Morgan Stanley
INVESTMENT MANAGEMENT

Monthly Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | MONTHLY COMMENTARY | SEPTEMBER 2018

We see a confluence of extremes right now in the market:

1. *US Momentum stocks (the year-to-date winners) are very expensive relative to the market.*
2. *The US Internet sector's outperformance to the Chinese Internet stocks is gigantic.*
3. *US Value stocks are at unusually depressed levels of cheapness.*
4. *US Consumer Staples stocks are very cheap.*
5. *US outperformance versus the rest of the world is at a high elevation.*
6. *European banks are extremely cheap relative to the rest of the European Index.*

Normally, I am not much of a believer in pure contrarian strategies for two primary reasons:

1. The market can stay irrational in its pricing a long time, and therefore buying simply because something is out of favor or selling because it is popular does not tend to be a recipe for success.
2. On the surface, who does not believe in "buying low" or "buying when there is blood in the streets"? In theory. That is classic Buffett. *But that's also not what most do*. Flows tend to chase performance, and therefore funds tend to get MORE inflows when their stocks are at highs than when their stocks are at lows. So most investors do just the opposite of what they espouse. Foolish investing? Perhaps. But I have learned to respect the market and not fight the trends, but rather embrace the reality that human behavior is a key component to investing.

AUTHOR

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Past performance is no guarantee of future results.

In other words, so much for contrarian strategies.

This is why the primary input to our quantitative models is factor performance. If growth is working, we want to be overweight growth. If value is working, we want to be overweight value. We look at styles in terms of factors and overweight those that have momentum.

But the history of all momentum strategies is when they finally hit the wall and reverse, the drawdowns can be dramatic. Likewise when a particular strategy has no momentum, it can become so oversold and so unloved that it is ripe for reversal and the gains can potentially be significant.

As a result, we try to build guardrails around our factor momentum strategies to alert us to potential reversals. How do we know when the likelihood of potential reversals occurring is elevated? We look at the valuation levels when they have occurred in the past. Obviously, there is no guarantee that the past will repeat itself, and therefore nothing is definitive, but it's a start.

As evidenced by the conclusions above, the guardrails are flashing warning signs of downside reversal risk for certain groups of stocks and upside opportunities for others.

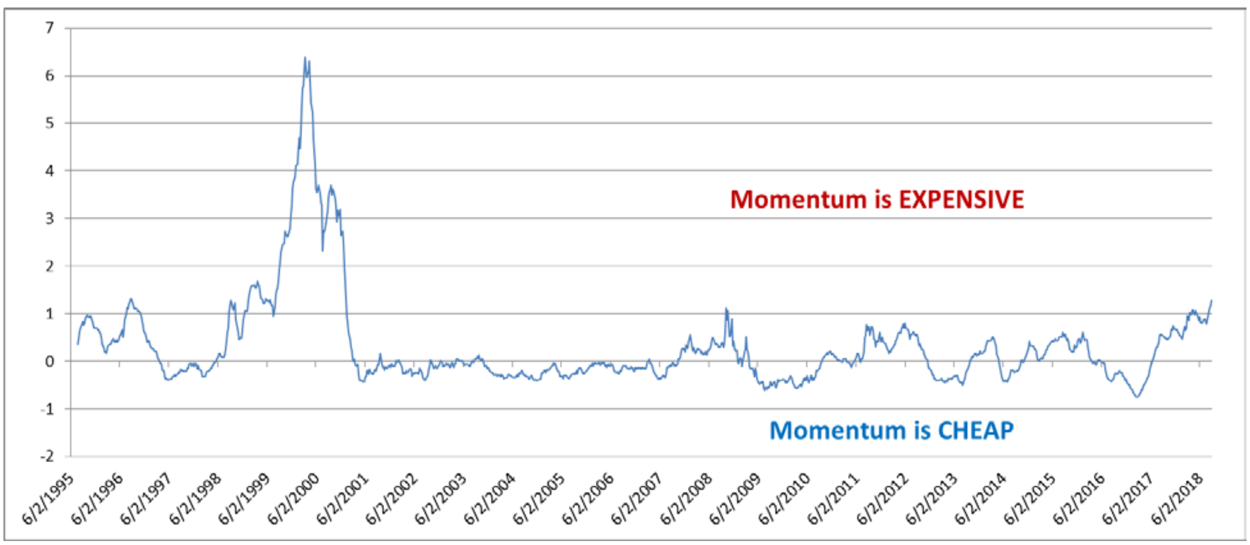
Here are some details and what we are doing about it.

1. US MOMENTUM

DISPLAY 1

Momentum Spread

August 1995 – August 2018



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Source: Factset. Momentum spread as defined by standardized price-to-book valuation differential between top decile momentum within Russell 1000 versus the market median in terms of standard deviation. Momentum is measured based on a combination of 1 year, 6 month, and 3 month performances.

As shown in the above chart, top momentum stocks are now trading over one standard deviation expensive to the index. They certainly reached more expensive levels in 1999-2000 but generally speaking, this level is a warning sign that the winners are far outpacing the losers and reversion to the mean is a distinct possibility.

From a sector standpoint, roughly half the momentum bucket is currently in technology and consumer discretionary.

What are we doing about it? Controlling our exposure to US technology, trimming as the positions have grown outsized, and reinvesting the proceeds into these less loved areas.

2. US INTERNET VERSUS CHINESE INTERNET

DISPLAY 2

Year-to-date a basket of US Internet stocks have outperformed the Chinese Internet stocks by 47%.

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Source: Factset as of September 5, 2018. Chinese Internet stocks as defined by KWEB; US Internet stocks as defined by FDN.

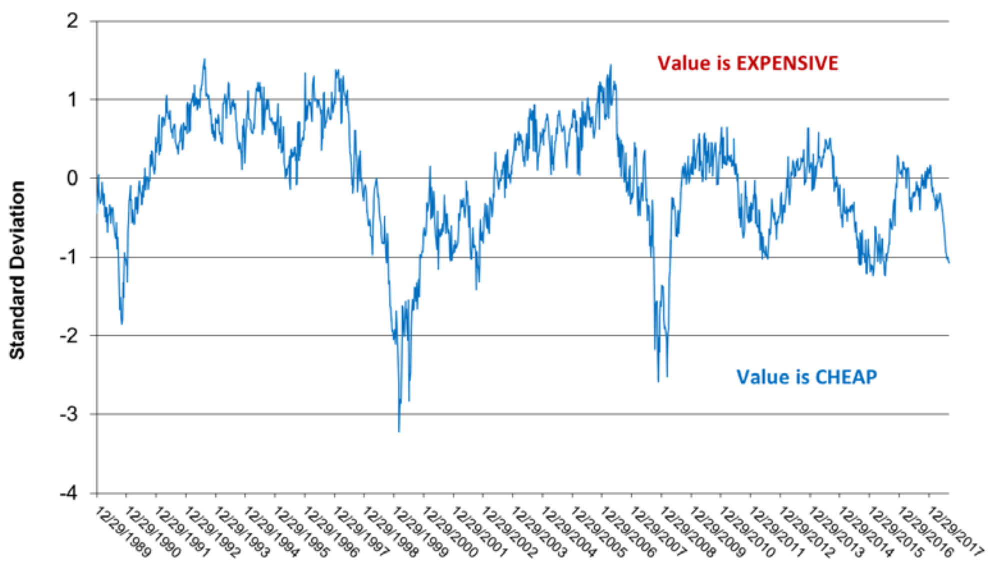
What are we doing about it? We have increased our exposure to Chinese Internet stocks.

3. US VALUE

DISPLAY 3

Value Spread

December 31, 1989 – August 31, 2018



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Source: Factset. Value spread as defined by the valuation differential between the cheapest decile of the Russell 1000 versus that of the market average. Valuation is based upon price-to-book, price-to-earnings, and price-to-free cash in terms of standard deviation.

Investors' distaste for value has only worsened, as value is now cheap versus history. There is no doubt value became even cheaper in 1990, 2000 and 2008. Each of these times preceded recessions. Either this spread is warning of a looming recession, or, if it's not, then it's likely a good time to increase value exposure.

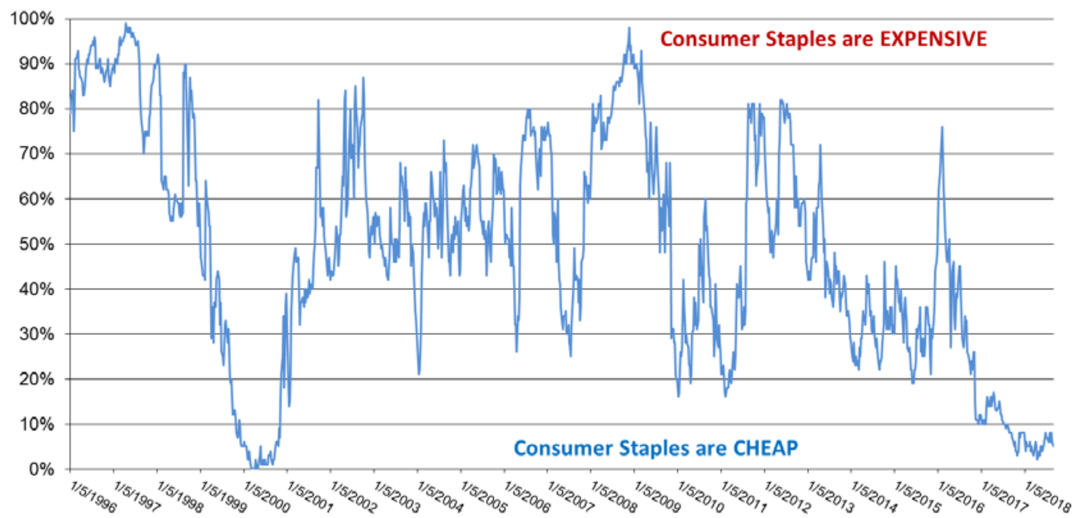
What are we doing about it? We continue to increase our value exposure. All of our strategies are overweight to their benchmarks in US financials and US energy companies.

4. US CONSUMER STAPLES

DISPLAY 4

Consumer Staples Valuation

December 31, 1995 – August 31, 2018



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Source: Factset. Historic valuation levels of companies with the S&P 500 that are classified as members of the GICS consumer staples sector.

Investors' love affair with technology/consumer discretionary has left the staid consumer staples stocks in the dust this year. The net result is they are cheap. We are mindful that historically post a yield curve inversion and into the final leg of a bull market, consumer staples tend to outperform. This cheapness seems to offer an opportunity to increase a previously very underweighted group.

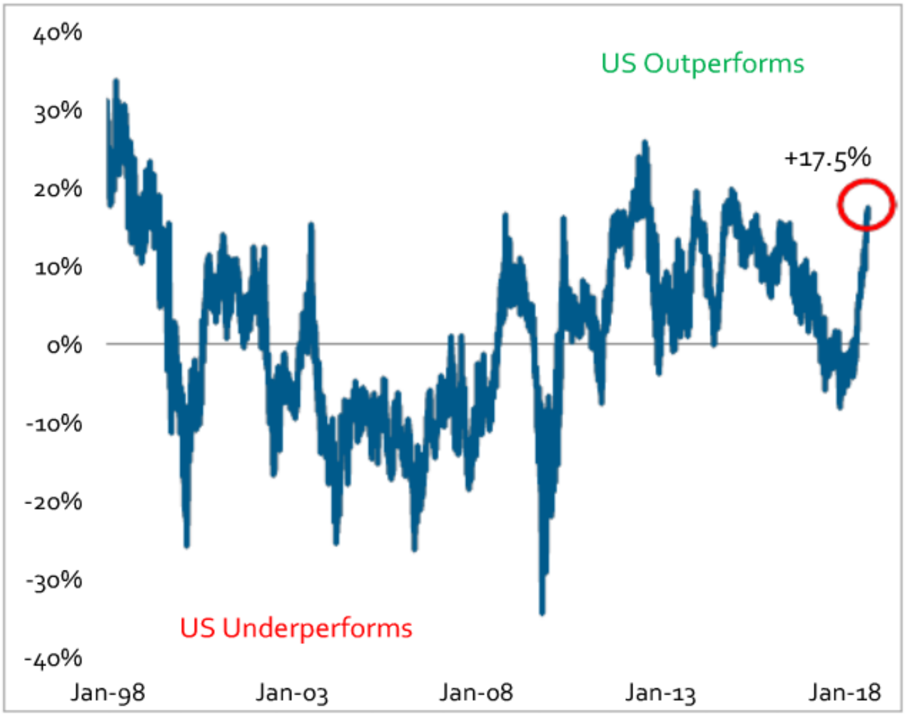
What are we doing about it? We have transitioned from close to a zero weighting in US consumer staples earlier this year to a modest overweight in the portfolios.

5. US VERSUS REST OF WORLD (ROW)

DISPLAY 5

Rolling 12-month Returns of S&P 500 vs. MSCI ACWI Ex-US

January 1, 1998 – August 31, 2018



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Source: Bloomberg as of August 31, 2018

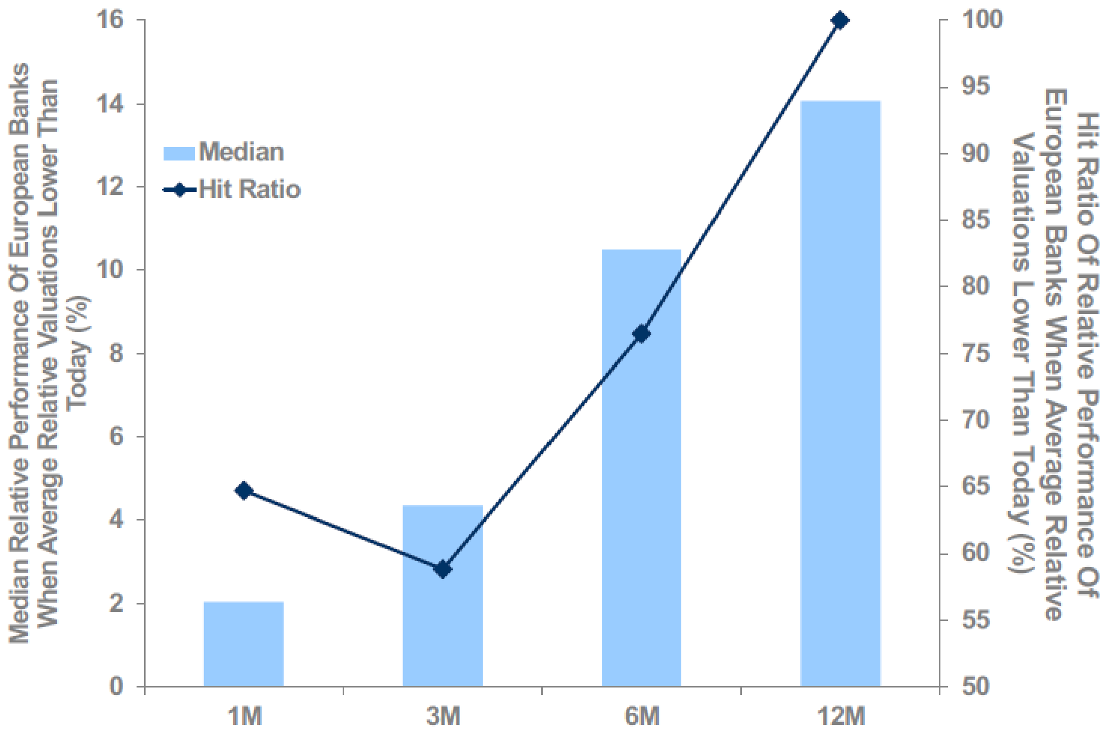
The relative performance of the US versus the Rest of the World is nearly as extreme as we have seen it in the past 20 years. Can it continue?

What are we doing about it? This is painful. We have been overweight non-US stocks for the year, and it has really hurt. We are not adjusting our allocations meaningfully.

6. EUROPEAN BANKS ARE EXTREMELY CHEAP

DISPLAY 6

Relative performance of European Banks versus MSCI Europe



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Source: MSCI, IBES, Morgan Stanley Research

Over the past 30 years, banks have always outperformed MSCI Europe over the subsequent 12 months when at current valuations or lower.

What are we doing about it? Without a doubt, it would be so easy to jettison European banks. I love to get the red off the portfolio holdings statement. While we have worked to reduce our book costs in these stocks, it would be imprudent to eliminate into this level of pessimism, given past history.

Two final points:

1). We are not wholesale dumping our growth/momentum stocks but we need to be mindful that the rubber band is stretched. No doubt, it has not been a fun period for anybody EXCEPT pure growth/momentum investors. Any value exposure and/or any non-US exposure has hurt performance. And we have both.

2). This is NOT a call that the market will go down. It seems to us it's more about the risk of some rotation occurring. We believe convergence could occur not because everything goes down and the unloved go down less, but rather because we envision convergence on the upside.

What could cause a convergence?

1). The Fed. Less hawkish

2). The Dollar. Less strong

3). EM Currencies. Less weak

4). 2 to 10 year yield curve. Resteepens

5). Tariffs…Progress on a resolution

Currently there is a ton of bad news priced into #1-#5. Which is why we are experiencing the extreme valuation/performance spreads. But then we suspect the spreads are so stretched that if anything positive occurs, these extremes will begin to revert.

"Interesting" times for sure.

Andrew

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