Caron's Corner Transcript – 5.8.2023

Wages, Inflation, Stability, Policy: Something's Got to Give

- The key macro factors at the moment are: 1) jobs/wages; 2) inflation; 3) financial market stability; and 4) central bank policy. Each are seemingly at odds with the other.
- Labor markets remain tight and inflation remains stubbornly high…why is that?
- We agree with Chairman Powell and the academics on this one: wages are not the cause for inflation, they are the result of it. Thus, a softening labor market that cools wages needs to be preceded first by a slowing economy.
- But does the economy need something to ***break*** in order to lower inflation, or is it different this time? We discuss in today's audio.

Jim Caron: Hello, everyone. This is Jim Caron, Co-CIO of Global Balanced and Risk Control Strategies.

Wages, inflation, financial stability and policy are all at odds with each other and something's got to give. So, look, the way that we look at it is that the key macro factors at the moment, which are jobs and wages and we got some of that data last week, inflation, which is an ongoing issue for all of us, and we have some of that data this week, financial market stability, and central bank policy. These are the four key factors that I'm looking at the moment. Now, each are seemingly at odds with each other. So let's get right into it.

So the four key risk factors that are unresolved, let's start with jobs and wages. So the latest jobs report in the US highlights broadly that labor markets remain tight. The unemployment rate fell to 3.4% which is the lowest it was since 1969. Average hourly wages year over year came in higher than expected at 4.4% versus 4.2%, which was expected. And productivity declined in the first quarter, keeping unit labor costs high rising to 6.3% versus 5.6% hoped for. Other measures of wages including the Employment Cost index corroborate this showing year over year wage growth remaining well above the 3.5% pace that the Fed sees as consistent with its 2% inflation target. The prime age employment to population ratio rose from 80.7% in March to 80.8% in April. So an increase of 0.1%, but it's still above that 80% threshold level that has historically been consistent with an economy that's at full employment. And this ratio is a key measure of tightness in the labor market but not all the labor market news is good. There were back month revisions that were negative and the three month average pace of job growth fell to 222,000 which is a decline of 123,000 from where it was last time. So the jobs growth number is still good, but it's slowing down and sometimes it's the delta that matters as we like to say. But that said, although the jobs market is slowing, it still remains very tight and we spent some time digging into jobs and wages because Jay Powell made special mention of that, and when he said that it may be this different this time during his press conference last week and that the U.S. may escape recession on account of the fact that the jobs market remains tight despite 500 basis points of rate hikes. So next up is inflation and this is the second factor.

So now we've gotten through jobs, we know it's tight but it's starting to slow down. But, the market still remains tight. But now with inflation, inflation remains stubbornly high and especially at the core and

pick your favorite measure of inflation, it's too high, whether it be CPI or PCE, it's still hanging around at 4.5% to 5% level. Make no mistake. Inflation is heading lower this year. It's just a question of "How low does it go?" and if it gets there in a timely enough manner to satisfy the Fed. So are high wages to blame? Is that what's going on? Is that why inflation is up? And we don't really think so. And this is where we agree with Powell and the academics on this one. Wages are not the cause for inflation. They're the result of it. That's a softening of the labor market that cools wages need to be proceeded first by a slowing of the economy.

And this is where we get to the third factor which is financial market stability. So the next question one might ask is then: "What slows the economy?" And this is where the speculation and uncertainty arrives. So as the lore would have it the Fed hikes until something breaks and this creates a slowdown in the economy that lowers inflation. But what breaks? The market is searching for clues and things, it's found some with stresses in the small and mid-size banks, commercial real estate and recent evidence of tighter lending conditions. Everyone is paying close attention to this but without a correlating risk factor that creates a sudden stop in economic activity, the economy keeps on plowing ahead. It ain't pretty but plowing ahead nonetheless. But does the economy need something to break in order to lower inflation or is it really different this time?

And now this is where we go back to the fourth factor, which is Central Bank Policy. The Fed seems to think it's different this time as Powell stated in the post FOMC presser, because the jobs market remains tight and the consumer is coming from a strong place. So can the Fed lower inflation without hurting the jobs market? Well, this is where we come back full circle to the tight labor market fed forecast. See the unemployment rate rising to 4.6%. Remember it's 3.4% today. The Fed sees it by the end of the year going to 4.6%. And the Fed sees this rise in the unemployment rate is sufficient to do the trick. Meaning that we end up getting a soft landing, which is their base case. So no recession again, that's their base case. The Fed still finds itself though between a rock and a hard place because if the Fed tightens too much and it puts financial stability at risk. Well, that's a problem. But if it doesn't tighten enough, then inflation may not come down as needed and required, which means that the Fed has to hike rates more, which then puts financial stability at greater risk. And this is the vicious spiral that I believe the fed is caught within.

And it's why I said that wages, inflation and financial stability are at odds with policy. So balancing the risks and finding asymmetries is really what we think the key to investing is this year. And it's difficult for us to have high conviction on where we may end up by the end of the year. So instead, what we're focusing on is finding asymmetries in the market for us to invest in. And this is premised on our core view that we discussed many times, which is that risks are more balanced than the consensus be bearish narrative would suggest. And we find that risk, asymmetries are most easily identified in the bond market. The market is pricing for rate cuts of over 100 basis points over the next 12 to 14 months. But we believe given that the Fed is still worried about sticking inflation that it may be slow to actually cut rates. Therefore, if we position for events that are just opposite of a hard landing outcome, we believe there are more scenarios for a positive return in which the aggressively priced for rates, if the aggressively priced rates are not realized. Additionally, it may take time for all of these events to unravel. So we prefer to get paid to wait by owning carry and collecting income positioning against a

hard landing affords us this opportunity. We can own higher yielding double B, let's say credit quality risk profiles alongside holding higher yielding high quality short duration instruments to create a synthetic investment grade exposure effectively. We like collecting carry but keeping interest rate exposure low because rates are already well priced for it to decline in equities. We can look for value and larger cap diversified and defensive positioning to include alongside our fixed income exposure. So as you've heard us say many times before and as we do like to say, it's better to, to balance the risks than be defensive and apply risk controls along the way. So I will not be doing Caron's Corner next week due to a travel schedule, but I will be back the week after that and until then, thank you all very much.

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.

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).

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.

CRC 5664001 Exp. 5/31/2024