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WEALTH MANAGEMENT

INVESTMENT STRATEGY

Global Investment Committee | September 2020

On the Markets

Weak Market Breadth to Be Resolved

Michael Wilson
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In late August, the S&P 500 Index struck *all-time highs* six days in a row. While this may seem inconsistent with the state of the economy, high unemployment and new cases of COVID-19, markets are forward-looking and the stock market is telling us the future is bright. I agree with this view, and believe that a new bull market began with the onset of the current recession. That is typical, even if it's hard to process. Bull markets are born from despair and often climb a wall of worry for years as more people find reasons to jump aboard. Based on the size and speed of this rally, the market seems to be confirming our view for a V-shaped economic recovery. We see no reason to doubt it.

Even so, one near-term concern is the market's recent extreme narrowness. To wit, the median S&P 500 stock is down 12% from its high, and nearly a third of the stocks are down more than 25% from their highs (see page 12). This suggests we are ripe for the first meaningful correction in this new bull market. The question is—what reason(s) will be used to justify it so it can gain momentum and last for more than a few days?

First, several universities have decided to backtrack on in-person learning due to outbreaks of COVID-19 as students returned to campus. Other schools followed with decisions to move fully online rather than risk outbreaks of their own. Remember, the biggest economic damage from this pandemic was from the lockdown rather than the virus itself. Second, Congress remains gridlocked over the next round of fiscal stimulus. Without it, the recovery will likely falter, which is why we think there is little chance Congress will fail to execute stimulus, especially in an election year. However, that doesn't mean we won't see some moments of doubt and uncertainty in the markets about the size and timing of the next package.

Of course, the other way the divergence between narrow breadth and all-time highs for stocks could be resolved is that breadth improves. In this scenario, the overall market correction never arrives but instead trades flat while the laggards catch up. Therefore, we continue to recommend investors maintain a barbell of COVID-19 performers (growth stocks) and cyclicals (value stocks) that will do better as the economy continues to recover. If our view on a V-shaped recovery is right, then the cyclicals should perform best. This includes small- and mid-cap consumer cyclicals and services, materials, financials and industrials. ■

TABLE OF CONTENTS

2 **You Have More Duration Than You Think**
Historically low interest rates have created duration risk both in stocks and bonds.

4 **Cognitive Dissonance in Treasuries**
The Fed's heavy hand may have undercut the US Treasury market's role as a harbinger of economic fundamentals.

6 **The Next FAANGs for the Next Cycle**
We've identified smaller companies that share the FAANGs' competitive dynamics.

7 **Housing Boom Shows No Signs of Letup**
It took a while for the builders' stocks to catch up with industry fundamentals, but now they're racing ahead.

8 **Investing for a Multipolar World**
The US and China are disassociating in key economic areas, with Europe facing a difficult balancing act.

10 **Investment Implications of the Shift to a Multipolar World**
Economic cycles and financial market trends are becoming less US-centric and more multipolar in nature.

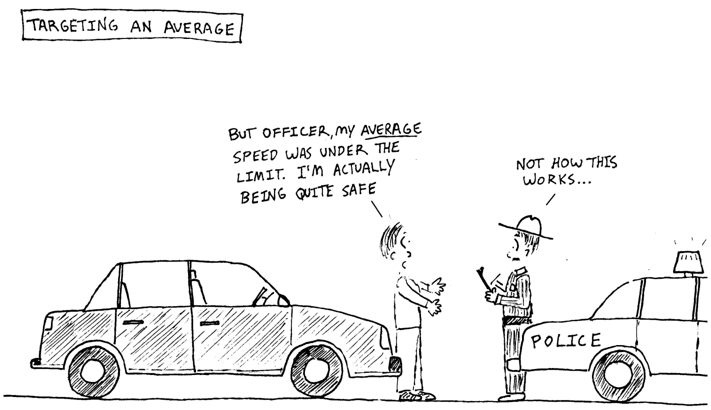
12 **Short Takes**
We see a tilt toward large-cap stocks in earnings estimates, look "under the hood" of the S&P 500's stock-by-stock performance and find reason that the laggard European stock market can finally outperform.

13 **Is Gold Still a Buy?**
Max Belmont of the First Eagle Global Value team talks with Morgan Stanley Wealth Management Market Strategist Vijay Chandar about whether gold makes sense as a portfolio holding.

CROSS-ASSET STRATEGY

You Have More Duration Than You Think

Andrew Sheets, Chief Cross-Asset Strategist, Morgan Stanley & Co.



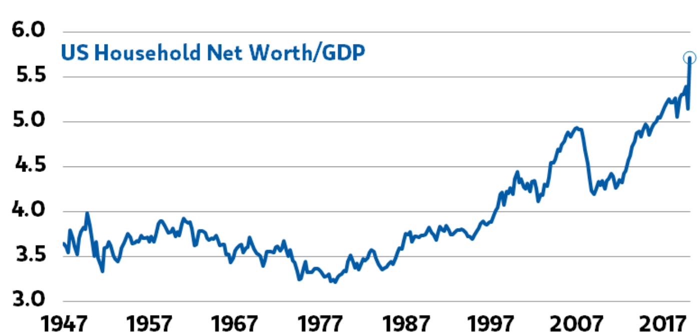
Source: Andrew Sheets, Morgan Stanley Research

This year we have seen a pandemic inflict enormous human and economic suffering. In the second quarter, the global economy contracted by the largest amount on record and, as autumn approaches, major questions around returning to school, work and other aspects of daily life remain.

For investors, 2020 has been something different. For the year to date, the value of the global equity market is broadly unchanged. The value of the global bond market is significantly higher, and home prices in many markets have risen. Indeed, an uncomfortable aspect of 2020 is that this terrible year has generally meant gains for asset owners. US household wealth/GDP hit a record high (see chart).

ECONOMIC RECOVERY. Many factors are behind this. The global economy is improving, in line with the V-shaped recovery thesis of Morgan Stanley & Co.'s economists,

US Household Net Worth Relative to GDP Hit an All-Time High This Year



Source: Morgan Stanley Research as of Aug. 9, 2020

and initial progress on a COVID-19 vaccine has been promising, lowering the probability of a larger, more permanent shock.

While both fiscal and monetary policy have been aggressive, with trillions spent in an attempt to offset the impact of the coronavirus, another driver has been a classic case of "having your cake and eating it, too." Global bond yields have remained near historical lows, even as global purchasing manager indexes have moved back above 50—a sign of economic expansion.

This matters: Global investors have historically high exposure to duration, a measure of bond risk that quantifies the effect of changes in interest rates on a bond or a bond portfolio. Critically, the higher the duration, the more sensitive the bond (or portfolio) is to changes in interest rates.

GLOBAL BONDS. Let's start with fixed income. First, the total amount of bonds owned by investors has grown. Using the Bloomberg Barclays Global Aggregate Bond Index as a proxy, the market value of the global bond market has risen 27% in just the past two years (see chart, page 3). Not only are there more bonds, but these bonds are longer in duration. Over the same two-year period, the duration of the global bond market has increased by roughly 5% to a record high, as both corporates and governments have taken advantage of low yields to extend maturities. This increase in duration has happened in a time of extremely high mortgage prepayment speeds; if those were to slow, global duration would increase further.

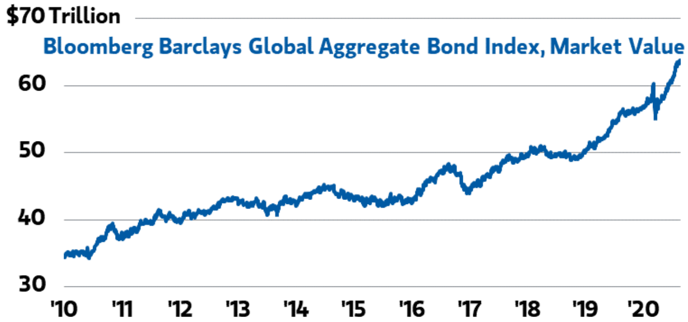
Since every bond is owned by someone, a larger, longer-duration market has meant strong returns from doing nothing more than holding the bond index—but this isn't just a story about bonds. It applies to equities, too.

REAL RATE CORRELATION. For the year to date, consumer discretionary stocks have had the highest correlation to US real rates—real yields lower, stocks higher—with the technology sector close behind. What do both sectors also have in common? They're getting larger.

At the start of 2019, these two sectors represented 24% of the global equity market. Today, it's 30%. Globally, investors hold $8.1 trillion more of these yield-sensitive sectors than they did only 18 months ago. This isn't just a US phenomenon; my colleague Jonathan Garner, Morgan Stanley & Co.'s chief Asia and emerging market equity strategist, notes that emerging market equities have also become much more tech-heavy in recent years.

All that's assuming one follows the benchmark. Our data suggests that these two sectors are popular and well-owned. Even if most investors are buying these stocks for their business models, rather than their sensitivity to interest rates, the attribute remains.

Value of Global Bonds Up 27% in the Past Two Years



Source: Bloomberg as of Aug. 26, 2020

LOOKING FOR DIVERSIFIERS. As yields have fallen and uncertainty abounds, investors have looked elsewhere for diversification. They have flocked to precious metals as "new diversifiers," but here, too, yield sensitivity looms. Rather than being a hedge, gold and silver may simply be another expression of an investor's exposure to real rates.

With the Federal Reserve suggesting it will shift its framework to be more dovish in the face of inflation, and recent data surprising to the upside, it's possible that the extreme levels of real rates persist for a little while longer. Indeed, my colleague Guneet Dhingra, MS & Co.'s head of US interest rates strategy, sees value in five-year US TIPS and expects real rates to fall further in the near term.

RATE EXPOSURE. It's important to take stock of just how much serendipity has been at work. From a growing bond market that's been extending in duration, to a global equity market where lower real yield winners have gained share, investors have become more exposed to rates even if they've taken no such action. This sensitivity is occurring at the richest levels ever recorded for these yields. This is one reason why my US colleagues have downgraded software—a sector with very high valuations and interest rate sensitivity—from overweight. For central banks, this dynamic should highlight the dangers of overcooking markets that are already doing quite well.

To be clear, we think that overall equity and credit markets can weather a modest rise in yields if they are driven by better data. Risk assets have frequently been happy to trade a better growth outlook for a higher discount rate, and we saw this pattern early last month when global purchasing managers' indexes surprised to the upside.

Still, the rise in duration across asset classes, at its most expensive levels on record, suggests that the transition won't be smooth. Whether one is an active or passive investor, this is a good time to evaluate your overall duration exposure. ■

FIXED INCOME

Cognitive Dissonance in Treasuries

Lisa Shalett, Chief Investment Officer and Head of Wealth Management Investment Resources, Morgan Stanley Wealth Management

The longest-ever US Treasury bull market is well into its fourth decade, a run that took the yield on 10-year bond down to 0.7% today from nearly 16% in 1981 (see chart below). Despite this megatrend of falling inflation expectations, lower realized inflation, and smaller nominal and real rates, most of the time the Treasury market acted as a rational arbiter of economic fortunes. In fact, when stock markets and bond markets disagreed, the bond market never seemed to get it wrong. When economic prospects were rosy and stocks were soaring, Treasury prices would fall and yields would go up, validating the "reflationary" view. When economic prospects dimmed and stocks fell, Treasury prices would appreciate, pushing yields down to signal weaker growth ahead. Portfolio diversification with a balanced mix of stocks and Treasuries was effective. Importantly, for most of the bull market in Treasuries, the 10-year Treasury real yield ranged between 0.5% and 3.5%, largely in the neighborhood of the economy's long-run growth potential.

A Long Bull Market in Bonds Drove Interest Rates Down Below 1%

Source: Bloomberg as of Aug. 24, 2020

Now, the Treasury market is behaving differently. Quantitative Easing, the policy tool of choice since the financial crisis, diluted correlations between Treasuries and the economy as the forceful hand of central bankers assumed an increasingly important role. In fact, we note that from 2008 to late 2013, the 10-year real yield plummeted to -40 basis points before rebounding to nearly 1% by late 2018. Even though correlations between stocks and Treasuries became positive, the 10-year real yield still effectively telegraphed the likely direction of important economic gauges such as the ISM Manufacturing Index. Now, this critical relationship appears broken as the 10-year real yield hit an all-time low of -100 basis points while the ISM rebounded strongly (see chart). This is not about one data point. The V-shaped recovery thesis has been broadly supported across manufacturing, services and even employment data, with the Citi US Economic Surprise Index sitting near all-time highs.

Real Yields Have Decoupled From Fundamentals

Source: Bloomberg as of Aug. 5, 2020

WHAT'S GOING ON? Why would the Treasury market reject the reflationary thesis embedded in the ISM manufacturing report while global stocks, credit, currencies and commodities are following the data? Does the bond market know something the rest of us don't? While many long-time bond bulls cling to the traditional thesis that falling Treasury yields indicate skepticism about the durability of the current rally, this time the Global Investment Committee is less convinced. In fact, with the nominal 10-year US Treasury rate now at only 50 basis points and the real rate at -100 basis points, we may have reached a point where policy distortions render the Treasury market useless as a harbinger of economic fundamentals. We think rates are this low because that is where policymakers want them to be, and not where they should be in pricing the economic recovery.

For starters, we believe that investors do not fully appreciate the role of liquidity in anchoring yields because they are using the financial crisis to gauge policy effectiveness. This is not a good comparison. During the crisis, the Federal Reserve balance sheet expanded by $3.6 trillion through four distinct QE programs over two and a half years. Monetary velocity plummeted, however, as banks held most of the new funds in reserve to shore up their balance sheets and clean up mortgage-related losses. Consumers were deleveraging, too. For comparison, between March and June of this year, the Fed balance sheet also expanded by $3.6 trillion—equal to more than 16% of annual US GDP.

SWIMMING IN LIQUIDITY. This time, M2 monetary growth is running at a 24% annual rate in large part because banks went into the COVID-19 lockdown with record levels of liquidity and capital-rich balance sheets. Despite high unemployment, consumers are swimming in liquidity thanks to government transfer payments. The household savings rate is a staggering 19% versus a normal 6%. Furthermore, this time Fed balance sheet expansion is not likely going to be as controlled as it was the last time. This time, fiscal spending is also skyrocketing, with COVID-19 programs likely to approach $5 trillion or $6 trillion when all is said and done. The Treasury will need to issue debt to finance that, and the Fed will undoubtedly monetize that debt in order to keep rates anchored. Thus, Treasury market purchases are huge and occurring in a concentrated time period, which distorts interest rates.

We also believe that the Fed has entered new territory in which the exhaustion of traditional tools like cutting the fed funds rate, which is already at the zero bound, is pushing policymakers to aggressive use of forward guidance. With the Fed having failed to deliver on the inflation mandate during the Ben Bernanke and Janet Yellen regimes, Fed Chair Jerome Powell has unequivocally doubled down. Fed policymakers have never been particularly good economic forecasters and, for much of the last cycle, markets outran Fed guidance. Recently, the Fed has proclaimed a commitment to forward guidance that is unprecedented in its duration, declaring to hold the fed funds rate at zero until December 2022. Many Fed observers, including the Morgan Stanley & Co. global rates team, expect the Fed to extend that through December 2023.

AGGRESSIVE GUIDANCE. Such aggressive action by the Fed has thus far proven potent and effective in averting the damage akin to the levels of economic shock and 14.5 million unemployed would imply. That said, as we have often noted, these policies come at a cost; beyond the much-discussed valuation bubbles in secular growth stocks, we see distortions in the Treasury market creating other risks. First, extremely low rates are encouraging risk-taking in the credit market and releveraging of corporate balance sheets. Already, option-adjusted spreads are back to 130 basis points in investment grade and 480 basis points in high yield, retracing more than three quarters of their precrisis levels. What's more, annual default rates are likely to be at a decade high, and bankruptcies are already there even though it's only August. Second, the collapse in real yields drives the rapid appreciation of commodities and the depreciation of the US dollar while encouraging speculative behavior such as trading cryptocurrencies. Artificially low interest rates also fuel the rise in "SPACs," or special blank-check acquisition companies. SPACs are a sort of fast-track initial public offering in which the company issuing stock plans to acquire but does not yet own a business.

All told, stocks, credit, commodities and currencies reflect the reflationary view, but not US Treasuries, where real yields are falling and nominal yields are anchored at all-time lows. We attribute the anomaly to the sheer distortive power of monetary policy, not to a harbinger of economic distress. Recognizing that long-term Treasury yields are no longer as useful as they once were in driving asset class valuations will be key to managing portfolio risk in the next year. Consider reducing exposure to long-duration Treasuries. We prefer intermediate-duration municipals for fixed income yield and capital preservation. ■

EQUITIES

The Next FAANGs for the Next Cycle

Denny Galindo, CFA, Investment Strategist, Morgan Stanley Wealth Management

The winners of one bull market aren't typically the same as the winners of the next bull market, as tech investors from the late 1990s and investors in banks and housing during the 2000s will painfully attest. If the FAANGs—an acronym for five popular and successful consumer-oriented technology companies—were the poster child for the 2010s bull market, it seems unlikely they would all perform well in the next bull market. As the S&P 500' Index's March 23 low is looking more and more likely to hold as the bear market bottom, it is time to consider which companies will lead the next cycle.

COMPETITIVE DYNAMICS. In May 2019, we identifed a new generation of potential FAANGs—companies that shared the competitive dynamics of the originals, such as leading share in large, fast-growing markets with network effects, economies of scale and recurring revenue trading at reasonable valuations. We highlighted 25 companies, and updated the report in July (See *Equity Model Portfolio Solutions,* "Special Report: Who Will Be the Next FAANGs?" July 22, 2020).

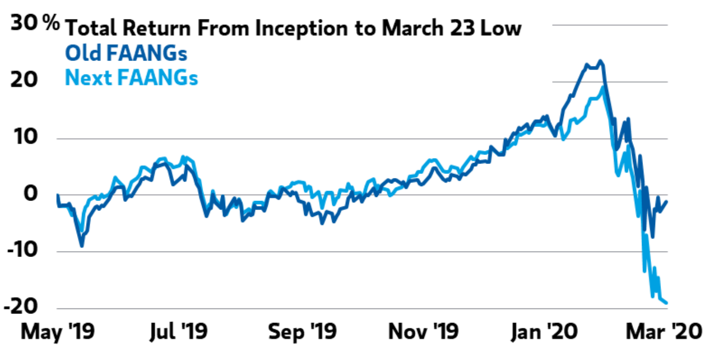
First, the original FAANGs still posted outstanding returns. They have returned 63% since May 21, 2019, beating both the Russell 1000 Growth Index and the average return of the Next FAANGS. They outperformed when the market was rallying into the February 2020 highs and as it was falling into the March 23 low (see chart, bottom left). Since then, the Next FAANGs have outperformed the old FAANGs by 10 percentage points (see chart, bottom right). While this could be a fluke over such a short horizon, the shift could also indicate that the original FAANGs have grown so large it is becoming harder for them to outperform. Three of the five FAANGs have market capitalizations in excess of $1 trillion, and the cheapest of them trades at 25 times consensus earnings for the 2021 fiscal year.

COMMON ATTRIBUTES. What do the Next FAANGs look like? After examining the FAANGs as they were in early 2013, we found nine common characteristics. There were exceptions but, in general, the original FAANGs had: (1) market capitalizations under $115 billion; (2) consensus revenue growth estimates greater than 10%; (3) price/earnings-to-growth ratios of less than 2; (4) leading market share; (5) a large, addressable market; (6) economies of scale; (7) the benefits of network effects; (8) recurring revenue; and (9) a focus on consumers.

Now, given the need for companies to increase productivity, we believe that the next FAANGs should have the first eight characteristics and a business-to-business instead of a consumer focus. After reviewing companies rated overweight or equal weight by Morgan Stanley & Co. Research, we identified 25 stocks that meet most of these criteria. The key to the next FAANGs is in network effects—the tendency of an additional user of a good or service to increase the value of that product for all other customers.

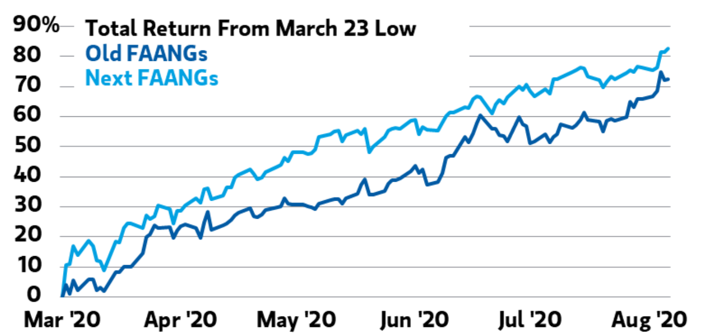
HEADROOM. The 24 stocks remaining on the Next FAANGs list (one was acquired) had an average market cap of $55 billion at the time of our one-year update. Growth stocks with smaller market caps have more room to grow for several years. Each benefits from network effects that give them pricing power as they grow, as long as they can continue to maintain their leading share. As a new cycle is starting, it's important to identify a new set of "FAANGs" to lead the way into the 2020s. ■

The Old FAANGs Still Ruled After We Identified the Next FAANGs ...



Source: Bloomberg, Morgan Stanley Wealth Management as of Aug. 28, 2020

... But Since the Bear Market Bottom, the Next FAANGs Have Outperformed



Source: Bloomberg, Morgan Stanley Wealth Management as of Aug. 28, 2020

EQUITIES

Housing Boom Shows No Signs of Letup

Nick Lentini, Associate, Morgan Stanley Wealth Management

Chris Baxter, Investment Strategist, Morgan Stanley Wealth Management

Vibhor Dave, CFA, Investment Strategist, Morgan Stanley Wealth Management

With people spending more time at home than ever before, it's no surprise that US homebuilders have benefitted. Google Trends reveals a nearly tenfold increase in searches around the "home buying process," and a 28-fold increase for queries about "funding a house through a 401(k)." Investor concerns that a disjointed reopening strategy and historically high unemployment rate will stall the recovery are not without merit, but recent strength in the housing market has provided a positive tailwind for operators in the homebuilding industry.

It took a while for the homebuilding stocks to catch up with industry fundamentals. They lagged behind the S&P 500 Index on a year-over-year basis through July, but have since outperformed. They now sit about 14% ahead of the broad index for the year to date, and the homebuilding sector is within 1% of its all-time high. It's natural to ask if the homebuilders' run is done for the cycle. For multiple reasons, we don't think so.

SUPPLY AND DEMAND. Of course, record-low mortgage rates near 3% have driven the demand for new homes, pushing the mortgage application rate to its highest level since 2009 (see first chart, right). Fueling this demand are apartment and city dwellers who are looking for more space and moving to suburban housing in light of the global pandemic. Robust demand is also reflected in new and pending home sales, with the latest reading showing a 12% year-over-year increase. The monthly new-home sales absorption rate, an indicator of how fast properties are selling, increased by 23% in June 2020—its highest level since 2016.

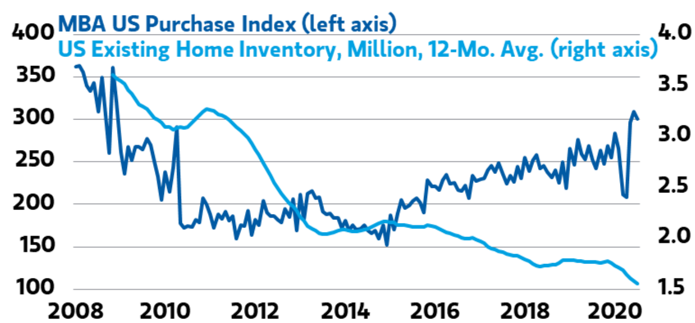
Data from Meyers Research, which provides research on the housing market, indicates that the increase in demand is widespread across the US, with 21 out of 25 markets posting year-over-year increases in the absorption rate. With demand surging, the inventory of existing homes for sale has been declining; the current level, 1.5 million available homes nationally, is at a multiyear low. With current supply unlikely to meet the expected demand, homebuilder optimism has been pushed to its highest level in three decades.

DEMOGRAPHIC TRENDS. The movement toward home ownership and away from renting has grown steadily in the past few years, but has been recently intensified by the "coronavirus escape" (see second chart, right). Importantly, demographic trends and better sentiment support an optimistic outlook on the industry. The latest home ownership rate saw the largest increase since 1966. This trend has been driven the most by individuals 35 years and under, often buying their starter home, and followed by the age 35-44 cohort, who are directly ahead of their peak earning years. With younger demographics fueling homeownership increases, this trend will likely increase pressure on housing demand in the coming years.

ATTRACTIVE FUNDAMENTALS. The case for homebuilding stocks is based on earnings and valuation. Earnings have recovered to within 5% of pre-COVID-19 levels, while S&P 500 profits are 15% lower than before the pandemic. Additionally, valuation on a forward price/earnings basis is 18.6 for homebuilders versus 26.2 for the S&P 500, a near 30% discount even though builders are traditionally an early cycle leader.

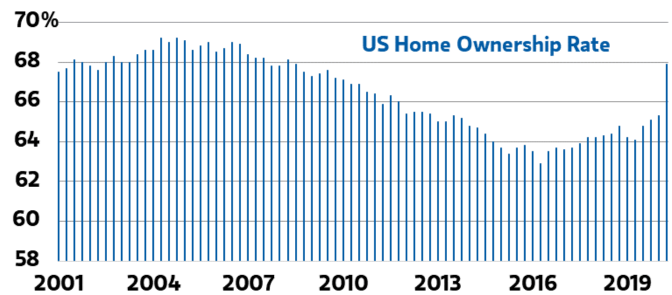
Given the favorable rate environment and unprecedented stimulus support, the current outperformance of homebuilders appears justified, and catalysts are in place for further potential expansion. To be sure, a fourth round of stimulus is critical and would provide supportive tailwinds against a resurgence of COVID-19 cases. Investors should keep an eye on confidence surveys and mortgage rates as strong indicators of future housing demand. ■

Mortgage Applications Jump, Home Inventory Falls



Source: Bloomberg as of Aug. 18, 2020

More Americans Choose to Be Homeowners



Source: Bloomberg as of Aug. 18, 2020

EQUITIES

Investing for a Multipolar World

Daniel Blake, Equity Strategist, Morgan Stanley Asia Limited+

For some time now the trend has been away from the unipolar "Washington consensus" in which the world appeared convergent politically, economically and socially. In collaboration with 142 Morgan Stanley & Co. global sector and stock research analysts—with insights on 35 global/regional sectors and over 500 companies—we explore the transition to a multipolar world. To be sure, multipolarity is far more complex than deglobalizing or decoupling.

In our framework, the US and China increasingly compete in multiple spheres ranging from technology and security to health policy, financial markets and corporate governance. Meanwhile, Europe, Japan and the rest of the world (RoW), including large emerging markets such as Brazil and India, attempt a balancing act, vying for influence and economic opportunity. As the corporate sector adjusts, one key outcome is the rising importance of the concept of "slowbalization," a slowdown or even partial reversal of globalization both in revenue mix and supply chain/operations as the risk/reward nexus for some industries shifts toward localization.

Top down, we explore five issues that will influence the landscape:

US/China Tensions Likely to Endure. While the Phase 1 trade deal between the two major powers was important, what's followed is a further demonstration that both sides' ambitions preclude the status quo from enduring. Tariffs may have held steady, but tighter export restrictions and the decertification of Hong Kong's special status with the US are just two ways in which the US continues to express its intent to draw barriers around at least certain types of commerce.

Europe, Japan and RoW to Strike a Balancing Act. Europe lacks a clear mechanism or incentive for addressing the challenges to its own interconnected nature to both the US and China, with negotiations often complicated by its two-track relationship with both markets customer and competitors. Meanwhile, Japanese corporations have customer bases and supply chains that are ever more skewed to the rest of Asia notwithstanding rivalries with China.

Multilateralism Is in Retreat. Consensus-based mechanisms have proven ill-suited to negotiations between an increasingly large and diverse membership. For example, the US decision not to fill vacancies on the World Trade Organization's Appellate Body has undermined its ability to settle disputes. The transition from formal institutions to unilateral action and informal multilateralism is a sign of a multipolar world.

Alternate Development Models Are Being Offered. Improved Sino-Russian relations, the emergence of China's Belt and Road Initiative, the Asia Infrastructure Investment Bank and the New Development Bank (formerly the BRICS Development Bank) are signs of a shift to a multipolar world, providing alternatives to the Bretton Woods institutions and setting up a competition for influence between the US and China.

Health Security Concerns May Exacerbate Slowbalization. The COVID-19 pandemic has triggered global debates about economic self-sufficiency versus efficiency—even more broadly than in health care. National policy responses are still emerging, but at the corporate level we see companies looking to further diversify supply chains.

We complement this top-down work with three proprietary bottom-up approaches:

We Map the Global Supply Chain and Revenue Flows and Assess Centrality. A company's domicile now has an impact on revenue and supply chain to a far greater extent than in the era of near-universal adherence to the Washington Consensus. (For an interactive tool that maps supply chains and revenue linkages across global equities, see "Investing for a Multipolar World," Morgan Stanley & Co., June 23, 2020.)

We Expand the Slowbalization Assessment. What sectors will benefit? Which will face headwinds? We argue the biggest beneficiaries will be "emerging regional champions" whose competitive position may even be strengthened by this theme (see table, page 9). At a sector level, we believe this includes Asia internet, global leisure and gaming, global payments and enterprise software, both US and EU. Meanwhile, we see a number of continued globalizers that our analysts expect to see a rising share of international revenues, continued outsourcing of operations/costs or both. In general, this category includes consumer-facing sectors such as beverages, food and staples, luxury, and media and entertainment.

In contrast, the costs of multipolarization are likely to be borne disproportionately by slowbalizers, which may face higher cost pressures and, in some cases, shrinking addressable markets. Falling into this category are Asia and US semiconductors, US internet and information technology (IT) hardware, global capital goods, global autos and shared mobility, Asia auto parts, global transport and Europe and US aerospace, although individual companies may differ in their exposures.

We Look to Expected Change in Revenue, Footprint and Post-COVID-19 Landscape. Our AlphaWise global analyst survey, covering 445 large-cap firms, provides meaningful insight into likely changes in corporate behavior over the next two to three years. We find interesting regional and sectoral divergences both in relation to changes in revenue mix and supply chains resulting from trade tensions, COVID-19 and domestic sourcing regulations, among other factors.

Our survey indicates that European firms (and to a lesser extent Japanese firms) remain more in the globalization mode (growing international revenue share and increasing international supply chain exposure) than their US peers. While expected organic or new market revenue growth (68%) is cited as the No. 1 driver of changes in revenue share by our analysts, trade tensions (11%), post-COVID-19 change in strategy (11%) and national security (6%) are also important for a significant minority of firms.

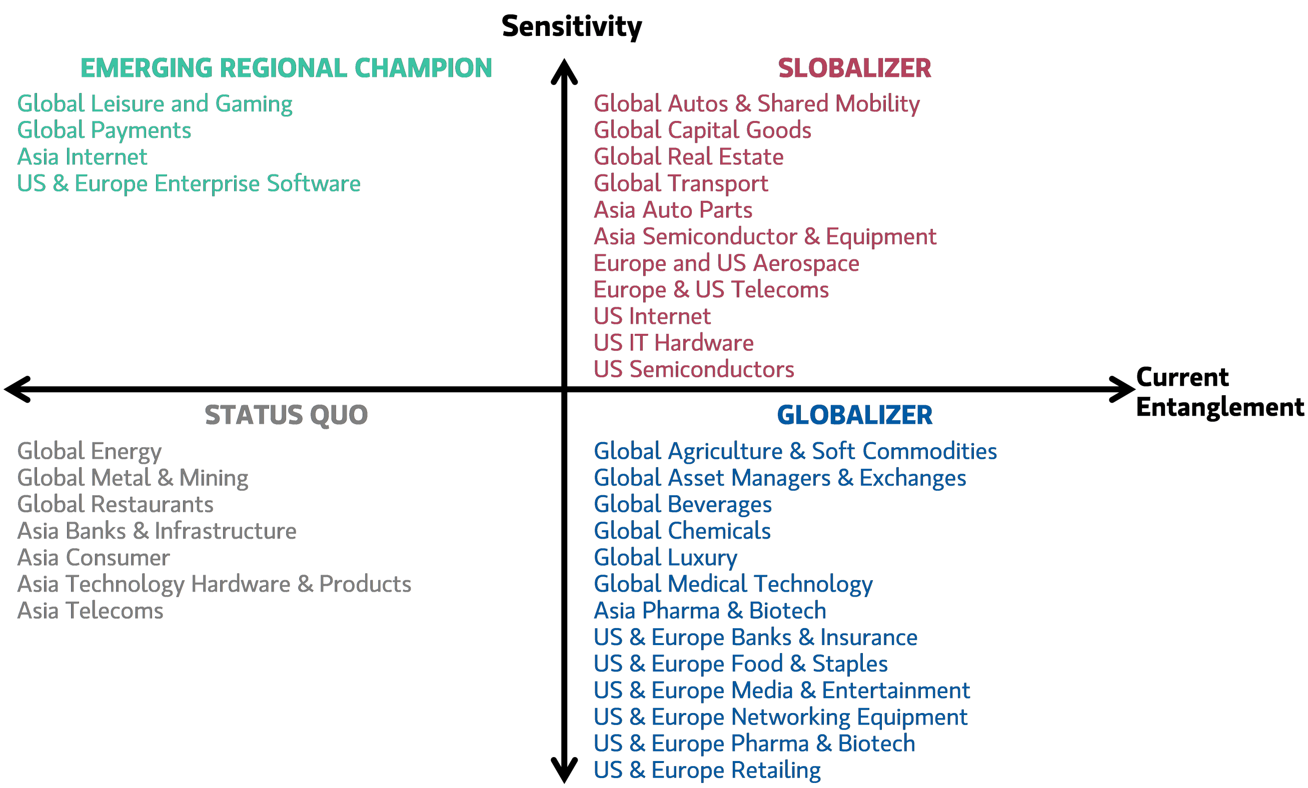
Highlighting a dynamic environment, our analysts think that either the composition or ranking for the top-three end markets will change for 26% of firms, with IT, industrials and consumer staples most likely to see changes in revenue mix. Meanwhile, the net balance of firms expecting to increase international supply chain exposure versus decrease is much smaller in the US (4%) than in Europe (27%). Of the 125 firms where we see supply chain changes, the factors driving those changes, in order of importance, are moving closer to end markets (44%), cost efficiencies (44%) and trade tensions (37%). Our analysts think that IT and communications services are more likely to see changes in international supply chain exposure. We also find evidence for a likely shift at the margin in the supply chain away from mainland China and other North Asian markets toward Southeast Asia and Europe (including Eastern Europe), but not the US.

This change in corporate behavior driven by a mix of economic and geopolitical incentives is precisely that first envisioned in our slowbalization playbook. While more pronounced for US firms, the trend appears global. Taken together, we think this evidence paints a nuanced picture of a world where some sectors still benefit from globalizing, while others must retrench.

Finally, we note a multipolar world is already driving changes in correlations for industrial production cycles and bond and equity market returns (see page 10). Equity market valuation dispersion is rising. At the stock level, we show that understanding varying degrees of state influence/ownership—a key feature distinguishing the US from Eurasia—is critical in driving regional divergence in valuations. ■

For a copy of "Investing for a Multipolar World," please contact your Financial Advisor.

How Our 35 Global/Regional Sectors Fit in the Four Quadrants of Slobalization



Source: Morgan Stanley Research as of June 23, 2020

EQUITIES

Investment Implications of the Shift to a Multipolar World

Daniel K. Blake, Equity Strategist, Morgan Stanley Asia Limited+

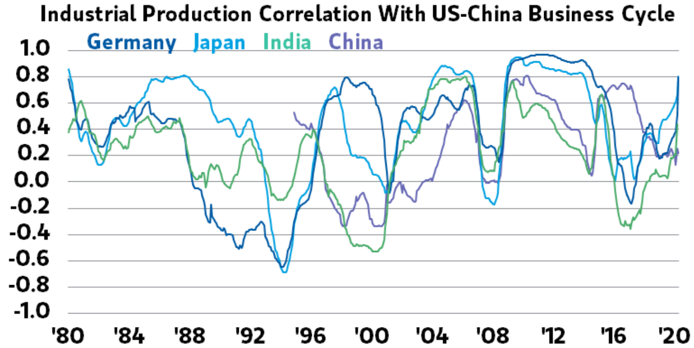
In the more multipolar world we are entering, traditional ideas of valuation convergence between geographies need to be completely rethought. It matters deeply where a company is domiciled, who is its investor base and what is its shareholder structure and relationship to the state. One can't simply argue that market A is cheap to market B because of its adjusted return on equity, or that stock C is cheap to stock D within the same global sector comparator group without consideration of these factors.

A key feature of the emergence of a multipolar world is that economic cycles and financial market trends are becoming less US-centric and more multipolar in nature. We think there is early evidence that this is happening. To explore this topic more formally, we undertook statistical analysis of changes in correlations over time in three regards: industrial production (IP), government bond yields and equity market returns.

Industrial Production. Supporting the thesis that we are entering a more multipolar world, when isolating the eight-year cycle for industrial production, we find that the correlation coefficients for the three major non-US economies have all structurally increased since the early 1990s, when globalization started in earnest (see chart). They reached recent peak levels in the 2012-2016 period. Since then, there is tentative evidence of reduced correlation in the 2017-2019 period before a jump due to the impact of COVID-19 this year. In particular, since the start of the 2017 recovery in China, its industrial production has never had a correlation coefficient over 0.4 to that of the US and is now about 0.2, whereas it was above 0.6 in both the 2011 and 2015 upcycles. China's industrial production cycle has deviated from that of the US. By the end of the 2019, upturns in Germany and Japan's IP cycles were also less correlated with the US than at prior cycle peaks. Meanwhile, India's IP cycle was actually negatively correlated with that of the US throughout 2016 and 2017 for the first time in more than 15 years.

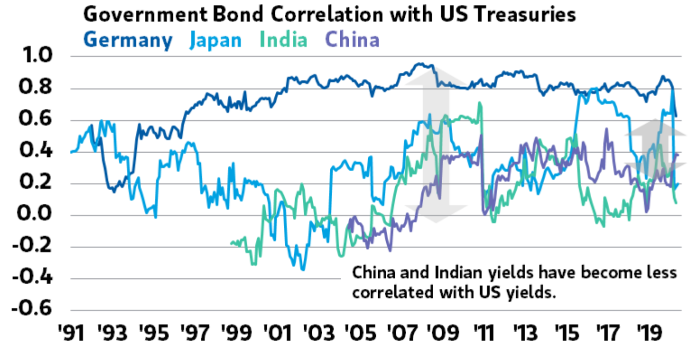
Government Bond Markets. The picture is similar in the government bond markets. We find a high and stable correlation between German Bund yields and US Treasury yields with no sign of structural change over time (see chart). In the past two years, Japanese government bond yields have reestablished a high correlation with Treasuries. However, there is evidence that changes in Chinese and Indian government bond yields have become somewhat less correlated with the US; the correlation coefficient has not moved above 0.4 since the beginning of the 2017 upswing whereas it approached 0.6 in several previous cycles. This resonates with the reduced correlation of Chinese IP

China's Business Cycle Has Become Less Correlated With the US Cycle



Note: Correlation is calculated based on data series of annual change in industrial production in each country.
Source: Datastream, Morgan Stanley Research as of June 23, 2020

Chinese Bonds' Correlation With US Treasuries Has Become Notably Lower Than Japan's and Germany's

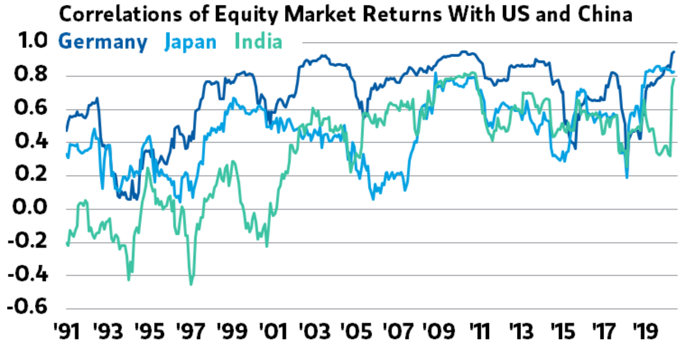


Note: Correlation is calculated based on a data series of the simple monthly changes in the 10-year government bond yield in each country.
Source: Datastream, Morgan Stanley Research as of May 31, 2020

cycles with those of the US and it is interesting that it has occurred even as foreign investors have been granted greater access to the China government bond market in recent years.

Equity Markets. As with bond yields, there is substantial variation in correlations over time. China's CSI 300 has generally been less correlated with the S&P 500 than Germany's DAX or Japan's TOPIX and at times—such as the 2014-2015 bull market—have almost zero correlation (see chart, page 11). This is likely due to foreign investors' previous lack of access to the market and the dominance of domestic retail investors, although this is now gradually changing. All four non-US markets are quite highly correlated with that of the US in recent months, which is most likely due to the common impact of COVID-19 on all economies and earnings cycles. Indian equities showed a steadily rising correlation with US equities from the mid 1990s to 2010 but a steady decline since then until this year, due to the pandemic.

China's and India's Equity Markets Have Become Less Correlated With the US and Germany



Note: Correlation is calculated based on a data series of monthly logarithmic total returns of the CSI 300 (China), TOPIX (Japan), Sensex (India) and the S&P 500.
Source: Datastream, Morgan Stanley Resarch as of May 31, 2020

Emerging Markets as a Concept. A multipolar world probably means the demise of the emerging markets (EM) concept in investment. That concept had its origins in the late 1980s in a different era in which history seemed to be characterized by a broad movement toward more liberal politics, open trade and investment flows. Deregulation and free market capitalism were promoted by international organizations heavily influenced by the US policymakers of that era. Indeed, the very term "emerging markets" was invented at the International Finance Corporation (part of the World Bank) as it sought to stimulate private equity investment in countries that had hitherto been mainly labeled as "lesser developed countries," or LCDs, and were still tarnished by the legacy of the widespread sovereign defaults of the early 1980s.

In the early 2000s a new concept came to the fore, focused on a smaller group of countries—the BRICs (Brazil, Russia, India and China). In terms of investment products launched, the BRICs never matched the earlier emerging markets concept. Other than large population size and geographies, these countries seemed to have relatively little in common with each other.

Persistent new listings—particularly from China—have meant that the emerging markets' share of global equity market capitalization has steadily risen and currently stands at an 11.5% weight in the MSCI All Country World Index (ACWI) versus 0.9% in 1988. However, EM equities have underperformed the MSCI ACWI since late 2010 and recently set a new relative performance low.

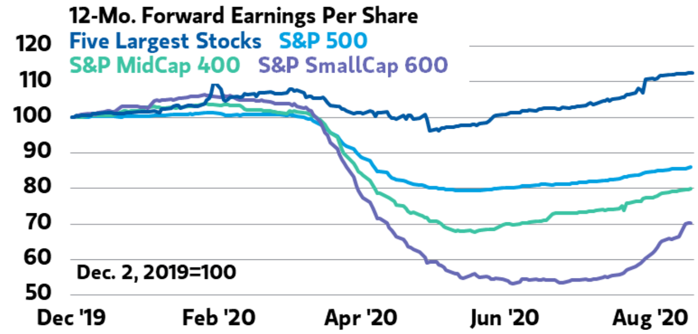
Moreover, EM equities have had persistently poor risk-adjusted returns. We analyzed the US dollar total return of the MSCI indexes for the major EM equity markets, as well as those in the US, Japan and Europe. We compare the 10-year total return's compound annual growth rate against the volatility in terms of annualized standard deviation. The overall EM index has had lower returns than the US, Japan or EU, with higher volatility. Even worse, within emerging markets, higher risk has been associated with lower equity returns. In addition, bond investing in EM dollar-denominated sovereign debt has delivered persistently superior risk-adjusted returns relative to EM equities. ■

For a copy of "Investing for a Multipolar World, " please contact your Financial Advisor.

Short Takes

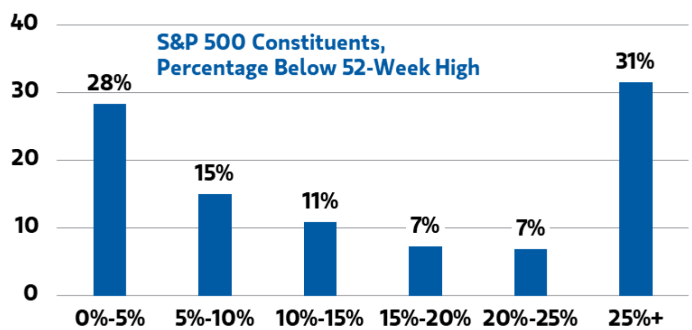
Earnings Estimates Start to Recover, but Not Equally for All Companies

Forward earnings estimates plunged around the time of the COVID-19 shutdown and started to recover in early July, but not equally among all market capitalizations. Estimates for the S&P 500, a benchmark of large-cap stocks, now sit about 15% below the prerecession level (see chart). Specifically, the S&P 500's five largest companies, which together account for about 25% of the index, have actually enjoyed a 13% forward earnings expansion since December. Small-cap and mid-cap companies suffered greater earnings markdowns, but are now seeing an accelerated recovery. Given recent all-time highs for the S&P 500 and, in particular, the five largest stocks, we see value in small-cap and mid-cap companies, where the greatest rate of change in earnings can be realized. What's more, we see higher potential investment returns in the smaller, lesser-known and less-researched companies.—*Nick Lentini*



Source: Bloomberg as of Aug. 20, 2020

To Get a Better Read on the Stock Market, Look "Under the Hood"

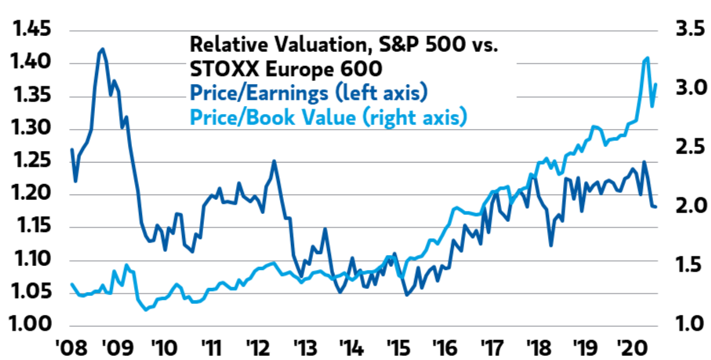


Source: Bloomberg as of Aug. 27, 2020

When market indexes make all-time highs, it can be useful to look "under the hood" and review the performance of individual stocks. The performance distribution of the constituents can explain what drove the index to its latest milestone and may give clues about the likelihood of further index-level gains. As the S&P 500 Index surpassed its previous all-time high, the median stock was still more than 12% below its own 52-week high. While a performance gap between the index and the median stock is common, the degree to which the index gains are attributable to a minority of stocks is one way of measuring market breadth. Currently, close to one-third of S&P 500 stocks are more than 25% below their 52-week high (see chart). This historical extreme in performance may not bode well for further index-level gains, but could present an opportunity for active stock pickers.—*Spencer J. Cavallo*

Europe's Long-Lagging Stock Market May Have the Power to Outperform US Equities

During the last market cycle, US equities handily outperformed European equities. Since 2008, 12-month US stocks outpaced European stocks in 70% of rolling 12-month periods, owing to stronger fundamentals. That has left the relative price/earnings ratio of the S&P 500 Index nearly 20% higher than the STOXX Europe 600 Index (see chart). Using price/book value, the US index is three times that of the European index. On relative earning revisions, the US is stronger, too, as US companies appear to do a better job in managing earnings expectations and delivering significantly better upside surprises. Even so, the new European stimulus package, with a seven-year budget plan and a €750 billion recovery fund, offers promising tailwinds for European equities. The outlook for the dollar remains bearish, and the relative strength of the euro versus the dollar could further bolster European returns for US investors.—*Vibhor Dave*



Source: Bloomberg as of July 31, 2020

Q&A

Is Gold Still a Buy?

The price of gold climbed above $2,000 an ounce in August, hitting new highs in nominal US dollar terms while also experiencing significant price volatility. The Global Investment Committee (GIC) has been favorable on gold for most of the past two years, as the GIC believes gold is quite attractive in an environment in which interest rates stay low but inflation pressures are rising. Gold also can provide a hedge against a weaker US dollar. Like most commodities, gold historically has done well when the dollar weakens, and, as part of broad commodity exposure, the GIC thinks gold can make sense for some portfolios. Amid this increasingly difficult environment, Morgan Stanley Wealth Management Market Strategist Vijay Chandar spoke with Max Belmont, a senior research analyst on First Eagle's Global Value team who covers precious metals. The following is an edited version of their conversation.

VIJAY CHANDAR (VC): What factors have historically driven the price of gold?

MAX BELMONT (MB): Four big themes drive the price of gold. The first is currency. The strength and the weakness of the US dollar—or any other currency in which you denominate gold—influences the price. Gold trades in US dollars, but it can be denominated in any currency in the world. When people say that the price of gold went up or down, that's only one frame of reference; many people believe—as we do at First Eagle—that gold is a unit of measurement. On this basis, a change in the price of gold from $1,500 an ounce to $2,000 an ounce, say, doesn't so much represent an increase in the price of gold as it does depreciation in the US dollar.

A second theme is economic drivers such as market uncertainty, inflation, interest rates, income growth and consumer confidence. Ultimately, one of the most important drivers for gold prices in the short, medium and long terms are real interest rates—the difference between the nominal interest rate and inflation. As a physical asset and no one's liability, gold doesn't provide a yield, meaning that real interest rates reflect the opportunity cost of owning gold. Historically, we have seen that gold has done well when real interest rates are below 2% on average, while its performance has been weaker when real interest rates exceed 2%.

Tactical flows are a third theme. These flows, characterized by derivative positioning on the futures exchanges, are important because they drive price momentum.

Finally, there's mine production and demand-side shocks. I would highlight that gold doesn't really fit the typical supply and demand framework because of its stock-to-flow ratio, or the available inventory of gold relative to its annual production. Unlike other real assets such as oil, iron ore, copper and many others, gold isn't consumed in industrial applications. Further, gold doesn't rot, rust, tarnish or otherwise debase. As a result, virtually all the gold ever mined remains as aboveground inventory today. We have around 60 years' worth of annual supply above ground, which would prevent a dramatic supply shock even in a year of zero mine production. Ultimately, the price of gold doesn't mean-revert to the marginal cost of production.

VC: How do you go about assessing gold's value or determining a price target?

MB: We do not forecast the price of gold, as it's incredibly hard to put a number on it. Gold is both procyclical and countercyclical. We have seen throughout history that gold has often been used by investors as a potential safe-haven asset, and gold's price often rallies during periods of uncertainty. The real value of gold over time has trended with global nominal GDP per capita, and cyclical variations around this trend should be driven ultimately by the perceived need for a potential hedge.

So, on one bookend, there were decades like the 1990s that produced below-trend values for gold, as investor confidence in the global financial and monetary architecture tempered demand for gold's attributes and ultimately resulted in weaker gold prices.

On the other bookend, we have times—such as the late 1970s and, more recently, the global financial crisis and the COVID-19 pandemic—of systemic distress during which we have seen gold's price increase amid widespread investor uncertainty. Recessions, too, have been favorable for the price of gold over the medium to long term, though short-term price corrections have not been uncommon.

VC: How do you think about the dollar going forward, and what impact it may have on gold?

MB: A fiat currency system—in which a government-issued currency isn't backed by a real asset like gold—ultimately gives central banks greater control over the economy because they can drive how much money is created. Though the value of the dollar spiked initially as investors sought safety in the global reserve currency, it has steadily weakened since. One of the consequences of the pandemic is that nominal interest rates have come down dramatically in the US as the Fed flooded the system with liquidity. Narrowing interest rate differentials can lead to a reversal of the carry trade, resulting in further weakening of the US dollar—and this can go on for a long time.

I would also mention that, in a world with significant deficits, extraordinary money supply growth and record debt levels, we must consider the possibility that there could come a time when faith in fiat currency begins to deteriorate—and gold is the most defensive of the real assets. Again, we don't seek to predict the future, but we have the humility to recognize that the world is complex and nonlinear and want to be prepared for a wide variety of disruptive circumstances.

VC: We live in a world now where we've gone through a recession, and while markets have largely recovered, there's still a fair amount of uncertainty as well as demand for defensive assets. Can you talk about how gold and gold equities reacted during the last recession in 2008 and 2009, and how you view gold as a defensive asset going forward?

MB: We weren't surprised by the price action we have seen this year in gold and gold-related assets. Movements in the price of gold in early 2020 reminded us of its behavior in the fourth quarter of 2008. In both periods of crisis, gold rose early on, then declined, only to increase again as central banks eased liquidity fears.

What we saw in March 2020 and in the 2008 peak of the global financial crisis was an initial spike in real interest rates driven by two factors. First, by participants in the bond market demanding higher yields as compensation for the additional risk that they're taking on during those moments. And second, by collapsing inflation expectations.

In March of this year, real interest rates within a matter of days increased from almost negative 60 basis points to around positive 60 basis points—which dragged down the price of gold. But by July, gold had established a new all-time high in nominal US dollar terms. We also saw a very similar pattern in the US dollar, and the dollar's strength at the March peak of the crisis led to a temporary decline in gold prices.

VC: If we think about how to implement a view on gold, the question is often: Do you look at metal's price, or do you look to play it on the equity side through gold mining stocks? How do you differentiate those choices, and what factors go into deciding if one is more attractive than another?

MB: Options for gold exposure include physical bullion, gold mining companies, gold royalty and streaming companies, as well as mutual funds, exchange-traded funds (ETFs) and derivatives. More recently, we have also seen digital gold based on blockchain technology. There are pros and cons of each.

Physical gold tends to be considered the most conservative form of gold ownership. It can be held in allocated accounts, is very liquid, and is free of counterparty or mining risks because it has been extracted from the ground. There are costs associated with bullion, however, including transport, storage and insurance.

While you can buy a physical ounce of bullion at spot gold prices, this may not be the most cost-efficient way to access gold exposure. Miners may offer cheaper ounces, especially if a miner can be bought at a market price, offers a "margin of safety" relative to the discounted run-off value of its reserves. But researching mining companies is time consuming. No two miners are alike, so there's a massive dispersion in gold stocks in terms of quality, valuation and returns.

Gold royalty businesses are a subsector of the mining business that historically has provided investors with some leverage to the price of gold but with less risk than owning the stock of miners. By funding mining projects in exchange for a share of production, these businesses seek to avoid the risks miners face, such as cost inflation, capital expenditure inflation, currency risk and operational risk. While royalty and streaming businesses tend to have low overhead costs and high margins—as high as 80%, with no capital outlays—they do carry capital allocation risks.

Actively managed gold mutual funds provide investors the benefit of institutional memory—the experience and knowledge of the research teams trying to understand the underlying assets and the different risk/return profiles of the individual miners.

ETFs offer broad-based exposure, typically through a basket of miners and bullion, as well as intraday trading capability, low fees and low investment minimums. One of the drawbacks with ETFs, however, is that you may end up owning a basket of miners that don't represent the best businesses in the industry.

Gold derivative strategies are more tactical than strategic. They provide leverage, and positions can be relatively easily established at very low commissions—but remember that leverage works both on the way up and on the way down.

Lastly, blockchain technology is something that we have seen come up more recently in the gold market. Having call options on digital gold is really in its infancy, and I think it needs to be time-tested to see how this emergent asset class ultimately develops.

VC: How do you view gold in the context of a broadly diversified portfolio, in terms of adding diversification either as defensive or as a hedge?

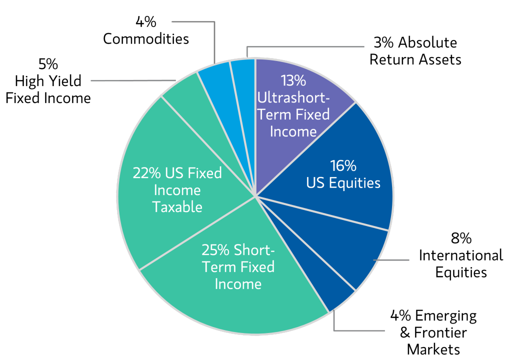
MB: Our diversified portfolios at First Eagle maintain a strategic allocation to gold-related investments as a long-duration potential hedge. Our allocation has been around 10% through a full market cycle, but it can fluctuate, given market dynamics, between 5% and 15%. This year, the allocation reached the high teens. Philosophically, we believe that a position less than 5% is too small to serve as a potential hedge, whereas anything above 20% represents a strategic bet on the direction of the gold price. ■

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

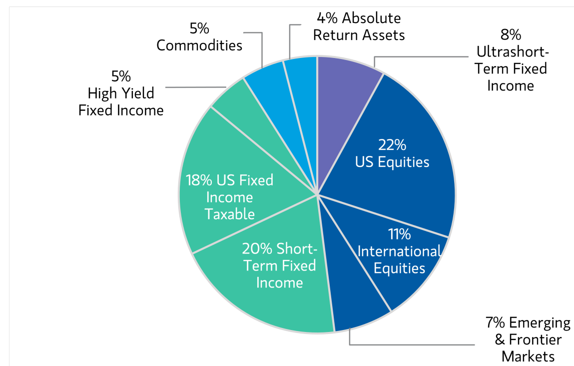
Global Investment Committee Tactical Asset Allocation

The Global Investment Committee provides guidance on asset allocation decisions through its various models. 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.

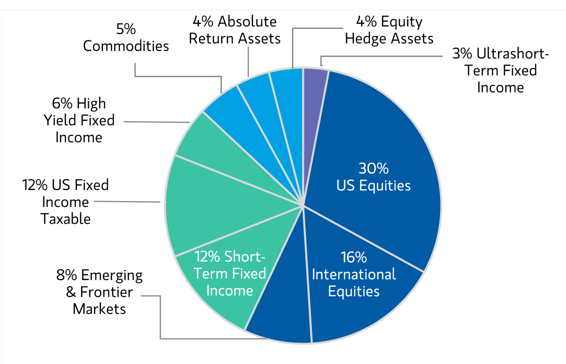
Wealth Conservation



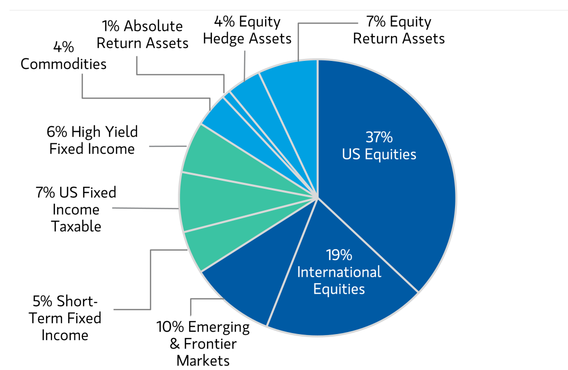
Income



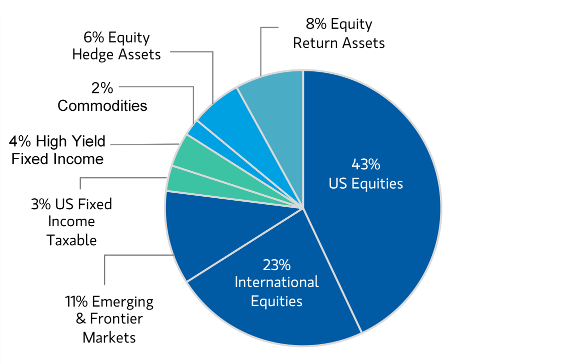
Balanced Growth



Market Growth



Opportunistic Growth



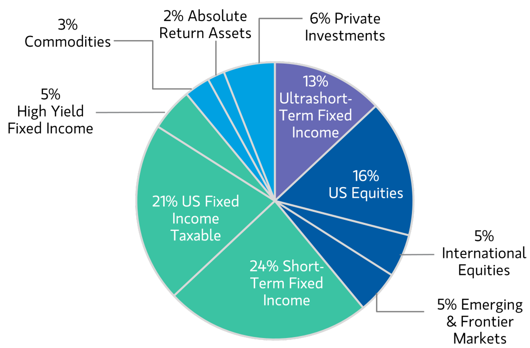
Key

- Ultrashort-Term Fixed Income
- Fixed Income & Preferreds
- Equities
- Alternatives

Source: Morgan Stanley Wealth Management GIC as of Aug. 31, 2020

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

Wealth Conservation



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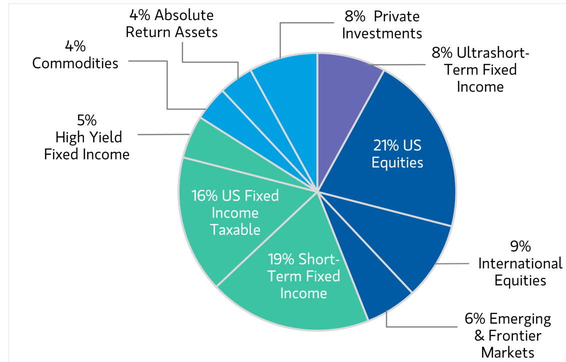
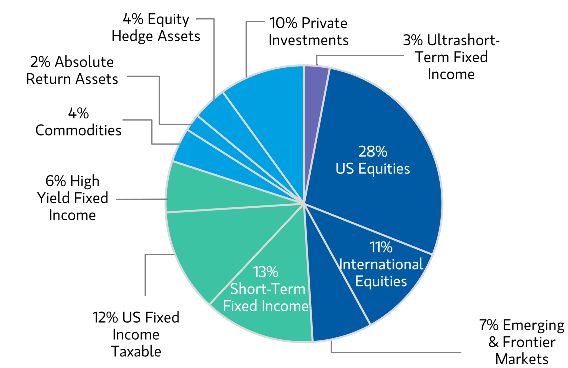
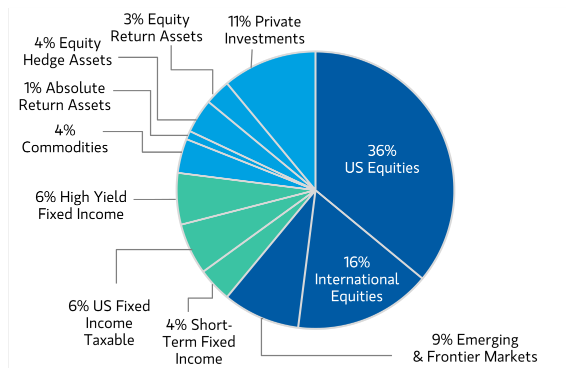


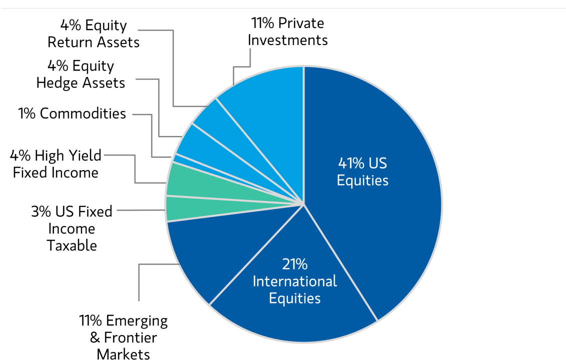
Balanced Growth



Market Growth



Opportunistic Growth



Key

- Ultrashort-Term Fixed Income
- Fixed Income & Preferreds
- Equities
- Alternatives

Source: Morgan Stanley Wealth Management GIC as of Aug. 31, 2020

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Overweight	Global stock markets have entered a bear market on concerns about the negative growth impact of the coronavirus. Although we expect US and global recessions in the second quarter of 2020, our base case is that recent extraordinary policy actions from both central banks and national governments will help cushion the economic impact. Markets are already pricing the most likely scenarios. We recently upgraded our exposure to large-cap growth and small- and mid-cap equities, believing that active stock pickers have a good entry point over the next several months.
International Equities (Developed Markets)	Market Weight	We recently reduced exposure to both Europe and Japan believing that, while policy responses were meaningful, their impact may ultimately be lumpy and diluted by additional headwinds—in the case of Europe, the lack of fiscal integration, and in Japan, the strength of yen.
Emerging Markets	Overweight	China was the first country to enter the COVID-19 crisis and appears poised to be the first out. Resumption of economic activity during the second quarter should jump-start global growth, especially given huge government stimulus programs. Ample liquidity from the Fed and a weakening dollar should catalyze investor interest. China stands to gain the most from US tariff rollbacks and global trade dynamics should improve. Valuations are attractive and local central banks should be able to maintain accommodation and stimulus. For most countries, especially China, the collapse in oil prices is a material tailwind for consumer purchasing power.
Global Fixed Income	**Relative Weight Within Fixed Income**	
US Investment Grade	Market Weight	We have recommended shorter-duration* (maturities) since March 2018, given the extremely low yields and potential capital losses associated with rising interest rates from such low levels, and had been pairing that position with a large exposure to long-term US Treasuries to hedge what we expected would be a modest correction in stocks. With long-term Treasury yields troughing for the cycle, we recently removed that position and resumed a benchmark exposure to duration. Recent dislocation of investment grade credit spreads and market illiquidity have created opportunities. Fed programs aimed at backstopping this market give reason to be an active bond selector.
International Investment Grade	Underweight	Negative interest rates suggest that this is not a preferred asset class for US-dollar clients at this time. Actively managed funds may provide very patient, risk-tolerant clients with income opportunities in select corporate credits.
Inflation-Protection Securities	Underweight	The "sudden stop" recession has caused a severe pricing of real interest rates, pushing them negative and near all-time lows. In the near term, upside appears limited.
High Yield	Overweight	High yield bonds remain at the epicenter of the dual risks from COVID-19 and the collapse in oil prices from the failure of OPEC negotiations. In our view, some of the most extreme risks have been discounted, especially in light of unprecedented monetary and fiscal policy intervention aimed not only at market liquidity but in bridging cash flow requirements. It's time to ease in opportunistically, using active managers.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Underweight	Real estate investment trusts (REITs) have performed very well as global growth slowed and interest rates fell. However, REITs remain expensive and are vulnerable to credit risks. We will revisit our position as nominal GDP troughs and/or valuations become more attractive.
Commodities	Overweight	The "sudden stop" global recession has driven commodities such as oil to multidecade lows. The rush to the "safe haven" US dollar, which is near its multiyear high, has exacerbated these dynamics. While we recognize the complexity of the geopolitical issues that surround oil, we believe that on a six-to-12-month basis the outlook for the global economy and overall demand will improve materially. Thus, we suggest risk-oriented clients establish exposure to the broad diversified asset class through the use of active managers. Pure passive exposure is not advised at this time.
Hedged Strategies (Hedge Funds and Managed Futures)	Overweight	The bear market associated with COVID-19 has driven volatility to historic extremes and led to wide dispersion in price performance and stock-level idiosyncratic risk. These factors tend to create a constructive environment for hedge fund managers who are good stock-pickers and can use leverage and risk management techniques to amplify returns. We prefer very active and fundamental strategies, especially equity long/short.

*For more about the risks to Duration, please see the Risk Considerations section beginning on page 18 of this report.
Source: Morgan Stanley Wealth Management GIC as of Aug. 31, 2020

Disclosure Section

The **Global Investment Committee (GIC)** is a group of seasoned investment professionals from Morgan Stanley & Co. and Morgan Stanley Wealth Management who meet regularly to discuss the global economy and markets. The committee determines the investment outlook that guides our advice to clients. They continually monitor developing economic and market conditions, review tactical outlooks and recommend asset allocation model weightings, as well as produce a suite of strategy, analysis, commentary, portfolio positioning suggestions and other reports and broadcasts.

Chris Baxter, Daniel Blake, Spencer Cavallo, Vijay Chandar, Vibhor Dave, Denny Galindo and Nick Lentini are not members of the Global Investment Committee and any implementation strategies suggested have not been reviewed or approved by the Global Investment Committee.

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Risk Considerations

Alternative Investments

The sole purpose of this material is to inform, and it in no way is intended to be an offer or solicitation to purchase or sell any security, other investment or service, or to attract any funds or deposits. Investments mentioned may not be appropriate for all clients. Any product discussed herein may be purchased only after a client has carefully reviewed the offering memorandum and executed the subscription documents. Morgan Stanley Wealth Management has not considered the actual or desired investment objectives, goals, strategies, guidelines, or factual circumstances of any investor in any fund(s). Before making any investment, each investor should carefully consider the risks associated with the investment, as discussed in the applicable offering memorandum, and make a determination based upon their own particular circumstances, that the investment is consistent with their investment objectives and risk tolerance.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are appropriate only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

Certain information contained herein may constitute forward-looking statements. Due to various risks and uncertainties, actual events, results or the performance of a fund may differ materially from those reflected or contemplated in such forward-looking statements. Clients should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing.

Alternative investments involve complex tax structures, tax inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund. Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance based on benchmark indices, not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results achieved by a particular asset allocation.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

ETF Investing

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics. ETFs investing in physical commodities and commodity or currency futures have special tax considerations. Physical commodities may be treated as collectibles subject to a maximum 28% long-term capital gains rates, while futures are marked-to-market and may be subject to a blended 60% long- and 40% short-term capital gains tax rate. Rolling futures positions may create taxable events. For specifics and a greater explanation of possible risks with ETFs¸ along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of an exchange-traded fund or mutual fund before investing. The prospectus contains this and other important information about the mutual fund. To obtain a prospectus, contact your Financial Advisor or visit the mutual fund company's website. Please read the prospectus carefully before investing.

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** and **frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

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.

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 appropriate 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.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be appropriate for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

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.

Although they are backed by the full faith and credit of the U.S. Government as to timely payment of principal and interest, **Treasury Bills** are subject to interest rate and inflation risk, as well as the opportunity risk of other more potentially lucrative investment opportunities.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum of $250,000 (including principal and accrued interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account, IRA etc.) per CD 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 the purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository. For more information visit the FDIC website at www.fdic.gov.

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.

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.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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.

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.

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

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. **Technology stocks** may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

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.

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.

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