Market Context

Markets have continued to be volatile as policymakers around the world try to not only curb the spread of COVID-19, but also support economies and markets through this unprecedented time. Notably, both intraday and daily market moves have been more similar in magnitude to monthly or quarterly returns.

As efforts to control the virus in Europe and the U.S. have intensified, so too has the economic impact from business closings and restrictions on people’s movement. The policy proposals have grown in scale and scope and the number of countries enacting significant packages has expanded. Importantly, the U.S. Federal Reserve (Fed) has enacted multiple measures to provide liquidity and funding including unlimited quantitative easing, expanding the menu of assets they will accept as collateral at the discount window, as well as swap lines. These combined measures, along with fiscal packages, should provide somewhat of a bridge across the depths of this downturn. Importantly, there is a global focus on identifying existing or novel drug therapies that are efficacious against COVID-19.
Portfolio Positioning

- Active International Allocation (AIA) is a core portfolio with a regional/country allocation process geared toward identifying positive structural change / reform potential as well as employing macro analysis to allocate appropriately through the market and economic cycles. We then conduct fundamental analysis to identify those stocks that best express investment opportunities within this macro framework. As part of our process, we invest to capture long-term themes across sectors and industries.

- In the midst of the COVID-19 pandemic, we are currently employing a barbell approach to our equity allocation. On one side, we are overweight countries, sectors, industries and stocks that we define as long-term structural growth winners. Currently the portfolio is overweight Germany, the Netherlands, Denmark, Singapore and France. Thematic investments we own include stable consumer franchises, e-commerce marketplaces, digital entertainment platforms, and healthcare innovators. The portfolio is currently underweight Emerging Markets, though we expect to add to positions as specific countries and stocks offer attractive growth and reasonable valuations based on our fundamental analysis.

- On the other side of the barbell, we hold positions that should benefit from their relation to the economic cycle, in contrast to the longer-term structural winners mentioned above. Specifically, we have focused on sectors and industries that are currently undergoing a downturn, but where we see consolidation and supply rationalization leading to significantly better industry dynamics, while the underlying fundamental demand outlook is still expected to grow faster than GDP during the eventual recovery phase. These investments include memory manufacturers, semiconductor equipment and foundries, low-cost airlines, online travel companies, copper and gold miners, and select oil services companies. These are higher beta industries that should move more closely with the economic cycle, and today they are trading at trough valuations on trough earnings power, rather than discounting their future EPS growth in the upcycle. We have added to these areas recently, as valuations have become more attractive and industry as well as company fundamentals are going to result in these companies gaining market share through the downturn, ensuring higher earnings power in a normalized economy.

- Structural underweight allocations include commodity countries that also exhibit hallmarks of credit excesses, including Canada, Australia and some parts of Latin America. We are also staying away from countries with credit excesses such as Italy and Japan and sectors such as financials, autos, real estate, telecom and utilities. These sectors have high operational and financial leverage, low margin profiles with little room for error, are more vulnerable to economic downturns, exhibit overcapacity and are challenged by disruption and regulation. Telecom and utilities in particular face significant investment costs from 5G and carbon taxes, respectively, without the benefit of an offset from pricing power.

- We have recently reduced the portfolio’s market exposure, particularly in Europe. This has helped portfolio performance on a relative basis as have our overweights in communication services, staples, technology and gold stocks. The cash position has also contributed to portfolio performance. Underweight allocations in Japan and China, an overweight to Germany and positioning in energy have recently detracted from performance.

Market Outlook

- We think it may be foolhardy to make high-conviction forecasts about the likely depth and duration of the economic impact from COVID-19. The range of forecasts, which is normally fairly tight, is quite wide. While we expect a negative impact to growth in 1Q and 2Q, we are also watching the monumental monetary and
fiscal stimulus that has been unveiled worldwide. The Fed’s actions already appear to be more forceful than during the Global Financial Crisis (2008). We also think the global monetary authorities are likely to continue expanding their toolkit in order to support liquidity in a wide range of asset classes, while fiscal authorities will provide even more stimulus to cushion the economy.

- Equity markets are discounting mechanisms, and have priced in the current crisis in record time. While the growth outlook has been slashed, recent days have seen equity markets rally when policy makers have acted to cushion these economic and market shocks. Equities typically bottom several months before the economic data, and as we witnessed in March of 2003 and March of 2009, sharp rallies off the bottom can take place even when the economic picture looks rather bleak. The massive wall of stimulus, both monetary and fiscal, combined with the potential for a peaking of transmission rates (not to mention potential medical treatment/vaccine breakthroughs) should keep markets underpinned.

- Adding to the recent market turmoil is the volatility in the energy markets and dramatic decline in the price of oil. Credit markets were unnerved due to the high leverage in many energy companies, especially in the U.S. shale segment. The drastic price decline created pressure on credit spreads as COVID-19 pushed yields to record lows, and spreads widened due to both economic concerns from the virus and the plummeting price of oil. As with many things, there is a silver lining to the drop in oil prices as it accrues to the consumer, which should help when spending recovers following this health care shock.

- If we use China and Asia as a template, Europe and the U.S. will emerge from this COVID-19 outbreak, and these economies will eventually stabilize. Looking at previous viral outbreaks like SARS, and other global shocks such as the 9-11 attacks, markets tend to nose-dive quickly as economic growth contracts on a short- to medium-term basis. However, according to our analysis, the period following exogenous shocks tends to produce strong economic and equity rebounds, primarily due to high levels of pent-up demand as well as the lagged effects of extraordinary stimulus.

- We are encouraged by global equity market action in the last week, with markets mostly holding important technical levels and rebounding strongly off of them. We think markets are likely to seesaw as this pandemic continues to evolve and while it is hard to call a market bottom, we think the formidable response by global health authorities, and economic / financial policymakers are all sensible and on the right track. There are a number of long-term structural issues that have made us cautious for some time, primarily the record level of public and private debt. For now we will maintain our barbell portfolio positioning and will continue to monitor the developments and keep you updated.

**RISK CONSIDERATIONS**

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. In general, equities securities’ values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio’s performance. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Privately placed and restricted securities may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (liquidity risk).
IMPORTANT DISCLOSURES

The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific MSIM product.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

The information herein is a general communication which is not impartial and has been prepared solely for information and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Past performance is no guarantee of future results.

This communication is not a product of Morgan Stanley’s Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy’s / product’s relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

DISTRIBUTION: This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.


U.S.: A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.
Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to “professional investors” as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. Singapore: This publication should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore (“SFA”), (ii) to a “relevant person” (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. This publication has not been reviewed by the Monetary Authority of Singapore. Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accepts responsibility for its contents. This publication, and any access to it, is intended only for “wholesale clients” within the meaning of the Australian Corporations Act.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. (“MSIMJ”)’s business with respect to discretionary investment management agreements (“IMA”) and investment advisory agreements (“IAA”). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION: EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Limited (“MSIM”). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

Charts and graphs provided herein are for illustrative purposes only.

The information contained in this communication is not a research recommendation or ‘investment research’ and is classified as a ‘Marketing Communication’ in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.
MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person’s circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM’s express written consent.

All information contained herein is proprietary and is protected under copyright law.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.