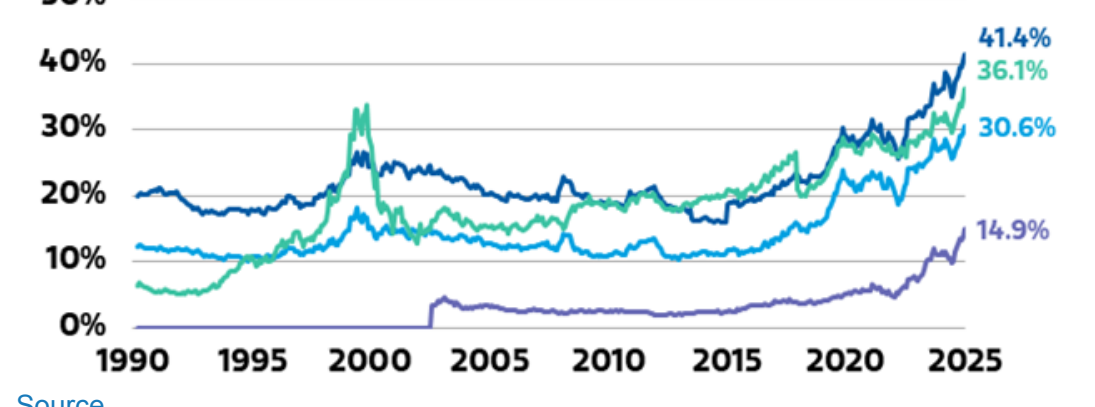


[Client Preferred Name]

October provided another month of positive performance. The S&P 500, Dow Jones Industrial, and NasDaq rose 2.3 percent, 2.6 percent, and 4.7 percent respectively. The Russell Midcap declined [0.8 percent](#) and the Russell 2000 (small caps) rose [1.8 percent](#). Peaking under the hood a bit, though, half the S&P 500 sectors were negative: materials, real estate, financials, energy and consumer staples. International stocks rallied as well, despite a pause in dollar weakening, with the MSCI EAFE up [1.2 percent](#) and the MSCI Emerging Markets up [4.2 percent](#). Bonds also closed up for the month with the Bloomberg US Aggregate Bond index gaining [0.6 percent](#) and the Bloomberg US Municipal index gaining [1.2 percent](#).

In our team's note to all our clients a month ago, we noted our current fear was not of imminent recession or inflation, but as Richard Bernstein [put it](#), that the "Fed adds unnecessary liquidity to the financial markets and speculation runs rampant. This might be fun for some investors in the short-term, but it could create serious misallocations within the economy and add to significant future inflation." Conversely, our hope was that the economy "reaccelerates without much inflation. This would result in a broadening of the market in a very healthy way."

Unfortunately, nothing about the market movements in October dissuaded from fearing the former or encouraged us to lean into the latter more optimistic and preferred narrative. Why? Markets were incredibly narrow in October. The S&P 500 rose 2.27 percent for the month, but the equal-weight S&P 500 actually declined 0.5 percent. The majority of performance and gains came from only a handful of high-momentum, widely held securities. How does this occur? It's because the major indices with the exception of the Dow Jones Industrial, are all market capitalization weighted. The largest firms now comprise over 41 percent of the S&P 500.



When market rallies are liquidity/momentum driven rather than fundamentally/earnings driven, we would expect to see such narrowness. Liquidity expansions often favor the most popular (and sometimes speculative) assets – but certainly the ones in the current investing zeitgeist. Presently, that likely translates to cryptocurrency and AI-related stocks. In defense of the AI stocks though, many have also demonstrated significant earnings growth this year. As fiduciaries, we would never be inclined to advise clients to place 30 percent of their portfolios in only five names or 36 percent in a single sector, but that is precisely what a purchase of an S&P 500 index fund entails today. There is great risk in being so concentrated especially because mega-caps as of yet do not have the revenue to justify their share of the market.



Morgan Stanley frames it [this way](#), "Overall, the Global Investment Committee sees an opportunity to reposition portfolios for solid but slowing US economic growth on the back of weaker labor markets in 2026. Recession odds, in our view, remain below 30%, and we acknowledge the likelihood of economic support in the first half of 2026 from a trifecta of stimulus: rate cuts, tax refunds and continued robust GenAI-linked capex. That said, we see the scope for upside economic surprises as narrow. This is especially true given consensus forecasts and expectations of 13%–14% profit growth for the S&P 500 next year.

Furthermore, in a valuation environment dominated by the need to drive productivity gains, and a policy environment driven by Washington access, we expect size, scale and pricing power to remain as important as ever. Specifically, we believe the "broadening economic success" thesis—as implied by market pricing and encompassing small, mid-sized and more credit-challenged firms—may disappoint, fostering a rotation back toward quality factors and strong fundamentals."

What does that mean for portfolios? It means we recommend shifting away from small and mid cap stocks, as well as more cyclical value stocks, as the likely winners in this liquidity-driven expansion will be the momentum trades such as the magnificent 7 stocks and other AI related names, as well as larger companies better able to withstand slowing economic growth in 2026 and benefit from AI adoption. We do fear that for the time being, bigger and more popular may outperform until the Fed has reason to change its policy guidance or due to some exogenous shock or a stall in the AI cap-ex build. As Lisa Shallett, our Chief Investment Officer, put it in her note from [October 20th](#), "ultimately, the "broadening economic reacceleration" thesis—including small, mid-sized and more-credit-challenged companies—may disappoint, resulting in a rotation back toward quality factors and strong fundamentals, once again favoring big over small."

It also means we need to keep a watchful eye over inflation data. This year, inflation expectations have largely run far above actual inflation data (we forecast that would occur on our team, though we were contrarian in that view). Lower-than-expected inflation has in turn acted to buoy markets which are driven, in the near term, by differences in investor expectations and reality. As we often say, it's not the level of good or bad that matters – it's all about the difference in expectation and reality. Bad but better-than-expected data makes markets climb. Good but worse-than-expected data makes them fall. The political appropriation of the word inflation to describe any price increase whatsoever created investor expectations that tariffs (a tax increase) would produce 2022-style-inflation (it peaked around 9 percent that year). That scenario has remained perennially just around the corner according to the majority of pundits since April. We have consistently argued in these missives against the simple "tariffs are inflationary" logic. Inflation has run at a rate just shy of 3 percent the last 12 months and we expect reported [October and November](#) numbers to be in line with that rate. But as we get deeper into 2026 – and especially if too much capital is allocated to AI compute at the expense of other needs – inflation may become resurgent at the same time investors tire of the tariff-driven inflation narrative. Consider the simple case that we build too many AI data centers but not enough electricity generation to power them. The result would be increasing electricity prices. Such price pressures might produce a compound problem – a Fed suddenly interested in reducing liquidity while labor markets [weaken](#), and aggregate spending slows as from a faltering AI related capex boom.

Were the Fed to become fearful that loose monetary policy is contributing to capital misallocation, their natural reflex will be to raise rates and restart quantitative tightening – always an auspicious sign for equity markets. Perhaps even more so now than normally, as Lisa Shallett detailed in her [October 27th note](#), "with the US economy powered by data-center and related capex, as well as a resilient consumer, extreme dispersion is creating distortions in a "K-shaped" economy. Notably, the top 40% of households are driving 60% of spending, as equity-ownership wealth effects swamp labor-income growth's contribution to consumption." In other words, the market going up is a big part of what's buoying the whole economy as wealthy investors spend more freely when their stock portfolios rise. For now, our team remains cautiously optimistic that markets may move higher – albeit with heightened volatility -- and we concur with Morgan Stanley that October was a return to liquidity driven momentum rather than evidence of a rising tide lifting all boats.

We also think there's a [good chance](#) the Supreme Court curtails the Trump administration's tariff program -- the Trump administration has asked the Court to [expedite the ruling](#) -- and that the [government reopens](#) in November. The markets will likely treat the former like a tax cut and the latter like a government stimulus program as the flood of [backpay](#) for wages and some suspended contract payments floods forth from federal coffers. We will not be shocked to see the equity markets rally a bit if those events come to pass before year end.

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

Hunter Stanco, CFA, MBA Managing Director Family Wealth Director direct - 210-277-4439 hunter.stanco@morganstanley.com	Ian Davis Senior Vice President Alternative Investments Director direct - 210-277-4422 ian.davis@morganstanley.com
Daniel Crites, CFP, MBA Vice President Financial Advisor direct - 210-277-4443 daniel.crites@morganstanley.com	Jeff Wright, CFP, CIMA Investment Consultant direct 210-277-4448 jeff.wright@morganstanley.com
Adriana Sferle Assistant Vice President Wealth Management Associate direct - 210-277-4469 adriana.sferle@morganstanley.com	Jeff Bowers Senior Registered Associate direct - 210-277-4419 jeff.bowers@morganstanley.com

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 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 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"), its affiliates and Morgan Stanley Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Individuals should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trusts, estate planning, charitable giving, philanthropic planning or other legal matters.

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.

Information contained herein has been obtained from sources considered to be reliable, but we do not warrant 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>

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.

Any type of continuous or periodic investment plan does not assure a profit and does not protect against loss in declining markets. Since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider their financial ability to continue their purchases through periods of low price levels.

Rebalancing does 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.

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 communication contains links to third party websites that are not affiliated with Morgan Stanley. These links are provided only as a convenience. The inclusion of any link is not and does not imply an affiliation, sponsorship, endorsement, approval, investigation, verification or monitoring by Morgan Stanley of any information contained in any third party website. In no event shall Morgan Stanley be responsible for the information contained on that site or your use of or inability to use such site. Furthermore, no information contained in the site constitutes a recommendation by Morgan Stanley to buy, sell, or hold any security, financial product, particular account or instrument discussed therein. You should also be aware that the terms and conditions of such site and the site's privacy policy may be different from those applicable to your use of any Morgan Stanley website.

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