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IDEA

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US Economics & Global Macro Strategy | North America

FOMC Preview: December Meeting

We expect the Fed to hold the policy rate at 5.375% and to cautiously shift communication from how high to how long. We continue to see it remaining on extended hold until its first cut in June 2024. Our strategists stay long UST 10y and long SFRZ4 on SFRU3Z4Z5 fly.

Key expectations

- The FOMC remains on hold at 5.375%, which we continue to see as the peak rate of the tightening cycle. We see it on extended hold until its first cut in June 2024.
- We expect little change in the FOMC statement, but Chair Powell's press conference and the Summary of Economic Projections will show a cautious shift from how high to how long.
- Our rates strategist stay biased long duration into the FOMC meeting, though remain wary that the payroll data ahead of the FOMC meeting could reset the narrative. For now, they suggest maintaining long 10y UST, and long SFRZ4 on SFRZ3Z4Z5 fly
- Our FX strategists expect USD to gain broadly for several reasons. The recent rise in EUR has not been accompanied by a meaningful justifying move in yield differentials. Euro area inflation pressures are flagging. And the December SEP may be a catalyst for a stronger USD.
- On the agency MBS side, our strategists remain neutral on mortgage basis with a bias towards underweight.

MORGAN STANLEY & CO. LLC

Ellen Zentner
Chief US Economist
Ellen.Zentner@morganstanley.com +1 212 296-4882

Guneet Dhingra, CFA
Strategist
Guneet.Dhingra@morganstanley.com +1 212 761-1445

Jay Bacow
Strategist
Jay.Bacow@morganstanley.com +1 212 761-2647

Andrew M Watrous
Strategist
Andrew.Watrous@morganstanley.com +1 212 761-5287

Matthew Hornbach
Strategist
Matthew.Hornbach@morganstanley.com +1 212 761-1837

Sam D Coffin
Economist
Sam.Coffin@morganstanley.com +1 212 761-4630

Diego Anzoategui
Economist
Diego.Anzoategui@morganstanley.com +1 212 761-8573

Sarah A Wolfe
Economist
Sarah.Wolfe@morganstanley.com +1 212 761-0857

MORGAN STANLEY MUFG SECURITIES CO., LTD.+

Zuri Z Zhao
Strategist
Zuri.Zhao@morganstanleymufg.com +81 3 6836-5466

MORGAN STANLEY & CO. LLC

Janie Xue
Strategist
Janie.Xue@morganstanley.com +1 212 761-6051

Lenoy Dujon
US/Canada Economist
Lenoy.Dujon@morganstanley.com +1 212 761-2779

Zoe K Strauss
Strategist
Zoe.Strauss@morganstanley.com +1 212 761-0407

Martin W Tobias, CFA
Strategist
Martin.Tobias@morganstanley.com +1 212 761-6076

US Economics

MORGAN STANLEY & CO. LLC

Ellen Zentner
Ellen.Zentner@morganstanley.com +1 212 296-4882

Sam Coffin
Sam.Coffin@morganstanley.com +1 212 761-4630

Diego Anzoategui
Diego.Anzoategui@morganstanley.com +1 212 761-2305

Sarah Wolfe
Sarah.Wolfe@morganstanley.com +1 212 761-0857

Lenoy Dujon
Lenoy.Dujon@morganstanley.com +1 212 761-2779

December FOMC

We expect the Fed to keep the target range for the federal funds rate unchanged at 5.25% to 5.50% (5.375% mid-point). We expect little change in the FOMC statement, but Chair Powell's press conference and the Summary of Economic Projections (SEP) will show a cautious shift from how high to how long.

Chair Powell's address at Spelman College last week set the tone, and we expect to hear similar communication in the press conference. He leaned further towards policy on hold, but his comments noted that "it would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease." While the Fed maintains the option to hike further if necessary, it has become less likely. The focus is shifting towards how long, instead of how high.

With our expectation for little change in the statement, we are much more focused on the Q&A with Chair Powell, where we expect him to turn more clearly to conversation about the current restrictiveness of policy, the lagged effects of earlier tightening, and progress toward Fed goals.

We have stressed for some time that the Fed is finished hiking, but it's taken until now for that thinking to crystallize among a broad range of policymakers. The courage for the Fed to remain on hold for such a lengthy period will be challenged, but bumpy disinflation ahead holds policy action until June.

For the FOMC policy statement: Regarding current conditions, we expect the FOMC statement to acknowledge that economic activity has slowed (in line with the Beige Book, which indicated "economic activity has slowed since the previous report" but in contrast to the last FOMC statement, which stated "that economic activity expanded at a strong pace in the third quarter"). Elsewhere, we expect a small change regarding the labor market to reflect the slowdown in job gains, e.g., job gains have slowed, but remain strong; unemployment has remained low. We expect little change to the description of inflation, e.g., inflation remains elevated.

The Committee likely maintains that "In determining the extent of additional policy firming that may be appropriate … the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments". We also expect the statement to repeat that the Committee will stand ready to adjust the policy rate as necessary to bring inflation to the 2% target over time. Finally, we expect no change to the Fed's balance sheet normalization plans.

Summary of Economic Projections

We expect notable changes to policy rates and inflation in the December SEP. We expect the SEP will reveal a higher growth estimate for this year (a mark to market) but leave later years unchanged. However, we expect cuts to the inflation estimates from 2023 through 2025, with core PCE inflation of 3.5% 4Q/4Q, 2.4% in 2024, and 2.2% in 2025 (vs. 3.7%, 2.6%, and 2.3% in the September SEP). **The dot plot also probably shifts down: no need for the additional hike this year, and a shift back to three from two cuts next year.**

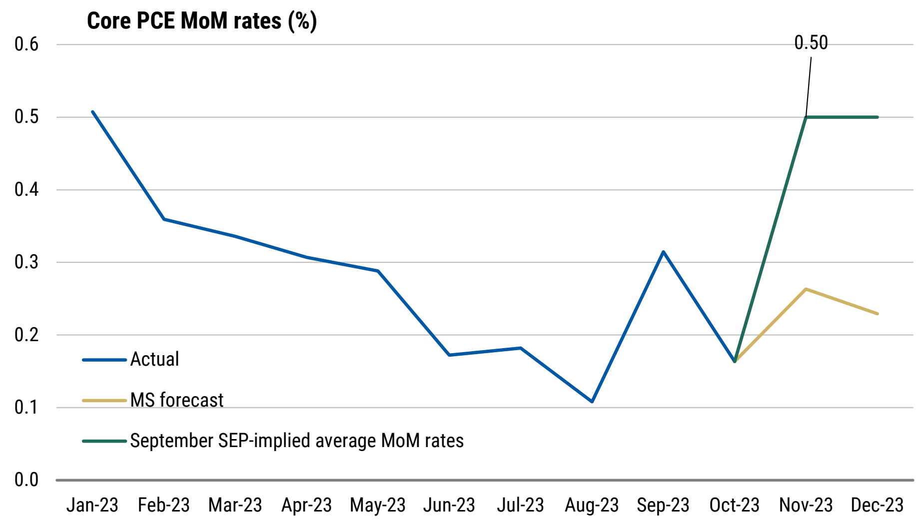
We expect GDP growth this year to mark-to-market higher, incorporating the 5.2% Q/Q annualized real GDP growth reported in 3Q23. We expect the median forecast for GDP to reveal a higher growth expectation of 2.5% 4Q/4Q in 2023 vs. 2.1% prior. We expect no change in the median forecast of 1.5% growth in 2024, and 1.8% in 2025 and 2026.

We expect the unemployment rate to undergo only a minor revision, marked up 10bp this year, from 3.8% to 3.9%. We expect no change in the Fed's unemployment rate forecast for the out years.

Core PCE inflation for 2023 YTD has well undershot the Fed's projections. Although GDP growth has consistently surprised the Fed's forecasts to the upside this year, core inflation has been surprising to the downside. In September, we noted that to meet the Fed's 2023 forecast for 3.7% core PCE, the monthly pace would need to average 0.33% for the rest of this year. With data through October, the required monthly pace for the rest of the year to reach the Fed's forecasts was lifted to 0.50%M (Exhibit 1). This is far above our forecast for inflation of 0.24%M on average for the last two months of the year. We expect the SEP to mark-to-market lower this year from 3.7% 4Q/4Q growth to 3.5% (Exhibit 2). We expect the rest of the path for core PCE inflation to move down as well, with 2024 lowered from 2.6% to 2.4% and 2025 from 2.3% to 2.2%.

Lastly, we expect the dots to show no hike in December, moving 2023 down from 5.6% to 5.4%. In 2024 and 2025, we expect a 50bp downward shift. For 2024, it only takes one dot currently at 5.1% to move to 4.8% to shift the median down 25bp next year. The lower 2023 path plus one extra 2024 dot shifting down should move the 2024 midpoint down to 4.6%. This 50bp downward shift in 2024 carries forward into 2025, which we expect moves lower, from 3.9% to 3.4%. In 2026, we expect the Fed to show more progress towards neutral given the better inflation path, moving 25bp lower, from 2.9% to 2.7%. **The longer-run dot is not well anchored, it would take two FOMC officials shifting from 2.500% to 2.625% to shift the median from 2.5% to 2.6%. Estimates of the longer-run projections tend to be very slow moving. If not at this meeting, we think it won't be long before the median estimate of the longer-run neutral rate moves higher (Exhibit 3).**

Exhibit 1: Core PCE inflation has well undershot the Fed's projections this year



Source: Bureau of Labor Statistics, Federal Reserve's September 2023 Summary of Economic Projections, Morgan Stanley Research forecasts

Exhibit 2: Summary of Economic Projections

Changes to the Summary of Economic Projections	2023	2024	2025	2026	Longer Run
Real GDP (% 4Q/4Q)					
FOMC December SEP	2.5	1.5	1.8	1.8	1.8
FOMC September SEP	2.1	1.5	1.8	1.8	1.8
Difference	*0.4*	*0.0*	*0.0*	*0.0*	*0.0*
Unemployment Rate (4Q Avg)					
FOMC December SEP	3.9	4.1	4.1	4.0	4.0
FOMC September SEP	3.8	4.1	4.1	4.0	4.0
Difference	*0.1*	*0.0*	*0.0*	*0.0*	*0.0*
Core PCE Inflation (% 4Q/4Q)					
FOMC December SEP	3.5	2.4	2.2	2.0	
FOMC September SEP	3.7	2.6	2.3	2.0	-
Difference	*-0.2*	*-0.2*	*-0.1*	*0.0*	-
Fed Funds Target					
FOMC December SEP	5.4	4.6	3.4	2.7	2.5
FOMC September SEP	5.6	5.1	3.9	2.9	2.5
Difference	*-0.20*	*-0.50*	*-0.50*	*-0.20*	*0.0*

Source: Federal Reserve Board, Morgan Stanley Research forecasts

Exhibit 3: Dot Plot

Source: Federal Reserve Board, Morgan Stanley Research forecasts
Note: FOMC projected path reflects the September Summary of Economic Projections

Global Macro Strategy

MORGAN STANLEY & CO. LLC

Guneet Dhingra, CFA
Guneet.Dhingra@morganstanley.com
+1 212 761-1445

Matthew Hornbach
Matthew.Hornbach@morganstanley.com
+1 212 761-1837

Martin Tobias, CFA, CMT
Martin. Tobias@morganstanley.com
+1 212 761-6076

Andrew Watrous
Andrew.Watrous@morganstanley.com
+1 212 761-5287

MORGAN STANLEY & CO. INTERNATIONAL PLC

David S. Adams, CFA
David.S.Adams@morganstanley.com
+44 20 7425-3518

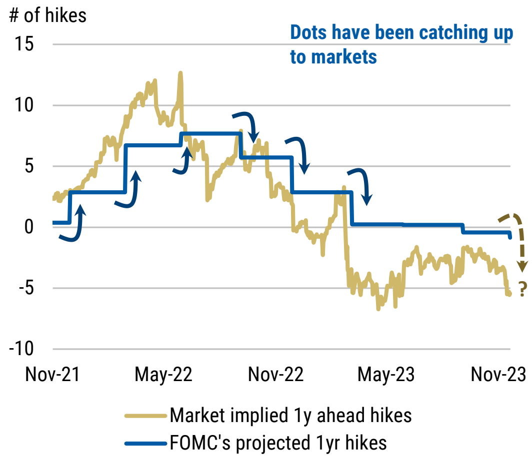
Will the Fed let the rally continue?

The December FOMC comes against a totally different backdrop from the last two meetings. The September meeting was during a period of very strong economic data, while the November meeting came amid a mixed slate of data. The December meeting, however, comes amid a clearer deterioration in economic data – with the duration bears currently on very thin ice. Growth, labor market, and inflation data – all three categories have not only weakened in absolute terms, but also surprised to the downside vs. already cooling expectations.

With this backdrop, our US economics team is expecting the Fed to acknowledge weaker data but not deliver any wholesale changes to the forward guidance. They see the FOMC 2024 dot at 4.625%, suggesting 3 cuts in 2024 from the current terminal rate of 5.375%.

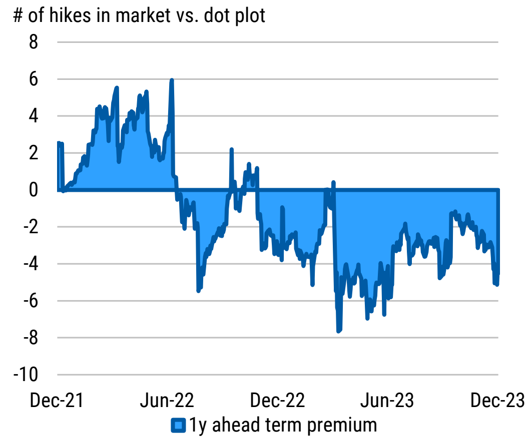
Notably, over the last two years, the FOMC dot plot has generally caught up to what the markets priced ahead of the FOMC meeting. In the June and September meetings, the Fed was 2-3 hikes higher than markets. If the Fed shows dot plot realizes like our economists expect, i.e., 3 cuts, markets pricing ~5 cuts would be in line with their standard gap with the dot plot. Anything more than 3 cuts could open the door to a significant rally in markets.

Exhibit 4: Market implied hikes/cuts 12m ahead vs. implied by the dot plot in the last 2 years



Source: Bloomberg, Fed, Morgan Stanley Research

Exhibit 5: Gap between market pricing and Fed dot plot – 12m out – in the last two years



Source: Bloomberg, Fed, Morgan Stanley Research

Will the second question come up? In the November 2023 FOMC press conference, Fed Chair Powell laid out a three-question approach about how to assess the Fed's policy tightening framework. The first question is about whether the fed funds rate is high enough. The second is then about how long to keep it there, and the third question is about cuts.

> ***November 2023 FOMC press conference:*** *The Committee is not thinking about rate cuts right now at all. We are not talking about rate cuts. We are still very focused on the first question, which is, have we achieved a stance of monetary policy that is sufficiently restrictive to bring inflation down to 3% over time sustainably?*

After an accumulation of evidence that tighter financial and credit conditions are weighing on economic activity, hiring, and inflation, the Minutes from the November 2023 FOMC meeting signaled the Fed is more confident that they have addressed the first question – the following sentence from the September 2023 Minutes was omitted: "one more increase in the target federal funds rate at a future meeting would likely be appropriate."

> ***November 2023 FOMC Minutes:*** *In discussing the policy outlook, participants continued to judge that it was critical that the stance of monetary policy be kept sufficiently restrictive to return inflation to the Committee's 2 percent objective over time.*
>
> *All participants judged that it would be appropriate for policy to remain at a restrictive stance for some time until inflation is clearly moving down sustainably toward the Committee's objective.*

Rates market investors will pay close attention to whether the Fed is now focusing on the second question, i.e., they have confidence that they are sufficiently restrictive, and the Fed is now thinking about how long to stay here. If the Fed signals anything around it, the market could feel validated in its dismissal of further rate hikes, and its focus on the pricing of rate cuts.

Funding market stresses heighten focus on QT: The recent tick up in the funding rates (SOFR), the sharp decline in the RRP facility, and the consequent uptick in the level of reserves suggest that banks' needs for reserves may even be moving up. And importantly, it is not only the total level of reserves that matters, but also the distribution of reserves between big and small banks – something investors and the Fed realized in 2019 as well.

The concentration of reserves within big banks leaves small banks more vulnerable to cash shortfalls. As we noted in Funding tectonic plates continue to shift (in our most recent weekly) – while reserves in the system appear healthy and rising, the gap between cash available to big and small banks keeps frictions intact. These frictions increase the risk that reserves reach a "scarcity point" sooner than most estimates assumed by investors – between 3Q24 and 2Q25.

With these risks gaining attention among investors, Fed Chair Powell is likely to face questions on the path for QT – and we expect markets to be listening with heightened attention. **Any signs that the Fed is even thinking about thinking about the end of QT could add more tailwinds into the long-duration trade.**

Overall, we stay biased long duration into the FOMC meeting, though remain wary that the payroll data ahead of the FOMC meeting could reset the narrative. For now, we suggest maintaining long 10y UST and long SFRZ4 on SFRZ3Z4Z5 fly.

- **Trade idea: Maintain long UST10y at 4.14%**
- **Trade idea: Maintain long SFRZ4 on SFRU3Z4Z5 fly**

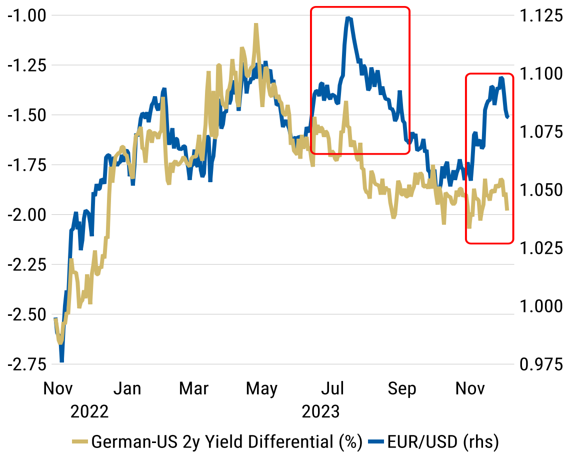
USD outlook

We expect USD to gain broadly for several reasons. The recent rise in EUR has not been accompanied by a meaningful justifying move in yield differentials. Euro area inflation pressures are flagging. And the December SEP may be a catalyst for a stronger USD.

1. Existing yield differentials. The recent USD decline has not been matched by a move in yield differentials – an echo of the July move that quickly reversed (Exhibit 6). Note that EUR returned to around 1.05 in 3Q – around the level consistent with interest rate differentials.

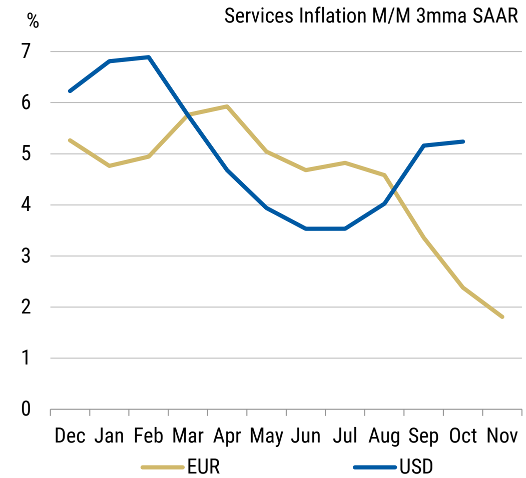
Those same interest rate differentials have not moved significantly and continue to suggest that fundamentals are a headwind to EUR.

Exhibit 6: As in July, yield differentials have not justified the magnitude of the EUR move higher



Source: Macrobond, Morgan Stanley Research

Exhibit 7: Euro area services inflation is annualizing below 2%



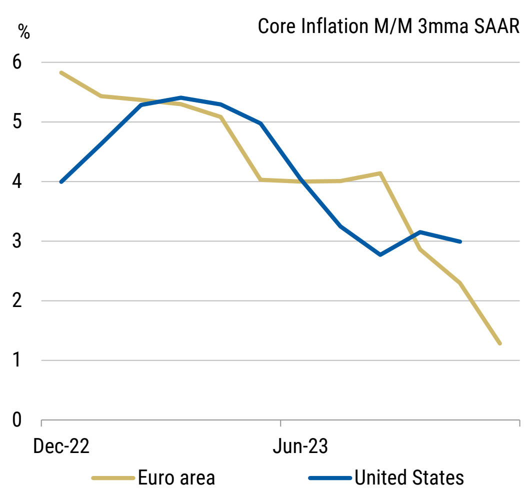
Source: Bloomberg, Macrobond, Morgan Stanley Research

2. Future yield moves. We see potential for market pricing to reflect risks of more near-term ECB cuts relative to the Fed.

Services and core European inflation have moved sharply lower on a seasonally adjusted annualized three-month moving average basis (see Exhibit 7 and Exhibit 8). Moving averages of both services and core inflation are now running below a 2% annualized rate in the euro area.

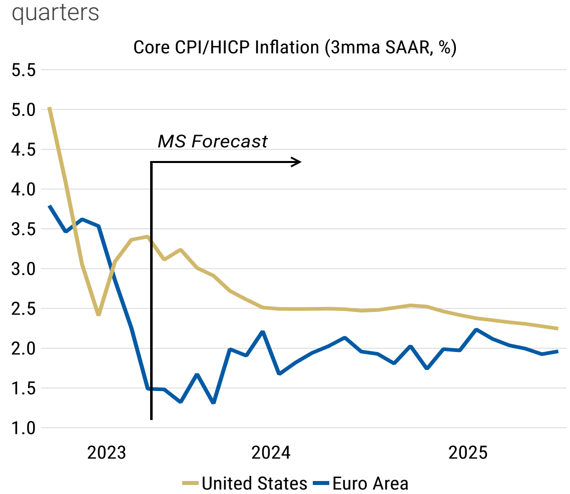
Our economics teams expect below-2% annualized core inflation to persist in the euro area over the next several months (Exhibit 9). The consecutive slow core HICP prints our economics anticipate may shift market pricing to increasingly reflect the possibility that below-target euro area inflation persists for several quarters.

Exhibit 8: Euro area core inflation is annualizing below 2%...



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 9: ...and will continue to do so for several quarters

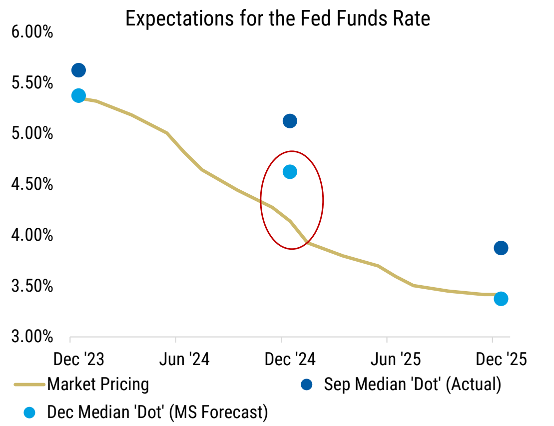


Source: Morgan Stanley Research

3. The December SEP – a potential near-term catalyst. As we discuss here, our economists expect the FOMC statement to acknowledge recent growth softening as indicated in the Beige Book. However, we expect the FOMC to maintain its view on inflation remaining "elevated" and to affirm its forward guidance, which leaves open the possibility of additional hikes and leans against the prospect of imminent rate cuts. Chair Powell's tone should reflect this as well, similar to his comments last Friday.

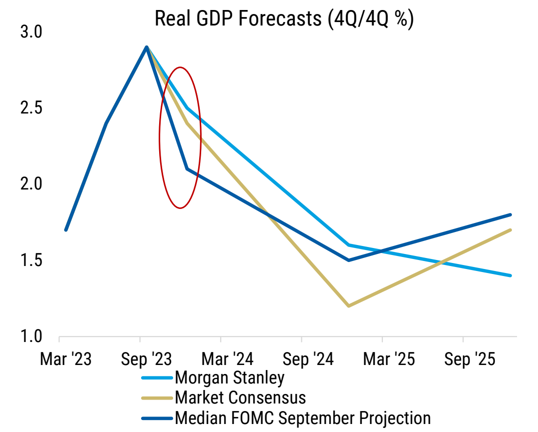
Our economists expect the median dot to imply three cuts at the end of 2024, followed by five cuts in 2025 and three more in 2026. This would signal fewer cuts than implied by current market pricing, particularly for 2024 (Exhibit 10).

Exhibit 10: Markets are pricing in 50bp more of cuts than we think the SEP may imply



Source: Federal Reserve, Bloomberg, MS STIRT Trading Desk, Morgan Stanley Research

Exhibit 11: The Fed's forecasts for growth may be revised higher, raising USD-positive risks



Source: Federal Reserve, Bloomberg, Morgan Stanley Research

The key USD-upside risk is that the December SEP shows a far shallower pace of normalization than implied by market pricing. In September only 5 out of 19 dots showed a level equal to or lower than our estimate of the December SEP median dot for 2024.

Since the September SEP was published, growth has tracked above the median 2023 growth forecast of 2.1%. 3Q GDP numbers were revised higher and 4Q GDP is tracking at a reasonable pace (1.3%). Both MS and the market are penciling in higher growth numbers than the Fed's September projections (Exhibit 11).

So what happens if the Fed's forecasts for 2024 growth *and* PCE both rise? A higher and flatter path back to 2% inflation driven by stronger-than-anticipated growth could lead the dots, or the appropriate level of the funds rate, to be modeled at higher levels. This could prove an unexpected shock for a market that is increasingly positioning for an imminent dovish pivot.

US Agency MBS

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

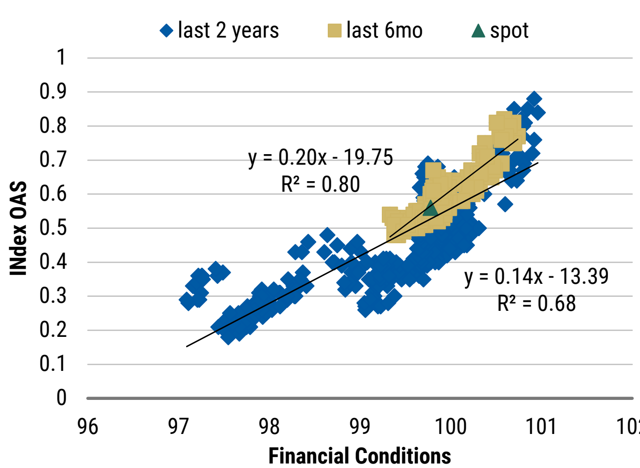
MORGAN STANLEY MUFG SECURITIES CO., Ltd.+ — **Zuri Zhao** Zuri.Zhao@morganstanleymufg.com +81 3 6836-5466

MORGAN STANLEY & CO. LLC — **Janie Xue** Janie.Xue@morganstanley.com +1 212 761-6051

With our economists expecting the Fed to remain on hold, with very little change to forward guidance, our mortgage view runs in the same vein. The mortgage market continues to wait for bank demand to return in earnest, which we don't expect until 2H24 – when Fed cuts occur and regulation clarity is achieved. Until then, mortgage valuations are dependent on active investors who can take profit. As such, we remain neutral on basis and and see 50-65bp range on index OAS as fair value**,** though we think we're likely to be towards the wider end of the range at the beginning of the year and the tighter end of the range at the end of the year as technicals improve**.**

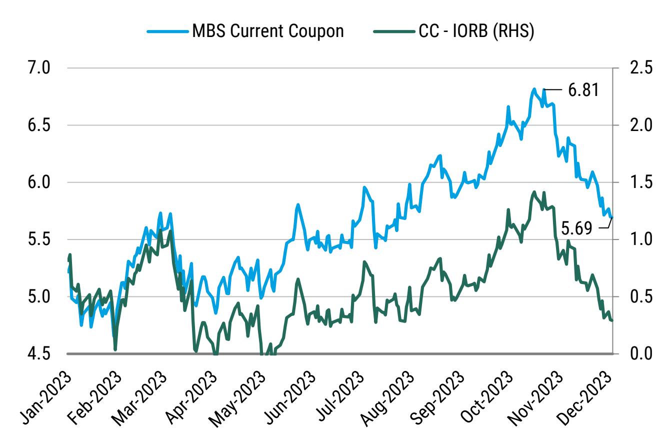
That being said, mortgages have been trading correlated with macro risks – and with financial conditions in particular (Exhibit 12). Current spot levels against financial conditions suggest that mortgages are close to fair versus history, but after this most recent rally, tightening on index OAS to 54bps puts us closer to preferring an underweight. From another perspective, current coupon has dropped ~110bps from the end of October until now (Exhibit 13). Given our forecast absence of bank demand, we think mortgages should be trading in the wider end of our spread range for the first half of the year.

Exhibit 12: Mortgages trading on top of financial conditions



Source: Morgan Stanley Research, Bloomberg, GSFCI Index as financials conditions index

Exhibit 13: Current coupon has fallen by 100+ bps in the last 30 trading days, meaning that the incentive for banks to move out of IORB into MBS has shrunk



Source: Bloomberg, Morgan Stanley Research

Furthermore, **the primary risk we see for the upcoming FOMC meeting is a sustained dovish reaction from the market.** In a scenario where rates rally faster than our forecasts and remain consistently lower, we could see supply next year shifted higher – with increased turnover as affordability eases, increased incentive to refinance for higher coupon cohorts, and increased Fed run-off of their mortgage portfolio without reinvestment.

The challenge is that we don't think this sustained rally would drive mortgage demand higher at the same time, if the Fed were to remain on hold until June. Of course, higher supply for already-poor demand in the first half of the year should cause mortgage performance to worsen as active investors are forced into additional digestion. Relief would still be waiting in the second half of the year, but the pain of the first half would be felt more acutely in this particular risk scenario.

Exhibit 14: We currently forecast $300bn net issuance for YE 2024, with $210bn of Fed run-off

	All mortgages											*Ginnie only*	
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023 FY Est**	**2024 Est**	**2023 FY Ginnie Est**	**2024 Ginnie Est**
Gross Issuance	923	1,251	1,472	1,304	1,171	1,532	3,161	3,484	1,701	1,000	1,050	500	450
Net Issuance	**69**	**163**	**229**	**315**	**281**	**224**	**506**	**868**	**539**	**250**	**300**	**175**	**180**
Demand													
GSEs	-46	-42	-43	-5	-15	0	-61	-26	-37	-2	0	0	0
Overseas	44	31	107	62	90	76	-30	102	167	150	175	120	140
Fed +Treasury	247	11	-6	24	-128	-217	610	577	27	-220	-210	-55	-53
Banks	11	177	220	140	70	86	522	326	-57	-100	75	50	100
REITs	8	-18	-1	40	21	36	-101	-22	2	25	25	0	0
Money Managers/ Others	-208	5	-48	48	196	198	-435	-89	437	397	235	60	-8
Net Demand ex Fed/Tsy/GSE	**-132**	**195**	**278**	**296**	**423**	**441**	**-42**	**317**	**550**	**472**	**510**	**230**	**233**

Source: Morgan Stanley Research forecasts

So we maintain our neutral stance on mortgages with some bias towards an underweight. In the meantime, we prefer G2/FN 4.5s and 5.0s in anticipation of bank demand, as well as low payup stories like FICO and LTV that should provide call protection in our low HPA environment.

Valuation Methodology & Risks

Trade Table

Global Macro Strategy				
TRADE	**ENTRY LEVEL**	**ENTRY DATE**	**RATIONALE**	**RISKS**
Long UST 10y	4.21%	1-Dec-23	Cooling economic data, more dovish Fed, and availability of term premiums suggest more room for duration rally.	The risk is that yields keep rising based on strong growth, hawkish Fed.
Long SFRZ4 on Z3Z4Z5 fly	-34bp	17-Nov-23	With a more balanced Fed, inflation data showing steady progress over the past months, and growth/labor data momentum slowing further into next year, the risk/reward to position for more/sooner cuts remains attractive.	Recent moderation in data strength reverses course, prompting the Fed to consider that rates are not sufficiently restrictive.

Exhibit 15: Agency MBS live trades and recommendations

Trade	Entry Date	Rationale	Risks
Long G2/FN 4.5 and 5 swaps *switched coupons on 12/1*	11/12/2023	Support from bank demand, low box swaps, attractive starting valuations, easy for banks to hedge	Heavy Ginnie supply in aggregate, not all banks buy discount Ginnies
Long low payup production coupon for investors looking for pool exposure (inv, FICO, social)	8/4/2023	Credit stories do well in world of low HPA, cheaper play vs roll trading poorly	Roll goes special, supply

Source: Morgan Stanley Research

Disclosure Section

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

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

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(as of November 30, 2023)

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	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1352	37%	273	43%	20%	605	39%
Equal-weight/Hold	1667	46%	303	47%	18%	708	46%
Not-Rated/Hold	3	0%	0	0%	0%	1	0%
Underweight/Sell	591	16%	64	10%	11%	221	14%
Total	3,613		640			1535	

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

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