

The GIC Weekly

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Upcoming Catalysts

June 25 Chicago Fed National Activity Index
June 25 US new home sales
June 26 Richmond Fed Manufacturing Survey
June 26 Conf. Board Consumer Confidence Idx.
June 27 US Wholesale Trade Report
June 27 US durable goods orders
June 27 US pending home sales
June 28 US first-quarter GDP
June 28 US initial jobless claims
June 28 Kansas City Fed Manufacturing Survey
June 28 Japan unemployment rate
June 28 Japan industrial production
June 29 US personal income and spending
June 29 Chicago PMI
June 29 U. of M. Consumer Sentiment Index
June 29 Euro Zone CPI
June 29 China manufacturing PMI

What We Are Talking About

- **Trade War Heats Up.** Trade rhetoric has gone from political posturing to a multifront confrontation that could impact the economy and the markets; tariffs on \$520 billion of US imports, or 21%, is in play, a number large enough to take back some tax reform stimulus; risks to US companies are asymmetric, with a majority of import tariffs related to intermediate inputs in their global supply chains, while foreign buyers can shun the US and find substitute suppliers for US agricultural and energy exports; while the trade war's longer-term impact is on growth, inflation and profit margins, in the short run the issue is uncertainty; the speed of escalation matters as swift moves could create volatility and a drag on financial conditions, while a long drawn-out process could stimulate inflation. **Consider** paring outsized gains in small caps and NASDAQ leaders and rebalancing to a more sector- and capitalization-neutral exposure.

Trade War Heats Up

For much of 2018, markets have looked through protectionist rhetoric coming out of Washington as political posturing aimed at solidifying the Republican base ahead of November's midterm elections and at establishing an opening negotiating position for a president bent on bilateral gamesmanship. At its highest level, the administration's objectives, grounded in so-called fairness, have really been aimed at reducing a massive trade deficit that has been six decades in the making and forestalling the inevitable march of China's industrial policy to become not only the largest economy in the world, but the most technologically advanced. On a more tactical level, the rhetoric has appeared more surgical, aimed at correcting specific imbalances that special interests have lobbied for years.

On its face, in neither case did this originally appear as a massive philosophical shift from a country whose companies have seen extraordinary expansion of profit margin as a result of globalization. Rather it seemed like business as usual executed in the unique style of the current president. As one-off headlines have continued to roll out, building

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off last year's washing machine and solar panel tariffs, first against China and then around global steel and aluminum imports and then European autos, the Wall Street consensus has focused on the usual data-driven, analytical approach to assessing impact rather than questioning a regime change in US trade policy. And as is typically the case, this exercise has resulted in the chorus of economists and strategists, suggesting that all told, the implications for the economy and markets are modest, not likely to shave more than a few tenths of a percent off global and regional GDP growth. While the Global Investment Committee doesn't dispute the top-down arithmetic of these exercises, we fear that they don't sufficiently capture the broader context and the reality of the policy change around globalization and the risks associated with America's increasingly aggressive position on trade.

Rather than a series of bilateral negotiations, we see a multifront trade confrontation in which the battlefields are extending to our borders, Canada and Mexico, and to our historic allies, the G-7 countries, trampling existing free trade pacts and inviting retaliation. With uncertainty rising, we no longer believe that the implications of Washington's trade talk are benign. What's more, this intensified headwind to growth may be coming just as growth momentum in global trade has started to wane (see *Chart of the Week*, page 3).

To begin with, the economic and market scope of the trade war is starting to add up. A recent report from Bernstein Research noted that of the \$2.5 trillion in US imports, the initial round of tariffs impacted roughly \$120 billion, or 5%, of the total; this includes the steel and aluminum tariffs and the first \$50 billion in China-related goods. Now, Bernstein has raised that estimate to \$520 billion, around 21% of the total, including the administration's threats to add \$200 billion in additional tariffs on Chinese goods and \$200 billion on European and Japanese automakers. Tariffs on at least \$34 billion of this total are set to take effect July 6. Perhaps of more concern, the focus of tariffs has come from only 107 product categories that the US Dept. of Commerce is investigating under Section 232 "national security threats" and Section 301 "alleged intellectual property theft." We see a risk in the administration taking an ever broader interpretation of these rules or an abandonment of them altogether as a rationale for trade actions.

As expected, our trade partners are fighting back. On June 22, the EU targeted \$3.2 billion of US exports of consumer products like motorcycles, jeans and liquor in retaliation for the US' steel and aluminum tariffs. What's more, some 36% of US exports are agricultural and energy-related commodities—so foreign buyers can easily find substitute supplies.

A less-appreciated fact is that the imposition of tariffs in a world of integrated, multinational supply chains may be completely self-destructive. Chetan Ahya, Morgan Stanley & Co.'s chief economist and global head of economics, estimates that roughly two-thirds of all goods traded globally are leveraged to global supply chains. He further points out that when such supply chains are disrupted, they impact the profits of foreign affiliates. As an example, he cites a 2014 study by the Peterson Institute for International Economics that shows that 60% of US imports from China originated from facilities owned by US, Japanese or Korean manufacturers. In categories of goods that are critical to US high tech companies and were targeted in the first \$50 billion of tariffs, the numbers are even higher; foreign affiliates account for nearly 90% of Chinese imports of computer and electronic parts, and 60% to 65% in electrical equipment, industrial machinery and transports.

Finally, investors may not be properly discounting trade tensions' impact on profit margins. Michael Goldstein of Empirical Research Partners points out that while manufactured goods, the target of trade confrontation, comprise only 12% of the US economy and 8.5% of the workforce, they currently account for more than 40% of S&P 500 profits. Indeed, manufacturing firms have profit margins that are roughly twice those of the remainder of the index, which is weighted toward services; manufacturers have driven nearly half of the growth in profits due to their outsized productivity gains.

Furthermore, by failing to understand how supply chains operate, Washington may be allowing the tail to wag the dog. Some \$1.6 trillion in US exports are vulnerable, but that's dwarfed by the fact that US multinationals have \$6 trillion in foreign affiliated sales to globally integrated supply chains. All told, a trade war is not simply about trade deficits, growth and inflation, but it is also about US company profits—and pass-through inflation to US consumers.

Bottom Line: In 2017, fiscal policy provided huge positive surprises to the economy in the form of tax reform. In 2018, with the economy humming and corporate earnings surging, the multifront escalation of a trade war into outright retaliatory measures risks short-circuiting the business cycle. Policymakers in Washington focused only on reducing bilateral trade deficits may not appreciate that globalization has created complex supply chains where reducing and taxing imports hurts only US companies and consumers. **Watch** for the cresting of S&P 500 earnings revisions breadth and momentum. **Consider** paring outsized gains in small caps and NASDAQ leaders and rebalancing toward a more sector- and capitalization-neutral exposure. ■

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Chart of the Week: Global Trade Already Cresting

Global trade has grown at nearly twice the rate of global GDP for most of the past, the 2013-2016 minirecession excluded. The upturn in global synchronous growth and the consequent uptick in global trade that began in mid-2017 was foretold by South Korean exports, which are a proxy for the front end of the global supply chain and tend to lead overall global trade by roughly four months (see chart). After seeing strong growth acceleration in the past two years, it recently hit close to 20% year over year; the recent collapse of South Korean export growth suggests that global trade growth is likely peaking. The escalation of trade war rhetoric is thus dangerous, potentially fueling a downturn that was already underway.



Source: Bloomberg as of June 21, 2018

Asset Class Performance and Heat Map (as of June 22, 2018)

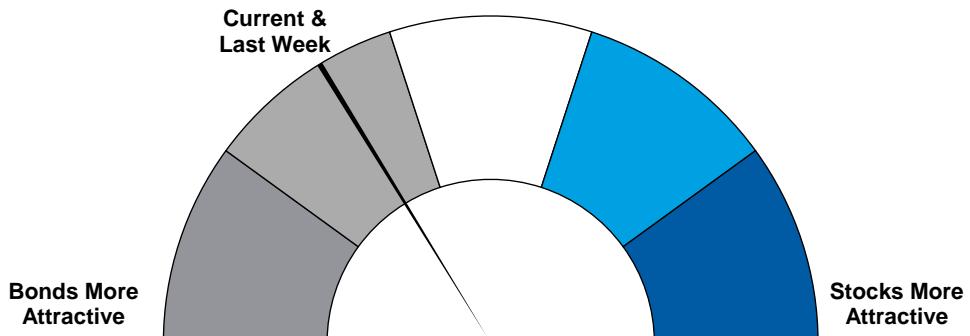
Asset Class	Annualized Returns (%)							Yield	Valuation	Volatility (%)	Correlation to Global Equities			
	YTD	1-Yr.	2017	3-Yr. ¹	5-Yr. ¹	10-Yr. ¹	20-Yr. ¹							
Cash								Current YTM	Current YTM	Avg. YTM ²	30 Days 20 Yrs. ¹			
90-Day US Treasury Bills	0.7	1.3	0.8	0.6	0.4	0.3	1.9	1.95	1.95	1.87	0.07	0.58	-0.19	-0.05
Global Equities								Current Div. Yld.	Current P/E	Avg. P/E ²				
US Large-Cap Growth	10.0	23.5	30.2	14.2	16.5	11.1	6.3	1.12	20.9	21.2	9.4	17.5	0.77	0.89
US Large-Cap Value	-1.6	7.8	15.1	8.1	9.9	7.2	6.0	2.95	13.8	13.9	9.9	14.2	0.81	0.89
US Mid-Cap Growth	8.5	20.0	22.0	8.9	12.1	8.8	7.6	0.70	20.5	26.7	10.6	23.2	0.68	0.81
US Mid-Cap Value	0.6	10.8	17.0	8.9	11.6	9.6	8.8	2.71	15.0	14.4	8.1	16.3	0.74	0.87
US Small-Cap Growth	11.3	25.9	23.4	11.3	13.7	10.9	9.9	0.57	26.9	24.0	10.0	21.9	0.54	0.83
US Small-Cap Value	5.8	16.4	11.5	10.1	11.5	10.6	9.3	2.41	18.1	17.1	8.4	17.3	0.63	0.84
Europe Equity	-1.8	6.8	26.2	4.0	5.9	2.1	4.6	3.45	13.7	14.2	14.8	18.1	0.88	0.94
Japan Equity	-0.4	11.7	24.4	6.9	8.6	3.3	4.3	2.10	13.0	20.1	10.3	16.9	0.04	0.71
Asia Pacific ex Japan Equity	-1.2	11.2	26.0	5.9	5.2	4.2	9.4	3.76	15.2	14.4	11.9	20.4	0.48	0.87
Emerging Markets	-5.2	10.6	37.8	6.6	4.9	2.0	8.5	2.44	11.4	11.3	13.7	23.0	0.66	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	2.74	18.0	31.0	1.4	1.4	-0.79	-0.15
US Fixed Income	-2.0	-1.3	3.5	1.4	2.0	3.7	4.7	3.33	45.0	55.0	4.0	3.4	-0.81	-0.05
International Fixed Income	-1.4	2.5	9.8	3.3	1.0	2.0	4.1	1.23	49.0	49.0	3.3	8.1	0.13	0.31
Inflation-Protected Securities	-2.9	1.6	9.0	2.3	1.2	2.6	5.8	-	-	-	3.6	7.7	-0.13	0.44
High Yield	-1.9	2.3	10.4	5.3	4.6	7.7	7.5	6.41	391.0	514.0	2.7	10.1	0.70	0.76
Emerging Markets Fixed. Inc.	-6.0	-1.4	15.2	2.5	-1.7	2.7	7.1	6.64	278.0	344.5	7.5	13.1	0.48	0.67
Alternative Investments								Current Div. Yld.						
Real Estate/REITs	0.6	7.4	15.0	5.3	5.9	4.1	8.6	3.93	-	-	7.5	18.0	0.65	0.80
MLP/Energy Infrastructure ³	0.8	3.0	-6.5	-8.1	-3.2	6.1	-	7.72	-	-	17.4	18.5	0.44	0.55
Commodities ex Prec. Metals	0.5	13.9	0.2	-3.8	-7.5	-9.4	0.6	-	-	-	10.8	17.0	0.35	0.44
Precious Metals	-3.6	0.3	10.9	1.3	-3.2	2.3	6.9	-	-	-	11.6	19.2	0.26	0.20
Hedged Strategies ⁴	-0.8	2.4	6.0	0.5	1.1	-0.5	-	-	-	-	2.9	6.0	0.75	0.64
Managed Futures ⁵	-2.5	-0.9	2.5	-1.9	-0.1	-2.2	-	-	-	-	7.0	7.9	0.33	0.18
S&P 500	4.0	15.4	21.8	11.0	13.0	9.1	6.6	1.81	16.4	16.0	8.87	14.9	0.84	0.95
Russell 2000	10.4	21.5	14.6	11.0	12.2	9.6	8.0	1.13	25.9	20.4	9.58	19.8	0.51	0.82
MSCI EAFE	-1.3	8.4	25.6	4.8	6.4	2.6	4.9	3.15	13.7	15.0	10.59	16.6	0.85	0.96
MSCI AC World	1.1	12.5	24.6	8.1	9.5	5.5	6.0	2.41	14.7	15.5	8.18	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 +0.5 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.

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Short-Term Stock and Bond Indicator



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

Indicator	Category	Reading
PMI (+)		Neutral
Durable Goods (+)		Neutral
Retail Sales (+)		Risk On
Manufacturing Hours Worked (+)		Neutral
Commodity Prices (+)	Inflation	Risk Off
Yield Curve: 10-Yr./Three-Mo.(-)		Risk On
Yield Curve: Two-Yr./Three-Mo.(-)		Risk Off
Pace of Interest Rate Hikes (-)		Neutral
Term Premium Model (-)		Risk On
High Yield Spreads (-)		Neutral
Investment Grade Spreads (-)		Neutral
Financial Conditions (-)		Risk Off
S&P 500 Earnings/Baa Yield (+)		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 (+)		Neutral
Implied Currency Volatility (-)		Neutral
Five-Yr. Macro Sensitivity (-)		Neutral
% Stocks Above 200-Day Moving Avg. (+)		Neutral
Cumulative Advance/Decline (+)		Neutral
S&P 500 Put/Call Ratio (-)		Neutral
Emerging Market Fund Flows (+)		Neutral
Smart Money Flow Index (+)		Neutral
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 22, 2018

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Fixed Income Insight: Junk Bond Pricing Is Rich

A strong economy and cash flows enhanced by tax cuts have allowed high yield bonds to be one of this year's strongest-performing fixed income asset classes. Nowhere has their resilience been more evident than in how the lowest-quality bonds—those rated CCC, or junk bonds—have traded versus those rated B, the highest-quality cohort of high yield bonds (see chart). Looking at the dollar price differentials, we are now at a cyclical low of less than six points and within striking distance of the June 2007 low of 4.6 points. It's also far tighter than the October 1997 low following the emerging market debt crisis. Current pricing suggests investor complacency. Although high yield bonds, like small-cap stocks, have been little affected by trade war anxiety thus far, we fear that escalation that trips up global supply chains would bleed into this sector as well, a clear risk when it is currently priced for perfection.



Source: FactSet as of June 21, 2018

Government Debt Monitor

Treasury Benchmark	US			Total Return (%)
	Current	ΔWTD	ΔYTD	
3-Month	1.91	-0.01	0.53	0.75
2-Year	2.54	-0.01	0.66	-0.07
5-Year	2.77	-0.03	0.56	-1.36
10-Year	2.89	-0.03	0.49	-3.16
30-Year	3.04	-0.01	0.30	-4.64
2-Yr./10-Yr. Spread (bp)	35	-1.97	-16.87	-
10-Yr. TIPS Breakeven (bp)	214	0.76	15.27	-
Interest Rate Volatility† (bp)	53	-0.05	6.43	-

Fixed Income Spread Dashboard

Investment Grade	MBS*	Duration	Yield-to-Worst (%)	OAS (bp)	OAS Range**	
		(Yrs.)		Rich	Cheap	
AAA	4.31	2.96	28	18	35	
AA	5.65	3.06	16	8	42	
A	7.26	3.79	98	68	18	125
BBB	7.18	4.41	158	115	214	
BB	4.43	5.34	258	212	476	
B	3.73	6.52	370	333	710	
CCC	3.29	10.17	762	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 22, 2018

Government Debt Monitor

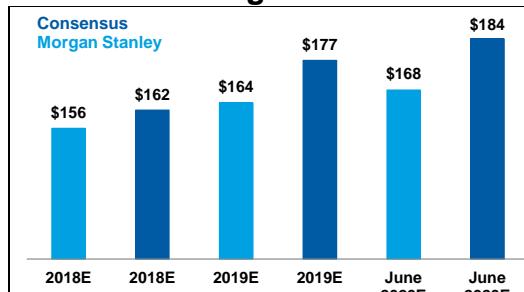
10-Year Govt. Bond	Global			Total Return (%)*
	Current	ΔWTD	ΔYTD	
France	0.71	-0.02	-0.07	2.13
Germany	0.34	-0.07	-0.09	2.48
Japan	0.03	0.00	-0.01	1.30
Spain	1.35	0.06	-0.21	3.38
UK	1.32	-0.01	0.13	0.06
3-Month LIBOR	2.34	0.01	0.64	-
US Tax Exempt				
10-Year AAA Muni	2.46	-0.01	0.48	-0.38
10-Yr. Muni/UST Ratio	84.98	0.54	2.72	-

Benchmark Returns

Index	Total Returns (%)		
	YTD	MTD	2017
Bloomberg Barclays US Aggregate	-1.95	-0.47	3.54
Bloomberg Barclays US MBS	-1.30	-0.30	2.47
Bloomberg Barclays US IG Corporate	-3.63	-0.95	6.42
Bloomberg Barclays Municipal	-0.38	-0.05	5.45
Bloomberg Barclays US High Yield	0.69	0.94	7.50
Bloomberg Barclays Global Aggregate	-1.61	-0.60	7.39
JPMorgan Emerging Market	-4.93	-0.69	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 22, 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	8.9%
Base Case	\$168	16.5	2,750	-1.2%
Bear Case	\$160	15.5	2,400	-12.9%
Current S&P 500 Price			2,755	

Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of June 22, 2018

Note: Price targets use forward 12-month earnings estimate

Source: Thomson Reuters, Morgan Stanley & Co. Research as of June 22, 2018

S&P 500 Sector Performance and Valuation (as of June 22, 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	-0.87	4.01	15.34	1.81		15.9	16.4
Energy	1.52	5.72	21.29	2.69	0.91	17.6	17.5
Materials	-2.07	-2.36	11.24	2.01	1.04	13.9	15.3
Industrials	-3.37	-3.41	6.98	1.97	1.02	16.2	16.0
Consumer Discretionary	-0.70	13.64	25.73	1.15	0.95	18.0	21.2
Consumer Staples	0.16	-8.34	-5.30	3.15	0.64	16.9	17.0
Health Care	-0.66	3.67	8.40	1.63	0.97	17.2	15.4
Financials	-1.41	-2.22	14.20	1.66	1.10	12.8	12.5
Information Technology	-1.29	13.35	31.31	1.09	1.26	20.7	18.7
Telecommunication Services	-0.51	-9.42	-1.16	5.33	0.75	16.3	10.0
Utilities	2.50	-1.95	-2.03	3.55	0.26	14.2	15.9
Real Estate	2.55	-0.41	3.32	3.33	0.55	15.2	17.2

*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 22, 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. Cyclicals and Defensives, and Quality and Junk are based on Morgan Stanley & Co. Research analysis.

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Morgan Stanley & Co. Forecasts (as of June 22, 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	1.13	1.19	1.28
UK	1.8	1.2	1.0	1.60	1.85	2.7	2.5	2.1	1.28	1.34	1.44
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	6.65	6.47	6.32

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of June 22, 2018)

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

Note: Text in a factor box denotes a color change; In China, Sentiment and Risk moved from risk asset neutral to risk asset positive as GRDI moved lower; In China, Earnings moved from risk asset neutral to risk asset positive as earnings surprises moved higher; In Brazil, Sentiment and Risk moved from risk asset neutral to risk asset positive as GRDI moved lower; for further explanation of the chart, see page 9.

Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending June 22, 2018)

	Positives	Negatives
Global Growth	<ul style="list-style-type: none"> June Markit US Services PMI in line with 56.5 forecast US housing starts up 5.0% month over month in May versus 1.9% expected Markit Euro Zone Manufacturing PMI in line with expectations in June Markit Euro Zone Services PMI, at 55.0, topped estimates in June Japan Manufacturing PMI ticked up in June 	<ul style="list-style-type: none"> Philadelphia Fed Survey disappointed in June at 19.9 versus expectations of 29.0 Markit US Manufacturing PMI down in June May US building permits down 4.6% month over month, below forecast US existing home sales fell 0.4% in May versus expectations of a 1.1% increase US Leading Economic Index up 0.2% in May versus 0.4% expected FHFA House Price Index below forecast in April
Rates	<ul style="list-style-type: none"> Bank of England kept its official bank rate unchanged at 0.5% Bank of Mexico increased its overnight rate by 25 basis points to 7.75% Central Bank of Brazil left monetary policy rate unchanged for the second straight meeting 	
Inflation	<ul style="list-style-type: none"> May Japan core CPI 0.3%, in line with forecast 	
Sentiment and Flows		<ul style="list-style-type: none"> Euro Zone Consumer Confidence weaker than forecast in June

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	
Real Estate/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 22, 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

ICE BofAML US HIGH YIELD INDEX

This index tracks the performance of US dollar-denominated, below-investment-grade corporate debt publicly issued in the US domestic market.

For more 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

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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.

Ultrashort 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.

Ultrashort-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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