23 October 2020 – Market Update
A Silver Lining on the Horizon

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

Markets are facing a confluence of uncertainties in the coming weeks. As the second wave of COVID-19 gathers pace in Europe, bringing many countries into various forms of lockdown, the US Presidential election is almost upon us. As discussed in previous notes, the US political will for meaningful and much-needed fiscal stimulus is faltering. The US Congress has still not replaced the expired stimulus programmes, which were helping to prop up the economy earlier in the year. Though talks continue, it is now highly unlikely that there will be a deal before the election.

If there is a silver lining, it is that once we have a clear US election result, there should be some political clarity and some removal of uncertainty. Until then, there is increasing likelihood that markets will experience further volatility, disrupting the recovery since March.

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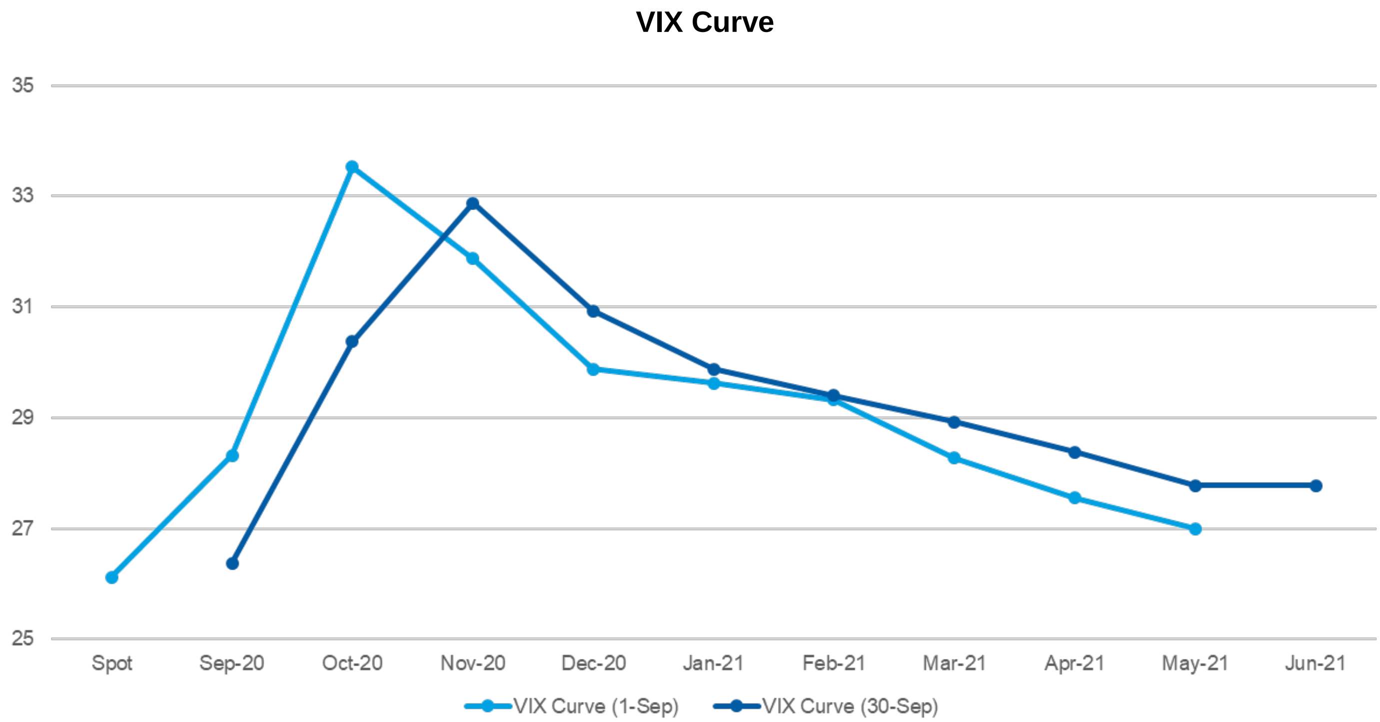
The uncertainty premium

It appears that the market is demanding an uncertainty premium in light of three factors: the upcoming US election, the second wave of COVID-19 and lack of fiscal stimulus in the US. The VIX futures are reflecting the fact that investors appear to be anticipating an extended period of heightened volatility following the election - reflecting uncertainty over the result and also the policy direction.



Source: Bloomberg, MSIM. Data as of 1 October 2020.

Whilst we believe that both US Presidential candidates are focused on economic recovery, clarity with respect to the policy direction can only come after the election. If President Trump wins, it is likely that policy uncertainty will be removed fairly swiftly. However, if Democratic presidential nominee Joe Biden gets into office, we can expect a transition period between the results and inauguration on 20 January 2021, before there is clarity.

Investment Positioning

The heightened near-term uncertainty in the run up to the US election persuades us that it is prudent to hold our defensive positioning for now, but also to seek out opportunities to be positioned in pockets of value. In the long term, post the election, the economy is likely to be rebooted for a continuation of the cyclical recovery. However, currently we have overweights in regions less affected by the US election and instead tied to China, given the latter country's effective containment of the virus and subsequent recovery. This includes Asia ex-Japan and, as discussed in previous notes, also German equities, given Germany's strong external demand from China. We have therefore maintained our China A share, Emerging Markets Asia equities and German equities overweights.

Our view is that growth stocks, especially the FAAMGs, are vulnerable from a valuation standpoint. Whilst valuation premiums have begun to compress, they remain well above average. If they fall, we believe they are likely to fall hard, pulling other sectors down with them. However, if regions and sectors with better valuations do fall, this would likely be less sharp. Moreover, if the contrary happens, bringing positive markets and economic conditions, then these undervalued areas could have substantial upside.

Tactical Positioning

Since our last note on 2 October, we have not made any changes to our broad asset mix beyond adjustments to calibrate the portfolios we manage, to help ensure we remain on track with respect to target volatility. However, we continue to look for tactical opportunities and have made the following change:

Emerging Markets Latin American Equities

On 13 October, we moved from neutral to overweight Emerging Markets Latin American (LatAm) equities. This shift is primarily a value play and we aim to capture the relative re-rating. As of the date that we initiated this position, 2021 P/E valuations had pulled back, given a combination of higher EPS growth expectations and recent weak price performance. Consequently, we believe LatAm is one of the few regions globally to be trading at fair-value (relative to 10-year median 12-month forward PE multiples). By comparison, on the same valuation metric, Global Developed Market Equities (MSCI World) are trading at a ~30% premium. Using a multiple based valuation approach this suggests 14% upside for MSCI LatAm from current levels[1]. In addition, sentiment, which for us is a contrarian indicator, was negative given weak price action and foreign outflows.

As of 21 October, the performance for this asset class has been positive since the move to overweight, with the MSCI Emerging Markets Latin America Index returning 2.3%, in USD terms[2].

1. Data source: Bloomberg.
2. Data source: Datastream.

Broad Asset Allocations

We have provided the latest effective asset allocation weights of each of our SIX Luxembourg SICAV funds in the following table, as of 21 October 2020.

	VOLATILITY P.A. [1]	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %*	
					PHYSICAL	SYNTHETIC*
MS INVF Global Balanced Risk Control Fund of Funds (EUR)	4% – 10%	30.9	63.9	2.0	4.1	-1.0
MS INVF Global Balanced Income Fund (EUR)	4% – 10%	25.4	56.7	2.0	8.7	7.1
MS INVF Global Balanced Fund (EUR)	4% – 10%	32.8	59.6	2.0	9.2	-3.7
MS INVF Global Balanced Defensive Fund (EUR)	2% – 6%	13.4	69.6	1.0	6.6	9.4
MS INVF Multi-Asset Risk Control Fund (USD)	4% - 10%	26.3	59.8	2.2	10.2	1.5
MS INVF Global Balanced Sustainable (EUR)	4% - 10%	23.8	70.5	2.0	6.5	-2.8

*Synthetic cash created from derivatives positions.
We have provided the effective weights for 21 October 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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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. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization 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. A **currency forward** is a hedging tool that does not involve any upfront payment. 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.

INDEX DEFINITIONS

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

Earnings per share (EPS) growth is the weighted average of earnings per share growth for all securities in the portfolio projected for the past five fiscal years. Earnings per share for a company is defined as total earnings divided by shares outstanding.

FAAMG: The top 5 stocks in the S&P 500 index, which have greater market capitalisation in aggregate than the bottom 350 stocks.

MSCI China A Index: A free float-adjusted market capitalization index that is designed to measure equity market performance of the China A share market. The performance of the Index is listed in US dollars and assumes reinvestment of net dividends.

The MSCI Emerging Markets (EM) Latin America Index captures large and mid-cap representation across 6 Emerging Markets (EM) countries (Brazil, Mexico, Columbia, Argentina, Peru, Chile) in Latin America. With 107 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI World Index: This index captures large-cap and mid-cap representation across 23 developed market countries. With 1,607 constituents, it accounts for about 85% of the free-float-adjusted market capitalization in each country.

Price-Earnings Ratio (P/E) is a valuation ratio of a company's current share price compared to its per-share earnings. Calculated as Market Value per Share / Earnings per Share.

VIX: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

VIX futures reflect the market's estimate of the value of the VIX Index on various expiration dates in the future.

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