

# MIDYEAR

## INVESTMENT OUTLOOK

Global Investment Committee | July 2020

## On the Markets

### Climbing a Wall of Worry

2020 has been an unusual year that started with record-low unemployment and equities making all-time highs nearly every day. In fact, in January and February it was hard to find *anyone* who was negative on the economy or the stock market. In March, that changed with the novel coronavirus turning into a full-fledged global pandemic. The subsequent lockdown of the US economy to fight the disease led to the most sudden and severe recession in history.

What followed next was the greatest monetary and fiscal stimulus ever enacted, which means we are likely to experience one of sharpest recoveries on record, too. Stock markets around the world seem to agree, with most major averages trading extremely well. Such a rally in stock prices has many people nervous that markets are disconnected from the fundamentals and do not reflect the still-looming risks—but equity markets move well ahead of the economy and are often the best leading indicator. In short, we think the V-shaped recovery in markets is foreshadowing what will be a V-shaped recovery in the economy and in earnings.

One thing investors may be overlooking is how fast earnings often rebound after a recession. The main feature of any recession is that unemployment rises sharply. In the current case, US unemployment shot up to nearly 15% from a record low of 3.5% in just two months. Typically, it takes one to two years for the unemployment rate to reach its cycle peak. Furthermore, the increase in unemployment was twice as large as usual, leaving companies' cost structures even leaner than normal coming out of recession. As a result, we think operating leverage could be explosive as the economy recovers. From an investment perspective, this means earnings will return to prior highs faster than most analysts forecast and stocks can continue to move higher, especially the more economically sensitive ones like small caps.

Another unusual feature of this recession is how bearish the average investor remains despite the record rally. From our analysis of investor positioning and conversations with clients, we view institutional investor sentiment as neutral at best, while individual investors remain outright bearish. We think this is because we are still in the midst of a health crisis that is disproportionately weighing on individual investors. This presents a wall of worry that will eventually be scaled when the virus is eradicated either by herd immunity or a vaccine. Therefore, any periods of weakness should in our view be used as an opportunity to add to equity positions. ■

#### Michael Wilson

Chief Investment Officer  
Chief US Equity Strategist  
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## CROSS-ASSET STRATEGY

### Trust, but Verify

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

Right now, the first question for our 12-month outlook is: How can we produce one? The global economy has seen a collapse of activity, an expansion of fiscal and monetary policy and a level of medical uncertainty without precedent in the modern era. Add to that a US presidential election, simmering US-China trade tension and wild swings in commodity markets and it would seem reasonable to throw up one's hands and say the old rules no longer apply.

We disagree. While the past four months have been exceptional, we think that this cycle has been, and will be, more "normal" than appreciated. A new cycle has started, and we think investors should position themselves as such. We expect stocks and credit will be modestly higher and tighter over the next 12 months, but see more compelling opportunities in traditional early-cycle rotations.

**NORMAL CYCLE.** We're trusting a normal-cycle playbook because of what preceded this downturn, how markets troughed and the recovery our economists are forecasting.

Every bear market and recession are different, but they are often preceded by common, cyclical patterns of behavior:

- A strong economy, with healthy labor markets and high consumer confidence
- Inflation rising above the recent trend
- High valuations and profit margins, low volatility and confident/bullish investor sentiment
- Central banks that have tightened policy in the prior 12 to 18 months in response to these factors
- An inverted yield curve in the prior six to 12 months based on bond markets anticipating trouble, with slower growth ahead priced in

All these late-cycle elements preceded the recession and the 2020 bear market. Indeed, since last year, the right strategy has generally been to invest as if recession risks were high, favoring long-duration bonds and defensive, high-quality stocks. As unusual as the COVID-19 shock was, it collided with a very typical, vulnerable, late-cycle market.

**MARKETS LEAD.** The prelude to the current crisis was surprisingly normal. So was its crescendo. Markets lead the economy, and when we compare where markets bottomed to where data bottomed (or is likely to bottom), the pattern matches the past five US recessions to an almost uncanny degree.

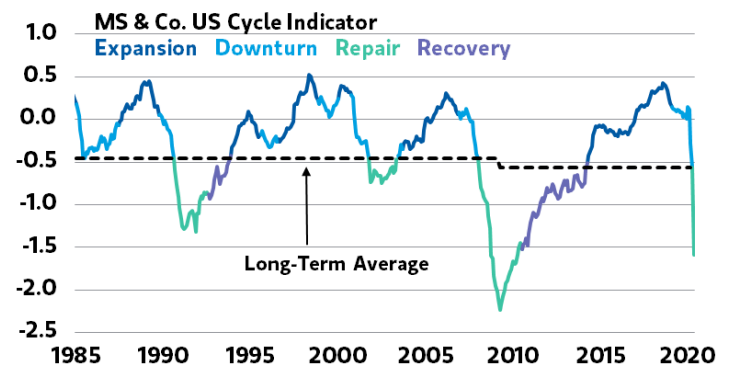
Other dynamics around the bottom were also normal, including the fact that equity volatility and credit spreads

peaked before equity markets troughed—and while the bounce from the lows has been unusually fast, so was the drawdown.

We also think that the economic recovery will look more normal than abnormal. This might sound odd, given the scale of the economic devastation, record job losses and significant medical uncertainty. Still, based on our economic forecasts, we think that growth in the developed markets could recover to prerecession levels by the end of 2021. This eight-quarter "time to recovery" would be about twice as fast as what followed the financial crisis and is similar to the US recessions of 1973 and 1981.

**WEAK DATA.** Global economic data is weak but set to improve. We think markets care more about the trend in data than the level. As such, while it may sound counterintuitive, we think fundamentals are currently supportive for risk taking, rather than a detriment. We see this in our cycle indicators as well. After first announcing "downturn" in June 2019, they entered "repair" in April 2020 (see chart). Overall, this early-cycle phase tends to be best for credit and selling volatility. Dividing it further, it has been most supportive following a trough in activity. We think that such a trough is happening now, and will improve thereafter.

#### Indicator Shows Cycle to Be Fairly in the "Repair" Phase

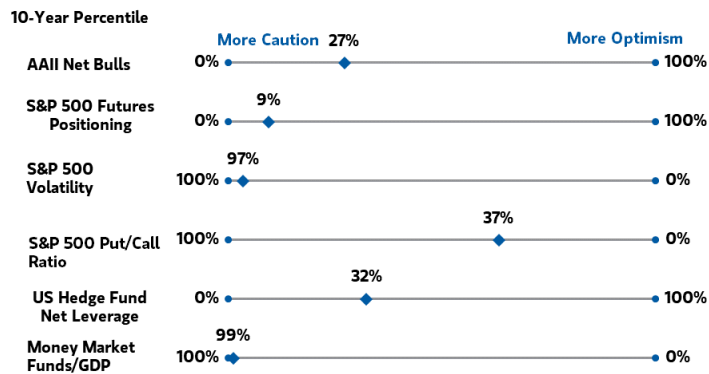


Source: Bloomberg, Haver Analytics, Datastream, Morgan Stanley Research as of May 31, 2020

Importantly, cyclical troughs often mean major changes in market leadership and performance. Early-cycle environments often see a bear steepening of the yield curve, that is, long-term yields increasing at a faster rate than short-term yields. We also expect rising inflation expectations and better relative performance from both small caps and cyclicals. All are investment strategies we currently like.

**TECHNICAL FACTORS.** Technical factors include supply and demand, investor sentiment and positioning, and central bank activity. Sentiment is particularly noteworthy. Consider the six metrics in the chart on page 3. Five of them are signaling

## Sentiment Metrics Show Signs of Caution



Source: Bloomberg, Morgan Stanley Prime Brokerage, Morgan Stanley Research as of June 14, 2020

caution based on where they stand for the past 10 years; two of them are nearly about as cautious as they've been. Caution is a contrarian indicator.

Central bank support, without exaggeration, is off the charts. The Federal Reserve is buying more assets relative to GDP than in Quantitative Easing 1, 2 and 3 combined. Together, the Fed and European Central Bank look set to buy roughly equal to all net supply across European and US sovereign and corporate debt this year.

All told, fundamentals, valuations and technicals look better for many early-cycle winners than the market overall. Our above-consensus economic forecasts help. Valuations for companies that typically do well at the start of an economic cycle are generally cheaper. And market positioning still has an "up in quality" bias, which is light for this point in the cycle.

**THREE RISKS.** Believing this is the start of a new cycle is not a new view and, given that, it's especially important to verify that three risks don't derail it:

**COVID-19.** Despite an expanding narrative that the disease is behind us, global case counts are still rising. While fatalities

are falling as health systems adapt and new infections are skewed toward younger cohorts, the menace has not gone away.

Specifically, Morgan Stanley & Co. estimates assume that US cases begin to rise again from mid-July, a delayed response to social distancing measures being lifted. Viewed from a distance, we currently believe that a "second wave" will be small. Still, when it starts, it will be impossible to know how far it will rise, and the effect on consumer and market psychology could be significant. Like we said, we're believers that trend often matters more to markets than level.

**The US elections and trade.** Asset markets, particularly those in the US, have often seen worse-than-average returns in the three months ahead of competitive US presidential elections. The reason is intuitive; from three months out, "wait and see" becomes tempting for both investors and companies that would otherwise take action. We expect investors to treat the US 2020 race as a close election between two candidates with extremely different policy platforms (see page 13). Ironically, despite these differences, one issue where we think that both candidates will sound similar is US-China trade. We think that the risk of an escalation of trade tension rises as the election approaches.

**Fiscal policy doesn't follow through.** Our current base case is that the US will pass a further \$1 trillion stimulus package between now and July and that the European Union will agree on a €750 billion recovery fund similar to the current French-German proposal. The failure or dilution of either and, more broadly, a premature shift back toward belt-tightening would be a major risk. A misguided focus on debt/GDP ratios and a premature shift to fiscal austerity was a major driver of why the recovery after the financial crisis was so weak. Note that we think the risk of monetary policy tightening prematurely is very low, and thus don't include it as a key risk we're worried about. ■

## ECONOMICS

## Still Embracing the V

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

What if in early April you had seen a forecast that by May global economic activity indicators would bottom out and the US labor market would go back to adding payrolls, and that by June the US economy would have almost fully reopened? You might well have dismissed it out of hand—but these are now the facts on the ground. Still, many investors remain downbeat on the pace of the recovery, and the consensus believes it will take years for the economy to get back to normal after the COVID-19 lockdown.

Based on recent growth data and policy actions, we have greater conviction that the recovery will be V-shaped. We expect global growth to bottom in the current quarter at a -8.6% year-over-year rate, with -12.9% for the G10 and -9.5% for the US. By the second quarter of next year, those numbers are 10.8%, 10.2% and 6.6%, respectively (see table).

There are reasons to expect that V. Most economies have reopened. Mobility—a key data point in the new normal—is on a sustained uptrend. Driving trends as per Apple's data show that 59% of the economies (excluding China) in our coverage are already at 75 (relative to the Jan. 13 baseline) or higher and 41% are registering 100 or more, compared with lows of 7% and 0%, respectively, in mid-April. What's more, the recovery in services is exceeding expectations in China, the US and the Euro Zone.

Of course, the number of new global COVID-19 cases continues to rise, reminding us that the virus is still spreading. However, biopharmaceutical companies have made significant

progress in recent months on both treatments and the development of a vaccine. As testing and tracing capacity ramp up, we believe that public health authorities are better positioned to manage a potential second wave; however, we highlight that those tools need to be marshaled effectively. It is in this context that we expect the recovery in the US to slow somewhat around the turn of the year before reaccelerating after a vaccine becomes broadly available by the second quarter of 2021 and the US can reach herd immunity by summer 2021.

We think that the COVID-19 recession will be sharper but shorter. With monthly indicators having troughed in April, we expect global growth to bounce in the third quarter of 2020 and remain on an upward trajectory. We also see global and developed market output reaching pre-COVID-19 levels in four and eight quarters, respectively (see charts, page 5).

### Why will this cycle will be shorter?

The current recession was triggered by the restrictions imposed on mobility. Because the endogenous cyclical imbalances were less severe entering this cycle than during the financial crisis, we argue the comeback will take much less time for several reasons:

**The financial system is in better shape, too.** This recession did not start with a financial crisis and, while we see a rise in nonperforming loans as inevitable over the coming months, we don't expect it to morph into another crisis—particularly with restrictions on mobility receding and policy support plentiful.

**Deleveraging pressures are also more moderate.** Coming into 2020, despite a record-long expansion, global private

## Morgan Stanley & Co. Real GDP Forecasts

	Quarterly Estimates (%)								Annual		
	2020				2021				2019	2020E	2021E
Real GDP	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
Global	-1.6	-8.6	-3.6	-1.9	3.0	10.8	6.2	5.7	3.1	-3.8	6.1
G10	-1.1	-12.9	-8.0	-6.4	-3.8	10.2	6.1	6.7	1.7	-7.1	4.5
US	0.3	-9.5	-7.7	-6.2	-4.0	6.6	6.7	7.0	2.3	-5.8	3.9
Euro Zone	-3.1	-18.5	-9.0	-7.8	-3.4	16.3	6.7	7.0	1.2	-9.6	6.5
Japan	-1.7	-7.4	-5.9	-3.0	-2.2	3.9	3.3	2.9	0.7	-4.5	1.9
UK	-1.6	-22.1	-8.6	-7.3	-4.4	22.7	5.5	5.0	1.4	-9.9	6.4
Emerging Markets	-1.8	-5.6	-0.6	1.2	7.6	11.3	6.3	5.1	4.1	-1.6	7.2
China	-6.8	1.5	5.3	6.3	19.0	9.7	6.0	5.0	6.1	2.0	9.2
India	3.1	-13.0	-1.0	3.5	5.0	20.2	7.5	5.4	4.9	-1.7	9.0
Brazil	-0.3	-10.7	-9.3	-8.0	-5.4	6.2	5.7	5.2	1.1	-7.2	2.9
Russia	1.6	-9.5	-6.8	-5.9	-4.0	8.3	5.9	5.4	1.3	-5.3	3.9

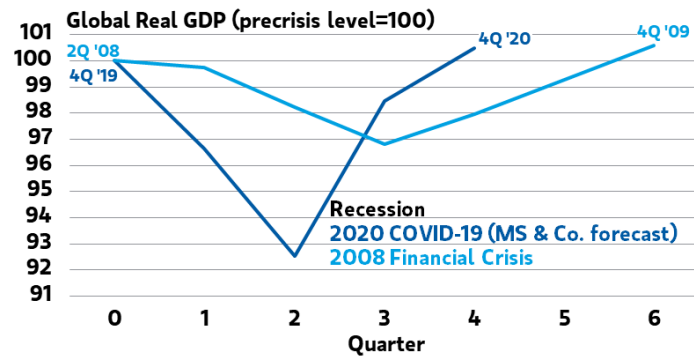
Note: Global and regional aggregates for GDP growth and GDP-weighted, using PPP weights

Source: IMF, Morgan Stanley Research as of June 14, 2020



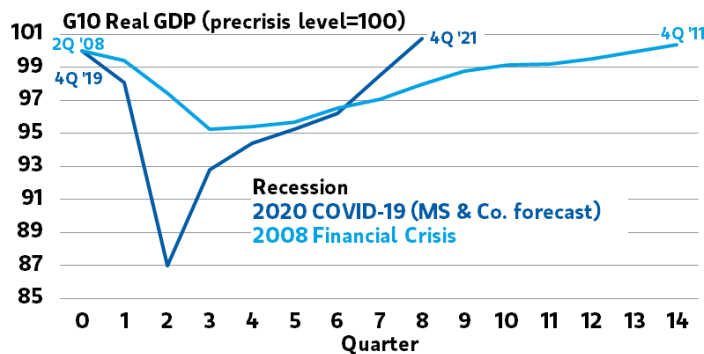
## ON THE MARKETS

### Global Output to Reach Pre-COVID-19 Level by the Fourth Quarter of 2020



Note: Global aggregate is a PPP-based GDP-weighted average  
Source: Haver Analytics, IMF, national sources, Morgan Stanley Research as of June 14, 2020

### G10 Output to Reach Pre-COVID-19 Level by Fourth Quarter of 2021



Note: G10 is PPP-based GDP-weighted average  
Source: Haver Analytics, IMF, national sources, Morgan Stanley Research as of June 14, 2020

nonfinancial sector debt had largely remained stable after declining steadily following the financial crisis, even though corporate sector leverage had been rising in the US. In aggregate, we see more moderate deleveraging pressures for the private nonfinancial sector in this cycle than in the previous one. Policy support has been decisive and sizeable. As with every recession, the policy response plays an important role in supporting the initial stages of the recovery. Policy action around the world has been far more decisive than during the financial crisis. Between February and May, all the central banks we cover have eased monetary policy, with global policy rates declining by 80 basis points to a new low of 1.44%.

On top of this, between March 11 and March 16, all G4 central banks announced they would expand their balance sheets in response to the pandemic. In this recession, the monetary and fiscal stimulus have been multiples of the 2008-2009

response. The G4 central banks will expand their balance sheet collectively by 28% of GDP in this cycle, compared with 7.1% from September 2008 to December 2008. Headline fiscal deficits across the G4 and China will also widen to a historical high of 16.9% of GDP in 2020, up from 5.6% in 2019.

We also expect fiscal policy to be more effective this time around. In 2008-2009, fiscal support mainly targeted the financial sector. However, the intense pressures of private sector deleveraging meant that policy support had a low multiplier effect. Fiscal stimulus today is flowing directly into the hands of nonfinancial corporations and households. Lower-income households, which have been hit worse in this recession and also have a higher propensity to spend, are getting policy support. In the US, about two-thirds of the unemployed are receiving benefits that are more than their regular wage income.

### What are the risks to the outlook?

The key variables are the virus and vaccine developments.

In our bear-case scenario, the number of new COVID-19 cases rises significantly and public health authorities decide to go back into lockdown, implementing severe measures that cause output to nearly revisit the trough levels for each economy seen in the first round. This produces a double-dip in the global economy. Global growth contracts by 7.0% in 2020 and grows by just 3.5% in 2021, and developed market (DM) economies don't recover to pre-COVID-19 levels over our end-2021 forecast horizon.

In our bull-case scenario, we assume the worst is behind us, and reopening and mobility improve even faster than in our base case, ushering in a full reopening and normalization of economic activity. Global growth still contracts in 2020, but by a lesser 1.4% rate, and the recovery in 2021 is much stronger at 7.0%. The DM economies will also reach pre-COVID-19 levels by the first half of 2021 instead of the fourth quarter 2021 target in our base case.

Other important risk factors we are watching include renewed US-China trade tension and US policy uncertainty. An escalation in trade tension, characterized by tariffs rising again, would rekindle the risk of nonlinearity restraining the recovery. For the US, we expect further fiscal support of \$1 trillion in our base case but see the risk that it might not materialize. This could pose downside risks to the recovery, particularly if the growth momentum were to falter. Moreover, policy uncertainty in the run-up to the US election in November could increase market volatility and dampen investment, employment and output more broadly. ■

## ECONOMICS

## US Economy Grows Into the New Normal

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

We believe the US economy has moved into expansion, making the recession the shortest on record for the past 100 years. Pent-up demand is coming through as COVID-19 restrictions are being lifted—with a 17.7% jump in retail sales in May. Still, we expect the path of growth to slow in the fall as the country moves through a second wave of infections and renewed risk aversion dampens growth. All told, our base case is for a 5.8% decline in real GDP this year. Growth then inflects around a vaccine in spring 2021, and climbs back to its pre-COVID-19 level by the end of 2021 (see table).

**ELEVATED UNEMPLOYMENT.** With the recovery, the unemployment rate is expected to decline from the second quarter peak, but will remain elevated, contingent on the ability of businesses to reopen and furloughed workers to return, offset by new entrants into the labor market. By the end of next year, we forecast the jobless rate to be 6.3%, about three percentage points above its pre-COVID-19 level.

Our surveys show households have mixed feelings about returning to more normal activities, and service sectors of the economy are apt to remain restricted for longer. Forbearance programs, stimulus checks and unemployment insurance soften the pain from loss of income, and an incredibly high savings rate—33% in April and 23% in May—should come down to fund pent-up demand this summer.

**HESITANT BUSINESSES.** Business investment looks more like a U than like a V. The lagged recovery in investment is driven by heightened uncertainty around the economic outlook and supply chains, as well as a drag from cuts to the energy investment sector. We expect residential investment to have an initial burst of activity before moderating.

In response to the demand shock from the economy's sudden stop, inflation is exhibiting short-term disinflationary pressures this year. We expect the Consumer Price Index (CPI) to log a 1.0% gain in 2020, down from 1.8% in 2019 and 2.4% in 2018, before climbing back by 2.2% in 2021. Further out, combined policy support and a rapid pace of growth in this cycle sow seeds for structurally higher inflation.

**POLICY HELP.** Our US public policy strategists see an additional round of fiscal support of about \$1 trillion in July that extends the lifeline to households and small businesses, as well as providing critical funding to state and local governments (see page 13). The \$600 per week boost to unemployed workers is set to expire on July 31, but our strategists expect some form of extension. It's important that these benefits do not expire when the jobless rate could still

be in the double digits. Instead, some step-down in benefits would slowly transition recipients away from government assistance and toward labor income, as tends to happen in a cyclical upturn. Adding another \$1 trillion to the CARES Act would increase the deficit/GDP ratio to 24.6%. That's a number that approaches World War II levels.

We see monetary policy remaining on autopilot to maintain accommodative financial conditions and keep vigil over liquidity conditions. We expect the Federal Reserve to maintain its US Treasury purchases at \$80 billion per month and step down its purchases of mortgage-backed securities starting in the fourth quarter. Alongside usage of the Fed's credit facilities, this brings its balance sheet to some \$10.3 trillion by the end of 2021.

**FORECAST RISKS.** The main risks to our forecasts are a second wave of infections in the fall that is not well-managed and results in another lockdown, entailing a renewed round of layoffs and a shock with a more lasting impact on confidence. Another risk is that further fiscal support is not forthcoming and runs out at a time when job losses are still significant.

**THE POST-COVID WORLD.** We expect consumer and business behavior will change post-COVID-19. Some of the change in activity will be temporary and owe to the restrictions on movement and operating capacity dictated by state governments. Other, more lasting changes will be more structural, such as more sustainable work-from-home arrangements, the movement of people away from urban centers and acceleration of existing trends such as e-commerce taking an ever-greater share of retail spending. ■

## Morgan Stanley &amp; Co. US Economic Forecasts

	2019	2020E	2021E
<b>Real GDP (%)</b>	2.3	-5.8	3.9
Private Consumption	2.6	-6.9	3.6
Government Consumption	2.3	0.2	1.4
Gross Fixed Investment	1.8	-6.3	5.7
<b>Contribution to GDP (percentage points)</b>			
Final Domestic Demand	2.4	-5.9	3.8
Net Exports	-0.1	0.3	0.1
Inventories	0.1	-0.3	0.2
Unemployment Rate (%)*	3.5	9.9	6.3
CPI (%)	1.8	1.0	2.2
Core PCE (%)	1.6	1.4	1.9
Policy Rate (%)	1.63	0.13	0.125
General Govt. Balance (% of GDP)	-4.8	-24.6	-14
Gross Govt. Debt (% of GDP)	108	138	151
Current Account Balance (% of GDP)	-2.3	-1.3	-1.2

\*End of period

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Morgan Stanley Research as of June 14, 2020

## EQUITIES

## Stronger Recoveries Expected for Developed Market Equities

**Michael Wilson**, Chief Investment Officer and Chief US Equity Strategist, Morgan Stanley & Co.

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

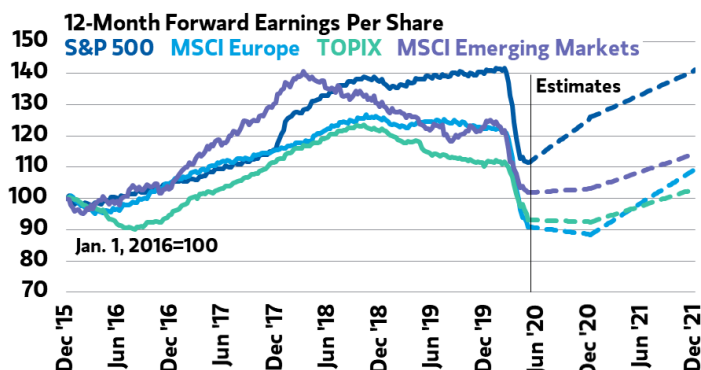
**Jonathan Garner**, Chief Asia and Emerging Markets Strategist, Morgan Stanley Asia Limited+

A once-in-a-century pandemic brought large parts of the global economy to a near standstill, with the scientific community still racing to develop vaccines and therapies as virus containment strategies have been refined. Equity markets did not prove immune to the freezing of liquidity across asset classes at the peak of the crisis in March and April. The VIX shot up to a peak of 85 and the MSCI All Country World Index saw a 33% year-to-date drawdown by the March 23 low. Fortunately, central banks acted forcefully to unblock asset markets with breathtaking liquidity injections while working with fiscal counterparts to mitigate corporate solvency risks through a combination of forbearance, concessional and risk-shared loans, wage-subsidy programs and direct transfers.

We see a rebound in global equities—37.6% as of June 26—as supported by an above-consensus view on the pace of the global economic recovery, support across various loan and credit markets and the suppression of real interest rates across the developed markets and several of the emerging markets. A solid earnings recovery, especially in the US and Europe, should also bolster equities (see chart).

The sharp recovery in forward price/earnings (P/E) multiples since the March low suggests the market has embraced this view. Looking out 12 months, we do see the extent of earnings recovery lifting indexes somewhat higher than current levels—in the developed markets in particular—while exceptionally accommodative policy holds valuations far above historical averages.

## V-Shaped Recovery Expected in Earnings Per Share



Source: IBES, FactSet, Morgan Stanley Research as of June 15, 2020

**HIGHER PRICE TARGETS.** We've lifted our 12-month price targets. Our base case equity market targets—now set for June 2021—move up across the board to 3,350 for the S&P 500 Index, 1,580 for the MSCI Europe Index, 1,550 for TOPIX and 920 for the MSCI Emerging Markets Index (see table, page 8). While our underlying earnings-per-share estimates are little changed from our most recently published updates, this reflects a 0.9-to-1.5 lift in our target P/E multiples and the capture of another six months of strong earnings recovery.

On valuations, while we project some modest derating from current levels of forward P/E multiples, we now assume that the US and Europe can hold near 10-year historical highs as risk premiums remain compressed by unprecedented policy action. We also expect Japan and the emerging markets hold to above-average levels. As shown in the table on page 8, we are forecasting a solid earnings recovery across the board.

We believe the long-awaited leadership rotation to value should be catalyzed by the embracing of active fiscal policy and a new market cycle in the US favoring small-cap value exposure over megacaps. At the same time, we expect Europe to experience game-changing fiscal transfers embedded in the European recovery fund compressing risk premia in value/cyclicals and periphery-exposed stocks. The case is less clear-cut across Asia and emerging markets including China, where policy action is less extensive. There, we generally prefer global cyclicals to deep value, although we have selective exposure to financials and energy.

**HIGHER VALUATIONS.** Our bull case embeds even higher valuations, which could be realized if central bank actions crowd investors out of both government and corporate bonds, leading conservatively positioned investors to raise equity allocations. In this scenario we would still see buying of value/cyclicals, while growth/quality names remain well supported. While the potential for a second wave of COVID-19 is a critical concern, our bear case fears center on political risks, including the potential for US-China relations to enter a disruptive decoupling phase amid crucial second half catalysts, including: a Phase 1 trade deal progress report; the formation of reaction to the Hong Kong Security Law and Legislative Council elections; and the US elections. The US policy landscape post November also risks a more austere set-up if the Democrats win the presidency and maintain control of the House of Representatives, but the Republicans maintain their Senate majority (see page 13).

## US

We turned bullish in mid to late March on the thesis that recessions mark the end, rather than the beginning, of bear markets. Further supporting this conclusion was our view that the bear market for the average stock had begun nearly two years ago, making March simply the final capitulation.

## ON THE MARKETS

### MS & Co. Top-Down Earnings Forecasts and Next 12 Months' P/E Assumptions

Index	June 2021 Base Case Target	MS EPS Forecast (year-over-year growth)			Consensus EPS Forecast (year-over-year growth)			MS Next 12 Mos. P/E	Consensus Next 12 Mos. P/E	Five-Yr. Avg. Consensus Next 12 Mos. P/E
	(% upside)	2020	2021	2022	2020	2021	2022	June 2021		
S&P 500	3,350	130	158	177	127	163	185	21.2	20.8	16.8
	12%	-20%	22%	12%	-22%	28%	14%			
MSCI Europe	1,580	57	83	103	75	99	114	17.0	17.4	14.3
	8%	-45%	45%	25%	-29%	33%	17%			
TOPIX	1,550	84	101	1133	88	109	123	14.5	16.3	13.5
	-2%	-16%	20%	12%	-4%	23%	14%			
MSCI Emerging Markets	920	62	73	81	67	82	94	12.0	14.2	11.8
	-8%	-8%	17%	11%	-7%	28%	14%			

Source: FactSet, Morgan Stanley Research as of June 26, 2020

Price action since then has played out in line with our recession playbook, confirming that it isn't different this time. We remain firmly in the camp that the economy is likely to experience a V-shaped recovery, which is exactly what the equity market is foreshadowing. Our 12-month base case target increases to 3,350 from 3,000, largely on a continued recovery trajectory in earnings through 2021 and 2022.

Our more bullish-than-consensus view stems from three points. The combination of the steepest recession with the largest coordinated monetary and fiscal stimulus in history almost guarantees that there will be a V-shaped recovery from the exceptionally deep trough. The reopening of the economy will happen faster than expected and without a major spike in new cases; even if this view is wrong, we do not believe that there will be another lockdown of the economy even if we have a second wave of COVID-19 because it's too damaging and we are now better prepared to deal with outbreaks, given wider testing and health care capabilities. Finally, sentiment and positioning remain overly bearish both in terms of absolute levels of risk and the defensive nature of individual holdings.

We see sector and style preferences as sources of potential outperformance as market participation broadens out. In line with our recession playbook, we retain our preference for small-cap stocks over large-cap stocks, and cyclicals over defensives. Late-cycle, high-quality stocks remain richly valued and are likely to re-rate lower as interest rates rise at the back end. We recommend a barbell of reasonably priced growth stocks with lower-quality cyclicals that are still priced for distress. At the sector level, we are overweight financials, industrials, materials and health care. We are underweight technology, consumer staples and utilities.

#### Europe

As proposed, the EU recovery fund is potentially a highly significant development for the Euro Zone. If enacted, it could arguably be seen as the fiscal equivalent of the Fed's "whatever it takes" policy. Since 2010, European asset valuations have suffered from an embedded risk premium, given lingering fears about a Euro Zone breakup, but a more coordinated and stronger fiscal response suggests that such concerns should abate over time. After years of persistent underperformance from both the European economy and equity markets, investor skepticism is high, sentiment is low and relative valuations are attractive; this should create the backdrop for a period of stronger performance going forward, assuming that policy progresses as planned. On the back of our economists' GDP upgrades, we have raised our 2021 and 2022 earnings-per-share growth by 5% in each year and lifted our P/E assumption by 1.5 P/E points to 17—a 10-year high.

We see opportunity in financials and the peripheral equity markets, both of which are unloved by investors and at all-time relative valuation lows. At the same time, the US dollar weakness that our currency team expects should be supportive to the commodity complex, so we are overweight mining and building materials. Together with our economists' expectations of an improving economic outlook, we should see a period of better performance from value.

#### Asia and Emerging Market Equities

Our above-consensus forecast for global growth recovery and constructive views on emerging markets (EM) currencies and credit help to mitigate downside risk across Asia and EM equities. In contrast to historical patterns, we see this recovery being led by the developed markets for three reasons: Greater policy/funding scope in the US, Europe and,

## ON THE MARKETS

to a lesser extent, Japan; an overhang of higher corporate leverage across EM equities, resulting in risks to cash flow, capital spending and capital raising; and less spillover from Chinese stimulus to commodity exporters, given the size and structure of stimulus relative to 2008.

We retain a preference for Japan and China A-shares and increased cyclicals exposure. We leave our EM equities stance at underweight and, within Asia and the emerging markets, we prefer Japan, which we see continuing to deliver a more defensive dividend and earnings profile on the back of underlying restructuring and strong balance sheets. At a

market level, we upgrade Indonesia and Greece to overweight alongside preferred markets China, Russia, India, Brazil and Singapore. We remain underweight Saudi Arabia, Mexico and Thailand. With US-China tension a key risk, we reiterate our clear preference for China A-shares versus ADRs. On a sector basis, we move more cyclical and favor information technology, consumer discretionary, energy and materials, while on a style basis, we hold a core quality bias but see a tactical opportunity for value. ■



## EQUITIES

# Why Laggard Small Caps May Be the Next Winners

Nick Lentini, Associate, Morgan Stanley Wealth Management

Chris Baxter, Investment Strategist, Morgan Stanley Wealth Management

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

However bad you thought the February-March sell-off was for the S&P 500 Index, for small-cap stocks it was worse. The Russell 2000 Index, which measures the performance of small-cap stocks, declined 42% peak to trough; in contrast, the S&P 500 Index, which is dominated by large and megacap companies, dropped 34% in the same period. Even with the market's rebound, the Russell 2000 is 8% lower than the S&P 500 today. Also weighing on small-cap stocks is that, since February, forward earnings estimates have been marked down 30% more than those of their large-cap peers. These gaps between large- and small-cap returns and earnings expectations may be causing hesitancy among investors, which is understandable. However, small-cap stocks have historically been the better performers early in the cycle.

**HIGHER BETA.** Small-cap stocks have a higher beta, or sensitivity to the overall market, than mid- and large-cap equities. As a result, they tend to decline more swiftly during downturns and rebound more aggressively during recoveries. This happens because smaller companies do not have the pricing power and economies of scale to lower their marginal costs and protect their profit margins, which results in a greater drop in earnings relative to larger companies. As evidence, large-cap stock earnings, based on forward earnings per share (EPS), have fallen roughly 20% while small caps currently sit at half their February 2020 peak.

Because prices for small-cap stocks have gone up more quickly than earnings estimates, the forward price/earnings (P/E) ratio jumped to 84 from 25. Although it may seem counterintuitive, now is precisely the time to buy small caps.

**DISCOUNTING HIGH VALUATION.** Here's why. We analyzed data from 1995 to the present and divided both earnings and valuation into quintiles. We then calculated the historical forward returns of small caps at each valuation and earnings level. Consider the Russell 2000's 84 P/E, which is in the top valuation quintile. Historically, this quintile has returned 12.1% during the following 12 months (see first chart). That is the second best-performing quintile. Ironically, the best one-year forward returns arose when P/E was very low, or cheaply valued, and when P/E was very high, usually when there were little earnings due to an economic downturn, which is likely the situation now. Essentially, the market looks ahead and discounts today's bleak profit picture.

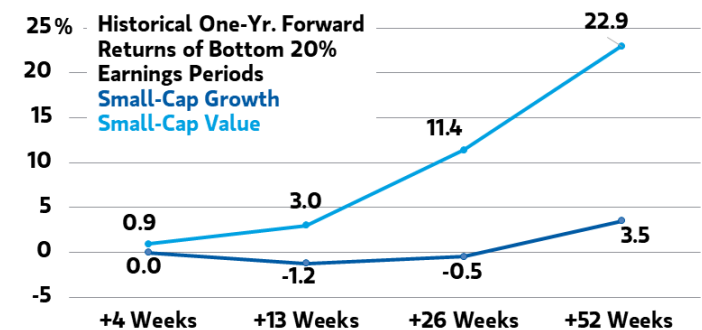
In another analysis, we use operating margins as a proxy for earnings because they're more stable cycle to cycle. We found

that the periods with the lowest earnings had the highest returns on average in the next 12 months; the lowest quintile returned 22.9% (see first chart). This indicates that low earnings present a buying opportunity ahead of a cyclical recovery. Current operating margins are in the fourth percentile of our data period, the bottom quintile.

**GROWTH VS. VALUE.** There are differences in behavior of small-cap growth and small-cap value stocks coming out of a period with historically low earnings. Within the bottom quintile of earnings, small-cap value returned an average 23% in the following year while small-cap growth returned only 4% (see second chart). This makes sense as low or negative earnings growth disproportionately hurts growth companies more than value due to the higher P/E ratios. Along a similar line of reasoning, we found the worst relative returns for small-cap growth come in the highest quintile of valuation. The Russell 2000 Growth Index currently has a forward P/E of 401, placing it in the highest quintile.

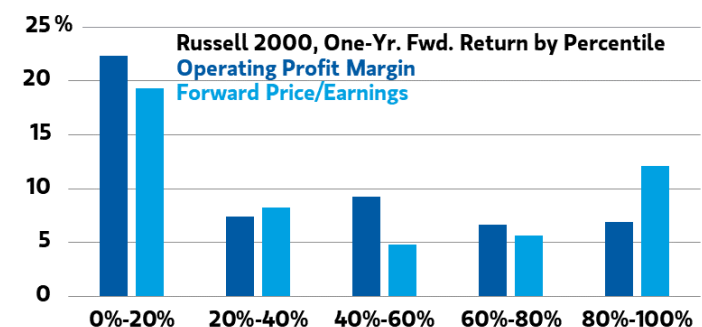
All told, while the causes of this recession may be different, we believe the recovery will be in line with historical data. The current trough in small-cap earnings and price levels presents an opportunity to buy small-cap equities at low prices before they realize a traditional early-cycle recovery. ■

## Value Has Topped Growth in Small-Cap Recoveries



Source: Bloomberg as of June 19, 2020

## Low Margin, Low P/E Stocks Outperformed



Source: FactSet as of April 30, 2020

## FIXED INCOME

## Central Bankers Keep Higher Yields in Check

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

With conventional central bank policies on hold through our 12-month forecast horizon, government bond performance should be mixed into the year's end, despite the V-shaped economic recovery and solid performance of riskier assets (see table).

**US.** We expect higher US Treasury yields, with the 10-year bond, now at 0.7%, trading just above 1.0% by the end of 2020 and finishing 2021 at 1.5%. A combination of a fast economic recovery, strong performance in risk assets and expectations for greater Treasury supply is apt to put upward pressure on yields, but the Federal Reserve's forward guidance and Quantitative Easing (QE) should temper the rise.

In the near term, Treasuries should be driven by the evolution of supply/demand expectations, with additional fiscal stimulus likely to put upward pressure on yields, particularly the long end. Over the following months, the focus will likely shift to the pace of the economic recovery.

We believe the Fed will keep a check on rising yields to prevent a premature tightening in financial conditions. Our economists expect the central bank to hold the federal funds rate at zero at least through the end of next year. In addition, the Fed is likely to provide concrete forward guidance, while running an \$80 billion per month, open-ended QE program with the option to increase the size or duration of Treasury purchases.

This policy mix should support a steepening of the seven-year/30-year Treasury yield curve, while limiting the rise in yields. The presidential election is a potential tailwind for higher yields, too. Outcomes with a united government (one party controls the White House and both chambers of Congress) and even some divided government results are conducive to additional fiscal stimulus, and thereby higher yields, in 2021.

In this context, inflation protection remains attractively priced. The rise in yields we project in 2020 is driven by breakeven inflation rates much more than real yields. Breakeven rates on inflation-protection bonds such as TIPS still have negative inflation risk premiums, but we think the V-shaped global economic recovery will reduce these negative inflation-risk premiums significantly by the end of the year.

**Euro Zone.** We forecast higher intermediate and longer-maturity Bund yields in the second half and through 2021. The skew for Bund yields appears to be moving toward higher yields despite increased purchases by the European Central

Bank (ECB) Pandemic Emergency Purchase Program. We think the potential ramp-up in higher-yielding, predominantly AAA-rated EU (and European Investment Bank) debt starting from pandemic-related bond issuance reduces demand for Bunds while additional stimulus in Germany could increase supply.

As Bund yields climb, they are apt to do so in the long end. Given our economists' expectation that inflation will remain sufficiently subdued to keep the ECB deposit rate unchanged for the next 12 months, it limits the rise in front-end yields.

**UK.** We look for rates to remain around current levels through the year as the Monetary Policy Committee (MPC) increases asset purchases while also cutting the Bank Rate to zero before possibly pursuing a negative rate. Inflation remains subdued in 2021, allowing the MPC to maintain an easing bias throughout most of the forecast horizon.

However, as economies begin to improve globally, the MPC will likely taper the balance sheet expansion, leading to a faster rise in rates. We also assume that the UK asks for and receives an extension in Brexit negotiations in line with our economists' view, but a hard Brexit is a serious risk until there is certainty about the outcome.

**Japan.** The global risk recovery narrative will weigh on the Japanese government bonds (JGB) and push term premiums higher across the curve. However, we expect the Bank of Japan's commitment to yield curve caps will prevent any significant increase in yields.

We have a constructive view on long-end JGBs. We believe that demand from domestic investors seeking positive yield and meeting regulatory requirements will offset the additional supply in the long end. We expect 30-year JGB yields to trade around 0.5% across the forecast horizon. A key risk to our view is that the market starts to price in a third supplementary budget and associated additional JGB issuance late this year, causing additional steepening pressure across the curve. ■

## MS &amp; CO. Government Bond Yield Forecasts (%)

Maturity	Two Years		Five Years		10 Years		30 Years	
Country	4Q '20	2Q '21	4Q '20	2Q '21	4Q '20	2Q '21	4Q '20	2Q '21
US	0.30	0.40	0.65	0.85	1.15	1.30	1.95	2.15
Germany	-0.55	-0.55	-0.45	-0.35	-0.10	0.05	0.30	0.45
Japan	-0.15	-0.15	-0.10	-0.10	0.00	0.00	0.50	0.50
UK	0.00	0.10	0.10	0.25	0.25	0.45	0.75	0.95

Source: Morgan Stanley Research as of June 14, 2020

## CURRENCIES

## The Dollar's Loss Is the Euro's Gain

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

The US dollar's strength in recent years can be explained simply: US assets had the world's highest risk-adjusted returns. As such, capital continued to flow into US financial assets at the expense of other destinations. The high and flat US yield curve made US Treasuries and credit (particularly investment grade) attractive. Meanwhile, the outperformance of US equities relative to global stocks writ large generated similar incentives for equity investors. These forces pushed the dollar higher.

**CHANGE OF FORTUNE.** However, this dynamic is changing. Unlike prior years, when growth outside the US was both less inspired and more volatile, the new post-COVID-19 economic cycle is likely to see the opposite. The Fed's decision in March to cut rates back to the zero lower bound has compressed US versus rest of world (RoW) yield differentials. The vulnerabilities of highly leveraged US firms to a liquidity crunch suggest that management may be more cautious with shareholder distributions in the future, which has been a major source of US equity outperformance.

In short, the US appears to be losing its competitive advantage in the contest for capital. This tends to be dollar negative, as capital flows into the US decrease or even become net outflows seeking other higher-yielding, higher-growth destinations. This is why the dollar typically declines when RoW growth outshines US growth. Indeed, the post-COVID-19 recovery is likely to be characterized by several factors, including growth faster than is typically seen after a recession, dovish central banks around the globe and elevated risk sentiment. All these interrelated forces tend to be dollar negative.

**EUROPEAN RECOVERY.** Where does the money go? A common refrain is that, even if the US is losing its luster, it's still the "cleanest dirty shirt," and thus the dollar will struggle to weaken. However, we think that Europe is on the road to becoming a "cleaner" dirty shirt than the US. Investor bearishness on Europe has been palpable for some time, as muted progress toward fiscal union, persistent political and populist risks and structurally low GDP growth rendered it an unattractive capital destination. The euro also faced capital outflows from Europe into other places like the US. However, by this time next year, we expect the euro to be worth about \$1.21, up about 7% (see table).

However, the recent EU debt proposal is a potential game-changer for a couple of reasons. First, by making meaningful progress toward fiscal union, we think that some of the risk premium for a potential EU breakup will abate. Second, we think that the creation of a large, liquid and likely AAA asset,

probably with a higher yield than Bunds and other Euro Zone AAA bonds, will attract inflows. This second point is quite important: Increased reserve allocations to the euro from their current low levels are apt to come at the expense the dollar.

**EMERGING MARKETS.** Another important destination will be the emerging markets. The experiences following the tech bubble and the financial crisis demonstrate that emerging markets tend to benefit when the economic cycle shifts from recession to recovery—even if large parts of the asset class will lag the developed markets in this particular recovery. Ultimately, we think that this projected growth profile, coupled with low developed market (DM) yields as DM central banks stay dovish, is a recipe for elevated risk sentiment and reach-for-yield behavior.

This thesis is not without risks. The first is a potential increase in US-China tension. At various points in 2018 and 2019, the dollar strengthened on concerns about global growth, global trade and globalization. Renewed tension between the US and China—trade related or otherwise—is likely to elevate those concerns again. The US is relatively insulated from global trade, with most of its economic activity generated internally. Thus, heightened global fears may once again lead to capital inflows into the US at the expense of other higher-risk, more globally integrated economies.

Another relates to the election. We think that one-party control of both the White House and Congress could result in more expansionary fiscal policy—raising growth, yields, capital imports and the dollar. A divided government scenario, from which we would expect more limited policy changes, presents a lower risk of this outcome, suggesting that the other global factors will dominate the dollar. ■

## Morgan Stanley &amp; Co. Currency Forecasts

Currency vs. US Dollar	Current	4Q '20	2Q '21	4Q '21
Euro	1.13	1.16	1.2	1.23
Japan	108	110	112	112
UK	1.23	1.25	1.25	1.30
China	7.08	7.10	7.08	7.00
Canada	1.37	1.30	1.33	1.35
Australia	0.69	0.73	0.74	0.74
Mexico	23.06	21.65	22.05	22.40

Source: Bloomberg, Morgan Stanley Research as of June 29, 2020

## POLITICS

## The Art of the Plausible

Michael D. Zezas, CFA, Strategist, Morgan Stanley & Co.

If you think this election could be a game-changer for the US economy and markets, we're with you. However, don't make the mistake of conflating candidates' provocative policy positions with future policy. Focusing on "plausible policy paths," we think the impact of the election on policy supports a constructive path for risk assets and headwinds for US Treasuries, consistent with our colleagues' positions in our midyear outlook.

First, a lesson from 2016: Ahead of the election, the conventional wisdom held that a Trump victory would be a risk-off event. The key mistake was conflating the outcome of the presidential race with overall government policy. The election resulted in a Republican sweep, but their plausible policy path for governing was limited by what they could deliver. That included tax cuts and deregulation, but not the spending cuts and health care repeal they also promised. This added up to an economically supportive fiscal expansion,

and it only took hours for the markets to put two and two together. In this cycle, we see investors making similar mistakes, focusing on the candidates' provocative positions and overlooking the plausible policy paths (see table). We differ from the consensus in three key areas:

**We expect more fiscal stimulus even though it's an election year.** Some believe it is in the Democrats' interest to deny Republicans the electoral benefit of a strong economy. We disagree. First, there's only weak evidence that a strong economy guarantees reelection of the incumbent. Second, government assistance in times of crisis is core to the Democrats' policy brand. Third, though fiscal expansion is rare in a divided government, it is a common reaction to a recession. While growth has turned positive, high unemployment is likely influencing the political calculus. Hence, we think the parties' areas of agreement could add up to another \$1 trillion package.

**Democratic win doesn't have to be risk off.** Investors responding to our election survey seem most concerned with a situation in which Democrats take back both the Senate

## Four Election Outcome Scenarios and Potential Impacts

Scenario	Net Fiscal Policy Expectation	Key Macro Impact	Probable Policy Changes	Fundamental Equity Impact
<b>Blue Wave:</b> Democrats win presidency, Senate and House	De facto proactive expansion through net spending	<b>Positive:</b> US GDP, US dollar <b>Negative:</b> US Treasuries	Rx drug pricing bill	<b>Positive:</b> Large managed care organizations, transportation, non-US oil and gas, renewables, large-cap banks, consumer finance <b>Negative:</b> Pharma, IT hardware, internet, telecom, US oil and gas, asset managers, tobacco
			Health care reform short of Medicare for All	
			SALT cap repeal	
			Tax changes as pay-fors with spending programs	
			Push for tech, net neutrality, environmental and financial regulations	
			Re-engagement with multilateral institutions	
<b>Red Redux:</b> Republicans win presidency, Senate and House	De facto proactive expansion tax cuts	<b>Positive:</b> US GDP, US dollar <b>Negative:</b> US Treasuries; emerging markets	Tax 2.0: extend cuts, repeal R&D tax cliff, deduct start-up costs	<b>Positive:</b> Telecom, US energy, asset managers <b>Negative:</b> Renewables
			Energy or oil sector aid	
			Continued disengagement from multilateral institutions	
			Regulatory actions within executive branch, like immigration-focused	
<b>Thin Red Line:</b> Republicans win presidency and Senate, Democrats hold House	Potential reactive expansion	<b>Negative:</b> US dollar	Regulatory actions within executive branch, like immigration-focused	<b>Positive:</b> Telecom, US energy, asset managers <b>Negative:</b> Renewables
			Continue disengagement from multilateral institutions	
<b>Blue Tide:</b> Democrats win presidency and hold House, Republicans hold Senate	No expected fiscal support	<b>Positive:</b> Emerging markets <b>Negative:</b> US dollar	Push for tech, net neutrality, environmental and financial regulations	<b>Positive:</b> Non-US energy, renewables <b>Negative:</b> US energy, IT hardware, internet, telecom, pharma, tobacco

Source: Morgan Stanley Research as of June 14, 2020

## ON THE MARKETS

and the White House, clearing a path for Biden's proposals of more than \$3 trillion in new taxes and tighter regulation. However, we think that fails to consider what is achievable. First, enacting these proposals would likely require the end of the filibuster—a strong possibility, but a major assumption. Second, Democrats likely have much more scope to spend than to raise taxes. In a sweep, Senate control will come via key wins by moderates, who are less likely to support an array of tax hikes. However, limited tax increases may not keep Democrats from their spending ambitions. Our survey shows that Democratic voters are keen on health care spending, with moderate-to-liberal voters overwhelmingly supporting the effort even if it means expanding the deficit. Hence, investors may be too focused on taxes, overlooking support for aggregate economic demand from fiscal expansion.

**Don't overreact to China tensions.** We've heard investor concerns that the current US administration will increase tariffs to boost its election prospects. We don't think the US will take this path. Our survey shows that voters are skeptical about China's role in the global arena, but more concerned

about the domestic economy. Since polls suggest that, on net, voters favor President Trump on the economy, the administration likely views a V-shaped recovery as essential to reelection. Hence, heightened rhetoric and fresh nontariff actions may be in the cards, but we think that tensions will likely stop short of higher tariffs.

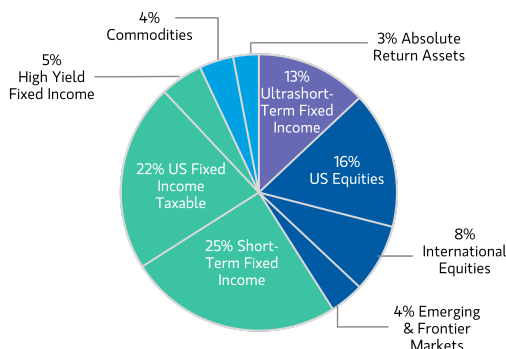
**Hence, election outcomes remain uncertain, but we think their influence on current policy choices and future policy paths is supportive of risk assets today.** More fiscal expansion this year bolsters our economists' call for a V-shaped recovery, and further fiscal support in a range of election scenarios could pave the way for sustained economic recovery. While this poses a challenge to long-term US Treasuries, we think it helps to extend recent gains in equities and credit. At the equity sector level, we highlight the potential for financials—an out-of-consensus favorite of our equity strategists—to outperform. They expect value stock outperformance and see positive exposure to a steeper yield curve from fiscal expansion. Those are factors we think would endure a variety of November outcomes. ■



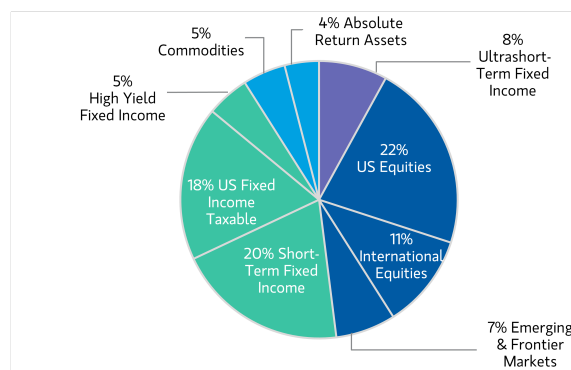
# Global Investment Committee Tactical Asset Allocation

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.

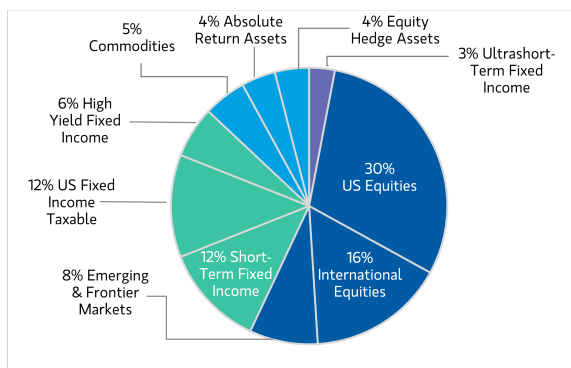
## Wealth Conservation



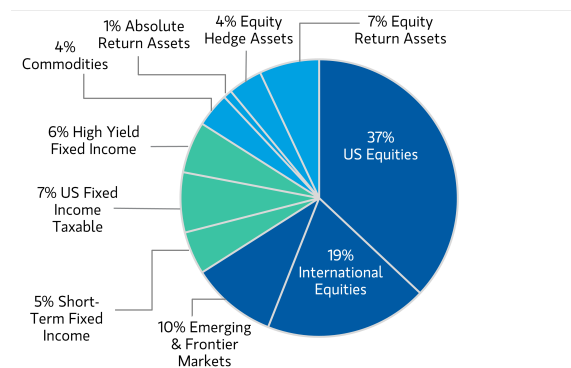
## Income



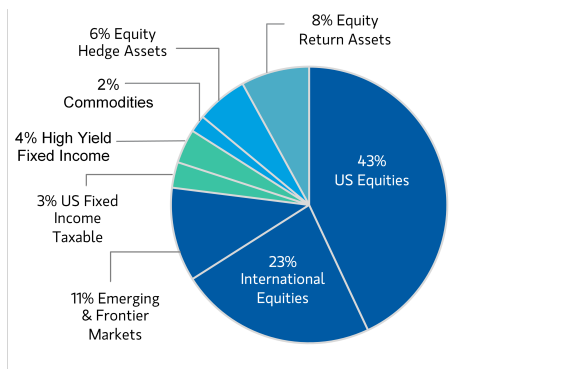
## Balanced Growth



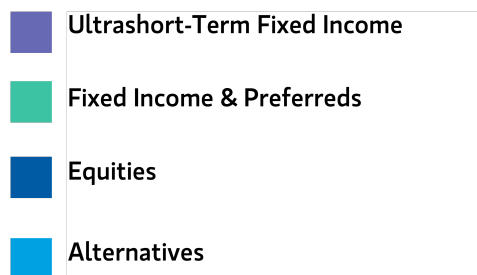
## Market Growth



## Opportunistic Growth



## Key

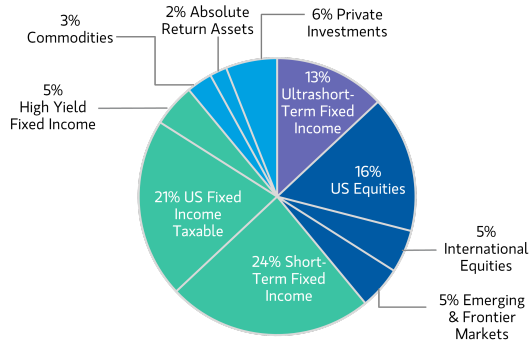


Source: Morgan Stanley Wealth Management GIC as of June 30, 2020

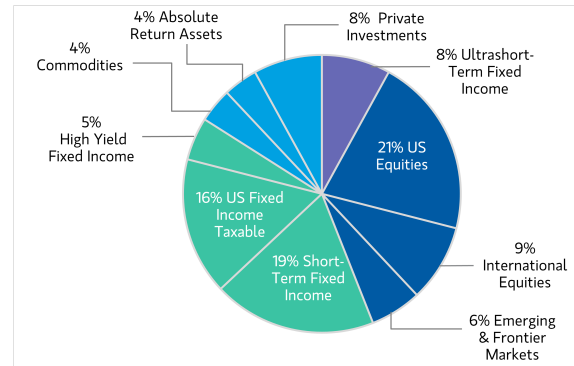
## ON THE MARKETS

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.

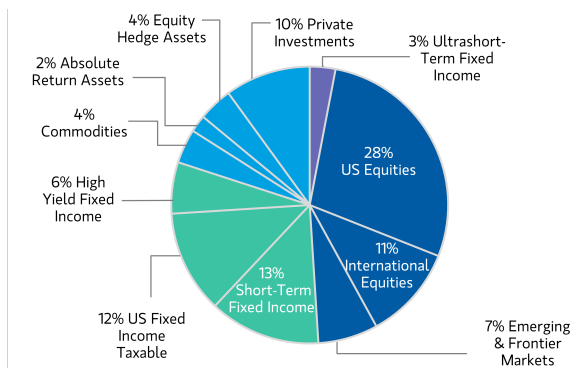
### Wealth Conservation



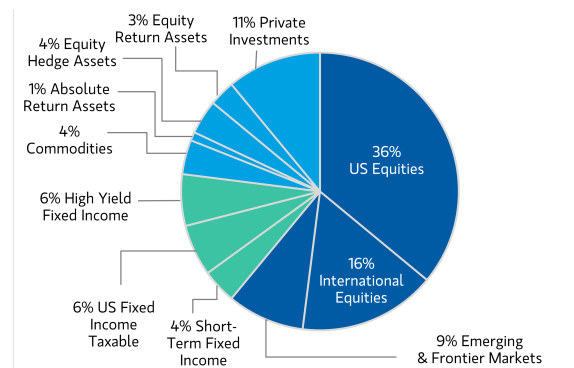
### Income



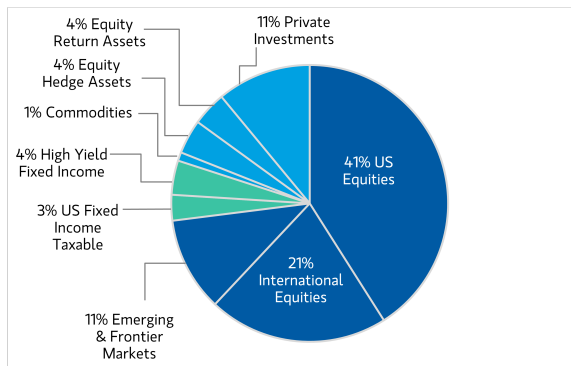
### Balanced Growth



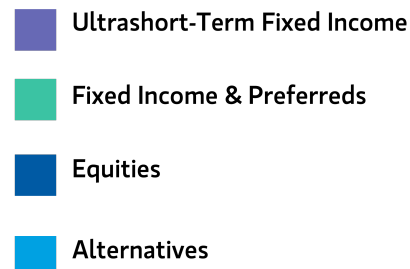
### Market Growth



### Opportunistic Growth



### Key



Source: Morgan Stanley Wealth Management GIC as of June 30, 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 GLC as of June 30, 2020

## Disclosure Section

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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, Chris Baxter, Vibhor Dave, Jonathan Garner, Nick Lentini, Graham Secker, Ellen Zentner and Michael D. Zezas 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.

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*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 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



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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](http://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

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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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