WEALTH MANAGEMENT

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Positioning

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Here We Go Again

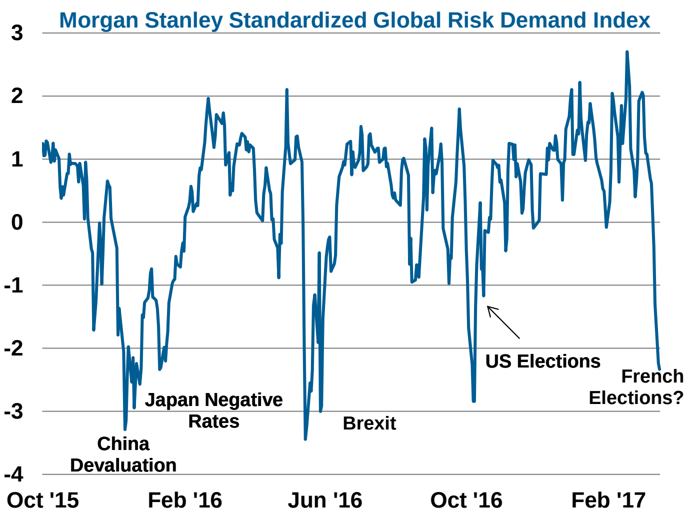
Albert Einstein is credited with saying, “insanity is doing the same thing over and over again and expecting different results.” First, I would never disagree with Albert Einstein about anything because, well, he’s Albert Einstein. Second, we all have examples of doing this in our personal lives. In my case, I can point to arguing with my wife thinking that *this* time I might win.

I’ve always felt like financial markets only exist to torture their participants, which is another form of insanity. We often recognize familiar patterns in stocks, bonds or currencies but then suggest “this time it’s different.” Of course, it’s usually not different this time and the markets have done their job once again of driving us insane. Most recently, we have noticed one such pattern creeping into the markets surrounding political events. With respect to policy and politics, 2016 was definitely a year to remember or, depending on one’s view, to forget. First, we had China’s currency devaluation and Japan’s foray into negative interest rates. Second came the UK’s referendum on whether to leave or stay within the European Union—the “Brexit.” Finally, of course, who could forget the US presidential election won by Donald Trump?

Each of these events had a meaningful impact on markets and its participants. While actual price moves varied greatly between the three, the risk aversion that got priced was quite similar. Exhibit 1 (see page 2) shows the Morgan Stanley Standardized Global Risk Demand Index, our favorite short-term measure of investor risk demand. The index gauges risk aversion by looking at volatility across global currency, bond and stock markets. It generally does an excellent job of capturing investor sentiment and can be indicative of actual positioning. We find the index to be most useful when it is at extreme levels, particularly on the downside when risk aversion, or fear, is high.

Looking at global risk demand, we see that market participants “reacted” strongly to the China devaluation and Bank of Japan’s move to negative rates in January 2016. That proved to be a great buying opportunity for risk assets. In June, we got a strong negative reading two weeks prior to the Brexit vote as market participants started to hedge the event. Still, there was a secondary reaction when the results came in, because not everyone had hedged. With the US election, hedging was also prevalent going into the event. Fear bottomed days before the actual results and then never returned to those levels. Today, we are witnessing another significant decline in risk demand as we approach the first round of the French presidential election on April 23.

Exhibit 1: Global Risk Demand Index Shows Investor Reaction to Major Events



Source: Bloomberg as of April 13, 2017

Are investors insane to do the same thing they have done on three recent occasions and expect a different outcome? Not necessarily, because for many short-term traders and even some investors, it is their job to hedge this type of risk. We think there could be maximum fear and hedging around the first round of elections, which may also coincide with rising geopolitical tensions surrounding both North Korea and Russia. However, we do not expect to see as big of a drawdown in global equities as during last year's scares—13% on China's devaluation, 8% on Brexit and 5% on the US elections. So far, global equities are down about 2% from the highs in March but still up 6% for the year to date. We recommend investors ignore these short-term moves and believe they create opportunities to add to holdings that should rebound quickly once these events pass. Of course, one must assume that the fundamental outlook affecting these assets remains intact, which we do.

An Economy With Broad Shoulders

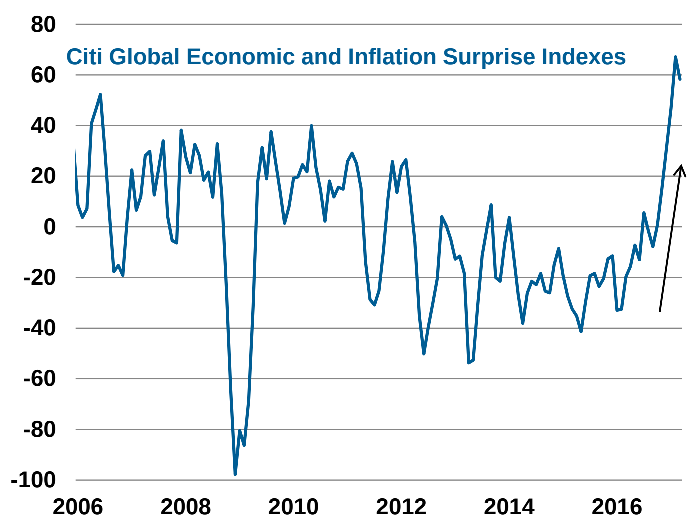
The global economy was already on the mend at the start of 2017, but the first quarter has shown even greater strength in the data. In fact, we are now experiencing one of the most synchronous economic expansions since 2009, when the global economy was starting to recover from the financial crisis. In our view, this is notable and important because it suggests that this time the expansion might be more sustainable. One of the salient traits of the recovery since 2009 has been below-trend GDP growth; less appreciated has been its fleeting nature. Every time it seemed like we were gaining momentum, a shock or drag appeared that prevented us from reaching escape velocity, leaving us mired in a lower growth channel. This is one of the reasons why monetary policy has remained so accommodative eight years into a recovery.

What we like about the data this year is the breadth we are seeing. In fact, when looking at the *combined* economic and inflation data, the surprises have never been greater or broader in the past 15 years (see Exhibit 2). In fact, Chetan Ahya and Elga Bartsch, Morgan Stanley & Co.'s chief global economists, just published a note highlighting this breadth and have raised their forecasts to the long-term average for the next 12 months. In fact, for the second quarter, they are now forecasting 4% global GDP growth, the first 4% print since the third quarter of 2013.

What's important about looking at the combined economic growth and inflation data is that this is a better representation of *nominal* rather than real GDP, and nominal GDP is a much better proxy for revenue growth. Our conclusion is that the breakout in this combined measure is indicative of a world that may be seeing a real uptick in nominal GDP and therefore revenue growth, exactly the headwind that investors have been discounting for the past several years. It's also why yield, quality and safety have been overpriced. We're seeing some of these factors come back into favor more recently as investors once again worry about shocks that could knock us back.

These data have not been lost on the stock market. During the first quarter, global stocks were up 7.5%, the best gain since the second quarter of 2013. More important, the breadth of this performance—the percentage of global stocks that were up—was the strongest since the second quarter of 2009. Based on our

Exhibit 2: Global Economic Surprises Have Been Highly Positive



Source: Bloomberg, Citi as of March 31, 2017 philosophy of "trust but verify," such a strong signal from the market is comforting if not confirming of our view that this recovery is more sustainable and should, at the minimum, last through the remainder of the year. The bottom line is that we have more confidence in our positive outlook for global economic and earnings growth, and hence, for equity markets.

Trump Trades Fade

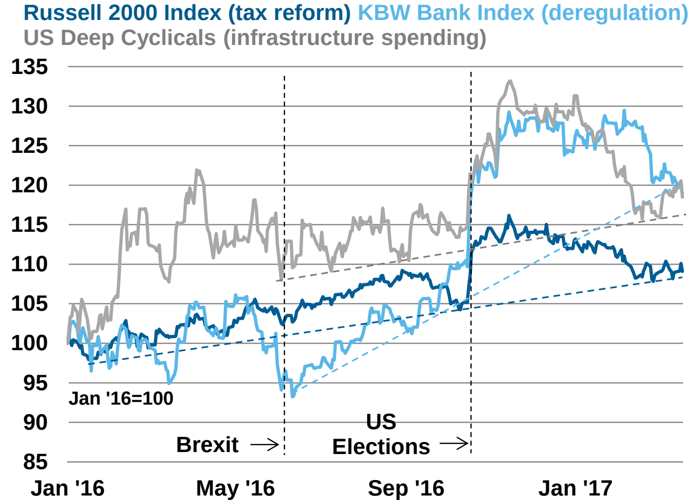
Since the presidential election we have gone through many stages of Donald Trump and his administration. While I'm not sure we are yet at the "acceptance" stage, it does seem like there is at least a lull in the media hyperbole, some of which may be related to the more restrained behavior of the president himself. In other words, people seem to at least be getting used to Donald Trump as president. However, there has also been a discounting process ongoing with respect to the president's ambitious progrowth agenda of lower taxes, reduced regulation and deficit spending on infrastructure. This, too, is weighing on the bullishness of many assets tied to these policies, not to mention the confidence of market participants and strategists.

This discount seemed to reach new heights when, lacking the votes on a Republican plan repeal and replace Obamacare, the House leadership did not allow the bill to come up for a vote. Many are citing this as a repudiation of Trump and his administration's ability to legislate, and conclude the progrowth policy is less likely to get done. Our view is that the market had been discounting that possibility for months and the health care flop may simply be the point of public recognition. A closer examination reveals this much more discriminating opinion by the market all year.

As our readers know, our view is that the markets were already discounting the very powerful cyclical upturn in the global economy by the time the US election took place. While the Trump/Republican win can accurately be described as a surprise to a large majority of individual market participants, the real impact could be seen in three key cohorts: banks, which would benefit from deregulation; small-cap stocks, potentially big winners from tax reform; and deep cyclicals, which stand to gain from infrastructure spending. Exhibit 3 shows the performance of these three cohorts relative to the S&P 500 since the beginning of 2016.

A few observations: First, the relative outperformance of all three began long before the election, largely due to the cyclical upturn in the global economy, though some might have been due to the likelihood of a Trump victory seeping into the broader market. For deep cyclicals and small caps, their relative outperformance began almost simultaneously with the cyclical

Exhibit 3: "Trump Trades" Started Before His Election, and Have Largely Faded



Source: Bloomberg as of April 12, 2017

trough in global growth in January 2016. Financials didn't bottom until after the Brexit vote and the final collapse in bond yields that took place in early July. Second, all three cohorts enjoyed an additional boost from the Trump turbocharge following the election, but they peaked in late December as the market began to question the ability of the incoming president's ability to legislate rather than pontificate.

Finally, both small caps and deep cyclicals have given back almost all of their post-election relative performance while banks have ceded about half. This makes sense to us because financial deregulation doesn't require legislative support the way tax reform and fiscal spending do. In other words, the market is putting very little value on Trump policies that require legislation. Meanwhile, emerging markets and health care stocks have done great this year, which suggest the market is not been worried about protectionism or the repeal of Obamacare. Rather than "bad Trump" getting priced, it's more like "ineffective Trump."

Still, we think there will ultimately be progress on tax reform and deregulation this year even if it takes longer and may be on a smaller scale than originally expected. In the context of what has been discounted by the market at this point, this will be viewed positively and we don't think this is a big significant risk to equity prices at this point. As a result, we suggest adding large-cap banks, small- and mid-cap stocks, and deep cyclicals like industrials and materials stocks which are levered to the acceleration in global synchronous growth. ■

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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