Caron's Corner Transcript 2.10.2025

Unearthing Value from Volatility

At What Level Does Higher Bond Yields Break Equities?

- **The proverbial question.** The answer is that it depends on 1) why yields are rising and 2) which ones. If yields are rising because the economy is growing faster than expected, inflation is remaining low and the yield curve is steepening to reflect higher productive growth, then equities and other risky assets can sustain higher bond yields. If yields are rising for more nefarious reasons, like deficit and credit concerns, or purposeful rate hikes to slow growth and inflation, then higher yields can be a problem. Context matters. There is no magic level, but when yields stop rising and plateau at a level that competes with equity returns, this is substantive. But yields need to stop rising first.

The Yield Curve Tells Us Where Yields Are Going

- **No trouble with the curve.** The question on many people's minds is where bond yields are headed, and we can use the yield curve to determine this. As supply chains normalize along with the U.S. economy, so should the yield curve. A normal slope of the 2s -10s U.S. Treasury (UST) yield curve is 50-75 basis points (bps). So, if the UST 2-yr stays anchored around 4.25%, consistent with pricing of 1-2 Fed cuts this year, then we think the UST 10-yr yield will be rangebound between 4.75 and 5%. If you think the Fed cuts 0-1 times, then the 10-yr yield could peak in the 5 - 5.25% range, and so forth. The bottom line is that term premia on the curve is reestablishing itself for many reasons, including deficits, tariffs and inflation expectations. As such, we should expect a more normal yield curve shape.

Fiscal Policy Super Bowl: Taxes, Tariffs, Deregulation

- **Fiscal policy vs. monetary policy.** Markets will remain responsive to announcements on tariffs, taxes, deregulation, immigration and fiscal spending. Should these policies carry inflationary implications, they may shift expectations for the path of monetary policy. Which side wins will depend on how financial markets react and the corresponding impact on financial conditions. This is likely to set the narrative for 1Q 2025. As we see it, President Trump will pay close attention to market reactions, particularly within equities, and might adjust his rhetoric accordingly. As such, much like how some think about a Fed-put, we should also think about a Trump-put.

PMIs, Manufacturing Recovery, Cyclicals

- **A global story.** As we move into 2025, perhaps the most powerful fundamental theme is a recovery in manufacturing PMIs. For the past three years, most PMIs have been below 50 and have struggled to break out. However, while ex-U.S. manufacturing remains challenged, leading indicators in the U.S. suggest a recovery may be forthcoming. We think this is important because a recovery in PMIs is highly correlated with a recovery in cyclical sectors that we call cap-ex beneficiaries. If we couple this with the possibility for deregulation in the U.S. and the necessity for higher investment and growth in the rest of the world (RoW), this should bolster cyclical market sectors. After all, many countries are onshoring and trying to reduce external vulnerabilities and dependencies. Effectively, more investment and capital expenditure (CapEx) increases the velocity of the already high level of global money supply, which may lead to an increase in economic activity.

Changes to Our Asset Allocation & Top Trades

- **Going UW duration.** We would like to take advantage of the recent drop in yields to further UW duration. We also think the curve will steepen, which reinforces our view to reduce longer duration assets from our holdings.
- **Adding to equity exposure, mainly Europe.** We maintained an OW to European banks as a cyclical play on Europe buy we are broadening our OW across European equities more generally. Why? Because we think the recovery in the global manufacturing sector will benefit Europe most as analysts and consensus expectations for price and earnings set the bar at a low level making it easier for Europe to surprise to the upside. Additionally, Europe is a large cap value play that we think is a good diversifier in portfolios. Don't look now, but European equities are best performers despite many coming into 2025 with an UW.
- **Adding to Materials.** We have long stated our view for a broadening of the US equity market and we initiated an OW to mid caps. We are putting a finer point on this and selecting the materials sector to increase our equity exposure. Again, this is a cyclical exposure that is consistent with our view on a PMI and manufacturing recovery globally.
- **Holding OW to HY credit.** We believe default risks remain low and still hold higher yield credit mainly in bank loans.

The market seems stunned by volatility and uncertainty but, as we see it, it's unearthing opportunities to find value and providing good entry points.

Jim Caron: Unearthing value from volatility. Well, it seems every day there's a new news cycle, and I think we just have to get used to that because the markets are going to be volatile this year for sure. So one of the things that is going on is that bond yields are moving up and down, and really what the concern is, is when yields start to move higher, people ask the question. At what level does higher yields break the equity markets, and it's the proverbial question and the answer is, well, it depends, and it depends on why yields are rising, which ones if yields are rising because the economy is growing faster than expected. Inflation is remaining low and the yield curve is steepening to reflect higher productive growth, then equities and other risky assets can sustain higher bond yields if yields are rising for more nefarious reasons like deficit in credit concerns or purposeful rate hikes to slow growth and inflation, then higher yields can be a problem. So context does matter and there is no magic level. But when yields stop rising and plateau at a level that, you know, that competes with equities or competes with equity returns, this is substantive, but yields need to stop rising first. So the yield curve is really where we're going to go to find the answers to this. And the way that we look at this is that if the spread between the 2 year and the 10 year note is typically between 50 and 75 basis points, at what level does the Fed funds rate then, you know, stop? So do people expect one rate cut? Do they expect two rate cuts or no rate cuts? Let's say the Fed doesn't cut rates at all. Let's say they go to they just stay at 4.5%. Well, if the yield curve normalizes and gets back to its 50% to 75 basis point level, then in theory, the 10 year note should trade about about 50 to 75 basis points roughly above the above the Fed funds rate, so you could get a 5% to 5.25% range in 10-year treasuries. That's possible for this year, and I just want to highlight that as a high water mark for yields because I don't think that necessarily breaks the equity markets again based on what I previously said. That if yields are rising for good reasons. But you know, clearly if we have more of a disinflationary slowdown in the markets, then certainly yields can go down. So in reality what we're really saying is that bond yields are likely to be in a range. We don't think that the current action makes the bond market destructive to the equity markets.

So now let's talk about what I call the fiscal policy Super Bowl taxes, tariffs, and deregulation. This is really what is driving markets today, and I think that people need to see this as a as an overall process right now. The big topic is tariffs. Starting in March, March 4th, President Trump has his State of the Union address. He's going to talk about his budget, his tax plans, and everything else. Tariffs are the first step in a process. We've talked about this in previous Caron's Corners. The first step in the process is to figure out how the government can generate some form of revenues through tariffs and then start to talk about taxes, meaning hopefully, well, according to President Trump, tax cuts to create some fiscal stimulus. Now there is likely to be somewhat of a drag on economic conditions based on these two events, but deregulation. is likely to add some growth as well. So therefore we have to look at all three of these things at once in order to really understand what's happening, see it as a process. Don't just look at it as individual events like tariffs, taxes, deregulation. They're actually all connected with each other.

Now moving on to PMIs in the manufacturing cycle, one of the things that we think is very interesting right now is that the manufacturing cycle is coming out of what I would call a 3 year recession. So if I look at global PMIs, They've been roughly below that 50 mark for an extended period of time and are now starting to rise back above. So what we want to do is we want to look at equity positions in markets globally, not just the US, Europe in particular is a beneficiary of this because it's more highly levered to a global manufacturing recovery where effectively. We start to see segments or sectors of the market coming out of recession. Manufacturing is one of those, and we want to invest in assets that are going to be more closely tied to it. So that's one of the real key elements to this, and this brings us into cyclicals, materials, and everything else.

So what are the changes to our asset allocation and our top trades? Well, we are going underweight duration. We would like to take advantage of the recent drop in yields to further underweight duration. We also think the curve will steepen, which reinforces our view to reduce longer duration assets from our holdings. The second thing is adding equity exposure, and this is mainly in Europe. We maintained an overweight to European banks as a cyclical play on Europe, but we are broadening this out to an overweight across the more broader European equity markets. Why? Because we think a recovery in global manufacturing, as I was just saying, recovery in that sector will benefit Europe the most, as analysts and consensus expectations for price and earnings. have set the bar low, making it easier for Europe to surprise to the upside. Additionally, Europe is a large cap value play that we think is a good diversifier in portfolios. Don't look now, but European equities are the best performers despite many coming into 2025 with an underweight. We are also adding to materials within equities. I think this is a key element here because effectively this is a cyclical, but we have long stated our view for broadening of the US equity market and we initiated overweights to midcaps, you know, going back into the going back into the 4th quarter. But we're now putting a finer point on this by selecting the material sector to increase our equity exposure. And again this is a cyclical exposure that is consistent with our view on PMIs and manufacturing recovery globally. We are also holding an overweight to credit. We still like high yield, high, higher yielding assets, I should say. We think, we think the default cycle remains low and that we stay out of recession territory in 2025. So the market seems stunned by volatility and uncertainty, but as we see it, it's unearthing opportunities to find value and, and it's providing good entry points for us. So with that, please stay tuned and we will be back with another Caron's Corner in a few weeks. Thank you.

RISK CONSIDERATIONS

Diversification does not eliminate the risk of loss. 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 (interestrate 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.

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: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC 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 and Eaton Vance 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 The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, 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.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited (“EVMI”) 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

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), Gorrissen Federspiel, Axel Towers, Axeltorv2, 1609 Copenhagen V, Denmark.

MIDDLE EAST:

Dubai: MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

This document is distributed in the Dubai International Financial Centre by Morgan Stanley Investment Management Limited (Representative Office), an entity regulated by the Dubai Financial Services Authority (DFSA). It is intended for use by professional clients and market counterparties only. This document is not intended for distribution to retail clients, and retail clients should not act upon the information contained in this document.

This document relates to a financial product which is not subject to any form of regulation or approval by the DFSA. The DFSA has no responsibility for reviewing or verifying any documents in connection with this financial product. Accordingly, the DFSA has not approved this document or any other associated documents nor taken any steps to verify the information set out in this document, and has no responsibility for it. The financial product to which this document relates may be illiquid and/or subject to restrictions on its resale or transfer. Prospective purchasers should conduct their own due diligence on the financial product. If you do not understand the contents of this document, you should consult an authorised financial adviser.

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 by Morgan Stanley Investment Management Company and 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 publication 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. Interests will only be offered in circumstances under which no disclosure is required under the Corporations Act 2001 (Cth) (the "Corporations Act"). Any offer of interests will not purport to be an offer of interests in circumstances under which disclosure is required under the Corporations Act and will only be made to persons who qualify as a "wholesale client" (as defined in the Corporations Act). This material will not be lodged with the Australian Securities and Investments Commission.

Japan: For professional investors, this material is circulated or distributed for informational purposes only. For those who are not professional investors, this material is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, 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 for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, 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 incorporated securities. Since these charges and expenses are different depending on a