Morgan Stanley

INVESTMENT MANAGEMENT

# Applied Equity Advisors Monthly Commentary

**[SOLUTIONS & MULTI-ASSET]** | APPLIED EQUITY ADVISORS TEAM | MONTHLY COMMENTARY | FEBRUARY 2018

Given the rapid selloff and the resultant questions we have received about the sustainability of this bull market, we thought it would be helpful to present our market views near term, for the rest of 2018, and longer term.

### 1. Near-Term View

As I wrote in the January commentary, equity market corrections commonly follow a "W" path. To me, that makes all the sense in the world. Traditionally after a sharp selloff, if the retest of the low happens, it typically arrives on average somewhere around a month later. So if the market were to retest the lows of early February that should be happening now. I think there is a decent chance the March 1st low was as much of a retest as we will see.

Here is why: historically, March and April are a great two-month period for equities. In fact, the March-April time period is the strongest two months in a calendar year.[1] A little window dressing into the end of the quarter by portfolio managers would put the February low into the rear view mirror.

### 2. 2018 Market Outlook

I remain of the view that 2018 will end up being a good year for equities. I still believe that with an accelerating economy, earnings revisions moving higher, low levels of inflation, and the bond market a woefully poor alternative to equities, it's way too early for anything but another good year for equities.

But not without further headaches and volatility.

I believe there is the potential for another correction, possibly this summer or fall, as a series of potential worries seem to be accumulating.


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Here are my three main concerns:

A. **Inverted yield curve.** The yield curve is flattening, primarily driven by the short-end of the curve rising. I think there is a decent chance the spread could go to zero sometime this fall. And as I discussed in the past, this is NOT the beginning of the end, but the press will most likely portray it that way and scare investors. In fact, the market has averaged a 3% decline once the spread hits zero.[2]

B. **Midterm elections.** I am no election specialist, but what I learned from the recent US presidential election is voter behavior changes much less than the supposed experts would like you to think. *After eight years of one party in power, Americans vote for change.* That is a simple statistic that so many prognosticators ignored.

   And during the *next* mid-terms, the losing party *usually gains a tremendous number of seats.* Americans consistently tack back the other way after a one-party big victory.

   Markets tend to like a divided Washington….one party in the White House and one in Congress. But what worries me is the bigger the victory by the Democrats, the more it would likely strengthen the resolve of the far left wing of the party. Historically, the stock market has done quite well under Democrats, but I doubt the policies of the far left would be warmly received. And it seems to me that this could create a worry that the entire deregulation regime could be derailed in another two years.

C. **2019 Comparisons.** One of the reasons that Q4 tends to be a seasonally good time for equities is inevitably that is when analysts roll their numbers to the next year. *Whether a company achieves its current year numbers becomes less important as Wall Street looks to the coming year.* As much as this year's numbers look good, it will make next year's numbers tougher to achieve. With tax reform + cash repatriation, the 2018 S&P 500 Index consensus estimate is $158.07[3]. *I do not think this estimate is finished going up.* That is good news for this year. That represents 19% + eps growth. But the more it goes up, the more underwhelming next year's growth is going to look. I suspect 2019 earnings growth could be in the mid-single digits.

*My conclusion*, from the February 2016 low to the January 2018 high, the S&P 500 has rallied 57% for a 25% compounded return over that two-year period. That's a lot. Maybe we are due for a breather year…still positive, but the rate of ascent needs to slow.

### 3. Longer-Term Equity Outlook

The call I have heard recently *that this is the beginning of the end* will NOT be an accurate one, in my opinion. ***I do not believe the euphoric stage has arrived yet.*** All the indicators suggest a recession is a ways off. As I have articulated a number of times, preceding the past four recessions, the market peaked on average two years after the yield curve first inverted. The shortest of those four periods was a year and a half.[44] I believe the period after the yield curve initially inverts is the euphoric stage.

So the bull market should power higher. I certainly concede we are in the later stage of a bull cycle, and therefore I do suggest sharpening the focus to make sure clients' asset allocations are not too out of alignment. But to me, the suggestion that the cliff is around the corner is too early.

### 4. How to be Positioned? US versus International/ Growth versus Value.

In periods leading up to yield curve inversions (where the economy is accelerating), higher beta cyclical stocks tend to outperform. This should help non-US developed markets relative to the US, given those markets are more cyclical in nature. That has NOT happened so far in 2018. To me it should, but my level of confidence, that when the dust settles, international markets will significantly outperform the US this year, is NOT high. That is precisely why we have US and non-US exposure in our global strategies. In my view, the fat pitch is not really US versus non-US, or Growth versus Value; it's avoiding the quality/defensive stocks that have interest rate sensitivity. These stocks appear to be breaking down and should get cheaper relative to the market before the bull market truly nears the beginning of the end.

So within our global strategies, we have a modest overweight to the non-US stocks versus US, but not a big bet. We have increased our value exposure relative to growth. But again, modestly. Notably, we are very underweight the bond proxies, which we view as our most important positioning.

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1 Navellier and Associates. March 6th, 2018; market as represented by the S&P 500 over the last 50 years.
2 Goldman Sachs, 2018 Outlook, January 2018; market as represented by the S&P 500 over the last 40 years
3 Factset as of March 5, 2018
4 Bloomberg, market as represented by the S&P 500 for period 1977 through 2017.