Morgan Stanley

Monthly Musings

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I hope you and your family had a great Thanksgiving!

Despite the delta variant scare and the parallel rotation out of value and back into growth stocks, global equities in general continue to signal full steam ahead on the post-COVID re-opening and recovery. Supported by strong economic numbers, albeit from an artificially low base, investors remain optimistic about a return to normalcy…unprecedented support from global central banks is also surely helping. And, with such a strong 1st half recovery, it's no surprise that investment grade bonds have been shunned for most of 2021. However, bond yields started to decline again in June as investors appear to be "sussing" out the "peak inflation scare" and/or are misinterpreting what central banks are attempting. Almost to the bank, central banks are basically stating that they want to see inflation above 2% before tightening monetary policy, yet, bond investors continue to provide ample demand for negative real (net of inflation) 10-year yields in the U.S. (1.63% nominal as of 11/24/21). I guess these investors believe we'll actually see deflation sometime over the next 10 years…although we haven't experienced deflation in at least seventy years in this country, including during the dot com bust of the early 2000's, the '08 – '09 Financial Crisis or during the recent COVID lockdown.[1] Go figure…

Of course, all the above is occurring in a pretty strange environment, writ large. Overall, society seems to be getting simultaneous cases of attention deficit disorder and myopia…and I blame it on the political-media complex. Our political system is firmly stuck in a dysfunctional feedback loop of just winning the next election and the money machine that drives U.S. elections is downright frightening. With this backdrop, along with the related "free money" policies, why wouldn't "meme" stocks and "assets" that were created as a joke be among the top performers this year?[2] Rationality and prudence be damned!

As I’ve written in the past, we are in dire need of campaign finance reform. I’d estimate that taking private money out of politics would solve around 90% of society’s ills. But, here’s an idea for the meantime, utilize blockchain technology for our political system (or think of the black box used to decipher what truly happened leading up to an airplane crash). In other words, instead of guessing or wondering, lets closely track where a politician has sourced their campaign money (this year and historically), what his or her views are on the various issues and who their business associates, etc., are. And let’s make it super accessible and transparent during any advertisement, stump speech or interview. This just might be the ultimate bi-partisan issue…and I believe it would rebuild confidence in our government and lead to a lower cost of capital (i.e., higher valuations) for U.S. assets, all else equal.

Forgiveness?

Sticking with the weirdness theme, you know we’re in a strange place when, given our record debt and deficit levels, we can advocate forgiving $1 trillion in student loan debt but, can’t forgive somebody who posted something stupid on social media when they were immature at the dawn of the social media age. Another example that falls in the “what in the heck is going on” category is people using their stimulus checks to trade stocks and other assets figuring they can get rich quick or, if not, the government may just provide another stimulus check…There are, of course, many more examples.

Interestingly, if taken in isolation, these trends (free money, cancel culture, etc.) are typically representative of a socialist or communist society. I actually believe that, ultimately, communism might be the ideal structure for society once we have exhausted all of the inventions/technological advances that increase the welfare of society…the reality, though, is that this is likely centuries away. In the meantime, capitalism, even with all its flaws, is still the ideal structure to provide the necessary incentive to drive advancement and bring more people out of poverty worldwide.

While negative externalities are the cost of doing business in a capitalistic system, it’s the total net benefit to society that is the key metric here. Interestingly, addressing negative externalities is where I believe the government can actually add tremendous value. A prime example are the policies that have helped to reduce pollution in our air and water systems, although more work needs to be done, of course. The aforementioned negative externalities resulting from our election process (ostensibly, an open and free system) would be an excellent choice for our government’s next effort. Although, they would really only be in charge of *enforcing a change* in campaign finance…I think it will require the will of the people to *actually initiate* it.

Greater Fool Theory (Are Investors Simply Paying Too Much for Future Cash Flows?)

Instead of debating growth vs value while investing in stocks, I recommend that investors disregard the hype (positive and negative) when it comes to sectors or factors when picking securities and, instead, focus on what all securities generate…cash flow. Interestingly, a significant % of financial assets are already invested in medium/long-term US Gov't bonds and large cap growth companies…investments that provide negative real yields and, sky-high valuations, respectively. And they are also among the longest duration assets that exist. In other words, investors are paying dearly today for, in many cases, relatively low future cash flows…even if the optimistic growth projections actually come to fruition. The math just doesn't work. Thus, much of the investable universe is very susceptible to poor performance in a rising interest rate environment…which I believe is increasingly likely.

I already mentioned earlier what US Treasury investors are assuming if they expect to make any real money over the next several years (i.e., deflation). Here's what I believe you are predicting if you buy the high growth/highly valued equities today and expect to make money over the next 2 – 3 years:

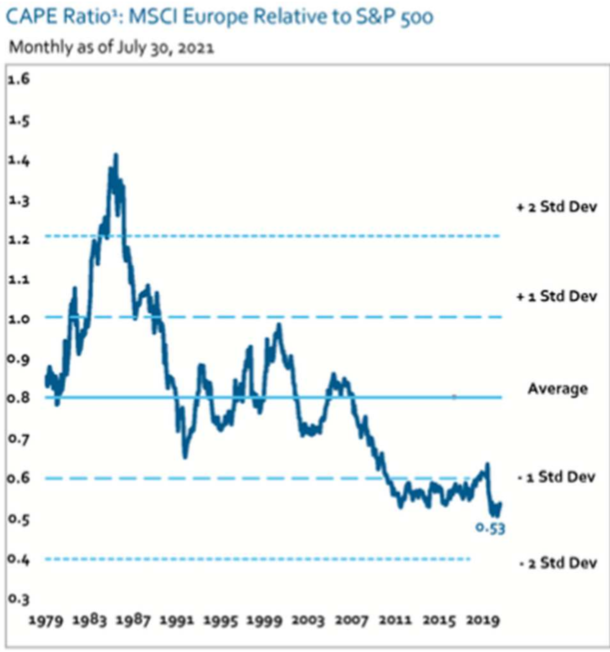
- A continued "stay at home" and "remote working" economy. It's true that the pandemic has changed behavior and fast forwarded some trends but, after some outperformance by value stocks in the first half of this year, the market again started pricing companies as if we're going to remain home in COVID lock down mode and just advertise to each other.

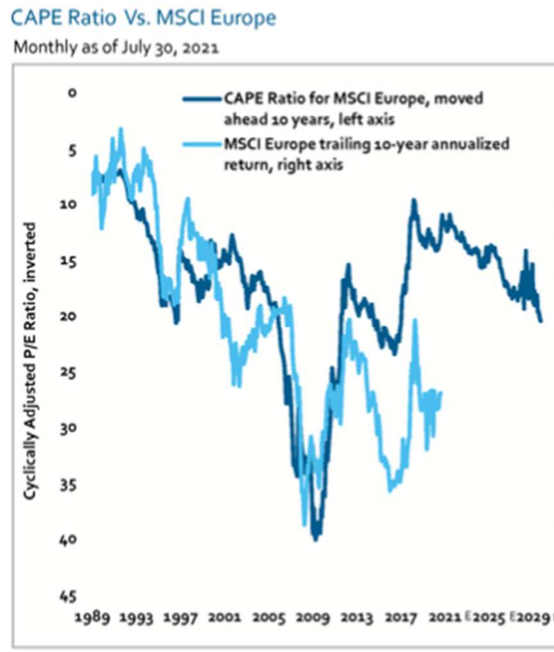
- Flawless execution and a status quo competitive environment. Two very large assumptions. For those Game of Thrones fans…Competition is coming. Regulation too.

- Interest rates remaining at the severely depressed current levels…with negative real yields across the U.S. yield curve and actual negative nominal yields in other major markets.

And you don't need just one of these things to work out…you need all three.

Importantly, there are entire sectors and, for that matter, continents with "multiple bogeys" embedded in them. See below for an example…European equities are relatively cheap vis a vis their U.S. counterparts. Comparing equites that fall in the value sector throughout the world against their growth counterparts yields similar looking graphs. So, we have the potential combination of starting from a relatively cheap level just as the relative fundamentals also appear to be turning positive for a number of stocks that largely fall under the "global value" category…that's where I'm shopping.





Source: Morgan Stanley ChartBook (See disclosures below)

See My Previous Investment Commentaries here: https://advisor.morganstanley.com/benedict-mcloughlin-group

***Tactical Allocation Tilts in my Global Growth and Global High-Income Model Portfolios (as of 11/24/21):**

Overweight

Long/Short Equity, Quality Dividend Paying Global Equities, Early Cycle Value stocks, Emerging Market Consumer Equities, Total Return Strategies

Underweight

High P/E technology/growth stocks, U.S. Treasuries, "High Quality" Corporate and Municipal Bonds, Long-Term Fixed Income

* These weightings do not consider each client's unique profile, preferences and/or constraints and therefore may not be applicable to you.

The Benedict-McLoughlin Group always strives to use sound judgment…at every decision point.

We bring experience, credentials, and tenacity which we expect to continue to enable us to help achieve our clients' goals over time.

Regards,
Chris

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The Benedict-McLoughlin Group – *"Institutional Caliber Portfolio Management, Customized to Your Personal Situation"*

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Notes:
1. Bloomberg Markets, 7/14/21.
2. Kiplinger.com, Dogecoin's a Joke, Don't Make Yourself the Punchline, 5/4/21.

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.

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Chartbook Source: FactSet, Morgan Stanley Wealth Management GIC. (1) The cyclically adjusted P/E ratio (CAPE), also known as Shiller P/E ratio, uses a 10-year average of inflation-adjusted earnings to value the stock market. Historically, cyclically adjusted price-earnings ratios have led subsequent returns with a 10-year lag. Recent price earnings levels suggest equity returns could be better going forward than they have been over the recent past, assuming the statistical relationship holds. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean.
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