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Morgan Stanley Global Macro Forum

Key Views Through Year-End

September 5, 2017

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Elga Bartsch – Global Co-Head of Economics and Chief European Economist/Economist

Sheena Shah – FX Strategist/Strategist

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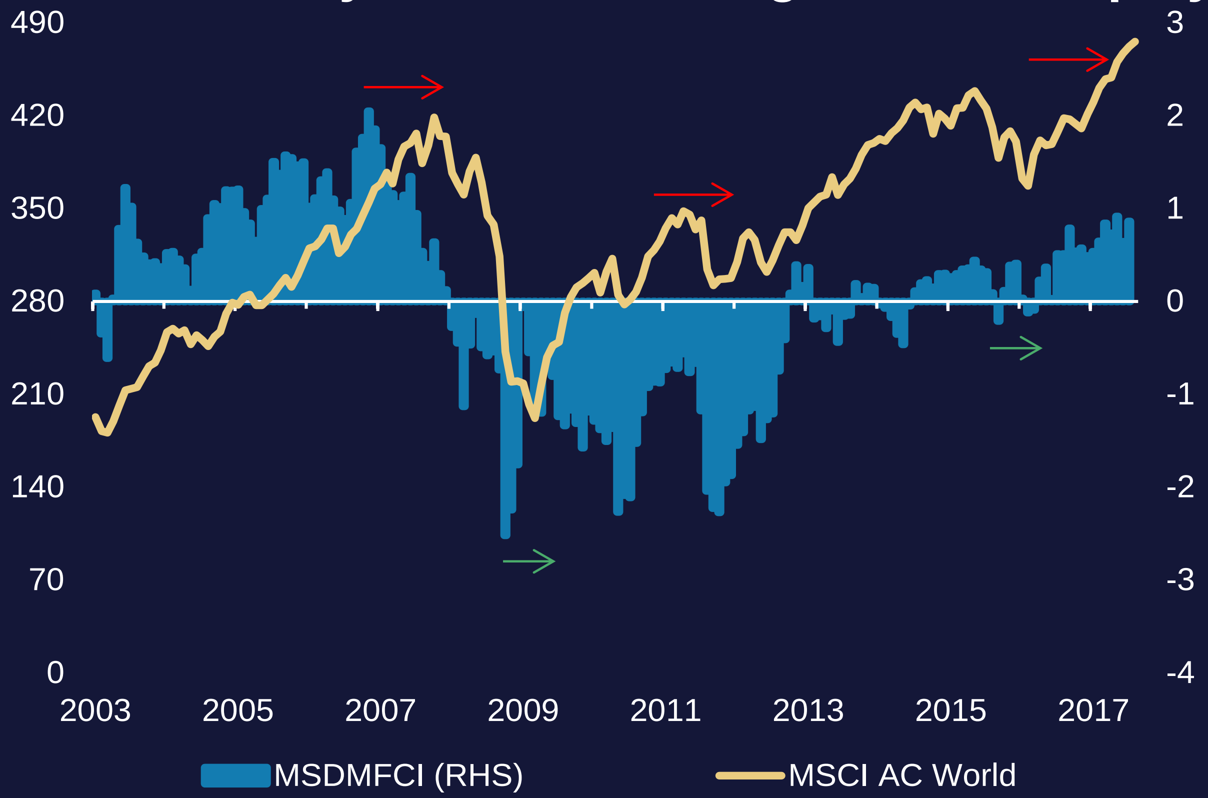
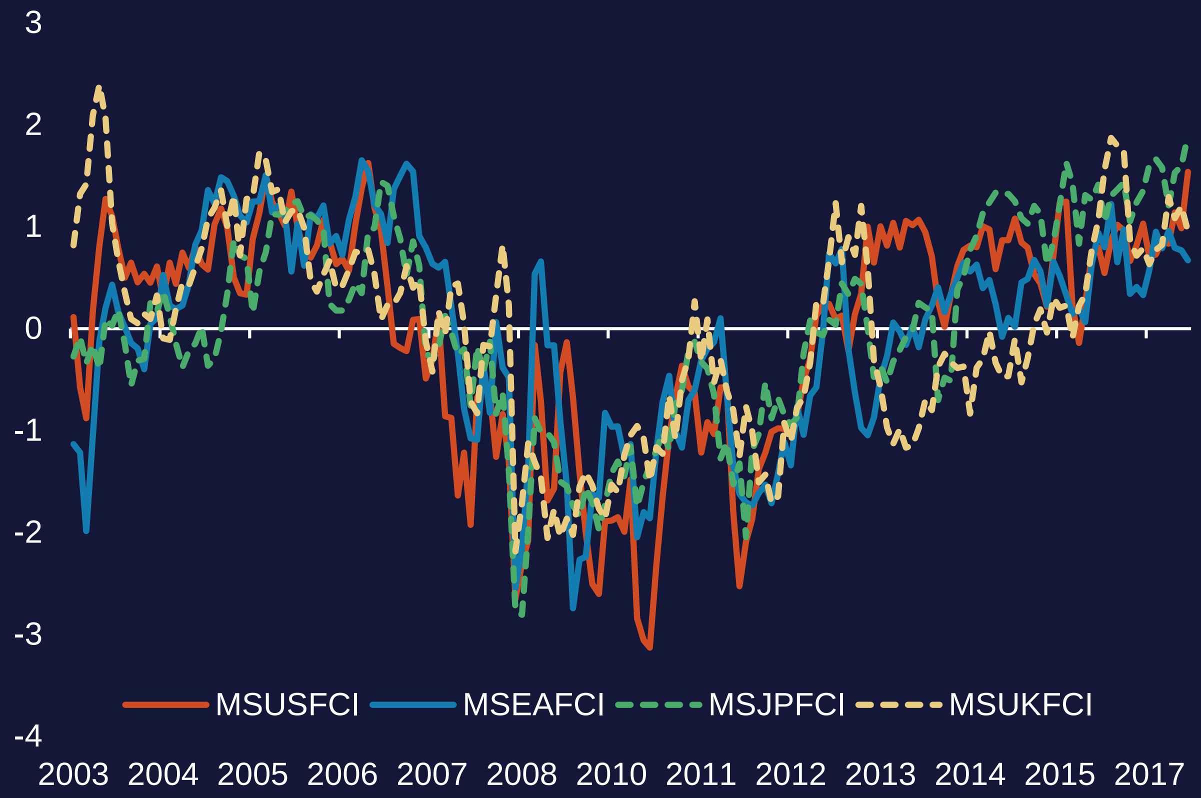
Elga Bartsch
Global Co-Head of Economics and Chief European Economist

MSDMFCI Historically Has Led Turning Points in Equity Market Cycles



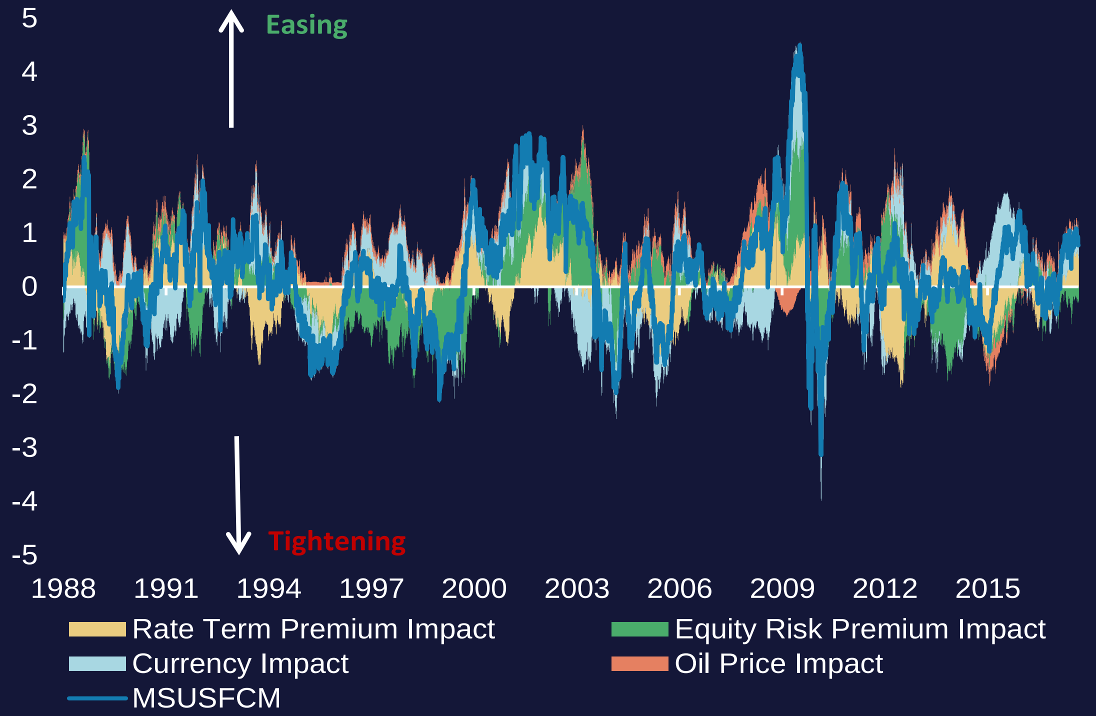
Source: MSCI, Morgan Stanley Research

The New Morgan Stanley National FCIs at a Glance



Source: Morgan Stanley Research

MSUSFCM and its Components



Note: Dynamic weights are determined from simulated responses of nominal GDP to a shock in the highlighted economic variables, following the FRB-US model (VAR version). A 100bp shock to the 10Y term premium or equity risk premium, a 10% USD TWI appreciation, or a US$10/barrel rise in oil prices translates into an average decline of -0.38, -0.19, -0.34, and -0.03 percentage points in nominal GDP within the first four quarters, respectively.
Source: Federal Reserve Board, FRED, Bloomberg, Morgan Stanley Research

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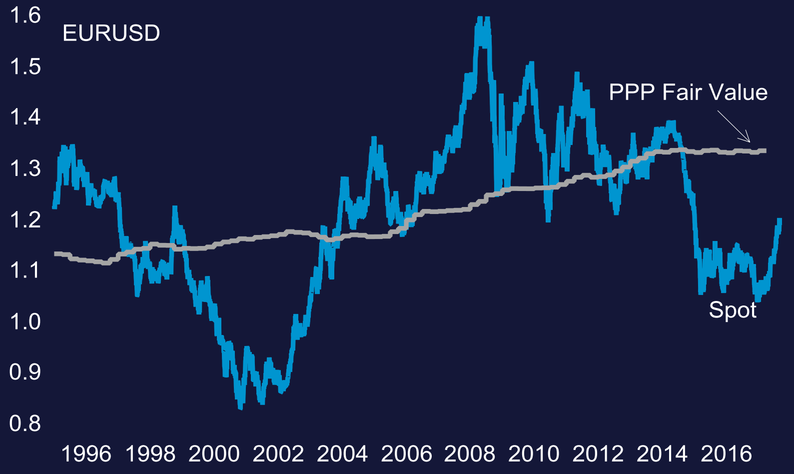
Sheena Shah

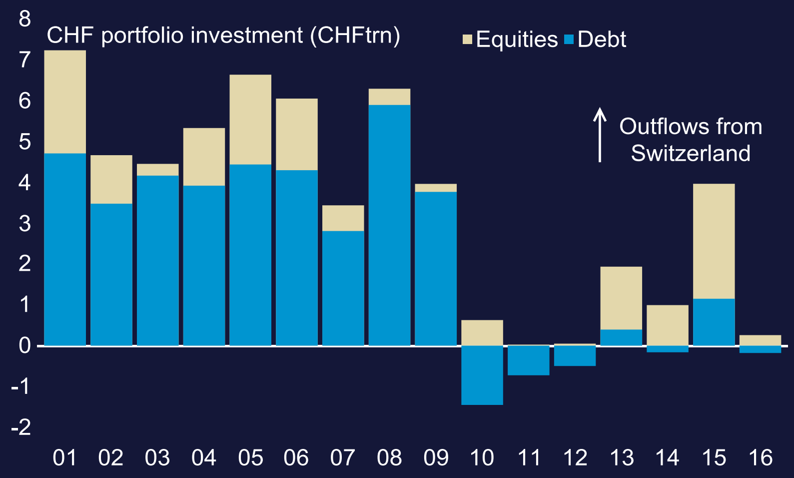
FX Strategist

EUR Strength on the Horizon

EURUSD trades below fair value



Swiss investors look to buy EUR assets



Source: Bloomberg, Macrobond, Morgan Stanley Research

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Michael Wilson

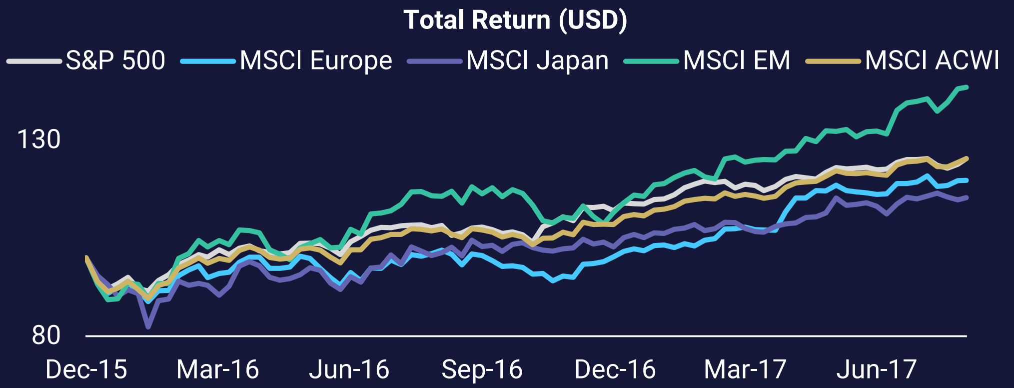
Chief US Equity Strategist and Chief Investment Officer of Institutional Securities & Wealth Management

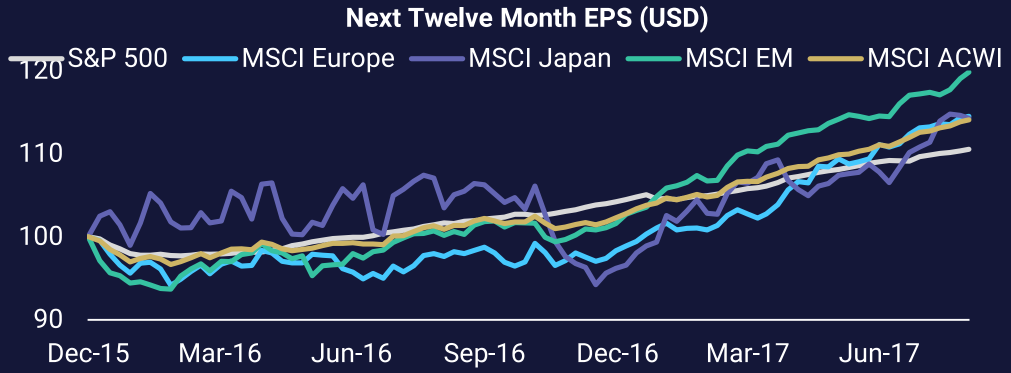
This Has Been a *Global* Equity Rally Driven by Earnings

MSCI AC World Earnings Scorecard - As of Sept 1

Sector	Growth Reported	Surprise %
Discretionary	8.8%	4.9%
Staples	6.0%	2.4%
Energy	51.7%	-4.0%
Financials	12.2%	8.1%
Health Care	4.7%	5.1%
Industrials	14.1%	4.5%
Info Tech	27.6%	11.3%
Materials	18.1%	4.1%
Real Estate	22.1%	12.2%
Telecom	-2.4%	0.6%
Utilities	-9.9%	26.9%
MSCI AC World	**13.4%**	**6.5%**

98% of cos have reported





Source: L: FactSet, Morgan Stanley Research. As of Sept 1, 2017. R: FactSet, Morgan Stanley Research. As of Aug. 31, 2017.

Breadth of Rally Supports Our Fundamental Views

Total Return YTD (in USD)					
	S&P 500	MSCI AC World	MSCI EM	MSCI Japan	MSCI Europe
Discretionary	11.0%	14.1%	28.8%	8.1%	16.7%
Staples	7.5%	12.7%	18.1%	16.9%	20.3%
Energy	-15.1%	-7.0%	10.0%	6.5%	2.2%
Financials	7.0%	14.0%	26.1%	1.0%	23.2%
Health Care	19.1%	17.5%	10.6%	10.0%	17.4%
Industrials	9.7%	15.4%	21.7%	14.4%	23.5%
Tech	26.6%	29.9%	47.6%	28.8%	27.8%
Materials	11.9%	19.1%	27.7%	20.8%	21.7%
Real Estate	8.9%	14.0%	39.6%	2.4%	17.0%
Telecom	-7.9%	6.1%	17.8%	14.2%	14.7%
Utilities	15.0%	17.5%	15.9%	7.2%	27.3%
Total	11.9%	15.5%	28.6%	12.3%	19.5%

Total Return - Dec. 31, 2012 through Sept. 1, 2013 (in USD)					
	S&P 500	MSCI AC World	MSCI EM	MSCI Japan	MSCI Europe
Discretionary	29.1%	26.6%	3.4%	33.4%	26.5%
Staples	16.1%	13.1%	-2.1%	22.8%	13.2%
Energy	15.4%	8.1%	-8.0%	-0.7%	5.5%
Financials	22.9%	14.8%	-4.8%	28.1%	19.2%
Health Care	28.5%	25.3%	4.4%	16.1%	22.1%
Industrials	23.9%	19.4%	-3.5%	18.1%	22.0%
Tech	13.4%	14.1%	6.0%	13.0%	23.9%
Materials	13.5%	-4.2%	-18.5%	20.4%	-0.1%
Real Estate	1.5%	-	-	-	-
Telecom	5.7%	15.4%	-1.3%	53.5%	28.8%
Utilities	10.1%	8.9%	-7.1%	26.3%	12.3%
Total	19.8%	14.9%	-4.1%	24.5%	16.7%

Source: Top: FactSet, Morgan Stanley Research. As of Sept. 1, 2017. Bottom: Bloomberg, Morgan Stanley Research. As of Aug. 31, 2017.

Summary and Key Conclusions

- Magnitude of the global recession in 2015 is still underappreciated
- Coordinated global monetary policy in March 2016 (Shanghai G-20) was a game-changer
- We now have most synchronous global economic recovery since the financial crisis
- Equity vol is low because economic surprises and earnings dispersion are low
- Populist movement around the world was/is *positive* catalyst for markets—fiscal policy
- Fiscal policy ➔nominal GDP > debt growth➔ *falling* equity risk
- "Classic late-cycle" in the US—waiting for excesses to develop in the real economy
    - Capex
    - M&A
    - Borrowing/lending
- Ironically, fiscal stimulus could shorten, not lengthen, the expansion
- No matter who is running the Fed, they will ultimately do their job and kill the cycle

***Global* equity rally continues; sentiment not exuberant; embrace it before it's over.**

➔ Favour Japan (FX-hedged), US, EM, Europe (FX-unhedged).

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Vishwanath Tirupattur

Head of US Fixed Income Research

Interest Rate Markets

- **US Interest rates to be relatively range-bound. Don’t expect rates to spike in 2017**
  - Market pricing ~ 30% probability of a December Fed hike based on inflation data to date
  - Lower inflation prints likely to continue until year-end
  - Market pricing just about one rate hike over the next year. We don’t expect it to price much more, absent a change in growth and inflation outlook
  - Fed balance sheet unwind is largely reflected in the Treasury markets
  - Meaningful yield differentials between US and Europe/Japan to persist for some time
  - FOMC appointments, particularly of the Fed Chair, are critical
  - Trades: Overweight in the belly of the curve

Corporate Credit, EM and Securitized Products

- **Cautious on US corporate credit. Expect a bumpier rest of 2017**
  - Credit markets underestimating the impact of the Fed’s balance sheet unwind
  - Valuations are stretched and margin for error is shrinking
- **Favour EM over credit. Prefer local market debt over external debt thanks to firmer EM FX**
  - EM debt inflows will outpace expected reductions, driven by the Fed’s balance sheet unwind
- **Significant pockets of opportunity remain in securitized products, particularly related to housing**
- **Trades:**
  - Credit: Up in quality. IG>loans>HY; long financials; CDX over cash
  - EM: In local rates, Mexico, Peru, Indonesia, India and Turkey; Argentina sovereign credit
  - Securitized: CRT, Agency CMBS, senior tranches of conduit CMBS and short WAL CLOs

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Andrew Sheets

Chief Cross-Asset Strategist

Morgan Stanley

Key Takeaways

Key Takeaways

- **A constructive backdrop into year-end**
  - Solid global growth, easy financial conditions and light positioning all help.
  - Yes, there are near-term risks (debt ceiling, North Korea). But we think supportive factors ultimately win out this year.

- **What do we like? Late-cycle positioning**
  - **O/W global equities**, with US and Japan as top regions. In EM, we're OW China and India.
  - **U/W US corporate credit**, which we expect to underperform before the cycle turns.
  - **Positive on EM fixed income** (local and HC), where we think valuations are still reasonable and fundamentals are improving. We like local rates in Mexico, Indonesia, India and Turkey.
  - In rates, favour the belly of the US curve, and **US and UK duration over eurozone duration**.
  - In FX, we are **bullish EUR**, which is on a multi-year uptrend.

Valuation Methodology and Risks

Trade	Entry Date	Rationale	Risk
Like Indonesia local bonds	06-Mar-17	We see a window for positive sentiment on Indonesia bonds, given the relatively high real yield in the region, while the supply for 2017 looks benign.	Despite an improvement in Indonesia's fundamentals, we remain cautious on rising market uncertainties out of China and the US, as IndoGBs and IDR tend to underperform in periods of increasing volatility.
Like India local bonds	06-Mar-17	While the RBI has switched from an accommodative stance to a neutral stance, we think low inflation until August gives scope to pick up carry in the front end. We expect the RBI to stay on hold for an extended period before hiking in 2H18, and forecast stable long-end rates in this period.	Spike in global volatility leading to a sell-off in EM FX and rates.
Like Mexico Local Bonds	02-May-17	We believe valuations for Mexico local rates are still attractive. With high carry, a strong currency, and what appears to be the end of the tightening cycle, Mexican local government bonds should continue to perform well.	US Treasuries sell off, risks build with regards to NAFTA renegotiation. Banxico needs to continue with the tightening cycle.
Like Turkey local bonds	02-Jun-17	The CBT continues to keep the funding rate at a historical high after surprising the market by being hawkish four times in a row since last November. The last time the CBT vowed to keep tight monetary policy until inflation declined was in January 2014 when it enacted emergency rate hikes, and such a tightening stance was kept for more than six months, which helped the local market rally in 2014.	Sell-off in core rates or a cabinet reshuffle that removes market-friendly ministers.
Like Peru Local Bonds	14-Jul-17	Peru's fundamentals are among the strongest in the region, notwithstanding downside risks to growth and political uncertainty. Local bonds offer attractive carry while a very steep curve bodes well for extending duration.	Risk aversion driven by external factors and thin liquidity in the local market.
Like Argentina Hard Currency Bonds	14-Jul-16	We envisage macro normalisation and transformation in Argentina. A positive election result can push the current spread of 40bp tighter vs. single B credits to at least 80bp. And 10y spreads vs. benchmark to be at 350bp by the end of the year. The much steeper 10s30s curve favours the long end of the USD curve and we still recommend buying EUR discount.	Fiscal consolidation efforts falter or confidence in the economy does not pick up as expected, leading to another growth slump.

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Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

Like: Based on current market conditions as of the date of this report the analyst expects that the relevant securities of the issuer that is subject of the recommendation will perform favorably over the relevant time period as compared to the overall market of comparable securities by other issuers. This is not intended to be, nor should it be interpreted as a formal fundamental rating of the issuer or its creditworthiness.

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History of recommendations for Turkey local currency bonds

Trade	Entry Date	Exit Date
Dislike Turkey Local Currency Bonds	17-Jul-16	27-Nov-16

Source: Morgan Stanley Research

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Disclosures

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(as of August 31, 2017)

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Overweight/Buy	**1164**	**36%**	**306**	**41%**	**26%**	**555**	**37%**
Equal-weight/Hold	**1425**	**44%**	**349**	**46%**	**24%**	**701**	**46%**
Not-Rated/Hold	**61**	**2%**	**6**	**1%**	**10%**	**10**	**1%**
Underweight/Sell	**606**	**19%**	**91**	**12%**	**15%**	**242**	**16%**
Total	**3,256**		**752**			**1508**	

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