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

**Ruchir Sharma**
Managing Director
Head, Emerging Markets Equity
212 296 0555
ruchir.sharma@morganstanley.com

## Executive Summary

The global economic crisis has taken a heavy toll on asset prices across the investment spectrum, including equities, credit and commodities. High levels of volatility have created a number of distressed investment opportunities, yet left many investors wondering how to rebalance their portfolios for optimal potential returns. As investors assess these opportunities, we believe they should focus on analyzing historic trends rather than responding to the sharp daily swings of the financial markets.

In this paper, we argue that, from a historical perspective, the case for stocks over bonds looks compelling today, with long-term expected returns favoring equities even with conservative assumptions. Specifically within equities, we believe emerging markets offer one of the best opportunities.

In our view, the roadmap for the US today resembles the one seen in Japan in the 1990s, but, contrary to popular perception, that does not mean an unabated dip in stock prices and the economy. Japanese stocks participated in some significant rallies during that decade, including three jumps of around 50%, all of which coincided with a temporary economic upturn. These recoveries—which are often described as cyclical bull markets within a structural downtrend—were triggered by government spending packages or export-led growth when the global economy was strong.

Similar conditions exist in the US today, with the effects of the official stimulus expected to be the strongest in the third and the fourth quarters of 2009. Growth in China too is showing strong signs of reviving. From this perspective, the recent market upswing is likely more substantive than a short-lived bear market rally. If that is the case, the S&P 500 could, in our view, rise to 1,000 sometime later this year. The rally could begin to fade by the end of 2009, once the impact of the stimulus begins to wear off.

That said, we expect emerging markets to continue to grow relatively faster than their developed counterparts, thus offering, in our view, a compelling combination of stronger growth prospects with attractive valuations.

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## Lessons from History

This paper reviews the historical performance of three major asset classes—equities, government bonds and commodities—dating back to the 1800s in an effort to a) compare the current opportunity set across asset classes; and b) assess cross-class valuations to help investors rebalance their portfolios.

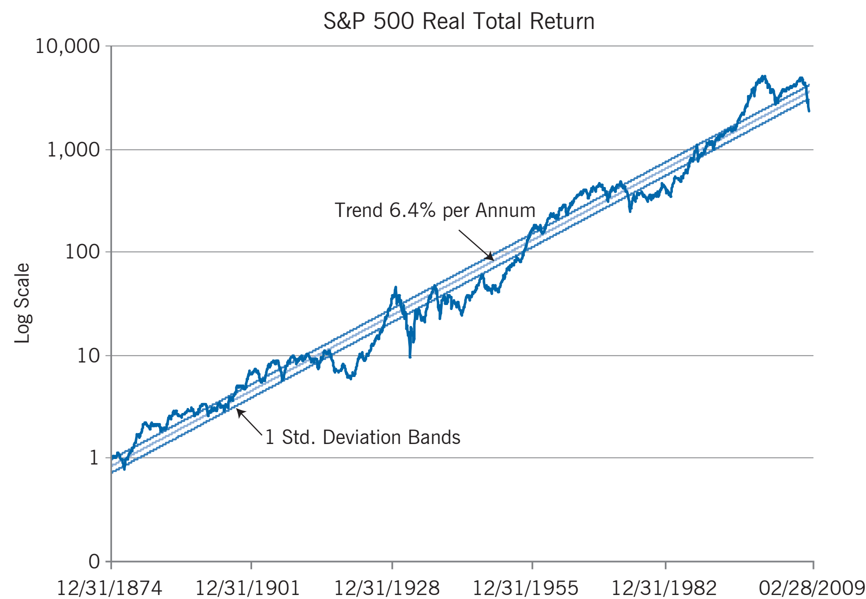
Our research shows that investment returns have followed a unique pattern over time: equities provided the strongest real returns in the long run; bonds provided relatively flattish real returns; and commodities, when adjusted for inflation, declined, despite temporary bouts of outperformance.

With that in mind, we compared historic and current levels of trend real returns across asset classes. We also looked at valuations in the various assets classes—including US and emerging market equities—to stress test these current levels against those of past secular bear market lows in an effort to unveil potentially attractive opportunities.

As illustrated in *Display 1*, the trend line for equities—represented here by the S&P 500 Index—shows a real annual return of 6.4% in the period between 1874 and early 2009. Over the past 150 years, there have been seven secular bear markets: 1867, 1921, 1932, 1938, 1942, 1974 and 1982. In most cases—except for the Great Depression (1932)—the market fell to around two standard deviations (SD) below trend.

Today, an equivalent two-standard deviation drop below trend implies an S&P 500 Index at approximately 600. Interestingly, the steep slide in the US equity market earlier this year pushed the market near that level, with the index hitting a year low of 676 points on March 9. The market has since rebounded, to trade around the 900-point level in early May.

### Display 1: Stocks Show Clear Upside-Return Pattern in the Long Run




Past performance is no guarantee of future results.

S&P 500 data used from 1925 to the end of February 2009. Stock performance prior to 1925 is based on price and inflation data as measured by the New York Stock Exchange (NYSE) and provided by Global Financial Data.

Source: Global Financial Data, Global Insight, MSIM GTAA Research, MSIM Emerging Market Research

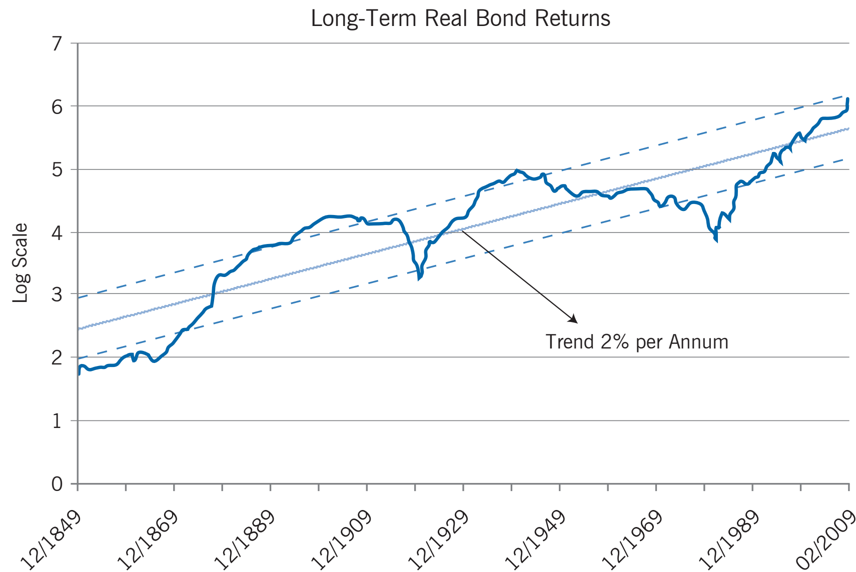
Further, normalized valuations for the S&P 500 on a return on equity (ROE) adjusted P/E basis show that stock prices in early March were trading at levels not seen since the early 1980s.

We also looked at historical and current valuations for emerging markets. Although long-term data availability is more limited for this specific asset class, we found that, on a normalized basis, emerging market equities were trading close to levels seen during the 1998 Asian crisis on a ROE adjusted P/E basis in early March.

It is important to note, however, that these numbers vary across regions. Valuations in Asia and in EMEA (Europe, Middle East and Africa) were at their historic lows (11.2 times and 7.3 times, respectively) at the end of March 2009.[1] Due to the commodity boom in recent years, Latin American stocks valuations were trading roughly at their historical average (13.5 times) in that same month.

Turning to fixed income, *Display 2* shows that, on average, Treasury bonds have delivered a 2% trend real annual return over time. Long-term real return of stocks relative to bonds are currently three standard deviations below trend. Additionally, for the first time in more than 50 years, the dividend yield of the US stock market at 3.25% (as measured by the S&P 500 Index) is higher than the 10-year Treasury yield, which stood at 3.12% as of April 30, 2009.

**Display 2: When Viewed from a Long-Term Perspective, Bonds Provided Relatively Flattish Returns**




Past performance is no guarantee of future results.

Data series reflects the real returns of 10-year Treasury bonds for the period between 1962 and the end of February 2009. Prior to 1962, the data reflect a consolidated time series that includes a mix of returns from five-, 10- and 20-year Treasury bonds.

Source: CSFB

Separately, we investigated the historical returns for commodities, using raw industrial prices as a proxy. *Display 3* shows that, when adjusted for inflation, commodity prices have declined over time, despite some interim rallies. BCA research shows that, in real terms, industrial prices are currently 75% below their 1800 levels. In our view, this long-term decline in prices is due to technological progress, new discoveries and limited value addition in commodity production.

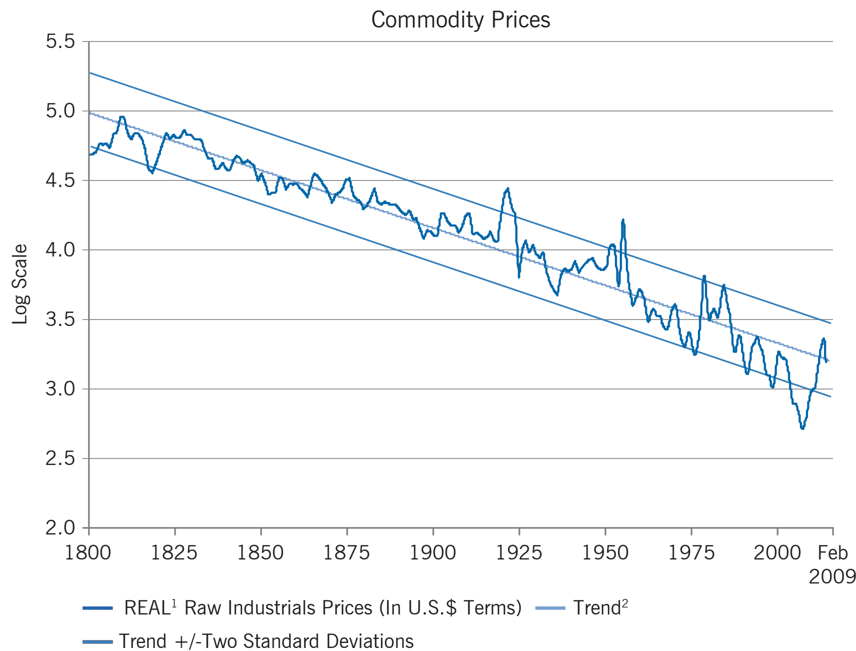
Although prices have fallen from peak levels, many commodities still trade well above their cost of production, suggesting that prices need to drop further before producers seriously consider closing plants. Further, inventories for most commodities have risen to five- or, in some cases, 10-year highs, even though spot rates remain well above prices seen a decade ago. This implies that prices will have to adjust as the excess inventories need to be cleared out.

Despite concerns about "peak oil," history shows that the major oil bear markets have been driven by demand rather than supply issues. Additionally, we have witnessed in the past that when demand eventually picks up, there is usually some new alternative (nuclear energy, natural gas, green technologies) eager to participate in the recovery and absorb some of the slack. In fact, the real price of oil today is at the same level as it was in 1976, and, prior to that, when oil was first put to mass use in the US in the 1870s.

Finally, commodities as an asset class are "late cyclicals" that have traditionally performed well either during the mature stages of a boom—when the global economy overheats and demand briefly exceeds supply—or during periods of high inflation.

[1] Based on FactSet-MSCI Indices data.

**Display 3: When Adjusted for Inflation, Commodity Prices Show Declining Pattern over Time**




[1]Adjusted by US GDP deflator.

[2]Time Trend from 1800 to 2008.

Historic commodity prices measured by the REAL Raw Industrial Prices data series.

Source: BCA Research

## Outlook and Conclusion

Our research suggests that the case for stocks over bonds looks compelling.

We see parallels with Japan in the 1990s and the US today. Japan saw several cyclical bull stock market rallies in its debt-deleveraging cycle in the 1990s, which coincided with temporary economic upturns. These recoveries were triggered by government spending packages or export-led growth when the global economy was strong.

Similar conditions exist today, with the effects of the stimulus expected to be the strongest in the third and the fourth quarters of this year. If that is the case, the S&P 500 could, in our view, rise to 1,000 sometime later this year. This rally could begin to fade by end 2009, once the impact of the stimulus begins to wear off.

Within equities, we favor emerging markets (EM). We believe that EM growth should remain above developed nations, averaging at pre-2002 levels of 3.5% and 4%.[2] Emerging countries that are importers of commodities will benefit from lower commodity prices and thrive in this environment. Falling commodity prices will also help reduce inflationary pressures and facilitate monetary easing, leading to higher domestic consumption in EM. The EM consumer is still underleveraged compared to the developed market consumer. Long consumer and short commodity is our favored trade in the EM world today.

Also, shown in *Display 4*, our long-term return assumptions suggests emerging markets could yield an annualized 11.9% potential return over the next 10 years. Comparatively, US, European and Japanese stocks are expected to return 8.1%, 9.4% and 8.3%, respectively, in the same timeframe.

Moreover, we expect emerging markets to continue to grow relatively faster than their developed counterparts, thus offering, in our view, a compelling combination of stronger growth prospects with attractive valuations. We believe that long-term investors would likely benefit from increasing their exposure to emerging markets at current levels.

[2]Data reflects average GDP data for 149 developing countries, as provided by the International Monetary Fund (IMF).

### Display 4: Long-Term Expected Returns Favor Emerging Markets

Breakdown of 10-Year Returns

| | US | Europe | Japan | EM |
|---|---|---|---|---|
| Earnings (Real) | 1.9% | (0.2)% | 1.5% | 3.0% |
| Inflation | 2.6 | 2.1 | 0.7 | 6.0 |
| **Earnings (Nominal)** | **4.5** | **1.9** | **2.3** | **9.0** |
| Change in P/E | 0.6 | 4.1 | 2.6 | 2.6 |
| Dividends | 2.9 | 3.8 | 2.3 | 2.7 |
| **Total Return (Local)** | **8.1** | **10.1** | **7.4** | **14.3** |
| Hedge | – | (0.6) | 0.9 | – |
| FX Appreciation | – | – | – | (2.4) |
| **Total Return** | **8.1** | **9.4** | **8.3** | **11.9** |

Source: Global Financial Data, Global Insight, MSIM GTAA Research, MSIM EM Research. Analysis based on long-term data ending 2008.

Long-term expected returns are based on discounted future cash flow models, with the input data ranging from economic growth, inflation expectations, to asset class specific information of the respective regions, such as earnings growth, dividend payout ratio, bond yields, default rates, etc. The US is represented by the S&P 500 and Europe, Japan and Emerging Markets are represented by their respective MSCI index. Additional information is available upon request.

All forward expectations are based on a proprietary methodology developed by the MSIM GTAA Research team. Forward looking estimates may involve known and unknown risks, uncertainties and other factors that may cause the actual results to be materially different from any future results expressed or implied by such forward looking estimates. As a result, no assurance can be given as to the future results implied herein, and neither the firm nor any other person assumes responsibility for the accuracy and completeness of such estimates.

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Assumption that real GDP growth equals earnings growth.
Historically Europe has traded at 12% discount to developed markets.
Historically GEM have traded at a 25% discount to developed markets.
REER appreciation of 1% (Balassa Samuelson) and depreciation of -3.4% due to inflation differentials assumed for GEM.

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1 2 3 4 5 6 7

(Not helpful) (Extremely helpful)

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

### 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.

### Minimum Target and Maximum Shortfall Risks

April 2009—One often hears that an investor needs to move toward a riskier stance in order to satisfy its return objectives. But exactly how much risk must that investor accept to have a good chance of reaching even a modest target return? In this paper, we find that target returns and shortfall risks can have very different probabilities of fulfillment. We also suggest that investors might be surprised by the beta level they must accept to have a reasonable probability of achieving a specific return goal.

### Planning for a More Sustainable Fiscal Future

April 2009—David Walker has long been an authoritative voice of reason in any discussion about US budgetary and economic policy issues. Adapted from the former US Comptroller General's keynote address at the recent Morgan Stanley Institutional Investor Conference, this paper outlines Mr. Walker's view that the US has strayed from many of the tenets of the country's founding fathers. In response, he proposes a "Grand Bargain" that embraces federal budget controls; Social Security, health care and tax reform; and an aggressive government-private sector collaboration to drive the effort.

### Finding Opportunities in Senior Loans Amid Increased Volatility

March 2009— The continuing market volatility represents a challenge to investors—but it has opened up substantial opportunities as well. One such opportunity, in our view, is the senior loan market. In this paper, we provide an update of our report from last fall that reflects MSIM's latest thinking amid rapidly evolving events. For example, while defaults have been rising, given the current pricing of loans in the secondary market, we believe that investors are being offered a significant cushion. Placing into context other fundamentals such as corporate leverage and issuer performance, this paper suggests that senior loans represent a compelling story for investors.

### Portfolio Liquidity and Fund-Level Betas

February 2009—Recent market turbulence has brought the importance of portfolio liquidity to the top of the agenda of many institutional investors. This paper analyzes and addresses this issue, providing a framework for how investors should approach a portfolio's liquidity needs. The paper shows that a fund's liquidity requirement will generally depend upon a number of complex factors, including the specific composition of assets, endogenous and exogenous commitments over various time horizons, the strength and resilience of the sponsor, and—perhaps most critically—the level of net inflows or outflows.

### Navigating the Recession: Identifying Tactical Opportunities amid the Slowdown

February 2009—In the wake of recent asset price declines, investors are seeking options for rebalancing their allocations and deploying capital in the coming months. This paper provides a macro-economic view of the markets through the eyes of three senior portfolio managers. It also looks at some of the underlying fundamentals from both a current and historical perspective, and drills down on select themes that investors should consider over an intermediate-term time horizon.

### The Infrastructure Opportunity: Repair, Build and Stimulate

February 2009—As the world grapples with a severe economic slowdown, government spending on infrastructure appears on the rise, creating opportunities. Our analysis suggests that a total $41 trillion will be needed by 2030 to build and repair infrastructure globally, a level of spending that, in our view, creates an attractive secular case for investing in infrastructure.

### Portfolio Choices for Oil Based Sovereign Wealth Funds

January 2009—Financial management of resources generated by oil sales has gained momentum recently in light of the growing endowment of oil-rich countries' sovereign wealth funds (SWF). This paper outlines a framework investors can use to address some of these issues, proposing that the optimal asset allocation for a SWF should take into consideration both speculative and hedging demand

### Portfolio Liquidity

January 2009—The deterioration in asset values during 2008 unveiled a host of new liquidity problems for many diversified portfolios. Portfolio managers need cash-like assets to fulfill immediate funding requirements, yet they must also maintain low concentrations of illiquid assets in their portfolios, sustain returns, and preserve beta sensitivity. In this paper, we set forth a basic framework for addressing the highly complex liquidity problem.

### Global Recovery Post Bubble

January 2009—While the worst of the global downturn may run its course by late 2009, the risk is that any rebound in 2010 will be anemic and fragile. In this article, Stephen Roach, Chairman of Morgan Stanley Asia, shares his views on the striking asymmetry of economic forces leading up to a global rebalancing.

### An Opportunistic Approach to Hedge Fund Investing In the New Market Landscape

January 2009—In this paper, we examine some of the primary causes of the industry's recent underperformance for hedge fund managers. We also look at a likely consequence of the growing pressure on managers—a consolidation that will put a premium on large, diversified hedge fund providers with institutional-quality operations. Within this context, we identify several market dislocations and distressed pricing opportunities that we believe hedge funds are well positioned to exploit.

### Private Equity Outlook: Evaluating Opportunities and Allocations amid the Credit Crunch

January 2009—While private equity is not impervious to the volatility inherent in the economic and business cycles, we anticipate that compelling investment opportunities will continue to surface. Our research shows that these opportunities will be characterized by attractive valuations and conservative leverage, and entail the acquisition of businesses that can be enhanced through operational/strategic changes and operate in niche markets. In the current environment, we believe that the middle market is more likely to offer prospects of this nature than the mega leveraged-buyout arena.

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