The GIC Weekly

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What We Are Talking About

- **Fed "Pause" Doesn't Mean "Stop."** Weak economic data, political uncertainty and tightening financial conditions that catalyzed a "bear market" in December 2018 contributed to a 180-degree shift in Fed guidance; "patience" on further rate hikes and balance sheet normalization has supported a powerful relief rally, taking the S&P 500 Index up about 15% from its trough; the Treasury market has priced in an end to the hiking cycle and quantitative tightening (QT), actions that ought to provide a buffer to the economy and enable a soft landing; now, however, the risk is asymmetric; financial conditions have eased, aided by loosening at other global central banks, while expectations and lowered forecasts have paved a path to economic "surprises"; the US labor market shows no sign of letting up and oil prices have rebounded, both of which could support inflation expectations; moreover, distortions from the government shutdown and swelling household tax refunds suggest US economic data may prove resilient in the second quarter of 2019, bringing the "pause" to an end; QT is uncharted territory, but we expect two rate hikes in 2019, starting in June. **Consider** tilting toward US value and cyclical equities as long as the Fed remains biased toward easing.

Upcoming Catalysts

Feb. 11 NFIB Small Business Optimism Index
Feb. 12 Japan Producer Price Index
Feb. 13 US Consumer Price Index
Feb. 13 Euro Zone industrial production
Feb. 13 Japan fourth-quarter GDP
Feb. 14 US initial jobless claims
Feb. 14 US retail sales
Feb. 14 Euro Zone fourth-quarter GDP
Feb. 14 Japan industrial production
Feb. 14 US Producer Price Index
Feb. 15 Empire State Manufacturing Survey
Feb. 15 U. of M. Consumer Sentiment Index

Fed "Pause" Doesn't Mean "Stop"

The last two market crashes—the dot-com bubble of 2001 and the financial crisis of 2007-08—have sensitized the Federal Reserve to financial stability, introducing financial conditions as an unofficial third mandate. As we have noted often, in an era in which shadow banking (lending through the capital markets) has exploded, this development has led to complex feedback loops wherein the Fed's reactions to markets are heightened and its policy transmission mechanisms quickened. Nowhere is that more evident than in

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the latest "bear market" episode in December 2018, when markets fell sharply on fears of global economic slowing and political uncertainty. The 20% decline in stock prices and widening in credit spreads, which contributed to already tightening financial conditions, was first met with dovish rhetoric by the Fed on Jan. 4 and then fully confirmed in a Jan. 25 press conference with a 180-degree shift from their tightening agenda to a neutral bias—a policy change with implications for both the pace of rate hikes and balance sheet normalization (or quantitative tightening). In an example of the market's penchant for cognitive dissonance, when the Fed said "pause," investors heard "stop."

Since then, a powerful relief rally has lifted the S&P 500 nearly 15% from its Christmas Eve 2018 trough. Underpinning the equity advance has been the reduction in real 10-year US Treasury yields, which have fallen nearly 30 basis points since last November, expanding price/earning ratios and offsetting what have been plummeting earnings estimates. Credit spreads have retraced as well. Expectations for further rate hikes as measured in the futures market have fallen to near zero through the middle of 2020. Although the Fed's actions have likely increased the odds of a soft landing in 2019, we caution investors about assuming that the so-called "Fed put" is back and that the "Goldilocks" economy of decent growth and low inflation will last. To the contrary, the Global Investment Committee remains skeptical that the Fed's policy cycle can so easily be concluded, given the complex crosscurrents and signals facing it in 2019.

For starters, financial conditions have already eased. In a Feb. 7 report, Morgan Stanley & Co. Chief US Economist Ellen Zentner estimated that the tightening in financial conditions in the fourth quarter of 2018 was equivalent to a hike of 80 basis points. In the space of seven weeks, not only have stock prices rebounded, but the US dollar has also weakened by about 2%. Shrinking credit spreads have enabled a surge in investment grade bond issuance in January. And while the Fed's Senior Loan Officer Survey (SLOS) indicated tight conditions for corporate and small business loans, many believe this may be a lagging indicator. Taken together, Zentner's current estimation is that financial conditions are now at a neutral level, with the primary negative effects of the initial tightening likely to be contained to the first quarter of 2019, a period already muted from the effects of the 35-day government shutdown.

A second factor is that despite November and December's deceleration in growth metrics, the January data has proven more stable, suggesting that the US economy may remain resilient. Chief on the list of positives was January's payroll report, with headline job growth of 304,000. Even with downward revisions, private payrolls have averaged 234,000 per month, well ahead of the 140,000 needed to sustain the unemployment rate, and in line with the 2017 average.

Most impressive about the payroll number is that unemployment is inching up, as the participation rate is in an uptrend and at its best levels since 2014. Supporting the robust job market is wage growth, which is growing at a 3.2% annualized rate; plus, the Job Openings and Labor Turnover Survey (JOLTS) remains at a record, near 7 million. US manufacturing PMI rebounded to a solid 56.6 in January, paced by new orders; with expectations having moderated in December, the reading came as a surprise, as measured by the Citi US Economic Surprise Index.

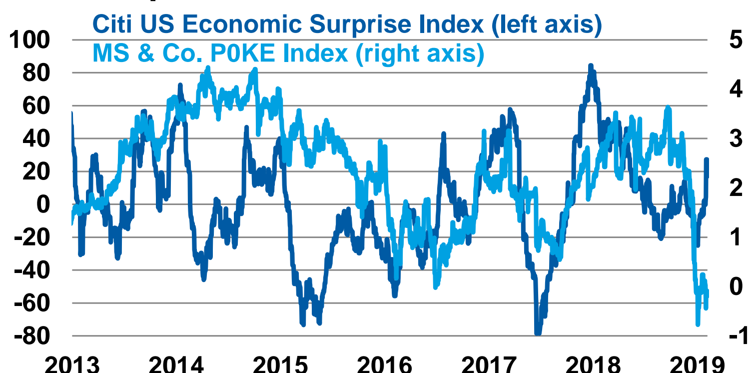
Beyond jobs and manufacturing strength, other factors to consider as to whether this resilience extends into the second quarter include the rebound effects from the government shutdown and swelling household tax refunds, both of which may support continued consumption. As illustrated in the *Chart of the Week* (see page 3), expectations for Fed rate hikes have been correlated with economic surprises. The recent data, if sustained, could force the Fed to reconsider its "pause."

A final factor facing the Fed is a resurgence in inflation expectations. Inflationary forces may be gathering as a result of the rebound in oil, given the strong correlation between inflation expectations and crude prices. Crude could easily rise higher if the political crisis in Venezuela turns into a full-blown oil embargo. The other wildcard is trade and tariffs. While media reports suggest progress in trade talks between the US and China, the March 1 deadline looms; absent a deal, there's the threat of higher import prices, a dynamic the Fed cannot ignore.

Bottom Line: The integration of financial stability as the unofficial third leg of the Federal Reserve's mandate has motivated its dovish shift, as the bank responded to tightening financial conditions and heightened political uncertainty. But investors should not read "patience" as the return of the "Fed put," wherein "Goldilocks" reigned supreme. To the contrary, we see rapidly normalizing financial conditions, resilient economic data, strong labor markets and rising inflation expectations presenting a challenge to the Fed by midyear. We could see rate hikes in June and December. **Watch** financial conditions, with inflation expectations and unemployment holding the keys to Fed "data dependency." **Consider** maintaining a tilt toward US value and cyclical equities, given the central bank's bias toward easing, which is likely to last through midyear. ■

Chart of the Week: Economic Surprises Could Upset Fed "Pause"

Since Fed rate hikes began in December 2015, the market implied pace of hikes (MS & Co. P0KE Index) has followed the direction of economic surprises, as measured by the Citi US Economic Surprise Index. Recent guidance that the Fed would be "patient" and pause before resuming hikes and that they may scale back balance sheet normalization has caused markets to discount the next Fed move. These reduced expectations have created a positive backdrop for economic surprises. In fact, the recent collapse in financial conditions fueled by higher stock markets, tighter credit spreads, a weaker dollar and stronger oil prices has helped sustain US economic resilience. Better PMI manufacturing data in January and momentum in job markets have caused the Citi index to hook up, implying the risk of assuming the "Fed is done."



Source: Bloomberg as of Feb. 7, 2019

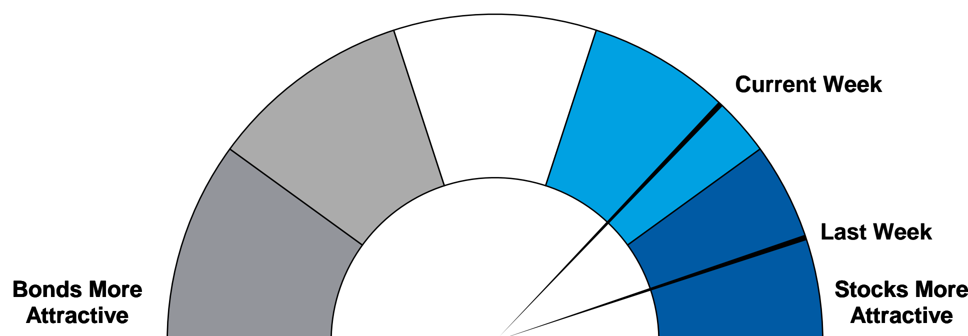
Asset Class Performance and Heat Map (as of Feb. 8, 2019)

Asset Class	Annualized Returns (%)							Yield	Valuation		Volatility (%)		Correlation to Global Equities	
Cash	**YTD**	**1-Yr.**	**2018**	**3-Yr.[1]**	**5-Yr.[1]**	**10-Yr.[1]**	**20-Yr.[1]**	**Current YTM**	**Current YTM**	**Avg. YTM[2]**	**30 Days**	**20 Yrs.[1]**	**30 Days**	**20 Yrs.[1]**
90-Day US Treasury Bills	0.3	2.0	1.9	1.0	0.6	0.4	1.8	2.42	2.42	1.79	0.08	0.55	-0.30	-0.05
Global Equities								**Current Div. Yld.**	**Current P/E**	**Avg. P/E[2]**				
US Large-Cap Growth	9.3	9.8	-0.9	11.2	10.8	15.3	4.6	1.06	20.6	20.9	15.5	17.0	0.91	0.89
US Large-Cap Value	6.8	4.9	-6.5	7.8	6.7	10.8	5.6	3.14	13.0	13.8	9.0	13.9	0.87	0.88
US Mid-Cap Growth	12.9	6.8	-7.9	6.1	6.0	14.4	6.5	0.66	20.4	26.5	12.6	22.7	0.92	0.81
US Mid-Cap Value	10.4	2.8	-11.4	7.9	6.4	13.4	8.7	2.93	13.6	14.4	9.1	16.1	0.90	0.88
US Small-Cap Growth	12.9	9.6	-6.6	9.5	6.3	15.1	9.3	0.61	26.1	24.0	13.8	21.4	0.90	0.83
US Small-Cap Value	12.3	3.6	-13.3	6.7	4.8	12.9	8.8	2.76	15.4	17.2	10.4	17.3	0.85	0.84
Europe Equity	5.2	-8.1	-14.3	2.7	0.0	6.8	3.7	3.81	12.8	13.9	11.8	17.9	0.83	0.94
Japan Equity	3.1	-10.5	-12.6	3.8	3.4	5.6	3.1	2.45	11.8	19.3	12.6	16.4	0.52	0.70
Asia Pacific ex Japan Equity	8.1	-0.8	-10.2	6.9	2.2	10.0	8.6	4.00	14.8	14.5	11.0	19.7	0.71	0.88
Emerging Markets	7.3	-8.4	-14.2	9.7	2.0	8.4	8.8	2.76	11.7	11.3	11.5	21.9	0.82	0.87
Global Fixed Income								**Current YTM**	**Current Spread**	**Avg. Spread[2]**				
Short-Term Fixed Income	0.5	2.3	1.6	1.2	1.0	1.5	3.1	2.66	17.0	31.0	0.9	1.4	-0.27	-0.14
US Fixed Income	1.2	3.2	0.0	2.1	2.5	3.5	4.5	3.16	47.0	54.0	2.4	3.4	-0.21	-0.03
International Fixed Income	1.0	-2.1	-1.9	3.1	0.3	2.0	3.3	1.18	56.0	49.0	4.0	7.9	0.07	0.32
Inflation-Protected Securities	2.2	-1.9	-4.2	3.6	1.3	3.9	5.3	-	-	-	4.8	7.7	0.11	0.45
High Yield	4.3	0.3	-4.1	6.6	3.3	11.1	7.8	6.85	448.0	499.0	3.5	9.5	0.77	0.75
Emerging Markets Fixed. Inc.	4.5	-4.3	-6.2	5.9	-1.0	3.5	7.7	6.24	280.0	332.5	7.2	11.6	0.44	0.66
Alternative Investments								**Current Div. Yld.**						
Real Estate/REITs	11.0	12.5	-5.5	4.4	5.4	10.4	8.6	3.96	-	-	7.9	17.9	0.56	0.80
MLP/Energy Infrastructure[3]	9.8	-3.8	-12.4	-1.1	-7.3	9.6	-	7.89	-	-	20.0	18.8	0.73	0.58
Commodities ex Prec. Metals	5.1	-6.9	-12.5	-0.7	-10.3	-5.0	0.8	-	-	-	13.4	16.8	0.72	0.46
Precious Metals	2.5	-1.5	-4.6	5.1	-0.9	3.1	6.8	-	-	-	8.0	19.1	0.07	0.18
Hedged Strategies[4]	2.3	-4.8	-6.7	0.4	-0.6	1.5	-	-	-	-	-	6.0	-	0.64
Managed Futures[5]	-1.8	-5.0	-3.2	-1.3	-0.1	-1.9	-	-	-	-	-	7.8	-	0.18
S&P 500	8.2	7.0	-4.4	9.3	8.5	13.1	5.6	1.94	15.8	15.8	11.35	14.5	0.94	0.95
Russell 2000	11.8	4.3	-11.0	7.4	4.4	12.0	7.4	1.35	25.9	20.3	12.48	19.6	0.89	0.82
MSCI EAFE	5.1	-7.8	-13.4	3.4	1.0	6.8	4.0	3.49	12.7	14.7	10.13	16.3	0.87	0.96
MSCI AC World	7.4	0.1	-8.9	7.2	4.8	10.0	5.0	2.61	14.2	15.3	9.93	15.3	1.00	1.00

Note: Performance values calculated using USD. 1. As of Jan. 31, 2019. 2. 20-year average as of Jan. 31, 2019. 3. Volatility and Correlation: June 30, 2006 – Present. 4. Volatility and Correlation: Jan 31, 1998 – Present Hedged strategies consist of hedge funds and managed futures 5. Volatility and Correlation: February 28, 1998 – Present. Cheap = Below -0.5 standard deviation; Moderate = Between +0.5 standard deviation and -0.5 standard deviation; Expensive = Above +.5 std dev. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean.
Source: Factset, Bloomberg, Morgan Stanley Wealth Management GIC.

Valuation	Volatility	Correlation
Cheap	Low	Low
Moderate	High	High
Expensive		

Short-Term Stock and Bond Indicator



	Macro		Policy		Fundamentals		Sentiment and Technicals	
	Growth	Inflation	Rates	Liquidity	Valuation & Market	Earnings	Sentiment	Technicals
Current	Neutral	Neutral	Very Positive	Neutral	Neutral	Neutral	Neutral	Very Positive
Last Week	Neutral	Very Positive	Very Positive	Very Positive	Very Positive	Neutral	Neutral	Very Positive

Indicator	Category	Reading
PMI (+)	Growth	Neutral
Durable Goods (+)		Neutral
Retail Sales (+)		Neutral
Manufacturing Hours Worked (+)		Risk Off
Commodity Prices (+)	Inflation	Neutral
Yield Curve: 10-Yr./Three-Mo.(-)	Rates	Risk On
Yield Curve: Two-Yr./Three-Mo.(-)		Risk On
Pace of Interest Rate Hikes (-)		Risk On
Term Premium Model (-)		Risk Off
High Yield Spreads (-)	Liquidity	Neutral
Investment Grade Spreads (-)		Neutral
Financial Conditions (-)		Risk On
S&P 500 Earnings/Baa Yield (+)	Valuation & Market Behavior	Neutral
Large vs. Small Performance (-)		Neutral
High- vs. Low-Quality Performance (-)		Neutral
High- vs. Low-Beta Performance (+)		Risk On
S&P 500 Forward Price/Earnings Ratio (+)		Risk On
Earnings Revisions Breadth (-)	Earnings	Neutral
Global Risk Demand (+)	Sentiment	Risk On
Implied Currency Volatility (-)		Risk On
Five-Yr. Macro Sensitivity (-)		Risk Off
% Stocks Above 200-Day Moving Avg. (+)	Technicals	Risk On
Cumulative Advance/Decline (+)		Risk On
S&P 500 Put/Call Ratio (-)		Neutral
Emerging Market Fund Flows (+)		Risk On
Smart Money Flow Index (+)		Risk On
Note: + Indicates that a rise in the indicator is linked to a more favorable outlook for risk assets; - indicates that a rise in the indicator is linked to a less favorable outlook for risk assets. Color coding is set in accordance with the impact on risk assets.		Positive for Stocks Relative to Bonds
		Neutral
		Negative for Stocks Relative to Bonds

Note: Commodity prices are represented by the Bloomberg Commodity Index; pace of interest rate hikes by the Morgan Stanley Pace of Rate Hikes Index; high yield spreads by the Bloomberg Barclays Aggregate US High Yield Index; investment grade spreads by the Bloomberg Barclays US Aggregate Index; financial conditions by the Morgan Stanley Financial Conditions Index; global risk demand and implied currency volatility by the Morgan Stanley Standardized Global Risk Demand Index. For more information on our Term Premium Model, please refer to our special report, *Using the Term Premium to Manage Portfolio Duration*, March 2016.
Source: Morgan Stanley Wealth Management GIC, Morgan Stanley & Co., Haver Analytics, Bloomberg, FactSet as of Feb. 8, 2019

Fixed Income Insight: Fed "Pause" Allows Yield Curves to Re-Steepen

Recent Fed guidance that it was pausing on rate hikes and might bring an earlier end to balance sheet normalization than previously indicated, seemed to deliver what the markets have been looking for. With the Federal Reserve on "pause," the odds of the expected GDP slowdown in 2019 ending in a gentle, soft landing have gone up. Such a prospect has caused a steepening of the yield curve from the "belly" (intermediate five-year bonds) to the long end, at 30 years. If this "Goldilocks" pricing persists, it may serve to stimulate bank lending, especially for the housing market. While this type of backdrop is often a good omen for value and cyclical stocks, in the bond market we continue to want to stay short duration.

Source: Bloomberg as of Feb. 8, 2019

Government Debt Monitor

Treasury Benchmark	US Yield (%) Current	ΔWTD	ΔYTD	Total Return (%) YTD
3-Month	2.41	0.03	0.06	0.26
2-Year	2.47	-0.04	-0.02	0.32
5-Year	2.44	-0.06	-0.07	0.59
10-Year	2.63	-0.05	-0.05	0.79
30-Year	2.98	-0.05	-0.03	1.33
2-Yr./10-Yr. Spread (bp)	17	-1.34	-2.75	-
10-Yr. TIPS Breakeven (bp)	183	-4.40	11.37	-
Interest Rate Volatility† (bp)	50	0.84	-16.95	-

Fixed Income Spread Dashboard

		Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	OAS Range** Rich	Cheap
Investment Grade	MBS*	4.19	3.32	40	17	44
Investment Grade	AAA	4.38	2.77	24	18	39
Investment Grade	AA	5.37	2.89	18	11	20
Investment Grade	A	7.24	3.62	101	68	124
Investment Grade	BBB	7.23	4.33	172	115	207
High Yield	BB	4.05	5.37	283	212	392
High Yield	B	3.56	7.18	469	332	598
High Yield	CCC	3.27	12.68	1,116	728	1,272

Unless stated, indexes utilized are FTSE Broad Investment Grade, FTSE High Yield, and FTSE Global Indexes
†Interest Rate Volatility measured by Merrill Lynch Option Volatility Estimate (MOVE) Index
*MBS distills high grade agency-rated mortgage-backed securities, a substantial subsector of investment grade indexes.
**OAS stands for Option-Adjusted Spread or spread over the Treasury. Grey diamond denotes current OAS; blue circle denotes two-year average.
Source: Bloomberg, The Yield Book® Software and Services. © 2019 FTSE Index LLC. All rights reserved. Data as of Feb. 8, 2019

Government Debt Monitor

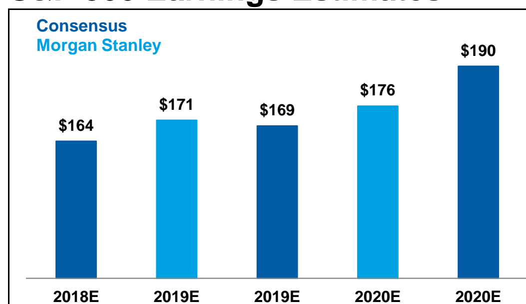
10-Year Govt. Bond	Global Yield (%) Current	ΔWTD	ΔYTD	Total Return (%)* YTD
France	0.54	-0.03	-0.17	1.73
Germany	0.09	-0.08	-0.15	1.87
Japan	-0.03	-0.01	-0.03	0.68
Spain	1.23	0.01	-0.18	1.79
UK	1.15	-0.10	-0.13	1.33
3-Month LIBOR	2.70	-0.04	-0.11	-
US Tax Exempt				
10-Year AAA Muni	2.16	-0.10	-0.16	1.02
10-Yr. Muni/UST Ratio	82.07	-1.65	-4.22	-

Benchmark Returns

Index	Total Returns (%) YTD	MTD	2017
Bloomberg Barclays US Aggregate	1.20	0.13	0.01
Bloomberg Barclays US MBS	0.74	-0.06	0.99
Bloomberg Barclays US IG Corporate	2.68	0.32	-2.51
Bloomberg Barclays Municipal	1.02	0.27	1.28
Bloomberg Barclays US High Yield	4.83	0.29	-2.08
Bloomberg Barclays Global Aggregate	1.03	-0.48	-1.20
JPMorgan Emerging Market	4.48	0.05	-4.61

*Global total returns reflect Citigroup 7- to 10-year bond indexes and Muni total returns reflect Bloomberg Barclays Municipal Bond Index Total Return
Source: Bloomberg, Thomson Reuters Municipal Market Data (MMD) as of Feb. 8, 2019

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of Feb. 8, 2019

MS & Co. S&P 500 Price Target: Year-End 2019

Landscape	Earnings	Price/Earnings Multiple	Price Target	Upside / Downside
Bull Case	$185	16.0	3,000	10.8%
Base Case	$176	15.5	2,750	1.6%
Bear Case	$161	15.0	2,400	-11.4%
	Current S&P 500 Price		2,708	

Note: 2019 price targets are based on estimated 2020 earnings.
Source: Thomson Reuters, Morgan Stanley & Co. Research as of Feb. 8, 2019

S&P 500 Sector Performance and Valuation (as of Feb. 8, 2019)

Index Name	Total Return			Dividend Yield (%)	Beta	20-Year Avg. Forward 12-Mo. PE	Forward 12-Mo. P/E*
	WTD (%)	YTD (%)	1-Year (%)				
S&P 500	***1.73***	***8.24***	***-2.06***	***1.94***		***15.7***	***15.8***
Energy	0.18	9.83	-14.29	3.15	0.95	17.4	**17.8**
Materials	-0.72	4.33	-13.35	2.01	0.97	13.9	**15.1**
Industrials	4.23	13.42	-6.44	2.04	1.03	16.1	**14.9**
Consumer Discretionary	-0.37	8.03	0.70	1.29	1.12	18.0	**19.7**
Consumer Staples	4.12	6.11	-3.87	2.99	0.53	16.8	**17.6**
Health Care	1.15	4.10	3.82	1.63	0.92	16.6	**15.6**
Financials	-1.21	7.85	-12.83	1.96	0.96	12.6	**11.4**
Information Technology	2.99	9.66	1.62	1.56	1.34	20.3	**16.7**
Telecommunication Services	2.02	9.63	-6.93	1.46	0.87	15.9	**17.2**
Utilities	4.45	5.28	14.89	3.33	0.24	14.3	**17.4**
Real Estate	4.32	11.57	13.30	3.14	0.51	15.3	**18.2**

*Dark blue/light blue/gray fill denotes whether current relative forward 12-month P/E is low/neutral/high relative to history.
Source: Morgan Stanley & Co. Research

Performance of Style and Cap Pairs (as of Feb. 8, 2019)

Source: Morgan Stanley & Co. Small Cap is represented by the Russell 2000 Index; Large Cap represented by the Russell 1000 Index; Growth represented by the Russell 1000 Growth Index; Value represented by the Russell 1000 Value Index.Cyclicals and Defensives, and Quality and Junk are based on Morgan Stanley & Co. Research analysis.

Morgan Stanley & Co. Forecasts (as of Feb. 8, 2019)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2018E	2019E	2020E	Q2 '19E	Q4 '19E	2018E	2019E	2020E	Q1 '19E	Q3 '19E	Q1 '20E
Global	3.7	3.5	3.5			2.8	2.7	2.9			
US	2.9	2.3	1.9	2.55	2.45	2.4	1.8	2.6			
Euro Zone	1.9	1.6	1.5			1.7	1.4	1.7	1.17	1.26	1.34
UK	1.2	1.2	1.5	1.55	1.65	2.5	2.0	2.0	1.34	1.45	1.54
Japan	0.7	1.2	0.6	0.20	0.18	1.0	0.0	0.6	109	104	100
Emerging Markets	4.8	4.7	4.8			3.4	3.6	3.5			
China	6.6	6.3	6.1			2.1	2.4	2.2	7.05	6.92	6.81

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of Feb. 8, 2019)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	GIC Conclusion
Japan	↓	↓	↓	↓	↑	↓	↓	Improving Profits and Weaker Yen
Europe	↓	↓	↓	↑	↑	↑	↑	Cyclical Headwinds from China Trade Links Abating
China	↓	↑	↑	↑	↑	↑	↑	Soft Landing Better than Expected
Brazil	↓	↓	↑	↓	↑	↑	↓	Political Stability Supports Recovery

Risk Asset Positive | Neutral | Risk Asset Negative

Note: Text in a factor box denotes a color change; for further explanation of the chart, see page 9.
Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending Feb. 8, 2019)

	Positives	Negatives
Global Growth	• US trade deficit narrowed to $49.3 billion in November vs. $54.0 billion expected decrease • January Euro Zone Markit Composite PMI beat forecast at 51.0 vs. 50.7 projected	• Weekly initial jobless claims at 234,000 vs. 221,000 projected • US Markit Composite PMI came in at 54.4 in January vs. 54.5 in December • US factory orders declined 0.6% month over month in November vs. an expected increase of 0.3% • November US durable goods orders weaker than expected at 0.7% vs. 1.5% forecast • Euro Zone PPI below estimate in December at 3.0% year over year vs. 3.1% expected
Rates	• Reserve Bank of India reduced repo rate by 25 basis points from 6.5% to 6.25%	

Source: Morgan Stanley Wealth Management GIC

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Underweight	US equities had a very difficult finish to 2018 after holding up better than other equity markets through the first three quarters. The highest quality market is always the last to fall and so we view the sell-off in US equities as a good sign that the worst of the cyclical bear market we expected at the beginning of 2018 is now behind us. We may look to revisit our position in US equities if the S&P 500 trades below 2,400 on a re-test of the lows made in December. From those levels, our target of 2,750 offers attractive upside.
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 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 the US dollar appearing to have made a cyclical top, global nominal GDP growth could trough in the first quarter as China's fiscal stimulus takes hold. This should disproportionately benefit 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. With the Quantitative Easing era now over, long-duration bonds are unlikely to provide the same level of portfolio diversification benefits as they have in the past. Therefore, we remain underweight long-duration bonds.
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 oil prices weighing on inflation expectations, these securities still offer relative value in the context of our expectations for global growth to accelerate, oil prices to trough and the US dollar to top. In short, inflation risk is underpriced
High Yield	Underweight	High yield bonds have recently fallen victim to the rolling bear market we predicted for global asset markets in 2018. They now offer better risk/reward, but equities still look more attractive given their recent correction. With a zero weighting in high yield since January 2018, we will revisit our allocation to high yield bonds during 2019 if spreads continue to widen.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Underweight	Real estate investment trusts (REITs) have rebounded in the second half of 2018 as global growth fears returned 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 sharply in the first half of 2018 only to give it all back as oil prices collapsed in the fourth quarter. With oil prices recovering again and a more favorable regulatory environment, MLPs should provide a reliable and attractive yield relative to high yield. The 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.

For more about the risks to Master Limited Partnerships (MLPs) and Duration, please see the Risk Considerations section beginning on page 10 of this report.

Source: Morgan Stanley Wealth Management GIC as of Feb. 8, 2019

Macro Factor Heat Map Key (see page 7)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	Conclusion
Dark Blue	Economic growth robust	Steep yield curve	Low-moderate and rising inflation	Liquidity robust in economy / banking system	Shorter-term sentiment and technicals bearish	Risk assets attractively valued	Earnings outlook robust	Confluence of factors supports a risk-on investment approach
Light Blue	Economic growth neutral	Normal yield curve	Low-moderate and declining inflation; moderate inflation; higher and falling inflation	Liquidity neutral in the economy / banking system	Shorter-term sentiment and technicals neutral	Risk assets neutral	Earnings outlook neutral	Confluence of factors supports a neutral investment approach
Gray	Economic growth anemic	Flat/inverted yield curve	Very high/low inflation/deflation; high and rising inflation	Liquidity low in economy / banking system	Shorter-term sentiment and technicals bullish	Risk assets are richly valued	Earnings outlook anemic	Confluence of factors supports a risk-off investment approach
Up	Growth accelerating	Yield curve steepening	Inflation rising	Liquidity increasing	Sentiment becoming more bullish	Valuations rising	Earnings outlook improving	
Down	Growth declining	Yield curve flattening	Inflation falling	Liquidity decreasing	Sentiment becoming more bearish	Valuations falling	Earnings outlook worsening	
Signal Horizon	One to three years	One to three years	One to three years	One to three years	One to three months	Six months to two years	Six months to two years	
Inputs	• Industrial production • Unemployment • Total return • Earnings revisions • Home prices • OECD LEI (China and Brazil) • MS & Co. ARIA (US)	• 10-year vs. 2-year government bond yield spread	• Consumer Price Index	• M1 growth • Private credit growth • Libor-OIS spread	• MS US Equity Risk Indicator (US) • MS Combined Market Timing Indicator (Europe) • MS Global Risk Demand Index • Relative strength index • Members above / below moving average. • Index above / below moving average • Consumer confidence	• Forward price/earnings ratio • Price/book ratio • Equity risk premium • High yield option-adjusted spread	• Earnings revisions breadth • Earnings surprise • Return on equity	• Weighted average z-score of all factors

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:
http://www.morganstanleyfa.com/public/projectfiles/id.pdf

Risk Considerations

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.

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **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.

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 of these risks may include but are not limited to: Loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices; Lack of liquidity in that there may be no secondary market for a fund; Volatility of returns; Restrictions on transferring interests in a fund; Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; Absence of information regarding valuations and pricing; Complex tax structures and delays in tax reporting; Less regulation and higher fees than mutual funds; and Risks associated with the operations, personnel, and processes of the manager. Further, opinions regarding Alternative Investments expressed herein may differ from the opinions expressed by Morgan Stanley Wealth Management and/or other businesses/affiliates of Morgan Stanley Wealth Management.

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.

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 bond funds Ultra-short bond funds are mutual funds and exchange-traded funds that generally invest in fixed income securities with very short maturities, typically less than one year. They are not money market funds. While money market funds attempt to maintain a stable net asset value, an ultra-short bond fund's net asset value will fluctuate, which may result in the loss of the principal amount invested. They are therefore subject to the risks associated with debt securities such as credit and interest rate risk.

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

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

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

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

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

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

Asset-backed securities generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments.

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

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.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

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

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.

Credit ratings are subject to change.

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.

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.

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