Global Investment Committee Monthly

IN BRIEF

July Meeting Summary

MARKETS. The recent sell-off in global equities is due primarily to concerns about both a cyclical softening, which we believe will be temporary, and developed-market (DM) public-debt issues, which we believe will also be addressed. We remain overweight (OW) in risk assets and underweight (UW) in cash and bonds. Within global equities, we continue to OW emerging market (EM) and US equities; we remain underweight in other DM equities. Within US equities, our capitalization preference is large caps; within style, it is growth. Within global bonds, we remain OW to investment-grade, high yield and EM debt and UW to developed-market sovereign and short-duration debt.

ECONOMICS. Monetary policy remains stimulative in the US, and we expect an acceptable deficit-reduction plan soon, with implementation after the 2012 elections. In Europe, fiscal policy is tightening, as is monetary policy. In Japan, a decent economic rebound is unlikely until 2012. Thus, we expect better growth in the US this year than in other DM economies. Concurrently, growth in the EM economies is likely to be much stronger than in DM countries. We expect inflation to be subdued in most DM nations; EM inflation should abate in the second half of 2011.

PROFITS. We are looking for 15% earnings-per-share (EPS) growth this year for US and global equities, driven by good sales growth and continued margin expansion. We expect EPS growth to be slightly lower in 2012.

INTEREST RATES. Apart from the European Central Bank, DM central-bank policy rates are likely to change little this year. Within the emerging markets, most Asian central banks are in the late stages of policy tightening. Yields on long-duration DM sovereign debt are likely to head higher, and investment-grade and high yield credit spreads should further compress.

CURRENCIES. Most of the trade-weighted US-dollar weakness is likely done. Longer term, we believe that the major DM currencies will decline relative to EM currencies such as the Chinese renminbi and the Indian rupee.

AUTHORS

JEFF APPLEGATE
Chief Investment Officer

DAVID M. DARST, CFA
Chief Investment Strategist

JOHN M. DILLON
Chief Municipal Bond Strategist

RUI DE FIGUEIREDO
Portfolio Solutions Group
*Morgan Stanley Alternative Investment Partners**

KEVIN FLANAGAN
Chief Fixed Income Strategist

ELIZABETH LYNN
Emerging Markets Equity Strategist

JONATHAN MACKAY
Senior Fixed Income Strategist

CHARLES REINHARD
Deputy Chief Investment Officer

DOUGLAS SCHINDEWOLF
Director of Tactical Asset Allocation

Summary of Strategic & Tactical Allocations for Global Investment Committee Asset Allocation Models

The table below summarizes our best thinking on the construction of strategic portfolios and tactical asset allocation. These three portfolios are a sampling of our guidance for investors with more than $20 million of investable assets, which are a subset of the GIC asset allocation models that are shown starting on page 18. The strategic equity allocations in these portfolios are in proportion to their share of global market capitalization. The latest changes are marked by arrows.

EFFECTIVE JULY 8, 2011

Model	Moderate Balanced Strategic Weight	Tactical Relative Weight	Equity & Alternative Investments Strategic Weight	Tactical Relative Weight	Bond & Alternative Investment Strategic Weight	Tactical Relative Weight
Global Cash	5%	-2%	0%	0%	25%	-2%
Global Bonds	37	-7 ▲	0	0	65	3 ▲
Global Equities	32	6	70	-4	0	0
Global Alternative/Absolute Return Investments	26	3 ▼	30	4	10	-1 ▼
Global Cash	5	-2	0	0	25	-2
Global Bonds						
Investment Grade	30	-10 ▲	-	-	65	3 ▲
Short Duration	5	-2	-	-	10	-3
Government/Government-Related	16	-10	-	-	33	-6
Corporate & Securitized	9	2 ▲	-	-	22	12 ▲
High Yield	4	2 ▲	-	-	-	-
Emerging Markets	3	1	-	-	-	-
Total Bonds	**37**	**-7 ▲**	**-**	**-**	**65**	**3 ▲**
Total Cash & Short Duration Bonds	10	-4	-	-	35	-5
Global Equities						
US Large	10	4	22	2	-	-
Growth	5	3	11	3	-	-
Value	5	1	11	-1	-	-
US Mid	2	1	4	0	-	-
Growth	1	1	2	0	-	-
Value	1	0	2	0	-	-
Canada	1	0	3	0	-	-
Europe	7	-3	16	-8	-	-
Europe ex UK	5	-3	11	-7	-	-
UK	2	0	5	-1	-	-
Developed Asia	4	-3	9	-6	-	-
Japan	3	-3	6	-6	-	-
Asia Pacific ex Japan	1	0	3	0	-	-
US Small	2	1	4	0	-	-
Growth	1	1	2	0	-	-
Value	1	0	2	0	-	-
World ex US Small Cap	2	1	4	0	-	-
Emerging Markets	4	5	8	8	-	-
Total Equities	**32**	**6**	**70**	**-4**	**-**	**-**
US Equity	14	6	30	2	-	-
Developed World ex US	14	-5	32	-14	-	-
Developed Market Equity	28	1	62	-12	-	-
Emerging Market Equity	4	5	8	8	-	-
Global Alternative/Absolute Return Investments						
REITs	3	1	2	1	-	-
Commodities	2	3	5	3	-	-
Inflation-Linked Securities	3	-1 ▼	-	-	10	-1 ▼
Managed Futures Funds	4	0	5	0	-	-
Hedge Funds	11	0	10	0	-	-
Private Real Estate	-	-	3	0	-	-
Private Equity	3	0	5	0	-	-
Total Alternative/Absolute Return Investments	**26**	**3 ▼**	**30**	**4**	**10**	**-1 ▼**

Source: Global Investment Committee as of July 8, 2011

Tactical Asset Allocation Reasoning

Global Bonds	Relative Weight Within Bonds	
Short Duration	Underweight	The steep yield curve leads us to seek better value in longer-dated corporate bonds.
Government	Underweight	Yields, which are not far from the historical lows reached during the financial crisis, are more likely to increase than to decrease. This is our least-favored segment of the bond market.
Investment-Grade Corporates	Overweight	An expanding global economy, solid corporate profit growth and, in the US, above-average yield spreads versus Treasuries lead us to favor this segment of the bond market.
High Yield	Overweight	Under the assumption that the economic expansion remains on track, history suggests that the yield spread over Treasuries, which is close to its long-term average, is likely to decline further.
Emerging Markets	Overweight	Yield spreads versus US Treasuries are somewhat above their declining long-term trend line, and inflation should peak before long. In addition, some currency appreciation seems likely.

Global Equities	Relative Weight Within Equities	
US	Overweight	The policy mix in the US is likely to result in stronger economic growth relative to most other developed markets. We favor large-cap stocks at the capitalization level and growth at the style level, based largely on favorable relative-valuation readings.
Developed Markets ex US	Underweight	At the regional level, we are market weight to Canada and the Asia Pacific ex Japan region (predominantly Australia) and underweight to Europe and Japan.
Emerging Markets	Overweight	This is our most-favored asset class on a one-year view; fundamental factors such as economic and earnings growth, government balance sheets and indebtedness remain favorable. Policymakers' efforts to prevent overheating and engineer "soft landings" in these economies may be coming to a successful end.

Global Alternative/ Absolute Return Investments	Relative Weight Within Alternative Investments	
REITs	Overweight	Industry tailwinds include an expanding global economy, limited new-property supply, banks' increased willingness to lend and an improved market for commercial mortgage-backed securities. Above-average dividend increases seem likely, given the combination of a relatively low payout ratio and improving fundamentals.
Commodities	Overweight	With global economic output at a record high and with particular strength in the emerging economies, the demand for most commodities should remain strong. Supply shortages could lead to price surges.
Inflation-Linked Securities	Underweight	With the peak in inflation expectations likely behind us for this cycle, we see better value elsewhere.

World of Woe as Profits Grow

Economic and fiscal concerns abound but corporate profits are up.

Current US and global cyclical economic softness, alongside concerns over US debt and deficits and Europe's ongoing sovereign debt woes, has raised investors' anxiety. While the intensity of the headlines may cause concern, in our view, the situation is not dire.

To start with, we expect GDP growth to pick up in the second half of this year, as some of the output lost to the devastation caused by March's earthquake in Japan is reversed and US consumption improves. US auto production should ramp up this month upon the recovery of Japanese industrial production, and somewhat-lower gasoline prices should no longer hamper discretionary spending.

There are other signs of economic improvement. Despite global headwinds, China's GDP beat expectations, growing at a 9.5% annual rate in the second quarter. Locally, the Bloomberg US Financial Conditions Index currently registers levels consistent with the last economic expansion and well above those readings recorded during the 2007-to-2009 financial crisis or last summer's economic soft patch—softness that prompted the Federal Reserve to undertake a second round of Quantitative Ease (see Chart 1).

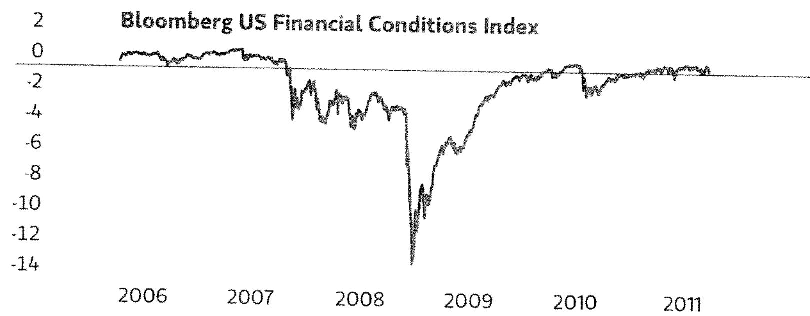
PROFITS ARE STRONG. Even while the US economy weakened, profits have remained strong. According to US National Income and Product Accounts (NIPA) data, after-tax corporate profits are at an all-time high. NIPA profits, a broader measure than that of a stock market index, are also well above the peak levels reached during the last bull cycle (see Chart 2). Profit margins are high, as productivity resulting from globalization, technology and past belt-tightening have constrained unit labor costs—the biggest expense for most firms. This is evident in the historically low labor and high profit shares of US national income (see Chart 3, page 5).

This high level of profits is evident in publicly traded companies, too. The 52-week forward consensus earnings-per-share (EPS) estimate for the companies in the Standard & Poor's 500 Index stands at just below $106, $3 higher than at the top of the last bull cycle and $10 higher than at the beginning of the year (see Table 3, page 9). This metric has stalled of late, but with the second-quarter earnings reporting season now under way, we expect this metric to begin to rise again as equity analysts digest the results and factor them into their outlooks.

Although the pace of earnings growth typically moderates as an expansion matures, it still appears to be solid; we expect US and global EPS growth of about 15% in 2011 and a little less in 2012. As the economic cycle matures, profit growth

Chart 1: US Financial Conditions Return to Prerecession Levels

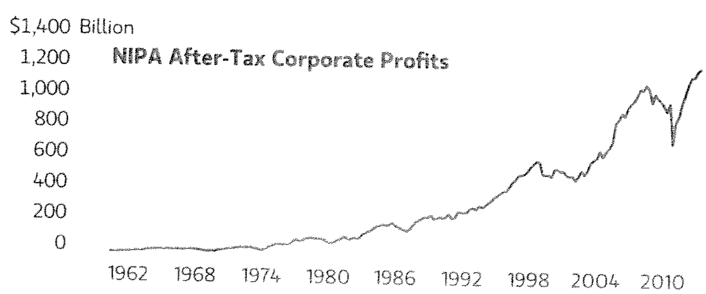
That huge cliff dive in this measure of financial conditions was the financial crisis in 2008. After a sharp rebound—and a growth scare last summer—conditions have normalized.



Note: The Bloomberg Financial Conditions Index combines yield spreads and indexes from the money markets, equity markets and bond markets into a normalized index. The values of this index are z-scores, which represent the number of standard deviations that current financial conditions lie above or below the average of the period from January 1994 through June 2008.
Source: Bloomberg as of July 13, 2011

Chart 2: NIPA Corporate Profits Reach an All-Time High

According to US National Income and Product Accounts (NIPA) data, after-tax corporate profits are at an all-time high. NIPA profits, a broader measure than that of a stock market index, are also well above the peak levels reached during the last bull cycle.



Source: Bureau of Economic Analysis as of March 31, 2011 should rely more on revenue growth and less on margin expansion. We continue to expect that profit growth will be the main driver of equity market returns.

Reasonable absolute and relative valuations provide additional support to equity prices. US and global equities forward price/earnings ratios, at 12.6 and 11.3, respectively, are toward the lower end of their historical ranges. On a relative basis, the global equity dividend yield is historically high when compared with yields on sovereign bonds and cash.

US JOBS STALL. In May and June, US job growth sharply decelerated, producing gains of just 25,000 and 18,000, respectively. The unemployment rate rose as well, to 9.2%. In light of the recent economic soft patch, Morgan Stanley's economists expect the Fed to maintain the easiest monetary policy in the history of the central bank. The Fed is not expected to begin raising policy rates until the third quarter of next year. We expect minor policy tightening to begin in the second quarter of 2012, as the Fed takes steps to shrink the size of its balance sheet.

It is understandable for the Fed to take its time before tightening, as US inflationary pressures appear to be easing. Moreover, both Morgan Stanley and Citi economists forecast inflation in the developing economies to be lower next year than this year (see Table 2, page 7). Historically, a decline in inflation has been a catalyst for higher emerging market (EM) equity prices (see Chart 8, page 10).

DEBT-CEILING CLIFF-HANGER. We think Congress will raise the US debt ceiling this summer for the 82nd time since World War II, but only after extended political theater. That increase will likely be tied to a deficit-reduction package in the neighborhood of $2 trillion across 10 years. Recent efforts for a $4 trillion deal that would have included entitlement reductions and progressive tax increases appears doomed ideologically. However, one feature in the final agreement could be certain outlay increases that are tied to an inflation index that is projected to be slightly lower than the current one in use, the effect of which would be slower growth in outlays versus the current projections (see Table 1, page 6). However, execution on the reductions will probably have to wait until after the 2012 elections. If such execution were to begin to shrink the deficit as a share of GDP, we would expect stock market multiples to expand, as they have in past episodes of deficit reduction.

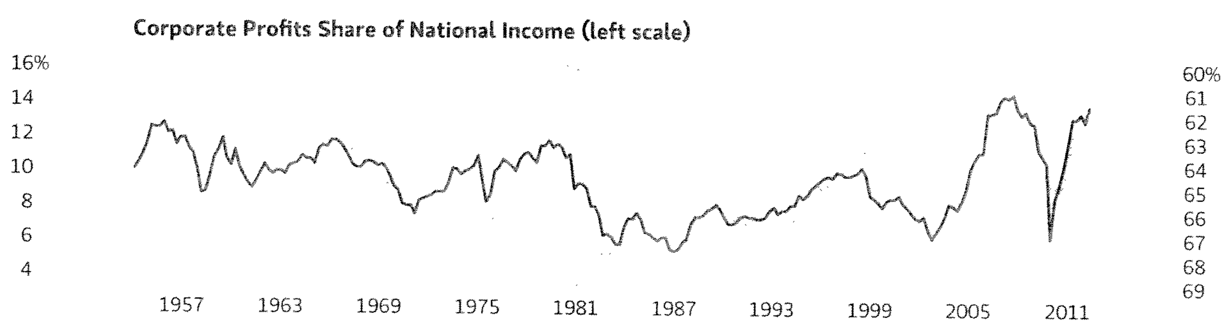
EUROPE SEEKS STABILITY. Moody's recently downgraded Greek, Portuguese and Irish government bonds to below investment grade, or "junk" status, citing too much debt and insufficient growth. Solvency pressures on Europe's periphery have also roiled markets and impacted larger countries like Spain and Italy, increasing the cost of financing their national debts.

Europe's financial leaders, along with the International Monetary Fund, are seeking a way to lower Greece's debt burden in a manner that stabilizes the regional credit picture, but this has not been easy. Much of this debt is held by Europe's banks, many of which we expect to raise capital following a recent banking stress test. Ultimately, any aid package Greece or other nations receive will put the EU on a path toward greater fiscal integration to complement its monetary union. Overall, the growth outlook isn't robust and debt issues will continue to weigh on the euro, especially in relation to EM currencies.

UNDERWEIGHTING EUROPE AND JAPAN. For the reasons mentioned above, we remain underweight to European equities. We are also underweight to Japanese equities. In Japan, recovery from the devastating natural disasters and nuclear-power-plant crisis is underway. However, neither monetary nor fiscal

Chart 3: Corporate Profits Take an Increasing Share of National Income

Profit margins are high, as productivity resulting from globalization, technology and past belt-tightening have constrained unit labor costs—the biggest expense for most firms. This is evident in the historically low labor and high profit shares of US national income.



Source: Bureau of Labor Statistics as of March 31, 2011

Table 1: What May Be Saved by Changing the Index for Entitlement and Tax Inflation Adjustments

(in billions)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2012 – 2021
Social Security	1	3	5	8	10	12	15	17	19	22	112
Other Cost of Living Adjustments	0	1	2	2	3	4	4	5	6	6	33
Other Spending*	0	0	1	1	1	2	3	4	5	6	23
Tax Code	1	2	4	6	8	10	12	13	15	17	88
Subtotal	3	7	11	17	22	28	34	39	44	51	255
Interest	0	0	1	1	2	4	5	8	10	13	44
Total	**$3**	**$7**	**$12**	**$18**	**$24**	**$32**	**$39**	**$47**	**$54**	**$63**	**$299**

*Excludes impact on Medicaid and health exchange subsidies, which could be substantial
Note: Numbers may not add up to 100 due to rounding.
Source: Congressional Budget Office, The Committee for a Responsible Federal Budget as of May 11, 2011

policy appears stimulative enough to sufficiently improve the outlook on a lasting basis. Nor does strong political leadership seem likely to emerge. Finally, Japan faces more-daunting deflation and demographic challenges than do other developed-market economies.

As the global economy expands and challenges appear, we continue to evaluate whether to reduce our risk exposure. Our analyses suggest that many risk assets—equities, corporate credit, real estate investment trusts (REITs) and commodities—remain attractive relative to most safe-haven asset classes such as cash and developed-market sovereign debt. As a result, our asset allocation models overweight global equities and alternative/absolute return investments and underweight government bonds and cash.

FAVORING CORPORATE AND EM DEBT. Within global fixed income, our portfolios remain tilted toward high-grade and high yield corporate debt—which offer reasonable spreads over government debt—and away from developed-market sovereign debt. Corporate bonds also offer high returns compared with inflation. US investors who can benefit from tax-free income may consider municipal bonds in lieu of corporate bonds. Because longer-maturity debt offers significantly higher yields than shorter maturities, we are also underweight in short-duration instruments and cash.

Our portfolios are also tilted toward emerging market debt, as credit-rating upgrades reflect a secular rerating. Yield spreads to US Treasuries are expected to contract as the credit quality of these issuers continues to improve.

OVERWEIGHTING ALTERNATIVES. A growing global economy, featuring robust economic advancement in emerging market countries, should spur demand for commodities. Improving economic fundamentals are likely to improve the supply/demand balance for commercial real estate. As a result, our portfolios have tactical overweight positions in two liquid alternative/absolute return asset classes: commodities and REITs. Because global inflation appears to be heading lower, we are underweight inflation-linked securities. ■

Economic Outlook

The Case for a Better Second Half

As we move into the third quarter, investors have been looking for clarity on the direction of the US economy. The first-half results did not live up to expectations, creating an environment of uncertainty similar to that of mid 2010. In general, the data that has come in so far have been mixed and have not provided much guidance. Nonetheless, the Global Investment Committee's base case holds steadfast: Growth should improve during the second half of the year.

This is not to say that there are no significant headwinds, and GDP forecasts have been revised downward. According to the latest estimate from the Morgan Stanley Economics team, real GDP for the second half of 2011 will be 3.5%, down from 4.0%; the full-year estimate is 2.6% (see Table 2). However, even with this downward revision, second-half growth would still be visibly above the first-half performance, which may come in at 2%, or lower.

RIPPLE EFFECT. We are optimistic on second-half growth because some factors that led to slower growth earlier this year are now reversing. Consider the March 11 Japanese earthquake and tsunami. The devastation was enormous, and the supply disruptions that occurred in Japan have rippled around the globe. The subsequent shortage of Japanese-built parts had an impact on many industries, with the motor-vehicle sector hit the hardest. Indeed, parts shortages emanating in Japan resulted in weak production figures in the US auto industry, especially among Japanese-owned plants.

Early March production schedules suggested that, had the disasters not occurred, second-quarter US GDP could have been more than a full percentage point higher. Morgan Stanley economists now estimate that at least 1.5 points were shaved from second-quarter growth. Data for the auto sector imply a rebound is imminent, with assemblies for the third quarter projected to add more than 1% to US growth (see Chart 4, page 8). While accurate statistics outside of the auto industry are more difficult to come by, it seems reasonable to expect a similar trend for other industries that may have been negatively affected by the break in the supply chain.

FUEL RELIEF. Another important change in the economic outlook comes from the price of gasoline. After surging to a peak in late April, gasoline futures have fallen just under 10% and, barring any outside forces, are expected to remain range bound near current levels for the next year. According to the most recent figures from the US Energy Information Administration, the average price of regular unleaded fuel is now down 32 cents per gallon from the recent high.

This pullback in prices at the pump should support an improved setting for household spending for the remainder of the year. What's more, even with the unemployment rate at historically high

Table 2: Morgan Stanley and Citi Global GDP and Inflation Forecasts

(year-over-year percent change)

Morgan Stanley	2010	2011	2012	% Contribution to Growth 2011
Global GDP	5.1	4.2	4.6	
Developed Economies	2.6	1.9	2.4	24
US	2.9	2.6	3.0	13
Euro Zone	1.7	2.0	1.2	7
UK	1.4	1.2	1.8	1
Japan	4.0	-1.2	2.9	-2
Developing Economies	7.8	6.6	6.7	76
Brazil	7.5	4.1	4.6	3
Russia	4.0	5.0	5.5	4
India	9.0	7.7	8.5	10
China	10.3	9.0	9.0	29
Global Consumer Prices				
Global Inflation	3.3	4.1	3.3	
Developed Economies	1.4	2.6	1.9	
Developing Economies	5.5	5.7	5.1	
US Core	1.0	1.5	2.1	
US CPI	1.6	3.1	2.2	

Citi	2010	2011	2012	% Contribution to Growth 2011
Global GDP	4.1	3.4	3.7	
Developed Economies	2.6	1.8	2.2	38
US	2.9	2.3	2.7	19
Euro Zone	1.7	1.9	1.2	13
UK	1.4	1.0	1.9	1
Japan	4.0	-0.5	3.1	-1
Developing Economies	7.3	6.3	6.2	62
Brazil	7.5	4.0	4.5	4
Russia	4.0	4.3	4.1	3
India	8.5	8.1	8.4	6
China	10.3	9.2	9.0	27
Global Consumer Prices				
Global Inflation	2.7	3.9	3.3	
Developed Economies	1.4	2.5	1.8	
Developing Economies	5.3	6.5	5.8	
US Core	1.0	1.5	1.5	
US CPI	1.6	2.9	1.6	

Note: Morgan Stanley regional and global forecasts are GDP-weighted averages, using Purchasing Power Parity estimates. That gives greater weights to developing economies. Citi forecasts use current foreign exchange rates.

Source: Morgan Stanley Research, Citi Investment Research & Analysis, Morgan Stanley Smith Barney as of July 20, 2011 levels, personal consumption continues to move higher (see Chart 5). According to the Bureau of Economic Analysis, real personal consumption expenditures (PCE) have risen in every quarter since the Great Recession ended two years ago. More recently, we've seen real PCE contribute about 1.5% to GDP during the first half of 2011. Looking at the remainder of the year, financial conditions should remain supportive. One of the offshoots of the Fed's Quantitative Ease (QE) was the provision of a more positive setting on this front; by most measures, even with QE2 ending, it would appear that effort has been reasonably successful.

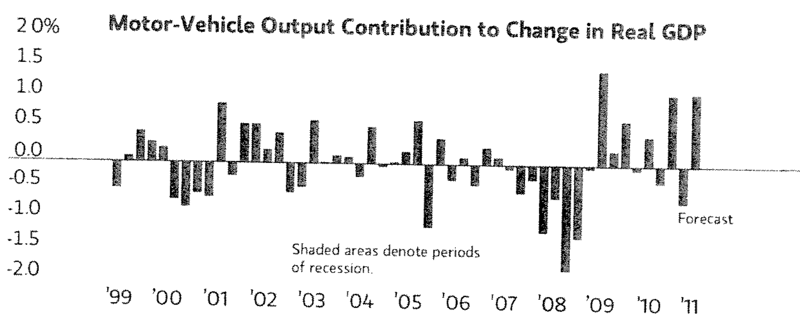
From the global perspective, the growth outlook continues to appear favorable, especially in the emerging markets. Monetary conditions are expected to stay historically accommodative, with Morgan Stanley noting, "Real policy rates [remain] in negative territory in many countries." With the peak in the global inflation cycle in sight, if not in rearview, Asian central-bank tightening appears about finished. Latin American central banks may have more tightening to do, but it is not likely to be aggressive. Within the developed world, we are beginning to see signs of improvement for Japan, as industrial-production figures for June returned to February's predisaster levels.

EMPLOYMENT HEADWINDS. The June Employment Situation report was certainly a disappointment, and there were no obvious anomalies within the data to suggest a huge reversal would be forthcoming next month. However, this set of statistics could essentially reflect the overall slowing of the broader economy. Thus, if we see better growth in the second half, employment gains could also resume—but at a more moderate pace. Looking at the numbers, from October 2010 through April of this year, the average monthly gain for nonfarm payrolls came in at 175,000; in the last two months, the average tally was only 22,000.

Recent purchasing-managers surveys suggest, if motor-vehicle production turns positive or merely becomes less of a near-term drag, it is conceivable that, later this year, future payroll gains could begin to move back toward the threshold of 150,000 to 175,000 per month. New job creation often comes with a lag, so higher readings may not become evident right away. However, if there is going to be some reversal of fortune on the jobs front, the weekly jobless claims may be the first data series to confirm such a trend. While we would caution not to draw a firm conclusion quite yet, we do note that jobless claims have fallen 73,000 from their recent peak in late April. ■

Chart 4: Changes in Motor-Vehicle Production Can Have a Large Impact on GDP

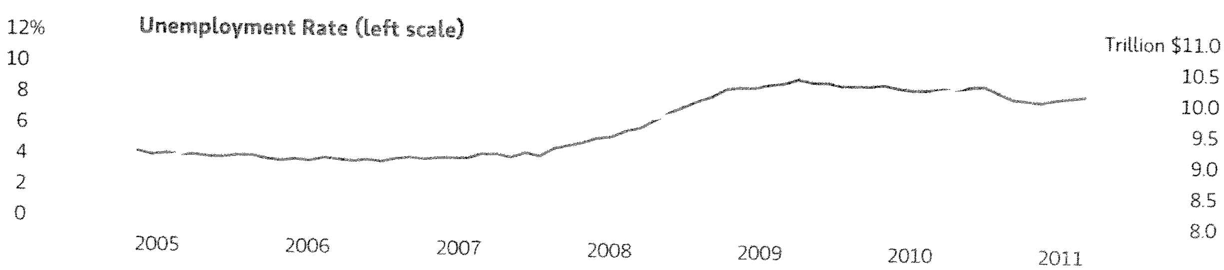
Motor-vehicle output can be a major contributor to, or detractor from, US GDP. In the second quarter of 2011, a shortage of parts from Japan resulted in decreased output. In the third quarter, that situation is expected to be reversed, helping to bolster US economic growth.



Source: Bureau of Economic Analysis, National Bureau of Economic Research, Morgan Stanley Economics as of July 13, 2011

Chart 5: Even With High Unemployment, Personal Consumption Continues to Climb

High unemployment has not prevented consumer expenditures from reaching an all-time high. Apparently, those still with a paycheck continue to spend at a healthy pace.



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Bloomberg as of July 13, 2011

Equities Outlook

Still-Solid Earnings Growth

One of our key assumptions is that corporate earnings growth will be the main driver of equity market performance this year. Halfway through the year, we've seen the consensus estimate for global earnings per share (EPS)—based on the constituents of the MSCI All Country World Index—rise to slightly above $27, which represents a 15% increase over 2010. Back in January, the 2011 estimate was $26. Robert Buckland, global equity strategist for Citi Investment Research & Analysis, thinks that consensus is too modest. Buckland is forecasting 18% global EPS growth for 2011 driven by revenue growth and margin expansion, with each making similar contributions (see Chart 6).

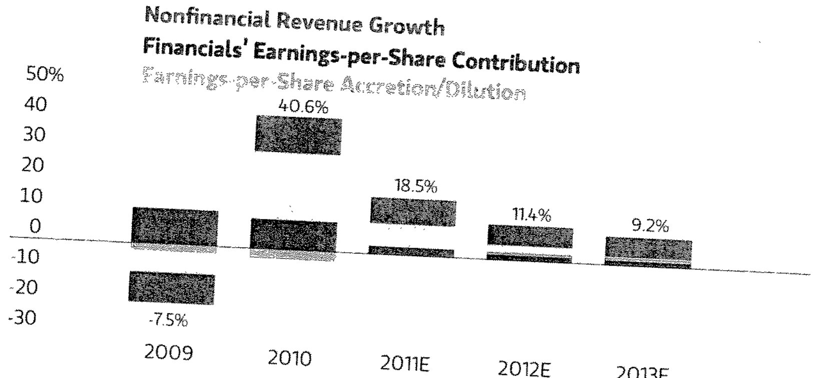
A TAD TOO OPTIMISTIC? In the US, the consensus estimate for EPS growth, based on the Standard & Poor's 500 Index, is about $98.35, which represents a 15% increase for the year (see Table 3). This estimate has risen since the start of 2011 and now matches our expectations. Our sense is that the US consensus estimates for next year, however, may be a tad too optimistic. Indeed, there recently have been indications of some retrenchment. We note that the 52-week forward earnings estimate, which had been steadily rising since April 2009, lately has stalled. Still, earnings growth appears likely to register a solid pace, so long as the economic expansion remains on track—as we expect it will.

We also note that the market's valuation appears to provide some cushion against an earnings shortfall. Based on forward earnings estimates, the MSCI All Country World Index's price/earnings ratio (P/E) is 11.6, compared with its long-term average of about 16 (see Chart 7, page 10). Similarly, the forward P/E for the S&P 500 Index is 12.5 compared with its long-term average of 14.

PREFERENCE FOR EQUITIES. Against this backdrop, we reaffirm our tactical preference for global equities over global bonds and cash. Within developed-market equities, we are tactically overweight to the US. Although the Federal Reserve no longer is actively pursuing Quantitative Ease, it is holding the size of its balance sheet steady by reinvesting the proceeds of maturing mortgage-backed securities into Treasuries. What's more, its policy stance is likely to remain accommodative for quite a while. Given that more

Chart 6: Revenues Are Likely to Drive Global Earnings Growth

As the economic cycle matures, profit growth comes more from revenue growth and less from margin expansion. In 2011, we expect margins and revenues to be equal contributors, but looking ahead, revenue growth is more important.



Source: Citi Investment Research & Analysis, FactSet as of July 6, 2011

Table 3: Earnings Forecasts for the Standard & Poor's 500, MSCI All Country World and MSCI Emerging Markets Indexes

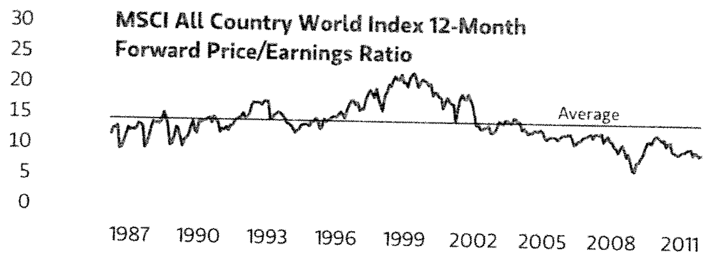
	S&P 500				Consensus of Wall Street Analysts					
	Morgan Stanley		Citi		S&P 500		MSCI All Country World		MSCI Emerging Markets	
	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change	Operating EPS	YOY Change
2010	$85.00	39%	$85.49	38%	$85.28	40%	$23.56	44%	$88.36	45%
2011	$93.00	9%	$98.00	15%	$98.35	15%	$27.18	15%	$102.17	16%
2012	$98.00	5%	$105.00	7%	$113.14	15%	$31.16	15%	$116.07	14%
52-Week Forward					$105.93		$29.51		$110.44	

Note: Citi estimates are before write offs

Source: Citi Investment Research & Analysis, Morgan Stanley Research, Thomson Financial, Datastream as of July 13, 2011

Chart 7: Global Equities Trade at Historically Low Valuation Levels

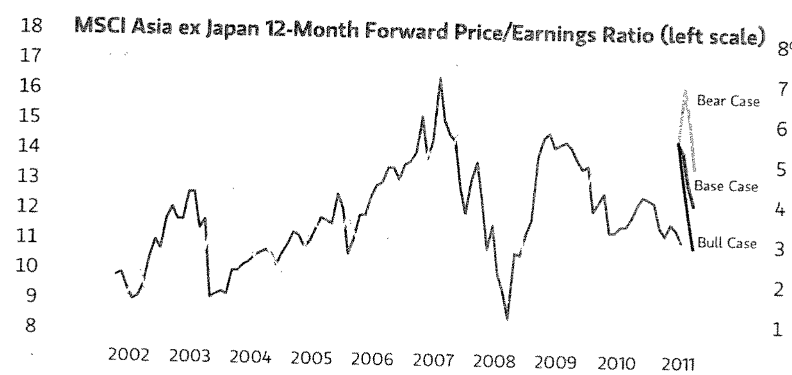
Global equities appear to be attractively valued based on forward earnings estimates. The price/earnings ratio is about 11 compared with a long-term average of 16.



Source: MSCI, FactSet as of July 19, 2011

Chart 8: In the Past, Falling Inflation in Emerging Asia Has Led to Higher Equity Valuations

With a forecasted drop in emerging markets inflation in the second half of 2011, the price/earnings (P/E) multiple is likely to expand, given the strong inverse correlation between consumer-price inflation and forward P/E ratios seen coming out of past inflationary periods.



Source: CEIC Data, Morgan Stanley Research as of July 13, 2011

than half of US, European and Japanese corporate profits are sourced locally, we believe this sets the stage for superior US equity market performance relative to other developed markets.

Within US stocks, we favor the large-cap sector. The forward P/Es for the Russell MidCap Index and the Russell 2000 Index (representing mid-cap and small-cap stocks, respectively) relative to that of the Russell Top 200 Index (a proxy for mega-cap stocks) are high by historical standards, suggesting that the largest US stocks are relatively inexpensive.

At the style level, we continue to favor growth stocks over value stocks. Here, too, the primary driver is relative valuation. By historical standards, value stocks are expensive relative to growth stocks, especially in the large-cap sector.

More Volatility, Little Change for Emerging Markets

The main story in emerging market (EM) equities so far this year is lots of volatility but little overall movement. Despite hefty moves during the past two months—an 8% pullback between early May and late June, and then a 6% rally from the recent market trough on June 20 to early July—the MSCI Emerging Markets Index is down only 2% for the year to date (through July 19). Why the big swings? Perhaps it was a tug-of-war between attractive valuations on one side versus many negatives on the other side, which included: worries about the economy, the European sovereign debt crisis, the Arab Spring and, in particular, rising inflation fears in the EM economies.

Despite its continued rise within emerging markets, the sense is that the inflation scare has begun to ease. In China—always the key to the EM and global-growth stories—the Morgan Stanley Economics team views the June inflation rate of 6.4% as the likely peak for the year. The prospective fall in China's inflation in the second half of the year means that the People's Bank of China should be close to the end of its tightening cycle. Its last interest rate hike was on July 7—the fifth such hike in the current cycle, which has also included nine increases in bank reserve requirements. China's 9.5% second-quarter GDP growth rate indicates that policymakers have apparently engineered their desired "soft landing."

INFLATION PEAK. All told, Morgan Stanley's base-case forecast is for EM inflation to fall back from a peak of around 6% at the end of June to just over 4% by the end of the year. Thus, the inflation problem in the emerging markets seems contained and should not preclude higher equity prices in the second half of the year. Both Morgan Stanley's and Citi's 2011 GDP outlooks for the EM economies have remained unchanged at more than 6%.

As inflation moderates, EM central banks will have room to bring their policy stance to neutral. The Morgan Stanley Economics team expects that, with the notable exceptions of Turkey and Brazil, most EM central banks will shift toward neutral over the next six-to-12 months. Additionally, because of the fiscal turbulence in Europe, EM central banks are much more likely to signal easing earlier than previously anticipated. This should be a catalyst for the equity market to move higher, as it would reduce uncertainty around monetary policy and allow the market to gain confidence in the sustainability of EM growth. Moreover, this lower inflation in the second half of 2011 should be a positive for price/earnings (P/E) multiple expansion, given the strong inverse correlation between inflation as measured by the Consumer Price Index and forward P/E ratios seen coming out of inflationary periods in the past (see Chart 8, page 10).

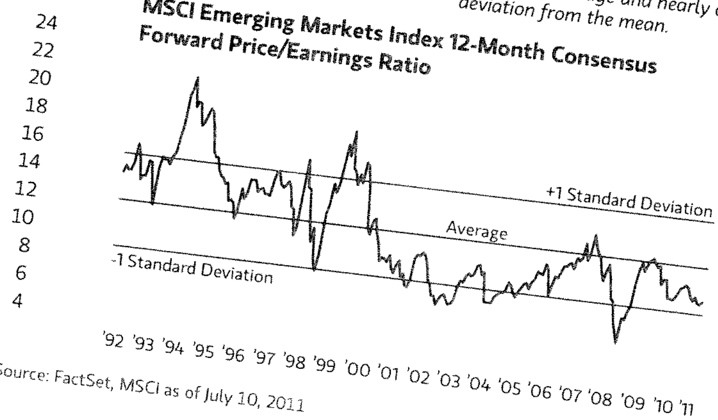
LOWER VALUATION. Given this year's flat trading in the face of strong EM earnings growth, the forward P/E ratio has declined to 10.5 from 11.9 at the end of 2010. The P/E is 18% below its post-1992 average, which is almost one standard deviation (see Chart 9). Meanwhile, on historical price-to-book ratios, the MSCI EM Index has declined slightly below 1.9, down from 2.1 at the start of the year. This is almost exactly in line with the post-1992 average.

Overall, we expect a much stronger performance over the rest of 2011, both in absolute terms and versus developed-market equities, as investors once again return their focus to the long-term attractiveness of EM equities. Morgan Stanley's year-end target for the MSCI Emerging Markets Index represents an increase of 16% from current levels, while Citi forecasts EM equities will rally another 24% this year. The risks to these optimistic views are higher-than-expected inflation and the potential for an EM policy mistake. ■

Chart 9. Emerging Market Equities Valuation Remains Low

Emerging market equities trade at what is historically a low valuation. The 12-month forward price/earnings ratio for the MSCI Emerging Markets Index is 18% below its post-1992 average and nearly one standard deviation from the mean.

MSCI Emerging Markets Index 12-Month Consensus Forward Price/Earnings Ratio



Source: FactSet, MSCI as of July 10, 2011

Fixed Income Outlook

No More Silver Bullets

With monetary policymakers running a bit low on ammunition, the Federal Reserve appears to be sidelined as a headline-making entity. Around some discussion of what type of policy response the Fed may have if the economy takes a turn for the worse, prior to recent Congressional testimony, Chairman Ben Bernanke's own words suggested that the bar had been raised rather high for any big splash—such as a third round of Quantitative Ease (QE3). Then, in his Congressional appearance on July 13, the chairman mentioned the possibility of renewed asset purchases. However, a QE3 is still far from likely, and one important factor would be renewed deflationary concerns—a development we do not foresee at this juncture.

Given the current economic backdrop, we believe that Fed policy is going to remain accommodative for the foreseeable future. In other words, monetary policy and the fed-funds rate seem to be destined to remain on hold longer than previously envisioned, and we do not see any formal rate hikes for the next 12 months, if not longer (see Table 4). The weak June employment figures will certainly not sit well with the Fed's own forecasts either. Another reason the Fed would be in no hurry to tighten policy is the large output gap—the difference between actual output of an economy versus its potential at full capacity (see Chart 10, page 13). Accordingly, recent economic weakness has resulted in a renewed widening. With the growth forecast lowered in June, the gap is expected to stay wider for longer and may not close until the end of 2014.

In fact, without any noticeable improvement on the jobs front, the reinvestment program will most likely remain in place for the rest of this year. The Federal Reserve Bank of New York reported that, from Nov. 12 of last year through June 30 of this year, the reinvestment program resulted in a total of $167 billion in Treasury purchases; according to the New York Fed's latest schedule, purchases to be made over the next month are estimated at roughly $14 billion.

POLICY RATE DIFFERENTIALS. The revised monetary policy outlook leaves the Fed as one of only a few remaining central banks maintaining a historically accommodative stance. The European Central Bank raised rates again at its last policy meeting, using hawkish language that suggests it is prepared to move at least once more in this tightening cycle. Among the developing economies' central banks, we are getting the sense of a change in direction. The Morgan Stanley Global Economics team believes that policy tightening is coming to an end and—with inflation likely peaking, China apparently engineering a soft landing and economic uncertainty increasing in the developed countries—there could be a quick swing from tightening to easing, especially if China's policymakers want to protect growth.

VOLATILE TREASURIES. Trading in the US Treasury market has become unusually volatile. After reaching a low of 2.87% on June 24 amid concerns about economic sluggishness and Euro Zone debt problems, the yield on the 10-year note quickly reversed course, increasing 32 basis points to 3.19% on July 1. This shift came on the release of the purchasing managers' reports and news that Greece would receive its near-term funding, along with a potential solution to its debt crisis. Then, the following week, the June US jobs figures and renewed negative headlines in Europe wiped out almost all of this yield increase, with

Table 4: Morgan Stanley and Citi Policy Rate and Government Bond Yield Forecasts

Morgan Stanley	Current Rate	3Q11	3Q12
Policy Rate (%)			
US	0.00–0.25	0.13	0.50
Euro Zone	1.50	1.50	2.00
Japan	0.10	0.05	0.05
UK	0.50	0.75	1.75
China	6.56*	6.56*	6.81*
10-Year Government Bond Yield (%)			
US	2.92	3.25	4.00
Euro Zone	2.72	3.45	3.75
Japan	1.08	1.30	1.50
UK	3.06	3.90	4.10

Citi	Current Rate	3Q11	3Q12
Policy Rate (%)			
US	0.00–0.25	0.25	0.50
Euro Zone	1.50	1.50	2.20
Japan	0.10	0.10	0.10
UK	0.50	0.50	1.25
China	3.50**	3.75**	3.75**
10-Year Government Bond Yield (%)			
US	2.92	3.10	3.60
Euro Zone	2.72	2.80	3.60
Japan	1.08	1.15	1.30
UK	3.06	3.15	3.85

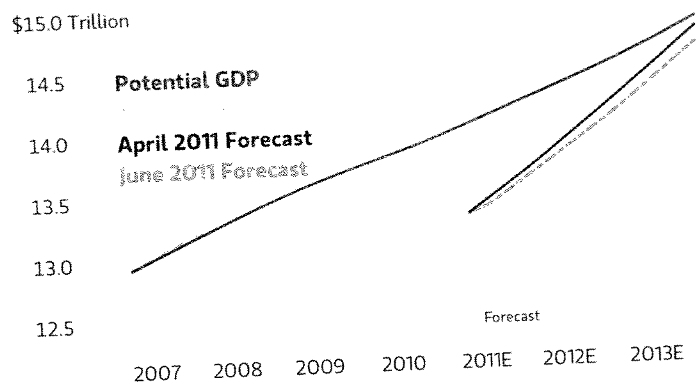
*Morgan Stanley's current and forecast policy rates use the one-year lending rate
**Citi's current and forecast policy rates use the one-year deposit rate
Source: Morgan Stanley Research, Citi Investment Research & Analysis as of July 20, 2011

the 10-year yield landing at 2.92%. We expect such volatile trading conditions to continue into the foreseeable future. In fact, in the near term, the volatility may be stepped up as the debt ceiling debate rages on.

Meanwhile, because no progress toward increasing the debt ceiling had been made by the agency's mid-July deadline, on July 13 Moody's Investor Service followed through on its prior report and placed the US sovereign debt Aaa rating on review for possible downgrade. This action is not just about Treasuries, but extends to debt issued by Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Farm Credit Banks. While Moody's action was initially related more to the debt ceiling and not necessarily contingent on the magnitude of budget cuts under discussion, Standard & Poor's does see a linkage. Thus, even if the debt ceiling is raised, if accompanying budget-cutting language does not meet certain criteria, S&P has said it could still downgrade the US sovereign rating from its current AAA status. As the clock continues to tick towards the August 2 deadline, the quickly changing headlines underscore the fluid nature of developments.

Chart 10: Output Gap Wider and Closing More Slowly

The output gap is the difference between the economy's actual GDP and its potential GDP. Because of the recent softness in the economic data, growth forecasts have been revised downward and the gap will stay wider longer, taking more time to close.



Source: International Strategy & Investment as of July 12, 2011

Credit Winds Cross the Atlantic

The credit markets have been buffeted recently by a stream of news out of Europe. Credit spreads widened significantly from early May through the third week in June, as news from Europe pointed to the growing likelihood of a near-term restructuring of Greek debt. The tone turned more positive in late June, when it appeared that European policymakers were going to be able to avoid a hard restructuring by crafting a second bailout package for the country. Over the past two weeks, the news flow has once again turned negative, and it now appears unlikely that a second bailout for Greece will be settled before this fall. Thus, the credit markets will likely be subject to a two-to-three-month period of uncertainty as they await a policy response from European leaders.

As a result of the varying news flow, the option adjusted spread (OAS) on the Barclays Capital US Aggregate Corporate Investment Grade Index widened more than 20 basis points from May 1 to June 24; since then, it tightened by three basis points. Now, at 155 basis points over Treasuries, the index is barely changed from the beginning of the year. Yet the rally in Treasuries has pushed the yield on the index down to 3.63%, which is 41 basis points lower than on Jan 1. All told, the total return on investment-grade credit is 4.87% for the year through July 19.

The OAS on the Barclays Capital US Aggregate Corporate High Yield Index widened 106 basis points from May 1 through June 24; since then, it has become tighter by 24 basis points. At 541 basis points over Treasuries, spreads are wide of long-term averages and the price of the index, at roughly 102.5, offers some upside potential. However, barring a sooner-than-expected deal out of Europe to resolve the sovereign debt crisis, high yield spreads will likely be range bound over the coming months. For the year through July 19, high yield is up 5.73%.

DAMAGE CONTROL. Before they can resolve the debt crisis, European policymakers must prevent its spread. During the last few weeks, Italian and Spanish 10-year bond yields breached 6% for the first time since the crisis began last year, and their respective credit default swaps jumped more than 100 basis points in a matter of days (see Chart 11, page 14). There are many reasons for contagion beyond Greece, Ireland and Portugal but, in our view, it essentially comes down to two primary issues. First, the "Troika" members—the European Union, the European Central Bank (ECB) and the International Monetary Fund—need to agree on a structure for the second bailout for Greece and, most important, decide what role private creditors will play. Second, European officials need to finalize the structure and size of a permanent crisis backstop, which will most likely mean a significant upsizing of the European Financial Stability Facility (EFSF). Revamping the EFSF is not a precondition for a second bailout of Greece, but it might be done in conjunction with the final terms for a second bailout.

These issues are not likely to be resolved in the coming weeks, as most European parliaments are on summer recess and won't return until early September. Any change to the EFSF needs to be ratified by the parliaments within the European Union. Barring a coordinated set of emergency meetings by all the EU parliaments, we will not see any significant progress until the fall. In the meantime, we expect the ECB to provide liquidity to countries in need by acting as the buyer of last resort. Through its open market operations, the ECB could buy bonds issued by Spain and Italy that are not taken up by the market. The central bank could do this behind the scenes, which would help to stem a rise in those countries' bond yields, or they could publicly state their intent to buy, which, in our view, would lead to a quick reversal in the sell-off in Spanish and Italian bonds.

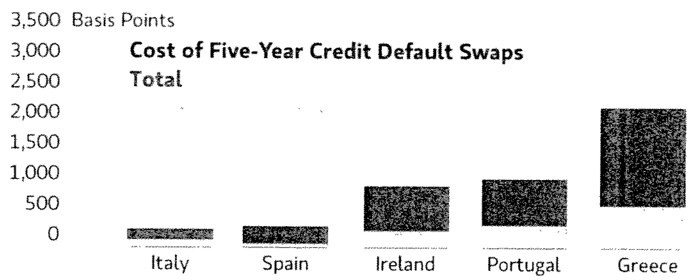
EUROPEAN BASE CASE. Our base case remains that European policymakers will ultimately agree to a policy response that stems the threat of contagion. This does not preclude a restructuring of Greek debt, which we think will occur when Greece receives its second bailout. This may also pave the road for a restructuring of Portuguese and Irish sovereign debt, but both of these countries have significantly lower debt/GDP ratios and deficit/GDP ratios than Greece, and thus the need for restructuring is not as great. We maintain our view that all peripheral European sovereign and corporate debt should be avoided.

STILL POSITIVE ON CREDIT. While we acknowledge the risks from Europe, we remain positive on the credit markets, given their strong fundamental base, positive technical backdrop and attractive relative-value proposition versus risk-free rates. We believe that these pillars of support should lead to continued outperformance for both investment-grade and high yield credit over the next six to 12 months. The Global Investment Committee (GIC) maintains overweight (OW) recommendations on both investment-grade and high yield corporate credit.

EMERGING MARKETS OVERWEIGHT. The GIC is also overweight in emerging market (EM) sovereign debt. EM debt has not been immune from some of the macro concerns plaguing risk markets over the past two months, with the Barclays Capital Emerging Markets Index

Chart 11: Costs Rise for Credit Default Swaps on Sovereign Debt in Peripheral Europe

Prices for credit default swaps—the cost of insuring bonds against default—have soared over the last month, especially in Greece, Portugal and Ireland. CDS prices for Greek debt, already the highest in Europe, soared 30% during the last month.



Source: Bloomberg as of July 12, 2011

at a current spread of 311 basis points over US Treasuries. Still, we believe EM debt is attractively valued. In addition, we believe we are near the end of the rise in inflationary pressures in the emerging markets and, thus, close to the end of the tightening cycle.

Although EM growth is likely to slow from current levels, it remains at a significantly higher level, on average, than growth in the developed economies. EM debt markets also continue to benefit from asset flows and positive reratings versus the developed economies. This last point was perfectly illustrated recently as Brazil was upgraded to Baa2 from Baa3 and placed on positive outlook by Moody's, while Portugal was downgraded to Ba2 from Baa1 and placed on negative outlook by Moody's. The rerating of EM sovereigns is likely to continue in the years ahead and is consistent with a secular trend of tightening spreads.

Municipals Much Improved at Midyear

The municipal bond market started 2011 with a whimper. Flows for muni bond mutual funds were solidly negative, with the market fearing an onslaught of new tax-exempt issues that would be difficult to absorb. Credit spreads were historically wide, the media outlets abuzz about the need for states to have access to the federal bankruptcy code and investors pondered the prospect of rampant defaults and bankruptcies. At the time, fixed income investors were also generally wary of rapidly rising inflation and interest rates.

Just six months later, we see a much brighter picture. After 29 consecutive weeks of outflows, muni bond fund flows have been positive in four of the last six weeks. Interest rates generally, and municipal bond yields specifically, have declined and now appear well anchored by a slow US economic trajectory and ongoing concerns regarding a growing number of peripheral European countries (see Table 5, page 15). Inflation fears have also eased.

REVENUE GROWTH. The underlying fundamentals are improving, too. The Nelson Rockefeller Institute of Government recently reported five consecutive quarters of growth in state revenues, with the first two-thirds of the sixth quarter coming in positive as well. Of the 46 states in which fiscal 2012 began on July 1, all but one have budgets that are balanced and signed. Importantly, these budgets were balanced without the assistance of federal stimulus funds. In addition, that "avalanche" of tax-exempt supply the market had feared early in the year has not yet materialized; actual new-issue tax-exempt supply through June is lower by 29% on a year-over-year basis. Though the pace of new issues has picked up recently, the market has since largely embraced the improved supply.

So, what about those rampant defaults projected in "muni-Armageddon" scenarios? Between January and June, the number of defaults fell by more than 50% versus the first half of 2010. What's more, the dollar value of those defaults was well under $1 billion—in a $2.9 trillion market. In addition, state and local governments have indeed been making the difficult decisions to cut spending and/or raise revenues: State and local spending declined at an annualized pace of 3.3% during the first quarter of 2011, which followed a similar decline of 3.8% during the same period in 2010. Meanwhile, job reductions have numbered more than 580,000 since payrolls peaked in 2008.

STUBBORN SPREADS. What hasn't changed? Credit spreads remain stubbornly wide and have shown significant tightening only in recent weeks. However, we see this as an extended opportunity to acquire mid-A-rated and higher general-obligation bonds and essential-service revenue bonds. The downgrade cycle that we have warned about for more than a year remains in full force, and we expect it to continue for another 12 months. For this reason, we are not currently embracing lower-rated investment-grade debt, specifically mid-BBB-rated issues.

In the near term, the municipal market outlook appears stable amid robust bond redemptions and coupon payments. Relative value versus similar-maturity US Treasuries is also compelling and suggests that municipal bonds may soon begin to outperform. We expect all states and most local governments to continue to pay debt service in a timely fashion—noting that projected state deficits are expected to decline in coming years. ■

Table 5: The Decline in Tax-Exempt Yields

Municipal bond prices have climbed this year, resulting in lower yields. Some of the gains came from falling US Treasury yields, but prices were helped by investors' realization that state and local government finances were in better shape than they had thought back in January.

	Dec. 31	July 19	Change (basis points)
AAA			
Five Year	1.63	1.19	-0.44
10 Year	3.16	2.66	-0.50
20 Year	4.39	3.83	-0.56
30 Year	4.68	4.32	-0.36
AA			
Five Year	1.81	1.37	-0.44
10 Year	3.36	2.90	-0.46
20 Year	4.63	4.06	-0.57
30 Year	4.92	4.51	-0.41
A			
Five Year	2.46	2.02	-0.44
10 Year	4.10	3.59	-0.51
20 Year	5.23	4.74	-0.49
30 Year	5.42	5.10	-0.32
BBB			
Five Year	3.44	3.10	-0.34
10 Year	5.02	4.59	-0.43
20 Year	5.88	5.49	-0.39
30 Year	6.04	5.83	-0.21

Source: Thomson-Reuters Municipal Market Data as of July 19, 2011

Global Alternatives/ Absolute Return Investments Outlook

Commodities Correction Continues

Commodities posted a second consecutive monthly decline during June, with the Dow Jones-UBS Commodity Index, our benchmark, decreasing by about 5%. That puts the second-quarter decline in the index at nearly 7%, amid weaker-than-expected economic data. In addition, the approaching end of the Fed's second round of Quantitative Ease seemed to elicit an exodus of speculative demand. Over the past year, the index posted a solid gain of about 26%, but it still underperformed the global stock market benchmark (see Chart 12).

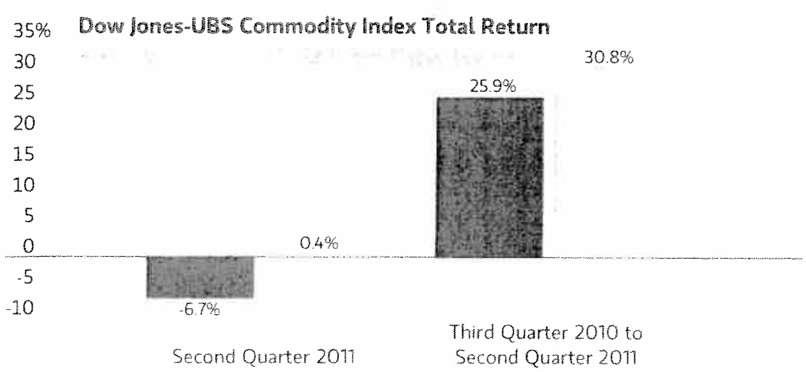
Despite the recent setback, we remain tactically overweight to commodities. We believe that the weaker-than-expected performance of the US and global economies during the second quarter will prove to be a temporary soft patch and that the pace of activity will pick up during the second half of the year. With the global economy generating a record-high level of output—with particular strength in the more manufacturing-intensive emerging economies—the underlying demand for most commodities is likely to remain strong.

WITHERING WHEAT. During June, the worst-performing sector was grains, which decreased nearly 12%; the best-performing sector was livestock, which increased by about 4%. Among individual commodities, the worst performer during June was wheat, which declined by about 25%; the best-performing individual commodity was sugar, which increased by some 18%. Such crosscurrents are not unusual, which is why we believe that most long-term investors will be better served if they use vehicles that provide broad-based exposure to the asset class, rather than those that target sectors or individual commodities.

Crude oil and gold continue to garner considerable attention. Hussein Allidina, head of commodity research at Morgan Stanley and a member of the Global Investment Committee, estimates the per-barrel price of Brent oil—the global benchmark—will average $120 this year and $130 during 2012. Currently, the price of Brent oil is about $116. He notes that robust demand from emerging economies is more than offsetting pockets of weakness among developed economies. Moreover, during the second half of this year, he expects OPEC production to turn up, reducing spare capacity. He believes such a backdrop skews the risk for prices to the upside. Not so for gold, Allidina notes, as he forecasts a price decline for the asset to follow the surge now underway. Allidina estimates that the per-ounce price of gold, which currently is about $1,600, will average $1,401 during 2011 and $1,330 during 2012.

Chart 12: Commodities Trail Global Equities

Weaker-than-expected economic data helped drive commodities prices down in the second quarter. On a trailing four quarters' basis, commodities were strong, but still fell shy of the total return for global equities.



Source: FactSet as of June 30, 2011

Hedge Fund Returns Go Flat

After a solid start to the year—with many hedge funds up 3% or more through April—many of those same funds gave back much of their gains in May and June, posting back-to-back losses. In June alone the HFRI Fund of Funds Composite Index lost 1.4%, with declines recorded in most major strategies; that brought the index's return to -0.2% for the first half of the year.

The best-performing major hedge fund style in June was relative value, with the HFRI Relative Value Index down just 0.2%. Positive contributions came from yield alternative and volatility exposure. These gains were only partially offset by losses in multistrategy credit funds and convertible-arbitrage strategies. Strategies focused on fixed income were affected by rising yields and widening credit spreads. Within mortgages, markets for nonagency, residential mortgage-backed securities faced significant selling pressure amid renewed concerns about broad housing fundamentals. Commercial mortgage-backed securities also suffered price deterioration.

A POOR MONTH FOR EQUITIES. June was a poor month for long/short equity hedge funds, as global markets suffered losses for the second straight month; the HFRI Equity Hedge Index declined 1.2%. Volatility edged higher, and every sector finished the month in the red. The worst-hit sector was financials, down 2.9%; consumer staples, which is typically defensive, fell nearly as much.

down 2.8%. Another surprise was that the best-performing sector was consumer discretionary, which lost just 0.3%.

Event-driven strategies were also affected by weak equity and credit markets. The HFRI Event Driven Index declined 1.0% in June. Losses came from postreorganization equities, distressed mortgage-backed securities and European financial-credit positions. Despite robust technology initial public offerings and mergers and acquisitions (M&A) activity, widening deal spreads had a negative impact on M&A exposure. Long/short credit funds withstood the market volatility better than the more long-biased distressed funds, benefiting from lower net exposure, gains from selective short positions and market-volatility trading.

REVERSALS HURT RETURNS. The HFRI Macro Index had the toughest month, declining 1.8% as macro managers extended their losses from May. Systematic trend-following strategies were affected by sharp reversals in the equity, commodity and currency markets; the HFRI Systematic Diversified Index posted a 2.3% decline for June. Exposures in long metals and soft commodities also declined, while currency positioning experienced significant volatility during the month, generating losses across both macro discretionary and currency strategies. Emerging market macro funds saw mixed results, largely driven by their ability to capitalize on a late rally, following the approval of additional financial aid to Greece.

SECOND-HALF OPPORTUNITIES. Looking forward, the current economic climate presents opportunities as well as challenges. First, the timing appears ripe for investors to shift from longer-biased managers to long/short managers in the credit space. In particular, long/short credit managers appear well positioned to navigate the micro-versus-macro tug-of-war, which has the potential to elevate credit market volatility in the near-to-medium term.

Largely positive micro factors in the credit markets include average bond prices that exceed par, a trailing 12-month default rate that is below its long-term average and global new-issue volume in the high yield market last year that surpassed historical annual records, according to Bank of America Merrill Lynch. On the other hand, the macro picture is relatively negative, facing escalating European sovereign risk, rising borrowing costs for US state governments and, depending on the outcome of the debt-ceiling battle in Washington, higher federal borrowing costs. All of this suggests that the best place to be among hedge fund credit strategies may be long/short credit; we see abundant opportunities for long/short managers who have superior security-selection skills and the flexibility to invest across the entire capital structure.

We also see opportunities among long/short equity managers. In this environment, fundamental stock picking becomes more important than trading on momentum. Specifically, there has been a material decline in cross-market equity correlations since the third quarter of 2010, even with the recent uptick in market volatility. If this trend continues, the importance of stock picking, industry selection and quantitative-strategy model performance should increase relative to broad macro calls.

This is not to say that investors should ignore the macro environment; it is simply our view that the best way to manage, and even profit from, macro uncertainty is through a well diversified global macro allocation. Since late 2008 and early 2009, volatility has declined across asset classes. That said, central-bank policies continue to diverge as each region faces its own set of economic issues and priorities. This divergence may reverse the downward trend in volatility, particularly in the fixed income and foreign exchange markets. ■

Global Investment Committee Asset Allocation Models

The Global Investment Committee (GIC) is made up of senior professionals from Morgan Stanley Research, Morgan Stanley Smith Barney, Citi Investment Research & Analysis and outside financial market experts. The committee provides guidance on investment allocation decisions through the creation and maintenance of various model portfolios.

The GIC's Asset Allocation Models shown on the following pages represent its best thinking on strategic and tactical asset allocation. In these portfolios, the strategic equity allocations are in proportion to their share of global market capitalization based on the MSCI All Country World Investable Market Index. As such, the strategic allocation to non-US stocks is more than 50% of the total equity allocation.

There are three sets of models designed to provide guidance for investors with less than $1 million (Level 1), between $1 million and $20 million (Level 2) and more than $20 million in investable assets (Level 3). Accordingly, the portfolio sets have varying levels of allocations to traditional asset classes, liquid alternative investments and illiquid investments. The GIC constructs each set of portfolios on a scale of increasing risk—that is, expected volatility—and expected return. Each set consists of eight risk-tolerance levels. In each case, model 1 is the least risky and is composed mostly of bonds. As the model numbers increase, the models introduce higher allocations to equities and thus, become riskier. Alternative/absolute return investments are present in all models and provide increased asset-class diversification.

The GIC has also created and maintains strategic and tactical allocations for several other model portfolios used in various advisory programs. Most of these model portfolios incorporate a home-country bias toward the US. Under this subjective constraint, the strategic equity allocations have a 70%/30% split between US and non-US markets, and the strategic fixed income allocations have an 80%/20% split.

Global Investment Committee Asset Allocation Models for Investors With Less Than $1 Million in Investable Assets (Level 1)

Tactical Changes Effective July 8, 2011

	Global Bonds and Inflation-linked Securities		Global Bonds, Global Equities and Alternative/Absolute Return Investments										Global Equities and Alternative/Absolute Return Investments			
Model Portfolios	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Global Cash	30%	28%	15%	13%	10%	8%	8%	6%	5%	3%	3%	1%	-	-	-	-
Global Bonds																
Investment Grade	60	63	55	46	42	32	30	20	21	11	6	2	-	-	-	-
Short Duration	15	12	15	13	10	8	7	5	5	3	2	0	-	-	-	-
Government/ Government-Related	29	23	25	16	21	11	15	5	10	0	2	0	-	-	-	-
Corporate & Securitized	16	28	15	17	11	13	8	10	6	8	2	2	-	-	-	-
High Yield	-	-	2	4	3	5	5	7	6	8	8	8	-	-	-	-
Emerging Markets	-	-	-	-	2	3	4	5	5	6	6	3	-	-	-	-
Total Bonds	**60**	**63**	**57**	**50**	**47**	**40**	**39**	**32**	**32**	**25**	**20**	**13**	**-**	**-**	**-**	**-**
Total Cash & Short Duration Bonds	45	40	30	26	20	16	15	11	10	6	5	1	-	-	-	-
Global Equities																
US Large	-	-	6	10	12	16	16	20	18	23	22	28	30	33	24	27
Growth	-	-	3	6	6	10	8	12	9	14	11	17	15	20	12	16
Value	-	-	3	4	6	6	8	8	9	9	11	11	15	13	12	11
US Mid	-	-	2	3	2	3	2	3	4	5	4	5	4	4	4	4
Growth	-	-	1	2	1	2	1	2	2	3	2	3	2	2	2	2
Value	-	-	1	1	1	1	1	1	2	2	2	2	2	2	2	2
Canada	-	-	1	1	1	1	2	2	2	2	2	2	3	3	3	3
Europe	-	-	4	2	9	5	10	6	12	7	15	9	21	13	18	9
Europe ex UK	-	-	3	1	6	2	7	3	8	3	10	5	14	7	12	5
UK	-	-	1	1	3	3	3	3	4	4	5	4	7	6	6	4
Developed Asia	-	-	3	1	4	1	6	2	7	2	9	3	12	4	11	4
Japan	-	-	2	0	3	0	4	0	5	0	6	0	8	0	7	0
Asia Pacific ex Japan	-	-	1	1	1	1	2	2	2	2	3	3	4	4	4	4
US Small	-	-	2	3	2	3	2	3	2	3	4	5	4	4	6	6
Growth	-	-	1	2	1	2	1	2	1	2	2	3	2	2	3	4
Value	-	-	1	1	1	1	1	1	1	1	2	2	2	2	3	2
World ex US Small	-	-	1	2	2	3	2	3	3	4	4	5	5	5	8	8
Emerging Markets	-	-	2	5	4	10	5	12	6	14	8	17	11	20	16	25
Total Equity	**-**	**-**	**21**	**27**	**36**	**42**	**45**	**51**	**54**	**60**	**68**	**74**	**90**	**86**	**90**	**86**
Total US Equity	-	-	10	16	16	22	20	26	24	31	30	38	38	41	34	37
Total Developed ex US Equity	-	-	9	6	16	10	20	13	24	15	30	19	41	25	40	24
Total Developed Market Equity	-	-	19	22	32	32	40	39	48	46	60	57	79	66	74	61
Total Emerging Market Equity	-	-	2	5	4	10	5	12	6	14	8	17	11	20	16	25
Global Alternative/Absolute Return Investments																
REITs	-	-	2	3	2	3	3	4	4	5	4	5	5	6	5	6
Commodities	-	-	2	5	2	5	2	5	2	5	3	6	5	8	5	8
Inflation-Linked Securities	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
Managed Futures	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Hedge Funds	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Real Estate	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Alternative/ Absolute Return Investments	**10**	**9**	**7**	**10**	**7**	**10**	**8**	**11**	**9**	**12**	**9**	**12**	**10**	**14**	**10**	**14**

Global Investment Committee Asset Allocation Models for Investors With $1 Million to $20 Million in Investable Assets (Level 2)

Tactical Changes Effective July 8, 2011

Model Portfolios	Global Bonds and Inflation-linked Securities		Global Bonds, Global Equities and Alternative/Absolute Return Investments										Global Equities and Alternative/Absolute Return Investments			
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Global Cash	25%	23%	13%	11%	8%	6%	5%	3%	3%	1%	2%	0%	-	-	-	-
Global Bonds																
Investment Grade	65	68	55	46	40	30	30	20	20	10	6	1	-	-	-	-
Short Duration	15	12	12	10	7	5	5	3	2	0	3	0	-	-	-	-
Government/ Government-Related	32	26	28	19	21	11	16	6	12	2	2	0	-	-	-	-
Corporate & Securitized	18	30	15	17	12	14	9	11	6	8	1	1	-	-	-	-
High Yield	-	-	2	4	3	5	4	6	5	7	6	6	-	-	-	-
Emerging Markets	-	-	-	-	2	3	3	4	4	5	4	2	-	-	-	-
Total Bonds	**65**	**68**	**57**	**50**	**45**	**38**	**37**	**30**	**29**	**22**	**16**	**9**	**-**	**-**	**-**	**-**
Total Cash & Short Duration Bonds	40	35	25	21	15	11	10	6	5	1	5	0	-	-	-	-
Global Equities																
US Large	-	-	6	11	8	11	12	17	14	18	18	24	24	26	20	22
Growth	-	-	3	7	4	7	6	10	7	11	9	14	12	16	10	13
Value	-	-	3	4	4	4	6	7	7	7	9	10	12	10	10	9
US Mid	-	-	-	-	2	3	2	3	4	5	4	5	4	4	4	4
Growth	-	-	-	-	1	2	1	2	2	3	2	3	2	2	2	2
Value	-	-	-	-	1	1	1	1	2	2	2	2	2	2	2	2
Canada	-	-	1	1	1	1	1	1	1	1	2	2	3	3	2	2
Europe	-	-	4	2	6	4	8	4	10	6	13	8	17	10	15	6
Europe ex UK	-	-	3	1	4	2	5	2	7	3	9	4	11	6	10	3
UK	-	-	1	1	2	2	3	2	3	3	4	4	6	4	5	3
Developed Asia	-	-	2	1	4	1	4	1	6	2	7	2	10	3	7	2
Japan	-	-	1	0	3	0	3	0	4	0	5	0	7	0	5	0
Asia Pacific ex Japan	-	-	1	1	1	1	1	1	2	2	2	2	3	3	2	2
US Small	-	-	-	-	2	3	2	3	2	3	4	5	4	4	6	6
Growth	-	-	-	-	1	2	1	2	1	2	2	3	2	2	3	4
Value	-	-	-	-	1	1	1	1	1	1	2	2	2	2	3	2
World ex US Small	-	-	1	2	2	2	2	2	2	3	3	3	4	4	7	7
Emerging Markets	-	-	2	5	3	9	4	10	5	12	7	15	9	17	14	22
Total Equity	**-**	**-**	**16**	**22**	**28**	**34**	**35**	**41**	**44**	**50**	**58**	**64**	**75**	**71**	**75**	**71**
Total US Equity	-	-	6	11	12	17	16	23	20	26	26	34	32	34	30	32
Total Developed ex US Equity	-	-	8	6	13	8	15	8	19	12	25	15	34	20	31	17
Total Developed Market Equity	-	-	14	17	25	25	31	31	39	38	51	49	66	54	61	49
Total Emerging Market Equity	-	-	2	5	3	9	4	10	5	12	7	15	9	17	14	22
Global Alternative/Absolute Return Investments																
REITs	-	-	2	3	2	3	3	4	4	5	4	5	5	6	5	6
Commodities	-	-	2	5	2	5	2	5	2	5	3	6	5	8	5	8
Inflation-Linked Securities	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
Managed Futures	-	-	2	2	4	4	4	4	4	4	5	5	5	5	5	5
Hedge Funds	-	-	5	5	8	8	11	11	11	11	10	10	10	10	10	10
Private Real Estate	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Private Equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total Alternative/ Absolute Return Investments	**10**	**9**	**14**	**17**	**19**	**22**	**23**	**26**	**24**	**27**	**24**	**27**	**25**	**29**	**25**	**29**

Global Investment Committee Asset Allocation Models for Investors With $20 Million or More in Investable Assets (Level 3)

Tactical Changes Effective July 8, 2011

Model Portfolios	Global Bonds and Inflation-linked Securities		Global Bonds, Global Equities and Alternative/Absolute Return Investments										Global Equities and Alternative/Absolute Return Investments			
	Model 1		Model 2		Model 3		Model 4		Model 5		Model 6		Model 7		Model 8	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Global Cash	25%	23%	13%	11%	8%	6%	5%	3%	3%	1%	2%	0%	-	-	-	-
Global Bonds																
Investment Grade	65	68	55	46	40	30	30	20	20	10	6	1	-	-	-	-
Short Duration	10	7	7	5	7	5	5	3	2	0	3	0	-	-	-	-
Government/ Government-Related	33	27	30	21	21	11	16	6	12	2	2	0	-	-	-	-
Corporate & Securitized	22	34	18	20	12	14	9	11	6	8	1	1	-	-	-	-
High Yield	-	-	2	4	3	5	4	6	5	7	6	6	-	-	-	-
Emerging Markets	-	-	-	-	2	3	3	4	4	5	4	2	-	-	-	-
Total Bonds	**65**	**68**	**57**	**50**	**45**	**38**	**37**	**30**	**29**	**22**	**16**	**9**	-	-	-	-
Total Cash & Short Duration Bonds	35	30	20	16	15	11	10	6	5	1	5	0	-	-	-	-
Global Equities																
US Large	-	-	6	11	8	12	10	14	14	18	18	24	22	24	18	20
Growth	-	-	3	7	4	7	5	8	7	11	9	14	11	14	9	12
Value	-	-	3	4	4	5	5	6	7	7	9	10	11	10	9	8
US Mid	-	-	-	-	2	2	2	3	2	3	4	5	4	4	4	4
Growth	-	-	-	-	1	1	1	2	1	2	2	3	2	2	2	2
Value	-	-	-	-	1	1	1	1	1	1	2	2	2	2	2	2
Canada	-	-	1	1	1	1	1	1	1	1	2	2	3	3	2	2
Europe	-	-	4	3	6	4	7	4	9	5	12	7	16	8	13	4
Europe ex UK	-	-	3	2	4	2	5	2	6	2	8	3	11	4	9	2
UK	-	-	1	1	2	2	2	2	3	3	4	4	5	4	4	2
Developed Asia	-	-	2	1	3	1	4	1	5	2	7	2	9	3	7	2
Japan	-	-	1	0	2	0	3	0	3	0	5	0	6	0	5	0
Asia Pacific ex Japan	-	-	1	1	1	1	1	1	2	2	2	2	3	3	2	2
US Small	-	-	-	-	2	2	2	3	2	3	2	3	4	4	6	6
Growth	-	-	-	-	1	1	1	2	1	2	1	2	2	2	3	4
Value	-	-	-	-	1	1	1	1	1	1	1	1	2	2	3	2
World ex US Small	-	-	1	2	1	2	2	3	2	3	3	3	4	4	7	7
Emerging Markets	-	-	2	4	3	8	4	9	5	11	6	14	8	16	13	21
Total Equity	-	-	**16**	**22**	**26**	**32**	**32**	**38**	**40**	**46**	**54**	**60**	**70**	**66**	**70**	**66**
Total US Equity	-	-	6	11	12	16	14	20	18	24	24	32	30	32	28	30
Total Developed ex US Equity	-	-	8	7	11	8	14	9	17	11	24	14	32	18	29	15
Total Developed Market Equity	-	-	14	18	23	24	28	29	35	35	48	46	62	50	57	45
Total Emerging Market Equity	-	-	2	4	3	8	4	9	5	11	6	14	8	16	13	21
Global Alternative/Absolute Return Investments																
REITs	-	-	2	3	2	3	3	4	2	3	2	3	2	3	2	3
Commodities	-	-	2	5	2	5	2	5	2	5	3	6	5	8	5	8
Inflation-Linked Securities	10	9	3	2	3	2	3	2	3	2	2	1	-	-	-	-
Managed Futures	-	-	2	2	4	4	4	4	4	4	5	5	5	5	5	5
Hedge Funds	-	-	5	5	8	8	11	11	11	11	10	10	10	10	10	10
Private Real Estate	-	-	-	-	-	-	-	-	2	2	2	2	3	3	3	3
Private Equity	-	-	-	-	2	2	3	3	4	4	4	4	5	5	5	5
Total Alternative/ Absolute Return Investments	**10**	**9**	**14**	**17**	**21**	**24**	**26**	**29**	**28**	**31**	**28**	**31**	**30**	**34**	**30**	**34**

Endnotes

1. The strategic allocation refers to the long-term investment weightings for the major asset classes that best fit an investor's specific circumstances, a risk profile including their ability and willingness to tolerate risk, and return objectives, and that take into account the asset returns, standard deviations of returns, and correlations of returns under varying economic and financial conditions.

2. The tactical allocation incorporates active decisions to overweight or to underweight asset classes in the near-term relative to their strategic allocation based on: (i) the current and projected financial and economic environment; (ii) evaluations of risk in global asset markets; and (iii) other fundamental, valuation, and psychological, technical, liquidity factors.

3. The eight portfolios displayed in the accompanying matrix are arranged from left to right in a general progression from conservative through moderate to aggressive risk profiles.

4. A conservative asset allocation risk profile tends to encompass: (i) relatively lower, or in some cases zero, levels of exposure to equities and to investments outside the investor's home country and currency; and (ii) relatively higher levels of exposure to cash, fixed income, and investments inside the investor's home country and currency. A conservative asset allocation risk profile style may generally be expected to exhibit lower price volatility as measured by the standard deviations of annual returns from the portfolio and generally seeks to generate a somewhat greater proportion of its returns from income as compared with capital gains.

5. A moderate asset allocation risk profile tends to encompass: (i) relatively moderate levels of exposure to equities and to investments outside the investor's home country and currency; and (ii) relatively moderate levels of exposure to cash, to fixed income and investments inside the investor's home country, and to currency. A moderate asset allocation risk profile may generally be expected to exhibit moderate price volatility as measured by the standard deviations of annual returns from the portfolio and generally seeks to generate a somewhat balanced proportion of its returns from income as well as from capital gains.

6. An aggressive asset allocation risk profile tends to encompass: (i) relatively higher levels of exposure to equities and to investments outside the investor's home country and currency; and (ii) relatively lower, or in come cases zero, levels of exposure to cash, to fixed income and investments inside the investor's home country, and to currency. An aggressive asset allocation risk profile may generally be expected to exhibit higher price volatility as measured by the standard deviations of annual returns from the portfolio and generally seeks to generate a somewhat lower proportion of its returns from income as compared with capital gains.

7. The cash/cash equivalent asset class may include US dollar-based short-term investments as well as non-US dollar-based short-term investments, and/or Exchange-Traded Funds (ETFs) or other instruments dedicated to US and/or to non-US cash and cash equivalents. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

8. Fixed income holdings may be either taxable or tax exempt, depending on the instrument and/or the investor's current and future tax status. As a matter of practice, many investors tend to hold certain types of investments in their taxable accounts, such as: (i) tax-exempt municipal bonds; and (ii) assets that generate a significant proportion of their total return from long-term capital gains. Similarly, many investors tend to hold certain other types of investments in their tax-deferred, tax-exempt, or low-tax accounts, such as: (i) taxable bonds; (ii) assets that generate a significant proportion of their total return in the form of dividends, taxable interest income, accredited income and/or short-term trading profits. It may thus be helpful for investors to mentally and/or computationally combine the assets held in their taxable and their tax-exempt accounts to gain perspective on the overall asset allocation of their investments.

9. Duration is a measure of the average cash-weighted term-to-maturity of a bond. It is a frequently used measure of the sensitivity of a bond's price and the present value of its cash flows relative to interest rate movements. The specific desired duration of investment grade, high yield and emerging markets bond holdings will usually be influenced by the investor's interest rate expectations. In a rising interest rate environment, investors may choose to generally shorten the duration of their fixed income holdings, and in a falling interest rate environment, investors may choose to generally lengthen the duration of their fixed income holdings.

10. Depending on the interest rate environment and other factors, certain fixed income securities, such as preferred stocks and convertible securities trading near their bond equivalent value, may be included within the fixed income asset category.

11. Global investment grade bonds include: (i) US dollar denominated or non-US dollar denominated US Treasury securities; (ii) US dollar denominated or non-US dollar denominated US Federal Agency and other Government-related securities; (iii) many US dollar denominated or non-US dollar denominated securitized and/or mortgage-backed securities carrying investment grade quality ratings from the major credit rating services; (iv) US dollar denominated or non-US dollar denominated corporate and/or municipal bonds carrying investment grade quality ratings from the major credit rating services; and (v) certain other US dollar denominated or non-US dollar denominated instruments. For tax-related and/or other reasons, some investors may implement their investment grade bond exposure through tax-exempt securities. In periods of deteriorating credit conditions, investors may choose to improve the credit quality of their bond holdings by focusing on higher-rated sectors of the global investment grade bond universe, and in periods of improving credit market conditions, investors may choose to lessen the credit quality of their bond holdings by focusing on a broader range of credit ratings, possibly including lower-rated issues, within the global investment grade bond universe. Non-US dollar Fixed Income Securities holdings are considered to be hedged into US dollars, unless otherwise noted. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

12. Short duration investment grade bonds are considered here to be fixed income instruments with a Moody's/Standard & Poor's credit quality rating of Baa3/BBB- or higher with duration of two years or less. Duration is a measure of the average cash-weighted term to maturity of a bond and is a frequently used measure of the sensitivity of a bond's price and the present value of its cash flow relative to interest rate movements.

13. Certain equity industry groups and their specific component companies may entail exposure to the forces and factors affecting alternative/absolute return investments, including: (i) real estate; (ii) commodities (including energy, agriculturals, base metals,

and precious metals); and (iii) direct ownership in timber and/or oil and gas properties. Such equity industry groups may be possibly considered with and included within the equity asset category.

14. For investors with investable assets greater than $1 million, the absolute equity weighting, as well as the relative degree of tactical versus strategic equity exposure, may be somewhat lower than total equity weightings for those investors with investable assets of less than $1 million. This is primarily due to the greater degree of accessibility that investors with investable assets greater than $1 million may have to the alternative/absolute return investments asset classes, which tend to be characterized by high investment minimums, possibly lower liquidity, and special capital entry and exit provisions.

15. Currency exposure for the non-US equity and non-US alternative/absolute return investments asset classes is generally not hedged into US dollars unless otherwise noted. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

16. As an alternative to investing in specific non-US countries, investment styles, market capitalization levels and companies, investors with investable assets of less than $1 million may choose to implement non-US equity asset class exposure through investment vehicles linked to a non-US broad market index. In a rising US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be lower than US dollar returns. In a falling US dollar environment, the return to US dollar-based investors from unhedged non-US dollar investments will be higher than US dollar returns.

17. For some investors, small percentage allocations to certain asset classes may entail inefficient considerations of cost, monitoring and liquidity; in such cases, investors may choose to aggregate these small-percentage allocations with similar asset classes within the same asset category.

18. The alternative/absolute return investments asset category is considered here to include asset classes that tend to respond to a range of influences in addition to and/or instead of the fundamental underlying forces such as interest rates, economic conditions, and corporate profitability affecting equities, fixed income securities, and cash asset categories. Such influences include: (i) supply-demand considerations for the underlying asset(s); (ii) investor preferences relating to store-of-value considerations; (iii) unconventional investment techniques involving short selling, the borrowing or lending of securities and/or investment capital; (iv) the use of swaps, options, futures and other derivatives; and/or (v) investment manager skill. Within an asset allocation context, alternative/absolute return investments are intended to provide some degree of exposure to returns and standard deviations of returns that tend generally not to be highly correlated with the investment performance of the equity, fixed income and cash asset categories. Due to the fact that many alternative/absolute return investments may have, compared to conventional asset classes: (i) less liquidity; (ii) higher investment vehicle minimums; (iii) unconventional frequency and methodology of pricing; (iv) extended investment timeframes and/or lockup periods; (v) unusual risk/reward profiles; (vi) less predictable timing for capital inflows and outflows; (vii) higher fee structures; (viii) greater or fewer regulatory, tax reporting, and/or compliance requirements; and (ix) more leverage, investors should consider the asset allocations set forth here in light of: (a) their own specific circumstances, risk profile including their ability and willingness to tolerate risk, and return objectives; (b) their short-term and long-term investment outlook; and (c) the universe of investments that are suitable for and appropriate to their investment temperament and wealth level.

19. Owing to the characteristics of alternative/absolute return investments, many asset classes within this asset category may not be available to investors at all wealth levels. Asset classes that may generally be unavailable to certain investor wealth levels because of minimum investor asset requirements and/or minimum instrument purchase requirements have blank percentage allocation weightings.

20. The global real estate investment trust (REIT) asset class, which tends toward investment exposure to commercial real estate properties (including, but not limited to, office buildings, apartment buildings, hotels and shopping centers), may also include publicly traded companies engaged in the ownership, development and/or management of real estate, and is considered here to exclude an investor's primary residence(s).

21. Real estate investment exposure may be achieved through private equity real estate interests. The private equity real estate asset class may involve special investment considerations, including: (i) investor net asset minimum criteria; (ii) investment vehicle entry and exit conditions; (iii) regulatory, tax reporting and/or compliance requirements; (iv) suitability guidelines; and (v) other risk factors.

22. The commodities asset class is considered here to include precious metals, base metals, agriculturals, energy and/or partnership or direct ownership interests in oil-, gas- and timber-related properties. Commodities exposure may also be implemented through holdings of Equity securities of precious metals-, base metals-, agricultural-, energy- and/or oil-, gas- and timber-related companies.

23. The US Treasury form of inflation-linked securities (known as Treasury Inflation-Protected Securities, or TIPS) is generally exempt from state and local income taxes. Each semiannual interest payment, including: (i) the coupon; and (ii) the accrued inflation adjustment amount, is subject to federal taxes on ordinary income each year. Ordinary income taxes are due on the inflation adjustments of the principal component of the security, even though the inflation adjustment portion is not realized until maturity or until the security is sold. The taxation of this "phantom income" may cause a misalignment between the investor's tax liabilities and actual cash coupon payments received from the investment. Morgan Stanley Smith Barney does not offer tax advice for investors. Investors should consult their tax counsel for specific advice regarding tax matters. Investment exposure to US or to non-US inflation-linked securities can be implemented on an individual instrument basis and/or through Exchange-Traded Funds (ETFs) specializing in such assets.

24. The private equity asset class is considered here to include several subcategories, such as: (i) leveraged buyout and management buyout activity; (ii) direct ownership of equity stakes in privately held firms; and (iii) venture capital investing. For the private equity asset class, special investment considerations may include: (i) investor net asset minimum criteria; (ii) investment vehicle entry and exit conditions; (iii) regulatory, tax reporting and/or compliance requirements; (iv) suitability guidelines; and (v) other risk factors that may vary by private equity subcategory.

25. For the managed futures funds asset class, special investment considerations include: (i) investor net asset minimum criteria; (ii) manager fees; and (iii) regulatory, tax reporting and/or compliance requirements. Managed futures funds may not be appropriate for all investors. In view of the relatively high standard deviations of returns that may be associated with any single managed futures manager, investors may choose to implement their allocations to managed futures funds using a managed futures fund of funds approach and/or a broadly diversified group of managed futures managers and strategies.

26. For the hedge funds asset class including hedge funds of funds, special investment considerations may include: (i) investor net asset minimum criteria; (ii) investment vehicle entry and exit conditions; (iii) regulatory, tax reporting and/or compliance requirements; (iv) suitability guidelines; and (v) other risk factors that may vary by investor category. Hedge funds or hedge funds of funds may not be suitable for all investors. In view of the potentially high standard deviations of returns that may be associated with any single hedge funds manager, investors may choose to implement their allocations to hedge funds using a fund of funds approach and/or a broadly diversified group of hedge fund managers and strategies. As a result of an additional layer of fees, funds of funds generally have higher fee structures than single hedge fund manager strategies.

Index Definitions

STANDARD & POOR'S 500 INDEX Widely regarded as the best single gauge of the US equities market, this capitalization-weighted index includes a representative sample of 500 leading companies in leading industries of the US economy.

MSCI ALL COUNTRY WORLD INDEX This free-float-adjusted market-capitalization index is designed to measure equity market performance in the developed and emerging markets.

RUSSELL TOP 200 INDEX This index measures the performance of the largest-cap segment of the US equity universe. It represents approximately 63% of the total market capitalization of the Russell 1000 companies.

RUSSELL MIDCAP INDEX This index includes the 800 smallest companies in the Russell 1000 index. It represents approximately 27% of the total market capitalization of the Russell 1000 companies.

RUSSELL 2000 INDEX This index measures the performance of the small-cap segment of the US equity universe. The companies in this index represent approximately 8% of the total market capitalization of that index.

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

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

MSCI EMERGING MARKETS INDEX This is a free-float-adjusted market-capitalization index designed to measure equity market performance in the global emerging markets.

MSCI ALL COUNTRY ASIA EX JAPAN INDEX This is a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of equities in China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

BARCLAYS CAPITAL US AGGREGATE CORPORATE INVESTMENT GRADE INDEX This index represents securities that are investment grade, SEC-registered, taxable and dollar denominated.

BARCLAYS CAPITAL US AGGREGATE CORPORATE HIGH YIELD INDEX The index includes publicly issued US-dollar-denominated non-investment grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year, are rated high yield using the middle rating of Moody's, S&P and Fitch, respectively, and have $600 million or more of outstanding face value.

BARCLAYS CAPITAL EMERGING MARKETS BOND INDEX This index provides a broad-based measure of the market for sovereign bonds issued by emerging market governments. The bonds in this index are denominated in US dollars.

DOW JONES-UBS COMMODITY INDEX This index comprises futures contracts on 19 physical commodities. These include energy, industrial metals, precious metals and agricultural commodities.

HFRI FUND OF FUNDS COMPOSITE INDEX This is an equal-weighted index of 650 hedge funds with at least $50 million in assets and 12-months of returns. Returns are reported in US dollars and are net of fees.

HFRI RELATIVE VALUE INDEX This index tracks managers that maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types.

HFRI EQUITY HEDGE INDEX Equity hedge strategies maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios.

HFRI EVENT DRIVEN INDEX Investment managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments.

HFRI MACRO INDEX Investment managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges security issuance or other capital structure adjustments.

HFRI SYSTEMATIC DIVERSIFIED INDEX Systematic diversified strategies have investment processes typically as function of mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies.

Disclosures

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. This is not a research report and was not prepared by the Research Departments of Morgan Stanley LLC or Citigroup Global Markets Inc. The views and opinions contained in this material are those of the author(s) and may differ materially from the views and opinions of others at Morgan Stanley Smith Barney LLC or any of its affiliate companies. Past performance is not necessarily a guide to future performance. Please refer to important information, disclosures and qualifications at the end of this material.

The author(s) (if any authors are noted) principally responsible for the preparation of this material receive compensation based upon various factors, including quality and accuracy of their work, firm revenues (including trading and capital markets revenues), client feedback and competitive factors. Morgan Stanley Smith Barney is involved in many businesses that may relate to companies, securities or instruments mentioned in this material.

This material has been prepared for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security/instrument, or to participate in any trading strategy. Any such offer would be made only after a prospective investor had completed its own independent investigation of the securities, instruments or transactions, and received all information it required to make its own investment decision, including, where applicable, a review of any offering circular or memorandum describing such security or instrument. That information would contain material information not contained herein and to which prospective participants are referred. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. We make no representation or warranty with respect to the accuracy or completeness of this material. Morgan Stanley Smith Barney has no obligation to provide updated information on the securities/instruments mentioned herein.

The securities/instruments discussed in this material may not be suitable for all investors. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Morgan Stanley Smith Barney recommends that investors independently evaluate specific investments and strategies, and encourages investors to seek the advice of a financial advisor. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities/instruments prices, market indexes, operational or financial conditions of companies and other issuers or other factors. Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Morgan Stanley Smith Barney does not represent that any such assumptions will reflect actual future events. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein.

This material should not be viewed as advice or recommendations with respect to asset allocation or any particular investment. This information is not intended to, and should not, form a primary basis for any investment decisions that you may make. Morgan Stanley Smith Barney is not acting as a fiduciary under either the Employee Retirement Income Security Act of 1974, as amended or under section 4975 of the Internal Revenue Code of 1986 as amended in providing this material.

Morgan Stanley Smith Barney and its affiliates do not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used or relied upon by any recipient, for any purpose, including the purpose of avoiding penalties that may be imposed on the taxpayer under US federal tax laws. Each client should consult his/her personal tax and/or legal advisor to learn about any potential tax or other implications that may result from acting on a particular recommendation.

International investing entails greater risk, as well as greater potential rewards compared to US 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, 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.

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.

A taxable equivalent yield is only one of many factors that should be considered when making an investment decision. Morgan Stanley Smith Barney and its Financial Advisors do not offer tax advice; investors should consult their tax advisors before making any tax-related investment decisions.

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 US Treasuries in times of low inflation.

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.

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.

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.

Certain securities referred to in this material may not have been registered under the US Securities Act of 1933, as amended, and, if not, may not be offered or sold absent an exemption therefrom. Recipients are required to comply with any legal or contractual restrictions on their purchase, holding, sale, exercise of rights or performance of obligations under any securities/instruments transaction.

Investing in foreign emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks.

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.

Past performance is no guarantee of future results. Estimates of future performance are based on assumptions that may not be realized. This material is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy.

This material is disseminated in Australia to "retail clients" within the meaning of the Australian Corporations Act by Morgan Stanley Smith Barney Australia Pty Ltd (A.B.N. 19 009 145 555, holder of Australian financial services license No. 240813).

Morgan Stanley Smith Barney is not incorporated under the People's Republic of China ("PRC") law and the research in relation to this report is conducted outside the PRC. This report will be distributed only upon request of a specific recipient. This report does not constitute an offer to sell or the solicitation of an offer to buy any securities in the PRC. PRC investors must have the relevant qualifications to invest in such securities and must be responsible for obtaining all relevant approvals, licenses, verifications and or registrations from PRC's relevant governmental authorities.

Morgan Stanley Private Wealth Management Ltd, which is authorized and regulated by the Financial Services Authority, approves for the purpose of section 21 of the Financial Services and Markets Act 2000, content for distribution in the United Kingdom.

Morgan Stanley Smith Barney is not acting as a municipal advisor and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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

Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

MSSB6800747 07/11