Topics in Portfolio Construction: Will the "Trump Trades" Continue?

December 8, 2016

From the Global Investment Committee

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Topics in Portfolio Construction Overview

Topics in Portfolio Construction is a monthly publication from the Global Investment Committee (GIC) for clients and their Financial Advisors who seek to generate risk-adjusted performance over a horizon of the next 12 months by applying quantitative analysis to the GIC's investment views.

In this month's edition, we answer:

Key Question One:	**Key Question Two:**	**Key Question Three:**
Will the recent rise in equities and interest rates continue?	EM has underperformed following the election—should the GIC remove its overweight?	Which industries may benefit from the Trump administration's policies?
Our View: Yes. We remain overweight equities, underweight long-duration bonds	**Our View:** No. Maintain emerging markets positions on the absence of fundamental stresses.	**Our View:** Favor industries levered to signaled policy changes with attractive factor profiles.

Connect with us:

- Contact us directly to learn more, get answers to your questions, or run customized analyses
- Read *Topics in Portfolio Construction*, our monthly publication that digs deeper into GIC advice on asset allocation decisions
- Reference *Quantitative Dashboard*, which provides monthly updates of the quantitative indicators driving our analysis
- See our slides within *ChartBook* for easy monitoring and presentation of our summary slides

Source: Morgan Stanley Wealth Management GIC

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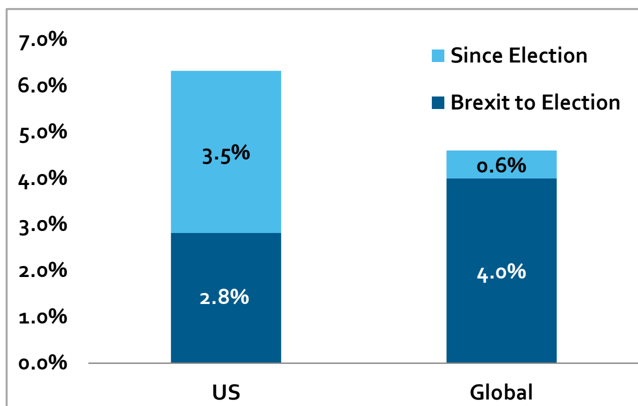
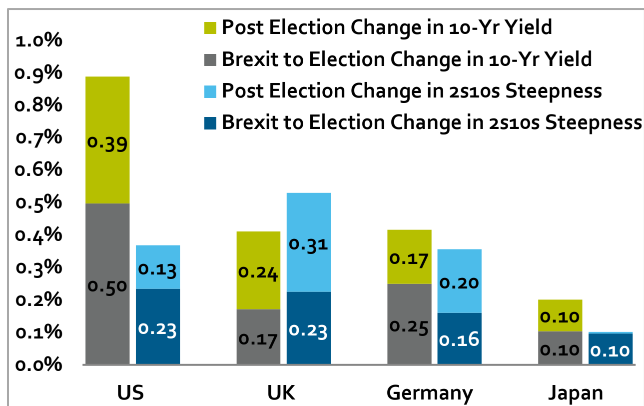
Key Question 1: Will the Rise in Equities and Interest Rates Continue?

The election has intensified the post-Brexit cyclical impulse, resulting in strong equity performance and higher, steeper yield curves.

US vs. Global Equity Market Performance[1]

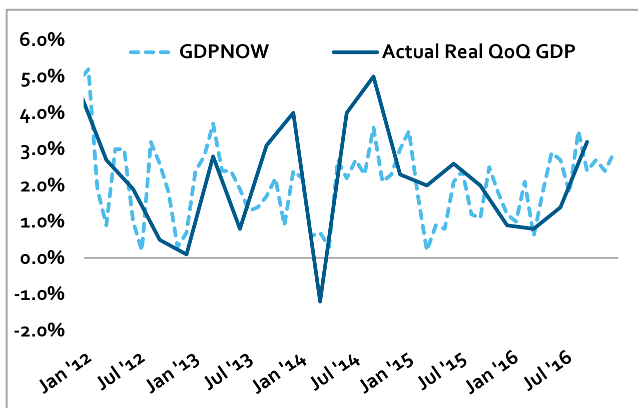


Change in Yield Curve Level and Steepness[2]



These trends are supported by reflationary economic data, with our Stock/Bond Indicator suggesting further potential upside to equities.

U.S. GDP Growth and GDPNow Estimate[3]



Stock and Bond Indicator Readings[4]

Current Readings		
Macro	Growth	Very Positive
	Inflation	Neutral
Policy	Rates	Neutral
	Liquidity	Very Positive
Fundamentals	Valuation & Market	Very Positive
	Earnings	Neutral
Sentiment and Technicals	Sentiment	Very Negative
	Technicals	Very Positive

Key Takeaways:

- **Maintain overweight of stocks versus bonds** on strengthening reflationary trends (p.12);
- **Remain underweight long-term bonds** given upward momentum to interest rates (p.13).

Source: Morgan Stanley Wealth Management GIC, Bloomberg, Haver Analytics, FactSet, Atlanta Fed. Note: 1) As of November 30, 2016. 2) June 24, 2016 – December 1, 2016. 3) As of November 30, 2016. 4) As of November 30, 2016

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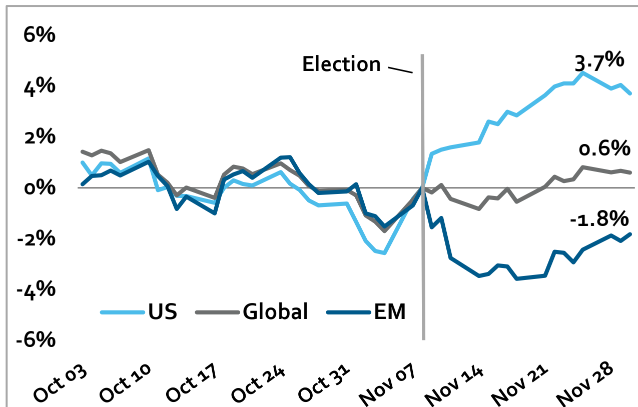
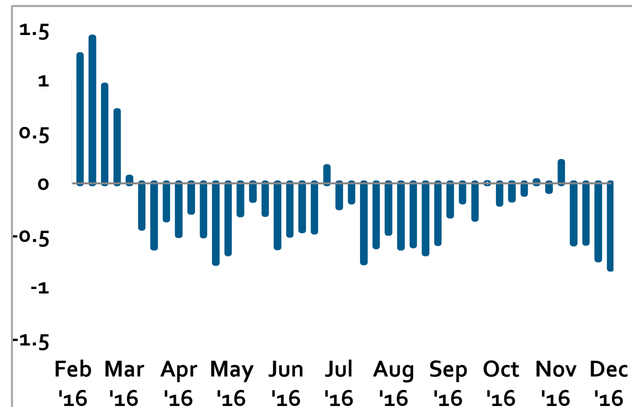
Key Question 2: Can Emerging Markets Withstand Current Macro Headwinds?

Should the GIC remove its EM overweight following post-election underperformance? We suggest holding positions, as stress appears absent based on financial conditions.

Cumulative Return of US, Global and EM Equities[1]

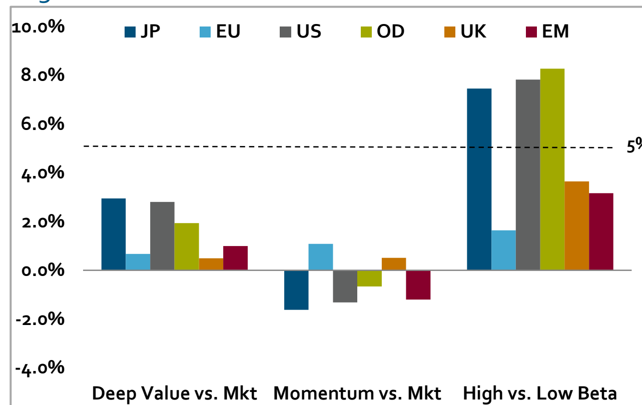


Morgan Stanley Financial Conditions Index[2]

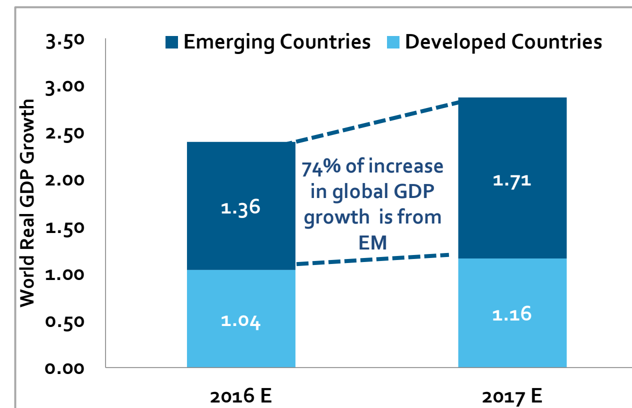


Widespread outperformance of risk-on strategies are further evidence of an improving global growth outlook, potentially led by strengthening EM economies.

Post-Election Regional Equity Performance by Market Segments[3]



Contribution to World GDP Growth by DM and EM[4]



Key Takeaways:

- Stay **overweight in Emerging Market equities**, consistent with GIC's tactical allocation positioning (p.15).
- Within Emerging Markets, **China H-shares and Taiwan** appear most attractive based on our Tactical Equity Framework (p.20).

Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet, For definitions of factors and universes, please reference our special report, *Tactical Equity Allocation: Introducing a Systematic Framework for Short-Term Investment Views*, December 2015. Note: 1) October 1, 2016 – November 30, 2016. 2) As of November 30, 2016. 3) As of November 2, 2016. 4) As of June 30, 2016.

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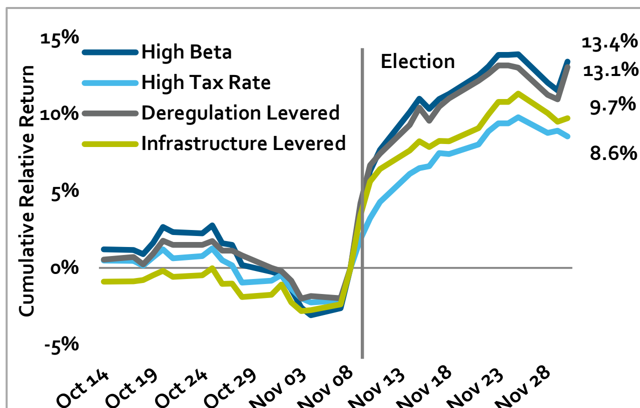
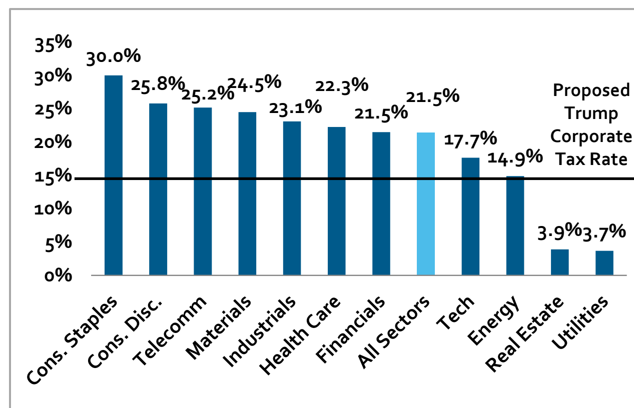
Key Question 3: Which Industries May Benefit from Trump's Signaled Policies?

Industries that can potentially benefit from Trump's policy proposals have led the market, with proposed corporate tax cuts benefitting sectors broadly.

Relative Return of US Companies Levered to Trump's Policy Proposals[1]



Corporate Tax Rates by Sector[2]

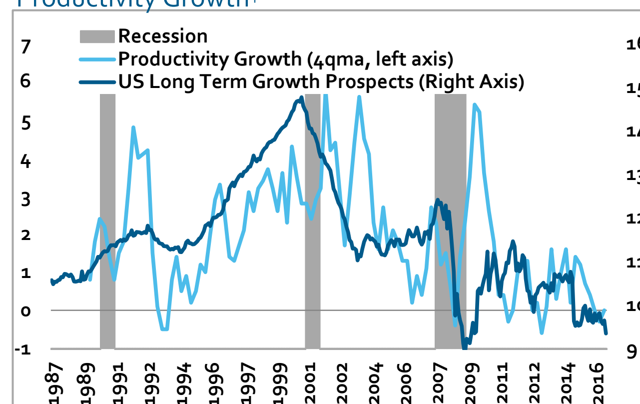


While ~$2 trillion of cash freed from overseas may have little immediate effect, longer-term earnings could benefit if the cash is deployed to productive investments.

Offshore Earnings Available for Repatriation[3]

Sector	Repatriable Foreign Earnings ($ Billion)
Information Technology	739
Health Care	492
Industrials	251
Consumer Staples	216
Financials	195
Energy	141
Materials	72
Consumer Discretionary	66
Total	2,174

Long-Term Earnings Growth Expectations and Labor Productivity Growth[4]



Key Takeaways:

Increase exposures to industries potentially benefitting from Trump's proposed policies (p.26), including:

- **High beta** industries levered to economic reflation;
- Industries **paying high tax rates** levered to tax reform;
- Energy and Financials industries based on proposed **reductions to regulation**;
- Industries levered to **rising infrastructure spending**.

Source: Morgan Stanley Wealth Management GIC, Morgan Stanley & Co., Bloomberg, FactSet, Company reports. For definitions of factors and universes, please reference our special report, *Tactical Equity Allocation: Introducing a Systematic Framework for Short-Term Investment Views*, December 2015. Note: 1) October 14, 2016 – November 30, 2016. 2) As of November 30, 2016. 3) As of September 30, 2016, 4) As of November 30, 2016.

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Summary: Quantitative Dashboard

We develop and maintain various quantitative tools to assist investment decision making in a systematic manner. The Quantitative Dashboard is now published as a standalone report providing ongoing readings from these tools.

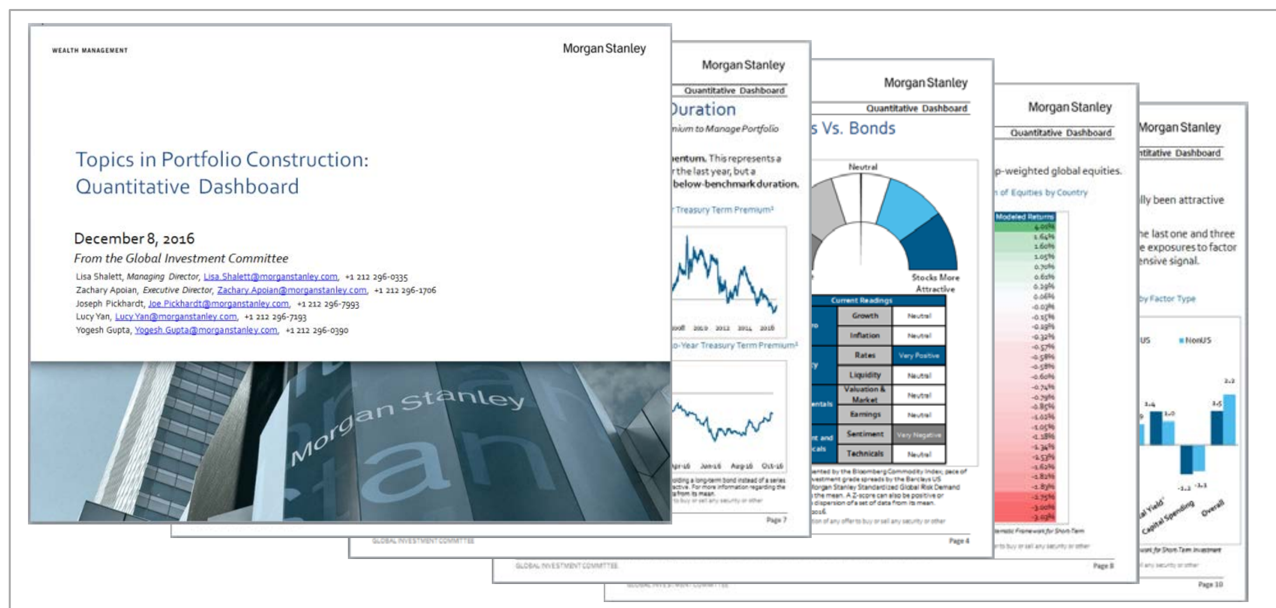
Quantitative Dashboard

Table of Contents

- Economic Cycle Model
- Stock and Bond Indicator
- Term Premium Framework
- Active vs. Passive Strategies
- Correlation and Macro Sensitivity
- Views on Region Exposures
- Factor Performances
- Views on Global Market Caps/Styles
- Factor Views for US Manager Selection

What's New:

- Based on your feedback, we will now publish the Quantitative Dashboard as a standalone publication every month.
- This month we are also adding additional metrics to the Dashboard, including our economic cycle model, macro sensitivity and correlation measures, enhanced details on active/passive inputs, and enhanced global attractiveness scores based on factors.



Source: Morgan Stanley Wealth Management GIC

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Our Views for Asset Allocation

Our views for major asset classes based on our quantitative tools:

Quant Indicators: Multi-Asset

		- - | - | o | + | + +		Rationale
Stocks / Bonds	Bonds	● (++)	Stocks	Accelerating growth, potential fiscal stimulus, troughing earnings positive for stocks; relative earnings yields attractive, but risks from fiscal/trade policies weigh

Quant Indicators: Equities

Regional Preferences		- - | - | o | + | + +		Rationale
US	Bearish	● (+)	Bullish	High-quality, accelerating growth, strengthening earnings with favorable comparisons through Q2 2017, and solid economic backdrop justify rich valuations
Europe	Bearish	● (- -)	Bullish	Valuations and total yields are compelling; Political, Brexit/EU negotiation, disappointing earnings, and banking risks weigh; volatility likely
UK	Bearish	● (+)	Bullish	Industrial, exporting companies benefit from global cyclicality and pound weakening; valuation and total yield attractive; risk of Brexit uncertainty constraining economic activity
Japan	Bearish	● (+)	Bullish	Recent Yen weakness may provide vital catalyst to earnings growth, and high-quality, attractively valued companies carry strong factor profile; key risks include efficacy of shifting monetary policy, effectiveness of fiscal stimulus programs
Other DM	Bearish	● (o)	Bullish	Attractive valuation and ample total yields favorable; profitability remains depressed by residual commodity-induced economic stress
EM	Bearish	● (o)	Bullish	Improved current accounts, accelerating growth, and valuations remain attractive, but higher USD/rates, potential tightening of US trade policy still poses risk; prefer China H to China A

Quant Indicators: Fixed Income

		- - | - | o | + | + +		Rationale
Credit / Rates	Rates	● (+)	Credit	Near-average but narrowing credit spreads suggest opportunity; prefer High Yield to Investment Grade
Short / Long Duration	Short	● (- -)	Long	Sharp rise in rates has improved term premiums; value is moderate, but await stabilizing interest rates before extending duration

Quant Indicators: Currency

		- - | - | o | + | + +		Rationale
Hedged / Unhedged	Hedged	● (- -)	No Hedge	Wider output gaps, potential for further monetary simulus may weaken GBP/EUR/JPY versus USD

Quant Indicators: Active vs. Passive

		- - | - | o | + | + +		Rationale
Active / Passive (US Only vs Strategic)	Passive	● (- -)	Active	Post-Election risk-on markets have benefitted passive strategies; awaiting declines in correlation and macro sensitivity for tactical active allocations

Source: Morgan Stanley Wealth Management GIC. Note: (1) Total yield is dividends paid plus net shares repurchased divided by market cap. Note: ++ is most attractive, + is moderately attractive, o is neutral, - is moderately unattractive, -- is most unattractive

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Will the Rise in Equities and Interest Rates Continue?

Post Election, Stocks Reflect Emboldened Growth Optimism

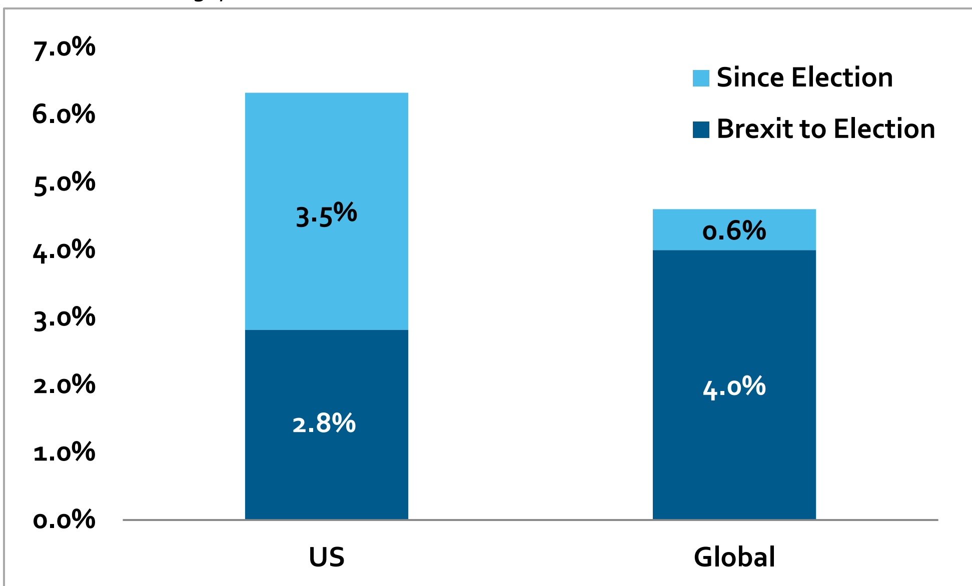
- Following the surprise results of the US election, financial assets have reacted strongly, pricing expectations for pro-growth policies, while largely shrugging off much-discussed potential risks concerning geopolitical shifts and protectionist trade policies.
- However, these **recent moves are, in fact, a continuation of pre-election trends**: on the back of improving economic data and earnings prospects, **global stocks and cyclically oriented strategies have been outperforming since the Brexit vote in June**.

Following the US election, equities have continued their post-Brexit rally…

…with performance primarily led by pro-cyclical exposures.

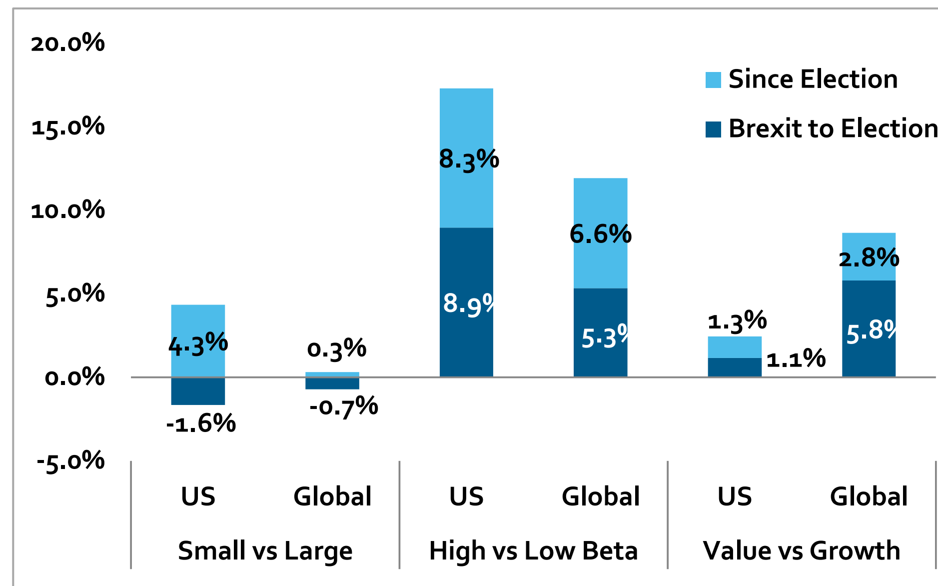
US and Global Equity Return

As of November 30, 2016



Relative Performance of Cyclical Strategies

As of November 30, 2016



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Global Yield Curves Likewise Indicate Renewed Cyclicality

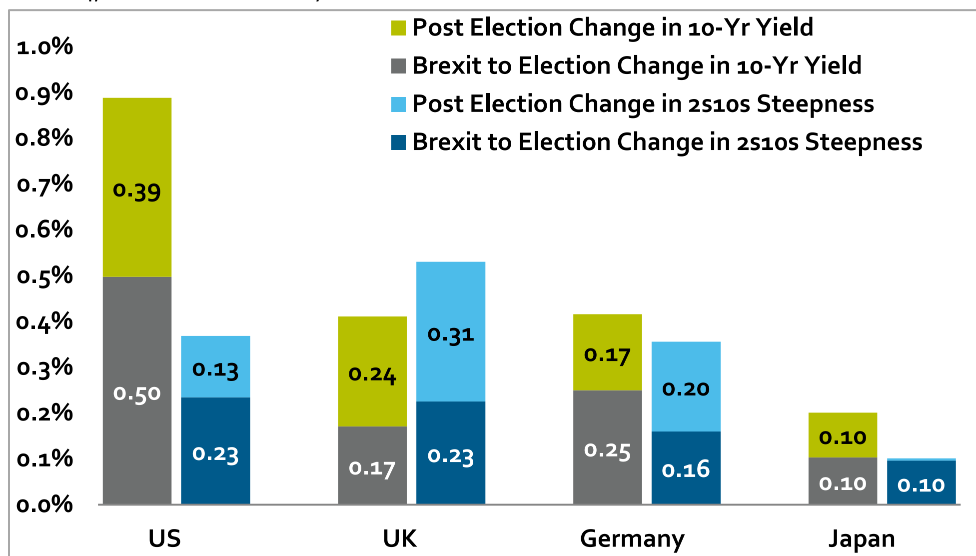
- Likewise, since Brexit, **rates have risen globally in anticipation of continuing improvement to economic growth**. Among major developed countries, the US has experienced the highest rate rise given the backdrop of the December Fed hike and a pro-fiscal stimulus president-elect.
- In the US, **the rate rise spans changes in inflation expectations and real rates**. Pre-election, the rate increase was largely due to inflation expectations reset higher; while post-election it was led by rising real interest rates; this is consistent with a reflationary economy, where both inflationary and growth-promoting forces are in place.

Across developed markets, rates are rising and yield curves are steepening, suggesting a more cyclical environment…

…Pre election, higher rates were led by inflation expectations; post-election, by higher real rates.

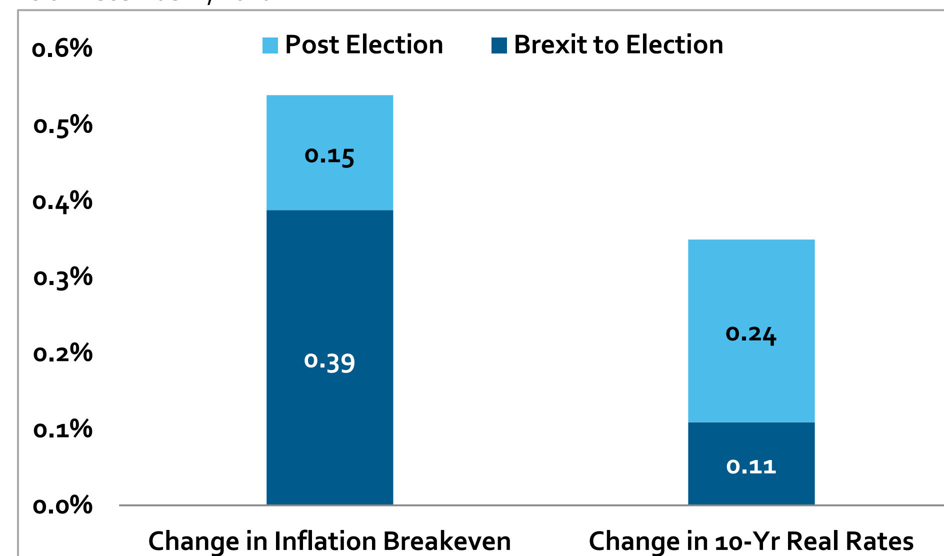
Change in Yield Curve Level and Steepness by Country

June 24, 2016 – December 1, 2016



US 10-Yr Rate Increases Due to Inflation Expectations vs. Real Rates

As of December 1, 2016



Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet

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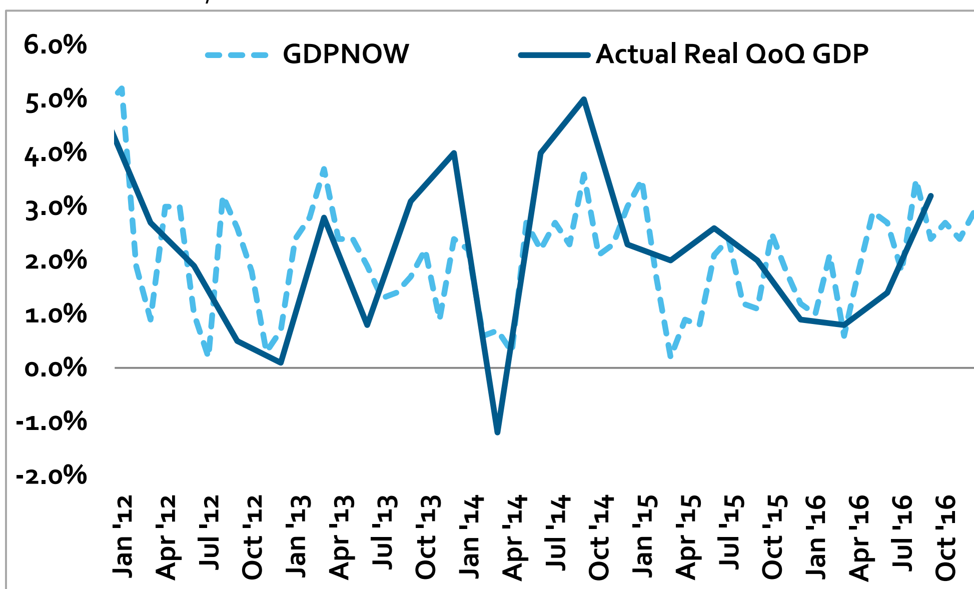
Economic Indicators Are Consistent with Reflation

- Higher inflation expectations and real rates are also consistent with an ongoing expansion in the U.S. economy. **Accelerating growth is driving real rates**: GDP rose at a 3.2% rate in the three months ended in September, the strongest quarter since Q3 2014. Recent GDPNow estimates for December remain strong at 2.9%.
- **Inflation has been driven by a tightening labor market**, a key factor in the expected December Fed rate hike. This tightness is evidenced by the labor markets where unemployment continues to fall, even on higher participation. This may result in inflationary wage growth.

Higher real rates are consistent with the acceleration of GDP growth observed throughout 2016…

U.S. Real GDP Actual Growth and GDPNow Forecast

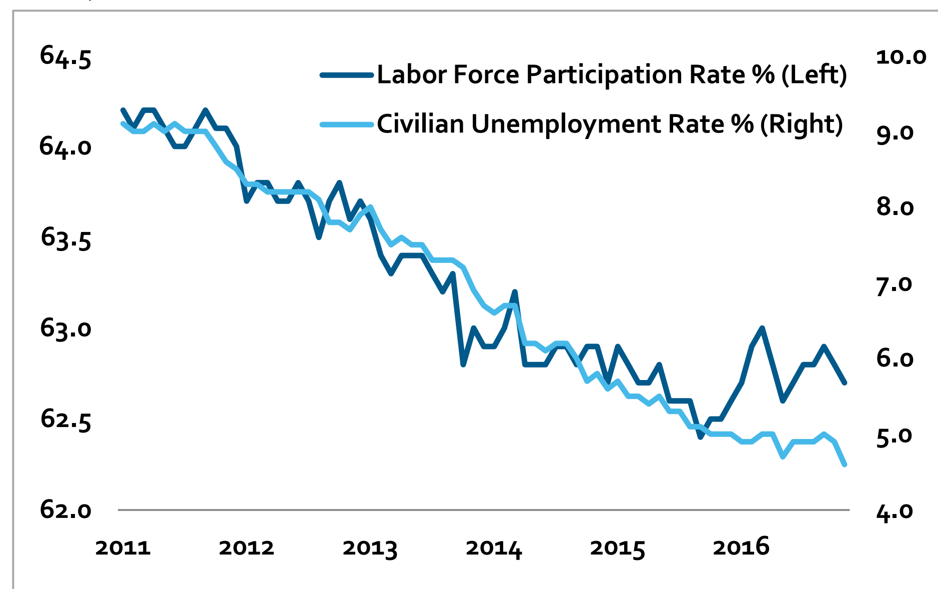
As of December 1, 2016



…With a tightening labor market suggesting wage growth potential, which could lead to higher inflation and yields.

Labor Market Measures

January 1, 2011 – November 30, 2016



Source: Morgan Stanley Wealth Management GIC, FactSet, Haver Analytics, Bloomberg, Atlanta Fed

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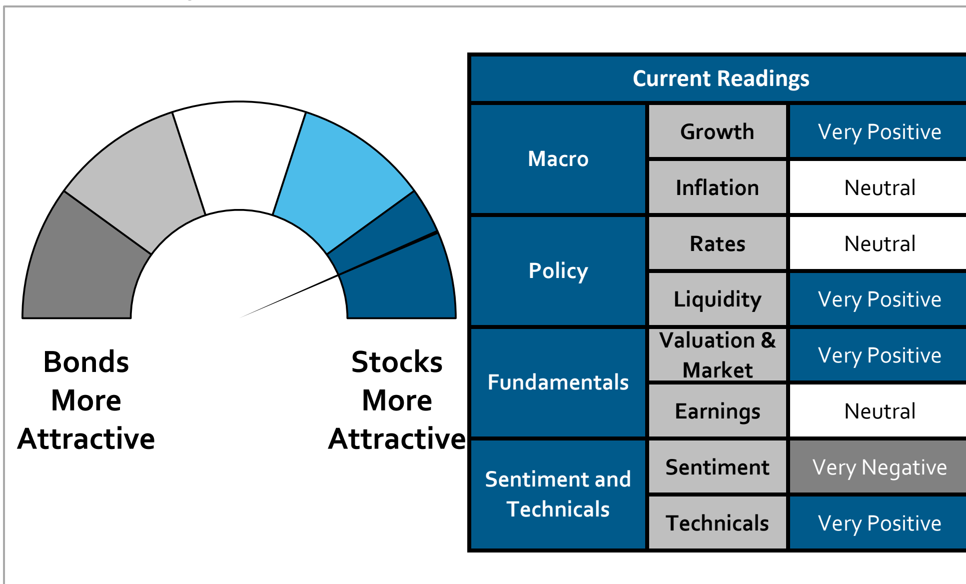
Our Stock/Bond Model, Positioning Data Suggest Further Strength in Equities

- Our Stock and Bond model, first introduced in the October edition of *Topics in Portfolio Construction*, **continues to favor stocks over bonds**, increasing its preference on the back of supportive growth, liquidity, market behavior, and technical signals. Note that updates are published weekly in The GIC Weekly and in the GIC Weekly Digest, and monthly in the Quantitative Dashboard.
- Despite strong recent market performance, investors have yet to embrace equities as they had pre-election, with **futures markets suggesting a net underweight position in US equities and 10-Year Treasuries**. This likely indicates that there is further room for the equity rally to run as investors who are out of position buy into the rally, and for rates to hold near current levels as investors move to take advantage of higher yields.

Our Stock and Bond Indicator continues to favor stocks over bonds...

Stock and Bond Indicator

As of December 3, 2016

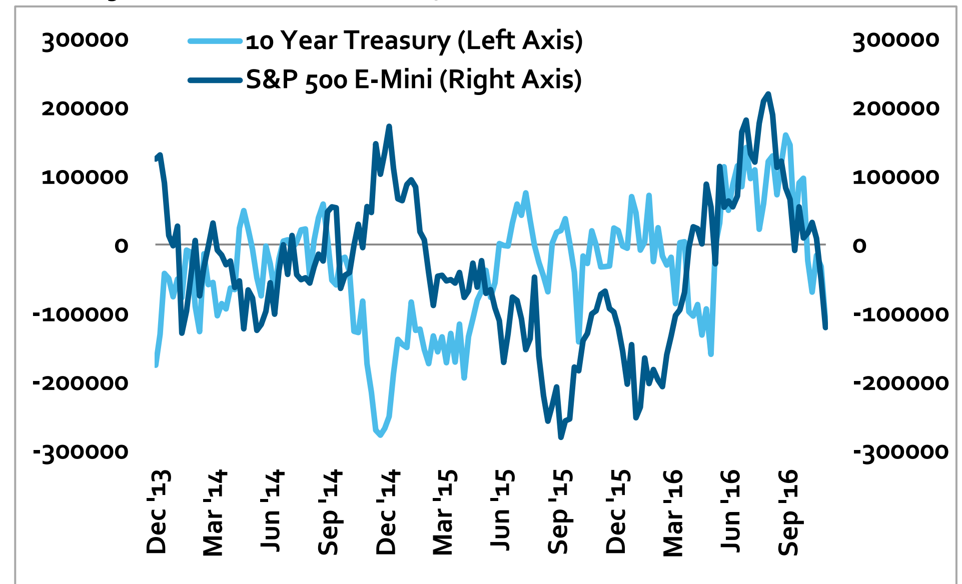


Current Readings		
Macro	Growth	Very Positive
	Inflation	Neutral
Policy	Rates	Neutral
	Liquidity	Very Positive
Fundamentals	Valuation & Market	Very Positive
	Earnings	Neutral
Sentiment and Technicals	Sentiment	Very Negative
	Technicals	Very Positive

...With investors still largely off-sides, equities may have further room to run.

S&P 500 and 10 Year Treasury Futures Net Positioning

Net Long Contracts as of November 29, 2016



Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet, Haver Analytics, CFTC

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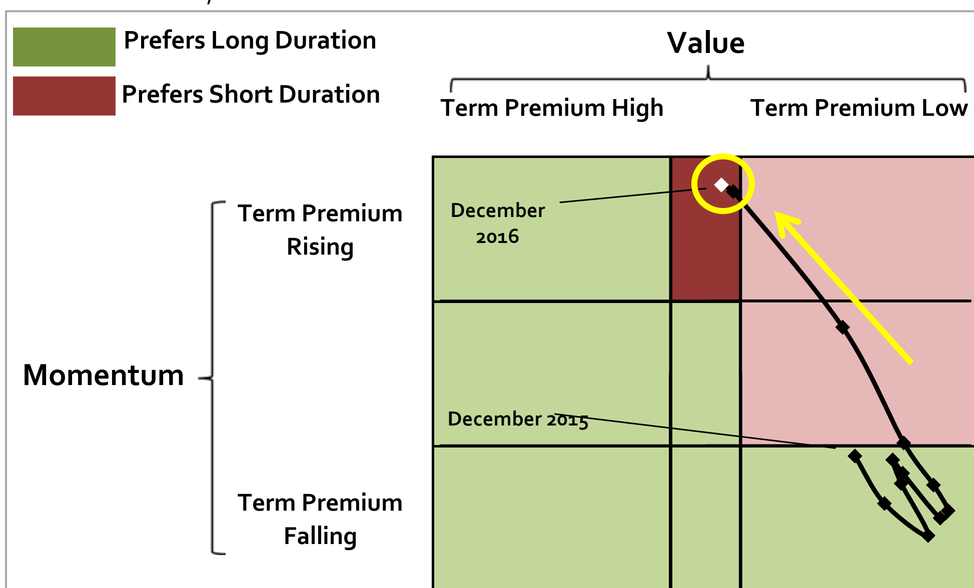
Value Case Has Improved on Higher Rates; Remain Short Duration

- To choose between long and short duration, we use our Term Premium framework. By design, this seeks to avoid long duration following periods where rates have risen sharply, unless they have reached high levels representing compelling value. **Even with the 10-year yield over 1% higher than July lows[1], value has improved, but is not at a level where long duration is attractive**.
- While we do continue to prefer short duration, interest rates in the US remain high versus international peers, suggesting that rates are unlikely to rise dramatically. Given current yields of 2.40%[1], **the MS&Co. Research target of 2.5-2.75% is consistent with our view, suggesting a move to long duration may be closer.**

Even following a rise in the 10-Year yield of over 1% since June, long-duration 'value' measure is not yet attractive.

Duration Framework Based on the US 10-Year Term Premium[2]

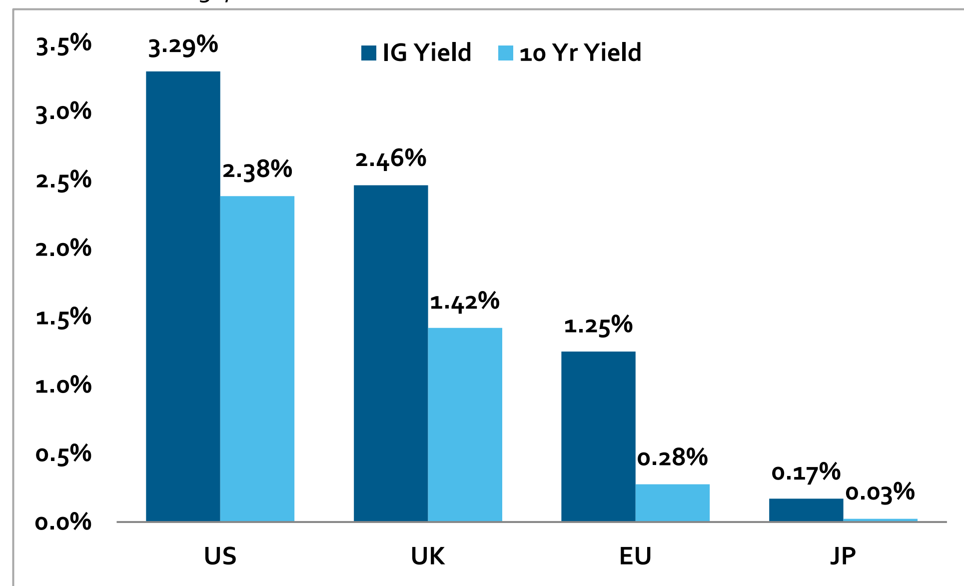
As of December 2, 2016



While higher rates are consistent with our view, attractive yields in US versus international peers likely limits upside.

Yields of Sovereign and Investment Grade Debt in Developed Countries

As of November 30, 2016



Source: FactSet, Federal Reserve Bank of New York, Haver Analytics, Morgan Stanley Wealth Management GIC. (1) The 10-Year Treasury yielded 2.40% on December 5, versus 1.36% on July 8. (2) The term premium is the excess yield that investors require to commit to holding a long-term bond instead of a series of shorter-term bonds. Note: When the indicator is in the green boxes, longer duration potentially looks more attractive. In the red boxes, shorter duration potentially looks more attractive. For more information regarding the framework, please see *Using the Term Premium to Manage Portfolio Duration*, published on March 30, 2016. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean.

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Can Emerging Markets Withstand Current Macro Headwinds?

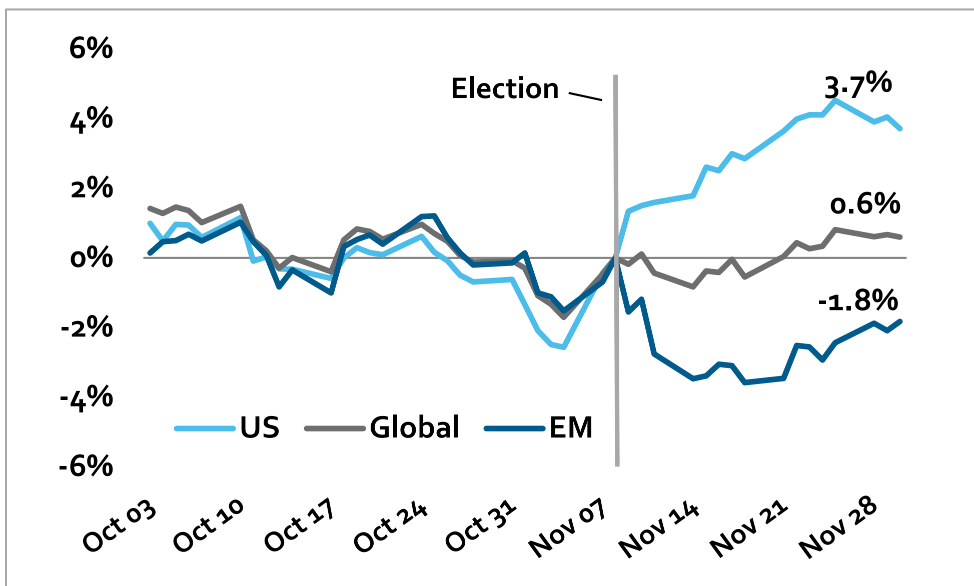
Since the Election, Emerging Markets Have Underperformed Global Equities

- US stocks have been on a steady climb spurred by Donald Trump's victory last month, while EM stocks have seen losses on fears of weakening trade, stress induced by a stronger USD and rising interest rates. Furthermore, despite generally strong equity performance across developed markets, the strengthening dollar has diminished most of the gains for US investors.
- While the market is concerned about a stronger dollar and higher rates, we **do not see severe stresses associated with EM illiquidity** feared by investors. We believe the **current sell-off is overdone and the price dislocation is temporary**, and suggest staying overweight in EM, consistent with the GIC allocation.

Post-election, US stocks have led while emerging markets have lagged.

Cumulative Return of US, Global and EM Equities

October 1, 2016 – November 30, 2016 (Indexed to Zero on Election Day)



Despite generally strong equity performance across developed markets in local currency terms, the stronger dollar has offset much of these gains.

Post-Election Returns by Region

November 8, 2106 – 30, 2016

	Local Return	USD Return
US	3.7%	3.7%
Other Developed	2.1%	0.6%
China A	2.0%	0.4%
UK	-0.2%	0.4%
Japan	7.4%	-1.2%
Emerging Europe	0.8%	-2.1%
Europe	1.1%	-2.4%
Emerging Asia ex China A	-1.8%	-4.4%
Latin America	-3.7%	-8.3%

Source: Morgan Stanley Wealth Management GIC, FactSet

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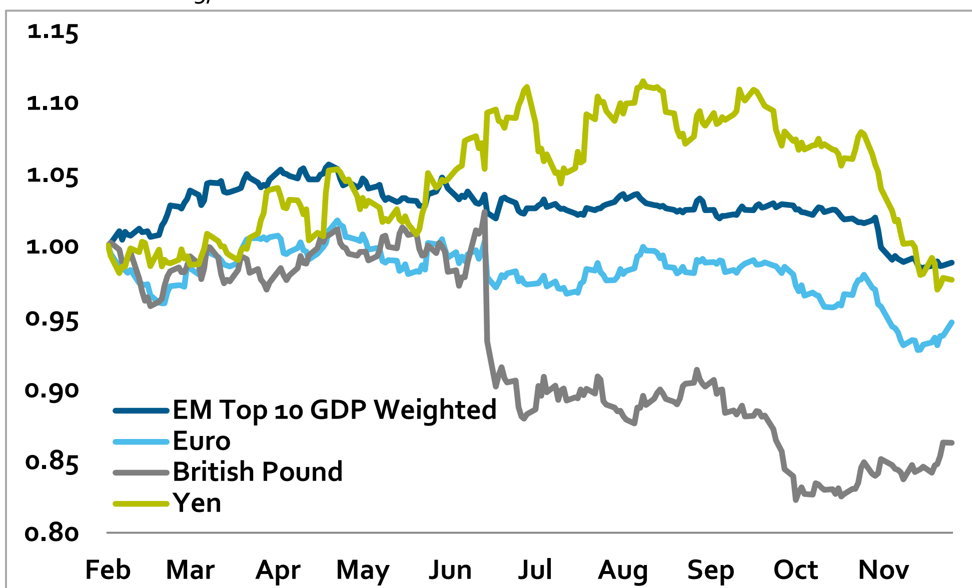
Relative Currency Strength Suggests EM Stress Is Limited

- **Emerging Market equities have underperformed following the US election**, reflecting concerns related to the strengthening US dollar and rising interest rates, as well as the possibility of politically driven disruptions to global trade. As Lisa Shalett wrote in the November 21 GIC Weekly, this sell-off may be overdone, given improving fundamentals off the February equity market bottom.
- **EM currencies have outperformed the euro and the yen versus the US dollar since the election**, and have remained relatively stable since their peak stress levels in February. Given continuing **loose financial conditions** and **an improved funding/liquidity outlook** for oil-sensitive EM countries after the recent OPEC supply cut, **we maintain our favorable outlook on EM equities.**

EM currencies reflect relative stability and improving economic fundamentals since the February market bottom…

Currencies Relative to USD Since February Market Bottom

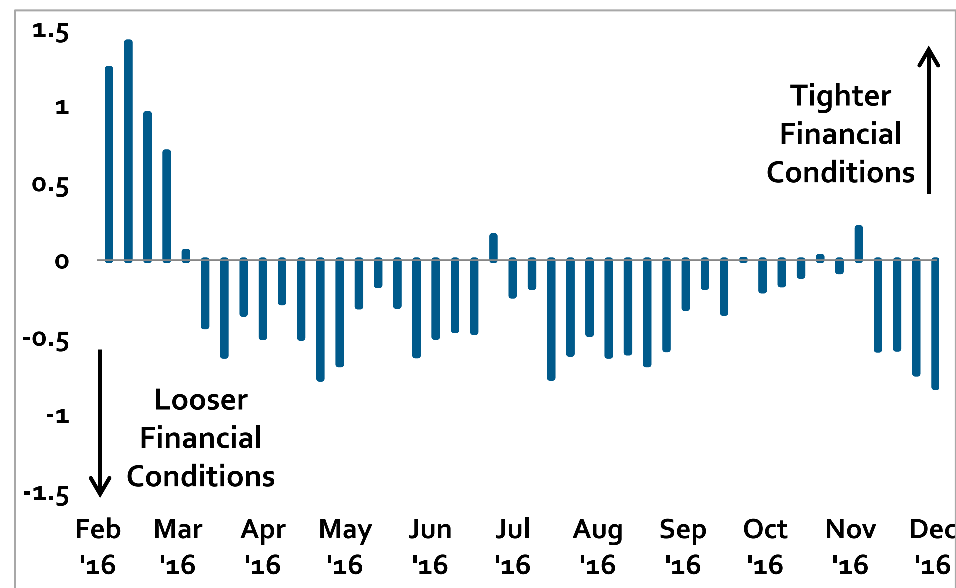
As of December 5, 2016



…And financial conditions remain supportive, suggesting a major liquidity squeeze is unlikely for EM countries.

Morgan Stanley Financial Conditions Index

As of December 2, 2016



Source: Morgan Stanley Wealth Management GIC, Bloomberg, Haver Analytics

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Outperformance of Global Risk-On Stocks Is Inconsistent with EM Difficulties

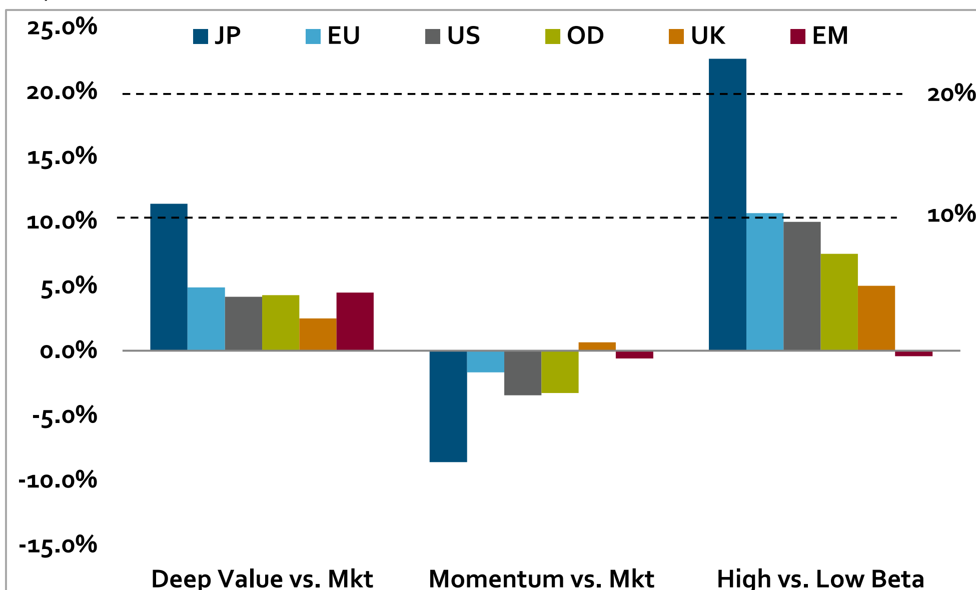
- **Factor effectiveness across the globe is suggestive of economic strength and cyclical upturn**, evidenced by continued outperformance of risk-on deep value and high beta stocks, coupled with underperformance of risk-off momentum stocks.
- Within EM, high beta stocks have outperformed post-US election—**this risk-on sentiment is inconsistent with the feared EM stress** caused by potential trade difficulties and dollar/interest rate strengthening. **We believe this sell-off may be short-lived.**

Cyclical stocks outperformed across regions from Brexit to the US Election…

…This trend continues post election, including in Emerging Markets , suggesting the sell-off may be overdone.

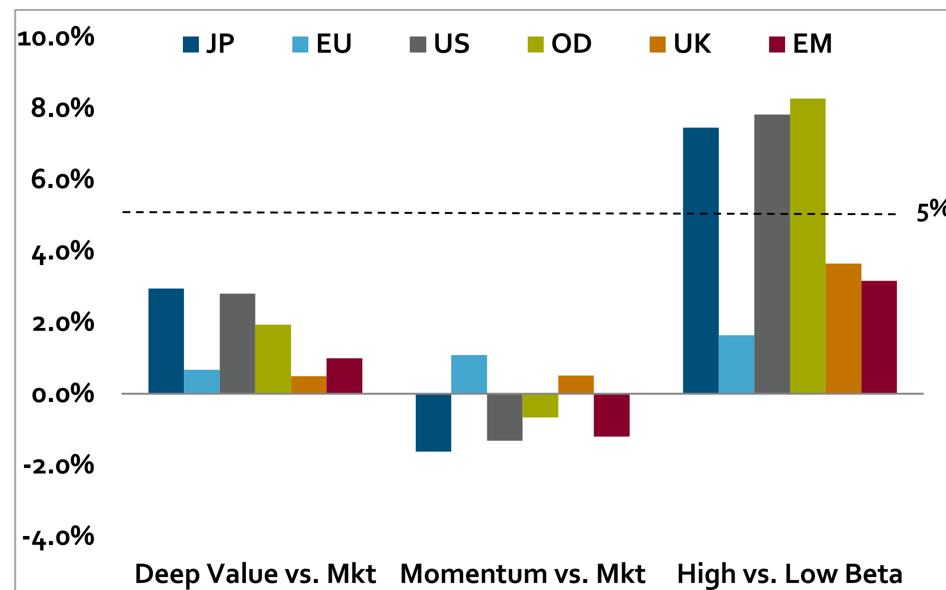
Pre-Election Regional Equity Performance by Market Segments[1]

July 1, 2016 – November 8, 2016



Post-Election Regional Equity Performance by Market Segments[1]

November 9, 2016 – November 30, 2016



Source: Morgan Stanley Wealth Management GIC, FactSet. For definitions of factors and universes, please reference our special report, *Tactical Equity Allocation: Introducing a Systematic Framework for Short-Term Investment Views*, December 2015. Note: (1) JP = Japan, US = Unites States, EU = European Union, OD= Other Developed, UK = United Kingdom, EM= Emerging Markets

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Low Correlation, Macro Sensitivity Is Suggestive of a Healthy Environment

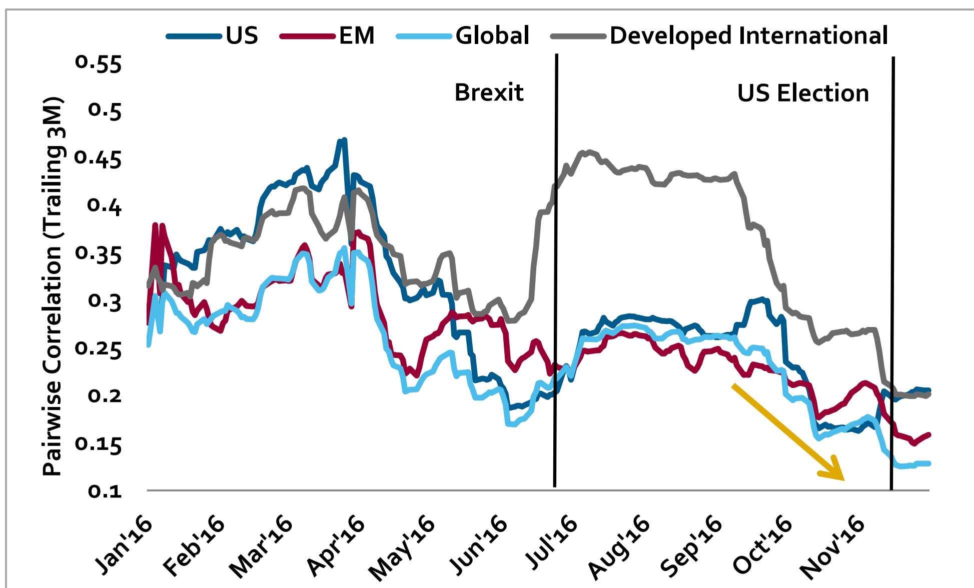
- **Global equity correlations have declined significantly since Brexit and now sit near 2016 lows** across regions. Low correlations suggest companies are not being traded indiscriminately, but rather on differences in their fundamentals, suggesting a more healthy investment environment.
- On the other hand, **macro sensitivity of equities and bonds has picked up modestly.** We believe this is related to the optimism concerning a potential acceleration in growth, and recent bond losses resulting from sharp interest rate gains. Despite recent increases, **levels remain below historical averages**, suggesting that fundamentals have driven returns more than macro effects.

Global equity correlations have declined to near 2016 lows…

…While inflections in growth and rates have raised recent macro sensitivity, levels remain below long-term averages.

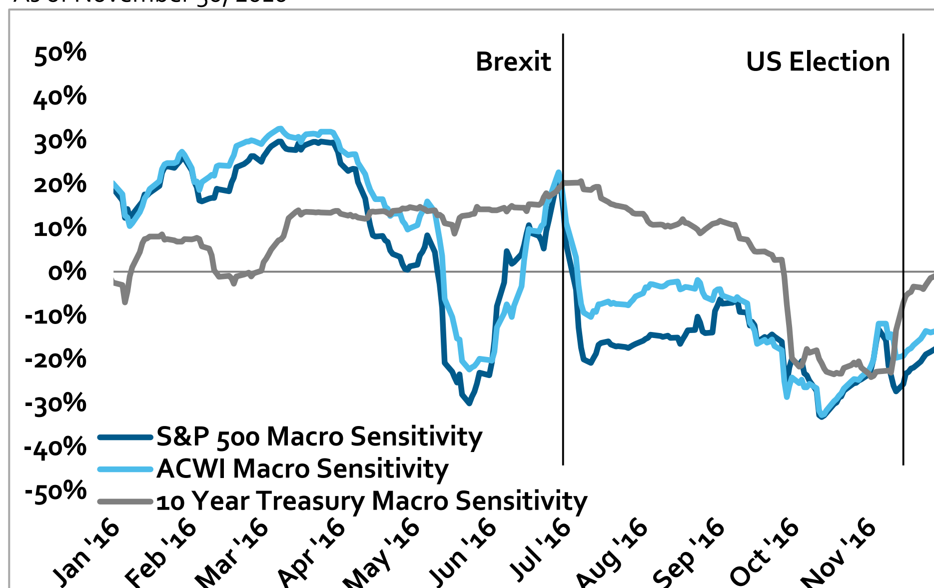
Trailing 3M Correlation by Regions

January 1, 2016 – November 30, 2016



Trailing 3M Macro Sensitivity[1]

As of November 30, 2016



Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet 1) Macro Sensitivities are measured as percentage of movements in S&P 500, ACWI and 10 Year Treasury Yield that can be explained by movements in US Dollar, Oil, Gold and 2 Year Treasury Yield.

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EM Economic Strengthening, Accelerating Growth Suggests Resilience

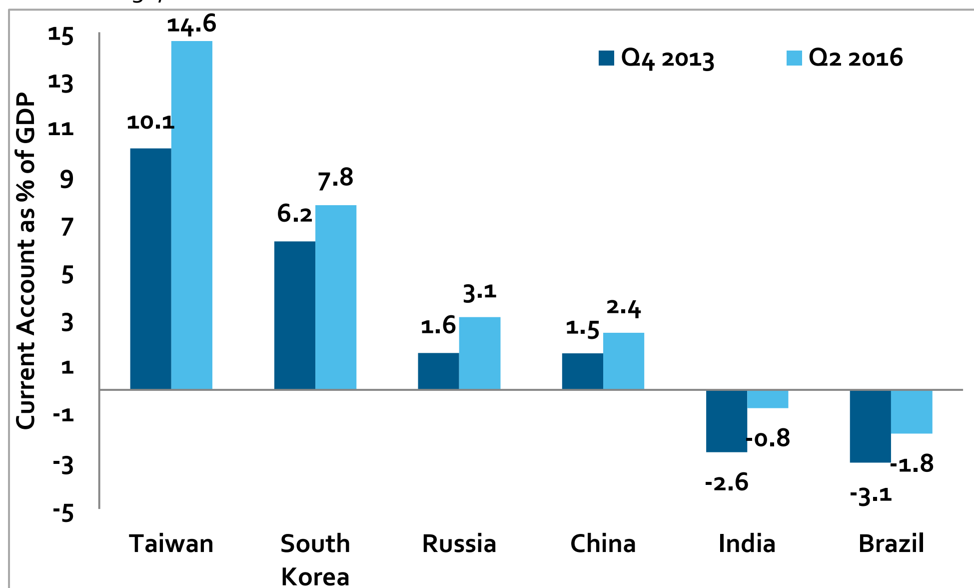
- Economic data agrees with the signs from financial markets that Emerging Market economies appear to be strengthening. **Current account balances have strengthened among major EM countries**, improving their ability to self-finance in periods where higher dollar strength and interest rates may compromise liquidity, as is feared today.
- EM's strength is also demonstrated by its significant contribution to a potential growth acceleration next year. **Emerging markets account for 74% of the expected uptick in 2017 global GDP growth.**

Strengthening current account balances have allowed EM nations to operate with strong USD and rising interest rates…

…EM accounts for 74% of the expected GDP growth acceleration from 2016 to 2017, reflecting a stronger position.

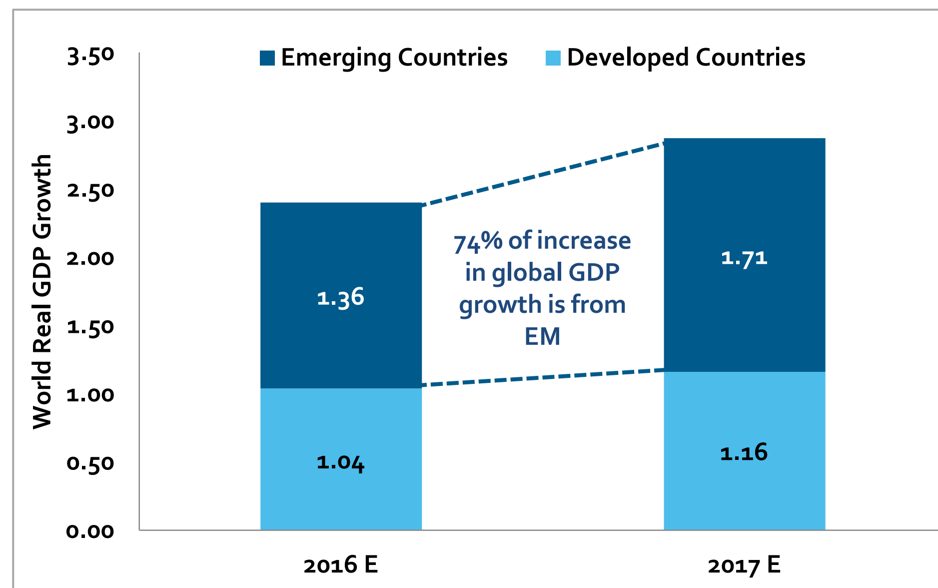
Current Account Balance of Major EM Countries

As of June 30, 2016



Contribution to World GDP Growth by DM and EM countries

As of June 30, 2016



Source: The World Bank, Morgan Stanley Wealth Management GIC, Bloomberg, FactSet

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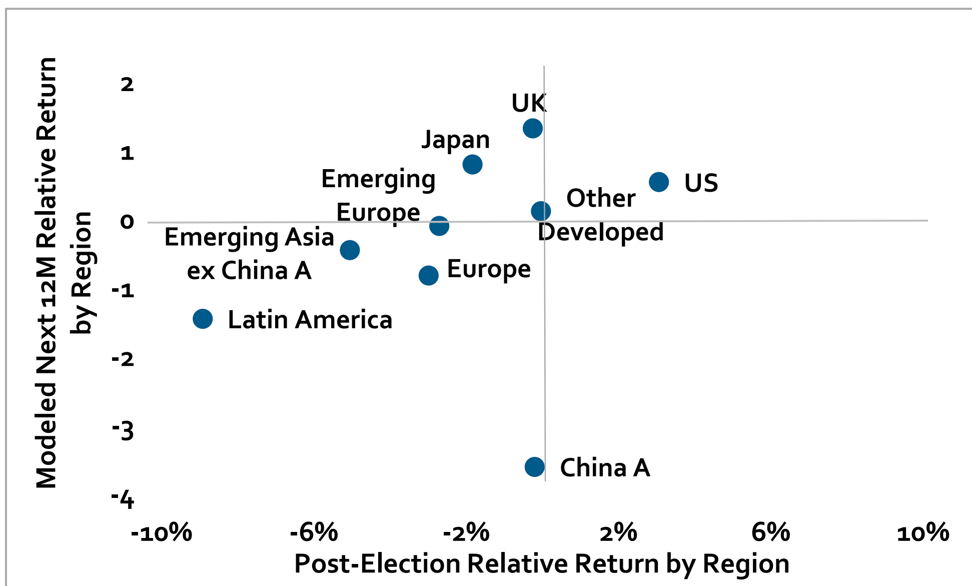
Stay Long EM Assets; We Prefer Emerging Europe and Asia to Latin America

- We believe recent post-election weakness presents an opportunity to add to EM assets at more attractive prices. Based on our factor-based Tactical Equity Framework, **we prefer broad exposure to EM Europe and Asia to Latin America.**
- At a more granular level, we screen individual countries (and China share classes). **Our preferred EM exposures include China H-Shares and Taiwan, while we suggest avoiding the Philippines and China A-Shares**.

Among EM regions, we prefer EM Europe and Asia to Latin America…

Regional Attractiveness Versus Post-Election Relative Performance

As of November 30, 2016



…With attractive country exposures including China H-Shares, Taiwan, South Korea, and Turkey

Attractive and Unattractive EM Country Screen

As of November 30, 2016

Country	Ranks (1= Best, 10= Worst)		
	High Quality	Value vs. Growth	Overall
Attractive			
China H	9	1	1
Taiwan	2	4	1
South Korea	10	3	2
Turkey	3	3	2
Poland	10	1	3
Avoid			
Mexico	5	8	8
Indonesia	5	9	9
Malaysia	4	2	9
China A	8	10	10
Philippines	4	9	10

Source: Morgan Stanley Wealth Management GIC, FactSet. For definitions of factors and universes, please reference our special report, *Tactical Equity Allocation: Introducing a Systematic Framework for Short-Term Investment Views*, December 2015.

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Which Industries May Benefit from Trump's Signaled Policies?

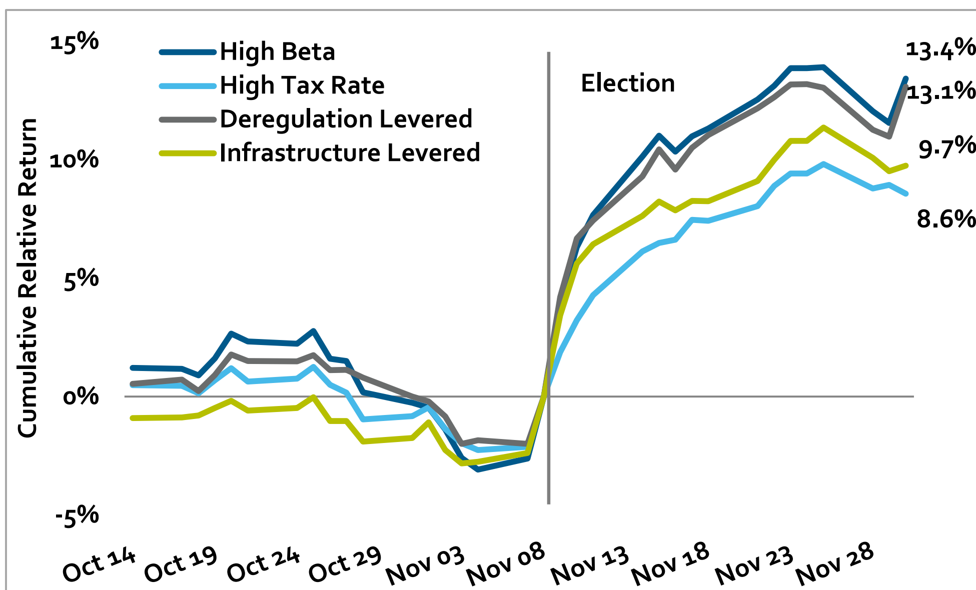
Companies Benefitting from Trump's Signaled Policies Have Outperformed

- The implications of Trump's signaled policies, including **corporate tax reduction, reduced regulation, and attempts to spur growth and infrastructure spending** have driven company and industry returns within the US.
- **Underperforming industries include many low-beta, defensive groups**. Additionally, many large-cap growth technology companies that have realized strong outperformance over the last several years have corrected. We believe this weakness has been driven by selling to source funds for a rotation toward more cyclical trades, and is less related to fundamental concerns.

Companies that can potentially benefit from Trump's policy proposals have led the market…

Relative Return of US Companies Levered to Trump's Policy Proposals

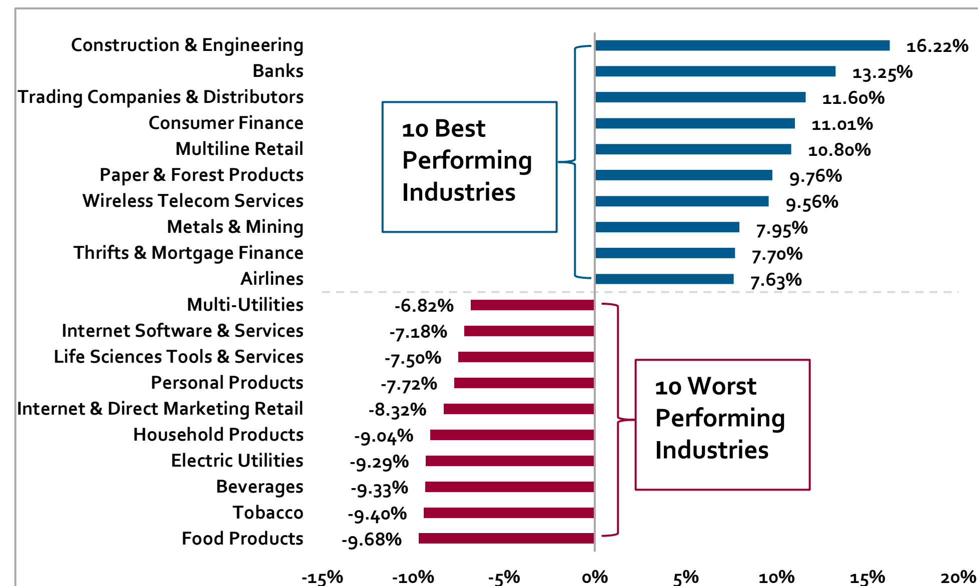
October 14, 2016 – November 30, 2016 (Indexed to Zero on Election Day)



…with industries levered to strong growth, lower taxes, reduced regulation and infrastructure expenditures outperforming.

US Industries: Best and Worst Post-Election Relative Returns

November 8, 2016 – November 30, 2016



Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet. For definitions of factors and universes, please reference our special report, *Tactical Equity Allocation: Introducing a Systematic Framework for Short-Term Investment Views*, December 2015.

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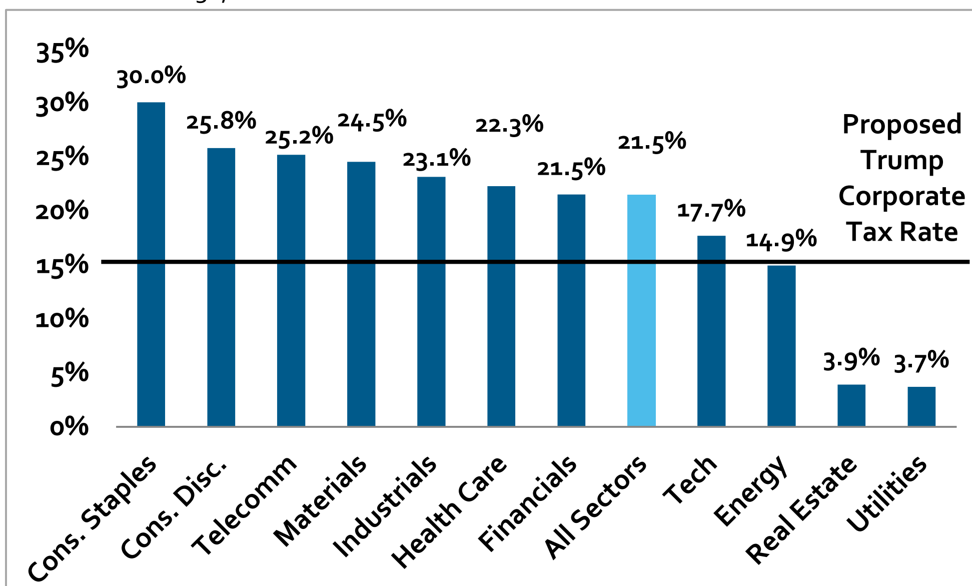
Corporate Tax Reform May Benefit Broad Earnings

- **Donald Trump has advocated corporate tax reform**, including a proposal to reduce the corporate tax rate to 15% from the current 35% gross of deductions.
- To gauge the effects of such a change, we did a simple analysis measuring the effect on 2017 expected earnings by sector, **assuming the tax rate fell from what was paid in the last year to a flat 15% rate**. Under these assumptions, **S&P 500 EPS rises by 8%**, with improvement focused in Consumer Staples and Discretionary, Telecom, and Materials.

A majority of US sectors pay taxes in excess of Trump's proposed 15% rate …

US Companies: Trailing 12-Month Realized Tax Rate

As of November 30, 2016



…which, if enacted, may potentially raise 2017 S&P 500 EPS by 8%.

S&P 500: Estimated Change in EPS Under 15% Tax Rate

As of November 30, 2016

	Current 2017E Estimate	2017E EPS Impact at 15% Corporate Tax	
		$	%
Tech	28.3	0.92	3.3%
Financials	23.7	1.97	8.3%
Health Care	21.2	1.98	9.4%
Cons. Disc.	15.0	2.19	14.6%
Industrials	13.1	1.39	10.6%
Cons. Staples	10.9	2.35	21.5%
Energy	5.3	0.00	-0.1%
Telecomm	4.2	0.57	13.6%
Utilities	4.1	-0.49	-11.7%
Materials	3.8	0.48	12.6%
Real Estate	3.6	-0.41	-11.5%
All Sectors	133.2	10.95	8.2%

Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet

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Repatriation Relief May Free $2 Trillion; Near-Term EPS Benefits Unlikely

- Included in tax reform is easing the tax rates on the repatriation of cash held by US companies in foreign accounts. MS & Co. Research has identified 122 of the S&P 500 companies **holding $2 Trillion in aggregate funds abroad. Reshoring these funds today may trigger a tax liability of 40%.**

- **Repatriated cash may benefit investors through dividends or share buybacks, or be reinvested in the business, but repatriating cash is unlikely to have an immediate benefit to earnings**. Funds may continue to be taxed under reforms (albeit at a potentially lower rate), in which case repatriation would continue to result in more modest one-time charges to earnings.

Many US companies selling products or services abroad have amassed cash piles…

Foreign Sales as a Percentage of Total Sales by Sector

As of November 30, 2016

Sector	Foreign Sales as a % of Total Sales
Information Technology	48.2%
Materials	47.7%
Consumer Staples	34.7%
Health Care	31.6%
Industrials	30.4%
Consumer Discretionary	27.8%
Energy	25.6%
Real Estate	11.3%
Utilities	6.1%
Telecommunications	4.7%

…Repatriation of these funds could result in the return of $2 Trillion held abroad.

S&P 500: Cumulative Offshore Earnings Available for Repatriation

As of September 30, 2016

Sector	Repatriable Foreign Earnings ($ Billion)
Information Technology	739
Health Care	492
Industrials	251
Consumer Staples	216
Financials	195
Energy	141
Materials	72
Consumer Discretionary	66
Total	2,174

Source: Morgan Stanley Wealth Management GIC, Morgan Stanley & Co., FactSet, Company Reports

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Repatriation-Driven Investment May Benefit Longer-Term Growth

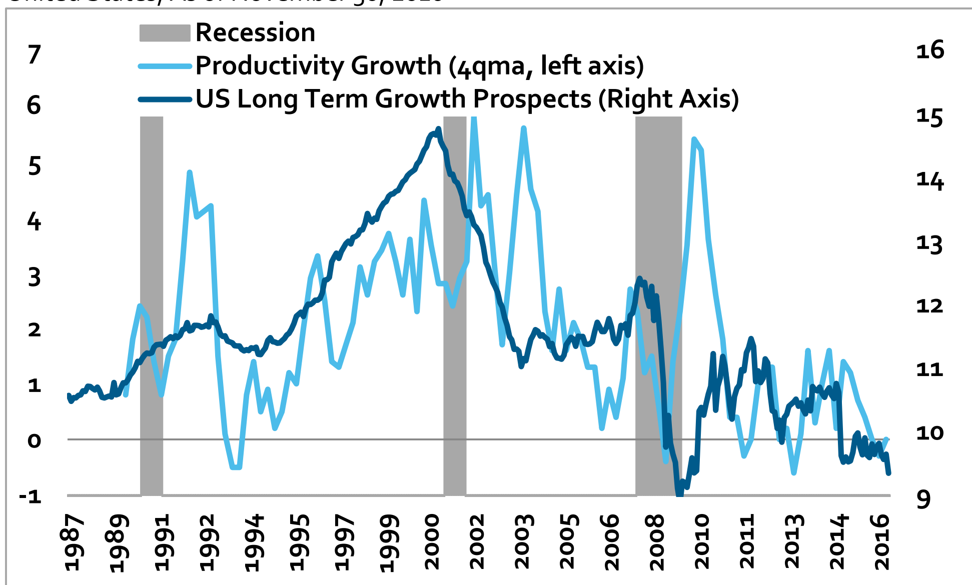
- As discussed in the GIC's recent special report, *Beyond Secular Stagnation*, one of the major contributors to below-average growth this cycle has been persistent under-investment and low productivity growth. **Productivity growth has remained significantly below average this cycle, which has contributed to the reduced long-term earnings growth expectations.**
- While unlikely to provide short-term EPS benefit (see page 24), many have suggested crafting incentives to encourage investment with repatriated assets. Historically, capital and R&D spending has shown the ability to benefit economic growth and longer-term corporate earnings. High ROIC sectors, including Tech and Health Care are most likely to benefit.

Falling productivity growth has gone hand-in-hand with falling long-term earnings growth prospects…

…However, repatriated assets could provide a long-term boost to productivity and earnings, especially in high-ROIC sectors.

Long-Term Earnings Growth Expectations[1] and Labor Productivity Growth

United States, As of November 30, 2016



S&P 500 Company Investment and Return on Invested Capital

United States, As of November 30, 2016

Sector	Capex / Sales	R&D / Sales	Cap % of SPX	ROIC
Info Tech	6.6	11.0	24.5	13.4
Health Care	1.9	7.0	14.8	11.2
Consumer Disc.	5.8	2.8	14.8	11.1
Industrials	6.1	3.6	11.7	10.8
Consumer Staples	2.7	0.4	12.5	10.3
Materials	8.5	3.2	3.2	7.3
Telecom	13.6	1.0	2.9	7.0
Real Estate	1.0	-	3.3	3.8
Utilities	32.4	0.4	3.5	3.6
Energy	14.1	1.4	8.7	-3.5

Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet. (1) Consensus estimate of next 5-year earnings growth.

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We Prefer Industries Levered to Trump Policies with Strong Factor Profiles

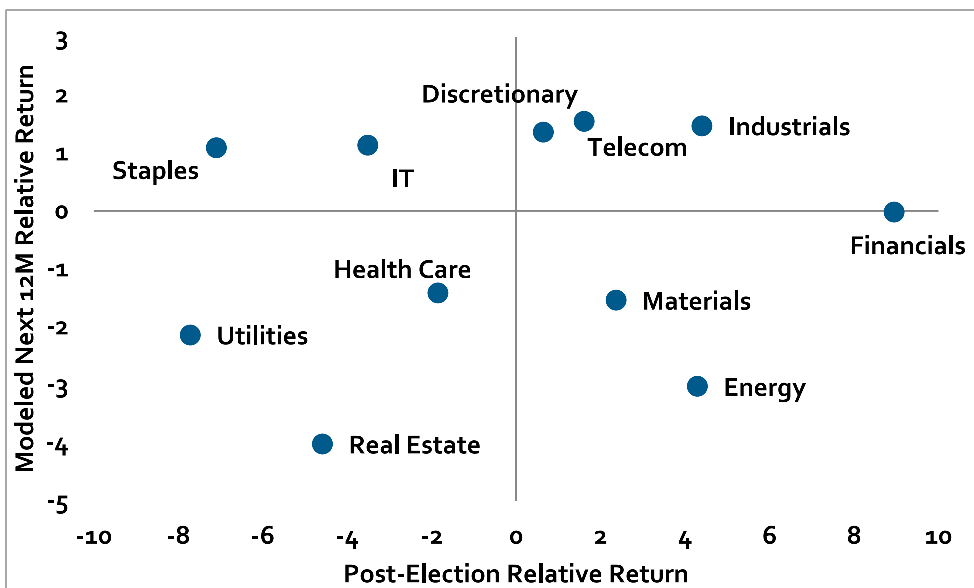
- Our quantitative factor-based Tactical Equity Framework suggests, the **post-election outperformance of US Industrials, Telecom and Consumer Discretionary stocks may continue**. Additionally, the **recent underperformance of Technology and Staples presents an opportunity to gain attractive exposure at better prices**.
- We also **screened US subindustries with attractive factor profiles and that may benefit from signaled Trump policies**. These subindustries could gain from stronger economic growth and reduced tax rates, and also may be levered to infrastructure spending or lower regulation.

Discretionary, Telecom, and Industrials may see momentum continue, while Tech and Staples may present opportunities…

…Attractive subindustries, including those levered to infrastructure spend and deregulation, are shown below.

US Equities Post Election and NTM Relative Return by Sectors

As of November 30, 2016



Top US Subindustries Screens

As of November 30, 2016

US Subindustry	Ranks (1=Best, High Beta	High Tax	Overall)	Rel. Return Since Election	Trump Theme
Construction Mach. & Heavy Trucks	2	2	2	6.8	Infrastructure
Electrical Components & Equipt.	2	2	2	5.6	Infrastructure
Industrial Machinery	2	2	2	4.8	Infrastructure
Security & Alarm Services	2	1	1	7.9	Infrastructure
Oil & Gas Drilling	1	5	1	10.5	Regulation
Life & Health Insurance	1	4	2	13.9	Regulation
Consumer Finance	2	1	2	12.5	Regulation
Broadcasting	2	2	1	4.4	
Auto Parts & Equipment	1	2	1	1.7	
Household Appliances	2	3	2	-1.5	
Paper Packaging	2	3	2	3.1	

Source: Morgan Stanley Wealth Management GIC, Bloomberg, FactSet. For definitions of factors and universes, please reference our special report, *Tactical Equity Allocation: Introducing a Systematic Framework for Short-Term Investment Views*, December 2015.

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Glossary and Risk Considerations

ALPHA The excess return of an investment relative to the return of a benchmark index.

BETA A measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

CORRELATION This is 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.

DISPERSION is a measure for the statistical distribution of portfolio returns . It is the asset-weighted standard deviation of individual portfolio returns within a comparable composite from the composite return.

DRAWDOWN is the peak-to-trough decline during a specific recorded period of an investment, fund or commodity.

INFORMATION RATIO (IR) is a ratio of portfolio returns above the returns of a benchmark—usually an index—to the volatility of those returns.

Risk Considerations

Zachary Apoian, Joseph Pickhardt, Lucy Yan and Yogesh Gupta are not members of the Global Investment Committee and any implementation strategies suggested have not been reviewed or approved by the Global Investment Committee.

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

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.

Master Limited Partnerships (MLPs) 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.

Derivative instruments: Options, futures contracts, options on futures contracts, forward contracts, swaps and structured products are examples of derivative instruments. Risks of derivative instruments include imperfect correlation between the value of the instruments and the underlying assets; risks of default by the other party to certain transactions; risks that the transactions may result in losses that partially or completely offset gains in portfolio positions; and risks that the transactions may not be liquid. Please see the fund's prospectus for additional information.

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 and frontier markets, since these countries may have relatively unstable governments and less established markets and economies.

Alternative investments which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

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.

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.

Risk Considerations and Disclosures

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.

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

Investing in foreign 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. 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.

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.

Investing in **smaller companies** involves greater risks than those associated with investing in more established companies, including significant stock price fluctuations and illiquidity.

Stocks of medium-sized companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Nondiversification: For a portfolio that holds a concentrated or limited number of securities, a decline in the value of these investments would cause the portfolio's overall value to decline to a greater degree than a less concentrated portfolio. Portfolios that invest a large percentage of assets in only one industry sector (or in only a few sectors) are more vulnerable to price fluctuation than those that diversify among a broad range of sectors.

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.

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 Wealth Management retains the right to change representative indices at any time.

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