

The GIC Weekly



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Upcoming Catalysts

June 11 Japan PPI
June 12 US CPI and PPI
June 13 FOMC meeting and rate decision
June 13 Euro Zone industrial production
June 13 China retail sales
June 13 China industrial production
June 14 US retail sales
June 14 US import/export prices
June 14 European Central Bank rate decision
June 15 Empire State Manufacturing Survey
June 15 US industrial production
June 15 US capacity utilization
June 15 U. of M. Consumer Sentiment Index
June 15 Euro Zone CPI
June 15 Bank of Japan meeting

What We Are Talking About

- **Surprise, Surprise.** Fears that the rebound in global synchronous growth—and the reflation that goes with it—is derailing under the weight of trade tensions, geopolitical stress, a stronger US dollar and tightening financial conditions are premature; to the contrary, as we approach second quarter's end, global growth is holding up and inflation data are firming; a government shake-up in Italy is likely to promote a more aggressive fiscal policy, bank reform and reignite urgency around EU integration; at the same time, the European Central Bank is surprisingly signaling a willingness to taper Quantitative Easing, which should narrow global interest rate differentials; this policy shift should also short-circuit the US dollar rebound, easing some pressures on trade, commodities and emerging market currencies; cycle is old but not over, so avoid de-risking too soon. **Consider** an active and diversified equity exposure, including energy, financials, industrials and tech companies leveraged to capital spending.

Surprise, Surprise

Recent weeks have provided no shortage of things for investors to worry about, yet markets have mostly churned in place, volleying between optimism and pessimism. For US investors, the issue is whether double-digit earnings gains from tax reform will be offset by a compression in the forward price/earnings (P/E) multiple, which has fallen to 16.5 from over 18 in January. While P/Es reflect rising short- and long-term interest rates, there are also concerns that ongoing trade hostilities and raging geopolitical brush fires—among them, North Korea, Iran, Italy and Spain—will upend global synchronous growth.

Outside the US, investors had to further contend with rising oil prices at the same time the US dollar was strengthening, a double-whammy for many in emerging market (EM) countries. Plummeting economic surprise indexes and disappointing April economic data further fueled investor anxieties. With the two-year/10-year US yield curve flattening, it is easy to understand those who were ready to “sell in May and go away.” But our reading



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of both recent data and events is much more constructive than the headlines would suggest. The Global Investment Committee believes that patient and disciplined investors still have time before de-risking their portfolios.

To begin with, we see the most recent global economic data as much better than expected. In the US, economic surprises have rebounded solidly and are broad based. In the May payroll report, trailing three-month job creation jumped back above the 200,000 a month level it has averaged for the past three years and the unemployment rate fell to 3.8%, the lowest since 2000. The last time it was lower was 1969. Importantly, job gains are coming with only moderate wage gains, a healthy dynamic that helps sustain momentum. May's ISM purchasing managers indexes for both manufacturing, at 57.8, and services, at 58.6, were robust, putting the composite PMI near a three-and-half-year high. With the all-important orders components soaring against a backdrop of shrinking inventories, momentum looks solid. Also, May had better data for personal consumption expenditures, construction spending, capex intentions and Morgan Stanley & Co.'s proprietary indicators. Equally important, trade was better than expected in May, with petroleum exports up 18% year over year and total exports pacing toward an all-time high.

Not surprisingly, economists are raising their second-quarter GDP forecasts (see *Chart of the Week*, page 3). MS & Co. economists expect 4.1% growth, which is near the consensus. Growth is also holding up in China, where slowing is much more glacial than expected, with industrial production up 6.4%, retail sales up more than 9% and net trade growth in double digits. With the world's two largest economies showing better-than-expected results, the global economy can cushion stumbles in several EM countries. Even in Europe, where there has been some sequential slowing, the composite PMI remains sustainably above 54, a level that suggests strong economic expansion; unemployment is at cycle lows; and consumer spending is growing at a more than 3% annual pace.

We also see inflation, monetary policy and interest rate dynamics beginning to shift in ways that actually may arrest the potentially destabilizing strength of the US dollar. Specifically, this past week the European Central Bank (ECB) surprised the markets by suggesting that it is ready to consider announcing a tapering of its Quantitative Easing program. MS & Co. strategists acknowledge that this decision may be as much about the central bank having reached technical limits of the program as it is signaling confidence that its inflation target is within reach. Still, the implication is a stronger euro from here on out as well as higher interest rates. In the wake of the ECB's

comments, the 10-year German Bund yield reset 12 basis points higher to nearly 50 basis points. This easing of the dollar is a positive for global trade and global financial conditions and many EM countries, several of which have been forced to hike local rates. In the past month, we have seen rate hikes in India, Brazil, Indonesia, Turkey, the Philippines and Romania while easing has been put on hold in South Africa and Russia. A weaker dollar should thus support global rebalancing.

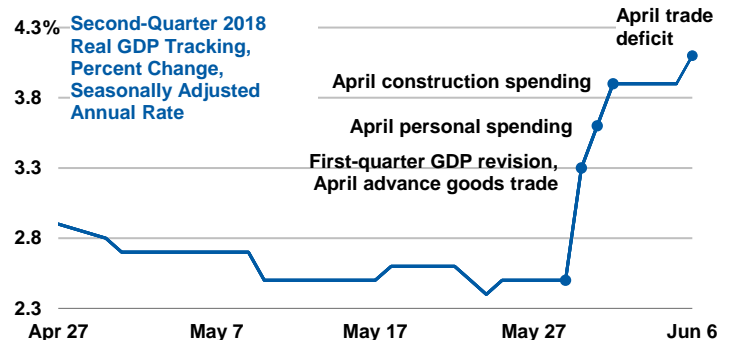
A final surprise is a redirection of the narrative around the political crisis in Italy. The initial market reaction was a markdown on Italian government bonds, which caused rates to soar. Indeed, the formation of an unlikely and Euro-skeptic coalition government of far-left and far-right parties raised fears about fiscal spending that would explode the debt load and raise the risks of a euro-exit or a banking crisis. More recent interpretations have been constructive. Specifically, with the US moving toward isolationism and wounds still fresh from Brexit, an abrupt shift in Italian politics coming at the same time that Spain is likely to form a center-left government suggest that the EU may finally address long-festered structural reform and shift its policy mix toward fiscal stimulus and banking union. Italy, unlike Greece and Portugal, is too big to fail if the euro is to survive. German Chancellor Angela Merkel and French President Emmanuel Macron are likely to have finally gotten that message and may be ready to deal with it at the EU summit meeting scheduled for June 28.

Bottom Line: Market volatility has rightfully increased and investors have struggled to generate positive returns in 2018. Risk premiums have had to reflect the regime change from 2017's benign backdrop. Changes in both US monetary and fiscal policy have generated tighter financial conditions, higher interest rates and stronger inflation just as investors contend with escalating trade tensions and rising geopolitical risks. While it would be easy to worry that such a combination this late in the cycle would decelerate global economic growth, it is not the case. In fact, the latest data suggest that the reflationary narrative has strengthened anew in the second quarter. Furthermore, we see the global forces at work, especially on a geopolitical level in places like Italy, actually easing the stresses; they are working to hasten a peaking of the US dollar and the closing of global interest rate differentials. This buys equity investors a bit more time. **Watch** the US dollar and high yield and emerging market credit spreads. **Consider** an active and diversified equity exposure, including energy, financials, industrials and tech companies leveraged to capital spending. ■

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Chart of the Week: Looking for Solid Second-Quarter GDP Growth

After a somewhat disappointing 2.2% reading for first-quarter US GDP, markets began worrying about economic slowing when they saw weakening in the April data. However, the May reports should allay their fears. The numbers suggest that growth in the second quarter has in fact rebounded powerfully. Ellen Zentner, MS & Co.'s chief US economist, recently raised her second-quarter GDP tracking estimate to 4.1% due to better-than-expected personal consumption spending, retail sales, PMIs and payrolls (see chart). Importantly, Zentner's revisions are being echoed in the consensus and the much-followed Atlanta Fed GDPNow Forecast Model is pointing toward 4.5%. Positive economic surprises and positive forecast revisions should provide a solid cushion for corporate earnings, putting a floor under US equities for a bit longer.



Source: Morgan Stanley & Co. Research as of June 6, 2018

Asset Class Performance and Heat Map (as of June 8, 2018)

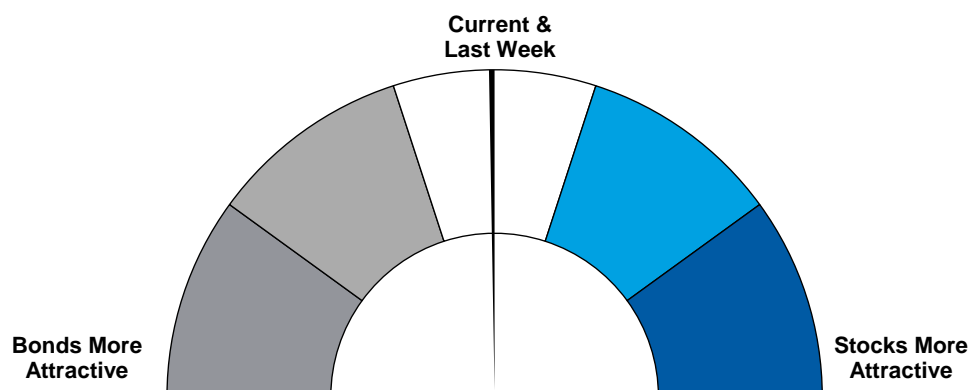
Asset Class	Annualized Returns (%)							Yield	Valuation		Volatility (%)		Correlation to Global Equities	
	YTD	1-Yr.	2017	3-Yr. ¹	5-Yr. ¹	10-Yr. ¹	20-Yr. ¹	Current YTM	Current YTM	Avg. YTM ²	30 Days	20 Yrs. ¹	30 Days	20 Yrs. ¹
Cash														
90-Day US Treasury Bills	0.7	1.3	0.8	0.6	0.4	0.3	0.9	1.95	1.95	1.87	0.07	0.58	-0.16	-0.05
Global Equities								Current Div. Yld.	Current P/E	Avg. P/E ²				
US Large-Cap Growth	10.7	23.5	30.2	14.2	16.5	11.1	6.3	1.12	21.0	21.2	9.9	17.5	0.84	0.89
US Large-Cap Value	-0.5	9.9	15.1	8.1	9.9	7.2	6.0	2.95	14.0	13.9	10.8	14.2	0.88	0.89
US Mid-Cap Growth	8.8	20.1	22.0	8.9	12.1	8.8	7.6	0.70	20.6	26.7	9.8	23.2	0.70	0.81
US Mid-Cap Value	0.8	11.2	17.0	8.9	11.6	9.6	8.8	2.71	15.1	14.4	8.3	16.3	0.80	0.87
US Small-Cap Growth	10.8	24.7	23.4	11.3	13.7	10.9	9.9	0.57	26.8	24.0	8.9	21.9	0.56	0.83
US Small-Cap Value	5.6	15.5	11.5	10.1	11.5	10.6	9.3	2.41	18.1	17.1	8.0	17.3	0.64	0.84
Europe Equity	-0.8	7.2	26.2	4.0	5.9	2.1	4.6	3.45	14.0	14.2	13.2	18.1	0.85	0.94
Japan Equity	2.0	14.5	24.4	6.9	8.6	3.3	4.3	2.10	13.2	20.1	10.9	16.9	0.02	0.71
Asia Pacific ex Japan Equity	0.3	12.8	26.0	5.9	5.2	4.2	9.4	3.76	15.2	14.4	11.3	20.4	0.56	0.87
Emerging Markets	-1.1	14.4	37.8	6.6	4.9	2.0	8.5	2.44	11.8	11.3	12.8	23.0	0.59	0.87
Global Fixed Income								Current YTM	Current Spread	Avg. Spread ²				
Short-Term Fixed Income	0.0	0.1	0.8	0.7	0.8	1.7	3.3	2.69	17.0	31.0	1.4	1.4	-0.69	-0.15
US Fixed Income	-2.1	-1.0	3.5	1.4	2.0	3.7	4.7	3.33	43.0	55.0	4.4	3.4	-0.55	-0.05
International Fixed Income	-1.0	2.5	9.8	3.3	1.0	2.0	4.1	1.31	51.0	49.0	4.9	8.1	0.32	0.31
Inflation-Protected Securities	-3.3	1.0	9.0	2.3	1.2	2.6	5.8	-	-	-	5.0	7.7	0.16	0.44
High Yield	-1.7	2.0	10.4	5.3	4.6	7.7	7.5	6.37	387.0	514.0	3.0	10.1	0.69	0.76
Emerging Markets Fixed. Inc.	-4.6	-0.6	15.2	2.5	-1.7	2.7	7.1	6.54	271.0	344.5	10.1	13.1	0.56	0.67
Alternative Investments								Current Div. Yld.						
REITs	0.8	7.6	15.0	5.3	5.9	4.1	8.6	3.90	-	-	8.0	18.0	0.65	0.80
MLP/Energy Infrastructure ³	1.8	-0.8	-6.5	-8.1	-3.2	6.1	-	7.63	-	-	13.7	18.5	0.38	0.55
Commodities ex Prec. Metals	3.6	13.3	0.2	-3.8	-7.5	-9.4	0.6	-	-	-	8.0	17.0	0.18	0.44
Precious Metals	-1.4	-0.6	10.9	1.3	-3.2	2.3	6.9	-	-	-	9.7	19.2	0.44	0.20
Hedged Strategies ⁴	-0.2	3.1	6.0	0.5	1.1	-0.5	-	-	-	-	2.7	6.0	0.64	0.64
Managed Futures ⁵	-2.3	-0.4	2.5	-1.9	-0.1	-2.2	-	-	-	-	7.8	7.9	0.24	0.18
S&P 500	4.8	16.4	21.8	11.0	13.0	9.1	6.6	1.79	16.6	16.0	9.81	14.9	0.88	0.95
Russell 2000	9.5	19.7	14.6	11.0	12.2	9.6	8.0	1.13	25.9	20.4	8.97	19.8	0.51	0.82
MSCI EAFE	0.1	9.5	25.6	4.8	6.4	2.6	4.9	3.15	13.9	15.0	9.75	16.6	0.81	0.96
MSCI AC World	2.5	13.9	24.6	8.1	9.5	5.5	6.0	2.41	15.0	15.5	8.28	15.5	1.00	1.00

Note: Performance values calculated using USD. 1. As of May 31, 2018. 2. 20-year average as of May 31, 2018. 3. Volatility and Correlation: June 30, 2006 – Present. 4. Volatility and Correlation: Jan 31, 1998 – Present Hedged strategies consist of hedge funds and managed futures 5. Volatility and Correlation: February 28, 1998 – Present. Cheap = Below -0.5 standard deviation; Moderate = Between +0.5 standard deviation and -0.5 standard deviation; Expensive = Above +.5 std dev. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean. Source: Factset, Bloomberg, Morgan Stanley Wealth Management GIC.

Cheap	Low	Low
Moderate	High	High
Expensive		

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Short-Term Stock and Bond Indicator



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

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

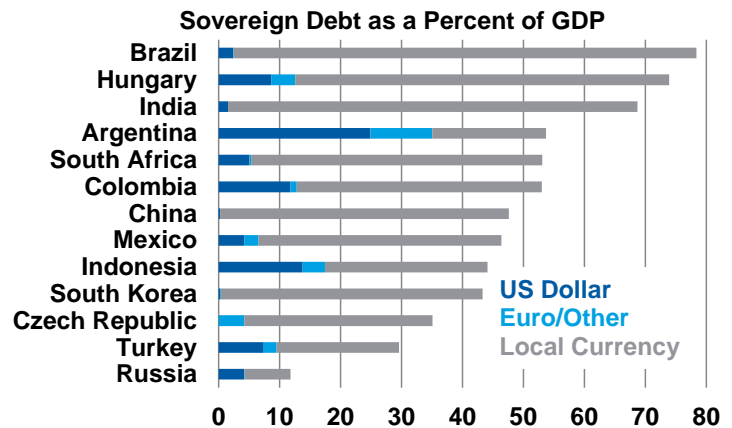
Note: Commodity prices are represented by the Bloomberg Commodity Index; pace of interest rate hikes by the Morgan Stanley Pace of Rate Hikes Index; high yield spreads by the Bloomberg Barclays Aggregate US High Yield Index; investment grade spreads by the Bloomberg Barclays US Aggregate Index; financial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

Source: Morgan Stanley Wealth Management GIC, Morgan Stanley & Co., Haver Analytics, Bloomberg, FactSet as of June 8, 2018

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Fixed Income Insight: Emerging Market Debt Not Just a Dollar Issue

The recent strengthening of the US dollar has been blamed for catalyzing volatility among emerging market (EM) currencies. The dollar is also blamed for contributing to the weak performance of EM debt, down nearly 5% for the year to date, according to the JP Morgan Emerging Markets Bond Index. While several EM countries remain highly dependent on dollar-denominated debt, a review of the current debt outstanding suggests that the vast majority of current issuance has actually been in local currency (see chart). Local currency debt is much more dependent on a country's central bank policies, inflation and real growth than on dollar dynamics. Even more important, many of the instances of poor debt performance have been driven by local political crises as is the case in Argentina, Turkey and Brazil. As a result, we are not yet ready to discount the potential for systemic contagion like the 1997 EM meltdown. But what we see now are idiosyncratic brush fires.



Source: Bloomberg as of June 8, 2018

Government Debt Monitor

US	Yield (%)		Total Return (%)	
	Current	ΔWTD	ΔYTD	YTD
Treasury Benchmark				
3-Month	1.91	0.00	0.53	0.67
2-Year	2.50	0.03	0.61	-0.05
5-Year	2.78	0.04	0.58	-1.48
10-Year	2.95	0.04	0.54	-3.57
30-Year	3.09	0.04	0.35	-5.44
2-Yr./10-Yr. Spread (bp)	45	1.78	-7.40	-
10-Yr. TIPS Breakeven (bp)	213	1.55	14.48	-
Interest Rate Volatility† (bp)	60	2.64	12.98	-

Fixed Income Spread Dashboard

	Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	OAS Range**	
				Rich	Cheap
Investment Grade	MBS*	5.25	3.52	32	9 — 35
	AAA	4.34	2.95	28	18 — 42
	AA	5.70	3.06	15	8 — 18
	A	7.31	3.75	93	68 — 125
	BBB	7.22	4.38	154	115 — 214
High Yield	BB	4.50	5.36	259	212 — 476
	B	3.79	6.63	378	333 — 710
	CCC	3.32	10.23	763	728 — 1,366

Unless stated, indexes utilized are FTSE Broad Investment Grade, FTSE High Yield, and FTSE Global Indexes

†Interest Rate Volatility measured by Merrill Lynch Option Volatility Estimate (MOVE) Index

*MBS distills high grade agency-rated mortgage-backed securities, a substantial subsector of investment grade indexes.

**OAS stands for Option-Adjusted Spread or spread over the Treasury. Grey diamond denotes current OAS; blue circle denotes two-year average.

Source: Bloomberg, The Yield Book® Software and Services. © 2018 FTSE Index LLC. All rights reserved. Data as of June 8, 2018

Government Debt Monitor

Global	Yield (%)		Total Return (%)*	
	Current	ΔWTD	ΔYTD	YTD
10-Year Govt. Bond				
France	0.81	0.11	0.03	0.68
Germany	0.45	0.06	0.02	1.42
Japan	0.04	0.00	0.00	1.05
Spain	1.46	0.03	-0.10	2.57
UK	1.39	0.11	0.20	-0.67
3-Month LIBOR	2.33	0.01	0.63	-
US Tax Exempt				
10-Year AAA Muni	2.46	0.03	0.48	-0.45
10-Yr. Muni/UST Ratio	83.62	-0.96	1.36	-

Benchmark Returns

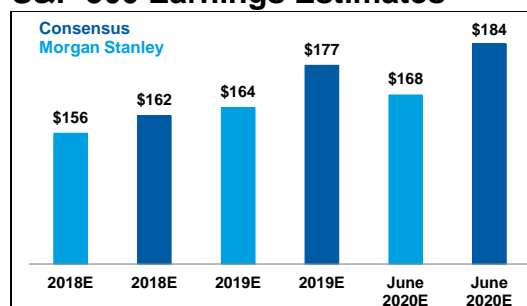
Index	Total Returns (%)		
	YTD	MTD	2017
Bloomberg Barclays US Aggregate	-2.07	-0.58	3.54
Bloomberg Barclays US MBS	-1.58	-0.58	2.47
Bloomberg Barclays US IG Corporate	-3.34	-0.66	6.42
Bloomberg Barclays Municipal	-0.45	-0.11	5.45
Bloomberg Barclays US High Yield	0.28	0.53	7.50
Bloomberg Barclays Global Aggregate	-1.42	-0.41	7.39
JPMorgan Emerging Market	-4.81	-0.56	9.32

*Global total returns reflect Citigroup 7- to 10-year bond indexes and Muni total returns reflect Bloomberg Barclays Municipal Bond Index Total Return

Source: Bloomberg, Thomson Reuters Municipal Market Data (MMD) as of June 8, 2018

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S&P 500 Earnings Estimates



MS & Co. 12-Month Forward Price Target for the S&P 500

Landscape	Earnings	Price/Earnings Multiple	Price Target	Upside / Downside
Bull Case	\$176	17.5	3,000	8.0%
Base Case	\$168	16.5	2,750	-1.1%
Bear Case	\$160	15.5	2,400	-13.6%
Current S&P 500 Price			2,779	

Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of June 8, 2018

Note: Price targets use forward 12-month earnings estimate
Source: Thomson Reuters, Morgan Stanley & Co. Research as of June 8, 2018

S&P 500 Sector Performance and Valuation (as of June 8, 2018)

Index Name	Total Return			Dividend Yield (%)	Beta	20-Year Avg. Forward 12-Mo. PE	Forward 12-Mo. P/E*
	WTD (%)	YTD (%)	1-Year (%)				
S&P 500	1.66	4.85	16.48	1.79		15.9	16.6
Energy	0.77	7.45	22.21	2.57	0.90	17.6	18.7
Materials	3.04	1.06	15.19	1.90	1.04	13.9	16.2
Industrials	1.61	1.31	13.55	1.86	1.01	16.2	16.8
Consumer Discretionary	3.21	11.91	22.03	1.17	0.96	18.0	20.5
Consumer Staples	2.43	-10.38	-8.74	3.17	0.65	16.9	16.9
Health Care	2.05	3.47	12.20	1.61	0.96	17.2	15.4
Financials	2.21	1.07	21.33	1.60	1.10	12.8	12.9
Information Technology	0.70	14.24	29.69	1.09	1.27	20.7	18.9
Telecommunication Services	3.36	-7.12	-0.75	5.57	0.73	16.3	10.4
Utilities	-3.02	-6.79	-7.05	3.70	0.26	14.2	15.3
Real Estate	1.18	-1.95	3.09	3.33	0.54	15.2	17.1

*Dark blue/light blue/gray fill denotes whether current relative forward 12-month P/E is low/neutral/high relative to history.

Source: Morgan Stanley & Co. Research

Performance of Style and Cap Pairs (as of June 8, 2018)



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

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Morgan Stanley & Co. Forecasts (as of June 8, 2018)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2017	2018E	2019E	Q4 '18E	Q2 '19E	2017	2018E	2019E	Q3 '18E	Q1 '19E	Q3 '19E
Global	3.7	3.9	3.8			2.5	2.9	2.8			
US	2.3	2.7	2.2	2.85	2.70	2.1	2.6	1.9			
Euro Zone	2.5	2.1	1.9			1.5	1.7	1.6	1.21	1.30	1.36
UK	1.8	1.2	1.0	1.60	1.85	2.7	2.5	2.1	1.32	1.42	1.50
Japan	1.7	1.3	1.5	0.08	0.10	0.5	1.1	1.0	104	98	95
Emerging Markets	4.8	5.0	5.0			3.1	3.4	3.5			
China	6.9	6.6	6.4	3.50	3.60	1.6	2.4	2.5	6.32	6.20	6.12

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of June 8, 2018)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	GIC Conclusion
China	↓	↑	↑	↑	↑	↓	↓	Soft Landing Better than Expected
Japan	↓	↓	↑	↓	↑	↑	↓	Corporate Profit Growth Offset Stronger Yen
Europe	↓	↓	↑	↓	↑	↓	↓	Preparing for ECB taper
Brazil	↑	↓	↑	↑	↓	↓	↓	Political Chaos Driving Currency Weakness
	Risk Asset Positive	Neutral	Risk Asset Negative					

Note: Text in a factor box denotes a color change; for further explanation of the chart, see page 9.

Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending June 8, 2018)

	Positives	Negatives
Global Growth	<ul style="list-style-type: none"> Markit US Composite PMI rose to 56.6 in May from 54.9 in April; US Services PMI rose to 56.8 in May from 55.7 in April ISM Nonmanufacturing Survey outperformed expectations in May, 58.6 versus 57.7 April US trade deficit decreased to \$46.2 billion against estimate of \$49 billion US wholesale inventories increased by 0.1% month over month in April Euro Zone first-quarter GDP in line with expectations, up 0.4% quarter over quarter China trade surplus decreased to \$25 billion in May 	<ul style="list-style-type: none"> Weekly initial jobless claims increased to 222,000 versus 220,000 expected April US factory orders fell by 0.8% versus an expected 0.5% decline May Euro Zone Markit Composite PMI remained flat at 54.1; Services PMI below forecast at 53.8 Japan first-quarter GDP down 0.2% quarter over quarter versus estimate of -0.1%
Rates	<ul style="list-style-type: none"> Reserve Bank of Australia kept key interest rate unchanged at 1.5% 	

Source: Morgan Stanley Wealth Management GIC

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Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Equal Weight	US equities have done exceptionally well since the global financial crisis, but they are now in the latter stages of a cyclical bull market. While the acceleration of the Trump/Republican progrowth agenda has created a booming economy and earnings outlook, it may also be sowing the seeds for the end of the cycle as the Fed is forced to raise rates and tighten policy in a more deliberate manner.
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets. The populist movements around the world are now spreading to Italy which may spur further fiscal support from Germany and France. This would be a potential positive catalyst but not likely to develop until September.
Emerging Markets	Overweight	Emerging market (EM) equities have been the best region over the past 24 months but are underperforming so far in 2018. Some of this is simply the result of a market that needs to consolidate spectacular gains the past few years. However, it is also directly related to the Fed's tightening campaign. We expect EM to find support not far from current levels and have a strong finish to the year.
Global Fixed Income	Relative Weight Within Fixed Income	
US Investment Grade	Underweight	We have recommended shorter-duration* (maturities) since March 2013 given the extremely low yields and potential capital losses associated with rising interest rates from such low levels. While interest rates have remained exceptionally low, US economic data have been very strong recently and the Fed is now raising rates at an accelerating pace. Adding some longer duration when 10-year US Treasury yields are above 3% percent makes sense.
International Investment Grade	Underweight	Yields are even lower outside the US, leaving very little value in international fixed income, particularly as the global economy begins to recover more broadly. While interest rates are likely to stay low, the offsetting diversification benefits do not warrant much, if any, position, in our view.
Inflation-Protected Securities	Overweight	With deflationary fears having become extreme in 2015 and early 2016, these securities still offer relative value in the context of our forecasted acceleration in global growth and our expectations for oil prices and the US dollar's year-over-year rate of change to revert toward 0%. That view played out in 2016 and 2017 but has not yet run its course.
High Yield	Underweight	High yield has performed exceptionally well since early 2016 with the stabilization in oil prices and retrenchment by the weaker players. We recently took our remaining high yield positions to zero as we prepare for deterioration in quality of earnings in the US led by lower operating margins. Credit spreads have likely reached a low for this cycle.
Alternative Investments	Relative Weight Within Alternative Investments	
REITs	Underweight	Real estate investment trusts (REITs) have underperformed global equities since mid-2016 when interest rates bottomed. We think it is still too early to reconsider our underweight zero allocation given the further rise in rates we expect and deteriorating fundamentals for the industry. Non-US REITs should be favored relative to domestic REITs.
Master Limited Partnerships/Energy Infrastructure*	Overweight	Master limited partnerships (MLPs) have traded better since their capitulation in March around the FERC regulatory announcement. With oil prices much more stable and on an upward path, MLPs have garnered more interest given their 8%-to-10% yields.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset category can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform when traditional asset categories are challenged by growth scares and/or interest rate volatility spikes. As volatility becomes more persistent in 2018, these strategies should do better than in recent years.

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

Source: Morgan Stanley Wealth Management GIC as of June 8, 2018

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Macro Factor Heat Map Key (see page 7)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	Conclusion
Dark Blue	Economic growth robust	Steep yield curve	Low-moderate and rising inflation	Liquidity robust in economy / banking system	Shorter-term sentiment and technicals bearish	Risk assets attractively valued	Earnings outlook robust	Confluence of factors supports a risk-on investment approach
Light Blue	Economic growth neutral	Normal yield curve	Low-moderate and declining inflation; moderate inflation; higher and falling inflation	Liquidity neutral in the economy / banking system	Shorter-term sentiment and technicals neutral	Risk assets neutral	Earnings outlook neutral	Confluence of factors supports a neutral investment approach
Gray	Economic growth anemic	Flat/inverted yield curve	Very high/low inflation/deflation; high and rising inflation	Liquidity low in economy / banking system	Shorter-term sentiment and technicals bullish	Risk assets are richly valued	Earnings outlook anemic	Confluence of factors supports a risk-off investment approach
Up	Growth accelerating	Yield curve steepening	Inflation rising	Liquidity increasing	Sentiment becoming more bullish	Valuations rising	Earnings outlook improving	
Down	Growth declining	Yield curve flattening	Inflation falling	Liquidity decreasing	Sentiment becoming more bearish	Valuations falling	Earnings outlook worsening	
Signal Horizon	One to three years	One to three years	One to three years	One to three years	One to three months	Six months to two years	Six months to two years	
Inputs	<ul style="list-style-type: none"> Industrial production Unemployment Total return Earnings revisions Home prices OECD LEI (China and Brazil) MS & Co. ARIA (US) 	<ul style="list-style-type: none"> 10-year vs. 2-year government bond yield spread 	<ul style="list-style-type: none"> Consumer Price Index 	<ul style="list-style-type: none"> M1 growth Private credit growth Libor-OIS spread 	<ul style="list-style-type: none"> MS US Equity Risk Indicator (US) MS Combined Market Timing Indicator (Europe) MS Global Risk Demand Index Relative strength index Members above / below moving average. Index above / below moving average Consumer confidence 	<ul style="list-style-type: none"> Forward price/earnings ratio Price/book ratio Equity risk premium High yield option-adjusted spread 	<ul style="list-style-type: none"> Earnings revisions breadth Earnings surprise Return on equity 	<ul style="list-style-type: none"> Weighted average z-score of all factors

Index Definitions

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

Hedged Strategy Definitions

Credit Long/Short: This strategy consists of a core holding of long credits hedged at all times with varying degrees of short sales of bonds and/or index options. Some managers maintain a substantial portion of assets within a hedge structure and commonly employ leverage.

Equity Long/Short: This strategy consists of a core holding of long equities hedged at all times with varying degrees of short sales of stock and/or index options. Some managers maintain a substantial portion of assets within a hedge structure and commonly employ leverage.

Market-neutral: A type of investment strategy undertaken by an investor or an investment manager that seeks to profit from both increasing and decreasing prices in one or more markets, while attempting to completely avoid some specific form of market risk.

Risk Considerations

MLPs

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Individual MLPs are publicly traded partnerships that have unique risks related to their structure. These include, but are not limited to, their reliance on the capital markets to fund growth, adverse ruling on the current tax treatment of distributions (typically mostly tax deferred), and commodity volume risk.

The potential tax benefits from investing in MLPs depend on their being treated as partnerships for federal income tax purposes and, if the MLP is deemed to be a corporation, then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value.

MLPs carry interest rate risk and may underperform in a rising interest rate environment. MLP funds accrue deferred income taxes for future tax liabilities associated with the portion of MLP distributions considered to be a tax-deferred return of capital and for any net operating gains as well as capital appreciation of its investments; this deferred tax liability is reflected in the daily NAV; and, as a result, the MLP fund's after-tax performance could differ significantly from the underlying assets even if the pre-tax performance is closely tracked.

Duration

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

International investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing. Certain of these risks may include but are not limited to: Loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices; Lack of liquidity in that there may be no secondary market for a fund; Volatility of returns; Restrictions on transferring interests in a fund; Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; Absence of information regarding valuations and pricing; Complex tax structures and delays in tax reporting; Less regulation and higher fees than mutual funds; and Risks associated with the operations, personnel, and processes of the manager. All expressions of opinion are subject to change without notice and are not intended to be a forecast of future events or results. Further, opinions regarding Alternative Investments expressed herein may differ from the opinions expressed by Morgan Stanley Wealth Management and/or other businesses/affiliates of Morgan Stanley Wealth Management. This is not a "research report" as defined by FINRA Rule 2241 and was not prepared by the Research Departments of Morgan Stanley Smith Barney LLC or Morgan Stanley & Co. LLC or its affiliates. Certain information contained herein may constitute forward-looking statements. Due to various risks and uncertainties, actual events, results or the performance of a fund may differ materially from those reflected or contemplated in such forward-looking statements. Clients should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by

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Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

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

Ultrasort-term fixed income asset class is comprised of fixed income securities with high quality, very short maturities. They are therefore subject to the risks associated with debt securities such as credit and interest rate risk

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

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

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

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

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

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

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

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

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

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

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

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

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

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.

The **indices selected by Morgan Stanley Wealth Management** to measure performance are representative of broad asset classes. Morgan Stanley Smith Barney LLC retains the right to change representative indices at any time.

Credit ratings are subject to change.

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

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

Technology stocks may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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

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