance sheets will be worse for HY issuers than loan companies.

Companies addressed near-term maturities in 2023



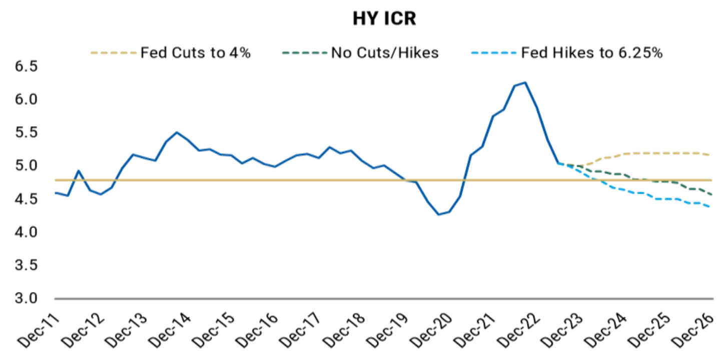
Source: ICE, PitchBook LCD, Morgan Stanley Research; Data as of Nov 15, 2023

The market expects a muted recovery in earnings



Source: Bloomberg, Morgan Stanley Research; Data as of Nov 15, 2023

HY coverage is set to deteriorate slowly as coupons reset at the time of refi

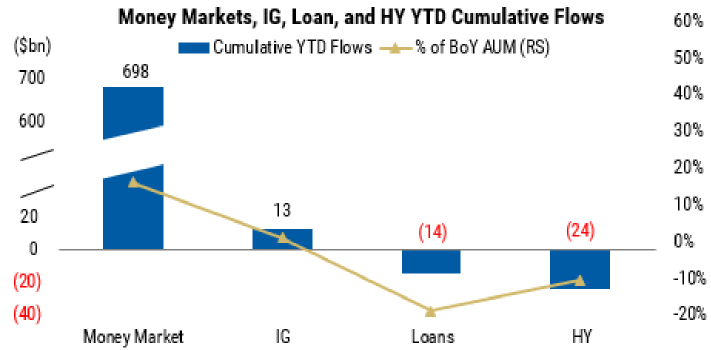


Source: S&P CapIQ, Bloomberg, Morgan Stanley Research; Data as of Nov 15, 2023

Key Themes | **Credit Demand Outlook**

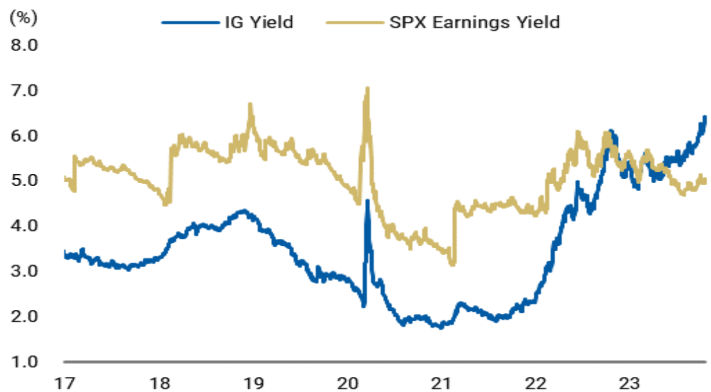
- With the Fed done hiking in our view, money sitting in "cash" should look to extend out the curve.
- We expect investment grade credit to be a key beneficiary of these re-allocation flows, especially the front end.
- Supply should remain muted, especially at the long end.
- Strategic allocators should continue to see better value in high grade credit vs. riskier assets.

Money market inflows have dwarfed those into credit



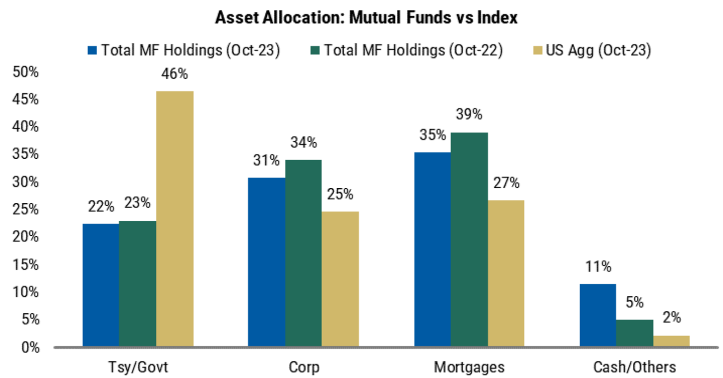
Source: Refinitiv, Morgan Stanley Research; Data as of Nov 15, 2023

IG yields vs. SPX earnings yield



Source: Bloomberg, Morgan Stanley Research; Data as of Nov 15, 2023

Asset allocation: Mutual funds vs. Index

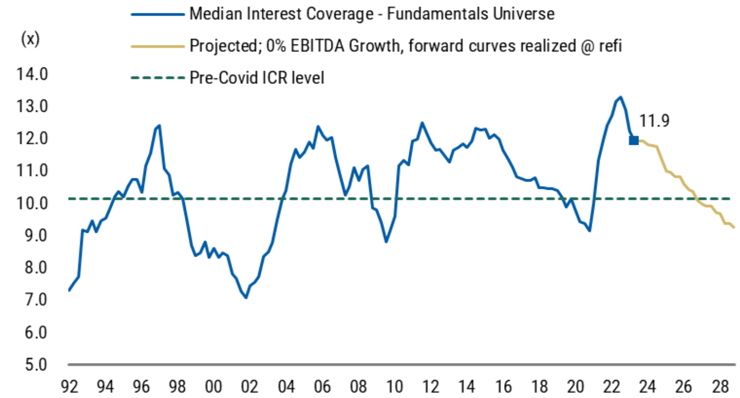


Source: Bloomberg, Morgan Stanley Research

Key Themes | Capital Structures in a Higher Rates World

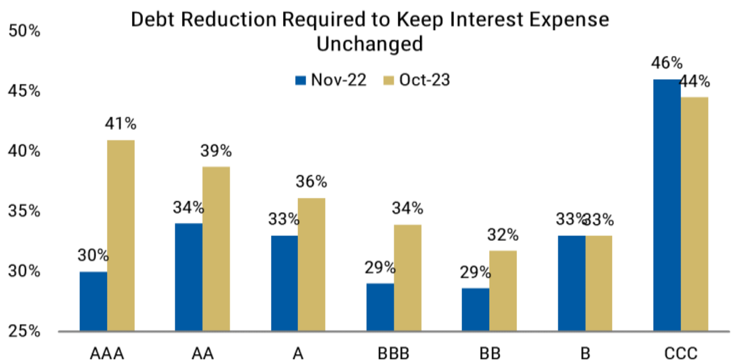
- In a higher rates environment, leveraged will need to come down to support these funding costs. Cost-of-capital curve does not support aggressive releveraging.
- Issuers would need to reduce debt loads by 30% to keep interest expense constant, assuming existing debt is refinanced into current coupon levels.
- The decline in interest coverage is gradual though, and supports gradual deleveraging rather than outright debt reduction

ICR set to decline further but at a modest pace



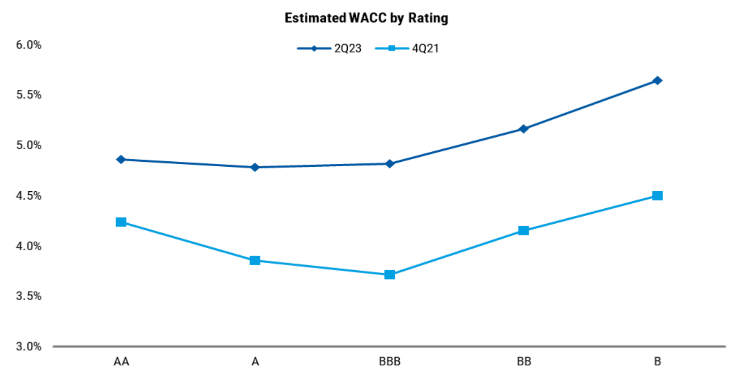
Source: Bloomberg, Morgan Stanley Research Estimates; Data as of Nov 15, 2023

>30% debt reduction would be required to keep interest expenses unchanged



Source: Bloomberg, Morgan Stanley Research; Data as of Nov 15, 2023

The WACC curve has steepened across the quality spectrum



Source: Bloomberg, ICE, Morgan Stanley Research; Data as of Nov 15, 2023

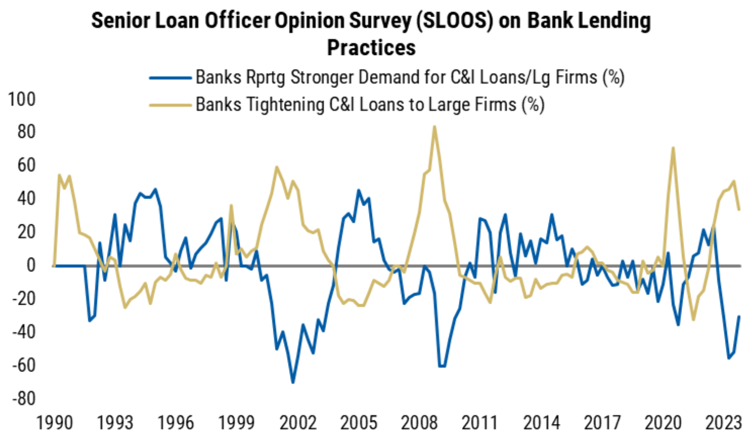
Key Themes | The Impact of Tighter Bank Credit Conditions

- Regulatory headwinds and higher cost of capital have weighed sharply on overall lending appetite. Net C&I loans outstanding on bank balance sheets have declined from a peak of $2.84tn to around $2.75tn.

- Rating downgrades of the regional banks sector have pushed up the credit spread component of net funding costs. Capital requirements are increasing across the group because of Basel III endgame.

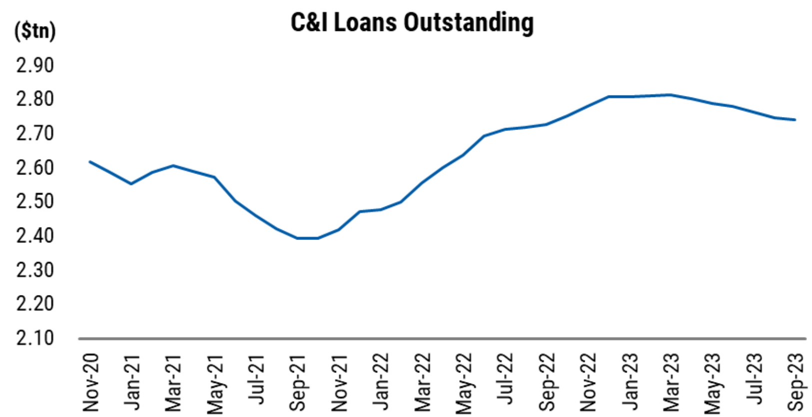
- The outlook for bank lending remains challenging. Our bank analysts expect C&I loan growth to continue decelerating until the middle of 2024. But we think systemic risks are behind us, with deposit trends stabilizing. C&I loan losses have remained contained.

Lending standards continued to tighten for C&I loans



Source: Federal Reserve, Morgan Stanley Research; Data as of Nov 15, 2023

C&I loan growth has declined as banks tighten credit conditions



Source: Federal Reserve, Morgan Stanley Research; Data as of Nov 15, 2023

INVESTMENT GRADE

Investment Grade | Attractive All-in Yields Ahead of Rate Cuts

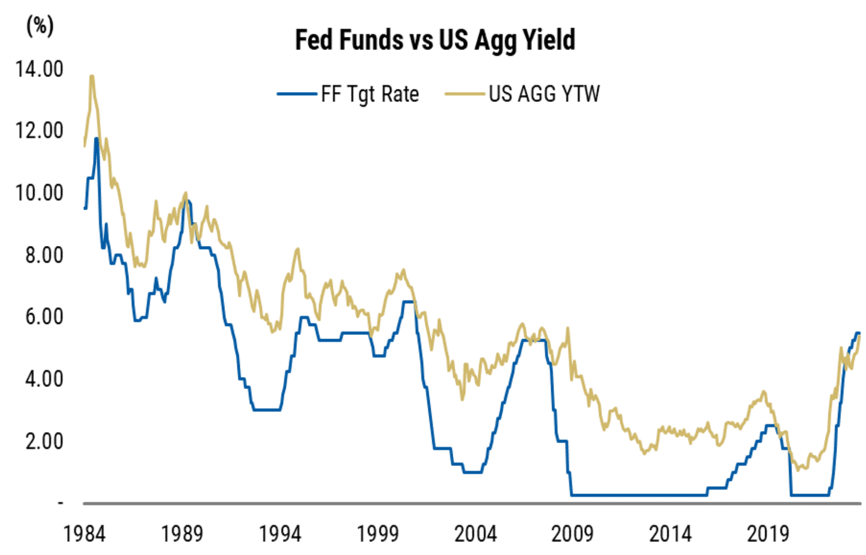
- We expect spreads to be sideways in IG. Excess returns look best in the front end on both an absolute level basis and volatility basis.
- The long end should be supported not only by less supply but also by a continued bid for duration from strategic yield buyers. But given how flat curves are, we don't see value there for index investors.
- Historically, the last rate hike in a cycle has provided an entry point for high grade bonds. Yields tend to come down either in a soft landing (e.g., 1994/95) as inflation cools, or in a downturn if the Fed has overtightened.

FY2024 US IG forecast

IG Forecast Summary: Tenor	Current OAS	Current Duration	Spread Target	Spread Change	Excess Return	Total Return
1-3Y	89	1.9	94	5	0.8%	8.2%
3-5Y	114	3.6	119	5	1.0%	9.0%
5-7Y	121	5.3	128	7	0.8%	9.5%
7-10Y	141	6.8	148	7	0.9%	9.8%
10-25Y	130	11.4	139	9	0.3%	7.5%
25Y+	124	14.6	133	9	-0.1%	9.8%
Ratings						
AAA/AA	51	8.1	58	7	-0.2%	8.0%
A	101	6.8	107	7	0.5%	8.6%
BBB	145	6.6	152	7	0.9%	9.1%
Full IG Market	**118**	**6.8**	**125**	**7**	**0.64%**	**8.79%**

Source: Bloomberg, Morgan Stanley Research forecasts

Last rate hike is usually good for high grade bonds



Source: Bloomberg, Morgan Stanley Research

Investment Grade | **Supply Outlook**

US IG 2024 supply outlook summary ($bn)

	2020	2021	2022	2023a[1]	2024e	'24/'23 ($)	'24/'23 (%)
US, Non-Financial							
Gross Issuance	1045	619	472	531	530	(1)	(0%)
Maturities	257	249	246	263	295	+32	12%
Calls / Tenders	223	239	81	46	55	+9	19%
Net (Maturities, Calls, Tenders)	565	131	144	221	180	(41)	(19%)
US, Financial							
Gross Issuance	361	387	353	295	410	+115	39%
Maturities	166	142	130	116	200	+84	73%
Calls / Tenders	69	83	69	66	75	+9	14%
Net (Maturities, Calls, Tenders)	126	162	155	114	135	+21	19%
Non-US, Non-Financial							
Gross Issuance	290	284	164	176	165	(11)	(6%)
Maturities	93	85	96	110	105	(5)	(4%)
Calls / Tenders	42	60	16	24	20	(4)	(18%)
Net (Maturities, Calls, Tenders)	155	139	52	42	40	(2)	(6%)
Non-US, Financial							
Gross Issuance	250	320	288	247	250	+3	1%
Maturities	184	193	159	167	175	+8	5%
Calls / Tenders	29	13	26	41	50	+9	23%
Net (Maturities, Calls, Tenders)	36	114	104	40	25	(15)	(37%)
Totals							
Total Gross Issuance	1,945	1,610	1,277	1,250	1,355	+105	8%
Total Maturities	700	668	631	656	775	+119	18%
Total Calls & Tenders	362	396	192	177	200	+23	13%
Total Net Issuance	883	546	455	417	380	(37)	(9%)
Total M&A	*147*	*217*	*121*	*160*	*175*	*+15*	*9%*

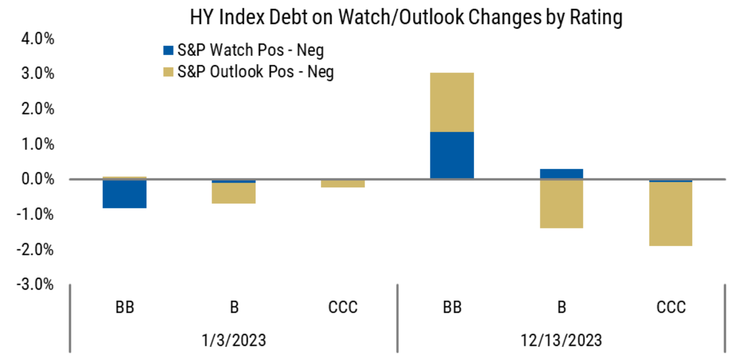
Source: Bloomberg, Morgan Stanley Research forecasts

- We expect $1.35tn in IG gross issuance in 2024, up 8% y/y, driven primarily by a sharp increase in maturities, while net issuance declines to $375bn.
- We expect US financial issuance to increase, driven by regional banks, while US non-financials issuance should fall as higher rates make borrowing less attractive.
- Demand has been healthy, especially in the long end as attractive all-in yield levels brought in buyers from pension funds and insurance companies.
- M&A-driven issuance increases modestly as appetite returns for acquisitive activity to the $175bn range.
- Slowing growth and elevated yields should keep issuers focused on managing leverage and interest expenses.

Investment Grade | Ratings Migration – Fewer Upgrades, but Not a Lot of Downgrades

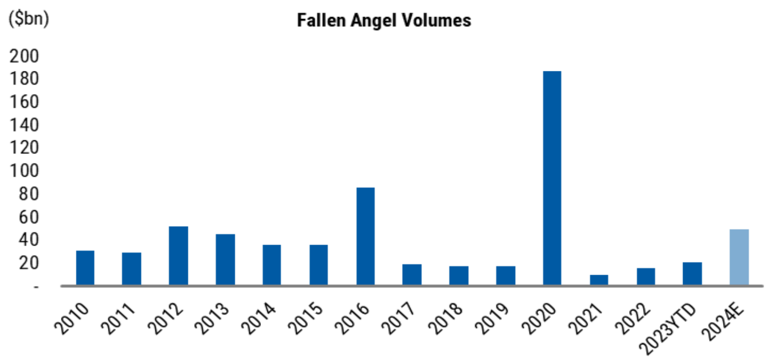
- IG rating migrations in 2023 remained healthy despite higher rates and challenges in the banking sector earlier in the year.
- The upgrade skew was heavily influenced by large single-name upgrades rather than being broad-based. Fallen angel volumes have been quite muted.
- Valuations within low BBBs are cheaper on a historical basis. The low BBB universe is now highly skewed towards secured debt.

There is now a higher skew for debt on negative watch/outlook, especially lower-rated cohorts



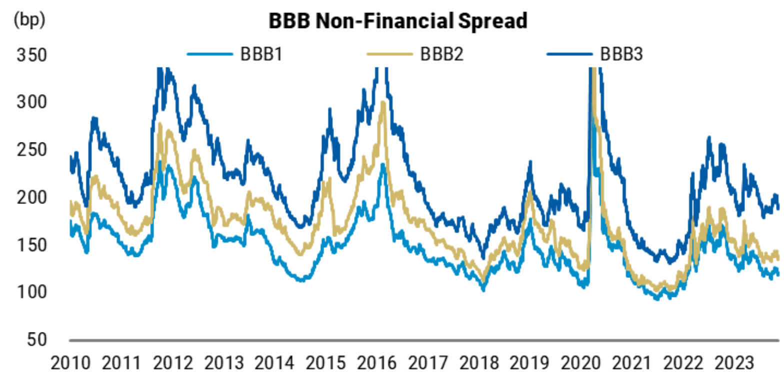
Source: Bloomberg, Morgan Stanley Research

Fallen angel volumes have been low vs. historical trends



Source: ICE, Morgan Stanley Research; Data as of Nov 15, 2023

Low BBBs spread screen wider vs. history

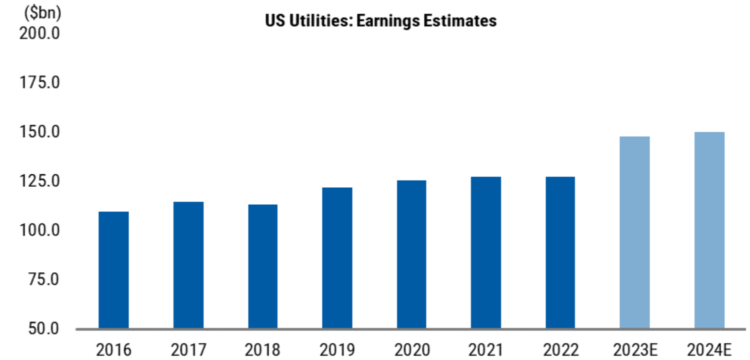


Source: ICE, Morgan Stanley Research

Investment Grade | **Cautious on Regional Banks, Maintain Preference for Utilities**

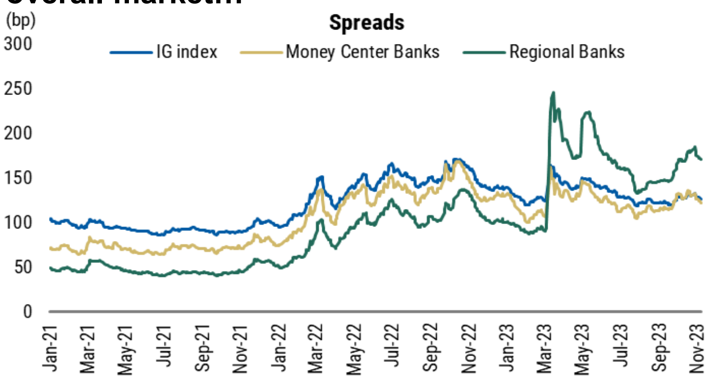
- With deposit pressure easing, the fundamental drivers should persist in a higher-for-longer environment.
- Issues on the asset side will start to matter. Regional banks have substantial exposure to CRE loans.
- Utilities sector lagged due to strong issuance and rates sell-off. Total returns could turn positive with the rally in rates as we expect rates to find a better footing.

Earnings to hold even in higher rates environment



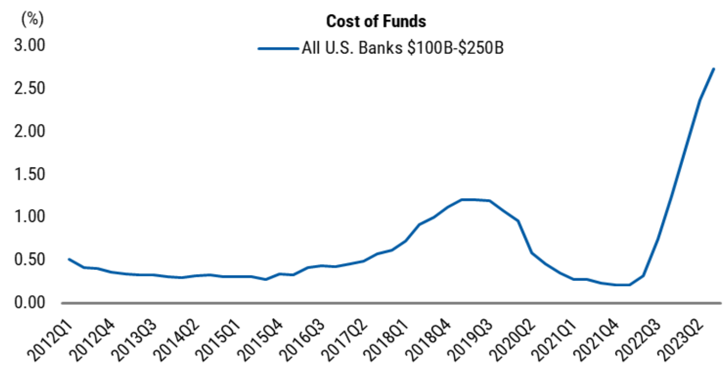
Source: ICE, Morgan Stanley Research; Data as of Nov 15, 2023

Regional bank spreads should decompress vs. overall market…



Source: ICE, Morgan Stanley Research; Data as of Nov 15, 2023

…but cost of funds remains steep at regional banks



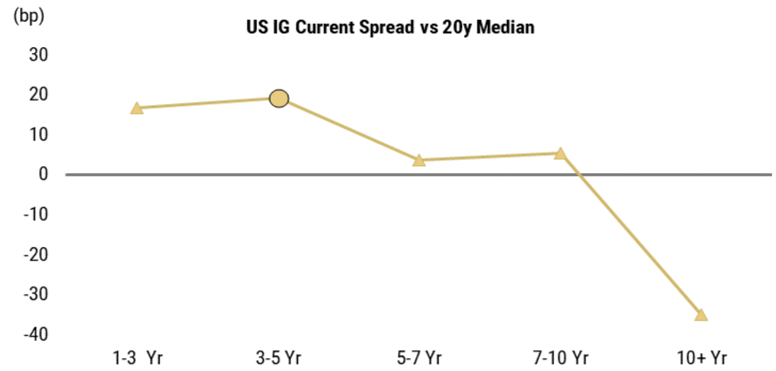
Source: SNL, Morgan Stanley Research; Note: Cost of funds defined as the total interest expense as a percent of the sum of average interest-bearing liabilities and average noninterest-bearing deposits

Investment Grade | Front End Screens Attractive on Many Measures

- YTD underperformance of the front end due to overhang of regional banks stress, cheaper and more efficient assets (e.g., ABS, T-Bills, etc.), and the use of shorter tenors as a widget to manage outflows with long-end dollar prices trading at deep discounts.

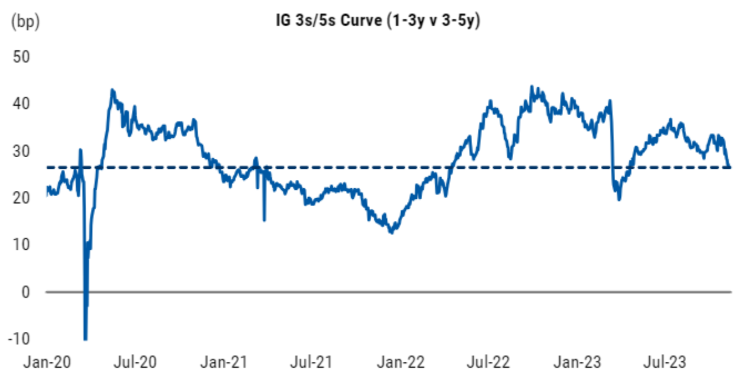
- Credit curves provide an upward-sloping term structure where it is possible to capture roll-down as opposed to the negative carry on the Treasury curve. The 3-5Y sector looks to be the sweet spot.

Short-dated IG cheap vs. history



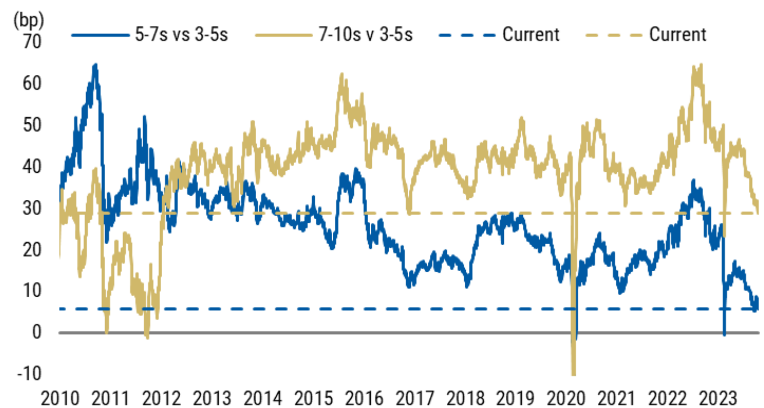
Source: Bloomberg, Morgan Stanley Research; Data as of Nov 15, 2023

Curves within the front end are steep…



Source: Bloomberg, Morgan Stanley Research; Data as of Nov 15, 2023

...but relatively flat from the 5y to 10y point

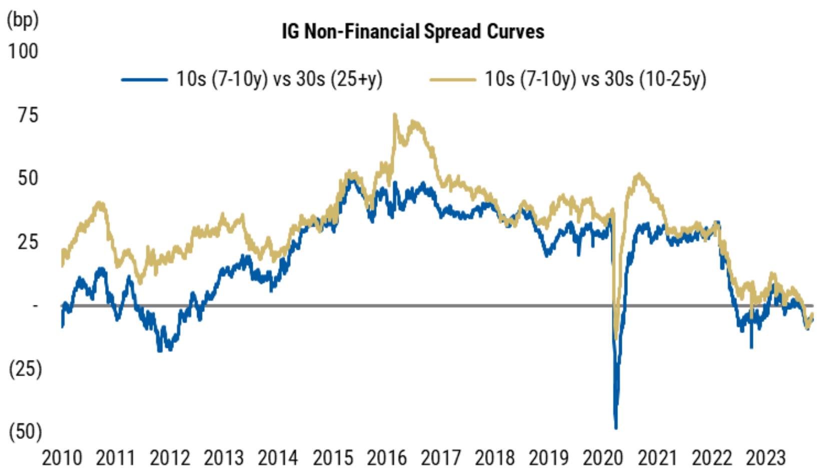


Source: Bloomberg, Morgan Stanley Research

Investment Grade | 10s30s to Steepen Over Time

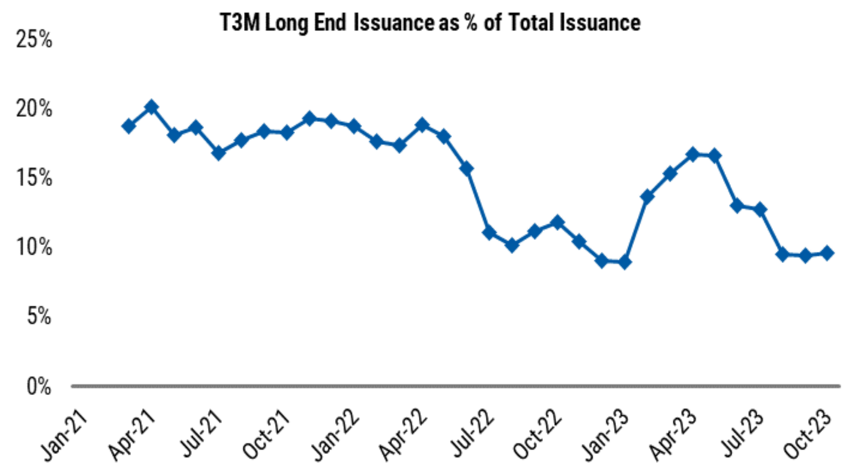
- Long-duration IG saw strong demand over the course of September as strategic investors have looked to lock in very attractive yields.
- If rates remain at these levels, supply at the long end is likely to remain low as issuers will hold back on locking in elevated funding costs.
- 10s-30s credit curves are very flat, at levels last seen in 2009. However, if rates decline, risk/reward for the long end both in terms of demand and supply starts to weaken very quickly.

10s30s curve inverted to levels last seen in 2009



Source: ICE, Morgan Stanley Research; Data as of Nov 15, 2023

Long-end supply has declined following the rate sell-off



Source: Dealogic, Morgan Stanley Research; Data as of Nov 15, 2023

Morgan Stanley

US LEVERAGED CREDIT

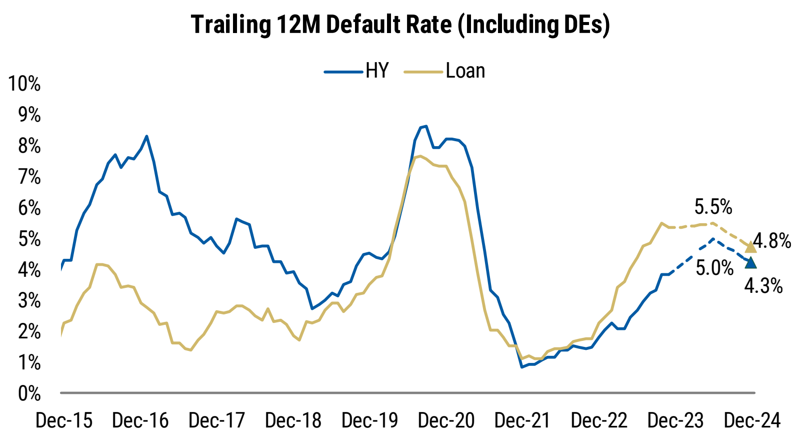
Leveraged Credit | **A Flatter but Longer Default Cycle…**

- We forecast defaults to peak in 2Q24 (at 5.0% in HY and 5.5% in loans) and end the year at **4.25% in HY and 4.75% in loans.**

- In the near term, we believe that default rates will trend higher given the recent expansion of CCC cohorts in HY and loans, and the front-loading of distress, especially in loans.

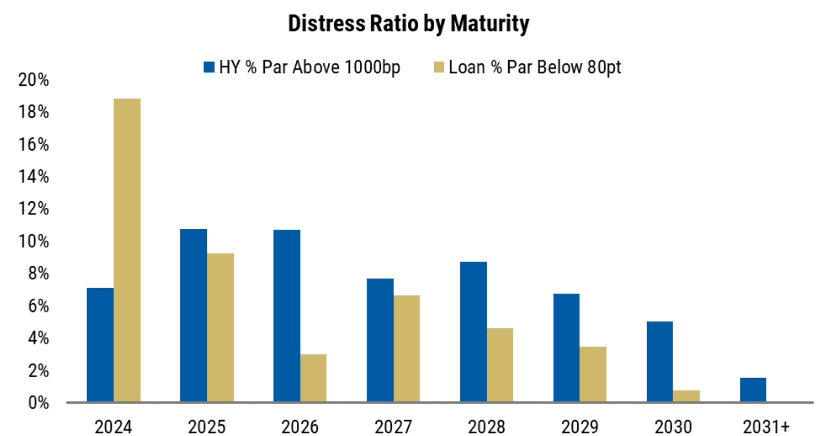
- The downward trend in defaults in 2H24 is informed by (1) a slowdown in fundamental deterioration, (2) maturity walls being progressively addressed, and (3) the backstop by PE sponsors and private credit.

We expect defaults to stay elevated and peak in 2Q24



Source: Moody's, PitchBook LCD, Morgan Stanley Research forecasts; Data as of Nov 30, 2023

Distress is concentrated in 2024 loans and 2025/26 HY bonds

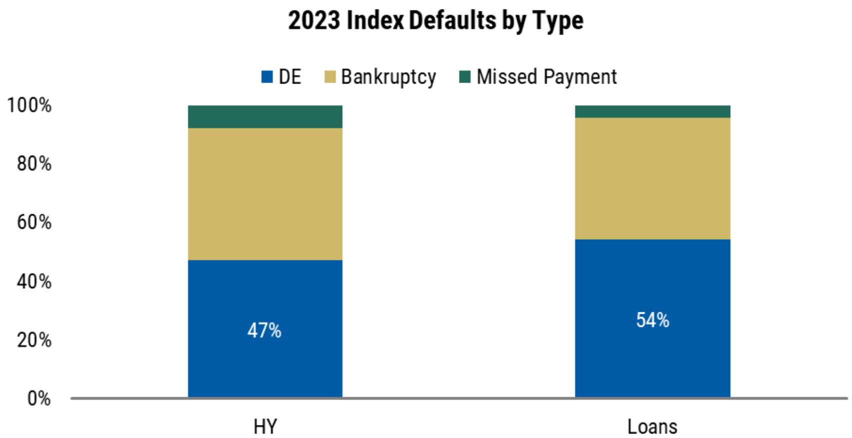


Source: ICE, PitchBook LCD, Bloomberg, Morgan Stanley Research

Leveraged Credit | **…with Weaker Recoveries for Loans**

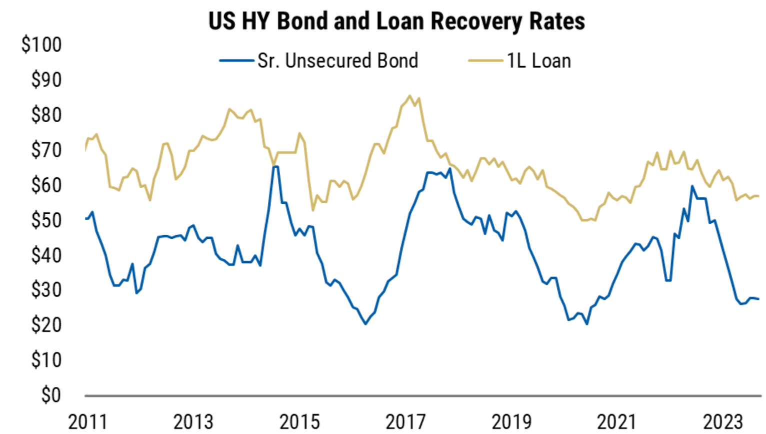
- We lower our loan recovery rate estimates to **45-50%** (from 55% previously).
- The prevalence of distressed exchanges/aggressive restructurings and the rising trend of "re-defaults" weigh on recovery rates. In particular, priming transactions can drive a wedge in recovery rates, with ultimate recoveries received by the primed lenders in a bankruptcy filing being meaningfully lower.
- The large share of loan-only names in the lower-rated cohorts skews recovery rates lower. Rating agencies point out that loans from loan-only companies tend to recover less than the ones from mixed capital structures with bond subordination.

Distressed exchanges have been prevalent in this default cycle



Source: Moody's, Bloomberg, Morgan Stanley Research; Data as of October 31, 2023.

Recovery rates have trended lower since late 2022



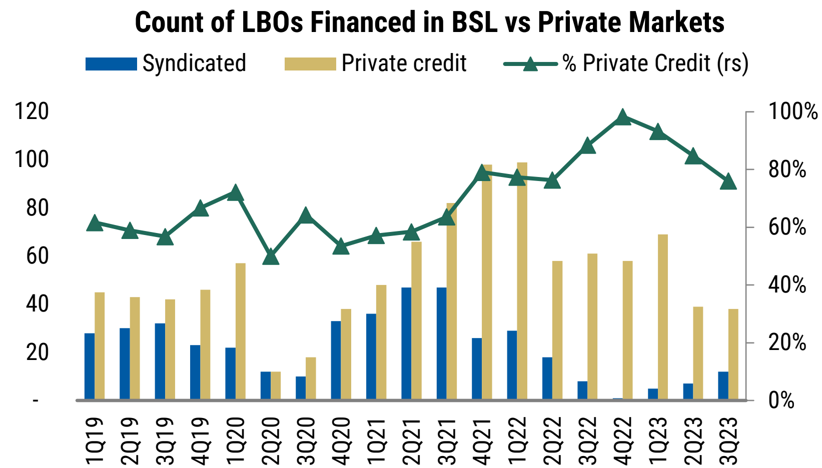
Source: Moody's, Morgan Stanley Research; Data as of Nov 30, 2023

Leveraged Credit | **The Role of Private Credit**

- Private credit had been expanding its market share in acquisition financing. Private credit-funded LBO deals kept rising as acquisition-related issuance ground to a halt. As a result, private credit accounted for over 70% of all LBO deals.

- **We see private credit helping to smooth out the default cycle.** While banks were pulling lack on lending, private credit extended refinancing solutions to BSL borrowers, especially within the sub-B3 territory. In our view, private credit is a key funding channel for companies in need of liquidity.

Private credit has been the dominant source of funding for LBO deals in recent years



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

BSL borrowers have turned to private credit for refinancing solutions

Company Name	Date	Debt Amount ($M)	Last BSL Deal Date	Company Rating Prior to New Financing (M/SP)
Hyland Software	Sep-23	$3,400	Mar-21	B3/B-
Trinseo SA	Sep-23	$1,077	Mar-21	B1/CCC+
Finastra	Aug-23	$5,300	Oct-19	Caa1/NR
Sabre Holdings	Jun-23	$700	Aug-22	B3/B-
Melissa & Doug	Apr-23	$260	Jun-18	NR/NR
RR Donnelley	Mar-23	$1,250	Jan-22	B3/B

Source: Pitchbook, Morgan Stanley Research

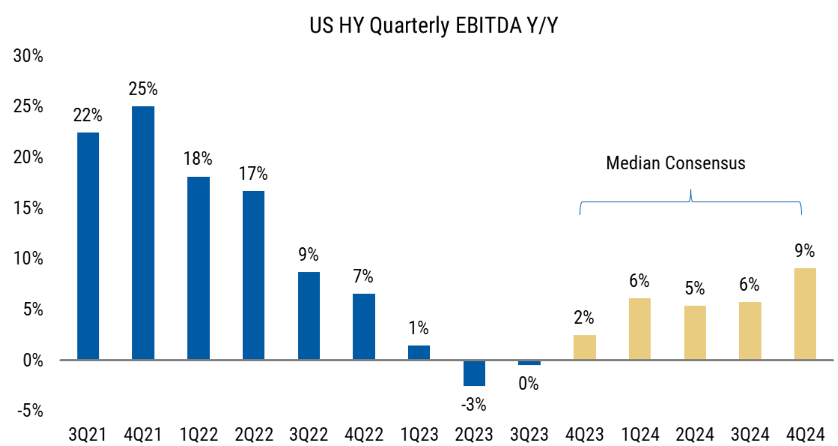
High Yield | **Fundamental Getting Worse, with Quality Degradation within Tails**

- In 2Q23, EBITDA growth fell into negative territory for the first time outside of recession windows. While the market expects a muted recovery from 4Q23, our equity strategists see a rebound in corporate earnings in 2H24.

- Pressure on EBITDA margins comes from top-line growth, as companies' pricing power wanes and the macro slowdown drives weaker demand/sales growth.

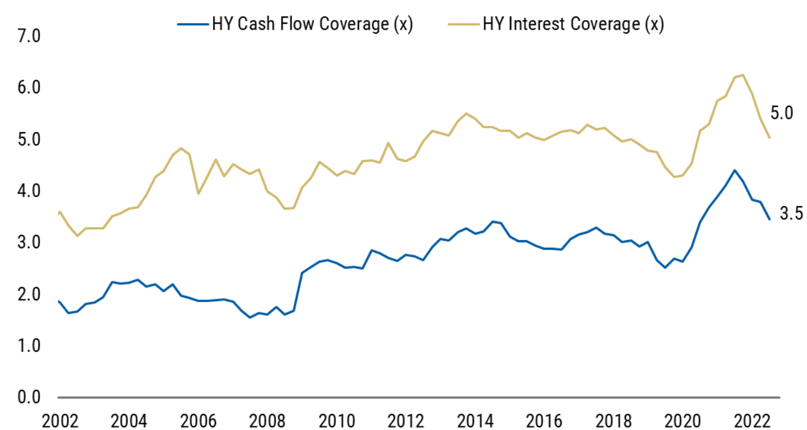
- Companies' ability to convert earnings into cash flow will be pivotal, considering the increasing importance of FCF down in the rating spectrum. According to S&P, positive FOCF is the key differentiator between B- and CCC profiles.

The market expects a muted recovery in earnings



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

HY cash flow coverage (adj. for capex) worse than ICR



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

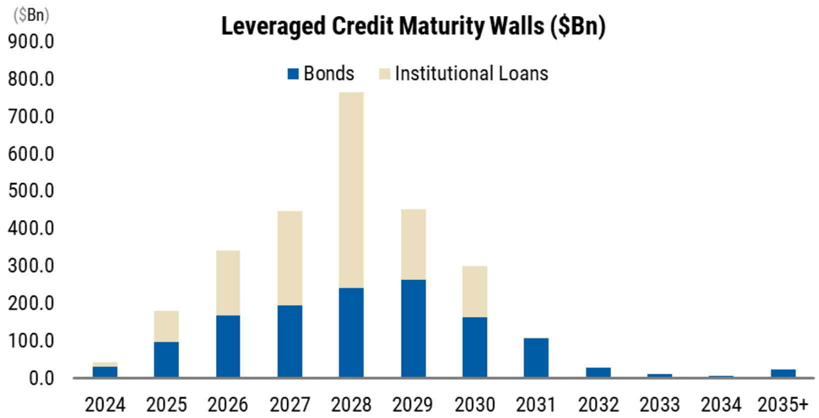
High Yield | Maturity Walls Ramping Up, with Refi Penalty Weighing More on HY Issuers

- Despite HY pre-YE 2025 maturities down nearly 40% versus YE 2022 levels, 2025 and 2026 maturities remain elevated, and we expect refinancing activity to persist.

- Coverage ratios should see further deterioration, as the growth of interest expense continues to outpace earnings growth. But we think the next leg of the feed-through of higher rates to sub-IG balance sheets will be slow to materialize.

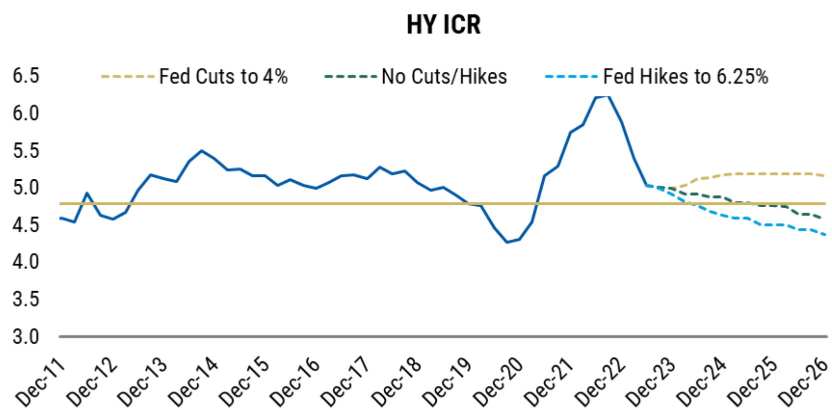
- **The refi pressure should weigh more on HY issuers** given the larger coupon reset for HY issuers at the time of refinancing. ICR trajectory assuming flat EBITDA and maturing debt to be refinanced 1 year before maturity suggests that the median HY issuer will see only a 0.2x drop in coverage through YE2024 if the Fed keeps policy rates on hold.

Refinancing will need to ramp up as 2025/26 maturities come into focus



Source: ICE, PitchBook LCD, Morgan Stanley Research; Data as of Dec 31, 2023

HY coverage expected to deteriorate more than loans as coupons reset higher at refi

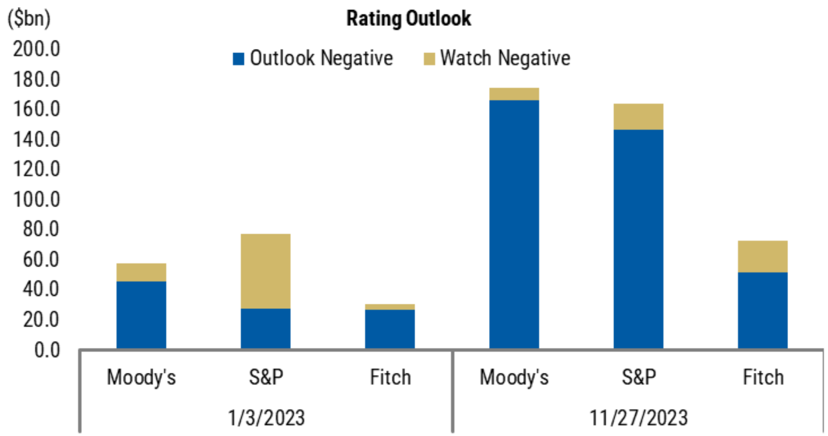


Source: Bloomberg, S&P Capital IQ, Morgan Stanley Research

High Yield | Quality Migration Trends and Risks in High Yield

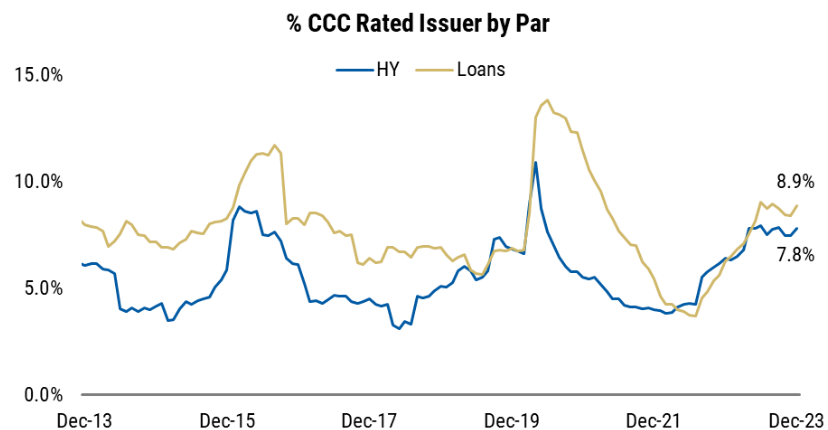
- Since the beginning of 2023, the cohort of outlook/watch negative HY bonds has increased substantially (over 100%) across the three rating agencies.
- The proportion of CCC issuers has expanded in HY and loans – this distressed cohort is weakly positioned.
- Downgrades from B to CCC were largely driven by macroeconomic headwinds leading to a weakened operating environment and refi risk.

Outlook and watch negative cohorts have increased in HY since beginning of year



Source: Bloomberg, Morgan Stanley Research

CCC cohorts have been expanding and they may face high downgrade/default pressures

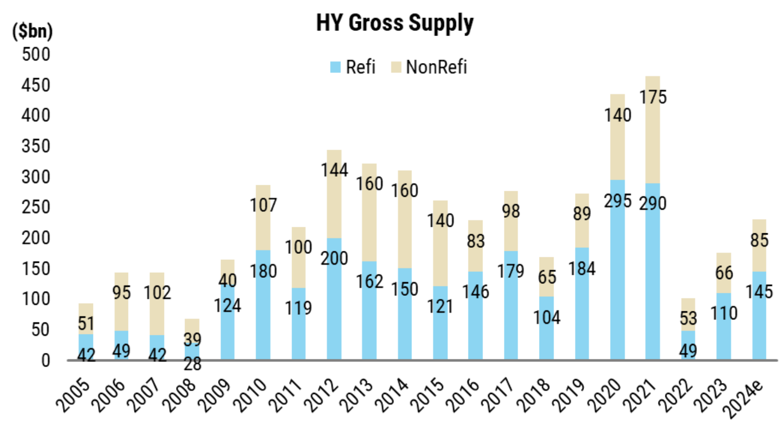


Source: ICE, PitchBook LCD, Bloomberg, Morgan Stanley Research; Data as of Dec 31, 2023

Supply Forecast | Higher Issuance for HY and Loans

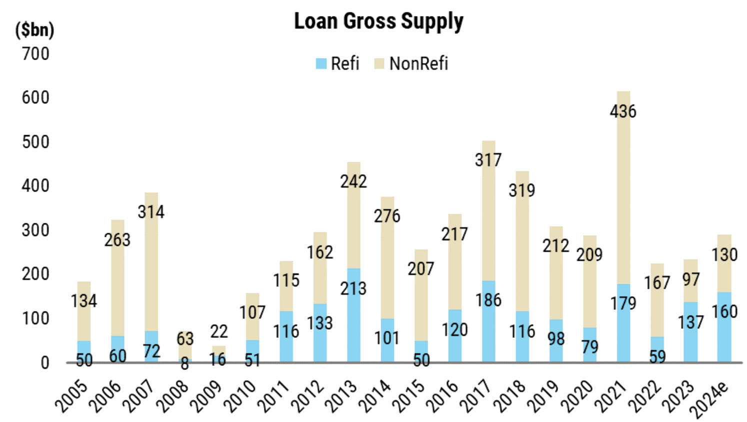
- **We expect HY gross issuance at $230bn (+32%Y) and institutional loan supply at $290bn (+20%Y) in 2024.**
- The gross issuance will continue to be driven by refinancing – **$145bn (+29%Y in HY)** and **$160bn (+14%Y in loans)** as near-term maturity walls ramp up.
- We expect a modest pick-up in deal activity, with acquisition financing volume increasing to **$145bn (splitting $45bn HY, $100bn loans)** as earnings improve and rate volatility subsides.

We forecast an increase in HY supply led by refinancing in 2024



Source: ICE, PitchBook LCD, Morgan Stanley Research forecasts; Data as of Dec 31, 2023

Similarly, we see gross supply for loans up but still at muted levels

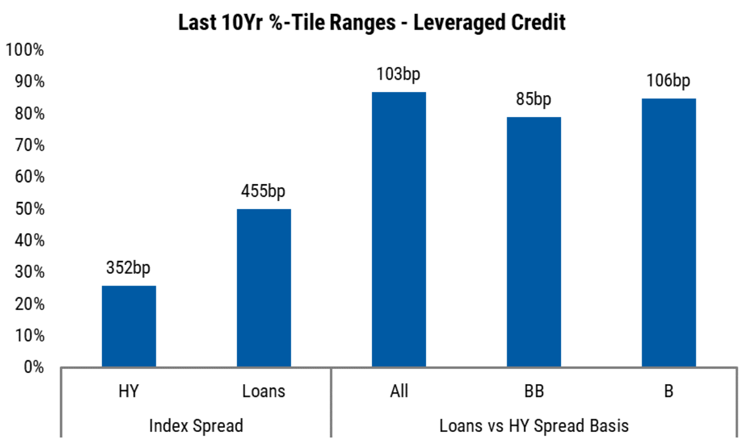


Source: ICE, PitchBook LCD, Morgan Stanley Research forecasts; Data as of Dec 31, 2023

Investment Recommendations | **Loans Over HY**

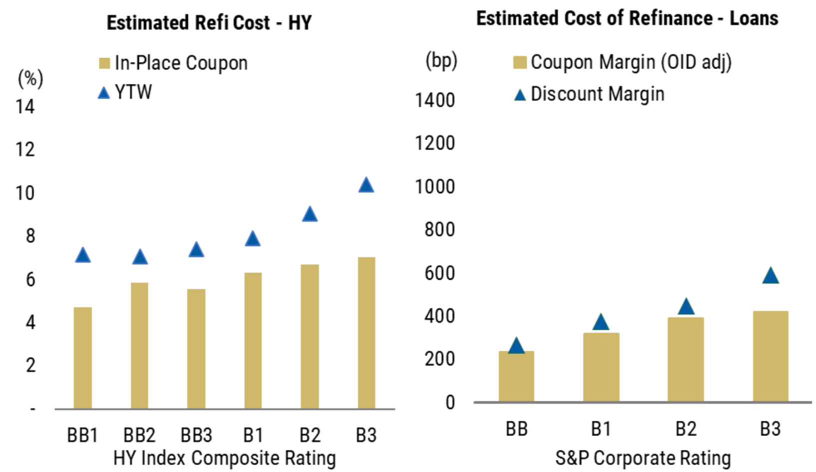
- We continue to like BB loans versus BB HY given the better risk/reward.
- We extend our preference for loans versus HY to mid- and low-single Bs as well given the incrementally higher refi cost penalty for HY names, which will likely hurt credit quality.
- Loans are relatively cheap versus HY bonds, with the headline spread basis of loan versus HY at the ~85th percentile over the past 10 years.

Spread basis between loans and HY is at the ~85th percentile (~100 bp)…



Source: Bloomberg, PitchBook LCD, Morgan Stanley Research; Data as of Jan 5, 2024

…and HY issuers will feel the pain of refinancing

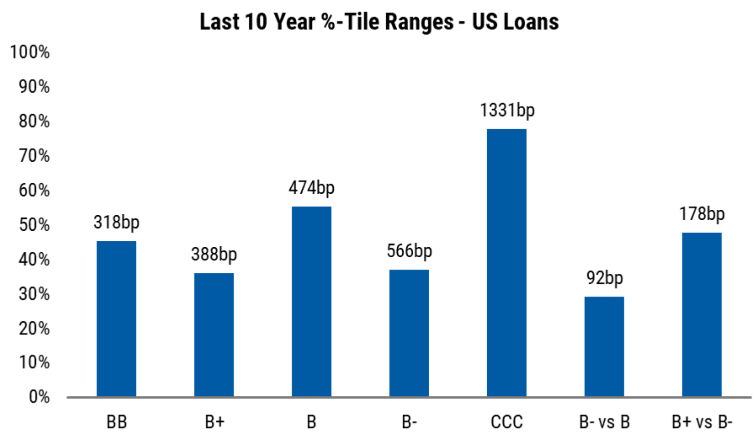


Source: Bloomberg, ICE, PitchBook LCD, Morgan Stanley Research

Investment Recommendations | **Up-in-Quality in Loans; Like B2s and Above**

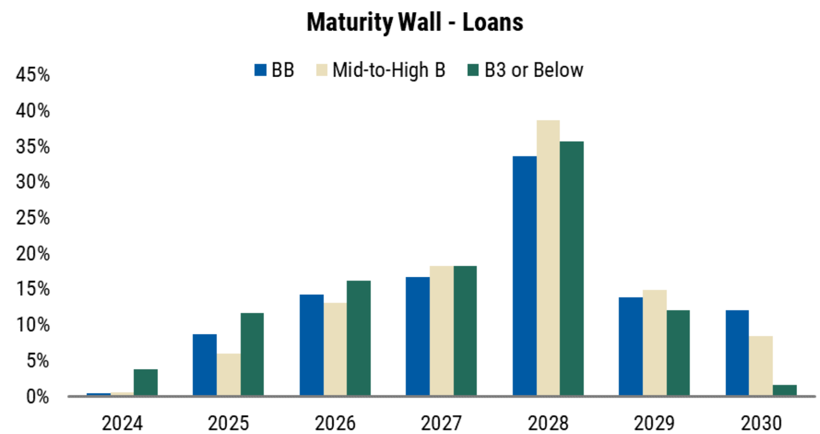
- B2 loans are attractive from the valuation perspective.
- Mid-to-high single Bs have made more progress in maturity extension.
- We remain cautious on sub-B3 credits for now. Although there are credit-picking opportunities, the overall cohort still faces meaningful fundamental challenges.

Flat B loans screen cheap as spreads are at the 55th percentile



Source: Bloomberg, PitchBook LCD, Morgan Stanley Research; Data as of Jan 5, 2024

Maturity walls for mid-to-high B loans are now more back-loaded relative to the rest of index



Source: PitchBook LCD, Morgan Stanley Research

Investment Recommendations | Like Short-Dated BBs in HY

- BB HY bonds may feel pressured to refi in 2024 as the near-term maturity walls draw closer.
- We like BB bonds maturing in 2024/25 given the healthy current income and the upside potential in the event of a take-out.
- The screen shows short-dated BBs with YTW versus coupon differential at 2% or less and trading below 99.5.

Short-dated BB bonds likely to be refinanced soon

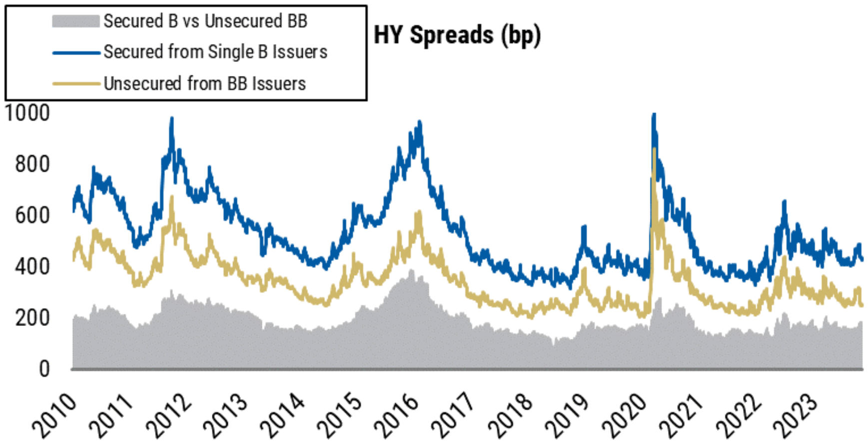
Company Name	Ticker	Sector	CUSIP	Face Value ($million)	Maturity	Coupon (%)	Price	OAS (bp)	M / SP Issuer Rating	Avg Issuer YTW (%)	Avg Issuer YTW - Coupon (%)
Sally Beauty Holdings Inc	SBH	Retail	79546VAL0	$680	12/1/2025	5.625	97.5	176	NA/BB-	6.96	1.34
Perenti Ltd	ASLAU	Basic Industry	71367VAA7	$433	10/7/2025	6.5	97.5	273	NA/NA	7.93	1.43
NuStar Energy LP	NSUS	Energy	67059TAG0	$600	10/1/2025	5.75	97.7	196	WR/NA	7.00	1.25
Drax Group PLC	DRXLN	Utility	26151AAA7	$500	11/1/2025	6.625	97.8	263	NA/NA	7.88	1.25
Sensata Technologies Holding P	ST	Technology & Electronics	81725WAJ2	$699	10/1/2025	5	97.8	117	Ba2/BB+	6.84	1.84
Gen Digital Inc	GEN	Technology & Electronics	871503AU2	$1,100	4/15/2025	5	98.1	107	Ba2/BB	6.71	1.71
CrownRock LP	CRROCK	Energy	228701AF5	$868	10/15/2025	5.625	98.3	128	NA/NA	6.49	0.87
Zeppelin-Stiftung Ferdinand gG	ZFFNGR	Automotive	98877DAC9	$1,077	4/29/2025	4.75	98.5	66	NA/NA	6.39	1.64
Energy Transfer LP	CMLP	Energy	226373AP3	$500	4/1/2025	5.75	98.5	152	WR/BBB	6.83	1.08
Stericycle Inc	SRCL	Services	858912AF5	$600	7/15/2024	5.375	98.7	187	WR/BB	7.23	1.86
Ball Corp	BALL	Capital Goods	058498AT3	$1,000	7/1/2025	5.25	98.8	90	Ba1/BB+	6.40	1.15
Neptune Energy Group Ltd	NEPENE	Energy	64073KAA1	$850	5/15/2025	6.625	98.9	200	NA/NA	7.44	0.81
Hilton Worldwide Holdings Inc	HLT	Leisure	432833AG6	$500	5/1/2025	5.375	99.0	64	Ba1/BB+	6.47	1.09
Sealed Air Corp	SEE	Capital Goods	81211KAW0	$425	12/1/2024	5.125	99.1	56	Ba1/BB+	6.77	1.64
AerCap Holdings NV	AER	Financial Services	00773HAA5	$500	6/15/2025	6.5	99.1	169	NA/BBB	8.41	1.91
Caesars Entertainment Inc	CGPHLC	Leisure	12770RAA1	$989	7/1/2025	5.75	99.2	69	NA/NA	6.25	0.50
Quebecor Inc	QBRCN	Media	92660FAG9	$600	6/15/2024	5.375	99.2	124	Ba1/BB+	6.64	1.27
Cedar Fair LP	FUN	Leisure	150190AF3	$1,000	5/1/2025	5.5	99.4	37	NA/BB-	6.71	1.21
Tri Pointe Homes Inc	TPH	Basic Industry	962178AN9	$450	6/15/2024	5.875	99.4	149	NA/BB-	7.15	1.28
Apollo Global Management Inc	PRSESE	Services	74166MAB2	$600	4/15/2024	5.25	99.5	98	NA/NA	6.95	1.70

Source: Bloomberg, ICE, Morgan Stanley Research; Data as of November 10, 2023.

Investment Recommendations | **Like BB Unsecured Over Single B Secured**

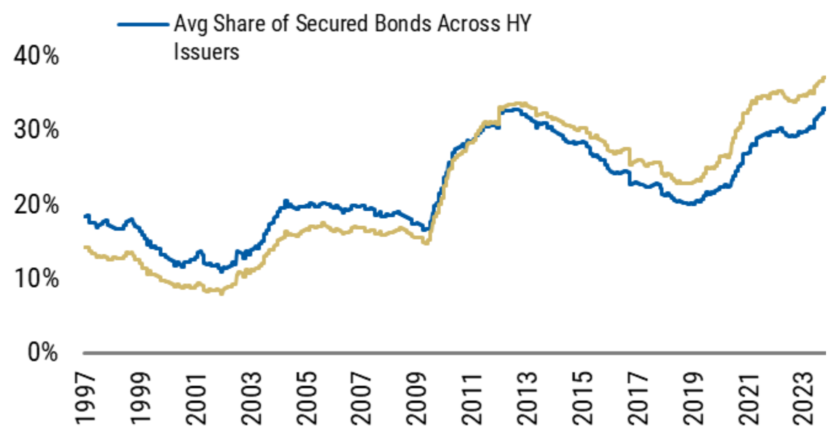
- Within HY, we prefer up in issuer quality over up in capital structure (of lower-rated names). In particular, we like unsecured bonds from BB rated issuers versus secured bonds from single B rated ones.
- **Unsecured BBs look cheaper.** The spread basis between secured bonds by B rated issuers versus unsecured BBs is slightly tighter than post-GFC averages.
- We also believe that the spread basis can go wider given the refi pressures within the lower-rated cohorts and potentially weaker recovery prospects given the higher secured concentration.

The spread pick-up from unsecured BBs to secured Bs is not compelling given risks for lower-quality issuers



Source: S&P, ICE, Morgan Stanley Research

We see an increasing proportion of secured bonds in HY capital structures vs. pre-Covid

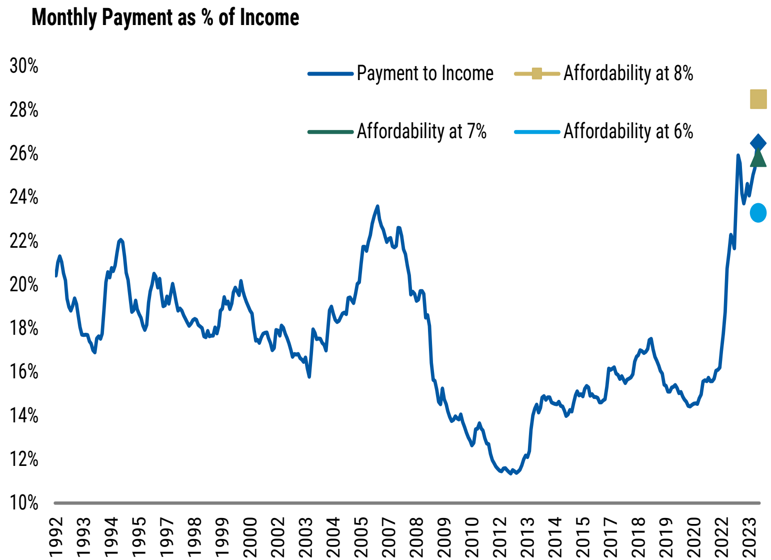


Source: ICE, Morgan Stanley Research

US HOUSING AND AGENCY MBS

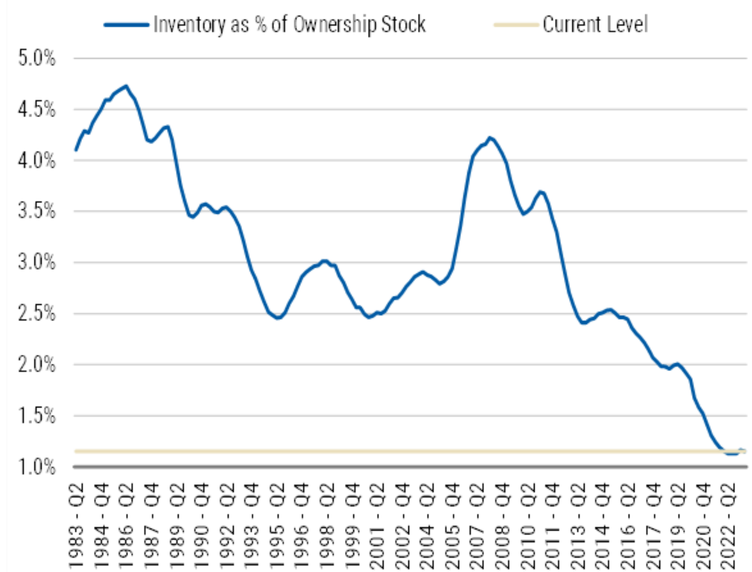
US Housing | Supply Constraints Have Supported Home Prices

The monthly payment as a % of household income remains elevated



Source: Morgan Stanley Research, NAR, Freddie Mac, US Census Bureau, NAR

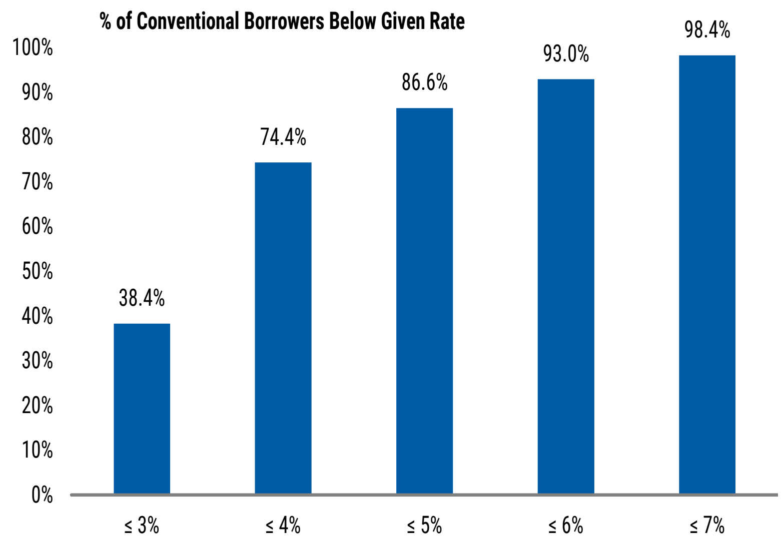
Listings are at the lowest levels on record



Source: Morgan Stanley Research, NAR, Freddie Mac, US Census Bureau, NAR

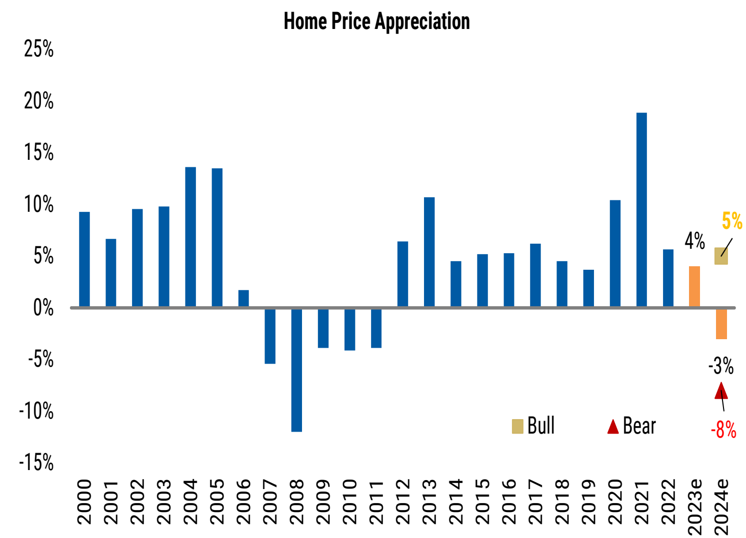
US Housing | Home Prices to Moderate as Affordability Improves

Distribution of outstanding conventional mortgages by mortgage rate



Source: Morgan Stanley Research forecasts, Case-Shiller, eMBS

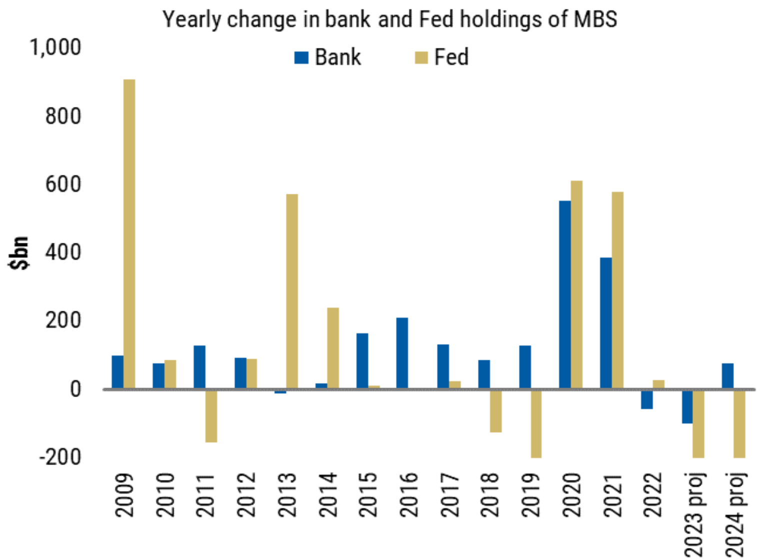
Home price forecasts



Source: Morgan Stanley Research forecasts, Case-Shiller, eMBS

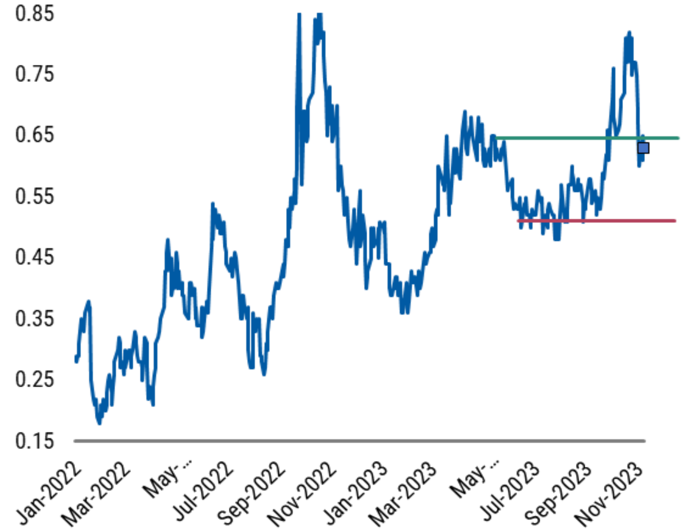
Agency MBS | **Technicals Get Better in 2H 2024**

Fed will continue QT and banks will reduce holdings



Source: Federal Reserve, SNL, Morgan Stanley Research forecasts

Investors should trade the range on the index



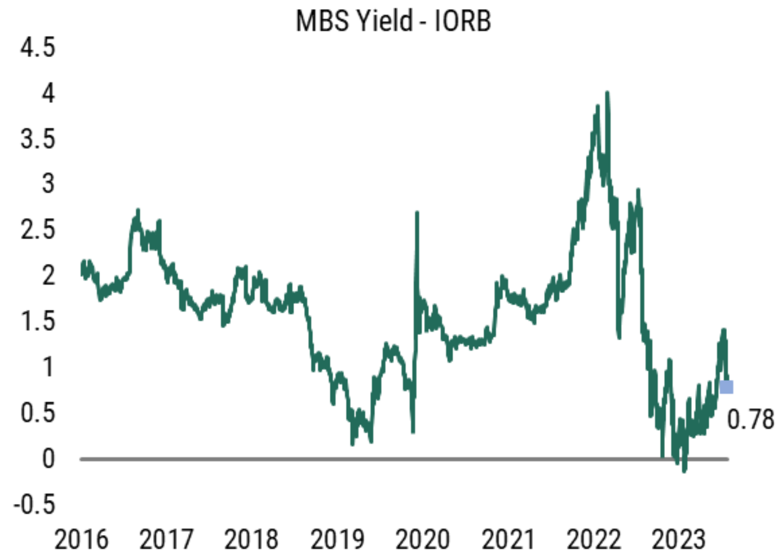
Source: Bloomberg, Morgan Stanley Research

Agency MBS | What Makes Banks Return to the Mortgage Market

1. Conviction that the next move from the Fed is a cut, not a hike (could be met by year-end)
2. More clarity around deposit durations (our banking equity analysts estimate six months after last hike)
3. An increase in NIM
4. More clarity around regulatory guidelines

We think bank demand will come in Ginnies, CMOs, and slight discount instead of par coupon TBA, but likely not until 2H24.

Banks earn 78bp of additional yield on current coupon mortgages vs. deploying money in excess reserves



Source: Bloomberg, Morgan Stanley Research

Agency MBS | Supply and Demand – Net Issuance Forecast to be $300 Billion for End-2024

Historical supply/demand breakdown by investor type ($bn)

	All mortgages											*Ginnie only*	
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023 YTD**	**2024 Est**	**2023 FY Ginnie Est**	**2024 Ginnie Est**
Gross Issuance	923	1,251	1,472	1,304	1,171	1,532	3,161	3,484	1,701	1,000	1,050	500	450
Net Issuance	**69**	**163**	**229**	**315**	**281**	**224**	**506**	**868**	**539**	**235**	**300**	**175**	**180**
Demand													
GSEs	-46	-42	-43	-5	-15	0	-61	-26	-37	1	0	0	0
Overseas	44	31	107	62	90	76	-30	102	167	158	175	120	140
Fed +Treasury	247	11	-6	24	-128	-217	610	577	27	-209	-210	-55	-53
Banks	11	177	220	140	70	86	522	326	-57	-165	75	50	100
REITs	8	-18	-1	40	21	36	-101	-22	2	32	25	0	0
Money Managers/ Others	-208	5	-48	48	196	198	-435	-89	437	418	235	60	-8
Net Demand ex Fed/Tsy/GSE	**-132**	**195**	**278**	**296**	**423**	**441**	**-42**	**317**	**550**	**443**	**510**	**230**	**233**

Source: Treasury, Federal Reserve, Fannie Mae, Freddie Mac, REIT and bank company filings, Morgan Stanley Research forecasts

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(as of December 31, 2023)

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Stock Rating Category	Coverage Universe Count	Coverage Universe % of Total	Investment Banking Clients (IBC) Count	Investment Banking Clients (IBC) % of Total IBC	Investment Banking Clients (IBC) % of Rating Category	Other Material Investment Services Clients (MISC) Count	Other Material Investment Services Clients (MISC) % of Total Other MISC
Overweight/Buy	**1346**	**37%**	**266**	**41%**	**20%**	**605**	**39%**
Equal-weight/Hold	**1668**	**46%**	**317**	**49%**	**19%**	**717**	**46%**
Not-Rated/Hold	**3**	**0%**	**0**	**0%**	**0%**	**1**	**0%**
Underweight/Sell	**598**	**17%**	**61**	**9%**	**10%**	**224**	**14%**
Total	**3,615**		**644**			**1547**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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