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INVESTMENT STRATEGY

Global Investment Committee | July 2021

On the Markets

It's Heating Up

Over the past year, the primary risk faced by companies centered on how to survive the sharpest economic downturn in 90 years. On reflection, what companies were able to do was an economic miracle. In aggregate, the US economy surpassed its pre-COVID high last quarter as corporate profits returned to peaks even faster. Now, with the economic recovery from COVID in full bloom, companies and investors are forced to face different questions.

First, how will consumers spend their money going forward? Will they continue to make elevated purchases of items commonly bought last year, or will there be a wallet share shift toward experiences they were unable to enjoy? Our view is that as stimulus checks and supplemental unemployment benefits run out this summer, consumers will have to make choices, and that means a rotation toward services and away from goods. Secondarily, higher costs are returning as businesses deal with supply chain shortages and surging demand. Most investors appreciate the spike in certain materials, like lumber, copper and semiconductors, but they also view such increases as temporary, or what the Fed calls "transitory." We're not quite as confident in that view, but we believe some price hikes will subside.

On the other hand, there is a growing risk rising labor costs will be more structural. First, the pandemic lockdown has impaired labor supply in a way that may not be easy to fix. Second, supplemental unemployment benefits and stimulus checks allowed many to return to the labor force more slowly. Third, thanks to the extraordinary rise in asset prices, including homes, some older workers are retiring sooner. Fourth, lockdowns may have impaired some workers' ability to return due to health issues. These factors suggest less labor force slack than usual at this stage of recovery. That means higher costs and lower profitability.

There is also a powerful political shift toward social equality. What this generally means is greater pressure on companies to pay higher wages. Finally, the pandemic has exposed the outsourcing model as vulnerable, leading many companies to rethink and reshore, which could mean higher costs.

The bottom line is the global economy is booming, but this is a known known, and asset markets reflect it. What isn't so clear is: At what price will this growth accrue? Higher costs mean lower profits—and another reason for the overall equity market to take a break this summer as the weather and economy heat up. ■

Michael Wilson
Chief Investment Officer
Chief US Equity Strategist
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ECONOMICS

The Paradigm Shift

Chetan Ahya, Economist, Morgan Stanley Asia Limited

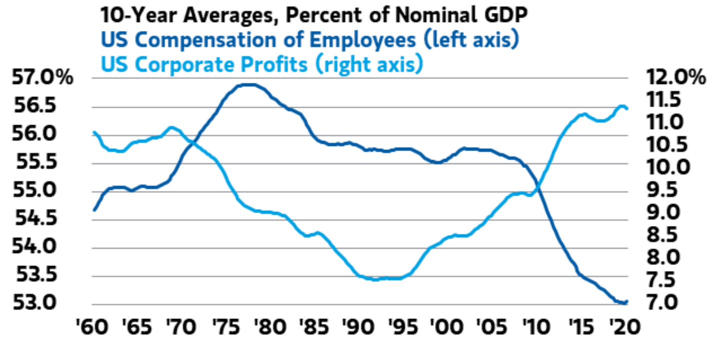
When pondering the most significant developments in global macro over the past three years, many would point to the pandemic and the structural changes it has brought to how we work and live. Still, the bigger story may be how the pandemic has triggered a paradigm shift in the way corporate profits and wages are distributed within national income. As this megatrend reverses in the US, the tide will likely turn in favor of higher inflation, with economic cycles running hotter but shorter.

For context, the share of corporate profits in GDP has been rising for the past 40 years, while the wage share has been declining until recently (see chart). At the same time, income inequality has increased sharply, and intergenerational mobility has declined. While these trends are global, the US has undoubtedly been at the forefront—and as they wore on into a fourth decade, they became increasingly unsustainable. Calls for action grew louder, and a collective voice began to make its way into policymaking circles. Now, with the burden of the COVID-19 recession falling most heavily on lower-income households, policymakers have been galvanized into action.

INCLUSIVE ECONOMIC GROWTH. How are policymakers addressing these issues, and what are the implications? At a macro level, they are explicitly aiming for a high-pressure economy. Drawing on the experience of the past cycle, they believe that such an economy will create broad-based and inclusive economic growth, which should help reduce the impact of the recession on lower-income households and address the longstanding problem of income inequality. Thus, the conduct of fiscal policy has shifted from austerity to activism. The fiscal response to this recession is already the largest since World War II, and policymakers are working on additional fiscal packages. The Federal Reserve, meanwhile, has recast both sides of its dual mandate, essentially creating room for unemployment rates to move lower, ensuring that labor market gains can be shared more broadly among low-income groups.

At a micro level, US policymakers are intervening to temper the adverse effects of market forces. Efforts underway to raise minimum wages are a case in point, but there will also be increasing scrutiny of the tech, trade and titans trio, which has been a key factor in holding down the wage share of GDP. The previous administration took a new tack on trade policy, and indications are that move will not be reversed under the current one. At the same time, policy makers are homing in on corporate titans and their actions. These companies, which tend to have high industry concentration, have blunted labor's bargaining power. Moreover, they typically have a low labor share of value added, and their proliferation has contributed to the general decline in the wage share of GDP.

Inequality Rose as Labor Share in Income Declined



Note: We have taken 10-year averages to smooth out fluctuations due to the business cycles. Compensation of employees and corporate profits do not sum to 100% because other components are excluded.
Source: Haver Analytics, BLS, BEA, Morgan Stanley & Co. Research as of March 31, 2021

HIGHER INFLATION, SHORTER CYCLES. As policymakers act to address income inequality and ensure inclusive growth, the wage share of GDP should start to reverse its 40-year decline. The reversal of this megatrend could have far-reaching implications for the macro landscape, and we highlight two in particular. First, the tide is turning in favor of higher inflation. Our base case is that US core personal consumption expenditure (PCE) inflation will rise above 2.0% annualized after adjusting for base effects. We also see a real risk that inflation could overshoot 2.5% annualized on a sustained basis. Second, economic cycles could run hotter but shorter. A high-pressure economy would mean a faster return to full employment, but tightening at a later stage of recovery runs the risk that shifts in policy stances could become more disruptive, truncating economic cycles.

The initial burst of decisive policy action has set the US on a new course. Going forward, how pervasive and persistent these actions turn out to be will determine how far the US economy travels in this new direction. While "reversal of megatrends" could potentially be disruptive, this course correction may actually set the stage for a more balanced and sustainable economic trajectory over the longer term. ■

Please refer to important information, disclosures and qualifications at the end of this material.

ECONOMICS

Confidence Crosscurrents

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

Recent volatility notwithstanding, stocks and bonds have been range-bound for the past 10 weeks as a tug-of-war has ensued between market participants focused on reflationary growth and those stressing defense. As investors have engaged in this debate, other contrasts have emerged as well. Among these is the divergence between corporate and consumer confidence.

CEO OPTIMISM. On the surface, it isn't hard to see why CEOs feel optimistic: First quarter earnings growth for S&P 500 companies averaged more than 50%, profit margins have risen and, due largely to a faster-than-expected reopening, corporate leaders have expressed strong forward outlooks. Coming off such an encouraging start to 2021, and despite some creeping complacency, the near future could be bright for spending, both in terms of capital expenditures and research and development (R&D). This year, "confidence" sits at its highest level since The Conference Board first started surveying chief executives in 1976.

Signs of a spending uptick are already showing up in metrics like nonresidential fixed investment, which increased at an 11.8% annualized clip in the first quarter of 2021. Meanwhile, R&D has been escalating. Given headwinds like supply chain disconnects and rising input costs, the trend is especially impressive. Indeed, such optimism is critical to continued capital spending.

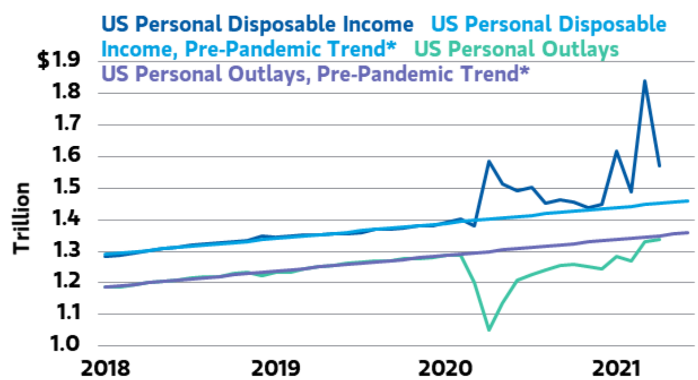
MIXED CONSUMER SENTIMENT. Consumer confidence, on the other hand, has been less upbeat. Having stalled recently, the June reading from the University of Michigan's Consumer Sentiment Index was up slightly from May, but is still down from April. The Conference Board's Expectations Index, which gauges consumers' short-term outlooks for income, business and labor market conditions, has also been up and down. While markets have shrugged off some recent misses, we believe this data can help resolve the ongoing investor debate.

By many measures, consumers appear to have plenty of reasons to be encouraged. Within a year of the worst recession since the Great Depression, the household savings rate, which averaged 7.7% in 2019, is hovering close to 15.0%, and household net worth has reached record highs. Prospects for wage gains look excellent, and initial unemployment claims have been declining. So, why has consumer confidence not been more correlated to business confidence? In our view, while consumers may appreciate a decent job market, they are increasingly concerned about inflation and the supply chain disruptions that are interfering with spending plans. To wit, the University of Michigan data shows expectations for overall inflation of 4.6% in the year ahead—more than double the Federal Reserve's 2.0% target.

These price worries seem to be colliding with poor product availability and, according to the Michigan survey, dampening consumer-buying intentions for large durable goods, autos and housing. Some consumers also may be less optimistic given the imminent withdrawal of government transfer payments. According to economist David Rosenberg, of Rosenberg Research, the problem is not just negative sequential comparisons in real personal income but the inherent volatility that stimulus payments have caused. Such volatility, in turn, has contributed to variability in consumption expenditures.

Disconnects between CEO and consumer confidence may be key to resolving the near-term investment controversy that has deadlocked markets between positioning for a strong cyclical and reflationary expansion or a disappointing stagflationary bust. Without consumers following through on anticipated purchases, CEO expansion plans may prove destructive. Notably, while US consumption has resumed its pre-pandemic pace, it hasn't exceeded that level—despite extensive stimulus (see chart). With growth in disposable income and savings fading back to trend, the US economy may miss an opportunity. Alternatively, if consumers do regain optimism, the risk of further overheating goes up.

Spending Has Yet to Overshoot



*2018-2019
Source: BCA Research as of May 31, 2021

Either way, the implication seems to be greater risk of a disappointment in demand or an inflation overshoot, with prospects for a boom/bust scenario increasing. For investors seeking to navigate these crosscurrents, we recommend a focus on earnings quality, profit achievability and valuation support. We also advise barbell positioning on the consumer with exposure to capital spending. ■

EQUITIES

Data Era Stocks: Quality Goes on Offense

Daniel Skelly, Head of Market Research and Strategy, Morgan Stanley Wealth Management

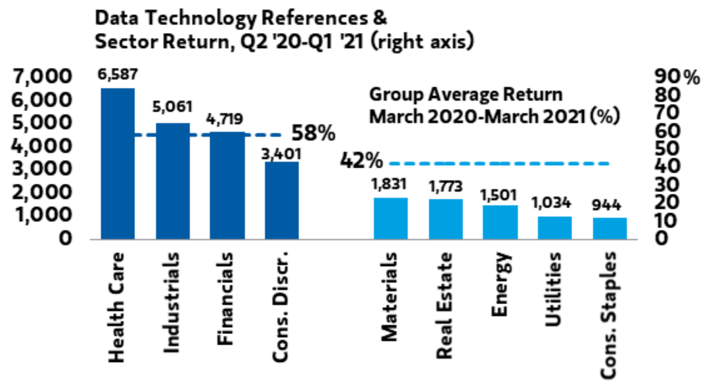
The ongoing debate over inflation and whether it will ultimately prove "sticky" or transitory remains unresolved. Still, something we can say with high conviction is the pace of recovery since last year's trough has been about twice as fast as previous cycles, with the tremendous rally pulling forward roughly two years' worth of returns into an approximately 12-month period. Given this backdrop, Morgan Stanley's strategists have advocated positioning for a "midcycle transition" with a focus on higher-quality stocks.

QUALITY IS BOTH OFFENSIVE AND DEFENSIVE. While quality is typically associated with the defensive benefits of strong balance sheets, in today's environment it can also offer attributes that are offensively oriented. Indeed, companies across sectors are utilizing strong balance sheets to invest in technology to drive higher productivity, pricing power and, ultimately, earnings. In the event inflation is sustained, we believe companies' ability to drive higher margins and offset rising inflation via their tech/data edge will be rewarded.

COVID ACCELERATES THE DATA ERA. The transition to the current "data era" technology cycle predated the pandemic. As many have noted, however, COVID-19 was a catalyst for the acceleration of this data era cycle (see *What's Technology Worth: Introducing Data Era Stocks 2.0*, October 10, 2020). Morgan Stanley Research analysts already see evidence business models are shifting in anticipation of permanent changes in consumer preferences. That is speeding up trends in e-commerce and e-services and expanding adoption of technologies like cloud computing, collaboration tools, automation and data analytics. While the tech sector has led research and development (R&D) spending, the diffusion of tech services into other sectors in order to drive productivity and growth presents more compelling opportunities today. Three areas we favor—where a stronger tech focus is being rewarded in the market—are health care, industrials and financials (see chart).

HEALTH CARE. With the historic speed of vaccine development, perhaps the most glaring example of technology's expanding reach is in health care. Large pharmaceutical companies are increasingly integrating artificial intelligence (AI) and Big Data to drive innovation in clinical trials and R&D. Clinical trial management organizations are utilizing advanced information analytics and Big Data to target specific patient populations and expedite clinical trial recruitment to bring new therapeutics to market faster. Managed care companies see significant opportunities to lower costs and simultaneously provide higher-quality care through adoption of AI and machine learning (ML). New health plans and provider models are leveraging AI and ML to tailor treatment for individual patients, resulting in better health outcomes and lower costs.

Technology Investments Are Being Rewarded at a Sector Level



Source: Morgan Stanley & Co. Research, Thomson Reuters, Sentieo

INDUSTRIALS. Once considered a classic "old economy" sector, the profile of many industrial companies is changing as software and data tools become more prevalent. Examples include aerospace companies providing automated avionics, smart sensors and connectivity tools to simplify flight, and one day to enable autonomous cargo delivery. Also, construction companies are providing products that target specific energy usage, office occupancy and safety. Air filtration systems will clearly be a priority after the pandemic. Even businesses assumed by some to be antiquated, like farms, are seeing tremendous tech change thanks to new products provided by machinery manufacturers. High-tech agricultural innovations are driving down costs and improving crop yields.

FINANCIALS. Having invested significantly in technology in recent years, the financials sector was well positioned for home connectivity as we entered the pandemic. In the banking sector, digital and mobile tools are vital for acquiring new customers and containing expenses in a low interest rate environment. On the asset management front, while AI and ML can improve traditional investment processes, many firms are poised to move beyond investing and toward providing sophisticated risk, trading and portfolio-construction tools. In wealth management, some of the same risk tools are helping advisors manage portfolios more efficiently, and data analytics is at the forefront of pursuing new business leads. Perhaps even more tangibly, as the pandemic has illustrated, video conferencing has supported connectivity and become an essential bridge to clients For the full list of *Data Era Stocks 2.0*, please contact your Financial Advisor. ■

CROSS-ASSET INVESTING

A Tale of Four Cities

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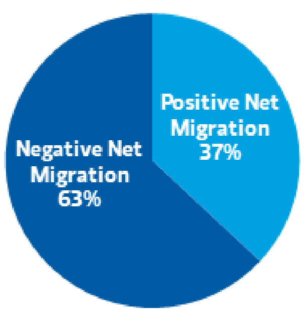
As the pandemic set in last year, a narrative took hold that cities would lose population and not recover, and assets whose viability relied on population density fell under pressure. We believe that reports of the demise of cities have been greatly exaggerated. The truth is more nuanced—and more positive.

DEFINING A FRAMEWORK. Cellphone tracking data shows that not all cities lost population (see chart below). Of those that did, many only lost people to neighboring counties, reflecting the enduring economic viability of the area. Further, the data points to the possibility that some migration could be temporary, notably among those with higher income and/or less community attachment, given that fresh, COVID-induced motives for relocation could start to wane now that the pandemic's end is in sight. Hence, investors need a framework to avoid making poor assumptions about the future of cities.

Of the 46 Markets Examined, 29 Experienced a Population Outflow

Markets by +/- Net Migration as of Q1 2021



Source: AlphaWise, Morgan Stanley & Co. Research, SafeGraph

To help make sense of this complicated story, we analyzed the top-46 US cities and sorted them into four buckets: 1) booming—cities that maintained a clear population growth trend throughout the pandemic; 2) rebounding—cities that lost population but are showing nascent growth signs; 3) steady—cities that lost population and are showing mixed signs of rebounding; and 4) lagging—cities that are still showing negative trends across all metrics.

In the context of our "Four Cities" framework, we see important implications that may be viewed from a regional and/or asset class perspective. First, a rising tide may not lift all Sun Belt markets, which have broadly benefited from population migrations in recent years. This out-of-consensus view is based on analysis that points to significant dispersion in post-COVID recovery paths. Several markets in the region—Jacksonville, Memphis and Charlotte—were found to be squarely in the "booming" or "rebounding" category, whereas Austin and Houston were "steady."

Second, with recovery uneven in California, the state requires monitoring. We categorize several of its markets as "lagging" and a select few as "rebounding." We believe this could indicate migration to markets within the state, as well as out of the state. Los Angeles and San Francisco, in particular, are on the watch list. San Diego and Sacramento are rebounding faster.

Third, recoveries of multifamily and office properties are uneven within markets. For example, San Francisco, Las Vegas, Atlanta and Phoenix are seeing stronger inflections in multifamily properties but lackluster office performance. Minneapolis is the only market where the office segment is recovering faster. This reinforces our view that multifamily fundamentals and stocks can continue to decouple from those of the office segment.

Given real estate's wide-reaching economic impact, it is simultaneously a key driver for multiple sectors and investment types. Pandemic-related population shifts, as viewed through our framework, have major investment implications. Below, we highlight our views of three key related sectors: municipal bonds, real estate investment trusts (REITs) and housing credit.

MUNICIPAL BONDS. Population loss is generally a reliable negative indicator for municipal credit health, as it reflects a shrinking tax base. COVID-era migration patterns can muddy the waters, but applying the Four Cities perspective helps to identify which cities in the "steady" or "lagging" groups are most at risk of suffering from population loss.

The market currently seems to be pricing in a positive fundamental trajectory for local government credit. Credit spreads have compressed below pre-COVID levels and below the long-term average, most likely due to the large amount of federal fiscal stimulus directly and indirectly supporting local economies.

Generally, a municipality can tap multiple resources to manage operational challenges in the short to intermediate term. For instance, should expected tax revenues come up short, general fund balances and reserves can be drawn on to meet debt obligations.

Such tools can help ease immediate pressures, but outmigration—if it proves to be a more secular trend—could chip away at credit quality over time. Near-term mitigation tactics could then lead to structural credit deficiencies. This risk bears watching and underscores our current underweight to the state and local sector.

REITS. Apartment fundamentals are improving quickly, with a strong recovery in demand allowing landlords to roll back concessions. Through the end of May, Class A effective rent growth rose by 540 basis points on a quarter-over-quarter basis to 4.9%, its highest level since the second quarter of 2007; Class B growth rose 270 basis points to 5.1%, near an all-time high.

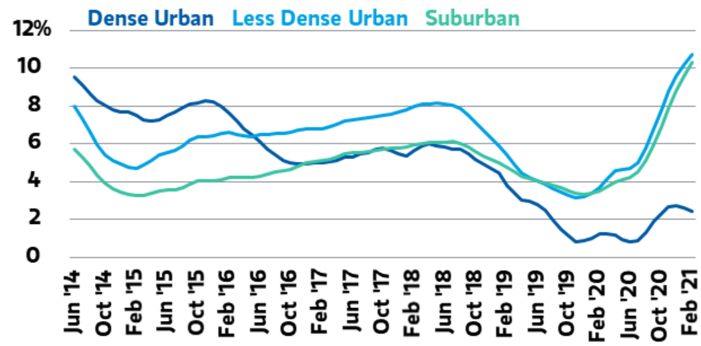
The recent acceleration in apartment rents supports record-high multiples that seem fair relative to REITs and cheap relative to the broader market. It's also in line with our view that apartments can be utilized as a hedge against inflation, given that shelter inflation accounts for a third of the consumer price index and a sixth of the personal consumption expenditures index.

Office properties remain under pressure from the effects of COVID-19, with office REITs still about 20% below their pre-COVID highs. As in every recession, there have been cyclical challenges, such as slower rent growth, but there are also longer-term risks—particularly due to emerging hybrid work models pushing vacancy rates higher and limiting pricing power.

In the near term, we believe office stocks can continue to selectively recover as return-to-work trends support incremental leasing and potentially rent growth. At the same time, the market has not yet priced in longer-term headwinds from what could be a structural shift in how people and businesses engage office space.

HOUSING AND RESIDENTIAL CREDIT. The housing market has generally benefitted from pandemic-related trends. Demand for single-family shelter was helped along by historically low mortgage rates, which increased buyers' purchasing power. With more than $400 billion worth of purchase mortgage originations in the third and fourth quarters, 2020 had the highest annual purchase originations in at least the past 17 years. Strong demand intersected with historically tight supply to drive home prices to their highest levels of growth since prior to great financial crisis.

The Home-Price Appreciation (HPA) Gap Is Growing



Source: Data acquired from Zillow.com, US Census Bureau, Morgan Stanley & Co. Research

That's the aggregate story, at the national level. Home-price appreciation (HPA), however, is never uniform across the country, and we observe notable differences across markets by population density (see chart above). HPA has increased substantially in less densely populated cities, as well as in the less densely populated zip codes of more crowded cities. In other words, markets that we identify as "booming" and "rebounding" are realizing higher levels of HPA than markets that we identify as "lagging."

This difference in the rate of home-price growth has manifested itself in substantial differences in mortgage performance. The equity that homeowners have built thanks to price appreciation is leading to higher prepayment speeds and lower delinquencies, which are strong credit outcomes for nonagency residential mortgage-backed securities (RMBS).

Population migration, while highly important, isn't the only factor affecting changes in home prices. Shelter supply and mortgage rates should also be considered. As the economy reopens and spurs further moves, cities that are set to regain some of the population they lost will likely be doing so in a higher-rate environment and amid somewhat looser supply. These dynamics will likely mute the potential price gains relative to what we have experienced over the past year. ■

This article was excerpted from the June 3 report from Morgan Stanley & Co. Research, "A Tale of 4 Cities." For a copy of the full report, contact your Financial Advisor.

Please refer to important information, disclosures and qualifications at the end of this material.

ALTERNATIVES

Uneven Rebound Offers Opportunity in Real Estate

Brandon Dees, Investment Analyst, Morgan Stanley Wealth Management

Last year, the global pandemic heightened caution across real estate and intensified both positive and negative multiyear trends in the asset class. For the year to date, the real estate market has been revived by the vaccine rollout, the economic reopening, investor optimism and a continuation of accommodative Federal Reserve policy and fiscal stimulus. Rising inflation and the desire for income, meanwhile, have driven investor appetite. Interestingly, however, public and private real estate markets have performed differently in response to these factors in 2021.

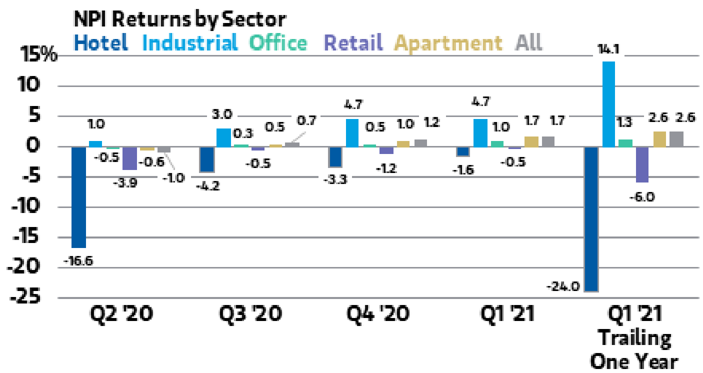
CAPITAL FORMATION AND DEAL ACTIVITY. During 2020, the economic lockdown temporarily slowed asset inflows and elevated investor concerns. While fundraising remained subdued in the first quarter of 2021, financial data provider Preqin estimates that private real estate dry powder measured $367 billion in April, equating to approximately $1 trillion in total buying power with leverage. Additionally, pockets of the market recently have experienced a resurgence in capital formation. According to Robert A. Stanger & Co., nontraded real estate investment trusts (REITs) have garnered $7.7 billion in inflows for the year to date through April. In fact, at $2.6 billion, April was a record month for nontraded REIT flows, which have moved beyond pre-COVID levels.

Deal activity continues to favor resilient areas with stable income streams, like multifamily apartments in growth markets, and secular demand beneficiaries, such as industrial assets. Recently announced deals include niche or alternative assets like self-storage, data centers and single-family rental.

ACCELERATING TRENDS. While COVID-19 disrupted the real estate market, the fact that the pandemic accelerated pre-existing trends cannot be overstated. For instance, the market was already experiencing: strong e-commerce penetration and demand for industrial assets; pressure on brick-and-mortar retail; favorable employment and population dynamics in nongateway growth markets; and imbalanced housing supply and demand. Fundamentals have recovered swiftly among the most favored property types, including strong rent collection, high occupancy and sizable increases in re-leasing spreads, and labor and material cost inflation is keeping new supply in check. Private real estate investment managers who identified these multiyear trends have benefited by maintaining exposure as valuations have increased, or by selling into strong demand.

DIVERGENT PERFORMANCE. There has been a sharp year-to-date bifurcation between the public and private real estate markets. After lagging broad US equities and posting a -7.6% return in 2020, publicly traded REITs, as represented by the MSCI US REIT Index, have surged 21.3% for the year through June 18, driven in part by a reopening trade for properties that were heavily impacted in 2020, including malls, offices and hotels. Active management has benefited, as top-ranked public REIT funds have maneuvered to not only include best-in-class REIT names but also to engage in tactical reopening value trades, which began rebounding late last year and have led in 2021.

Private Real Estate Returns Have Recently Improved



Source: NCREIF as of March 31, 2021

Conversely, private real estate performance has been relatively muted. The National Council of Real Estate Investment Fiduciaries Property Index (NPI), a total return index for private commercial real estate, returned 1.7% in the first quarter of 2021 (see chart). Performance was driven by resilience in the industrial and apartment sectors, while office, retail and hotels detracted. Private market performance still directionally represents a continuation of the trends that began in the second quarter of 2020. After generally ranging from flat to the mid single digits last year, many nontraded REIT strategies have generated sizable net monthly returns to start 2021, as managers who have avoided the most problematic property types continue to experience strong and improving operating metrics, along with increased capital flows and transactional activity.

BOTTOM LINE. We believe investors should have a well-balanced real estate investment strategy that anticipates a post-COVID era. Real estate should serve a number of functions, including portfolio diversifier, alternative source of income, return enhancer and effective inflation hedge. In our view, the current midcycle backdrop, characterized by increasing growth and inflation, is a historically accommodative environment for real estate. Investors who effectively utilize both public and private strategies may benefit from the continuation of favorable supply/demand dynamics, secular growth and tactical value positioning, including in public market reopening trades. ■

EQUITIES

Wealth and Asset Management: Competing for Growth

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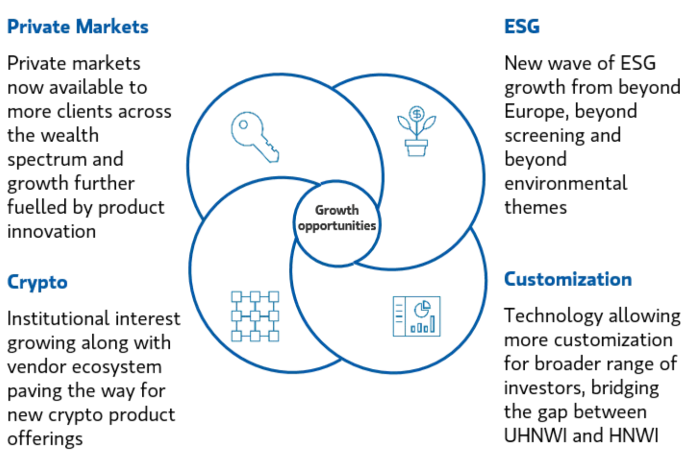
The wealth management and asset management industries are at an inflection point—one that could have significant implications over the next decade as new products and technologies reshape the competitive landscape. Both face a common set of challenges and opportunities, driven by forces such as the quickly changing macroeconomic environment, shifts in client demand and the continued evolution of technology aimed at delivering better investment and advisory solutions.

Considering the wealth and asset management industries together is an apt approach, given that they share a critical charge to understand the needs of end clients and then identify investment opportunities to satisfy those needs. Analyzing them jointly, we conducted a study informed by 23 interviews with senior executives in both industries, representing a combined $34 trillion in assets under management (AUM). While we recognize there are other important themes for wealth and asset management, such as opportunities in China, we see four particular growth areas that are critical for both industries—and that are fueling competition (see chart).

Wealth and Asset Managers Share Key Growth Opportunities



Source: Oliver Wyman analysis, Morgan Stanley & Co. Research

PRIVATE MARKETS. Robust growth over the past decade has helped private markets reach $7 trillion in AUM, with $13 trillion anticipated by 2025. Despite some concerns about valuations, growth is likely to be driven by investor demand for yield and inflation protection, plus the emergence of new supply-side drivers and, notably, the development of structures and delivery models designed to expand access to retail investors.

Emerging distribution platforms along with product innovation can help remove once-tall hurdles—such as illiquidity and high minimum thresholds—for individuals to invest in private markets. With these distribution channels serving as a complement to wealth advisory, a wider range of wealth managers can now build an offering in this space and develop more diversified exposure across managers and funds. Asset managers can use these platforms to improve their access to individual investors in a cost-efficient way. They can also utilize new product structures—a "semiliquid" private markets solution, for instance—to take advantage of retail demand.

ESG. Environmental, social and governance (ESG) considerations are already a major driver of opportunities for wealth and asset managers. We anticipate the next wave of opportunity to come from three macro shifts: beyond Europe, beyond screening and beyond "E."

ESG investing has been primarily a European phenomenon, with the region representing around 85% of total category AUM at the end of 2020. Now growth in North America has begun to accelerate. At relatively early stages, current trends for non-Europe ESG investing indicate a long runway for growth. Also, we observe a strategic shift from what are typically viewed as "less mature" strategies, such as screening and exclusion, to "more mature" strategies, such as impact and thematic investments. This transition will require managers to go beyond high-level scores and use more outcome-oriented data to monitor and report on tangible ESG results. Further, such "mature" strategies will require managers to decompose ESG into its individual components and enable investors to zero in on the specific themes and goals they care about.

As wealth and asset managers gear up to ride this next wave of growth, data will become increasingly important with regard to managers' ESG capabilities and proposition. Many will rely on third-party data providers, but leaders will stand out in their ability to analyze that data, as well as the quality of their research and company-level engagements.

CRYPTOCURRENCIES. Total market capitalization of cryptocurrencies exceeded $2 trillion in April 2021, up from below $50 billion four years ago. Institutional investors—attracted to the asset class' strong returns, low correlation and institutionally suitable products—have served as another tailwind for crypto, accompanying strong retail trading activity and family office investments.

Institutionalization of crypto creates a significant opportunity for wealth and asset managers, who can no longer ignore this trend. At the same time, there are significant barriers to broader adoption of the asset class, including regulatory uncertainty, high volatility and sustainability concerns.

In this environment, larger wealth managers will need to make the call on how to participate, while smaller players can still decide whether this is a market they want to enter. Also, crypto is likely to draw a growing number of private investors, including younger and more technology-savvy asset owners. That means wealth managers will need to develop offerings specific to the demands of this segment. Asset managers who want to participate in crypto should consider a range of product responses, from incorporating the assets as part of an existing multiasset fund, to creating dedicated passive or active crypto products, to offering structured solutions.

CUSTOMIZATION. Access to customized portfolios has so far been the preserve of institutions and ultra-high-net-worth (UHNW) individuals due to the high cost, high-touch model required and the limited scalability of such offerings. Recently we observe three developing factors that will enable customization at an unprecedented scale.

First, investors are increasingly seeking underlying investment vehicles, such as separately managed accounts (SMAs), that allow for direct holdings to customize their strategies. Second, new technology makes it easier to hold securities at lower investment amounts, including in fractional shares. Third, direct indexing can now accommodate more specific and customized exposures.

These factors help managers integrate personal needs and preferences for a wider array of investors. Wealth managers can offer customization further down the wealth spectrum and at much lower cost through automation. This is an opportunity to bridge the gap between UHNW and high-net-worth investors—or, put another way, between fully bespoke and highly standardized services. It's also a chance to consider expanding customization to entry-level high net worth and the affluent; asset managers will need to decide how to scale their SMA platforms for smaller account sizes. While delivering these products creates greater optionality and more potential value for clients, it also increases the burden on asset managers to help investors best utilize these options.

We believe these four growth areas have the potential to drive valuations and earnings for wealth and asset managers. In our view, considerations of private markets access and ESG investing propositions are already meaningful to asset flows. Developments in portfolio customization are in early days but can be increasingly meaningful in a changing tax regime. We don't see a significant impact from crypto to valuations in the near term, but we acknowledge its long-term potential for disruption. ■

This article was excerpted from "Competing for Growth," a June 10, Bluepaper from Morgan Stanley & Co. Research. For a copy of the full report, contact your Financial Advisor.

FIXED INCOME

Interest in Taxable Munis Expands

Daryl Helsing, CFA, Associate, Morgan Stanley Wealth Management
Matthew Gastall, Investment Strategist, Morgan Stanley Wealth Management

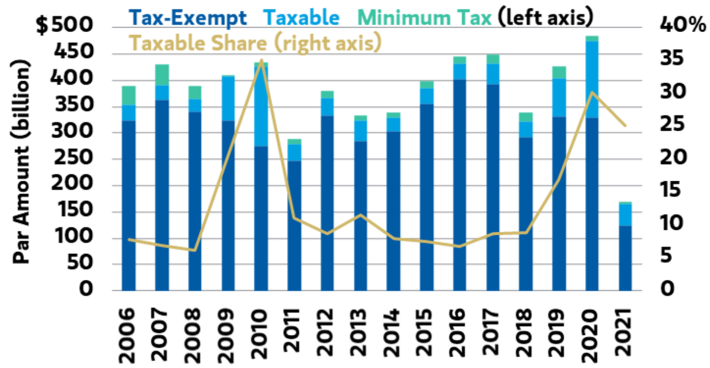
On the heels of last year's strong recovery, it's been a healthy year for the municipal bond market. Prices and spreads have held in well, and issuance has been solid. However, many investors aren't aware that a considerable portion of new-issue volume has actually been taxable rather than tax-free. As the taxable municipal bond space continues to grow, we think it's one investors should explore.

Taxable municipal bonds are state or local government securities whose interest payments are not exempt from federal income taxes, often because the bonds' proceeds do not provide a direct or significant benefit to the general public. Taxable issuance has accelerated recently, as public entities have utilized the structures to refinance tax-exempt debt in compliance with changes passed in 2017's Tax Cuts and Jobs Act (TCJA).

In our view, passage of the TCJA was one of the most significant developments in the municipal market over the last 40 years. Alongside other transformative measures, the legislation limited the ability of states and local governments to advance or prerefund debt. Modifying a strategy long practiced by US municipalities, it contained measures promoting circumstances whereby only one of an issuer's tax-exempt financing vehicles would remain outstanding. Hence, if a public entity that originally qualified to issue tax-exempt debt wished to refinance an obligation before a redemption date, the transaction often needed to be executed by issuing a federally taxable bond.

ISSUANCE SURGE IN 2020. Following the onset of the pandemic, the flight-to-quality fostered declining interest rates, which, in turn, encouraged municipal issuers to become more active in refinancing outstanding debts, even when the transactions were completed with taxable structures. Having grown in 2019, the prevalence of taxable municipal deals accelerated sharply in 2020. From 2011 to 2018, taxable supply constituted roughly 7% to 11% of primary activity. Taxable issuance expanded to 17% and 30% in 2019 and 2020, respectively (see chart). In fact, last year's gross primary supply record for municipals overall was bolstered considerably by taxables, as tax-exempt supply was actually lower than in several periods in the prior economic cycle. While most taxable muni volume was for refunding, new money issuance also reached the highest levels since 2010.

Taxable Share of Municipal Gross Issuance Has Been on the Rise



Source: The Bond Buyer as of May 31, 2021

Though still healthy, issuance has moderated recently due to higher US Treasury yields, the relative strength of tax-exempt securities to Treasuries and issuer patience in awaiting possible new legislative action from Washington. Along with the impact of interest rates, taxable municipals could be shaped by potential upcoming legislation pertaining to public finance, as some in Congress have called for a restoration of tax-exempt refunding and a revival of the Build America Bonds (BABs) program utilized under the Obama Administration.

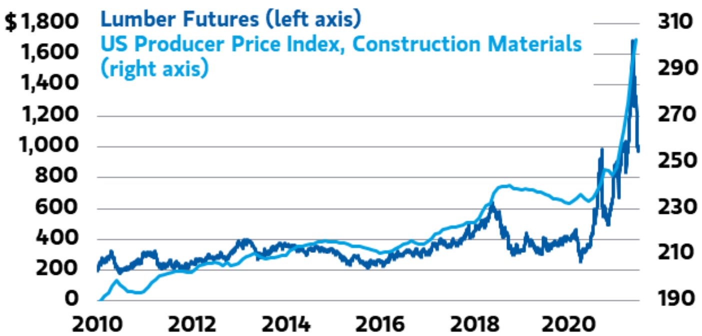
FREQUENTLY HIGHER NOMINAL YIELDS. Taxable municipals often offer higher nominal yields (pretax) than tax-exempt securities. Consequently, investors that benefit less from exemptions, such as those in low federal tax brackets and/or residing in low-tax states, may earn a higher rate-of-return. Taxable municipal bonds provide such investors with an additional option to potentially diversify positioning, reduce volatility, increase credit quality and enhance returns. The expansion of the taxable municipal market has provided clients in low-to-middle income tax brackets with more municipal securities to consider when building their fixed income portfolios. The current market offers not only an increased supply of taxable instruments, but also a greater number of securities issued by essential public entities, which are often highly creditworthy.

Investors should monitor call provisions and note that the bonds may be more volatile than some other municipal debt, as the structures are less common and can pay lower coupons. As with fixed income in general, it's also important to be aware of duration, especially in a shifting rate environment. We believe taxable muni bonds can function as very effective complements to other taxable instruments, especially on the short end of the yield curve and for buy-and-hold investors in lower federal tax brackets and/or low-tax states. ■

Please refer to important information, disclosures and qualifications at the end of this material.

Short Takes

Timber!

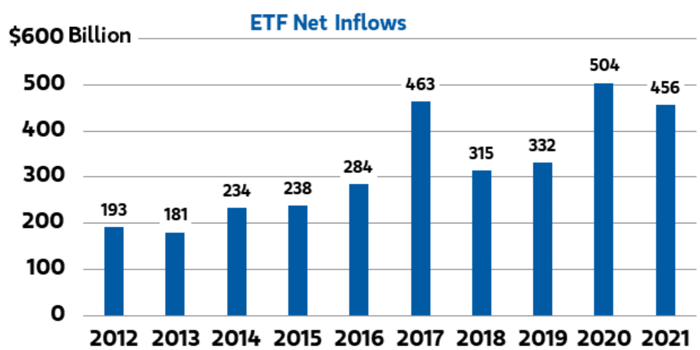


Source: Bloomberg as of June 29, 2021

Amid the lockdown of 2020, many chose to move from big cities to the suburbs, in some cases building new homes. Partially as a result, the demand for construction materials began to outstrip supply, while home prices also began to accelerate. One of the main culprits of this supply/demand imbalance was the availability of lumber, which, from April 1, 2020 to May 7, 2021, rose from $260 to $1,686 per 1,000 board feet (see chart). However, since then lumber futures have declined 56%. They now sit at $740, as sawmills have begun ramping up, and some have delayed purchases. Even as prices have come down from all-time highs, however, many expect a strong housing cycle to keep lumber prices at elevated levels for longer.—*Jonah Silverman*

US-Listed ETF Flows on Track for Record Year

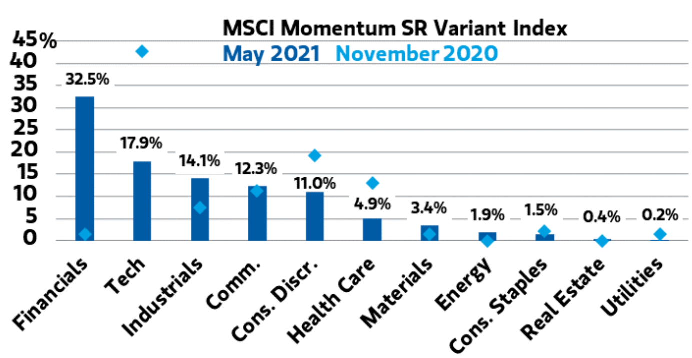
Following what was the largest year ever for US-listed ETF flows, 2021 is poised to smash 2020's record and become a new milestone year, as net inflows have already matched 90% of last year's total (see chart). Money has been flowing into the US large-cap blend, broad bond, US value, international–developed and emerging markets fund categories. There are 2,455 US-listed ETFs with $6.5 trillion in total assets. Growth in the number of new ETFs has also accelerated. Thus far in 2021, 179 new funds have come to market following more than 300 in 2020. After accounting for 56% of last year's new fund launches, actively managed ETFs have made up 68% of 2021's launch total. The US-listed ETF market continues to thrive, as evidenced by the surge in flows and continued product innovation.—*Michael Suchanick*



Source: Bloomberg as of June 25, 2021

Momentum Shifts From Growth to Value

Based on the idea that recent performance trends, either higher or lower, are likely to continue, equity price momentum is often used by investors to help determine portfolio allocations. The momentum factor, which underwent its last semiannual rebalance in May, uses trailing six and 12-month sector performance to determine weightings (see chart). The index has historically had a strong weighting in growth style equities but recently saw a significant move away from growth (down 33%) and into value (up 46%) following robust value performance in 2021. Specifically, financials moved up 31%, while technology, which remains the second highest sector, declined from 41% to 18%. While changes in momentum can be temporary, we view the latest move from growth to value as a potential indicator of the shift to a midcycle environment.—*Nick Lentini, CFA*



Source: Bloomberg as of May 31, 2021

Q&A

Playing the Global Reopening Rebound

The US has emerged as an obvious winner amid the current recovery, but even prior to the pandemic not all nations stood on equal footing. In fact, by early 2020, some developed and emerging countries had yet to reach highs seen prior to the great financial crisis. While the S&P 500 has had annual gains of almost 15% in the past 10 years, developed international and emerging markets have only returned 9.8% and 4.7% per year, respectively. With US equities at or near all-time highs, this moment offers an attractive opportunity for investors to consider select overseas exposure, says David Herro, international equities CIO at Harris Associates and portfolio manager for a number of Oakmark Funds. "While the marketplace is always very dynamic," he explains, "the price you pay for a business always matters." Herro recently spoke with Sachin Manchanda, head of equity model portfolios for Morgan Stanley Wealth Management. The following is an edited version of their conversation.

Sachin Manchanda (SM): As the world reopens in different phases, what do you think the new normal will look like?

David Herro (DH): When this whole thing started, of course there was a knee-jerk reaction by markets. A lot of people believed that we'd be in a prolonged recession, or maybe even depression, and what happened was something very different.

I think all too often people looked in the rearview mirror. They looked to 2007, 2008 and 2009 and they extrapolated —which was a big mistake because, one, the authorities were quick to make changes to adapt to the pandemic and, two, thanks to technology many people were able to continue to do their jobs.

Ten to 20 years ago, we did not have the technology—the bandwidth, the equipment, the software, the hardware. Looking ahead, I think there will be more remote work and people can choose where they work. It won't completely replace in-work situations. People still need to be together for certain periods of time, but is it five days a week?

I think travel will recover, but business travel will not be the same.

Coming out of this pandemic, we've also had people who were working but haven't been spending. They have built up huge savings and I think we'll see a lot more spending and a stronger recovery than we expect.

SM: What are your expectations for growth by region and how is that affecting where you believe the pockets of opportunity are?

DH: The US reopened in many places before other locations in Europe and the rest of the world. I would argue that our stimulus was stronger. As a result, you see this very strong, robust economy and a rebound in US equity prices. We're in the fourth, fifth or sixth inning—whereas, in Europe they are just starting to reopen.

Something else to consider is that in the last decade, prior to the pandemic, the US recovered much stronger than Europe following the last big crisis—and Europe had to deal with the Greek crisis, the sovereign debt crisis and Brexit.

All of these various issues in essence slowed European growth and these types of macro events discouraged investors from investing in European equities. A huge valuation differential opened up and, as a result, even before this pandemic, I would say European equities looked more attractively priced.

Then comes the pandemic and the recovery from the pandemic—and the US sprints into a recovery. We're starting to see some valuations get stretched in the US. Europe is starting from a much lower base and with a lagging recovery, which to me really represents great opportunity—especially since so many of the global European economies consist of global companies with a lot of exposure to the hot pockets of growth, including the United States.

I look at the premium auto sector in Europe in particular and see companies that are heavily exposed to the roaring US market. In the meantime, the European market is starting to pick up.

Look at financials in particular. Because Europe had the bane of negative and low interest rates—which prevented investors from going in despite the fact that European financials still were able to grow their earnings—we're now starting to see pressure on interest rates, which is another sign that this value gap will close in the next two or three years. In the meantime, they are all trading at single-digit PEs, high single-digit yields and mid-single-digit price to book.

Lastly, within emerging markets (EM), we really have to look stock by stock. I would say as far as EM is concerned, I don't see huge value and I don't see huge overvaluation. My advice there is to be selective and look for quality at a good price.

SM: How do you look for opportunities with the importance of China changed now versus in the past?

DH: In my 35 years as a professional investor, no bigger economic phenomenon has happened than the rapid growth and development of China. We've seen not only massive economic growth, but exponential growth in GDP per head. In the late 1970s/early 1980s, GDP per head was around $300 or $400; now it's probably $13,000 or $14,000 dollars, based on purchasing power parity (PPP).

This was a result of China's economy opening to the benefits of the global economy. While other places like Japan and even Europe slowed, China was there to pick up the slack.

A lot of people have been elevated from poverty to prosperity, and when you have a large population growing that rapidly, that is conducive to global economic growth—and especially beneficial to those Western companies with exposure in China.

On the other hand, you have to be careful because China no longer wants to be passive. We see this in the South China Sea, in intellectual property disputes, in what's happening with Hong Kong and perhaps even Taiwan. I think this might present new problems.

Investors also have to be cautious about transparency in corporate governance and the rule of law, because this is not a developed market. It has grown rapidly, a lot of wealth has been created, but it's still not without pitfalls.

SM: Japan's Nikkei Index recently topped 30,000 for the first time since the 1990s. Given this strong rally and the corporate governance changes that we have started to see, what are your thoughts on Japan?

DH: In the 1980s, it was very hard if not impossible to find value, because the average Japanese stock traded at 60- to 70-times earnings and five-times book. Despite that high price, the average return on equity of a Japanese company was just 7% or 8%. You had a bubble.

The Nikkei peaked in 1989 at around 40,000, and as you said, it just traded at 30,000. We still have not made it back to the peak of the late 1980s.

Until the earthquake and tsunami happened in 2011, as a professional investor I was underweight Japan. Then the earthquake tsunami came, the market cracked, the yen strengthened, and eventually they found their footing.

Abe won the election, pledging to fight deflation and the strong yen and, lo and behold, I became overweight and profited over the next year or two. Here we are, 10 years later, and we're back underweight. Why? Because as investors we look at the price we pay for what we get. Even with attempts at reform, corporate Japan still earns just 7% or 8% return on equity and stocks trade at relatively heady multiples.

SM: What are your thoughts on the dollar and how does it play a role as you look at international markets?

DH: When we buy a foreign stock, we also buy the underlying currency. You have to make sure if you're buying an overvalued currency that you protect yourself. Of course, currency valuation and currency movements are very unpredictable in the short and medium term, so we look at PPP and other factors and, if it is measurably overvalued, we buy protection in the form of hedges.

Today we almost have the opposite role. The dollar had a five-year period where it went from weak to strong. Today, most other currencies are undervalued and so it represents an opportunity. Beyond undervalued stocks, you're also now buying undervalued currency.

SM: How has the value versus growth dynamic played out in European and Asian markets and what are your expectations for the future?

DH: Value performance over the past 11 years was like four or five standard deviations away from growth, meaning it significantly underperformed—and this was a global phenomenon.

Then the pandemic hit and it got worse. It closed up a little bit toward the end of last year, but we still have a wide dispersion. Plus, you have special purpose acquisition companies (SPACs), cryptocurrencies and other things that are attracting asset flow, which in a way could be detracting from value.

I believe that the gap between value and momentum or value and growth or value and nonvalue is going to close as a result of the rapid growth coming out of the pandemic and as a result of continued fiscal and monetary stimulus, as well as the reopening of the economy.

There's a lot of money out there and there is a lot of stimulus still out there. There's a lot of pent-up demand out there. This will pressure interest rates, and the stocks that will most greatly benefit from a recovering economy and higher interest rates are industrials, materials and financials. I think value is still in the second or third or fourth inning and has a long way to run.

SM: What are the biggest challenges in this environment?

DH: Regulatory environments are getting harsher all over the world. Yes, smart transparent regulations are always necessary in a free market system, but regulators can become obtrusive. If they lack common sense, they can do things that restrict trade and supply.

So we have to recognize the regulatory and legal environments, and we have to make sure we consider the prices of the companies impacted by these risks. It's never static; the environment is always changing, and we have to make sure that we are aware and make the necessary portfolio adjustments.

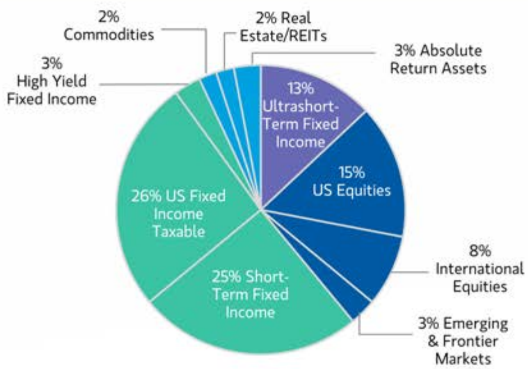
As an investor you must never stop being dynamic. You always have to consider the world around you and make adjustments where necessary.

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

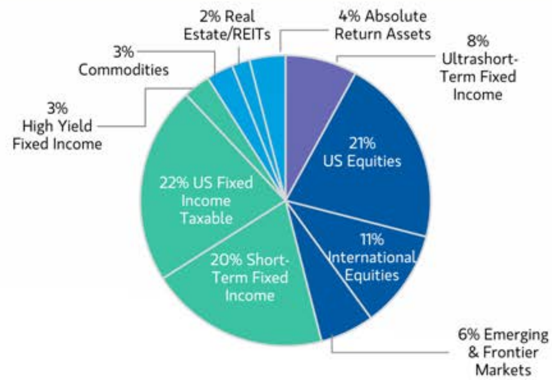
Global Investment Committee Tactical Asset Allocation

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

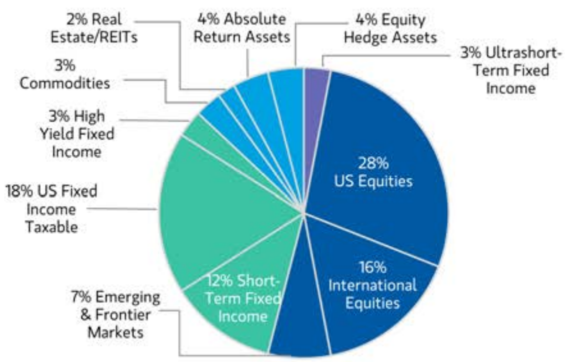
Wealth Conservation



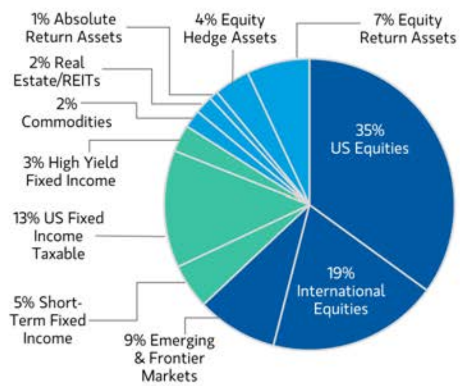
Income



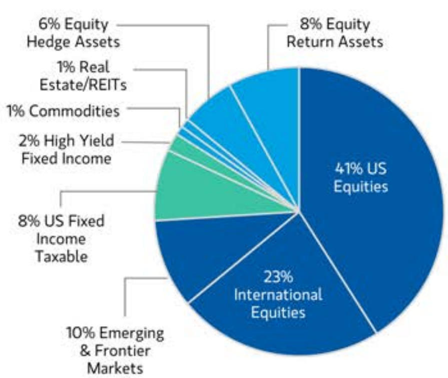
Balanced Growth



Market Growth



Opportunistic Growth



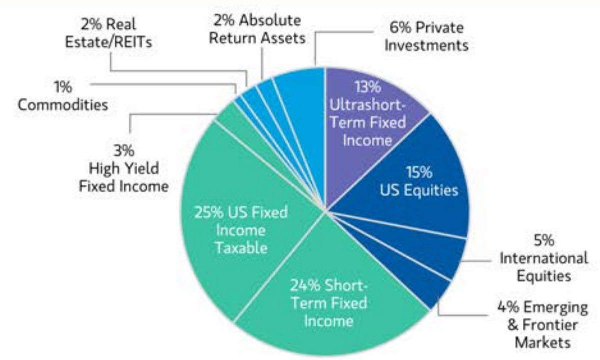
Key

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

Source: Morgan Stanley Wealth Management GIC as of June 30, 2021

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

Wealth Conservation



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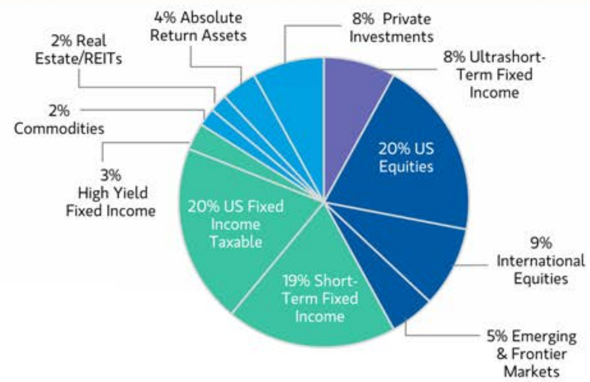

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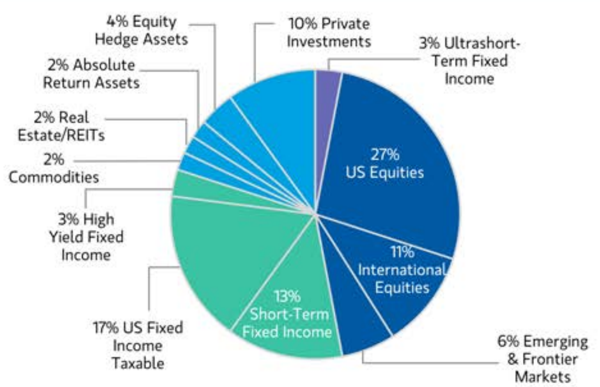
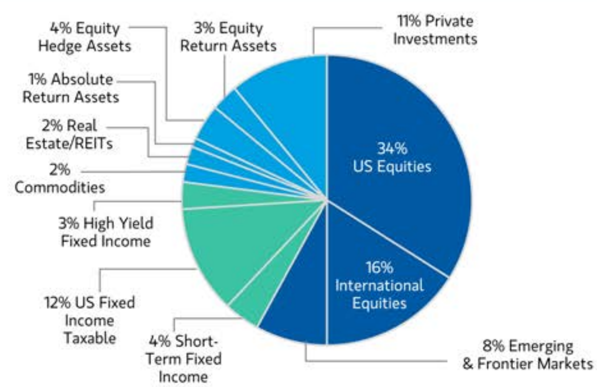
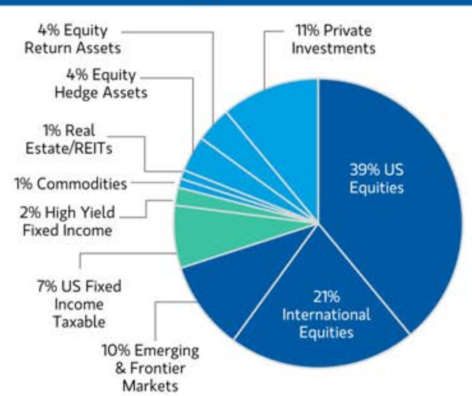


Market Growth



Opportunistic Growth



Key

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

Source: Morgan Stanley Wealth Management GIC as of June 30, 2021

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Overweight	As the S&P 500 has continued to hit all-time highs, pricing the fastest recovery from recession in the last five business cycles, we recently reduced exposure to expensive US growth stocks with a focus on SMID exposure. From here we enter the midcycle adjustment, where gains moderate as expectations get recalibrated and policy normalizes. Odds of a 10%-15% correction are increasing as the outlook for inflation and higher rates crystalizes.
International Equities (Developed Markets)	Market Weight	In Europe, prospects for fiscal stimulus and concrete moves toward pan-Europe fiscal integration are game changers. In Japan, economic recovery is gaining momentum, and we expect shareholder-friendly and positive return-on-equity policies to persist. The 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. While valuations are attractive and local central banks should be able to maintain accommodation and stimulus, we need to be more selective now as rising commodity prices are a blessing or a curse, depending on the country.
Global Fixed Income	**Relative Weight Within Fixed Income**	
US Investment Grade	Market Weight	After moving in 2018 to a maximum underweight to core US fixed income with a strong tilt toward short duration, we recently moved to partially neutralize our extreme positioning. Since 2020, nominal long rates have nearly doubled while inflation breakevens are near multidecade highs. With two-thirds of the cycle repricing behind us and stock volatility likely to stay high, we are using this exposure to collect low-volatility income.
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 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	Market Weight	We recently halved our exposure to the equity-like asset class, wanting to reduce equity beta of portfolios. High yield bonds have rallied aggressively with the unprecedented provision of liquidity from the Fed and fiscal stimulus from Washington. Surging commodity prices have also repaired balance sheets of oil-levered companies. With spreads near all-time tights, the upside is limited.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Overweight	With the debate between growth and rising rates moving to center stage, we recently added modestly to the asset class, believing it is a diversifying source of income that is also leveraged to reflation. With real interest rates still negative and inflation expectations rising, we expect to be selective opportunistic investors in the sector this year, with a focus on residential.
Commodities	Market Weight	Sooner-than-expected economic and COVID-19 recoveries in both China and the US have shocked supply chains drained from last year's closures. Now most major commodities are rallying in a chase to keep up with improving demand. The impact is broad-based, affecting areas as diverse as industrial metals, soft agricultural, lumber and semiconductors. Longer term, increased global capital spending, a strong US housing market, a weaker US dollar and rising overall inflation suggest the asset class will likely remain opportunistically bid.
Hedged Strategies (Hedge Funds and Managed Futures)	Overweight	With broad market valuations rich, a majority of returns from here will be based on company earnings growth and managements' ability to navigate rising costs, surging demand and disruptive competition. These factors 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 GIC as of June 30, 2021

Disclosure Section

Important Information

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, Michael J. Cyprys, Brandon Dees, James Egan, Matthew Gastall, Betsy L. Graseck, Bruce Hamilton, Daryl Helsing, Richard Hill, Nick Lentini, Vikram Malhotra, Sachin Manchanda, Jonah Silverman, Daniel Skelly, Magdalena L. Stoklosa, Michael Suchanick and Michael 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.

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

Risk Considerations

Alternative Investments

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

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

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

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

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

Hypothetical Performance

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

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

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

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

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

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

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

ETF Investing

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

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

MLPs

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

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

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

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

Duration

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

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

Credit ratings are subject to change.

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

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