Morgan Stanley

INVESTMENT MANAGEMENT

2017 Outlook

Did 2016 "Steal" 2017 Returns?

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If there were ever an axiom of investing that seems so applicable to the past two years, it's this one: *follow the earnings trends.* Relatively flat earnings meant the stock market barely budged for 18 months (between January 2015 and July 2016.) Only as earnings projections finally started to move higher did equity prices follow. *The past two years have really not been more complicated than that.*

We were once again reminded just how important this relationship is.

From the end of 2014 until the summer of 2016, stocks in the U.S. flatlined for the simple reason that earnings for the market overall went nowhere. Yes, lots of volatility in stocks along the way, but once the dust settled, the market had done virtually nothing.

Pre-election market anticipated earnings growth in 2017

That began to change last fall. As much as many pundits have ascribed the market rally to the ascendancy of the Trump presidency, what really was starting to change was the upcoming earnings inflection—even before the election.

And that was not very hard to figure out. While the business media was focused on the election, a simple analysis of earnings trends by sector would have led almost anyone to determine that the period of flatline earnings was coming to an end. And that would be good for equity prices. *Follow the earnings trends.*

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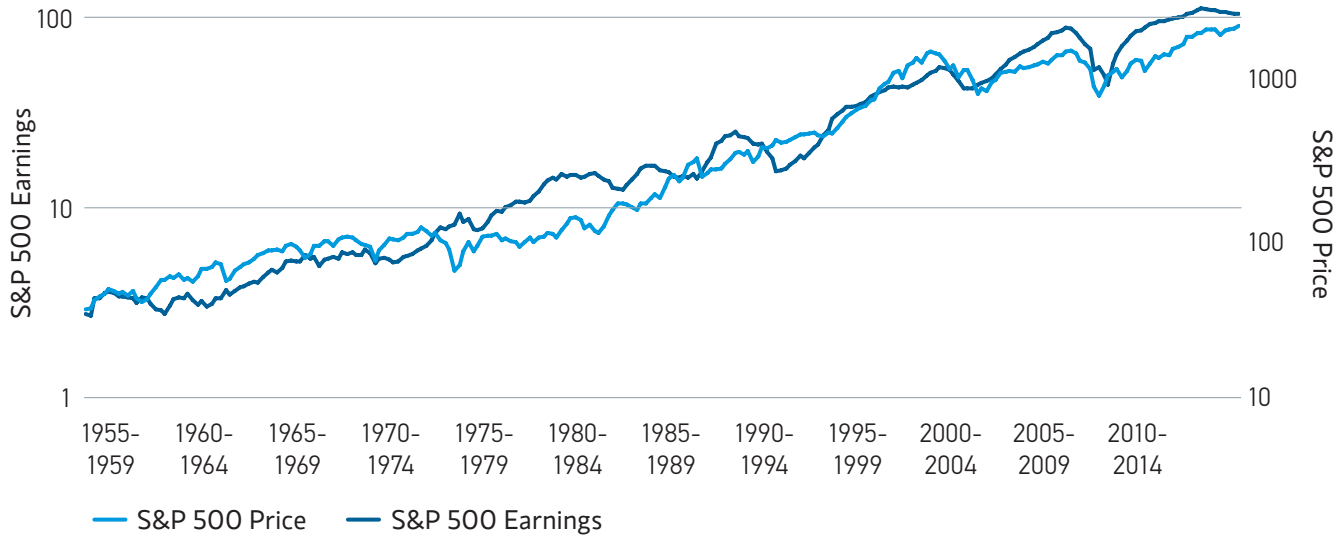
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DISPLAY 1

Earnings and equity prices: A cozy relationship



Source: Bloomberg; as of September 30, 2016.

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We all know that historically the fourth quarter tends to be seasonally strong for equities. Stocks generally embed expectations of what could happen in the future, and given Wall Street analysts almost always start the year with optimistic earnings growth, some of that expectation is usually pulled forward into the previous fourth-quarter equity returns. Hence, potentially good seasonal returns.

2016 was no different. To be clear, S&P 500 earnings growth for the entire year 2016 was a paltry 0.6%. And yet the index appreciated by 9.5%[1], all of which came later in the year.

Why? Because as we enter 2017, earnings growth is estimated at 12.0%.[1] Much better earnings growth than we have experienced the last two years

That's the good news. Stocks did a heck of a lot better in 2016 than what 2016 EPS growth would have suggested.

Now it gets tougher

The bad news is the markets have seemingly "stolen" into 2016 some from 2017 returns.

Hence, the earnings inflection has largely been priced into the market. *The easy lifting came in fourth-quarter, 2016. Now it gets tougher.* And from here we need to determine why those earnings trends might be too high or too low, not to mention whether there is any chance of a *change* in what investors will pay for those earnings. There are a few key variables that could move the baseline:

- *Initial earnings estimates are usually too high…*

  As I mentioned above, historically Wall Street analysts begin the year overly optimistic. In fact, according to Thompson Reuters I/B/E/S, over the last 30 years, only *twice* has the S&P 500 delivered an earnings number that was equal to or higher than initially expected.[2] A 93% failure ratio is not to be taken lightly. In other words, *the 2017 earnings numbers are probably too high,* which could bring the outlook for the year *lower.*

- *…but 2017 estimates may not include all good news…*

  Could 2017 be one of those unusual outlier years? In my mind, here is the one reason that is possible: the $132.87 estimated EPS for the S&P 500 in 2017 does not factor in any Trump fiscal policy reform. How do I know that? Simply because that $132.87 was the estimate prior to the Presidential election when the overwhelming consensus was that Hillary Clinton would be the 45th President. Hence corporate tax cuts, tax repatriation of cash holdings, infrastructure spending all could have a positive impact on S&P 500 earnings. I do not believe this potential good news is factored into earnings yet.

[1] Factset; as of 12/31/2016. Estimates provided herein are subject to change and may not actually come to pass.

[2] Price return not including dividends.

We will be watching as the narrative of the Trump Presidency unfolds. Unfortunately, if more upside for the market is driven by political changes, the media's obsession with every "tweet" could mean that we should expect more volatility. Fiscal policy reform won't be linear. Expect some disappointments along the way, which inevitably could lead to overreactions. While I would certainly not profess to be a political expert, I expect the relationship between Trump and the Republican Congress won't be nearly as "unified" as we perceive now.

A question we receive often is "How do the dollar and the Fed influence this outlook?" *I think they will serve to moderate the tails.* In other words, if the economy initially does not accelerate as much as what the earnings growth numbers expect, then the dollar will likely weaken and the Fed will likely back off rate increases, which should be positive. But if the economy accelerates and the earnings numbers prove too low, then the dollar will likely strengthen and the Fed might get more hawkish, which could likely cause some breaking to the acceleration.

- *… and multiple expansion could drive prices higher*

  While earnings growth is the key input to any forward projections, the multiple paid for those earnings is a vital determinant. To ignore it is to assume human emotional opinions about equities are constant. And we all know that is just not the case.

  I think there is a good chance the P/E multiple continues to move higher, for a couple of reasons:

  First, we haven't yet reached euphoria. In my experience, when the market goes from undervalued (as it was in 2009), it typically ends at not just slightly overvalued, (as it is today), but really overvalued. The failure of the bears is their simple assumption that because the market is currently trading slightly above average valuation, returns won't continue to be good. That's not the norm.

  Bull cycles begin with emotions in despair and end in irrational euphoria. My expectation is this could be the year we move from the optimistic to euphoric stage if investors move out of bonds and into stocks. And that will likely lead to further multiple expansion.

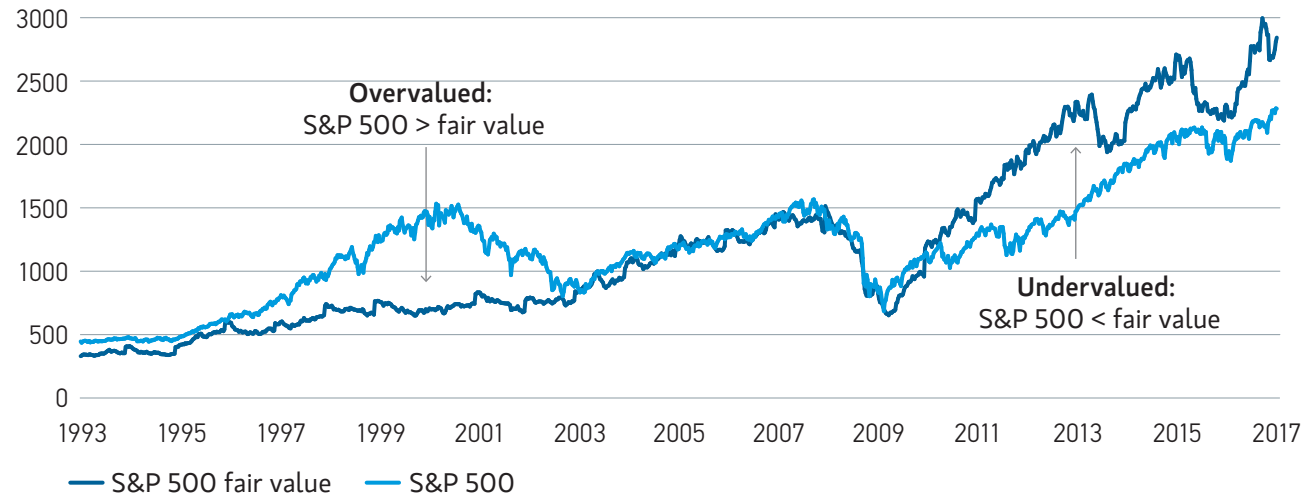
  Second, the quality of earnings could improve. Since this bull market commenced, it has consistently traded at a discount to its 'fair value', as measured by a multiple of current interest rates *(Display 2).* This has nagged me for some time. Many investors slavishly stuck to these valuation models all through the early and mid-1990s only to ignore when the market traded substantially above in the late 1990s. What a mistake that was!

  Today, we have just the opposite. Since 2009, the market has continuously traded below fair value throughout this bull market, yet many investors have chosen to ignore this metric as I rarely hear discussions about this disparity. Could that be a mistake again? Below is the chart of this spread. As you can see just recently the gap has closed as rates have gone up pushing the fair value lower.

I suspect that this gap will continue to close not just because rates move up, but because historically the market pays a *higher* multiple for stronger economic growth and a little inflation, at least initially. In other words, earnings growth driven by top-line growth

DISPLAY 2

Evaluating fair value: Mind the gap



Source: Bloomberg as of November 28, 2016, Morgan Stanley Wealth Management GIC; EPS is Earning-Per-Share.

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deserves a higher multiple than earnings growth driven by anemic revenue growth plus margin improvement and stock buybacks. And top-line growth could occur in 2017.

So we expect the U.S. market to deliver a low single-digit year, unless fiscal policy reform drives earnings estimates higher. Another factor that could unleash a more bullish market would be an expansion of P/E multiples driven by an improvement in earnings quality.

Passive portfolios may reach a breaking point

My number one worry for the market is the flood into passive strategies. Eight years into a bull market and the overwhelming consensus is "just buy the entire market"? As the Wall Street Journal pointed out, "passive portfolios will reach a breaking point when valuations become too skewed relative to those in active portfolios, as they did in the dot.com bubble in 1999 and again in 2007."[3]

And what did those two dates presage? Big ugly bear markets. When everyone is on one side of the boat, I worry about what that means.

What about positioning within the equity market? From a tactical standpoint, we don't believe the value rally is over. To be clear, we don't see value as necessarily cheap and growth as necessarily expensive. Value has traded up to average, and growth has traded off to average. But remember, as I said before, trends don't typically stop at average; historically they overshoot. Many professional investors remain underweighted in value stocks (especially financials),[4] and we suspect ultimately they will need to right this before value outperformance ends.

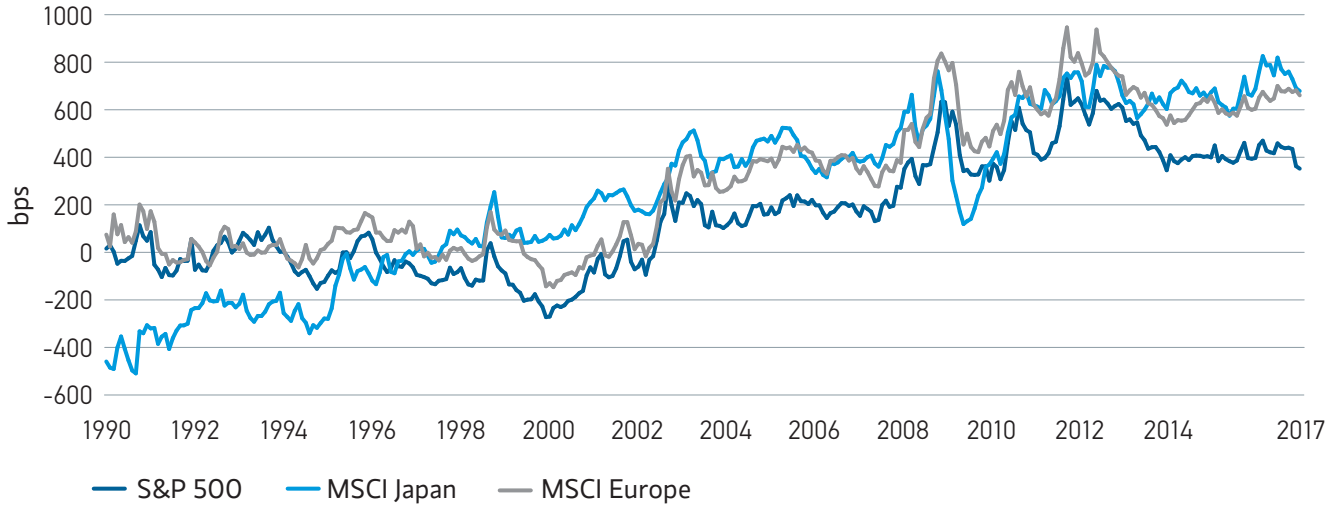
Europe & Japan: Reasons for optimism

Within developed markets outside the U.S., we are most optimistic on the recovery in Europe. Value stocks appear especially attractive. A shocking statistic is the magnitude of outperformance of relatively safe, quality stocks relative to value stocks over the past ten years in Europe. This outperformance peaked last July and has begun to reverse as the macro environment has started to improve.[5] However, historically when value begins to work, this lasts for over two years and the magnitude of outperformance is dramatic.[6] We think the outperformance of value since last July is just the beginning. More importantly, when value works, it's generally a signal that the economy is improving. And that can potentially lead to good equity returns.

DISPLAY 3

Equity risk premiums suggest rewards may be greater outside of US

Next 12-Month Equity Risk Premium



Source: Bloomberg, Factset as of December 19, 2016

Equity Risk Premium is represented by EPS/ Baa Rate. **Past performance is no guarantee of future performance. Indices are unmanaged and not available for direct investment.** They are shown for illustrative purposes only and do not represent the performance of any specific investment. Forecasts/Estimates provided herein are subject to change and may not actually come to pass.

[3] Wall Street Journal, January 6, 2017.

[4] Barron's, January 7, 2017.

[5] Factset; as of 9/30/2016.

[6] Hedge Fund Review, Morgan Stanley, December 2016.

European returns have potential to be superior to U.S. returns for the simple reason that expectations are even more depressed. Look at the equity risk premiums for Europe and Japan versus the U.S. They are even higher, which implies even lower expectations. But as we discussed with the U.S., that equity risk premium is likely to close only with stronger economic growth, and that is quite likely an opportunity for investors in Europe. A combination of earnings recovery plus P/E expansion might be even more profound in Europe.

Recap: Follow the earnings

Regardless of region, my conclusion for 2017 is that, as in past years, equity performance will be largely dependent upon the ability for companies to deliver earnings growth. Could 2017 be the year to surprise on the upside? Time will tell.

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