

A Bear Market Rally or the Start of Something Bigger?

- Inflation is down, but the jobs data is still strong.
- In fact, the consensus view is that inflation has peaked and will decline in 2023.
- However, there are almost two jobs open for every unemployed person, so wage inflation is neither dead nor dying.
- All in all, a 50 basis point hike by the Fed is more likely in December, 75 now less probable.
- The market is currently pricing in a terminal policy rate of 5.00%.

Jim Caron: Last week was a historic week for markets almost on any measure and one of the questions out there is was the bull market an overreaction? Or is this just a bear market rally? This is the question that people are trying to answer right now. But what's also very important for us is to find some type of an investment hedge given the uncertainty of whether or not this rally has real legs, or is just a bear market rally. So let's get into this.

If we look at the data from last week CPI month over month fell to 0.4% versus 0.6%. That month over month decline is really what the market is focused on and it's what the Fed is telling us that they're focused on. But core CPI month over month also fell to 0.3% from 0.5%. Now the year over year numbers are still tracking at 7.7%, but that was lower than expected at 7.9%. So on the inflation front things look like they're cooling down.

But what we have to remember is the jobs data is still actually very strong, meaning wage inflation is neither dead nor dying. According to the payroll report wage inflation came in at 4.7% which was down from 5%. But it's still too high for the Fed's comfort and is inconsistent with their 2% inflation target. This number needs to get down below 3%. And the JOLTS data that came out see the unemployment ratio at 1.9 versus 1.7, meaning that there's almost two jobs open for every unemployed person. This indicates a pretty strong jobs market.

So, all together, we have to try to understand what the narrative might become. One of the key takeaways is that a 50 basis point hike in December becomes much more likely and that 75 basis points is less likely. The terminal policy rate that was thought to reach 5.25% just a week ago, or even 5.50%, both by many credible forecasters seems less likely right now. Perhaps the Fed shifts the dot-plot for the terminal rate at the December meeting from 4.5% - 4.75%, which is where they have been, but they might shift it a little higher to 4.75% - 5.0%. And for what it's worth, that's where I think the terminal rate lands. But I don't make these forecasts, it's just an estimation. But it's also very consistent with what the market's pricing right now.

Let's look at the yield curve, specifically the spread between the 10-year Treasury minus the 3-month T-Bill. This is the spread the Fed looks at and this spread rarely gets more inverted than -75 basis points. I'm going to use to try to understand where the 10-year Treasury yield may land at this

point in the cycle, with so many things are in flux. Simply subtracting 75 basis points from the average Fed funds rate over three months or the 3-month T-Bill more simply gives us a reasonable level to think about where the 10-year yield may land. And I'll put a plus or minus 25 basis points on that. So, if the Fed goes to a 5% policy and I subtract 75 basis points then the 10-year Treasury yields could get up to 4.25% plus or minus 25 basis points. But, if they only go to a 4.75% rate - which is very possible - then a 4.0% yield plus or minus 25 basis points is reasonable. Today 10-year Treasury yields are below 4.0%. What we have to ask ourselves is how long will the Fed hold levels at the term policy rates of 4.75 or 5.0%. How long will they keep those there? I think it could be as long as 12 months, all else equal and that's historically what would be required to bring inflation lower. It's not just a question of the Fed hiking rates to 4.75% or 5.0%, but then how long will they actually keep it there?

Now the second thing that's going to impact the 10-year Treasury is the growth trajectory. If people think that we're headed into more of a deeper recession than a mild one, then 10-year Treasury yields and long-term bond yields are going to drop faster. That's where you can better hedge yourself against a recession. If inflation is dropping and we're going to get a slowdown next year this is an opportunity for people to own the back end and this is something that many people are doing and why the curve is remaining inverted. But these are the factors that are going to drive the level of 10-year yields where of course the front end yields are going to be driven by Fed policy, and it looks like they're still going to move up to that 4.75 to 5% level. So we've got to keep that in mind despite the fact that bond yields have come down at the end of last week.

The question then becomes about inflation and whether inflation will decline in 2023. The consensus answer is most likely, that's what many forecasters are expecting. That's just the year-over-year base effects, it's the math, but the surprise in CPI last week was twofold. One, many forecasters were projecting an upside surprise versus consensus and this was a big mess. The second is that the magnitude of the drop in CPI was quite large and perhaps this is payback from previous months stronger than expected numbers. If we think about a bond investment playbook, we now have to think about what has changed and how do we decipher these risks? Well, the market thought it was on a collision course with a hard landing, but now with this material drop in inflation and this tempers Fed policy, namely aggressive rate hikes in the future get tempered, which makes a soft landing possible. Not probable, but it makes a soft landing possible. The other point is that this could be viewed as the big moment everybody was waiting for. Inflation has peaked! Many are proclaiming this that and yes, it seems most likely that inflation has probably peaked at this point.

With U.S. inflation, if I look at the year-over-year from October it was 7.7% and it fell to its lowest level since January. The core measure was 6.3% and this also looks as though it has peaked. However the driver of the fall in core CPI was core goods inflation, and if you remember we did a podcast talking about goods and services. The majority of the drop in inflation came from the goods sector falling to 5.1% from the peak of 12.3% in February, a dramatic drop. However, core **services** inflation was steady at 6.7%. So the service component is still holding tight and that's where the effects of a tight labor market and strong household cash balances are felt. If nothing else this ensures that the message from the Fed doesn't get much softer. Credit spreads are tighter but this is not exactly what the Fed wanted to see. Yes the Fed is happy to see inflation come in lower but maybe it all happened too fast. So both

the path and pace matter and the Fed believes inflation can be controlled by policy through the asset price channel and that's why this rally is concerning to them. In their mind if financial conditions ease because asset prices went up due to a very sharp drop in CPI, well equity price spreads coming in actually just might be inflationary in the future. They're not really solving the problem. This is their concern but nevertheless bond yields may still settle into a range because it does seem like inflation is likely to have peaked at this point. However, you know, as many people would like to point out, we've been fooled about this before but maybe this time it really is different, in the sense that inflation has peaked.

Credit markets today look even better now because, number one, default risks may be tempered with the tempering of rate hikes, where the Fed may not feel the need to hike until something breaks in the economy. That means there may be less deterioration in credit fundamentals and all told, IG yields were very attractive, well north of 5.5% even 6% yields based on Bloomberg indices. High yield, was also attractive, above 9%, again based on Bloomberg indices. So a mild recession scenario today is starting to gain a lot more attraction with the all-in yield of many credit sectors still reasonably high. This is going to attract many buyers, especially if you expect there to be a "slow death" and inflation coming down in the future.

Looking at housing and consumer credit, I think the markets are also taking notice of that. Mortgage rates may now start to settle down into a range and there's less risk of perpetually rising rates which has been lowering housing affordability. Home prices may begin a process of normalization versus the correction phase and consumer credit may also get a reprieve as asset prices may not keep rising as quickly. All of these things are good factors and certainly helpful to the broader economy. But there are risks and what we have to ask ourselves has risk premium declined durably, which would keep asset prices high and robust for the next period of time? We're trying to answer the question "Is just a bear market rally or is this the start of something bigger?"

To answer, I'm going to first look at risk premia, which hasn't declined durably, so I'm going to say no, not yet. It's too early to make that call. But the case for risk premium declining durably is selected. Let's worry about the Fed crashing the economy to rein in inflation. That's good news. Cash flows now can be valued with more certainty because of discount factors, meaning interest rates. We are going to settle into a range where we can discount future cash flows at that rate with more certainty. That certainly brings down risk premium. It helps valuations. So that also means that riskier assets become less risky by definition. But the case against risk premia coming down more durably is that correlation risk still remains high. The trouble with 2022 is that the stock and bond performance have been moving in the same direction. When these correlations moved together with positive performance, it's ignored, in fact embraced, because as long as people are making strong performance and making positive performance, nobody really seems to pay attention if they're highly correlated.

But high correlation is a risk, and when these correlations moved together with negative performance, it's disastrous. Just look at 2022 performance. That's exactly what happened in 2022. High correlations make it difficult to diversify a portfolio and reduce risk and I still think we're in that phase right now. We're in a high correlation market, where fixed income performance and equity performance is highly

correlated with each other, and it's hard to achieve meaningful diversification. It's hard for me to say that risk premia has come down durably and that we can expect from most likely expected volatility in the future.

But now let's talk about barbells and yield curves and these are some of the hedging opportunities. Now as we know the barbell strategy we've been advocating is adding duration to fixed income portfolios, but we've been advocating owning some front-end and owning some back-end too. Let's say 50% of the front-end, 50% of the back end, add those two components of duration together in your portfolio, get an average duration of around three years. That's been what I've called the "sweet spot" for fixed income portfolios, and I still think that's the case. As an aside, you know we may have seen an overreaction to the CPI. It's one of the largest market responses with multi-sigma moves to say the least.

It is widely expected that inflation will fall towards 3% in the next 12 months but it may still require a terminal policy rate of 5% for that to remain sticky for quite some time in order to bring inflation down. It's one of the reasons why I think about the barbell type strategies - you want to have a hedge against rising interest rates. Owning some front-end bonds is one way to hedge that, but I also want to hedge out recession risk by owning some back-end bonds too. That's the barbell. We're most likely to see the curve remain inverted for a period of time, but clearly the question is, how much? For that I refer back to that -75 basis point spread between 3-month T-bills and 10-year yields. They give me some guidance as to where I think the 10-year yield may logically land. The curve could invert more, but it would require that the Fed holds rates at 5% into a deep recession, not a mild recession, and I don't think that's likely.

I think it could be said that we've already seen the peak in the inversion and now the yield curve is just going to remain inverted but it's going to move within a range. If the Fed pivots and cuts rates later in 2023 10-years may stay around that 4% level while 2-year Treasuries fall to 3.5%. That sounds crazy, but the curve has done things like that before. If the Fed does pivot and if rate cuts are warranted, we would expect front-end bond yields to come down quite a lot in the yield curve to dis-invert. That's effectively another way that we can hedge against a slowdown in the markets as well, and possibly even a deeper recession. So again, looking at barbell type strategies and fixed income portfolios and also yield curve strategies in in fixing portfolios. It's one of the reasons I like barbells broadly speaking and strategies to hedge against equity performance. Hopefully that brings correlations into line and we get a more diversified, less risky portfolio. This is a lot of technical stuff going on, but we are at a turning point in the markets, so I think it's appropriate to bring up all of these different factors.

RISK CONSIDERATIONS

Diversification does not eliminate risk of loss. There is no assurance that a portfolio 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 portfolio may be subject to certain additional risks. **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. **Mortgage- and asset-backed securities** are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. **Certain U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. **High-yield securities (“junk bonds”)** are lower-rated securities that may have a higher degree of credit and liquidity risk. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. **Foreign securities** are subject to currency, political, economic and market risks. The risks of investing **emerging market countries** are greater than risks associated with investments in foreign developed countries. Sovereign debt securities are subject to default risk. Derivative instruments may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Restricted and illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). The initial interest rate on a **floating-rate security** may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk.

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.

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without the Firm’s express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

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).

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.

CRC 5120326 Exp. 11/30/2023