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# Q3 2024

## EXECUTIVE SUMMARY

Despite several stints of increased volatility, the market rallied to yet another all-time high as data releases continued to support the soft-landing thesis. The Federal Reserve delivered a 50-basis-point rate cut, which was on the higher end of estimates, noting further progress on inflation and potential risks to the labor market. It is important to note that this larger cut was done in an economy that is still growing. Unlike previous easing cycles, we view this dovish pivot as the Fed’s way of extending the economic expansion as opposed to alleviating recessionary conditions. The Fed cited the economy and labor market as healthy but has essentially taken an insurance policy to get ahead of any potential deterioration in the labor market. This was following the July jobs report that showed that hiring fell sharply while the unemployment rate rose for the fourth straight month. This sparked recessionary fears that caused rates to plummet and catalyzed a rally in rate sensitive areas of the market including real estate and utilities as the potential for rate cuts seemed more likely. Market leaders, including semiconductors, fell into a bear market while defensive stocks outperformed as concerns around slowing growth surpassed inflation fears. The mixed economic data we’ve been getting is very typical of a classic soft landing, where positive and negative surprises tend to offset each other yet conditions remain good enough to keep the economy in positive yet cooling territory. Going forward, we expect the market to remain sensitive to incoming data, especially in the labor market. Currently, equity markets are assuming double-digit profit gains to end the year despite third quarter numbers being revised lower. If growth disappoints on the downside or profit growth expectations are not achieved, equity markets may not react as favorably regardless of what the Fed does. We remain optimistic around a soft landing but expect the remainder of the year to remain volatile given the uncertainty surrounding future monetary policy and the upcoming elections. In addition, it remains to be seen whether China’s slowdown will be mitigated by fiscal stimulus and whether the unwinding of the yen carry trade will reemerge.

### Current Thoughts

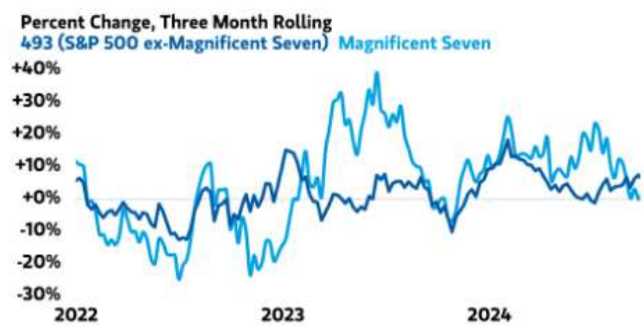
- We expect large market movements to continue both on the upside and downside caused by an increase in data sensitive algorithmic trading.
- Given the high degree of dispersion between stocks with low and high expectations, we believe active management is well positioned to find companies that are more likely to deliver on expectations.
- Market breadth is likely to further improve and a rotation away of the Magnificent Seven may continue.
- Extremely loose financial conditions remain supportive of asset prices, despite both stocks and bonds appearing overbought in the near term.
- Clients concerned about reinvestment risk can look to extend duration as appropriate.
- We expect private equity to be a beneficiary of lower rates as it may present better exit opportunities.
- We believe corporate credit should continue to benefit from lower rates, high levels of liquidity and low defaults.
- We see opportunities in quality midcap stocks that can benefit from a lower cost of capital and better valuations.
- We continue to see opportunities in real assets including infrastructure as a way to diversify portfolios with lower correlation.

## Markets

The S&P 500 reached a new all-time high after the Fed delivered a 50-basis-point rate cut and signaled that another 50 may be on the way before year end. This has certainly surprised to the upside given that the Atlanta Fed raised its third-quarter GDP growth estimate to a 3.0% annualized rate from 2.5% after retail sales unexpectedly rose in August and were revised higher for July. Core CPI growth also increased from 0.2% in July to 0.3% in August, above consensus expectations. Headline CPI declined to 2.5% year-over-year in July, in-line with consensus expectations and below July's 2.9% year-over-year pace thanks to lower energy prices. Gas prices fell as demand for oil in China, a large oil consumer, fell amid a slowing economy.[1] The data has been all over the place over the last several months, giving mixed messages. This is consistent with a soft landing, where data is neither too hot to stoke inflation fears nor too cold to signal a recession. While consumer spending remains strong, the labor market has stalled. As we've noted before, the strong influx of immigration poses risks to rising unemployment as the supply of labor begins to outstrip demand. While the layoff rate is still well below the pre-pandemic rate, according to the latest Bureau of Labor Statistics JOLTS data, falling job openings and slowing payrolls pose risks to employment. Over the last three months, the recent slowing in the labor market now stands as a bigger risk than inflation in the eyes of the Fed. The unemployment rate is still low at 4.2%, but that is up from 3.7% at the start of the year. In the most recent Summary of Economic Projections (SEP), Fed officials forecasted unemployment to move up slightly to 4.4% in the fourth quarter of 2024—and remain there through the end of 2025.[2] We believe it would take a real downturn to spur a pickup in layoffs. We see this as unlikely as a scarcity in skills has buffered employment. For instance, despite the slowing in manufacturing and weak new orders, job losses have remained low. Before the Fed even announced that the time for rate cuts has come, we saw a massive downward move in rates after July job openings missed expectations by 35%.[3] Had it not been for the massive increase in the labor supply, this data may not have been viewed as poorly as fewer job openings are preferred over firings and layoffs. However, when job openings cannot absorb all the new job market entrants, unemployment, as a whole, is likely to rise.

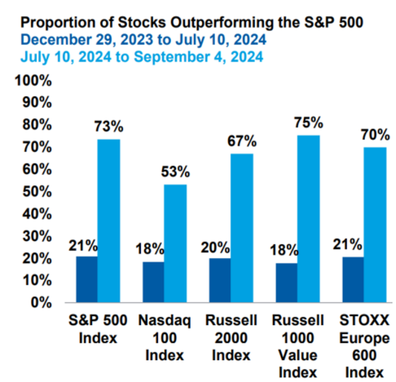

Source: Bloomberg as of July 31, 2024

The fall in rates that soon followed the data caused a defensive shift in the market and a sharp pullback in the "Magnificent Seven." As more companies started to participate in the rally at their expense, index concentration declined.




Source: Bloomberg, Morgan Stanley Wealth Management GIO. Data as of September 23, 2024.

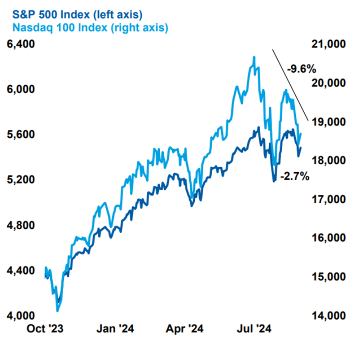
Just as these stocks benefitted disproportionately from the crowding out of the rest of the economy when rates were higher, falling rates enforced the case that more companies have the potential to surprise to the upside from here and provide a better near-term risk/reward.




Source: Morgan Stanley Wealth Management GIC, Jim Paulsen Perspectives as of September 6, 2024

1 Morgan Stanley Daily Positioning; September 9, 2024
2 JP Morgan-Strategist Sarah Stillpass; September 20, 2024
3 Morgan Stanley - The GIC Weekly; August 19, 2024

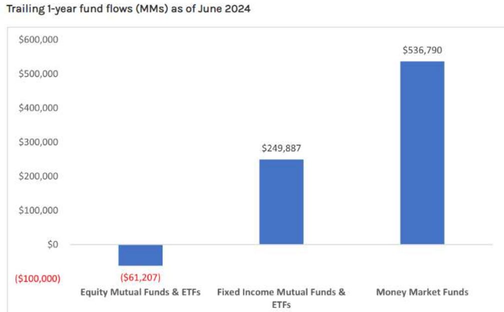
In fact, despite the large pullback in many semiconductor stocks and "Magnificent 7" members from their all-time July highs, the index was largely spared thanks to gains from the rest of the market. Given that the S&P 500 is a much more diversified index than the Nasdaq 100, it held up better as more of its components participated in the rally.




Source: Morgan Stanley Wealth Management GIC, Bloomberg as of September 9, 2024

While 550 basis points of rate increases hurt the most rate sensitive parts of the economy and the lower end consumer, they have not dented GDP nor slowed spending done by wealthy consumers and mega-cap companies. They have actually helped wealthy investors accumulate income from attractive yields in money market funds and other cash-like products.

Trailing 1-year fund flows (MMs) as of June 2024




Source: Strategas

We do not expect falling rates to have a meaningful impact on the lower end consumer in the near term. Despite the current annual inflation rate falling to 2.5%, the lowest since February 2021, the lower end consumer continues to struggle as prices are still 21.2% more expensive since the early pandemic days of February 2020. Only about 6% of the nearly 400 items the Bureau of Labor Statistics tracks are cheaper today.[4] Housing affordability remains a challenge and the stickiest parts of inflation including shelter and medical expenses have actually surprised to the upside. This explains why mortgage demand is unlikely to see a huge increase despite a fall in mortgage rates. Shelter is the largest component in consumer inflation indices. 40% of the housing stock has no mortgage. Of the remaining housing stock that is mortgaged, 60% include mortgages that are locked below 4%. Therefore, it may take a much larger fall in rates to meaningfully move volume in the housing market as a whole.[5]

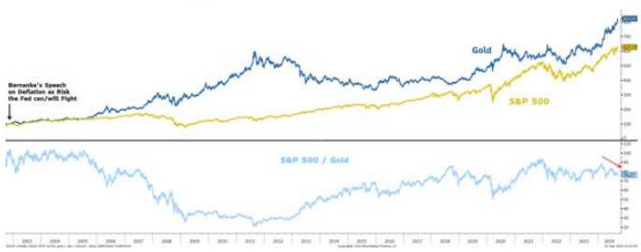
Given that a soft landing is now fully priced in, the market may shift its focus to earnings. Expectations for ~13% 2024 earnings growth seem back end loaded considering that earnings growth for the first half of the year was only 4%. Meanwhile, Q3 earnings growth estimates have fallen from 7.5% to 4.2%. More companies outside of the Mag 7 will need to deliver. It remains to be seen whether productivity gains will be enough to move margins sufficiently given that Artificial Intelligence ("AI") benefits are likely to materialize further out into the future. So far, economic readings are showing that productivity has, on average, grown more than 2% over the past six quarters.[5] We've also seen how much power the labor data holds in terms of moving markets. We expect this to continue given the increase in data dependent algorithmic trading. Any potential changes in the unemployment rate and payroll data can either catalyze a rally or a pullback in equities. Extraordinarily loose financial conditions can also cushion markets going into year-end as excessive fiscal deficit spending has come at a time when unemployment has been near 50-year lows.


The budget deficit for August came in almost $90 billion above forecasts for the month, bringing the year-to-date deficit above $1.8 trillion. This fiscal impulse has been supportive of growth. With the Fed cutting 50 basis-points just weeks after the markets were pricing in 25, it is hard to deny that lower rates

4 Bankrate-Sarah Foster; September 11, 2024
5 Morgan Stanley - The GIC Weekly; September 23, 2024

may be assisting the Treasury in its efforts to fund the government's massive budget deficits and debt. The uses of liquidity have kept valuations elevated and may continue to do so. Back in 2002, Ben Bernanke highlighted the tools the Fed could use to avoid deflation including more coordinated policy between monetary and fiscal. In a world in which the government decides to keep the economy going via heavy fiscal spending, lower rates and other policy tools are helpful in terms of supporting that spending. As a result, the purchasing power of US dollars has fallen much more than what conventional measures of inflation would suggest. Gold, high quality real estate, stocks and other inflation hedges have done well historically as the purchasing power of the dollar has declined. In fact, this explains why cryptocurrency, which is seen as a fiat currency, has grown in popularity and why gold has outperformed the S&P 500 YTD since 2002.[6]

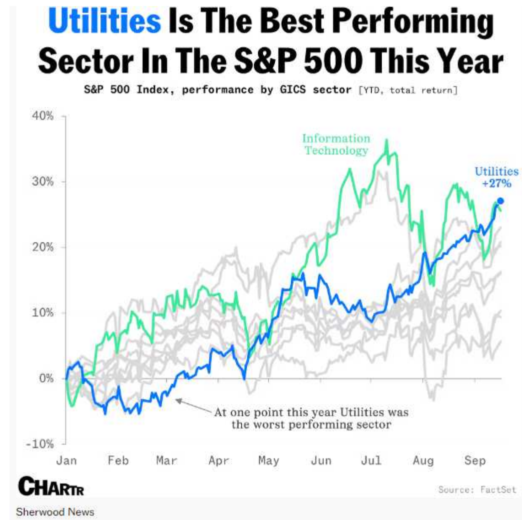
**Exhibit 13:** Gold Outperforming the Highest Quality Index of Stocks as Markets Focus on Stimulus




Source: Bloomberg, Morgan Stanley Research

Another example is the reverse repo facility, which still has close to $300 billion to help the Treasury fund its growing deficits. This facility was initially created to help fund Covid/Post-Covid deficits and has been used for over $2 trillion in funding.[6] The Treasury has heavily skewed its issuance to the front end of the curve via treasury bills. This means that the burden of this deficit spending can be alleviated to some extent by lowering rates more rapidly.

We continue to advocate for active stock picking in this environment. While the S&P 500 as a whole may seem rich, we continue to see opportunities beneath the surface. Within the AI-related theme, we mentioned last quarter that relative strength has shifted from Semis and Tech Hardware to Power and Energy Infrastructure. That theme has continued to play out. Given increased power consumption from data centers, the Power and Equipment and Energy and Gas Infrastructure industry groups have started to outperform the S&P 500. In fact, the top performing sector YTD is utilities, a defensive sector with a unique mix of higher dividend yields and now higher growth expectations thanks to AI.[7] Many utility stocks are indirectly exposed to AI by powering the ever-growing demand for data centers. Data center cooling also remains an important growth opportunity, providing room for stock picking.




We also see opportunities in midcap companies given that it may not take the same magnitude of rate cuts for them to benefit from a lower cost of capital versus small caps. Quality midcaps are also less dependent on regional banks, many of which are still lending constrained.


## International & EM

So far, it seems one of the risks for ex-US stocks has been somewhat alleviated. Just before the Chinese government began its fiscal stimulus pivot, China's core Consumer Price Index (CPI) was tracking post-

6 Morgan Stanley Weekly Warm-up; September 23, 2024
7 Capital Market Indices-September 30, 2024

COVID lows, raising concerns around deflation becoming more persistent. With housing accounting for a third of household wealth and roughly 20% of the economy, a struggling housing sector posed a major challenge for consumer spending. Record youth unemployment, as high as 17% in July, compounded the deflationary threat while nominal wage growth slowed.[8] Foreign direct investment into China have eroded in the post-COVID years, as investors have been put off by regulatory crackdowns and geopolitical tensions. Chinese demand for commodities like copper and oil were also slumping. China has since drastically stepped up its fiscal stimulus program in response. The government plans to issue 2 trillion yuan of debt ($284.43 billion) to fund an unprecedented amount of consumer subsidies and corporate buybacks. The People's Bank of China also took several measures to increase liquidity, including a 50-basis point cut in the reserve requirement, a reduction in the reverse repo rate. We also saw the mortgage rate reduced by 0.50%, the minimum down payment ratio reduced to 15% from 25%, and additional funds dedicated to support affordable housing.[9] These actions spurred a massive rally in Chinese equities. This has also positively impacted US and international companies with large exposures to China. While we are still cautious on China in the event that a potential escalation of the US-China trade war could heighten concerns, we are more optimistic on international stocks levered to China, including the luxury sector. We look to active management in order to separate such risks from opportunities. For instance, after a huge run up in Japanese equities, active managers were able to take advantage of a meaningful pullback that was catalyzed by the unwinding of the yen carry trade. The Bank of Japan hiked interest rates in late July just as weaker-than-expected US economic data caused investors to rapidly adjust their views on interest rate differentials, assuming that the Federal Reserve may cut rates more aggressively while the BoJ does the opposite. This caused a rapid appreciation in the Japanese yen versus the US dollar, catalyzing more than a 25% drop in Japanese equities.[11] Along with other risky assets, Japanese equities have since largely recovered from those lows.

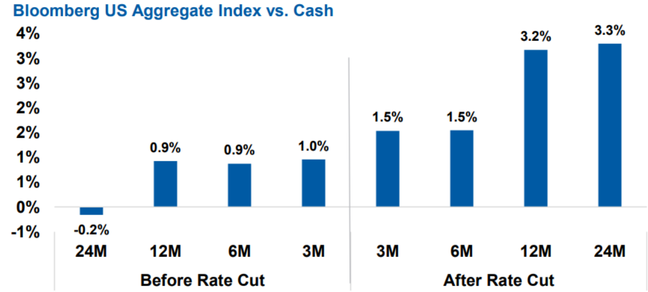
While the US dollar could weaken further amid a continued decline in interest rate differentials, this is not a guarantee, especially as the US dollar has tended to benefit from defensive inflows. We could see this occurring as we approach the election. International equities, which have underperformed their US counterparts, could see tailwinds if dollar weakness persists. Secular themes including AI, infrastructure and data center investments, electrification and healthcare provide opportunities in ex-US stocks as well. Similarly, select stocks in areas such as Korea and Taiwan can continue to see AI tailwinds while India continues to benefit from supply chain reconfigurations.

**Fixed Income & Rates**

As we noted, concerns over the job market in July caused rates to plummet and bonds to rally aggressively. The bond market priced in more than 250-basis points of rate cuts by next Decembr, which was more than we've seen in 1984 and 2001, when we had full blown recessions.[10] Despite positive growth, the bond market was convinced that the Fed was behind the curve. The 2-year US Treasury yield fell further than the 10-year US Treasury yield leading to positive steeping and an un-iversion of the yield curve. However, after the Fed implemented a 50-basis point rate cut, expectations for a soft landing had risen causing the 10-year yield to shoot back up from an almost two-year low of 3.61% on Sept. 16 to approximately 3.75% by Sept. 19. The 30-year bond yield, which fell to 3.93%, is now back to 4.1%. This makes sense to us as long dated treasury yields neutralized their recessionary pricing. While holding cash helped fixed income portfolios from price depreciation during the hiking cycle, interest rate cuts are expected to continue for the remainder of the year. An additional 50 basis point of rate cuts in 2024 will cause yields in deposit and savings accounts, short-term certificates of deposit and money market yields to fall.

8 Morgan Stanley; Global Insights – September 18, 2024
9 China Last Night – Brendan Ahern; September 25, 2025
10 Morgan Stanley Weekly Warm-up; September 16, 2024
11 Morgan Stanley - The GIC Weekly; August 12, 2024

**Excess Return of Bonds over Cash Before and After Rate Cuts**
**Bloomberg US Aggregate Index vs. Cash**




Source: Morgan Stanley Wealth Management GIC, Bloomberg as of March 31, 2024. Excess return represents the average quarterly total return of the portfolio relative to its benchmark. A portfolio with a positive excess return has on average outperformed its benchmark on a quarterly basis. This statistic is obtained by subtracting the benchmark return from the portfolio's return.



Pivoting from cash to intermediate dated fixed income in the current environment offers investors with large cash and ultra-short overweights to lock in higher yields. The credit market has been especially resilient as cash flows and liquidity have remained strong. Fundamentals for corporates have also been strong. Despite the rally in lower quality bonds catalyzed by the recent rate cuts, we prefer to stay up in quality. On the tax-free side, while outsized new issuance may continue to challenge the municipal market in the short term, we still see value for investors that are worried about the direction of their tax rates heading into the election. To be clear, we do not see rates heading back to pre-Covid lows. Nor do we think investors need to own the back end of the curve given the risks that fiscal spending won't slow. We prefer a duration neutral stance as opposed to a duration overweight given the risk of reflation if growth comes in stronger than expected. With that said, as the yield curve is no longer inverted, we see no reason to maintain a large overweight to ultra-short positions including cash.

## Alternatives

We see private equity sponsors as one of the main beneficiaries of the Fed's initial rate cut. While 50-basis points may not be enough to move mortgages or help the lower end consumer, lower interest rates typically lead to cheaper leverage, higher valuations, and improved exit opportunities for portfolio companies. Fund managers have relied more on strategic buyers as a means of exiting positions in portfolio companies while M&A (mergers and acquisitions) and IPO activity (initial public offerings) remained fairly muted. Rapidly rising interest rates led to sharp declines in dealmaking, exits, and fund-raising. This has caused a decline in distributions which prevented limited partners from reinvesting proceeds into newer funds. As limited partners have seen a pickup in capital calls, they have put more pressure on general partners to return cash quicker. Private credit, meanwhile, has been in a unique position, meaning that it has tailwinds regardless of the rate environment. Private credit is a source of financing for private equity. A pickup in private equity deals can provide a pickup in financing deals for private credit. Lower rates can also improve interest coverage for their portfolio companies. In recent years, private lenders formed strategic partnerships with insurance companies. For lenders, this has expanded their supply of long-term capital. Meanwhile, for insurers, which have long-duration liabilities, private credit strategies may offer a diversified and potentially higher-yielding approach to satisfy risk-return objectives. As the direct lending space has grown, managers with scale, experience across various credit cycles, and competitive advantages in deal sourcing have been beneficiaries. We see opportunities in infrastructure focused on essential assets with stable income that have historically been less correlated to macroeconomic conditions. In addition, as we mentioned earlier, there will be an increased need in digital and physical infrastructure to power AI. We expect both public and private infrastructure capital will be needed to fill in the gap. Lastly, we expect private and public real estate to see tailwinds from falling capitalization rates.

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

We remain in an environment with accommodative liquidity has helped finance our ever-growing budget deficit. While there are signs of growth slowing, we continue to have strong consumer spending and a generally healthy labor market. Corporate profit growth has continued to turn positive in 2024 after a period of stagnation. Nevertheless, fourth quarter estimates have a high bar to beat, assuming margin expansion will come from productivity gains as opposed to job cuts. We expect the Fed to do as they say and deliver an additional 50-basis points of rate cuts, which can benefit the more interest rate sensitive parts of the economy. We expect market breadth to improve further and expand beyond the "Magnificent 7". We advise investors to be mindful of overconcentration risks among outperformers. We expect volatility to remain elevated heading into the election as high uncertainty may hold up decision making as it pertains to investing, hiring, capital expenditures and other factors related to changes in the tax code. The composition of the next Congress will likely have greater implications for policymaking than the winner of the Presidential election. Importantly, tax policy could have significant impacts for investors and the economy, with potential individual and corporate tax increases on the table. However, we remind investors that to a large degree, both presidential candidates are known knowns as a Harris administration is likely to carry on with the same agenda as President Biden. Markets performed well during the tenure of both administrations. In the end, the presidential decision has had less of an influence on market returns.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The interest rate on a floating-rate security may be lower than that of a fixed-rate security of the same maturity. The reference rate could be an index or an interest rate. There can be no assurance that the reference rate will increase. The interest rate is subject to change and the projected yield to maturity at purchase may or may not be realized due to changes in the reference rate. Some floating rate securities specify rate minimums (floors) and maximums (caps). Some floating-rate securities may be subject to call risk.

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Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

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Indices are unmanaged. An investor cannot invest directly in an index.

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

Interest on municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, local tax-exemption typically applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

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.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other important information about the mutual fund. Read the prospectus carefully before investing.

Treasury and Government Money Market: You could lose money by investing in the Fund. Although the Fund seeks to preserve your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

You could lose money by investing in a Money Market Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Asset Allocation, Diversification and Rebalancing do not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum of $250,000 (including principal and accrued interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account, IRA etc.) per CD depository. Investors are responsible for monitoring the total amount held with each CD depository. All deposits at a single depository held in the same insurable capacity will be aggregated for the purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository. For more information visit the FDIC website at www.fdic.gov.

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2024 Forbes Best-In-State Wealth Management Teams
Source: Forbes.com (Jan 2024) 2024 Forbes Best-In-State Wealth Management Teams ranking awarded in 2024. This ranking was determined based on an evaluation process conducted by SHOOK Research LLC (the research company) in partnership with Forbes (the publisher) for the period from 3/31/22–3/31/23. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors paid a fee to SHOOK Research LLC, for placement on its rankings. This ranking is based on in-person and telephone due diligence meetings to evaluate each Financial Advisor qualitatively, a major component of a ranking algorithm that includes client retention, industry experience, review of compliance records, firm nominations, and quantitative criteria, including assets under management and revenue generated for their firms. Investment performance is not a criterion. Rankings are based on the opinions of SHOOK Research LLC, and may not be representative of any one client's experience; investors must carefully choose the right Financial Advisor or team for their own situation and perform their own due diligence. This ranking is not indicative of the Financial Advisor's future performance. Morgan Stanley Smith Barney LLC is not affiliated with SHOOK Research LLC or Forbes. For more information, see www.SHOOKresearch.com.

2024 Barron's Top 1,200 Financial Advisors: State-by-State
Source: Barron's (March 2024) Barron's Top 1,200 Financial Advisors: State-by-State ranking awarded in 2024. This ranking was determined based on an evaluation process conducted by Barron's for the period from Oct 2022-Sept 2023. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth

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