Jim Caron on Bloomberg:

Fed Is on a Predictable Course to 3%

March 16, 2017

Jim Caron, Managing Director
Global Fixed Income Team

The U.S. Federal Reserve (Fed) March Announcement: no surprises.

The Fed is on a predictable and charted course for three rate hikes per year (dot plots) until they reach their destination of 3%. But the announcement did have some important nuances to note.

1. The Fed increased their confidence that they would hit their 2% inflation target.

2. However, they were careful not to signal an accelerated pace of hikes by noting that core inflation (PCE) was below the 2% target, despite headline inflation being above 2% (what they referred to as having a "symmetric" view on their inflation target).

R*: By holding the 3% long-term policy rate stable along with a 2% inflation target, the Fed implies that the neutral equilibrium real Federal Funds Rate (R*) is 1%.

The implication of that is the recent Fed hike should be viewed as a removal of excess accommodation, not a "tightening." This is because the "real" Federal Funds Rate today (nominal less inflation) is ~ -75 bps to ~ -100 bps, which is still accommodative.

Investment implications

1. This rise in rates is still supportive of growth and risky assets.

2. The pace of Fed hikes should be orderly and predictable. We believe this means fixed income assets can still produce positive excess returns despite rising rates.

3. Our preference is to construct portfolios with more credit exposure than interest rate exposure. Default rates should fall as the economy improves, which will likely support credit. We will overweight assets to construct a portfolio that exhibits what we believe to be winning characteristics for the current environment. They are: i) assets with improving fundamentals, ii) attractive yields, iii) idiosyncratic factors the support their price, and iv) assets with more credit rather than interest rate sensitivity.

4. We believe active management may be the best approach to investing in fixed income, as passive management may become more risky as rates rise.

5. Assets we believe will perform best in a rising rate environment albeit, with greater risk, are: non-agency residential mortgage-backed securities (RMBS) (more credit than rate sensitive), emerging markets (our top pick is Mexico, a non-consensus view) and high yield, with a focus on middle-market issuers whose performance is driven mainly by idiosyncratic factors rather than a rate cycle.

Important Disclosures

This material is for use of Professional Clients only, except in the U.S. where the material may be redistributed or used with the general public.

The views, opinions, forecasts and estimates expressed are those of the portfolio manager as of date presented and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product. All information provided is for informational and educational purposes only and should not be deemed as a recommendation. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor. In addition, this material is not an offer, or a solicitation of an offer, to buy or sell any security or instrument or to participate in any trading strategy.

RISK CONSIDERATIONS: There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the fund will decline and that the value of fund shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. Investing involves risks including the possible loss of principal.

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 the current rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. Longer-term securities may be more sensitive to interest rate changes. In a declining interest-rate environment, the portfolio may generate less income. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain **U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High yield securities ("junk bonds")** are lower rated securities that may have a higher degree of credit and liquidity risk. **Public bank loans** are subject to liquidity risk and the credit risks of lower rated securities. **Foreign securities are** subject to currency, political, economic and market risks. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed countries. **Sovereign debt securities** are subject to default risk. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid** securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Due to the possibility that prepayments will alter the cash flows on **Collateralized mortgage obligations** (CMOs), it is not possible to determine in advance their final maturity date or average life. In addition, if the collateral securing the CMOs or any third party guarantees are insufficient to make payments, the portfolio could sustain a loss.

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is only intended for and will be only distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

EMEA:
This communication was issued and approved in the United Kingdom by Morgan Stanley Investment Management Limited, 25 Cabot Square, Canary Wharf, London E14 4QA, authorized and regulated by the Financial Conduct Authority, for distribution to Professional Clients only and must not be relied upon or acted upon by Retail Clients (each as defined in the UK Financial Conduct Authority's rules).

Financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If such a person considers an investment she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

U.S.:
A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2**.**

Please consider the investment objective, risks, charges and expenses of the fund carefully before investing. The prospectus contains this and other information about the fund. To obtain a prospectus, download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Hong Kong:
This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to “professional investors” as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong.

Singapore:
This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore (“SFA”), (ii) to a “relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them.

Australia:
This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for “wholesale clients” within the meaning of the Australian Corporations Act.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

© 2016 Morgan Stanley. All rights reserved CRC 1736718 Exp.: 03/16/2018