Morgan Stanley

INVESTMENT MANAGEMENT

2019 Market Outlook

The Four C's for 2019: Caffeine, Credit, China & Chameleons

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As we enter 2019, two specific challenges face the two largest economies in the world. First, will U.S. financial markets have a soft, bumpy or hard landing following the economic cycle peaks of growth and earnings that were reached in 2018? Second, will stimulus policies in China stabilize growth conditions in the year ahead? Resolutions for both will have significant global implications for economies and financial asset prices alike.

These challenges are represented thematically as our Four C's for 2019: Caffeine, Credit, China and Chameleons.

Caffeine

Caffeine represents the fiscal boost the U.S. experienced from tax policy, which led to an earnings and growth cycle that exceeded the expectations of many forecasters and catalyzed an appreciation in the U.S. dollar. We believe this caffeine boost wears off in 2019, leaving the economy to reconcile the fallout from the growth and earnings peaks reached in 2018. Simply put, will the U.S. economy have a soft, bumpy or hard landing?

Context is important. We believe that tax reform and deregulation spurred business investment and a capital deepening that catalyzed a reversal in the falling trend in productivity. The rise in productivity may have a longer-lasting impact that may lead to higher potential growth. The initial impulse was recorded in 2018 with U.S. gross domestic product (GDP) growing at 3% versus original consensus estimates of around 2%, which proved too low. Consensus expectations is for full year growth to slow to 2.6% in 2019, however, on a 12-month rolling basis, 4Q19/4Q18 growth is expected to trough at 1.7%, a level we think is about equal to potential growth. Full year growth is expected to then be 2.2% for 2020.

What comes next is the key. If the U.S. Federal Reserve (Fed) engineers a soft landing and growth temporarily falls only to potential, then we think this will produce a positive outcome for financial assets. This is the soft landing scenario. If the slowdown in growth slows to levels slightly below potential and is perceived as transitory, lasting only a few quarters before resuming above 2% growth, we consider this a bumpy landing. However, if growth levels fall below potential for what the market perceives to be an extended period that may include a recession, this is the hard landing scenario. Of course, the Fed is likely to ease policy in the hard landing scenario and possibly even the bumpy one. Which scenario comes to pass will be very dependent on how inflation evolves. If inflation remains well-behaved, meaning rising gently (or maybe not at all!), probabilities of a soft or bumpy landing rise significantly.

Credit

Credit asset performance will be impacted by post peak dynamics in growth and earnings. It needs to be recognized that this asset class is especially vulnerable due to high levels of leverage in the post quantitative easing (QE) era. Although a recession is not our base case scenario in the next couple of years, risk premia has risen and will likely rise further, adjusting spreads wider to reflect the increased weighting of this risk. But, this also assumes static behavior in the corporate sector.

We should not assume solidly performing companies will do nothing if credit conditions deteriorate further. How soon, how deep and how long a slowdown might materialize are therefore questions that need to be reconciled.

The credit cycle is intricately linked to how Fed policy will influence the economic landing in the post peak growth and earnings period. Investment-grade credit is particularly sensitive to this, given the increased level of leverage in the aftermath of QE policies. A simple, somewhat oversimplified rule of thumb might be that the landing is expected to be soft if the Fed ends the cycle with policy rates at 3% or less, bumpy from 3% to 3.5% and hard if above 3.5%. Market concerns seem skewed to the worst-case scenario *(Display 1).*

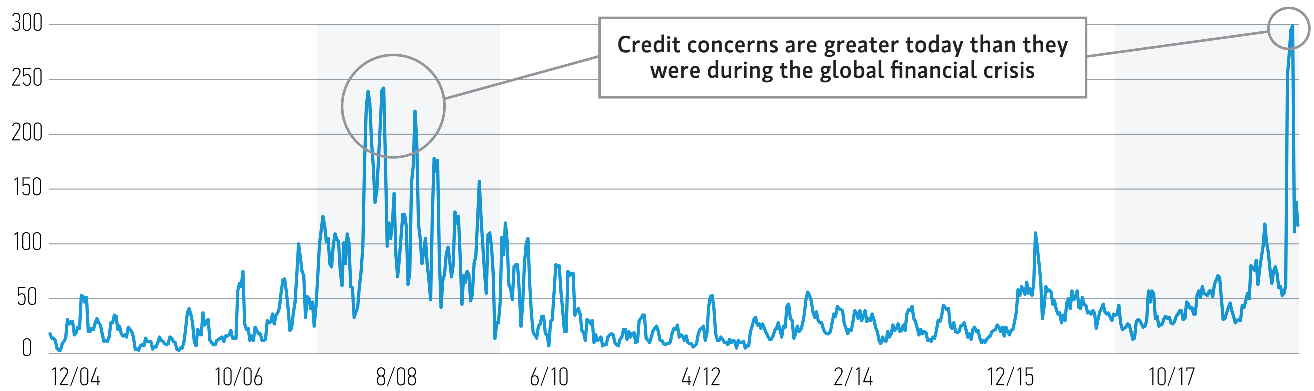
China

China policy has significant influence on the global economic cycle. China had been tightening policy considerably in 2017 through mid-2018. In 2017, China increased short rates by

DISPLAY 1

Markets Are (Over?) Anxious to Price the End of the Cycle

Google Key Word Search: "Credit Cycle"



Source: Google. Data as of October 31, 2018.

over 200 basis points (bps), as measured by one-month fixings on the Shanghai Interbank Offered Rate (SHIBOR), and the yuan rose over 7%, all of which represented a significant tightening of policy. The impact on the Chinese economy was perhaps felt more deeply in 2018 due to a deterioration in U.S.-China trade relations.

In response, China has engaged in aggressive easing with stimulus polices, such as reducing the same SHIBOR by more than 200 bps in 2018 and required reserve ratio (RRR) cuts of 250 bps. Additionally, Beijing has eased lending standards for banks and is expected to expand government borrowing by as much as 3% of GDP, which amounts to approximately $400 billion in dollar terms.[1] We are already seeing early signs of stimulus working to stabilize asset prices. Since easing policies tend to lag, we may see further stability and possibly even a rebound in 2019, which will be supportive of global asset prices especially, but not only confined to, emerging markets.

Chameleon

Chameleon refers to the need to have flexibility to be nimble and change as different investment opportunities may arise as we learn more about the post peak growth and earnings period. It is not yet clear whether the market will experience a soft, bumpy or hard landing post the peak. Asset prices are incorporating this uncertainty as we speak, and adjusting risk premia accordingly higher.

Serving as our base-case scenario, we interpret the recent volatility in the market as a mid to late cycle reset, not an end-of-cycle hard landing. For the sake of simplicity and clarity, our outlook is in favor of a soft to bumpy landing scenario. Implicit in our base case is that the Fed will be responsive to a tightening of financial conditions, namely, in the form of higher interest rates, a strengthening of the U.S. dollar, wider credit spreads and weaker equity prices. Perhaps it took the market to acknowledge that the peak in growth and earnings was behind it to respond to rising policy rates. The Fed is finally getting the tightening they were aiming for—the key for them is not to overdo it by over-tightening and creating a policy error that might lead to a hard landing. Our bet is that they will not make this mistake.

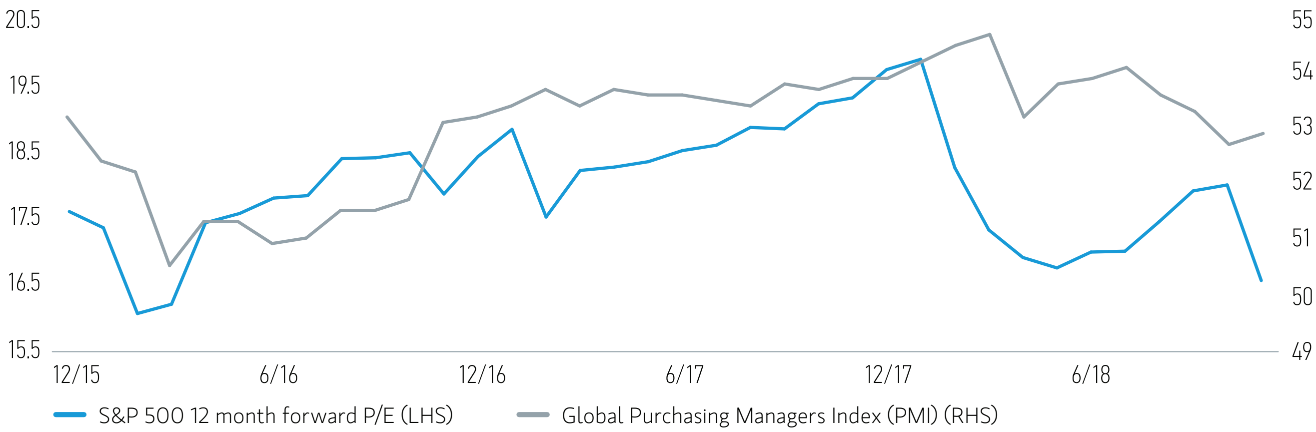
It is therefore likely that the market may also acknowledge that the peak in the U.S. Treasury 10-year yield is destined to stay below 3.50%. In this scenario, money flows away from the U.S. dollar as peak earnings have passed and growth differentials between the U.S. and the rest of the world narrow. These will be the first steps to ease financial conditions and with that occurring, money may be attracted to assets that have sold-off well beyond their fundamental valuations *(Display 2)*. However, we are likely to have to be patient, as this may not occur until mid-2019 or later.

Emerging markets stand out as an asset class that has sold off extensively, beyond fundamental valuations. High-yield and investment-grade credit also generated greater-than-expected losses, and the U.S. dollar, which gained so much in 2018, stands to reverse course in the year ahead. We expect interest rates to remain largely in a benign range-bound environment, though we expect investment opportunities to be idiosyncratic, driven by extreme misvaluations relative to economic fundamentals. We believe these idiosyncratic opportunities can be best taken advantage of by active and flexible strategy mandates. Given all of the risks facing the world, some of which could easily come to pass, we do not see 2019 as producing systematic index opportunities that favor passive investment strategies. Having a diversified, flexible, chameleon-like approach, capable of adapting to the world's zigs and zags, is, in our opinion, more likely to produce superior investment results in 2019.

DISPLAY 2

Global PMI vs. S&P 500 Forward P/E

Valuations have fallen further and faster than implied by fundamentals



Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
Source: Haver Analytics. Data as of October 31, 2018.

[1] Source: Cornerstone Macro. Data as of November 5, 2018.

Conclusion

Be prepared to be flexible and ready to adapt in 2019. Market uncertainty revolves around determining whether or not the end of the Fed tightening cycle will produce a soft, bumpy or hard landing; whether or not China's stimulus policies enacted in 2018 (and likely continuing into 2019) will stabilize their economy in 2019. Additional considerations reside with Europe and BREXIT, political risks that are difficult to value. Risk premia is on the rise and consequently pushing asset prices below fundamental valuations in a non-uniform manner. The investment opportunities reside in idiosyncratic factors within each country/sector/security where misvaluations in price relative to fundamentals are greatest. Flexible, nimble and active management of strategies may be most effective in the year ahead.

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