Call it superstitious, but we in Applied Equity Advisors are always uncomfortable producing our market outlook commentary for the following year until the current year is complete. Much can happen in December that could impact our projections about the coming year. Certainly December 2018 is a case in point!

So here is our analysis as we sit at the end of December 2018, albeit emotionally exhausted after quite a month. *(And please also listen to our 2019 Market Commentary webcast, originally taped Thursday, January 3rd, 2019)*

In summary, we believe the short-term outlook for the market immediately past the treacherous December 2018 is a decent recovery. Sentiment and breadth is so stretched that if the market is consistent with history, we should see rallies from these levels.¹ But that does not necessarily mean we have resolved many of the issues that caused this recent correction. That will take time, likely with more weakness to come. Nevertheless, as we contemplate returns for the 2019 full year, we think it would be emotionally easy but intellectually foolish to be LESS optimistic. 2018 washed out many of the excesses, setting up 2019 to be a better year.

We believe the US stock market’s December 2018 gyrations are reflecting a crisis in confidence, but not a 2019 economic recession.

During rocky times for the stock market, we are reminded of Ben Graham’s famous commentary that the stock market is a voting machine short term, tallying up who is popular and who is not, and a weighing machine long-term, assessing the substance of companies.
Are the fundamentals rolling over, or has the stock market’s popularity simply plummeted? As I stood in unusually long lines both at my local Starbucks on Christmas Eve morning and later in the day at Nordstrom Rack (the checkout line snaked halfway through the store), it sure did not feel to me as though the world was crashing. But then there is the stock market.

Of course, it’s important to consider that the stock market is a leading indicator. Consumer spending is not. So is the market screaming recession in 2019? Is it the end of the road for this cycle? Or was this truly one heck of a bump in the road?

We believe the stock market is reflecting the stresses of:

1. **Fears of a trade war** and the unrepentant verbal assaults which appear naïve to the corporate uncertainty they cause.
2. **Fed policy** that appears to be determined by peering through the rear view mirror.
3. **Increased risks of geopolitical mistakes** given the resignations of key Trump administration leaders.
4. **A government shutdown** and the potential for a protracted battle.

In brief, Trump’s and Powell’s policies and actions are not currently being perceived as market friendly (nor are those of European politicians), and the market’s short-term voting machine has reflected that.

FedEx CEO Fred Smith said succinctly on his December quarterly call:

```
And I’ll just conclude by saying most of the issues that we’re dealing with today are induced by bad political choices, making a bad decision about a new tax, creating a tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprises in China, the tariffs that the United States put in unilaterally.2
```

Will these issues cause negative GDP growth? While we certainly agree that policy errors can lead to a decline, we do not conclude that is what faces us currently.

We could pull out an arsenal of predictors that are **not** suggesting recession. Our personal favorite is that the 2-10 year yield curve has **not** inverted yet.

Historically, a yield curve inversion has always preceded a recession. Additionally, as I will explain later, it is simply mathematically difficult for there to be a recession.

So does a -19.8% decline fully reflect a crisis of confidence? In the 1998 and 2011 crises in confidence (without economic recessions) 19% peak to trough declines were triggered. **We suspect this is currently happening.**

Finally, it’s important to consider the calendar. Year-end tax loss selling undoubtedly exacerbated the declines.

**Now, on to 2019.**

**Many of the excesses appear to have been washed out in 2018, and that is a good thing.**

**Therefore, as we consider the outlook for the full 2019 year, we believe it would be a classic behavioral mistake to be LESS optimistic toward 2019 than 2018.** We felt 2018 was going to be a “pause” year and are therefore more positive on 2019.

**However, there are some key short-term hurdles the market must first overcome, and we believe that will take some time.**

In our opinion, the story of the market in 2018 was one of mean reversions. Where excesses existed entering into 2018, they have now corrected.

Consider:

1. We have experienced above average volatility, following below average volatility in 2017.
2. We have experienced a subpar year of market returns, following two above average years.
3. Economic expectations have regressed lower, having started 2018 at sky high levels.
4. Investor sentiment (a contrarian predictor) is substantially lower today than it was at the beginning of 2018.

Therefore, we do believe it’s important not to frame a 2019 outlook based on “rear view mirror” driving.

Likewise, just because the calendar turns does not mean that the issues that originally caused these mean reversions simply go away. That will take time, and the associated uncertainty will likely cause more volatility.
Two major issues worry us for 2019:

1). **We believe there is a better than 50/50 chance of an earnings recession in the US in 2019, even if an economic recession is unlikely.**

Very simply, the key reason we doubt an economic recession is around the corner is the math. If a recession is technically defined as two quarters of negative year over year growth, then it is important to remember that the higher the growth in one year, the greater the likelihood of negative growth the next. Likewise, low growth lessens the likelihood of recessions.

Take a look at the difference between earnings growth and economic growth. Which looks vulnerable to you?

**DISPLAY 1**

1. Refinitiv, S&P, Morgan Stanley Research, Full year EPS is sum of 4 quarters, Based on data available as of December 18, 2018

*Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise.*

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.

Simply put, Q1-Q3 2018 was substantially above average for earnings growth but not for GDP growth. **We believe that makes Q1-Q3 2019 very vulnerable to negative earnings growth.** But as you can see, current consensus is for 6% EPS growth. So those numbers would have to come down. With the market recently down 19.8% peak to trough, we would argue that negative earnings growth is already reflected in stock prices. However, a market rebound prior to earnings season could make the market more vulnerable to conservative corporate guidance and the resultant estimate cuts from the research analyst community.

So why do we believe these 6% earnings growth numbers won’t be met? The inner working of the stock market, which famed hedge fund manager Stanley Druckenmiller calls “the best economist out there”\(^3\), is screaming slowdown. The economically sensitive sectors, particularly the early cycle sensitives (financials, industrials) have been brutally punished. When utilities are the best performers, it’s never a good sign.

There is precedent for an earnings recession without an economic recession.
DISPLAY 2

Earnings recessions without economic recessions.

<table>
<thead>
<tr>
<th>First Negative Quarter</th>
<th>Last Negative Quarter</th>
<th>Market Peak Date</th>
<th>Market Trough Date</th>
<th>Peak to Trough Decline in S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q2 1951</td>
<td>Q2 62</td>
<td>6/12/1950</td>
<td>7/13/1950</td>
<td>-13.5%</td>
</tr>
<tr>
<td>Q1 1987</td>
<td>Q3 67</td>
<td>2/9/1986</td>
<td>10/7/1986</td>
<td>-25.2%</td>
</tr>
<tr>
<td>Q1 1985</td>
<td>Q4 86</td>
<td>11/29/1983</td>
<td>7/24/1984</td>
<td>-15.6%</td>
</tr>
<tr>
<td>Q1 113</td>
<td>Q3 13</td>
<td>5/1/2012</td>
<td>6/4/2012</td>
<td>-8.9%</td>
</tr>
<tr>
<td>Q2 15</td>
<td>Q3 16</td>
<td>5/19/2015</td>
<td>2/11/2016</td>
<td>-14.5%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td></td>
<td></td>
<td><strong>-16.2%</strong></td>
</tr>
</tbody>
</table>

Source: St. Louis Fed, U.S. Bureau of Economic Analysis, Bloomberg

Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise. 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.

Our conclusion is that the recent -19.8% decline reflects simply an earnings recession.

2). **We believe there is a risk that the Fed might NOT back off from their rate increase policy stance as quickly as the market wishes.**

The Fed closely observes the Chicago Fed Financial Conditions Index.

DISPLAY 3

Chicago Fed National Financial Conditions Index

2014 - present

![Chart of Chicago Fed National Financial Conditions Index](chart.png)

Source: Bloomberg as of December 19, 2018

The Chicago Fed’s National Financial Conditions Index (NFCI) provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets and the traditional and “shadow” banking systems. The NFCI is constructed to have an average value of zero and a standard deviation of one over a sample period extending back to 1973. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise. 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.
In February 2016 when then Fed Chair Janet Yellen reversed direction and announced further rate increases would be on hold, the Financial Conditions index was much more stressed than today.

Do conditions need to worsen before the Fed gets more cautious?

So again, our conclusion is that the -19.8% decline already priced in worsening financial conditions. However, as said before, any significant rally would only make the market vulnerable to a Fed that appears more hawkish than the market wishes.

We do believe the trade war will find some resolution in early 2019. Why? Because both sides desperately want and need a deal. The Chinese economy has slowed significantly (December Chinese Manufacturing PMIs were the weakest since early 2016) and President Trump’s litmus test of success, the stock market, has just taken a broad-side hit.

As much as we do believe that 2019 will be a better year, we need to remember just where the US is in the economic cycle: late stage. We are reminded of this quote:

Don’t tug on Superman’s cape. Don’t spit into the wind. And most definitely, don’t fight the Fed. That’s what they say on Wall Street. When the central bank is printing, get your money in stocks.

Financial conditions are actually tightening in the US. The Fed is gradually taking the punch bowl away. That is more analogous to spitting into the wind than down wind.

Yet there is a place in the world where the economy is weaker, where the stock market reflects even deeper pain BUT central bank policy is fueling a recovery. Here the wind is behind us.

CHINA.

China is using both monetary and fiscal stimulus to reignite their slowing economy. And with a market that has experienced a 32% peak to trough decline in 2018, we believe 2019 could potentially be a repeat of 2016 when China’s recovery led the momentum in the global recovery.

This is a major reversal from our 2018 outlook piece where we warned that:

the inflows into Emerging Markets and into EM Asia in particular have been red-hot recently, making them potentially the most vulnerable to significant pullbacks as market volatility increases in 2018.

Finally, in full disclosure, not all of our mean reversion projections for 2018 occurred. Non-US Developed Markets did not outperform the US in 2018. We felt that given their recent underperformance and given the US was likely to have a less stellar year, 2018 could be the year for global non-US relative performance to mean revert.


It would be so easy to throw in the towel. But in particular, Europe is flashing a very high level of bearishness. Our MSIM colleague Matthew Leeman penned an excellent piece titled Europe – forever the ugly duckling? With over $50 billion of net outflows from European funds just through October, 2018 is on track to surpass 2016 as the worst in 15 years.

Could some positive resolution on Brexit be the ignition for a rally? We will see shortly, but we do observe that most European economically sensitive stocks are dirt cheap versus their history. That tells us there is plenty of bad news imbedded in the prices.

In conclusion, as we enter 2019, there is no question that it is emotionally easier to be more bearish today than at the outset of 2018, a classic human behavior known as recency bias.

Therein lies the conflict we often discuss. The most powerful concept of investing is mean reversion, but that conflicts with human tendency to put greater weighting on what has just occurred.

Given 2018 appears to have cleared out many excesses, we are ultimately in the camp that believes 2019 will be a better year, as 2012 and 2016 were similarly better than most expected. Unquestionably, there are serious issues to overcome, but after a year like 2018 and removing the emotional toll, a higher level of optimism is warranted.
RISK CONSIDERATIONS

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.

DEFINITIONS

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 performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. market, including 500 leading companies in the U.S. economy. Standard deviation is a measure that is used to quantify the amount of variation or dispersion of a set of data values.

DISTRIBUTION

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


Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")’s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives, nature and risks before investing. As an investment fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.16% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

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.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.

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 or 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. This material has not been reviewed by the Monetary Authority of Singapore.

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.

IMPORTANT INFORMATION

EMEA: This communication has been issued by Morgan Stanley Investment Management Limited (“MSIM”). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

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.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. All investments involve risks, including the possible loss of principal. 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.

Except as otherwise indicated, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

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.

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.

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.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, 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.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail. Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM’s express written consent.

All information contained herein is proprietary and is protected under copyright law.

© 2019 Morgan Stanley. All rights reserved.

1 Sentiment Trader December 2018
2 CBS News December 19, 2018
3 Bloomberg December 2018
4 Casey Research, January 2014
5 Remain Calm and Carry On, January 2018
6 Morgan Stanley Investment Management. 2019 Market Outlook, Europe-forever the ugly duckling?