On the Markets

MICHAEL WILSON

Chief Investment Officer
Chief US Equity Strategist
Morgan Stanley & Co.

Modest Expectations

Last month, Morgan Stanley & Co. published global economic and market outlooks for 2020. To summarize, our outlook assumes a modest recovery in the global economy next year led by emerging market economies after what has been a rather meaningful and broad slowdown. We assume US GDP growth stabilizes near the third quarter level, or 1.8%.

With just modest GDP growth in the US and little slack in the labor market, profit margins will likely remain under pressure for the average US company. Operating leverage is already decidedly negative across a wide swath of companies and sectors based on the latest earnings reports. GDP growth of 1.8% combined with lower margins would result in little, if any, earning-per-share (EPS) growth in the US next year for the S&P 500. Smaller capitalization companies could see a second full year of negative EPS growth.

With the Federal Reserve on hold, our interest rates strategy team expects a relatively restrained outlook for the 10-year US Treasury yield next year in the 1.75%-2.0% range. This should translate into a more stable environment for equity valuations, a sharp contrast to what we experienced in 2018, when they slid, or 2019, when they jumped. That means 2020 will likely come down to finding companies with reasonable valuations that can surprise to the upside on earnings. In other words, we see a return to good, old-fashioned stock-picking as opposed to trading big moves in the indexes, the more rewarding strategy of the past two years.

This dynamic also leads us to international equity markets, where both economic and earnings growth look better than the US and valuations are cheaper. Our preferences also reflect another important theme we have been espousing since early 2016—global reflation. This theme was originally based on multiple drivers—synchronous global growth and monetary policy, a weaker US dollar and a rise in populism. After a robust 2016 and 2017, the theme took a break as global growth slowed. While it's possible that this past summer was the end of the pause in the global reflation narrative and global reflation is back, we think asset markets are responding more to the massive central bank balance sheet expansion.

Global reflation remains a powerful longer-term theme to consider for one's portfolio allocations, one that we have positioned for in our recommendations since 2016. However, the multiyear consolidation of this theme could persist until the global economy bottoms definitively and we have more evidence that the margin pressures and trade tensions are truly abating. Therefore, stick with the reflation theme with outsized allocations to international equities and US value stocks but look to add only on pullbacks rather than chase performance. ■

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Sequencing the Cycle

ANDREW SHEETS

Chief Cross-Asset Strategist
Morgan Stanley & Co.

At first glance, the 2020 investment outlook looks easy. Our economists expect global growth to bottom in the current quarter and improve thereafter. Such a move suggests that US and global purchasing managers indexes (PMIs) will soon inflect upward, and such moves usually boost equity and credit returns (see chart). Simple, easy, no more to see here—but even so, we see three reasons why next year defies such a simple characterization:

●Relative to past PMI and growth inflections, current valuations are unusually high while the rebound we forecast is unusually weak.

●This recovery varies widely in magnitude and timing: An uneven recovery will collide with uneven valuations. US risk assets are too expensive for the modest pickup we forecast, while rest-of-the-world assets are cheaper with a larger cyclical impulse.

●This recovery also rests on a knife's edge. The enactment of tariffs this month, which is not our base case, could be enough to push our global economic forecasts to near global recession.

PROCEED WITH CAUTION. The differences between the timing of the recovery and cross-asset valuations suggest that sequencing the cycle is our key 2020 theme. This means being more aggressive in better-valued markets, which we think are now early-cycle with growth set to improve most, and being more defensive in expensive markets, where we see modest or even no improvement in fundamentals. Plus, this outlook could be changed materially by spur-of-the-moment tariff decisions.

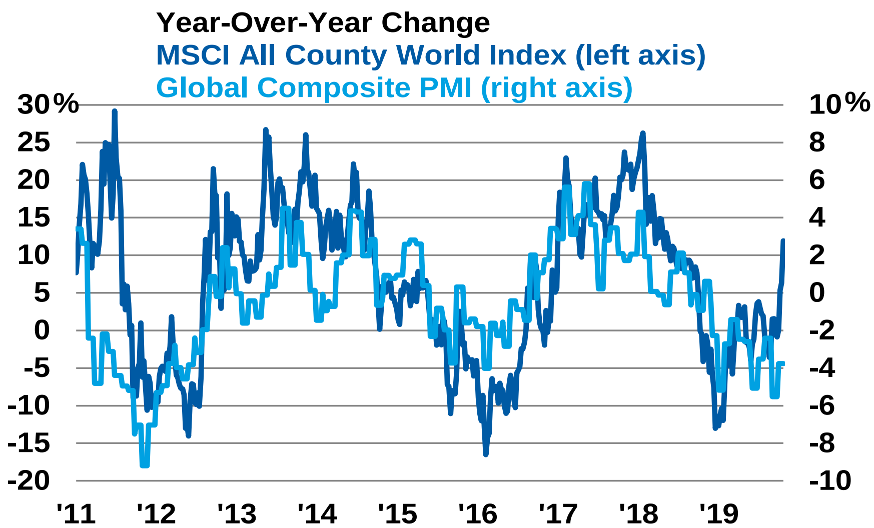
In forecasting 2020, we recall 2019's challenges. In November 2018, we were neutral equities and bonds, underweight credit and overweight cash. Our caution was based on concern that growth would slow and our cycle indicators would turn.

CENTRAL BANK POLICIES. Growth slowed and our indicators turned, but we underestimated three things: the aggressiveness of the central bank response; the decline in inflation both in the developed markets and the emerging markets that would make this possible; and the willingness of investors to pay much higher multiples even as global earnings growth turned downward. With valuations much higher entering 2020—and expectations for no further action from the Federal Reserve, the European Central Bank or the Bank of Japan—we are skeptical that central banks can pull off the same trick twice.

Growth also slowed differently than we expected. We thought the US would decelerate more; instead, the rest of the world did. This drove modest US dollar strength instead of our expectation of weakness, but with the rest of the world's growth having slowed more in 2019, it now enjoys a much lower bar to do relatively better.

SUMMING UP. By asset class, we prefer non-US equities relative to US, choosing to focus on where valuations are reasonable and 2020 earnings expectations are achievable (see page 6). In particular, we favor equities in Korea, Japan, Brazil, the UK and Spain. We expect value-style stocks to outperform the growth stocks for different reasons in different regions. As for interest rates, we see US yields kept range-bound by the muted economy and election-year uncertainty. In contrast, yields in the UK and Germany should rise as global growth and political uncertainty recedes, and those forces are apt to work against the US dollar. Better growth abroad also favors corporate credit in Europe versus the US. As for commodities, we see oil remaining around $60 a barrel, and soft demand and limited inflation capping most markets. In short, there's too much of everything. ■

Global Equities Discount an Upturn in Global Growth



Source: Markit, national sources, IMF, Morgan Stanley & Co. Research as of Nov. 17, 2019

The Late-Cycle Expansion Extends

CHETAN AHYA

Chief Economist and Global Head of Economics
Morgan Stanley & Co.

In our framework, trade and monetary policy are the key determinants of swings in the global economy. Since early 2018, trade tensions have persistently escalated. The resulting drag on global corporate confidence and capital spending drove down global growth to an estimated annualized GDP of 2.9% in the current quarter from a peak of 4.1% in 2018's first quarter. While economic sluggishness did trigger a monetary policy response early last year, the initial pace of easing was hesitant and its effectiveness was dampened by ongoing trade tensions.

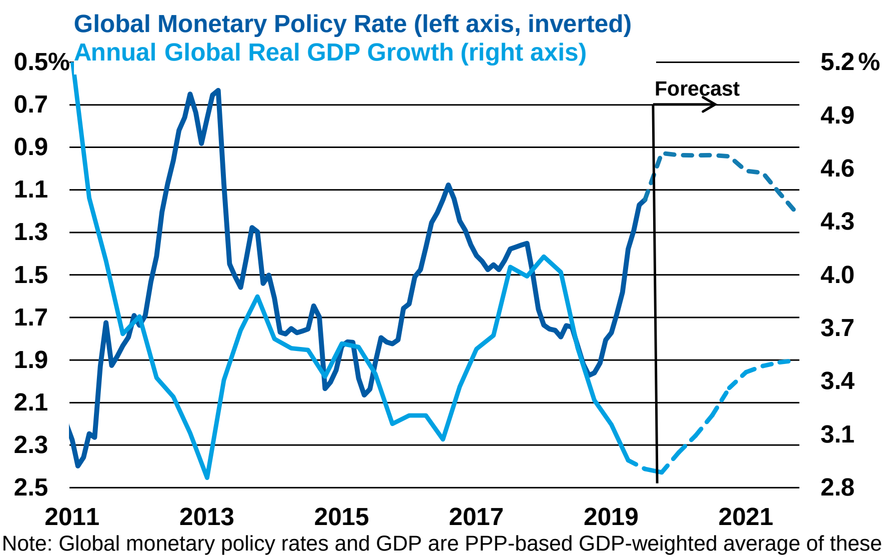
Now, while our framework hasn't changed, the inputs have. First, renewed US-China talks have staved off further tariff increases. The overall tone of the discussions has remained broadly constructive, and we think that a "phase one" deal could be signed, which would further reduce the risks of increased tariffs. Second, central banks around the world picked up the pace of easing since the third quarter (see chart). What's more, 20 central banks have eased monetary policy during the past 12 months. We expect additional easing, with the global weighted-average policy rate touching a seven-year low by March 2020.

More importantly, for the first time in seven quarters, trade tensions and monetary policy are easing simultaneously. Throughout 2018, tighter policy and escalating trade tensions both weighed on growth, and even though monetary policy began to ease early last year, it was offset by rising trade tensions. Today, these two forces are reinforcing each other and supporting the global economy. We expect consumption growth to be supported by healthy household balance sheets, moderate wage growth and, in the developed markets, still-low unemployment. As consumption growth improves, the corporate sector will likely think about maintenance capital spending, at a minimum to feed domestic demand. After end-demand turns up and utilization ratios start to rise again, we expect a relatively modest improvement in capital spending from the second quarter on, as the magnitude of the recovery will be constrained by lingering uncertainties.

For 2020, we see global average GDP growth at 3.2% versus 2019's 3.0% (see table, page 4). We expect a recovery in the first quarter to gradually gain momentum, reaching 3.4% by the fourth quarter versus the current quarter's 2.9%. That's the result of a strong pickup in the emerging markets—4.7% by 2020's final quarter versus 3.8% in the current quarter—and more gradual growth in the developed markets. In our estimates, the US economy, with an estimated 1.8% GDP growth, outperforms the G10. Among the emerging markets, we expect China GDP to weigh in at 6.1% in the fourth quarter compared with 5.9% in the current quarter; similarly, India could have a 6.6% fourth quarter versus the current 4.8%.

Now, let's look at the other highlights.

Easing Helps to Support a Recovery in Global Growth



Note: Global monetary policy rates and GDP are PPP-based GDP-weighted average of these variables for economies under MS & Co. coverage.
Source: Haver Analytics, CEIC, national sources and MS & Co. Research as of Nov. 17, 2019

Developed Markets Improve Gradually

In the US, we expect growth to stabilize around trend in 2020, as lower rates help to offset fading fiscal support (see page 5). In the Euro Zone, growth picks up gradually during the course of the year as external headwinds ease and the impact of policy stimulus kicks in. We expect only a modest recovery in the Euro Zone as the magnitude of easing has been limited and its effectiveness constrained. In Japan, we expect growth to remain relatively sluggish with the consumption-tax hike weighing on activity despite the uptick in construction spending around the Tokyo 2020 Olympics. In the UK, we expect an orderly Brexit resolution and fiscal easing to drive an improvement in growth.

A Stronger Pickup in Emerging Markets

In China, an easing of trade tensions should lift corporate sentiment, and continued policy support will help to drive a recovery in growth. In emerging markets outside China, macro stability has given central banks room to ease monetary policy, which helps to support a recovery in growth. In India, the improvement in the health of the financial sector should reduce risk aversion and, coupled with continued policy reforms, drive an improvement in domestic demand. Similarly, in Brazil, lower interest rates could help boost consumer demand and the passage of pension reform should bolster sentiment in the corporate sector. In Russia, an acceleration in infrastructure spending, supported by fiscal easing, lifts growth higher in 2020.

Modest Rise in Inflationary Pressures

A modest recovery in growth also brings about a modest uptick in inflation. In the developed markets, core inflation moves up to an annualized 2.0% in the US in the second quarter, but moves sideways for the rest of the year. However, for the Euro Zone and Japan, we are expecting inflation to rise gradually but remain below their respective central banks' targets in the 2020-2021 period. For the emerging markets, the majority of the economies have kept macro stability risks in check, and thus inflationary pressures have been well contained. We expect this to continue into 2020, with inflation staying close to the respective central banks' target ranges. In the near term for China, higher food prices lead to elevated headline CPI in 2020's first half, but we expect this to reverse in the second half of the year.

Morgan Stanley & Co. Real GDP Forecasts

	2019E	2020E			2021E			2022-2024E
	Base	Bear	Base	Bull	Bear	Base	Bull	Base
Global	**3.0%**	**2.0%**	**3.2%**	**3.9%**	**2.1%**	**3.5%**	**4.3%**	**3.3%**
G10	**1.7**	**0.1**	**1.3**	**1.9**	**0.1**	**1.5**	**2.4**	**1.1**
US	2.3	0.3	1.8	2.4	-0.2	1.9	2.8	1.1
Euro Zone	1.2	-0.3	0.9	1.6	0.3	1.2	1.9	0.6
Japan	0.9	-0.6	0.0	0.5	-0.2	0.7	1.2	1.0
UK	1.2	0.3	1.4	1.9	1.3	2.0	2.6	1.2
Emerging Markets	**3.9**	**3.2**	**4.4**	**5.1**	**3.5**	**4.7**	**5.5**	**4.6**
China	6.1	5.3	6.0	6.4	5.1	5.9	6.3	5.2
India	5.0	5.3	6.3	7.0	5.8	6.8	7.5	7.2
Brazil	0.8	1.3	2.2	3.4	1.5	3.1	3.8	2.2
Russia	1.2	0.2	1.7	3.0	0.2	2.0	3.5	1.8

Note: The above aggregates are weighted by purchasing power parity.
Source: Bloomberg, IMF, Morgan Stanley & Co. Research as of Nov. 17, 2019

More Easing Expected in Emerging Markets

Twenty of the 32 central banks we cover have already eased monetary policy in 2019. Looking into 2020, monetary policy will remain accommodative, and we expect 13 central banks to ease further, bringing the global weighted-average policy rates to a seven-year low by March 2020. These rate cuts that we expect are concentrated in the emerging markets, with the central banks in India, Brazil and Russia trimming rates once more to take nominal policy rates in these countries to either a historical or a postcrisis low. In the developed markets, the Federal Reserve, European Central Bank and the Bank of Japan should stay on hold throughout 2020, while we expect one rate hike by the Bank of England late next year. ■

"Insurance" Cuts Pay Off

ELLEN ZENTNER

Chief US Economist
Morgan Stanley & Co.

The Federal Reserve's promise and delivery of interest rate cuts as "insurance" have paid off. In our view, lower interest rates will continue to support the economy in 2020, which helps to counteract less support from fiscal policy. Exports and business investment should rise from very low levels on the back of an improvement in global growth.

These factors are enough to stabilize the slowdown in growth. Our base-case GDP forecast is 1.8%, down from an estimated 2.3% for 2019 (see table). Even with slower growth, we see higher headline and core inflation. In our outlook, the unemployment rate falls to 3.2% from this year's estimated 3.5%. The Fed remains on hold to allow inflationary pressures to build from an ever-tightening labor market.

We think consumers, the largest part of the economy, will put in an average year. We see low rates as supportive, but the impulse from the 2019 cuts has largely been absorbed. A healthy labor market continues to drive wage gains, which affects most US households. Rising after-tax income continues to outpace rising debt, increasing the cushion of savings.

CONSTRAINED GAINS. Our equity strategists expect further gains in financial asset wealth to be constrained, keeping a lid on the wealth effect and, therefore, spending among high-income households. Heightened uncertainty on trade policy, which in turn has driven stock market volatility at times, has weighed on confidence broadly. Should layoffs begin to rise, a cutback in consumer spending would closely follow.

We expect business investment to make a tepid comeback next year, thanks to a better balance of inventories and stronger global growth. The manufacturing slowdown thus far is tracking prior slowdowns that did not end in recession.

SLOWER JOB GROWTH. Net job gains in the private sector should continue to slow, which is to be expected this late in the business cycle. Even so, the gains should be enough to keep the unemployment rate mildly under pressure, in turn exerting upward pressure on private sector hourly wages. One catalyst to watch: 2020 is the year of the decennial US census, which means the federal government will hire several hundred thousand temporary workers as it ramps up from January through May, then shed those workers into the fall. We expect the flow of these workers to support personal income, spending and saving in the first half relative to the second half.

HIGHER INFLATION. Inflation is supported by a better global growth backdrop, but the dominant effect in our forecast is slack. We estimate that a tighter labor market will boost inflation. Notable downside risks to inflation would come from a stronger dollar and lower energy prices than expected, as well as an unknown schedule for methodological changes from the Bureau of Labor Statistics.

Our policy view remains unchanged: The Fed has moved into an extended hold, waiting for core PCE inflation to move convincingly above 2.0% and with inflation expectations strongly anchored at 2.0%. Only after core PCE has reached 2.5% do we pencil in two hikes—and that's in the back half of 2021.

FISCAL SUPPORT. In 2020, fiscal support remains positive, but the GDP contribution from government slides to 0.3 percentage points from 0.5 percentage points. A predetermined spending cap means there isn't much uncertainty around fiscal support, at least through 2020. We believe that the first chance for stimulus would come in 2021—and that, of course, depends on the electoral outcome. ■

Morgan Stanley & Co. US Economic Forecast

	2018	2019E	2020E	2021E
Real GDP (% annual)	**2.9**	**2.3**	**1.8**	**1.9**
Private consumption	3.0	2.6	2.4	2.4
Government consumption	1.7	2.4	2.2	1.2
Gross fixed investment	4.6	1.4	1.2	1.8
GDP contribution (percentage points)				
Final domestic demand	3.1	2.4	2.3	2.1
Net exports	-0.3	-0.2	-0.3	-0.2
Unemployment rate* (% annual)	3.8	3.5	3.2	3.1
Consumer Price Index (% annual)	2.4	1.8	2.4	3.1
Core PCE** (% annual)	1.9	1.6	2.0	2.4
Policy rate*	2.375%	1.625%	1.625%	2.125%
General govt. balance (% GDP)	-4.2	-4.6	-4.6	-4.4
Gross govt. debt (% GDP)	106.1	107.2	107.5	107.2
Current account balance (% GDP)	-2.4	-2.4	-2.5	-2.5

*End of period **Personal Consumption Expenditure Index
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, MS & Co. Research as of Nov. 17, 2019

A Preference for Value and The Rest of the World

MICHAEL WILSON
Chief Investment Officer
Chief US Equity Strategist
Morgan Stanley & Co.

GRAHAM SECKER
Head of European and UK Equity Strategy
Morgan Stanley & Co International plc+

JONATHAN GARNER
Chief Asia and Emerging Markets Strategist
Morgan Stanley Asia Limited

The path for global GDP growth may look better next year, but our economists project that the rebound is only to modest levels of economic growth that, in many cases, are still below trend. With many valuations across major equity markets already having rebounded to slightly above five-year averages, we don't think it prudent to rely on more expansion of the price/earnings (P/E) multiple to drive stocks higher in what is still a fairly tepid growth environment. This means that forward returns at this point need to be driven by a realization of the earnings growth that is already in the price.

An outlook that hinges on easing trade tensions, monetary easing and stabilization of growth at a low rate embeds a high degree of uncertainty. Our bull, bear and base cases reflect this concern. Generally, the ranges are widest for Europe and the emerging markets—both regions with significant exposure to the global growth environment and trade tensions—where our regional strategy teams think that valuations could see large volatility across different scenarios. The range of outcomes looks a bit narrower for Japan and the US. In Japan, we expect positive structural trends like improving governance, higher return on equity and return of capital to help to support the multiple in a downside scenario. In our view, the US benefits from lower interest rates and flows to a more defensive equity index in the case where global growth disappoints.

RELATIVE EARNINGS GROWTH. Relative earnings growth is a core component of our relative preferences across equity regions. We showed earlier that, in the absence of material changes to multiples, earnings growth is the principal driver behind our regional price targets and the relative up/downside (see table).

Morgan Stanley & Co.'s 2020 Equity Market Targets

Index	Current Price	New Price Target/ Change From Current Price		
		Bull	Base	Bear
S&P 500	3,141	3,250	3,000	2,750
		4%	-5%	-12%
MSCI Europe	1,659	2,030	1,720	1,280
		22%	4%	-23%
TOPIX	1,699	2,050	1,860	1,375
		21%	9%	-19%
MSCI Emerging Markets	1,040	1,250	1,150	800
		20%	11%	-23%

Source: FactSet, Morgan Stanley & Co. Research as of Nov. 29, 2019

Following the end of the last postcrisis mini cycle, earnings grew at a robust rate across all major equity indexes. From the start of 2017 on, earnings among the various global equity indexes failed to keep pace with the S&P 500, which was fueled by tax cuts and their impact on the economy. Forward earnings expectations across the emerging markets, Europe and Japan have all actually fallen during the past two years, while earnings estimates for the US have continued to rise.

Now, we think that a mix of easier comparisons, better ex US global growth relative to US growth, monetary easing, a weaker dollar and easing of trade tensions are all contributing to a dramatic shift in the rate of change in earnings growth across global equities. The US forward 12-month earnings numbers have begun to stagnate and even turn a bit lower, while the emerging markets, Europe and Japan all look to be bottoming (see chart, page 7). In the US, we expect earnings to remain under pressure as profit margins continue to get squeezed. The forecasts from our economics team, which include slow growth and accelerating wage gains, are likely to amplify these pressures and weigh on the outlook for earnings further, which should translate into better earnings growth outside the US.

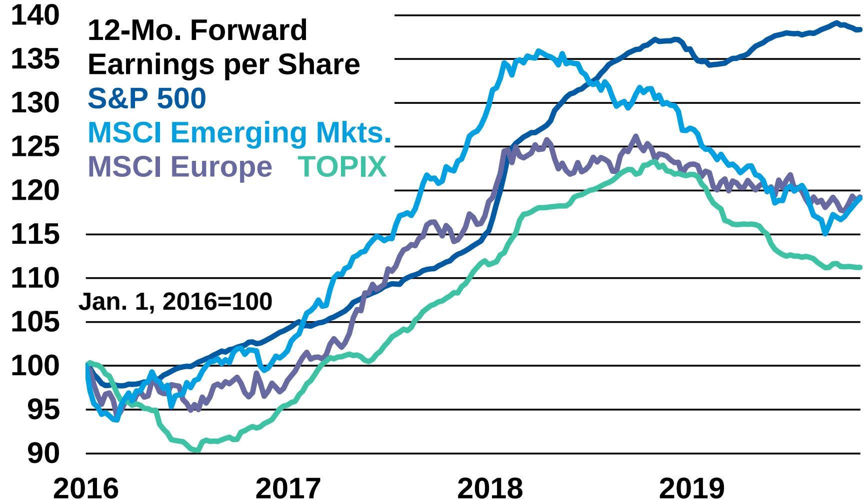
PREMIUM MULTIPLE. On a relative basis, the US also has the least room for multiple expansion. The US generally trades at a premium multiple to global equities, but even relative to its own history this premium looks to be at the high end, meaning that it most likely will not appreciate further and may even fall on a relative basis. We believe that if our economic and earnings forecast comes to pass, the US' relative premium will decline as investors move to non-US markets with better growth prospects. On this basis, Europe looks cheapest versus its own history, which is why we feel comfortable giving it some credit for a higher multiple in our base-case targets.

While the emerging markets appear marginally elevated relative to their own history on this metric, our base case actually embeds some multiple contraction. This allows for potential upside if better growth helps to support the modestly elevated relative multiple.

We continue to prefer value-style equities to the growth style, but for different reasons across regions. Outside the US, our preference for value has more of a cyclical tilt, given the relative improvement in global growth and trade embedded in our house forecasts. For the emerging markets, this means rotating away from yield plays and toward global cyclicals like autos, capital goods and tech hardware. In Europe, our team likes autos, banks and mining companies as a play on rising yields outside the US. In the US, where we forecast the smallest cyclical inflection, we are looking more for the continued underperformance of growth stocks rather than the outperformance of value stocks. In an environment where growth picks up modestly, we think that the defensive/quality premium built into growth stocks should recede and, in an environment where economic growth disappoints, we think that further reductions in business spending will begin to press on the earnings of the parts of the growth complex that have been treated as noncyclical, such as software.

TRADE TENSIONS. We are not incorporating a full de-escalation of trade tensions in our house outlook, but we do assume that there is no material upswing in trade disputes and tariffs. The assumption allows our economists to embed forecasts of higher confidence, a resumption of business investment, inflecting global trade and, therefore, better global growth. In turn, this allows us to assume higher earnings and that multiples on equity indexes can remain around current levels in the coming year.

Forward Earnings Outside the US Are Turning Up, While US Estimates Are Likely to Fall



Source: FactSet, MS & Co. Research as of Nov. 17, 2019

If we are wrong about trade, many of these core assumptions may be challenged, and we suspect that equity markets globally would trade somewhere closer to our bear cases than our current base cases. That's because earnings estimates would need to be marked down and a higher equity risk premium demanded by investors will lower multiples. Without knowing the exact form or timing of increased trade friction, we're hesitant to make a precise forecast other than to say that the scenario is closer to our bear case, and our relative preference for the emerging markets versus the US will likely be challenged. ■

Investing for Dividends—Growth Tops Yield

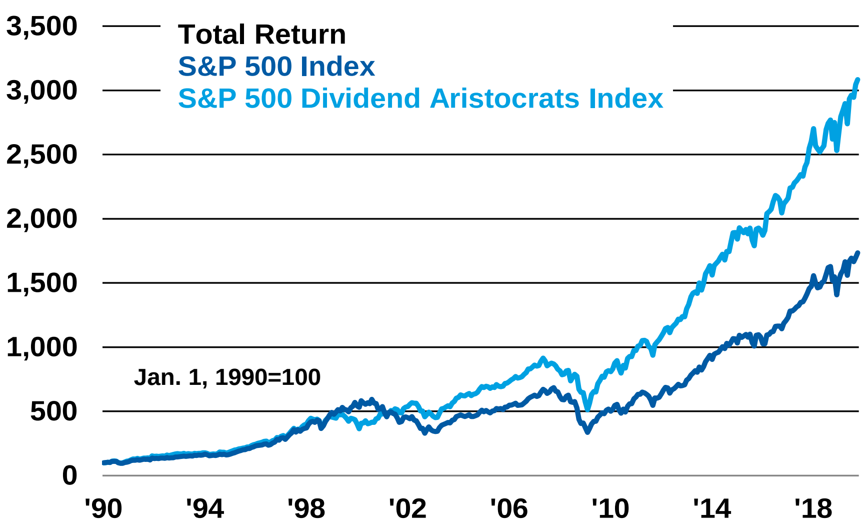
DANIEL SKELLY
Senior Equity Strategist
Morgan Stanley Wealth Management
KEVIN DEMERS, CFA
Equity Strategist
Morgan Stanley Wealth Management

Interest rates have declined sharply during the past 12 months as bonds priced in a slowing global economy and increasingly dovish monetary policy; after peaking at 3.25% in November 2018, the 10-year US Treasury yield currently sits at 1.76%. "Bond proxies," or high-dividend stocks, have benefitted from this combination of lower growth and interest rates. Of note, the utilities and real estate sectors have rallied 20% this year. Looking at the past 10 years, this puts both sectors in the top quintile of annual performance—with still a month to go.

This outperformance has put income-oriented equity investors in a difficult position. With valuations currently near peak levels in many high-dividend sectors, the risk/reward looks less attractive. An additional headwind to these stocks into next year is the possibility of a pickup in global growth. Morgan Stanley & Co. economists expect a recovery as soon as the first quarter of 2020 as trade tensions ease and continued easy money policy supports growth. If this plays out, inflation and real interest rates could pick up, which in turn could trigger reversal of high-dividend stocks' outperformance. In a potentially reflationary scenario, we favor "dividend growth."

Besides the tactical case for dividend growth, this factor also has been effective over the long term (see chart). Since 1990, the S&P 500 Dividend Aristocrats Index—comprising companies that have raised dividends consistently for 25 or more years—has produced a 12.0% annualized total return versus the S&P 500 Index's 10.0%. In addition, we see that the dividend growth factor has cushioned the downside; since 1990 the maximum monthly drawdown for the Aristocrats has been -13% versus the S&P 500's -17%; both occurred in 2008.

Dividend Growth Has Been an Effective Strategy



Source: Bloomberg as of Oct. 31, 2019

In the current environment, we note three sectors where we find dividend growth traits. Notably (and ironically) all of these sectors are considered more "value oriented" and have generally lagged the growth/defensive parts of the market. However, we could see improved performance if a rotation to value materializes in 2020. That's the expectation of Michael Wilson, MS & Co.'s chief investment officer and chief US equity strategist.

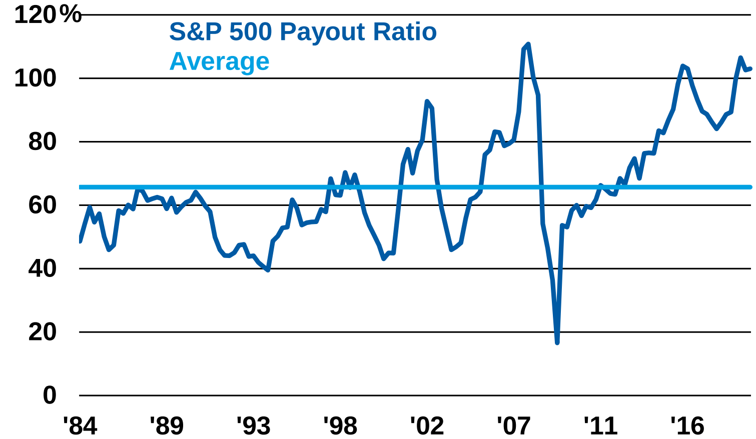
Financials. Rising interest rates would typically be a headwind for dividend stocks, but not banks. As rates rise, so does net interest income, a contributor to earnings. Additionally, given increased regulation since the financial crisis, banks have built up plenty of excess capital, which may be used for share repurchases. With a 3% average dividend yield and a 27% five-year dividend growth rate, we see banks as a compelling source of income.

Industrials. The industrial sector has been hit by negative sentiment, largely driven by falling purchasing manager indexes and uncertainty about trade. This has capped valuations, currently at 16.5 times consensus fiscal year 2020 earnings per share, a 5% discount to the market. Consider industries such as building products and machinery, which have an average yield of 1.7% and a five-year 11% compound annual growth rate (CAGR).

Health Care. With limited cyclical drivers, the health care sector provides both defensive and growth characteristics. Valuations are currently depressed due to political, not fundamental, reasons. However, as candidate policy stances firm up, we think that the political discount should subside. In this sector, look to managed care and pharmaceutical stocks, which provide a unique combination of attractive valuation and growth, offering an average yield of 1.9% and a 9.0% five-year annualized earnings growth rate. ■

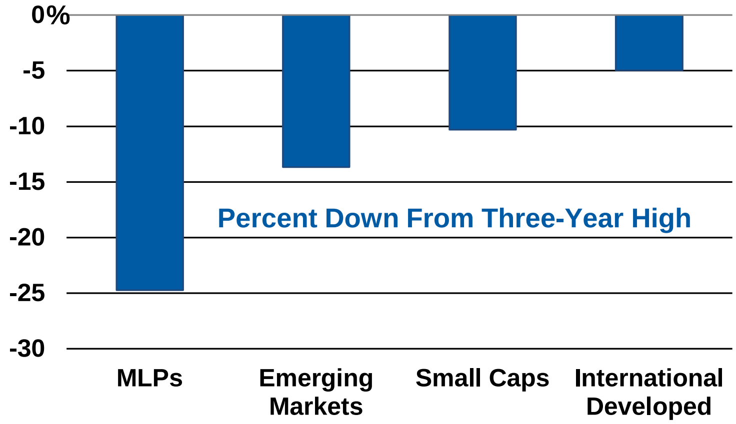
S&P 500 Payout Ratio Climbs to a Likely Unsustainable Level

Headline earnings growth for the S&P 500 is expected to be flat to slightly positive for 2019. However, even this modest achievement would not have been possible without a major contribution from corporate stock repurchases; by reducing the number of shares, buybacks effectively increase reported earnings per share (EPS). Corporate buyback activity in the US has expanded rapidly over the past decade and is now near an all-time high. Looking at shareholder return, a more comprehensive measure that considers both dividends and share repurchases, the largest US companies are currently paying out more than 100% of their earnings as dividends or buybacks. The S&P 500's total payout ratio has rarely reached 100% in the past 30-plus years, and it has never stayed there for long (see chart). In our view, the current excessive buyback activity is unsustainable—and a reason to question the achievability of 2020 consensus EPS estimates.
—*Spencer Cavallo*



Source: S&P, Morgan Stanley & Co. Research as of Sept. 30, 2019

For Tax-Loss Harvesting, 2019 Delivered a Poor Crop

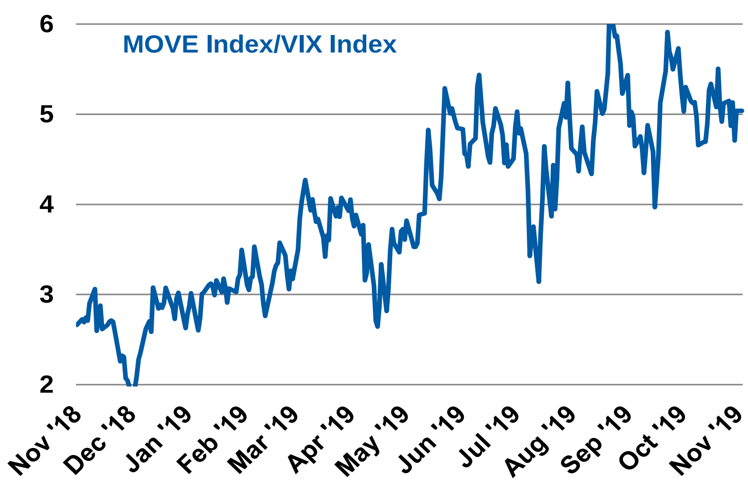


Source: Bloomberg as of Nov. 22, 2019

'Tis the season when investments that have not done well during the year often do even worse as investors seek tax-loss swaps. They sell losers for tax losses and replace them with investments with similar objectives (but not too similar, lest they violate the IRS' wash-sale provisions). This year, thanks to strong gains in both equity and fixed income markets, opportunities for tax losses in exchange-traded funds and closed-end funds are few. Energy-related funds, including those holding master limited partnerships, could be candidates (see page 10). They're down 25% from their three-year high (see chart). Other candidates for tax selling are in small-cap stocks and non-US equities, both emerging and developed markets. The Global Investment Committee prefers non-US equities to US equities going forward, so taking a loss and reestablishing a position may be a good move. In fixed income, senior loan funds could face year-end selling pressure.
—*Gray Perkins*

Bond Investors Are Much More Skittish Than the Stock Market Crowd

Both the stock and bond markets have made noteworthy gains this year, but perhaps not for the same reason. The bond market may be signaling a recession, yet the S&P 500 Index is at a record high, which suggests investor optimism about the near future. Similarly, there has been a divergence between the MOVE Index, which tracks the volatility of US Treasury yields, and the VIX Index, which measures the stock market's volatility (see chart). The MOVE Index has crept up over the past 12 months while the VIX has remained largely subdued, and the ratio between the two has reached extreme levels. Clearly, the current level of systematic risk—built around trade tensions, economic growth and political uncertainty—worries bond investors more than it does equity investors. Historically, sovereign bond investors have been more sensitive to economic growth as it affects inflation and monetary policy, which calls for caution for the equity market.—*Aili Chen*



Source: Bloomberg as of Nov. 25, 2019

MLPs/Midstream—Waiting For the Tide to Turn

VIJAY CHANDAR

Market Strategist
Morgan Stanley Wealth Management

Indexes that track master limited partnerships (MLPs) and energy infrastructure have been testing and, in some cases, breaking below their 2016 lows. Investors are right to question if industry conditions are worsening. We believe the fundamental backdrop in 2019 is significantly better than in 2015-2016. The most important "fundamental" for the midstream industry is oil and natural gas production volume, which is at an all-time high (see chart). As the US is set to produce more oil and gas, it needs more infrastructure to move it and process it.

IMPROVED CASH FLOW. Strong volume growth translates to industry cash flows. In 2018, per-share earnings before taxes, interest, depreciation and amortization (EBITDA) for the Alerian MLP Infrastructure Index grew 12% and 2019 growth is on track for a 9% gain. Mid-single-digit growth is also forecast for 2020-2021. In contrast, per-share EBITDA declined more than 20% in 2015-2016. Industry leverage, as measured by net debt to EBITDA, is down about 15% from its peak, leaving balance sheets much improved. Companies also largely have shifted away from funding capital spending with equity issuance, reducing their reliance on favorable capital market conditions. While equity markets paint a bleak picture, debt markets are more sanguine. Credit spreads in the midstream sector have been stable all year and remain near their tightest levels of the cycle.

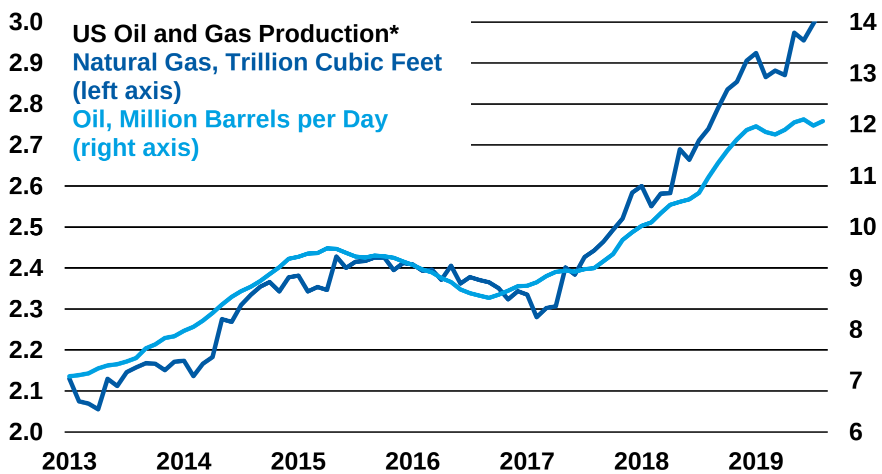
Valuations are rivalling their lowest since 2009. The Alerian MLP Infrastructure Index trades at just 9.2 enterprise value/forward EBITDA estimates, in line with the postcrisis lows of 8.5 in 2016 and 9.0 in 2018. (Enterprise value is the market capitalization of a company plus its long-term debt and short-term debt, minus cash on the balance sheet.) Current valuations are more than 10% below their historical average. On a distribution basis, the sector also looks inexpensive. For the Alerian Midstream Energy Index (AMEI), the distribution yield is 7.5%, near a 10-year high. On a relative basis, yield spread versus the 10-year US Treasury is also near its highest level in recent history.

DISTRIBUTION GROWTH. Importantly, the Alerian MLP Infrastructure Index is poised to deliver distribution growth in 2019, ending a five-year streak of cutting payouts—and this growth is also forecast to continue in 2020 and 2021. Historically, MLP prices have generally moved in concert with distributions; when distributions are growing, MLPs have traded well, and we believe the industry is returning to sustainable distribution growth. Importantly, the US midstream "majors"—the 10 largest US-listed midstream companies by market capitalization—all have maintained or raised their distributions in 2019, with average distribution growth for the year coming in at 10.2%. While there may be funding pressure or distribution risk in some smaller companies, we believe the majors are largely well positioned to maintain and increase their distributions.

In all, we believe price action has disconnected from fundamentals. Balance sheets are in better shape, commodity trends have been favorable and cash flow and distributions are growing again. That said, the sector is "cheap without a catalyst," and with potential technical pressures on the horizon, volatility should be expected to remain high. We would focus on larger-cap holdings and stress that investors should adopt a flexible mandate to investing in energy infrastructure, given shifting industry dynamics. ■

This article is an excerpt from the Special Report, "MLPs/Midstream—Waiting for the Tide to Turn," Nov. 15, 2019. For a copy of the report, please contact your Financial Advisor.

US Energy Production at New High and Still Growing



*Three-month moving average
Source: Bloomberg, Morgan Stanley & Co. as of Aug. 31, 2019

Upward Pressure on Bond Yields, But Not Too Much

MATTHEW HORNBACH

Global Head of Interest Rate Strategy
Morgan Stanley & Co.

Our economists expect the global economy to recover modestly in 2020, helped by both a détente in trade tensions and central bank easing. They expect global growth to recover from the first quarter of the year, to levels that are still subpar, driven by economies outside the US led by China and the emerging markets initially, followed by the Euro Zone. All told, that should put some upward pressure on government bond yields early in the year—but not too much.

Despite the more optimistic growth outlook, our economists still see downside risks, driven by three factors. First, while trade tensions between the US and China seem to have eased for now, uncertainties will linger. Second, in the event of another global shock, central banks have less room to respond. Third, while expansions don't die of old age, they become more sensitive to the challenges that come with age.

Here is how we view government bond markets:

US

We expect US Treasury yields to spend the first half of 2020 contending with higher yields in Europe, though we don't expect upward pressure on Treasury yields to last very long. We see the 10-year US Treasury yield trading around 2% as yields in Europe take flight (see table). Higher Treasury yields should help the yield curve remain steeper than its inverted state throughout the middle of 2019.

The presidential election will highlight the second half (see page 12). Expectations for policies that might result from the election will affect how Treasury yields evolve, and polling may influence investors. In addition, uncertainty about election outcomes, policy priorities and policy paths will loom over businesses, consumers and investors alike, and may subdue economic activity or prevent a robust increase in demand. In 2020's second half, we think that the 10-year US Treasury yield will revisit 1.75%—the middle of the 1.5%-to-2.0% range that took hold in the second half of this year.

UK

We foresee gilt yields rising due to the combination of greater clarity about Brexit and substantial fiscal easing. We expect the Bank of England's Monetary Policy Committee (MPC) to move toward a rate hike in the second half of 2020. At its November 2019 meeting, the MPC voted 7-2 to keep interest rates unchanged, with two members voting for a rate cut. However, our economists believe that the outcome of the meeting was more hawkish than the vote would imply. Current MPC forecasts do not include the additional fiscal easing our economists expect next year, meaning that current estimates for 2020 growth and inflation, as well as potential UK gilt supply, may be too low.

Euro Zone

We expect a rise in longer-maturity German Bund yields, consistent with our economists' expectation for a modest rebound in Euro Zone growth and inflation. In our view, the probability of higher yields in the two-year and five-year maturities remains fairly low and any increase in yields will be in the 10-year and 30-year Bunds. The European Central Bank has made it clear that becoming more hawkish will require a prolonged period of targeting above-trend inflation. We see this environment as consistent with stable front-end yields and higher long-end yields.

Japan

The Bank of Japan (BOJ) left open the possibility of further rate cuts by tweaking its forward guidance in October. Hence, we expect the market to price in possible rate cuts. We expect short-end yields to remain anchored around -0.20% next year, and see Japanese government bond (JGB) yields moving in that neighborhood into the first half of 2020. Then, we see yields moving lower in the second half as strong demand for long-end JGBs emerges. We don't see the BOJ changing its policy framework in order to prevent lower long-end yields. ■

Morgan Stanley & Co. Sovereign Bond Yield Forecasts

Maturity	Two-Yr.		Five-Yr.		10-Yr.		30-Yr.	
Country	2Q '20	4Q '20	2Q '20	4Q '20	2Q '20	4Q '20	2Q '20	4Q '20
US	1.65%	1.55%	1.80%	1.60%	2.00%	1.75%	2.50%	2.25%
Germany	-0.60	-0.55	-0.50	-0.45	0.10	0.15	0.70	0.80
Japan	-0.20	-0.28	-0.23	-0.30	-0.13	-0.20	0.40	0.25
UK	0.75	0.85	0.90	1.00	1.25	1.40	1.85	2.00

Source: Morgan Stanley & Co. Research as of Nov. 17, 2019

An Early Guide to the US Election

MICHAEL D. ZEZAS, CFA
Strategist
Morgan Stanley & Co.

MARK T. SCHMIDT, CFA
Strategist
Morgan Stanley & Co.

MEREDITH M. PICKETT
Strategist
Morgan Stanley & Co.

Ten months out, we identify election scenarios, the policies we expect they put in play, and what's most exposed, both positively and negatively. Divided versus unified government is the key macro variable, with unified government a path to potential fiscal expansion. Yet, the impact on sectors varies by the party in control.

Investors agree: Elections have consequences. We surveyed 645 investors on their expectations for the investment impact of the 2020 election. Here are the conclusions: (1) Most expect the election to have a significant impact on the market for the next 12 months, with nine out of 10 expecting a moderate-to-significant impact; (2) Fiscal policy and tax changes are their top two concerns, and the election's impact on the business cycle may be more important than its impact on the most recent policy risk—trade policy. Investors see Democrats as de-escalating tariffs with China, which, in our view, would lift near-term growth expectations.

Even so, investors also are more likely to associate a Democratic victory with an equity market sell-off. Perhaps that's because investors see Democrats as less likely to pursue fiscal expansion. We think this could suggest investors' late-cycle concerns and the need to combat them with traditional countermeasures. These concerns are valid to us. The difference between Republicans and Democrats on key policy issues is stark.

Reactive is better than proactive. Investor expectations and market pricing appear at odds, making markets vulnerable to volatility on swings in the race for the White House. While investors expect outcomes could drive policy in meaningfully different ways, option markets are currently not pricing in meaningful policy changes. Options for the broad equity index, or technology and financial sectors, for example, are not incorporating potential pressure that our survey respondents expect from a Democratic victory. Current pricing suggests a trust in the status quo will continue, but it also means that small changes in the campaign narrative can potentially shake investors' outlooks and turn markets more volatile.

While it would be reasonable to deduce from our survey that moves toward a Democratic victory could initially weigh on risk markets, we wouldn't have confidence in the durability of such a reaction. The 2016 election serves as a cautionary tale. Then, survey respondents overwhelmingly identified a Trump victory with an equity market sell-off—and on election night 2016, that's what happened in the futures market, at least for a few hours. The subsequent risk asset rally is well known. In our view, investors realized that a unified Republican government was a path to tax-cut stimulus. Hence, we think investors must consider the total government outcome of the election, the policy path it drives and whether that path is reflected in the price in order to react appropriately to election-driven market volatility.

Expect policy ambitions to fall short in practice. While the policy ambitions of each party contrast in both direction and magnitude, that doesn't mean investors should assume those policies will actually be implemented if the party takes control of the White House. While we agree that elections have consequences, those consequences don't simply align with the campaign platform of the future president. Rather, postelection policy paths tend to conform more in direction than precision to a candidate's platform, as they are moderated and constrained by the composition of Congress. So while it is rational to investigate candidates' policy proposals, we wouldn't assume a high likelihood of implementation just because their sponsor wins the White House. History shows that in the first year in office, presidents typically can deliver legislatively on only about half of their campaign promises, even when their party controls Congress. Hence, a presidential candidate's campaign promises should be treated not as a "to do" list but as an indication of policy objectives.

What's more, when transformative legislation happens, it is likely to be more moderate. A study from Skopos Labs argues that, historically, legislation that is more likely to be enacted is typically sponsored by more moderate members of Congress. We think this pattern would carry forward, even under a unified government scenario. Consider, for example, that a unified Democratic government would likely have at least two senators from states that lean Republican, probably a sufficient number to ensure successful legislation will be moderated.

Building on observations of the electorate from 2016 and 2018, we establish four stylized scenarios for 2020 (see table, page 13): Thin Red Line (Republican President/Senate, Democratic House); Blue Tide (Democratic President/House, Republican Senate); Blue Wave (Democratic President, Senate/House); and Red Redux

Key Fundamental Exposures by Plausible Postelection Policy Path

	Scenarios	Potential Pressures +	Potential Pressures -
Divided Government	**Blue Tide** **D President** **R Senate** **D House**	Emerging Markets Energy (non-US oil and gas, renewables)	US Dollar Energy (US-focused oil and gas) Large-Cap Banks Consumer Finance IT Hardware US Internet Telecom Pharma
Divided Government	**Thin Red Line** **R President** **R Senate** **D House**	Large-Cap Banks Consumer Finance Telecom US Energy Asset Managers	US Dollar
Unified Government	**Blue Wave** **D President** **D Senate** **D House**	US GDP US Dollar Large Managed Care Organizations Transportation Energy (non-US oil and gas, renewables)	US Treasuries Pharma Large-Cap Banks Consumer Finance IT Hardware US Internet Telecom Energy (US-focused oil and gas) Asset Managers
Unified Government	**Red Redux** **R President** **R Senate** **R House**	US GDP US Dollar Telecom Financials US Energy Asset Managers	Emerging Markets US Treasuries

Source: Morgan Stanley & Co. Research as of Nov. 4, 2019

Republican President/Senate/House). For each, we have "plausible policy paths"—which policy proposals to take seriously under each scenario and which to ignore. To do so, we apply the above guidelines and substantiate our conclusions using the findings of a model built by Skopos Labs on the attributes of legislation that affect its likelihood of enactment.

Macro impact is more about unified versus divided than Republican versus Democrat. Divided government tends toward legislative gridlock and, though divided governments could still influence the outlook through regulatory reinterpretations and impact in business sentiment, they are unlikely to deliver transformative policy. Hence, divided government is unlikely to deliver policy that counteracts the current late-cycle economic conditions. A more surprising observation might be that we see some symmetry to the potential direction of the macro impact in both unified government scenarios. While far from assured, both open the possibility of fiscal expansion.

This appears to cut against electorate expectations, at least as it pertains to the Blue Wave. Our survey suggests investors see a Democratic White House as both less likely to pursue fiscal stimulus and more likely to coincide with weakness in risk assets. Perhaps it is because investors also see Democrats as more likely to pursue policies that will challenge profitability in sectors such as health care.

Yet our US economics team counters that this conclusion is not necessarily true, at least in the near term. A policy of net stimulus, even with tax increases, can be a directional positive for growth, depending on its composition. Hence, markets may reflect a reflation theme over time if a larger margin of victory for either side becomes more likely, though the sectors that would benefit most will differ based on the winning party.

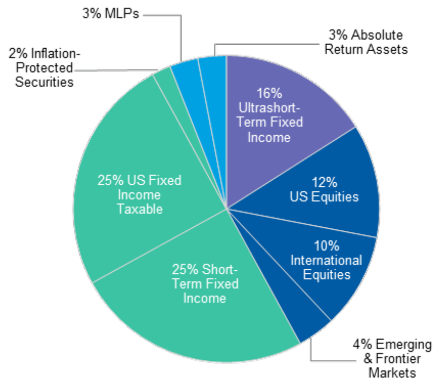
Sector impacts vary more in magnitude and direction across scenarios. While many of the existential legislation proposals that investors have expressed concerns about seem unlikely across our scenarios, more likely but less ambitious initiatives would still have a meaningful effect on fundamentals. That's in part due to regulatory changes that can be initiated by the president. While those changes typically take years to implement, we think it is fair to recognize the potential impact of such moves. While our table focuses on key fundamental exposures, sector analysts in their dedicated sections also focus on how scenarios can influence investor sentiment in the near term. Hence, in some cases the view of potential near-term market influences may be different from the view on the potential policy impact of a scenario. Health care is a good example of this, where concerns around Medicare-for-All could pressure stocks of health insurance companies, though we view that policy as unlikely even in a Democratic sweep. ■

The above is an excerpt from a Morgan Stanley & Co. US Public Policy Report, "2020 Vision: An Early Guide to the US Election," Nov. 4, 2019. For the report, please contact your Financial Advisor.

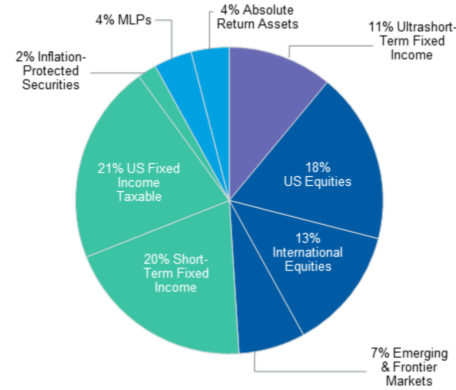
Global Investment Committee Tactical Asset Allocation

The Global Investment Committee provides guidance on asset allocation decisions through its various models. The five models below are recommended for investors with up to $25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return.

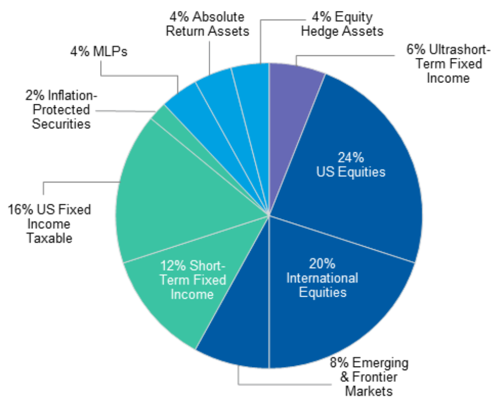
Wealth Conservation



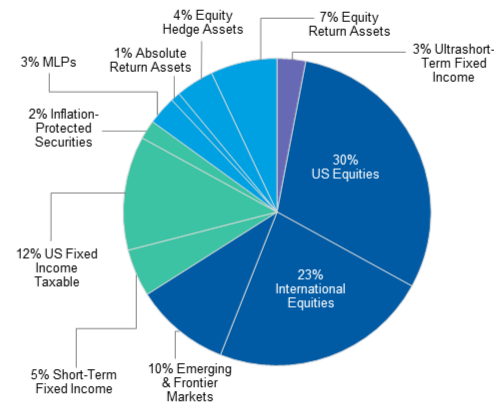
Income



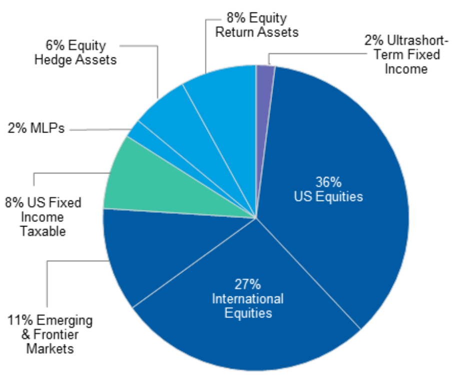
Balanced Growth



Market Growth



Opportunistic Growth



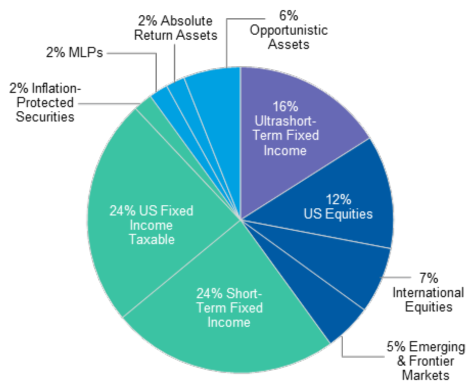
Key

- **Ultrashort-Term Fixed Income**
- **Fixed Income & Preferreds**
- **Equities**
- **Alternatives**

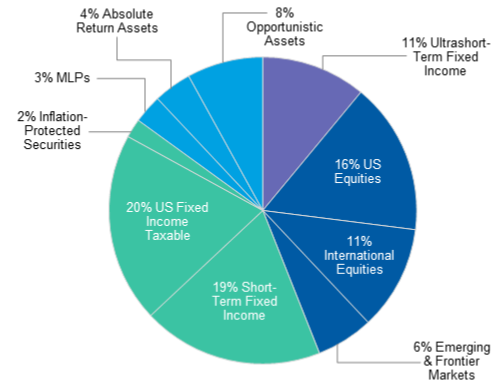
Source: Morgan Stanley Wealth Management GIC as of Nov. 30, 2019

The Global Investment Committee provides guidance on asset allocation decisions through its various models. The five models below are recommended for investors with over $25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return.

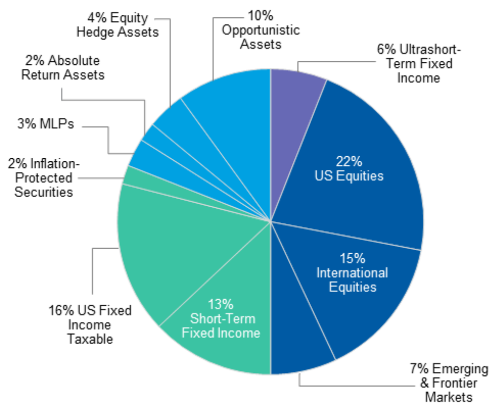
Wealth Conservation



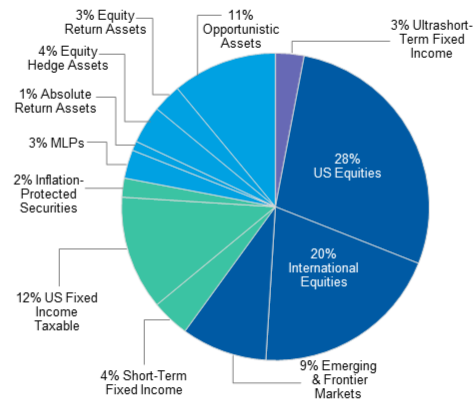
Income



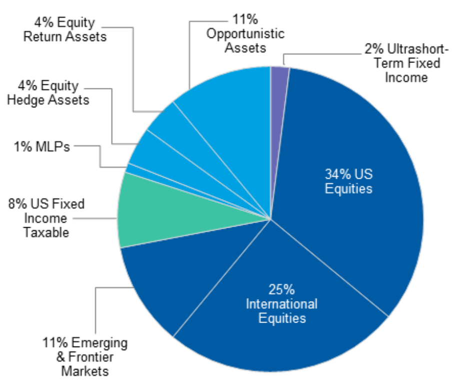
Balanced Growth



Market Growth



Opportunistic Growth



Key

- **Ultrashort-Term Fixed Income**
- **Fixed Income & Preferreds**
- **Equities**
- **Alternatives**

Source: Morgan Stanley Wealth Management GIC as of Nov. 30, 2019

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Underweight	While the benchmark S&P 500 has recently made an all-time high, higher risk indexes like the small-cap Russell 2000 Index are well below the high made last year. Meanwhile, sector leadership has come from defensive and high-quality sectors, which is indicative of a market that is not as bullish as it may appear. We think this is due to both economic and earnings growth, which have slowed materially this year and are apt to weigh on US stocks in the third quarter. Our year-end base case S&P 500 price target remains 2,750.
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets. The populist movements around the world are likely to drive more fiscal policy action in both regions, especially in Europe, which will allow the central banks to exit their extraordinary monetary policies and help valuations to rise.
Emerging Markets	Overweight	After a difficult first 10 months of 2018, emerging market (EM) equities have performed relatively well, a positive sign for future leadership. With our view for the US dollar to make a secular top this year, global nominal GDP growth should accelerate faster than the US GDP, particularly as China's fiscal stimulus takes hold. This should disproportionately benefit international equities, led by EM equities.
Global Fixed Income	**Relative Weight Within Fixed Income**	
US Investment Grade	Underweight	We have recommended shorter-duration* (maturities) since March 2013 given the extremely low yields and potential capital losses associated with rising interest rates from such low levels. We are also increasingly concerned that credit spreads do not reflect the current earnings recession in the US or the significant leverage now present on corporate balance sheet. Therefore, we are underweight US investment grade.
International Investment Grade	Underweight	Yields are even lower outside the US, leaving very little value in international fixed income, particularly as the global economy begins to recover more broadly. While interest rates are likely to stay low, the offsetting diversification benefits do not warrant much, if any, position, in our view.
Inflation-Protected Securities	Overweight	With the recent collapse in real yields from the Fed's pivot, these securities offer little relative value in the context of our expectations for global growth to eventually accelerate, oil prices to trough and the US dollar to top. In short, inflation risk is underpriced.
High Yield	Underweight	High yield bonds have rebounded with equity markets this year as the Fed pivoted to a more dovish policy. Since February, high yield has underperformed investment grade as it starts to reflect earnings recession risk in the US. With a zero weighting in high yield since January 2018, we will revisit our allocation to high yield bonds during 2019 if spreads widen appropriately.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Underweight	Real estate investment trusts (REITs) have performed very well as global growth slowed and interest rates fell. However, REITs remain expensive and are vulnerable to credit risks. We will revisit our position as nominal GDP troughs and/or valuations become more attractive.
Master Limited Partnerships/Energy Infrastructure*	Overweight	Master limited partnerships (MLPs) rebounded this year. With oil prices recovering and a more favorable regulatory environment, MLPs should provide a reliable and attractive yield relative to high yield. Global supply shortages from Iranian sanctions should also be supportive for fracking activity and pipeline construction, both of which should lead to an acceleration in dividend growth.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset category can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform when traditional asset categories are challenged by growth scares and/or interest rate volatility spikes. With the recent surge in volatility, these strategies could perform better on a relative basis.

Source: Morgan Stanley Wealth Management GIC as of Nov. 30, 2019

For more about the risks to Master Limited Partnerships (MLPs) and Duration, please see the Risk Considerations section beginning on page 17 of this report.

The **Global Investment Committee (GIC)** is a group of seasoned investment professionals from Morgan Stanley & Co. and Morgan Stanley Wealth Management who meet regularly to discuss the global economy and markets. The committee determines the investment outlook that guides our advice to clients. They continually monitor developing economic and market conditions, review tactical outlooks and recommend asset allocation model weightings, as well as produce a suite of strategy, analysis, commentary, portfolio positioning suggestions and other reports and broadcasts.

Chetan Ahya, Spencer Cavallo, Vijay Chandar, Aili Chen, Kevin Demers, Jonathan Garner, Matthew Hornbach, Gray Perkins, Meredith Pickett, Mark Schmidt, Graham Secker, Daniel Skelly, Ellen Zentner and Michael Zezas are not members of the Global Investment Committee and any implementation strategies suggested have not been reviewed or approved by the Global Investment Committee.

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Risk Considerations

Alternative Investments

The sole purpose of this material is to inform, and it in no way is intended to be an offer or solicitation to purchase or sell any security, other investment or service, or to attract any funds or deposits. Investments mentioned may not be suitable for all clients. Any product discussed herein may be purchased only after a client has carefully reviewed the offering memorandum and executed the subscription documents. Morgan Stanley Wealth Management has not considered the actual or desired investment objectives, goals, strategies, guidelines, or factual circumstances of any investor in any fund(s). Before making any investment, each investor should carefully consider the risks associated with the investment, as discussed in the applicable offering memorandum, and make a determination based upon their own particular circumstances, that the investment is consistent with their investment objectives and risk tolerance.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

Certain information contained herein may constitute forward-looking statements. Due to various risks and uncertainties, actual events, results or the performance of a fund may differ materially from those reflected or contemplated in such forward-looking statements. Clients should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing.

Alternative investments involve complex tax structures, tax inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund. Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance based on benchmark indices, not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results achieved by a particular asset allocation.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

ETF Investing

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics. ETFs investing in physical commodities and commodity or currency futures have special tax considerations. Physical commodities may be treated as collectibles subject to a maximum 28% long-term capital gains rates, while futures are marked-to-market and may be subject to a blended 60% long- and 40% short-term capital gains tax rate. Rolling futures positions may create taxable events. For specifics and a greater explanation of possible risks with ETFs¸ along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of an exchange-traded fund or mutual fund before investing. The prospectus contains this and other important information about the mutual fund. To obtain a prospectus, contact your Financial Advisor or visit the mutual fund company's website. Please read the prospectus carefully before investing.

MLPs

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Individual MLPs are publicly traded partnerships that have unique risks related to their structure. These include, but are not limited to, their reliance on the capital markets to fund growth, adverse ruling on the current tax treatment of distributions (typically mostly tax deferred), and commodity volume risk.

The potential tax benefits from investing in MLPs depend on their being treated as partnerships for federal income tax purposes and, if the MLP is deemed to be a corporation, then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value.

MLPs carry interest rate risk and may underperform in a rising interest rate environment. MLP funds accrue deferred income taxes for future tax liabilities associated with the portion of MLP distributions considered to be a tax-deferred return of capital and for any net operating gains as well as capital appreciation of its investments; this deferred tax liability is reflected in the daily NAV; and, as a result, the MLP fund's after-tax performance could differ significantly from the underlying assets even if the pre-tax performance is closely tracked.

Duration

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with **emerging markets** and **frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Ultrashort-term fixed income asset class is comprised of fixed income securities with high quality, very short maturities. They are therefore subject to the risks associated with debt securities such as credit and interest rate risk.

Although they are backed by the full faith and credit of the U.S. Government as to timely payment of principal and interest, **Treasury Bills** are subject to interest rate and inflation risk, as well as the opportunity risk of other more potentially lucrative investment opportunities.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum of $250,000 (including principal and accrued interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account, IRA etc.) per CD depository. Investors are responsible for monitoring the total amount held with each CD depository. All deposits at a single depository held in the same insurable capacity will be aggregated for the purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository. For more information visit the FDIC website at www.fdic.gov.

The majority of $25 and $1000 par **preferred securities** are "callable" meaning that the issuer may retire the securities at specific prices and dates prior to maturity. Interest/dividend payments on certain preferred issues may be deferred by the issuer for periods of up to 5 to 10 years, depending on the particular issue. The investor would still have income tax liability even though payments would not have been received. Price quoted is per $25 or $1,000 share, unless otherwise specified. Current yield is calculated by multiplying the coupon by par value divided by the market price.

The initial interest rate on a **floating-rate security** may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk.

The market value of **convertible bonds** and the underlying common stock(s) will fluctuate and after purchase may be worth more or less than original cost. If sold prior to maturity, investors may receive more or less than their original purchase price or maturity value, depending on market conditions. Callable bonds may be redeemed by the issuer prior to maturity. Additional call features may exist that could affect yield.

Some $25 or $1000 par **preferred securities** are QDI (Qualified Dividend Income) eligible. Information on QDI eligibility is obtained from third party sources. The dividend income on QDI eligible preferreds qualifies for a reduced tax rate. Many traditional 'dividend paying' perpetual preferred securities (traditional preferreds with no maturity date) are QDI eligible. In order to qualify for the preferential tax treatment all qualifying preferred securities must be held by investors for a minimum period – 91 days during a 180 day window period, beginning 90 days before the ex-dividend date.

Principal is returned on a monthly basis over the life of a **mortgage-backed security.** Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Companies paying **dividends** can reduce or cut payouts at any time.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Credit ratings are subject to change.

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

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