Morgan Stanley

INVESTMENT MANAGEMENT

Mid-month Commentary

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Given the powerful beginning to 2018 and the questions we have received about the market's sustainability, we thought it was worthwhile to send a short mid-month commentary.

First, let me start with an interesting take on tax reform I heard this past week:

> *Warren Buffett said on CNBC's "Squawk Box." "You had this major change in the silent stockholder in American business who has been content with 35 percent ... and now instead of getting 35 percent interest in the earnings they get a 21 percent and that makes the remaining stock more valuable."*
>
> *The billionaire chairman and CEO of Berkshire Hathaway worked through the simple math. He said as a result of the tax bill a stock owner's share of profits went to 79 percent from 65 percent.*
>
> *"That's more than a 20 percent increase in the earning power. And you've just given it to me, nothing has changed in the business," he said.*
>
> *Buffett also said the magnitude of the corporate tax rate cut is not reflected in the stock market yet.*
>
> ***"I think 21 percent was not baked in. That's a huge reduction," he added.***[1]

I agree. I think we can conclude that tax reform was NOT baked into stock prices at the outset of 2018. *And we are seeing this at the portfolio level for the stocks we own.* Wall Street analysts have returned from their holidays, and as they work through their companies' lower taxes, they are raising their numbers. When this happens, stocks tend to respond positively. At least for the stocks we watch.

So are we nearing the end of this readjustment? Let's take a look.

Lower taxes impact earnings in two ways. First is the net benefit from paying that "silent stockholder" less. The second is what companies will do with the extra cash they won't be paying to that silent stockholder. *The earnings increases seem to be focused on the first benefit and I have seen very little discussion of the second.* Likely, that is coming.

But, let's discuss the first derivative: the tax cut.

Below is the current consensus 2018 estimate for the S&P 500 versus where the 2018 estimate was this past December and at the end of 2016. In our January 2nd outlook call, we mentioned that the number was actually *lower* at the end of December 2017 than it was a year ago. That has begun to change, but not by much. In our opinion, there is still more to go. I suspect by the time Q4 earnings conference calls are over, the 2018 numbers will be recalibrated substantially higher than the $3.29 they have been adjusted so far. Will the market anticipate this in advance? So far, not so.

DISPLAY 1

As of	2018 S&P 500 Consensus Earnings Estimate (per share)
1/12/2018	$150.12
12/20/2017	$146.83
12/31/2016	$148.80

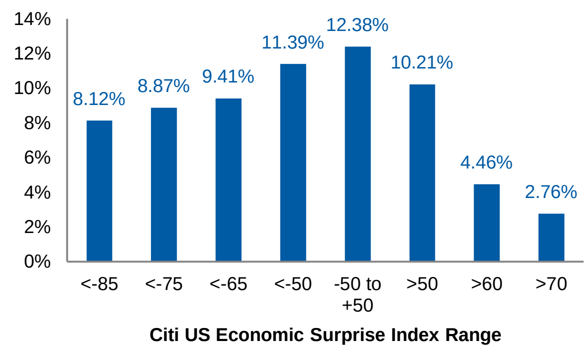
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
Source: FactSet

I think the second derivative is just as important, and Wall Street has appeared NOT to be focused on this…YET. What are companies going to do with that extra cash? In 2017, that cash was going to the US government and now it's staying with the companies that earned it. So if the ROE on that money is above 0%, it will be accretive to earnings. What about cash repatriation? *Accretive deployment announcements should cause yet another round of upward earnings revisions.*

So I have a hard time seeing a meaningful market pullback into the earnings season which is only getting started. But clearly, given the recent strength, the market is vulnerable near-term. Expectations of better economic growth are high and that has me worried. The Citi Economic Surprise Index recently hit its highest level in the past five years. And historically here is how the market has done when the CESI is north of 60 as it is currently.

DISPLAY 2

Average Annualized Forward 6-Month S&P 500 Total Return
January 2003 to December 2017 (daily data)



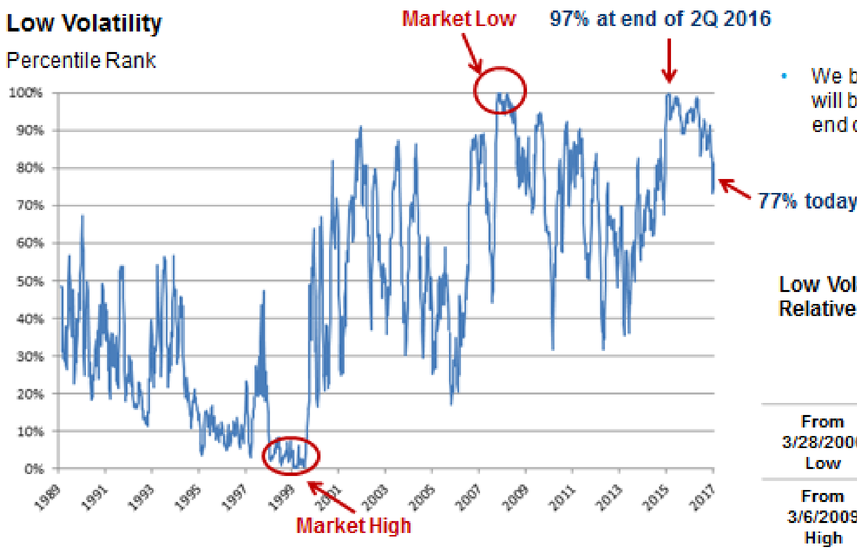
Source: Leuthold Group
This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index defintions.

Is this time different? Ultimately, stocks have tended to follow earnings and I do not think the earnings revisions are done yet. But near-term ancillary risks are growing. I suspect the market will become more vulnerable post earnings season.

One final note which has benefitted our strategies greatly this month. As anyone who has read my commentaries knows, for some time I have felt the most egregiously priced group of stocks has been the low volatility/bond proxies. Historically, the stock market has not peaked until investors stopped clinging to the measure of downside protection this group of stocks has tended to provide. As a result, our strategies have been underweight the group for a very long time.

Yet the low volatility/bond proxy stocks have remained richly priced far longer than I have felt possible. But a combination of: 1). higher interest rates, 2). better economic data, and 3). more positive investor sentiment has finally caused the unwind to begin. Notice their relative valuation has recently dropped, albeit from a high level. I suspect any negative economic surprise or market weakness will come with a short-term counter rally in these stocks. But longer-term, their cheapening valuations are entirely consistent with the euphoric stage of a bull market. And there seems to be a long way to go.

DISPLAY 3



- We believe low volatility stocks will be priced cheap at the tail end of a bull market.

Low Volatility Performance Relative to Russell 1000 Index

	Next 6 Months	Next 1 Year
From 3/28/2000 Low	+12.57%	+34.30%
From 3/6/2009 High	-27.65%	-28.64%

Source: Factset as of January 12, 2018. Low volatility is measured as average price to book valuation of bottom quintile based on weekly price standard deviation going back 20 weeks. Percentile rank of the ratio of Low Volatility P/B vs Russell 1000 P/B with 100% being the most overvalued and 0% most undervalued. **Past performance is no guarantee of future performance.** 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.

Andrew

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[1] "Billionaire investors including Tepper, Buffett-say Trump's 'huge' tax cut is bullish for stocks." CNBC. Tae Kim. January 10, 2018

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