The GIC Weekly

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What We Are Talking About

- **Reflating Europe.** Market momentum from Quantitative Easing, a weak euro and positive economic surprises; decent earnings revisions, better inflation data and importantly, improving credit growth signal upturn in cycle; broad valuation support is weakening, suggesting a preference for active management. Consider value plays in Europe, focusing on energy and banks.
- **India: The Next Chapter.** Secular growth story continues with pro-growth budget, reforms aimed at infrastructure investment and monetary stimulus; with best demographics of the next decade and change-oriented political leadership, growth potential is underappreciated. Consider adding India equity exposure in the context of an emerging markets underweight.

New in The GIC Weekly
Our Active vs. Passive Model Update. See page 6

Reflating Europe

European stocks have been among the global equity markets' best performers year to date. The MSCI Europe Index is up about 15% in local currency, outperforming the S&P 500 by roughly 13 percentage points and by three percentage points in US dollars. While much of the move comes from the European Central Bank's (ECB) Quantitative Easing (QE), recent data suggest that the mix of ultralow interest rates, low oil prices and a weak euro is reflating the Euro Zone economy. Also helping investor confidence is a cease-fire in Russia/Ukraine and a framework for resolving the Greek debt crisis. The Global Investment Committee (GIC), which has been overweight European equities in context of the Great Rebalancing theme, has been surprised by the swiftness of equities' move up. So, we ask, is there still reason to maintain our bullish position?

The answer is squarely yes, as we are seeing real improvements in key fundamentals that suggest good opportunities remain. Still, looking foward, balancing risk and reward may require more selectivity. Here's why:

First, economic surprises have gained momentum in recent weeks. Euro Zone PMIs in both manufacturing and services have been better than expected, especially in Germany. In addition, retail sales are growing at a 3.7% annualized rate, the fastest pace in eight years.

Upcoming Catalysts

Mar. 9 China CPI and PPI
Mar. 10 NFIB Small Business Optimism Index
Mar. 10 US JOLTS survey
Mar. 12 US retail sales
Mar. 12 US Import/Export Price Indexes
Mar. 12 Euro Zone industrial production
Mar. 13 US Producer Price Index
Mar. 13 U. of M. Consumer Sentiment Index

Consumer confidence is at its best level in six years and unemployment dropped to 11.2% in January from 11.4%, where it has been for most of the last year. Even more encouraging, given the fears around deflation, there has been better-than-expected inflation data—again especially in Germany, where the Consumer Price Index (CPI) readings went to an annualized 0.1% rate from -0.4%. This shift is critical to reversing global inflationary expectations, which have been plummeting since mid-2014, when oil prices first cracked, and have acted as a weight on German Bund yields (see *Fixed Income Weekly Insight*, page 7). QE typically signals a near-term bottom in bond yields as inflationary expectations increase and the increase in interest rates tends to, somewhat counterintuitively, incentivize investment. These developments suggest that the Euro Zone may track QE in the US, intimating further market upside driven by improvements in real growth.

Probably even more important than current economic activity is the rapid shift in indicators of future growth. Specifically, we have seen a meaningful pickup in money growth as measured by M1 and M3 (see *Chart of the Week*, page 3). Improvements in liquidity, financial conditions and money-supply growth tend to lead bank lending by 18 months to two years, and credit growth, in turn, is a major driver of GDP gains. With QE just starting, we see a runway for further gains in credit growth.

In addition, we are seeing improving corporate confidence both in terms of current earnings performance and positive earnings revisions. In 2014's fourth quarter, MSCI Europe earnings ex financials grew 10% on top-line gains of 5.4%, with earnings for the median company growing at a 12% pace. This profits season has been the best since 2010. Graham Secker, European equity strategist for Morgan Stanley & Co. (MS & Co.), recently boosted his earnings growth forecast to 12% from 10%. European companies are upgrading their earnings estimates for the third quarter in a row, and European revisions are outpacing the US by the widest margins in more than five years. Tailwinds from lower borrowing costs, low energy costs and the euro, at 1.08 to the dollar, should provide further support.

Bottom Line: Even with the near 15% year-to-date gain in the MSCI Europe Index, stocks appear attractive versus bond yields. However, with a 12-month forward price/earnings ratio of 15.2, the highest since 2002 and above the 25-year average of 13, the GIC believes investors should be focusing less on the broad picture and more on stock picking. **Watch** cyclical versus defensive valuations for signs of normalization. **Consider** looking for value in Europe, focusing on energy and especially banks. Relative to other European cyclicals, banks have only been cheaper than today 9% of the time in the last 20 years.

India: The Next Chapter

With China trying to execute a soft landing, investors have turned their sights on India as the next engine of global growth. Contrasting China's growth during the last 15 years with that of India has become routine sport. China's ability to dictate an investment-led, debt-fueled and export-oriented plan transformed an agrarian economy into an urban, manufacturing powerhouse. At the same time, India's fragmented, diverse democracy has yet to fashion its large, young and well-educated workforce into a highly productive, manufacturing economy.

Last year's election of reform-oriented Prime Minister Narendra Modi has given investors hope. Lower oil prices and shifting currency dynamics provide reformers a shot at breaking the back of inflation, which has run between 6% and 8% a year during the past five years, and redirecting monies from energy subsidies to public investment. Perhaps the most encouraging development has been the strength of India's currency. In the last 18 months, the rupee has appreciated in nominal and real trade-weighted terms, a reflection of improving current and fiscal deficits, decelerating inflation and better relative growth.

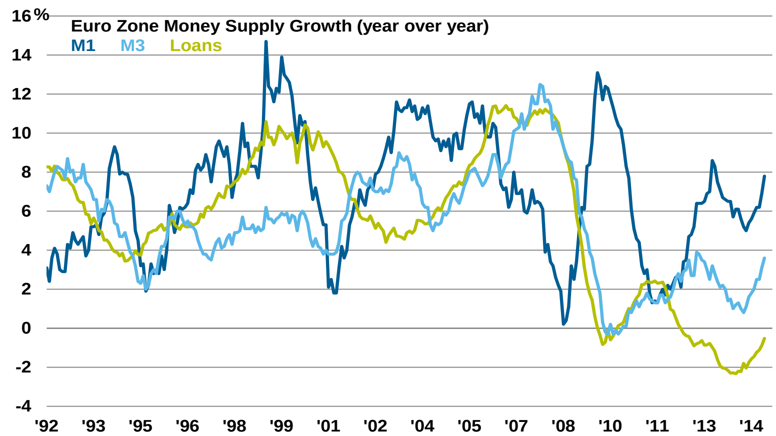
This has not been missed by investors, who bid up Indian equities by some 40% in the last year. Even so, the GIC believes India's economic momentum can accelerate and investors in Indian equities will see upside surprises. Chetan Ahya, MS & Co.'s chief Asia Pacific economist, expects companies in the S&P BSE Sensex Index will have a 24% compound earnings growth rate during the next two years versus the current 17% consensus estimate.

We remain optimistic on India for three basic reasons. First, Modi's much-anticipated fiscal budget announced last week was unabashedly pro-growth. Most importantly, the proposals pulled back original plans to move quickly toward fiscal consolidation and austerity, which should allow for a reduction in the corporate tax rate, higher growth in government-directed capital spending and increased allocations to infrastructure. Next, the reforms on infrastructure building—one of India's greatest impediments to faster growth—are truly comprehensive. In addition, the plan calls for issuing tax-free bonds to support rail, road and irrigation projects. Finally, on the back of declining inflation, the Royal Bank of India cut interest rates by 25 basis points, kicking off what Ahya believes will be 125 basis points in total cuts by the end of the year.

Bottom Line: India may, in fact, be at an inflection point in tapping her unrivaled potential. Investors' historic skepticism has created opportunities**. Watch** for stability of the rupee as a sign of good relative fundamentals. **Consider** adding India equity exposure in the context of an emerging markets underweight. ■

Chart of the Week: European Money Supply and Credit Growth Drive Reflation

The European Central Bank's Jan. 22 announcement of Quantitative Easing has contributed to powerful gains in Euro Zone stocks so far this year. Part of the enthusiasm comes from the view that the purchases will help weaken the euro, which, at 1.08 versus the US dollar, is at the lowest level since 2003 and should support exporters. Although actual bond buying starts today, Euro Zone market liquidity looks to already be improving in anticipation of better financial conditions. Both M1 and M3 money supply growth have rebounded, typically a harbinger of positive credit growth. Along with bond-purchase guidelines, the ECB also issued positive growth forecasts, suggesting real GDP growth of 1.5% in the next 12 months, 1.9% in 2016 and 2.1% in 2017.



M1 – cash and assets that can quickly be converted into currency.
M3 – less liquid assets referred to as "near, near money."

Source: Datastream, European Central Bank, Eurostat, Morgan Stanley & Co. Research as of Dec. 15, 2014

Asset Class Performance and Heat Map (as of Mar. 6, 2015)

Asset Class	Annualized Returns (%)							Yield	Valuation		Volatility (%)		Correlation to Global Equities	
Cash	**YTD**	**1-Yr.**	**2014**	**3-Yr.***	**5-Yr.***	**10-Yr.***	**20-Yr.***	**Current YTM**	**Current YTM**	**Avg. YTM**	**30 Days**	**20 Yrs.***	**30 Days**	**20 Yrs.***
90-Day US Treasury Bills	0.0	0.0	0.0	0.1	0.1	1.4	2.7	0.01	0.02	1.46	0.00	0.64	-0.11	0.00
Global Equities								**Current Div. Yld.**	**Current P/E***	**Avg. P/E****				
US Large-Cap Growth	4.0	16.7	15.0	20.7	16.8	8.5	8.9	1.22	19.9	17.9	9.9	17.9	0.88	0.88
US Large-Cap Value	-1.6	9.7	12.2	17.5	13.8	6.6	9.3	2.84	15.6	12.8	10.6	14.4	0.92	0.88
US Mid-Cap Growth	3.4	10.5	11.9	19.6	18.0	9.1	9.3	0.83	22.2	20.2	11.6	23.6	0.91	0.80
US Mid-Cap Value	1.0	11.4	13.2	20.9	17.1	9.1	11.6	2.54	16.9	14.0	10.7	16.3	0.89	0.87
US Small-Cap Growth	3.9	4.1	5.5	19.8	17.8	10.4	11.0	0.57	28.4	22.0	11.1	22.6	0.92	0.82
US Small-Cap Value	0.4	6.3	9.7	19.6	16.3	9.2	11.7	2.34	19.0	17.4	11.6	17.1	0.92	0.84
Europe Equity	3.6	-4.6	-5.7	12.5	7.2	5.4	8.1	3.00	16.1	13.3	11.5	18.0	0.89	0.94
Japan Equity	8.4	9.4	-3.7	10.8	5.8	2.9	0.5	1.68	15.3	17.3	14.8	18.2	0.10	0.66
Asia Pacific ex Japan Equity	3.2	1.5	-0.3	9.5	7.6	8.9	7.8	3.75	15.7	14.1	11.8	21.6	0.19	0.84
Emerging Markets*****	1.8	4.2	-1.8	4.6	3.4	8.8	6.6	2.57	11.8	10.5	10.0	23.4	0.72	0.85
Global Fixed Income								**Current YTM**	**Current Spread**	**Avg. Spread****				
Short-Term Fixed Income	0.2	1.0	1.4	1.6	2.2	3.5	4.9	1.15	25.0	30.0	2.1	2.1	0.28	-0.06
US Fixed Income	0.1	4.2	6.0	3.4	4.6	4.9	6.2	2.13	42.0	54.0	4.2	3.6	0.19	0.00
International Fixed Income	0.9	7.2	8.4	5.9	4.8	4.7	6.5	1.12	37.0	53.5	2.1	2.6	0.17	-0.05
Inflation-Linked Securities	-4.3	-3.3	3.5	2.6	4.5	5.0	7.6	-	-	-	8.1	7.3	0.61	0.43
High Yield	2.8	3.1	2.6	9.3	9.0	8.3	9.2	6.49	465.0	489.5	1.8	9.7	0.50	0.73
Emerging Markets Fixed. Inc.	1.7	9.0	8.2	8.3	8.6	9.0	10.7	6.15	337.0	302.5	3.1	10.2	0.63	0.45
Alternative Investments								**Current Div. Yld.**						
REITs	0.9	11.2	14.7	16.7	13.3	7.7	9.9	3.22	-	-	13.3	18.3	0.77	0.79
Master Limited Partnerships***	-3.5	-0.3	4.8	10.8	15.9	12.9	-	6.11	-	-	18.7	15.5	0.64	0.11
Commodities ex Prec. Metals	-4.0	-27.4	-18.7	-10.9	-6.1	-4.0	2.2	-	-	-	21.1	16.5	0.39	0.44
Precious Metals	-1.1	-16.9	-6.7	-9.4	2.5	10.6	6.6	-	-	-	16.2	18.9	0.30	0.21
Hedged Strategies****	-	4.7	3.3	5.5	3.3	3.0	5.8	-	-	-	-	-	-	0.69
Managed Futures****	-	13.1	12.2	3.5	2.5	3.6	6.3	-	-	-	-	-	-	-0.06
S&P 500	1.0	12.8	13.7	19.2	15.6	7.6	9.5	1.87	16.9	14.9	10.12	15.2	0.92	0.95
Russell 2000	1.2	2.3	4.9	17.9	15.7	7.9	9.5	1.35	23.2	20.6	11.51	19.8	0.91	0.81
MSCI EAFE	4.6	-1.0	-4.5	11.7	6.9	5.2	5.7	2.87	15.8	13.8	8.89	16.6	0.82	0.96
MSCI AC World	2.2	6.1	4.7	14.1	10.4	6.7	7.4	2.36	16.0	14.1	8.49	15.6	1.00	1.00

Valuation	Volatility	Correlation
Cheap	Low	Low
Moderate	High	High
Expensive		

*Feb. 28, 2015 **20-year average as of Feb. 28, 2015. ***Volatility and Correlation: June 30, 2006 - Present. ****Hedged strategies consist of hedge funds and managed futures; returns as of Jan. 31, 2015. *****Values calculated using USD
Source: FactSet, Bloomberg

Morgan Stanley & Co. Forecasts (as of March 6, 2015)

	Real GDP Growth (%)			10-Yr. Govt. Bond Yield (%)		Headline Inflation (%)			Currency Versus US Dollar		
	2014E	2015E	2016E	Q1 '15E	Q4 '15E	2014E	2015E	2016E	Q1 '15E	Q4 '15E	Q2 '16E
Global	3.3	3.5	3.9			3.5	3.0	3.6			
US	2.4	3.3	2.4	2.5	2.9	1.6	-0.3	2.1			
Euro Zone	0.8	1.0	1.7			0.4	-0.1	1.5	1.12	1.05	1.02
UK	2.6	2.5	1.9	2.3	2.7	1.5	0.5	1.7	1.48	1.38	1.39
Japan	0.0	1.0	1.9	0.4	0.7	2.7	0.8	1.6	118	127	125
Emerging Markets	4.5	4.3	5.0			5.2	5.3	4.9			
China	7.4	7.0	7.2	3.4	3.2	2.0	2.0	2.4	6.16	6.09	6.09

Source: Morgan Stanley & Co.

Macro Factor Heat Map (as of March 6, 2015)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	GIC Conclusion
US	↓	↓ Curve Steepened	↓	↑	↑	↑	↓	Steady Growth; Mounting Earnings Headwinds
Japan	↑	↓	↑	↓	↓	↑	↑	Encouraging Momentum
Europe	↑	↓	↓	↑	↑	↓	↑	Positive Catalysts Evident
China	↓	↓	↓	↑	↓	↓	↓	Non-Consensus Bulls
Brazil	↓	↓	↑ CPI Elevated	↓	↑	↓	↓	Stagflation; Avoid

Risk Asset Positive	Neutral	Risk Asset Negative

Note: Text in a factor box denotes a color change; US rates went from neutral to risk asset positive as the curve steepened; Brazil inflation/deflation went from neutral to risk asset negative as CPI Y/Y rose to elevated levels. For a further explanation of the chart, see page 9.

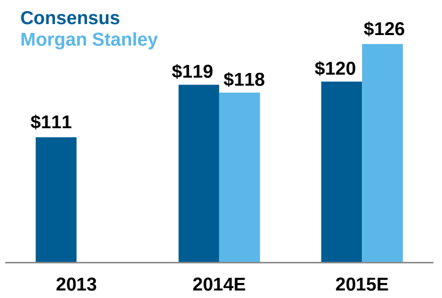
Source: Morgan Stanley Wealth Management GIC

Market Factor Data Points (for the week ending March 6, 2015)

	Positives	Negatives
Global Growth	• US February payrolls very strong at 295,000, with unemployment rate down to 5.5% • US February private payrolls in line with expectations • February US ISM nonmanufacturing index higher than estimated • Fed Beige Book showed modest economic expansion • January German retail sales rose faster than expected	• US average hourly earnings growth still "stuck" at 2% • January US factory orders dropped versus estimates for an increase • US construction spending declined in January • February US ISM manufacturing slowed further • January German factory orders fell more than expected • China lowered its growth forecast to 7%
Rates	• European Central Bank left rates unchanged, but confirmed buying bonds down to negative 0.2% yields • India announced surprise rate cut • China's central bank lowered policy rate	
Inflation	• Inflation expectations in the US and Europe appear to be bottoming	• February Euro Zone CPI fell, though less than forecast • January Euro Zone PPI lower than expected
Sentiment and Flows	• European Central Bank unveiled stimulus plan • M&A and share repurchase activity remains robust	• US fund flows still defensive, favoring bonds to stocks

Source: Morgan Stanley Wealth Management GIC

S&P 500 Earnings Estimates



Source: FactSet, Thomson Reuters, Morgan Stanley & Co. Research as of March 6, 2015

MS & Co. S&P 500 12-Month Price Target

EPS Landscape	Scenario Probability	2014E	2015E	2016E	P/E Ratio	Scenario Target	Upside / Downside
Bull Case	20%	120.0	133.2	147.9	18.6	2,750	32.8%
Growth			*11%*	*11%*			
Base Case	60%	118.4	126.1	134.3	16.9	2,275	9.8%
Growth			*7%*	*7%*			
Bear Case	20%	117.0	112.3	112.3	15.1	1,700	-17.9%
Growth			*-4%*	*0%*			
Current S&P 500 Price						2,071	

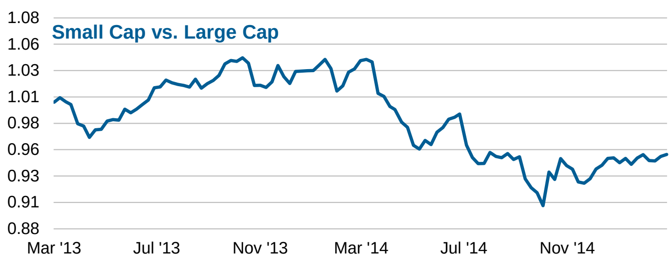
Source: Thomson Reuters, Morgan Stanley & Co. Research as of March 6, 2015

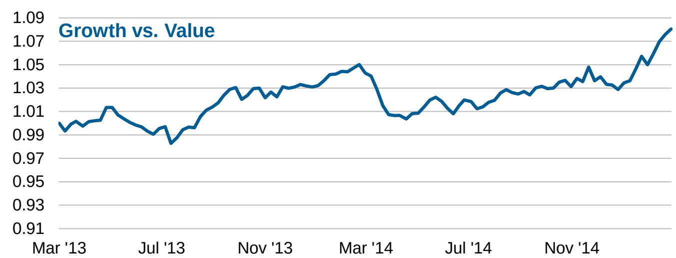
S&P 500 Sector Performance and Valuation (as of March 6, 2015)

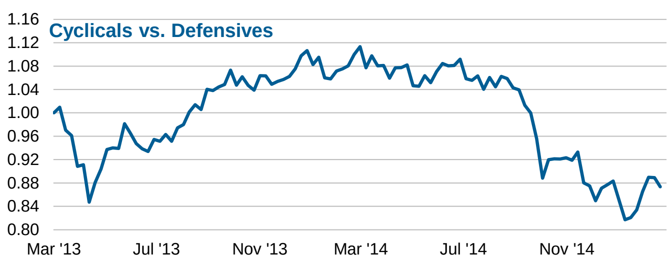
	Total Return					
Index Name	**WTD (%)**	**YTD (%)**	**1-Year (%)**	**Dividend Yield (%)**	**Beta**	**Forward 12-Mo. P/E***
S&P 500	***-1.54***	***2.57***	***15.83***	***1.87***		***16.9***
Energy	-2.86	-0.95	-6.78	2.85	1.18	26.8
Materials	-1.96	6.00	11.58	2.00	1.09	17.6
Industrials	-1.81	1.79	12.92	1.99	1.06	16.3
Consumer Discretionary	-0.75	5.29	15.92	1.32	1.02	19.1
Consumer Staples	-2.51	3.10	22.55	2.46	0.65	19.6
Health Care	-1.14	5.60	23.54	1.35	1.04	17.7
Financials	-0.49	-1.45	14.81	1.69	1.04	13.3
Information Technology	-1.41	4.01	22.33	1.40	1.10	16.0
Telecommunication Services	-2.73	5.40	12.96	4.83	0.58	13.8
Utilities	-4.06	-4.18	16.78	3.51	0.51	16.0

*Dark blue/light blue/gray fill denotes whether current relative forward 12-month P/E is low/neutral/high relative to history
Source: Morgan Stanley & Co.

Performance of Style and Cap Pairs (as of March 6, 2015)



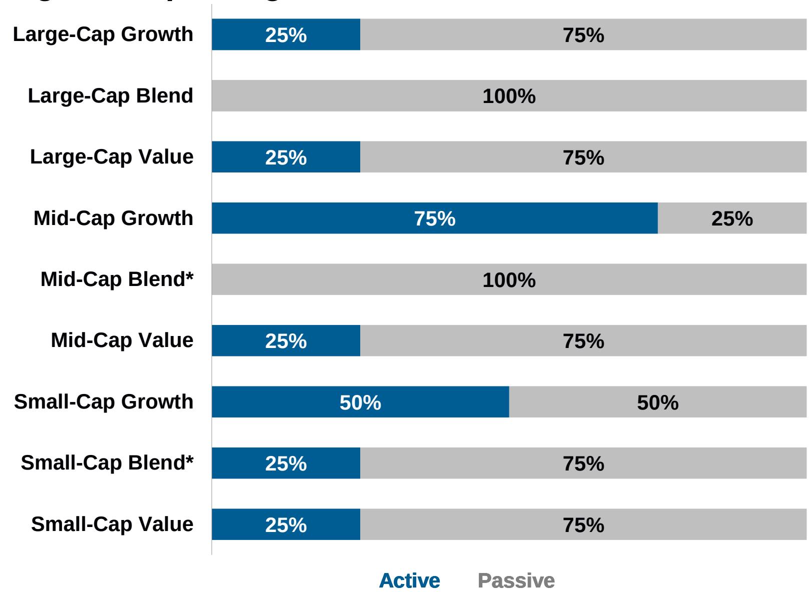




Source: Morgan Stanley & Co. Small Cap is represented by the Russell 2000 Index; Large Cap represented by the Russell 1000 Index; Growth represented by the Russell 1000 Growth Index; Value represented by the Russell 1000 Value Index.Cyclicals, Defensives. Quality and Junk are based on Morgan Stanley & Co. Research analysis.

Active vs. Passive Strategies: Passive Signals Improving (next update April 6)

The GIC's active versus passive strategies model generates recommendations of whether to invest in actively or passively managed mutual funds. Based on February's market action, we see slight increases in passive strategies: mid-cap blend went to 100% passive from 75% and small-cap blend went to 75% passive from 50% (see chart). These changes are driven by strong performance in global risk assets, with the highest returns in high-beta, speculative segments. Active managers tend to become incrementally less attractive in such periods because of their bias to underweight these areas in favor of higher-quality stocks. Accordingly, the performance in turbulent markets is often financed by underperformance in these stronger periods.



*Mid-cap blend went to 100% passive from 75% passive and small-cap blend went to 75% passive from 50% passive. For a further explanation of the active and passive strategies model, see page 10.
Source: Morgan Stanley Wealth Management GIC as of Feb, 27, 2015

Active vs. Passive Model Factors by Style (as of Feb. 27, 2015)

	Return Correlation	Valuation Dispersion	Deep Value Dispersion	Earnings Estimate Dispersion	Flows to Active Funds	Return Dispersion	Yield Curve Slope	Recent Active Manager Success
Growth			Not Applicable		Moderate Passive		Neutral	Strong Passive
Blend	Neutral	Moderate Passive	Neutral	Neutral		Moderate Passive*	Strong Active	Strong Passive
Value					Not Applicable		Moderate Active*	Strong Passive

*Changed since last publication of the model.
Source: Morgan Stanley Wealth Management GIC

Active Mutual Fund Manager Benchmark Relative Returns (as of Feb. 27, 2015)

Style Box Performance	Large-Cap Growth (%)	Large-Cap Blend (%)	Large-Cap Value (%)	Mid-Cap Growth(%)	Mid-Cap Blend(%)	Mid-Cap Value(%)	Small-Cap Growth(%)	Small-Cap Blend (%)	Small-Cap Value (%)
Year to Date	-0.58	-0.06	0.94	-0.44	-0.71	-0.02	-0.66	-0.44	0.78
2014	-3.05	-2.73	-3.24	-4.90	-5.41	-5.44	-3.17	-1.10	-0.88
Managers Outperforming									
Q1 2014	33	46	20	34	26	7	48	49	40
Q2 2014	19	28	33	11	23	23	31	57	59
Q3 2014	35	25	43	19	27	33	64	72	79
Q4 2014	44	30	18	41	29	31	13	21	17
2014 Average	33	32	28	26	26	23	39	50	49

Source: Morningstar as of Feb. 27, 2015
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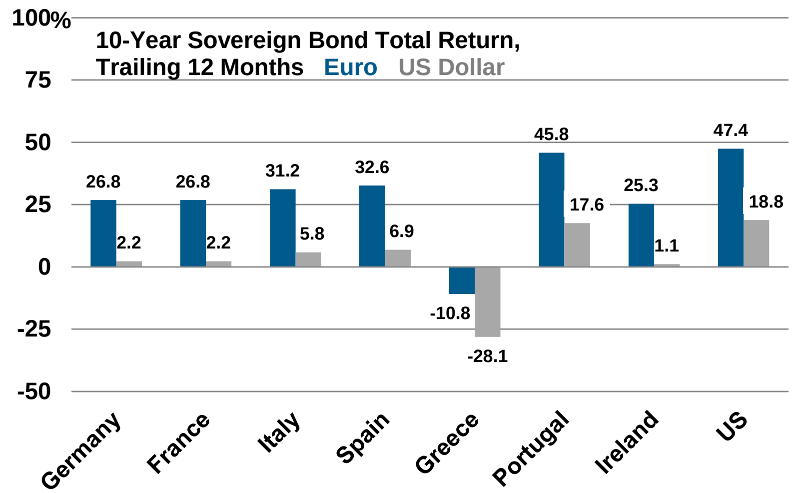
Fixed Income Weekly Insight: Looking Back on a Big Year for Sovereign Bond Returns

Sovereign bonds have performed exceptionally well during the past 12 months, save for those issued by Greece. In fact, 10-year sovereign bonds have returned in excess of 25% in euro terms as slow growth has pushed yields lower—even negative in some cases—and bond prices higher. We believe this trend will ultimately reverse as investor confidence and economic stimulus restore economic prospects. As such, we remain cautious on global bond rates and prefer credit investments.



Source: Bloomberg, TrendMacro as of March 6, 2015

Government Debt Monitor (as of March 6, 2015)

US					Global				
	Yield (%)			Total Return (%)		Yield (%)			Total Return (%)*
Treasury Benchmark	Current	ΔWTD	ΔYTD	YTD	**10-Year Govt. Bond**	Current	ΔWTD	ΔYTD	YTD
3-Month	0.01	-0.01	-0.03	0.00	France	0.69	0.09	-0.13	1.47
2-Year	0.72	0.11	0.06	0.28	Germany	0.39	0.07	-0.15	1.42
5-Year	1.69	0.20	0.04	0.66	Japan	0.39	0.06	0.07	-0.31
10-Year	2.24	0.25	0.07	0.83	Spain	1.29	0.03	-0.31	2.63
30-Year	2.84	0.25	0.09	1.10	UK	1.95	0.15	0.19	-0.97
2-Yr./10-Yr. Spread (bp)	152	14.34	1.13	-	3-Month LIBOR	0.26	0.00	0.01	-
10-Yr. TIPS Breakeven (bp)	183	-0.08	15.27	-	**US Tax Exempt**				
					10-Year AAA Muni	2.17	0.15	-0.60	0.46
Interest Rate Volatility** (bp)	87	-4.80	17.65	-	10-Yr. Muni/UST Ratio	97.31	-3.69	5.28	-

*Global total returns reflect Citigroup 7- to 10-year bond indexes and Muni total returns reflect Barclays Municipal Bond Index Total Return
**Interest Rate Volatility measured by Merrill Lynch Option Volatility Estimate (MOVE) Index
Source: Bloomberg, Thomson Reuters Municipal Market Data (MMD)

Fixed Income Spread Dashboard

`		Duration (Yrs.)	Yield-to-Worst (%)	OAS (bp)	OAS Range** Past Two Years (bp) Rich	Cheap
Investment Grade	MBS*	3.32	2.02	3	0	65
	AAA	4.11	1.44	26	9	33
	AA	4.68	1.66	5	4	30
	A	7.04	2.64	95	79	133
	BBB	7.58	3.58	175	134	212
High Yield	BB	4.60	4.81	336	253	451
	B	3.72	6.40	518	367	641
	CCC	3.44	9.80	866	664	1,125

Benchmark Returns

	Total Returns (%)		
Index	YTD	MTD	2014
Barclays Aggregate	0.74	-0.39	5.97
Barclays US MBS	0.51	-0.17	6.08
Barclays Municipal	0.46	-0.26	9.05
Investment Grade	1.38	-0.42	7.48
High Yield	2.85	-0.18	1.83
World Government Bonds (FX)	0.96	-0.37	8.47
Emerging Markets US$	1.15	-0.47	6.95

Unless stated, indexes utilized are Citi Broad Investment Grade, Citi High Yield, and Citi Global Indexes.
*MBS distills high grade agency-rated mortgage-backed securities, a substantial subsector of investment grade indexes.
**OAS stands for Option-Adjusted Spread or spread over the Treasury. Grey diamond denotes current OAS; blue circle denotes two-year average.
Source: Bloomberg, The Yield Book® Software and Services.

Tactical Asset Allocation Reasoning

Global Equities	**Relative Weight Within Equities**	
US	Overweight	While US equities have done exceptionally well since the global financial crisis, they still offer attractive upside potential, particularly relative to bonds. We believe the US and global economies continue to heal, making recession neither imminent nor likely in 2015. This is constructive for global equities, including the US.
International Equities (Developed Markets)	Overweight	We maintain a positive bias for Japanese and European equity markets given the political and structural changes taking place in Japan and our expectation for an improving economic outlook in Europe. European and Japanese central banks are now engaged in much more aggressive monetary policy than the US. Europe and Japan are also moving away from fiscal austerity, which should be relatively more stimulative for growth on a rate-of-change basis.
Emerging Markets	Underweight	Emerging market (EM) equities have been a mixed bag for the past few years and we expect that to continue. We remain underweight the broader region as many countries go through a necessary rebalancing of growth. Furthermore, the Fed's rate hike cycle began with the tapering of Quantitative Easing last year and is likely to lead to further US-dollar strength as the Fed raises rates this year—another negative for the EM region broadly. We recommend investors take a narrower approach, focusing on oil-importing countries such as India, China, Taiwan, Korea, Malaysia and the Philippines.
Global Fixed Income	**Relative Weight Within Fixed Income**	
US Investment Grade	Overweight	We have recommended shorter-duration* (maturities) since March 2013 given the extremely low yields and potential capital losses associated with the rising interest rates. We have subsequently reduced the size of our overweight in short duration as we expect short-term interest rates to move higher as the Fed moves toward its first rate hike. Within investment grade, we prefer BBB-rated corporates and A-rated municipals over US Treasuries.
International Investment Grade	Equal Weight	Yields are low globally, so not much additional value accrues to owning international bonds beyond some diversification benefit.
Inflation-Linked Securities	Underweight	We have been underweight inflation-linked securities since March 2013 given negative real yields across all maturities. Recently, these yields have turned modestly positive but remain unattractive, in our view, due to the longer-duration characteristics of TIPS and limited risk for unexpected inflation.
High Yield	Overweight	The sharp decline in oil prices has created some dislocations in the US high yield market. Broadly speaking, we believe default rates are likely to remain muted as the economy recovers slowly, keeping corporate and consumer behavior conservative. We prefer shorter-duration and higher-quality (B to BB) issues and vigilance on security selection at this stage of the credit cycle. With energy-related issues, investors need to be very selective until the price of crude oil stabilizes.
Emerging Market Bonds	Underweight	Similar to emerging market equities, we remain underweight on the basis that the beginning of the Fed's rate hike cycle will likely be a disproportionate headwind for emerging market debt relative to other debt markets.
Alternative Investments	**Relative Weight Within Alternative Investments**	
REITs	Equal Weight	Falling interest rates led to very good performance for REITs in 2014. At current levels, we believe REITs are fairly valued and offer more select opportunities. The industrial and commercial segments tend to outperform at this stage of the recovery. Non-US REITs should also be favored relative to domestic REITs at this point.
Commodities	Equal Weight	Most commodities have underperformed in the past few years, with energy leading the charge lower. While commodities look more attractive at this point as a diversifier against potential geopolitical shocks, the fundamental case keeps us with an equal-weight tactical recommendation.
Master Limited Partnerships*	Equal Weight	Master limited partnerships (MLPs) should continue to do well as they provide diversification benefits to traditional assets and a substantial yield that is valuable in a low interest rate world. Many MLPs are levered to commodity consumption, which is more predictable than prices. The recent sell-off in crude oil prices has created some good opportunities in MLPs with midstream assets like pipelines.
Hedged Strategies (Hedge Funds and Managed Futures)	Equal Weight	This asset class can provide uncorrelated exposure to traditional risk-asset markets. It has outperformed equities when growth has slowed and has worked well in more challenging financial markets.

For more about the risks to Master Limited Partnerships (MLPs) and Duration, please see the Risk Considerations section beginning on page 12 of this report.

Source: Morgan Stanley Wealth Management GIC as of March 6, 2015

Macro Factor Heat Map Key (see page 4)

(see page 4)

	Economic Growth	Rates	Inflation / Deflation	Liquidity	Sentiment and Risk	Valuation	Earnings	Conclusion
Dark Blue	Economic growth robust	Steep yield curve	Low-moderate and rising inflation	Liquidity robust in economy / banking system	Shorter-term sentiment and technicals bearish	Risk assets attractively valued	Earnings outlook robust	Confluence of factors supports a risk-on investment approach
Light Blue	Economic growth neutral	Normal yield curve	Low-moderate and declining inflation; moderate inflation; higher and falling inflation	Liquidity neutral in the economy / banking system	Shorter-term sentiment and technicals neutral	Risk assets neutral	Earnings outlook neutral	Confluence of factors supports a neutral investment approach
Gray	Economic growth anemic	Flat/inverted yield curve	Very high/low inflation/deflation; high and rising inflation	Liquidity low in economy / banking system	Shorter-term sentiment and technicals bullish	Risk assets are richly valued	Earnings outlook anemic	Confluence of factors supports a risk-off investment approach
Up	Growth accelerating	Yield curve steepening	Inflation rising	Liquidity increasing	Sentiment becoming more bullish	Valuations rising	Earnings outlook improving	
Down	Growth declining	Yield curve flattening	Inflation falling	Liquidity decreasing	Sentiment becoming more bearish	Valuations falling	Earnings outlook worsening	
Signal Hor izon	One to three years	One to three years	One to three years	One to three years	One to three months	Six months to two years	Six months to two years	
Inputs	• Industrial prod-uction • Unemployment • Total return • Earnings revisions • Home prices • OECD LEI (China and Brazil) • MS & Co. ARIA (US)	• 10-year vs. 2-year government bond yield spread	• Consumer Price Index	• M1 growth • Private credit growth • Libor-OIS spread	• MS US Equity Risk Indicator (US) • MS Combined Market Timing Indicator (Europe) • MS Global Risk Demand Index • Relative strength index • Members above / below moving average. • Index above / below moving average • Consumer confidence	• Forward price/earnings ratio • Price/book ratio • Equity risk premium • High yield option-adjusted spread	• Earnings revisions breadth • Earnings surprise • Return on equity	• Weighted average z-score of all factors

Active vs. Passive Strategies Model Explanatory Notes

For decades, debate has raged among proponents of the active and passive approaches to equity investing. Many argue that the sophistication and experience of professional active managers is necessary in the everchanging investment landscape; others point to the better long-term performance of passive approaches, in part due to lower management fees. Investors will often take sides and allocate exclusively to either active or passive funds. Our work suggests neither approach is always better and, instead, the optimal choice depends on investment style, say large-cap value or small-cap growth, the investment backdrop.

In allocating between active and passive strategies, we couple our model-driven view of the current environment with the long-term performance of active strategies across styles. The model recommends being fully active when the environment is most attractive, fully passive when least attractive and more balanced when moderate.

We develop the model by fitting historical standardized factor values within each of the nine size (large/mid/small) and style (growth/blend/value) boxes, against the proportion of managers outperforming during the following four quarters. We then utilize the model by estimating the proportion of active managers who will outpeform based on historically realized proportions during the backtest period when factors have been of comparable attractiveness. Recommendations allocate within each size/style box to active and passive funds in a means consistent with maximizing expective relative return. The model's current recommendations are in the chart at the top of page 6.

To assess the market environment, the model looks at nine factors and assigns ratings to them depending on how they affect growth, blend or value investment styles. These factors are in the second chart on page 6, "Active vs. Passive Model Factors by Style." The factors are:

RETURN CORRELATION Markets with low return correlation among stock returns are synonymous with a "market of stocks," and are ideal for managers attempting to outperform through security selection. In contrast, in markets with high return correlation, stocks tend to move in tandem, which is a difficult environment for active managers.

VALUATION DISPERSION Near-term valuation dispersion measures the difference between "attractive" and "expensive" companies and compares the current difference with what has been observed historically. High valuation dispersion suggests that investors are discriminating among companies with different earnings achievability. When valuation dispersion is low, the market is pricing all companies similarly. In periods of wide valuation dispersion, companies in which there are concerns about short-term earnings growth trade at deeper discounts, which creates larger opportunities for active managers.

DEEP VALUE DISPERSION Similar to near-term value, this measure looks at the current spread between attractive and expensive based on price/book value, and then compares this spread with its history. Periods with wider spreads benefit value managers, and, similar to near-term value, tend to occur during periods of elevated market stress.

EARNINGS ESTIMATE DISPERSION Earnings estimate dispersion attempts to measure the prevailing level of controversy among analysts. Similar estimates of company earnings by sell-side analysts create little opportunity, but widespread differences among estimates provide more opportunities to earn alpha related to the surprise from resolving uncertainty.

FLOWS TO ACTIVE FUNDS Fund liquidity creates asset movement in and out of funds that, at times, may be beneficial or disruptive for active managers. Here, we focus on growth and blend managers whose portfolios include both growth and value stocks. As flows enter these funds, managers continue to buy consensus favorites and perpetuate their outperformance. This argument is less relevant within value, where other characteristics tend to generate outperformance. Based on this, we do not use fund flows for the value style.

RETURN DISPERSION Return dispersion is a formalized measure of the performance spread in equities. In periods in which there are greater differences in realized return between the best- and the worst-performing stocks, active managers are better able to beat their benchmarks. Markets can display high return dispersion, such as the recovery from the 2009 credit crisis, when deep value and low-quality names dramatically outperformed their higher-quality and growth counterparts. In contrast, recent markets have seen much smaller differences between outperforming and underperforming styles.

YIELD CURVE SLOPE An unusually flat yield curve signals an outsized chance of recession and suggests complacency among market participants. This raises the likelihood of market corrections. During market turbulence, active funds typically outperform due to an overweight of high-quality companies, leading to superior performance in market declines. Because of this, a flatter yield curve is expected to benefit active managers across styles.

RECENT ACTIVE MANAGER SUCCESS We have observed that periods that favor both active and passive managers tend to persist, often for several years. Because of this, an indication of the environment for active performance is the performance itself. If managers have outperformed in the immediate past, they are likely to continue outperforming in the immediate future. We can use the percentage of managers outperforming explicitly to forecast potential outperformance.

The final chart summarizes returns for active mutual fund managers. The top portion of the chart shows the performance of each investment style.The bottom part shows the percentage of managers that beat their benchmark in each category.

For more information on the active versus passive model, see "Active vs. Passive Managers: Which Should You Use?"

Index and Survey Definitions

BARCLAYS MUNICIPAL BOND INDEX This is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

BARCLAYS US AGGREGATE BOND INDEX This index tracks US-dollar-denominated investment grade fixed rate bonds. These include US Treasuries, US-government-related, securitized and corporate securities.

BARCLAYS US CORPORATE HIGH-YIELD INDEX This index measures the market of US-dollar-denominated, noninvestment grade, fixed-rate, taxable corporate bonds.

BARCLAYS US MORTGAGE-BACKED SECURITIES INDEX This is an index which covers the mortgage-backed securities component of the Barclays US Aggregate Bond Index.

BEIGE BOOK A commonly used name for the Fed report called the *Summary of Commentary on Current Economic Conditions by Federal Reserve District.* It is published just before the FOMC meeting on interest rates and is used to inform the members on changes in the economy since the last meeting..

CITI US BIG CORPORATE BOND INDEX This is a comprehensive representation of the US investment grade corporate bond market.

CITI EMERGING MARKET SOVEREIGN BOND INDEX This index includes Brady bonds and US-dollar-denominated emerging markets sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It comprises debt in Africa, Asia, Europe and Latin America.

CITI EURO BROAD INVESTMENT GRADE BOND (EUROBIG) INDEX This is a comprehensive representation of the European investment grade corporate bond market.

CITI HIGH YIELD MARKET INDEX This index captures the performance of the below-investment-grade debt issued by corporations domiciled in the US and Canada.

CITI FRANCE GBI CURRENCY HEDGED 7 TO 10 YEAR USD This index measures the performance of France sovereign bonds in the seven-to-10-year maturity range and is denominated in US dollars.

CITI GERMANY GBI CURRENCY HEDGED 7 TO 10 YEAR USD This index measures the performance of Germany sovereign bonds in the seven-to-10-year maturity range and is denominated in US dollars.

CITI JAPAN GBI CURRENCY HEDGED 7 TO 10 YEAR USD This index measures the performance of Japan sovereign bonds in the seven-to-10-year maturity range and is denominated in US dollars.

CITI SPAIN GBI CURRENCY HEDGED 7 TO 10 YEAR USD This index measures the performance of Spain sovereign bonds in the seven-to-10-year maturity range and is denominated in US dollars.

CITI UK GBI CURRENCY HEDGED 7 TO 10 YEAR USD This index measures the performance of UK sovereign bonds in the seven- to-10-year maturity range and is denominated in US dollars.

CONSUMER PRICE INDEX This index examines the weighted average of prices of a basket of consumer goods and services.

INSTITUTE OF SUPPLY MANAGEMENT (ISM) MANUFACTURING INDEX This index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders and supplier deliveries.

INSTITUTE OF SUPPLY MANAGEMENT (ISM) NONMANUFACTURING INDEX An index based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management (ISM).

MERRILL LYNCH OPTION VOLATILITY ESTIMATE (MOVE) INDEX This is a yield-curve-weighted index of the normalized implied volatility on one-month US Treasury options.

MORGAN STANLEY COMBINED MARKET TIMING INDICATOR (CMTI) The CMTI is an average across the Risk, Fundamentals and Composite Valuation Indicators.

MORGAN STANLEY GLOBAL RISK DEMAND INDEX This index tracks risk sentiment as reflected in the relative price movements of seven “risky” assets versus their “safer” counterparts; plus, three volatility indicators.

MORGAN STANLEY EQUITY RISK INDICATOR This is a proprietary sentiment and risk indicator for US equities.

MSCI EUROPE INDEX This index has large-, mid and small-cap representation across 16 Developed Markets countries in Europe. With 1,372 constituents, the index covers approximately 99% of the free float-adjusted market capitalization across the Developed Markets countries of Europe.

PRODUCER PRICE INDEX This index measures wholesale price levels in the economy.

PURCHASING MANAGERS’ INDEXES (PMI) These economic indicators are derived mostly from monthly surveys of private-sector companies. The principal producers of PMIs are Markit Group, which conducts PMIs for more than 30 countries, and the Institute for Supply Management, which conducts PMIs for the US.

RUSSELL 1000 GROWTH INDEX This index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth.

RUSSELL 1000 VALUE INDEX This index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth.

RUSSELL 2000 INDEX This index measures the performance of those the 2,000 smallest companies in the Russell 3000 Index.

RUSSELL 3000 INDEX This index measures the performance of the 3,000 largest US companies based on total market capitalization.

S&P 500 INDEX This capitalization-weighted index includes a representative sample of 500 leading companies in leading industries in the US economy.

S&P BSE SENSEX INDEX This index is India’s most bellwether equity index. It is designed to measure the performance of the 30 largest, most-liquid and financially sound companies listed on BSE Ltd.

Risk Considerations

MLPs

Master Limited Partnerships (MLPs) are limited partnerships or limited liability companies that are taxed as partnerships and whose interests (limited partnership units or limited liability company units) are traded on securities exchanges like shares of common stock. Currently, most MLPs operate in the energy, natural resources or real estate sectors. Investments in MLP interests are subject to the risks generally applicable to companies in the energy and natural resources sectors, including commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

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. MLP funds accrue deferred income taxes for future tax liabilities associated with the portion of MLP distributions considered to be a tax-deferred return of capital and for any net operating gains as well as capital appreciation of its investments; this deferred tax liability is reflected in the daily NAV; and, as a result, the MLP fund’s after-tax performance could differ significantly from the underlying assets even if the pre-tax performance is closely tracked.

Duration

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.

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.

Alternative investments which may be referenced in this report, including private equity funds, real estate funds, hedge funds, managed futures funds, and funds of hedge funds, private equity, and managed futures funds, are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and risks associated with the operations, personnel and processes of the advisor.

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.

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.

Interest on municipal bonds is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence.

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.

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.

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.

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

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.

The **indices selected by Morgan Stanley Wealth Management** to measure performance are representative of broad asset classes. Morgan Stanley Smith Barney LLC retains the right to change representative indices at any time.

Credit ratings are subject to change.

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.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies.

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.

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 foreign 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.

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