Morgan Stanley

INVESTMENT MANAGEMENT

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Markets jitter, but economy on track

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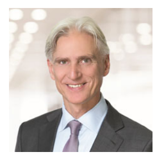

ANDREW HARMSTONE

Managing Director,
Lead Global Portfolio Manager,
Global Balanced Risk Control Team

MANFRED HUI

Managing Director,
Co-Lead Global Portfolio Manager, Global Balanced Risk Control Team

Cyclical recovery continues: Global equities continued their move up for most of February and after a volatile final week, they closed the month positive at 2.4% (MSCI ACWI in USD terms[1]), despite markets' nervousness over the prospect of inflation and rate rises. Both the US and Europe had the same narrative, ending the month up (S&P 500 2.8%[1], Euro STOXX 50 4.6%[1]). The VIX came down from the late January spike, caused by the short squeeze generated by Reddit investors and others, to hover around the low 20s throughout February. However, by month-end the VIX spiked back up to 28[2] in the wake of the volatility of the final days.

Economic recovery still on track

Strong retail sales data and PPI in the US beat consensus expectations, reinforcing the ongoing recovery story. Retail sales increased 5.3%[3] MoM compared to an expected 1.1%, reflecting increased spending after the December stimulus. US PPI had its largest increase since 2009, rising 1.3%[4] MoM in January, reflective of some supply side pressure. In the longer term, rising input prices could represent a risk though for corporate earnings. We are positive with regard to growth, given encouraging vaccine news. The US was particularly

1. Bloomberg, 28 February 2021.
2. Refinitiv Datastream, 26 February 2021.
3. The U.S. Census Bureau announced advanced monthly sales estimates of U.S. retail and food services sales for January 2021. Released 17 February 2021. www.census.gov/retail. MoM stands for month-on-month.
4. U.S. Bureau of Labor Statistics. Producer Price Index News Release Summary. Released 17 February 2021. www.bls.gov/news.release

positive due to faster vaccine rollouts and less severe lockdowns compared with the EU, which also faced some supply challenges. In addition, the weak employment data in the US reinforces the need for stimulus and easier monetary policies. With further potential stimulus in March, more household spending is likely and would be further supportive. That said, such stimulus implies a downside risk for bonds.

Markets jittery as anticipated risks materialise

Whilst we have confidence in the economy, it is important to distinguish this from the jittery market, which is expensive and has been exhibiting exuberance. In January, retail investors appeared to drive valuations up, however institutional investors may also now have already bought and cannot be relied upon to support the market. In particular, the risks surrounding interest rate rises are materialising, which was the main contributor to end of February volatility in equities and fixed income markets. Whilst the Federal Reserve tried to calm markets by indicating they are in no rush to hike rates, they also believe the economy will strengthen, which suggests the contrary – unless they allow the economy to run hot for a while. If indeed the economy does improve faster than expected, bond yields are likely to go up – bad for bonds, but also possibly unnerving equity investors.

The supply and demand for bonds may also be an issue. The US Treasury is issuing substantial amounts of debt, with the Fed being the main incremental buyer, artificially suppressing interest rates. Whilst the Fed is currently accommodative, growth expectations are high and could lead the Fed to consider reducing buying. In fact, in order to restrain a rise in bond yields, the Fed may need to step up buying of newly issued government debt, as private sector demand for the debt might fall when economic growth strengthens.

Investment implications

We increased our allocation to equities twice during February from a neutral allocation. This was on the basis of a continuing positive growth outlook, with the prospect of further stimulus from the US, central banks remaining accommodative, positive earnings trends and lower market volatility. While in the month we raised our equity allocation, the rising risks associated with potentially rising bond yields in the face of strong economic growth have led to a risk budget driven reduction in equities right at month-end. We maintain a bias to cyclicals over growth stocks, as we continue to have confidence in the recovery and rotation trade.

Gold

We moved from positive to neutral gold on the basis that fiscal stimulus, a decline in COVID-19 cases and likely acceleration in economic recovery bode well for pro-cyclical trades, with likely more downside to “safe haven” assets. US real yields, which have a negative correlation to gold, have risen sharply over the past month, removing a key pillar of support for the asset. Also, gold’s correlation with equities and fixed income are at historical highs, so benefits from diversification have likely diminished.

LatAm Equities

With respect to LatAm equities we also moved from positive to neutral given our anticipated rerating scenario has played out. LatAm growth momentum has also slowed in 2021 owing to a slow vaccine roll-out, a re-escalation in COVID-19 cases, and ongoing inflationary pressure in Brazil, which has pushed forward expectations of rate hikes. Government intervention in the state-run oil group signals the risk of further populist driven policies, likely making investors more cautious. With respect to valuations, the discount that was present when we moved positive has been eroded.

Tactical positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Small Cap				■	
Eurozone			■		
Germany				■	
UK				■	
Japan			■		
Asia ex Japan				■	
China A-Shares			■		
Emerging Markets			■		
LatAm			■		
Global Infrastructure			■		
Global Property			■		
Global Clean Energy				■	
Global Financials				■	
Global Conventional Energy				■	

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit			■		
US High Yield			■		
European High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries		■			
US Inflation			■		
German Bunds		■			
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Gold			■		
Industrial Metals			■		

Source: MSIM GBaR team, as of 8 March 2021. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor.

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Euro STOXX 50 Index: Provides a blue-chip representation of supersector leaders in the Eurozone.

MSCI All-Country World ex USA Index (MSCI ACWI): A free-float-adjusted market-capitalization index that is designed to measure equity market performance in developed and emerging markets, excluding the United States.

Producer Price Index (PPI): is an inflationary indicator used to evaluate wholesale price levels in the economy.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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