



The Benedict-McLoughlin Report 2018 Mid-Year Update

By Christopher Benedict, CFA

- Global equities have done OK so far in 2018 in the face of tighter monetary policy.
- While a short-term correction is likely, I believe we still have some runway left in this economic expansion and equity bull market...my "Investing 2.0" continues to play out.
- Value sectors/geographies look interesting given their relatively attractive valuation and an expected uptick in the earnings of economically sensitive sectors/companies.

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After a first quarter correction, global equities remain resilient through August, led by the U.S. markets. The battle continues between the competing forces of solid economic/earnings growth and the reduction of monetary stimulus on a global basis. The U.S. remains the standout on the economic growth front with Q2 2018 GDP growth of 4.2%, the fastest quarterly pace since 2014.¹ Recent indicators show that the fiscal stimuli of tax cuts and deregulation continue to work their way positively through the U.S. economy.

Globally, the growth outlook has been a bit more mixed. While Europe and Japan plod along, other countries such as Argentina, Turkey and Brazil are in crisis mode as global investors have begun to separate the wheat from the chaff. While not all emerging market countries are suffering, it is important to note that total emerging market borrowing has increased from \$21 trillion (145% of GDP) in 2007 to \$63 trillion (210% of GDP) in 2017.² During the low interest rate regime we had following the Great Recession, an increase in debt of that magnitude did not really change the overall servicing cost of the larger debt load. Now, with the Fed right in the middle of a tightening cycle (see first graph on p.5), investors are acutely aware that countries like Argentina,

Turkey and Brazil (among others) have increased borrowing a bit too much while also running large budget and trade deficits. This differing economic performance has indeed led to diverging stock market performances of many emerging market countries which have been weak vis a vis the U.S.

Moving forward, while there are a number of moving parts globally, I believe the continued normalization of monetary policy will remain the key driver of global economies and financial markets over the next couple of years. Not only is this the first tightening cycle by the Fed in over twelve years, it is the first ever tightening cycle after the unprecedented zero interest rate policy and quantitative easing. Importantly, the global economy has been doing fairly well and I believe it can handle a gradual normalization of monetary policy. Of note, the U.S. has been receiving the aforementioned fiscal stimulus with more potentially on the way in the form of "Tax Reform 2.0" and an infrastructure spending program.³ Still, any monetary tightening cycle has inherent risks and it remains to be seen if the Fed and other central banks can bring us in for that "soft landing". Global trade is another wild card which I discuss in more detail below.

Terms of Trade

Given the current focus on global trade in both form and substance, I think it is helpful for investors to review how international commerce affects economies and investment opportunities. To be sure, trade among different countries/regions has been an important contributor to global prosperity for centuries...from the simple concept (yet profound at the time) of introducing goods or technologies to parts of the world where they previously never existed...to the more nuanced concept of comparative advantage. The economic benefits are well documented but, there are also other ancillary benefits. For example, all else equal, when two countries or regions are engaged in productive commerce, they are less likely to engage in armed conflict. So, why so much recent interest in seemingly reversing from this course? Why is the current U.S. administration threatening to impose tariffs on anybody who would listen and why did the U.K. vote to leave the European Union (and the free trade regime therein)?

Taking a step back, the theory of comparative advantage effectively states that countries should focus on the goods and services that they can produce at the lowest relative cost. Now, the original theory was based on two hypothetical countries trading only with each other. And, of course, several factors help determine the relative cost of production for each country such as the amount of labor and land as well as overall technological prowess. Thus, a country with abundant cheap labor, like China, has a comparative advantage in many labor intensive products, all else equal. This is why they are the largest assembler of smartphones in the world, for example, creating many thousands of jobs in China and lowering prices for consumers in the U.S. and elsewhere. This dynamic, of course, also works with other products but, has also helped cause a \$336 billion U.S. trade deficit with China.⁴ Furthermore, this same dynamic has eliminated many thousands of manufacturing jobs in the U.S. and other developed countries including the U.K. Clearly, many of the disaffected people in this trading regime believe this dislocation “externality” of “efficient” global trade is not worth the overall benefit to society as a whole. And, while there are certainly other factors

involved, I believe it was this disaffected population that helped “Brexit” get passed and also helped the current administration get elected.

Looking ahead, the ongoing rhetoric and threat of an all-out trade war will likely continue to cause consternation for both investors and business leaders. To be sure, in addition to potentially catering to their base, the administration likely truly believes that the U.S. is involved in some unfair trade deals and in some cases they are right. The potential issue is that an ostensibly improved trade deal for the U.S. could have unintended consequences given how globally integrated some supply chains are...the auto industry is a good example of this. Additionally, the potential for retaliation also brings in the possibility of a “tit for tat” scenario, which not only could be economically detrimental to all parties but, also could create lasting ill will among countries and regions. Finally, a world of increased trade barriers likely pushes up inflation, which could lower global asset values.

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

The U.S. market has been the clear leader so far in 2018 and large growth stocks have been the standouts. Interestingly, some of the largest technology companies have been the best performers due entirely to multiple expansion as opposed to an expectation of faster growth. This is an important distinction as it basically is a reflection of investor sentiment (which can be fleeting) rather than a change in the fundamental outlook. Meanwhile, many “value” sectors and stocks have been left for dead. Investors have been ignoring the improving fundamentals of some of these sectors/companies as the growth stock momentum has sucked all of the air out of the room. While momentum can last longer than one would think, the shift is typically swift and impactful.

One unloved area that could eventually attract some attention is emerging market (EM) equities. Generally speaking, EM equities have been experiencing the double whammy of negative fundamentals as well as negative momentum and are among the worst performers thus far in 2018. A tightening Federal Reserve and the aforementioned trade tensions are both giving investors pause. At the end of the day, when considering an entry point into EM (and generally any sector that has underperformed), it is akin to a game of chicken between weighing the effect of continued policy tightening and when it is actually all (or mostly) priced in. I believe we're close to the latter and we have our buy list ready. In addition to emerging markets, companies in sectors such as financial services and energy are prominent on this list.

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

Traditional intermediate and long term bonds remain unattractive as central banks around the world continue to tighten monetary policy away from the emergency levels that resulted from the Great Recession. The standard fixed income benchmark, the Barclay's Aggregate Bond Index, has lost money so far this year...down approximately 1% through 8/31/18.⁵ Basic bond math dictates that this index will be negative again over the next twelve months if the yield on the U.S. 10-Year Treasury Note rises to what I believe is the current fair value of 3.75% (It currently yields 2.94%). I think this is a likely scenario as the recent strength of the U.S. economy is now being accompanied by higher wage growth (+2.9% in August), which is the major driver of inflation (see second graph on p.5).⁶ Combine this with higher Treasury bond supply from both higher deficits and the Federal Reserve's selling of their holdings and the risk may be to the upside of my target.

Given this outlook, we continue to underweight any duration in our model portfolios and are instead focusing on taking credit risk via short-term high yield bonds to achieve a positive return in the face of rising interest rates. We also continue to take a diversified approach to income investing and include dividend paying equities, master limited partnerships (MLP's) and other "non-traditional" income producing securities in our model portfolios. And, continuing with the value theme discussed above, emerging market debt has been beaten down enough to make this sector interesting again, in my opinion.

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Tactical Allocation Recommendations

Equities:	+1	Fixed Income:	...-1	Alternative Investments:	...Equal
U.S.	Equal	Treasuries	-2		
Int'l/EM	Equal	Inv. Grade Corp./Muni	Equal		
Growth	-1	High Yield	+1		
Value	+1	REITS	-1		
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.

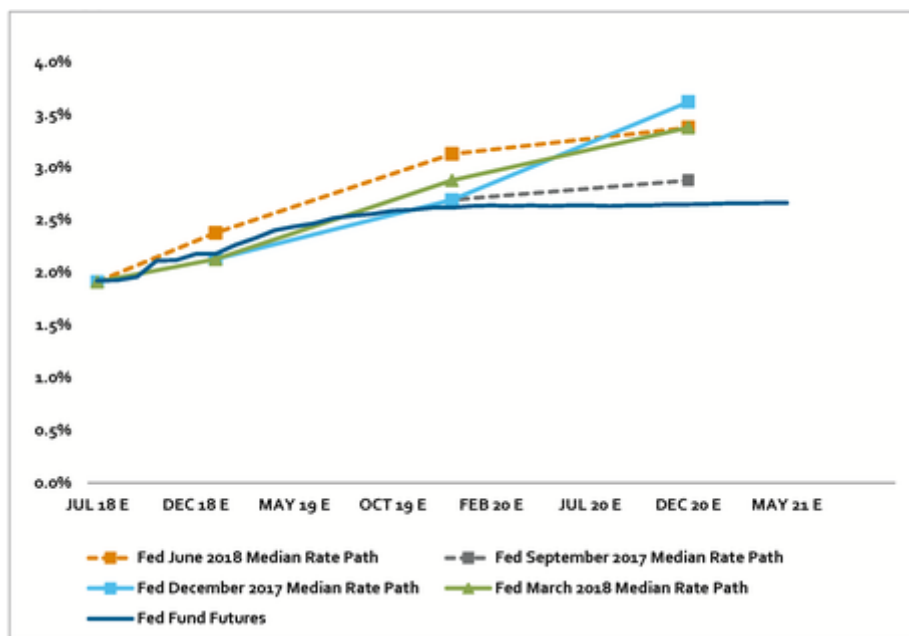
Changes from the 2018 Investment Outlook: None

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

Changes from the 2018 Investment Outlook: None

GRAPHS OF INTEREST

Fed Funds Futures Curve and Median Rate Path (as of 7/31/18)



Source: Morgan Stanley, Chart Book – August 2018

U.S. 10-Year Yield vs. Nominal GDP (6/30/18 & 7/31/18)



Source: Morgan Stanley, Chart Book – August 2018

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1. Bloomberg News, 8/29/18.
2. Bloomberg News, 9/3/18.
3. Bloomberg News, 9/5/18
4. Bloomberg News, 9/8/18.
5. Bloomberg Markets, 8/31/18.
6. Bloomberg, News, 9/7/18.

The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. As of May 2005 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom. An investment cannot be made directly in a market index.

S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Past performance is no guarantee of future results.

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