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The Benedict-McLoughlin Report 2019 Mid-Year Update

By Christopher Benedict, CFA

- Global equities remain resilient, although a shift from growth to value may be underway.
- Investing 1.0 is still my base case, although tail risks have emerged.
- Global debt levels continue to rise at a brisk pace, however, the cost of that debt continues to decline…for now.

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The Benedict-McLoughlin Group
Chris Benedict, CFA®
First Vice President – Wealth Management
Senior Portfolio Manager
Alternative Investments Director
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

http://fa.morganstanley.com/benedictmcloughlingroup/

Global markets have had a nice recovery so far in 2019 after a weak finish to 2018…buoyed by a resilient U.S. economy and a more accommodative Federal Reserve. Due to what appears to be a successful guiding down of interest rates by the U.S. Administration, market expectations have moved from three more rate hikes as of late last year all the way to two more rate cuts, on top of the recent cut on 7/31/19.[1] Longer-term rates have followed suit with the yield on the U.S. 10-Year Treasury Note, for example, declining from 3.24% in November to a low of 1.47% in late August.[2] When factoring in inflation (i.e., real rates), government bonds across the developed economies, including the U.S., offer negative returns for as long as an investor wants to lose money.

Wait, it gets worse. Outside of the U.S., interest rates in many developed nations are actually in negative territory on an absolute basis. The yield on the German 10-Year bond, for example, is -0.70% as of 8/27/19.[3] Yes, that is right, investors have the privilege of paying the German government $7000 per annum for every $1 million lent to them for ten years. Would it not be cheaper just to store your money somewhere either physically or digitally…and not have to tie it up for ten years and/or be subject to loss of principal if rates move back up? I assume Silicon Valley is figuring out a better solution as I write this…the total addressable market (TAM), the big buzzword for venture capital investors, is certainly large enough for them at $17 trillion.[4]

A reasonable person might ask; Who is buying these money losing securities? Good question. $17 trillion exists as a "liability" on several government balance sheets, so, they also sit on the balance sheets of countless investment entities as an "asset". And, yes, some foreign buyers might simply be buying these negative yields as a currency play. Others must be buying because these negative yielding countries have deflation in which case the real yield is actually positive, right? Well, actually, both German and Japanese inflation, for example, is positive at 1.4% and 0.5%, respectively, as measured by CPI.[5] Another potential culprit and the group that is often cited as buying low yielding bonds, or, in this case, negative yielding, is the insurance companies. Insurance companies have longer duration liabilities (underwritten insurance policies) and will strive to match these up with similar duration assets, like bonds. The problem with this is the question of how an investment that an owner needs to pay out cash on is actually an asset…sounds more like another liability to me. Another explanation of the persistency of negative rates is simply pure speculation. We know that bond prices move in the opposite direction of interest rates and if interest rates moved from 0% to -1%, for example, a longer term bond with, say, a duration of 15 would appreciate by 15%. Pretty nice return but, to get an incremental return, once the instrument is already at a negative yield, requires yields to get even more negative. This would be going from strange to ludicrous. It might happen but, it will be without me.

In any case, the question for investors is…which market is more accurately predicting the future? Is it the stock market in signaling positive, albeit subdued, economic growth or is it the bond market in signaling an impending recession and deflation for many years? In my opinion, the short answer is that the bond market is likely just a little premature in what it is predicting. And, even if this more negative outcome is, in fact, coming soon, sovereign bonds are already priced that way, so, there is no upside, in my opinion. The more optimistic picture that equities are painting appears to be correct as monetary policy remains extremely accommodative globally and, in my opinion, we have already likely experienced maximum consternation in regards to the global trade outlook.

Investing 1.0 – Update

Given the seemingly different signals that the bond and stock market are giving, it is probably worth re-visitng my Investing 1.0 thesis. As a reminder, I hypothesized in December 2016 that the Republican sweep of the elections would "push out" the next recession by a couple of years and effectively give risk assets a runway for about two to three more years (or two and half years, i.e., "Investing 2.5"). Fast forward almost three years and, with the appropriate flexibility inherent in these types of predictions, I think we are now in an "Investing 1.0" world. In other words, risk assets like global equities should continue to perform well through approximately Q3-2020 as the outlook for economic growth and earnings remains decent.

While Investing 1.0 is still my base case, I do believe there is now a tail risk on both sides. In other words, the idea that we actually could be in an Investing 0.0 or 2.5 world is not out of the realm of possibility (i.e., 0.0 = we've already peaked and 2.5 = the bull market can continue for another 2 - 3 years.). I do not believe either scenario is likely but, I assign an admittedly unscientific probability of 10% for either scenario…enough to explore what might cause them to come to fruition as well as what it might mean for the investing landcape.

So, what would validate what the bond market has seemingly been predicting in regards to an imminent recession along with the corollary that global equities have already peaked for this cycle? Given that much of the recent softening of economic indicators has been due to uncertainty over trade policy, I believe we would need to see a further trade war escalation with China as well as with other countries/blocs. While I believe the Administration has been talking down trade in recent months in order to drive interest rates lower, the uncertainty has been real for CEO's as well as investors. Basically, it is pretty hard for companies to plan and invest when the rules are in flux and certain companies are unsure if they should reconfigure their Chinese/Asian supply chains or just wait it out. This uncertainty appears to have spread to other companies who are not directly affected and this pause in activity has been evident in the recent softer economic indicators. This uncertainty would likely continue and potentially get worse if the trade war escalated with China and spread to other countries. Investor sentiment would likely suffer as well and this combination is the typical mix that leads to economic downturns and weak stock markets.

On the more constructive side, what are some of the things that would need to transpire to put us in an Investing 2.5 world? Again, I would point to trade as a significant catalyst. A sweeping and iron-clad trade agreement with China would likely be the foundation of a more promising outlook. Uncertainty would likely be lifted both practically and from an investor sentiment standpoint. This could then set the stage for increased investment and a return of "animal spirits" across the board. In addition to this hypothetical positive trade development, a Republican win in the 2020 elections would likely mean a continuation of economic and financial market friendly policies and would be necessary, in my opinion, to really drive a multi-year continuation of this economic expansion and bull market.

The most likely scenario, however, remains Investing 1.0, in my opinion. My base case is that the trade situation improves, although we may not end up with a perfect deal with China or other countries but, I think it will be enough to lift some of the uncertainty. And, as CEO's get more clarity, I would expect an uptick in investment and sentiment which should help increase economic growth in 2020. Additionally, we may see additional fiscal stimulus in the U.S. (and potentially elsewhere) which could provide more support. That scenario would be convenient for the incumbent Administration as the election approaches in November 2020.

Risks to the economy: An all-out global trade war; 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

Given above, it will not surprise most readers that we are overweight value equities in our model portfolios. Value stocks tend to be a bit more economically sensitive and are typically the outsized earnings beneficiaries of an improved economy. Additionally, value stocks are historically cheap and have been underperforming their growth stock counterparts for many years (see graph on p.5). The slowdown in economic growth due to trade war uncertainty caused another leg down this summer in relative performance. If we do, in fact, see a re-acceleration in economic growth in 2020, I would expect companies in the value sectors such as financials, energy and consumer discretionary to do relatively well.

Keeping with the value theme, one could argue that most of the world's equity markets outside of the U.S. fit into this category (see graph on p.5). While this graph highlights the developed international markets, emerging markets have also underperformed during this cycle. It is true that the European and Japanese economies have had slower growth but, the relative valuation is now attractive in my opinion. And, some international markets, like China, actually have higher economic growth and a cheaper valuation than the U.S. In fact, average real incomes have grown 8.4% per year in China vs. 1.4% in the U.S. over the last ten years and the income gap between two countries is still very large.[6] We continue to focus on those companies and sectors that can benefit from the growth of the middle class in China and other emerging markets.

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

Assumption: Something that cannot go on forever (i.e., negative interest rates), will not.

Besides contractually losing money, what are the other ramifications of negative bond yields? I already mentioned the whole confusion of whether a negative yielding bond is an asset or a liability. On a broader scale, what is the value of money if it is free (or less than free)? Interest rates are the price of an ostensibly scarce resource (capital) and if the price has gone to free and beyond, does not the value of the resource diminish? Further, it is important to consider who is able to borrow so cheaply…arguably the entities with the least amount of discipline…governments. Case in point, and while the U.S. still has positive nominal interest rates, the debt deal agreed upon by the U.S. Administration and Congress guarantees trillion dollar deficits for years…and this is with the more "fiscally responsible" party controlling the executive branch.[7] Cheap money today may in fact be stealing from future generations as part of it will need to be paid back while the remaining balance will have to be refinanced.

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 potentially rising interest rates. We also continue to take a diversified approach to income investing and include international fixed income, dividend paying equities, master limited partnerships (MLP's) and other "non-traditional" income producing securities in our model portfolios.

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Tactical Allocation Strategy for My Model Portfolios (as of 8/31/19)

Equities:	+1	Fixed Income:	-1	Alternative Investments:	Equal
U.S.	Equal	Treasuries	-2		
Int'l/EM	Equal	Inv. Grade Corp./Muni	Equal		
Growth	-2	High Yield	+1		
Value	+2	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 2019 Investment Outlook: None

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

Changes from the 2019 Investment Outlook: None

GRAPHS OF INTEREST

MSCI World Value Index vs. MSCI World Growth Index (as of 7/31/19)

Source: Morgan Stanley, Chart Book – August 2019

MSCI EAFE vs. S&P 500 (as of 6/30/19)

Source: Morgan Stanley, Chart Book – August 2019

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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

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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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