R Thoughts

Morgan Stanley

The Diamond Peak Group
at
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> The stock market is a device for transferring money from the impatient to the patient.
>
> Warren Buffett

In a dramatic reversal from the nearly across-the-board decline of every major asset class in 2018, the first half of calendar year 2019 rewarded investors by exhibiting universally positive returns. The DJ Industrial Average, the S&P 500 Index and the NASDAQ Composite Index generated 6-month returns of 15.4%, 18.5% and 21.3% respectively. Declines in interest rates worldwide also lead to positive returns for most bond investors.[1]

The Bond Markets

Today, global bond markets are perhaps the most irrational in history. Worldwide, interest rates paid on bonds issued by governments are at or near all-time lows. It is hard to believe but there is a record $13 trillion dollars' worth of global sovereign bonds which are trading at a negative yield.[2] Yes, that's correct—bonds issued by foreign governments, mostly in the European Union, Switzerland, Scandinavia and Japan—of which the owners pay for the privilege of holding the bonds. No interest, no upside, only negative interest payments made by the bond-holders to the bond issuers.

Good luck if you are an investor in Europe looking to find a positive yield on a top-quality security. The nation of Austria (Aa1/AA+) recently issued another edition of its "century bonds," bonds maturing in September 2117—with a yield of 1.171%. Investors in this issue are locking up 1.171% for 100 years and institutional investors, such as pension funds and insurance companies, are hungry enough for high-quality fixed-income securities to pay an "irrational" price for these bonds. "In a world of negative yields, positive returns are scarce."[2]

It's no wonder global investors may look at the U.S Treasury 10-year Bond—backed by the full faith and credit of the U.S. Government and currently as of July 5, 2019 yielding 2.00%—as an attractive investment vehicle in a world otherwise dominated with lower or negative income opportunities. This also may shed a bit of light on why the yield on the 10-year has declined over the past 12 months from 2.84% on 6/28/2018 to 2.01% on 6/28/2019. Compared to other sovereign debt offerings U.S. Government bonds at present generally offer higher interest rates and better credit ratings. As the demand for these bonds has increased so has the price, resulting in a lower yield to maturity for the existing bonds.[3]

The Stock Markets

As stewards of investment capital our job is to find the most promising long-term return opportunities with the least amount of relative risk. hose return opportunities can take us into various asset classes, U.S. stocks, International stocks, Fixed Income—Bonds, Commodities, Currencies and Cash.

At present, we find the current investment climate somewhat disconcerting. As we mentioned in the last edition of *RThoughts*, the relationship between U.S. stocks—as measured by the S&P 500—and interest rates—as measured by the 10-Year U.S. Treasury bond—are each reflecting two different economic outcomes.

One of these markets is currently mispriced. Could it be the S&P 500, trading at all-time highs, at nearly 18 times forward earnings and anticipating an economic

soft landing, lower interest rates and a quick resolution to trade disputes? Or is it U.S. Treasuries, which are currently priced for a recession, with yield curves inverted (shorter rates higher than longer rates) and the expectation that the Federal Reserve might cut interest rates 4 more times in the next 12 months?

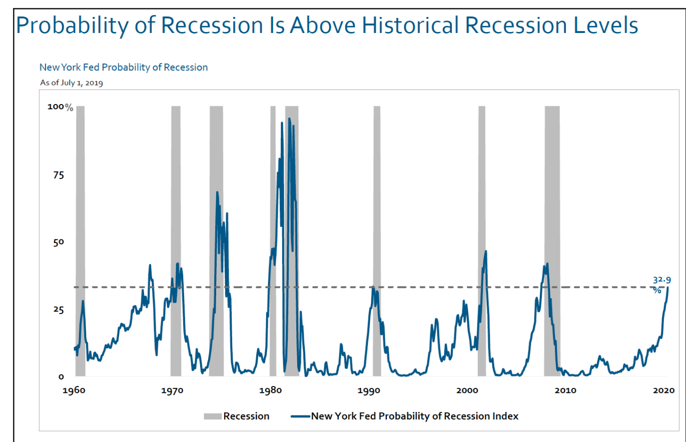
This phenomenon of rising stock prices while interest rates decline would suggest completely opposite narratives. This situation sometimes occurs but is rarely sustainable as the change in the six-month U.S. Treasury yield and stock returns have moved in the same direction 80% of the time in the past 20 years.[4]

What we are saying here, is that the current pricing of the stock and bond market is almost untenable—the bond market is discounting the probability of a recession on the horizon, while the stock market is telling us of increased economic activity and the potential of higher equity prices ahead.

As both the stock and bond markets can't be right over the long term, which view should we back? With the S&P 500 Index currently trading slightly over 3000 (7-15-2019) we believe that near-term risks are stacked against the equity market and investors should remain cautious.

Although currently a minority opinion, Morgan Staley strategists believe the case for a minor recession in the U.S. is increasing over the next 12-months. We take this opinion very seriously. Below is their Case for Recession.[5]

Despite the S&P 500 trading near all-time highs, we are increasingly concerned about the rising risk of an economic recession. Among other factors, this may be driven by an overtightening of monetary policy by the Fed. On May 22, this led to an inversion of the yield curve. Yield-curve inversion has been a historically reliable predictor of recession, and adjusted for unconventional monetary policy, may have occurred in December 2018. The result has been that the NY Fed's Probability of Recession Index is now above 30%, a level that has proceeded each recession since 1970. (See Chart in next column)



Source[6]

Leading indicators are pointing toward further deterioration in both economic growth and corporate earnings. Global new orders PMI, which has typically led earnings growth by 12 months, is now below 50, indicating contraction. MS & Co.'s earnings leading indicator as well as the OECD's global growth leading indicator both point to further deceleration. Market signals beyond rates are flashing warning signs as well. The wholesaler inventories-to-sales ratio is picking up, as defensive companies continue to outperform cyclical ones. The gold-to-silver price ratio, an indication of "safe-haven" demand, is also approaching cycle highs.

A number of confidence measures have decelerated in recent months, reflecting a potential tipping point that could impact future investment and hiring. Corporate confidence, small business optimism, earnings revisions breadth, and the Morgan Stanley Business Conditions Index have all decelerated while small business uncertainty has risen.

Markets peak on average seven months prior to a recession. After 10 years of expansion, investors should use this environment as an opportunity to ensure their asset allocation matches their risk tolerances and long-term strategy. A well thought-out plan is critical to riding out turbulent markets.

Although in the minority, the Morgan Stanley outlook on the economy and the U.S stock market is consistent with other independent firms. The Leuthold Group currently states, "Over a 12-month horizon, we now believe a U.S. recession is very likely" . . . and, "Current leadership

trends continue to track their 1998-99 behavior in an almost eerie fashion . . .. "[7] Cypress Capital currently places their Market Risk Index at "78% out of 100%, still firmly in the defensive/cautious territory.[8]

Although we have used several variations of the chart below it is useful to dust off and review periodically. It exhibits investor psychology at various stages of a stock market cycle. To review—late in the 1990s and early 2000 as well as perhaps in 2007, investors showed all the behavioral traits consistent with the Excitement, Thrill, and Euphoria stage with stock prices then declining appreciably in the corresponding several years. On the opposite extreme one needs to only reflect back to late 2008 early 2009 for what the Despondency/Depression cycle looked like and how investors responded to it. It was—in retrospect—a point of maximum investment opportunity.

Source[9]

So the question we continually ask ourselves—and also to you—is to where are we on this Optimism, Euphoria, Anxiety, Despondency, Depression cycle? Does the U.S. Stock market at present discount the possibility of slower economic growth over the next year or does it overlook that possibility exhibited by the bond market and believe economic growth continues unabated into the future? We believe at present the U.S. stock market is priced to perfection and risks of a market decline have increased significantly in the past few months. We would argue that the current investor emotional level is somewhere between optimism and thrill which also adds to the risks we see now.

The U.S. stock market continues to have a number of positive factors still in its favor.

For one, from a relative strength standpoint, U.S. stocks continue to be the strongest asset class of the six (International Equities, Fixed Income, Currencies, Commodities and Cash) we currently monitor. Until we witness a change in this dynamic we will continue to give U.S. stocks the benefit of the doubt and overweight them in portfolios.

Second, we believe policy still remains very favorable to risk assets. Tax rates remain low, regulations for businesses on the national level continue to remain positive and there are rumors of additional pro-growth policy initiatives which could support increased stock prices in the future. One in particular could be very significant.

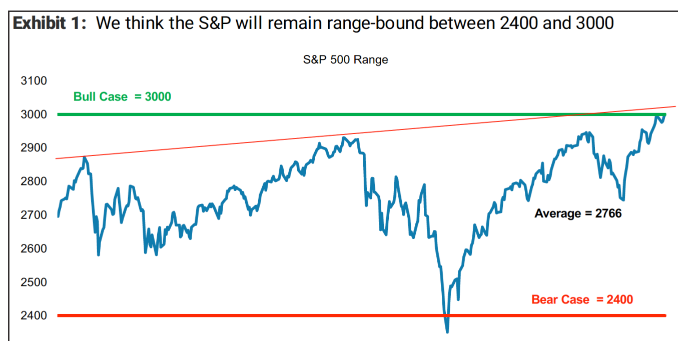
As detailed in the *Washington Post* on Sunday, July 14th by Steven Moore, the Trump Administration is moving to index capital gains taxes for inflation. If passed, this could be one of the most significant pro-growth initiatives in recent history. Such a move would unleash trillions of dollars in capital and be extremely good for U.S. stocks.

Quoting Mr. Moore, "In an ideal world, Congress would define a gain for an asset held over a long period of time as taking into account inflation. This would reward risk taking and capital investment by reducing the "real" capital gains tax. It would also induce more shareholders to sell stocks in old assets . . . and buy into shares of new-age companies that will be the wealth and job creators of the future. I suspect most Americans would think that would be a fair treatment."[10]

In our opinion, this proposal is a fair, common-sense approach to long-term capital gain taxes. What are the chances of its passage into law?

As we scan the investment horizon we observe some positives and some potential negatives. This is nothing new. Longer term, as long as policy decisions favor pro-growth outcomes, we remain optimistic on equity/

growth assets. Shorter term, over the next few months, we currently possess some general reservations on the continued upward path of equity prices.



Source[11]

Until we witness another round of earnings increases in U.S. stocks we remain committed to the belief that the S&P 500 will trade between 2400 on the low and 3000 on the high side. In order to help control risk in the portfolios we manage on your behalf, we have currently increased cash levels and employed a small set of equity hedges in an effort to reduce the downside capture on any overall stock market decline.

Following the advice of The Oracle of Omaha, we will also be deploying patience to make the most of the current market ride.

As we close we wish you a wonderful and enjoyable rest of the summer. Please feel to contact us with any questions, concerns or explanations.

Sources and Footnotes

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Return to article

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Return to article

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Chart: Recession Probability Approaches Critical Threshold
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[7] The Leuthold Group Institutional Research, (July 2019). *The Green Book*.
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[9] MS Wealth Management (May 2019), Wealth Management Perspectives, *Morgan Stanley-Wealth Management Investment Resources, Chartbook-Intro to Investing*.

Chart: It's Easy to Let Emotions Get in the Way.
Return to article

[10] Moore, Stephen. (July 14, 2019) Trump Moves to Lessen the Pain of Capital Gains Taxes, *The Washington Post*.
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Exhibit 1: We Think the S&P ill remain range-bound between 2400 and 3000—Bloomberg, Morgan Stanley Research forecasts
Return to article

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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.

Derivatives, in general, involve special risks and costs that may result in losses. The successful use of derivatives requires sophisticated management, in order to manage and analyze derivatives transactions. The prices of derivatives may move in unexpected ways, especially in abnormal market conditions. In addition, correlation between the particular derivative and an asset or liability of the manager may not be what the investment manager expected. Some derivatives are "leveraged" and therefore may magnify or otherwise increase investment losses. Other risks include the potential liability to terminate or sell derivative positions, as a result of counterparty failure to settle or other reasons.

The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. An investment cannot be made directly in a market index.

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