On the Markets

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TABLE OF CONTENTS

Uncomfortable

When I was a teenager doing backbreaking work as a landscaper in the brutal Texas summer sun, I was really motivated to do well in school, secure a college education and eventually get a white-collar desk job that would not be so physically exhausting or demanding. However, after 25 years of sitting, my back certainly isn't thanking me, as a desk job may be one of the worst things for it. It's gotten so uncomfortable that I now look forward to doing yard work at home!

When I published our 2017 outlook in January, I must confess there was a little apprehension in pushing the "send" button. In this business, making an out-of-consensus call can be nearly as uncomfortable as back pain. However, being too comfortable is a recipe for either underperformance or, at best, mediocrity. The title "Are You Ready for Euphoria?" definitely raised some eyebrows, but it didn't really resonate with most people, who were still preoccupied with the election of President Donald Trump. Instead, we heard "fade the inauguration," because the market has over-discounted "good Trump" and ignored the "bad Trump" risks. As an aside, the emerging markets were the consensus favorite sell. To recall, our excitement was not about President Trump, but rather the global synchronous economic recovery that began in the first quarter of 2016.

Since January, equity markets around the world have done exceptionally well, with international stocks leading the way—in US dollars, emerging markets were up 11%, Europe gained nearly 8% and Japan rose 5% in the first quarter. The US has held its own, up 6% as well. When annualized, these are remarkably strong returns that reinforce our optimistic outlook. Is Trump making Europe, Japan and the emerging markets great again, too?

Probably not, and that's the point. It's the global synchronous recovery at work, in our view, and on this score the data have continued to surprise on the upside—at a rate that has surprised even us. The fact that global equity markets are recognizing these facts is good, not bad (or fake) news. There was some handwringing recently around the failed attempt to repeal and replace Obamacare, with many now questioning this administration's ability to pass tax reform and deregulation—i.e., what investors see as the good stuff. But we have some more good news for you: Economics trumps politics every time. So we remain bullish on both the economy and global equity markets. ■

Can the Synchronous Recovery Last?

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For the first time since 2010, the global economy is enjoying a synchronous recovery (see chart). The developed markets' (DM) private sector is exiting deleveraging after several years of slow growth due to a focus on balance sheet repair and, after four years of adjustment, the emerging markets are in a recovery mode. These trends create a positive feedback loop. Indeed, the DM economies account for 60% of emerging market (EM) exports, so as their real import growth accelerates, EM exports are rebounding. What's more, an improving EM outlook reduces DM disinflationary pressures.

How sustainable is this recovery? Typically business cycles end with macrostability risks (price, external and financial) spiking, forcing policymakers to tighten monetary and/or fiscal policy. In this cycle, considering that emerging markets inflation and current account balances are moving toward their central banks' comfort zones, it is unlikely that macrostability risks will surface soon. Moreover, the emerging markets now have high levels of real rate differentials vis-à-vis the US, providing adequate buffers against normalization of the Federal Reserve's monetary policy.

DEVELOPED MARKET RISK. In our view, the key risk to the global cycle is apt to come from the developed markets—most likely the US, considering that it is most advanced in the business cycle. Moreover, the US tends to have an outsized influence on the global cycle, particularly the emerging markets. While price stability features prominently in debating the monetary policy stance of any central bank, financial stability is clearly emerging as an equally important factor.

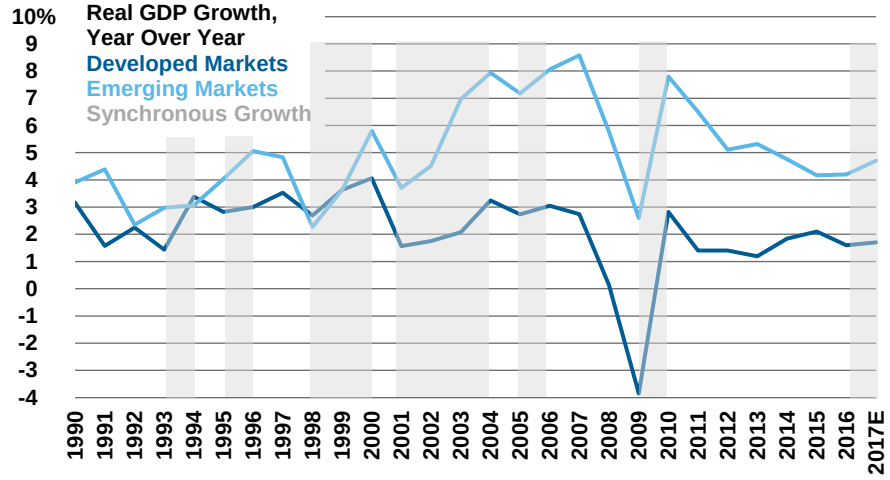
How will it play it out? For insight, we can look at history. The late '60s saw fiscal expansion at a time of strong growth and low unemployment. In the mid '80s, the US pursued expansionary fiscal and protectionist policies in an improving economy. We look at similarities and differences versus today, analyzing asset class performance by fiscal deficit and unemployment quartiles.

To that end, private-sector leverage has picked up modestly in the US. In fact, the household-sector balance sheet, which was the epicenter of the credit crisis, had been deleveraging until 2016's third quarter. Moreover, the regulatory environment has been relatively credit-restrictive. Hence, we see moderate risk to financial stability. However, risks could rise, considering that monetary policy is still accommodative, and particularly so if the administration eases financial regulations. Price stability is a critical risk, too—especially since the core Personal Consumption Expenditures Index inflation rate is close to the Fed's target and US unemployment is around the rate below which inflation could accelerate. Reflecting this, we expect the Fed to hike rates six times by year-end 2018 (see page 3). We expect other major DM central banks to take a less dovish/more hawkish stance.

STRONGER INFLATION. The synchronous recovery is likely to bring upside inflation risk in the near term, as the EM recovery could reduce disinflationary pressures from abroad further and/or there could be a potential upside surprise from a stronger-than-expected pick-up in US domestic demand. That said, we still see low risks of a major inflation surge. Fed Chair Janet Yellen has weighed in on this recently, noting that, in the last two cycles, inflation did not surge even as unemployment declined below the natural rate.

Against this backdrop, the global expansion remains intact. DM central banks are unlikely to be provoked into aggressive tightening, which should allow for the EM recovery to continue. However, if the global private investment recovery, particularly in the US, is stronger than we expect, it will support productivity growth and sustain the global expansion for longer. ■

The First Global Synchronous Recovery Since 2010



Source: IMF, Morgan Stanley Research as of March 26, 2017

The Fed: A Hike and a Surprise

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Why did Federal Reserve policymakers feel the need to raise rates at its March meeting? Not only is the incoming data unfolding in line with its economic outlook, but financial conditions have eased materially since December's rate hike. Simply put, the Fed raises rates to tighten financial conditions. If financial conditions don't tighten, there's more work to be done.

Right after the March 15 action, financial conditions eased and, if sustained, this would inform policymakers that additional hikes are needed. Moreover, following this rate hike, the Fed's Federal Open Market Committee (FOMC) still described its policy stance of as accommodative, which means it feels it can do more. Unless the incoming data deteriorate, or financial conditions tighten sharply, we expect the Fed to next hike rates at its June meeting. Beyond June, we look for a third hike in December, followed by four more in 2018.

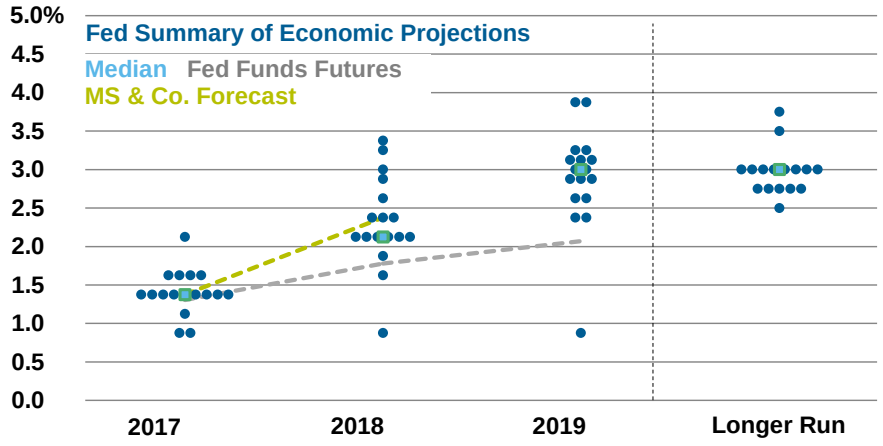
EASING FINANCIAL CONDITIONS. Even before the March hike, financial conditions had eased. Since December, the broad US dollar weakened, bond yields dropped and the S&P 500 rallied. Between the December meeting and late February, we estimate the net easing in financial conditions was the equivalent of slightly less than a 75-basis-point rate cut. Now that the Fed has raised rates 50 basis points cumulatively since December, we figure that the easing in financial conditions has been about the equivalent of a 60-basis-point rate cut. This easing can be partially explained by less-hawkish-than-expected updates to the Fed's latest Summary of Economic Projections, a survey of FOMC members (see chart).

STEEPER PATH. In response to the more supportive financial conditions, several policymakers incorporated a steeper path for rates into the outlook, but not enough to move the median higher in 2017 or 2018. The median FOMC member sees three hikes this year, bringing the target range at year-end 2017 to between 1.25% and 1.50%. This is then followed by three hikes in 2018, bringing the target range at year-end 2018 to between 2.00% and 2.25%. The median FOMC participant then sees the federal funds rate rising to its longer-run norm of 3.00% in 2019, up from 2.88% previously. While the median dot did not move higher in 2017, the average did rise somewhat. We feel the message to markets from this drift upward is that the risk is for more, rather than fewer, rate hikes this year—even though the FOMC still sees risks to its outlook as "roughly balanced." Additionally, changes to the path shifted the mean moderately upward in 2018 as well.

FED BALANCE SHEET. In Chair Janet Yellen's post-meeting press conference, the first question was on the timing of the drawdown of the Fed's balance sheet. Yellen remained fairly vague, which we take as a sign that the process of balance sheet normalization will not begin in the near term. We have assumed that the policy process will be, as the Fed said "well underway," when the federal funds rate reaches 1.5%—about halfway to equilibrium.

Given our expectation for the Fed to deliver three hikes in 2017, we expect rhetoric to ramp up around the balance sheet during the course of the year—something that is prevalent in the minutes from FOMC meetings and in speeches. We expect a firm signal in the September meeting minutes and an announcement in December that, beginning in January 2018, the FOMC will cease reinvestments of its agency mortgage-backed securities. If so, it would also be an important step on the road to normalization. ■

The Fed's Own Interest Rate Projections Have Becomes a Little Less Hawkish



Source: FOMC March 2017 Summary of Economic Projections, Morgan Stanley Research as of March 16, 2017

These May Not Be the Tax Reforms You're Looking For

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Morgan Stanley & Co.

A few months ago, the conventional wisdom was that with Donald Trump in the White House and the Republicans in control of the House and Senate, the gridlock that characterized many of the Obama years would be over. Now, the failure of Trump and the Republican leadership to repeal and replace the Affordable Care Act last month is sobering lesson that single-party control does not necessarily clear the policymaking path. In the wake of the health care flop, Trump and House Speaker Paul Ryan said they would turn to another one of their campaign promises—tax reform.

Not that overhauling the tax code is any easier than revamping health care. Health care accounts for about 20% of GDP while the tax code addresses everyone and everything in the economy. Rewriting the tax code may not distribute the benefits and drawbacks equally, so it creates winners and losers. That invites armies of lobbyists to weigh in on the legislative process. Congressmen and senators, too, look out for favored industries and constituents when shaping legislation. So in anticipation of the tax reform battles, we have summarized the various scenarios and how they might play out (see table, page 5).

Will comprehensive tax reform be delivered in the next 12 months? If not, when?

A common refrain from clients in our discussions about taxes is that failure to deliver timely reforms could be as negative a market catalyst as delivering the wrong ones. We think it's a valid point, particularly given some fixed income strategists' opinion that their markets are implicitly expecting beneficial tax outcomes. In our view, reform is coming in the next 12 months (70% subjective probability), as Republicans have a strong motive and a variety of tools to circumvent legislative and political barriers to success.

Will some form of "border tax" be included?

This is the critical uncertainty in tax reform. Including a border tax of some kind may be disruptive to the US economy in the near term, but it has the practical benefit of raising money toward a revenue-neutral, permanent tax cut and the political benefit of satisfying the president's promise to make trade "fairer." Not including a border tax would leave two very different options: a deficit-funded, stimulative, but sunsetting tax cut—or a modest, fully funded, permanent tax cut. In short, we don't see any obvious win-win scenarios, but we do see a meaningful variety based on this decision point.

Currently, we think this is a toss-up, with a 50% chance of some type of border tax. Enough Republican senators have expressed displeasure with the idea to keep tax reform from passing, and this ought to lower the odds. However, the president won't let go of the concept. His closest economic advisors have floated alternatives, like a "reciprocal" tax, which suggests his administration is looking for a politically palatable way to make a border tax work, perhaps recognizing the practical legislative and political benefits cited earlier.

What form would a border tax take?

Not all border taxes are created equal, and hence this point drives a variety of positive and negative outcomes for the US economy and markets. The border-adjustability tax (BAT), as proposed by House Republicans, would drive a revenue-neutral, nonstimulus reform that would likely need to be phased in to mitigate the risks of unintended economic consequences. This could also potentially spark retaliation from trading partners if found to be not compliant with the World Trade Organization. A reciprocal tax, which we take to mean an effort to level the playing field by taxing imports equal to the difference between a country's value-added tax (VAT) and US state and local sales taxes, could offer some alternative benefits. This provides hypothetical flexibility to retailers who could lower costs by importing from lower-VAT countries and the potential to replace the revenue raised by the border tax. Yet retailers, free traders and their GOP Senate allies may see it as a veiled tariff and/or extra tax on consumers.

Yet another alternative could be an "executive option reciprocal tax," giving the US Treasury the authority, but not the requirement, to use a reciprocal tax if certain conditions are met. This could give the president a tool that adds credibility to his threats about penalizing offshoring and pursuit of "fairer" trade and deal renegotiations, without automatically triggering reciprocal trade actions. The option would likely increase deficits, and would thus require some of the budget tactics to mollify deficit hawks that we've previously discussed.

A final alternative, as implausible as it might sound on the surface, would be a VAT that includes carve-outs for key products that blunt its regressive nature. VATs have historically been anathema to Republicans, and a VAT wouldn't guarantee the type of tax congruence that the president might want with trading partners. However, it could fund substantial income tax rate cuts. Hence, we don't think it implausible that Republicans could eventually find a way to embrace it.

In our view, these latter two approaches

Assessing Various Scenarios for Tax Reform

Scenario Rationale	Corp. Tax Rate	Border Tax?	Deficit / Stimulus?
Delayed Gratification Republican divisions on health care carry over to tax reform. A compromise takes time, pushing reform later into 2018	N/A (delay)	No	N/A (delay)
Seriously, Not Literally Budget tactics make way to lower rates and increase near-term deficits. Limits to deductions and exclusions for high-income earners appease both deficit hawks and populists. Backloads other spending cuts to pay for tax cuts	20%-25%	No	Yes
Art of the Deal Similar to "seriously, not literally," but with a narrow value-added tax (VAT) and or "executive option" reciprocal tax to meet the president's desire to discourage offshoring	20-25	Yes for reciprocal or narrow VAT	Yes
Curb Your Enthusiasm Importers kill the idea of border taxes, eliminating a way to pay for tax cuts. Deficit hawks hold firm on refusing to pay for cuts via the deficit. Hence, rate cuts are muted. Immediate expensing of capital spending doesn't survive, but limits to net interest deductibility do.	25-28	No	No
Saving Speaker Ryan The president throws his support behind a phased-in border adjustability tax (BAT), cajoling enough Republican senators to reluctantly vote for tax reform	20-25	Yes: Phased in BAT	No
Going European Revenue lost from Senate opposition to House BAT plan must be replaced. Republicans find the right messaging and political cover to embrace a VAT. This leaves the US with a hybrid corporate VAT and an income tax system, much like Europe	20-25	Yes: Full VAT	No
Party Foul Like "delayed gratification," GOP divisions laid bare by the health care fight cannot be overcome, and the approaching midterm elections put an indefinite delay to tax reform	None	No	No
Full Trump Unable to craft a politically palatable, revenue-neutral, growth-friendly bill, the president succeeds in a populist push for a large, deficit-funded tax cut	15-20	No	Yes

Source: Morgan Stanley Research as of March 3, 2017

—executive option reciprocal tax and a watered-down VAT—stand out from the others. Particularly, they offer face-saving, though admittedly flawed, provisions to the president, House Republicans and Senate Republicans concerned about importers' business models and free trade.

If a border tax is not adopted, we're biased toward the idea that Republicans eventually abandon revenue neutrality (though perhaps not in name) and accept a sunsetting tax cut, given the president's more casual attitude toward deficits, the motivation to deliver a meaningful decrease in headline tax rates and increasing signs from GOP senators that they're willing to accept some deficit expansion. This could be a gambit that tax benefits will deliver a larger majority in midterm elections, creating an avenue toward making the tax reform permanent. Face-saving measures like balanced out-year budgets within the 10-year budget window and independent validation of the fiscal benefits of a deficit-funded tax plan, perhaps from the Office of Management and Budget, could assist. ■

Value Stocks Can Be Momentum Stocks, Too

ZACHARY APOIAN

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To many, the term "momentum stocks" evokes thoughts of highly speculative equities—perhaps a company with a product or innovation that has driven extraordinary recent earnings growth and has been bid up to dizzyingly rich valuations by hopeful investors on the premise this growth might continue. Certainly, this is something quite different than disciplined value investing—or is it?

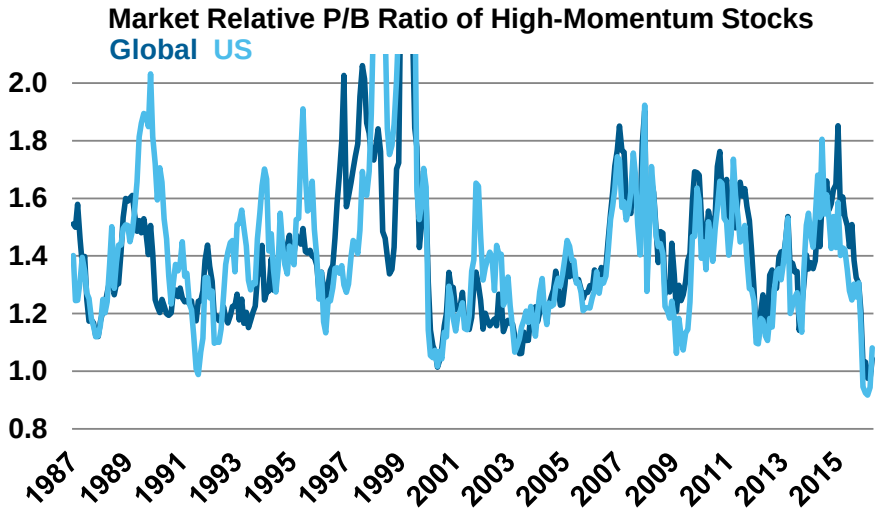
STRENGTH BEGETS STRENGTH. In the current environment, momentum investing is quite different. For starters, investing based on momentum is not a phenomenon created by risk-seeking day-traders. Instead, momentum is a carefully studied phenomenon with a rich body of work within finance theory. The simple idea that financial assets that have outperformed recently may continue to outperform has been resilient, with evidence spanning time periods and asset classes. Our work has observed this phenomenon within equities, and when implemented in a prudent manner an overweight to companies that have outperformed in the past six to 12 months has historically improved long-term returns versus the broad market.

Applying this definition to equities provides insight into the opportunity presented by the current momentum stocks. Under normal circumstances, the classic momentum companies having the strongest growth characteristics, including those with the fastest recent earnings growth and highest valuations, typically comprise a large portion of momentum stocks. Uncharacteristically, however, current momentum includes a large representation of deep-value stocks, including substantial numbers from financials, industrials, energy and materials companies. While these sectors have benefitted from the global economic strengthening of the past year, they remain cheaper than many traditional growth segments. As a result, rather than trade at the normal premium valuation, momentum stocks have recently traded at a discount to the market on a price/book value basis—a condition we have not observed in nearly 30 years of market history (see chart).

EMBEDDED SKEPTICISM. Does the presence of these well-valued companies bolster the case to invest in momentum stocks? We believe so, for two reasons. First, historically, when momentum stocks have been attractively valued, their record of outperforming the broader market has been strong, both domestically and outside the US. Stated differently, attractively valued stocks embed skepticism that prevents attaining a valuation equaling that of the market. Perhaps these cyclical areas are reflecting concerns of a potential recession derailing our extended, nine-year-long business cycle. Alternatively, discounts of cyclical companies could reflect fears that the US fiscal policy measures that many are expecting to boost the economy could disappoint. At any rate, these fears provide the proverbial "wall of worry" which, if economic strength continues and fears recede, could drive continuing outperformance for these companies.

Secondly, investing in cyclical, deep-value companies works well with our broader economic view: Economies have strengthened, with growth and inflation data surging since the middle of 2016. We believe these reflationary forces could continue. If so, these attractively valued companies are well represented within momentum stocks and also more sensitive to the state of the economy. An ongoing cyclical upturn could drive outperformance through elevated earnings growth. ■

High-Momentum Stocks Trade at Attractive Valuations Relative to the Global and US Markets



Source: FactSet, Morgan Stanley Wealth Management GIC as of March 31, 2017

Changing Preferences and E-Commerce Rock Retail

DENNY GALINDO

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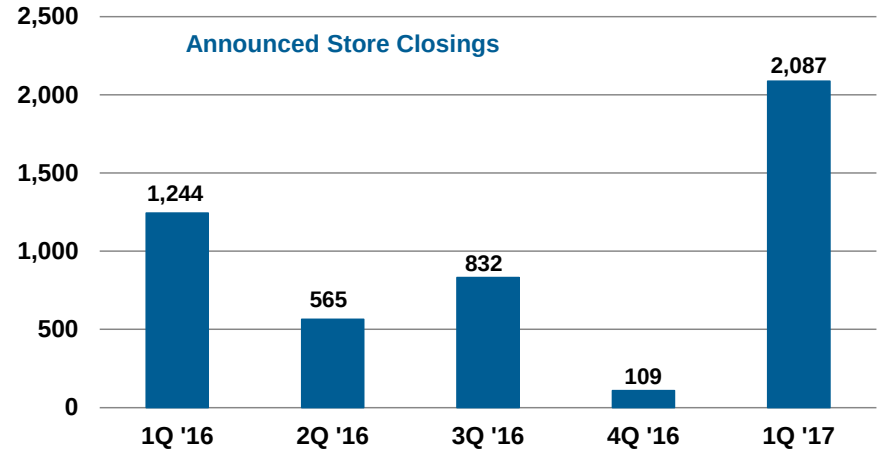
Consumer spending represents 70% of the US economy and retail is about one third of that. Even though spending is forecast to increase 2.5% this year and consumer sentiment indicators are reaching levels not seen since the early '00s, retail is troubled. Shoppers' growing preference for online purchases, the overbuilding of stores and rising interest rates all pressure retailing. So far this year, retailing stocks are up 7% and the S&P 500 is up 6%, yet nearly half the stocks are down for the year to date. Some of the largest index constituents are e-commerce only and have double-digit returns that offset declines from traditional retailers.

Online sales have been around since the '90s and account for up 8% of the retail market. They are growing at a 14% annual rate versus 4% for total retail sales. Some of the largest e-commerce businesses have expanded from niche specialties, such as books and music, to electronics, toys, and household goods to products that require a timely, efficient distribution (food) and product expertise (auto parts). While many specialty retailers initially sidestepped the growth in e-commerce by expanding their geographic footprint, today US per capita retail square footage is more than four to five times that of Japan, France or the UK. As global interest rates rise, so does the cost of maintaining a physical presence.

It's no surprise that stores are shutting down. More than 2,000 store closings have been announced so far this year, according to Morgan Stanley & Co. Research (see chart). Such closings impact malls: by lowering traffic at nearby stores; pricing, which flows down to industry profits; and inventory, as fewer stores require less inventory. Interestingly, fear of a retailer's bankruptcy can be self-fulfilling; vendors may require stiffer payment terms for struggling retailers, which could exacerbate any underlying cash-flow issues. In addition to pricing and traffic pressures, uncertainty regarding a potential US border tax—most retailers import much of their wares—seems likely to weigh on the sector until the details of tax reform are finalized (see page 4).

A Surge in Stores Shutting Their Doors



Source: Morgan Stanley Research as of March 29, 2017

However, even an industry in turmoil has winners. We focus on consumer-facing businesses with recurring customer sales and customer loyalty, secular growth and the least exposure to store closings.

Business models with high upfront costs often lead to recurring sales. Organizations with annual fees, such as warehouse clubs, encourage customers to concentrate purchases to maximize the value of the fee. The companies with the best selection tend to achieve a high and growing share and stable revenue from membership fees. Another form of customer captivity is organizations like media companies; they may win over a customer with a popular movie, then generate a repeat sale at an affiliated resort or through branded consumer content. In both cases, recurring sales often lead to less volatile stock prices and high returns.

Consumer companies with favorable secular growth. Online-only retailers are gaining share of total retail transactions yet they account for only 8% of the total. That means they have room to increase penetration. Additionally, payment networks are still gaining share versus cash and actually benefit from online growth. These secular growth industries are well positioned to grow as traditional retailers struggle.

Second-order effects on store traffic and inventory. Companies depending on mall traffic will likely feel the impact of store closures nearby—even if their own businesses are solidly profitable. Consumer products companies selling wares from T-shirts to shoes to cosmetics may suffer as liquidating stores redistribute inventories to other stores, reducing new orders or marking down inventories for quick sales, thereby suppressing prices. Generally, a focus on customer captivity, recurring revenue and secular growth while avoiding second-order impacts should reduce risks and lead to better returns. ■

Three Phases to Oil-Market Rebalancing

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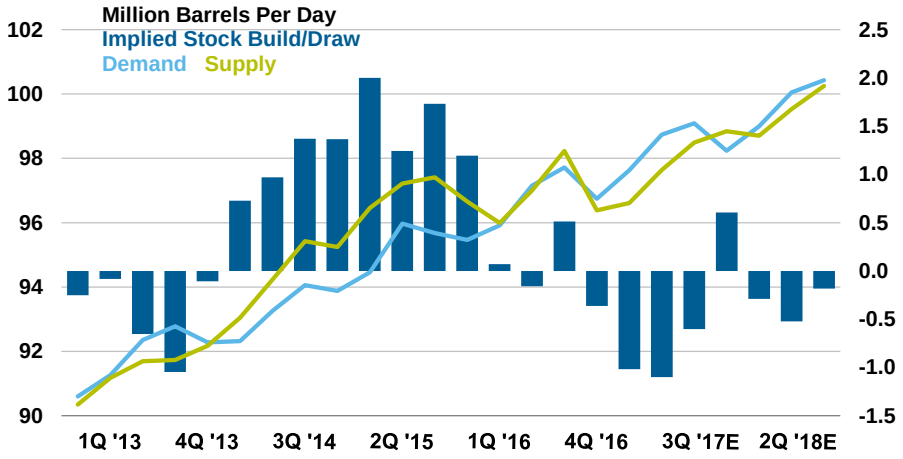
The problem with oil is that there is always too much or too little," economist Myron Watkins wrote in 1937 in his seminal paper on the oil market, *Oil: Stabilization or Conservation.* This has remained the case ever since. Last month, oil markets once again feared there would be too much when a surprise build in US inventories, combined with Saudi Arabia's oil minister's comments that OPEC may not extend its current production deal. This sent West Texas Intermediate crude oil down 9% in one week to back below $50 barrel. Still, despite these short-term jitters, we view the medium-term outlook as constructive.

STEADY DEMAND GROWTH. Despite concerns over the growth of renewables and sales of electric vehicles, oil demand has been growing strongly ever since the price decline. OPEC has successfully constrained output and, although drilling activity in US shale is accelerating, this will probably not come quick enough to prevent a period of sizeable inventory drawdowns later this year (see chart). To allow oil to destock, the forward curve will need to move into backwardation, in which futures prices are higher than today's spot price. With the long end well underpinned by marginal-cost arguments, short-dated oil futures will need to move higher—we think into the low $60s—toward the end of the year.

At that point, we believe OPEC's discipline will probably start to wane and US shale growth will strongly accelerate. On our estimates, US shale can return to growth of roughly 1 million barrels per day (MBD) between the fourth quarter of 2017 and the fourth quarter of 2018. Still, the market seems broadly balanced next year against a backdrop of demand growing at, or slightly above, the historical trend rate and declines in supply from several non-US/non-OPEC countries.

MS & Co. Expects Strong Oil Demand Later This Year



Source: Morgan Stanley Research as of March 19, 2017

Some might argue the ability of US supply growth alone to meet the lion's share of global demand growth is problematic. However, there is precedent: Between 2005 and 2015, the US met 76% of all demand growth. With a broadly balanced market, prices should remain stable in the low $60s throughout 2018.

LONG-TERM GROWTH. The world is adding 1 billion people every 14 to 15 years, and during each of these periods global GDP per capita typically rises by 35% to 40%. It has historically been difficult to offset this by improving energy efficiency. Consider that the global car fleet is growing by about 40 million units per year. Around 1% of new cars are electric, but if the rest drove 9,000 miles per year and achieved 40 miles per gallon, that alone would cause oil demand to grow by 600,000 per day every year. That would account for half the 10-year trend growth rate—before taking into account the impact of growing fleets of trucks, planes and ships, as well as rising demand from the petrochemical sector.

By 2020, we estimate that about 1.5 MBD of demand will need to come from projects that have not been sanctioned yet, but that have breakeven oil prices of $70 to $75 per barrel. By 2025, the reliance on this category of projects could rise to between 7 million and 8 million barrels per day. Around the turn of the decade, oil prices will need to be sufficient to incentivize development of these reserves.

EQUITY PLAYS. How can investors express this view? Our equity strategists are overweight energy in Europe, which has lagged for the year to date, trades at a discount to the US and has a positive cost-reduction story. Meanwhile, in the US, we see oil services as better placed than exploration and production companies for a pickup in US production. ■

Make Room for Mortgages In Your Portfolio

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The Global Investment Committee's thesis that global reflation is supportive of risk assets rings true in fixed income. As positive growth momentum and stable fundamentals help to compress risk premiums, bond sectors like credit, which trade at a spread over US Treasuries, appear attractive.

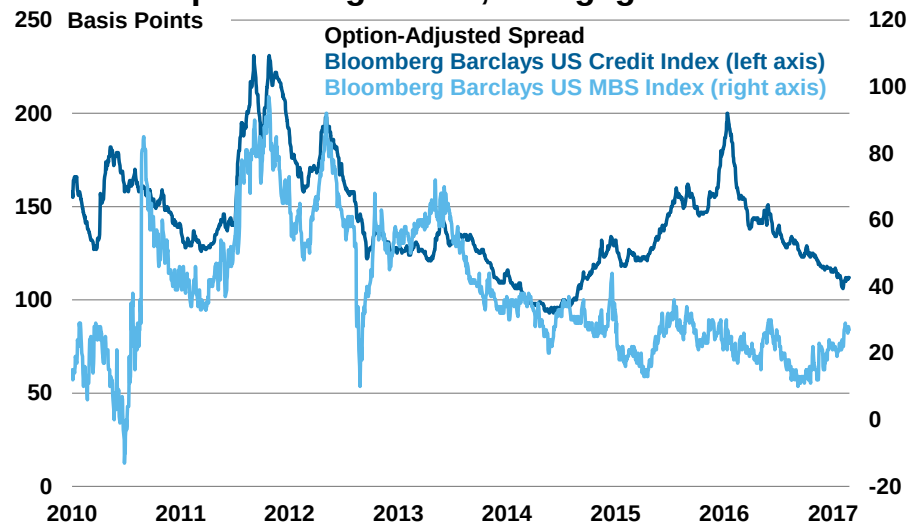
While investment grade and high yield corporate bonds remain core holdings, we view mortgage-backed securities (MBS) as an attractive source of risk-adjusted return. Within the $10 trillion-plus mortgage market, investors can diversify across a wide variety of risk factors, including interest rate risk and credit risk, in both commercial and residential real estate.

In particular, we believe that agency and nonagency residential MBS are good alternatives to credit-sensitive sectors. Agency residential MBS are issued by government agencies, such as Ginnie Mae, Fannie Mae and Freddie Mac, while nonagency residential MBS are issued by private entities, such as financial firms.

Relative Valuation. Higher interest rates, increasing volatility and uncertainty around the Federal Reserve's balance sheet policy have led to cheaper valuations in the agency MBS market. While other sectors, like corporate credit, richened, agency MBS spreads widened some 30 basis points (see chart).

Credit Quality. Mortgage-related investments can provide a high-quality complement to other fixed income sectors. Agency mortgages carry either an implicit or explicit US government guarantee, while nonagency mortgages offer an array of credit-quality choices. In general, mortgages benefit from a senior secured standing in the underlying asset. By contrast, investment grade or high yield corporate bonds are often unsecured.

As Credit Spreads Tightened, Mortgages Eased



Source: Bloomberg as of March 28, 2017

Portfolio Diversification. MBS can provide diversification to portfolios. There tends to be relative stability in residential real estate prices over time, balancing more volatile portfolio allocations. In addition, agency MBS have exhibited a significantly lower correlation to equities than high yield and investment grade corporate bonds, offering greater diversification for a holistic portfolio.

Positive Fundamentals. We expect the housing market to remain resilient in 2017, as demand continues to outpace supply and bullish economic fundamentals, including rising wages and strong job growth, lend support. However, affordability may prove challenging going forward, particularly for first-time home buyers, as home prices rise more rapidly than wages and mortgage rates increase, albeit off of historic lows. Nonagency MBS, which offer substantial yield premiums, should directly benefit from improvements in the housing market.

Supply and Demand. From a supply perspective, there are competing forces in the agency MBS market. MS & Co. economists expect that the Fed will cease MBS reinvestments in early 2018 as the first step in shrinking its $4.2 trillion balance sheet, rendering an additional $15 billion in monthly supply. However, we expect higher volatility and higher interest rates to persist, which should mean lower gross MBS supply due to slower prepayments and less refinancing. Within the nonagency MBS market, technical conditions are positive, as the market still has a negative net supply and new issuance in 2017 is expected to be roughly $50 billion, slightly less than that of 2016.

In all, despite our expectation for higher interest rates, we view MBS as a good source of risk-adjusted returns. Given their attractive valuations, high credit quality, low correlation to equities and strong fundamentals, consider adding agency and nonagency residential MBS. The time is ripe for a mortgage-focused strategy in bond or balanced income portfolios. ■

Prudence and Patience

MATTHEW GASTALL

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Morgan Stanley Wealth Management

Prudence, Patience, Hope and Despair are the names of four islands in Narragansett Bay situated northwest of Newport, RI. Prudence and Patience are the larger and more prominent of the four and, according to local legend, were rewarded with their names as an endorsement of their virtues. Both these values are broad, timeless and relevant in today's municipal bond markets: Patience is called for as investors await the details of fiscal stimulus, tax reform and infrastructure spending—and prudent credit selection and maturity positioning can mean muni investors will be rewarded for that patience (see chart).

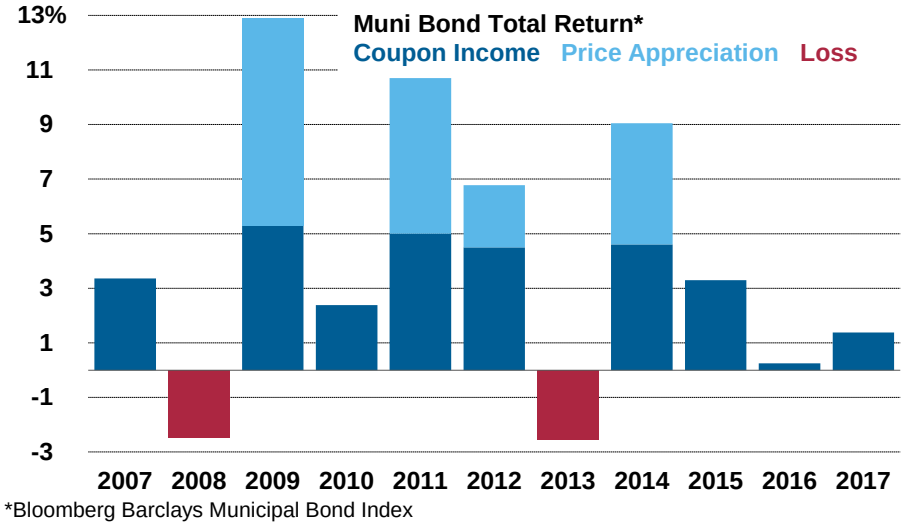
EXPECTATIONS MATTER. Moving forward, there are a number of developments that could be bullish for the muni market. The first deals with expectations. We've experienced considerable movement since last year's elections. If these anticipations are not met with economic progress, financial markets run the risk of being underwhelmed, which could incite a risk-off trade that typically supports a move toward fixed income. Additionally, investors are awaiting the first-round results of yet another important election this month; if France's National Front leader Marine Le Pen wins or makes it to the run-off, it will raise anxieties about the future of the European Union and perhaps trigger a risk-off trade. Finally, tax-exempt issuance usually slows during the summer, which often creates a constructive backdrop where investors are challenged in finding supply.

Of course, there's reason for caution as well. New-issue supply, though modest in comparison with recent years, is still high right now. Preliminary data exhibit a more than 30% decline in March's bond redemptions, which means there is less cash available to reinvest in any new supply. There's also the possibility of an adverse market reaction if and when the administration announces its tax reform and fiscal stimulus plans. If the tax plan includes federal income tax rate cuts, changes to muni bond tax exemption or the promotion of government debt issuance (federal or local) to finance infrastructure initiatives, the municipal bond market may be rattled.

OUR THREE OBJECTIVES. Tying these dynamics together, we would strategically approach the market with three objectives at this time: Reward patience by maintaining current allocations, watch for late-spring entry points and hold cash for deployment in the case of market weakness. From our perspective, global economic conditions may support a gradual rise in interest rates while tax reform may affect the value of the municipal exemption, but neither is significant enough to modify allocations and forgo income—particularly considering transaction costs and the lack of comparable investment alternatives.

When investing, we like exposure to high-quality municipal securities due to tight spreads and favor above-market-coupon bonds—at least 4.5%—for their generous income and defensive attributes. Additionally, we recommend an overall neutral portfolio duration, which can be achieved by utilizing a bond ladder of evenly distributed short and intermediate maturities. Note that nearly 80% of the yield curve is captured by year 12. Finally, the current environment is conducive for investors looking to strengthen positioning—say, by moving up in credit quality or shortening duration—as the market awaits news from Washington and beyond. ■

Returns Bolstered by Coupon Income



*Bloomberg Barclays Municipal Bond Index
Source: Thomson Reuters Municipal Market Data as of March 27, 2017

Keeping More of What Your Investments Earn

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For most people, investing is what you do because you want to retire with your lifestyle, put your kids through college or build a legacy. In other words, investing is a means to an end, not a goal in and of itself. In many cases, the margin between achieving goals and not doing so is slim, and closing any deficit that might be there can be difficult.

If at any point savings are considered inadequate to fund future spending, there are several options: Save more, but that may not be possible or desirable if it limits current spending; reduce the ambitiousness of your goal (e.g., delay retirement), which also may not be possible or desirable; or look to increase portfolio returns, perhaps by taking on more investment risk, which can be discomfiting. What's more, investors may have already adjusted strategy to take full advantage of risk positioning, illiquidity premiums and active management. What then?

REDUCING THE TAX BITE. Become more tax efficient. That means utilizing products, strategies and account types to reduce the bite that taxes can take from investment returns. Consider an investor in the upper-income bracket in a high-tax state who just sold an investment that will be treated as a short-term capital gain (held less than one year). The chart below shows what happens if aftertax proceeds are continuously reinvested and the target investments continue to generate short-term returns of 10% per year for 10 years. In that instance, the investor keeps less than 40 cents of every dollar.

This example also suggests investors might be able to enhance their returns by utilizing tax-reduction strategies, which in many cases can be done without increasing risk. These approaches range from the simple and commonly utilized, such as municipal bonds and Roth individual retirement accounts, to the complex and esoteric, such as universal life insurance and investment-only variable annuities. They also bear a low-to-high range of impact on taxes. Note that we focus our analysis here on wealth accumulation for attaining investor spending goals.

ASSET LOCATION. Utilizing tax-exempt securities or tax-advantaged accounts is one of the straightforward approaches to reducing tax drag, but it may have significant limitations for some investors. By contrast, tax-deferral strategies that postpone tax liabilities—the longer the deferral the greater the benefit—can reduce the impact of taxes on investments because they allows investors to earn compound returns on deferred tax liabilities during the deferral period. Tax deferral can be done with common, simple methods like individual retirement accounts (IRA) and 401(k)s, as well as with the use of more complex and less-well-known products and strategies. "Asset location"—strategically placing assets in various accounts to take advantage of their tax features— may also enhance aftertax returns.

At its most impactful, tax deferral can also reduce the effective tax rates themselves through judicious timing of taxable distributions and capital gains. This is especially so for affluent investors for whom IRAs and 401(k)s accommodate a small fraction of their income. We refer to these complex strategies as "integrated tax strategies," as they require a systematic approach to the range of investments, account types, distributions and other client circumstances and call for less-known, more complex products and investment types. The table on page 12 shows the broad avenues by which tax efficiency can be enhanced. ■

Also contributing to this report were Zi Ye, CFA, and Stephanie Wang. For the complete version of this special report, please contact your Financial Advisor.

Taxes Reduce Investment Earnings*

*Based on upper-income investor in a high-tax state, earning 10% a year in short-term returns and reinvesting profits
For illustrative purposes only
Source: Morgan Stanley Wealth Management as of March 2017

Approaches for Improving Aftertax Returns

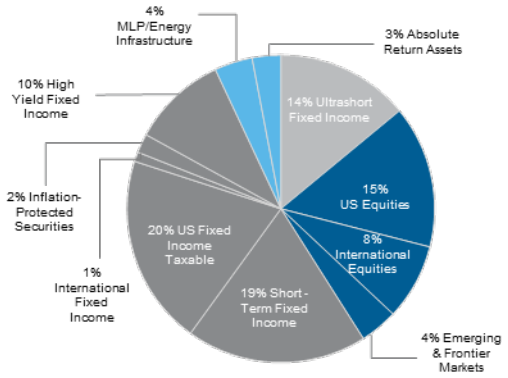
Strategy	Recommended for Investors Who …	How It Works	Illustrative Incremental Added Return (per year)*
Tax Exemption			
Municipal Bonds	Need immediate income Have a high marginal tax rate Have a conservative-to-moderate risk tolerance	Interest payments are exempt from federal (and often state and local) taxes. Illustrative value added is based on top marginal federal tax rates and prevailing yields	0.92%
Roth Individual Retirement Account	Everyone	Returns are generally not taxed and qualified withdrawals are tax exempt. Contributions, however, are not tax deductible. Illustrative value added is based on top marginal federal tax rates, yearly contributions and a 50% equity/50% bond portfolio held for 40 years	2.06
Tax Deferral			
Tax-Advantaged Retirement Plan	Everyone	Contributions are typically tax deductible and investments generally grow tax deferred. Withdrawals after age 59½ are usually taxed as ordinary income. Illustrative value added is based on top marginal federal tax rates, yearly contributions and a 50% equity/50% bond portfolio held for 40 years	2.06
529 Education/ Health Care Savings Account	Have qualifying expenditures/low medical expenses	Investments generally grow tax deferred and qualified withdrawals are tax exempt. Contributions to 529 Plans are not tax deductible (in some cases they are state-tax deductible). Contributions to Health Care Savings Accounts may be tax deductible, but their availability is restricted to high-deductible health insurance plans. Illustrative value added is based on a 529 plan, top marginal federal tax rates, yearly contributions and a 50% equity/50% bond portfolio for 18 years	1.83
Investment-Only Variable Annuity	Have a long investment horizon Have no plan to take income in the short term Expect to be in a lower tax bracket after retirement Have high-growth but tax-inefficient investments Have savings above contribution limits on qualified retirement plans Want to leave a legacy	These are not subject to contribution limits or maximum income requirements from the IRS, though insurers may impose limits. Investments grow tax deferred and nonprincipal withdrawals are taxed as ordinary income. Gains are assumed to be distributed prior to principal, (i.e., "last in, first out") unless the contract is annuitized, after which all payments include a prorated principal component. Illustrative value added is based on a 1% per annum fee, top marginal federal tax rates, a lump-sum contribution and a 50% equity/50% bond portfolio held for 40 years	0.12
Tax-Managed Investments	Have a long investment horizon Have a high marginal tax rate	Portfolios are of liquid securities, typically equities, in which losses are actively "harvested" to create tax losses, and proceeds are reinvested in similar securities. Illustrative value-added is based on top marginal federal tax rates and continuous tax-loss harvesting for 30 years*	0.30
Integrated Tax			
Tax-Efficient Asset Location	Have savings above contribution limits on qualified retirement plans	Investment types are arranged across taxable and tax-advantaged accounts to maximize the tax benefits conferred by tax-advantaged accounts. Asset location leverage is increased through use of an investment-only variable annuity. Illustrative value added is based on top marginal tax rates for 20 years before retirement and a 25% federal tax rate at retirement. Overall portfolio strategy is based on a 60% equity/40% fixed income allocation	0.59
Universal Life Insurance	Need life insurance Have a long investment horizon Don't plan to take income in the short term Have a high marginal tax rate Have high-growth but tax-inefficient investments Have savings above contribution limits on qualified retirement plans Want to leave a legacy	Premiums grow tax free net of the cost of insurance and fees. Original premium amounts can be withdrawn tax-free and gains can be similarly withdrawn in the form of loans against death benefits. Illustrated value added is based on top marginal federal tax rates for 20 years before retirement and a 25% federal tax rate for 20 years after retirement. Overall portfolio strategy is based on a 60% equity/40% fixed income allocation. Additional benefits conferred through providing a means to reduce average tax rates by smoothing reported income are not quantified here	0.28
Withdrawal Sequencing	Have adequate savings relative to spending needs Have a high marginal tax rate Have sources of low-tax distributions with which to smooth income	Investment liquidations to support retirement spending are sequenced in order to increase tax efficiency. Withdrawals from taxable accounts come first to extend tax-deferred/tax-exempt growth of other investments. Income smoothing and partial Roth conversion is conducted to lower effective tax rates and minimize spikes in taxable income driven by required minimum distributions. Illustrated value added is based on top marginal federal tax rates for 20 years preretirement, and a 5% initial withdrawal rate for 30 years in retirement. Overall portfolio strategy is based on a 60% equity/40% fixed income allocation, assuming an efficient tax allocation across accounts	0.64

*For details on the calculations and case studies, see Tax Efficiency: Getting to What You Need by Keeping More of What You Earn
Source: Morgan Stanley Wealth Management GIC as of March 2017

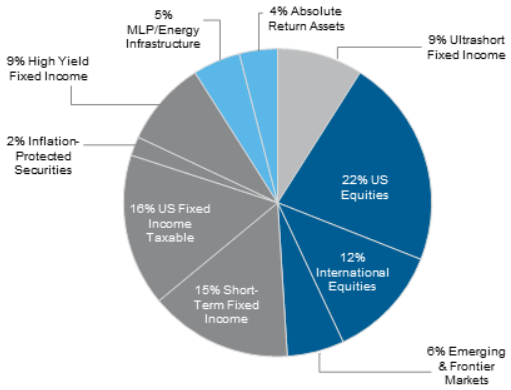
Global Investment Committee Tactical Asset Allocation

The Global Investment Committee provides guidance on asset allocation decisions through its various models. The five models below are recommended for investors with up to $25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return.

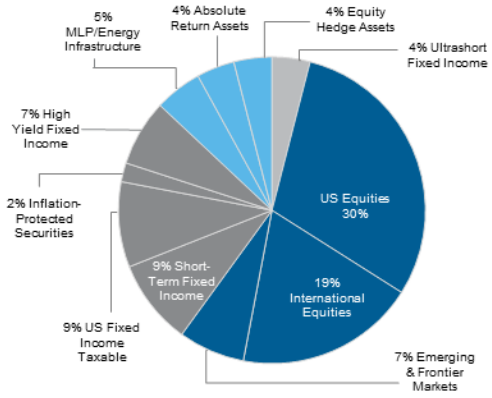
Capital Preservation



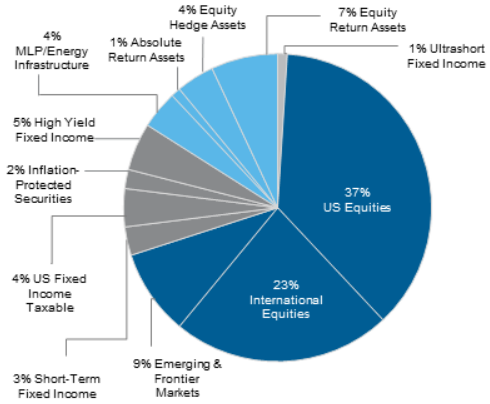
Income



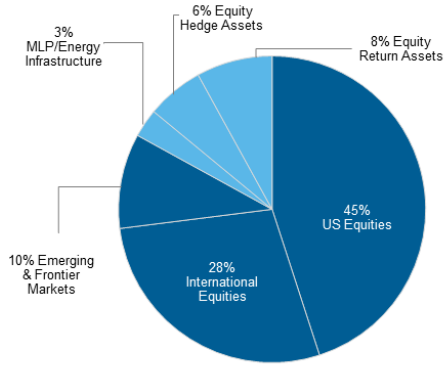
Balanced Growth



Market Growth



Opportunistic Growth



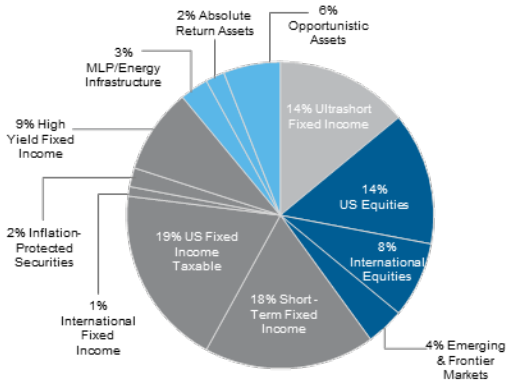
Key

- **Ultrashort Fixed Income**
- **Fixed Income & Preferreds**
- **Equities**
- **Alternatives**

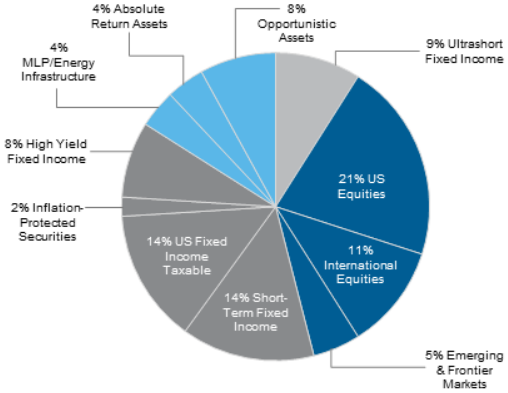
Source: Morgan Stanley Wealth Management GIC as of March 31, 2017

The Global Investment Committee provides guidance on asset allocation decisions through its various models. The five models below are recommended for investors with over $25 million in investable assets. They are based on an increasing scale of risk (expected volatility) and expected return.

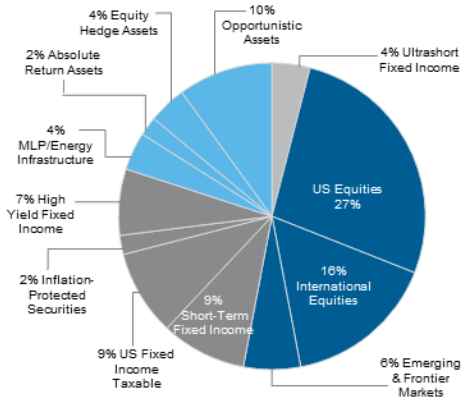
Capital Preservation



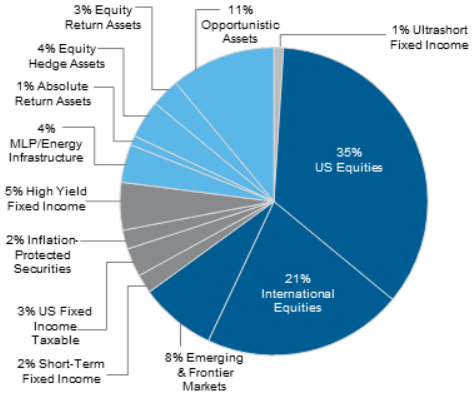
Income



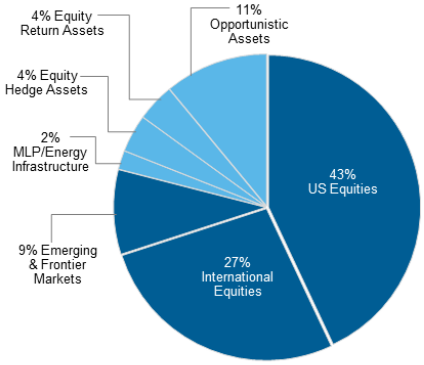
Balanced Growth



Market Growth



Opportunistic Growth



Key

- **Ultrashort Fixed Income**
- **Fixed Income & Preferreds**
- **Equities**
- **Alternatives**

Source: Morgan Stanley Wealth Management GIC as of March 31, 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 desperately 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, expectations for oil prices and that 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 to be 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 being 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 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.

Source: Morgan Stanley Wealth Management GIC as of March 31, 2017

For more about the risks to Master Limited Partnerships (MLPs) and Duration, please see the Risk Considerations section beginning on page 17 of this report.

Glossary

CORRELATION This is a statistical measure of how two securities move in relation to each other. This measure is often converted into what is known as correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation coefficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random. A correlation greater than 0.8 is generally described as strong, whereas a correlation less than 0.5 is generally described as weak.

VOLATILITY This is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

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

Risk Considerations

Alternative Investments

The sole purpose of this material is to inform, and it in no way is intended to be an offer or solicitation to purchase or sell any security, other investment or service, or to attract any funds or deposits. Investments mentioned may not be suitable for all clients. Any product discussed herein may be purchased only after a client has carefully reviewed the offering memorandum and executed the subscription documents. Morgan Stanley Wealth Management has not considered the actual or desired investment objectives, goals, strategies, guidelines, or factual circumstances of any investor in any fund(s). Before making any investment, each investor should carefully consider the risks associated with the investment, as discussed in the applicable offering memorandum, and make a determination based upon their own particular circumstances, that the investment is consistent with their investment objectives and risk tolerance.

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 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.

Alternative investments involve complex tax structures, tax inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund. Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are offered pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.

Hypothetical Performance

General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance based on benchmark indices, not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results achieved by a particular asset allocation.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment

results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

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.

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-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.

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.

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

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.

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

Besides the general risk of holding securities that may decline in value, **closed-end funds** may have additional risks related to declining market prices relative to net asset values (NAVs), active manager underperformance, and potential leverage. Some funds also invest in foreign securities, which may involve currency risk.

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

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.

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.

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

Credit ratings are subject to change.

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