Morgan Stanley

INVESTMENT MANAGEMENT

Finding the Summit

GLOBAL LIQUIDITY TEAM | INVESTMENT INSIGHT | 2023

AUTHORS

BRIAN BUCK
Executive Director

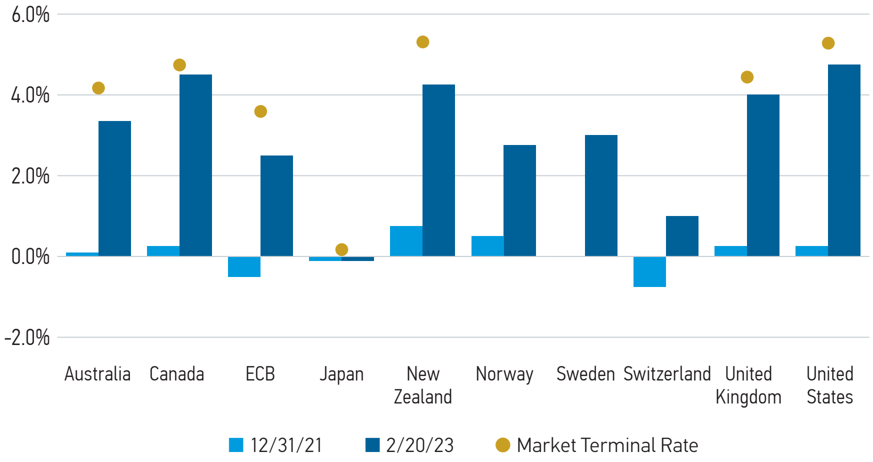
BOB LEGGETT
Executive Director

When preparing for a mountain summit, skilled hikers understand that navigation, communication, and survival skills are essential for success. Navigation skills help hikers to understand where they are and where they are headed. Basic survival skills help hikers read weather clouds, particularly the shape of those clouds and the implications for incoming weather. Communication skills are also required to relay information, warn others of impending dangers, and share the direction taken and when the journey might end. As central banks near their "peak" rates, they are charged with having similar skills—navigating, communicating and reading the "weather charts" to understand if they should forge ahead towards the peak or turn back forcing them to abandon their summit climb.

In 2022, 10 major developed market central banks hiked rates a combined 113 times[1] bringing the total rate hike to 2,825bps. While the pace and scale of the rate hikes was unprecedented for many economies, the summit has likely not been reached and persistent inflation along with continued strong signals from the labor markets requires further central bank hiking actions until the peak is reached. As we turn the calendar to 2023, the Bank of England, ECB, and Federal Reserve have acknowledged that signs of softening inflation and slowing economies may be surfacing, however upside risks remain and investors should

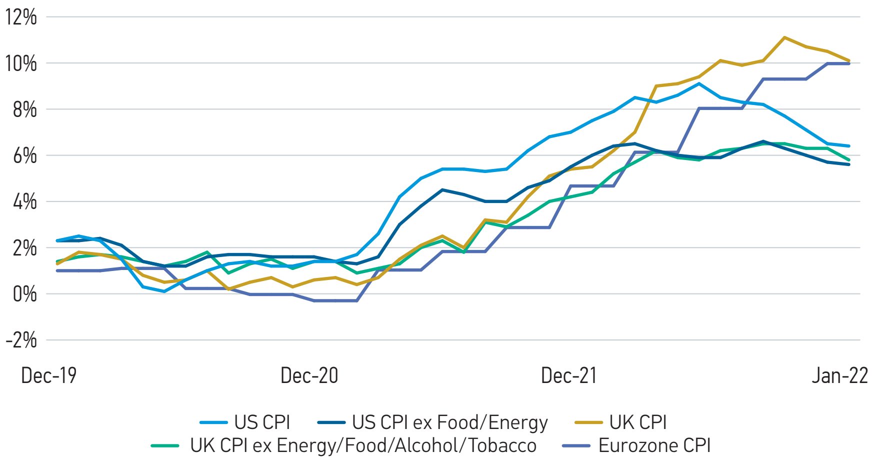
[1] Source: Global Liquidity Team, assuming each rate hike is 25 bps.

DISPLAY 1
Central Bank Interest Rate Policy



Source: Bloomberg

DISPLAY 2
Global Inflation Trends



Source: Bloomberg

not be complacent against higher rates as central banks step down the pace of tightening:

BANK OF ENGLAND – after raising rates 325 basis points in 2022, the BOE still has more work to do as a mix of shocks which the UK has experienced over the last few years—labour supply shortfall, global supply chain disruptions, and higher energy prices, may imply more persistent inflationary pressures and a more forceful policy response. While a correction in the housing market appears to be underway and sign of labour market slackening have begun, chronically high inflation prints will require the BOE to continue its march towards a peak policy rate of 4.50% with risks tilted towards the upside if inflation prints fail to moderate in the first quarter. Clouding the picture is a labour market where a shortage of workers which has led to a declining participation rate, labour strife, and an aging population which has led to wage pressures as higher inflation has curtailed consumer purchasing power.

EUROPEAN CENTRAL BANK – after raising rates 300bps in 2022, the market expects the ECB to increase rates another 150bps by the summer of 2023. With inflation surging above 10% in Q422, tight labor markets, and signs of stronger wage growth, which has lagged inflation, ECB officials remain adamant that they have more ground to cover and longer to go in their fight against inflation. While lower energy prices, China's reopening, and warm weather have led to a more resilient European economy, tight labor market conditions have prompted worries from ECB officials that inflation will remain above the ECB's target until 2025.

FEDERAL RESERVE BANK – Markets continue to perceive the Fed's terminal rate as less than 5% even as Federal Reserve officials reiterate concerns that inflation remains elevated and more work may be required. While recent measures of inflation have softened, a strong labor market and relatively easy financial conditions are complicating the Fed's effort to bring inflation durably lower. As the FOMC moves closer to what they view as peak rates, the Fed will be looking for compelling signs that inflation is on a firm downward path or, if not, that rates will need to be held at a higher level for longer to help ensure that inflation returns to the central bank's 2% target. Once the Fed reaches the peak, the market believes the Fed will quickly reverse course a view which is inconsistent with central banker rhetoric. At the very least, we believe that the market interest rate expectations need to increase and come closer in line with the Fed messaging and projections as service wage inflation appears to remain elevated.

As the calendar turns to a new year, developed market central banks will continue to push forward with monetary policy actions to reach their peak rates. Further central bank messaging will likely become more nuanced as inflation pressures moderate and the BOE, ECB, and Fed communications signal slowing the pace of policy rate increases. For example, across economies while inflation is moderating, labor pressures remain as the effects of Covid, early retirement, and continued strong service labor demand could pressure inflation higher. As the clouds of goods and housing inflation dissipate, the implications of labor market strength may signal whether central banks will need to forge ahead to the summit. Investors, similar to skilled hikers will need to pay attention to the weather clouds and how those clouds may foreshadow forthcoming changes either in the weather or on central bank policy as they move towards the summit.

Risk Considerations

There is no assurance that a portfolio 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. 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 these portfolios. Please be aware that these portfolios may be subject to certain additional risks and general market liquidity (market risk). **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.

IMPORTANT INFORMATION

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.

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.

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.

U.S.

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

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 may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than to (i) an accredited investor (ii) an expert investor or (iii) an institutional investor as defined in Section 4A of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); or (iv) 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.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

Japan

This material may not be circulated or distributed, whether directly or indirectly, to persons in Japan other than to (i) a professional investor as defined in Article 2 of the Financial Instruments and Exchange Act ("FIEA") or (ii) otherwise pursuant to, and in accordance with the conditions of, any other allocable provision of the FIEA. This material is disseminated in Japan by Morgan Stanley Investment Management (Japan) Co., Ltd., Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

Explore our site at **www.morganstanley.com/im**

CRC 5478732 Exp. 2/29/2024 10354389_KC_0123
A4