The GIC Weekly

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What We Are Talking About

- **Trump's Unpriced Inflation Agenda.** A rising fiscal deficit is pressuring real interest rates; inflation expectations have moved up modestly, anticipating higher wages and commodity prices; bond market complacent because inflation metrics have remained well-behaved, but forward-looking indicators point to accelerating prices; an overt weak dollar policy, tariffs and threats to pursue intellectual property violations by China are all likely to put pressure on prices which, on a three-month rolling basis, are rising at the fastest pace in a decade; leadership change at the State Dept. could mean reinstating sanctions on Iran, leading to higher oil prices. **Consider** adding inflation proxies such as financial and energy-related equities, gold and inflation-protected securities.

Upcoming Catalysts

March 19 Japan trade balance
March 21 FOMC meeting
March 21 US existing home sales
March 21 Japan Manufacturing PMI
March 22 Markit US Manufacturing PMI
March 22 Markit US Services PMI
March 22 US Leading Economic Index
March 22 Kansas City Fed Manufacturing Survey
March 22 Japan Consumer Price Index
March 22 Euro Zone Markit Composite PMI
March 23 US durable goods orders
March 23 US new home sales

Trump's Unpriced Inflation Agenda

So far this year, the stock market has been about adjusting to a stimulative US fiscal policy that translates into stronger economic growth, albeit with slightly higher interest rates. To wit: the market's 10% correction in February on the back of a near 50-basis-point jump in the 10-year US Treasury yield. These moves reduced the S&P 500 forward price/earnings ratio to 16.5 from 18.3 in December.

Roughly half the increase in the 10-year Treasury yield came from higher real rates, about 75 to 80 basis points. We can attribute this to a 30% year-over-year increase in Treasury issuance, a widening of the budget deficit to nearly 6% of GDP and inflation expectations which are vacillating between 2.0% and 2.1%. While February's average hourly earnings and Consumer Price Index (CPI) were okay from an inflation standpoint, they are trailing indicators. All told, we are concerned about bond market complacency.

In our view, policies coming out of Washington are aggressively pro-inflation, a development that has yet to be priced. Although tariffs on steel and aluminum may be too small or too idiosyncratic to impact overall prices, we worry that the combination of mounting supply-chain pressures, an overt weak dollar policy, potential protectionist actions against China, failure to reach a new deal on NAFTA, blocked cross-border mergers and new leadership at the State Department could all combine to drive inflation higher than expected.

To begin with, inflationary pressures are all around. The US Producer Price Index (PPI) suggests inflationary trends in the manufacturing supply chain. This month, the headline PPI rose to a 2.8% year-over-year rate, with the core rising to 2.7%. These robust readings of inflation correlate with strong survey data from the National Federation of Independent Business (NFIB); at 107.6, the survey was the second-highest in 45 years. Similarly, the Business Roundtable CEO Outlook Index recently hit its highest point in its 15-year history. In both surveys, businesses large and small disclosed a high level of intentions to invest and expand, hire workers and raise wages. In the NFIB survey, 13% of respondents indicated they were planning price hikes. On wage gains, we see upward pressure, too. The Atlanta Fed Wage Growth Tracker is running close to 3%, about in line with the three-month trend of 3.2%. Ellen Zentner, chief US economist for Morgan Stanley & Co., forecasts that annualized wage gains will breach 3% by this year's third quarter.

While the latest CPI report failed to surprise to the upside, it was because of a rare dip in medical costs and yet another round of discounting by cell phone companies. David Rosenberg, chief economist and strategist at Gluskin Sheff & Associates Inc., points out that the issue for the CPI is acceleration and here, the trend is clear in the rolling three-month year-over-year change: 1.9% in November, 2.3% in December, 2.9% in January and 3.1% in February. Rosenberg notes that this trend is the highest since before the financial crisis. Furthermore, the impact of the weaker US dollar on import costs is just beginning to be felt as the stabilization in core goods inflation has correlated strongly with the weakening greenback. Import prices for February were up well ahead of expectations, tracking gains of 3.5% year over year (see *Chart of the Week*, page 3).

A second point is that tariffs and trade wars are unambiguously inflationary and a regressive tax on US consumers. While the initial estimates for the impact of higher steel and aluminum tariffs are only $10 billion now that Canada and Mexico have been exempted, the more recent threats of tariffs on Chinese imports could extract as much as $60 billion from US pockets—the equivalent of about 10% of the recent tax cuts. This comes on top of tariffs imposed last month on solar panels and washing machines aimed directly at imports from China and South Korea, respectively. While initially, these actions taken together are not estimated to add more than five basis points to the CPI, the risk is a tit-for-tat escalation that would provoke anticipatory price hikes by US companies to offset possible loss of overseas sales. Even more concerning is the potential escalation of a trade war should the president charge China with intellectual property infringement at the World Trade Organization (WTO) and use his power to levy additional tariffs. Such an action risks swift retaliatory action that would directly hit some of America's fastest-growing export industries—tech, media, financial services and pharmaceuticals/biotech. It could also block inbound foreign direct investment.

A final inflationary threat comes from anti-globalization, isolationism and nationalism. Globalization and free trade have been overarching foreign policy since 2001, when China joined the WTO. During this time, global trade exploded; manufacturing supply chains realigned toward countries and labor pools with comparative advantages; and deflation and disinflation lowered the global cost of capital. During this period, US corporate profit margins have risen to all-time highs as companies optimized their global supply chains.

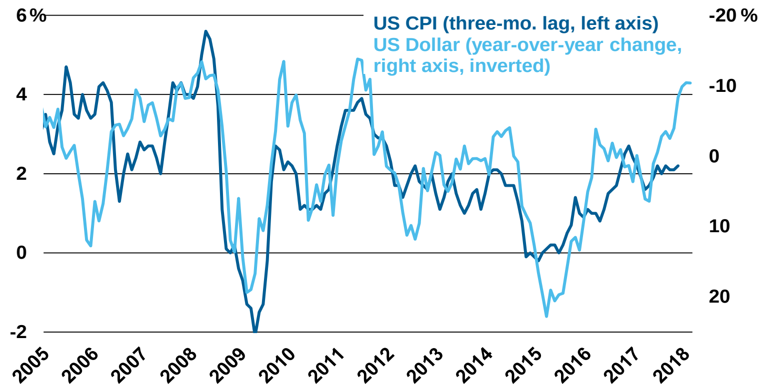
Should foreign policy follow this same path toward isolationism and nationalism, it may further stoke inflationary pressures. For example, a change in State Department leadership could result in a resumption of trade sanctions on Iran that would restrict global oil supply and drive oil prices higher. And this says nothing of the growing warnings from the Pentagon that a trade war promulgated against America's military allies undermines our standing abroad and reduces the likelihood of cost-effective sharing of intelligence.

A broad look at the administration's economic policy reveals little concern about higher debt, higher deficits and higher inflation. While a pick-up in inflation is still healthy for an economy recovering from a financial crisis, we caution investors that unintended consequences of the president's policies could snowball, creating a scenario in which the Federal Reserve is behind the curve and starts to hike rates aggressively.

Bottom Line: Like the tax cuts that appear to have stoked an already recovering global economy, we believe that a weak dollar policy, trade protectionism and tariffs, along with leadership changes at the State Department, could further propel inflation. The bond market remains complacent about this threat. **Watch** forward inflation expectations for signs that Treasury yields will head higher. **Consider** adding inflation proxies such as financial and energy-related equities, gold and inflation-protected securities. ■

Chart of the Week: Weaker Dollar Presages Higher Headline Inflation

Somewhat benign headline inflation readings in February have contributed to the 10-year Treasury yield retracing roughly five basis points this past week to 2.85%. We believe that the market views inflation readings as current measures of pricing pressures when in fact we see them as lagging indicators. What is more important is the intermediate term, and on that score, acceleration in prices is undeniable (see chart).Looking forward, our research suggest that upward pressure should remain as the weaker dollar, which has fallen roughly 10% over the past year, signals that headline inflation in the next three months is headed higher. This should push up Treasury yields and heighten rhetoric about the pace of Federal Reserve rate hikes potentially moving to four this year from the currently expected three.



Source: Bloomberg as of Feb. 28, 2018

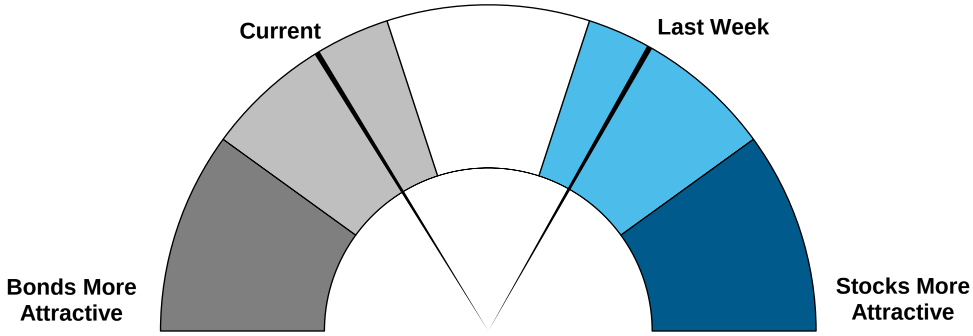
Asset Class Performance and Heat Map (as of March 16, 2018)

Asset Class	Annualized Returns (%)							Yield	Valuation		Volatility (%)		Correlation to Global Equities	
Cash	**YTD**	**1-Yr.**	**2017**	**3-Yr.[1]**	**5-Yr.[1]**	**10-Yr.[1]**	**20-Yr.[1]**	**Current YTM**	**Current YTM**	**Avg. YTM[2]**	**30 Days**	**20 Yrs.[1]**	**30 Days**	**20 Yrs.[1]**
90-Day US Treasury Bills	0.3	1.0	0.8	0.5	0.3	0.3	1.9	1.70	1.70	1.91	0.06	0.59	0.17	-0.05
Global Equities								**Current Div. Yld.**	**Current P/E**	**Avg. P/E[2]**				
US Large-Cap Growth	7.5	27.3	30.2	13.8	17.6	11.8	6.4	1.07	21.6	21.3	14.2	17.5	0.92	0.89
US Large-Cap Value	-0.4	9.7	15.1	8.9	12.2	7.6	6.4	2.82	14.6	13.9	14.2	14.2	0.93	0.89
US Mid-Cap Growth	5.6	20.3	22.0	8.2	13.1	9.6	7.5	0.68	21.0	26.7	12.8	23.3	0.86	0.81
US Mid-Cap Value	0.7	11.9	17.0	9.1	13.3	10.4	8.9	2.68	15.8	14.4	13.4	16.3	0.86	0.88
US Small-Cap Growth	4.9	23.2	23.4	9.7	14.3	11.4	9.4	0.59	26.8	24.0	13.2	22.0	0.80	0.84
US Small-Cap Value	0.2	9.1	11.5	7.9	11.6	10.7	9.0	2.54	17.9	17.1	13.6	17.3	0.79	0.84
Europe Equity	-0.4	17.7	26.2	4.9	7.2	2.8	5.2	3.36	14.1	14.2	10.9	18.2	0.77	0.94
Japan Equity	1.6	18.9	24.4	10.0	10.8	4.1	3.7	1.99	13.4	20.3	14.2	17.0	0.44	0.70
Asia Pacific ex Japan Equity	-0.2	13.3	26.0	6.2	4.2	4.7	8.4	3.68	15.3	14.4	13.2	20.6	0.56	0.86
Emerging Markets	5.0	29.2	37.8	9.4	5.4	3.0	8.2	2.28	12.6	11.3	13.3	23.2	0.66	0.86
Global Fixed Income								**Current YTM**	**Current Spread**	**Avg. Spread[2]**				
Short-Term Fixed Income	-0.3	0.3	0.8	0.7	0.7	1.6	3.3	2.50	18.0	31.0	0.6	1.4	-0.01	-0.15
US Fixed Income	-2.0	1.4	3.5	1.1	1.7	3.6	4.8	3.18	39.0	55.0	2.6	3.4	-0.02	-0.05
International Fixed Income	2.6	11.0	9.8	3.3	1.0	2.2	4.3	1.13	36.0	49.0	5.2	8.1	0.15	0.30
Inflation-Protected Securities	0.7	8.2	9.0	2.7	1.2	2.8	6.2	-	-	-	3.9	7.6	0.19	0.44
High Yield	-0.3	7.4	10.4	6.5	5.4	8.3	7.6	5.87	342.0	514.0	2.2	10.1	0.63	0.76
Emerging Markets Fixed. Inc.	3.2	12.4	15.2	4.0	-1.0	3.6	7.4	6.10	217.0	346.5	5.8	13.0	0.60	0.68
Alternative Investments								**Current Div. Yld.**						
REITs	-2.9	8.5	15.0	2.8	5.0	3.9	7.9	3.97	-	-	10.0	18.1	0.70	0.80
MLP/Energy Infrastructure[3]	-6.4	-15.1	-6.5	-10.4	-3.5	5.7	-	7.97	-	-	22.8	18.4	0.40	0.56
Commodities ex Prec. Metals	-0.5	4.4	0.2	-5.9	-8.7	-9.7	0.1	-	-	-	7.3	17.0	0.33	0.44
Precious Metals	-1.1	2.6	10.9	1.2	-6.0	1.2	6.6	-	-	-	11.9	19.3	0.39	0.20
Hedged Strategies[4]	0.1	4.3	6.0	1.0	1.6	-0.4	-	-	-	-	4.3	6.0	0.83	0.64
Managed Futures[5]	-1.4	1.3	2.5	-2.1	-0.1	-2.4	-	-	-	-	6.4	7.9	0.46	0.18
S&P 500	3.4	17.9	21.8	11.1	14.7	9.7	6.9	1.77	17.1	16.0	13.95	14.9	0.94	0.95
Russell 2000	3.5	15.9	14.6	8.5	12.2	9.7	7.5	1.51	23.1	20.4	14.68	19.8	0.77	0.82
MSCI EAFE	0.1	17.3	25.6	6.1	7.5	3.3	5.1	3.05	14.1	15.1	9.72	16.6	0.79	0.96
MSCI AC World	2.3	18.6	24.6	8.9	10.7	6.2	6.2	2.34	15.4	15.5	10.62	15.6	1.00	1.00

Valuation	Volatility	Correlation
Cheap	Low	Low
Moderate	High	High
Expensive		

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

Short-Term Stock and Bond Indicator



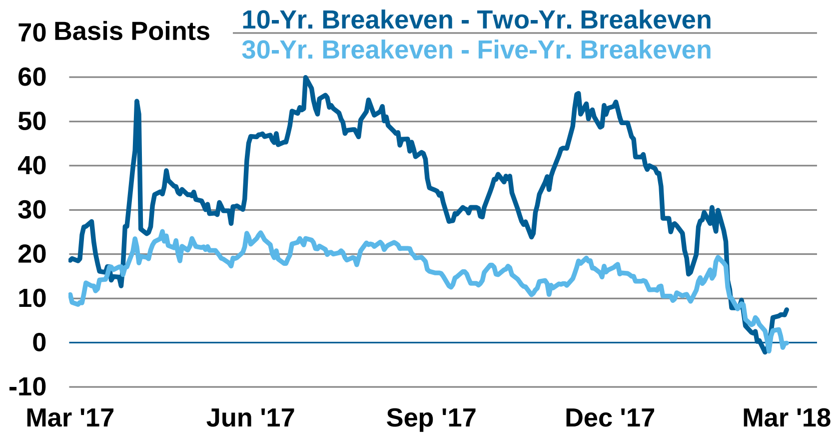
	Macro		Policy		Fundamentals		Sentiment and Technicals	
	Growth	Inflation	Rates	Liquidity	Valuation & Market	Earnings	Sentiment	Technicals
Current	Very Negative	Neutral	Very Positive	Neutral	Neutral	Very Negative	Neutral	Neutral
Last Week	Very Negative	Neutral	Very Positive	Very Positive	Neutral	Very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

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

Note: Commodity prices are represented by the Bloomberg Commodity Index; pace of interest rate hikes by the Morgan Stanley Pace of Rate Hikes Index; high yield spreads by the Bloomberg Barclays Aggregate US High Yield Index; investment grade spreads by the Bloomberg Barclays US Aggregate Index; financial conditions by the Morgan Stanley Financial Conditions Index; global risk demand and implied currency volatility by the Morgan Stanley Standardized Global Risk Demand Index. For more information on our Term Premium Model, please refer to our special report, *Using the Term Premium to Manage Portfolio Duration*, March 2016.
Source: Morgan Stanley Wealth Management GIC, Morgan Stanley & Co., Haver Analytics, Bloomberg, FactSet as of March 16, 2018

Fixed Income Insight: Is the Market Underpricing Future Inflation?

Tax cuts and deficit-financed fiscal stimulus appear to have done little to influence inflation expectations at the longer end of the yield curve. To the contrary, current inflation breakeven curves have plummeted since the beginning of the year, with investors assuming any inflationary impulse from better growth, a weaker dollar and protectionist policies are very short lived, impacting only shorter rates. While the nominal Treasury curve has flattened as well, the breakeven curve is now completely flat (see chart). If the market is wrong and the Fed's 2% inflation target appears more achievable—as we believe it will be as all economic variables normalize—the damage to long-duration bonds could still be meaningful.



Source: Bloomberg as of March 16, 2018

Government Debt Monitor

US				
	Yield (%)			Total Return (%)
Treasury Benchmark	**Current**	**ΔWTD**	**ΔYTD**	**YTD**
3-Month	1.77	0.11	0.39	0.29
2-Year	2.29	0.03	0.41	-0.28
5-Year	2.64	-0.01	0.44	-1.53
10-Year	2.84	-0.05	0.44	-3.38
30-Year	3.08	-0.08	0.34	-6.08
2-Yr./10-Yr. Spread (bp)	55	-8.22	3.12	-
10-Yr. TIPS Breakeven (bp)	208	-4.10	10.12	-
Interest Rate Volatility† (bp)	59	0.04	12.41	-

Fixed Income Spread Dashboard

		Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	OAS Range** Rich	Cheap
Investment Grade	MBS*	5.08	3.39	29	9	35
	AAA	4.40	2.79	28	18	42
	AA	5.63	2.93	14	8	18
	A	7.32	3.56	86	68	125
	BBB	7.32	4.10	137	115	228
High Yield	BB	4.54	5.19	256	212	487
	B	3.71	6.47	386	333	777
	CCC	3.25	10.82	897	851	1,724

Unless stated, indexes utilized are FTSE Broad Investment Grade, FTSE High Yield, and FTSE Global Indexes
†Interest Rate Volatility measured by Merrill Lynch Option Volatility Estimate (MOVE) Index
*MBS distills high grade agency-rated mortgage-backed securities, a substantial subsector of investment grade indexes.
**OAS stands for Option-Adjusted Spread or spread over the Treasury. Grey diamond denotes current OAS; blue circle denotes two-year average.
Source: Bloomberg, The Yield Book® Software and Services. Data as of March 16, 2018

Government Debt Monitor

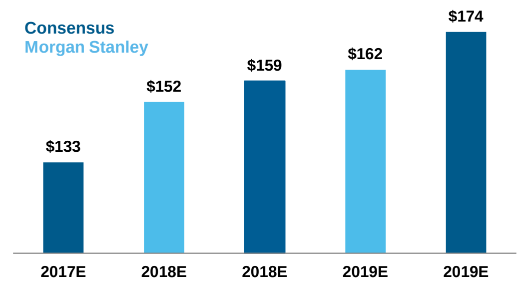
Global				
	Yield (%)			Total Return (%)*
10-Year Govt. Bond	**Current**	**ΔWTD**	**ΔYTD**	**YTD**
France	0.81	-0.08	0.03	-0.13
Germany	0.57	-0.08	0.15	-0.33
Japan	0.03	-0.02	-0.01	0.60
Spain	1.36	-0.07	-0.19	2.21
UK	1.43	-0.06	0.24	-1.43
3-Month LIBOR	2.20	0.11	0.51	-
US Tax Exempt				
10-Year AAA Muni	2.50	0.01	0.52	-1.37
10-Yr. Muni/UST Ratio	87.84	1.74	5.58	-

Benchmark Returns

	Total Returns (%)		
Index	**YTD**	**MTD**	**2017**
Bloomberg Barclays US Aggregate	-2.00	0.09	3.54
Bloomberg Barclays US MBS	-1.67	0.15	2.47
Bloomberg Barclays US IG Corporate	-2.80	-0.25	6.42
Bloomberg Barclays Municipal	-1.37	0.10	5.45
Bloomberg Barclays US High Yield	-0.59	-0.34	7.50
Bloomberg Barclays Global Aggregate	0.84	0.55	7.39
JPMorgan Emerging Market	-2.06	0.09	9.32

*Global total returns reflect Citigroup 7- to 10-year bond indexes and Muni total returns reflect Bloomberg Barclays Municipal Bond Index Total Return
Source: Bloomberg, Thomson Reuters Municipal Market Data (MMD) as of March 16, 2018

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of March 16, 2018

MS & Co. 2018 Price Target for the S&P 500

Landscape	Earnings	Price/Earnings Multiple	Price Target	Upside / Downside
Bull Case	$162	18.5	3,000	9.0%
Base Case	$162	17.0	2,750	-0.1%
Bear Case	$144	16.0	2,300	-16.4%
	Current S&P 500 Price		2,752	

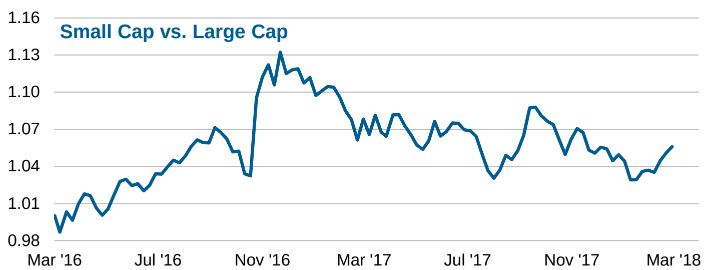
Note: Price targets use 2019 earnings estimate.
Source: Thomson Reuters, Morgan Stanley & Co. Research as of March 16, 2018

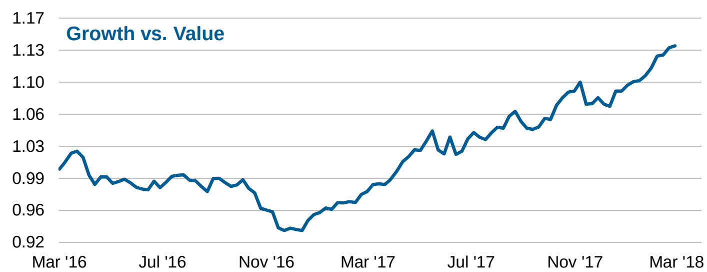
S&P 500 Sector Performance and Valuation (as of March 16, 2018)

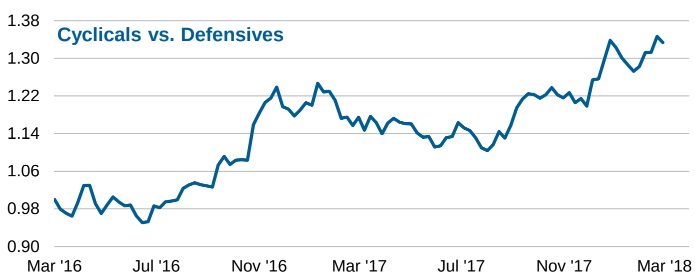
Index Name	Total Return			Dividend Yield (%)	Beta	20-Year Avg. Forward 12-Mo. PE	Forward 12-Mo. P/E*
	WTD (%)	YTD (%)	1-Year (%)				
S&P 500	***-1.20***	***3.38***	***17.86***	***1.77***		***16.0***	***17.1***
Energy	-0.83	-5.96	0.11	2.86	0.92	17.6	**19.4**
Materials	-3.18	-1.76	15.49	1.93	1.04	13.9	**16.7**
Industrials	-1.97	1.50	17.01	1.84	1.04	16.3	**17.6**
Consumer Discretionary	-0.68	7.07	22.31	1.22	0.93	18.0	**20.4**
Consumer Staples	-1.97	-6.03	-0.63	2.78	0.64	17.0	**17.5**
Health Care	-0.88	3.90	15.11	1.56	0.93	17.3	**16.0**
Financials	-2.38	3.93	18.90	1.52	1.18	12.8	**13.6**
Information Technology	-0.95	10.46	36.61	1.10	1.24	20.8	**19.2**
Telecommunication Services	-0.66	-4.91	-4.32	5.34	0.83	16.4	**10.7**
Utilities	2.64	-3.70	2.16	3.59	0.30	14.2	**16.3**
Real Estate	1.52	-4.50	4.15	3.35	0.57	15.3	**17.0**

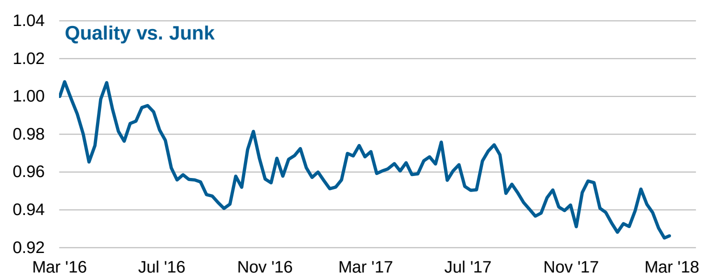
*Dark blue/light blue/gray fill denotes whether current relative forward 12-month P/E is low/neutral/high relative to history.
Source: Morgan Stanley & Co. Research

Performance of Style and Cap Pairs (as of March 16, 2018)









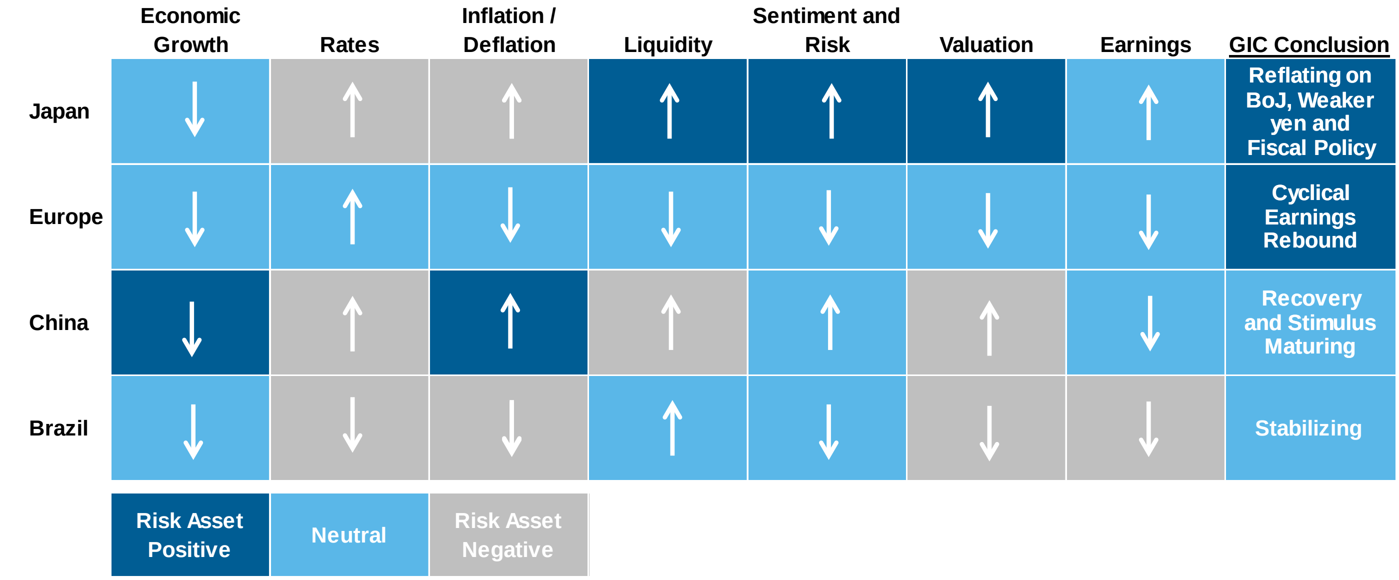
Source: Morgan Stanley & Co. Small Cap is represented by the Russell 2000 Index; Large Cap represented by the Russell 1000 Index; Growth represented by the Russell 1000 Growth Index; Value represented by the Russell 1000 Value Index.Cyclicals and Defensives, and Quality and Junk are based on Morgan Stanley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

Morgan Stanley & Co. Forecasts (as of March 16, 2018)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2017E	2018E	2019E	Q2 '18E	Q4 '18E	2017E	2018E	2019E	Q2 '18E	Q4 '18E	Q2 '19E
Global	3.7	3.9	3.8			2.5	3.0	2.8			
US	2.3	2.6	2.1	2.15	1.95	2.1	2.3	1.7			
Euro Zone	2.5	2.1	1.9			1.5	2.0	1.7	1.22	1.30	1.35
UK	1.7	1.1	0.8	1.50	1.55	2.7	2.8	2.1	1.32	1.38	1.43
Japan	1.6	1.3	1.5	0.08	0.20	0.5	1.3	0.9	110	101	96
Emerging Markets	4.7	5.0	5.0			3.1	3.6	3.6			
China	6.9	6.5	6.3	4.40	4.25	1.6	2.7	2.8	6.40	6.25	6.20

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of March 16, 2018)



Note: Text in a factor box denotes a color change; for further explanation of the chart, see page 9.
Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending March 16, 2018)

	Positives	Negatives
Global Growth	• Univ. of Mich. Consumer Sentiment Index at cycle high of 102.0 in March • Empire State Manufacturing Survey hit 22.5 in March, 15.0 expected • NFIB Small Business Optimism Index surged in February, highest since 1983 • February month-over-month US industrial production up 1.1% versus 0.4% expected • January JOLTS survey showed more job openings than expected	• US retail sales missed expectations in February, down 0.1% versus up 0.3%, month over month • US housing starts dropped 7% month over month in February • Euro Zone industrial production missed expectations in January,-1.0% versus -0.5% • February China retail sales slightly below forecast at 9.7% year over year
Inflation	• US headline and core CPI both met expectations of 2.2% and 1.8% year over year in February • US import prices match forecast in February, up 3.5% year over year	• Year-over-year Euro Zone CPI revised lower to 1.1% from 1.2% in February
Sentiment		• US high yield spreads widened on the week to 341 basis points

Source: Morgan Stanley Wealth Management GIC

Tactical Asset Allocation Reasoning

Global Equities	Relative Weight Within Equities	
US	Equal Weight	US equities have done exceptionally well since the global financial crisis, but they are now in the latter stages of a cyclical bull market. While the acceleration of the Trump/Republican progrowth agenda has helped us achieve our 2,700 price target for the S&P 500 earlier than expected, it ironically brings the end of the cycle closer. In addition, sentiment is much more bullish than it was a year ago.
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets. The populist movements around the world are likely to drive more fiscal policy action in both regions, which is necessary for the central banks to exit their extraordinary monetary policies.
Emerging Markets	Overweight	Emerging market (EM) equities have been the best region over the past 24 months and for the year to date. With the US dollar appearing to have made a cyclical top, global growth and earnings accelerating, and financial conditions remaining loose, we think EM equities will continue to keep up with global equity markets but are unlikely to lead as strongly.
Global Fixed Income	**Relative Weight Within Fixed Income**	
US Investment Grade	Underweight	We have recommended shorter-duration* (maturities) since March 2013 given the extremely low yields and potential capital losses associated with rising interest rates from such low levels. While interest rates have remained exceptionally low, recent US economic data have been very strong recently and the Fed is now raising rates at an accelerating pace. Combined with our expectation for the European Central Bank to taper its bond purchases later in 2018 and the Bank of Japan likely to raise its yield target, higher interest rates are likely this year.
International Investment Grade	Underweight	Yields are even lower outside the US, leaving very little value in international fixed income, particularly as the global economy begins to recover more broadly. While interest rates are likely to stay low, the offsetting diversification benefits do not warrant much, if any, position, in our view.
Inflation-Protected Securities	Overweight	With deflationary fears having become extreme in 2015 and early 2016, these securities still offer relative value in the context of our forecasted acceleration in global growth and our expectations for oil prices and the US dollar's year-over-year rate of change to revert back toward 0%. That view played out in 2016 and 2017 but has not yet run its course.
High Yield	Underweight	High yield has performed exceptionally well since early 2016 with the stabilization in oil prices and retrenchment by the weaker players. We recently took our remaining high yield positions to zero as we prepare for deterioration in quality of earnings in the US led by lower operating margins. Credit spreads have likely reached a low for this cycle.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Underweight	Real estate investment trusts (REITs) have underperformed global equities since mid-2016 when interest rates bottomed. We think it is still too early to reconsider our underweight zero allocation given the further rise in rates we expect and deteriorating fundamentals for the industry. Non-US REITs should be favored relative to domestic REITs.
Master Limited Partnerships/Energy Infrastructure*	Overweight	Master limited partnerships (MLPs) rebounded sharply from a devastating 2015 but, with oil's slide, performed poorly in 2017. With oil prices recovering again and a more favorable regulatory environment, MLPs should provide a reliable and attractive yield relative to high yield. The Trump presidency should also be supportive for fracking activity and pipeline construction, both of which should lead to an acceleration in dividend growth.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset category can provide uncorrelated exposure to traditional risk-asset markets. It tends to outperform when traditional asset categories are challenged by growth scares and/or interest rate volatility spikes. As volatility becomes more persistent in 2018, these strategies should do better than in recent years.

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

Source: Morgan Stanley Wealth Management GIC as of March 16, 2018

Macro Factor Heat Map Key (see page 7)

	Economic Growth	**Rates**	**Inflation / Deflation**	**Liquidity**	**Sentiment and Risk**	**Valuation**	**Earnings**	**Conclusion**
Dark Blue	Economic growth robust	Steep yield curve	Low-moderate and rising inflation	Liquidity robust in economy / banking system	Shorter-term sentiment and technicals bearish	Risk assets attractively valued	Earnings outlook robust	Confluence of factors supports a risk-on investment approach
Light Blue	Economic growth neutral	Normal yield curve	Low-moderate and declining inflation; moderate inflation; higher and falling inflation	Liquidity neutral in the economy / banking system	Shorter-term sentiment and technicals neutral	Risk assets neutral	Earnings outlook neutral	Confluence of factors supports a neutral investment approach
Gray	Economic growth anemic	Flat/inverted yield curve	Very high/low inflation/deflation; high and rising inflation	Liquidity low in economy / banking system	Shorter-term sentiment and technicals bullish	Risk assets are richly valued	Earnings outlook anemic	Confluence of factors supports a risk-off investment approach
Up	Growth accelerating	Yield curve steepening	Inflation rising	Liquidity increasing	Sentiment becoming more bullish	Valuations rising	Earnings outlook improving	
Down	Growth declining	Yield curve flattening	Inflation falling	Liquidity decreasing	Sentiment becoming more bearish	Valuations falling	Earnings outlook worsening	
Signal Horizon	One to three years	One to three years	One to three years	One to three years	One to three months	Six months to two years	Six months to two years	
Inputs	• 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

Index Definitions

The Business Roundtable CEO Economic Outlook Survey, conducted quarterly since the fourth quarter of 2002, is designed to provide a picture of the future direction of the U.S. economy by asking CEOs to report their plans for their company's sales, capex and employment in the next six months.

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

Hedged Strategy Definitions

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

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

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

Risk Considerations

MLPs

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

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

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

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

Duration

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

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

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing. Certain of these risks may include but are not limited to: Loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices; Lack of liquidity in that there may be no secondary market for a fund; Volatility of returns; Restrictions on transferring interests in a fund; Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized; Absence of information regarding valuations and pricing; Complex tax structures and delays in tax reporting; Less regulation and higher fees than mutual funds; and Risks associated with the operations, personnel, and processes of the manager. All expressions of opinion are subject to change without notice and are not intended to be a forecast of future events or results. Further, opinions regarding Alternative Investments expressed herein may differ from the opinions expressed by Morgan Stanley Wealth Management and/or other businesses/affiliates of Morgan Stanley Wealth Management. This is not a "research report" as defined by FINRA Rule 2241 and was not prepared by the Research Departments of Morgan Stanley Smith Barney LLC or Morgan Stanley & Co. LLC or its affiliates. Certain information contained herein may constitute forward-looking statements. Due to various risks and uncertainties, actual events, results or the performance of a fund may differ materially from those reflected or contemplated in such forward-looking statements. Clients should carefully consider the investment objectives, risks, charges, and expenses of a fund before investing. Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by 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. In Consulting Group's advisory programs, alternative investments are limited to US-registered mutual funds, separate account strategies and exchange-traded funds (ETFs) that seek to pursue alternative investment strategies or returns utilizing publicly traded securities. Investment products in this category may employ various investment strategies and techniques for both hedging and more speculative purposes such as short-selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss. Alternative investments are not suitable for all investors. As a diversified global financial services firm, Morgan Stanley Wealth Management engages in a broad spectrum of activities including financial advisory services, investment management activities, sponsoring and managing private investment funds, engaging in broker-dealer transactions and principal securities, commodities and foreign exchange transactions, research publication, and other activities. In the ordinary course of its business, Morgan Stanley Wealth Management therefore engages in activities where Morgan Stanley Wealth Management's interests may conflict with the interests of its clients, including the private investment funds it manages. Morgan Stanley Wealth Management can give no assurance that conflicts of interest will be resolved in favor of its clients or any such fund. 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.

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.

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

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

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

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

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