May 23, 2019

What Happened in the Markets?

- US stocks declined on Thursday, with the S&P 500 dropping 1.2% to close at 2,822. All three major US averages ended lower on the session: the NASDAQ Composite lost 1.6%, and the Dow Jones Industrial Average shed roughly 300 points, or 1.1%.
- Trade fears continue to weigh on markets and prompted a sharp pull-back in stocks globally on Thursday. Major equity indices across China, Europe, and the US all fell more than 1%, as investors sought the relative safety of government bonds and gold amid a worsening outlook for the standoff between Washington and Beijing. Beyond tariffs, the White House has threatened to blacklist additional Chinese technology firms, leading analysts to predict that the conflict could persist for longer than previously expected. The ongoing dispute and associated uncertainty about growth also contributed to a sell-off in oil, which had its worst day of 2019.
- Nine of 11 S&P sectors finished the session in the red. Utilities (+0.8%), Real Estate (+0.5%), and Consumer Staples (-0.1%) outperformed on the day, while Energy (-3.1%), Technology (-1.7%), and Industrials (-1.6%) lagged the broader market.
- Treasuries gained on the day as yields fell along the curve. The benchmark 10-year yield settled around 2.31% as of the 4 p.m. equity market close – its lowest level since 2017. The prices of Brent (-4.4%) and WTI (-5.6%) Crude oil contracts posted their worst performance of the year. The US dollar weakened relative to its major peers as measured by the US Dollar Index, while gold rose.

Catalysts for Market Move

US equities faced a day of sharp selling as the S&P 500 lost 1.2%, but an attempt at a late afternoon rebound led the index to close above its session lows. Close to 80% of stocks in the index were negative on the day. Among the major US benchmarks, losses were steepest in the tech-heavy NASDAQ Composite, which dropped 1.6%, while the Dow fell by 1.1% in comparison. Looking at investing styles, value stocks moderately edged out growth by 0.3% based on the Russell 1000 Value and Growth indices. Large-cap stocks outperformed small-caps by 0.7%, as measured by the Russell 2000 and Russell 1000 indices. Further, defensive stocks led cyclicals by around 3.1%, reflecting the day's negative tenor for risk assets. Outside the US, European benchmarks ended their session broadly lower with the Euro Stoxx 50 Index dropping 1.8%. The Shanghai Shenzhen CSI 300 Index, an index of Chinese A-shares, fell 1.8% in overnight trading.

Trade tensions remained the primary focus for markets, as growing evidence of an escalating and protracted conflict between the US and China contributed to a pull-back in global equities on Thursday. Rhetoric has sharpened in recent days, with the Chinese state-run newspaper running critical op-eds aimed at Washington, while the US administration threatened to blacklist several more major Chinese technology companies from doing business with American firms. The heightening situation has led many analysts and economists to reassess their baseline expectations for how the trade war will play out, with an increasing number suggesting it could be a prolonged affair. More immediately, trade fears have weighed heavily on oil prices. Following poor inventory numbers on Wednesday, Brent (-4.4%) and WTI (-5.6%) crude posted their worst daily performances of 2019, driven in part by fears of declining trade causing a slowdown in demand. As stocks and oil fell, bonds rallied as treasury yields touched their lowest levels since late 2017. Lastly, weak manufacturing, services, and home sales data released Thursday morning added to the muddled outlook for the US economy, and likely added to the day's risk-off sentiment.

The S&P 500's down day marked the fifteenth 1%+ move of 2019, and the sixth in which stocks fell. The VIX Index, a forward-looking measure of S&P 500 volatility, finished just below 17 as of the equity market close. At current levels, US equities appear fully valued and may be underpricing the risks of higher inflation, pressures to corporate margins, and a slowdown in capital spending. The combination of full valuations, underappreciated risks to corporate profits, and escalating geopolitical uncertainty suggests to us that market volatility will remain elevated in the coming months. Further, the Federal Reserve is likely to stay on hold for the rest of 2019 as its emphasis on data dependence could mean future monetary policy will not support asset prices to the extent investors now expect. The S&P 500 Index is currently up 12.6% year to date, while the NASDAQ Composite has gained 15%, and the Russell 2000 Index has risen 11%. Both the S&P 500 and NASDAQ have fallen from their recent all-time highs, and are now roughly 5% below those levels. This sell-off has eased pressure slightly on valuations, lowering the S&P 500's consensus forward price-to-earnings multiple from its 17.5x value earlier this month to 16.2x currently.

The Global Investment Committee's Outlook

The market environment in 2018 was one of the most challenging for equity investors since the Financial Crisis, with every region and most stocks delivering negative returns. Unusually, bonds and alternative investments simultaneously fared poorly, reducing the effectiveness of asset allocation in balancing out the losses with some gains. In sharp contrast with how 2018 ended, 2019 began with a sharp and broad rally across the majority of risk asset classes. Beginning in January, the dramatic pivot by the Federal Reserve to embrace a patient policy approach helped ease financial conditions and improve market sentiment. Overall, the GIC expects 2019 will be a better year than 2018 both in terms of absolute returns and the breadth of those returns. However, with significantly more good news currently priced into markets, the GIC advises caution as US stocks appear fully valued and earnings forecasts may have further to fall. While the GIC remains overweight equities relative to fixed income, it believes international stocks, particularly emerging markets, may offer the most upside going forward. Within fixed income, the GIC remains underweight corporate credit, and prefers high-quality short-duration bonds as a proxy for cash, which it will look to deploy throughout 2019 as opportunities arise. It also recommends a moderate allocation to long-duration Treasuries as a defensive portfolio hedge against the risk of a future equity or credit market correction.

Market data provided by Bloomberg.

Dow Jones Industrial Average (DJIA): A price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

Euro STOXX 50 Index: Provides a blue-chip representation of supersector leaders in the Eurozone.

Hang Seng China Enterprises Index: This is a free-float-adjusted, capitalization-weighted index of the "H" shares, which are shares of mainland China companies that trade in Hong Kong.

NASDAQ Composite Index: A broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

Russell 1000 Growth Index: measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Index: measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 2000 Index: measures the performance of the 2,000 smallest companies in the Russell 3000 Index.
S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.
US Trade-Weighted Dollar Index: A weighted average of the foreign exchange value of the US dollar against a subset of the broad index currencies that circulate widely outside the US.
VIX: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

Disclosures

Morgan Stanley Wealth Management is the trade name of Morgan Stanley Smith Barney LLC, a registered broker-dealer in the United States. This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Past performance is not necessarily a guide to future performance.

The material has been prepared for informational purposes only and is not an offer or recommendation to buy, hold or sell or a solicitation of an offer to buy or sell any security, sector or other financial instrument, or to participate in any trading strategy. It has been prepared without regard to the individual financial circumstances and objectives of individual investors. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We and our third-party data providers make no representation or warranty with respect to the accuracy or completeness of this material. Past performance is no guarantee of future results.

This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. This information is not intended to, and should not, form a primary basis for any investment decisions that you may make. Morgan Stanley Wealth Management is not acting as a fiduciary under either the Employee Retirement Income Security Act of 1974, as amended ("ERISA") or under section 4975 of the Internal Revenue Code of 1986 as amended ("Code") in providing this material except as otherwise provided in writing by Morgan Stanley and/or as described at www.morganstanley.com/disclosures/dol.

Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors do not provide legal or tax advice. Each client should always consult his/her personal tax and/or legal advisor for information concerning his/her individual situation and to learn about any potential tax or other implications that may result from acting on a particular recommendation.

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies. **Investing in foreign emerging markets** entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions.

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** are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. **Duration**, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment. **Investing in smaller companies** involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity. **Stocks of medium-sized companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Value investing** does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected. **Growth investing** does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention. **Physical precious metals** are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

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

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile.

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

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

This material is disseminated in the United States of America by Morgan Stanley Smith Barney LLC.