May proved to be a good month for stock markets; fixed income markets also produced positive returns. The S&P 500 rose about 5 percent last month; the rally extended down the capitalization spectrum with the Russell 2000 (small caps) and Russell Mid Cap indices up 5.0 percent and 2.9 percent respectively. International stocks rallied about 3.9 percent as measured by the MSCI all cap world ex-US index. Bonds rose as rates retreated after the April scare. The Bloomberg US aggregate gained 1.7 percent for the month. All in all, May was a welcome reprieve from April's declines.

As you know, these monthly missives focus on the risks we see that others might not. At the beginning of the year, our worry was that inflation would persist and interest rates would remain higher for longer. That has proven to be the case. At this point, we think the consensus is about right with regard to rates – the Fed will likely cut short-term interest rates one to three times at the end of 2024. Inflation will average something like 3.2 or 3.3 percent for the year. Much as we said in January – that's not a bad environment for stocks or bonds. Falling inflation and fed rate cuts normally correlate to broad market rallies. We still anticipate high single digit returns for an average stock in 2024 and mid-single digit returns for bond portfolios. Frankly, we could use a "normal" year where nothing to exciting or dramatic occurs and we are hopeful 2024 turns out just so.

The Bank of Canada, that country's central bank, cut rates on Wednesday June 5th – making it the first G7 central bank to do so. In this Month's On the Markets , Morgan Stanley's GIC anticipated that "both the European Central Bank (ECB) and the Bank of England will cut short-term rates in June and August, respectively on the back of soft inflation that approaches their targes by the end of the year." The Bank of England ultimately chose not to cut. The GIC expects the Federal Reserve to delay as well "with a rate cut in September, lagging because of noisy inflation data." Ultimately Morgan Stanley does not think inflation will hit the Fed's 2% target on its preferred measure, the Personal Consumption Expenditures Index (PCE), until late 2025 at the earliest. That sounds reasonable as a time frame to us.

As we often say, as financial advisors, we are compensated to manage risk. What risks do we see now? Lisa Shallett wrote in her GIC Weekly from May 29th that "with the 10-year Treasury yield at 4.5 percent, the S&P 500 equity risk premiums is a mere 35 basis points vs the 25-year average of more than 250 basis points, a level that implies a forward price/earnings ratio of nearly 21…. this is one of the highest forward multiples in the last 35 years, rivals the 2021 high, approaches the all-time might hit in the dotcom bubble and is in the 90th percentile of the last 100 years." The risk we see (and that she sees) relates to valuations on the Magnificent 7 stocks; should their sales growth disappoint and/or their competition erode profit margins, the ensuring share price declines could be substantial. Furthermore, excess profits tend to invite more competition over time, not less.

That said, we also think the risk is concentrated in those Magnificent 7 stocks. The PE of the Mag 7 is close to 40 – but the PE of the Equal Weight S&P is around 16 or 17 and the PEs of the S&P Small Cap index, MSCI EM, and Europe are all less than 15. None of the other parts of the market appear expensive by historical standards. This performance difference between the Magnificent 7 and the rest of the stock market mostly occurred after 2022. Normally, most stocks and high-yield bonds are highly correlated to the overall business cycle. As

Richard Bernstein wrote on April 30th, "the divergence in the performance of large and small capitalization stocks and high- and low-quality bonds is highly unusual and extremely inconsistent. Something must give. We continue to believe that economic precedent will hold. Profits are accelerating and credit conditions remain healthy. The broadening of fundamentals suggests it is the Magnificent 7 that will be the asset to 'give' and underperform." Our team agrees and remains cautiously optimistic that the Fed's first rate cut this fall will prompt a rally in small cap stocks, mid cap stocks and perhaps even the average stock, while also ushering in an overall positive year for investment grade bonds – even if the returns stack toward the last few months of the year. Much the same thing occurred in late 2023.

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

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

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

Please note that the URL(s) or hyperlink(s) in this material is not to a Morgan Stanley Smith Barney LLC website. It was created, operated and maintained by a different entity. Morgan Stanley Smith Barney

LLC is not implying an affiliation, sponsorship, endorsement with/of the third party or that any monitoring is being done by Morgan Stanley of any information contained within the linked site; nor do we guarantee its accuracy or completeness. Morgan Stanley is not responsible for the information contained on the third party web site or the use of or inability to use such site.

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 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.

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 6673762 06/2024