We see a confluence of extremes right now in the market:

1. **US Momentum stocks** (the year-to-date winners) are very expensive relative to the market.
2. The **US Internet sector’s outperformance to the Chinese Internet stocks** is gigantic.
3. **US Value stocks** are at unusually depressed levels of cheapness.
4. **US Consumer Staples** stocks are very cheap.
5. **US outperformance versus the rest of the world** is at a high elevation.
6. **European banks** are extremely cheap relative to the rest of the **European Index**.

Normally, I am not much of a believer in **pure contrarian strategies** for two primary reasons:

1. The market can stay irrational in its pricing a long time, and therefore buying simply because something is out of favor or selling because it is popular does not tend to be a recipe for success.

2. On the surface, who does not believe in “buying low” or “buying when there is blood in the streets”? In theory. That is classic Buffett. **But that’s also not what most do.** Flows tend to chase performance, and therefore funds tend to get MORE inflows when their stocks are at highs than when their stocks are at lows. So most investors do just the opposite of what they espouse. Foolish investing? Perhaps. But I have learned to respect the market and not fight the trends, but rather embrace the reality that human behavior is a key component to investing.
In other words, so much for contrarian strategies. This is why the primary input to our quantitative models is factor performance. If growth is working, we want to be overweight growth. If value is working, we want to be overweight value. We look at styles in terms of factors and overweight those that have momentum.

But the history of all momentum strategies is when they finally hit the wall and reverse, the drawdowns can be dramatic. Likewise when a particular strategy has no momentum, it can become so oversold and so unloved that it is ripe for reversal and the gains can potentially be significant.

1. US MOMENTUM

As a result, we try to build guardrails around our factor momentum strategies to alert us to potential reversals. How do we know when the likelihood of potential reversals occurring is elevated? We look at the valuation levels when they have occurred in the past. Obviously, there is no guarantee that the past will repeat itself, and therefore nothing is definitive, but it’s a start.

As evidenced by the conclusions above, the guardrails are flashing warning signs of downside reversal risk for certain groups of stocks and upside opportunities for others.

Here are some details and what we are doing about it.

1. US MOMENTUM

DISPLAY 1

Momentum Spread
August 1995 – August 2018

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 definitions.

Source: Factset. Momentum spread as defined by standardized price-to-book valuation differential between top decile momentum within Russell 1000 versus the market median in terms of standard deviation. Momentum is measured based on a combination of 1 year, 6 month, and 3 month performances.

As shown in the above chart, top momentum stocks are now trading over one standard deviation expensive to the index. They certainly reached more expensive levels in 1999-2000 but generally speaking, this level is a warning sign that the winners are far outpacing the losers and reversion to the mean is a distinct possibility.

From a sector standpoint, roughly half the momentum bucket is currently in technology and consumer discretionary.

What are we doing about it? Controlling our exposure to US technology, trimming as the positions have grown outsized, and reinvesting the proceeds into these less loved areas.
2. US INTERNET VERSUS CHINESE INTERNET

DISPLAY 2

Year-to-date a basket of US Internet stocks have outperformed the Chinese Internet stocks by 47%.

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.

Source: Factset as of September 5, 2018. Chinese Internet stocks as defined by KWEB; US Internet stocks as defined by FDN.

*What are we doing about it?* We have increased our exposure to Chinese Internet stocks.
3. US VALUE

DISPLAY 3

Value Spread
December 31, 1989 – August 31, 2018

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.

Source: Factset. Value spread as defined by the valuation differential between the cheapest decile of the Russell 1000 versus that of the market average. Valuation is based upon price-to-book, price-to-earnings, and price-to-free cash in terms of standard deviation.

Investors’ distaste for value has only worsened, as value is now cheap versus history. There is no doubt value became even cheaper in 1990, 2000 and 2008. Each of these times preceded recessions. Either this spread is warning of a looming recession, or, if it’s not, then it’s likely a good time to increase value exposure.

*What are we doing about it?* We continue to increase our value exposure. All of our strategies are overweight to their benchmarks in US financials and US energy companies.
4. US CONSUMER STAPLES

DISPLAY 4

Consumer Staples Valuation
December 31, 1995 – August 31, 2018

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.

Source: Factset. Historic valuation levels of companies with the S&P 500 that are classified as members of the GICS consumer staples sector.

Investors’ love affair with technology/consumer discretionary has left the staid consumer staples stocks in the dust this year. The net result is they are cheap. We are mindful that historically post a yield curve inversion and into the final leg of a bull market, consumer staples tend to outperform. This cheapness seems to offer an opportunity to increase a previously very underweighted group.

What are we doing about it? We have transitioned from close to a zero weighting in US consumer staples earlier this year to a modest overweight in the portfolios.
5. US VERSUS REST OF WORLD (ROW)

DISPLAY 5

Rolling 12-month Returns of S&P 500 vs. MSCI ACWI Ex-US
January 1, 1998 – August 31, 2018

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.
Source: Bloomberg as of August 31, 2018

The relative performance of the US versus the Rest of the World is nearly as extreme as we have seen it in the past 20 years. Can it continue?

What are we doing about it? This is painful. We have been overweight non-US stocks for the year, and it has really hurt. We are not adjusting our allocations meaningfully.
6. EUROPEAN BANKS ARE EXTREMELY CHEAP

DISPLAY 6

Relative performance of European Banks versus MSCI Europe

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.

Source: MSCI, IBES, Morgan Stanley Research

Over the past 30 years, banks have always outperformed MSCI Europe over the subsequent 12 months when at current valuations or lower.

What are we doing about it? Without a doubt, it would be so easy to jettison European banks. I love to get the red off the portfolio holdings statement. While we have worked to reduce our book costs in these stocks, it would be imprudent to eliminate into this level of pessimism, given past history.
Two final points:

1). We are not wholesale dumping our growth/momentum stocks but we need to be mindful that the rubber band is stretched. No doubt, it has not been a fun period for anybody EXCEPT pure growth/momentum investors. Any value exposure and/or any non-US exposure has hurt performance. And we have both.

2). This is NOT a call that the market will go down. It seems to us it’s more about the risk of some rotation occurring. We believe convergence could occur not because everything goes down and the unloved go down less, but rather because we envision convergence on the upside.

What could cause a convergence?

1). The Fed. Less hawkish
2). The Dollar. Less strong
3). EM Currencies. Less weak
4). 2 to 10 year yield curve. Resteepens
5). Tariffs…Progress on a resolution

Currently there is a ton of bad news priced into #1-#5. Which is why we are experiencing the extreme valuation/performance spreads. But then we suspect the spreads are so stretched that if anything positive occurs, these extremes will begin to revert.

“Interesting” times for sure.

Andrew
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 PORTFOLIO WILL DECLINE AND 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. IN GENERAL, EQUITIES SECURITIES’ VALUES ALSO FLUCTUATE IN RESPONSE TO ACTIVITIES SPECIFIC TO A COMPANY. STOCKS OF SMALL- AND MEDIUM-CAPITALIZATION COMPANIES ENTAIL SPECIAL RISKS, SUCH AS LIMITED PRODUCT LINES, MARKETS AND FINANCIAL RESOURCES, AND GREATER MARKET VOLATILITY THAN SECURITIES OF LARGER, MORE ESTABLISHED COMPANIES. INVESTMENTS IN FOREIGN MARKETS ENTAIL SPECIAL RISKS SUCH AS CURRENCY, POLITICAL, ECONOMIC, MARKET AND LIQUIDITY RISKS. ILLIQUID SECURITIES MAY BE MORE DIFFICULT TO SELL AND VALUE THAN PUBLICLY TRADED SECURITIES (LIQUIDITY RISK). NON-DIVERSIFIED PORTFOLIOS OFTEN INVEST IN A MORE LIMITED NUMBER OF ISSUERS. AS SUCH, CHANGES IN THE FINANCIAL CONDITION OR MARKET VALUE OF A SINGLE ISSUER MAY CAUSE GREATER VOLATILITY.

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. 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. The S&P 500® Index measures performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. market, including 500 leading companies in the U.S. economy. The MSCI World Index is a free float adjusted market capitalization weighted index designed to measure performance of developed equity markets globally. The term “free float” refers to the portion of shares deemed to be available for purchase in public equity markets. The Index’s performance is listed in U.S. dollars and assumes reinvestment of net dividends. 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 ACWI ex US Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 24 Emerging Markets countries. With 2,152 constituents, the index covers approximately 85% of the global equity opportunity set outside the U.S. 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. The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. The Russell 1000 Index is an index of approximately 1,000 of the largest companies in the U.S. equity market. It represents the top companies by market capitalization. The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those companies with lower price-to-book ratios and lower expected growth values. The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those companies with higher price-to-book ratios and higher forecasted growth values. Standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values.

DISTRIBUTION

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

United Kingdom: Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. Dubai: Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158, Germany: Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). Italy: Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360986. The Netherlands: Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. Switzerland: Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht (“FinMA”). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074, 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. (“MSIMJ”)’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 MSIMJ to make all investment decisions based on an analysis of the
value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, 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, MSIMJ 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 MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

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 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

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.

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 or 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.

IMPORTANT INFORMATION

EMEA: This communication has been issued by Morgan Stanley Investment Management Limited (“MSIM”). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

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.

This material is a general communication, which is not impartial and has been prepared solely for informational 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. All investments involve risks, including the possible loss of principal. The information herein has not been based on a consideration of any individual investor 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.

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.

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.

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.