The GIC Weekly

LISA SHALETT

Head of Wealth Management
Investment Resources
Head of Investment & Portfolio Strategies
Morgan Stanley Wealth Management

Lisa.Shalett@morganstanley.com
+1 212 296-0335

What We Are Talking About

- **Washington's Woes Are Not Wall Street's.** Higher risk premiums related to political chaos for President Trump should prove short-lived; hope for progrowth policy has been declining since January; a flatter yield curve, falling inflation expectations and record net long positions in long-term US Treasuries confirm skepticism was well entrenched before last week's stock market sell-off; the result of Washington's distractions could be a more gradual path of Fed rate hikes, a weaker US dollar, and/or less Congressional dysfunction; ultimately, the business cycle is likely to extend, reducing odds of a boom/bust scenario; global equity markets will likely go higher, powered by earnings growth; Treasuries appear vulnerable. **Consider** using volatility to rebalance global equity exposure, adding Japan, emerging markets and European financials while lightening up on long-term bonds.

Washington's Woes Are Not Wall Street's

Although politics— and civic life in general— are undeniably important and certainly provide emotional, intellectual and entertainment value, politics has never much mattered to intermediate-term investment returns. As a result, the Global Investment Committee has never advocated investing based on purely political headlines. Our approach is always to draw out what the policy implications of government actions could be for the real economy and for corporate earnings. Through this lens, our bullish view on global equities is unchanged.

One of the maxims of investing is that in the long run, it's fundamentals that matter. In the short run, sentiment rules the day—and sentiment is often influenced by perceptions of stability. While some may grouse that revelations of possible misdeeds by current or former members of the Trump administration demand a higher risk premium, we think this is little more than the punctuation mark on a narrative that has been evolving since Inauguration Day. Although Trump was a volatile personality long before he took office, the Republican majority in Congress has been viewed as providing protective ballast and a shield. That notion and importantly, a global banking system awash in liquidity, have

Upcoming Catalysts

May 22 Chicago Fed National Activity Index
May 23 Markit US Composite PMI
May 23 US new home sales
May 23 Richmond Fed Manufacturing Survey
May 23 Markit EU Composite Index
May 24 FOMC May meeting minutes
May 25 Kansas City Fed Manufacturing Survey
May 25 UK GDP
May 25 Japan CPI
May 26 U. of M. Consumer Sentiment Index
May 26 US durable goods orders
May 26 US first-quarter GDP revision

allowed the VIX to plummet. On May 8, this widely watched measure of stock market volatility hit a cycle low of 9.8%, less than half of its 10-year average. Many strategists pointed to this historically low volatility as a sign of complacency and thus, future risks. In contrast, we argued that the low VIX is not predictive but a reflection of a benign market environment that supported taking risk. Even today, the backdrop of solid global growth, rising earnings, rebounding capital spending and improving labor markets is little changed. Certainly, perceptions of policy stability have been roiled and the probability of aggressive implementation of the Trump agenda is falling. The past week's events in Washington, though shocking and disquieting in the lens of politics, do little to shake our view about economic and earnings stability. We believe that ultimately the fundamentals will help stabilize the market.

As we have been pointing out during the past three months, the so-called "Trump trade"—premised on a Republican majority being able to effectively advance legislation on the Obamacare repeal, tax reform, infrastructure spending and deregulation—began unwinding in January. Financials, small caps and industrials—proxies for the Trump policy themes—have underperformed the broader index and have given back all but about 2% to 3% of their postelection gains (see *Chart of the Week,* page 3). Inflation expectations—as measured by the five-year/five-year forward breakeven rate—and the 30-year US Treasury yield, a key metric for Trump's desired deficit spending, are down 21 and 27 basis points, respectively, in the same period. This echoes the trend in the two-year/10-year US Treasury yield curve, which initially steepened on postelection optimism and has now flattened to its pre-election level. Finally, skepticism about both the business cycle and the likelihood that any fiscal program would be enacted—and/or could have impact this late in cycle—can be seen in the US dollar. The greenback has hit a six-month low despite the Federal Reserve's tightening policy and record net long speculative positioning in US long bond futures, which is effectively a bet on lower interest rates ahead (see *Fixed Income Insight,* page 7). In fact, the market-derived probability of two further rate hikes this year has fallen to 60% today from 80% a week ago. The implication is that the market has already discounted policy failure and any future success on that front would be an upside surprise.

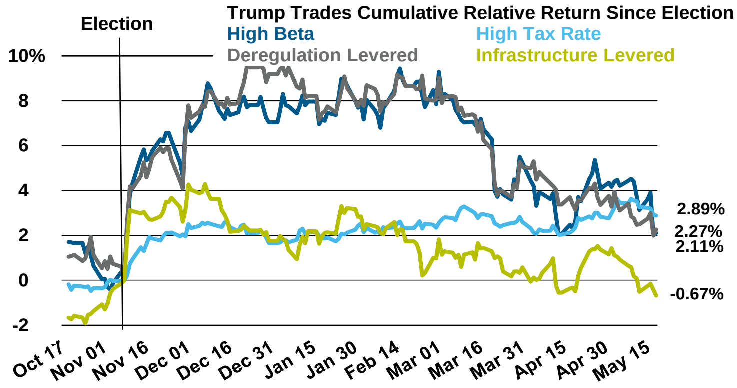
A second factor to consider is the unintended consequences that could come from the derailing of Trump's fiscal stimulus agenda. To wit, one of the risks we flagged in January was that an aggressive fiscal program this late in a business cycle could create a boom that turns to bust. This would be true if Fed policymakers, already intent on an acceleration of their tightening efforts, were to react. With the likelihood of fiscal stimulus now being delayed, the Fed might slow the pace of rate hikes, creating conditions that could allow for an extension of the business cycle. Such policy slowing would likely be reflected in currency markets, where reduced policy divergence would take upward pressure off the US dollar, which in turn supports global commodities like oil which are priced in dollars. A weaker dollar is also supportive of the emerging markets as the weaker greenback provides the foundation for positive capital flows and capital formation. What's more, a combination of a slower Fed and a weaker dollar might produce improved odds of "Goldilocks" inflation—neither too hot nor too cold. That's a scenario that might be better for long-term investment returns than one in which rapid and aggressive deficit spending through unfunded tax cuts causes inflation to spike.

Finally, consider that recent developments in Washington may actually foster a rapprochement after nearly 15 years of extreme partisanship and legislative dysfunction. We have often noted that the populist wave that delivered the surprise election to an inexperienced and brash outsider like Trump was rooted in the extreme anger and frustration of a middle class left behind by globalization, technological assault and wealth concentration, factors that are driving inexorable income inequality. While the Republican majority in Congress was promising progrowth policies that were potentially good for corporate earnings and short-run economic growth, policies proposed thus far do not attack the real structural challenges. Perhaps only through a severe leadership scandal or constitutional crisis will the current fevered partisanship be broken, forged by a new bipartisan political coalition that can put country over party. With the 2018 mid-term elections only 18 months away, such a coalition could yield a refreshing upside surprise.

Bottom Line: Chaos in Washington is discomforting and disappointing but not unexpected by the markets, as the so-called progrowth Trump trade has been fading since Inauguration Day. Defensive positioning reflects growing skepticism. We remain focused on fundamentals that can power earnings and here, the bullish narrative continues to hold. If anything, forces that could have triggered a boom/bust scenario have likely moderated, suggesting odds of a Goldilocks scenario with a slower Fed and weaker dollar fueling upside surprises in the second half of 2017. **Watch** for interest rates, the US dollar and the yield curve to stabilize. **Consider** using volatility to rebalance global equity exposure, adding Japan, emerging markets and European financials while lightening up on long-term bonds. ■

Chart of the Week: Limited Downside for the "Trump Trade"

Last November's surprise election of Donald Trump along with a Republican majority in Congress sparked investor enthusiasm for a progrowth agenda that rewarded beneficiaries of tax reform, infrastructure spending and deregulation. Small caps, industrials and financials were particular sectors that benefitted. But those trades have been fading since January as investors recognized the difficulty of driving aggressive and rapid legislation (see chart). Initial failures such as efforts to repeal and replace Obamacare have become emblematic of the challenges. Clearly, the latest scandals will prove a further distraction and delay any likelihood of quick policy success. However, investors need not panic about downside risks as initial optimism is nearly completely unwound, with stocks most associated with Trump policy positions now within 2% to 3% of their pre-election prices.



Source: FactSet, Morgan Stanley Wealth Management GIC as of May 18, 2017

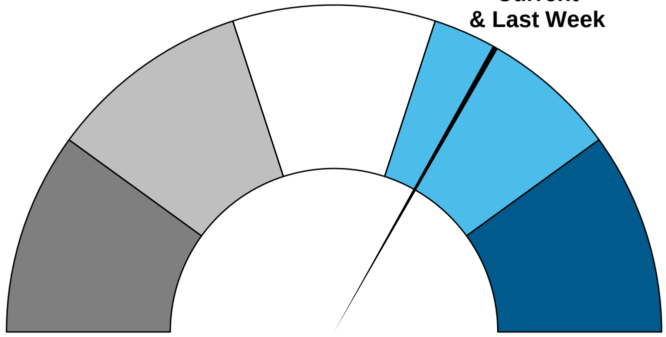
Asset Class Performance and Heat Map (as of May 19, 2017)

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	0.2	0.4	0.3	0.2	0.1	0.6	2.1	0.82	0.82	2.07	0.02	0.61	0.31	-0.02
Global Equities								**Current Div. Yld.**	**Current P/E**	**Avg. P/E[2]**				
US Large-Cap Growth	13.3	22.4	6.5	13.1	14.4	9.3	7.1	1.28	20.6	21.4	8.7	17.8	0.80	0.89
US Large-Cap Value	2.4	16.8	16.3	8.3	12.8	5.3	7.3	2.87	15.7	13.9	8.7	14.4	0.93	0.89
US Mid-Cap Growth	8.3	16.7	6.4	8.6	12.2	7.3	8.1	0.84	22.0	26.7	10.2	23.5	0.85	0.81
US Mid-Cap Value	3.6	21.0	20.9	9.6	14.6	6.9	10.1	2.53	16.1	14.3	10.5	16.5	0.88	0.87
US Small-Cap Growth	6.3	24.3	14.0	8.8	13.1	8.9	10.5	0.66	27.4	23.9	12.1	22.4	0.79	0.83
US Small-Cap Value	-0.1	22.9	25.8	9.5	13.9	8.1	10.5	2.34	20.1	17.0	12.8	17.5	0.80	0.84
Europe Equity	16.9	21.6	0.2	-0.6	7.5	1.0	6.1	3.27	15.2	14.9	15.3	18.4	0.83	0.94
Japan Equity	7.5	16.5	2.7	7.7	8.0	1.1	2.3	2.05	14.1	21.3	11.9	17.6	-0.03	0.69
Asia Pacific ex Japan Equity	10.6	20.3	8.0	1.7	5.2	4.2	6.5	3.64	15.1	14.9	8.4	21.7	0.53	0.85
Emerging Markets	16.1	30.8	11.6	2.2	1.9	2.8	6.0	2.42	12.0	11.6	11.2	23.8	0.62	0.86
Global Fixed Income								**Current YTM**	**Current Spread**	**Avg. Spread[2]**				
Short-Term Fixed Income	0.7	1.0	1.3	1.0	0.9	2.3	3.7	1.49	18.0	31.0	0.7	1.4	-0.52	-0.12
US Fixed Income	2.0	1.4	2.6	2.7	2.3	4.3	5.3	2.50	42.0	55.0	3.1	3.4	-0.53	-0.03
International Fixed Income	5.2	-0.4	1.8	-2.0	-0.7	2.8	4.2	0.99	43.0	50.0	5.4	8.1	-0.01	0.29
Inflation-Protected Securities	4.5	5.6	6.5	0.6	0.8	3.9	6.5	-	-	-	6.7	7.6	0.06	0.43
High Yield	5.7	13.0	14.3	3.9	6.7	7.4	8.0	5.65	374.0	513.0	2.5	10.2	0.66	0.76
Emerging Markets Fixed. Inc.	8.7	11.2	9.9	-2.6	-1.6	3.9	7.4	6.44	254.0	357.0	9.8	13.2	0.53	0.68
Alternative Investments								**Current Div. Yld.**						
REITs	5.1	7.4	4.6	5.4	7.5	1.6	7.6	3.78	-	-	6.6	18.5	0.24	0.79
MLP/Energy Infrastructure[3]	1.2	10.3	18.3	-6.9	1.9	6.4	-	5.94	-	-	17.6	18.5	0.58	0.56
Commodities ex Prec. Metals	-4.7	0.6	11.6	-17.5	-10.4	-8.2	-0.9	-	-	-	12.0	17.1	0.18	0.42
Precious Metals	7.5	-0.8	9.5	-2.1	-7.4	4.8	6.7	-	-	-	11.6	19.4	-0.27	0.20
Hedged Strategies[4]	1.9	6.6	2.5	0.0	1.4	-0.7	-	-	-	-	2.1	6.1	0.83	0.64
Managed Futures[5]	-1.5	-2.9	-2.9	0.3	-0.5	-0.9	-	-	-	-	3.7	7.9	0.51	0.17
S&P 500	7.2	19.2	12.0	10.5	13.7	7.2	7.6	1.94	17.3	17.2	8.62	15.2	0.90	0.95
Russell 2000	1.2	26.7	21.3	9.0	12.9	7.0	8.7	1.51	23.3	20.9	14.09	20.0	0.79	0.82
MSCI EAFE	13.8	20.0	1.5	1.3	7.3	1.3	5.1	3.03	14.9	15.8	10.09	16.9	0.85	0.96
MSCI AC World	10.2	20.5	8.5	5.9	9.6	4.3	6.4	2.41	15.7	15.7	7.96	15.8	1.00	1.00

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

Note: Performance values calculated using USD. 1. As of April 28, 2017. 2. 20-year average as of April 28, 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.

Short-Term Stock and Bond Indicator



	Macro		Policy		Fundamentals		Sentiment and Technicals	
	Growth	Inflation	Rates	Liquidity	Valuation & Market	Earnings	Sentiment	Technicals
Current	Neutral	Neutral	Very Positive	Neutral	Neutral	Neutral	Neutral	Neutral
Last Week	Neutral	Neutral	Neutral	Very Positive	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	-0.58	-2.11
Durable Goods (+)	Growth	Neutral	0.27	0.03
Retail Sales (+)	Growth	Neutral	0.17	0.46
Manufacturing Hours Worked (+)	Growth	Neutral	-0.11	0.02
Commodity Prices (+)	Inflation	Neutral and Rising	0.59	1.98
Yield Curve: 10-Yr./Three-Mo.(-)	Rates	Low and Falling	1.92	1.81
Yield Curve: Two-Yr./Three-Mo.(-)	Rates	Neutral and Falling	0.22	1.39
Pace of Interest Rate Hikes (-)	Rates	Low and Falling	1.65	0.69
Term Premium Model (-)	Rates	Short Duration	-	-
High Yield Spreads (-)	Liquidity	Neutral and Rising	0.43	-0.82
Investment Grade Spreads (-)	Liquidity	Neutral and Rising	0.72	-0.65
Financial Conditions (-)	Liquidity	Neutral	-0.12	0.05
S&P 500 Earnings/Baa Yield (+)	Valuation & Market Behavior	Low and Rising	-1.48	0.82
Large vs. Small Performance (-)	Valuation & Market Behavior	Neutral	-0.33	-0.22
High- vs. Low-Quality Performance (-)	Valuation & Market Behavior	Neutral	0.47	0.38
High- vs. Low-Beta Performance (+)	Valuation & Market Behavior	Neutral and Falling	-0.04	-0.72
S&P 500 Forward Price/Earnings Ratio (+)	Valuation & Market Behavior	Neutral and Falling	0.11	-0.64
Earnings Revisions Breadth (-)	Earnings	-	-	-
Global Risk Demand (+)	Sentiment	Neutral and Falling	-0.11	-1.66
Implied Currency Volatility (-)	Sentiment	Low and Rising	1.66	-1.61
Five-Yr. Macro Sensitivity (-)	Sentiment	High and Rising	-1.36	-0.91
% Stocks Above 200-Day Moving Avg. (+)	Technicals	Neutral and Falling	-0.89	-0.58
Cumulative Advance/Decline (+)	Technicals	Neutral and Falling	-0.28	-0.67
S&P 500 Put/Call Ratio (-)	Technicals	Neutral and Rising	-0.07	-0.80
Emerging Market Fund Flows (+)	Technicals	Neutral	0.52	0.13
Smart Money Flow Index (+)	Technicals	Neutral	0.13	-0.07

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

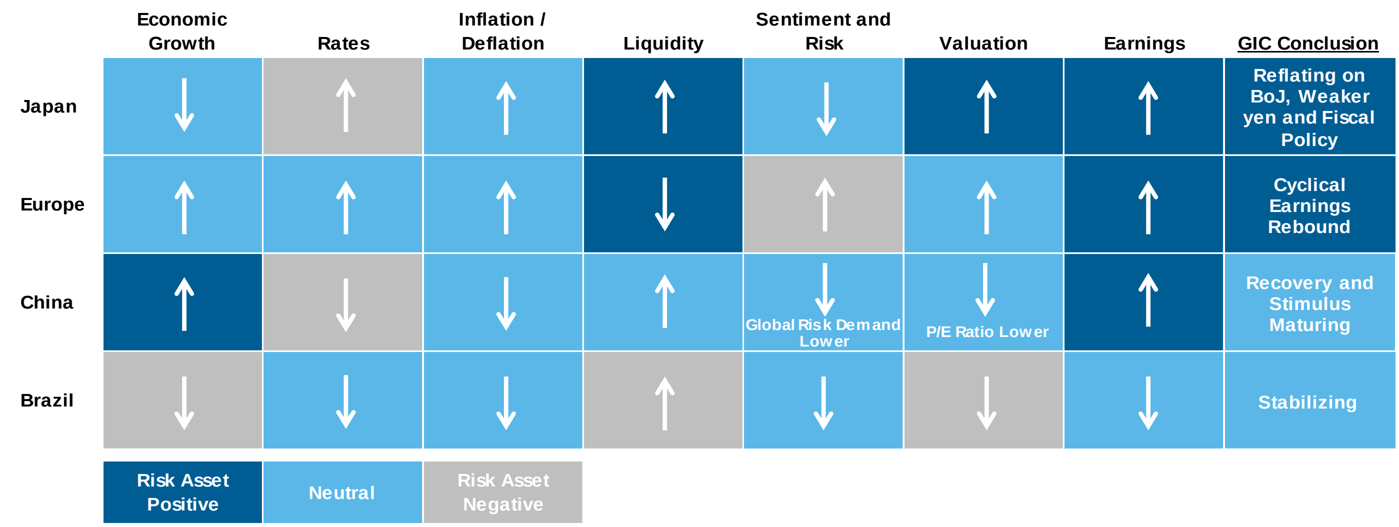
Note: Commodity prices are represented by the Bloomberg Commodity Index; pace of interest rate hikes by the Morgan Stanley Pace of Rate Hikes Index; high yield spreads by the Bloomberg Barclays Aggregate US High Yield Index; investment grade spreads by the Bloomberg Barclays US Aggregate Index; financial 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 May 19, 2017

Morgan Stanley & Co. Forecasts (as of May 19, 2017)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2016E	2017E	2018E	Q2 ’17E	Q4 ’17E	2016E	2017E	2018E	Q2 ’17E	Q4 ’17E	Q2 ’18E
Global	3.1	3.5	3.7			2.5	2.9	2.8			
US	1.6	2.0	2.0	2.50	2.50	1.3	2.5	2.1			
Euro Zone	1.7	1.8	1.7			0.2	1.7	1.4	1.01	0.97	1.02
UK	1.8	1.8	1.1	1.40	1.25	0.7	2.7	2.6	1.26	1.28	1.30
Japan	1.0	1.3	0.9	0.00	0.20	-0.1	0.9	1.7	115	120	125
Emerging Markets	4.2	4.7	5.0			3.9	3.6	3.5			
China	6.7	6.4	6.2	2.95	2.80	2.0	2.3	2.2	7.00	7.10	7.17

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of May 19, 2017)



Note: Text in a factor box denotes a color change; In China, Sentiment and Risk moved to risk asset neutral from risk asset negative as the Global Risk Demand Index declined. Valuations also moved to risk asset neutral from negative as valuations measured by the price to earnings ratio decreased; for further explanation of the chart, see page 9.

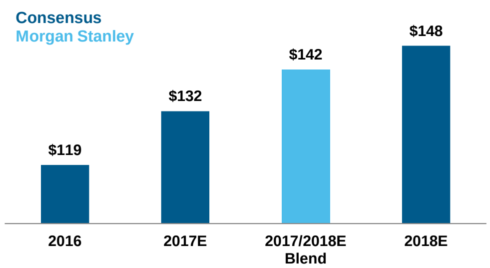
Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending May 19, 2017)

	Positives	Negatives
Global Growth	• May NAHB Housing Market Index beat expectations • May Philly Fed survey more than doubled forecast • US industrial production surged 1.0% month over month in April versus 0.4% estimate • Euro Zone first-quarter GDP up 1.7% year over year, in line with expectations • First-quarter Japan GDP accelerated 2.2% year over year for fifth straight quarterly gain • Japan machine tool orders continued upward trend in April	• May Empire State Manufacturing Survey had surprise miss of -1.0 vs. 7.5 expectation • April US housing starts below expectations at 1.17 million units, • US leading indicators up 0.3% in April, below expectations
Rates	• Mexico raised interest rates 25 basis points to 6.75%	
Inflation	• April Euro Zone CPI up 1.9% year over year in line with expectations • April UK CPI up 2.7% year over year • Germany PPI up 3.4% in April, highest in six years	
Sentiment	• Oil rallied off Saudi Arabia and Russia talks of extending production cuts	• S&P 500 posted worst trading day of 2017, down nearly 2%, triggered by headlines out of Washington • Political chaos in Brazil roiled emerging markets

Source: Morgan Stanley Wealth Management GIC

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of May 19, 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	25.9%
Base Case	142.00	19.0	2,700	13.4%
Bear Case	126.50	16.6	2,100	-11.8%
	Current S&P 500 Price		2,3821	

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

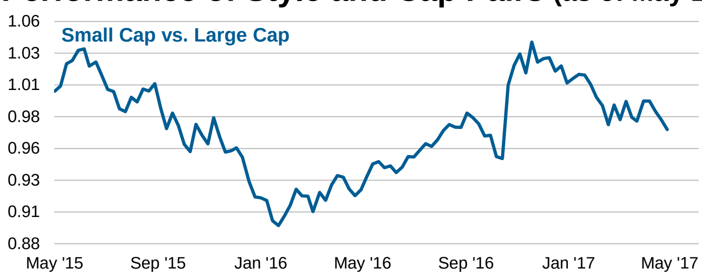
S&P 500 Sector Performance and Valuation (as of May 19, 2017)

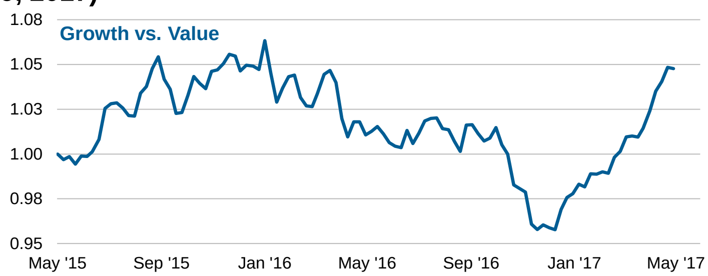
Index Name	Total Return WTD (%)	Total Return YTD (%)	Total Return 1-Year (%)	Dividend Yield (%)	Beta	20-Year Avg. Forward 12-Mo. PE	Forward 12-Mo. P/E*
S&P 500	***-0.32***	***7.24***	***19.24***	***1.94***		***17.2***	***17.3***
Energy	0.40	-9.05	4.43	2.82	1.16	17.9	**27.1**
Materials	-0.42	5.92	16.46	2.07	1.13	16.5	**17.6**
Industrials	-0.13	6.09	22.14	2.06	1.09	17.5	**17.4**
Consumer Discretionary	-0.75	10.05	17.65	1.38	0.96	19.4	**19.3**
Consumer Staples	0.68	7.79	8.82	2.60	0.59	19.8	**20.1**
Health Care	-0.34	9.37	10.54	1.66	0.91	18.7	**15.6**
Financials	-0.99	0.69	27.07	1.69	1.36	13.2	**13.2**
Information Technology	-0.63	17.71	37.27	1.30	1.09	22.4	**18.3**
Telecommunication Services	-0.65	-9.42	0.20	5.00	0.59	17.8	**12.7**
Utilities	0.64	8.03	11.96	3.40	0.38	14.6	**17.7**
Real Estate	1.35	4.11	6.30	3.34	0.64	15.2	**17.7**

*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 May 19, 2017)

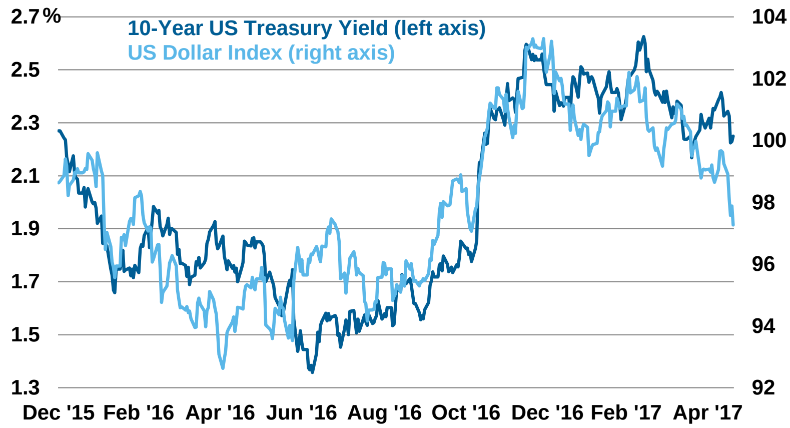




Source: Morgan Stanley & Co. Small Cap is represented by the Russell 2000 Index; Large Cap represented by the Russell 1000 Index; Growth represented by the Russell 1000 Growth Index; Value represented by the Russell 1000 Value Index.Cyclicals and Defensives, and Quality and Junk are based on Morgan Stanley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

Fixed Income Insight: A Refreshing Pause for Interest Rates and the Dollar

Risk-off positioning following the revelation of further investigations into President Trump and his administration has accelerated the downside for the US dollar and weakness in Treasury yields (see chart). The most recent moves are likely driven by sentiment and perceptions about risk. Against a backdrop in which economic growth is accelerating, earnings are growing by double digits and the Federal Reserve is poised to raise rates, these moves may actually help extend the business cycle by sustaining stimulative financial conditions. Beyond the direct economic benefits, we see secondary support for the reflation thesis coming from the emerging markets and from commodity- and import-driven inflation.



Source: Bloomberg as of May 19, 2017

Government Debt Monitor

US				
	Yield (%)			Total Return (%)
Treasury Benchmark	**Current**	**ΔWTD**	**ΔYTD**	**YTD**
3-Month	0.90	0.04	0.41	0.17
2-Year	1.27	-0.02	0.08	0.39
5-Year	1.78	-0.07	-0.15	1.42
10-Year	2.23	-0.09	-0.21	2.35
30-Year	2.90	-0.09	-0.17	3.86
2-Yr./10-Yr. Spread (bp)	96	-7.10	-29.17	-
10-Yr. TIPS Breakeven (bp)	185	-1.67	-12.31	-
Interest Rate Volatility† (bp)	58	2.11	-13.80	-

Fixed Income Spread Dashboard

		Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	OAS Range** Rich	OAS Range** Cheap
Investment Grade	MBS*	4.53	2.75	23	3	35
Investment Grade	AAA	4.40	1.93	29	19	44
Investment Grade	AA	5.49	2.21	13	6	18
Investment Grade	A	7.46	2.92	91	89	158
Investment Grade	BBB	7.29	3.49	145	143	295
High Yield	BB	4.32	4.44	273	264	662
High Yield	B	3.73	5.88	416	386	1,009
High Yield	CCC	2.86	10.48	961	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. © 2017 Citigroup Index LLC. All rights reserved. Data as of May 19, 2017

Government Debt Monitor

Global				
	Yield (%)			Total Return (%)*
10-Year Govt. Bond	**Current**	**ΔWTD**	**ΔYTD**	**YTD**
France	0.80	-0.04	0.12	0.46
Germany	0.37	-0.02	0.16	-0.16
Japan	0.04	0.00	-0.01	0.68
Spain	1.56	-0.05	0.18	1.21
UK	1.09	0.01	-0.14	2.24
3-Month LIBOR	1.17	-0.01	0.17	-
US Tax Exempt				
10-Year AAA Muni	2.01	-0.10	-0.30	3.25
10-Yr. Muni/UST Ratio	89.61	-0.99	-5.02	-

Benchmark Returns

	Total Returns (%)		
Index	**YTD**	**MTD**	**2016**
Bloomberg Barclays US Aggregate	2.05	0.44	2.65
Bloomberg Barclays US MBS	1.45	0.32	1.67
Bloomberg Barclays US IG Corporate	3.07	0.75	6.11
Bloomberg Barclays Municipal	3.25	0.92	0.25
Bloomberg Barclays US High Yield	4.35	0.45	17.13
Bloomberg Barclays Global Aggregate	3.96	1.02	2.09
JPMorgan Emerging Market	5.89	0.28	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 May 19, 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 May19, 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. 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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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