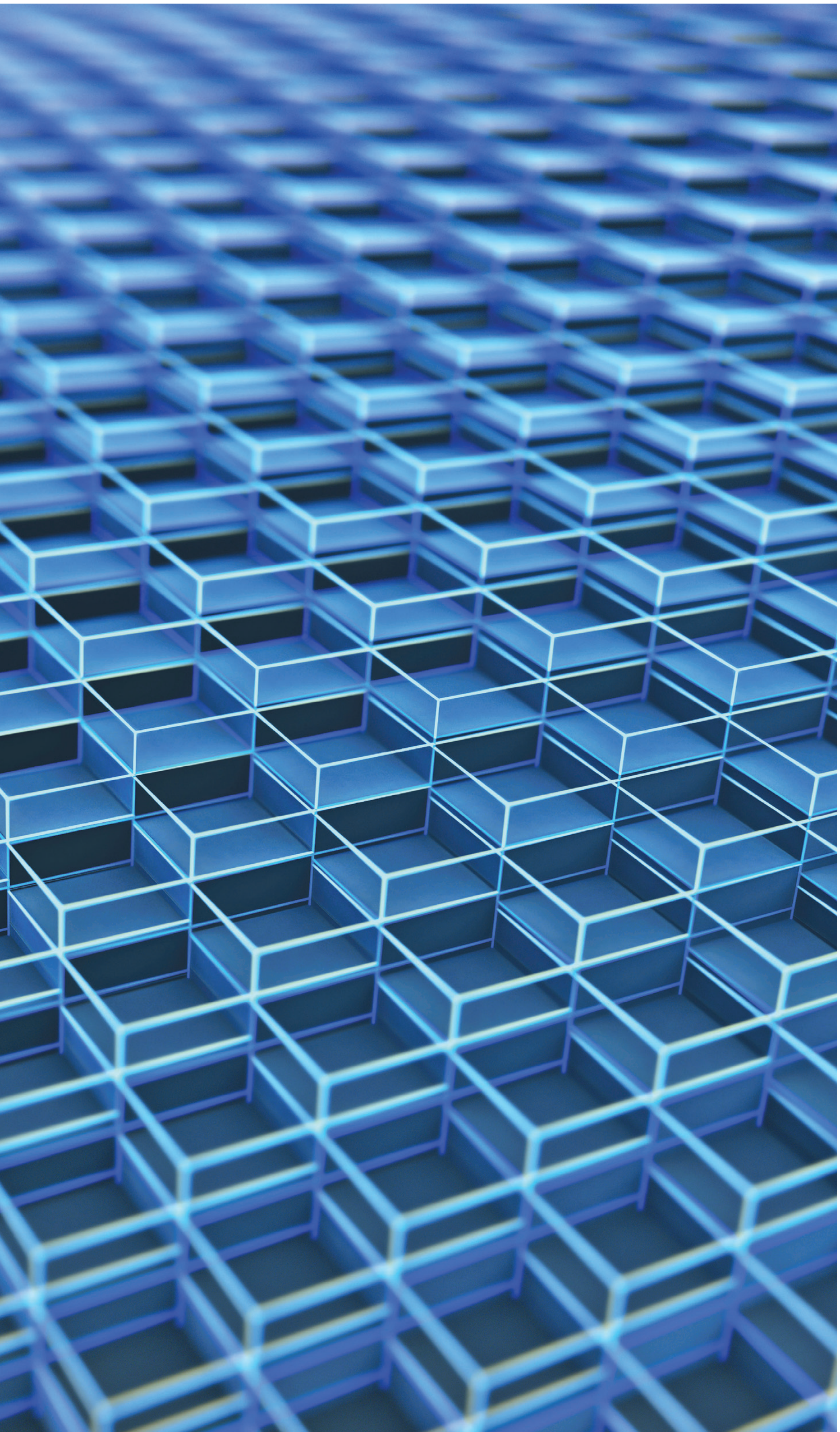
Morgan Stanley

INVESTMENT MANAGEMENT



2022 Market Outlook

Rising rates key in shaping road to recovery

As we enter 2022, we see labor market and inflation dynamics paving the way toward a tightening of monetary policy by the U.S. Federal Reserve (Fed). That said, we expect Fed tightening to proceed at a modest pace, as persistent supply-side price pressures related to COVID-19 complicate the inflation picture. Combined with mid-cycle growth rates, we believe these factors should result in moderate but positive equity returns in the coming year. Our preference is for quality stocks, and for developed over emerging markets equities.

ANDREW HARMSTONE
Managing Director
Senior Portfolio Manager and Head of the Global Balanced Risk Control Team

SOLUTIONS & MULTI-ASSET | GLOBAL BALANCED RISK CONTROL TEAM

Inflation Dynamics Pose a Challenge for Fed Policy, Suggesting Caution in Hiking Pace

THE U.S. LABOR MARKET CLOSE TO FED'S DEFINITION OF HEALTHY

Lower participation rate: The labor force participation rate failed to recover fully in 2021, partially reflecting lingering effects from COVID-19 and unemployment support. While we expect these factors to dissipate gradually, it is likely that some workforce attrition will be permanent due to lifestyle changes and early retirements.

From the Fed's perspective, the lower participation rate is less of an issue when compared to the aftermath of the global financial crisis (GFC). Unlike then, today the trend is not a response to depressed economic activity.

With less competition for jobs, many workers (especially in the prime age band), are drawing on accumulated savings and taking more time to re-enter the labor force. Additionally, employed people are using tighter employment conditions to switch jobs for increased pay, as reflected in an observable trend in high resignation rates.

Although the participation rate will likely recover in time, the prevailing labor-market conditions support workers' bargaining power and put upward pressure on wages.

Robust and inclusive labor market recovery: Wage growth has been higher for lower income groups, who also benefitted from fiscal support offered post-pandemic. This dynamic helps to offset the regressive effects of higher prices and is in line with the Fed's new and broader definition of a healthy labor market. Given how lower-paid workers experienced downward mobility and rising indebtedness in the past decade, it is of little surprise that a strong bid for goods has emerged, as savings surged.

HIKES POSE A UNIQUE CHALLENGE FOR THE FED

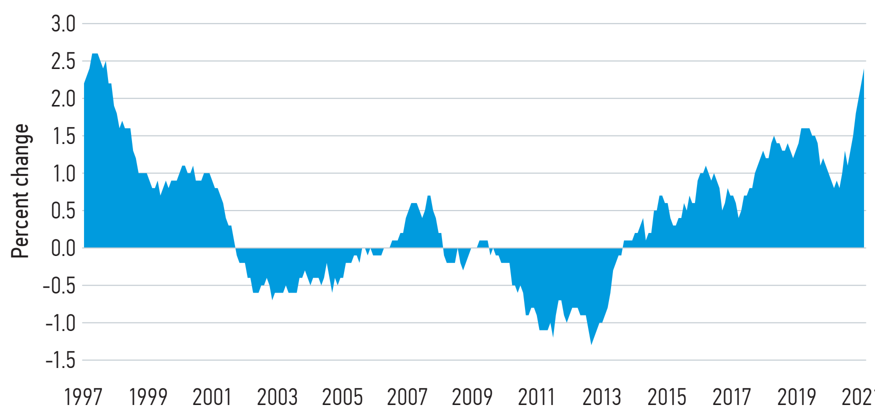
Rising wages and ultra-low mortgage rates have bolstered housing prices, contributing to above average rises in the shelter component of the Consumer Price Index (CPI). From this perspective, the Fed should consider tapering more quickly and starting to hike rates, thereby lifting mortgage borrowing costs to temper housing-market demand.

However, today's high inflation is not a one-sided story of demand. Supply-side issues persist, affecting prices for goods and foods. As energy prices normalize and supply-chain constraints ease into 2022, these price pressures should begin to abate. That said, statements from food companies indicate that food prices will remain elevated in 2022, while industry data from indicators such as the Manheim Used Vehicle Value Index are ticking higher,[1] suggesting that upward pressure on these CPI components has not yet peaked. Omicron-related disruptions, if prolonged, will only contribute to constrained supply, in our view.

DISPLAY 1

Nominal Wage Growth Surging

Bottom vs. Top Quartile



Note: Figure shows the 12-month moving average of year-on-year median wage growth. First quartile is bottom 25th percentile of wage distribution, fourth is top 25th.

Source: U.S. Federal Reserve Bank of Atlanta, as of 30 November 2021.

DISPLAY 2

Implied Rate Levels by Hiking Path Scenario

SCENARIO NAME	HIKING PACE	TERMINAL RATE	END OF YEAR 2022 10Y	5Y	2Y
Strong Inflation/growth	1 hike every 3 months from March 2022	2.25%	2.17	2.09	1.86
Base Case	**3 hikes in 2022/2023 and 1 hike in 2024/2025**	**2.00%**	**1.87**	**1.74**	**1.41**
Inflation/growth slowdown	1 hike every 6 months from June 2022	1.75%	1.58	1.41	0.94

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Source: Morgan Stanley Investment Management. As of December 21, 2021.

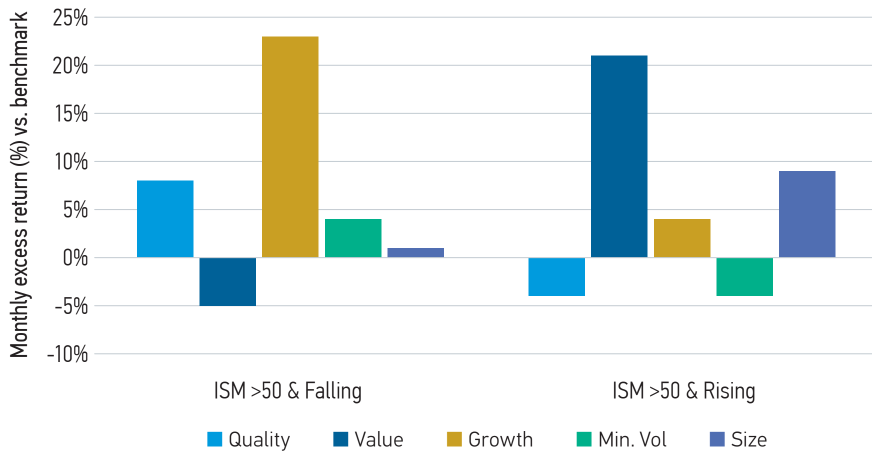
[1] Manheim Used Vehicle Value Index, as of November 30, 2021.

Importantly, Fed tapering and hikes are less effective in quelling supply-side inflationary pressures than those related to "overheating" demand. While hikes can spur U.S. dollar strength and lead to lower imported goods prices (partially offsetting supply-chain inflation), a stronger currency can also hurt the services sector. Furthermore, by boosting import demand, supply-chain bottlenecks in industries such as shipping could be exacerbated.

Although these supply-side dynamics present challenges, we expect robust macroeconomic data will provide sufficient ammunition for a fairly steady pace of hikes in 2022 and 2023. Considering the very low starting point for Fed rates, this should alleviate concerns of economic overheating, while freeing up some space for monetary policy maneuverability in the future (a difficult undertaking at 0% rates). When it comes to the Fed's terminal rate, we remain slightly more optimistic than the market, as implied by current pricing, which reflects our expectations of growth remaining supportive.

DISPLAY 3

Growth and Quality Tend to Outperform as the Cycle Matures



The chart shows monthly excess return of the MSCI USA Value, Growth and Quality Indexes vs. the MSCI USA Index for the two ISM manufacturing index scenarios. Time frame of analysis is 2000 – 2021.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Important Information section for index definitions.

Sources: Bloomberg, Morgan Stanley Investment Management, as of November 30, 2021.

Mid-Cycle Environment Favors Mildly Positive Equity Returns in 2022

TOTAL RETURN SENSITIVITY

Global equities should benefit from healthy global economic growth, which we expect to remain above potential in most regions in 2022. Expectations for high single-digit growth in earnings per share (EPS) remain below previous non-recession years, but still look sufficient to support positive total returns in equities.

That said, high initial valuations (especially in the U.S.) remain a key risk, given the move towards a tighter monetary policy stance. For example, we calculate that a de-rating of 10% in price-to-earnings multiples would cancel out the high single-digit EPS growth in most countries (except China, where consensus EPS growth forecasts are higher).

If the recent close relationship between U.S. inflation-adjusted yields and the 12-month forward price-to-earnings (P/E) multiple in the S&P 500 holds, then every 10-basis point (bp) rise in 10-year U.S. real yields should lead to a 0.4x de-rating in the multiple. Thus, a 50bp rise in 10-year real yields would result in a roughly 10% de-rating in the multiple from current levels.

With our current base-case outlook of 10-year U.S. Treasury yields rising toward 1.80%, primarily driven by real yields, we expect mid-single-digit returns for U.S. equities in 2022—a level that is in line with other developed-markets regions.

INVESTOR POSITIONING

Net inflows are unlikely to act as a tailwind for equity markets in 2022. Investors started 2021 with relatively light positioning, but increased exposure as fundamentals improved and equities rallied throughout the year.

Recently, speculative investors appear to have added to their net long exposure to the S&P 500 and positioning now appears somewhat stretched compared to recent history. At the same time, equity allocations by U.S. households have surpassed 40%, likely spurred along by the scarcity of other high-return alternatives to stocks.

Notwithstanding these factors, we expect equity allocations to rise in 2022, as forecasts for modest tightening will sustain rates at historically low levels.

PREFERENCE FOR QUALITY

Fed hiking is likely to occur toward the mid-point of the business cycle in 2022. As shown in *Display 3*, at this point in the cycle quality and growth companies appear better positioned than value and small caps, which are unable to benefit from their greater operating leverage. However, with elevated valuations increasing the vulnerability of growth stocks, quality appears to be the area with particular potential as we move into 2022.

Notably, the susceptibility of the economy to external shocks increases with the length of the business cycle, and thus raises recession risks. In such a scenario, higher quality companies and certain equity markets (e.g., the U.S.) appear better placed to outperform than others (e.g., emerging markets and Europe).

ELEVATED VALUATIONS

Given current valuation levels, the earning yields for equities still look attractive versus bonds. However, the comparative attractiveness could diminish as rates rise and fixed income becomes a more viable alternative again.

Current valuation levels leave equities vulnerable to multiples compression (in part due to reduced liquidity injections in the market by central banks) and earnings shocks, given that growth is forecast to be slower in 2022.

Bumpy Road to Recovery for Emerging Markets

INFLATION AND INFECTION RATES PRINCIPAL CHALLENGES FOR EMERGING MARKETS

We expect emerging markets to face challenges in 2022, with consensus forecasts signaling weaker growth in China and the commodity-exporting economies. If commodity prices turn downward, emerging-markets equity indexes could be harshly penalized, as Latin America and EMEA[2] have high weightings in commodity-related sectors within their respective MSCI regional indexes.

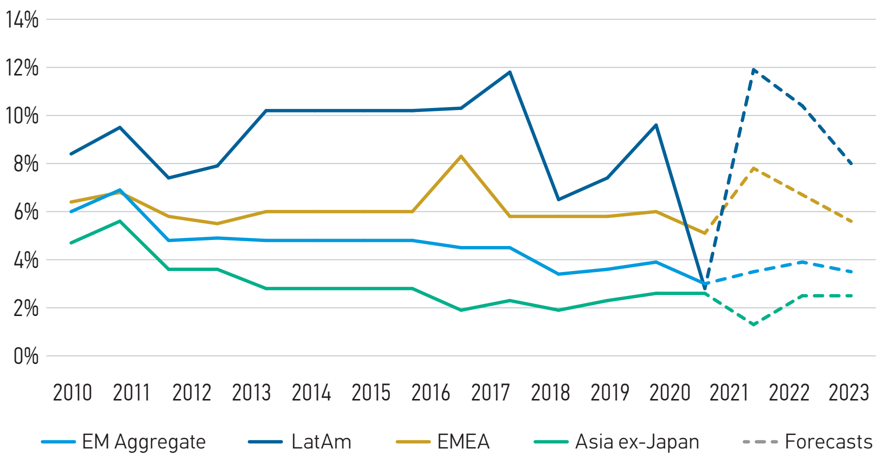
Supply-chain disruptions and pent-up demand have caused a dramatic spike in commodity prices, especially in food prices for Latin America, where high inflation is expected to persist *(Display 4)*. Given the poor inflation outlook, we expect central banks to hike rates in both Latin America and Asia ex-China countries in the year ahead.

The public health situation in emerging markets will be another key challenge, as the majority of the countries are still under-vaccinated and the new Omicron variant remains a key risk.

DISPLAY 4

Inflation Upsurge Highest in Latin America

EM Inflation



Inflation estimates for the years 2021-2023. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Source: Bloomberg, Morgan Stanley Investment Management, as of November 30, 2021.

Lastly, emerging markets had a robust rebound in current accounts and terms of trade driven by strong external demand in 2021. As external demand gradually softens in 2022, however, this tailwind could fade. And while the management of public finances remained relatively prudent throughout the pandemic, fiscal deficits widened and debt burdens still grew. As a result, emerging economies remain more exposed to rising rates.

Investment Implications

By taking an in-depth look across markets, we believe we can build better investment outcomes for clients. In doing so, we seek out opportunities that our research indicates will perform well at this point of the cycle, while avoiding those that will not.

With an outlook of moderately strong growth, continued price pressures and monetary tightening ahead, we are maintaining a cautious and selective approach in 2022. Not surprisingly in an environment of rising rates, we remain underweight duration.

Within equity markets, as we move towards the above-mentioned mid-cycle environment, we expect to move from the value space to quality, and favor developed over emerging markets. While valuations remain elevated, finding attractive entry points will be key for capturing value.

[2] Europe, Middle East and Africa

DISPLAY 5

Latest Tactical Views

ASSET CLASS	––	–	=	+	++
Equity					
US			■		
US Financials				■	
US Energy				■	
US Growth		■			
US Value				■	
Eurozone			■		
UK			■		
European Financials				■	
European Energy				■	
Japan			■		
Asia ex Japan			■		
China Internet				■	
Emerging Markets			■		
Global Infrastructure			■		
Global Property			■		

ASSET CLASS	––	–	=	+	++
Fixed Income					
IG Credit		■			
US High Yield			■		
European High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries		■			
US Inflation			■		
German Bunds		■			
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Gold			■		
Industrial Metals			■		

This section is provided solely to demonstrate the Investment Team's views and type of analysis used in implementing their investment strategy. Not to be construed as investment or research recommendation.

Note: Underweight, overweight and neutral signals detail our tactical views, across globally-diversified equity and fixed income regions and sub-asset classes. These views are expressed relative to a neutral allocation, which we term an 'anchor portfolio'; this anchor portfolio is not based purely on a market-cap weighted benchmark, such as the MSCI ACWI, but instead blends several approaches, including GDP-weighted, cap-weighted, risk parity and equal-weighted benchmarks.

Source: MSIM GBaR team, as of December 22, 2021. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor. The signals represent the GBaR team's view on each asset class. A negative signal indicates a negative or underweight relative view, a positive signal indicates a positive or overweight relative view.

APPENDIX: Asset Class Views in Detail

Equities

US EQUITIES: NEUTRAL

Fundamentals—Neutral: There is less risk that the U.S. will re-introduce COVID-19 related restrictions compared to Europe, supporting the outlook for relative economic, sales and EPS growth and reducing left-tail risks. EPS are expected to grow marginally quicker in the U.S. in 2021 compared to other developed market (DM) regions, but margins are already near record-highs, leaving less room for expansion, especially given higher costs from numerous drivers: Wages, energy, transportation costs, among others. Any meaningful rise in bond yields could hit the U.S. more profoundly due a high level of concentration in "high duration" growth stocks, making the fundamental picture mixed. In our view, U.S. financial stocks are a good hedge in this risk scenario.

Valuations—Negative: U.S. equities did not de-rate meaningfully over 2021 and remain expensive compared to history. Relative to other DM equity markets, they have become even more expensive, as other regions experienced deeper de-ratings. Given the richness of U.S. Treasurys, the U.S. equity risk premium over bonds has not yet reached the lows of the previous cycle or the era before the global financial crisis (GFC). In our view, this factor is likely to help cushion any valuation de-rating, even under a base-case outlook of moderately higher yields, which should limit downside risk.

Technicals & Sentiment—Neutral: Fund flows into U.S. equities were strong throughout 2021 and remained largely positive, even during episodes of volatility spikes. Survey sentiment has recently become bearish on the back of COVID-19 variant fears and the Fed's hawkish tilt. Other survey sentiment measures have also declined from the excessively bullish levels observed in September and early November 2021 and are currently in neutral territory.

EUROZONE EQUITIES: NEUTRAL

Fundamentals—Neutral: Following strong growth during most of the year, new headwinds have emerged for the region, including rising energy prices and decelerating global growth. In addition, Europe has been hit by a fourth COVID-19 wave, which preceded the Omicron variant and led to another round of social mobility restrictions across the region. We expect growth in the Eurozone to moderate to lower but positive levels, supported by sustained fiscal and monetary policy. Key political risks, such as the upcoming elections in Italy and France, represent potential sources of volatility in the coming year.

Valuations—Neutral: Absolute valuations are currently above long-term medians, despite de-rating recently and falling back toward the top end of the pre-pandemic range. In relative terms, Eurozone equities are trading at a historic low to the U.S., which also reflects the Value/Growth bias of the two regions. As we expect global interest rates to rise gradually and for growth in the U.S. to outperform the Eurozone, we do not expect the valuation discount between European and U.S. stocks to shrink dramatically in the short term.

Technicals & Sentiment—Supportive*: After significant outflows in 2019 and 2020, flows have stabilized. However, positioning remains low as flows into European assets have been lagging global flows over the past year.

U.K. EQUITIES: NEUTRAL

Fundamentals—Neutral: Soft data from the manufacturing and services sectors point toward continued strong demand in 2022. In absolute terms, earnings recovered in 2021 and are now likely to be a touch ahead of pre-pandemic levels. However, for the more globally focused FTSE 100 Index, which generates 70% of revenues outside of the U.K., we remain cautious. Stronger synchronized global growth and reduced COVID-19 infections across the world would cause us to reassess our view with a more positive outlook.

Valuations—Neutral: U.K. large-cap equities continue to screen as inexpensive relative to other DM equity indexes. For example, the FTSE 100 Index trades at a significant P/E discount relative to its historic average and relative to the Europe ex-U.K. index. Nevertheless, the cheapness of U.K. equities is not new, and, when taking into account the sector composition of the index, ESG factors and currency impact, valuations appear less attractive. For the more domestically oriented FTSE 250 Index, valuations appear elevated after the recent re-rating and slowdown in earnings momentum.

Technicals & Sentiment—Supportive*: Looking at fund flows, U.K. equities have been out of favor in the eyes of international investors for over five years, since the Brexit referendum of 2016. In 2021, outflows continued, leaving space for a reversal if fundamentals shift.

* When looking at sentiment, we often read strong outflows and deteriorating sentiment on an asset class as a contrarian positive signal (and vice versa for positive sentiment trends), as there is increased potential of pricing overshooting fundamentals.

Sector Views

U.S. & EUROPEAN FINANCIALS: POSITIVE

Fundamentals—Positive: Growth trends and rising interest rates should continue to support the sector in 2022, which saw improving earnings performance in 2021.

Valuations—Neutral: Valuations improved toward neutral levels in 2021.

Technicals & Sentiment—Neutral: The sector saw positive flows in 2021, reversing some of the negative sentiment that had affected the sector in past years.

U.S. & EUROPEAN TRADITIONAL ENERGY: POSITIVE

Fundamentals—Positive: We expect oil prices to remain supported in 2022, given the changed reaction function of U.S. producers. They are now more likely to prioritize returns to shareholders over a ramp up in production growth, even amid higher prices. At the current oil price, companies can generate attractive cash flow levels, which can also support high dividend yields.

Valuations—Positive: Valuations remain below pre-pandemic levels in many cases and we expect improved profitability to help close this gap. However, valuation upside appears to be limited by overarching investor concerns surrounding energy transition dynamics in the sector.

Technicals & Sentiment—Neutral: The sector saw positive flows in 2021, but sentiment remains hindered by ongoing concerns by investors over headwinds coming from the transition to clean energy sources.

U.S. VALUE VERSUS U.S. GROWTH

Fundamentals—Neutral: Growth stocks, despite solid earnings numbers, are more exposed to headwinds from rising rates, which should eventually reduce the premium investors are willing to pay for certain expensive segments of the market. In contrast, many areas of the value segment are likely to be beneficiaries of rising rates as well as the ongoing trend of above-average growth.

Valuations—Positive: Value continues to screen as inexpensive versus growth stocks, despite some re-rating at certain points in 2021.

Technicals & Sentiment—Supportive: Growth stocks have enjoyed favorable flows since the worst of the pandemic, leaving them more exposed to turns in sentiment. Value stocks show greater potential for further inflows, despite a more positive environment in 2021.

JAPANESE EQUITIES: NEUTRAL

Fundamentals—Neutral: The Japanese economy should benefit at the start of 2022 from a reopening, which is later than in the U.S. and Europe. Japan has one of the highest vaccination rates in the world, which should help to limit COVID-19 disruptions going forward. Notwithstanding this, many crucial sectors in Japanese indexes continue to be negatively affected by supply-chain bottlenecks, which have blocked the full benefits of a weaker Yen from filtering through to companies. While we expect supply-chain issues to ease in 2022, there is little evidence that the situation will meaningfully improve in the coming months, which will likely impact the Japanese equity market. On balance, we believe these headwinds will make meaningful outperformance versus other DMs hard to achieve, especially at the start of 2022.

Valuations—Positive: On a relative basis, Japanese equities trade at significant discount to DM peers, which partly reflects investor concern over longer-term dynamics that, if not addressed, could justify a permanent discount for the asset class. For this reason, we continue to look for environments of strong fundamental tailwinds for the region for a more constructive overall view.

Technicals & Sentiment—Neutral: Flows into Japan have continued to reflect caution from investors and concerns over a lack of competitiveness versus other DM markets, with many indicators showing space for an improvement in flows. Recent headlines from Prime Minister Fumio Kishida's new administration regarding potential changes to buyback regulations will do little, however, to reduce investor concerns over corporate governance and may further diminish foreign interest for the asset class.

ASIA EX-JAPAN EQUITIES: NEUTRAL

Fundamentals—Neutral: The region will likely be a tale of two stories in 2022. East Asian economic powerhouses, such as Taiwan and Korea, may face some headwinds from a cyclical downturn in semiconductor demand, while secular megatrends and supply-chain disruptions may provide some cushion to growth. Conversely, South East Asia will likely face continued challenges from a multitude of fiscal and economic headwinds, as well as from a higher risk of COVID-19 contagion due to low vaccination rates.

Valuations—Neutral: The aggregate index P/E valuation is trading around a 13% premium over the 10-year median, which has retraced significantly from a peak premium of 46% (China's massive regulatory crackdown contributed most heavily to the decline). From a relative perspective, valuations are trading near their historic discount level of 12% relative to S&P 500 on a 10-year median basis.

Technicals & Sentiment —Neutral: Asia ex-Japan saw record fund inflows in 2021, comparable to 2018, according to EPFR, but we have also seen outflows from foreign investors. Sentiment remains weak, as China's slowdown will have a knock-on impact on its regional trade partners in Asia and increase uncertainty for foreign investors.

CHINESE EQUITIES: NEUTRAL

Fundamentals—Neutral: China will likely face continued regulatory tightening and crackdowns in 2022, as the authorities attempt to restructure the economy in an effort to achieve more sustainable and stable growth in line with government objectives and its 14th Five-Year Plan (2021-25). Additionally, the economy is still recovering from the real estate market slowdown. The government has taken minor steps to inject more liquidity, cut reserve requirements and stimulate credit through local government special bonds. However, the overall credit impulse remains languid and has yet to rebound, leaving the fundamental picture uncertain.

Valuations—Neutral: The P/E ratio for Chinese equities[3] is currently trading at a 13% premium over the 10-year median, but has retraced significantly from the peak premium of 65% in February 2021. While valuations are cheaper, in our view, the huge de-rating is justified by the crackdown on Internet and real estate companies. Relative valuations are trading near historic lows at a 16% discount relative to the S&P 500. A strong credit impulse would be a key catalyst for a positive multiples trend in 2022.

Technicals & Sentiment—Unsupportive*: Overall investor sentiment remains weak due to political and regulatory concerns. Despite a large sell-off in Chinese equities, net flows remain positive, suggesting that investors are still adopting a wait-and-see mindset, while sitting on the sidelines.

LATIN AMERICAN EQUITIES: NEUTRAL

Fundamentals—Negative: Consensus earnings for the region are expected to be significantly lower, if not negative, in 2022, mainly due to decelerating economic activity. Our pessimistic view reflects weaker global growth, declining commodity prices and tightening U.S. monetary policy. In Brazil, the run-up to the October 2022 elections could negatively impact the risk-reward profile, especially if the political uncertainty surrounding the outcome is prolonged.

Valuations—Positive: Relative to the broader EM index, Latin American equities look attractively valued across most key valuation metrics. From a P/E perspective, there is a large potential upside from re-rating, as most countries are trading well below historic averages.

Technicals & Sentiment—Neutral: While EM equity funds continued to see inflows over the past year, Latin American fund outflows have continued for nine consecutive months, reflecting the ongoing uncertainty for the region's outlook.

Fixed Income

U.S. GOVERNMENT BONDS: NEGATIVE

Fundamentals—Negative: Recent hawkish commentary from the Fed has led the market to price in an aggressive hiking pace, starting in 2022. While we expect Fed hikes to start mid-year, we foresee a slightly less aggressive pace than the market. More importantly, we believe that space exists for improvement in the market's pricing of the Fed terminal rate. An improvement in this pricing component should open the way to more upward pressure on U.S. long-term rates, leading us to maintain an underweight to duration.

Valuations—Negative: U.S. long-term rates still appear to have excessive pessimism priced in regarding longer-term growth and, therefore, screen as expensive against other macro indicators and historic levels. We believe some of this gap will close in 2022, with rates moving moderately upwards and reducing the expensiveness of the asset class.

Technicals & Sentiment—Neutral: This year, we expect less support for U.S. long-term rates to come from external demand sources, such as Japanese investors, who may be motivated by expectations of rates moving toward 2%. Market pricing of Fed hikes, on the other hand, appears very hawkish, leaving little room for aggressive surprises on the front end. As a result, the picture for sentiment and technicals is fairly balanced, in our view.

EUROPEAN GOVERNMENT BONDS: NEGATIVE ON BUNDS

Fundamentals—Negative: We expect lower but above-trend growth in Europe, which should make the European Central Bank comfortable in reducing the amount of monetary easing in the coming year, leaving room for rates to move upwards.

Valuations—Negative: Bund rates screen as expensive on most of our metrics, reflecting ongoing uncertainty over the longer-term growth trajectory of the German economy. We expect above-trend growth in 2022 to reduce this uncertainty, helping to normalize valuations.

Technicals & Sentiment—Neutral: Increased issuance of AAA-rated EU supra-national debt will potentially cause a decrease in demand for German debt, given the higher yield pickup of EU supra-national debt.

[3] Chinese equities are represented by the MSCI China Index. As of December 16, 2021.

INVESTMENT GRADE (IG) CREDIT: NEGATIVE

Fundamentals—Neutral: Economic output should remain above potential in the U.S. and Europe in 2022, supporting revenue and earnings growth for issuers and credit risk premiums for the overall asset class. Central banks are set to scale back or outright remove accommodation over the next year, creating a headwind toward H2 2022 for IG credit. When given the high interest rate sensitivity of IG indexes, there is a risk that total returns will turn out to be slightly negative in 2022, if rates rise.

Valuations—Negative: IG credit spreads continued to tighten throughout 2021 and remained in a tight range for most of the year. Currently, spreads are near the pre-GFC lows, limiting the scope for further spread compression, despite still favorable fundamentals and macro conditions.

Technicals & Sentiment—Neutral: We continued to see strong inflows in IG credit in 2021 until late in the year when COVID-19 fears resurfaced and the Fed shifted its stance on inflation. As long as rates remain close to historic lows, flows should remain supportive for the asset class. The (net) supply of U.S. dollar and euro IG issuance should decline slightly from 2021 levels, leaving the sentiment and technical picture balanced.

HIGH YIELD (HY) CREDIT: NEUTRAL

Fundamentals—Positive: The period of balance sheet repair for HY companies is behind us and issuers have started to invest for future growth given the strong global aggregate demand picture in 2021 and going into 2022. Fundamentals are unlikely to worsen in the near-term and HY should be more insulated from higher rates, given the lower duration characteristics of the leading indexes and higher spread cushion than IG credit.

Valuations—Negative: As is the case for IG, HY credit spreads in the U.S. and Europe are also near pre-GFC lows. Given the low yield environment and benign macro backdrop expected in H1 2022, there is still some scope for spread tightening, but HY total returns in 2022 should be driven predominantly by carry and less by spread compression.

Technicals & Sentiment—Neutral: Flows into high yield credit remained robust in 2021, as fundamentals improved greatly and spreads tightened continually. HY credit issuance is likely to slow further in 2022, with a larger decline in net supply expected in the U.S. than in the Eurozone.

EMERGING MARKETS (EM) DEBT: NEUTRAL

Fundamentals—Neutral: We expect 2022 to remain a challenging year for EM economies. Latin American central banks have hiked interest rates significantly, adding to debt-servicing costs without a significant fall in (strong) inflationary pressures. In EMEA, the economic tailwind from commodities is likely to wane gradually. In Asia, the slowdown in China's growth is likely to impact its regional trade partners at the same time that Asian central banks appear poised to raise rates. In 2021, EMs had a strong rebound in current accounts and terms of trade driven by robust external demand. However, as external demand gradually softens in 2022, this tailwind could fade. Despite relatively prudent fiscal management during the pandemic, EM economies face higher fiscal deficits and growing debt burdens. Additionally, COVID-19 looks set to remain a sizable roadblock for EM countries in the year ahead.

Valuations—Neutral: Based on our forward-looking multifactor model on global growth, the VIX and economic fundamentals, hard currency spreads appear to be fairly valued. However, our oil model implies a slight discount at current prices, given that 36% of the JP Morgan Emerging Market Bond Index are net oil exporters. Meanwhile, commodity prices and external trade imply that EM FX is trading at a discount, but we believe these factors play a less significant role for performance in a non-goldilocks economic environment.

Sentiment—Negative: The appetite for hard currency bonds has resumed its uptrend, with cumulative flows exceeding all-time highs, even as the pace slowed toward the end of 2021. For local currency bonds, the cumulative flows briefly touched 2019 highs, rolling over slightly toward the end of the year in 2021. Overall, sentiment for EM economies appear soft, as fundamentals remain weak in the wake of the COVID-19 crisis.

U.S. DOLLAR

Higher market volatility, a faster pace of rate rises in the U.S., as well as a relative growth advantage for the U.S. versus other DMs, should continue to act as tailwinds for the U.S. dollar in 2022. That said, elevated valuations and some pressure coming from the U.S. current account deficit may limit the upside potential.

OIL

Moving into 2022, we continue to see restrained supply as the main factor supporting oil prices. Even as OPEC ramps up production, capacity constraints by some members will likely become tight, while U.S. producers are prioritizing shareholder returns over increased production, despite higher prices. Both factors should contribute to lower supply than there would have been otherwise. On the demand side, ongoing disruptions related to COVID-19 remain a significant headwind, but as activity normalizes, we could see a very tight market in 2022, which would likely push oil prices higher than in the pre-pandemic period.

Risk Considerations

There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio.

DEFINITIONS

Basis point: One basis point = 0.01%. **Consumer Price Index (CPI)** measures changes in the price level of a market basket of consumer goods and services purchased by households. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. **Earnings per share (EPS)** is the portion of a company's profit allocated to each outstanding share of common stock. The **global financial crisis (GFC)** refers to the period of extreme stress in global financial markets and banking systems between mid 2007 and early 2009. The **ISM manufacturing index** is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy. A reading above 50 indicates an expansion of the manufacturing segment of the economy compared to the previous month. A reading below 50 suggests a contraction. **Price-Earnings (P/E)** is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

INDEX DEFINITIONS

The **Bloomberg U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market. The **Bloomberg Global Aggregate Corporate Index** is the corporate component of the Bloomberg Barclays Global Aggregate index, which provides a broad-based measure of the global investment-grade fixed income markets. "Bloomberg®" and the Bloomberg Index/Indices used are service marks of Bloomberg Finance L.P. and its affiliates, and have been licensed for use for certain purposes by Morgan Stanley Investment Management (MSIM). Bloomberg is not affiliated with MSIM, does not approve, endorse, review, or recommend any product, and does not guarantee the timeliness, accurateness, or completeness of any data or information relating to any product. The **FTSE 100 Index** is an index of the 100 largest companies (by market capitalization) in the United Kingdom. The **FTSE 250 Index** is an index is a capitalisation-weighted index consisting of the 101st to the 350th largest companies listed on the London Stock Exchange. The **JP Morgan Emerging Markets Bond Index Global (EMBI Global)** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI All Country Asia Ex-Japan Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of Asia, excluding Japan. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective. The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI Europe ex UK Index** captures large and mid cap representation across 14 developed markets countries in Europe. The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI Japan Index** is a free-floated adjusted market capitalization weighted index that is designed to track the equity market performance of Japanese securities listed on the Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ and Nagoya Stock Exchange. The MSCI Japan Index is constructed based on the MSCI Global Investable Market Indices Methodology, targeting a free-float market capitalization coverage of 85%. The **MSCI USA Index** is designed to measure the performance of the large and mid cap segments of the U.S. market. The **MSCI USA Value Index** captures large and mid cap US securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. The **MSCI USA Growth Index** captures large and mid cap securities exhibiting overall growth style characteristics in the US. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend. The **MSCI USA Quality Index** is based on the MSCI USA Index, its parent index, which includes large and mid cap stocks in the US equity market. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The **S&P 500® Index** measures the performance of the large-cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy.

The indexes shown in this report are not meant to depict the performance of any specific investment, and the indexes shown do not include any expenses, fees or sales charges, which would lower performance. The indexes shown are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

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