# THE HARBOR VIEW

A QUARTERLY INVESTORS REPORT FROM **THE HARBOR GROUP AT MORGAN STANLEY**

## Q3 2021

### EXECUTIVE SUMMARY

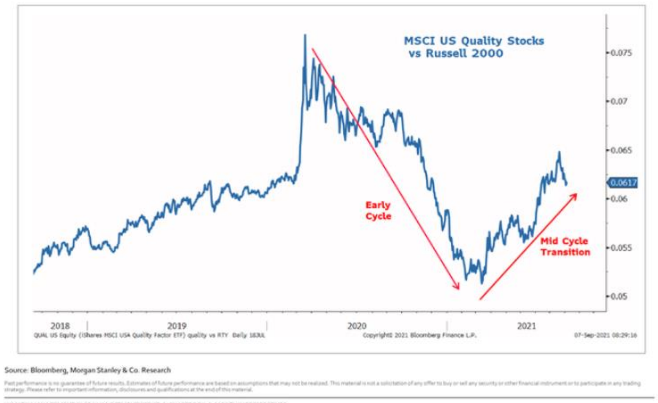

An impressive corporate earnings season catalyzed the market higher for most of the quarter. However, fears over the spread of the Delta variant soon weighed on growth estimates as the service sector failed to recover as quickly as expected. This was initially met with the Fed reassuring markets that while they were planning to taper bond purchases, the decision to hike rates would be tied to stricter contingencies, including full employment. This sent 10-year treasury yields lower and prompted growth-oriented stocks to initially resume their leadership. As the quarter progressed, inflationary pressures continued to mount due to tight supply chains, labor shortages and rising commodity prices. Fed Chairman Powell finally cautioned that these factors may last longer than expected and caught the market off guard by signaling that tapering could end as early as the middle of next year, which put the probability of rate hikes back on the table. The sharp upward move in yields that followed sent equity markets lower, especially longer duration growth stocks. From here on out, we believe that growth is likely to decelerate as input and labor costs begin to weigh on margins at the same time as taxes are set to rise and monetary and fiscal policy gets pulled back. We recommend staying balanced across style boxes as market leadership may remain inconsistent. We continue to favor owning quality companies with strong pricing power and brand loyalty.


### A Colder Winter?

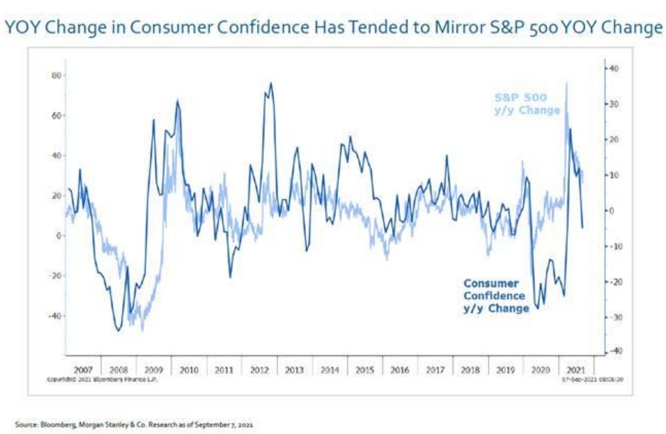
- Equity upside will become more limited given the potential for tapering and higher rates.
- Corporate profits are likely to decelerate due to higher costs from tight supply chains, labor shortages, rising commodity prices and potentially higher taxes.
- We see more upside in International Equities that have been late to the recovery as vaccination rates in Europe and other Developed Markets now exceed those in the U.S.
- We recommend a barbell approach between quality growth stocks and consumer cyclicals to hedge against a variety of market rotation outcomes that are dependent upon interest rates and COVID cases.
- We continue to prefer credit and shorter duration assets within fixed income as investors are not getting paid to take on duration risk.
- We continue to like structured notes and select alternative investments as a source of yield and diversification. This includes private real estate, which can also hedge against inflation.

**Markets**

A rise in COVID cases caused by the spread of the Delta variant temporarily slowed down the global reopening process. It initially resulted in a reversal in market leadership away from cyclical re-opening stocks back to defensive and growth-oriented quality stocks that are less economically sensitive. In a similar fashion, larger cap stocks that have been better able to sustain margins in the face of higher costs have outpaced small caps.

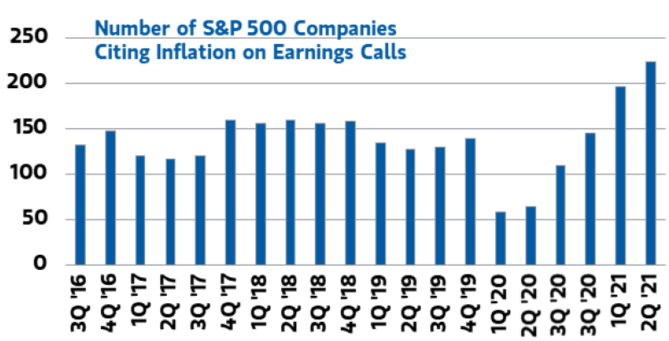



The disappointing August jobs report and declining consumer confidence led to a massive reduction in forecasts for third quarter GDP (Global Domestic Product) growth. At Morgan Stanley & Co., Chief US Economist, Ellen Zentner, slashed her forecast to an annualized 2.9% from 6.5%. Consumers have not shown the same strength in services consumption due to the severity of the Delta variant. As consumption makes up 70% of the economy, its recovery will be critical to the market.



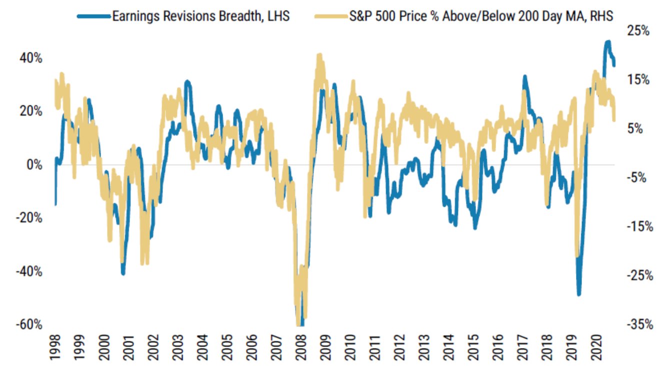

Demand across the sectors that were hit the hardest by the pandemic including air travel, hotels, entertainment, leisure, and restaurants has been much weaker than expected. As a result, hiring in those sectors has also been weaker, which caused the August nonfarm payroll report to disappoint. If COVID cases were to subside consistently, we may get a rotation back towards some of the consumer services stocks that have suffered from the rise in Delta cases. While this presents some opportunity for upside on the services demand front, we still believe that corporate profits will get pressured worse than many anticipate. Currently, labor remains constrained for several reasons. Unemployment benefits have incentivized many to stay at home while others have either left the workforce altogether. There has also been an accelerated pace of retirement among baby boomers. Therefore, even with the recent expiration of unemployment benefits, payroll reports are showing that job gains are now coming with higher wages as employers struggle to fill positions. The Job Openings and Labor Turnover Survey, known as "JOLTS," continues to show job availability at all-time highs with nearly two jobs available for every unemployed adult. The emergence of new disruptive sectors is also adding to the increase in job options. With the worker now having the upper hand, it appears that wage pressures are here to stay. In addition, other inputs also continue to remain scarce due to supply side bottlenecks persisting. Weather-related disasters have only made matters worse by leading to delays and lost demand from product unavailability. Many companies have even reinstated purchase limits on basic high demand consumer items. Shipping costs have also increased meaningfully. The World Container Index (WCI), which is a benchmark for the container freight rate, has increased sixfold since January 2019. The Baltic Dry Index, which is a proxy for global shipping from Asia, is now at its highest since 2005. Commodities and energy prices have also gone up. Industrial metal prices for copper, zinc, aluminum, and nickel are all up while West Texas Intermediate (WTI) crude is back above levels last seen in 2018. Despite decarbonization efforts, weather related incidents have kept the pressure on supplies while demand has been resilient. The prices of both thermal coal and natural gas have gone up, making electricity costs even higher. Investors have assumed that companies will be able to pass on these costs to consumers. We argue that it will not be so easy to do so across the board. The increase in what companies are paying to make goods is now outpacing the increase in consumer prices. The Producer Price Index (PPI), which represents corporate/wholesaler costs, has risen eight months in a row and is now running at 10.5% year over year. On the other hand, the Consumer Price Index (CPI), which represents what consumers pay for goods, is running at 5.3%. The gap between costs and prices received is one of the largest in more than 40 years and has typically coincided with lower 12 months forward S&P 500 margins. Corporate management teams have already expressed concerns about slower growth from higher costs, tight supply chains, labor shortages, rising commodity prices and potentially higher taxes. This will likely result in analysts being forced to start cutting earnings revisions. Forward earnings revisions are still currently overly optimistic, especially for companies that saw a strong pull forward in demand. A potential rollover could catch markets by surprise. Operating margins are currently at historically unprecedented levels as corporations had massive operating leverage thanks to a reduction in labor costs coupled with a cheap cost of capital and unleashed pent up demand. Going forward, this will no longer be sustainable. While earnings may be still be strong, a slowdown is imminent due to the peak in the rate of change.

Companies in S&P 500 Citing Inflation Increases




Source: Bloomberg as of Sept. 23, 2021

We expect that stocks have already started to sense this as the percentage of stocks trading above their 200-day moving average has started to roll over.




Source: Factset, Bloomberg, Morgan Stanley Research

Even the Fed has marked up its tapering and rate hiking forecasts as it finally acknowledges the persistence of inflationary pressures. This caused 10-year yields to jump. The rise in rates means that financial conditions are tightening, which will weigh on equity multiples. The move back and forth in rates has also impacted market and sector leadership. Higher rates have been accompanied by Value outperforming Growth and small caps outperforming large caps, even if they all turn down together. Another risk continues to be COVID cases. While we continue to remain optimistic on this front, growth may disappoint further if the areas that have been most impacted by the pandemic do not recover as quickly as expected. We also expect that slower growth in China will have implications for overall global growth. These headwinds include the bankruptcy of property developer, Evergrande, and the crackdown on Chinese companies by their government. Either way, we may get a pullback before year end due to either higher inflation and interest rates or a more significant growth disappointment. Unlike the second half of 2020 and the first half of 2021, the safety net of unprecedented fiscal and monetary support will be behind us. While we expect the debt ceiling to be raised, we note that the passage of an Infrastructure deal is different from sending people checks. This time, it won't be free – it will be paid for via higher taxes. This could potentially hinder investment growth from both corporations and individuals.

**International Markets**

Like the Fed, the European Central Bank (ECB) has also decided to reduce the pace of asset purchases under its pandemic emergency purchase program for Q4. Europe has followed the same playbook as the U.S. and China as both growth and inflation have exceeded expectations. While earnings estimates still lag pre-COVID levels in some areas, earnings revisions have been rising. After a rough start due to lockdown measures and a slow vaccine rollout, Europe has overtaken the U.S. in vaccination rates. The Euro area PMI (purchasing managers' index) has also come in higher than expected, implying that business activity is increasing. Japan has also started to recover as its vaccine rollout is finally picking up. Within Asia, Singapore has been a clear vaccination outperformer.

Emerging Markets have been more of a mixed bag. COVID worries, inflation concerns, and China's regulatory crackdown on tech, education and consumer companies have led to negative sentiment toward emerging markets, driving their underperformance. Some countries have seen a retightening of COVID-related restrictions while others have had to grapple with rate hikes in the face of inflationary pressures that have been running well above target. China had to reimpose travel restrictions and local lockdowns within the country during a major part of the summer holidays. Brazil, India, Russia and Mexico, among others have already hiked interest rates to fight high inflation. Differences in vaccination rates have also been extreme. Higher commodity prices have benefited emerging economies that are net exporters. We reiterate that EM performance as a whole may tell a very different story than that of individual regions. We would also point out that the MSCI Emerging Markets Index is dominated by Asian growth companies. This brings us to our next point – China. We remain bullish on China over the long term despite the painful recent underperformance. China's main goal is to advance its middle class and surpass the United States as the top international powerhouse. Xi Jinping's policies have been successful in moving millions out of poverty so far. This is precisely why China has stepped-up regulation as businesses have grown unchecked. While China has placed additional compliance burdens on the consumer and internet sectors, many of these companies are essential to China's growth and provide essential value to its users due to their strong network effects. While most U.S.-listed Chinese stocks already have dual listings in Hong Kong, Chinese companies can continue to go public in the U.S. as long as they meet listing requirements. Companies have been given three years, which is ample time to provide sufficient audit disclosures or list elsewhere. The education sector experienced an idiosyncratic shock as spending on private tutoring comprised an extreme portion of the Chinese consumer's income and led to inequality. China has been adamant about achieving independence in key segments of its economy including technology, and the "Made in China 2025" plan is a testament to that goal.

We also do not believe that Evergrande's bankruptcy will lead to a major financial contagion. Our Asia Economists believe that the spillover risk to China's overall economy will be manageable. However, it will likely weigh on China's growth for the next few quarters, which may weigh on sentiment. China has also struggled with a widespread energy shortage that has led to power cuts and forced parts of its manufacturing sector to go offline. This will negatively impact the country's industrial activity as well as global supply chains.

**Fixed Income & Rates**

As we've mentioned, the Federal Reserve has changed its tone from first saying that tapering does not mean tightening. The Fed has recently articulated that we should expect tapering to begin in December. However, the speed in which they expect to finish tapering took the market by surprise and caused a pullback. The target of mid 2022 is about a quarter sooner than the market had been anticipating and increases the odds for a rate hike in 2022. Treasury futures have significantly moved up expectations for the first rate hike to occur in 15 months as opposed to 18 months. We have also met the criteria for substantial further improvement toward the Fed's inflation goal. In fact, inflation is now historically high and well above the Fed's 2% target. Chairman Powell is also optimistic that the economy is on track to deliver "maximum employment." How much the virus continues to spread will impact the Fed's goal of full employment. Services such as hospitality and leisure are tied to consumer sentiment with regards to the virus. We believe that many facets of inflation will not be transitory. As we mentioned, workers have gained the upper hand when it comes to the prices they expect to be paid. It will be a lot more difficult for employers to slash wages again, especially as workers have more options. The same goes for rents. According to Morgan Stanley & Co.'s property & real estate investment trust analysts, effective rent growth on a year-over-year basis is testing new highs this quarter, and the level now stands 9% above the 2019 average. We expect that it will take well into next year for supply chains to get back to normal. That leaves plenty of time for upward pressures to build on core goods prices.

As rate moves have been volatile over the course of the year, we don't think it's worth taking on duration risk especially as the Fed steps aside as a bond buyer. In addition, increased fiscal spending on infrastructure and other measures will also place upward pressure on yields. We prefer credit, which has been resilient given strong corporate profitability and healthy balance sheets. While global equities have had some minor downturns this year, credit markets have shown no deterioration. In fact, credit spreads have tightened further.

**Closing Thoughts**

While we do not think the pandemic will upend the market's recovery, the spread of the virus can certainly impact the rotation from goods to services, which account for 70% of GDP. What we do have more conviction in is that growth is likely to decelerate as financial conditions tighten. Valuations remain vulnerable if higher-than expected inflation persists and earnings roll over due to higher input and labor costs, lost demand and margin pressures from higher taxes. While we will have an event heavy quarter to navigate, we prefer to remain opptimistic while preparing for negative outcomes as well as investment opportunities. Many risks remain as we close out the year but we remind investors that it is normal for growth to moderate after a post-recession bounce.

**Hot Topic**

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