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Nine Investment Ideas for 2009

NINE INVESTMENT IDEAS FOR 2009

As the calendar approaches 2009, the Morgan Stanley Global Wealth Management Asset Allocation and Investment Strategy Group has been monitoring the macro landscape for sensible investment ideas. The turmoil of 2008 has created a number of anomalies in global asset markets. We have consulted many Analysts and Strategists at Morgan Stanley to share their best thinking for the year ahead. After reviewing the many investments, markets, and strategies that were put forth, we have carefully selected the final nine ideas for the year ahead. The order in which the ideas are presented does not reflect any degree of preference.

1. INVESTMENT GRADE CORPORATE BONDS

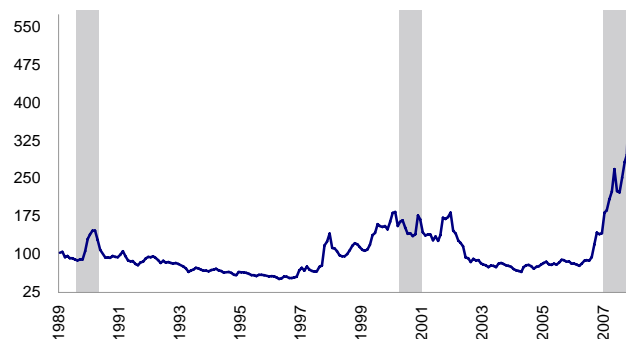
The financial markets are heading into 2009 in a challenging macro investment environment, with extremely high volatility across many asset classes. Morgan Stanley's Global Fixed Income Strategy Head Greg Peters sees favorable risk/reward opportunities for fixed income investors in U.S. high quality (single A-rated or better) investment grade corporate bonds.

In his Outlook report, "2009 – *The Year of Credit*," Greg notes that from a fundamental standpoint, funding, liquidity, and transparency issues for most credit-related instruments demands a premium yield, with high quality Investment Grade securities trading at particularly attractive levels. Valuation represents the cornerstone to his view, with credit spreads (the difference in yield due to different credit quality) for single A-rated corporate bonds at three times the level during the last recession in 2001 (see Figure 1).

Overall, Greg points out that U.S. Corporate Debt/Cash levels are at half the reading in 2002, rendering companies better positioned to weather the economic recession. Additionally, the U.S. monetary and fiscal policy actions have been early and aggressive to address the financial crisis from several perspectives. As a result, the U.S. Treasury yield curve is quite steep and likely supportive of

an economic recovery in due course, especially with short-term U.S. Treasury yields virtually at zero.

Figure 1: Single-A Credit Spread to U.S. Treasury (in basis points)



Note: Data are as of December 1, 2008. Shading represents economic recessions as defined by the National Bureau of Economic Research.

Source: Bloomberg, National Bureau of Economic Research, Morgan Stanley Research Global Wealth Management Asset Allocation and Investment Strategy Group.

The Fixed Income Strategy team is closely monitoring four factors that may presage stabilization in the fixed income markets. First, large financial institutions lending to one another and the abatement of fears of counterparty failure. Second, banks' deleveraging progressing, with declines in bank asset-to-tangible equity ratios. Third, financial markets continuing to work through the downturn in U.S. corporate earnings; Morgan Stanley's U.S. Equity Strategist Abhijit Chakraborti expects 2009 S&P 500 operating earnings to be \$53 per share, a 27% decline from 2008 earnings. Fourth, the U.S. housing market, one of the early causes of the financial crisis, may be the last factor to show signs of bottoming.

2. INFLATION-INDEXED SECURITIES

In spite of investors' concerns over the dramatic increase in the price of crude oil in the first half of 2008 possibly feeding thought to inflation, it was deflationary fears that were paramount toward the end of the year.

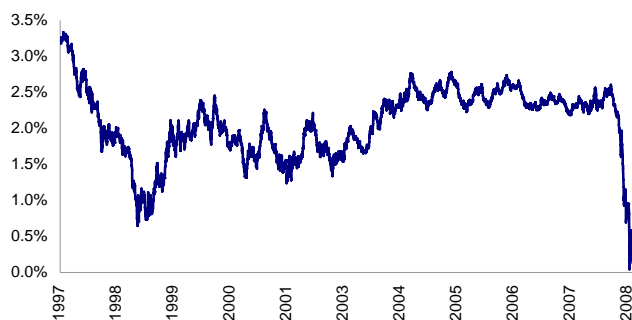
Morgan Stanley's Head of Global Interest Rate Strategy Jim Caron has pointed out the severe deflation-related

dislocations in Treasury Inflation-Protected Securities (TIPS) have made this market especially inexpensive. Specifically, the Breakeven Inflation Rate measures the difference between the yield to maturity on a conventional U.S. Treasury security and the corresponding maturity TIP. As of December 2008, the implied 10-year Breakeven Inflation Rate was at 0.23% – calculated as the U.S. Treasury 10-year note yield to maturity, 2.08%, minus the TIP 10-year note yield to maturity, 1.85%. This rate measures the level of U.S. Headline CPI Inflation the fixed income market is discounting *per annum* for the next 10 years. As illustrated in Figure 2, the Breakeven Inflation Rate collapsed in October 2008 and has registered its lowest reading since U.S. TIPS were initially issued in 1997.

While the Morgan Stanley Economics team is forecasting the full year Consumer Price Index to fall to -0.3% in 2009, the team is expecting a rebound to 3.1% in 2010. If this forecast comes to fruition, the current implied cost of inflation protection is relatively inexpensive.

By way of background, TIPS are securities whose coupon rate is fixed but whose principal is indexed to the U.S. Headline CPI Index; as inflation rises or falls the principal of the bond fluctuates. At final maturity, the bond is redeemed at the inflation-adjusted principal, or original issue principal, whichever is *greater*.

Figure 2: U.S. Breakeven CPI Inflation Rate
10-Year Treasury Yield minus 10-Year TIP Yield (%)



Note: Data are as of December 18, 2008.
Source: Bloomberg, Global Wealth Management Asset Allocation Group.

3. PRE-REFUNDED MUNICIPAL BONDS

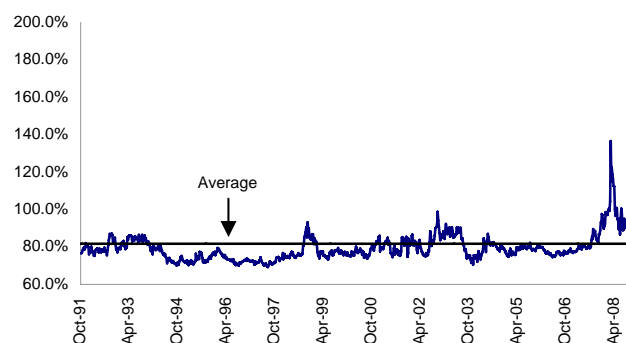
Many of the credit-related fixed income markets came under intense selling pressure in 2008 and a prolonged flight-to-quality scenario developed in which investors shunned virtually all non-U.S. Treasury fixed income securities. Municipal Bonds were not spared, facing significant selling pressure during 2008. Prices fell on Municipal Bonds, pushing yields above the yields of comparable U.S. Treasuries for virtually all maturities, a relatively unusual occurrence.

According to Morgan Stanley’s Global Wealth Management Municipal Bond Strategist John Dillon, the Municipal Bond market is in the process of a fundamental pricing shift, to an environment driven by credit sensitivity as the primary influence, followed secondarily by interest rate sensitivity. This is due to two factors: (i) credit-rating downgrades of the monoline bond insurers which backed many municipal bond issues; and (ii) financial stresses inflicted by the economic recession on state and local municipalities’ credit ratings.

Because of the potential for credit-related dislocations to continue, John and his team are recommending Pre-Refunded Municipal Bonds as a part of the Municipal Bond market that appears attractive.

Pre-Refunded Municipal Bonds are previously issued Municipal Bonds which generally carry coupon rates that are above prevailing interest rates; such bonds have been determined by the municipality to be secured by an escrow fund sufficient to pay off the entire bond issue on a specific call date in the future. The capital used to buy securities to back the escrow fund has been raised by issuing a new lower-interest bond. This process allows a municipality to effectively retire debt that has relatively high coupon rates and refund it at lower interest rates. It is important to note that many types of securities can be placed in an escrow fund; thus it is important to focus on pre-refunded bonds that are escrowed using either U.S. Treasuries or State and Local Government Series, known as SLGS.

Figure 3: 5-Year Pre-Refunded Municipal Bond Yield
as Percentage of 5-Year U.S. Treasury Yield



Note: Data are as of December 8, 2008.
Source: John Dillon, Morgan Stanley Municipal Bond Strategy, Bloomberg.

As seen in Figure 3, Pre-Refunded Municipal Bonds yields have historically approximated an average 80% of the yield on U.S. Treasuries due to the Federal income tax exemption on coupon income. However, unusual developments related to the dislocations in the credit markets have caused federally tax-exempt Pre-Refunded Municipal Bonds to yield *more than* federally-taxable U.S.

Treasuries. We expect this relationship between Pre-Refunded Municipal Bonds and U.S. Treasuries to revert to its long-run relationship over time, with the current anomaly making this sector attractive for credit-sensitive investors in the Municipal Bond market.

4. GOLD

Gold proved relatively resilient in 2008 and appears to offer the potential for long-run capital protection. The Morgan Stanley Commodity Research Team led by Hussein Allidina has a positive view on gold for 2009 and 2010.

In his December 5, 2008 report, “*Commodities, Beggars Must be Choosers*,” Hussein notes that gold prices did not appreciate through the financial crisis to the extent expected, in part because certain investors were selling assets that had gains over the most recent five years (gold has gained 14.9% annually since the beginning of 2004) to meet margin calls on other assets.

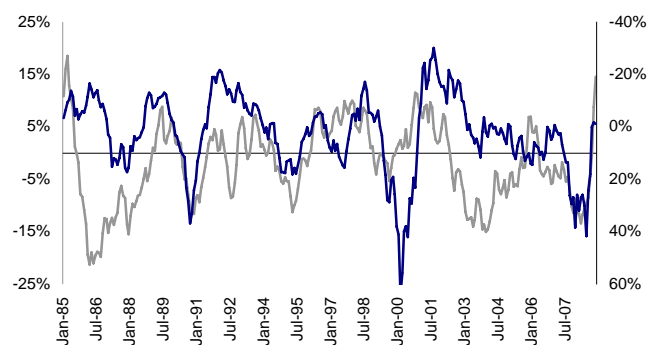
Hussein and his team view the deleveraging cycle, while continuing through 2009, as potentially having passed its peak in November 2008, as possibly reflected in the December 2008 pullback in the U.S. Dollar. While near term deflation may put downward pressure on gold prices, Hussein feels that in the longer-term low mine production and growing consumer demand represent a secular bullish trend for gold prices.

5. U.S. CYCLICALS OVER GLOBAL CYCLICALS

Morgan Stanley’s U.S. Equity Strategy Team of Abhijit Chakraborti and Jason Todd has been advocating for some time that investors focus on the market rotation that appears under way from global Cyclical to domestic Cyclical. They view this trend as continuing in 2009. They see materials, industrials, and energy (which have been consistently strong beneficiaries of strong global economic growth for much of the 2003-mid 2008 time period) as lagging behind domestically focused Cyclical companies. They expect out performance of U.S. Cyclical to be consistent with the global macro outlook and falling bond yields. They see further deterioration in non-U.S. economic growth, together with potentially improving U.S. growth momentum, as supportive of U.S. Cyclical versus global Cyclical.

In addition, rising pressures on global corporate profits and cash flows that should threaten future capital expenditures further conviction of an underweight of global Cyclical relative to domestic Cyclical.

Figure 4: Global Cyclical Relative to U.S. Domestic Cyclical (Right Scale) and U.S. Trade Weighted Dollar (Left Scale)



Note: Data are as of November 30, 2008.
Source: Bloomberg, Morgan Stanley Research.

Specifically, the team is deemphasizing global capital goods companies because of greater risks of project cancellation outside of the U.S. and materials, specifically industrial metals, railroads, and agricultural-related companies affected by commodity pricing weakness. They are emphasizing U.S. low-end (discounters) and food and drug retailing that may benefit from fiscal spending initiatives, together with selected financials that are expected to benefit from a steep yield curve.

6. TELECOMMUNICATION SERVICES

Morgan Stanley’s Telecommunication Services Analyst Simon Flannery has a positive view on the industry and believes it is poised to potentially outperform the broader S&P 500 Index in 2009.

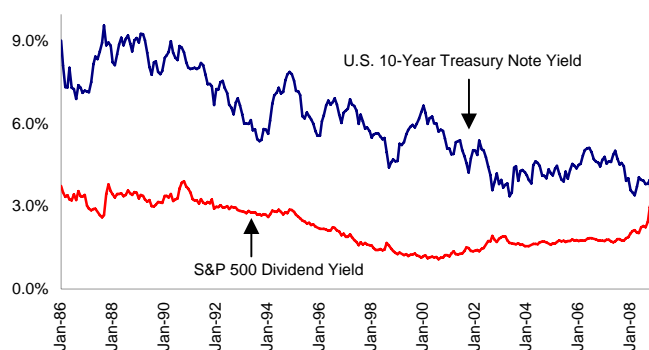
Three key elements underlie Simon’s positive view on the

Second, while the Telecom Services sector has been affected by the credit crisis, Simon views the group possessing a solid position with strong balance sheets from a leverage and liquidity standpoint. Third, Telecom Services has a defensive business model positioned for a period of modest economic growth that is not dependent on global economic growth dynamics.

7. DIVIDEND GROWERS

Of the many landmark events affecting the investment landscape in 2008, one was especially important for income-oriented investors: for the first time in 50 years, the dividend yield of the S&P 500 Index exceeded the yield on the U.S. 10-year Treasury Note.

Figure 6: S&P 500 Index Dividend Yield and U.S. 10-Year Treasury Note Yield (%)



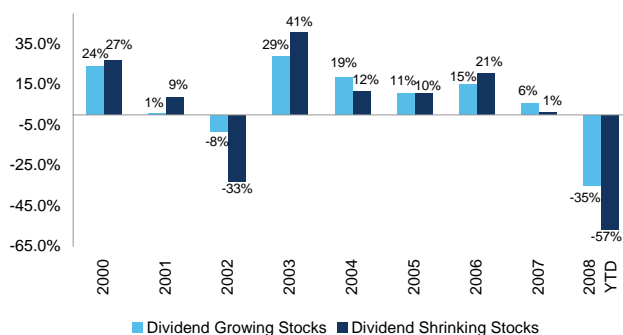
Note: Data are as of December 17, 2008.
Source: Bloomberg, Morgan Stanley Global Wealth Management Asset Allocation Group.

Two interpretations of this significant reading are possible: (i) the U.S. equity market has become deeply oversold and it is a sign of valuation support for the markets; or (ii) the equity market has suffered a permanent de-rating and equity investors will demand a premium to risk-free U.S. Treasury Note yields as compensation to assume the risk of owning equities. The former rationale seems the more plausible one, in light of the hyper-stimulative policy responses from the monetary and fiscal authorities to the financial crisis that should produce a recovery in time, in our opinion.

However, not all dividend-paying equities are created equal. For investors focused on dividends, it is necessary to look for companies that not only pay dividends but also consistently *grow* their dividends. We envision that the volatility that has characterized the current investment environment will likely continue through 2009, as secular increases in volatility generally last for multi-year periods. Historically, during periods of financial market turbulence, companies that have increased their dividends have outperformed companies that have reduced their dividends.

As show in Figure 7, this has been the case in five out of the last nine years.

Figure 7: Price Return of S&P 500 Index Dividend Growing Stocks vs. Dividend Shrinking Stocks (%)



Note: Data are as of December 17, 2008.
Source: Factset, Morgan Stanley Global Wealth Management Asset Allocation Group.

8. EMERGING MARKETS ASIA

After a grueling year for Emerging Market (EM) equities in 2008, Morgan Stanley's Emerging Market Equity Strategist Jonathan Garner expects a recovery in 2009. Specifically, he expects a sharp turnaround in overall EM with EM Asia to lead the rally, outperforming EM Latin America and EM Europe, Middle East, and Africa (EMEA).

Table 1: MSCI Emerging Markets Asia Index Weight by Country

COUNTRY	WEIGHT (%)
China	33.1
Korea	23.6
Taiwan	19.5
India	12.3
Malaysia	5.2
Indonesia	2.6
Thailand	2.5
Philippines	0.9
Pakistan	0.3
Total	100.0

Note: Data are as of December 16, 2008. The MSCI Emerging Markets Asia Index is a free-float adjusted market capitalization index that is designed to measure equity market performance in the emerging markets of Asia, which consists of the 9 country indices listed above. MSCI China Index includes H shares, B shares, Red Chip Shares, and P Chip Shares. H Shares are traded in Hong Kong, B Shares are traded in Shanghai and Shenzhen, and Red Chip and P Chip Shares are shares of companies that are majority owned by the Chinese state.

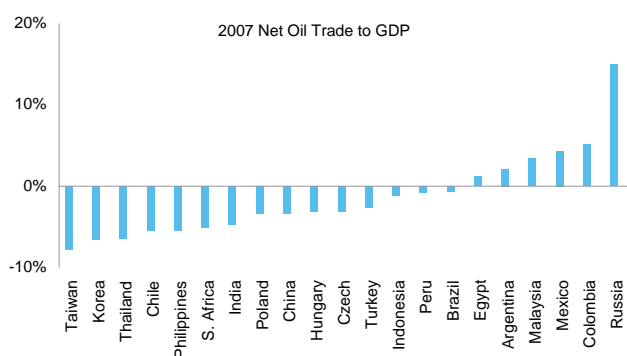
Source: Factset, MSCI Barra.

Jonathan's positive view on EM Asia is based on three factors. First, because of the Asian Crisis in 1997/1998, many local Asian countries implemented structural macro and micro economic improvements, which have led to stronger sovereign balance sheets. As proof, he points out that within the MSCI EM universe, the five countries with the lowest Gross External Debt/Foreign Exchange Reserve Ratio (a key measure of debt loads) are all in Asia (China, Taiwan, Thailand, Malaysia, and India). This should give

Emerging Asia the scope to use aggressive fiscal and monetary policy actions to combat the global economic recession.

Second, Jonathan notes that the larger Asian economies derive a substantial terms-of-trade benefit from lower crude oil and commodity prices. With the collapse in oil prices over the past year (crude oil has declined -60% from mid-December 2007 to mid-December 2008), EM Asia has significant room to benefit from lower energy prices. In previous episodes of declining crude oil prices, specifically 4Q 98 – 2Q 99 and 4Q 01 – 2Q 02, EM Asia outperformed EM Latin America and EMEA by approximately 50%.

Figure 8: Asia's Net Oil Importers to Benefit from Lower Oil Prices



Note: Data are as of December 16, 2008.

Source: Jonathan Garner, Morgan Stanley Head of Emerging Markets Research, BP Statistical Review, IMF. Uses net import/exports of oil with an average WTI price of \$72 and 2007 nominal US\$ GDP from IMF.

Third, in previous episodes of economic weakness, EM Asian Corporate Earnings Per Share have tended to trough before EM Latin America or EMEA. Jonathan expects this pattern to be repeated in this cycle. As of the end of December 2008, earnings revisions were far more negative for Asia than for other regions of the EM, and he thinks that Asia may turn positive before the rest of the asset class due to EM Asia's high weighting in Information Technology that tends to lead the way in a recovery.

9. AUSTRALIAN DOLLAR

Morgan Stanley's Currency Strategy team's 2009 Outlook report, "Year of the Bear?", centers around their view that the year ahead will differentiate between two investment environments: (i) early in 2009, they expect the dominant theme to focus on continued fallout from the credit crisis and the global economic slowdown; and (ii) later in the year, an eventual upturn if and when the aggressive actions by monetary and fiscal authority policy makers begin to gain traction.

The team expects that policy makers may be slow to withdraw stimulus, due to uncertainty surrounding the

timing and pace of an economic recovery. In addition, they will need to remove the massive doses of stimulus that have been injected at a gradual pace. Consistent with the view that stimulus will be present in the financial markets for a meaningful period of time to help restart global growth, the Australian Dollar is poised to restrengthen versus the U.S. Dollar. Australia is geared to a global economic recovery through the country's heavy concentration in natural resources, in particular commodities. In addition, if the Chinese slowdown proves more shallow or the recovery more pronounced, the Australia Dollar stands to benefit.

The authors would like to acknowledge the outstanding effort of Gina Nguyen in compiling this report.

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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 generally offer a lower return. There is no guarantee that investors will receive par if TIPS are sold before maturity. Because the return of TIPS is linked to inflation, TIPS may significantly underperform vs. fixed return treasuries in times of low inflation.

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