

# Investmentfocus

November 2009

## Inflation Outlook: On the Razor's Edge

### Executive Summary

As we begin to turn the page on the final chapter of 2009, it appears that several key investment debates have emerged on the global macro front. First and foremost is our belief that the “fat pitch” in the market is the similarity in valuation between high-growth and low-growth equities around the world. We detailed this issue last month (see “A Changing of the Guard,” October, 2009), and remain steadfast in the camp that 2010 will be the year of growth investing, as portfolio managers and asset allocators will likely win through both superior growth and upward price-to-earnings valuation.

Inflation is another area of investment debate we have been working on, especially its impact on global capital markets. This topic is the focus of this month's article. Undoubtedly, with the massive flood of central-bank liquidity flowing through the system, there is a lot of investor concern surrounding potential inflation surprises. That might as well be the case, but our analysis shows that inflation, after a cyclical bounce in the next few months, will likely remain low—potentially troublingly so—in 2010. In fact, we see uncomfortably low inflation as a much bigger risk to global equity markets in 2010 than either “traditional” inflationary pressures or the much ballyhooed double-dip earnings scenario.

Following are the key factors underpinning our thinking on inflation in 2010:

- Compliments of excess capacity, year-over-year US core inflation rates have historically fallen more than 2% in the first 36 months of an economic recovery.
- A subtler headwind we see developing is that mega-cap companies around the world are exerting renewed, and sometimes dramatic, price pressure on their smaller competitors in an effort to defend market share. Our conclusion from this “revenge of the establishment” is two-fold: First, we expect pricing increases in most industries, particularly domestic and consumer-related, to remain extremely

*(continued on next page)*



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**Executive Summary (cont'd)**

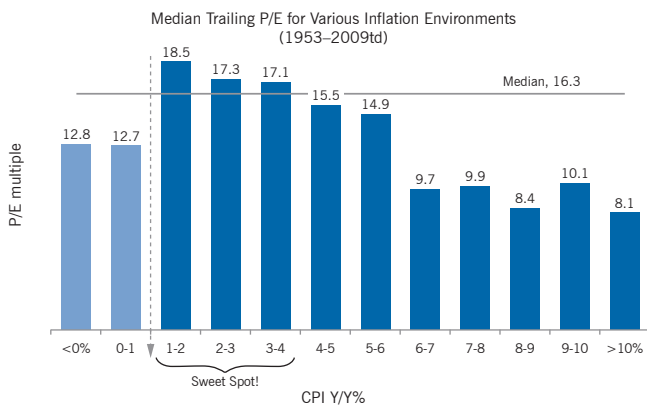
subdued, even as capacity utilization increases in 2010. Second, while larger cap, market leaders are likely to make their expected profit forecasts, we think that smaller competitors could have both their margins and earnings compromised by a heightened competitive environment.

- Deleveraging is essentially deflationary. With debt as a percentage of GDP at such high levels in the US and Europe, we are of the mindset that deleveraging is a more powerful force than the temporary liquidity injections of central banks.
- Approximately 30% of the headline US CPI index, and 40% of the core (ex-food and energy) index, is highly sensitive to the home and apartment rental market. Importantly, rents typically lag home prices by two years. With US existing home prices down 6.5% versus a year ago as of September 2009 (latest data), history suggests rental prices could remain under pressure until at least the back half of 2011.
- We expect muted income growth for the foreseeable future in developed markets. In the past, inflationary pressures were often associated with rising incomes.
- The recent growth of the US monetary base (i.e., coins, bank notes and bank reserves) does not necessarily mean that there will be anything close to commensurate growth in the broader money supply. Bank reserves have exploded, but we believe that this will not translate into significant deposit or loan growth in developed markets in 2010.

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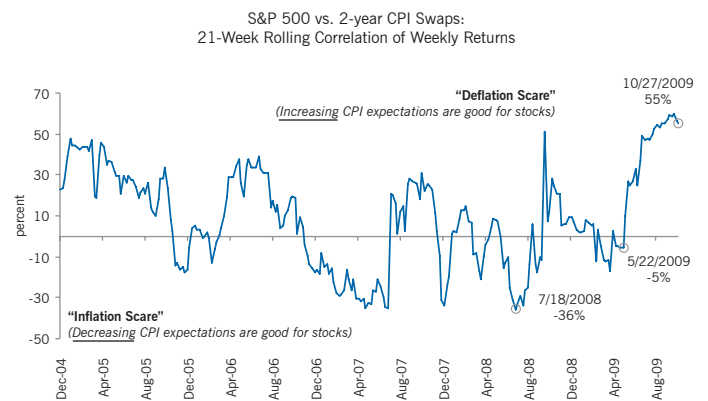
The Bloomberg consensus forecast for US headline inflation as of October 27, 2009 was 1.9% for 2010 and 2.2% for 2011, but, as we discuss below, we think that such an outlook appears to be overstating price pressures. The swaps market seems to agree with us, as it is pricing in that inflation rates two years from now will be just above 1%. While we do not act as dedicated inflation forecasters per se, we are watching this particular macro variable extremely closely because **most major stock market indices lose around 20% to 30% of their trading multiple when headline inflation falls below 1%** (*Exhibit 1*). Not surprisingly, equity markets have proven highly sensitive to any shifts in inflation expectations as of late (*Exhibit 2*).

**Exhibit 1: Equity multiples tend to fall when inflation drops below 1%**



Inflation measured by the US CPI  
 As of September 2009  
 Source: Morgan Stanley, BLS, Haver, Thomson Financial and Factset

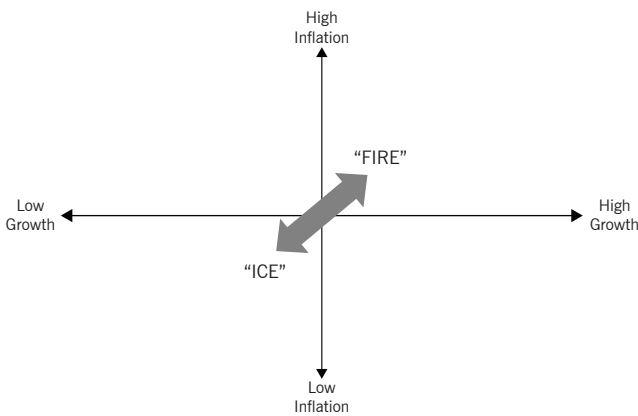
**Exhibit 2: Recent trading patterns reinforce equity market's historical preference for higher inflation expectations**



As of October 27, 2009  
 Source: Bloomberg and MSIM

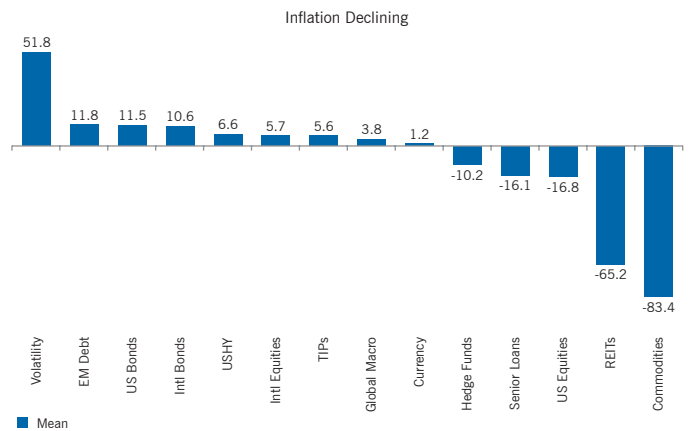
If the “razor’s edge” on inflation cuts to the downside more than we expect, and we do indeed enter what we would deem a sustained “ice” scenario (*Exhibit 3*) at some point in 2010, it might be in some investors’ interest to reconsider their tactical asset allocation strategies. Specifically, we would envision a reduction of overweight positions in risk assets—equities in particular—and a shift of fixed income exposures away from credit and towards global sovereign bonds. *Exhibit 4* illustrates how different asset classes have performed in declining inflation environments.

**Exhibit 3: Asset-class performance responds to the direction of growth and inflation**



Source: MSIM

**Exhibit 4: Riskier assets have performed poorly in declining-inflation scenarios**



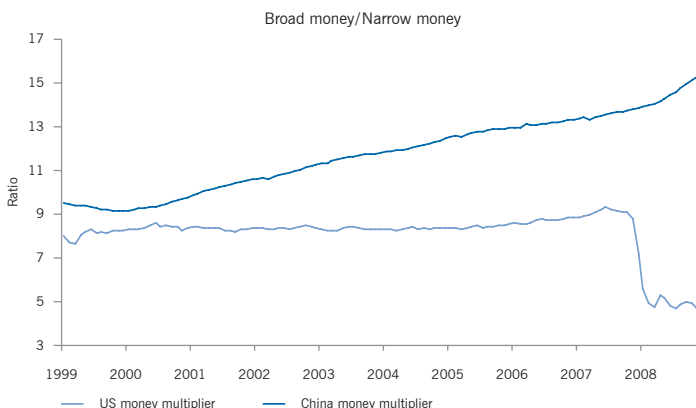
Past performance is no guarantee of future results.

Chart shows average annualized return for each asset class when inflation declines 0.5% or more month-over-month; data from January 1990 through September 2009. Inflation measured by the US CPI. See asset-class proxies in the disclosures section of this paper.

Source: Datastream, Bloomberg and FactSet.

Importantly, if we are just plain wrong on inflation, and it turns out to be an upside surprise for the global capital markets in 2010, we think it will be driven by one of two issues. On the one hand, the money multiplier could re-assert itself as consumers and corporations begin again to use credit to grow their businesses. This is certainly happening in China and other emerging markets, but we do not see it gaining momentum in the US and Europe (*Exhibit 5*). On the other hand, a dollar collapse could derail our low inflation/deflation outlook, particularly as it relates to its effect on commodities (*Exhibit 6*). Ironically, were this to occur in a disorderly fashion, global equity markets would likely face the same headwind that we envision in a deflationary environment: major multiple contraction.

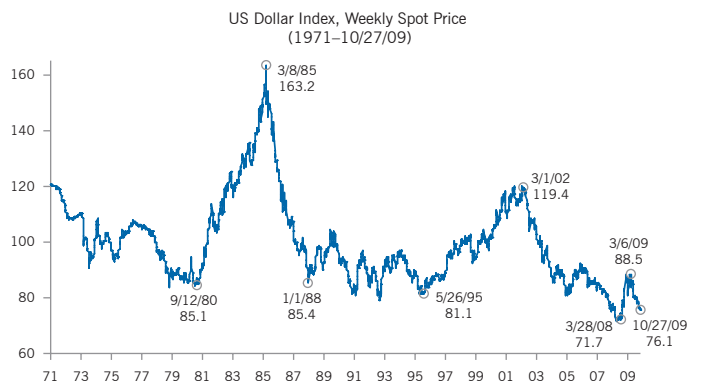
**Exhibit 5: Money multiplier, not money supply, is key to inflation**



As of September, 2009

Source: Haver, Credit Suisse and MSIM

**Exhibit 6: A US dollar collapse could derail our low-inflation/deflation outlook**



Source: InterContinental Exchange and Bloomberg

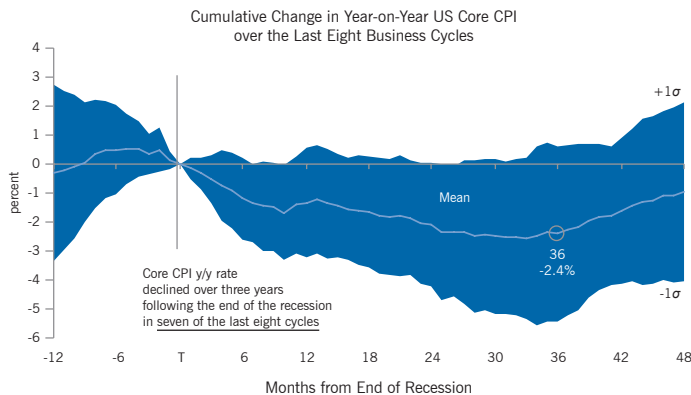
## Is Deflation the Bigger Risk?

As we mentioned previously, there seems to be a lot of chatter in the investment community about the imminent return of inflation. In theory, inflation concerns make sense as global central banks have injected trillions of dollars into the system as a result of the recent economic meltdown. However, we think near-term inflation concerns are misguided, particularly in the developed markets. Why? We detail our thoughts below.

### *Ironically, despite excess liquidity, inflation usually falls at the beginning of an economic recovery*

A bet on inflation at this point in the business cycle is essentially a bet against history. As shown in *Exhibit 7*, the year-over-year rate of core CPI inflation has declined over three years in the US following seven of the last eight recessions. Importantly, the historical pattern would not look too different even if we included food and energy costs. The reason for the pattern is intuitive: The end of recessions are also points of peak economic slack, characterized by low capacity utilization, high output gaps and entrenched unemployment, which, combined, contribute to persistently low pricing power in the opening quarters of economic recoveries.

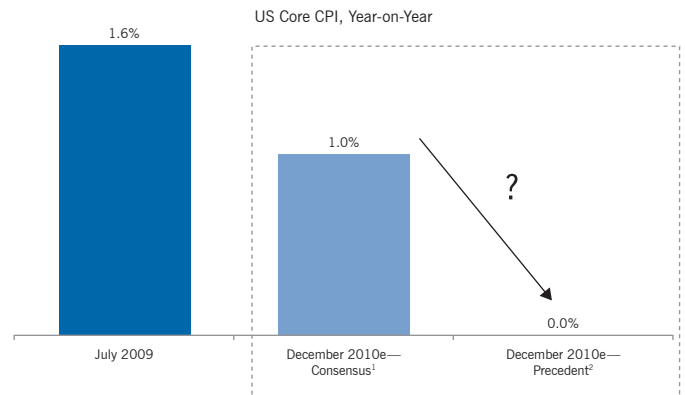
**Exhibit 7: Inflation typically collapses following the end of US recessions...**



Based on US recessions ended 5/1958, 3/1961, 12/1970, 4/1975, 8/1980, 12/1982, 4/1991 and 12/2001.

Source: NBER, Bureau of Labor Statistics, Goldman Sachs Research and MSIM

**Exhibit 8: ...But consensus estimates suggest the decline will be less severe in this cycle**



<sup>1</sup> Average of published forecasts of Morgan Stanley, Citigroup, Deutsche Bank, Barclays, UBS, Goldman Sachs and Bank of America-Merrill Lynch as of 10/27/09.

<sup>2</sup>“Precedent” calculation applies historical pattern as per *Exhibit 7*, assuming the most recent US recession ended in 3Q 2009.

Source: Bureau of Labor Statistics and MSIM

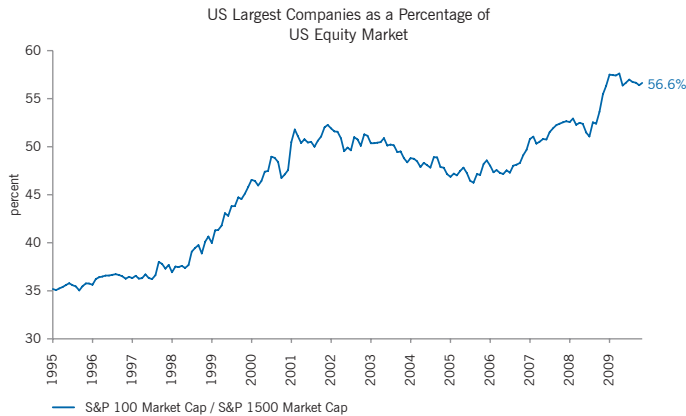
### *We see big US companies exerting more pricing pressure, a trend we expect to gain momentum*

As consumption hovers below trend, we expect mega-cap companies to leverage their heft and become disinflationary price setters (*Exhibits 9 and 10*). Already, US telecom behemoth Verizon has dented pricing in the pre-paid market, which had been dominated by upstart competitors like MetroPCS and Leap Wireless. Meanwhile, Wal-Mart is offering \$10 toys to entice Christmas shoppers (on average, about 30% cheaper than other discount retailers’ offerings, and significantly cheaper than most “mom-and-pop” toy-store prices).

Within technology, Hewlett-Packard is offering rock-bottom personal computer offerings in China to build share, while Morgan Stanley Industrials analyst Scott Davis recently conveyed to clients that, while current pricing is fine, he could envision 2011 pricing on new contracts being down 10% or more in areas such as gas turbines, wind turbines and medical equipment.

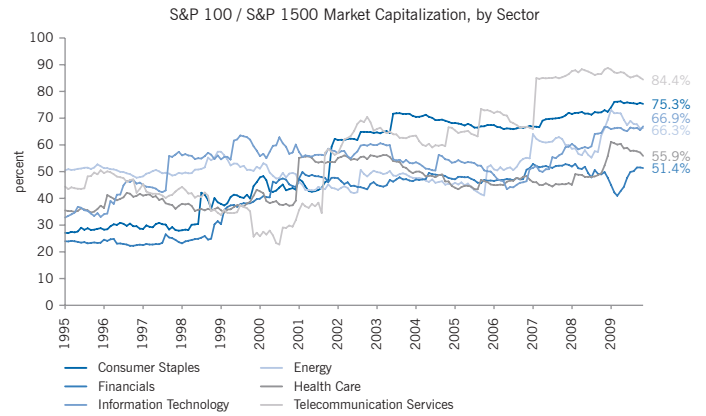
Our conclusion from this “revenge of the establishment” is two-fold: First, we expect pricing increases in most industries to remain extremely subdued, even as capacity utilization increases in 2010. Second, while larger cap, market leaders are likely to make their expected profit forecasts, we think that smaller competitors could have both their margins and earnings compromised by a heightened competitive environment.

**Exhibit 9: Large US companies dominate the broader market...**



Through October 27, 2009  
Source: S&P and Factset

**Exhibit 10: ...As the majority of sectors are moved by the biggest players**

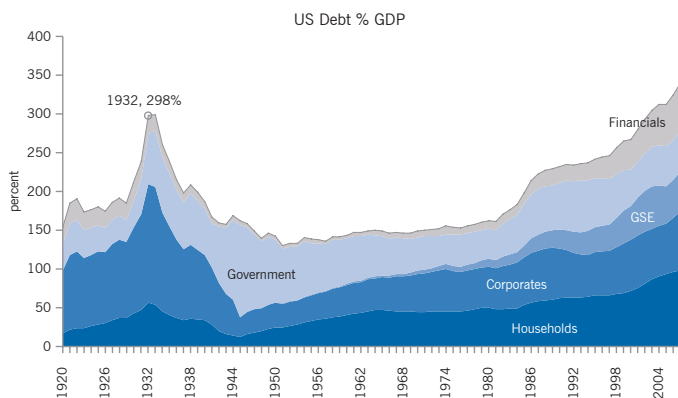


Through October 27, 2009  
Source: S&P and Factset

*Deleveraging is deflationary*

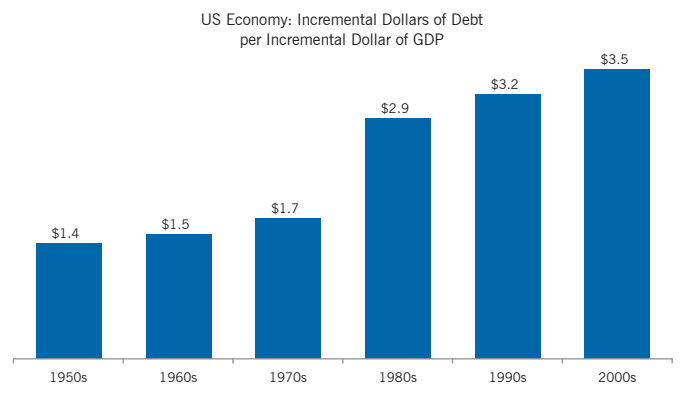
While low rates and government stimulus are inflationary in theory, deleveraging, which is the cornerstone of the Great Recession, is wildly deflationary. Importantly, during this most recent debt cycle, much of the debt has not created productive growth. As Mervyn King, Governor of the Bank of England, recently said, “Never in the field of financial endeavor has so much money been owed by so few to so many. And, one might add, so far with little real reform.” Total debt (including households, government and non-financial corporates) stood at roughly 320% of GDP in the US (*Exhibit 11*), 250% in the Euro-area, and 340% in Japan as of the end of this year’s second quarter. With those lofty numbers as backdrop, our humble opinion is that the downward pressure on prices that accompany deleveraging cycles has just begun. To be sure, we acknowledge that the significant transfer of debt from the private sector to the public sector in recent months is a net positive for corporate profitability (and, hence, the reason why George Bernard Shaw once correctly predicted that a government that robs Peter to pay Paul can always depend on the support of Paul). However, it should not obscure the fact that overall net debt levels are actually still rising. Probably more importantly, though, is that as debt levels do come down, inflation, economic growth and asset valuations will likely all be pressured. *Exhibit 12* shows the dramatic effect that incremental debt has had on stoking above-average growth in recent decades.

**Exhibit 11: The elephant in the room**



Through December 2008  
Source: Morgan Stanley Research, BEA, Federal Reserve and “The Statistical History of the United States” by Ben Wattenberg

**Exhibit 12: Now, more than ever, it takes money to make money**

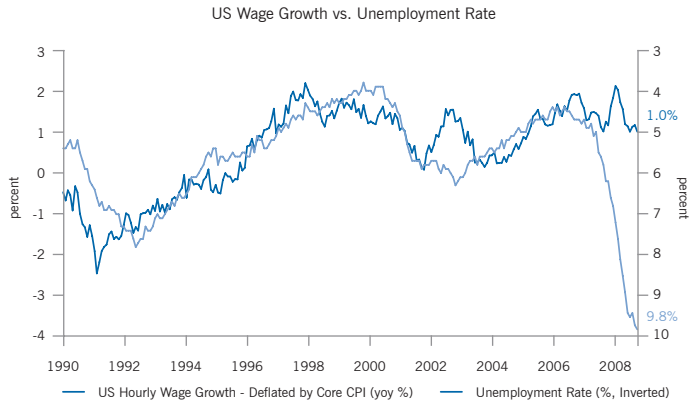


2000s = 1999-2008  
Source: Morgan Stanley Research, BEA, Federal Reserve and “The Statistical History of the United States” by Ben Wattenberg

*Labor costs to remain under pressure*

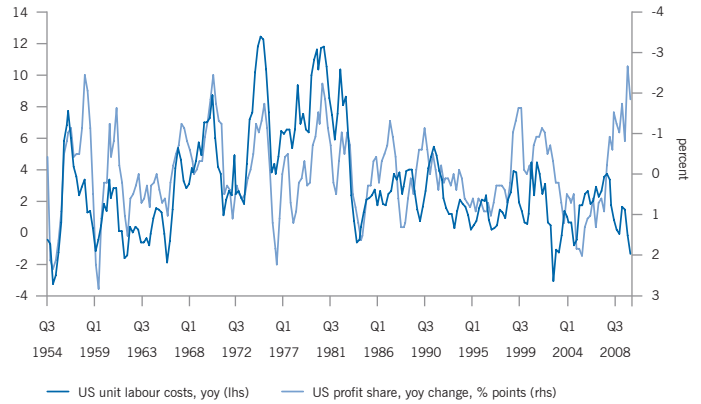
High inflation regimes are generally sparked by tight capacity in the labor market. At present, we actually see the exact opposite in the US and Europe. In fact, as *Exhibit 13* shows, wage growth could actually come under further pressure unless unemployment bounces back sharply in the next few months. In addition, a focus by US corporations to bolster profitability is keeping wage growth trends at or near historic lows (*Exhibit 14*).

**Exhibit 13: Wage growth remains benign under loose labor conditions...**



Through September 2009  
Source: Bureau of Labor Statistics, DRI and Datastream

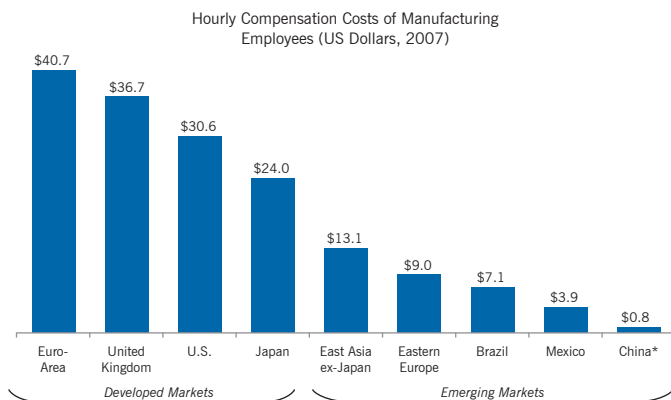
**Exhibit 14: ...As corporations continue to keep labor costs low to protect profit margins**



Through 2Q 2009  
Source: Factset and Credit Suisse

Looking ahead, international competition represents another structural headwind that is likely to limit the potential for employee wages to drive inflation higher. The pressures from globalization continue to force US firms to outsource increasingly larger portions of their production to low-cost alternatives, like India and China. Importantly, even firms that do not outsource businesses must keep expenses down to remain competitive, as developed-world manufacturing employees earn hourly wages several times higher than what many of their emerging-markets peers earn (*Exhibit 15*).

**Exhibit 15: The large gap between developed- and emerging-market labor costs persists**



\*China detail is as of 2006. All other regions shown are as of 2007.  
Source: US Department of Labor and Bureau of Labor Statistics, March 2009

**Exhibit 16: Shelter weighs heavy on the US consumer price index**

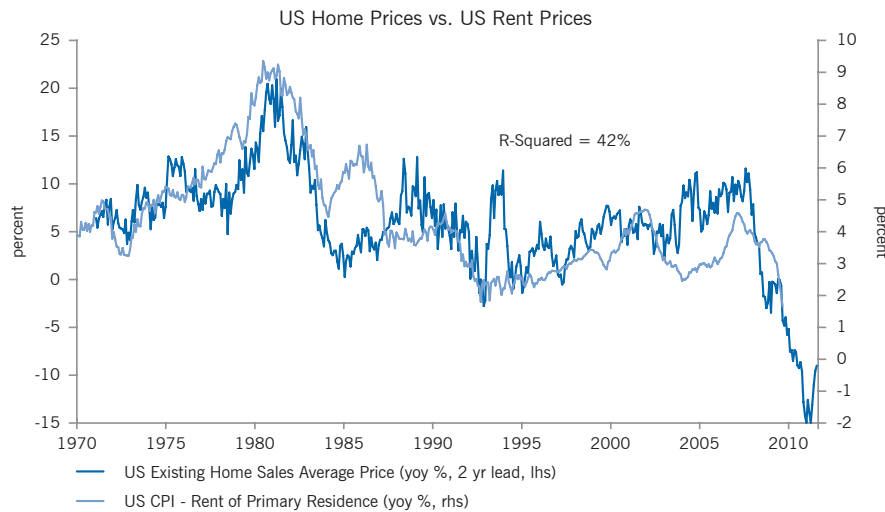
Category	% in Core CPI	% in CPI
Owner's Equivalent Rent	31.43	24.43
Rent of primary residence	7.66	5.96
Total rent-sensitive elements	39.09	30.39

As of October 2009  
Source: Haver and Bureau of Labor Statistics

*Owners' Equivalent Rent likely to remain muted*

If there is such thing as a “fog of war” in inflation analysis, it has to be shelter and its major sub-components, Owners' Equivalent Rent (OER) and Rent of Primary Residence. According to the Bureau of Labor's statistics, OER is a measure of “the amount a homeowner would pay to rent, or would earn from renting, his or her home in a competitive market.” Regardless of whether one agrees that rental prices are the most appropriate gauge of owner-occupied housing costs, it is important to pay close attention to OER, as it accounts for almost one quarter of the total and a third of the core CPI index. The costs born by actual renters (i.e., “Rent of Primary Residence”) account for another 6% to 8% of CPI weight. All in all, rental prices govern directly or indirectly fully 30% of headline CPI and 39% of core CPI (*Exhibit 16*).

**Exhibit 17: Declines in home prices foreshadow depressed rent prices over the next two years**

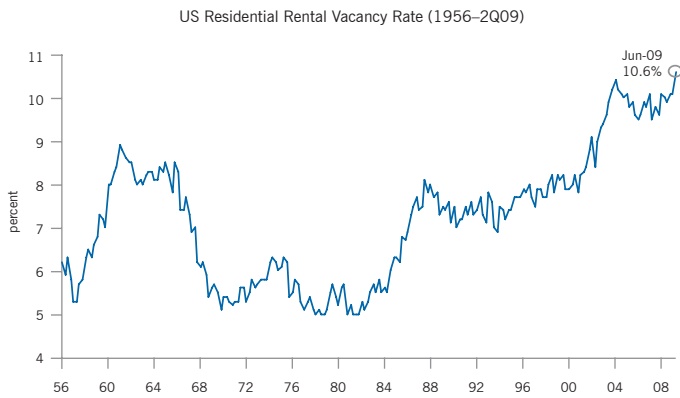


Through September 2009

Source: National Association of Realtors, Bureau of Labor Statistics and DRI

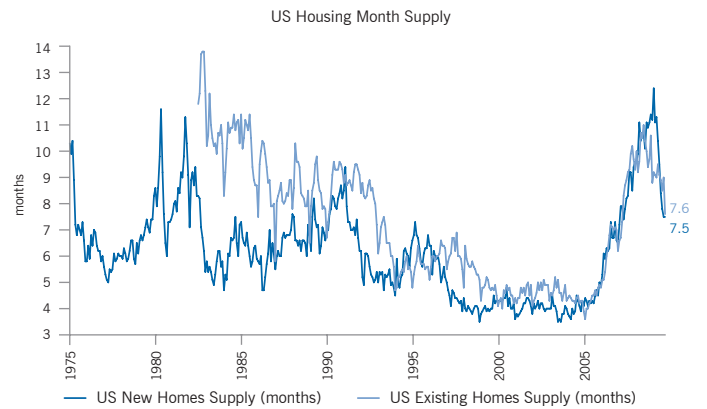
Looking ahead, we see OER flat to down 1% to 2% in 2010. Key to our thinking is that statistical analysis suggests rents lag home prices by approximately two years (*Exhibit 17*). Put in concrete terms, the rental market needs time to adjust to both the weak demand and excess supply that prevails at the tail end of housing busts. We do see such disinflationary forces in place on the demand side, as rental vacancies—which are correlated with unemployment—hovered near post-war highs as of the second quarter of 2009 (*Exhibit 18, next page*). On the supply side, meanwhile, residential for-sale inventory still hovers around seven months (*Exhibit 19, next page*). We believe a significant chunk of that excess inventory will make its way into the rental market at least temporarily, as developers and homeowners look to generate cash flow from their unsold assets. In recent months, we have seen news of condo projects “going rental” not just in former high-flying areas—like California, Florida and Las Vegas—but also in metropolitan centers like New York City and Chicago.

**Exhibit 18: Residential rental vacancy rate is at a historic peak**



Source: US Census Bureau

**Exhibit 19: Excess supply pressures homeowners and developers to consider renting out properties**



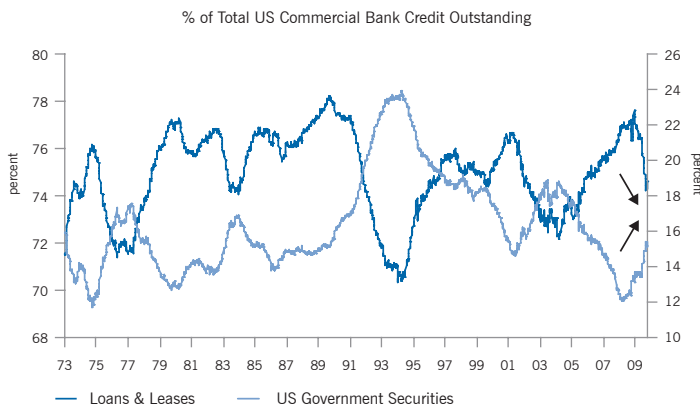
Through September 2009

Source: US Department of Commerce, Bureau of the Census and DRI

*Base money growth does not mean broad money growth in the near term*

Our thesis that deflation, not inflation, is the bigger near-term concern also rests on the premise that the expansion of the US monetary base (primarily in the form of excess bank reserves) engineered by the Federal Reserve will not lead to uncontrolled deposit growth. Key to our thinking is that such a re-assertion of the money multiplier would require that banks grow their loan books aggressively, which is something we do not see happening. Instead, as shown in *Exhibit 20*, financial institutions are using their capital to buy Treasuries and agency securities, not make loans. Bottom line: Given that corporations are running at low net debt-to-equity ratios, excess capacity utilization, and an overstock of commercial and residential real estate, we just do not see the growth of the US monetary base causing major inflationary pressure over the next 12 to 15 months. The bond market certainly seems to share our view, as the two-year forward implied inflation rate, as calculated by Bloomberg, was hovering just north of 1% as of October 30, even with oil over \$80 per barrel. It's also worth noting that even if money growth does pick up steam, it will not necessarily portend traditional unchecked inflation. As my colleague Anjun Zhou points out, there is little near-term explanatory relationship between growth in money supply and change in year-over-year inflation (*Exhibit 21*). Rather, we could envision that inflation shows up in asset appreciation in non-traditional "stores" of value.

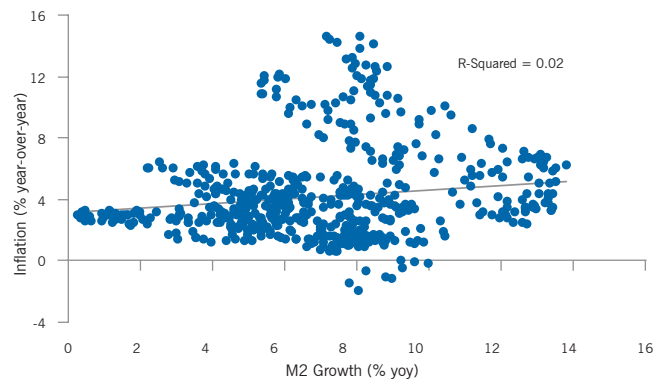
**Exhibit 20: Banks are extending more credit to the US government, not the private sector**



As of October 14, 2009

Source: Federal Reserve, Haver and MSIM

**Exhibit 21: Little relationship between M2 growth and year-over-year inflation**



Data between January 1960 and August 2009

Source: DataStream

## Conclusion

We remain firm in our conviction that the likelihood of a low-inflation/deflation scenario meaningfully exceeds the possibility of surging price pressures going forward. Our analysis suggests that a confluence of factors is likely to keep a lid on US inflationary advances in the near to medium term, including: a) continued excess capacity; b) efforts by large companies to use pricing power to gain market share; c) ongoing deleveraging, which is essentially deflationary; and d) continued downward pressure from falling housing and rent prices on the consumer price index.

Additionally, we see two other key factors keeping inflation in check in developed nations: muted income growth in the foreseeable future, and our belief that the recent expansion of the monetary base will not translate into a commensurate increase in the broader money supply, as banks have been, for the most part, using the money to lend back to governments instead of inflating private-sector credit availability.

Such a scenario, if it comes to pass, implies that high-quality growth equities are likely to remain an attractive investment option for the coming 12 months, as we continue to expect the asset class to outperform its lower-quality peers.

All this is not to say that our forecast comes without risks. For example, history shows that a steep drop in inflation—say, anything below 1%—could have detrimental effects on equity investing. Additionally, a disorderly drop in the value of the US dollar poses another threat to our forecast, especially due to the likely impact of a weaker dollar on the prices of commodities worldwide. If so, we believe it might be in some investors' interest to reconsider their tactical asset allocation strategies. Specifically, we would envision a reduction of overweight positions in risk assets—equities in particular—and a shift of fixed-income exposures away from credit and towards global sovereign bonds.

## Disclosures

The views expressed are those of the author as of October 28, 2009. The author's views are subject to change at any time due to market or economic conditions without notice to the recipients of this document. The views expressed does not reflect the opinions of all portfolio managers at MS IM, or the views of the firm as a whole, and may not be reflected in the strategies and products that the Firm offers.

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Asset-class proxies utilized in Exhibit 4 of this paper are as follows:

Asset Class	Data Used
Volatility	CBOE SPX Volatility Index
EM Debt	JPM EMBI Global
US Bonds	Barclays US Aggregate
International Bonds	JPM Global Gov't Bond ex USA
US HY	Barclays US Corporate High Yield Index
TIPs	Barclays Global Inflation-Linked Bonds - US TIPS
International Equities	MSCI World ex USA
Global Macro	HFRX Macro Index
FX	Barclays Trader Indexes Currency
Hedge Funds	HFRF Fund of Funds Composite Index
Senior Loans	S&P/LSTA Leveraged Loan Index
US Equities	S&P 500
REITs	FTSE / NAREIT Equity REITS Index
Commodities	S&P GSCI

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# Morgan Stanley Investment Management Publications

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

## Charting the Comeback Trail in Japan via Small-Cap Equities

November 2009—As world economies stay on the path to recovery, Japan remains either forgotten or avoided by most investors. Is this strategy correct? Or are investors risking being underexposed to a potentially significant period of outperformance for Japanese stocks? If so, what presents the most attractive opportunity: large or small caps? In this paper, we tackle these questions, and examine Japanese stocks in general and small caps in particular.

## Recovery Myths

October 2009—As the US economy continues to show signs of improvement, many investors have begun to wonder about the sustainability and strength of the recovery. In this research report, Richard Berner tackles this issue, and identifies what he believes are three myths currently fueling this economic debate.

## A Changing of the Guard

October 2009—The global equity market recovery has so far been defined by a strong rally in high-beta stocks. But history suggests that these “junk rallies” have typically lasted, on average, about six months from the markets’ trough. In this paper, Henry H. McVey argues that we are now on the cusp of a major shift in global equity market leadership.

## Investing in a Horizontal World

October 2009—Correlations among world economies and asset classes have increased dramatically as of late. But is this situation sustainable in the long run? In this article, Ruchir Sharma argues that the case for differentiation based on local factors is strong and getting stronger.

## The New Landscape for Fixed Income: From Treasuries to TALF

October 2009—As the global credit crisis shows signs of easing, institutional investors confront a crucial issue: How to exploit the new investment landscape to generate the higher potential returns of equities, while striving to maintain the lower volatility often associated with fixed income? In this white paper, we address this question, and propose a framework through which investors can set up opportunistic fixed-income portfolios.

## Financials: Less Bang for Your Beta

September 2009—The Great Recession has undoubtedly taken a heavy toll on financials. But now that the downturn has begun to show signs of abating, how can investors best explore potential opportunities within the sector? In this paper, Henry McVey tackles this key issue, and shares his outlook for financials.

## Convertible Bonds: Back in the Spotlight

August 2009—While optimism appears to have returned to global capital markets, uncertainty surrounding the timing of the economic recovery has led some investors to remain sidelined until a sustainable recovery process becomes more clearly defined. But how do you determine optimal market entry points? In this paper, we investigate convertible bonds as a potential solution to the current market-timing dilemma.

## US Corporate Profitability—Support on the Margin

August 2009—Although US corporate earnings have dropped steeply since the start of the Great Recession, net margins for non-financial firms have been surprisingly resilient compared to previous downturns. What does that mean to equity trading levels? Does this represent a tactical opportunity? Henry McVey provides answers in this article.

## Challenges to Rebalancing the US Economy

July 2009—The global financial crisis has exposed the vulnerability of unbalanced US and global growth. The ensuing recession, however, is now helping to rebalance the US economy. The question now is: Will this rebalancing process be benign for economies and markets, or will it be disruptive? In this paper, we tackle this difficult question by examining the challenges ahead for the US economy.

## The “Renaissance” of Global Macro Investing

July 2009—In his inaugural article since returning to Morgan Stanley, Henry McVey, MSIM’s Head of Global Macro and Asset Allocation, highlights his current views on the direction of financial markets, and argues that a key upshot of the Great Recession will be an augmented role for the traditional top-down, macro-investing approach.

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