

Morgan Stanley

INVESTMENT MANAGEMENT

Q3 2018 Review and Update: Sell-off or correction?

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MARKET PULSE | 24 October 2018

2018 has brought the return of volatility. The first volatility spike came at the beginning of February when we had stronger-than-expected inflation and an upward adjustment in bond yields. The market experienced further bouts of volatility at the end of March, when the first of the US/China trade tariffs were announced. During the second week of October, markets experienced yet another spell of heightened volatility, triggered by investors' realisation of the likely extent of U.S. monetary policy tightening, which impacted both fixed income and equity.

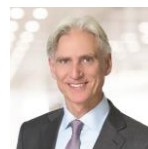
Year-to-date, our flagship MS INVF Global Balanced Risk Control Fund has returned 0.08%¹, partly reflecting the equity sell-off at the start of the year and the defensive positioning with a low equity allocation, which we implemented throughout most of Q3, due to our concerns of the impact of trade tensions on global growth.

Given recent market volatility, we reflect on the year so far and explain our latest positioning.

2018 has been a year of U.S. outperformance versus the Rest of the World (RoW)

The U.S. market has been amongst the strongest performing equity markets in 2018 and if we account for the U.S. dollar strength, the U.S. market has been one of the top returning G20 markets². This outperformance is not entirely surprising, as market volatility in recent months has been squarely located

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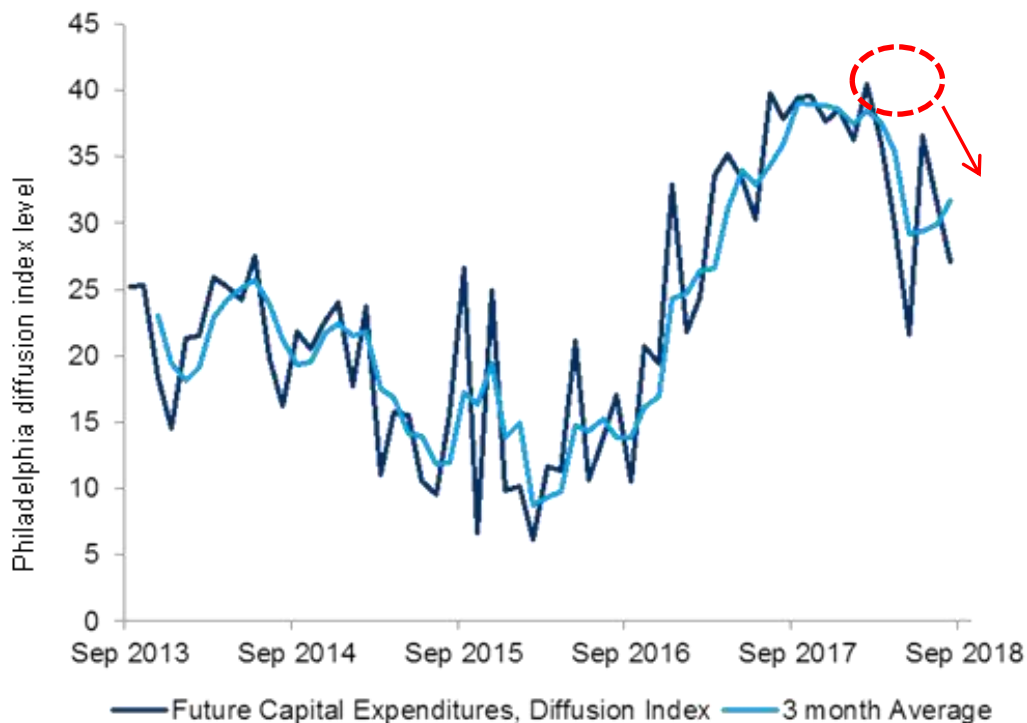
¹ Gross, in euro terms, cumulative to 30 September 2018.

² Source: Datastream.

outside the U.S. and the U.S. has been seen as a “new safe haven”. In Europe, investors have had multiple concerns including the impact of Brexit, Italian fiscal policy and the risk of contagion of a default in Turkish debt to European banks. Asian Emerging Markets (EM) and Japan have been hurt by slowing growth in China, worsened by the impact of the escalating China-U.S. trade war. Sharp depreciations in EM FX have also put EM assets under pressure. Compared to the RoW, the U.S. has continued to release strong economic data. The net effect has been outflows from European, Japanese and EM assets, and inflows to safe haven U.S. assets during this period of uncertainty. This has resulted in extreme levels of bullishness in the U.S. dollar and U.S. equities, causing lofty relative U.S. valuations.

This has been particularly true for the technology sector, the largest sector in the S&P 500, but also for other U.S. growth sectors, namely the consumer discretionary sector. Nonetheless, we believed that the divergence between the U.S. and the RoW, which had been increasing since May 2018, would not continue indefinitely. In September, we started to see some economic data (Chart 1) indicating the first signs of the potential for slower growth in the U.S. After hitting a cycle peak in February 2018, future capital expenditure intentions of U.S. businesses, as measured by the Federal Reserve Bank of Philadelphia diffusion index, have started to deteriorate. This slowdown in investment potentially caused by uncertainty from trade tensions could manifest itself in lower growth figures in the coming quarters.

Chart 1: **Lower business capex intentions in 2018³**



³ Source: Datastream, Federal Reserve Bank of Philadelphia. Data as of 28 September 2018. Current Employment; Diffusion Index for FRB - Philadelphia District, retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/NECDFA066MSFRBPHI>. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

What happened in October?

In October, our concerns were realised when the Fed indicated they might tighten monetary policy, beyond normalisation, triggering market volatility. Rising bond yields have contributed to the move down, but in our view investors may also finally be questioning whether U.S. earnings truly are immune to slowing global growth and rising input costs. Top-line revenue growth may slow due to weaker China growth and related pullback in business capital expenditures, both driven partly by U.S./China trade tensions. At the same time, margins may come under pressure from a very tight labour market (unemployment is a 49 year low⁴) and rising wage costs coupled with other rising input costs, namely: raw materials, higher oil price and rising freight cost inflation.

Events to watch

There are a number of events creating uncertainty in the market and which we believe are key to assess if we experienced a sell-off or correction in the market. We are monitoring these closely to ascertain their possible impact, both in the coming weeks and in the following months. These include:

U.S. earnings

Until recently, the U.S. had escaped negative earnings revisions, unlike Europe, the UK and Japan. We are just at the beginning of the reporting season and this will run to the beginning of November. The forward guidance provided by US corporates will be key to market sentiment and will likely dictate whether a retracement is likely or if we will continue to see a decline in equities. In our view, U.S. equities are likely to face further downside in the short term.

U.S. mid-term election, possible results and implications

We believe a key-risk is the U.S. mid-term election – once this has passed (and whatever the results), we will have greater clarity whether the Trump administration will have the scope to pursue key policy objectives.

President Trump may manage to keep his majority, but in our opinion the more likely scenario is one where the U.S. ends up with a split Congress and this could be the most positive outcome for the markets. Given that tariffs could be seen as being partly politically-motivated, this could mark a watershed in trade tensions, or allow the administration to think more constructively about the economy in the two remaining years before the 2020 elections.

On the other hand, we could have a scenario where we experience a major political change, with the Democrats winning both the House and the Senate and this could lead to a less market-friendly outcome. Under this scenario we could possibly experience an increase in regulations (related to social media, the oil and gas sector and climate change,) and a possible increase in taxes targeting the wealthier end of the population.

⁴ Source: Reuters.

U.S./China trade negotiations

Sentiment has deteriorated sharply with strong outflows from Chinese equities. However, as the trade war between China and the U.S. continues, we do not expect a turn in sentiment in the near term.

Compounding this is the fact that trade tensions are coinciding with a particularly vulnerable period for the Chinese economy as the government transitions from an investment driven economy to one focused on consumption.

Further rate increase

The recent run up in the 10-year U.S. bond yields was the immediate catalyst in the spike in equity volatility. It is worth recalling that rising bond yield also appeared to spark the February correction. Inflation could be a headwind, justifying further Fed rate increases, which in turn could result in even higher bond yields and further volatility.

Possible results of the Mueller investigation

Given the proximity of the U.S. mid-term elections, we believe that Robert Mueller is likely to be cautious and avoid any perception of election interference, meaning that the results of his investigation may be presented only after 6 November 2018. If the results are unfavourable or represent a threat to President Trump, this could cause more volatility in the markets. This is because the President has passed substantially business friendly regulation and this could reverse if his influence is diminished.

Recent fund positioning and opportunities to move back into equity

In September we increased our equity positioning as we believed trade tensions had eased, especially after President Trump announced trade tariffs on China, which were less punitive than previously indicated and compared with what the market had anticipated. This led us to increase our position in equities especially in Europe and Japan, in relative terms to the U.S. With respect to Japan, the de-escalation of the U.S.-China trade war was supportive of Japanese equities. Fundamentals were improving as the trends in Japanese earnings were supportive (12-month forward EPS growth expectations are rising). At the same time sentiment was improving and Japan proved to be a likely beneficiary of the convergence trade between the U.S. and the rest of the world. On the other hand, European valuations looked attractive and macro data started to be more mixed than negative.

While increasing equity exposure modestly, we recognised a potential increase in “tail risk” (extreme negative price moves). In addition to trade tensions, we believe there is a substantial concentration of assets in U.S. equities and that the U.S. would not have remained immune from general market volatility. Due to these factors, we felt it was prudent to enhance “tail risk” protection of our U.S. exposure via put options with a December strike, expiring well after the November U.S. mid-term election. This hedge has helped to protect the portfolio during the market volatility experienced in the second week of October. We have kept this in place to help protect the portfolio from any further volatility. During October, we also decreased our equity exposure across our portfolios, at the beginning and during the market correction. Gold has been flat most of the year, but our position in this asset class, as a geopolitical hedge has been benefiting us given October events. We also removed our overweight to Europe, due to ongoing deterioration of economic data. In addition, we have gradually increased our exposure to emerging market hard currency corporate debt as valuations are attractive, after the indiscriminate sell-off and fundamentals moved into positive territory.

MARKET PULSE

Overall our positioning is relatively defensive as you can see from the current equity exposure, given the key risks which we have described above. Once there is greater certainty on these events, this could provide an opportunity to move back into equities. In the meantime, our current positioning in fixed income and cash should allow keeps us relatively protected should market volatility persist.

With specific reference to our mutual funds range, we have provided in the table below the target asset allocations of each of our four Luxembourg SICAV Funds, as of 24 October 2018. Please note that the positions we hold in cash are comprised of a combination of cash and short term money market instruments, along with the backing of the short futures positions we implemented in our portfolios.

	VOLATILITY P.A. ¹	EQUITY %	FIXED INCOME %	COMMODITIES %	CASH %
MS INV F Global Balanced Risk Control Fund	4% – 10%	15.0	63.0	2.5	19.5
MS INV F Global Balanced Income Fund	4% – 10%	15.0	63.0	2.5	19.5
MS INV F Global Balanced Fund	4% – 10%	15.5	62.5	2.5	19.5
MS INV F Global Balanced Defensive Fund	2% – 6%	9.0	76.5	1.0	13.5

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 INV F standards for Morgan Stanley Investment Funds.

1. Volatility targets are indicative ranges. There is no assurance that these targets will be attained.

GBaR team expansion

Over the next 12 months, Lead Portfolio Manager Andrew Harmstone will be increasing his time spent in Asia as we establish our local team presence in Singapore. Research analyst Eric Zhang already moved to the region in May and is looking to expand the team with the addition of another analyst focusing on Asia research. Whilst our core team remains in Europe, the team's expansion through our Asia base brings a number of benefits, including enhanced regional research and further trading capabilities for our global strategy, reflecting our commitment to continuously strengthen GBaR's capabilities for our clients.



RISK CONSIDERATIONS

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.

DEFINITIONS

Consumer Price Index (CPI) measures changes in the price level of a market basket of consumer goods and services purchased by households.

US Producer Price Index (PPI) measures the average change over time in the selling prices received by domestic producers for their output. The prices included are from the first commercial transaction for many products and some services.

U.S. Treasury Inflation-Protected Securities (TIPS) are the inflation-indexed bonds issued by the U.S. Treasury.

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