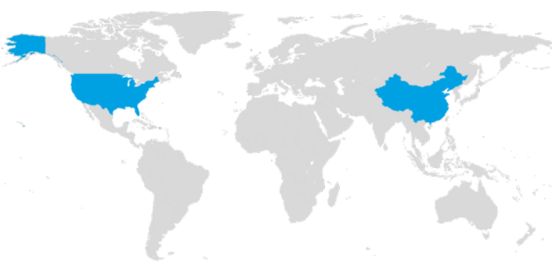
Geo-Markets

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

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



Market Risk Outlook

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Mission Impossible: Resolving the Trade Dispute With China

With no clear path to resolution, the trade dispute between the US and China will likely last much longer than markets anticipate.

On Aug. 3, China responded to the US' proposed $200 billion tariffs with additional tariffs on $60 billion of US goods, hinting at additional rounds of escalation rather than a quick resolution. The $200 billion of US tariffs will take effect on Sept. 6 after a public comment period has completed; the latest Chinese tariffs are likely to start shortly after. The US has the upper hand in this dispute as it exports fewer goods to China than China sends to the US. The Trump administration will probably not relent on its pressure for better intellectual property protection, which is the real impetus for the dispute. Securing US intellectual property, especially in high tech, is not just an economic concern, but potentially vital to national security.

China is unlikely to give in on meaningful intellectual property. The US Trade Representative estimates that counterfeiting and piracy make up 20% of China's economic growth. Compare that to the 6% contribution from exports to the US, and it is clear why China will likely stay the current course on high tech. The Chinese industrial policy known as "Made in China 2025" reflects policy decisions to become a global leader in robotics, information technology and aviation. These technologies have national security implications, and negotiations over soybean imports are a minor factor in the broader dispute.

With no clear resolution in sight, investors should position their portfolios for a protracted trade dispute that may reflect a shift in the global trading regime. Avoid industries with revenues most sensitive to China such as semiconductors and transportation. More domestically focused sectors such as media and professional services companies have less China risk. Primary economic risk continues to come from slower investment in business expansion late in the cycle. Inflation-linked assets and managed futures may help to conserve capital if higher prices on imported goods cause inflation to rise.

Topic	Commentary	Conclusion
Trade	US-China trade rhetoric has been escalated recently as the Trump administration threatened to raise the tariff on $200 billion in goods to 25% from 10%. US markets have mostly ignored the risk while Chinese stocks sold off sharply. Additionally, US Trade Representative Robert Lighthizer recently told a Senate subcommittee that he believes NAFTA renegotiations will be concluded soon and that a new deal could be ratified before the end of the year. Government procedures surrounding trade deals make that timeline unlikely, but all sides are looking to sign an agreement as quickly as possible.	Continue to short Chinese equities because of slowing economy (Nov. 16, 2017). Prolonged trade dispute adds risk. US small- and mid-caps are less vulnerable; Europe potentially benefits. Expect higher costs of goods sold for large US firms with the most-vulnerable supply chains (March 18)
Europe's Fiscal Dilemma	UK Secretary of State for International Trade Liam Fox recently said that a "no-deal" outcome for Brexit was now more likely than a negotiated exit from the EU. The remarks came as Prime Minister Theresa May met with regional leaders to advance her Brexit plan. The pound has dropped nearly 10% since April as the market has begun to price the increased chance of a failure to reach an agreement.	Remain overweight European equities on lower rates and weaker currency (March 14). Still, risk in periphery is elevated. Closely monitor geopolitical developments that could weigh on financials. Prefer core countries to periphery and Spain over Italy
Latin America Elections	Brazil's elections are now a main focus, and the field of contenders is solidifying. The right-wing candidate Jair Bolsonaro selected a former general as his running mate, while center-right candidate Geraldo Alckmin chose Ana Amélia Lemos, a conservative senator. In addition, two left-leaning parties announced an alliance that should strengthen their bid to gain a plurality in the first round of elections on Oct. 7.	Long Pacific markets (Chile, Colombia and Peru), short Atlantic (Argentina, Brazil and Mexico) on election and economic risks. Defensive sectors like consumer staples and health care have historically outperformed before and after elections (May 8)
Defense and Cyber	President Trump is widely expected to sign into law the National Defense Authorization Act this week, and with it changes to the Committee on Foreign Investment in the US. The adjustments will give the review body greater power to evaluate transactions with foreign nations on a national security basis. The increased scrutiny is mainly aimed at Chinese investment.	Long cyber companies positioned to benefit from increased spending in the latest US budget (March 15). Defense stocks also appear poised to rise
US Midterm Elections	The absence of robust polling in the lull following primary season has prompted a deeper look at campaign financing to glean election frontrunners. In the fundraising race for the House, Democrats appear to be doing well, having posted back-to-back months of record inflows. They doubled Republicans' haul in May and outpaced them in June. The top 25 incumbent-challengers with the most campaign cash on hand are also all Democrats. While these figures do not tell the entire story, they represent a concerted effort for the opposition party as they seek a net 23-seat gain to secure a majority	Infrastructure bill unlikely before midterms (April 26). Instead, consider firms that benefit from higher capital spending, which the market may be underestimating. Also, cybersecurity firms could benefit from concerns about election integrity (March 5). US defensive sectors have historically outperformed ahead of the midterm elections while cyclical stocks have done well after (May 22)
Emerging Markets	Emerging markets performance improved in July, with the MSCI Emerging Markets Index up 2.3% on a total-return basis. Headwinds remain, but recent Chinese commitment to stimulating the credit markets has bolstered sentiment. India's central bank lifted the policy rate to a two-year high while specifically citing looming "currency wars" as a risk to the economy. The first task for Imran Khan, Pakistan's newly elected leader, will be to navigate a likely IMF bailout. Elsewhere, investors questioned Turkey's commitment to central bank independence when it left rates unchanged despite accelerating inflation and currency depreciation; Turkish sovereign yields rose in response	Maintain overweight in the emerging markets. However, tighter financial conditions, a stronger dollar and high oil prices do pose risks. Middle East/North Africa positions include long Egypt (Jan. 31) and short Turkey (Jan. 31). Asia positions include long India (March 14) and short Malaysia (May 22)

Topic	Commentary	Conclusion
North Korea	The return of the remains of US war casualties from North Korea was heralded as progress, though there remains little to show on the nuclear front. Both sides have accused the other of not following through on their commitments made during the June summit. Publicly, the US and North Korea remain committed to the process, with a second summit potentially in the works for later in 2018. News that North Korea may be building a new weapons test site was not encouraging	Stick with the holding pattern on South Korean risk assets (May 8). A major reunification project would leave plenty of time to earn potential upside after a possible deal. On-again, off-again, on-again pattern of negotiations is simply too uncertain
Energy	Oil has traded mostly sideways since early July, as news threatening supplies was counterbalanced by inventories surprising on the upside. While still down from recent peaks, continued geopolitical volatility, especially concerning major producers such as Iran, should keep prices range bound	Remain long oil and oil-exposed companies (Jan. 10) even though catalysts for higher prices have weakened. Consider income-generating assets like master limited partnerships that have less potential upside with higher prices but may generate income in the current range of $65 to $75 per barrel
Iran	A cratering rial has forced Iranian authorities to take emergency measures to support the currency, including controls to prevent hard currency from leaving the country. The snapback of US sanctions and the lack of ability to tap global capital markets have made the task of stemming the currency rout increasingly difficult, and have forced the government to take drastic action such as purchasing gold on the open market to act as a potential buffer for future crises	Short Middle East equities as Iran and Saudi Arabia remain on a collision course over regional supremacy even as oil moves higher (Jan. 31). The US' unilateral withdrawal could create drag on the US and the global economy if oil prices spike
Tech Regulation	Tech giants have been meeting with the US Commerce Department in order to craft proposals to protect web users' privacy. One goal of these meetings is crafting a blueprint that Congress could use to pass a legislative framework that oversees data protection. Election hacking continues to be a hot-button issue with a recent announcement that a social media platform discovered similar attempts to influence the 2018 election as in the 2016 election. This report has support from the US intelligence community. Finally, a ride-sharing firm shut down the self-driving truck project, choosing to focus solely on autonomous cars—the division had previously been under fire for stealing proprietary designs from competitors	Use regulation-driven weakness as buying opportunities for top tech companies. Expect new round of debate over regulation close to US midterms. Tech also benefits from US tax bill encouraging capital expenditures

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 foreign markets and 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. 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.

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.

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.

Managed futures investments are speculative, involve a high degree of risk, use significant leverage, have limited liquidity and/or may be generally illiquid, may incur substantial charges, may subject investors to conflicts of interest, and are usually suitable only for the risk capital portion of an investor's portfolio. Before investing in any partnership and in order to make an informed decision, investors should read the applicable prospectus and/or offering documents carefully for additional information, including charges, expenses, and risks. Managed futures investments are not intended to replace equities or fixed income securities but rather may act as a complement to these asset categories in a diversified portfolio.

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.

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.

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.

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

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

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.

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.

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