R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

Winter 2020

morganstanleyfa.com/diamondpeakgroup

> Welcome to the party, pal.
>
> Bruce Willis
> NYPD Detective John McClane
> *Die Hard*, 1988

In the holiday movie classic *Die Hard*, McClane enters the fictional Nakatomi Plaza in Los Angeles on Christmas Eve to attend his estranged wife's company Christmas party and finds the mood festive—almost euphoric. It had been a great year for the company and nothing could possibly go wrong—until it does.

In many ways the returns in the financial markets in 2019 were mirror images of themselves from those of 2018 which then were mirror images of the results in 2017.

After enjoying the low volatility and positive monthly returns in 2017, 2018 was characterized as a disappointing year in which no major asset class provided returns that outpaced inflation.[1]

Welcome to the party that was 2019 in the worldwide equity markets.

Spurred on by the punchbowl of liquidity supplied by the Federal Reserve and other Central Banks around the world, the Dow Jones Industrial Average returned 25.3% in 2019. Not to be outdone the S&P 500 surged to a return of 31.5%. Each sector in the S&P 500 experienced at least double-digit gains. All markets in Europe and Asia, with the lone exception of the FTSE Bursa—Malaysia generated positive returns.[2]

The current attitude of investors in the equity markets worldwide is perhaps similar to the party-goers at the beginning of *Die Hard*—festive, almost euphoric. More on that in a bit.

The Stock Markets

Twelve months ago we were all looking back on a somewhat dreary 2018, a year in which all major large-cap indexes had lost ground. Trade concerns with China, deteriorating political strife, slowing growth aboard and a less accommodative Federal Reserve all took their collective toll on investor moods.

Fast forward a year. Global growth is still uncertain, the national political environment is most certainly worse, not better. What has changed for the positive is a limited trade truce between the US and China, but many details still need to be worked out prior to a long-term accord being completed.

What's more, the Federal Reserve has altered its monetary outlook—going from raising short-term interest rates, as it did in 2018, to lowering them three times over the course of the past year. This has added a tremendous amount of liquidity to the nation's economy and helped support higher prices for risk assets like stocks.

This decade was also a favorable one, especially for those investing in index products based on the S&P 500. The decade had an 11.23% annualized rate (13.56% with dividends), as the longest-running bull market continued on (from March 9, 2009), with the help of low-interest rates and strong, steady consumer spending.[3]

Proving again just how difficult the period between early 2000 and early 2009 was for domestic equities, returns would have declined to 4.02% or 6.06% with dividends if we measure the twenty years from 2000 to 2019.[3]

We find it interesting that over the past three years, the S&P 500 Index has experienced only 6 individual months of negative returns. There were only two months in 2019 when stock prices retreated, August (-1.58%) and May (-6.35%). In contrast, 2018 saw 4 months of declines, capped off with that December's -9.03%. We were blessed with not one month of negative returns in 2017. Six negative months out of 36 is evidence of below average volatility within the U.S. equity markets.[4]

Policy Based Investing wrote this week, "A new year has begun, but the economic policy landscape has not changed much. The most important driver for asset allocation in 2020 remains this year's Presidential election. U.S. equities remain favorable as odds are high that pro-growth economic policies will be re-elected in November."[5]

We will continue to monitor developments regarding the November election only in its potential impact to affect policy—taxes, regulations, pro-growth economic policies. We think any threat to these would undoubtedly cause downside turmoil in risk on assets like U.S. stocks.

At present it seems to us there is a significant amount of investor enthusiasm surrounding, in particular, the U.S. equity markets. That's not unusual after a notable year of positive performance.

We remain constructive on the domestic stock markets however it is important to remember that stocks don't go up in a straight line. Policy Based Investing states, "Even in the very best economic policy in years the U.S. stock market has sell-offs. With the current Fear/Greed Index at 93/100, now is not a low risk entry point for U.S. stocks. This doesn't mean stocks will go down, but there is likely to be a lower risk moment in 2020 to buy. Roughly one year ago, in the depths of the December 2018 monetary policy panic, the Fear/Greed Index was 16/100."[6]

It appears to us that market participants are currently more tilted towards a Euphoric mood. Throughout our investment history we have found that these periods can turn out to be problematic over the near to intermediate term.

In our opinion there is a certain amount of FOMO (Fear of Missing Out) occurring in the markets at present. Positive performance begets more positive performance as investors eschew valuations and continue to buy what is going up. A positive feed-back loop occurs leading to the very real prospect of a "melt-up" occurring. That's exactly what happened to stock prices in the late 1990s.

Investopedia defines a melt-up as "dramatic and unexpected improvement in the investment performance of an asset class, driven partly by a stampede of investors who don't want to miss out on its rise, rather than the fundamental improvements in the economy."

Everyone has their own opinion on the outlook for the economy and thereby justify whether or not stock prices are currently cheap or expensive. We would argue that they are currently neither cheap nor significantly overvalued but that's really not the point of this argument.

What is common in most "melt-ups" is the lack of rationality. The only factor considered is that the stock price(s) continues to rise. Fundamentals and valuations are often over-looked in the decision making process. To put it another way, risk management practices are often of no significance in markets such as these. The ultimate quest for return is all that remains. We believe this single-minded focus on returns is beginning to create a feed-back loop.

Using the S&P 500 as a proxy for "the market" it might become evident how the positive feedback loop can get started.

Looking at the top 5 stocks in the S&P 500 "Capitalization (Size) Weighted" Index we observe the following companies and their respective weighting within the index:[7]

Apple, Inc.	4.57%
Microsoft Corporation	4.48%
Alphabet Inc. (Class A & B)	3.11%
Amazon.com Inc.	2.91%
Facebook, Inc.	1.93%

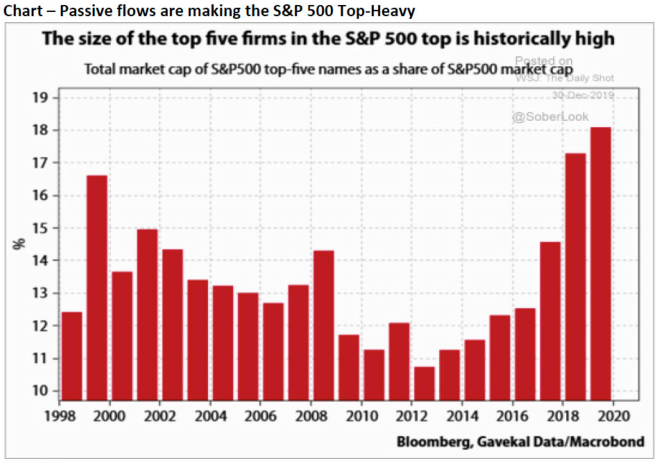
Throughout history investors have a rear-view mirror as it pertains to their choices in which asset classes they favor. For the past nine years the best performing asset class has unquestionably been U.S. stocks and in our observations "indexing" has been the preferred investment vehicle to participate in and gain exposure to that specific asset class.[3]

When $10,000 dollars is invested into the S&P 500 Cap Weighted Index it buys each of the companies in the index in their current "cap-weighted" percentage. So based on the table above every $10,000 dollars invested in the index would buy $457 of Apple, $448 of Microsoft, $311 of Alphabet, $291 of Amazon and $193 of Facebook.

As index investors buy more of the index its buys more of the companies in the index which drives up prices which results in additional buying. This is the feed-back loop. When this occurs without regard to valuations and fundamentals it results in the aforementioned "melt-up."

To further illustrate this point please consider the chart below.[8]

Chart – Passive flows are making the S&P 500 Top-Heavy



Source: WSJ

These top five companies combined are currently valued at historic levels as a share of the total S&P 500 market value. The top five companies today represent a higher percentage of the overall index as the top five companies did in late 1999 which has often referred to the last real "bubble" in stock prices.

The upward pressure from the demand for stocks from buyers is exacerbated by sellers. For the same reason everyone with cash is rushing to buy, we believe those now fully invested are not selling because they believe prices will be higher in the future. And, as we've discussed many times in previous *RThoughts*, when demand for anything out paces supply the results are higher prices.

On the individual security level this chart may put the current market environment in perspective.[9]

Chart – Apple's Market Cap has surpassed the entire US Energy sector

Currently the market value of the largest company in the U.S.—Apple—is worth more than the entire energy sector.

In our experiences we have tended to see these sorts of aberrations, not at market bottoms but at levels when stocks are vulnerable to some sort of temporary correction.

Despite all of the above we continue to remain generally favorable on risk assets like Domestic and International equities. We are currently not fully invested, dialing down the "dimmer switch" of risk to levels that we believe would allow our portfolios to better weather any change in the otherwise uber-confident market outlook.

And at some point, as John McClane found out in *Die Hard*, even the best of parties can suddenly come to an end.

The essence of investment management is the management of risks, not the management of returns.

~ Benjamin Graham.

Sources and Footnotes

1 *MS Wealth Management*—Market Strategies Daily Positioning, January 3, 2019
Back to article

2 *MS Wealth Management*—Capital Market Indices, January 2, 2020.
Back to article

3 *S&P Dow Jones Indices*—Market Attributes—December 2019.
Back to article (page 1)
Back to article (page 2)
Back to article (page 3)

4 Morgan Stanley: Account Level—Fixed Period Performance.
Back to article

5 *Policy Based Investing*, January 6, 2020.
Back to article

6 *Policy Based Investing,* January 6, 2020.
Back to article

7 DWA Chart SPY Top Positions January 10, 2020.
Back to article

8 Chart: Cypress Capital Market Outlook, Mark T. Dodson, CFA. January 3, 2020.
Back to article

9 Chart: Cypress Capital Market Outlook, Mark T. Dodson, CFA. January 3, 2020.
Back to article

The Diamond Peak Group at Morgan Stanley

Jim Kniffin CPM®
Branch Manager, Senior Vice President,
Portfolio Management Director, Financial Advisor
503.588.5741
NMLS #1262143

Scott Bigham, CFP®
First Vice President, Portfolio Management Director, Financial Advisor
503.588.5726
NMLS #1274637

John Sipple, CFP®
First Vice President,
Portfolio Management Director, Financial Advisor
503.588.5705
NMLS #1261821

William Stabler
Vice President
Portfolio Manager, Financial Advisor
503.588.5744
NMLS#1282844

4582 SE Commercial St., Suite 200
Salem, OR 97302

Written January 3, 2020

Disclaimers

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.

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.

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.

Diversification does not assure a profit or protect against loss in a declining market.

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.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

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 FTSE Bursa Malaysia KLCI Index comprises of the largest 30 companies by full market capitalization on Bursa Malaysia's Main Board. When launched, on July 6, 2009 it replaced the Bursa Malaysia KLCI Index starting at the closing value of the KLCI Index on July 3 2009, also inheriting the full history of the KLCI Index. An investment cannot be made directly in a market index.

Morgan Stanley Smith Barney LLC. Member SIPC.