June 14, 2020 05:15 PM GMT

Global Strategy Mid-Year Outlook

Trust, but Verify

Trust that this cycle is more normal than appreciated and that an early-cycle playbook will work. Verify that trade, policy and the pandemic don't knock these conditions off course.

Matthew Hornbach, Guneet Dhingra, Tony Small, Koichi Sugisaki, Sheena Shah, David Adams, James Lord, Srikanth Sankaran, Vishwas Patkar, Max Blass, Kelvin Pang, Jay Bacow, James Egan, Michael Zezas and Barbara Boakye are fixed income strategists and are not opining on equity securities. Their views are clearly delineated.

Contributors

MORGAN STANLEY & CO. INTERNATIONAL PLC+
Andrew Sheets
Strategist
+44 20 7677-2905
Andrew.Sheets@morganstanley.com

MORGAN STANLEY & CO. LLC
Jay Bacow
Strategist
+1 212 761-2647
Jay.Bacow@morganstanley.com

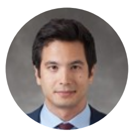
MORGAN STANLEY & CO. INTERNATIONAL PLC+
Susan Bates
Commodity Strategist
+44 20 7425-4110
Susan.Bates@morganstanley.com

MORGAN STANLEY & CO. LLC
James Egan
Strategist
+1 212 761-4715
James.F.Egan@MorganStanley.com

MORGAN STANLEY ASIA LIMITED+
Jonathan F Garner
Equity Strategist
+852 2848-7288
Jonathan.Garner@morganstanley.com

MORGAN STANLEY & CO. LLC
Matthew Hornbach
Strategist
+1 212 761-1837
Matthew.Hornbach@morganstanley.com

MORGAN STANLEY & CO. LLC
Boris Lerner
Quantitative Strategist
+1 212 761-0759
Boris.Lerner@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+
James K Lord
Strategist
+44 20 7677-3254
James.Lord@morganstanley.com

MORGAN STANLEY & CO. INTERNATIONAL PLC+
Wanting Low
Strategist
+44 20 7425-6841
Wanting.Low@morganstanley.com

MORGAN STANLEY & CO. INTERNATIONAL PLC+
Phanikiran L Naraparaju
Strategist
+44 20 7677-5065
Phanikiran.Naraparaju@morganstanley.com

MORGAN STANLEY & CO. INTERNATIONAL PLC+
Naomi Z Poole
Strategist
+44 20 7425-9714
Naomi.Poole@morganstanley.com

MORGAN STANLEY & CO. INTERNATIONAL PLC+
Martijn Rats, CFA
Equity Analyst and Commodities Strategist
+44 20 7425-6618
Martijn.Rats@morganstanley.com

MORGAN STANLEY & CO. LLC
Srikanth Sankaran
Strategist
+1 212 761-3910
Srikanth.Sankaran@morganstanley.com

MORGAN STANLEY & CO. INTERNATIONAL PLC+
Graham Secker
Equity Strategist
+44 20 7425-6188
Graham.Secker@morganstanley.com

MORGAN STANLEY & CO. LLC
Serena W Tang
Strategist
+1 212 761-3380
Serena.Tang@morganstanley.com

MORGAN STANLEY & CO. LLC
Vishwanath Tirupattur
Strategist
+1 212 761-1043
Vishwanath.Tirupattur@morganstanley.com

MORGAN STANLEY & CO. LLC
Michael J Wilson
Equity Strategist
+1 212 761-2532
M.Wilson@morganstanley.com

MORGAN STANLEY & CO. LLC
Michael D Zezas, CFA
Strategist
+1 212 761-8609
Michael.Zezas@morganstanley.com

+ = Analysts employed by non-U.S. affiliates are not registered with FINRA, may not be associated persons of the member and may not be subject to NASD/NYSE restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account.

Global Strategy Mid-Year Outlook

Trust, but Verify

At Morgan Stanley, we've added a fifth value to our core values: Committing to Diversity and Inclusion. We reject racism and discrimination of any kind. We fervently hope that this historic moment can be a catalyst for positive change that safeguards equality and human dignity for all.

Trust, but verify, that this cycle is more 'normal' than appreciated: The patterns that preceded the recession had normal late-cycle characteristics. The manner in which markets bottomed in March followed prior recessions. The market is still underpricing the extent to which the recovery could also follow that traditional playbook.

The opportunity is in 'early-cycle' rotation: We're trusting the early-cycle playbook, and while outright gains look modest, fundamentals, valuations and technicals all support more rotation towards traditional early-cycle beneficiaries. We see the best risk/reward in owning credit (broadly) and selling volatility, and reduce government bonds to UW. Verify that late-summer risks to health, trade and politics remain manageable.

Global equities – V is for value: Recent gains limit overall upside, but early-cycle rotation has further to go. By region, US and Europe over EM. By style, favor US small caps and cyclicals and European value.

G10 rates – early cycle = higher yields + steeper curves: Expensive valuations and better growth should push yields higher and the curve steeper – a 'normal' early-cycle pattern. Yields in the US and Germany should underperform the UK and Australia.

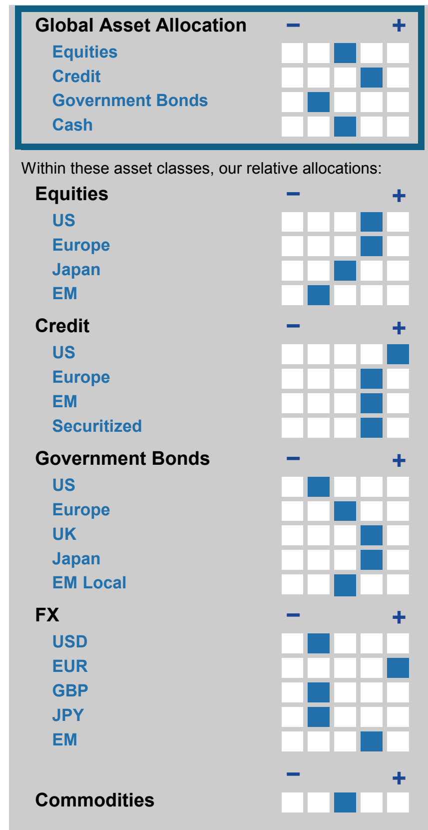
G10 FX – weaker DXY, stronger EUR: We think that EUR is cheap, underowned and a beneficiary of a reduction in tail risks from a new recovery fund. The dollar should weaken as global growth rebounds and Fed easing outpaces other central banks.

EM fixed income – a fragile recovery: We remain constructive given better global growth and a dovish Fed, with EM credit offering the best risk/reward. We like RUB, ZAR, IDR, INR and HUF.

Corporate credit – quality compression: With gaps between BBB-A and B-BB credit wide, we think that investors are being paid well to move down modestly in quality.

Securitized credit – modest mezz: We think that the best risk/reward lies in mezzanine exposure in CLOs. We expect CMBS to underperform, given a more material COVID-19 impact.

Commodities – expect dispersion: Commodity prices should rise modestly over the next 6-12 months. We're bullish on copper based on a strong China recovery, and more cautious on oil and aluminium, given weaker fundamentals.



For individual investors, our market outlook should be seen in the context of a long investment horizon that is underpinned by a comprehensive financial plan. Your clients' financial plan should reflect the goals they are looking to achieve over time and a disciplined approach to asset allocation, saving and withdrawals.

Contents

5 Cross-asset strategy: Trust (the cycle) but verify

11 Top trades across asset classes

12 Global equities: Post-COVID-19 recovery better for DM than EM equities

17 G10 rates: Mixed performance versus forwards

20 G10 FX: EUR now a 'cleaner dirty shirt'

23 Global EM fixed income: A fragile recovery

26 Global credit: Turning over a new leaf

30 Global securitized products: Modest mezz

33 Munis: Uncertain direction, attractive price

35 Commodities: Balanced for now but long-term inflationary tailwinds emerging

38 Global volatility: Better days ahead

40 Global quant: Embracing Value

43 What we debated

44 How consistent are our forecasts?

45 Expected returns and risk/reward

47 Morgan Stanley key economic forecasts

48 Morgan Stanley global currency forecasts

49 Morgan Stanley government bond yield/spread forecasts

50 Valuation methodology and risks

What's changed

Exhibit 1:

What's changed in our forecasts – economics

What's Changed - Economics

	OLD FORECASTS		NEW FORECASTS		Δ from Last Forecast	
	2020e	2021e	2020e	2021e	2020e	2021e
Real GDP						
Global (%Y)	-3.5	6.0	-3.8	6.1	-0.3	0.1
G10 (%Q, SAAR)	-7.3	4.8	-7.1	4.5	0.2	-0.3
US	-5.8	5.3	-5.8	3.9	0.0	-1.4
Euro Area	-10.8	6.0	-9.6	6.5	1.2	0.5
Japan	-5.3	1.1	-4.5	1.9	0.8	0.8
UK	-9.6	4.9	-9.9	6.4	-0.3	1.5
EM (%Y)	-0.9	6.8	-1.6	7.2	-0.7	0.4
China	2.0	9.2	2.0	9.2	0.0	0.0
India	-1.9	9.0	-1.7	9.0	0.2	0.0
Brazil	-5.1	1.0	-7.2	2.9	-2.1	1.9
Russia	-2.5	3.4	-5.3	3.9	-2.8	0.5
CPI (%Y)						
Global	2.4	2.6	2.2	2.6	-0.2	0.0
G10	0.4	1.6	0.6	1.5	0.2	-0.1
US	0.7	2.5	1.0	2.2	0.3	-0.3
Euro Area	0.4	1.1	0.2	1.2	-0.2	0.1
Japan	-0.4	-0.6	-0.4	-0.6	0.0	0.0
UK	0.9	1.6	0.8	1.3	-0.1	-0.3
EM	3.7	3.3	3.3	3.3	-0.4	0.0
China	3.7	3.0	2.9	3.1	-0.8	0.1
India	4.9	3.9	4.9	3.9	0.0	0.0
Brazil	3.1	3.5	2.3	3.2	-0.8	-0.3
Russia	3.4	3.3	3.0	3.1	-0.4	-0.2

Source: Morgan Stanley Research forecasts; Note: Old forecasts refer to latest published forecasts, as of June 12, 2020.

Exhibit 2:

What's changed in our forecasts – assets

What's Changed - Assets

Base Case Forecasts	OLD Q4 2020	NEW Q2 2021	Δ from last f'cast
Equities			
S&P 500	3,000	3,350	12%
MSCI Europe	1,310	1,580	21%
Topix	1,350	1,550	15%
MSCI EM	800	920	15%
FX			
USD/JPY	99	112	13%
EUR/USD	1.16	1.20	3%
GBP/USD	1.35	1.25	-7%
Rates (% percent)			(bp Δ)
UST 10yr	0.80	1.30	50
DBR 10yr	0.00	0.05	5
UKT 10yr	1.20	0.45	-75
JGB 10yr	0.00	0.00	0
Credit (bps)			(bp Δ)
US IG	200	135	-65
US HY	725	550	-175
EUR IG	55	80	25
EUR HY	355	400	45
Italy 10yr	125	90	-35
EM Sovs	360	400	40
US CMBS AAA	95	95	0

Source: Morgan Stanley Research forecasts; Note: Old forecasts refer to latest published forecasts, as of June 12, 2020.

Cross-asset strategy: Trust (the cycle) but verify

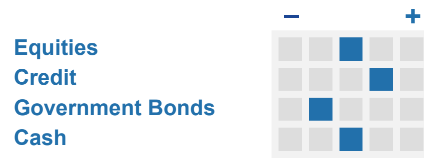
Andrew Sheets
Andrew.Sheets@morganstanley.com
+44 20 7677-2905
Morgan Stanley & Co. International plc+

Cross-Asset Strategy Team

Key investment ideas

• Trust that 'normal' early-cycle dynamics can apply over the next 6-12 months. Verify that risks to health, trade and political uncertainty don't disrupt this story.

• **Key views:** Credit and volatility-selling offer the best risk/reward. We like many early-cycle beneficiaries: US small caps, EU peripheral stocks, curve steepeners, inflation breakevens and short DXY. We lower government bonds to underweight and raise cash to equal-weight.



The first question for a 12-month outlook is how can we produce one? The global economy has seen a collapse of activity, an expansion of fiscal and monetary policy and a level of medical uncertainty without precedent in the modern era. Throw in a US presidential election, simmering US-China trade tension and wild swings in commodity markets, and it would seem reasonable to throw up one's hands and say that the old rules no longer apply.

We disagree. While the last four months have been exceptional, we think that this cycle has been, and will be, more 'normal' than appreciated. A new cycle has started, and we think that investors should position as such. We think that stocks and credit will be modestly higher and tighter over the next 12 months, but see the more compelling opportunity in traditional 'early-cycle' rotations.

Trusting the cycle

We're trusting a 'normal' cycle playbook because of what preceded this downturn, how markets troughed and the recovery our economists are forecasting.

What preceded the bear market was 'normal'

Every bear market and recession is different. But they are often preceded by common, cyclical patterns of behavior, including:

- A strong economy, with healthy labour markets and high consumer confidence.
- Inflation (CPI) rising above the recent trend.
- High valuations and profit margins, low volatility and confident/bullish investor sentiment.
- Central banks that have tightened policy in the prior 12-18 months in response to these factors.
- An inverted yield curve in the prior 6-12 months, as bond markets sense trouble, and price in slower growth ahead.

All these late-cycle elements preceded the recession and bear market of 2020: Indeed, since *last year*, the right strategy has generally been to invest as if recession risks were high, favoring long-duration bonds and defensive, high-quality stocks. As 'unusual' as the COVID-19 shock was, it collided with a very typical, vulnerable, late-cycle market.

How markets bottomed was 'normal'

The prelude to the current crisis was surprisingly 'normal'. So was its crescendo. *Markets lead the economy*, and when we compare where markets bottomed to where data bottomed (or are likely to bottom), the pattern matches the last five US recessions to an almost uncanny degree.

Other dynamics around the bottom were also 'normal', including the fact that equity volatility and credit spreads peaked before equity markets troughed. And while the bounce from the lows has been unusually fast, so was the drawdown.

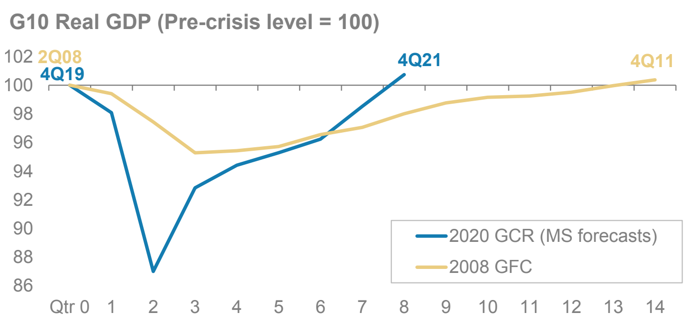
We think that it could be a (reasonably) 'normal' recovery

This bear market was preceded by 'normal' late-cycle dynamics and bottomed with many 'normal' characteristics. Both are arguments that historical patterns can still apply. But there's another – we think that the economic recovery will look more 'normal' than abnormal.

This might sound odd, given the scale of the economic devastation, record job losses and significant medical uncertainty. But based on our economic forecasts, **we think that DM growth could recover to pre-recession levels by the end of 2021.** This eight-quarter 'time to recovery' would be about *twice* as fast as what followed the GFC, and is *similar* to the US recessions of 1973 and 1981. Every recession and cycle is different, but again, we challenge the notion that this one defies all precedents.

Exhibit 3:

Our economists expect a much faster recovery than the GFC



Source: Haver Analytics, Morgan Stanley Research forecasts

Since we think that history can still act as a guide, the next step is to apply it. At present, *we think that fundamentals, valuations and technicals all remain 'better-than-average' for forward-looking risk premiums*. This dovetails with generally modest gains across our strategists' bottom-up 12-month forecasts. Together, we think that this argues for modest gains in global equities and credit over the next year, with bigger moves in underlying early-cycle rotation.

The early-cycle checklist – fundamentals/ valuations/technicals

Better-than-average fundamentals

Global economic data are weak but set to improve. We think that markets care more about the trend in data than the level. As such, while it may sound counter-intuitive, we think that 'fundamentals' are currently supportive for risk-taking, rather than a detriment.

What do we mean? Taking US PMI and industrial production data back to 1950, we divide them into four possible stages – above or below average (above or below 50 for PMI), and rising or falling. We then look at following six-month returns for the S&P 500 in each of these quadrants. For markets, an environment where bad data are improving isn't bad.

Exhibit 4:

'Bad' data often lead to better-than-average performance

S&P 500 6M Forward Returns vs. Avg

	PMI	
	< 50	> 50
Rising	2.0%	-0.4%
Falling	1.8%	-1.2%
	Industrial Production	
	Below Avg	Above Avg
Rising	0.0%	-0.9%
Falling	1.1%	-0.6%

Source: Bloomberg, Morgan Stanley Research; Note: We define rising/falling defined as 1m change in 6m smoothed moving average.

Exhibit 5:

Cross-asset returns in 'repair': Overall, and below/after an indicator low

	Next 12M Return vs All-Date Average		
	All Repair	Repair Until Indicator Low	Repair After Indicator Low
S&P 500	-2.3%	-8.4%	5.9%
UST 10Y	1.8%	3.3%	-0.4%
US IG (XS)	2.6%	2.5%	2.7%
US HY (XS)	8.6%	7.8%	9.7%

Source: Bloomberg, Morgan Stanley Research; Note: Data from 1985 for equities and rates, and 1988 for credit.

We see this in our cycle indicators as well. After first announcing 'downturn' in June 2019, they entered 'repair' in April 2020. Overall, this early-cycle phase tends to be best for credit and selling volatility. But dividing it further, it has been *most* supportive following a trough in activity. We think that this trough is happening now, and will improve thereafter.

Importantly, cyclical troughs often mean major changes in market leadership and performance. Early-cycle environments often see bear-steepening of the yield curve, rising inflation expectations and better relative performance from both small-caps and cyclicals. All are investment strategies we currently like.

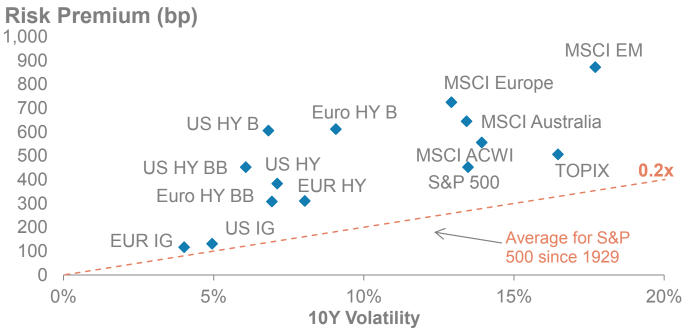
Better-than-average risk premiums

While many markets have rallied back sharply from March lows, improvement remains uneven. Overall, we think that risk premiums remain above average, at least on enough asset classes to matter.

To quantify this, **Exhibit 6** looks at estimated risk premiums for a variety of asset classes relative to volatility. The dotted line represents the risk premium/volatility of the S&P 500 since 1929. We think that most investors would see US stocks as a 'good' investment over that time; most assets today are still comfortably above this line.

Exhibit 6:

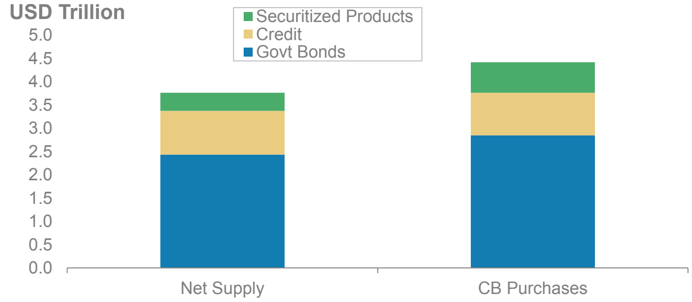
Cross-asset risk premiums versus volatility are reasonable



Source: Bloomberg, Morgan Stanley Research; Note: For equities we show cyclically adjusted earnings yield - 10-year real yield, and for credit we show loss-adjusted spread. 10Y vol is realized vol of monthly returns. The dotted line shows the annualized return for S&P 500 versus UST 10Y since 1929 relative to realized vol of monthly returns over the same period.

Exhibit 7:

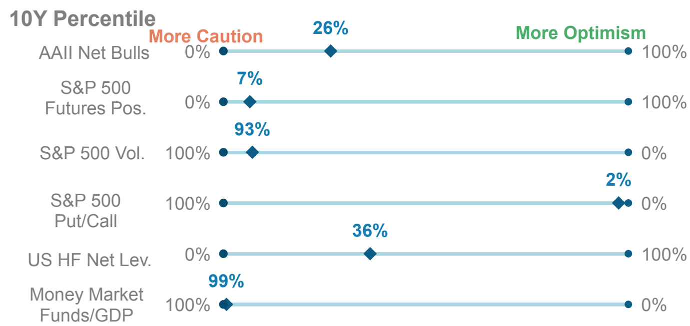
Central bank purchases exceed net supply



Source: Morgan Stanley Research forecasts; Note: We aggregate supply forecasts and central bank purchases for 2020 across Europe and the US.

Exhibit 8:

Signs of caution persist



Source: Bloomberg, Morgan Stanley Prime Brokerage, Morgan Stanley Research

Better-than-average technicals

'Technicals' is a catch-all for supply and demand, investor sentiment and positioning, and central bank activity. We think that all remain better than average for supporting risk premiums.

Central bank support, without exaggeration, is off the charts. The Federal Reserve is buying more assets relative to GDP than QE1, 2 and 3 combined. Together, the Fed and ECB look set to buy roughly equal to all net supply across European and US sovereign and corporate debt this year. More tactically, after heavy supply in April and May, *we think that peripheral and corporate supply will now slow over the summer*, while CLO and CMBS issuance should also be light.

Meanwhile, investor sentiment and positioning look restrained. In **Exhibit 8**, we show a variety of sentiment indicators relative to their 10-year range.

Importantly, fundamentals, valuations and technicals look better for many 'early-cycle' winners than the market overall: Our above-consensus economic forecasts help. The valuation of early-cycle beneficiaries is generally cheaper. And with market positioning still having an 'up in quality' bias, we think that early-cycle positioning is light.

Putting it together – our framework

Our cross-asset framework remains rooted in merging two approaches to asset allocation – a top-down, cycle-driven estimate of risk premiums, and our strategists' bottom-up estimates for 12-month returns. We think that there is value in the union of objective and subjective, model and human, and this remains a good *starting point* for thinking about where our preferences should lie.

Above, we discussed why we think those cycle-adjusted risk premiums are somewhat better than average. This generally dovetails with our strategists' bottom-up estimates, refreshed for this outlook. More detail on what drives these forecasts can be found in the following sections.

We think that our allocation should be linked to where we see the best risk-adjusted return. **Exhibit 9** brings these approaches together. Column (A) shows our cycle-adjusted estimate of return versus cash. Column (B) shows our strategists' forecast return. Column (C) is the average versus cash. Column D shows these returns adjusted for volatility.

Combining risk premiums, how we think the economic cycle should modify those risk premiums and our bottom-up forecasts, we think that:

- The best risk/reward is in corporate, securitized and EM credit. We remain overweight.
- The risk/reward of government bonds is poor, and we move underweight.
- The risk/reward of equities is mixed-to-positive. We are modestly positive, in the band of allocation we consider 'equal-weight'.

Verify – three overlapping risks to watch

Believing this is the start of a new cycle is not a new view, and given that, it's especially important to *verify* that three risks to the cycle don't derail it.

COVID-19: Despite an expanding narrative that 'the disease is behind us', global case counts are still rising. While fatalities are falling as health systems adapt and new infections are skewed towards younger cohorts, the menace has not gone away.

Specifically, Morgan Stanley estimates assume that **US cases begin to rise again from mid-July,** a delayed response to social distancing measures being lifted. Viewed from a distance, we currently believe that a 'second wave' will be small. But when it starts, it won't be possible to know how far it will rise, and the effect on consumer and market psychology could be significant. After all, we're believers that trend often matters more to markets than level.

Exhibit 9:

Averaging cycle-adjusted risk premiums and our 12-month forecasts, we think that the best risk-adjusted returns lie in credit

		Top-Down Risk Premium	Cycle Boost/Drag	(A) Top-Down Expected Returns Cycle-Adj Returns	(B) Bottom-Up 12M Outlook** MS Base Case Rtn Forecast	(C) Avg (A, B - Cash) Forecast Excess Rtn	(D) (C)/ Vol Framework Expected Rtn/ Vol	MS Asset Allocation vs Benchmark
Equities	US	△	●	8.6%	13.0%	10.7%	0.4	+1%
	Europe	●	△	9.6%	12.3%	11.2%	0.5	+1%
	Japan	●	◆	5.1%	0.1%	2.7%	0.1	+0%
	EM	●	●	18.9%	-4.3%	7.2%	0.4	-1%
Bonds	Treasuries	◆	△	1.5%	-4.5%	-1.7%	-0.2	-3%
	Bunds	◆	●	2.4%	-4.1%	-0.3%	0.0	-2%
	JGBs	◆	●	1.4%	0.3%	1.0%	0.4	+1%
	EM Local*	-	-	- -	-2.3%	-2.5%	-0.4	+0%
Credit	US IG	●	●	4.5%	4.0%	4.2%	0.6	+2%
	US HY	△	●	13.0%	8.4%	10.7%	1.4	
	EUR IG	△	△	2.5%	2.7%	2.6%	0.8	+1%
	EUR HY	△	●	15.9%	6.3%	11.1%	1.6	
	EM $	●	●	10.3%	11.1%	10.7%	1.7	+1%
	Securitised^	-	-	- -	1.8%	1.8%	1.2	+1%

Legend: ● (LT Rtns): LT Z-score > 0.5 (Cyc): Phase with best returns for the asset ◆ LT Rtns): LT Z-score < -0.5 (Cyc): Phase with worst returns for the asset

Source: Morgan Stanley Research forecasts; Note: *EM Local is FX-hedged. ^Securitized is an average of agency MBS, CLO AAA and CMBS AAA. 'Cycle-Adj Returns' shows cycle-adjusted long-term expected returns when US cycle is in current phase (repair). We weight the cycle modifier assuming an 80% chance that the indicator has troughed, and a 20% chance that it has not (Exhibit 5). All returns for credit are excess returns. 12m cash rate is for the respective region. 12m bottom-up numbers are annualized returns of June 2021 target levels.

We are most focused on the US and UK, large economies that are reopening despite total infection levels being relatively high, and several key EM countries (Brazil, India, Russia) where infection rates continue to rise.

The US elections and trade: Asset markets, particularly US ones, have often seen worse-than-average returns in the three months ahead of competitive US presidential elections. The reason is intuitive; from three months out, 'wait and see' becomes tempting for both investors and companies that would otherwise take action. We expect investors to treat the US 2020 race as a close election, between two candidates with extremely different policy platforms.

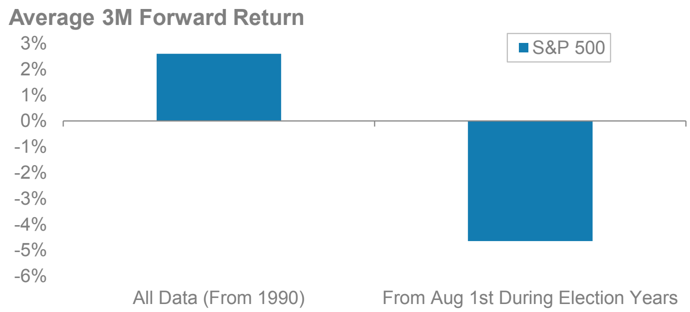
Ironically, despite these differences, one issue where we think that both candidates will sound similar is US-China trade. We think that the risk of an escalation of trade tension rises as the election approaches.

Fiscal policy doesn't follow through: Our current base case is that the US will pass a further US$1 trillion stimulus package between now and July and that the European Union will agree on a €750 billion recovery fund very similar to the current French-German proposal. The failure or dilution of either and, more broadly, a premature shift back towards belt-tightening would be a major risk. A misguided focus on debt/GDP ratios and a premature shift to fiscal austerity was a major driver of why the post-GFC recovery was so weak.

Note that we think the risk of monetary policy tightening prematurely is *very* low, and thus don't include it as a key risk we're worried about.

Exhibit 11:

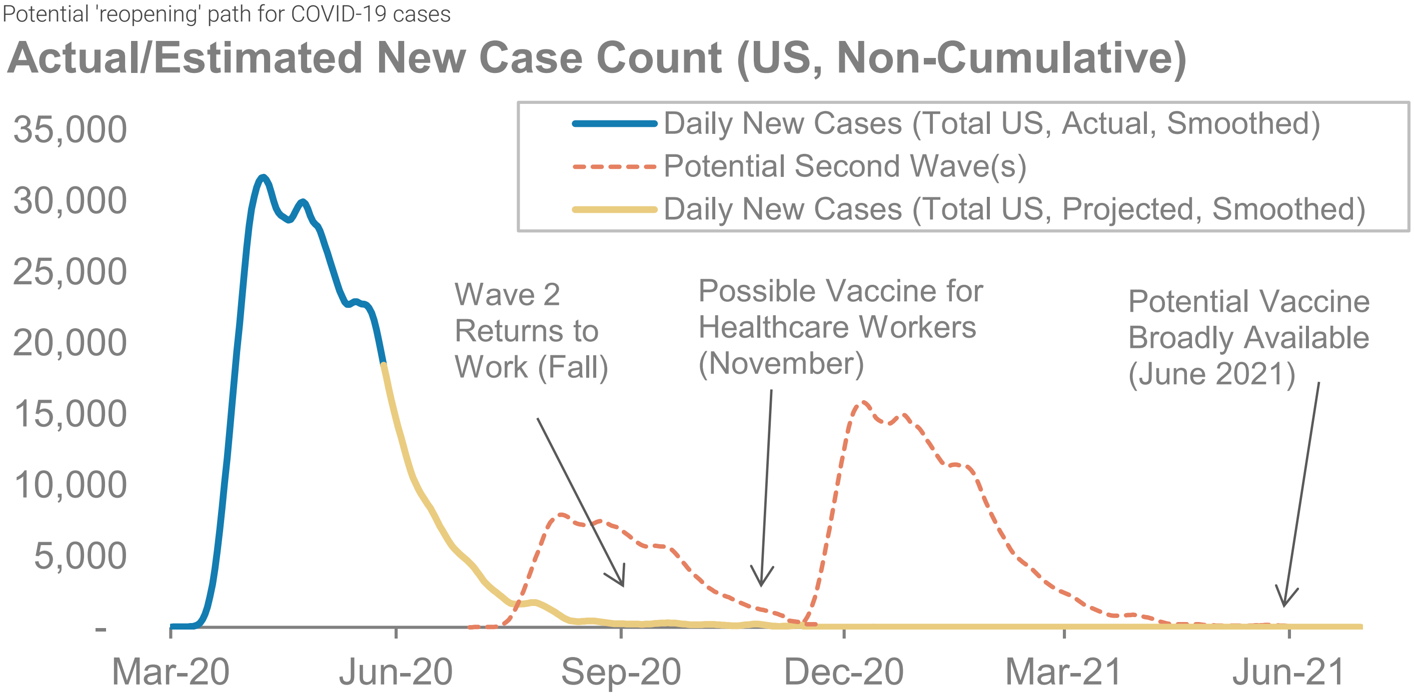
Equities tend to see worse-than-average performance leading up to US elections



Source: Bloomberg, Morgan Stanley Research; Note: We exclude 1996, where polls were never very close over the course of the summer prior to the election.

Exhibit 10:

Potential 'reopening' path for COVID-19 cases



Source: Morgan Stanley Research forecasts; Note: For more detail on the model, see Biotechnology: COVID-19 Outbreak Dynamics - Daily Update Vs Our Model, June 12, 2020

'Normal' early-cycle trades, the exceptions, and key views by asset class

'Normal' early-cycle strategies we like: Selling equity and credit volatility, short US and German duration, steeper government bond curves, a weaker DXY, owning EM and securitized credit, BBB-A and B-BB corporate spread compression, small over large cap equities, cyclical over defensive equities.

'Normal' early-cycle strategies we think won't work as well this time: EM equities, which we think underperform in this cycle. Oil, iron ore and aluminium, where we think that fundamentals look vulnerable.

Global equities: We see modest gains overall but much bigger moves in sector and style, as a new cycle catalyzes still extreme relative valuation and positioning. US and Europe are most preferred, EM least.

Government bonds: We think that US and German duration see higher yields and steeper curves. Peripheral spreads compress on policy support and less supply. JGBs, UKTs and ACGBs are relative winners.

Global FX: DXY weakens due to better global growth, a smaller yield advantage, expensive valuation and an approaching US election. EUR, AUD and NOK to outperform, GBP, SEK and CHF to lag.

EM fixed income: We see more compression in higher-yielding EM FX and EM credit; we like RUB, ZAR, HUF, INR and IDR in FX, and IGBs, INDOGBs, OFZs, KTBs and CGBs in local rates.

Global credit: We see modest further tightening and more compression between BBB-A and B-BB. Balance longs in cash with hedges in richer CDS indices.

Commodities: While commodities are 'usually' an early-cycle reflationary winner, be selective. Oil, iron ore and aluminium all face more challenging fundamentals.

Bull and bear cases

Bull case: Faster normalization, better medical outcomes, a 'sweep' by either US party

We think that the bull case is a turbo-charged version of our base case, which leads global growth to hit pre-recession levels before 4Q21, and where a flood of accommodation leads to a sharp, post-1998-style recovery.

How could faster normalization possibly be achieved? A positive surprise on vaccine development, which means wide availability earlier than our current mid-2021 base case. A smoother reopening of the global economy, which fails to generate any material second wave. A 'sweep' by either US political party opens the door for more fiscal easing, while the European Union's recovery fund turns out to be just the start of even larger initiatives. Phase 1 of the US-China trade deal holds, real progress is made on Phase 2, and the UK ultimately lands on a softer Brexit outcome with the European Union.

In this scenarios, we think that yields rise and the curve steepens much faster than we forecast, the dollar falls more than we forecast and EM equities do better relative to DM equities than we forecast.

Bear case: The double-dip

Double-dip recessions were a concern post the GFC, but are also rare (see Don't Double-Dip Your Chips, November 6, 2009). We think that the bear case sees infection rates start to rise again, difficulty for governments deciding whether to restrict activity or 'tough it out', the US election catalyzing even harsher trade rhetoric and further fiscal support in the US, Europe and Japan fizzling out.

This scenario would lead to a 'W' or 'L' shaped recession, and would mean yields fall, the curve stays flat, spreads widen and large cap growth outperforms, all counter to our current recommendations.

You'll note that we didn't mention central bank policy in either the bull or bear case. This is intentional. We think that DM central banks have put their cards on the table, and will be extremely accommodative in a range of scenarios. If policy disappoints, we think that this is far more likely to come from the fiscal side.

Top trades across asset classes

Exhibit 14:

Top trades across asset classes

	Asset Class	Trade	Level (L) / Target (T)	Rationale	Type	Risks
1	Equities	Long Russell 2000 vs. S&P 500	Target upside: 10.4%	Small caps typically lead coming out of a recession. Russell 2000's valuations are now much cheaper relative to S&P 500 after sustained underperformance in recent years. The record stimulus directed at corporate credit, and small/medium businesses in particular, should benefit small caps the most.	Alpha	Recession is more prolonged and deeper than we expect.
2	Equities	Long US Financials	Target upside: 23.8%	Our recession playbook suggests that, after sell-offs of 25%, leadership remains defensive but it shifts slightly more cyclical (banks, semis, consumer durables/apparel). In particular, financials screens well as a sector which tends to outperform following large historical sell-offs.	Beta	Recession is more prolonged and deeper than we expect.
3	Equity Vol	Sell S&P 500 3m 25Delta Strangle	Yield (3m): 5.0%	Volatility risk premia remains attractive even at current levels, especially in equity and credit. Implied vols in the top quartile are inconsistent with the scale of the broader expectations for a 'V' recovery and upbeat risk environment.	Beta	A second wave disrupts and prolongs the recovery, keeping volatility high.
4	Equities	Long Spain and Italy vs. EM Equity	Target upside: 10%	Lower risk premia for eurozone assets translate into a more constructive view on EUR, tighter peripheral spreads and higher Bund yields. This combination should be supportive for periphery equity markets, which are unloved by investors and at all-time relative valuation lows.	Alpha	EM equities rally faster than we expect on an unusually strong global recovery.
5	Rates	Long US 30yr Breakevens	Spread L: 149bp T: 190bp	Breakeven valuations remain extremely cheap and we expect this to normalize on the Fed's easing push as liquidity conditions and overall financial conditions improve. Our US economists think that core inflation is likely to surprise to the upside as expectations remain subdued.	Beta	A second wave disrupts and prolongs the recovery, keeping inflation subdued.
6	Rates	Long US 7s30s Steepeners	Spread L: 89bp T:125bp	Historically, curves steepen in the recovery phase of the cycle (troughing right before recessionary periods and peaking past the recessions). We would expect the yield curve to steepen as the supply/demand dynamic becomes increasingly unfavorable for Treasuries on the back of a near-record fiscal deficit.	Alpha	Macro news flow dominates the impact of supply/demand dynamics on the shape of the curve.
7	Rates	Long 10yr BTPs vs. 10yr DBRs	Spread L: 191bp T:115bp	By the end of 2020, we look for Italy to have lower debt-servicing costs and a lower free float of bonds than it did at the start of 2020 after accounting for ECB purchases. Order book sizes for Italian paper at syndication have been record-breaking in 2Q20 as the MEF continues to efficiently execute on its diverse funding strategy.	Alpha	Domestic growth remains challenged.
8	FX	Long EUR Basket (vs. USD, CHF, GBP and SEK)	Target upside: 3.8%	The recent EU debt proposal means that some of the risk premium for EU break-up risk which has been embedded in European assets since the eurozone debt crisis will abate. The creation of a new large and liquid (likely), higher-yielding AAA asset will attract inflows from real money investors and reserve managers alike and support EUR higher.	Alpha	Trade tension escalation creates safe-haven demand for USD. Eurozone recovery disappoints.
9	FX	Long EMFX Basket (RUB, ZAR, IDR, INR, HUF)	Target upside: 8%	EMFX risk premia are still attractive, as currencies remain weaker than where they would typically be, given movements in USD and risk appetite trends, while EM bond curves are very steep. Positioning and sentiment in EM fixed income are still not overly bullish.	Beta	Fundamentals in EM are likely to remain more challenged compared to DM economies.
10	EM Fixed Income	Long EM Credit	L: 482bp T: 400bp	EM credit spreads are cheap both outright and versus US credit, producing some of the best returns across asset classes. Technicals are still supportive, with above-average cash balances and UW allocations to single Bs leaving funds' beta closer to neutral. Issuance picking up in also positive for now as it demonstrates that countries have market access.	Beta	Shutdown of primary markets, disruption of market access.
11	Credit Vol	Buy CDX HY 3m 45D/25D 1x2 Call Spreads	Cost: 0.04% Max P&L: 3%	US HY volatility, like equity volatility, is still in the top quartile of history and has an attractive risk premium. Within credit, HY volatility and spreads have lagged the normalization we have seen in CDX IG. We like CDX HY 1x2 receiver spreads to position for implied vol to normalize and spreads to tighten.	Alpha	Spreads collapse far more than we expect on positioning squeeze/hunt for yield.
12	Credit	Buy Protection on CDX IG33 Mezz Tranche (7-15%)	L: 109bp	Much of the spread premium in the CDX IG indices is in the tail of COVID-19-exposed names that trade very wide to the rest of the market and the equity tranche. We think that the non-tail names are quite tight	Hedge	Cyclical risks remain contained despite idiosyncratic defaults.
13	Credit	Long CDX IG 3s5s Steepener	L: 16bp T: 25bp	Credit curves have remained very flat, despite the rally in index spreads. 3s/5s curves look quite flat relative to the level of spreads. Corporates are focused on shoring up near-term liquidity (at the expense of long-term leverage) and year-to-date corporate issuance has already surpassed 2019 issuance.	Alpha	A deeper recession, resulting in more severe defaults.
14	Commodity	Short Aluminium	L: 1,626 T: 1,465	Aluminium's exposure to the automotive sector and its price-inelastic supply side make it the hardest hit of the metals. The high cost of restarting aluminium smelting capacity, falling costs thanks to low energy and aluminium prices and long-term power agreements mean that aluminium production is sticky.	Hedge	Major smelter closures may limit further declines in price.
15	Commodity	Buy Brent 1yr $45/$53 1x2 Call Spreads	Cost 0%. Max P&L: 8.0$	We expect oil upside to be capped on muted trend growth in oil demand post-recovery, the return of shale production at higher oil prices and OPEC starting to defend its market share more forcefully. Brent volatility is still in the top quartile. 1x2 call spreads is a defensive way to express a short volatility bias.	Alpha	Demand recovery is even stronger than we expect, pushing oil beyond $61.

Source: Morgan Stanley Research; Note: These are our current trades. All previous trades from cross-asset strategy are considered closed.

Global equities: Post-COVID-19 recovery better for DM than EM equities


Michael J. Wilson
M.Wilson@morganstanley.com
+1 212 761-2532
Morgan Stanley & Co. LLC


Graham Secker
Graham.Secker@morganstanley.com
+44 207 425 6188
Morgan Stanley & Co. International plc+


Jonathan Garner
Jonathan.Garner@morganstanley.com
+852 2848-7288
Morgan Stanley Asia Limited+

Key investment ideas

• **Bottom line:** An above-consensus global growth recovery and valuation support from innovative and sustained monetary and fiscal policy stimulus should be supportive to equity markets and warrant a shift to cyclical leadership. In contrast to history, we see this recovery continuing to favor DM over EM markets.

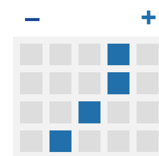
• **Upside drivers:** We see the COVID-19 recession marking the start of a new cycle for US equities, while in Europe the proposed recovery fund is a game changer and should compress risk premia across asset classes, especially for financials and periphery/value stocks. Japan equities are supported by structurally improved RoE resilience. EM sovereign and corporate funding risks and greater COVID-19 and trade tension exposure are mitigated by G3 central bank easing and broad US dollar weakness.

• **What has changed:** We lift our targets across the board, factoring in another six months of solid earnings recovery, while our target valuations move up 0.9-1.5 P/E points on supportive financial conditions. The US and Europe are most preferred, with EM least preferred.

• **Where we differ:** We recommend a broad rotation into cyclicals and value across global equities. However, we are most below consensus on EM EPS and do not see EM equities leading the next phase of the recovery.

Equities

US
Europe
Japan
EM

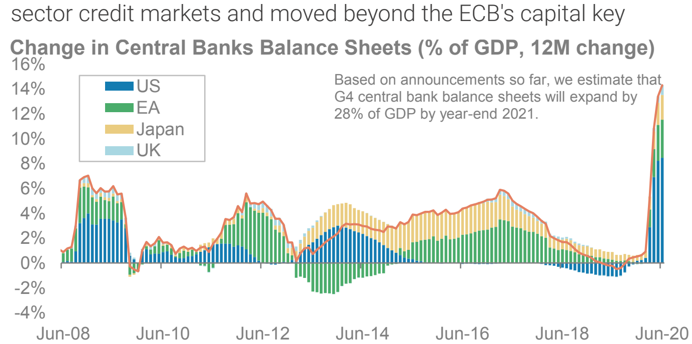


The great COVID-19 equities bear market – fast in, fast out

Reconciling a sudden stop with extraordinary stimulus: A once-in-a-century pandemic brought large parts of the global economy to a near-standstill, with the scientific community still racing to develop vaccines and therapies as virus containment strategies have been refined. Equity markets did not prove immune to the freezing of liquidity across asset classes at the peak of the crisis in March/April, as the VIX shot up to a peak of 85 and ACWI saw a 33% year-to-date drawdown to its lows on March 23. Fortunately, central banks were far from frozen in their response, acting forcefully to unblock asset markets with breathtaking liquidity injections (**Exhibit 15**) while working with fiscal counterparts to mitigate corporate solvency risks through a combination of forbearance, concessional and risk-shared loans, wage-subsidy programs and direct transfers.

Exhibit 15:

G4 central bank balance sheets are expanding at an unprecedented rate and the composition of programs has also expanded into private sector credit markets and moved beyond the ECB's capital key

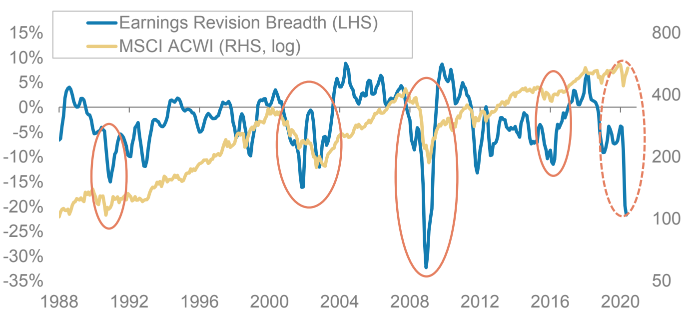


Source: Fed, ECB, BoJ, BoE, Morgan Stanley Research estimates; Note: June 2020 for the US is as of June 10, for the euro area is as of June 5, and for Japan is as of June 12. UK Jun-20 value is per Morgan Stanley estimates.

The new normal looks asset price-friendly, at least in the near term: We see the recent recovery in global equities as supported by an above-consensus view on the pace of global recovery, support across various loan and credit markets and the suppression of real interest rates from QE programs across DMs and several (though not all) EMs. The sharp recovery in forward P/E multiples suggests that the market has embraced this view. But, looking out over the next 12 months, we do see the extent of earnings recovery lifting indices somewhat higher than current levels in DM in particular while exceptionally accommodative policy holds valuations around 2 SDs above historical averages. We do see unresolved questions about the longer-term impacts and exit strategy from the policy actions summarized by our colleagues in our Global Macro Mid-Year Outlook, but they are likely to be asked by the market only over the medium term (as was the case in the QT era when valuations compressed).

Exhibit 16:

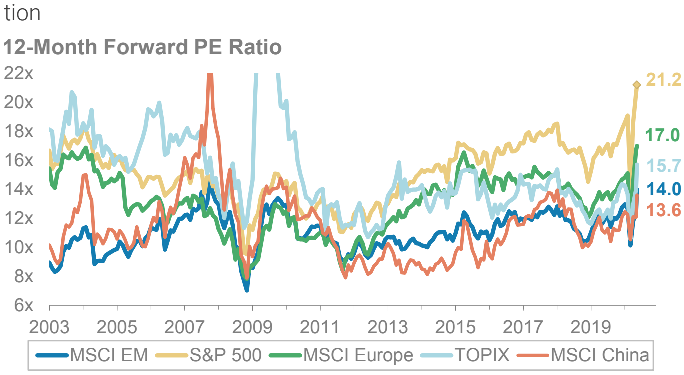
Global equities versus earnings revisions breadth (upgrades less downgrades) – avoiding a second wave of downgrades will be key to holding the market rebound



Source: RIMES, IBES, Morgan Stanley Research; At each month-end, MSCI ACWI index-level earnings revision breadth is derived using a bottom-up approach, calculated as (a) sum of '3-month average number of upward EPS revisions for each constituent', less (b) sum of '3-month average number of downward EPS revisions for each constituent', scaled by (c) sum of '3-month average number of EPS estimates for each constituent'. MSCI ACWI Price Index (USD) is employed here.

Exhibit 17:

Forward P/E multiples expand sharply as the market attempts to look through the COVID-19 recession impact on EPS – we think that most of these gains are sustainable, given the extent of policy accommodation

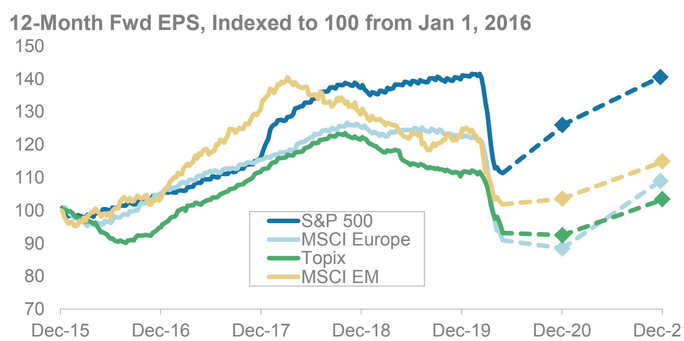


Source: IBES, FactSet, Morgan Stanley Research

Targets move up 12-20% on higher valuation assumptions and another six months of earnings recovery: Our base case equity market targets – now set for June 2021 – move up across the board to 3,350 for S&P500 (+12% from spot), 1,580 for MSCI Europe (+10%), 1,550 for TOPIX (-2%) and 920 for MSCI EM (-7%). While our underlying EPS profiles are little changed from our most recently published updates, this reflects a 0.9-1.5x lift in our target P/E multiples and the capture of another six months of strong earnings recovery. On valuations, while we project some modest de-rating from current levels of forward P/E multiples, we now assume that the US and Europe can hold near 10-year historical highs as risk premia remain compressed by unprecedented policy action, with Japan and EM also holding above-average levels. As shown in **Exhibit 18** , we are forecasting a solid earnings recovery across the board. We are closer to consensus for the US (4% below for 2021 EPS), compared with Europe (-16%), Japan (-13%) and EM (-12%).

Exhibit 18:

We see the most V-shaped profile for US earnings, with Europe ranking second, driven by fiscal support and relatively high exposure to cyclicals



Source: IBES, FactSet, Morgan Stanley Research

Exhibit 19:

Morgan Stanley base case earnings forecast and June 2021 index price targets

Index	Current Price	June-2021 Base Case Index Target (% Upside)	MS Base Case (Old)	MS Top-down Base Case EPS Forecast			Consensus EPS Forecast (YoY Growth)			MS Base Case N12M P/E June-2021	Current Consensus N12M P/E	5 Year Avg. Consensus N12M P/E
				2020	2021	2022	2020	2021	2022			
S&P 500	3,002	3,350	3,000	130	158	177	128	164	187	20.0	21.2	16.8
		12%	*0%*	*-20%*	*22%*	*12%*	*-22%*	*28%*	*14%*			
MSCI Europe	1,439	1,580	1,310	57	83	103	75	99	114	17.0	17.0	14.3
		10%	*-9%*	*-45%*	*45%*	*25%*	*-28%*	*32%*	*16%*			
TOPIX	1,589	1,550	1,350	84	101	113	100	116	129	14.5	15.7	13.5
		-2%	*-15%*	*-16%*	*20%*	*12%*	*1%*	*16%*	*11%*			
MSCI EM	994	920	800	62	73	81	67	82	94	12.0	14.0	11.8
		-7%	*-19%*	*-8%*	*17%*	*11%*	*-1%*	*23%*	*14%*			

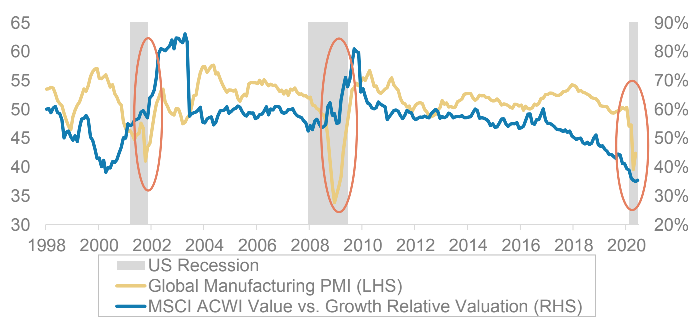
Source: FactSet, Morgan Stanley Research forecasts; Note: Pricing as of June 11, 2020

This 'V' is for value...and cyclicals: We believe that the long-awaited leadership rotation to value should be catalyzed by the embracing of active fiscal policy and a new market cycle in the US favoring small cap value exposure over mega cap, while Europe sees game-changing fiscal transfers embedded in the European recovery fund compressing risk premia in value/cyclicals and periphery-exposed stocks. The case is less clear-cut across Asia/EM including China, where policy action is less extensive. There we generally prefer global cyclicals to deep value, although we have selective exposure to financials and energy.

Balancing risk of missing out against an unstable (geo)political landscape: Our bull case embeds even higher valuations, which could be seen if central bank action crowds investors out of both government and corporate bond exposure into stocks, leading conservatively positioned investors to raise equities exposure further. In this scenario we would still see buying of value/cyclicals, while growth/quality names remain well supported. While the potential for a second wave of COVID-19 is a key concern, our bear case fears center on political risks, including the potential for US-China relations to enter a disruptive decoupling phase amid crucial 2H20 catalysts (including a Phase 1 trade deal progress report, the formation of/reaction to the Hong Kong Security Law and Legislative Council elections and the US elections). The US policy landscape post-November also risks a more austere set-up if it results in a divided government with a Republican-majority Senate (see US 2020 Election: A Revised Guide to Economic Policy Paths & Market Impacts, June 8, 2020).

Exhibit 20:

MSCI ACWI Value is at a new record aggregate valuation discount to Growth – historically Value has outperformed in the recovery phase from US recessions



Source: Haver Analytics, FactSet, NBER, Morgan Stanley Research; Valuation differential shows an equal-weighted average of the ratio of trailing earnings yield, dividend yield and book value yield for MSCI Value versus MSCI Growth indices.

Exhibit 21:

Global sector and style preferences

Sector & Style Preferences	S&P 500	MSCI Europe	TOPIX	MSCI EM
Sector Preferences	**OW:** Financials, Industrials, Materials, Healthcare	**OW:** Financials, Materials, Utilities	**OW:** Financials-ex-Banks, W/Sale Trade, Foods, Real Estate	**OW:** Technology, Discretionary, Energy, Materials
	UW: Technology, Staples, Utilities	**UW:** Staples, Energy, Luxury	**UW:** IT/Services, Steel & Non-Ferrous, Transport, Autos	**UW:** Communication Services, Healthcare, Utilities
Style Preferences	1) Small over Large 2) Cyclicals over Defensives	1) Periphery 2) Value	1) Corp Gov Improvement 2) Blue Paper Innovation Leaders 3) Quality Cyclicals	1) Cyclicals over Defensives 2) Value with Higher FCF yield

Source: Morgan Stanley Research

Exhibit 22:

Morgan Stanley equity market bull/base/bear case forecasts

Index	Current Price	New Target Price - June 2021 (% from current levels)			Old Target Price - Dec 2020 (% from current levels)		
		Bull	Base	Bear	Bull	Base	Bear
S&P 500	3,002	3,700	**3,350**	2,900	3,250	3,000	2,500
		23%	*12%*	*-3%*	*8%*	*0%*	*-17%*
MSCI Europe	1,439	1,810	**1,580**	1,280	1,550	1,310	1,050
		26%	*10%*	*-11%*	*8%*	*-9%*	*-27%*
TOPIX	1,589	1,840	**1,550**	1,200	1,600	1,350	1,050
		16%	*-2%*	*-24%*	*1%*	*-15%*	*-34%*
MSCI EM	994	1,200	**920**	715	1,050	800	650
		21%	*-7%*	*-28%*	*6%*	*-19%*	*-35%*

Source: FactSet, Morgan Stanley Research forecasts; Note: Pricing as of June 11, 2020.

Our key regional forecasts and views

US equities (Mike Wilson)

Bear markets end with recessions: We turned bullish in mid/late March on the thesis that recessions mark the end, rather than the beginning, of bear markets (see Bear Markets End with the Cycle; Time to Employ a Recession Playbook, March 23, 2020). Further supporting this conclusion was our view that the bear market for the average stock had begun almost two years ago, making March simply the final capitulation. Price action since then has played out in line with our recession playbook, confirming that it isn't different this time. We remain firmly in the camp that the economy is likely to experience a V-shaped recovery, which is exactly what the equity market is foreshadowing. Our 12-month bull/base/bear targets increase to 3,700/3,350/2,900 from 3,250/3,000/2,500, largely on a continued recovery trajectory in earnings through 2021 and 2022.

Health crisis nature of this recession has resulted in unprecedented stimulus: Our more bullish view on S&P 500 than consensus stems from three key points: i) The combination of the steepest recession with the largest coordinated monetary and fiscal stimulus in history almost guarantees that there will be a V-shaped recovery from the exceptionally deep trough; ii) The reopening of the economy will happen faster than expected and without a major spike in new cases. If this view is wrong, we believe that there will not be another lockdown of the economy even if we have a second wave of COVID-19 because it's too damaging and we are now better prepared to deal with outbreaks, given wider testing and healthcare capabilities; and iii) Sentiment and positioning remain overly bearish both in terms of absolute levels of risk and the defensive nature of individual holdings.

Sector/style preferences: We see sector/style preferences as a meaningful source of potential alpha as the market participation broadens out. In line with our recession playbook, we retain our preference for small over large caps and cyclicals over defensives. Late-cycle, high-quality stocks remain richly valued and are likely to re-rate lower as interest rates rise at the back end. We continue to recommend a barbell of reasonably priced growth stocks with lower-quality cyclicals that can make it through the recession but are still priced for distress. At the sector level, we are overweight financials, industrials, materials and healthcare. We are underweight technology, staples and utilities.

European equities (Graham Secker)

EU recovery fund a 'game changer' for EU equities... As proposed, the EU recovery fund is potentially a highly significant moment for the eurozone (if enacted, it could arguably be seen as the fiscal equivalent of "Whatever it Takes") which should reinforce a cyclical economic recovery in the region and lower risk premia on European assets. Since 2010 European asset valuations have suffered from an embedded risk premium, given lingering fears about a eurozone break-up, but a more co-ordinated and stronger fiscal response suggests that such concerns should abate over time. After multiple years of persistent underperformance from both the European economy and equity markets, investor skepticism is high, sentiment is low and relative valuations are attractive; this should create the backdrop for a period of stronger performance going forward, assuming that policy progresses as planned. On the back of our economists' GDP upgrades, we have raised our 2021 and 2022 EPS growth by 5% in each year and lifted our P/E assumption by 1.5 P/E points to 17.0x, a 10-year high.

...which should spark a rotation towards financials/periphery/value: As discussed elsewhere, lower risk premia for eurozone assets translate into a more constructive view on EUR, tighter peripheral spreads and higher Bund yields. This combination should be supportive for financials and periphery equity markets, both of which are unloved by investors and at all-time relative valuation lows – we are overweight banks, insurance and diversified financials. At the same time, the USD weakness that our FX team expects should be supportive to the commodity complex and we are overweight mining and building materials. Together with our economists' expectations of an improving economic outlook, this overall backdrop suggests that we are likely to see a period of better performance from value, which would be something of a 'pain trade' for many European investors. We are underweight expensive cyclicals (such as luxury goods) and expensive quality (such as consumer staples and Switzerland) that are arguably most at risk of a valuation de-rating on higher core bond yields.

Asia and EM equities (Jonathan Garner)

Recovery, but not with EM leadership this time: Our above-consensus forecast for global growth recovery and constructive views on EM FX and credit help to mitigate downside risk across Asia and EM equities. But in contrast to historical patterns, we see this recovery being led by DM markets for three reasons: i) Greater policy/funding scope (and arguably fiscal/monetary regime shifts) in the US, Europe and, to a lesser extent, Japan; ii) An overhang of higher corporate leverage across EM equities, resulting in CCC risks to cash-flow, capex and capital raising (see our deep dive report); and iii) Less spillover from Chinese stimulus to commodity exporters, given the relative size/structure of stimulus versus 2008. Indeed, we see many of the dynamics of the 2009-10 recovery reversed here – back then deleveraging DM consumers and stimulus-boosted EMs drove leadership from commodity exporters and EM domestic demand plays, whereas this time EMs face tighter constraints.

Retain preference for Japan and China A-shares and increase cyclicals exposure: We leave our EM equities stance at UW and within our Asia/EM coverage continue to prefer Japan, which we see continuing to deliver a more defensive DPS/EPS profile on the back of underlying restructuring and strong balance sheets. At a market level, we upgrade Indonesia and Greece to OW alongside preferred markets China, Russia, India, Brazil and Singapore. We remain UW Saudi Arabia, Mexico and Thailand. With US-China tension a key risk, we reiterate our clear preference for China A-shares versus ADRs. On a sector basis, we move more cyclical and favor IT, discretionary, energy and materials, while on a style basis, we hold a core quality bias but see a tactical opportunity for value.

G10 rates: Mixed performance versus forwards


Matthew Hornbach
Matthew.Hornbach@morganstanley.com
+1 212 761-1837
Morgan Stanley & Co. LLC


Koichi Sugisaki
Koichi.Sugisaki@morganstanley.com
+1 212 761-1445
Morgan Stanley MUFG Securities Co., Ltd.+


Guneet Dhingra
Guneet.Dhingra@morganstanley.com
+1 212 761-1445
Morgan Stanley & Co. LLC


David S. Adams
David.S.Adams@morganstanley.com
+1 212 761-1481
Morgan Stanley & Co. LLC


Tony Small
Tony.Small@morganstanley.com
+44 20 7677-2571
Morgan Stanley & Co. International plc+

Key investment ideas

- With conventional central bank policies on hold through our forecast horizon, government bond performance should be mixed into year-end, despite the V-shaped economic recovery and solid performance of riskier asset classes.

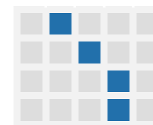
- **We suggest a duration underweight in USTs and DBRs into year-end; a bullish stance on UKTs, JGBs, ACGBs and NZGBs; and a neutral stance on CAGBs. We expect BTPs to have the best total returns in the euro area.**

- We forecast steeper yield curves than market-implied forwards into year-end in the US and Canada, but flatter yield curves in the UK, Japan and Australia.

- **Top trades:** UST 7s30s steepener, CAGB 2s10s steepener, underweight UST 10y and DBR 10y versus UKT 10y and ACGB 10y, long 10y BTPs versus 10y DBRs.

Government Bonds – +

US
Europe
UK
Japan



In the US, we expect Treasury yields to move higher over the forecast horizon. We see 10-year Treasury yields trading just above 1% by the end of 2020, while ending 2021 even higher at 1.5%. A combination of fast economic recovery, strong performance in risk assets and expectations for even more Treasury supply will push yields higher, while the Fed's forward guidance and QE will temper the rise in yields, and enable a steepening of the yield curve.

In the near term, the Treasury market will be driven by the evolution of supply/demand expectations, with additional fiscal stimulus likely to put upward pressure on yields, particularly the long end, where the Treasury has focused much of its coupon issuance. Over the following months, the focus will likely shift to the pace of economic recovery, where our economists expect a faster-than-consensus path for recovery, which will continue to support higher yields.

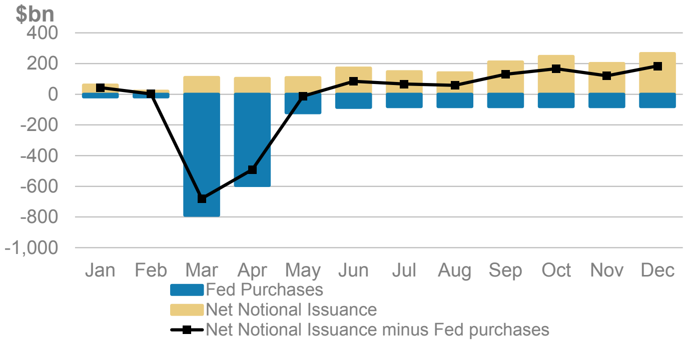
The Fed will keep a check on rising yields as the economy recovers to prevent a premature tightening in financial conditions. Our US economics team expects the Fed to hold rates at zero, at least through the end of 2021. In addition, the Fed is likely to provide concrete forward guidance, likely at the September FOMC meeting, while running an US$80 billion/month open-ended QE Treasury program, with the optionality to increase the size or duration of Treasury purchases. This policy mix should support a steepening of the 7s30s Treasury curve, while limiting the overall rise in yields.

The US presidential election in November 2020 is a potential tailwind for high yields as well. Outcomes with a united government (either all chambers controlled by Democrats or Republicans), and even some divided government outcomes (e.g., Republican President, Republican Senate, Democrat House) remain conducive to additional fiscal stimulus to support the economic recovery, and thereby higher yields in 2021.

In this context, inflation protection remains attractively priced. The rise in yields we project in 2020 is driven by breakeven inflation rates much more than real yields. TIPS inflation breakevens still offer negative inflation risk premiums to investors, and we think that the V-shaped global economic recovery will reduce these negative inflation risk premiums significantly by the end of the year.

Exhibit 23:

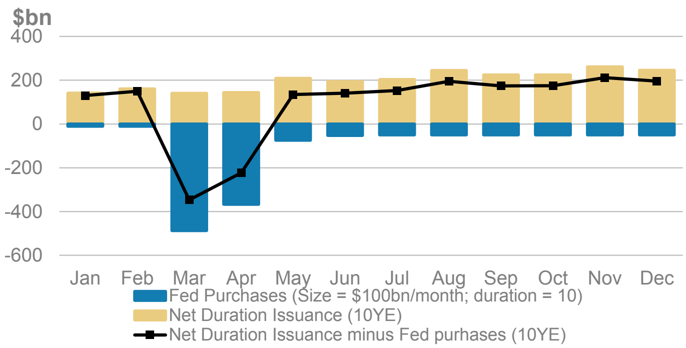
Treasury supply versus Fed QE in notional dollars over the coming months



Source: Bloomberg, Morgan Stanley Research

Exhibit 24:

Treasury supply versus Fed QE in 10-year duration-equivalent over the coming months



Source: Bloomberg, Morgan Stanley Research

In the euro area, we forecast a rise in intermediate and longer-maturity Bund yields into 2H20 and through 2021. The skew for Bund yields appears to be moving towards higher yields and steeper curves despite the upsize in the ECB's PEPP purchases. We think that the potential ramp in higher-yielding, predominantly AAA rated EU (and EIB) debt starting from SURE in 2020 and Next Generation EU in 2021 reduces demand for Bunds from reserve managers and asset managers simultaneous with expectations for larger Bund supply from additional stimulus measures in Germany and near-term uncertainty from the GCC ruling.

As Bund yields climb gradually, they do so with a steepening bias to the 2s10s and 5s30s curves, given expectations for EU issuance to be primarily in the long end and given our economists' expectation that inflation will remain sufficiently subdued to keep the ECB deposit rate unchanged throughout the forecast horizon, limiting the extent to which front-end yields may climb.

We assume that a resolution is eventually found to the GCC proportionality ruling, meaning that there is little risk that the ECB and Bundesbank stop purchasing or even start selling Bunds. However, as our economists have highlighted, there remains uncertainty about this assumption. As the recovery in Europe begins to take hold, we look for the ECB strategy review to begin again in late 2020 and 2021 with a renewed focus on the pros and cons of the existing policy framework.

For euro area sovereign spreads, we continue to forecast broad-based tightening of sovereign spreads to Bunds in 2H20 that continues into 2021, led by the periphery. The ECB will continue to buy aggressively for the remainder of 2020 and into 2021 following the €600 billion increase in PEPP and extension of forward guidance. However, during this time we anticipate lower primary market issuance needs relative to the substantial levels observed in April and May 2020 due to reopenings of economies and some sources of EU funding like SURE and eventually Next Generation EU becoming available. The conditions appear to be in place for a negative net supply technical post-ECB buying in the back half of 2020, particularly since we forecast that many periphery countries are already more than 50% done with their funding needs for the full year.

The likely ramp in issuance from the EU (and EIB) that will start slowly in 2020 due to SURE monies and pick up pace in 2021 and 2022 should replace a portion of longer-maturity primary market issuance by the periphery during this time, leading to overall lower gross and net issuance levels in coming years. This translates into gradually flattening 5s30s and 10s30s curves in the periphery during late 2020, which then pick up pace in 2021.

Additionally, greater disbursements to the periphery from the EU in grant form should cushion some of the COVID-19 hits to GDP growth in the near term, help to strengthen recoveries in the medium term, further reduce the cost of servicing debt, lead to smaller increases in debt/GDP ratios and an eventual reversal of the debt/GDP increases realized during COVID-19, reduce concerns about euro area break-up risk, and more than likely eliminate the risk of any downgrades to high yield for BTPs in particular.

In Italy, we anticipate the 10y BTP/Bund spread moving to 115bp by the end of 2020 and eventually sub-100bp by the middle of 2021. For the second straight year we look for BTPs to have the strongest outperformance and total returns in the euro area in the back half of the year.

Order book sizes for Italian paper at syndication have been record-breaking in 2Q20 as the MEF continues to execute efficiently on its diverse funding strategy, utilizing a combination of retail BTP Italia, Flex BOTs, more benchmark syndication offerings, specialist taps and overall larger auction sizes. By the end of 2020, we look for Italy (as well as many other euro area countries) to have lower debt-servicing costs and a lower free float of bonds than it did at the start of 2020 after accounting for ECB purchases. This should occur despite increased issuance and a higher debt/GDP ratio.

In the UK, we look for rates to remain around current levels in 2H20 as the MPC increases asset purchases by £100-200 billion by the end of the year while also cutting Bank Rate to zero before potentially pursuing a negative Bank Rate, in line with our economists' estimates. Inflation remains subdued in 2021, allowing the MPC to maintain an easing bias throughout most of the forecast horizon.

However, as economies begin to improve globally in the back half of 2020 and into 2021, we look for the MPC to gradually taper the size of balance sheet expansion and with it the pace of weekly purchases. We anticipate that this will allow the market to focus more intensely on the likelihood of supply from still sizeable fiscal ambitions starting to significantly exceed MPC purchases and reinvestments, most likely in mid-to-late 2021, leading to a faster rise in gilt yields and a steepening of curves.

We assume that the UK asks for and receives an extension in Brexit negotiations in line with our economists' view, but a hard Brexit poses a material risk until there is certainty about the outcome.

In Japan, the global risk recovery narrative will weigh on the JGB market and push term premiums higher across the curve. However, we expect the BoJ's commitment to YCC to prevent any significant rise in yields. We don't expect the additional JGB issuance from this July to catalyze material changes in JGB yields, since: (1) The market already priced in the issuance when the expectations for additional issuance materialized; (2) The BoJ will increase JGB purchases accordingly (particularly below 10-year maturities); and (3) Issuance doesn't drain the cash liquidity in the banking system if the government eventually spends the money in the real economy.

We continue to have a constructive view on long-end JGBs. We believe that demand from domestic investors seeking positive yield and meeting regulatory requirements will offset the additional supply in the long end. We expect 30-year JGB yields to trade around 0.5% across the forecast horizon. We see a temporary rally towards 1Q21 as Japanese lifers will likely accelerate their duration demand ahead of Japanese fiscal year-end, as seasonality suggests. A key risk to our view is that the market starts to price in a third supplementary budget and associated additional JGB issuance late this year, causing additional bear-steepening pressure across the curve.

In the dollar bloc, we expect rates to rise and the curves to bear-steepen modestly, in line with global yields, though the magnitude of the moves will fail to keep pace with the US, in line with historical relationships. In Australia, we expect long-end yields to rise in tandem with the Treasury curve, though we expect the moves higher to be blunted by purchases from both foreign investors and the RBA itself. Australia's high risk-adjusted yields will likely make it a target for foreign capital flows in a post-COVID-19 world characterized by dovish central banks and low carry. We expect the RBA to maintain its three-year yield curve control target of 25bp, anchoring the front end, but as the curve steepens out we think that it will restart its asset purchases to a modest degree in order to slow, but not outright arrest, the rise in yields.

In Canada, we think that yields will largely track US yields as they typically do. With no major changes in BoC policy expected, we think that the primary drivers of Canadian yields will be the BoC's ongoing asset purchase program of government securities, which we anticipate to continue at the current C$5 billion/week pace through year-end, and the path for US rates. New Zealand rates are to rise by less than global peers as the RBNZ continues its NZ$60 billion asset purchase program through 1Q21, though as the program reaches its conclusion and bond purchases taper, we then see scope for yields to rise slightly faster in 2021.

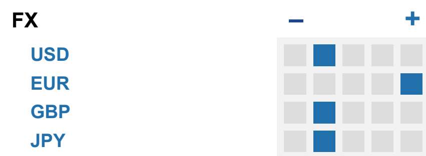
G10 FX: EUR now a 'cleaner dirty shirt'

Matthew Hornbach
Matthew.Hornbach@morganstanley.com
+1 212 761-1837
Morgan Stanley & Co. LLC

Sheena Shah
Sheena.Shah@morganstanley.com
+44 20 7677-2571
Morgan Stanley & Co. International plc+

David S.Adams
David.S.Adams@morganstanley.com
+1 212 761-1481
Morgan Stanley & Co. LLC

Koichi.Sugisaki
Koichi.Sugisaki@morganstanley.com
+1 212 761-1445
Morgan Stanley MUFG Securities Co., Ltd.+



Key investment ideas

• **USD should continue to weaken** as global growth outperformance and elevated risk sentiment happen as US assets lose their growth and yield advantage.

• **EUR/USD pushes higher** as steps towards EU fiscal union reduce EUR break-up risks and investors add to underweight positions in Europe. **GBP underperforms** amid a dovish BoE and Brexit uncertainties. **NOK should gain** as Norges Bank continues its purchases. **EUR/CHF rises** alongside risk and a dovish Riksbank **supports EUR/SEK**.

• **USD/JPY rises marginally but is roughly range-bound** as its high risk sensitivity is tempered by Japanese FX-hedging flows.

• **AUD/USD sees front-loaded gains** from a less dovish RBA and tight relationship with risk and global growth. **NZD/USD hold steady in 2020,** caught between the positive global narrative and a dovish RBNZ. **USD/CAD falls initially but rises to 1.35** as structural economic challenges persist.

• **EM FX gains** amid the positive risk and recovery outlook, though limited policy space to support growth **keeps gains muted.**

Dog days of summer keep the heat on USD

The USD strength observed in recent years reflected a fairly simple concept: US assets had the highest risk-adjusted returns in the world. This was driven by multiple factors – a procyclical fiscal stimulus generating above-trend growth and prompting a hawkish Fed response; the US economy's relative insensitivity to global trade and its resilience to a pullback in globalization; increasing corporate leverage via debt-financed shareholder distributions; and its relative perceived safety in the wake of unprecedented policy uncertainty.

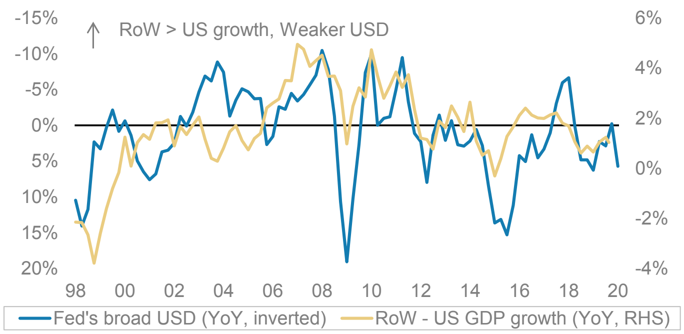
The result of these factors was that capital continued to flow into US financial assets in size at the expense of other destinations. The high and flat US yield curve made US Treasuries and credit (particularly IG) an attractive place for global investors to flock – particularly on an FX-unhedged basis. Meanwhile, the outperformance of US equities relative to global stocks writ large generated similar incentives for equity investors. These forces pushed USD higher.

However, this dynamic is changing. Unlike prior years where growth outside the US was both less inspired and more volatile, the new post-COVID-19 economic cycle is likely to see the opposite. RoW growth may once again trump that seen in the US. The Fed's decision in March to cut rates back to the zero lower bound (ZLB) has compressed US-RoW yield differentials by roughly 200bp in the G3. The vulnerabilities of highly levered US firms to a liquidity crunch suggest that C-suites may be more cautious with shareholder distributions in the future, a key source of US equity outperformance.

In short, the US appears to be losing its competitive advantage in the competition for capital – and this tends to be USD-negative, as capital flows decreasingly into the US (or even out of the US) and into other higher-yielding, higher-growth destinations. This is why we tend to observe that when RoW growth outshines US growth, USD falls (**Exhibit 25**). Indeed, the post-COVID-19 recovery is likely to be characterized by several factors – growth faster than one typically sees after a recession; dovish central banks around the globe; and elevated risk sentiment. All these interrelated forces tend to be USD-negative.

Exhibit 25:

USD tends to weaken broadly when RoW growth outperforms that in the US



Source: Macrobond, Morgan Stanley Research

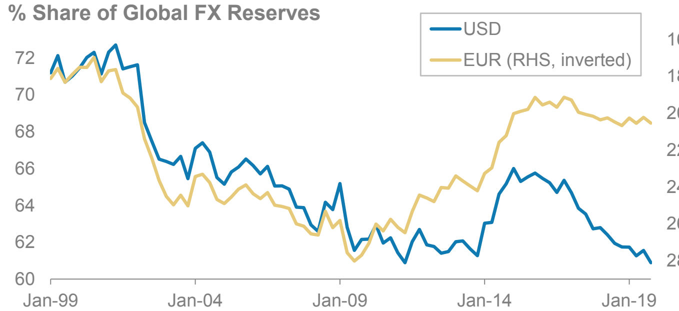
But where does the money go? A common refrain we hear is that, even if the US is losing its luster, it's still the 'cleanest dirty shirt', and therefore USD will struggle to weaken. After all, savings particularly from large capital exporters like Japan will likely continue to flood into global markets, and they have to go somewhere. Indeed, continued capital exports should keep USD/JPY on a modest upward path even despite Japanese investors increasing their FX hedge ratios as US front-end yields have fallen (which would be JPY-positive).

One destination, we think, is Europe – which is on the road to becoming a 'cleaner dirty shirt' than the US. Investor bearishness on Europe has been palpable for some time, as muted progress towards fiscal union, persistent political and populist risks and structurally low growth rendered it an unattractive capital destination. EUR/USD faced further headwinds from substantive capital outflows from Europe into other places like the US.

However, the recent EU debt proposal is a potential game changer for a couple of reasons. First, by making meaningful and potentially permanent progress towards fiscal union, we think that some of the risk premium for EU break-up risk which has been embedded in European assets since the eurozone debt crisis will abate. And second, we think that the creation of a large and liquid (likely) AAA asset, which will likely yield above other eurozone AAA bonds like Bunds, will attract inflows from real money investors and reserve managers alike. This second point is quite important – increased reserve allocations to EUR from their currently low levels are likely to come at the expense of USD (**Exhibit 26**).

Exhibit 26:

An increase in FX reserves allocated in EUR is likely to come at the expense of USD



Source: Macrobond, Morgan Stanley Research

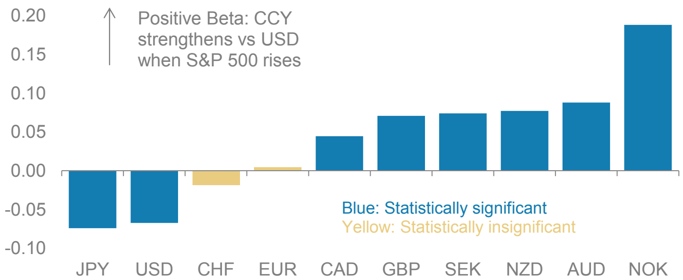
We think that another important destination will be EM. The experiences following the tech bubble and the GFC demonstrate that EMs tend to benefit when the economic cycle shifts from recession to recovery – even if large parts of the asset class will lag DM in this particular recovery. Ultimately, we think that this projected growth profile, coupled with low DM yields as DM central banks stay dovish, is a recipe for elevated risk sentiment and reach-for-yield behavior. At the same time, EMs will struggle for growth, given more limited policy space, and so we think that the rally will be front-loaded to 3Q and recommend RUB, ZAR and INR.

This rosy thesis is not without risk. Two key risks stand out to us – both of which are political. The first is a potential increase in US-China tension. 2018 and 2019 at various points saw USD strength and risk-negative price action as concerns about global growth, global trade and globalization rose in response. A re-escalation of tension between the US and China – trade-related or otherwise – is likely to elevate these concerns once again. The US is relatively insulated from global trade, with most of its economic activity generated internally, and so a re-escalation of global fears may once again lead to capital inflows into the US at the expense of other higher-risk, more globally integrated environs.

Exhibit 27:

G10 currency sensitivity to equity markets

1Y Beta (Regression of CCYUSD with S&P 500)



Source: Macrobond, Morgan Stanley Research

Another relates to the US 2020 election and the US fiscal outlook. As we note here, the US policy outlook could have important implications for USD. As discussed above, expansionary fiscal policy in the US played a key part in attracting capital into the US at the expense of other areas. We think that electoral outcomes in which one party has control of both the White House and Congress could result in more expansionary fiscal policy – raising US growth, US yields, US capital imports and USD. A divided government scenario, from which we would expect more limited policy changes, presents a lower risk of this outcome, suggesting that the other global factors will dominate the USD outlook. In any event, we are watching US fiscal policy closely.

Currency summaries

The **EUR/USD** rally is driven by both more positive sentiment around the currency union as the EU recovery fund and joint debt issuance become more active and global growth momentum weakens USD. We expect the EUR rally to come in stages – initially positioning and sentiment adjustment (no longer bearish) followed by active allocation to the eurozone assets via equities as growth picks up. The new EU debt issuance in 2021 could over the longer run attract inflows from reserve managers too, if yields are higher. We target 1.16 for the end of this year and 1.23 by end-2021.

We expect **GBP/USD** to trade flat this year and be a relative underperformer as the Bank of England is due to cut rates to negative and a Brexit trade deal is unlikely to be achieved this year. We don't expect GBP/USD to trade a new low as positive global risk sentiment and high oil prices (versus a few months ago) boost GBP generally. We expect GBP/USD to trade to 1.25 this year and 1.30 by end-2021.

USD/JPY should remain relatively unchanged in 2020 but should begin rising gradually in 2021, up to 112 by year-end. USD/JPY is caught between competing forces. Its positive correlation to risk demand suggests USD/JPY upside, but we think that these upside flows will be tempered by increased hedging flows by Japanese asset managers increasing the FX hedges on their existing foreign asset holdings.

We expect **CHF** to weaken versus EUR back to 1.20 over the longer run as EUR strengthens broadly. We expect the Swiss National Bank to keep up interventions should CHF start to strengthen again.

We expect **NOK** to outperform versus EUR this year as Norges Bank is buying a large volume of NOK each day to support fiscal spending. NOK valuation is no longer as extremely weak as in mid-March so the upside is limited to 10.15.

We expect **SEK** to weaken marginally this year as the Riksbank ramps up QE purchases and cuts rates. Stronger eurozone sentiment limits the downside for SEK, which we see strengthening in 2021.

AUD/USD should see front-loaded gains {0.71 in 3Q, 0.73 in 4Q} as Australia represents the 'tip of the spear' of the global recovery – a shallower-than-average trough in output due to lockdowns, a relatively less dovish RBA and high risk sensitivity and exposure to other positive growth areas like China. 2021 gains are more muted as RoW growth catches up with Australia and the broader process of domestic consumer deleveraging takes hold. AUD/USD holds steady around 0.74 by end-2021.

NZD/USD is caught between two competing forces in 2H20 – the improving global backdrop but also a dovish RBNZ putting downward pressure on local rates. These two forces leave NZD/USD only marginally higher in 2H20 (0.64 in 3Q, 0.65 in 4Q), and enable AUD/NZD to rise to 1.12 by year-end. NZD catches up to AUD in 2021 as the RBNZ tapers its purchases, narrowing policy differentials and allowing NZD to gain from the global recovery. We expect a front-loaded rally from 0.67 in 1Q21 to 0.70 by end-2021, with AUD/NZD falling back down to 1.06.

CAD lags risk currencies as its structural economic challenges (oil price declines, housing imbalances) 'come home to roost' amid the global recovery, leading capital to flow to alternative higher-yielding and faster-growing destinations. This leaves USD/CAD with only modest front-loaded declines in 2H20 to 1.30 by year-end before it begins turning upwards in 2021 to 1.35 by end-2021, the top end of the rough fair value range for USD/CAD of 1.25-1.35.

Global EM fixed income: A fragile recovery

James Lord
James.Lord@morganstanley.com
+44 20 7677-3254
Morgan Stanley & Co. International plc+

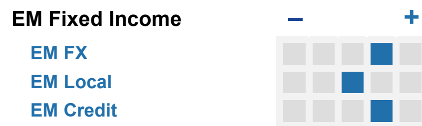
EM Fixed Income Strategy Team

Key investment ideas

• **Moderate bulls:** We expect to see moderate gains in the near term, supported by not yet stretched valuations and positioning. Yet, fundamentals in EM are weak.

• **In local markets,** we turn neutral from bullish on duration and see modest FX gains by year-end. We stay bullish on RUB, ZAR, HUF, INR and IDR. We like IGBs, INDOGBs, OFZs, KTBs and CGBs.

• **In credit,** we see EMBIG Diversified spreads compressing to 416bp by end-2020, justifying a still bullish stance that favors higher-beta credits.



Overview

We continue to hold a bullish view on EM FX and credit, but we have changed our view on EM local currency duration to neutral from bullish. Overall, we pencil in a continued, fragile recovery in EM risk assets over the second half of the year. We expect about 3-5% total return for both EM credit and EM local markets (all in) in 2H, though we expect most of that to be achieved by 3Q.

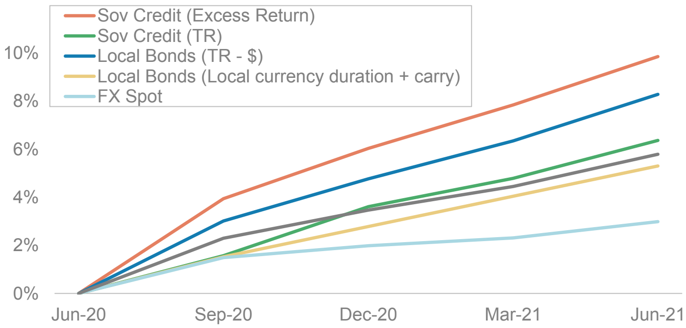
Why a continued recovery? Let us explain the rationale for expecting the recovery to continue. It is pretty straightforward. First, our economics team expects to see a continued further recovery in the global economy, on the assumption that US-China trade relations to do not deteriorate again significantly. Second, we are bearish on USD broadly speaking. Third, in our view EM FX and credit still offer some value. Finally, we do not believe that positioning is particularly heavy, except in local debt, where we now turn neutral. Most of our investor conversations have tended to point towards a disbelief about a V-shaped global economic recovery, though those opinions are likely shifting in line with the improving economic data.

Why would the recovery be fragile? There are many risks. First, fundamentals in EM are likely to remain more challenged compared to DM economies – at least in those EM economies that are most relevant for EM fixed income. This can be seen in our economics team's GDP forecasts. They generally show Asia outperforming, with GDP recovering to pre-COVID-19 levels later this year or in the first half of 2021. This is a quick recovery and stands in stark contrast to CEEMEA and Latin America, where output doesn't fully recover until 2022 or 2023 in most cases. This weak growth will create pressure on government budgets, leading to wider fiscal deficits and higher debt loads while also creating risks around social stability in light of higher unemployment. Second, there are plenty of global macro risks to worry about, the most important of which is the US-China relationship. While we are not pencilling in a full-blown trade dispute in our forecasts, the risk of seeing more volatility in the relationship, given the various tension around COVID-19 and trade issues, is of course real.

Front-loaded gains: Because of the weak fundamentals and policy risks, which could emerge later in the year, we are more inclined to front-load the rally. To gauge when to take the bullish view off and move to a neutral or bearish stance, we will be primarily watching positioning. Once positioning and, by extension, sentiment are bullish and complacent, we will likely reconsider our view. We feel we have reached that point already in local currency duration, where investors are very overweight versus the benchmark.

Exhibit 28:

Hard currency bonds to outperform



Source: Bloomberg, Morgan Stanley Research forecasts; Note: Priced as of June 5, 2020.

Exhibit 29:

LatAm and CEEMEA to lag Asia

Estimate of when real GDP returns to pre-crisis levels					
AxJ		CEEMEA		LatAm	
China	3Q20	Russia	2Q22	Brazil	3Q23
India	4Q20	Poland	4Q21	Mexico	4Q23
Hong Kong	2Q21	Czech Rep	2Q22	Chile	3Q21
Korea	1Q21	Hungary	4Q21	Peru	2Q22
Taiwan	1Q21	Ukraine	2Q22	Colombia	4Q22
Singapore	2Q21	Turkey	1Q22	Argentina	1Q23
Indonesia	1Q21	Nigeria	4Q20		
Malaysia	2Q21				
Thailand	2Q21				
Philippines	1Q21				

Source: Morgan Stanley Research forecasts

Local markets

Turning neutral on duration: Our forecasts suggest about a 4.8% total return by the end of the year in local markets, which would bring full-year total returns to roughly flat. More than half of the expected return from here is yield, with small gains in FX and zero returns from duration. As a reminder, we forecast a GBI-weighted 10-year bond yield and combine it with our FX forecasts. However, we don't see any scope for yields to drop from here. Why not? First, positioning is heavily overweight duration. Second, we see higher UST yields from here. Third, while term premia exists in HY EM local bonds, it is mostly due to South Africa and Brazil and, given rising fiscal risks there, we do not see much value.

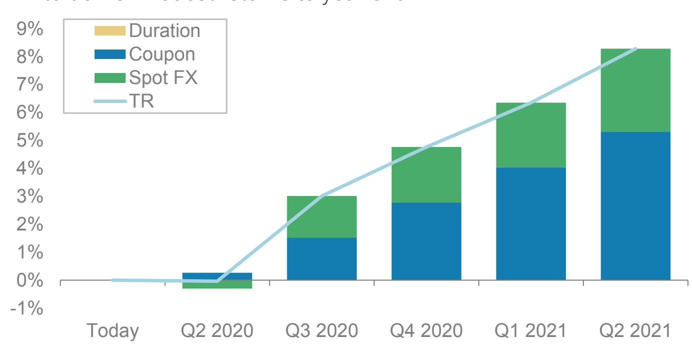
Low inflation and more rate cuts: We are a touch more dovish than the consensus on inflation and central bank policy rates. For central bank policy rates, we are more dovish than the market in Mexico, Russia, Peru and Brazil while our inflation forecasts in CEEMEA and Latin America are particularly dovish. This should support local bonds, so we do not see a reason to turn bearish.

What do we like in local debt? We see more scope in Indonesia and Russia for a further reduction in term premia and, off-index, we like India too. We like Mexican rates, but more in the front end. In low-yielders, we like China and Korea. Low-yielders will likely be more sensitive to any spike in UST yields than high-yielders, given valuation differentials.

In FX, valuations are cheap due to risk premia and the weaker USD trend we expect is supportive of the asset class. But there isn't much room before our 1.16 EUR/USD forecast is hit, and we expect USD/CNY to track broadly sideways into year-end. Hence, we are only pencilling in a small rally. Our favored markets remain RUB, HUF, ZAR, IDR and INR, where we have been long for some time. We see least value in Latin America, though MXN and BRL could rally in the short term purely due to beta. We have a bearish skew to our FX forecasts, with our USD/EM bull case about 8% higher than the base case, while the bear case is only about 3% lower.

Exhibit 30:

FX to deliver modest returns to year-end

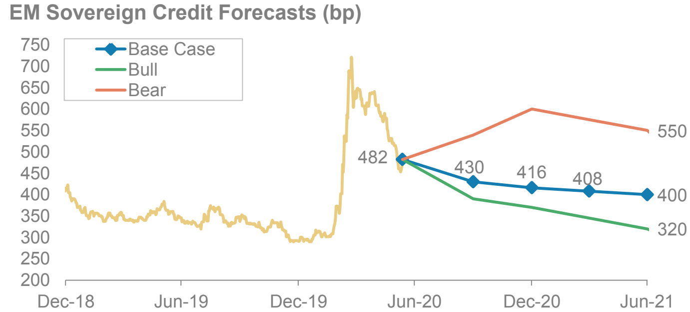


Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 31:

We expect a front-loaded tightening in sovereign spreads

EM Sovereign Credit Forecasts (bp)



Source: Bloomberg, Morgan Stanley Research forecasts

Sovereign credit

More upside in the near term – stay long: We forecast EMBI Diversified index spreads to reach 416bp by the end of the year, which when combined with UST yields that rise by around 35bp, with 10-year US Treasury yields hitting 1.15%, leaves total returns of 3.6% from today until the end of the year. Accounting for year-to-date losses of 3.1%, it would bring 2020 full-year returns to +0.5%, an impressive recovery given the 17% loss by March. As noted above, fundamentals are supportive in the near term. However, valuations remain the key driver, with EM credit spreads cheap both outright and versus US credit. Technicals are also still supportive, where cash balances are above average levels and allocations to single Bs have reduced to UW to leave funds' beta closer to neutral on aggregate. Issuance picking up is also positive for now as it demonstrates that countries have market access and thus reduces the need for debt standstills, with worries around supply indigestion likely only coming later.

Lower-rated credits drive returns... Breaking down the forecast tightening, around 40% of the spread tightening comes from single B and distressed credits. Tighter US HY spread forecasts and still cheap EM versus US single B valuations are key drivers since this allows spreads to end tighter from current levels but remain wide versus longer-term averages. The rebound is also supported by higher commodity prices and additional lending being made available. For the distressed bucket, an average cash price of 53 also shows that even for the countries that will undergo debt restructurings, a lot is priced in already, with our forecast for instance assuming a successful Argentina restructuring in the coming quarter. High-quality credits and quasi-sovereigns provide the remainder of the spread tightening while mid-tier credits have less room to tighten, given their fundamental challenges.

...before a more challenging 2021: We anticipate that the spread tightening flattens out into 2021, with the index ending 2Q21 at 400bp. While distressed credits and the high-quality credit buckets see some further spread tightening, the mid-tier and single B credits will likely come up against challenging fundamentals and debt-sustainability concerns in particular. Key drivers are that neither EM growth nor fiscal deficits in 2021 are expected to return to 2019 levels, requiring higher credit risk premia due to increased debt concerns. Additionally, while debt suspension and new financing are being provided to single B credits to help to address liquidity concerns with little conditionality for now, this is likely to change into the end of the year as focus shifts towards evaluating solvency concerns instead once there is more clarity about the impact of the current downturn.

Sticking with higher-beta credits for now: Expecting the recent rally to extend for now, we also suggest still positioning in the higher-beta credits, including HY, the weaker IG complex and quasi-sovereigns.

A wide bull/bear skew in the near term: The bull case sees spreads return below 400bp in the coming months and eventually reaching 320bp, which would require a significantly improved outlook for EM, likely driven by a sharp recovery in growth and higher commodity prices. The bear case sees a much slower growth recovery leading to significant concerns about fiscal deficits and funding needs, in turn leading to a pick-up in expected defaults and the debt standstill talks gaining speed again.

Global credit: Turning over a new leaf


Srikanth Sankaran
Srikanth.Sankaran@morganstanley.com
+1 212 761-3910
Morgan Stanley & Co. LLC


Kelvin Pang
Kelvin.Pang@morganstanley.com
+852 2848-8204
Morgan Stanley Asia Limited+


Vishwas Patkar
Vishwas.Patkar@morganstanley.com
+1 212 761-8041
Morgan Stanley & Co. LLC


Max Blass
Max.Blass@morganstanley.com
+44 20 7677-9569
Morgan Stanley & Co. International plc+

Key investment ideas

• **A new cycle begins:** As near-term liquidity challenges from the COVID-19 shock are addressed, we expect corporates to increasingly focus on balance sheet repair. Improving growth and earnings will help companies to manage the deleveraging process, particularly in the US and Europe.

• **Preference for US over Europe and Asia:** Relative valuation and expectations of improved technicals make the US our region of choice within credit. International flows should also provide a tailwind due to lower hedging costs and limited yield opportunities elsewhere.

• **Compression in US and Europe, quality in Asia:** We prefer cyclicals and BBBs in IG, while single Bs are our preferred pocket in HY. In Asia, we think that IG will outperform HY in the near term, but we are bullish on both in the medium-to-longer term.

We remain constructive on global credit: We maintain an overweight stance on corporate credit markets and expect the asset class to deliver positive excess returns over the forecast horizon. Spreads have come a long way from the period of peak dislocation in March and have moved firmly out of the recession band. But they also remain wide of historical averages globally. We see room for further spread compression but expect it to be far more gradual in comparison to recent weeks. Our view is informed by three considerations: i) Our economists' call for a sharp growth rebound; ii) A reset to the 'repair' phase of the cycle in the US and Europe; and iii) Market technicals associated with zero interest rate policies across most of the developed world.

A sharp rebound in economic growth and corporate earnings is a tailwind for credit performance: Our economists' call for a 'sharper but shorter' recession sees DM output return to pre-COVID-19 levels towards the back half of 2021. Sectors most impacted by the virus see the sharpest recovery. The related improvement in corporate earnings should translate into an organic/involuntary deleveraging that bodes well for credit fundamentals. Stimulus measures have been unprecedented in scale and coordinated in nature. In particular, the inclusion of corporate bonds in the monetary policy intervention template acts as a credible backstop in the bear case and a tailwind in the bull case.

We expect corporates to focus on balance sheet repair: Our thesis is that we have now entered a new credit cycle. The transition periods are by definition periods of heightened uncertainty and stress but they are accompanied by a shift in corporate behavior. Defaults and downgrades continue to rise but survivors focus on balance sheet repair. This shift matters most in the US, where corporate leverage was at record highs even before the COVID-19 shock. The implications are twofold. First, voluntary debt reduction amplifies the earnings impulse and accelerates the deleveraging process. Second, with liquidity buffers sufficiently high and funding needs tempered, issuance volumes are likely to drop significantly in the second half of the year. While the latter is part of the central narrative in the US and Europe, we remain wary of the near-term technical headwinds in Asia.

In a zero interest rate, yield-starved investment environment, demand for credit is likely to remain supportive: In both the US and Europe, central banks remain a source of programmatic demand. But more importantly, the nature of shock potentially sees a combination of a tepid inflation impulse and patient monetary policy keep bond yields low. The corollary is that demand for credit is likely to remain supported by both domestic and international flows. As discussed below, the story is more nuanced in Asia, where we expect HY supply to outpace demand over the near term.

Exhibit 32:

Global credit return forecasts – one-year forward

Spread Forecast

	Current	Bull Case	Base Case	Bear Case
US Investment Grade	169	115	135	250
US High Yield	642	400	550	825
US Leveraged Loans	560	400	500	825
EUR IG	109	50	80	170
EUR HY	488	325	400	675
Asia	415	320	365	540

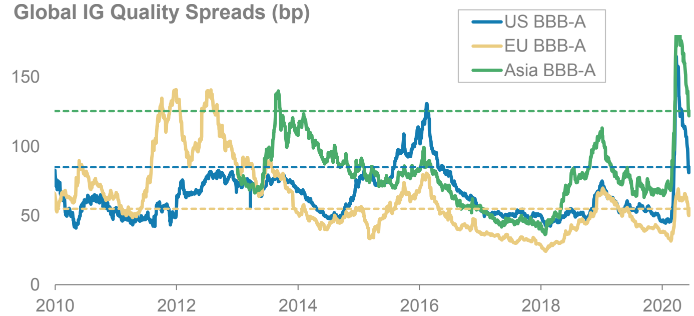
Excess Return Forecast

	Bull Case	Base Case	Bear Case
US Investment Grade	6.1%	4.0%	-2.7%
US High Yield	15.3%	8.4%	-5.2%
US Leveraged Loans	6.7%	5.3%	-6.6%
EUR IG	4.3%	2.7%	-2.2%
EUR HY	9.8%	6.3%	-6.2%
Asia	7.0%	5.3%	-1.0%

Source: Markit, Morgan Stanley Research forecasts; Note: Pricing as of June 11, 2020. Asia credit is blended Asia IG (70%) and Asia HY (30%). Excess return for Asia is based on historical default rate of 2.5% for Asia HY.

Exhibit 33:

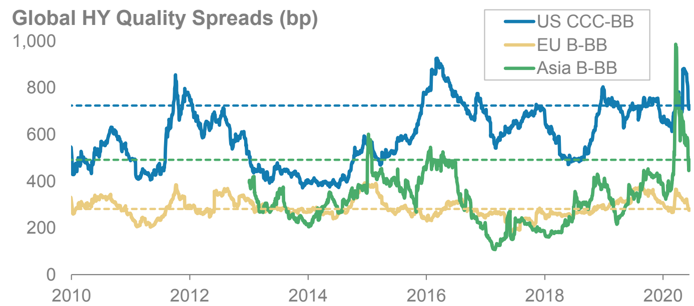
BBB-A basis remains elevated globally...



Source: ICE, Bloomberg, IHS Markit, Morgan Stanley Research

Exhibit 34:

...and credit curves are steep in HY too



Source: ICE, Bloomberg, IHS Markit, Morgan Stanley Research

US > Europe > Asia. Buying high beta in US and Europe but maintaining a quality bias in Asia: We see room for further compression in the cyclical premiums and in the basis across the quality spectrum in the US and Europe. In IG, we advocate a rotation into cyclical sectors, BBB > A and moving further out the duration curve. In HY, BBs should benefit from yield buyer demand across the US and Europe. But for traditional HY buyers, we see Bs as the sweet spot but would also look to add more CCCs in the US when the economic recovery gathers momentum. Meanwhile, the potential impact of re-escalating US-China trade tensions keeps us more defensive in our allocation to Asia.

Where we could be wrong: Markets have no doubt entered a window of exuberance in recent weeks and are marked by a willingness to pay up for risk. Some giveback on gains is likely if tactical allocators to credit start taking profit. The key risks to our optimistic outlook stem from a stronger-than-expected disruption from a second wave of COVID-19 and/or trade disruptions that would impair our economic thesis. Alternately, insufficient emphasis or progress on voluntary deleveraging as we exit the period of peak stress is another downside risk scenario.

US credit

A time to outperform: US is our preferred region within credit. Although the recent leg of the rally has rekindled some concerns about 'too far, too quickly', we expect returns to remain robust across investment grade and leveraged credit. In our base case forecasts, HY outperforms IG in absolute returns. We do not expect the Fed's corporate bond purchase programs to run at full capacity for these returns to materialize, but we do expect them to act as a safety net. Our working assumption is that the primary market facility will see minimal take-up but the utilization rate of the secondary facility is likely to be in the 25-50% range. It is not current market conditions but retaining credibility with future crisis interventions that necessitates a follow-through from the Fed. We would also not rule out potential changes in the program if needed to improve the secondary purchase volumes.

Move down in quality, out the curve and into cyclical sectors: In investment grade, we recommend buying COVID-19-exposed names/sectors that are trading significantly wider than the market. Many of these companies have raised financing over the past couple of months. A V-shaped recovery will help a quicker earnings rebound. We are also overweight BBBs over As as the fallen angel risk has either played out, or is fully priced in. We also believe that the incentive to delever is now much stronger for BBBs than it is for As. On the leveraged credit side, we shift to a neutral stance on HY versus loans after the recent leg of HY outperformance. Our case for layering more unsecured risk within HY (see Don't Overpay for Security, May 26, 2020) remains intact. Adjusting for our default forecasts and assuming that a majority of the defaults come from the price-distressed tails, we find that loss-adjusted carry is highest in the single B ratings bucket. So, even a modest compression in the basis should help this ratings cohort to outperform. While we also see room for compression in generic CCC risk premiums, much of the premium in this ratings bucket is for default risk. Single-name selection there matters much more than a top-down call on buying the tails.

European credit

More room to run: Over the next year, we forecast EUR IG and HY spreads to tighten by 29bp and 88bp, generating excess returns of 2.7% and 6.3%, respectively. While there has already been a sharp retracement in spreads since the March wides, we believe that valuations continue to look attractive relative to history. A combination of tailwinds such as the large monetary and fiscal packages as well as a nascent economic recovery support our constructive stance. Our colleagues' expectations of higher Bund yields coupled with tighter peripheral spreads should provide an additional boost to high-quality credit. Lower down the ratings spectrum, we expect fundamental challenges to remain significant for sectors most affected by social distancing such as retail and leisure. While defaults are anticipated to rise over the forecast horizon, we think that much is now in the price.

Compression to benefit higher-beta pockets: In IG, we recommend that investors take advantage of senior debt, which continues to offer wider spreads. We like increasing exposure to cyclicals and BBBs. In financials, we prefer the largest Italian banks. We also maintain our preference for bonds over CDS. While the scope for capital structure compression is more limited now, we like subordinated debt across fins and non-fins as a source of carry. In HY, we advocate increasing exposure to single Bs as potential loss-adjusted returns compare favorably to higher-rated cohorts based on conservative default and recovery assumptions. Within BBs, we broaden our recommendations to encompass cyclical credits. Across loans and bonds, our preference is for the latter, given weaker fundamentals and more limited upside in loans.

Asia credit

We think that sequencing really matters; near-term cautious on China HY and sticking to IG risk… We currently have a cautious view on China HY in the near term. This tactical caution is mainly driven by our expectation of weaker technicals. Although the China HY property sector has mostly pre-funded its 2020 redemptions, we think that the sector needs to start thinking of 1Q21 refinancing soon. At the same time, demand for Asia credit had not recovered fully from the sell-off in March and could remain weak against the backdrop of escalating US-China trade tension. Hence, we believe that the increase in China HY property's net supply will put pressure on spreads in the near term. We think that it makes sense for investors to tactically reduce some China HY risk in the near term and add back risk gradually as supply starts to pick up. In contrast, we think that Asia/China IG credit will do well in the near term and outperform HY, driven by lower net supply and a relatively cheaper valuation versus HY.

…but we are bullish on both in the medium-to-long term: However, if we look at Asia credit from a 12-month forecast horizon, we expect a broad-based tightening in Asia credit spreads. Valuations currently remain cheap for Asia credit. For example, Asia IG is trading 51bp wider than its long-term fair value while China HY is trading 224bp over its long-term fair value. At the same time, our economic team is expecting a strong rebound in AxJ economies next year (8.5%Y GDP growth). Easy onshore financial conditions, such as our expectation of higher China broad credit growth by year-end, support our thesis of lower default rates for both Asia and China credit. On the technical side, net supply could be lower for China HY in the later part of the year if we are right on net supply picking up soon, which is a technical positive. In our China economists' bear case, they expect that trade tension could escalate further, denting business sentiment and even bringing back cancelled/eased tariffs. They also expect that a second wave of the global pandemic leads to a double-dip in China exports. This scenario is clearly significant risk for Asia credit (particularly for HY) from a fundamental and sentiment perspective, which explains the downside skew in our forecast towards our bear case.

Credit derivatives

We maintain a preference for cash credit over synthetics, with the basis still at wide levels, and cash continuing to be supported by the Fed, and the overseas bid, with supply slowing down meaningfully. Cash spreads broadly remain wider than historical averages, whereas CDX spreads, post the recent rally, are now below the long-term average. In addition, the CDX indices offer very little risk premium outside the tail names, with CDX IG trading at 41bp ex-fallen angels, at 34bp excluding the ten widest names, and CDX HY trading at ~$109/300bp after excluding potential near-term defaults.

In the derivatives space, our highest-conviction view is to position for 3s-5s CDX steepeners broadly, both in IG and HY. The curve has remained flat relative to history in IG, driven by the COVID-19-exposed names, given the lack of long-term clarity on the fundamental health of these names. However, with most of the stressed names having raised capital over the past few weeks to manage near-term liquidity, in addition to the Fed backstop for fallen angels, we think that the curve should be steeper. In addition, we like being long short-dated 0-3% in IG29. The tail of the CDX IG indices is comprised of COVID-19-exposed names that trade very wide to the rest of the market, and in most cases have been downgraded to HY. Similar to the steepener trade, the tranche long monetizes excess default risk premium priced into the short end of the curve.

In the vol space, we continue to think that HY vol is too elevated and offers the best selling opportunity. We like overwriting in HY or owning 1x2 call spreads. We also like going long the HY super-senior tranche to capture systemic risk premium. In IG, the steep downside skew provides the most compelling opportunity, which we recommend monetizing by owning bullish risk reversals.

For convex shorts, we see opportunities in buying protection on IG 7-15% versus the index or owning protection on tight-trading BBB names that are trading through pre-COVID-19 levels.

Global securitized products: Modest mezz

Jay Bacow
Jay.Bacow@morganstanley.com
+1 212 761-2647
Morgan Stanley & Co. LLC

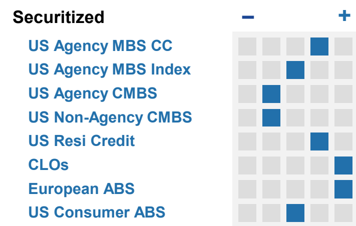
James Egan
James.Egan@morganstanley.com
+1 212 761-4715
Morgan Stanley & Co. LLC

Key investment ideas

• **In general we are positive across most of securitized products:** Combining our economists' outlook with central bank support and reasonable valuations, we think that this is a positive environment for most securitized product investments.

• **What's in the price matters:** While we think that the fundamentals of the US housing market > fundamentals of CLO > CMBS, price matters too. Higher-quality tranches have already priced in much of the recovery, in our opinion, whereas lower-quality tranches have not. Thus, **we recommend going down in quality,** with our preferred areas being, in order, CLO mezz in the US and Europe, CRT B1s and CMBX.11 BBB-. Improved medium-term growth prospects and lower tail risks in Europe as a result of the recovery fund bode well for European ABS.

• **Agency MBS for banks, but not money managers:** We think that agency MBS makes sense for banks looking for assets with better capital treatment, but money managers should be neutral MBS and overweight both corporate and securitized credit, given our more positive outlook on those sectors.

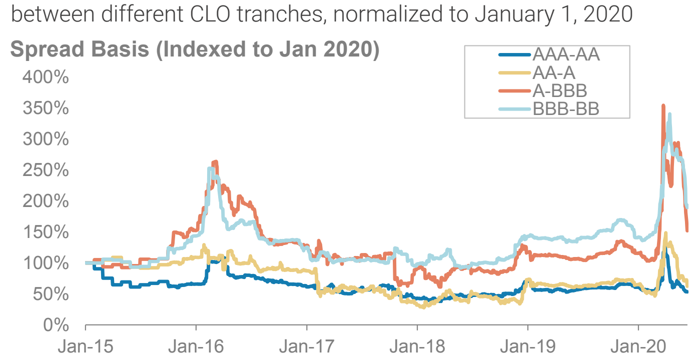


Key themes for the next 12 months

Positive on securitized products in general: While the breadth of securitized products is wide, we are constructive on most of the sub asset classes, given supportive central bank actions and actions from legislative bodies to support borrowers and reduce delinquencies, along with reasonable starting valuations. Of course, while the risks taken in something like agency MBS versus CLO mezz are quite different, so are the spreads, so we can't paint all of securitized products with a single brush. In general, we are most bullish on US and European CLOs, along with European ABS, as valuations are wide and even under stressed default scenarios the structures provide protection. We are constructive on US agency MBS and US resi credit, given support from the FHFA to ease COVID-19-related concerns and support from the Fed, though slightly less sanguine on CMBS, given uncertainty regarding demand post-COVID-19.

Down the stack and across the pond: We think that the highest risk-adjusted returns are down the capital stack in CLOs as junior mezzanine debt has lagged the rally that we see at the top of the capital stack (see Digging Through the Mezz, May 28, 2020, and European CLO Strategy: Testing CLOs vs. a PIK Up in Defaults and CCCs, May 15, 2020). The structural protections insulate mezz from losses on a majority of the universe in our analysis, and we recommend adding BBB and BB in both US and European CLOs along with selective Bs in the latter. Given support from the ECB and more robust enhancement levels for the comparable rating, we maintain a slight preference for European CLOs where possible, along with European ABS.

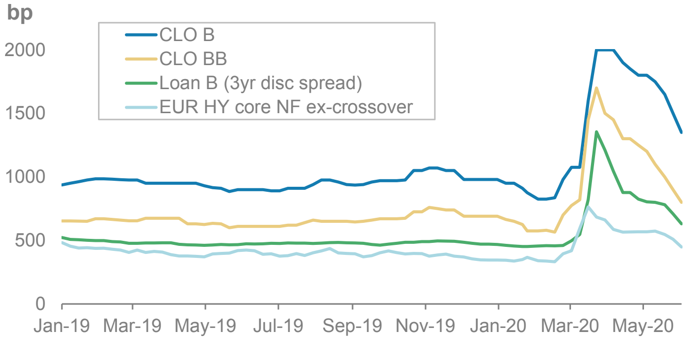
Exhibit 35:
US CLO mezz has lagged in the recent rally: Differences in spread between different CLO tranches, normalized to January 1, 2020



Source: Palmer Square Capital Management, Morgan Stanley Research

Exhibit 36:

European CLO Bs have lagged the retracement



Source: S&P LCD, Markit iBoxx, Morgan Stanley Research

A nickel ain't worth a dime anymore: While mezzanine debt across securitized capital structures continues to lag the rally at the top, we are cognizant that it has caught up significantly over the past few weeks. While we are still bullish on longer-term prospects for mezz, some of the easy money has been made and there may be some near-term profit-taking. We are cognizant that there are a number of opportunities for volatility in the coming weeks and months across products, including a growing percentage of CLO tranches PIKing and resi credit deals failing delinquency tests. We think that these occurrences are well within market expectations, but recent spread tightening has caused the bull/bear/base skew to be less compelling now than in mid-May. However, our broader economic outlook combined with current carry warrants going further down capital structures.

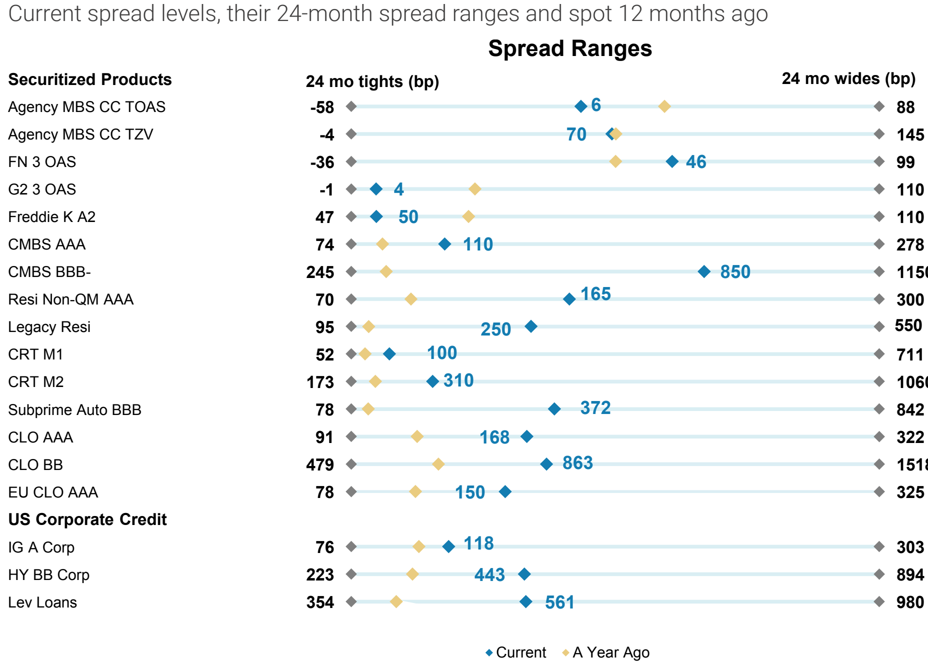
...but we view commercial real estate as more challenged: We see three compounding headwinds for CRE: 1) Our economists' projections for job growth are severe, and that's important because CRE prices are highly correlated to job growth; 2) COVID-19 is challenging the integrity of the lease over the near term as some tenants can't or won't pay rents; and 3) We estimate that the Fed is providing support to only 15% of the US$3.7 trillion CRE debt market. Bottom line, we think that the market is pricing in that commercial real estate can be left behind in a V-shaped recovery as REITs have underperformed the S&P 500 by ~8% in 2Q to-date and by ~14% year-to-date. We also believe it's possible that the trough is going to be deeper and, more importantly, the recovery to normalization will take longer than the market expects.

Agency MBS benefits from attractive starting valuations on lower coupons, strong carry and unprecedented Fed support. However, a stronger-than-expected housing market combined with higher securitization rates has led to record-setting gross issuance; all-time-low mortgages rates and uncertainty around prepay behavior from borrowers undergoing forbearance increase the model risk, and our more positive outlook on corporate and securitized credit means that we think investors will find better alternatives if they have the ability.

Housing is holding up better than expected... The narrative pre-pandemic was that the housing market was on a very solid foundation and was poised to inflect higher in light of robust demand in the face of historically tight supply. The only variable that was holding housing back was a challenged affordability environment exacerbated by tight credit standards (though these same standards contributed to the healthy foundation). It would appear that demand is holding up, and that tight supply is only getting tighter. Credit standards have tightened dramatically, but lower mortgage rates have helped with affordability. This shallower-than-expected pullback in housing activity, combined with the healthy foundation the housing market was on heading into the pandemic, leaves us more constructive on the housing market broadly, and home prices in particular going forward.

Exhibit 37:

Current spread levels, their 24-month spread ranges and spot 12 months ago



Source: Bloomberg, The Yield Book, TRACE, Morgan Stanley Research; Note: Data as of June 10, 2020.

Our best ideas across products

While the supportive growth and policy outlook are not uniquely supportive of the **US CLO** market at the expense of other securitized assets, the structural protections within CLO debt are what make us comfortable going down the capital structure to CLO BBs. While the more credit-remote portions of the capital structure (i.e., AAAs through As) have recovered much of March's sell-off, the junior mezzanine portions of the capital structure continue to lag the rally. Taking elevated one-year default forecasts into account, we can still run lifetime defaults on CLO portfolios far in excess of anything we've seen historically and realize attractive yields. This call is supported by technical tailwinds including muted new issuance volumes and new capital being raised to target this asset class.

Improved medium-term growth prospects and lower tail risks in Europe as a result of the recovery fund bode well for **EU securitized assets,** particularly European CLO debt. While fundamental risks exist, the EU ABS and CLO universe is robust and can withstand a moderate pick-up in stress. Primary activity remains low, new capital is being raised for dislocated assets (CLO deep mezz, for example) and the ECB's purchase programs continue to serve as supportive market technicals.

The solid foundation we believe the US housing market to be on provides a positive fundamental backdrop for **resi credit.** Near-term cash flow dynamics within capital structures are challenged by increasing levels of forbearance, potentially leading to failed delinquency tests. However, recent announcements by the FHFA and the GSEs are supportive of CRT. While the rally of the past few weeks has been substantial, we think that the capital structure will compress further and prefer the B1 tranche within CRT.

Agency MBS will benefit from massive Fed support, as they are projected to net add three times organic net issuance, but face tailwinds from record-high gross issuance and uncertainty around valuations, given record-low mortgages rates and rapidly evolving prepay dynamics as the GSEs attempt to counter the economic effects of COVID-19. We recommend a neutral position for money managers as corporate credit and securitized credit look to have more advantageous returns, but an overweight for banks, which should find mortgages yielding superior returns to Treasury alternatives.

In **CMBS,** we think that the easy money has already been made in AAA spreads and further tightening will be limited absent a rally in corporates, given TALF funding levels. We are tempted by BBB- spreads, given absolute yields, but underwriting bonds is challenging, given limited transparency on cash flows and the Fed providing minimal support to the CRE debt markets. AAA spreads have retraced 86% from their March wides to S+110bp, given the benefit of TALF, but BBB-s have only retraced 43% to S+850bp. We'd prefer to play a beta rally in the CMBS market by going long CMBX.BBB-.11 versus CDX.HY; and we think that alpha can be generated by moving lower in the SASB capital structure where investors can analyze a single property versus the 50-70 required in a conduit deal.

Agency CMBS has benefited from both Fed support and being one of the few sources of high-quality duration, and is now trading at pre-COVID-19 levels. We think that the technicals are still strong, given a lack of other spread assets with longer duration, but expect spreads to widen slightly as investors find more yield in either single-family or non-guaranteed CMBS markets.

The bear case in resi and **consumer** revolves around the fiscal stimulus angle. In our view, augmented unemployment benefits and other forms of fiscal stimulus have supported consumers' ability to continue to make debt payments despite 40+ million people losing their jobs. Survey data from the NY Fed show that consumers expect this support to continue. If it were to taper off while the unemployment rate remains elevated, delinquencies should climb substantially and investors could once again question full principal recovery down capital structures. In this environment, we would recommend staying at the top of securitized capital structures.

Exhibit 38:

Morgan Stanley 2Q21 spread and excess return forecasts across securitized products

		Spreads			Excess Returns		
Product	Current	Bull	Base	Bear	Bull	Base	Bear
Agency MBS OAS	29	20	25	50	0.7%	0.5%	-0.8%
CRT M1	100	75	90	200	1.4%	1.2%	-0.5%
CRT M2	310	200	250	600	8.6%	6.1%	-11.4%
CRT B1	550	400	475	775	18.1%	11.8%	-13.3%
CMBS AAA	110	80	95	250	4.1%	2.6%	-12.8%
CMBS BBB-	850	650	800	1250	28.5%	13.5%	-31.5%
Agency CMBS	50	45	55	80	1.0%	0.1%	-2.2%
US CLO AAA	168	140	150	200	2.8%	2.4%	0.4%
US CLO BB	863	750	850	1200	17.3%	9.6%	-17.4%
EU CLO Senior	150	110	125	200	3.5%	2.8%	-1.0%
UK Prime Senior	55	35	45	125	1.2%	0.9%	-1.6%
UK NC Senior	120	65	85	200	3.1%	2.4%	-1.6%
Spanish Senior	70	35	50	140	1.9%	1.4%	-1.8%

Source: The Yield Book, Bloomberg, TRACE, Morgan Stanley Research forecasts; Note: Data as of June 10, 2020.

Munis: Uncertain direction, attractive price

Michael Zezas, CFA
Michael.Zezas@morganstanley.com
+1 212 761-8609
Morgan Stanley & Co. LLC

Barbara Boakye
Barbara.Boakye@morganstanley.com
+1 212 761-1654
Morgan Stanley & Co. LLC

Key investment ideas

- Fed intervention and federal aid mean that jump-to-default risk in the muni market has largely been mitigated.
- Though munis have rallied substantially and the near-term market path remains uncertain, risk premia are still pricing in plenty of challenges.
- Hence, we continue to like munis, and see particular value in mid-grade sectors such as airports.

While market functioning remains fragile and near-term paths uncertain, we continue to think that investors who have a need to own USD-denominated fixed income will see solid performance from munis over the next 6-12 months. We cite the following three reasons:

1) While Fed intervention isn't directly aimed at healing market functioning as it is for other credit markets, it is providing substantial support for credit quality: While the CARES Act provided the Fed equity capital to intervene in the primary and/or secondary muni market, so far it has only elected to do the former via the Municipal Liquidity Facility (MLF). Furthermore, it has priced the MLF to a rate that is more consistent with a borrowing backstop than a mechanism that will improve market risk premia by taking supply out of the market (see MLF: A Backstop, Not a Replacement, May 12, 2020). In this regard, the message from the Fed appears to be 'market, heal thyself'.

Yet the Fed's action provides a meaningful credit backstop to the market. In particular, the MLF capacity is greater than the budget deficit needs we calculate in our base case for states and locals, and is sufficient to help in a bear case after accounting for state reserve drains and spending freezes (see States of Austerity, May 1, 2020).

Issuers are starting to tap the MLF for liquidity, with Illinois being the first state to borrow. The Fed has also expanded the program to include smaller borrowers at the discretion of state governors; the New York Metropolitan Transportation Authority (MTA) has been granted access, which should help to alleviate the unprecedented revenue deterioration the agency has experienced.

2) Fed intervention plus Congressional support largely mitigate jump-to-default risk in investment grade munis: In addition to the MLF, the CARES Act allocated pools of money that, in our view, largely blunted the risk of jump-to-default in key investment grade sectors. In addition to states and locals, substantial cash was allocated to already cash-rich airports. Furthermore, hospitals received meaningful allocations directly coupled with changes to COVID-19 service reimbursements in order to help to preserve operating liquidity (see CARE for Munis, March 27, 2020). Although default risk is largely mitigated, negative credit rating action is expected.

3) Risk premia measures, while far off their wides, are still pricing in a lot of risk: While we hesitate to read much into muni/Treasury ratios beyond telling us that there aren't enough 'traditional' investors in the market to properly price the benefit of the tax-exempt coupon, we still see munis as attractive on a spread to Treasury basis. For example, the Bloomberg Barclays Muni 10-year index spread to the 10-year TSY is currently at 65bp, roughly 15bp above the wides during and following the global financial crisis. This is important because although the prior recession may be weaker in absolute growth loss terms, our economists expect that the duration will have been much longer than the event we're currently experiencing. When coupled with the support we cite above, as well as the overall mass of the fiscal stimulus we expect the US government to have provided before 3Q is done, we think that the risk premia in munis may be overstating the level of risk in the overall asset class.

Exhibit 39:

Muni returns and ratio targets through 2Q21

10Y Return, Ratio Targets - 2Q21	Base	Bull	Bear
Excess returns	**2.1%**	**1.3%**	**-1.2%**
Total Returns	-1.4%	-0.9%	0.4%
10Y Ratio	81%	91%	213%

Source: Morgan Stanley Research forecasts; *Note: The bull case represents a rates sell-off which corresponds with negative sentiment for the overall US economy.*

Still, we think that investors should focus on taking advantage of this dynamic through increasing high-grade and mid-grade muni exposure, but not yet high yield munis.

We continue to use our three-phase process (see Healing Takes Time, March 25, 2020) to guide investor exposure to muni credit. Munis are healing, but it is still early days for the asset class. In line with phase one, ratios have descended meaningfully from their liquidity crunch peaks. The 10-year ratio is now 128%, yet progress in quality spreads has been more measured. This is evidenced by the 55bp pricing premium between the safest issuers and the index, nearly 70% of MMD.

As munis move beyond phase one and into phase two during our forecasting period, we see the most value in mid-grade spread compression. The spread differential between high-grade and mid-grade issuers leaves room for substantial positive returns. AAA to single A spreads averaged 40bp in the 12 months leading to the heavy outflow period experienced in March. By May, spreads climbed to 120bp and have settled around 115bp. Airport issuers tell a similar story, with spreads to MMD at 70-75bp wide from pre-March averages, and remain single digits lower from the most recent peak. We maintain an overweight allocation to transportation with a preference for general airport revenue bonds.

Our optimism for munis is cautioned by what we suspect will be a fragile market fraught with liquidity challenges, headline risk and weak economic fundamentals. These factors will continue to be headwinds for sustained muni inflows and in turn slow progress into phase three of healing. Hence, we maintain our underweight allocation to high yield.

Commodities: Balanced for now but long-term inflationary tailwinds emerging

Martijn Rats
Martijn.Rats@morganstanley.com
+44 20 7425-6618
Morgan Stanley & Co. International plc+

Susan Bates
Susan.Bates@morganstanley.com
+44 20 7425-4110
Morgan Stanley & Co. International plc+

Key investment ideas

• After the recent rally, near-term risks are broadly balanced across most commodity markets.

• However, over the medium term, our calls for a weaker US dollar and a return of inflation make a stronger case for commodities.

• Near term, we focus on specific dislocations: In energy, we see value in deferred **Brent** time spreads, **gasoline** cracks spreads and the summer-winter spread in **European natural gas.**

• In metals, **gold** remains well supported by quantitative easing measures. **Copper** is our preferred metal to play a recovery from COVID-19 while we are bears in 2H20 on **iron ore** and **aluminium.**

Limited upside after the rally but long-term inflationary pressures on the horizon

With 'peak oversupply' now behind us in practically all commodity markets, prices have recovered strongly from their April lows. By now, risks are broadly balanced in most segments. Our base case forecasts call for upside over the next six months for most commodities, but only in the order of single-digit percentages.

Gold has benefited from the sharp expansion in the monetary base and will likely remain supported. However, it has already rallied beyond our target of US$1,700/oz. Oil prices have doubled from their lows as supply and demand have moved back into balance. However, this has relied on heavy OPEC cuts, curtailments in several non-OPEC countries that are now 'in the money' again, as well as a sharp acceleration in Chinese imports, which probably goes beyond what was required to meet the upturn in domestic demand. Altogether, this appears to be a fragile set of factors. At the same time, many industrial metals are trading at or even above our estimate for long-term marginal cost again and, similar to oil, rely on strong Chinese imports to continue.

As lockdown measures are unwound, commodity demand will likely increase and support prices. However, given that practically all commodity forward curves are in contango, this does not create meaningful upside to futures. Taking into account our bottom-up commodity-by-commodity price forecasts, we set our year-end target for the MS RADAR (ticker: MSCYRX0T Index) at 490, implying ~3% upside potential from current levels.

Still, a longer-term case for commodities is appearing on the horizon. Our economists are calling for both a weakening of the US dollar as well as a pick-up in inflation (see The Return of Inflation, May 10, 2020). For now, the impact is at the edge of our forecast horizon – our colleagues expect inflationary pressure to build only by 2022. However, commodities have historically been useful as hedges against inflation. And when inflation returns, it can accelerate sharply.

This does not have much impact on our forecasts for the next 6-12 months but is nevertheless firmly on our radar. For now, we focus on specific ideas as discussed below: Brent time spreads, gasoline crack spreads, the summer-winter spread in natural gas, as well as gold and copper.

Energy – focus on deferred Brent time spreads, gasoline crack spreads and the summer-winter spread in natural gas

Oil markets have largely rebalanced: Global oil markets were significantly oversupplied in April, albeit not quite as much as the market feared. Based on observed inventory changes and early demand reports, we estimate that demand fell ~17 mb/d year on year, considerably less than for example the IEA's estimate of a decline of 29 mb/d.

From there, supply fell sharply as the OPEC+ cuts came into force in May, US production started to decline and countries ranging from Brazil to Norway to Ecuador all took barrels off the market. In the seaborne market, tanker loadings fell sharply in May, particularly from the Arab Gulf, while China accelerated imports. As a result, oil-in-transit is now trending down, and onshore and floating storage have broadly flatlined. This suggests that supply and demand have broadly come into balance, allowing prices to rise.

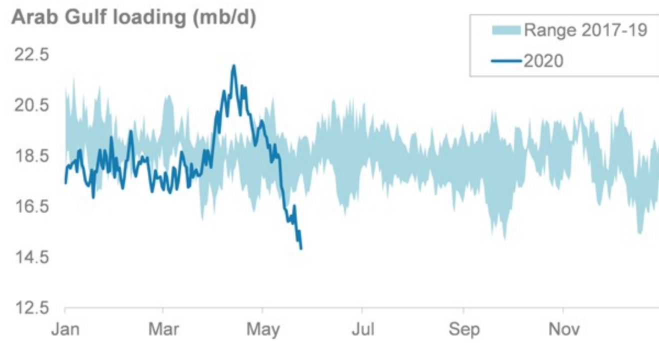
share more forcefully. The combination of these two factors leaves only limited room for US shale to grow. With an average break-even of ~US$40/bbl, WTI cannot trade much above that for long periods – otherwise, growth would simply be too strong. On that basis, we expect Brent to be anchored at ~US$45/bbl in the coming years – a level we expect Brent to reach by mid-2021. In the short run, we expect that the weakness in refining margins, which remain historically low, will also weigh on the pace of price recovery.

Value in deferred Brent time spreads: Although upside to flat price is arguably modest, we continue to see value in deferred time spreads. After rebalancing earlier than anticipated, we expect inventories to start drawing meaningfully during 4Q20 and 1Q21. Time spreads in that part of the forward curve are still in contango, while the pace of inventory draws and the level of inventories should justify modest backwardation by the end of 1Q21. As discussed here, we see upside in the March-December 2021 Brent timespread.

Gasoline rebound to drive crack spreads higher: We expect gasoline to lead the recovery in oil demand as people around the world gradually return to work and likely avoid public transport where possible. This is visible in high-frequency inventories, which have broadly stabilized in the last six weeks, in sharp contrast to distillate stocks, which have continued to increase. We expect that crack spreads will need to incentivize yield switching back to gasoline. Hence, we see upside to the Aug 2020 RBOB-Brent crack spread.

Exhibit 40:

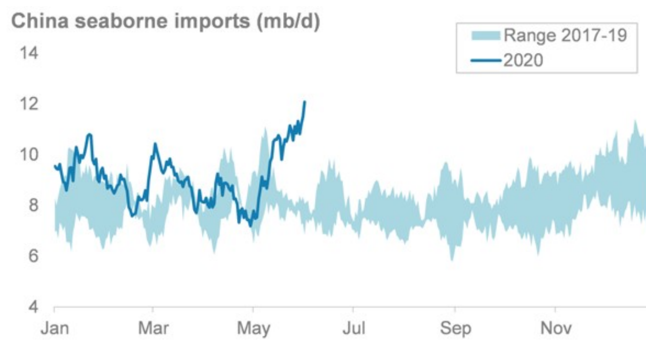
Arab Gulf loadings are down...



Source: ClipperData, Morgan Stanley Research

Exhibit 41:

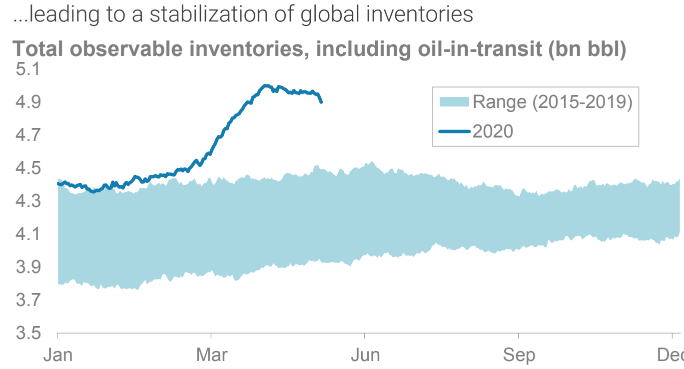
...and Chinese imports are up...



Source: ClipperData, Morgan Stanley Research

Exhibit 42:

...leading to a stabilization of global inventories



Source: ClipperData, Morgan Stanley Research

Falling shale break-evens cap upside at ~US$45: We expect oil prices to continue on an upward trend over the next 6-12 months, although after the recent rally the remaining upside has inevitably shrunk substantially. The vast majority of lost oil demand is likely to come back in the next few quarters but it still takes until end-2021 to recover back to 2019 levels, on our estimates. Also, trend growth in oil demand thereafter is likely to be more muted than in the past. At the same time, we expect that OPEC will start to defend its market

Natural gas close to bottoming out; summer-winter spread to rally: Natural gas prices have declined to such low levels that it has left the industry substantially unprofitable. In Europe and Asia, gas prices are now below the marginal cost of US LNG supply. From here, risks are skewed higher, in our view, driven by recovering demand, supply curtailments and investment delays (see also Natural Gas: Approaching the Bottom? May 19, 2020). We specifically see value in the summer versus winter spread (i.e., Aug versus Feb) in TTF prices.

Metals & bulks

Precious metals

Financial conditions remain very supportive for **gold** – unprecedented global quantitative easing, negative real rates and a weakening US dollar are all positive drivers underpinning gold's price. However, slower central bank buying, low inflation, improving sentiment and weakness in fabrication markets cap upside in the near term, and we expect prices to remain range-bound until later in the year. Our base case forecast of US$1,700/oz in 4Q20 carries some upside risk, though, and we highlight our bull case of US$1,900/oz – which would be achievable on a combination of further US dollar weakness and negative real rates, combined with weaker equity markets, central bank buying and a recovery in fabrication demand (see Gold – Macro vs Micro, April 22, 2020).

As lockdowns have begun to ease, **silver** has staged a strong rally – benefiting from both improved market sentiment towards its industrial drivers (automotive, electronics, solar energy), as well as strong buying by investors wanting to add precious metals exposure, but deterred from gold by its already-high price. However, the market fundamentals for silver are lagging its spot price and we see limited further upside versus spot over the balance of the year.

Base metals

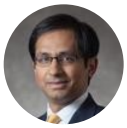
COVID-19 hit metals demand hard, but a tandem impact on both mine and scrap supply, together with rapid stimulus and China's 2Q recovery, have lent resilience to the markets. **Copper** in particular has managed to avoid any large metal inventory build, as downstream restocking activity in China, >500kt of lost mine supply and a tight secondary market have absorbed much of the downturn. Near-term downside risk stems from the restart of mines now under way, together with easing scrap supply and a potential pause in China's buying activity, as its metal consumption through April-May has outpaced the recovery in end-use markets. However, by 4Q20 we expect a sustainable price lift to have emerged, and forecast US$5,732/t (US$2.60/lb) in 4Q20.

The other base metals are more challenged by inventory overhang following the 1H20 shutdowns. This is particularly the case in **aluminium,** where we estimate that 13 weeks' inventory will have built by year-end, on a 3.8Mt market surplus. With a limited supply response from ex-China smelters, continued ramp of domestic China capacity and a constrained automotive sector, risk is to the downside versus spot. We forecast US$1,465/t in 4Q20 (see Aluminium – Kicking the can down the road, May 26, 2020).

Iron ore

Iron ore has become the preferred commodity play on Chinese stimulus. With China's robust steel output (+2.6%Y in Jan-Apr) and 75% of all shipped iron ore heading for China, the steelmaking ingredient has fared well. Iron ore broke through the US$100/t barrier in late May on hopes that China's stimulus package would spur on steel-intensive infrastructure projects and concerns about falling exports from Brazil, the world's second-largest producer. Although our China economist forecasts 9.5%Y growth in infrastructure fixed asset investment this year, we don't expect that China's steel output will grow significantly from current elevated levels. Not only will it take about nine months until issued credit will translate into actual steel demand, we also wonder how steel-intensive the next generation of infrastructure projects will be. Furthermore, non-infrastructure steel demand (73% in China) is less likely to benefit from the stimulus, and the weakness in manufacturing and transport end-use demand will partially offset the strength in infrastructure demand, in our view. Amid relatively steady Chinese steel production, we believe that a recovery in Brazilian exports will drive a downward price correction in 2H20, as we expect the current operational issues to be of a short-term nature.

Global volatility: Better days ahead



Phanikiran Naraparaju
Phanikiran.Naraparaju@morganstanley.com
+44 20 7677-5065
Morgan Stanley & Co. International plc+

Key investment ideas

- **Volatility normalization still in early stages:** We still see room for volatility to fall further, especially in equity and credit. Implied vols in the top quartile are inconsistent with the scale of the broader expectations for a 'V' recovery and upbeat risk environment. FX/rates have two-way opportunities, having fully unwound the volatility spike in some cases.
- **Second-order measures of risk premium to compress next:** Alongside volatility levels, second-order measures of risk premium such as skews, high-beta versus low-beta vol spreads and term structures also have to normalize further and offer attractive risk premium.

Volatility normalization has just begun, in our view. Current implied volatility in equities and credit is inconsistently high compared to our economists' expectations for a 'V' shaped recovery, a benign policy rate outlook and the remarkable rally in asset prices. The last time S&P 500 was above 3,200 in January, VIX was less than half of current levels.

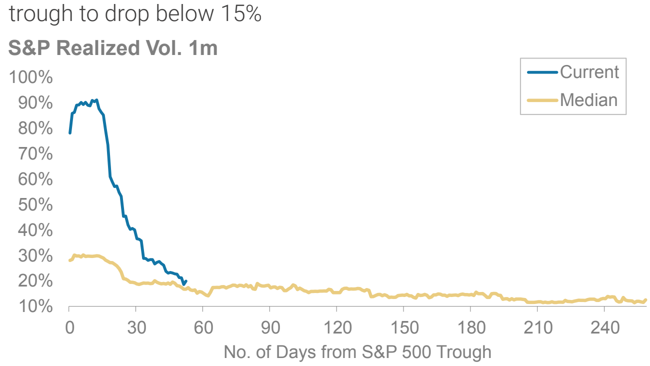
In the near term, the sharp rebound has kept realized from falling (even more) but we expect realized vols to fall quickly once data reinforce the price action. We find that in the twenty odd previous bear markets since the 1920s, it took just five weeks on average from the market trough for 1m realized volatility to fall below 20% but six months for 1m realized volatility to fall below 15%. We expect VIX to settle in the 15-20 range in the second half of the year.

Demand for hedging on fears of a second wave may keep implied vol declines gradual from here, but this may not be a bad thing. It will embed a higher volatility risk premium for a longer period and also help to dampen volatility spikes.

In contrast to equities and credit, rates volatility has been one of the fastest to normalize. FX volatilities are bifurcated, with some G10 vols, notably JPY vols, looking attractive as a long, having reverted close to 15-year lows. JPY realized vols didn't drop below 6% until more than ten months from previous market troughs on average. However, EM FX vols have high risk premium similar to equity and credit and are still attractive to sell volatility.

Exhibit 43:

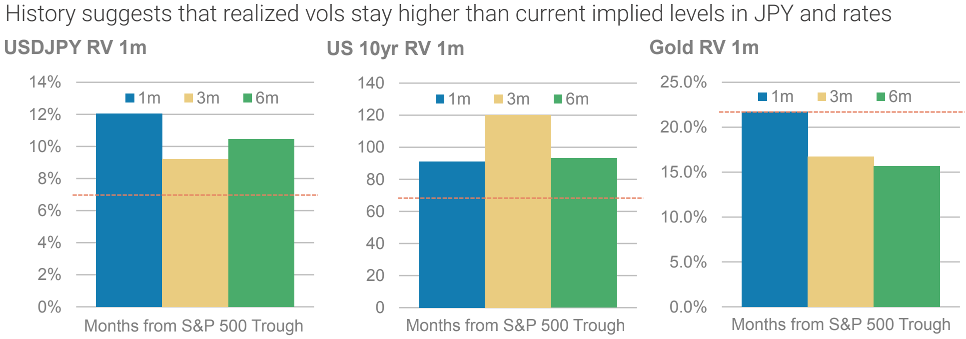
Realized volatility on average takes six months from the market trough to drop below 15%



Source: Bloomberg, Morgan Stanley Research

Exhibit 44:

History suggests that realized vols stay higher than current implied levels in JPY and rates



Source: Bloomberg, Morgan Stanley Research; Note: Dotted line shows current 3m implied vol.

Second-order measures of term premium are also attractive

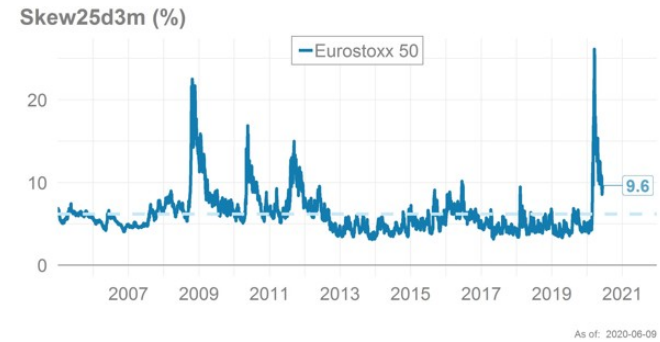
Alongside volatility levels, second-order measures of risk premium such as skews, high-beta versus low-beta vol spreads and term structures also have to normalize further and offer attractive risk premium. Some of the key views we have play for normalization in these:

Fading the skews in European stocks and CDX IG: Options skews are still far from normalized and will come under pressure as volatility eases. We think that this particularly applies in European equities, which have been underowned recently and benefit from the recovery fund, and in IG credit, where skew is still high despite the Fed's visible support.

Compression of volatility spreads in FX: Volatility dispersion is high both between G10 FX and EM FX but also within the groups. USD/MXN vol is several points higher than USD/KRW, with spread close to the top quintile. In G10 FX, we have a similar disconnect between AUD and JPY vols, with JPY vols now below 2019 levels.

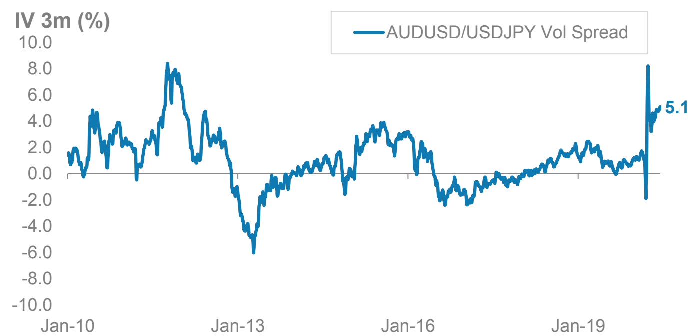
Rates – fading negative rates, positioning for steeper curves: Rates volatility has normalized the fastest and potentially offers two-way opportunities to be long and short vol. Our more constructive view on the macro front means that we are inclined to fade negative rates and position for steeper curves. Inverted term structures are also a source of return in rates volatility.

Exhibit 45:
Skew remains extreme



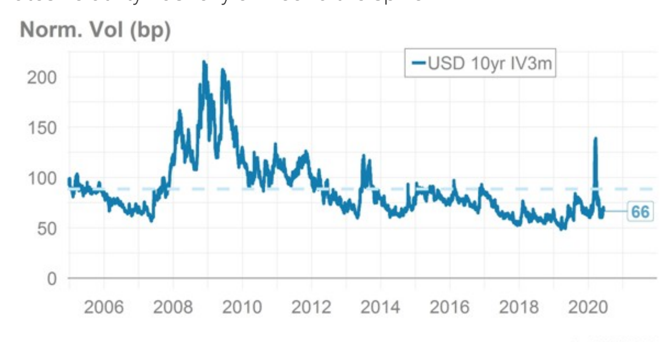
Source: Bloomberg, Morgan Stanley Research

Exhibit 46:
FX vol dispersion is high. Vol spreads between AUD and JPY vols are still extreme



Source: Bloomberg, Morgan Stanley Research

Exhibit 47:
Rates volatility has fully unwound the spike



Source: Bloomberg, Morgan Stanley Research

Global quant: Embracing Value

Boris Lerner
Boris.Lerner@morganstanley.com
+1 212 761-0759
Morgan Stanley & Co. LLC

Alix Guerrini
Alix.Guerrini@morganstanley.com
+44 20 7425-9055
Morgan Stanley & Co. International plc+

Yinan Zhang
Yinan.Zhang@morganstanley.com
+852 3963-3507
Morgan Stanley Asia Limited+

Key investment ideas

Our factor outlook is largely shaped by the Morgan Stanley economic and strategy forecasts:

- The V-shaped recovery projected by our economists, coupled with the coordinated global fiscal spending, should favor Value factors over the next year.
- In the US, we are overweight Value and Small Cap, neutral on Quality and Growth and underweight Low Vol and Low Beta factors. We like Value and Small Cap, as these factors tend to outperform in an economic recovery, and would be the top beneficiaries from increased fiscal spending. And we are negative on Low Vol as this factor is defensive, and tends to underperform when markets move from risk-off to risk-on regimes.
- In Europe, we are also positive on Value and Size (small). The recovery backdrop is supportive, valuations troughed to all-time low in April for Value and the announcements relative to EU recovery fund are particularly favorable. We maintain our negative view on Low Vol due to its all-time high valuation and its sharp negative skew to recoveries. Lastly, we remain positive on Total Yield due to cheap valuations (all-time low on a Price/Book basis) as well as its positive exposure to inflation and high correlation with Value.
- In Asia and EM, we recommend a disciplined investing approach focusing on a high Quality factor in a market regime of rising political uncertainty. Meanwhile, we do not have a high conviction in either Value or Growth stocks. We believe that the Value style is not preferred because of a lack of near-term catalyst to reverse the easing and low rate backdrop, while the Growth style is not preferred because it is difficult to sustain the current high premium over low-growth stocks against the current macro backdrop.

Value is on the rise

The COVID-19 pandemic has wreaked havoc on the global economy, shuttering business and sending unemployment to record levels. Equity markets sold off across the world, with investors seeking safety in Low Vol, Low Financial Leverage, High Profitability, Larger Cap and High Growth stocks. These factors have continued to hold their ground even after the headline indices have troughed and started to recover.

However, as the recovery is starting to gather steam, and businesses are beginning to reopen, we are seeing signs of rotation into more pro-cyclical factors. **We expect this rotation to persist, and as the economies continue to recover around the world with the help of increased fiscal spending, we think that Value and Smaller Cap stocks will be the main beneficiaries.**

We continue to like Quality, especially in combination with Value, although we are concerned that it may underperform in the initial stages of the recovery: There are many risks to the economic recovery and these risks vary across different parts of the world, so Quality overlay may be more prudent in some regions than others.

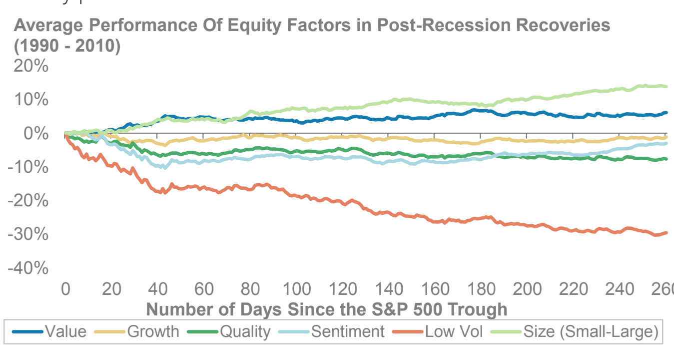
We are generally negative on defensive factors such as Low Vol or Low Beta: These factors tend to work best in times of stress and economic instability, and have outperformed significantly in the early phases of the COVID-19 sell-off. The performance has started to lag as investor sentiment began to improve, and we expect these factors to continue to struggle as the recovery accelerates.

While the continued economic recovery should be favorable for risk assets, we expect equity markets to react differently in different parts of the world. Our equity strategists prefer US and European equities, but are more cautious on EM and don't expect it to follow the 'usual' early-cycle playbook.

In the US, we are overweight Value and Size (Small over Large), and underweight Low Vol: As we have pointed out in US Equity Strategy: Bear Markets End with the Cycle; Time to Employ a Recession Playbook, March 23, 2020, recessions and large economic shocks tend to bring about a rotation in factors. Initially, investors often seek the safety of more defensive equities, with lower volatility, higher balance sheet quality and larger market cap. As the economy starts to recover and sentiment changes, investors usually rotate out of safer assets into more pro-cyclical factors, such as Value and Smaller Cap (**Exhibit 48**). We think that this time is no different, and see many signs that our recession playbook is playing out.

Exhibit 48:

Value and Small Cap tend to outperform in recoveries, while Low Vol is usually punished the most



Source: Morgan Stanley Research

We continue to like Quality in the US over the long term, although we are concerned that a strong rally of many Quality metrics in the last few months could result in short-term underperformance. However, over the longer term, we think that stocks with Low Financial Leverage and High Profitability are best positioned to partake in the economic recovery and are more resilient to any potential political instability, such as the US elections or a potential rise in global trade disputes.

In Europe, we are positive on Value and Size (Small over Large) as well: The new macro exposures are explicitly pro-cyclical, pushing for Value and Size (Small) against Low Vol, Momentum or Quality. The recovery backdrop is supportive, valuations troughed to an all-time low in April for Value, and the announcements relative to the EU recovery fund are particularly favorable.

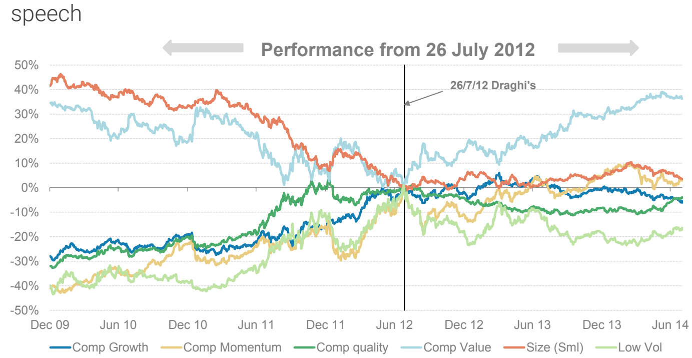
Indeed, one of the biggest catalysts we see in Europe for the broader Value complex is the proposed EU recovery fund, through a reduction of the current tail risks, a compression of the equity risk premium and relative support for financials and the periphery. We think that this proposal is very similar to the 2012 "Whatever it Takes" policy and, if enacted, could provide strong support for Value and Small Cap factors in Europe. As detailed in **Exhibit 49** , Value should be the main beneficiary of an agreement on the recovery fund. After the July 2012 "Whatever it Takes" announcement, the Value factor rebounded 20% in two months and followed a positive trend during the subsequent two years, posting a 40% increase. On the flip side, Low Vol and Momentum corrected sharply after the ECB announcement, dropping around 15% in two months, with Low Vol still underperforming by 23% six months later.

We maintain our negative view on Low Vol... due to its all-time high valuation and its sharp negative skew to recoveries.

...and remain positive on Total Yield due to extremely cheap valuations (all-time low on a Price/Book basis) as well as its positive exposure to inflation and high correlation with Value.

Exhibit 49:

Factor performance before/after Mario Draghi's "Whatever it Takes" speech



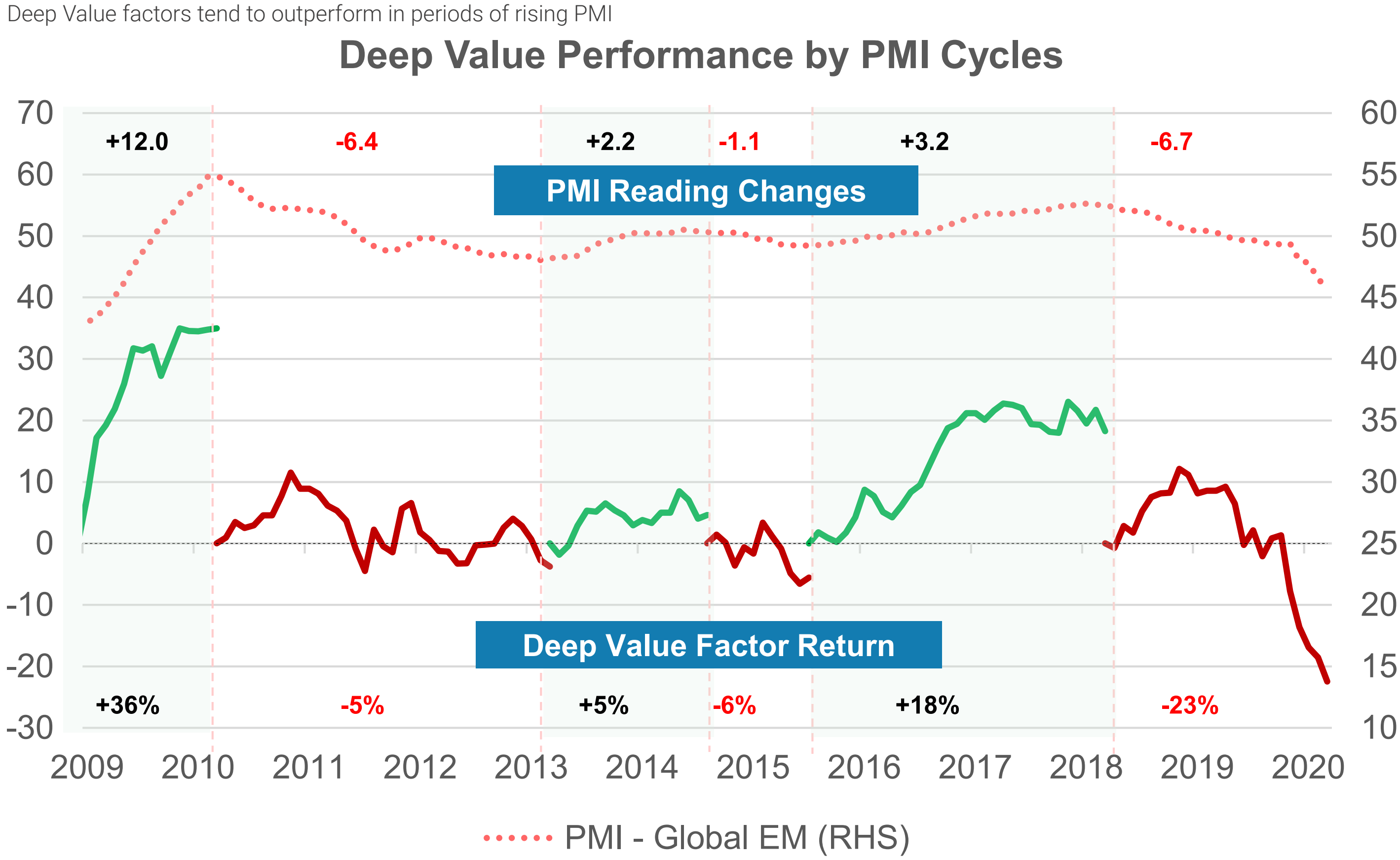
Source: FactSet, Morgan Stanley Research; The factor performances are long/short returns of the top versus bottom quintile in MSCI Europe. The portfolios are rebalanced quarterly and returns are equal-weighted.

In Asia and EM, we maintain our strategic preference for Quality in 2H20, mainly due to the rising political tension that will likely keep the market volatile. Meanwhile, we do not see clear catalysts that structurally favor Value or Growth. The global easing and low rate backdrop is likely to be a norm in the foreseeable future, which would hinder the performance of Value stocks, while the premium of Growth stocks is currently priced at an all-time-high after the 2008 GFC, which implies limited room for Growth stocks to outperform.

At the same time, we recommend a tactical preference for cyclical Value within the next three months: From a tactical allocation perspective, we do see relative opportunities among Value stocks in APxJ/EM markets and suggest that investors pay attention to valuation re-rating and changes to PMI. Valuation re-rating tends to lead ROE improvement. The current market consensus expects ROE among APxJ/EM corporates to face pressure in FY20, and start to recover in FY21. Historically, we saw re-rating of P/B valuation take place before ROE picks up, and during those periods the Deep Value/Reversal factors were strongly favored. The PMI cycles also demonstrated a statistically positive correlation with the performance of Value stocks. With our house view that the global economy continues to reopen and PMIs to pick up thereafter, the potential alpha opportunities offered by Value stocks should be back on investors' radars.

Exhibit 50:

Deep Value factors tend to outperform in periods of rising PMI



Source: Morgan Stanley Research

What we debated

Andrew Sheets
Andrew.Sheets@morganstanley.com
+44 20 7677-2905
Morgan Stanley & Co. International plc+

This outlook involved multiple discussions with the entire Morgan Stanley global economic and strategy teams. The following dominated our internal debate.

There was more agreement than normal around this outlook, perhaps because it is largely an extension of existing views. Still, the debate centered largely on three areas:

The recent rally: Markets have risen sharply over the last three weeks, the period over which we debate and construct this 12-month outlook. While this is not meant to be tactical document, price still matters on a longer horizon, and recent gains cut upside even as we raised targets. The final version of this document is more tempered than the first draft.

How much does COVID-19 matter? There was outright disagreement on this point between those who believe rising case counts would have a limited impact (given little political will to shut down activity again, and those who were more concerned. Ultimately, we took some comfort in our base case for US growth that shows steady improvement this year, even with a small second wave over the summer. But given significant uncertainty, this remains an issue to verify.

Europe: Developments around the recovery fund meant that Europe received a special, outsized amount of discussion, mostly around how much these developments really change the region's narrative after so many false dawns. Ultimately, we concluded that the reduced risk to our bear case was substantial enough that we made updates to our views ahead of this outlook (see Strategy and Economics: EU Recovery Fund – a Game Changer? May 21, 2020, and European Equity Strategy: EU Recovery Fund = more upside for Europe, Financials & the Periphery, June 3, 2020).

China and Japan: With time limited, there was much less discussion than normal of the world's second- and third-largest economies, and an expectation that neither would see outsized policy surprises.

How consistent are our forecasts?

Cross-Asset Strategy Team

To better understand where Morgan Stanley strategists are out of consensus, or where we are forecasting unusual moves versus history, the cross-asset team runs an exercise every outlook process, examining whether our 12-month price targets are consistent with each other, and historical moves.

We run simple multi-variable linear regressions for every forecast market, using all other markets' performance as variables. For example, our model would look at whether the S&P next 12-month forecast price change is roughly in line with, say, what our FX strategists are expecting for USD/JPY, where our rates team sees UST yields going, or what our credit colleagues believe to be the right level for US HY spreads. If the expected 12-month return for one asset diverges significantly from what's forecast for other markets, there could be two possibilities: i) The price target is inconsistent with Morgan Stanley Research's outlook, and where we are most likely to be wrong; or ii) Our strategists are expecting moves which are unusual compared to history, for good reason. It's the second category that interests us the most here.

Exhibit 51:

Forecast face-off model – how do our price targets compare to each other and history?

	As of Jun 11, 2020	MSe 4Q21 Target	MSe 12M Chg	Model- Implied ± 1σ Range	Diverge from Model?
Equities					
S&P 500	3002	3350	11.6%		Y
MSCI Europe	1439	1580	9.8%		Y
TOPIX	1589	1550	-2.4%		Y
MSCI EM	994	920	-7.4%		Y
FX					
USDJPY	107	112	4.8%		Y
EURUSD	1.13	1.20	6.2%		Y
GBPUSD	1.26	1.25	-0.8%		Y
AUDUSD	0.69	0.74	8.0%		Y
Rates (%)					
UST 10Y	0.67	1.30	0.63		Y
Bunds 10Y	-0.41	0.05	0.46		
UKT 10Y	0.20	0.45	0.25		
JGB 10Y	0.01	0.00	-0.01		
Credit (bps)					
US IG	169	135	-34		
US HY	642	550	-92		Y
EUR IG	109	80	-29		
EUR HY	488	400	-88		Y
BTP 10y	191	90	-101		Y
EM Sovs	483	400	-83		Y
Commodities					
Brent	39	40	3.8%		
Gold	1738	1700	-2.2%		Y

Source: Bloomberg, Morgan Stanley Research; Note: Our 'model' numbers are based on linear regressions, using the last 15 years of history to examine cross-asset relationships. The model flags a divergence if the magnitude of move predicted by our strategists falls outside the model's 1 standard deviation range.

Our forecast face-off model suggests that behavior of the assets below is likely going to deviate the most from the historical patterns over the next 12 months:

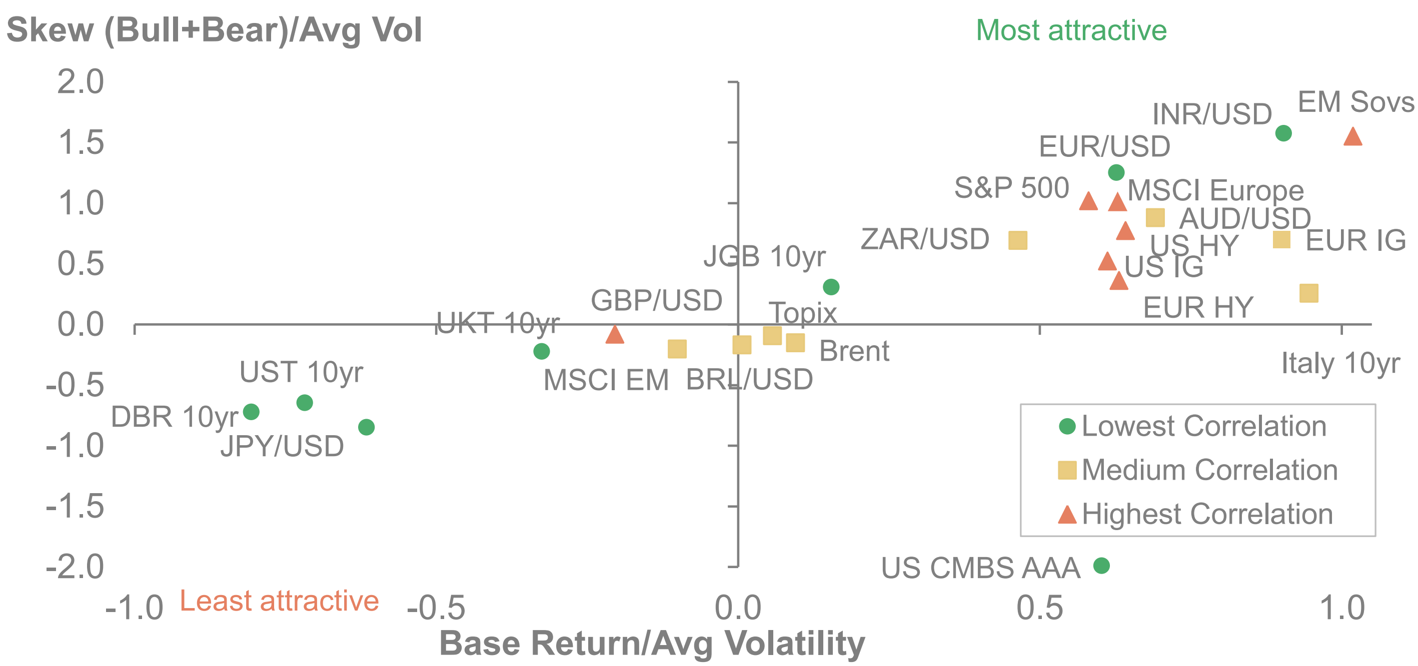
European assets and FX: Our equity, FX and credit strategy teams all forecast European assets to do better than what history suggests, given other teams' expectations for risk assets and rates. In particular, our 12-month targets calling for stronger European equities, tighter EUR HY and peripheral spreads, higher Bund yields and stronger EUR imply a deviation from past correlations. Our strategists think that this time could be different, given the support the new EU recovery fund would give to European risk assets, which in turn could attract flows into the region, even as Bund yields climb higher on the back of larger supply from additional stimulus (see Strategy and Economics: EU Recovery Fund – a Game Changer? May 21, 2020).

EM stocks: Our forecast for single-digit downside in EM equities doesn't entirely agree with our projections for a weaker USD and generally more bullish forecast for US and European equities; in fact, our more bearish EM equities target also flies in the face of what our own cross-asset cycle model would suggest – that EM stocks should outperform when the economy is in recovery. Our equity colleagues argue that EM equities will likely underperform this time around as the growth rebound will be DM-led this time, unlike in prior cycles; corporate leverage across EM equities is also elevated compared to the last recovery, and spillover from China stimulus will likely be less of a factor today versus the experience of 2009-10.

EM stocks versus EM credit: Much weaker EM equities also don't agree with our forecast for much tighter EM credit spreads – historically, returns for the two assets tend to be positively correlated. We think that performance of the two can diverge given the very different geographical exposure of benchmark EM equity indices versus EM $ credit indices currently, as well as the fact that valuations look outright cheap for EM $ spreads, while EM equities is at best fair on a forward P/E basis.

Expected returns and risk/reward

Global asset classes – expected 12-month return vs. risk



Source: Morgan Stanley Research. Note: 'Expected returns' based on Morgan Stanley Strategy 2Q21 forecasts and current market prices. Correlation is 10Y relative to global equities (MSCI ACWI). Credit returns are excess returns. Low correlations include negative correlations. Volatility is the average of long-term average and option implied where available.

Exhibit 52:

Morgan Stanley key market forecasts

	As of Jun 11, 2020	Q2 2021 Forecast		
		Bear	Base	Bull
Equities				
S&P 500	3,002	2,900	3,350	3,700
MSCI Europe	1,439	1,280	1,580	1,810
Topix	1,589	1,200	1,550	1,840
MSCI EM	994	715	920	1,200
FX				
USD/JPY	107	105	112	115
EUR/USD	1.13	1.14	1.20	1.26
GBP/USD	1.26	1.15	1.25	1.35
AUD/USD	0.69	0.68	0.74	0.76
USD/INR	75.8	71.8	74.0	77.7
USD/ZAR	17.2	15.7	16.5	18.2
USD/BRL	4.98	4.85	5.00	5.35
Rates (% percent)				
UST 10yr	0.67	1.65	1.30	0.40
DBR 10yr	-0.41	0.35	0.05	-0.75
UKT 10yr	0.20	0.75	0.45	-0.10
JGB 10yr	0.01	0.05	0.00	-0.05
Credit (bps)				
US IG	169	250	135	115
US HY	642	825	550	400
EUR IG	109	170	80	50
EUR HY	488	675	400	325
Italy 10yr	191	330	90	55
EM Sovs	483	550	400	320
US CMBS AAA	110	250	95	80
Commodities				
Brent	38.6	25.0	40.0	50.0

Source: Markit, MSCI, Bloomberg, The Yield Book, Morgan Stanley Research forecasts

Exhibit 53:

12m return and risk forecasts

	12m Return			Volatility		Return/Risk
Asset	Bear Case	Base Case	Bull Case	Option Implied	LT Average	Base case Return/Vol
Equities						
S&P 500	-1%	13.0%	24%	27%	18%	0.58
MSCI Europe	-7%	12.3%	27%	23%	17%	0.63
Topix	-21%	0.1%	17%	21%	20%	0.01
MSCI EM	-24%	-4.3%	22%	26%	16%	-0.20
FX						
JPY/USD	-8%	-5.1%	1%	7%	9%	-0.62
EUR/USD	0%	5.0%	10%	7%	9%	0.63
GBP/USD	-9%	-1.0%	7%	10%	9%	-0.10
AUD/USD	-1%	7.6%	10%	11%	11%	0.69
INR/USD	2%	6.2%	9%	7%	7%	0.90
ZAR/USD	-2%	7.5%	13%	16%	16%	0.46
BRL/USD	-5%	0.9%	4%	15%	15%	0.06
Rates						
UST 10yr	-8%	4.5%	4%	6%	6%	-0.72
DBR 10yr	-7%	4.1%	3%	5%	5%	-0.81
UKT 10yr	-4%	-1.8%	3%	6%	6%	-0.32
JGB 10yr	0%	0.3%	1%	2%	2%	0.15
Credit (Excess Return)						
US IG	-3%	4.0%	6%	10%	3%	0.61
US HY	-5%	8.4%	15%	20%	6%	0.64
EUR IG	-2%	2.7%	4%	4%	2%	0.90
EUR HY	-6%	6.3%	10%	15%	5%	0.63
Italy 10yr	-11%	10.2%	13%	11%	10%	0.95
EM Sovs	0%	11.1%	17%	14%	7%	1.02
US CMBS AAA	-13%	2.6%	4%	6%	3%	0.60
Agency MBS	-0.8%	0.5%	0.7%	2%	1%	0.28
Commodities						
Brent	-34%	3.6%	28%	39%	36%	0.10

Source: Bloomberg, Morgan Stanley Research forecasts; Note: We show annualized returns based on June 2021 targets.

Exhibit 54:

Current Morgan Stanley asset allocations

MS Asset Allocation Views	O/W vs. Benchmark	Change vs. Last Month
Equities	+1%	
US	+1%	-1%
Europe	+1%	+1%
Japan	0%	
EM	-1%	
Govt. Bonds	-4%	-2%
US	-3%	-2%
Europe	-2%	
Japan	+1%	+1%
EM Local (FX-hedged)	0%	-1%
Credit	+5%	-2%
US Corp.	+2%	
EU Corp.	+1%	
EM Sov.	+1%	-1%
Securitised	+1%	-1%
Cash	-2%	+4%
Commod.	0%	

Source: Morgan Stanley Research Note: Text in grey represents the change vs. previous allocation.

Exhibit 55:

What's in our benchmarks?

Asset	Sub-Asset	Weight	Returns Index	Sub-Weights
Equities	US Equities	25%	SPX Index	25%
	European Equities	10%	MSCI Europe	10%
	Japan Equities	5%	TOPIX	5%
	EM Equities	10%	MSCI EM	10%
Rates	US Rates	10%	UST 10yr	10%
	European Rates	10%	DBR 10yr	10%
	Japan Rates	5%	JGB 10yr	5%
	EM Local	5%	MS EM Local Index*	5%
Credit	US Corporates	6%	US BIG Corp index (Yield Book)	4%
			US HY Market (Yield Book)	2%
	European Corporates	3%	iBoxx EUR IG Corporate Index	2%
			iBoxx EUR HY Index	1%
	EM Sovereigns	3%	EMBI Global Index	3%
	Securitized Credit	3%	Agency MBS	0.75%
			Non-Agency MBS	0.75%
			CLO	0.75%
			CMBS	0.75%
Other	Commodities	2%	Bloomberg Commodity Index	2%
	Cash	3%	US Libor 1m	3%

Source: Bloomberg, Morgan Stanley Research forecasts; Note: * MS constant-weighted basket of 10yr Local bonds.

Morgan Stanley key economic forecasts

Exhibit 56:

Morgan Stanley key economic forecasts

	Quarterly												Annual		
	2019				2020				2021				2019	2020E	2021E
Real GDP (%Q, SAAR)	1Q	2Q	3Q	4Q	1QE	2QE	3QE	4QE	1QE	2QE	3QE	4QE			
Global	**3.7**	**3.9**	**2.4**	**1.4**	**-12.8**	**-16.2**	**28.8**	**8.5**	**4.3**	**4.8**	**7.2**	**7.2**	**3.1**	**-3.8**	**6.1**
G10	**2.5**	**1.4**	**1.5**	**0.2**	**-7.5**	**-38.1**	**29.7**	**7.0**	**3.7**	**4.1**	**9.8**	**9.3**	**1.7**	**-7.1**	**4.5**
US	3.1	2.0	2.1	2.1	-5.0	-32.4	10.6	9.2	3.9	3.1	10.7	10.4	2.3	-5.8	3.9
Euro Area	2.0	0.4	1.2	0.2	-13.6	-49.7	57.4	5.8	4.2	5.3	11.7	11.7	1.2	-9.6	6.5
Japan	2.6	2.1	0.0	-7.2	-2.2	-19.6	8.3	4.0	0.9	3.6	4.1	3.2	0.7	-4.5	1.9
UK	2.7	-0.6	2.1	0.1	-7.7	-61.0	93.9	5.7	4.7	5.7	5.9	3.6	1.4	-9.9	6.4
EM (%Y)	**4.2**	**4.1**	**4.0**	**4.1**	**-1.8**	**-5.6**	**-0.6**	**1.2**	**7.6**	**11.3**	**6.3**	**5.1**	**4.1**	**-1.6**	**7.2**
China (%Y)	6.4	6.2	6.0	6.0	-6.8	1.5	5.3	6.3	19.0	9.7	6.0	5.0	6.1	2.0	9.2
India (%Y)	5.7	5.2	4.4	4.1	3.1	-13.0	-1.0	3.5	5.0	20.2	7.5	5.4	4.9	-1.7	9.0
Brazil (%Y)	0.6	1.1	1.2	1.7	-0.3	-10.7	-9.3	-8.0	-5.4	6.2	5.7	5.2	1.1	-7.2	2.9
Russia (%Y)	0.4	1.1	1.5	2.1	1.6	-9.5	-6.8	-5.9	-4.0	8.3	5.9	5.4	1.3	-5.3	3.9
Consumer price inflation (%Y)															
Global*	**2.5**	**2.8**	**2.6**	**3.0**	**3.4**	**2.0**	**1.8**	**1.5**	**1.8**	**2.8**	**2.9**	**2.9**	**2.7**	**2.2**	**2.6**
G10	**1.5**	**1.6**	**1.4**	**1.5**	**1.6**	**0.3**	**0.3**	**0.2**	**0.6**	**1.7**	**1.7**	**1.8**	**1.5**	**0.6**	**1.5**
US	1.8	1.8	1.8	2.0	2.1	0.5	0.9	0.7	1.2	2.8	2.4	2.5	1.8	1.0	2.2
Euro Area	1.4	1.4	1.0	1.0	1.1	0.2	-0.3	-0.2	0.6	1.1	1.5	1.5	1.2	0.2	1.2
Japan^	0.3	0.8	0.3	0.5	0.5	-0.1	-0.6	-1.3	-1.3	-0.9	-0.4	0.1	0.5	-0.4	-0.6
UK	1.9	2.0	1.8	1.4	1.7	0.6	0.4	0.6	0.7	1.4	1.4	1.5	1.8	0.8	1.3
EM*	**3.2**	**3.6**	**3.4**	**4.2**	**4.7**	**3.2**	**2.8**	**2.4**	**2.5**	**3.6**	**3.6**	**3.6**	**3.6**	**3.3**	**3.3**
China	1.8	2.6	2.9	4.3	5.0	2.7	2.1	1.8	2.2	3.7	3.4	3.1	2.9	2.9	3.1
India	2.5	3.1	3.5	5.8	6.7	5.4	4.7	2.8	2.8	3.9	4.4	4.6	3.7	4.9	3.9
Brazil	4.1	4.3	3.2	3.4	3.8	2.0	1.8	1.8	1.8	3.4	3.9	3.8	3.7	2.3	3.2
Russia	5.2	5.0	4.3	3.5	2.4	3.0	3.4	3.2	3.0	2.6	3.0	3.8	4.5	3.0	3.1
Monetary policy rate (% p.a.)															
US	2.375	2.375	1.875	1.625	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	1.625	0.125	0.125
Euro Area#	-0.40	-0.40	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Japan	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.75	0.75	0.75	0.75	0.75	0.10	0.10	0.00	0.00	0.00	0.00	0.00	0.75	0.00	0.00
China^^	2.59	2.41	2.63	2.36	1.83	1.60	1.60	1.60	1.60	1.60	1.60	1.60	2.36	1.60	1.60
India	6.25	5.75	5.15	5.15	4.40	4.00	3.75	3.75	3.75	3.75	3.75	4.00	5.15	3.75	4.00
Brazil	6.50	6.50	5.50	4.50	3.75	2.25	2.25	2.25	2.25	2.75	3.75	4.75	4.50	2.25	4.75
Russia	7.75	7.50	7.00	6.25	6.00	4.50	4.00	4.00	4.00	4.00	4.25	4.50	6.25	4.00	4.50

Source: IMF, Morgan Stanley Research forecasts; Note: Global and regional aggregates for GDP growth are GDP-weighted averages, using PPP weights; Japan policy rate is the interest rate on excess reserves; CPI numbers are period average. Global* and EM* Consumer Price Inflation Aggregates exclude Venezuela and Argentina. ^Japan CPI includes VAT and free child education impact. ^^7-day repo rate. #Euro area policy rate refers to depo rate

Morgan Stanley global currency forecasts

Exhibit 57:
Morgan Stanley FX forecasts – click here for custom cross forecasts

	2020		2021			
	3Q	4Q	1Q	2Q	3Q	4Q
EUR/USD	1.15	1.16	1.18	1.20	1.21	1.23
USD/JPY	109	110	110	112	112	112
GBP/USD	1.27	1.26	1.22	1.25	1.28	1.30
USD/CHF	0.95	0.95	0.94	0.93	0.96	0.98
USD/SEK	9.26	9.14	8.90	8.67	8.43	8.13
USD/NOK	8.96	8.75	8.90	9.17	9.09	8.94
USD/CAD	1.31	1.30	1.31	1.33	1.35	1.35
AUD/USD	0.71	0.73	0.74	0.74	0.74	0.74
NZD/USD	0.64	0.65	0.67	0.68	0.69	0.70
EUR/JPY	125	128	130	134	136	138
EUR/GBP	0.91	0.92	0.97	0.96	0.95	0.95
EUR/CHF	1.09	1.10	1.11	1.12	1.16	1.20
EUR/SEK	10.65	10.60	10.50	10.40	10.20	10.00
EUR/NOK	10.30	10.15	10.50	11.00	11.00	11.00
USD/CNY	7.15	7.10	7.10	7.08	7.02	7.00
USD/HKD	7.85	7.80	7.75	7.75	7.75	7.75
USD/IDR	13850	13800	13700	13600	13500	13500
USD/INR	75.20	74.80	74.40	74.00	73.80	73.60
USD/KRW	1215	1210	1205	1200	1190	1180
USD/MYR	4.26	4.25	4.24	4.21	4.19	4.17
USD/PHP	49.70	49.50	49.40	49.20	49.00	49.00
USD/SGD	1.39	1.38	1.38	1.38	1.37	1.37
USD/TWD	29.70	29.60	29.50	29.40	29.40	29.30
USD/THB	31.40	31.20	31.00	30.60	30.40	30.00
USD/BRL	5.10	5.05	5.00	5.00	5.00	5.00
USD/MXN	21.90	21.65	21.90	22.05	22.20	22.40
USD/ARS	75.00	82.50	87.80	94.00	101.00	108.00
USD/CLP	775	795	800	800	800	800
USD/COP	3560	3650	3650	3650	3650	3650
USD/PEN	3.40	3.45	3.40	3.40	3.40	3.40
USD/ZAR	16.0	16.0	16.5	16.5	16.5	16.5
USD/TRY	6.50	6.50	6.70	6.80	7.00	7.00
USD/ILS	3.48	3.46	3.46	3.46	3.46	3.46
USD/RUB	66.0	65.0	65.0	64.5	64.0	63.5
EUR/PLN	4.38	4.36	4.33	4.30	4.28	4.25
EUR/CZK	26.4	26.2	25.8	25.4	25.1	24.8
EUR/HUF	344	342	341	340	340	339
DXY Index	96	95	95	94	93	92
Fed's Broad USD	119	118	118	118	118	118
ECB EUR TWI	100.2	100.6	102.1	103.0	103.1	103.9

Source: Morgan Stanley Research forecasts

Morgan Stanley government bond yield/ spread forecasts

Exhibit 58:

Morgan Stanley government bond yield/spread forecasts – base cases

	2-Year		5-Year		10-Year		30-Year	
	4Q20	2Q21	4Q20	2Q21	4Q20	2Q21	4Q20	2Q21
US	0.30	0.40	0.65	0.85	1.15	1.30	1.95	2.15
Germany	-0.55	-0.55	-0.45	-0.35	-0.10	0.05	0.30	0.45
Japan	-0.15	-0.15	-0.10	-0.10	0.00	0.00	0.50	0.50
UK	0.00	0.10	0.10	0.25	0.25	0.45	0.75	0.95
Australia	0.25	0.25	0.45	0.50	1.05	1.15	1.95	2.15
New Zealand	0.25	0.25	0.45	0.55	1.00	1.10	n/a	n/a
Canada	0.20	0.20	0.50	0.60	0.80	0.85	1.45	1.55
Austria*	5	0	10	5	15	5	15	5
Netherlands*	0	0	0	0	10	0	0	-5
France*	5	5	10	5	20	15	50	40
Belgium*	5	5	10	5	25	20	50	40
Ireland*	5	5	15	5	30	20	55	45
Spain*	15	10	30	15	55	35	90	60
Italy*	40	30	80	50	115	90	175	135
Portugal*	15	10	35	20	45	30	90	60

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

Exhibit 59:

Morgan Stanley government bond yield/spread forecasts – bull, bear, base cases

10-year	Bull		Base		Bear	
	4Q20	2Q21	4Q20	2Q21	4Q20	2Q21
US	0.55	0.40	1.15	1.30	1.50	1.65
Germany	-0.70	-0.75	-0.10	0.05	0.15	0.35
Japan	-0.05	-0.05	0.00	0.00	0.05	0.05
UK	0.00	-0.10	0.25	0.45	0.50	0.75
Australia	0.60	0.40	1.05	1.15	1.30	1.60
New Zealand	0.50	0.40	1.00	1.10	1.20	1.30
Canada	0.35	0.35	0.80	0.85	0.90	1.05
Austria*	5	0	15	5	55	65
Netherlands*	0	-5	10	0	40	50
France*	10	0	20	15	75	90
Belgium*	15	5	25	20	85	100
Ireland*	15	5	30	20	90	105
Spain*	35	25	55	35	175	195
Italy*	75	55	115	90	300	330
Portugal*	25	15	45	30	180	200

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

Valuation methodology and risks

Exhibit 60:

Rates trades: Rationale and risks

Trade	Entry Level	Entry Date	Rationale	Risks
Underweight 10y UST and 10y DBR vs. 10y UKT and 10y ACGB	-22.6bp	14-Jun-20	In the US, a fast economic recovery along with an even higher expectation for supply could drive the curve steeper, while in Germany the skew for Bunds appears to be higher in the light of the creation of a substitute AAA rated EU debt for financing SURE and Next Generation EU in 2020 and 2021, respectively. In relative terms in the UK the curve should flatten more on the expectation of NIRP and easy MPC policy while in Australia the relative demand driven by the RBA and foreign investors should help the curve to steep less than the US and German ones.	Re-emergence of COVID-19 or a less pronounced economic recovery would lead investors to bid for safe-haven assets, which in turn would support US Treasuries and Bunds more than UK gilts and Australian bonds. This would flatten the US and German curves more than the UK and Australian ones
Long 10y BTP vs 10y Bund	188bp	14-Jun-20	We expect the EU recovery fund and ECB buying to create a negative technical for supply that should support Italian yield compression. At the same time, skew for Bunds is negative since the issuance of common European debt would create an alternative to Bunds, which would edge higher, tightening the spread.	A larger-than-expected increase in Italian issuance needs or the failure of the EU to agree on a recovery plan would trigger a sell-off in Italian debt, leading to a widening in the spread to Bunds.
7s30s UST steepeners	96bp	10-Jun-20	With strong verbal forward guidance from the Fed at its June meeting, we think the belly can continue to richen. We extend our 5s30s curve steepeners to 7s30s curve steepeners	The risk is that the curve flattens, driven by negative surprises on economic data, and the probability of Treasury QE duration extension increases.
CAGB 2s10s steepeners	39bp	05-Jun-20	We suggest investors hedge the risk that global growth continues to accelerate faster than investors expect by entering into Canadian curve steepeners. We think the Canadian yield curve offers a prime candidate for this hedge, as we expect the US Treasury curve to steepen and investors may begin to bring forward expectations for the conclusion of BoC LSAPs.	A risk to the new Canadian curve steepener trade is that that new BoC Governor Macklem expresses an intention to raise the overnight target rate faster than investors expect.

Source: Morgan Stanley Research

Exhibit 61:

EM stances: Rationale and risks

Trade	Date	Rationale	Risks
Like Russia Rates	24-Apr-20	We think that duration will continue to trade well as the CBR's rhetoric has been more dovish. The probability of a bigger rate cut at the next meeting is increasing while the market is underpricing that scenario. We think that state banks will increase their OFZ ownership more significantly, which will alleviate the pressure from the supply side.	We see the main risk from the currency side in case EMFX weakens as an asset class.
Like Korea Rates	20-Apr-20	The BoK cut its policy rate by 50bp. However, long-end rates didn't move along with the cut, given that investors were concerned about a wider fiscal stimulus. The BoK commented that it would conduct more active outright government bond purchases while the government said that it will not issue more KTBs to fund the extra budgets. The NPS mentioned that it is scaling back its overseas asset purchases.	Risk sentiment returns. New BoK board members are more hawkish than the previous members.
Like Indonesia Rates	20-Apr-20	The OW position was one of the catalysts that triggered the sell-off. Foreign ownership of INDOGBs has dropped significantly and positioning has become clean. Valuation becomes cheap, with Indonesia offering the third-highest real rates in EM. Indonesia is likely to benefit from an EM rebound.	Governments fund the wide budget through INDOGBs more than market expectations.
Like China Rates	27-Jan-20	Given the sell-off in onshore equity, onshore investors could recycle their investments from equity into fixed income, supporting CGBs. The PBOC has been injecting short-term liquidity ahead of the Chinese New Year and is likely to keep liquidity ample after that to facilitate special bond issuance.	Stronger inflation and more local government bond issuance.
Like India Rates	13-Sep-19	With our India economists expecting another 40-60bp in RBI cuts, we see further room for Indian duration to rally.	Higher UST yields and global oil prices.

Source: Morgan Stanley Research

Exhibit 62:

EM trades: Rationale and risks

Trade	Entry Date	Current Price	Rationale	Risks
Long RUB, INR, ZAR, HUF vs. USD	7-Apr-20	108.3	We turn tactically bullish on EMFX as we believe it has seen the low, and a short-term bounce is on the cards. We pick high-quality high-yielders which we believe have further room to go. We switch COP for ZAR and remain long RUB, INR and HUF.	We refrain from a long strategic allocation as significant fiscal and external funding pressures remain.
Short USD/MXN vs. Long USD/KRW, 6m Straddle	1-Jun-20	5.58	While KRW term structure exhibits some premia as it is one of the steepest on a historical basis, 6m volatility looks unusually low vis-à-vis high-beta currencies. The USD/MXN-USD/KRW 6m vol spread is as wide as in the previous electoral episode where Mexico was in focus, something that we think is mispriced as we do believe that the likelihood of the US trade rhetoric turning equally harsh on Mexico ahead of the presidential elections is much lower.	Trade tensions between US and Mexico escalate, while US/China trade tensions de-escalate on the margin.
Buy Mexico Udibono Nov 2023 (FX-Hedged)	12-May-20	2.11	We think that cash bonds offer better value than TIIEs as the latter still trade well through MBonos in an environment where risk-aversion has normalized. In addition, implied inflation is priced too low. While certainly the current environment calls for a period of low inflation, we do not expect it to average below 3%Y in the medium term, especially when the policy mix suggests a higher inflation risk premium due to its focus on consumption and should be detrimental for investment. We still refrain from extending duration as our models suggest that most of the recent steepness is well explained by the clear deterioration in the fiscal outlook.	Inflation decelerating more than our expectations.

Source: Morgan Stanley Research

Exhibit 63:

Credit and SPG trades: Rationale and risks

Trade	Entry Date	Current Price	Rationale	Risk
CDX IG 3s-5s steepener	13-May-20	16bp	Early-cycle recovery trade. Curve still flat relative to spread levels because of tail names. Tail names have raised a lot of liquidity, and have a Fed backstop.	Growth rolls over again, curve bear flattens.
CDX HY 3s-5s steepener	14-Jun-20	-45bp	Early-cycle recovery trade. Default cycle likely to be sharp but short. Carry and roll-down is attractive.	Default cycle more severe than we expect.
IG bullish risk reversals (70/90)	4-Jun-20	5c	Steep skew, offers cushion relative to outright longs.	Spreads widen or skew steepens.
1x2 call spreads in HY (100.5/103)	4-Jun-20	4c	Vol remains elevated in HY, rally expected to be defensive in nature.	Very sharp growth rebound that takes HY back to the tights.
Long IG29 0-3%	14-Jun-20	37pts U/F	Excess default premium priced into short-end IG. Tail names have raised liquidity, have Fed backstop.	Growth slowdown that drives a jump to default in the tail names.
Long HY33 Super Senior (35-100%)	4-Jun-20	94bp	With the Fed backstopping low-beta HY, systemic risk premium should be lower. SS is an attractive way to sell vol.	Systemic concerns resurface, risk allocation to senior tranche rises.
Short IG33 7-15% vs. index (delta-hedged)	13-May-20	76bp	Convex trade that should work in a broad sell-off as well as a rally.	Idiosyncratic risks rise.
Long CMBX.BBB-.11 versus CDX.HY	14-Jun-20	CMBX.BBB-.11: Dollar price: US$80.12 bp spread: 641bp CDX HY: 494	The price for CMBX.BBB-.11 stands 20% below its 2020 peak compared to an average of -18% for the other BBB- tranches across other CMBX series and -8% for CDX.HY. The index references 2017 vintage deals that are not anticipated to mature until 2027 on average and therefore underperformed as a result of its longer duration profile relative to earlier vintage CMBX series that reference more seasoned loans. We think this provides an opportunity for investors to go long a recovery trade as CMBS stages a catch-up rally to CDX.HY. We like CMBX.11 relative to other indices given higher-quality underwriting, where we see average expected deal losses of 4.5%, which results in the lowest BBB- tranche losses across CMBX series at 2.4%. This compares to BBB- tranche losses for other CMBX series that range from 6.5% for CMBX.12 to 24.4% for CMBX.8. Furthermore, the index has limited near-term maturity risk as the loans mature in 2027 on average, which is important, given the US$2.1 trillion of CRE mortgages maturing over the next five years including an all-time peak of US$453 billion in 2022.	A risk-off environment where CMBX.11 underperforms, given a beta relative to CDX.HY of 1.09, 1.20 relative to other BBB- tranches and 4.26 relative to AAA.11. There is also a risk that losses accelerate beyond our expected case, as evidenced by our bear case where we project a 44% write-down to the BBB-.11 tranche.

Source: Morgan Stanley Research

Appendix: Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

Like: Based on current market conditions as of the date of this report the analyst expects that the relevant securities of the issuer that is subject of the recommendation will perform favorably over the relevant time period as compared to the overall market of comparable securities by other issuers. This is not intended to be, nor should it be interpreted as a formal fundamental rating of the issuer or its creditworthiness.

Dislike: Based on current market conditions as of the date of this report the analyst expects that the relevant securities of the issuer that is subject of the recommendation will perform unfavorably over the relevant time period as compared to the overall market of comparable securities by other issuers. This is not intended to be, nor should it be interpreted as a formal fundamental rating of the issuer or its creditworthiness.

Unless otherwise specified, the time frame for recommendations included in the Morgan Stanley Fixed Income Research reports is 6 - 12 months and the price of financial instruments mentioned in the recommendation is as at the date and time of publication of the recommendation.

When more than one issuer or instrument is included in a recommendation, analyst expects one part of the trade to outperform the other trade or combination of other trades included in the recommendation on a relative basis.

For important disclosures related to the proportion of all investment recommendations over the past 12 months that fit each of the categories defined above, and the proportion of issuers corresponding to each of those categories to which Morgan Stanley has supplied material services, please see the Morgan Stanley disclosure at https://ny.matrix.ms.com/eqr/article/webapp/6e5a152a-7e65-11ea-90da-583d0f5e0518?ch=rpint&sch=ar

Exhibit 64:

History of recommendations for EM stances

History of recommendations for Russia Local Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Like Russia Local Currency Bonds	25-Mar-19	3-Aug-19

Source: Morgan Stanley Research

Exhibit 65:

History of recommendations for EM trades

Short USDMXN vs Long USDKRW, 6m Straddle

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
USD/MXN	6m	Buy 6m USDMXN call (19.00 strike) - long 6m USD/MXN risk reversal	15-Aug-19	70426	16-Sep-19				10m	USDMXN curncy
USD/MXN	6m	Buy USDMXN 6m6m FVA	17-Jan-20	9.00%	09-Mar-20	14.59%				USDMXN Curncy
USD/MXN	6m	Sell 6m 25D MXN Risk Reversal	4-May-20	5.4825	01-Jun-20	22.17			10m	USDMXN25R6M BGN Curncy

Source: Morgan Stanley Research

Exhibit 66:

History of recommendations for trades

UST 7s30s Steepener

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
US Government Bonds 5 Yr Yield	5y	UST 5s30s Steepener	20-May-20	108.00	14-Jun-20	115.00				USGG5YR Index
US Government Bonds 30 Yr Yield	30y	UST 5s30s Steepener	20-May-20	108.00	14-Jun-20	115.00				USGG30YR Index

Long Spain and Italy vs. EM Equity

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
FTSE 100 Index	-	Long FTSE 100 and IBEX vs. SMI	17-Nov-19	7365.00	11-Feb-20	7467.00				UKX Index
IBEX 35 Index	-	Long FTSE 100 and IBEX vs. SMI	17-Nov-19	9307.00	11-Feb-20	9811.00				IBEX Index
Swiss Market Index	-	Long FTSE 100 and IBEX vs. SMI	17-Nov-19	10314.00	11-Feb-20	11002.00				SMI Index

Long EMFX Basket (RUB, ZAR, IDR, INR, HUF)

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
USD/INR	12m	Sell USD/INR 12m NDF	18-Nov-19	72.18	24-Mar-20	72.46				IRN+12M Curncy

Long Russell 2000 vs S&P 500

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
S&P 500 Index	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					SPX Index
Eurostoxx Index	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					SX5E Index
Nikkei 225	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					NKY Index
HSCEI Index	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					HSCEI Index
Nasdaq 100 Index	N/A	Short Nasdaq vs S&P 500	9-Sep-19	7853.00	17-Nov-19	8263.00				NDX Index
S&P 500 Index	N/A	Short Nasdaq vs S&P 500	9-Sep-19	2979.00	17-Nov-19	3091.00				SPX Index
KOSPI 200 Index	1Y	Buy Kospi Variance vs S&P 500 Variance	9-Sep-19	0.25%	17-Nov-19					KOSPI2 Index
S&P 500 Index	1Y	Buy Kospi Variance vs S&P 500 Variance	9-Sep-19	0.25%	17-Nov-19					SPX Index
KOSPI 200 Index	1Y	Buy Kospi 1yr Variance vs. S&P 500 1yr Variance	2-Dec-19	-1.80%	16-Mar-20					KOSPI2 Index
S&P 500 Index	1Y	Buy Kospi 1yr Variance vs. S&P 500 1yr Variance	2-Dec-19	-1.80%	16-Mar-20					SPX Index
CDX HY	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	0.43%	16-Mar-20					IBOXHYSE Index
S&P 500 Index	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	1.15%	16-Mar-20					SPX Index
Russell 2000 Index	-	Short Russell 2000 vs S&P 500	17-Nov-19	1589.00	17-Mar-20	1037.00				RTY Index
S&P 500 Index	-	Short Russell 2000 vs S&P 500	17-Nov-19	3091.00	17-Mar-20	2386.00				SPX Index
Nasdaq 100 Index	-	Short Nasdaq vs S&P 500	17-Mar-20	7020.00	15-Apr-20					NDX Index
S&P 500 Index	-	Short Nasdaq vs S&P 500	17-Mar-20	2386.00	15-Apr-20					SPX Index
S&P 500 Index	3m	Sell 3m ATM Straddle on S&P 500	18-Mar-20	0.03	25-Mar-20					SPX Index
S&P 500 Index	3m	Sell S&P 500 25D Strangle	25-Mar-20	7.50%	30-Apr-20					SPX Index
S&P 500 Index	-	Buy S&P 500	13-Mar-20	2480.65	14-Jun-20	3190.00				SPX Index

Short Aluminum

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
Aluminium Dec 2020 Future	30-Oct-20	Short Aluminum vs. Copper	10-Jan-20	1862	17-Mar-20	1707				LAZ20 Comdty

Sell S&P 500 25d Strangle

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
S&P 500 Index	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					SPX Index
Eurostoxx Index	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					SX5E Index
Nikkei 225	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					NKY Index
HSCEI Index	6m	Buy Best-of-Put (Dec-19 ATM) on Global Index Basket	29-May-19	11.50%	02-Dec-19					HSCEI Index
Nasdaq 100 Index	N/A	Short Nasdaq vs S&P 500	9-Sep-19	7853.00	17-Nov-19	8263.00				NDX Index
S&P 500 Index	N/A	Short Nasdaq vs S&P 500	9-Sep-19	2979.00	17-Nov-19	3091.00				SPX Index
KOSPI 200 Index	1Y	Buy Kospi Variance vs S&P 500 Variance	9-Sep-19	0.25%	17-Nov-19					KOSPI2 Index
S&P 500 Index	1Y	Buy Kospi Variance vs S&P 500 Variance	9-Sep-19	0.25%	17-Nov-19					SPX Index
KOSPI 200 Index	1Y	Buy Kospi 1yr Variance vs. S&P 500 1yr Variance	2-Dec-19	-1.80%	16-Mar-20					KOSPI2 Index
S&P 500 Index	1Y	Buy Kospi 1yr Variance vs. S&P 500 1yr Variance	2-Dec-19	-1.80%	16-Mar-20					SPX Index
CDX HY	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	0.43%	16-Mar-20					IBOXHYSE Index
S&P 500 Index	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	1.15%	16-Mar-20					SPX Index
Russell 2000 Index	-	Short Russell 2000 vs S&P 500	17-Nov-19	1589.00	17-Mar-20	1037.00				RTY Index
S&P 500 Index	-	Short Russell 2000 vs S&P 500	17-Nov-19	3091.00	17-Mar-20	2386.00				SPX Index
Nasdaq 100 Index	-	Short Nasdaq vs S&P 500	17-Mar-20	7020.00						NDX Index
S&P 500 Index	-	Short Nasdaq vs S&P 500	17-Mar-20	2386.00						SPX Index
S&P 500 Index	3m	Sell 3m ATM Straddle on S&P 500	18-Mar-20	2.90%	25-Mar-20					SPX Index
S&P 500 Index	3m	Sell S&P 500 25D Strangle	25-Mar-20	7.50%	30-Apr-20					SPX Index
S&P 500 Index	-	Buy S&P 500	13-Mar-20	2480.65	14-Jun-20	3190.00				SPX Index

Source: Morgan Stanley Research

Exhibit 67:

History of recommendations for trades (continued)

Long CDX IG 3s5s Steepener Buy Protection on CDX IG33 Mezz Tranche (7-15%)										
Instrument	**Maturity**	**Trade**	**Entry Date**	**Entry Level**	**Exit Date**	**Exit Level**	**Target/ Objective**	**Stop/Re-assess**	**Size of Trade or Unit/Notional**	**CUSIP/ISIN/ BLOOMBERG**
CDX IG	20-Dec-23	Short CDX IG	27-Feb-19	60bp	27-Aug-19					IBOXUMAE Index
CDX IG	20-Sep-19	Buy CDX IG September 70/95 Put spreads	15-Apr-19	0.00	28-Jun-19					IBOXUMAE Index
CDX IG	4m	Long CDX IG September 75/95 Payer Spreads	12-May-19	64.40	09-Sep-19	51.10				IBOXUMAE Index
CDX IG	1Y	Long CDX IG 5s10s Flattener (Duration Neutral)	9-Jun-19	48.00	17-Nov-19					IBOXUMAE Index
CDX HY	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXHYSE Index
CDX IG	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXUMAE Index
CDX IG	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.00	01-Oct-19					IBOXUMAE Index
CDX HY	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.00	01-Oct-19					IBOXHYSE Index
CDX IG	5Y	Long 10Y CDX IG32 vs. short 5Y CDX IG32	10-Jun-19	54.00	10-Dec-19					IBOXUMAE Index
CDX IG	10Y	Long 10Y CDX IG32 vs. short 5Y CDX IG32	10-Jun-19	101.00	10-Dec-19					IBOXUMAE Index
CDX IG	7Y	Long 7Y CDX IG32 vs. short 5Y CDX IG32	18-Jul-19	83.00	18-Jan-20					IBOXUMAE Index
CDX IG	5Y	Long 7Y CDX IG32 vs. short 5Y CDX IG32	18-Jul-19	54.66	18-Jan-20					IBOXUMAE Index
CDX IG	1.5Y	Short 5Y CDX IG27	18-Jul-19	28.00	18-Jan-20					IBOXUMAE Index
CDX IG	1.5Y	Long 10Y CDX IG27	18-Jul-19	86.00	18-Jan-20					IBOXUMAE Index
CDX IG	4m	Long CDX IG September 70/90 Payer Spreads	9-Sep-19	64.40	17-Nov-19					IBOXUMAE Index
CDX IG	3m	Buy CDX IG Dec-19 70/90 Payer Spreads	30-Sep-19	0.00	01-Nov-19					IBOXUMAE Index
Iboxx USD AxJ IG	5Y	Long Asia IG corporates vs Short CDX IG	17-Nov-19	161.00	17-May-20					IBXXAX90 Index
CDX IG	5Y	Long Asia IG corporates vs Short CDX IG	17-Nov-19	51.48	17-May-20					IBOXUMAE Index
CDX IG	1Y	Long CDX IG 5s10s Flattener (Duration Neutral)	17-Nov-19	47.00	17-Mar-20	124.70				IBOXUMAE Index
CDX IG	3m	Buy CDX IG Dec-19 60/75 Payer Spreads	1-Nov-19	0.00	02-Dec-19					IBOXUMAE Index
CDX IG	4m	Buy CDX IG March 60/75 Payer Spreads	17-Nov-19	0.00	10-Jan-20	0.00				IBOXUMAE Index
CDX HY33 BB	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	126.46bp	18-May-20					IBOXHYSE Index
CDX IG	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	52.42bp	18-May-20					IBOXUMAE Index
CDX IG31 0-3%	5Y	Short CDX IG31 0-3% Tranche vs. Long CDX IG 31 Delta-adjusted	18-Nov-19	859bp	18-May-20					IBOXUMAE Index
CDX IG 31	5Y	Short CDX IG31 0-3% Tranche vs. Long CDX IG 31 Delta-adjusted	18-Nov-19	40.7bp	18-May-20					IBOXUMAE Index
ITRX EUR32	5Y	Long iTraxx Main vs. Short CDX IG	18-Nov-19	48.6bp	18-May-20					ITRXEBE Index
CDX IG 33	5Y	Long iTraxx Main vs. Short CDX IG	18-Nov-19	52.42bp	18-May-20					IBOXUMAE Index
CDX IG	3m	Buy CDX IG March 60/75 Payer Spreads	10-Jan-20	0.00	17-Mar-20	124.70				IBOXUMAE Index
CDX IG	16-Mar-20	Buy CDX IG Mar-20 55/70 Payer Spreads	17-Jan-20	0.00	25-Feb-20					IBOXUMAE Index
CDX IG	20-May-20	Buy CDX IG May-20 65/85 Payer Spreads	25-Feb-20	0.00	25-Mar-20					IBOXUMAE Index
CDX IG	20-May-20	Buy CDX IG May-20 1x2 Receiver Spreads (45D/25D)	25-Mar-20	0.00	30-Apr-20					IBOXUMAE Index
CDX IG	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.00	30-Apr-20					IBOXUMAE Index
CDX HY	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.00	30-Apr-20					IBOXHYSE Index
CDX IG	20-May-20	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.00	30-Apr-20					IBOXUMAE Index
CDX IG	20-Jun-20	Buy CDX IG June-20 1x2 Receiver Spreads (45D/25D)	15-Apr-20	0.00%	20-May-20	2.00%				IBOXUMAE Index
CDX IG	20-Jun-20	Sell CDX IG June 90bp Strike Straddle	30-Apr-20	1.00%	04-Jun-20	1.00%				IBOXUMAE Index

Buy CDX HY 3m 1x2 Receiver Spreads (45D/25D)										
Instrument	**Maturity**	**Trade**	**Entry Date**	**Entry Level**	**Exit Date**	**Exit Level**	**Target/ Objective**	**Stop/Re-assess**	**Size of Trade or Unit/Notional**	**CUSIP/ISIN/ BLOOMBERG**
CDX HY	2Y	Short HY25 Index	11-Mar-19	237bp	11-Sep-19					IBOXHYSE Index
CDX HY	3Y	Short HY27 Index	11-Mar-19	286bp	11-Sep-19					IBOXHYSE Index
CDX HY	5Y	Short HY27 Index	11-Mar-19	222bp	11-Sep-19					IBOXHYSE Index
CDX HY	5Y	Short 15-25% vs. Index	11-Mar-19	500bp	11-Sep-19					IBOXHYSE Index
IBOXIG	5Y	Short CDX HY 32 vs. Long 4x CDX IG32	10-Jun-19	63.74	10-Dec-19					IBOXIG Index
CDX HY	5Y	Short CDX HY 32 vs. Long 4x CDX IG32	10-Jun-19	368.272	10-Dec-19					IBOXHYSE Index
CDX HY	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXHYSE Index
CDX IG	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXUMAE Index
CDX IG	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.12%	01-Oct-19					IBOXUMAE Index
CDX HY	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.12%	01-Oct-19					IBOXHYSE Index
CDX HY	5Y	Short CDX HY 15-25% vs. Index	10-Jun-19	40940.00%	10-Dec-19					IBOXHYSE Index
CDX HY	5Y	Short CDX HY 15-25% vs. Index	10-Jun-19	36827.00%	10-Dec-19					IBOXHYSE Index
CDX HY	5Y	Long CDX HY 32 vs. Short HY March TRS	10-Jun-19	36800.00%	10-Dec-19					IBOXHYSE Index
CDX HY	3Y	Long CDX HY 32 5Y vs. Short HY32 3Y	18-Jul-19	27400.00%	18-Jan-20					CDX HY
CDX HY	5Y	Long CDX HY 32 5Y vs. Short HY32 3Y	18-Jul-19	33200.00%	18-Jan-20					CDX HY
CDX HY	2m	Buy CDX HY Nov-19 50D Payers (Delta-Hedged)	30-Sep-19	0.85%	01-Nov-19					IBOXHYSE Index
CDX HY	2m	Buy CDX HY Dec-19 50D Payers (Delta-Hedged)	1-Nov-19	0.70%	02-Dec-19					IBOXHYSE Index
CDX HY33 BB	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	126.46bp	18-May-20					IBOXHYSE Index
CDX IG	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	52.42bp	18-May-20					IBOXUMAE Index
CDX HY	5Y	Short CDX HY excluding 10 widest names	18-Nov-19	249bp	18-May-20					IBOXHYSE Index
CDX HY	5Y	Short CDX HY33 15-100% Tranche	18-Nov-19	96.52bp	18-May-20					IBOXHYSE Index
CDX HY31 15-25%	5Y	Short CDX HY31 15-25% Tranche	18-Nov-19	307.91bp	18-May-20					IBOXHYSE Index
CDX HY	6M	Buy 50D HY Payer vs. Sell 5X IG Payer ATM	18-Nov-19	2c	18-May-20	0.00				IBOXHYSE Index
IBOXIG	6M	Buy 50D HY Payer vs. Sell 5X IG Payer ATM	18-Nov-19	1.7c	18-May-20	0.00				IBOXIG Index
CDX HY	2m	Buy CDX HY Jan-20 50D Payers (Delta-Hedged)	2-Dec-19	0.60%	17-Jan-20	0.00				IBOXHYSE Index
CDX HY	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	0.43%	16-Mar-20					IBOXHYSE Index
S&P 500 Index	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	1.15%	16-Mar-20					SPX Index
CDX IG	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.10%	30-Apr-20					IBOXUMAE Index
CDX HY	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.10%	30-Apr-20					IBOXHYSE Index
CDX IG	20-May-20	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.10%	30-Apr-20					IBOXUMAE Index
CDX HY	20-Jul-20	Buy CDX HY July 1x2 Call Spreads (50D/33D)	30-Apr-20	0.00%	04-Jun-20	0.00				IBOXHYSE Index
CDX HY	20-Jun-20	Buy CDX HY July-20 1x2 Receiver Spreads (45D/25D)	20-May-20	0.00%	14-Jun-20	0.01				IBOXHYSE Index

Source: Morgan Stanley Research

Exhibit 68:

History of recommendations for trades (continued)

Short 7-15% Equity Tranche vs. Long CDX IG
Short 7-15% vs. Index delta-adjusted
Long CDX IG 3s5s Steepener
Buy CDX IG 2m Bullish Risk Reversals (70/90)
Long IG29 0-3%

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
CDX IG	20-Dec-23	Short CDX IG	27-Feb-19	60bp	27-Aug-19					IBOXUMAE Index
CDX IG	20-Sep-19	Buy CDX IG September 70/95 Put spreads	15-Apr-19	0.00	28-Jun-19					IBOXUMAE Index
CDX IG	4m	Long CDX IG September 75/95 Payer Spreads	12-May-19	64.40	09-Sep-19	51.10				IBOXUMAE Index
CDX IG	1Y	Long CDX IG 5s10s Flattener (Duration Neutral)	9-Jun-19	48.00	17-Nov-19					IBOXUMAE Index
CDX HY	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXHYSE Index
CDX IG	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXUMAE Index
CDX IG	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.00	01-Oct-19					IBOXUMAE Index
CDX HY	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.00	01-Oct-19					IBOXHYSE Index
CDX IG	5Y	Long 10Y CDX IG32 vs. short 5Y CDX IG32	10-Jun-19	54.00	10-Dec-19					IBOXUMAE Index
CDX IG	10Y	Long 10Y CDX IG32 vs. short 5Y CDX IG32	10-Jun-19	101.00	10-Dec-19					IBOXUMAE Index
CDX IG	7Y	Long 7Y CDX IG32 vs. short 5Y CDX IG32	18-Jul-19	83.00	18-Jan-20					IBOXUMAE Index
CDX IG	5Y	Long 7Y CDX IG32 vs. short 5Y CDX IG32	18-Jul-19	54.66	18-Jan-20					IBOXUMAE Index
CDX IG	1.5Y	Short 5Y CDX IG27	18-Jul-19	28.00	18-Jan-20					IBOXUMAE Index
CDX IG	1.5Y	Long 10Y CDX IG27	18-Jul-19	86.00	18-Jan-20					IBOXUMAE Index
CDX IG	4m	Long CDX IG September 70/90 Payer Spreads	9-Sep-19	64.40	17-Nov-19					IBOXUMAE Index
CDX IG	3m	Buy CDX IG Dec-19 70/90 Payer Spreads	30-Sep-19	0.00	01-Nov-19					IBOXUMAE Index
Iboxx USD AxJ IG	5Y	Long Asia IG corporates vs Short CDX IG	17-Nov-19	161.00	17-May-20					IBXXAX90 Index
CDX IG	5Y	Long Asia IG corporates vs Short CDX IG	17-Nov-19	51.48	17-May-20					IBOXUMAE Index
CDX IG	1Y	Long CDX IG 5s10s Flattener (Duration Neutral)	17-Nov-19	47.00	17-Mar-20	124.70				IBOXUMAE Index
CDX IG	3m	Buy CDX IG Dec-19 60/75 Payer Spreads	1-Nov-19	0.00	02-Dec-19					IBOXUMAE Index
CDX IG	4m	Buy CDX IG March 60/75 Payer Spreads	17-Nov-19	0.00	10-Jan-20	0.00				IBOXUMAE Index
CDX HY33 BB	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	126.46bp	18-May-20					IBOXHYSE Index
CDX IG	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	52.42bp	18-May-20					IBOXUMAE Index
CDX IG31 0-3%	5Y	Short CDX IG31 0-3% Tranche vs. Long CDX IG 31 Delta-adjusted	18-Nov-19	859bp	18-May-20					IBOXUMAE Index
CDX IG 31	5Y	Short CDX IG31 0-3% Tranche vs. Long CDX IG 31 Delta-adjusted	18-Nov-19	40.7bp	18-May-20					IBOXUMAE Index
ITRX EUR32	5Y	Long iTraxx Main vs. Short CDX IG	18-Nov-19	48.6bp	18-May-20					ITRXEBE Index
CDX IG 33	5Y	Long iTraxx Main vs. Short CDX IG	18-Nov-19	52.42bp	18-May-20					IBOXUMAE Index
CDX IG	3m	Buy CDX IG March 60/75 Payer Spreads	10-Jan-20	0.00	17-Mar-20	124.70				IBOXUMAE Index
CDX IG	16-Mar-20	Buy CDX IG Mar-20 55/70 Payer Spreads	17-Jan-20	0.00	25-Feb-20					IBOXUMAE Index
CDX IG	20-May-20	Buy CDX IG May-20 65/85 Payer Spreads	25-Feb-20	0.00	25-Mar-20					IBOXUMAE Index
CDX IG	20-May-20	Buy CDX IG May-20 1x2 Receiver Spreads (45D/25D)	25-Mar-20	0.00	30-Apr-20					IBOXUMAE Index
CDX IG	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.00	30-Apr-20					IBOXUMAE Index
CDX HY	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.00	30-Apr-20					IBOXHYSE Index
CDX IG	20-May-20	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.00	30-Apr-20					IBOXUMAE Index
CDX IG	20-Jun-20	Buy CDX IG June-20 1x2 Receiver Spreads (45D/25D)	15-Apr-20	0.00%	20-May-20	2.00%				IBOXUMAE Index

3s-5s CDX HY Steepener
Buy CDX HY 3m 1x2 Call Spreads (100.5/103)
Long HY33 Super Senior (35-100%)

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG
CDX HY	2Y	Short HY25 Index	11-Mar-19	237bp	11-Sep-19					IBOXHYSE Index
CDX HY	3Y	Short HY27 Index	11-Mar-19	286bp	11-Sep-19					IBOXHYSE Index
CDX HY	5Y	Short HY27 Index	11-Mar-19	222bp	11-Sep-19					IBOXHYSE Index
CDX HY	5Y	Short 15-25% vs. Index	11-Mar-19	500bp	11-Sep-19					IBOXHYSE Index
IBOXIG	5Y	Short CDX HY 32 vs. Long 4x CDX IG32	10-Jun-19	63.74	10-Dec-19					IBOXIG Index
CDX HY	5Y	Short CDX HY 32 vs. Long 4x CDX IG32	10-Jun-19	368.272	10-Dec-19					IBOXHYSE Index
CDX HY	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXHYSE Index
CDX IG	3m	Buy 25D HY Payer vs. Sell 25D IG Payer	10-Jun-19	0.55%	10-Sep-19					IBOXUMAE Index
CDX IG	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.12%	01-Oct-19					IBOXUMAE Index
CDX HY	3m	Credit Decompression (Sell Oct 25D IG Payer, Buy 25D HY Payer)	10-Jun-19	0.12%	01-Oct-19					IBOXHYSE Index
CDX HY	5Y	Short CDX HY 15-25% vs. Index	10-Jun-19	40940.00%	10-Dec-19					IBOXHYSE Index
CDX HY	5Y	Short CDX HY 15-25% vs. Index	10-Jun-19	36827.00%	10-Dec-19					IBOXHYSE Index
CDX HY	5Y	Long CDX HY 32 vs. Short HY March TRS	10-Jun-19	36800.00%	10-Dec-19					IBOXHYSE Index
CDX HY	3Y	Long CDX HY 32 5Y vs. Short HY32 3Y	18-Jul-19	27400.00%	18-Jan-20					CDX HY
CDX HY	5Y	Long CDX HY 32 5Y vs. Short HY32 3Y	18-Jul-19	33200.00%	18-Jan-20					CDX HY
CDX HY	2m	Buy CDX HY Nov-19 50D Payers (Delta-Hedged)	30-Sep-19	0.85%	01-Nov-19					IBOXHYSE Index
CDX HY	2m	Buy CDX HY Dec-19 50D Payers (Delta-Hedged)	1-Nov-19	0.70%	02-Dec-19					IBOXHYSE Index
CDX HY33 BB	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	126.46bp	18-May-20					IBOXHYSE Index
CDX IG	5Y	Short BB CDS vs Long CDX IG	18-Nov-19	52.42bp	18-May-20					IBOXUMAE Index
CDX HY	5Y	Short CDX HY excluding 10 widest names	18-Nov-19	249bp	18-May-20					IBOXHYSE Index
CDX HY	5Y	Short CDX HY33 15-100% Tranche	18-Nov-19	96.52bp	18-May-20					IBOXHYSE Index
CDX HY31 15-25%	5Y	Short CDX HY31 15-25% Tranche	18-Nov-19	307.91bp	18-May-20					IBOXHYSE Index
CDX HY	6M	Buy 50D HY Payer vs. Sell 5X IG Payer ATM	18-Nov-19	2c	18-May-20	0.00				IBOXHYSE Index
IBOXIG	6M	Buy 50D HY Payer vs. Sell 5X IG Payer ATM	18-Nov-19	1.7c	18-May-20	0.00				IBOXIG Index
CDX HY	2m	Buy CDX HY Jan-20 50D Payers (Delta-Hedged)	2-Dec-19	0.60%	17-Jan-20	0.00				IBOXHYSE Index
CDX HY	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	0.43%	16-Mar-20					IBOXHYSE Index
S&P 500 Index	3m	Buy 3 CDX HY 3m 25D Puts, Sell 1 S&P 500 3m 25D Put	17-Jan-20	1.15%	16-Mar-20					SPX Index
CDX IG	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.10%	30-Apr-20					IBOXUMAE Index
CDX HY	5Y	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.10%	30-Apr-20					IBOXHYSE Index
CDX IG	20-May-20	Credit Decompression Hedged with CDX IG May 150 Strike Puts	25-Mar-20	0.10%	30-Apr-20					IBOXUMAE Index
CDX HY	20-Jul-20	Buy CDX HY July 1x2 Call Spreads (50D/33D)	30-Apr-20	0.00%	04-Jun-20	0.00				IBOXHYSE Index
CDX HY	20-Jun-20	Buy CDX HY July-20 1x2 Receiver Spreads (45D/25D)	20-May-20	0.00%	14-Jun-20	0.01				IBOXHYSE Index

Source: Morgan Stanley Research

Important note regarding economic sanctions. This research references country/ies which are generally the subject of selective sanctions programs administered or enforced by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), the European Union and/or by other countries and multi-national bodies. Users of this report are solely responsible for ensuring that their investment activities in relation to any sanctioned country/ies are carried out in compliance with applicable sanctions.

Strategy Risk Factors

Buying calls or call spreads: Investors who buy call options risk loss of the entire premium paid if the underlying security finishes below the strike price at expiration. Investors who buy call spreads (buy a call and sell a further OTM call) also have a maximum loss of the entire up-front premium paid. The maximum gain from buying call spreads is the difference between the strike prices, less the upfront premium paid.

Buying puts or put spreads: Investors who buy put options risk loss of the entire premium paid if the underlying security finishes above the strike price at expiration. Investors who buy put spreads (buy a put and sell a further OTM put) also have a maximum loss of the upfront premium paid. The maximum gain from buying put spreads is the difference between the strike prices, less the upfront premium paid.

Selling calls: Investors who sell covered calls (own the underlying security and sell a call) risk limiting their upside to the strike price plus the upfront premium received and may have their security called away if the security price exceeds the strike price of the short call. Additionally, the investor has full downside exposure that is only partially offset by the upfront premium taken in. Investors short naked calls (i.e. sold calls but don't hold underlying security) risk unlimited losses of security price less strike price. Investors who sell naked call spreads (i.e. sell a call and buy a farther out-of-the-money call with no underlying security position) have a maximum loss of the difference between the long call strike and the short call strike, less the upfront premium taken in, if the underlying security finishes above the long call strike at expiration. The maximum gain is the upfront premium taken in, if the security finishes below the short call strike at expiration.

Selling puts: Put sellers commit to buying the underlying security at the strike price in the event the security falls below the strike price. The maximum loss is the full strike price less the premium received for selling the put. Put sellers who are also long a lower dollar-strike put face a maximum loss of the difference between the long and short put strikes less the options premium received.

Buying strangles: The maximum loss is the entire premium paid (put + call), if the security finishes between the put strike and the call strike at expiration.

Selling strangles or straddles: Investors who are long a security and short a strangle or straddle risk capping their upside in the security to the strike price of the call that is sold plus the upfront premium received. Additionally, if the security trades below the strike price of the short put, the investor risks losing the difference between the strike price and the security price (less the value of the premium received) on the short put and will also experience losses in the security position if he owns shares. The maximum potential loss is the full value of the strike price (less the value of the premium received) plus losses on the long security position. Investors who are short naked strangles or straddles have unlimited potential loss since if the security trades above the call strike price, the investor risks losing the difference between the strike price and the security price (less the value of the premium received) on the short call. Additionally, they are obligated to buy the security at the put strike price (less upfront premium received) if the security finishes below the put strike price at expiration. Strangle/straddle sellers risk assignment on short put positions that become in the money. Additionally, they risk having stock called away from short call positions that become in the money.

Options Disclaimer

Options are not for everyone. Before engaging in the purchasing or writing of options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved, including the risks pertaining to the business and financial condition of the issuer and the underlying stock. A secondary market may not exist for these securities. For customers of Morgan Stanley & Co. Incorporated who are purchasing or writing exchange-traded options, your attention is called to the publication "Characteristics and Risks of Standardized Options;" in particular, the statement entitled "Risks of Option Writers." That publication, which you should have read and understood prior to investing in options, can be viewed on the Web at the following address: http://www.optionsclearing.com/about/publications/character-risks.jsp. Spreading may also entail substantial commissions, because it involves at least twice the number of contracts as a long or short position and because spreads are almost invariably closed out prior to expiration. Potential investors should be advised that the tax treatment applicable to spread transactions should be carefully reviewed prior to entering into any transaction. Also, it should be pointed out that while the investor who engages in spread transactions may be reducing risk, he is also reducing his profit potential. The risk/ reward ratio, hence, is an important consideration.

The risk of exercise in a spread position is the same as that in a short position. Certain investors may be able to anticipate exercise and execute a "rollover" transaction. However, should exercise occur, it would clearly mark the end of the spread position and thereby change the risk/reward ratio. Due to early assignments of the short side of the spread, what appears to be a limited risk spread may have more risk than initially perceived. An investor with a spread position in index options that is assigned an exercise is at risk for any adverse movement in the current level between the time the settlement value is determined on the date when the exercise notice is filed with OCC and the time when such investor sells or exercises the long leg of the spread. Other multiple-option strategies involving cash settled options, including combinations and straddles, present similar risk.

Important information: Examples within are indicative only, please call your local Morgan Stanley Sales representative for current levels.

By selling an option, the seller receives a premium from the option purchaser, and the purchase receives the right to exercise the option at the strike price. If the option purchaser elects to exercise the option, the option seller is obligated to deliver/purchase the underlying shares to/from the option buyer at the strike price. If the option seller does not own the underlying security while maintaining the short option position (naked), the option seller is exposed to unlimited market risk.

Spreading may entail substantial commissions, because it involves at least twice the number of contracts as a long or short position and because spreads are almost invariably closed out prior to expiration. Potential investors should carefully review tax treatment applicable to spread transactions prior to entering into any transactions.

Multi-legged strategies are only effective if all components of a suggested trade are implemented.

Investors in long option strategies are at risk of losing all of their option premiums. Investors in short option strategies are at risk of unlimited losses.

There are special risks associated with uncovered option writing which expose the investor to potentially significant loss. Therefore, this type of strategy may not be suitable for all customers approved for options transactions. The potential loss of uncovered call writing is unlimited. The writer of an uncovered call is in an extremely risky position, and may incur large losses if the value of the underlying instrument increases above the exercise price.

As with writing uncovered calls, the risk of writing uncovered put options is substantial. The writer of an uncovered put option bears a risk of loss if the value of the underlying instrument declines below the exercise price. Such loss could be substantial if there is a significant decline in the value of the underlying instrument.

Uncovered option writing is thus suitable only for the knowledgeable investor who understands the risks, has the financial capacity and willingness to incur potentially substantial losses, and has sufficient liquid assets to meet applicable margin requirements. In this regard, if the value of the underlying instrument moves against an uncovered writer's options position, the investor's broker may request significant additional margin payments. If an investor does not make such margin payments, the broker may liquidate stock or options positions in the investor's account, with little or no prior notice in accordance with the investor's margin agreement.

For combination writing, where the investor writes both a put and a call on the same underlying instrument, the potential risk is unlimited.

If a secondary market in options were to become unavailable, investors could not engage in closing transactions, and an option writer would remain obligated until expiration or assignment.

The writer of an American-style option is subject to being assigned an exercise at any time after he has written the option until the option expires. By contrast, the writer of a European-style option is subject to exercise assignment only during the exercise period.

Disclosure Section

Mortgage Backed Securities (MBS) and Collateralized Mortgage Obligations (CMO)

Principal is returned on a monthly basis over the life of the security. Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information. Government agency backing applies only to the face value of the CMO and not to any premium paid.

The information and opinions in Morgan Stanley Research were prepared or are disseminated by Morgan Stanley & Co. LLC and/or Morgan Stanley C.T.V.M. S.A. and/or Morgan Stanley México, Casa de Bolsa, S.A. de C.V. and/or Morgan Stanley Canada Limited and/or Morgan Stanley & Co. International plc and/or Morgan Stanley Europe S.E. and/or RMB Morgan Stanley Proprietary Limited and/or Morgan Stanley MUFG Securities Co., Ltd. and/or Morgan Stanley Capital Group Japan Co., Ltd. and/or Morgan Stanley Asia Limited and/or Morgan Stanley Asia (Singapore) Pte. (Registration number 199206298Z) and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H), regulated by the Monetary Authority of Singapore (which accepts legal responsibility for its contents and should be contacted with respect to any matters arising from, or in connection with, Morgan Stanley Research) and/or Morgan Stanley Taiwan Limited and/or Morgan Stanley & Co International plc, Seoul Branch, and/or Morgan Stanley Australia Limited (A.B.N. 67 003 734 576, holder of Australian financial services license No. 233742, which accepts responsibility for its contents), and/or Morgan Stanley Wealth Management Australia Pty Ltd (A.B.N. 19 009 145 555, holder of Australian financial services license No. 240813, which accepts responsibility for its contents), and/or Morgan Stanley India Company Private Limited, regulated by the Securities and Exchange Board of India ("SEBI") and holder of licenses as a Research Analyst (SEBI Registration No. INH000001105), Stock Broker (BSE Registration No. INB011054237 and NSE Registration No. INB/INF231054231), Merchant Banker (SEBI Registration No. INM000011203), and depository participant with National Securities Depository Limited (SEBI Registration No. IN-DP-NSDL-372-2014) which accepts the responsibility for its contents and should be contacted with respect to any matters arising from, or in connection with, Morgan Stanley Research, and/or PT. Morgan Stanley Sekuritas Indonesia and their affiliates (collectively, "Morgan Stanley").

For important disclosures, stock price charts and equity rating histories regarding companies that are the subject of this report, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures, or contact your investment representative or Morgan Stanley Research at 1585 Broadway, (Attention: Research Management), New York, NY, 10036 USA.

For valuation methodology and risks associated with any recommendation, rating or price target referenced in this research report, please contact the Client Support Team as follows: US/Canada +1 800 303-2495; Hong Kong +852 2848-5999; Latin America +1 718 754-5444 (U.S.); London +44 (0)20-7425-8169; Singapore +65 6834-6860; Sydney +61 (0)2-9770-1505; Tokyo +81 (0)3-6836-9000. Alternatively you may contact your investment representative or Morgan Stanley Research at 1585 Broadway, (Attention: Research Management), New York, NY 10036 USA.

Analyst Certification

The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report: Jay Bacow; Susan Bates; James Egan; Jonathan F Garner; Matthew Hornbach; Boris Lerner; James K Lord; Wanting Low; Phanikiran L Naraparaju; Naomi Z Poole; Martijn Rats, CFA; Srikanth Sankaran; Graham Secker; Andrew Sheets; Serena W Tang; Vishwanath Tirupattur; Michael J Wilson; Michael D Zezas, CFA.

Unless otherwise stated, the individuals listed on the cover page of this report are research analysts.

Global Research Conflict Management Policy

Morgan Stanley Research has been published in accordance with our conflict management policy, which is available at www.morganstanley.com/institutional/research/conflictpolicies. A Portuguese version of the policy can be found at www.morganstanley.com.br

Important Regulatory Disclosures on Subject Companies

Within the last 12 months, Morgan Stanley managed or co-managed a public offering (or 144A offering) of securities of Italy, United Kingdom, United States of America.

In the next 3 months, Morgan Stanley expects to receive or intends to seek compensation for investment banking services from Australia, Canada, China, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, South Korea, United Kingdom, United States of America.

Within the last 12 months, Morgan Stanley has received compensation for products and services other than investment banking services from Germany.

Within the last 12 months, Morgan Stanley has provided or is providing investment banking services to, or has an investment banking client relationship with, the following company: Australia, Canada, China, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, South Korea, United Kingdom, United States of America.

Within the last 12 months, Morgan Stanley has either provided or is providing non-investment banking, securities-related services to and/or in the past has entered into an agreement to provide services or has a client relationship with the following company: Germany, Italy, Mexico, New Zealand.

The equity research analysts or strategists principally responsible for the preparation of Morgan Stanley Research have received compensation based upon various factors, including quality of research, investor client feedback, stock picking, competitive factors, firm revenues and overall investment banking revenues. Equity Research analysts' or strategists' compensation is not linked to investment banking or capital markets transactions performed by Morgan Stanley or the profitability or revenues of particular trading desks.

Morgan Stanley and its affiliates do business that relates to companies/instruments covered in Morgan Stanley Research, including market making, providing liquidity, fund management, commercial banking, extension of credit, investment services and investment banking. Morgan Stanley sells to and buys from customers the securities/instruments of companies covered in Morgan Stanley Research on a principal basis. Morgan Stanley may have a position in the debt of the Company or instruments discussed in this report. Morgan Stanley trades or may trade as principal in the debt securities (or in related derivatives) that are the subject of the debt research report.

Certain disclosures listed above are also for compliance with applicable regulations in non-US jurisdictions.

STOCK RATINGS

Morgan Stanley uses a relative rating system using terms such as Overweight, Equal-weight, Not-Rated or Underweight (see definitions below). Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold and sell. Investors should carefully read the definitions of all ratings used in Morgan Stanley Research. In addition, since Morgan Stanley Research contains more complete information concerning the analyst's views, investors should carefully read Morgan Stanley Research, in its entirety, and not infer the contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations.

Global Stock Ratings Distribution

(as of May 31, 2020)

The Stock Ratings described below apply to Morgan Stanley's Fundamental Equity Research and do not apply to Debt Research produced by the Firm.

For disclosure purposes only (in accordance with FINRA requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight, Not-Rated and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we cover. Overweight, Equal-weight, Not-Rated and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Not-Rated to hold and Underweight to sell recommendations, respectively.

	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1220	38%	317	43%	26%	550	37%
Equal-weight/Hold	1433	45%	336	46%	23%	687	47%
Not-Rated/Hold	5	0%	1	0%	20%	4	0%
Underweight/Sell	554	17%	79	11%	14%	227	15%
Total	3,212		733			1468	

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.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.

Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

Important Disclosures for Morgan Stanley Smith Barney LLC Customers

Important disclosures regarding the relationship between the companies that are the subject of Morgan Stanley Research and Morgan Stanley Smith Barney LLC or Morgan Stanley or any of their affiliates, are available on the Morgan Stanley Wealth Management disclosure website at www.morganstanley.com/online/researchdisclosures. For Morgan Stanley specific disclosures, you may refer to www.morganstanley.com/researchdisclosures.

Each Morgan Stanley Equity Research report is reviewed and approved on behalf of Morgan Stanley Smith Barney LLC. This review and approval is conducted by the same person who reviews the Equity Research report on behalf of Morgan Stanley. This could create a conflict of interest.

Other Important Disclosures

Morgan Stanley & Co. International PLC and its affiliates have a significant financial interest in the debt securities of Australia, Canada, China, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, South Korea, United Kingdom.

Morgan Stanley Research policy is to update research reports as and when the Research Analyst and Research Management deem appropriate, based on developments with the issuer, the sector, or the market that may have a material impact on the research views or opinions stated therein. In addition, certain Research publications are intended to be updated on a regular periodic basis (weekly/monthly/quarterly/annual) and will ordinarily be updated with that frequency, unless the Research Analyst and Research Management determine that a different publication schedule is appropriate based on current conditions.

Morgan Stanley is not acting as a municipal advisor and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Morgan Stanley produces an equity research product called a "Tactical Idea." Views contained in a "Tactical Idea" on a particular stock may be contrary to the recommendations or views expressed in research on the same stock. This may be the result of differing time horizons, methodologies, market events, or other factors. For all research available on a particular stock, please contact your sales representative or go to Matrix at http://www.morganstanley.com/matrix.

Morgan Stanley Research is provided to our clients through our proprietary research portal on Matrix and also distributed electronically by Morgan Stanley to clients. Certain, but not all, Morgan Stanley Research products are also made available to clients through third-party vendors or redistributed to clients through alternate electronic means as a convenience. For access to all available Morgan Stanley Research, please contact your sales representative or go to Matrix at http://www.morganstanley.com/matrix.

Any access and/or use of Morgan Stanley Research is subject to Morgan Stanley's Terms of Use (http://www.morganstanley.com/terms.html). By accessing and/or using Morgan Stanley Research, you are indicating that you have read and agree to be bound by our Terms of Use (http://www.morganstanley.com/terms.html). In addition you consent to Morgan Stanley processing your personal data and using cookies in accordance with our Privacy Policy and our Global Cookies Policy (http://www.morganstanley.com/privacy_pledge.html), including for the purposes of setting your preferences and to collect readership data so that we can deliver better and more personalized service and products to you. To find out more information about how Morgan Stanley processes personal data, how we use cookies and how to reject cookies see our Privacy Policy and our Global Cookies Policy (http://www.morganstanley.com/privacy_pledge.html).

If you do not agree to our Terms of Use and/or if you do not wish to provide your consent to Morgan Stanley processing your personal data or using cookies please do not access our research.

Morgan Stanley Research does not provide individually tailored investment advice. Morgan Stanley Research has been prepared without regard to the circumstances and objectives of those who receive it. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial adviser. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. The securities, instruments, or strategies discussed in Morgan Stanley Research may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them. Morgan Stanley Research is not an offer to buy or sell or the solicitation of an offer to buy or sell any security/instrument or to participate in any particular trading strategy. The value of and income from your investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities/instruments transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. If provided, and unless otherwise stated, the closing price on the cover page is that of the primary exchange for the subject company's securities/instruments.

The fixed income research analysts, strategists or economists principally responsible for the preparation of Morgan Stanley Research have received compensation based upon various factors, including quality, accuracy and value of research, firm profitability or revenues (which include fixed income trading and capital markets profitability or revenues), client feedback and competitive factors. Fixed Income Research analysts', strategists' or economists' compensation is not linked to investment banking or capital markets transactions performed by Morgan Stanley or the profitability or revenues of particular trading desks.

The "Important Regulatory Disclosures on Subject Companies" section in Morgan Stanley Research lists all companies mentioned where Morgan Stanley owns 1% or more of a class of common equity securities of the companies. For all other companies mentioned in Morgan Stanley Research, Morgan Stanley may have an investment of less than 1% in securities/instruments or derivatives of securities/instruments of companies and may trade them in ways different from those discussed in Morgan Stanley Research. Employees of Morgan Stanley not involved in the preparation of Morgan Stanley Research may have investments in securities/instruments or derivatives of securities/instruments of companies mentioned and may trade them in ways different from those discussed in Morgan Stanley Research. Derivatives may be issued by Morgan Stanley or associated persons.

With the exception of information regarding Morgan Stanley, Morgan Stanley Research is based on public information. Morgan Stanley makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to tell you when opinions or information in Morgan Stanley Research change apart from when we intend to discontinue equity research coverage of a subject company. Facts and views presented in Morgan Stanley Research have not been reviewed by, and may not reflect information known to, professionals in other Morgan Stanley business areas, including investment banking personnel.

Morgan Stanley Research personnel may participate in company events such as site visits and are generally prohibited from accepting payment by the company of associated expenses unless pre-approved by authorized members of Research management.

Morgan Stanley may make investment decisions that are inconsistent with the recommendations or views in this report.

To our readers based in Taiwan or trading in Taiwan securities/instruments: Information on securities/instruments that trade in Taiwan is distributed by Morgan Stanley Taiwan Limited ("MSTL"). Such information is for your reference only. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Morgan Stanley Research may not be distributed to the public media or quoted or used by the public media without the express written consent of Morgan Stanley. Any non-customer reader within the scope of Article 7-1 of the Taiwan Stock Exchange Recommendation Regulations accessing and/or receiving Morgan Stanley Research is not permitted to provide Morgan Stanley Research to any third party (including but not limited to related parties, affiliated companies and any other third parties) or engage in any activities regarding Morgan Stanley Research which may create or give the appearance of creating a conflict of interest. Information on securities/instruments that do not trade in Taiwan is for informational purposes only and is not to be construed as a recommendation or a solicitation to trade in such securities/instruments. MSTL may not execute transactions for clients in these securities/instruments.

Certain information in Morgan Stanley Research was sourced by employees of the Shanghai Representative Office of Morgan Stanley Asia Limited for the use of Morgan Stanley Asia Limited.

Morgan Stanley is not incorporated under PRC law and the research in relation to this report is conducted outside the PRC. Morgan Stanley Research does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors shall have the relevant qualifications to invest in such securities and shall be responsible for obtaining all relevant approvals, licenses, verifications and/or registrations from the relevant governmental authorities themselves. Neither this report nor any part of it is intended as, or shall constitute, provision of any consultancy or advisory service of securities investment as defined under PRC law. Such information is provided for your reference only.

Morgan Stanley Research is disseminated in Brazil by Morgan Stanley C.T.V.M. S.A. located at Av. Brigadeiro Faria Lima, 3600, 6th floor, São Paulo - SP, Brazil; and is regulated by the Comissão de Valores Mobiliários; in Mexico by Morgan Stanley México, Casa de Bolsa, S.A. de C.V which is regulated by Comision Nacional Bancaria y de Valores. Paseo de los Tamarindos 90, Torre 1, Col. Bosques de las Lomas Floor 29, 05120 Mexico City; in Japan by Morgan Stanley MUFG Securities Co., Ltd. and, for Commodities related research reports only, Morgan Stanley Capital Group Japan Co., Ltd; in Hong Kong by Morgan Stanley Asia Limited (which accepts responsibility for its contents) and by Morgan Stanley Asia International Limited, Hong Kong Branch; in Singapore by Morgan Stanley Asia (Singapore) Pte. (Registration number 199206298Z) and/or Morgan Stanley Asia (Singapore) Securities Pte Ltd (Registration number 200008434H), regulated by the Monetary Authority of Singapore (which accepts legal responsibility for its contents and should be contacted with respect to any matters arising from, or in connection with, Morgan Stanley Research) and by Morgan Stanley Asia International Limited, Singapore Branch (Registration number T11FC0207F); in Australia to "wholesale clients" within the meaning of the Australian Corporations Act by Morgan Stanley Australia Limited A.B.N. 67 003 734 576, holder of Australian financial services license No. 233742, which accepts responsibility for its contents; in Australia to "wholesale clients" and "retail clients" within the meaning of the Australian Corporations Act by Morgan Stanley Wealth Management Australia Pty Ltd (A.B.N. 19 009 145 555, holder of Australian financial services license No. 240813, which accepts responsibility for its contents; in Korea by Morgan Stanley & Co International plc, Seoul Branch; in India by Morgan Stanley India Company Private Limited; in Indonesia by PT. Morgan Stanley Sekuritas Indonesia; in Canada by Morgan Stanley Canada Limited, which has approved of and takes responsibility for its contents in Canada; in Germany and the European Economic Area where required by Morgan Stanley Europe S.E., regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin); in Spain by Morgan Stanley, S.V., S.A., a Morgan Stanley group company, which is supervised by the Spanish Securities Markets Commission (CNMV) and states that Morgan Stanley Research has been written and distributed in accordance with the rules of conduct applicable to financial research as established under Spanish regulations; in the US by Morgan Stanley & Co. LLC, which accepts responsibility for its contents. Morgan Stanley & Co. International plc, authorized by the Prudential Regulatory Authority and regulated by the Financial Conduct Authority and the Prudential Regulatory Authority, disseminates in the UK research that it has prepared, and approves solely for the purposes of section 21 of the Financial Services and Markets Act 2000, research which has been prepared by any of its affiliates. RMB Morgan Stanley Proprietary Limited is a member of the JSE Limited and A2X (Pty) Ltd. RMB Morgan Stanley Proprietary Limited is a joint venture owned equally by Morgan Stanley International Holdings Inc. and RMB Investment Advisory (Proprietary) Limited, which is wholly owned by FirstRand Limited. The information in Morgan Stanley Research is being disseminated by Morgan Stanley Saudi Arabia, regulated by the Capital Market Authority in the Kingdom of Saudi Arabia , and is directed at Sophisticated investors only.

The information in Morgan Stanley Research is being communicated by Morgan Stanley & Co. International plc (DIFC Branch), regulated by the Dubai Financial Services Authority (the DFSA), and is directed at Professional Clients only, as defined by the DFSA. The financial products or financial services to which this research relates will only be made available to a customer who we are satisfied meets the regulatory criteria to be a Professional Client.

The information in Morgan Stanley Research is being communicated by Morgan Stanley & Co. International plc (QFC Branch), regulated by the Qatar Financial Centre Regulatory Authority (the QFCRA), and is directed at business customers and market counterparties only and is not intended for Retail Customers as defined by the QFCRA.

As required by the Capital Markets Board of Turkey, investment information, comments and recommendations stated here, are not within the scope of investment advisory activity. Investment advisory service is provided exclusively to persons based on their risk and income preferences by the authorized firms. Comments and recommendations stated here are general in nature. These opinions may not fit to your financial status, risk and return preferences. For this reason, to make an investment decision by relying solely to this information stated here may not bring about outcomes that fit your expectations.

The trademarks and service marks contained in Morgan Stanley Research are the property of their respective owners. Third-party data providers make no warranties or representations relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages relating to such data. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and S&P.

Indicators and trackers referenced in Morgan Stanley Research may not be used as, or treated as, a benchmark under Regulation EU 2016/1011, or any other similar framework.

Morgan Stanley

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
20 Bank Street, Canary Wharf
London E14 4AD
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
1-9-7 Otemachi, Chiyoda-ku
Tokyo 100-8104
Japan
Tel: +81 (0) 3 6836 5000

Asia/Pacific
1 Austin Road West
Kowloon
Hong Kong
Tel: +852 2848 5200