Caron's Corner Transcript- 8.29.2022

R.I.P. Cycle: Recession, Inflation and Policy Risks Are at Odds with Each Other

- The market has entered an R.I.P. Cycle (Recession, Inflation and Policy risk). This is a rare cycle not seen since the 1970s in which the Fed needs to balance rising inflation risks against recession risk.
- To reduce recession risk, policy needs to be easier. But to reduce inflation risk, policy needs to be tighter. This puts policy at odds with itself. Policy needs to tighten enough to lower inflation but not so much that it triggers a deep recession. This amplifies policy risk.
- Using monetary policy to counter recession and inflation risks presents a great challenge. There are many risks and it's easy to make a mistake, which can be costly, or deadly. Hence, R.I.P.
- We believe the Fed funds rate will peak around 3.75%, which implies an inverted yield curve.
- The Fed may be able to get inflation to ~2.5% in 2023 but may NOT be able to keep it there. The risk is that inflation rebounds with second round effects, which may keep policy tight for longer.

"Hello everyone. This is Jim Caron portfolio manager and fixed income strategist. Today I want to talk about a thesis in the markets that I call the R. I. P. Cycle. The R. I. P. Cycle is a combination of Recession, Inflation and Policy risks, something we need to think about as we move into the remaining part of the year and even into 2023. This will be with us for a while and you're going to hear me talk about it a lot.

The way that I'm thinking about it is that the market has entered in R. I. P. Cycle. This this is a rarity, something we haven't seen since the 1970s where the Fed needed to balance rising inflation risks against recession risks. This ultimately means that the policy response is at odds with itself because to reduce recession risk policy needs to be easier. But to reduce inflation risk policy needs to actually be tighter, which puts any policy at odds with itself. In the end policy needs to tighten enough to lower inflation but not tightened so much that it triggers a deep recession. This amplifies the policy risk. Europe and the U. K. are also going through their own R. I. P. Cycle with energy, inflation and recession risks. But using monetary policy to counter recession and inflation risk presents what I would say is a great challenge. There are many risks and it's easy to make a mistake which can be costly or deadly. Hence, the R. I. P. Cycle.

Once we start to put things into the context of what we learned on Friday when Powell spoke at Jackson Hole, well, I think this is really where the rubber starts to meet the road. What we learned from Powell was that a 3.75% terminal Fed funds policy rate is still in play. Powell was very clear about that. This is what the Fed projected at the June FOMC meeting, reiterated at the July FOMC meeting, and every Fed speaker since then has communicated the same. Powell basically just followed through on his word. Policy rates need to keep rising well above what the Fed considers to be the long term neutral rate, 2.5%, and be kept it there for a period of time. Based on what we know, it's unlikely for the Fed to veer off this course and that's why markets are volatile today.

Let me now go through a few key takeaways from my perspective in terms of what Powell said on Friday, and things that we should be thinking about. There are two important points. Number one, the terminal Fed funds rate is 3.75 and we are likely to get there and there's no reason to think that we're not. That's what the Fed has been telling us. Number two is that Powell is telling us that they will keep

the terminal rate there for a while, which basically means no pivot. Powell's goal was to do away with the notion the Fed is pivoting from hiking to cutting rates. Powell effectively said "No, we're not cutting, we're going to keep rates high for a period of time." That's what caused the markets to reprice some of those risks, and Powell is willing to pay the price. This is a key takeaway. Powell is willing to pay the price to lower inflation and what exactly is that price? Well, as he says, a "sustained period of below trend growth." He feels that the labor markets need to soften, we need to get the unemployment rate to rise and try to stop wage inflation. That's the cost of getting inflation back to target. Powell did not, however, indicate threshold levels of how much pain the economy may actually take, meaning there's no magic level of unemployment, no magic level of what below trend GDP growth might be that stops the Fed.

But the one thing that he did say is that what's going to keep them hiking rates and keeping then high is that a failure to reduce inflation would bring greater pain to households and businesses in the future if this wasn't addressed today. Powell was very committed to this. A third point is how high policy rates go and for how long and again, quoting Powell "Policy is moving sufficiently where we think 3.75% is a sufficiently high level." That's restrictive enough, above the neutral rate of 2.5%, and the Fed is not in a position to pause or stop anytime soon. And the second point is for how long might the Fed keep these rates high? And what Powell said is that it may be necessary to keep policy restrictive which means way above 2.5% neutral rate for some time which means no pivot to bring inflation back to target.

This is actually the only new information that we learned from Jackson Hole and that everything else was really just a reiteration of what the Fed has been telling us since June - that they're targeting 3.75% in the Fed funds rate and they plan to keep it there for some period of time. What I also thought was interesting from the speeches is that there was no emphasis on the Fed being data dependent. Remember data dependence was the big talk after the July FOMC meeting. That was all the buzz. Powell really didn't make any emphasis on this and this is important. The reason why is because Powell wanted to clearly communicate his commitment to hiking rates and keeping them there for a sustained period of time. He didn't want to confuse the message and give the doves, i.e. those who want lower rates, an out.

For example, we have a couple of important data points coming up. On Friday, payrolls, on September 13th, C. P. I. If those numbers come out a little bit soft, people may come out and say the Fed's going to not hike rates as much. The Fed's going to pivot. To reiterate, what Powell is basically saying is no we're not pivoting, we're going to keep these rates high for a significant period of time. Yes, there is some data dependence to this, but he's not emphasizing this at this point and that's why. Look, everybody's asking the same question about what happens at the September FOMC meeting. Do they hike 50 or 75 basis points? There was really no mention of that. But I would say that based on his comments that there was a slight nod to a 75 basis point rate hike at a minimum. That's what the risks are. Many people think it's going to be a 50 basis point rate hike, but I would counter that there is upside risk to that.

When we start to think about all of this, what matters most to asset pricing is how high the Fed funds rate goes. To repeat, we think 3.75%. And how long does it stay there? This will dictate the path of rising long term rates. For example, the 10-year Treasury yield plays a large role in asset valuations. Think

about default risk cycles, P/E ratios, styles of investing, like growth versus value. The key connection point is how long policy rates stay high. A question for a later time is if 3.75% and the policy rate is actually high enough to do the job of lowering inflation to target and keeping it there for a long period of time, is that still actually high enough? Will the Fed actually have to do more? Well, that's something that we're going to have to discuss later.

But as far as we can see it right now, the Fed seems like they're on a mission to hit a 3.75% funds rate. One of the things that we have to do is think about the costs for the Fed. So, yes, I think the question is NOT just whether the Fed can bring inflation down. Yes, the Fed can absolutely bring inflation down, they can create enough of a slowdown in the market that they create a recession they can absolutely bring inflation down. But at what cost are they willing to pay to keep that inflation low and at target? This is the battleground of the debate, and what the Fed is basically telling us right now is that they see a 3.75% policy rate as having little impact on the unemployment rate. So if there's not a lot of cost to get the policy rate to 3.75%, why not just go ahead and do it?

In the Fed's summary of economic projections last June and ones they're going to give us again on September 21, they expect the unemployment rate to rise to 4.1% from 3.5% today, only a 0.6% uptick. That is the cost of getting the Fed funds policy rate to 3.75. That's what the Fed is screaming at us right now, and we just have to listen to them. But my sense is that few people actually believe that the Fed will only do damage to the unemployment rate that gets us to 4.1%. Many think that the unemployment rate needs to go much higher in order to bring down inflation and that's something that we're going to have to think about. **I'm in the camp that I think that the Fed needs to enact policy that brings the unemployment rate much higher in order to bring down inflation**. The cost is actually higher than they think. But that's my thought. Powell just reiterated all of these points at Jackson Hole and it's why I call it the R. I. P. Cycle. In essence, this is really about balancing Recession, Inflation and Policy risks all at once. I think the market has already priced for a 3.75% terminal Fed funds rate. It's really only if the Fed signals that they need to move well above 3.75% that asset prices and default risks will price in a deeper recession.

Just a quick comment on asset prices and views for investing. As I said, we still believe that the Fed funds rate will peak around 3.75% and that the Fed will be able to likely get inflation towards target of 2.5% in 2023. But they may not be able to keep it there. The risk is that it rebounds with second round effects and inflation actually starts to come back up. This means the Fed may end up keeping policy tighter for longer. That's certainly a risk that we need to think about going forward and incorporate into our investment decisions. But given the strength of labor market, we can see the recession may be mild, but credit valuations and prices in high yield spreads are already relatively tight. Investment grade spreads are relatively tight as well. We're not seeing this recession risk reflected in credit markets at the time. I think that they're very fully valued as a result given the economic risk and it's something that we need to be wary of. We still believe that the mortgage market, particularly the non-agency space, is very attractive. Housing is weakening, yes, but that's already priced in and the conditions today are not like they were in 2008. That's something that we have to be mindful of.

Now, emerging markets (EM). Certainly not for the faint of heart, but it may be time to start thinking about the space. Just have it on your radar, start following and tracking it. This is a market where if inflation does start to come down, the real yields in emerging markets will be the highest of any other asset class. You could really prosper pretty well in that space, possibly. It's just a question of timing and what risks we need to get through before it's actually time to start thinking about investing in EM. I still like floating rate assets, like bank loans and things of that nature because essentially, I still think that the Fed is going to hike rates. They're going to continue to go at least to 3.75%, meaning a move higher in short term rates and floating rate assets. Some credit can potentially produce returns. But essentially the way that we are thinking about it is that it has a lot in the price and there's some opportunities here. The dollar has been strengthening and continues to get stronger and it almost goes without saying that a stronger dollar is not good for global growth. That's why we're a little bit hesitant on emerging markets. The euro zone is likely headed for recession by the end of 2022, at least that's what many economists are thinking. Clearly energy prices are moving higher. The ECB will likely continue to hike rates to restore credibility, but they may start their rate hiking cycle sooner than the Fed.

What I tried to do today was create a framework to try to understand what's happening in the markets. I call it the R.I.P. Cycle – Recession, Inflation and Policy risks - and this is how we're going to start to think through this over the coming weeks months and potentially even quarters. This is the start of a theme that I'm going to develop, and I'll be back with you with more tangible ideas from an investing in an asset allocation perspective."

Risk Considerations

Diversification does not eliminate risk of loss. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. **Fixed income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes. Mortgage- and asset-backed securities are sensitive to early prepayment risk and a higher risk of default, and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. **Certain U.S. government securities** purchased by the Strategy, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the U.S. It is possible that these issuers will not have the funds to meet their payment obligations in the future. High-

yield securities ("junk bonds") are lower-rated securities that may have a higher degree of credit and liquidity risk. Public bank loans are subject to liquidity risk and the credit risks of lower-rated securities. Foreign securities are subject to currency, political, economic and market risks. The risks of investing emerging market countries are greater than risks associated with investments in foreign developed countries. Sovereign debt securities are subject to default risk. Derivative instruments may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. Restricted and illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk).

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 Fund Management (Ireland) Limited 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 disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act. Calvert Research and Management, ARBN 635 157 434 is regulated by the U.S. Securities and Exchange Commission under U.S. laws which differ from Australian laws. Calvert Research and Management is exempt from the requirement to hold an Australian financial services licence in accordance with class order 03/1100 in respect of the provision of financial services to wholesale clients in Australia.

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 4919654   Exp 8/31/2023