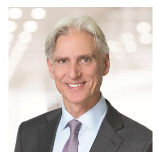
3 July 2020 – Market Update

Coronavirus: A critical juncture

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



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As we enter the second half of 2020, we reach a critical juncture. To some investors it appears that an economic recovery is under way. The speed and scale of country reopenings, particularly in the US, have been accompanied by a number of positive data releases over the past month and sharp, positive economic surprises. Bolstered by this and positive sentiment, global equities recorded their best quarter since Q2 2009, with the MSCI ACWI Index (USD) up 18.7%[1]. However, having now benefited from the reopenings, we believe that gains will likely prove harder to come by and in the months ahead we could see a slow, rather than V-shaped, recovery.

We remain concerned about the risk of a second wave of localised COVID-19 cases, which is already evident in a number of cities and regions, for example in Australia, Germany and China. The US remains the global epicentre for coronavirus cases, with the spread of COVID-19 escalating in several states including California, Texas and Florida, which appear to have reopened prematurely. In addition, we see a number of risks on the horizon, which confirm our conviction to maintain our defensive positioning.

Hidden damage to the economy is beginning to show

Despite a number of apparent economic positives, hidden damage to the economy is starting to be revealed. The strongest quarterly equity gains in more than a decade have arrived against an increasingly worrying fundamental backdrop. With the number of sporadic resurgences of the virus rising across key US states,

[1] Bloomberg, as of 30 June 2020.

SMEs[2], particularly within the leisure, hospitality and retail sectors, are likely to face a wave of bankruptcies, indicating also that unemployment will remain persistently high.

This wave will come after the US has already experienced record-breaking levels of bankruptcies during the first half of 2020. According to Bloomberg, 13 US companies (with liabilities of over $50mn) filed for bankruptcy during the week of 13-20 June. This brings the total for the year to 117, matching the peak set in 2009. Bankruptcy filings have overwhelmingly been concentrated within two sectors, with Consumer Discretionary contributing to 40% of filings and Energy 18%[3]. These sectors were already facing structural headwinds pre-COVID-19. Therefore, what we are likely seeing is an acceleration of existing structural trends such as the demise of bricks and mortar retail and decelerating global oil demand.

Political risk

In our opinion, controlling the spread of COVID-19 and managing the economic impact should be the two key focuses for the US government. However, we expect political risk to gradually heighten in the second half of the year, as we draw closer to the US Presidential election. If President Trump is not re-elected, there is a strong risk that 2018's tax reforms will be reversed, which could have a meaningful impact on equity valuations. Furthermore, there is also the risk of US-China trade tensions escalating, which has already led to some volatility of late.

One bright spot is the potential for stimulus through investment in infrastructure. Both the Democrats and Republicans are advocating a renewed stimulus package, which would include substantial infrastructure spending, though they are divided on the exact focus. Given recent positive market momentum and good economic data releases, policymakers may feel less urgency than at the beginning of the crisis, so political considerations may increasingly come into play. However, we believe such support packages will still be much needed as other support for the economy comes to an end. The extra $600 per week unemployment payment from the CARES Act[4], which has been a significant support, expires at the end of July and is unlikely to be renewed.

Looking to Europe, the region is surging on the reopening of the economy. Having generally been successful in flattening the infection rate curve, Europe has seen its equity markets outperform the US. Support is also likely to come from infrastructure spending. Whilst the EU Recovery Plan[5] is still to be approved, the EU appears to be seizing the moment, and channelling the need for stimulus towards potentially huge spending on renewables.

Portfolio positioning: Caution is warranted.

We maintain a defensive bias through relatively low equity positioning, to maintain a stable risk profile. When comparing the percentile distribution of the S&P 500 daily returns during the COVID-19 pandemic (March 2020 – June 2020) with 2019 (April 2019 – December 2019), the median ratio of S&P 500 return percentiles for the 2020 period is 4.5 times greater than the 2019 period. This highlights that equity market moves are far larger this year, first responding to successive country lockdowns, a collapse of economic activity in April and early May, followed by a partial resurgence in this activity as countries reopened.

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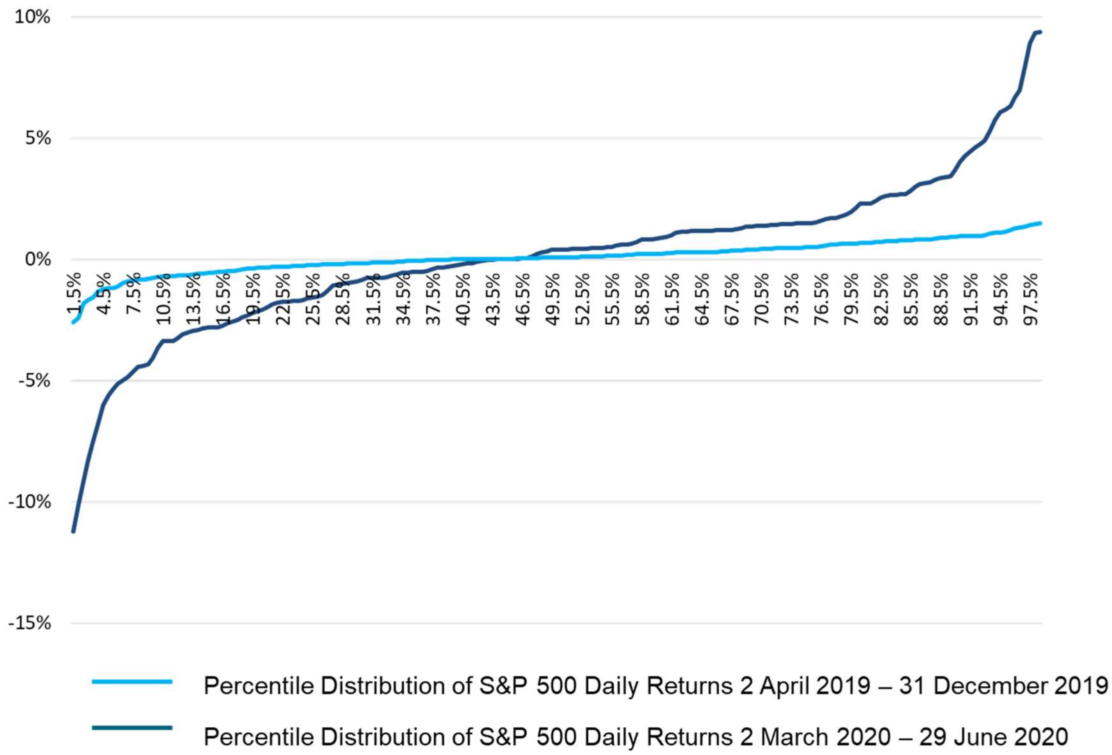
[2] SMEs: Small and medium-sized enterprises

[3] Year-to-date data from Bloomberg as at 29 June 2020.

[4] The US Coronavirus Aid, Relief, and Economic Security Act, signed 27 March 2020. $2 trillion stimulus package to support the economy due to the impact of COVID-19 pandemic. www.home.treasury.gov/policy-issues/cares

[5] EU Commission. www.ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/recovery-plan-europe_en

Percentile Distribution of S&P 500 Daily Returns



Source: Datastream.

Since our last note on 16 June, we have not made any changes to our broad asset mix or to tactical positioning within global equities and global fixed income. Our defensive positioning is reflected in our avoidance of the most overvalued equity sectors and regions, as we seek structural growth opportunities that are supported by both fundamentals and valuations.

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 2 July 2020.

	VOLATILITY P.A. [1]	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %*	
					PHYSICAL	SYNTHETIC*
MS INVF Global Balanced Risk Control Fund of Funds (EUR)	4% – 10%	29.2	59.6	2.0	7.7	1.6
MS INVF Global Balanced Income Fund (EUR)	4% – 10%	24.2	64.7	2.0	9.6	-0.4
MS INVF Global Balanced Fund (EUR)	4% – 10%	24.5	64.7	2.0	7.8	0.9
MS INVF Global Balanced Defensive Fund (EUR)	2% – 6%	9.5	79.8	1.5	5.9	3.3
MS INVF Multi-Asset Risk Control Fund (USD)	4% - 10%	23.4	60.9	2.1	3.6	10

*Synthetic cash created from derivatives positions.

We have provided the effective weights for 2 July 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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MSCI ACWI Index: The Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) is a free float-adjusted market capitalisation index that is designed to measure equity market performance in the global developed and emerging markets.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalisation US stocks.

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