Morgan Stanley

Monthly Musings

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So, this is what a paradigm shift looks like in the markets, huh? After unprecedented monetary stimulus by the Federal Reserve and other central banks due to the pandemic shutdowns, the path to normalization has begun. The only remaining questions are how fast and how far they will go towards normalization. Which, I guess, begs the question of what is "normal"? Is it post-Financial Crisis normal where the fed funds rate and 10-Year Treasury yield maxed out at 2.5% and just above 3%, respectively? Levels that were basically at or a hair above the inflation rate at the time.[1] Or, will this cycle's normal be more like the pre-Financial Crisis monetary tightening where both the fed funds rate and the yield on the 10-Year regularly peaked well above the inflation rate. In fact, the 1990s and 2000s, for example, saw positive real yields on both the Fed Funds rate and the 10-Year on multiple occasions.[2] Either way, long duration assets have more room to the downside by my measure…although the Ukraine/Russia situation could keep a lid on rates in the short-term.

Of course, none of this is getting past equity market investors, astute as they are. Not too long ago, many technology/growth companies were priced as if (1) they would sustain their COVID-lockdown-boosted growth rates forever, (2) interest rates would stay near 0% forever and (3) competition and regulation would not be a major factor. In many cases, companies were priced as if all three of these dynamics would hold true. I have written that you just need one of these to fail and you would take significant hits to valuations. Now, it seems that all three are failing to hold.

Indeed, several of the "pandemic darlings" have already been declining for the past six months or so but, it has generally been underneath the surface of the major indices…until now. The larger growth companies that still dominate the large indices like the S&P 500 and the Nasdaq are finally feeling some of the pressure of the higher interest rates reality…but, there's more to go, in my opinion. And, while many of these "pandemic darlings" are already down significantly, most of them are still richly valued. Luckily for investors, however, I believe there

remains a number of attractively priced stocks in the global value arena…we continue to overweight this area in our model portfolios.

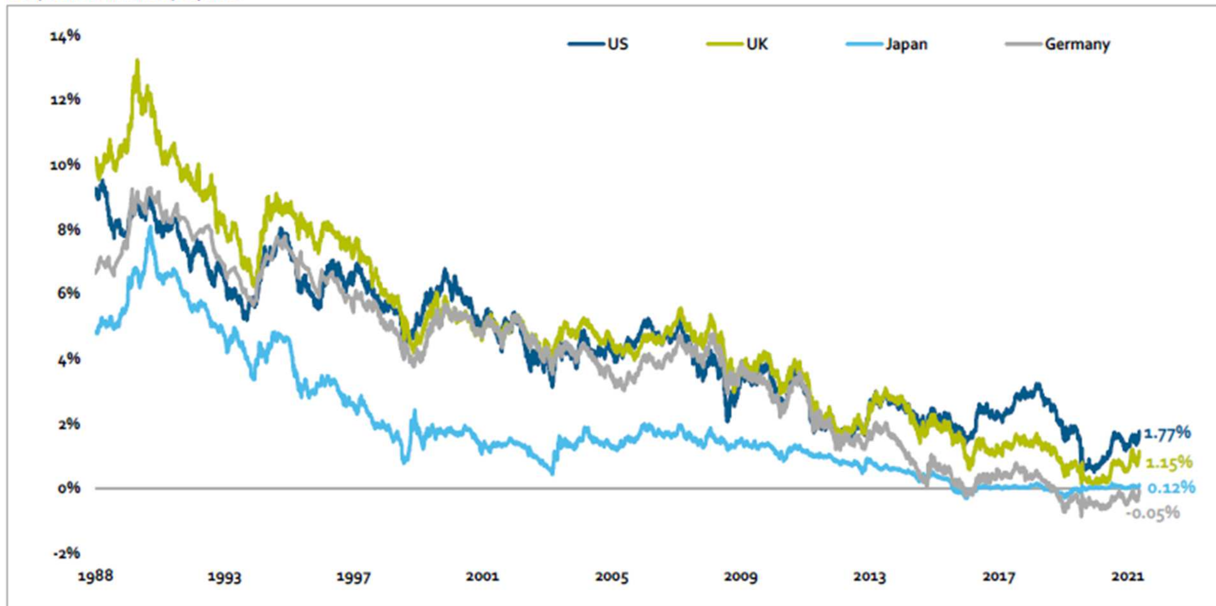
Where Should Interest Rates Be?

To be sure, bond market investors have begun pricing in a meaningful tightening cycle with the 2 and 10-Year Treasury yields recently climbing above 1.5% and 2%, respectively, from around 0.20% and 1.25% in mid-2021.[3] And, this is a global phenomenon…as of 2/12/22, the German 10-Year Bund, for example, now yields 0.29% after spending much of the last three years in negative yielding territory (see graph below). These are significant moves from a percentage change in rates but, still fairly small moves on an absolute basis.

So how much will rates increase? As mentioned above, the U.S. 10-Year real interest rate has historically been positive and was actually as high as 4% in 1999 – 2000. If we use the recent Core CPI reading of 6%, this would imply a high end of 10% for the 10-Year yield...not likely, in my opinion.[4] But, even if we assume inflation cools down to let's say the 3% area and we then assume only a real yield of 1%, this equates to a 4% 10-Year Treasury yield. The risk appears solidly skewed towards rising yields (lower bond prices).

How will history judge investment managers who actually bought negative yielding debt, effectively paying governments to take their money? I guess if you had a strong thesis that we were on the cusp of significant deflation over the next several years it would make sense. I understand that math but, I definitely don't understand that thesis given we really never got close to deflation after the bursting of the dot-com bubble or after the Financial Crisis. I guess many investors believed that the record setting monetary policy used during COVID was here to stay. My view is that things that can't last forever…won't.

Isn't it time to let market forces once again play the majority role in our economy and markets? Adam Smith, who wrote *The Wealth of Nations*, famously referred to the "Invisible Hand" when referring to capitalism and free markets. More fundamentally, Charles Darwin referred to the "Survival of the Fittest". Species that can't thrive in an environment and can't adapt will eventually die off. Recent government policies have basically ignored this basic truth and effectively picked winners…artificially. Bad governments, bad politicians and bad companies should be allowed to fail. History has shown us that freewill ultimately leads to the best societal outcomes…just look at the many examples of capitalistic and democratic societies compared to the alternatives.



I Don't Want to Sound Like a Broken Record, But…

…Longer duration, high growth stocks have been egregiously priced since "peak pandemic benefit" and were facing both the prospect of decelerating growth as the lockdown effect waned as well as rising interest rates. The market has finally recognized this and the big question that remains is what the correct multiple is for this sector of the market…my view is that it's lower than where it is currently.

As a reminder, the true/fair value of a company is the present value of its future cash flows…whether it's a technology, consumer, or an energy company. That's it. Now, it's rare that a company ever trades right at fair value due to difficulties in predicting the future as well as the fact that investors often have different opinions on what the future will bring. However, other technical factors occasionally come into play in the markets such as sentiment, momentum, and many others. These drivers occasionally take stock prices very far from fair value…both above and below the mark.

Mathematically, a growing perpetuity is a good example of this basic valuation concept, in my opinion. Here is the basic formula:

$PV=CF/(r-g)$

PV = present value

CF = cash flow

r = discount rate

g = growth rate

And the “r” is further broken down as r = risk free rate + risk premium. The risk-free rate would be the 10-Year Treasury yield for this example.

So, imagine Company ABC who generates $100 of free cash flow, is growing it at 10% and has a discount rate of 12%. Its value would be $100/(0.12 – 0.10) = $5000. But what if interest rates go up 3 percentage points? Now, it’s worth $100/(0.15 – 0.10) = $2000. How about if ABC’s growth rate declines a bit as well to, let’s say, 8%? Now it’s worth $100/(0.15 – 0.08) = $1429. That’s a 71% lower valuation with higher interest rates and slower growth.

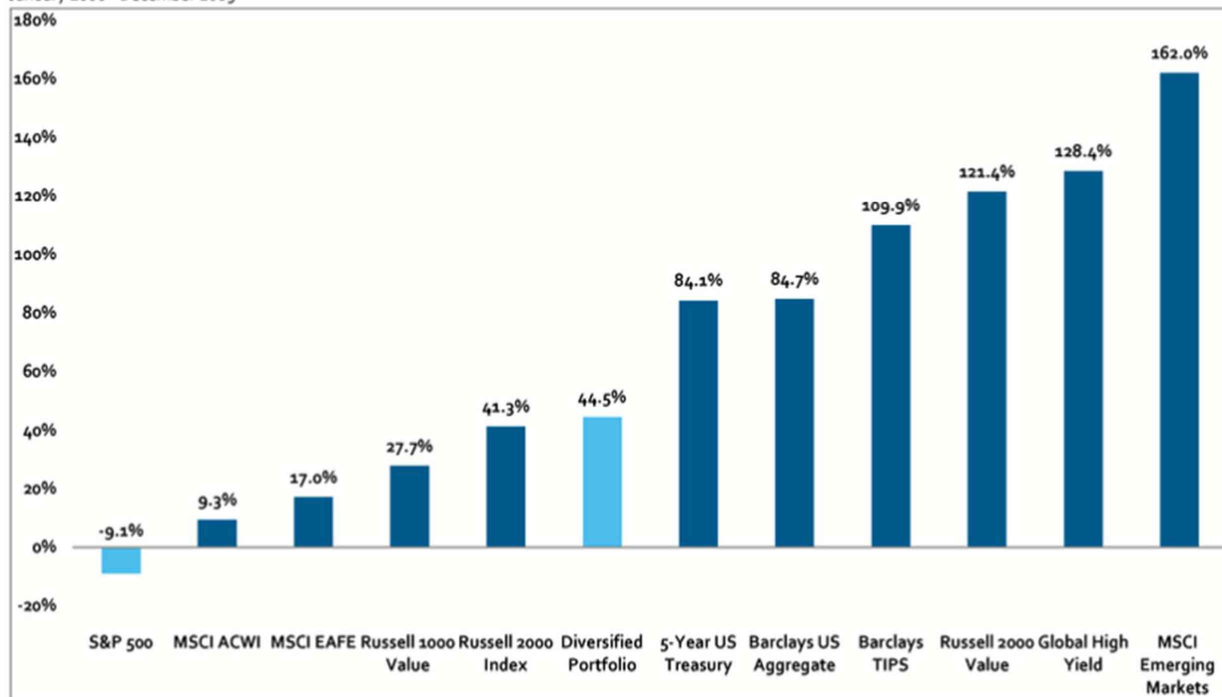
Of course, this is a simplistic example but, I think it demonstrates how sensitive valuations can be to changes in interest rates and growth rates. Let’s take a quick look at the growth sector through this general prism…see graph below. When the line is moving down and to the right, growth stocks are outperforming value stocks (and vice versa).

Source: Morgan Stanley ChartBook (See disclosures below)

Two periods stick out to me…the late 1990s through March 2000 when the dot-com bubble peaked and the period just after the Financial Crisis from 2009 basically all the way until 2021. The dot-com bubble was “rationalized” at the time by the high growth rates that would seemingly last forever (i.e., the “g” was very high). They, of course, didn’t and several years of relative underperformance ensued along with significant absolute losses. The period following the Financial Crisis was highlighted by record monetary policy with interest rates at 0% and

the Fed undertaking their first ever Quantitative Easing (QE…buying bonds). So, the risk free rate was artificially low (helping the "r" stay low). And, while the Fed did begin to raise rates in the mid to late teens, along came COVID and the Fed repeated its playbook from 2009…and then some (see the steep move down on above graph starting in March 2020).

Importantly, it's still possible to achieve pretty good returns even when buying near a high point in the market, particularly if much of the overall return has been dominated by one area of the market. The graph below shows the example of the "lost decade" of the S&P 500 after the dot-com bubble peak…several areas of the market did well during this time frame after being shunned during the late 1990s tech/growth focused market. I believe the same opportunity is in front of us now for global value stocks.



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 2/22/22):**

Overweight	**Underweight**
Global Value Equities, Long/Short Equity Strategies, Quality Dividend	High P/E technology/growth stocks, U.S. Treasuries, "High Quality"

Paying Global Equities, Emerging Market Consumer Equities, Total Return Strategies	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, 2/8/22.
2. Bloomberg Markets, 2/10/22.
3. Bloomberg Markets, 2/12/22.
4. Bloomberg News, 2/10/22

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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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