Morgan Stanley
INVESTMENT MANAGEMENT

No Easy Fix

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CUSTOM SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 2 September 2022

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After a sustained rally over the summer, both the U.S and Europe sold off, with the S&P 500 (TR) (USD) down 4.1% and MSCI Europe (TR) (EUR) -4.9%[1]. Japanese equities appear to offer some defensiveness, as the MSCI Japan (TR) (JPY) returned 1.1%[1]. The MSCI Emerging Markets Index (USD) returns also proved more defensive, marginally up 0.5%[1]. Energy was once more the top performing sector over the month, as the MSCI ACWI Energy (USD) returned 2.4%[1]. However, after much of the year significantly above $100 a barrel, there was some relief as oil finally moved below this, with WTI ending the month $90.1bbl and Brent $96bbl[1]. As markets sold off, the VIX index began creeping back up, reaching 26 by month end[2].

The selloff can partly be attributed to the continuing conundrum faced by central banks, including the Federal Reserve (the Fed), European Central Bank (ECB) and the Bank of England (BoE). They must hike enough to control inflation, but with the risk of pushing their economies into a recession. At Jackson Hole, Federal Reserve Chairman, Jerome Powell re-iterated the Fed's hawkish resolve, stating that even if softening labour markets and slower growth were to bring some pain, "failure to restore price stability would mean far greater pain"[3].

Hard landing in the U.S.?

However, there are a number of factors which could help the U.S. avoid a hard landing in 2022. Capital expenditure (capex) is better supported compared with previous cycles, given healthy credit demand. Pent-up demand and the need for energy investment should also support capex. Capex may be front-loaded too, as the tax advantage of depreciating 100% in one year – part of Trump's Tax Cuts and Jobs Act 2017 - starts to decrease annually from 2023. Moreover, though U.S. consumers are seeing inflation erode their personal

Notes:
[1] Bloomberg, 1-month returns, as of 31 August 2022. TR is total return, bbl is barrel of oil.
[2] Bloomberg, 31 August 2022.
[3] Monetary Policy and Price Stability, Chair Jerome H. Powell, 26 August 2022. Board of Governors of the Federal Reserve System www.federalreserve.gov/newsevents/speech/powell20220826a.htm

income in real terms and savings rates have fallen to their lowest level since 2008 (i.e. from a pandemic high of 26% to 5.1%[4], they still have a higher stock of personal savings compared to pre-pandemic levels, which can cushion spending. Whilst consumers are leveraging up, again this is not as pronounced as previous cycles, since leverage levels have been in decline since 2008's Global Financial Crisis. The housing market, despite its current strength, is one of the main vectors which could help the Fed bring inflation under control, given mortgages' sensitivity to rate rises.

That said, if inflation does not come down the Fed may have to act more aggressively than market participants currently anticipate, to prevent it becoming entrenched. Combine this with the time it takes for hikes to take effect, if it then turns out that the policy is too aggressive, it may be too late for the Fed to reverse its actions and avoid a hard landing.

The long winter

We are in an energy crisis caused by supply shortages. Therefore, government measures to cushion the blow to consumers are likely to support demand, in turn leading to higher prices, in a self-defeating cycle. As high energy prices exacerbate inflation, the only way central banks can act is by supporting currencies and suppressing activity enough to avoid an entrenchment of inflationary expectations. In this context, Europe is lagging in its hiking cycle and has a higher exposure to Russian gas supply, so may be more vulnerable to recessionary risks. Whilst the region has for now been able to remain on track to achieve its storage fill targets through gas supplies from UK pipelines, as we move into winter, this could come under pressure as temperatures drop. Unless supply is restored, only demand destruction can resolve the demand-supply mismatch. Again, there is no easy solution to this conundrum.

Investment implications

We maintain a cautious equity exposure and reduced duration in light of the increasing pressure on Central Banks to prevent inflation expectations from de-anchoring. Against this backdrop, we made the following tactical changes to our views:

U.S. 10-Year Treasuries

We moved from neutral to underweight U.S. 10-Year Treasuries, moving to short-dated T-Bills to reduce duration.

U.S. High Yield

We increased our underweight to U.S. High Yield and added to our short-dated T-Bills. Recently, U.S. High Yield spreads have tightened significantly, with many market participants forecasting the Fed will soon reach the terminal rate and rate cuts should commence in 2023, with economic growth remaining positive. In contrast, we believe these scenarios are mutually exclusive and look for a higher terminal rate and no significant cuts to the Fed funds rate in 2023, unless there is a deep recession in the U.S.. U.S. High Yield remains expensive compared to U.S. Investment Grade, but this pricing should turn as Fed tightening impacts lower quality borrowers negatively.

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.**

Notes:

[4] US Real Personal Income is -3.4%, with Personal Saving Rate at 5.1% vs 8.7% long term median (based on YoY 3month moving average). U.S. Bureau of Economic Analysis (BEA), MSIM, 30 August 2022.

Tactical Positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Energy				■	
US High Dividend				■	
US Value			■		
Eurozone		■			
UK			■		
European Energy				■	
Japan			■		
Asia ex Japan			■		
Chinese Equities				■	
Emerging Markets			■		
Global Growth		■			
Global Infrastructure			■		
Global Property			■		

Asset Class	--	-	=	+	++
Fixed Income					
US IG Credit			■		
EU IG Credit				■	
US High Yield		■			
EU High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries		■	□		
German Bunds			■		
EU Peripheral Bonds		■			
JGBs		■			
Commodities					
Energy			■		
Gold				■	
Currencies					
Euro			■		
JPY				■	

■ Latest view □ Previous view

Source: MSIM GBaR team, as of 31 August 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. The signals represent the GBaR team's view on each asset class. A negative signal indicates a negative or underweight relative view, a positive signal indicates a positive or overweight relative view. Light blue indicates the tactical view before the change, with dark blue indicating the view as of 31 August 2022.

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Brent Crude, is oil originating from the North Sea and is one of the two largest benchmarks in oil pricing, the other being West Texas Intermediate (WTI).

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.

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

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 U.S. 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.

West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing. It is the underlying commodity of Chicago Mercantile Exchange's oil futures contracts.

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