Morgan Stanley

INVESTMENT MANAGEMENT

# Secular Stagnation: R.I.P.

SOLUTIONS & MULTI ASSET | GLOBAL BALANCED RISK CONTROL TEAM | MACRO INSIGHT | 2018


AUTHOR

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"What did we get right?" That's the question on the minds of asset managers as they write their outlooks for the past year. In our December outlook, *2018: Expect the Unexpected*, we predicted possible surprises this year in inflation and volatility. Since these surprises came to fruition in February, we decided to step back and interpret what they might mean for the rest of 2018.

**Stocks rally — until inflation becomes a concern**

The theory behind secular stagnation is that the economy grows very slowly, and as a result, inflation and bond yields stay contained. Within a few years, the economy potentially stumbles into a recession. Instead, strong economic numbers, and positive consumer sentiment helped fuel an explosive stock market rally in January. Fuelled by the U.S. tax bill and a lot of very positive sentiment, a chart of the January rally looks like a trajectory for Elon Musk's Falcon Heavy rocket ship *(Display 1)*.

At the end of January, higher-than-expected payroll numbers and wage growth surprised investors. Most believed that the global economy would shuffle along slowly, with inflation remaining in negative territory. But the payroll and wage data raised the prospect of higher inflation, fuelling concerns that the Federal Reserve (Fed) would tighten rates and create more headwinds for equities. The changed outlook helped cause stocks to tumble *(Display 1)*.

The positive labour report also caused the yield curve to steepen. Many investors—who had been positioned for a flattening yield curve—started reversing that trade, triggering a significant sell-off in the bond market. This may have finally broken a 30-year trend of declining bond yields *(Display 2)*.

## Sell-off amplified by a surprise in volatility

Simple panic selling and repositioning were likely the primary triggers of the sell-off. But we believe investors' short positions in VIX[1] futures—a widespread strategy in late 2017 for those anticipating a low volatility environment—amplified the effects. As the market traded lower, the VIX rose and these short positions came under pressure. Investors had to close them out by buying them back, which drove VIX prices even higher.

The Euro Stoxx 50 Volatility Index (VSTOXX)[2], another volatility index, is usually higher than the VIX. Interestingly, on 6 February, the intraday peak of the VSTOXX was only 32, while the VIX was 50.2.[3] This underscores our belief that existing short positions in the VIX—and the subsequent need to cover them after the sell-off—placed upward pressure on the VIX, amplifying the volatility in the markets.

The VIX and the equity market tend to be inversely correlated, so investors who want to help protect against a rising VIX might be tempted to hedge their risk. But this would also exacerbate downward pressure on the stock market *(Display 3)*.

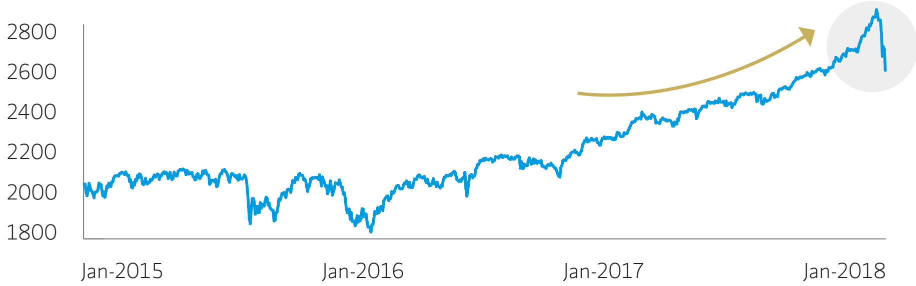
## What does this mean for equities?

The sell-off in equities drove the 12-month forward PE ratios down from over 19.0x to about 16.8x, making valuations somewhat more attractive. Meanwhile, we see little that would stop global economic momentum other than a sharp spike in real (versus nominal)

**DISPLAY 1**

**Rocket ship performance, then profit taking**

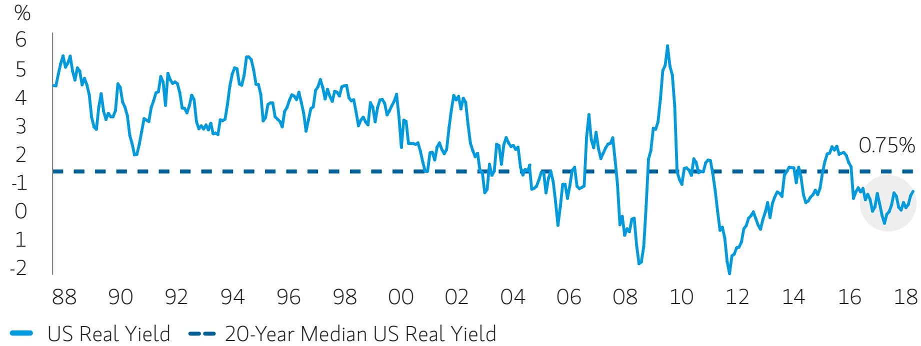
S&P 500 Composite Price Index




Source: Bloomberg, Datastream for the S&P 500® Index. Data as of 8 February 2018. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

**DISPLAY 2**

**An end to the 30-year era of declining bond yields?**

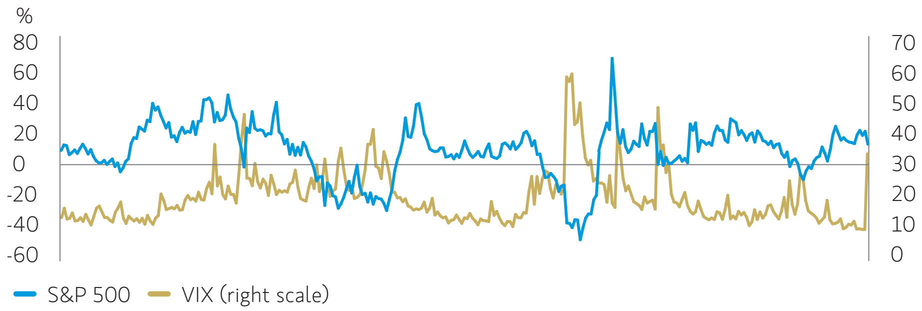



Source: Bloomberg, Datastream. Data as of 8th February 2018. U.S. Real Yields are based on U.S. 10-Year Treasuries adjusted for actual inflation, which is based on the Consumer Price Index (CPI).

**DISPLAY 3**

**Stock prices and volatility tend to move in opposite directions**

YoY Annualised




Source: Bloomberg, Datastream for the S&P 500® Index and the Chicago Board Options Exchange (CBOE) Market Volatility Index (VIX). Data as of 8 February 2018. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

[1] The Chicago Board of Exchange (CBOE) Volatility Index® (VIX®) measures expectations of 30-day volatility, based on the implied volatilities of a range of S&P 500 index options.

[2] VSTOXX Indices are based on EURO STOXX 50 real-time options prices and are designed to reflect the expectations of volatility

[3] Source: Bloomberg

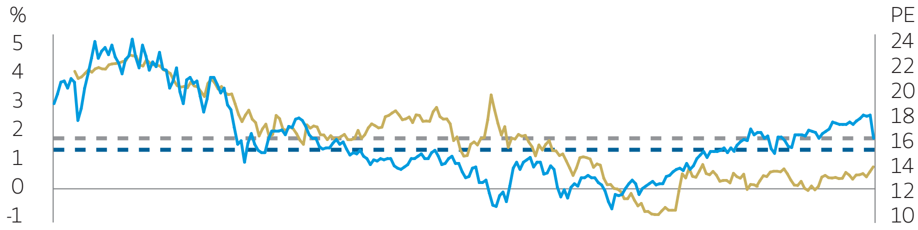
interest rates, which could drive borrowing costs higher.

We expect bond yields[4] to climb above 3%. If they hit 3% and inflation rises to 2%, real yields will be around 1%. With real yields averaging 1.6% over the last 20 years, this is not high from a historical perspective. Also, comparing valuations and real yields reveals that forward PEs have risen noticeably faster than real yields in recent years. This suggests that real yields could potentially climb a fair amount before putting pressure on forward PEs *(Display 4)*.

If interest rates rise dramatically, real yields can change quickly. For now, in the absence of a sudden rise and without an uptick in inflation, we do not see real yields rising higher than 1.5%. Given that the Institute of Supply Management (ISM) data recently hit cyclical highs, it is unlikely that real yields in the 1.0-1.5% range would be enough to slow the economy down *(Display 5)*.

**DISPLAY 4**

**Real yields of 1.0–1.5% are not enough to compress PE multiples**

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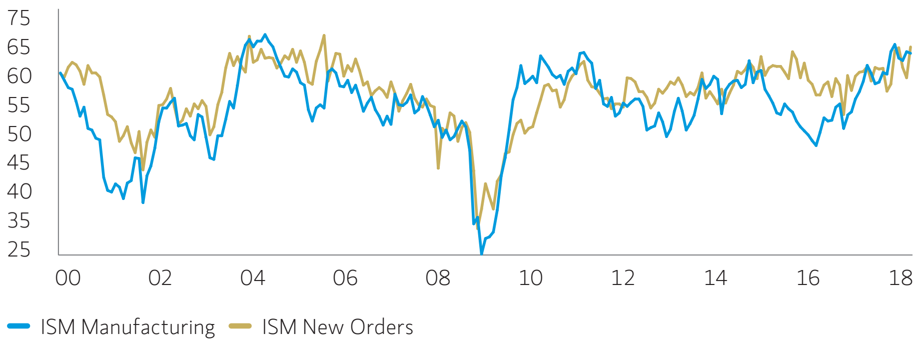
**DISPLAY 5**

**New orders fly as manufacturing output reach cyclical heights**

YoY Annualised




Source: Bloomberg, DataStream. Data as of 8 February 2018. S&P 500® Index. ISM data is provided by the Institute for Supply Management. The reports and further detail can be found on the website: https://www.instituteforsupplymanagement.org

### Monetary policy: All about managing expectations

Although an unexpected change in Fed policy could cause rates to jump, the Fed places a high premium on transparency and predictability. It has made it clear that it projects three or four hikes this year and three next year; the market has arguably been slow to price in those already-stated views. Given how concerned central banks are about upsetting the markets, it seems unlikely that the Fed, the European Central Bank (ECB) or the Bank of Japan (BoJ) would dramatically change their stated policies.

Continued quantitative easing in Japan and, to a lesser extent, Europe may suppress U.S. bond yields. Although we believe that rates are likely to experience an upward trend from here, that pace may slow a bit when rates hit 3%, barring an unexpected change in policy.

### Inflation: Building steam, but slowly

As we predicted one year ago in our market outlook "Runaway Train", higher wages, rising rates and accelerated growth are feeding inflationary pressure. The Fed itself is also a source of pressure, since it's currently sitting on huge excess reserves that could flow into the U.S. economy. Inflation may surprise on the upside this year both in terms of Consumer Price Index (CPI) and wage increases.

One of the notable changes in the underlying U.S. economy has been growth in the capital investment. Not surprisingly, it's beginning to ignite wage inflation. The good news is that this business spending is also starting to improve productivity *(Display 6)*.

Both valuations and consumer sentiment may be at high levels, but with stable real yields, rising productivity and

[4] U.S. 10-Year Treasure bond yields

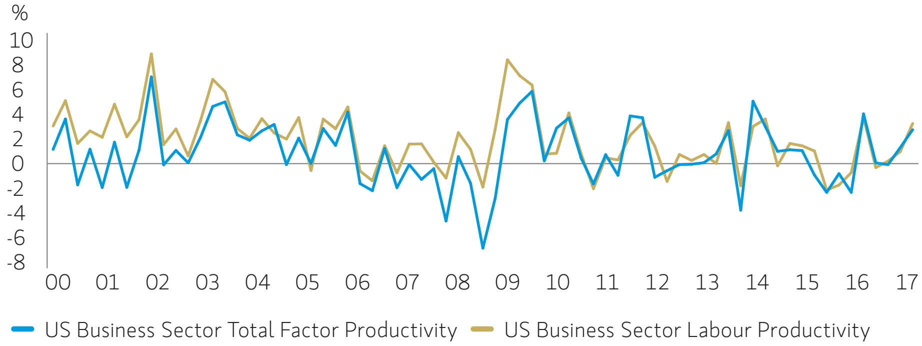
"normalised" valuations, the equity outlook is not necessarily negative—as long as economic growth continues.

The bigger risk, however, is for bonds. Aside from inflation-protected securities, bonds are priced in nominal yield rather than real yield terms. Even if real yields don't rise—because inflation keeps pace with the rise in bond yields—regular bond prices will suffer if nominal yields rise.

**DISPLAY 6**

**Capital expenditure growth can drive wage inflation—but also boost productivity**

Annualised Quarterly Rate




Source: Federal Reserve Bank of Atlanta, Bureau of Economic Analysis. Data as of 8 February 2018. Total Factor Productivity is a measure of the efficiency of all inputs to a production process.

## Europe: Stronger euro may hurt large caps

Although Europe's economy is strengthening, there are some potential downsides: Faster-than-expected rate hikes could cause a spike in the euro, which could hurt large European companies that rely on exports. However, small to mid-cap companies are less exposed to a higher euro.

In Europe, as in the United States, higher rates are likely to affect yield-seeking investors adversely. In Europe, though, inflation may be more muted because rising currency tends to depress domestic inflation. A higher euro would also reduce pressure on the European Central Bank to raise rates faster than expected.

## Japan: Likely to continue quantitative easing

Sustained quantitative easing in Japan has kept rates low, and inflation appears tame. The Bank of Japan wants to encourage some level of inflation, which has been difficult to achieve with a strong yen. Japan's desire to offset the strength of the yen seems to suggest that it will continue its quantitative easing programme. As in Europe, small-cap companies in Japan are likely to benefit from economic growth more than the export-driven large-cap companies.

## China: Still in control

The Chinese government appears to be quite serious about dealing with excess leverage and has closed down unprofitable businesses. This tends to stall growth in a nominal sense, but it can increase long-term profitability. The Chinese yuan strengthened quite a bit until very recently, which may reflect a policy decision to reduce pressure from the United States on trade issues.

## Emerging markets: Beneficiaries of global growth

Emerging markets are likely to continue to benefit from strong global growth.

There is a tendency for the energy sector to prosper at this stage in the economic cycle. With stable energy prices, it's reasonable to expect positive growth for those emerging markets with more energy exposure.

## Political risks remain

Significant political risks are likely to continue in emerging markets, particularly in Latin America. Elections in Brazil, Mexico, and Venezuela could act as a destabilising force because some of the candidates are running on populist platforms, and doctrinaire policy could affect the economy. Tensions in the Korean Peninsula appear to be easing amid more positive dialogue. Although political risks have lessened in Europe, they are likely to heat up in the U.S. as ongoing partisan politics gather steam during the mid- term elections.

## Summary: Expect volatility against a backdrop of global growth

The dramatic market correction in February confirmed the surprises we predicted in inflation and volatility. However, we don't see a reason to be overly concerned about equities, as long as the U.S. economy keeps churning along as its current pace.

The bigger risk is for bonds. Higher wages, rising rates and accelerated growth are feeding inflationary pressures. But because inflation is slow to shift into gear, we don't expect it to accelerate until next year. Aside from inflation-protected securities, bonds are priced in nominal yield rather than real yield terms. Even if real yields don't rise—because inflation keeps pace with higher bond yields—regular bonds could suffer from rising nominal yields.

For the rest of 2018, we expect a continuation of global economic growth and corporate earnings. Clearly, it appears we are nearing the end of secular stagnation.

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