Morgan Stanley

INVESTMENT MANAGEMENT

Markets Break Through the Debt Ceiling

June 2023

CUSTOMISED SOLUTIONS | GLOBAL BALANCED RISK CONTROL TEAM | PATH | 5 June 2023

The S&P 500 Index struggled, but managed to remain marginally positive in May amid the US debt ceiling negotiations, returning 0.4%[1] (USD). In comparison the MSCI Europe (EUR) Index, fell sharply, returning -2.3%.[1] Worries about a global economic slowdown, weak Chinese economic data and uncertainty over the US debt ceiling outweighed optimism over signs of easing inflation. The MSCI Emerging Markets (USD) Index also moved down 1.7%[1]. Further cooling in US-China relations, resulted in the MSCI China (CNY) Index returning -5.6%[1]. Chinese equities have been on the ropes all year, with Hong Kong listed shares entering bear market territory this month, as measured by the Hang Seng Index. In contrast, Japanese equities performed exceedingly well, with the MSCI Japan (JPY) Index returning 4.5%.[1]

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Whilst Japanese equities have been cheap for years, corporate reforms and Japan's apparent exit from deflation and transition to a moderately inflationary economy, acted as a catalyst for foreign investors to buy. The US 10-Year yield remained quite volatile during the month, ending May at 3.6%[2] after reaching a high of 3.8%[3] in the days before month end. Equity volatility was surprising subdued during the month, with the VIX index ending the month at 17.9[2].

It is worth mentioning that the first couple of days of June saw a strong broad-based rally in the S&P 500 and a collapse in the VIX to 14.6[4], following the signing of the US debt ceiling bill. Further, whilst technology

Notes:

[1] Bloomberg, 1-month returns, local currency unless otherwise stated, as of 31 May 2023.
[2] Bloomberg, 31 May 2023.
[3] Bloomberg, 25 May 2023.
[4] Bloomberg, 2 June 2023.

was May's best performing sector, with advances in Artificial Intelligence giving a boost to the S&P 500[5] and NASDAQ, our belief that the rest of the market would catch up was supported in the early June pickup.

Markets Break Through the Debt Ceiling

In the final week of May, the White House and Republicans reached an agreement on a prospective bill, which raised optimism that a disorderly US government default could be averted. This is positive news in the short-term, however, the true risk lies in the longer-term consequences of this policy framework. The fallout as a result of the debt ceiling deal is likely to lead to a fiscal tightening, in the form of not spending what has been already earmarked to be spent. Post-COVID fiscal stimulus has been propping up the consumer and this is now likely to decline, bringing the longer-term risk of loss of consumer strength, just as savings are declining and real incomes are coming down. This will go hand-in-hand with a tightening monetary policy.

We are currently in an environment where inflation is set to become a major challenge, however, central banks now realise that they cannot increase nominal rates as aggressively as they once did without jeopardising a particular segment of the economic landscape. At present, the market has been shorting equities, but if this situation changes and more evidence for a soft-landing outcome emerges, as our base case suggests, we may well see a substantial change in market positioning resulting in a sharp increase in upside risk across the broad equity market. We mean to participate in the upside, whilst strong labour markets appear to be leading consumption resilience and earnings resilience appears to be continuing. The bottom line is that, while there are still market uncertainties, there are still high-quality investment opportunities available to us.

Investment Implications

Economic imbalances indicate that market volatility although currently depressed, may re-emerge. While many investors believe a recession has now been pushed back to 2024, rather than 2023, defensive positioning or "waiting" for the recession can be costly. To paraphrase Benjamin Franklin: those who would "purchase a temporary safety[6]" by being overly defensive, may regret it. Moreover, investors are contending with two fat tail risks – a soft versus a hard landing. To help ensure that we can manage both risks, we are keeping portfolios balanced and well-diversified[7]. As we have been saying throughout 2023, it is better to be balanced than defensive.

Bearing this in mind, we increased equities in May, to ensure our risk-targeted portfolios stay in line with their volatility target, as despite the debt ceiling negotiations during the month, market volatility has remained subdued. We also made the following tactical changes in May:

Notes:

[5] Bloomberg, 1-month return, S&P 500 Technology (USD) Index is 9.5%, and NASDAQ Composite (USD) Index 5.9% as of 31 May 2023.

[6] Pennsylvania Assembly: Reply to the Governor, 11 November 1755," *Founders Online,* National Archives, https://founders.archives.gov/documents/Franklin/01-06-02-0107. [Original source: *The Papers of Benjamin Franklin,* vol. 6, *April 1, 1755, through September 30, 1756*, ed. Leonard W. Labaree. New Haven and London: Yale University Press, 1963, pp. 238–243

[7] Diversification does not eliminate the risk of loss.

SOFR Rates
We entered the SOFR rates position to reduce interest rate exposure in portfolios as short-term forward rates are expecting significant and aggressive rate cuts by the US Federal Reserve, that we do not think will be delivered. This is consistent with our view that it is unlikely that the US economy will experience a hard landing.

Chinese equities
We removed the overweight to Chinese equities, which we added in January, as we are not seeing an acceleration in economic momentum, nor earnings revisions, despite the re-opening impetus.

Copper
We removed the overweight to copper, as we believe that in the short-term, copper prices are likely to remain under pressure due to waning Chinese demand and the challenging global economic growth outlook.

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				
US Small Cap				Latest view	
Eurozone			Latest view		
Eurozone Banks				Latest view	
FTSE MIB				Latest view	
EU Energy				Latest view	
UK			Latest view		
Japan			Latest view		
Asia ex Japan			Latest view		
Emerging Markets			Latest view		
China			Latest view	Previous view	
Global Infrastructure			Latest view		
Global Property			Latest view		
Commodities					
Gold			Latest view		
Oil				Latest view	
Copper			Latest view	Previous view	

Asset Class	--	-	=	+	++
Fixed Income					
US IG Credit			Latest view		
European IG Credit				Latest view	
US High Yield			Latest view		
EU High Yield			Latest view		
EM HC Sov Debt				Latest view	
EM LC Sov Debt			Latest view		
Mexican LC Sov Debt				Latest view	
EM Corporate Debt			Latest view		
US Treasuries			Latest view		
Mar24/Jun24 SOFR Futures		Latest view	Previous view		
EU Core Gov. Bonds		Latest view			
EU Peripheral Gov. Bonds			Latest view		
UK Gilts		Latest view			
JGBs		Latest view			
Asset Backed Securities					Latest view
Currencies					
Euro					Latest view
GBP			Latest view		
JPY				Latest view	

Latest view   Previous view

Source: MSIM GBaR team. Previous view is as of 30 April 2023 and current view is as of 31 May 2023. 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.

RISK CONSIDERATIONS

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

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INDEX DEFINITIONS

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.

The **Hang Seng Index** (HSI) is a freefloat-adjusted market-capitalization-weighted stock index for the largest companies on traded on the Hong Kong stock exchange.

MSCI China Index: This free-float adjusted capitalization-weighted index is designed to measure the performance of China-based equities.

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

MSCI Emerging Markets Index captures large and mid cap representation across 27 Emerging Markets (EM) countries. With 1,417 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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

NASDAQ Composite Index: A broad-based capitalisation-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

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

S&P 500 Technology Index: The S&P 500® Information Technology comprises those companies included in the S&P 500 that are classified as members of the GICS® information technology sector.

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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