Morgan Stanley

INVESTMENT MANAGEMENT

Mid-Month Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | MID-MONTH COMMENTARY | AUGUST 2018

"WHAT'S YOUR TIME-FRAME?"

AUTHOR

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

Given the number of questions we have received about the potential rotation from growth to value and the potential for a market decline in the US, here are our views on these topics.

Question 1: Is this Rotation from Growth to Value for real?

My conclusion is:

It depends on your time frame.

As part of our investment process, we track how expensive value is relative to the market versus history using Russell indices.[1] By the week of July 23rd, given the magnitude of outperformance of the growth index and the impact of that outperformance on the market overall, that value spread became one standard deviation cheap. In other words, value stocks became unusually cheap. The most recent two times that spread achieved this level of cheapness was in May 2012 and August 2015. Over the next twelve months, large-cap value did outperform large-cap growth both times.[2] So there appears to be some validity here. Cumulative fund flows into value managers by the end of June had trailed flows into growth managers by $15 billion YTD[3] which reconfirms:

1. Value was really unloved.
2. The consistency of human behavior, chasing what has already worked.

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.

Two caveats, however:

1. My comparisons were only for the last two times the spread became this cheap. In prior instances, value became 2.5 standard deviations cheap in 2008, and in 2000 it hit over 3. Let's say you had rotated into value early, when it became one standard deviation cheap in early 2008 or 1999. You would have been *crushed, destroyed, thrown to the wolves and probably would have lost all your assets* first *before* ultimately being positively rewarded by the end of 2009 and 2000, given the spread did resolve itself back to "fair value" both times. (As it did in 2013 and 2016 as well). In other words, being right, but way early is no better than being wrong.
2. While Growth underperformed Value in 2012 and 2015 from this point of valuation over the next year, returns were still very strong on an absolute basis.[4]

I do not believe we are in a period like 2000 or 2008, because growth is just not that expensive. While some technology stocks have become pricey, growth stocks are not to the levels of expensiveness they were in 2000, 2008 nor even in 2012.[5] Perhaps the best analogy is 2015, where value modestly outperformed growth over the next 12 months. Given value has already outperformed growth by 287 basis points since July 25th[6], a lot of outperformance has already occurred.

As a core manager, we have our feet in both growth and value camps but can move a bit more decisively one way or another if warranted. In my opinion, there is a lot of bad news priced into some of the value sectors (and emerging markets as well), and if we get any positive catalysts (such as resolution of trade tensions) these might likely continue to outperform near-term.

Bottom line: Tactically, we believe value is set up to outperform growth short term, but longer-term, I do not expect substantial outperformance. *What is your time-frame?*

Question 2: Is the Market Overall headed for Turbulence?

My conclusion is:

It depends on your time frame.

We have seen rolling bear corrections already in various equity markets. From their peaks earlier this year through July 31st, Emerging Markets is down 14%, Europe and Japan are down 9% and China is off 21%[7], but the S&P 500 is down less than 2%. Could the S&P 500 sail through without any further pain? I doubt it.

1. My experience is that when the market focuses on the micro (corporate earnings, new product announcements, 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 a 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.
2. Statistically, the market struggles in the three months leading up to the midterm elections (Aug-Oct). On average, down -1.1%.[8] Of course, the market won't bleed lower by a tiny percentage every day. So this further supports vulnerabilities.
3. My view since the beginning of the year has been that this will be a year with positive but less stellar returns for the market. But at July 31st levels, the S&P 500 was annualizing 2018 at an 11.3% return which in my opinion is probably a bit high.

All these point to a near-term market pullback or at the very least, justification for near-term more caution for the US.

But I have a problem with getting overly bearish on the market. Here's why:

1. Bull markets generally end for one of two reasons:
   a. Earnings estimates get way too far ahead of reality and as the economy turns, the numbers have to come down. That is the story of what happened in 2007.

      That is not happening now.

      Companies are reporting *better* than expected results. Estimates have been revised higher, not lower.[9]
   b. P/E multiples get to nosebleed, unsustainable levels, as we saw in March 2000.[10]

      That is not happening now.

      At current levels, the market is trading at 15.8 x the current 2019 estimate. A pretty reasonable level. And if we do have some sort of pullback, that would make the market even more attractive on a P/E basis.

2. As I wrote in the May commentary:

> *Post the last 18 mid-terms, the market has generated an average return of +16.5% over the next 12 months. And the "hit ratio" is 100%, meaning the market has been positive all 18 times.*[11] *So a pretty good outlook later in the year.*

Bottom line: Tactically, I do expect some sort of near-term weakness, but looking out longer-term, I expect more gains ahead. *What is your time-frame?*

One final point about markets rotating and churning. Personally, a broadening out of performance for the market is a great relief. Narrow breadth is a dangerous indicator. As someone trying to balance delivering performance with good risk management, it becomes problematic when only a couple of very high priced stocks deliver most of the return of the market as they did in Q2 and into early July. Three cheers for more stocks participating, even if the overall market might experience a greater case of the jitters near-term.

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 designed to measure performance of developed equity markets globally. The term "free float" refers to the portion of shares deemed to be available for purchase in public equity markets. The Index's performance is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. 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 **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI Japan Index** is is designed to measure the performance of the large and mid cap segments of the Japanese market. The **Russell 1000 Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those companies with lower price-to-book ratios and lower expected growth values. The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those companies with higher price-to-book ratios and higher forecasted growth values. **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.

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 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. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. **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.

---

[1] As measured 100 cheapest stocks on a P/BK, P/E and P/FCF basis relative to the Russell 1000

[2] As measured the performance of the Russell 1000 Value Index as surrogate for large-cap Value and Russell 1000 Growth Index for large-cap growth.

[3] Morgan Stanley Research

[4] Returns over next 12 months:

2012	Russell 1000 Value:	36.9%
	Russell 1000 Growth:	27.6%
2015	Russell 1000 Value:	12.7%
	Russell 1000 Growth:	12.0%

[5] As measured 100 stocks with highest estimated growth rate relative to the Russell 1000.

[6] As measured the performance of Russell 1000 Value as surrogate for large-cap Value and Russell 1000 Growth for large-cap growth.

[7] As measured emerging markets:EEM, Europe:IEV, Japan:EWJ, China:SHCOMP.

[8] Over a 72 year time period. Sam Stovall. "Market Wrap". June 3rd

[9] The 2018 consensus S&P 500 estimate has risen over the last month from $160.94 to $161.31 and 2019 from $176.94 to $177.61. Factset

[10] The forward P/E in March 2000 got to 24.2x. Bloomberg

[11] Sam Stovall. "Market Wrap". June 3rd.