WEALTH MANAGEMENT

Morgan Stanley

Monthly Investment Perspectives

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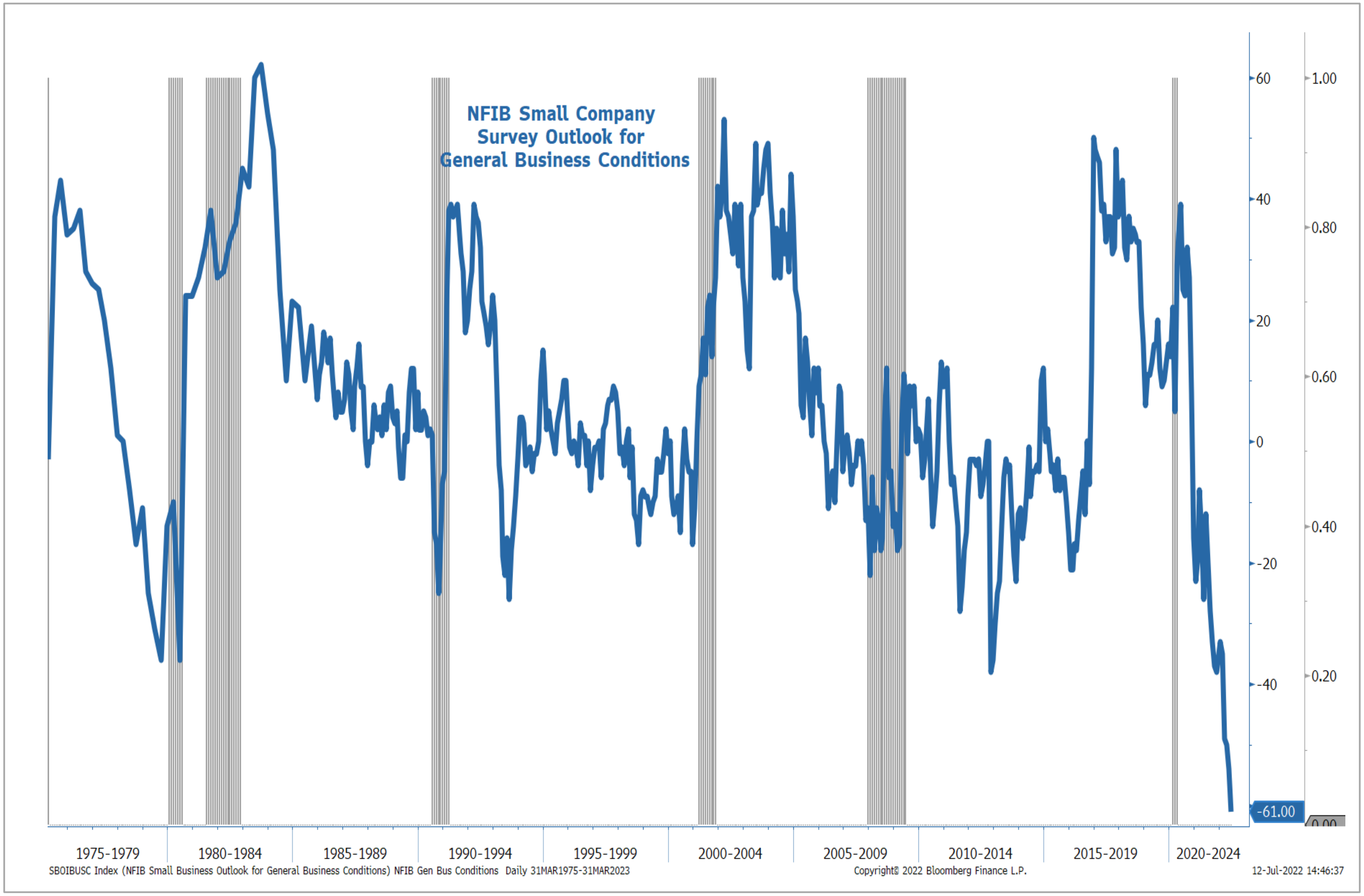
July 2022

The Hotter but Shorter Cycle Is Playing Out Across Asset Markets

- **Russian Invasion of Ukraine Amplifies the Fire *and* Ice:** The de-rating of asset prices has been ongoing for almost a year, but it remains incomplete, in our view. Peak rate of change in policy and economic/earnings growth has typically coincided with more conservative investment and has ended with a broader equity market correction. Over the past 12 months we have experienced a bear market in many asset categories. We have been expecting the final stage of this rolling correction to end with a 20% correction in the S&P 500 and Nasdaq. That has happened this year but the bear market remains incomplete in our view until earnings forecasts more accurately reflect our concerns around payback in demand, margin pressure from inflation and Fed tightening.
- **Hotter but Shorter Cycle Is Playing Out Even Faster.** This entire recession and recovery has been one of the fastest on record. In fact, based on the data it now looks like we are already late cycle, with recession risks increasing significantly for next year (40% probability and rising). This late cycle has been confirmed by the very defensive leadership exhibited within equity markets. Yield curve flattening is the bond market's way of saying the Fed has already gone far enough, we are late cycle and closer to a recession than not. At this point, we recommend buying bond duration as a hedge against slowing growth/recession.
- **The Year of the Stock Picker.** With tightening financial conditions and slowing growth making this a much more difficult year for stocks, investors are going to have to be better stock pickers to generate strong returns—i.e., good active managers should outperform passive strategies. The high dispersion between stocks suggests that opportunity is available, if not difficult to find in the current environment. We are focused on companies with high operational efficiency and earnings stability in a world of higher inflation and cost of capital. This means low capex, low inventory/sales growth and low labor costs.
- **Stocks and Commodities Are Good Hedges Against Inflation Until Now.** Higher inflation drives nominal GDP higher, which can be good for earnings growth and, therefore, stocks. However, food and energy inflation from the conflict in Ukraine acts as a tax on the consumer that hurts more stocks than it helps. It can also destroy demand for commodities. In short, we are now into the bad part of inflation for stocks. The fact that commodities are rolling over now is not a good sign that the Fed can orchestrate a soft landing.
- **Inflation Is the Key to the *Secular* Bull Market for Stocks and Bear Market for Bonds**. The shift in policy from monetary to fiscal dominance is a significant change that has implications for our asset allocation recommendations. A US recession was always a necessary condition for this outcome and the health-crisis nature of this event further supported this regime shift. Finally, other inflationary trends were well established before the latest recession began—populism, nationalism, de-globalization, and now a major conflict that removes the second largest exporter of oil from the market. One-party control of the US government tends to accelerate and implement these policy changes.

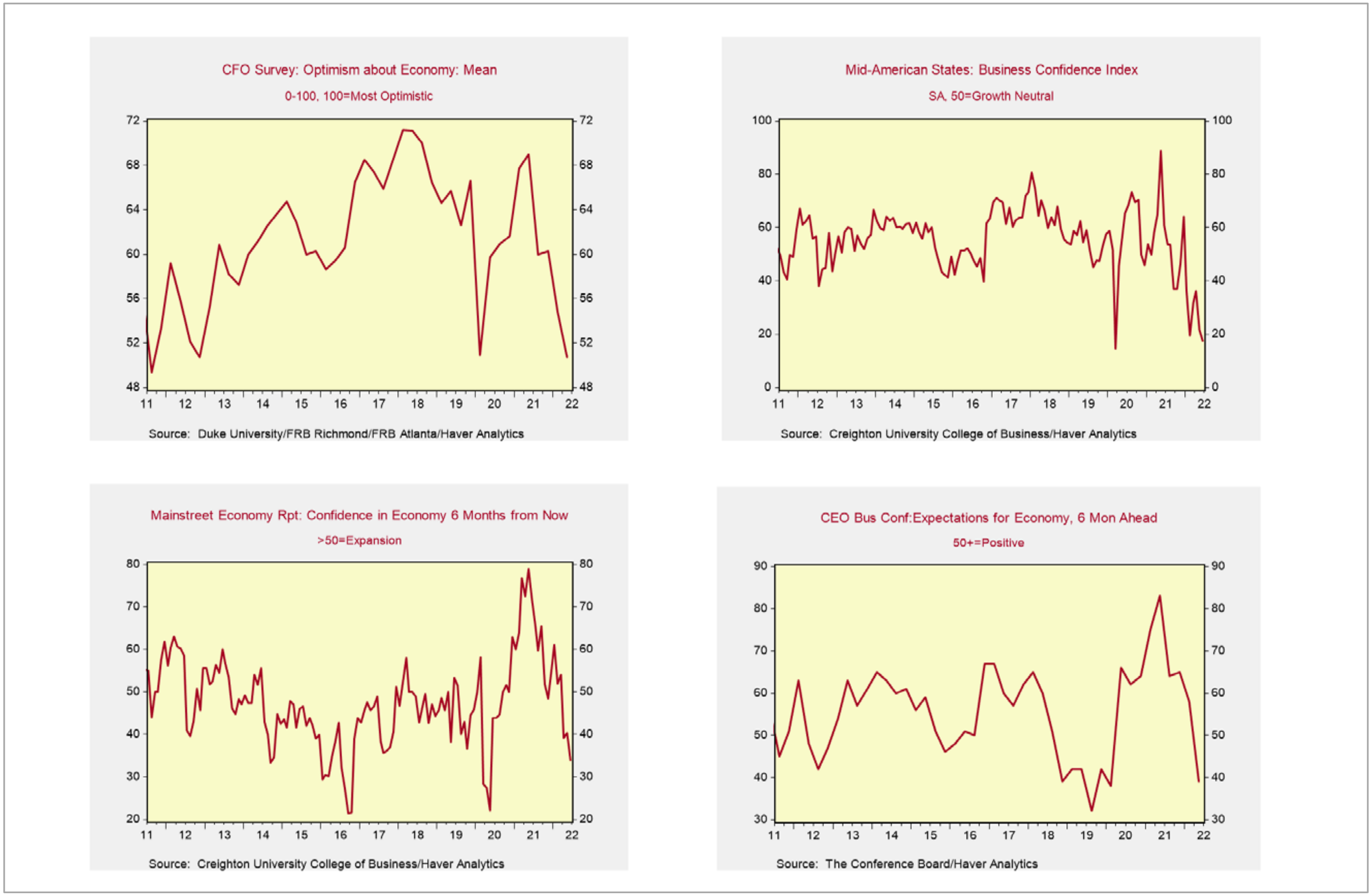
Source: Morgan Stanley & Co. Research.

Small Business Confidence Has Collapsed



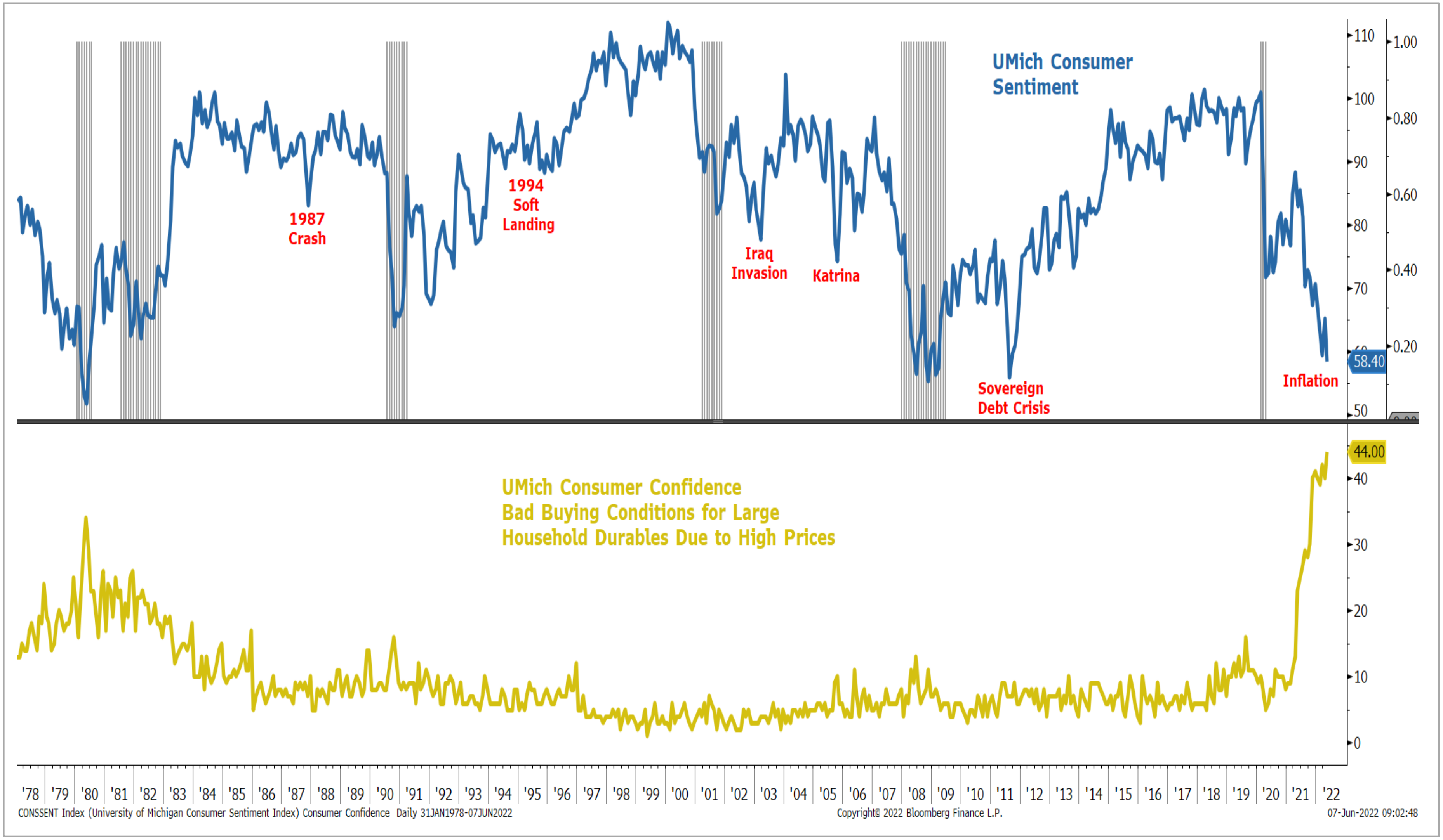
Source: Haver Analytics, Morgan Stanley & Co. Research as of July 12, 2022

Other Corporate Surveys Are Also at Very Low Levels



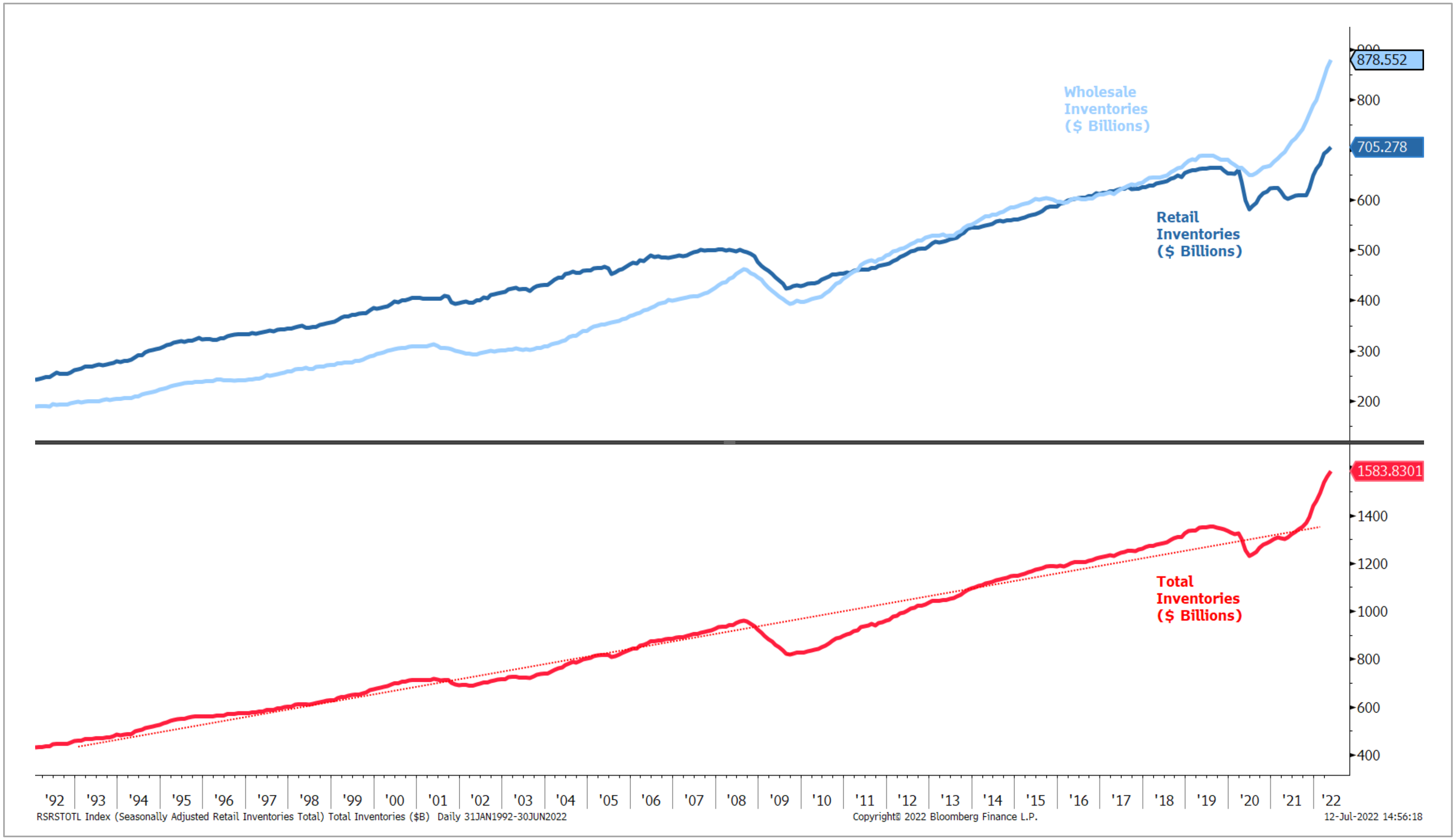
Source: Haver Analytics, Morgan Stanley & Co. Research as of June 2022

Consumer Confidence Has Also Collapsed Due to Inflation



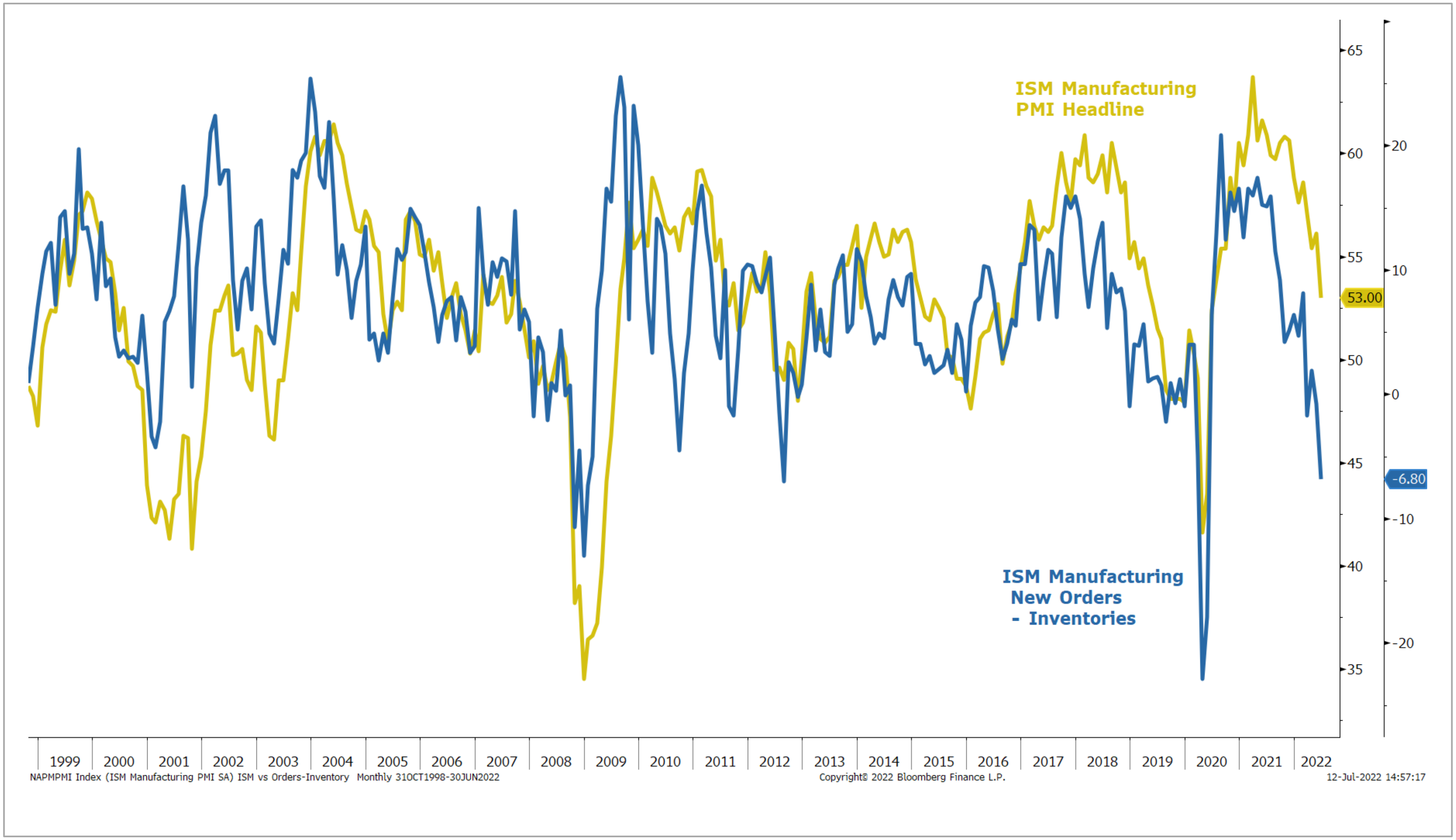
Source: Bloomberg, Morgan Stanley & Co. Research as of June 7, 2022

As Projected, Inventories Are Now Rising Too Quickly and Affecting Margins



Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022

These Higher Inventories Are Coming Just as Demand Is Fading



Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022

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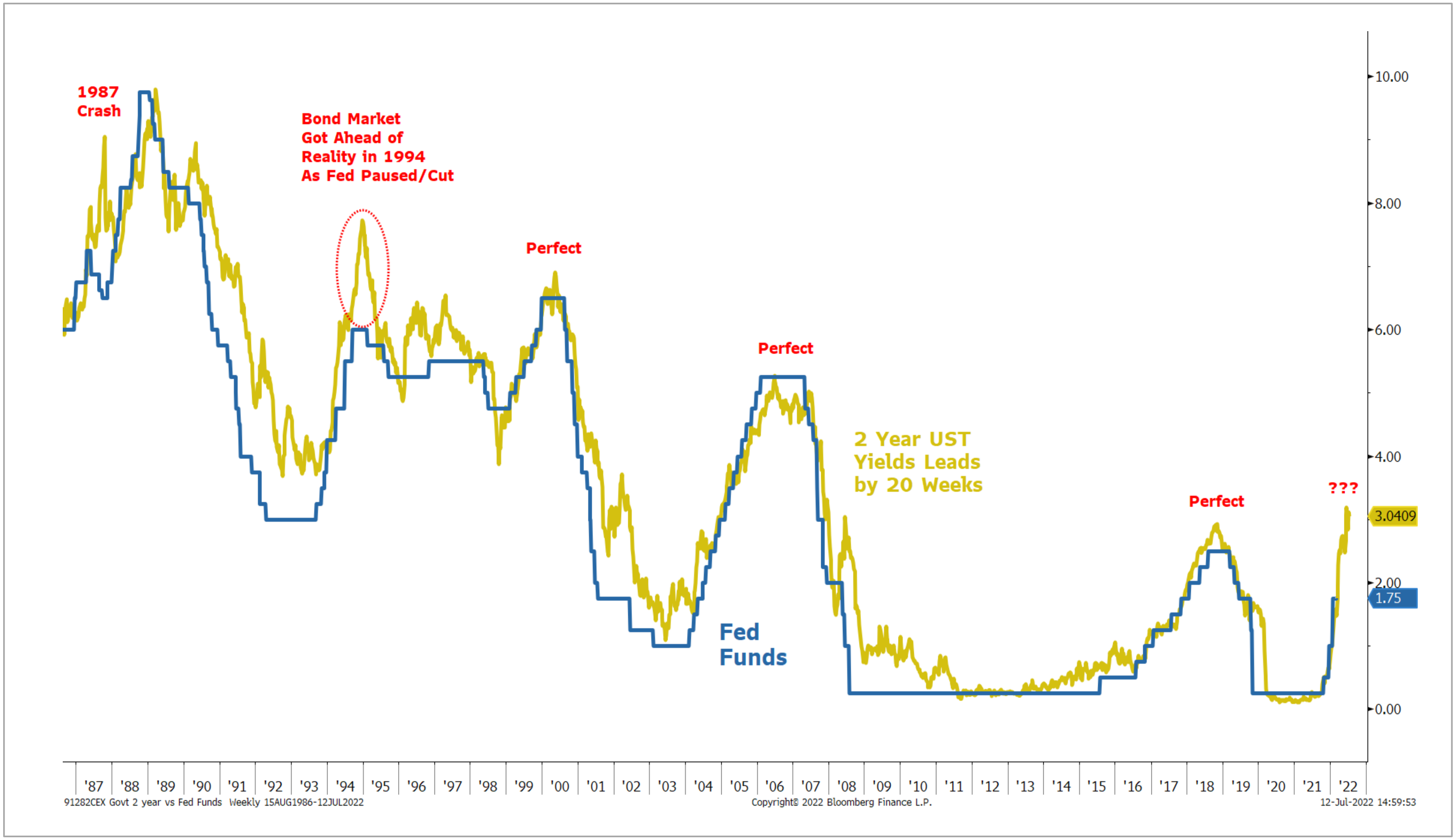
Bond Market Moves Ahead of the Fed and Does the Tightening on Economy

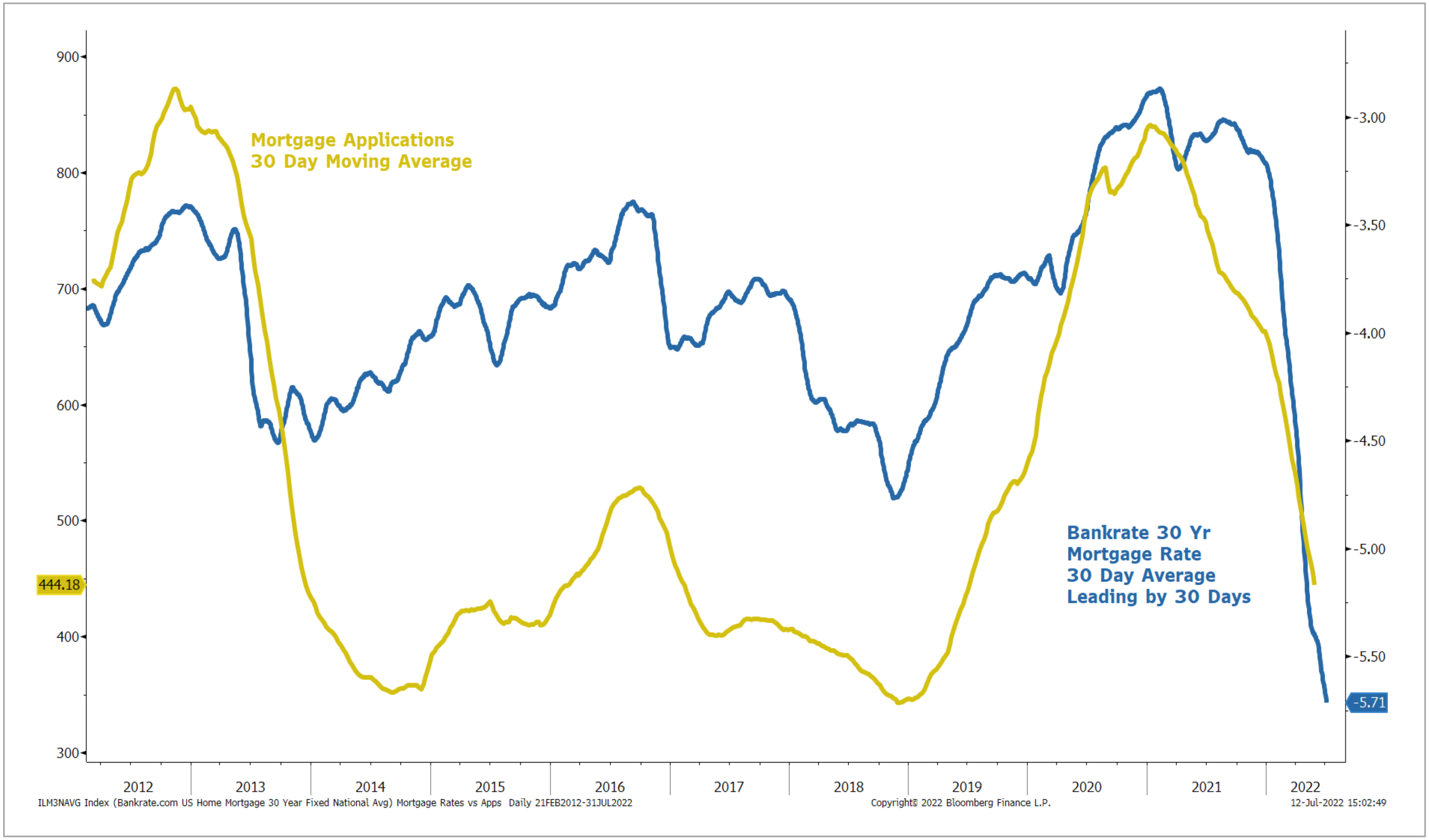


Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022.

Bond Market Moves Ahead of the Fed and Does the Tightening on Economy

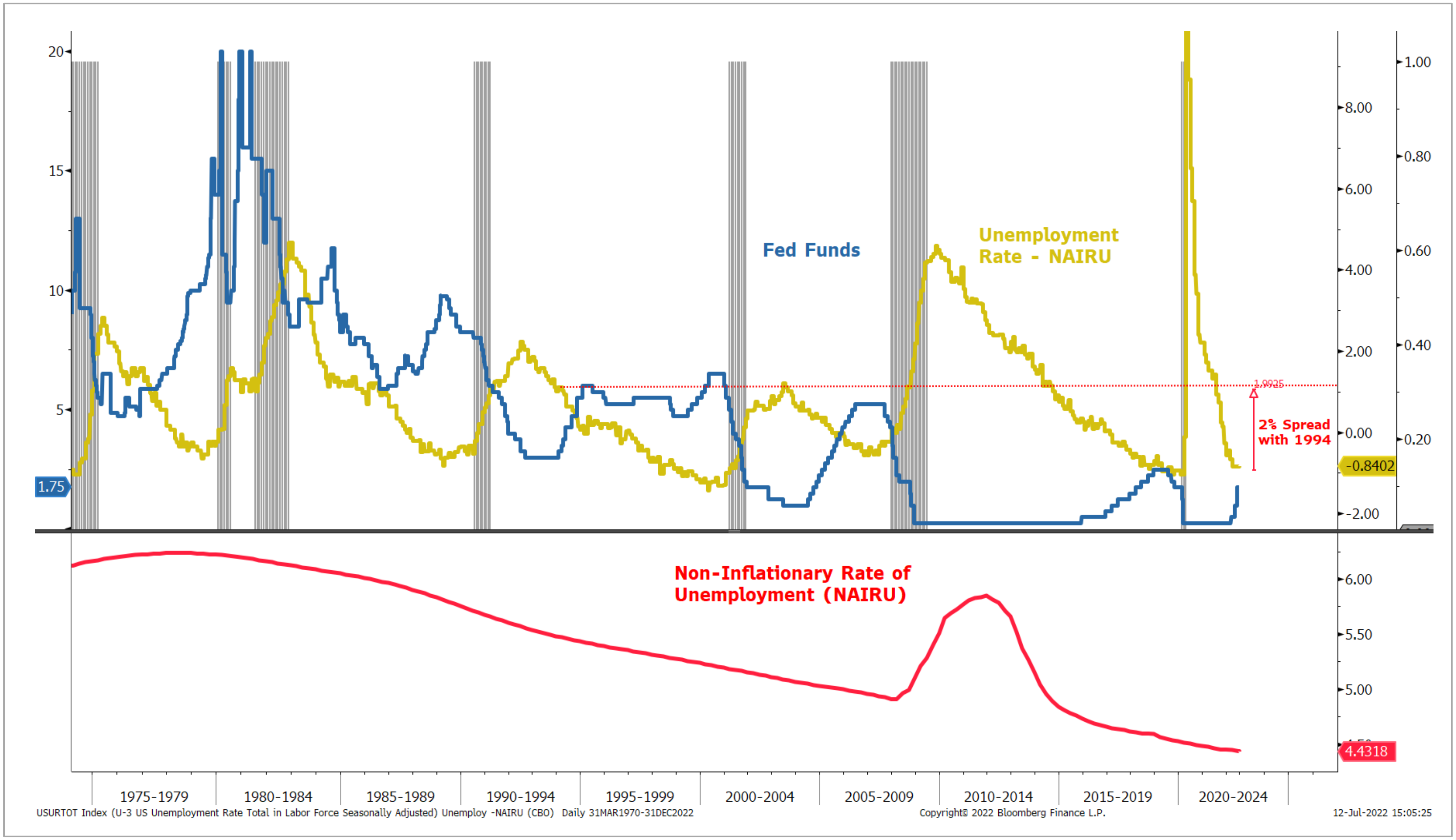
Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022. * MS Terminal Rate is peak Fed Funds rate as priced in the Eurodollar market

As Evidenced by the Effect Higher Rates Are Having on Housing



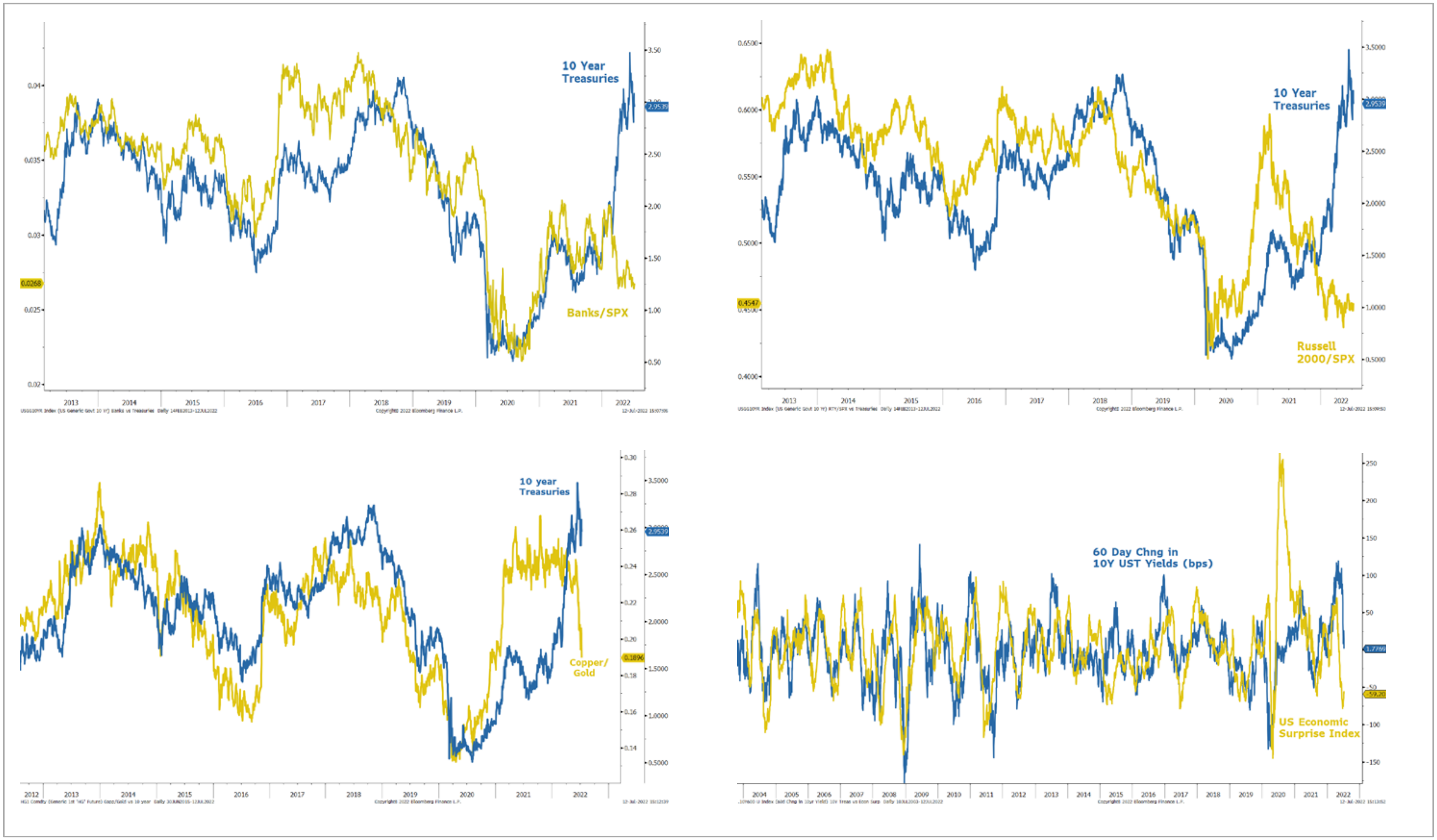
Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022

Investors Are Hoping for 1994 but Based on Labor Tightness, It's Unlikely



Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022.

Bonds Continue to Diverge from Other Signals of Slower Growth



Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022

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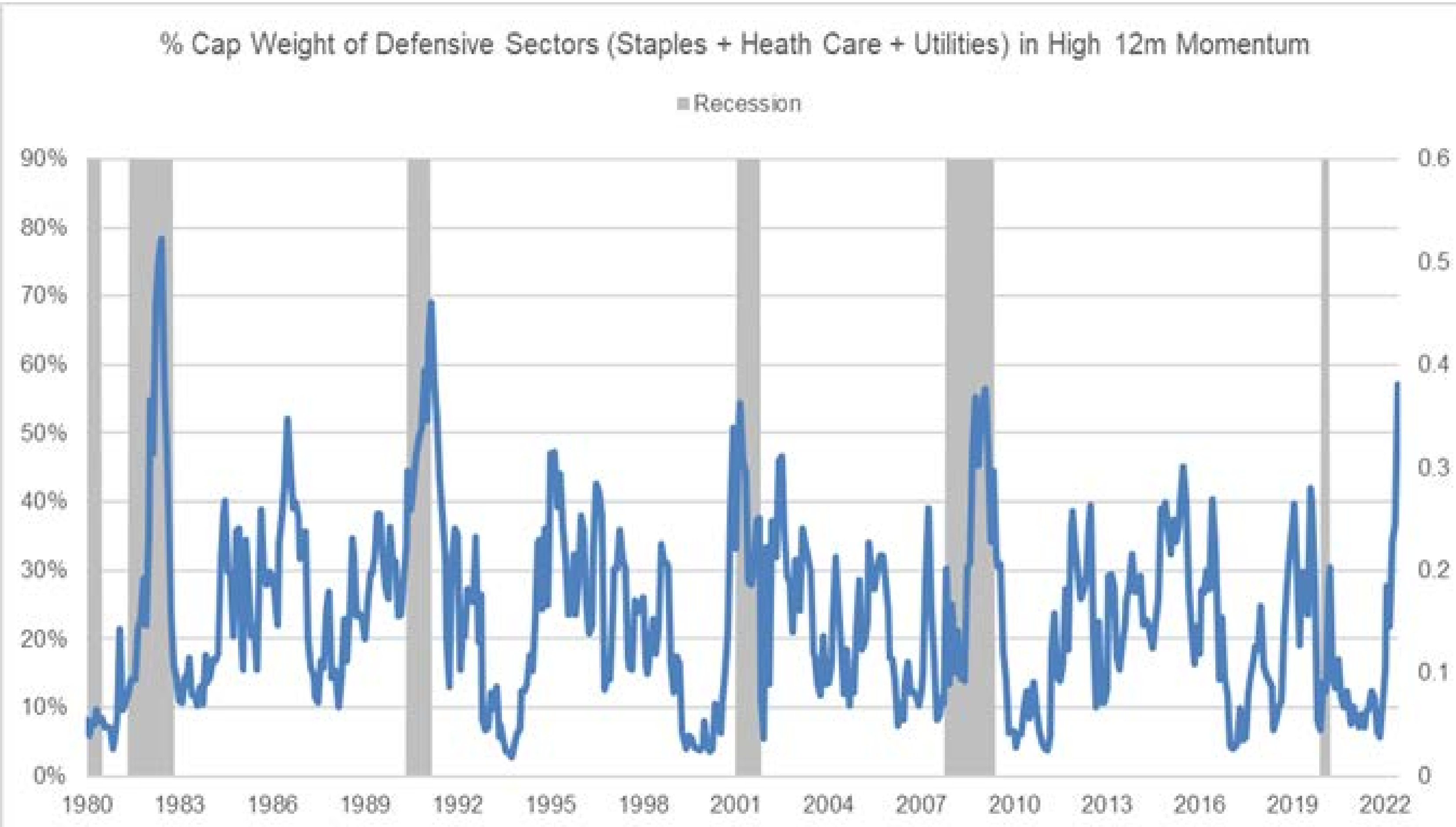
Peak Inflation Suggests Defensive Positioning Is Appropriate

Sector Rel. Performance in Inflation Regimes, Jan 2000 - Feb 2022	Above Trend & Falling	Above Trend & Rising	Below Trend & Falling	Below Trend & Rising	Correlation with 10yr B/Es
S&P 500	-7.1%	17.2%	-19.2%	32.8%	0.45
Cyclical/Defensive	-11.1%	9.6%	-24.0%	26.0%	0.42
Energy	-5.4%	12.7%	-32.0%	28.9%	0.27
Materials	-0.9%	3.5%	-10.0%	14.6%	0.15
Industrials	0.4%	2.8%	-3.4%	3.5%	0.05
Consumer Discretionary	-0.6%	-3.1%	1.3%	7.9%	0.03
Consumer Staples	11.2%	-12.4%	21.4%	-18.3%	-0.41
Health Care	10.1%	-4.0%	13.8%	-9.6%	-0.25
Financials	-1.0%	1.4%	-3.9%	-1.0%	0.00
Information Technology	-7.2%	7.4%	-5.6%	5.4%	0.16
Communication Services	-13.6%	2.1%	-2.8%	4.1%	0.08
Utilities	13.1%	-9.7%	22.2%	-30.1%	-0.27
Real Estate	8.9%	-6.2%	8.9%	-10.4%	-0.14

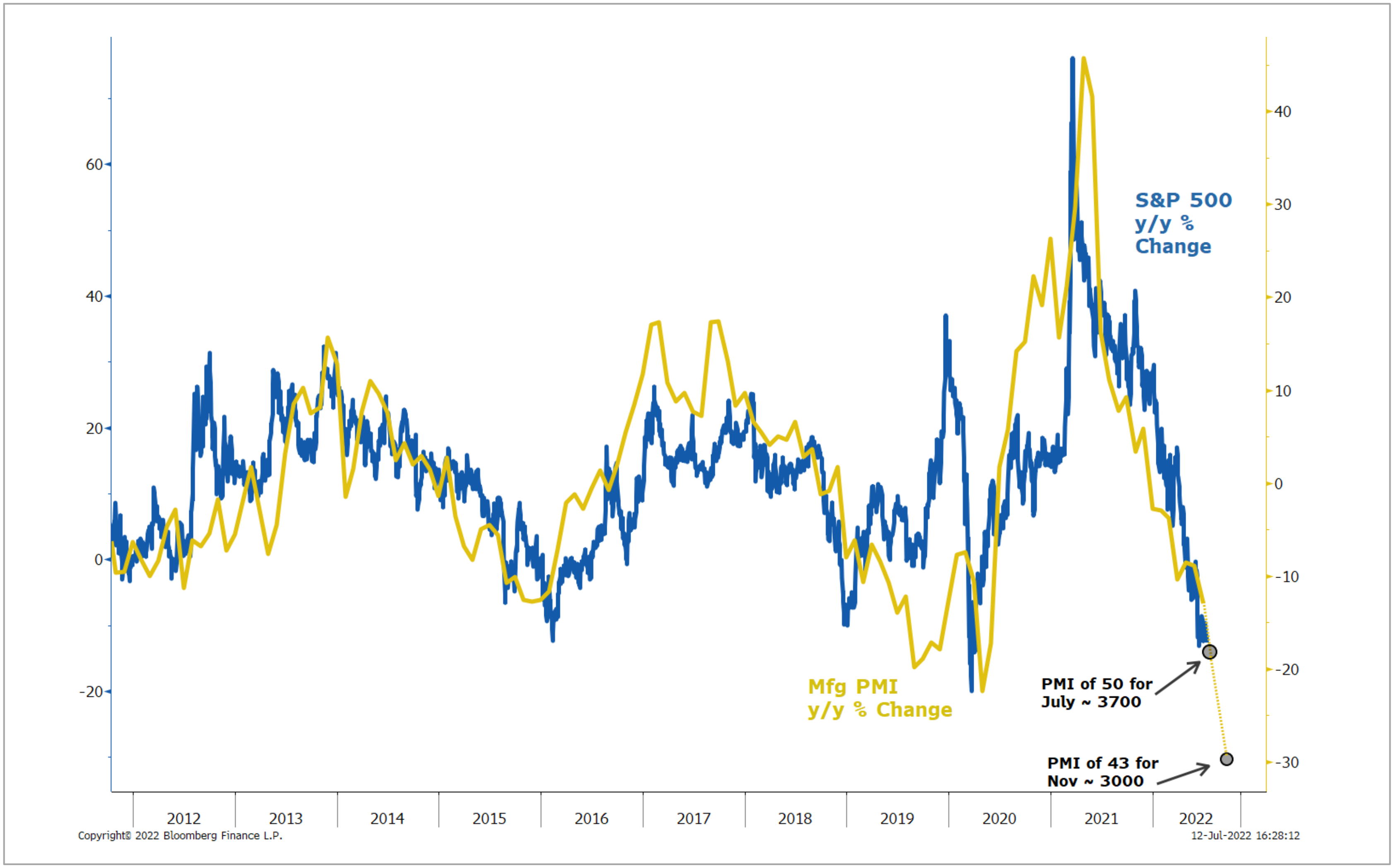
Source: Morgan Stanley & Co. Research as of May 31, 2022

Internals of Stock Market Are Already Pricing a Recession



Source: Refinitive, Morgan Stanley & Co. Research as of July 12, 2022

But the S&P 500 Is far from Pricing a Recession Based on the PMIs



Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022

Fair Value on S&P 500 Is 3400-3500—Well Below Current Level of 3800

S&P 500 Forward Equity Risk Premium Sensitivity (in bps; leveraging MS ERP/PMI model)

	ISM Composite PMI Level (percent rank vs. history)								
	48 (16th)	50 (22th)	52 (30th)	54 (43th)	56 (62th)	58 (78th)	60 (89th)	62 (94th)	64 (97th)
ERP (bps)	428	411	395	379	363	347	330	314	298

ERP (bps)
Current = 332

S&P 500 Forward P/E Sensitivity - PMI Vs. Rates (leveraging MS ERP/PMI model)

10-Year Yield (%)	ISM Composite PMI Level (percent rank vs. history)								
	48 (16th)	50 (22th)	52 (30th)	54 (43th)	56 (62th)	58 (78th)	60 (89th)	62 (94th)	64 (97th)
2.5	14.8	15.1	15.5	15.9	16.3	16.8	17.2	17.7	18.2
2.6	14.5	14.9	15.3	15.6	16.1	16.5	16.9	17.4	17.9
2.7	14.3	14.7	15.0	15.4	15.8	16.2	16.7	17.1	17.6
2.8	14.1	14.5	14.8	15.2	15.6	16.0	16.4	16.8	17.3
2.9	13.9	14.3	14.6	**14.9**	**15.3**	15.7	16.1	16.5	17.0
3.0	13.7	14.1	14.4	**14.7**	**15.1**	15.5	15.9	16.3	16.7
3.1	13.6	13.9	14.2	14.5	14.9	15.2	15.6	16.0	16.4
3.2	13.4	13.7	14.0	14.3	14.6	15.0	15.4	15.8	16.2
3.3	13.2	13.5	13.8	14.1	14.4	14.8	15.1	15.5	15.9

P/E
Current = 15.9

S&P 500 Price Sensitivity - PMI Vs. Rates (leveraging MS ERP/PMI model & consens. fwd. EPS)

10-Year Yield (%)	ISM Composite PMI Level (percent rank vs. history)								
	48 (16th)	50 (22th)	52 (30th)	54 (43th)	56 (62th)	58 (78th)	60 (89th)	62 (94th)	64 (97th)
2.5	3,546	3,633	3,724	3,820	3,921	4,027	4,139	4,258	4,384
2.6	3,494	3,579	3,667	3,760	3,858	3,961	4,069	4,184	4,306
2.7	3,444	3,526	3,612	3,702	3,797	3,896	4,002	4,112	4,230
2.8	3,396	3,475	3,558	3,646	3,738	3,834	3,936	4,043	4,157
2.9	3,348	3,426	3,506	**3,591**	**3,680**	3,774	3,873	3,976	4,086
3.0	3,302	3,377	3,456	**3,538**	**3,625**	3,716	3,811	3,912	4,018
3.1	3,257	3,331	3,407	3,487	3,571	3,659	3,752	3,849	3,951
3.2	3,214	3,285	3,359	3,437	3,519	3,604	3,694	3,788	3,888
3.3	3,171	3,241	3,313	3,389	3,468	3,551	3,638	3,729	3,826

Price
Current = 3,819

S&P 500 Price Sensitivity - PMI Vs. Rates (leveraging MS ERP/PMI model & MS fwd. EPS)

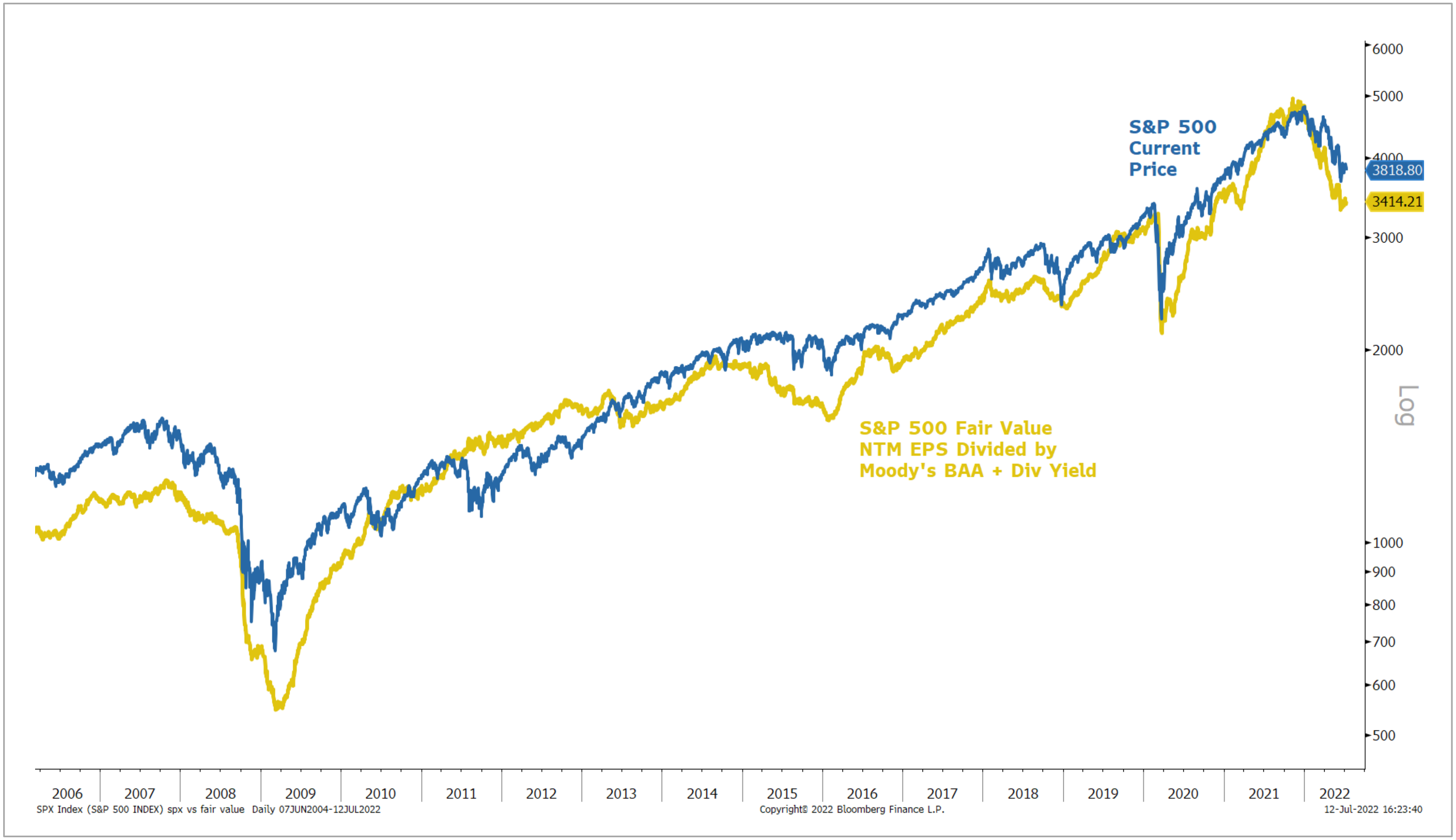
10-Year Yield (%)	ISM Composite PMI Level (percent rank vs. history)								
	48 (16th)	50 (22th)	52 (30th)	54 (43th)	56 (62th)	58 (78th)	60 (89th)	62 (94th)	64 (97th)
2.5	3,406	3,490	3,577	3,669	3,766	3,869	3,977	4,091	4,212
2.6	3,357	3,438	3,523	3,612	3,706	3,805	3,909	4,019	4,136
2.7	3,309	3,387	3,470	3,556	3,647	3,743	3,844	3,951	4,063
2.8	3,262	3,338	3,418	3,502	3,591	3,683	3,781	3,884	3,993
2.9	3,216	3,291	3,368	**3,450**	**3,536**	3,626	3,720	3,820	3,925
3.0	3,172	3,244	3,320	**3,399**	**3,482**	3,569	3,661	3,758	3,859
3.1	3,129	3,199	3,273	3,350	3,430	3,515	3,604	3,697	3,796
3.2	3,087	3,156	3,227	3,302	3,380	3,462	3,549	3,639	3,735
3.3	3,047	3,113	3,183	3,255	3,331	3,411	3,495	3,583	3,675

Price
Current = 3,819

Model Implied Fair Value Range

Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022.

Using Market-Based Cost of Capital, S&P 500 Fair Value Is 3414



Source: Bloomberg, Morgan Stanley & Co. Research as of July 12, 2022.

LT Treasury Yields Have Made Secular Low but Now Making Cyclical Top

Source: Bloomberg, Morgan Stanley & Co. Research as of July 11, 2022

Asset Class Risk Considerations

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For index, indicator and survey definitions referenced in this report please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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 not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results.

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

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

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

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

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

Investing in foreign markets entails risks not typically associated with domestic markets, such as currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. These risks may be 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 small- to medium-sized companies entails special risks, such as limited product lines, markets and financial resources, and greater volatility than securities of larger, more established companies.

The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer.

High yield bonds (bonds rated below investment grade) may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk, price volatility, and limited liquidity in the secondary market. High yield bonds should comprise only a limited portion of a balanced portfolio.

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.

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.

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.

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

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

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

Asset Class Risk Considerations and Disclosures

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. **Health care sector stocks** are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

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.

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.

Any type of **continuous or periodic investment plan** does not assure a profit and does not protect against loss in declining markets. Since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider his financial ability to continue his purchases through periods of low price levels.

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.

The returns on a portfolio consisting primarily of **environmental, social, and governance-aware investments (ESG)** may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client's account will be managed as described herein.

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