

Final stretch of 2016: Positives outweigh negatives

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The headlines that came out of the U.K. in the days leading up to and just after the Brexit vote were alarming:

- *Brexit would prompt stock market and house price crash, says IMF (May 13th)*
- *The Brexit crash will make all of you poorer – be warned (June 20th)*
- *The post-Brexit pain is yet to come for the emerging world (July 17th)*

The Brexit outcome on June 23rd did cause a stock market correction... *for one day*: The MSCI Europe dropped -6.8%, the S&P 500 -3.6% and MSCI Emerging Markets -3.6%.¹ We now know that the panic on June 24th in response to the surprise Brexit outcome was a mistake: Since that day, the MSCI Europe Index is up +8.5%, the S&P 500 is up +7.0% and the MSCI Emerging Markets Index is up +12.4%.² So much for the doomsday headlines.

Market psychology: It's complicated

The “shoot first, ask questions later” approach is hardly ever a successful strategy. One adage says the stock market trades to inflict the maximum amount of pain. Inevitably, on that post-Brexit Friday, the market sucked out all the weak holders through a kneejerk wave of selling. Then, painfully, the sellers saw the market grind higher.

¹ In euros for MSCI Europe and US dollars for the S&P 500 and MSCI Emerging Markets.

² Total return through August 25th. Past performance is no guarantee of future results.

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I should start counting the number of times I get asked the question: “When is the next crash?” Big corrections usually do not occur when everyone anticipates them. As Peter Lynch said, *“Far more money has been lost by investors preparing for corrections or trying to anticipate corrections, than has been lost in corrections themselves.”*³

Geopolitical events that crop up in the slow-news-flow days of summer, as Brexit did, tend to cause undue market anxieties. Since July, I have maintained that the consensus bearish view was concerning. In effect I have been “cautious on being cautious.” With the S&P 500 and MSCI World indices basically trading sideways since the end of 2014 through the first half of 2016, resulting in bearish sentiment building (classic rear view window investing), it made sense that the market would break to the upside.⁴

A temporary pullback is possible

Since the end of June, however, equity markets have risen rather significantly.⁴ Has sentiment shifted enough to now warrant some caution? The level of bearishness is far less than when I made the “Cautious on being cautious” call.⁵ With the market overbought short-term, a pullback is very possible. But if it occurs, I doubt it will be meaningful or lasting. As Investors Business Daily said: *The more talk there is about an imminent market pullback, the less likely it is to happen.*⁶

Current bearishness is fueled by the memory of equity markets rolling over in late summer last year, driven by Chinese yuan devaluation and the collapse in energy prices. Government policy action is always hard to predict, but there are some key differences between this year and last—especially in the US.

Three reasons this year is different

Unlike a year ago, there are now plenty of indicators that suggest the market is

³ The Smartest Things Ever Said About Market Timing. Larry Swedroe. December 28th, 2009.

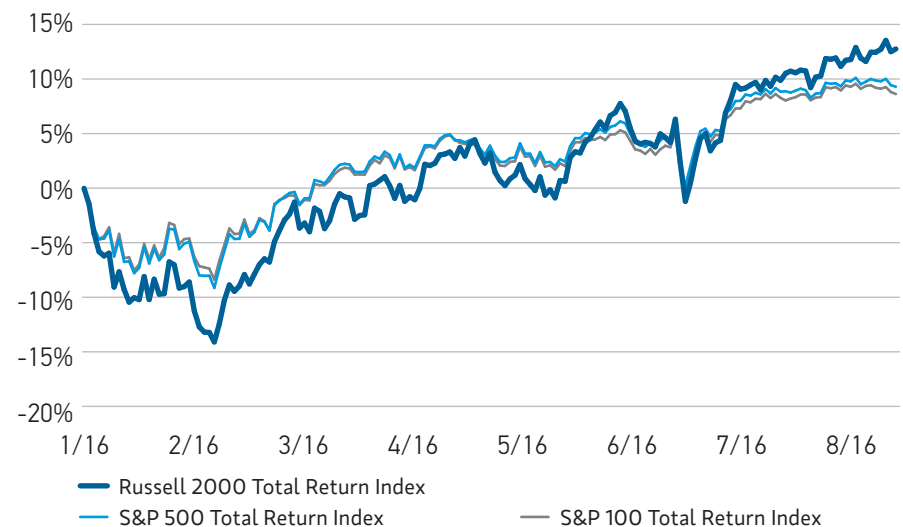
⁴ Past performance is no guarantee of future results.

⁵ CNBC July 11th, 2016.

⁶ IBD, August 25th.

DISPLAY 1

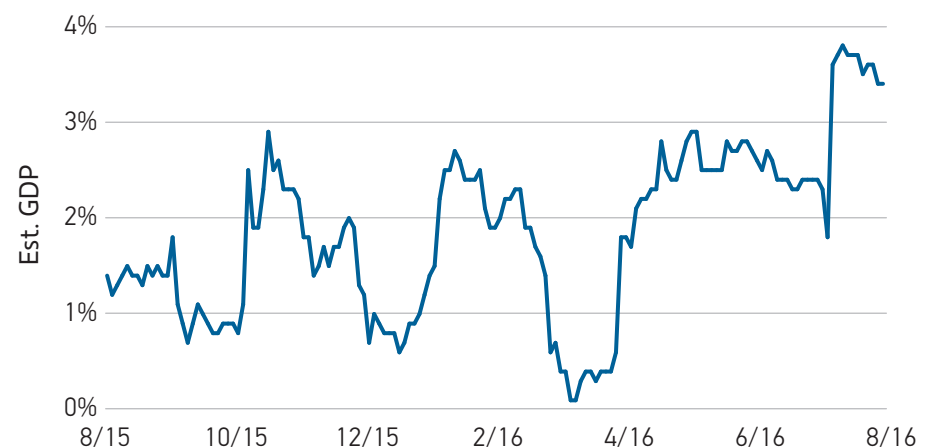
Small-cap strength usually suggests further upside potential in equities



Source: Factset, as of August 25, 2016. Past performance is no guarantee of future results.

DISPLAY 2

GDP forecast now above 3.0%



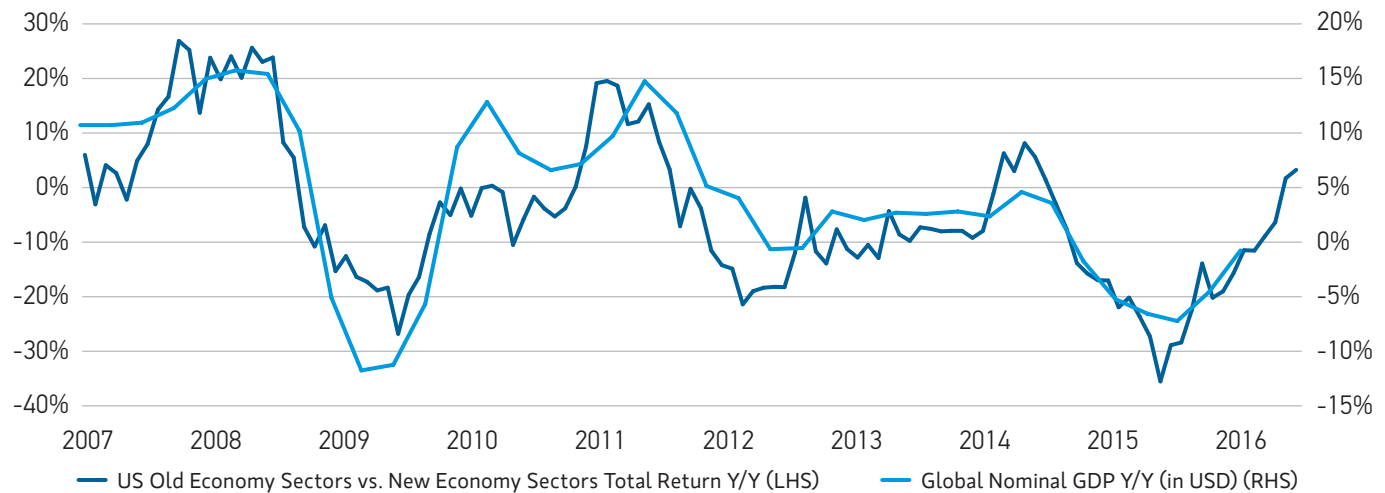
Source: Atlanta Federal Reserve; Bloomberg Finance L.P. As of August 26, 2016. Forecasts/Estimates provided herein are subject to change and may not actually come to pass.

healthy and the economy is actually on the cusp of accelerating. Here are a few:

1. *Since Brexit, market breadth is wide*
Good breadth and small-cap outperformance suggests: a) There is upside to the market over the next 6-12 months and b) The economy is healthy and accelerating. Small-caps tend to outperform when there is confidence that economic growth is broadening out. On the flip side, as was the case

last year, narrow leadership usually occurs when there is a belief in limited growth (*Display 1*).

2. *Economic activity has recently broken to the upside*
The Atlanta Fed's GDP now estimates overall GDP growth will move above the 3% mark for the first time since early 2015 (which not coincidentally was when the equity market ran out of steam) (*Display 2*).

DISPLAY 3**Upturn driven partly by old economy sectors**

Source: Morgan Stanley Wealth Management Global Investment Committee. As of August 30, 2016. Old economy sectors include industrials, energy and materials; new economy sectors include consumer discretionary, staples and healthcare. Past performance is no guarantee of future results.

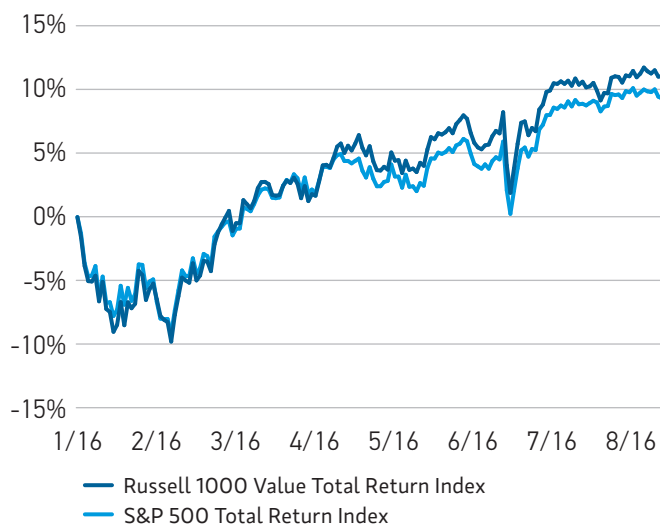
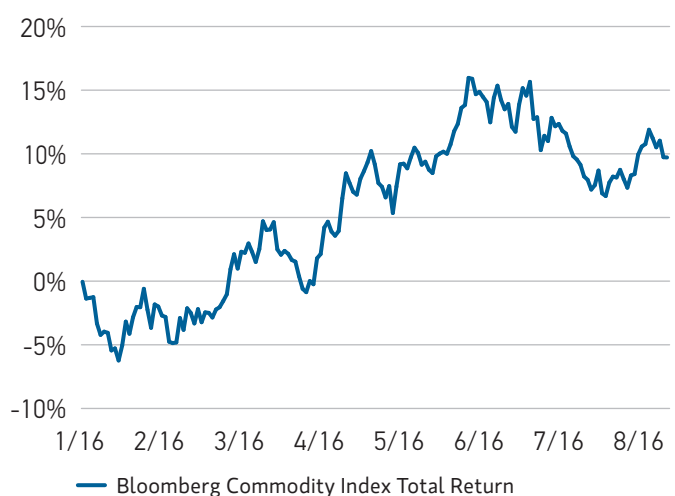
Justification for accelerating economic growth makes sense, when one considers where last year's damage was incurred. Energy prices and the ramifications of the strong dollar hit the "old economy" sectors hard, especially in the second half of 2015. Given this year's higher energy prices and that dollar strengthening has run out of steam, it's easy to see the year-over-year numbers improve (*Display 3*).

3. Resurgence in value stocks

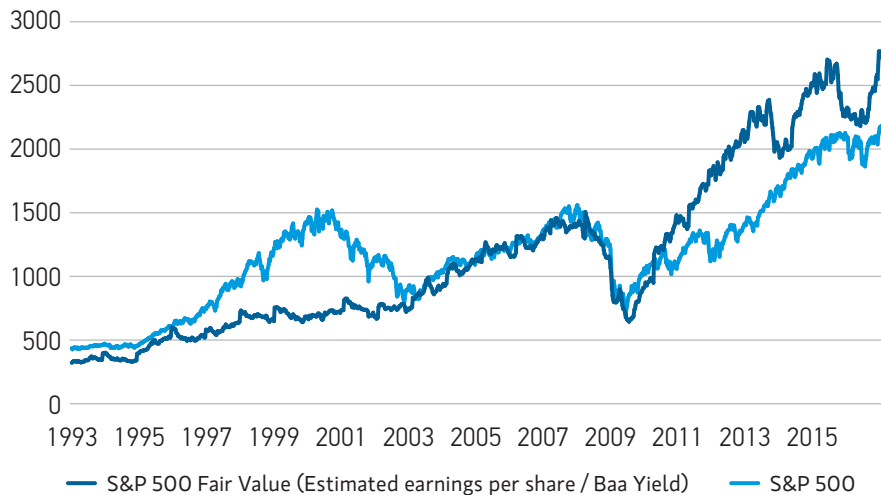
It seems that higher energy prices are translating into market gains, driving value stocks higher this year. The market has begun to anticipate a recovery for industrials, commodities and other old economy industries that dominate the Russell 1000 Value Index (*Displays 4*).

Inflation and the Fed: Getting back to normal

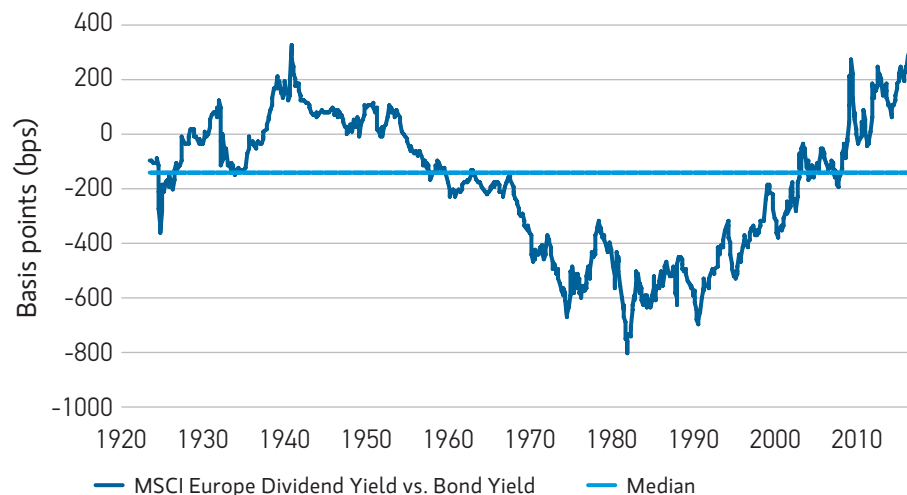
But if the economy is accelerating, should we be worried about inflation or the Fed moving to raise rates? On August 23, *The Wall Street Journal* reported that "Weekly wages for workers in the bottom quarter of the income scale (those making about \$13/hour) rose 3.1% year-over-year in the second quarter, the largest increase since 2009."

DISPLAY 4**Value stocks have turned a corner...****...as have commodities**

Source: Bloomberg Finance L.P. As of August 25, 2016. Past performance is no guarantee of future results.

DISPLAY 5**Equities look cheap based on today's interest rate levels**

Source: Standard & Poor's; Morgan Stanley Wealth Management Global Investment Committee; as of August 25, 2016. Past performance is no guarantee of future results. Forecasts/Estimates provided herein are subject to change and may not actually come to pass.

DISPLAY 6**European stocks are cheap on a yield basis**

Source: Morgan Stanley Research, MSCI. Note: Government bond yield uses market cap weighted average of European country 10Y bond yields. As of July 29, 2016.

Putting it into perspective: Historically, a normal Fed rate hike cycle results in 27 rate raises for a total of 667 basis points. A $\frac{1}{4}$ rate increase would bring the total Fed rate increases to a whopping two in this cycle, hardly justification for panic. All the hand-wringing about “normalization” is overdone. Normalizing rates could give investors confidence that the Fed is acting rationally. We need to get it over with and move on.

US: Accelerating growth could boost earnings quality

A question investors often ask is, “Is the market too expensive?” Before answering, remember that the stock market reflects the *present* value of *future* earnings. If the market multiple gets too high based on expected *future* earnings (i.e., the forward P/E is too high), stocks are at risk of falling. Even worse, if expected earnings

fall short of expectations, stocks could fall precipitously. It's all about the future.

So where are we today? The consensus S&P 500 forward earnings for the next 12 months is \$127.⁷ That puts the S&P 500 at 17.1x. Above average? Yes. Expensive? No. In fact, based on where interest rates are, stocks appear cheap (*Display 5*).

There are many reasons for this undervaluation to have existed since 2010. Aggressive Fed monetary policy driving rates lower is one of them. Another important one is the quality of earnings. Because the US economy has limped along at an anemic rate, corporations have engaged in financial engineering to boost earnings beyond what could be generated through pure organic growth. And the stock market is smart enough to sniff that out. I do not believe the market will pay the same multiple for earnings that have been partially supported by share buybacks, debt refinancings, or cost cutting/margin improvement as by earnings from pure top line revenues.

But what if the economy accelerates as I believe it will? Do price-earnings ratios go up or down? Conventional thinking is P/Es would go down as interest rates go up. I disagree—at least initially. Assuming better economic growth acts as a catalyst for better organic earnings, the market is likely to place a higher multiple on those earnings. And that would be bullish. And that's consistent with history. As rates rise off the doormat, P/Es typically do expand. They typically contract only when bond yields become more competitive with stock returns. And it's too early for that with the 10-year Treasury yielding only around 1.5%. So, it's very possible that P/E multiples expand from here as the economy accelerates.

Europe: Equities cheap but have some baggage

That's the US. Europe is in a different phase. Clearly, European stocks are cheap on a yield basis. In fact, since World War II, they have never been so cheap (*Display 6*).

⁷ Factset, as of August 25th, 2016

DISPLAY 7**Keep an eye on the US dollar**

Source: Bloomberg Finance L.P. DXY (US dollar index) as of August 25, 2016.

So we see very little downside to European equities. The flip side is there are a range of political issues that could weigh mightily. Brexit, Italy's referendum, Germany's election, rumblings of other countries exiting the EU (like The Netherlands) will likely give the bears more than their share of airtime. Lots to worry about. Not to mention, the breadth is not nearly as positive and economic acceleration is much less likely here.

**Emerging markets:
Vulnerable after dramatic run-up**

One area which we are a bit more cautious on is emerging markets. As I noted above, MSCI Emerging Markets is up 13% from June 24th and 15% year-to-date.⁸ Retail fund flows have turned very positive which is a bit of a warning flag.

We significantly increased our exposure to emerging markets towards the end of last year and the MSCI Emerging Markets Index is up dramatically since then. So these markets are more vulnerable to a more meaningful correction given their outperformance so far this year, especially if the Fed is more destabilizing to the markets than I anticipate.

Conclusion: Strong support for equities heading into yearend

Could I be wrong? Sure. Fed policy could be more destabilizing than I suspect. Based on Janet Yellen's hawkishly dovish (or dovishly hawkish) speech she gave at Jackson Hole in late August, I doubt the Fed will move aggressively or roil the markets in a big way. But it is still the most significant risk to the forecast.

Another potential threat would be a strengthening dollar, triggered by aggressive Fed action. This would upset the "recovering economy" pillar of my thesis, so watching the US dollar index (DXY)⁹ will be key (*Display 7*).

All that said, typically, the fourth quarter is seasonally the best time for equities. Analysts roll their numbers to the next year and optimism usually commences. With so many active managers and hedge funds facing another year of anemic returns, I cannot envision many sitting on the sidelines and just "locking in gains." And positive data is likely to further bolster investors' confidence.

But the fourth quarter is still a month away, and September traditionally is the worst month for equities. Hold tight and beware of doomsday headlines!

⁸ Total return through August 25th. Past performance is no guarantee of future results.

⁹ US dollar vs a basket of currencies

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