Morgan Stanley

INVESTMENT MANAGEMENT

Andrew Slimmon Equity Market Commentary

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

AUTHOR

ANDREW SLIMMON
Managing Director and Senior Portfolio Manager, Applied Equity Advisors

1. On the surface, **<u>I am surprised this most recent correction was so muted</u>**:

Consider:

a. Weakening US economic data is leading to a growth (recession) scare.
b. China tariff/trade tensions appear to be worsening.
c. Threats of Mexican tariffs.
d. Yield curve has reinverted.
e. As of April 30, 2019, the S&P 500 was up 18% YTD (i.e., vulnerable).

Yet the S&P 500 peak (April 30th, 2019) to trough (June 3rd, 2019) was only down -6.8%.

<u>Is that all the bears can muster?</u>

2. Some view the meager pullback as investor complacency; implying that the risks above are not being priced appropriately.

<u>I strongly disagree.</u>

3. Here is a little fact that I think explains exactly why we have not seen a bigger drawdown:

<u>Since 1940, we have never experienced two 10% drawdowns within 9 months of each other.</u> [1]

My explanation would be that skittish investors are so traumatized after the first 10% pullback they never reinvest. As a result, there is not enough ammunition for a second selloff of the same magnitude.

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

Consider:

a. The current % Bullish sentiment is 22%. The sentiment at the point of the December 2018 low which preceded a monster rally was 21%.[2]

b. Net long hedge fund exposure is about 5% (100% is the point of maximum bullishness). "Caution is eclipsing complacency."[3]

c. Mutual fund and ETF net flows have been negative every month YTD, with the exception of February, which was barely positive.[4]

So it's not complacency, but rather that investors are already prepared for the worst. **In my opinion, that puts a floor on the magnitude of the drawdown**.

Therefore, I suspect that the low of this correction is behind us….at least for now.

4. In the past, I have discussed that the period from just before US mid-term elections (end of Q3) to the end of the second quarter of the following year is historically an extremely good time for equities. **Since 1946, the market has been higher during this period 100% of the time** (18 out of 18 times).[5]

On September 30th, 2018, the S&P 500 was at 2,914. Either the S&P 500 will be above this level on June 30th, 2019 or the streak will be over. Although past performance is no guarantee of future results, I will go with 19 out of 19 times!

5. As I have also written in the past, a consistent pattern we have experienced in this current bull market is the retesting of corrections. **These retests have tended to happen around two months following the first drawdown**.[6]

If the most recent low was June 3rd, a **mid-summer retest** is entirely possible.

Of course, corrections happen for a reason. To me, a likely cause could be further anxiety about weakening growth, perhaps articulated during upcoming Q2 earnings reports. Time will tell, but that's one possibility.

6. I continue to believe that 2019, **a post-pause year**, will be a good year for equities, with the S&P 500 **north of 3,000** by the end of the year.

7. Portfolio Positioning

a. We are **maintaining our Asia ex-Japan technology** exposure, as much as that positioning has been painful lately. Chinese Internet stocks are down 20% since the April recovery high and are extraordinarily cheap versus their US comparables.[7] What's more, I do find it interesting that at the time when the Chinese government is helping their big Internet companies, our government is turning against ours. I would think that would result in a more narrow valuation gap.

b. Our global portfolios have roughly **20% allocated to Europe**. It's not huge, but it's not nearly as negative as most others are positioned.

c. In the US, our portfolios are **overweight growth, equal-weight bond proxy/defensives**, and **modestly underweight value**. This positioning has definitely helped our recent performance.

A few points on this:

1. It is **way too late** to get defensive. Utilities and REITs were by far the best performing sectors in May.[8] I suspect as we get further into the summer we may consider lightening up in these defensive sectors if and when we have some mid-summer chop.

2. Value is so under-owned (or even shorted) that ANY good news (such as a re-steepening of the yield curve or a Fed rate cut) could be a catalyst for a more sustainable equity rally. We think it's still a little too early, but something we are focused on.

3. Growth remains king, at least for now.

As always, we are agnostic towards regions and styles.

Just calling it how we see it!

Andrew

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. The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **Shanghai Composite Index** is a capitalization-weighted stock market index designed to track the price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. 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.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom**: Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. **Dubai**: Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany**: Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy**: Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands**: Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland**: Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074. **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 and nature of risks before investing. As an investment advisory 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

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 marketing communication has been issued by Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Authorised and regulated by Central Bank of Ireland. ("MSIM Ireland").

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.

[1] S&P 500 Index, Factset and Lowry's May 31st,2019.
[2] Bloomberg June 6th.2019.
[3] Nick Savone: Global Reflections May 31st, 2019. Long-Short exposure since 2010.
[4] Investment Company Institute.
[5] New York Times, Ned Davis Research
[6] 2010 retest 55 days later, 2011 retest 56 days later, 2018 retests, 53 and 56 days later.
[7] As measured by the KWEB ETF index.
[8] Factset.