Morgan Stanley

Monthly Musings

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In this Musings, I'll cover the following:

- The overall market, particularly the growth cohort, is expensive but, there are cheap areas of the market below the surface
- I believe a number of catalysts are aligning to finally usher in a new and sustainable value cycle
- If I am right, don't just focus on "value"…focus on "deep value"

Welcome to the new cycle…

BACKDROP

The fact that "growth" stocks have trounced "value" stocks for a protracted period of time is not news to most investors. The graph below illustrates this relationship and clearly shows how well growth stocks have done relative to value since around 2010 with a "blowoff" extreme in the aftermath of COVID when the general consensus was that we'd all be stuck working from home and surfing social media for most of the day. Eventually, value just got too cheap and had a snap back rally...and we've had fits and starts of growth and value each going on multi-month runs in recent years.

Of course, artificial intelligence (AI) has increasingly been the focus of just about everyone and it certainly has caught the attention of growth investors. The record breaking build-out of AI infrastructure has benefited sectors ranging from software to semiconductors to power generation. As with any revolutionary technology, the optimism is palpable and eventually the market typically fully prices in the strong expected fundamentals well before the actual fundamentals peak.

Source: Morgan Stanley ChartBook (See disclosures below)

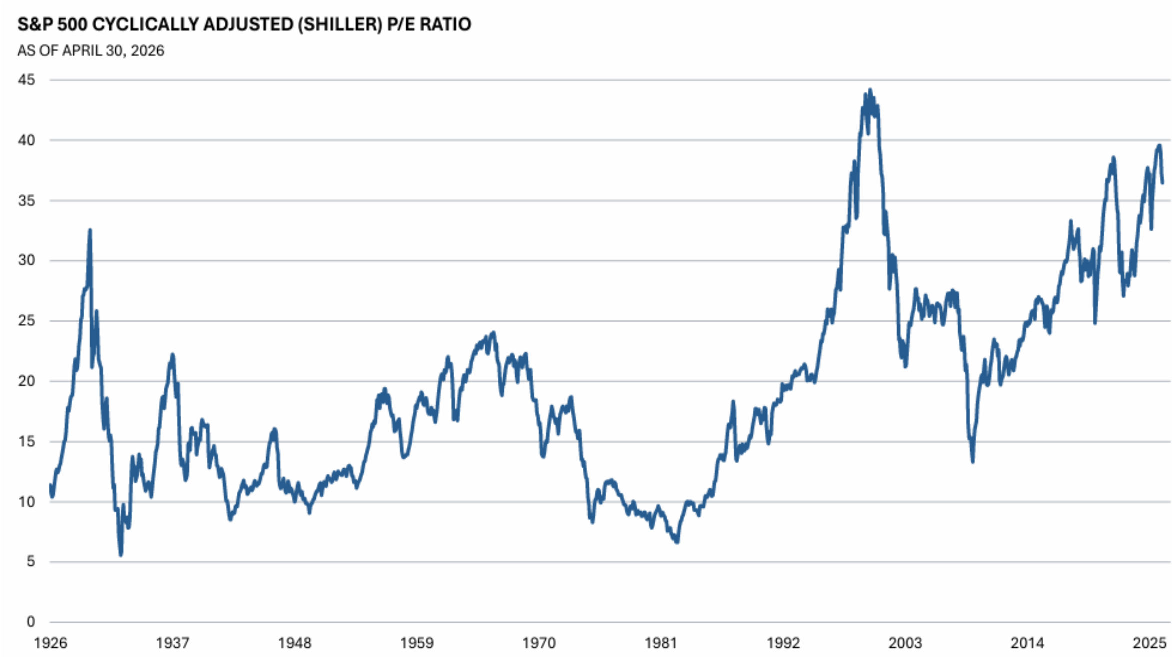
WHAT HAS CHANGED?

While the growth of AI doesn't appear to be abating, a number of factors are aligning that signal a shift in market leadership, in my opinion. Below is a non-exhaustive list…

Valuation:

Overall, the S&P 500 (with its large weighting in technology stocks) is at its 2nd highest ever valuation level as measured by the cyclically adjusted P/E ratio (see graph below). The only time it has been more expensive was during the dot-com peak in 1999-2000…not a great sign as it took over 12 years for the S&P 500 to make a new high after the March 2000 peak.[1]

Digging a bit deeper, the semiconductor index is trading around 71x profits and 15x sales, both multi-decade high valuations.[2] Semiconductors are big beneficiaries of the AI buildout and their stocks have had an epic run but, some of them have gone vertical in recent months. Yes, the fundamentals are strong but, the risk is extrapolating above average growth for too long in notoriously cyclical sectors. It's basically impossible to call the absolute peak but, it sure does feel like we are getting close.



Source: Morgan Stanley ChartBook (See disclosures below)

The Nature of the Beast:

Large, industrial revolution types of events have happened before in the past (i.e., railroads, internet) and history has shown that a large number of companies simply don't make it and go bankrupt. The excitement of a very real game-changing technology attracts a ton of capital and everyone's business model has them capturing significant market share which, of course, is impossible. This time appears to be following the same pattern as we see massive capital raises almost daily across the debt and equity markets, public and private. The competition across all of the AI sectors is intensifying…

The good news is that this is the nature of capitalism…the societal benefits are enormous, beyond the significant wealth already created. The broad productivity gains from the railroad and the internet were massive and I expect similar benefits from AI. Additionally, the tax revenue generated from economic activity and capital gains helps to fund much needed social programs. The key for investors is to avoid the eventual losers…and not to overpay for the eventual winners.

AI Adoption:

If AI does eventually live up to all of the hype…and I am generally optimistic…then the benefits to the "non-AI" companies should be significant. Anecdotally, I'm experiencing productivity benefits both in my personal and professional life...and I think I'm still pretty far from taking full advantage of it. Estimates certainly vary but, a report by EY-Parthenon expects labor productivity to increase by 1.5 – 3% over the next decade.[3] I believe this is reasonable given what we saw as internet adoption proliferated.

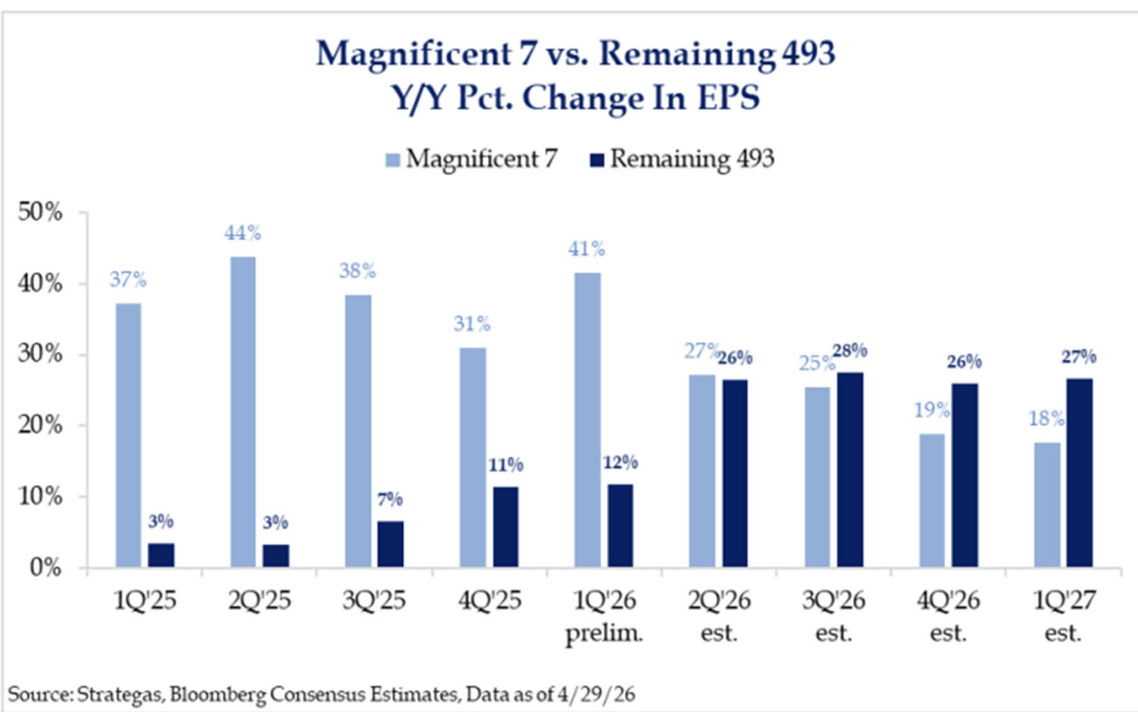
And let's not forget where all of those revenues are coming from in all of these "brilliant" business models…the customers! Of course, those revenues will only materialize if the customers expect (and achieve) a significant ROI from incorporating AI into their business models. I think this bodes well for margin expansion for those successful adopters.

Economic Growth:

Another potential catalyst is that value stocks tend to be more leveraged to the economy as compared to secular growth companies like in the technology sector. The war in Iran certainly put a damper on economic growth in regards to both general sentiment along with the very real spike in energy prices. If the war is really over, we can potentially begin to feel the positive effects of the "One Big Beautiful Bill" Act (OBBBA) and other stimulus. Here's a non-exhaustive list of positive factors:

1) Continued strong capex due to AI and $200 billion of OBBBA incentives[4]
2) Corporate tax cuts have exceeded tariffs collected YTD[4]
3) $60 billion of consumer tax refunds[4]
4) Approximately $100 billion of fewer capital gains taxes in April due to the OBBBA[4]
5) $700 billion increase in bank deposits since the Fed balance sheet expansion[4]

All of the above should help end the "earnings exceptionalism" that growth/technology stocks have enjoyed for years (see graph below). Combine this with the aforementioned AI adoption thesis and I think we have a potentially potent mix. And if the higher for longer interest rate environment persists, this may favor lower duration assets like value/cyclical stocks vis a vis longer duration growth stocks.



WHAT TO DO

Despite what I've laid out, I wouldn't suggest going out and selling all of your growth/tech stocks…it's really a recommendation for fresh capital as well as a diversification play. Investors can get exposure to value stocks several different ways: Individual stock picking, ETFs, mutual funds, separately managed accounts (SMAs) and via alternative investments. Be careful with index ETFs, however, as a number of "growthier" names (which I would avoid at this point) have somehow found their way into some major value indices.

In addition to potentially providing better relative returns going forward, deep value stocks tend to zig when the AI focused stocks zag…and this may reduce overall portfolio risk.

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

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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 Global Core and Global Value Opportunities strategies are designed to achieve growth via investments in global equities. The Global High-Income strategy is designed to achieve above average income via investments in bonds, ETFs, closed end funds and dividend paying equities.

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, 6/20/26
2. Bloomberg News, 5/31/26.
3. www.weforum.org 1/26/26.
4. Strategas Research, 6/9/26.

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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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