Today’s bond market offers investors a rare set of opportunities to suit a wide range of portfolio objectives. Rates have risen across the yield curve in many markets, but the short end has increased more. Our investment managers outline strategies for seeking higher current income or capital appreciation during this unusual yield curve inversion, with more attractive choices than we have seen in over a decade.

**ANDREW SZCZUROWSKI, CFA**
Head of Agency MBS
Portfolio Manager

This year’s agency MBS market offers investors a rare opportunity.

"U.S. mortgage rates recently surged to 23-year highs at just shy of 8%, causing many prospective home buyers to pause their search. However, the spike in rates has created an attractive opportunity to lend to the diminished pool of active borrowers, and the agency MBS market is one way that investors can cater to this demand. The agency MBS market has recently experienced a “buyers strike” of its own, which has kept U.S. banks, overseas investors and money managers on the sidelines. As a result, U.S. Government-guaranteed agency MBS spreads are now wider than BBB-rated corporates, and yields are nearing 6.5%. While demand has been weak, home sellers are holding back listings too, which is creating a substantial decline in supply and thus technical support for the MBS sector. We believe buyers will be lured back by today’s attractive valuations and yields and, as more buyers come back in, that the sector will outperform other investment grade options."

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Note: The returns referred to in this document are those of representative indexes and are not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

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1 Bloomberg, As of September 29, 2023.
Given the Fed’s positioning, taking on duration in municipals may benefit client portfolios

“In our view, the Fed is poised to keep policy rates at their current elevated level for longer as the economy appears to remain resilient. If economic activity does soften, rates should move lower, which would be beneficial for investors who took an opportunity to extend duration and lock in higher yields. This could prove worthwhile over the longer term from a total return perspective and if even some of the municipal bond fund outflows from 2022 reverse, that could prove to be a nice tailwind to performance.”

High yields resilient as spreads contract

“Global demand for high yield credit remains robust, despite continued hawkish rhetoric from multiple global central banks and growing dispersion in the earnings and forward guidance of high yield companies. We believe the further bifurcation between the “haves and have-nots” in leveraged credit screams for active management. Skilled bottom-up credit selection is imperative and investors would behoove themselves to look for managers with a proven track record of effectively navigating a volatile landscape.”

Investor Implications

**GOOD ENTRY POINTS**

Last year’s rout in fixed income markets has left starting yields sitting at, or close to, historic highs. From current levels, we see an opportunity to earn respectable income and capital appreciation across the duration spectrum from agency MBS to municipal bonds and longer duration high yield securities.

**ALWAYS ACTIVE**

While opportunities are emerging, an active approach is warranted for navigating fixed income in the current market conditions. Whether in sovereign debt, corporate bonds or structured securities, we believe that capitalizing on opportunities will require a combination of skilled expertise, careful risk management and the nimbleness and flexibility to adjust positions as market conditions change.

**SWEET SPOTS**

No two investors will seek to capitalize on the curve in the exact same way. However, broad opportunities exist across several fixed income sectors. This should grant each investor a degree of choice as they seek the sweet spot that best serves their unique aims, objectives and risk tolerance to complement their portfolio.
Risk Considerations

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g., natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Mortgage- and asset-backed securities are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher rated investments. Income from tax-exempt municipal obligations could be declared taxable because of changes in tax laws, adverse interpretations by the relevant taxing authority or the non-compliant conduct of the issuer of an obligation.

Source of all data: Morgan Stanley Investment Management, as of September 29, 2023, unless otherwise specified.

IMPORTANT INFORMATION & DISCLOSURE

DEFINITIONS

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment managers, please refer to Form ADV Part 2.

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