With the world economy emerging from a growth scare in the fourth quarter of 2018, we were confident that the U.S. and global economies were steadily recovering and not headed towards a recession. Our expectation was that the recovery may take a few more quarters to take hold, based on a combination of cyclical and structural trends.

That all changed on 10 May, when an increase in tariffs on Chinese imports announced by President Trump took effect, reviving the game of tariffs between China and the U.S. that has been a drag on the global economy. This did not come as a surprise to us, as the US-China trade tension is one of the key binary risks we highlighted in our previous outlook.

Despite the tensions, we believe the medium-term growth story remains intact, but given recent heightening of trade tensions this may be delayed. In fact, these trade tensions may increase the likelihood of further fiscal stimulus in China and the U.S., although this may be accompanied by volatility. Treading carefully around potential near-term volatility, investors should be keeping an eye on the midgame. We are navigating this near-term disruption by reducing risk in our portfolios on a short-term basis, with the aim of eventually moving back into equities.

“China-U.S. trade tensions have hindered world trade, resulting in the most significant decline in volumes since the 2008 crisis.”
Despite tensions, global trade might have found a floor

The China-U.S. trade tensions have hindered world trade, resulting in the most significant decline in volumes since the 2008 crisis (Display 1) and impacting export reliant economies. World trade flows pulled back in February 2019, following a January improvement, in a move that was telegraphed by Q1 softness in new export order PMI (Purchasing Managers’ Index) data.

Prior to recent tensions, new export data had indicated a significant rebound in Chinese orders and a potential bottom for orders in Europe (Display 2). The trade battles of early May have the potential to again destabilise this in the short run, but we still expect trade flows to improve in the medium term.

China is important to the recovery

A central piece to the turnaround has been the stimulus in China. While the current stimulus is only about 1.5% of GDP on the fiscal side—a steep drop from nearly 10% in 2008—it is far more targeted.¹

The last three Chinese stimulus cycles drove money into the property markets, which is a quick way to boost consumption. Cities like Beijing, Shanghai and Shenzhen experienced property price increases as high as 30-40% per annum.² This created a bubble as people sought to direct more funds into the “easy money” property markets.

Today’s stimulus has been devised to prevent the bubble from bursting: It includes policies aimed at maintaining the relative tightening on the property side, while directing the fiscal stimulus to the private sector and the consumer. Given the nature of the new stimulus, we expect it to operate more slowly than in the past, but ultimately be more sustainable.

² Bloomberg, China 1st Tier Cities Newly Built Commercial Residential Bldgs Price YoY Avg.

---

DISPLAY 1
Trade flows damaged by tariffs


DISPLAY 2
China’s new export orders rebound and the eurozone may have found a floor

The Chinese consumer is far more indebted today than in the past. Over the last 10 years, debt levels have nearly doubled (Display 3). Although still manageable compared to other countries’ debts, the speed with which this level has risen is a concern. Also concerning is the younger generation’s struggle to save: The cost of living is rising, and mortgage rates are running at about 5% to 6%, compared to 2% in the UK. It will not be easy for consumers to go on a “spending spree.”

While aware of the longer-term risks of growing household debt, Chinese policymakers do not want their economy to slow any further. With tariff tensions rising again, they have already made some tentative moves to further increase the stimulus—but they seem to be keeping further increases in property prices as a last resort.

The value of U.S. public infrastructure . . .

Both the President and Congressional Democrats have supported fiscal stimulus through infrastructure programmes—with a $2 trillion target discussed last November. Nevertheless, during a recent meeting with the Democratic leadership, Trump made his support for infrastructure contingent on Congressional investigations into his administration and business stopping. While this is a setback it appears that backchannels for progress on legislative initiatives still remain open (for example, the disaster aid bill just passed by the Senate and is still supported by Trump). We still believe that an infrastructure spending programme remains highly popular with the public and would be likely to prevent a recession in 2020. These politically powerful drivers suggest that this initiative may be reconsidered soon. Senate Republican support would be contingent on how this initiative was funded and a gasoline tax, which has not been increased since the Clinton administration remains a good possibility even though in the end a major infrastructure bill is likely to be front-loaded and paid for initially with debt.

. . . and the case for an uptick in private investment

Business fixed investment is typically the most cyclical element in GDP, with a disproportionate impact on the business cycle. Display 4 tracks how core CapEx growth recovered from the lows of 2015 and 2016, peaked in December 2017 and then stabilised somewhat before plunging in 2018. This sharp drop was likely in large part due to the trade war. Uncertainties about global supply chains forced businesses to postpone needed investment. The slight March 2019 rebound represents the biggest improvement in corporate investment in eight months. The recent revival in tensions certainly has the potential to postpone CapEx again, but there are several trends constructive for business fixed investment to grow in the medium term. Most

---

**DISPLAY 3**

**Owing more: Chinese consumer debt is rising**

![Chart showing household debt as a percentage of urban disposable income from 2004 to 2018]


**DISPLAY 4**

**U.S. business equipment orders are stable-to-improving**

![Chart showing U.S. capital goods new orders nondefense excluding aircraft from 2005 to 2019]

Source: U.S. Census Bureau, Bloomberg. Data as at 10 May 2019.
importantly, there is a significant pent-up demand—with existing capital equipment very obsolete and technological change moving at a rapid pace, businesses desperately need to upgrade their capital stock.

Meanwhile, climate change-related disruptions will tend to accelerate the rate of capital investment as the economy transitions towards things like electric vehicles and solar energy. And any fiscal stimulus programme based on infrastructure spending would also boost capital expenditures (CapEx).

**Stimulus prospects in Europe**

As populist movements continue to gather support—as demonstrated in the recent EU Parliamentary elections—the pressure on European governments to increase spending grows. A stimulus agenda appears to be gaining with it. The Eurozone’s four largest economies now appearing likely to implement expansionary fiscal measures in 2019. This expectation is supported by the latest data from the European Commission, which anticipate some degree of stimulus from Germany, France, Italy and Spain (Display 5).

**The outlook for automobiles**

The traditional bounce in auto production may not be as pronounced as during previous cycles. In fact, the disruptive transition from internal combustion engine to electrical vehicles may weaken the effect of industry growth in the short term. Many auto manufacturers are planning to shift to electric vehicles, a change that could be quite constructive for longer-term capital investment. Employment, though, could suffer because the production of electric vehicles requires far less labour. Automakers may close down facilities before they open new ones, so to the extent this occurs, it could take time to see the potential boost to net investment.

**We expect a recovery, but not in the traditional V-shape**

While stimulus from China helped create a V-shaped recovery in 2015-2016, their current stimulus is both smaller and designed to benefit just China, with less constructive spillover to the rest of the world.

Global inventories are also generally too high, likely due to stockpiling in anticipation of Brexit disruptions and the trade war (Display 6). This excessive inventory cycle will have to be worked off. For example, the semiconductor downturn has not bottomed, with high chip inventory levels still weakening spending.

**DISPLAY 5**

For Eurozone’s four largest economies, stimulus looks likely

*Change in cyclically-adjusted primary balance (+ is fiscal boost)*

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>-0.8</td>
<td>0.8</td>
</tr>
<tr>
<td>France</td>
<td>-0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Italy</td>
<td>-0.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Spain</td>
<td>-0.4</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: European Commission, MSIM. Data from European Economic Forecast (Spring 2019) released on 7 May 2019. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

**DISPLAY 6**

UK manufacturing inventories show evidence of stockpiling

Nevertheless, what is usually missing from a sustainable recovery is growth in CapEx. Today, we see strong potential for CapEx growth, though it may be postponed by trade tensions. Moreover, we see several self-reinforcing countercyclical elements that may help even in the face of the trade war. The more intense the tariff tensions become, the more likely it becomes that the Chinese will increase their stimulus and the U.S. will pass a significant infrastructure plan. And companies are more prepared now for shifted supply chains than they were when the trade war was initiated.

**Ignore (mostly) the trade noise**

The medium-term outlook is positive. While trade issues do suggest near-term caution, fiscal stimulus in China, potential U.S. infrastructure spending and the pent-up demand for capital expenditure are all powerful positives that are ready to help the markets as soon as the trade dispute is resolved.

A resolution would also help with European fixed investment, which is closely tied to trade. Eurozone equity valuations look attractive based on the average yield premium versus bonds (Display 7). Also, the European Central Bank (ECB) is turning much friendlier towards the banking system than it was in the past. We also expect more consolidation in European banks. One area where we are cautious is the U.S. technology sector, where valuations again appear to be overshooting earnings.

On bonds, our longer-term outlook is positive for the economy, so negative for bonds. But tariff tensions can make bonds, on a temporary basis, look more attractive.

**The growth story remains intact**

As highlighted in one of our recent commentaries, the revival of U.S.-China trade tensions is one of the binary risks that could complicate our generally positive view on a global recovery. And while these unpredictable lightning strikes emanating from the White House have a disruptive near-term impact, we nonetheless remain positive on the medium-term growth story—the midgame.
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. 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 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. In general, equities securities’ values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. Stocks of small-capitalisation 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. The use of leverage may increase volatility in the Portfolio. Diversification does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.
DEFINITIONS
The CPB Merchandise World Trade Volume Index measures the volume of trade across borders between the world’s major regions. The CIPS/Markit UK Manufacturing Purchasing Managers’ Index (PMI) is a composite index based on individual indexes with the following weights: New Orders - 0.3, Output - 0.25, Employment. The CPB World Trade Monitor shows that the volume of world trade decreased 1.7% in February, having increased 2.1% in January (initial estimate 2.3%). The MSCI EMU (European Economic and Monetary Union) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of countries within EMU. The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

Business fixed investment means investment in the machines, tools and equipment that businesses buy for use in further production of goods and services. The stock of these machines or plant equipment, etc. represents fixed capital. Capital expenditure or capital expense (CapEx) is the money a company spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land.

DISCLOSURES
The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic 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. Except as otherwise indicated, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof. Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness. The information herein is a general communications which is not impartial and has been prepared solely for information and educational 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 material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent, legal and financial advice, including advice as to tax consequences, before making any investment decision.

Past performance is no guarantee of future results. Charts and graphs provided herein are for illustrative purposes only.

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 commentary is only intended for, and will be only distributed to, persons resident in jurisdictions where 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 product’s relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

DISTRIBUTION
This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability is available in accordance with local laws or regulations.


Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please 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 BANK 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. This material has not been reviewed by the Monetary Authority of Singapore. Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 316182, which accepts 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.

Taiwan: This material is provided for informational purposes only and does not constitute a solicitation where such a solicitation is unlawful. The products mentioned herein this material may or may not have been registered with the Securities and Futures Bureau of the Financial Supervisory Commission in Taiwan, Republic of China ("ROC") pursuant to relevant securities laws and regulations. Such products may only be made available in the ROC if they are (a) registered for public sale in the ROC or (b) availed on a private placement basis to specified financial institutions and other entities and individuals meeting specific criteria pursuant to the private placement provisions of the ROC Rules Governing Offshore Funds.

Korea: This material is not, and under no circumstances is to be construed as an offering of securities in Korea. No representation is being made with respect to the eligibility of any recipients of this material under the laws of Korea, including but without limitation, the Foreign Exchange Transaction Law and Regulations thereunder. The Fund’s mentioned herein this material may or may not have been registered with the Financial Services Commission of Korea under the Financial Investment Services and Capital Markets Act and may not be offered directly or indirectly, in Korea or to any resident of Korea except pursuant to applicable laws and regulations of Korea.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd ("MSIM")’s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIM to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIM accepts such commission. The client shall delegate to MSIM the authorities necessary for making investment. MSIM exercises the delegated authorities based on investment decisions of MSIM, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.16% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIM cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIM; Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson’s Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Authorised and regulated by Central Bank of Ireland ("MSIM Ireland").

The information contained in this communication is not a research recommendation or ‘investment research’ and is classified as a ‘Marketing Communication’ in accordance with the applicable European regulation or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research. MSIM Ireland has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. MSIM Ireland shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If you are a distributor of the Morgan Stanley Investment Funds, some or all of the funds or shares in individual funds may be available for distribution. Please refer to your sub-distribution agreement for these details before forwarding fund information to your clients. The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM Ireland’s express written consent.

All information contained herein is proprietary and is protected under copyright law. Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.