INVESTMENT MANAGEMENT

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Market Outlook

Global

2015 into 2016: What are we watching?

AUTHOR

ANDREW HARMSTONE
Managing Director
Portfolio Manager
Global Balanced Risk Control (GBaR) Strategy

Morgan Stanley Investment Management

We believe the present moment reflects a significant change in the structure of the global economy, comparable to the scale of change we saw in 1973, when the OPEC oil embargo enabled oil producers to seize control over the pricing of their own natural resource. But this time, almost in reverse.

Historically there has been a significant amount of volatility as markets adjust to new the new reality, so for that reason, I think, at least at the beginning of the year, it makes sense to maintain a relatively cautious outlook, with respect to this potential volatility.

The most visible indications of the change in economic power and outlook occurred about a year ago when OPEC decided to not support the price of oil. The purpose of this was to put other oil producers out of business, in order to bring prices back up to previous levels and restore their economic control. The price of oil had been dropping from the summer and the expectation in the markets was that the Saudis, in particular, would cut back on their production by a couple of million barrels a day, in order to equilibrate the market and return the price to an upward trajectory.

Notwithstanding the damage to revenues this exerted on extraction processes that have a higher production price point per barrel, certain other variables are changing the dynamics of the oil markets in a significant way. For example, the differential technology that is used to extract shale oil makes production more resilient to interruption. Put simply, these wells can be switched off; a move which would degrade the product of more traditional extraction processes. In addition, countries which have hitherto been locked out of the oil markets because of sanctions (Iran) or affected by regional turmoil (Iraq) are coming back on stream, albeit steadily. So, there now appears to be a ceiling on the price of oil, somewhere around $60-plus a barrel – for the short term at least,

This leaves a situation where there's no easy method for OPEC producers and the non-OPEC producers to actually reach an agreement to cut back on the production, and at the meeting in December this year, it appeared there is no agreement forthcoming.

This seismic shift switches power back to the developed nations, as it means that the market is now setting the price of oil and not a cartel or a cartel-like organisation.

The precipitous drop in the oil price and the commensurate effect upon oil company revenues has, however, had a catastrophic effect upon energy and industrial investments. Indeed, according to the research firm Wood Mackenzie, as much as $1.5 trillion worth of investments are no longer viable at prices of less than $50 a barrel[1].

The knock on impact on global growth (GDP growth) is clear when explained in the context that global growth is, in its most basic form, composed of four components. The first one is consumption, the second is investment, the third is exports versus imports – or net exports – and finally government spending.

Given the withdrawal of investment in oil, consumer spending has been become an even more critical part of growth. This is particularly true in the United States.

Aside from the volatility element and the impact on the global economy, the reduction in the price of oil reflects a shift in economic power from the producers of oil to the consumers. As such you would expect to see a significant boost to countries which are major energy consumers (and without much production) such as Europe, Japan, and India.

The issue, though, is with timing. We have had the decline in oil, we've had the cutback in investments, but we haven't, as yet, had a commensurate increase on the spending side.

Another concern, arguably more headline grabbing, is the sharp decline in demand from China: extremely important given China's economy is about the same size as the United States. Historically the economy of China has been largely supported by investment spending and exports. Roughly 50 percent, of recent Chinese GDP growth was derived from investment spending[2].

This source of growth proved difficult to sustain, however, because the investment spending was financed by, and informed by, government policy that encouraged the banking sector to lend to certain sectors of the economy, in order to boost those sectors of the economy, regardless of the default risk.

Ultimately, the development of the debt created a drag, which the Chinese government clearly has been aware of as it made it a policy goal to shift to consumption. However, the stock market correction that occurred this summer really significantly weakened the likelihood of success of that strategy. Ultimately this is a meaningful fiscal hit to the consumer sector of the economy, because 80 percent of the investors in the market are the same individuals spending and consuming[3].

The manufacturing side of the Chinese economy – an old driver of exports – is also weakening substantially, in part owing to softness in demand from developed markets. And so the government, I think, is hoping that consumption will recover. I believe it's unlikely to do that. Government data on this has been opaque so I feel that the signals point to more surprises of weakness in demand from China and the market volatility associated with weak demand from that.

So I think we could see a similar period of economic weakness that we saw in 73-74, which was essentially demand-driven. It might not necessarily be a recession, in a global sense, but just very weak growth. This would have a commensurate impact on equity prices.

This kind of scenario is not readily amenable to monetary policy, because monetary policy controls interest rates, so if interest rates are the cause of a decline in the market, as in like '94 or '80, it can be reversed by loosening monetary policy very easily. If a financial crisis is the cause, then a combination of monetary policy, reforms and so on are needed, like in 2008.

But a purely demand-driven decline – you need some fiscal stimulus to turn it around. And aside from what we've talked about from oil there doesn't seem to be any fiscal stimulus out there. Indeed the U.S. economy, the U.S. government, is struggling with this issue of controlling the government deficit

In Europe, the same thing. Austerity is still driving most of the markets in Europe, or the countries in Europe, as they have a fiscal pact that actually has legal teeth to penalize countries for spending too much.

China could instruct major fiscal stimulus if they wanted to, however it would mark a return to policies which are not sustainable in the long term.

Emerging markets arguably have priced in a lot of the deflationary impact. They've gone down a lot and the currencies have gone down a lot. And so it may be that the opportunities for turnaround in the market are more on the emerging side then on the developed side. But it's probably premature to go into emerging market equities until we get some kind of resolution on whether the developed markets are going to stabilize or go down further.

So, for that reason we're seeing, this demand-weak recessionary impulse, or deflationary impulse, working its way through the system at the same time as the deflationary of oil is working its way through the system. Looking into next year we're likely to see, I think, a fair amount of volatility from all of these deflationary impulses until energy consumers decide to spend the savings from cheaper energy.

Further into the year I believe there's reason for optimism for fiscal stimulus. In terms of getting back into the market it might well be the case that emerging markets will be the place to go because of valuation considerations.

[1] CNN, 29th September 2015: http://money.cnn.com/2015/09/21/news/economy/oil-production-prices/
[2] The World Bank, December 2015
[3] Credit Suisse, July 2015

United States

ECONOMICS

In late November, the Bureau of Economic Analysis (BEA) said that, according to its second estimate, the U.S. economy grew at an annual rate of 2.1% in 3Q15. The BEA had assessed that the economy expanded at an annual rate of 3.9% in 2Q15. The BEA indicated that the deceleration in the latest quarter had been broadly based, with slower growth in exports and most elements of domestic demand. At the beginning of December, the Institute for Supply Management (ISM) noted that its purchasing manager's index (PMI) for the U.S. manufacturing sector was 48.6% in November, down from 50.1% in October. New orders and production contracted, as did inventories. Supplier deliveries slowed during the month. However, employment grew. The Census Bureau reported that, in seasonally adjusted terms, retail sales in October amounted to US$447.3bn. This was 0.1% higher than in September and 1.7% higher than in the same month of 2014. The Bureau of Labor Statistics (BLS) had said that total non-farm payroll employment rose by 271,000 in October and that the unemployment rate remained essentially unchanged at 5.0%. 'Job gains occurred in professional and business services, health care, retail trade, food services and drinking places, and construction.' The BLS noted separately that, in terms of the consumer price index (CPI), inflation over the 12 months to October had been 0.2% (not seasonally adjusted). Excluding food and energy prices, the corresponding figure was plus 1.9%.

At its meeting in late October, the Federal Open Market Committee decided to maintain the federal funds rate at 0.00-0.25%, although Richmond Federal Reserve President Jeffrey Lacker once again voted for a 25 basis point increase. Market participants judged the tone of the Fed's comments as being hawkish – and indicative of a rate rise at the meeting in December.

EQUITIES

The major U.S. equity indices basically tracked sideways during November. The MSCI U.S. Index, for instance, rose by 0.11%. Investors assessed that the environment for corporate profits remained positive, in spite of the signs of a slowing of activity in the manufacturing sector.

BONDS

U.S. Treasuries were sold off in November. Yields on two- and five- year Treasuries rose by 21 and 13 basis points, while yields on longer-dated Treasuries increased by about 5 basis points.

In credit markets, spreads on sub-investment grade corporate bonds in the U.S. widened sharply, as the issuers were seen as being vulnerable to higher interest rates. However, spreads on investment grade credit generally tightened slightly.

Europe

ECONOMICS

A number of pointers suggest that overall conditions in the euro area continue to improve, if gradually, in a number of countries. Markit's PMI for the euro area's manufacturing sector rose marginally from 52.3 in October to 52.8 in October. Markit highlighted that the expansion of production and new orders was the fastest for around 18 months. There was an expansion in output and new business in all countries other than Greece. Markit's PMI for the services sector advanced from 54.1 to 54.6: service sector new business grew at the fastest pace in four-and-a-half years. Eurostat reported that, according to its flash estimate, GDP in the euro area rose by 0.3% thorough 3Q15. Growth across the European Union (EU) as a whole was 0.4%. Relative to 3Q14, growth was estimated at 1.6% and 1.9% respectively. Eurostat noted separately that industrial production was 0.3% lower in the euro area in the month of September and also 0.3% lower year-on-year. Across the EU as a whole, the corresponding figures were lower by 0.1% for both periods. According to Eurostat's flash estimate, which was published at the beginning of December, annual inflation in the euro area during November was stable at 0.1%.

At its policy meeting in early December, the European Cemtral Bank (ECB) kept the refi rate unchanged at 0.05%. However, a number of other changes were announced. The deposit rate was reduced by 10 basis points to -0.30%. The period over which the ECB's asset purchase program will run – at the current rate of €60bn per month – was extended until the end of March 2017 (or beyond, if needed). Principal payments on the securities purchased under the program will be reinvested. The scope of the program has been broadened, so that it now includes euro-denominated securities that are issued by regional and local governments in the euro area. The ECB's main refinancing and longer-term refinancing operations will be continued for as long as necessary, or at least until late 2017.

Overall, economic and business conditions remain positive in the UK. At the beginning of December, Markit and CIPS said that their PMI for the manufacturing sector slipped from 55.2 in October to 52.7 in November. Output and orders expanded more slowly. Conversely, the PMI for the UK's services sector increased from 54.9 to 55.9. The Office for National Statistics (ONS) reported that its Index of Production rose by 1.1% over the year to September 2015. In the September quarter, the largest contribution to growth had come from mining and quarrying. In late November, the ONS noted that, according to its second estimate, the UK's economy grew by 0.5% in 3Q15, or by 0.2 percentage point less than in 2Q15. The ONS considers that GDP was 2.3% higher in 3Q15 than it had been in 3Q14. In mid-November, the ONS' labour market survey found that the unemployment rate was 5.3% in the three months to the end of September: this was the lowest level since the three months to May 2008. The ONS observed separately that year-on-year CPI inflation was -0.1% in the year to October 2015 – or the same as it had been in the year to September.

The Monetary Policy Committee of the Bank of England (BoE) kept Bank Rate and the size of the asset purchase program unchanged, at 0.50% and £375bn respectively, at its meetings in early November. However, once again, Committee member Ian McCafferty voted for a 25 basis point rise in Bank Rate. The Committee highlighted the downside risks to inflation and growth. All members of the Committee continued to agree that Bank Rate would likely stay below average historical levels for some time into the future.

EQUITIES

The MSCI Europe Index fell by 1.99% in U.S. dollar terms during November. The MSCI Europe ex UK Index slipped by 1.68%, while the MSCI UK Index retreated by 2.68%. During the month, the U.S. dollar rose by 4.01% and 2.41%, respectively, relative to the euro and sterling.

BONDS

As had been the case in October, the main feature of the month was the fall in yields on government bonds in the euro area, given investors' (incorrect) anticipation that the ECB would increase the size of its asset purchasing program.

Yields on two-year government bonds in the euro area generally fell by 5-10 basis points, as did yields on 10 year bonds. Yields on five-year bonds generally slipped by 9-16 basis points. Falls were larger for bonds issued by some governments in the periphery of the euro area. Yields on two-, five- and 10- year Portuguese government bonds slipped by 19, 28 and 22 basis points respectively.

Yields on two-year UK Gilts were hardly unaltered during the month. However, yields on five-, 10- and 30- year Gilts slipped by 6, 10 and 9 basis points respectively.

In credit markets, spreads on sub-investment grade corporate bonds in the euro area narrowed, as investors anticipated the ECB's further easing of monetary policy. Spreads on most categories of investment grade credit narrowed slightly.

Japan

ECONOMICS

At the beginning of December, Nikkei noted that its PMI for the Japanese manufacturing sector had risen from 52.4 in October to 52.6 in November, indicating an acceleration in activity. The latest survey found that new orders rose at a marked rate, while employment and buying activity also grew 'solidly'. The Statistics Bureau reported that average monthly consumption spending per household amounted to ¥282,401 in October – down 2.1% in nominal terms and down 2.4% in real terms relative to the same month of 2014. The Statistics Bureau noted separately that CPI inflation in Japan was 0.3% over the year to October, given that the CPI had fallen by 0.1% in that month. The Ministry of Economy Trade and Industry (METI) said that industrial production rose by 1.4% in seasonally adjusted terms in October and was down 1.4% over the previous year. According to the preliminary estimate of the Cabinet Office, real GDP fell by 0.2% in 3Q15, or at an annual rate of 0.8%.

The Bank of Japan kept its policy settings unchanged at the meeting in mid-November. The Bank of Japan will buy Japanese Government Bonds (JGBs) so that the amount outstanding rises by around ¥80tn annually. The average remaining maturity of the bonds bought will be seven-to-10 years. The Bank of Japan will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that the amounts outstanding rise at annual paces of around ¥3tn and ¥90bn respectively. Holdings of commercial paper and corporate bonds will be maintained at about ¥2.2tn and ¥3.2tn respectively.

EQUITIES

The MSCI Japan Index fell by 1.03% in U.S. dollar terms during the month. Over the course of November, the yen dropped by 2.06% against the U.S. dollar.

BONDS

As usual, yields on Japanese Government Bonds (JGBs) were little changed over the course of the month.

Asia-Pacific, ex-Japan

ECONOMICS

Bank Indonesia (that country's central bank) eased monetary policy slightly in November, by reducing the primary reserve requirement in local currency from 8.0% to 7.50%. PMIs pointed to a slowing or a contraction in manufacturing activity in most countries in the region. In India, for instance, Nikkei's manufacturing PMI slipped from 50.7 in October to a 25 month low of 50.3 in November. Activity in the services sector has also stagnated. In China, Caixin's PMI for the manufacturing sector rose from 48.3 in October to 48.6 in November, a level that is still consistent with a contraction in activity. Caixin's PMI for the Chinese services sector pointed to slow growth.

EQUITIES

In November, the emerging markets of the Asia-Pacific retreated slightly, having made good gains in October. The MSCI EM Asia Index fell by 3.31% in U.S. dollar terms. Most of the MSCI Indices for individual countries fell by a similar amount.

Rising by 1.27%, the MSCI Malaysia Index was a regional outperformer. Most regional currencies slipped slightly against the U.S. dollar over the month.

Latin America

ECONOMICS

At the end of November, Colombia's Banco de la República (BanRep, the central bank) increased its key policy rate by another 25 basis points to 5.50%: this move followed a 50 basis point hike in October. BanRep is concerned about inflationary pressures and noted that domestic demand has been stronger than anticipated. In Brazil, the central bank kept the key rate (Selic) unaltered at 14.25%: however a minority of the policy board (Copom) voted for a 50 basis point rise. Meanwhile, Markit's PMI for Brazil's manufacturing sector slipped from 44.1 in October to an 80-month low of 43.8 in November. The latest survey identified the fastest rate of job losses in manufacturing since the global financial crisis. Activity in Brazil's services sector has also been contracting. Markit's PMI for the manufacturing sector of Mexico remained unchanged at 53.0 in November, pointing to a 'solid' overall improvement in business conditions.

EQUITIES

Slippage in commodity prices caused investors to sell down their investments in Latin America. Over the month, the MSCI EM Latin America Index fell by 3.96% in U.S dollar terms. In part because of the slippage in the currency, the MSCI Colombia Index retreated by 16.40%. Falls in commodity prices also contributed to the underperformance of the MSCI Chile Index and the MSCI Peru Index, which retreated by 7.68% and 8.67% respectively.

Eastern Europe, Middle East & Africa

ECONOMICS

PMIs for the manufacturing sectors of countries in Central and Eastern Europe generally pointed to modest growth in activity in November. At its meeting in the middle of the month, the South African Reserve Bank sought to counter rising inflationary pressures by increasing its key policy rate by 25 basis points to 6.25%. Conversely, the Central Bank of Nigeria reduced its key rate by 200 basis points to 11.00%, and lowered the Cash Reserve Requirement ratio from 25% to 20% in response to the weakening of economic activity.

EQUITIES

The MSCI EM Europe & Middle East Index fell by 2.31% in U.S. dollar terms during November. Rising by 0.57%, the MSCI Russia Index was the regional outperformer. In a month in which the price of oil dropped sharply, the MSCI Qatar and MSCI United Arab Emirates (UAE) Indices fell by 13.89% and 9.55% respectively. The MSCI Egypt Index retreated by 15.36%. The weakness of the economy (and slippage during the month in the rand) contributed to the 7.00% fall in the MSCI South Africa Index.

About the Author

ANDREW HARMSTONE

Managing Director

Andrew is Lead Portfolio Manager for the Global Balanced Risk Control Strategy (GBaR) and a member of the Global Multi Asset Group led by Cyril Moullé-Berteaux. He joined Morgan Stanley in 2008 and has 34 years of relevant industry experience. Prior to joining the firm, Andrew worked at Bear Stearns as head of European Equity Quantitative Research. Previously, he headed European Equity Derivatives and Quantitative Research at Lehman Brothers. While at Lehman, Andrew was voted first place in Derivatives Research in Europe in the 2004 Institutional Investor survey. Andrew has also worked as head of Product Development at Credit Suisse and has held various positions including the European head of Structured Derivatives and U.S. Head of the Futures and Options Group at J.P. Morgan Investment Management. He was also a consultant to the Presidential Task Force on Market Mechanisms investigating the 1987 Market Break. Andrew received an M.A. in business economics from the University of Pennsylvania, U.S. and a B.A. (Honors) in economics from the University of Wisconsin.

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[1] **SOURCE:** Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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Past performance is no guarantee of future results.

Charts and graphs provided herein are for illustrative purposes only.

INDEX DEFINITIONS

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **MSCI U.S. Index** is designed to measure the performance of the large and mid cap segments of the U.S. market.

The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI Europe ex UK Index** captures large and mid cap representation across 14 developed markets countries in Europe.

The **MSCI United Kingdom Index** is designed to measure the performance of the large and mid cap segments of the UK market.

The **MSCI Japan Index** is a free-floated adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%.

The **MSCI Emerging Markets Asia Index** captures large and mid cap representation across 8 Emerging Markets countries. With 535 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI Malaysia Index** is designed to measure the performance of the large and mid cap segments of the Malaysian market. With 42 constituents, the index covers about 85% of the Malaysian equity universe.

The **MSCI Emerging Markets Latin America Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets within Latin America. The MSCI Emerging Markets Latin America Index consists of the following 5 emerging market country indices: Brazil, Chile, Colombia, Mexico and Peru.

The **MSCI Colombia Index** is designed to measure the performance of the large and mid cap segments of the Colombian market.

The **MSCI Chile Index** is designed to measure the performance of the large and mid cap segments of the Chilean market. With 20 constituents, the index covers approximately 85% of the Chile equity universe.

The **MSCI Emerging Markets Europe and Middle East Index** captures large and mid cap representation across 8 Emerging Markets (EM) countries in Europe and Middle East*. With 106 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the Emerging Markets equity universe in Europe and the Middle East.

The **MSCI Russia Index** is designed to measure the performance of the large and mid cap segments of the Russian market.

The **MSCI Qatar Index** is designed to measure the performance of the large and mid cap segments of the Qatari market.

The **MSCI United Arab Emirates (UAE) Index** is designed to measure the performance of the large and mid cap segments of the UAE market.

The **MSCI Egypt Index** is designed to measure the performance of the large and mid cap segments of the Egyptian market.

The **MSCI South Africa Index** is designed to measure the performance of the large and mid cap segments of the South African market.

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