Morgan Stanley

Monthly Musings

Chris Benedict, CFA
The Benedict-McLoughlin Group @ Morgan Stanley

July 11, 2022

With the US Federal Reserve in full inflation-fighting mode, the "adjustments" continue in both the equity and fixed income markets…The MSCI All Country World Index is down 19.97% year-to-date through 6/30/22 and the Bloomberg Aggregate Bond Index is down 10.35%.[1] This was the worst first half for stocks and bonds in decades.[2] Underneath the surface, value stocks are holding up better than their growth counterparts as evidenced by the S&P 500 value index "only" being down 11.42% while the growth index is down 27.62%.[3] Digging further reveals even more pain…for example, as of 5/19/22, the average stock in the Nasdaq 100 and the small cap Russell 2000 was down 34.2% and 44.6%, respectively.[4] And this has gotten worse in recent weeks…the damage is clearly significant underneath the surface of the major indices.

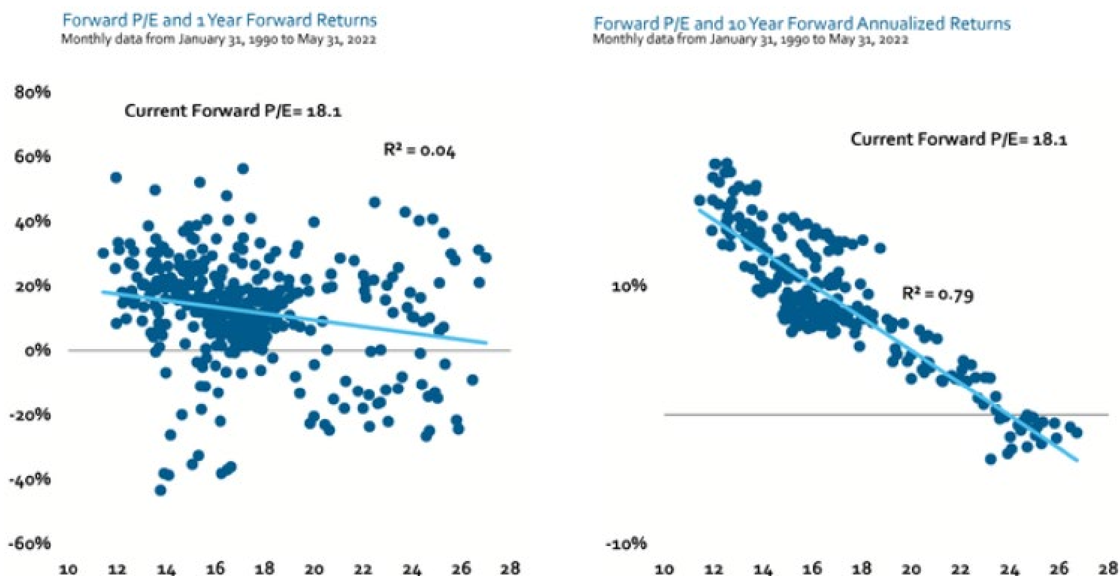
Unfortunately, I think the large indices likely lose their relative safe-haven status and have further to go on the downside. In a Morgan Stanley study last month, our analysts measured that, at around the 4100 level, the largest 5% of the S&P 500 stocks were trading at a 40% median premium to pre-COVID levels compared to 17% for the rest of the index.[5] Given that the largest 25 stocks make up around a 35% weighting of the index, any reduction of this premium puts downward pressure on the overall index (let alone the 17% premium of the rest). Well, we certainly experienced some of this in June and Morgan Stanley's Chief Market Strategist, Mike Wilson, believes that we could go as low as 3350 in the next 12 months on the S&P 500 in his bear case…his base case target is 3900, right around current levels.[6]

Despite my pessimism on the overall S&P 500 (and Nasdaq 100), I do believe there are pockets of significant opportunity away from the U.S. mega-caps. Overall, we continue to overweight global value equities in our model portfolios, and this has helped mitigate a fair amount of downside so far in 2022. Specifically, the global financial, healthcare, energy infrastructure and telecom sectors are good places to shop, in my opinion. And, given the

large sell-off in growth stocks, there are a handful that finally look attractive again…the so called GARP strategy (growth at a reasonable price). But, selectivity is key. Importantly, our allocation to alternative investments has also helped mitigate downside so far in 2022.

A Multi-Year Opportunity?

While it's hard to know where the next couple of months or even quarters will take us, the overall next cycle looks much clearer, in my opinion. I continue to believe global value stocks will outperform. Valuation matters and the cheaper you can buy stocks, the better the long term return is. The chart just below illustrates this very nicely. The left half shows that the correlation between valuation and return is close to zero (0.04) over a one year time frame. However, the right half shows that this same correlation approaches one (0.79) over a 10-year period.



Source: Morgan Stanley ChartBook (See disclosures below)

There is also a technical reason why I believe global value stocks will do well (at least relative to growth stocks)…we've recently finished an extreme period of relative underperformance for value stocks. The graph below shows the relative performance of growth stocks vs. value stocks…when the line is moving down, growth is outperforming, when moving up, value is outperforming. The twelve years or so starting in 2010 was very good for growth stocks, largely due to artificially depressed interest rates following the 2008 – 2009 Financial Crisis and then again when COVID hit. The value of long duration assets like growth stocks is inversely correlated to interest rates…and when you approach 0%, well, it can get out of hand.

Relative Performance of Value vs. Growth

MSCI World Value Index vs. MSCI World Growth Index*

Monthly data through May 31, 2022

Source: Morgan Stanley ChartBook (See disclosures below)

While I have the most conviction in the value vs. growth factor over this next cycle, I also believe the international vs. U.S. factor will be important as well. The graph below shows the performance of international stocks vs. U.S. stocks. When the line is headed down, the U.S. is outperforming, when it goes up, international is outperforming. It has been a good decade to focus on U.S. only…but, if history even just rhymes, this won't last. Importantly, international valuations are both much lower than the U.S. and they are also below their own long term average.[7]

The graph below focuses on developed international stocks but, a graph of emerging market stocks looks similar…and the opportunity may be even greater. Emerging market valuations are both absolutely and relatively cheap but, the historical reasons for this are well known: higher inflation, political instability, lots of government debt, sub-optimal policies, etc. But, don't those reasons also apply to much of the developed world currently? So, we have similar risks between emerging and develped markets but, according to Bloomberg, emerging markets are expected to grow their economies by around 2.5 percentage points faster than developed economies in both 2023 and 2024.[8] Combine that with attractive valuations as well as the recent period of underperformance and I believe there are some opportunities for investors.

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 7/11/22):**

Overweight	**Underweight**
Global Value Equities, Long/Short Equity Strategies, Quality Dividend Paying Global Equities, Emerging Market Consumer Equities, Total Return Strategies	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

Christopher N. Benedict, CFA, CEPA
Senior Portfolio Manager/Financial Advisor
Alternative Investments Director

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

Morgan Stanley Wealth Management
10960 Wilshire Boulevard, Ste 2000 │ Los Angeles, CA 90024
310-443-0556 │ 800-648-3833 │ (F) 310-443-0566
chris.benedict@morganstanley.com

Sharpen your financial focus. Simplify your financial life. Learn more – watch the two minute Account Aggregation Video

Learn about our new *Goals Planning System (GPS)* – watch the two minute GPS Video

Linked in: www.linkedin.com/in/chrisbenedictcfa

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

NMLS #1278939

Notes:
1. Bloomberg Markets, 7/8/22.
2. Bloomberg News, 7/2/22.
3. Bloomberg Markets, 7/8/22.
4. Morgan Stanley, Daily Positioning, 5/19/22.
5. Morgan Stanley, US Equity Strategy, 6/6/22.
6. Morgan Stanley, US Equity Strategy, 6/6/22.
7. Morgan Stanley, The GIC Weekly, 7/18/22.
8. Bloomberg News, 7/3/22.

The investments listed may not be suitable for all investors. Morgan Stanley Smith Barney LLC recommends that investors independently evaluate particular investments and encourages investors to seek the advice of a financial advisor. The appropriateness of a particular investment will depend upon an investor's individual circumstances and objectives.

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are appropriate only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

Past performance is no guarantee of future results. Actual results may vary. Diversification does not assure a profit or protect against loss in a declining market.

Alternative investments involve complex tax structures, tax inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund.

Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are only made available pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.

Actual results may vary and past performance is no guarantee of future results.

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.

The individuals mentioned as the Portfolio Management Team are Financial Advisors with Morgan Stanley participating in the Morgan Stanley Portfolio Management program. The Portfolio Management program is an investment advisory program in which the client's Financial Advisor invests the client's assets on a discretionary basis in a range of securities. The Portfolio Management program is described in the applicable Morgan Stanley ADV Part 2, available at www.morganstanley.com/ADV or from your Financial Advisor.

Holdings are subject to change daily, so any securities discussed in this material may or may not be included in your account if you invest in this investment strategy. Past performance of any security is not a guarantee of future performance. There is no guarantee that this investment strategy will work under all market conditions. Do not assume that any holdings mentioned were, or will be, profitable.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The strategies and/or investments discussed in this material may not be suitable for all investors. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

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.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustration purposes only and do not show the performance of any specific investment. Reference to an index does not imply that the portfolio will achieve return, volatility or other results similar to the index. The composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error target, all of which are subject to change over time . For index, indicator and survey definitions referenced in this report please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Morgan Stanley Smith Barney LLC. Member SIPC CRC#4863814

© 2020 Morgan Stanley. All rights reserved