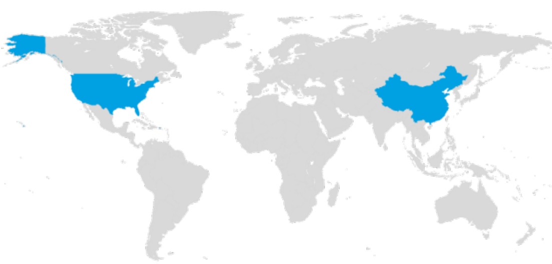
Geo-Markets

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

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



Market Risk Outlook

Rank	Topic
1	Trade
2	Europe's Fiscal Dilemma
3	Latin America Elections
4	Defense and Cyber
5	US Midterm Elections
6	North Korea
7	Emerging Markets
8	Energy
9	Iran
10	Tech Regulation

A Guide to China's Asymmetric Trade Response

China will be left with no real reciprocal trade options should the US impose additional tariffs, and investors should understand alternate policy moves.

Current tariff rates do not directly threaten global growth, but the potential ancillary effects are starting to weigh on markets. The math is relatively straightforward, though keeping tabs has not proven simple. In 2017, the US imported $506 billion from China and China imported $155 billion from the US. The US now has tariffs on $34 billion of imports and China has placed tariffs on an equal $34 billion of US imports. Imposing a 25% tariff on all traded goods would come to $165 billion, small considering the two countries together have a $33.5 trillion economy. The Global Investment Committee has expressed concerns about ancillary or second-order effects on business investment and animal spirits, which can create economic drag.

China cannot reciprocally match $200 billion of proposed US tariffs given its total imports of $155 billion, but it could impose costs on the US through other channels. China has threatened additional $80 billion tariffs should the US move forward with the proposed $200 billion. That would leave $41 billion left and China facing a net tariff differential of $120 billion. China might not choose to impose additional tariffs on tech equipment, but could opt for influencing the US by a range of asymmetric measures. We identify six: devaluing the currency to improve exports; selling US Treasuries to spike bond yields; targeting cross-border mergers, acquisitions and joint ventures in China; using health and safety regulation to hold up US goods on the docks; stepped-up cyberattacks; and a targeted campaign of compromising intellectual property. Others include moves on North Korea or South China Sea.

Selling US dollars or Treasuries would have the most immediate market impact, but cyberattacks or stepped-up intellectual property theft might draw the most severe US response. The renminbi weakened 8% since the start of the trade spats, with some evidence suggesting that Chinese banks intervened to slow the decline. Removal of accommodation would send the currency lower. China also owns 19% of US Treasuries, a potential source of interest rate volatility.

Topic	Commentary	Conclusion
Trade	China and US trade dispute continues (see page 1). Elsewhere, Europe hinted at reducing tariffs on US cars, which would be a serious concession to the White House. The move would avoid potential tariffs on $200 billion in cars and parts, possibly increasing the cost of foreign cars by an average of $6,000. NAFTA negotiations received a bilateral nod between Mexico and the US, as President-Elect Andrés Manuel López Obrador indicated his preference for a speedy conclusion. However, the announcement does not help address key issues	Continue to short Chinese equities because of slowing economy (Nov. 16, 2017). Prolonged trade dispute adds risk. US small- and mid-caps are less vulnerable; Europe potentially benefits. Expect higher costs of goods sold for large US firms with the most-vulnerable supply chains (March 18)
Europe's Fiscal Dilemma	While the UK saw continued turmoil over Brexit and the risk to Prime Minister Theresa May's government mounted, European political events were reasonably subdued after the NATO summit. Things should remain reasonably quiet through mid-August, but expect more noise as EU draws closer to September budget debates	Remain overweight European equities on lower rates and weaker currency (March 14). Still, risk in periphery is elevated. Closely monitor geopolitical developments that could weigh on financials. Prefer core countries to periphery and Spain over Italy
Latin America Elections	Markets are still absorbing Andrés Manuel López Obrador's victory, and were somewhat enthused by the victory speech; the MSCI Mexico Index jumped 11.2%. The relief rally has so far gone as expected, up until the announcement of the oil minister this past week, which has reignited concerns over left-leaning policy and even the potential of nationalizing the energy industry. Eyes have now turned to Brazil's elections, where the centrist parties are expected to be in weeks-long negotiations over backing a single candidate. Failure to reach a consensus centrist candidate would greatly improve the chances of a left-leaning victory	Long Pacific markets (Chile, Colombia and Peru), short Atlantic (Argentina, Brazil and Mexico) on election and economic risks. Regional defensive sectors like consumer staples and health care have historically outperformed before and after elections (May 8)
Defense and Cyber	At the press conference following the July 16 US-Russia summit, President Trump disavowed US intelligence agency findings about Russian interference in the 2016 election. That drew ire from many, and the next day the president said he misspoke. This turn of events is unlikely to draw a censure from Congress so close to the midterm elections. The move does increase the possibility of prolonged investigation should the Democrats take the House. Separately, the Department of Defense issued a number of contracts last week helping to buttress the Industrials sector otherwise beleaguered by trade rhetoric	Long cyber companies positioned to benefit from increased spending in latest US budget (March 15). Defense stocks also appear poised to rise
US Midterm Elections	The absence of robust polling in the lull following primary season has prompted a deeper look at campaign financing to glean election frontrunners. In the fundraising race for the House, Democrats appear to be doing well, having posted back-to-back months of record inflows. They doubled Republicans' haul in May and outpaced them in June. The top 25 incumbent-challengers with the most campaign cash on hand are also all Democrats. While these figures do not tell the entire story, they represent a concerted effort for the opposition party as they seek a net 23-seat gain to secure a majority	Infrastructure bill unlikely before midterms (April 26). Instead, consider firms that benefit from higher capital spending, which the market may be underestimating. Also, cybersecurity firms could benefit from concerns about election integrity (March 5). US defensive sectors have historically outperformed ahead of the midterm elections while cyclical has does well after (May 22)

Topic	Commentary	Conclusion
Emerging Markets	Emerging markets (EM) risk remains elevated, though there are indicators that the markets may be oversold. Concerns over weakness in China were tempered slightly as retail sales growth held up in June, but industrial production was slower than expected and the renminbi threatened 52-week lows. China will continue to search for domestic policy solutions to tariff pressure on the economy, possibly spurring credit growth. Fitch downgraded Turkish sovereign debt from BB+ to BB over concerns regarding its current accounts, currency pressures and economic policy credibility. There is likely to be a confidence vote in India, which will leave the prime minister in power but possibly galvanize opposition groups in a move that would be unfriendly to markets. For the year to date (through July 19), the MSCI Emerging Markets Index is down 6.1% on a total return basis in US dollars. The performance of the five largest bourses in the index are: Shanghai Composite, -15.5%; Korea Stock Exchange, -13.1%; Taiwan Stock Exchange, +2.2%; Indian Sensex Index, +1.1%; FTSE/JSE Africa (South Africa), -11.5%	Maintain EM overweight, but tighter financial conditions, a stronger dollar and high oil prices do pose risks. Middle East/North Africa positions include long Egypt (Jan. 31) and short Turkey (Jan. 31). Asia positions include long India (March 14) and short Malaysia (May 22)
North Korea	There has been little public follow-on to the heralded North Korea discussions. One outcome of the US-Russia summit was a Russian commitment to support ongoing talks and North Korean denuclearization. US Secretary of State Mike Pompeo held another round of discussions, but they were not viewed as fruitful to reaching a final agreement. MSCI South Korea Index is down 6.2% since the June 12 meeting, suggesting there is little confidence in long-term progress currently priced in	Stick with the holding pattern on South Korean risk assets (May 8). A major reunification project would leave plenty of time to earn potential upside after a possible deal. On-again, off-again, on-again pattern of negotiations is simply too uncertain
Energy	Oil is now down 6.9% from the recent peak as part of a broader commodity sell-off that some attribute to trade. Oil volatility this year has climbed to a year high of 32 from 16. The International Energy Agency warned that OPEC production increase may push capability to the edge and increase the risk of supply shocks should disruption occur. Despite this warning, the White House is contemplating tapping the US strategic reserve to keep oil prices at or below current levels	Remain long oil and oil-exposed companies (Jan. 10) even though catalysts for higher prices have weakened. Consider income-generating assets like master limited partnerships that have less potential upside with higher prices but may generate income in the current range of $65 to $75 per barrel
Iran	Europe moves closer to providing an exemption allowing central banks to conduct business with Iran. This comes after the US withdrew from agreement and amid Europe’s attempt to salvage the deal. China may increase purchases of Iranian oil following US tariff moves	Short Middle East equities as Iran and Saudi Arabia remain on a collision course over regional supremacy even as oil moves higher (Jan. 31). The US’ unilateral withdrawal could create drag on the US and the global economy if oil prices spike
Tech Regulation	In response to increasing calls for regulating large social media and technology companies, lawmakers have questioned in recent hearings whether these companies should retain the liability exemption for user content. Reversal of this exemption would lead to increased oversight costs for these companies as they struggle with flagging and removing user content. There were also closed door talks between policymakers and leading social media companies with focus on the 2018 election. Abroad, the EU has continued to press American technology companies on the antitrust front with a recent $5 billion fine for allegedly using phone software to push users to specific search engines. Legislative efforts to bring back net neutrality achieved a win with a GOP congressman introducing a bill in the House	Use regulation-driven weakness as buying opportunities for top tech companies. Expect new round of debate over regulation close to US midterms. Tech also benefits from US tax bill encouraging capital expenditures

Index Definitions

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

Risk Considerations

Investing in foreign markets and emerging markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Physical precious metals are non-regulated products. Precious metals are speculative investments, which may experience short-term and long term price volatility. The value of precious metals investments may fluctuate and may appreciate or decline, depending on market conditions. If sold in a declining market, the price you receive may be less than your original investment. Unlike bonds and stocks, precious metals do not make interest or dividend payments. Therefore, precious metals may not be suitable for investors who require current income. Precious metals are commodities that should be safely stored, which may impose additional costs on the investor. The Securities Investor Protection Corporation ("SIPC") provides certain protection for customers' cash and securities in the event of a brokerage firm's bankruptcy, other financial difficulties, or if customers' assets are missing. SIPC insurance does not apply to precious metals or other commodities.

Master Limited Partnerships (MLPs): Individual MLPs are publicly traded partnerships that have unique risks related to their structure. These include, but are not limited to, their reliance on the capital markets to fund growth, adverse ruling on the current tax treatment of distributions (typically mostly tax deferred), and commodity volume risk. The potential tax benefits from investing in MLPs depend on their being treated as partnerships for federal income tax purposes and, if the MLP is deemed to be a corporation, then its income would be subject to federal taxation at the entity level, reducing the amount of cash available for distribution to the fund which could result in a reduction of the fund's value. MLPs carry interest rate risk and may underperform in a rising interest rate environment.

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

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

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

Credit ratings are subject to change.

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

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

Technology stocks may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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