Morgan Stanley

INVESTMENT MANAGEMENT

October 31, 2022

International

MSIM Forward

How our investment managers navigate volatile markets

Summary

- Equity and income markets remain highly volatile as investors struggle with mixed signals on inflation, growth and central bank policy.
- A summer rally went against the general downward trend for U.S. equities in 2022, but that stalled in mid-August, with the S&P 500 Index hitting a low for the year in September.
- Since then, the S&P 500 has bounced in anticipation of slower rate hikes from the Federal Reserve after three consecutive 75 basis point increases.
- While real GDP grew at an annualized rate of 2.6% in the third quarter—the first positive change this year—concerns about recession linger, highlighted by the inversion since July of the 2-year/10-year U.S. Treasury yield curve.
- As always, our investment managers seek to actively capitalize on the opportunities presented by volatile investor sentiment, while ensuring that portfolio risk profiles remain appropriate for their strategies.
- Our strategies are designed to seek fundamental value that helps build client wealth over the course of many business cycles.
- In our view, times like these underscore the value of active management. We believe in carefully assessing the fluctuations driven by all kinds of disruptions, and in taking dynamic actions that best serve the long-term interests of our clients.

Contents

EQUITY MARKETS

Andrew Slimmon
Head of Applied Equity Advisors

Fear is Rampant, Sentiment is Low. Time to Buy?

I continue to expect a late fourth quarter rally that will lift equities through the end of the year. There are three reasons for this:

- Inflation trends are finally improving.
- Third quarter earnings were not as horrible as widely expected—again.
- My expectation is that in 2023, the Federal Reserve's hawkish appetite will become increasingly untenable into a weakening economy. Look, it's easier to talk tough with commodity inflation, but harder with rising unemployment.

Longer term, the S&P 500 Index (SPX) on a cap-weighted basis does not look particularly attractive:

- The 10 largest stocks comprise 26% (!) of the index, and are expensive on both an absolute and a relative basis.[1]
- The remaining 490 stocks are far, far cheaper—and might provide some excellent investment opportunities.[2]

Is an aggressive Fed sending the U.S. into a recession or not?

- With so many stocks down 40% to 50% or more, their current pricing already reflects a recession outcome. My Applied Equity Advisors (AEA) team is adding to its portfolios from this group.
- The same is not necessarily true for the SPX cap-weighted, given its top-heavy nature.

Price targets on the upside and downside provide healthy metrics for strategists and analysts.

- Emotionally, however, recency biases may preclude investors from shifting their views on a dime.
- "Why sell that? It's doing great!" and "Why buy that? It's doing terribly" are classic examples of recency bias, setting up investors for suboptimal results.

In my opinion, the only consistency to equity investing is the "fear > greed > fear" roller coaster. Investment styles, sectors and regions get too popular, then too despised.

- Our team preference is unconstrained, core strategies. This flexibility allows us to seek to buy fear and sell greed wherever opportunity presents. We let the markets dictate.
- We seek to buy great companies that get thrown overboard, and fund from companies currently on a pedestal.

So where are fear and greed currently? Again, the top ten are still on a pedestal. Additionally:

- Consumer sentiment hit an all-time low in July.[3] Fear is rampant. A host of high-quality consumer discretionary stock prices reflect this.
- Crude oil futures have gone from below $0 a barrel (high fear) in 2020 to $90 today. Energy stocks are up on the pedestal as well.

[1] Bloomberg

[2] FactSet

[3] University of Michigan Consumer Sentiment Survey

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

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Stocks of small-and medium-capitalization companies entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

INCOME MARKETS

Jim Caron
Chief Fixed Income Strategist

Are We There Yet?

- The market is trying to determine when the Federal Reserve will stop hiking, which is tethered to the prescriptive precondition of falling inflation.
- Historically, the Fed doesn't stop tightening until policy rates exceed the inflation rate. Since inflation is still rising, this muddies the view.
- That leaves three burning questions the market is trying to answer:
  - When will the Fed stop tightening? That would be a buy signal.
  - What will be the terminal policy rate level? That indicates a valuation bottom.
  - How long will the Fed hold at that level? This tells us the optimal duration of a bond portfolio.

Inflation risk – Parsing the data

- Producer Price Index (PPI) data: Headline and core were 8.5% and 5.6%, respectively. Services inflation (excluding trade, transportation and warehousing) was up from 0.4% to 0.6%.
- Consumer Price Index (CPI) data: Headline and core were 8.2% and 6.6%, respectively. That's the highest core reading in 40 years! Here again, services inflation continues to soar.
- Service sector inflation is a big problem for the Fed because it can be harder to control with rate hikes and more firmly embeds itself into stickier inflation expectations.
- University of Michigan Sentiment: The one-year ahead inflation expectations index rose from 4.7% to 5.1%, despite gas prices slowing their decline—a troubling sign for the Fed.
- Unless inflation drops over the next three months, **there is a policy risk** that the Fed will have adjust the forecast of its terminal policy rate above 4.75%.

Policy risk – How high do rates need to go?

- That's difficult to answer, but rooted in the Fed's econometric models:
  - The Fed uses the Phillips Curve—unemployment rate versus inflation rate—and sees wage inflation as the primary source of inflation.
  - The Fed's estimate of NAIRU (Non-Accelerating Inflation Rate of Unemployment)—the rate that balances full employment and price stability—is key. The Fed sees unemployment reaching 4.4%, consistent with bringing inflation to their target of 2.3%.
  - The Fed looks at how their projected policy path is impacting employment and inflation—that is, a feedback loop to the Phillips Curve.
- So far we are not seeing progress toward the Fed meeting its goals. Unemployment fell to a cycle low of 3.5%, but inflation has kept rising.
- Based on the Fed models, policy rates may need to reach the 5% to 5.5% level. **This is not a forecast**, but an extrapolation from current conditions.

Not All the News Is Bad

- The market is incorporating these risks into asset prices.
- The structural factors keeping the jobs market tight are the same factors that may keep the U.S. economy from slipping into a deep recession.
- The investment implication is that although we may not have bottomed, we are close and able to find well-valued assets to hold through the likely upcoming volatility.

Risk Considerations: 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.

EMERGING MARKETS

Jitania Kandhari
Deputy CIO of the Solutions and Multi-Asset Group, Co-Lead Portfolio Manager for Active International Allocation, Head of Macro and Thematic Research for Emerging Markets Equity

China's Economic, Geopolitical and Technological Aspirations and Challenges

China's economy: past, present and future

- For four decades beginning in the 1980s, China enjoyed supercharged growth after opening to foreign trade and investment and implementing free-market reforms, becoming the world's #2 economy.
- In the past two decades, Chinese growth and markets were driven by manufacturing and exports in 2000s, moving to an internet and software-based economy in 2010s.
- China faces headwinds—including demographic decline, high and rising debt, deglobalization—that have led to growth downshifting in the middle of 2010s as the economy reached middle income levels, a point where all Asian tigers have seen economic growth decline.
- The technology revolution and digital transformation prevented a much bigger slowdown in the past 10 years, with the digital economy expanding from 5% of the economy then to 40% now.
- But the manufacturing and real estate sectors that propelled growth and lifted asset markets in the past will not be the future drivers for China, as President Xi Jinping has cracked down on internet giants and pushed to make state-owned enterprises bigger and stronger, amid a partial decoupling from the U.S.
- Recent convergence in the growth of the private and state-owned sectors signals that the government is playing a bigger role in the economy, leading to lower productivity and growth as the role of state capitalism increases in the coming years.
- Growth in the rest of this decade will likely come from hard tech, science-based industries, which the government should support to increase productivity in the economy.

China's geopolitical aspirations and challenges

- Until recently, Chinese leaders had emphasized the country's peaceful rise. Under Xi, China has adopted a more muscular approach to foreign policy, extending its economic influence abroad through the Belt and Road Initiative while engaging in territorial disputes and military threats against neighbors—and more recently trying to expand the role of its currency.
- Russia's invasion of Ukraine has reinforced Moscow-Beijing relationship, but China will be reluctant to cross U.S. red lines given its economic interlinkages with the West.
- China benefits from discounted Russian oil and minerals, but trade with Russia accounts for only 3% of its total trade. China means more to Russia, while the West means more to China.
- The war in Ukraine has focused attention on the future of Taiwan. China has sought after the island since 1949, vowing to "unify" Taiwan with the mainland—using force if necessary. The costs would be catastrophic, however, given the high degree of economic interdependence with the U.S. and Europe; we believe peaceful unification rather than a military invasion is the most plausible scenario.
- Beijing is vulnerable financially. China is the world's biggest exporter and one of the strongest contributors to global growth but the yuan has several limitations and cannot displace the U.S. dollar (USD) as the top reserve currency.
- While Beijing will continue to leverage its financial power by forming currency blocs and creating mechanisms to facilitate trading in yuan—such as the Cross-Border Interbank Payment System (CIPS) and the digital yuan (e-CNY)—chipping away at the USD will not be easy.
- China will counter U.S. financial dominance through dual currency payment systems and regional economic alliances, but diversification from the dollar will be slow moving.

China and U.S. technology race

- The technology race is at the heart of the U.S.-China rivalry. The Pentagon has warned that China is developing technologies to conduct long-range precision strikes as well as space and cyber capabilities to counter U.S. dominance.

- China leads in telecommunications such as developing and installing 5G and Green Tech solar panels and wind turbines, while the U.S. leads in artificial intelligence, semiconductors and online gaming.
- The Biden administration's new controls on China-bound technologies intend to constrain the development of China's semiconductor industry and keep cutting-edge chips out of China's hands. The restrictions could be tightened over time to steer firms away from China, thwarting attempts by Beijing to innovate its way around the constraint.
- China trails South Korea and Taiwan in semiconductor manufacturing, but Chinese wafer fabrication facilities lack the technology required to make advanced chips.
- Since Beijing will not be able to retaliate against Washington, the state will instead turn inwards to focus on domestic technological development and growth.

Key takeaways

- The risk premium in Chinese assets has increased significantly. China has economic, geopolitical and technological aspirations, but faces challenges to meet its goals.
- Market drivers of the last two decades—such as real estate or consumer-focused internet companies—will not be the drivers of this decade. Instead, China 3.0 themes for the 2020s include upgrading consumption, renewable energy and indigenous technology advancements that will be the drivers of growth and productivity, and markets.
- Further risks include a real estate driven financial accident, a more aggressive technological decoupling from the U.S., increased government involvement in the economy and a geopolitical miscalculation.

EXCHANGE RATES

Andrew Harmstone
Portfolio Manager,
Head of Global
Balanced Risk Control
(GBaR)
Senior Portfolio
Manager, Global
Multi-Asset

Currency Strength Diverges for Net Exporters and Importers of Energy

Energy's impact on exchange rates

- Developments in the international energy market are acting as a significant driver for shifts in country trade balances and movements in exchange rates for key global currencies.
- Generally, net energy importers such as the European Union and Japan have seen their Real Effective Exchange Rates (REER) fall this year, whereas net energy exporters like the U.S. have seen an appreciating or stable REER.
- In our view, these trends are likely to be sustained: Oil and gas prices may eventually settle at higher levels, leading to a gradually lower contribution to overall inflation, yet energy could continue to act as a significant determinant of net export trends and the relative strength or weakness of currencies.

Energy price outlook

- We expect energy prices to remain elevated for the foreseeable future, with supply shortages sustained by two principal factors:
  - Perhaps foremost in readers' minds is the potential for a long-lasting halt in Russia's supply of oil and gas to Europe.
  - Underinvestment in oil exploration has become more pronounced in recent years, with more money flowing toward the sustainable energy transition, which represents a long-term structural shift.
- Even if the Russia-Ukraine conflict concludes, the energy transition may prove to be a source of structural support for the U.S. dollar, while remaining a headwind for net energy importing currencies such as the euro, sterling and Japanese yen.

New regime for bonds

- These dynamics are likely to impact bonds. Not only is the U.S. a net energy exporter, but a stronger currency also reduces imported inflation. This puts the U.S. at an advantage relative to the likes of the eurozone, whose weaker currency gives the European Central Bank further reason to tighten.
- Indeed, the energy crisis is an ongoing issue for sovereigns in the region, which is likely to force central banks to remain hawkish to cool the economy, support foreign exchange and avoid an entrenchment of inflation expectations.
- We anticipate longer-term inflation expectations for both the U.S. and Europe to be at least 2.5%—meaningfully above averages over the last decade and suggesting that equilibrium bond yields are also likely to be higher.
- By contrast, the Bank of Japan remains the outlier among developed market central banks, given its ultra-loose monetary policy. The widening U.S.-Japan yield differential and worsening terms of trade do not support the currency.

Risk Considerations: 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. 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. 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. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Diversification does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

COUNTERPOINT GLOBAL

COUNTERPOINT GLOBAL

Today, what we are seeing are incredible companies that are relatively early in their life cycles and that we believe have the potential to be much bigger down the line.

What We Are Seeing

There has obviously been a lot of volatility and carnage in equities, at least in the short term. Many investors have tended to default to generalizations like "risk on, risk off" or "long-duration assets" or "high-multiple assets," instead of focusing on individual companies.

As a result, there has been a flight towards the perceived safety of the largest companies in the world, which drive index performance.

One of the bigger misconceptions in the market today is that high growth companies or companies earlier in their life cycle are somehow worse off in a higher interest rate environment. We believe there is not really a huge difference in the impact relative to other equities as they are all "long duration" assets. Despite market volatility, fear and uncertainty, the fundamentals of the companies we own largely remain healthy.

What We Are Doing

We continue to be focused on company fundamentals and look to build portfolios of unique companies with diverse business drivers, strong sustainable competitive advantages and healthy secular growth prospects. On the margin, in situations where we believe the fundamentals remained intact and prices became more attractive, we tried to take advantage of the volatility—adding to some positions and initiating a few new ones as well. However, we have largely stayed the course with the businesses we already own.

A few areas we have been investing in for many years that we remain excited about include:

- **Software as a service.** We believe many such stocks are trading at a significant discount to where they were five, six and seven years ago. However, a major software company recently acquired another at one of the highest multiples ever paid for a software company. To us, that indicates that there is considerable value in this sector.
- **Specific companies in e-commerce.** Many offer their customers time savings and convenience, and some have an attractive recurring revenue business model as part of their sales are tied to subscriptions.
- **Genetic sequencing.** Some of these companies are engaged in research that has the potential to develop better healthcare tools for a variety of diseases.

We must stress that, in our view, not all companies in these sectors are attractive. We like to make long-term investments in unique companies that we can own for many years, and that is only possible with a thorough understanding of company-specific fundamentals.

What We Are Watching

While we have never maintained a market or macro outlook, we are starting to see some pre-conditions for catalysts that could change market sentiment for the better. The Fed's tightening has already resulted in some dramatic changes to inflationary costs—not across the board in all facets, but enough progress to consider what will happen when the Fed steps back from what we see as its "maximum hawkish" policy.

Catalysts are also starting to emerge in M&A space—the software company acquisition mentioned earlier is a good example. It caught many people off guard, and such moves can reframe how investors view companies. We are seeing comparable activity in private equity as well.

We think we have portfolios of companies more oriented towards secular growth, rather than cyclical performance. Today, what we are seeing are incredible companies that are relatively early in their life cycles and that we believe have the potential to be much bigger down the line.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Stocks of small- and medium-capitalization companies entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies.

INTERNATIONAL EQUITY TEAM

William Lock
Head of International Equity

Bruno Paulson
Portfolio Manager

Jill Ytuarte
Portfolio Specialist

We seek to own companies that can compound in good times and bad, thanks to their pricing power and recurring revenues.

What We Are Seeing

- The MSCI World Index has fallen by more than 25% in just nine months, all due to derating, with forward earnings actually up year to date through September 30, 2022.
- In today's environment of supply shortages and high inflation, neither pricing power nor recurring revenue—the "superpowers" we seek in high quality companies—have helped so far: Pricing power currently appears widespread, and recurring revenue can be a drag until long-term contracts are repriced.
- Moving into a slowdown/recession that threatens record corporate margins, we are less worried about our portfolios' earnings vulnerability, as we believe their genuine pricing power and recurring revenues should come into their own.
- During past periods of falling earnings for the market, our strategies have historically tended to deliver relative outperformance.

What We Are Doing

- Keeping cool heads and focusing on our active investment process:
  - **Active research:** detailed initiation reports and models subject to the scrutiny of the whole team, supplemented with ESG risk analysis via our Material Risk Indicator.
  - **Active decision making:** our mission is to identify potential high quality compounders—companies with recurring revenues, sustainably high returns on operating capital, and strong free cash flows, all at reasonable valuations.
  - **Active engagement:** meeting with company management matters; we use our meetings with senior members of the companies we own to test the investment rationale, gauge integrity and understand management's strategy, incentives, capital allocation and commitment to returns on operating capital.
  - **Active portfolio construction:** with disciplined research up front and the discipline to say no when stocks do not make the grade, the annual turnover of our high conviction, concentrated portfolios can be minimized.
  - **Active monitoring:** our centralized research repository, real-time data and news dashboards enable us to stay current and on top of developing corporate events.
  - **Active client service and communication:** our goal is world-class investment strategies matched by world-class communication with clients, which is especially important during tumultuous markets.

What We Are Watching

- We believe a focus on high quality equities is all the more relevant in today's market environment.
- Earnings and multiples are what we watch in our quest to grow capital and not lose it over the long term. We seek to own companies that can compound in good times and bad, thanks to their pricing power and recurring revenues.
- Our 26-year track record has demonstrated that a portfolio of high quality, well-managed companies—whose strong intangibles (for example, brands, licenses and networks) help them hold on to customers and margins—is better able to compound our clients' investments over time.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. Illiquid securities may be more difficult to sell and value than public traded securities (liquidity risk). The use of futures includes the possible imperfect correlation between the price of futures contracts and movements in the prices of the securities being hedged, and the possible absence of a liquid secondary market for any particular investment. ESG Strategies that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

CALVERT INTERNATIONAL EQUITY

Christopher M. Dyer, CFA
Head of Global Team, Portfolio Manager
Eaton Vance Equity

Ian Kirwan
Portfolio Manager, Global Team Eaton Vance Equity

The alarm that is driving fund managers to hold cash and defensive stocks will increasingly create opportunities to move against consensus.

What We Are Seeing

- There are increasing signs that the consumer is feeling inflationary pain and trading down. We expect this situation to get worse before it gets better. Interestingly, the industrial and commodities parts of the economy remain very firm. Will this crack as the combination of surging inflation and higher rates cycles further through the global economy?
- China's COVID policy is exacerbating the global supply chain bottlenecks that kicked off this inflation cycle. Although the lockdown in Shanghai is now easing, the transportation infrastructure remains very congested—feeding back into the inflation loop, of course, and pushing central bankers to move faster and harder on monetary policy.
- Higher bond yields mean growth stocks are de-rating and selling off swiftly; we think this creates opportunity as the baby is thrown out with the bathwater.
- Bank of America's "Global Fund Manager Survey" for June reveals that optimism on global growth has hit an all-time low since the survey began in 1994: 73% of respondents said they expect a weaker economy in the next 12 months. With the S&P 500 Index now officially in a bear market—the 20th in the last 140 years—it appears the COVID honeymoon in financial markets is definitively over.

What We Are Doing

- We had taken a more defensive posture in our strategy several months ago, but recently we have begun to recycle some capital from our defensive winners back into names that have de-rated this year.
- Higher valuations had been a building headwind for some of our long-term holdings in 2021, so we had taken several holdings down to much smaller active weights. We are now seeing an opportunity to begin adding back.
- As investor fears build, we look for attractive openings: The alarm that is driving fund managers to hold cash and defensive stocks will increasingly create opportunities to move against consensus.
- We are not meaningfully changing the composition of our portfolios, but we believe the risk-reward framework is naturally improving in more economically sensitive sectors as many investors rush for cover.

What We Are Watching

- **Economic sector signals:** We are closely monitoring consumer credit within financials—and order patterns in the industrial/materials space—for signs that non-consumer sectors feel the increasing economic pressure.
- **Chinese government policy on both COVID and its wider economy:** Despite the growing trend to re-shore manufacturing away from countries like China, it remains the "Factory of the World." China's ability to navigate the effects of COVID on manufacturing and supply chains will continue to have a meaningful impact on global gross domestic product (GDP) trends in 2022.
- **Inflation expectations:** The majority of investors expect the current inflation surge to be temporary. We are closely following the stickier elements of inflation, such as wages and housing rental rates, to help assess its direction.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. Illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

EMERGING MARKET LEADERS

Vishal Gupta
Portfolio Manager, Emerging Markets Leaders

Even as we remain focused on a three to five year investment horizon, we follow the changes in consensus earnings estimates to better understand near-term market expectations.

What We Are Seeing

- Geopolitical tensions and the Federal Reserve's interest rate plans are two areas of continued focus. Although we cannot predict near-term inflation rates, we are seeing strong earnings growth momentum from our portfolio companies.
- The seasoned management teams of our companies are re-assessing and re-calibrating their growth strategies in response to higher interest rates and a more challenging environment for raising capital.
- The current environment has helped industry leaders increase their market share and better position new offerings.

What We Are Doing

- The recent market sell-off has meant that many multi-year growth companies have seen significant declines and now offer additional opportunities to get positioned.
- On top of exploring new ideas and themes in the portfolio, we have consolidated our positions in those companies that we feel are best placed in their industries.
- We are also back on the road, meeting with companies in several countries including Brazil, Indonesia and India, while our China-based analyst continues with her on-site meetings.

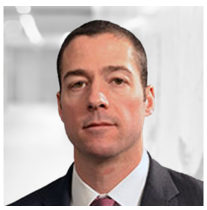
What We Are Watching

- We continue to monitor how our invested companies execute their day-to-day business and keep an eye on their earnings delivery. Even as we remain focused on a three to five year investment horizon, we follow the changes in consensus earnings estimates to better understand near-term market expectations.
- We are assessing the longer-term earnings growth drivers to anticipate possible changes in management's growth strategies, which could deliver profitability goals at an earlier stage rather than looking for growth at all costs.
- We are also monitoring the liquidity dynamics of the market. While our companies have adequate reserves and little to no debt, we are aware that changes in financial system liquidity can have adverse impacts on valuation multiples and investor sentiment.

Risk Considerations: The value of equity securities can fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries.

HIGH YIELD

Stephen C. Concannon, CFA
Co-Head of High Yield, Portfolio Manager



Will Reardon
Institutional Portfolio Manager

In the end, it comes down to receiving the appropriate compensation for taking credit risk, so our primary focus remains re-underwriting our investments and ensuring we are being aptly paid for the underlying risk.

What We Are Seeing

- Volatility across global risk markets has leapt this year as we contend with nearly synchronous, aggressive tightening of monetary policy by multiple global central banks, amid slowing global economic growth and already tightening credit conditions.
- The realized and potential impact on corporate fundamentals has resulted in a significant repricing across global high yield markets.
- Over the first nine months of this year, dispersion[1] in the U.S. high yield market increased from approximately 52% to 73%, in line with the long-term average.
- At the same time, the average spread in the high yield market, as measured by the ICE BofA U.S. High Yield Index, increased from 330 bps to 550 bps.
  - That means the spread began the year ranked in the tightest percentile relative to the last 10 years and ended September in about the 84th percentile!
- Meanwhile, the average spread differential between the single-B and CCC segments of the index more than doubled, from 314 bps to 687 bps. Quarter-end valuations appear appropriate in aggregate—even attractive in select cases—from the standpoint of an investor oriented to the long term.

What We Are Doing

- At present, we remain inclined to reduce exposure to cyclicals and segments exhibiting asymmetric risk/return characteristics, while adding exposure to more defensive sectors trading wide of historic norms.
  - For example, the health care sector's average spread trades approximately 40 bps tighter than the index average historically, but ended the third quarter trading 87 bps wider.
- We are looking to trim our underweight in BBs and add to situations with durable free cash flow—particularly within high-margin service-based segments with high recurring revenue.

What We Are Watching

- In the end, it comes down to receiving the appropriate compensation for taking credit risk, so our primary focus remains re-underwriting our investments and ensuring we are being aptly paid for the underlying risk.
- We expect credit risk to continue to climb as corporate fundamentals become increasingly challenged amid softening economic growth, elevated input costs and difficult capital markets conditions.
- Quarter-end valuations feel relatively appropriate, on average, but we believe further spread widening is the most likely path forward.
- Should average spreads move materially wider, we will soon approach levels that are attractive from a long-term perspective—even in light of the risks we've mentioned. Long-term oriented investors will benefit from being poised to add exposure in the event of meaningful spread widening.

[1] Dispersion is the percentage of the index that is trading more than 1% below or above the index average from the perspective of credit spread.

Index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

Risk Considerations: Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. As interest rates rise, the value of certain income investments is likely to decline. Investments rated below investment grade (typically referred to as "junk") are generally subject to greater price volatility and illiquidity than higher rated investments.

GLOBAL BALANCED RISK CONTROL (GBAR)

Andrew Harmstone
Portfolio Manager,
Head of Global
Balanced Risk Control
(GBaR)
Senior Portfolio
Manager, Global
Multi-Asset

We are maintaining a stable risk profile across our multi-asset strategies that is guided by our top-down asset allocation views on macro themes and tactical positioning across regions and sub-asset classes.

What We Are Seeing

- Volatility has hit financial markets, causing both equities and bonds to tumble and leaving few asset classes untouched, aside from cash.
- High global energy prices continue to exert upward pressure on prices, while also driving currency movements, with oil and gas playing a more determinant role for the trade balance outcomes of net importers and exporters of energy.
- In many key markets, central banks have moved forcefully to rein in high inflation by hiking policy rates and adopting more restrictive policy stances to act as a brake on growth ahead.

What We Are Doing

- We are maintaining a stable risk profile across our multi-asset strategies that is guided by our top-down asset allocation views on macro themes and tactical positioning across regions and sub-asset classes.
- We reduced equities initially, given increasing pressure on central banks to prevent inflation expectations from de-anchoring, and we also lowered duration across sovereign bond holdings.
- We moved underweight U.S. equities, as we are concerned about further potential downside from the hawkish Federal Reserve and the deteriorating earnings outlook. In our view, U.S. equities remain overvalued and vulnerable to repricing if margins start to come down due to wage pressures and softening economic growth.
- We replaced our overweight to potentially vulnerable U.S. high dividend, low volatility equities with a hedged overweight to Japanese equities, which remain relatively resilient amid the current market downturn, supported by accelerating economic activity post COVID, Japanese yen depreciation and cheaper valuations—especially versus the U.S.
- We moved underweight European 10-Year government bonds to reduce the European bond duration, as the energy crisis continues to be an issue for the region's sovereigns.

What We Are Watching

- We are monitoring trends in inflation and monetary policy closely, with the expectation that the current environment will continue to growth prospects for many economies.
- As we look across regions, sectors and asset classes, we maintain an active approach to controlling risks, while seeking out the most attractive relative value opportunities to reflect in the tactical positioning of our portfolios.

Risk Considerations: 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. 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. 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. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed markets. Diversification does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

INDEX DEFINITIONS

Consumer Price Index (CPI) is a measure of the change in the average price level of a fixed basket of goods and services purchased by consumers.

Producer Price Index (PPI) is a measure of the change in the average price level of a fixed basket of goods and services purchased by producers.

S&P 500® Index is an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

Russell 1000® Value Index is an unmanaged index of U.S. large cap value stocks.

Russell 1000® Growth Index is an unmanaged index of U.S. large cap growth stocks.

MSCI World Index is a market-cap weighted index that captures large and mid-cap stock performance across 23 developed market countries.

MSCI Emerging Markets Index is an unmanaged index of emerging markets common stocks.

Morningstar LSTA US Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

ICE BofA U.S. High Yield Index is an unmanaged index of below-investment grade U.S. corporate bonds.

ICE BofA U.S. MBS Index is an unmanaged index of U.S. mortgage-backed securities.

S&P Dow Jones Indices are a product of S&P Dow Jones Indices LLC ("S&P DJI") and have been licensed for use. S&P® and S&P 500® are registered trademarks of S&P DJI; Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); S&P DJI, Dow Jones and their respective affiliates do not sponsor, endorse, sell or promote the Fund, will not have any liability with respect thereto and do not have any liability for any errors, omissions, or interruptions of the S&P Dow Jones Indices.

MSCI indexes are net of foreign withholding taxes. Source: MSCI. MSCI data may not be reproduced or used for any other purpose. MSCI provides no warranties, has not prepared or approved this report, and has no liability hereunder.

ICE BofA Indexes: ICE® BofA® indices are not for redistribution or other uses; provided "as is", without warranties, and with no liability. Eaton Vance has prepared this report and ICE Data Indices, LLC does not endorse it, or guarantee, review, or endorse Eaton Vance's products. BofA® is a licensed registered trademark of Bank of America Corporation in the United States and other countries.

Risk Considerations:

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. 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. 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, investors can lose money investing. See offering document for more description of risks associated with each strategy.

Important Information

Date of Data: 10/31/22.

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.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

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 U.S. 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

ASIA

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 may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than to (i) an accredited investor (ii) an expert investor or (iii) an institutional investor as defined in Section 4A of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); or (iv) 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 document is circulated or distributed for informational purposes only. For those who are not professional investors, this document 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 document 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.

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

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