Morgan Stanley

INVESTMENT MANAGEMENT

Andrew Slimmon Equity Market Commentary

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1. There are two investment axioms which seem to explain why the stock market was recently at an all-time high:
   a. The stock market focuses on the ***rate of change.***
   b. The stock market is a ***forward predictor.***

   In essence, the market anticipates the rate of change before it occurs.
2. That's fine for explaining what has already happened. ***But now what?***
   a. In my opinion, we are only partway through the process of the market anticipating a 2020 reacceleration, and therefore, I continue to believe the S&P 500 will be ***well north of 3,000 by year-end***.
   b. But ***August could be a painful month***. We are about to enter the summer doldrums, in my opinion a vacuum without "healthy" news flow.
   c. Longer-term, the recent quote from Warren Buffett is worthy of some analysis:

      "***I think stocks are ridiculously cheap if you believe….that 3% on the 30 year bonds make sense***". *CNBC, May 6th, 2019*

I am sure we have all experienced owning some growth stock that reported a great quarter and yet the stock was **crushed**. *Huh?* Often a selloff is attributed to "a slower rate of growth than what was seen in the past". In essence, the rate of change decelerated. Stocks tend to peak in great periods when the rate of change turns negative. Likewise, the market usually bottoms in the middle of recessions when the rate of change turns positive.

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That's important to understand as we review the consensus earnings and resultant year-over-year growth for the S&P 500[1]:

DISPLAY 1

	2018	2019 (E)	2020 (E)
S&P 500 Consensus Earnings	$161.48	$165.77	$183.92
Year-over-year earnings growth	+20.9%	+2.7%	+10.9%
Change in growth rate	+8.9%	-18.2%	+8.2%

Clearly, corporate tax reform induced big growth in 2018, which led to the rate of change turning negative in 2019, and at least for now, the rate of change reaccelerating in 2020.

Didn't the equity market predict this quite well?

a. A strong rally in 2017 in front of great earnings growth in 2018.
b. A weak market in 2018 in front of decelerating earnings growth in 2019.
c. And now ***another strong market in anticipation of a reacceleration in earnings growth in 2020***.

Will the earnings growth rate for 2020 turn out to be accurate or not? We won't know until next year, but the market is rallying off that expectation now. This is why I believe the market will be higher by year-end. ***I believe the market will continue to price in expected earnings growth reacceleration into year-end.***

In essence, very low levels of 2019 earnings growth (and economic growth, too, for that matter) result in a very high likelihood of reacceleration in 2020.

There is one more reason why I am confident in the reacceleration next year. It all has to do with the following chart[2]:

DISPLAY 2

No Recession in 2 Years Before Election

RECESSION?	President (Year)	REELECTION?
NO	Obama (2012)	YES
NO	Bush 43 (2004)	YES
NO	Clinton (1996)	YES
NO	Reagan (1984)	YES
NO	Nixon (1972)	YES
NO	LBJ (1964)	YES
NO	IKE (1956)	YES
NO	Truman (1948)	YES
NO	FDR (1944)	YES
NO	FDR (1940)	YES
NO	FDR (1936)	YES
NO	Wilson (1916)	YES

Recession in 2 Years Before Election

RECESSION?	President (Year)	REELECTION?
YES	Bush 41 (1992)	NO
YES	Carter (1980)	NO
YES	Ford (1976)	NO
YES	Hoover (1932)	NO
YES	Coolidge (1924)	YES
YES	Taft (1912)	NO

With the exception of "Silent Cal," US Presidents have not been re-elected unless the economy was doing well. With 2020 being a US election year, I fully expect measures will be taken to ensure strong economic growth ***leading up to when Americans enter the voting booth***. Should it come as any surprise that the US/China discussions are rocky now? ***A trade deal in 2019 is far less impactful than a trade deal in 2020*** (heralded with hyperbole).

August has historically been the most volatile month since the VIX Index was created in 1990.[3] When I think about what "volatility" really means, I am reminded of the old adage: *"the stock market goes up on an escalator and down in an elevator."*[4] More volatility is code for "bad markets".

To me, it's about the information flow or lack thereof. As I wrote last August,

> *My experience is that when the market focuses on the micro (corporate earnings, products etc.) the market does well but when it focuses on the macro (geopolitics, Fed, etc.) it struggles more. Unfortunately, we are exiting a great earnings period and entering the period with less micro news. The news flow rotation from the micro to the macro is worrisome. This is exactly why August is generally a tough period for the market.*[5]

It seems to ring true this year as well.

Additionally, as I highlighted in my July Mid-year 2019 Outlook webcast, ***there is evidence of retests of corrections.***[6] When we have experienced market drawdowns, we have also pretty consistently seen retests about two months later. In 2018 alone, we had a selloff in February followed by a retest in April and a selloff in October, with a nasty retest in December.

In late-May 2019, we had a 7.5% drawdown which bottomed on June 3rd with the S&P 500 at 2,745. Could we see 2,745 this month (two months later) ***which would be a painful 8.5% decline*** from the July 26th high? As I wrote last month, my only hesitation is:

> *…with so much money on the sidelines waiting for a pullback, rarely does the market give what so many want.*[7]

To state the obvious, we likely will not see a 8.5% decline ***without bad news*** that will unnerve investors and inevitably cause some of those same investors who wanted a pullback to hesitate. I suspect "tariff wars" and "increased recession risks" will be the most likely catchphrases.

Finally, is the market too richly priced for any upside? That is a question I often receive. It is true that the S&P 500 is trading at a premium of 16.6x to its historical 15.9x forward P/E.[8] However, that would be looking at equities in a vacuum. If equities are expected to be the present value of expected future cash flows, then the interest rate used to determine present value meaningfully impacts fair value. The lower the rates, the higher the present value of those future cash flows.

That is the genesis of Warren Buffett's comment: ***stocks are cheap, assuming rates stay at this level***. In fairness, he goes on to say he has a hard time expecting rates to remain at these levels over the long term, with large budget deficits and the expectation of inflation eventually picking up. While I certainly do not want to disagree with the Oracle of Omaha, I have a hard time seeing the 30-year yield soaring any time soon, given rates in the rest of the developed world are substantially lower than ours.

Bottom line, either P/E multiples or interest rates are headed higher.

My bet?

P/E multiples.

Andrew

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[1] Factset as of July 30th, 2019
[2] WSJ, Daily Shot, May 23, 2019
[3] Nomura Cross-Asset. Charlie McElligott. July 31st, 2019
[4] Real Money, June 11, 2019
[5] August 2018, Mid-Month Commentary: What's Your Time-Frame?
[6] Bloomberg
[7] July 2019 Commentary: Isn't The Stock Market A Forward Predictor?
[8] Facset, since September 1995 as of August 2, 2019.