Basis Points

Fixed Income Strategy

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The statistics listed below are as of August 5, 2014:

Fed Funds Target Rate	zero to 0.25%
Year-Over-Year Change in CPI	2.1%
GDP (2Q 2014)	4.0%
DXY Index	81.60
Unemployment Rate	6.2%

Source: Morgan Stanley Wealth Management Fixed Income Strategy, Bureau of Labor Statistics, Bureau of Economic Analysis

Upcoming Federal Open Market Committee Meetings (FOMC):

- Sep 16 and 17
- Oct 28 and 29

Source: Federal Reserve Board

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

Don't Look Back

- Economic activity did snap back from the weak first quarter showing, with Q2 real GDP rising by 4.0%. Morgan Stanley & Co. (MS & Co.) economists look for growth to be more consistent in the second half of the year, starting with their Q3 tracking estimate of +2.2%, or more in line with the trend. Labor market activity continues to improve, but wage pressures are seemingly non-existent.
- Flight-to-quality issues gave Treasuries a boost through the second half of July. The broader market's reaction to the July jobs report underscores how the 'bar has been raised' on upcoming economic data to push yields higher.
- The Fed has become more data dependent as employment and inflation numbers have come closer to their dual mandate. The lack of wage growth should play a key role in the decision-making process going forward, and without improvement, 'lift-off' may have to wait. We do not expect the Fed to raise rates until 2H15.
- *Taxable Fixed Income:* US IG spreads were relatively resilient over the last month, while a visible sell-off occurred in the HY space. HY spreads are now at their widest readings since mid-winter.
- *Municipals:* The broader municipal market continued to remain steadfast even in the wake of negative headlines, especially with respect Puerto Rico. Our municipal strategists continue to advocate caution in the municipal high yield arena due to Puerto Rico's credit challenges and the potential for fund outflows.

Please note that *Basis Points* is being retired. This will be the last edition of this report.

Fixed Income Asset Allocation

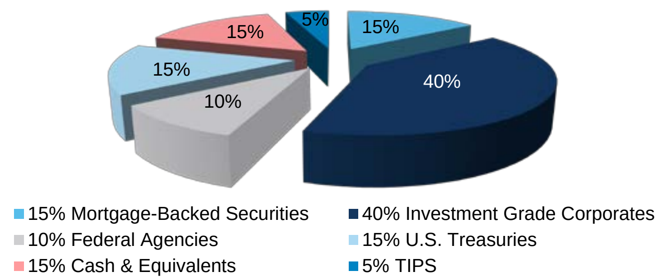
Last month within our Municipal Model, we reduced our weighting to High Yield, bringing the allocation to a low of 5%. While the broader municipal market has been resilient of late, the situation in Puerto Rico and potential subsequent impacts highlight how challenges still remain.

Fixed Income Model weightings:

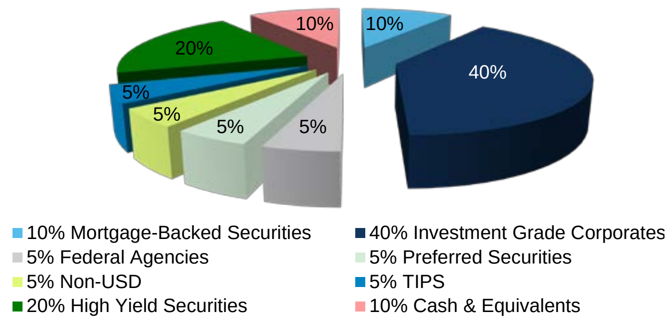
- **Conservative Model:** IG Corps 40%; US Treasuries 15%; gov't/agency MBS 15%
- **Moderate Model:** IG Corps 40%; HY 20%; gov't/agency MBS 10%
- **Aggressive Model:** IG Corps 45%; HY 25%; gov't/agency MBS 10%
- **Municipal Model:** Core Municipal 35%; Intermediate Duration 30%; High Yield 5%

Fixed Income Models

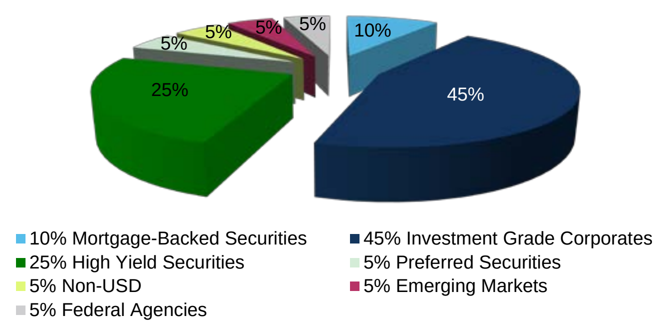
Conservative Model



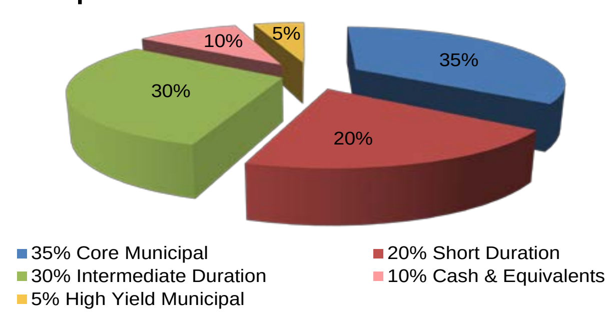
Moderate Model



Aggressive Model



Municipal Model



Source: Morgan Stanley Wealth Management Fixed Income Strategy

Investment Backdrop

Don't Look Back

The recent spate of economic data received over the last week or so confirmed the widely held belief that the surprisingly weak economic performance during the first quarter was a short-lived phenomenon, and that growth would rebound in the April/June period. According to the Bureau of Economic Analysis, Q1 real GDP fell a revised -2.1% and was followed by a robust +4.0% reading in Q2. As the reader will recall, the money and bond markets had waited a long time for this validation, so perhaps it's safe to say, we can put the first half of 2014 behind us and look toward the remaining six months of the year as guidance. In other words, don't look back.

It appears as if 2H is shaping up to be somewhat similar to the recent trendline. From 2010 through 2013, the economy expanded at an average pace of +2.2%, or identical to MS & Co.'s tracking estimate for Q3 of this year. For every step forward we see on the labor market front and in manufacturing activity, the US economy has now taken a step back in the areas of housing and construction. Thus, even though there can be significant quarterly fluctuations (see 1H14), investors get stuck looking at growth mired in the +2.0% to + 2.5% range, with no evidence of change on the horizon.

This is the scenario facing the Fed for the rest of this year and into 2015. At their recently concluded July FOMC meeting, the Fed did not necessarily send any new signals, but it appears as if they were finally forced to recognize the progress that has been made in achieving their dual mandates. The employment aspect had received the lion's share of the attention, but the policymakers also addressed the inflation side of the equation, albeit grudgingly it would appear.

Going forward, though, there seems to be little doubt that Fed Chair Yellen's laser-like focus is going to be on the degree of slack that remains in the labor market. The June Employment Cost Index (ECI) report helped to re-establish the prior trend following the surprising slowdown in Q1, but despite another solid gain in total nonfarm payrolls, wage growth is definitely lagging. According to the latest read from the Bureau of Labor Statistics, average hourly earnings grew at only a +2.0% annual rate in July, or essentially the same pace that has been witnessed since mid-2009. The lack of wage growth should play a key role in the Fed's decision-making process going forward, and without improvement, 'lift-off' may have to wait. We do not expect the Fed to raise rates until 2H15.

UST Market

Against the current backdrop, the UST 10-yr yield has continued to reside at the lower end of our preferred trading range. In fact, flight-to-quality buying resulting from the Malaysian airliner incident in Ukraine, Middle East fighting in Gaza as well as Argentinian default headlines, during the second half of July has, at times, placed the 10-yr yield a few bp below our lower boundary. The UST market reaction to the July jobs report proved instructive. Despite another solid showing for total nonfarm payrolls (+209,000 and 6th straight reading above +200,000), yields actually fell as the remainder of the report did not live up to expectations. In other words, the 'bar has been raised' to push yields higher from an economic vantage point.

One could definitely argue that a degree of complacency has entered into the equation as well. This point was underscored by the negative reaction following the stronger-than-expected showings by the GDP and ECI reports as July was coming to a close. Nevertheless, in order for an upward trajectory for the 10-yr yield to be sustainable, the market is going to need more consistency on the data front, rather than what was witnessed during the first half of the year. Our broader operating range for the UST 10-yr yield remains 2.50%-3.25%.

Fixed Income Sector Commentary

Investment Grade

Investment Grade credit has benefited from both the "up-in-quality" trade over the past month and the rally in long-end rates. The spread on the Citi BIG Corporate Index is only 5bp wider from the low of 96bp hit in late June while the yield on the index is unchanged. The Treasury yield curve bull flattened (long rates rallied more than short rates), which added to the total return of IG credit given its long duration profile. IG credit has been remarkably stable since the middle of March, trading within a very tight 10bp range. We expect this range bound pattern will persist, barring a sudden rise in interest rates. Yet, at current spread levels investors have little cushion to offset the negative effect of rising rates which will eat into total returns.

So how do you play IG at the current stage of this cycle? We believe picking the right maturities and sectors that might benefit from rising rates and inflation will be key ingredients to investors outperforming the broader market over the next 6-12 months.

We continue to see value in the 3-7 year maturity bucket, as it has a shorter-duration profile than the overall market and will likely be less sensitive to investor flows versus very short maturities. We also believe investors should be looking to add duration as rates rise toward 3% on the 10-year, based on our view that the yield curve will "bear flatten" (short rates rising further than long rates) as we move toward the first Fed rate hikes.

From a sector perspective, inflation can eat into corporate margins unless companies can feed rising input costs through to their end markets. Food & Beverage, Base Metal Mining companies and

Energy companies all generally fit into this category. Financials can also benefit from rising rates as higher yields expand their net interest margins.

High Yield Credit

It has been a volatile month for High Yield (HY) investors. The Citi High Yield Market Index hit a post-crisis low in spread terms of 361bp on June 23; it also hit an all-time low yield of 4.90%. However, the good times could not be sustained. Spreads have widened 90bp and the yield on the index is higher by more than 1%. From a total return perspective the index has lost 1.96% in that period and is now trailing IG credit in year-to-date return by more than 230bp.

The sell-off has been painful, but in our opinion it is more likely investors have been taking profits and perhaps setting money aside for new issues once the blackout period around earnings season ends. Another factor which probably didn't help was the market has been trading at a dollar price above the average call price of the market, which limits price upside. The price of the index is now 102.57 a full point and a half below the average call price. Finally, the length and depth of this sell-off is not that severe relative to other periods of weakness since last summer. We have seen six periods where spreads have widened since May of last year, this one is the second biggest in spread terms and dollar price, and although it may not be done yet it also the second longest. However, with the dollar price well below the average call price, and spreads on the index firmly above 400bp, valuations are slightly more attractive and we believe investors will start looking to put money back to work in HY over the coming weeks.

The late innings of the credit cycle are essentially clipping-your-coupon innings. Price upside appears limited for the broader market, but can be found in individual issues, and investors are getting a higher income stream than IG can offer. However, it should be noted that when the cycle turns it can happen very quickly, as it did in late '01 and late '07.

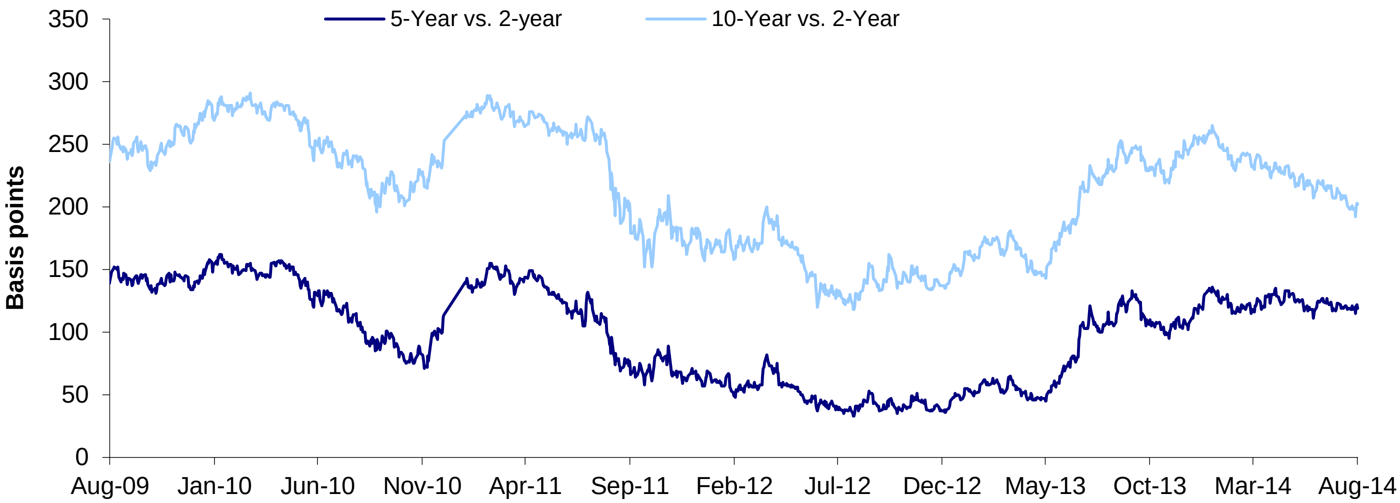
Emerging Markets

There have been two big stories in emerging markets (EM) credit over the past two months, one is obviously the situation in Ukraine/Russia, but the other is the remarkable resilience of EM spreads. Outside of widening in Russia, other major EM countries have either rallied or traded sideways. This could just be money moving out of Russia and into other credits, but it also goes to show how the benign backdrop of lower rates in the US and lower market volatility has allowed EM credits to continue rallying despite weaker growth and in some countries higher inflation.

Outside of geopolitical tensions, the benign rate backdrop in the US is unlikely to last for long and as such, the vulnerabilities remain high for EM economies.

Fixed Income Snapshots: Treasuries and Municipals

U.S. Treasury Yield Curve (2s/5s: 2s/10s)



Source: Morgan Stanley Wealth Management Fixed Income Strategy, Bloomberg. Data as of 8/1/2014.

Differential in yields between U.S. Treasury 10-year maturity and U.S. Treasury 2-year maturity, and differential in yields between U.S. Treasury 5-year maturity and U.S. Treasury 2-year maturity.

10-Year Municipal Yield to Treasury Ratio

Source: Municipal Market Data (MMD), Bloomberg. Data as of 8/1/2014.

The 10-year AAA municipal bond yield as a percentage of the benchmark 10-year U.S. Treasury note yield. The 10-year AAA municipal index, which is derived from MMD's daily generic yield curves, represents the average yield of non-insured AAA-rated State G.O. bonds and reflects the offer-side of the market determined from trading activity and markets. The benchmark 10-year U.S. Treasury yield is the yield of the most recently auctioned 10-year Treasury note reported on a daily basis (as of the prior day's close).

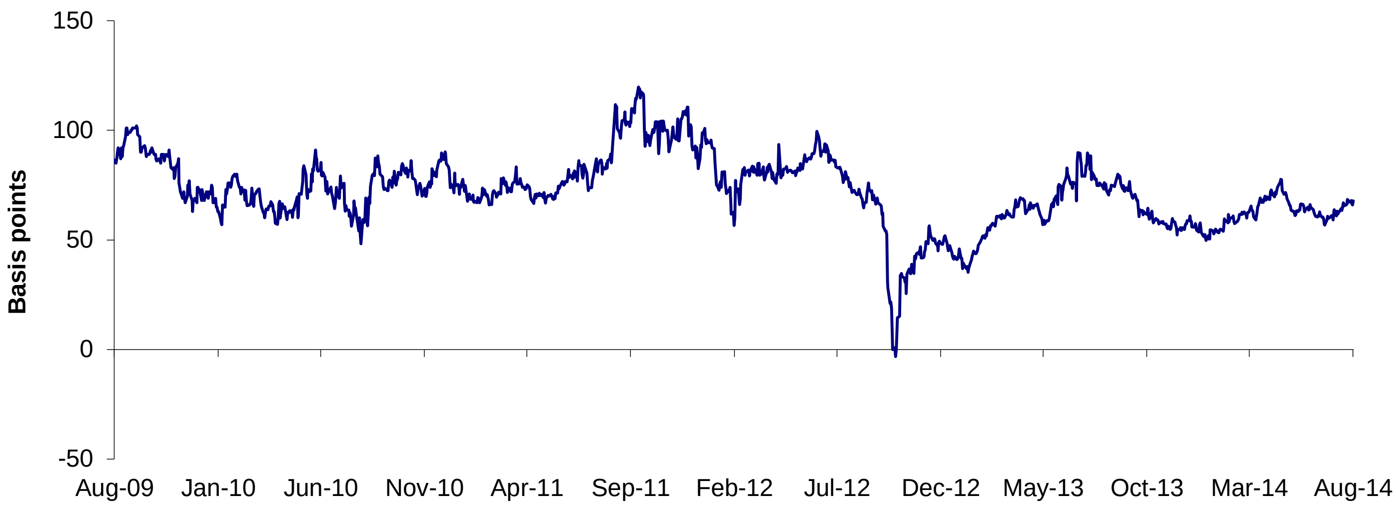
Fixed Income Snapshots: Agencies and Mortgage-Backed Securities

5-Year Federal Agencies Spread to Treasuries

Source: Morgan Stanley Wealth Management Fixed Income Strategy, Bloomberg. Data as of 8/1/2014.

Fair Market Value U.S. Government Federal Agency spreads to Fair Market Value U.S. Treasuries for 5-year maturities. Federal Agency and Treasury indices shown are derived from Bloomberg's Option Free Fair Market Yield Curves, which provide the composite yield of all outstanding securities around each maturity point. For example, the Federal Agency 5-year includes all outstanding Federal Agency securities maturing in 2019.

30-Year Fannie Mae MBS Current Coupon Spread to 10-Year Treasuries



Source: Morgan Stanley Wealth Management Fixed Income Strategy, Bloomberg. Data as of 8/1/2014.

Fair Market Value 30-year FNMA MBS Current Coupon spread to Fair Market Value 10-year Treasuries. Due to risks of MBS structure (e.g., prepayments and extension risk), the 10-year Treasury is used as the benchmark for the 30-year FNMA maturity. The MBS and Treasury indices shown are derived from Bloomberg's Option Free Fair Market Yield Curves. The 30-year FNMA MBS index represents the composite yield of all outstanding FNMA MBS current coupon securities maturing in 2044, while the 10-year Treasury index represents the composite yield of all outstanding Treasury notes maturing in 2024.

Fixed Income Snapshots: Investment Grade and High Yield Corporates

Investment Grade Corporate Index to Treasuries

Source: Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved. Data as of 8/1/2014.

The Citi US BIG Corporate Index is designed to track the performance of US dollar-denominated US and non-US corporate bonds. It excludes US government guaranteed and non-US sovereign and provincial securities. Bonds must have a fixed coupon, a minimum of one year to maturity and be rated a minimum of BBB-/Baa3 by both S&P and Moody's.

High Yield Corporate Index to Treasuries

Source: Analytics Provided by The Yield Book® Software and Services. © 2014 Citigroup Index LLC. All rights reserved. Data as of 8/1/2014.

The Citi High Yield Market Index is designed to capture the performance of below investment grade debt issued by corporates domiciled in the United States or Canada. Bonds must have a fixed coupon, a minimum of one year to maturity and be rated a maximum of BB+/Ba1 by both S&P and Moody's.

Fixed Income Risk Considerations

Call Risk - Some securities may be callable. If the security is called, the investor bears the risk of reinvesting the proceeds at a lower rate of return.

Credit Risk - The risk that the issuer might be unable to pay interest and/or principal on a timely basis. Widely recognized rating agencies, such as Moody's Investor Services and Standard & Poor’s, offer their assessment of an issuer’s creditworthiness. U.S. Treasury securities are considered the “safest” investment as they are backed by the “full faith and credit” of the U.S. Government. On the other end of the scale, high yield corporate bonds are considered to have the greatest credit risk.

Duration Risk - 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.

Interest Rate Risk - The risk that the market value of securities might rise or fall, primarily due to changes in prevailing interest rates. All fixed income securities are susceptible to fluctuations in interest rates; generally, if interest rates rise, bond prices will fall, and vice versa.

Prepayment Risk - In a CMO or MBS, the risk that an investor's principal will be returned sooner than originally expected, due to principal prepayments made by homeowners on the underlying mortgage loans.

Reinvestment Risk - The risk that the income stream from the investment may be reinvested at a lower interest rate. This risk is especially evident during periods of falling interest rates where coupon payments are reinvested at a lower rate than the current instrument.

Secondary Market Risk - While a secondary market exists for most fixed income securities, there is no guarantee that a secondary market will exist for a particular fixed income security. Furthermore, if a security is sold prior to maturity, the price received may be more or less than face value, or the amount of the original investment.

Index data is based on index total return - Fixed income securities, including municipal bonds, are subject to certain risks including interest rate risk, credit risk, reinvestment and valuation risks. The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Information provided herein has been obtained from outside sources that are deemed to be reliable. However, Morgan Stanley Wealth Management has not independently verified them and we make no guarantees, express or implied, as to their accuracy or completeness or as to whether they are current. Past performance is not a guarantee of future performance. The indices are unmanaged and are shown for illustrative purposes only and do not represent the performance of any specific investment. Investors cannot invest directly in an index.

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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.

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.

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 Wealth Management retains the right to change representative indices at any time.

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 rate on a **floating rate or index-linked preferred 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/linked index. However, there can be no assurance that these increases will occur.

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.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum amount of $250,000 (including principal and interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account) per CD depository, through December 31, 2013. On January 1, 2014, the maximum insurable amount will return to $100,000 (including principal and interest) for all insurable capacities except IRAs and certain self-directed retirement accounts, which will remain at $250,000 per depository. Investors are responsible for monitoring the total amount held with each CD depository. All deposits at a single depository held in the same insurable capacity will be aggregated for purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository held through Morgan Stanley Smith Barney. A secondary market in CDs may be limited. CDs sold prior to maturity are subject to market risk and therefore investors may receive more or less than the amount invested or the face value. Callable CDs are callable at the sole discretion of the issuer. For more information about FDIC insurance, please visit the FDIC website at www.fdic.gov.

Contingent return (e.g. index-linked) CDs are treated as having original issue discount (OID) for tax purposes. Although interest is not received until maturity, the CD is assumed to pay a pre-determined interest rate that will be treated as current income for tax purposes if held in a taxable account. Investors should be made aware that contingent return CDs generally feature an "averaging" method of return calculation, which averages the changes in value of the relevant index as measured on predetermined dates over the life of the CD. Therefore, the CD's return will not mirror the actual index value or return. If the measured index return using the averaging method is zero or negative, the investor receives no interest. Some contingent return CDs also have a participation rate (the degree to which an investor participates in the measured return of the index) that is less than 100%. Interest on contingent return CDs is not eligible for FDIC insurance before the final valuation date.

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

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

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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