



The Benedict-McLoughlin Report 2017 Investment Outlook

By Christopher Benedict, CFA

- Global financial markets remain resilient in the wake of a surprise outcome in the U.S. Presidential election
- With the S&P 500 up over 11% since the election through 3/31/17, investors appear optimistic about a Republican-led pro-growth agenda¹
- The Federal Reserve will remain in focus for the foreseeable future as a continued monetary tightening cycle may bring back some volatility

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.

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Global financial markets continue to digest the new landscape following the U.S. elections in November. After a very brief overnight sell-off the night of the election, investors have essentially been in “risk-on” mode ever since. The prospect of pro-growth policies has “trumped” the potential higher volatility and uncertainty that is possible under the new Administration. To be fair, financial markets were de-risking leading up to the election given the typical uncertainty that accompanies elections, so, a post-election rally may not be that surprising given that at least a new Administration was actually selected and investors could then adjust to the expected policy changes. However, the strength and persistence of the rally has been surprising to many. And, while a modest correction could occur anytime, the positive momentum may continue.

On paper, the bulls on economic growth have reason to be optimistic. Many of the policies that are being touted by the new Administration are viewed as “pro-growth”. Tax cuts, deregulation, and infrastructure spending have proven to boost economic growth over relatively shorter time periods but, these policies can also have some negative consequences over the medium and long-term (i.e., increased debt levels, corporate abuses,

etc.). It is imperative to find the right balance and continuously strive to achieve optimal policy targets. Of course, the eventual outcome is uncertain, so, I believe it will require some faith by investors as well as some very close monitoring.

Investing 2.5

Currently, my view is one of cautious optimism, at least as it relates to economic growth and the investment outlook. To be sure, the economy has come a long way since the Great Recession of 2008-2009. For example, the unemployment rate has declined from 10.1% to 4.6% as of 12/31/16 (see graph on p.10).² However, the overall pace of economic growth has been below average during this recovery. Even if only about two-thirds of these pro-growth policies are implemented, I would expect the boost to growth to be measurable. My working thesis is that the effect of these policies will push out the inevitable next recession by 1 – 2 years, all else equal. So, pre-election, if the expectation was that the next recession (and bear market) might be in the 2018 time frame, maybe we are now looking at 2019 – 2020. Until such time, we may enjoy a favorable 2 – 3 year window for risk assets...splitting the middle would be

2 ½ years, or, “Investing 2.5”.

Of course, 2020 is another major election year, so, there is a chance that the party in power saves some “policy bullets” to keep the economy growing during the election process. At the same time, there is some “unintended consequences” risk embedded in some of the policies in play. Let’s take a closer look at what will likely be the major drivers of the economy and financial markets over the next few years:

Fiscal Policy

The Administration has discussed a three-pronged fiscal stimulus agenda: Tax cuts/reform (corporate and personal), de-regulation, and infrastructure spending. Each of these actions has the potential to be a meaningful growth driver in their own right and each would be a boost to the labor market. Of course, each also has some potential negative effects as well. However, if designed and implemented correctly, I believe these policies would be a net positive for the economy.

The optimal tax rate has long been debated but, the crux of the debate is to find the rate that maximizes revenue. Too high a rate and the taxpayers become disincentivized to undertake the taxed activity and the reduction of this taxed activity outweighs the higher tax rate, thus reducing overall revenue. Similarly, too low a rate and revenue is left on the table as, at some point, the lower tax rate does not incentivize more of the taxed activity.

The low hanging fruit in the U.S. is the corporate tax rate. The U.S. has the highest combined rate (federal and local) in the world. At 38.9%, it compares with rates of approximately 30% in both Italy and Germany, for example...countries that are typically considered socialist leaning.³ At its best, this high rate incentivizes companies to employ armies of tax lawyers to figure out ways to avoid paying such a penal rate. At its worst, it incentivizes companies to do such things like a “tax inversion” where a company effectively relocates its legal domicile to a country with a lower tax rate, like Ireland, for example (12.5% rate). Clearly, 38.9% of zero is zero. The World Bank estimates that a reduction of the

federal corporate rate to 15% would improve U.S. growth to 2.5% in 2017 and 2.9% next year and boost global growth by 0.1% and 0.3%, respectively.⁴

The same basic idea applies to personal income tax rates as well. Lower tax rates puts more disposable income directly in consumers’ pockets and Morgan Stanley estimates that U.S. households have typically spent more than 75% of tax cuts.⁵ Currently, individuals in the highest federal tax bracket and living in the states with the highest state income tax rates pay a combined marginal rate in excess of 50%, so, there is certainly some room for adjustment. Importantly, many of these taxpayers are small business owners. Lowering the marginal rate on this group of taxpayers has the potential to provide benefits beyond just putting more disposable income in their pockets. One example is the potential to add jobs if their businesses grow a little faster...not only creating more income tax revenue but, also, creating more disposable income in the economy, etc. None of this is lost on small business owners...the survey run in December by the National Federation of Independent Business (NFIB), which measures the sentiment of this group, was at its highest level since 2004.⁶

De-regulation is another area that small businesses would applaud...large businesses too. By their very nature, regulations are profit sapping...whether it is an elongated review/approval process for a project or price controls. Importantly, I strongly believe that a certain level of regulation is necessary. In my opinion, any negative externalities that exist which are not rectified by the free market should be regulated by the government...many environmental regulations fall into this category. A simple example is the factory that could easily (and cheaply) dispose of its toxic waste into a nearby river, thus contaminating it and creating a multitude of other costs (monetary and other) for the rest of the community. I feel regulating this activity is clearly beneficial to society. However, overall, the pendulum can swing too far in one direction as the government overreaches...this is where many economists believe we are currently. So, a careful pruning of regulations would seem reasonable and, where applicable, a more efficient methodology to regulate should be utilized. For example, the potential use of a carbon tax combined with a free market in

carbon credits would enable the achievement of an overall carbon emission target/limit while, at the same time, allow those entities that can achieve a reduction in carbon emissions more efficiently to bear the brunt.

The final area of fiscal stimulus is good old fashioned government spending (i.e., priming the pump). Of course, government spending or “investment” is only a positive if it results in a decent return on investment (ROI). The idea of using a ROI “hurdle” is as important as ever due to the record amount of government debt we now carry...and the debt continues to pile up as evidenced by our fiscal 2016 deficit of \$587 billion.⁷ In fact, the Congressional Budget Office projected in January that the federal debt will grow by more than 50% or \$10 trillion over the next 10 years.⁸

Certain projects appear to be good candidates for reasonable ROI outcomes, particularly in the transportation area. The relative antiquity of our airports is oft mentioned...and rightly so, in my opinion. If a modernized airport could reduce overall check-in times, reduce delays and increase safety (and create jobs), the benefits are likely to be significant. Our highways and roadways are certainly another area. As an aside, I am a resident of Los Angeles and the highway system is essentially unusable for a large chunk of the day...some drastic and creative thinking is necessary...and soon but, I will save that discussion for another day.

Monetary Policy

While the Federal Reserve is an apolitical institution, the Administration does have important indirect influences, not the least of which is the power to appoint the Fed Governors, including the Chairperson. Maybe more important is the Administration’s ability to influence fiscal policy...which can affect how the Fed conducts monetary policy. In any case, I believe monetary policy will continue to be a very important factor for the economy and financial markets.

With a few rate hikes under their belt, the Fed finally appears to be on the path to “normalization”...and, once they begin to sell some of the bonds sitting on their balance sheet, I think we can declare the U.S. removed from “emergency” monetary policy...that process may

begin by the end of 2017. Of course, the Fed has not been in any rush to close the spigot in recent years as the labor market has had some slack and inflation has been relatively contained. However, with the aforementioned improvement in the labor market and the prospect of expansionary fiscal policy, the Fed may be running the risk of “falling behind the curve”. If these large infrastructure projects (which need a lot of workers) run into a baby boom generation that is just beginning to exit the labor force, we may be in for some significant wage inflation. On the other side, financial markets are as global as ever and interest rates remain very low (although rising) in other developed nations, which should act as a sort of tether for U.S. interest rates. Net-net, the Fed will likely remain diligent but, measured in the current tightening cycle.

Global Trade/Immigration

The Administration’s ultimate view on globalization is probably the biggest wild card over the next few years. Investors should hope that their “bark” is worse than their “bite” as it relates to the rhetoric so far. Free trade works in both theory and in practice for the benefit of the overall global economy. Free trade enables the most efficient producer of a good or service to compete away the inefficient producers on a global scale, thus providing lower prices for consumers everywhere, particularly in the U.S. Protectionist policies would work against this. In fact, Barclay’s estimates that border tax adjustments could increase inflation by one percentage point annually.⁹ Furthermore, the Organization for Economic Cooperation and Development (OECD) estimates that if the U.S., Europe and China all raised the cost of trade by 10%, global growth could be reduced by 0.2% - 0.3% annually over the next ten years.¹⁰

I put the whole immigration issue in the same “globalization” bucket. The ability to control our borders is no doubt a major consideration for any Administration but, there is an important balance to maintain. We are obviously a country built on immigrants and this reality has played a significant role, for many reasons, in what makes us a truly great country. But, besides all of that, there is a practical reason to maintain a policy that encourages a healthy amount of

immigration...population growth. The most recent census data showed that the population in the U.S. only grew 0.7%, the lowest rate of growth since the Great Depression years of 1936 and 1937.¹¹ Since our fertility rate is not expected to increase, we must rely on immigration to achieve any meaningful population growth. As it is currently constructed, the American Machine does not work without population growth...just ask Japan.

U.S. Reputational Risk

According to at least a few mainstream media sources, the election results signaled no less than the end of the world as we know it. Of course, “reputational risk” is hard to quantify but, as former Supreme Court Justice Potter Stewart famously said about pornography, “I know it when I see it”. Whether we actually see “it” currently is up for debate but, I would argue we are at least rated a strong “R”, if not NC-17. And even if the Administration believes it has the best intentions...perception does matter. Our reputation as the freest and strongest country comes with a lot of benefits: Cheap interest rates on a growing debt balance, American products enjoy a “Made in America” premium, relative world peace/order...to name a few. Disrupting any of it would be very costly.

Implications for Investors

Well, one thing should be clear: Investors should stay on their toes! Also, an increasingly important question for investors is “active” management or “passive” management (i.e., indexing). Since the Great Recession, the Fed has effectively been the elephant in the room, squashing interest rates down and keeping volatility historically low. It has also helped keep correlations between economic sectors very high. In fact, correlations have averaged 82% since 2008 compared to the normal 50%, according to ConvergeX.¹² We have experienced similar high correlations across geographic regions and even asset classes as the “risk on, risk off” trade seemed to explain a lot of market moves since the Great Recession.

However, there are signs that the environment may be getting better for active managers. While it is reasonable

to think the backdrop became more conducive to active management post-election, due to the surprise factor as well as certain policy expectations, the trend actually began before the election as the market begun to price in a move towards normalizing interest rates. As rates increase, volatility tends to increase and risk management becomes more important...something that active managers pride themselves on. Importantly, correlations are, in fact, decreasing as well...down to 56.8% in December, according to ConvergeX.¹³ I believe this trend continues.

Asset Allocation¹⁴

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 on next page). Finally, a rebalancing 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. 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.

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.

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.

Current Strategy

Given my view that the economic backdrop should remain constructive over the next few years, we are tilting our model portfolios towards risk (with periods of tactical “risk off”). Sectors that should do well in an expansionary economic environment include consumer discretionary, energy, industrials and materials. Sectors that we will largely avoid include consumer staples and utilities (see table on p. 10). Overall, the S&P 500 trades at price to earnings (P/E) ratio of just under 18 on 2017 earnings estimates...but, this goes down to approximately 16.4 if the corporate tax rate is reduced to 15% and is reflected in earnings, according to Morgan Stanley.¹⁵ So, potentially undervalued but, with a fair amount of uncertainty in regards to what the final policies will actually look like.

Globally, valuations in general look relatively attractive compared to the S&P 500 after several years of underperformance (see graph on p. 11). The fundamentals appear to be turning for the better in Europe as well as certain emerging market countries like China. Barring draconian trade policy out of the U.S., international markets should perform better over the next few years. Companies that are exposed to the emerging market consumer should do well.

On the income side, I continue to believe that buying developed economy government bonds is not really investing anymore...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 than U.S. Treasuries as it provides short-term safety without the potential volatility/downside if rates do continue to rise (see graph on p. 11). 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. 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. Our model portfolios are also utilizing Master Limited Partnerships, Yield Co.’s and dividend paying equities to generate income.

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 tables on the next page and on p.12 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	+1	Floating Rates	+2		
Small/Mid Cap	-1				

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

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(Other) Things to Watch

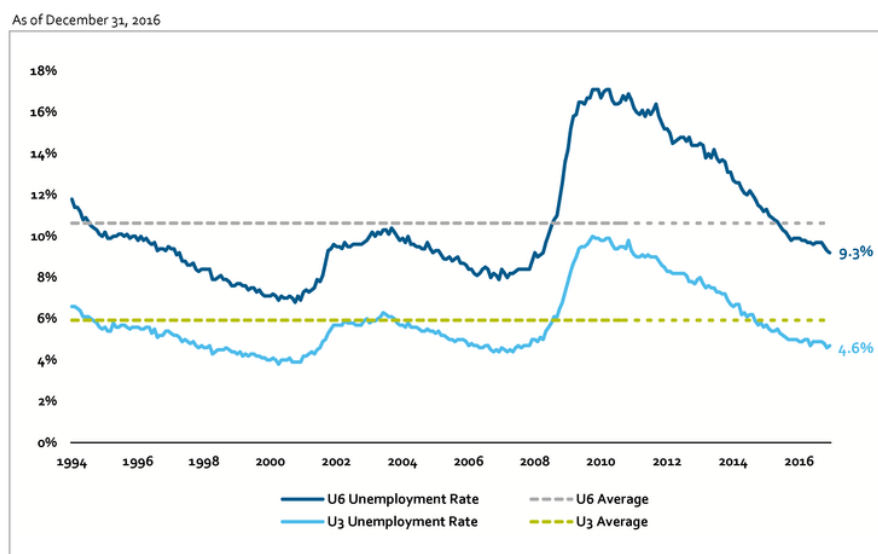
- **U.S. Deficit/U.S. Dollar:** Although improving, we continue to run large deficits and it appears that this will improve only modestly over the next year or two. Recent strength in the dollar as a result of interest rate differentials may hurt the profits of U.S. multinationals and, while the strength 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. The new Administration appears to want to bring the U.S. back towards that optimal point.
- **Terrorism:** Sporadic terrorist strikes in Western nations remind us that the threat is still there. While these attacks in the West are serious, 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.

- **Unemployment:** The unemployment rate in the U.S. peaked at 10.1% in 2009 and has finally dropped below 5% (4.6%) (12/31/16) seven years into the recovery.¹⁶ 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, while also improving, paints a less optimistic employment situation. I would expect successful fiscal stimulus to provide support to the labor market.
- **Europe:** Despite the exit of the U.K. from the E.U., Europe has the potential to become 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 fairly healthy and normal 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. The path of interest rates is a wild card, though. If rates rise too fast, it could counteract improving fundamentals overall.

GRAPHS OF INTEREST

U.S. Unemployment Rate: U6 vs U3



Source: Morgan Stanley Wealth Management GIC, Bureau of Labor Statistics, Bloomberg

President-Elect Trump: Sector Implications

As of November 2016

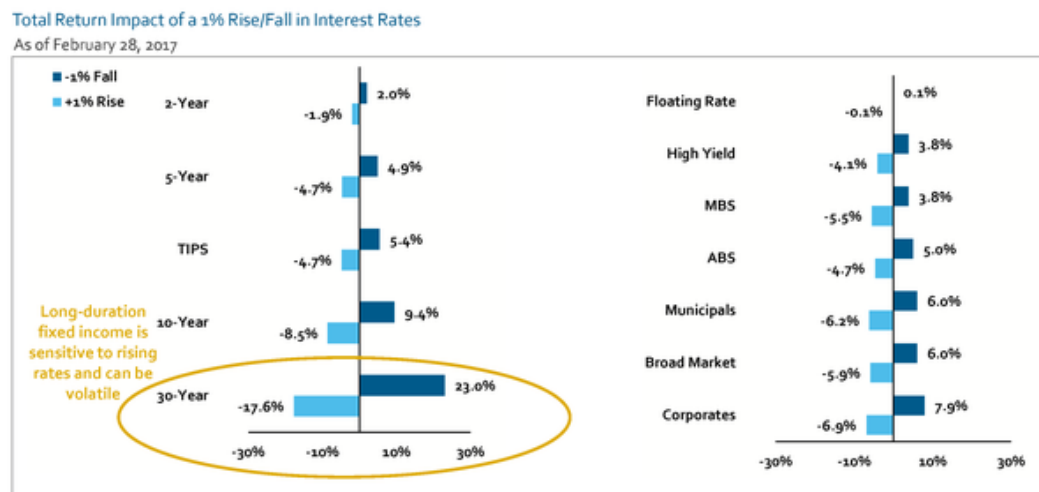
	Trump	
	Policy Theme	Implications (+/-)
Technology	• Repatriation of overseas corporate cash at 10% tax rate	+ Companies with large foreign cash balances
Financials	• Less financial regulation • Corporate tax reform	+ Banks, asset managers
Healthcare	• Repeal Affordable Care Act • Pass own reforms to broaden healthcare	+ Pharmaceuticals - Hospitals, Affordable Care Act beneficiaries
Consumer Discretionary	• Middle-class tax relief • Simplify tax code • Lower corporate tax rate to 15%	+ Retail, consumer goods
Consumer Staples	• Opposes expanded free trade: Trans-Pacific Partnership agreement	- Consumer goods importers/exporters
Industrials	• Committed to massive increase in infrastructure spending	+ Defense, infrastructure, energy related - Renewable energy
Energy	• Supports US energy independence	+ Oil & gas, fossil fuels, nuclear - Clean energy
Utilities	• Traditional power generation	+ Coal, nuclear - Wind, solar, renewable
Materials	• Committed to massive increase in infrastructure spending	+ Defense, infrastructure, energy related
Telecom	• Infrastructure spending	+ Internet/telecom infrastructure

Source: Morgan Stanley Wealth Management GIC, DonaldJTrump.com, Strategas Research Partners

U.S. vs. International - Relative Performance (1992 – 2016)



Source: Morgan Stanley Wealth Management GIC



Source: Morgan Stanley Wealth Management GIC

Summary of Overweights and Underweights

Asset Class/ Industry/Sector	Reason
OVERWEIGHTS	
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 stabilizing U.S. dollar over time.
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.
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 a la the U.S. Federal Reserve, which is positive. Valuations in Europe are cheap on a relative and absolute basis.
Corporate/High Yield Fixed Income	In the context of an overall underweight in fixed income, I am overweighting this sub-asset class. An expansionary economic backdrop should help keep yield spreads relatively tight.
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 3 percentage points above LIBOR. ¹⁷ Many of the existing securities outstanding are trading below par so there is the added potential of capital appreciation as credit markets normalize.
Absolute/Total Return Strategies	In what I believe will be a relatively modest return environment over the next 10 years, 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.
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.*

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1. Bloomberg Markets, 3/31/17.
2. Morgan Stanley Chartbook, 1/31/17.
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4. Bloomberg News, 1/10/17.
5. 2017 U.S. Consumer Outlook, Morgan Stanley Research, 1/4/17.
6. Barron's, 1/16/17.
7. Bloomberg News, 1/17/17.
8. Barron's, 1/30/17.
9. Barron's, 1/16/17.
10. Barron's, 1/16/17.
11. Bloomberg News, 1/3/17.
12. Barron's, 12/26/16.
13. Barron's, 12/26/16.
14. Much of this section is from my 2004 Investment Outlook, Oppenheimer & Co. Inc., 2/16/04.
15. On The Markets, Morgan Stanley, January 2017.
16. Morgan Stanley Chartbook, 1/31/17.
17. LSTA, www.lsta.org, 3/31/16.

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.

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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.

Sample Holdings consist of the top issues in each sector within the model portfolio as of 3/31/17. These sample holdings are for informational purposes only and should not be deemed to be a recommendation to purchase or sell the securities mentioned. There are no guarantees that any securities mentioned will be held in a client's account. It should not be assumed that the securities transactions or holdings discussed were or will be profitable. Data are indicative only as of the given date. Holdings will fluctuate, and no assurance can be given that an actual portfolio will be able to obtain the same attributes.

Please see additional important information at the end of this report

The individuals mentioned as the Portfolio Management Team are Financial Advisors with Morgan Stanley participating in the Morgan Stanley Portfolio Management program. The Portfolio Management program is an investment advisory program in which the client's Financial Advisor invests the client's assets on a discretionary basis in a range of securities. The Portfolio Management program is described in the applicable Morgan Stanley ADV Part 2, available at www.morganstanley.com/ADV or from your Financial Advisor.

Past performance of any security is not a guarantee of future performance. There is no guarantee that this investment strategy will work under all market conditions.

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