Morgan Stanley

Asset Allocation Update

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Summary

- Trade tensions have escalated again, with additional tariffs announced by both the US and China on August 23, and we expect global growth to decelerate further.
- Our US market cycle indicator in 'downturn‘ suggests a challenging environment for risk assets.
- Together with our expectations of weaker earnings, expensive valuations and a re-escalation in trade tensions we remain cautious on equities in the short term.
- However, the US labor market remains strong and central banks have been proactive around the world - ensuring attractive risk premia - whilst financial conditions have remained well behaved.

  - Whilst we keep our defensive posture in the short term, we don’t think abandoning stocks at the asset allocation level is the right thing to do.
  - There will opportunities once we have passed a ~10% correction as well as once earnings expectations reflect the more challenging outlook and progress is made on US-China trade negotiations.

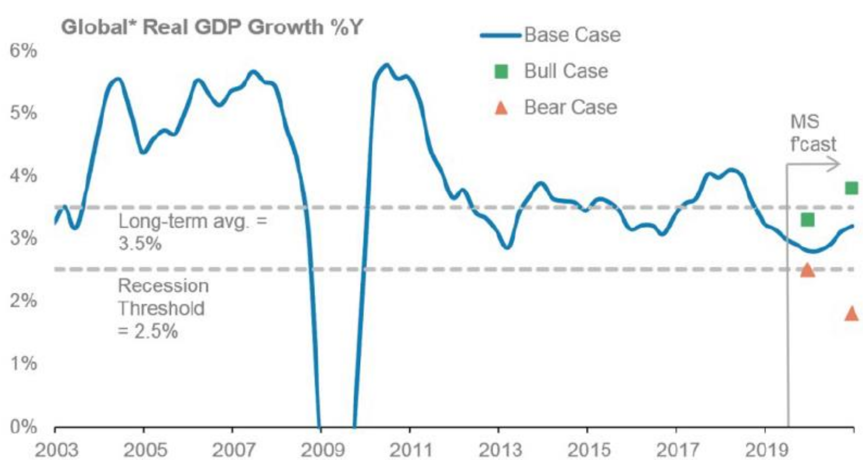
Environment Remains Challenging

Trade tensions have already taken a toll on global growth via weaker corporate confidence, the capex cycle and trade activity - causing longer lasting impacts to the global cycle.

The latest escalation in trade tensions will dent global growth further, averaging ~2.7%Y over the next four quarters.

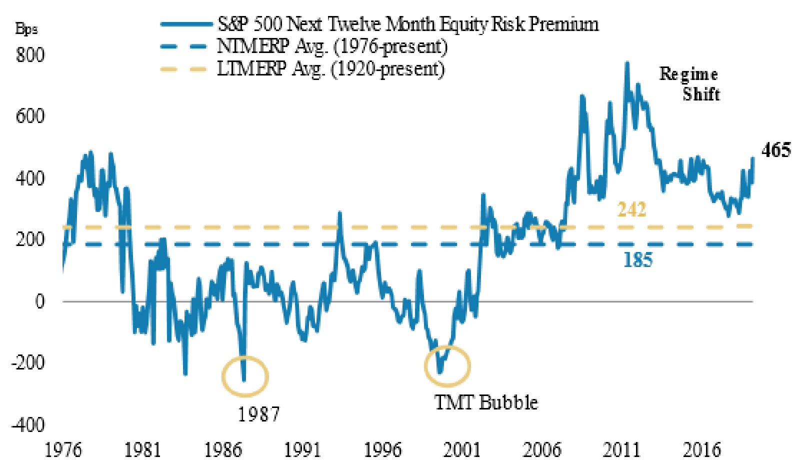
But Central Banks remain extremely accommodative around the world, ensuring easy financial conditions and supporting equities' relative value (vs bonds and cash).

Figure 1: Global Real GDP Growth



Source: Haver Analytics, CEIC, IMF, Morgan Stanley Research forecasts; *Global GDP includes countries under Morgan Stanley coverage, and the real GDP growth is PPP-based GDP-weighted averages

Figure 2: US Equities Risk Premium



Source: Morgan Stanley Research. LTM equity risk premium average is since 1920. ERP based on forward earnings yield and 10-year Treasury Yield. As at August 15, 2019

Keep an allocation in Emerging Markets despite ongoing uncertainty

Emerging Market (EM) equities face headwinds from weaker global growth and ongoing trade uncertainty.

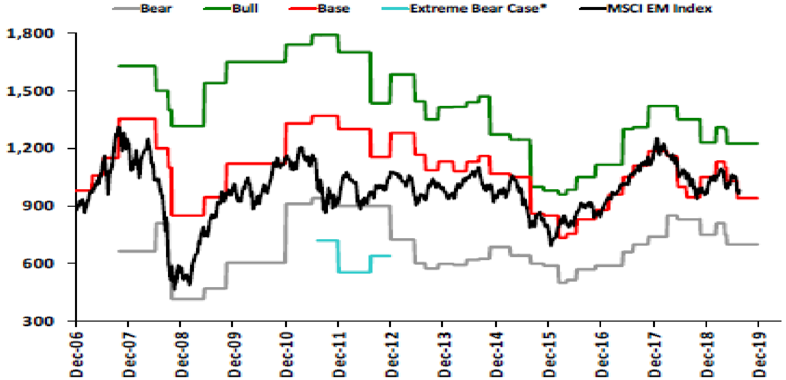
On the positive side however:

i) We believe the simultaneous easing from DM and EM central banks is positive for financial conditions in EM.

ii) EM equities are already reflecting the current environment.

➢ Regional selection within EM is essential.

Figure 3: MSCI EM Target History Since Initiation



*Included potential scenario of Eurozone Breakup

Source: MSCI, Morgan Stanley Research. Weekly data as at August 21, 2019

India – Downside risks are mounting but policies remain supportive

Macro Outlook:

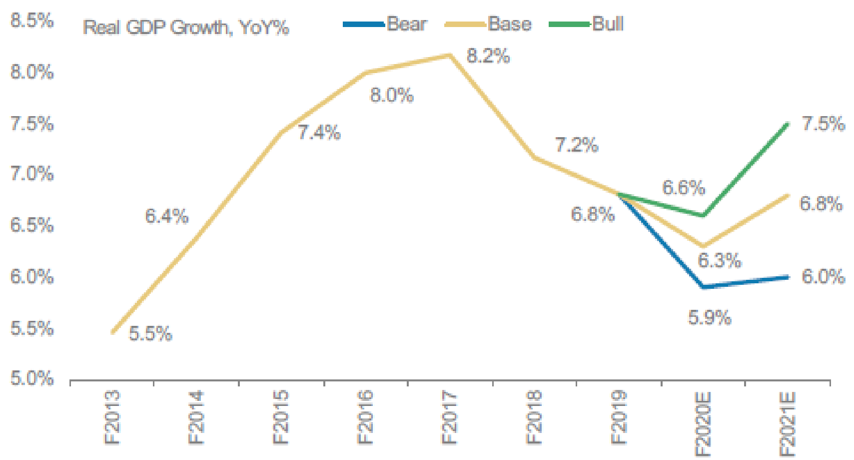
Delays in policy transmission are affecting the domestic demand outlook and continued trade tensions are weakening the external demand outlook.

But we still expect estimates to Real GDP growth of 6.0% for CY2019 and 6.8% for CY2020, given the support from both the fiscal and monetary side.

Equity Market Outlook:

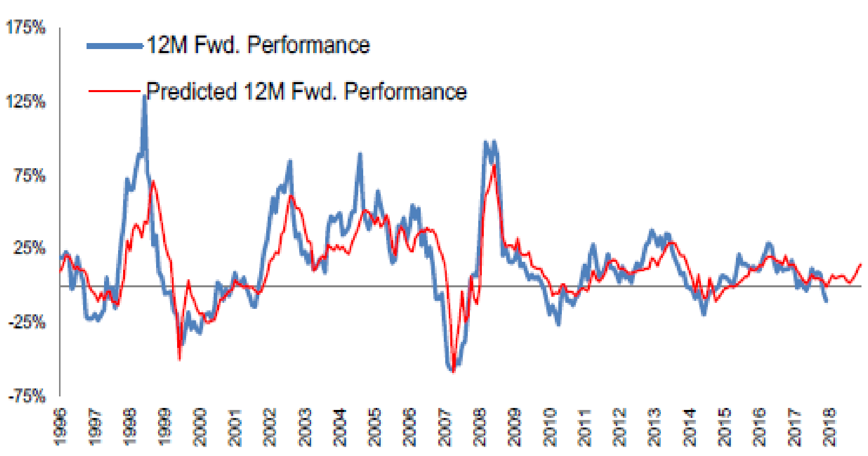
We remain positive on Indian stocks - within EM - on the back of subdued oil prices, fiscal and monetary support, and India's defensive characteristics amidst global trade tensions as well as better relative valuations.

Figure 4: India Real GDP Forecast



Source: CEIC, Morgan Stanley Research estimates (E)

Figure 5: Morgan Stanley Valuation Indicator



Source: RIMES, MSCI, Bloomberg, CDSL, SEBI, Morgan Stanley Research

Tactical Asset Allocation Positioning and Recommendations

Key portfolio recommendations

Tactically Cautious on Equities

- Defensive exposure in equities (Min Vol, Quality Yield). Less exposure to cyclicals for the time being.
- Mild OW Australia: prefer blend of defense and Materials sector.

Neutral Fixed Income

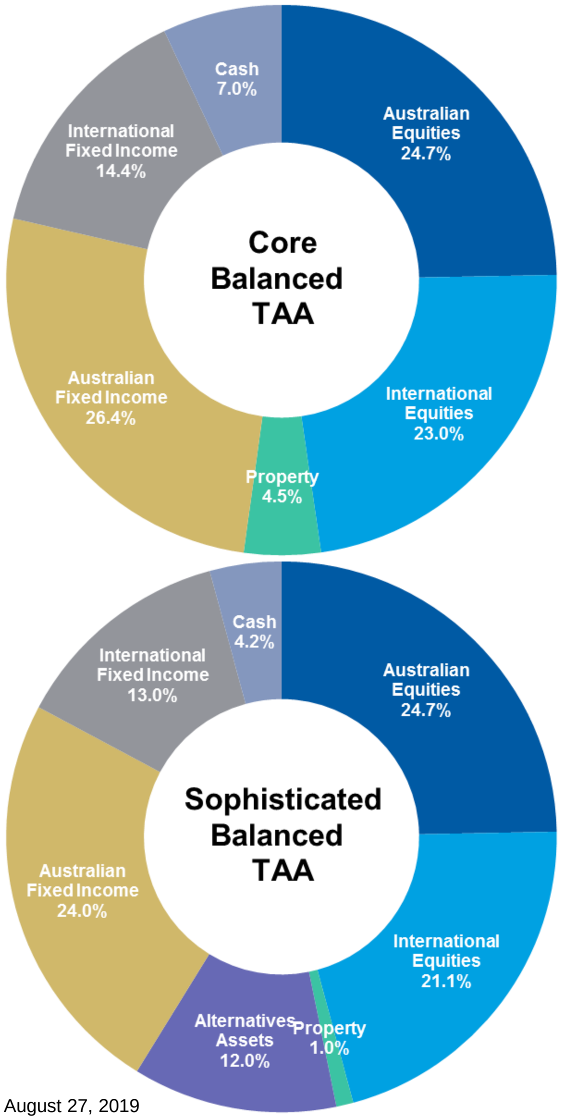
- Favor International over Australia.
- Increase quality: Build positions in Government bonds if yields overshoot and prefer Investment Grade over High Yield.

Retain foreign currency exposure for downside protection

- Keep majority unhedged as a tail hedge.

Beta trade running out of steam / higher volatility

- Look for selected Hedge Funds.
- Unlisted supported by low yields near term, but we are cautious for the medium term.



Source: MSWM Research. As at August 27, 2019

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