Morgan Stanley

INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Will the Bond Bear Kill the Equity Bull?

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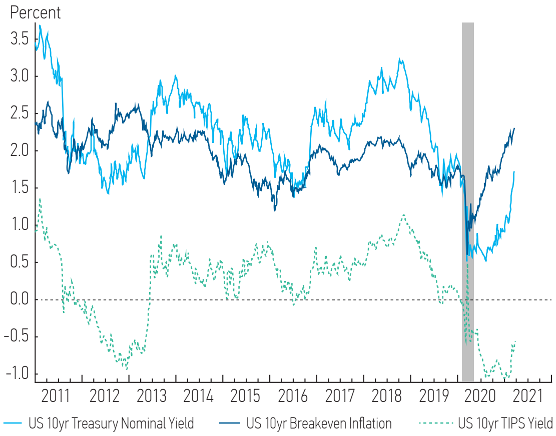
2021 already looks very different from 2020. U.S. GDP is on track for 8% growth in the first quarter with consumer spending powered by enormous fiscal stimulus (and more coming), free money from the Federal Reserve (Fed), and the beginning of economic re-opening. Even corporates are getting in on the action, with capital spending indicators very positive in recent months. With a greater number of vaccines approved, produced, distributed, and into people's arms, the reopening of the economy is likely to proceed further, helping to bring back most of the 10 million jobs lost to the pandemic. Pent-up demand will likely drive even more consumer spending. As it usually does in a recovery, the bond market began to sell off, with 10-year Treasury yields rising more than 100 basis points above the spring 2020 lows of 0.51%, initially driven by inflation breakevens but more recently also by real yields (See *Display 1*).[1] This bond sell-off caused stocks, which started the year at a decent pace, to wobble (See *Display 2*). Global equities have corrected only -5% from the mid-February peak, but the key question in markets has quickly turned to: will the bond bear kill the equity bull?[2]

Display 1: **Economic Recovery Driving Bond Yields Up From Pandemic Lows**
Nominal U.S. 10-Year Yield vs. U.S. 10-Year Breakeven and U.S. 10-Year TIPS Yield



Source: MSIM Global Multi-Asset Team Analysis and Estimates, Datastream. Data as of March 10, 2020.
Forecasts / estimates are based on current conditions, subject to change, and may not necessarily come to pass.

In this letter, we identify and evaluate the key factors needed to answer this question. As usual, market prices reflect a multitude of fundamental and technical drivers, many of which operate at cross purposes. We see some very supportive factors continuing for the stock market but also some threats, particularly as the second half approaches. We analyze each in turn here:

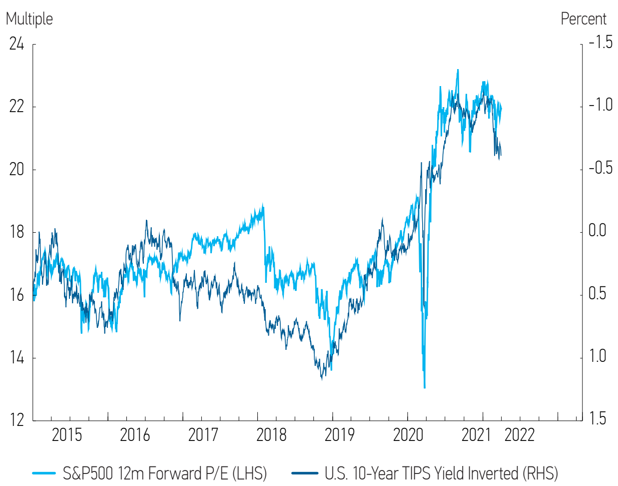
Threats to the equity bull market:

- One of the most worrisome threats to global equities is the excessive speculation visible in many parts of the market, including in the very high level of enthusiasm

[1] MSIM Global Multi-Asset Team; Bloomberg; as of March 8, 2021.
[2] MSIM Global Multi-Asset Team; Bloomberg; MSCI ACWI in USD, as of March 5, 2021.

for stocks amongst retail investors. Speculative fever is evident in $160 billion of initial public offerings (IPOs) in 2020 (twice the 1999 total), nearly more SPAC issuance in the first two months of 2021 than in all of 2020 (itself a record by a mile),[3] very high trading volumes by retail investors in short-dated call options and penny stocks, near record levels of M&A activity (indicating high levels of enthusiasm by corporates and CEOs), and net equity exposure of U.S., European, and Asian hedge funds at 11-year-highs. Not to mention localized bubbles in electric vehicles, hydrogen plays, and crypto currencies. Historically, this level of speculative enthusiasm has only been present around major market tops, but "around" can often mean months, quarters, or even years—recalling Alan Greenspan's Irrational Exuberance speech of December 1996, more than three years before the eventual top in the market in March 2000.[4]

Display 2: **Higher Interest Rates Pressuring Equity Multiples**
U.S. Equities 12M FWD P/E vs. U.S. 10-Year TIPS Yield



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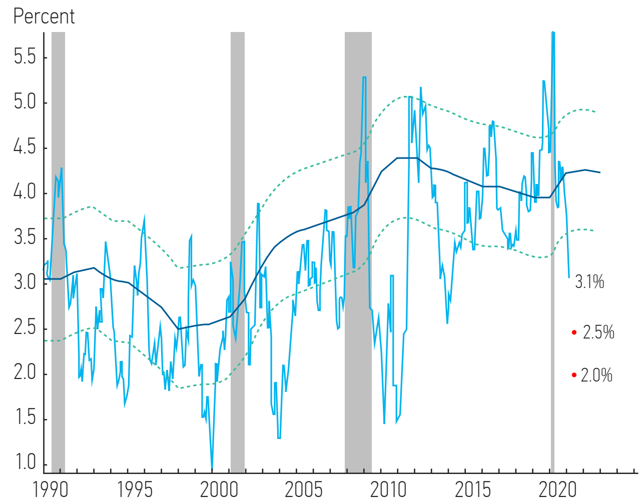
- High valuations for the equity market are also a clear vulnerability, though it is well known that valuation does not predict returns over short horizons but rather gives an indication of potential returns in the event that fundamentals revert to the mean. S&P 500 Index valuations reached 23.0x in late 2020, higher than they have been for 99% of the time since 1900. U.S. equity multiples were higher for only a year in 1999-2000, when they reached a peak at 24.5x.[5] It can be argued that these high valuations are justified given that long-term market yields, which serve as both the discount rate for company cashflows and as an investor's opportunity cost, are still near record lows. As a result, the equity risk premium (ERP) offered on U.S. stocks over 30-year U.S. Treasuries today, though down from more than 600 basis points last March, is still elevated at 300 basis points (compared with 1999-2000 when the ERP was below 100 basis points) (See *Display 3*). This means that stocks, while expensive in absolute terms, are still more attractive today relative to bonds than they were in the dot-com bubble.[6] Net-net, equity valuations are nearly the most overvalued they have ever been in absolute terms but only overvalued (as opposed to extremely overvalued) relative to bonds.

Display 3: **Equities Still Offer More Than 300bps Risk Premium Over Bonds**
U.S. Equity Risk Premium with Fair Value Bands



Source: MSIM Global Multi-Asset Team Analysis and Estimates, Bloomberg, MSCI, Factset, Haver. Data as of March 10, 2020.
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- Equities have been beneficiaries of low interest rates for a couple of decades, but negative real interest rates have significantly boosted the "TINA" (There Is No Alternative) case for equities. Low rates are the reason why equities still offer a 300 basis point risk premium over bonds. But a reset in bond yield levels appears to be occurring as the market prices in the strength of the likely recovery, overheating, as well as the possibility of an inflationary regime change. Of the 110 basis points increase in 10-year U.S. Treasuries since August, 64 basis points came from inflation expectations rising to 2.21% and 44 basis points from real yields (Treasury Inflation Protected Securities, or TIPS) rising to a still very low level of -0.62%.[7] Over the next two to three quarters, when the reopening, fiscal stimulus, free money, and pent-up demand all combine to create the potentially most inflationary environment in 40 or 50 years, we expect that inflation expectations (which reference the CPI, not the PCE) will rise above 2.5%. We believe this will force the Fed to acknowledge the changed environment, taper quantitative easing purchases, and begin to discuss hiking rates. The market will likely move ahead of the Fed and re-price real yields (TIPS) to a positive +0.50% at least (though if inflation expectations become unanchored, they could go much higher).

At this point, it is unclear how quickly this scenario could unfold, but the next +50 basis point increase in real yields would push the equity

[3] MSIM Global Multi-Asset Team; SPAC stands for Special Purpose Acquisition Company, which is a company with no existing business operations which is formed solely to raise capital through an initial public offering (IPO) in order to acquire an existing company.
[4] Greenspan, Alan. "The Challenge of Central Banking in a Democratic Society." Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research, 5 December 1996, Washington, D.C.
[5] MSIM Global Multi-Asset Team; Factset; Based on 12-month forward price-to-earnings ratios.
[6] We estimate that the current ERP is 100 basis points below its "fair" value (of 400 basis points), that suggests equities are too expensive to relative fundamentals, but not as expensive as in the dot-com bubble, when the ERP was 150 basis points below its "fair" value.
[7] MSIM Global Multi-Asset Team; Bloomberg; as of March 8, 2021.

risk premium down to 250 basis points, and the next, to 200 basis points. Even though this level of equity risk premium still indicates that equities offer some compensation over bonds, we expect that such a low level of compensation for the risks associated with holding stocks will force a significant equity multiple de-rating. According to our models, in order to fully offset a move in real yields to +0.50% (from the January low of -1.11%), equity valuations would have to correct from the late 2020 peak of 23x to approximately 16x.

The above scenario is very likely a deep bear case, rather than our base case, for two reasons: first, if growth is indeed as strong as we expect, valuations can stay higher than normal for longer so that only part of the real bond yield increase would need to be offset (investors tend to pay higher price-to-earnings ratios, or P/Es, when economic growth is strong and low P/Es when growth is weak); and second, the "P/E" may need to correct but the "E" will rise strongly (see below under Supports). Net-net, stronger growth and above-target inflation will likely lead to higher bond yields, which could put pressure on very elevated equity multiples.

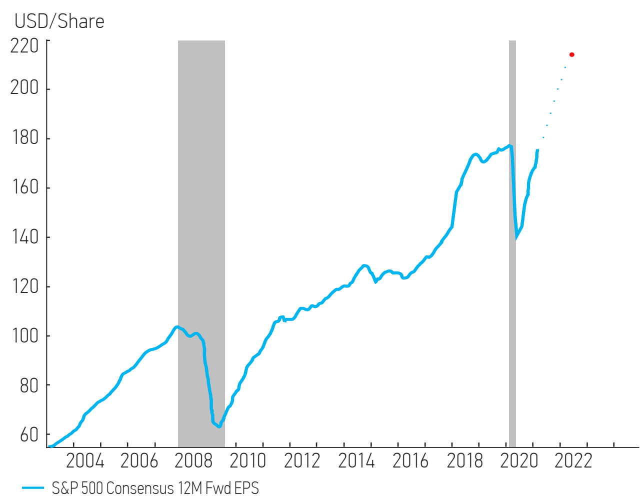
- For now, fiscal policy is highly supportive of the economy and markets with $2.8 trillion of stimulus hitting the economy in 2021 (13% of GDP!). However, by the second half of 2021, the market will be forced to contemplate the second part of Biden's agenda, a very large 10-year infrastructure plan funded partially by tax increases. We expect the Biden administration to raise the corporate tax rate to at least 25% (from 21%), to increase taxes on foreign earnings, and to impose a minimum corporate tax. The sum of these tax increases will likely hit S&P profits by approximately -5%, undoing about half of the Trump tax cuts.

Supports for the equity bull market:

- We forecast that the best economic growth since World War II to lead to very strong earnings growth in 2021 and 2022: the consensus expects +25% and +15% earnings per share (EPS) growth for the U.S., but our models indicate that these estimates will prove too low by at least 5%. As a result, over the course of this year, consensus 12-month forward EPS estimates, which already bake in +25% for 2021, will likely climb by +20% or more (+5% because of surprises to 2021 earnings and +15% as the 12 month forward window rolls to 2022 earnings) (See *Display 4*). This strong earnings growth should be a partial—though significant—offset to yield-driven multiple compression.

Display 4: **S&P 500 Forward Earnings Per Share Likely to Grow 20% Over Next Twelve Months**

S&P 500: Consensus 12M Fwd EPS



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- It is important to note that, even though yields are likely to rise further from here, putting pressure on equity valuations, historically bear markets in bonds have NOT led to bear markets in stocks. In the past 30 years, bonds have sold off an average of 160 basis points in a variety of early, mid and late stages of the economic cycle, but stocks have never fallen into a bear market (see *Display 5*). As discussed above, rising bond yields do sometimes cause equity multiple compression but, in most cases, earnings growth completely offsets it for a simple reason: in the past 30 years, bond bear markets have tended to occur in economic recoveries or expansions. What has killed equity bull markets is the Fed hiking rates, which eventually causes a recession and falling earnings.

Display 5: **Impact of Bond Market Sell-offs on Equities (1991-2021)**

	Increase in 10-Year Yields (bps)	S&P 500 Return (%)	Fwd P/E Multiple Change (%)	Fwd EPS Change (%)
1993 - 1994	286	-1	-20	20
1996	153	7	5	2
1998 - 2000	263	50	39	12
2003 - 2004	177	13	-7	18
2005 - 2006	135	4	-10	14
2008 - 2009	120	5	26	-14
2012 - 2013	157	34	22	9
2016 - 2018	159	34	-5	30
MEDIAN	158	10	0	13

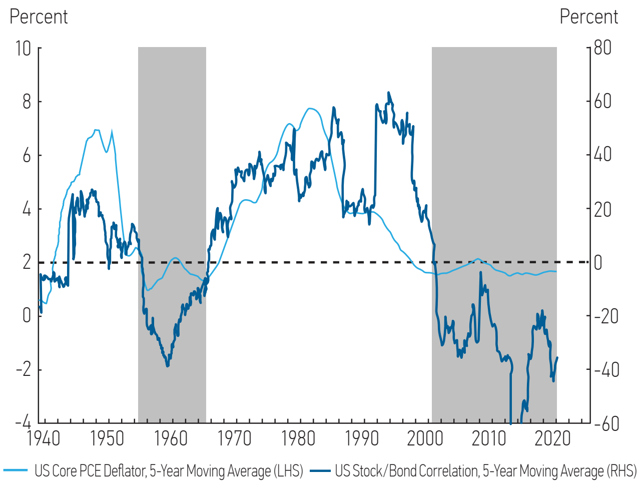
Source: MSIM Global Multi-Asset Team Analysis and Estimates. Data as of March 10, 2020. The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

An extremely important caveat to this analysis is that most of the past 30 years has seen muted inflation: either stable around or below 2%, or declining quickly towards it. And because of low inflation, the correlation between stocks and bonds has been negative. In other words, when bond prices fell (and yields rose), equities have tended to go up—because rising yields implied better growth and a lower chance of deflation. Things were radically different in the higher inflation environment from 1965 to the 1990s, when the correlation between stocks and bonds was positive. Inflation first broke out above 2% in 1966 and remained there for three decades until the late 1990s. During that whole period, rising bond yields actually caused most of the bear markets. This occurred because bond yields rose as a result of the Fed's struggles to contain inflation which progressively spiked higher (to 6% in 1970, 10% in 1974 and 14% in 1980). And each behind-the-curve Fed tightening cycle caused deep recessions (oil shocks did not help either). Thus, higher yields meant economic recession, profit declines and high cash rates competing with equities: stocks fell when bond prices fell (yields rose).

The key in the current environment, therefore, is how fast and how far inflation rises: if it rises sustainably and significantly above 2% due to an overstimulated and overheated economy, the stock-bond correlation is likely to reverse (from negative to positive) and higher bond yields will cause deep multiple compression that earnings will not be able to offset, especially as Fed tightening eventually will cause a recession and double digit earnings declines (See *Display 6*). Our expectation is that the initial inflation increases will be seen as temporary and thus benign, but that by the second half of 2021, any sustained, above 2.0-2.5% inflation will cause a disproportionate reaction from the bond market that equities will have difficulty withstanding.

Display 6: **Stock / Bond Correlation Turns Positive When Inflation Goes Above 2%**

U.S. Core PCE Deflator vs. U.S. Stock / Bond Correlation



Source: MSIM Global Multi-Asset Team Analysis and Estimates. Data as of March 10, 2020.

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- The Fed's new dovish Flexible Average Inflation Targeting framework is a potential support for equities as they wrestle with rising inflation expectations and rising bond yields. The Fed has made clear that it does not intend to raise rates until inflation is sustainably above 2% and the economy has reached full employment. This is likely to cause the Fed to lag in tapering quantitative easing and raising interest rates. It may even cause the Fed to consider measures to prevent market yields from rising excessively. These inflationary policy actions would be positive for equities in the near term as they would suppress a rise in the price of money, a boon for all assets. In the longer term, these policies do run the risk of unanchoring inflation expectations, ultimately requiring more tightening in response.

On balance, given the cross currents between threats and supports to equities, we conclude that stock market multiples are likely to compress, potentially significantly, from 22x forward EPS to 16-18x, but that the majority of this multiple compression will be offset by forward earnings climbing at a 20% annual pace. We do worry that, as the second half of the year approaches, the yield-reset-driven multiple compression may occur more rapidly than the steady monthly increase in forward earnings, making stocks vulnerable to a (potentially deep) correction, particularly given the very high level of speculative activity in markets. This would be the case particularly if inflation were to show signs of rising above 2% on a more permanent basis (i.e. not driven by base effects or one-time reopening effects).

Because the bond market (and eventually the Fed) and economic and earnings growth are in a tug-of-war and the outcome for equities is not decisive, we believe it is more important to continue to focus on where the asymmetries and investment opportunities are—"underneath the hood", or below the asset class level. While stronger growth, higher inflation and higher bond yields may be a mixed bag for an expensive and frothy stock market, they are an unequivocal boon to cheap and cyclical Value stocks. Value stocks have been victims of "Low Nominals" for the past few years: low nominal growth has hurt the earnings growth of lower margin, more indebted Value companies and low nominal rates have boosted the valuation of long duration Anti-Value (i.e. expensive) and Growth stocks. But 2021 is seeing a clear shift to "Higher Nominals", with nominal economic growth likely to rise 10% or more (8%+ real GDP growth and around 2% inflation) and nominal rates rising (the magnitude is uncertain but a return to sub-1% 30-year yields seems very unlikely). As a result, we have reduced our modest equity overweight to neutral and continue to concentrate our risk budget on cheap reopening plays and still-extremely-cheap Value stocks (relative to very expensive Anti-Value stocks).

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