

Global Investment Committee | May 2020

On the Markets

The Grand Reopening

Everything goes in cycles, and the US economy is no exception. Ironically, in January some pundits were suggesting the business cycle may have been repealed. Three months later, we find ourselves in the steepest recession on record. Most will blame this recession exclusively on the coronavirus, but that was just the trigger. This recession was already coming our way thanks to the excesses that had been building for years.

Much like business cycles ebb and flow, the excesses tend to alternate between the consumer and corporate segments of the economy. The recent cycle's excesses were centered on the corporate sector, with company debt reaching all-time highs. In an era of secular stagnation, companies were happy to lever up in an effort to generate better earnings growth. At the same time, consumers were less willing to take on too much debt given their disastrous experience with the housing bubble. Instead, consumers delevered by choosing to pay down debt and to save more.

What this means is that consumers may be in a better position to recover from this recession than the last one. Furthermore, with the trigger of this recession centered on a health crisis, the policy response has been unprecedented and directed right at the consumer. We believe such an outcome is bullish for stocks as this recession proves to be quite deep but shorter-lived than is typical.

Many states have begun to roll out their reopening plans. Whether these moves prove to be premature remains to be seen, but it will likely be very difficult to have another national lockdown even if COVID-19 returns. Instead, it's more likely we will learn to live with the virus and protect the most vulnerable members of our communities while keeping the economy in operation.

This means that the stay-at-home winners may no longer be the place to be. Instead, back-to-work beneficiaries could be better opportunities. Thus I have been recommending early-cycle stocks that would likely benefit most from an economic recovery—specifically, housing, leisure, travel, restaurants, branded apparel and banks. I would also include materials and industrial stocks that would benefit from a potential infrastructure spending bill. Finally, small- and mid-sized company stocks tend to fare better than larger ones as an expansion begins. All told, I remain bullish on recovery from what could be the steepest recession on record. I suggest you buy the dips and focus on the past cycle's underperformers as they are more likely to outperform in this new economic cycle and likely bull market. ■

Michael Wilson

Chief Investment Officer
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CROSS-ASSET STRATEGY

Short-Term Pain for Long-Term Gain

Andrew Sheets, Chief Cross-Asset Strategist, Morgan Stanley & Co.

Late last year, I met with the pension fund for a physicians' association in the western US. I've been thinking a lot about that meeting recently, especially when some aspect of the market, or working from home, is particularly frustrating. However disrupted things may seem at the moment, they pale in comparison to what those in medicine, services and other fields at the front line of the response to COVID-19 are going through. So, this seems like a good time to emphasize a key part of our view: What's best for fighting the pandemic, the health of the economy and the market may be the same thing: making sure the reopening of the economy is done right.

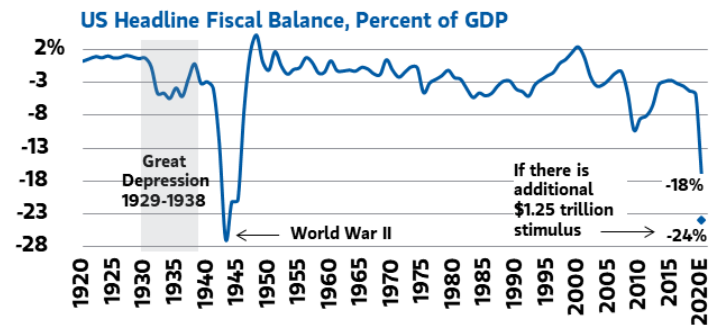
UNFOLDING PROCESS. In thinking about the path for the economy, Morgan Stanley's economists and health care analysts have been working together. Matthew Harrison, Morgan Stanley & Co.'s lead biotechnology analyst, has written about what is needed for sustainable "reopening" for the economy (see page 3). We see the process unfolding in waves, starting in midsummer. Even then, however, the return to work will be slow. Our economists do not expect to see prerecession US or global growth until the fourth quarter of 2021.

When the discussion turns to markets, however, it is often presented as a trade-off: The faster the reopening, the less pressure on earnings, defaults and asset prices. We disagree with this framing.

WORST HAS PASSED. If you give investors confidence that the worst is behind them, history suggests they can put up with quite a bit of bad news. We think this is especially true for credit spreads and levels of volatility, which often hit their worst levels several months before the trough in economic data—and even farther ahead of things returning to "normal." If, as we forecast, April and May represent the low of economic activity in the US, a market low in March would be consistent with past patterns of market anticipation.

Indeed, the best times to invest are often when a weak economy creates lower prices. We hear investor concerns about a coming rise in default rates and large declines in earnings, but credit spreads have tended to improve well ahead of the peak in default rates—which is why my colleague Srikanth Sankaran is overweight corporate credit. Similarly, Michael Wilson, MS & Co.'s chief investment officer and chief US equity strategist, recently raised his year-end target for the S&P 500 to 3,000 from 2,750. Both are reasons why we think equity volatility can fall further from here.

In Fighting the Recession, the Fiscal Deficit Could Become the Worst Since World War II



Source: BEA, the Historical Statistics of the United States, Morgan Stanley Research as of April 15, 2020

FORGIVING POOR DATA. We think this applies even though the current quarter looks to be the worst quarter for economic activity in any investor's lifetime. As long as investors are confident that the next quarter is a little better, and the path from there is improving, we think markets will be more forgiving of poor data.

Importantly, this thinking is predicated on April and May being the low for US and global economic activity. In the US, at least, the Federal Reserve's balance sheet expansion should help keep interest rates low and provide liquidity. Fiscal stimulus has been aggressive, too, so much that the US fiscal deficit is now expected to widen to 18% of GDP, the largest reading since World War II (see chart). However, reopening the economy before the key medical prerequisites are in place would inject significantly more uncertainty over whether the worst for the economy is behind us by the end of the second quarter. Such a scenario would pose a clear risk to our positive bias toward current markets.

NO TRADE-OFF. In short, we don't see a trade-off between what's required to control coronavirus cases and a better long-run impact for markets and the economy. More than 100 years ago, the same appeared to be true. In a March 27 article for Liberty Street Economics, a blog published by the Federal Reserve Bank of New York, authors Sergio Correia, Stephan Luck and Emil Verner examined the responses of different cities to the 1918 pandemic. The conclusion is striking: Cities that implemented stronger social distancing measures ultimately saw higher levels of industrial production. Fighting the pandemic and protecting the economy were one and the same. To wit, in 1918, the Dow Jones Industrial Average rose 10%.

Today's challenges are serious and scary, but also surmountable. What's best for fighting the pandemic, protecting the economy and supporting the market may actually be one and the same. Draw a line under the worst of the crisis, and investors can sail through the squall. ■

HEALTH POLICY

A Prescription for Getting the US Back to Work

Matthew Harrison, Biotechnology Analyst, Morgan Stanley & Co.

We see a slow return to work, with US cases peaking mid-May and social distancing reductions in June as diagnostic/serology testing becomes widely available and hospital capacity is extended. Variable levels of social distancing will remain until a vaccine is publically accessible in the spring of 2021.

TWO PEAKS. In our view, the US is likely to experience two peaks—one for the coastal regions and one for the interior. While we anticipated an initial peak in mid-April for the cities with the first outbreaks, we see a second peak from interior regions of the country pushing the ultimate US peak to mid-May (see chart). We expect some resumed activity in the coastal regions earlier, but we believe governors will be hesitant to broadly relax social distancing rules until the immediate threat of imported cases is diminished, and resumptions will be limited until there is a full US peak.

Our view of a peak in mid-May could be underappreciated by the market. Importantly, investors should expect social distancing to wax and wane during the next year to contain "hot spots" before a vaccine becomes widely available. Three critical criteria must be met prior to resuming activity:

(1) A peak in mortality. While new cases will peak first, we

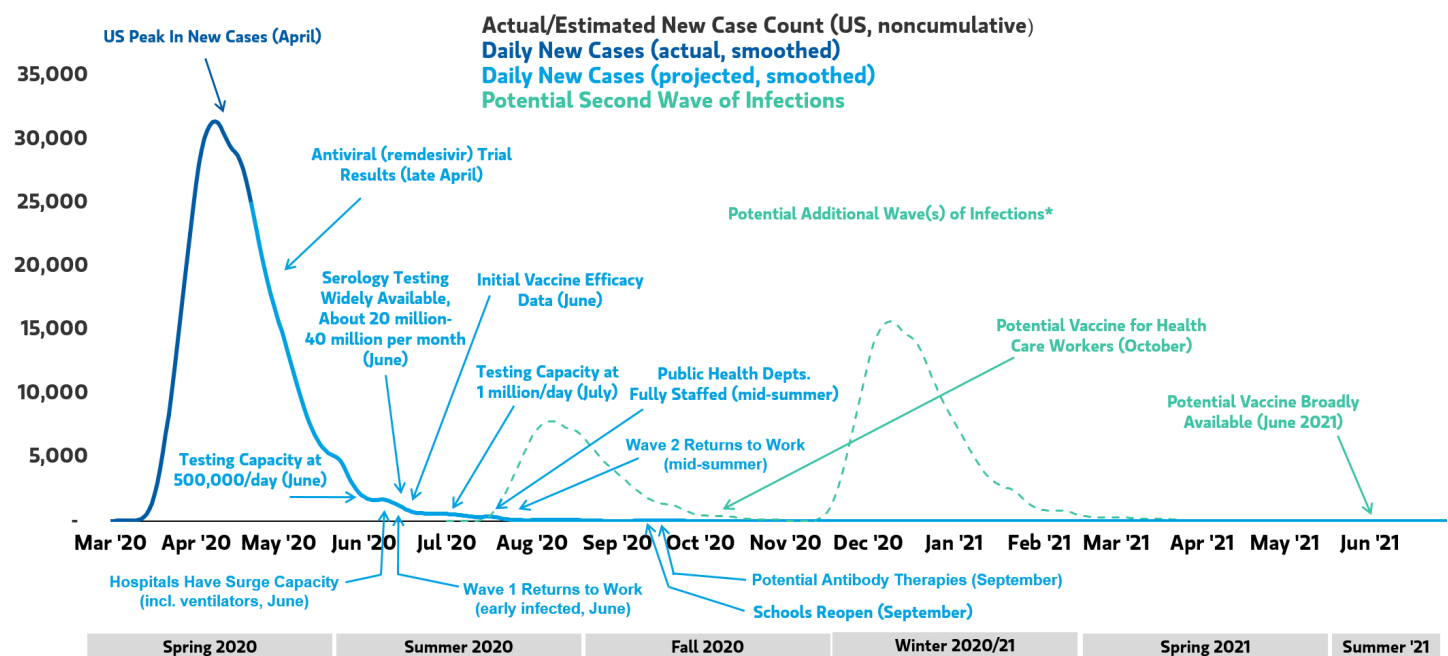
do not believe governors are likely to allow any meaningful resumption until cumulative mortality peaks, which lags new cases by about 20 days. This suggests nominal resumption could begin in June.

(2) Expanded health infrastructure. States will need to have appropriate public health infrastructure and testing capacity to allow for surveillance of new hot spots, which we also expect in June. The CDC currently maintains a flu surveillance network, which tracks annual influenza activity. We believe a national surveillance system of a similar scale will be required to track COVID-19.

(3) Testing. Both testing for active infection to find hot spots before they turn into full-blown outbreaks and testing blood to understand the current outbreak are important. We believe the US could reach about 1 million tests per day by July, which we believe is the minimum necessary to provide appropriate sentinel surveillance in the population. That said, we could expect social distancing to turn on and off as additional waves of infection materialize.

COME BACK IN STAGES. Coming back to work is likely to happen in stages, with reduced staffing in offices. We believe the first wave to return will be those who have recovered from the virus (positive serology) and the young and healthy. We see a maximum of 50% of employees being allowed back in the office over the summer months. We do argue that schools should be reopened for the fall, as kids do not appear to be significant vectors for disease spread. Importantly,

A Projected Timeline and Milestones for a Return to Work in the US



*Timing and size of additional waves are illustrative as they are hard to predict. We would expect the earliest a second wave to occur is four to six weeks after a reopening.

Source: Morgan Stanley Research as of April 23, 2020

ON THE MARKETS

investors should expect new waves of infection to arrive, as early as this fall.

Those new waves will require variable levels of social distancing that are turned on or off depending on the level of the outbreak. The reason we highlight the need for an effective COVID-19 surveillance network is that the scope of these outbreaks can be minimized if they are discovered early. South Korea's handling of its outbreak is a prime example of this potential. Overall, investors should prepare for reduced levels of activity until there is a vaccine and should expect social distancing to be reenacted as hot spots develop over the next one to two years.

DRUG PIPELINE. The drug pipeline presents the only near-term opportunity to meaningfully alter the speed of resumption. Ahead of full availability of a vaccine, promising

antivirals and antibody therapies will be in development through the late summer. We believe at least some of these drugs can be successful and help turn severe cases into more mild forms of the disease. Such a success could reduce the potential strain on hospitals and allow public health officials to support a broader reopening of the economy ahead of a vaccine's availability.

We highlight that key data points from China can provide a benchmark for a resumption in activities. Importantly, the US will lag China for several reasons. China's peak new cases occurred on Feb. 3; 80% of hotels reopened as of Feb. 27, 99% of businesses resumed some form of activity as of March 17 and 73% of restaurants reopened as of March 18. About half of metro riders resumed travel as of March 26. China's economy reached about 80% of prior production levels about 40 days from the peak. ■

MARKETS

Stocks Are on the Path to Recovery

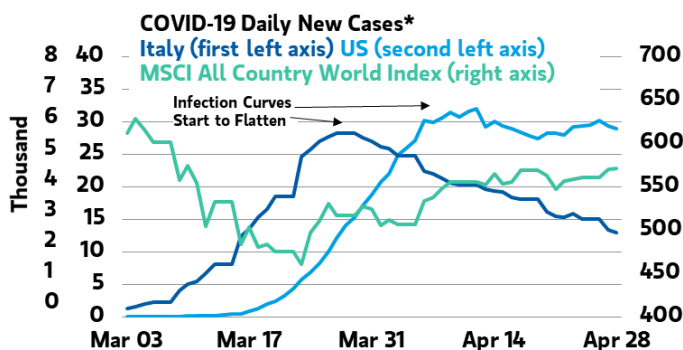
Zachary Apoian, Investment Strategist, Morgan Stanley Wealth Management
Jinjin Zhang, Associate, Morgan Stanley Wealth Management

COVID-19's unending interruption to our once normal way of life continues. US cases climbed to 1,005,147 by April 28, up from 122,653 one month prior and a mere 16 two months before. To slow this unrelenting spread, much of our country has remained under stay-at-home orders that severely confine normal activity. Economic consequences have been severe. Over 30 million people, or more than 18% of the US labor force, have filed for unemployment since March 14, erasing a decade's worth of job creation.

Yet in this uncertain environment, astoundingly, markets have found reason to rally. The S&P 500 Index, after closing on March 23 at a loss of 34% from the Feb. 19 all-time high, stocks rallied sharply, recovering more than about 60% of these losses in about a month.

Why have markets rallied as economies remain at an indefinite standstill? Here we explore several drivers of this recent strength. In short, markets are wired to seek opportunities. Today, this translates to a willingness to hold through the current turbulence in order to benefit from the eventual recovery whose foundation we believe has been laid. While we all must remain vigilant to protect both our personal and portfolio health, the path to a recovery does appear to be taking shape. ■

The COVID-19 Infection Curve Has Started to Flatten



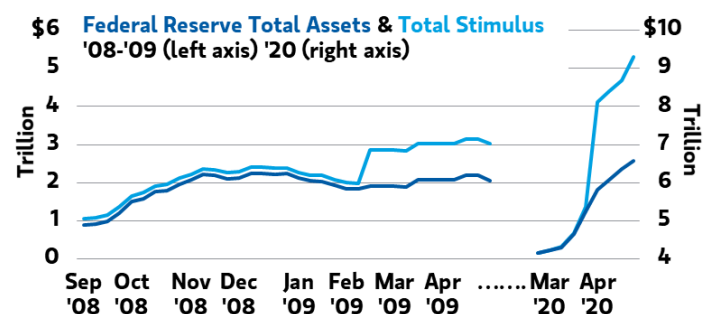
*New cases are the average daily cases over the prior week.
Source: CDC, FactSet as of April 28, 2020

The ability to contain and control COVID-19 is essential to any normalization. While total numbers of cases in the US continue to rise, global equity markets have applauded that the rate of spread does appear to be slowing, particularly in the hardest-hit areas (see chart). Markets have confirmed the importance of stopping COVID-19's spread. Notably, global equities bottomed in late March when Italy's daily new cases started to peak and many US states instituted social distancing and other mitigation measures that had shown to be effective in flattening the curve. In China and South Korea, where the spread occurred earlier, similar measures, coupled with mass testing, have all but halted the growth of new cases. While the markets have applauded containment, restarting economies poses a challenge. Harsh restrictions have been frustrating and

economic damage has been severe. However, a premature or imprudent relaxation of containment policies has the potential to reignite growth of infections and pose further economic setbacks that could become more difficult to cure.

US Policymakers Take Aggressive and Unprecedented Actions

Seeking to limit the potential fallout from the economically disruptive mitigation measures, policymakers have acted to bridge the gap until economies can be reopened. These actions have been taken at a greater speed and magnitude than even the then-unprecedented steps taken in 2008 (see chart). On the monetary front, the Federal Reserve has taken its benchmark rate to near zero, begun purchasing a broad array of securities and opened a lending program to support the economy. Under these measures, the Fed balance sheet has so far expanded by \$2 trillion in the past two months, compared with about \$1 trillion over six months in the financial crisis. Congress has also passed fiscal stimulus far outpacing measures taken during the financial crisis. We project the total impact of these steps may reach nearly half the annual economic output of the US economy. The size and breadth of this response, plus potential for more if the economy continues to falter, has helped soothe anxieties and fuel an eventual recovery.



Source: Federal Reserve Economic Data as of April 22, 2020

Along With Uncertainties Come Attractive Opportunities



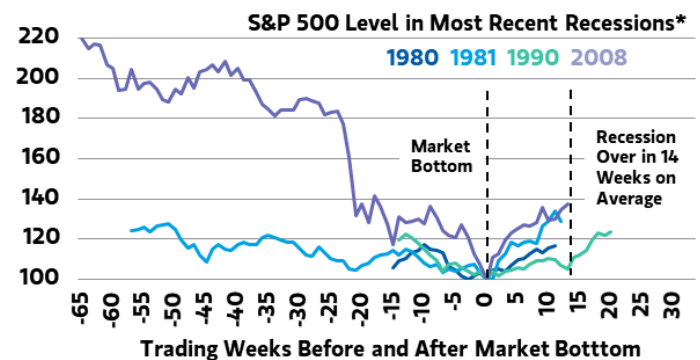
Source: FactSet as of April 28, 2020

It is hard to imagine a more uncertain scenario for earnings than an indefinite halt of economic activity. Even so, investors have shown willingness to accept these risks to own stocks at sufficiently attractive valuations. Here we measure valuations with the forward price/earnings (P/E) ratio—or the value of a company as a multiple of the next year's projected earnings. The fears and outsized impact of COVID-19 in March drove the P/E down to 13 from 18, well below the 10-year average of 15 and beneath the 13.5 reached in December 2018 (see chart). Though circumstances have remained dire, investors have actively responded to this opportunity with anxiety of not missing out on further recovery. Since then, valuations have returned to above pre-COVID levels, driven by expectations of

an eventual return to more normal earnings growth. The bottom line: Investors have shown a willingness to look beyond even today's difficulties when valuations are compelling.

Stocks Don't Wait for the Economy to Recover

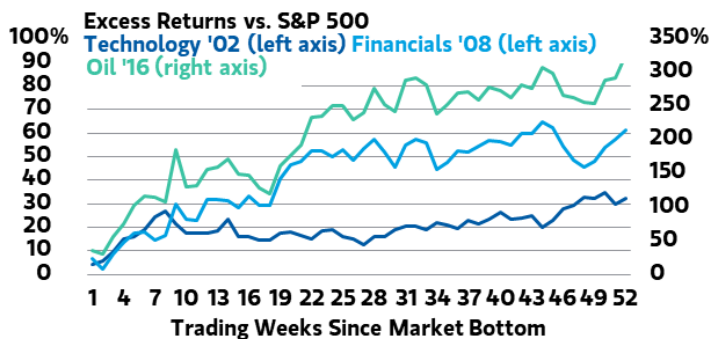
In time, the current period will likely be officially classified as a recession, something the spikes in unemployment and declines in activity all but render obvious. Though the economy's sudden stop has dragged down equity prices, we would not expect markets to stall their recovery awaiting a recovery in the economy. For example, in 10 of the past 11 recessions, stocks have bottomed before the recession ended. In the past 30 years, markets have begun their recovery by an average of 14 weeks prior to when economic growth again resumed (see chart). Similar to valuations, markets constantly anticipate developments, looking to seize opportunities presented by today's green shoots that have the potential to flourish tomorrow.



*The 2002 recession is excluded because stock market bottomed after the recession ended.

Source: FactSet as of April 28, 2020

Strength Has Historically Emerged From Stressful Periods



Source: FactSet as of April 28, 2020

The magnitude of the current downturn has created stress among a broad swath of industries. Not surprisingly, most notable losses are in the companies most hurt by the COVID-19 mitigation measures: those tied closely to physical locations, those with complex supply chains and those highly sensitive to economic growth. In spite of today's difficulties, we do not believe this period spells the end of hotels or shopping malls—in fact, based on history, such periods of stress may actually strengthen these industries. That may appear counterintuitive, but market corrections help consolidate industries: Inefficient companies exit, leaders rise to a more dominant competitive position and those left are better able to innovate through any structural challenges. Evidence for this is the 2001 technology

bubble, the 2008-2009 financial crisis and the 2016 oil-price correction, as the most-damaged industries outperformed in the year following the market bottom (see chart).

GLOBAL MACRO

Stuck in the Middle of Two

Matthew Hornbach, Global Head of Macro Strategy, Morgan Stanley & Co.

Usually interest rate and currency investors only have to deal with one event at a time, and in one country at a time. Sometimes it's a central bank easing program, and other times it's a government fiscal stimulus package. Even during normal times, investors debate the extent to which markets appropriately discount events like these and sometimes even debate how and when markets are supposed to do the discounting.

The procyclical US fiscal stimulus delivered in the 2017 Tax Cuts and Jobs Act (TCJA) is a perfect example. It occurred as the Federal Reserve was tightening, raising the fed funds rate gradually and predictably. Into the end of 2017, when the stimulus passed, and throughout most of 2018, investors worried about the impact of greater government bond supply on US Treasury yields.

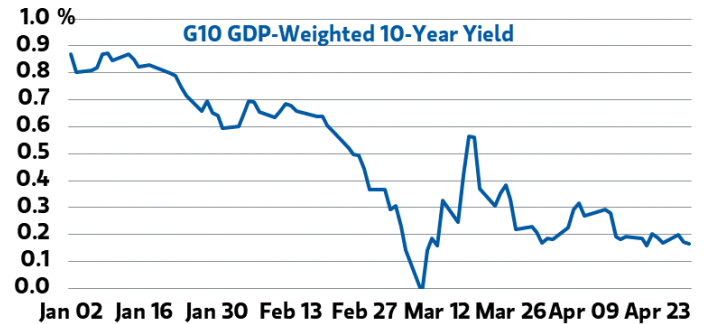
Throughout 2018, we thought market prices had already discounted the fiscal deficit and, as such, investors were better served by focusing on other factors that could move markets. In particular, we thought that, by the end of 2017, the rates market had priced in the expected increase in supply—well before the US Treasury delivered any of the additional supply. Furthermore, we thought that markets priced in the expected economic impact of the tax cuts in early 2018.

BREAKING NEW GROUND. In retrospect, the environment that allowed us to analyze the situation pales in comparison with the complexity of the present. For the past two months, global central banks have eased monetary policy and governments have eased fiscal policy simultaneously. For both central banks and governments, these programs broke new ground in spirit, size and pace.

How are investors meant to navigate the push and pull of fiscal stimulus versus monetary stimulus in the developed markets? Fiscal stimulus, all else being equal, should raise expectations for growth and inflation, put upward pressure on both real and nominal interest rates, on breakeven inflation rates and strengthen the value of the currency. Monetary stimulus, on the other hand, should put downward pressure on real rates, put upward pressure on breakeven inflation rates and weaken the currency.

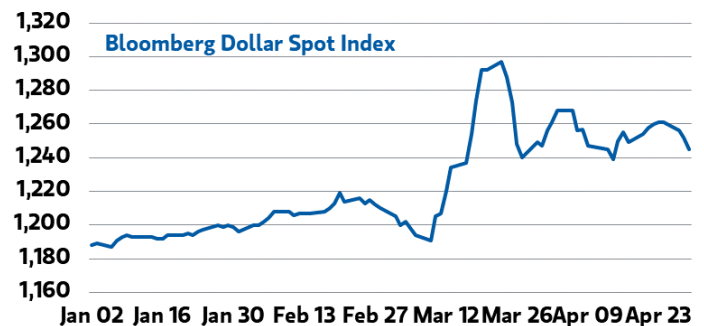
When both monetary policy and fiscal policy are at play, in different sizes, in different regions and at the same time, there is complexity everywhere. This complexity has manifested itself in volatile, but surprisingly range-bound, rates and currency markets. Many charts now show a sideways consolidation of prices after an extremely volatile first half of March.

G10 Yield Has Moved Sideways for the Past Month



Source: Morgan Stanley Research, Bloomberg as of April 29, 2020

After Surging in March, US Dollar Settles Down



Source: Morgan Stanley Research, Bloomberg as of April 29, 2020

SIDWAYS MARKETS. In rates markets, where the impact of fiscal policy and monetary policy is most clear-cut, we've seen yields across G10 markets move in a sideways range over the past month (see chart, top). The tilt of the consolidation—toward lower yields—reflects the direction of the initial impulse that began in February.

Similarly, the US dollar's value has moved sideways over the past month; However, the tilt of the consolidation—toward a weaker dollar—has been against the impulsive move higher in March (see chart, bottom). In both cases, the tilt of these consolidations reflects the power of central bank intervention in bond markets.

For bond yields, we think the downward tilt in the consolidation reflects the view that central banks will remove more government bond supply than fiscal authorities will provide. For the US dollar, we think the downward tilt reflects the view that the Fed will buy more bonds than other central banks, thereby increasing the supply of dollars by more than other central banks increase the supply of other currencies. In what follows, we discuss how markets price each factor—fiscal policy and monetary policy—using the US and its markets as a guide.

Fiscal to the Left of Me ...

Expectations for changes in fiscal policy can affect expectations for changes in government bond supply, real growth and inflation. Changes in those expectations haven't had an impact on the direction of interest rates—both those usually controlled by the Fed directly and those usually not. In developed economies with monetary systems similar to the US, expectations for higher fiscal deficits bring with them expectations for higher government bond supply, real growth and inflation.

So how do these expectations affect prices in the bond market? In our view, markets are forward-looking discounting machines. The rates market prices in changes in supply as investor expectations form for those changes much more so than when fiscal authorities actually deliver the supply. As for the expected economic effects of fiscal policy, we think the market prices them in thereafter.

ADJUSTING EXPECTATIONS. As investors adjust expectations, their behavior changes such that, by the time the supply actually arrives, investors are prepared to take it down. Of course, this holds only as long as the size of the eventual supply meets those previously formed expectations. This forward-looking aspect of investor behavior makes analyzing the effect of government bond supply on yields difficult. For example, the US deficit in 2019 was larger than usual, but Treasury yields fell dramatically that year.

Wanting to better capture the impact of government bond supply on yields, we would rather analyze how expectations for supply change over time instead of changes in supply itself. Alas, we can't find data that captures expectations for government bond supply because it doesn't exist. We only have data on actual supply and its changes over time. One model for how the bond market incorporates expectations looks at the deficit/GDP ratio and 10-year yields five years forward. Based on an expected increase of 11 percentage points in the deficit/GDP ratio in 2020-2021, the model projects the forward rate to be 275 basis points higher. Instead, since early February, the forward rate was down about 75 basis points.

... QE to the Right

Why did the rate go down? Look to the Fed. As the Fed aggressively lowered the fed funds rate by 150 basis points in March, market expectations built for the Fed to begin QE—and that sent yields lower. Expectations for Quantitative Easing (QE) play an important role in the movement of Treasury yields, given how much they have fallen in the face of expectations for massive Treasury supply. Those expectations haven't fully formed yet, given the lingering uncertainties.

How big will the fiscal deficit—including the CARES Act and the automatic, countercyclical stabilizers—actually be? And how will the US Treasury finance it? And how, when, and will the Fed transition its Treasury QE program—currently focused on market functioning and liquidity—into one more focused on easing financial conditions?

ECONOMIC IMPACT. Once these questions are answered, what will the economic impact of it all be? Naturally, the expectations that drive market prices can change as facts change, and those changes will affect prices again. As initial assessments of fiscal and monetary policy change based on new guidance or actions from fiscal and monetary authorities, investors adjust positions in markets. It's par for the course to see economic data surprises catalyze adjustments to previously held views.

Adding further complexity to the effects of fiscal and monetary stimulus on yields is the expected economic effect. An easing of monetary policy, or an easing of fiscal policy, should have implications for the economic outlook and, thus, implications for Treasury yields. Both fiscal and monetary stimulus should raise expectations for growth and inflation, all else equal being, and lead to upward pressure on interest rates. But when?

In addition, the expected economic effect of the CARES Act is to fill in the growth and inflation holes created by the COVID-19 recession. These holes are of unknown depth, given uncertainty around the length of time social distancing measures and lockdowns will be in place. As such, for now we think the bond market will continue to focus on the expected supply effect of the CARES Act. ■

MUNICIPAL BONDS

Muni Market Stabilizes, Giving Investors a Chance to Upgrade

Daryl Helsing, CFA, Associate, Morgan Stanley Wealth Management

Matthew Gastall, Investment Strategist, Morgan Stanley Wealth Management

After experiencing acute weakness in March, the broader municipal bond market staged an impressive rebound in recent weeks, supported by unprecedented fiscal and monetary support. In March, the 10-year AAA yield peaked at 2.79%, the highest since autumn 2018; by April 27, bonds rallied enough to send it back to 1.28%—lower, in fact, from where it began the year.

Market volatility has settled down to some extent as money flow to and from municipal bond funds has become more balanced, ending a six-week stretch of outflows, with some weeks recording near the largest on record. With technical pressures having abated, at least for now, COVID-19's impact on the credit of issuers has come into focus (see table).

BUDGET REVISIONS. Numerous state and local governments, including some of the most adversely affected, have recently revised budget projections to account for the disruption caused by the coronavirus shutdown. Some have included significant reductions in various tax revenues, as well as higher liabilities as a result of job losses. Operating and nonoperating revenues of various sectors will also be

challenged by subdued economic activity with health care, transportation, higher education and tourism-related areas particularly vulnerable. S&P now has a negative outlook for all US public finance sectors, after recently updating several to negative based on the likely recession brought on by COVID-19. This means the probability of ratings downgrades has risen across the market.

Just as the prevalence of the virus varies greatly from state to state and city to city, so too does the expected economic impact. It is also important to consider the disparate financial position issuers were in prior to the onset of the crisis. The credit quality of municipal issuers before the crisis will be an important determinant of their ability to weather the storm and the speed and extent to which they can recover. On a positive note, state governments in aggregate have amassed “rainy day” fund balances significantly over the past cycle, which was, up until recently, the longest recorded economic expansion in US history.

SAFETY PREFERRED. The market's preference for safety has been manifested in the outperformance of higher-rated bonds. The greater vulnerability of lower-rated credits has led to spread widening across rating tiers. While the valuations of many AAA/AA-rated bonds have fully recovered from the recent bout of volatility, there are many A/BBB-rated bonds that remain near their lows, with some even experiencing further weakness during the recent period of broader market healing.

Muni Sector Outlooks and Recommended Rating Parameters

Sector	Minimum Rating*	Comments
State GO/State Appropriated	Aa2/AA	Pension, OPEB, COVID-19 challenges exist; state and local tax (SALT) headwinds remain; volatility/downgrades continue, so be selective
Local GO	Aa1/AA+	State-aid, pension, SALT challenges; COVID risks possibly lower, but notable; focus on high quality
Essential Services (water and sewer)	Aa3/AA-	Essential-purpose highly beneficial, where applicable; capital needs may create select challenges
US Public Power	Aa3/AA-	Favored as their revenues are noncyclical; evolving power markets and regulation may create select challenges
State Housing Finance Agencies	Aa2/AA	Exposed to housing momentum; diversified business models; COVID and recession risks; SALT challenges in high-tax states
Higher Education	Aa2/AA	We recommend higher-rated, well-established due to student selectivity, price sensitivity and select COVID risks
Transportation	Aa1/AA+	Considerable COVID and recession challenges; focus on issuers with high stable-credit qualities
Not-for-Profit Hospitals	Aa2/AA	Maintain focus on highest-rated, largest systems; sector risks include COVID, ACA and Medicaid expansion challenges
Tax-Secured/Dedicated-Tax	Aa2/AA	Often less political, but COVID challenge notable; stick with high-quality tax bonds with no commingling of revenues

*Moody's/S&P ratings; minimum suggested credit rating for buy-and-hold accounts

Source: Morgan Stanley Wealth Management Municipal Research as of April 30, 2020

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Due to the uneven impact of COVID-19 on issuer credit, there will likely be greater performance dispersion across the market relative to before the pandemic, which was characterized by historic credit spread compression. As the economic fallout becomes more apparent in coming months, periods of volatility may erupt creating market dislocation, as was the case in March. The importance of issuer and security selection has been validated by recent market experience.

STAY SHORT. Fundamental concerns and potential downgrades will need to be monitored moving forward, but it's important to keep in mind that high-quality municipals have been traditionally viewed as flight-to-quality instruments for buy-and-hold investors. We suggest that buyers keep to

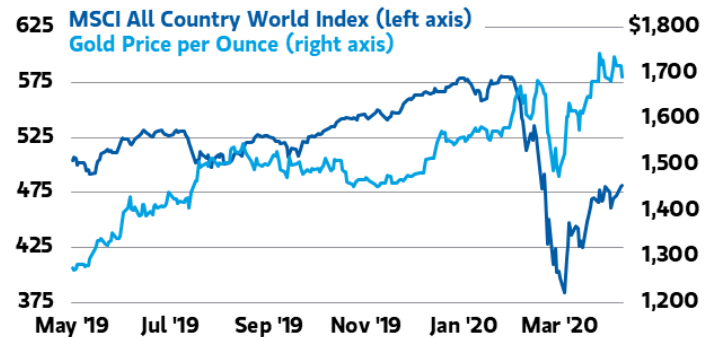
short-term bonds, with a focus on prerefunded AA-rated or higher-quality state general obligation bonds, and highly rated essential-service revenue bonds—think water, sewer and electric.

Given the market stabilization that's taken place, we recommend investors use the current environment as an opportunity to complete portfolio cleanup trades, if and where appropriate. Though the yield curve has steepened and credit spreads have widened modestly, most metrics remain below their historical averages. In fact, current dynamics may still offer one of the more advantageous periods throughout the past decade to upgrade accounts from both a credit and interest rate perspective. ■

Short Takes

Gold and Global Equities Rarely Travel Together, but They Are Moving in Tandem Right Now

Gold and global equities, which are typically uncorrelated in the short term, have recently started moving in tandem as global stocks rallied 25% from their late-March low (see chart). While not entirely uncorrelated over the long term, the 20-year stock-bond correlation of 0.11 highlights the portfolio diversification benefits that gold can provide investors in the intermediate term. Heading into March, a rare confluence of factors, namely the coronavirus pandemic and liquidity-driven panic selling, were balanced, albeit with a lag, by global central bank measures to bolster the economy. Easy monetary policy and fiscal coordination aided a rebound in global equities, while simultaneously lifting precious metals. With the unprecedented global monetary and fiscal stimulus, the positive relationship between stocks and gold could become even tighter. While the aggressive stimulus can be seen as putting a floor under stock prices, it also raises concerns about inflation. Gold has historically been considered a hedge against inflation.—*Chris Baxter*



Note: Gold price is the spot price from the London Bullion Market Association.
Source: Bloomberg as of April 28, 2020

Homebuilders' Confidence Index Suffered the Biggest One-Month Drop in 30 Years

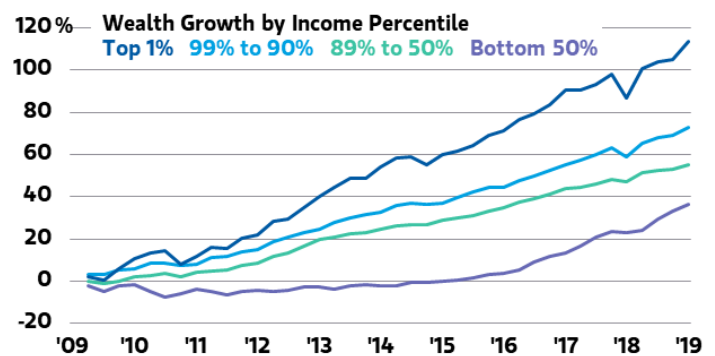


Source: Bloomberg as of April 15, 2020

It was only December 2019 when the NAHB/Wells Fargo Housing Market Index hit 76, its highest level since 1998 (see chart). The builders' confidence was buoyed by low mortgage rates, easy credit and low unemployment. Since then, the COVID-19 pandemic, a sudden-stop recession and a bear market in equities have deflated builder bullishness. In April, the index dropped to 30 from March's 72, or 58%. In the same period, an index tracking prospective buyers' traffic plunged 77%. Meanwhile, the supply side is also affected as construction is not considered essential in many states. As consumers delay home purchases, housing will remain under pressure, with some stability possible with an expected recovery in economic activity later this year.—*Vibhor Dave*

Half of US Households Missed Out on the Past Decade's Capital Markets Returns

Capital markets returns have been robust in the past decade —13.5% annualized return for the S&P 500 in the 10 years ending Dec. 31, 2019—yet these gains in wealth went to relatively few, according to Federal Reserve data (see chart). The top 1% by income saw nearly 8% annualized growth in wealth since 2010. In contrast, the bottom 50% had only 3% growth. This disparity was likely caused by the difference in investable assets, which is less among lower-income households. For this reason, households below the 50% threshold have significantly less savings to help them cope with unexpected medical expenses or sudden unemployment, as is the situation for many caused by the pandemic shutdown. The good news is that most of these taxpayers will get stimulus checks.—*Nick Lentini*



Source: Federal Reserve as of Dec. 31, 2019

ALTERNATIVES

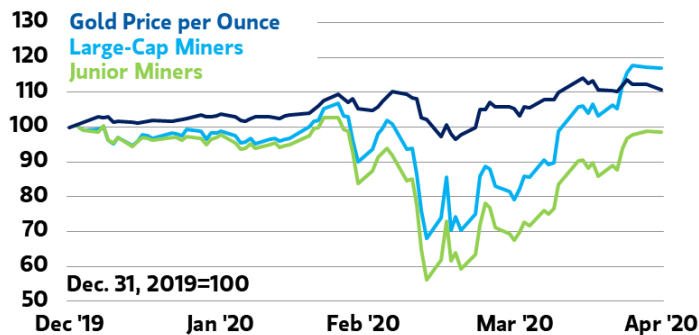
Gold's Return Can Vary Depending How You Own It

Gray Perkins, Associate, Morgan Stanley Wealth Management

John Duggan, Investment Strategist, Morgan Stanley Wealth Management

So far in this tumultuous year, exposure to gold has mostly served investors well. Under the surface, however, depending on how investors owned the yellow metal—via either bullion, large-cap miners or junior miners—the experience may have been a bumpy one. With a variety of exchange-traded funds (ETFs) available for all three types, it's important for investors to understand their differences and how those dissimilarities have affected recent performance (see chart). Furthermore, in our view, the variable return paths underline potential advantages of taking a multipronged approach.

After Steep Declines, Large-Cap Miners Are Edging Out Gold, but Junior Miners Are Still Lagging



Note: Gold price is the spot price from the London Bullion Market Association; indexes for large-cap and junior miners levels are based on composites of US-listed ETFs. are composites of listed US exchange-traded funds.

Source: Bloomberg as of April 29, 2020

Bullion-based ETFs, backed by physical gold, are among the most liquid choices and have dependable records of matching spot prices. Still, they come with certain trade-offs, including subjecting investors to a collectibles tax. ETFs focused on gold miners arguably have fewer quirks due to their more simplistic approach of holding shares of individual mining companies. Since the Federal Reserve's policy shift in 2018's fourth quarter, gold prices, and thus bullion-backed ETFs, have marched higher, albeit with brief bouts of weakness.

"SAFE HAVEN" TRADE. Turning to 2020, an overall dovish environment has persisted, as markets reacted to fears over the impact of COVID-19. These events spurred investors to seek gold for its "safe haven" attributes and the tendency for spot prices to move inversely to real interest rates. Additionally, a substantial amount of global government debt had low-to-negative yields, which made them less attractive alternatives than in prior crises. To be sure, gold prices are not immune to volatility. After climbing to \$1,684

per ounce in early March, prices corrected and returns briefly turned negative for the year to date due to a widespread liquidity crunch. Prices have since recovered, with bullion-backed ETFs recently notching fresh seven-year highs.

While the gold price has been generally resilient this year, ETFs holding gold mining stocks sold off sharply in March, with returns temporarily declining well beyond those of bullion-based funds. This divergence can be attributed to several factors, including: investors were quick to shun more cyclical industries when the breadth of the economic downturn became apparent; mining stocks are equities, too, and the group declines in sympathy with broader equity indexes; and the complications around the spread of COVID-19, including social distancing, have forced mines across the globe to close, thereby limiting near-term revenues. Despite these setbacks, over longer periods of bullion strength, returns have actually tilted in miners' favor as they tend to be leveraged to spot prices. Recently, as bullion has recovered, miners have trended upward with large-cap mining ETFs now outstripping bullion returns for the year to date.

JUNIOR MINERS. Though they have rallied recently, junior miners—companies roughly \$2 billion or less in market capitalization—still have negative returns for the year to date. In addition to more closely shadowing small-cap stocks, which have lagged large caps meaningfully in 2020, junior gold miner indexes are typically more geographically diverse than their larger-cap peers. Some tend to have less US exposure and greater allocations to countries such as Australia, Russia and South Africa, all of which have hampered the junior indexes and ETFs at times this year. Additionally, junior miner indexes tend to tilt more strongly toward exploration companies, which are riskier than more diversified operations and can increase beta.

As gold spot prices flirt with record highs, investors may be revisiting or considering allocations. Indeed, Susan Bates, Morgan Stanley & Co.'s global commodity strategist, has a positive outlook for the precious metal this year. She expects global monetary easing to support prices well after the economic impact from COVID-19 has waned. However, her forecast of \$1,725 per ounce for the first quarter of 2021 is only slightly above the current spot price of \$1,703 (as of April 29). Importantly, Bates projects a longer-term price decline, as witnessed in 2013, once widespread Quantitative Easing is retracted. As such, we suggest investors take a diversified approach to gold. In the near term, we believe mining-focused ETFs could outperform if they participate in cyclical momentum. That said, while we are likely beholden to central bank easing for now, when this support is eventually withdrawn, we'd expect the historically less volatile bullion-backed ETFs to have less severe drawdowns than their mining peers. ■

Q&A

Hard-Hit European Stock Markets May Offer Opportunities

Europe wasn't the first continent to be hit by the coronavirus, but its markets are among the globe's hardest hit. Some stocks have sunk to 20-year lows, and therein lies opportunities, says Sarah Ketterer, CEO of Causeway Capital Management. "There will be companies that come out of this crisis limping along as we've seen in Japan over decades," she explains. "Then others will use this crisis to make some major changes. They won't let the crisis go to waste and they will come out of this stronger." Ketterer recently spoke with Sachin Manchanda, head of global equity model portfolios for Morgan Stanley Wealth Management, about why she believes bottom-up stock selection and an active approach is critical right now. The following is an edited version of their conversation.

SACHIN MANCHANDA (SM): How do you view COVID-19's economic impact on Europe?

SARAH KETTERER (SK): The macro situation is dire. There's no doubt about that. European banks are telling us that they're expecting a double-digit percentage shrink in GDP growth for the full-year 2020, with perhaps as much as 10% in Germany, 15% in Italy and somewhere between those two for the rest of the Continent. The UK may be in that range as well.

While the banks are preparing for a terrible situation, it's now being mitigated by huge public policy stimulus, and they expect a very considerable recovery. I don't know if you call that V-shaped or U-shaped, but it's something that investors should be able to take advantage of.

These macroeconomic forecasts are more conservative than those of the IMF. The reason why the banks are doing that is because they represent the financing part of Europe, and being ultraconservative serves them well. They plan appropriately because the equity market is making the assumption that banks are going to need to raise capital. That's certainly the way the banks are trading. They've been abysmal.

Europe is a region that very much depends on its small companies getting the financing they need. It is effectively a constellation of 25 million to 30 million small-to-medium-sized enterprises (SMEs) with less than 250 employees—and the vast majority of them are tiny, with fewer than nine employees, and they are not listed. So what really drives the European economy isn't the listed European companies.

Both individual governments and, in particular, the European Central Bank, have stepped up in ways that I think are commensurate what the Federal Reserve has done in the US. They've moved very quickly to infuse liquidity into this SME sector and to avoid insolvency.

SM: Are you seeing signs of recovery anywhere?

SK: Europe is ahead of the US with the virus and is coming out sooner. We see in Spain, for example, that manufacturing and construction work resumed as recently as mid April. Austria began to allow shops to reopen in early April. In Italy, bookshops, laundries, stationers, children's clothing stores—they all reopened on a trial basis in mid April. Denmark opened elementary schools.

The next wave will be Norway and Switzerland, where they're going to start opening schools, and then Germany, Iceland and France. France is locked down until May 11, but they're watching the rest of Europe because—to the degree that they can reopen without additional outbreaks—no country wants to drag its feet. The shutdown is very costly for governments and, ultimately, taxpayers, so the sooner they can open economies the better.

SM: How has this pandemic affected the investment landscape?

SK: This crisis brought a certain amount of market pessimism that washed over listed European companies and reached every market in every region. The areas particularly hard-hit—as it became apparent that COVID-19 was not going to be confined to Asia—were travel and leisure, retail, airlines, homebuilders, autos and banks.

I can make a very strong argument that many, if not all of these companies and their industries and respective sectors, are better positioned in this crisis than they were in the global financial crisis of 2008. Yet, they trade at lower valuation multiples than they did then. In some cases, we saw stocks go to 20-year lows.

The number of companies that value investors are able to buy today, which weren't available as recently as just two months ago, is quite extraordinary. These companies are generally multinational, so their livelihoods are not entirely dependent on the European economy, with one exception: listed European banks, for whom the domestic economies are very important. The banks are some of the most hard-hit stocks in Europe. So, if the recovery forecasts are anywhere near reality in 2021, they may present some of the most attractive opportunities.

SM: We know that European banks have suspended their dividends. Why do you think the sector looks attractive?

SK: History shows us the best time to own banks anywhere in the developed world is at the bottom of a recession—because they tend to be the most economically sensitive sector. Remember, too, banking is a financially geared model, with a small amount of equity for a large amount of assets. So, to the degree that the environment is going to improve and the market senses this, equity markets discount economic recovery before we see it in the data—and banks tend to do phenomenally well.

ON THE MARKETS

The MSCI Europe Banks Index is now lower than it was in the worst days of the 2008 global financial crisis, which, by the way, was catalyzed by banks. Now, the banks' Tier 1 capital ratio—which indicates their financial strength, or their total amount of equity capital as a percentage of risk-weighted assets—is at an all-time high. The gap between European banks' market cap and the amount of equity they have (Tier 1 capital ratio), which European regulators have been working for years to shore up, is absolutely enormous.

So between that and the state aid that's flowing fast and furiously, if it plays out as we expect, this could be the biggest banking boom recovery we've ever seen in the history of capital markets. After that, I'd want to sell them, dividends or no dividends, because it's a very cyclical business.

SM: What other characteristics are you looking for when determining potential winners?

SK: Everybody wants quality. Who wants garbage? But the key is what you pay for it. In an environment of uncertainty—having no idea how long this will last, or if there will be recurrences of the virus and if vaccines will be delayed further than early 2021—you need companies to be able to stay in business. So what we're looking for is, number one, financial strength.

We're also looking for experienced management teams that know exactly how to manage their businesses, how to market their products and how to attract and energize the consumer.

In this environment of constantly being undermined by new technologies, we look for companies that can innovate, and then we consider corporate governance, management that has focused attention on their shareholders.

Lastly, one more thing that I think is also critical, is that the companies be at the tail end of their capital expenditure cycle. We want to invest in companies that have already built the plant and bought the equipment they need to produce what they planned for this part of the cycle. The reason why this is so essential is because when free cash flow starts to rise again, a good part of that cash often gets returned to shareholders in the form of dividends and share repurchases. The capital return story has definitely been delayed by the coronavirus, but we believe it will be back in force as early as next year.

SM: Do you see a "survival of the fittest" scenario playing out?

SK: The losing companies are those with poor financial strength or weak balance sheets; these are the companies that have had to go to their lenders and take down more lines of credit—if they can get them.

What you want are companies that have scale. This is particularly true for the deeply cyclical stocks. You want to own the lowest-cost producer or manufacturer. It's crucial, because if they're not going out of business, the competitors are going to be hurt to the point at which they can't compete.

The ones that can't keep up are in a liquidity panic—and they're evident across every sector and industry. This sell-off has given us a chance to find more companies that operate with few competitors, or oligopolies that have desirable competitive moats, which might be, in this concept of quality, one of the most important characteristics.

SM: How might the current crisis affect Brexit?

SK: We don't hear much about Brexit, but we have the same opinion we've had for a couple of years: Politicians do what is necessary to get themselves reelected. The UK has plenty of challenges right now, as does Continental Europe. We're convinced that the two sides will reach an agreement or there will be another deferral and they'll give each other six more months.

SM: What are you watching that might make this picture look less rosy?

SK: There has been a lot of indiscriminant trading. What I mean by that is valuation doesn't appear to matter to support the buying or the selling. This could be a function of interest rates falling even further, but it's hard to say exactly what's causing this. Maybe it's the greater influence of passive investing or the increase in algorithmic trading.

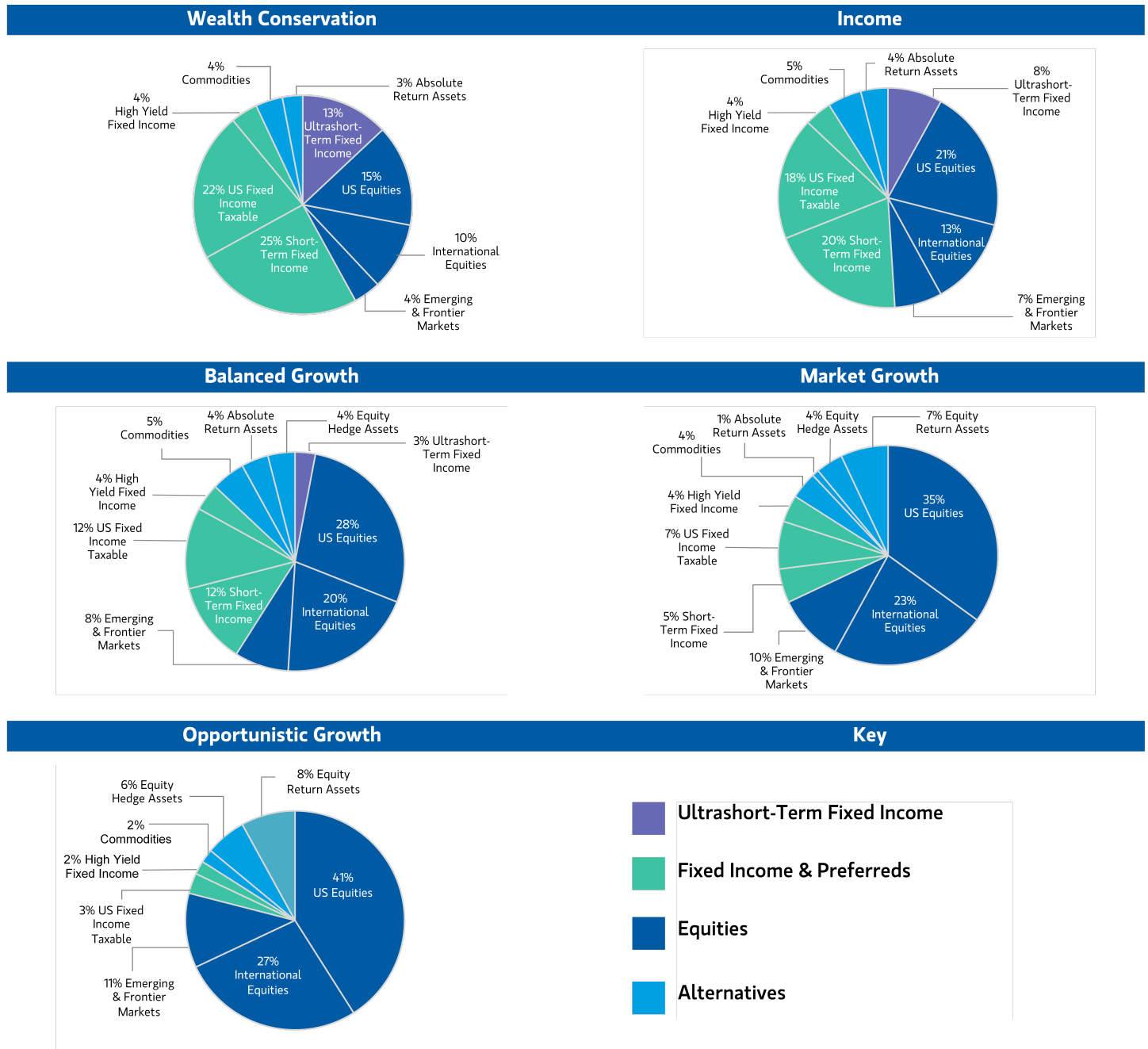
As a value investor in particular, you have to believe that fundamentals will assert themselves. That also means that all of this extremely loose monetary policy doesn't end up artificially incentivizing risk-taking and creating distortions.

Ultimately, we need to avoid deflation. That's the biggest threat hanging out there. It's not Brexit or Angela Merkel being angry with President Macron. It's all to do with prices falling, which is devastating for financial institutions. It's also terrible for economies and it sort of takes the whole "time value of money" concept and tosses it on its head. You have to believe that money is worth more now than the identical sum in the future. That's just critical to investing. ■

Sarah Ketterer is not an employee of Morgan Stanley Wealth Management or its affiliates. Opinions expressed by her are her own and may not necessarily reflect those of Morgan Stanley Wealth Management or its affiliates.

Global Investment Committee Tactical Asset Allocation

The Global Investment Committee provides guidance on asset allocation decisions through its various models. The five models below are recommended for investors with up to \$25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return.

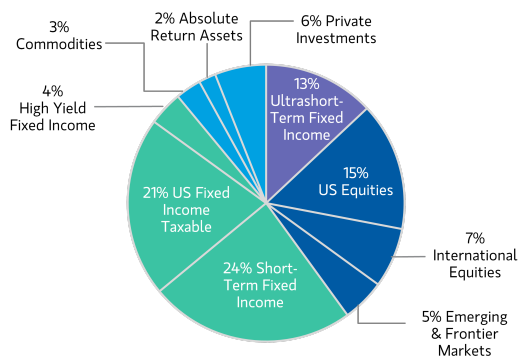


Source: Morgan Stanley Wealth Management GIC as of April 30, 2020

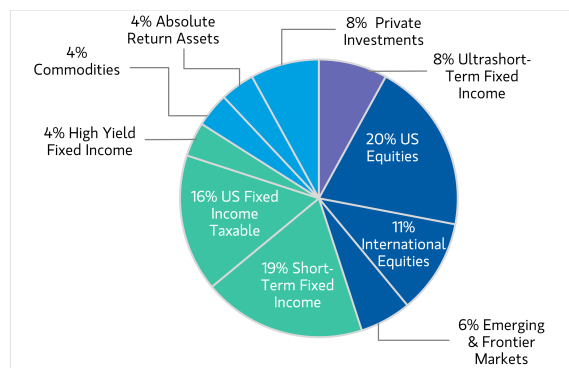
ON THE MARKETS

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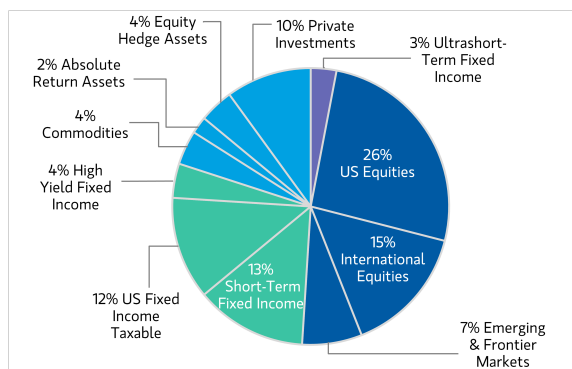
Wealth Conservation



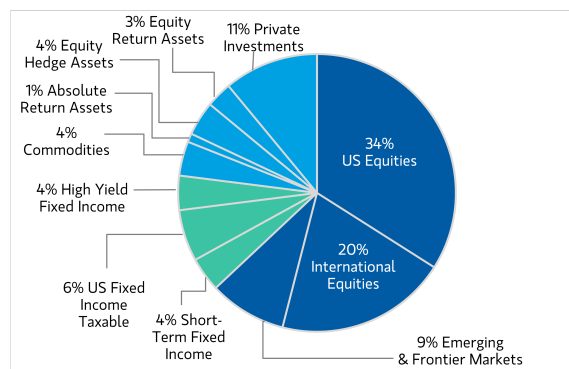
Income



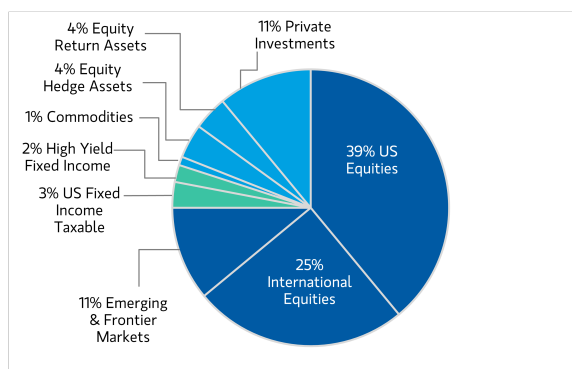
Balanced Growth



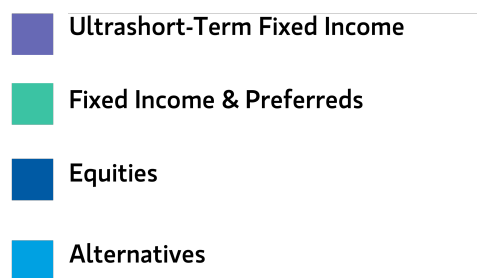
Market Growth



Opportunistic Growth



Key



Source: Morgan Stanley Wealth Management GIC as of April 30, 2020

Tactical Asset Allocation Reasoning

Global Equities		Relative Weight Within Equities
US	Market Weight	Global stock markets have entered a bear market on concerns about the negative growth impact of the coronavirus. Although we expect US and global recessions in the second quarter of 2020, our base case is that recent extraordinary policy actions from both central banks and national governments will help cushion the economic impact. Markets are already pricing the most likely scenarios. We recently upgraded our exposure to large-cap growth and small- and mid-cap equities, believing that active stock pickers have a good entry point over the next several months
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets. Recent bear market sell-offs have created extreme valuations and, as in the US, policymakers look to be ready to provide policy stabilizers. A global recovery in the second half coupled with US-dollar depreciation from crisis level highs are likely to provide the catalysts
Emerging Markets	Overweight	China was the first country to enter the COVID-19 crisis and appears poised to be the first out. Resumption of economic activity during the second quarter should jump-start global growth, especially given huge government stimulus programs. Ample liquidity from the Fed and a weakening dollar should catalyze investor interest. China stands to gain the most from US tariff rollbacks and global trade dynamics should improve. Valuations are attractive and local central banks should be able to maintain accommodation and stimulus. For most countries, especially China, the collapse in oil prices is material tailwind for consumer purchasing power
Global Fixed Income		Relative Weight Within Fixed Income
US Investment Grade	Market Weight	We have recommended shorter-duration* (maturities) since March 2018 given the extremely low yields and potential capital losses associated with rising interest rates from such low levels and had been pairing that position with a large exposure to long-term US Treasuries to hedge what we expected would be a modest correction in stocks. With long-term Treasury yields bottoming for the cycle, we recently sold that position and resumed a benchmark exposure to duration. Recent dislocation of investment grade credit spreads and market illiquidity have created opportunities. Fed programs aimed at backstopping this market give reason to be an active bond selector
International Investment Grade	Underweight	Negative interest rates suggest that this is not a preferred asset class for US-dollar clients at this time. Actively managed funds may provide very patient, risk tolerant clients with income opportunities in select corporate credits
Inflation-Protection Securities	Underweight	The "sudden stop" recession has caused a severe pricing of real interest rates, pushing them negative and near all-time lows. In the near term, upside is limited
High Yield	Overweight	High yield bonds remain at the epicenter of the dual risks from COVID-19 and the collapse in oil prices from the failure of OPEC negotiations. In our view, some of the most extreme risks have been discounted, especially in light of unprecedented monetary and fiscal policy intervention aimed not only at market liquidity but in bridging cash flow requirements. It's time to ease in opportunistically using active managers
Alternative Investments		Relative Weight Within Alternative Investments
REITs	Underweight	Real estate investment trusts (REITs) have performed very well as global growth slowed and interest rates fell. However, REITs remain expensive and are vulnerable to credit risks. We will revisit our position as nominal GDP troughs and/or valuations become more attractive
Commodities	Overweight	The "sudden stop" global recession has driven commodities such as oil to multidecade lows. The rush to the safety of the US dollar, which is near multiyear high, has exacerbated these dynamics. While we recognize the complexity of the geopolitical issues that surround oil, we believe that on a six-to-12-month basis the outlook for the global economy and overall demand improves materially. Thus, we suggest risk-oriented clients to establish exposure to the broad diversified asset class through the use of active managers. Pure passive exposure is not advised
Hedged Strategies (Hedge Funds and Managed Futures)	Overweight	The bear market associated with COVID-19 has driven volatility to historic extremes and led to wide dispersion in price performance and stock-level idiosyncratic risk. These factors tend to create a constructive environment for hedge fund managers who are good stock-pickers and can use leverage and risk management techniques to amplify returns. We prefer very active and fundamental strategies, especially equity long/short

*For more about the risks to Duration, please see the Risk Considerations section beginning on page 18 of this report.

Source: Morgan Stanley Wealth Management GLC as of April 30, 2020

Disclosure Section

The **Global Investment Committee (GIC)** is a group of seasoned investment professionals from Morgan Stanley & Co. and Morgan Stanley Wealth Management who meet regularly to discuss the global economy and markets. The committee determines the investment outlook that guides our advice to clients. They continually monitor developing economic and market conditions, review tactical outlooks and recommend asset allocation model weightings, as well as produce a suite of strategy, analysis, commentary, portfolio positioning suggestions and other reports and broadcasts.

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Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following: <https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions>

Risk Considerations

Alternative Investments

The sole purpose of this material is to inform, and it in no way is intended to be an offer or solicitation to purchase or sell any security, other investment or service, or to attract any funds or deposits. Investments mentioned may not be appropriate for all clients. Any product discussed herein may be purchased only after a client has carefully reviewed the offering memorandum and executed the subscription documents. Morgan Stanley Wealth Management has not considered the actual or desired investment objectives, goals, strategies, guidelines, or factual circumstances of any investor in any fund(s). Before making any investment, each investor should carefully consider the risks associated with the investment, as discussed in the applicable offering memorandum, and make a determination based upon their own particular circumstances, that the investment is consistent with their investment objectives and risk tolerance.

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 appropriate 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 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.

Alternative investments involve complex tax structures, tax inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund. Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance based on benchmark indices, not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results achieved by a particular asset allocation.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

ON THE MARKETS

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

ETF Investing

An investment in an **exchange-traded fund** involves risks similar to those of investing in a broadly based portfolio of equity securities traded on an exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock and bond prices. Investing in an international ETF also involves certain risks and considerations not typically associated with investing in an ETF that invests in the securities of U.S. issues, such as political, currency, economic and market risks. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies. ETFs investing in physical commodities and commodity or currency futures have special tax considerations. Physical commodities may be treated as collectibles subject to a maximum 28% long-term capital gains rates, while futures are marked-to-market and may be subject to a blended 60% long- and 40% short-term capital gains tax rate. Rolling futures positions may create taxable events. For specifics and a greater explanation of possible risks with ETFs, along with the ETF's investment objectives, charges and expenses, please consult a copy of the ETF's prospectus. Investing in sectors may be more volatile than diversifying across many industries. The investment return and principal value of ETF investments will fluctuate, so an investor's ETF shares (Creation Units), if or when sold, may be worth more or less than the original cost. ETFs are redeemable only in Creation Unit size through an Authorized Participant and are not individually redeemable from an ETF.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of an exchange-traded fund or mutual fund before investing. The prospectus contains this and other important information about the mutual fund. To obtain a prospectus, contact your Financial Advisor or visit the mutual fund company's website. Please read the prospectus carefully before investing.

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** and **frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

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.

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 appropriate 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

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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 appropriate 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-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.

Although they are backed by the full faith and credit of the U.S. Government as to timely payment of principal and interest, **Treasury Bills** are subject to interest rate and inflation risk, as well as the opportunity risk of other more potentially lucrative investment opportunities.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum of \$250,000 (including principal and accrued interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account, IRA etc.) per CD depository. Investors are responsible for monitoring the total amount held with each CD depository. All deposits at a single depository held in the same insurable capacity will be aggregated for the purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository. For more information visit the FDIC website at www.fdic.gov.

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.

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

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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.

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.

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.

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.

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.

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

Credit ratings are subject to change.

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.

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