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). 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

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

Display 1: Economic Recovery Driving Bond Yields Up From Pandemic Lows

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.

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), 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

• 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%. 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

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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.
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.

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% inflation will cause a disproportionate reaction from the bond market that equities will have difficulty withstanding.

- 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.


<table>
<thead>
<tr>
<th>Year Range</th>
<th>Increase in 10-Year Yields (bps)</th>
<th>S&amp;P 500 Return (%)</th>
<th>Fwd P/E Multiple Change (%)</th>
<th>Fwd EPS Change (%)</th>
</tr>
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<tbody>
<tr>
<td>1993 - 1994</td>
<td>286</td>
<td>-1</td>
<td>-20</td>
<td>20</td>
</tr>
<tr>
<td>1996</td>
<td>153</td>
<td>7</td>
<td>5</td>
<td>2</td>
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<tr>
<td>1998 - 2000</td>
<td>263</td>
<td>50</td>
<td>39</td>
<td>12</td>
</tr>
<tr>
<td>2003 - 2004</td>
<td>177</td>
<td>13</td>
<td>-7</td>
<td>18</td>
</tr>
<tr>
<td>2005 - 2006</td>
<td>135</td>
<td>4</td>
<td>10</td>
<td>14</td>
</tr>
<tr>
<td>2008 - 2009</td>
<td>120</td>
<td>5</td>
<td>26</td>
<td>-14</td>
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<tr>
<td>2012 - 2013</td>
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<tr>
<td>MEDIAN</td>
<td>158</td>
<td>10</td>
<td>0</td>
<td>13</td>
</tr>
</tbody>
</table>

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.
In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. The creditworthiness of the issuer and general market liquidity (market risk). 

Interest payments (credit risk), changes in interest rates (interest-rate risk), 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).

**Risk Considerations**

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equity securities’ values fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. Longer-term securities may be more sensitive to interest rate changes. Mortgage- and asset-backed securities (MBS and ABS) are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain U.S. government securities purchased by the Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. The issuer or governmental authority that controls the repayment of sovereign debt may not be willing or able to repay the principal and/or pay interest when due in accordance with the terms of such obligations. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Real estate investment trusts are subject to risks similar to those associated with the direct ownership of real estate and they are sensitive to such factors as management skills and changes in tax laws. Restricted and illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio’s performance. Trading in, and investment exposure to, the commodities markets may involve substantial risks and subject the Portfolio to greater volatility.
Nondiversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. By investing in investment company securities, the portfolio is subject to the underlying risks of that investment company’s portfolio securities. In addition to the Portfolio’s fees and expenses, the Portfolio generally would bear its share of the investment company’s fees and expenses.

**Subsidiary and Tax Risk.** The Portfolio may seek to gain exposure to the commodity markets through investments in the Subsidiary or commodity index-linked structured notes. The Subsidiary is not registered under the 1940 Act and is not subject to all the investor protections of the 1940 Act. Historically, the Internal Revenue Service (“IRS”) has issued private letter rulings in which

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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 one a 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®).

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**TreasurymInflation-Protected Securities**, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

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