THE HARBOR VIEW

A QUARTERLY INVESTORS REPORT FROM THE HARBOR GROUP AT MORGAN STANLEY

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Q3 2023

EXECUTIVE SUMMARY

The market's performance for the quarter has been dismal despite better-than-expected earnings and significantly better first half GDP growth. As soon as headline inflation started to rebound around August, much of the good news was no longer celebrated as it indicated that the Fed might remain higher for longer. Although the Fed kept rates steady at their September meeting, they noted that lowering inflation from here will get more difficult and may warrant one more hike this year and potentially two more in 2024. This disappointed investors that were already pricing in several rate cuts in 2024. Ultimately, we think price action weakens in Q4 as the consumer finally takes a breather. Oil prices, interest rates and the dollar have all moved upwards and have the potential to negatively impact consumer spending going forward. Credit card delinquencies have started to rise, excess savings have fallen, and student loan repayments will start to resume. The higher earnings that the Street now expects for the next 12 months may not be achievable against this more challenging backdrop and we think that might get priced in soon. While we continue to expect a soft landing, we think growth expectations have become too lofty while stubborn inflation makes the likelihood for easier policy accommodation less realistic. We expect to take advantage of buying opportunities as they present themselves.

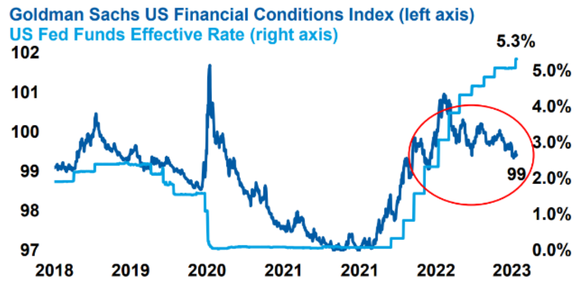
Current Thoughts

- We expect to see some near-term consolidation as the Fed remains focused on inflation in order to prevent a buildup of excesses that might put the economy at risk for a harder landing next year.
- We continue to emphasize equal weights for large cap growth and value with a focus on quality as subsectors face higher commodity prices and lower consumer discretionary spending.
- We prefer larger and mid-cap companies over small cap in a later cycle and risk off environment
- We have become more negative on Emerging Markets as the dollar is likely to remain strong and China continues to slow.
- We expect rates to remain range bound unless a more meaningful slowdown materializes.
- Within fixed income, we maintain a preference for shorter and intermediate duration bonds.
- We continue to like private credit as banks are likely to lend less as financial conditions tighten.
- While we see stress in the office and retail sectors within real estate, we believe the overall housing market remains healthy due to the ongoing shortage of total homes for sale.
- We continue to view structured products and alternative investments as options to mitigate risk and portfolio diversifiers for eligible investors, where appropriate.

Markets

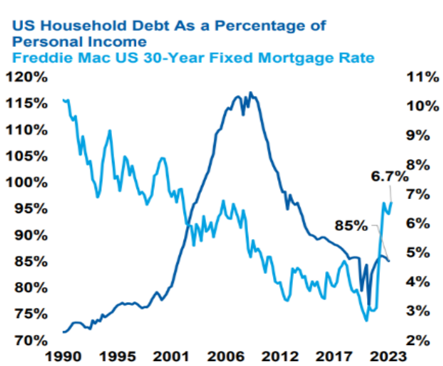
Despite all of the Fed's tightening thus far, they have not been successful in destroying demand. The massive amount of stimulus we've had has allowed both corporates and consumers to shore up their balance sheets and propel spending from both sides. On the corporate side, by the end of the Q2 earnings season, over 60% of S&P 500 companies increased capex over the last year.[1]

Higher Rates Have Not Yet Tightened Financial Conditions



Source: Morgan Stanley & Co. Research, FactSet as of July 31, 2023

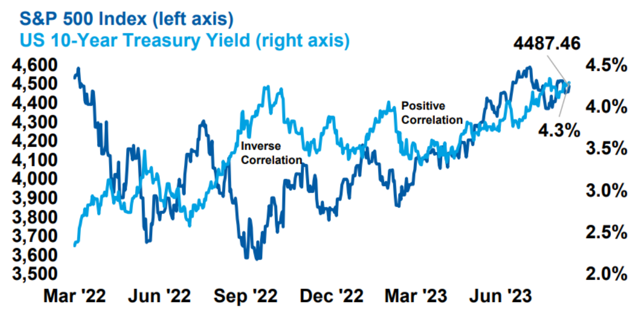
The economy has been less interest rate sensitive than it has in the past. This has also allowed liquidity to remain ample despite a major drop in year over year bank lending. Corporates and households have generally avoided the pain of tighter lending standards as most have locked in lower rates during 2020 and 2021, when lending standards were more favorable. That has allowed debt demand to remain relatively low despite constrained debt supply and has allowed the consumer to keep spending despite higher inflation related pricing.



Source: Morgan Stanley Wealth Management GIC, Bloomberg as of March 31, 2023

This enabled the economy to grow faster than expected, resulting in a string of positive economic surprises. As recession expectations started to fade, investors fueled a market rally that helped reverse a good portion of last year's bear market. Strong earnings results fueled by spending supported forecasts that Q3 GDP could now be as high as 5%.[2] This upwards revision in GDP soon caused interest rates to surge again, pressuring equity multiples and stalling the market's rally this year.

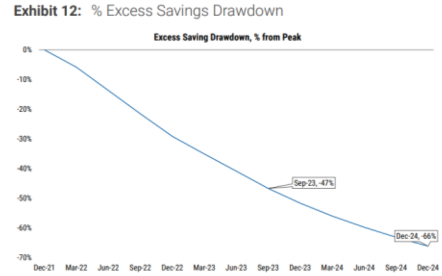
Last Six Weeks, the Rally Has Stalled as Rates Have Continued to Increase



Source: Morgan Stanley Wealth Management GIC, Bloomberg as of September 11, 2023

In a similar fashion, earnings expectations have also moved up considerably. FactSet's CY2024 and CY2025 estimates imply sequential growth of 11.9% and 11.6%, respectively.[3] Q1 and Q2 earnings were easier to beat as expectations were low going into this year and already reflected a more dismal outlook. The lowered bar was more achievable as companies were successful in passing on costs to the consumer. However, fading pricing power now poses risks to earnings just as the bar has been reset higher. The Fed's Beige Book has indicated this fading pricing power is more widespread than consensus earnings forecasts currently project. Consumers have now shifted from tapping into their savings to increasing their credit card debt loads. Excess savings are estimated to have declined from a late-2021 peak of $2.1 trillion to approximately $100 billion. Meanwhile, credit card balances have soared to an all-time high of more than $1 trillion. This comes as credit cards have increased their average annual percentage rates to 22% from approximately 15% over the last decade.[4]

Exhibit 12: % Excess Savings Drawdown



Source: Morgan Stanley US Economics Research

1 JP Morgan Global Investment Strategy; September 8, 2023.

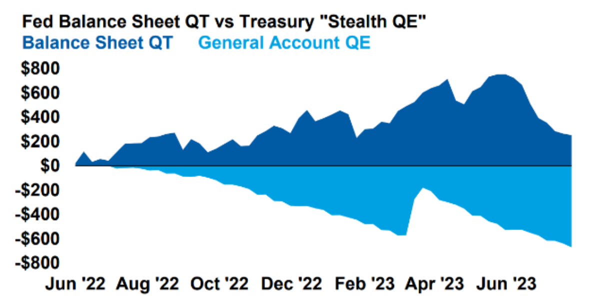
2 Atlanta Fed GDP Now; September 19, 2023

3 Global Investment Committee; Topics in Portfolio Construction. September 19, 2023

4 The GIC Weekly – September 18, 2023 (Morgan Stanley Publication)

In addition, student loan payments, which have been paused for about three years, are set to resume. According to the New York Fed's most recent Survey of Consumer Expectations, consumers' concerns about their finances are growing, while their outlooks regarding job prospects and income are deteriorating. Consumer spending accounts for over 68% of the U.S. GDP.[5] That means even small changes in consumer habits and sentiment can have a large impact on the entire economy. In addition, rising oil prices are likely to further weigh on spending. While higher gas prices have a smaller impact on core CPI, the greater impact might be on the consumer's buying power if prices stay high for long enough. Geopolitical factors make this hard to predict, especially as oil demand remains strong and production cuts have been significant.

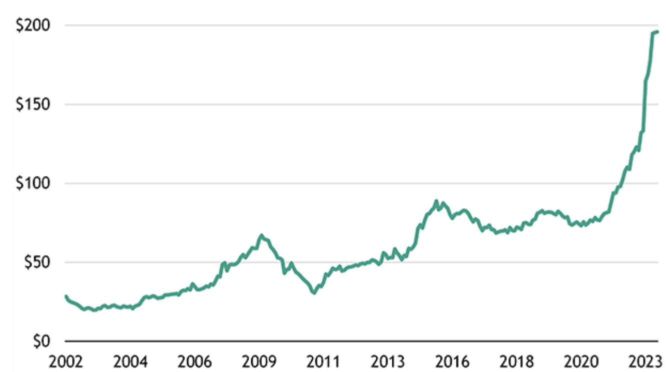
Lastly, we expect that tailwinds from fiscal support, which have aided the consumer thus far, will slow. The recent lifting of the debt ceiling until 2025 has cleared the way for the Treasury Department to issue more T-bills. The substantial increase in the supply of Treasury securities expected to fund the government's expenditures has offset just about all of the Fed's tightening. In fact, it led to Fitch Ratings' downgrade of the US Treasury's debt. We believe fiscal spending will need to get pulled back given this recent downgrade in addition to higher funding costs and potential political consequences.



Source: Morgan Stanley Wealth Management GIC, Bloomberg as of July 26, 2023

For its part, the Fed has made it clear that it is more focused on taming inflation than preventing a market pullback. While down on a year over year basis, inflation remains stubbornly high, and we believe the market might be overconfident in how much or how quickly it will fall. The services-linked personal consumption expenditures accelerated for the third month in a row. The uptick in core services inflation confirms data from the ISM Services Prices Paid Index and the Producer Price Index, with the headline level for the latter up 8.4% on an annualized basis, up from last month's 3.6% annualized pace.[4] A major risk is that those who believed that inflation would be transitory to begin with might be too quick to call for its disappearance. One of the biggest challenges for the Fed has been the strong job market. Unions have been successful in negotiating higher salaries while many states have implemented higher minimum wages. Ultimately, we think the consumer will no longer accept these costs being passed onto them. However, we also believe that a strong labor market is what keeps us optimistic around a soft-landing scenario. Given the hiring challenges during the pandemic and the continuing shortage of labor, companies are more likely to hold on to employees in order to remain prepared during periods of high demand. Both initial jobless claims and continuing claims continue to fall, showing that neither the Hollywood nor the UAW strikes are creating dents. In fact, we expect to see even more job creation after the passage of the CHIPS and Science Act, and Infrastructure Investment and Jobs Act (IIJA). There have already been many announcements of new manufacturing, infrastructure, and clean energy projects, especially as we work to secure supply chains and reduce our dependence on China.

Figure 1: Total US Manufacturing Construction Spending
($ in billions; seasonally adjusted annualized rate)



Source: US Census Bureau, as of 7/31/2023

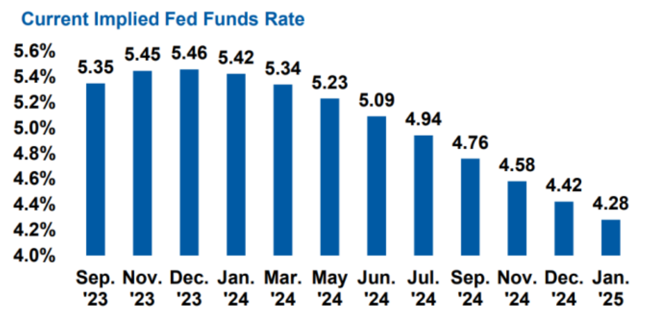
It remains to be seen what the actual impact of this will be on growth and inflation as the Fed's 2% target is becoming harder to achieve. Fed Chair Powell acknowledged that while policy is restrictive it remains uncertain if it's sufficiently high enough. Uncertainty is skewed towards holding or further rate hikes, not cuts. In addition, the war between Russia and Ukraine seems to have no end in sight, increasing the chances that the US will continue to

5 CEIC DATA - United States Private Consumption; June 30, 2023.

4 The GIC Weekly – September 18, 2023 (Morgan Stanley Publication)

spend to prevent Russia's advances. While we still believe a soft landing is possible, we do not believe it will come from easier policy in the near term. Markets may continue to get disappointed by not believing in the Fed's commitment to fight inflation.

The Fed Fund Futures Market Still Assuming at Least Four Rate Cuts in 2024…



Source: Morgan Stanley & Co. Research, FactSet as of September 11, 2023

We expect volatility will remain elevated around a government shutdown. Our economists note that a shutdown that gets resolved within a couple of weeks is unlikely to hinder growth. Historically, shutdowns have ended when the economic risk and the perceived political risk becomes more real. For instance, the 35-day shutdown under former President Trump ended after the air traffic controllers who weren't being paid stopped showing up to work, causing delays. In a similar situation, our economists expect lower consumption from deferred government salaries and other spending to reduce GDP by 0.05% for each week of shutdown, with a more muted impact if workers receive back pay when the shutdown ends.[6] Longer shutdowns, however, have the potential to reduce consumption. Under these circumstances, rates can fall quickly, as growth expectations are likely to get reset lower.

Given the uncertainty around global growth and commodity prices, we continue to advocate for equal weightings to large cap growth and large cap value. Growth has recently lagged in September, as rates have re-rated higher. Meanwhile, value has benefitted from having greater exposure to the energy sector. Some of this may reverse if global growth slows. PE multiples are actually not as high when we strip out the handful of large index stocks that have been responsible for most of the strong performance this year. Underneath the surface, many stocks and sectors are actually down or at least lagging the S&P 500, presenting an opportunity for active management. We continue to remind investors that while some of the winners may keep winning over the longer term, passive strategies and algorithms programmatically buy more of the leading stocks on the way up but also sell more on the way down. This phenomenon has caused the degree to which certain stocks outperform or underperform to become more extreme. Therefore, being overly concentrated in any given cohort can potentially put entire portfolios at risk. We would use a pullback to add to higher quality, less cyclical companies with inelastic demand.

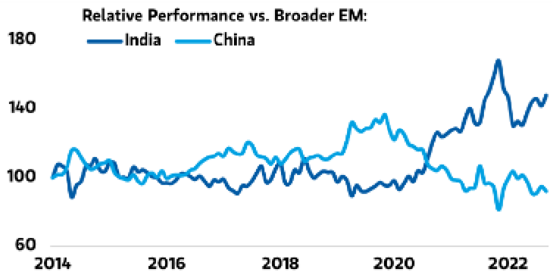
International & EM

The ECB announced a 10th consecutive hike due to upward revisions in newly published macroeconomic projections, which see inflation averaging at 5.6% this year from a prior forecast of 5.4%, and 3.2% next year from a previous forecast of 3%. The stronger dollar continues to be a headwind in general and we don't see that changing anytime soon. Last year, Europe surprised to the upside thanks to a mild winter, which reduced energy demand and lowered energy prices. We do not claim to be weather predicters and acknowledge that potentially colder weather this year remains a risk as the war with Russia continues. Europe's transition to cleaner energy sources will take a longer time to play out than most expect. We have a tactical preference to increase underweights to international markets via private investments, where high quality companies are still cheap and volatility remains well below that of public international markets.

Within Emerging Markets, we have become more pessimistic given the Fed's higher for longer stance. More importantly, political and structural issues in China, which still account for a large portion of the MSCI EM Index, make hopes for a stimulus-led rebound more unpredictable. China housing bubble could lead to wealth destruction and a longer than expected growth drag. This year, China's softening activity data, including stagnant spending, elevated youth unemployment and a slump in housing, has

6 Sunday Starts; Morgan Stanley publication; September 24, 2023

fed into a potentially dangerous cycle of deflation. Other EM countries such as India have benefitted from companies moving their supply chains in order to decrease their dependance on China. Recent softness in Chinese equities has boosted India in relative terms, reversing the pattern from 2016 to 2020.[3]



Source: Bloomberg, Morgan Stanley Wealth Management GIC. Data as of August 31, 2023.

Elsewhere, Taiwan and Korea have benefited from their concentration in Technology Hardware & Equipment and Semiconductor names. Overall, EM may become a stock picker's market once again, but currency impacts and geopolitical impacts have made investing there increasingly more difficult.

Fixed Income & Rates

While the Fed may stay higher for longer, our expectation for a soft landing still supports our favorable view on high quality credit. So far, money market funds, short-term U.S. Treasury securities, and certificates of deposit (CDs) have been attractive places to park cash while the Fed hiked rates and they may continue to be. However, we do not recommend shifting the bulk of one's entire fixed income allocation into these assets as trying to time reinvesment risk remains difficult. Yields have moved higher in response to the Fed's rate hikes and opportunities still remain. While we believe that Fed cuts seem less likely than most expect, we still advise investors to lock in attractive rates when they can to avoid the possibility of reinvesting proceeds at potentially lower rates in the future. Corporates have borrowed at record lows and and continue to hold ample cash reserves. Strong interest coverage has helped keep credit spreads tight and delivered attractive yield options for fixed income investors. While bankruptcies have increased, they have remained contained. We continue to like a mix of higher yielding ultra-short and short duration assets and longer dated municipals bonds.

Alternatives

Manager and fund selection has become increasingly important in selecting alternative investments. The dry powder that fund managers amassed while valuations were elevated should position them well to deploy capital at attractive prices. We see infrastructure and other hard assets such as residential real estate as attractive investments in the case that inflation declines at a much slower than expected pace. While there has been stress in the commercial real estate market given regional bank turmoil, experienced managers have been able to raise rents in properties across other subsectors and negotiate inflation protected rent escalators. Meanwhile, private credit is likely to become an even bigger source of capital as banks are forced to lend even less. As the cost of capital rises, many companies will continue to depend on them for funding assistance. As the direct lending space has grown, we look for larger managers with scale, experience across various credit cycles, and competitive advantages in deal sourcing. We do expect fundraising to become more difficult for managers and see an increased need for co-investments. Managers with dry powder and experience across sectors are well positioned as others depend on them for extra capital in order to close deals. We favor managers which have experience in distressed markets and dislocations. We also like the ability of secondaries focused managers that can take advantage of forced selling at depressed prices. Portfolio companies that rely on credit facilities may be calling more capital than anticipated from investors. As uncertainty is on the rise, we remind eligible investors that such tools are available to help mitigate risk and diversify portfolios.

To Sum Up

While we believe there may not be many more hikes ahead of us, we do believe inflation will stay high enough to prevent any premature rate cuts from the Fed. Inflation, while on the right track, will have a slow and uneven journey down. We are cognizant to not fight the Fed and note that, going forward, fiscal stimulus may no longer be able to

3 Global Investment Committee; Topics in Portfolio Construction. September 19, 2023

offset monetary tightening. We believe that higher rates may continue to pressure valuation multiples just as the newly revised earnings expectations might not be achievable. Factors that we will be watching include fading fiscal stimulus, volatility around a potential government shutdown, higher oil prices and the Fed's response to inflation. We continue to look out for potential buying opportunities if we reach oversold conditions.

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For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. NOTE: High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Real estate investments are subject to special risks, including interest rate and property value fluctuations, as well as risks related to general and economic conditions.

Risks of private real estate include: illiquidity; a long-term investment horizon with a limited or nonexistent secondary market; lack of transparency; volatility (risk of loss); and leverage.

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