MorganStanley

The Benedict-McLoughlin Report
2017 Mid-Year Update

By Christopher Benedict, CFA

- Risk assets have performed well so far in 2017, despite several headwinds
- Global equities may be due for a correction as central banks around the world continue to tighten monetary policy
- The economic outlook remains constructive over the next 2 - 3 years

THE BENEDICT-MCLOUGHLIN GROUP

The Benedict-McLoughlin Group provides investment advisory and wealth management services to a broad range of individuals, families, and institutions. As a boutique investment advisory practice specializing in portfolio management, we offer our clients direct access to their portfolio decision-maker, uniquely differentiating us from our competition. While we offer our clients a widerange of investment options, including individually managed portfolios, most importantly, we bring the knowledge and experience as well as a hands-on style that helps our clients make well- informed decisions at every stage of the investment decision-making process.

The Benedict-McLoughlin Group
Chris Benedict, CFA®
First Vice President – Wealth Management
Senior Portfolio Manager
chris.benedict@morganstanley.com

Brian McLoughlin
Vice President – Wealth Management
Financial Advisor
brian.mcloughlin@morganstanley.com
10960 Wilshire Boulevard
Los Angeles, CA 90024
Tel 310-443-0555
Fax 310-443-0566

Global investors continue to be optimistic in the face of several potential headwinds. Despite a "unique" Administration in the U.S., central banks that are tightening monetary policy globally, and still a large degree of indebtedness worldwide, global equity markets are up over 11% in the first half of 2017.[1] To be sure, economic growth appears balanced in most geographies but, it has not really been gangbusters anywhere…and has essentially been on the same path for the past several years. In any case, equity markets appear to be climbing the proverbial "wall of worry" (no pun intended).

While I acknowledge the apparent risks, I remain optimistic over the next two to three years. That said, I would put the chances of a market correction above 50/50 before year-end as investors come to grip with the fact that the Federal Reserve appears determined to "sop up" the excess liquidity that has been built up over seven years or so. Although economic growth and inflation remain relatively subdued, the Fed continues to signal its intent to increase interest rates. Furthermore, the largest unwinding of a balance sheet in history still lies ahead of us. The Fed may indicate in September that they will begin to sell the $4 trillion in bonds that they have accumulated since the Great Recession.[2] (Let us also not forget that the European Central Bank has a similar sized balance sheet.[3]) Most economists and investors agree that the Fed's bond buying program or QE (Quantitative Easing) has been supportive of financial markets over the past several years. In fact, the steady rise of the Fed's balance sheet mirrors the steady rise of the U.S. stock market (See graph on p. 5). So, investors might wonder what happens to risk assets as the Fed's balance sheet is reduced…we shall see but, I think an increase in volatility, at the least, should be expected.

Investing 2.5 - Update

My regular readers are familiar with my "Investing 2.5" thesis that I introduced in my December 2016 "Monthly Musings" which postulates that the results of the U.S. election pushed out the next recession a couple of years to maybe the 2020 – 2021 time frame and this could give risk assets a "window of opportunity" of two to three years (i.e. "2.5" years). Basically, the expected pro-growth policies of a Republican Administration and Congress should give the economy at least some kind of boost. Of course, we have not seen any real policy progress seven months in but, as I have written previously, I believe much of the policy changes can still be implemented even if the political climate remains less than optimal.

While de-regulation will likely continue to be an ongoing "chipping away" process, the focus appears to be turning towards tax reform. Depending on how "reformed" the tax code becomes (read: how much both the personal and corporate tax rates get reduced), the impact on the economy and economic profits could be significant. Analysts at S&P Global Market Intelligence estimated that the earnings of S&P 500 companies would increase by $1.31 for every one percentage point cut in the corporate tax rate.[4] Of course, there is a fine balance between lowering tax rates while still maintaining enough tax revenue to run the government (without massive deficits). Conservative philosophy states that the increase in economic activity resulting from lower tax rates will result in at least as much revenue. I generally subscribe to this notion; however, there is an optimal rate to strive for. The risk here is that we do not get close enough to this rate to reap any benefits.

Another important "leg" of the Conservative agenda is infrastructure investment/improvement. Unfortunately it has taken the devastation of Hurricane Harvey to return the spotlight back to this important area. To be sure, Texas will require billions of dollars of investment to rebuild roads, bridges, levees, buildings and houses. Ironically, it is expected to give a boost to the Texas economy as the rebuilding progresses. This type of potential boost exists for the economy as a whole if a well thought out infrastructure plan is implemented. Not only would it result in increased capital investment and employment but, the productivity gains would also pay dividends for years.

Risks to the economy: Large, chronic budget deficits (including unfunded entitlement program liabilities) may eventually cause higher interest rates; A sharp appreciation of the U.S. dollar would likely put pressure on export-focused businesses including manufacturing which could hurt job growth in the U.S.; Military conflict; Terrorism; A renewed credit crisis spurred by sovereign debt concerns in Europe (or the U.S. or Japan) may reduce global economic activity and investor confidence.

The Stock Market

Global equities have had a strong 2017 thus far and the strength has been widespread, geographically speaking. Developed markets like the U.S and Europe are doing well along with emerging markets, which have been helped by a weak U.S. dollar so far in 2017. While I expect international equities to do well for the rest of this cycle, this recent weak dollar tailwind may reverse over the next several months. Overall, valuations are not exactly cheap but, they are not at worrisome levels as long as the economy keeps chugging along at least as fast as it has been.

While equity gains have been broad so far in 2017 on a geographic basis, they have been narrower on a sector and style basis. For example, U.S. growth stocks have outperformed value stocks by approximately 1000 basis points (ten percentage points) since December 2016.[5] And, much of that growth outperformance was further focused in a handful of large technology stocks. It is true that most of these large tech growth companies are currently enjoying excellent fundamentals…but, investors might ask how long this fundamental outlook will last and how much of it is already reflected in current valuations. There is the possibility that many years of potential future growth has been pulled forward with the recent increase in valuations. In some cases, valuations imply continued flawless execution, no competition and no regulatory interference (i.e. antitrust). A closer look unveils the possibility that many of the business plans of these companies are increasingly targeting the same markets. So, some caution might be warranted…not because a large decline in these names is necessarily imminent but, that maybe future returns may be more muted. Of course, the same could be said for a similar sector set up in the late 1990s which actually resulted in substantial further gains in a "blow-off top" that eventually ended in pain.

Assuming my thesis plays out in a general sense, value and cyclical areas of the market should perform well over the next two to three years. Some examples: Financial services companies should benefit from rising interest rates which helps their profitability as well as increased loan volumes as economic activity improves. Consumer discretionary companies should benefit from rising disposable income resulting from lower tax rates and a strong labor market. Materials and capital goods companies should benefit from infrastructure spending. Importantly, many of these companies are trading at attractive valuations and pay solid dividends.

Risks: Geopolitical events may cause highly volatile stock prices; A significant up-tick in inflation which could result from too much economic stimulus would likely compress valuations; Conversely, the U.S. Federal Reserve may feel obligated to raise interest rates faster than otherwise would be expected to quell inflation which may hurt the economic recovery; The pendulum of government regulation in the U.S. may swing too far the other way (i.e., potentially too accommodative) which could set the stage for another financial crisis; Terrorism; Military conflict.

The Bond Market

(Excerpted from my June 2017 "Monthly Musings")[6]

One of the main pillars of my thesis is a continued move towards the normalization of interest rates and monetary policy. In a nutshell, this means higher interest rates. We saw a sizable move up in the yield of the U.S. 10-Year Treasury-Note during the 2nd half of 2016 but, we've seen some retrenchment so far in 2017. I think the "normalization" will resume soon and here's why:

- The Fed. Their increase in the Fed Funds rate on 6/14/17 shows that they will not be swayed by short term softness in the economic statistics. They continue to signal their determination to normalize interest rates, albeit slowly. They've publicly stated that their expected Fed Funds rate in 2019 is in excess of 3%...or, around 2% higher than it is currently.
- The Fed, Part II. They are about to undertake the biggest balance sheet unwind in history ($4.5 trillion). While there will be monthly "caps" in how many bonds they will sell, it will still be a sizable effective increase in the supply of bonds. This will likely push bond prices downward (driving rates higher).
- Reversion to the mean. So, what is the "fundamentally correct" level for the yield of the 10-Year Treasury if we are, indeed, normalizing? Historically, a good starting point is the inflation rate + 2%. So, with inflation running in the 1.75% range, a reasonable target might be 1.75% + 2% = 3.75%. That's my "North Star" of where the yield will go in this cycle. It's at 2.15% currently.
- Inflation has bottomed in this cycle, in my opinion. If the collapse of oil in 2015-2016 didn't put a dent in either CPI or Core CPI, then maybe there is some underlying "tightness" in pricing. On top of that, a continuing tightening in the labor market will likely eventually cause wage inflation. In fact, the Q1 2017 employment cost index rose 0.8%, the strongest rate since 2007.[7]
- Economic stimulus (tax cuts, de-regulation, infrastructure spending). As indicated above, my view is that some economic stimulus will get implemented. This will boost the economy and might boost inflation and/or inflation expectations. Interestingly, according to Bloomberg, the age of private fixed assets in the U.S. is 22.4 years, the oldest since 1955.[8] The stars may be aligning for an up-tick in infrastructure/capital investment…

So, what should investors do? Overall, I think a rise in interest rates to the levels I describe above, will not hurt the economy much if you believe the "neutral rate" is around that "inflation rate + 2%" I mentioned. If we end up going above this, which is possible, than the conversation of when the next recession will be should begin.

cnb

Tactical Allocation Strategy for My Model Portfolios (as of 6/30/17)

Equities	Equal	Fixed Income	-1	Alternative Investments	+1
U.S.	-1	Treasuries	-2		
Int'l/EM	+1	Inv. Grade Corporate	+1		
Growth	-1	High Yield	+1		
Value	+1	REITS	-2		
Large Cap	Equal	Floating Rate	+2		
Small/Mid Cap	Equal				

Legend	
+2	20% Overweight
+1	10% Overweight
Equal	Equal Weight
-1	10% Underweight
-2	20% Underweight

Overweights: Large Cap Multinational Equities (U.S. and Europe), Consumer focused China/Emerging Market Equities, Sustainably High Dividend Yield Equities, Value Equities, Short-term Corporate/High-Yield Fixed Income, Floating Rate Loans/Bonds, Absolute/Total Return Strategies.

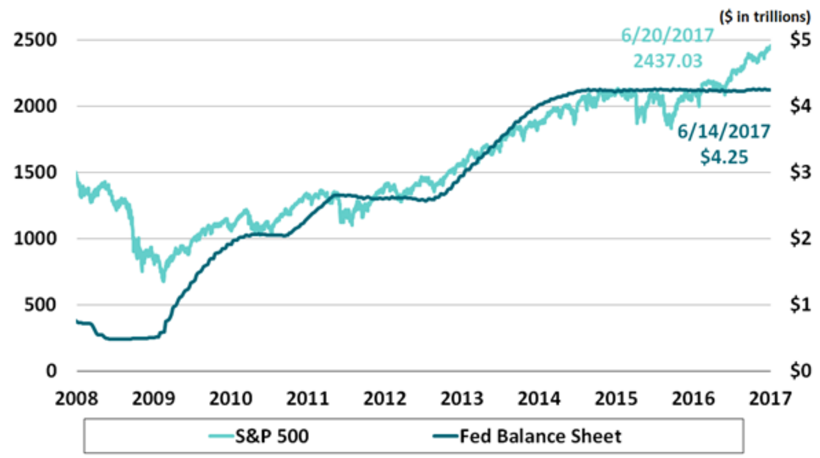
Changes from the 2017 Investment Outlook: Added: Value Equities

Underweights: Long-term Fixed Income, U.S. Treasury Securities, Developed Market Consumer Staples Equities, REITs.

Changes from the 2017 Investment Outlook: Removed: Small Cap Equities

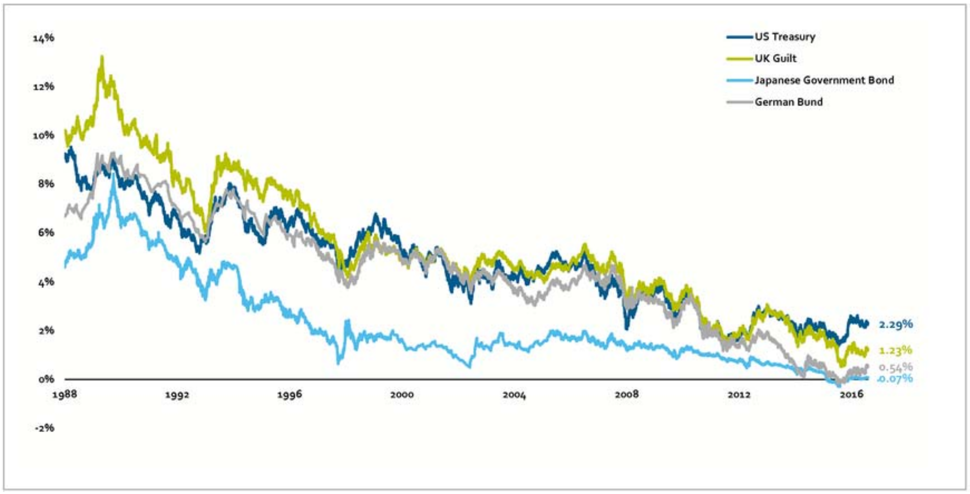
GRAPHS OF INTEREST

Fed Balance Sheet vs. S&P 500 (as of 6/30/17)



Source: Gavekal Research, Evercore ISI, www.cnbc.com – July 2017

10-Year Sovereign Bond Yields (7/31/17)



Source: Morgan Stanley, Chart Book – August 2017

1. Bloomberg Markets, 6/30/16.
2. Federal Reserve, www.federalreserve.gov, 8/28/17.
3. Bloomberg News, 9/1/17.
4. Here's How Much Trump Tax Cuts Could Boost the Stock Market, www.investors.com, 12/2/16.
5. GIC Weekly, Morgan Stanley, 8/28/17.
6. Monthly Musings, C. Benedict, Morgan Stanley, 6/14/17.
7. Bloomberg News, 4/28/17.
8. Bloomberg News, 4/28/17.

The Benedict-McLoughlin Group at Morgan Stanley

10960 Wilshire Boulevard
Los Angeles, CA 90024

Phone: 310.443.0555
Fax: 310.443.0566

chris.benedict@morganstanley.com
brian.mcloughlin@morganstanley.com

Date of first use: 9/1/17

6611996 02/11