THE HARBOR VIEW

A QUARTERLY INVESTORS REPORT FROM THE HARBOR GROUP AT MORGAN STANLEY

Q2 2022

EXECUTIVE SUMMARY

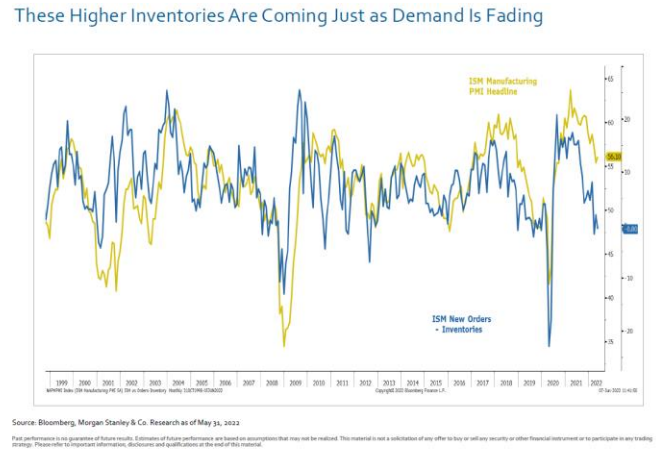
2022’s volatile bear market has been frustrating following the past several years of exceptionally strong returns with short corrections. In fact, even the ones we experienced in 2018 and 2020 have lasted less than 30 days. While the swift derating of asset prices may feel extreme, we remind investors that we are simply coming out of a two-year V-shaped recovery period in which companies significantly over-earned given the vast extent of COVID-19 induced stimulus. While growth was expected to slow from unsustainably high levels, the extent of that slowdown has yet to be accounted for when looking at how high earnings estimates are currently. We do not think it is feasible for companies to maintain record-high operating profit margins in the face of surging costs, a stronger dollar and declining sentiment from both consumers and CEOs. The inventory glut that we are seeing as supply chains heal confirms that companies were not prepared for the demand destruction that is taking place due to a payback in demand following a period of overconsumption. We believe we are reaching the point where many companies will no longer be able to pass along rising costs to consumers that are getting deterred by high inflation. We advise clients to remain patient and avoid short term relief rallies until multiples rerate to a level that more accurately addresses these concerns.

Current Thoughts

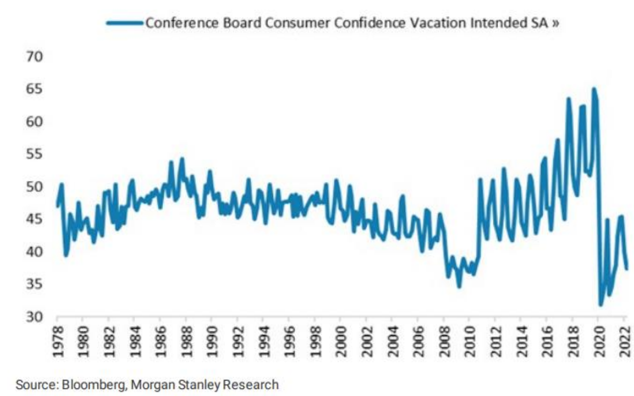
- We see current S&P 500 forecasts implying 13.5% year-over-year profit growth as unachievable as companies grapple with higher costs, worsening sentiment, and lower demand.
- Financial conditions are likely to tighten as the Fed begins unwinding its massive balance sheet and may be forced to increase the pace of its rate hikes.
- While we still do not expect an economic recession, a profits recession is much more likely.
- We expect a discounting cycle to lead the next round of stock derating as companies will struggle to maintain pricing power if inflation causes the consumer to pull back and downgrade.
- The probability of another 75-basis point rate hike at the next Fed meeting has increased given that inflation continues to surprise to the upside, hurting both consumers and businesses.
- Following a Fed tightening induced sell-off, we see opportunities in treasuries, investment grade credit and municipal bonds. As we get closer to a peak in rates, we expect them to behave more defensively.
- We like structured products and alternative investments as lower volatility options and diversifiers.
- We recommend staying diversified across styles, geographies, and market caps. Past underperformers such as small caps and international stocks are likely to fall less from here as their earnings expectations have already been cut lower.

Markets

We have been experiencing a rolling bear market across many asset categories over the past 12 months. While the S&P 500 has fallen over 21% so far, there has been much worse damage at the single stock level. Companies entered 2022 with record high profits that were well above the long-term trend. Although CEOs started citing rising pressures from higher wages, raw materials and other expenses, markets largely shrugged off concerns about rising inflation as companies successfully passed these costs along to consumers. In fact, inflation was seen as a positive for stocks as higher prices initially led to higher profits when demand held. However, earnings guidance, revisions, and corporate sentiment have all moved to their lowest levels since the pandemic began in 2020. Rising food and energy costs, in particular, have had the net effect of a tax increase on consumers, hurting many more stocks than it helps. The length of the ongoing war in Ukraine has further amplified this and creates additional uncertainties. Although earnings growth has already slowed sharply, current S&P 500 forecasts are still trending upward and implying 13.5% year-over-year profit growth. We are skeptical given that prices are now reaching a point where they are causing a destruction in demand as the consumer struggles to spend as much in the face of higher inflation. Consumer sentiment is plummeting given a 20% year-over-year contraction in real personal disposable income due to the end of COVID-linked government transfer payments. Consumer spending is expected to slow down meaningfully. We remind investors that the market is not the economy. Although consumers may still be contributing positively to GDP growth, they will do so at a much lower level. This rate of change will weigh on margins and markets. The pricing power that many companies enjoyed thus far is unlikely to be sustainable. We are already seeing this as inventory metrics have returned to pre-pandemic levels while companies were not prepared for the decline in consumer demand that left them with excess product on hand. This typically triggers a discounting cycle which can further pressure margins as companies cut prices to lure back consumers.

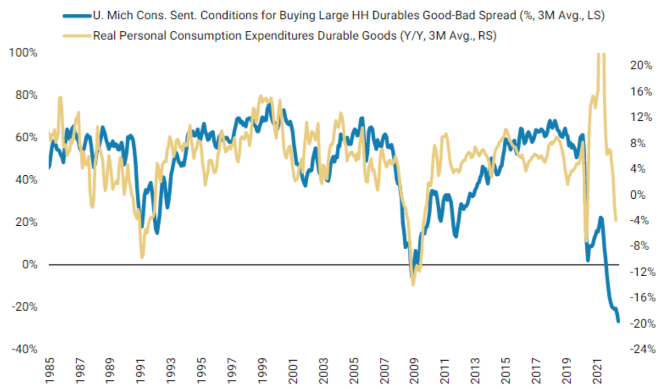


Over the past few weeks, the consumer sector has been exponentially punished as several large retailers cited much weaker than expected demand and profitability. Retail sales also posted an unexpected 0.3% decline in May. This is essentially a reversal of the over earning companies experienced or a payback in demand from the COVID-induced economic lockdown. While this has caused some investors to shift their focus back towards the re-opening trade, we would argue that the shift from goods to services may also disappoint as it is comes at a time when inflation is cutting into non-discretionary items like shelter, food, and energy. As noted below, airline and other travel expenses are now becoming out of reach for many households.



This time around, we are no longer convinced that the consumer will save the day when it comes to elevated earnings expectations. We would note that the most recent drivers of heightened inflation as measured by the CPI (consumer price index) were from non-discretionary items such as medical care and rents as well as surging prices for services. It is no longer deniable that inflation is broadening out and has the potential to stay higher for longer. While we acknowledge that consumer balance sheets remain healthy, there is a big difference in whether consumers have the capacity to spend and whether they will have the desire to do so. Nearly half of consumers believe that their financial situation is worse now than it was a year ago. Despite household balance sheets remaining strong, consumers' perception is that their financial situation has deteriorated.

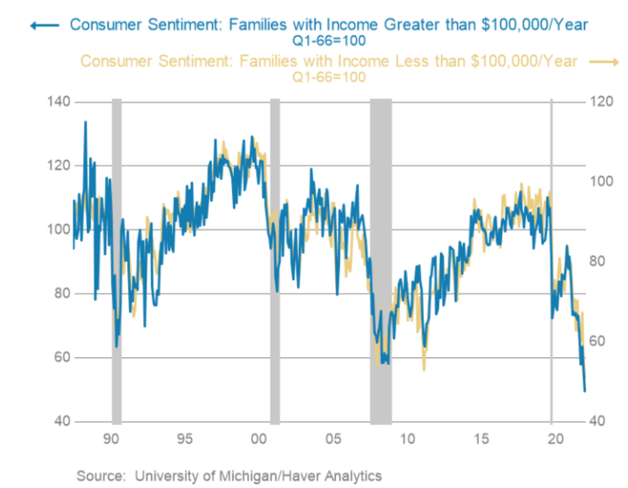
Exhibit 6: Continued Fall in Buying Intentions for Durable Goods Paints a Challenging Picture for Goods Personal Consumption Growth



Source: Haver, Morgan Stanley Research.

Negative sentiment has also plagued higher earners, posing risks that a slowdown in consumer spending may be worse than expected.

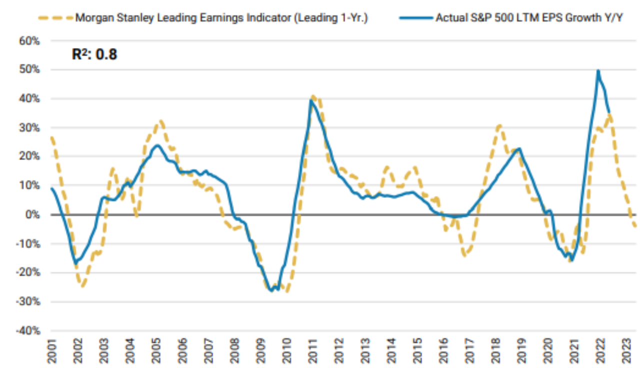
Exhibit 5: ...With Higher End Consumer Sentiment Collapsing even Faster



Source: Haver, Morgan Stanley Research.

Historically, high-end consumer spending during past recessions has come down to the extent in which both real estate and stock market wealth decline. While home prices have held up, stock market returns have proven vulnerable. However, historical analysis does not capture core inflation that is growing at a rate faster than any time in the last 30+ years. In fact, our AlphaWise consumer survey showed that over 50% of high-income respondents viewed inflation as their top concern. As a result, a slowdown in consumption can be worse than expected in 3Q and 4Q. Another underestimated risk we see is a more pronounced slowdown in high-income jobs. We have already seen a slew of companies announcing hiring slowdowns, freezes and layoffs. This is important as consumer spending accounts for 69% of U.S. GDP, with the high-end consumer accounting for over 28% of that. Again, we do not expect an economic recession and while consumer spending is likely to remain positive, a slowdown could be greater than what is currently baked into forward earnings estimates.

Exhibit 12: Our top-down earnings model suggests a meaningful deceleration in EPS growth over the next 12 months.

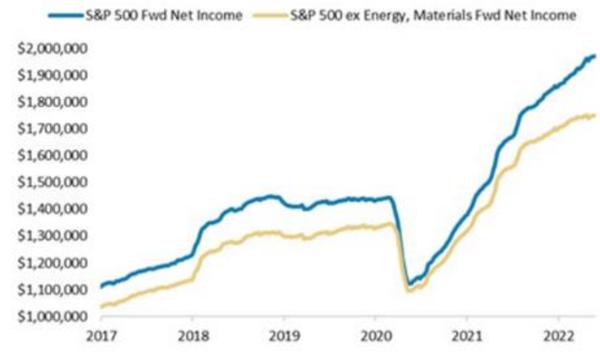


Source: FactSet, Bloomberg, Morgan Stanley Research

We also note that while earnings revisions have come down, they have not been negative enough to bring down NTM EPS (next 12 months earnings per share) growth. Nevertheless, companies and analysts are typically slow to bring estimates down and this time should be no different.

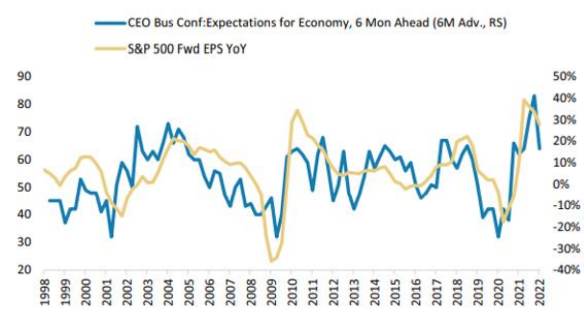
Source: Factset, Morgan Stanley Research

In fact, overall forward earnings expectations are quite dim if we back out Energy and Materials, which, when combined, only make up less than 8% of the S&P 500 index.



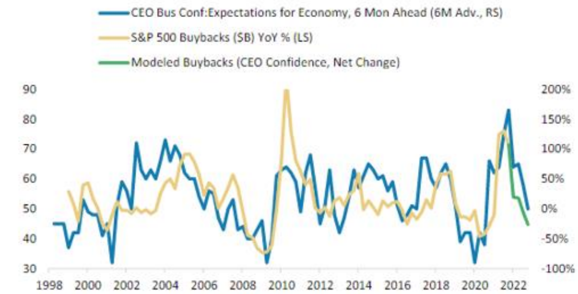
Source:Factset, Morgan Stanley Research

Going forward, we also expect a stronger dollar to pressure profits. Approximately ~40% of S&P 500 revenues come from overseas. Several companies with the largest index weights have already started to cite currency headwinds. Overall CEO confidence has fallen noticeably and is yet another reason why we believe current profit forecasts are unattainable. As Morgan Stanley's Chief Investment Officer, Lisa Shalett, points out, the Conference Board survey that is used to measure CEO confidence has recently collapsed to 40, a reading that has coincided with profit recessions, or negative year-over-year change in earnings.



Source: Haver, Bloomberg, Morgan Stanley Research

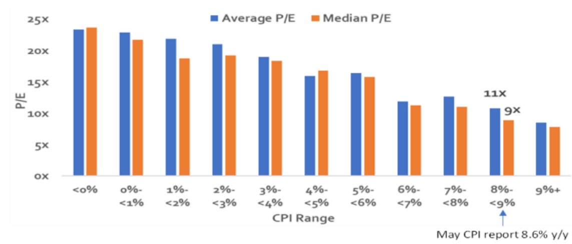
We also believe that consensus is being overly optimistic around buybacks given the extent of negative guidance from companies and CEO pessimism



Note: We estimated a reading of 50 for 2Q22 CEO Confidence in our model as a rough continuation of the current downtrend and difficult macro environment. Source: Haver, Bloomberg, Morgan Stanley Research

Lastly, we do not believe the market has fully priced in the full impact that tightening financial conditions will have on both inflation and demand. We got our first taste of this when the market sold off following the 8.6% year over year jump in the CPI which erased any hopes that the Fed would pause its policy path. The chart below shows that multiples are still elevated when the CPI level is this high.

Quarterly Data Back to 1960 Shows 8%-9% CPI Brings Average S&P 500 P/E of 11x (Wilson sees current fair value around 14.6x vs. the 2021 year-end P/E of 21.5x and current P/E of 16.4x)



Source: Blomberg, Morgan Stanley Wealth Management Global Investment Office (GIO), as of 6/10/2022

In essence, some tightening already occurred as markets rushed to price in even more Fed hikes, causing interest rates to spike across the curve and risk assets to fall rapidly. Two-year Treasury yields hit 3.44%, the highest level since 2007 while 10-year Treasury yields hit 3.45%, the highest level since 2011. Aside from rates, the Fed is just beginning to embark on the second leg of its Quantitative Tightening ("QT") program. They will sell $47.5 billion of securities from their balance sheet for three months and will ramp up to a monthly pace of $95 billion in September. While this is the fastest tightening cycle we've seen in decades, the Fed has no other option as inflation has broadened out and has the potential to stay higher for longer. Events in Ukraine and China have also raised the importance of onshoring, which places further upward pressure on costs and longer-run inflation expectations. This has caused the media to immediately focus on the recession narrative. While a recession is not imminent, the odds for one occurring in the coming 12 months have certainly increased. We remind investors that all this means, by definition, is that we may experience two consecutive quarters of negative GDP growth. This is less alarming than it sounds when considering that 2020 and 2021's expansive fiscal stimulus policy drove above-trend growth to begin with. It is normal to see a deceleration from last year's near 13% nominal GDP growth. Even in MS & Co.'s bear case, the U.S. economy enters a shallow recession in the second half of this year with real GDP falling -0.3%, in 3Q and -0.8% in 4Q annualized. We do want to make it clear to investors that a potential profits recession is much more likely than an economic one. We believe that profit growth has peaked and will turn negative for at least a few quarters until inventory levels normalize and costs stabilize. The economy is well prepared to absorb this for now given the financial health of banks, corporations, and households. While there may continue to be layoffs and hiring halts, the labor market is expected to remain strong given the current amount of job openings. Unlike prior recessions that were fueled by excesses in the housing market and credit bubbles, the most significant excess in the current environment has been in unprofitable companies that were supported by negative real interest rates for too long. Multiples for those companies have already corrected. We also note that while an inversion of the 2s-10s curve has historically preceded recessions, high yield spreads, which have often risen after prior instances of inversion, have still remained below their long-term averages. We also note that while the housing sector is cooling due to a decrease in affordability and demand for mortgages, prices have remained stable as supply remains constrained. Higher input and labor costs have also deterred a proliferation of excess new construction.

MS & Co.'s base case is a twelve-month price target of 3,900 for the S&P 500. This scenario assumes earnings and revenue growth decelerates due to high-cost pressures in a slowing growth environment. The June 2023 bear case of 3,350 assumes a slowdown in earnings growth rate, margin pressure, persistent inflation, and a recession. We believe it is possible to approach our bear case in the coming months, which we would see as a buying opportunity.

International Markets

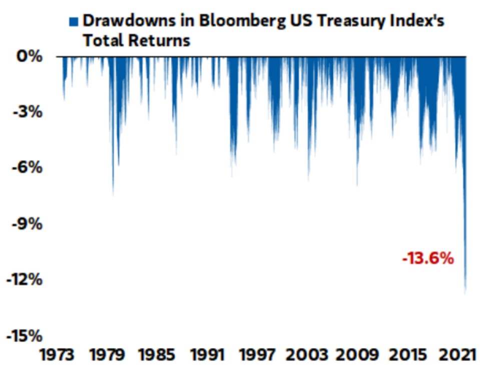
It seems ironic that Europe, Japan and China have all outperformed the U.S. considering the strength of the dollar in addition to the ongoing war and series of lockdowns in China. However, it is important to note that those markets never participated in the type of rally that U.S. stocks experienced and therefore had a much shorter runway to fall. This is precisely why we have advocated for diversified portfolios over the years. Unlike in U.S. markets, a great deal of pessimism was already priced in. Despite cheaper valuations, we still see headwinds from a stronger dollar that is unlikely to peak until autumn. By then, we expect peak Fed hawkishness and weak global growth to be fully priced in. Following its latest monetary policy meeting, the ECB (European Central Bank) announced that it will raise interest rates by 25 basis points in July. While this is much less aggressive than what we are seeing from the Fed, we note that so was the ECB's pandemic policy response. Japan continues to maintain its status quo with low inflation and central bank policy on hold. Most emerging market economies are already well into their hiking cycles and could see rate hikes peak over the next 12 months. Commodity price inflation has exacerbated the performance dispersion between importers and exporters in EM. The strengthening dollar has made this dynamic even more painful for countries leveraged to U.S. dollar-denominated debt. These imbalances have caused spreads in emerging market debt to widen. EM equities as a whole are much further along in their bear market as valuations and growth expectations have already been reset. While there is opportunity over the longer term, the next three to six months may still pose risks stemming from the strong dollar and geopolitical events. While we are not outright bullish, we note that international and emerging markets are likely to fall less than U.S. equities from here, absent of worsening geopolitical events.

Energy

After several years of underperformance, Energy seems to be the sector that most investors are still bullish on. Energy price inflation has only gotten worse after the second largest exporter of oil was banished from the market following Ukraine's invasion. With oil shortages so severe, we continue to see price upside but note that there is a risk of eventually reaching a level of demand destruction. Energy is typically a late cycle sector and has sold off meaningfully on days in which sentiment declined and inflation exceeded expectations. Energy and commodities may continue to outperform unless an outright recession occurs. We are not trying to time the peak and therefore remain neutral with a preference for more defensive names with strong balance sheets.

Fixed Income & Rates

The first half of 2022 has been one of the worst on record for core fixed income. The anticipation of Fed tightening has caused a significant sell-off that we see as a tactical entry point for U.S. treasuries, investment grade credit and municipal bonds. We believe that most of the pain is likely behind us as the market has already priced in additional rates hikes.



Source: Bloomberg, Morgan Stanley Wealth Management GIC. Data as of June 10, 2022.

We believe bonds can provide downside protection if growth surprises to the downside. In fact, they have already started to hold up better than equities. We advise investors who are overly overweight short duration and lower-quality credit to consider moving back towards a more neutral positioning with a focus towards higher quality. We prefer investment grade credit over high yield credit at this point in the cycle.

We also find the currently high ratio of investment-grade municipals' yields to equivalent-maturity treasuries as attractive for taxable investors. Municipal bonds have also seen an extreme retracement due to higher rates and mutual fund outflows. We believe their strong credit quality appears is being underappreciated relative to other fixed income sectors.

Alternatives

We believe that the need for alternatives has grown considerably as uncertainties in equity markets continue to plague investors. While individual energy stocks can still offer opportunities, we would not chase commodity-oriented alternative funds at this time. Private equity continues to benefit from companies staying private for longer given heightened equity market volatility. As the cost of capital rises, many companies will continue to look for funding assistance through the private markets. In addition, while we recommend investors avoid profitless growth in the public markets, we see this as an attractive opportunity for private growth funds to capitalize on lower valuations. We also like structured notes as a way to access market exposure with contingent downside protection and an opportunity to earn additional income. As uncertainty is on the rise, we remind eligible investors that such tools are available to help mitigate risk and diversify portfolios.

Closing Thoughts

A recalibration of profit and economic forecasts from unsustainable levels was to be expected coming out of a V-shaped recovery. While rising interest rates and higher inflation have caused valuation multiples to compress, earnings estimates are still too high given the demand destruction we are starting to see from higher costs and poor sentiment. The full extent of tightening financial conditions from the Fed's plan for additional interest rate hikes and balance sheet reduction is still not being accounted for by analysts who assume that S&P 500 corporate margins can continue growing at double digits. While many individual stocks have already corrected, we see additional downside risks at the index level in the coming months until expectations come back down to earth. We believe that we are in a bear market phase of a secular bull market. While recessions may become more frequent from here on out, they are also likely to be much shallower given the new monetary and fiscal policy regime shifts. Volatility can present opportunities for those who remain patient and levelheaded. Trying to time when to get in and get out of the market has proven to disappoint investors over the long run.

Team Updates

We are happy to announce that our Harbor Group team member Rich Frank married his sweetheart Tiffany last weekend. The team was there to celebrate their special day in style.

Wishing them all the best!

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Source: Barrons.com (March, 2022). Top 1,200 Financial Advisors: State-by-State as identified by Barron's magazine, using quantitative and qualitative criteria and selected from a pool of over 6,000 nominations. Advisors in the Top 1,200 Financial Advisors list have a minimum of seven years of financial services experience. Qualitative factors include, but are not limited to, compliance record and philanthropic work. Investment performance is not a criterion. The rating may not be representative of any one client's experience and is not indicative of the Financial Advisor's future performance. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors pays a fee to Barron's in exchange for the rating. Barron's is a registered trademark of Dow Jones & Company, L.P. All rights reserved.

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