Positioning

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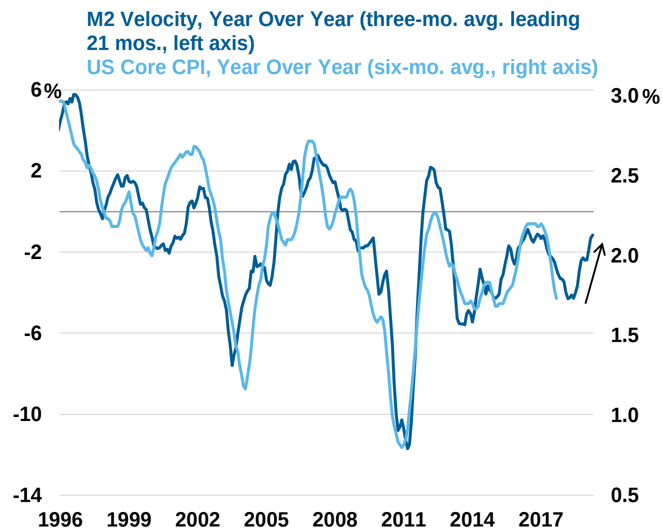
Finally Seeing Some Optimism

During the past 18 months, our primary narrative about the investment landscape has not changed much. However, I have noticed market commentators, the media and institutional investors starting to acknowledge this narrative more broadly. Specifically, I now hear many espousing the "synchronous global recovery" theme we were highlighting a year ago and the idea that corporate earnings are the main reason for the global equity rally. Meanwhile, we no longer get pushback on our call for higher valuations and there's less hand-wringing over political or even geopolitical concerns; our view has been consistently that the business cycle trumps politics. As long as we see accelerating growth and stable financial conditions, equity markets around the world will likely continue to perform well, especially in the context of such negative investor sentiment. However, sentiment is no longer so negative, though it's still far from exuberant. More on that in the next section.

The one part of our narrative that has yet to catch on is that inflation is not dead and may be stirring, getting ready for a more significant run next year. Fixed income investors in particular have essentially given up on inflation ever coming back as little upside risk of that happening is priced into interest rate markets. Even the Federal Reserve seems to be perplexed at why inflation remains so low in the face of full employment and an economy that seems to be doing just fine. Everywhere I travel in the US I see a boom as measured by the lack of open seats on airplanes, sold-out hotels and crowded restaurants, not to mention the almost out-of-control construction activity in every city. These are exactly the kinds of things that lead to inflation, but we aren't in the business of guessing. Instead, we have leading indicators to help us navigate.

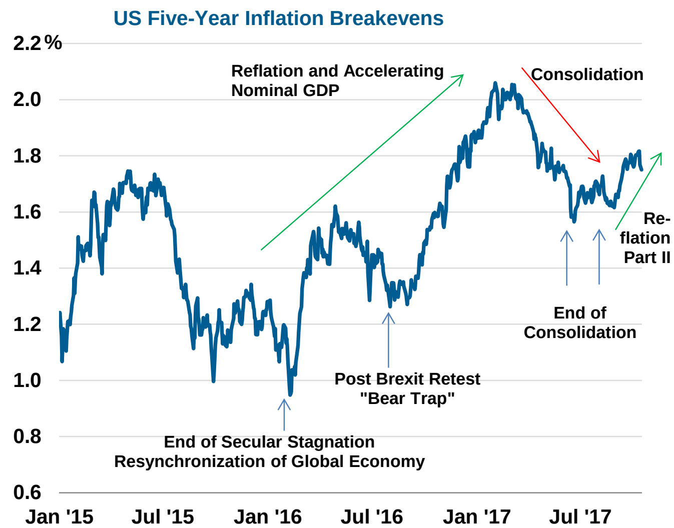
The year-over-year change in money velocity is our favorite indicator because it's been quite accurate for more than 20 years (see Exhibit 1, page 2). As the chart shows, money velocity (dark blue line) typically leads core inflation (light blue line) by 21 months. It clearly predicted a precipitous fall in core inflation this year. So, to hear institutional

Exhibit 1: Our Favorite Indicator Points Toward Rising Inflation



Source: Haver Analytics, Bloomberg, Morgan Stanley Research as of Aug. 31, 2017 (M2); of Sept. 30, 2017 (core CPI)

Exhibit 2: Reflation Part II Appears To Be Underway



Source: Bloomberg, Morgan Stanley Research as of Oct. 12, 2017

investors and even Federal Reserve officials talk about how they are confused as to why inflation is falling this year actually confuses us. Many drivers of inflation work with a long lag and so focusing on current data can lead to wrong conclusions. The good news is that our indicator is suggesting we are likely to see a near-term trough in core inflation before it ramps up into next year toward the Fed's 2% goal.

Perhaps you might be asking why this is good news? Isn't inflation a bad thing? Who likes higher prices? Generally speaking, high inflation is a bad thing and for those of us who can remember the 1970s, we know how destructive it can be. However, inflation that is too low or outright deflation can be just as destructive—just ask Japan. The other factor that must be considered is the fact that there is still a tremendous amount of outstanding debt in the world, especially at the government and corporate level. In such a world, deflation is like kryptonite. So, anytime inflation looks like it's breaking lower—like this year—it makes global investors and markets quite nervous. Therefore, a signal that inflation is bottoming should be welcomed by global equity investors.

The other reason rising inflation is a good thing is that it suggests secular stagnation—a permanent, low-growth regime—is ending. Regular readers may recall our aggressive stance in the summer of 2016 that cited the Brexit as an important bottom for growth and inflation expectations—that is, the end of secular stagnation. We viewed the enormous flight to safety immediately after the referendum as a final capitulation to this long-standing consensus view. Because they are emotionally charged, political events have a way of faking out even the smartest investors. We view the US election of Donald Trump in the same manner for the US specifically. Markets understand this quite well even if investors remain confused (see Exhibit 2). Inflation expectations clearly bottomed with the resynchronization of global growth in February 2016. The affirmative Brexit referendum simply served to retest that bottom, but without new lows. Last fall, reflation became the rage as many governments focused on progrowth policies thanks to political pressure that culminated with the US elections in November. As usual, investors then became too excited and bid inflation expectations too high, along with assets that benefit from higher growth and interest rates—i.e., banks, small-cap stocks, energy and industrials. After trading down in the middle part of the year, those assets reasserted their leadership in August and should continue to be good areas to look for further outperformance until the end of the cycle.

Euphoria Remains Absent

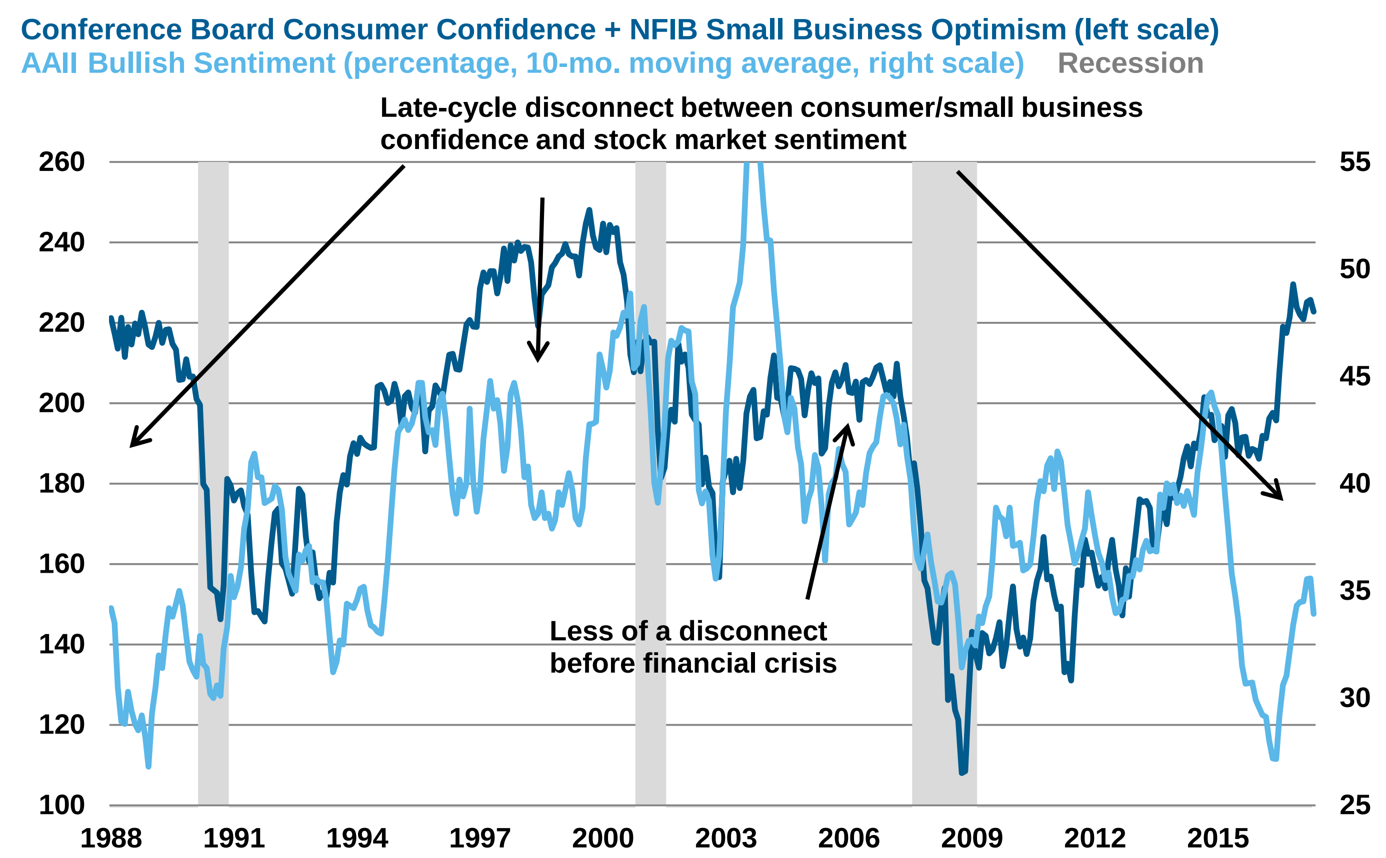
After the 2016 election, there was a burst in confidence from both individuals and small business owners that was unusual. We wrote about this earlier in the year and highlighted the fact that we have never seen such an increase in the combined confidence of individuals and business owners in the later stages of an economic expansion. Based on this observation and other factors, we thought investors would finally capitulate in what has been the most hated bull market in history and show some signs of optimism if not outright euphoria—the classic signs of a market top.

While institutional investors, the media and some sell-side commentators have started to show signs of capitulation this year, we have not yet observed that with individuals' behavior. Immediately following the US election we did see a material inflow to US equity exchange-traded funds (ETFs) and mutual funds from retail investors. That is precisely why some of the global reflation trades noted above got ahead of the fundamentals at the beginning of the year. However, once they faded, so did the flows, or vice versa. During the past six months, retail flows to US equity ETFs and mutual funds have been *negative* to the tune of approximately $75 billion.

Exhibit 3 illustrates the divergence between confidence in the economic environment and investor sentiment. As you can see, consumer and business confidence remain at elevated levels after the rise late last year. Some might be surprised at this fact given the seemingly incessant noise around politics, three major hurricanes and devastating fires. To me, these high readings simply reflect what we have been highlighting all year: We are in the midst of the broadest and most synchronous global economic recovery since the financial crisis and people are feeling the positive effects of that in their paycheck and job security. Nowhere is this confidence more evident than in the quit rate, which is at its highest since 2006, and unfilled job vacancies, which are the highest since 2000.

So why is investor sentiment still muted? Part of the answer is that due to the financial crisis and the dot.com bubble bursting in 2001-2002, retail investors remain scarred and apprehensive about investing in equities. That may not change for this generation, which means we may not reach a level of euphoria this cycle. The other observation is that this is typical behavior in a late-cycle economy. Looking again at Exhibit 3, we can see this divergence in both the late 1980s and late 1990s. In both periods, confidence was high, the economy was humming but investor sentiment stayed low. Only in 2005-2007, another late-cycle period, did we observe relatively bullish retail investor sentiment. Nevertheless, retail sentiment is much closer to the lows of the past 35 years and well below average, arguing we

Exhibit 3: Wide Divergence Between Economic Confidence and Investor Sentiment



Source: Bloomberg as of Sept. 30, 2017

are likely to see some optimism like the spike late last year. I suspect it will coincide with tax legislation being signed by early next year along with continued economic and earnings growth, which we foresee lasting well into the first half of 2018.

Tax Cuts Still Not Priced

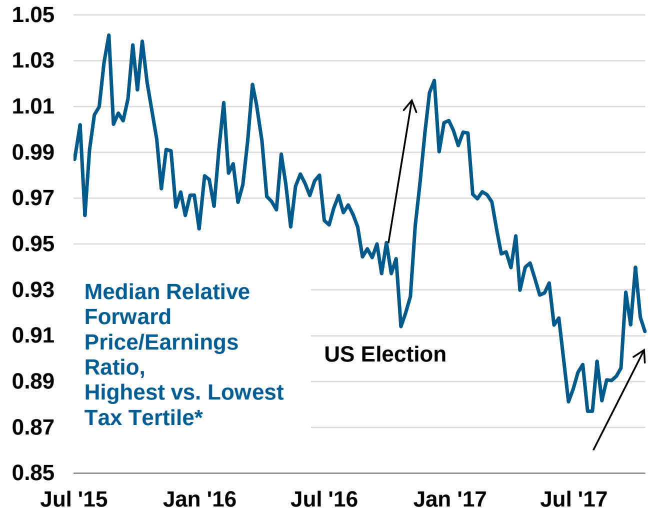
In the past several quarters, we have witnessed both too much excitement and too much despair around the progrowth agenda put forth by President Trump and the Republican leadership. It's important to note that uncertainty surrounding the agenda has not had a negative effect on consumer or business confidence—both remain remarkably resilient. We have also noticed that confidence has not yet translated into economic actions by either corporations or individuals—similar to the divergence in investor sentiment.

We think much of this inaction has to do with the uncertainty and timing around tax reform. For example, it's difficult for corporate managers to decide capital spending budgets or whether they want to engage in mergers or acquisitions until they know if and how the tax code might be changing. Similarly, consumers may be waiting to act on their higher confidence until they see some more details here, too. In other words, we think there is a lot more to the tax cuts than just a tax bill and higher profits. Lower tax rates could have a positive effect on the entire economy which would enhance the top line and create a virtuous circle of profits.

Recently, small/mid cap stocks have rallied sharply on increased expectations for tax cuts. For most of this year, small/mid caps underperformed large-cap stocks as the progrowth agenda seemed to sputter. Back in August we highlighted these fading expectations and we thought it had gone too far, recommending clients look again at stocks that would benefit the most from tax cuts. Small/mid-cap stocks qualify given their higher effective tax rates relative to large-cap stocks. The rally has been quite positive but we think there is more to go if tax cuts actually happen—an outcome we now handicap at 75% probability by the first quarter of 2018.

What gives us confidence that tax cuts are not fully priced? We looked at the valuations—price/earnings (P/E) multiples—for

Exhibit 4: Valuation Shifts Back Toward Companies With Higher Tax Rates



*S&P 500 companies
Source: FactSet as of Oct. 13, 2017

the companies which pay the highest tax rates in the US relative to the companies that pay the lowest tax rates (see Exhibit 4). It's easy to see that immediately following the election, we saw a massive spike in the relative valuations for the higher-taxed companies relative to the lower-taxed companies. One could argue this valuation disparity went too far, but it spent most of the year revaluing lower as hopes for tax and other progrowth legislation faded. By August, this fear became too great, in our view, which is why we then recommended clients increase their small/mid-cap stock investments.

As you can see, there has been a sharp rebound but it's fair to say it could go much further based on the post-election move. So, while we expect some consolidation and even modest correction in equity markets after such a good run, we would be looking to add to those sectors and styles levered to tax cuts and better global growth and inflation. Those include small/mid caps, energy, financials, industrials and technology. ■

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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