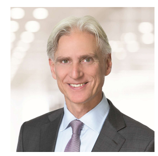
1 June 2020 – Market Update

Coronavirus: Positioning for tactical opportunities

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



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Having increased the equity allocation in our portfolios in late May, we have also identified a number of tactical opportunities in the fixed income space. In this week's update we discuss each investment idea which led to these position changes:

European Peripheral Bonds

Although the outlook for Europe remains uncertain, the news of a EUR 750bn recovery fund proposed by the European Union, following earlier proposals by France and Germany, is an important development. The recovery fund is likely to allocate resources to countries hardest hit by the coronavirus pandemic, and would directly address the asymmetric hit to growth that was one of the factors driving our move to an underweight position in March. Whilst the criteria for allocating the funds to individual countries are yet to be determined, exposure to tourism could potentially guide the allocations, given this is an area particularly hard hit. If this is the case, peripherals are likely to benefit given their high exposure to the sector.

We are fairly confident of a positive outcome, despite a pushback by the "frugal four", Austria, Denmark, the Netherlands and Sweden, who issued a counter-proposal, which included the provision of loans rather than grants. Whilst the ECB has provided a strong short-term commitment to support markets, once the proposed recovery plan is finalised it could offer the longer-term support needed. In the meantime, their measures such as the ECB purchase programmes should support spreads during this transition towards stronger fiscal support for peripheral economies.

Whilst there may be some volatility during the negotiation phase, a positive outcome should reduce downside risk materially and warrants a removal of our underweight and move to a neutral positioning. The markets rallied on the news of the recovery fund, however although recent performance suggests that sentiment has improved, it is not exuberant. Moreover, whilst spreads on Spanish and Italian bonds have tightened to an extent, they remain cheap.

There are also further dynamics to consider. The recovery fund would make the EU the second-largest AAA issuer in Europe after Germany, creating a new supply of AAA-rated bonds at yields more attractive than core country yields, so they could attract investors in search of better carry. This would be a big game changer, with potential implications for European core countries which could see a reduction in demand. A ramp-up in the higher-rated debt universe in the euro area may not lead to outright selling of Bund holdings, but may lead to less demand for them in the future.

Emerging Market Local Currency (EM LC) Sovereign Debt

Emerging Market Hard Currency (EM HC) Sovereign Debt

There are a number of developments which justify an upgrade to our signal on EM LC Sovereign Debt from underweight to neutral and EM HC Sovereign Debt from neutral to overweight. Whilst fundamentals indicate that global growth is likely to be weak in 2020, we believe that the worst is behind us. A lot of the negative factors have to a certain extent been priced into EM Sovereign Debt, including slower global growth, the fall in oil prices, weakness in economic fundamentals (current account, FX reserves and debt), the impact of COVID-19 and downgrades.

With the expectation that the recovery of the global economy and confidence are very gradual, and in the absence of a second wave of the virus hitting growth, we anticipate that EM Sovereign Debt spreads will tighten towards the end of 2020. Backtests show that EM Sovereign Debt tends to experience sharp drawdowns within a short period, but is also often spared from second waves.

We downgraded our signal to EM LC Sovereign Debt at the beginning of April, motivated by concerns that emerging markets economies were likely to face severe pressure related to the pandemic. We believed this firstly because there appeared at the time to be limited options for stimulus to buffer the economy against the shock. Secondly, we were also concerned about the healthcare infrastructure which is generally less robust than in developed economies.

However, we were positively surprised by the size of the stimulus response by emerging markets, which has been largely on a par with developed markets, and also emerging market’s relative success, particularly in Asia, in limiting the impact of the virus. Consequently, we feel the tail risks to EM currencies have diminished meaningfully, justifying our move from underweight to neutral EM LC Sovereign Debt.

The fall in oil prices is one of the negative factors which has been priced in. That said, the oil price futures curve is currently trading at contango, meaning that WTI prices are expected to recover. However, we are still wary of the risk of a further collapse in oil prices and continue to monitor this closely. There is also the potential for additional risks which we are staying alert to, such as second wave escalation, the revival of US-China trade tensions, the US presidential election, the de-globalisation of supply chains and higher market volatility.

Tactical Preferences

We have provided an overview of our latest tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			Current		
Eurozone		Current			
UK			Current		
Japan		Current			
Asia ex Japan				Current	
China				Current	
Emerging Markets			Current		
LatAm			Current		
Global Consumer Staples				Current	
Global Infrastructure			Current		
Global Property		Current			

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit			Current		
US High Yield		Current			
European High Yield		Current			
EM Sovereign Debt HC			Previous	Current	
EM Sovereign Debt LC		Previous	Current		
US Treasuries				Current	
US Inflation			Current		
German Bunds		Current			
EU Peripheral Bonds		Previous	Current		
JGBs			Current		
Commodities					
Gold				Current	
Industrial Metals			Current		

Current positioning

Previous positioning

Source: MSIM GBaR team, as of 29 May 2020. For informational 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 tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes.

Broad Asset Allocations

We have provided the latest effective asset allocation weights of each of our five Luxembourg SICAV funds in the following table, as of 29 May 2020.

	VOLATILITY P.A. [1]	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %*	
					PHYSICAL	SYNTHETIC*
MS INVF Global Balanced Risk Control Fund of Funds (EUR)	4% – 10%	24.3	53.2	4.3	11.9	6.3
MS INVF Global Balanced Income Fund (EUR)	4% – 10%	26.2	48.2	4.4	12.8	8.4
MS INVF Global Balanced Fund (EUR)	4% – 10%	27.8	48.1	4.4	6.6	13.0
MS INVF Global Balanced Defensive Fund (EUR)	2% – 6%	9.9	67.0	3.5	8.1	11.5
MS INVF Multi-Asset Risk Control Fund (USD)	4% - 10%	23.9	59.7	4.2	2.8	9.4

*Synthetic cash created from derivatives positions.
We have provided the effective weights for 29 May 2020 at the time of publication. Weights may deviate marginally from these weights after publication due to data revisions.

Source: Global Balanced Risk Control team, Morgan Stanley Investment Management. Allocations are subject to change on a daily basis and without notice. For information only and not a recommendation to buy or sell specific investment strategy. MS INVF standards for Morgan Stanley Investment Funds. [1]. Volatility targets are indicative ranges. There is no assurance that these targets will be attained.

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