Morgan Stanley

Monthly Musings

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In this Musings, I'll cover the following:

- Generational Opportunity in Global Value stocks
- Buying a dollar for sixty cents is still better than buying one for a dollar forty
- Artificial Intelligence (AI) will be good for the tool users (adopters) as well as the tool providers (enablers)

There are lots of cheap stocks out there. This may seem counterintuitive given the strong rebound for the S&P 500 in 2023 and the fact that it recently breached it's 2021 all-time high. However, beneath the surface of the mega-cap growth stock-driven index, cash flow is on sale, in my opinion. The top 7 companies in the S&P 500 account for 29% of the index, up from 20% in January 2023.[1] And, these "Magnificent 7" are valued at an incredible $10 trillion +…which was the value of the entire S&P 500 as recently as 2011.[2] From a valuation perspective, the forward P/E ratio for these 7 is close to 30 while the P/E ratio on the equal weighted S&P 500 is closer to 16.[3] And there are many stocks trading at a single digit P/E ratio. Maybe a better description than a "Global Value" opportunity is a "Global Cash Flow" opportunity. In my opinion, cash flow is mispriced across many sectors and many regions.

The Global Cash Flow Opportunity

(Note: Much of this section is from my February 2022 Monthly Musings)

In my opinion, 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

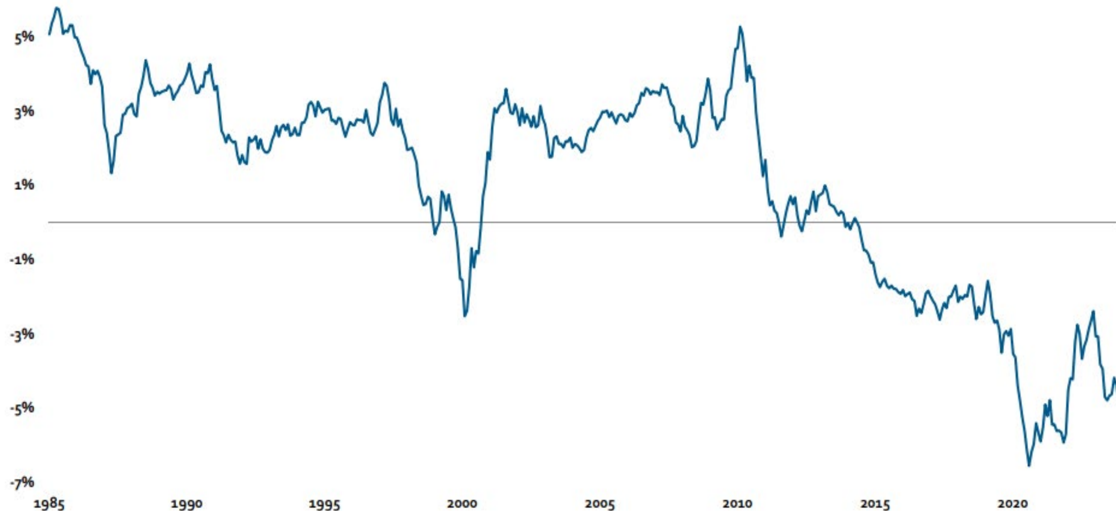
r = discount rate

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.

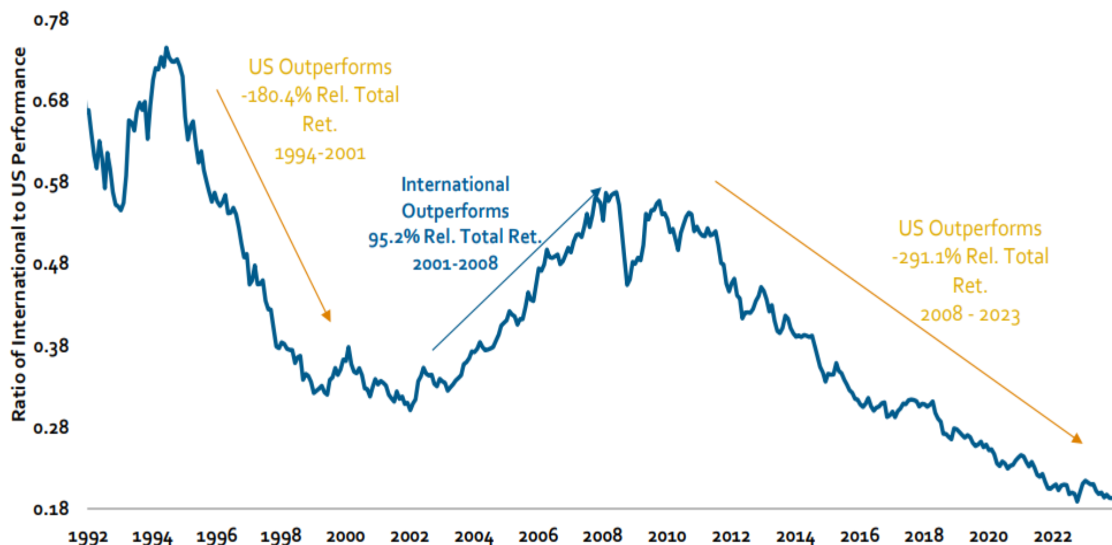
Of course, this is a simplistic example but, I think it demonstrates how sensitive valuations can be to changes in interest rates and growth rates. Let's take a quick look at the growth sector through this general prism…see graph below. When the line is moving down and to the right, growth stocks are 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).[4] 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).

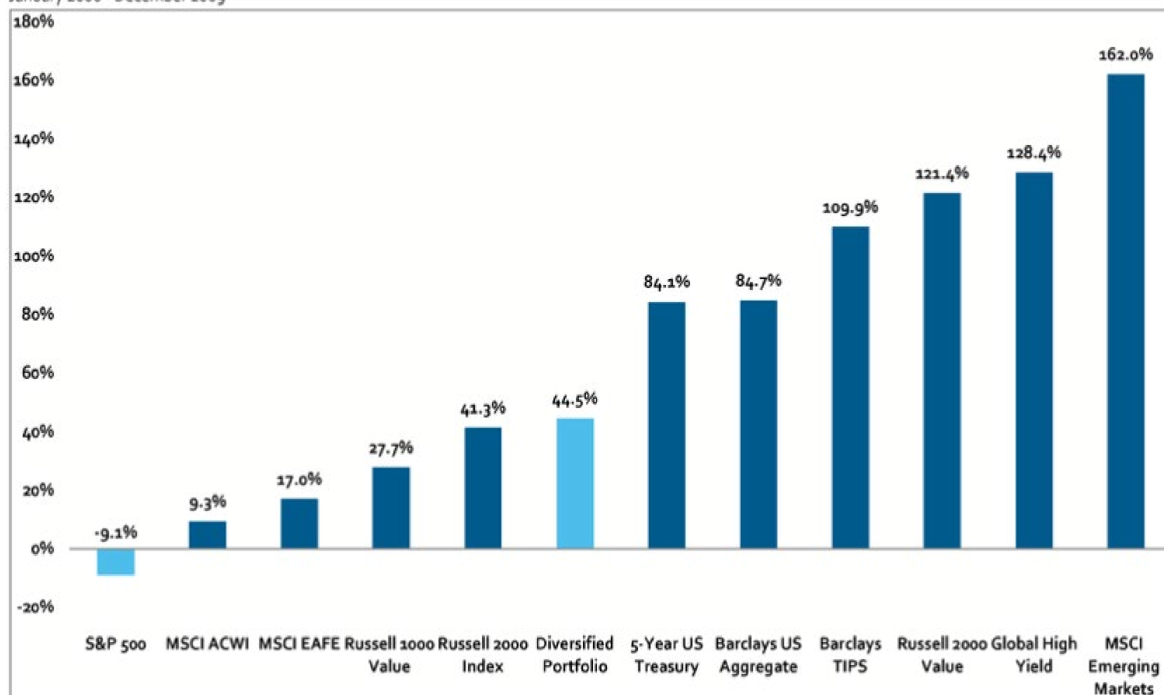
A similar (and related) phenomenon has played out between the U.S. and the rest of the world. See graph below.



Source: Morgan Stanley ChartBook (See disclosures below)

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 may be in front of us now for global value stocks.

Total Returns
January 2000 - December 2009



Source: Morgan Stanley Chartbook (see disclosure below)

What About AI?

Of course, the elephant in the room (especially when trying to make a case for value stocks) is the current Artificial Intelligence (AI) craze, Investors seem to be asking “Why discount 1 or 2 years of incremental cash flow for AI related stocks when you can bake in 6+ years of growth…right now”?!?! Of course,there will be some clear winners in the sectors that provide the “picks and shovels” like select companies in the software, data center and semiconductor space. In fact, Morgan Stanley analysts estimate the opportunity is in the several hundreds of billions of dollars range for the “enablers”.[5] But, the question for investors is…how much is already priced in?

How about the potential beneficiaries in the “adopter” ranks?. After all, companies are not prospecting for gold…they are implementing productivity enhancing systems with the expectation of improved bottom lines. From a macro perspective, consulting firm McKinsey estimates that AI could add 0.6 percentage points annually to US GDP.[6] Similarly, Cresset Capital LLC points out that analysts estimate AI can add $7 trillion to global GDP over the next decade.[7] Furthermore, many emerging market economies have a unique opportunity to “leapfrog” the entrenched “non – AI” infrastructure in the developed world (a la the wireless telecom/internet infrastructure buildout where many economies simply skipped installing any wireline infrastructure).

Overall, the AI phenomenon is just an additive factor to what I believe is a compelling global cash flow/value thesis. For example, I believe a number of

global banks are simply too cheaply priced and AI efficiencies could be the catalyst to garner investor attention. According to the McKinsey Global Institute report, banks utilizing AI could boost their earnings by as much as $340 billion annually…equivalent to a 9 – 15% boost in operating profits.[8] I don't care if this cash flow is generated by banks or martians…it's just cash flow.

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

***Tactical Allocation Strategies in my Global Growth and Global High-Income Model Portfolios:**

Overweight	Underweight
Global Value Equities, Long/Short Equity Strategies, Quality Dividend Paying Global Equities, Emerging Market Consumer Equities, Total Return Strategies, Shorter-term Corporate Bonds	High P/E technology/growth stocks, Mid and 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,
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The Benedict-McLoughlin Group – *"Institutional Caliber Portfolio Management, Customized to Your Personal Situation"*

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Notes:

1. Bloomberg News, 1/19/24.
2. Bloomberg Markets, 10/6/23.
3. Bloomberg News, 1/19/24.
4. Bloomberg Markets, 2/15/24.
5. Morgan Stanley Research, 10/2/23.
6. Bloomberg News, 11/15/23.
7. Bloomberg News, 1/13/24.
8. Bloomberg News, 12/5/23.

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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. Past performance is no guarantee of future results. Estimates of future performance are based on assumptions that may not be realized. This material is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Please refer to important information, disclosures and qualifications at the end of this material.

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