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2024 Global Strategy Outlook

Threading the Needle

The end of hikes and start of cuts mean high grade bonds outperform, USD stays strong, and EM assets lag. US stocks see positive returns but risks are front-loaded. With markets pricing in a smooth macro transition, there's little room for error.



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Contributors



MORGAN STANLEY & CO. LLC

Serena W Tang

Strategist

+1 212 761-3380

Serena.Tang@morganstanley.com



MORGAN STANLEY INDIA COMPANY PRIVATE LIMITED+

Soham Sen

Strategist

+91 22 6514-3442

Soham.Sen1@morganstanley.com



MORGAN STANLEY & CO. LLC

Jay Bacow

Strategist

+1 212 761-2647

Jay.Bacow@morganstanley.com



MORGAN STANLEY & CO. LLC

Barbara A Boakye, CFA

Strategist

+1 212 761-1654

Barbara.Boakye@morganstanley.com



MORGAN STANLEY ASIA LIMITED+

Min Dai

Strategist

+852 2239-7983

Min.Dai@morganstanley.com



MORGAN STANLEY ASIA (SINGAPORE) PTE.+

Jonathan F Garner

Equity Strategist

+65 6834-8172

Jonathan.Garner@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Ronald Ho, CFA

Quantitative Analyst

+44 20 7425-2722

Ronald.Ho@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Stephan M Kessler

Quantitative Analyst

+44 20 7425-2854

Stephan.Kessler@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Neville Z Mandimika

Strategist

+44 20 7425-2509

Neville.Mandimika@morganstanley.com



MORGAN STANLEY & CO. LLC

Vishwas Patkar

Strategist

+1 212 761-8041

Vishwas.Patkar@morganstanley.com



MORGAN STANLEY & CO. LLC

Vishwanath Tirupattur

Strategist

+1 212 761-1043

Vishwanath.Tirupattur@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Erika J Singh-Cundy

Strategist

+44 20 7425-0960

Erika.Singh-Cundy@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Aron Becker

Strategist

+44 20 7677-0754

Aron.Becker@morganstanley.com



MORGAN STANLEY & CO. LLC

Stephen C Byrd

Equity Analyst

+1 212 761-3865

Stephen.Byrd@morganstanley.com



MORGAN STANLEY & CO. LLC

Guneet Dhingra, CFA

Strategist

+1 212 761-1445

Guneet.Dhingra@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Vasundhara Goel

Strategist

+44 20 7677-0693

Vasundhara.Goel@morganstanley.com



MORGAN STANLEY & CO. LLC

Matthew Hornbach

Strategist

+1 212 761-1837

Matthew.Hornbach@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

James K Lord

Strategist

+44 20 7677-3254

James.Lord@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Eric S Oynoyan

Strategist

+44 20 7425-1945

Eric.Oynoyan@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. INTERNATIONAL PLC+

Arif Ahmed

Strategist

+44 20 7425-1023

Arif.Ahmed@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

David S. Adams, CFA

Strategist

+44 20 7425-3518

David.S.Adams@morganstanley.com



MORGAN STANLEY ASIA (SINGAPORE) PTE.+

Daniel K Blake

Equity Strategist

+65 6834-6597

Daniel.Blake@morganstanley.com



MORGAN STANLEY & CO. LLC

Karen Chen

Strategist

+1 212 761-1199

Karen.Chen@morganstanley.com



MORGAN STANLEY & CO. LLC

James Egan

Strategist

+1 212 761-4715

James.F.Egan@MorganStanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Amy Gower (Amy Sergeant), CFA

Commodities Strategist

+44 20 7677-6937

Amy.Sergeant@morganstanley.com



MORGAN STANLEY & CO. LLC

Joyce Jiang

Strategist

+1 212 761-0165

Joyce.Jiang@morganstanley.com



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Giorgio Magagnotti, CFA

Equity Strategist

+44 20 7425-1965

Giorgio.Magagnotti@morganstanley.com



MORGAN STANLEY ASIA LIMITED+

Kelvin Pang

Strategist

+852 2848-8204

Kelvin.Pang@morganstanley.com



MORGAN STANLEY & CO. LLC

Mark T Schmidt, CFA

Strategist

+1 212 296-8702

Mark.Schmidt1@morganstanley.com

Contributors



MORGAN STANLEY & CO. INTERNATIONAL PLC+

Andrew Sheets

Strategist

+44 20 7677-2905

Andrew.Sheets@morganstanley.com



MORGAN STANLEY MUFG SECURITIES CO., LTD.+

Koichi Sugisaki

Strategist

+81 3 6836-8428

Koichi.Sugisaki@morganstanleymufg.com



MORGAN STANLEY & CO. LLC

Simon Waever

Strategist

+1 212 296-8101

Simon.Waever@morganstanley.com



MORGAN STANLEY & CO. LLC

Andrew M Watrous

Strategist

+1 212 761-5287

Andrew.Watrous@morganstanley.com



MORGAN STANLEY & CO. LLC

Michael J Wilson

Equity Strategist

+1 212 761-2532

M.Wilson@morganstanley.com



MORGAN STANLEY ASIA LIMITED+

Gilbert Wong, CFA

Quantitative Strategist

+852 2848-7102

Gilbert.Wong@morganstanley.com



MORGAN STANLEY & CO. LLC

Ioana Zamfir

Strategist

+1 212 761-4012

Ioana.Zamfir@morganstanley.com



MORGAN STANLEY MUFG SECURITIES CO., LTD.+

Zuri Z Zhao

Strategist

+81 3 6836-5466

Zuri.Zhao@morganstanleymufg.com

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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.

Threading the Needle

While many assets are *already* fairly priced for a soft landing, 2024 remains a good year for 'income investing'. Opportunities abound in high-quality fixed income – DM government bonds, IG credit, agency MBS, and senior tranches of securitized credit. Unlike the last two years when we had strong RoW > US, we expect that US assets will find 2024 easier, and EM markets less so.

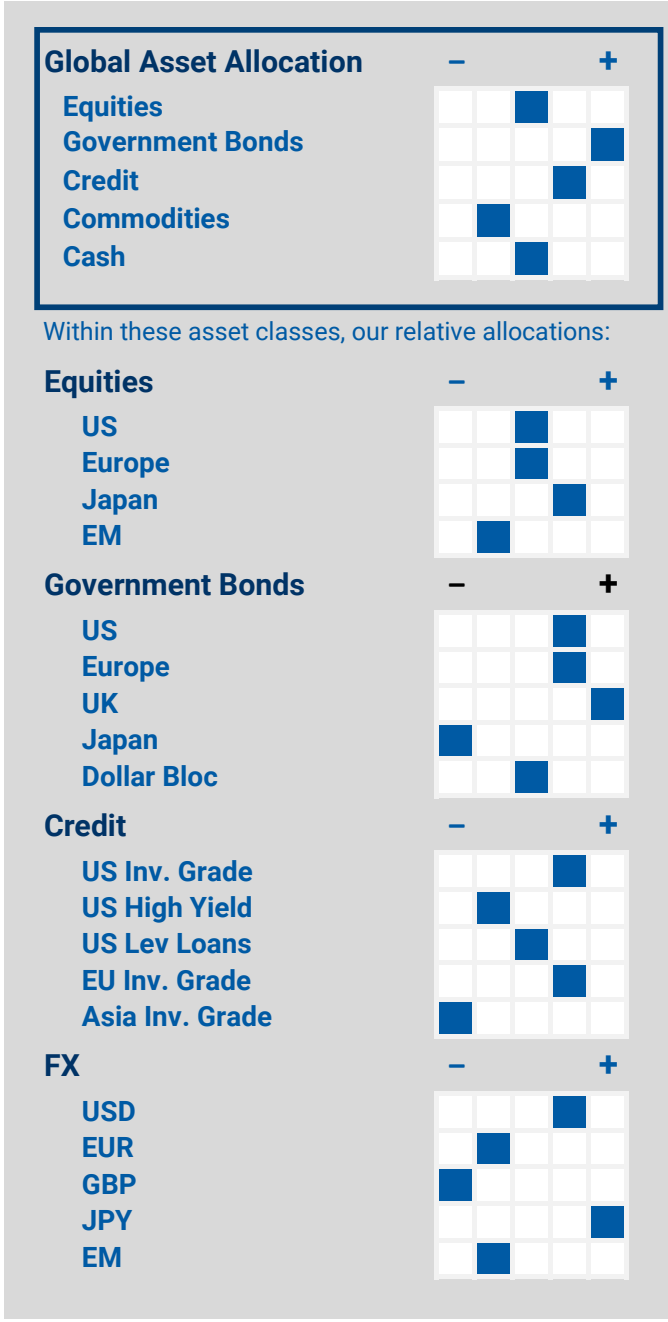
Global equities – Japan leads, look for US earnings recovery: Japan reflation and ROE improvement are secular positives while Europe and EM growth likely disappoint. We expect US earnings growth to trough in early 2024 and rebound thereafter. We recommend a barbell of defensive growth and late-cycle cyclicals. We see the S&P 500 at 4,500 at end-2024.

G10 rates – overweight duration: Easing drives yields lower in the US, Europe, the UK, and the dollar bloc. Curves steepen globally, except in Japan. With the BoJ eventually delivering a rate hike, we expect JGB long-end yields to remain near current levels even as other global benchmark yields decline. We forecast UST 10Y at 3.95%, DBR 10Y at 1.80%, and JGB 10Y at 0.90% by the end of 2024.

G10 FX – USD peaks in spring but further weakness contained: USD strength continues through 1Q, as growth and rate divergence continue and USD's defensive characteristics remain alluring. JPY outperforms on the back of the BoJ exiting YCC and NIRP. We see the DXY at 107 by end-2024.

EM fixed income – still cautious: USD strength and continued fund outflows lead EM credit spreads to go sideways. We would hold off on adding more beta risk until spreads are wider. We favor IG over HY in sovereign credit and see limited prospects for a recovery in EM local bonds without a recovery in USTs. High US rates will likely cannibalize broader EM fixed income flows, and so we need US rates to turn lower to prompt inflows to EM.

Corporate credit – up-in-quality time: IG credit is part of a 'constellation' of reasonably priced high-quality fixed income, supported by a Fed/ECB pause and soft landing. For leveraged credit, still-high rates and slower growth erode credit quality, keeping defaults and downgrades above average. We expect more tiering and wider spreads. We prefer IG over HY across the US, Europe, and Asia, and BBs over Bs across bonds and loans.



Securitized products – disparate narratives: Agency mortgages see positive excess returns, but spread vol remains high. Besides high-quality carry in senior tranches in securitized credit, a soft landing drives our out-of-consensus constructive views down the capital stack – we like CLO mezz and subprime auto BBBs.

Commodities – range-bound energy: We expect Brent to remain range-bound around US$85/bbl as rising demand meets non-OPEC supply. We are constructive on copper on the back of stronger-than-expected China demand. Geopolitical risk premiums should determine gold prices.

Cross-Asset Strategy: Threading the Needle

Serena Tang
Serena.Tang@morganstanley.com
+1 212 761-3380
Morgan Stanley & Co. LLC

Vishwanath Tirupattur
Vishwanath.Tirupattur@morganstanley.com
+1 212 761-1043
Morgan Stanley & Co. LLC

Arif Ahmed
Arif.Ahmed@morganstanley.com
+44 20 7425-1023
Morgan Stanley & Co. International plc+

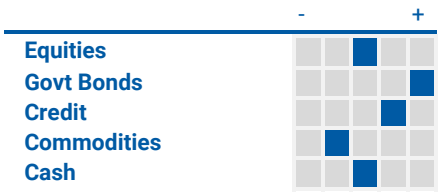
Soham Sen
Soham.Sen1@morganstanley.com
+91 22 6514-3442
Morgan Stanley India Company Private Limited+

Erika Singh-Cundy
Erika.Singh-Cundy@morganstanley.com
+44 20 7425-0960
Morgan Stanley & Co. International plc+

Key investment ideas

- **Growth and inflation moderate, allowing the Fed and ECB to normalize policy. But with assets pricing a benign environment to perfection, macro and markets would need to stick the landing to justify valuations.**
- **Own high grade fixed income – buy USTs, IG corporates. Selectively add equities – own Japan, wait on the US. USD stays strong.**

Exhibit 1: Our top-down allocation



Source: Morgan Stanley Research

For investors, 2024 should be all about threading the needle: With our baseline expectation that 2024 will see slowing growth, falling inflation, and eventually easier policy, we'd need to see the macro outlook sticking the landing across all of these to justify current valuations – many assets are *already* fairly priced for this benign environment.

And the eye of the needle is smaller and narrower than usual, as is the usual case in late-cycle: Financial conditions are tight. Rate cuts generally aren't expected until later in 2024. Downside risks to global growth are high. An earnings recession is still in train. Bond supply continues to be a market concern. EM fundamentals face headwinds. Cross-asset correlations have not budged from extremes. Finesse will be needed to find openings in markets which can generate positive returns.

What needs to – and should – stick the landing

1) Benign growth, falling inflation

Markets have seesawed between pricing in US economic growth to be cooling or too hot, seeing inflation falling at a steady pace or being stickier, and policy needing to be tighter or looser.

Consensus now has consolidated around the narrative of a 'soft landing', and we agree. **Our economists see global growth drifting below-trend, but still positive at 2.8%Y, and inflation gradually drifting downwards,** with US core PCE at 2.6% 4Q/4Q in 2024 and euro area core inflation at 2.3%Y.

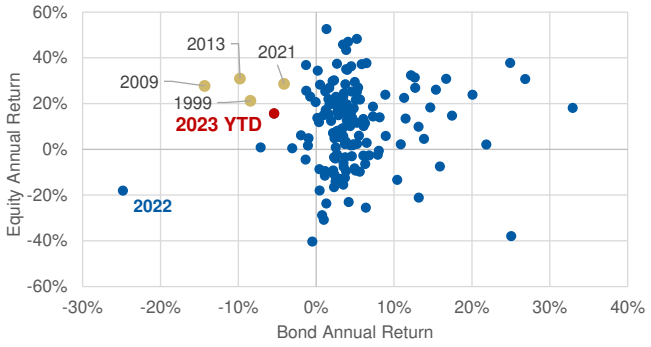
However, most of this benign scenario where growth, inflation, and policy normalize is already mostly reflected in valuations, especially after the recent rally we've seen. Stocks and bonds performance this year has been similar to only four other years' performance – 1999, 2009, 2013, and 2021. In every single one of these episodes, US PMIs rebounded rapidly from troughs and marked the start of a new market cycle. In other words, markets seem to already assume that central banks *can* stick the landing. There is little room for error as far as valuations are concerned.

Exhibit 2: Morgan Stanley growth, inflation, and policy forecasts

Region	GDP (%Y)		Core Inf.		Policy Rate	
	YE23	*YE24*	*YE23*	*YE24*	*YE23*	*YE24*
Global	3.0	2.8	-	-	-	-
US	2.4	1.9	4.2	2.6	5.375	4.375
Eurozone	0.4	0.5	5.0	2.3	4.00	3.00
Japan	2.0	1.0	4.0	2.3	-0.10	0.25
China	5.1	4.2	0.7	1.0	1.80	1.60
India	6.6	6.4	5.1	4.2	6.50	6.00

Source: Morgan Stanley Research forecasts

Exhibit 3: Stocks and bonds returns in 2023 have been closer to early-cycle periods instead of late-cycle ones



Source: Bloomberg, NBER, Jordà-Schularick-Taylor Macrohistory Database, Morgan Stanley Research; Note: Data back to 1871. Bond return is return on long-maturity UST. Data as of Nov 8, 2023.

2) Easier policy coming through

We believe that high grade fixed income will outperform in total return terms, with **UST 10Y yields falling to 3.95% and DBR to 1.80% by end-2024**. **IG corporate credit spreads should stay contained,** moving sideways, supported by a benign economic environment. For these narratives to play out and support valuations requires bonds to find relief from Fed and ECB pauses and successfully weather still-tight financial conditions.

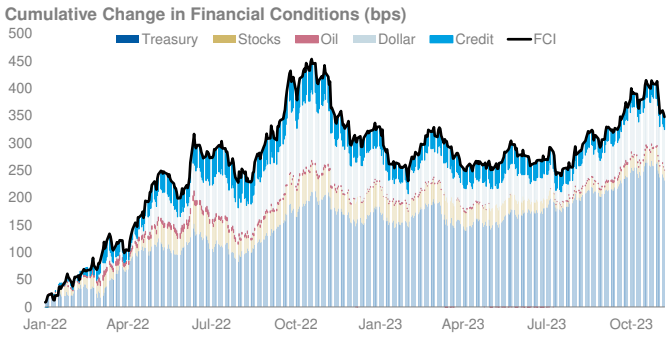
Central banks will have to get the balance correct between tightening just enough and easing quickly enough. DM policymakers should largely succeed, **and we expect the Fed and ECB to both make their first rate cut in June,** helping to manage a glide lower in growth and inflation. **The BoJ is the rare exception,** where we expect gradual tightening via removal of YCC and NIRP in January 2024, and a first hike in July 2024.

We are also encouraged by corporates' ability to push out maturity walls, as capital markets have stayed open for refinancing, and private credit markets provide a release valve for lower-quality names. There is a tail of names who may find addressing the maturity wall next year difficult, and we expect **US and EU default rates to climb towards a peak of 5.0% and 4.5% by mid-2024, respectively.** But high-quality credit should fare well, supporting valuations.

3) China growth finds its footing

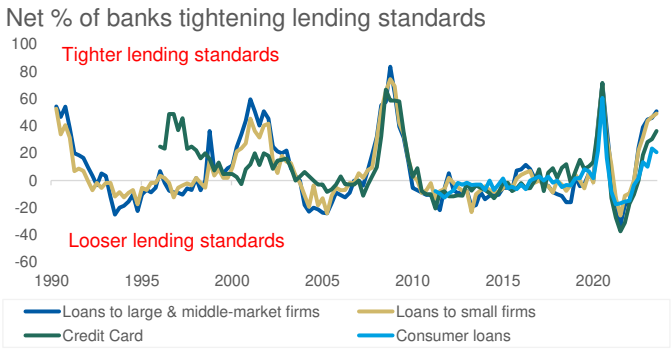
A key risk identified by our China economists and strategists is that China could fall into a structural debt-deflation loop, dragging down earnings and growth. There would be knock-on effects on growth in the rest of Asia – every 1pp slowdown in China's real GDP growth would reduce Asia ex China growth by 15bp.

Exhibit 4: Financial conditions have tightened by the equivalent of ~78bp since mid-2023



Source: Bloomberg, Morgan Stanley Research

Exhibit 5: US bank lending standards have been tightening since mid-2022



Source: Federal Reserve, Haver Analytics, Morgan Stanley Research

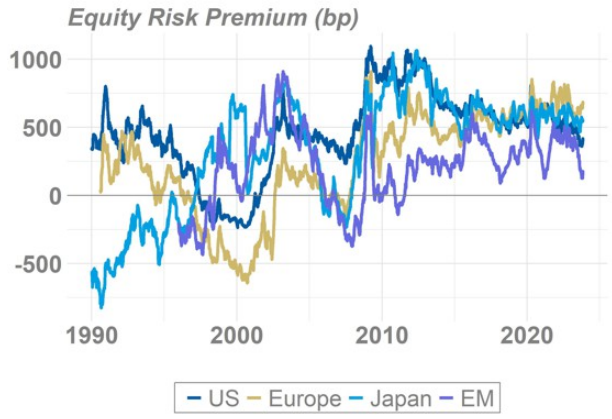
This is not our base case for China and we think that the economy can find its balance. We expect **real GDP growth to improve slightly to 4.2%Y in 2024,** and inflation to rise gradually to 1.1%Y in 2024 from 0.3%Y in 2023 with further fiscal and monetary easing. Risks are still skewed to the downside, which is one reason why we are **EW on undervalued Chinese equities** and see **RMB weaker** from here.

4) Earnings rebounding in 2024 after troughing

Our N12M expected returns across the major equity markets are comfortably positive: For the US, we are forecasting 4.7% of total returns, and for Europe 4.4%. Stock indices also seem to see an improving outlook across regions – equity risk premiums have been compressing through this year, with EM and US equities in particular looking rich versus other regions, and US stocks looking rich to credit.

However, to justify those levels of equity risk premiums and to achieve these levels of expected returns requires stocks to overcome an earnings recession in the US – **we see earnings troughing in early 2024** and staging a durable recovery thereafter. The story is similar in Europe – earnings will need to successfully walk that narrow L-shaped path as the region narrowly avoids an economic recession.

Exhibit 6: US and EM equity risk premiums have fallen the most this past year



Source: Morgan Stanley Research

Exhibit 7: US equity risk premiums have compressed significantly versus credit



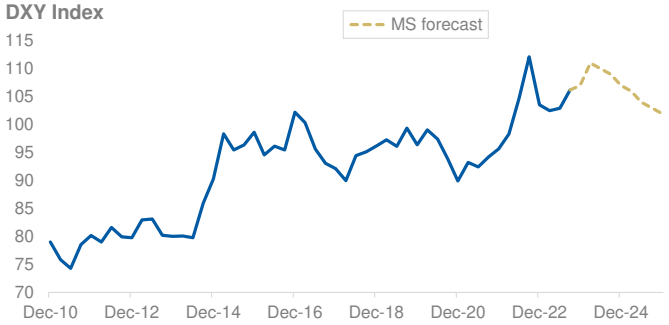
Source: Morgan Stanley Research

5) Dollar strength stalls

The story for 2024 will likely be a tale of two halves, especially for USD: With US growth still relatively strong in 1H and the risk-off environment from stocks and earnings troughing early next year, we forecast the DXY to rise to 111 by the spring. From 2Q onwards, with US growth softening and cuts being priced in, USD can weaken slightly to end the year at 107.

This view that the dollar will strengthen in 1H and then fall in 2H underpins our view on EM. Stable yields and USD strength offset the expected decline in inflation, keeping EM rates steady. Meanwhile, a weaker USD and fall in US rates can prompt inflows back to EM assets by mid-2024. The challenge is that IG and low-risk HY names have *already* mostly priced in these countries' ability to navigate and adjust to higher yields and a stronger USD.

Exhibit 8: We expect the dollar to continue its trend before falling from a peak from 2Q onwards



Source: Bloomberg, Morgan Stanley Research forecasts

What works in an imperfect world

Currently valuations reflect the expectation that all of the above happen *just* right and that macro and markets normalize without a hitch in 2024. Such a perfect landing is hard to pull off.

For investors, it means that **2024 will once again be a good year for income investing.** Even if rates don't fall as much as we expect, for yield-focused investors US core bonds at 6%+ yields are the most attractive since 2009. Valuations for high-quality fixed income look attractive outright. Risk/reward for high-quality fixed income also looks better *on a cross-asset basis*. Treasury and Bund yields are the highest they've been in the last 10 years. Credit spreads are also cheaper. This supports our **OW in high-quality fixed income.**

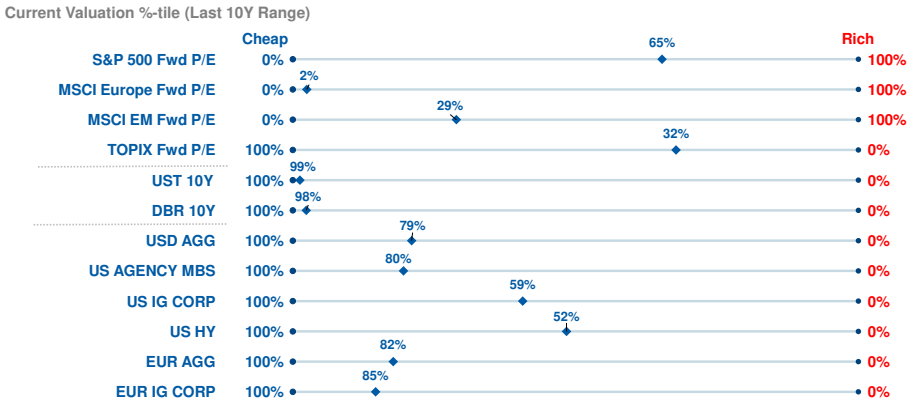
Selectively adding equity exposure also makes it easier to weather any potential turbulence that makes for a bumpy landing, and **this means being OW in Japanese equities and timing re-entry into US stocks in 2024 right.**

For Japanese stocks, we've long argued that the market is supported by secular factors, lifting ROE to converge with global stocks. This is playing out. The region is also more insulated from downside risks to Asia growth and geopolitical risks.

What usually happens between the last hike and the first cut also points to carefully timing US leadership. Equities tend to do ok coming out of the last Fed hike. But in the three months going into an easing cycle, stocks start to sell off as fed funds cuts tend to happen when growth and inflation slow, a headwind to risk assets. Importantly, while US equities also see those challenges, they outperform global stocks.

We also think that **US assets will find 2024 easier, and EM markets less so. Unlike the prior two years where we had a strong RoW > US preference, 2024 is different.** US equities for the whole year have fair returns and a *better skew of outcomes* than European and EM stocks, especially if macro doesn't stick the landing – flight to quality means the US outperforms. Total returns for USD fixed income are good, and lower hedging costs for foreign investors mean that USD bonds look more attractive than they did a year ago for that investor base.

Exhibit 9: Where are valuations today?



Source: Bloomberg, Datastream, Morgan Stanley Research; Note: Equities = forward P/E, rates = nominal yield, credit = spread; percentiles are based on these values.

Exhibit 10: Average returns around the last Fed hike and first Fed cut with curve inversion

	Average Returns after "Last Fed Hike" with 2s10s Inverted		*Average Returns going into "First Fed Cut" with 2s10s Inverted*	
	3m	*6m*	*6m*	*3m*
EQUITIES				
MSCI ACWI	4.5%	6.4%	-3.1%	-4.8%
S&P 500	3.2%	4.5%	1.3%	-1.9%
MSCI Europe Local	3.7%	5.9%	-0.1%	-3.2%
TOPIX	2.2%	1.4%	-2.4%	-4.6%
MSCI EM	9.0%	6.8%	1.1%	0.6%
FX				
DXY	4.3%	6.3%	5.8%	3.2%
JPY*	-2.2%	-3.8%	-3.8%	-2.8%
EUR*	-4.6%	-6.1%	-6.0%	-3.0%
RATES				
UST 10Y	5.0%	7.1%	3.9%	2.9%
Bunds 10Y	2.6%	4.7%	1.0%	1.5%
CREDIT (XS Returns)				
US Agg	0.2%	0.2%	-0.6%	-0.6%
US IG	0.3%	0.2%	-1.9%	-2.0%
US HY	-0.7%	-2.1%	-6.1%	-6.7%
US MBS	0.3%	0.3%	-0.5%	-0.6%
COMMODITIES				
Brent	4.3%	8.2%	16.8%	3.5%
Gold	-9.2%	-11.0%	-11.0%	-5.0%
Copper	-4.0%	-8.2%	1.7%	-8.3%

Source: Bloomberg, Morgan Stanley Research; Note: We use price returns for equities, FX, and commodities, total returns for rates, and excess returns for credit; *Returns are shown as XXXUSD. The last Fed hike analysis includes eight episodes for FX, rates, SPX, MSCI Europe, TOPIX, and gold. and four episodes for the remaining assets. The first Fed cut analysis includes eight episodes for FX, rates, SPX, MSCI Europe, and TOPIX, seven episodes for gold, four episodes for credit, MSCI ACWI, MSCI EM, Brent, and 3m time frame for copper, and three episodes for 6m time frame for copper.

At the other end, apart from a few exceptions, EM should find it harder to justify current valuations after the recent rally. EM returns look less than compelling across stocks, credit, and local rates. While it is true that our economists see EM growth beating DM from a level basis, the gap is narrower than in prior years Fundamentals look challenging for EM. Geopolitics will weigh on some countries. And the potential for China entering a debt-deflation loop remains a headwind to EM outperformance.

Cross-asset allocation recommendations

Exhibit 11: Our asset allocation recommendations

Asset	Allocation	OW/UW	vs Bnch	vs Last
EQUITIES		-2%		+0%
US		+0%		+6%
Europe		-2%		-1%
Japan		+4%		+1%
EM		-4%		-6%
CORE FIXED INC.		+11%		+3%
Govt Bonds		+6%		+1%
Agency MBS		+1%		+0%
IG Corporate		+4%		+2%
OTHER FIXED INC.		-4%		-2%
US HY Corp		-2%		+0%
EM $ Sov		-1%		-1%
EM Local		-2%		-2%
US Lev Loans		-1%		+0%
CLO AAA		+2%		+1%
COMMODITIES		-4%		+0%
CASH		-1%		-1%

Source: Morgan Stanley Research; Note: Overweights and underweights are versus our cross-asset benchmark, see Morgan Stanley Cross-Asset Benchmark for the full breakdown.

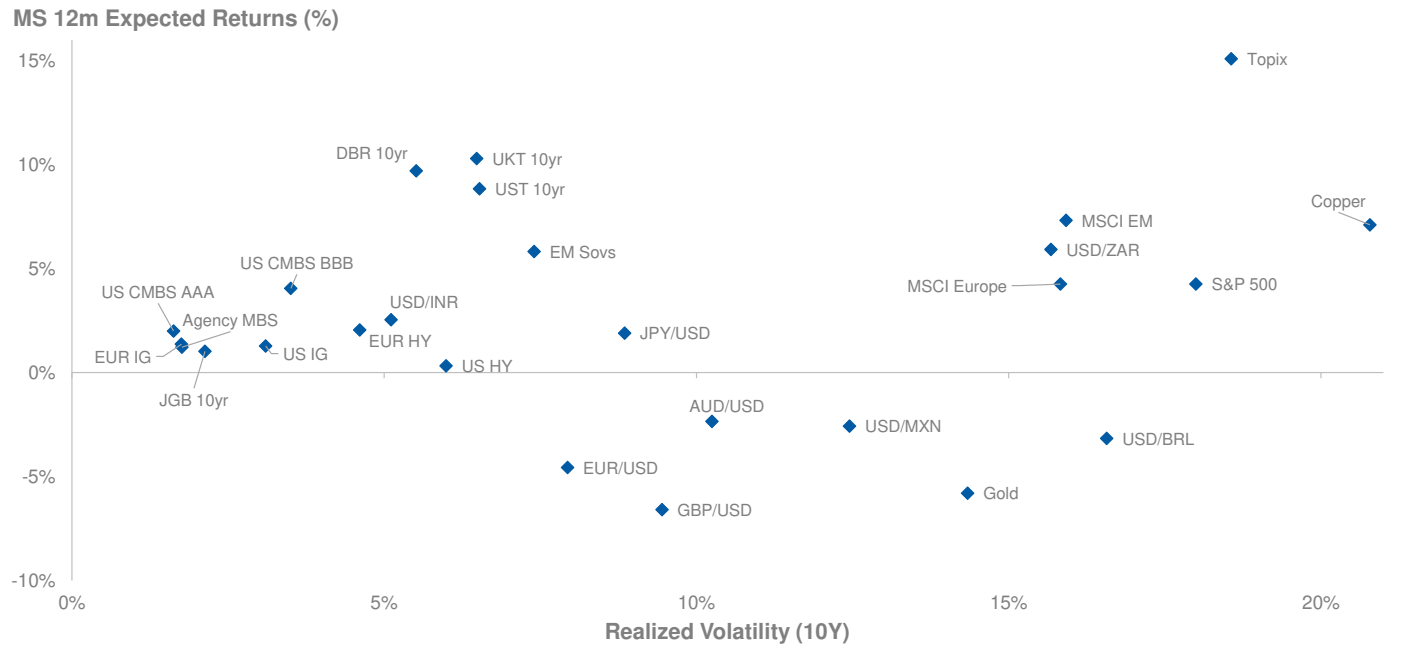
We recommend an **EW in stocks, OW in core fixed income, UW in other fixed income, UW in commodities, and EW in cash.**

With our strategy colleagues' positive but below-average returns for equities and bullish yield targets, fixed income expected relative risk/reward remains attractive. Momentum in US mutual funds and ETF flows into high-quality fixed income as well as asset managers continuing to add across the US Treasury curve are additional tailwinds to the asset class.

Within equities, Japan is our most preferred region and only OW, while EM is our least preferred at UW, dragged down by Asia growth risks. For core fixed income, our key OW are in government bonds – both USTs and EGBs – while we stay more neutral on agency mortgages. We have pared back risk in EM fixed income, but added to CLO. We remain UW in commodities, and stay EW in cash.

See Our Discretionary Multi-Asset Portfolio for more details.

Exhibit 12: Expected risk/reward across assets



Source: MSCI, Bloomberg, Morgan Stanley Research forecasts; Note: Returns are total returns, except for credit, where we forecast excess returns versus government bonds. Commodity returns are calculated relative to futures to account for carry. All currency returns are shown as XXXUSD return.

Top thematic trades

1) Equities returns are back – adding risk selectively

We like assets which are cheap and work in an environment where macro sticks the landing, but also if it doesn't. This naturally means we want more defensive exposure. Our current top trades below reflect our preference for equities:

- **Long Japanese equities (unhedged)**
  - Rationale: TOPIX is in a secular bull market, helped by stronger growth and corporate governance. We see inflows continuing from foreign investors closing UW positions to OW as an additional tailwind.
  - Risk: Larger change to BoJ policy and/or weaker global growth drive a stronger JPY than our FX strategists have forecast.

- **Long (India + Mexico) versus MSCI EM**
  - Rationale: Nearshoring presents a long-term and multi-wave opportunity for Mexico's investment cycle. Macro-stability, structural reforms, and strong FDI and portfolio flows set up India for superior EPS growth versus EM. On the other hand, the broader MSCI EM index faces earnings risks from rising USD strength and geopolitical uncertainties.
  - Risk: Infrastructure bottlenecks and fiscal deterioration in Mexico. Negative market reaction to 2024 general elections in India may result in drawdowns. China growth surprises to the upside.

- **Long ACWI Industrials + ACWI Healthcare**
  - Rationale: We see healthcare as a late-cycle outperformer given its defensive and growth properties, and prefer industrials relative to broader cyclicals. Valuations remain attractive versus history, and earnings revisions see an inflection.
  - Risk: Leading macro data inflect higher and equity market internals broaden out, favoring pro-cyclical sectors.

2) High-quality fixed income attractive – adding government bonds and IG

With our forecasts for Treasury yields falling through the forecast horizon, high-quality fixed income has compelling risk/reward. With financial conditions being easier, credit should also outperform. Our current top trades below reflect a quality bias within fixed income:

- **Long UST 30Y**
  - Rationale: High real yields, slowing US growth, and a commitment by the Fed to keep rates restrictive to bring down inflation should support US duration.
  - Risk: Stronger growth raises expectations for inflation and the neutral rate.

- **Long UK 10Y**
  - Rationale: Our strategists expect normalization of monetary policy as disinflation is sustained while growth remains weak. Yields fall across the term structure on an expectation of more cuts.
  - Risk: Inflation proving sticky, and the BoE remaining hawkish.
- **CLO AAA and BB barbell**
  - Rationale: Our strategists believe that CLO AAAs offer attractive high-quality carry, and a barbelled allocation into BBs provides attractive yields that give a cushion against potential spread widening in 1H24, before benefitting from spread tightening into the end of the year.
  - Risk: Higher-for-longer rates lead to worse corporate fundamentals than projected.

- **Short CDX HY 15-100% versus CDX IG**
  - Rationale: Our strategists see decompression within credit, as in the base case, slower growth, restrictive policy and a tail of credits that haven't made progress in addressing maturity walls drive US default rates higher by mid-2024.
  - Risk: Stronger growth coupled with lower risk premiums for lower-rated credit.

3) US > RoW assets – lean into stronger-for-longer USD, cautious on EM

We expect US growth to soften but stay strong relative to other regions. Risk-off sentiment in 1H also drives safe-haven demand for USD and USD-denominated assets.

- **Short EUR/USD**
  - Rationale: Our strategists forecast lower EUR/USD by year-end. Data in Europe continue to soften, with the risk of a technical recession rising further. EUR has failed to rally in recent days despite the fall in US rates and buoyancy in equities, likely in part reflecting the dour economic outlook.
  - Risk: Improving European economic outlook and a hawkish central bank.

- **Short CNH/INR**
  - Rationale: Has attractive carry, and our strategists believe that CNY should weaken in basket terms over the medium

term given the deflation pressure and weaker exports.
    - Risk: Significant fiscal stimulus from China and USD weakness.
- **Receive 5yr CNY NDIRS**
    - Rationale: The China rates market has seen a decent sell-off in recent days on the back of higher 7-day repo fixing. But should China growth continue to disappoint, the PBOC would have to stay on the dovish side or even cut rates again. The fixing could be more normalized, in line with the policy rate, which should help China rates to move lower.
    - Risk: Significant fiscal stimulus from China and USD weakness.

Bull case – robust growth, but more hikes

The upside growth scenario sees a much stronger US economy led by continued strength in consumption as unemployment falls. The Fed hikes by another 100bp in 2024. This lifts growth and inflation in the euro area, Japan, and the UK, but also means policy remains restrictive for longer in 2024. Rate cuts get pushed out to 2025.

Bear case – China debt-deflation loop cools global growth

The downside growth scenario is China experiencing a debt-deflation loop. Corporate defaults rise, credit growth falters, and spending falls as consumers see wealth locked up in a property decline and become more uncertain about future income. Asian economies are most affected by spillovers, and the euro area also sees some pain. However, the US is more insulated, and imports disinflation from Asia and sees inflation drop sharply. In this scenario, it's clear that the Fed has overshot, and we can see a mild recession.

Imagining the next market shock

Vishwanath Tirupattur

2023 gave us multiple episodes of significant market dislocation – the volatility in the US regional banking sector and the unrelenting spikes in long-term DM government bond yields during August-October, followed by a furious rally in the last few weeks – just to highlight a few. The sell-off in US Treasuries was particularly gruelling, with the 10-year yields exceeding 5% in the third week of October, a level not seen since 2007 and an increase of about 125bp since the July trough. Major market moves like these have been painful to investors. As such, in a year ahead outlook, we think it useful to think outside our framework to consider the potential risks such as this. To be clear, none of these are our base case expectations. They are simply vulnerabilities in the system that investors ought to pay attention to, in our view.

Most DM central banks have signalled that they will keep rates at the peak until they are convinced that inflation is converging to target. We expect the first cuts to come in 2024. As was the case in the last two years, the Bank of Japan stands out yet again. Our economists expect the BoJ to hike in July 2024 from the zero interest rate after leaving both the Negative Interest Rate Policy (NIRP) and Yield Curve Control (YCC) in January 2024. Given how long policy rates have been ultra-accommodating in Japan, there is risk of market fragility when a material turnabout in monetary policy comes to fruition, especially given the allure of JPY as both a funding currency and a haven.

While relative calm has returned to the regional banking sector after the volatility earlier in the year, challenges to the business models of regional banks remain. While the deposit flight from the regional banking sector has slowed demonstrably, the cost of deposit funding has gone up sharply and regional banks have been shoring up their liquidity positions. That the borrowing from the Bank Term Funding Program (BTFP) that the Fed instituted in the middle of March stands at US$109 billion suggests that the liquidity challenges facing the smaller banks remain. Beyond what has happened thus far, a series of regulatory changes are forthcoming. As Morgan Stanley banking analysts, Betsy Graseck and Manan Gosalia, highlight, these upcoming changes affect the outlook for many of these banks, which will continue to pressure their margins and thus their profitability. We would watch carefully if the BTFP, currently scheduled to end on March 10, 2024, gets extended or how the implementation timelines for incremental regulations evolve.

Adjacent to the regional banking issue is the imminent refinancing need of the US commercial real estate (CRE) sector. We estimate that of the US$4.4 trillion of outstanding CRE debt, about US$2 trillion is due to be refinanced between 2023-25, half of which sits on bank balance sheets and 70% of this on the balance sheets of small banks (excluding the top 25 banks). In that sense, the small banks are both the largest lender to the CRE sector and the weakest links, given the challenges outlined above. Given that certain CRE property types, most notably office, face a secular challenge in terms of flexible work, how the CRE wall of maturities gets resolved, given its intrinsic links to the banking system, bears close monitoring.

Funding conditions are shifting quickly, as evidenced by the fast decline in the Fed's reverse repo purchase (RRP) operations. This is an important dynamic as it signals who the willing marginal lender is. If there is a large balance in the RRP, money market funds (MMFs) should continue to be willing to invest in higher-yielding alternatives. Once the RRP is depleted, that burden shifts to banks (reserves) as the other group of front-end investors that becomes willing to lend excess cash currently earning a fixed rate (IORB). As Morgan Stanley's short duration strategist, Efrain Tejeda, notes, life after the RRP is set to bring a new regime for money market rates as SOFR and EFFR become de-anchored from the RRP rate. Instead, they will have to rely on the responsiveness of reserves to higher funding rates, taking funding conditions to a world that will more closely resemble 2018 rather than the past year. In other words, once the RRP is depleted in 2024, the impact of QT is likely to switch gears, bringing clearer signs of reserve scarcity and the potential for funding disruptions.

Exhibit 13: Morgan Stanley forecasts

	As of Nov 08, 2023	Q4 2024 Forecast			Q4 2024 Return Forecast			Volatility	Base Case Return/Risk
		Bear	Base	Bull	Bear	Base	Bull		
Equities						Total Returns			
S&P 500	4,383	3,850	**4,500**	5,050	-10.6%	**4.3%**	16.8%	18%	0.24
MSCI Europe	1,798	1,480	**1,810**	2,040	-14.1%	**4.3%**	17.0%	16%	0.27
Topix	2,306	1,850	**2,600**	2,800	-17.4%	**15.1%**	23.8%	19%	0.81
MSCI EM	958	750	**1,000**	1,140	-18.8%	**7.3%**	21.9%	16%	0.46
FX						Total Returns			
USD/**JPY**	151	146	**140**	132	-2.3%	**1.9%**	8.1%	9%	0.21
EUR/USD	1.07	1.00	**1.04**	1.10	-8.5%	**-4.6%**	1.3%	8%	-0.58
GBP/USD	1.23	1.10	**1.15**	1.22	-10.3%	**-6.6%**	-1.0%	9%	-0.70
AUD/USD	0.64	0.60	**0.63**	0.67	-6.3%	**-2.3%**	3.6%	10%	-0.23
USD/**INR**	83.3	85.8	**82.5**	79.2	6.7%	**2.5%**	-1.3%	5%	0.50
USD/**ZAR**	18.5	18.4	**18.0**	17.3	10.2%	**5.9%**	3.9%	16%	0.38
USD/**BRL**	4.91	5.80	**5.30**	4.80	6.5%	**-3.2%**	-11.2%	17%	-0.19
USD/**MXN**	17.5	20.5	**19.3**	18.5	1.1%	**-2.6%**	-8.1%	12%	-0.21
USD/**CNY**	7.28	7.70	**7.45**	7.20	3.2%	**-0.2%**	-3.7%	4%	-0.06
Rates (% percent)						Total Returns			
UST 10yr	4.49	5.05	**3.95**	2.50	0.0%	**8.8%**	21.2%	7%	1.35
DBR 10yr	2.62	2.70	**1.80**	1.50	1.8%	**9.7%**	12.6%	6%	1.76
UKT 10yr	4.24	4.60	**3.50**	3.00	1.5%	**10.3%**	14.3%	6%	1.59
JGB 10yr	0.85	1.80	**0.90**	0.35	-6.8%	**1.0%**	6.1%	2%	0.48
Credit (bps)						Excess Returns			
US IG	125	165	**125**	90	-1.4%	**1.3%**	3.7%	3%	0.41
US HY	398	600	**475**	325	-4.4%	**0.3%**	5.8%	6%	0.05
EUR IG	156	225	**160**	120	-1.5%	**1.4%**	3.1%	2%	0.78
EUR HY	457	675	**525**	400	-2.6%	**2.0%**	5.9%	5%	0.44
EM $ Sov	432	550	**410**	350	-3.5%	**5.8%**	9.8%	7%	0.79
Sec. Products (bps)						Excess Returns			
US Agency MBS	65	85	**55**	40	-0.6%	**1.2%**	2.1%	2%	0.69
US CMBS AAA	150	175	**145**	110	-1.0%	**2.0%**	5.5%	2%	1.23
US CMBS BBB-	900	1,150	**950**	800	-15.8%	**4.1%**	18.9%	4%	1.16
Commodities						Total Returns			
Brent	80	65	**85**	125	-15.3%	**10.8%**	63.0%	39%	0.28
Copper	8,058.5	7,650.0	**9,000.0**	10,802.6	-9.0%	**7.1%**	28.6%	21%	0.34
Gold	1,959	1,755	**1,950**	2,243	-15.2%	**-5.8%**	8.4%	14%	-0.40

Source: MSCI, Bloomberg, Morgan Stanley Research forecasts; Note: Returns are total returns, except for credit, where we forecast excess returns versus government bonds. Equity returns exclude net buyback yield. Commodity returns are calculated relative to futures to account for carry. All currency returns are shown as XXXUSD return. We use CNH/USD carry as a proxy for CNY/USD carry. Volatility is 10y realized vol.

What's changed

Exhibit 14: What's changed in our forecasts – economics

What's Changed - Economics

	OLD FORECASTS		NEW FORECASTS		Δ from Last Forecast	
	2023e	2024e	2023e	2024e	2023e	2024e
Real GDP (%YoY)						
Global	2.9	2.8	3.0	2.8	0.1	0.0
G10	0.9	0.9	1.5	1.2	0.6	0.3
US	1.2	0.8	2.4	1.9	1.2	1.1
Euro Area	0.7	1.0	0.4	0.5	-0.3	-0.5
Japan	1.1	1.1	2.0	1.0	0.9	-0.1
UK	0.2	0.5	0.5	-0.1	0.3	-0.6
EM	4.4	4.2	4.2	4.0	-0.2	-0.2
China	5.7	4.9	5.1	4.2	-0.6	-0.7
India	6.5	6.4	6.6	6.4	0.1	0.0
Brazil	2.0	1.8	3.1	1.7	1.1	-0.1
CPI (%Y)						
Global*	3.8	2.7	3.8	2.6	0.0	-0.1
G10	4.6	2.3	4.8	2.5	0.2	0.2
US	3.8	2.2	4.1	2.1	0.3	-0.1
Euro Area	5.4	2.3	5.6	2.4	0.2	0.1
Japan	3.2	2.1	3.3	3.2	0.1	1.1
UK	7.1	2.1	7.4	2.8	0.3	0.7
EM*	3.2	3.0	3.1	2.7	-0.1	-0.3
China	0.9	1.6	0.3	1.1	-0.6	-0.5
India	5.5	4.9	5.6	5.1	0.1	0.2
Brazil	5.0	4.5	4.6	4.3	-0.4	-0.2

Source: IMF, Morgan Stanley Research forecasts; Note: Global and regional aggregates for GDP growth are GDP-weighted averages, using PPP weights excluding Ukraine; CPI numbers are period average; Global* and EM* consumer price inflation aggregates exclude Argentina, Turkey, Egypt and Ukraine; Old forecasts refer to forecasts published as of June 4, 2023.

Exhibit 15: What's changed in our forecasts – assets

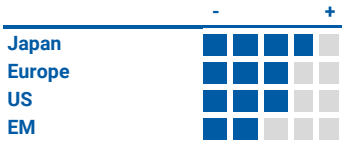
What's Changed - Assets

Base Case Forecasts	OLD	NEW	Δ from last f'cast
	Q2 2024	Q4 2024	
Equities			
S&P 500	4,200	4,500	7%
MSCI Europe	1,970	1,810	-8%
Topix	2,400	2,600	8%
MSCI EM	1,100	1,000	-9%
FX			
USD/JPY	132	140	6%
EUR/USD	1.06	1.04	-2%
GBP/USD	1.17	1.15	-2%
Rates (% percent)			**(bp Δ)**
UST 10yr	3.30	3.95	65
DBR 10yr	1.60	1.80	20
UKT 10yr	3.40	3.50	10
JGB 10yr	0.40	0.90	50
Credit (bps)			**(bp Δ)**
US IG	150	125	-25
US HY	550	475	-75
EUR IG	175	160	-15
EUR HY	550	525	-25
EM Sovs	450	410	-40
Securitized Credit (bps)			**(bp Δ)**
US Agency MBS	45	55	10

Source: Morgan Stanley Research forecasts; Note: Old forecasts refer to 2Q24 published forecasts, as of June 4, 2023.

Key Calls by Asset Class

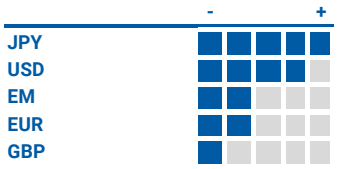
Equities – EW : 1H24 should be challenging given a stronger dollar, restrictive policy, US earnings recession still in train, and a tepid China recovery. Rotation opportunities should present themselves into 2H24. Japan is our high-conviction regional pick, while we are EW on US and European equities and UW on EM equities.



Government bonds – OW : We expect UST, core EGB, and UKT yields to fall through 2024 as markets price in the start of rate-cut cycles *and* a quicker pace of cuts. The exception is Japan, where we see JGB yields flatter into 2Q24 as the BoJ begins to normalize policy. We are most constructive on UKTs, OW on USTs and EGBs, and UW on JGBs.



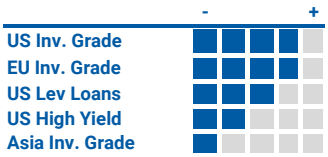
FX – USD strength continues : 2024 should see USD remaining strong as rate differentials continue to favor USD, as does the currency's safe-haven nature. JPY is the one currency we expect will do well against USD, driven by policy convergence. We are most bullish on JPY, followed by USD. We are cautious on EUR and EMFX, and most negative on GBP.



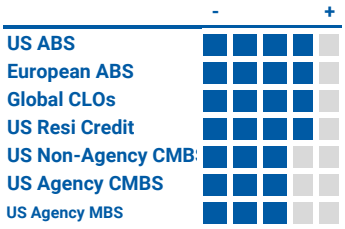
EM fixed income – EW : EM credit spreads should widen and EMFX should be weaker in 1H24 on the back of the US economy expanding more than consensus forecasts. We expect a gradual recovery in EM rates, and would need to see US rates falling to see a return of inflows to EM. Within sovereign credit, IG total returns should outperform in the near term but HY spreads should eventually tighten more by end-2024.



Corporate credit – OW : IG is well supported by benign macro, strong corporate fundamentals, and termed-out maturities. But we still see IG-HY decompression as the skew of returns is negative – in the case of better growth, higher rates for longer hurt leveraged credit, while in the case of a mild recession, more cyclical HY suffers. We like IG over loans over HY.



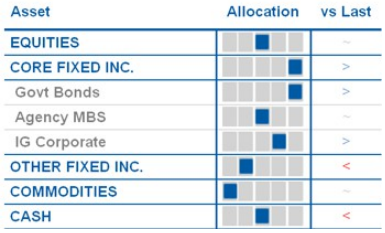
Securitized credit – OW : Through 2024, spreads should tighten across several pockets of securitized products as markets price in more Fed cuts and reduced FX-hedging costs for non-USD investors see some demand return. We see agency's move tighter to be bumpy. Unlike for corporate credit, we like going down the capital stack. We like CLO mezz and consumer ABS, and are more cautious on US CRE. In Europe we stay in the IG tranches in UK RMBS and CLOs.



Commodities : Strong demand for oil to trend-revert while non-OPEC supply can meet additional demand, leading oil to trade sideways in 2024. We think that gold is rich versus what US 10-year real yields would imply, and for gold to stay at current levels would mean either geopolitical risks remain or yields move lower. We like copper because of strong-than-expected China demand.

Our Discretionary Multi-Asset Portfolio

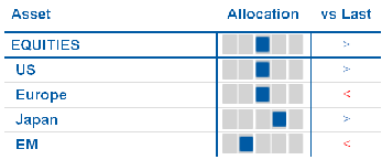
Exhibit 16: Our discretionary top-down allocation



Asset	Allocation	vs Last
EQUITIES		~
CORE FIXED INC.		>
Govt Bonds		>
Agency MBS		~
IG Corporate		>
OTHER FIXED INC.		<
COMMODITIES		~
CASH		<

Source: Morgan Stanley Research

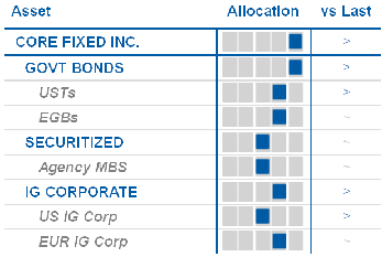
Exhibit 17: Equities allocation



Asset	Allocation	vs Last
EQUITIES		>
US		>
Europe		<
Japan		>
EM		<

Source: Morgan Stanley Research

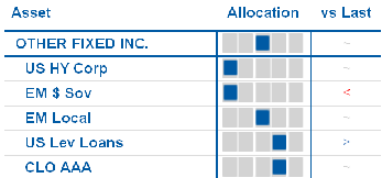
Exhibit 18: Core fixed income allocation



Asset	Allocation	vs Last
CORE FIXED INC.		>
GOVT BONDS		>
USTs		>
EGBs		~
SECURITIZED		~
Agency MBS		~
IG CORPORATE		>
US IG Corp		>
EUR IG Corp		~

Source: Morgan Stanley Research

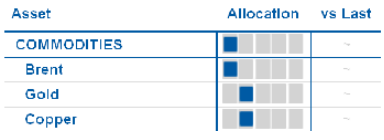
Exhibit 19: Other fixed income allocation



Asset	Allocation	vs Last
OTHER FIXED INC.		~
US HY Corp		~
EM $ Sov		<
EM Local		~
US Lev Loans		>
CLO AAA		~

Source: Morgan Stanley Research

Exhibit 20: Commodities allocation



Asset	Allocation	vs Last
COMMODITIES		~
Brent		~
Gold		~
Copper		~

Source: Morgan Stanley Research

Core fixed income > equities and cash > other fixed income > commodities

Risk/reward – expected return of ~7.7%: Based on Morgan Stanley strategists' most current year-ahead forecasts, **our discretionary allocation portfolio has expected return of 7.7% and volatility of 7.8% for 1.0x of return/vol.** This compares to the cross-asset benchmark expected return of 7.1% and volatility of 8.4% for 0.8x of return/vol, and the USD 60/40 expected return of 5.9% and volatility of 9.6% for 0.6x of return/vol.

Portfolio profile – tilt defensive, like USD: Given our macro outlook, our recommended allocation has lower risk than the benchmark, mostly due to the large UW in EM equities and commodities. The preferences for high grade fixed income and defensive equity regions also mean that downside deviation and cVaR are all less severe than our cross-asset benchmark, or a traditional USD 60/40 portfolio. Guided by our optimal portfolios exposures, our discretionary allocation also has much lower beta to commodities and higher beta to USD compared to our cross-asset benchmark and USD 60/40 portfolio.

Portfolio summary

- **EW equities (-2% versus benchmark): Japanese equities (+4% versus benchmark)** remain a bright spot because of cheap relative valuations – especially after FX hedging – and continued bullish sentiment from asset managers as reflected in positioning data. **We've pared our UW in US equities to EW versus our benchmark** allocation, driven by near-term earnings risk, but a better risk/reward profile in 2024 than this year. Our allocation **took down EM equities to UW from EW (-4% versus benchmark)** due to growth risks, headwinds from a strong USD, and outflows, and we prefer to be selective. **We remain EW in Europe.**
- **OW core fixed income (+11% versus benchmark):** We recommend having higher-than-benchmark exposure to all high grade fixed income markets. In **government bonds (+6% versus benchmark),** we added duration risk via USTs given our projection for cuts in the fed funds rate. The story is similar in IG corporates **(+4% versus benchmark),** where lower yields lift total returns, and fundamentals remain strong.
- **UW other fixed income (-4% versus benchmark):** We've **pared back exposure to EM credit (-1% versus benchmark)** and **EM rates (-2% versus benchmark)** given our expectations that EM assets would lag as long as USD remains strong and US yields are higher for longer. We add to **CLO AAAs (+2% versus benchmark)** on the back of our constructive outlook for securitized credit.
- **UW commodities:** We have no allocation to commodities in our discretionary portfolio, as tepid growth and demand-supply dynamics see prices trade within a range.

Exhibit 21: How do assets stack up combining a top-down cycle-adjusted fair value view and bottom-up strategists' next 12M forecasts? High grade fixed income looks good, while equities and other fixed income are more of a mixed bag

	(A) Top-Down Expected Returns			(B) Bottom-Up	(C) Framework Forecast	(D) Framework R/R	MS Cross-Asset			
Asset	LTCMA	Cycle Drag/ Boost	Cycle-Adj. Rtn	MSe	Rtn Less Cash	Rtn/Vol	Alloc	OW/UW	vs Bench.	vs Last
EQUITIES								-2%	-2	+0%
US Eqty	9.6%	-5.6%	4.0%	4.3%	-1.2%	-0.1	30%	+0%		+6%
European Eqty	10.5%	-7.4%	3.2%	4.3%	0.1%	0.0	8%	-2%		-1%
Japan Eqty	6.4%	-2.3%	4.1%	15.1%	8.9%	0.6	9%	+4%		+1%
EM Eqty	7.2%	3.6%	10.8%	7.3%	3.7%	0.3	6%	-4%		-6%
CORE FIXED INC.								+11%	11	
GOVT BONDS							22%	+6%		+1%
USTs	4.8%	1.9%	6.7%	8.2%	2.1%	0.5	13%	+3%		+1%
EGBs	4.6%	0.2%	4.8%	9.6%	3.6%	0.7	9%	+3%		+0%
SECURITIZED							6%	+1%		+0%
Agency MBS	5.6%	1.3%	6.8%	9.5%	2.8%	0.7	6%	+1%		+0%
IG CORPORATE							11%	+4%		+2%
US IG Corp	6.4%	-0.1%	6.3%	9.6%	2.6%	0.4	7%	+2%		+2%
EUR IG Corp	4.3%	-1.2%	3.1%	9.6%	2.8%	0.6	4%	+2%		+0%
OTHER FIXED INC.								-4%	-4	-2%
US HY Corp	5.5%	-5.3%	0.1%	8.8%	-0.9%	-0.1	0%	-2%		+0%
EM $ Sov	6.5%	-1.4%	5.1%	14.6%	4.5%	0.5	1%	-1%		-1%
EM Local	~	~	~	6.4%	1.0%	0.3	2%	-2%		-2%
US Lev Loans	~	~	~	4.2%	-1.1%	-0.2	0%	-1%		+0%
CLO AAA	~	~	~	7.1%	1.7%	0.9	3%	+2%		+1%
COMMODITIES								-4%	-4	+0%
Brent	~	~	~	8.7%	3.4%	0.1	0%	-2%		+0%
Gold	~	~	~	-4.9%	-10.3%	-0.7	0%	-1%		+0%
Copper	~	~	~	8.7%	3.4%	0.2	0%	-1%		+0%
CASH								-1%	-1	-1%
Cash	~	~	~	5.4%	0.0%		2%	-1%		-1%

Source: Morgan Stanley Research; Note: 'vs Last' is versus last published – November 6, 2023.

Exhibit 22: Discretionary allocation expected risk/reward

Metric	MS Cross-Asset Ptf	MS XA Benchmark	USD 60/40 Ptf
RISK REWARD			
Expected Return	7.7%	7.1%	5.9%
Vol	7.8%	8.4%	9.5%
Rtn/Vol	1.00	0.84	0.61
HISTORICAL RISK REWARD			
Historical Return	6.5%	4.9%	6.0%
Historical Vol	7.8%	8.4%	9.6%
Historical Rtn/Vol	0.84	0.58	0.62
RISK PROFILE			
Downside Dev*	1.7%	1.8%	1.8%
VaR*	-4.5%	-4.1%	-4.3%
cVaR*	-5.8%	-6.2%	-6.1%

Note:

Based on trailing 10Y monthly returns.

Source: Morgan Stanley Research forecasts

Exhibit 23: Discretionary allocation betas

Metric	MS Cross-Asset Ptf	MS XA Benchmark	USD 60/40 Ptf
vs EQUITIES			
MSCI ACWI (H)	0.66	0.69	0.70
S&P 500	0.59	0.60	0.64
vs FIXED INCOME			
Global AGG (H)	1.10	1.12	1.30
US AGG	0.86	0.92	1.04
UST	0.28	0.27	0.44
vs COMMODITIES			
WTI	0.08	0.11	0.08
Gold	0.07	0.14	0.11
Copper	0.20	0.26	0.22
vs FX			
DXY	-0.50	-0.73	-0.61
EUR	0.35	0.54	0.43

Source: Morgan Stanley Research

Top Trades Across Asset Classes

Exhibit 24: Top trades across asset classes

	Asset Class	Trade	Level (L)	Rationale	Type	Risks
1	Equities	Long JP equities (unhedged)	2306	TOPIX is in a secular bull market, helped by stronger growth and corporate governance. We see inflows continuing from foreign investors closing UW positions to OW as an additional tailwind.	Beta	Larger change to BoJ policy and/or weaker global growth drive a stronger JPY than our FX strategists have forecast.
2	Equities	Long (India + Mexico) vs MSCI EM	L India: 2216.4 L Mexico: 6065.3 L MSCI EM: 957.9	Nearshoring presents a long-term and multi-wave opportunity for Mexico's investment cycle. Macro-stability, structural reforms and strong FDI and portfolio flows set up India for superior EPS growth versus EM. On the other hand, the broader MSCI EM index faces earnings risks from rising USD strength and geopolitical uncertainties.	Alpha	Infrastructure bottlenecks and fiscal deterioration in Mexico. Negative market reaction to 2024 general elections in India may result in drawdowns. China growth surprises to the upside.
3	Equities	Long ACWI Industrials + ACWI Healthcare	L Industrials: 317.2 L Healthcare: 330.8	We see healthcare as a late-cycle outperformer given its defensive and growth properties, and prefer industrials relative to broader cyclicals. Valuations remain attractive versus history, and earnings revisions see an inflection.	Beta	Leading macro data inflect higher and equity market internals broaden out, favoring pro-cyclical sectors.
4	Rates	Long UST 30Y	Yield: 4.6	High real yields, slowing US growth and a commitment by the Fed to keep rates restrictive to bring down inflation should support US duration.	Hedge	Stronger growth raises expectations for inflation and the neutral rate.
5	Rates	Long UK 10Y	Yield: 4.2	Our strategists expect normalization of monetary policy as disinflation is sustained while growth remains weak. Yields fall across the term structure on expectation of more cuts.	Hedge	Inflation proving sticky, and BoE remaining hawkish.
6	FX	Short EUR/USD	1.0709	Our strategists forecast a lower EUR/USD by year-end. Data in Europe continue to soften with the risk of a technical recession rising further. EUR has failed to rally in recent days despite the fall in US rates and buoyancy in equities, likely in part reflecting the dour economic outlook.	Alpha	Improving European economic outlook and a hawkish central bank.
7	EM	Short CNH/INR	11.43	It has attractive carry, and our strategists believe that CNY should weaken in basket terms over the medium term given the deflation pressure and weaker exports.	Hedge	Significant fiscal stimulus from China and USD weakness.
8	EM	Receive 5yr CNY NDIRS	Yield: 2.4	The China rates market has seen a decent sell-off in recent days on the back of higher 7-day repo fixing. But should China growth continue to disappoint, the PBOC would have to stay on the dovish side or even cut rates again. The fixing could be more normalised, in line with the policy rate, which should help China rates to move lower.	Hedge	Significant fiscal stimulus from China and USD weakness.
9	Credit	CDX HY 15-100% vs CDX IG	L CDX HY: 467.2 L CDX IG: 69.5	Our strategists see decompression within credit in the base case, with slower growth, restrictive policy and a tail of credits that haven't made progress in addressing maturity walls driving the US default rate higher by mid-2024.	Beta	Stronger growth coupled with lower risk premiums for lower-rated credit.
10	Credit	CLO AAA and BB barbell	NA	Our strategists believe CLO AAAs offer attractive, high-quality carry, with a barbelled allocation into BBs providing attractive yields that give a cushion against potential spread widening in 1H24, before benefitting from spread tightening into the end of the year.	Alpha	Higher-for-longer rates leads to worse corporate fundamentals than projected.

Source: Morgan Stanley Research; Note: These are our current trades. All previous trades from cross-asset strategy not reflected here are considered closed.

Global Equities: Adjusting to the New Normal

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

Jonathan Garner
Jonathan.Garner@morganstanley.com
+65 6834-8172
Morgan Stanley Asia Limited+

Giorgio Magagnotti
Giorgio.Magagnotti@morganstanley.com
+44 20 7425-1965
Morgan Stanley & Co. International plc+

Key investment ideas

• **Stay patient and look for engagement opportunities into mid-2024:** We see a still-difficult outlook for global equities into 1H24, with our macro colleagues now forecasting later policy rate cuts and further USD appreciation. Global growth is expected to slow further and China has not shown a comprehensive response to debt-deflation risks. Falling inflation and expected policy easing in 2H24 should support a later recovery, but we think that investors should remain selective, given that earnings are still adjusting lower and aggregate valuations are expensive to history.

• **S&P 500 target moves up to 4,500, but near-term risks persist:** We continue to recommend a defensive growth and late-cycle cyclicals barbell and look for a durable earnings recovery to emerge during 2024. For December 2024, we forecast a 17.0x P/E multiple on 12-month forward EPS (2025) of US$266, which equates to a 4,500 index target (versus 4,200 previously for June 2024). In the short term, we expect the earnings recession to continue as weak earnings revisions breadth and performance in cyclical and interest rate-sensitive areas of the market corroborate near-term growth risks.

• **Retain a preference for Japan equities and caution on EM:** We see TOPIX moving further into its secular bull market, with our target rolling up to 2,600 (13% upside potential). We expect further inflows from both foreign investors (closing UW positions) and retail investors (driven by NISA program reforms) positioning for stronger nominal growth and corporate governance. In contrast, earnings and valuations for EM equities remain under pressure and we trim our target again to 1,000 (4% upside potential).

• **Modest upside for European equities; stay EW:** Earnings concerns are building – we anticipate the trough in 1Q. The larger challenge is that any recovery is likely to be L-shaped. Valuations are low but we expect only a slight re-rating from 11.9x to 12.0x as higher-for-longer yields provide a challenging backdrop. Our regression analysis shows a rising inverse correlation between yields and multiples. Rising buyback activity lends technical support, narrowing risk/reward. While we see just 1% upside potential to our price target, adding total yield brings total return to 6.5%, in line with the US.

Exhibit 25: Equities top-down preferences

Equities	-				+
US			■		
Europe			■		
Japan				■	
EM		■			

Source: Morgan Stanley Research

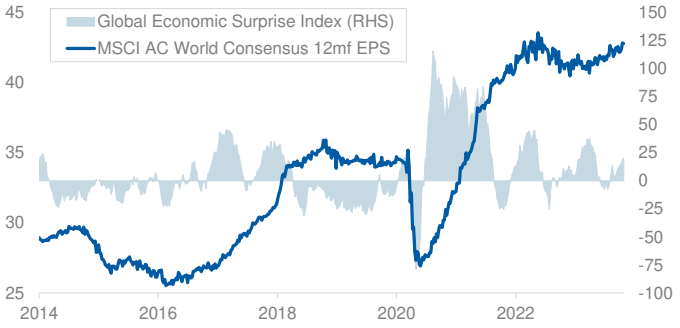
Exhibit 26: Equity indices targets

4Q24 Target	Base
S&P 500	4,500
MSCI Europe	1,810
TOPIX	2,600
MSCI EM	1,000

Source: Morgan Stanley Research forecasts

Macro resilience and AI potential surprised in 2023... Equity markets' performance this year was characterized by the unwind of the recession fears that were largely priced in at the October 2022 trough. While China's reopening and recovery proved muted, the US powered on and growth in India and broader G10 (especially Japan) was stronger than expected. This upside surprise to growth, as well as cost discipline in mega-cap tech and excitement over new AI-related revenue streams, led to earnings revisions moving higher for the MSCI All Country World Index (ACWI) from March onwards. Equity markets, particularly in 2Q, therefore looked through continued monetary policy tightening from the US and reached their highs for the year by mid-July.

Exhibit 27: MSCI AC World Index 12-month forward EPS versus Global Economic Surprise Index – the upswing in growth in 1H23 helped to drive positive revisions and market performance



Source: Bloomberg, IBES, Morgan Stanley Research; Note: Data as of October 26, 2023.

Exhibit 28: MSCI AC World Index 12-month forward P/E versus US 10-year real yield – still downward pressure on valuations from higher discount rates



Source: Bloomberg, IBES, Morgan Stanley Research; Note: Data as of November 8, 2023.

...but the slowdown was only deferred and should weigh on global equities over the next 3-6 months: Performance beneath the surface was not as strong as it appeared, with the average US stock underperforming the S&P 500 index by over 12pp year to date. Europe is seeing near-recessionary conditions, Asia PMIs are rolling over, and tighter financial conditions should eventually weigh on US growth. Meanwhile, policymakers in China are struggling with the '3D' challenges of debt, demographics, and deflation, which is only made more difficult by the 'de-risking' in our multipolar world baseline. The recent jump in oil prices consequent upon recent geopolitical events in the Middle East is an additional concern. Our colleagues' higher-for-longer policy profile and forecast for further USD appreciation should keep pressure on earnings and valuations heading into 1H24 and may dash any hopes of a year-end seasonal rally. Global equities (MSCI ACWI) are still trading at the 70th percentile of their 20-year average (15.5x spot versus 14.6x mean).

Better engagement opportunities may emerge into summer: Our economists forecast a soft landing in the US and China, while global disinflation allows monetary policy easing from 2H24. This should see an opportunity to add to equities alongside a retracement of global bond yields and the US dollar that our strategists see around mid-year. As this cycle normalizes, we see the US, Europe, and EM coming out of earnings recessions in 2024. while Japan earnings growth continues. Indeed, Japan bucked the trend last year and is the only market that we see beating consensus earnings forecasts out to 2025, given top-down and bottom-up drivers outlined in our recent Japan Blue Paper revisit (see Japan Secular Bull Market Arrives: Here is How to Play It, October 15, 2023).

Exhibit 29: Regional performance of equal-weighted versus headline index – narrow breadth and mega-cap leadership have masked broader weakness at the stock level



Source: FactSet, Morgan Stanley Research; Note: Data as of November 8, 2023.

Exhibit 30: Outlook for equity market earnings, valuations, and targets

Index	Current Price	Dec-2024 Base Case Index Target (%) Upside	Prior Target (Jun-2024) (% upside)	MS Top-Down EPS YoY %			Consensus EPS Forecast YoY %			MS Base Case N12M P/E Dec-2024	Current Consensus N12M P/E	10 Year Avg. Consensus N12M P/E
				2023	2024	2025	2023	2024	2025			
S&P 500	4,383	4,500 *3%*	4,200 *-4%*	215 *-2%*	229 *7%*	266 *16%*	221 *1%*	246 *12%*	275 *12%*	17.0	18.1	17.5
MSCI Europe	1,798	1810 *1%*	1,970 *10%*	141 *-4%*	145 *3%*	152 *5%*	143 *-3%*	152 *7%*	166 *9%*	12.0	11.9	14.4
TOPIX	2,306	2600 *13%*	2,400 *4%*	157 *9%*	172 *10%*	186 *8%*	157 *9%*	171 *9%*	185 *9%*	14.0	13.5	13.9
MSCI EM	958	1000 *4%*	1,050 *10%*	72 *-4%*	80 *11%*	91 *14%*	72 *-4%*	85 *18%*	97 *15%*	11.0	11.5	12.0

Source: FactSet, IBES, Morgan Stanley Research forecasts; Note: Data as of November 8, 2023.

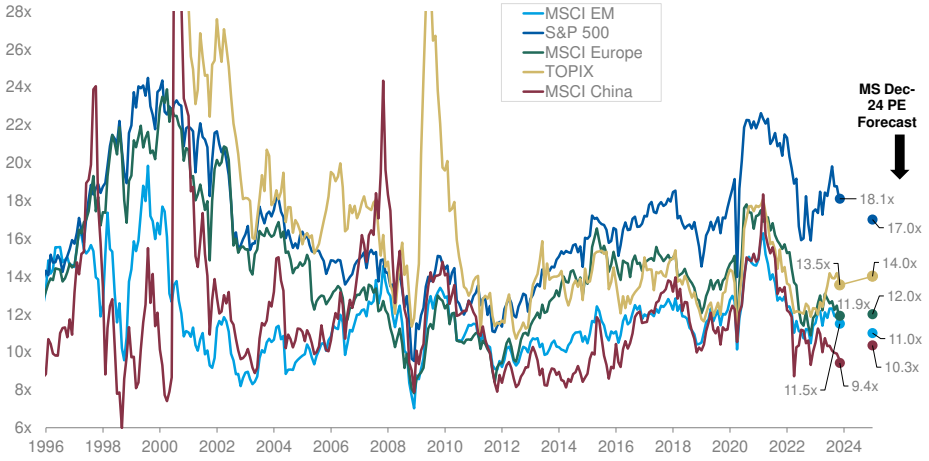
Regional preferences: We expect Japan equities to continue to outperform EM and China, given our relatively positive view on both earnings and valuations. We remain EW on Europe, where valuations are the lowest to history of the major regions. We move to a neutral stance on US equities as well given the earnings recovery we see taking hold next year. That said, near-term cyclical and interest rate headwinds keep us cautious in the short term.

Sector and style recommendations are generally defensive: Across the various regions, we have tilted towards defensives and quality, with a focus on high dividend and free cashflow yields. In the US, we like healthcare, staples, and utilities, select growth opportunities, and late-cycle cyclicals. In Asia, we expect a recovery in semiconductors and also prefer energy and nearshoring-exposed industrials. We like financials in Japan, Singapore, India, and Indonesia.

Risks are skewed up front and to the downside: One path to the bear case would be a near-term upside shock to the oil price – and hence a shock to consumer confidence, purchasing power, and business costs – consequent upon current geopolitical risk events. In this regard it is worth recalling the role that a spike in the oil price has played on numerous occasions in the past in driving bear case outcomes for equities, including 1973/74, 1979/80, 1990/91, and 2007/08. The second risk, outlined in our economists' downside scenario, is that China (~18% of global GDP) enters a debt-deflation trap with nominal GDP growth slowing to 2-3%Y (and likely lower again in USD terms). Were both of these scenarios to occur simultaneously, we would expect a more negative impact on Asia (including Japan) and Europe than on US equities.

In contrast, the path to the bull case could lie through a reduction in geopolitical risks, lower commodity prices, and sustained global disinflation, with an easing of the US dollar and rates versus our base case outlook. In this scenario, we would see EM and Japan best positioned through a stronger earnings profile and valuation re-rating.

Exhibit 31: Consensus 12-month forward P/E by region with Morgan Stanley December 2024 12-month forward P/E target



Source: IBES, FactSet, Rimes, Morgan Stanley Research; Note: Data as of November 8, 2023.

Exhibit 32: Equity sector and style preferences

	S&P 500	TOPIX	MSCI APxJ/EM	MSCI Europe
Sector Preferences	**OW:** Healthcare, Consumer Staples, Utilities	**OW:** Banks, Real Estate, Food & Beverage	**OW:** Industrials, Information Technology, Energy	**OW:** Energy, Healthcare, Pharma, Technology, Telecoms, Luxury Goods, Utilities
	UW: Broad Consumer Cyclicals	**UW:** Steel & Non-Ferrous Metals, Machinery, Pharma	**UW:** Real Estate, Consumer Staples	**UW:** Autos, Capital Goods, Chemicals, Construction & Materials
Style Preferences	1) Barbell of Defensive Growth & Late-Cycle Cyclicals	1) Productivity & Innovation Leaders v3	1) APxJ/EM Best Business Models	1) Defensives > Cyclicals
	2) High Operational Efficiency	2) Corporate Reform Candidates	2) Balanced Value/Growth	2) Growth > Value
	3) Earnings Stability/Quality	3) Value > Growth	3) Long Quality and Earnings Revisions	3) Quality

Source: Morgan Stanley Research

Exhibit 33: Base/bull/bear case outlook for global equities

Index	Current Price	New Target Price - Dec 2024 *(% from current levels)*			Old Target Price - June 2024 *(% from current levels)*		
		Bull	Base	Bear	Bull	Base	Bear
S&P 500	4,383	5,050 *15%*	**4,500 *3%***	3,850 *-12%*	4,700 *7%*	4,200 *-4%*	3,700 *-16%*
MSCI Europe	1,798	2,040 *13%*	**1,810 *1%***	1,480 *-18%*	2,240 *25%*	1,970 *10%*	1,625 *-10%*
TOPIX	2,306	2,800 *21%*	**2,600 *13%***	1,850 *-20%*	2,600 *13%*	2,400 *4%*	1,850 *-20%*
MSCI EM	958	1,140 *19%*	**1,000 *4%***	750 *-22%*	1,140 *19%*	1,050 *10%*	750 *-22%*

Source: FactSet, Morgan Stanley Research forecasts; Note: Data as of November 8, 2023.

US: Near-term uncertainty gives way to an earnings recovery

Near-term uncertainty should give way to an earnings recovery as we progress through next year. For December 2024, we forecast a 17.0x P/E multiple on 12-month forward EPS (2025) of US$266, which equates to a 4,500 price target ~12 months from today. Our 2024 earnings forecast of US$229 (+7%Y) assumes 4-5%Y top-line growth in addition to modest margin expansion as labor cost pressures ease. Our 2024 EPS estimate is also consistent with output

from our leading earnings models, which show a recovery in growth next year. In line with our comments in Standing Fast, September 10, 2023, our updated 2023 earnings forecast moves closer to our prior bull case, which brings our 2024 EPS growth rate down even though our 2024 estimate is little changed at US$229. 2025 represents a strong earnings growth environment (+16%Y) as positive operating leverage and tech-driven productivity growth lead to margin expansion. On the valuation front, we forecast a ~190bp equity risk premium (currently ~100bp); combined with our rates strategists' 3.95% 10-year forecast, this equates to a 17.0x forward P/E multiple at the end of next year (currently 18.1x).

While the medium-term outlook for earnings looks positive, the near-term backdrop remains challenged. Earnings revisions breadth, which typically leads consensus estimates, has rolled over once again and is at the lowest level since March this year. Underpinning this trend is more cautious corporate commentary overall that's once again centered on the macro – corporate transcript mentions of "macro risks" (and related terms) are historically elevated according to AlphaSense data. Leading indicators like the ISM PMIs and the Conference Board Consumer Confidence Index have also taken a recent turn lower amid increasing cyclical and geopolitical risks. Furthermore, the significant fiscal impulse that helped to fuel the resilience of growth this year is now decelerating in rate-of-change terms. Finally, a 'higher for longer' rate backdrop is increasingly weighing on both corporate and consumer sentiment.

In our view, the combination of these factors suggests that the earnings recession will likely persist into early next year before a durable recovery takes hold. Weak breadth and performance in cyclical and interest rate-sensitive areas of the market corroborate this near-term growth risk. As such, we continue to recommend a defensive growth and late-cycle cyclicals barbell. We also see stock-specific risk remaining elevated, which should be supportive of a stock-picking environment and indicative of a richer opportunity set under the surface of the market where valuations are more compelling than they are at the cap-weighted index level.

Europe: Earnings trough on the horizon but L-shaped recovery thereafter

At the time of our mid-year outlook, Europe was the best-performing major region globally. That relative strength has been unwinding since: First, any optimism on China reopening (with Europe's relatively high exposure) has faded, with focus shifting to downside risks. Europe also has a tricky balancing act, walking the geopolitical tightrope between China and the US. Officials have termed it 'derisking without decoupling', which can prove difficult for certain sectors such as autos. Second, certain sizeable sectors with secular drivers – notably luxury and capital goods – have begun to see growth disappointments in the current earnings season. Both are likely due to the new normal environment of 'higher for longer' rates leading to a declining aspirational consumer and falling capex budgets. For beloved sectors and stocks, the skew in share price performance on any disappointments has been decidedly negative.

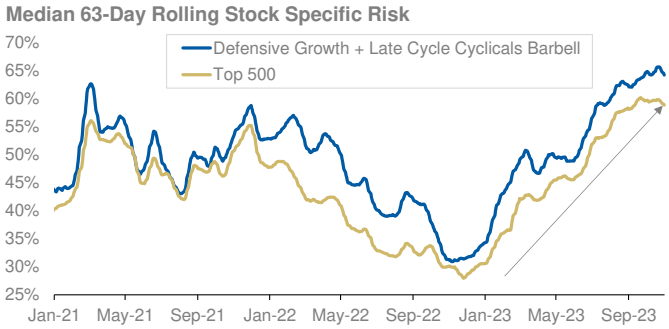
Exhibit 34: We recommend a defensive growth + late-cycle cyclicals barbell, which has historically outperformed in similar macro situations

Relative Performance in Decelerating Conference Board LEI Regimes

	Defensives	Lower Vol Growth	Late Cycle Cyclicals	Defensive Growth + "Late Cycle" Cyclicals Barbell
1973	-3.8%	-2.9%	12.5%	**1.6%**
1978	-11.8%	-13.5%	23.3%	**-1.3%**
1980	7.0%	11.9%	-17.6%	**-1.0%**
1989	16.8%	19.5%	2.9%	**12.6%**
2000	35.6%	12.1%	21.1%	**27.0%**
2006	12.6%	1.7%	12.2%	**10.9%**
2019	3.7%	7.9%	-12.6%	**-1.1%**
Current	*2.3%*	*5.1%*	*42.4%*	***15.3%***
Average	**7.8%**	**5.2%**	**10.5%**	**8.0%**

Source: Bloomberg, Compustat, Morgan Stanley Research; Note: Regimes defined as LEI contractions from the cycle peak of at least 3%. Recession periods not included. Far right column is a combination of the three columns to its left.

Exhibit 35: Elevated stock-specific risk suggests that it's prudent to deploy a stock-picking approach

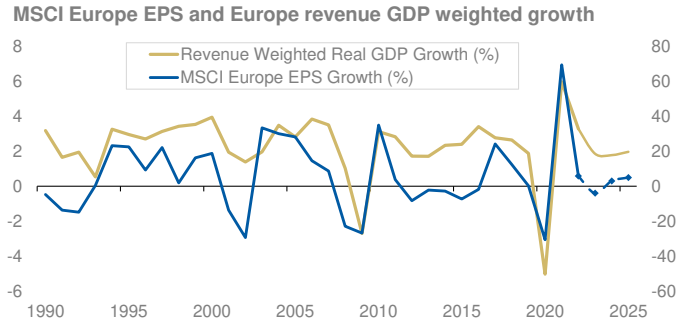


Source: Compustat, Morgan Stanley Research; Note: 10-day moving average shown.

Our leading indicators suggest that European earnings are likely to broadly bottom in 1Q: The issue is not so much the depth of the decline – European macro indicators have been weak for some time while earnings are broadly less cyclical than in past cycles. The problem is that **we do not see drivers for a V-shaped recovery post-trough.** For example, our European economists have euro area GDP rising from 0.4%Y this year to just 0.5%Y in 2024, a decidedly L-shaped recovery path.

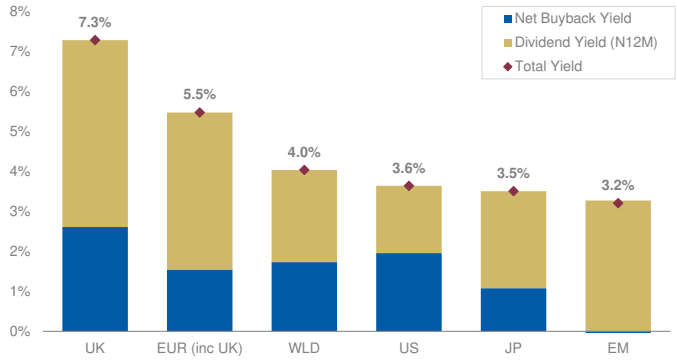
Europe of course remains cheap but we see the multiple rising only marginally from the current 11.9x to 12.0x on the back of our rates strategy team's forecast of US 10-year yields declining to 3.95%

Exhibit 36: GDP forecasts suggest that European equities' earnings growth recovery is more likely to be L-shaped than V-shaped



Source: MSCI, IBES, company data, Morgan Stanley Research

Exhibit 37: High total yields, and in particular rising buybacks amid low share volumes, are a support, limiting downside somewhat



Source: FactSet, Morgan Stanley Research

in 4Q24. 'Higher for longer' yields hold back any prospect of a European equities re-rating given a structurally rising inverse correlation between Europe's NTM P/E multiple and US 10-year yields.

As for downside support, European buybacks are on the rise and, with declining share liquidity, this means a technical support factor unlike in prior years. Europe's trailing buyback volume has risen to the 98th percentile versus history from close to the 0th percentile a year ago. Europe's dividend yield remains high as well. All in, **if we add Europe's total yield to our price target, we get to a return of 6.5% versus a less compelling 1% on price alone. This puts Europe's 'total' target return in line with the US.**

Japan: Secular bull market to continue

Japan equities remain the top pick market across our coverage and we recently published a Japan Insight report five years on from our original Blue Paper thesis. Sustained reflation and rising productivity at the macro level – working in combination with improved corporate governance at the micro level – will likely drive further improvement in corporate profitability in Japan. We raised our forecast for MSCI Japan return on equity to 12% (from 11%) by end-2025. This would be almost 2.5x the level when Abenomics was launched in late 2012. In turn, this will likely drive further valuation re-rating from 1.4x P/B to 1.8x and market outperformance versus global equity peers.

For our 2024 outlook, we lift our TOPIX target from 2,400 to 2,600 as we roll out another six months into solid EPS growth (10%Y in 2024 and 8%Y in 2025, helped by our higher USD/JPY profile of 140 for 4Q24). We think that Japan's equity market can withstand policy adjustment by the BoJ, which we see as in the early stages of simply responding to stronger nominal growth. Indeed, our target P/E multiple moves up by 0.5x to 14.0x, in line with its 20-year average, reflecting likely further support from foreign investors as well as inflows following Japan's revised Nippon Individual Savings Account (NISA) scheme that takes effect on January 1.

We now recommend an unhedged FX allocation for USD-based investors' Japanese equity allocations, given the balance of risk towards lower USD/JPY. We note that historically Japan equities have *risen* in USD terms during periods of sharp JPY appreciation, as the beta between USD/JPY and TOPIX (JPY) is less than one. Within Japan, we continue to favor **banks and lifers** for exposure to BoJ policy normalization, **domestic over exporter** stocks for nominal GDP recovery and JPY consolidation, as well as a basket of **corporate reform beneficiaries.**

Stay defensive in EM

Our MSCI EM target moves down to 1,000 from 1,050, as our below-consensus earnings forecasts for the index need to be lowered by another 5% across 2023-25. Key headwinds include the slowing global growth backdrop, higher interest expense burdens, and a further weakness in key EM exchange rates against the USD-denominated index. At the sector level, we see the prospect of an earnings recovery in semiconductors, but other cyclicals should remain challenged until China's growth momentum improves materially, while secular growth segments such as the EV supply chain absorb near-term overcapacity pressures. Our target 12-month forward P/E valuation also moves down by 0.5x to 11.0x as we factor in a 'higher for longer' policy rate and real interest rate regime.

Within APxJ and EM we prefer India, Mexico, Singapore, Greece, and Poland, having recently downgraded Korea and further downgraded our stance on Middle East equities. Our market, sector, and stock selection have moved more defensive since summer, in particular by narrowing our IT and China exposures. For details, see Market Allocation – Defensive Steps: Add to India, Upgrade Singapore and

Poland to OW, October 18, 2023.

On the risk outlook, our bear case of debt-deflation in China and weaker global growth would be a major further blow to the EM asset class, likely resulting in a full unwind of the sharp but fickle rally that was seen from October 2022. Japan would not be immune from this scenario, although expectations for China-exposed companies are already low and the greater risk would come from a US/EU recession and sharp JPY appreciation. We are also mindful of elevated geopolitical uncertainty and key elections in 1H24 (including in Taiwan, India, Indonesia, Mexico and likely in Japan). Our bull case features a much stronger policy response and hence market outlook for China, which would also restart the cyclical rally in other exporter-oriented markets, with Japan likely still performing well in this scenario.

G10 Rates: Land of Confusion

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

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

Koichi Sugisaki
Koichi.Sugisaki@morganstanley.com
+81 3 6836-8428
Morgan Stanley MUFG Securities Co., Ltd.+

Eric Oynoyan
Eric.Oynoyan@morganstanley.com
+44 20 7425-1945
Morgan Stanley & Co. International plc+

Fabio Bassanin
Fabio.Bassanin@morganstanley.com
+44 20 7425-1869
Morgan Stanley & Co. International plc+

Andrew Watrous
Andrew.Watrous@morganstanley.com
+1 212 761-5287
Morgan Stanley & Co. LLC

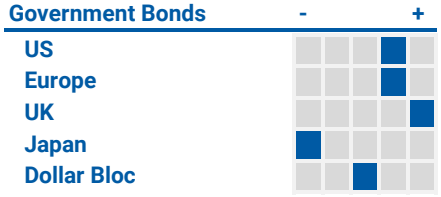
Key investment ideas

• **We suggest an overweight stance on government bond duration** as we expect yields to end the year in line with or below their market-implied forwards.

• **In the US,** we expect Treasury yields to move lower over the forecast horizon, with 10-year Treasury yields trading around 4.20% by 1H24 and 3.95% by the end of 2024. **In Europe,** the decline in core rates should be gradual due to a slow pace of ECB monetary policy normalization and heavy EGB supply in 1H24 combined with the start of PEPP quantitative tightening. **In the UK,** we see yields declining across the term structure and a bull flattening of the curve. We expect the BoE to deliver 100bp of cuts in 2024 compared to ~60bp priced in by the market. **In Japan,** we expect JGB long-end yields to remain near current levels even as other global benchmark yields decline, given that the BoJ eventually delivers on expectations for a rate hike. **In the dollar bloc,** we expect curves to bull steepen in 2024 as price pressures subside in all three economies. The Australian curve remains flatter than other curves, while the New Zealand curve steepens relative to Australia. Front-end Canadian yields fall swiftly in the second half of the year.

• **Top trades:** In the US, we suggest buying UST 30-year bonds outright. In Europe, we suggest selling BTP 10-year versus DBR 10-year. In the UK, we suggest receiving the Feb '24/Aug '24 MPC spread. In Japan, we suggest 10s30s steepeners (10-year OIS versus 30-year JGB). We also suggest a New Zealand OIS 2s10s steepener versus Australia OIS 2s10s flattener.

Exhibit 38: G10 rates top-down preferences



Source: Morgan Stanley Research

Exhibit 39: Bond yield targets

4Q24 Target	Base
10-year	
US	3.95
Germany	1.80
Japan	0.90
UK	3.50
2-year	
US	3.70
Germany	1.60
Japan	0.20
UK	3.20

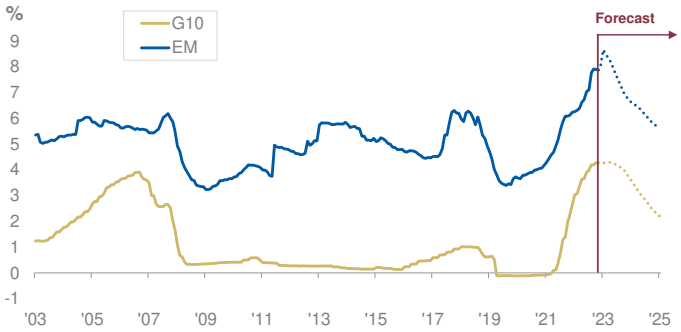
Source: Morgan Stanley Research forecasts

What central banks gave in 2020 and 2021, central banks more than took away in 2022 and 2023 – at least when it came to interest rate-related monetary policy. Both G10 and EM central banks raised rates to levels not seen in over 20 years. Considering the possibility that equilibrium rates have trended lower over the past few decades, central bank policy rates may be much more restrictive today than at any point since the 1970s.

However, we can't say the same for central bank balance sheets, which remain larger than before the pandemic, despite shrinking for well over a year now. Our economists forecast continued declines in the balance sheets of the Fed, ECB, BoE, and BoJ, Nevertheless, in aggregate, the balance sheet sizes of these G4 central banks should remain above their pre-pandemic level at the end of 2024 and 2025.

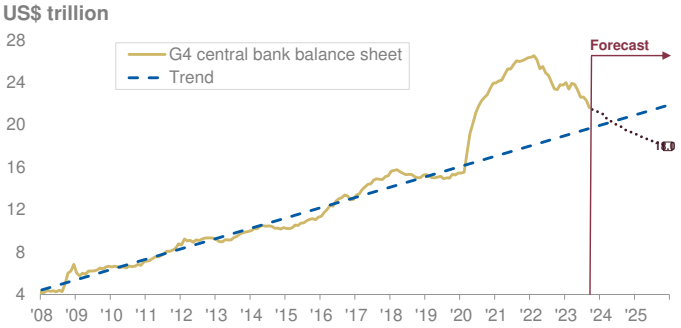
Alongside a continued shrinking of balance sheets should come lower policy rates – an important difference from previous cycles. Our economists project the Fed, ECB, BoE, and Riksbank to kick off the G10 easing cycle in 2Q24, with the BoC and Norges Bank following suit in 3Q24. Market-implied pricing differs from our economists' calls, but not in uniform ways. For example, markets price in a similar start to rate cuts from the Fed, but a less aggressive path

Exhibit 40: G10 and EM central bank policy rates and Morgan Stanley projection



Source: National central banks, Morgan Stanley Research forecasts

Exhibit 41: G4 central bank balance sheet size and Morgan Stanley projection



Source: National central banks, Morgan Stanley Research forecasts

thereafter. Markets also price in a later start and less aggressive path for the BoE.

Sovereign supply may be another area that confuses rates investors. We expect net coupon government bond supply (not including bills) to increase significantly across the G7 in 2024 after taking central bank activity into account. Net coupon bond supply after central bank purchases amounts to US$2.45 trillion in 2024, up from US$1.68 trillion in 2023, a year-on-year change of US$774 billion.

Our projected increase in G7 coupon bond supply won't be the largest year-on-year increase in the past 15 years – 2009, 2018, and 2021 saw larger increases. Despite the large increase, we think that most investors already expect it. This suggests that market prices/yields already reflect the increase in the stock of bonds, i.e., the 'stock effect'. Of course, plenty of opportunity should arise to capture 'flow effects' from the actual issuance.

In our view, the macro environment – which will drive central banks to start easing – will drive bond yields lower, causing confusion among investors who fret about higher bond supply. All in all, our outlook for G10 rates markets in 2024 promises to inject doubt into the minds of investors who bought into the idea that higher yields were here to stay. Instead of inspiring confidence in 'higher for longer', rates markets will confuse.

In the US, we expect Treasury yields to move lower over the forecast horizon, with 10-year Treasury yields trading around 4.20% by 1H24 and 3.95% by the end of 2024. Cooling growth, labor markets, and inflation, a rate-cutting cycle starting in June 2024, more flexible Treasury supply, and a return of buyers missing in 2H23 help to drive both lower rate expectations and term premiums in 2024. Fiscal policy, which played a key role in lifting growth and yields higher in 2023, does not provide any further impetus heading into the US elections in 2024.

The first half of 2024 is characterized by markets reversing some of the rise in real yields in 2H23, as they de-link healthy growth from inflation risks, given the role of rising labor supply raised by Chair Powell. The recent flexibility shown by the US Treasury around coupon supply keeps the 'Treasury oversupply' narrative at bay. As macro conditions cool, and the Fed inches towards a rate cut by June 2024, buyers like banks and overseas investors who shied away from Treasuries in 2H23 should step back into the Treasury market.

Fed actions dominate 2H24. Our economists see the Fed cutting rates for the first time this cycle – by 25bp in June 2024, with three more 25bp cuts in 2024. They see another eight 25bp cuts in 2025. With this Fed forecast, we expect front-end yields to gap lower in 2H24, with back-end yields falling modestly, steepening the curve. 2-year yields end 1H24 at 4.40% and hit 3.70% by the end of 2024.

In 1H24, we see the decline in yields led by the back end, modestly bull flattening the curve. With cooling growth and flexible Treasury supply, back-end yields price out the recent themes that drove higher yields in 2H23. On the other hand, the rate-cutting cycle dominates in 2H24, causing a significant bull steepening of the curve. With both bull flattening and bull steepening in play at various points in the year, we see more bang for the buck in bullish duration trades, rather than positioning for curve moves. We suggest long 30-year Treasuries as a medium-term trade for 1H24.

We see a wide range within our bull and bear case scenarios, given the wide range of possibilities – from a series of more rate hikes, to a fast cutting cycle. In the bull case for the US economy and bear case for US Treasuries, our economists see four more 25bp hikes in 2024. We see bear flattening of the curve, with 10-year yields ending 1H24 at 4.75% and ending 2024 at 5.05%. In the bear case for the economy and bull case for Treasuries, our economists see 350bp of cuts in 2024. We see bull steepening of the curve, with 10-year yields ending 1H24 at 3.30% and ending 2024 at 2.50%. We expect interest

rates volatility to stay high at least until a clear direction emerges for US rates.

In our base case, as inflation risks cool, we see 5-year and 10-year breakevens tighten from their locally wide levels and settling around 2.25% by the end of 2024 – very close to levels consistent with the Fed's 2%Y inflation target. On the back of cooling growth, we see real yields leading the bulk of the decline in nominal yields, with 10-year real yields ending 2024 around 1.70%.

In the euro area, although we consider that the ECB's monetary policy tightening is now behind us, with the last deposit facility hike in September, the decline in core long-term rates in 2024 should be gradual due to a slow pace of ECB monetary policy normalization from June 2024, and heavy EGB supply in 1H24 combined with the start of PEPP quantitative tightening.

On the positive side, our economists expect eurozone headline inflation to decline at a faster pace in 2024 than inflation fixings, with both the year-on-year headline and core series close to 2%Y by late 2024, and we forecast a lower growth rate than the ECB, i.e., 0.5%Y versus 1%Y.

On the negative side, the ECB cuts are going to be gradual at the start of the easing process in 2H24, i.e., a 100bp easing instead of the 150bp expected earlier. The front-loading of EGB supply in 1H24 also leads us to forecast a higher 10-year Bund yield that the level implied by our Bund long-term model, hence our forecast of 2.50% for 1Q24 and 2.10% for 2Q24. The fall below 2% could be postponed to the summer and we see stable 10-year yields at 1.80% from 3Q24 as the steepening could accelerate with bigger ECB cuts in 4Q24. Our forecasts imply a 10s30s slope significantly steeper than forwards by 2024.

For the bear case, stronger wage growth in 2024 would lead the ECB to hike by 25bp in June and September 2024, i.e., a 4.5% terminal rate, before some marginal easing by late 2025. This higher path of short-term rates could be partly offset by the falling headline inflation series, although slower than in the base case, allowing relative stability of 10-year Bund yields around 2.70-2.80% for most of 2024. Unsurprisingly, 2-year yields should post new highs by 2Q24, i.e., a 2s10s slope much lower than forwards by late 2024.

For euro area sovereign spreads, 2024 should be characterized by diverging paths between eurozone countries, with one group with Germany, Austria, and Portugal benefiting from supportive supply statistics while another group with Italy, Belgium, and Ireland is likely to witness higher supply whatever the metrics. Our call for a rewidening of EGB spreads since June 2023 should last longer, with a peak in spreads expected now in 1Q24 instead of 4Q23 due the resumption of the heavy issuance in 1Q24, weaker activity data, and a PEPP QT announcement.

A gradual tightening the rest of the year is our central scenario as we consider that investors could return to carry trades like non-core EGBs with the start of the ECB monetary policy normalization. Once again, we consider that the widening in the 10-year BTP/Bund spread should be the most pronounced – we forecast a 220bp level by 1Q24 in our base case and 250bp in our bear case. In our bull case, we would expect the spread to hover around the current level, highlighting the asymmetry of outcome for BTPs in 2024.

In the UK, we expect a normalization of the monetary policy stance as we get more evidence of sustained progress in disinflation while economic growth remains weak. Expectations for rate cuts should then increase and support lower yields and steeper curves as the BoE's rhetoric changes gradually towards a normalization of the policy stance. We thus see yields declining across the term structure and a bull flattening of the curve throughout the forecasting period in our base case. Accordingly, we forecast the 10-year gilt yield at 3.70% for 2Q24 and 3.50% for 4Q24.

Furthermore, we expect the BoE to deliver 100bp of cumulative cuts by the end of 2024 – compared to ~60bp priced in by the market – hence our forecasts imply lower yields and a steeper curve than current forward rates. That said, a more resilient US economy and better-than-expected UK economic growth remain headwinds to our base case, and we expect Bank Rate at 5.75% by 2024 in a bear case scenario, where strong demand and inflation pressures force the BoE to hike twice again. Under these conditions, we forecast the 10-year gilt yield at 4.80% for 2Q24 and 4.60% for 4Q24.

Additionally, the gilt market should continue to face ongoing challenges: higher-than-historical gilt supply poses a risk for valuations especially as the BoE is carrying out QT operations, despite our view that active sales should be halted once policy stance normalization commences. Meanwhile, demand from historical buyers of long-end gilts should remain subdued as funding ratios across pension funds have improved at a time when we expect risk-transfer activity to increase to historical highs.

In Japan, we expect JGB yields to flatten into 2Q24 as the BoJ begins its normalization cycle. Our economists expect the BoJ to remove NIRP (-0.1% -> 0%) in January 2024, and hike rates by another 25bp in 3Q24, as a one-off income tax cut will take effect from June/July. That said, they don't see any additional hike up to 2025, since they expect core CPI to go below 2.0%Y from 3Q24.

Meanwhile, the market has already fully priced in the BoJ to remove NIRP by January 2024, and sees another 25bp hike in July 2024. On top of that, the market has priced in more than 40bp of hikes by 4Q25. Given the relatively hawkish BoJ policy path already priced in by the market and with the core CPI measure expected to go below 2%Y in 2H24, we expect the market to reprice the future BoJ policy trajectory lower as it begins its normalization process. Moreover, we see the term premium in JGB yields being pushed lower at a gradual pace alongside the lower UST yields.

We expect the front-end yield to be traded higher on the constant-maturity basis as the BoJ's actual rate hike would be reflected in the rates expectation. Meanwhile, we see the 10-year+ JGB yield trading resilient throughout the forecast horizon, given the high sensitivity to UST yield changes. We expect the 10-year JGB yield to end 2Q24 at 0.85% and 4Q24 at 0.90%. We see the curve to twist flatten in the less-than-10-year sector.

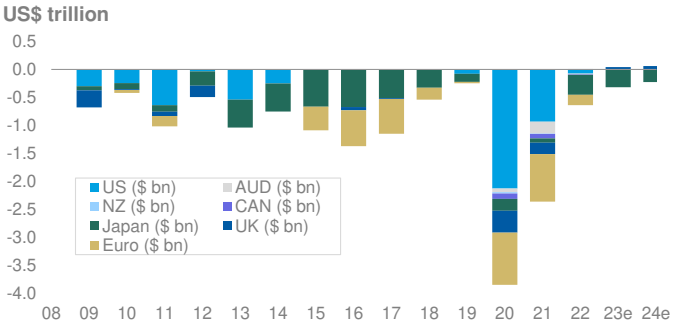
In the dollar bloc, we expect curves to bull steepen in 2024 as price pressures subside in all three economies. The Australian curve remains flatter than other curves into 2Q as domestic growth remains robust and the RBA keeps rates on hold longer than peer central banks. The New Zealand curve steepens relative to Australia as growth continues to decelerate despite elevated inflation. Front-end Canadian yields fall swiftly in the second half of the year as inflation descends towards the midpoint of the BoC's inflation control target range and the BoC and the Fed retreat from a restrictive policy stance.

In Canada, front-end policy rate compression with the US by end-2025 has been priced in, but allows 2-year yield differentials to narrow as a comparable pace of cutting from a similar level is priced into the front end of both North American curves. Our quantitative model suggests that the 2-year point is slightly cheap while the 10-year point is slightly rich, so our forecasts maintain a relatively wide 2s10s spread. Growth remains sluggish through 2024 as consumption stays subdued and fiscal support remains anemic relative to the US. However, a stubbornly slow deceleration of price pressures keeps long-end Canadian bonds from outperforming their American counterparts.

In Australia, we see front-end yields drifting sideways through 1H24 as resilient inflation pressures lead the RBA to raise rates to 4.60%, and then keep rates on hold longer (i.e., cut later) than peer central banks. 2-year yields decline in 2H24 as the RBA signals that achieving its goal of inflation of 2-3%Y is within sight. Iron ore and coal exports rise into 2H24 as Chinese growth recovers, steepening 2s30s against a backdrop of growth reacceleration on a quarter-on-quarter basis.

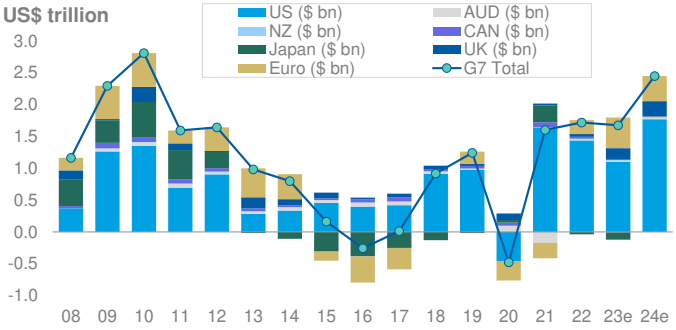
In New Zealand, we see front-end yields staying elevated through 1H24 as inflation descends at a disappointingly slow pace (remaining above 4%Y through mid-2024), keeping the RBNZ from signalling a descent from its policy rate peak at 5.50%. The NZGB curve bull steepens in 2H24 as CPI inflation decelerates below the pace in Australia and growth continues to decelerate from the 2022 highs.

Exhibit 42: Central bank impact on net coupon bond supply, notional in USD, 2008-22 actual, 2023-24 expected



Source: National treasuries, national central banks, Morgan Stanley Research estimates

Exhibit 43: Gross coupon bond issuance net of redemptions and central bank purchases, notional in USD, 2008-22 actual, 2023-24 expected



Source: National treasuries, national central banks, Morgan Stanley Research estimates

FX: Charting the Northwest Passage

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

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

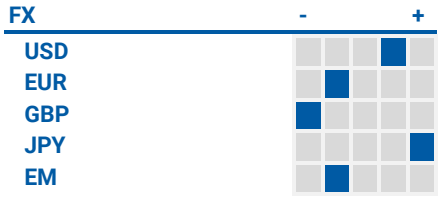
Koichi Sugisaki
Koichi.Sugisaki@morganstanley.com
+81 3 6836-8428
Morgan Stanley MUFG Securities Co., Ltd.+

David S. Adams
David.S.Adams@morganstanley.com
+44 20 7425-3518
Morgan Stanley & Co. International plc+

Key investment ideas

- **USD is stronger for longer through the winter:** USD strength continues as growth and rate divergence continues and USD's defensive characteristics remain alluring.
- **USD peaks in the spring but fails to fall:** Peak and falling real policy rates and increasing growth symmetry are mostly counterbalanced by favorable rate differentials, low absolute growth rates, and USD-positive political risks.
- **Top trades:** Short EUR/USD to 1.00, short GBP/NOK to 12.20, and short AUD/JPY to 88.00.

Exhibit 44: FX top-down preferences



Source: Morgan Stanley Research

Exhibit 45: FX targets

4Q24 Target	Base
EUR/USD	1.04
USD/JPY	140
GBP/USD	1.15
AUD/USD	0.63

Source: Morgan Stanley Research forecasts

As part of our forecasting process, we tried to craft (plausible) outcomes that could generate both a higher and a lower USD. **Charting a path to USD strength proved straightforward,** given recent history – US and RoW growth and yield divergence, geopolitical 'unknown unknowns', and demand for defense and carry all proved helpful for USD.

However, charting a course to a weaker USD proved much more like navigating the Northwest Passage, or the often-frozen pathway for ships to sail from Europe to Asia via the North American Arctic. **Like the Northwest Passage in winter, the pathways through to a weaker USD appear narrower, cloudier, and fraught with risk.**

Threading the needle of a 'soft landing' to generate USD weakness is possible but tricky: US data need to soften meaningfully enough to end the 'US outperformance' narrative, **but gradually and predictably enough** so as to avoid a repricing of a 'hard landing'.

Investors would need to get more optimistic about RoW growth – a task made harder, not easier, by a rapid US deceleration: And of course, even if one considers this outcome probable, it will take at a minimum a few months to confirm given the large gap between US and RoW data and the time needed to generate such a consistent and gradual change.

Disinflation and central bank rate cuts in 2024 might serve to boost risk appetite, which tends to weigh on USD, but with European central banks cutting rates both earlier and more meaningfully than many markets expect, the **shift in rate differentials in USD's favor might counterbalance the normally risk-positive and thus USD-negative impacts from central bank easing.**

And, of course, **the skew of risks** – which market prices incorporate, but modal forecasts do not – **makes it harder for USD to weaken.** Geopolitical risks, either from global tensions impacting commodity prices and supply, or from changes in US foreign and trade policy in 2025, are likely to remain if not increase in the market price.

Growth risks around the world remain asymmetrically skewed to the downside as central bankers continue to try to 'stick the landing' from elevated to target inflation. Even as central bankers begin their cutting cycle, we think it is unlikely that they will want to prematurely declare 'mission accomplished'; a hawkish bias in tone, coupled with growth rates uncomfortably close to negative territory, may keep subjective recession probabilities in elevated territory, supporting defensive currencies at the margin.

We think that the trend of USD strength is likely to continue, at least for the next few months, with the DXY forecast to rise to 111 by the spring, a roughly 5% gain from current levels. The 'stronger for longer' USD path incorporates US outperformance across a variety of metrics:

- **Growth:** US growth, while slowing, is expected to outperform expectations and remain near trend levels, contrasting sharply with recessionary or near-recessionary levels in Europe and uncompellingly weak growth in China (Exhibit 46).
- **Rates:** While US yields have likely peaked and the Fed begins cutting in 2024, European central banks cut sooner and faster than expected. This keeps rate differentials moving in USD's favor.
- **Defense:** USD 'outperforms' its peers in offering defensive characteristics in a world with low growth rates, asymmetric downside risks from central bank restrictiveness, and geopolitical risks.

This base case of US 'outperformance' through the winter keeps the pathway through the Northwest Passage of USD weakness hard to find and navigate – not impossible, but difficult. However, **as we approach the spring and summer, the ice begins to thaw and 2Q sees the risks around USD turning more balanced and away from clear strength.**

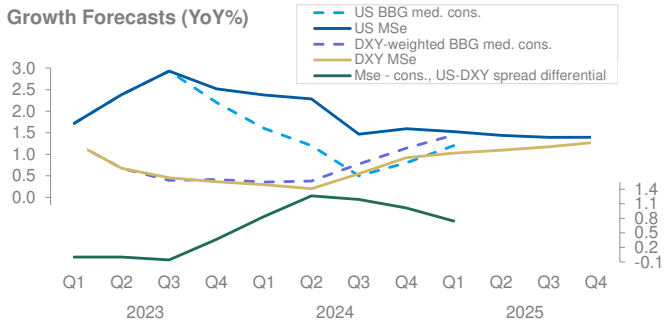
The peak and start of the decline in real policy rates begins to shift the growth asymmetry closer to symmetry: Investors begin turning their focus away from the past (recession concerns, restrictive policy rates, growth weakness) and towards the future (rates returning to neutral, China and Europe re-emerging from weakness).

But while the Northwest Passage may become increasingly navigable, icebergs and hazards remain which limit USD downside.

As noted above, real rates globally may be falling but rate differentials still continue to favor USD. Growth expectations may become more balanced but the absolute level remains quite low and risks still abound from central bank normalization. Political factors may also limit USD's weakening as the long-term trend of deglobalization continues and investors increasingly price in USD-positive risks around US foreign and trade policy in 2025 and beyond.

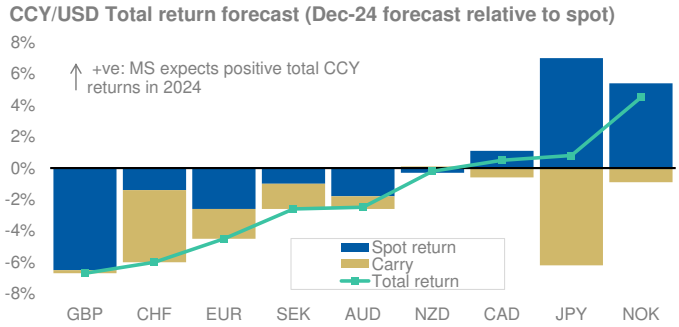
As a result, while forces may align in the spring and summer to make the Northwest Passage to USD weakness more navigable, it's not as

Exhibit 46: US growth outperformance should continue into 2024, both in absolute terms and relative to expectations



Source: Macrobond, Morgan Stanley Research forecasts

Exhibit 47: NOK offers the highest total return while GBP and CHF are the largest underperformers based on our forecasts



Source: Bloomberg, Morgan Stanley Research forecasts

obvious that markets will complete the journey. **The absence of compelling alternatives to buy versus USD keep USD weakness in 2H24 quite limited, with the DXY only falling to 107 by year-end.**

A scenario where US growth undershoots our base case but the RoW accelerates faster and more meaningfully is, in our view, one of the clearest paths for USD to take a significant turn lower. This is envisioned in our **bear case, which puts the DXY at 101 by end-2024.** This risk case becomes more and more plausible as we approach the middle of next year. But our base case is one where counterbalancing forces keep USD from losing much of its allure, limiting its fall.

The clear exception to widespread USD strength is JPY, which ends up the broad-based outperformer: We see USD/JPY falling to 142 by mid-2024. JPY's outperformance is chiefly explained by rate differentials – both falling US rates as well as an end of YCC and negative rates in January and, eventually, rate hikes from the BoJ.

While Japan leads, Europe lags: Technical recessions in the eurozone, Sweden, and the UK lead these central banks to begin the cutting cycle first in the second quarter. Uncompelling growth and falling rates weigh on these currencies, with **EUR/USD returning to parity by 1Q24 and staying around the 1.00 level for most of the year**.

GBP chiefly benefited from its high carry this year, but we expect the BoE to cut far faster and more aggressively than what's priced. Coupled with low growth and GBP's greater risk sensitivity, this leads **GBP/USD to fall to 1.14 by mid-2024 and EUR/GBP to rise to 0.90 by end-2024.**

Nordic currencies are poised for meaningful divergence. We expect **NOK to be the top performer** (outside JPY) in G10 FX, bucking the European trend, aided by slowing Norges Bank FX purchases, hawkish monetary policy, and cheap valuations. This brings **EUR/NOK from a peak of 12.00 at year-end down to 11.00 by end-2024.**

However, SEK follows a much more challenging path, as the temporary boost from the Riksbank's SEK-buying FX-hedging program fades and global and local weakness keep SEK less buoyant until the summer. These divergent paths bring **NOK/SEK back to 1.05 by end-2024. EUR/CHF remains range-bound and reaches 0.95** by end-2024, bounded between its safe-haven status on the one hand and more explicit welcoming of CHF weakness by the SNB on the other.

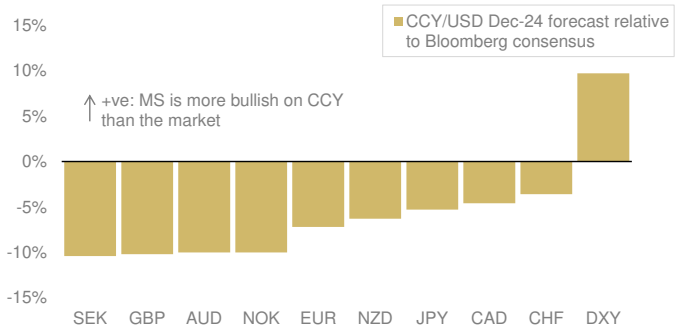
Dollar bloc currencies largely track the broader USD contour, with regional exposures guiding relative performance; exposure to the **outperforming US relatively bolsters CAD, rising only to 1.41 by 1Q24,** while **AUD falls to 0.61** given its exposure to China. **NZD splits the difference,** rising to 1.07 versus AUD but underperforming CAD marginally.

EM – more FX weakness ahead: We expect to see the trend of USD strength persist against EM currencies too. The main EM currencies that we track are those within the GBI-EM local markets index, though that is not a comprehensive list. The low point for EM currencies in our forecast profile is 2Q24, reflecting the peak of the USD profile, and is 4.3% below current levels. This spot level is similar to the lows EM currencies made versus USD in October last year.

The level of carry available on EM currencies is extremely low (about 1.9% over 12 months), thanks to high short-term USD interest rates. Our FX total return projections suggest a -3% total return by the middle of 2024, before recouping those losses by the end of 2024.

A clear source of support for USD over the coming six months is the increase our economists are expecting to see in US real policy rates relative to EM. Even as inflation starts to come down, the Fed is not expected to cut rates until well into 2H24, while many EMs and other advanced economies are expected to cut rates earlier in the year. We expect the real policy rate differential between EM central banks (as represented by the economies in the GBI-EM index) and the Fed to compress through to the middle of 2024, reaching 0%, before widening again in favor of EM by the end of the year.

Exhibit 48: Morgan Stanley remains more bullish than consensus on USD



Source: Bloomberg, Morgan Stanley Research forecasts

Within Latin America, we see **MXN outperforming** in the short term but expect to see some additional risk premia in the currency as we move through 1H24 and towards the presidential elections. We see MXN weakening sharply in 1H on the back of fiscal concerns, with Banxico likely to also start cutting rates in the second half of the year. We see **BRL underperforming** more in 2H as the BCB continues with rate cuts and the currency fails to recover in line with the rest of the asset class.

In Asia, we expect continued **CNY weakness.** The PBOC is likely to tolerate a weak currency in order to support an economy struggling to contain deflationary pressure. We see USD/CNY moving up to 7.50 with the trade-weighted basket also weakening. In contrast, we see **INR outperforming** amid USD strength thanks to RBI intervention and expectations of stability ahead of the election. The February budget should be market-friendly and thus be supportive of equity inflows.

In CEEMEA, we see **HUF underperforming** on the back of EUR weakness, a lackluster growth recovery, and continued tension between the government and the EU. **PLN** and **CZK** should see a stronger performance of their currencies. **ZAR will likely weaken** in 1H ahead of the election on account of fiscal concerns and beta to USD before a recovery in 2H as the market digests the growing evidence of increases in energy availability.

Global EM Fixed Income: Patience Required

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

Simon Waever
Simon.Waever@morganstanley.com
+1 212 296-8101
Morgan Stanley & Co. LLC

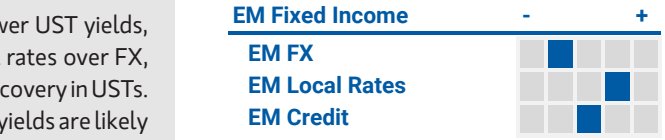
Min Dai
Min.Dai@morganstanley.com
+852 2239-7983
Morgan Stanley Asia Limited+

Key investment ideas

• We expect USD strength to continue, but this time with gradually lower UST yields, which support EM bonds. This leaves us with a preference for EM local rates over FX, though a recovery in EM local bonds will be dependent on the expected recovery in USTs. High US rates will likely cannibalize broader fixed income flows, so lower yields are likely needed to prompt inflows to EM. This should happen gradually in 1H and accelerate in 2H24.

• In sovereign credit, we see index spreads peaking at 460bp in early 2024 before ending the year at 410bp. Adding lower UST yields, total return end up positive at 14%.

Exhibit 49: EM fixed income top-down preferences



Source: Morgan Stanley Research

Exhibit 50: EM fixed income targets

4Q24 Target	Base
EM $ Sov Credit	410
EM Local	6.4%

Source: Morgan Stanley Research forecasts

Overview

Often, the market views contained within sell-side year ahead outlooks tend to be the opposite of the dominant trend from the previous year. Last year was a case in point, where most were calling for a reversal of the rise in yields and a sell-off in USD. As we know, yields continued to rise and USD has generally had a good year, rising against most currencies with the exception of a handful of EMs.

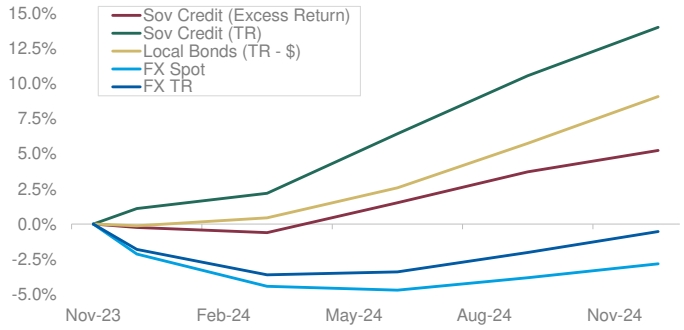
This year we are taking a different approach, at least for EM credit and FX, where we are forecasting further spread widening and currency weakness through 1H24, continuing the trend of the past few months. For EM credit, we expect spreads to hit 460bp. In FX, we see around 4% weakness in spot terms through to 2Q24, with carry only offsetting these losses to a small extent given that available carry sits at just 1.9% on an annual basis.

The key driver of this outlook is the expectation that the US economy continues to expand at near-potential growth rates over 1H24. Our US economics team's growth numbers are well in excess of the consensus forecast (which could admittedly change once all banks have published their year ahead outlooks) for 1H24. Should those expectations be realized, data surprises through 1H24 should support the dollar and prevent the market from pricing much of an easing cycle from the Fed. At the same time, our economists are expecting the eurozone to be in recession, allowing the ECB to begin cuts earlier. Meanwhile, China's growth recovery remains slow and unconvincing to the market, with our China equity strategists expecting further losses over the coming months.

The US-eurozone divergence is reflected in our rates strategy team's forecasts, with differentials expected to move in a USD-supportive direction. With high US rates expected for some time, USD strength and wider spreads should be expected. Over 2H, US rates start to price in a more significant easing cycle from the Fed as growth slows. The first Fed cut begins in June with a much deeper easing cycle expected versus current market pricing, suggesting that USD weakness can be sustained through 2H24 and into 2025.

As for EM rates, we expect a gradual recovery in 1H, with modest drops in UST yields and USD strength offsetting the expected continued decline in inflation. A recovery in EM local bonds will be dependent on a recovery in USTs. High US rates will likely cannibalize broader fixed income flows, so lower yields are likely needed to prompt inflows to EM. This should happen gradually in 1H24 but more significantly in 2H24.

Exhibit 51: Global EM quarterly forecast returns



Source: Morgan Stanley Research forecasts

Exhibit 52: EM credit spread forecasts



Source: Bloomberg, Haver Analytics, Morgan Stanley Research forecasts

Sovereign credit

External factors are not supportive enough: All the broader Morgan Stanley forecasts suggest upwards pressure on EM credit spreads from here. This includes wider US HY credit spreads, a lower S&P 500, and a stronger dollar in the next six months. Slightly lower US Treasury yields help to take some of the pressure off yet the set-up is still one of 'higher for longer'. In particular, our expectation for the first rate cut by the Fed is in June 2024. One immediate consequence is that outflows from the asset class are likely to continue, leaving technicals overall challenging. For EM credit spreads to tighten against such a backdrop requires significant EM growth outperformance. However, with US growth expected to remain resilient in 1H24, such signs may only become evident into 2H24.

Yet the key problem remains valuations: The key issue, as has been the case for most of 2023, is that markets have done well to price the different outlooks facing the various rating buckets of the index.

The IG and low-risk HY bucket (mainly BBs and very strong Bs) will be facing higher funding costs. Ideally countries would either see higher growth rates or fiscal consolidation to deal with this, yet neither seem feasible at this point. This means that the debt trajectory will resume its upwards path for most countries. On the positive side, these countries still have market access and overall fundamentals are resilient, with central banks having taken conventional paths and no significant external imbalances (unlike during the taper tantrum). The problem is that this is priced already, in our view. Spreads for these two buckets are still very tight, both outright and versus US corporate credit spreads.

The higher-risk HY bucket (performing single Bs and below) clearly does trade much wider and looks cheap versus history, both outright and versus US credit. Yet many countries in this bucket also face a maturity wall that increases into 2024-25 at a time when we expect few to have market access. While it doesn't mean that we expect a rise in defaults, it does mean that spreads should remain wide to account for still-growing liquidity risks. Many countries will be in IMF programs yet we think that these help countries to muddle through as opposed to leading to key fundamental improvements. Finally, and on a more positive note, we do see progress among the countries that have already defaulted, with Zambia and Suriname likely to complete their restructurings before the end of the year and Ghana and Sri Lanka following in 2024. Not only would this be positive for the outlook for the asset class, but it also means that index spreads should reduce optically, even if total returns do not change.

Our investment thesis remains cautious: We see spreads wider in 1Q24 before recovering for the remainder of the year to end 4Q24 at 410bp. With slightly lower UST yields, the total return ends up positive at 14% from today until end-4Q24. This means that we hold off on adding more beta risk until spreads are wider. Within HY, our key picks are mostly within the single B and below rated bucket, given that this is where valuations are cheap. Selectivity is important, with access to financing away from markets key.

Local markets

In Asia, we believe that a combination of stronger USD, elevated oil prices, and a bumpy recovery in China would lead to front-loaded FX weakness in 1Q24. We expect the PBOC to ease its control of CNY and allow it to weaken in line with the broad USD move in order to reduce deflation pressure and support exports. CNY weakness could cause currencies such as MYR, SGD, and TWD to underperform. On the other hand, we expect high carry currencies such as INR and IDR to outperform thanks to their central bank support via either intervention or rate hikes, which could provide some carry opportunities into year-end.

In rates, we are a bit more upbeat after being bearish on Asian duration for the past two months. Lower UST yields in 2024 could alle-

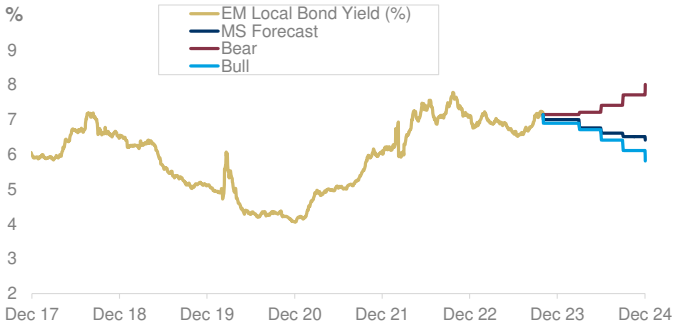
viate pressure on some Asian central banks, some of which were forced to hike rates last month. We see opportunities to receive rates or long duration in markets such as Indonesia. We are also constructive on China duration. Liquidity has been tight in recent months in order to support CNY, but we expect this tightness to reverse in 2024 given the growth outlook and the need for the PBOC to support the economy.

In LatAm, we forecast gradual underperformance in BRL, CLP, and COP, even in 2H24, as a weaker USD should be offset by reducing carry. MXN should be the outlier of the region, in our view, given idiosyncratic (Mexican election) and US factors (slowdown in US data, US election). For now, we expect more of the upside pressure in 1H (peak of 20.00), but we think that risks to our 2H24 USD/MXN forecasts are also skewed to the upside given the US backdrop. To be clear, we think that MXN's underperformance will be a 2024 story and the currency should continue to trade well into end-2023.

In rates, we operate under the assumption that regional central banks will be adequately sensitive to potential FX pressures stemming from a narrowing policy rate differential versus the US, and that they will proceed at a more gradual pace. We do see risks that some regional central banks such as Brazil's will have to pause their easing given local noise. We like to receive 5-year IBR versus CAM, and we would also look to tactically receive DIs into year-end, but we prefer to wait for more clarity on the potential 2024 fiscal deficit projection change. For now, we still think that US rates should remain the bigger driver of TIIE price action, but we do see scope for outperformance versus US rates, should Banxico's November dovish shift mark an actual inflection point in the central bank's rhetoric.

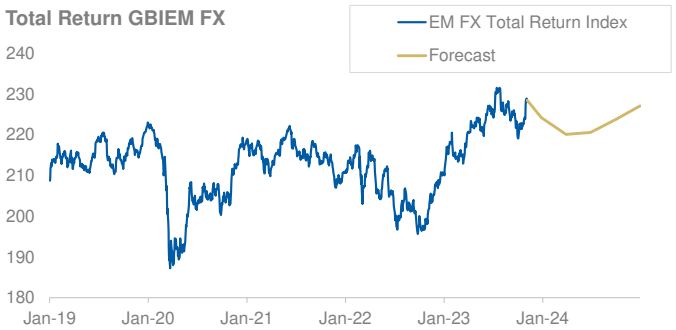
In CEEMEA, we expect to see HUF underperformance within the CEEMEA region. Real policy rates are likely to rise for CZK and PLN, versus unchanged for HUF. The National Bank of Hungary will likely remain mindful of excessive currency weakness but the more front-loaded expectation of rate cuts expected by our economics team suggests marginally less caution about the currency than was previously the case. HUF is also likely to be weighed down by continued difficulties in relations with the EU. CZK is likely to remain weighed down by the continued weakness in the eurozone, which for an economy as open as the Czech Republic is likely to keep the currency under pressure, and we expect it to perform in between HUF and PLN, with the latter being the strongest. Elsewhere, ZAR should be weak in 1H due to the strength of USD and fiscal uncertainties in the run-up to the elections (date not yet decided, but likely to be in 2Q) but should have a strong 2H as global conditions improve and the domestic story focuses on the end of load-shedding. TRY continues its nominal depreciation but should beat the forwards in the run-up to the local elections, with a faster pace of depreciation thereafter.

Exhibit 53: Our base case is for lower local government bond yields in EM by end-2024



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 54: EM FX total return forecast



Source: Bloomberg, Morgan Stanley Research forecasts

In rates, the most interesting story we see is in South African government bonds, where yields in the long end of the curve are very high in real terms, reflecting credit risk and heavy supply. Yet, a key component of credit risk is the perceived unsustainable nature of the fiscal position, and at least part of this is down to the weak growth potential of the economy. Our economist sees potential and realized growth moving higher over 2024 and beyond as electricity capacity grows, posing less of a constraint on the economy. SAGBs are likely to perform well over the course of the year.

Global Credit: A Constellation of Quality

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

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

Aron Becker
Aron.Becker@morganstanley.com
+44 20 7677-0754
Morgan Stanley & Co. International plc+

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

Key investment ideas

- **IG credit is part of a 'constellation' of reasonably priced high-quality fixed income,** supported by a Fed/ECB pause and soft landing. Growth momentum, interest rate sensitivity, and equity leadership support decompression.
- **For leveraged credit, higher rates and slower growth should erode credit quality, keeping defaults and downgrades above average:** We call for wider spreads and expect more tiering.
- **Top trades:** We are up-in-quality across regions. We like loans over bonds in the US, front-end IG (3-5-year), and the belly in Europe (5-10-year). We like Yankee banks, but are cautious on US regionals. In derivatives, we like CDX and iTraxx decompression and long IG 7-15% tranche.

Exhibit 55: Credit top-down preferences

Credit	-	+
US Inv. Grade		■
US High Yield	■	
US Lev Loans		■
EU Inv. Grade		■
Asia Inv. Grade	■	

Source: Morgan Stanley Research

Exhibit 56: Credit spread targets

4Q24 Target	Base
US Investment Grade	125
US High Yield	475
US Lev Loans	525
EUR IG	160
EUR HY	525
Asia IG	132

Source: Morgan Stanley Research forecasts

Credit was a 'good house on a bad (bond) block' in 2023. IG credit outperformed Treasuries, MBS, and securitized credit. High yield outperformed EM debt. Loan returns have nearly matched US/EU equities.

In 2024, slowing growth, less inflation, and eventual central bank rate cuts should mean that the fixed income 'block' gets better. Credit won't be the best house, but US and EU IG produce reasonable excess returns and good real returns. We think that Asia credit lags on regional risks to growth, and lower-rated spreads widen as higher interest costs drive dispersion. Steep credit curves are a key driver of 'alpha': take advantage of good roll-down in 5-10-year EUR IG, 3-5-year US IG, and CDX 5-year 7-15%. Look for flattening in high yield.

Global investment grade – what more do you want?

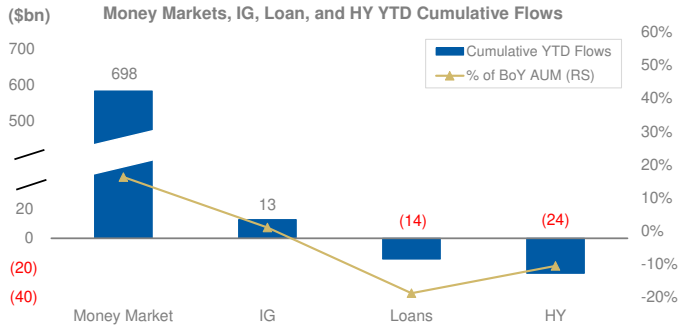
The ideal environment for IG credit is a world of wide spreads, modest growth, low issuance, healthy balance sheets, steady or modestly easing monetary policy, and cautious management teams. While spreads aren't wide, the rest apply.

The macro forecasts from our economists look helpful. Growth is slower, which should help to keep management teams conservative, but still positive, avoiding recession and larger default outcomes. Inflation continues to moderate, which means that the Fed and ECB are done with rate increases, and begin rate cuts next year.

For US and EU IG non-financials, balance sheet metrics are strong and companies were proactive in terming out debt at attractive rates (the average US IG bond matures in ~11 years). We think that issuers view current rates as expensive, and with yields elevated and central banks holding (and then cutting), they will try to delay non-financial issuance. Supply should underwhelm.

For large banks, capital ratios and profitability are historically high, while slower loan growth may reduce funding needs. We think that US regional banks face more fundamental and supply risk, but weighted by market cap we expect financials in the US, Europe, and Japan to outperform.

Exhibit 57: Flows to cash have dwarfed flows to credit



Source: Refinitiv, Morgan Stanley Research

Less IG supply should be met with more demand. Yields on corporate bonds are near 20+ year highs, outright or relative to expected inflation. Pension funds are incentivized to de-risk as funding gaps have narrowed, household exposure to bonds is modest, and the record amounts of cash in money market funds may look to extend duration if confidence grows that central bank rate hikes are finished.

With IG fundamentals and technical supportive, the challenge turns to valuation. Relative to the last ~20 years and adjusting for quality, yields are high, outright spreads are roughly average, and spreads relative to other high-quality fixed income (MBS, AAA ABS) are expensive. It's complicated.

By region, US and EU IG performance is similar, as we think that cheaper EU valuations are broadly balanced against greater risks to growth. Asia IG underperforms on greater growth uncertainty and weaker fundamentals; low issuance is the main reason why we don't expect spreads in Asia to widen more.

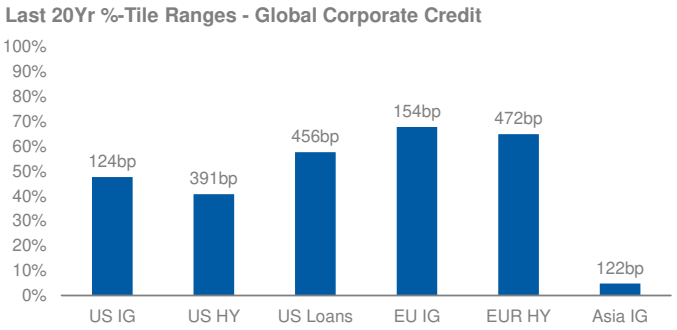
We see a symmetric skew around this range-bound IG base case, which may seem odd given the nature of the asset class and a (mild) recession in our bear case. Yet, our economics bull case feels a lot like the mid-1990s, a period that saw very tight IG valuations.

IG spreads should be wider in our bear case of a mild recession, but we also see a strong case that this scenario would be less severe for credit than the last four downturns (2000 – bursting the largest equity bubble in history, 2008 – the largest banking crisis in 80 years, 2011-12 – the EU sovereign crisis, 2020 – a global pandemic). All were unusually systemic and unusually tough on investment grade. They are too punitive to guide our bear scenario.

Global leveraged finance – tiering up

The story in leveraged finance is similar, just faded. Our baseline of a soft landing and rate cuts in 2024 is helpful. But pressure from still-

Exhibit 58: Spreads closer to 'average' than 'rich' (except for Asia IG)



Source: Bloomberg, PitchBook LCD, Morgan Stanley Research

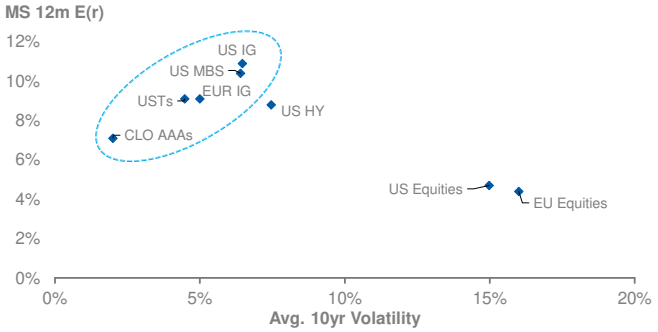
Exhibit 59: End-2024 spread and return forecasts

	4Q24 Spread F'Cast				Excess Return		
	Current	Bull	Base	Bear	Bull	Base	Bear
US Investment Grade	125	90	125	165	3.6	1.5	-1.0
US High Yield	398	325	475	600	6.2	-0.1	-5.5
US Leveraged Loans	489	400	525	675	6.8	1.6	-4.6
EUR IG	156	120	160	225	3.2	1.4	-1.6
EUR HY	458	400	525	675	5.9	1.8	-3.2
Asia IG	123	110	132	190	1.9	0.8	-2.2

Source: Bloomberg, PitchBook LCD, Morgan Stanley Research forecasts; Note: Pricing as of November 8, 2023.

We think that our macro story suggests lower rate volatility and more flows into bonds, which should help all high grade fixed income, but help MBS/ABS the most. **IG credit is part of a constellation of quality fixed income** – it no longer outperforms, but still holds up.

Exhibit 60: IG part of a 'constellation' of quality

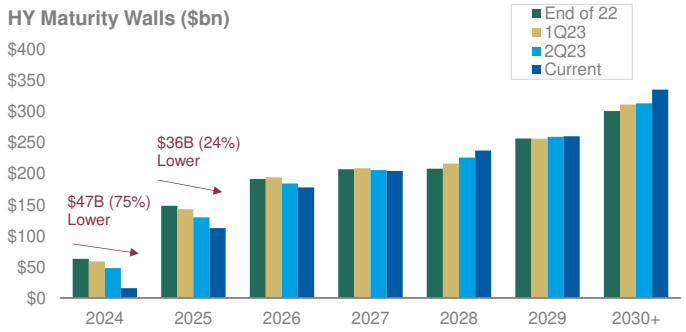


Source: Morgan Stanley Research forecasts

high rates, decelerating growth, richer valuations, and signals from equity markets argue for patience. For now, **we think that credit sees decompression.**

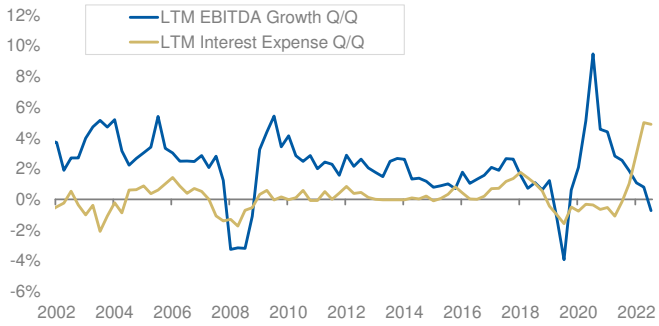
This decompression is driven by poor convexity across our economic scenarios: If growth is better than our baseline, leaving rates higher for longer, leveraged credit faces a sharper impact given greater leverage and shorter liabilities. Note that from the last rate hike in February 1995 to December 1999, cumulative excess returns

Exhibit 61: Issuers have made progress in addressing 2024/25 maturities; further out refinancing risks remain



Source: ICE, Morgan Stanley Research

Exhibit 62: Quality headwinds for sub-IG credit are higher as expensive funding erodes cash flow and margins



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

for US CCC credit were just ~2.5% (total, not per year), against a backdrop which saw a soft landing, strong growth, technological innovation, and 'higher for longer' rates.

If growth is *worse* than our baseline, and there is a mild recession in the US and Europe, the smaller, more cyclical nature of this cohort leaves it more exposed.

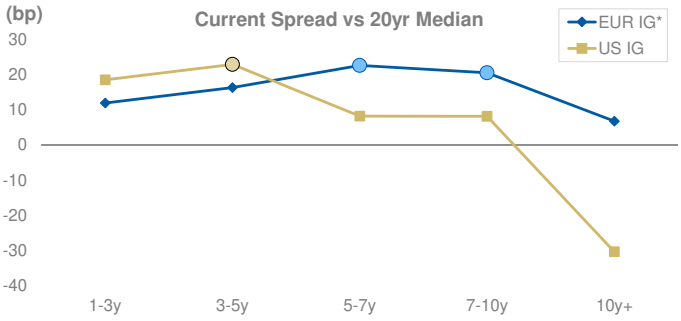
And in our baseline, compensation for going down in quality is below average at a time when equity markets are seeing historical underperformance for smaller, more cyclical companies. In this base case, slower growth, restrictive policy, and a tail of credits that haven't made progress addressing maturity walls drive the US/EU default rate to a peak at 5.0%/4.5% by mid-2024. The fact that a large share of issuers are addressing this wall, and the presence of new capital from private credit, argue against a higher base case default rate from here.

An up-in-quality bias means we prefer IG over HY across the US, Europe, and Asia, and BBs over Bs across bonds and loans. Within Bs, we prefer B1 and B2 over B3, and see low spread pick-up in the latter for, in our view, much greater risk. Rather than a 'problem sector', per se, we see credit tiering driven by interest coverage, as leveraged capital structures that made sense at 5% yields simply don't work at 9-10%. To express decompression, **we like Main versus XOver and CDX IG versus CDX HY,** although we like short CDX HY 15-100% versus CDX IG even more, as it avoids HY tail names already pricing in significant distress.

Curves rule

We see curves as a major driver of credit alpha in IG and HY, trumping sectors. We think that 'curves rule' because: 1) Credit is a rare asset class that is 'positive carry, positive roll'; 2) Curve shapes are unusual; and 3) Curves offer the ability to both maximize carry with the end to rate hikes, and improve convexity.

Exhibit 63: Short-dated IG cheap versus history in the US, belly screens better in Europe



Source: Bloomberg, Morgan Stanley Research; *Non-fin snr ex real estate.

In IG cash, **we like USD 3-5-year and EUR 5-10-year,** both of which 'roll into' a richer part of the curve with potentially improving demand. In CDS, **XOver 3s5s looks too steep** given spread levels and EU economic risks; we like flatteners. In tranches, we like **long risk in CDX IG 7-15%,** which is loss remote, offers 1.5x the spread of the index, and is supported by roll and time decay.

Key views

Within a range-bound 2024, we see opportunities for both offense and defense. Look out for our regional credit outlooks in the coming days, which will have more specifics on expressing these views through screens and baskets.

Where to be more defensive: Cyclicals in Europe, Hong Kong and Korea IG corporates, US regional banks, China property, US/EU single Bs (especially B-/B3), tranche equity.

Where to take more risk: Financials in the US (money center), Europe (LT2), and Japan (senior-TLAC), China IG long end, being down the capital structure in stronger names (i.e., corporate hybrids and AT1 over high yield, tranche senior mezz, BB loans.

Global Securitized Products: Nobody Puts BB(B) in the Corner

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

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

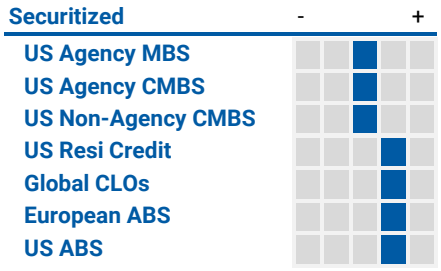
Vasundhara Goel
Vasundhara.Goel@morganstanley.com
+44 20 7677-0693
Morgan Stanley & Co. International plc+

Zuri Zhao
Zuri.Zhao@morganstanleymufg.com
+81 3 6836-5466
Morgan Stanley MUFG Securities Co., Ltd.+

Key investment ideas

- We think that securitized credit offers multiple opportunities for high-quality carry, including senior tranches of CLOs, consumer ABS, and non-QM. A soft landing should also present an opportunity for investors to selectively move down the capital structure, where we prefer CLO mezz and subprime auto BBBs. We are more cautious on US CRE. In Europe, we stay in the IG tranches of UK RMBS and CLOs.
- We expect home prices to fall modestly as housing activity picks up versus 2023, with new home sales outpacing existing sales, but the strong fundamentals of existing homeowners prevent sizeable corrections.
- We expect agency MBS to end the year with positive excess returns and tighter spreads, but spread vol to remain high, and for investors to have the opportunity to trade the asset class from both the long and short side.

Exhibit 64: Securitized credit top-down preferences



Source: Morgan Stanley Research

We are constructive on the outlook for securitized products in 2024: Market pricing reflects a range of potential outcomes, as it is supposed to. If the Fed's policy rates evolve in a fashion that is consistent with our economists' forecasts, expectations that are currently reflected in market pricing, the probability of some of the more dire tail scenarios will come down. Effectively, the market will *thread the needle*. We believe that this presents an opportunity for investors to move down the capital structure within securitized credit. **We forecast strong results for CLO mezz and subprime auto BBBs.**

While the path forward is rarely a straight line, attractive starting valuations provide a carry buffer as markets try to ascertain the timing, pace, and reason for the Fed easing cycle. **Thus, we think that the year starts off with a focus on earning carry and we like initially owning senior tranches of CLOs, non-QM AAAs, and consumer ABS AAAs.** The most liquid, high-quality carry is obviously in agency MBS, where we expect both single and multifamily mortgages to end the year slightly tighter. The Fed easing provides a tailwind for MBS, but the path for agency mortgages will likely be volatile and opportunistic. CMBS faces continued fundamental pressures in the year ahead, but the market has priced a good deal of this in. Europe faces more subdued growth and elevated borrowing costs, putting pressure on fundamentals, but supportive technicals in RMBS and the carry argument in CLOs should result in positive expected returns at the top of the capital stack.

The US housing market finds itself in an interesting position heading into 2024. Recent bouts of rate volatility have led to swings in affordability. The immediate response in the market has been renewed decreases in inventory, which we think provide near-term support for home prices. As rates come down throughout the year, we would expect affordability to improve and for-sale inventory to increase. Both of these developments are constructive for housing activity, but the latter provides a potential counterbalance for home prices. We expect housing activity to be stronger in 2H24 and new home sales to increase more than existing home sales over the course of the full year (+7.5%Y versus +2.5%Y), while single-unit starts follow new home sales higher as well (+10%Y). Home prices should see modest declines as the growth in inventory offsets the increased demand. Homeowners retain strong hands, and we don't expect any sizeable correction in prices, but we do think that they will be down 3%Y in 2024.

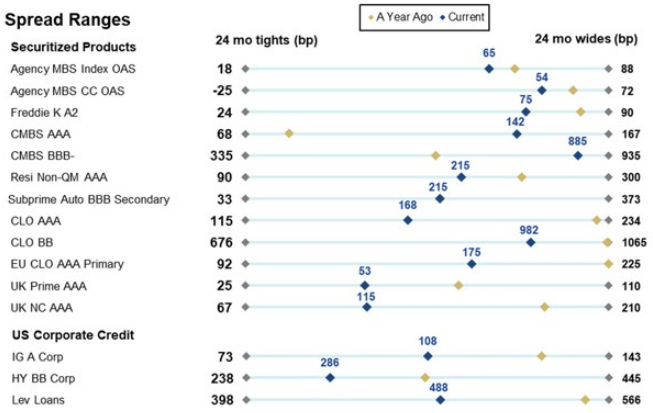
Agency spreads have been far from stable, and our base case is **agency MBS to tighten moderately over the year with volatile spreads, allowing investors to trade from the long and short side.** The technicals are still difficult, but prices reflect the weak sentiment. The market has tested wider levels and bounced off those wide levels in October 2022, May 2023, and October 2023. Towards the second half, sentiment turns more positive as the Fed will start to communicate the end of QT, and a steeper curve will cause higher NIM for banks and REITs, reduced FX-hedging costs for overseas investors, and incentivize retail to move out of cash, but this is still a way off in a very liquid product.

Slightly higher housing activity likely outweighs modestly lower home prices, and so issuance picks up, as do discount speeds, which also benefit from another year of seasoning. Given our rate forecasts this suggests that discount bonds should outperform production MBS. Ginnies should continue to see support, especially as banks come back to the market, but we still expect US$300 billion net issuance and US$210 billion Fed run-off, of which we only think that banks will take out $75 billion as portfolio holdings grow in the second half while dealer positions shrink. **Agency CMBS has much better technicals than single family MBS, but worse valuations, and thus is likely situated to tighten in sympathy.** At the end of the year, we expect positive returns in both single and multifamily agency MBS, but high spread vol should allow investors the opportunity to trade ranges.

In the securitized credit markets, we are facing a range of different fundamental narratives that are priced in to varying degrees across products: While the US housing outlook is far from what we would call bullish, we are confident in the level of support in the market from a healthy foundation that has shown few signs of erosion. At the other end of the spectrum, while CRE fundamentals have arguably outperformed expectations, we think that delinquencies and special servicing rates are poised to increase in the year ahead as the market tackles elevated maturities across conduit, SASB, and CRE CLOs. The resi credit and CMBS markets have priced in at least some of the relative optimism/pessimism of these disparate scenarios.

Starting with the comparatively constructive fundamental backdrop of resi credit, home prices remaining elevated – even if they don't continue climbing – combined with what we think are shifting consumer payment priorities towards mortgages as homeowners look to protect the equity in their home and their low cost of funding should keep defaults and severities contained. While non-agency RMBS issuance volumes should increase alongside climbing sales volumes and decreasing mortgage rates, we think that the increase will be marginal. **We think that CRT offers attractive carry, with fundamental expectations leaving us comfortable moving down to the B1 tranche. Non-QM AAAs also offer attractive returns.**

Exhibit 65: 24-month spread ranges across securitized products



Source: Bloomberg, Yield Book, TRACE, Morgan Stanley Research; Note: Data as of November 9, 2023.

Exhibit 66: The agency mortgage index has traded towards stress levels recently for unclear reasons



Source: Bloomberg, Morgan Stanley Research; Note: Data as of November 9, 2023.

We think that US CLOs offer opportunities across the debt stack throughout 2024: The fundamental backdrop isn't bad, but it isn't great either. Our corporate credit strategists expect leveraged loan defaults to peak in 1H24 before improving throughout 2H, though to remain above long-run averages throughout the forecast horizon. When we combine that forecast with their expectation for slowing downgrades, we are left with a market that is paring down tail risks as we progress through the year.

Ultimately, we think that spread-tightening potential at the top of the capital structure is going to be capped, given the potential for elevated issuance as 2022 deals might face an increased amount of calls in the year ahead while we think that US banks are unlikely to come back in a meaningful way. **We still think that CLO AAAs offer attractive, high-quality carry,** and that for investors looking to pick up some additional spread **AAs are trading in the 90th percentile relative to AAAs over the past year.** Furthermore, we think that the improving fundamental narrative into end-2024 argues for a **barbelled allocation into BBs, where 14-15% yields provide cushion against potential spread volatility in 1H24 before benefitting from**

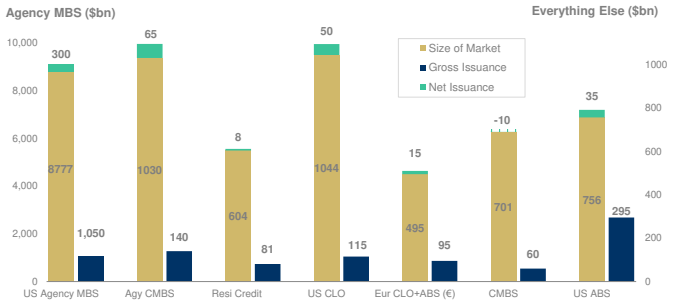
spread tightening into the end of the year.

Within ABS, we think that fundamentals for the US consumer ex housing lie somewhere in between the housing market and commercial real estate. We expect performance to continue to worsen in the near term. That said, real wage growth turned positive in 2Q23 and we expect inflation to continue falling. As this, combined with the tightening in lending standards we have seen for the past year, flows through to ABS markets, we expect performance to improve as we progress through 2024. The rates team's call for a bull steepening of the curve benefits the short, AAA part of the ABS capital structure, which we see as cheap to IG corporates compared to its relationship over the past 10 years. We also think that **improving credit performance throughout the year would allow for spread compression across the capital structure – so for spread investors, we see opportunities in subprime auto BBBs.**

While we believe that the **CMBS** market has priced in more fundamental distress than other asset classes, we also think that fundamentals will remain in focus throughout 2024. As banks continue to step back from the market, we also think there is an argument that issuance volumes in CMBS can increase – both in absolute terms and as a percentage of total CRE origination next year. **For investors looking for duration, the top of the capital structure is cheap to IG corporates and offers upside if fundamental scenarios play out much better than expectations. We do not think that it is time to recommend going down CMBS capital structures.**

In Europe, the tale of two halves is alive and well, as the impact of higher rates continues to feed through to fundamentals in 1H24 before we get some relief in the year's final months. In the UK, we think that RMBS fundamentals will get a bit worse before they get better as more mortgages exit fixed rates. We calculate that about 20% of the UK mortgage market ends its fixed term next year. Similarly, CLOs are faced with a prolonged period framed by slow growth in Europe and pressures from high rates. Defaults don't spike, thanks to a pushed-out maturity wall, but stay elevated and above the long-run average. As the year draws to a close, lower borrowing costs and supportive technicals limit the downside in RMBS, but **we recommend staying defensive in IG tranches of UK NC and BTL. In CLOs, AAAs remain a defensive, high carry, liquid opportunity and, for investors looking for a higher rate of return, BBBs screen as most attractive versus high yield and other parts of the CLO stack.**

Exhibit 67: 2024 gross and net issuance forecasts



Source: eMBS, Intex, Trepp, Morgan Stanley Research forecasts

Where could we be wrong?

As we started off, realizing the central tendency means we avoided any alternative paths and risks. For instance, just a few weeks ago the agency market was trading at levels that could really only be compared to the global financial crisis from a valuations perspective before mortgage rates rallied 50bp, saving our outlook from having the word "uncharted" appear too many times. Should we test higher rates again, we would expect spreads to be challenged, particularly if money managers see outflows or there is another regional bank crisis.

On the other hand, while our forecast is for lower rates, it's more about policy normalizing than easing to stimulate the economy. If either the Fed needed to cut rates aggressively in a recessionary scenario or the market simply interpreted the cuts as indicative of recessionary concerns instead of simply returning to r*, clearly investors would want to be up in quality, and the negative convexity that mortgages would realize initially would cause underperformance and likely bleed into other securitized asset classes.

Exhibit 68: Morgan Stanley 4Q24 spread and excess return forecasts across securitized products

		Spreads			Excess Returns		
Product	Current	Bull	Base	Bear	Bull	Base	Bear
YoY HPA Forecast	3%	5%	-3%	-8%	-	-	-
Agency MBS Index OAS	65	40	55	85	2.2%	1.3%	-0.6%
Non-QM AAA	215	90	165	250	4.7%	3.2%	1.5%
Subprime Auto AAA Primary	80	50	60	100	1.1%	1.0%	0.6%
Subprime Auto BBB Primary	265	200	225	350	4.9%	4.1%	-0.3%
CMBS AAA Secondary	142	110	145	175	4.6%	1.1%	-1.8%
CMBS BBB- Secondary	885	800	950	1150	17.4%	2.4%	-17.7%
Agency CMBS Primary	75	55	65	90	2.7%	1.7%	-0.7%
US CLO AAA Secondary	168	150	160	185	2.2%	1.9%	1.2%
US CLO BB Secondary	982	850	950	1200	18.6%	12.0%	-4.5%
EU CLO Primary	175	140	170	210	3.7%	2.0%	-0.2%
UK Prime	53	35	45	70	1.1%	0.8%	0.0%
UK NC Senior	115	75	105	150	2.6%	1.5%	-0.1%

Source: Morgan Stanley Research forecasts

Munis: Twice Is Nice

Mark Schmidt, CFA
Mark.Schmidt1@morganstanley.com
+1 212 296-8702
Morgan Stanley & Co. LLC

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

Key investment ideas

- **Positive total returns:** Similar to other high-quality asset classes, muni total returns are poised to outperform.
- **Positive tax-exempt excess returns; negative taxable excess returns:** While exempts should deliver flat to modestly positive excess returns, we think that taxable valuations imply slightly negative excess returns from here.
- **Growth in supply and demand:** We think that supply can increase by around 5% from here, with net supply jumping as many refunding deals remain out of the money. Mutual fund demand returns, though flows stay shy of the 2021 heyday.
- **Up in quality to outperform:** We prefer IG to HY. We expect more pockets of distress to emerge in HY next year. Today's high risk-free rates do not help the HY value proposition in general.

Exhibit 69: Munis key forecasts

2024 Total Returns	Base
Tax-Exempt	8%
Taxable	11%

Source: Morgan Stanley Research forecasts

Exhibit 70: Base case targets

4Q24 Targets	Base
10Y AAA Ratio	70%
30Y AAA Ratio	90%
10Y Credit Spread	40
30Y Credit Spread	60
Taxable Credit Spread	110
Taxable Index Yield	5%

Source: Morgan Stanley Research forecasts

Though the market set-up looks eerily similar to last year, we think that it's 'second time's the charm' for munis in 2024: State and local governments remain well positioned despite slowing GDP growth. We forecast 4%Y growth in tax revenues. We expect credit spreads to tighten modestly, helped by dependable household demand and a relatively stable ratings outlook.

We think that separate accounts and ETFs will continue to drive demand: Though the mutual fund community may never reach prior AUM highs, we do think that funds will be active throughout the year, deploying leverage to take advantage of attractive 5%+ IG yields.

We forecast supply to increase by about 5%Y to US$375-395 billion: We expect new projects to drive most of the increase, as issuers make peace with a 'higher for longer' rates environment. Still, higher yields put many calls out of the money; weak refunding activity should dampen overall issuance.

We expect positive total returns and modestly negative excess returns for taxable municipals: Taxable muni valuations are close to historical tights. Though fundamentals remain solid, spreads do not price in late-cycle risks to the same extent that other high-quality asset classes do. With that said, a lack of advance refundings mean that taxables should retain scarcity value. Although FX-hedged yields have improved, carry still looks negative for hedged overseas investors.

Commodities: Volatility but No Clear Trend

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

Amy Gower
Amy.Sergeant@morganstanley.com
+44 20 7677-6937
Morgan Stanley & Co. International plc+

Key investment ideas

• **Energy – range-bound:** We see Brent range-bound around US$85/bbl. Oil demand has grown strongly in 2023 but will likely revert to historical trend growth in 2024. At the same time, non-OPEC supply growth is also robust, meeting practically all additional demand and leaving little room for extra OPEC oil.

• **Base metals – remain selective:** We prefer aluminum and copper within the base metals complex. Both have seen stronger-than-expected China demand driven by property completions and green applications. In aluminum, Yunnan seasonal supply cuts are returning, while the cost curve also provides support. In copper, our balance has tightened as supply disruptions continue and new mines ramp more slowly while positioning remains short. We are more cautious on nickel, with EV market challenges and rising supply. We prefer zinc to lead with supply disruptions and recent underperformance.

• **Gold prices** have been volatile as investors balance rising yields and geopolitical risk. ETF inflows are picking up and short covering has taken positioning higher, but for current prices to hold, we believe that either geopolitical risk needs to remain or yields need to move lower.

• We see **bulk commodity prices** staying resilient, with steel production cuts in China looking increasingly unlikely, keeping demand for iron ore and met coal strong. Thermal coal will depend on how the winter plays out, but we think that risk/reward is skewed to the upside.

Exhibit 71: Commodities price targets

4Q24 Target	Base
Brent	85
Copper	9,000
Gold	1,950

Source: Morgan Stanley Research forecasts

Energy

Crude oil: Biased lower over time; extended OPEC cuts required

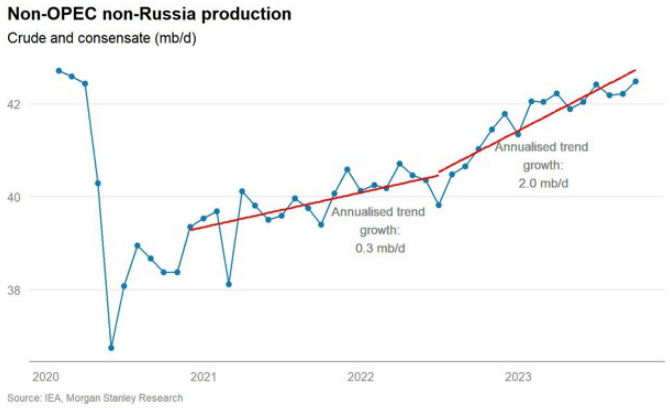
Much has changed in the oil market over the last year. Most notably, non-OPEC+ production has been stronger than expected. Coming out of Covid, oil production outside OPEC and Russia initially grew at an annualized trend rate of ~0.3 mb/d (Exhibit 72). However, after the oil price surge in 1H22, this accelerated sharply. Since summer 2022, the trend rate of growth in non-OPEC, non-Russia production has been an impressive ~2 mb/d year on year.

In many ways, this is surprising. Investment levels in new oil & gas fields have been under considerable pressure in recent years, and fell to very low levels in 2020/21. Alas, such is the resilience and tenacity of the oil industry. When prices are high, supply ultimately flows. At such growth rates, non-OPEC production is meeting the vast majority of global oil demand growth, leaving little room for OPEC to boost output.

Looking into 2024, we expect non-OPEC supply growth to slow to ~1.4 mb/d from 2.1 mb/d in 2023. This already assumes a very significant slowdown in US growth (from 0.9 mb/d to 0.4 mb/d next year), but with some growth from Canada, Brazil, Guyana, global biofuels, and NGLs, non-OPEC supply can still reach that level, we estimate.

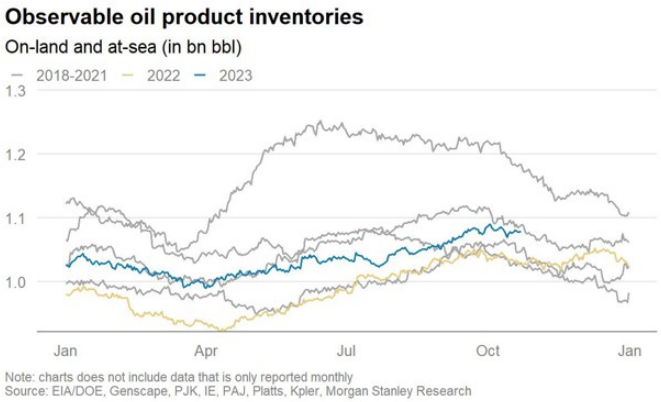
On the other hand, demand will probably also slow. China has

Exhibit 72: Non-OPEC, non-Russia production has accelerated sharply since summer 2022



Source: IEA, Morgan Stanley Research

Exhibit 73: Inventories of refined oil products should be drawing by now but they are not, suggesting soft demand



Source: EIA/DOE, Genscape, PJK, IE, PAJ, Platts, Kpler, Morgan Stanley Research; Note: Chart does not include data that are only reported monthly.

accounted for nearly half of global oil demand growth in the last 20 years, but that contribution will probably diminish. The effect of electric vehicles is still small but will probably shave 0.2-0.3 mb/d off demand growth going forward as well. The sharp rise in interest rates is slowing global economic growth, and thus oil demand, and the very high prices of oil – particularly diesel – in many emerging markets when measured in local currency terms are also headwinds. For now, our working assumption is that demand growth slows from ~2.1 mb/d this year to ~1.3 mb/d in 2024 – nearly identical to the slowdown in non-OPEC supply.

With those estimates, we put the 'call-on-OPEC' (i.e., the theoretical amount OPEC would need to produce to balance the market) at 28.4 mb/d. However, that would mean the call-on-OPEC is within 0.1 mb/d of 28.5 mb/d *for the fourth consecutive year*, i.e., flat throughout 2021-24. Given that OPEC countries have production growth plans of their own, this creates a degree of tension.

Although OPEC production decisions are always important in the oil market, they are especially important at the moment. For now, OPEC is withholding production and balancing the market. Our expectation is that it will continue to do this in 2024 as well. This means ongoing high spare capacity, which probably means oil has limited room to rally, but also limited downside. If OPEC manages global inventories so they remain around current levels, our models suggest that Brent should continue to trade around the mid-US$80s, slightly lower than today's price (see here and here).

Metals & bulks

Precious metals: High rates versus geopolitical risk

After trading in a narrow range of US$1,900-2,000/oz through 2Q/3Q, 4Q has seen gold price volatility pick up. Macro conditions continue to be challenging for gold as a non-yielding asset, with gold ETF holdings seeing almost continuous outflows since April 2022 as investors have switched to other assets. However, central bank buying has been very strong, up 14% year to date and a record high for January-September. This has been driven mainly by Chinese central bank buying, as well as purchases from Turkey, Poland, and others, allowing gold prices to hold up relative to yields (see here). Gold fell to a low of US$1,820/oz as real yields reached post-GFC highs, but more recently geopolitical risk seems to be providing some support to prices. Using the 2023 regression of gold versus US 10-year real yields would imply a gold price of ~US$1,850/oz, or around US$130/oz lower than current levels, suggesting that a geopolitical risk premium is emerging (see here). CFTC data show that net long positioning has rebounded strongly, but this seems to be more short covering than new longs so far.

Base metals: Aluminum and copper preferred

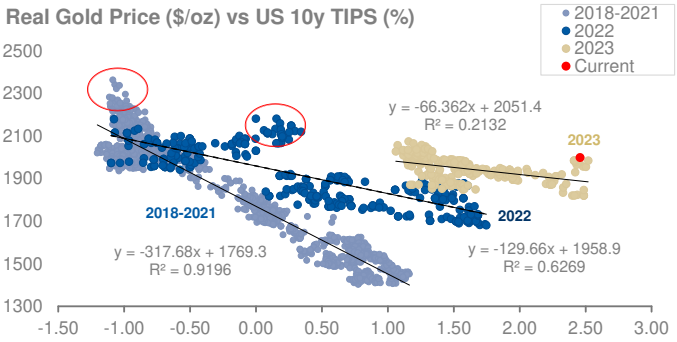
In base metals, our order of preference from most bullish to most bearish is aluminum, copper, zinc, nickel, and lead. Despite bearish macro sentiment on China, apparent consumption for aluminum and copper has been much stronger than expected, supported by green demand and property completions (Exhibit 75). In contrast, zinc is more exposed to steel and property new starts, and doesn't benefit as much from green demand. We also see a constrained aluminum supply side, with limited likelihood of curtailed European smelters

resuming output, in our view, while China's smelters in Yunnan are facing hydro-driven output restrictions once again (see here and here). Aluminum also has support from the cost curve, currently trading around the 90th percentile, with rising energy prices likely driving some upside pressure (we forecast US$2,350/t for 1Q24). In copper, we now see a balanced, rather than surplus, market for 2023 and 2024, as new mines have been slower to come through and Chile's supply disruptions have remained elevated. With positioning quite short by now, we see upside price risks ahead (we forecast US$8,850/t in 1Q24). We are more neutral on zinc, with mined cost support found recently, driving some shutdowns. We remain cautious on nickel as more class 1 (or LME deliverable) supply ramps up and LFP batteries (containing no nickel) gain share. For more details, see The Price Deck - 4Q23: Muddle Along, September 20, 2023.

Dry bulks: More resilient

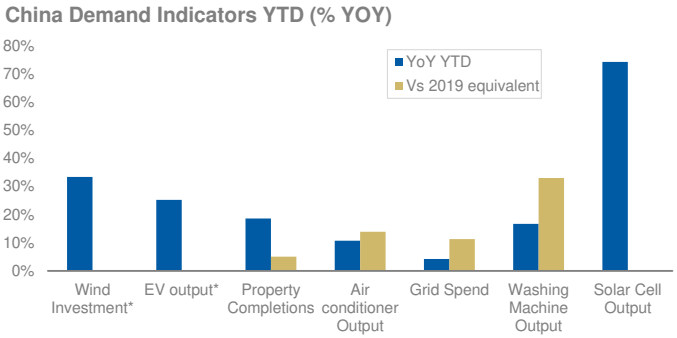
Iron ore has been much more resilient than expected during 3Q as China's expected steel production cuts have not come through. Combined with strong Blast Furnace utilization due to lower scrap availability for Electric Arc Furnaces, and weaker Chinese iron ore output, China's demand for imported iron ore has been strong. Supply is picking up seasonally but this seems to be absorbed so far, with China's port inventories very low. We expect iron ore prices to remain resilient (we forecast US$120/t for 1Q24) with a steel production cut looking increasingly unlikely for this year and weather-related supply disruptions ahead. However, with steel mill margins under pressure and strong met coal pricing, we think that steel prices would need to rise to justify a higher iron ore price. Metallurgical or steel-making coal is also back in focus, with a plethora of supply disruptions and strong demand from China and India supporting prices. For thermal coal, we see risk/reward skewed to the upside into winter, with China's coal imports up 73% year to date at an all-time high and risks to supply, but the price will depend on how the winter plays out. For more details, see What's Next for the Bulks? October 2, 2023.

Exhibit 74: Gold is trading at the top end of the 2023 range versus real yields, supported by geopolitical risk



Source: Bloomberg, US BLS, Morgan Stanley Research; Note: Red circles show other examples of safe-haven demand in 2020 and April 2022.

Exhibit 75: China's copper and aluminum demand have been more resilient than expected



Source: Bloomberg, Morgan Stanley Research; Note: Wind/Solar/EV are all up >100% since 2019.

Global Quant: Carry with Quality

Stephan Kessler
Stephan.Kessler@morganstanley.com
+44 20 7425-2854
Morgan Stanley & Co. International plc+

Ronald Ho
Ronald.Ho@morganstanley.com
+44 20 7425-2722
Morgan Stanley & Co. International plc+

Gilbert Wong
Gilbert.Wong@morganstanley.com
+852 2848-7102
Morgan Stanley Asia Limited+

Key investment ideas

- The market backdrop in 2024 is one of plateauing rates and an expectation for central banks across the globe to take back some of their hikes.
- While investors may speculate on the timing and extent of monetary policy rate reversals, rates are likely to remain higher than they have been in several years. Higher rates are expected to have a dampening effect on growth and markets are likely to be volatile, and diversification across quant strategies is key.
- For quantitative investment strategies, a combination of equity **Value and Quality** remains attractive due to affordable valuations, defensive characteristics, and fundamental market dynamics. Higher rates levels and dispersion provide a positive environment for a range of QIS **Carry strategies.**
- Moving to regional equity factors, **in the US,** we suggest staying resilient through profitability and cash as interest rates remains 'higher for longer'. **In Europe,** we would recommend downside protection with cash exposures amid below-potential growth prospects. **In APxJ/EM,** we suggest taking a neutral stance between Value and Growth, and look for Quality and Revisions factors to achieve defensiveness. **In Japan,** we continued to prefer Value amid rising JGB yields.

Our quant outlook is largely shaped in the Morgan Stanley economics and strategy forecasts. We highlight our views on the underlying equity market dynamics, expressed via factors, and emphasize several quantitative investment strategies (QIS) across asset classes that can help investors to navigate markets.

'Higher for longer' rates lead to carry opportunities in QIS

One of the key messages from our economists and strategists is that rates stay higher for longer, with the first rate cut in the US now expected for June 2024. This environment favors an investment style focused on income in rates but has an adverse effect on the equity outlook.

In the QIS space, the higher rates environment favors defensive equities. In an environment where rates remain higher, the market starts to focus quite naturally on the ability of companies to withstand higher borrowing costs. This shifts the focus onto companies of high quality with strong balance sheets, high return on equity, and sufficient cash flow. While this market environment is supportive for Quality, we note that bottom-up indicators such as signal intensity, stock-specific risk, valuation, etc. send mixed signals. Equity valuations in terms of earnings yield or dividend yield are also becoming increasingly relevant for market participants. This trend in market focus should be supportive for Value investing. In addition, we find a particularly strong outlook for Value strategies based on signal intensity, cheapness of the factor, and return dispersion for European and US Value. While equity Value investing is often vulnerable in periods of challenging equity markets, we do not think that this is the case this time around. This view is based on the observation that the catalyst for equity market challenges is higher rates, which tend to be positive for Value investing. Thus, we expect a combination of global equity Value and Quality strategies to deliver strong returns, at least in 1H24. As we expect a normalization of monetary policy rates from mid-year in the US and Europe, these tailwinds to Value and Quality may diminish and the outlook needs to be reassessed.

Increasing dispersion in rates across tenures and countries opens up opportunities for strategies aiming at harvesting Carry returns. Indicators such as return dispersion, valuation, and signal intensity show a strong opportunity set particularly for FX EM Carry. We also see a particularly strong environment for rates Carry. Here indicators such as signal intensity and valuation point towards a strong performance in cross-country rates Carry.

Trend following has been a strategy that experienced significant volatility this year. Particularly challenging were periods around the rates volatility triggered by the SVB collapse in March 2023, due to the short positions many trend-following strategies held in rates. Given the expectations from our economists and macro strategists that policy rates have plateaued in many regions, rates trend-fol-

lowing strategies with a built-in long bias may fare particularly well once central banks start to take rates down.

Diving into details of equity factor strategies delivers a more nuanced picture than history implies

US – stay resilient through profitability and cash as interest rates remain 'higher for longer': Our economists believe that the Fed will keep interest rates steady until June 2024, when it delivers the first cut of 25bp. The effect of the currently tight monetary policy would weigh on the economy into 2024 and 2025. Under the 'higher for longer' interest rate environment in the late market cycle, firms could face more challenges in funding their debt and maintaining their profit margins. Earnings would be key to identifying alpha opportunities.

As such, we suggest Quality exposures such as high profitability, one key factor being ROIC. We also like factor exposures that are cash-centric, such as net buyback yield. Our study of factor performance of high rate regimes since the 1980s suggests that these two exposures tend to produce more resilient performance in the current regime compared to the 40-year history (Exhibit 76).

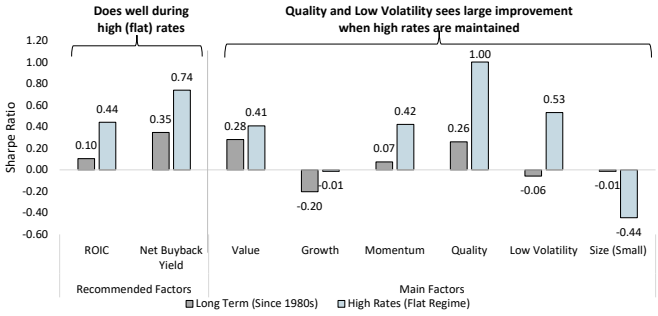
Prior to the first rate cut as forecast in June, US rates could remain elevated but volatile in 1H24. Our US rates strategists are forecasting the 10-year Treasury yield to edge lower from the current level to 4.20% by mid-2024, and eventually down further to 3.95% by the end of 2024. When there is more clarity about the Fed's rates path, we would incrementally favor more Growth exposures, particularly towards 2H24. We would highlight that the Low PEG factor could provide such exposure at a relatively more attractive valuation than other Growth factors.

Europe – protect downside with cash exposures amid below-potential growth prospects: Our economists expect the restrictive monetary policy in the euro area to continue to weigh on economic growth, which would stay below potential. The weak economy could lead to the first rate cut by the ECB in June 2024. As the risk of economic growth skews to the downside with interest rates remaining elevated, we would suggest staying defensive.

Compared to the US, we would stress 'cash exposures' as the core element of our factor preferences, such as Free Cash Flow Yield and Total Yield factors. Our study of factor performance in high rate regimes in Europe since the 1980s suggests that these two exposures tend to deliver robust backtest performance with 1.10 and 1.80 Sharpe ratios, respectively (Exhibit 77).

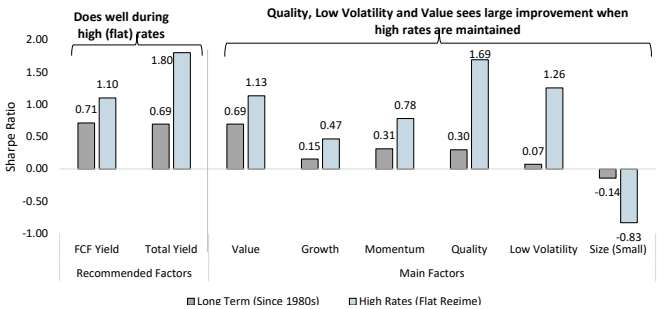
While buyback volumes are still strong currently, should economic growth in the euro area become more subdued in a bear case scenario, buyback volumes could become more volatile than dividends given the discretionary nature of buybacks. The Total Yield factor would provide exposure in dividends as well, serving as downside protection.

Exhibit 76: US: We recommend ROIC and Net Buyback Yield factor for a high rates regime



Source: OECD, FactSet, Morgan Stanley Research; Note: The factor performances are long/short returns of the top versus bottom quintile in MSCI US since 1980s or as available. The portfolios are rebalanced quarterly and returns are equal-weighted.

Exhibit 77: Europe: We recommend FCF Yield and Total Yield for a high rates regime



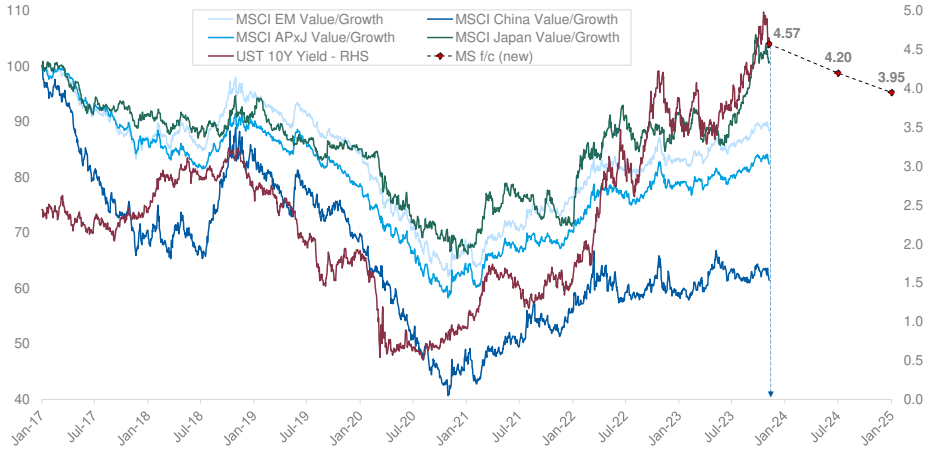
Source: OECD, FactSet, Morgan Stanley Research; Note: The factor performances are long/short returns of the top versus bottom quintile in MSCI Europe since 1980s or as available. The portfolios are rebalanced quarterly and returns are equal-weighted.

Asia-Pacific/EM – turn neutral between Value and Growth in APxJ/EM amid a late-cycle market, but stay strategically with Value in Japan: In APxJ/EM, we have been preferring Value over Growth in 2H23, which has played out amid dollar strengthening and elevated US Treasury bond yields. Yet, into the end of 2023, there are increasing expectations of 'peaked dollar and bond yields' per our quant model captured in bond and FX derivatives markets. Such market dynamics usually would favor Growth stocks to outperform tactically, while our house view also expects US Treasury bond yields and the dollar to moderate throughout 2024. As such, we suggest that investors gradually add back Growth exposure, and move to a neutral stance between Value and Growth in 1Q24. Meanwhile, as we are approaching a market late-cycle phase with tight financial conditions, market volatility might remain high in near term. Thus, Quality and Earnings Revision factors are still what we prefer to achieve

alpha. Meanwhile, we expect that the better timing to turn bullish on Growth will be in 2Q24.

In Japan, we continue to prefer Value in 2024 as we expect JGB bond yields to trend higher and the local regulatory reform initiatives remain tailwinds to re-rate Value stocks. Still, the risk of our call here is a stronger-than-expected JPY outlook in 2024, so we believe that the overall outperformance of Japan Value over Growth will be less than in 2023.

Exhibit 78: US Treasury 10-year bond yield versus Value/Growth relative performance in Asia/EM



Source: Bloomberg, MSCI, Morgan Stanley Research forecasts; Note; Data coverage from January 1, 2017 to November 8, 2023.

The performance data provided is a hypothetical illustration of mathematical principles; it does not predict or project the performance of an investment or investment strategy. Past performance is no guarantee of future results.

Sustainability: A Journey to Maturity

Stephen Byrd
Stephen.Byrd@morganstanley.com
+1-212-761-3865
Morgan Stanley & Co. LLC

Key investment ideas – we see eight key areas of investor focus for 2024

1. Capitalize on unprecedented, widespread negative sentiment towards Energy Transition stocks
2. Re-wiring of global supply chains
3. Risk and opportunity frameworks around the impacts of climate change to develop
4. Progress within the voluntary carbon offsets, with carbon removals preferred
5. Growing focus of the benefits and risks of GenAI/ LLMs
6. The rise of social investing
7. Resilience and evolution of ESG investing
8. Green nuance in focus in fixed income, though innovation continues

1. Capitalize on unprecedented, widespread negative sentiment towards Energy Transition stocks

Many stocks exposed to the Energy Transition have underperformed significantly in 2023, driven by a combination of technical factors (such as interest rates) and fundamental concerns with growth and profitability. These fundamental concerns have manifested as major headwinds for some stocks, but have not impacted others that have continued to produce strong growth and returns. The value proposition from the shift to cleaner business models continues to be highly attractive in much of the world, and we see continuing signs of further cost reductions across a wide range of decarbonization technologies.

These conflicting dynamics drive our investment strategy – focus on Energy Transition stocks that have high barriers to entry, where the growth and return potential are not reflected in stock prices: We favor a high degree of selectivity over thematic investing. We recommend avoiding those Energy Transition business models that face risks of commoditization, and we also suggest caution in investing in businesses facing funding risks and/or significant execution risks. **For 2024, we recommend that investors focus on players in the space with scale, large economic moats, strong balance sheets, and access to capital.** We also see other technologies gaining traction in 2024, namely carbon capture and long-duration iron-air energy storage.

2. Re-wiring of global supply chains

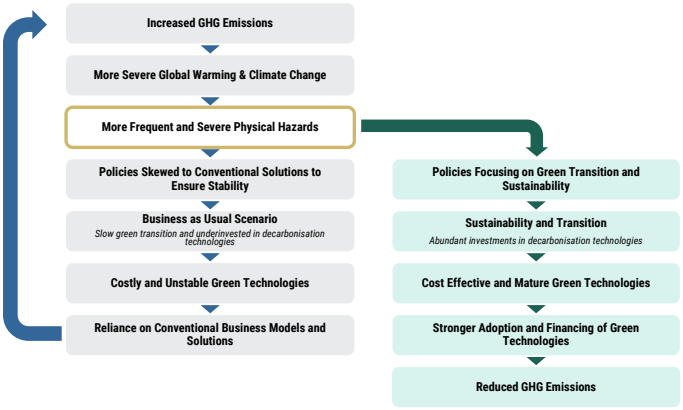
Supply chain shortages during Covid, the conflict in Ukraine, and geopolitical issues (such as US-China trade tensions) have exacerbated trends around the re-wiring of the global economy: There are numerous ESG implications of this re-wiring that investors should pay attention to, in our view, including:

- **On the environmental front,** carbon footprints are set to change drastically as highly energy-intensive activities are relocated, with the ultimate impact dependent on the energy mix of local electric grids. A favorable dynamic would be the shortening of transportation routes to get products to their final destination.
- **On the social front,** in 2023 we have seen increased focus on human/labor rights dynamics, a trend that we expect will continue as the re-wiring of global economies and the energy transition take shape. Beyond the clear labor implications (positive for some countries and detrimental for other), we believe that nearshoring provides better oversight and reduces financial, reputational, and legal risks related to potential linkage to human and labor rights violations.

3. Risk and opportunity frameworks around the impacts of climate change to develop

As physical risks of climate change are increasingly felt across regions and sectors, we see strengthened focus on climate adaptation: We believe that climate adaptation will increasingly become a focus and think that it is an underappreciated theme for investors compared to mitigation. **We see opportunities in climate adaptation and resilience solutions** – we see investors identifying technologies that have synergies with mitigation (e.g., forest-based adaptation, resilient power systems, and energy storage). Increased investment in these technologies will likely be needed to break the 'negative feedback loop' (Exhibit 79).

Exhibit 79: Interplay of physical and transition risks



Source: Morgan Stanley Research

Exhibit 80: Our views on the benefits and risks of AI through an ESG lens

Benefits of AI (Through An ESG Lens)		Risks of AI (Through An ESG Lens)	
Power grid optimization and Resilience	Biodiversity protection and monitoring	Data privacy and security	Data selection bias and unfairness
Agriculture production and efficiencies	Conservation of limited water resources	AI model unaligned w/ existing laws/policies	Human bias and unfairness
Health care access and efficient drug development	Education access and outcomes	Misaligned culture on AI risks and escalation practices	Deepfakes & misinformation
Energy efficiencies in manufacturing	Air quality improvement	Cybersecurity	General safety concerns
Air pollution and quality	Weather prediction and natural disaster mitigation	Employment and recruitment	Carbon footprint and emissions
ESG investing approaches	Carbon emissions verification		
ESG-related corporate disclosures			

Source: Morgan Stanley Research

4. Progress within the voluntary carbon offsets, with carbon removals preferred

2024 will see the beginning of labelling of carbon offset project types that pass through rigorous assessment by the leading supply-side integrity initiative in the market – the ICVCM. This important step will provide a fresh start for a market that has experienced a 90% sell-off in futures, and we expect projects that are granted the CCP label by the ICVCM to be strongly preferred by buyers. **While we expect some avoidance projects (both nature and tech-based) to benefit from this restored confidence, we think that the market will by and large continue to favor removals and prices for these projects should remain elevated.** CORSIA Phase 1 also begins, and so we expect demand for projects from airlines to be a dominant market force.

5. Growing focus of the benefits and risks of GenAI/ LLMs

We continue to expect rapid development with GenAI/Large Language Models (LLMs), particularly as more models are in production: Given the general-purpose nature of GenAI/LLMs, we believe that research and development will continue to progress on this technology and we are excited for what this may mean in pursuit of sustainability goals across environmental, social, and governance pillars. However, we also think that while the benefits can drive improvements in society, we should be mindful of the risks associated with GenAI specifically around safety, bias, and security.

In 2024, we think that further discussion on GenAI use cases in solving climate change, healthcare, education, and ESG data challenges will be more appreciated by investors. When it comes to GenAI risks, we continue to expect discussions to take center stage, with the potential for greater investor focus on ensuring that corporates have AI governance and risk-management strategies in place.

6. The rise of social investing

Social investing to gain steam via growing AUM (currently at 23% CAGR over 2020-23) and as social data availability grows, enabling greater ESG integration: According to the UN's 2020 estimates ~US$3.3-4.5 trillion annually needs to be mobilized to achieve the 2030 Agenda for Sustainable Development. Recent humanitarian crises have only exacerbated this social inequality, drawing attention to the need for capital to address social challenges.

In 2024, we expect to see growth in the number of social-focused funds and the dedicated AUM, as well as greater investor focus on social integration within their existing funds: Our work on company culture and on gender diversity has determined that leading stocks outperform the broader universe on a number of metrics; investors with dedicated ESG funds and otherwise will continue to leverage these non-traditional data points to drive alpha in the coming years.

7. Resilience and evolution of ESG investing

Resilience and evolution of ESG investing – two areas of focus in 2024: 2022-23 put ESG investing to the test, specifically the decarbonization theme. In 2024, we expect increased investor focus on identifying companies that are 'walking the walk' – those that are delivering on their decarbonization goals and particularly those with tangible results in the near term and/or those that have committed to allocate a significant amount of capital to decarbonization technologies (ESG 'rate of change' stories). **We believe it is this nuanced approach, over thematic investing, that has the potential to generate the most alpha.** We expect quantitative approaches along this theme to gain traction. Regulation will also continue to evolve and promulgate, which will drive data availability.

8. Green nuance is the focus in fixed income, though innovation continues

We expect two areas of increased focus within the green bond universe: 1) Project-level investment; and 2) Alignment with the EU taxonomy. Issuers are looking to understand their options when it comes to issuing EU taxonomy-aligned green bonds, so we expect gradual growth (and some experimentation) when it comes to issuing EU Green Bond Standard green bonds. We think that investors will prioritize a portfolio of diverse project-type exposure as the data improve. Innovations (such as debt-for-nature swaps, catastrophe bonds, and carbon-linked instruments) will continue, particularly in emerging markets, but we think that ultimately the stalwart green bond will be preferred by issuers and investors alike.

What We Debated

Serena Tang
Serena.Tang@morganstanley.com
+1 212 761-3380
Morgan Stanley & Co. LLC

Vishwanath Tirupattur
Vishwanath.Tirupattur@morganstanley.com
+1 212 761-1043
Morgan Stanley & Co. LLC

This year ahead outlook involved intense discussions with the entire Morgan Stanley global economics and strategy teams. Here are some key issues we debated:

Slowdown but no recession? In their baseline scenario, our economists expect a significant slowdown in DM economies while taming inflation but without dipping into an outright recession. Restrictive monetary policy should continue to exert pressure on the economic cycle over the forecast horizon because inflation only sustainably converges to target in 2025. While recessions remain a risk everywhere, we expect any recession (such as in the UK) to be shallow because inflation is falling with full employment, so real incomes should hold up, leaving consumption resilient, despite more volatile investment spending.

The China question: Relative to the expectations in our mid-year outlook, China growth surprised to the downside. We clearly overestimated the ability and willingness of policymakers in China to deal with the looming 3D threat. While we expect policymakers to accelerate reflationary policies next year, expanding the augmented fiscal deficit by another 1.5pp of GDP, our expectations for growth are now more modest. We expect subpar improvement in both growth and inflation in 2024-25, with real GDP growth reaching a below-consensus 4.2%Y/4.0%Y. More central government-led stimulus will only cushion the economy against continued deleveraging in the housing sector and local government financial vehicles (LGFV).

Agency MBS versus US IG credit: While our preference for high-quality fixed income products is clear, we debated how relative value between agency MBS and IG credit will play out over the course of the year ahead. While agency MBS spreads have been far from stable, and the technicals are still challenging, we think that prices reflect the weak sentiment. Towards 2H24, we expect that sentiment turns more positive, with the Fed nearing the end of QT and yield curve steepening. This should bring back US domestic banks to the MBS market, catalyzing modest tightening in agency MBS spreads. While IG fundamentals and technicals are supportive, valuations are a challenge. Our macro story suggests lower rate volatility and more fund flows into bonds, which should help all high grade fixed income, but help agency MBS more.

Formal NIRP/YCC exit: Our economists expect the BoJ to formally end the framework by removing the NIRP and long-term rate target in January 2024, with the risk of an early move in December 2023. They also expect a 25bp rate hike in July 2024, and expect the BoJ to abolish the monetary base commitment in 2Q25, starting gradual QT with a reduction in JGB purchases. The combination of rate differentials – both falling US rates as well as an end of YCC and negative rates in January – and, eventually, a rate hike from the BoJ results in the emergence of broad-based outperformance of JPY. We debated the implications of the strengthening of JPY. We expect that as JPY emerges stronger over the course of the year, FX-hedging costs for non-yen assets fall, which favors high-quality spread products such as agency MBS, IG credit, and CLO AAAs.

Real estate challenges: US residential and commercial real estate markets diverged dramatically over the course of 2023 and their trajectory in the year ahead was an important debate. The dramatic affordability challenges through higher mortgage rates resulted in a significant pullback of existing home sales, thus renewed decreases in inventory, which provided near-term support for home prices. On the other hand, the combination of challenges for key lenders (regional banks) and secular changes to select property types (office), coupled with an imminent and persistent wall of maturities that need to be refinanced, drove commercial real estate prices and sales meaningfully lower. Looking ahead, as rates come down, we expect affordability to improve and for-sale inventory to increase. US home prices should see modest declines (down 3%Y) as the growth in inventory offsets the increased demand. With fundamental stresses remaining largely unresolved, we expect the outlook for commercial real estate to remain challenging.

Known unknowns: As of this writing, the world is grappling with heightened geopolitical tensions. While some market signals such as the price of oil suggest that the conflicts may remain regional, the potential for escalation cannot be ruled out. Furthermore, 2024 is an important election year, with presidential elections coming up in the US and Mexico, among other countries. While we realize that geopolitics and electoral politics could have a substantial bearing on market outcomes, we have no way of handicapping either at this stage.

How Consistent Are Our Forecasts?

Serena Tang
Serena.Tang@morganstanley.com
+1 212 761-3380
Morgan Stanley & Co. LLC

How reasonable are our forecasts relative to each other? We use various regression models for every forecast market, using *all other markets*' performance as variables. For example, our model would look at whether the S&P 500 next 12-month forecast price change is roughly in line with our forecasts for USD/JPY, US 10-year yields, and so on. In other words, the model gives insight into whether our strategists' forecasts imply asset correlations to differ significantly from recent history.

A top-down observation: All our forecasts *taken together* roughly agree with each other and point to an environment where US equities has a good risk/reward profile relative to other stock markets, where USD is stronger across nearly all major crosses, where gold and copper trade in a range (but with a negative skew), and credit spreads widen, but not by much.

Two things stand out most in this set of forecasts:

The first is that the decline in yields we're expecting is unusual: Historical correlations suggest that in this environment where our strategists are forecasting low but positive returns for stocks and credit spreads slightly wider, government bond yields *do* tend to fall – just not by the 120bp we're expecting for the UST 2-year, or the 50bp we're projecting for the UST 10-year.

But does this make sense? Given the big moves in rates this year and the fact that our economists expect the Fed to start cutting in June by 25bp, and ending 2024 with the fed funds rate at 4.375%, a fall in yields of the magnitude our macro strategists see is probable. What goes up (quickly) must come down (quickly?).

The second is how out-of-sync our forecasts for Japan across the board are: Our price target of 2,600 for the TOPIX suggests much higher upside than what our various other strategists' forecasts for rates, FX, credit, and commodities would imply. Similarly, modelled JPY is weaker than our own target of 140, and views on the market environment implied by all other forecasts suggest that the JGB 2-year yield should go lower, not higher.

Exhibit 81: Forecast 'face off': How do our equities, FX, and commodities price targets compare to each other and history?

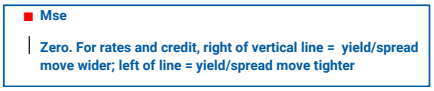
Equities		4Q24 Target	Estimate ranges vs MSe
S&P 500	4383	4500	
MSCI Europe	1798	1810	
TOPIX	2306	2600	
MSCI EM	958	1000	
FX			
USDJPY	151	140	
EURUSD	1.07	1.04	
GBPUSD	1.23	1.15	
AUDUSD	0.6	0.6	
USDINR	83.3	82.5	
USDZAR	18.5	18.0	
USDMXN	17.5	19.3	
USDBRL	4.9	5.3	
Commodities			
Brent	79.5	85.0	
Gold	1,959	1,950	
Copper Spot ($)	8,059	9,000	



Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 82: Forecast 'face off': How do our rates and credit yield and price targets compare to each other and history?

2Y Rates (%)		4Q24 Target	Estimate ranges vs MSe
UST 2Y	4.93	3.70	
Bunds 2Y	2.99	1.60	
UKT 2Y	4.60	3.20	
JGB 2Y	0.12	0.20	
10Y Rates (%)			
UST 10Y	4.49	3.95	
Bunds 10Y	2.62	1.80	
UKT 10Y	4.24	3.50	
JGB 10Y	0.85	0.90	
Credit (bps)			
US IG	125	125	
US HY	398	475	
EUR IG	156	160	
US MBS	65	55	



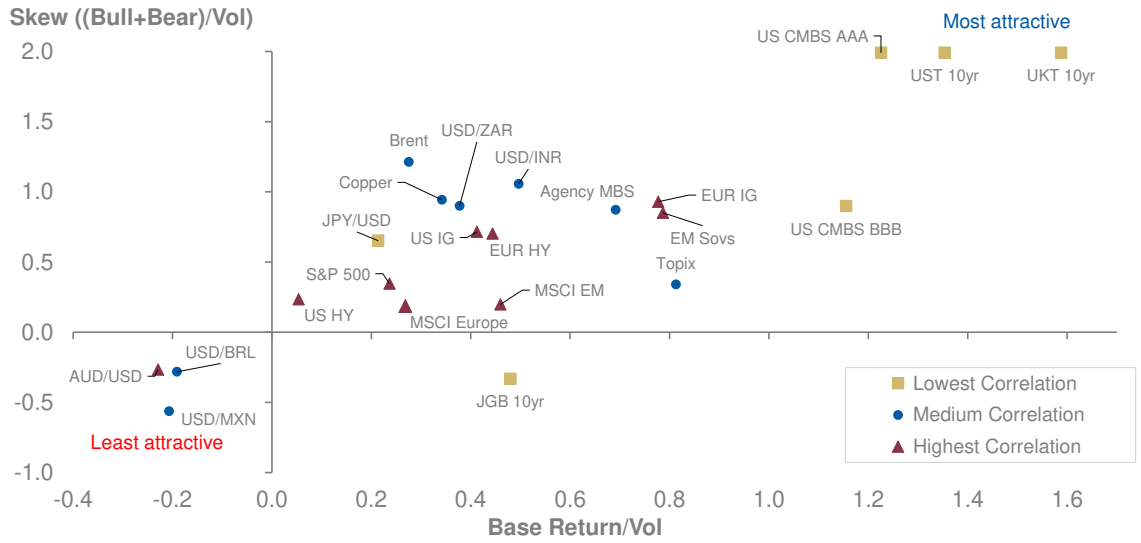
Source: Bloomberg, Morgan Stanley Research forecasts

These forecasts being out of line with history is not surprising. Our economists have flagged the BoJ exiting YCC and NIRP in January

2024 – with the risk that it happens earlier – and our equity strategists have argued that Japanese equities are benefiting from structural changes around corporate governance. The fact that Japanese assets across the board stand out so much reflects Morgan Stanley strategists' high-conviction view that, for Japan, this time is different.

Expected Returns and Risk/Reward

Exhibit 83: Global asset classes – expected 4Q24 return vs. risk



Source: Market1, MSCI, Bloomberg, Morgan Stanley Research forecasts; Note: 'Expected returns' based on Morgan Stanley strategy 4Q24 forecasts. Correlation is 10y relative to global equities (MSCI ACWI). Returns are total returns, except for credit, where we forecast excess returns. Equity returns exclude net buyback yield. Commodity returns are calculated relative to futures to account for carry. All currency returns are shown as XXXUSD return. Volatility is 10y realized vol

Exhibit 84: Morgan Stanley forecasts

	As of Nov 08, 2023	Q4 2024 Forecast			Q4 2024 Return Forecast			Volatility	Base Case Return/Risk
		Bear	Base	Bull	Bear	Base	Bull		
Equities						Total Returns			
S&P 500	4,383	3,850	**4,500**	5,050	-10.6%	**4.3%**	16.8%	18%	0.24
MSCI Europe	1,798	1,480	**1,810**	2,040	-14.1%	**4.3%**	17.0%	16%	0.27
Topix	2,306	1,850	**2,600**	2,800	-17.4%	**15.1%**	23.8%	19%	0.81
MSCI EM	958	750	**1,000**	1,140	-18.8%	**7.3%**	21.9%	16%	0.46
FX						Total Returns			
USD/**JPY**	151	146	**140**	132	-2.3%	**1.9%**	8.1%	9%	0.21
EUR/USD	1.07	1.00	**1.04**	1.10	-8.5%	**-4.6%**	1.3%	8%	-0.58
GBP/USD	1.23	1.10	**1.15**	1.22	-10.3%	**-6.6%**	-1.0%	9%	-0.70
AUD/USD	0.64	0.60	**0.63**	0.67	-6.3%	**-2.3%**	3.6%	10%	-0.23
USD/**INR**	83.3	85.8	**82.5**	79.2	6.7%	**2.5%**	-1.3%	5%	0.50
USD/**ZAR**	18.5	18.4	**18.0**	17.3	10.2%	**5.9%**	3.9%	16%	0.38
USD/**BRL**	4.91	5.80	**5.30**	4.80	6.5%	**-3.2%**	-11.2%	17%	-0.19
USD/**MXN**	17.5	20.5	**19.3**	18.5	1.1%	**-2.6%**	-8.1%	12%	-0.21
USD/**CNY**	7.28	7.70	**7.45**	7.20	3.2%	**-0.2%**	-3.7%	4%	-0.06
Rates (% percent)						Total Returns			
UST 10yr	4.49	5.05	**3.95**	2.50	0.0%	**8.8%**	21.2%	7%	1.35
DBR 10yr	2.62	2.70	**1.80**	1.50	1.8%	**9.7%**	12.6%	6%	1.76
UKT 10yr	4.24	4.60	**3.50**	3.00	1.5%	**10.3%**	14.3%	6%	1.59
JGB 10yr	0.85	1.80	**0.90**	0.35	-6.8%	**1.0%**	6.1%	2%	0.48
Credit (bps)						Excess Returns			
US IG	125	165	**125**	90	-1.4%	**1.3%**	3.7%	3%	0.41
US HY	398	600	**475**	325	-4.4%	**0.3%**	5.8%	6%	0.05
EUR IG	156	225	**160**	120	-1.5%	**1.4%**	3.1%	2%	0.78
EUR HY	457	675	**525**	400	-2.6%	**2.0%**	5.9%	5%	0.44
EM $ Sov	432	550	**410**	350	-3.5%	**5.8%**	9.8%	7%	0.79
Sec. Products (bps)						Excess Returns			
US Agency MBS	65	85	**55**	40	-0.6%	**1.2%**	2.1%	2%	0.69
US CMBS AAA	150	175	**145**	110	-1.0%	**2.0%**	5.5%	2%	1.23
US CMBS BBB-	900	1,150	**950**	800	-15.8%	**4.1%**	18.9%	4%	1.16
Commodities						Total Returns			
Brent	80	65	**85**	125	-15.3%	**10.8%**	63.0%	39%	0.28
Copper	8,058.5	7,650.0	**9,000.0**	10,802.6	-9.0%	**7.1%**	28.6%	21%	0.34
Gold	1,959	1,755	**1,950**	2,243	-15.2%	**-5.8%**	8.4%	14%	-0.40

Source: MSCI, Bloomberg, Morgan Stanley Research forecasts; Note: Returns are total returns, except for credit, where we forecast excess returns versus government bonds. Equity returns exclude net buyback yield. Commodity returns are calculated relative to futures to account for carry. All currency returns are shown as XXXUSD return. We use CNH/USD carry as a proxy for CNY/USD carry. Volatility is 10y realized vol.

Morgan Stanley Key Economic Forecasts

Exhibit 85: Morgan Stanley key economic forecasts

	2023				2024				2025			
Real GDP (%Y)	**1Q**	**2Q**	**3Q**	**4QE**	**1QE**	**2QE**	**3QE**	**4QE**	**1QE**	**2QE**	**3QE**	**4QE**
Global	**3.0**	**3.4**	**2.9**	**2.9**	**2.6**	**2.9**	**2.7**	**2.9**	**3.0**	**2.9**	**2.9**	**2.8**
G10	**1.5**	**1.5**	**1.6**	**1.4**	**1.3**	**1.2**	**1.0**	**1.2**	**1.3**	**1.3**	**1.3**	**1.3**
US	1.7	2.4	2.9	2.5	2.4	2.3	1.5	1.6	1.5	1.4	1.4	1.4
Euro Area	1.2	0.5	0.1	0.0	0.2	0.2	0.6	1.0	1.0	1.0	1.1	1.1
Japan	2.0	1.6	2.3	2.1	1.6	0.6	0.8	1.0	1.1	1.0	1.0	1.2
UK	0.5	0.6	0.6	0.4	-0.2	-0.4	-0.1	0.2	0.7	1.0	1.1	1.1
EM	**4.0**	**4.8**	**3.9**	**4.1**	**3.5**	**4.3**	**4.0**	**4.2**	**4.3**	**4.1**	**4.0**	**3.8**
China	4.5	6.3	4.9	4.9	3.6	5.0	3.9	4.1	4.5	4.2	3.8	3.5
India	6.1	7.8	6.5	6.0	5.7	6.4	6.7	6.7	6.3	6.5	6.7	6.4
Brazil	4.0	3.4	1.9	2.9	1.3	1.8	1.8	2.0	1.6	1.5	1.6	1.7
Consumer price inflation (%Y)												
Global*	**5.3**	**3.8**	**3.5**	**2.8**	**2.7**	**2.8**	**2.5**	**2.5**	**2.3**	**2.3**	**2.4**	**2.4**
G10	**6.6**	**5.0**	**4.3**	**3.3**	**2.8**	**2.6**	**2.3**	**2.1**	**2.1**	**2.0**	**2.0**	**2.0**
US	5.8	4.1	3.6	3.1	2.5	2.4	1.9	1.8	1.9	2.0	2.1	2.1
Euro Area	8.0	6.2	5.0	3.1	2.8	2.6	2.2	2.1	2.0	2.0	2.0	2.0
Japan	3.6	3.3	3.2	3.2	3.1	3.5	3.6	2.7	2.5	2.0	1.4	1.2
UK	10.2	8.4	6.7	4.3	3.7	2.5	2.6	2.4	1.9	1.8	1.8	1.8
EM*	**4.3**	**2.9**	**2.8**	**2.4**	**2.7**	**2.8**	**2.6**	**2.9**	**2.5**	**2.5**	**2.7**	**2.8**
China	1.3	0.1	-0.1	-0.1	0.7	1.1	1.2	1.5	1.1	1.2	1.6	1.9
India	6.2	4.6	6.4	5.1	5.5	5.7	3.9	5.3	4.7	4.7	4.9	4.9
Brazil	5.3	3.8	4.6	4.8	4.4	4.0	4.4	4.3	4.0	3.8	3.6	3.5
Monetary policy rate (% p.a.)												
US	4.875	5.125	5.375	5.375	5.375	5.125	4.875	4.375	3.875	3.375	2.875	2.375
Euro Area#	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.00	2.50	2.25	2.00	2.00
Japan	-0.10	-0.10	-0.10	-0.10	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25
UK	4.25	5.00	5.25	5.25	5.25	5.00	4.75	4.25	3.75	3.25	2.75	2.50
China^^	2.00	1.90	1.80	1.80	1.70	1.70	1.60	1.60	1.60	1.60	1.60	1.60
India	6.50	6.50	6.50	6.50	6.50	6.25	6.00	6.00	6.00	6.00	6.00	6.00
Brazil	13.75	13.75	12.75	11.75	10.75	10.25	10.00	10.00	9.50	9.00	8.50	8.50

Source: IMF, Morgan Stanley Research forecasts; Note: Global and regional aggregates for GDP growth are GDP-weighted averages, using PPP weights excluding Ukraine; Japan policy rate is the interest rate on excess reserves; CPI numbers are period average; Global* and EM* consumer price inflation aggregates exclude Argentina, Turkey, Egypt and Ukraine.

Morgan Stanley Global Currency Forecasts

Exhibit 86: Morgan Stanley FX forecasts

	2023	2024				2025			
	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
EUR/USD	1.04	1.00	1.01	1.02	1.04	1.05	1.07	1.08	1.10
USD/JPY	147	145	142	140	140	140	139	139	138
GBP/USD	1.19	1.14	1.14	1.14	1.15	1.18	1.20	1.23	1.25
USD/CHF	0.89	0.94	0.93	0.93	0.91	0.91	0.91	0.91	0.91
USD/SEK	11.1	11.8	11.6	11.4	11.1	10.9	10.7	10.5	10.3
USD/NOK	11.5	11.9	11.5	11.1	10.6	10.4	10.2	10.0	9.9
USD/CAD	1.38	1.41	1.40	1.37	1.36	1.34	1.33	1.31	1.30
AUD/USD	0.63	0.61	0.62	0.62	0.63	0.65	0.68	0.70	0.72
NZD/USD	0.58	0.57	0.58	0.58	0.59	0.60	0.62	0.63	0.64
EUR/JPY	153	145	143	143	146	147	149	150	152
EUR/GBP	0.87	0.88	0.89	0.89	0.90	0.90	0.89	0.88	0.88
EUR/CHF	0.93	0.94	0.94	0.95	0.95	0.96	0.98	0.99	1.00
EUR/SEK	11.5	11.8	11.7	11.6	11.5	11.4	11.4	11.3	11.3
EUR/NOK	12.0	11.9	11.6	11.3	11.0	11.0	10.9	10.9	10.9
USD/CNY	7.30	7.45	7.50	7.48	7.45	7.42	7.38	7.34	7.28
USD/HKD	7.82	7.84	7.83	7.81	7.79	7.79	7.78	7.77	7.76
USD/IDR	15,700	15,900	15,700	15,600	15,500	15,356	15,213	15,069	14,926
USD/INR	83.4	83.7	83.6	83.0	82.5	81.5	80.4	79.4	78.4
USD/KRW	1,320	1,350	1,340	1,320	1,290	1,281	1,271	1,262	1,253
USD/MYR	4.7	4.8	4.8	4.7	4.7	4.6	4.5	4.5	4.4
USD/PHP	56.5	57.5	57.0	56.5	56.0	56.0	56.0	56.0	56.0
USD/SGD	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
USD/TWD	32.4	32.8	32.6	32.4	31.8	31.6	31.4	31.2	30.9
USD/THB	35.8	36.5	36.3	36.0	35.2	35.2	35.1	35.1	35.1
USD/BRL	5.0	5.1	5.2	5.3	5.3	5.3	5.2	5.2	5.1
USD/MXN	17.8	19.0	20.0	19.5	19.3	19.3	19.3	19.3	19.3
USD/ARS	672	858	1,022	1,172	1,318	1,461	1,612	1,762	1,898
USD/CLP	920	930	950	930	925	900	875	850	825
USD/COP	4,150	4,300	4,400	4,450	4,500	4,350	4,200	4,050	3,900
USD/ZAR	19.0	19.5	19.0	18.5	18.0	17.9	17.8	17.7	17.6
USD/TRY	30.0	31.5	35.0	36.5	38.0	39.0	41.0	43.0	45.0
USD/ILS	4.0	4.1	4.0	3.9	3.9	3.9	3.8	3.8	3.7
EUR/PLN	4.5	4.5	4.4	4.3	4.2	4.2	4.1	4.1	4.0
EUR/CZK	24.8	25.0	24.5	24.0	23.5	24.2	24.9	25.6	26.3
EUR/HUF	385	390	395	400	400	395	384	376	367
DXY Index	107	111	110	109	107	106	104	103	102
Fed's Broad USD	124	128	128	127	125	124	123	122	121
ECB EUR TWI	96.3	95.1	95.5	95.7	96.3	96.9	97.3	97.8	98.2

Source: Morgan Stanley Research forecasts

Morgan Stanley Government Bond Yield/Spread Forecasts

Exhibit 87: Morgan Stanley government bond yield/spread forecasts – base cases

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

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

Exhibit 88: Morgan Stanley government bond yield/spread forecasts – bull, bear, base cases

10Y	Bull		Base		Bear	
	2Q24	4Q24	2Q24	4Q24	2Q24	4Q24
US	3.30	2.50	4.20	3.95	4.75	5.05
Germany	1.90	1.50	2.10	1.80	2.80	2.70
Japan	0.50	0.35	0.85	0.90	1.20	1.80
UK	3.60	3.00	3.70	3.50	4.80	4.60
Australia	3.70	3.50	4.55	4.40	4.90	4.90
New Zealand	4.10	4.00	4.95	4.85	5.40	5.40
Canada	2.75	2.45	3.60	3.30	3.95	3.95
Austria*	55	45	55	45	60	55
Netherlands*	35	30	35	30	35	35
France*	60	55	60	55	70	65
Belgium*	70	60	70	65	80	70
Ireland*	55	50	55	50	65	60
Spain*	100	95	110	100	115	110
Italy*	185	170	210	190	235	220
Portugal*	65	60	85	75	105	100

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

Morgan Stanley Cross-Asset Benchmark

Exhibit 89: Morgan Stanley cross-asset benchmark

		Hedged Returns				Unhedged Returns			
Asset	Wght	T1W	T1M	T3M	T12M	T1W	T1M	T3M	T12M
BENCHMARK	~	3.2%	1.9%	-1.6%	11.4%	3.1%	1.8%	-2.7%	11.0%
EQUITIES									
US Equities	30.0%	4.1%	1.4%	-2.6%	16.0%	4.1%	1.4%	-2.6%	16.0%
European Equities	10.0%	2.2%	0.0%	-2.0%	11.3%	3.9%	1.6%	-4.6%	15.5%
Japan Equities	5.0%	4.9%	4.9%	5.5%	30.6%	-1.0%	-2.8%	-7.4%	13.0%
EM Equities	10.0%	4.7%	2.0%	-2.8%	9.7%	5.9%	3.4%	-3.0%	10.5%
CORE FIXED INCOME									
USTs	10.0%	1.5%	1.3%	-2.2%	1.3%	1.5%	1.3%	-2.2%	1.3%
EGBs	6.0%	0.7%	1.8%	-0.9%	1.7%	2.3%	3.6%	-3.2%	6.1%
Agency MBS	5.0%	2.4%	1.6%	-3.1%	1.7%	2.4%	1.6%	-3.1%	1.7%
US IG	5.0%	2.1%	1.6%	-2.4%	4.9%	2.1%	1.6%	-2.4%	4.9%
EUR IG	2.0%	0.6%	1.5%	0.4%	7.0%	2.2%	3.3%	-1.8%	11.6%
OTHER FIXED INCOME									
US HY	2.0%	2.4%	2.5%	0.6%	9.5%	2.4%	2.5%	0.6%	9.5%
EM $ Sov	2.0%	2.5%	3.2%	-3.0%	8.3%	2.5%	3.2%	-3.0%	8.3%
EM Local	4.0%	1.1%	1.2%	-1.4%	5.7%	3.5%	4.4%	-1.7%	11.4%
US Lev Loans	1.0%	0.4%	0.5%	1.8%	8.9%	0.4%	0.5%	1.8%	8.9%
CLO AAA	1.0%	0.0%	0.0%	1.0%	8.1%	0.0%	0.0%	1.0%	8.1%
COMMODITIES									
Brent	2.0%	-2.2%	0.4%	-0.2%	-1.6%	-2.3%	0.3%	-0.2%	-1.6%
Gold	1.0%	-1.1%	7.3%	1.9%	14.3%	-1.1%	7.3%	1.9%	14.3%
Copper	1.0%	0.5%	1.4%	-2.3%	3.2%	0.4%	1.4%	-2.3%	3.2%
CASH									
CASH	3.0%	0.1%	0.5%	1.3%	4.8%	0.1%	0.5%	1.3%	4.8%

Source: Bloomberg, Morgan Stanley Research

Valuation Methodology and Risks

Exhibit 90: EM trades

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Receive 5y IBR vs. pay 5y CAM	30-Oct-23	290	230	340	We recommend 5-year IBR receivers versus 5-year CAM payers, as a play on divergent valuations (relative to neutral rate levels and to US rates) and as we think that BanRep is likely to start its easing cycle before the end of the year. We note that BanRep is the only regional central bank with a dual mandate and, although CPI expectations remain unanchored (end-2024 roughly 230bp above target), recent economic data have started to surprise to the downside more meaningfully.	A more hawkish BanRep that pushes back against near-term cuts.

Source: Morgan Stanley Research

Exhibit 91: G10 FX and rates trades

Trade	Date	Entry Level	Rationale	Risks
Short GBP/NOK	12-Nov-23	13.5890	BoE dovishness should contrast with a relatively hawkish Norges Bank while slowing Norges Bank FX purchases should reduce downward pressure on NOK.	Norwegian data slow markedly, leading to significant Norges Bank rate cuts.
Short AUD/JPY	12-Nov-23	96.305	Falling US yields should support a rising JPY while AUD should remain under pressure as Chinese growth fails to rebound meaningfully.	US yields remain elevated, weighing on JPY, or Chinese growth improves markedly, bolstering China-sensitive AUD.
Short BTP 4.35% May 33 versus Bund 1.7% Aug 32	03-Nov-23	180bp	After the recent repricing of the 10-year spread, we think that the risk/reward for the structural short 10-year BTP versus Bund is attractive again.	A continuation of the rally in credit indices, which would support BTPs in the near term.
Rec. Feb'24-Aug'24 MPC	03-Nov-23	-30bp	The UK money market curve looks too steep, especially when compared to other markets, given that few cuts are still priced in for 2024 and the easing cycle is seen to be coming later than the ECB and Fed. As we believe that deeper rate cuts should be priced in for 2024, with our economist's expectation for a first cut in May 2024, we enter into a receive Feb'24-Aug'24 MPC spread.	More hawkish BoE rhetoric and better economic data, which could steepen the money market sector.
Rec 10y TONA OIS versus short 30y JGB (DV01 1.5 vs 1)	06-Oct-23	25.5bp	The attractive positive carry and rolldown to position for a lower BoJ rate-hiking path with less sensitivity to UST developments.	The market prices in a sharper BoJ rate-hiking cycle due to factors such as a renewed acceleration in domestic inflation.
New Zealand OIS 2s10s steepener	12-Nov-23	34bp	We expect the NZGB curve to bull steepen in 2024 as CPI inflation decelerates below the pace in Australia and growth continues to decelerate from the 2022 highs. Real retail sales may fall below their pre-Covid pace as high rates weigh on the economy, leading the RBNZ to signal removal of policy restrictions in 1H24.	Substantial near-term fiscal stimulus from New Zealand's new governing coalition would likely warrant higher near-term yields, flattening the 2s10s curve.
Australia OIS 2s10s flattener	12-Nov-23	24bp	We expect front-end Australian yields to drift sideways through 1H24 as resilient inflation pressures lead the RBA to raise rates to 4.60%, and then keep rates on hold longer (i.e., cut later) than peer central banks. On a cross-market basis, this resilience in the front end of the Australian yield curve is likely to keep the 2s10s spread from widening significantly.	A pronounced decline in Australian inflation during early 2024.

Source: Morgan Stanley Research

Exhibit 92: Credit trades

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Long CDX IG vs. HY	12-Nov-23	CDX IG: 69bp CDX HY: 443bp	NA	NA	We expect interest coverage to be a key driver of credit tiering, with leveraged capital structures most sensitive to elevated rates and slowing growth. We recommend positioning for decompression through CDX IG versus HY.	If growth remains resilient and inflation falls faster than central banks' forecast, allowing them to normalise policy at a faster-than-expected pace, leveraged credit could continue to outperform.
Long 7-15% CDX 5yr	12-Nov-23	101bp	NA	NA	Exposure benefits from strong carry and rolldown in a range-bound spread environment. Extremely loss-remote relative to our economic expectations.	A broader repricing of credit risk wider in the short term, as investors could view this as a cost-effective way to be short spread beta.
Long Main vs. Xover	12-Nov-23	Main: 76bp Xover: 409bp	NA	NA	We expect interest coverage to be a key driver of credit tiering, with leveraged capital structures most sensitive to elevated rates and slowing growth. We recommend positioning for decompression through Main versus Xover.	If growth remains resilient and inflation falls faster than central banks' forecast, allowing them to normalise policy at a faster-than-expected pace, leveraged credit could continue to outperform.
Xover 3s5s Flattener	45242	Xover 3Y: 325bp Xover 5Y: 409bp	NA	NA	XOver 3s5s looks too steep given spread levels and EU economic risks; we like flatteners.	A more meaningful pick-up in HY issuance could reprice long-end spreads wider while simultaneously easing refinancing concerns in short-end bonds, steepening curves even further.

Source: Morgan Stanley Research

Exhibit 93: History of recommendations for rates trades

Sell BTP 4.4% May 2033 versus Buy DBR 1.7% Aug 2032

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
DBR 1.7 08/15/32	15-Aug-32	2s10s BTP vs BUNDS	18-Nov-22	2.08	20-Jan-23	2.11				DE0001102606
DBR 1 08/15/24	15-Aug-24	2s10s BTP vs BUNDS	18-Nov-22	2.11	20-Jan-23	2.53				DE0001102366
BTPS 2 ¾ 12/01/32	12-Jan-32	2s10s BTP vs BUNDS	18-Nov-22	4.03	20-Jan-23	3.91				IT0005494239
BTPS 0 08/15/24	15-Aug-24	2s10s BTP vs BUNDS	18-Nov-22	2.74	20-Jan-23	2.97				IT0005452989
FRTR 2 11/25/32	25-Nov-23	Buy OAT 2% Nov 32 vs Bund Aug 1.7% 32	03-Feb-23	2.64	27-Sep-23	3.3	35bp			FR0014008KZ3
DBR 1.7 08/15/32	15-Aug-32	Buy OAT 2% Nov 32 vs Bund Aug 1.7% 32	03-Feb-23	2.16	27-Sep-23	2.73	35bp			DE0001102606
DBR 1.7 08/15/32 Corp	15-Aug-23	Sell BTP 4.4% May 2033 vs buy DBR 1.7% Aug 2032	04-Aug-23	2.51	29-Sep-23	2.774		153.0		DE0001102606
BTPS 4.4 05/01/33 Corp	1-May-33	Sell BTP 4.4% May 2033 vs buy DBR 1.7% Aug 2032	04-Aug-23	4.15	29-Sep-23	4.691		153.0		IT0005518128

Receive Feb'24-Aug'24 MPC

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
May'23 MPC	11-May-23	Pay May'23-Aug'23 MPC Spread	17-Mar-23	4.2bp	14-Apr-23	25bp	40bp	-20bp		GPSF2A Curncy
Aug'23 MPC	3-Aug-23	Pay May'23-Aug'23 MPC Spread	17-Mar-23	4.2bp	14-Apr-23	25bp	40bp	-20bp		GPSF4A Curncy
Jun'23 MPC	22-Jun-23	Rec Jun'23-Aug'23 MPC Spread	28-Apr-23	16.9bp	24-May-23	30bp	0bp	25bp		GPSF2A Curncy
Aug'23 MPC	3-Aug-23	Rec Jun'23-Aug'23 MPC Spread	28-Apr-23	16.9bp	24-May-23	30bp	0bp	25bp		GPSF3A Curncy
Mar'24 MPC	21-Mar-24	Rec. Dec'23-Mar'24 MPC	07-Jul-23	12bp	19-Jul-23	-1.7bp	0bp	22bp		GPSF6A BGN Curncy
Dec'23 MPC	14-Dec-23	Rec. Dec'23-Mar'24 MPC	07-Jul-23	12bp	19-Jul-23	-1.7bp	0bp	22bp		GPSF4A BGN Curncy
Mar'24 MPC	21-Mar-24	Rec. Dec'23-Mar'24 MPC	18-Aug-23	11bp	08-Sep-23	0.3bp	0bp	18bp		GPSF5A BGN Curncy
Dec'23 MPC	14-Dec-23	Rec. Dec'23-Mar'24 MPC	18-Aug-23	11bp	08-Sep-23	0.3bp	0bp	18bp		GPSF3A BGN Curncy

Source: Morgan Stanley Research

Exhibit 94: History of recommendations for credit trades

Short iTraxx Xover versus Long iTraxx Main

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
iTraxx Xover	5Y	Xover - 5xMain Decompression	05-Sep-22	562.00	03-Mar-23	401.00				ITRXEXE
5x iTraxx Main	5Y	Xover - 5xMain Decompression	05-Sep-22	114.00	03-Mar-23	77.00				ITRXEBE
iTraxx Main	3m	Buy iTraxx Main 3m 1x2 Payer Spreads	14-Oct-22	0.00	13-Nov-22	0.00				ITRXEBE
iTraxx Main	3m	Buy iTraxx Main 3m 1x2 Payer Spreads	29-Sep-22	0.00	29-Dec-22	0.00				ITRXEBE
iTraxx Xover	5Y	Long iTraxx Main vs Xover on 4:1 Ratio	13-Nov-22	523.00	11-May-23	455.00				ITRXEXE
iTraxx Main	5Y	Long iTraxx Main vs Xover on 4:1 Ratio	13-Nov-22	106.00	11-May-23	87.00				ITRXEBE
iTraxx Main	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	106.00	11-May-23	87.00				ITRXEBE
CDX IG	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	89.00	11-May-23	81.00				IBOXUMAE
		Long AT1 vs. HY	04-Jun-23	155.40	08-Oct-23	157.6526				IBXXC2D1 Index
iTraxx XO		Long AT1 vs. HY	04-Jun-23	410.00	08-Oct-23	461.119				ITRXEXE Index

Short CDX HY versus Long CDX IG

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	5y	Buy Protection on HY 15-25% Tranche and IG 3-7% Tranche	25-Apr-22	580bp	13-Jan-23	714bp				IBOXHYSE Index
CDX IG	5y	Buy Protection on HY 15-25% Tranche and IG 3-7% Tranche	25-Apr-22	346bp	13-Jan-23	367bp				IBOXUMAE Index
CDX HY	5y	US Credit Decompression (Short HY vs. IG)	10-May-22	479.2	13-Feb-23	428.467				IBOXHYSE Index
CDX IG	5y	US Credit Decompression (Short HY vs. IG)	10-May-22	86.6	13-Feb-23	70.463				IBOXUMAE Index
CDX IG	5s10s	Credit Flatteners: CDX HY 3s5s and CDX IG 5s10s	25-May-22	33.50	13-Jan-23	37.00				IBOXUMAE Index
CDX HY	3s5s	Credit Flatteners: CDX HY 3s5s and CDX IG 5s10s	25-May-22	48.00	13-Jan-23	47.00				IBOXHYSE Index
Short-dated IG	5Y	Long US Short-dated IG vs. S&P 500	16-Sep-22	0.05	13-Nov-22	5.70%				IBOXUMAE Index
S&P 500		Long US Short-dated IG vs. S&P 500	16-Sep-22	3946.01	13-Nov-22	3828.11				SPX Index
CDX IG	3m	Buy CDX IG 3m 1x2 Payer Spreads	29-Sep-22	0.00	29-Dec-22	0				IBOXUMAE Index
iTraxx Main	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	106.00	11-May-23	87.00				ITRXEBE
CDX IG	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	89.00	11-May-23	81.00				IBOXUMAE
CDX IG		Credit Decompression (Long US IG vs. HY)	04-Jun-23	450.5	12-Nov-23	467.208				IBOXHYSE Index
CDX HY		Credit Decompression (Long US IG vs. HY)	04-Jun-23	71.3	12-Nov-23	69.478				IBOXUMAE Index

Long 7-15% CDX 5yr

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	5y	Buy Protection on HY 15-25% Tranche and IG 3-7% Tranche	25-Apr-22	580bp	13-Jan-23	714bp				IBOXHYSE Index
CDX IG	5y	Buy Protection on HY 15-25% Tranche and IG 3-7% Tranche	25-Apr-22	346bp	13-Jan-23	367bp				IBOXUMAE Index
CDX HY	5y	US Credit Decompression (Short HY vs. IG)	10-May-22	479.2	13-Feb-23	428.467				IBOXHYSE Index
CDX IG	5y	US Credit Decompression (Short HY vs. IG)	10-May-22	86.6	13-Feb-23	70.463				IBOXUMAE Index
CDX IG	5s10s	Credit Flatteners: CDX HY 3s5s and CDX IG 5s10s	25-May-22	33.50	13-Jan-23	37.00				IBOXUMAE Index
CDX HY	3s5s	Credit Flatteners: CDX HY 3s5s and CDX IG 5s10s	25-May-22	48.00	13-Jan-23	47.00				IBOXHYSE Index
Short-dated IG	5Y	Long US Short-dated IG vs. S&P 500	16-Sep-22	0.05	13-Nov-22	5.70%				IBOXUMAE Index
S&P 500		Long US Short-dated IG vs. S&P 500	16-Sep-22	3946.01	13-Nov-22	3828.11				SPX Index
CDX IG	3m	Buy CDX IG 3m 1x2 Payer Spreads	29-Sep-22	0.00	29-Dec-22	0				IBOXUMAE Index
iTraxx Main	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	106.00	11-May-23	87.00				ITRXEBE
CDX IG	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	89.00	11-May-23	81.00				IBOXUMAE
CDX IG		Credit Decompression (Long US IG vs. HY)	04-Jun-23	450.5	12-Nov-23	467.208				IBOXHYSE Index
CDX HY		Credit Decompression (Long US IG vs. HY)	04-Jun-23	71.3	12-Nov-23	69.478				IBOXUMAE Index

iTraxx Xover 3s5s 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
iTraxx Xover	5Y	Xover - 5xMain Decompression	05-Sep-22	562.00	03-Mar-23	401.00				ITRXEXE
5x iTraxx Main	5Y	Xover - 5xMain Decompression	05-Sep-22	114.00	03-Mar-23	77.00				ITRXEBE
iTraxx Xover	5Y	Long iTraxx Main vs Xover on 4:1 Ratio	13-Nov-22	523.00	11-May-23	455.00				ITRXEXE
iTraxx Main	5Y	Long iTraxx Main vs Xover on 4:1 Ratio	13-Nov-22	106.00	11-May-23	87.00				ITRXEBE
		Long AT1 vs. HY	04-Jun-23	155.40	08-Oct-23	157.6526				IBXXC2D1 Index
iTraxx XO		Long AT1 vs. HY	04-Jun-23	410.00	08-Oct-23	461.119				ITRXEXE Index

Source: Morgan Stanley Research

Exhibit 95: History of recommendations for cross-asset trades

Long TOPIX (FX-Unhedged)

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
TOPIX Index	1y	Underwrite Japan Equities. Sell Topix 1yr 10% OTM Puts	25-May-22	4.6%	13-Jan-23	1.40%				TPX Index
TWSE Index		Long Korea, Taiwan and Japan Equities	14-Oct-22	13081.00	13-Nov-22	13638.81				TWSE Index
TPX Index		Long Korea, Taiwan and Japan Equities	14-Oct-22	1869.00	13-Nov-22	1949.49				TPX Index
KOSPI Index		Long Korea, Taiwan and Japan Equities	14-Oct-22	2202.00	13-Nov-22	2424.41				KOSPI Index
Topix Japan		Long Japan	04-Jun-23	2182.70	08-Oct-23	2263.76				TPX Index

Long MSCI ACWI Industrials + MSCI ACWI Healthcare

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
MSCI World Healthcare		Long DM Healthcare vs. Market	04-Jun-23	341.40	08-Oct-23	332.62				MXWO0HC Index
MSCI ACWI		Long DM Healthcare vs. Market	04-Jun-23	663.30	08-Oct-23	647.59				MXWD Index

Short CDX HY 15-100% versus CDX IG

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	5y	Buy Protection on HY 15-25% Tranche and IG 3-7% Tranche	25-Apr-22	580bp	13-Jan-23	714bp				IBOXHYSE Index
CDX IG	5y	Buy Protection on HY 15-25% Tranche and IG 3-7% Tranche	25-Apr-22	346bp	13-Jan-23	367bp				IBOXUMAE Index
CDX HY	5y	US Credit Decompression (Short HY vs. IG)	10-May-22	479.2	13-Feb-23	428.467				IBOXHYSE Index
CDX IG	5y	US Credit Decompression (Short HY vs. IG)	10-May-22	86.6	13-Feb-23	70.463				IBOXUMAE Index
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CDX HY	3s5s	Credit Flatteners: CDX HY 3s5s and CDX IG 5s10s	25-May-22	48.00	13-Jan-23	47.00				IBOXHYSE Index
Short-dated IG	5Y	Long US Short-dated IG vs. S&P 500	16-Sep-22	0.05	13-Nov-22	5.70%				IBOXUMAE Index
S&P 500		Long US Short-dated IG vs. S&P 500	16-Sep-22	3946.01	13-Nov-22	3828.11				SPX Index
CDX IG	3m	Buy CDX IG 3m 1x2 Payer Spreads	29-Sep-22	0.00	29-Dec-22	0				IBOXUMAE Index
iTraxx Main	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	106.00	11-May-23	87.00				ITRXEBE
CDX IG	5Y	Long iTraxx Main vs CDX IG	13-Nov-22	89.00	11-May-23	81.00				IBOXUMAE
CDX IG		Credit Decompression (Long US IG vs. HY)	04-Jun-23	450.5	12-Nov-23	467.208				IBOXHYSE Index
CDX HY		Credit Decompression (Long US IG vs. HY)	04-Jun-23	71.3	12-Nov-23	69.478				IBOXUMAE Index

Long CLO Barbell (AAAs, BBs)

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 CLOs		Long CLO Barbell (80% AAAs, 20% BBs)	13-Nov-22	0.07	05-Apr-23	121.53				PCLOAAAT Index
Long CLOAAA		Long CLO AAAs	04-Jun-23	L+169.532	08-Oct-23	126.9				PCLOAAAT Index

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.

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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.

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(as of October 31, 2023)

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Equal-weight/Hold	1664	46%	299	47%	18%	700	46%
Not-Rated/Hold	3	0%	0	0%	0%	1	0%
Underweight/Sell	588	16%	61	10%	10%	220	15%
Total	3,592		630			1515	

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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