



The Benedict-McLoughlin Report 2016 Investment Outlook

By Christopher Benedict, CFA

- Global markets have started the year on a weak note...which is a continuation of the underlying weakness that emerged in the back half of 2015
- While our conviction level has decreased a bit in a nod to recent market action, we continue to believe that steady growth (albeit relatively slow) is the base case, not a recession
- The negative effects of low commodity prices such as lower capital expenditures and credit market weakness should begin to give way to the positive effects of lower input costs and higher disposable income as we move through 2016

THE BENEDICT-MCLOUGHLIN GROUP

The Benedict-McLoughlin Group provides investment advisory and wealth management services to a broad range of individuals, families, and institutions. As a boutique investment advisory practice specializing in portfolio management, we offer our clients direct access to their portfolio decision-maker, uniquely differentiating us from our competition. While we offer our clients a wide-range of investment options, including individually managed portfolios, most importantly, we bring the knowledge and experience as well as a hands-on style that helps our clients make well-informed decisions at every stage of the investment decision-making process.

The Benedict-McLoughlin Group Chris Benedict, CFA®

First Vice President – Wealth Management
Senior Portfolio Manager
chris.benedict@morganstanley.com

Brian McLoughlin

Vice President – Wealth Management
Financial Advisor
brian.mcloughlin@morganstanley.com
10960 Wilshire Boulevard
Los Angeles, CA 90024
Tel 310-443-0555
Fax 310-443-0566

Before I had the chance to wish “good riddance” to 2015, 2016 has already proven to be a tough year...and we’re only just over a month into it. Importantly, the current weakness in equities (and other risk assets) is really a continuation of what started in 2015, despite the fact that major global equity indices posted relatively “flat” results in 2015. Besides the solid performance of a handful of large technology stocks which helped prop up the S&P 500, 30% of the stocks in this index were actually in a bear market in 2015 (i.e., down > 20%).¹ And this underlying weakness has spread thus far in 2016 with 70% of the stocks in the Russell 2000 index (small caps), for example, now in bear market territory, as of 1/18/16.²

The bond market is also sending signals of a significant economic slowdown. Interest rates on “high quality” government debt are declining as investors seek relative safety. For example, the yield on the 10-Year U.S. Treasury Note has decreased to below 1.70% in early February from the 2.3% it yielded when the Federal Reserve raised rates in mid-December. Credit spreads have also widened considerably. In fact, according to MKM partners, the extra yield required above government securities by corporate bonds investors is at levels only seen during or after recessions.³ A similar story has played out

in the high yield market, particularly in the energy sector.

So, with global financial markets telling us that a recession is imminent, do the economic statistics point to the same conclusion? The answer is not so cut and dry...it really depends on which sector and which part of the world is considered. The energy and mining sectors are effectively at depression levels as evidenced by a massive drop in profits as well as job losses. This weakness has also affected those industries that cater to the aforementioned sectors. On the other hand, consumer focused sectors such as airlines and automobile manufacturers are benefitting from low fuel prices and a relatively healthy job market. Globally, Europe and Japan are still growing while some commodity focused emerging market economies like Russia and Brazil are already in recession. The wild card remains China and, while their growth has slowed in recent years, they just reiterated a target growth range of 6.5 – 7% for 2016. It is also important to note that, despite the ominous market signs, history shows that a recession may not be coming. The S&P 500 just had its 42nd correction of 10% since 1927...interestingly, only thirteen of these previous corrections came within a year of a recession.⁴

A Wall of Worry...Time to Climb It?

At this point, the worry list for investors is both long...and well documented. While advances in technology and communications have brought great dividends to society, there have been some negative externalities as well. News travels around the world at lightning speed, which is a good thing...however, it is the repetition of that news that may, at times, serve investors poorly. For example, we can learn about how China's "economic demise" will wreak havoc for global investors on the radio on the way to work, on the business news once we get to work, in the newspaper, on the web, via news alerts, and via Tweets, for good measure. Then, get it again on the way home and on the evening news...and then top it all off by having somebody like me write about it! The point is that the constant barrage of the same bad news can eventually affect investor psychology...something that I believe we are experiencing so far in 2016.

That said, there has been some real negative news for investors to digest. I will attempt to summarize and synthesize some of the main issues and then share what I believe the implications are for investors as we move through the rest of 2016 and beyond.

Energy/Commodities Collapse:

If investors could point to the biggest culprit for the recent weakness in equities/risk assets, it would be the massive decline in the price of oil and other commodities. Several years of \$100+ oil attracted massive investment in the development of both traditional supply as well as new efficient technologies (fracking, horizontal drilling, etc.). The result has been a significant increase in global supply, particularly from the U.S....just in time for a downturn in economic growth in China and the rest of the world. Importantly, global demand for oil continues to increase, so, the decline in price is largely supply-induced and this has different implications for the investment and economic outlook as compared to a demand-induced decline. In fact, while some forecasters have pointed to the decline in oil and other commodities as a sign that we are headed for a recession, history has shown that it is actually price

spikes, not price collapses, that presage recessions (see graph on p. 9).

Of course, this decline in oil/commodities has produced both losers and winners. Producers (companies and countries) have clearly suffered while consumers overall have benefitted. Net-net, energy is an input cost and a move down from \$100 for oil is a net positive. While certain regions like Saudi Arabia and Texas, for example, are feeling the pain, China's annual savings from the drop in oil and other commodities amount to \$460 billion.⁵ Similarly, energy companies have been decimated while airlines, for example, are experiencing record profits. Eventually, the cure for low prices of any commodity is low prices, as unprofitable supply is shut down and taken offline. This does take some time but, I would expect a higher price for oil by the end of 2016, although I doubt we will see the \$100 level anytime soon.

China Slowdown:

While the decline in commodity prices has likely been the biggest reason for the sell-off, it is the state of the Chinese economy that garners most of the media attention. As alluded to above, readers of this piece have likely consumed significant media coverage of this topic and will continue to for the foreseeable future. There are two fairly established truths that most people would agree on: (1) China's overall economy is transitioning from an export/investment driven economy to a consumer driven one and (2) China's overall growth rate has slowed and is expected to continue its slower growth over the next several years. But, there is also a camp that believes, at least according to many media reports, that China is effectively a "sham" and this will eventually bring down the global economy. While I acknowledge the risks as they relate to the Chinese economy, I completely disagree with the extreme pessimistic view.

While China's system has a number of differences as compared to the West, the greatest similarity is that it is full of human beings trying to make a better life for themselves...and it is happening. Per capita income rose 7.4% in 2015 and has effectively doubled since the great Recession (graph on p. 9).⁶ This income growth is

both welcome and necessary as China emphasizes consumption as a larger part of their economy. And, while China's growth target of 6.5 – 7% for 2016 is slower than recent years, it is still healthy.

Despite the oft-cited risks, I believe China often gets painted with an unfair brush. Some complain that the 6.5 – 7% growth target is either too optimistic and/or they have to rely on too much debt to achieve it. But, it is important to note that the size of China's current economy (\$11.4 trillion) is roughly the size of the U.S. economy in 2002.⁷ Since then, the U.S. growth rate has averaged about one-third of China's current expected rate...and a lot of American debt was used along the way.⁸ Another interesting investor concern is the devaluation of the Chinese currency, the Renminbi (RMB), which has declined approximately 9% vs. the U.S. dollar since its peak in 2014. The bears see this as a major negative, although an approximate 50% decline in the Japanese currency has been a boon to the Japanese economy and stock market. A similar, although not as dramatic, move in the Euro has done the same for Europe. So, this investor questions the negativity surrounding a modest RMB devaluation, especially considering how strong the RMB has effectively been given that it has been linked to the U.S. dollar, the strongest currency on the planet in recent years. There are more examples but, the point is that, while imbalances and risks are present in the Chinese economy, they are well documented and, I believe exaggerated in some cases. Importantly, Chinese and Hong Kong equities sit at levels only slightly higher than they were sixteen years ago, so, maybe some of the current concerns are already reflected in equity values.

Government Debt Levels:

The debt issue is not just a Chinese one. The amount of debt in the world is at record levels, which is clearly significant and something that investors should continue to monitor. But, it should not be forgotten that most of the debt resides in the U.S., Japan and Europe where investors are settling for very low interest rates and, in some cases, are actually paying these governments to give them money (i.e., negative interest rates). Think about that one for a minute. Of course, the buyers of these bonds would argue that if inflation (or deflation)

ends up averaging negative 2% per year for the next ten years, then a current 10-year bond that yields 0%, for example, would result in a positive 2% real return. The problem with that view is that inflation remains comfortably above 0%, even in the face of dramatically lower commodity prices. If we do not see deflation after the price of oil declines by 75%, then I am not sure when we will.

Overall, a default by a major economy (or even the scare of one) is the biggest risk of high levels of government debt. We have already experienced minor occurrences like Greece and Puerto Rico but, a reduction in confidence in one of the developed economies would cause significant dislocation in global markets. The fact that we have historically low/negative rates signals that we are not going to see this anytime soon. However, a real concern is that high utilization of government debt can reduce future economic growth by essentially "pulling forward" growth as well as potentially "crowding out" the availability of private sector debt. I believe the relatively slow recovery since the Great Recession is largely due to these phenomena...and it appears that this will continue for the foreseeable future.

Terrorism:

High profile terrorist strikes in both France and California have brought this perennial risk back to the forefront in everybody's minds. While these attacks in the West were heinous, they pale in comparison to what has been happening in the Middle East, particularly in Syria. Besides the obvious and tragic human toll, it is a combination of the waste of resources used to combat terrorism (military, police, etc.) as well as a reduction in overall freedom that acts as a detriment to economic activity.

Overall, terrorism adds to global uncertainty and this increases the risk premium for investors (i.e., lower asset valuations, all else equal). And, unfortunately, terrorism will continue to be a perennial risk and terrorists will continue to be active globally. Of course, a worst case would result from a terrorist strike using Weapons of Mass Destruction (WMD), either nuclear or biological. A large enough event has the potential to negatively affect globalization and even population growth.

Asset Allocation⁹

Of course, before any investor begins to analyze specific markets or securities, a proper asset allocation strategy should be established. Unfortunately, asset allocation often takes a back seat to specific securities or sectors in investment research reports and the financial media. This is a bit counterintuitive as the asset allocation decision is often described as one of the most important decisions an investor has to make. Every investor has unique objectives and risk tolerances and constructing an allocation strategy based on these unique characteristics can help minimize unnecessary risk given a certain return objective or, similarly, help maximize the expected return given a certain risk level. The fact that different asset classes and sub-asset classes are not perfectly correlated enables what amounts to be the closest thing to a “free lunch” in the investment world as overall portfolio risk may be reduced by combining asset classes that are uncorrelated. Therefore, it is my contention that a proper asset allocation strategy implemented and managed in a disciplined fashion by a qualified investment professional can add significant value. However, it is important to note that even proper diversification does not guarantee a profit or protect against a loss, as 2008 and early 2009 so vividly demonstrated.

I essentially address asset allocation strategy at three levels; long-term (strategic) target allocation ranges, short/intermediate-term (tactical) adjustments within target ranges, and periodic re-balancing. For example, considering a hypothetical investor with a strategic target allocation of 50% stocks and 50% bonds (for the sake of simplicity, ignore other asset classes for the moment), I would target strategic ranges of 35 – 65% for stocks and 35 – 65% for fixed income as opposed to actual fixed-point targets of 50% each. Once a strategic range is established, I then tactically determine where in the range we should be. The more attractive I believe equities are, for example, the higher the allocation within the range. Of course, these ranges also apply to sub-asset classes like small versus large capitalization equities, for example (see table below). Finally, a re-balancing review is done at least annually or following significant market moves.

The philosophical underpinning of my approach to asset allocation is rooted in the belief that the core of an investment portfolio should be strategically positioned for the long-term, given the specific objectives and risk tolerance of the investor. To be sure, wholesale market-timing calls (i.e., shifting entire allocation into all stocks or all cash, for example) have historically proven difficult to execute consistently. However, by allowing subtle, tactical shifts within the strategic ranges, skilled portfolio managers are generally able to take advantage of relative value discrepancies while still leaving room for error. For example, in early 2003, I moved my equity exposure to the high end of strategic ranges because I believed the relative risk/return tradeoff between stocks and investment-grade fixed income significantly favored stocks. Although that turned out to be correct, if equities had continued their downward slide following the Internet bubble and 9/11, an investor's long-term plan should not have been significantly impaired. Compare that to a market timer who may have thought the market bottomed and moved 100% into equities in 2001/early 2002 or in 2008 (pre-Lehman Brothers bankruptcy), only to suffer through significant declines which take many years to make up. Similarly, investors that moved to 100% cash may run the risk of getting back in the stock market too late over the next months or years in order to achieve their long-term return objectives.

Finally, careful monitoring and rebalancing are considered essential components of a disciplined approach. A major benefit of rebalancing, of course, is the potential reduction of overall portfolio volatility. For example, if stocks outperform bonds for a period of time, eventually an investor's allocation to stocks will likely grow to a percentage above the high end of the strategic range. In this case, rebalancing would require trimming stocks and adding to fixed income. Recent examples of this would have been during the stock market run-up in the late 1990s and 2006 - 2007 where trimming stocks and adding to fixed income served investors well while the opposite move in late 2002/early 2003 and late 2008/early 2009 was the appropriate adjustment. By incorporating rebalancing in an asset allocation strategy, an investor is essentially “forced” to sell relatively dear assets while buying relatively cheap assets. Buying low and selling high has never served an

investor wrong. The last fifteen years has proven to be a good time period to follow the re-balance discipline as global markets have generally traded in a fairly wide trading range. It will be important for investors to continue to monitor their portfolios as relative

performance of certain sub-asset classes (i.e., US equities relative to international equities, for example) may have stretched relative valuations too far and will eventually succumb to the “reversion to the mean” phenomenon that tends to repeat itself in financial markets.

Hypothetical Allocation Ranges with a Balanced Allocation*

Asset Class	Minimum (%)	Target (%)	Maximum (%)
Domestic Large Cap Equities	10%	20%	40%
Global Small/Mid Cap Equities	0%	5%	15%
International/EM Equities	5%	<u>15%</u>	30%
Total Equities	25%	40%	55%
Tax-Exempt Fixed Income	5%	20%	35%
Global Taxable Fixed Income	0%	10%	25%
High Yield/Floating Rate Fixed Income	0%	<u>10%</u>	20%
Total Fixed Income	25%	40%	55%
Specialty/Alternative/Opportunistic**	5%	20%	35%
Total		100%	

* For illustrative purposes only and should not be construed as a specific recommendation.

** Specialty/ Alternative/Opportunistic may include hedge funds, private equity, real estate as well as tactical investments that are shorter term in nature.

Please note that alternative investments, such as hedge funds and funds of hedge funds are made available only to qualified investors and involve varying degrees of risk.

Importantly, many new investment vehicles are making this process easier for the knowledgeable investor. Not only should investors broaden their horizons geographically speaking, I believe they also need to broaden their horizons in terms of investment vehicles as well. Gone are the days where an investor just had to consider stocks, bonds and mutual funds. Today, we have Separately Managed Accounts (SMAs), Exchange Traded Funds (ETFs), closed-end funds, asset-linked Certificates of Deposit and, of course, an increasing number of alternative strategies (for qualified investors). Furthermore, over 2000

international companies are tradable in the U.S. via American Depositary Receipts (ADRs). These choices, while potentially daunting, enable private investors as well as smaller institutions to invest on the same playing field as the largest and most sophisticated institutional investors. From my perspective, these choices enable tremendous flexibility to match specific client objectives with the appropriate investment allocation, the appropriate investment vehicle, and the ability to manage the entire process in the most effective manner.

Current Strategy

Overall, with the exception of the government bonds of developed countries, the valuations of most asset classes now vary between mildly attractive and very attractive. Financial markets have effectively priced in a mild recession, so, as long as we do not experience a significant economic downturn, then risk assets should be able to hold their own from here. And, if we avoid a recession altogether, I believe risk assets could rebound nicely from current levels. That said, maintaining a diversified portfolio is especially important during uncertain markets like we are experiencing currently.

Although the S&P 500 statistics from 2015 appear relatively subdued, the underbelly of the market was weak and this has really come to a head in early 2016. Overall, I believe the S&P 500 is reasonably valued and now trades at a below average forward price to earnings (P/E) ratio.¹⁰ However, certain sectors appear downright cheap after the recent sell-off. U.S. banks, for example, have been hit particularly hard so far in 2016 on concerns about their exposure to energy loans as well as the potential for lower interest rates, which would crimp their earnings at the margin. These concerns are overdone, in my opinion. According to Moody's, energy loans account for only 2.3% of total loans, which appears manageable.¹¹ And, their valuations appear to discount a lot of bad news with several large cap banks trading at sizeable discounts to tangible book value.¹² I also recommend overweighting the consumer discretionary sector as disposal income increases due to lower energy prices and a relatively strong labor market. Speaking of energy, while it may be early, investors should monitor this sector and look for an entry point in 2016 as I expect the price to stabilize as production cuts begin to be discounted by investors.

Looking beyond the U.S., value has also emerged in certain international markets. Europe, in particular, looks interesting as they are still 2 – 3 years behind where the U.S. is in regards to monetary policy and equities in Europe are trading at historically low relative valuations vs. the U.S. (see graph on p. 10). Emerging markets (EM) equities are also at historically low relative and absolute valuations (see graph on p. 10). Of course, this has been the case for a couple of years and EM

equities have underperformed. However, according to Emerging Global Advisors, EM economic growth is poised to experience its first acceleration since 2010 and this relative economic strength is expected to translate into better relative equity performance.¹³ EM consumer exposed equities look especially attractive, in my opinion.

On the income side, at this point, buying developed economy government bonds is not really investing anymore, in my opinion...it is more of a speculative play on the collapse of our economic system. Negative real rates and even negative absolute rates are typically not good buy levels for bonds. I believe sitting in cash is a better alternative as it provides short-term safety without the potential volatility/drawdown if rates do begin to rise again. Investors that would like to achieve a return in the fixed income portion of their portfolios should consider overweighting high yield corporate and emerging market bonds, especially after recent weakness. Given the higher spreads (i.e., higher yields), I believe it is more beneficial to take appropriate credit risk as opposed to interest rate risk at this point.

Where appropriate, non-traditional investments such as total and absolute return strategies are also an important part of a well balance portfolio, in my opinion. These strategies attempt to achieve a decent return regardless of how equity markets are performing and may help to reduce overall portfolio risk due to their low correlation to traditional equities and fixed income. Please see the tables on the next page and on p. 11 for a summary of my overweights and underweights.

Tactical Allocation Recommendations

Equities	+1	Fixed Income	-1	Alternative Investments	Equal
U.S.	-1	Treasuries	-2		
Int'l/Em. Mkts	+1	Inv. Grade Corp./Muni's	+1		
Growth	Equal	High Yield	+1		
Value	Equal	REITS	-2		
Large Cap	+2	Floating Rates	+2		
Small/Mid Cap	-2				

Legend	
+2	20% Overweight
+1	10% Overweight
Equal	Equal Weight
-1	10% Underweight
-2	20% Underweight

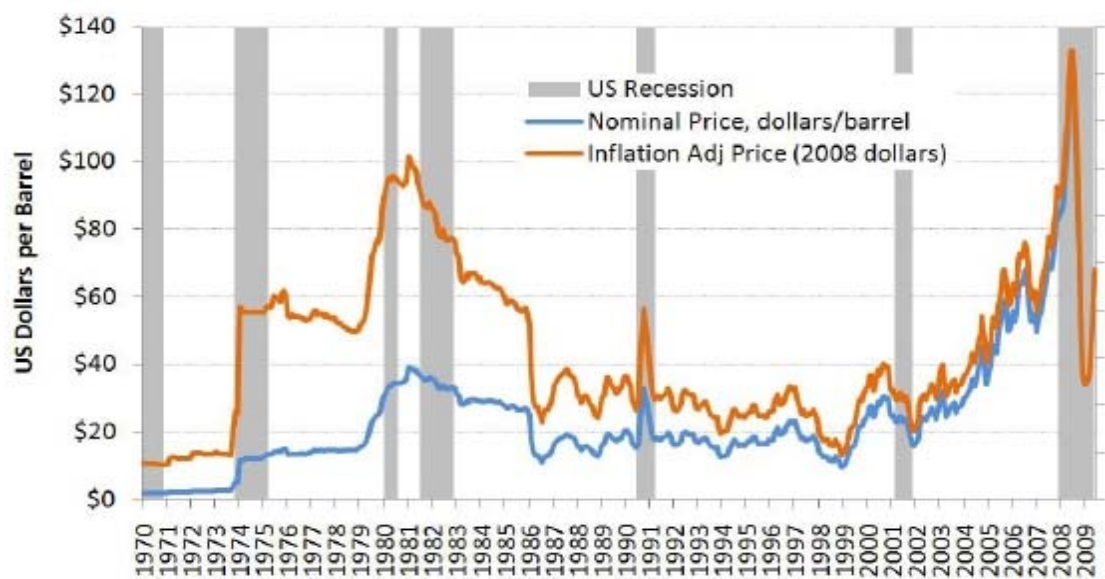
For illustrative purposes only and should not be construed as a specific recommendation. Alternative investments are made available only to qualified investors and involve varying degrees of risk.

(Other) Things to Watch

- **U.S. Deficit/U.S. Dollar:** Although improving, we continue to run large deficits and it appears that this will improve only modestly over the next year or two. Recent strength in the dollar as a result of interest rate differentials may hurt the profits of U.S. multinationals and, while the strength may continue in the short-term, I am more neutral on the dollar, broadly speaking, over the next year or two. Weakness in the Yen and the Euro can cause regional trade issues and not everybody's currency can weaken at the same time. That said, the clearest case for continued dollar strength remains vs. the Yen, in my opinion.
- **The “Welfare State”:** Social safety nets play an important role in a modern economy; however, they can also dis-incentivize people from becoming productive members of society. There is an optimal point and any country/economy that goes beyond this point risks developing a culture where risk-taking is less prevalent, which could reduce economic dynamism at the margin.
- **Stimulus - Monetary and Fiscal:** I believe we have already passed the point of maximum accommodation in the U.S. The Federal Reserve has finally begun raising the federal funds rate and will likely continue the process in 2016, although likely at a measured pace. The continued budget problems at all levels of government (including entitlements) in the U.S. really limits any chance of massive fiscal stimulus, in my opinion, although the improvement in recent years may give the U.S. some flexibility to evaluate some positive ROI projects, particularly on the transportation infrastructure front.
- **Unemployment:** The unemployment rate in the U.S. peaked at 10.1% in 2009 and has dropped to 5.0% (as of 1/1/16) almost seven years into a recovery.¹⁴ Further, this figure has been supported by a decreasing labor participation rate. Economists expect unemployment to remain relatively high throughout the recovery. In fact, a broader measure of the unemployment rate, U-6, paints a less optimistic employment situation. However, the Fed will remain relatively accommodative until the statistics improve further.
- **Europe:** Europe has finally moved from being a potential source of the next crisis to potentially becoming a positive catalyst that could help move the global economy to the next stage of recovery. While the membership of the European Union may, in fact, be different three years from now, the original reasons for the European Union (efficiency, increased global competitiveness, etc.) are as relevant as ever, in my opinion. Investors should hope for a relatively orderly evolution.
- **U.S. Housing Market:** The statistics appear to be consistent with a healing housing market. Prices have been rising in the past couple of years and housing starts have improved from unsustainably low levels. Overall, I expect the measured recovery for housing to continue for a few more years. After ten years of artificial forces effectively distorting housing both to the upside and downside, I expect the return to a “normal” market will continue to be a stabilizing force for the economy.
- **Protectionism:** The severe global recession and its aftermath has factions in many countries pushing for policies that would “protect” their respective economies. Of course, we have learned that protectionist policies during the Great Depression exacerbated that economic downturn and we have proven the economic benefits of free trade in both theory and practice. I mean, come on, is this not why we educate ourselves?

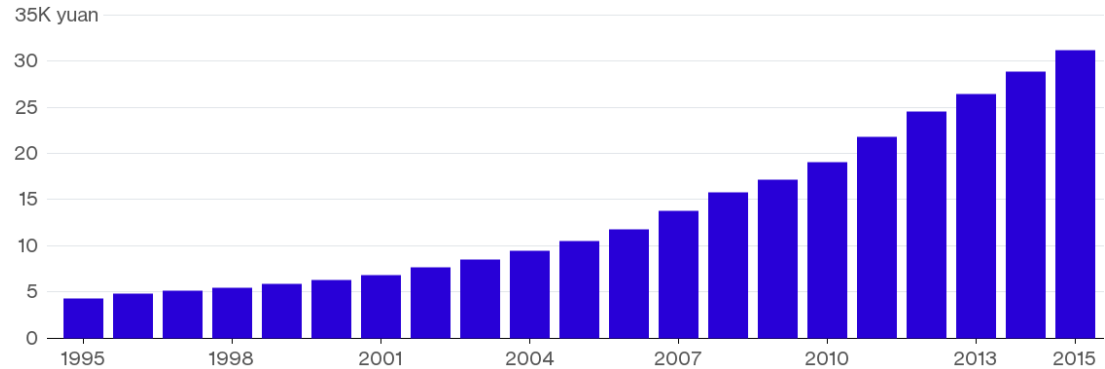
GRAPHS OF INTEREST

Price of Oil vs. Recessions



Source: Peak Watch, EIA, NBER

China Urban Household per Capita Annual Disposable Income



Source: National Bureau of Statistics of China

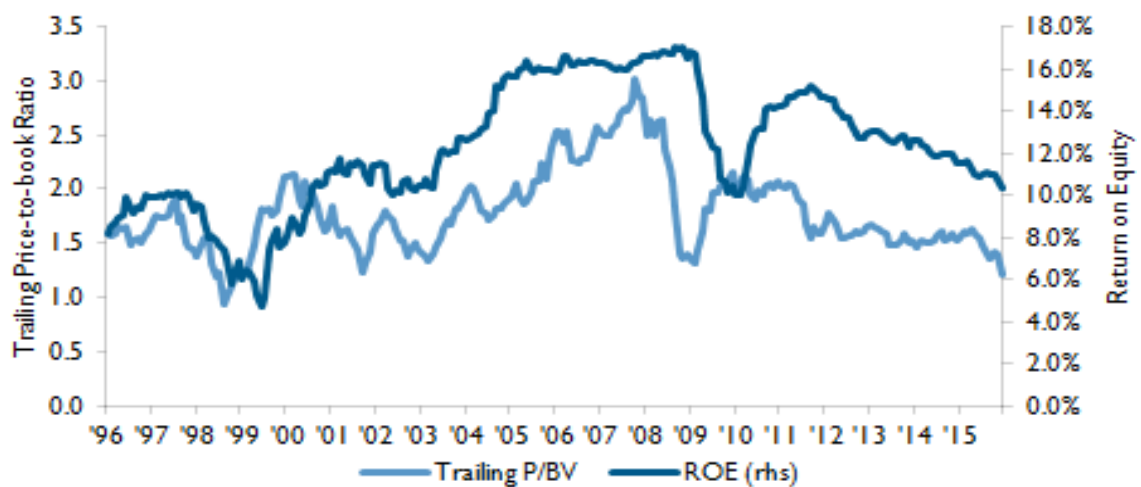
U.S. – Europe Relative Valuation (1979 – 2015)



Source: FactSet, Morgan Stanley Wealth Management GIC

EM Valuations are Pricing in a Financial Crisis

1/31/1996 - 12/31/2015



Source: Emerging Global Advisors, Bloomberg, MSCI

Summary of Overweights and Underweights

Asset Class/ Industry/Sector	Reason
OVERWEIGHTS	
Absolute/Total Return Strategies	In what I believe will be a relatively modest return environment across asset classes, strategies that are designed to achieve high single digit returns may be additive to overall portfolio returns. These strategies typically have a low correlation to traditional assets, which may help reduce overall portfolio risk.
Large Cap Multi-Nationals	Still cheaper than small caps on many metrics. Large cap multi-nationals are generally in stronger financial shape and are more exposed to global growth, particularly from emerging markets. U.S. based multinationals would get added benefit from a weakening U.S. dollar over time.
High Dividend Yield Equities	Over the long run, dividends have accounted for a significant portion of the total return in equities. I believe this will be the case over the short and intermediate term as well.
China/Emerging Markets (Consumer Focused)	I believe we are in a significant shift of economic “power” from a U.S./Europe driven economic model to one where emerging market consumers decide that they would like a similar lifestyle which they increasingly see Westerners enjoy on the TV/Internet. There is still a very wide per-capita income gap between the emerging and developing markets that I expect will continue to narrow over time. Importantly, this dynamic should create a positive feedback loop for the global economy.
Europe	Europe’s financial system is approximately three years behind the U.S. in regards to de-leveraging and cleaning up their balance sheets. The ECB has re-upped its commitment to keep rates low as the U.S. Federal Reserve, which is positive. Valuations in Europe are cheap on a relative and absolute basis.
Below Book Value Financial Companies	The ghosts of the financial crisis still lurk in certain sub-sectors and companies, particularly in how the market is valuing them. The companies that I am interested in have been improving their operations and I expect will continue to do so. Ultimately, I expect the market to begin to recognize this which should drive their valuations higher...and I expect this to happen in 2016.
Consumer Discretionary	Consumers have been helped by low interest rates for years and have increasingly been helped by the improving labor market. The drop in oil prices is further help. This combination should help the housing, retail and consumer technology sectors, among others. Any wage improvement would be a boost.
Corporate/High Yield Fixed Income	In the context of an overall underweight in fixed income, I am overweighting this sub-asset class. The recent widening of yield spreads due to the oil price decline provides select opportunities, particularly short and intermediate maturities.
Floating Rate Loans/Bonds	In the context of an overall underweight in fixed income, I am overweighting this sub-asset class. The floating rate nature of these securities essentially eliminates any duration risk while still yielding almost 4 percentage points above LIBOR. ¹⁵ Many of the existing securities outstanding are trading below par so there is the added potential of capital appreciation as credit markets normalize.
UNDERWEIGHTS	
Long-term Fixed Income	Rates remain low. Real rate of return below historical average. Aggressive rate cuts by the Federal Reserve may stoke higher future inflation. Higher quality bonds relatively expensive versus equities.
U.S. Treasury Securities	Low yields, potential future inflation and increasing supply to fund record deficits pretty much sums it up.
Small Cap Equities	The global nature of large caps (i.e., larger companies derive a greater percentage of their revenues from faster growing emerging markets) and relative valuation continues to favor large caps.
Developed Market Consumer Staples Stocks	Seen as a “safe haven” in the early years of the recovery, they are now expensively valued as a result. Further, other sectors have become more “palatable” as the global economy stabilizes.
Real Estate Investments Trusts (REITs)	The U.S. commercial real estate has stabilized after the meltdown of 2008/2009. However, the recovery continues to be slow and dividend yields are still unattractive, particularly as overall interest rates rise.

*For illustrative purposes only and should not be construed as a specific recommendation. A review of each investors financial situation and risk tolerances must be performed to determine suitability of any investments. * indicates new recommended overweight or underweight.*

The Benedict-McLoughlin Group at Morgan Stanley

10960 Wilshire Boulevard
Los Angeles, CA 90024

Phone: 310.443.0555
Fax: 310.443.0566

chris.benedict@morganstanley.com
brian.mcloughlin@morganstanley.com

1. 2015's Tally: Stocks Drop Nearly 1%, Barron's, 1/4/16.
2. Roundtable, Barron's, 1/18/16.
3. Up and Down Wall Street, Barron's, 1/18/16.
4. Deeper Dive Into Market Monsoon Shows Recession Alert Mute, Bloomberg News, 1/25/16.
5. China-Spurred Commodities Rout Brings Home \$460 Billion Dividend, Bloomberg News, 1/24/16.
6. China Jobs Health Check: Holding Up But Watch Out for Headwinds, Bloomberg News, 1/24/16.
7. China Is a Long-Term Buy, So Stop Freaking Out, Bloomberg News, 1/4/16.
8. www.worldbank.org
9. Much of this section is from my 2004 Investment Outlook, Oppenheimer & Co. Inc., 2/16/04.
10. S&P 500 Valuation Appears Reasonable, GIC Chart Book, Morgan Stanley, 1/31/16.
11. Oil, Gas Loans Not Likely to Choke Big U.S. Banks, Moody's Says, Bloomberg News, 2/5/16.
12. Time to Buy the Banks, Barron's, 2/1/16.
13. EM GDP Growth Expected to Accelerate in 2016, Emerging Perspectives, Emerging Global Advisors, 1/11/16.
14. Bloomberg L.P., 2/5/16.
15. LSTA, www.lsta.org, 2/15/16

Investments in high-yield or distressed securities involves a substantial risk of default and/or loss of principal and may be more difficult to sell prior to maturity than investment grade securities. Accordingly, they are not suitable for all investors and careful consideration should be given to individual objectives before engaging in such transactions.

Investors should be willing and able to assume the risks of equity investing. The value of a client's portfolio changes daily and can be affected by changes in interest rates, general market conditions and other political, social and economic developments, as well as specific matters relating to the companies in which securities the portfolio holds.

Small cap stocks carry greater risk than investments in larger, more established companies.

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Smith Barney or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security.

This report contains forward looking statements and there can be no guarantees they will come to pass. The information and statistical data contained herein have been obtained from sources believed to be reliable but in no way are guaranteed by Morgan Stanley Wealth Management as to accuracy or completeness.

There is no guarantee that the investments mentioned will be in each client's portfolio.

The investments listed may not be suitable for all investors. Morgan Stanley Smith Barney LLC recommends that investors independently evaluate particular investments, and encourages investors to seek the advice of a financial advisor. The appropriateness of a particular investment will depend upon an investor's individual circumstances and objectives.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

Actual results may vary and past performance is no guarantee of future results.

Asset Allocation, Diversification and Rebalancing do not guarantee a profit or protect against a loss.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The strategies and/or investments discussed in this material may not be suitable for all investors. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Equity securities may fluctuate in response to news on companies, industries, market conditions and the general economic environment. Companies cannot assure or guarantee a certain rate of return or dividend yield; they can increase, decrease or totally eliminate their dividends without notice.

The initial interest rate on an inflation-linked 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 CPI. However, there can be no assurance that these increases in CPI will occur. Some inflation-linked securities may be subject to call risk.

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

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. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Master Limited Partnerships (MLPs) are (rolled-up) 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. Because of their narrow focus, MLPs maintain exposure to price volatility of commodities and/or underlying assets and tend to be more volatile than investments that diversify across many sectors and companies. MLPs are also subject to additional risks including: investors having limited control and rights to vote on matters affecting the MLP, limited access to capital, cash flow risk, lack of liquidity, dilution risk, conflict of interests, and limited call rights related to acquisitions.

REITs are subject to special risk considerations similar to those associated with the direct ownership of real estate. Real estate valuations may be subject to factors such as changing general and local economic, financial, competitive, and environmental conditions. REITs may not be suitable for every investor.

Dividend income from REITs will generally not be treated as qualified dividend income and therefore will not be eligible for reduced rates of taxation.

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

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of May 30 2011, the **MSCI World Index** consists of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. An investment cannot be made directly in a market index.

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.

Morgan Stanley Smith Barney LLC. Member SIPC.

Date of first use: 2/22/16