The GIC Weekly

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What We Are Talking About

- **Q4 earnings season disappointing?** Tech, financials and health care provide most enthusiasm; consumer stocks show their warts; financial stocks at important cycle inflection point. 2014 bullish outlook intact

- **China's growth, deleveraging and credit risks**. Slowing as expected; fear of trust product default overblown; no systemic risk, rather a headwind to growth; EM currency volatility apt to persist; recommend reducing EM debt

- **Improving muni market.** Better liquidity, lower volatility and new-issue supply, moderation in interest rates. Yield-hungry investors may want to build ladders or cherry-pick bonds in the 20-to-30-year maturities.

Company Earnings and Management Guidance

Expectations for fourth-quarter earnings had been lowered coming into the year, but even so, the first reports were a mixed bag. In the first full week of announcements, roughly 100 of the companies in the S&P 500 Index* have reported: Revenues are running roughly 2% ahead of expectations with earnings on average 4% to 5% better than the consensus. About 67% of companies have beaten estimates, which is better than the 15-year average of 65%. Even so, anxiety rules.

Notable trends have emerged that may mark a shift in sector leadership. Consumer discretionary stocks, recently market darlings despite demanding valuations, were among the disappointments, while content and media firms are holding up. While forecasts of a better labor market have kept investors upbeat on these stocks, recent acceleration in the sector's capital spending suggests it's time to be more discriminating. Tech trends still support the thesis of mobility, cloud, software and services over hardware. Financials show an uptrend in credit quality and balance sheet health. Bank deposits continue to grow at a vigorous double-digit pace and, while we see glimmers of credit expansion based on card transactions, overall lending remains sluggish as mortgages continue to be

***Please reference page 6 for index definitions.**

Upcoming Catalysts

Jan. 28 US durable goods, Case-Shiller Home Price Index and consumer confidence reports
Jan. 28-29 Federal Open Market Committee meeting
Jan. 31 Chinese Lunar New Year holiday
Feb. 5 Bank of England meeting
Feb. 6 European Central Bank meeting

restructured (see Chart of the Week, page 3). Credit growth is key to unlocking liquidity in the system and powering the next leg up in bank earnings as well as the broader economy. The question is whether loan demand will materialize.

Bottom Line: Markets are anticipating the transition from postcrisis workout to global synchronous recovery. Although navigating from here will be bumpy, our conviction remains strong and we would add equities into weakness. Financials, a leading indicator of the cycle thus far, will likely mark the transition. With valuation dispersion low, separating winners and losers will depend on finding companies that beat revenue forecasts. **Watch** 2014 earnings guidance on growth and investment. **Consider** adding to US financial holdings. The sector is levered to growth and provides a hedge against rising rates. In addition, US financials, while priced at par with European peers, now have better balance sheets.

China's Delicate Transition

The thesis of global synchronous growth hinges largely on China, the world's second largest economy. Consensus expectations look for the country's growth to slow but remain above 7% this year. China's challenge is complicated: slow credit growth; recapitalize balance sheets; raise interest rates; and rebalance the economy from investment and infrastructure spending toward consumption. The more bullish view puts faith in the reformist agenda and leadership skills of top administrators. The more bearish take centers on the so-called shadow banking system whereby local and state-owned banks have extended shaky credits beyond the purview of the People's Bank of China (PBOC), possibly fueling unproductive investments and asset bubbles. In addition, some banks have securitized risky loans and sold them to investors as high yield investment products.

Recent news has focused markets on this debate as China reported weaker-than-expected PMI numbers. At the same time, headlines surfaced about the possible January 31 default of a trust product linked to China's biggest state-owned bank. Fears of a credit-related event against the backdrop of other emerging market (EM) currency volatility have put markets on edge. Chinese authorities have been restraining credit growth since last May and pushing up short-term interest rates—a process that has been a delicate negotiation requiring periodic injections of short-term liquidity into the banking system. Thus far the scenario of gradually slowing growth has carried the day as indicators such as fixed asset investment, industrial production and the Baltic Dry shipping index remain constructive.

The GIC believes that the current anxiety around the trust default is likely overblown and that residual risks will be modest. For starters, the trust assets are relatively small and are largely held by wealthy investors. Beijing has some desire and incentive to engineer the default to support its agenda of restricting practices such as repackaging risky loans while at the same time preventing a crisis of confidence in the banks. Finally, the PBOC is well aware that critically damaging the trust product channel would further hurt system-wide liquidity given they are funding short-duration* liabilities. As a result, MS & Co. China analysts believe that the PBOC will find a way to mitigate investor losses but, at the same time, signal its desire to curb the appetite for these vehicles. The result, we believe, will be headwinds to consumption-driven growth but not a dislocation.

Bottom Line: We believe EM risk is greater outside China than inside. China is executing a delicate transition in its economy that is apt to produce volatility and fears about growth. Chinese equities are down 21% year to date, a reflection of rising investor skepticism. But we think China's leaders show a command of the complexity and may in fact surprise on the upside. As a test of China's resolve around market-based reforms, we see authorities allowing some default risk to spill over to investors, thus avoiding the moral hazard of bailouts, but containing systemic issues and liquidity impact. China GDP is still forecast at above 7% this year. **Watch** China bank lending rates and growth indicators. **Consider** further reducing exposure to emerging market debt where there is rising inflation, falling currencies, deteriorating credit quality and political turmoil.

Improving Dynamics in the Muni Market

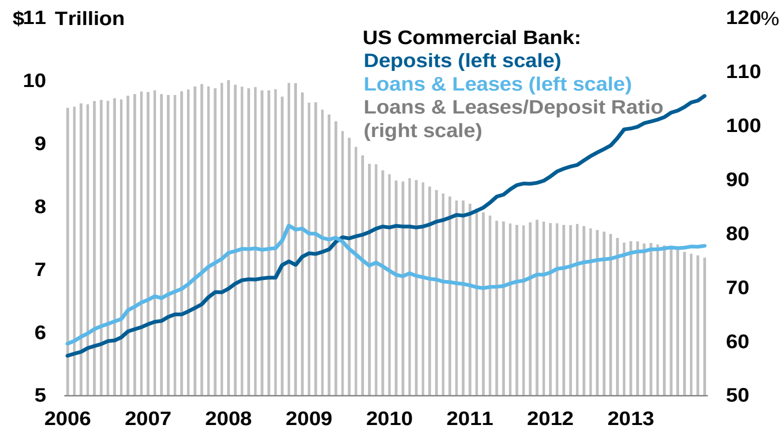
For the last six months, the municipal bond market has been buffeted by fund outflows, rising interest rate risk and fears of high-profile defaults and bankruptcies. However, recent data, including inflows and narrowing discounts on closed-end funds, suggest that liquidity is improving. The credit picture is brighter, too, thanks to gains in real estate prices, jobs and thus, tax receipts. In addition, the prospect of changing munis' tax treatment is likely below the horizon as the leadership of Senate Finance Committee and House Ways and Means Committee are in transition and the midterm elections are approaching.

Bottom Line: Muni market risks look to be abating and relative value appears to be solid—especially versus other parts of the investment grade universe, which are approaching full value and are more exposed to rate volatility in the intermediate maturities. **Watch** muni supply and fund flows for liquidity. **Consider** laddering muni portfolios and selectively adding some long-duration bonds for their yields. ■

For more information about the risks to Duration, please see the Risk Considerations section beginning on page 7.

Chart of the Week: Bank Deposits Have Climbed, but Loan Balances Languish

While bank balance sheets have been the beneficiaries of a deposit base that has nearly doubled since 2006, loan balances have continued to languish. Today, bank credit is only marginally above 2008 levels. As the Federal Reserve exits Quantitative Easing, a self-sustaining growth recovery will demand a better functioning credit transmission mechanism. Tighter regulation and capital controls explain much of the so-called "trapped liquidity," with loans to deposits in the system now running at roughly 70% versus prior peaks in excess of 90%. We believe that banks have material operating leverage if lending were to pick up, especially given current steepness of the yield curve.



Source: Federal Reserve, Bloomberg as of Dec. 31, 2013

Market Factor Data Points

For the week ending Jan. 10, 2014	Positives	Negatives
Global Growth	• UK unemployment rate dropped to 7.1% from 7.4%	• Disappointing China PMI • Weaker-than-expected rebound in new home sales • Mixed earnings results, with weakness driven by the consumer discretionary sector • Marginal increase in jobless claims • December's leading indicator index was positive, but below expectations
Sentiment and Flows	• AAII Bull/Bear survey spread is tightening due to the increase in bearish sentiment	• Margin debt at all-time high • VIX remains near 52-week low

Source: Morgan Stanley Wealth Management as of Jan. 24, 2014

Morgan Stanley & Co. Forecasts as of Jan. 24, 2014

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2013E	2014E	2015E	2013	2014E	2013E	2014E	2015E	Q1 2014E	2014E	2015E
Global	2.9	3.4	3.7			3.2	3.3	3.4			
US	1.6	2.6	2.7	3.0	3.5	1.5	1.5	1.6			
Euro Zone	-0.5	0.5	1.1			1.4	1.1	1.3	1.34	1.24	1.23
UK	1.4	2.5	2.2	3.0	3.4	2.6	2.5	2.3	1.62	1.57	1.46
Japan	1.8	1.3	1.1	0.7	1.1	0.3	2.4	1.3	103	109	121
Emerging Markets	4.7	5.0	5.3			5.0	5.0	4.7			
China	7.6	7.2	7.4	4.6	4.2	2.7	3.2	3.6	6.08	5.91	5.74

Source: Morgan Stanley & Co. Research as of Jan. 24, 2014. Government bond yields for 2013 are as of Dec. 31.

Asset Class Performance and Heat Map

(As of Jan. 24, 2014)

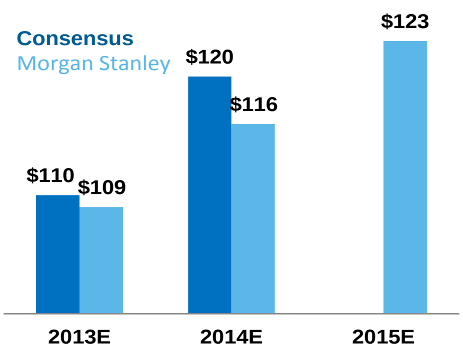
Asset Class	Annualized Returns (%)							Valuation		Volatility (%)		Correlation to Global Equities	
Cash	**YTD**	**1-Yr.**	**3-Yr.***	**5-Yr.***	**7-Yr.***	**10-Yr.***	**20-Yr.***	**Current YTM**	**Avg. YTM**	**30 Days**	**20 Yrs.***	**30 Days**	**20 Yrs.***
90-Day US Treasury Bills	0.0	0.0	0.1	0.1	1.0	1.6	2.9	0.07	2.90	0.00	0.63	-0.16	-0.01
Global Equities								**Current P/E***	**Avg. P/E****				
US Large-Cap Growth	-2.7	23.1	17.1	19.9	8.4	7.5	8.4	17.1	21.3	12.2	17.9	0.86	0.86
US Large-Cap Value	-3.4	21.2	15.5	15.1	4.1	6.9	9.0	13.1	13.5	10.2	14.5	0.83	0.88
US Mid-Cap Growth	-2.7	24.3	15.9	23.5	7.8	9.3	8.8	20.7	26.3	13.9	23.6	0.88	0.88
US Mid-Cap Value	-3.3	23.4	16.3	20.8	6.2	10.3	10.9	15.0	13.6	12.3	16.4	0.91	0.91
US Small-Cap Growth	-1.4	33.2	17.4	24.7	10.7	11.5	10.6	24.2	23.2	14.7	22.6	0.87	0.82
US Small-Cap Value	-1.7	24.2	15.7	21.5	8.0	10.2	11.2	17.6	16.1	12.2	17.0	0.89	0.84
Europe Equity	-1.7	19.2	10.6	14.1	2.5	7.9	8.5	13.8	14.8	12.9	18.0	0.88	0.94
Japan Equity	-0.7	25.6	5.8	7.8	-0.1	4.4	1.3	14.6	26.4	14.8	18.7	0.22	0.67
Asia Pacific ex Japan Equity	-4.2	-3.0	4.8	18.4	6.3	11.8	6.5	14.1	14.7	10.0	21.8	0.44	0.84
Emerging Markets	-5.2	-9.2	-1.7	15.1	4.1	11.5	5.7	10.3	12.3	10.9	23.8	0.72	0.84
Global Fixed Income								**Current Spread**	**Avg. Spread****				
Short-Term Fixed Income	0.3	0.5	1.9	2.9	3.8	3.4	4.8	-178.3	-42.4	1.4	2.2	-0.22	-0.04
US Fixed Income	1.2	-0.7	3.3	4.4	4.9	4.5	5.7	45.0	52.0	3.2	3.7	-0.26	0.02
International Fixed Income	1.1	2.0	3.8	3.8	4.1	4.3	5.8	54.0	57.0	1.6	2.8	-0.39	-0.05
Inflation-Linked Securities	0.2	-6.4	3.7	6.9	5.3	6.0	7.4	-	-	4.4	7.3	0.25	0.41
High Yield	0.5	5.2	9.6	19.0	8.9	9.2	8.6	428.0	473.5	1.6	9.9	0.58	0.72
Emerging Markets Fixed. Inc.	-0.3	-1.0	7.1	8.6	8.6	9.2	9.6	313.0	388.0	2.3	10.7	0.57	0.45
Alternative Investments													
REITs	-0.2	-0.9	6.8	15.6	0.1	8.7	7.9	-	-	6.7	18.5	0.82	0.79
Commodities ex Prec. Metals	0.7	-6.9	-8.3	0.6	-4.5	-0.4	4.3	-	-	10.3	16.1	-0.11	0.44
Precious Metals	4.3	-29.5	-8.4	7.2	8.0	10.9	6.2	-	-	15.5	18.6	-0.27	0.20
Hedged Strategies***	8.7	8.7	2.4	4.8	1.3	3.4	5.4	-	-	-	-	-	0.68
Managed Futures***	0.8	0.8	-1.8	-0.8	2.3	2.5	5.8	-	-	-	-	-	-0.08

Valuation	Volatility	Correlation
Cheap	**Low**	**Low**
Moderate	**High**	**High**
Expensive		

*Dec. 31, 2013. **20-year average ***Nov. 30, 2013. Hedged strategies consist of hedge funds and managed futures.

Source: FactSet, Bloomberg

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of Jan. 24, 2014

MS & Co. 12-Month S&P 500 Target Methodology

EPS Landscape	Scenario Probability	2013E	2014E	2015E	P/E Ratio	Scenario Target	Upside / Downside
Bull Case	20%	111.5	122.6	134.9	17.9	2,414	34.8%
Growth		*8%*	*10%*	*10%*			
Base Case	60%	109.4	116.0	122.9	16.4	2,014	12.5%
Growth		*6%*	*6%*	*6%*			
Bear Case	20%	107.3	102.0	102.0	14.9	1,519	-15.2%
Growth		*4%*	*(5%)*	*0%*			
Current S&P 500 Price						1,790	

Source: Thomson Reuters, Morgan Stanley & Co. Research as of Jan. 24, 2014

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Equal Weight	While US equities have done exceptionally well since the global financial crisis, they still offer attractive upside potential, particularly relative to bonds. We believe the global economy continues to heal from the financial crisis, making recession neither imminent nor likely in 2014. This is constructive for stocks.
International Equities (Developed Markets)	Overweight	We maintain our bias for Japanese and European equity markets given the political changes taking place in Japan and the improving economic outlook in Europe. Japan outperformed the US last year and Europe was very strong in the second half. We believe Japan and Europe will continue to perform well in 2014 because of their more nascent economic and earnings recoveries.
Emerging Markets	Underweight	Emerging markets have been disappointing. Policy remains too tight in major countries, both voluntarily (China) and involuntarily (India and Brazil). The beginning of Quantitative Easing (QE) is also likely to have a disproportionately negative impact on emerging market equities.

Global Fixed Income	Relative Weight Within Fixed Income	
US Investment Grade	Overweight	We have recommended shorter-duration (maturities) since March 2013 given the potential capital losses associated with the rising interest rates from such low levels. Yields have risen since then, but not enough for us to change that advice. Within investment grade, we prefer BBB-rated corporates and A-rated municipals over US Treasuries.
International Investment Grade	Equal Weight	Yields are low globally, so not much additional value accrues to owning international bonds beyond some diversification benefit.
Inflation-Linked Securities	Underweight	We have been underweight inflation-linked securities since March 2013, given negative real yields across all maturities. Recently, these yields have turned modestly positive but remain unattractive, in our view, due to the longer-duration characteristics of TIPS.
High Yield	Equal Weight	Yields and spreads are near record lows. However, default rates are likely to remain muted as the economy recovers slowly, keeping corporate and consumer behavior conservative. We prefer shorter-duration and higher-quality (B to BB) issues and vigilance on security selection at this stage of the credit cycle.
Emerging Market Bonds	Underweight	We reduced our weighting to equal weight from overweight in March 2013 due to record-low spreads and yields. Similar to emerging market equities, we recently moved to underweight on the basis that tapering of QE will likely be a disproportionate headwind for emerging market debt relative to other debt markets.

Alternative Investments	Relative Weight Within Alternative Investments	
REITs	Equal Weight	Rising interest rates explain most of the poor performance since May 2013. At current levels, we believe REITs are fairly valued and offer select opportunities. The industrial and commercial segments tend to outperform at this stage of the recovery. International REITs should also be favored relative to domestic REITs at this point in the cycle.
Commodities	Equal Weight	Commodities performed poorly in 2013 as: real interest rates rose; China maintained tight monetary and fiscal policies; and the US dollar strengthened. Recent stabilization in China and new growth initiatives may help near-term performance. Commodities provide some ballast to a traditional equity/bond portfolio.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset class can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform equities when growth slows and works well in more challenging financial markets.

Source: Morgan Stanley Wealth Management as of Jan. 24, 2014

Index Definitions

S&P 500 INDEX Regarded as the best single gauge of the US equities market, this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries of the US economy.

Risk Considerations

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 which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay 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 advisor.

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.

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.

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.

Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

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

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.

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