Morgan Stanley

INVESTMENT MANAGEMENT

Monthly Commentary

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CONCLUSIONS:

1. Bear markets, as qualified by greater than 20% drops, are almost always in front of economic recessions. There are exceptions which we will address. And there is an economic recession out there eventually, but we do not see indications of one in 2019. We will detail why.
2. As much as we have just retested the October 29th low, bull market corrections (less than 20% drops) take time to work themselves out. Don't be surprised if this one has more pain remaining.
3. The momentum outperformance (largely comprised of large-cap tech) has reversed. This is actually healthy for the market. What if the Fed were to move to a "pause"? We believe that would accelerate a rotation into new leadership sectors.

Here are the details for each:

1. In my mind, unless there is at least a 20% drawdown in the US equity market, it really makes no sense to do anything other than to sit tight and gut it out (unless of course you want to pay more taxes, not less).

   Economic recessions are so relevant because, of the sixteen 20+% declines the US market has experienced in the past 85 years, thirteen of them were in front of economic recessions. Could an economic recession be around the corner?

   I doubt it, but must concede I am worried that I have not heard any strategist predict an economic recession next year. High levels of consensus opinion worry me. Having said that, the usual predictors that would justify being contrarian are just not there:

   a. The yield curve tends to invert well in advance of a recession. Currently it has not yet, or at the very least is only getting close to flat.[1]

   b. The Fed normally would be finished raising rates and is either well into the pause mode or is even cutting rates in front of a recession. Currently the Fed is still in raising mode.[2]

c. S&P earnings growth rate has peaked on average 4.5 years in advance of a recession. Currently 2018 might be the peak year, but 4.5 years ago it was not.[3]

d. Leading Economic Indicators have peaked on average 5 years before a recession. Currently 2018 might have been the peak year. [4]

Our conclusion is either:

a. We are about to face a recession that is unlike anything we have experienced.

b. There is something looming that could have a similar impact as one of those three times that there was a 20+% drawdown not in front of a recession.

c. No economic recession.

So which is it?

Here is something else that worries me:

As many who have read my comments for a while know, I believe investors generally overemphasize the geopolitical effect on the equity market.

But I must point out, one of the three exceptions when there was a bear market without a recession was late 1961 to 1962. And what was happening then? Rising tensions with a superpower…Russia. The Bay of Pigs, the Berlin Wall, culminating in the Cuban Missile Crisis, etc.

Is that analogous to today's rising tensions with another superpower… China? I think there is a chance we are underestimating the geopolitical risks today. Time will tell, and we could know a lot more shortly.

Nevertheless, my base case remains no recession….with the pain contained to less than 20% (although to be clear, over 40% of all S&P 500 stocks are down more than 20% from their highs).[5]

2. As I wrote last month:

B*ull market corrections during this 9 ½ year bull market have followed consistent "W" patterns. The selloff, partial rally and then a retest. To me, "W" bottoms seem consistent with investor behavior. "V" corrections don't clear out the weak holders like "W" bottoms do. And that is always healthy.*

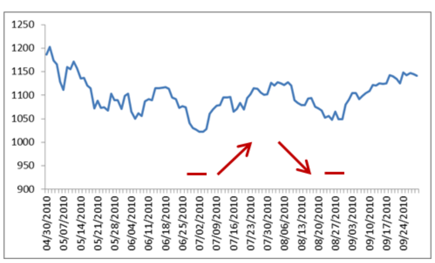
From September 20th to October 29th, 2018, the market experienced a 9.9% decline followed by a partial 6.5% recovery, only to drop back to the lows last Friday, November 23rd. Sounds like a perfect "W" pattern!

But here is the problem. Unfortunately the "retest", or the second "V" takes some time. Just look at three recent corrections in this current bull market.

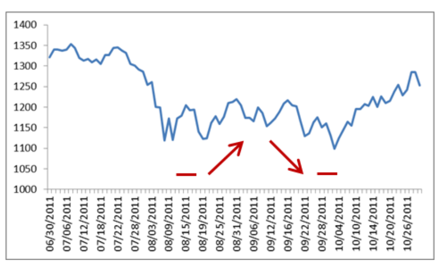
DISPLAY 1

S&P 500 Returns

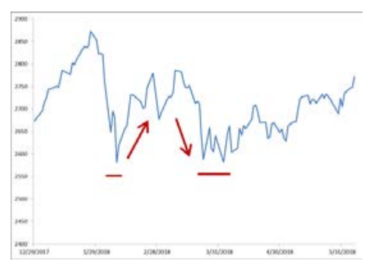
May 2010 through September 2010



July 2011 through October 2011



January 2018 through June 2018



Source: Bloomberg
*See risk considerations and disclosures below. **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. See Important Disclosures for index definitions.

In 2010, the retest was **38** trading days later. In 2011, it took **40** days. And earlier this year, the retest was **35** days later. Perhaps random, yet amazing in the consistency. With the recent low on October 29th, a more consistent retest would not come until just before Christmas. Not last Friday. ***Bah-Humbug!***

The mid-December Fed meeting and this week's G20 summit will obviously impact market sentiment near-term. Maybe this time is different. But the point is, I question whether we are out of the woods yet. I believe it makes sense to be prepared for more gut-check time.

3. In our September 12th commentary we wrote:

Top momentum stocks are now trading over one standard deviation expensive to the index. They certainly reached more expensive levels in 1999-2000 but generally speaking, this level is a warning sign that the winners are far outpacing the losers and reversion to the mean is a distinct possibility. From a sector standpoint, roughly half the momentum bucket is currently in technology and consumer discretionary.

Additionally, *30% of **every** US equity ETF (605 out of 1,756) hold FAANG names.*[6]

That is a combination of both expensive and crowded.

Since the September 14th market peak of outperformance, the XLK (Tech ETF) is down 14.5%, the XLY (Consumer discretionary) is down 12.7%, and the MTUM (Momentum ETF) is down 13.9% versus the S&P 500 down 9.4%.[7] The momentum carnage last Monday, November 19th alone was a 4 standard deviation one day event.[8]

We believe this is healthy for the market. Simply put, shake-outs that correct overbought situations are cleansing. We have seen this level of valuation/crowding a few times in the current bull market and rotations have consistently led to new leadership and *a resumption of the bull market.* But in late 1999, we saw *no* rotation once this high level of expensiveness was hit. No cleansing. Those momentum stocks became hyperbolically expensive. But that condition did not last long, and once that bubble burst four months later, it led to a very painful bear market.

While this is healthy for the market overall, this type of momentum correction tends to lead to new market leadership. In essence, the primary sectors that were in the momentum bucket are replaced. To me, that would mean out go US technology and consumer discretionary and in comes something new.

A change in Fed policy quite likely would accelerate such a rotation. There does seem to be some consistency in the types of stocks that lead during different parts of an economic cycle. When the Fed is raising rates, growth strategies tend to outperform. But once the Fed takes their foot off the brakes to move to the "pause" phase, growth strategies fade and stable value/dividend strategies lead the market.

That reminds me of the old saying, "the market has a tendency to move in a fashion that inflicts to most pain on the most participants".[9] If 30% of **all** ETFs own FAANG, I know where the pain is.

In conclusion, we believe the secular bull market is intact. Do not be shaken out during this corrective phase, even if has not run its full course. But we also believe there will be new leadership in the next leg.

Andrew

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[1] Bloomberg
[2] Bloomberg
3 Ed Hyman, Evercore ISI
4 Ed Hyman, Evercore ISI
5 Wilson Weekly Wrap, Morgan Stanley Research
6 William O'Neil and Co. "FAANG Capitulation"
7 Bloomberg. As of November, 23rd, 2018
8 Nick Savone, Global Reflections, Morgan Stanley Research This is provided for informational purposes only and is not an offer for any named ETF
9 Seeking Alpha. January 5th, 2018