Morgan Stanley

INVESTMENT MANAGEMENT

Andrew Slimmon Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | MONTHLY COMMENTARY | MAY 2019

KEY CONCLUSIONS

1. One of the most consistent features of this decade-long bull market is that the returns in the years **after** lackluster "pause" years have been very good.

2. We expect 2019 to be even better than previous "post-pause" years because of the unusually depressed 2018 year-end price.

3. A 2019 ending price on the S&P 500 above 3,000 and thus over 20% for the year is a distinct possibility.

4. However, even in the other good "post-pause" years in this bull market, there have been nasty drawdowns.

5. As we wrote last month, investors have experienced very few bad days so far in 2019, and we felt as the market approached 3,000, something would cause a correction. Voila….tariffs. We were due.

6. We doubt the trade dispute with China will result in a lengthy, multi-year escalation for one simple reason: Presidents do **not** get re-elected when the economy is very weak. A "no deal" outcome would have a substantial negative impact on the US economy.

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A cynical question I receive from time to time is, "*you are an equity manager, so aren't you always bullish?*" I generally resist pointing out that:

1. Remaining steadfastly optimistic has been about the most accurate market call anyone could realistically have made over the last decade.
2. As much as being bearish sounds smarter, the bull market's path is littered with trampled, pessimistic strategists.

It is true that Applied Equity Advisors' mandate is to be invested in equities. But there are times to dial up our risk exposure to reflect a more optimistic outlook, and there are times to dial down our risk exposure when we need to be more cautious.

Those who watch our portfolios closely know that over the past couple of months, we have been dialing ***down*** *our risk, primarily by increasing our exposure to REITs and utilities.* In our opinion, the beta (aka "risk") factor was quite overbought by early-April, indicating it was time for us to make sure our portfolio risk metrics were below those of the market. Simply put, given the strong year-to-date returns of both the market and our strategies on an absolute and relative basis, we saw the need to increase our more defensive exposures.

Where are we today having recently experienced a 5% pullback in the S&P 500?

1. On the surface, that is not much of a pullback. I would be shocked if the market does not experience bigger corrections than that in 2019, leading me to believe that maintaining our more defensive positioning is the correct decision.
2. What nags me is the overarching heightened bearish sentiment. With only a 5% correction, consider:
   a. The beta factor has been crushed (risk off).
   b. The VIX (a measure of volatility) has shot up.
   c. Investor expectations of a Fed rate cut and subsequent recession have soared.

In the first week in May, global equities experienced redemptions of -$20.5 billion, a 99th percentile weekly outflow since 2000, culminating 8 consecutive weeks of outflows.[1]

That is a lot of running to the hills. Yet the market is **only** down 5% from its April 30th high?

Wow.

My conclusion:

I think "the hills" are crowded with skittish investors. **Perhaps everyone who could panic has done so, which could actually limit the downside.** Or at least until inflows resume.

In essence, the time to dial down the risk in our portfolios has now passed.

Andrew

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[1] Nomura Cross-Asset Strategy., May 10th, 2019

