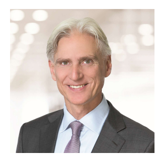
Morgan Stanley

INVESTMENT MANAGEMENT

December 2021
Fed's Hawkish Turn: Inflation No Longer "Transitory"

CUSTOM SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 3 DECEMBER 2021



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Global markets fell sharply as Omicron, a new mutation of COVID emerged. Prior to the volatility on 26 November, markets had been up on the month, although having less momentum than previous rebounds. The S&P 500 and MSCI Europe Index subsequently closed the month down -0.7% (USD) and -2.5% (EUR) respectively[1]. The MSCI Japan Index was down over the month at -2.9% (JPY)[1]. The MSCI Emerging Markets Index was hit harder, down -4.1% (USD).[1]

There was trouble for this year's star sector, as energy became this month's worst performing sector, with the MSCI ACWI Energy (TR) Index down -6.9% (USD)[1]. After a period of relatively low volatility, the VIX spiked to 28.6[2] on the day Omicron came to light, remaining elevated through to month end. It is still unclear how severe the new variant is and whether vaccines will provide enough defence. However, the uncertainty was enough of a catalyst for a selloff.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

[1] Bloomberg, 1-month performance as of 30 November 2021.
[2] Bloomberg, as of 26 November 2021.

US interest rates likely to rise, but only moderately

Federal Reserve Chairman Jerome Powell's Senate testimony as November drew to a close, was surprisingly hawkish, despite acknowledging the risk of Omicron. Chairman Powell's indication that it is time to stop using the term "transitory" to describe inflation, accordingly triggered a negative market reaction. Indeed, if there are further port closures and supply issues as a result of this new variant of COVID, this is likely to exacerbate inflation. We expect US interest rates to rise, but only moderately because we expect the Fed to aim to minimise the impact on markets. However, in this higher risk environment, a path of normalisation for rates, which does not upset markets, but which effectively counters inflationary pressures, is getting increasingly difficult to achieve.

Global shipping disruptions – are we there yet?

With global supply chain disruptions having been with us for much of 2021, due to a combination of demand induced by the pandemic and supply bottlenecks – many are asking when this will finally be alleviated. Industry surveys indicate that 50% of respondents expect to wait until 1H22 and 33% until 2H22 for normalisation[3].

Investment Implications

On a forward-looking basis, the rising uncertainty about how much the Fed may taper, suggests maintaining a cautious risk exposure. Having trimmed our overweight to value in September, we have trimmed our underweight to growth in November. We also reduced our position in energy and added to Chinese internet equities from a tactical standpoint:

Global Energy

We have been overweight global energy since January 2021. We implemented this as part of our rotation to cyclicals and value. At the time, US and European energy were trading at a discount to the broader market, but fundamentals were improving. Since then, energy has soared and despite recent struggles, it is still the best performing sector year-to-date, with the MSCI ACWI Energy returning 32.2% (USD)[4]. With the US government taking action to curb the increase in oil prices – a trend which could cap the upside in the short term, we have trimmed to take profits.

Chinese Internet Equities

We implemented a modest overweight to Chinese internet equities in September 2021, given strong fundamentals, stablising regulatory headwinds and attractive valuations since the more than 50% decline since February 2021's peak[5]. We added to this position, given we should be closer to the bottom of the regulatory cycle and valuations remain attractive.

[3] CNBC, New York Times, MS Research, MSIM. Data as of 15 October 2021. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
[4] Bloomberg, year-to-date performance as of 30 November 2021
[5] As measured by the KraneShares CSI China Internet UCITS ETF. From 16 February 2021 to 30 September 2021 there was a drop of -55%. This is for illustrative purposes only and should not be deemed as a recommendation to buy or sell the ETF shown.

Tactical positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++	Asset Class	--	-	=	+	++
Equity						**Fixed Income**					
US			■			IG Credit		■			
US Value				■		US High Yield			■		
US Growth		■				European High Yield			■		
Eurozone			■			EM Sovereign Debt HC			■		
UK			■			EM Sovereign Debt LC			■		
Japan			■			US Treasuries		■			
Asia ex Japan			■			US Inflation			■		
China Internet				■		German Bunds		■			
Emerging Markets			■			EU Peripheral Bonds			■		
LatAm			■			JGBs			■		
Global Infrastructure			■			**Commodities**					
Global Property			■			Gold			■		
Global Financials				■		Industrial Metals			■		
Global Energy				■							

Source: MSIM GBaR team, as of 30 November 2021. For informational 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 tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation, or specific needs of any individual investor.

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INDEX DEFINITIONS

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KraneShares CSI China Internet ETF seeks to measure the performance of the investable universe of publicly traded China-based companies whose primary business or businesses are in the Internet and Internet-related sectors.

MSCI ACWI Energy Index includes large and mid cap securities across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries*. All securities in the index are classified in the Energy as per the Global Industry Classification Standard (GICS®).

MSCI Europe Index: The MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX©: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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