

Higher Yields Are a Headwind, Not a Stop Sign

- Higher yields don't have to kill the risk rally
- Bond yields are rising again and the instinctive market reaction is fairly predictable
- Higher yields mean lower equity valuations, higher financing costs, pressure on private markets and wider credit spreads
- But I think this misses the most important question, because not every rise in interest rates means the same thing

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives, Taxes and short-term Transitional (cash) investing.

Today's topic is higher yields and that they are a headwind, but not a stop sign. Higher yields don't have to kill the risk rally. Bond yields are rising again and whenever that happens the instinctive market reaction is pretty predictable. Higher yields mean lower equity valuations, higher financing costs, pressure on private markets and wider credit spreads. But I think that misses the point. The most important question because not every rise in interest rates means the same thing. Let's get into it.

So why are yields rising? If yields are rising because inflation expectations are becoming unanchored or because central banks are deliberately trying to crush demand, that's clearly problematic for risk assets. But if yields are rising because 1) economic growth is stronger, 2) nominal incomes are growing and 3) there is an extraordinary demand for capital to fund investment, then that's a very different environment. And I think that is much closer to the environment we are in today. Look at the economic data. The September flash U.S. composite PMI jumped to 58.4, its strongest reading in more than five years. Payroll growth in that survey was also the strongest in more than four years. The ISM's tell a similar story. Manufacturing is at 54.6, expanding for an eighth consecutive month. Production is running at 58.3, services at 55.4. With business activity above 61 and new orders above 60, those aren't recession numbers. And importantly, this expansion is increasingly capital intensive. The economy is investing in AI data centers, power generation and transmission, semiconductor capacity, manufacturing infrastructure and defense. That all requires enormous amounts of capital. In fact, the Federal Reserve itself described capital investment as robust in September, while saying economic activity continues to expand at a solid pace and unemployment has changed little.

So here's the critical point. When the demand for capital goes up, the price of capital should go up too, and that price is the interest rate. So higher bond yields do not necessarily tell us something is wrong. They may be telling us that there is simply more productive demands for capital. And that distinction matters enormously for asset prices. Take equities. Yes, mechanically, a higher discount rate puts downward pressure on valuation multiples. But valuation is only half the equation. The other half is cash flow. If nominal growth is stronger, corporate revenues can be stronger, earnings can be stronger. Cash

flows can be stronger. So instead of thinking rates up equals equities down, think of it as a tug of war. And the tug of war is higher. Discount rates pull valuation down but higher cash flows push values up. If the reason rates are rising is stronger nominal growth and stronger investment demand than the second force can offset a meaningful part of the first. That doesn't mean valuations are immune to higher rates. It means higher rates may slow the rise in asset values rather than reverse it. And I think that distinction is incredibly important.

The same logic applies to credit higher interest expense matters, but defaults are ultimately about the ability to service that debt. If nominal revenues and corporate cash flows remain healthy, companies have more capacity to absorb higher financing costs. Strong nominal growth can therefore support credit fundamentals, even with Treasury yields at higher levels. And private markets aren't exempt from this logic either. People sometimes talk about private equity infrastructure or real estate, as though higher bond yields must automatically force values sharply lower. Again, that's too simplistic. A higher discount rate is a headwind, absolutely, but if the underlying asset is generating and growing nominal cash flows, and particularly if it sits directly in the path of this CapEx boom, then those cash flows can continue to compound. So once again, higher yields means slower valuation appreciation not necessarily valuation destruction.

Now what about inflation? There is an important caveat here which is inflation. Energy prices are keeping inflation pressures alive. In August, gasoline prices rose 3.9% and energy prices rose 2.1% in the month. Headline CPI rose 0.4%, but core CPI was 2.4% YoY. So I would categorize the inflation problem in this way the disinflation process has not disappeared. But it's too slow, uneven and vulnerable to energy shocks. In other words, inflation is moving lower, but it's not moving lower fast enough. And that matters for central banks. The Fed raised its policy rates by 25 basis points in September, while simultaneously describing economic activity as solid capital investment, robust in the labor market and broadly stable. I think the distinction here is important. Central banks are taking away accommodation because the economy can withstand less accommodation. That is different from deliberately engineering a recession.

And that brings us back to markets. The level of yields absolutely does matter. But the reason yields are at the level matters even more. If yields rise because inflation is spiraling and growth is collapsing, well that's bad news. We can all agree. If yields rise because the economy needs more capital, because investment is booming, nominal growth is healthy, corporate cash flows are expanding and the labor market remains resilient, well that's a very different signal. So don't automatically interpret every rise in bond yields as the end of the risk asset cycle. In this environment, higher yields may not stop asset prices from rising. They may simply change the speed at which they rise. And for investors, understanding that distinction may be far more important than the next twenty or thirty basis points in the bond market. The bottom line is we remain overweight equities and underweight duration while earning higher yields, but long quality fixed income.

RISK CONSIDERATIONS

Diversification does not eliminate the risk of loss. **Catalyst events, such as AI, Crypto, and Tokenization** adoption, carries the risk that such catalysts may not occur, may be delayed, or that the market may react differently than expected. Companies focused on these areas may have limited product lines, markets or financial resources, and their management and performance may be particularly impacted by events that adversely affect AI adoption, such as rapid changes in product technology cycles, product obsolescence, government regulation, cybersecurity concerns and competition.

There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology** and assumptions regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. **Equity values** fluctuate in response to activities specific to a company. **Stocks of small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other Investment Funds, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of leverage may increase volatility in the Portfolio.

IMPORTANT DISCLOSURES:

Past performance is no guarantee of future results. The returns referred to in the audio are those of representative indices and are not meant to depict the performance of a specific investment.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.

For important information about the investment managers, please refer to Form ADV Part 2.

The views and opinions and/or analysis expressed are those of the author or the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass.

Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively “the Firm”), and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific strategy or product the Firm offers. Future results may differ significantly depending on factors such as changes in securities or financial markets or general economic conditions.

This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

This material is not a product of Morgan Stanley’s Research Department and should not be regarded as a research material or a recommendation.

The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person’s circumstances and purpose. The Firm shall not be liable for, and accepts no liability for, the use or misuse of this material by any such financial intermediary.

This material may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this material in another language, the English version shall prevail.

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without the Firm’s express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

Eaton Vance is part of Morgan Stanley Investment Management. Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

DISTRIBUTION

This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC, Parametric SAS, and Atlanta Capital Management LLC.

This material has been issued by any one or more of the following entities:

EMEA:

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at 24-26 City Quay, Dublin 2, DO2 NY19, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

In Switzerland, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Italy: MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. The **Netherlands:** MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. **France:** MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain:** MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany:** MSIM FMIL, Frankfurt Branch, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Denmark:** MSIM FMIL (Copenhagen Branch), Gorrisen Federspiel, Axel Towers, Axeltorv2, 1609 Copenhagen V, Denmark.

MIDDLE EAST:

Dubai International Financial Centre: This information does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe for or purchase, any securities or investment products in the UAE (including the Dubai International Financial Centre and the Abu Dhabi Global Market) and accordingly should not be construed as such. Furthermore, this information is being made available on the basis that the recipient acknowledges and understands that the entities and securities to which it may relate have not been approved, licensed by or registered with the UAE Central Bank, the Dubai Financial Services Authority, the UAE Securities and Commodities Authority, the Financial Services Regulatory Authority or any other relevant licensing authority or government agency in the UAE. The content of this report has not been approved by or filed with the UAE Central Bank, the Dubai Financial Services Authority, the UAE Securities and Commodities Authority or the Financial Services Regulatory Authority.

Abu Dhabi Global Market ("ADGM"): This material is sent strictly within the context of, and constitutes, an Exempt Communication. This material relates to content which is not subject to any form of regulation or approval by the Financial Services Regulatory Authority of the Abu Dhabi Global Market (the "FSRA").

Saudi Arabia: This financial promotion was issued and approved for use in Saudi Arabia by Morgan Stanley Saudi Arabia, Al Rashid Tower, Kings Sand Street, Riyadh, Saudi Arabia, authorized and regulated by the Capital Market Authority license number 06044-37.

U.S.: NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Latin America (Brazil, Chile Colombia, Mexico, Peru, and Uruguay)

This material is for use with an institutional investor or a qualified investor only. All information contained herein is confidential and is for the exclusive use and review of the intended addressee, and may not be passed on to any third party. This material is provided for informational purposes only and does not constitute a public offering, solicitation or recommendation to buy or sell for any product, service, security and/or strategy. A decision to invest should only be made after reading the strategy documentation and conducting in-depth and independent due diligence.

ASIA PACIFIC

Hong Kong: This material is disseminated by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to “professional investors” as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this material have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This material is disseminated in Singapore by Morgan Stanley Investment Management Company, Registration No. 199002743C. This material should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore (“SFA”), (ii) to a “relevant person” (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This material has not been reviewed by the Monetary Authority of Singapore. **Australia:** This material is provided by Morgan Stanley Investment Management (Australia) Pty Ltd ABN 22122040037, AFSL No. 314182 and its affiliates and does not constitute an offer of interests. Morgan Stanley Investment Management (Australia) Pty Limited arranges for MSIM affiliates to provide financial services to Australian wholesale clients. This material will not be lodged with the Australian Securities and Investments Commission.

Japan: For professional investors, this material is circulated or distributed solely for informational purposes. For non-professional investors, this material is provided in connection with Morgan Stanley Investment Management (Japan) Co., Ltd. (“MSIMJ”)’s business with respect to discretionary investment management agreements (“IMA”) and investment advisory agreements (“IAA”). This does not constitute a recommendation or solicitation of transactions nor offers any particular financial instruments. Under an IMA, with respect to the management of client assets, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary to make such investment decisions. MSIMJ exercises these delegated authorities accordingly, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for underlying securities. Since these charges and expenses vary by contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read thoroughly the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This material is distributed in Japan by MSIMJ, Registered No. 410 (Director of Kanto Regional Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, the Investment Management Association of Japan and the Type II Financial Instruments Firms Association..