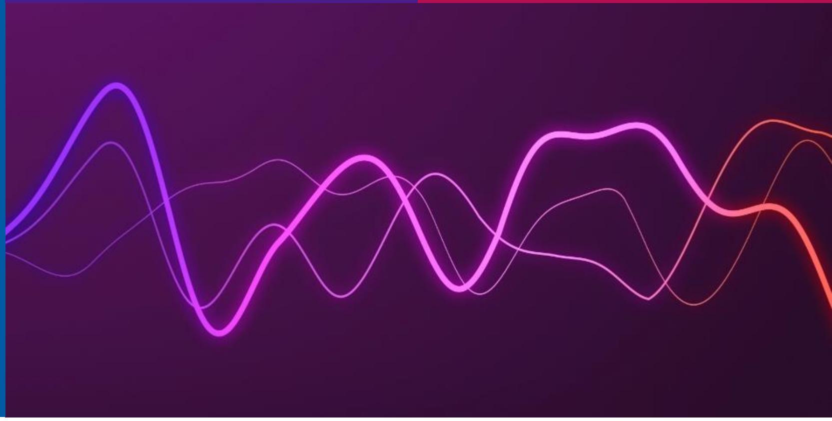
Morgan Stanley
INVESTMENT MANAGEMENT

The BEAT

BONDS | EQUITIES | ALTERNATIVES | TRANSITION



October 2024

Previously known as the Monthly Market Monitor.

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The **BEAT**, previously known as the Monthly Market Monitor, provides connectivity between changing market events and implications for investor portfolios.

Spanning **B**onds, **E**quities, **A**lternatives and **T**ransition*, this monthly review provides timely information across a broad array of markets and investment topics.

Each edition explores investment ideas, identifies areas of focus and provides a comprehensive outlook on asset allocation — all supported by a concise review of economic and asset class data through clear and impactful charts.

We believe The **BEAT** is a critical desk reference that enables more informed discussion and understanding of financial markets.

If you are viewing this book on your computer or tablet, **click or tap on the section box to jump to the beginning of each section.**

Data provided is for informational use only. See end of report for important additional information.
*Transition is an asset allocation view, which refers to cash, cash equivalents or liquid short-duration assets, such as short-dated Treasuries, that can be used to “transition” to other asset classes.

TOP IDEAS

Key Themes for October

Crossing Peak Uncertainty

October represents peak uncertainty. Markets have been wrestling with the start of Fed rate cuts and the U.S. election outcomes of both the president and the makeup of Congress. This uncertainty has led to volatility and wild swings in asset prices. But by early November we will know the results and markets may be relieved of this uncertainty, which could enable prices to trade within a more stable range. Of course, there will always be surprises, but asset allocation decisions can be made with more confidence after we cross this peak uncertainty in October.

Why Did the Fed Start with a 50-Basis Point Cut?

Labor market uncertainty. There are many reasonable explanations that justify starting with a 50-basis point (bp) cut. They range from a “catch-up” cut, regretting they didn’t start in July, to an insurance cut to solidify a soft-landing outcome. However, we are skeptical and think there is more to it. Specifically, we think the Fed may be worried that the labor market - upon which their policy reaction function hinges - is weaker than the data suggests. Note that labor data since the pandemic has been volatile and consistently revised lower, as immigration is one key source of uncertainty. This is just our theory, but something we will be watching closely.

U.S. Elections: What Do We Think We Know?

What candidates say - and how they govern - can be different. The greatest uncertainty surrounds VP Harris. Academic analysis reveals her voting record in the Senate as very progressive and far left, according to Voteview.com. But she promises to govern as a moderate. There is less uncertainty with Trump because he's been president before. Both candidate’s policies may add to the deficit, but both believe their spending will be paid for: Trump through deregulation and tariffs, Harris through progressive redistributive polices. But what may matter most is the makeup of Congress, which could enable their plans. This is what we are watching most closely.

Is Inflation Really Dead?

Maybe not dead yet, just sleeping. The narrative surrounding the recent Fed cut is that the decline in inflation has given them comfort to lower rates. But it may not be that simple. If we look at other central banks, e.g., the Bank of England, ECB and others, they started cutting rates but then had to slow their planned pace of cuts because inflation proved more stubborn, and the labor market/wages remained sticky stronger. The Fed is set to cut interest rates steadily for the remainder of this year into 2025 and finishing 2026 around 3%. If the U.S. experiences the same as other global economies, then planned Fed cuts may encounter challenges. This is a risk to current lofty asset valuations.

The views and opinions expressed are those of the Portfolio Solutions Group at the time of writing of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. Not to be construed as an investment or research recommendation.

TOP IDEAS

The Portfolio Solutions Group – Our Top 4 Ideas

Holding Underweight in Duration

Rate cuts are well priced. Despite the Fed's announcement to cut by 50 bps, we remain underweight duration. The reason is that we believe 250 bps of rate cuts are already priced in for Fed policy rates to fall toward 3%. Additionally, we believe the yield curve will continue to steepen as the Fed makes progress toward cutting rates. The longer-term average spread between Fed funds and the U.S. Treasury (UST) 10-year yield is 75 bps. So, even if the Fed cuts to 3%, as priced, then the UST 10-year may end up around 3.75%. This also suggests holding longer duration will not be an optimal hedge.

Equities: A Potential Shift to Cyclicals From Defensives

A positive inflection in data surprises could reverse a defensive trend in market internals. The key theme for 2023 was growth resilience with economic data persistently surprising to the upside. This carried through to April 2024, at which point economic data started to soften relative to expectations and continued to soften into August. Consistent with this shift, markets saw defensive sectors outperform cyclicals, and defensive factors outperform (e.g., low vol over high vol). A positive inflection in economic surprise over the last month now bears watching with the potential to drive a more cyclical shift in equity market internals.

Reducing HY from OW to Neutral, and moving IG up to UW

Tight spreads, excess returns at risk. To be sure, we are not negative on High Yield (HY). We still believe in a soft landing and a modest default cycle that would be consistent with that view. Our move to Neutral from OW reflects our desire to take profits, as bond yields have dropped after the Fed cut rates by 50 bps and the subsequent tightening of spreads. This tightening makes us question how much excess return from spread is available compared to returns stemming from duration. Given that we think duration has become a more key element to returns, we prefer to upgrade short duration Investment Grade (IG) with proceeds from reducing HY.

Exiting French Equity Exposure

Muddling through. We initiated an exposure in French equities at the start of the summer due to political volatility that sharply reduced French asset valuations, including sovereign bond spreads, to levels not seen since the 2012 surrounding fallout from the financial crisis. Given the strong performance across European equities, we viewed this as an opportunity to buy France on the cheap and play for a rebound. France did bounce from the early summer malaise, but sectors were affected less by domestic politics, more by Chinese demand e.g., consumer, luxury have lagged. We think France will muddle through as we are looking to exit our exposure.

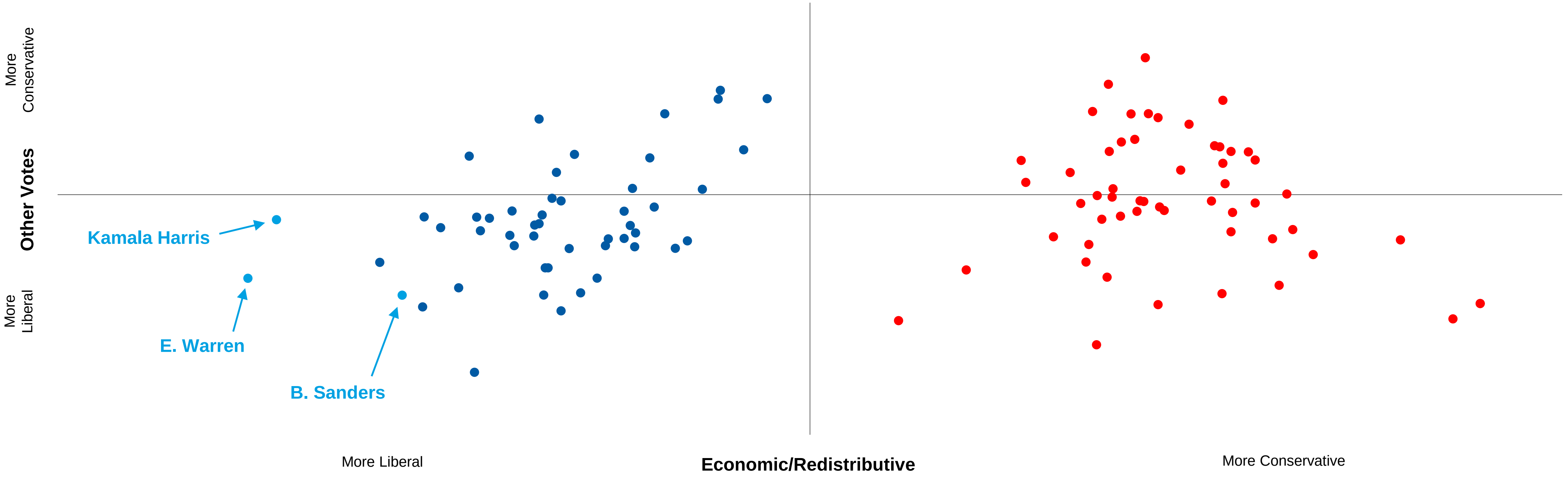
TOP IDEAS

We Know Who Trump Is. But What About Harris: Far Left or Moderate?

What candidates say and how they govern can be different. The greatest uncertainty surrounds VP Harris. Academic analysis reveals her voting record in the Senate as very progressive and far left. Both candidate's policies may add to the deficit, though the makeup of Congress will ultimately constrain or enable plans.

Voteview.com Scores Harris' Voting Record as Far Left

115th Congress (2017–2019) - Senate



Source: Voteview.com, MSIM Portfolio Solutions Group. Data as of September 15, 2024. Voteview allows users to view every congressional roll call vote in American history on a map of the United States and on a liberal-conservative ideological map including information about the ideological positions of voting Senators and Representatives. Developed by Poole & Rosenthal, Princeton University, 1993. The views and opinions expressed are those of the Portfolio Solutions Group at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.