Morgan Stanley

INVESTMENT MANAGEMENT

Relative developed market labour resilience, despite slower growth

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CUSTOMIZED SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 5 December 2022

ANDREW HARMSTONE

Managing Director, Lead Global Portfolio Manager, Global Balanced Risk Control Team

MANFRED HUI

Managing Director, Co-Lead Global Portfolio Manager, Global Balanced Risk Control Team

Global equities rose in November, with the S&P 500 Index returning 5.6%[1]. In local currency terms, the MSCI Europe Index and MSCI Japan Index each returned 6.9% and 3.0% respectively[1]. However, emerging market equities far outstripped developed markets, with the MSCI EM Index (USD) gaining 14.8%[1]. Despite a sharp fall in oil prices, this price action was not reflected in the energy sector, as the MSCI ACWI Energy Index (USD) continued moving higher, returning 3.7%[1]. Federal Reserve Chair Jerome Powell indicated at month end that “moderating the pace of rate increases may come as soon as the December meeting[2].” Combined with the U.S. Consumer Price Index (CPI) move down, at least for now the market appears to see this as positive for risk. Reflecting this mildly risk-on sentiment, the U.S. 10-Year yield, which had been above 4.0% since the second half of October, fell to end the month at 3.7%[3]. The VIX continued to trend down to 20.6[3].

Relative developed market labour resilience, despite slower growth

The U.S. labour market appears to be starting to normalise with elevated, but declining job openings, quit rates and wage growth. These indicate the demand-supply imbalance in the post-Covid U.S. labour market has begun to rebalance. In the current environment where excess labour demand is reflected primarily in job openings, jobless claims and by extension the unemployment rate, may prove more resilient. This may support consumption, which should support the economy. In contrast, Europe’s labour market appears structurally tighter

Notes:

[1] Bloomberg, 1-month returns, total return indices, as of 30 November 2022.

[2] Speech, Chair Jerome H. Powell, Inflation and the Labor Market. Board of Governors of the Federal Reserve System, 30 November 2022. www.federalreserve.gov/newsevents/speech/powell20221130a.htm accessed 1 December 2022.

[3] Bloomberg, as of 30 November 2022.

than that of the U.S., with growing risk of wage growth catching up with inflation, increasing the risk of persistent core inflation. This increases the risk of a de-anchoring of inflation expectations in Europe and subsequently puts a floor on long duration European bond yields. Consequently, we have a slight bias for U.S. over European duration.

Investment implications

Our equity and fixed income allocations reflect our defensive positioning and is broadly unchanged this month. Overall, the outlook for duration has become more balanced recently, given the move down in U.S. CPI[4] and deteriorating macro picture. As we look to 2023, we prefer higher income assets, and U.S. fixed income, with risks tilted to the downside for equity markets and tilted to the upside for U.S. Treasuries. We made the following tactical changes in November:

European Banks Equities

First initiated in September, we have added to this overweight position, as the supporting factors continue to persist, such as the higher rate environment.

Global Energy Equities

We added to overweight global energy equities, as a higher oil price regime is supportive of the energy sector and while re-rating is yet to happen, the upside appears significant.

European Investment Grade Corporates

We moved overweight European investment grade corporates. With all-in yields the highest in a decade, for many developed market investment grade corporates is becoming more attractive. Upside risks to spreads remain in the U.S., but this risk is less severe in Europe.

European 10-Year Government Bonds

In September, we moved underweight European 10-Year government bonds, to reduce duration, as the ongoing energy crisis was likely to force central banks to remain hawkish to cool inflation. We reduced this in November, with German Bund rates moving closer to our 2.2% target, where we would consider adding further exposure and we now see risks are more balanced for them to stay above 2%[5]. We are keeping the underweight to peripheral European bonds, which have tightened significantly and look vulnerable to widening.

Emerging Market Corporate Debt

We moved from overweight to neutral Emerging Market corporate debt, with the highest risk exposure to Asia and China, which face uncertainty from China's bumpy Covid reopening and property market. The shorter duration profile for EM corporate debt means that the asset class is unlikely to benefit as much from bond yields rolling over, as the global tightening cycle peaks.

Notes:

[4] US CPI headline inflation for October 2022 was 7.7% before seasonal adjustment year-on-year. U.S. Bureau of Labor Statistics, released 10 November 2022.

[5] This is a target of the GBaR team, based on GBaR estimates and analysis.

Emerging Market Sovereign Debt

We moved overweight Emerging Market sovereign debt, as some EM economies are ahead of DM central banks in hiking rates and arguably have a better grip on inflation. Therefore, their economies and currencies could be resilient and better prepared going into this inflation-induced slowdown. In addition, the asset class has longer duration and highest carry within credit.

Sterling (GBP)

In November, we closed the underweight to Sterling, first initiated in October. Downside risks have diminished greatly due to the change in government and a renewed focus on fiscal stability. Lower energy prices have also reduced stress on the current account and (imported) inflationary pressures. The Bank of England having a more cautious stance on hikes could lead to a less severe recession – a net positive for the UK economy (compared with already depressed expectations) and GBP.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results. See Disclosure section for index definitions.**

Tactical Positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US		Latest view			
Eurozone		Latest view			
Eurozone Banks				Previous view	Latest view
Global Energy				Previous view	Latest view
UK			Latest view		
Japan				Latest view	
Asia ex Japan			Latest view		
Chinese Equities			Latest view		
Emerging Markets			Latest view		
Global Growth		Latest view			
Global Infrastructure			Latest view		
Global Property			Latest view		

Latest view   Previous view

Source: MSIM GBaR team, as of 30 November 2022. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor. The signals represent the GBaR team's view on each asset class. A negative signal indicates a negative or underweight relative view, a positive signal indicates a positive or overweight relative view.

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit			Latest view		
European IG Credit			Previous view	Latest view	
US High Yield	Latest view				
EU High Yield			Latest view		
EM Sov Debt (LC & HC)			Previous view	Latest view	
EM Corporate Debt			Latest view	Previous view	
LatAm Short Duration Debt				Latest view	
US Treasuries			Latest view		
EU Core Gov. Bonds		Previous view	Latest view		
EU Peripheral Gov. Bonds		Latest view			
UK Gilts		Latest view			
JGBs		Latest view			
Commodities					
Gold			Latest view		
Currencies					
Euro			Latest view		
GBP	Previous view		Latest view		
JPY			Latest view		

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There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio.

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The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

Consumer Price Index: The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

MSCI ACWI Energy Index includes large and mid cap securities across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries*. All securities in the index are classified in the Energy as per the Global Industry Classification Standard (GICS®).

MSCI Europe Index: The MSCI Europe Index captures large and mid-cap representation across 15 developed markets (DM) countries in Europe.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

VIX©: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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