Caron's Corner Transcript – 10.3.2024

The BEAT for October – Key Themes and Top Ideas

- Before we get to our Key Themes and Top Ideas, my #1 concern is that the labor market may be higher than the stated 4.2%.
- How much higher, hard to say, but the employment data has been consistently revised weaker.
- This has implications for Fed policy and what they may need to do to defend their stated 4.4% unemployment rate threshold.
- It may mean they want to cut aggressively, but inflation may not allow them to do so.
- Additionally the high fiscal deficit means government spending programs to support the economy may be limited.
- Putting it all together, **<u>the US may encounter a period of diminished counter cyclical monetary and fiscal policy tools to buffer future shocks to the economy</u>**.
- Ultimately, this could increase risk premia for assets broadly.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to The BEAT for October. Before we get into our key themes, let me go through what I think is a top concern which is that the labor market may be weaker than reported numbers imply, and the real unemployment rate may actually be higher than the stated 4.2%. How much higher, it's really hard to say, but the unemployment data has been consistently revised weaker. So if there's an error in the data, it's toward weaker, not stronger employment situations. This has implications for Fed policy and what they may need to do to defend their stated 4.4% unemployment rate threshold, and it may mean that they want to cut aggressively but inflation may not allow them to do so. We do think that we are still in an inflationary environment although it has been coming down. Additionally, the high level of the fiscal deficit means that government spending programs to support the economy may also be limited. So going forward, putting it all together, the US may encounter a period of diminished countercyclical monetary and fiscal policy tools to buffer shocks to the economy and this could increase risk premium broadly. That's really the backdrop of where we stand.

As we move into October, our first key theme is about crossing peak uncertainty. October represents peak uncertainty. Markets have been wrestling with the start of Fed rate cuts the US election outcomes of both president and the make up of Congress. This uncertainty has led to volatility and wild swings in asset prices. But by early November, we should know the results and markets may be relieved of this uncertainty which could enable prices to trade within a more stable range. Of course, there will always be surprises, but asset allocation decisions can be made with more confidence after we cross this peak uncertainty in October.

Now let's talk a little bit about why the Fed cut 50 basis points. I know this may sound like ancient history, but I still think it ties to the labor market uncertainty and there are many reasonable explanations that justify starting with a 50 basis point rate cut. These explanations range from a “catch-up” cut, regretting that they didn't start in July, to an insurance cut to solidify a soft landing outcome. However, we are skeptical and think there's more to it. Specifically we think the Fed may be worried that the labor market, upon which their policy reaction function hinges, is weaker than data suggests. Note that labor data since the pandemic has been volatile and consistently revised lower as immigration is one of the key sources of uncertainty given the population. This is just our theory, but something we will be watching closely.

Onto the elections. What do we think we know at this point? Well, what the candidates say and how they govern can be different. The greatest uncertainty surrounds Vice President Harris. Academic analysis reveals her voting record in the Senate as being very progressive and far left according to Voteview.com, but she promises to govern as a moderate. There's less uncertainty with Trump because he's been president before. Both candidate policies may add to the deficit, but both believe their spending will be paid for: Trump's through deregulation and tariffs, Harris’ through progressive redistributive policies. But what may matter most is the makeup of Congress who can enable the candidates plans to go forward or not. This again is what we're going to be watching closely.

Onto inflation. Is it really dead? Maybe not dead yet? Just sleeping? The narrative surrounding the recent Fed cut is that the decline in inflation has given them comfort to lower rates. But it may not be that simple. If we look at other central banks, for example, the Bank of England and the ECB and others, they all started cutting rates but then had to slow their planned pace of cuts because inflation proved more stubborn and the labor market and wages remained relatively sticky. The Fed is set to cut interest rates steadily for the remainder of this year and into 2025, finishing in 2026 with a policy rate of 3%. If the US experience is the same as other global economies, the planned pace of Fed cuts may encounter challenges. This is something else that we have to be wary of in terms of valuations.

So what does this mean for our asset allocations and positioning? Well, first off, we are going to hold our underweight in duration. Yes, this is happening despite the fact that the Fed is expected to cut interest rates. The reason why is that the markets are already pricing in 250 basis points of cuts already. We think the bond markets are well priced and well positioned for this move. We don't really believe that there's a lot of upside in bonds from a duration perspective.

As such, we're going to maintain an underweight in equities. There's definitely been a shift from cyclicals to defensives. What's happening is a broadening out of the overall market, meaning that it's not just about a small segment of technology stocks that's driving the entire market. The market is starting to broaden out and people are starting to look at more cash flow oriented businesses and stocks. This is getting more to the defensive side, like utilities. For example, all of these different areas of the markets are starting to also participate in some of the upside. That makes for a more healthy, positive move higher in equities. We're still neutral with some positive risk on tilts in terms of our allocation.

Now a big change for us is that we are reducing high yield from overweight to neutral and we're moving our investment grade allocation up a notch. So we are underweight but we are going to become a little less underweight in investment grade. Let me explain. We're not negative on high yield, we just think that yields came down so much that the yield in high yield is not really that high anymore. It doesn't give us as much excess return over treasuries and is therefore a bit less attractive. We would rather wait for a pullback to get back into that asset class. It's purely a profit taking exercise in terms of investment grade. We think short duration investment grade actually looks attractive, so we are moving some of the proceeds from our reduction in high yield into short duration in investment grade.

Lastly looking internationally, we did take a long exposure in French equities. To be frank, we've been quite disappointed in the performance of this market in the sector. We thought the political changes might bring on some catch up moves in in France across the CAC 40 (a benchmark index for the French stock market) and the like. That really hasn't happened. It's really just kind of moved along with the indices and it really hasn't closed the gap in a material way. So we think that France is really just in a position to muddle through which means that it's not overly attractive to us. Therefore we're going to close that position.

RISK CONSIDERATIONS

Diversification does not eliminate the risk of loss. There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio.

IMPORTANT DISCLOSURES:

Past performance is no guarantee of future results. The returns referred to in the audio are those of representative indices and are not meant to depict the performance of a specific investment.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.

For important information about the investment managers, please refer to Form ADV Part 2.

The views and opinions and/or analysis expressed are those of the author or the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific strategy or product the Firm offers. Future results may differ significantly depending on factors such as changes in securities or financial markets or general economic conditions.

This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

This material is not a product of Morgan Stanley's Research Department and should not be regarded as a research material or a recommendation.

The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person's circumstances and purpose. The Firm shall not be liable for, and accepts no liability for, the use or misuse of this material by any such financial intermediary.

This material may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this material in another language, the English version shall prevail.

Eaton Vance is part of Morgan Stanley Investment Management. Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

DISTRIBUTION

This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC and Atlanta Capital Management LLC.

This material has been issued by any one or more of the following entities:

EMEA:

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM and Eaton Vance materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

In Switzerland, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited ("EVMI") 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

Italy: MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. The **Netherlands:** MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. **France:** MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain:** MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany**: MSIM FMIL, Frankfurt Branch, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Denmark:** MSIM FMIL (Copenhagen Branch), Gorrissen Federspiel, Axel Towers, Axeltorv2, 1609 Copenhagen V, Denmark.

MIDDLE EAST:
Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

This document is distributed in the Dubai International Financial Centre by Morgan Stanley Investment Management Limited (Representative Office), an entity regulated by the Dubai Financial Services Authority (DFSA). It is intended for use by professional clients and market counterparties only. This document is not intended for distribution to retail clients, and retail clients should not act upon the information contained in this document.

This document relates to a financial product which is not subject to any form of regulation or approval by the DFSA. The DFSA has no responsibility for reviewing or verifying any documents in connection with this financial product. Accordingly, the DFSA has not approved this document or any other associated documents nor taken any steps to verify the information set out in this document, and has no responsibility for it. The financial product to which this document relates may be illiquid and/or subject to restrictions on its resale or transfer. Prospective purchasers should conduct their own due diligence on the financial product. If you do not understand the contents of this document, you should consult an authorised financial adviser**.**

U.S.: NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Latin America (Brazil, Chile Colombia, Mexico, Peru, and Uruguay)

This material is for use with an institutional investor or a qualified investor only. All information contained herein is confidential and is for the exclusive use and review of the intended addressee, and may not be passed on to any third party. This material is provided for informational purposes only and does not constitute a public offering, solicitation or recommendation to buy or sell for any product, service, security and/or strategy. A decision to invest should only be made after reading the strategy documentation and conducting in-depth and independent due diligence.

ASIA PACIFIC

Hong Kong: This material is disseminated by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to “professional investors” as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this material have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This material is disseminated by Morgan Stanley Investment Management Company and should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore (“SFA”); (ii) to a “relevant person” (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This material is provided by Morgan Stanley Investment Management (Australia) Pty Ltd ABN 22122040037, AFSL No. 314182 and its affiliates and does not constitute an offer of interests. Morgan Stanley Investment Management (Australia) Pty Limited arranges for MSIM affiliates to provide financial services to Australian wholesale clients. Interests will only be offered in circumstances under which no disclosure is required under the Corporations Act 2001 (Cth) (the “Corporations Act”). Any offer of interests will not purport to be an offer of interests in circumstances under which disclosure is required under the Corporations Act and will only be made to persons who qualify as a “wholesale client” (as defined in the Corporations Act). This material will not be lodged with the Australian Securities and Investments Commission.

Japan: For professional investors, this material is circulated or distributed for informational purposes only. For those who are not professional investors, this material is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. (“MSIMJ”)’s business with respect to discretionary investment management agreements (“IMA”) and investment advisory agreements (“IAA”). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This material is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.