Last month's note from us was a December and full year 2023 recap and our list of our expectations for 2024. To summarize it briefly, we are cautiously optimistic that 2024 will provide positive returns – we think single digits – for both stock and bond markets. In January, the MSCI World climbed 0.6 percent and the Bloomberg Aggregate bond index declined 0.3 percent. US stocks fared slightly better than international stocks with the S&P, Dow Jones Industrial, and Nasdaq climbing 1.7 percent, 1.3 percent, and 1.0 percent respectively.

Lisa Shalett, Chief Investment Officer, summed up January succinctly in this Month's On The Markets, writing, "In certain ways, January picked up where 2023 ended—with US equities pushing through to new highs, enthusiasm around a soft landing prevailing and the Fed taking victory laps on inflation reduction expected to catalyze rapid rate cuts. Investors also expressed optimism about the trajectory of corporate profits. Meanwhile, fears over economic softness lingered, edging investors back to a handful of megacap tech stocks on the assumption that their AI-linked stories immunize them from the vagaries of interest rates and the business cycle."

Our prediction last month that the Fed would not lower rates as much as the markets were assuming seems to have come true already. Chairman Powell signaled in his most recent comments that rate cuts may not begin in March or even May. Inflation seems to have at least stopped decelerating; we are already feeling comfortable with our prediction that inflation will prove difficult to tame in 2024.

We have noticed that the fear of missing out has reached a crescendo with clients. It's palpable to us in meetings, on phone calls and from the question clients ask us. For that reason, we want this February's note to focus on risk more than potential return. What's worrying us for 2024? Ultimately, it's that experience has taught us to be contrarians and to focus on valuations, not returns, when assessing risk. Chasing momentum in the markets feels great, right up until it doesn't.

On the bright side, the fear of "missing out" and the risk seems to apply to an exceptionally narrow number of securities this cycle. The purpose of this month's note is to draw attention to the mathematics of what "missing out" means right now and just how much risk one would have to take to outperform in a market where almost all return comes from only a handful of stocks. Last year, the magnificent 7 stocks started the year at 25% of the S&P 500 by market cap and contributed about 61% of the index's total return for the year. As of the end of January, those stocks make up about 30 percent of the S&P 500. Outperforming in this environment would require having more than 25 or 30 percent of your wealth in the magnificent 7. Technology stocks along with media and telecom now comprise 34% of the weight of the S&P 500 by sector but represent only 11% of GDP. Why? Because that's what everyone is buying. No matter the price. No matter the risk. No matter the valuation.

Morgan Stanley's research team has become so concerned about unaddressed concentration in the average investor portfolio, they issued a special report in January dedicated solely to the topic. If you read our commentaries each month, nothing we are about to highlight from that report should be too surprising. It seems the word "index" has substituted for diversification in the mind of the average investor. Diversification now exists in name, but not in the underlying holdings of portfolios. The report

concludes that “stagnant growth, low interest rates and a relatively favorable regulatory climate have allowed technology leaders to cement their advantage through tactical acquisitions. Given historic levels of index concentration, investors must assess the road ahead for US megacaps as an integral part of their portfolio construction decisions. While further concentration could extend 2023’s themes, any retracement would likely threaten index-level returns and even diversified portfolios.”

The report identifies three overarching issues. We would encourage you to at least glance at the supporting data and graphs it contains:

- *S&P 500 concentration is at a historic extreme—producing unanticipated and underpriced risks. The concentration prevalent today is especially differentiated in that the most valuable names are highly correlated with each other, by factor, sector and subsector. History suggests that high levels of concentration are rarely sustainable and ultimately self-undermined. This favors stock-picking and active management in the short term and the equal-weighted index for passive investors.*
- *This time, S&P 500 concentration is also heavily skewed toward the most expensive stocks, suggesting that the duration of the benchmark index has become extended. Said another way, it is highly correlated with interest rates. The implication is that, among the largest names, macro factors like Fed policy and inflation can swamp idiosyncratic drivers of earnings, essentially causing stock-bond correlations to turn or remain positive.*
- *The combination of these equity-index risks and structural shifts in stock-bond correlations, along with the end of the 40-year (1981-2021) US bond bull market, greatly diminishes the effective portfolio-risk-diversification benefits of a traditional 60/40 asset allocation. The implication is that the importance of noncorrelated alternative assets increases meaningfully. The GIC believes this especially favors real assets and hedge funds, and private investments secondarily.*

So, what does all that mean with regard to our portfolio recommendations? What should we change in your accounts if we are concerned about this risk? Our team thinks the historical ways we have optimized portfolios according to the tenets of modern portfolio theory may fail in this environment. In a nutshell, we have to find new ways to create meaningfully diversified portfolios – not just portfolios that appear diversified because of the labels we place on the indices within them. From a practical perspective, it means we need to add more hedged, inflation-protected, private (both credit and equity) and real estate investments if we hope to replicate the historical success and risk reduction benefits of a traditional stock/bond portfolio going forward.

While we intend to continue to own all the magnificent seven stocks and will also continue to own bonds, our focus in the first part of 2024 will be on contending with the risk that so much concentration and duration has imparted into portfolios.

We cannot time markets. That said, the GIC weekly from January 29th did highlight that the supply and demand issues around treasuries and money supply could be much less supportive of the long duration trade

in 2024 than they were in 2023. We will be keeping a close eye on money growth and treasury issuance early this year as changes in money supply are harbingers of interest rate moves.

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 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.

Diversification does not guarantee a profit or protect against loss in a declining financial market.

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

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.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

This material has been prepared for informational purposes only. It 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. Morgan Stanley Smith Barney LLC (''Morgan Stanley'') recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Morgan Stanley Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Past performance is no guarantee of future results.

CRC 6369568 02/2024