Morgan Stanley

INVESTMENT MANAGEMENT

2021 Market Outlook

Now It Gets Tougher

Though we expect 2021 to be an overall good year for equities, we should anticipate a tougher road ahead, with a lot more volatility. Hear more from Andrew Slimmon, Head of our Applied Equity Advisors Team.

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SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM

In my opinion, equity returns post-covid are going to be tougher to generate than while we remain in the midst of this horrible pandemic. Strange I know, but equity returns do not necessarily line up with the current state of the economy.

However, before we go into detail about why 2021 will be a more challenging year, let's quickly review the past year. In my opinion, there were three very powerful investment lessons from 2020:

1. History ***does*** tend to repeat itself in the stock market. The path the market has followed during the pandemic has not been very different than in other pandemics.
2. The ***'disconnect'*** between the stock market and the economy did ***not*** exist in the past either. The stock market is a forward indicator. The economy and investor emotions are coincidental/lagging.
3. Don't fight the Fed. Liquidity injections drive asset prices.

As I am fond of saying, I firmly believe complexity creates readership and viewership, but more often than not, investing is more straightforward. "Simplicity, while rarely intellectually satisfying, is hard to beat in this business."[1]

Keeping these important lessons in mind, let's now turn to what we see as we begin our much-anticipated new year.

1. AS A BACKDROP, 2020 WAS A CLASSIC FIRST YEAR COMING OUT OF A RECESSION. EERILY SIMILAR TO 2009.

- There was way too much bearishness on the part of investors.
- Too much cash sat on the sidelines as the market recovered and moved upward following the drop in March.
- There was a lack of volatility once the market began to rally.
- Bears capitulated as the market ascended.

2. WE EXPECT 2021 TO BE SIMILAR TO 2010 FOR THE MARKET: THE SECOND YEAR OF A NEW BULL MARKET.

- Following the historically strong year in 2009, the market[2] returned a good year overall in 2010.
- But perhaps the market first needs to take a breather after the 65% return from the March low. As it did in 2010.
- Unfortunately, the market rarely, if ever, simply pauses. I think we should brace ourselves for ***a lot more volatility*** in 2021, just as happened in 2010.
- Increased volatility will shake out the reluctant bulls at the exact wrong time! We have seen this movie before—hold tight! As I said, the second year of a new bull market tends to be quite good overall…just more gut wrenching.

3. 2010'S VOLATILITY WAS CAUSED BY A GROWTH SCARE. IN CONTRAST, 2021 COULD BE CAUSED BY A GROWTH BOOM:

- Overwhelmingly, sell side forecasts believe that US 10-year Treasury yields will finish the year at less than 1.5%. Perhaps we should expect a bigger than expected move higher in bond yields if we get a post-pandemic spending surge.
- The result could force the Fed to be less dovish.
- As rates move up, high equity valuations become harder to justify.
- Consider:
  - Since 1976, the average forward P/E ratio for the S&P 500 has been 14x…putting the current multiple of 23x in the 98th percentile vs. history. Over those 44 years, US equities have never sustained a multiple this high outside of the tech bubble.[3]
  - Since 1976, the gap between the S&P earnings yield and the yield on US 10-year notes has averaged 240 bps…as compared to 340 bps currently…putting today's earnings yield spread in just the 30th percentile vs. history. Said another way, stocks relative to Treasuries are still on the cheaper end of history.[3]
  - Hence, if current valuations are predicated on low rates, returns become more challenging if rates begin to surprise on the upside.

4. THERE IS A SUBSET OF GROWTH STOCKS THAT ARE AS HIGHLY PRICED AS AT THE TOP OF THE TECH BUBBLE IN 2000.

- When looking at the 100 fastest growing companies in the US, valuation levels are not at their most extreme, and in fact came down as a group late in 2020. However, when looking at the 50 fastest growers, valuation levels are as stretched as they were in 2000.[4]
- As they did in 2000, could higher rates and/or a less dovish Fed cause the tech bubble to deflate? Is it time to back away from these fastest growers that have experienced a frenzy of buying of late?

5. VALUE STOCKS, HOWEVER, REPRESENT A COMPELLING OPPORTUNITY.

- Historically, the best time to own value stocks has been when the economy is exiting a recession.
- As a group, value stocks began their recovery in 2020, yet they are still over 2.5 standard deviations cheap relative to their history.[5] We believe there is still plenty of money to be made!
- For us, the best opportunity to capture the recovery is in financials and consumer discretionary stocks.

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[1] Strategas. December 2020.

[2] The S&P 500 Index represents the "market".

[3] Goldman Sachs, December 3, 2020. 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

[4] Factset. High growth as defined by the valuation differential in terms of standard deviation between the highest growth decile of the Russell 1000 based on low beta, high growth, high volatility, and high momentum versus that of the market median.

[5] Source: Bloomberg, Factset. 1990 through 2020. Value spread as defined by the valuation differential between the cheapest decile of the Russell 1000 versus that of the market average. Valuation is based upon price-to-book, price-to-earnings, and price-to-free cash in terms of standard deviation.

6. US DOLLAR DEPRECIATION IS A POSITIVE FOR EMERGING MARKETS AND ESPECIALLY ASIA.

- In our opinion, we should focus more on the direction of currencies and less on politics. As shown in *Display 1*, when the US Dollar appreciates, Asia ex-Japan equity markets have tended to move down, but with US Dollar depreciation, Asia ex-Japan equities have tended to move up, as has been the case recently.[6]
- Currently, we prefer Asia ex-Japan markets more than Europe or Japan.
- But they won't be immune to volatility.

My conclusion for 2021? We believe it will be an overall good year for equities, but BUCKLE UP!!! That would be consistent with the second year of a bull market.

Call it simplistic, but you know what I think about simplicity.

DISPLAY 1

Focus more on the direction of currencies / less on politics

(IN USD)	ASIA EX-JAPAN CURRENCIES	ASIA EX-JAPAN EQUITIES
September 1, 2014 to January 12, 2016	-7.27%	-24.29%
December 23, 2016 to March 27, 2018	+11.67%	+43.65%
March 27, 2018 to October 18, 2018	-6.04%	-18.17%
March 23, 2020 to December 30, 2020	+10.31%	+67.91%

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[6] Bloomberg. Asia ex-Japan Currencies as defined by MSASJCXO - MSCI AC Asia ex Japan Currency USD Index. Asia ex-Japan Equities as defined by MXASJ - MSCI AC Asia ex Japan Index.

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