Morgan Stanley

First Quarter 2018

# The 545 Group Investment Insights

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*We are pleased to offer this quarter's "Investment Insights" newsletter summarizing our team's current views and opinions on relevant economic, geopolitical and capital market events. Please contact us if you would like to discuss the investment climate and your portfolio in more detail. As always, thank you for your business.*

## Global Economy

Economic data took a back seat to global stock market volatility, rising interest rates, anxiety around trade policy and uncertainty around social media privacy rules. That said, there were several important economic developments, including a robust 4th Q with real GDP at 2.9%, US employment near 50-year lows of 4.1%, household net worth surpassing $100,000 for the 1st time ever, a solid housing market and strong manufacturing activity. It is worth noting that the current US economic expansion, which began 105 months ago, is now the third-largest period of sustained economic growth since 1900 behind the 1991-2001 (120 months) and 1962-1970 (106 months) expansions. This led to newly appointed Fed Chief Powell stating that "economic outlook has strengthened in recent months" as he announced a 25bp Fed Funds rate hike to 1.75%. The above indicators provide confidence that an economic recession is unlikely in the near term. The global economy is witnessing synchronized growth led again by the EM countries and Morgan Stanley maintains a 2.9% GDP growth target through 2019. [1]

## Global Stocks

The S&P 500 finished roughly 1% below where we started the year. While this 1% drawdown may not sound dramatic, it included much higher volatility with a 7.5% rally in January followed by a 10% correction into February, and very bumpy markets since then. Investors lived through twenty-three 1% or greater moves during the quarter after years of abnormally low volatility. [2] We urged investors with a longer-term perspective to weather the storm, reminding them of the old saying that "the only people who get hurt on a roller coaster are those that jump off". From these lower levels, we remain cautiously optimistic on stocks given a generally favorable economic backdrop, decent valuations after the recent pullback and a potentially strong corporate earnings season ahead. Morgan Stanley's Chief Equity Strategist Mike Wilson writes; "we think many of the risks that have rattled markets of late (inflationary fears, Fed, rolling economic surprise indices, trade concerns, fears of potential regulatory backlash to internet stock leaders, a flattening curve and rising volatility) have now been been priced in. We remain disciplined buyers of global equities at these levels." [3] Organic corporate earnings growth momentum and tax bill incentives have prompted S&P consensus analyst estimates to increase steadily from $33.86 (Q417) to $42.00(Q418). [3] The S&P 500 is now trading at 16.4x EPS, which is at the low end of Morgan Stanley's target near-term range. We continue to foresee higher volatility and recommend taking advantage of market sell-offs for disciplined entry points into high quality franchise stocks with a focus on later-cycle, inflation-sensitive sectors including value-oriented technology, industrials and financials.

## Global Bonds

Global bonds posted underwhelming returns during Q1. The 10-year US Treasury yield traded in the 2.8-3.0% range during the quarter while the 30-year fared only slightly higher in the 3.0-3.25% range. [2] We continue to recommend fixed income for risk mitigation with an emphasis on short duration and inflationary sensitive exposure.

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## Outlook and Opportunities

This section summarizes the 545 Group's current views on the relative attractiveness of major asset classes. We base these tactical weightings on our assessment of each asset class's relative attractiveness compared to that asset class's historical risk-adjusted return as well as other opportunities available across the investing landscape. These weightings do not consider each client's unique profile, preferences and/or constraints and therefore may not be applicable to you.

| Asset Class | Weighting | Rationale |
|---|---|---|
| **Cash** | Under | Unattractive due to historically-low yields and potential opportunity cost from non-investment. Maintain as a reserve for new and opportunistic purchases |
| **Investment Grade Bonds** | In-Line | We continue to maintain shorter-duration maturities given extremely low yields and higher rates later this year. |
| **Opportunistic Bonds** | In-Line | Underweight high yield due to tight spreads. Overweight inflation-protected securities given GDP growth prospects and anticipated rate increases |
| **US Stocks** | In-Line | Our S&P target remains 2,750 due to favorable economic/earnings growth outlook and fair valuations. Market volatility is testing investor sentiment. China trade tariff is a concern. |
| **Non-US (Developed) Stocks** | Over | We remain overweight Japan and Europe. Morgan Stanley believes populist movements around the world could fuel more fiscal policy action.[4] |
| **Emerging Market Stocks** | Over | The EM region continues to be the best region over the past 24 months. Morgan Stanley believes EM will keep up with global developed markets but are unlikely to lead as strongly.[4] |
| **Alternative Investments** | In-Line | Consider energy infrastructure, which should benefit from energy deregulation, new production, and new pipeline construction<br>Certain Private Equity sectors, particularly opportunistic credit and middle market buyout funds may be attractive for investors who can accept liquidity constraints<br>Underweight traditionally structured Hedge Funds |

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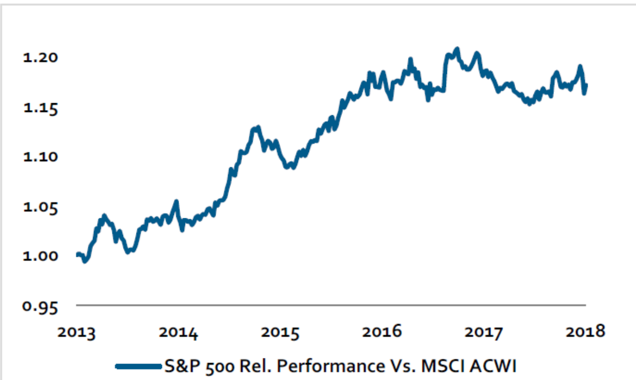
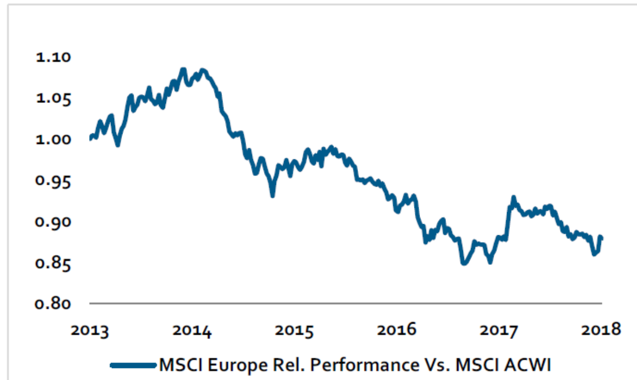
## Charts of the Quarter

The following charts substantiate the views outlined in this quarterly piece.

### Figure 1. Global Equity Relative Performance vs MSCI ACWI [2]




### Figure 2. S&P 500 Price Target [5]

Morgan Stanley S&P 500 Price Target: Year End 2018

| Landscape | Earnings | Multiple | Price Target | Upside / Downside |
|---|---|---|---|---|
| Bull Case | $162 | 18.5x | 3,000 | 13.6% |
| Base Case | $162 | 17.0x | 2,750 | 4.1% |
| Bear Case | $144 | 16.0x | 2,300 | -12.9% |
| Current S&P 500 Price as of: | 3/29/2018 | | 2,641 | |

## The 545 Group at Morgan Stanley Private Wealth Management

Our investment team's roots at Morgan Stanley date to 1979 when Morgan Stanley entered the private wealth management industry. We have each spent the majority – if not all – of our careers at Morgan Stanley, a unique differentiator in an industry of constant change. Collectively, we represent over 100 years of experience structuring, implementing and managing wealth for sophisticated investors, their families and their related charitable entities. [3] This team of private wealth advisors, analysts, traders, portfolio reporting experts and customer service associates has built a nationally recognized practice focused on catering to the needs of ultra-wealthy investors.

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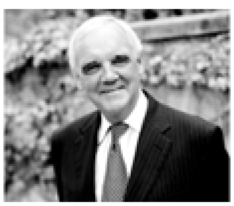

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[3] *Experience by advisor: Greg Vaughan, 34 years; Bob Dixon, 37 years; Mark Douglass, 24 years, Jason Bogardus, 15 years.*

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This newsletter contains forward looking statements and there can be no guarantees they will come to pass. Historical data shown represents past performance and does not guarantee comparable future results. The information and statistical data contained herein have been obtained from sources believed to be reliable but in no way are guaranteed by Morgan Stanley as to accuracy or completeness.

Interest in 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, local tax-exemption typically applies if securities are issued within one's city of residence.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. **NOTE:** High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

An investment cannot be made directly in a market index.

The MSCI ACWI All Country World Index is a weighted index designed to provide a broad measure of equity-market performance throughout the world. As of January 2009, this index contains stocks from 46 different countries. There are 23 countries classified as developed markets and 23 countries considered emerging markets. Typically the index is built first at the country level, and then the 46 indexes are aggregated into the MSCI All Country World Index.

**The MSCI Europe Index captures large and mid cap representation across 15 Developed Markets (DM) countries in Europe*. With 445 constituents, the index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.**
**The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 320 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.**

S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of June 30, 2014, the **MSCI EAFE Index** consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 30, 2014, the **MSCI Emerging Markets Index** consists of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.
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**Barclays Capital Global Aggregate Bond**: This index provides a broad-based measure of the global investment-grade, fixed-rate debt markets.

**Barclays Capital US Corporate High Yield Bond**: This index is composed of fixed-rate, publicly issued, non-investment grade debt.

Barclays U.S. Aggregate Bond Index covers the USD-denominated, investment-grade (rated Baa3 or above by Moody's), fixed-rate, and taxable areas of the bond market. This is the broadest measure of the taxable U.S. bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, all with maturities of 1 year or more. An investment cannot be made directly in a market index.

The Lipper Short Term Muni Index consists of municipal debt issues with dollar-weighted average maturities of one to five years. Number of Index Components: 10. An investment cannot be made directly in a market index.

The Citi High Yield Market Index is a broad measure of the North American high yield market. An investment cannot be made directly in a market index.

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An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Some of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;
- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Private equity interests may be highly illiquid, involve a high degree of risk and be subject to transfer restrictions.

Stocks of small and medium-sized companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more established companies.

Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

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<u>Sources used in this publication:</u>

[1] Morgan Stanley Research: Michael Wilson, *Global Investment Committee,* April 2018
[2] Morgan Stanley Research: Vijay Chandar, *Daily Positioning,* April 2018
[3] Morgan Stanley Research: Michael Wilson, *US Equity Strategy,* April 2018
[4] Morgan Stanley Research: Lisa Shalett, *The GIC Weekly,* March 2018
[5] Morgan Stanley Research: Michael Wilson, *Strategy Data Pack,* April 2018