Morgan Stanley

INVESTMENT MANAGEMENT

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MSIM Forward

How our investment managers navigate volatile markets

Summary

- Investors have remained riveted on the U.S. Federal Reserve and the path of inflation, which touched an annual rate of 9%, based on June data. As expected, the Fed raised its target rate by 75 basis points (bps) to 2.5% on July 27.
- The latest GDP release on July 28 showed the real U.S. economy slowing by an annualized rate of 0.9% in the second quarter, following a decline of 1.6% in the first quarter—consecutive negative numbers that enter recession territory. The yield curve, based on 2 year/10 year Treasurys, flattened for most of the second quarter and inverted on July 7—a classic bond market flag for a recession.
- The S&P 500 Index registered modest gains in July, bouncing roughly upwards from its low point for the year in mid-June. And investors took heart from comments of Fed Chair Jerome Powell, who said "at some point it will be appropriate to slow down" the pace of rate hikes. Stocks rallied sharply in the hours after Powell's remarks, taking it as a sign of more dovish policy going forward.
- Yet Powell pointedly referenced the Fed's June "dot plot" projections, which anticipate another 100 bps in hikes by the end of the year. And he said the Fed would reduce its guidance on future moves, with "data dependent" decisions to be made on a meeting-by-meeting basis.
- We might take this to mean that the Fed believes it has achieved the goal of trying to get ahead of the curve of inflation—or at least not too far behind.
- As for investors, they have plenty of tools for gauging the path of inflation and growth. But if the Fed is true to its word and stays mum on future moves, the market will be losing a big yardstick.
- In our view, times like these underscore the value of active management. We believe in carefully assessing the fluctuations driven by all kinds of disruptions, and in taking dynamic actions that best serve the long-term interests of our clients.

Contents

EQUITY MARKETS

Bruno Paulson
Portfolio Manager
International Equity

Markets Are Down, but Earnings Are Not… Yet

- Equity markets have had a terrible first half of 2022, with the MSCI World Index down more than 20% in U.S. dollars—the worst start in over 50 years. The bizarre element is that the decline has all been down to *derating*, while earnings have not yet been hit.
- Earnings estimates for 2022 and 2023 are both up slightly, meaning that the 12-months forward earnings number is up 5% this year, benefiting from the increasing weight of the higher 2023 estimate as the year progresses.
- The derating is arguably less bizarre given the extreme multiple at the start of the year, which at 19.3 times forward earnings was 36% above the average during the 17 years between the tech bubble bursting in 2003 and the pandemic starting in 2019—a period when the multiple never even reached 17 times!
- The derating has taken the multiple down to 14.6 times, only 3% above the average over that period. This has clearly reduced multiple risk from here, shifting our concern to the prospects for earnings.

Economic grounds for anxiety about earnings

- Unfortunately, there are plenty of grounds to be anxious about earnings, even if inflation helps revenue growth, at least in nominal terms. The major threat in the short term is the prospect of an economic slowdown or recession.
- Central banks are attempting to counter inflation by dampening demand through higher rates, hoping to calibrate their rate rises to achieve a soft landing. Economic forecasts seem to reflect that this is achievable: the Organization for Economic Cooperation and Development (OECD) anticipates 1% to 2% growth for the U.S. and the euro area for 2023, with inflation falling and unemployment rising only marginally.
- The issue is that monetary policy can be analogous to trying to shift a brick by pulling on an elastic band—there is no effect until suddenly the central bank, along with the economy as a whole, gets a brick in the face.
- What is clear is that for now, there are no signs of any risk of downturn in the current earnings numbers, given the continued robustness of the estimates.

Excess demand, supply shortages and pricing power

- The risk to earnings is raised by the current record level of margins, with the MSCI World Index forward EBIT (earnings before interest and taxes) margin edging up further to 16.7% this year, against a 13.3% average and a 15.2% peak in the 2003-2019 period.
- It seems that excess demand is allowing companies to pass on even more than the rise in their input costs, be it through inflation (raising prices), *shrinkflation* (reducing product sizes) or *skimpflation* (trimming the level of services).
- Any end to shortages—or worse still, a shift to excess supply—could end this phase of generalized pricing power, with more commoditized companies suffering, while genuine pricing power holds up better.
- In the longer term, there could be further pressures on earnings from companies facing rising interest costs, needing to build more resilient supply chains or being forced to pay for the negative externalities they create—even potentially from higher corporate tax rates as governments look to repair their own finances.

Parallels with the Global Financial Crisis

- The Global Financial Crisis of 2008-2009 provides an interesting precedent. After the market peaked in October 2007, the first phase was a market drop of 15% over the next eight months through summer 2008.
- During this phase, forward earnings rose even as the market derated—a clear parallel to the 2022 experience so far.
- It was only in the second half of 2008 that earnings started to fall sharply—along with a further erosion in multiples—to arrive at the market trough another eight months later in early 2009.
- Whatever happens from here in 2022-2023 will not be a repeat of 2008-2009. However, the market's earnings are distinctly vulnerable given their current elevated level and the probable economic slowdown.

INCOME MARKETS

Eric Stein, CFA
Chief Investment Officer, Fixed Income

Fed Signals Possible Slowdown in Rate Hikes as Economy Cools

- As expected, the Federal Open Market Committee (FOMC) raised its fed funds target by 75 basis points (bps) to 2.5% at its meeting on July 27. But the big news came from the commentary of Fed Chair Jerome Powell, which was taken by the market as quite dovish.
- Powell indicated that after the latest action, which followed a comparable 75-bps hike in June, "at some point it will be appropriate to slow down." He noted that the fed funds rate, at 2.5%, is at a level that the Fed considers "neutral"—that is, neither tight nor loose.
- This comment signals that we are in a new phase where the size of future rate hikes will be data dependent and determined on a meeting-by-meeting basis. Powell said the Fed "would not provide the kind of clear guidance that we had provided on the way to neutral."
- Powell referenced the June "dot plot," which anticipates another 100 bps in hikes by the end of the year. That is consistent with increases in the fed funds rate of 50 bps in September and 25 bps in the final two meetings of the year, which would bring the fed funds rate to 3.5%.
- He also mentioned hikes projected in the dot plot in 2023—this could be Powell's way of managing the market's expectations for a near-term easing scenario.

Two-way risk

- I think the market still believes there is two-way risk. If inflation continues to surprise on the upside, the Fed could go another 75 bps or even 100 bps at the next meeting. But I don't think this is the base case.
- High-frequency data on inflation, like commodity prices and inflation expectations, are cooling. In the "real economy," signs of a slowdown are evident, as Powell mentioned.
- Right after the meeting, on July 28, the latest GDP release showed the U.S. economy slowed by an annualized real rate of 0.9% in the second quarter, following a decline of 1.6% in the first quarter—numbers that enter recession territory.

Market reaction to dovish implications

- The markets reacted to Powell's comments on July 27 with a big risk-on rally: Equities were up sharply, the yield curve steepened and the U.S. dollar was broadly weaker.
- This is very consistent with investors looking past the 75-bps hike, which was fairly well priced in, to the implications of a more dovish policy implemented on a meeting-by-meeting basis.
- When there is a big immediate rally sparked by the outcome of Fed meetings, we often see reversals on the following day. We will see how the market digests the latest soft GDP figures on July 28, and whether it reinforces the likelihood of a more dovish policy.

Bottom line

- After two big 75-bps rate hikes, the Fed appears to have achieved its goal of trying to get ahead of—or at least not too far behind—the curve of inflation, and policymakers seem prepared to raise rates at a slower pace.
- Now, with less guidance from the Fed, we are entering a period when data on inflation and growth will be scrutinized for clues even more closely.

EMERGING MARKETS

Jitania Kandhari
Deputy CIO of the Solutions and Multi-Asset Group,
Co-Lead Portfolio Manager for Active International Allocation,
Head of Macro and Thematic Research for Emerging Markets Equity

Current EM Valuations Have Historically Been Followed by Strong Three-Year Returns

Case for emerging markets

- The 2010s was the worst decade for emerging markets (EM) since the 1930s, and the asset class has continued to underperform in 2022.
- The Fed's aggressive monetary tightening to control inflation has added to concerns about lower global growth, while the fallout from the continued war in Ukraine has exacerbated food and energy prices amid ongoing supply disruptions.
- EM has typically exhibited more volatility compared to other asset classes. However, we remain positive on our outlook for the coming decade, with current valuations and currencies at historic lows and discounting worst-case outcomes.
- Underlying trends driving EM economies include digitalization, the commodities upcycle, manufacturing upside and government reform.

Volatility in EM is the norm

- EM equities have experienced considerable ups and downs, exhibiting the highest volatility rates across all asset classes, including commodities, developed market (DM) equities and credit.
- Since 1988, EM equities have outperformed major sectors and asset classes—including U.S. stocks, despite Wall Street's decade-long bull market. The MSCI Emerging Markets Index has gained 9.7% annualized over this period, 180 basis points above developed-market returns, as represented by MSCI World Index returns through June 30, 2022.
- EM, composed of 24 countries currently, has endured a number of crises, including the Asian financial crisis, the Russian debt default, multiple Latin American fiscal crises and the COVID pandemic. The ensuing downturns have historically provided good entry points, with almost every crisis followed by a period of growth and outperformance for EM equities in aggregate.

EM relative performance and valuations near 2000 lows

- An improving growth differential of EM versus DM has historically provided a tailwind for equity market returns. We believe the current growth differential should improve in favor of EM.
- Notably, inflation in EM is now lower than in the U.S. for the first time since the EM index's inception, reducing pressure on central banks to increase rates to cool off demand.
- EM valuations on an absolute basis and relative to DM are at or near two standard deviations below average and at near record lows. These levels of valuations have historically been followed by strong three-year forward returns.[1]
- Aggregate currency valuations (excluding China) are also below historic lows. EM tends to outperform DM after reaching these foreign exchange (FX) market entry levels. Currency has, on average, accounted for one-third of equity market returns for USD investors.[2]

[1] Source: MSIM, Bloomberg, FactSet, Global Insight. Based on MSIM composite valuation indicators for the MSCI Emerging Markets and MSCI World indices, analyzing price/book value, 12-month forward price/earnings, price/earnings, price/cash earnings, dividend yield and price/sales. Data since MSCI EM index inception in 1988 through 7/19/22.

[2] Source: MSIM, Bloomberg, FactSet, Haver Analytics, Global Insight. Data as of 7/19/22.

Structural reasons for an EM comeback

- We expect strength in commodities, digital adoption, and manufacturing upside and reforms to be supportive for several pockets of EM.
- Commodities should experience an upcycle given the rising demand for green commodities coupled with capital expenditure discipline in most commodities over the past decade. Many countries in Africa, Latin America and the Middle East will benefit from the export of oil, metals and food products.
- Pandemic-induced reforms in EM countries have led to privatizing inefficient state-owned enterprises in countries like India, lowering taxes in countries like Brazil and revamping labor laws in countries like Indonesia.
- EM countries like Vietnam, Mexico and Poland are big winners when Western manufacturers diversify out of China.
- Rapid spread of the digital technologies will act as a new growth driver for several EM that are following the U.S./China models for e-commerce, fintech and digital entertainment. Consumers in emerging economies are more likely to adopt mobile internet services.
- We believe aggregate EM performance can hold up better than in the past, given the region's high interest rates and cheap valuations. We think growth in developing economies will continue to outpace the U.S.
- EM private external debt rose by $1 trillion over the past five years, hitting $7.4 trillion at the end of 2021, reflecting growth in China alongside borrowing by Hong Kong and Singapore financial centers to fund Asian entities.
- Elsewhere, external private sector borrowing has flat-lined and is falling as a share of GDP, suggesting corporate sector balance sheets are generally healthy across EM.
- Current levels offer a very attractive entry point into the asset class based on long-term performance, valuations and fundamentals.

INFLATION

Jim Caron
Chief Fixed Income Strategist

Mixed Signals in the Market? Consider a Barbell Approach for Bonds

- Data series in the market are at odds with each other, sending mixed signals to investors depending on whether they consider inflation—a lagging indicator—or sentiment and survey data on economic activity, which are more forward-looking measures.
- This trend is not uncommon and tends to emerge around inflection points in the economic cycle.
- Now that we are at such a point, we think a nuanced, barbell approach is required to effectively counteract the conflicting signals.

At an inflection point

- The inflection point today reflects the transition in consensus expectations from a soft landing for the U.S. economy to a hard one, potentially recessionary.
- This change in consensus is fueled by the acknowledgment that the U.S. Federal Reserve will likely continue to hike rates aggressively into any downturn.
- The Fed typically ends its rate hiking cycle when sentiment and survey data bottom out, but this time is different, because inflation has remained obstinately high.

Nominal versus real data

- Adding to the confusion is a comparison of *nominal* data, which does not account for inflation, to *real* data that does.
- For instance, the release of retail sales data in June showed a sharp increase of 1% month-over-month in *nominal* terms. Yet headline inflation rose 1.3% over the same period, meaning that consumer economic activity actually fell -0.3% in real terms.
- A deeper dive into the data indicates that consumers are spending more, but buying fewer goods, suggesting that profit margins and earnings may shrink.
- Making matters worse, inventories will eventually decline, another factor that weighs heavily on GDP growth.
- Businesses may be forced to lay off workers, something that is already starting to happen. In fact, despite all the talk of rising nominal wages, real wages, when adjusted for inflation, have actually fallen -3.4% through May.
- So which data should an investor follow, *nominal* or *real*? As you can see with our wage example above, we think the *real* data is more informative and a better predictor of future economic activity.
- The message is clear—the Fed will likely keep hiking rates to address inflation, all at the expense of real economic activity, which will likely fall.
- In fact, the 2/10 U.S. Treasury yield curve is already sniffing this out as it both flattens and inverts, with shorter maturity bond yields already higher than longer ones at multiple points along the curve.

Investing in a mixed signal market

- Our approach to investing in fixed income during these cryptic times is to employ a *barbell* strategy. This involves balancing the ownership of floating rate and short duration bonds designed to take advantage of rising rates, while simultaneously owning longer duration and high quality core fixed income as a counterweight.
- Our goal is to strike a balance and create a bond portfolio with approximately 3 years in overall duration.

Risk Considerations: 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.

CORE EQUITY

Andrew Slimmon
Head of Applied
Equity Advisors

This is still a battle royale between the Fed and corporate fundamentals, yet earnings estimates today are *higher* than they were at the beginning of 2022—in other words, the "E" in the Price/Earnings ratio is not collapsing.

What We Are Seeing

- We intend to remain cautious through the summer, primarily because the Fed continues to tighten… a lot.
- While we think inflation has peaked, we are a *long* way from getting to the level the Fed is targeting, making it much too early to call when policymakers will stop raising rates.
- As I have said all year, this is still a battle royale between the Fed and corporate fundamentals, yet earnings estimates today are *higher* than they were at the beginning of 2022—in other words, the "E" in the Price/Earnings ratio is not collapsing.

What We Are Doing

- As of June 2022, the University of Michigan Consumer Sentiment Indicator is at a 44-year low—and this is a good thing. Consumers have been hammered by a rise in gas and food prices to the point where stocks in the consumer discretionary sector have been washed out. To us, however, this represents a "fat pitch" buying opportunity.
- To increase our holdings in consumer discretionary stocks, we are paring our energy and defensive positions, which have had a good run for us, but that we expect to revert to the mean.
- We continue to like China. When the pandemic hit, the U.S. and Europe addressed the problem with boatloads of money. China instead went into lockdown mode, with no monetary relief and consequently no inflation problem. In fact, China is the only major equity market that is up over the past 12 weeks.
- We are reducing our underweight to a portion of our growth position. Valuations for the top 50 growth stocks are still too elevated for a rising interest rate environment. However, the broader growth group is close enough to average valuation to begin to reduce the underweight by seeking out quality growth names.

What We Are Watching

- Remember, the Fed is not your friend. While we believe inflation has peaked, the Fed has a long way to go to get to its target. We will keep an eye on corporate fundamentals, but just do not expect to see an earnings collapse, as predicted by many.
- We believe too much time is spent on recession talk, and not enough on return metrics. Since World War II, market returns for the S&P 500 Index after a 20% market drop have averaged +21.5% for the following 6 months and +31.3% over the next 12 months.
- The second year of a presidential term has historically been the weakest for equities, with the second quarter of that year usually the worst, while the fourth quarter is typically the best.
- As the incumbent party in power traditionally loses, the market has historically rallied on a switch to centrist policies. We expect this year to be no exception. Therefore, I think the second half of 2022 should be much better for the market than the first.

VALUE EQUITY

Aaron Dunn, CFA
Co-Head of
Value Equity

Brad Galko, CFA
Co-Head of
Value Equity

We believe the case for active equity portfolio management—that is, the ability to sift through the noise and focus on the fundamentals that have helped to drive alpha over time—is essential in the current environment.

What We Are Seeing

- As we entered 2022, we noted that the U.S. macroeconomic backdrop was broadly tilted in favor of value equities, and the second quarter continued the trend of the Russell 1000 Value Index materially outperforming Russell 1000 Growth—by nearly 900 basis points on a total return basis.
- Market volatility isn't new. However, today's investors face an almost perfect storm, with geopolitical upheaval and the ongoing pandemic having altered everything from global peace post-World War II to monetary policy and supply chains for food and energy.
- History suggests that these value-outperformance cycles can persist for many years—albeit not always in a straight line. Historically, inflation paradigm shifts have been associated with longer, stronger cycles in U.S. value versus growth—such as the periods from May 1940 to August 1948 and June 1972 to July 1979.
- We believe the sharp shift in the current inflation regime is representative of a long potential run of the value cycle.

What We Are Doing

- We continue to focus on franchises that fall into what we call an *Opportunistic Value* approach. This consists of company-by-company analysis informed by deep, fundamental research to find stocks priced below our estimates of their intrinsic value.
- As long-term investors, we are always looking for opportunities to buy good companies when they have been mispriced. In today's macroeconomic environment, we believe select companies within financial services (given inflation and interest rates), healthcare (with innovation in this sector being a priority for governments), and industrials (as the Russia/Ukraine war is redefining political partnerships) may offer investment opportunity.
- During periods of market stress or volatility, we find our approach especially constructive. Rather than managing portfolios for the next week or quarter, we focus on long-term results.
- We are initiating new positions in companies where we have high conviction that they are priced attractively with solid fundamentals. We believe these companies are simply moving in the short-term because of general movement within their sector, rather than anything specific to a particular company.

What We Are Watching

- The Bank of America "Global Fund Manager Survey" for June revealed that optimism on global growth has hit an all-time low since the survey began in 1994.[1]
- We are closely watching earnings season, monitoring how much deterioration there truly is. And we use our team's deep knowledge of our companies to assess their earnings power through the cycle, so we can gauge whether short-term earnings results provide long-term alpha opportunities.
- We believe the case for active equity portfolio management—that is, the ability to sift through the noise and focus on the fundamentals that have helped to drive alpha over time—is essential in the current environment.

[1] BofA Research Investment Committee, Fama & French. Data through May 2022.

Risk Considerations: The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the U.S. and global markets. The value of equity securities is sensitive to stock market volatility.

U.S. MULTI-SECTOR

Vishal Khanduja, CFA
Co-Head of U.S.
Multi-Sector

Risk assets are now priced for more aggressive monetary tightening and a higher probability that the U.S. and global economies will slip into recession.

What We Are Seeing

- Worries about how far central banks would go to control inflation sent bond yields sharply higher and triggered a global sell-off in equities and credit during the second quarter.
- Once markets priced in an aggressive front-loaded scenario for rates, the focus shifted to the damage higher rates would inflict on the economy and the implications for defaults/recoveries and credit conditions for corporations and consumers.
- Fed officials have expressed confidence that the U.S. economy would be strong enough to weather significantly higher interest rates, and tight conditions in the labor market have so far tended to support this view. An estimated $4.2 trillion[1] in additional savings accumulated during the pandemic contributed to healthy levels of consumer spending, while businesses also continued to spend—with core capital goods orders posting three straight months of gains.

What We Are Doing

- The outlook for the domestic economy may be uncertain, but we believe valuations help to compensate, with Treasury yields at multi-year highs and credit spreads at or near recessionary levels. This market repricing has created opportunities to capture attractive prospective returns, potentially with less risk than we have seen since the global financial crisis.
- While we have become more constructive on duration after these yield adjustments, our portfolios remain underweight at the long end of the curve—to us, 10-year and longer real rates of 50 to 90 basis points are not compelling when inflation is still high and the Fed is rolling off its balance sheet. Consistent with our view on longer rates, portfolios remained positioned for curve steepening.
- We ended the second quarter with a neutral weight in investment-grade credit: Valuations have become more attractive, but demand has softened with outflows and increased hedging costs. We continue to prefer financials over nonfinancials, as we expect financials to outperform when growth is weaker.
- In portfolios that can own below investment grade, we have taken opportunities to reduce exposure to high-priced bank loans—which have performed well this year from a total return standpoint—in favor of high yield bonds—primarily BB-rated issues with deeply discounted prices that may help to build in further downside protection.

What We Are Watching

- Global inflation has been much stronger and more persistent than expected. With central banks having little or no control over the supply side, market participants may think that Fed policymakers would be willing to risk a recession to avoid an inflationary spiral. Risk assets are now priced for more aggressive monetary tightening and a higher probability that the U.S. and global economies will slip into recession.
- The U.S. job market is showing signs of cooling, as evidenced by the uptick in layoffs and hiring freezes in sectors like technology and real estate, but we believe the current labor supply/demand imbalance could mitigate the severity of the slowdown.
- While accumulated consumer savings are becoming more depleted in some segments, that cushion could still be large enough to serve as a buffer against ongoing inflation and a mild growth shock. Similarly, businesses have strengthened their balance sheets during the past couple of years, so they may also be well-positioned for possible growth headwinds.

[1] U.S. Federal Reserve. Data as of 12/31/21.

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MUNICIPAL BONDS

Evan Rourke, CFA
Director, Portfolio Management
Parametric

Should the inflation data ease and fund outflows stop, we think the municipal market is well situated to put in a strong performance in the second half of the year.

What We Are Seeing

- Investors have responded to notably higher yields inside of five years, and the municipal curve has steepened, since May even as the Treasury curve has inverted.
- Municipals are now trending more expensive in first few years of the curve, but they are fairly valued in five years and cheaper further out compared to their five-year averages. However, increased Treasury volatility is also increasing ratio volatility.
- We continue to see an opportunistic entry point for investors in high tax brackets who are looking to put some cash to work.
- The upward move in rates is impacting the coupon structure of new issue deals, with increased issuance of 4% and 5% coupons.

What We Are Doing

- Much as before, we are staying the course, and we think municipal investors may want to consider doing the same.
- Generally, selling a security that is trading at a loss creates a realized tax loss, which can be used to offset realized capital gains from this year, or carried over to future tax years. We continue to harvest tax losses as part of our ongoing tax loss harvesting process whenever we see opportunities.
- For total return strategies, rate volatility is still creating inefficiencies that we can take advantage of. When the opportunity presents itself, we are "couponing up."

What We Are Watching

- Overall, the stage looks to be set for a better second half in the municipal market, with the increased yields appearing to attract investors in separately managed accounts (SMAs).
- The supply/demand dynamic has shifted favorably, as the summer underwriting calendar is light, and reinvestment flows from called and maturing bonds are expected to exceed issuance.
- Funds are still seeing outflows, though they are slowing significantly. Until that trend comes to an end, it is likely to temper any rally in the market.
- Should the inflation data ease and fund outflows stop, we think the municipal market is well situated to put in a strong performance in the second half of the year.

Risk Considerations: An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Debt securities are subject to risks that the issuer will not meet its payment obligations.

Tax-loss harvesting involves certain risks including, among others, the risk that the new investment could perform worse than the original investment and that transaction cost could offset the tax benefit. There may also be unintended tax implications. Prospective investors should consult with a tax or legal advisor before making any investment decision.

MORTGAGE-BACKED SECURITIES

Andrew Szczurowski, CFA
Head of Agency MBS

Bear in mind that this is not the same Fed who yielded to every risk asset decline over the past few cycles: This cycle they are behind the curve on inflation.

What We Are Seeing

- Mortgage rates continued their march higher in the second quarter of 2022 with the average 30-year fixed rate mortgage surpassing 5.8%[1]—its highest reading since late 2008. At current levels, mortgage rates are now higher than 99% of all outstanding conventional mortgages, making it uneconomical for most homeowners to refinance; unsurprisingly, the level of refi activity has fallen to a 22-year low.
- Despite prepayment risk becoming somewhat of a non-issue for MBS investors, spreads have continued to widen: In mid-July, the current coupon MBS spread nearly touched 150 basis points (bps) over Treasurys—a level not seen since the Global Financial Crisis of 2008-2009.
- While uncertainty regarding the ultimate path of the Fed's quantitative tightening program may warrant MBS spreads that are wider than normal, we think the longer-term resting level for this AAA-rated asset class should be lower than where it stands now.

What We Are Doing

- We continue to believe that short-end rates may be biased to the upside in the near term, so in an attempt to protect against rising rates, we have kept our duration short.
- One way we can do this is by moving up in coupon. Coupons on most outstanding MBS range from 2% to 2.5%, which carry durations of 6.9 years and 6.5 years, respectively, for Ginnie Mae bonds. By contrast, we have been favoring Ginnie Mae 5% bonds, with a duration of just over 2 years.[2]
- Not only do these higher coupon bonds come with shorter durations, but they also offer meaningfully wider spreads. The combination of higher yields and shorter durations—not to mention being explicitly guaranteed by the U.S. Government—make them attractive options versus other high quality alternatives, such as investment-grade corporates.

What We Are Watching

- Following the June CPI report, the bond market is actually now expecting the Fed to begin cutting rates in early 2023. While rate cuts will inevitably come one day, it seems unlikely that the Fed would be so quick to declare victory over inflation and make a policy pivot just two quarters from now.
- Given how much Fed officials need to preserve their credibility to fight inflation after letting it run at the highest rate in four decades, we expect them to continue pumping the brakes on the economy to cool inflation.
- We think market participants should bear in mind that this is not the same Fed who yielded to every risk asset decline over the past few cycles: This cycle they are behind the curve on inflation, which likely means an inability to reverse rate hikes as soon as the market expects.

[1] Freddie Mac. As of 6/30/22.

[2] Wells Fargo. As of 7/19/22.

Risk Considerations: The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. Securities with longer durations tend to be more sensitive to interest rate changes than securities with shorter durations. As interest rates rise, the value of certain income investments is likely to decline. Mortgage- and asset-backed securities are subject to credit, interest rate, prepayment and extension risk. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. U.S. Treasury securities generally have a lower return than other obligations because of their higher credit quality and market liquidity. While certain U.S. government sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the U.S. Treasury.

EMERGING MARKETS DEBT

Marshall Stocker, Ph.D., CFA
Co-Head of Emerging Markets Debt, Portfolio Manager

John Baur
Co-Head of Emerging Markets Debt, Portfolio Manager

Dispersion among individual emerging markets is wide, and an informed and discerning eye is critical. We remain focused on analyzing the direction of policy in each emerging and frontier markets country.

What We Are Seeing

- We have seen emerging markets (EM) continue to be impacted by the same themes as the broader markets. Specifically, the Fed, inflation and broad U.S. dollar strength; the global repercussions of the Russia-Ukraine war—including elevated food and energy prices—and China's growth outlook and corresponding policy response.
- We have seen a number of EM countries default on dollar debt over the past couple of years; that number is likely to increase steadily as heavily indebted countries are struggling to earn enough dollars to pay those debts.
- Crossover buyers into EM debt (EMD) appear to have near record low allocations, while outflows from the space year to date period have been near record high levels. We are seeing signs that these factors may be bottoming and the associated technical pressure on the asset class could be in the process of easing.
- In light of this, we believe valuations in the local rate and credit areas of the EMD market are particularly compelling. While no one can ever correctly call the bottom, we believe investors with an intermediate- to long-term time horizon will likely be well served by allocations to EM debt.
- As is always the case, dispersion among individual emerging markets is wide, and an informed and discerning eye is critical.

What We Are Doing

- We remain focused on analyzing the direction of policy in each emerging and frontier markets country. As we have also come to expect, the management of these challenges at the individual country level spans a broad spectrum, with some countries managing quite well and others not so much.
- The first-order effects of the challenges are quite clear and seemingly well-priced by the market. Our work is focused on identifying second- and even third-order effects, which the market may not be discounting yet.
- We are still finding countries where governments are committed to structural reforms aimed at improving their economies and the prospects for investment. Historically, this has led to better standards of living for the local populace as well as capital market outperformance and a reduced cost of capital—a powerful combination.

What We Are Watching

- While we don't believe we have a competitive advantage in predicting their direction, we are watching the commodity markets quite carefully, given their importance to much of the emerging world as well as the broader macro environment.
- Similarly, we don't try to predict Federal Reserve actions, but rather we do observe the Fed and the market's pricing of its policies. With expectations for the current tightening cycle easing recently, EMD markets have reacted positively. We continue to watch the Fed and other major central banks carefully as they walk a fine line between addressing inflation and suppressing growth.
- The Russia-Ukraine war represents a large-scale humanitarian tragedy, and the ongoing second-order effects on the world's food and energy supplies continue to impact the rest of the world. We remain skeptical of a near-term resolution and believe winter will represent an important inflection point for potential negotiations.
- The Chinese economy is in a tricky spot, with the combination of its commitment to Common Prosperity and zero-COVID policy. With 20th party congress coming up in October, President Xi's power remains unquestioned, yet other leadership changes will be important in determining the future of policy.

Risk Considerations: The value of investments may increase or decrease in response to economic and financial events (whether real or perceived) in the U.S. and global markets. The strategy employs an "absolute return" investment approach, benchmarking itself to an index of cash instruments and seeking to achieve returns that are largely independent of broad movements in stocks and bonds. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. In emerging or frontier countries, these risks may be more significant. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. Exposure to derivatives involves risks different from, or possibly greater than, the risks associated with investing directly in securities and other investments. As interest rates rise, the value of certain income investments is likely to decline. The value of commodities investments will generally be affected by overall market movements and factors specific to a particular industry or commodity, including weather, embargoes, tariffs, or health, political, international and regulatory developments.

GLOBAL BALANCED RISK CONTROL

Andrew Harmstone
Head of Global Balanced Risk Control (GBaR)
Senior Portfolio Manager, Global Multi-Asset

We are maintaining a stable risk profile across our multi-asset strategies that is guided by our top-down asset allocation views on macro themes and tactical positioning across regions and sub-asset classes.

What We Are Seeing

- Volatility continued to roil major equity markets last month, as investor sentiment soured further on the outlook for continued price pressures, rising interest rates and data releases pointing to a sharp decline in demand among U.S. consumers.
- We expect that pricing in areas such as housing—where the consumer price index (CPI) lags changes in rental rates—may sustain higher inflation readings into the second half of the year, even if prices for other CPI components begin to fall in line with moderating demand.
- In China, along with fiscal and monetary stimulus, support for the residential property market should aid stronger economic activity as the country gradually comes out of lockdown. So we are more positive on prospects for China's onshore equity market, and we also anticipate that the country's healthier economic outlook could be positive for global energy equities.

What We Are Doing

- In recent months, we have moved to capitalize on new tactical opportunities that we have identified, deploying cash holdings back into markets and increasing our exposure to duration risk by investing broadly across fixed income markets.
- Elsewhere, we have maintained our positioning in equities—with overweights to China and global energy markets—while slightly increasing our total exposure to commodities.
- We are maintaining a stable risk profile across our multi-asset strategies that is guided by our top-down asset allocation views on macro themes and tactical positioning across regions and sub-asset classes.

What We Are Watching

- We are closely monitoring inflation trends and monetary policy in the U.S. and Europe, as we ultimately believe that today's heightened price pressures could force hurried rate hikes by central banks that result in excessive tightening and recession.
- In our view, the risk of overshooting on policy tightening is slightly higher in the U.S., with the Federal Reserve having signaled that it will move aggressively to tamp down rampant price pressures.
- To us, the risk of recession appears increasingly likely—not least because additional interest rate hikes will likely arrive at a time when growth is already beginning to weaken. If an economic downturn does materialize, we may even see central banks shift back toward more benign policy positions in the second half of the year.

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. 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. 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. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Diversification does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

INDEX DEFINITIONS

Consumer Price Index (CPI) is a measure of the change in the average price level of a fixed basket of goods and services purchased by consumers.

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

Russell 1000® Value Index is an unmanaged index of U.S. large cap value stocks.

Russell 1000® Growth Index is an unmanaged index of U.S. large cap growth stocks.

MSCI World Index is a market-cap weighted index that captures large and mid-cap stock performance across 23 developed market countries.

MSCI Emerging Markets Index is an unmanaged index of emerging markets common stocks

Risk Considerations:

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. There is no assurance that a portfolio 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. 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, investors can lose money investing. See offering document for more description of risks associated with each strategy.

Important Information

Date of Data: 7/29/22.

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MIDDLE EAST

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor- Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

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