Morgan Stanley

WEALTH MANAGEMENT

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The 1% Move

What Happened in the Markets?

- The S&P 500 declined 1.8% Wednesday to close at 4,226. With today's sell-off, the index is now down 11.3% year-to-date.
- US equities dropped for the fourth consecutive session as markets remain on edge over continued geopolitical tensions between Russia and Ukraine. On Tuesday, the US unveiled sanctions against Russia following the latter's recent escalation in tensions with Ukraine; on Wednesday, the US announced further sanctions that appeared to spark another sharp move lower in equities in the middle of the session. However, similar to Tuesday's trading action, while equities sold off broadly, interest rates actually moved higher across the curve.
- Ten of the 11 S&P 500 sectors were lower on the session, with Energy (+1.0%) the lone positive sector. Information Technology (-2.6%) and Consumer Discretionary (-3.4%) lagged the broader market.
- Interest rates moved higher across the curve, with 10-year Treasury yields trading to 1.98% as of the 4 p.m. equity market close. WTI oil was slightly higher, trading at $92 per barrel, while gold was also modestly higher above $1,900 per ounce. The US dollar strengthened as measured by the US Dollar Index.
- The Nasdaq 100 declined 2.6% and the Russell 2000 Index dipped 1.8%.

What to Watch Going Forward

- **Geopolitical Tensions:** Uncertainty remains elevated following Russia's announcement this past weekend that it would recognize two separatist groups in eastern Ukraine as independent regions. The move prompted response from the international community, and on Tuesday the US announced sanctions against Russia in response to the recent escalation in Ukraine. On Wednesday, the US followed up with more sanctions against Russia, which prompted a new leg lower in stocks in the afternoon; as a result, the S&P 500 ended up closing near its lows of the day, and is now down 11.9% from the January 3 all-time high. We expect markets to remain volatile in the near term as the situation remains fluid.
- **4Q21 Earnings:** So far, 88% of the S&P 500 has reported earnings with 31% blended 4Q21 earnings growth year over year (y/y). Seventy-six percent of companies have beaten earnings expectations with an aggregate beat rate of 5.9%, which is above the median rate of 5.1% since 2008. Energy and Information Technology sectors have been the biggest contributors to earnings growth this quarter, while Utilities and Consumer Staples have lagged. While results have been strong, forward guidance has been mixed with the ratio of negative to positive earnings guidance currently the highest since 2016. There are 27 more companies expected to report this week.
- **Monetary Policy:** Markets continue to gauge the timing and scale of future U.S. rate hikes and balance sheet adjustments that are anticipated to begin following the next Fed meeting March 15-16. While geopolitical uncertainty is currently affecting market sentiment and short-term conditions, the Federal Reserve will continue to monitor incoming inflation and economic data in the coming months to help guide future monetary policy actions.
- **Economic Calendar:** Weekly Jobless Claims, New Home Sales (2/24); Personal Income and Spending, Durable Goods Orders, University of Michigan Sentiment (2/25).

The Global Investment Committee’s Outlook

With the Fed poised to respond to 40-year highs in inflation through both rate hikes and balance sheet run-off in 2022, the GIC’s call for a 5%-15% correction in the indices remains intact. Our base case year-end 2022 target of 4,400 for the S&P 500 and our bull case of 5,000 corresponds to a view that rising rates and higher policy uncertainty demands lower price/earnings ratios and our forecast embeds an estimate of 18x forward earnings, despite a forecast for earnings growth of 10%-12% in 2022. With earnings revisions likely peaking, short-term tactical investors should upgrade their portfolios by dialing back extreme positioning and allocating more exposure toward high-quality cyclicals, defensives and growth at a reasonable price.

We barbell Financials and Energy with exposure to Utilities, Staples and Healthcare. While the US recovery matures, we see opportunities outside the US as relatively more attractive especially given less expensive valuations and exposure to economic cyclicality. In fixed income, the challenge is two-fold: generating sufficient income, while also preserving capital in a rising rate and higher inflation environment. This requires a diversified and active exposure, with our preference toward a mix of cash/ultrashort duration, high yield credit, preferreds, leveraged loans, and asset-backed securities, including select mortgage-backed, and dividend-paying stocks. Real assets such as gold, infrastructure, and real estate present an attractive opportunity as a portfolio ballast for income generation and as an inflation hedge.

Disclosure Section

Market data provided by Bloomberg.

Dow Jones Industrial Average (DJIA): A price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

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

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

US Trade-Weighted Dollar Index: A weighted average of the foreign exchange value of the 17US dollar against a subset of the broad index currencies that circulate widely outside the US.

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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. **Investing in foreign emerging markets** entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **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. The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer. **High yield bonds** are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. **Ultrashort-term fixed income** asset class is comprised of fixed income securities with high quality, very short maturities. They are therefore subject to the risks associated with debt securities such as credit and interest rate risk. **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.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation. The majority of $25 and $1000 par **preferred securities** are "callable" meaning that the issuer may retire the securities at specific prices and dates prior to maturity. Interest/dividend payments on certain preferred issues may be deferred by the issuer for periods of up to 5 to 10 years, depending on the particular issue. The investor would still have income tax liability even though payments would not have been received. Price quoted is per $25 or $1,000 share, unless otherwise specified. Current yield is calculated by multiplying the coupon by par value divided by the market price. Some $25 or $1000 par **preferred securities** are QDI (Qualified Dividend Income) eligible. Information on QDI eligibility is obtained from third party sources. The dividend income on QDI eligible preferreds qualifies for a reduced tax rate. Many traditional 'dividend paying' perpetual preferred securities (traditional preferreds with no maturity date) are QDI eligible. In order to qualify for the preferential tax treatment all qualifying preferred securities must be held by investors for a minimum period – 91 days during a 180 day window period, beginning 90 days before the ex-dividend date. The market value of **convertible bonds** and the underlying common stock(s) will fluctuate and after purchase may be worth more or less than original cost. If sold prior to maturity, investors may receive more or less than their original purchase price or maturity value, depending on market conditions. Callable bonds may be redeemed by the issuer prior to maturity. Additional call features may exist that could affect yield. Principal is returned on a monthly basis over the life of a **mortgage-backed security**. Principal prepayment can significantly affect the monthly income stream and the maturity of any type of MBS, including standard MBS, CMOs and Lottery Bonds. Yields and average lives are estimated based on prepayment assumptions and are subject to change based on actual prepayment of the mortgages in the underlying pools. The level of predictability of an MBS/CMO's average life, and its market price, depends on the type of MBS/CMO class purchased and interest rate movements. In general, as interest rates fall, prepayment speeds are likely to increase, thus shortening the MBS/CMO's average life and likely causing its market price to rise. Conversely, as interest rates rise, prepayment speeds are likely to decrease, thus lengthening average life and likely causing the MBS/CMO's market price to fall. Some MBS/CMOs may have "original issue discount" (OID). OID occurs if the MBS/CMO's original issue price is below its stated redemption price at maturity, and results in "imputed interest" that must be reported annually for tax purposes, resulting in a tax liability even though interest was not received. Investors are urged to consult their tax advisors for more information. **Asset-backed securities** generally decrease in value as a result of interest rate increases, but may benefit less than other fixed-income securities from declining interest rates, principally because of prepayments. **Yields** are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

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

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, 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.

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.

Companies paying **dividends** can reduce or cut payouts at any time.

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.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be appropriate for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities. Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. **Health care sector stocks** are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets. **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 returns on a portfolio consisting primarily of **environmental, social, and governance-aware investments (ESG)** may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client's account will be managed as described herein. 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.

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