February 2018: Market Update

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MARKET PULSE | 7 February 2018

The Main Causes of the Recent Market Correction

In our view, the sell-off was largely caused by two surprises, which we flagged in our 2018 outlook – namely, stronger than expected inflation and an upward adjustment in bond yields.

At a more granular level, the course of the sell-off can be described as follows: Equity markets started to sell-off last Monday, 29 January 2018 after a very strong rally to start the year. In our view, initially the sell-off could be attributed to end-of-month profit taking (the S&P 500 rallied 7.5% in 4 weeks, while emerging market equities recorded double digit gains) and recognition that bond yields had risen steeply over the course of the month (yields rose 25bps between 31 December 2017 and 26 January 2018 when the market peaked)[1]. There may also have been increased caution ahead of the January Federal Open Market Committee (FOMC) meeting on 31 January.

The sell-off accelerated following the release of US Non-Farm Payrolls data on Friday 2 February, which showed that average wage growth in January grew at 2.9%YoY vs. expectations of 2.6% annual growth[1]. This was the fastest wage growth recorded in the US in almost a decade. We believe, the strength of this data caused markets to re-assess their view on the pace of Federal Reserve rate hikes – consequently US 10-year bond yields adjusted further to an YTD high of 2.85% while the sell-off in equities accelerated[1].

Finally, it is worth commenting on the magnitude of the moves in markets over the past month. In our view, there is evidence that the proliferation in products such as leveraged ETFs (which did not exist in prior market cycles) may have amplified both the January rally and the subsequent sell-off.

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[1] Source: Bloomberg.

IS THIS THE START OF A BEAR MARKET?

We do not think this is the start of a bear market and in our view the backdrop for equities remains supportive. While we expect the Federal Reserve (the Fed) to follow through on its rate hike intentions, we do not expect an increase in the number of rate hikes projected by the Fed (currently 3 rate hikes in 2018 and 3 in 2019). Moreover, while we expect US 10-year bond yields to rise above 3.0%, at this stage we do not think that they will increase significantly above this level given ongoing quantitative easing (QE) programmes in other markets (namely Japan) and strong demand for bonds from global sovereign wealth and pension funds.

We expect equities to see further upside in 2018 for a number of reasons. Firstly, economic growth is expected to continue to be robust in 2018 with accelerating growth in both emerging and developed markets. Macro data releases over the past few days affirm this view - China's Caixin Services PMI for January reached a 3 year high (based on available data), Brazil's services PMI moved back into expansionary territory while US ISM non-manufacturing PMI hit a new cycle high of 59.9[1]. Secondly, earnings growth expectations remain robust and valuations (while not cheap) look relatively more attractive following recent market weakness. Finally, while rising inflation is negative for bonds, it is not necessarily negative for equities – real yields will stay low if inflation rises at the same pace as nominal yields.

In summary, our longstanding concern around rising rates has materialised, while geopolitical risks have fallen. Consequently, in our view, the sell-off constitutes an opportunity to selectively add to risk assets.

With specific reference to our mutual funds range, we have provided below the new target allocations of each of our four Luxembourg SICAV Funds, as of 7 February 2018:

	VOLATILITY TARGET P.A.[1]	EQUITY %	COMMODITIES %	FIXED INCOME %	CASH %
MS INVF Global Balanced Risk Control Fund	4% – 10%	57.5	3.0	39.00	0.50
MS INVF Global Balanced Income Fund	4% – 10%	57.0	3.0	32.5	7.5
MS INVF Global Balanced Fund	4% – 10%	57.5	3.0	38.5	1.00
MS INVF Global Balanced Defensive Fund	2% – 6%	28.5	2.5	66.00	3.00

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management.
Allocations are subject to change on a daily basis and without notice.
MS INVF standards for Morgan Stanley Investment Funds.
1. Volatility targets are indicative ranges.

RISK CONSIDERATIONS

- Past performance is not a guarantee of future performance. The value of the investments and the income from them can go down as well as up and an investor may not get back the amount invested. There can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

- The Asset Allocation strategies provide the Investment Adviser with wide discretion to allocate between different asset classes. From time to time, the Asset Allocation may have significant exposure to a single or limited number of fixed income or equity asset classes. Accordingly, the relative relevance of the risks associated with equity securities, Fixed Income Securities and derivatives will fluctuate over time.
- Funds that specialise in a particular region or market sector are more risky than those which hold a very broad spread of investments. Where portfolio concentration is in one sector it is subject to greater risk and volatility than other portfolios that are more diversified and the value of its shares may be more substantially affected by economic events in the real estate industry.
- Investments in derivative instruments carry certain inherent risks such as the risk of counter party default and before investing you should ensure you fully understand these risks. Use of leverage may also magnify losses as well as gains to the extent that leverage is employed.
- These investments are designed for investors who understand and are willing to accept these risks. Performance may be volatile, and an investor could lose all or a substantial portion of his or her investment.
- The value of bonds are likely to decrease if interest rates rise and vice versa.
- The value of financial derivative instruments are highly sensitive and may result in losses in excess of the amount invested by the Sub-Fund.
- Issuers may not be able to repay their debts, if this happens the value of your investment will decrease. This risk is higher where the fund invests in a bond with a lower credit rating.
- The fund relies on other parties to fulfil certain services, investments or transactions. If these parties become insolvent, it may expose the fund to financial loss.
- There may be an insufficient number of buyers or sellers which may affect the funds ability to buy or sell securities.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets.
- The derivative strategy aims to increase the income paid to investors, but there is potential for the fund to suffer losses.
- Commodity investments can change significantly and quickly in value as a large variety of factors affect them.

DEFINITIONS

PMI (Purchasing Managers' Index) data: Further details can be found on the website: https://www.markiteconomics.com/Survey/Page.mvc/AboutPMIData

The US ISM non-manufacturing PMI is provided by the Institute for Supply Management. The reports and further detail can be found on the website: https://www.instituteforsupplymanagement.org/certification/content.cfm?ItemNumber=28965&navItemNumber=30165&SSO=1

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