

Global Investment Committee | December 2020

On the Markets

Looking Forward to 2021

November is the month when our macro team gets together to discuss its year-ahead outlooks across all asset classes. It's a collaborative two-week process that allows us to think about the next 12 months rather than the next 12 hours. I enjoy this process but the US election and the ongoing global pandemic presented some unique challenges this year.

The 12-month view is often easier to map out than the very short-term outlook because it comes down to two things that can be analyzed and forecast—earnings and interest rates. While fund flows, sentiment or positioning may dominate stock prices in the short term, the price of a stock is ultimately determined by earnings and valuation, which is heavily dependent on interest rates. On both counts, our calls this year have been consistent. We've been ahead of the consensus on the recovery story but more bearish than consensus on bonds, especially long-term ones, as we think interest rates are likely to head meaningfully higher next year.

Last month, we received good news that supports these views: a market-friendly election outcome (likely divided government); and two effective vaccines, which is exactly what the doctor ordered to get the economy fully reopened next year. That's the good news. The bad news is that we still have to deal with a runoff in Georgia to determine the final congressional makeup, and that the vaccine likely won't be ready for mass distribution for another three or four months as case counts and deaths increase. This juxtaposition feeds directly into our short- versus long-term dilemma when thinking about our 2021 outlook.

With US equity markets a bit exhausted at the moment, I see the risk of one more drawdown before the end of the year. Nevertheless, I remain a steadfast bull on a 12-month view in terms of both the earnings outlook and the markets. New bull markets that coincide with a new economic cycle last for years, and the business cycle tends to override the political one. As for the S&P 500 Index, we forecast a 10% gain in the next 12 months as earnings continue to surprise on the upside but higher interest rates lead to somewhat lower valuations—a typical feature of the first year coming out of a recession. While 10% upside is attractive, the real opportunity is likely to take place below the surface in smaller-cap stocks that have greater sensitivity to what is likely to be a very strong economic recovery, along with financials, consumer services, materials, industrials and cyclical technology stocks. ■

Michael Wilson

Chief Investment Officer
Chief US Equity Strategist
Morgan Stanley & Co. LLC

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ECONOMICS

The Next Phase of the V

Chetan Ahya, Chief Global Economist and Global Head of Economics, Morgan Stanley & Co.

Global economic activity came to a near standstill in March and April, but a restart of economies and the opening of the monetary and fiscal stimulus floodgates helped a supercharged recovery take hold in May. This steep decline and sharp rebound—hence, the “V-shaped” recovery—have meant that global economic output will have climbed above pre-COVID-19 levels in the current quarter based on seasonally adjusted GDP levels. This is an outcome we forecast, but it was distinctly not the consensus view.

Now, as we consider the 2021 global macro outlook, we see three critical factors to keep in mind: a global synchronous recovery, emerging markets boarding the reflation train and a regime change in US inflation dynamics.

A Global Synchronous Recovery Is Taking Hold

The once-in-a-century global pandemic of 2020 should morph into a synchronous recovery in 2021. On our count, such a recovery—with both the developed markets and the emerging markets accelerating in the same year—has taken place 12 times over the past 40 years, the last time in 2017.

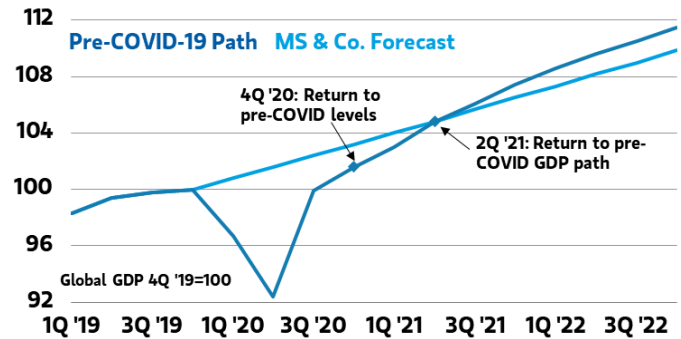
Of course, in the near term, COVID-19 exerts a heavy influence on growth. Rising cases constrain economic activity in the developed markets, while the improving COVID-19 situation in emerging markets should allow them to outperform for the next three to four months. As the developed markets emerge from the winter, growth should pick up, and by March/April we expect all regions and all sectors of the global economy to be in recovery.

GAINING MOMENTUM. With the global economy already back at the pre-COVID-19 level of output—that of fourth quarter 2019—we expect the recovery to gain momentum. Despite the sharp gyrations in output in the previous six quarters, in 2021's second quarter the global economy returns to the path it would have followed absent the COVID-19 shock (see chart). We forecast global growth at a 6.4% annual rate for 2021 (see table).

This projection stands in stark contrast to the consensus, which expects the pandemic will have a bigger impact on private sector risk appetite and hence global growth. However, consumers have driven the recovery and investment growth—a reflection of the private corporate sector's risk tolerance—and they are bouncing back, too. Keep in mind that the shock was exogenous and policy support was timely, coordinated and sizeable, helping to get the global economy back onto this path.

VACCINE AVAILABILITY. The recent positive news on COVID-19 vaccine development bolsters our confidence in our

Global Growth Is Likely to Return to Pre-COVID-19 Path in 2021



Note: The pre-COVID-19 GDP path refers to the trajectory that global GDP would have followed prior to the COVID-19 shock and is calculated using Morgan Stanley & Co. Research forecasts as of Jan. 21, 2020.

Source: Haver Analytics, IMF, national sources, Morgan Stanley & Co. Research as of Nov. 15, 2020

constructive views on the economy. We are cognizant there are processes to navigate before a vaccine is eventually approved for emergency use and broadly available, but these developments are nonetheless steps in the right direction. By now, households and companies have learned how to manage in a COVID-19 environment, such as by making purchases online and managing work-from-home routines. The news on a vaccine will help buoy private sector confidence that we can avoid further lockdowns beyond the winter and that a full reopening of the economy can be a mid-2021 event. In addition, we believe that the vaccination of the vulnerable population and the advent of rapid testing will be key in reopening economies, even for the COVID-19-sensitive sectors.

In the near term, COVID-19 still influences developed market growth. In the US, hospitalizations are now above their June/July levels and will likely warrant implementing restrictions in a number of states and cities, especially limiting indoor dining. However, the strong carryover momentum and still improving high-frequency indicators suggest we are unlikely to see a sequential decline in GDP—though we do pencil in monthly declines in consumer spending in November and December.

In Europe, restrictions have already been implemented and we therefore expect a decline in activity through the winter. Encouragingly, we see early signs of stabilizing case numbers in the UK and declining case counts in the Netherlands, which implemented restrictions about a week or two earlier than the rest of Europe, as well as more recently in France. In both the US and Europe, we expect once restrictions are lifted the growth payback will keep the end destinations of pre-COVID-19 output levels intact.

Morgan Stanley & Co. Real GDP Forecasts

	2020E	2021E			2022E			2023-2025E
Real GDP	Base	Bear	Base	Bull	Bear	Base	Bull	Base
Global	-3.5%	4.6%	6.4%	8.2%	3.4%	4.4%	5.4%	3.1%
G10	-5.4	2.8	5.1	7.5	2.8	3.9	4.9	1.6
US	-3.5	3.1	5.9	8.7	3.0	4.1	5.3	1.7
Euro Zone	-7.2	2.7	5.0	6.9	3.0	3.9	4.3	1.5
Japan	-5.2	1.4	2.4	3.7	0.9	2.4	3.9	1.0
UK	-11.4	2.3	5.3	8.1	4.5	5.5	6.5	2.5
Emerging Markets	-2.0	6.0	7.4	8.8	3.8	4.7	5.7	4.2
China	2.3	8.0	9.0	10.0	4.8	5.4	6.0	4.7
India	-5.7	9.0	9.8	10.9	5.3	6.0	7.0	6.0
Brazil	-4.0	2.1	4.3	5.5	1.3	2.7	4.3	2.2
Russia	-4.0	1.1	3.4	5.6	2.6	3.2	3.8	1.8

Note: Aggregates are PPP-weighted.

Source: Bloomberg, Haver Analytics, IMF, Morgan Stanley & Co. Research as of Nov. 15, 2020

Emerging Markets Boarding the Reflation Train

The emerging markets ex China, which initially lagged the recovery, are catching up. The COVID-19 situation is improving across a large swath of the emerging markets, allowing policymakers to reopen their economies further even before a vaccine becomes available. Trade-dependent economies such as South Korea and Taiwan are already well into their recoveries, while in the large, arguably more domestic demand-oriented economies, such as India and Brazil, a number of indicators have recently exceeded pre-COVID-19 levels and are registering positive year-on-year growth (see table). What's more, we expect rising support from external demand, especially driven by a wider US current account deficit, low US rates and a weak US dollar. We add to that China's growth impulse and the lagged effects of monetary easing and liquidity provision. All told, these factors should continue into 2021, with emerging markets growth rising to 7.4% on an annual basis, which is higher than the consensus expectation of 6.3%.

The Inflation Regime Change in the US

Every recession leaves an indelible mark, and 2020's COVID-19 recession is no exception. Post 2008, the consensus slowly but surely got to grips with how economies would evolve in the wake of the financial crisis and the long-lasting effects it would have. This time, we think it is inflation dynamics that have fundamentally changed, and consensus has not fully embraced this notion. We see a strong case for the return of inflation in this cycle, especially in the US. Ellen Zentner, MS & Co.'s chief US economist, expects core Personal Consumption Expenditure inflation to reach a 2% annual rate by the second half of next year and rise above 2% a year on a sustained basis starting in 2022.

We have been highlighting for some time that political and economic triggers would bring about changes leading to higher inflation in this cycle. To recap, we saw the declining wage share in GDP, rising income inequality and declining natural interest rates as catalysts for policymakers to take action. In effect, this meant policymakers were warming to the idea of using fiscal policy actively and were moving toward disrupting the trio of tech, trade and titans that had played a role in depressing wages and their transmission to inflation.

LABOR MARKET. As the recession hit, it exacerbated preexisting trends in income inequality. Low-income households have borne the brunt of this recession, accounting for as much as 68% of the private sector job losses from February to April. While decisive policy stimulus has helped to lift economic output, the accelerated restructuring of the economy has driven a divergence between economic activity (which has been on a V-shaped recovery) and the labor market. As a case in point, despite US GDP being at 97% of pre-COVID-19 levels in the third quarter, the underlying adjusted unemployment rate is still at 10.2% versus a pre-COVID-19 run rate of 3.5%.

Against this backdrop, policymakers have made clear their intent to enact policies that would help lower-income households, either via direct fiscal action or indirectly by allowing the economy to run "red hot." By the first quarter, US GDP should reach 98.7% of pre-COVID-19 levels, yet policy support will likely remain very accommodative. We expect the Federal Reserve to keep the federal funds rate at zero while continuing to expand its balance sheet further—by \$1.3 trillion over the course of 2021. We are expecting further fiscal stimulus to be enacted, which will keep the fiscal deficit relatively high at 10.7% of GDP in 2021 relative to 15.2% in

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2020. With these accommodative policy stances unchanged even as output nears pre-COVID-19 levels in 2021, they will only help to lift aggregate demand and, along with it, inflationary pressures. For context, GDP was last close to these levels in 2019's fourth quarter when the policy rate stood at 1.625%, the Fed's balance sheet was 19.2% of GDP and the fiscal deficit for 2019 was 4.8%.

All told, we expect inflation to rise above 2% 22 months after the start of the recession, about 2022 onward, and to be sustained above that thereafter. After the last two recessions, it took 40 and 50 months, respectively, to get that high. ■

ECONOMICS

US Economy: Resilient and Self-Sustaining

Ellen Zentner, Chief US Economist, Morgan Stanley & Co.

Our base case is that the pace of recovery picks up steam after a difficult winter as it returns to normalization. We expect the rising threat of COVID-19 to dampen growth through the first months of 2021, but for the baseline level of activity created by momentum through the fall to be enough to sustain the economy and lift our GDP growth forecast to an annualized 5.9% (see table). Moreover, further fiscal support is likely to come in reaction to the rise in hospitalizations and renewed restrictions, and it could include increased money for testing, tracing and vaccine distribution, as well as income for households. We expect a 4.1% annual rate for 2022 GDP growth. Also in our forecast, the US economy returns to its pre-COVID-19 level of output in the second quarter of next year.

LOWER UNEMPLOYMENT. The post-vaccine recovery encourages increased labor-force participation, while a faster pace of economic output creates plenty of space for new entrants into the labor market. On balance, this brings the unemployment rate down to 5.1% in the fourth quarter of 2021 and 4.0% in the fourth quarter of 2022—a historically sharp decline (the most recently reported jobless rate is 6.9% for October 2020). The drop in unemployment, in turn, supports growth in labor income throughout the forecast horizon.

Following a difficult winter with sequential declines in consumer spending into the new year, we expect growth in labor income and broad dissemination of a vaccine in spring 2021 to help services spending catch up to goods spending—which had already moved above its pre-COVID-19 level in the second quarter—by midyear. Meanwhile, low mortgage rates, sizing up and continued outmigration from city centers keep housing activity strong, which in turn fuels home-related spending.

FISCAL IMPACT. Fiscal expansion, when done early in a recovery, has the most impact and lifts inflationary pressures

further. We have repeatedly made the case that inflation will surprise to the upside in this cycle, and indeed both consensus and the Fed have risen to our forecasts this year. Still, we take our expectation for core measures of inflation higher over the forecast horizon. Our expected level of unemployment points to a substantial closing of the employment gap, which supports higher core Personal Consumption Expenditure (PCE) inflation, as does increased aggregate demand. We forecast core PCE inflation to move through the 2% annual rate on a sustained basis starting in late 2021, then rising further to 2.2% at the end of 2022.

With our stronger outlook, we expect the Federal Reserve to begin to take its foot off the accelerator by reducing the pace of its asset purchases beginning in January 2022. This is one quarter earlier than we previously anticipated. An outcome in line with our expectation would bring the size of the balance sheet to \$8.7 trillion by the end of 2021 and \$9.0 trillion by the end of 2022. Seeing inflation sustained at or above a 2% annual rate for a time with substantial progress towards maximum employment, the Fed begins to raise the target range of the federal funds rate from the zero bound in 2023's third quarter, nine months earlier than our previous expectation.

DOWNSIDE RISK. Where can we be wrong? The downside risks are dominated by COVID-19's path, particularly if it worsens in the absence of further fiscal stimulus. If so, a more drawn-out recovery leads to longer stints of unemployment and greater permanent job loss. An earlier, robust dissemination of the vaccine and Democrats completing a larger portion of their wish list are key drivers of upside risk that could lead to materially higher GDP growth. ■

Morgan Stanley & Co. US Economic Forecast

	2020E	2021E	2022E
Real GDP (%)	-3.5	5.9	4.1
Private Consumption	-3.8	6.0	4.0
Government Consumption	1.2	1.5	1.8
Gross Fixed Investment	-1.6	5.9	4.9
GDP Contribution (percentage points)			
Final Domestic Demand	-2.9	5.6	4.2
Net Exports	0.2	-0.9	-0.4
Inventories	-0.7	1.2	0.4
Unemployment Rate*(%)	6.7	5.1	4.0
Consumer Price Index (%)	1.2	1.8	2.5
Core PCE** (%)	1.5	1.9	2.2
Policy Rate (%)	0.125	0.125	0.125
General Govt. Balance (% of GDP)	-15.2	-10.7	-4.5
Gross Govt. Debt (% of GDP)	125.1	128.0	126.0
Current Account Balance (% of GDP)	-3.2	-3.8	-4.0

*End of period **Personal Consumption Expenditure Index

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Morgan Stanley Research as of Nov. 15, 2020

EQUITIES

Strong Growth, Strong Returns

Michael Wilson, Chief US Equity Strategist, Morgan Stanley & Co.

Graham Secker, Head of European and UK Equity Strategy, Morgan Stanley & Co., International plc+

Jonathan Garner, Chief Asia and Emerging Market Equity Strategist, Morgan Stanley Asia Limited+

This time last year, we wrote that the late-cycle economic backdrop, elevated valuations and heightened investor optimism would translate into below-consensus expectations for earnings per share (EPS) and subdued single-digit returns. Now, the pandemic leaves us in quite a different place. We believe that we have now transitioned to an early cycle environment, which implies strong profit growth that we believe is not yet priced in the markets (see table).

We Forecast Solid Equity Returns Across the Developed Markets in the Next 12 Months

Index	Current Price	New Target Price – December 2021 (change from current price)		
		Bull	Base	Bear
S&P 500	3,575	4,175	3,900	3,375
		18%	10%	-5%
MSCI Europe	1,562	1,870	1,730	1,410
		20%	11%	-10%
TOPIX	1,726	2,000	1,870	1,300
		16%	8%	-25%
MSCI Emerging Markets	1,182	1,400	1,250	900
		18%	6%	-24%

Source: FactSet, Morgan Stanley & Co. Research as of Nov. 15, 2020

When economies emerge from recession, there is concern about the speed and strength of recovery. Still, the degree of uncertainty here is arguably greater than normal, given the unprecedented pandemic and record monetary and fiscal stimulus. Although the increase in COVID-19 cases in Europe and the US may lead to some near-term economic weakness, it is unlikely to derail a strong profit rebound during the next 12 months, in our view. Instead, strong nominal GDP growth next year implies a sizeable acceleration in revenue growth, which should be turbocharged by impressive operating leverage. Our top-down 2021 EPS growth forecasts for all regions are 25% to 30%, with further double-digit growth expected in 2022, too (see chart).

UNSETTLING UNCERTAINTY. Although rising COVID-19 cases and recent geopolitical uncertainty can be unsettling for investors, in our opinion they also have the benefit of muting investor sentiment and ensuring the strong growth outlook we envisage is not priced into equity markets. For example,

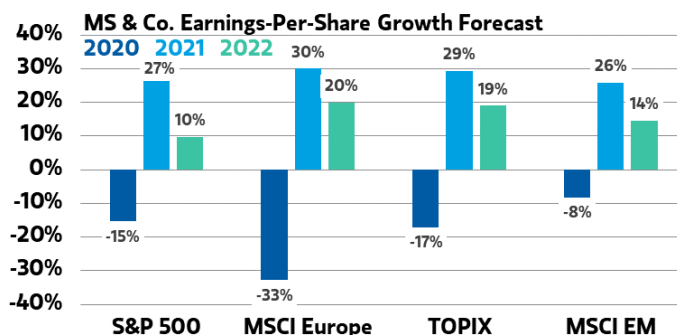
there's a close link over time between the respective year-on-year change in the global purchasing managers index (PMI) and MSCI World Index. However, the equity index is currently lagging by an unusual amount; this time last year, equities were running ahead of the PMI. This analysis becomes even more compelling when we measure the PMI against the relative 12-month return of stocks versus bonds; the latter catching up to the former would require a 35% outperformance. Alternatively, we can flip this logic and say that asset markets are pricing in a sub-50 global PMI instead of the current 53.3.

The unique cause of the 2020 recession has meant policymakers have been given unprecedented latitude to respond without meaningful pushback, whether that is record peacetime fiscal deficits or large-scale Quantitative Easing. While this has proved critical in supporting asset markets through this year, what may also prove unique is its persistence into the recovery, with our economists expecting further fiscal and monetary stimulus during 2021. In their recent report, our bond strategists highlighted that developed market central banks look set to add liquidity worth 0.76% of annual nominal GDP, on average, every month in 2021.

HIGHER FOR LONGER. Policymakers' desire to maintain substantial policy support into the recovery should allow elevated equity valuations to remain higher for longer. Hence, although valuations look somewhat rich in absolute terms, we expect these multiples to moderate only modestly during the next 12 months—given that central banks will not be tightening policy into the earnings recovery, as usually occurs, and equities continue to look attractive versus bonds. This should provide even greater support to stocks at the beginning of a new cycle when confidence about the subsequent EPS outlook is highest.

We believe risks around our base case lean in a positive direction. The implied upside under our bull case assumptions is materially bigger than the downside in our bear case for the

We Expect a Strong EPS Recovery Across All Regions Next Year



Source: Morgan Stanley & Co. Research as of Nov. 15, 2020

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US and Europe. We believe that the bear case revolves around either a COVID-19-related disruption having a longer-than-expected impact on economies or a more significant rise in bond yields driving a material decrease in valuation. Upside risks could come from greater-than-expected operating leverage, pushing EPS growth even higher, or a further rise in equity valuations, perhaps prompted by an asset allocation shift into equities or an upturn in mergers and acquisitions given an encouraging backdrop of rising earnings, reasonable valuations and cheap and abundant liquidity.

We prefer the developed markets to the emerging markets. Our top-down forecasts suggest comparable upside across all three main regions, albeit with different drivers. For example, strong ongoing price and earnings momentum should continue to support the US. Europe and Japan should benefit from global deflation, given their greater value characteristics. As for Asia and the emerging markets, we expect China's performance to moderate versus the rest of the emerging markets, and we have upgraded India to overweight.

As befits the start of a new cycle, we have a preference for cyclical, especially in the US and Europe, where we are also overweight financials. The prospect of higher bond yields and strong earnings growth suggests that greater valuation discipline is needed than previously, so we are cautious on expensive defensive/growth stocks.

US

We see upside into 2021 on the back of robust earnings, not valuations. With nominal annualized US GDP growth of about 7% and global GDP growth of about 9%, we expect the top line to rebound with powerful flow-through to earnings, given companies' focus on costs. This recovery is no different from others, and we'll pass peak earnings before peak sales as margins lead the way. Evidence for the rebound has been mounting, with most parts of the market outside of a few areas more directly affected by COVID-19 already seeing a return to year-on-year operating profit growth as cost cuts have offset top-line declines. Our base case for additional fiscal stimulus even in a divided government scenario supports the consumer balance sheet and a path to reopening from the end of the first quarter. As such, we think that earnings growth will be significant and surprise to the upside. Higher long-term interest rates will be a headwind to valuation, but we expect a partial offset from falling equity risk premiums. On balance, we see upside as earnings growth exceeds compression in price/earnings ratios.

Normally, uncertainty rises with time, but today we have higher conviction in our six-to-12-month view than in our three-month outlook. Near term, the market still needs to work through COVID-19's second wave, doubts around fiscal stimulus and the Georgia US Senate runoff. Ultimately, we expect fiscal support to come through and see the size of

support as correlated with the impact of the virus. In other words, we see fiscal policy ready to offset COVID-19's economic fallout and take 2020's lesson that concerted fiscal and monetary policy can be an effective economic support. In the near term, with full valuations and a seasonal gap in data to confirm better earnings, we see the market as range-bound with risks skewed lower. We advise using pullbacks to add risk, particularly cyclical assets.

In line with our recession playbook, we retain our preference for small caps over large caps and cyclicals over defensives. High-quality and certain secular growth stocks remain richly valued and are likely to re-rate relatively lower as long-term interest rates rise. We continue to recommend a barbell of reasonably priced growth stocks with cyclicals that will flourish in the recovery. At the sector level, we are overweight financials, industrials, materials and health care. We are underweight consumer staples and utilities.

Europe

It appears that 2020 will go down as the worst year for European equities' relative performance since the 1980s, reflecting the region's materially weaker economic and profit growth. However, poor 2020 performance should set Europe up for a strong rebound next year and into 2022 as well; we forecast EPS growth of 30% in 2021 and 20% in 2022.

Given COVID-19's significant impact on the European economy, it should be a relative beneficiary of positive vaccine news. The EU recovery fund should also be formally signed in due course, with proceeds starting to be distributed in the second half of 2021, supporting materially above-trend GDP growth in 2022 and 2023. Europe's relative valuation characteristics also mean that it is less vulnerable to higher global yields.

Within Europe, we prefer cyclicals over defensives and selected value sectors over expensive quality stocks; reopening beneficiaries look attractive to us as a source of cheap cyclical with an impending catalyst. We are overweight financials, materials and consumer services; we are underweight consumer staples, health care, energy and software.

Asia/Emerging Markets and Japan

"Reversion to the mean" thinking is particularly dangerous in an era of profound and accelerating structural challenges, including technological disruption, COVID-19/health care, climate change and the investment implications of a shift to a multipolar world. We are leaving several key core preferences unchanged. Most notably, we still expect Japan and China (specifically A-shares) to continue to outperform versus Asia/emerging markets over the cycle, with energy and banks lagging. Within China, we are transitioning to late-cycle plays. We are also upgrading India to overweight given structural reforms and a strong expected growth recovery. ■

FIXED INCOME

G10 Interest Rates:
Reflation vs. Liquidity

Matthew Hornbach, Global Head of Macro Strategy, Morgan Stanley & Co.

A combination of a continued V-shaped economic recovery aided by vaccines, modest fiscal support and a dovish Federal Reserve should allow US Treasury yields to move higher in the new year, led by the longer maturities. The benchmark 10-year yield, now at 0.85%, should trade slightly below 1.5% by the end of 2021 (see table). A successful COVID-19 vaccine would support the next leg of our V-shaped recovery narrative. We see Treasury yields rising in the first half as the vaccine becomes more widely available.

Consistent with the Fed's average inflation targeting policy, policymakers will prefer to wait for actual improvement in data—rather than expected improvement in data—before acting, particularly for inflation. Within this reactive approach, our economists see a low likelihood that the Fed makes substantive changes its economic projections before June 2021, allowing the yield curve to steepen and inflation breakeven rates to head toward 2%.

The role of fiscal policy takes a back seat in our Treasury yield forecasts, given the relatively smaller fiscal stimulus expected under a likely divided government, as well as lowered needs for increasing coupon sizes in 2021, given the significant increases in coupon sizes in 2020. Moreover, our public policy strategists expect fiscal stimulus to be more reactive to economic or market weakness, rather than proactive, further lowering its impact on Treasury yields.

Yield moves occurring in 2022 are more reflective of the Fed looking to dial down accommodation, as our economists expect the Fed to move toward a tapering of Treasury purchases in 2022's first quarter. We see real yields starting to rise in 2022, while breakevens stabilize. We expect the nominal 10-year yield to hit 1.85% by the end of 2022.

Euro Zone

We see Bund yields rising gradually above current market levels with a modest steepening bias in the two-year/10-year and five-year/30-year yield curves in 2021 and into 2022. Even so, we expect Bund yields to remain negative up to the 10-year maturity. Supply is likely to increase across the Euro Zone in the first half as governments again look to front-load their issuance into the first half of the year. However, expected bond purchases by the European Central Bank (ECB) should lead to negative net supply for the year. All told, that will likely mean that any rise in Bund yields will have less to do with the Euro Zone specifically and more to do with the prospect of rising US Treasury yields. However, a faster-than-expected distribution of a global vaccine could lead markets to question whether, first, the ECB continues with bond purchases for the entirety of the year and, second, whether core Euro Zone countries pull back on fiscal expansion faster than expected.

UK

The outlook for gilts is likely to remain highly uncertain given Brexit, questions about the Bank of England's (BOE) willingness to adopt a negative policy rate, ongoing lockdowns, the outlook for the budget/supply due to extended government furlough and assistance programs, the Scottish elections and, finally, the speed of BOE gilt purchases in 2021. We forecast gilt yields to rise modestly in 2021 with a steepening bias to the two-year/10-year and five-year/30-year yield curves.

Japan

Although the continued global economic recovery will likely weigh on global bond markets, we continue to expect the Bank of Japan's strong commitment to yield curve control to prevent a large rise in yields. We expect the yield on the 10-year Japanese government bond to end 2021 at 0.00%. We maintain a constructive view on the long end, although we anticipate higher term premiums in response to the global V-shaped recovery and subsequently higher global bond yields. We expect the 30-year yield to end 2021 at 0.55%. A key risk for our view is that another serious lockdown related to COVID-19 forces the government to implement another fiscal stimulus program. ■

Morgan Stanley & Co. Government Bond Yield Forecast

Maturity	Two-Yr.		Five-Yr.		10-Yr.		30-Yr.	
Country	2Q '21	4Q '21	2Q '21	4Q '21	2Q '21	4Q '21	2Q '21	4Q '21
US	0.35%	0.40%	0.65%	0.70%	1.30%	1.45%	2.20%	2.40%
Germany	-0.60	-0.55	-0.60	-0.50	-0.35	-0.20	0.15	0.35
Japan	-0.15	-0.15	-0.10	-0.10	0.00	0.00	0.55	0.55
UK	0.00	0.10	0.20	0.30	0.55	0.70	1.05	1.20

Source: Morgan Stanley & Co. Research as of Nov. 15, 2020

CURRENCIES

Global Recovery Equals US Dollar Weakness

Matthew Hornbach, Global Head of Macro Strategy, Morgan Stanley & Co.

The US dollar topped this year, and we forecast it to weaken further in 2021, falling about 4% as measured by the US Dollar Index (DXY). We expect the euro, now at 1.18, to trade at 1.25 by this time next year (see table). Liquidity from central banks is still ample and expanding, while supportive government fiscal spending should help risk assets to rise, particularly into the first half of 2021. The greenback tends to weaken alongside strong global growth, which is in our forecast, too. US real yields are expected to stay low. Catalysts that will weaken the dollar include: continued announcements of successful COVID-19 vaccine trials and then the distribution of the vaccine; agreement on a Brexit trade deal; spending from the EU recovery fund; and a continuation of low fed funds rates even as economic growth picks up.

SAFE HAVEN. We continue to see the dollar as the best safe-haven currency in the G10, rising in times of risk-off and falling in times of risk-on. This is because, now that US nominal rates have converged to global peers, the dollar is likely to be used as the funding currency of choice for foreign exchange carry trades or, increasingly, for corporate borrowing. Second, global investors that accumulated dollar-denominated assets in the last five to seven years may now choose to hedge those assets as the cost to hedge is cheaper and the dollar is in decline. We expect Japanese and Euro Zone investors to increase their dollar hedges in 2021.

Since floating exchange rates began in the 1970s, the dollar has had two full up and down cycles. The bearish cycles were on average six to seven years in length, which suggests that if March 2020 was the DXY's peak, the dollar will still be in the middle of that downtrend next year. The downward journey may not be as smooth as it was in the late '80s or early '00s. Historical analysis of Fed rate cycles shows that big DXY peaks occurred around 20 months after the market started to price in the rate-cutting cycle. This pattern occurred again

recently, with the two-year US Treasury yield peaking in November 2018, and the DXY following suit 16 months later in March 2020.

POLICY EASING. The combination of fiscal and monetary easing has caused investors to question which will be more important in driving currency price action. Historically expansionary fiscal policy coupled with more austere monetary policy has been most currency-positive, with dovish monetary policy and tight fiscal policy being the most currency-negative. In the end, we think that fiscal spending will be more important in 2021, as this has a more direct impact on growth. Markets will be most focused on whether the prospective new US administration can deliver large fiscal support, which would be bullish for risk and bearish for the dollar. The size of the stimulus is dependent on whether the Democrats win the Georgia Senate seats on Jan. 5. Globally fiscal stimulus is expected to continue but at a smaller scale than in 2020, while monetary policy is expected to remain accommodative.

The risks to our bearish dollar outlook mainly center on the path of global growth, which is affected by the availability of an effective COVID-19 vaccine. After the positive outcome from the Pfizer vaccine, our biotech analysts expect other positive Phase 3 trial news and distribution around March or April. The dollar would strengthen if a vaccine isn't available next year and economies return to lockdowns.

RAISING RATES? We also assume that the Federal Reserve will be tested on its average inflation targeting framework when the US economic outlook improves. Should some Fed members decide to talk about when to raise rates due to stronger inflation and employment, then the dollar weakness may not be as large as we forecast. Most developed market countries are facing risks of high debt levels and unemployment due to COVID-19 restrictions and lockdowns. So, any worries about those issues continuing after global travel resumes could be a worry for risk markets and bullish for the dollar. ■

Morgan Stanley & Co. Currency Forecasts

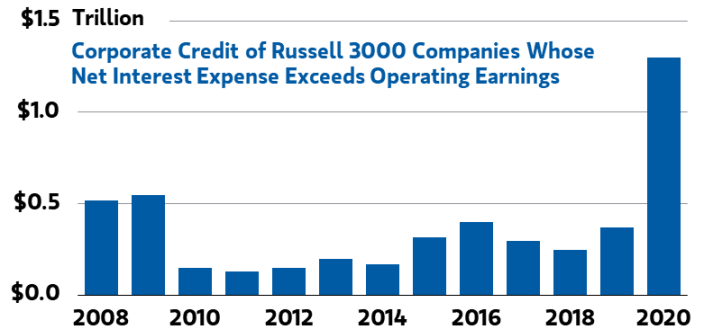
Currency vs.								
US Dollar	1Q '21	2Q '21	3Q '21	4Q '21	1Q '22	2Q '22	3Q '22	4Q '22
Euro Zone	1.20	1.23	1.24	1.25	1.24	1.23	1.22	1.21
UK	1.33	1.35	1.32	1.32	1.32	1.32	1.32	1.32
Japan	103	103	104	105	105	105	105	105
China	6.55	6.50	6.45	6.40	6.38	6.37	6.36	6.35

Source: Morgan Stanley & Co. Research as of Nov. 15, 2020

Short Takes

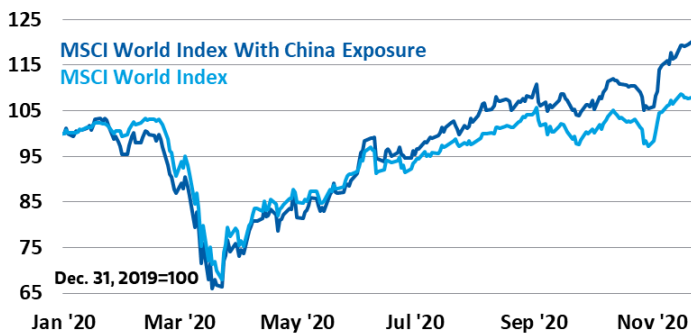
With Easy Access to Cheap Financing, “Zombie” Companies Are on the Rise

“Zombie” companies are defined as companies whose interest expense is greater than their operating income. In this sense, they are losing money every quarter but survive by financing and refinancing with cheap debt. An analysis of the Russell 3000 Index—a broad metric covering 98% of US companies—shows that, based on third quarter earnings, zombie company debt is at an all-time high of more than \$1.3 trillion (see chart). Recessions typically wash out the weakest companies alongside market excesses, but this time has been different. The Federal Reserve’s actions to ease financial conditions provided much needed support for financial markets. It also threw a lifeline to zombies, which, in combination with federal aid to business, has also helped keep them in operation.—*Nick Lentini*



Source: Bloomberg as of Nov. 17, 2020

China’s Emergence From Recession Can Be Seen in Global Equities



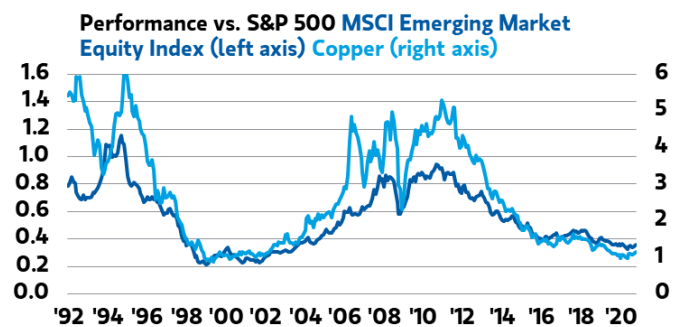
Source: Bloomberg as of Nov. 19, 2020

Jonah Silverman

China emerged from recession months ago, and investors globally have taken notice. The MSCI World With China Exposure Index—the 50 companies in the MSCI World Index with the highest revenue exposure to China—has outperformed the MSCI World Index by 12 percentage points so far this year (see chart). China posted 4.9% year-over-year GDP growth in the third quarter, and MS & Co. economists forecast 9.0% GDP growth for China in 2021. We find investment in China attractive due to positive real interest rates, improved corporate debt dynamics and a strengthening renminbi. China also stands to benefit from the new Association of South East Nations trade pact, potentially less-volatile trade relations with the US and a weaker US dollar.—

Copper’s Rebound Points Toward Strong Emerging Market Performance

Copper prices have rallied since their March lows, and strong fundamentals present a constructive outlook. MS & Co. metals analysts are bullish on copper and forecast a rising price through 2021. This is supported by a high market deficit caused by weak supply growth, low global inventory and weakening inflation expectations. What’s more, within the expected V-shaped global economic recovery, copper is likely to be resilient. This should bode well for emerging market equities as they have a high correlation with copper prices (see chart). As both the largest producers and consumers of the metal, copper’s rising price is a sign of emerging markets’ economic acceleration.—*Vibhor Dave*



Source: Bloomberg as of Oct. 31, 2020

POLICY

Policymakers and the Pandemic: Defining a New Business Cycle

Lisa Shalett, Chief Investment Officer and Head of the Global Investment Office, Morgan Stanley Wealth Management

Nick Lentini, Associate, Morgan Stanley Wealth Management

The following is a summary of our Nov. 9 Special Report. For the complete report, contact your Financial Advisor.

The business cycle that followed the Great Financial Crisis (GFC), one of the longest in duration and most sluggish in modern history, came to an abrupt end in March 2020 when the COVID-19 pandemic forced an economic shutdown. As is always the case, the cycle was uniquely defined by what led up to it and the policy actions employed to combat the damage from the preceding recession. That cycle (post GFC) was one of secular stagnation, including: below-average GDP growth, weak capital deepening, poor productivity gains, deflation and deleveraging by systemically important banks and households. An aging population exacerbated the dynamic with excess savings far outstripping growth and investment opportunities. The policy backdrop was dominated by the Federal Reserve's embrace of financial repression, executed through Quantitative Easing (QE) and \$4 trillion worth of balance sheet expansion. Those actions brought the 10-year US Treasury yield to an all-time low of 0.5% this year, from nearly 4% in 2009. While the Federal Reserve's bond purchases injected liquidity and greased financial conditions, actual money growth was unremarkable at a 6.2% annualized rate. The velocity of money plummeted

as banks rebuilt reserves and recapitalized balance sheets. Banks' returns on equity froze under the chill of regulation.

Legislators, for their part, were parsimonious following the initial government bailouts of 2009-2011, with fiscal action focused on deregulation and then on 2017's historic corporate tax cut. That cut took the maximum corporate tax rate to 21% from 35%, and companies largely used the cash on the biggest-ever wave of share repurchases. At the same time, corporate debt markets grew more than sixfold, as issuers exploited capital costs at all-time lows to recapitalize balance sheets, leaving nonfinancial business debt relative to GDP at a record 57%. By the cycle's end, unemployment had reached a 50-year low, corporate profits as a share of GDP hit a record high and inflation remained frustratingly low, all while income gains for the average American household stalled.

FIVEFOLD GAIN. Although these forces did little to lift real wages, they produced one of the best decades ever for investors. Falling interest rates, shrinking share bases and soaring corporate profits powered a more than fivefold increase in the S&P 500 Index between its 2009 nadir and the Feb. 19 high; the compound annual return of nearly 15% was twice the post- World War II average. The period also coincided with the golden age of private equity, which drove a widening wealth gap and exacerbated the income inequality divide that had been growing for 40 years. This confluence of policy, economics and social outcomes was pushing political polarization to extremes as the global pandemic hit. As a result, the current recession, in which the seeds of the next business cycle germinate, was made all the more unique by

How the Economy Moves From Secular Stagnation to COVID-19 Recession and Expansion

	Post-GFC/Age of Secular Stagnation	COVID-19 Recession	Post-COVID-19 Expansion
	2009-Feb. 2020	March 2020- June 2021	July 2021
Metric	Actual	Estimate	Estimate
Real Average Annual US GDP Growth	1.8%	-5.7%	2.5%-3.5%
10-Yr. Nominal US Treasury Yield	To <1% from 4%	To 1%> from <1%	2.5%-4.0%
Annual Core PCE Inflation	1.6%	1.3%	2.2%-2.5%
Trade-Weighted US Dollar Change	28.2%	-8%	-10%
US Government Debt/GDP	Rose to 100%	103%-105%	TBD
Annual Average Productivity Growth	1.4%	N/A	2.2%
Average Annual Wage Growth	1.6%	N/A	2.0%+
Corporate Tax Rate	To 21% from 35%	21%	Expected to rise to 28%
Peak Corporate Profits Share of GDP	12%	6%	8%
S&P 500 Average Annual Price Gain	14.8%	7.0%-8.0%	4.5%-5.5%
Average Trailing Price/Earnings Ratio	24.5	27.0	20.5

Source: Morgan Stanley Wealth Management Global Investment Committee as of Nov. 9, 2020

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the nature of the COVID-19 crisis itself, as it exposed yet additional dimensions of social inequality.

As we write this, the coronavirus pandemic is still with us, somewhat coloring our conclusions with the myopia of current conditions. For investors, it seems the threats to personal health, the global scale of the pandemic, the damage it has already inflicted—more than 1.2 million fatalities worldwide and more than 233,600 in the US (as of Nov. 4)—and the unfathomable impact to daily life that the pandemic has wrought has obfuscated the need for critical reflection on the nascent business cycle. For now, most eyes are focused simply on the hope of recovering to prior levels of activity.

Already, equities, as measured by the S&P 500 Index, have fully recovered from the coronavirus-related bear market that started in March. The index posted an all-time high of 3,627 on Nov. 16, reflecting gains of more than 60% from the trough and 14.1% for the year to date.

UNPRECEDENTED POLICY ACTION. Certainly, we have acknowledged the drivers of the stock market's optimism. Monetary and fiscal policy action have been outsized and unprecedented. The Fed, leveraging its balance sheet and lending programs to the fullest, has already injected more than \$3 trillion into fixed income markets in 2.5 months—an amount it took them 2.5 years to spend after the GFC. Congressional authorizations of direct payments and lending programs have also totaled \$3 trillion thus far. This brings cumulative stimulus of more than 25% of annual GDP against 2020 GDP recession shortfalls that are now estimated at only 3% to 5%. In fact, there is powerful evidence that the economy has weathered the worst of the storm: Personal income, savings rates and spending are strong, considering that nearly 30 million people have filed for some form of unemployment insurance. Furthermore, evidence of a V-shaped economic recovery has been validated in manufacturing indexes, housing reports, capital goods orders and even labor markets.

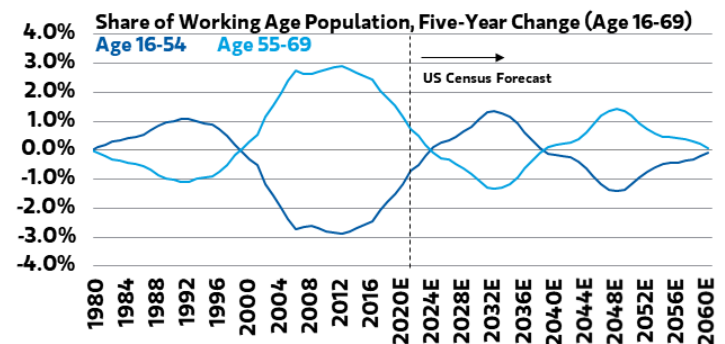
That said, the composition of the market recovery has, for the most part, reminded observers of last cycle's market behavior. The leaders have been long-duration assets, mega-cap tech stocks and passive indexes. We understand that many investors presume that what worked from 2009 through 2020 will work in the next cycle. After all, the behavioral changes required of quarantines and "work/learn from home" have accentuated the dominance of current market leaders in tech, mobility and social media. Many feel the factors that characterized the age of secular stagnation—an activist Fed, powerful technology trends and overall deflation—will continue. We strongly disagree, and this report is devoted to articulating that case.

Specifically, our findings are that the new business cycle—and the stock market that accompanies it—will be defined by very different parameters, constraints and policy options than

those in the era of secular stagnation (see table). Perhaps most provocatively, we suggest it was only a crisis exactly like COVID-19 that would simultaneously prompt aggressive and coordinated policy action as well as jump-start and accelerate structural trends—a powerful combination that we view as necessary in order to break the legacy of secular stagnation.

For starters, the combination of remarkable and simultaneous fiscal and monetary stimulus suggests a reflationary expansion that returns GDP to more normal levels of 2.5% to 3.5% per year. Some shifting structural tailwinds that we foretold in our 2016 *Special Report*, "Beyond Secular Stagnation," are also likely to remain positive factors: improved demographics, with the aging out of the baby boomers and the maturation and work force entry of millennials and Gen Zs (see chart); accelerating productivity growth, as tech adoption and innovation focuses more on businesses and less on consumers; and the releveraging of household and bank balance sheets.

Demographic Headwinds Should End as Baby Boomers Leave the Workforce



Source: Haver Analytics as of Oct. 20, 2020

EXOGENOUS SHOCK. COVID-19 has also been an exogenous shock that has likely driven both permanent changes and significantly accelerated trends in place. In the aftermath of the pandemic, we see industry transformations linked to business automation and contactless service models. Delivery for nearly everything, from higher education to health care, is being redesigned in real time, suggesting we are living in a period ripe for radical transformation. Concurrently, we see serious challenges to the outlook for segments of the economy that are becoming obsolete, such as mall-based and Main Street retailing, as well as commercial real estate focused on urban offices. So too, we question the presumed dominance of certain "work from home" (WFH) highfliers, whose 2020 performance constituted, in our minds, one-time peak "pulled forward" demand rather than sustainable growth that could lead markets in the next cycle.

The pandemic has also refocused the national debate on

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health care reform and the wisdom of tying health insurance to employment status, a dynamic amplified by renewed evidence of social and racial inequality. We see populist-driven pressures reviving antitrust regulation, encouraging a new look at tax reform and policies that provide wage and benefit gains for labor. Climate change is also likely to remain a challenge, creating social costs but also investment opportunities in technologies and infrastructure to address the issue. We conclude that, in aggregate, the locus of pressures on corporate profitability will shift meaningfully and reflect these trends throughout the next cycle. Challenges to the incumbency of near monopolists and megacap leaders of the last decade are likely to intensify, while industries left behind in the last decade, such as services and industrial companies, will likely see new opportunities.

POLICY CONSTRAINTS. Even if economic dynamism improves, policy is likely to be constrained, with both monetary and fiscal limits requiring innovation and experimentation. This could bring short-term accommodation for markets and the economy, but also long-term risks. The Fed, already at the zero lower bound (ZLB) on the fed funds rate and committed to unlimited QE, has taken a radical departure from institutional orthodoxy. Policymakers adopted “average inflation targeting” (AIT) and dismissed the relevance of the Phillips curve, actions aimed at driving inflation expectations upward. This represents a break with the 40 years of Fed policy that helped drive the longest bull market in US Treasuries in history, and, in our opinion, speaks to a secular trough in nominal interest rates.

Now, with the Fed out of conventional policy options, policymakers will need to consider more innovative tools—negative interest rates, yield curve control and/or complete debt monetization. Not only is usage of these tools in the economy of the world’s reserve currency mostly untested, but such policies may have unintended consequences. The pursuit of negative nominal interest rates is particularly questionable, as it places huge burdens on banks and creates perverse incentives for customers to seek even further

shelter in shadow banking and the less-regulated cash/payment platforms. Yield curve control and complete debt monetization inevitably mean even bigger central bank balance sheets and complicate the Fed’s political independence.

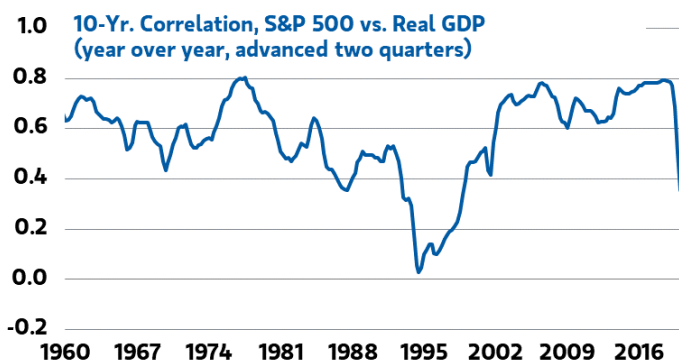
RATE SUPPRESSION. As we take stock of the last cycle’s policy innovations, an obvious irony appears: Policymakers addressed the GFC—a crisis born of excess housing-related debt concentrated on the balance sheets of households and banks—with even more debt. What’s more, central banks like the Fed have also failed to acknowledge the unintended consequences of their money-printing largesse. Essentially, the artificial suppression of interest rates has forced excessive risk-taking and constrained the natural cleansing process of defaults and bankruptcies, thus perpetuating unprofitable “zombie” companies and excess manufacturing capacity. The effect was to reinforce the very excess savings problem that caused secular stagnation in the first place, feeding the very disinflationary and deflationary forces they claim to be combating. Extending and amplifying the policies likely risks exacerbating these problems, even as the markets have risen to new heights—risking asset bubbles.

The policy-driven disconnect between the financial and real economy is even more stark today, as equity markets have shown a negative correlation to economic growth in the past quarter (see chart). Such dynamics also clearly exemplify the Fed’s contribution to rising wealth inequality. Indeed, with political division and rancor, both worsened by inequality, now reaching such a fevered pitch, policy sustainability itself may become a constraint on Fed action, irrespective of the complex political overlays of any particular policy.

Fiscal policy, for its part, is also likely to hit limits, as record annual deficits are now driving the debt/GDP ratio to an extreme last seen following the end of World War II—a dynamic that risks another ratings downgrade of US debt. Although record-low nominal and real rates suggest that the cost of new government debt may not be a near-term constraint, traditional economics notes that high government debt and new taxes to fund spending tend to “crowd out” growth-oriented investment. Furthermore, even if debt is serviceable, the government will need to find buyers. The fraying relationship with China, which holds about 5% of US government securities, presents a great risk to the Treasury market. What’s more, China is aiming to encourage recognition of the renminbi as a reserve currency, which would also create serious competition for both the dollar and Treasury bonds.

MODERN MONETARY THEORY. In the face of such persistent challenges and broken economic relationships, the “conventional” theories about the limitations of both fiscal and monetary policy responses are under question. Among the most provocative and consequential challenges is

The Stock Market and the Economy Have Diverged, Likely Due to Extraordinary Fed Actions



Source: Cornerstone Macro as of Oct. 16, 2020

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“modern monetary theory” (MMT), which advocates an active, expansionary and cooperative role for both fiscal and monetary policymakers. Indeed, MMT’s call for aggressive fiscal policy, financed by debt monetization rather than tax revenues, not only suggests that inflation is the only constraint on policy action, but even calls into question the very distinction between monetary and fiscal policy. Although we have no knowledge of how these policy choices will be pursued, the chances are growing that some combination of new policy innovations will be embraced. In the cycle ahead we see policymakers’ strategy—unspoken but implicit—centering on US dollar debasement, as this is the only way to simultaneously tame both deflation and debt. Importantly, with US relative growth and yield advantages no longer sufficient to offset both the current account and trade deficits, a meaningfully weaker dollar is not simply a wish but is justified by fundamentals.

Positioning for the Post-COVID-19 New Bull Market

	Post-GFC "Age Of Secular Stagnation"	Post-COVID-19 New Bull Market
Equities		
Regions	US	International, especially emerging markets, China and Japan
Sectors	Tech, defensives	Financials, materials, industrials, health care, clean energy
Themes	Smart phone ecosystem, social media	Housing, clean energy, infrastructure/capex, robotics, autonomous vehicles, AI/data analytics, cybersecurity
Capitalization	Mega cap	Large-, mid- and small- stocks
Factors	Low volatility, momentum	Value, quality
Exposure	Passive	Active
US Dollar	Hedged	Unhedged
Fixed Income		
Rates Positioning	Long	Short-intermediate
Credit Exposure	BBB, high yield	Munis, high-quality investment grade
Alternatives		
	Private equity, private credit	Gold, commodities, equity hedge funds, real estate, infrastructure

Source: Morgan Stanley Wealth Management as of Nov. 9, 2020

Ultimately, we conclude that the combination of new chapters in both monetary and fiscal policy will prove supportive of growth acceleration and normalization—but not without consequences. Whether shifting dynamics around inflation and the US dollar come as a direct outgrowth of policy choices or from the transformational impact of the COVID-19 recession itself, the implications are clear: not only higher interest rates and a steeper yield curve, but also a higher cost of capital for corporations and lower valuation multiples. Perhaps equally noteworthy, the lack of dual-policy flexibility means that the vulnerability to future recessions is quite high, while maneuvering room for policymakers is quite limited. These are dynamics that have important implications for stocks and bonds.

RETURN ASSUMPTIONS. Even before the pandemic, our forward-looking return assumptions for US stocks and bonds were weak and below their long-run averages (see *Annual Update of Capital Market Assumptions*, April 7, 2020). Our aggregate investment stance still calls for an equity bull market with stocks outperforming bonds, a preference for value over growth, international over US, small- and mid-versus mega-cap stocks and active stock- picking as opposed to passive index investments.

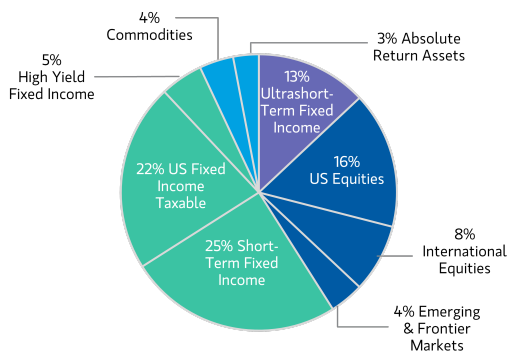
As for the post-COVID-19 portfolio, we are focused on the risks from the likely failure of stock/bond diversification, rising inflation, rising interest rates and a falling dollar. As a result, we are keen to the following: add real assets such as gold, commodities, inflation-protection securities and real estate; embrace hedge funds for income and absolute returns as bond substitutes; and be willing to consider noncorrelated assets like illiquid investments in infrastructure and green energy (see table). The limitations to investment opportunities in US stocks and bonds have us focused anew on emerging markets, with China’s upcoming decade of financialization a centerpiece of portfolio strategy. Cryptocurrencies are also likely to become a viable investable asset class. The “Five Ds”—demographics, digitization 2.0, deglobalization, debt monetization and dollar debasement—make us even more confident that market leadership could shift away from technology linked to social media and toward next-generation providers in financial services and health care, as well as industrial companies that are embracing technology around robotics, clean energy, sensing and autonomous vehicles, industrial batteries and artificial intelligence. ■

Also contributing this report was Joe Pickhardt, a paid consultant who is not an employee of Morgan Stanley Wealth Management. His opinions are solely his own and may not necessarily reflect those of Morgan Stanley Wealth Management or its affiliates.

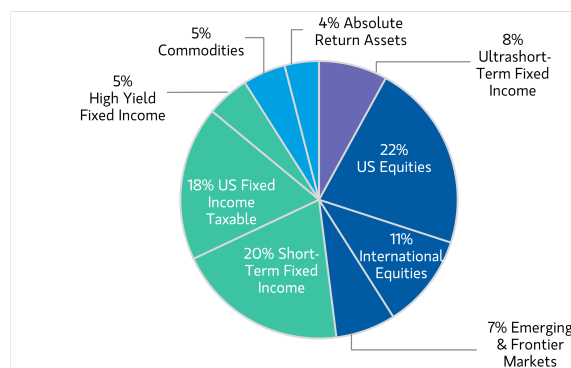
Global Investment Committee Tactical Asset Allocation

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

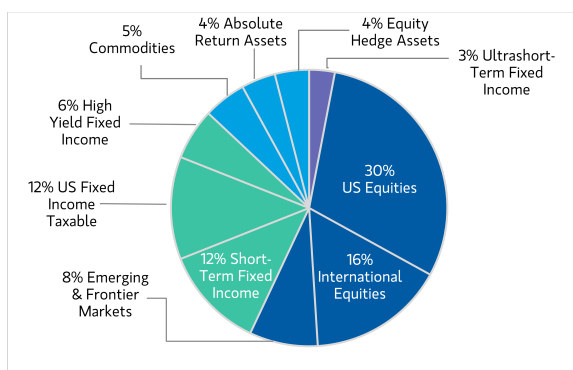
Wealth Conservation



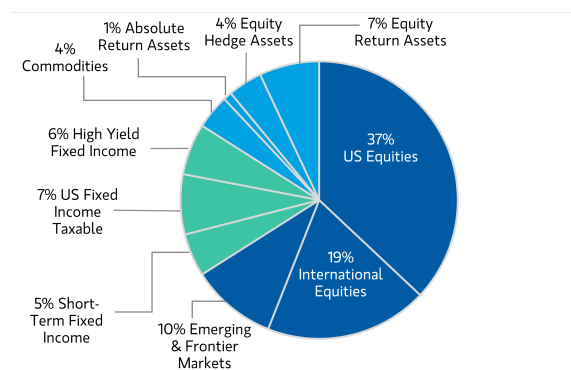
Income



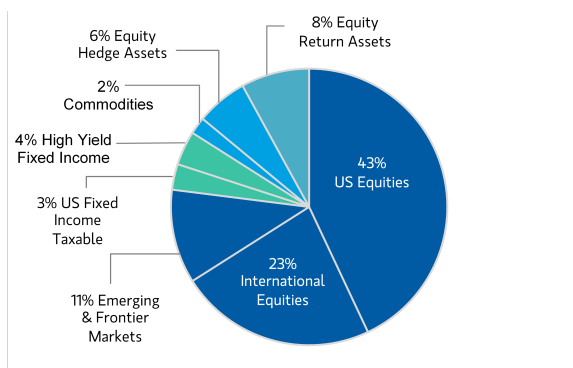
Balanced Growth



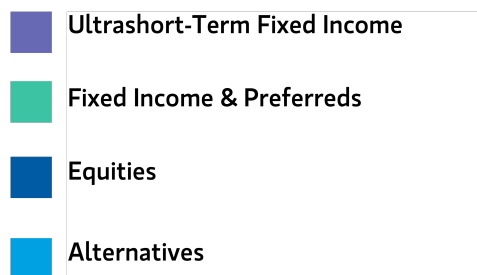
Market Growth



Opportunistic Growth



Key

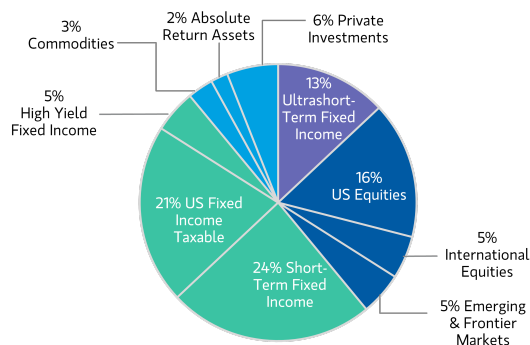


Source: Morgan Stanley Wealth Management GIC as of Nov. 30, 2020

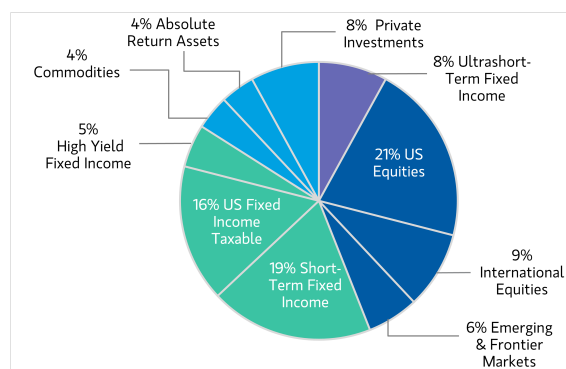
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The Global Investment Committee provides guidance on asset allocation decisions through its various models. The five models below are recommended for investors with over \$25 million in investable assets. They are based on an increasing scale of risk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

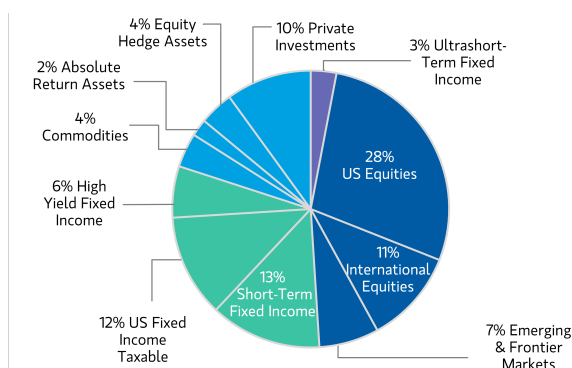
Wealth Conservation



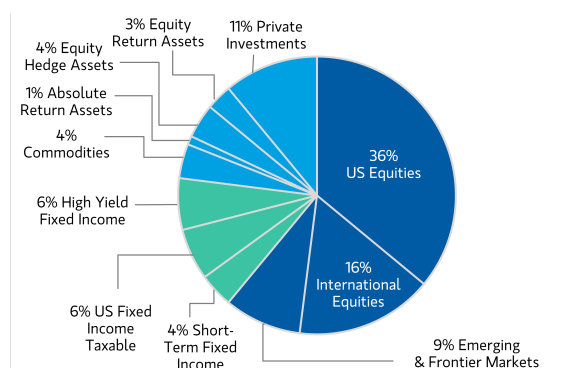
Income



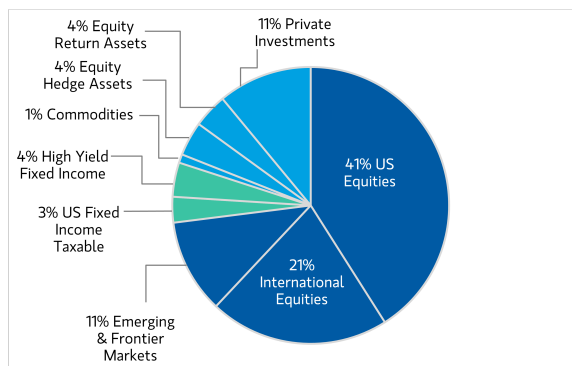
Balanced Growth



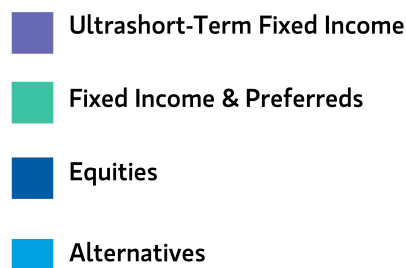
Market Growth



Opportunistic Growth



Key



Source: Morgan Stanley Wealth Management GIC as of Nov. 30, 2020

Tactical Asset Allocation Reasoning

Global Equities		Relative Weight Within Equities
US	Overweight	A V-shaped recovery is central to our thesis that a new business cycle and bull market have begun. Risks remain around election-related policy changes, fiscal stimulus and availability of a COVID-19 vaccine, but we expect 2021 GDP growth in the 5%-to-6% range, which should improve profits among cyclical and small-/mid-cap companies. We prefer active stock-picking rather than holding the S&P 500 Index, which is highly concentrated in tech stocks linked to the work-from-home and smart-phone ecosystems. Those leaders are likely fully priced, facing tough year-over-year comparisons and decelerating sequential momentum.
International Equities (Developed Markets)	Market Weight	We are constructive on international. In Europe, brightening prospects for fiscal stimulus and concrete moves toward pan-Europe fiscal integration are game-changers. In Japan, economic recovery is gaining momentum on the back of resurgent global trade, and we expect the focus on shareholder-friendly and positive return-on-equity policies to persist. The structural as well as cyclical weakening of the US dollar is a tailwind.
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 17 of this report.
Source: Morgan Stanley Wealth Management GLC as of Nov. 30, 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.

Chetan Ahya, Vibhor Dave, Jonathan Garner, Matthew Hornbach, Nick Lentini, Graham Secker, Jonah Silverman and Ellen Zentner 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

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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.

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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 economies. 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

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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

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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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