The GIC Weekly

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What We Are Talking About

- **Churning Controversies.** Recent tech sell-off against the backdrop of stable market indexes suggests sector rotation, not broader risk-off swoon; it marks a renewal of the reflation debate, which has been sidelined since March; if improvement in financials and value-style stocks continues, it could be an inflection point in deteriorating economic surprises; it could also signal divergence between the stock and bond markets, which have been positively correlated this quarter, pricing both an economic slowdown and a Fed policy mistake; GIC positioning remains levered to Fed guidance, with growth improving through year end; revival of the reflation trade would also support exposure to non-US markets, which are more levered to global growth; with crosscurrents in currencies, commodities and policy high, it's a stock-picker's market. **Consider** US banks, currency-hedged Japanese cyclicals and stable growth stocks in Europe and the emerging markets.

Upcoming Catalysts

June 20 US current account balance
June 21 US existing home sales
June 22 US initial jobless claims
June 22 US Leading Economic Index
June 22 Kansas City Fed Manufacturing Survey
June 22 Japan Manufacturing PMI
June 22 Euro Zone consumer confidence
June 23 Markit US Composite PMI
June 23 US new home sales
June 23 Euro Zone Markit Composite PMI

Churning Controversies

So far this year, markets have been buffeted by two major controversies. First, there has been a disconnect between US Treasury market prices and the Federal Reserve's guidance on policy tightening: The flattening yield curve is signaling that investors expect the Fed to make a policy mistake. Second, the correlation of stocks and bonds is shifting: In late 2016 and early 2017, talk of reflation created a negative correlation between the two, sending bond prices down (yields up) and stocks up. Since then, there's been a positive correlation as bond prices rose (yields declined) and stocks continued to climb. Although investors need to view Treasury market action against the unique backdrop of global quantitative easing and its yield-curve distortions, the reality is that skepticism about reflation is fading (see *The GIC Weekly*, June 12). In turn, these controversies have in large part determined equity market leadership, which thus far has been dominated by growth and defensive stocks—especially tech stocks— over value and cyclical stocks.

With the sell-off in tech stocks that began June 9 that has taken stocks down 3% to 4%, investors are questioning the market's message: Is the swoon in the NASDAQ a harbinger of a broader risk-off move? What signals is it sending about the economy? And/or is the sector rotation we are seeing a reflection of another reset in the correlation regime between stocks and bonds? While the Global Investment Committee takes sharp moves like the ones we have seen among some of the tech highfliers seriously, we are not overly concerned. Rather, we see the move as reigniting an important debate on reflation and the level and direction of longer-term interest rates which, in the short run, is likely to support overall markets, extend the duration of the business cycle and continue to rebalance geographic and sectoral leadership.

First of all, the tech sell-off has not thus far damaged overall market technicals or positioning. In fact, while the NASDAQ is off roughly 3% from its all-time high, other market indexes have remained very strong. On June 13, the Dow Jones Industrial Average, the S&P 500 and the Russell 2000, a measure of small-cap stocks, reached new highs. As noted by Chief Investment Officer Mike Wilson in the June issue of *Positioning*, breadth statistics remain constructive: The S&P 500 advance/decline line and the index itself are near highs. Global equity markets have been similarly robust, with flows to equity mutual funds sustaining positive momentum despite weakness in tech. To us, this signals that investors still have an appetite for risk, a conclusion that is validated by supportive financial conditions and stable credit spreads. Equally encouraging is that while tech stocks have sold off and defensive utilities have hit new highs, it is not a pure risk-off sector rotation. To the contrary, value-oriented sectors have begun to rebound, perhaps signaling that the mix of strong economic data and deteriorating economic surprise readings is about to inflect.

The rebound in financials is most telling about how to interpret market signals and the implication for the business cycle. Specifically, as we illustrate in the *Chart of the Week* (see page 3), relative performance of financials versus technology stocks has historically correlated highly with the level of the three-month/10-year Treasury yield curve. We read the simultaneous positive move in financials with a negative move in tech stocks—which are notoriously sensitive to interest rates because they are inherently long-duration assets—as suggesting that longer-term bonds and interest rates are likely to reprice.

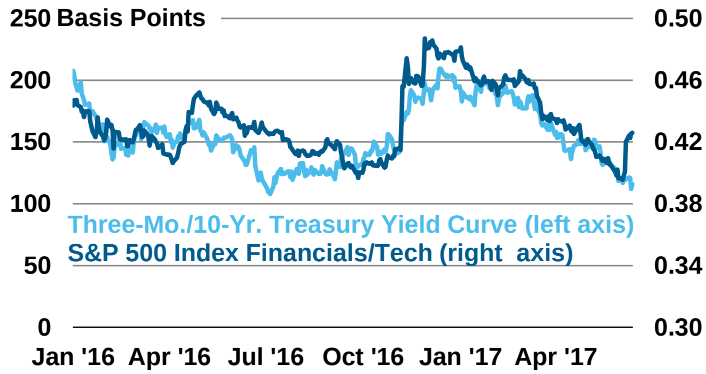
Why might the market finally be pricing higher interest rates? We see two possible drivers, both of which may finally be operating in concert. First is that rather buying into the narrative of a Fed policy mistake, the stock market is actually starting to believe that the Fed wants to drive long-term rates higher. The past week's Fed meeting was a case in point: Chair Yellen remained steadfast in her commitment to one more hike in 2017—likely in December—and three to four more in 2018. She also signaled the framework for balance sheet normalization that is likely in September. Importantly for Treasuries, Morgan Stanley & Co. Chief US Economist Ellen Zentner believes that initially, 60% of what rolls off the balance sheet will be Treasuries. The second reason rates may be headed higher is that investors, in fact, do believe—as does the GIC—that the reflationary thesis of real growth, real rates and inflation pickup should be revisited. Granted, the dispersion between strong sentiment-driven surveys and hard economic data has created some recent disappointments and recent CPI data were somewhat light. However, readings on global capital spending and global trade continue to suggest a global synchronous recovery. In addition, the MS & Co. survey on US growth rebounded in May by the fastest rate in its history, suggesting forecasts for a solid second-quarter GDP rebound are on track.

A final message from the tech sell-off comes from a factor and geographical perspective. Typically, in a market focused on high secular growth, investors prefer companies with high cash balances and exposure to the "quality" factors, which leads to massive outperformance of large-cap US tech stocks. But unlike other sector rotations that are simply a reigniting of interest in stocks levered to global growth, this shift has occurred while stock-level correlations have again receded. Specifically, this is not just a rotation based simply on a strong or weak dollar or strong or weak commodity prices. With commodities showing dispersion and a range-bound US dollar, we recommend picking stocks from a global menu.

Bottom Line: We are not overly concerned with the recent tech sell-off. We see it as a renewal of the debate around reflation and the direction/level of longer-term interest rates rather than a commentary on the economic cycle. While the bond market remains at odds with the Fed and the reflation narrative, in our view, the pickup in capital spending intentions and global trade will sustain earnings growth. We also believe stock prices are technically supported by neutral positioning, good breadth, strong global liquidity and financial conditions, and bright earnings prospects. With crosscurrents in currencies, commodities and policy uncertainty, it remains a stock-picker's market. **Watch** financial conditions, inflation and credit spreads as harbingers of economic/market cycle. **Consider** US banks, currency-hedged Japanese cyclicals and stable growth stocks in Europe and the emerging markets. ■

Chart of the Week: Sector Rotation and the Yield Curve

One of this year's main market controversies is the fate of the so-called reflation trade that dominated performance from November 2016 through March of this year but has since faded. Premised on an increase in both real rates and inflation expectations, the reflation dynamic originally supported a steepening of the yield curve and thus the relative outperformance of financials versus tech stocks (see chart). Since the March market reset on reflation, however, tech sector performance has dominated, a trend that has abruptly reversed with the tech-heavy NASDAQ Index now down 3% from its high. With financials now outperforming, we see the stock market diverging from bond market expectations of further economic slowing. If the signal from financials is correct, we see the yield curve resetting and long-duration bonds selling off.



Source: Bloomberg as of June 15, 2017

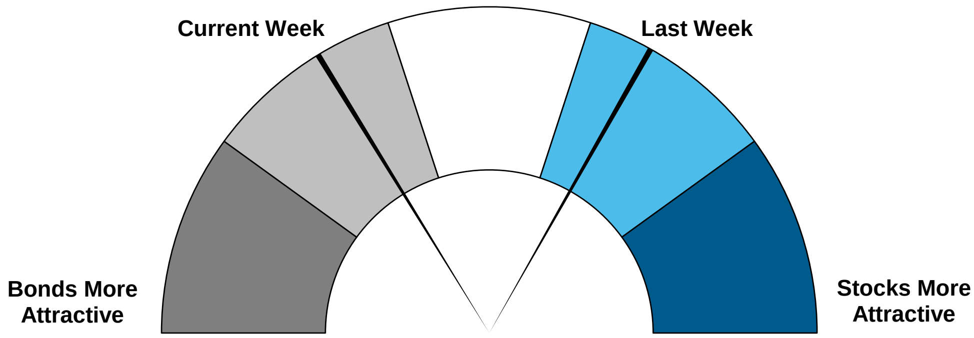
Asset Class Performance and Heat Map (as of June 16, 2017)

Asset Class	Annualized Returns (%)							Yield	Valuation		Volatility (%)		Correlation to Global Equities	
Cash	YTD	1-Yr.	2016	3-Yr.[1]	5-Yr.[1]	10-Yr.[1]	20-Yr.[1]	Current YTM	Current YTM	Avg. YTM[2]	30 Days	20 Yrs.[1]	30 Days	20 Yrs.[1]
90-Day US Treasury Bills	0.3	0.4	0.3	0.2	0.1	0.5	2.1	0.99	0.99	2.06	0.03	0.61	-0.08	-0.03
Global Equities								Current Div. Yld.	Current P/E	Avg. P/E[2]				
US Large-Cap Growth	14.9	21.8	6.5	12.9	16.6	9.2	6.9	1.27	20.9	21.4	10.1	17.8	0.77	0.89
US Large-Cap Value	5.7	17.8	16.3	7.8	14.2	5.0	7.0	2.88	15.5	13.9	7.7	14.4	0.70	0.88
US Mid-Cap Growth	10.1	16.0	6.4	7.7	14.2	7.0	7.7	0.84	21.8	26.7	9.7	23.4	0.81	0.81
US Mid-Cap Value	7.7	22.4	20.9	9.1	16.5	6.6	9.8	2.54	15.8	14.3	9.4	16.5	0.73	0.87
US Small-Cap Growth	8.7	21.5	14.0	8.5	14.9	8.3	9.8	0.67	27.0	24.0	12.0	22.2	0.78	0.83
US Small-Cap Value	2.5	21.8	25.8	8.1	14.8	7.4	9.9	2.42	19.3	17.0	12.5	17.4	0.66	0.84
Europe Equity	16.6	25.9	0.2	0.7	11.4	1.3	6.2	3.25	15.1	14.9	10.3	18.4	0.80	0.94
Japan Equity	10.6	22.1	2.7	7.3	10.7	1.3	1.9	2.08	14.3	21.2	13.6	17.5	0.37	0.69
Asia Pacific ex Japan Equity	13.5	24.3	8.0	0.7	7.7	3.8	6.2	3.72	15.2	14.9	10.3	21.7	0.72	0.85
Emerging Markets	17.3	28.7	11.6	2.0	4.9	2.6	6.0	2.39	12.3	11.6	10.8	23.8	0.69	0.86
Global Fixed Income								Current YTM	Current Spread	Avg. Spread[2]				
Short-Term Fixed Income	0.7	0.6	1.3	1.0	1.0	2.3	3.6	1.53	17.0	31.0	0.6	1.4	-0.21	-0.13
US Fixed Income	2.7	0.6	2.6	2.5	2.2	4.5	5.3	2.47	44.0	55.0	2.8	3.4	-0.22	-0.03
International Fixed Income	5.9	-2.3	1.8	-1.5	0.2	3.2	4.2	0.97	41.0	50.0	7.1	8.1	0.09	0.29
Inflation-Protected Securities	3.8	3.3	6.5	0.1	1.2	4.0	6.5	-	-	-	7.5	7.6	0.28	0.43
High Yield	6.4	12.7	14.3	4.1	7.7	7.5	7.9	5.59	371.0	513.0	2.4	10.2	0.63	0.76
Emerging Markets Fixed. Inc.	11.0	11.8	9.9	-2.6	0.3	3.9	7.4	6.21	253.0	357.0	9.5	13.2	0.58	0.68
Alternative Investments								Current Div. Yld.						
REITs	9.0	8.6	4.6	4.8	9.3	1.6	7.3	3.69	-	-	5.8	18.5	0.50	0.79
MLP/Energy Infrastructure[3]	-5.6	1.1	18.3	-9.3	2.6	5.9	-	6.40	-	-	15.9	18.5	0.43	0.56
Commodities ex Prec. Metals	-9.2	-6.8	11.6	-17.2	-9.0	-8.3	-1.0	-	-	-	11.9	17.1	0.06	0.42
Precious Metals	7.3	-5.0	9.5	-0.8	-6.0	5.1	6.7	-	-	-	13.1	19.4	0.13	0.21
Hedged Strategies[4]	2.3	6.1	2.5	-0.1	1.8	-1.0	-	-	-	-	2.6	6.1	0.92	0.64
Managed Futures[5]	-0.1	-2.3	-2.9	0.2	-0.5	-1.2	-	-	-	-	5.6	7.9	0.78	0.17
S&P 500	9.7	19.6	12.0	10.1	15.4	6.9	7.4	1.89	17.6	17.2	7.89	15.1	0.84	0.95
Russell 2000	4.3	24.3	21.3	8.0	14.0	6.4	8.0	1.51	23.9	20.9	13.81	19.9	0.70	0.82
MSCI EAFE	14.7	24.6	1.5	2.0	10.7	1.5	5.0	3.03	14.9	15.8	9.63	16.8	0.77	0.96
MSCI AC World	12.0	21.9	8.5	5.9	12.1	4.2	6.2	2.41	15.9	15.7	7.09	15.8	1.00	1.00

Note: Performance values calculated using USD. 1. As of May 31, 2017. 2. 20-year average as of May 31, 2017. 3. Volatility and Correlation: June 30, 2006 – Present. 4. Volatility and Correlation: Jan 31, 1998 – Present Hedged strategies consist of hedge funds and managed futures 5. Volatility and Correlation: February 28, 1998 – Present. Cheap = Below -0.5 standard deviation; Moderate = Between +0.5 standard deviation and -0.5 standard deviation; Expensive = Above +.5 std dev. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean. Source: Factset, Bloomberg, Morgan Stanley Wealth Management GIC.

Cheap	Low	Low
Moderate	High	High
Expensive		

Short-Term Stock and Bond Indicator



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

Indicator	Category	Absolute Level and Change	Impact on Risk Assets: Z-Score of Level	Impact on Risk Assets: Z-Score of Change
PMI (+)	Growth	Neutral and Falling	-0.57	-0.92
Durable Goods (+)		Neutral	-0.06	-0.29
Retail Sales (+)		Low and Falling	-1.22	-1.20
Manufacturing Hours Worked (+)		Neutral	-0.11	0.16
Commodity Prices (+)	Inflation	Neutral and Falling	-0.87	-0.83
Yield Curve: 10-Yr./Three-Mo.(-)	Rates	Low and Falling	2.25	0.87
Yield Curve: Two-Yr./Three-Mo.(-)		Neutral and Falling	0.61	1.08
Pace of Interest Rate Hikes (-)		Low and Falling	1.89	0.71
Term Premium Model (-)		Long Duration	-	-
High Yield Spreads (-)	Liquidity	Neutral	-0.01	0.22
Investment Grade Spreads (-)		Neutral	0.63	-0.30
Financial Conditions (-)		Neutral and Falling	0.53	0.66
S&P 500 Earnings/Baa Yield (+)	Valuation & Market Behavior	Low and Rising	-1.35	0.55
Large vs. Small Performance (-)		Low	1.22	0.22
High- vs. Low-Quality Performance (-)		Neutral and Rising	-0.51	-0.57
High- vs. Low-Beta Performance (+)		Neutral and Falling	-0.49	-0.63
S&P 500 Forward Price/Earnings Ratio (+)		Neutral	0.55	0.30
Earnings Revisions Breadth (-)	Earnings	-	-	-
Global Risk Demand (+)	Sentiment	Neutral	0.54	0.11
Implied Currency Volatility (-)		Neutral and Falling	0.86	1.13
Five-Yr. Macro Sensitivity (-)		High and Falling	-1.13	0.72
% Stocks Above 200-Day Moving Avg. (+)	Technicals	Neutral	0.30	0.34
Cumulative Advance/Decline (+)		Neutral	0.55	0.22
S&P 500 Put/Call Ratio (-)		Neutral and Falling	0.25	1.46
Emerging Market Fund Flows (+)		Neutral	0.52	0.13
Smart Money Flow Index (+)		Neutral and Rising	0.82	0.52

Note: + Indicates that a rise in the indicator is linked to a more favorable outlook for risk assets;- indicates that a rise in the indicator is linked to a less favorable outlook for risk assets. Z-Scores and color coding are set in accordance with the impact on risk assets. A z-score is a statistical measurement of a score's relationship to the mean in a group of scores. A z-score of 0 means the score is the same as the mean.

Positive for Stocks Relative to Bonds
Neutral
Negative for Stocks Relative to Bonds

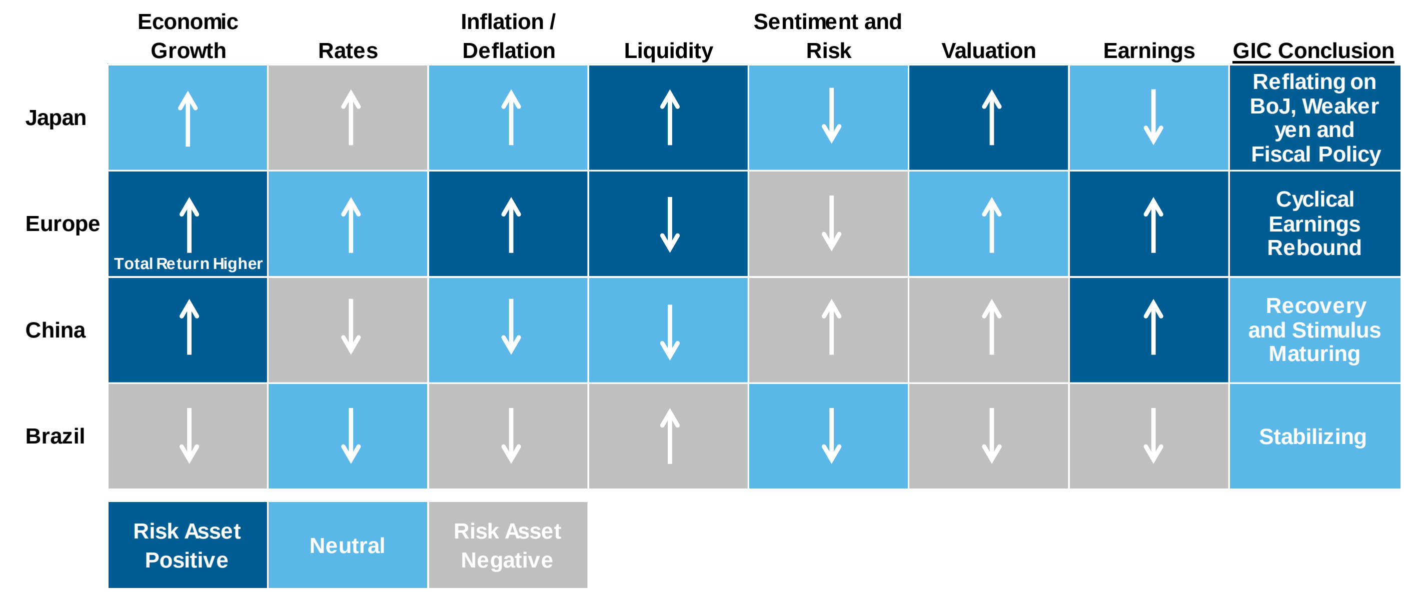
Note: Commodity prices are represented by the Bloomberg Commodity Index; pace of interest rate hikes by the Morgan Stanley Pace of Rate Hikes Index; high yield spreads by the Bloomberg Barclays Aggregate US High Yield Index; investment grade spreads by the Bloomberg Barclays US Aggregate Index; financial conditions by the Morgan Stanley Financial Conditions Index; global risk demand and implied currency volatility by the Morgan Stanley Standardized Global Risk Demand Index. For more information on our Term Premium Model, please refer to our special report, *Using the Term Premium to Manage Portfolio Duration*, March 2016.
Source: Morgan Stanley Wealth Management GIC, Morgan Stanley & Co., Haver Analytics, Bloomberg, FactSet as of June 16, 2017

Morgan Stanley & Co. Forecasts (as of June 16, 2017)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2016	2017E	2018E	Q4 '17E	Q2 '18E	2016	2017E	2018E	Q4 '17E	Q2 '18E	Q4 '18E
Global	3.1	3.6	3.7			2.6	2.8	2.8			
US	1.6	2.2	2.2	2.45	2.40	1.3	2.1	1.9			
Euro Zone	1.7	1.9	1.6			0.2	1.6	1.3	1.18	1.16	1.11
UK	1.8	1.7	1.1	1.00	0.95	0.7	2.8	3.1	1.28	1.23	1.24
Japan	1.0	1.6	1.1	0.08	0.20	-0.1	0.6	1.2	118	116	110
Emerging Markets	4.2	4.7	5.0			3.9	3.5	3.5			
China	6.7	6.6	6.4	3.89	3.85	2.0	2.3	2.2	6.90	6.95	7.00

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of June 16, 2017)



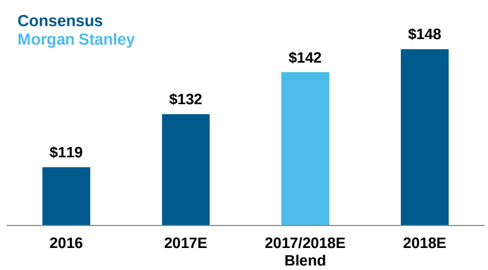
Note: Text in a factor box denotes a color change; In Europe, Economic Growth transitioned from risk asset neutral to risk asset positive as total return for the region turned higher; for further explanation of the chart, see page 9.
Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending June 16, 2017)

	Positives	Negatives
Global Growth	• Philadelphia Fed Survey above expectations in June • Empire State Manufacturing Survey rebounded sharply in June • May NFIB Small Business Optimism Index in line with expectations and remains near cycle highs • April Japan industrial production at multiyear high, 4.0% gain month over month	• NAHB Housing Market Index declined in June • June U. of M. Consumer Sentiment below estimates • May US Treasury budget deficit larger than expected • Retail sales fell unexpectedly in May • US industrial production stalled in May • Housing starts declined 5.5% in May • Japan machine tool orders disappointed in May
Rates	• Fed hiked rates 25 basis points, expects one more hike this year; announced plan to wind down balance sheet • As expected, Bank of Japan declined to tighten policy	• Bank of England kept rates unchanged at 0.25%, though three members dissented, wanting to hike rates to control inflation
Inflation	• US PPI flat in May in line with expectations • UK CPI up 2.9% year over year in May • Euro Zone CPI at 1.4% year over year as expected	• US CPI showed continued weakness in May, -0.1% month over month • Japan PPI slightly below estimates in May at 2.1% year over year
Sentiment		• Crude oil and gasoline inventory data disappoint, oil retreats to below $45 per barrel

Source: Morgan Stanley Wealth Management GIC

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of June 16, 2017

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

Landscape	Earnings	Price/Earnings Multiple	Price Target	Upside / Downside
Bull Case	142.00	21.1	3,000	22.3%
Base Case	142.00	19.0	2,700	10.1%
Bear Case	126.50	16.6	2,100	-14.4%
	Current S&P 500 Price		2,453	

Source: Thomson Reuters, Morgan Stanley & Co. Research as of June 19 2017

S&P 500 Sector Performance and Valuation (as of June 16, 2017)

Index Name	Total Return			Dividend Yield (%)	Beta	20-Year Avg. Forward 12-Mo. PE	Forward 12-Mo. P/E*
	WTD (%)	YTD (%)	1-Year (%)				
S&P 500	***0.12***	***9.74***	***19.56***	***1.89***		***17.2***	***17.6***
Energy	0.52	-10.60	1.18	2.88	1.14	17.9	**26.4**
Materials	-0.75	9.64	17.38	1.99	1.15	16.5	**18.1**
Industrials	1.74	10.66	24.47	1.95	1.09	17.5	**18.1**
Consumer Discretionary	-0.02	11.53	17.47	1.35	0.97	19.4	**19.5**
Consumer Staples	-0.45	10.05	7.72	2.52	0.61	19.8	**20.7**
Health Care	0.60	13.73	11.68	1.61	0.89	18.7	**16.1**
Financials	0.34	5.27	34.61	1.62	1.36	13.2	**13.8**
Information Technology	-1.14	18.02	33.88	1.30	1.09	22.4	**18.3**
Telecommunication Services	0.08	-7.24	-3.26	4.86	0.60	17.8	**13.1**
Utilities	1.65	13.28	11.33	3.26	0.40	14.6	**18.4**
Real Estate	1.61	7.15	4.64	3.24	0.65	15.2	**18.1**

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

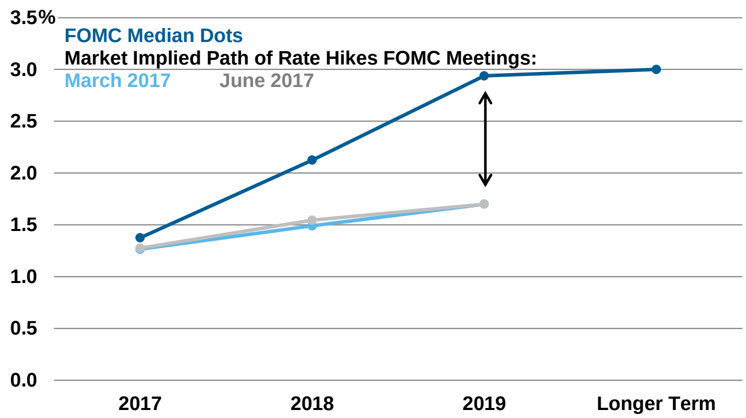
Source: Morgan Stanley & Co.

Performance of Style and Cap Pairs (as of June 16, 2017)

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

Fixed Income Insight: Bond Market Continues to Discount a Policy Mistake

Despite hawkish rhetoric and the third Federal Reserve rate hike in as many meetings, the US Treasury market continued to shrug off Fed guidance, and the futures pricing of the rates curve literally has remained unchanged since March. Based on this implied view, bond investors are discounting only 1.5-to-two more 25-basis-point hikes between now and 2019. Such a scenario is at odds with Fed forecasts for six-to-seven more hikes and a terminal fed funds rate of 3%. While the Fed seems anchored on the potential for inflation to pick up as labor markets continue to tighten, skeptical investors seem focused on recent inflation and economic surprise data that has disappointed. Resolving this disconnect could drive volatility during the summer and fall.



Source: Morgan Stanley Wealth Management Fixed Income Strategy and Bloomberg as of June 16, 2017

Government Debt Monitor

US				
	Yield (%)			Total Return (%)
Treasury Benchmark	Current	ΔWTD	ΔYTD	YTD
3-Month	1.00	0.01	0.50	0.23
2-Year	1.32	-0.02	0.13	0.41
5-Year	1.74	-0.02	-0.18	1.73
10-Year	2.15	-0.05	-0.29	3.33
30-Year	2.78	-0.08	-0.29	6.62
2-Yr./10-Yr. Spread (bp)	84	-2.95	-41.97	-
10-Yr. TIPS Breakeven (bp)	168	-11.99	-28.98	-
Interest Rate Volatility† (bp)	51	-1.07	-20.15	-

Fixed Income Spread Dashboard

		Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	OAS Range** Rich	Cheap
Investment Grade	MBS*	4.13	2.67	28	9	35
	AAA	4.40	1.91	27	20	44
	AA	5.38	2.16	14	8	18
	A	7.59	2.87	89	89	158
	BBB	7.35	3.43	144	143	295
High Yield	BB	4.17	4.36	267	259	662
	B	3.64	5.80	413	386	1,009
	CCC	2.78	10.57	988	851	1,972

Unless stated, indexes utilized are Citi Broad Investment Grade, Citi High Yield, and Citi Global Indexes
†Interest Rate Volatility measured by Merrill Lynch Option Volatility Estimate (MOVE) Index
*MBS distills high grade agency-rated mortgage-backed securities, a substantial subsector of investment grade indexes.
**OAS stands for Option-Adjusted Spread or spread over the Treasury. Grey diamond denotes current OAS; blue circle denotes two-year average.
Source: Bloomberg, The Yield Book® Software and Services. Data as of June 16, 2017

Government Debt Monitor

Global				
	Yield (%)			Total Return (%)*
10-Year Govt. Bond	Current	ΔWTD	ΔYTD	YTD
France	0.63	-0.01	-0.05	2.01
Germany	0.28	0.01	0.07	0.70
Japan	0.05	0.00	0.01	0.74
Spain	1.45	0.01	0.07	2.27
UK	1.02	0.01	-0.22	2.88
3-Month LIBOR	1.27	0.04	0.28	-
US Tax Exempt				
10-Year AAA Muni	1.86	-0.01	-0.45	4.05
10-Yr. Muni/UST Ratio	86.31	1.19	-8.32	-

Benchmark Returns

	Total Returns (%)		
Index	YTD	MTD	2016
Bloomberg Barclays US Aggregate	2.69	0.30	2.65
Bloomberg Barclays US MBS	1.75	-0.01	1.67
Bloomberg Barclays US IG Corporate	4.11	0.61	6.11
Bloomberg Barclays Municipal	4.05	0.11	0.25
Bloomberg Barclays US High Yield	5.02	0.22	17.13
Bloomberg Barclays Global Aggregate	4.66	0.15	2.09
JPMorgan Emerging Market	6.94	0.43	10.19

*Global total returns reflect Citigroup 7- to 10-year bond indexes and Muni total returns reflect Bloomberg Barclays Municipal Bond Index Total Return
Source: Bloomberg, Thomson Reuters Municipal Market Data (MMD) as of June 16, 2017

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Overweight	While US equities have done exceptionally well since the global financial crisis, they are now in the latter stages of a cyclical bull market. This bull market was challenged during the past year by fears of recession and political events. With the recent Trump/Republican win, it appears that investors are getting more excited about potential growth and "animal spirits" are on the rise. This is likely to lead to the final euphoric stage of this cyclical bull market, which could be quite powerful in 2017's first half.
International Equities (Developed Markets)	Equal Weight	We maintain a positive bias for Japanese and European equity markets despite the political challenges that both markets faced in the past year. Ironically, the populist movement around the world is likely to drive more fiscal policy action in both regions, which is needed to make the extraordinary monetary policy offered in both regions more effective. Both are still at record levels of cheapness. We continue to recommend hedging currency risk for 50% of European and Japanese positions.
Emerging Markets	Overweight	Emerging market (EM) equities have been much better performers during 2016 than in the prior three years. However, new concerns have arisen with the recent strength in the US dollar and the rise in interest rates. With global growth and earnings accelerating and financial conditions remaining loose, we think EM equities will perform well again in 2017.
Global Fixed Income	**Relative Weight Within Fixed Income**	
US Investment Grade	Underweight	We have recommended shorter-duration* (maturities) since March 2013 given the extremely low yields and potential capital losses associated with rising interest rates from such low levels. The Trump election win has inspired markets to think about inflation again. This has caused a meaningful rise in longer-term interest rates, a move that is likely 75% of the way done and should abate as the Fed raises rates this year. Within investment grade, we prefer BBB-rated corporates and A-rated municipals to US Treasuries.
International Investment Grade	Underweight	Yields are even lower outside the US, leaving very little value in international fixed income, particularly as the global economy begins to recover more broadly. While interest rates are likely to stay low, the offsetting diversification benefits do not warrant much, if any, position, in our view.
Inflation-Protected Securities	Overweight	With deflationary fears having become extreme in 2015 and early 2016, these securities still offer relative value in the context of our forecasted acceleration in global growth, and expectations for oil prices and the US dollar's year-over-year rate of change to revert back toward 0%. That view played out in 2016 but has not yet run its course.
High Yield	Overweight	The sharp decline in oil prices created significant dislocations in the US high yield market in 2015. Broadly speaking, we believe default rates are likely to remain contained as the economy avoids recession, while corporate and consumer behavior continues conservative. This has led to better performance in 2016, along with lower volatility than equities. We think this can continue but we are getting closer to fully valued.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Underweight	Real estate investment trusts (REITs) underperformed in 2016, but it is still too early to reconsider our underweight zero allocation given the further rise in rates we expect and deteriorating fundamentals for the industry. Non-US REITs should be favored relative to domestic REITs.
Master Limited Partnerships/Energy Infrastructure*	Overweight	Master limited partnerships (MLPs) were devastated during the oil-price collapse and have rebounded sharply. As long as oil remains above $40 per barrel, they should provide a reliable and attractive yield. A Trump presidency should also be supportive for fracking activity and pipeline construction, both of which should lead to an acceleration in dividend growth. MLPs should be one of the strongest asset categories in the first half of 2017.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset category can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform when traditional asset categories are challenged by growth scares and/or interest rate volatility spikes. As volatility becomes more persistent in 2017, these strategies should do better than in recent years.

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

Source: Morgan Stanley Wealth Management GIC as of June 16, 2017

Macro Factor Heat Map Key (see page 5)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	Conclusion
Dark Blue	Economic growth robust	Steep yield curve	Low-moderate and rising inflation	Liquidity robust in economy / banking system	Shorter-term sentiment and technicals bearish	Risk assets attractively valued	Earnings outlook robust	Confluence of factors supports a risk-on investment approach
Light Blue	Economic growth neutral	Normal yield curve	Low-moderate and declining inflation; moderate inflation; higher and falling inflation	Liquidity neutral in the economy / banking system	Shorter-term sentiment and technicals neutral	Risk assets neutral	Earnings outlook neutral	Confluence of factors supports a neutral investment approach
Gray	Economic growth anemic	Flat/inverted yield curve	Very high/low inflation/deflation; high and rising inflation	Liquidity low in economy / banking system	Shorter-term sentiment and technicals bullish	Risk assets are richly valued	Earnings outlook anemic	Confluence of factors supports a risk-off investment approach
Up	Growth accelerating	Yield curve steepening	Inflation rising	Liquidity increasing	Sentiment becoming more bullish	Valuations rising	Earnings outlook improving	
Down	Growth declining	Yield curve flattening	Inflation falling	Liquidity decreasing	Sentiment becoming more bearish	Valuations falling	Earnings outlook worsening	
Signal Horizon	One to three years	One to three years	One to three years	One to three years	One to three months	Six months to two years	Six months to two years	
Inputs	• Industrial production • Unemployment • Total return • Earnings revisions • Home prices • OECD LEI (China and Brazil) • MS & Co. ARIA (US)	• 10-year vs. 2-year government bond yield spread	• Consumer Price Index	• M1 growth • Private credit growth • Libor-OIS spread	• MS US Equity Risk Indicator (US) • MS Combined Market Timing Indicator (Europe) • MS Global Risk Demand Index • Relative strength index • Members above / below moving average. • Index above / below moving average • Consumer confidence	• Forward price/earnings ratio • Price/book ratio • Equity risk premium • High yield option-adjusted spread	• Earnings revisions breadth • Earnings surprise • Return on equity	• Weighted average z-score of all factors

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

Risk Considerations

MLPs

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

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

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

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

Duration

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

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

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing. Certain of these risks may include but are not limited to: Loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices; Lack of liquidity in that there may be no secondary market for a fund; Volatility of returns; Restrictions on transferring interests in a fund; Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; Absence of information regarding valuations and pricing; Complex tax structures and delays in tax reporting; Less regulation and higher fees than mutual funds; and Risks associated with the operations, personnel, and processes of the manager. 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Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Credit ratings are subject to change.

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

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

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

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

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

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