MorganStanley SmithBarney

Current Outlook

Monetary Policy versus Fiscal Policy

NORTH AMERICA

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Morgan Stanley Smith Barney Forecast Summary

Major Indices	Price 7/25/2012	CIRA 2012E Target Year-End	CIRA Indicated Upside		Morgan Stanley 2012E Target Year-End	Morgan Stanley Indicated Upside	
S&P 500	1,338	1,425	6.5%		1,167	-12.8%	
Dow Jones Industrials	12,676	13,550	6.9%		NA	NA	
Russell 2000	769	NA	NA		NA	NA	
		CIRA			Morgan Stanley		
Economic Data	**2010A**	**2011A**	**2012E**	**2013E**	**2011 A**	**2012E**	**2013E**
Real GDP (4Q/4Q % Change)	3.1%	1.6%	1.9%	2.0%	1.6%	2.0%	1.7%
Core CPI (Y/Y % Chg)	1.0%	1.6%	1.9%	1.6%	1.7%	2.3%	2.1%
Fed Funds (4Q Avg)	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%	0.15%
Unemployment Rate	9.6%	9.0%	8.1%	8.0%	9.0%	8.2%	8.1%
10-Year Treasury Note (4Q Avg)	3.21%	2.05%	1.65%	2.60%	2.05%	1.90%	1.85%
		CIRA			Morgan Stanley		
EPS Data	**2010A**	**2011E**	**2012E**	**2013E**	**2011E**	**2012E**	**2013E**
S&P 500 Operating EPS	$62.60	$97.84	$103.25	$108.00	$96.00	$100.00	$103.00
S&P 500 P/E Ratio	21.4	13.7	13.0	12.4	13.9	13.4	13.0
Factset Fundamentals	$84.95	$97.07	$102.87	$115.60	NA	NA	NA
IBES Bottom Up EPS	$83.42	$96.12	$102.84	$115.19	NA	NA	NA

Source: Morgan Stanley Smith Barney Portfolio Strategy, Citi Investment Research & Analysis (CIRA), Morgan Stanley & Co. LLC, Bloomberg, FactSet

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US Economic Overview

- Looking ahead to US economic activity in 2H12, uncertainty continues to play an outsized role. In our opinion, the tepid pace of expansion has not been about the interest rate setting for some time now. If it were, one could argue that the historically low rate backdrop should have led to a visibly more robust pace of activity by now. This uncertainty comes in multiple forms and in no special order: taxes, regulatory, health care repercussions now that the Supreme Court upheld the Affordable Care Act, and the Euro Zone. In addition, MS economists and we have noted in the past that economic downturns that are based upon a financial crisis take longer to work through due to the ongoing deleveraging process.

  - **Fed Outlook:** Recent coordinated global central bank action represented a new law of diminishing returns, as financial markets failed to respond in much of a positive way. While that has been our stance from an economic vantage point for quite some time now, especially with respect to the Fed, the more disturbing point this time around is the utter lack of enthusiasm to these moves from the global investment community. Nevertheless, Chairman Bernanke reiterated at the June FOMC press conference "the Committee is prepared to take further action." Some of the Fed's potential options would be an MBS-based QE3, adjusting their interest rate guidance or lowering the rate for interest on excess reserves (IOER).

  - **Employment Outlook:** After a robust start to 2012, new hiring in the second quarter trailed off in a very visible way. From December through March, average new job creation was placed at +225,000. Meanwhile, from April through June, the average monthly payroll gain was only +75,000. This was the weakest three-month performance since the summer of 2010, with the key difference between these two experiences being that negative figures were involved back then. The unemployment rate stayed at 8.2%, and in our opinion, seems poised to remain in the 8.0% to 8.5% range right up to the Presidential election in early November. Along the same lines, the civilian labor force participation rate remains at its early-1980's low of 63.8%.

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Taxable Fixed Income Outlook

- Domestic economic data, while important, continue to take more of a backseat to the safety-premium trade. It remains an event-driven market. However, as we've been finding out lately, these 'events' don't produce the same staying power as we've seen in the past, and the UST market moves on quickly to the next chain of headlines. We don't see signs of this trading pattern changing anytime soon.

  – **UST Yield Curve**: A heightened safety premium, combined with a lack of quality alternatives on the global stage, has created a setting where we see the near-term trading range for the UST 10-yr yield to be 1.20% to 1.75%/2.00%. Broadly speaking, we still like the 2.40% level to cap things on the upside from more of a longer-term perspective. With respect to the shape of the yield cure, remember our rule of thumb; risk off is a flattener, risk on is a steepener.

  – **The Best Game in Town:** Despite a recession in Europe and subpar global and domestic growth, strong corporate fundamentals should limit credit deterioration over the coming year. Versus prior slow growth/recessionary periods corporate leverage is significantly lower, liquidity positions are higher, and debt maturity schedules are much more manageable. We continue to find value in duration extension trades given the steepness of the credit curve. The most attractive part of the Investment Grade credit curve is in the 5-8 year maturity range. We recommend BBB- and A-rated issuers that have strong balance sheets and improving fundamentals. We continue to like the Regional Banking sector as a relative value play, but warn that volatility will likely remain elevated given the ongoing crisis in Europe. We favor U.S. banks over European banks. We also see select opportunities in the Telecom, Utilities and Insurance sectors.

  – **Select Opportunities in High Yield and Emerging Markets:** The headline, or trailing 12-month, default rate likely bottomed in mid-2011 around 1.5% versus its peak of 13%-14% at the end of 2009. However, the default rate will likely rise from current levels due to growing funding constraints for lower-rated issuers. We expect the default rate to be 3%-4% a year from now. For investors with a 12-month horizon who are willing to deal with heightened volatility, we believe there are select opportunities in the High Yield market. We like higher-quality B and BB-rated credits, which appear attractive on a risk-adjusted basis compared to CCC-rated issues. We believe the carry, or income earned by owning higher quality High Yield, will help generate total return with less downside risk versus lower-rated issuers. Despite slower Global growth, Emerging Market economies should continue to outgrow developed markets over the coming years. We favor high-growth countries in Latin America and Asia, and believe the stronger growth story and relatively higher yields in EM bonds versus developed country bonds will continue drawing investors to this asset class in 2012 and beyond. We prefer US$-denominated EM bonds over local currency issues.

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US Equity Outlook

- **Following the S&P 500's powerful 12.6% first quarter rally, an increase in volatility amid continued high macro uncertainty made the second quarter a more treacherous environment for equity investors**. Overall, we view the relatively modest 2.8% S&P 500 decline in the second quarter as somewhat understating the challenges for stock pickers during the quarter. That said, putting 1Q and 2Q together, the S&P 500 1H12 total return of 9.5% is the highest 1H return since 2003, and a surprisingly strong performance given the clear global economic slowdown in 2Q, now threatening to more negatively impact US corporate earnings, the lynchpin of the equity market rally of the past several years. In essence, the three largest global economies were either at stall speed (US, China) or in recession (Europe) as the second quarter came to a close. For instance, the June manufacturing Purchasing Managers Indices (PMIs) for these three regions were all "flashing orange," i.e., at or below the key 50 boom/bust threshold. The US PMI came in at 49.7 (indicating manufacturing contraction for the first time since June 2009), China was weak at 50.2, while the Euro Zone remained firmly in contraction at 45.1.

  – **The prevailing MS & Co. and MSSB views remain cautious.** Specifically, MS & Co. US Equity Strategist Adam Parker continues to look for a market correction. His S&P 500 year-end target is 1167, 14% below the July 25 close. Importantly, he applies the following probabilities: 15% to a bullish target of 1450, 50% to a base case of 1237 and 35% to a bear case of just 944. There are three pillars to his views: 1) the multiple will continue to contract as equities wrestle with macro headwinds; 2) earnings expectations are too high given declining global GDP expectations; 3) Given the $1.5+ trillion of cash on US balance sheets, Adam believes the best way to position portfolios is to continue to emphasize stocks with strong dividends and buybacks. In addition, the MSSB Global Investment Committee maintains its cautious view on risk assets. They argue that a decline in leading economic indicators has increased the odds of US recession. The GIC broadly prefers traditional safe-haven assets to risk assets.

  – **Key US market debates**: 1) The looming 2013 fiscal cliff and tax increases, and continued fiscal challenges thereafter; 2) US economy in a 2%-2.25% GDP growth trend, and 2Q and 3Q data suggest further slowing below 2%; 3) even if the Fed decides to act this summer (not the MS & Co. view), there does not appear to be much bang for its buck; 4) corporate balance sheets are in good shape but margin pressures seem likely to increase; 5) 2013 S&P 500 P/E valuation at 12x consensus estimates is at a reasonable, below median (13.7x) level, but consensus 2013 EPS estimates look too high, in Adam Parker's view.

  – **Preferred positioning: Maintaining a defensive stance.** With a looming US fiscal cliff, weak global growth and European uncertainty, we believe remaining relatively cautious from both a top-down sector positioning angle as well as with quality-driven, bottom-up stock selections will pay off over the balance of the year. In particular, we continue to seek out less-correlated, more company-specific factor driven stocks, emphasizing "return of capital." We expect to continue to focus on less-cyclical, recurring business models with visibility, free cash flow generation, and attractive pricing power, particularly those returning capital to shareholders. Consistent with that, we retain an emphasis on dividend yield and dividend growth.

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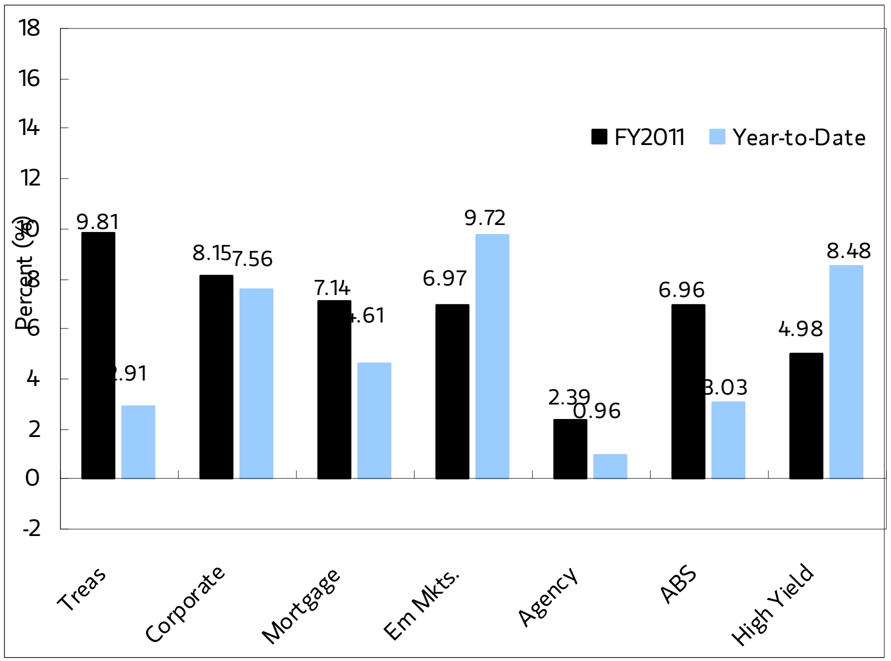
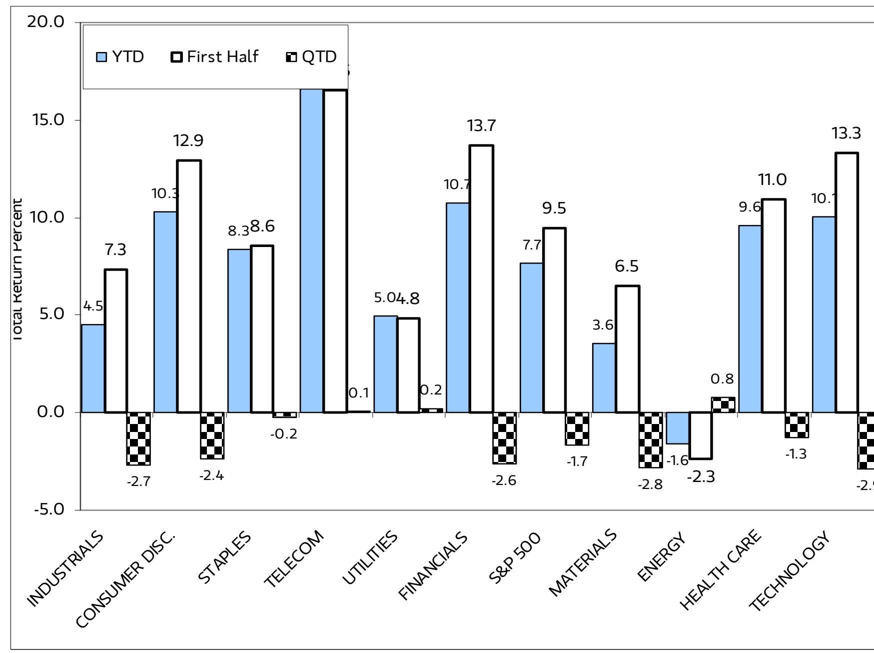
Asset Returns

Fixed Income Returns (as of 7/25/2012)



Source: Morgan Stanley Smith Barney Portfolio Strategy Group and FactSet

S&P 500 Sector Returns (as of 7/25/2012)



Source: Morgan Stanley Smith Barney Portfolio Strategy Group and FactSet

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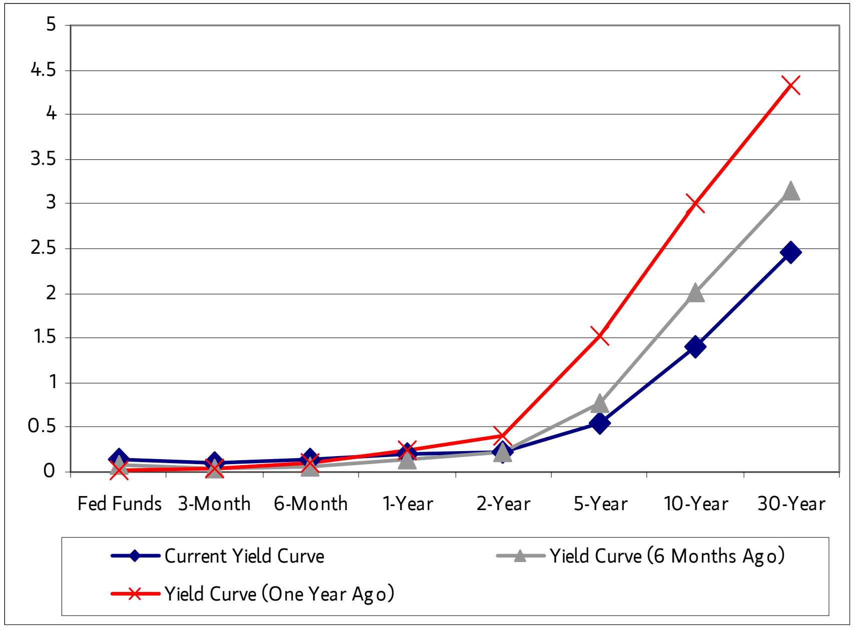
Useful Charts

US Treasury Yield Curve (as of 7/25/2012)



Source: Morgan Stanley Smith Barney Portfolio Strategy Group and FactSet

US Broad Fed Trade Weighted Index (as of 7/25/2012)

Source: Morgan Stanley Smith Barney Portfolio Strategy Group and FactSet

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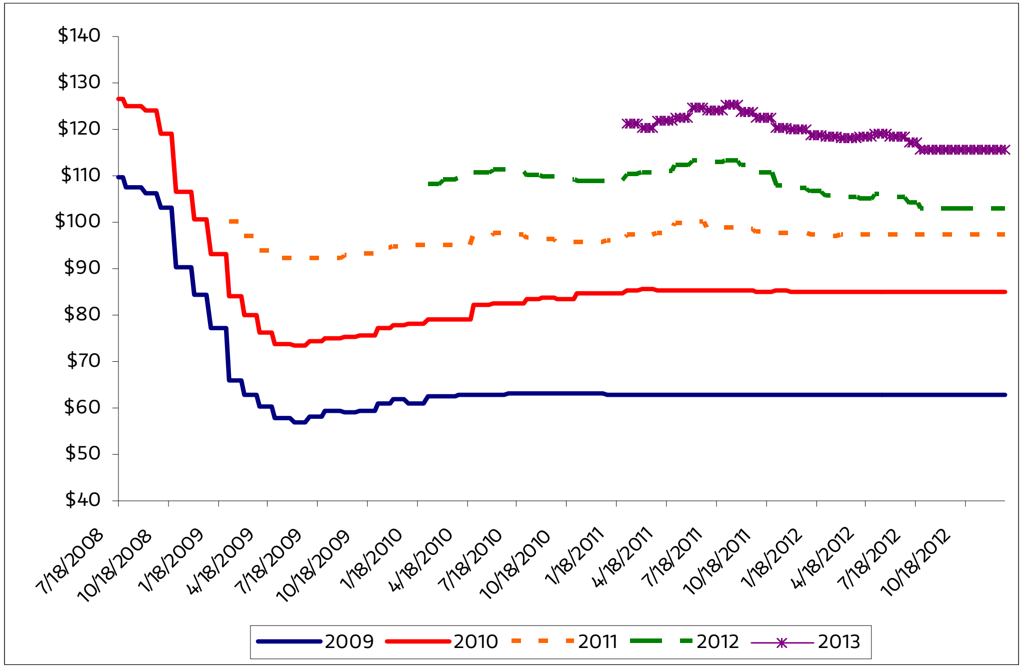
S&P 500 Earnings Information

S&P 500 Bottom-Up Consensus Forecasts (as of 7/25/2012)



Source: Morgan Stanley Smith Barney Portfolio Strategy Group and FactSet

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