Morgan Stanley

INVESTMENT MANAGEMENT

Applied Equity Advisors Monthly Commentary

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Since the inception of these monthly commentaries, the goal has been to make the commentary more timely and relevant for you than a typical asset managers' quarterly letters. We listen to what questions you have (*please keep them coming!*) and at the very least, try to provide the potential answers to the client inquiries you are receiving.

Some months are more bountiful than others. This was one of those months.

Therefore, I will spare the attribution overview in order to provide my best guess at answering four questions which many of you have asked recently:

1. What would I do with fresh cash? (in terms of investing today)
2. Will we have any type of pullback and what would be the cause?
3. This economic cycle has lasted a long time. How will we know when we are nearing the end?
4. How will flow into passive products ultimately impact this bull market?

1. FRESH CASH

How to Invest When Equities are Up a Lot?

First, for any new account that has money earmarked to equities, I will almost always counsel to get some of the money to work immediately.

When the market is up as much as it is currently, dollar cost averaging seems to make even more sense. Dollar cost averaging[1] involves investing a fixed amount on a regular basis regardless of whether or not the market is up or down. As I wrote last month, Q4 is historically a very good quarter for stocks. But that has come, historically, after weakness in the August/September time frame, which we just did not see this year. The result is that stocks look pretty overbought at this point:

DISPLAY 1

The relative strength indicator for the S&P 500 is overbought:

Source: Bloomberg as of October 4, 2017.

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.** See Disclosure section for index definitions.

[1] **Dollar cost averaging** does not ensure a profit or protect against the risk of loss. It involves continuous investing regardless of fluctuating prices. Investors should consider their ability to continue investing through periods of fluctuating market conditions.

DISPLAY 2

And short-term sentiment looks rather optimistic[2]

One final reason for a potential pullback is that we are coming up to earnings report season. And as much as Q3 earnings overall are only projected to be up 2.8% year-over-year[3] (a low bar), I get nervous when the market has been strong leading into earnings season, as that means expectations are high.

So while Q4 tends to be a seasonally strong period (at least until mid-December), it's hard to see we won't have some pause. To me that argues for incremental investing.

2. RISKS TO THE MARKET BEYOND THE OVERBOUGHT SITUATION?

a. *Tax Reform Does Not Happen Nearly As Quickly as Expected.*

Ronald Reagan was elected in 1980 and then re-elected in 1984. But does anyone remember when his Tax Reform Act finally was enacted? **1986**. And he got along with Tip O'Neil, Democratic Speaker of the House. While Paul Ryan is "technically" part of the same party, I don't see Trump, Ryan or Minority Leader Nancy Pelosi as exactly pals. Today the Republicans don't need the Democrats as much, but one has to be somewhat cynical about anything happening in DC. Especially given the splintering of the Republican Party.

[2] The Daily Shot, WSJ, October 6, 2017

[3] Factset as of October 9, 2017

Retiring Senator Bob Corker said Republicans' battle on tax reform will make health care look like a "piece of cake', and he won't vote for legislation that adds to the deficit-something the Trump administration's plan very well might. The Tennessee Republican speaking to reporters on Capital Hill, said there's a big difference from tax reform-actually overhauling the system-and tax cuts. Tax reform takes intestinal fortitude, and staring people down for the good of the country, he said.[4]

b. Resignations by Key Cabinet Members

Clearly the market has been comforted, despite President Trump's unpredictability, because of the stability of his key advisors. I have to believe that a Tillerson, Cohen, or Ross resignation would be greeted poorly.

c. Mid-term elections in 2018

Clearly this is not a near term issue, but I think this will be a real risk for the market in 2018. Who remembers the term President Obama used to describe the outcome of the 2010 mid-terms? *"Shellacking".*

Unless opinion polls for Congress improve, the Republicans will likely be very vulnerable in the mid-terms, which historically go against the incumbent party. A very strong victory by the Democrats could empower the more liberal part of the Democratic Party, and I suspect that would embolden discussions about Elizabeth Warren running for President. Not an outcome the markets would relish. And certainly the markets would not sit around waiting until next November. This discussion would likely filter into the markets far earlier in the year based on the successes and failures of Congress. Pay close attention to Congress's approval ratings.

d. Could there be a bubble out there that could burst?

This bit of news caught my eye:

Usually when a company rebrands itself by diving into the digital currency space, the stock waits until the announcement to take-off. In the case of Bioptix Inc, a maker of diagnostic machinery for the biotech industry, it didn't bother waiting. The penny stock ***nearly doubled in value*** in the days leading up to the company's announcement Wednesday that its ***renaming itself*** Riot Blockchain Inc. to reflect a new focus on buying cryptocurrency and blockchain businesses.[5]

e. Anti-Trust Discussion

Like then, it can be hard today to imagine how our mighty superpowers could be threatened. Some of the most valuable American companies, notably those in the new-age tech and internet sectors, have governments worried about their power. Two of these mega-companies were just marched before Congress to testify about how their services might have been used to turn the last presidential election in Donald Trump's favor. European Union antitrust rulings are also targeting these firms. The largest online retailer is accused of wrecking traditional brick-and-mortar retailers. Meanwhile, Franklin Foers's new book, *World Without Mind*, captures the growing sense that the four "knowledge monopolies," as he calls the companies, have all but subjugated humanity.[6]

3. HOW WILL WE KNOW WHEN WE ARE NEARING THE END OF THIS BULL MARKET CYCLE?

As much as we need to have an opinion on the short-term risks to the market, I believe much of what we hear and read is largely noise. Trying to time short-term overbought and oversold situations and assessing the risks of what could cause corrections makes for good CNBC discussions, but practically, it's a waste to try to time. In other words, everything in the above section 2 is a potential risk, yet I don't see any of them as a reason to adjust asset allocation.

Here is what we should be focused on: The Fed. Let's face facts: ***Bull markets are generally killed by the Fed.*** At this juncture of the cycle, it would seem prudent to remind everyone of that simple saying: ***Don't Fight the Fed.*** When the Fed is accommodative, the economy usually stinks, stocks are in the dumps and investors are generally too negative. Time to buy. When the Fed turns restrictive, the economy tends to be roaring, stocks are high and investors are euphoric. Time to sell.

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[4] 361 Capital, October 2, 2017

[5] CBS News. This is not a holding in our Strategies.

[6] Bloomberg Technology, October 4, 2017.

DISPLAY 3

So where is the Fed in that continuum and what signals should we watch?

Fed Raises Rates →Inverted Yield Curve → Recession
Are We There Yet?

Initial Inversion	Stock Market Peak	Time Difference	S&P 500 Gain from Inversion to Peak[1]
12/14/1988	7/16/1990	579 days	41.46%
4/24/1998	3/24/2000	861 days	41.60%
12/27/2005	10/9/2007	651 days	28.80%
	Average:	**697 days**	**37.28%**

Source: Bloomberg as of August 31, 2017.

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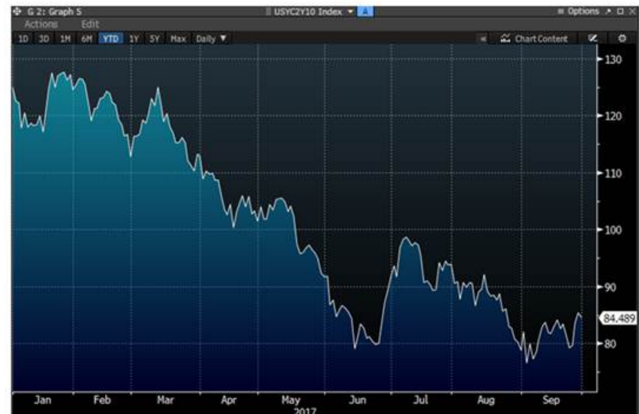
There is lot of information on the above chart, but in my mind, it is very powerful. Here are the conclusions:

a. Historically as the Fed begins to raise the Fed funds rate (the light blue line) the yield curve spread (10-year yield minus 2-year yield, the dark blue line) begins to flatten and then ultimately inverts (10-year yields less than the 2-year).

b. The yield curve inverting has been a very good predictor of a future bull market peak and the next recession (grey bars).

So where are we today? The yield curve spread has in fact come down. Below is a wider version of the spread.

DISPLAY 4



Source: Bloomberg as of September 29, 2017.

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As you can see, the spread has come down quite a bit this year. But in fact, it's still positive by 84 basis points[7].

Going back to that first Fed chart, what I find fascinating is the time frame between yield curve inverting and the market peaking. On average, leading up to the past three recessions, the market continued to move higher *for another 1.9 years and appreciated another 37%* ***after the yield curve inverted.*** Intuitively this makes sense to me. If the Fed starts to raise rates, it would mean the economy is accelerating, wages are accelerating, earnings are accelerating and therefore optimism is accelerating, too. And this is why there are various studies that have shown that a significant portion of the total bull market return comes in this final leg. It's the blow-off stage. But that comes after the yield curve inverts. What the bond market is telling us is that ***we are not even there yet***.

[7] Newsweek, Tech & Science, October 9, 2017

4. HOW WILL PASSIVE PRODUCTS IMPACT THIS BULL MARKET?

In November 2015, we published a white paper on active versus passive management. Be on the lookout for an update which will be coming soon. Our key conclusions as it pertains to the question are:

1. Data suggests that ETF investors make poor investment timing decisions. The funds they buy tend to underperform the ones they sell.
2. Ultimately it's likely the bull market will peak higher than expected and the next bear market will bottom even lower because of it. In other words, passive products magnify the tails. This week's Barron's summed up the next bear market (when it comes) well:

Some $2 trillion has rotated from actively managed and value-focused funds to passive ones-a rotation that Marko Kolanovic, JPMorgan's top quantitative strategist, contends may ultimately hurt the stock market. In a note to clients, Kolanovic characterized the shift as eliminating "a large pool of assets that would be standing ready to buy cheap public securities and backstop a market disruption".[8]

Finally, three cheers for behavioral economist Richard Thaler who just won the 2017 Nobel Prize in Economics. The Royal Swedish Academy has acknowledged something that everyone who has been in this business a long-time knows very well. *When it comes to money, people do not behave rationally*. But at least there is consistency to that irrationality!

[8] Bloomberg, September 29, 2017

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