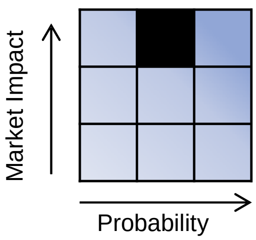
Geo-Markets

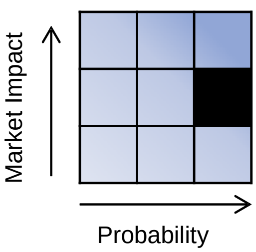
SCOTT HELFSTEIN, PhD
Executive Director
Morgan Stanley Wealth Management
Scott.Helfstein@morganstanley.com
+1 212 296-2632

IAN MANLEY
Morgan Stanley Wealth Management
Ian.Manley@morganstanley.com
+1 212 296-0929

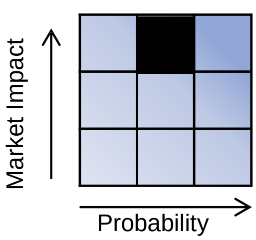
Trade: Focus on Tech Over Tariffs



LatAm: Poor Post-Election Equities



Korea: What Is Denuclearization?



Forget Tariffs, Tech Is True Trade Battlefield

This issue includes:

- Technology rather than tariffs is the main battlefield for US and China. Expect greater uncertainty over private-sector global expansion plans.
- Equity performance in Latin America in the back part of election years is rough, so look to defensive positioning.
- Progress in Korea peace talks would be good for investors, but remains too speculative for all but the most risk-acceptant investors.
- Geo-Dashboard: Europe on the move with Britain, France and Spain now among best performers in equities (page 4, middle), but remain cautious as risk based on implied probability spiked in France (page 5, top).

Assets: **China-Exposed Companies**	**TRADE** **Tech Fissures Cast Dark Cloud Over US-China**	**Action:** **Reduce**

While many news outlets focused on tariffs as the primary battlefront in the escalating US-China trade dispute, this increasingly looks like the side show. As incendiary trade rhetoric declined, and hopes for diplomatic breakthroughs improved, the US focused on quieter and lesser-known initiatives aimed at reducing technology transfer. We believe that investors should expect a prolonged dispute and resolution process. This conflict could be more important to the future of technology markets than global economic growth.

The centerpiece of the administration's efforts is rules, which could come out as soon as next month, that strengthen a national security committee responsible for reviewing whether private transactions threaten US national security. Changes to the committee mandate have been under review for some time, but now there is an increased emphasis on slowing acquisitions by foreign companies of US firms with military-relevant technology. The definition of military-relevant is also expanding, as off-the-shelf technologies find military applications and innovations such as artificial intelligence find a home in defense.

There is a new part of the puzzle. Policymakers are also reviewing restrictions that would limit the ability of US firms to make foreign investments that could result in technology transfer. This is almost certainly aimed at Chinese joint ventures, in which US companies form partnerships locally to gain market access for their products. Local partners then get access to technology that could be passed along. A joint intelligence assessment by former heads of the Office of the Director of National Intelligence and National Security Agency estimated China's theft of US intellectual property at $600 billion per year. The restrictions measure aims to limit high-tech seepage from cross-border joint ventures.

The US administration is also reportedly exploring a third tactic that would restrict some groups of Chinese nationals from engaging in militarily sensitive scientific research in the US. By restricting access to labs and certain projects, the move aims at reducing risk that foreign nationals return home with those technologies.

These three policies are undergoing various stages of review and likely weighed on the US discussions with China late last week. Unsurprisingly, little came of the bilateral engagement. The Chinese had publicly stated that they were unwilling to discuss two major requests from the Trump administration: They would neither open dialogue on reducing the trade deficit by $100 billion, nor were they willing to consider curtailing their proposed $300 billion in government support for initiatives such as artificial intelligence and quantum computing. For an administration looking to reduce trade imbalances and limit China's technological advance, this was an inauspicious start.

Conclusion: While the economic impact of the US-China trade dispute remains modest, behavior on both sides suggests escalation rather than quick resolution. China is not likely to restrict imports of high-tech goods given their priorities, but expect greater uncertainty over private-sector global expansion plans. ■

Assets: LatAm Consumer Staples and Health Care	LATIN AMERICA Elections Produce Poor Equity Returns	Action: Long

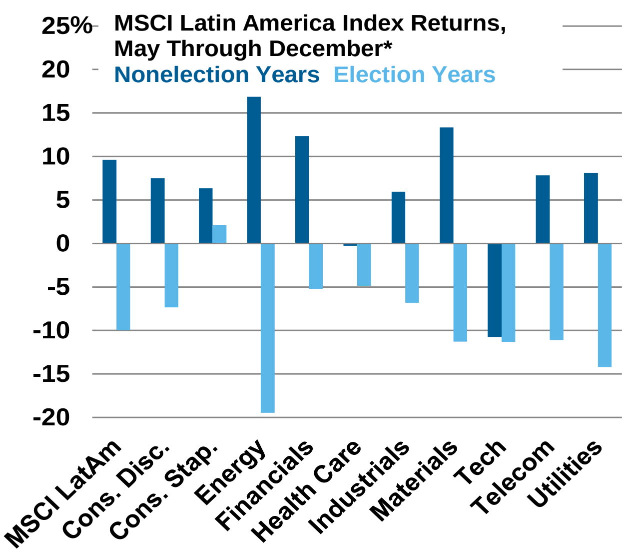
While Latin America's economic growth remains robust, concerns mount over the coming elections in Brazil and Mexico. Historical equity performance is not kind to investors in election years. We examine the past performance of the Latin American markets and sectors as well as look at performance from the beginning of the year to May and then May to the end of the year. What we learned: Get defensive on regional exposure.

This year is the first time since 1996 that Brazil and Mexico will have elections in the same calendar year. Brazil has multiple candidates who are relatively unknown, with no one polling much above 20%. A president elected with a weak mandate will have trouble garnering support from other elected officials for much-needed and politically difficult fiscal reforms. By contrast, mainstream parties in Mexican elections typically have run vitriolic campaigns against one another, which this year opened the door for a third-party challenge that could undo many of the reforms put in place during the current administration.

Since the launch of the MSCI Latin America Index in 1995, Brazil and Mexico have had six and four elections, respectively. Brazil's presidential election is every four years and Mexico's, every six. In sum, there have been seven years in which one of the two countries, or both, held elections and 15 without.

The equity returns are instructive. The average annual returns for MSCI Latin America without an election in Brazil or Mexico is 21.0% compared to -5.6% for years with an election. Four out of seven of the election years saw a down market, while only five of 15 times in nonelection years did the market close down.

Exhibit 1: Defensive Sectors Outperform Late in Election Years



*Since 1995
Source: Bloomberg, Morgan Stanley Wealth Management.

Compounding concern, investors should not expect a second-half relief rally. There is no evidence that equities rally into the second half of the year once election results are in. From May through December, regional equities were down 10.0% in election years and gained 9.6% in years without elections.

Similarly, equities underperformed in the first part of election years, gaining only 3.9% compared with nonelection-year gains of 9.6% in the same period. There was only one instance, the 2010 Brazilian election, in which regional equities declined in the first four months and then turned positive for the remainder of the year. The returns in the last eight months lagged the earlier four in every other election year.

Sector differentials are reasonably large in some cases. Investors are best off looking at traditional defensive sectors like consumer staples and health care during election years (see Exhibit 1, page 2). Financials and industrials have historically declined less than other sectors in election years as well. Sectors tied to government policy have not fared well. Energy has taken the largest hit, losing 19.5%, followed by utilities and materials. This is a reasonable market response given the policy uncertainty of new regimes.

In the first four months of the year, every sector is historically up, despite the upcoming election, with technology and materials traditionally leading. The only sector that has been up on average in the back part of the year was consumer staples. Similar to past election years, regional equities were up in the first four months of the year, gaining 6.0% with energy, materials and financials leading. Historical returns suggest that that a reversal is more likely than a further rally.

Conclusion: Hedge existing Latin American exposures and consider defensive sectors like staples and health care. ■

Assets: South Korean Equities	**KOREA** The Definition of Denuclearization	**Action:** Neutral

Investors have welcomed the recent US-North Korea-South Korea détente. This could be a positive development, but the outcome is likely to hinge on differing definitions of “denuclearization.” That concept may mean something different to North Korea than to the US. We believe that progress toward a lasting peace on the Korean peninsula would generate strong returns. All but the most speculative investors may choose to wait before betting on diplomatic success.

The first meeting between North and South Korean leaders in 11 years seems to have gone well. There is even talk of formally ending the war that began in 1950. The US administration seems committed to discussions as well. Kim Jong-un has opened the door to denuclearization, but this might be setting the bar too high.

North Korea has achieved modest nuclear weapons capabilities at great cost, and as the armaments do have a deterrent effect. Further, the fate of leaders in Libya and Iraq who lost their capabilities to produce weapons of mass destruction did not end well for them. Expecting Kim to disarm would be expecting the irrational for a leader that has led a country largely besieged on all sides. Disarmament to Kim likely means a halt to testing and development of new nuclear and ballistic weapons as well as a modest inspection regimen, not nuclear disarmament.

The US might be willing to make concessions toward peace and normalization of relations, but is unlikely to get the North to give up its nuclear arsenal and the means with which to produce it. If this is the desired short- or even medium-term end goal, there may be less room for agreement than hoped. By themselves, diplomatic talks raise the stakes as failure could lead to military escalation. Should the US walk away unsatisfied, the rallying cry could well be something like “we tried the carrot, now the stick.”

Conclusion: Further progress on Korea is a tailwind for risk assets, but investing on that particular outcome is highly speculative, given the range of potential outcomes. Meaningful change on the peninsula will produce opportunities for long-term returns and multiple entry points for investors. ■

Regional Cross-Sector Returns

Sector	Pacific		Latin America		Europe		US		World	
	Two Week	Year to Date	Two Week	Year to Date	Two Week	Year to Date	Two Week	Year to Date	Two Week	Year to Date
Cons. Disc.	-1.2%	0.0%	-6.1%	-11.6%	2.6%	4.9%	-1.3%	4.2%	-1.2%	3.4%
Cons. Stap.	-1.3	3.0	-6.1	-5.3	0.2	-7.3	-7.5	-14.3	-5.2	-10.1
Energy	-1.1	-2.2	-2.8	19.7	3.9	7.6	0.1	2.3	-0.2	2.4
Financials	0.0	-2.4	-7.7	5.6	1.1	-0.8	-1.1	-2.8	-1.2	-2.6
Healthcare	-1.9	5.0	-11.1	-21.2	1.5	-3.2	-2.5	-1.9	-2.3	-1.9
Industrials	-1.5	-2.2	-6.0	-2.5	0.9	-1.4	-6.3	-5.7	-4.2	-4.0
Materials	-1.6	-4.5	-5.9	8.1	0.3	-0.6	-5.3	-5.9	-3.6	-3.7
Tech	-1.3	-0.6	-4.0	-23.8	1.9	3.0	-2.4	4.9	-2.3	4.3
Telecom	-0.3	0.2	-8.2	3.1	2.5	-1.9	-5.3	-12.8	-2.7	-6.7
Utilities	2.5	5.6	-5.2	-2.8	2.7	3.4	1.3	-2.4	0.7	-0.2

Source: Morgan Stanley Wealth Management, Bloomberg as of May 2, 2018

Best Performers

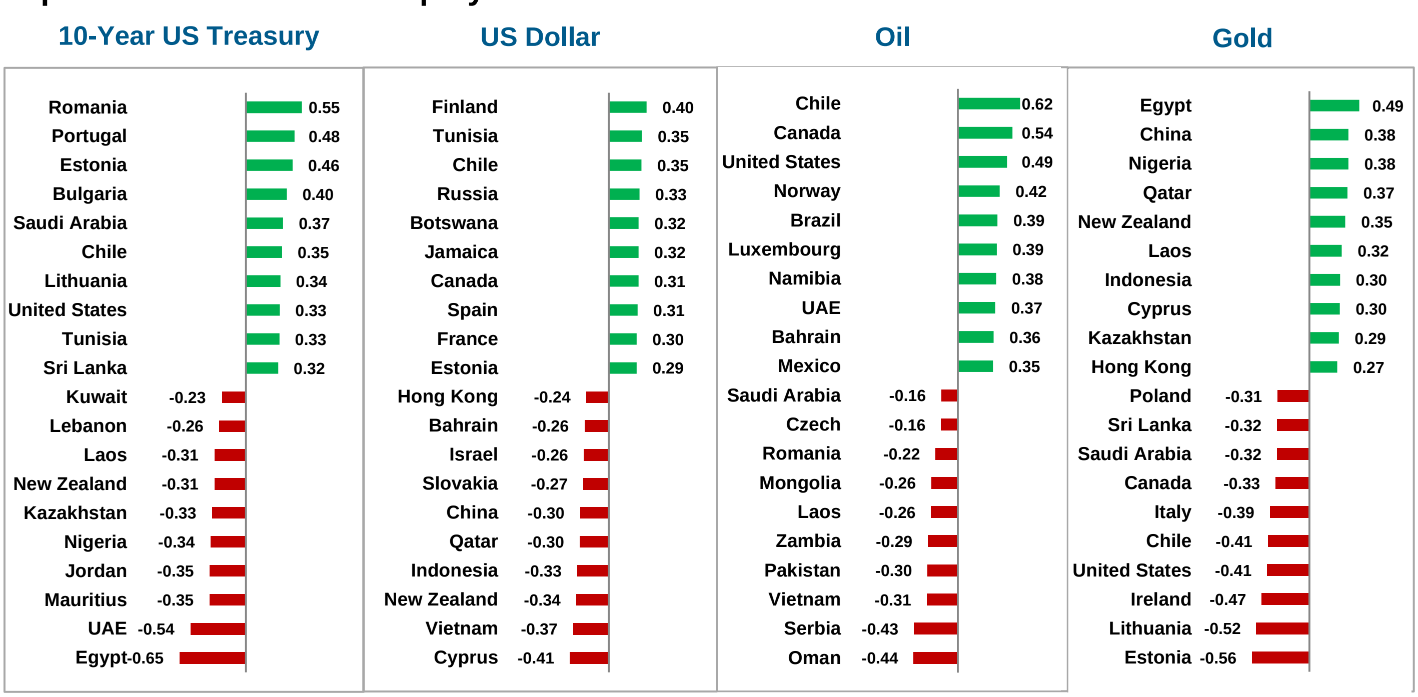
Last Two Weeks		Last 12 Months	
Latvia	6.04%	Ghana	85.0%
Luxembourg	3.56	Nigeria	69.5
Britain	3.28	Kazakhstan	64.4
Australia	3.24	Mongolia	52.0
France	3.06	Egypt	49.9
Sweden	3.03	Vietnam	47.2
Jordan	2.80	Argentina	40.9
Finland	2.80	Kenya	37.8
Egypt	2.76	Latvia	37.3
Spain	2.75	Peru	37.1

Worst Performers

Last Two Weeks		Last 12 Months	
Vietnam	-9.58%	Oman	-10.0%
Turkey	-6.24	Pakistan	-8.33
Argentina	-6.08	Qatar	-6.91
Indonesia	-4.67	Laos	-5.77
Kenya	-3.92	Malta	-4.67
Bahrain	-3.14	Botswana	-3.56
United States	-2.67	Spain	-2.31
Mexico	-2.44	Luxembourg	-2.29
Romania	-2.27	Croatia	-1.67
Hungary	-2.05	Poland	-1.63

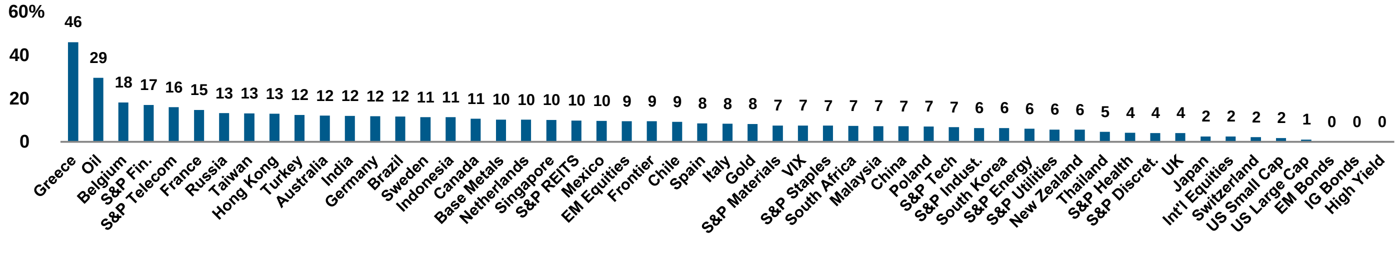
Green/red indicates a country is in the top/bottom 10 of world equity index total returns in local currencies for both the last two weeks and the last 12 months. Source: Morgan Stanley Wealth Management as of May 2, 2018

Top 10/Bottom 10 Global Equity-Macro Correlations



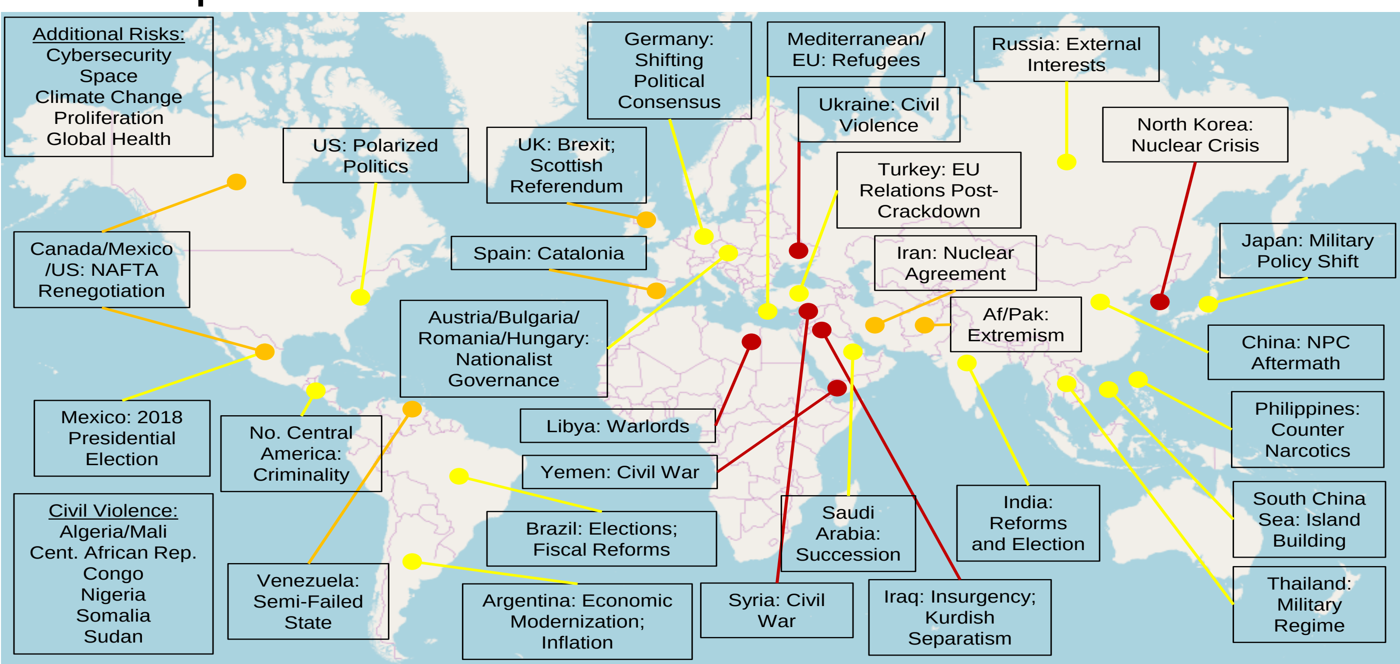
Note: Calculated using correlation of 30-day rolling returns on 82 global equity indices.
Source: Morgan Stanley Wealth Management, Bloomberg as of May 2, 2018

Probability of +5%/-5% One-Month Change in Global Asset Prices



Note: Probability of a +5%/-5% move calculated using implied probability on ETF options by calculating the standard deviation on month expiration call contracts and using the prior day close for the mean. Source: Morgan Stanley Wealth Management as of May 2, 2018

Global Hotspots



Source: Morgan Stanley Wealth Management.

Media and Internet Search Scores on Political Violence

Source: Morgan Stanley Wealth Management, GDELT (Google Database of Events, Language, and Tone). Indicates number of global news articles about material conflict published in last two weeks, as a percent of those published in last 12 months. Top 15 investable markets as of May 2, 2018.

Index Definitions

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

Risk Considerations

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.

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 suitable 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.

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.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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

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

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.

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