Morgan Stanley

WEALTH MANAGEMENT

January 27, 2021

The 1% Move

What Happened in the Markets?

- US stocks traded lower on Wednesday as the S&P 500 declined 2.6% to close at 3,751. With the sell-off, the index is now down 0.1% year to date.
- The S&P 500 recorded its steepest one-day loss in three months as volatility returns to Wall Street. While there was no single catalyst to explain the weakness, a number of factors likely contributed to Wednesday's decline. 4Q earnings season, the January FOMC meeting and the surge in high-short interest stocks all were topics of interest during the trading session. However, while these events likely played a part in the sell-off, some consolidation may have already been due given the extent of recent market gains, and that is likely what we are seeing this week.
- All 11 S&P 500 sectors finished the session lower, with Energy (-1.4%) and Real Estate (-1.4%) outperforming the broader market, while Consumer Discretionary (-3.1%) and Communication Services (-3.8%) lagged the broader market.
- Rates were lower across the curve, with the 10-year Treasury yield falling to 1.01% as of the 4 p.m. equity market close. Gold was 0.5% lower, while WTI oil was flat at nearly $53 per barrel. The US dollar strengthened modestly in the trading session, as measured by the US Dollar Index.

Catalysts for Market Move

US stocks fell 2.6% on Wednesday as the S&P 500 recorded its sharpest one-day drop since October 2020. A number of factors likely contributed to the sell-off, though markets may have already been susceptible for some consolidation given the extent of recent market gains; in fact, all three of the major US equity averages had recorded new all-time highs within the past week. A busy week of earnings results has given markets much to digest, with nearly 40% of the S&P 500 by market cap offering 4Q results. While earnings have largely come in above expectations, stock reaction has been mixed, perhaps suggesting the recent rally across markets has left a higher bar and even strong results are not being bought. Markets also seemed fixated on the surge of stocks with high short-interest this week, which perhaps has triggered some investor caution that speculative excesses may be building. Finally, Wednesday also saw the January FOMC meeting; while the rate decision went as expected with the committee offering few changes to its outlook, equities did continue to sell off into the close of the session. While Wednesday's near 3% sell-off may be concerning, markets are coming off of a strong upward trend in recent months that has seen few significant drawdowns; some consolidation should be expected and the sell-off likely reflects that with the S&P 500 now back to flat on the year to date.

The Global Investment Committee's Outlook

Record and unprecedented stimulus from both the Fed and Congress has unleashed a V-shaped recovery in global trade, manufacturing, goods retailing, and housing. That momentum, coupled with the resolution of the US Presidential election and much better-than-expected initial trial outcomes for COVID-19 vaccines, has lifted equity markets to new all-time highs. Although investors are correct to be concerned about index level valuations, which have reached multi-decade extremes at more than 22x forward earnings, the economic and profit dynamics in 2021 could support another 5%-10% gain to 3,900 for the S&P 500. Another round of fiscal stimulus, continuing Fed accommodation, and swelling pent-up demand for consumer services, may also support economic growth acceleration to 5%-6% real GDP, with inflation rebounding to more than 2%, a scenario that should support 27% year-over-year profit gains. However, optimal navigation of this burgeoning new business cycle will require care as Treasury rates are likely to move higher, creating a headwind for long-duration assets. In stocks, our preferences remain focused on quality and valuation support, attributes that remain in small caps, international stocks and cyclicals, including financials, which should benefit from the steeper yield curve. Dollar weakness is likely to continue as policy choices are debasing and relative growth outside the US becomes more compelling, supporting the case for emerging markets and commodities. In fixed income, the challenge is two-fold: Generating sufficient income, while also preserving capital, requires a diversified and active exposure, with our preference toward a mix of corporate credit (IG and HY), preferreds,

leveraged loans, asset-backed securities, including select mortgage-backed, and dividend-paying stocks. Capital preservation and portfolio hedging from equity volatility may be achieved with a combination of cash and ultra-short duration instruments, and absolute return hedge funds. Real assets like gold, infrastructure and real estate for inflation support should be bought opportunistically.

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 US dollar against a subset of the broad index currencies that circulate widely outside the US.

Disclosures

Morgan Stanley Wealth Management is the trade name of Morgan Stanley Smith Barney LLC, a registered broker-dealer in the United States. This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Past performance is not necessarily a guide to future performance.

The material has been prepared for informational purposes only and is not an offer or recommendation to buy, hold or sell or a solicitation of an offer to buy or sell any security, sector or other financial instrument, or to participate in any trading strategy. It has been prepared without regard to the individual financial circumstances and objectives of individual investors. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We and our third-party data providers make no representation or warranty with respect to the accuracy or completeness of this material. Past performance is no guarantee of future results.

This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. This information is not intended to, and should not, form a primary basis for any investment decisions that you may make. Morgan Stanley Wealth Management is not acting as a fiduciary under either the Employee Retirement Income Security Act of 1974, as amended ("ERISA") or under section 4975 of the Internal Revenue Code of 1986 as amended ("Code") in providing this material except as otherwise provided in writing by Morgan Stanley and/or as described at www.morganstanley.com/disclosures/dol.

Morgan Stanley Smith Barney LLC, its affiliates and Morgan Stanley Financial Advisors do not provide legal or tax advice. Each client should always consult his/her personal tax and/or legal advisor for information concerning his/her individual situation and to learn about any potential tax or other implications that may result from acting on a particular recommendation.

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.

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 **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.

This material is disseminated in the United States of America by Morgan Stanley Smith Barney LLC.

RSI1611783207931 01/2021