Morgan Stanley

INVESTMENT MANAGEMENT

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Three Events and a Rally

CUSTOM SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 5 JANUARY 2022

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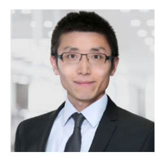

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December 2021 was dominated by three events: the spread of Omicron; the US Federal Reserve's announcement on the likely future path of tapering and rate hikes; and a setback to US President Biden's Build Back Better fiscal bill. The first half of December saw markets recover from November's COVID-induced sell-off. However, the exponential spread of this new variant across the globe prompted a further sell-off in mid-December, only to rally as we approached year end.

Despite a choppy December, all three major developed markets closed the month up, with the S&P 500 (USD) at 4.5%, the MSCI Europe Index (EUR) returning 5.5% and the MSCI Japan Index (JPY) 3.4%[1]. The US remained the clear outperformer for 2021, returning 28.7%[2]. The MSCI Emerging Markets Index (USD) suffered under the threat of Omicron, returning 1.9% on the month.[1] Having spiked in late November-early December – at 1 December, the VIX stood at 31[3] - volatility was relatively subdued for most of December, ending the year at a level of 17.[4]

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 31 December 2021.
2. Bloomberg, S&P 500 (USD) 1-year returns as of 31 December 2021.
3. Bloomberg, as of 1 December 2021
4. Bloomberg, as of 31 December 2021.

FOMC announcement removes some uncertainty

The Fed delivered what markets expected - doubling the speed of tapering from mid-January 2022 and projecting three rate hikes in 2022, with three more in 2023[5]. The Fed appears to have finally caught up with markets. With the announcement helping to remove some uncertainty around Fed actions, markets rallied on the day. Our base case for the rate hike path is now in line with Fed projections for 2022/2023, and slightly more optimistic than the market on the terminal rate reached for this cycle, as we expect two more hikes in the 2024/2025 period. This hiking path would imply (absent any term premium) a US 10-Year Treasury at 1.87[6] by end of 2022.

Build Back Better suffers a heavy blow

US President Biden's Build Back Better bill is a cornerstone of his COVID relief, social welfare and climate agenda. The rejection of the bill by Democratic Senator Manchin was therefore a heavy blow to Biden, as he requires the support of all 50 Senate Democrats to bring it into law. There is still hope that the fiscal bill will pass in one form or another – indeed, markets are still expecting some fiscal support – but it will likely be smaller than the proposed $1.75 trillion, in turn potentially lowering US GDP forecasts. However, there could also be some positives from this, as it lowers the likelihood of tax increases, while reduced fiscal stimulus could dampen rising inflation, which has been exacerbated by COVID supply-side dynamics. In November, US headline CPI rose an astounding 6.8% YoY[7], the highest in 39 years.

Investment Implications

In the days after the Fed announcement, markets welcomed clarity from the Fed. We did not make any changes to our equity positioning or tactical changes during the month. As we enter 2022, we are prudently positioned. We believe that equities should continue to outperform fixed income. Whilst we may not see the same surge in equities that we saw throughout 2021, we still expect to see moderately positive equity performance, as the healthy growth outlook should remain. However, high valuations and the potential for multiple compression for equities in the face of interest rate rises remain a concern. Whilst we have tilted towards value for much of 2021, as we look forward to 2022 we anticipate a favourable environment for quality growth stocks, which tend to outperform mid-cycle. We maintain an underweight to duration considering the outlook for rates.

5. 15 December 2021. Federal Open Market Committee (FOMC). www.federalreserve.gov/monetarypolicy/fomcpresconf20211215.htm
6. GBaR team estimates, as of 21 December 2021.
7. U.S. Bureau of Labor Statistics, Economic News Release, Consumer Price Index Summary – November 2021, released 10 December 2021. Year-on-year (YoY) figure is before seasonal adjustment.

Tactical positioning

We have provided our tactical views below:

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

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					
Gold			■		
Industrial Metals			■		

Source: MSIM GBaR team, as of 31 December 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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Consumer Price Index: Examines the weighted average of prices of a basket of consumer goods and services as an inflation measure Headline CPI includes all elements of the basket, but core CPI removes food and energy which tend to be volatile.

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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