

Positioning



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Climbing the Wall of Worry—Still

As I wrote earlier this month in *On the Markets*, there has been an extraordinary amount of concern about the next downturn. In fact, since the beginning of this bull market in early 2009, more has been written about the potential risk than the reward. I suspect this is to be expected after two 50% corrections in US equities that left virtually every investor severely damaged and scarred. What it really did was prevent people from embracing one of the best cyclical bull markets of our lifetime—in both stocks and bonds.

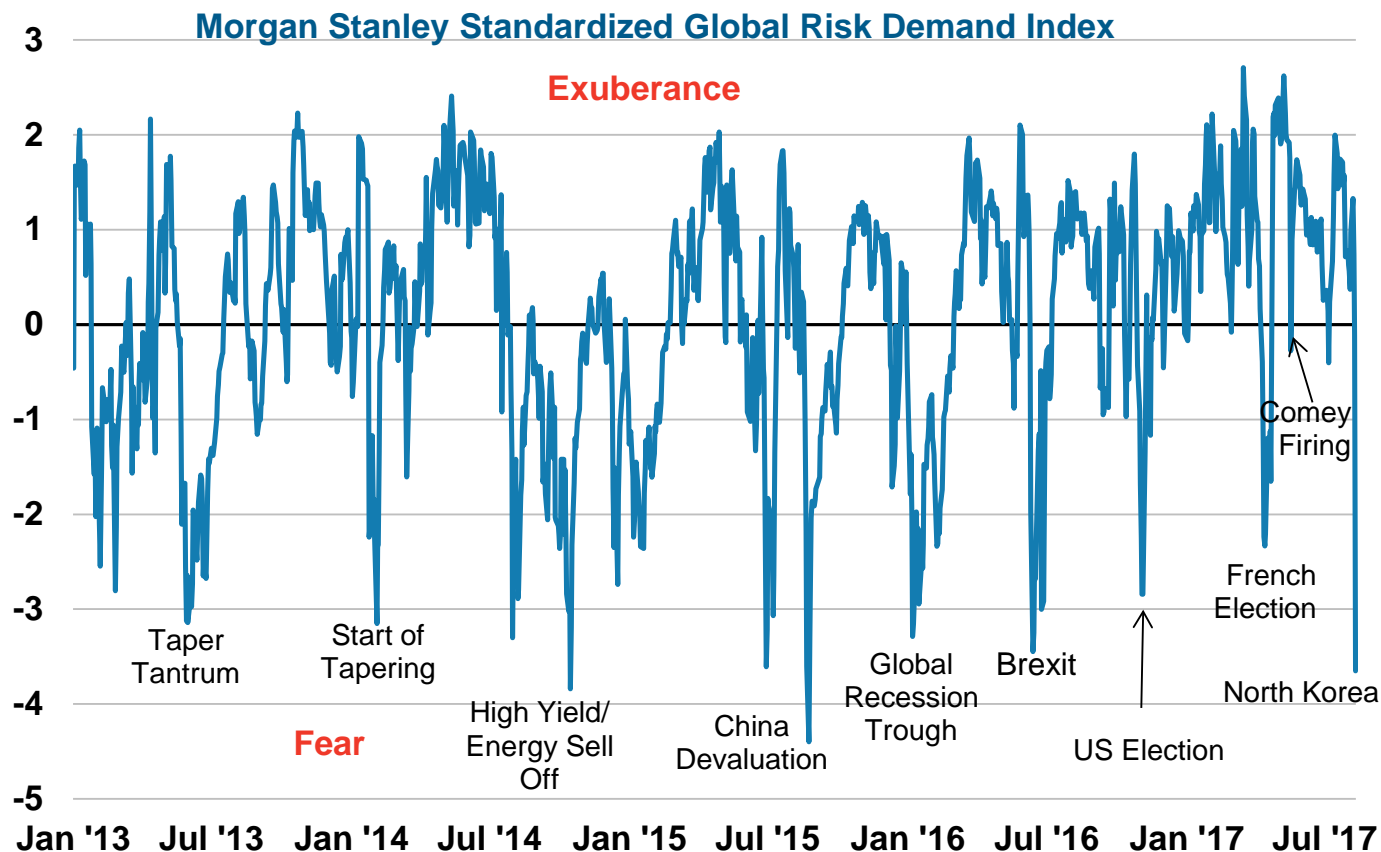
Truth be told, the best returns of this cycle are likely behind us. However, there should still be good returns to be had before the end of this cyclical bull market. Fretting about minor corrections is exactly the kind of behavior that has prevented the average investor from fully participating during the past eight years. The concerns lately have been circumstantial for the most part, lacking in fundamental merit and centering on speculation about what bad things could happen. In contrast, our work has been focused more on what we can analyze and predict. Specifically, we're concerned with corporate profits, economic data and other macro factors that tend to lead the earnings cycle. The biggest benefit of such focus is that it keeps us out of the political and geopolitical arena which, generally, is a distraction.

In January, we provocatively titled our year-ahead outlook "Are You Ready for Euphoria?" because we thought investors were finally ready to embrace this bull market. From a price standpoint, we can say "so far, so good." Global equity markets are annualizing north of 25% for the year to date, with the riskiest markets leading the way. The S&P 500 Index is annualizing at just 19% which puts us right on track for our target of 2,700 by year-end—a target we maintain in the face of continued skepticism. Investors and the media have yet to embrace this bull market and until they do, we are likely to keep climbing the wall of worry.

The latest worry is investor complacency. Specifically, there is great concern that low volatility in the markets is bound to reverse, that investors are ignoring the real concerns about North Korea, a US debt ceiling that expires this fall, an unpredictable president and Washington gridlock. Our view is that the equity markets have low volatility because we have been experiencing low volatility in the things that drive equity prices—interest rates, economic data and corporate earnings. Therefore, low volatility is not the



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Exhibit 1: Investors Are at Their Most Risk Averse Position in Two Years

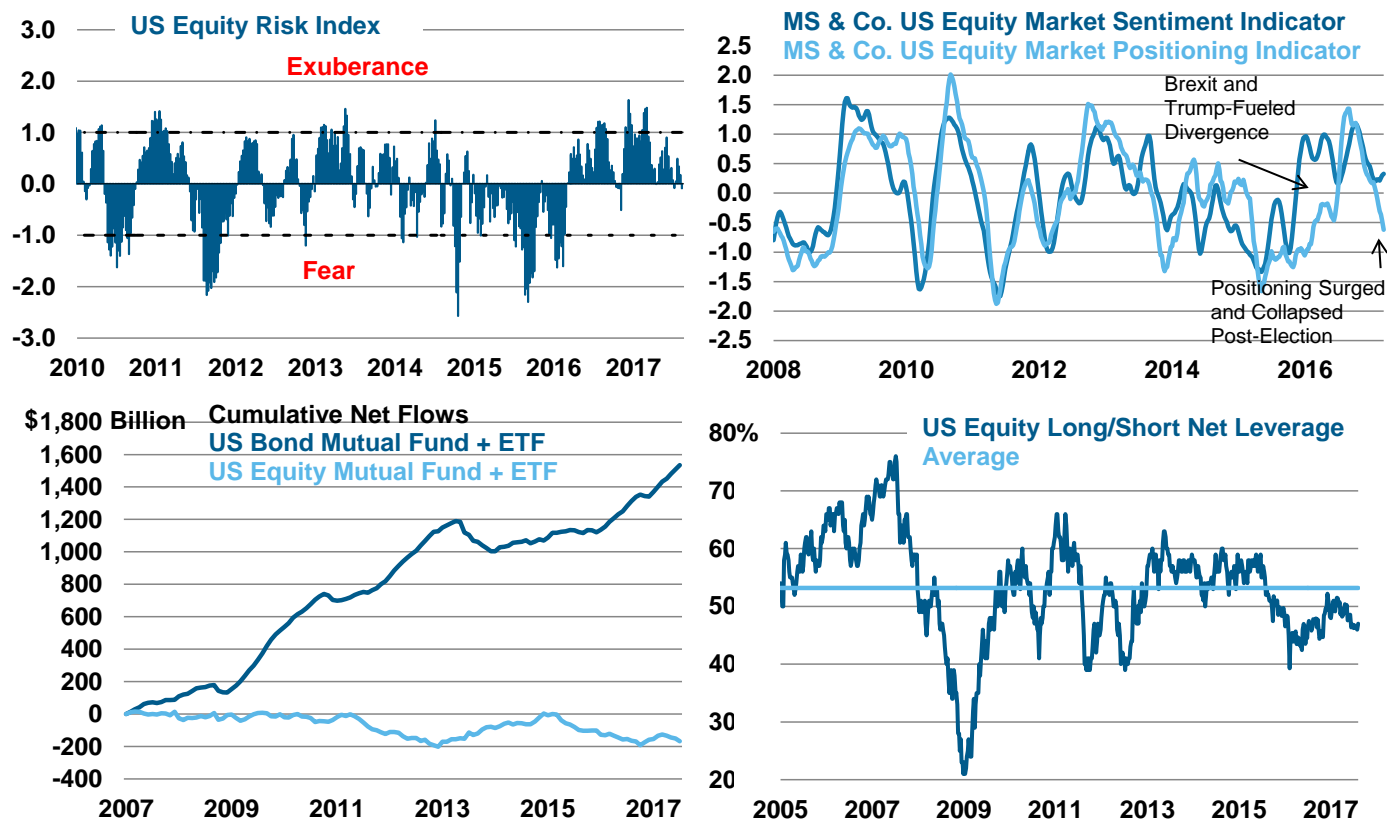
Source: Morgan Stanley & Co. Research as of Aug. 11, 2017; Morgan Stanley Prime Brokerage as of Aug. 11, 2017; Haver Analytics, ICI as of July 31, 2017; Morgan Stanley & Co. Research, Morgan Stanley Prime Brokerage; Haver Analytics, Bloomberg, FactSet as of July 31, 2017

result of investor complacency but rather reflects a very good investment environment that should be embraced. This past week, that view was challenged by escalating concerns about a potential military conflict with North Korea. In three short days we seem to have corrected that anomaly (see Exhibit 1). In short, this chart is our proprietary measure of risk aversion in global equity, credit and currency markets. It is based on volatility and when volatility spikes, the line goes lower. As you can see, investors have reached one of their most risk averse postures in the past several years—a time when we've had some rather scary events.

To further our point about investors' lack of willingness to embrace this bull market, we show a series of charts (see Exhibit 2, page 3). First, top left is our proprietary US Equity Risk Indicator which combines both sentiment and positioning data. As you can see, we are in a neutral zone after reaching a more exuberant range at the end of last year following the US election. Since then, investors have become more skeptical about policy change and hence less bullish about US equity markets. On the top right, we break down positioning from

sentiment data and discover a widening divergence between the two, with investor positioning more negative than sentiment. This looks similar to last fall's pattern going into the election season, which turned out to be a positive set-up for a strong finish into year-end. We think today's divergence is the result of investor anxiety about normal seasonal weakness in a year that has yet to see more than a three percent correction. To us, this means it's going to be difficult to sell-off significantly when investors are already set up for it. The bottom left chart simply shows how unloved this bull market has been by individual investors. Since 2007, US equity mutual funds and exchange-traded funds have suffered net outflows to the tune of \$250 billion while close to \$1.6 trillion have flowed into bond funds—wow. Finally, on the bottom right, our hedge fund clients currently have net equity exposure well below their historical average since 2005. Specifically, hedge funds have only been more conservatively positioned 17% of the time going back to 2005—hardly an exuberant position.

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Exhibit 2: These Measures Show Investors Still Unwilling to Embrace the Bull Market

Source: Morgan Stanley & Co. Research as of Aug. 11, 2017 (upper left) ; Morgan Stanley & Co. Research, Morgan Stanley Prime Brokerage, Haver Analytics, Bloomberg, FactSet as of July 31, 2017 (upper right); Haver Analytics, ICI as of July 31, 2017 (lower left); Morgan Stanley Prime Brokerage as of Aug. 11, 2017 (lower right).

What Are We Watching?

Our call for a powerful global equity rally driven by earnings growth and multiple expansion has played out nicely over the past 18 months. So, I understand investors' anxiety. Nobody wants to be the last one to the party, especially given how bad the last two recessions were for investors. As I have been writing as MSWM's chief investment officer for the past four years, we are laser-focused on preserving our clients' capital without abandoning their investment goals.

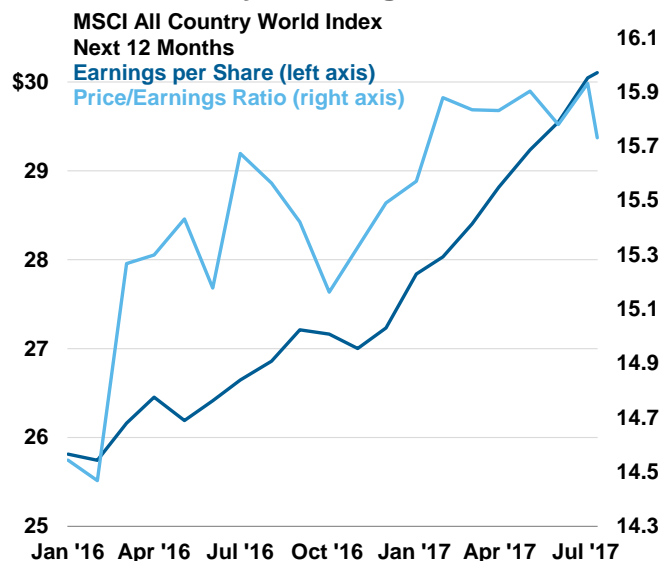
So, with that as a backdrop, what *are* we watching to tell us it's time to reduce risk? Simplistically, prices for risky financial assets (stocks and credit) are determined by growth and interest rates. Given that we are solidly in the midst of the most synchronous global economic recovery since 2010 and the just-reported second-quarter earnings season was once again much better than expected, we are comfortable with the growth side of the equation. Despite this better growth, interest rates have remained subdued. Meanwhile credit spreads take their cues from company fundamentals, so the better economic and

earnings results have kept spreads tight, which is another healthy sign. What this all adds up to is easy financial conditions which, in turn, support higher equity valuations and prices—exactly what we have witnessed all year.

Exhibit 3 on page 4 shows the MSCI All Country World Index against the forward 12-month earnings forecast and forward price/earnings (P/E) multiple. What's clear is that both earnings and valuations have been expanding for the past 18 months. This has been our call; so when people ask us what is going to drive equity prices higher going forward, my response is the same thing that has driven them the past 18 months—earnings and valuations. Many will argue that valuations are already stretched with some saying we are in a "bubble," a term that's grossly overused. As you can see, the earnings recovery could not have been smoother or steadier while the valuation expansion has been choppier. However, each has contributed about half of the total return in the index during this period, a healthy balance in our view. Currently, the forward P/E is 15.7, which does not seem egregious given the exceptionally low interest rates and inflation around the world.

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Exhibit 3: Global Equity Markets Have Been Driven by Earnings and Valuations



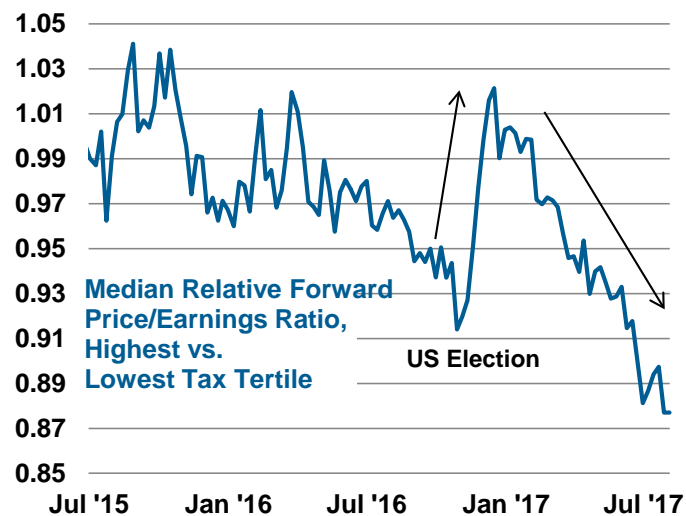
Source: FactSet as of Aug. 10, 2017

We also have an eye on equity risk premiums—the excess return that the stock market provides over the risk-free rate—which remain elevated around the world as they have been since the financial crisis. However, with the significant changes last year in terms of both monetary and fiscal policy direction, we think equity markets now realize growth is likely to be better and more stable going forward. This argues for lower risk premiums, or higher equity valuation; and that is exactly what has been happening. We think the revaluation process is incomplete and expect another 10% before we reach “fair value,” at which point further appreciation will have to come purely in the form of earnings growth. In the meantime, we will be monitoring our growth indicators and financial conditions for any sign that the revaluation process will end prematurely.

Be Careful What You Wish For

There continues to be a tremendous amount of attention on the lack of progress in Washington on the new administration’s progrowth agenda. So far, we have seen meaningful action where legislation is not needed. Specifically, there have been numerous executive orders that reduce the increasing regulatory burden as well as appointments of people who share the goal of sharply reducing existing regulations. For instance, the “one in, two out” rule-making order is a perfect example of such change. We have also seen pipelines approved that were blocked for years and a repealing of regulations through the Congressional Review Act. Perhaps the most important change that isn’t often discussed is the appointments of “deregulators”

Exhibit 4: Tax Cuts Appear to Have Been Priced Out of the Market’s Expectations



Source: FactSet as of Aug. 10, 2017

to key government posts: Secretary of Energy Rick Perry; EPA Administrator Scott Pruitt; Secretary of Education Betsy DeVos; Federal Communications Commission Chairman Ajit Pai; and Randal Quarles, nominated but not yet confirmed as vice chair of the Federal Reserve Board for bank supervision. Such appointments will have a dramatic effect on how existing laws and regulations are interpreted and could reduce the red tape that has been slowing growth for the better part of two decades.

The American Action Forum, an independent nonprofit think tank run by former Congressional Budget Office Director Douglas Holtz-Eakin, estimates that the reduction in regulations under the new administration could reduce more than \$100 billion in costs for the US economy per year. Fewer regulations will also make it easier to get business done, which ultimately means more new job creation and economic growth. By the way, this is not a partisan issue and the increase in regulation did not start with President Obama. In fact, regulations have been expanding for 25 years under both Democrats and Republicans. The pendulum has simply gone too far—a natural response to a financial crisis—and there is a long way for it to swing back. According to the Bureau of Labor Statistics, 4.7 million jobs were created by establishments less than one year old in 1999—a number that dropped to 3.0 million in 2015. While not all of this is due to greater regulation, it has been blamed for a good part of it.

Meanwhile, the inability of the Republican Congress to repeal and replace the Affordable Care Act has lowered investor

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confidence on the parts of the progrowth agenda that do require legislative approval such as tax cuts and an infrastructure bill. We can see this in the valuations of companies with high tax rates relative to those with relatively low tax rates (see Exhibit 4, page 3), not to mention the continued downward pressure on long-term interest rates. It also explains a good part of why small- and mid-capitalization stocks have underperformed large-cap stocks this year. Said another way, the market is no longer expecting tax cuts, and this is arguably a good thing because it lowers the bar for what companies need to deliver on earnings.

Our view is that we are likely to get a tax deal before the end of the first quarter of 2018 simply because politically, the Republicans have to deliver something going into a very important midterm election year. However, as we look forward

we can't help but think additional fiscal stimulus—mainly tax cuts and infrastructure spending—might not be what we need at this stage of the economic cycle. After all, the economy is in pretty good shape at the moment, growing at a 2.6% annual rate in the second quarter with full employment and inflation under control. This has allowed the Fed to move slowly and keep the party going. If we were to get a big fiscal stimulus at such a late stage in the economic cycle it might very well ignite inflation expectations and interest rates. If so, the Fed would likely tighten even faster, thereby bringing the end of the cycle sooner than it would otherwise occur. In other words, as investors we should be careful what we're wishing for at this point. ■

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Index Definitions

MORGAN STANLEY & CO. EQUITY MARKET POSITIONING INDICATOR This indicator combines data on mutual fund beta, hedge fund net leverage and fund flows..

MORGAN STANLEY & CO. US EQUITY MARKET SENTIMENT INDICATOR This indicator is a compilation of the percentage of bulls measured in surveys by Domini Social Investments, the American Assn. of Independent Investors and Institutional Investor.

For index, indicator and survey definitions referenced in this report please visit the following:
<http://www.morganstanleyfa.com/public/projectfiles/id.pdf>

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