Morgan Stanley

INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

U.S. Industrials Poised to Outperform

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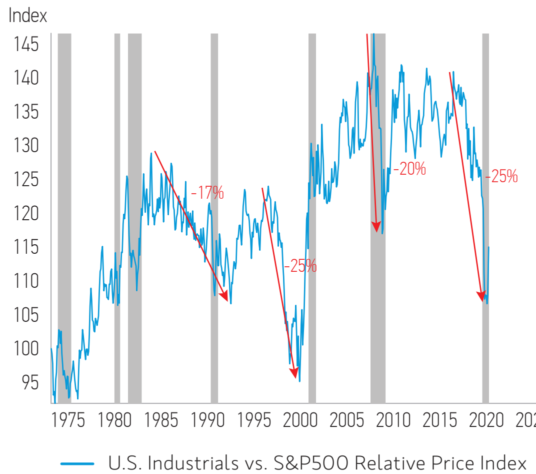
Many long-running economic and market trends (such as low inflation and slow growth, or bull markets in bonds and tech) appear extended in terms of duration, overvaluation and heavy positioning. It is likely that a new market regime, whose winners will be different, is afoot. The industrials sector is likely to be one of the winners. After a period of nearly 10 years of underperformance, we believe industrials are undervalued and stand to benefit from a strong industrial recovery in the near term, normalization of the virus-disrupted travel sector, a shift in fiscal spending towards infrastructure, and increased investment spending associated with the continued moderation in offshoring manufacturing capacity. We are overweight the industrials sector in our client portfolios and review the case for this investment below.

The recent collapse in the industrials sector (-25% underperformance vs. the U.S. equity market over the past three years and -10% this year) has been large even by the standards of a recessionary environment *(Display 1)*.[1] Industrials have underperformed on average by -11% in a typical recession over the past 50 years. This year the virus hit the travel sector (including aerospace and airlines), which underperformed particularly strongly, whereas the broader U.S. equity market has been lifted by the tech sector which actually benefited from COVID-19. As a result of this virus-aggravated recession, the recent bout of underperformance is on par with the worst on record (-25% from 1994-2000). Historically, as a recession ended, the industrials sector started to outperform and usually beat the market by +8% in each of the following one and two years.

A cyclical growth recovery is already underway, as signaled by numerous activity indicators and surveys. Given the atypical nature of this recession and the potential for lasting structural shifts, the natural question is how such

Display 1: **U.S. Industrials Underperformance vs. U.S. Equities on Par With Worst on Record**



Source: MSCI, Factset, Bloomberg. Data as of September 18, 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.**
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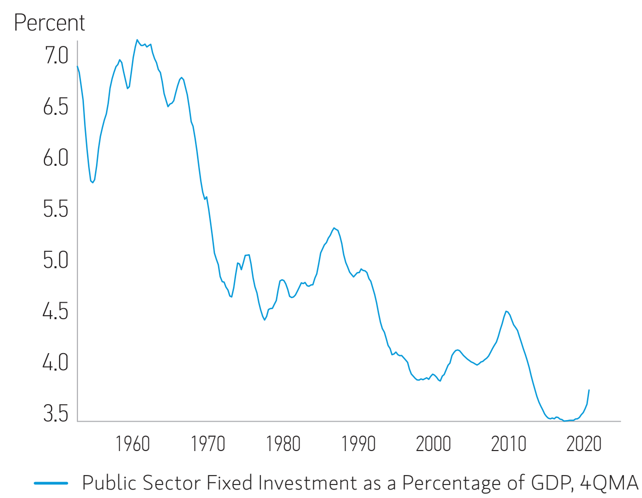
shifts could affect the industrials sector. The aerospace and airlines companies represent nearly 20% of the sector's market capitalization and have been particularly hard hit by restrictions on travel. A normalization not only of domestic air travel, which is already occurring in many large economies, but also of international flights, would be required for the sector's earnings to normalize. As we mentioned in our last monthly letter, such a scenario is likely on a 12-month horizon as a combination of effective immunity in some countries and availability of a vaccine is likely to bring the virus under control. However, the industrials sector's recovery does not depend solely on the recovery of aerospace. Many of its other sub-groups have turned out to be net beneficiaries of the nascent recovery. While spending on services was curtailed due to social distancing, despite largely resilient incomes cushioned by generous fiscal transfer payments, spending on the goods sector of the economy boomed. In July, nominal consumer spending on goods was 6% higher than the end of 2019 level, while spending on services was less than 1% higher. This is the opposite of what has tended to happen in prior recessions, during which services spending typically remains more resilient. The housing sector, which drives numerous related goods consumption items, has boomed, fueled by lower rates and urban flight. New home sales are running at a pace of nearly 800,000 units (annualized), a new cycle high.[2] Anecdotal evidence abounds of low goods inventories, especially in the automotive and housing industries. Industrial production, a reliable indicator of the industrials sector's earnings, has made only a partial recovery, retracing 50% of the decline since December 2019. With buoyant goods demand and low inventories, we expect a pronounced cyclical industrial recovery to continue to unfold.

A similar dynamic appears to be playing out in the commodities sector, where severe production cuts (whether because of the virus, prior low prices, or supply management agreements) have led to low inventories (e.g. copper and other metals) and balanced or deficit markets (oil, iron ore, copper). Given the underinvestment in many commodity segments over the past five to six years, especially in metals and mining, we expect investment activity to rebound, benefiting the mining industry supply chain within the industrials sector.

Business-cycle moves aside, since the 1970s, the industrials sector has had longer periods of out- and underperformance.[3] These cycles have tended to last between 8 and 14 years, or 11 on average. Two upcycles (1975-86 and 2000-08) lasted 10 and 8 years, respectively, and resulted in +43% average outperformance relative to the S&P 500 Index. Each was then followed by two downcycles (1986-2000 and 2008-20), which lasted 8 and 12 years, respectively, and resulted in similar underperformance of -25% each time (assuming we are right that industrials will begin to outperform this year). In addition to an attractive near-term cyclical outlook, we expect the sector's outperformance to last beyond the near term cyclical recovery, as several secular drivers are likely to become lasting tailwinds.

We anticipate the industrials sector will be a major beneficiary of two potentially significant secular trends: fiscal spending on infrastructure and reshoring. Social and political attitudes toward fiscal spending appear to have undergone a radical transformation in recent years. In the current environment of low inflation, low bond yields and stable currencies, policymakers in many major economies, and in the U.S. most clearly, appear to have come to view fiscal spending as a major policy tool both during downturns to cushion the economy and during expansions in order to achieve social and political goals. In contrast to the past expansion, which saw fiscal consolidations in the U.S. and in Europe dampen growth for a number of years, we expect continued fiscal stimulus during the coming expansion. However, as the economy and the labor market recover, we believe the emphasis of fiscal spending will shift from income support and assistance for businesses to investment. From 6.5% of GDP in the early 1960s, public sector investment in the U.S. fell to 3.3% of GDP in 2018, the lowest share in history *(Display 2)*. The average age of U.S. infrastructure continues to reach new records. For example, public streets and highways are on average 29 years old, compared to 17 years in the 1950's and 1960's. Hypothetically, a $1 trillion fiscal infrastructure spending program over five years would lift total fixed investment by 27%. Assuming the infrastructure-exposed machinery manufacturers within industrials captures ~11% of this spending, this would represent an average 1-2% revenue uplift and 3-5% earnings uplift. The precise focus of any future fiscal stimulus is difficult to ascertain at this stage as plans tend to be vague. However, whether it is focused on green energy or traditional infrastructure, the industrials sector overall would be a prime beneficiary (though the impact on its subgroups such as for instance electrical equipment versus construction machinery may vary).

Display 2: **Public Sector Investment in the U.S. To Rise from Historical Low**



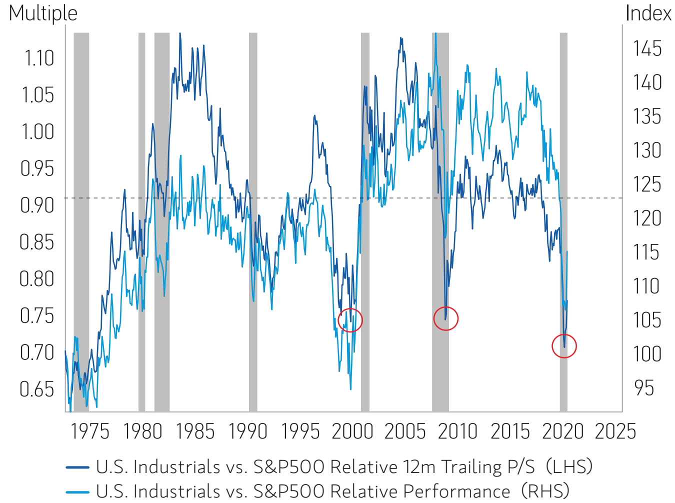
Source: Haver, FRB, BEA. Data as of September 18, 2020.

Just like public infrastructure, domestic equipment investment has also been in a relative decline over the past few decades. Excluding technology, it peaked at near 6.5% of GDP in 1979 and has fallen to around 4.5% of GDP over the past decade. The prospect of reshoring of manufacturing supply chains appears more real than ever, as concerns about security of supply remain following disruptions during the early stages of the pandemic and as a result of unresolved trade tensions between the U.S. and China. There is a high chance that tax and regulatory incentives to accelerate reshoring will be implemented over the coming years. At present, many surveys of corporate decision-makers suggest greater willingness and planning around repatriation or relocation of production to bring it closer to the target market (as the case may be for foreign exporters to the U.S.). For example, in a recent survey of senior U.S. corporate executives, 77% of U.S. companies indicated that they have already repatriated, are in the process of repatriating, or are planning to repatriate some of their manufacturing capacity, with the U.S. being the top destination.[4] We estimate that approximately $2.5 trillion of production capacity repatriated would result in close to $1 trillion additional investment over five years, with the automation and construction segments of the industrials sector poised to benefit the most.

Current valuation of the sector is cheap: the sector is valued at 0.75x relative to the S&P 500 Index on price-to-trailing 12 month sales, a nearly 25% discount to the historical average relative discount *(Display 3)*.[5] This stable measure has been highly useful during prior recessionary downturns, when earnings and cashflow-based valuation measures are less reliable. After reaching this level of undervaluation on three occasions during the past 30 years, the sector has historically staged a +15% rally over the following 12 months.[6] The collapse in earnings during this downturn has been larger than in most prior downturns but was comparable to the earnings downturn in 2008.[7] However, relative to the broader U.S. equity market, the earnings collapse was the largest in history, over 20% worse than for the broader market. With the sector trading on par with the market on forward price to earnings (as compared to a small premium historically), a full earnings recovery would leave industrials undervalued by close to 25%. For a sector whose volatility (relative to the broader market) is just 8%, a full closure of the undervaluation would result in a very attractive potential return profile.

Perhaps not all of the fundamental developments we envision will play out as expected. But what makes the industrials sector attractive at this point is the number of things that are likely to go right: a manufacturing-driven cyclical recovery, air travel normalization as the virus abates, and structural acceleration in public and private investment in the U.S. In addition, we believe the sector's discounted valuation provides a large cushion in case earnings recovery and growth expectations turn out to be less pronounced than expected.

Display 3: **Current Relative Valuations at a 25% Discount to the Historical Average**



Source: MSCI, Factset, Bloomberg. Data as of September 18, 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.**

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FOOTNOTES

[1] MSIM Global Multi-Asset Team Analysis; Factset; S&P 500 Industrials Index vs. S&P 500 Index.
[2] MSIM Global Multi-Asset team estimates; using a 3-month moving average.
[3] MSIM Global Multi-Asset team estimates; using a 6-month moving average.
[4] MSIM Global Multi-Asset team; UBS Research.
[5] MSIM Global Multi-Asset Team Analysis; Factset; S&P 500 Industrials Index vs. S&P 500 Index.
[6] MSIM Global Multi-Asset Team Analysis; data from 1990 to 2020.
[7] MSIM Global Multi-Asset team estimates; using 12 month forward earnings.

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The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

The **Russell 1000®** Value Index is an index that measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The **S&P 500 Total** Return Index is an index that consists of 500 stocks chosen for market size, liquidity and industry group representation. The S&P Index is a market value weighted index with each stock's weight proportionate to its market value. The S&P Index is one of the most widely used benchmarks of U.S. equity performance. The performance of the S&P Index does not account for any management fees, incentive compensation, commissions or other expenses that would be incurred pursuing such strategy. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend.

The **S&P GSCI®** is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities.

The **Sharpe ratio** was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Volatility is a measure of the price fluctuations of an asset or portfolio.

The **S&P U.S. Treasury** Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year U.S. Treasury note or bond.

The **MSCI USA Energy** Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Energy sector as per the Global Industry Classification Standard (GICS®).

The MSCI **USA Materials** Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Materials sector as per the Global Industry Classification Standard (GICS®). The S&P GSCI Gold Index, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future.

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