

On the Markets

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Testing, Testing

Equity and other risky asset markets have remained highly volatile since the abrupt correction witnessed in late August. To recall, over just five trading days, the S&P 500 Index fell approximately 11% in a straight line, taking what had been decent year-to-date returns of about 3% well into negative territory—the first 10% correction in US equities in four years. Since then, asset prices enjoyed a nice rally, but they are now probing lower again. The question for investors: Is this the end of the correction or the beginning of the next leg down?

In last month's *Positioning* ("Trump"ed, Sept. 17, 2015), I discussed the typical trading pattern in highly volatile equity market corrections. First, such corrections are normally accompanied by either excessive valuations, growth scares or both. Second, they typically go through a two-stage process before bottoming, with a momentum low followed by a retest of those lows about two months later. I think it's safe to say that we are now currently experiencing that retest. That means an important low is probably in the making, which presents investors with the most attractive opportunity we have seen in several years to add to risk investments.

Why do we think this is a retest and not the beginning of another downward move? First, there is still a low probability of recession in the next 12 months. Second, valuations are not rich. Finally, markets tend to bottom on bad news, not good news. There has been no shortage of bad news: the IMF's latest markdown of global GDP growth prospects, Hillary Clinton's tweet to institute price controls on pharmaceuticals if elected president, Volkswagen's vehicle emissions scandal, increased uncertainty about the Federal Reserve's interest rate path, a new US debt ceiling debate and lingering political risk across Europe. For now, those headlines are overshadowing the good news about the US housing and labor markets.

This kind of bifurcation has typically led to more attractively valued asset prices, and that is generally what we are seeing today. With interest rates stable during the past six months, prices for stocks and for corporate bonds have become much cheaper. To wit, the spread between the average US company's earnings yield (earnings divided by price) and the 10-year US Treasury yield is about twice as high as normal and, in Europe, the spread is approaching levels not seen since Europe's sovereign-debt crisis in 2012. In other words, investors are now aggressively shunning risky assets—which usually indicates a good time to buy them. ■

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Cycle Slower, Not Over

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These are testing times. Thin summer markets were struck by a self-reinforcing cycle of lower commodity prices, inflation expectations and asset prices, each seeming to confirm the other's dire outlook for the global economy. Emerging markets led the move lower, but the pain was soon widespread, pushing even the S&P 500 to its first 10% correction in more than three years. Gauges of investor fear have hit levels seen only a handful of times since the financial crisis.

Times like these make it all the more important to step back and assess why things feel so bad and whether the sell-off can last. In our view, the remainder of 2015 rests on three questions: Is the global cycle finally turning and, if it is, doesn't the worst surely lie ahead? Even if the cycle isn't turning, aren't valuations rich—given a later-cycle environment or slower growth path? Even if the cycle isn't turning and valuations are fine, aren't there more headwinds—China's

slowdown and a Federal Reserve rate hike being the most prominent—than catalysts between now and the year's end?

To remain constructive, the answer to all three must be “no.” Thus, we recommend raising overall exposure. This is not because our economic outlook is better (it is not), or because risks do not remain (they do). It is because, in enough instances to matter, we believe these concerns are reflected in the price.

Our forecasts for global growth have been revised downward, led by the US, where we now assume a structurally lower path (see table). Elsewhere, trends look somewhat better, with 2016 forecast to be stronger than 2015 in Europe, Japan and the emerging markets, albeit to a smaller extent than before.

So, what about the weakness in commodity markets as a sign of conditions being far worse? Commodity prices have been declining steadily for four years, suggesting these trends are about more than just growth. What's notable here is that demand for oil, both broadly and for China, has actually been holding up quite well. We believe lower oil prices will delay the rebound in headline inflation across the G10 economies, but we also believe inflation's path is still higher, as core inflation is forecast to trend up in the

US, UK, the Euro Zone and Japan. Meanwhile, oil prices stabilize around current levels on our forecasts, pushing headline inflation higher as we move into next year.

Lower and slower growth and inflation should also mean a lower and slower pace of central-bank tightening. We expect the Federal Reserve to wait until December to hike rates but now assume a more gradual rise thereafter. Across the G10, policy rates should rise more slowly than inflation during the next 18 months (see chart, page 3); i.e., accommodative policy is not going away.

We now see slower growth, slower reflation and slower retrenchment of central-bank policy than before. Assuming the first two outweigh the third, our asset class forecasts include more-conservative assumptions for earnings growth, default risk and the bull-bear skew than they did previously. Now, let's consider the big questions:

Is the Cycle Peaking?

This question is paramount. The global economy has expanded for six years, compared with a post-1974 average expansion of 6.2 years. If growth and animal spirits are rolling over, recent market weakness is only a taste of what could lie ahead. We think, however, that this cycle has further to go.

First, we find the idea that the expansion is in danger because of how long it has lasted unconvincing. Growth in this cycle has been unusually muted and unsynchronized across regions, at times hobbled by legacies of the worst financial crisis since the 1930s. This recovery has battled unusually tight fiscal policy and credit conditions on its way toward normalization. It seems reasonable that it will take longer than normal to overheat, in our view.

More empirically, we struggle with the evidence. If conditions are softening, it isn't showing up in important data points.

Morgan Stanley & Co.'s Key Economic Forecasts

	Real GDP			CPI*		
	2015	2016	2017	2015	2016	2017
Global	3.1%	3.4%	3.7%	3.1%	3.5%	4.0%
US	2.4	1.9	1.8	0.1	1.5	2.2
Euro Zone	1.3	1.9	1.8	0.1	1.3	1.7
Japan	0.5	1.6	0.8	0.6	1.3	2.6

*Headline inflation

Source: Morgan Stanley & Co. Research as of Aug. 31, 2015

Purchasing managers' indexes in the US, the Euro Zone and Japan still look healthy. Credit growth is finally positive across all three regions, and while readings from our cycle indicators confirm the notion that we are in the final "expansion" phase, it would be extremely unusual to peak out at such a muted level.

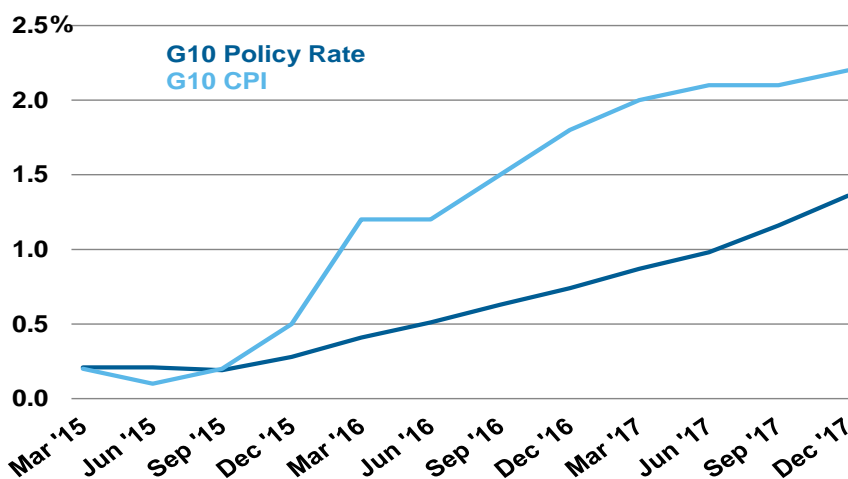
What about the emerging markets, where conditions look worse? They are going through a long, drawn-out and painful adjustment. Yet, similar to the trend in commodity prices, we view this as the latest stage of a long-running adjustment story. Brazil and Russia have already entered recessions, and indicators linked to Chinese growth have already decelerated from this time last year.

What's more, although the sharp declines in emerging market currency markets have raised fears of another late-'90s-style currency crisis, our economics team sees some positive differences versus those episodes. The presence of persistent disinflationary pressures, current-account surpluses, flexible exchange rates and adequate foreign exchange reserves gives policymakers in the region better control over liquidity conditions.

Are Valuations Reasonable?

Even if the cycle isn't turning, our economic forecasts are more downbeat than before. Do valuations look reasonable? In many cases, we think they do. Let's assume that, while it is not over, we are in the cycle's latter stages, consistent with the readings of our global and US cycle models. That phase, which we term "expansion," has occurred 11 times in the US since 1955, covering a total of 263 months. The S&P 500, arguably the most highly valued equity market in the world today, trades almost exactly where it usually does during the later stages of an upturn. Credit, which tends to do worse in late-cycle markets, is already much wider than what is normal at this point in a cycle. Government bonds, to no one's surprise, look rich. In addition,

G10 Inflation Still Set to Rise Faster Than Policy Rates Measures



Note: September 2015 and beyond are forecasts. CPI is headline inflation.

Source: Morgan Stanley & Co. Research as of Aug. 31, 2015

both the equity risk premium and credit risk premium—the expected return in excess of a risk-free investment—are slightly above average. Would we prefer cheaper levels? Absolutely—but we are skeptical that investors will revolt over valuations that still look quite normal, at least for now.

And What About Those Near-Term Headwinds?

Even if the cycle isn't turning and valuations are reasonable, the short term still matters. As much as one likes to focus on longer horizons, it's no fun being really wrong before you're right. With data from China continuing to weaken, the Fed poised to hike this year, commodities in free fall and earnings growth lackluster, aren't the cards stacked against you?

To answer whether outcomes can beat expectations, let's start with where markets have placed that bar. There are a number of ways to track fear and greed, and while no one metric is perfect, we find it powerful when many are saying the same thing. When markets are this worried, the bar for "better" tends to be lower.

What could help? We'd point to several events in our forecasts.

Monetary Policy. We expect the Fed to wait until December to hike the federal funds rate and then normalize rates by what is historically a very gradual pace. The recent volatility in Greece and the emerging markets, meanwhile, gives the European Central Bank a more dovish bias. We also expect the Bank of Japan will be conducting Quantitative Easing well into next year.

China. We expect China to ease fiscal and monetary policy further, which, when combined with the easing already in train since February, should lead to stabilization in growth before the end of the year. We think that would be taken well by broader markets.

Commodities. Falling commodity prices have been widely cited in recent growth fears, and correlations with oil are unusually high. Yet our analysts see marginally higher prices in their current forecasts and believe underlying demand (especially in oil) is stronger than perceived. In the meantime, lower prices also have positive effects and could mean that US gas prices hit \$2 per gallon later this year, representing a boost for the consumer. ■

The Fed Forgoes Rate Hike—For Now

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As we expected, the Federal Open Market Committee (FOMC) took a pass on raising the federal funds rate at its September meeting and it also crafted a surprisingly dovish statement about future monetary policy. The result was not the hawkish pass we had expected, nor was it the dovish pass our interest rate strategists saw as a risk, but somewhere perfectly balanced in between.

Still, a rate hike this year remains in play. After the meeting, Federal Reserve Chair Janet Yellen said that most FOMC members see it as appropriate, but a 2015 hike is not a foregone conclusion. What's holding the Fed back? Global-growth concerns have pushed the broad trade-weighted dollar higher. While financial conditions have tightened and, as Yellen said, the US economy is "surprisingly strong," in light of global economic and

financial developments, she said the FOMC needs a "little bit more time" to evaluate their likely impacts on the US.

TIGHTER FINANCIAL CONDITIONS.

Financial conditions, as measured by the Chicago Fed's Adjusted National Financial Conditions Index (ANFCI), have responded differently in past Fed tightening cycles, in part based on how prepared markets were for the first rate hike. The latest moves in the ANFCI have indeed been comparable to the early stages of past Fed tightening cycles. Wrapped up in those tighter financial conditions is the effect of the rapid rise in the Fed's nominal Broad Trade-Weighted Dollar Index, which has moved inversely in tandem with energy prices and raised the downside risks to inflation. On the cusp of the September meeting, year-on-year growth in core personal consumption expenditure (PCE) prices moved lower to 1.2%, well below the Fed's 2.0% goal. Going forward, the Fed will need to gauge whether the

downside risks to inflation have eased, and the dollar and energy will play an important role.

Finally, the FOMC continued to promise that even after the economy is running at full capacity, the federal funds rate is expected to run below its "normal" longer-run level for some time. The Fed's latest Summary of Economic Projections, a survey of FOMC members, shows GDP, unemployment and core PCE lower now than in June (see table).

LOWER GDP FORECAST. In an exploration of supply-side constraints on the economy, we recently lowered to 1.5% from 2.0% our estimate of potential GDP—the longer-run rate of GDP growth with maximum resource utilization consistent with stable inflation and absent business-cycle fluctuations. We noted that this would have important implications for longer-run monetary policy and that Fed staffers had also lowered their estimates of the economy's potential. This more sobering take has begun to permeate consensus thinking.

The Fed chair has stressed that it's not the date of first tightening that is important, but the fact that policymakers have promised a lower-for-longer interest rate world. That said, policymakers are also aware that the first rate hike is always the trickiest and tends to have an outsized market reaction. Thus far the desire to test the economy's resilience against that potentially outsized market reaction has been lacking. The Fed waits and watches for financial conditions to ease and, when they do, the Fed will move.

DECEMBER HIKE. Our expectation for a December start to rate hikes remains unchanged. The FOMC chose not to send a definitive signal that a 2015 hike is not in the cards, but left room for the possibility that upward pressure on the dollar will remain in check. ■

Federal Reserve Summary of Economic Prospects

	2015	2016	2017	2018	Longer Run
Real GDP					
September 2015	2.1%	2.3%	2.2%	2.0%	2.0%
June 2015	1.9	2.5	2.3	-	2.0
Unemployment Rate					
September 2015	5.0	4.8	4.8	4.8	4.9
June 2015	5.3	5.1	5.0	-	5.0
Core PCE Inflation					
September 2015	1.4	1.7	1.9	2.0	-
June 2015	1.3	1.8	2.0	-	-

Note: Refers to the median of FOMC projections. Projections for changes in real GDP and core PCE inflation are percent changes from fourth quarter of the previous year to the fourth quarter of the year indicated. Projections for the unemployment rate are for the average in fourth quarter of the year indicated.

Source: Federal Reserve, Morgan Stanley & Co. Research as of Sept. 17, 2015

Melt Up After Melt Down?

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Given the recent sharp sell-off in global risk assets, the regional equity strategists put our heads together and have generally reached an agreement. Much has changed since mid-August but, even after lowering our targets, we have a positive bull-bear tilt and strong upside to our base cases. We did not anticipate the correction, but we think that it creates opportunities.

US

Our US economics team is forecasting lower growth, higher inflation and the Fed to raise rates five times between now and the end of 2016. This makes the bear case more plausible. To account for this, we have made some changes to our bull-base-bear forecasts for the S&P 500. For our base case, we have moved our 12-month target down to 2,200 from 2,275, to reflect our economics team's forecast, and embedded a slightly lower base-case forward price/earnings ratio (P/E) of 16.6

versus the previous 17.2 (see table). For 2016, we are now forecasting \$128.50 in S&P 500 earnings per share (EPS) versus our prior forecast of \$131.00 and the bottom-up consensus estimate of \$132.38. The stronger dollar and lower economic forecast caused us to trim our 2016 earnings outlook, though the recent dollar/euro weakness is a positive for earnings relative to a few weeks ago.

We have kept our 2015 top-down EPS estimate of \$124 unchanged, ahead of the consensus bottom-up number just below \$120. In our base case, the 2015 bottom-up estimates are too low, but the 2016 bottom-up numbers are too high. Importantly, the total yield—dividend plus net repurchase yield—will likely remain well above 4% for 2016, supporting our view of the market.

We have lowered our bull and bear targets by 7% and 12%, respectively, with our new bull case at 2,425 versus our prior bull-case target of 2,600, and our new bear case at 1,500 versus a prior expectation of 1,700. The combination of lower growth, the potential for higher inflation and a retrenching Fed dampens the bull-case potential, in our judgment. There is much more downside in the US from our base case to our bear case than there is upside

from our base case to our bull case, and more so than in Europe or Japan.

We still think this expansion can potentially last until 2020. Our laundry list of items to monitor the length of the cycle includes economic factors, corporate behaviors and credit-cycle metrics. If we “mark to market” where we are on this list of signposts today versus a year ago, it is mixed but not really that negative given the market's downbeat mood.

STYLE AND SECTOR. Clients have asked about tilting away from growth stocks, given their strong run. Our analysis shows that there appear to be several “clusters” or types of growth and several types of value. The type of growth that has worked recently is unlikely to result in a short-term reversal into value. Moreover, when you compare the growth and value universe on a host of metrics—including valuation; capital use and profitability; growth and sentiment; capital structure and leverage; our timing indicator; and macro-factor sensitivity—the case for moving to value isn't compelling.

We now favor large-capitalization stocks over small-cap stocks. For about a year we have been recommending the opposite on the specter of more margin expansion, less currency exposure and deepening mergers-and-acquisitions activity. Still, with the less “risk-on” macro call, we think it's prudent to skew a bit toward higher-quality and larger-cap where possible. Our allocations are balanced across defensives and cyclical. We are overweight financials and consumer discretionary; underweight consumer staples, industrials and materials; and market weight technology, health care, utilities, telecom and energy.

Europe

Although the downgrade to our European GDP numbers was milder than those seen elsewhere, we have had to make a significant downgrade to our earnings forecasts due to sharp falls in commodity prices and the increase in our

Morgan Stanley & Co 12-Month Base Case Price Target Assumptions

Region/Index	2015E EPS Growth		2016E EPS Growth		Forward P/E		Base Case Return
	New	Prior	New	Prior	New	Prior	
US (S&P 500)	4.0%	4.0%	4.0%	5.0%	16.6	17.2	16.9%
Europe (MSCI)	0.0	12.0	7.0	9.0	15.0	15.5	17.7
Japan (Topix)	18.0	16.0	11.0	11.0	14.4	14.8	26.5
Emerging Markets (MSCI)	-11.0	2.0	8.0	10.0	11.2	12.1	10.8

Source: Morgan Stanley & Co. Research as of Sept. 28, 2015

currency strategists' euro forecast. In our base case, we now assume EPS growth is flat in 2015 and 7% in 2016, down from 12% and 9%, respectively.

The clearest indication of the influence of falling commodity prices is in the earnings trends for the UK versus Euro Zone; we calculate that first-half EPS in the UK was down around 20% year over year, while first-half EPS for the Euro Zone was up 15% to 20%. In our base case, we assume some multiple expansion with a target multiple of 15 on the next-12-month's P/E, in line with the average of the past 12 months. While increases in US interest rates and European inflation would be generally negative for P/Es, we believe they can be offset by the European Central Bank's ongoing Quantitative Easing (QE) and the deep undervaluation of stocks relative to bonds. The dividend yield on the MSCI Europe Index is more than two percentage points higher than a weighted European bond yield. These new forecasts imply a 12-month price target for MSCI Europe of 1,550, representing potential upside of 10.6% from current levels, not including a further 3%-to-4% potential return from dividends.

EURO ZONE OVERWEIGHTS. We recommend investors overweight Euro Zone exposure within their portfolios given our expectation of further GDP improvement, helped by the ECB's ongoing QE. Italy remains a key overweight. We like banks because of the progress made on earnings, dividends and capital that is lowering the sector's implied cost of equity.

Note that stocks with above-average Euro Zone exposure are now enjoying the best earnings-revisions trends across the market. We remain underweight the UK given headwinds from commodity prices and the strong British pound. At this stage we remain heavily underweight emerging markets/China exposure in our portfolio, although we are looking for an opportunity in this area later in the year. Commodity sectors are likely to be most sensitive to any shift in sentiment toward China,

perhaps as a result of further stimulus announcements.

Given elevated relative valuations, we remain underweight most of the defensive sectors—consumer staples, pharmaceuticals and utilities—and recommend income-oriented equity investors adopt a relatively sector-neutral approach to identifying companies with a decent dividend yield and reasonable growth prospects. Within cyclicals we are overweight selective domestic plays, such as business services, airlines, cruises, media and hotels. We are underweight luxury goods and capital goods.

Emerging Markets and Asia

We recommend investors raise weightings on Japan and buy into the current weakness. Our house forecasts imply modest yen weakness and, alongside a supplementary budget that appears now to be under discussion, the Bank of Japan is able to ease further if required, in our view. We continue to be above bottom-up consensus on earnings, and even assuming a lower forward P/E, our 12-month target price for the Topix is unchanged at 1,740. We make major reductions in our targets for the MSCI Emerging Markets Index, Asia Pacific ex Japan Index and China H-shares. As a result of these new base cases and our bull-bear skew, our preference hierarchy continues to be Japan, over Asia-Pacific ex Japan, over the emerging markets.

TOPIX TARGET UNCHANGED. Unlike in the emerging markets or Asia-Pacific ex Japan, the Topix is in a structural bull EPS trend that we expect to continue. Looking forward, our earnings forecast uses our three-factor EPS model, which includes yen/US dollar, global PMI and the domestic Economy Watchers Survey. We also take into account an upcoming corporate-tax rate reduction. We remain above consensus, forecasting 18% EPS growth in 2015 and 11% in 2016. We now expect Topix to trade on a forward P/E of 14.4 one year from now, versus a prior base case of 14.8 and a current one-year

forward P/E of 13.7. The Government Pension Investment Fund (GPIF), the largest domestic buyer of equities, has seen its domestic weighting come off from its peak of 24.4% on Aug. 17 to 22.9% currently, due to the correction in equities. We expect the GPIF to move toward its neutral domestic equity target weight of 25.0% in the near term.

REGIONAL DOWNGRADES. We have made substantial downgrades in target prices for regional indexes. The ongoing earnings recession in all major countries and sectors in the emerging markets/Asia-Pacific ex Japan continues to broaden and deepen. Our economics team now forecasts EM GDP growth of only 4.1% in 2015 versus 4.4% previously and down from 4.8% in 2014. We have also factored in our new currency forecasts for the region. As a result, we cut our 2015 base-case EPS forecasts, in US dollars, to \$65.10 from \$76.40 for the emerging markets and to \$32.40 from \$36.20 in Asia Pacific ex Japan. This means that we now expect year-over-year EPS declines of 11% for the MSCI Emerging Markets Index and 3% for MSCI Asia Pacific ex Japan. These new EPS forecasts are well below the bottom-up consensus of \$75.10 and \$34.80.

Even with the downgrades, we have country-specific recommendations. Our top pick in Asia ex Japan is India. We are also overweight in Taiwan and Singapore, which we view as high quality from a macro perspective and where we think recent declines are overdone. We continue to underweight three commodity producers—Brazil, Russia and South Africa—as well as Korea and Thailand. In Southeast Asia, we prefer Singapore to Malaysia, Thailand and Indonesia. For these latter three countries, external headwinds—volatility in external funding, falls in commodity prices and slower Chinese growth—negatively combine with uncertain domestic growth and political outlooks. ■

A Tale of Two Sectors

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With investors acutely focused in recent weeks on macro issues, including the Federal Reserve's decision to put off hiking interest rates and the ongoing impact from China on global liquidity and trade, Morgan Stanley conferences on health care and industrials offered views from managements on more company-specific issues. Unsurprisingly, as this year's divergence in sector performance would indicate, the tone of health care executives and investors in New York was more sanguine than that of industrial management teams in Laguna Beach, Calif. Below are some of the key takeaways from both conferences:

Health Care

Pipelines and innovation. Optimism ran high that the drug breakthroughs of the past several years would continue. Indeed, a few biotech and pharmaceutical companies delivered positive updates on lung cancer, melanoma, cholesterol and diabetes drugs. The positive tone from the drug manufacturers was echoed by clinical-research outsourcing firms, which were bullish on 2016 growth given their clients' higher spending levels and ongoing outsourcing trends.

Mergers and acquisitions. Even with roughly \$400 billion in completed and pending deals so far this year—the most of any market sector—deal making remains a focus for many management teams. With tax-inversion deals no longer on the table, the discussion ranged from elevated

valuations of more expensive target assets to waiting for late-stage data before making transactions. Given cheap financing costs in a low interest rate environment, and the need to extend revenues, we expect to see robust merger activity to continue.

Utilization. While there had been some uncertainty in recent years as to the impact of the Affordable Care Act, hospitals cited strong volumes and continued reform benefits. Also, the improving US economic backdrop has helped drive utilization, with hospital admissions higher in the first half of 2015 versus the first half of 2014.

Drug pricing. Given seemingly excessive prices for certain drugs, pharmaceutical companies defended these costs by pointing to drug prices in the context of the totality of care, and how better drugs ultimately are cost effective. Additionally, drug distributors highlighted that slowing generic price inflation in recent quarters would likely continue into 2016, although some of that impact would be offset by higher prices for branded drugs.

No China impact. Several life-science-tools companies with global exposure noted that recent economic trends in China have not affected their day-to-day business. In our view, this underscores the secular growth outlook for their products. China's focus remains on driving health care, food safety and environmental progress—areas that are highly expected to be a large part of the next five-year plan and areas where the government is unlikely to reduce funding.

Industrials

End-market trends. While the environment for multi-industry companies seems to be getting tougher, construction remains a bright spot in the US. Rails offered mixed commentary, with weaker traffic offset by strong pricing trends. The companies continue to work toward operational efficiency and improving service levels. Lastly, US airlines were positive, given a deceleration in capacity growth, healthy demand and a stable competitive environment.

Increasing local competition. Pricing appears to be softening and several companies expect more increased competition from non-US competitors, who now have the benefit of cheaper currencies. The bright spot was that the commodity deflation is helping on the cost side, as hedges and long-term supply agreements expire. That dynamic may help US companies bolster profit margins.

Capital deployment. There is an increased focus on mergers and acquisitions as companies seek to offset slower organic revenue growth. Furthermore, managements sounded flexible on sacrificing their credit rating to achieve their capital-allocation targets. We expect to see higher deal activity in the sector, particularly as companies seek to utilize cash held overseas.

Slower in China, mixed in the US. Companies pointed to a slowdown in emerging markets, flatter activity in Europe and a mixed US industrial sector. While most executives noted continued weakness in China going into 2016, they remain positive on the long-term growth prospects for the country. The tone toward the US was more mixed, with a bearish tone toward general industrial and oil-and-gas markets and companies sounding more positive toward construction and consumer end markets. ■

MLPs Face a Perfect Storm

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The sell-off across the universe of master limited partnerships (MLPs)* intensified last month, with the Alerian MLP Index now off nearly 35% for the year to date (as of Sept. 28), sharply underperforming the broader energy sector. In fact, MLPs—which are perceived to be more stable, less commodity-sensitive businesses—are lagging even exploration and production, as well as the oil services subsectors, for the year to date (see chart). That’s unusual because those two subsectors are much more directly affected by the sharp decline in oil prices. What gives?

In our view, MLPs are facing a “perfect storm” of fundamentals. Specifically, continued uncertainty around volume, commodity prices and interest rates has stoked investor fears. Coupled with the relative lack of liquidity in the space and concerns over open-end mutual fund outflows, this has led to a sharp decline in unit prices; from its peak last year, the Alerian MLP Index is now off 43%.

UNCERTAINTY AMPLIFIES VOLATILITY.

To be clear, these concerns have merit. As we have highlighted in recent months, continued uncertainty around volumes, prices and rates is likely to amplify the sector’s volatility in coming months. For the midstream MLPs to survive, the amount of oil and gas coming out of the ground must rise, because it feeds their gathering, processing, transportation and storage infrastructure. A primary fear of markets today is that declining prices will lead to a steep decline in US drilling activity. In fact,

data released by the Energy Information Administration suggest US crude-oil production may have begun that decline during the summer.

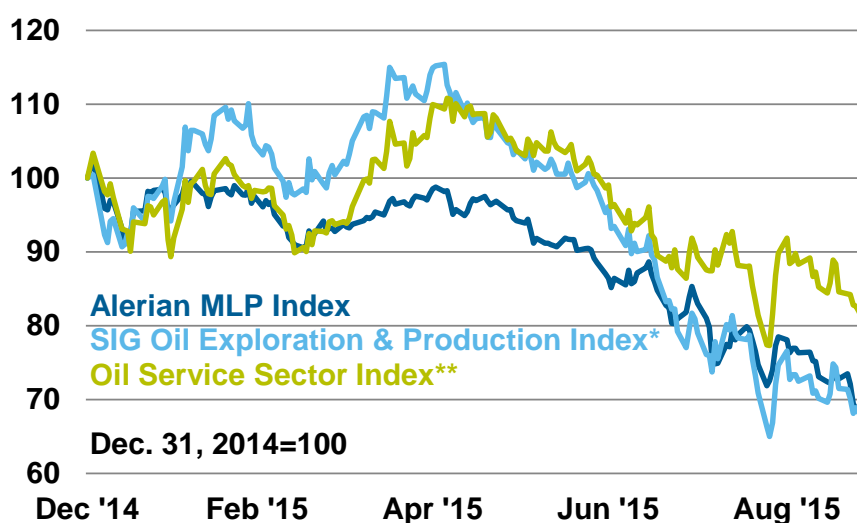
Concerns about US production are not new. However, a wrinkle has emerged in recent weeks that exacerbates the risk: While previously the market believed US volumes and prices would be linked—declining US production would create tighter oil markets that would, in turn, send prices higher—now we are seeing signs that US supply could roll over while crude prices also remain weak given production growth in other parts of the world, namely OPEC countries. Linger worries about a rise in interest rates, alongside an environment in which volume faces pressure while commodity prices see no relief, have created the “perfect storm” for midstream MLPs. Still, we see this storm as

a near-term issue and, looking out over the medium and long term, we believe US supply will need to grow to meet global demand. Put together, while the midstream thesis may be delayed, we do not believe it is dead.

COMPARISON TO FINANCIAL CRISIS.

Given the extent of recent MLP weakness, many investors are comparing today to the financial crisis. We hesitate to suggest that the current period is an appropriate comparison, particularly as then the entire global financial system was called into question, capital markets were effectively closed and commodity prices perhaps had even less visibility than we have today. However, we do think the financial crisis can be useful in terms of framing current action. In 2008 and 2009, peak to trough, the Alerian MLP Index fell 57% in price terms but yielded more than 10% at its low; so far in the current cycle, the index has fallen 42% from its peak last year and the index’s yield is approaching 8%. While this suggests there could be further downside if conditions continue to worsen, we think markets have priced in many of the challenges facing MLPs. ■

MLP Prices Hit Harder Than E&P and Oil Services



*Philadelphia Stock Exchange SIG Oil Exploration & Production Index

**Philadelphia Stock Exchange Oil Service Sector Index

Source: Bloomberg as of Sept. 28, 2015

***For more information about the risks to Master Limited Partnerships (MLPs), please see the Risk Considerations section beginning on page 17 of this report.**

Oil: From Bad Now to Better in 2016

ADAM LONGSON

Energy Commodity Strategist
Morgan Stanley & Co.

While the oil market now seems to appreciate that prices need to remain low well into 2016 in order to discourage investment and stimulate demand, the consensus remains overly pessimistic on the timing and magnitude of an inevitable cyclical recovery. Fundamentals are challenged but, in our view, the estimates of the magnitude of oversupply are grossly overstated. Even assuming a notable deceleration in demand growth, we expect to see supply and demand rebalancing by the fourth quarter of 2016. By 2017, we could see Brent crude at \$85 per barrel or higher, which should provide incentive for US production growth.

NEAR-TERM OUTLOOK. If things look better two years out, it is in contrast to the remainder of this year and the first half of

next year. We estimate 2015 global crude oil oversupply will average about 800,000 barrels per day versus demand growth of roughly 2.1 million barrels per day for the year to date. Nevertheless, with the lifting of economic sanctions, new shipments from Iran next year are likely to keep the market oversupplied. As a result, the price for Brent oil will likely be range-bound during the next 12 months as the supply overhang is absorbed. Plus, with no intrinsic value underpinning pricing, we expect price volatility to remain elevated. Oil will likely continue to trade on currencies, technical factors and headlines about China, US production and OPEC.

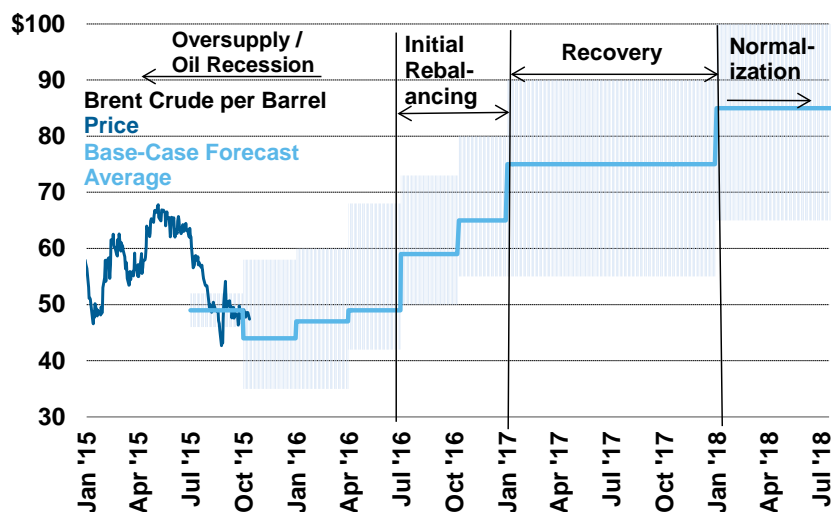
THE CYCLE TURNS. The cycle should turn in 2017. Supply-driven cycles inherently take longer to play out, but recovery will occur. If not for a large increase in OPEC supply—at least 1 million-plus barrels per day on a year-over-year basis—there might be no

oversupply now, and OPEC does not have the capacity to lift production at this pace each year. Plus, while we don't expect supply to retrench, low prices should discourage investment and thus slow supply growth. Hence, equilibrium can be achieved if demand simply catches up to supply. The good news is that oil demand from refineries is already growing at the fastest pace in a decade, except perhaps that 2010 bounce-back from the global financial crisis.

True, there are some market commentators that call for a sustained low-price environment, but they fail to recognize both the cost structure within the US and the inherent cyclical nature of the industry. We expect lower highs this cycle due to cost deflation, but even if the US could supply the globe (which we doubt), incentivizing that much growth would require much higher prices. The large increase in drilling activity that would be required would put upward pressure on service costs—the most cyclical part of the industry—and require producers to drill in much-lower-quality acreage.

FORECAST RISKS. To be sure, there are risks to our outlook. A GDP slowdown could result in reduced product demand, particularly for transport fuels. If the US dollar continues to appreciate, it is likely to weigh on dollar-denominated commodities like oil. If Iran increases supplies faster or in greater volume than anticipated, it could depress prices and delay recovery. An early bounce-back in prices could prompt producers to lock in prices and, once hedged, producers will continue to pump oil regardless of the price. If the ban on US exports of crude oil is lifted and there is a concerted effort to drive down inventories, it could add 100 million barrels to global markets. In that case, the \$85 target moves farther and farther away—into 2018. ■

Oil's Supply Cycle Can Take Longer to Recover



Source: Bloomberg, Morgan Stanley & Co. Commodity Research as of Sept. 28, 2015

Prepping Your Portfolio for The “Stretch Run”

SUZANNE LINDQUIST

Fixed Income Strategist
Morgan Stanley Wealth Management

After weeks of talking about teams preparing for the “stretch run,” the last leg of the Major League Baseball season is upon us. For the first time since 2006, my team, the New York Mets, is in the playoffs. Pitching has been the Mets’ strongest suit this season, but that alone will not win a pennant. Depth and breadth of talent in the batting box and on the field along with great coaching wins games.

The same principles can be applied to investing, as offense, defense and nimble management are the key drivers. In the same way coaches arrange their rosters to take advantage of their opponent’s weaknesses, successful investors develop strategies to exploit market opportunities.

Today’s bond market is challenging. The correction in global stocks, the resulting spike in volatility and the impact of lower commodity prices all have driven spreads on investment grade and high yield corporate bonds wider. Moreover, the Federal Open Market Committee’s (FOMC) decision to pass on a federal funds rate hike has been paralyzing, too, with the chatter around timing intensifying on nearly every data release. So let’s take a break from Fed watching to strategize your fixed income game.

Focus on yield. Our lead-off strategy is to choose sectors that provide income, helping to buffer against higher interest rates. Financials as a sector appears attractive at these levels, as their spreads have widened out over the past year with the rest of the broad corporate bond market. They also stand to benefit from a de-emphasis on their volatile capital markets businesses, improved balance

sheets and overall credit growth. Thus, our top choice is bank-preferred securities, as they have generated significant incremental yield relative to the underlying quality of the issuers. Recently, as volatility has roiled equities, it is not surprising that preferred securities have experienced fluctuation as well. While we expect volatility to continue in the near term, we believe preferreds will ultimately perform well, especially if volatility subsides. Banks have increased their Tier 1 capital (see chart), maintaining higher ratios than required by regulators.

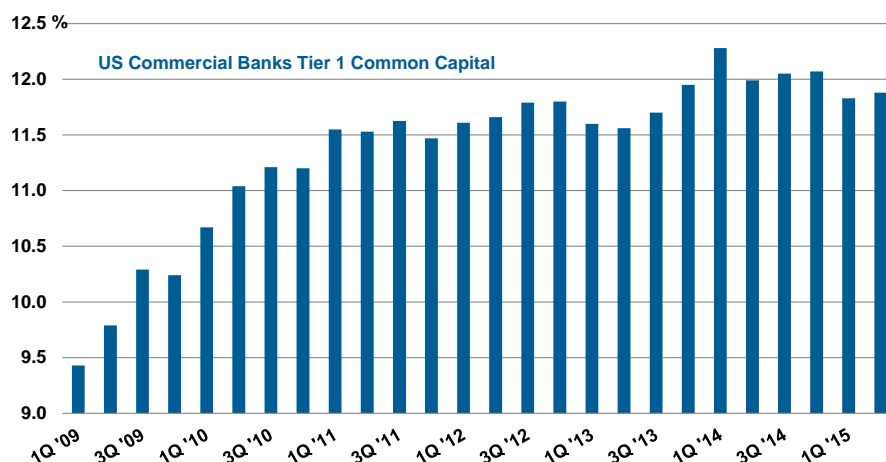
Exploit untapped value. It’s also important to find undervalued sectors that can provide positive total returns through price appreciation and income generation. To that end, we favor securities with exposure to the housing market, discretionary consumer spending and transportation, specifically airlines. The housing market has performed favorably this year, as a combination of home sales,

housing starts and building permits are all up and home affordability is at a record high. The consumer discretionary sector has outperformed, too, as consumers have spent gas-pump savings with restaurants, retailers and the travel-and-leisure companies.

Smart defense. Playing defense is critical to staying ahead of the curve. Buy downside support with short-duration securities. In passing on a September rate hike, the FOMC cited global-growth concerns. However, given that the US unemployment rate is the lowest since April 2008, we still expect a rate hike in December. Moreover, we believe that the rate hike is not currently priced in and see some upside for yields, especially in the two-to-five-year segment of the yield curve. We expect 10-year yields to move higher, too.

Keep your eye on the ball. Just as baseball teams are about to learn that all stretch runs aren’t created equal when it comes to contenders, investors must be aware that dynamic market environments require dynamic strategies. We believe that a well-diversified portfolio is always paramount, and that managing return against risk is critical to winning in the long run. Play ball. ■

Increased Regulatory Capital Bolsters Bank Securities



Source: SNL Financial as of June 30, 2015

Muni Bonds Get Back to Business

JOHN DILLON

Municipal Bond Strategist
Morgan Stanley Wealth Management

With the much-anticipated September meeting of the Federal Open Market Committee now on the books with the “no change” box checked, municipal bond investors may want to take a moment to reassess the current state of the market, what has worked and what hasn’t, as well as where the value—and the peril—reside.

With a year-to-date total return of 1.64% for the Barclays Municipal Bond Index (as of Sept. 29) the tax-exempt market has been holding up quite well. This is despite overall interest rate volatility, political, ratings and price volatility for Chicago amid a continuously challenged Illinois backdrop, and the ongoing saga that is the slow-moving restructuring plans of Puerto Rico and its related bond issuers. Having been around long enough to know it wasn’t always this

way, we view the resilience of the muni market in the face of such localized difficulties constructively, believing the absence of systemic impact represents an indication of “efficiency” on the road to a more idiosyncratic, credit-based arena.

PAID TO WAIT. While a number of bond muni market headwinds have surfaced in recent years, in the muni market, investors are getting paid to wait them out. The 10-year municipal relative-value ratio is 100%, which means tax-exempt munis are yielding as much as taxable Treasuries; the 25-year average for the relative-value ratio is 86%. The muni yield curve, at 290 basis points, is steep by historical standards—the 25-year average is 255 basis points—and investors can still find a defensive 5% coupon structure in the markets.

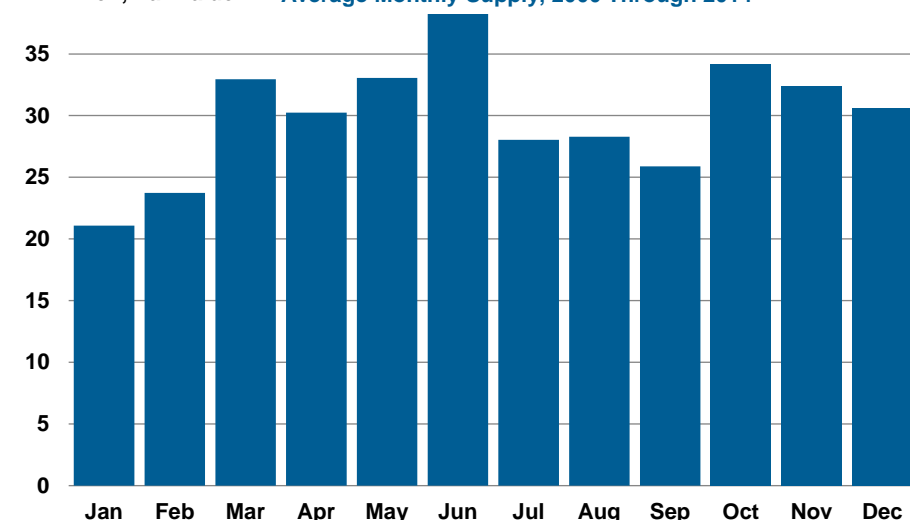
Despite year-to-date new-issue-volume statistics that have handily eclipsed recent years’ data, available bond supply remains constrained, as robust refunding activity

rendered net supply minimal at best. An encouraging sign in recent months is that “new money” issuance is on the rise, which does add to net supply. With states and local governments experiencing a modest economic expansion, the stage could be set for ample bonds this fall—a seasonally strong period for issuance, generally—at otherwise elevated yields that continue to reflect market anxieties about when the Fed will finally lift rates (see chart).

WHAT TO DO. We continue to favor revenue bonds over local general-obligation (GO) bonds and remain comfortable with all states’ GO bonds, as well as state-level appropriated paper. We advocate implementing this bifurcated credit focus by targeting upper-A-and-higher ratings for local GOs, which contrasts with our mid-BBB-and-higher parameters for essential-service revenue debt. Our target maturity range on the curve is 15 to 25 years, and we remain cautious on short-dated paper with maturities inside four years. Finally, we continue to strongly advocate bonds with coupons of at least 5% because eventually rates will rise. However, in the meantime, investors can enjoy the tax-exempt coupons. ■

Autumn Has Typically Been a Season of Higher Municipal Bond Issuance

\$40 Billion, Par Value — Average Monthly Supply, 2000 Through 2014



Source: Thomson Reuters Municipal Market Data as of Sept. 28, 2015

The Shifting Growth Paradigm

Recent financial headlines, coupled with sharp market swings, have many believing that the growth outlook is gloomy. Rick Rieder, BlackRock's chief investment officer of fundamental fixed income, doesn't buy into the bleak view. "I think people are way too cynical about where this economy is operating today." While global growth is likely to be "slower than it was 20 or 30 years ago," he notes that "the US economy is operating at a pretty strong level." Rieder recently spoke with Mike Wilson, Morgan Stanley Wealth Management's chief investment officer, about the need to "change the fabric of how we look at the world." The following is an edited version of their conversation.

MIKE WILSON (MW): What is your big picture of the global economy and the US economy?

RICK RIEDER (RR): I spend a lot of time on demographics and leverage. We have an aging population globally, which means growth in the world has to be lower than it's been historically, and the fact that we've had deleveraging in the global economy for a number of years creates a drag on growth. So I think global growth is going to be moderate for a number of years.

That being said, within this construct, I think the US economy is operating at a very high level. There are a number of skeptics who say the economy is disappointing and that you haven't seen the post-recession resurgence that you should have—but I just don't buy it.

The US economy, in GDP terms, has grown 2.7% over the past year versus about 1.5% annually over the last 15 years.

So we are growing faster than we have over the last 15 years, while creating an extraordinary amount of jobs—roughly 250,000 jobs a month for almost two years now, creating almost 6 million jobs in the country. When you take those things that you can count, like auto sales, home sales, hiring, you are seeing a dynamic that is pretty impressive.

The thing that I believe does not get nearly as much attention is how technology is changing the world. I think we can grow at a much lower cost base than we have historically because much of the technology today—Uber, Airbnb, iPhones—is geared towards the sharing economy, which acts as a replacement for so many goods. What happens is you can do things more efficiently.

MW: Do you feel like growth in Europe and Japan might actually be better than the US in the near term?

RR: A series of impulses—currency, the energy dynamic, negative real rates—have created better growth in Europe and Japan, but it's very hard to create aggregate demand in those regions because of the demographics and the embedded leverage. And because, I would argue, they are more mature, less technology- or service-oriented economies, there's less benefit of that fuel than in the US.

In the near term, those economies are certainly going to do okay. I think they are going to get more stimulus—fiscal as well as monetary—and I think they might have a short cycle of better growth. The places where the short cycle is stabilizing and improving present some of the best investment opportunities that we see, whether they're in the debt or the equity markets.

MW: Should we be concerned about the slowdown in global trade?

RR: There are two parts to this. One is that global trade gets measured oftentimes in the wrong form, in terms of currencies. If you actually take volumes and you look at global trade from a volume perspective—like the price of energy—the volumes are not as concerning as the top-line data would suggest. So I'm not sure it's measured accurately when people talk about the incredible stress on trade.

Secondly, I don't think people factor in that there is a significant change in the dynamic of what's driving economies today. The construct of the global economy, particularly the US, is changing so much faster than people recognize. We are becoming much more of a service economy and, globally, we see this dichotomy between services and manufacturing.

Look at things that used to drive consumption in the world—TVs, radios, dishwashers—and think about the costs that have come down and how they have been replaced. Think about what's happening in China and Brazil. As economies evolve and move away from being export, commodity and manufacturing oriented, it is much more difficult on those regions.

MW: Some people say this type of two-tiered economy is not a healthy economy and that we can't have a strong services economy and a weak manufacturing economy and still be fine. Would you agree?

RR: No. Some of the older, more traditional companies fall back on this opinion that they only have three ways to generate earnings: top-line revenue, profit margins and leverage. And you are seeing something profound taking place, which is that it's hard to grow top-line revenue because of that framework of global growth and trade and manufacturing. It's very hard to keep your profit margins moving up, which is why there is so much mergers-and-acquisitions activity today.

But then the third point, leverage, is why we are seeing so much financing in the credit markets—particularly in investment grade multinationals. It's because that's the third tool you would rely on. "Can I put another turn to leverage and keep my return on investment up, particularly if we are going through a slower cyclical period?" You are seeing that play out directly in the markets today. I think it's a really big deal and it's just a changing economy and it's a changing way that companies are thinking about it, which is having a big influence on the markets.

MW: Where do you think the Federal Reserve is in terms of raising rates?

RR: Given all the stats, I think they could have gone in March, and I certainly think they could have gone in June or September. Now, I am worried that the window is closing. I worry that we have created 250,000 jobs a month for such a long period of time that I think the payroll numbers may not be able to keep up with what we've had here. It's important for the Fed that we hit the target but they also believe you have to have momentum through it.

The bar that the Fed is going to raise in December is higher because of year-end balance sheets and velocities of the system—because it's right before the holiday season. I think you can evenly split that we have a rate hike in October or December. There's a long discussion about the Fed can't do it in October because there's no press conference, which is not true. Although October is on the table, there's very little data that comes out before the next meeting, so it's unlikely. I think resolving uncertainty is much more important than 25 basis points.

MW: What do you think was the primary trigger for the volatility spike in August?

RR: I think there were a few things at play. I think one is the liquidity paradigm in the world is definitely changed.

Two, I do think that China growth and currency dynamics were a very big deal. The hard thing about China is the data is opaque, so the exact rate of deceleration is

hard to figure out, and the impact that has on commodities and on global trade, particularly on trade in Asian and the emerging markets, is an especially daunting dynamic. I also think the misinterpretation of what the Chinese were doing with the rapid 10% depreciation of their currency was destabilizing to a bunch of markets.

Third, I think commodities and the changing nature of the economy with regards to manufacturing started to play through. Headlines on global trade and commodities created some of the volatility.

Then, fourth is obviously the Fed. As much as I don't think a 25-basis-point hike is a big deal, there are a lot of people that do.

I would say it was the confluence of those events. I don't think we are going back to the dips we saw in 2011.

MW: What is your outlook for rates and at what point does duration become attractive?

RR: We think rates are going to drift higher. There are a whole lot of reasons why the rates market is going to stay low for a long time, including what the European Central Bank (ECB) and the Bank of Japan do. I think the 10-year Treasury yield is going to somewhere between 2.35% to 2.50% this year. I think next year the 10-year can approach 3%.

We have some duration in some of our tactical portfolios. We like holding the duration in other parts of the world like Italy and Spain, Australia and Korea. The global demand for rates is still pretty high. We are still going to have moderate inflation for a period of time. So I think as the 10-year part of the curve gets up into the mid-to-high-2% range, there is a buy.

MW: Where are you finding value in credit?

RR: We think the leverage that's happening is pricing investment grade at a decent level so we have been adding a bit. I think the levels in high yield, from a spread perspective, are pretty interesting.

I have seen some of the analysis that says default rates are going to pick up precipitously, but we think fundamentals

are in pretty good shape in high yield. Tail risk is higher today and will be higher for the foreseeable future, but we have been adding risk—though not adding duration alongside of it—much more deliberately than we have in the past.

MW: What are the risks you now watch for?

RR: I think there are a variety of things to think about. One, so much of what happens in markets is driven by policy and that's not necessarily equilibrium. The Fed and the ECB have distorted asset prices. When things shift or the direction changes you get big moves. Lower liquidity and higher volatility is attached to that.

The second point I would argue is that people are not generating a lot of return in this environment. Anytime you have a marketplace where you don't have tailwind of return behind you, there is less conviction and less willingness to take a loss—and that also creates more volatility and results in less liquidity in the system.

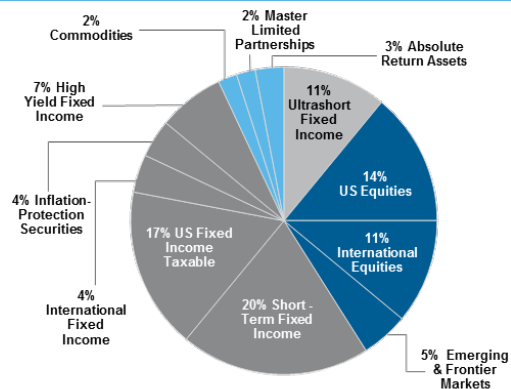
So how do you think about that from an investment paradigm? I think you have to consider taking a look at risk assets, given valuations in some of these markets, with selectivity and with a great deal of research and analysis because you still have to be careful because of the volatility in the markets. Tail risk is bigger, no matter the asset class. I think you should also hold more cash against your position, because of the risk, but also because opportunities may present themselves. I would be blown away if they weren't real opportunities in the next two months. Lastly, I think you need to think about whether you are trying to take beta risk or are you trying to generate return using things like currencies or rates. ■

Rick Rieder is not an employee of Morgan Stanley Wealth Management. Opinions expressed by him are solely his own and may not necessarily reflect those of Morgan Stanley Wealth Management or its affiliates.

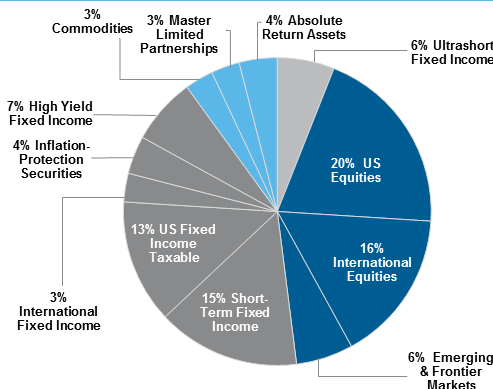
Global Investment Committee Tactical Asset Allocation

The Global Investment Committee provides guidance on asset allocation decisions through its various model portfolios. The five models below are recommended for investors with up to \$25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return.

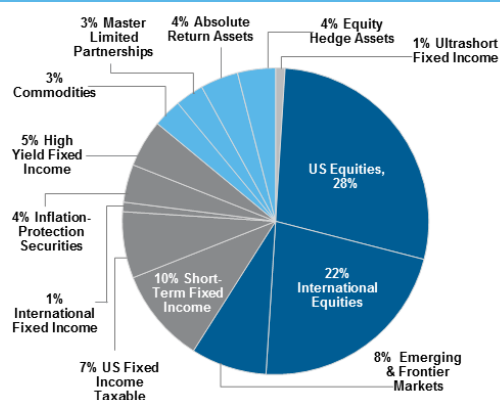
Capital Preservation



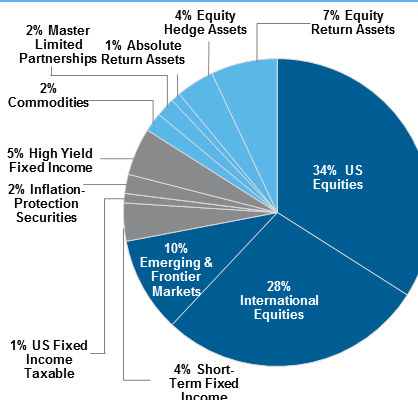
Income



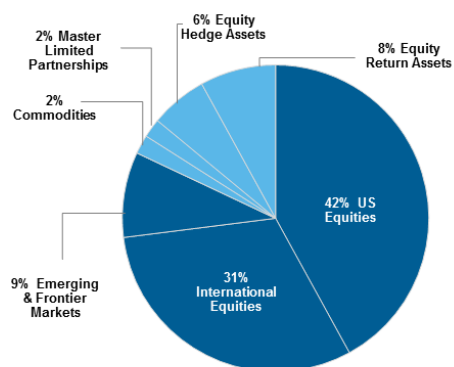
Balanced Growth



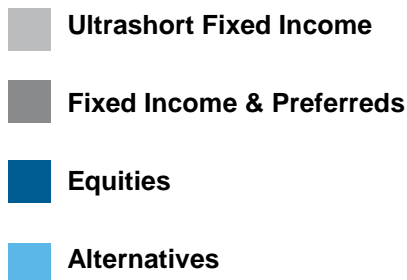
Market Growth



Opportunistic Growth



Key



Source: Morgan Stanley Wealth Management GIC as of Sept. 30, 2015

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Overweight	While US equities have done exceptionally well since the global financial crisis, they are now in the midst of their first 10% correction in four years. We believe the US and global economies continue to heal, making recession neither imminent nor likely in 2015 or 2016. US equities are still the highest quality in the world and provide a lower-risk way of participating in the rebound.
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets given the political and structural changes taking place in Japan and our expectation for an improving economic outlook in Europe. European and Japanese central banks are now engaged in much more aggressive monetary policy than the US, while also moving away from fiscal austerity. Both of these markets are more highly leveraged to the global economy and represent a higher risk/higher reward way to participate in a rebound.
Emerging Markets	Overweight	Emerging market (EM) equities have been a mixed bag for the past few years and we expect that to continue. While the broad EM equities asset class remains vulnerable to Fed tightening and US dollar strength, the market is pricing in much of this risk. We expect a rebound to commence in the next 12 months as weak EM currencies lead to better relative growth. We recommend selectivity: India, China H-shares, Taiwan and Korea.
Global Fixed Income	Relative Weight Within Fixed Income	
US Investment Grade	Overweight	We have recommended shorter-duration* (maturities) since March 2013 given the extremely low yields and potential capital losses associated with rising interest rates from such low levels. We have subsequently reduced the size of our overweight in short duration with short-term interest rates now expected to move higher with the Fed's tightening cycle later this year or in early 2016. Within investment grade, we prefer BBB-rated corporates and A-rated municipals to US Treasuries.
International Investment Grade	Underweight	Yields are extremely low globally, leaving very little value in international fixed income, particularly as the global economy begins to recover more broadly. While interest rates are likely to stay low, the offsetting diversification benefits do not warrant much, if any, position, in our view.
Inflation-Protected Securities	Overweight	With deflationary fears having become extreme in the first quarter of 2015, we believe these securities now offer relative value in the context of our forecasted acceleration in global growth and expectations for oil prices and US dollar year-over-year rate of change to revert back toward 0%.
High Yield	Overweight	The sharp decline in oil prices has created some dislocations in the US high yield market. Broadly speaking, we believe default rates are likely to remain muted as the economy recovers, while corporate and consumer behavior continue to be conservative. We prefer higher-quality (B to BB) issues and vigilance on security selection at this stage of the credit cycle. With energy-related issues, investors should remain selective.
Emerging Market Bonds	Underweight	We remain underweight as the Fed's rate-hike cycle will likely be a disproportionate headwind for emerging market (EM) debt. Much like EM equities, EM debt exposure should be selective. For investors who want to own EM debt, the GIC recommends US-dollar-denominated debt with a focus on China, India and Mexico.
Alternative Investments	Relative Weight Within Alternative Investments	
REITs	Underweight	With our expectation for rising interest rates, we believe REITs are now fairly to slightly overvalued, especially relative to other high-yielding asset categories. Therefore, we recently reduced our tactical asset allocation. Non-US REITs should be favored relative to domestic REITs at this point.
Commodities	Overweight	Most commodities have underperformed in the past few years, with energy leading the charge lower. We believe commodities are likely to perform better for the remainder of 2015 as global growth reaccelerates and the oil market comes into better supply/demand balance.
Master Limited Partnerships*	Equal Weight	Master limited partnerships (MLPs) have been devastated during 2015 due to collapsing oil prices and a less hospitable financing market. We expect tax-loss selling to weigh on MLPs into the fourth quarter but think MLPs should rally as oil prices and financing markets stabilize. That will likely be a rally to sell.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset category can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform when traditional asset categories are challenged by growth scares and/or interest rate volatility spikes. Within this asset category, we favor event-driven strategies, given our expectation for increased mergers-and-acquisitions activity.

Source: Morgan Stanley Wealth Management GIC as of Sept. 30, 2015

***For more information about the risks to Master Limited Partnerships (MLPs) and Duration, please see the Risk Considerations section beginning on page 17 of this report.**

Index Definitions

ALERIAN MLP INDEX This is a composite of the 50 most prominent energy master limited partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated in real time on a price-return basis and on a total-return basis.

BARCLAYS MUNICIPAL BOND INDEX This is a rules-based market-value-weighted index engineered for the long-term tax-exempt bond market.

CHICAGO FED ADJUSTED NATIONAL FINANCIAL CONDITIONS INDEX This is a weekly update on US financial conditions in money markets, debt and equity markets and the traditional and shadow banking systems. The adjustment isolates a component of financial conditions uncorrelated with economic conditions.

JAPAN ECONOMY WATCHERS SURVEY This survey tracks the general state of the economy as it relates to businesses. It can include broad economy-wide conditions or specific economic conditions of a particular industry.

MSCI ASIA PACIFIC EX JAPAN INDEX. This index captures large- and mid-cap representation across four of the five developed markets and eight emerging market countries in the Asia Pacific region.

MSCI EMERGING MARKETS INDEX This index captures large-, mid- and small-cap representation across 21 emerging market countries.

MSCI EUROPE INDEX This index has large-, mid- and small-cap representation across 16 developed market countries in Europe. With 1,372 constituents, the index covers approximately 99% of the free float-adjusted market capitalization of Europe's developed market countries.

PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX This is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households. The measure includes data pertaining to durables, nondurables and services.

PHILADELPHIA STOCK EXCHANGE SIG OIL EXPLORATION & PRODUCTION INDEX This is an equal-dollar-weighted index comprising 22 companies that own, lease and operate oil and gas facilities.

PHILADELPHIA STOCK EXCHANGE OIL SERVICES SECTOR INDEX This is a price-weighted index comprising 15 companies that provide oil drilling and production services, oil-field equipment, support services and geophysical/reservoir systems.

PURCHASING MANAGERS INDEXES (PMI) These economic indicators are derived mostly from monthly surveys of private-sector companies. The principal producers of PMIs are Markit Group, which conducts PMIs for more than 30 countries, and the Institute for Supply Management, which conducts PMIs for the US.

S&P 500 INDEX Regarded as the best single gauge of the US equities market, this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries in the US economy.

TOPIX (TOKYO STOCK EXCHANGE INDEX) This free-floated-adjusted index tracks all domestic companies of the exchange's First Section.

US BROAD TRADE-WEIGHTED DOLLAR INDEX Published weekly by the Federal Reserve Board, this index is a weighted average of the dollar's value against the currencies of 26 US trading partners.

Risk Considerations

MLPs

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Individual MLPs are publicly traded partnerships that have unique risks related to their structure. These include, but are not limited to, their reliance on the capital markets to fund growth, adverse ruling on the current tax treatment of distributions (typically mostly tax deferred), and commodity volume risk.

The potential tax benefits from investing in MLPs depend on their being treated as partnerships for federal income tax purposes and, if the MLP is deemed to be a corporation, then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value.

MLPs carry interest rate risk and may underperform in a rising interest rate environment. MLP funds accrue deferred income taxes for future tax liabilities associated with the portion of MLP distributions considered to be a tax-deferred return of capital and for any net operating gains as well as capital appreciation of its investments; this deferred tax liability is reflected in the daily NAV; and, as a result, the MLP fund's after-tax performance could differ significantly from the underlying assets even if the pre-tax performance is closely tracked.

Duration

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Alternative investments which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Ultrashort-term fixed income asset class is comprised of fixed income securities with high quality, very short maturities. They are therefore subject to the risks associated with debt securities such as credit and interest rate risk.

The majority of \$25 and \$1000 par **preferred securities** are “callable” meaning that the issuer may retire the securities at specific prices and dates prior to maturity. Interest/dividend payments on certain preferred issues may be deferred by the issuer for periods of up to 5 to 10 years, depending on the particular issue. The investor would still have income tax liability even though payments would not have been received. Price quoted is per \$25 or \$1,000 share, unless otherwise specified. Current yield is calculated by multiplying the coupon by par value divided by the market price.

The initial interest rate on a **floating-rate security** may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk.

The market value of **convertible bonds** and the underlying common stock(s) will fluctuate and after purchase may be worth more or less than original cost. If sold prior to maturity, investors may receive more or less than their original purchase price or maturity value, depending on market conditions. Callable bonds may be redeemed by the issuer prior to maturity. Additional call features may exist that could affect yield.

Some \$25 or \$1000 par **preferred securities** are QDI (Qualified Dividend Income) eligible. Information on QDI eligibility is obtained from third party sources. The dividend income on QDI eligible preferreds qualifies for a reduced tax rate. Many traditional ‘dividend paying’ perpetual preferred securities (traditional preferreds with no maturity date) are QDI eligible. In order to qualify for the preferential tax treatment all qualifying preferred securities must be held by investors for a minimum period – 91 days during a 180 day window period, beginning 90 days before the ex-dividend date.

Asset-backed securities generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Companies paying **dividends** can reduce or cut payouts at any time.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Stocks of medium-sized companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The **indices selected by Morgan Stanley Wealth Management** to measure performance are representative of broad asset classes. Morgan Stanley Smith Barney LLC retains the right to change representative indices at any time.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. These risks are magnified in **frontier markets**.

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Credit ratings are subject to change.

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