

# Investment*focus*

July 2009

## The “Renaissance” of Global Macro Investing

### Executive Summary

An important upshot of the Great Recession will likely be a “renaissance” for the traditional top-down, liquid, global macro-investing approach. Several reasons, in my view, are contributing to the increased influence of macro factors in investment decisions. The most salient ones include:

- An unprecedented amount of government stimulus globally;
- Still-high correlations among markets and asset classes;
- A potential shift in demand drivers from developed to developing countries; and
- The importance of tactical agility during periods between bull markets.

In this paper, I analyze these topics in detail, and argue that—given the large changes we are experiencing across the global economy and entire investment business world—a broad array of constituents will likely re-embrace the merits of a top-down investment framework in the foreseeable future.

I also argue that investors within the asset-allocation community will be required to enhance their analytical tools in an effort to find out which investments will actually serve as diversification instruments for large portfolios, especially during periods of market stress.



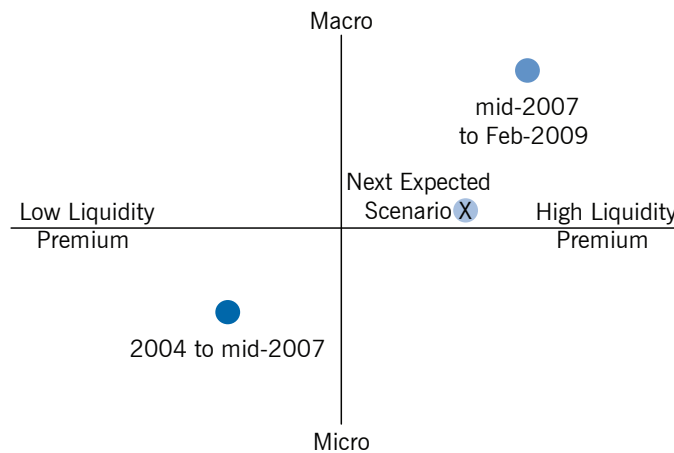
**Henry McVey**

Managing Director  
Head, Global Macro and Asset Allocation  
212 296 0404  
[henry.mcvey@morganstanley.com](mailto:henry.mcvey@morganstanley.com)

Since I rejoined Morgan Stanley in June, more than a few colleagues have asked me why I moved into global macro/asset allocation versus traditional long/short investing. My answer is simple: opportunity. Without question, I am increasingly of the view that one of the major outcomes of the Great Recession will be a sustained “renaissance” for the traditional top-down, liquid, global macro-investing approach.

Unlike the 2004-2007 period, which was dominated by a low volatility, micro, single-stock focus, the Great Recession has unleashed a plethora of new and unusual macro considerations—including heightened government intervention and non-traditional liquidity programs—that are likely to heavily influence the direction of the global capital markets for the foreseeable future (*Exhibit 1*).

### Exhibit 1: The Great Recession has heightened market awareness of macro considerations



Source: Morgan Stanley

Although there are many reasons why I see macro factors playing a more important role in influencing investment decisions, I believe that three key factors stand out: unprecedented government stimulus, still-high correlations and growing foreign demand. Additionally, it is also important to understand the importance of tactical agility in periods between bull markets. The remainder of this paper explores these topics individually in further detail.

### Unprecedented monetary and fiscal stimulus: The genie is not going back in the bottle anytime soon

We can all argue whether the government allocated resources to the right “holes” in the global economy, but it would be hard to argue that they did not do enough. As *Exhibit 2* shows, the magnitude of monetary and fiscal stimulus in the United States in the current recession—which has been characterized by high asset price volatility (*Exhibit 3*)—is of epic proportions. It essentially dwarfs every other period, including the depression of the 1930s. Consistent with intervention, many parts of the U.S. economy—financial services in particular—are migrating from a period of de-regulation to one of re-regulation.

Even if I am right that Armageddon has been averted, there is likely to be a lot of macro uncertainty surrounding the “exit plan” once the economy stabilizes. Drunk on liquidity and low interest rates, my world view is that the global capital markets may find at some point, as former Eagles band member Joe Walsh sang, that “it’s hard to leave when you can’t find the door.”

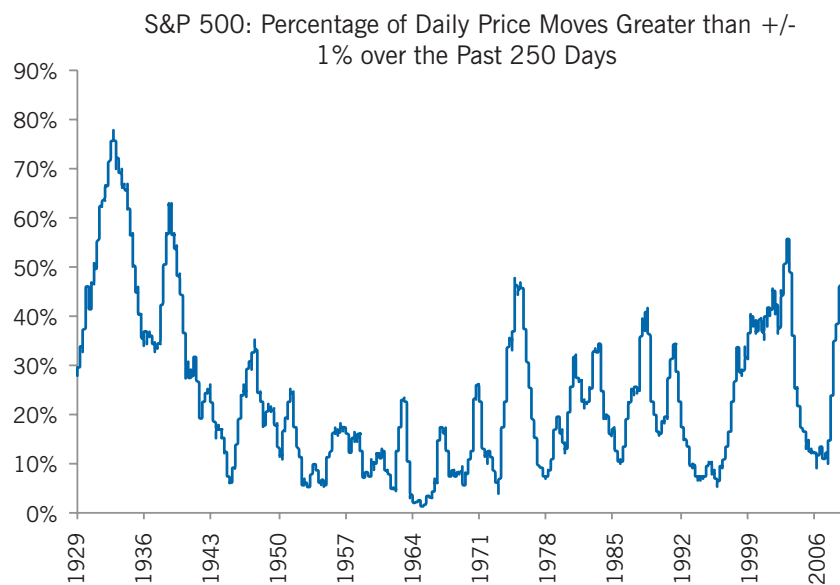
**Exhibit 2: Government has deployed unprecedented monetary and fiscal stimulus in the U.S.**

What government did—and did not—do						
Peak	Trough	Length (months)	Decline in real GDP	Stimulus as % of GDP		
				Monetary	Fiscal	Combined
Aug-29	Mar-33	43	27.0%	3.4%	4.9%	8.3%
May-37	Jun-38	13	3.4	0.0	2.2	2.2
Nov-48	Oct-49	11	1.7	-2.2	5.5	3.3
Jul-53	May-54	10	2.7	0.0	-1.4	-1.4
Aug-57	Apr-58	8	3.2	0.0	3.2	3.2
Apr-60	Feb-61	10	1.0	0.7	1.0	1.7
Dec-69	Nov-70	11	0.2	0.3	2.4	2.7
Nov-73	Mar-75	16	3.1	0.9	3.1	4.0
Jan-80	Jul-80	6	2.2	0.4	1.1	1.5
Jul-81	Nov-82	16	2.6	0.3	3.5	2.8
Jul-90	Mar-91	8	1.3	1.0	1.8	2.8
Mar-01	Nov-01	8	0.2	1.3	5.9	7.2
Dec-07	Mar-09	15	1.8	18.0*	11.9*	29.9*

\*Estimated

Source: Federal Reserve, Congressional Budget Office and Grant's Interest Rate Observer

**Exhibit 3: S&P 500 price volatility has approached a level not seen since the great depression**



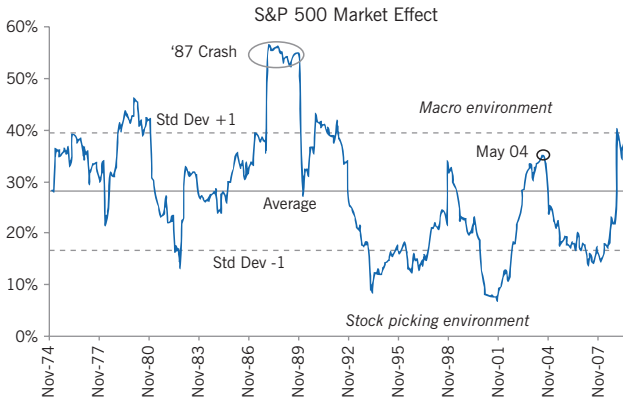
As of July 14, 2009.

Source: Bloomberg and MSIM Research

**Inter-sector correlations remain high at a time when sector dispersions have exploded**

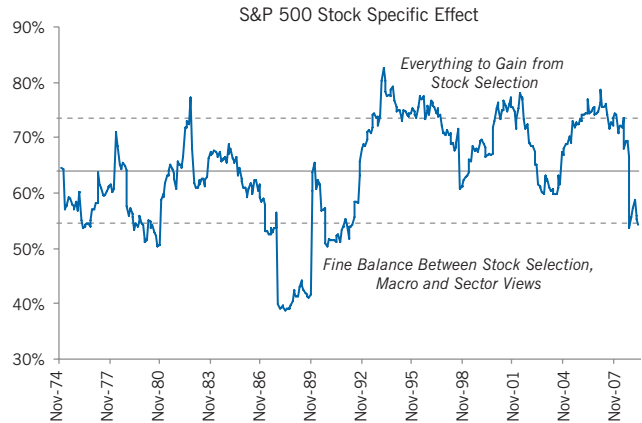
In 2006, I wrote a piece called “Market of One” (see Morgan Stanley Research article dated Oct. 26, 2006), which highlighted the risk associated with increasing correlations across asset classes. Now in the current post-bust environment, correlations are beginning to fall, but statistical work still shows that the “market effect”<sup>1</sup> is dominating in many asset classes, a trend we expect to persist. *Exhibits 4 and 5* illustrate this phenomenon.

**Exhibit 4: Current environment is still dominated by the “market effect”...**



As of June 30, 2009.  
Source: Factset and Morgan Stanley Trading

**Exhibit 5: ...suggesting a balanced approach between top-down and bottom-up disciplines**

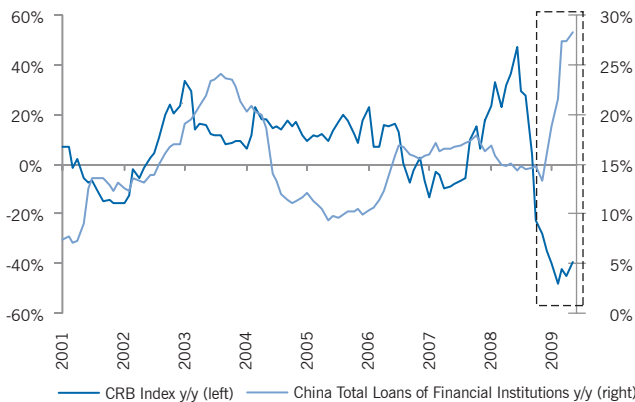


As of June 30, 2009.  
Source: Factset and Morgan Stanley Trading

**Non-U.S. growth is now a bigger swing factor**

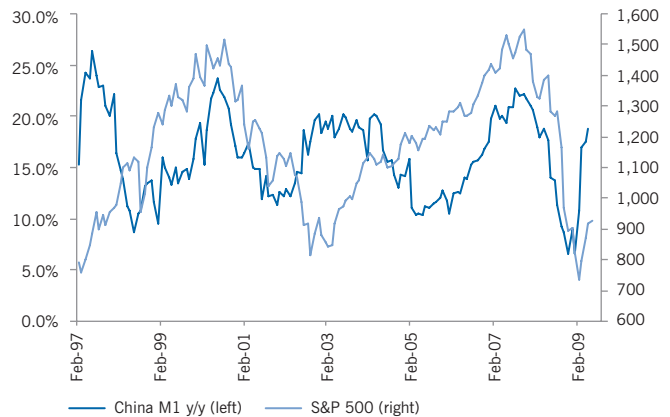
A quick review of what China’s recent lending initiatives did to commodities and commodity-related securities in first half of 2009 (*Exhibit 6 and 7*) reinforces our view that the global capital markets are on the cusp of major change in demand drivers. From our vantage point, the incremental demand from Asia and Latin America for commodity-related inputs is a secular, not cyclical, story.

**Exhibit 6: Chinese government stimulus coincided with commodity market stabilization...**



Source: The People’s Bank of China and Bloomberg

**Exhibit 7: ...and the recent U.S. equity rally**



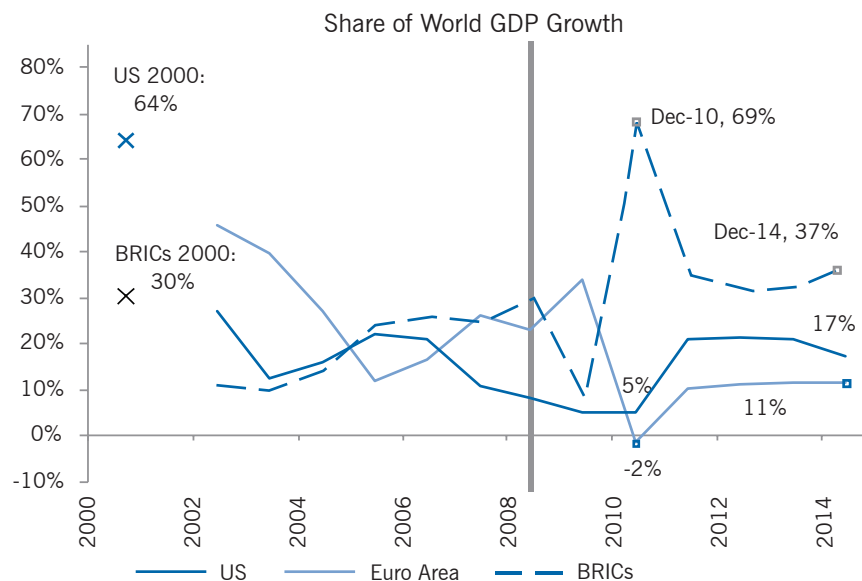
Source: The People’s Bank of China and Bloomberg

<sup>1</sup>Market effect and sector effect are estimated using a two-stage least squares approach. Idiosyncratic risk is estimated as the residual, after eliminating market effect and sector effect.

Further, even if we were to ignore recent policy events out of China, I remain convinced we are seeing a seismic shift in consumption/ demand functions from the U.S. consumer to the emerging economies. Just consider that China automotive sales could exceed U.S. sales for the first time in 2009. The China Passenger Car Association recently estimated automobile sales in China will grow to 11 million units in 2009, while recent U.S. sales trends point towards a full-year number closer to 10 million. Looking more broadly, the IMF estimates the BRIC (Brazil, Russia, India and China) contribution to world GDP growth will be close to 70% in 2010, while the United States will only contribute 5% (*Exhibit 8*).

All told, we think that domestic consumption ex-healthcare in the combined emerging markets is likely to exceed that of the United States by 2011 in absolute dollars. Probably more important, though, is that the potential for consumption to grow in these economies is significant, as it represents a small proportion of GDP versus the U.S. and other mature economies (*Exhibit 9*).

**Exhibit 8: BRICs look set to contribute most of world GDP growth in 2010 and beyond**



Source: International Monetary Fund (IMF) estimates. All forecasts are subject to change at any time and may not come to pass due to changes in market or economic conditions.

**Exhibit 9: Prepare for a seismic shift in consumption/demand dynamics from the U.S. consumer to emerging economies**

Current GDP Components			
<b>US</b>			
Consumption	Investment	Government	Net Exports
71%	14%	20%	-5%
<b>China</b>			
Consumption	Investment	Government	Net Exports
36%	41%	14%	9%

As of April 2009.

Source: U.S. Bureau of Economic Analysis (BEA) and IMF World Economic Outlook (April 2009)

## Late stage bear markets require a tactical approach

My base view on equities is that we are essentially two-thirds of the way through a secular bear market that started in 2000. Phase I of the secular bear market was driven by significant multiple contraction during the 2000-2002 period, while Phase II of the bear market, which we are now just exiting, was driven more by massive earnings contraction.

Looking ahead, I think the third and final stage (Phase III) will be remembered for its wild swings in the markets, as we fulfill the final condition of this secular bear market: longevity. As *Exhibit 10* details, periods between U.S. bull markets typically generate much sound and fury signifying nothing. In particular, they are characterized by unusually high day-to-day volatility (19% annualized, on average) but no capital gains.

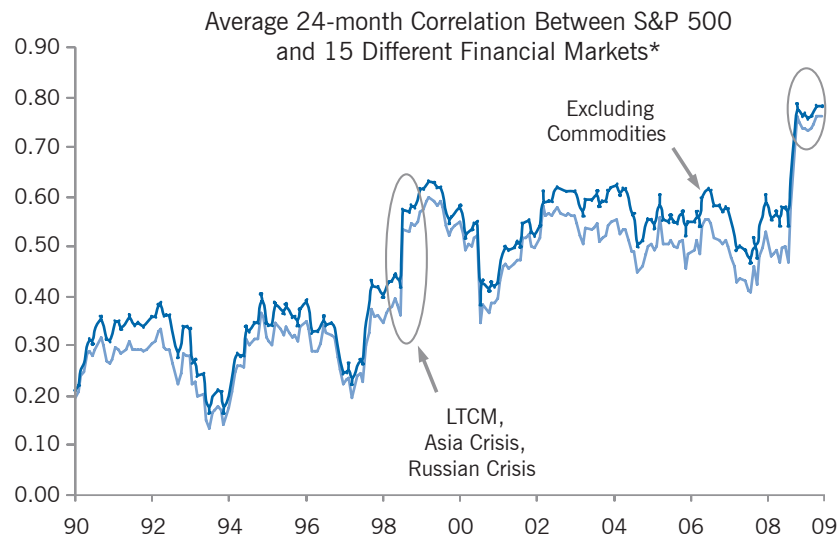
It is also worth noting that alternative assets often offer little if any refuge from a U.S. equity storm. *Exhibit 11* shows that the average correlation between the S&P 500 and other world financial markets is now nearly 80%, up from less than 50% pre-crisis. Put another way, sometimes the only real diversification element is cash. Similar correlation spikes were in evidence during the 1998 and 2000-2002 financial crises.

### Exhibit 10: Periods between bull markets are typically characterized by high volatility and low returns

Low Date	High Date	Duration (Years)	Annualized Price Return	Average Realized Volatility
06/12/1928	09/06/1929	1.2	56%	17%
03/14/1935	04/06/1936	1.1	85%	18%
04/28/1942	07/14/1943	1.2	54%	12%
11/29/1943	02/05/1946	2.2	27%	11%
06/13/1949	06/12/1950	1.0	43%	10%
07/17/1950	01/05/1953	2.5	21%	11%
09/14/1953	09/23/1955	2.0	41%	10%
10/22/1957	08/03/1959	1.8	28%	10%
10/25/1960	12/12/1961	1.1	34%	8%
10/23/1962	02/09/1966	3.3	19%	7%
11/23/1971	01/11/1973	1.1	29%	8%
09/16/1975	09/21/1976	1.0	31%	12%
08/12/1982	10/10/1983	1.2	57%	17%
07/24/1984	08/25/1987	3.1	31%	13%
12/04/1987	10/09/1989	1.8	29%	15%
10/11/1990	10/07/1997	7.0	19%	11%
03/11/2003	10/09/2007	4.6	16%	12%
AVERAGE BULL MARKET		2.2	29%	11%
ALL OTHER PERIODS		2.6	0%	19%

Bull markets defined as periods of one year or longer without a 10% or greater correction in the S&P 500. Realized volatility measured on an annualized 22-day trailing basis. Period analyzed: 1928 – June 2009.

Source: Bloomberg and MSIM

**Exhibit 11: Financial market correlations remain high**

As of June 30, 2009.

\*MSCI UK, Germany, France, Japan, Singapore, Australia, EM Asia, Latin America, EM Europe, Russell 2000, Gold Futures, Crude Oil Futures and CRB Index Futures.

Source: Morgan Stanley Trading

**Conclusion: Re-embrace the merits of a top-down approach to investment decisions**

I certainly do not mean to argue that single security analysis does not matter. It does and always will, as it remains the foundation of fundamental investing. In fact, as we are seeing in 2009, the majority of active managers has beat their benchmarks following the severe market downdraft of 2008. Instead, what I am suggesting is that—given the enormous changes we are experiencing across the global economy and entire investment business—we will see a broader array of market constituents re-embrace the merits of a top-down investment framework.

At the same time, I think investors within the asset allocation community will need to do much more analysis on what investments actually serve as diversification tools, particularly during periods of market stress.

We see plenty of room for growth. As of March 31, 2009, global macro hedge funds accounted for less than 10% of existing funds, according to Bloomberg data, and we estimate that a similar proportion of long-only mutual-fund assets are invested in global asset allocation products. Even more importantly, however, I expect top-down asset allocation will be instrumental in not only generating gains but also preserving capital for years to come.

The document has been prepared as information for investors and it is not a recommendation to buy or sell any particular security or to adopt any investment strategy. This material has been prepared using sources of information generally believed to be reliable but no representation can be made as to its accuracy. Information in this presentation does not contend to address the financial objectives, situation or specific needs of any individual investor.

The views expressed in the presentation are those of the authors as of July 2009, are subject to change based on market and economic conditions, and are not necessarily representative of the opinions and views of the firm as a whole. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. Past performance is not indicative of future results.

The information in this report, is for informational purposes only, and should in no way be considered a research report from Morgan Stanley Investment Management (“MSIM”), as MSIM does not create or produce research.

All investments involve risks, including a loss of principal. Alternative investments are speculative and involve a high degree of risk and may engage in the use of leverage, short sales and derivatives. Derivatives can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on performance. Employing leverage may result in increased volatility. These investments are designed for investors who understand and are willing to accept these risks. Performance may be volatile, and an investor could lose all or a substantial portion of his or her investment.

# Morgan Stanley Investment Management Publications

Following are recent thought-leadership papers covering a range of investment issues:

## Operational Improvement: The Key to Value Creation in Private Equity

July 2009—The global financial crisis is reshaping the private equity landscape. While lingering tight credit has increased competition for new deals, opportunities for “home runs” to offset underperforming investments are now limited. As a result, private equity firms have become even more dependent on their ability to improve operational performance in every deal to generate attractive returns. But what is the best way to enhance operations and unlock value from portfolio companies? In this paper, we examine the many approaches firms can take in deploying operational expertise.

## How the Tight Credit Market Is Augmenting the Investment Opportunity for Private Debt Capital

May 2009—The dislocation in the credit markets has set the stage for a widening gap between the supply of, and demand for, capital. What solution could potentially fill this gap? This paper suggests that a combination of traditional and non-traditional sources of debt capital should emerge in response to this imbalance. Specifically, we believe that private credit capital targeting middle-market issuers is likely to be an important focus for investors.

## Return Targets and Percentile Fans

May 2009—A portfolio's beta exposure has traditionally been a key factor influencing the prospects for reaching return targets. But how much beta does one need to increase one's chances of

exceeding the risk-free rate over a one-year period? Conversely, how much beta risk is necessary to satisfy target returns in the long run? In this paper, we address these issues, and provide a compelling framework for understanding beta exposures.

## Looking Beyond the Valley: Identifying Cross Asset-Class Opportunities

May 2009—The global economic crisis has taken a heavy toll on asset prices across the investment spectrum, including equities, credit and commodities, creating a number of distressed investment opportunities. Yet, many investors are still wondering how to best assess these opportunities, and how to rebalance their portfolios for optimal potential returns. This paper addresses these questions, and lays out a comprehensive roadmap for investors to gauge the current opportunities and place them in the proper historical context.

## Accessing Investment Opportunities in a Real Estate Recession

May 2009—We believe that the most severe economic crisis since World War II is creating the most compelling commercial real estate opportunities in a generation. In this paper, we examine the causes of the ongoing market correction, quantify the impact of the crisis to date, and compare the current real estate recession to past market downturns. Due to the unique combination of events that precipitated the current slowdown, investors could have the chance to purchase the debt and/or equity of real estate at what we view as historically attractive terms.

The views and opinions expressed within these publications are those of the authors, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

**For a copy of any of these papers, please contact your relationship manager, e-mail us at [info@morganstanley.com](mailto:info@morganstanley.com) or visit our website at [www.morganstanley.com/im](http://www.morganstanley.com/im).**

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

© 2009 Morgan Stanley

# Morgan Stanley

[www.morganstanley.com/im](http://www.morganstanley.com/im)

U09-03211-1T07/09