Morgan Stanley

INVESTMENT MANAGEMENT

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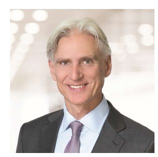
Finding Bright Spots Amongst Dark Clouds

CUSTOM SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 1 MAY 2022



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In a month where most global assets tumbled across both equities and fixed income, positioning in the bright spots of commodities and UK equities, all of which were up over the month, offered some cushion. As anticipated, markets took another leg lower. The S&P 500 had the worst performance of the major developed markets, down -8.7% (USD), with the MSCI Europe holding up better, down -0.5% (EUR) after a relief rally[1]. After a brief reprieve in March, the MSCI Japan continued its downward trajectory, -2.7% (JPY)[1]. The MSCI Emerging Markets Index also fared worse at -5.5%[1] (USD). The VIX reflected the volatility, spiking to 33 at month end[1]. Bonds underperformed equities, as the US 10-year Treasury yield continued to move higher to 2.9%[1] by April end.

Are investors underestimating Fed tightening?

At 8.5%[2], US headline inflation is at a 40-year high and continues to accelerate. Investors still appear to be underestimating the amount of tightening necessary to cool inflation. Given continued inflationary pressures from an ultra-tight US labour market, energy and food price increases, the terminal rate of the current hiking cycle should exceed consensus expectations and what markets are currently pricing.

[1] Bloomberg 30 April 2022.
[2] In March 2022, US CPI Headline Inflation was 8.5% YoY before seasonal adjustment, www.bls.gov/news.release/cpi.nr0.htm

The Fed Fund futures are indicating a terminal Fed Funds rate of 3.25%[3]. We believe the risks remain skewed to the upside and expect a terminal rate of at least 3.50% is required to keep inflation under control. This points to further downside pressure on US treasury bonds. Europe is less exposed to rate rises compared with the US, but inflation is still running unacceptably high, exacerbated by exposure to Russia-Ukraine.

Inflation: to settle at elevated levels

Whilst inflation should eventually stabilise, in the short-term China's lockdowns are impacting supply chains. We believe inflation is likely to settle at elevated levels, above the Fed's 2% target, as deflationary trends over the past decade, such as globalisation reverse and commodity supply shortages sustain upward pressure on prices. This has implications on equities, as higher real yields and inflation act as headwinds to equity valuations and earnings. Tighter margins, given pressures on wages and input costs, may not be passed to the consumer, as they too take a hit from increasing oil and food prices.

Investment Implications

Given the uncertain environment and potential for spikes in volatility, we have maintained our defensive, low equity positioning since last month. Portfolios managed by the GBaR team which permit options, benefitted from our enhanced tail risk hedging strategy, as they pulled the portfolios further out of equities as markets fell. Towards the end of the month, we reconciled the options and the target equity weight, increasing these portfolios' equity weights to ensure they are in line.

We made tactical changes, adding those which should benefit from the commodity theme, such as Brazil - a large commodity exporter. We are underweight Europe versus the US, due to the former's increased recession risk, given exposure to Russia-Ukraine conflict. We made adjustments to bond exposures, reducing duration, given further Fed tightening and potential downside for bonds.

Eurozone equities

We initially reduced eurozone equities in March and after the recent relief rally, moved from neutral to underweight in April. There appears to be limited upside for stocks and significant tail risks, including a potential consumption-led slowdown, rising inflation pressures and margin compression on equities.

Brazilian equities

We moved overweight Brazilian equities, which should benefit from persistently high commodity prices on a tight market and positive terms of trade. A peak in the Selic rate in 2H 2022 should also support earnings growth, while valuations and sentiment remain supportive, despite the rally year-to-date.

[3] Bloomberg, 28 April 2022.

Emerging market local debt

We moved overweight short duration commodity-exporting high yielders. A selection of Latin American, South African and Indonesian high yielders are likely to benefit from positive terms of trade given the rally in commodities. A rollover of inflation is also likely to offer positive real yield. We expressed this through adding to the emerging market local debt basket.

European high Yield

We moved from overweight to neutral European high yield, moving into cash for now. We believe the risk-reward has turned negative after the recent aggressive tightening in spreads towards the 10-year average level, leaving them slightly rich compared with European investment grade spreads.

US duration

Whilst we briefly increased duration last month, we reversed this in April, moving from neutral to underweight. Given current inflationary trends, we believe the market is still pricing an excessively low Fed funds terminal rate. Additionally, as the effects of Quantitative Tightening manifest in supply and demand balances, risks to long-term yields remain skewed to the downside.

US 10-year breakeven

We moved overweight to neutral, through removal of TIPS and positioned in short dated 1-3 year US treasuries or cash. As TIPS have an average maturity of 7-8 years, this reduction is in line with our move to underweight duration.

JPY/USD

We moved underweight Japanese Yen relative to the US dollar. Despite the weakening Yen, the Bank of Japan is likely to remain reluctant to change their policy to support their currency, as Japan's recovery remains subdued. Furthermore, importers are selling the Yen to pay for increasingly expensive imports and exports remain constrained by supply chain disruptions in key industries. If this continues, real money selling could remain an issue.

Industrial Metals

For portfolios which held industrial metals through an ETF, we have removed the position and place this into cash for now.

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.**

Tactical positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Energy				■	
US Value				■	
Eurozone		■			
UK				■	
European Energy				■	
Japan			■		
Asia ex Japan			■		
China Internet			■		
Emerging Markets			■		
Brazil				■	
Global Growth		■			
Global Infrastructure			■		
Global Property			■		

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit		■			
US High Yield			■		
European High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC				■	
US Treasuries		■			
US Inflation			■		
German Bunds			■		
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Broad Commodities				■	
Gold				■	
Industrial Metals		■			
Currencies					
EUR/USD		■			
JPY/USD		■			

Source: MSIM GBaR team, as of 30 April 2022. 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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There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in

commodity-linked notes involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio’s performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio.

INDEX DEFINITIONS

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Consumer Price Index: The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Fed Funds Rate: The interest rate that banks charge other institutions for lending excess cash to them from their reserve balances on an overnight basis.

FTSE 100: Financial Times Stock Exchange 100 Index represents the top 100 companies by market-cap listed on the London Stock Exchange.

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.

Selic rate: Brasil’s base interest rate defined by the Central Bank of Brasil.

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

U.S. Treasury Inflation-Protected Securities (TIPS) are the inflation-indexed bonds issued by the U.S. Treasury.

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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