Morgan Stanley

INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Key Investment Themes Into 2019

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AUTHORS

CYRIL MOULLÉ-BERTEAUX
Portfolio Manager
Head of Global Multi-Asset Team
Managing Director

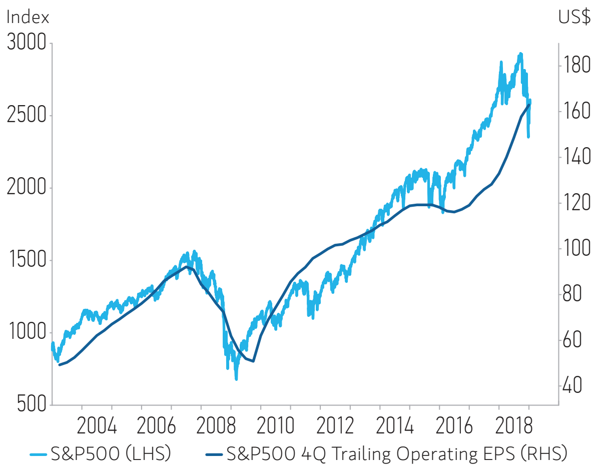
SERGEI PARMENOV
Portfolio Manager
Global Multi-Asset Team
Managing Director

The fourth quarter of 2018 saw substantial shifts in global asset prices, sentiment and fundamentals: global growth went from a 3.5% pace to tracking closer to 2.7%, the market went from expecting nearly three Fed hikes in 2019 to zero, and the S&P 500 declined nearly 20% *(Display 1)* from late September to late December while U.S. Treasury yields fell to January 2018 levels.[1] In light of this, in this month's letter, we review our outlook for key investment themes heading into 2019:

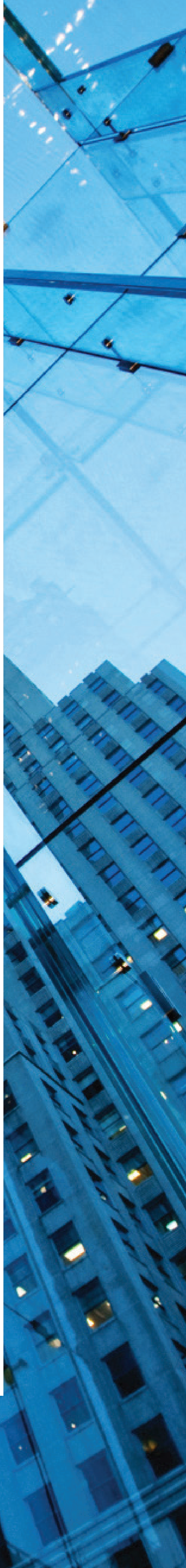
1) After a 2018 where the Fed's Free Money regime ended (see March 2018 Viewpoint: "Regime Shift – The End of Free Money") and equity markets massively underperformed the real economy and profits, we expect a pause in the Fed's rate hiking cycle, a modest rebound in risky assets, and a stabilization in equity market multiples in the first half of the year. By the second half, we believe the focus will shift from equity multiple compression to earnings growth disappointments as a likely 2020 recession approaches.

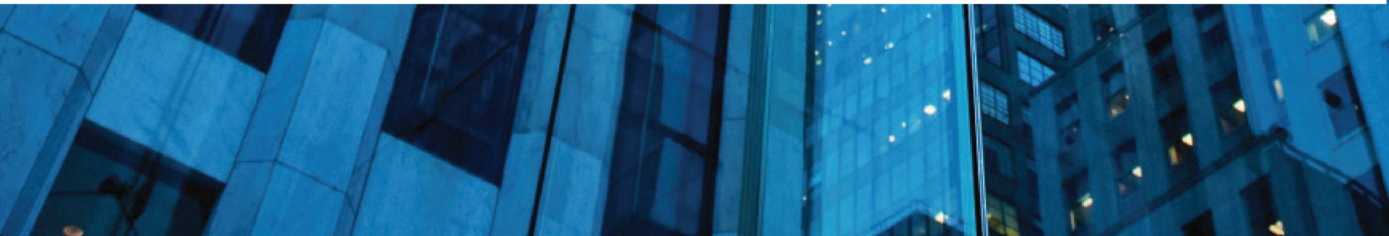
   In 2018, earnings in the U.S. grew 23% and yet stocks fell -6% because price-to-earnings (P/E) multiples compressed by 24%—from 20.1x to 15.4x on trailing P/E.[2] This is a greater than average multiple compression compared with a typical Fed tightening cycle (historically, 9%), mostly because equity multiples rose when the Fed initially tightened policy in December 2015 (from 17.3x in December 2015 to 20.1x by December 2017). Combined with the multiple drop in 2018, total multiple compression in the recent tightening cycle has been -11%—generally in line with the historical average of -9%.[3] If the Fed does indeed pause while it assesses the impact of tighter financial conditions (higher

Display 1: **Stock Prices Converge Back to Earnings**
S&P 500 vs. 4Q2018 Trailing Operating Earnings Per Share



Note: axes are scaled to show a S&P Price vs. Operating EPS relationship equivalent to 15.8x P/E multiple over the entire period
Source: MSIM Global Multi-Asset Team Analysis.
Data as of January 13, 2019.
The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**
See Disclosure section for index definitions.





fed funds rates, lower stock prices, wider credit spreads, higher government bond yields) on the economy, Fed-driven multiple compression is likely over.

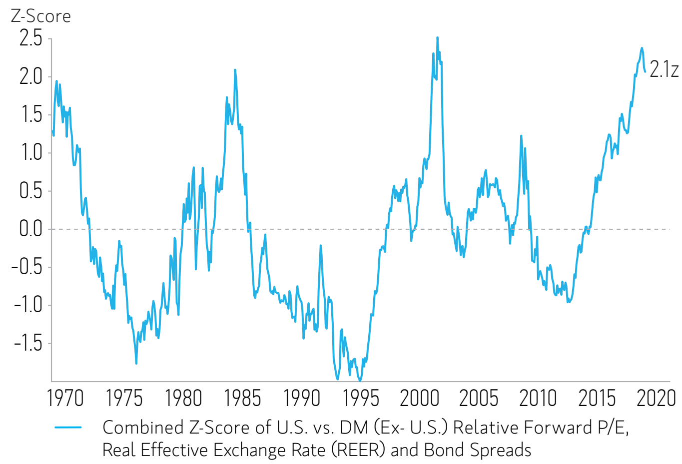
Earnings growth expectations, on the other hand, are likely to keep falling throughout 2019. This will likely put a ceiling on stock prices in 2019 and drive the resumption of the bear market in the second half of the year into 2020. The consensus currently expects 7.5% earnings per share (EPS) growth in 2019 (down from 10.5% just three months ago), but actual earnings are likely to fall short of this expectation and, on our models, will most likely shrink on a year-over-year basis by the fourth quarter of 2019.[4] This earnings miss will be driven by the negative impact of slowing economic growth on revenues, U.S. dollar strength, and margin compression as labor costs outpace selling prices. 2020 will likely see down earnings for the year *and* multiple compression (as usually happens in a recession). As discussed in prior letters, we expect a recession to be driven by tight Fed policy (we think that fed funds at 2.40% with core PCE inflation at 1.90% is modestly tight, assuming a zero neutral rate), the end of fiscal easing, a stronger U.S. dollar, and weaker trade. So far, our proprietary long-leading recession indicator does not signal a recession in the next 15 months, but it is close and we will be monitoring it over the coming year. Given this outlook, amid current asset valuations (slightly cheap) and positioning (oversold), we maintain a neutral position in global equities and a modest overweight in bonds (primarily in U.S. Treasuries and TIPS).

2) **U.S. exceptionalism is likely coming to an end.** In the last decade, U.S. equities outperformed global equities by 150%.[5] This was generally driven by better economic activity (U.S. GDP is now nearly 20% above its pre-Global Financial Crisis level, whereas the eurozone's, for example, is only 7% higher), more generous policy (easy monetary policy in most countries but more fiscal policy easing in the U.S. than in most developed countries), and a better mix of faster growing companies (i.e., more tech and internet companies in the U.S. and fewer banks and commodity stocks). The result is that U.S. stocks now trade at a 40% premium to the rest of the world's stocks (on trailing earnings). Similarly, the U.S. dollar is 7% (or 0.7 standard deviations) above its long-term average on a real effective exchange rate basis.[6] *(See Display 2)*

A key axiom of ours is that 'the winners of one decade are rarely the winners of the next'. After a decade, winners tend to be overpriced and overloved as past fundamentals are extrapolated—all three apply to U.S. assets today. In this case, it does not mean that the rest of the world is necessarily going to catch up to the U.S. More likely, the U.S. will 'catch down' to the rest of the world, with its economic growth dropping below emerging markets (EM) ex-China growth (3-3.5%) and to a 1.5% pace that is similar to European growth.[7] In that environment, U.S. stocks and the U.S. dollar are likely to underperform—why pay a 40% premium for the same economic growth? In our portfolio, we have begun positioning for this potentially multi-year theme with overweight positions in global equities and EM ex-China equities, funded by U.S. equity underweights, and with overweight positions in developed and emerging market ex-China currencies against the U.S. dollar.

Display 2: **U.S. Assets Overvalued Relative to Rest of World**

U.S. vs. Developed Market (ex-U.S.) Asset Valuations (Equities, Fixed Income and Currencies)



Source: MSIM Global Multi-Asset Team Analysis.
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3) **China bumpy landing risks are currently underappreciated and underpriced by markets.** Investors have clearly recognized that Chinese growth has been weakening for the past two to three quarters, as have Chinese policymakers who ended an 18-month tightening cycle in July 2018. However, we believe there is widespread complacency about the Chinese government's ability to achieve its policy objectives (which investors assume to be: sufficiently strong economic growth to ensure social stability, the cornerstone of the Chinese Communist Party's legitimacy). In our opinion, investors' confidence in the Chinese government is simply based on what happened in the last three down cycles over the past decade (first in 2008-09, then in 2011-2012, and again in 2015-16). In each downturn the authorities responded vigorously, and each easing cycle delivered improved economic growth and eventually market recoveries (notwithstanding resulting volatility, e.g. the A-share bubble burst in 2015, the 2015-16 renminbi devaluation).

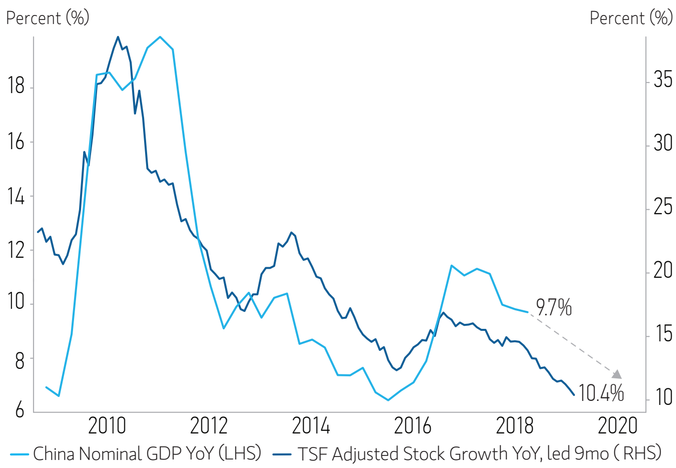
Our work indicates that Chinese policymakers are now caught between a rock and a hard place: they want strong growth between 6-6.5% (profits shrink and defaults rise below the range of 6-6.5% growth) *and*, at the same time, a stable currency (in order not to attract the ire of President Trump), no housing bubble (President Xi: "houses are for living in, not for speculating") and contained financial risks/leverage. Because of the irreconcilability of these multiple objectives, the government's easing campaign which started in July 2018 has been much more modest than the prior three easing cycles (no "flood-irrigation stimulus," as Prime Minister Li Keqiang described it in October): there has been no generalized property easing; the central bank repeatedly cut reserve requirements but has not cut interest rates, with the result being a continued negative credit impulse *(Display 3);* and fiscal policy is clearly being eased with tax cuts and increased infrastructure spending, but significantly offset by stronger tax collection enforcement.[8]

In addition, the current state of the Chinese economy is very different than when massive stimulus was first implemented 10 years ago: China's private non-financial debt has nearly doubled—from 112% to 206%—and is now greater than any emerging country and most developed countries (including the U.S.).[9] The effectiveness of policy easing is likely to be much reduced compared to prior episodes.

Eventually, by this summer, we expect the authorities will be forced to open the floodgates and ease property policy, ease restrictions on shadow banking and local government leverage, and cut interest rates, as they have done in prior easing cycles. But in our view, this will occur after a deeper and longer slowdown than most expect. As a result, we are maintaining a cautious stance on Chinese stocks, the renminbi, and developed market stocks most sensitive to Chinese growth and the currency, such as luxury goods and elevator stocks. We also recognize that weaker Chinese growth and a weaker renminbi may also impact the rest of emerging markets, which is a risk to our emerging market ex-China currency and equity overweights. We note that many emerging market countries have already begun to deleverage after banking busts or deep recessions in recent years and therefore, should be less vulnerable (but not invulnerable) to a deeper China slowdown.

Display 3: **China Bumpy Landing Risks Underappreciated**

China Nominal GDP Growth vs. Total Social Financing (TSF) Stock Growth



Source: MSIM Global Multi-Asset Team Analysis.
Data as of January 13, 2019.

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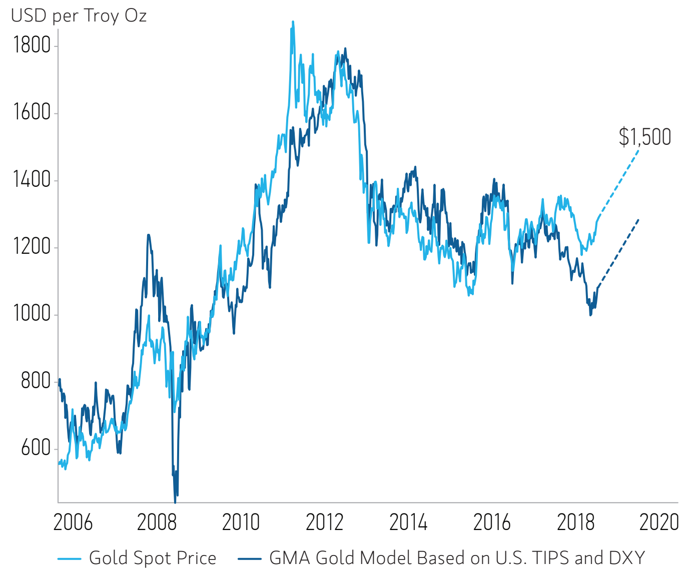
4) **Continue to own gold in 2019.** We are not gold bugs and don't believe that the fiat currency system is bound for failure. However, gold does tend to outperform when real interest rates fall, particularly if real rates are negative, and the U.S. dollar weakens (*Display 4*). Basically, gold is viewed as an attractive safe haven asset when investors earn negative returns in U.S. dollar cash.

Display 4: **Gold to Rally to $1,500**

Gold Spot Price Forecasted on U.S. TIPS and Dollar



Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Source: MSIM Global Multi-Asset Team Analysis.
Data as of January 13, 2019.

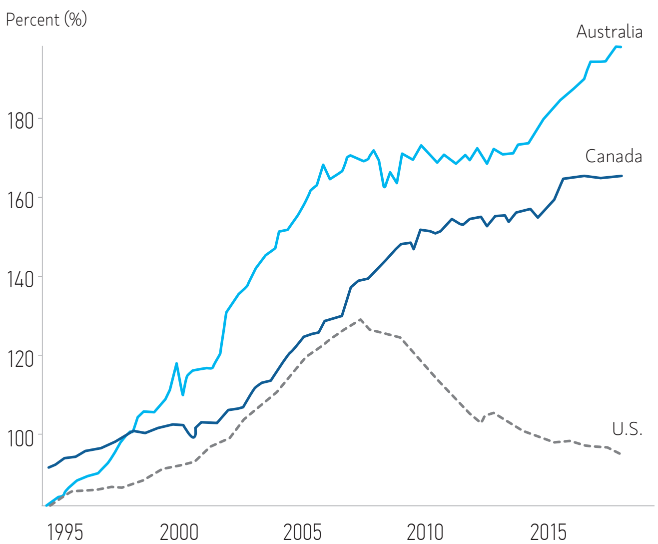
Policy rates in the U.S. have risen from 0-0.25% to 2.40%, but are only 50 basis points above core inflation.[10] If the Fed pause extends beyond this summer, markets will likely begin to price in the possibility of a return to zero or even negative real interest rates. From current levels, it would only take two rate cuts to reach zero real rates: this would be very supportive of further upside for gold, particularly after a deep and multiyear bear market.

In addition, a weaker dollar helps gold, as it typically means miners' costs are higher and global demand is stronger. We also expect supply-side dynamics to be supportive of the gold price over the next five years, as mine supply declines from multiple years of underinvestment. We initiated an overweight position in gold in the fourth quarter of 2018. For more details on our views, please see our November 2018 Global Multi Asset Viewpoint: "The Case for Higher Gold Prices."

5) **Australia and Canada housing and credit bubbles finally deflate.** Unlike many other housing bubbles which collapsed in the past 10 years, usually taking the local banking system down with them, Australia and Canada's housing bubbles continued to build, fed by ever increasing mortgage debt. Household debt in these countries stands at record highs of 165-200% of disposable income, 50% above peak U.S. household leverage in 2006, and comparable to Spanish and Irish household leverage at the peak of their housing bubbles *(Display 5)*.[11] In the meantime, Australian and Canadian banks continue to reserve record low levels of provisions against potential future bad debts. Interestingly, higher mortgage rates and increased macro-prudential regulation are creating the first significant cracks in those housing markets: Australian finance approvals are down over 20% from peaks and house prices there have already fallen by over 6% in the past year; in Canada, Toronto and Vancouver full-year home sales fell 16% and 32%, respectively.[12] A combination of tightening financing conditions (both standards and costs) with near-record supply is likely to create a housing bust similar to those seen elsewhere in the past decade. This will have significant repercussions across their respective economies, and will likely generate a bad debt cycle that the banks are neither ready nor priced for. Home prices could decline 20% from current levels and could generate a 30-40% hit to bank earnings.[13] As a result, we are cautious on Canada and Australia, especially the banks.

Display 5: **Australia and Canada Housing Credit Bubble**

Household Debt to Disposable Income

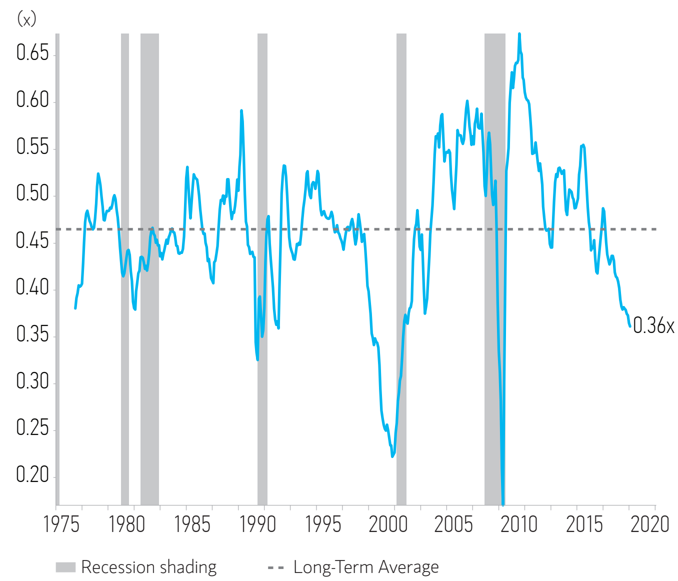


Source: MSIM Global Multi-Asset Team Analysis. Data as of January 13, 2019.

6) **After 12 years of growth stocks outperformance, value stocks finally outperform** as growth proves more cyclical than investors expect, and as venture capital and private equity funds seek exits for their tech and internet holdings through a wave of initial public offerings, potentially flooding public markets. Value stocks are as cheap as they have been over the past 40 years (except during the tech bubble), with the Russell 1000 Value Index trading at a 28% discount to the Russell 1000 Growth Index, 8% below their long-term average discount. The GMA team's proprietary measure of "pure value" is trading at a 27% discount to its historical average, only more extreme at the peak of the financial crisis and during the 2000 tech bubble *(Display 6)*.[14]

Display 6: **U.S. Pure Value Cheapest in 18 Years‡**

GMA Pure Value Index Relative Valuation Composite (3mma)



Source: MSIM Global Multi-Asset Team Analysis; Russell; Standard & Poor's. Data as of January 15, 2019.

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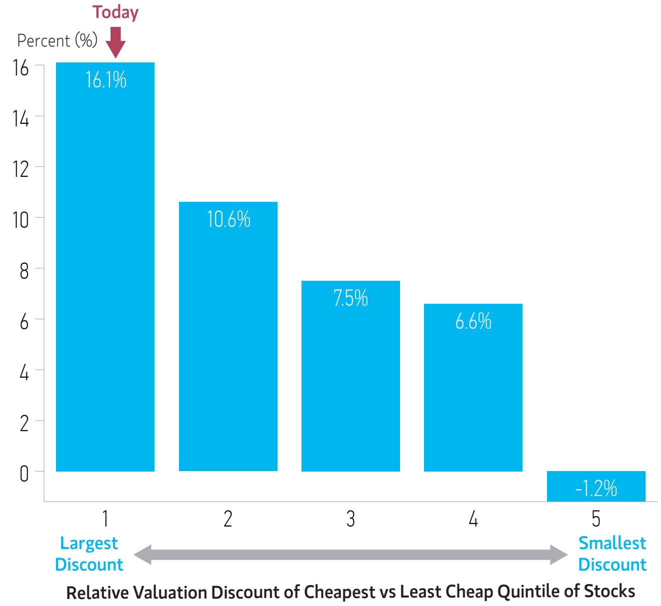
‡ The Global Multi-Asset Team (GMA)-constructed "pure" value and growth style baskets, which include the top half of value (or growth) stocks in the S&P 500 Index (i.e. 50% cheapest stocks for value and 50% "growth-iest" stocks for growth). We define value and growth similarly to Russell (which uses P/B, historical sales growth, and EPS estimates), though we use more factors. We also equal weight stocks rather than use capitalization weights, and the value and growth baskets have an equal number of stocks from each sector to neutralize sector effects.

Historically from these levels, value stocks have outperformed non-value stocks by 16% over the next 12 months *(Display 7)*.[15] Given the magnitude and duration of underperformance in this cycle, they could outperform by twice as much. The caveat is that value stocks typically outperform beginning in the middle of recessions, after their earnings have been decimated and the markets start to sniff out a reacceleration in economic activity—clearly not the case at this point. We are currently considering a partial position in value stocks (hedged with non-value stocks; partial because the slowdown we expect in 2019-20 may generate an even better opportunity for value stocks).

Display 7: **Value Outperformance Based on Starting Valuations**

Subsequent 12m Relative Total Return



12m Subsequent Performance of Best vs. Worst Value Quintile Based on Starting Relative Valuations (1975-2017)

Source: MSIM Global Multi-Asset Team Analysis; Russell; Standard & Poor's. Data as of January 15, 2019.

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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 that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equity securities'** values fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. **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 the current rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. **Longer-term securities** may be more sensitive to interest rate changes. In a declining interest-rate environment, the portfolio may generate less income. **Mortgage- and asset-backed securities (MBS and ABS)** are sensitive t 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. Certain **U.S. government securities** purchased by the Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. The issuer or governmental authority that controls the repayment of **sovereign debt** may not be willing or able to repay the principal and/ or pay interest when due in accordance with the terms of such obligations. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed countries. **Real estate investment trusts** are subject to risks similar to those associated with the direct ownership of real estate and they are sensitive to such factors as management skills and changes in tax laws. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. Trading in, and investment exposure to, the **commodities** markets may involve substantial risks and subject the Portfolio to greater volatility. **Nondiversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. By investing in **investment company securities,** the portfolio is subject to the underlying risks of that investment company's portfolio securities. In addition to the Portfolio's fees and expenses, the Portfolio generally would bear its share of the investment company's fees and expenses. **Subsidiary and Tax Risk** The Portfolio may seek to gain exposure to the commodity markets through investments in the Subsidiary or commodity index-linked structured notes. The Subsidiary is not registered under the 1940 Act and is not subject to all the investor protections of the 1940 Act. Historically, the Internal Revenue Service ("IRS") has issued private letter rulings in which the IRS specifically concluded that income and gains from investments in commodity index-linked structured notes or a wholly-owned foreign subsidiary that invests in commodity-linked instruments are "qualifying income" for purposes of compliance with Subchapter M of the Internal Revenue Code of 1986, as amended (the "Code"). The Portfolio has not received such a private letter ruling, and is not able to rely on private letter rulings issued to other taxpayers. If the Portfolio failed to qualify as a regulated investment company, it would be subject to federal and state income tax on all of its taxable income at regular corporate tax rates with no deduction for any distributions paid to shareholders, which would significantly adversely affect the returns to, and could cause substantial losses for, Portfolio shareholders.

FOOTNOTES

[1] MSIM Global Multi Asset Team analysis; Bloomberg.

[2] MSIM Global Multi Asset Team analysis; IBES Pro Forma EPS as of January 9, 2019. Actual/trailing 2018 EPS rose by +22.6%, while trailing P/E multiples contracted by 23.5%, and the market fell -6.3% (1.23 x 0.76 = 0.94).

[3] MSIM Global Multi Asset Team analysis; IBES Pro Forma EPS as of January 9, 2019. Trailing P/E multiples rose 16% from Dec 2015 to Dec 2017 but then contracted 23.5% in 2018. The net of a 15% increase and subsequent 24% contraction is n 11% multiple compression (1.16 x 0.77 = 0.89).

[4] MSIM Global Multi Asset Team estimates; IBES.

[5] MSIM Global Multi Asset Team analysis; Bloomberg. From 30 June 2008 to 30 September 2018, the S&P 500 returned +184%, while MSCI All-Country World ex-US Index (in USD) returned 29%.

[6] MSIM Global Multi Asset Team analysis; Bloomberg; Haver (entire paragraph).

[7] MSIM Global Multi Asset Team estimates.

[8] Ten-year hangover," The Economist, November 15 2018. Accessed January 11, 2018. https://www.economist.com/finance-and-economics/2018/11/15/what-china-talks-about-when-it-talks-about-stimulus

[9] MSIM Global Multi Asset Team analysis; BIS.

[10] MSIM Global Multi Asset Team analysis; Bloomberg.

[11] MSIM Global Multi Asset Team analysis; Haver. Spanish household leverage was 142% of disposable income at the peak, and Irish household leverage reached 232%.

[12] MSIM Global Multi Asset Team analysis; Australian Bureau of Statistics; Toronto Real Estate Board; Real Estate Board of Greater Vancouver.

[13] MSIM Global Multi Asset Team estimates.

[14] MSIM Global Multi Asset Team analysis; Haver; Datastream. A proprietary measure of "pure value" which is equal weighted and sector neutral. It is constructed by the GMA team based on the cheapest vs. most expensive quintile of stocks, based on a composite of five valuation metrics.

[15] MSIM Global Multi Asset Team estimates; Haver; Datastream.

DEFINITIONS

The indices are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

MSCI All Country World Index (MSCI ACWI) is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed and emerging markets.

The **S&P 500 Index** comprises 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The index is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

The **U.S. Dollar Index (DXY)** tracks the performance of a basket of leading global currencies versus the U.S. dollar. The index represents both developed and emerging market currencies that have the highest liquidity in the currency markets.

The **information ratio** (IR) is a measure of portfolio returns above the returns of a benchmark, usually an index, to the volatility of those returns.

The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

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