July produced the most sanguine and welcome markets of the year – with just about everything that wasn't the Magnificent 7 rallying -- prompted by the well-suspected but now Powel-confirmed fall Federal reserve rates cuts. As Lisa Shallett, our Chief Investment Strategist, wrote in this month's On the Markets, "after one of the longest Federal Reserve policy pauses in history, markets spent the bulk of July discounting a September start to rate cuts with near-100% certainty. Catalyzed by a convincing slowdown in June inflation, including improvement in "sticky" components, the upshot was plunging US Treasury yields, with the bellwether two-year rate down 46 basis points, accompanied by a rotation in equity leadership emblematic of the traditional policy-easing playbook." For the month, the Dow Jones increased 4.5 percent, the Russell Mid-cap gained 4.7 percent, and the Russell 2000 (small caps) gained 10.2 percent. The Nasdaq was the only major index to decline, by 0.7 percent, as international stocks also rallied by about 3 percent, depending on the particular index. Bonds also had a good month as rates began to fall in anticipation of Fed cuts – the Aggregate Bond index gained 2.3 percent.

So far, August has proved as tumultuous as July was sanguine, with recession fears spiking on the heels of a poor jobs report the first week of August and the great unwind of the Yen-carry trade to start the second week. In fact, the first 5 days of August erased all of July's gains other than those found in the bond markets. Essentially every equity market globally had its worst day since the 2022 correction – or since the great financial crisis in the case of many Asian markets – on Monday August 5th. So what caused such a tumultuous drop on the 5th and immediate rebound on the 6th?

As you probably know, Japan has been mired in deflation or disinflation for most of the last 20 years. Consequently, their Federal Reserve equivalent, the Bank of Japan, has held Japanese interest rates at zero for the last 15 years or so. This policy – and its extended duration – encouraged Japanese investors and institutional investors alike to borrow money in Japan at very low rates and invest in securities in other countries that had a higher yield. If you can borrow at 1 percent and earn 5 percent, you make a 4 percent spread on someone else's money. If the Yen also weakens against the currency of that foreign investment, that's gravy on top, as when you convert back to Yen, you have more Yen than required to repay your debt. This is called the Yen-carry trade. Consequently, there are millions of Japanese investors, hedge funds, institutions, and even retail traders that are effectively short Yen – they borrow Yen – and long non-Japanese stocks and bonds. Lately, this policy has made the Japanese Yen very weak versus the dollar especially. So, on Wednesday the 31st of July, the Bank of Japan decided to raise interest rates for the first time in 15 years or so in order to lessen domestic inflation as a weaker currency, all else held equal, makes foreign imports more expensive and Japan is suddenly facing inflation. The hawkish policy change caused the Yen to immediately appreciate versus the dollar. In turn, all the Yen-carry traders rushed to liquidate non-Yen assets to cover their short/borrowed Yen positions. Hence, the big sell-off in global markets. This was a classic liquidity rush as investors liquidated everything under the sun to generate dollars to purchase Yen and cover their Yen borrowings.

Is it over? We can't know for sure yet. On the one hand, there is a still a significant amount of Yen-carry trade out there. On the other hand, the Bank of Japan and the US Federal Reserve certainly took note of what happened and seemed likely to respond based on their public comments. Japan has the unfortunate position of having to choose between inflation and higher rates/Yen carry unwind. It's not going to be an easy choice and they may very well continue to raise rates. In the United States, a broad

decline in stock values triggered but further Yen-carry unwind would almost certainly increase the odds of a recession as the high-end consumer would, for the first time, likely begin to pare spending as has already occurred among the less wealthy. Right now, Morgan Stanley's base case, and ours, remains that there will not be a recession 2024 or early 2025. One poor jobs number – a notoriously unreliable government statistic – did not alter that thinking. Nor did one day of Yen-carry unwind. But, we cannot say this is insignificant either.

What happened on the 5th does parlay into one of our big concerns, however. As you know, our team has steadfastly maintained the inflationary impulse is broadly on the rise globally. What is happening in Japan right now is a microcosm of where the whole Western world has positioned itself. We remain concerned investors underappreciate the risk that inflation will not return to its pre-covid status where 2 percent functioned as a cap on the inflation rate. Instead, we think going forward, 2 percent is more likely to be a floor – with periodic spikes above 3 or even 4 percent becoming increasingly common. Our Global Investment Committee wrote an excellent Special Report this month addresses the asset allocation implications of this concern – in a more inflationary environment, the benefits diversify only between stocks and bonds lessens as the correlation of bond and equity markets increases. In other words, during persistent inflationary regimes, portfolios will require more investments in non-corelated fixed income, floating rate bonds, inflation protected bonds, and alternative investments to hedge recession/equity risk. Absent those additions to portfolios, it may prove very difficult to smooth the ride during periods of market volatility so retirement income and portfolio predictability can be assured.

Overall, we have not changed our thoughts on positioning as a consequence of this early August upheaval. We remain are optimistic on the rest of the stocks outside the magnificent 7 for earnings reasons. As Lisa Shallet wrote, "the earnings-growth-rate disparity between the Mag 7 and the 493 other S&P 500 stocks is poised to mean-revert, based on FactSet estimates for the second half of 2024 through 2025. Notably, the Mag 7 is now facing prior-period earnings levels that will make for more-difficult comparisons, contributing to deceleration to the 15%-17% year-over-year range; meanwhile, earnings growth for "the 493" is positioned to rebound off flat prior-year comparables and accelerate to an average annualized 12%-15% gain." The GIC is less excited than our team about the prospects for small and mid-cap stocks, but they also see no recession as the base case and a rally in "everything else" as we move toward the first fed rate cut. We are happy that our call for falling rates has finally come to fruition and bond investors are being rewarded for their patience this year.

As always, if you have any questions or concerns, please don't hesitate to reach out to any member of the team.

NOTICE: Morgan Stanley is not acting as a municipal advisor and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. If you have received this communication in error, please destroy all electronic and paper copies and notify the sender immediately. Mistransmission is not intended to waive confidentiality or privilege. Morgan Stanley reserves the right, to the extent permitted under applicable law, to monitor electronic communications. This message is subject to terms available at the following link:https://www.morganstanley.com/disclaimers. If you cannot access these links, please notify us by reply message and we will send the contents to you. By communicating with Morgan Stanley you acknowledge that you have read, understand and consent, (where applicable), to the foregoing and the Morgan Stanley General Disclaimers.

Please see our **Privacy Pledge** for details about how Morgan Stanley handles personal information.

If you would like to update your email preferences or unsubscribe from marketing emails from Morgan Stanley Wealth Management, you may do so **here**. Please note, you will still receive service emails from Morgan Stanley Wealth Management.

Not all products and services may be available to persons living outside of the United States.

Morgan Stanley Wealth Management
2000 Westchester Avenue, Purchase, NY 10577-2530 USA

Morgan Stanley Smith Barney LLC. Member SIPC

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The strategies and/or investments discussed in this material may not be appropriate for all investors. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

The investments listed may not be appropriate for all investors. Morgan Stanley Smith Barney LLC recommends that investors independently evaluate particular investments, and encourages investors to seek the advice of a financial advisor. The appropriateness of a particular investment will depend upon an investor's individual circumstances and objectives.

Morgan Stanley Smith Barney LLC offers a wide array of brokerage and advisory services to its clients, each of which may create a different type of relationship with different obligations to you. Please visit us at http://www.morganstanleyindividual.com or consult with your Financial Advisor to understand these differences.

This material contains forward looking statements and there can be no guarantees they will come to pass. The information and statistical data contained herein have been obtained from sources believed to be reliable but in no way are guaranteed by Morgan Stanley as to accuracy or completeness. There is no guarantee that any investments mentioned will be in each client's portfolio.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

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