Morgan Stanley

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Fixed Income Research

Credit Strategy Conference Call
July 22, 2013

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Investment Grade and Credit Derivatives Strategy

Overview

Rates Revaluation

The Credit vs. Rates Debate

Many market participants have spent the past year asking what would happen to credit markets in a rates backup. We finally have the answer, or at least stage one of it: Credit across IG, HY, EM and Munis suffered in the peak of rates uncertainty, giving YTD gains or extending losses. However, as rate stability resurfaced, credit gained better footing, though not necessarily equally.

Duration and Curve Dynamics

With a bear-steepening of the Treasury curve and related underperformance of long-end IG spreads, we moved to a neutral stance on credit duration, raising our recommendation on the long end to EW from UW. We continue to expect outperformance in the 3-7yr sector.

The Technical Tea Leaves

Despite it being a long duration market, US IG has the firmest footing in our view given a healthy balance of stronger LDI and insurance flows with weaker total return flows. HY, EM and Munis benefit less from this balance, as flows remain skewed to investors more sensitive to short-term performance.

IG Sectors – Adding Utilities to the View

The underperformance in June was particularly hard on the higher-beta sectors, especially those levered to the commodities and EM stories. This month, we add Utilities to our sector focus with an equal-weight view, while remaining overweight TMT and Financials.

Models Were "Rallying" While Markets Weren't

We maintain an OW recommendation on US IG and take comfort that our model-based base-case predictions for IG have rallied from just above 160 bp at the beginning of the year to just under 140 bp today, driven largely by higher rates and a stronger GDP growth picture. HY valuations are also more attractive, but we remain EW with a 3% total return target. The muni selloff reduces some of the downside risk that drove our negative outlook, but we maintain a cautious stance.

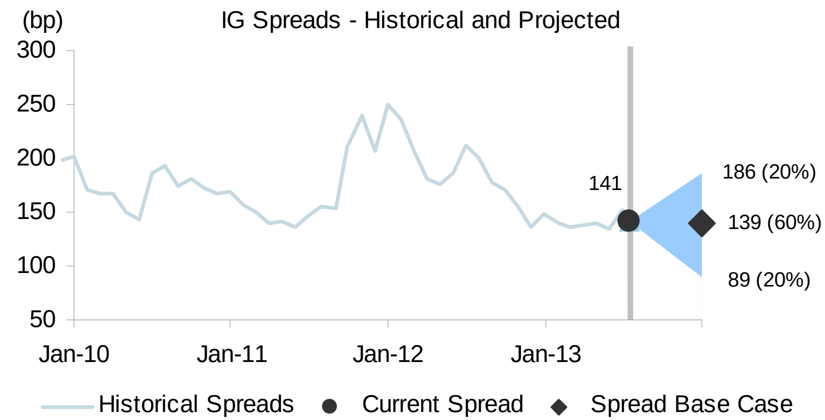
Selectively Add in EM IG Yankees

Our EM strategy team maintains an EW rating on EM corporate credit, upgrading recently to reflect the valuation opportunity. EM IG issuers have negatively impacted IG performance this year, reducing YTD excess returns by nearly one-fifth. Longer-maturity, lower-quality and LatAm names lagged and we maintain a relatively defensive stance in EM corporate credits, seeing value in QS O&G and selected quasi-sovereign bank bonds.

2013 US Investment Grade Credit Spread Forecasts

Scenario / Probability	Summary
Bull Case 89 bp Spread **(20% probability)**	Greater employment and consumer spending materializes and lifts economic confidence in a virtuous cycle. This, combined with strength in housing, causes US growth to increase, corporate earnings to surprise to the upside, and rates to rise in an orderly manner. As a result, volatility falls in the equity markets. European sovereign and funding issues move further to resolution. The ECB cuts rates and pushes peripheral yields aggressively lower. EM countries push through swift structural reforms that lift confidence and accelerate the transition to the new growth models.
Base Case 139 bp Spread **(60% probability)**	The sub-par US economic recovery continues, though growth picks up in 2H13 with tapering beginning in the second half, leading rates to rise in an orderly manner. The low-yield, high-demand environment encourages firms to issue, and earnings growth remains positive as firms remain profitable. Inflation and equity market volatility remain in check.
Bear Case 186 bp Spread **(20% probability)**	European stresses persist, and US growth fails to materialize, and Asia slows noticeably. The US faces substantial fiscal tightening and business spending remains stagnant. Growth falls to near recession levels, earnings are weakly positive, and balance sheets deteriorate. The Fed continues their low guidance and asset purchases as rates fall substantially. In the face of these combined headwinds, investors demand more compensation for added risk.

Modest Overweight Investment Grade Credit in 2013 Year-End Forecast



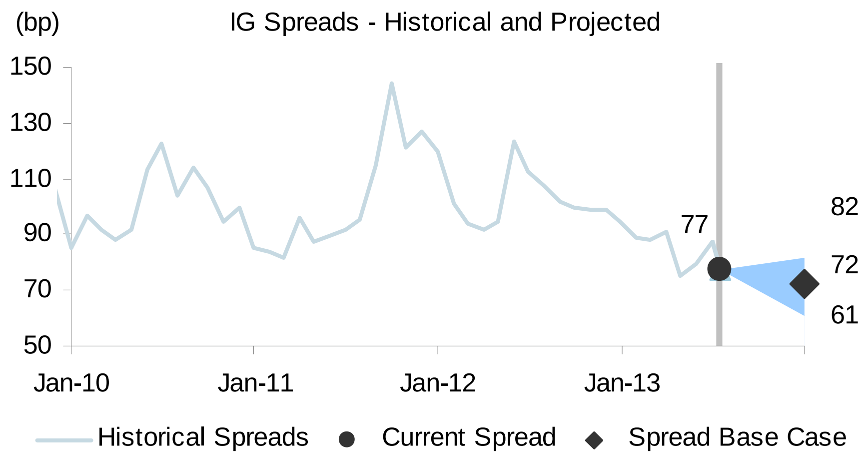
- **Why modest overweight?**
  - Despite historically low yields, IG has a solid carry story. Our probability-weighted excess return forecast is 1.3% for 2013.
  - Our call is based on a continued strong technical backdrop, an environment of positive growth, and muted systemic risk.
- **Catalysts:**
  - Higher US growth into the 2H 2013 materializes
  - European fiscal integration and lender of last resort becomes reality
  - The Fed engages in an orderly decrease of fixed income asset purchases
- **Risks:**
  - Sub-par growth, renewed European sovereign issues, or an EM growth slowdown leaves the US vulnerable to shocks.
  - The deterioration of fundamentals increase the cost of borrowing
  - Weak dealer inventories and uncertain liquidity environment
  - Another US sovereign ratings downgrade

Source: Morgan Stanley estimates, the Yield Book historical

2013 CDX IG Spread Forecasts

Scenario	Summary
Bull Case 61 bp Spread	Faster progress on fiscal consolidation in Europe complements stronger US growth leaving systemic risk in check. Policy certainty lifts business and consumer confidence, allowing business inventories to climb. This, combined with strength in housing, causes US growth and corporate earnings to surprise to the upside, while producer inflation remains in check. Meanwhile dividend payments increases slightly as retained earnings contribute to higher capital spending.
Base Case 72 bp Spread	The sub-par US recovery continues though growth picks up in 2H13 with reduced policy uncertainty and corporate earnings meet consensus. Investor pressure on cash balances increases and dividend payout ratios return to their higher historical average. PPI trends downward, and bank funding spreads are flat as the Fed tapers in the second half.
Bear Case 82 bp Spread	Risks skew to the bear case as the US faces substantial fiscal tightening and business spending moves downwards, leading to a slower growth regime or mild recession. Producer inflation inches higher due to international unrest, inventories stagnate due to fiscal issues, and European sovereign woes trigger funding stresses. Investor flight ensues and spreads reach levels modestly higher than current ones.

CDS a Better Way to Implement Longs



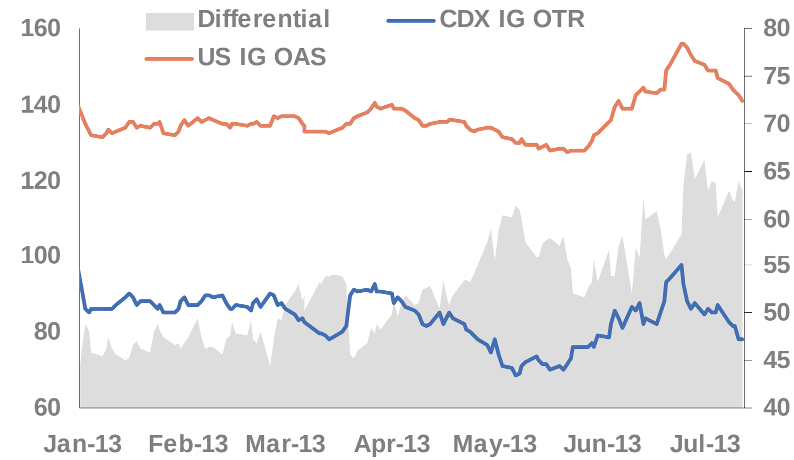
- **Our Call on CDX IG**
  - We are modestly overweight US cash IG, given strong balance sheets and a macro backdrop that is weak, but supportive for credit.
  - However, we think the CDS market is a better way to implement longs.
- **Catalysts:**
  - US economic data surprise to the upside and business and consumer confidence push earnings higher.
  - A resolution of or strong steps toward a resolution of the Eurozone sovereign situation is a positive.
- **Risks:**
  - Second half growth fails to materialize and leads the US into a recession, erasing confidence in US risks assets generally.
  - High cash balances yield to investor pressure and tax increases, as dividends increase and balance sheets weaken.
  - International unrest or little progress made towards correcting the old EM export-led model of growth leads to higher producer inflation.

Source: Morgan Stanley Research, Bloomberg

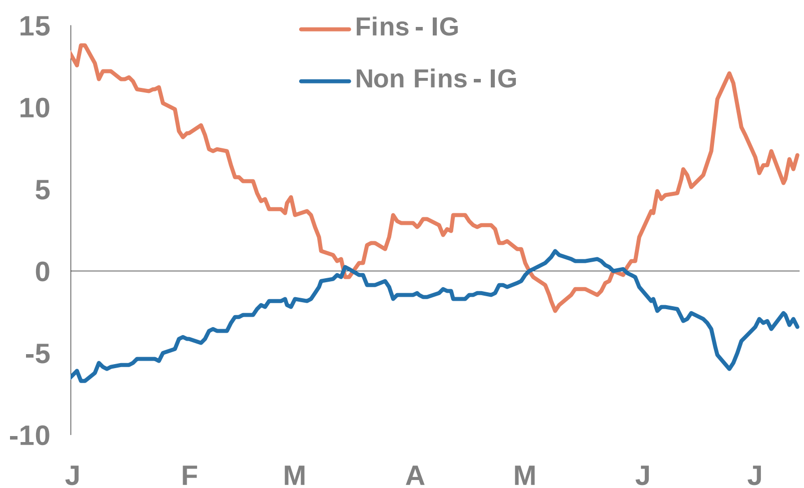
2013 Performance

Rising Rates Have Caused A Sharp Decline in Average Prices

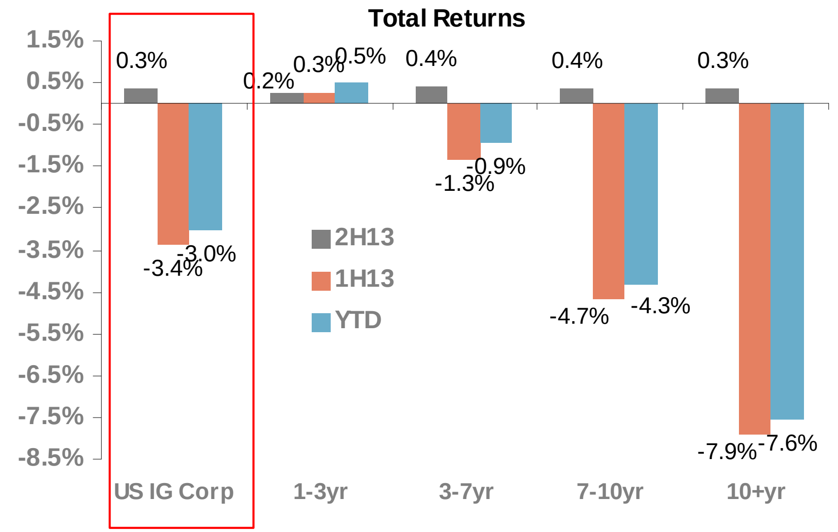
CDX IG vs US IG Spreads



Financials vs Non-Financials



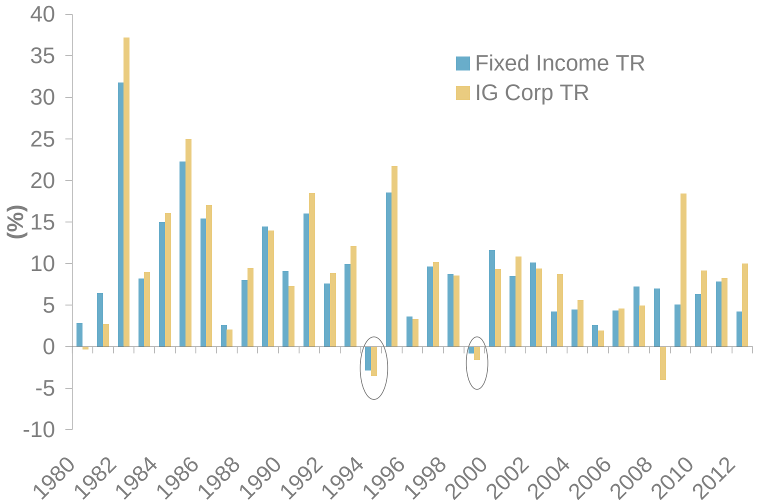
2H13 Returns Slightly Positive After Negative First Half



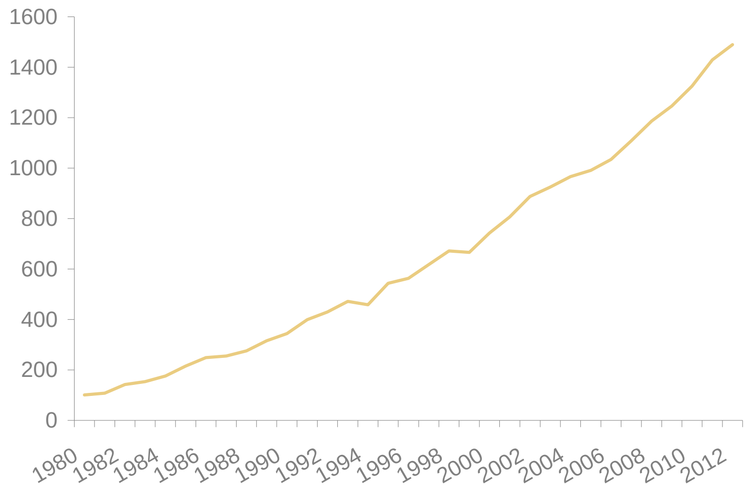
Source: Morgan Stanley Research, Yieldbook

33-Year Bull Market for Fixed Income

Only Two Negative Years for Fixed Income Since 1980



A Good Run for Fixed Income –8.6% Average Annual Return



Source: Morgan Stanley Research

The Anatomy of a 33-Year Bull Market

Fixed Income offered consistent returns. A full generation of investors has enjoyed an incredible run, where returns have averaged 8.6% annually and have been remarkably consistent, with only two negative years. During this period, yields have fallen from 13% to 1.5%, and despite last year's double-digit credit performance, broader fixed income returns of 4% were already weak relative to history.

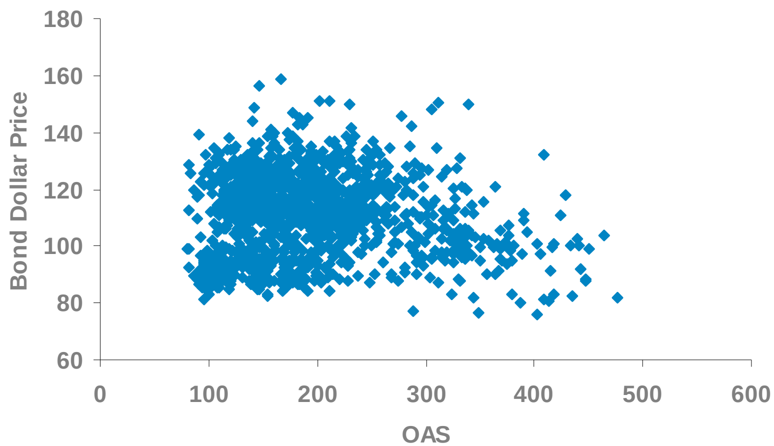
Where are we headed? In an environment in which we are comfortable with fundamentals and valuations from a credit spreads perspective, our biggest concern for the credit markets is how flows and the investing culture will take shape in a world that will be challenged by significantly lower total returns than those to which a full generation of fixed investors have been accustomed.

We focus on four investment themes for a world where rates contribute little, and could take away a lot.

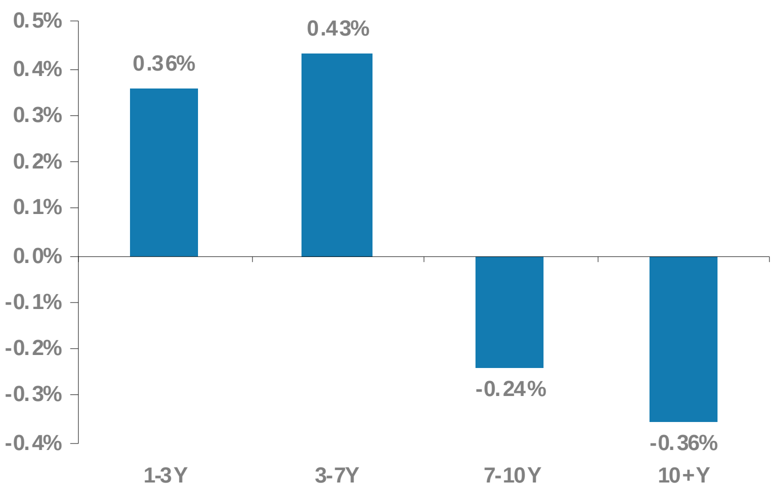
- Curve Positioning
- Hedging Interest Rate Risk
- Credit Risk over Duration Risk - CDS Overlays, Tranches
- Loans over Bonds

Tactically Neutral on Credit Duration, Equal-weight the Long End

Most Dispersion in Spreads and Prices in the IG Long End



Long-end Hurt IG the Most in 1H13; Front End Benefits from Carry and Lower Duration



Source: Morgan Stanley Research, Yieldbook, Note: These numbers are for 1H13

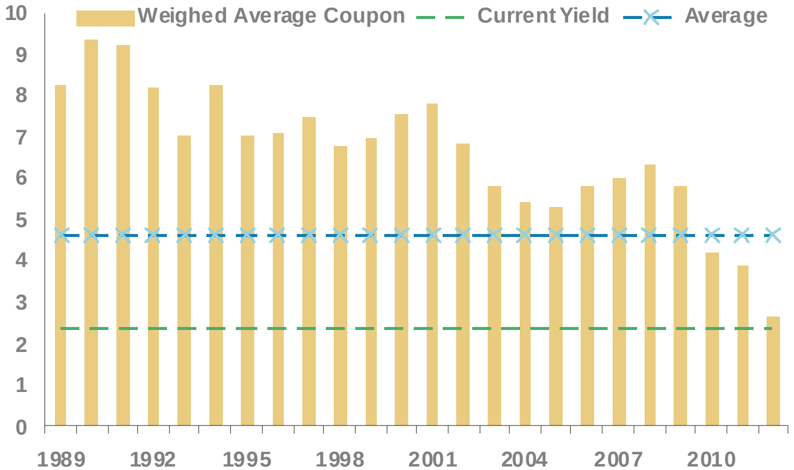
Duration Drives Performance in 1H13. The IG story for 2013 has been a tale of two markets, with the front end (<7yrs) outperforming Treasuries by nearly 0.40%, but the long end underperforming woefully. The net result was a market that ended the first half of 2013 almost flat to Treasuries.

Moving to a Neural Stance on Credit Duration: Given the current valuation picture, our rates team's tactical long duration bias, and technicals in the IG market, we move to a more neutral stance on this sector. Our view is tactical in nature, while acknowledging that long duration IG remains most vulnerable to total return headwinds and outflows on a strategic basis.

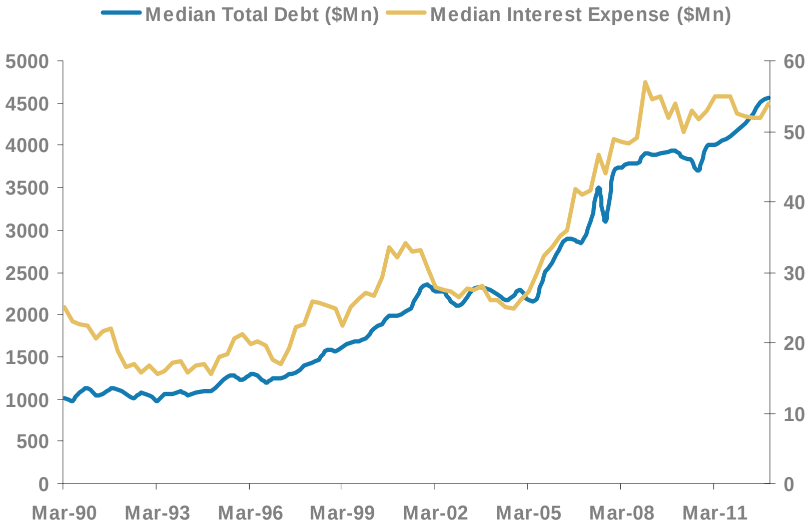
3-7yr Sector Remains Most Attractive: Overall, we still find the front end and belly of the curve the best place to be. While this sector has suffered from lower yields shutting out several investors in the past few years, the back-up in yields should motivate flows given the relative lack of duration risks and superior roll-down.

All Debt Is Not Created Equal

Current Coupons for AAA-A Rated Corporate Debt Near 2%



Median IG Interest Expense Is Flat Despite Growing Debt



Source: Morgan Stanley Research, Yieldbook, Bloomberg

Low Rates Have Helped Reduce Debt Serving Costs Significantly

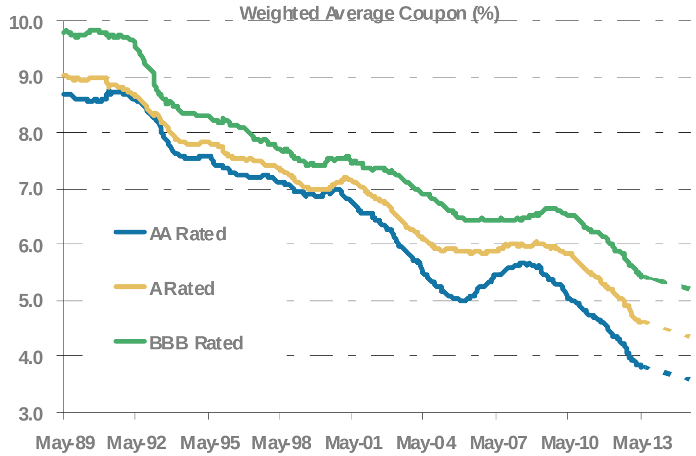
Thanks to extraordinary central bank policy, many investment grade corporates are borrowing today at long-term rates that are both at historic lows and even below average levels of inflation. Whether or not we return to “normal” inflation, there are significant long-term fundamental benefits for such funding.

Interest Cost Flat Lining: Growth in debt over the past 5 years for median IG issuers has come at basically zero incremental debt cost, thanks to the yield environment. This has led to interest coverage ratios for AA and A-rated corporates at multi-decade highs and provides much of a fundamental tailwind.

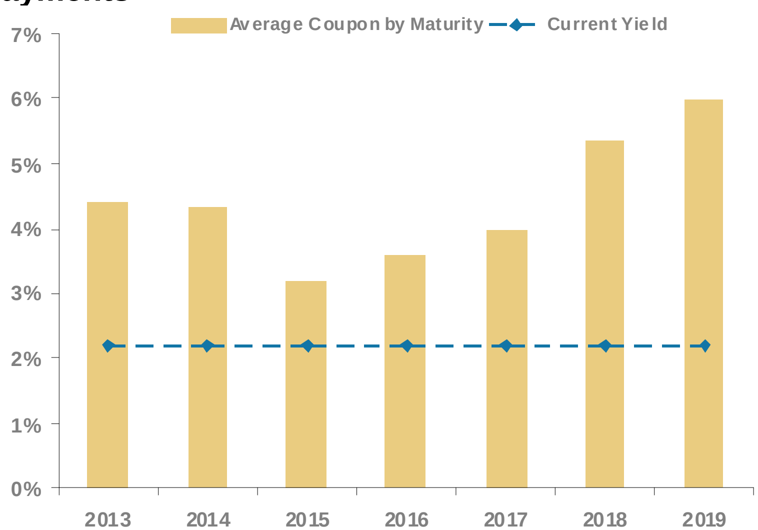
Tailwind to Tail Risk: The key risk for investors is actually deflation, and we believe that part of the credit risk premium investors are receiving today is actually to compensate for this potential outcome. If deflation were to occur, this fundamental tailwind could turn into a tail risk.

Average Coupons Below Average Inflation Rates

Weighted Average Coupons by Rating



High Coupon Debt Roll-Off Should Further Reduce Coupon Payments

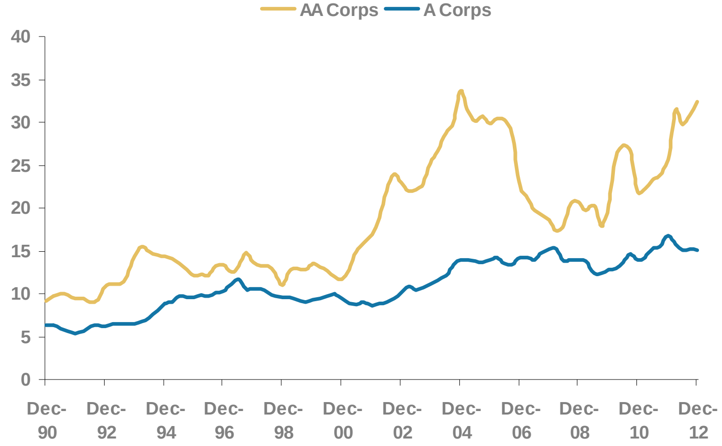


- Based on the Citi IG Corp index, we estimate that the weighted average coupon for typical IG companies is 1.5% lower today, relative to pre-crisis levels (we use late 2007 as a reference). This change is most pronounced for AA issuers, who on average are paying coupons 2.0% lower.
- The current coupon for high quality issuers is close to 2%, which is well below historical average inflation rates.
- Going forward, our analysis suggests the average coupon for AA/A rated companies could go lower by another 50bp over 3 years if interest rates do not change.
- Another benefit of low rates across the curve for corporates is their ability to term out their debt profiles, thus reducing the risk of refinancing over the medium term. The implication of this is that a period of sustained high inflation/real growth increases the PV of the gap between the rate of real growth and debt servicing costs, which should eventually flow through to the bottom line.

Source: Morgan Stanley Research, Yieldbook, Bloomberg

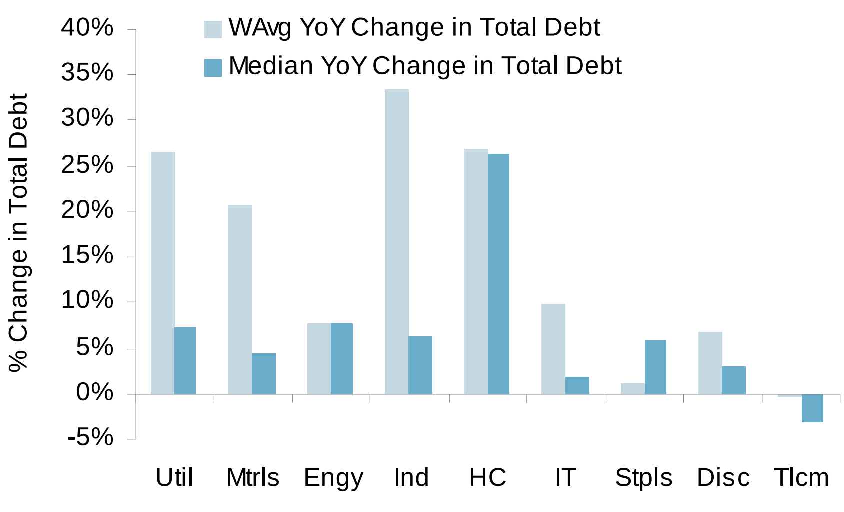
Interest Expense Ratio at Highs, Despite of Rising Leverage

Interest Coverage Ratios for High-Quality Corporates

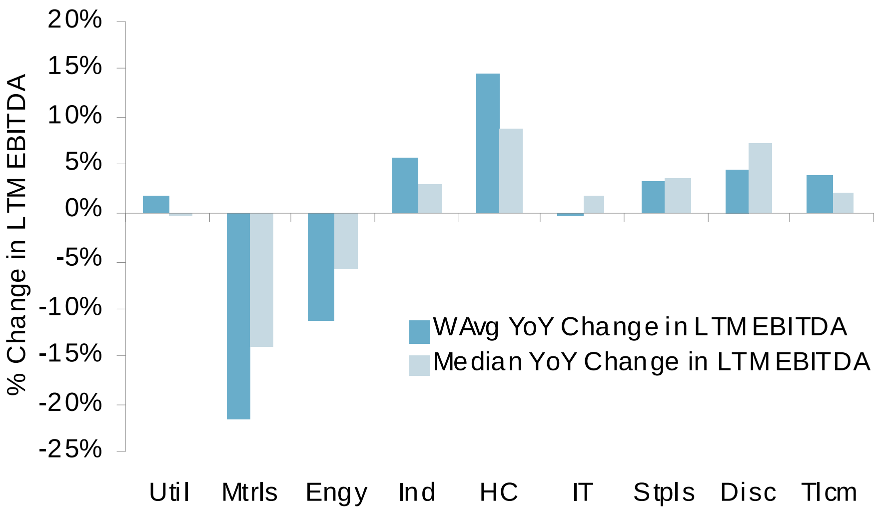


- Not surprisingly, the healthy interest expense metric can help reduce the weakness in other fundamental measures. The one metric that stands out is the interest coverage ratio, which remains at or near all-time highs for AAA–A issuers.
- The healthy interest coverage ratio comes against a backdrop of rising leverage, which is now ubiquitous in US IG. However, the drivers of this leverage are different across ratings and sectors.
- As such, in a rising inflation environment, we are less worried about a rise in leverage due to higher debt levels, given that it represents cheap term funding.

Change in Total Debt Across Sectors



EBITDA Growth Across Sectors



Source: Morgan Stanley Research, Yieldbook, Bloomberg

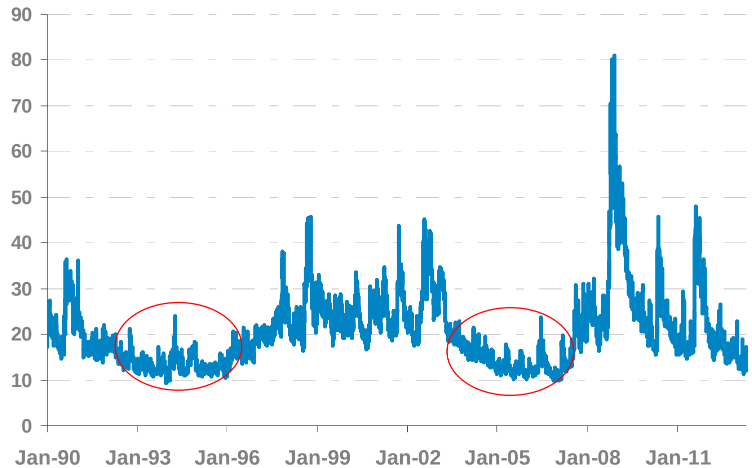
Cross Asset Volatility Monitor

	Current Levels					Realized Vol		12m Range: ATM Vol		12m Range: 3m Imp-1m Rlzd Sprd		12m Range: Skew		12m Range: Term Struct	
	Underlying	ATM Vol	3m Imp-1m Rlzd Sprd	Skew	Term Struct	1 Month	3 Month	%-Tile	High / Low	%-Tile	High / Low	%-Tile	High / Low	%-Tile	High / Low
Equities *(3m vol)*															
S&P 500	1683	14%	-0.7%	7.4%	-2.3%	14%	13%	35%	19% / 11%	11%	11% / -2%	5%	11% / 6%	83%	-1% / -5%
RUSSELL 2000	1043	18%	1.1%	7.5%	-2.1%	17%	16%	33%	24% / 15%	18%	13% / -6%	0%	10% / 7%	78%	-1% / -5%
DJ EURO STOXX 50	2675	18%	-5.6%	7.1%	-0.9%	24%	19%	49%	25% / 14%	6%	12% / -10%	72%	8% / 5%	86%	1% / -4%
DAX	8218	17%	-5.2%	7.5%	-1.7%	22%	18%	61%	23% / 13%	3%	11% / -6%	48%	10% / 6%	74%	1% / -4%
FTSE 100	6583	15%	-5.0%	6.1%	-0.8%	20%	16%	79%	18% / 10%	0%	11% / -5%	23%	10% / 5%	90%	1% / -4%
HANG SENG	21312	19%	-5.6%	5.3%	0.0%	24%	19%	86%	22% / 14%	1%	8% / -7%	94%	7% / 2%	94%	2% / -4%
VIX	14	47%	-56.4%	-8.9%		99%	106%	4%	78% / 45%	34%	13% / -138%	81%	-3% / -16%		0% / 0%
Equity Sectors (*3m Vol*)															
US Financials (XLF)	20	17%	0.2%	5.9%	-2.2%	17%	16%	34%	22% / 15%	18%	15% / -3%	17%	10% / 5%	79%	0% / -5%
Credit *(3m vol)*															
CDX IG	77.0	1.6%	-0.6%	1.4%		2.2%	1.8%	29%	3% / 1%	1%	1% / -1%	47%	2% / 1%		
iTraxx Main	105.1			1.8%		3.3%	2.7%		4% / 2%		2% / -1%	39%	3% / 1%		
CDX HY	370.6	8.2%	-2.7%	2.1%		10.9%	8.6%	41%	13% / 6%	0%	6% / -3%	35%	6% / 1%		
iTraxx Xover	424.2	9.0%	-1.5%	5.4%		10.5%	8.9%	60%	12% / 5%	18%	4% / -5%	65%	7% / 4%		
Rates *(3m vol on 10y rates)*															
USD	2.77%	103.9	-31.29	24.97	-0.48	135.2	101.4	93%	121 / 59	0%	30 / -31	49%	31 / 19	90%	11 / -14
EUR	1.91%	74.1	-6.21	13.46	-6.08	80.3	65.6	78%	90 / 53	12%	32 / -13	93%	20 / 1	57%	2 / -12
FX *(3m vol)*															
EUR-USD	1.31	9%	-1.0%	1.2%	-0.3%	10%	9%	81%	11% / 7%	7%	3% / -1%	52%	2% / 0%	94%	0% / -2%
USD-JPY	99.9	14%	-0.4%	1.4%	0.3%	14%	15%	90%	16% / 7%	29%	2% / -4%	99%	2% / -1%	55%	2% / -3%
GBP-USD	1.51	9%	-1.0%	1.3%	0.0%	10%	8%	99%	9% / 5%	8%	2% / -2%	84%	2% / 0%	99%	0% / -2%
Commodities *(3m vol)*															
Oil	106.3	21%	-3.3%	2.3%	1.4%	23%	21%	16%	34% / 17%	8%	22% / -9%	18%	5% / 1%	50%	5% / -3%
Natural Gas	3.67	30%	-2.3%	0.9%	6.7%	34%	34%	20%	50% / 27%	12%	27% / -10%	74%	4% / -3%	54%	17% / 1%
Gold	1284	21%	-15.0%	1.5%	0.4%	34%	25%	92%	26% / 12%	7%	7% / -28%	77%	5% / -1%	80%	6% / -6%

Notes: Skews are as follows: For equities and commodities: (90% price put vol – 110% call vol) For credit: (130% spread payer vol – 80% receiver vol) For rates: (+50 bps payer vol - -50 receiver vol). For FX: -1 x 25d risk reversal (puts vol less calls vol for the numerator currency). All term structures are the 3m ATM vol less the 1y ATM vol.
Source: Morgan Stanley Research, Quantitative and Derivative Strategies, Bloomberg.

Are We in a Low Vol World, and How Should We Position?

VIX Below 20%: Periods of Sustained Low Volatility Require Different Playbooks



CDX IG: Range-bound in 2013

Source: Morgan Stanley Research

What Defines a Low Volatility World

- Driven by extremely supportive global central bank policy pushing investors out the risk curve, low inflation, a slow growth world that drives correlation down, and significantly reduced Eurozone tail risks, volatility is certainly low enough today to open the debate on whether we are in a low volatility period.
- Based on history, we define a low volatility world as equity realized volatility below 15%, VIX below 20%, and CDX IG implied price volatility below 2.25%. Such environments can have brief periods of volatility that exceed these thresholds, but they usually do not last long.
- Based on recent market data, the current market environment does feel like one of low volatility, but we will not know if this is one for the history books until it actually becomes history.
- If we are in a low vol world, however, the playbook for credit investment requires material changes if one wants to generate reasonable alpha.
- When trying to understand any volatility regime, hindsight is perhaps the only perfect science. 2004-2007 is the most recent sustained period of low market volatility and one that is often cited. We look at this period in credit and equities to identify the optimal options playbook for a low vol environment.

Introducing Credit Futures Contracts

- **ICE CDX.IG Index Futures Launched on June 17:** Futures contracts are a mainstay of liquidity in most financial markets, but credit was the exception as OTC CDS indices have been the instruments of choice. The new futures contract will be a cash-settled instrument linked to a “when-issued” version of the 5-year CDX IG index.
- **Why Futures and Why Now?** The answer may be in its simplicity. Many financial futures traders use the contracts to manage short-term market risks of their longer-term investments. Investors who are not set up to trade OTC swaps may find gaining approval to trade financial futures less onerous. Futures contracts have margin cost benefits relative to swaps, and the Dodd-Frank-driven standardization of CDS index trading has created more of a level playing field with exchanges.
- **Exposure Differences – Futures vs. Swaps:** There are many material differences between credit index futures and CDS swaps. Futures users are trading the expected future price of an index rather than credit protection. Futures will cash settle at maturity with daily margining along the way, and they are constant maturity in nature, so roll-down is not an issue.

Timeline for CDX Index Futures Contracts

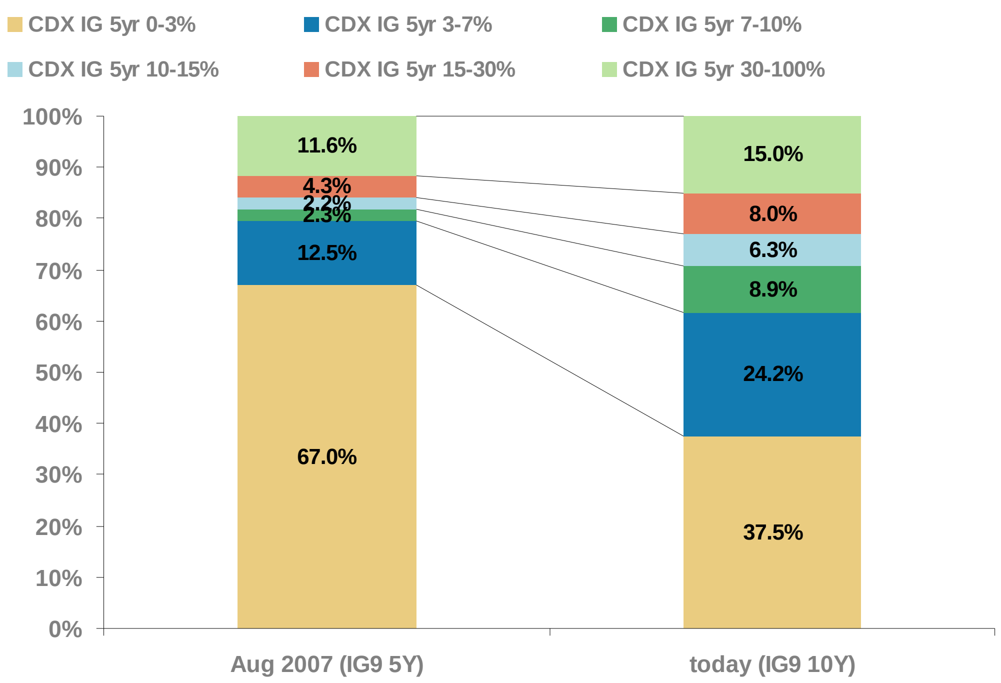
Contract number	Start Date	Expiry	When-Issued Index Referenced by Contract	OTR Swap Index at Launch
1	17-Jun-13	20-Sep-13	IG21	IG20
2	22-Jul-13	20-Mar-14	IG22	IG20
3	20-Jan-14	20-Sep-14	IG23	IG21
4	22-Jul-14	20-Mar-15	IG24	IG22
5	20-Jan-15	20-Sep-15	IG25	IG23

- **Futures Contract Details:** After the initial launch, new futures contracts will begin trading every July and January on “when-issued” indices with expiry in March and September respectively, coinciding with the CDS index rolls. Initial margins are expected to be 0.40% for CDX IG.
- **When-Issued Index Details:** Markit has already adjusted index rules to be objective and deterministic and they will update expected constituents of new indices on a weekly basis. The new rules include ratings, debt outstanding, liquidity and spread level criteria. For IG, downgraded or defaulted issuers would simply be removed from the universe prior to index creation.

Source: Morgan Stanley Research, ICE

Short IG9 10Y 15-30%

Risk Allocation: 2007 versus Today



Source: Morgan Stanley Research

Cheap Carry for High Delta Exposure

- For US portfolios, we think one short opportunity is in junior super senior tranches in legacy IG indices (IG9 10y 15-30%).
- At an annual spread of 50bp, with a delta of 0.9x, we think this hedge has better risk-reward relative to option strategies, which can cost several multiples on an annualized basis.
- Relative to real super senior risk, we think these tranches have more sensitivity to the underlying market spreads and are likely to work better in a moderate tail scenario
- Unlike mezzanine tranches, on a risk allocation basis, this tranche does not stand out as being excessively cheap today.

Upgrading the Consumer Sector to Equal-weight

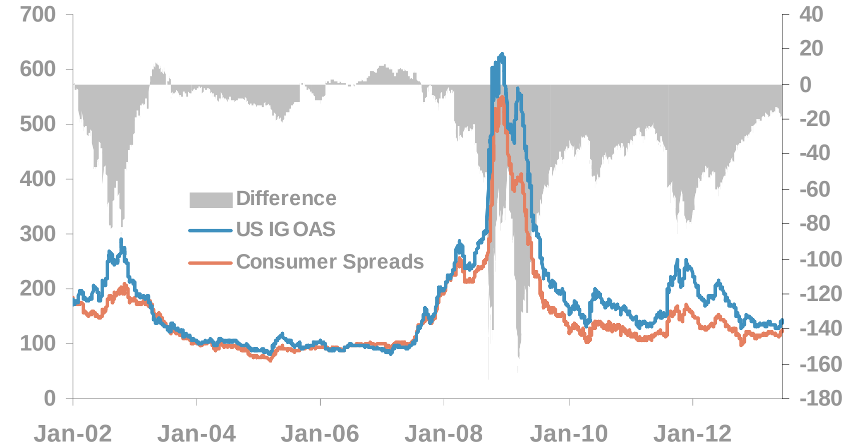
A Consumer-led Economic Rebound Provides a Buffer for Valuation and Fundamental Headwinds

Tailwinds: The second-half rebound in global economic growth is a theme our global economics team has been emphasizing for much of this year. A decent portion of this move to "Daylight" (from the "Twilight" we've been in) is predicated on DM growth, and even more specifically the US growth and healing story. Our economics team expects the US consumer to lead the way from a tepid first half to a more robust second half.

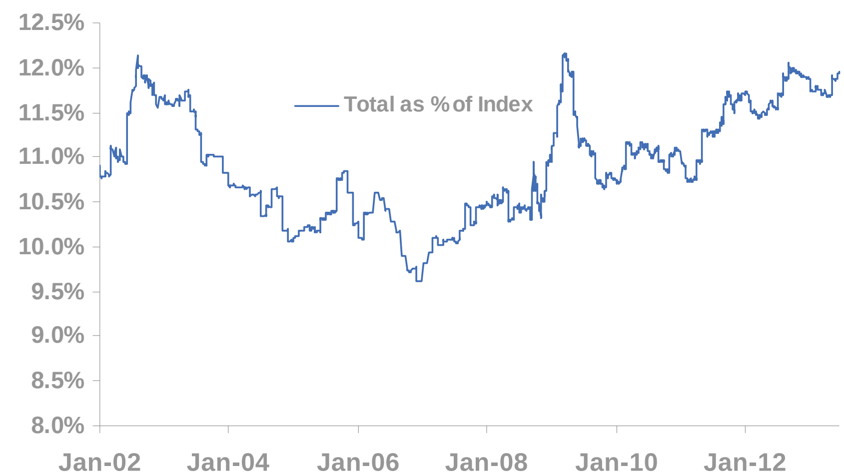
Headwinds: the Consumer sector faces several headwinds and we would look for some improvement before considering upgrading further to an Overweight.

- the sector also depends on strong growth coming from China / EM (particularly for the Staples sub-sectors) where the economic story is less certain.
- Second, valuations remain tight; thus, if anything, we would advise investors to be **tactically ready to buy on dips and dislocations** between the sector and broader IG.
- Third, we would watch employment data. While our economics team anticipates improvement in the labor market, we think the Consumer sector could be sensitive to some factors the official unemployment rate may not fully capture, such as the participation rate and the underemployment rate.

Consumer Trades Tight to IG



Consumer Share of the Overall IG Market



Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Consumer Sector Model

Building a model: For the Consumer sector model, we use three out-sample periods: (1) A year-long period pre-crisis, (2) A year-long period at the peak of the crisis, and then (3) The last 12 months. What we end up with is a model with reasonably high R^2 levels in the 70% range for the insample and outsample periods, and a model that accurately predicts the *direction* of spreads during the crisis, though is slightly off in terms of *magnitude* for large tail moves.

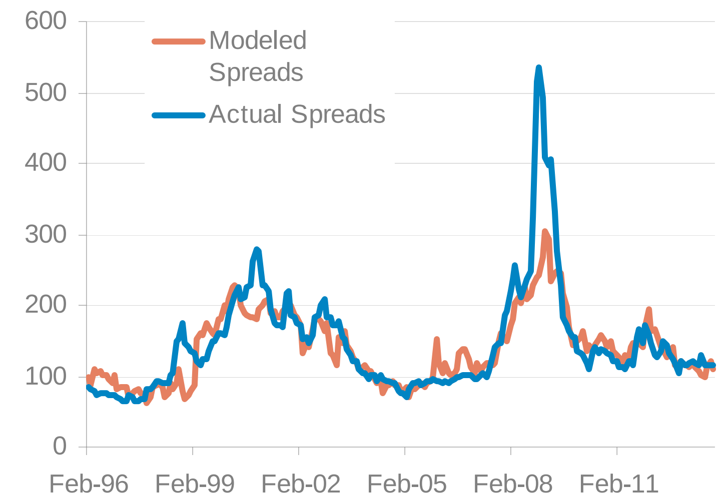
Factors: Not surprisingly, of all the variables we tested, those most closely related to the American consumer showed up as highly significant. These included various measures of inflation, employment data, income and consumption data, gasoline prices and housing, to name a few.

- In the end, we settled on CPI for inflation, jobless claims for employment, and housing for our macro factors.
- On the fundamental side, we include both median interest coverage and leverage for our universe of credit entities.
- Finally, we include a volatility variable, similar to the one we have included in previous models. Given that much of the risk premium in IG is volatility (up to 50%, as we recently noted in Credit Derivatives Insights: Living in a Low-Vol World), we find this to be a particularly significant factor, especially during major sell-offs.

Consumer Model Variables and Sensitivities

Consumer	Factor Sensitivity
US CPI Urban Consumers YoY NSA	1.1
US Continuing Jobless Claims SA	4.3%
S&P/Case-Shiller Composite-20	(12.3)
Consumer Sector Interest Coverage	(0.9)
Consumer Sector Leverage	0.15x
Consumer 3m Implied Vol	2.8

Historical Consumer Sector Spreads vs Model Spreads



Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Equal-weight Industrials

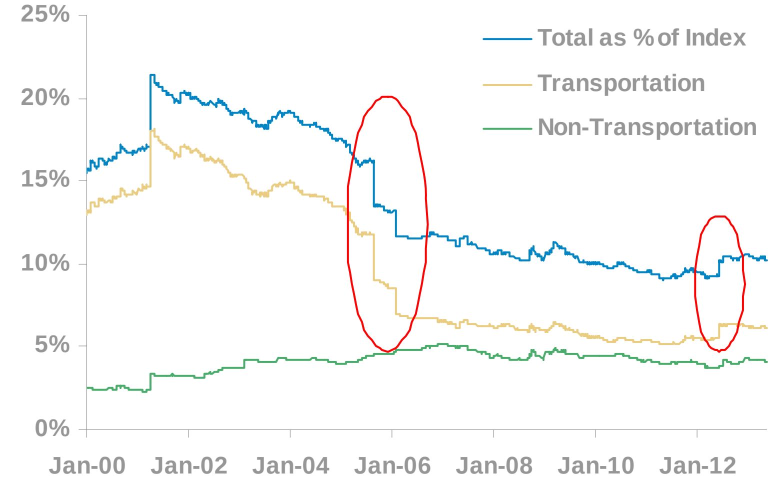
Commodities pricing, valuations and fundamentals are all key factors for the Industrials sector

Tailwinds: From a valuation standpoint, this is a generally very low-beta sector, without a great deal of room for further outperformance overall, particularly given our general overweight on US IG corporate credit.

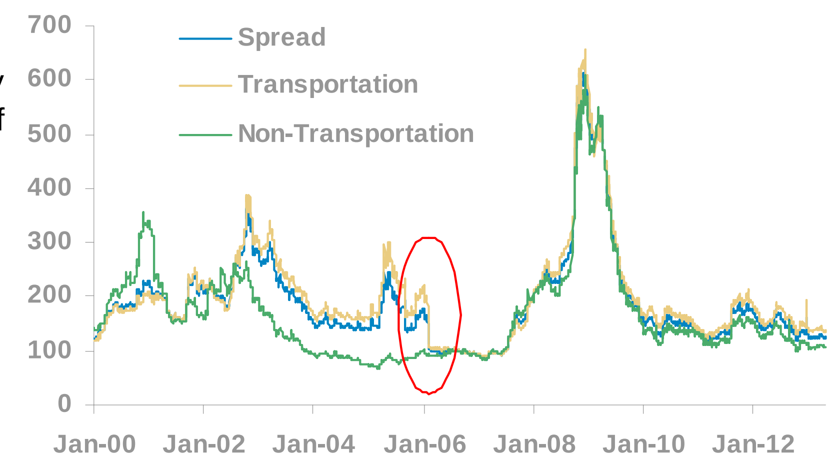
On the upside, the improving macro backdrop and softening commodities story are generally positive for the sector, and are factors included in our Industrials model.

Headwinds: However, our model, which we will discuss in greater detail later, shows that the sector is far more sensitive to changes in fundamentals and volatility levels, on which we are somewhat less constructive. Furthermore, this sector has higher LBO risk than other sectors; about 30% of the IG names on our LBO screen are Industrials names, second only to TMT, and likely related to the on average lower leverage we have seen in many of these names.

Industrials as a % of the Broader IG Market



Impact of Autos on Industrials Spread Levels



Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Source: Morgan Stanley Research, Yieldbook.

Industrials Model

In the Industrials model, constituent inclusion had a defining impact on the spread levels of the overall sector, and thus we chose to take the 6 months before and after the removal of the Autos names and remove these 12 months from the in-sample period. Furthermore, as we have done for the TMT sector, we wanted to keep the crisis period in the out-sample as well, so as not to skew the factor sensitivities.

Thus this model, unlike prior models, includes three out-sample periods: June 2005 through May 2006, August 2008 through July 2009, and May 2012 through today.

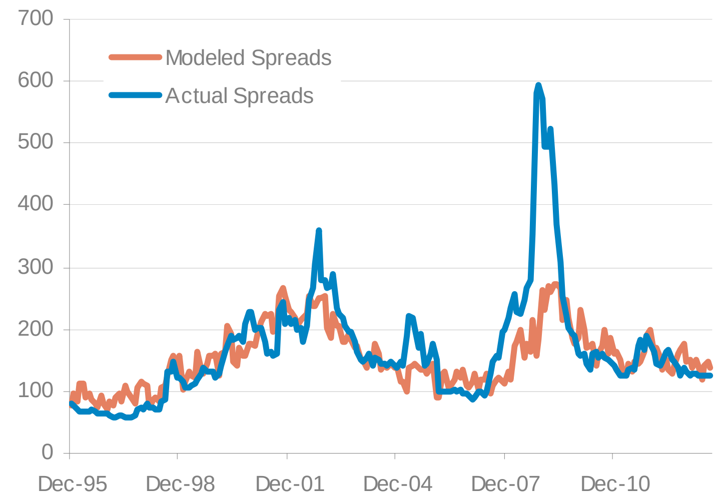
Our variables are as follows:

- Three are macro variables intended to assess the business and industrials market environment (Industrial Production and Business New Orders).
- Next we have commodities pricing, which should be an input cost for this sector.
- On the micro side of the equation, we use median issuer leverage for the sector, taken from our credit databases, and then dividend yield for the equities Industrials sector.
- Finally, we include a volatility variable, similar to the one we have included in previous models. Given that much of the risk premium in IG is volatility, we find this to be a particularly significant factor, especially during major sell-offs.

Industrials Model Variables and Sensitivities

Industrials Model	Factor Sensitivity
ISM Manufacturing Report on Business New Orders SA	(8.49)
US Industrial Production 2007=100 SA	-0.8%
Thomson Reuters/Jefferies CRB Commodity Index	5.5%
Industrials Sector Dividend Yield	7.8%
IG Credit Issuer Leverage	0.12x
Industrials 3m Implied Volatility	3.9%

Historical Industrials Spreads vs Modeled Spreads



Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Underweight the Healthcare Sector

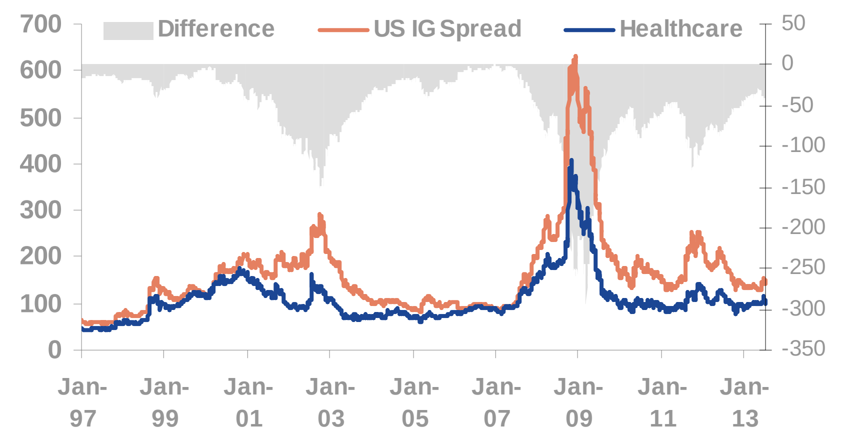
Tight Valuations, Weaker Fundamentals, and Shareholder friendly activity make Healthcare an Underweight:

- **Valuations.** First, the sector is currently trading 40bps through the broader IG market and the only way we see further outperformance from here is with a significant backup in spreads in the broader market.
- **Fundamentals.** Second, in our model building process, many micro factors seemed more significant than the macro factors. Right now, in our view, the macro backdrop looks reasonably supportive for the second half of the year, yet the fundamental story in credit overall (and Healthcare is no exception) looks to be weakening.
- **Shareholder positive / credit negative.** Third, our equity team's rationale for an overweight on the equity side is largely predicated on factors that are at best neutral for credit (equity valuations looked attractive) and at worst a negative for the bonds (they prefer sectors with attractive dividend growth).
- **Geographic sources of revenue.** Finally, one area that is not necessarily an outright cause for concern, but not necessarily a positive for the sector in today's environment, is geographic sources of revenues. For this, we focus on the top 10 largest Pharmaceutical names in the IG index (which account for 70% of the entire sub-sector, and thus about half of the Healthcare sector as a whole), and for this group close to half of total sales came from foreign countries in 2012.

Overseas Revenue Growth in the Healthcare Sector

Company	2012	2011	2010	2009
AMGEN INC	22.1%	23.1%	22.7%	22.0%
ABBVIE INC	43.2%	44.3%	42.6%	43.0%
GLAXOSMITHKLINE CAP INC	70.0%	70.7%	69.4%	66.2%
MERCK & CO INC	56.9%	57.3%	56.0%	47.5%
EXPRESS SCRIPTS HOLDING	0.1%	0.1%	0.1%	0.2%
PFIZER INC	60.9%	58.7%	57.0%	56.5%
JOHNSON & JOHNSON	55.6%	55.5%	52.2%	50.1%
NOVARTIS CAPITAL CORP	67.2%	67.2%	66.6%	67.8%
ASTRAZENECA PLC	53.3%	50.9%	50.0%	47.9%
TEVA PHARM FIN CO LLC	48.6%	51.9%	41.7%	41.3%

Healthcare Has Consistently Traded Through IG



Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Healthcare Model

Building a model: For the Healthcare model we include the crisis in the in-sample period, something we have not been doing for many of our other sector models. Our rationale is that this sector consistently trades in a much narrower range than the rest of the market given the relatively higher-quality nature of the constituents, and our sensitivities were already running close to one standard deviation. The net result is a model with in-sample, out-sample and total sample R2 levels in the high 50% range.

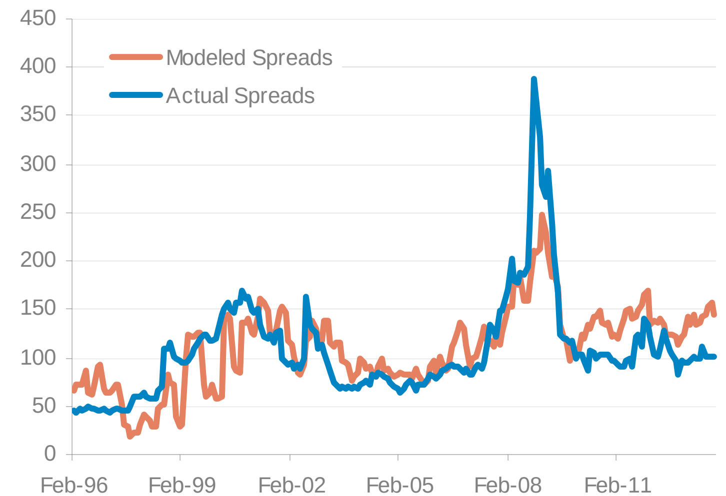
Factors: For our variables, we are more heavily weighted toward the micro factors in the Healthcare model, at the expense of the macro side of the equation. This makes sense to us, given that this sector, particularly the dominant Pharmaceuticals sub-sector, is less macro driven, particularly on the credit side.

- For our macro factors, we use US GDP growth, a factor we have used before in both our broad IG model as well as the Utilities sector, as well as PPI.
- For fundamental variables, we use dividend per share on the constituents in the equity sector as well as interest coverage, which has been a generally less positive story this year for Healthcare, and then finally, as in previous models, we use median leverage for the constituents of the sector.
- Lastly, we include a volatility variable, similar to the one we have included in other sector models.

Healthcare Model Variables and Sensitivities

Healthcare	Factor Sensitivity
GDP QoQ Chained	(1.8)
US PPI By Processing Stage Finished Goods Total YoY NS	2.0
Healthcare Sector 1-Year Rlzd Dividend Growth Rate	6.0
Healthcare Sector Interest Coverage	(2.2)
Healthcare Sector Leverage	0.23x
Healthcare 3m Implied Vol	6.4

Historical Healthcare Spreads vs Modeled Spreads



Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

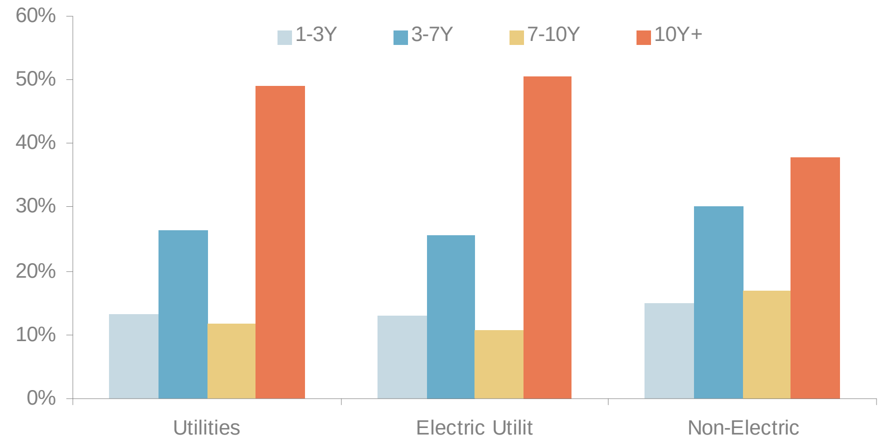
Equal-weight Utilities

Offsetting Fundamentals, Valuations and the Regulatory Outlook Make Utilities an Equal-Weight in Our View

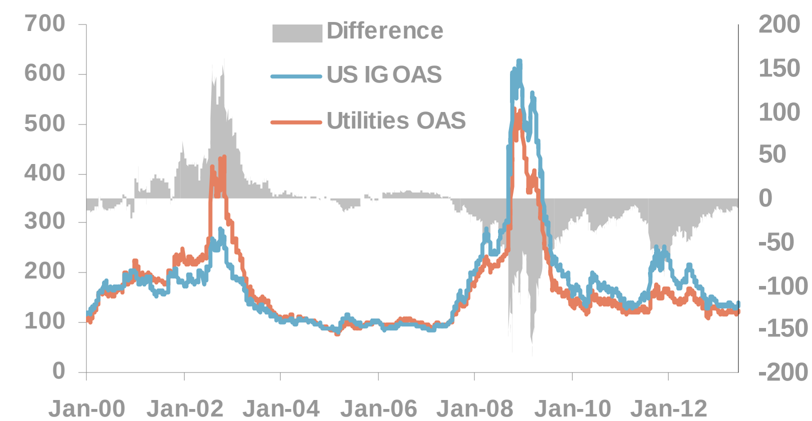
We are equal-weight on Utilities, given the relative stability on the fundamental outlook and current valuations. Still, the regulatory environment remains a headwind, as many utilities companies face tough choices in the coming months and years, regarding whether to upgrade facilities to meet increasingly stringent EPA requirements, or to build new ones altogether. While eventually these costs can (and will) be passed on to the consumer, in the near term they could mean compressed margins and potential new, longer duration issuance, factors that our model would not be able to capture.

Utilities as we define it here is actually similar to the public utilities sector in the municipal market, and in fact, but for the fact that many issuers in this space can issue in tax-exempt form, this sector would actually be much larger than the roughly $300bn in size, or around 8% of the total IG market we see today. Our municipal analysts estimate the tax-exempt Utilities market is around $500bn in size.

Utilities Are a Longer Duration Sector



Utilities Spreads vs US IG



Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Utilities Model

Building a model: For the Utilities model, we use three out-sample periods: (1) A year-long period pre-crisis, (2) A year-long period at the peak of the crisis, so as not to end up with a model that is overly sensitive to housing prices (like we saw in TMT) and then (3) The last 12 months. What we end up with is a model with reasonably high R^2 levels of 88% in-sample and 56% out-sample and a model that accurately predicts the *direction* of spreads during the crisis, though is slightly off in terms of *magnitude* for large tail moves.

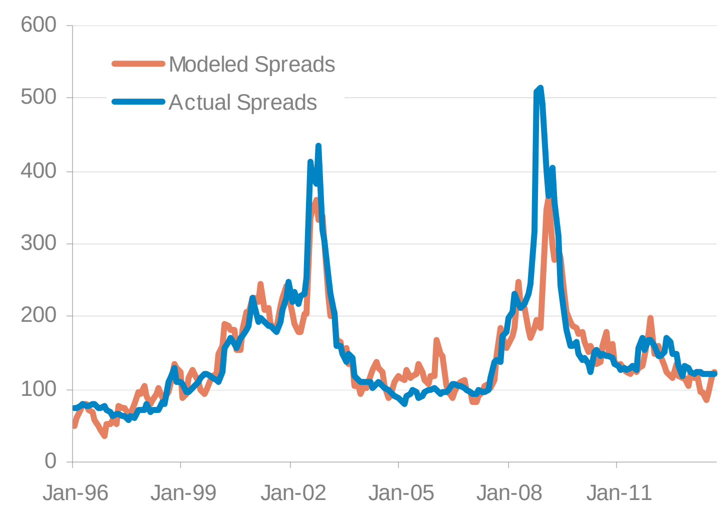
Factors: We think it is interesting to note that while the model is reasonably accurate in terms of spreads historically, it shows remarkably low sensitivity to many of the variables, a phenomenon we noted in the Industrials sector as well. Both of these sectors are lower beta, tighter spread sectors, so lower sensitivities are not necessarily incongruent, but certainly worth noting.

- In this model, as before, we include macro variables, notably US GDP as well as US housing prices as measured by Case-Schiller.
- On the micro side, we look at ROE, which has special implications for Utilities in particular.
- Additionally, as in previous models we use median leverage for the constituents of the sector.
- Finally, we include a volatility variable, similar to the one we have included in previous models.

Utilities Model Variables and Sensitivities

Utilities	Factor Sensitivity
GDP QoQ Chained	(4.95)
S&P/Case-Shiller Composite-20	(9.43)
Utilities Sector ROE	(5.43)
US Generic Govt 2 Year Yield	(2.45)
Utilities Sector Leverage	0.29x
Utilities 3m Implied Volatility	1.6%

Historical Utilities Spreads vs Modeled Spreads



Source: Morgan Stanley Research, Yieldbook, Bloomberg.

Note: Factor sensitivity is the amount the input variable must change for a +10bps impact on the prediction

Leveraged Finance Strategy

Executive Summary

We Expect Some Volatility to Last

- For much of 2013, risk/reward has been unattractive for high yield credit, and we have recommend fairly defensive positioning as a result. Valuations have improved modestly.
- We are staying patient and think volatility around a potential QE exit and a still uncertain global macro backdrop will last for some time.
- Credit fundamentals have been weakening. This earnings season is important to watch for signs as to whether the much talked about ‘strong 2H recovery’ will play out.

This Taper is Different

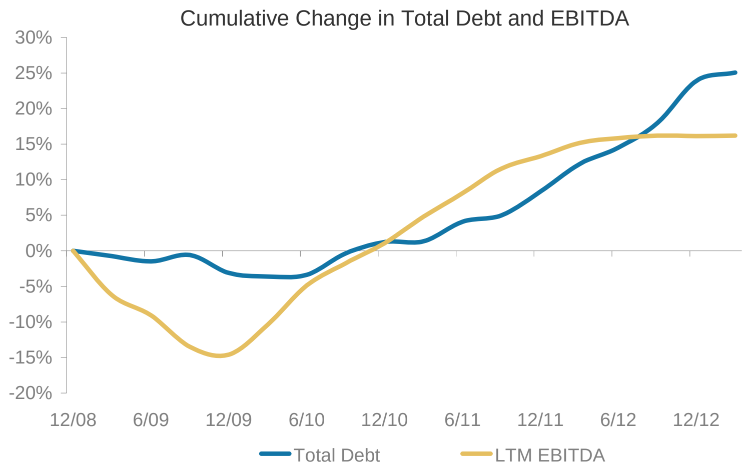
- Markets have been volatile in between prior periods of QE, and the initial withdrawal of liquidity by the Fed is usually a volatility inducing event. But it typically does not mark the end of the credit cycle.
- Usually rising rates equal tighter spreads, but that correlation has broken down. Rising rates have led to flows out of the ‘yield trades,’ which have worked so well over the past few years.
- Rising rate volatility means credit investors need a larger risk premium.

Game of Loans: US vs Europe

- Risk-adjusted valuations are more attractive in the US loan market but dispersion is higher in Europe.
- European loans have weaker fundamentals relative to those in the US. However, the new issue environment has been much more ‘issuer-friendly’ in the US.
- The US has been a story of strong demand, thanks to substantial fund inflows and robust CLO issuance. In Europe, positive technicals have been much more a result of weak net supply.

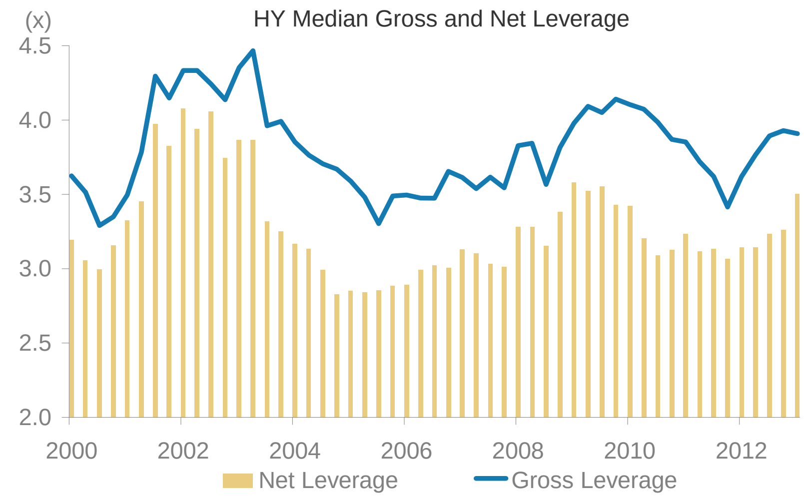
Balance Sheet Quality Is Slowly Deteriorating

EBITDA Growth Is Flat-lining, While Total Debt Growth Is Accelerating…



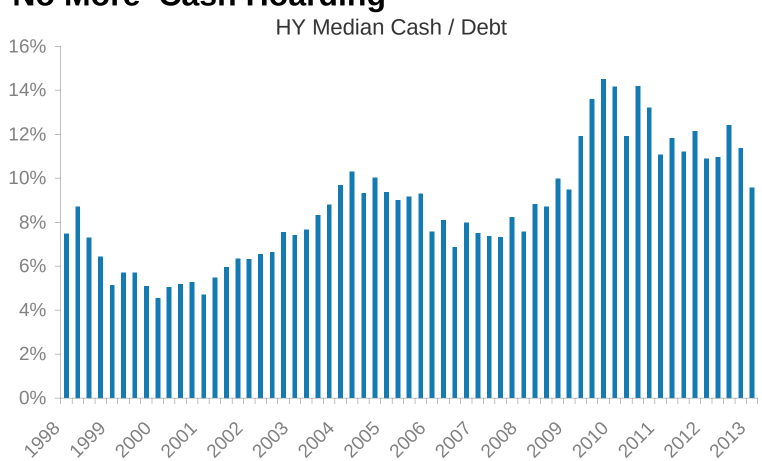
Source: Morgan Stanley, Bloomberg, Company Filings

…Leverage Is Trending Higher as a Result



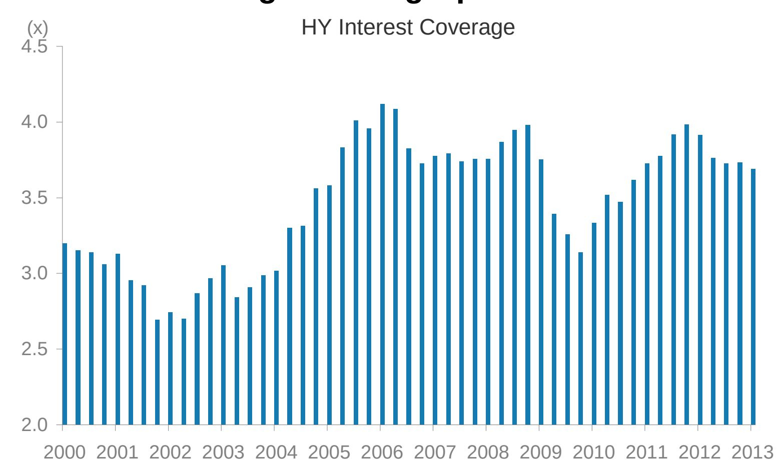
Source: Morgan Stanley, Bloomberg, Company Filings

No More 'Cash Hoarding'



Source: Morgan Stanley, Bloomberg, Company Filings

Interest Coverage Holding Up Given Low Interest Costs

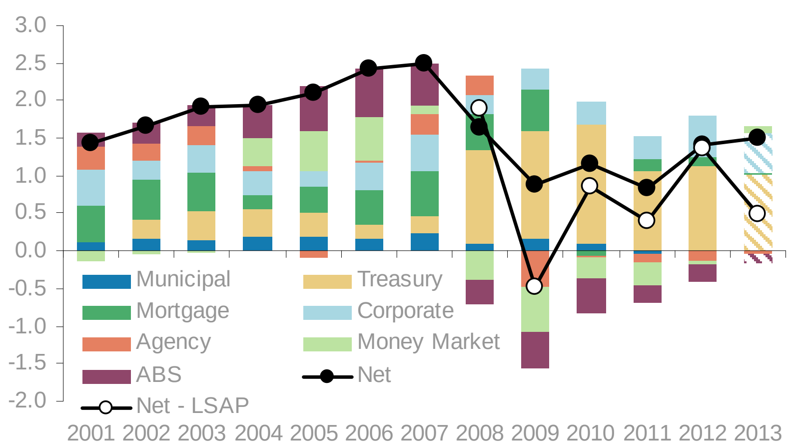


Source: Morgan Stanley, Bloomberg, Company Filings

The Impact of QE on Credit

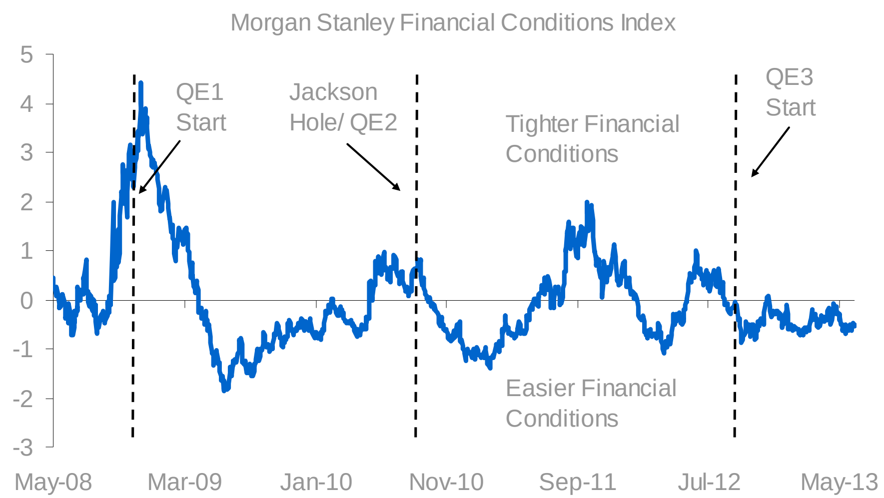
- In our view, the rally in markets this year has been more about reduced tail risks (Europe and DC specifically) than purely QE. But QE has helped.
- QE theoretically works through various channels. The Fed is taking fixed income supply out of the market, lowering interest rates and pushing investors out the risk spectrum. QE also drives easier financial conditions.
- Though direct economic impacts may be minimal, if investors expect QE to work, it works.

The Fed Has Taken Substantial Fixed Income Supply Out of the Market



Source: Federal Reserve Board, Haver Analytics, Morgan Stanley Research estimates

QE Has Coincided with Easier Financial Conditions

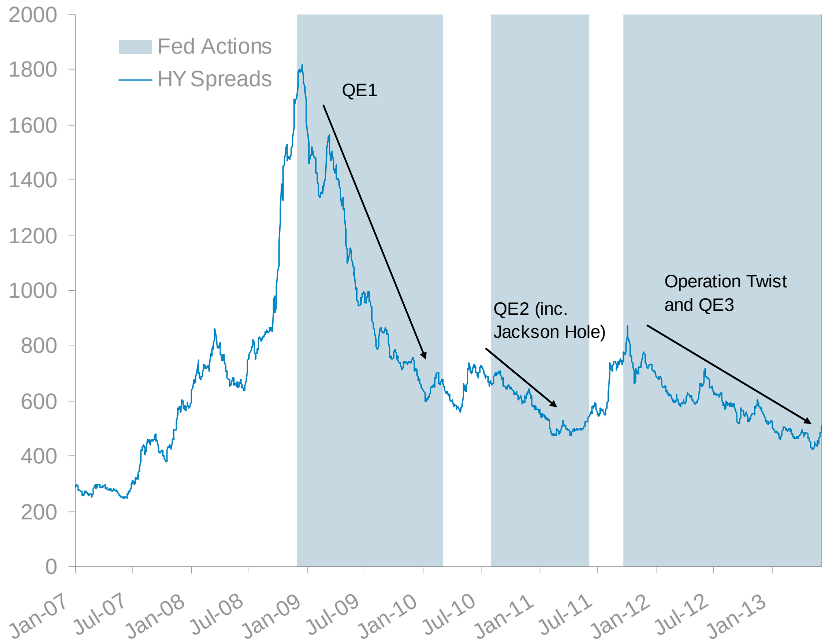


Source: Morgan Stanley Research, Bloomberg

Fearing the Taper

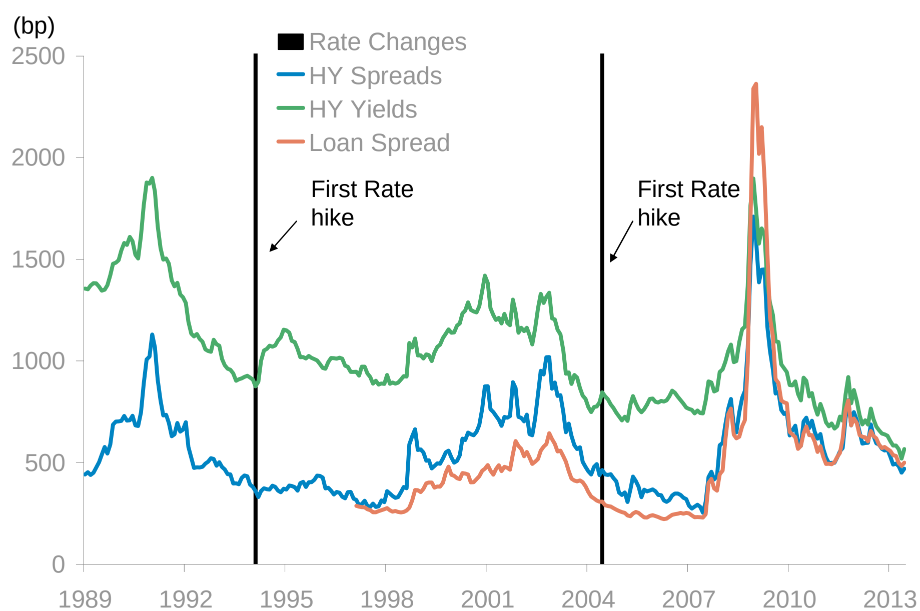
- Markets have not done well in between prior periods of QE.
- Three potential scenarios post QE3:
  - The Fed tapers, growth accelerates, rates are stable – 'Goldilocks'
  - The Fed tapers, the economy can't handle it so growth rolls over, rates rally – Bigger bear case
  - The Fed tapers, growth accelerates, rates sell off more than expected – Smaller bear case

Corrections in Credit Have Come Between Rounds of QE



Source: Morgan Stanley Research, Bloomberg, the Yield Book

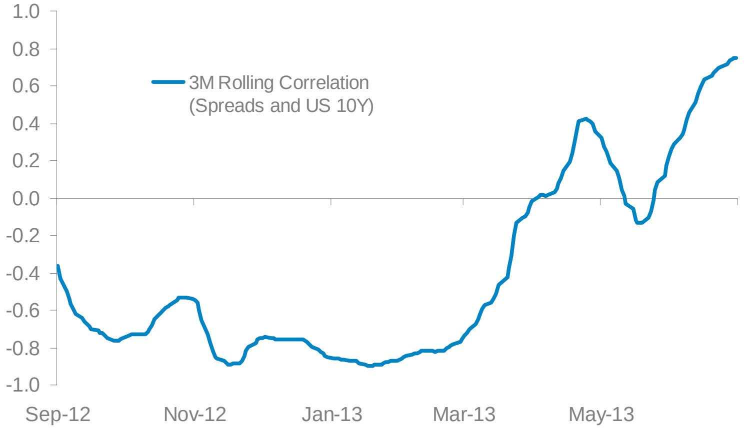
The Initial Removal of Liquidity by the Fed Historically Does Not Mark the Cycle Tights in Spreads



Source: Morgan Stanley Research, Bloomberg, the Yield Book

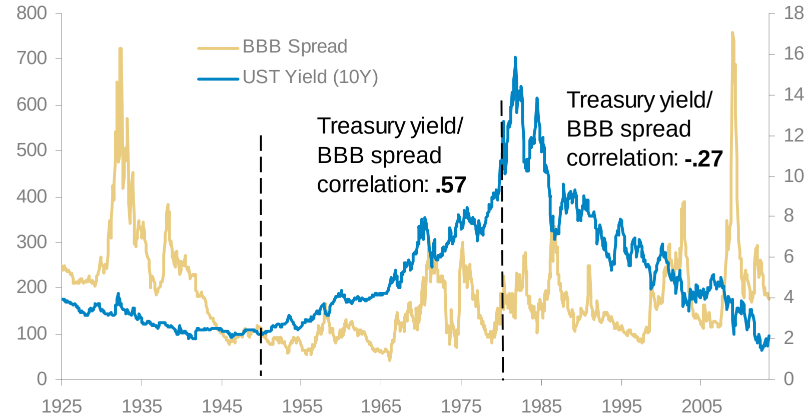
If Rates Rise Because the Market Anticipates the End of QE, Spreads May Not Tighten

Usually Higher Rates = Tighter Spreads, but that Correlation is Breaking Down



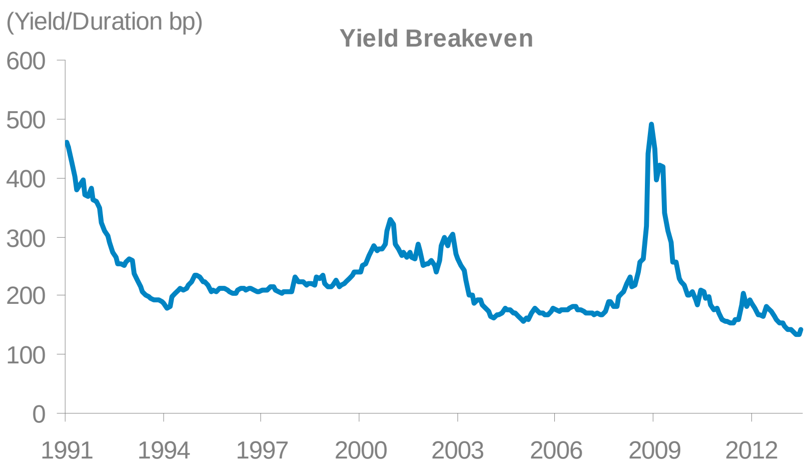
Source: Morgan Stanley, the Yield Book, Bloomberg

A Positive Correlation Between Rates and Spreads is Not Unprecedented



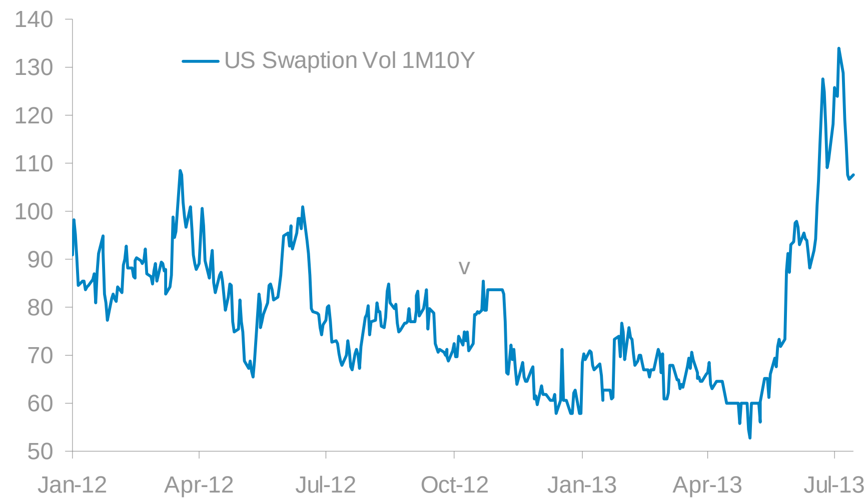
Source: Morgan Stanley, the Yield Book, Bloomberg, Moody's

Breakevens are Low and Negative Total Returns Can Drive Outflows



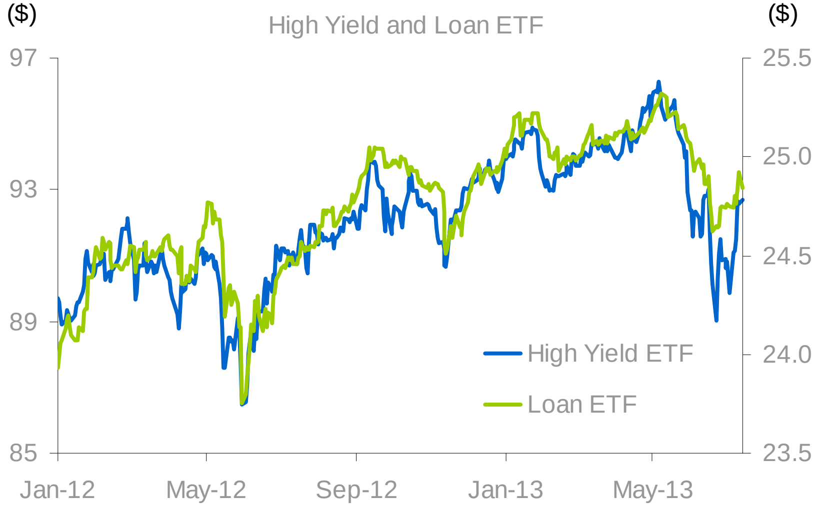
Source: Morgan Stanley, the Yield Book

Rising Volatility Requires a Larger Risk Premium

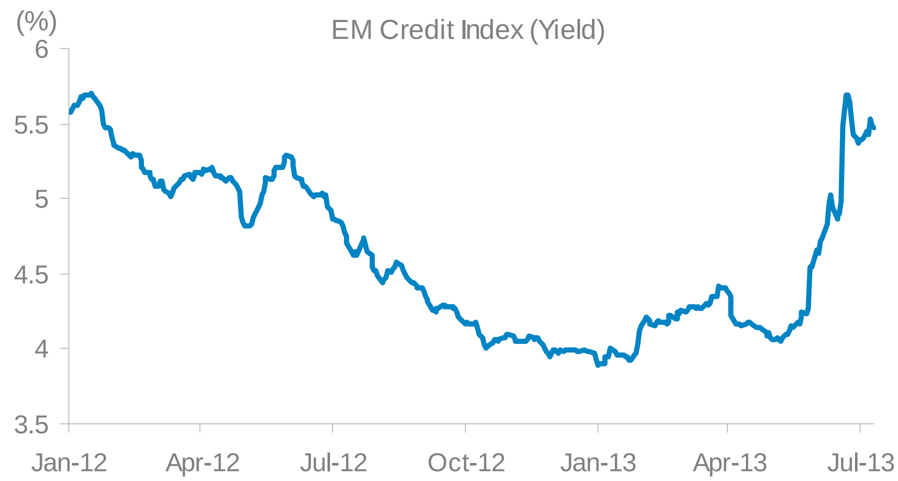


Source: Morgan Stanley, Bloomberg

QE Has Driven a Chase for Yield, and that 'Yield Trade' Unraveled in June



Source: Morgan Stanley, Bloomberg



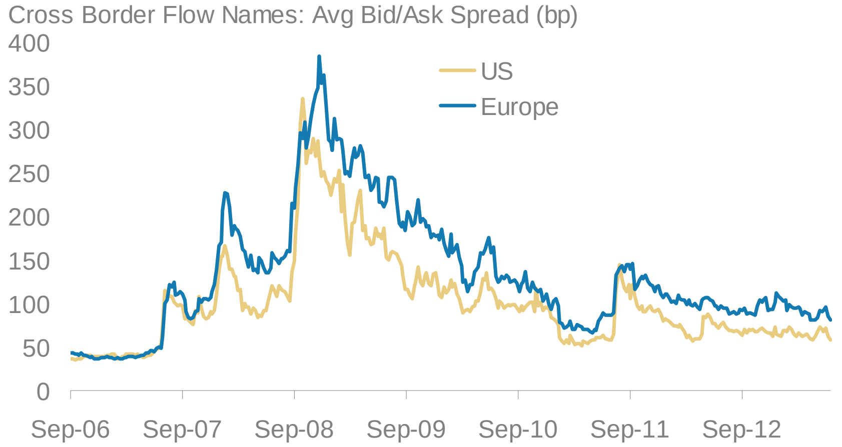
Source: Morgan Stanley, Bloomberg, the Yield Book

Source: Morgan Stanley, Bloomberg

Source: Morgan Stanley, Bloomberg

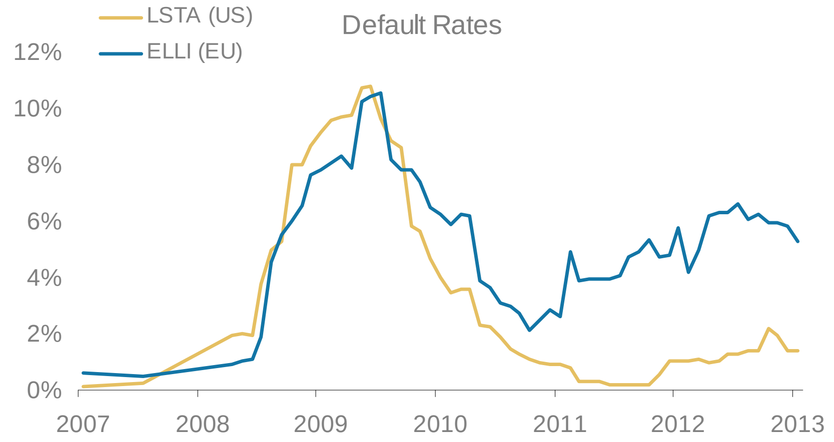
US versus European Loans – Fundamentals Generally Weaker in Europe

Liquidity and Transparency are Worse in Europe



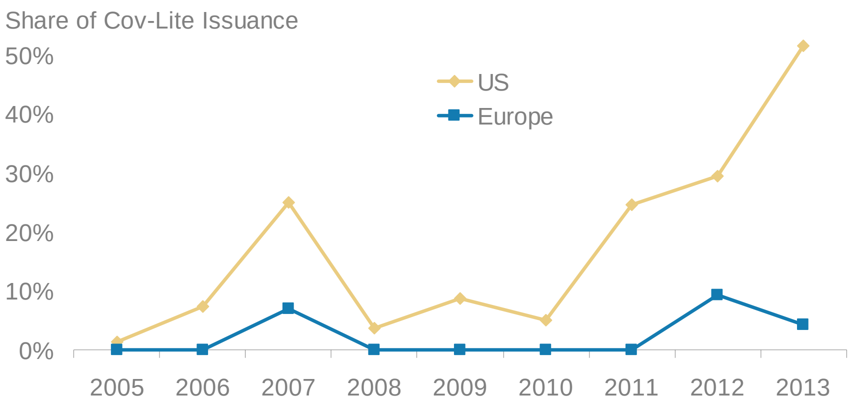
Source: Morgan Stanley, S&P LCD

Loan Default Rates Much Higher in Europe



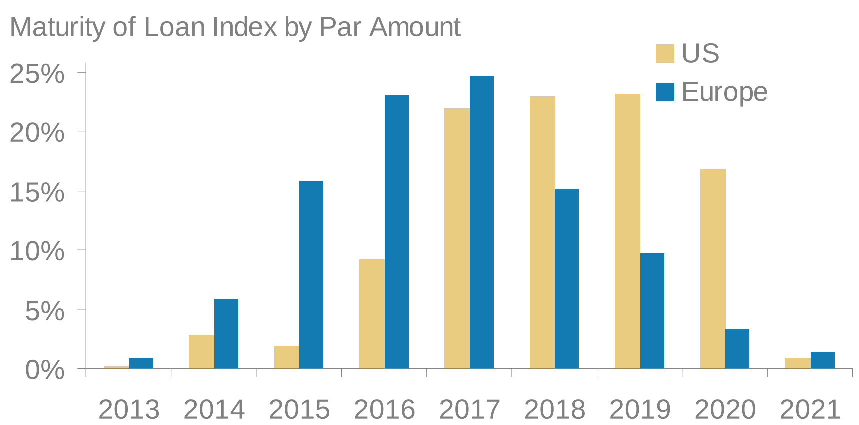
Source: Morgan Stanley, Bloomberg, Company Filings

But Credit Conditions Very ‘Issuer Friendly’ in the US



Source: Morgan Stanley, S&P LCD

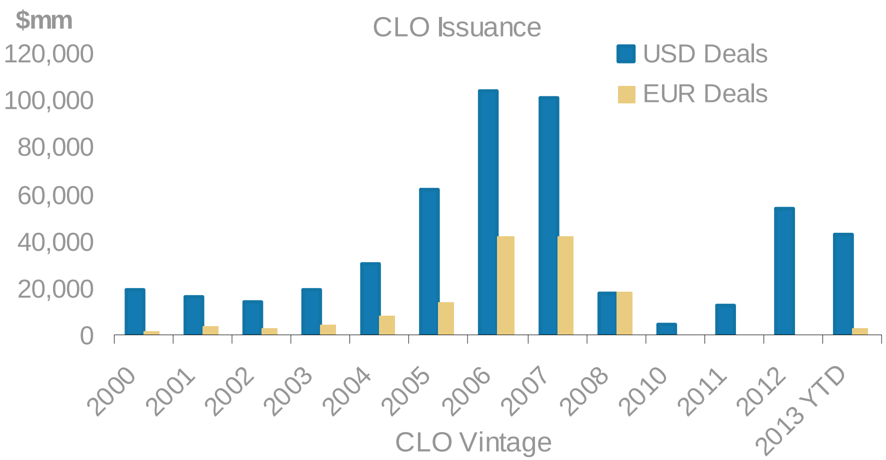
More Front-Loaded Maturities in Europe



Source: Morgan Stanley, S&P LCD

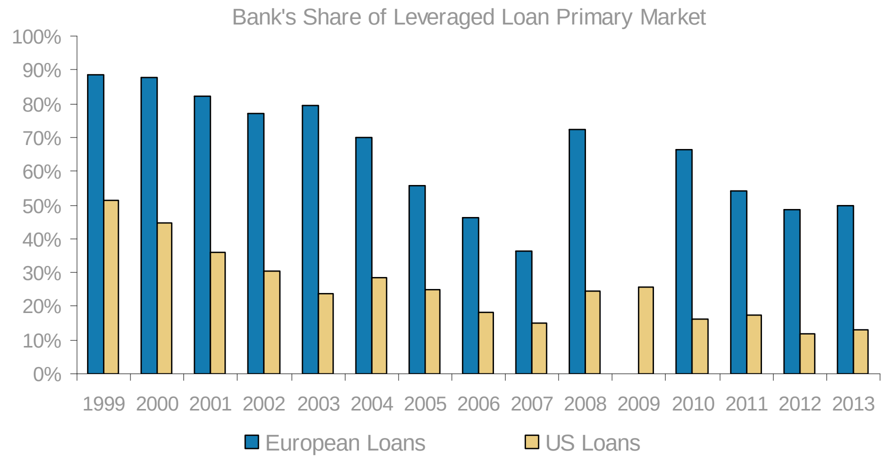
US versus European Loans – Both Supply and Demand Stronger in the US

Demand Stronger in the US Given Fund Inflows and CLOs



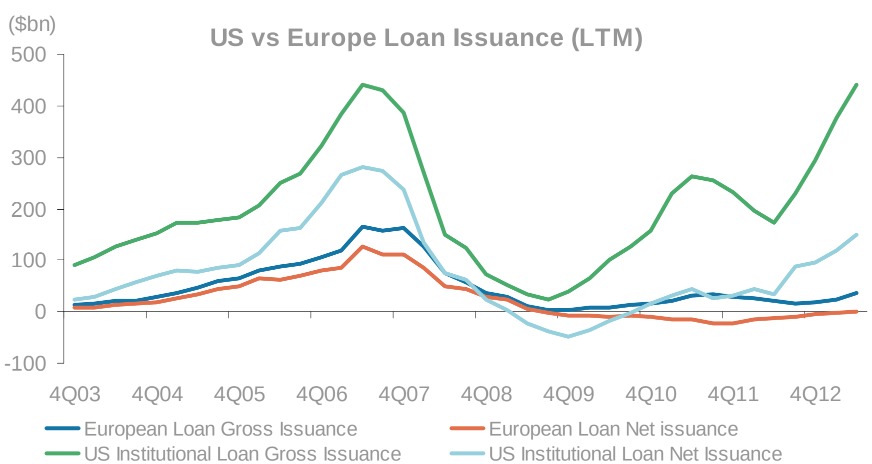
Source: Morgan Stanley, S&P LCD

European Demand Hamstrung by High Bank Ownership



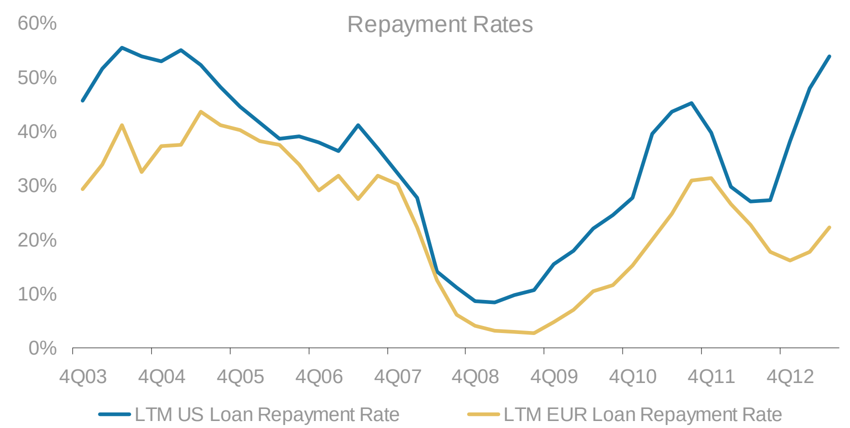
Source: Morgan Stanley, S&P LCD

Technicals Still Robust in Europe Given Weak Supply



Source: Morgan Stanley, S&P LCD

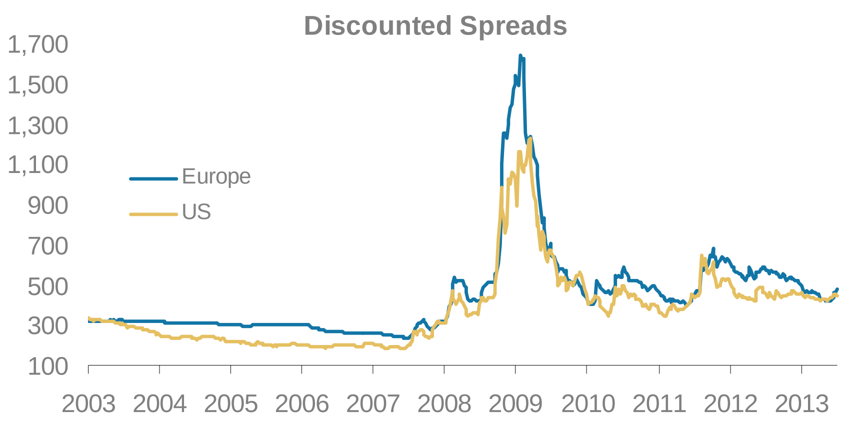
Strong Demand a Double-Edged Sword for US Loans



Source: Morgan Stanley, S&P LCD

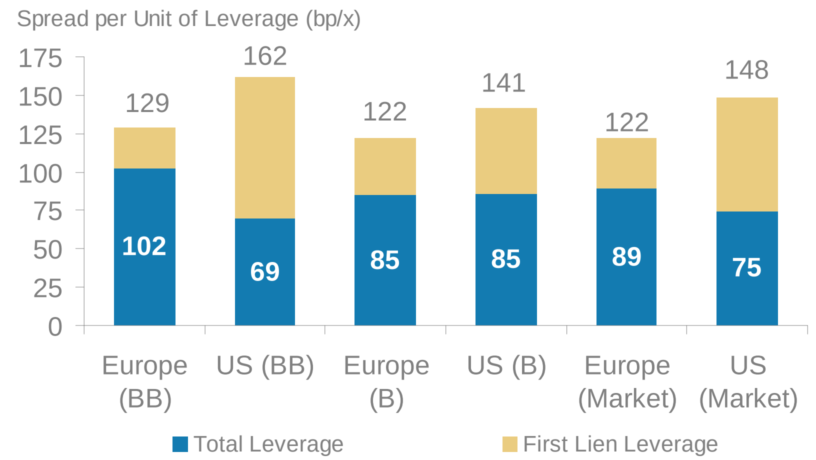
Risk-Adjusted Valuations More Attractive in US Loans, but Dispersion Higher in Europe

Spreads Only 30bp Wider in the European Loan Market



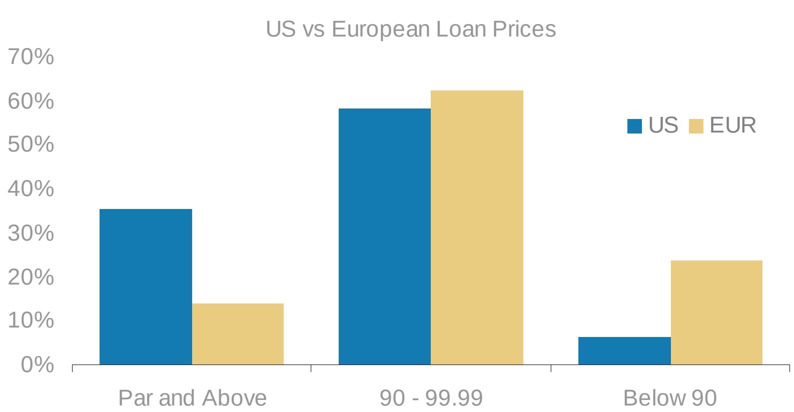
Source: Morgan Stanley, S&P LCD

Risk-Adjusted Valuations a Bit Better in the US



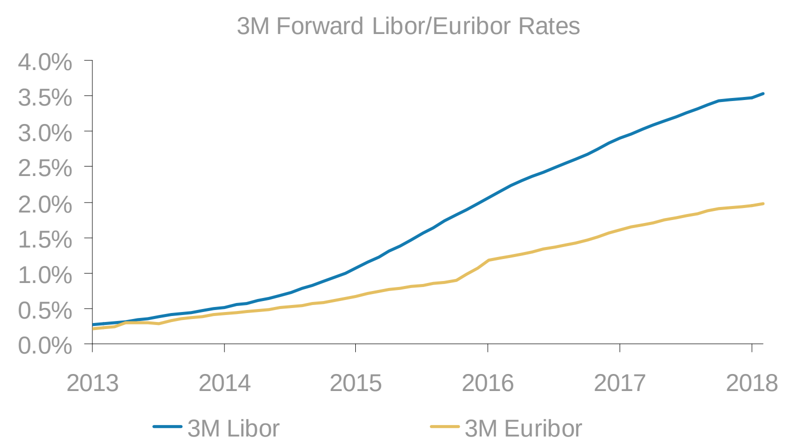
Source: Morgan Stanley, Bloomberg, Company Filings

Dispersion is Greater in Europe



Source: Morgan Stanley, S&P LCD

Rising Short Rates More Likely Down the Line in the US



Source: Morgan Stanley, Bloomberg

Relative Value – Single Names and CLOs

Comparing Spreads and Leverage for US and European Loans

EUR/US	Name	Sector	Gross Leverage	Lev. Through Loan	SPL (bp/x) Total Debt	SPL (bp/x) First Lien Debt
EUR	Wind	Telecom	5.2x	3.5x	101	148
US	Level 3 Communications	Telecom	5.7x	1.8x	76	241
EUR	ISS	Services	6.9x	5.6x	51	62
US	Catalina Marketing	Services	6.8x	2.5x	52	142
EUR	Smurfit Kappa	Packaging	3.4x	3.4x	110	110
US	Berry Plastics	Packaging	4.9x	3.2x	50	77
EUR	Gala	Gaming	6.2x	5.0x	82	102
US	MGM	Gaming	8.2x	2.1x	39	152
EUR	Schmolz	Industrial	6.3x	-	120	-
US	Rexnord	Industrial	5.3x	2.3x	63	145
EUR	Convatec	Healthcare	10.5x	4.6x	34	79
US	Kinetic Concepts	Healthcare	6.3x	3.0x	61	128
EUR	Bakkavor	Food & Bev	5.5x	5.5x	136	138
US	US Foodservice	Food & Bev	5.9x	4.2x	71	100
EUR	Ono	Cable/Media	4.6x	3.9x	118	139
US	Hubbard Radio	Cable/Media	4.7x	4.7x	86	86

Source: Morgan Stanley, Bloomberg, Company Filings

Comparison of US and European CLOs

New Issue Deals	Credit Enhancement		Spreads	
Original Rating	EUR CLO New Issue	US CLO New Issue	EUR CLO New Issue	US CLO New Issue
AAA	40%	36%	135	125
AA	32%	25%	175	205
A	25%	19%	290	350
BBB	20%	12%	425	450
BB	14%	7%	550	650

Legacy Deals	Credit Enhancement		Spreads	
Original Rating	Legacy EUR CLO	Legacy US CLO	Legacy EUR CLO	Legacy US CLO
AAA	38%	43%	175	120
AA	25%	28%	315	210
A	14%	19%	490	310
BBB	11%	12%	700	425
BB	8%	9%	900	630

Source: Morgan Stanley, S&P LCD

European Dollar Issuers Since 2012

Issuer	Industry	Facility Rating	Most Recent Deal	Deal Size($MM)
Springer Science and Business Media	Printing & Publishing	NR/NR	Jul-13	1559
Ocean Rig UDW	Oil & Gas	B+/B2	Jun-13	1800
Technicolor SA	TV	B/B3	Jun-13	830
Polyconcept Holding BV	Services & Leasing	B/Ba3	Jun-13	296
Armacell International GmbH	Building Materials	CCC+/Caa2	Jun-13	85
Navios Maritime Holdings Inc	Transportation	BB/Ba3	Jun-13	250
Emerald Expositions Holdings	Services & Leasing	BB-/B2	Jun-13	90
Merlin Entertainment Group	Entertainment & Leisure	BB-/B1	May-13	602
Jazz Pharmaceuticals Plc	Healthcare	BB+/Ba3	May-13	757
Allflex Holdings Inc	Manufacturing & Machinery	NR/NR	May-13	240
Oxea Group	Chemicals	CCC+/Caa1	May-13	325
CSM Bakery	Food & Beverage	CCC+/B3	May-13	150
Clondalkin Group plc	Forest Product	NR/Caa2	May-13	95
Pacific Drilling SA	Oil & Gas	BB/NR	May-13	500
ION Trading Technologies	Computers & Electronics	CCC+/Caa2	May-13	375
FLY Leasing Limited	Services & Leasing	BBB-/B1	May-13	380
LBC Tank Terminals	Transportation	BB/NR	Apr-13	396
Grohe Holding GmbH	Building Materials	B-/B2	Apr-13	255
SS&C Technologies Holdings Europe S.A.R.L	Computers & Electronics	BB/Ba3	Apr-13	66
UPC Holdings	Cable	BB-/Ba3	Apr-13	1303
Covis Pharma Sarl	Healthcare	B/B3	Apr-13	240
ISS Global	Services & Leasing	BB-/Ba3	Mar-13	350
AWAS Aviation Capital Ltd	Services & Leasing	BBB/Ba2	Mar-13	347
Constellium France SAS	Metals & Mining	B/B1	Feb-13	360
Schaeffler AG	Automotive	B+/Ba3	Feb-13	1700
Monarch	Chemicals	B-/B3	Feb-13	150
Univar NV	Chemicals	B+/B2	Feb-13	250
Kabel Deutschland GmbH	Cable	BB/Ba2	Jan-13	750
Taminco NV	Chemicals	BB-/B1	Jan-13	348
Alcatel-Lucent	Telecom Equipment	BB-/B1	Jan-13	1750
NXP Semiconductors	Computers & Electronics	B+/B2	Dec-12	500
Dematic	Manufacturing & Machinery	B/B1	Dec-12	615
Fresenius AG	Healthcare	BBB-/Baa3	Nov-12	1300
AZ Electronic Materials	Computers & Electronics	NR/NR	Nov-12	440
Kloeckner Pentaplast GmbH & Co KG	Chemicals	B/Ba3	Oct-12	435
Fresenius Medical Care AG	Healthcare	BBB-/Baa3	Oct-12	3200
BSN Medical GmbH	Healthcare	B+/Ba3	Oct-12	289
Intelsat S.A.	Telecom	BB-/B1	Sep-12	3718
Algeco Scotsman Group	Building Materials	NR/NR	Sep-12	1250
Excelitas Technologies Corp	Computers & Electronics	BB-/B1	Aug-12	223
ELO Touch Solutions	Computers & Electronics	CCC+/Caa1	May-12	85
LyondellBasell Industries	Chemicals	NR/NR	Apr-12	2000
Oberthur Technologies	Computers & Electronics	B/NR	Mar-12	250
Grifols SA	Healthcare	BB/Ba3	Jan-12	2500

Source: Morgan Stanley, S&P

Securitized Products Strategy

Effect of Higher Rates on the Housing Recovery

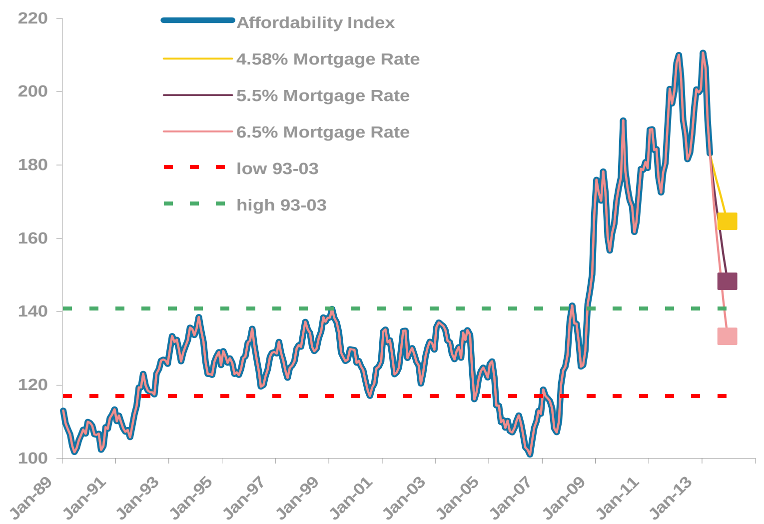
Despite the recent rise in rates, we remain constructive on US Housing prices.

- Our 6% - 8% call for 2013 remains intact, and we think risks are to the upside for our call.
- While we expect the rate of increase to moderate over the next 12-24 months, this is already reflected in our base-case projections: up 4% - 6% in 2014 and 3% - 5% in 2015.

Mortgages remain affordable relative to long-term average.

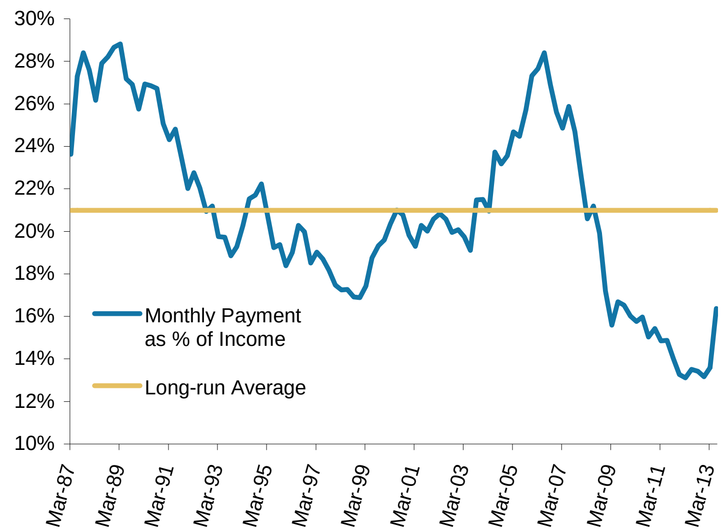
- While the combination of HPA and rate increases has brought NAR's affordability index down from recent peaks, it remains well above its usual range.
- At 16.4%, mortgage payments as a proportion of median family income remain well under the long-run average of 21%.

Understanding the Sensitivity of NAR's Mortgage Affordability Index to Mortgage Rates



Source: NAR, Morgan Stanley Research

Monthly Payments as a Percent of Income Remain Well Below Average



Source: DataQuick, Morgan Stanley Research

Effect of Higher Rates on the Housing Recovery (Cont.)

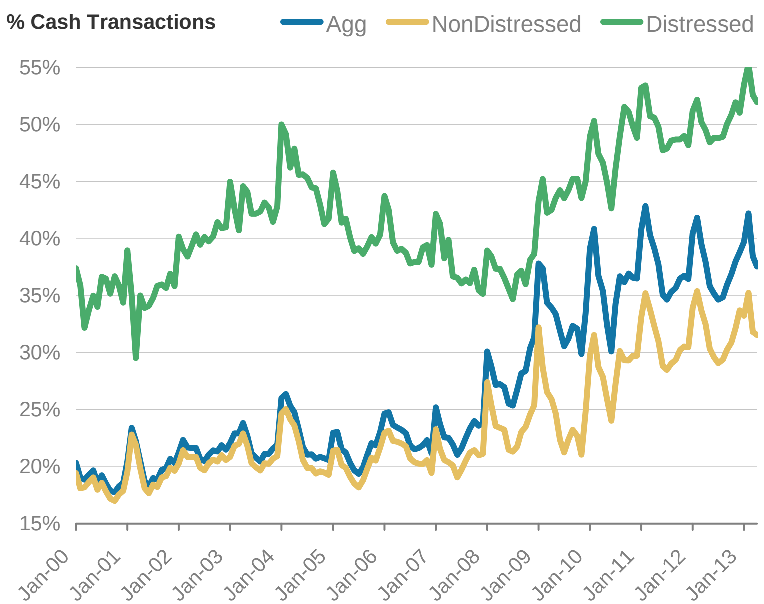
Recent Rise in Cash Sales

- The share of cash buyers has doubled, from around 20% pre-crisis to nearly 40% currently.
- By definition, this segment is less sensitive to the level of rates.

Refinance Likely to Be Impacted More Than Purchase

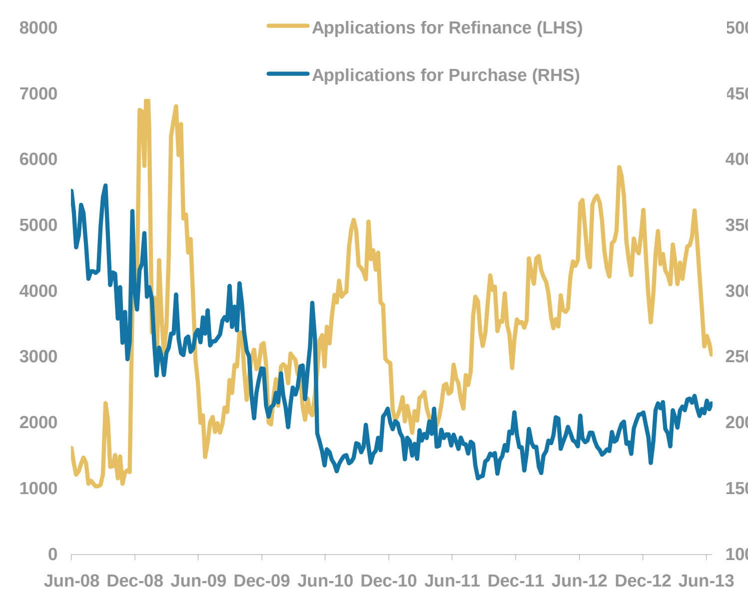
- Higher rates have made refinancing less attractive as the incentive to refinance has been reduced.
- However, the volume of purchase mortgages has remained relatively stable – up 16% year-over-year.

Share of Cash Sales has Doubled from Pre-Crisis



Source: DataQuick, Morgan Stanley Research

Refinance Applications Fall While Purchase Applications Grind Higher



Source: Bloomberg, Morgan Stanley Research

Effect of Higher Rates on the Housing Recovery (Cont.)

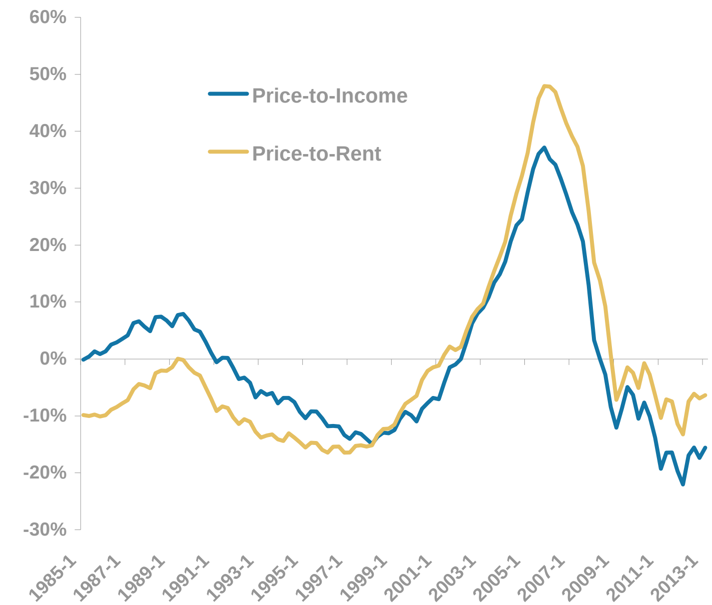
Valuation Metrics Remain Supportive

- Price-to-rent and price-to-income ratios are below their long-term historical averages by 6.4% and 15.6%, respectively.

Increasing Supply Is a Concern

- Tight supply had been a tailwind to the housing recovery, but it is beginning to be less so.
- Beginning in January of this year, both new and existing supply have increased every month. New homes available for sale have increased 9% while existing inventory has jumped 25%.

Housing Remains Undervalued



Source: Bloomberg, Morgan Stanley Research

Has Supply Finally Bottomed?

Source: Bloomberg, Morgan Stanley Research

Rising Rates and Relative Value in CLOs

The recent sell-off in rates has led to a rough few weeks across risk assets, including CLOs.

Floating Rate Nature of CLOs

Relative to fixed rate credit products, the CLO structures with floating rate assets and floating rate liabilities are significantly less exposed to interest rate risk and thus offer an attractive value proposition.

Slower Loan Prepayments

Higher rates, wider loan spreads and lower market liquidity for loans decrease the prospects for loan repricings, and by extension, loan prepayment rates in CLOs. This helps moderate the recent trend of declining weighted average spreads (WAS) in CLO portfolios, which is a positive for excess spread in completed CLO transactions and thus a positive for distributions to equity tranches in those deals. Slower prepayments have the negative effect of prolonging the remaining weighted average life (WAL) of amortizing debt tranches, particularly the senior tranches.

Optional Redemptions

Optional redemption activities of legacy CLOs may also slow down in the near term, as lower asset prices reduce the liquidation value of the equity tranches, and wider spreads in new CLO formations may provide fewer opportunities for refinancing through optional redemptions..

Effects on CLO New Issuance

Notwithstanding the spread widening observed in CLO liabilities, given the changes on the asset spreads, excess spread for new issue CLOs remains substantial, and therefore, our projection for US CLO new issuance for 2013 remains in the $60-70 billion range.

Changes in Relative Value Across Capital Structure

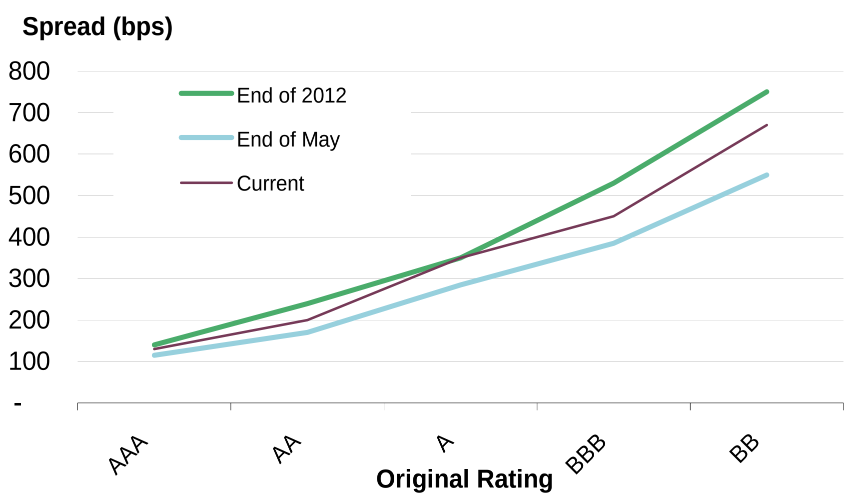
Given the spread widening in this sell-off, the relative value proposition in CLO debt has shifted down in the capital structure – in favor of mezzanine tranches (A, BBB and BB tranches) in both legacy and new issue transactions.

Source: Morgan Stanley estimates, the Yield Book historical

Relative Value – CLOs vs CMBS

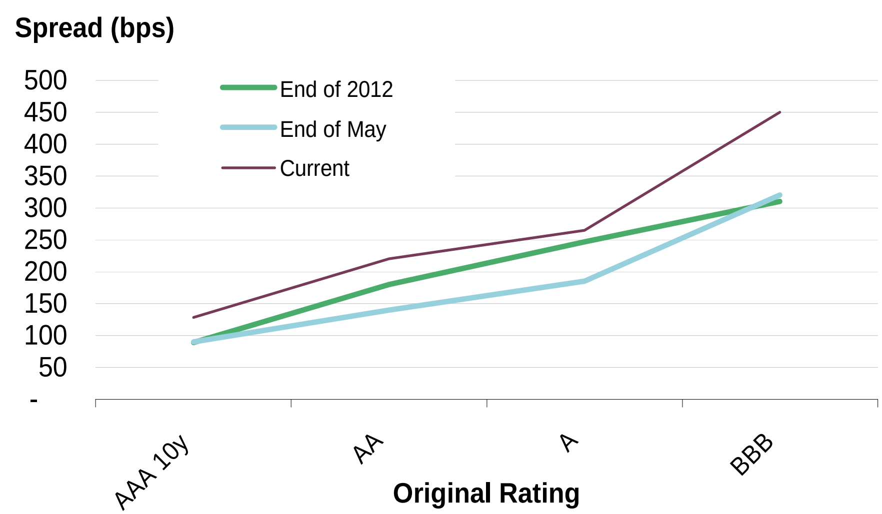
- Credit curves in new issue CLOs and CMBS both have steepened in June, with CMBS widening more so that new issue spreads of the two products now stand at a comparable level. Currently, on a spread basis, AAA tranches of both are roughly in the same context (125-130bp).
- The relative value argument between the fixed rate CMBS AAAs and the floating rate CLO AAAs in effect boils down to expectations of the extent of increase in 10-year rates versus the carry differential, currently at about 2.4% over the next two years. We estimate the break-even level of rise in 10-year rates to offset the carry differential of 2.4% to be roughly in the range of 50-60bp. In other words, if investors expect that 10-year rates will increase by less than 50-60bp over the next two years, the carry differential compensates for the interest rate risk in the fixed rate CMBS AAA bonds. On the other hand, if expectations are for 10-year rates to increase more than 50-60bp over the next two years, the better interest rate protection in the CLO AAAs offsets the carry differential.

New Issue CLO Pricing Spreads



Source: Morgan Stanley Research, S&P LCD
Note: Current CLO spreads represent DMs.

New Issue CMBS Pricing Spreads



Source: Morgan Stanley Research

Emerging Markets Strategy

Tactically Equalweight on EM Credit

Pockets of value in EM Credit Following Sharp Re-pricing

We maintain our tactically Equalweight call on EM credit. Since mid-May, investors have re-priced the EM asset class to factor in risks from i) increased volatility; ii) poor secondary market liquidity; iii) less favourable fundamentals; and iv) a possible negative feedback loop between a stronger USD and upward pressure in local rates with a possible negative impact on EM growth.

Medium-term risks limit scope for a sustained recovery in asset prices. The prospect of less abundant global liquidity has caused investors to scrutinise their holdings more closely. Secondly, a further downturn in China growth is likely to have knock-on effects in the rest of EM.

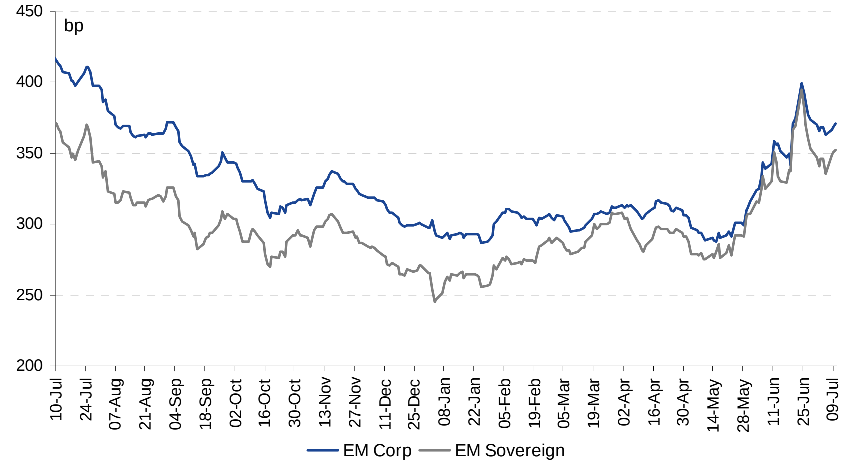
Looking at the broader asset class, EM corporates have outperformed sovereign credit

EM corporate total return YTD is -4.4% outperforming sovereign returns of -9.1%. The broader EM corporates outperformance versus sovereign is a function of the higher carry and shorter average duration of corporates.

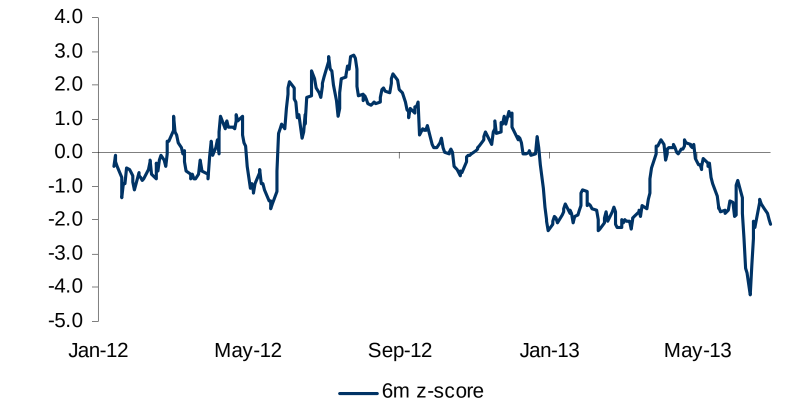
On a historical basis, EM corporates look rich versus sovereigns. However, when we risk-adjust the spread moves in corporate credit, over the past month there has in fact been underperformance.

See *EM Strategy Update: Tilting to Neutral Stance*, June 28, 2013.

EM Corporate Has Lagged the Recent Sovereign Rebound



EM Corporates Still Look Relatively 'Rich' to Sovereigns



Source: Morgan Stanley Research, Bloomberg

In EM Credit, We Are Positioned Defensively

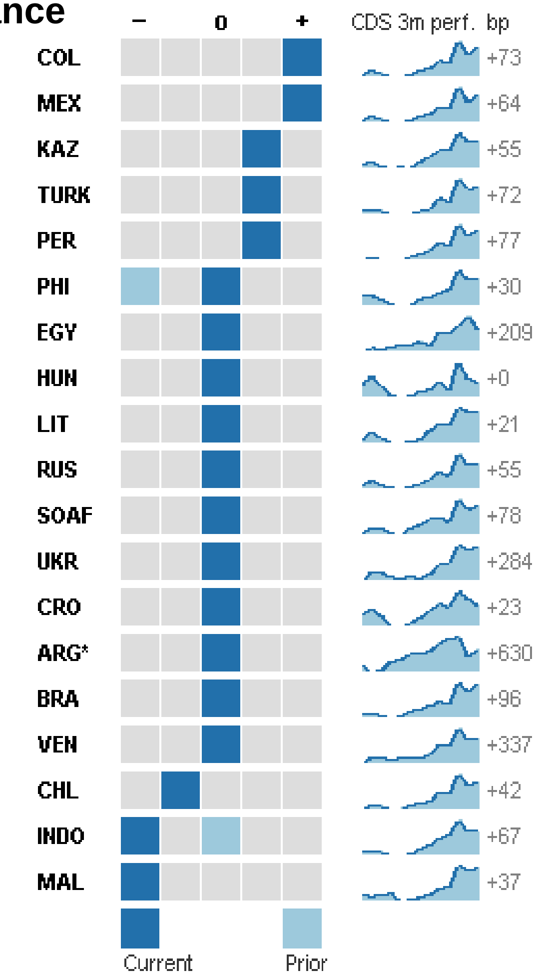
Near-term volatility and medium-term headwinds cause us to position defensively

Valuations are more attractive and the technical backdrop is currently favourable; however, fundamentals remain a headwind. At the core of our medium-term view is the deterioration in macro fundamentals. As we highlighted above, China growth concerns are likely to cap a sustained rally in EM credit. Nevertheless, valuations and positioning will allow for more stable market conditions in the near term.

We reiterate our preference for low-beta credits. LatAm IG suffered the most in the recent selloff, as investors reduced positions in the liquid bonds most exposed to moves in UST. Given our view that a large part of the UST move is likely behind us, our largest overweight positions in our sovereign portfolio are Mexico and Colombia.

In corporate credit, we look for opportunities in quasi-sovereign corporates. We maintain a relatively defensive stance in EM corporate credit. We are focused on credits with strong underlying credit fundamentals where the recent moves have created more attractive risk/reward. Being mindful of supply risk, we see value in QS O&G credits and selected senior quasi-sovereign bank bonds. In the IG space, we like CDEL '21, KZOKZ '43 and BANBRA '20.

EM Sovereign Credit Relative Assessment and 3m Performance



Notes: Indicative pricing for CDEL 3.875's maturing on 11/3/21, KZOKZ 5.75's maturing on 4/30/43, and BANBRA 5.375's maturing on 1/15/21 are $100, $91, and $100 respectively. Source: Morgan Stanley Research, Bloomberg

EM Yankees Market Has Weighed Down Index Excess Returns

Negative US IG total returns are mainly due to rates movements and not EM

US IG total returns YTD are approximately -3.2%. For the US IG index, almost all of the negative return has occurred due to the bear steepening in the rates curve. In other words, credit risk has not materially repriced higher overall.

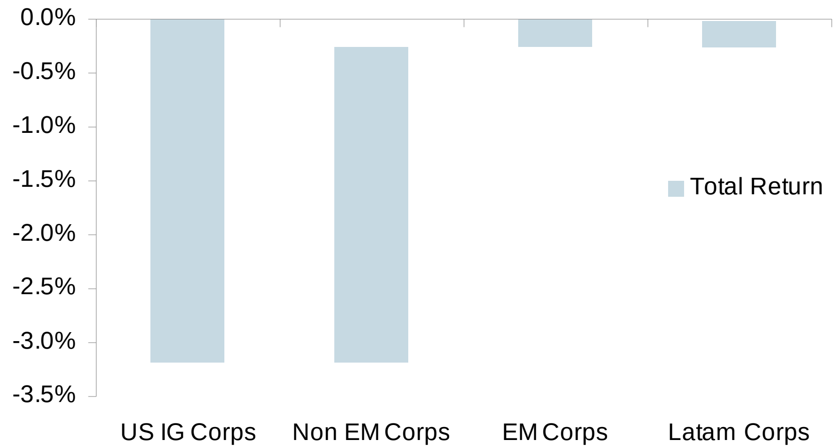
EM IG corporates total returns YTD are approximately -7.9%, but their market weight is only ~3% of the index. As such, the impact of EM on the index is marginal (with the bulk coming from LatAm), contributing only -0.3% to the index YTD total return.

Meanwhile EM has pulled down excess returns

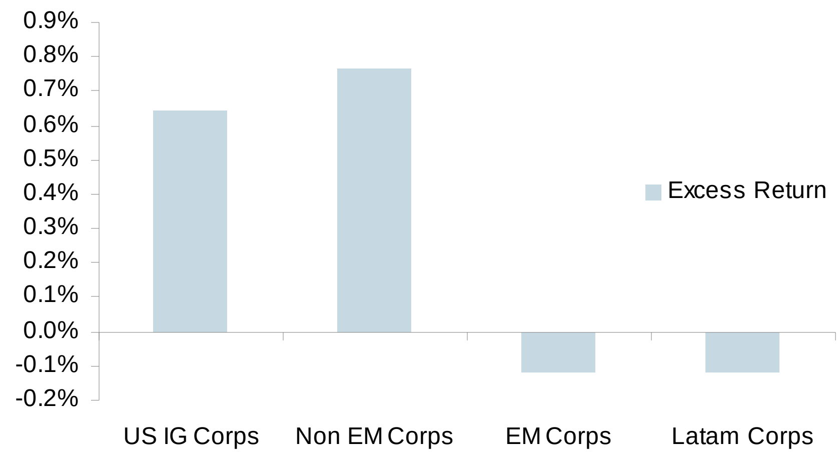
US IG excess returns YTD are approximately +0.6% YTD: Spreads continue to be positively range-bound despite the rates movements in the IG market. This makes sense in the context of potentially higher growth and earnings, low inflation, strong balance sheets, and natural buyers of long-dated risk.

The EM credit risk component in US IG indices has deteriorated as YTD excess returns are -3.8%, bringing down the US IG index return. Since the YTD US IG excess return was relatively small, the negative EM sector excess return contributed a sizeable -0.1% to the index. In other words, the EM IG Yankees sector cut excess returns for the index by ~20%.

EM IG Yankees contribution to total returns small



But for excess returns, EM sector is significant



Source: Morgan Stanley Research, Bloomberg, Yieldbook.

EM Yankee Segments Also Underperformed US IG Counterparts

EM IG Yankee corporates have underperformed when controlling for sector…

Non-Financials and Financials have underperformed equally: Both Fins and non-Fins have underperformed their US IG counterparts by ~4% YTD for total and excess returns. However, non-Financials is a much larger sector (~$98Bn versus ~$6Bn).

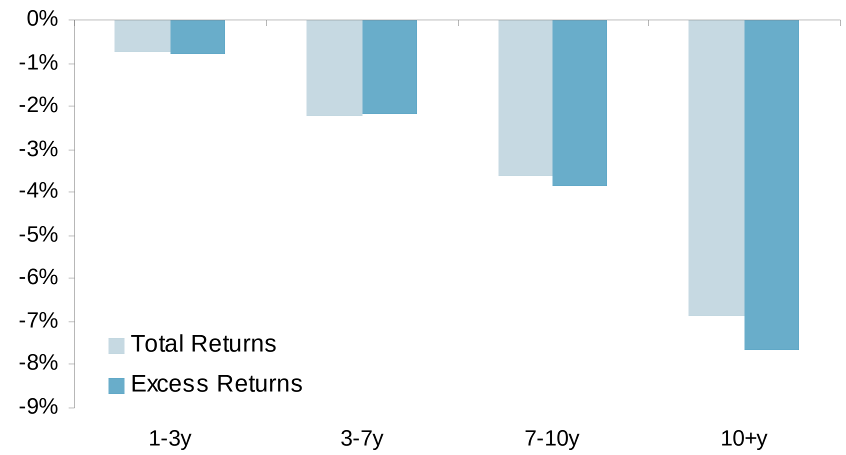
Mainly long-dated Brazilian and Mexican quasi-sovereign and benchmark bonds have spearheaded the move lower. Nearly half (6 of 14) bonds issued with large notionals (>$1Bn) have logged double-digit excess return losses. These issuers include Vale, Petrobras, and America Movil.

…and for maturity and rating

The long end has underperformed the most…: The average OAS change for the 10+ maturity sector is ~+60bps YTD, while for the index, it was only +14bps. In fact, the EM IG Yankee >10y maturity sector has returned 6.9% and 7.7% less relative to its index counterpart in terms of total and excess returns.

…as has lower quality EM IG Yankees. BBB EM Yankees had a spread selloff of +~60bps versus an US IG index selloff of only 10bps. In fact, the EM IG Yankee BBB sector has returned 5.9% and 5.1% less relative to its index counterpart in terms of total and excess returns.

EM Yankees vs. US IG index returns by maturity



EM Yankees vs. US IG index returns by rating

Source: Morgan Stanley Research, Bloomberg, Yieldbook.

Within EM Yankees, LatAm Has Lagged

We saw some dispersion within EM Yankees

Overall corporates slightly outperformed sovereigns. Within EM Yankees, sovereigns produced -9.1% and -4.9% total and excess returns and EM corporates produced -7.9% and -3.8% total and excess returns.

LatAm performed the worst. LatAm sovereigns and corporates returned -5.7% and -4.4% excess return YTD (-10.8% and -8.3% total return YTD).

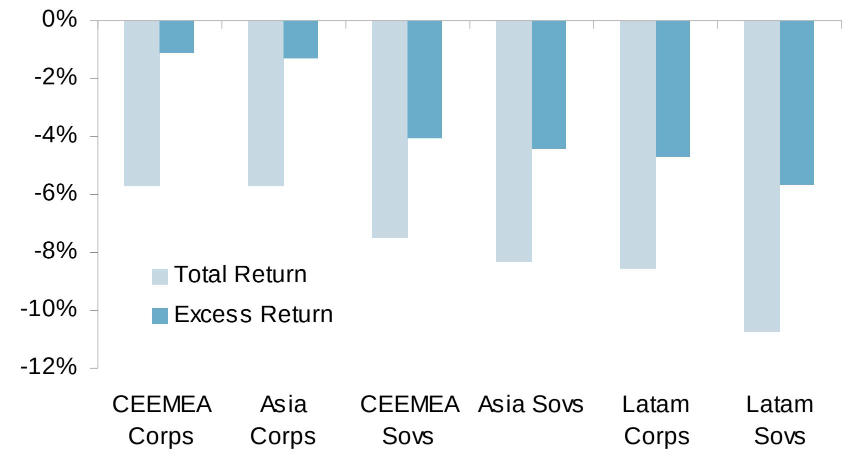
Within LatAm, the largest issuer countries spearheaded the move lower. Both Brazil and Mexico sovereigns and corporates (the two largest Yankee issuer countries) contributed greatly with -11% and -9% total returns YTD.

EM sector contributed marginally negative return volatility

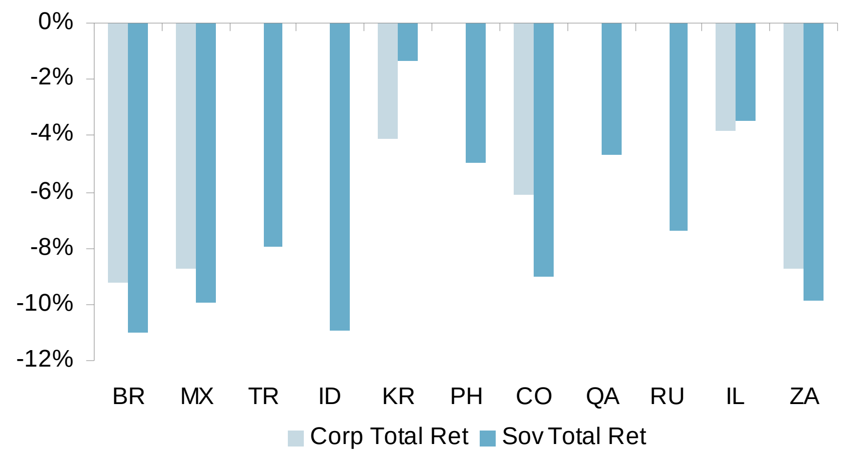
EM IG Yankees realized return volatility was significantly higher than the index. The EM sector generated 4.8% annualized monthly return vol versus 2.8% for the US IG index. Due to the small size of the sector, the incremental vol from the sector was only ~0.1%.

Portfolios with higher EM allocations risk greater return volatility. Although we still like certain pockets in EM, we are cautious with an Equalweight recommendation overall, in part, because of greater volatility of returns.

EM IG Yankee returns by region



Largest issuer countries underperformed



Source: Morgan Stanley Research, Bloomberg, Yieldbook, TRACE.

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(as of June 30, 2013)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1020**	**36%**	**410**	**39%**	**40%**
Equal-weight/Hold	**1263**	**44%**	**485**	**47%**	**38%**
Not-Rated/Hold	**109**	**4%**	**24**	**2%**	**22%**
Underweight/Sell	**469**	**16%**	**123**	**12%**	**26%**
Total	**2,861**		**1042**		

Data include common stock and ADRs currently assigned ratings. 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. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O). The stock's total return is expected to exceed 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). The stock's total return is expected to be in line with 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 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). The stock's total return is expected to be below 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.

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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.

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