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

- **Lower for How Much Longer?** Accelerating inflation, better-than-expected growth and progress toward central bank policy normalization were shrugged off by the rate markets this week, leaving yields below their mid-May peaks; despite the Fed's hawkish guidance, the efforts by politicians to stir up controversy and tightening financial conditions, investors remain focused on the fact that while uncertainty over monetary policy may have fallen, skepticism as to the sustainability of current trends has risen, thus keeping a lid on yields; yet again, as has been the case for the past nine years, investors appear to be questioning the Fed's projections, suggesting that the peak in cycle rates—or the neutral rate—is much lower than official forecasts and that a policy mistake is in the offing; with US rates anchored by those in Europe, China and Japan, "lower for longer" will persist; meanwhile, inflation, growth and US deficits are likely being underestimated. **Consider** sticking with cash and short-duration Treasuries and municipals, as it's still too early to add term length to a complacent market.

Upcoming Catalysts

June 19 US housing starts
June 19 US building permits
June 20 US current account balance
June 20 US existing home sales
June 21 Philadelphia Fed Survey
June 21 FHFA House Price Index
June 21 US Leading Economic Index
June 21 Euro Zone consumer confidence
June 21 Japan CPI
June 21 Japan Manufacturing PMI
June 22 US Markit Manufacturing PMI
June 22 US Markit Services PMI
June 22 Euro Zone Manufacturing PMI
June 22 Euro Zone Services PMI

Lower for How Much Longer?

This week brought a material dose of clarity to global rates markets, with the Federal Reserve raising rates by 25 basis points as expected and communicating its intent to hike a total of four times in 2018 (instead of the currently discounted three times), and with the European Central Bank (ECB) extending its Quantitative Easing taper into the fourth quarter, while committing itself to holding off on rate hikes until mid-2019. This combination of a more hawkish Fed and a more dovish ECB was greeted with a shrug from the rates markets, where yields basically held steady, well below their mid-May highs. A number of factors seem to be at play here as investors dismissed the Fed's new guidance. First, there is the belief that extending the Quantitative Easing taper and pushing out ECB rate hikes to the middle of 2019 will anchor US yields. Second is the thesis that this policy divergence will result in a stronger US dollar, creating a headwind for financial conditions and US stocks while helping to mute recent growth and inflation trends, thus explaining why the two-year/10-year US yield curve has compressed to a cycle low of 38 basis points. Indeed, following the ECB announcement, the euro weakened from about $1.18, falling back to its six-month lows of $1.15. And finally, there is the view that the Fed once again remains overly optimistic in its assessment of the neutral rate, currently estimated at 2.875%, and ultimately will be forced to roll back on its plans for another four to five rate hikes before the end of 2019.

While the Global Investment Committee understands such views, we don't believe they reflect a balanced assessment of current conditions, which include accelerating inflation trends that may prove sticky, rising deficits in the US that could weigh on Treasury issuance and cost of capital and the possibility that real growth in the US economy will exceed the 80-to-90 basis points that is currently being discounted.

To begin with, we are not sure that the market has priced in inflation expectations correctly, having made an assumption that the Fed is prepared to let prices "run hot." While easy comparisons to a year ago—so-called base effects—undoubtedly may account for some of the pickup in standard inflation metrics, our reading of the data is that price acceleration throughout the economy is broad-based and could prove to be lasting, rather than peaking in the next two to three months, as the current consensus forecasts. The May consumer price index (CPI) delivered a 2.8% year-over-year headline reading, up from 2.5% in April, thus marking the highest measure in six years. Excluding food and energy, core CPI rose at a 2.2% clip, nearly the highest rate seen in the past nine years.

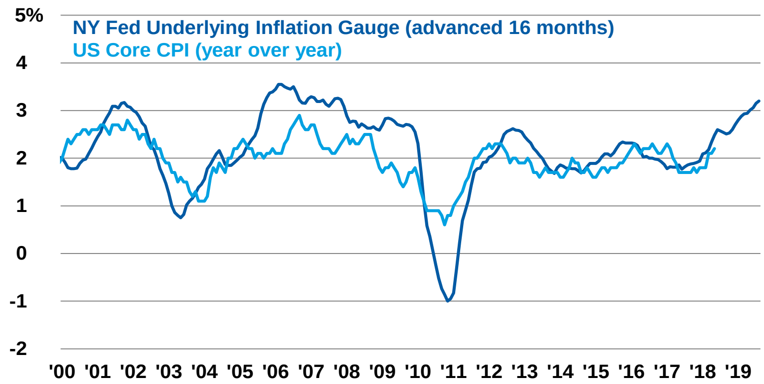
Of critical importance is not only the possibility that energy price increases will prove to be more long-lasting than is currently believed, but that the recent price jumps in Medicare health receipts and prescription drug prices, which yielded downside surprises last year as Obamacare benefits matured, will persist as that program is dismantled. (See the report, "Business Conditions: Mixed Messages," June 11.) These metrics were echoed in the "trends up" as reflected in the producer price index, which was up 3.1% versus last year. Survey-based price-trend data is also showing signs of a steady rise in inflation, with input and output prices from the Markit PMI at a seven-year high, ISM services prices at the highest level in five years and the share of small businesses that plan to raise prices at a 10-year high, according to the NFIB Small Business Optimism Index survey. Most importantly, the New York Federal Reserve's Underlying Inflation Gauge, one of the most powerful forward predictors of inflation trends, moved to an 11½-year high, which is of significance because, as David Rosenberg of Gluskin Sheff noted, this gauge leads actual core CPI by 16 months, with a 76% correlation (see *Chart of the Week*, page 3). None of this even begins to take into consideration the potential fallout from trade wars and tariffs, which are unequivocally inflationary.

Besides complacency on the inflation outlook, we are not sure that the US dollar strengthening narrative is rock solid either. As we pointed out previously (echoing Morgan Stanley & Co. currency strategist Hans Redeker), the US dollar has shown only limited correlation to relative growth, relative yield differentials and policy divergences that have persisted since the greenback peaked back in February 2017. Despite the huge growth stimulus coming out of the tax reform bill, the trade-weighted dollar as measured by the US Dollar Index is still below its year-to-date high of 94.8, and is 3.5% below its 52-week high of 97.8. This is taking place against a backdrop where two-year Treasury yields are up over 100 basis points. We believe the tug of war on the dollar is about more than the Fed. Essentially, the central bank is hitting the brakes just as they are running off the balance sheet (forecast at $600 billion in the next 12 months), while the US Treasury is set to finance an exploding deficit and rising debt, upping net issuance by more than $400 billion over the same period, against a backdrop of rising trade deficits. These twin deficits and Fed balance sheet actions may raise the cost of capital and weigh on dollar demand.

Bottom Line: After nine years of walking a tightrope of accommodation, central bankers are taking steps to solidify a policy of rate normalization. In the US and Europe, monetary authorities have declared victory on deflation, suggesting that economic healing is on a self-sustaining path. Despite this confidence, investors remain complacent, anchoring longer-duration yields in the belief that growth and inflation trends will prove unsustainable and that the slow pace of the ECB will ultimately put a lid on US Treasury yields, along with promoting a stronger US dollar. We are less convinced that the Fed guidance is wrong and thus believe bond market volatility will remain high. Inflation, real growth potential and US twin deficits are being underpriced as risks, and it is too soon to add duration on a risk-adjusted return basis. **Watch** the 10-year Treasury in timing the yield-curve inversion, as we think odds are even that one more surge over 3% is possible before rates roll over for good. **Consider** sticking with cash and short-duration Treasuries and municipals, as it is still too early to add term length in a complacent market. ■

Chart of the Week: Inflation Pressures May Not Fade

Current Treasury market pricing suggests stable inflation trends, in line with consensus thinking that CPI metrics will peak over the next two to three months. We, however, are less sanguine. We note that the drivers of inflation captured by the New York Federal Reserve Underlying Inflation Gauge have firmed strongly; this index tends to lead core CPI by 16 months, and points to an inflation reading of more than 3% in 2019. Moreover, the critical dynamics of rising energy and healthcare prices are not likely to fade, but instead should feed the inflationary dynamic. Adding fuel to the fire of prices rising is the possibility of trade wars, which are unequivocally inflationary. All of these pressures pose serious risks for long- duration bonds.



Source: Bloomberg as of May 31, 2018

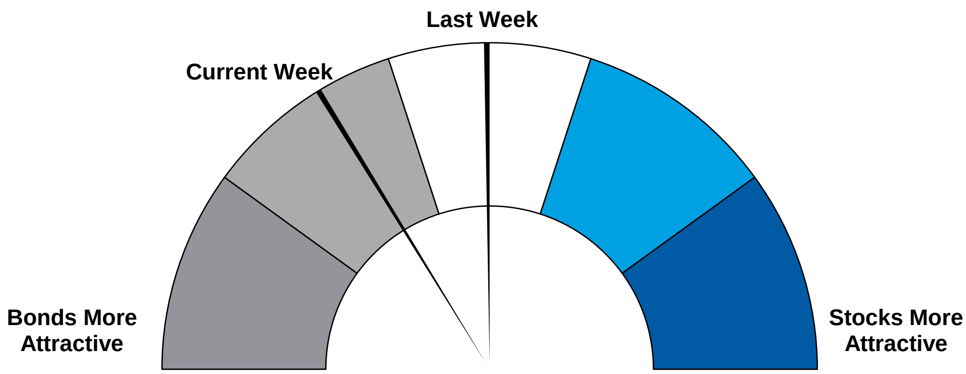
Asset Class Performance and Heat Map (as of June 15, 2018)

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	0.7	1.3	0.8	0.6	0.4	0.3	1.9	1.95	1.95	1.87	0.07	0.58	-0.05	-0.05
Global Equities								**Current Div. Yld.**	**Current P/E**	**Avg. P/E[2]**				
US Large-Cap Growth	11.3	25.9	30.2	14.2	16.5	11.1	6.3	1.12	21.1	21.2	9.5	17.5	0.82	0.89
US Large-Cap Value	-0.8	8.2	15.1	8.1	9.9	7.2	6.0	2.95	13.9	13.9	10.0	14.2	0.84	0.89
US Mid-Cap Growth	9.8	21.6	22.0	8.9	12.1	8.8	7.6	0.70	20.8	26.7	9.6	23.2	0.70	0.81
US Mid-Cap Value	0.5	9.6	17.0	8.9	11.6	9.6	8.8	2.71	15.0	14.4	8.4	16.3	0.77	0.87
US Small-Cap Growth	11.9	27.0	23.4	11.3	13.7	10.9	9.9	0.57	27.0	24.0	9.0	21.9	0.58	0.83
US Small-Cap Value	5.0	14.0	11.5	10.1	11.5	10.6	9.3	2.41	18.0	17.1	8.3	17.3	0.66	0.84
Europe Equity	-1.0	8.4	26.2	4.0	5.9	2.1	4.6	3.45	14.0	14.2	13.7	18.1	0.84	0.94
Japan Equity	1.5	14.6	24.4	6.9	8.6	3.3	4.3	2.10	13.3	20.1	9.9	16.9	-0.07	0.71
Asia Pacific ex Japan Equity	-1.3	10.0	26.0	5.9	5.2	4.2	9.4	3.76	15.1	14.4	11.1	20.4	0.49	0.87
Emerging Markets	-3.0	13.9	37.8	6.6	4.9	2.0	8.5	2.44	11.7	11.3	12.5	23.0	0.57	0.87
Global Fixed Income								**Current YTM**	**Current Spread**	**Avg. Spread[2]**				
Short-Term Fixed Income	-0.1	0.1	0.8	0.7	0.8	1.7	3.3	2.75	17.0	31.0	1.4	1.4	-0.71	-0.15
US Fixed Income	-1.9	-1.1	3.5	1.4	2.0	3.7	4.7	3.33	43.0	55.0	4.4	3.4	-0.61	-0.05
International Fixed Income	-1.6	2.3	9.8	3.3	1.0	2.0	4.1	1.24	46.0	49.0	4.5	8.1	0.27	0.31
Inflation-Protected Securities	-3.1	2.1	9.0	2.3	1.2	2.6	5.8	-	-	-	4.6	7.7	0.11	0.44
High Yield	-2.0	1.8	10.4	5.3	4.6	7.7	7.5	6.37	384.0	514.0	2.5	10.1	0.72	0.76
Emerging Markets Fixed. Inc.	-6.4	-2.5	15.2	2.5	-1.7	2.7	7.1	6.65	278.0	344.5	9.1	13.1	0.54	0.67
Alternative Investments								**Current Div. Yld.**						
REITs	0.0	5.6	15.0	5.3	5.9	4.1	8.6	3.94	-	-	8.4	18.0	0.61	0.80
MLP/Energy Infrastructure[3]	-0.9	-0.6	-6.5	-8.1	-3.2	6.1	-	7.79	-	-	16.7	18.5	0.45	0.55
Commodities ex Prec. Metals	0.9	11.8	0.2	-3.8	-7.5	-9.4	0.6	-	-	-	9.4	17.0	0.15	0.44
Precious Metals	-3.1	0.2	10.9	1.3	-3.2	2.3	6.9	-	-	-	13.5	19.2	0.40	0.20
Hedged Strategies[4]	-0.1	3.4	6.0	0.5	1.1	-0.5	-	-	-	-	2.6	6.0	0.61	0.64
Managed Futures[5]	-1.3	1.3	2.5	-1.9	-0.1	-2.2	-	-	-	-	7.2	7.9	0.11	0.18
S&P 500	4.9	16.5	21.8	11.0	13.0	9.1	6.6	1.80	16.6	16.0	9.17	14.9	0.87	0.95
Russell 2000	10.3	20.9	14.6	11.0	12.2	9.6	8.0	1.13	25.9	20.4	8.91	19.8	0.55	0.82
MSCI EAFE	-0.4	10.0	25.6	4.8	6.4	2.6	4.9	3.15	13.9	15.0	9.59	16.6	0.81	0.96
MSCI AC World	2.1	14.0	24.6	8.1	9.5	5.5	6.0	2.41	15.0	15.5	7.78	15.5	1.00	1.00

Note: Performance values calculated using USD. 1. As of May 31, 2018. 2. 20-year average as of May 31, 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.

Cheap	**Low**	**Low**
Moderate	**High**	**High**
Expensive		

Short-Term Stock and Bond Indicator



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

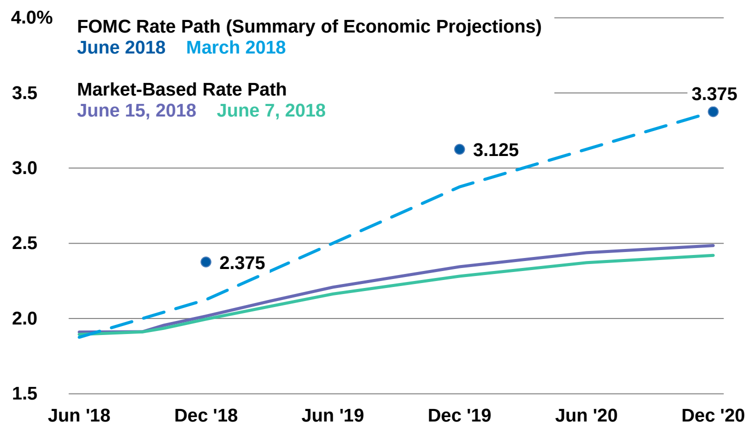
Indicator	Category	Reading
PMI (+)	Growth	Neutral
Durable Goods (+)		Neutral
Retail Sales (+)		Risk On
Manufacturing Hours Worked (+)		Neutral
Commodity Prices (+)	Inflation	Neutral
Yield Curve: 10-Yr./Three-Mo.(-)	Rates	Risk On
Yield Curve: Two-Yr./Three-Mo.(-)		Risk Off
Pace of Interest Rate Hikes (-)		Neutral
Term Premium Model (-)		Risk On
High Yield Spreads (-)	Liquidity	Neutral
Investment Grade Spreads (-)		Neutral
Financial Conditions (-)		Neutral
S&P 500 Earnings/Baa Yield (+)	Valuation & Market Behavior	Risk Off
Large vs. Small Performance (-)		Neutral
High- vs. Low-Quality Performance (-)		Neutral
High- vs. Low-Beta Performance (+)		Neutral
S&P 500 Forward Price/Earnings Ratio (+)		Neutral
Earnings Revisions Breadth (-)	Earnings	Risk Off
Global Risk Demand (+)	Sentiment	Neutral
Implied Currency Volatility (-)		Neutral
Five-Yr. Macro Sensitivity (-)		Neutral
% Stocks Above 200-Day Moving Avg. (+)	Technicals	Neutral
Cumulative Advance/Decline (+)		Neutral
S&P 500 Put/Call Ratio (-)		Risk On
Emerging Market Fund Flows (+)		Neutral
Smart Money Flow Index (+)		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 June 15, 2018

Fixed Income Insight: Market Still Doubts the Fed

The Federal Reserve raised rates for the seventh time this week, lifting its key lending rate by 25 basis points, to 1.75%. The central bank also provided a more hawkish guidance, saying that there would be two more rate hikes before the end of the year, instead of just one, and that there could be another three rate increases in 2019. As has been the case throughout the cycle, the market is looking through the current hawkish forecast, assuming that some combination of a stronger US dollar, weaker growth and disappointing inflation will either cause the Fed to hit the pause button or else make a policy mistake that will lead to a recession. We are more sanguine, given the Fed's pristine navigation in this cycle. Moreover, fiscal stimulus supports the higher terminal rate.



Source: Bloomberg as of June 15, 2018

Government Debt Monitor

	US			
	Yield (%)			Total Return (%)
Treasury Benchmark	**Current**	**ΔWTD**	**ΔYTD**	**YTD**
3-Month	1.92	0.01	0.54	0.71
2-Year	2.55	0.05	0.66	-0.12
5-Year	2.80	0.01	0.59	-1.54
10-Year	2.92	-0.03	0.52	-3.39
30-Year	3.05	-0.04	0.31	-4.73
2-Yr./10-Yr. Spread (bp)	37	-7.50	-14.90	-
10-Yr. TIPS Breakeven (bp)	213	0.03	14.51	-
Interest Rate Volatility† (bp)	53	-6.49	6.48	-

Fixed Income Spread Dashboard

		Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	Rich		Cheap
Investment Grade	MBS*	5.17	3.49	32	9		35
	AAA	4.34	2.97	27	18		42
	AA	5.67	3.07	15	8		18
	A	7.30	3.76	93	68		125
	BBB	7.22	4.38	154	115		214
High Yield	BB	4.44	5.30	252	212		476
	B	3.75	6.51	364	333		710
	CCC	3.30	10.11	751	728		1,366

OAS Range**

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. © 2018 FTSE Index LLC. All rights reserved. Data as of June 15, 2018

Government Debt Monitor

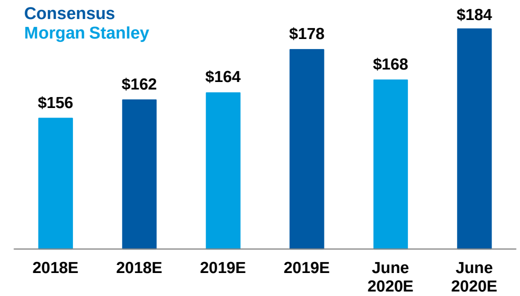
	Global			
	Yield (%)			Total Return (%)*
10-Year Govt. Bond	**Current**	**ΔWTD**	**ΔYTD**	**YTD**
France	0.73	-0.08	-0.05	1.83
Germany	0.40	-0.05	-0.02	1.88
Japan	0.03	-0.01	-0.01	1.20
Spain	1.29	-0.17	-0.27	3.86
UK	1.33	-0.06	0.14	0.02
3-Month LIBOR	2.33	0.00	0.63	-
US Tax Exempt				
10-Year AAA Muni	2.49	0.02	0.51	-0.49
10-Yr. Muni/UST Ratio	84.96	1.33	2.70	-

Benchmark Returns

	Total Returns (%)		
Index	**YTD**	**MTD**	**2017**
Bloomberg Barclays US Aggregate	-1.94	-0.45	3.54
Bloomberg Barclays US MBS	-1.39	-0.39	2.47
Bloomberg Barclays US IG Corporate	-3.20	-0.51	6.42
Bloomberg Barclays Municipal	-0.49	-0.15	5.45
Bloomberg Barclays US High Yield	0.73	0.98	7.50
Bloomberg Barclays Global Aggregate	-1.71	-0.70	7.39
JPMorgan Emerging Market	-5.36	-1.14	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 June 15, 2018

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of June 15, 2018

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

Landscape	Earnings	Price/Earnings Multiple	Price Target	Upside / Downside
Bull Case	$176	17.5	3,000	7.9%
Base Case	$168	16.5	2,750	-1.1%
Bear Case	$160	15.5	2,400	-13.7%
	Current S&P 500 Price		2,780	

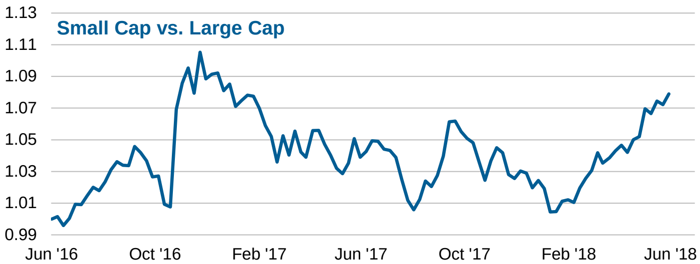
Note: Price targets use forward 12-month earnings estimate
Source: Thomson Reuters, Morgan Stanley & Co. Research as of June 15, 2018

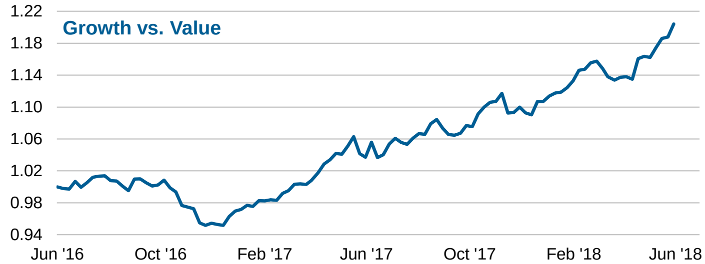
S&P 500 Sector Performance and Valuation (as of June 15, 2018)

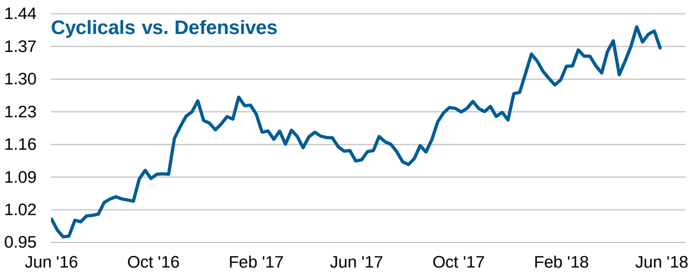
Index Name	Total Return			Dividend Yield (%)	Beta	20-Year Avg. Forward 12-Mo. PE	Forward 12-Mo. P/E*
	WTD (%)	YTD (%)	1-Year (%)				
S&P 500	***0.07***	***4.92***	***16.28***	***1.80***		***15.9***	***16.6***
Energy	-3.08	4.14	16.48	2.67	0.90	17.6	**17.7**
Materials	-1.34	-0.30	12.09	1.94	1.04	13.9	**15.9**
Industrials	-1.34	-0.04	10.44	1.89	1.01	16.2	**16.6**
Consumer Discretionary	2.27	14.44	25.59	1.16	0.96	18.0	**20.9**
Consumer Staples	2.11	-8.49	-6.73	3.12	0.65	16.9	**17.2**
Health Care	0.86	4.35	12.09	1.61	0.96	17.2	**15.5**
Financials	-1.87	-0.82	14.57	1.64	1.10	12.8	**12.6**
Information Technology	0.51	14.83	34.20	1.09	1.27	20.7	**18.9**
Telecommunication Services	-1.97	-8.95	-3.12	5.71	0.75	16.3	**10.2**
Utilities	2.63	-4.34	-4.32	3.61	0.26	14.2	**15.7**
Real Estate	-0.97	-2.89	0.84	3.38	0.55	15.2	**16.9**

*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 June 15, 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 June 15, 2018)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2017	2018E	2019E	Q4 '18E	Q2 '19E	2017	2018E	2019E	Q3 '18E	Q1 '19E	Q3 '19E
Global	3.7	3.9	3.8			2.5	2.9	2.8			
US	2.3	2.7	2.2	2.85	2.70	2.1	2.6	1.9			
Euro Zone	2.5	2.1	1.9			1.5	1.7	1.6	1.21	1.30	1.36
UK	1.8	1.2	1.0	1.60	1.85	2.7	2.5	2.1	1.32	1.42	1.50
Japan	1.7	1.3	1.5	0.08	0.10	0.5	1.1	1.0	104	98	95
Emerging Markets	4.8	5.0	5.0			3.1	3.4	3.5			
China	6.9	6.6	6.4	3.50	3.60	1.6	2.4	2.5	6.32	6.20	6.12

Source: Morgan Stanley & Co. Research

Macro Factor Heat Map (as of June 15, 2018)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	GIC Conclusion
China	↓	↑	↑	↓	↓	↓	↑	Soft Landing Better than Expected
Japan	↓	↓	↑	↓	↑	↑	↓	Corporate Profit Growth Offset Stronger Yen
Europe	↓	↓	↑	↓	↑	↓	↓	Preparing for ECB taper
Brazil	↑	↓	↑	↑	↑ Declining RSI	↓ P/E and P/B Contraction	↑	Political Chaos Driving Currency Weakness

Risk Asset Positive	Neutral	Risk Asset Negative

Note: Text in a factor box denotes a color change; In Brazil, Sentiment and Risk moved from positive to neutral due to declining RSI; Valuation moved from negative to neutral due to P/E and P/B Contraction; for further explanation of the chart, see page 9.

Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending June 15, 2018)

	Positives	Negatives
Global Growth	• Initial jobless claims fell to 218,000 • Empire State Manufacturing Survey hit 25 in June, versus 18.8 expected • May US retail sales increased 0.8% month over month, beating estimates • US import and export prices both rose 0.6% month over month in May, beating expectations • Japan industrial production in April rose 0.5% month over month	• May US Industrial production declined 0.1% month over month versus estimated 0.2% increase • US capacity utilization fell to 77.9% in May • April Euro Zone industrial production declined 0.9% month over month • May China retail sales below expectations at 8.5% year over year versus estimate of 9.6% • China industrial production drops to 6.8% year over year in May versus estimate of 7.0%
Rates	• Federal Reserve raised its target rate to 2% • European Central Bank left key rates unchanged • Bank of Japan kept policy rate unchanged at -0.1%	
Inflation	• May US CPI at 0.2% month over month, year over year CPI at 2.8%, both in line with estimates • May US PPI at 0.5% month over month, year over year PPI at 3.1%, both exceed the estimates • Euro Zone May CPI at 1.1% year over year • May Japan PPI beat forecast, up 0.6% month over month	
Sentiment and Flows	• U. of Mich. Consumer Sentiment Index up in June	

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 created a booming economy and earnings outlook, it may also be sowing the seeds for the end of the cycle as the Fed is forced to raise rates and tighten policy in a more deliberate manner.
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets. The populist movements around the world are now spreading to Italy which may spur further fiscal support from Germany and France. This would be a potential positive catalyst but not likely to develop until September.
Emerging Markets	Overweight	Emerging market (EM) equities have been the best region over the past 24 months but are underperforming so far in 2018. Some of this is simply the result of a market that needs to consolidate spectacular gains the past few years. However, it is also directly related to the Fed's tightening campaign. We expect EM to find support not far from current levels and have a strong finish to the year.
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, US economic data have been very strong recently and the Fed is now raising rates at an accelerating pace. Adding some longer duration when 10-year US Treasury yields are above 3% percent makes sense.
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 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) have traded better since their capitulation in March around the FERC regulatory announcement. With oil prices much more stable and on an upward path, MLPs have garnered more interest given their 8%-to-10% yields.
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 June 15, 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

For 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

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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.

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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