Morgan Stanley

INVESTMENT MANAGEMENT

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US Inflation: Real or Noise?

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 1 June 2021

Despite a rocky month of mixed data from US employment and CPI figures, the S&P 500 finished the month almost flat at 0.7% (USD terms)[1]. The first half of the month brought a dip in markets, followed by a rebound in the second half. The US has been leading, but this month we saw the first tentative signs of the baton being passed to Europe as its reopening progresses, with the Euro Stoxx 50 up 2.5% (EUR terms). The shift has not yet reached Japan, which saw the Nikkei 225 flat at 0.2% over the month.

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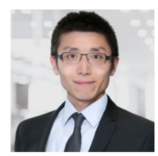

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The beginning of May brought a disappointing US jobs report, with little change to unemployment, which remained significantly above pre-pandemic levels[2]. However, the mid-May inflation surprise, contributed further to the US market selloff, as headline US CPI figures came in at 4.2%, the largest 12-month increase since September 2008.[3] In the wake of all this, after two months trending down, "The Fear Index", lived up to its name, as the VIX spiked to 28[4], but has since moved back to its previous sub-20 levels.

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, 31 May 2021.
[2] The US Unemployment rate is 6.1% versus 3.5% in February 2020, before the pandemic escalated. The Employment Situation – April 2021. Bureau of Labor Statistics. Released 7 May 2021. www.bls.gov/news.release/pdf/empsit.pdf
[3] Consumer Price Index – April 2021 headline CPI increased to 4.2% oya (over year ago before non-seasonally adjusted). Bureau of Labor Statistics. Released 12 May 2021. www.bls.gov/news.release/pdf/cpi.pdf
[4] Bloomberg, 12 May 2021.

US Inflation: Real or Noise?

The inflation we are seeing is partly due to base effects, given the comparatively low figure 12 months ago during the severe lockdowns, in contrast to the current figure which has been boosted by the reopening and pent-up demand. Also supporting inflation is the rapidly closing output gap. However, the economy is not yet at full capacity. Bottlenecks on the supply side are contributing as businesses struggle to reach full operational mode. Wage growth may be required to attract workers, which in turn could contribute to inflation. If high demand and low supply in these bottlenecks continue, inflation may be boosted above what base effects imply. The disappointing US jobs report probably reflects these inflationary bottleneck effects. It also may reflect that many jobs tied to re-opening have been filled already. A significant portion of the remaining unemployed may have lost their jobs due to structural economic changes (e.g. the closing of brick and mortar retail) and these are not coming back.

The spike in inflation appears to be interpreted by The Federal Reserve as transitory. The Fed is focused on the long term, not temporary spikes in inflation. The Fed endeavoured to calm markets, but nonetheless, at some point they will need to taper, as hinted in their minutes, and eventually raise rates. Our base case is that we are likely to see US inflation above 2% for the time being and interest rates may increase sooner than the Fed projects. That said, we do not see this as a run-away inflation scenario. However, it may be just enough, to trigger rate rises that do not just offset inflation, but also push up real yields. Moreover, strong non-inflationary growth also puts pressure on real yields. A significant rise in real yields could result in volatility for equities, which are vulnerable given their current high valuations.

Investment Implications

We reduced risk mid-May due to the equity market volatility, combined with our view that the strength of the recovery may have been priced in, against a backdrop of rising inflation and potentially interest rates. This is consistent with our view of a potential increase in volatility towards the end of the year, when risks such as potential US tax increases and the US Federal Reserve tapering of asset purchases begin to rise. We have made a number of tactical trades over the month, which we detail below:

US Investment Grade Credit

We moved from neutral to underweight US Investment Grade Credit. In view of benign economic fundamentals, we expect US Investment Grade spreads could remain tight in the near term. However, the elevated valuations mean there is limited potential for upside from capital appreciation and we do not see the low carry providing attractive risk reward.

US Value Equities

We increased our allocation to US Value Equities, adding to our position initiated in April. This is a continuation of our tilt to cyclicals and US Value Equities, which are benefitting from the reopening and strong economic recovery. Earnings revisions continue to support and Value is trading at a discount to Growth. Though there has been no change fundamentally since we moved overweight in mid-April, we have since seen confirmation of our view with Value outperforming the S&P 500 by 2.2%.[5]

Tactical positioning

We have provided our latest tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Value				■	
US Growth		■			
Eurozone			■		
Germany				■	
UK				■	
Japan			■		
Asia ex Japan			■		
Emerging Markets			■		
LatAm			■		
Global Infrastructure			■		
Global Property			■		
Global Financials				■	
Global Conventional 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 May 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.

RISK CONSIDERATIONS

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

[5] The Russell Value Futures outperformed the S&P 500 TR (USD) by 2.2% since initiation on 16 April to 31 May 2021, the iShares MSCI USA Enhanced Value ETF outperformed the S&P 500 TR (USD) 1.9% over the same period.

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.

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Consumer Price Index: Examines the weighted average of prices of a basket of consumer goods and services.

Euro STOXX 50 Index: Provides a blue-chip representation of supersector leaders in the Eurozone.

MSCI Emerging Markets IMI Index: This index captures large, mid and small cap representation across 21 emerging market countries.

NIKKEI 225 Index: This price-weighted index is comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

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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