Morgan Stanley

INVESTMENT MANAGEMENT

U.S. Equity Outlook: Trump Won, Now Back to Fundamentals

SOLUTIONS & MULTI ASSET | APPLIED EQUITY ADVISORS TEAM | MACRO INSIGHT | 2016

AUTHOR

ANDREW SLIMMON
Managing Director

With the U.S. presidential election now behind us, we see a number of positive signs for the U.S. equity market in the fourth quarter and next year, though not without risks which must be watched closely. Although the Trump win initially registered as a surprise in the markets, we believe the focus should now return to stock fundamentals.

Fiscal reform has historically buoyed equities

The election result has appeared to demonstrate Americans' desire for economic stimulus. Although much remains to be seen about policy details, a Republican president with a Republican majority in Congress should be better positioned to pass fiscal policy reform than a Democrat in the White House with a Republican-led Congress. As such, we think political uncertainty may actually be diminishing.

In addition to less uncertainty overhanging the market, the possibility of fiscal policy reform could act as another reason for optimism in the equity markets. Since 1906, the S&P 500* has delivered a series of bear market cycles lasting on average 17 years, followed by bull market cycles of an average duration of 14 years.[1] Looking at the most recent, from 1966 to 1982, the stock market compounded at 4% annualized.

[1] Bloomberg, Robert Schiller

* **Past performance is no guarantee of future results.** This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. See disclosures for index definition.

Then, in 1982, fiscal policy reform helped fuel the market's most recent bull run that eventually peaked in 2000. Compare that to today. Since 2000, the market has grown at an annualized rate of approximately 4%. We are 16 years into this bear cycle, and the prospect of fiscal policy reform is now on the table. While we should not expect the types of returns the S&P 500 experienced in the 1990's, perhaps a change in fiscal policy could act as a catalyst to jumpstart the next bull rally.

A rebound in earnings growth should drive multiple expansion

With the election behind us, we believe the markets are beginning to focus on company fundamentals. Due to the rebound in the price of oil from its low in early February, certain sectors that were in recession last year, namely energy, materials and industrials should be poised to see improvement in 2017, given easier year-over-year comparisons. And consensus 2017 S&P 500 earnings in general are showing a 13% improvement over 2016 earnings,[2] which is positive.

With the potential for better earnings and reduced uncertainty, multiples can expand. On an absolute basis, the market isn't cheap; the stock market's price-to-earnings (P/E) ratio is trading above historical valuations. But consider that the long-term average valuation levels represent a period of much higher interest rates than we have today. Since 2009, taking the current low interest-rate environment into account, we believe the S&P 500 "fair value" relative to bonds remains at a discount. While antithetical, if interest rates begin to rise, we would expect that discount to narrow because it would signal the potential for higher growth.

We also see potential for P/E expansion on improved revenue growth, which could be spurred by a modest rise in inflation. Conventional wisdom says that inflation is bad for stocks. However, historically, slowly rising inflation has bolstered revenue growth, which in turn has led to an initial period of multiple expansion.[3] Of course, once interest rates rise to a certain level, bonds should become more competitive with stocks, causing P/Es to contract. But, we're not there yet.

We favor growth over low-growth stocks

We view the current opportunity set not as growth versus value, but rather growth versus low-growth. We believe stocks with sensitivity to economic acceleration are most likely to benefit. Financials, industrials, and select health care stocks look especially attractive to us, as these areas have been some of the more beaten-down sectors of late. Conversely, lower volatility, dividend yielding stocks, such as consumer staples, utilities, and telecommunications, are more likely to underperform. These stocks tend to be trading at high valuations currently, as investors have sought bond surrogates in the low yield environment of the past few years.

Risks we're watching

Although we are generally optimistic with regards to the market's fundamentals, we're monitoring possible headwinds along several fronts. The potential for a trade war remains on our radar but there won't be any clarity on this issue for a while. In the near-term, we continue to watch for vulnerabilities to an earnings recovery, for example, retreating oil prices or a spike in the US dollar, which could hurt exporters and multinationals' profits, as we saw in the second half of 2014. Fast-rising inflation could also create headwinds for equities, as would a Fed that moves aggressively to raise rates. From a global perspective, we prefer the U.S. to Europe, where political uncertainty is set to increase with key elections across the Continent in 2017. In the emerging markets, we're avoiding any short-term, knee-jerk reactions to the U.S. election.

[2] Bloomberg

[3] Factset, Robert Schiller, MSWM Global Investment Committee

This material is for use of Professional Clients only, except in the U.S. where the material may be redistributed or used with the general public.

The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

All information provided has been prepared solely for information purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

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 may therefore be less than what you paid for them. 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. 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. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. **Illiquid securities** may be more difficult to sell and value than publicly 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.

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. 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.

The S&P 500® Index measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This communication is only intended for and will be only distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's / product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

EMEA:

This communication was issued and approved in the United Kingdom by Morgan Stanley Investment Management Limited, 25 Cabot Square, Canary Wharf, London E14 4QA, authorized and regulated by the Financial Conduct Authority, for distribution to Professional Clients only and must not be relied upon or acted upon by Retail Clients (each as defined in the UK Financial Conduct Authority's rules).

Financial intermediaries are required to satisfy themselves that the information in this document is suitable 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. If such a person considers an investment she/he should always ensure that she/he has satisfied herself/himself that she/he has been properly advised by that financial intermediary about the suitability of an investment.

U.S.:

A separately managed account may not be suitable 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.

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 document 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.

Australia:

This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept 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.

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

In the U.S., Investments Products are: NOT FDIC INSURED | OFFER NOT BANK GUARANTEED | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

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