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Global

Outlook

Global Cross-Asset Strategy

Cross-Asset Navigator

Hope Is Not a Strategy

Policy makers are again responding to the renewed sense of global crisis. Major DM central banks have extended dollar swap facilities with the Fed, and the Fed announced details of 'Operation Twist' and other easing measures earlier today that were greater than the market expected. Thus continues the cycle of Crisis, Response, Improvement and Complacency (CRIC) that has triggered swings in risk markets since 2007.

We recommend selling into policy-inspired rallies. First, it seems increasingly difficult for policy makers to achieve the material impact of their prior interventions. Conventional tools are exhausted, and there are growing institutional, legal and political barriers to more unconventional policy options. Second, while monetary policy remains growth-supportive, fiscal policy is set to become a significant headwind in developed economies in 2012. We are increasingly inclined to make DM recession our investment base case. We may hope that recession is avoided, but hope is not an investment strategy.

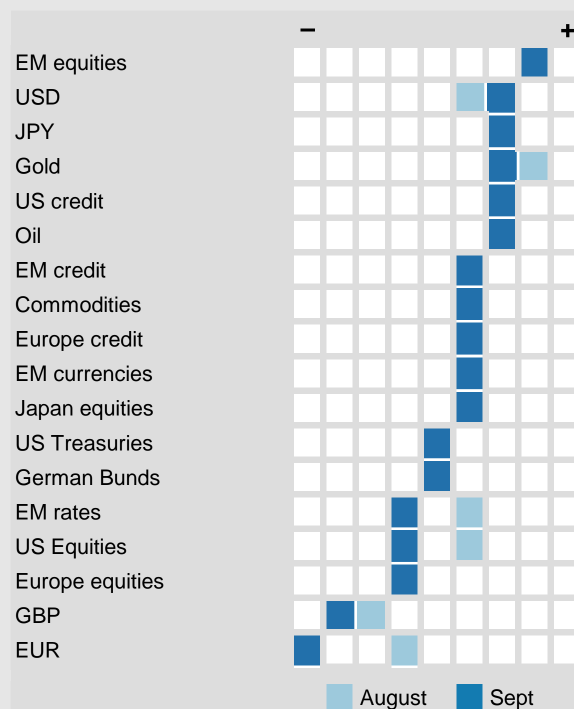
With policy makers dominating the outlook, the tail risks are getting wider. Our base case is caution. But in a highly uncertain world we are also looking at cheap ways to hedge against upside tail risk (pg 3).

EM assets offer some positives amid the gloom. However, we have been too bullish on EM equities. Having said that, we continue to see reasons why EM equities should perform *relatively* better than DM equities over the medium term (pg 6).

4 charts: 1) spread differential for financial vs. industrial credit; 2) ECB dollar loan decision easing funding pressures; 3) US mega-cap stocks are attractively valued; 4) revising down the EUR (pg 8).

Asset Class Views (3-6 months)

Base Case: Neutral on DM risky assets, and would continue to reduce risk in rallies; OW EM risk assets.



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Global Cross-Asset Strategy Overview

Base Case (3-6 months)

On a long-term strategic perspective, we are bearish on developed market equities, while bullish on emerging market assets. DM is now in the midst of what is likely to be an extended period of deleveraging, leading to a subpar economic expansion. In contrast, the strong secular fundamentals for EM economies should continue.

Tactically, we would reduce risk in rallies of DM assets, and expect EM to outperform on a relative basis. However, unless the monetary and fiscal policy response is coordinated and unexpectedly positive, the rallies in DM are unlikely to be sustained.

A G10 recession is not our base case for 2012, but the impact of fiscal and monetary policy responses to weak growth is likely to be limited. If there is a DM recession in the next year, then risk assets have significantly further to fall next year.

The Eurozone debt crisis "end game" has accelerated, in our view, and the risks of the crisis getting worse have risen. The previous policy responses have failed to contain the spread of risk to the core. Near-term risk containment will continue to depend on the large and aggressive periphery bond purchases by the ECB and reform of the EFSF.

Slowing growth in EM is a risk, but growth should stabilize by year-end. A soft landing in EM still looks on track, and EM central banks now have latitude to cut rates to support growth without raising too many concerns about credibility. However, EM is vulnerable to a DM recession.

Risk Factors / Catalysts

- **A Greek default.** While default is unlikely near term, lack of progress on EFSF reform, Greece austerity measures, or PSI take-up would further deepen the crisis.
- **The US economy stays at "stall speed."** If growth stays below 2%, recession is dangerously close; job growth close to 150k per month is needed for growth sustainability.
- **Fiscal policy proves counter-productive.** With US stimulus set to expire and fiscal consolidation elsewhere in DM, fiscal policy could tip a weak recovery into recession.
- **Slower growth in Asia/EM.** The risk is that policy cannot respond fast enough or in sufficient size. Although inflation remains high, Turkey and Brazil have already cut rates.
- **Upside risk: China policy.** Faster CNY appreciation and fiscal stimulus, but especially a policy rate cut, could contain downside growth risks in Asia, and boost markets.
- **Upside risk: coordinated policy response.** Decisive monetary action by G10 central banks, with matching fiscal support.

Asset Class Views

We continue to reduce risk and position for a "risk off" environment. We lower US equities to UW, expecting more weakness while long-term valuations are high. In DM, we generally prefer bonds and especially credit over equities, as credit is pricing in worse scenarios. Flight-to-safety assets (USD, JPY, gold) are attractive, given the number of events risks in 4Q11.

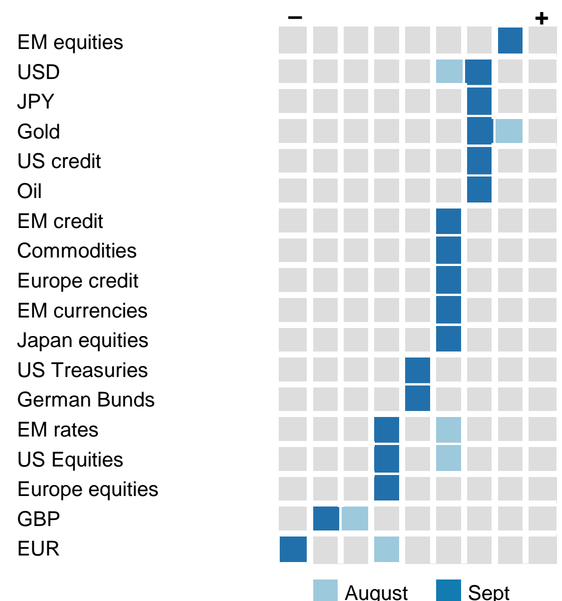
We maintain our strategic preference for EM assets over DM. However, we reduce our tactical conviction as growth fears increase. EM fixed income is vulnerable to funding market stress, and rates are pricing in aggressive cuts.

Maintain neutral position on government bonds. With the Fed likely on hold until at least 2013 and Operation Twist, the 10Y UST should stay range-bound. Bunds have gotten rich, but flight-to-safety status will keep them bid.

USD strength, EUR weakness. Expect USD strength as a risk-off trade, JPY should also remain supported; EUR most at risk because of debt crisis, less hawkish ECB, and slowdown in central bank reserve accumulation.

Commodities stay resilient, if growth does. Gold remains attractive but is at risk of a tactical correction. Even a modest expansion in 2H11 will tighten commodity balances, particularly oil, keeping prices supported.

Relative Preferences



Covering Our Tail

- Strategically, we are a seller of rallies. More practically, we would prefer to hedge against the upside rise, rather than aim to trade any (temporary) improvement in risk assets.
- Given high volatility, and skew in options markets, vanilla hedging is now expensive. However, there are opportunities created by the different pricing for macro risk now apparent across asset classes.
- Below we outline several specific trades for clients to cheapen the cost of protecting against upside risk.

In the United States, portions of this report regarding non-US options are intended for Morgan Stanley's Institutional Clients only.

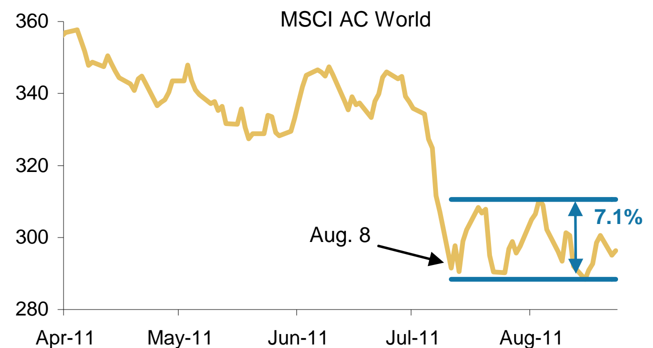
Risk assets appear to be at an inflection point. The macro outlook remains problematic, and there is an ongoing risk that policy actions could move markets sharply. With equities range-bound for six weeks — the MSCI AC World equity index has traded in a 7% band since August 8 (Exhibit 1) — investors are just as concerned about a break higher as protecting against the downside.

We remain sellers of any rallies. A policy-induced rally is possible but a sustainable rally would require more constructive policy than is likely. In the US, the Fed's introduction of 'Operation Twist' is not a game-changer. We would take more note of fiscal policy surprise – but that appears increasingly unlikely. Policy prospects look no better in Europe, even though the stakes are higher. Even EM is showing signs of stress: EM equities underperformed DM equities by 5% so far this month. EM rate cuts could help, but EM support for DM growth, let alone de-coupling, appears unlikely, at least on a 1-2 quarter view.

We prefer upside tail hedges to chasing a rally. While the risk-reward looks skewed to the downside, de-risking now would increase the pain of even a short-lived rally, which remains possible. Tail hedge trades that offer upside exposure to rallies at relatively low cost are an appealing way to play positive policy surprises, yet still continue to de-risk in these rallies. This strategy also reduces the need to buy downside protection, which is costly given high volatility.

Market dislocations and recent price action also create hedging opportunities. While equities have stabilized since the sell-off in early August, credit spreads have continued to widen, a divergence that cannot persist indefinitely (Exhibit 2).

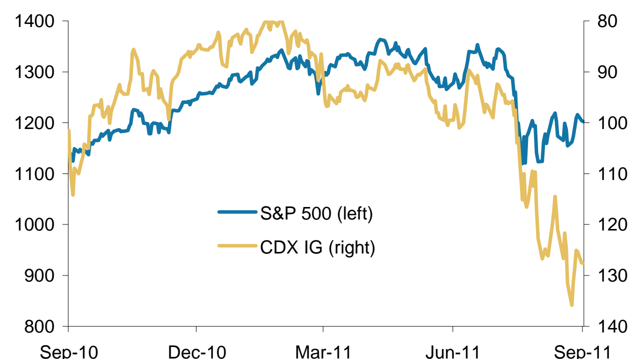
Exhibit 1
Equities Have Been Range-Bound Since August



Source: Bloomberg, Morgan Stanley Research

Credit is pricing in a greater risk of recession and systemic concerns out of Europe. Equities will either follow credit lower if these fears prove correct, or both will rally on an improved growth and policy outlook. For now, this dislocation provides a way to play tail hedges in equities, funded by credit. Breakdowns in other typical cross-asset relationships suggest other opportunities for playing tails. For instance, many EM currencies sold off last week as US equities moved higher.

Exhibit 2
Credit Has Continued to Underperform Equity



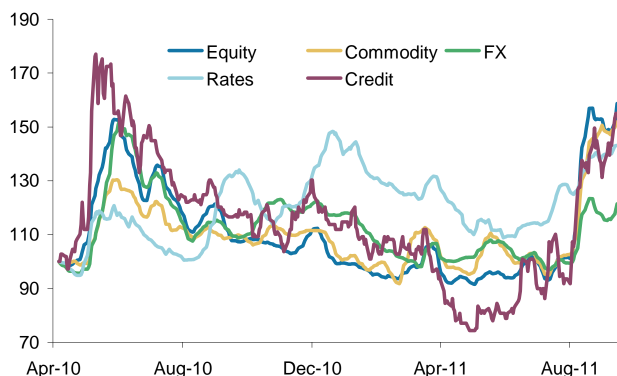
Source: Bloomberg, Morgan Stanley Research

Hedging themes to play upside macro scenarios

Volatility for all asset classes has risen significantly since mid-year, with the moves most pronounced for equities, credit, and commodities (Exhibit 3). That fact, combined with high levels of skew and inverted term structures for volatility,

makes simple hedging trades expensive. Our equity derivatives team has shown that volatility takes time to fall after a big spike, though a substantial policy response helps to accelerate the decline (see *Positioning for Policy Response*, September 14).

Exhibit 3
Volatility Has Increased in All Asset Classes, But Especially in Credit



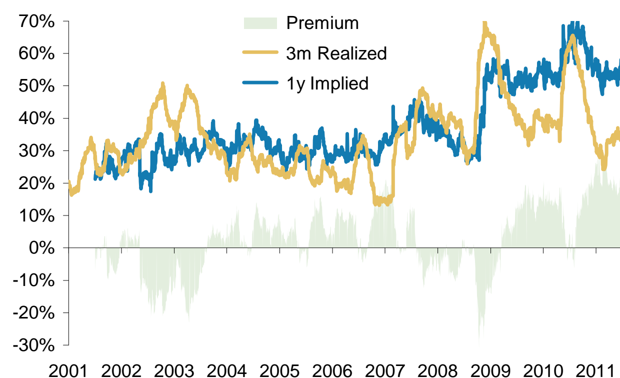
Note: Equity includes S&P, EuroStoxx, Nikkei, Kospi, Bovespa, and Hang Seng. Commodity includes gold and oil. FX includes EURUSD, JPYUSD, USDKRW, and AUDUSD. Rates includes USD Libor, Euribor, and JPY Libor 3m3m 10y vol. Credit includes CDX IG and iTraxx Main.
Source: Bloomberg, Morgan Stanley Research, Quantitative and Derivative Strategies

With that as context, we consider some thematic ways to play for the upside tail and a reversal of recent risk-off price action, specifically as a result of an improving macro environment. In some cases that could occur because of a specific policy response. But certain markets are already pricing for worse scenarios than others. Exploiting these discrepancies is another way to play for upside if the macro improves, or at least reduce the cost of hedges.

Sell correlation, as it should fall as markets normalize. One measure of just how much the macro is driving risk markets is that the realized correlation among S&P 500 stocks has reached multi-year highs (Exhibit 4). The factors behind this development are well known: rising sovereign and systemic risk in Europe, slowing global growth, and actual or potential policy responses are all overwhelming micro fundamentals and valuation. Proactive policies that improve the Eurozone and global growth outlook would be constructive for markets, diminishing the impact of macro. Moreover, the upcoming earnings season will put the focus back on earnings fundamentals, allowing for greater idiosyncratic differentiation. Together, these factors could cause realized correlations to fall fairly quickly, as they rarely stay at elevated levels for an extended period. Implied correlations are slower to correct, but should still move lower. The major risk to the trade is that correlation could instead increase.

Trade idea: Sell variance on the SPX, buy variance on the top 50 single names in the SPX; the equivalent of a short position on correlation. To hedge risk, we would "leg into the trade."

Exhibit 4
Realized Correlation Is Highest Since 1987



Source: Bloomberg, Morgan Stanley Research, Quantitative and Derivative Strategies

Buy equity upside, funded by rates moving higher with equities. The Fed is very likely to keep policy rates low for at least the next two years, and with Operation Twist the entire yield curve could be anchored near historically low levels. However, for much of the past two years, equities and yields moved higher together; an improving economy meant that rising stock prices coincided with rising yields on the expectation of policy normalization. That relationship has broken down somewhat over the past couple months as rates continued to fall as part of the Fed's strategy to keep them low. Consequently, the correlation between equities and rates has fallen. If the growth outlook improves and risk asset prices move higher, rates may initially stay low due to the Fed policy. But if the correlation resumes, rising rates may signal a more sustainable recovery for equities. Thus, to play for equity upside at lower cost, SPX calls that knock-in on rates rising above a minimum level but still below implied forward rates can cheapen the options by 70%. The major risk to the trade is that markets rally and rates remain at current levels or increase and the call does not activate.

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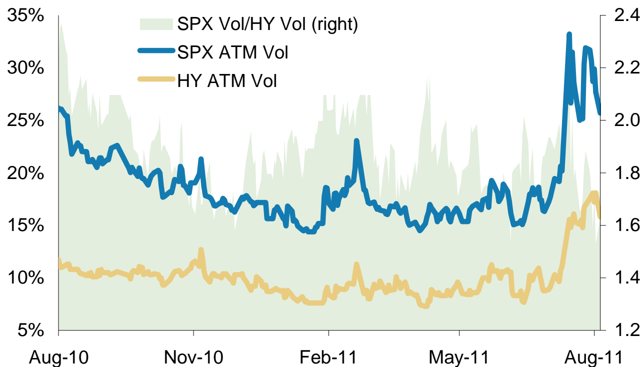
Trade idea: Buy SPX 105% call that knocks-in on 10Yr CMS below 2.25% at expiry for an indicative offer of 2.1% of spot (70% discount to vanilla).

Sell expensive credit volatility and buy equity upside as dislocations abate. As Exhibits 2 and 3 indicated, credit performance has lagged equities, while credit volatility has increased relatively more on a normalized basis, which is also apparent in Exhibit 5 with the ratio of equity and credit volatility falling. Credit is arguably pricing in a greater risk of recession than equities. This divergence can't persist. In an upside scenario, both credit and equities rally. But even though credit has sold off more, equities are likely to react faster and more sharply to positive policy developments and better growth data as credit recovers more cautiously. Credit's greater dislocation can be monetized by selling volatility to reduce the cost of purchasing equity upside. Our preferred method is to sell a Strangle on the CDX HY index. It generates a 2% premium, and doesn't incur a loss unless the HY index falls below 80 (currently ~93.5). This wide range reflects the high volatility. The major risk to the trade is that credit spreads widen and the CDX HY index falls below 80.

Trade idea: Sell HY Strangle 80-100; buy SPX 105% call.

Exhibit 5
Volatility Has Increased Relatively More for HY Than for Equities

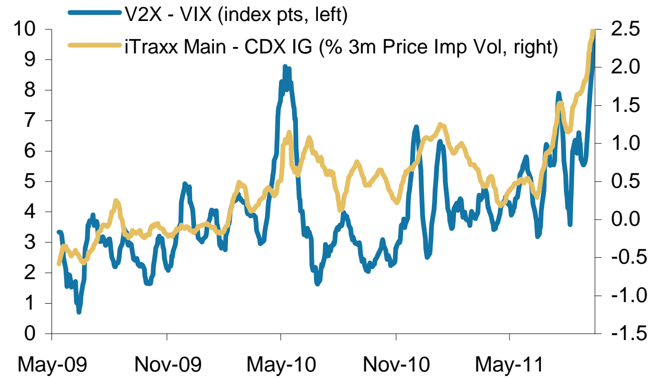


Source: Morgan Stanley Research, Quantitative and Derivative Strategies

Buy call options on falling default premium in credit quality. A consequence of credit pricing in more severe outcomes than equities is that it implies a significant risk of default. That's true in both the US and Europe, though risk is arguably higher in the latter because of the systemic threat stemming from the sovereign debt crisis. This is evident in equity and credit volatility both being relatively higher in Europe than the US, with the differences for both asset classes trending up the past couple of months (Exhibit 6). Any number of policy actions in Europe that temper sovereign risk, such as bank recapitalizations or accelerated reform of the EFSF, should also reduce the risk of default in credit generally. Indeed, investment grade credit is pricing in much higher risk of defaults than are likely to materialize and are far above historical loss rates (Exhibit 7). Our preferred way to monetize this excess default risk is through the structured credit tranche market. The equity tranche in particular is highly levered to credit defaults, as they are effectively "options" on credit improvement and currently offer payoff ratios of roughly 6:1. The major risk to the trade is a pick-up in actual defaults with low recoveries.

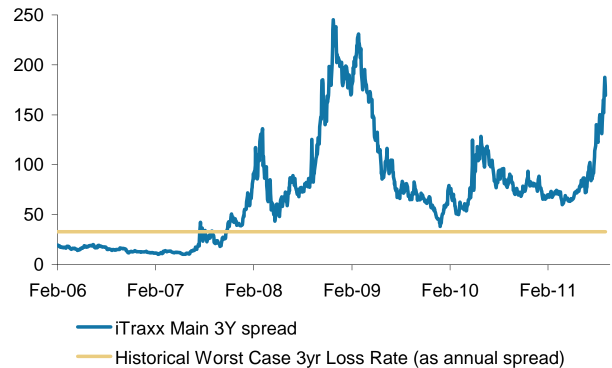
Trade idea: Equity tranche POs (principal only).

Exhibit 6
Higher Equity and Credit Volatility in Europe than in the US



Source: Bloomberg, Morgan Stanley Research

Exhibit 7
iTraxx Main 3Y Spreads Much Wider Than Historical Loss Compensation



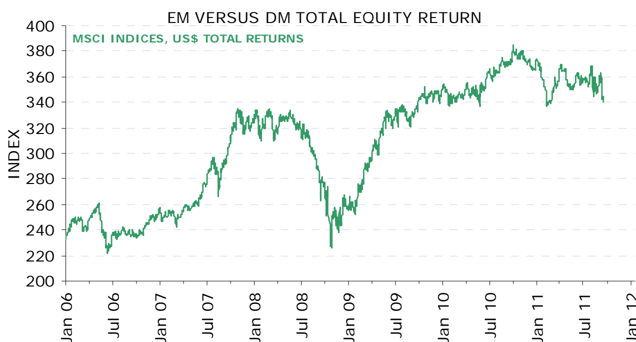
Source: Morgan Stanley Research

Waiting For EM To Perform

- Our bullish relative call on emerging market equities has not worked. Credit and rates in EM have performed better, but FX is now coming under pressure (notably, in Asia).
- Emerging economies don't face the same structural issues as developed economies. However, they do face an awkward mix of policy tightening, upside risk to inflation and slowing growth.
- We expect EM outperformance on a 1-2 quarter horizon, as softer growth eases inflation pressures, and an increasing number of policy-makers in EM switch from tightening to easing stance.
- Ironically, the factors pointing to *relative* EM performance would be enhanced if the downside macro risks in DM eventuate. However, such an outcome – renewed DM recession – would likely mean further absolute declines in EM equities.

We had expected emerging market equities to outperform developed market equities since July. They have not (Exhibit 1). EM equities have returned -18% since early July, versus -13½% for DM equities (based on US dollar, total return MSCI indices). (As with Jonathan Garner, our EM equity strategist, we were cautious on EM in the first half. See Jonathan's annual preview, *2011 Outlook: Slowing Growth, Rising Inflation And Higher Policy Rates – Less Bullish Than Consensus*, 1 December 2010.)

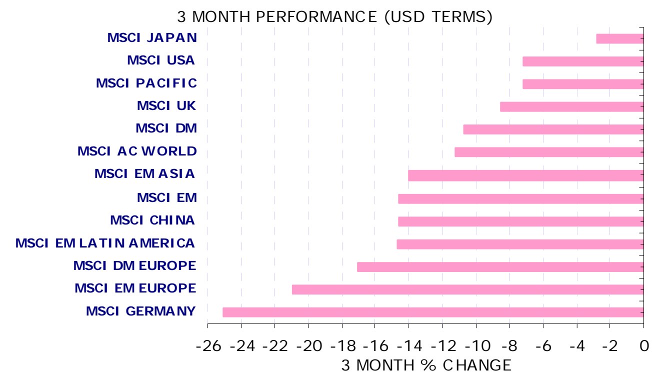
Exhibit 1
EM Modestly Under-performing DM This Year



Source: MSCI, Morgan Stanley Research

To be fair, a simple EM/DM split misses the key feature of equity performance over the past quarter: sharp losses in Europe (both developed and emerging), moderate losses in the US and Japan, and most emerging markets sitting somewhere in between these extremes (Exhibit 2).

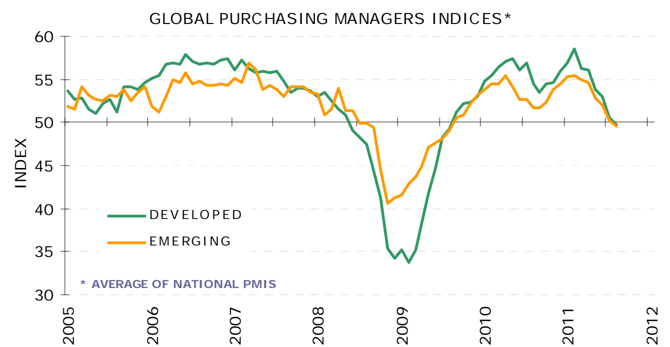
Exhibit 2
Europe Lags, Japan/US Outperform



Source: MSCI, Morgan Stanley Research

Moreover, it's clear that developed markets face more dangerous structural problems, and DM policy makers have less scope to respond to cycle problems. On a medium-term horizon, Jonathan Garner remains confident of strategic EM outperformance versus DM equities.

Exhibit 3
A Global Growth Scare



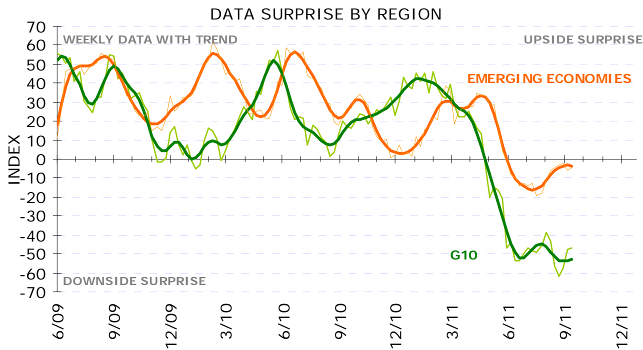
Source: DataStream, Bloomberg, Morgan Stanley Research

However, EM now faces an awkward mix of cycle headwinds. First, it is caught up in the global growth slowdown. Monthly purchasing manager indices have fallen to the 50 growth/contraction threshold in EM economies as well as DM economies (Exhibit 3). (Note that this is growth/contraction for the manufacturing sector, not the overall economy).

Macro data in EM have also been falling short of market expectations over the past quarter (Exhibit 4). Chetan Ahya,

our Asia ex-Japan chief economist, notes that both internal and external demand indicators in Asia are slowing. Asian exports have fallen since March (based on country data accounting for three-quarters of the regional total). (See Asia Pacific Economics: No Escape from Weaker Growth In The Developed World, 18 August.)

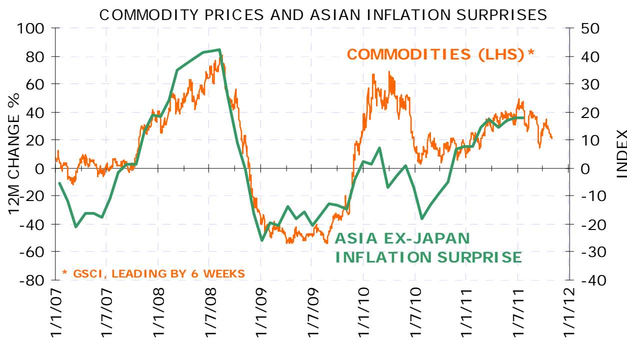
Exhibit 4
Growth Data Have Been Disappointing in EM



Source: Citibank, Morgan Stanley Research

Second, while growth indicators have been slowing, inflation indicators have surprised on the high side (Exhibit 5). There is now clear concern that inflation will be stickier than previously expected.

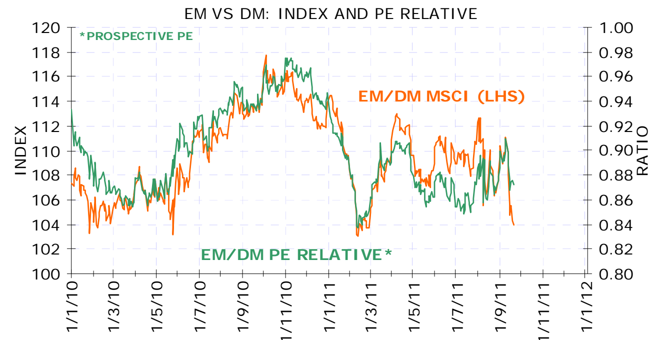
Exhibit 5
Asian Inflation Surprises



Source: GS/S&P, Citibank; Morgan Stanley Research

Third, policy makers continue to have a tightening bias, at least in Asia. Important EM central banks have recently eased monetary policy – notably, Brazil, Russia and Turkey. However, rates were increased in India, and a move to easier monetary policy in China doesn't appear imminent. Chetan believes that, for now, Chinese policy makers remain more focused on the risk of rising inflation rather than weak growth.

Exhibit 6
EM Nearing The Relative Value Lows of Past Year



Source: MSCI, Bloomberg, Morgan Stanley Research

Valuation alone may not be a catalyst for EM outperformance. However, EM equities are now trading on a 12% PE discount to DM equities based on consensus 12 month-ahead earning forecasts. This is approaching the discount that signalled EM outperformance earlier this year and in first half of 2010 (Exhibit 6).

More to the point, we expect that Asian inflation is at, or near, a cycle peak. Chetan believes that inflation is likely to remain above policy makers' comfort zone until the end of the year. However, we think that forward-looking investors would see the peak in inflation as signalling that rates are near a peak – opening up the prospect of EM central banks switching to an easier policy stance. Consequently, we expect that EM equities will be able to outperform on a 1-2 quarter view.

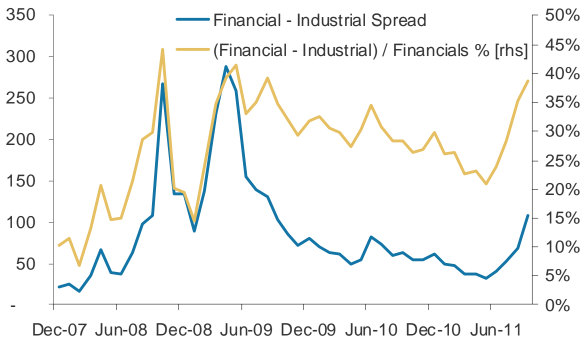
Ironically, if the downside risks to DM growth eventuate – and our macro colleagues see the developed economies as 'dangerously close' to recession – then it would strengthen the case for a turn to easier policy in EM later this year. While EM would also face greater downside risks to growth in this scenario, the basis for expecting *relative* outperformance would increase. However, it seems likely that if the developed economies fall into recession, there would likely be further *absolute* downside to EM equities on a 1-2 quarter view. The absolute low for EM equities would, in this scenario, require a signal that the EM policy response has got traction, and EM growth indicators to start surprising on the high side. That would, in our view, be likely in the first half of 2012.

Global Cross-Asset Chart Corner

US Credit

Rizwan Hussain

Corporate credit re-priced too dramatically and we are constructive on the space. Risk premiums are too elevated, even in light of the macro risks. We believe current valuations can be supported in an environment of slow growth and deleveraging. We prefer Financials within US IG credit, as it is the most dislocated sector despite improvements to balance sheets and business models. Financial spreads should compress to Industrials as credit conditions stabilize, although relatively higher volatility is likely.



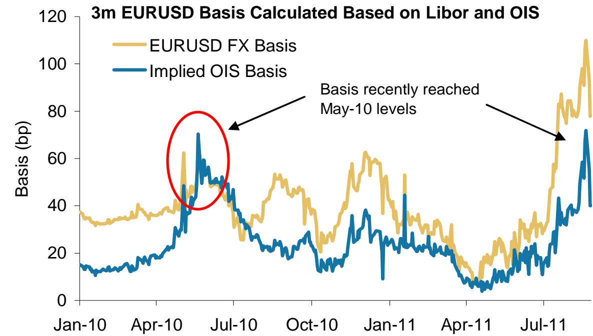
Source: Bloomberg, The Yield Book, Morgan Stanley Research

Global Credit Strategy: Global Credit Outlook - Credit for the Long Run, September 4

US Interest Rates

Jim Caron

Funding risk has eased back on the ECB's decision to provide new 3m dollar swap facilities. Adjusting the 3m EURUSD Libor basis (for 3m Euribor lagging lower overnight funding expectations) to better isolate funding risk, the implied OIS basis came off wides on the dollar loan news. We believe the coordinated action between the ECB, Fed, BoE, BoJ and SNB should help mitigate systemic risk and help funding markets absorb potential shocks. At present, funding markets are still functioning well.



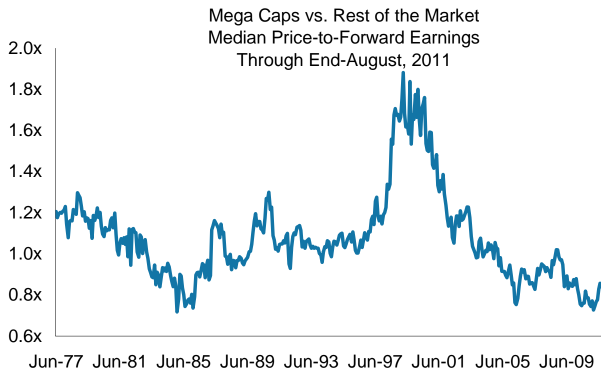
Source: Reuters, Morgan Stanley Research

US Rates Strategy Brief: ECB Dollar Loans to Ease Funding Pressures, September 15

US Equities

Adam Parker

We position the same way regardless of whether it is our bear or bull case that materializes. The two scenarios add up to a 90% chance of poor economic conditions; thus, either way we favour defensive positioning. In addition to defensive sectors, we like mega caps for their very attractive valuations, as well as stocks with high and sustainable dividend yields.



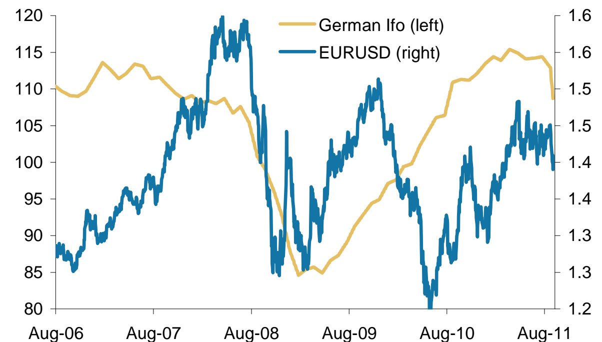
Source: FactSet, Morgan Stanley Research

U.S. Equity Strategy: It Just Doesn't Matter, September 6

FX

Hans Redeker

We have lowered our EUR forecast to 1.30 for year-end and 1.25 in Q1 2012. In the Eurozone, manufacturing data has started to follow sentiment indicators down, trade is slowing, and the ECB has removed its tightening bias. Meanwhile, internationally supportive flows have started to decline as central banks slow their pace of reserve accumulation. ECB bond purchases and policy and political uncertainty pose additional downside risks to the EUR.



Source: Thomson Reuters EcoWin Datastream

G10 FX Forecast Changes, September 13

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The risk of exercise in a spread position is the same as that in a short position. Certain investors may be able to anticipate exercise and execute a "rollover" transaction. However, should exercise occur, it would clearly mark the end of the spread position and thereby change the risk/reward ratio. Due to early assignments of the short side of the spread, what appears to be a limited risk spread may have more risk than initially perceived. An investor with a spread position in index options that is assigned an exercise is at risk for any adverse movement in the current level between the time the settlement value is determined on the date when the exercise notice is filed with OCC and the time when such investor sells or exercises the long leg of the spread. Other multiple-option strategies involving cash settled options, including combinations and straddles, present similar risk.
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- By selling an option, the seller receives a premium from the option purchaser, and the purchase receives the right to exercise the option at the strike price. If the option purchaser elects to exercise the option, the option seller is obligated to deliver/purchase the underlying shares to/from the option buyer at the strike price. If the option seller does not own the underlying security while maintaining the short option position (naked), the option seller is exposed to unlimited market risk.
- Spreading may entail substantial commissions, because it involves at least twice the number of contracts as a long or short position and because spreads are almost invariably closed out prior to expiration. Potential investors should carefully review tax treatment applicable to spread transactions prior to entering into any transactions.
- Multi-legged strategies are only effective if all components of a suggested trade are implemented.
- Investors in long option strategies are at risk of losing all of their option premiums. Investors in short option strategies are at risk of unlimited losses.
- There are special risks associated with uncovered option writing which expose the investor to potentially significant loss. Therefore, this type of strategy may not be suitable for all customers approved for options transactions. The potential loss of uncovered call writing is unlimited. The writer of an uncovered call is in an extremely risky position, and may incur large losses if the value of the underlying instrument increases above the exercise price.
- As with writing uncovered calls, the risk of writing uncovered put options is substantial. The writer of an uncovered put option bears a risk of loss if the value of the underlying instrument declines below the exercise price. Such loss could be substantial if there is a significant decline in the value of the underlying instrument.
- Uncovered option writing is thus suitable only for the knowledgeable investor who understands the risks, has the financial capacity and willingness to incur potentially substantial losses, and has sufficient liquid assets to meet applicable margin requirements. In this regard, if the value of the underlying instrument moves against an uncovered writer's options position, the investor's broker may request significant additional margin payments. If an investor does not make such margin payments, the broker may liquidate stock or options positions in the investor's account, with little or no prior notice in accordance with the investor's margin agreement.
- For combination writing, where the investor writes both a put and a call on the same underlying instrument, the potential risk is unlimited.
- If a secondary market in options were to become unavailable, investors could not engage in closing transactions, and an option writer would remain obligated until expiration or assignment.
- The writer of an American-style option is subject to being assigned an exercise at any time after he has written the option until the option expires. By contrast, the writer of a European-style option is subject to exercise assignment only during the exercise period.

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**1120**	**41%**	**460**	**48%**	**41%**
Equal-weight/Hold	**1151**	**42%**	**389**	**40%**	**34%**
Not-Rated/Hold	**114**	**4%**	**21**	**2%**	**18%**
Underweight/Sell	**374**	**14%**	**93**	**10%**	**25%**
Total	**2,759**		**963**		

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