Morgan Stanley

INVESTMENT MANAGEMENT

Tales From the Emerging World

No, the Markets Aren't Crazy

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | MACRO INSIGHT | 2020

AUTHOR

RUCHIR SHARMA
Head of Emerging Markets and Chief Global Strategist

Amid the sharpest global contraction since World War II, global stock markets around the world just finished one of their best quarters on record, triggering a flood of commentary about how the market has "lost its mind," even its morals. Many people we talk to these days seem deeply offended by the spectacle of the market rising while the world is still suffering from the coronavirus.

But there is a method behind the market "madness." Since the March crash, the market has surged back to levels that are very pricey, but there is nothing irrational about the fact that stock prices have posted such strong gains even as the pandemic has rolled on.

Market prices are a collective bet on the future of the economy, and this market has been way ahead of professional economists in anticipating the path of the ongoing recovery. This is prophetic, not delusional, and also quite typical. Our research shows that, in the post-World War II era, markets have a much better record of accurately anticipating booms and busts than economists do.[1]

At the surface, the market is now indeed very inflated relative to economic fundamentals. On some valuation metrics, the U.S. stock market is currently the most expensive that it has been outside of the bubble period in 1999-2000.[2] The very-easy money policies of the Fed and other central banks have clearly inflated asset prices.

But the stock market's valuations have always been very sensitive to interest rates, with lower rates making stocks look more attractive. Unsurprisingly, many investors now say they prefer stocks simply because fixed income instruments are yielding so little.

[1] MSIM. As of 2019.

[2] MSIM, Bloomberg, Factset, Haver. Data as of June 30, 2020.

Stimulus money is also finding its way into the stock market, unleashing speculative juices and further inflating prices. Over the past few months, the amount of money in U.S. money market funds and bank deposits has increased by a trillion dollars each,[3] and many people—bored at home under lockdown—are using some of that money to day trade. Retail investors now account for 20 to 25 percent of all trades, up from 15 percent at the end of last year.[4]

While the flood of newbie investors and easy money may have turbocharged stock market returns, that does not mean the overall direction of the market is "crazy." Any period of volatility as unusual as this one will leave individual investors in varying states of fear and greed, depending on their temperament and biases. But acting together, their individual extremes cancel each other out, and the market takes on the character of a forecasting machine, incorporating new information constantly and, though not perfectly, at least more efficiently than individual experts do.

The stock market bottomed in late March this year and, on cue, the economy troughed a few weeks later. Then, as economists kept downgrading their GDP growth forecasts in April and May, the stock market kept rallying. It was looking ahead on the notion that with countries gradually coming out of lockdowns, and governments providing record levels of fiscal stimulus, economic activity was bound to improve.

It was only after the U.S. monthly employment report for May was released in early June, and it surprised massively on the upside, that the consensus forecast of economists registered even a faint hint of improvement. By then the global economy had, by one estimate, recovered nearly a third of the 17% drop it had experienced due to the pandemic.[5]

The market is constantly trying to capture every zig and zag in economic sentiment, so its ups and downs at times suggest only that economic conditions are shifting at the margin—getting less bad or less good. Over time, the fit between the economy and the market has been quite tight in countries with sophisticated capital markets such as the United States.

Now, the market is treating the pandemic for what it is, a major natural disaster that hits suddenly and then disappears—only this time it is not at all clear how long it will take to fully disappear. In recent weeks, as U.S. cases surged and some large states halted or reversed the reopening process, the market started moving sideways, watching and waiting to see if this turns into a full blown second wave, with more deaths and extended lockdowns.

In short, the market's sudden plunge, sharp recovery and current state of suspended animation have mapped very closely—and far more presciently than the economic forecasting consensus—the path of a very unusual economic cycle, which now ranks among the sharpest and shortest recessions in post WWII history.[6]

This is consistent with our historical research, which shows that, whatever the armchair experts may say, stock markets generally have a clearer vision of the future than economists do. Of the 11 U.S. recessions between 1947 and 2007, the stock market started falling before every one, on average about eight months before.[1]

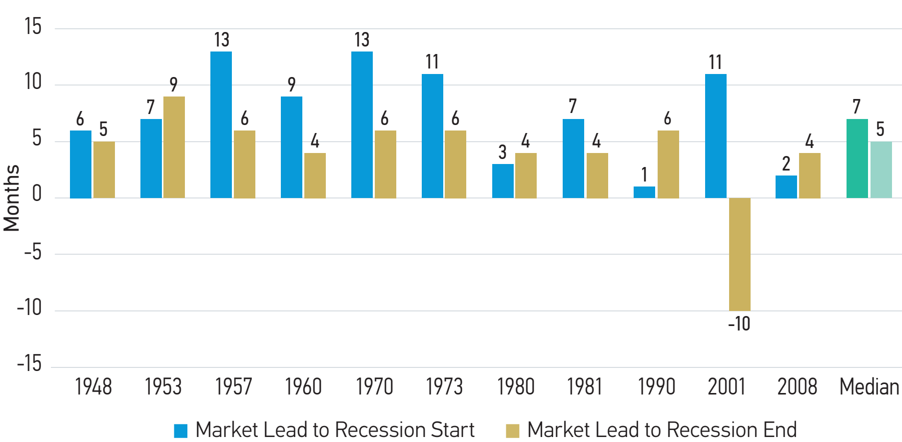
It is true, as critics like to point out, that the market has also sent false signals, plunging when no recession was coming (as it did in 1987) or disconnecting sharply from economic fundamentals (as it did during the tech bubble of 2000). But it is still a more reliable barometer than the consensus call of professional economists. Their record in forecasting postwar recessions is 0 for 11.[7]

On the flipside, in 10 of the 11 postwar recoveries, the stock market bottomed out well before the economy troughed.[1] The gains were often most powerful at the beginning phase of a new bull market. So to see the stock market rise strongly in the face of continuing economic hardship—as

DISPLAY 1

The Markets Are Prescient

Market moves typically lead the start of a recession by 7 months, and the end of a recession by 5 months



Source: MSIM analysis, NBER, Bloomberg, Factset.

[3] Crane Data. As of April 2020.

[4] Bloomberg. As of July 2020.

[5] Goldman Sachs. As of June 8th 2020.

[6] MSIM, Bloomberg, Factset, Haver. As of July 2020.

[7] Ned Davis, "Ned's Insights," November 14, 2014.

it did in the second quarter—is hardly inconsistent with historical experience.

Still, below the surface the market is sending a more subtle message about the future than the headlines suggest. While the S&P 500 is flat for the year, it has been held afloat largely by the explosion in the virtual economy, which is benefiting above all the tech giants like Amazon and Microsoft. The performance and valuation gap between the heavyweight tech stocks and the rest of the market is about as wide as it has ever been. While sensing that the economy as a whole is past the point of maximum decline, the market also sees stronger growth prospects for tech than for the rest, as the pandemic drives economic activity online.

Though stock valuations have been inflated by lower and lower interest rates, the market remains the best barometer of the economic cycle. Over the course of history, and of this pandemic, the market has been a step or two ahead of commentators and experts in anticipating the future. Yes, easy money has juiced up the market, but it has not "lost its mind," as yet.

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, **equities securities'** values also 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 the risks generally associated with investments in foreign developed countries. **Stocks of small- and medium-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **Non-diversified 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.

About Morgan Stanley Investment Management[8]

Morgan Stanley Investment Management, together with its investment advisory affiliates, has 718 investment professionals around the world and approximately $584 billion in assets under management or supervision as of March 31, 2020. Morgan Stanley Investment Management strives to provide outstanding long-term investment performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes governments, institutions, corporations and individuals worldwide. For more information, please visit our website at www.morganstanley.com/im. This material is current as of the date specified, is for educational purposes only and does not contend to address the financial objectives, situation or specific needs of any individual investor.

[8] Assets under management as of March 31, 2020. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

DEFINITIONS: Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0)44 588 1074.

U.S.: A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This publication should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accepts responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION: EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

Charts and graphs provided herein are for illustrative purposes only.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is appropriate for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

Explore our site at **www.morganstanley.com/im**

CRC 3167579 06/30/2021 9873473 Lit-Link: EMEWRLDBRO 07/21/20