Caron's Corner Transcript – 2.1.2023

Fed Recap: The Song Remains the Same, but the End Is Near

Jim Caron: I'd like to discuss the Fed meeting today and I think I can sum it up in one quote from Fed Chair Powell, namely "we're talking about a couple of more hikes" where "a couple" to me means two. This suggests that they probably hike in March and again in May, perhaps, where the next meeting is March 15, the meeting after that May 3. So now we're talking about a terminal policy rate of 5 - 5.25% which has really been our base case. But it is that quote that is really what created the risk-friendly move in markets and you can see there's a big turnaround as the Fed conference press conference started and I think it's important to highlight that maybe the Fed has to walk that statement back but we're going to really focus on that right now. It looks like a terminal rate of 5 - 5.25% is becoming more of a certainty and risky assets seem happy with that. However, Powell is still trying to impress that they have "more work to do" to ensure that there are two-sided risks. That market prices do not run hot and prematurely or excessively and ease financial conditions which will cut against their inflation fighting objectives. The way I would summarize this meeting is I can sandwich it between two phrases. The first phrase is "the song remains the same" and the second is "but the end is near."

So let's talk about the song remains the same. Today's message is really just a carbon copy of the December FOMC meeting. He made the same old arguments at today's meeting. What he said was that labor markets remained strong which is keeping inflation risks elevated and despite the decline in CPI and wage inflation, it's still too high and inconsistent with inflation becoming anchored at target levels. Then he went on to still discuss the services versus goods sector. Now we've talked about this a lot in the past and he said that goods inflation is falling, but service sector inflation remains high and this is why he's a bit concerned. In fact, the Feds favored measure of service sector inflation, which he which he quoted or which he highlighted is core services ex-housing, which "hasn't even started to fall." He's certainly very focused on that service sector inflation and particularly core services ex-housing. He went on to say this measure is the majority of the core PCE index, which as we all know, is the Feds favored measure of inflation overall. The chief risk for the Fed is inflation becoming unanchored later. This has the risk of a wage price spiral and rising inflation expectations have become entrenched into the market. Powell concluded that by saying that "we still have a lot of work to do," exactly what he said at the December meeting. The markets were expecting a more dovish statement from the Fed. Some thought this might be the last Fed hike, but that doesn't seem likely based on what they're saying. The fact of the matter is Powell is still trying to keep the debate alive that the terminal rate is not firmly determined. He hinted at the fact that they might have one or two more – "a couple more" as he said - hikes to go.

Let's parse to the second part of this phrase, ". . .but the End Is Near." The expected 25 basis point rate hike was delivered, a slowdown from the 50 basis point pace that was expected. But the level of the policy rate is still up for debate, and that's what the Fed is trying to communicate. The Fed is signaling that they are not done hiking and that they expect ongoing increases, which makes them think "increases" with an "s" meaning more than just one, likely in March, then potentially again on May 3rd. But that's yet to be confirmed. This is all data dependent, but we can expect another 25 basis point hike in March with the door open for an additional 25 in May until the job is done in, ultimately meaning that they are confident that inflation not only has fallen, but it's going to remain anchored around target levels. Now that might be a big ask, but that's what they're telling us right now. The other thing to note is that there was no Summary of Economic Projections at this meeting. This is the Fed's forecast. They weren't able to come together as a committee and make a quarterly forecast like they typically do, so Powell can't front-run the economic and policy forecasts of the committee. He's basically stuck repeating what was said at the December meeting. It's hard for him to deliver another policy message to the market. However, the decision was unanimous to hike 25 basis points even amongst the newly appointed and supposedly dovish voting members. That's another point worth highlighting. Nevertheless, Powell noted that there will be two employment reports and two CPI reports before the next meeting, meaning there's more data for them to look at. To me this gives the Fed optionality to hike one more time at the March 15th meeting and depending on how the data looks, maybe again at on May 3rd, but that's going to be the data dependent. Bottom line is it does seem like the market is positioned for a stable Fed starting sometime in the second quarter and this will likely usher in a range bound price action for US Treasury bond yields, and with labor market so tight it may be hard to have a deep recession.

So a soft landing is becoming more and more possible. We saw today's JOLTS numbers, and job openings moved up to 11 million. The vacancies, the number of job openings per unemployed person, is almost 2 to 1 (1.9 to 1). The labor market still seems pretty strong and this will keep credit default risks low, credit cards and autos and everything else, and favor higher-beta fixed income including asset-backed securities, high yield, emerging markets, these are all sectors that would benefit from a more stable interest rate environment and a soft landing. But from an equity perspective, there is no question that earnings are going through a correction as profit margins come under pressure. However, if we do end up with a soft landing, which amounts to really a correction, but not the start of a deeper bear market, then investors may be willing to pay higher valuations for future cash flows. In other words, multiples may stay elevated despite the fact that earnings today are starting to come down. Ultimately, the Fed kept the debate open for the terminal policy rate at 5 - 5.25 percent alive and well, but almost assured the markets that it would stop there. That's what I think the markets are really keen on, that they're liking the certainty that they're seeing from the Fed, that this rate hiking cycle is coming to an end, and people are building in really a higher probability for soft landing. Those are my key takeaways from this meeting and overall, I thought Powell did a very good job in trying to balance this message. Clearly the markets like it and we'll see if the Fed decides to walk that statement back "that they may only have a couple of more hikes to do." That's what we're going to be watching for.

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.

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).

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 5440447 Exp. 2/29/2024