

# On the Markets

Midyear Investment  
Outlook

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## Payback Time

With all of the attention being paid to US-China trade talks, many investors have failed to see the significance of recent economic reports. First, core durable goods orders, down 0.9% year over year, were much weaker than expected, with a big downward revision to the prior month as well. Capital spending also disappointed, leading our economists to reduce their forecast of second quarter US GDP growth to just 0.6%, which is the weakest since the 2015's fourth quarter—the last time we had an earnings recession. Finally, both the manufacturing and services components of the **Markit Purchasing Managers Index**, leading indicators for the economy, were much weaker than expected.

This slowdown in capital spending doesn't surprise me given last year's boom. In fact, it's consistent with our view that 2019 could well be a year of payback due to 2018's outsized capital spending and inventory building. I bring this up because many investors seem to think the recent slowdown is all due to the escalation of US-China trade tensions—but all of the data points above were for the month of April, which reflects economic activity before the trade talks broke down.

I've been vocal about the likelihood of US earnings and the economic cycle disappointing this year, with the second half recovery many companies have promised and investors are expecting potentially failing to materialize. On that score, leading companies in the semiconductor and industrial sectors are starting to acknowledge this reality.

The good news is that markets aren't completely naive about slowing growth. All year, defensive and high-quality stocks have been leading the performance of the broader indexes. It also explains why the S&P 500 is outperforming the riskier international markets this year. Finally, 10-year US Treasuries and other government bonds are making new highs in price—and consequently, new lows in yield—as investors seem to be hunkering down for slower growth. If you listen to what the markets have really been saying this year, they seem to be reinforcing our view for growth to disappoint.

We recommend investors remain defensively positioned within their equity portfolios in areas like utilities and consumer staples. High-quality growth stocks should also continue to do well but selectivity is key, because if growth slows further many of these stocks could disappoint on earnings. We suspect certain technology stocks could be particularly vulnerable given the recent evidence of a slowdown in capital spending and high valuations that do not reflect this risk. Once these expectations adjust to more realistic outcomes or the stocks correct appropriately, it may be time to become more constructive on equity markets, including technology stocks—but not before then. ■

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# Mind the Gaps

ANDREW SHEETS

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Imagine if several years ago, someone had told you the following: The S&P 500 would be trading at about 17 times forward earnings with single-digit earnings growth. The yield curve would be flat, global purchasing managers indexes (PMIs) would be weak, small-cap and cyclical stocks would be underperforming, yields would be falling, central banks would have already gone out of their way to sound accommodative and global markets would be up strongly. We'd wager that the average investor would have voiced more than a bit of concern.

Yet, here we are with those conditions, and the predominant concern until a month ago appeared to revolve around whether markets could go up a lot more. Increased trade tensions have helped take this optimism off the boil, but the question remains: Is the performance pattern for the year to date a template for the rest of the

year, or an aberration?

We think it's aberrant behavior, as moves during the past few months put heavy pressure on three gaps. Dovish central bank pricing already implies little concern about the output gap. Unsustainable first quarter US growth should reverse, narrowing the gap between growth in the US and the rest of world (RoW) and—with prices generally recovering much faster than fundamentals this year—a price versus fundamentals gap looms unevenly across assets.

These themes dominate how we think about markets for the next 12 months. They leave us with a modestly defensive posture, a strong preference for RoW over US assets and conviction that the market is overpricing the Goldilocks scenario.

## The Output Gap

Many factors are behind the strong year-to-date performance across nearly all assets, but the most powerful, in our view,

has been the apparent relief of the “output gap.” In 2018, it looked like this gap was finally closing, with further growth bringing higher inflation and tighter policy. This trade-off was at the core of our “tricky handoff” narrative in 2018, and made almost all assets decidedly unhappy.

Then, 2019 brought relief. In the first quarter, US GDP growth accelerated to a 3.2% annualized rate while inflation as measured by the core Personal Consumption Expenditure Index fell—a sign that maybe there was spare capacity in the economy after all. That was unquestionably good news, and if one is looking for a single explanation for the remarkable difference between 2018 and 2019, we think it's fading concerns over the output gap, which has meant that monetary policy could ease even as growth fears subsided (see chart).

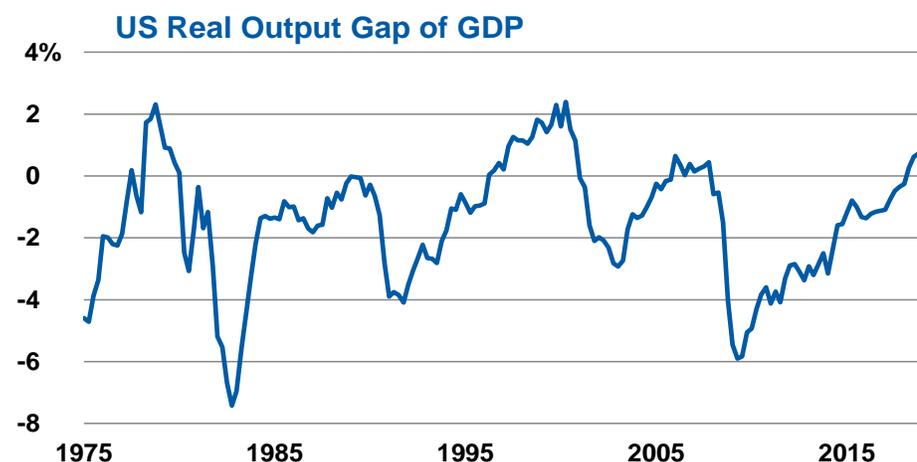
Still, closing of the output gap is also the problem, suggesting that easy central bank policy on a lack of inflationary pressure is already the market's assumption. That's the case even as estimates of the output gap continue to narrow and measures of inflation outside of core PCE don't show the same moderation.

If spare capacity still exists, and a lack of inflation allows policy to remain easy, couldn't this drive a “melt-up” in markets similar to the late 1990s? We are skeptical. The late 1990s had much better GDP growth, earnings growth and demographic tailwinds that supported heavy participation by individual investors. With the risks to our economic forecasts skewed to the downside (see page 7), this scenario seems unlikely.

## US vs. RoW Growth Gap

Moving away from our overall growth and inflation forecasts, an important part of our macro story is the reversal we forecast between US and RoW growth. We expected this to occur last November

## Narrower Output Gap Implies Less Policy Flexibility



Source: Morgan Stanley & Co. Research as of May 12, 2019

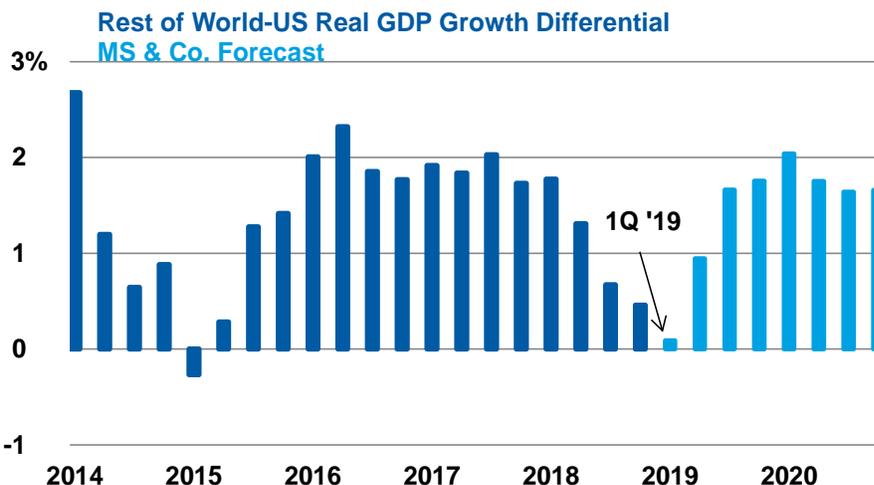
when we published our 2019 outlook, and appeared vindicated as growth fears gripped the US market. Then, US growth bounced back in this year's first quarter while growth in Europe, China and Japan disappointed. We think that these developments mean the growth reversal story has been delayed, not derailed.

Going forward, we see this story playing out on both fronts (see chart). US growth should slow as fiscal policy tightens and temporary boosts to first quarter GDP fade. Meanwhile, in Europe and China, fiscal policy is easing and PMIs should rebound off cycle lows, even if trade tensions make the timing and magnitude of this more uncertain than a few weeks ago. December 2018 offers important clues about what this might mean for relative performance. That month, when expectations of US versus RoW growth appeared to be reversing, the US dollar fell, RoW equities outperformed, duration in the US outperformed Europe and both value and cyclicals did much better than their betas had suggested. In the next 12 months, we expect all those performance trends to apply, understanding that they would represent major reversals in trends that have been in place for a decade.

### The Price vs. Fundamentals Gap

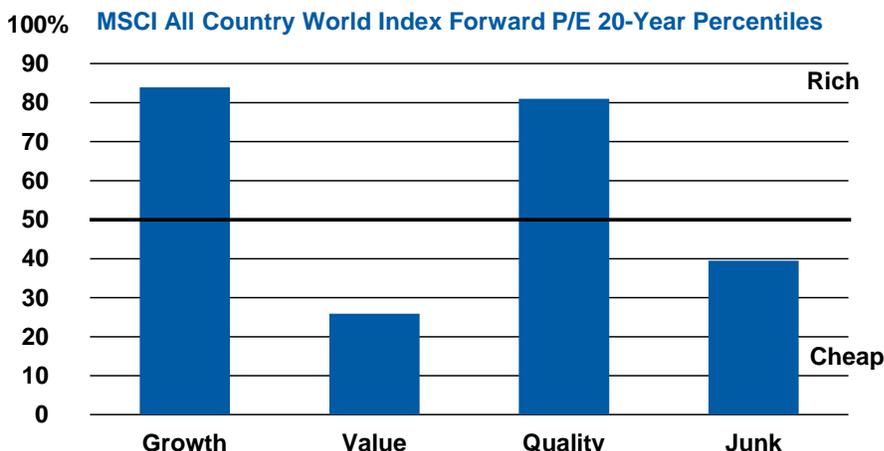
The final gap is between the large rally in risk premiums for the year to date and the more uneven trends in fundamentals. Some of the rally was clearly justified, as prices began the year well below our end-2019 base case for equity and credit. The issue now, rather, is how far these prices have come—especially as, in the time since, some fundamentals have worsened. In equities, markets have made substantial gains even as earnings estimates have fallen, meaning that multiple expansion has accounted for more than 100% of the

## We Expect RoW Growth to Outperform the US



Note: Rest of world includes all economies covered by Morgan Stanley & Co. except the US. Source: Morgan Stanley & Co. Research as of May 12, 2019

## Valuations for Growth and Quality Are Elevated



Note: Based on data from 1999 onward Source: Morgan Stanley & Co. Research as of May 12, 2019

In credit, spreads are back to the lower end of their 10-year range. In interest rates, a global rally has meant that yield has diminished dramatically, with the return from holding bonds near the lows of the last 20 years. Finally, in currencies, the relatively higher yield on US dollar assets has driven the greenback's valuations to extreme levels, implying a high degree of

confidence in our view that US growth outperformance continues.

Of course, not all prices have swelled. The equity market had bid up both growth and quality stocks, leaving value and junk by the wayside (see chart). This is an odd response for a market that's supposedly confident that economic growth is fine. We don't think that it is sustainable. ■

ON THE MARKETS / ECONOMICS

# Trade Tensions Cloud the Global Economic Outlook

CHETAN AHYA

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The global economy has swung back to a regime of policy dominance. Unlike 2017 and 2018's first half when the private sector was on an autonomous recovery path and policy accommodation could be withdrawn, now the global economy is again highly dependent on policy support. In the current minicycle, the interplay of trade tensions and policy easing will continue to determine the cycle's swings.

**SIGNIFICANT RISK.** Trade tensions have become a key risk. The main mitigating factors compared with the second half of 2018 are that China has already put a significant amount of fiscal stimulus in place (\$250 billion, about 1.75% of GDP) alongside the requisite monetary accommodation, while the Federal Reserve has moved away from its tightening bias. Since December, US financial conditions have eased by the equivalent of nearly 90 basis points in the fed funds rate, and they remain supportive of growth. In our base case, policy support from China combined with easier financial conditions should translate into a modest recovery. Using a temporary escalation scenario, our base case for 2019 global economic growth is 3.4% (see table).

Trade tensions can be assessed by the initial impact of tariffs and their spillover effects on supply chains, as well as the impact on corporate confidence and capital investment. The integration of supply chains both domestically and globally has meant that any trade measures implemented on a single country or sector will likely extend beyond the direct impact and produce significant spillover.

**CORPORATE CONFIDENCE.** The damage from trade tensions is more pronounced via corporate confidence and capital spending channels than in direct trade. Indeed, global investment fell to 3.4% as compared with 4.7% in 2018's first quarter. In March, global capital goods imports were down 3% on a three-month moving average basis versus a 21% gain a year ago. At the same time, global growth slowed by 0.8 percentage points. Given that easing has only recently led to a tentative recovery in corporate confidence, the cycle is at risk if the damage to confidence becomes entrenched, spending fails to improve and a negative feedback loop of weaker growth/tighter financial conditions unfolds.

Given the situation, we posit three scenarios for trade tensions:

**Temporary escalation.** The 25% tariffs remain in place for about four weeks, talks continue and there is progress toward a

deal. China's easing measures remain intact, the Fed stays on hold and policy support helps the global economy to recover toward trend growth.

**Extended escalation.** Tariffs stay in place for around three to four months. Talks continue, but corporate confidence takes a major hit for the second time in six months. Downward pressure on growth builds: Chinese policymakers ease both monetary and fiscal policy while the Fed cuts rates by an initial 50 basis points. China and US growth weaken by 20 basis points and 30 basis points, respectively, relative to the baseline, even after the policy response. Net-net, global growth decelerates to an annualized 2.7% to 2.9% by the third quarter from the first quarter's 3.2%, but the global economy avoids recession—just barely.

**No deal.** With no agreement, the US imposes tariffs on all China imports and China imposes 25% tariffs on all US imports while restricting state-owned enterprises' purchases from the US. With this shock to the global economy, even though the Fed cuts rates all the way to zero by spring 2020 and China embarks on aggressive monetary and fiscal stimulus, a global recession cannot be prevented. ■

## Morgan Stanley & Co. Real GDP Forecasts

	2018		2019E		2020E		2021-23E	
	Base	Bear	Base	Bull	Bear	Base	Base	
<b>Global</b>	<b>3.7%</b>	<b>2.5%</b>	<b>3.4%</b>	<b>3.8%</b>	<b>2.0%</b>	<b>3.5%</b>	<b>4.4%</b>	<b>3.5%</b>
<b>G10</b>	<b>2.1</b>	<b>1.0</b>	<b>1.6</b>	<b>1.9</b>	<b>-0.3</b>	<b>1.6</b>	<b>2.4</b>	<b>1.2</b>
<b>US</b>	2.9	1.9	2.4	2.6	-0.2	2.1	2.8	1.1
<b>Euro Zone</b>	1.8	0.6	1.2	1.5	-0.3	1.4	2.4	1.0
<b>Japan</b>	0.8	-0.7	0.3	0.5	-1.0	0.3	0.8	1.3
<b>UK</b>	1.4	0.9	1.2	1.3	0.1	1.5	2.1	1.3
<b>Emrg. Mkts.</b>	<b>4.8</b>	<b>3.6</b>	<b>4.5</b>	<b>5.1</b>	<b>3.5</b>	<b>4.8</b>	<b>5.7</b>	<b>4.8</b>
<b>China</b>	6.6	6.0	6.5	6.8	5.5	6.3	6.7	5.5
<b>India</b>	7.4	6.3	7.0	7.5	6.4	7.4	8.2	7.3
<b>Brazil</b>	1.1	0.6	1.4	2.2	1.2	2.5	3.3	2.4
<b>Russia</b>	2.3	0.3	1.5	2.7	0.2	1.8	3.4	1.8

Note: The above aggregates are weighted by purchasing power parity.

Source: Bloomberg, IMF, Morgan Stanley & Co. Research as of May 12, 2019

# US: Waiting Patiently

## ELLEN ZENTNER

Chief US Economist  
Morgan Stanley & Co.

Earlier this year, headwinds cut growth in final private domestic demand by half, but those transitory factors—government shutdown, weather and a bout of market volatility—have faded.

Financial conditions have eased, the labor market continues to strengthen, wages are rising, consumer spending and confidence have rebounded and capital spending plans have stabilized. We have taken up full-year 2019 growth to 2.4% versus 2.0% previously. We have also adjusted 2020 growth, shaving it to 2.1% versus 2.2%.

**DOWNSIDE RISKS.** Still, risks to the outlook skew to the downside and are driven externally by trade negotiations. Further or prolonged escalation of trade tensions would weigh on the economy via less demand for US exports, dampened corporate sentiment that weighs on

investment and hiring plans and spillover into the broader US supply chain.

Financial market reactions could lead to a tightening of conditions that amplify negative reactions through the broader economy. In an extended escalation scenario, GDP growth loses about a half a percentage point, some of which we expect would be offset by the Federal Reserve, as policymakers cut the fed funds rate by 50 basis points (see page 6).

We also believe that core inflation remains subdued through the first half of 2020. We have brought down our 2019 core inflation forecasts across the board, with 1.7% for the core Personal Consumption Expenditure Index and 2.1% for the Consumer Price Index. In our estimation, the upwardly revised unemployment rate path of 3.5% shaves off 0.2 percentage points from our 2020 core inflation projections.

**POLICY PIVOT.** Bowing to the Federal

Reserve's policy pivot, we have removed an additional hike in 2020. We now expect the Fed to remain on hold until the second half of 2020, delivering hikes in September and December. Following seven consecutive months of inflation above the 2% annualized goal, the two hikes we envision will be a gentle push on the part of the Fed to keep inflation above that hurdle while at the same time not losing control over its growth.

We believe that the Fed's focus on its inflation target will result in a change to its longer-run policy goal in January 2020 that instructs what happens when the nominal policy rate nears or hits zero. We expect that, when faced with the lower bound, the Fed will adopt a soft average inflation target going forward but with safeguards to address inflation overshooting and financial stability concerns.

**BEAR CASE.** In our bear case, trade tensions, market volatility and tighter financial conditions weigh on the US economy. This begins a negative feedback loop in which the US consumer retreats and margin pressures lead to a large-scale cutback on labor and corporate investment. Upward pressure on the dollar leads to sustained downside on inflation. With incoming data pointing to negative GDP growth in the second half of 2019 and inflation slipping lower, the Fed begins to cut rates aggressively in 50-basis-point increments. Rate cuts accelerate in 2020, falling back to zero by the spring.

In addition to trade tensions, we expect headline risk around the debt ceiling and budget debates that will play out early in the fall. Our baseline incorporates our US public policy strategists' expectations that we will be able to get past these issues, but that the debate will be contentious.

Ultimately both parties will want to avoid a cliff in an election cycle and the budget caps will be raised to match the amount in fiscal year 2018, such that the effect on government spending is neutral. ■

## MS & Co. US Economic Midyear Outlook

	2017	2018	2019E	2020E
<b>Real GDP Growth</b>	<b>2.2%</b>	<b>2.9%</b>	<b>2.4%</b>	<b>2.1%</b>
Private Consumption	2.5	2.6	2.3	2.4
Government Consumption	-0.1	1.5	2.8	2.1
Gross Fixed Investment	4.0	4.8	3.6	3.9
<b>Contribution to GDP (percentage points)</b>	<b>-0.1</b>	<b>5.5</b>	<b>3.7</b>	<b>2.8</b>
Final Domestic Demand	2.5	3.0	2.6	2.7
Net Exports	-0.3	-0.2	-0.1	-0.4
Inventories	0.0	0.1	0.0	-0.3
Government	0.2	0.3	0.5	0.9
<b>CPI</b>	<b>2.1</b>	<b>2.4</b>	<b>2.1</b>	<b>2.6</b>
<b>Core PCEPI*</b>	<b>1.6</b>	<b>1.9</b>	<b>1.7</b>	<b>2.2</b>
<b>Unemployment Rate**</b>	<b>4.1</b>	<b>3.8</b>	<b>3.5</b>	<b>3.2</b>

\*Personal Consumption Expenditure Price Index

\*\*Projections are for the average in the fourth quarter of the year indicated.

Source: Morgan Stanley & Co. Research as of May 12, 2019

# Where Do Tariffs Land? Everywhere

ELLEN ZENTNER

Chief US Economist  
Morgan Stanley & Co.

The US has placed \$74 billion in tariffs on Chinese products so far, and some major retailers have warned of higher prices ahead (see table). However, this is not a dollar-for-dollar pass-through. Here are other ways tariffs can be absorbed.

**Reduced profit margins for Chinese producers.** Chinese producers may lower prices to offset part of the tariffs paid by US importers. While not widespread, some anecdotal evidence suggests it is happening to a limited degree.

**US dollar appreciation against the renminbi.** This occurred last year and is happening again now, and should have the same effect as Chinese producers lowering prices to offset tariffs. Import prices from China, excluding the effect of tariffs, were down an annualized 1.1% in April, likely from dollar appreciation against the renminbi. When tariffs were raised by

about \$30 billion on May 10, the renminbi depreciated sharply in response.

**Substitution away from Chinese-produced goods.** Demand for these goods should decline as prices inclusive of tariffs rise and consumers and businesses purchase goods made elsewhere or reduce demand altogether. There is probably some scope for demand reductions, particularly for durable goods for which purchases can be delayed; the first two waves of \$50 billion of Chinese imports subject to a 25% tariff were mainly entirely capital equipment. Perhaps as a response, the value of Chinese imports declined an annualized 18.5% in March. Overall, these first three channels likely absorbed about half of the value of tariffs in place before May 10.

**Reduced US profit margins.** For capital goods and intermediate inputs, we think US producers will absorb a substantial portion of higher tariff costs

through lower profit margins. For finished consumer goods, profit margins on many are so large that there is room to absorb tariffs. Costs also could be absorbed by local distributors and retailers. Anecdotal evidence, as well as companies' earnings reports, suggests some tariffs costs have been absorbed through profit margins. Given the evidence on the other tariff absorption channels, a nontrivial portion (say, one-fifth) of tariff costs appears to have been absorbed in margins.

For reference, US aftertax profits were about \$2 trillion in the US in 2018, so a reduction of \$15 billion to \$40 billion could lower aggregate profit growth by 0.75% to 2.0%. Similarly, our equity analysts estimate that the direct effect of the 25% tariff on \$200 billion of Chinese imports shaves 1.0% to 1.5% from the net income of S&P 500 companies.

**Higher consumer prices.** Tariffs on capital goods should ultimately raise the cost of production for consumer goods, but the higher cost is likely to be spread out over a number of years since capital equipment is durable and often financed with debt. We expect about 10% of the cost of tariffs on capital goods will be absorbed by higher consumer prices per year. We expect higher intermediate input costs to pass through gradually to consumer prices as well, with about 20% of the tariff costs being absorbed by higher consumer prices per year.

For consumer goods, a simple calculation based on rough translations of import categories into CPI components yields a higher upper bound on consumer price pass-through, and we do assume higher pass through into the core Personal Consumption Expenditure Index: 54% in the 12 months after tariffs are implemented, with half of that occurring within the first three months. The higher pass-through is mainly due to the knock-on effect of tariffs raising prices for other goods, mainly substitute goods produced domestically or in countries competing with China. ■

## How Trade Could Incrementally Impact Inflation

Policy Action	Inflation Impact (percentage points)*	
	2019	2020
<b>Temporary Escalation</b> <ul style="list-style-type: none"> <li>• 25% tariffs for a relatively short time</li> <li>• Talks continue</li> </ul>	0.05	0.04
<b>Extended Escalation**</b> <ul style="list-style-type: none"> <li>• Tariffs remain for a longer period</li> <li>• Talks continue</li> </ul>	0.10	0.07
<b>No Deal</b> <ul style="list-style-type: none"> <li>• US imposes tariffs on all Chinese imports; talks stall</li> <li>• China places 25% tariffs on all US imports; restricts purchases by state-owned enterprises</li> </ul>	0.26	0.13

\*Incremental impact on core Personal Consumer Expenditure

\*\*This scenario varies slightly from the global assumption of three to four months. Instead, we assume extended escalation to be more lasting, such that inflation impact becomes more visible.

Source: Morgan Stanley & Co. Research as of May 23, 2019

ON THE MARKETS / EQUITIES

# Tougher Times Ahead for Global Equities

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Forecasts from our global economists remain generally supportive for equity markets as they project a moderate recovery in global growth against a backdrop of low inflation and dovish central banks. However, the main issue is the extent to which this benign backdrop is already reflected in current valuations, given that global equities have enjoyed an 18% jump in the price/earnings (P/E) ratio since the start of the year, despite material declines in 2019 earnings estimates. Are we facing a “travel and arrive” situation, or is there is scope for further upside?

In support of travel and arrive, the more cautious view is that the best news about dovish pivots by central banks—especially the Federal Reserve—is behind us, while

uncertainty around US-China trade tensions is rising again after a dip through the first quarter. Given that, in our opinion, these two factors together were the biggest driver of equities in the first part of this year, we strongly believe the best period of market returns is now behind us. In our base case we assume that the renewed upturn in US-China trade tensions proves temporary, albeit with the likelihood that weaker markets may be required to act as a circuit breaker to encourage de-escalation. However, it is also plausible that this latest bout of uncertainty proves more persistent and increases downside risks for growth and risk assets.

**MUTED SENTIMENT.** In our base case forecasts we still have upside to our 12-month price targets for non-US equity markets (see table). Still, we are reluctant to reduce our global equity exposure aggressively for two reasons. First, we believe that investor sentiment toward the global economy remains muted, particularly in relation to skepticism about the strength and breadth of China’s

recovery and its ability to boost the wider growth outlook across Europe, Asia and the emerging markets. Consequently, evidence that global growth is indeed beginning to recover (in line with our economists’ view) should be supportive for stocks.

Second, while a nearly 20% year-to-date P/E expansion sounds excessive, it is not obvious that equity valuations have overshot absent a sustained rise in trade tensions. The rebound in the MSCI World Index’s next 12 months’ (NTM) P/E ratio from the December low has now paused and is below its median since 1987 (see chart, page 8). At the regional level, equity valuations still look quite low for Europe and especially Japan, while the emerging markets appear extended versus the last five and 10 years (see chart, page 8).

**US FULLY PRICED.** The US is where we think equities are most fully priced. After years of outperforming, relative valuations are close to all-time highs, and the region is a heavy consensus overweight among investors. For much of the last decade, US outperformance has been driven by both a relative valuation rerating and superior earnings trends, but we believe that the earnings per share is coming under increasing pressure due to rising margin pressures. By the end of 2020, our top-down forecasts for S&P earnings are 10% below consensus.

## MS & Co. Top-Down Earnings Forecasts and Next 12 Months’ P/E Assumptions

Index	Jun '20 Base Case Index Target	MS Top-Down Base Case EPS Forecast (year-over-year growth)			Consensus EPS Forecast (year-over-year growth)			MS Base Case Next 12 Mos. P/E	Consensus	Consensus	Next12 Mos. P/E
	(% upside)	2019	2020	2021	2019	2020	2021	June '20	Next 12 Mos. P/E	Five-Yr. Avg.	10-Yr. Avg.
<b>S&amp;P 500</b>	2,750 -4%	162.0 0%	170.0 5%	180.0 6%	168.0 4%	187.0 11%	207.0 11%	15.8	16.7	16.6	15.0
<b>MSCI Europe</b>	1,640 9%	112.0 4%	116.0 4%	123.0 6%	113.0 5%	123.0 9%	132.0 7%	13.7	13.3	14.4	12.9
<b>TOPIX</b>	1,700 12%	122.0 3%	128.0 5%	134.0 5%	125.3 6%	133.3 6%	142.6 3%	13.5	12.0	13.7	14.3
<b>MSCI EM</b>	1,030 3%	85.1 6%	91.9 8%	98.7 7%	85.4 6%	96.9 13%	107.8 11%	11.5	11.6	11.6	11.2

Source: IBES, RIMES, Morgan Stanley Research forecasts as of May 27, 2019

In a number of respects Japan is the opposite image of the US. It is tactically oversold and unloved while average relative valuations are at all-time lows. The MSCI Japan Index's dividend yield is now within 2% of that of the MSCI World Index for the first time since 1972. We also think that the return on equity for Japanese companies is on a structurally rising trend. More tactically, earnings revisions should be sensitive to an improvement in China's growth, while any potential deferment to the consumption tax hike would likely lift economic and earnings growth expectations. We give such a 50-50 chance of that happening.

**UNLOVED AND UNDERVALUED.**

Although Europe and Japan can be classified as both unloved and undervalued, we prefer Japan as it seems to offer a better potential earnings and profitability story and more compelling undervaluation. Our top-down European EPS forecasts are 6% below consensus by December 2020 versus 4% below for Japan—and, unlike Japan, we see little scope for P/E expansion in Europe.

One pushback to our cautious view on the US is investor perception that the region is relatively defensive in any risk-off event while still offering good upside in a more positive environment. Such is the crowded positioning in US stocks that we think this argument no longer holds true. Indeed, the one-year beta of the MSCI USA Index versus the MSCI World Index is at a 20-year high—a stark contrast to Europe, where the beta is at a 20-year low (see chart, page 9). Furthermore, the data shows the US beta is now higher in up and down markets than any of the other major regions.

Here are our key regional forecasts and views:

**US**

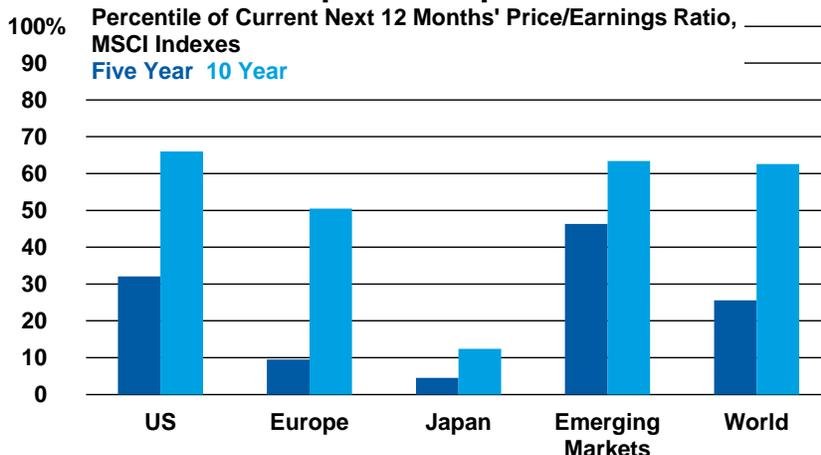
•Our 2,400 to 3,000 bear-bull range for the S&P 500 has played out well so far, but the speed and timing of the moves—both to the downside in December and to the upside this year—have surprised us. Tightening financial conditions and

**Forward MSCI World P/E Below Long-Term Median**



Source: MSCI, IBES, Morgan Stanley & Co. Research as of May 21, 2019

**Valuations for Europe and Japan Still Look Low**



Source: MSCI, IBES, Morgan Stanley & Co. Research as of May 21, 2019

peaking growth last year led to material multiple compression, while this year's Fed pivot and expected bottoming in global growth spurred a massive rally.

•Rapid Fed shifts moved the market multiple quickly, but not the earnings growth outlook. Equity troubles last year began with earnings estimates weakening at twice their normal seasonal rate. Then, new Fed Chair Jerome Powell's perceived lack of sensitivity to market concerns accelerated the declines—and P/E multiples fell 20%. The Fed's pivot on Jan. 4, the dovish rhetoric that followed and expectations for a second half growth rebound led to a 25% rise in multiples. We're skeptical that the Fed can fix the growth problem on its own, because looser

financial conditions won't relieve pressures from tight labor markets, excess inventory, slowing capital spending, difficult year-over-year comparisons and still-high expectations for the second half, as well as 2020.

•The fully priced Fed and earnings slowdown skew risk/reward negatively. The global economy is bottoming now and the Fed's pivot should help to keep the US economy growing at about 2%, but we expect payback from last year's boom in the near term and margin pressures to force NTM earnings forecasts lower. As expectations fall, likely in the second half of 2019, we expect pressure on the multiple, leaving us with an S&P base case target of 2,750. We think that the market is

fully priced at our bull case of 3,000, which assumes a multiple of 16.8, the high end of our fair-value range on what we think are best-case earnings per share for 2020 through 2021. Our bear case of 2,400 remains unchanged and embeds a mid-single-digit earnings contraction in 2020 alongside a lower P/E.

- We retain our preference for large caps over small caps and remain cautious on richly valued, late-cycle, high-quality stocks. We continue to skew defensively in our sector recommendations with our overweights on consumer staples and utilities and some value cyclical exposure in financials. We remain underweight consumer discretionary and technology.

## Europe

- Although European equities have rallied sharply since we had a buy signal on our market-timing indicators last December, we still see some modest 6% upside to our new price target in the next 12 months, which incorporates modest upgrades to our earnings per share and P/E assumptions.

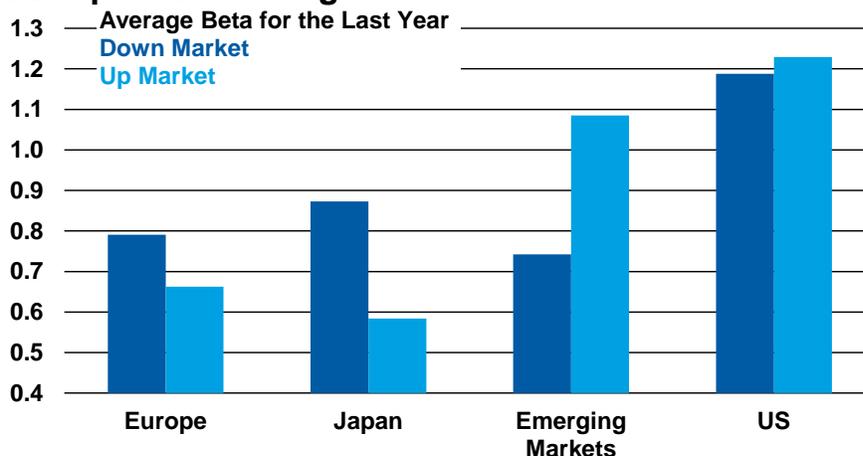
- We raised our 2019 EPS growth forecast to 4% from 1% to reflect our currency team's new forecast for the euro relative to the dollar, which is considerably weaker than previously, as well as a higher oil price forecast from our commodity strategists.

- We raised our P/E assumption modestly to 13.7, the long-run median, from 13.1. This upgrade primarily reflects reduced uncertainty around central bank policy and our base case view that the latest bout of US-China trade uncertainty proves to be temporary.

As reflected in the persistent outflows from the region, we think that investor sentiment toward Europe remains low, with concerns about a lack of growth and the potential for EU auto tariffs. Any sign that the domestic economy is recovering should prove a positive catalyst for stocks.

- The level of valuation dispersion is particularly extreme in Europe, and we recommend that investors selectively rotate from quality to value. Our

## US Equities No Longer Low Beta in Down Markets



Source: MSCI, Morgan Stanley & Co. Research as of May 21, 2019

overweights are cheap cyclicals—such as autos, mining and transportation—and Euro Zone domestic cyclicals, plus insurance, telecom, real estate and the FTSE 100 Index. Our underweights are expensive cyclicals such as capital goods, chemicals and retailing. Pharmaceuticals are an underweight, too.

## Asia and the Emerging Markets

- Having lagged substantially year to date, we think that Japan outperforms the emerging markets going forward. The rationale for the Japan catch-up trade is based on relative valuations to both the emerging markets and the US; relative outperformance in the second half at a similar stage of the Chinese and global business cycles (on our base case outlook); a delay in the consumption-tax hike; and that Japan is more defensive than emerging markets oil prices or US-China and US-EU trade tensions worsen.

- China A-shares should cease outperformance over offshore China stocks, as the major upside surprise in China stimulus lies behind us. Also, valuations for A-shares recently moved above both emerging markets and the MSCI China Index after having been at a 15% discount late last year.

- We remain overweight Brazil and India but downgrade Taiwan to underweight from equal weight on

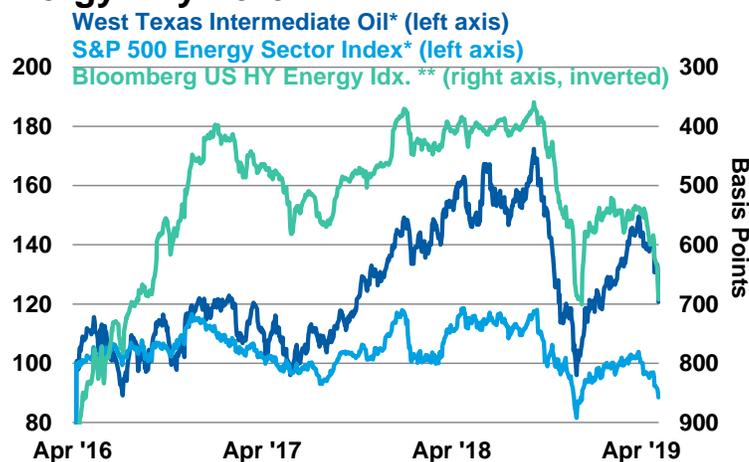
increased caution over tech hardware after stock-price gains and given our bottom-up team's concerns about a second half recovery and supply chain interruptions arising from trade tensions. For Brazil, the cyclical story is compelling and should unfold after fiscal reform is enacted in some form in the second half.

Unemployment is 12.2%, industrial capacity utilization is running well below the historical average and the benchmark overnight interest rate is at a historical 6.5% low, while 2019 through 2021 inflation expectations are well anchored below 4.0%. Meanwhile, India is likely to enter a postelection environment in which monetary policy is able to ease, given much improved fiscal and external deficits. Growth could also rebound, which should help equities.

- On the sector side, we remain overweight materials, energy and real estate but upgrade utilities to overweight as a defensive pivot, except in Japan. We retain an overweight on financials in Japan but downgrade elsewhere in Asia and the emerging markets. In Japan, we continue to focus on firms that are productivity and innovation leaders and exhibit trend corporate governance and improvement in return on equity. From a style perspective, we continue to favor quality and prefer value to growth. ■

## Why Oil Stocks Don't Have Much Energy Anymore

Though they have slid a bit in the past few weeks, oil prices are up nearly 18% this year. In contrast, the S&P 500 Energy Sector Index is up only 2% (see chart). While historically there has been a strong correlation between oil, energy stocks and corporate spreads for energy companies, those relationships started to change in mid-2016 when energy stocks began to underperform. Energy debt, however, has generally traded closely with oil prices. The spread narrowed to 625 basis points on May 24 from 690 basis points at the start of the year—and ricocheted to 693 in the month-end sell-off. While temporary divergences are not unusual, three years have passed, suggesting that secular factors may be at work. Although energy equities remain correlated with oil prices, they have trailed the commodity's performance, weighed down by concerns relating to long-term earnings growth, increased opportunities in renewable energy and a gradual shift in consumer preferences away from fossil fuels.—*Nicholas Lentini*



\*May 2, 2016=100 \*\*Option-adjusted credit spread  
 Source: Bloomberg as of May 31, 2019

## Global Trade Continues to Decline

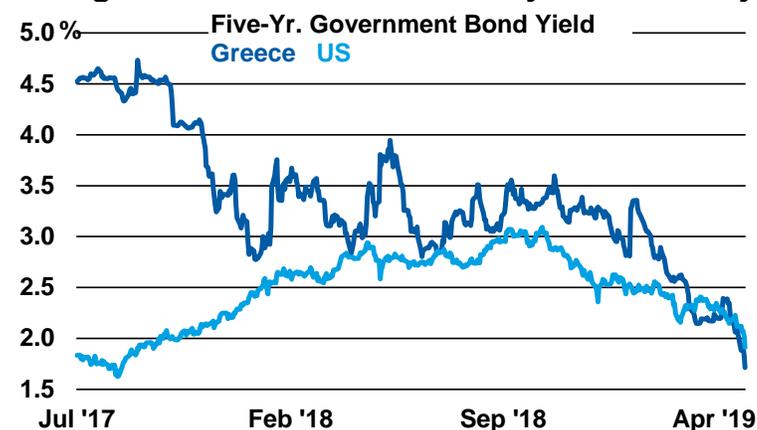


Source: Bloomberg as of Feb. 28, 2019

Growth in global exports has continued to decline, having dipped to negative year-over-year readings in December (see chart). This downward momentum has emerged amid rising protectionism and uncertain trade negotiations, particularly between the US and China. The standoff between the two countries has dragged meaningfully on world exports this year, exacerbated by a strong US dollar. Any further escalation in the trade dispute would likely create further distortions in global supply chain, crimping business investments and softening global demand. Historically, global growth has tightly tracked global trade. The sharp downturn of global exports provides further evidence that demand from major markets is waning, underscoring the significant risks of decelerating global growth from ongoing trade tensions.—*Lisha Ge*

## The Curious Case of a Greek Bond Yielding Less Than a Like-Maturity US Treasury

Not that many years ago, the IMF, the European Central Bank and the European Commission granted Greece a \$375 billion bailout that also led to massive government cutbacks, a deep recession and widespread unemployment. Greece exited the bailout plan last summer, and it still has a mountain of debt. Yet, five-year Greek government bonds, given a junk bond rating of B+ by Standard & Poor's, now trade at a 1.71% yield (see chart). In contrast, the five-year US Treasury note, with an investment grade AA+ credit rating, yields 1.91%. Typically, yields follow credit quality, so why is the five-year Greek government bond yield lower than that of the five-year US Treasury? For international bond buyers, the Greek issues may be attractive because comparable-maturity German, French and Japanese bonds have negative yields. In fact, it costs money to own a bond with a negative yield.—*Chris Baxter*



Source: Bloomberg as of May 31, 2019

# Global Government Bond Yields Apt to Remain Low

**MATTHEW HORNBACH**

Global Head of Interest Rate Strategy  
Morgan Stanley & Co.

With central banks mostly on hold, inflation subdued and downside risks abound, we expect developed market sovereign yields to remain low from a historical perspective. In general, we expect lower yields in the US and higher yields in Germany and the UK (see table). Yield curves in the US and Japan should see the least movement, while curves are likely to steepen in Germany and flatten in the UK. Thematically, we think the yield spread between the US and Europe will continue to shrink.

**US.** We expect the 10-year Treasury yield, now at 2.14%, should be about 2.25% by the end the year as the Federal Reserve remains on hold and global risks weigh on investors' minds. Poor performance in equity and corporate credit markets, as forecast by our respective strategists, should aid in the decline of Treasury yields. Given the higher yields on Treasuries and higher level of monetary policy rates relative to other liquid government bond markets, Treasuries should be the investor choice for hedging the downside in risky assets. Given these factors, we expect the market to continue pricing in rate cuts, even though our

economists do not project them.

In terms of the Treasury curve, we expect it to remain flat relative to history. We no longer see a pronounced or long-lasting curve inversion, given that the Fed does not anticipate a rate hike until 2020. At the same time, we don't see a steepening yield curve, given that our economists don't have rate cuts in the base case.

**Euro Zone.** We forecast a modest rise in intermediate- and longer-maturity German Bund yields in the second half of 2019 and first half of 2020, as both growth and inflation rebound in Europe following a prolonged period of disappointment on both fronts. However, our economists anticipate that growth will begin to fall below trend in 2020, consistent with a European Central Bank (ECB) that will be somewhat reluctant to embrace the near-term rebound, resulting in an unchanged ECB deposit rate.

In our view, the likelihood of only moderate engagement by the ECB with any second half growth and inflation rebound will limit a rise in Bund yields. That said, the balance of risks for Bund yields remains to the upside should growth accelerate faster than expected and year-on-year inflation bottom sooner than expected. A perception by the market that

the next ECB president is more hawkish could also act as an upside risk for Bund yields.

**UK.** Our economists expect a "softer" Brexit deal to be ratified in November 2019, allowing the UK to enter the transition period. Given the Monetary Policy Committee's (MPC) underlying hawkish bias, we think upon ratification it will swiftly guide the markets toward a rate hike in January 2020. As we approach the fourth quarter, we expect gilt yields to rise gradually in anticipation of a softer outcome. Gilt yields will continue to be volatile around Brexit-related news flow, but are likely to be largely range-bound until the uncertainty is lifted definitively. We expect to see a more pronounced sell-off toward the end of the year and into early 2020 on the back of both ratification and the MPC returning to focus.

**Japan.** Given a subdued inflation outlook, our economists expect the Bank of Japan to push back the timing of forward guidance on the long- and short-term policy rates from "at least through around spring 2020" to at least fall 2020. Clear forward guidance and subdued actual core Consumer Price Index numbers will keep the rate expectations well anchored below 0% over our forecast horizon, in our view.

From a supply/demand perspective, we believe that Japanese life insurance companies will continue to demand super-long Japanese government bonds (JGBs)—the only assets on the JGB yield curve able to provide attractive yields. We expect the 30-year JGB to end at 0.45% in the second quarter of next year. As for short-to-medium-term yields, we expect them to remain anchored below the level of short-term policy rates, thanks to sustainable demand from overseas investors. ■

## MS & Co. Government Bond Yield Forecasts

Maturity	Two Years		Five Years		10 Years		30-Years	
	4Q '19	2Q '20	4Q '19	2Q '20	4Q '19	2Q '20	4Q '19	2Q '20
Country								
<b>US</b>	2.15%	2.05%	2.10%	2.00%	2.25%	2.20%	2.65%	2.60%
<b>Germany</b>	-0.50	-0.45	-0.25	-0.20	-0.08	-0.08	0.90	1.05
<b>Japan</b>	-0.18	-0.18	-0.18	-0.18	-0.08	-0.08	0.45	0.45
<b>UK</b>	0.90	1.15	1.00	1.35	1.30	1.40	1.75	1.85

Source: Morgan Stanley & Co. Research as of May 12, 2019

ON THE MARKETS / CURRENCIES

# Short-Term Fixed Income Funds Gain Appeal

**SUSAN K. MCDOWELL**

Fixed Income Strategist  
Morgan Stanley Wealth Management

**OLGA PUJARA, CFA**

Fixed Income Strategist  
Morgan Stanley Wealth Management

With short-term interest rates well above the near-zero levels where they sat for years after the financial crisis and, thanks to the flat yield curve, yielding a little less than long-term bonds, investors are increasingly turning to shorter-term fixed income investments. These funds can provide some income while serving as a hedge against market volatility (see table).

Short-duration fixed income fund assets have grown to \$480 billion from \$100 billion in the past 10 years. With stocks turning more volatile in May while the yield on the benchmark 10-year Treasury note is once again below 2.5%, Global Investment Manager Analysis (GIMA) expects to see interest in these funds grow.

Short-duration fixed income funds are diverse and differ in risk/return profile and expected yields. GIMA's due diligence process makes sure many quality managers are available on our platform, but Financial Advisors need to choose the right vehicle for their client's needs.

Below are some short-duration fixed income categories and guidelines for when to consider different options:

**Money Market Funds.** These funds can act as a proxy for cash and are a good option for emergency funds or assets ready to be deployed for a purchase, large expense or new investment. Securities in money market funds must have an average maturity of 60 days or less. They are not insured by the FDIC.

**Ultrashort Bond Funds.** One step up in duration from money market funds,

ultrashort funds invest in slightly longer-term fixed income instruments and typically have an average duration of six to 18 months. They may take limited credit and interest rate risk and are a good option for investors who want safety, but also some yield. The 10-year average annual return for ultrashort bond funds through 2018 was 1.7%, according to Morningstar.

**Short-Term Bond.** These funds are another step out on the maturity horizon and typically have durations of 18 months to three years. Risks and yields vary depending on the fund's strategy. Credit, interest rate and liquidity risks are all possible. The 10-year average annual return for these funds through 2018 was 2.4%, according to Morningstar.

**Short-Term High Yield.** These funds invest in securities rated below investment grade with maturities of 18 months to three years. Clearly, they take much more credit risk than investment grade short-term funds. Yields can be quite a bit higher, but potential for losses is, too. These funds are appropriate as part of a

high yield allocation in a portfolio.

**Short-Term Municipal Bond.** For taxable accounts, there are tax-exempt versions of all the short-term fixed income fund categories. The 10-year average annual return for short-term municipal bond funds through 2018 was 2.4%, according to Morningstar. There are additional considerations when choosing a short duration fund. For example, some funds may represent a single asset class (corporate bonds, bank loans or government bonds), or diversify across security types. It may include securities that may have elevated risks, like emerging market debt, high yield bonds or bank loans; such funds may include "plus" or "multisector" in their names. Funds can also vary by how sensitive they are to interest rate fluctuations.

Market shocks, shifting economic conditions, geopolitical events, and esoteric environments can also influence how these funds perform. Evidence suggests that under most market conditions, lower-risk strategies with shorter durations have provided a positive hedge and low correlation to riskier fixed income and equities. Similarly, higher-risk strategies with a longer duration have provided less of a hedge during market shocks and rising interest rate environments. ■

## Short-Duration Index Returns During Market Shocks

Event	Main Year	S&P 500	US Treasury Returns		
			Three-Mo. Bills*	Two-Year Notes**	Five-Year Notes**
Iraq Invaded Kuwait	1990	-13.5%	0.7%	1.1%	-0.1%
Russian and Long-Term Capital Management (LTCM)	1998	-15.4	0.9	2.2	3.2
Bursting of Tech Bubble and 9/11	2001	-29.3	8.7	15.4	19.6
Financial Crisis	2008	-50.9	2.8	8.6	16.7
2016 Elections	2016	12	0.1	-0.5	-2.2

\*ICE BofAML 3-Month Treasury Bill Index

\*\*Ryan Labs 2-Year and 5-Year Treasury Indexes

Source: Morgan Stanley Wealth Management Portfolio Analytics

ON THE MARKETS / CURRENCIES

# Preparing for the US Dollar Sell-Off

## HANS REDEKER

Head of FX Strategy Team  
Morgan Stanley & Co. International PLC+

For the past 20 years, the US dollar has benefited from improving global liquidity conditions, which were in turn driven by the rest of the world increasing its net savings and the accommodative monetary policy from inflation-targeting central banks. US capital imports flourished in this environment, keeping funding conditions supportive. It also incentivized companies to leverage up and therefor eroded US balance sheet quality.

Now, the tide may be turning for the dollar. External savings have started to decline, and while inflation may stay low for now, global capacity reserves should ease once non-US growth regains some of

the momentum lost last year due to trade tensions and China's previous financial deleveraging policy. Hence, the bulk of central bank accommodation may be behind us.

**LESS LIQUIDITY.** Looking ahead, tighter global liquidity conditions seem more likely, which will not bode well for the currencies of areas dependent on capital imports, such as the dollar. What's more, eroding US real yields reduce the attractiveness of dollar-based assets, and that should translate into dollar weakness as the US capital inflows reverse. Broadly speaking, we see the US Dollar Index, now at 97, declining about 10% by the end of 2020 (see chart).

Initially, we expect low-yielding

currencies, such as the Japanese yen, currently at 108 to the dollar, and the euro, at 1.12, should lead the rally against the weakening dollar (see table). Our forecast for the yen is 108 in the fourth quarter, 104 a year from now and 98 by year-end 2020. The euro has a similar trajectory: 1.16 in the fourth quarter, 1.20 by mid 2020 and 1.26 by the end of 2020. In our view, emerging market (EM) currencies as a bloc may follow suit, also making gains against the greenback.

**EM ASSETS.** Later this year, EM assets may benefit from US dollar weakness and low real yields. Deteriorating global liquidity conditions won't necessarily be positive for the emerging markets, but a weaker dollar should offset some of the pressure. EM countries and companies that issued dollar-based bonds should find it easier to service their debt as their payments will be in a depreciating currency. ■

## MS & Co. Expects a Decline In the US Dollar Index



Source: Morgan Stanley & Co. Research as of May 31, 2019

## MS & Co. Global Currency Forecasts

Currency vs. US Dollar	Current	4Q '19	2Q '20	4Q '20
Euro	1.12	1.16	1.20	1.26
Japan	108	108	104	98
UK	1.26	1.38	1.45	1.51
China	6.90	6.60	6.50	6.45
Canada	1.35	1.30	1.32	1.34
Australia	0.70	0.71	0.73	0.75
Brazil	3.91	3.75	3.65	3.65
Mexico	18.92	19.00	19.30	19.60
US Dollar Index	98	94	91	87
Fed's Broad US Dollar Idx.	129	111	109	107

Source: Bloomberg, MS & Co. Research as of May 28, 2019

# The Bullish Case for European Equities

The case for investing in Europe is an easy one, says Katrina Dudley, portfolio manager of the Franklin Mutual European Fund—but not on account of promising growth potential or outstanding earnings prospects. “Investor perception is so low,” she explains, “that the bar Europe has to reach is not that high for you to have a better-than-expected outcome.” At its best so far in 2019, the MSCI Europe Index was still 5% below its high from before the financial crisis. Meanwhile, the S&P 500 has come close to nearly doubling the 1,565 peak it hit amid the housing bubble. Dudley recently shared her thoughts on Europe, including challenges and attractive investment opportunities, with Vijay Chandar, a market strategist at Morgan Stanley Wealth Management. The following is an edited version of their conversation.

**VIJAY CHANDAR (VC):** What are your thoughts on Europe’s growth prospects?

**KATRINA DUDLEY (KD):** We are quite bullish on Europe. We aren’t saying this time is different, or that Europe is suddenly going to have a 4% to 5% growth rate. The market perception of Europe’s growth potential is so extraordinarily low given all the negative news in 2018 and into early 2019, that it represents an investment opportunity. We’ve had Brexit headlines, Italy headlines, etc., that have caused investors to become pessimistic on the region, but we don’t think the low expectations match the underlying macro trends that we’re seeing.

There are a lot of reasons that we think there’s an opportunity in the European equity market. Back in April 2018, you

had the sanctions from the US against Russia that actually pulled back the growth in the Russian economy—and Europe does a lot of business with Russia, so that was a headwind. Also last year, Turkey, a big export partner, was fairly disruptive. Looking ahead, as these headwinds annualize, we expect good export growth in the region.

Not many US investors are aware that the Rhine was close to dry last summer, which disrupted chemical supply chains and had a negative impact on GDP growth in that region. Now the Rhine levels are back up, and we don’t expect that to continue.

Oil prices started to strengthen in the first half of 2018, and that was another headwind that we think is settling now. Finally, the French protests last year were destructive to the markets, and had repercussions throughout the region. The last year saw an unusually high number of one-time events that occurred both within and outside the European region and the low likelihood of this repeating in 2019 makes us more optimistic in general.

We also have supportive monetary policy. The European Central Bank (ECB) has been very clear that rates will remain low in order to support economic growth in the region, and generally speaking, fiscal policy is easing. For example, Italy is putting more stimulus into the Italian economy. Recall that, coming out of the financial crisis, Europe had more restrictive fiscal policies than we had in the US. Now, most European countries have fiscal policies that are supportive of economic growth.

European consumers are a little different from US consumers—they have been a lot more conservative in terms of consumer spending, and I would say there’s probably a little more pent-up demand for buying goods and services.

Finally, whereas in the US we are concerned about corporate debt levels, companies that operate in the real core economy of Europe have significantly lower levels of leverage than a similar subset of companies in the US. This has implications in terms of their ability to do mergers and acquisitions (M&A) and where they can create value through synergies and taking costs out, or it gives them flexibility to buy back shares.

**VC:** How would you classify where Europe is in the economic cycle today?

**KD:** We’re not seeing any of the classic recession indicators here in the US or over in Europe. I think that is one of the disconnects we’re seeing between what happens in the stock market, particularly toward the end of December when you had that sell-off, and what is happening in the underlying economy. In Europe, we have low levels of leverage in the corporate sector, so we don’t see any risk on the balance sheet side. We see a consumer who is confident and has the potential to increase spending as a result.

What differentiates the European market and some of its performance versus what you’ve seen in the US market is that the US has a high percentage of its market cap in companies you would probably call “disruptive.” In Europe, on the other hand, you have a fairly large amount of market cap invested in sectors that are being disrupted, and I think a number of investors are completely ignoring those disrupted sectors saying that all companies involved in those sectors are uninvestable.

That’s where value investors and stock-pickers come in. We think there are opportunities to invest in some of these

disrupted sectors—but you need to do your homework on them.

**VC:** How does this frame your view of where you're finding opportunities?

**KD:** You need to dig into the companies, do your homework and understand exactly what is driving them, and what is driving the free cash flows.

One big theme is the rise of electric vehicles and autonomous vehicles. I think a lot of investors look at this and say, "I don't want to own any company that's connected in any way to the traditional automotive supply chain," and so they won't invest in any automotive suppliers.

We look at the car of the future and say it still needs to have four tires—so we own a tire company. There are also growth areas within these sectors. For example, autonomous cars need more sensors, and sensing is a light-based technology, so we own one of the leaders there.

When analyzing these companies you need to ask if they have businesses exposed to some of these legacy technologies. What are the implications of that exposure? We are not going to suddenly change out the entire population of worldwide cars to electric and autonomous vehicles overnight. Many of the suppliers have long tails of these businesses with aftermarket opportunities, and we need to make sure people understand that tail. We also need to make sure the company understands the tail and its decline curve so they can adjust their production footprint accordingly.

**VC:** How do you view the three big political issues—the ongoing budget discussions between Italy and the EU, the protests in France and Brexit—in the context of European equities?

**KD:** For Italy, we think the solution will be a flexible definition of what it means to breach the budget targets—the same way lenders and borrowers here use adjusted EBITDA (earnings before interest, tax, depreciation and amortization) in the debt agreements. In our opinion, Italy will get to adjust what they need to put in their budget and what they don't—so technically they will not breach the rules. They will not be able to go too far out of

bounds, but I think they'll be given some flexibility through definition changes.

On Brexit, I was surprised they kicked the can down the road. There is some hope of a second referendum, but we don't believe there will be one.

I was in France when the first round of protests happened, and it was actually fairly benign. It made great media headlines versus what was happening on the ground. It's resulted in a slight tempering of demand, but it is not an Armageddon event.

We have seen the rise of populist parties across the region with many running on an anti-centralization platform. As a result the new European Parliament will need to be more considerate of national interests when making decisions going forward.

**VC:** How do you feel about trade dynamics in terms of the impact of US-China relations on Chinese growth in general, on European businesses, as well as how any US-European trade agreements might affect things?

**KD:** To the extent that the China-US trade war pressures Chinese companies, you will start to see a slowing in demand that could result in job losses. Trump wants his photo op. He wants to have a trade deal with China, so something ultimately will be done. But when they come to an agreement, I have a feeling if you read the terms of the deal written up in the US press and compare that to what is written about that same deal in the Chinese press, they won't necessarily match up.

Could Trump then turn to Europe? One big debate is about US cars, which, in general, do not fit on European roads. The president has said that EU policies make it impossible for US car companies to sell there. We think he is ignoring the suitability of the product for the European road system.

I think there will be some continuation of tariffs on European cars, but it won't escalate to the same level as the US-China trade tensions. Additionally, you have to consider the UK and what happens with Brexit when looking at European trade negotiations.

**VC:** What is the outlook for financials?

**KD:** Many European banks are trading at below book value, anticipating that they will never earn a return above their cost of equity for the foreseeable future. That's what the market is pricing in. We see the banking sector from a stock-picking point of view, looking for banks that meet our valuation criteria with catalysts. You have a number of banks in the Nordic region that tend to trade at richer valuations. Some of those, however, have sold off because they've been heavily focused on lending to the household sector, and for example, you had a downturn in the Swedish housing market and this negatively impacted the banks. In this situation, the stocks sold off but they didn't get "cheap."

**VC:** What would make you a bit more cautious about performance?

**KD:** The European equity market has the medal for the longest consecutive period of outflows in over a decade.

When we consider our bullish view on the region, you should put that in the context that we are bullish because we believe the investor base is too pessimistic. Europe doesn't need to do much for its equities to outperform.

Equity market valuations are reasonable, and with corporates under-levered compared with US peers, we see opportunity for these companies to create value through M&A or share buybacks.

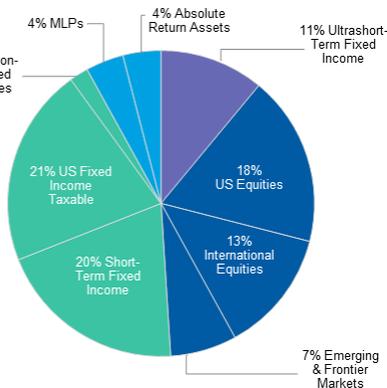
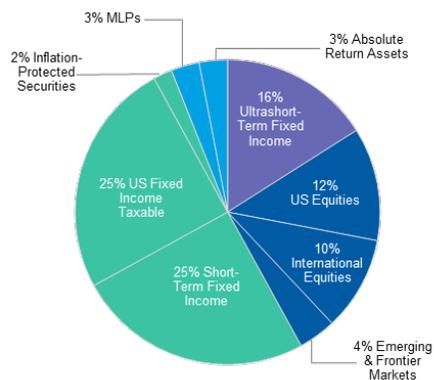
The political risks are difficult to predict. Brexit is coming in October, but there could be a deal before that date. I would be remiss if I didn't remind everyone that the European Central Bank presidency is due to change in October. Mario Draghi, president since 2011, has been fairly hawkish. It's something we need to watch, and while I don't think it is a significant risk, it is something to be aware of. ■

*Katrina Dudley is not an employee of Morgan Stanley Wealth Management. Opinions expressed by her are solely her own and may not necessarily reflect those of Morgan Stanley Wealth Management or its affiliates.*

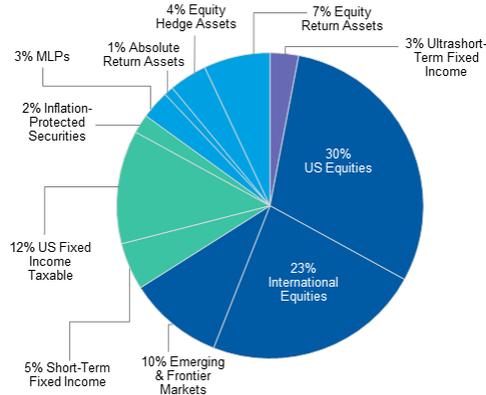
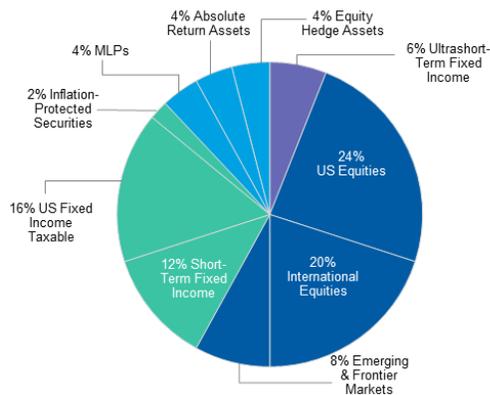
# Global Investment Committee Tactical Asset Allocation

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.

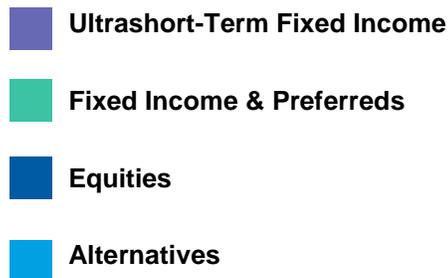
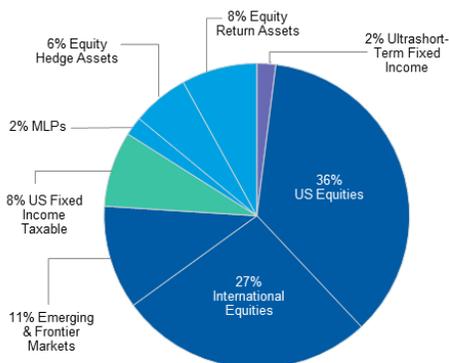
## Wealth Conservation Income



## Balanced Growth Market Growth



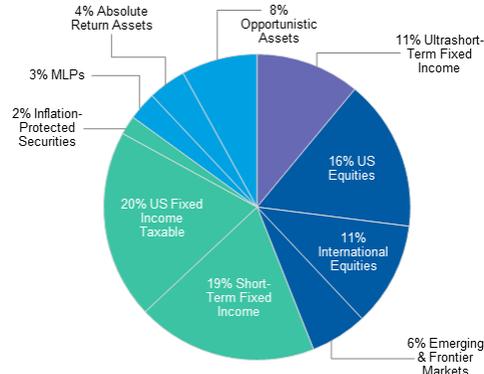
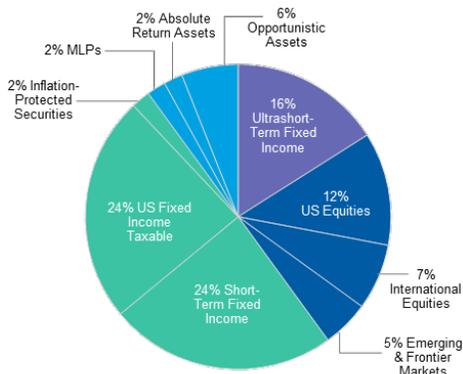
## Opportunistic Growth Key



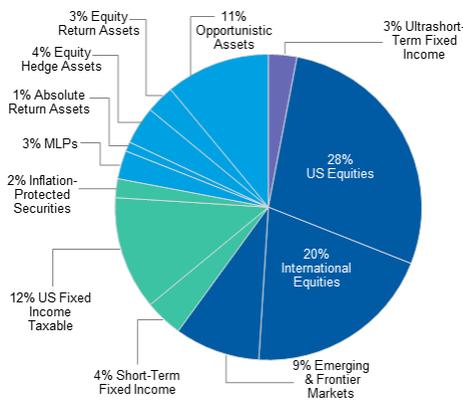
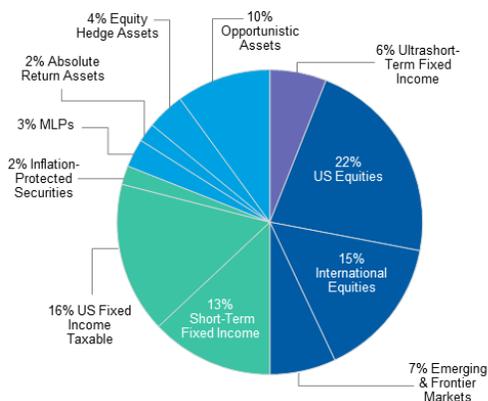
Source: Morgan Stanley Wealth Management GIC as of May 31, 2019

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.

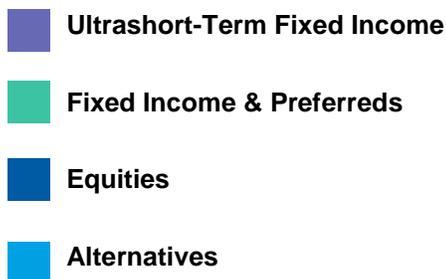
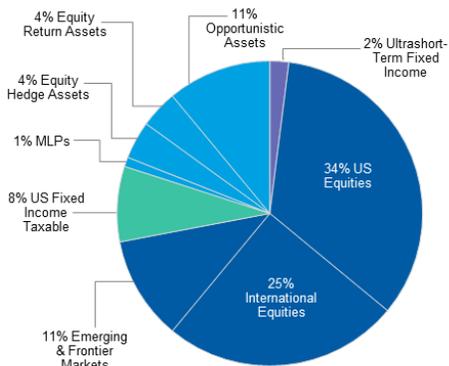
**Wealth Conservation** **Income**



**Balanced Growth** **Market Growth**



**Opportunistic Growth** **Key**



Source: Morgan Stanley Wealth Management GIC as of May 31, 2019

## Tactical Asset Allocation Reasoning

Global Equities		Relative Weight Within Equities
US	Underweight	After the worst fourth quarter since 2008, the S&P 500 had its best first quarter since 1998. This kind of volatility is unusual and was precipitated by a Federal Reserve that appeared too hawkish in December, only to reverse course on its policy perhaps faster than we've ever witnessed. Meanwhile, economic and earnings fundamentals continue to deteriorate, leaving us with an unexciting target of just 2,750 for the S&P 500 this year. As a result, we remain underweight the US.
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 nor 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 May 31, 2019

**\*For more about the risks to Master Limited Partnerships (MLPs) and Duration, please see the Risk Considerations section beginning on page 18 of this report.**

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**Chetan Ahya, Chris Baxter, Vijay Chandar, Jonathan Garner, Lisha Ge, Matthew Hornbach, Nicholas Lentini, Susan McDowell, Olga Pujara, Hans Redeker, Graham Secker and Ellen Zentner 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

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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.

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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.

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**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](http://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

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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.

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