R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

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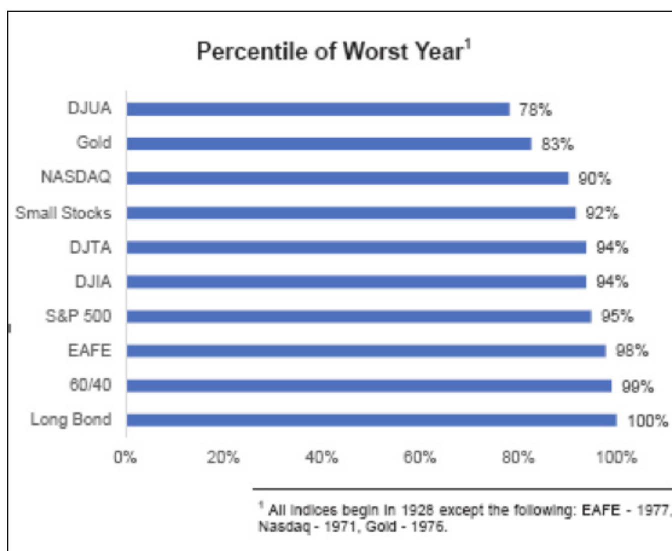
> "… Sometimes I feel, like I've been tied to the whippin' post."
>
> "Whipping Post"
> The Allman Brothers Band, 1969

To state the obvious—so far 2022 has been a very difficult year for both stock and bond investors worldwide who may feel like they've taken a beating.

As seen in Chart 1 below, to put the first three quarters into perspective, we have ranked the yearly performance of major assets and indices compared to prior years. As you can see, there was no place to hide, not even in gold.

For example, at the end of third quarter 2022 the 30-year Treasury long-bond was down 33.92% for the year, which is its worst performance since 1928. The S&P 500 Index was down 23.5%, which is worse than 95% of all other years.[1]



Notice also the long acclaimed 60/40 stock-bond portfolio which experienced declines worse than 99% of all other years. It truly has been a year when investors have felt a bit black and blue.

The Bond Markets

Starting my (jk) professional career in 1981 has afforded me insights into just how inflation and higher interest rates affect corporate profits and the overall health of the economy. Inflation and interest rates last peaked in 1981 ushering in a generational long-term bull market for bond investors. This year has put an end to that cycle.

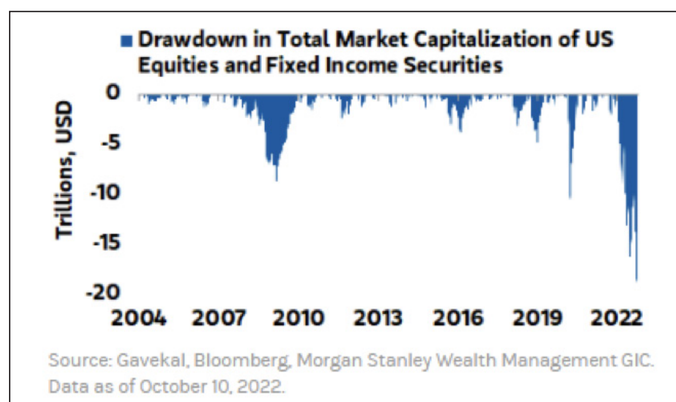
With the benchmark 10-Year Treasury Bond now currently yielding more than 4%, the magnitude of interest rate increases this year are unprecedented. The yield on the 10-Year has now increased over 150% year-to-date—rising from just under 1.50% at the end of the year to 4.22% as of Thursday, October 20th.[2]

As we mentioned in the Summer 2022 edition of *RThoughts*, over the past 60 years (1962-2021), the yield on the 10-year Treasury Bond has never doubled in a calendar year. Since the 10-Year is the polestar for most fixed-income and mortgage rate pricing, its higher yields have spillover effects on the economy.

We are now witnessing significantly higher home-mortgage rates with the average rate on a 30-year mortgage at 6.95%, up from 3.09% a year earlier.[2] Home sales have slowed as mortgage applications fell 38% from a year earlier in the week ended October 14, according to the Mortgage Bankers Association.[2]

We are seeing the effects of higher inflation and interest rates beyond the housing industry. Consumer confidence has slipped noticeably over the past few months. Persistent inflation, much tighter monetary policy and multiple threads of uncertainty have contributed to higher bond yields, lower equity valuations and higher stock-bond correlations.

As seen in Chart 2 below, the volatility has prompted a drawdown in U.S. equities and fixed income securities of more than $18 trillion, more than double the U.S. dollar drawdown in the Global Financial Crisis and 50% more than the COVID-19 selloff. Amid the turmoil, investors have fled risk for the safety of money market assets which reached $4 trillion dollars. At some point in the future more constructive sentiment could eventually draw some of this "dry powder" from skittish investors possibly adding support to stock prices at these levels.



Through this carnage in the fixed income markets, we are now starting to realize some opportunities in this space. Unlike the COVID crisis in the Spring of 2020, there are more credible investment options in Treasury Bonds and other fixed income instruments, taking away the popular TINA—"There Is No Alternative" to stocks—narrative.

With U.S. Treasury rates currently yielding more than 4% across nearly all the maturity spectrum, we see short-term opportunities here.[2]

As inflation peaks, corporate profits slow and the economy weakens with them, we believe interest rates now have room to head lower, which sets up the potential for capital gains in the value of those bonds. Remember, as rates decline the value of the underlying bond will generally increase.

However, as we discussed in our last edition of *RThoughts*, this is very much a tactical trade, one in which we are looking for a specific potential result. In absence of such result, we would not anticipate being long-term investors in those Treasuries.

The Stock Markets

While experiencing declines of more than 25% from its all-time highs earlier this year, the S&P 500 Index recovered in October with a gain of 8.1% for the month overall.[3] Through the end of October, the major indexes have all experienced declines—albeit with significant dispersion—with the Dow Jones Industrial Average down 8.4% YTD, the S&P 500 off 17.7% for the year so far and the tech-laden NASDAQ index retreating almost 30%.[3]

Regular readers of *RThoughts* know these developments are not a surprise to us and something we have been preparing for over the past year. However, we believe it is more important at this juncture to look ahead to potential market-moving developments rather than looking in the rear-view mirror.

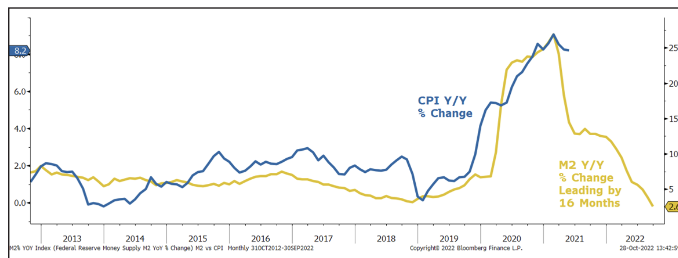
"Investors see a myriad of unknowns right now, but we prefer to structure portfolios for the only two certainties we see for the next 6-12 months: 1) the Federal Reserve will continue to be tightening or raising short-term interest rates and 2) corporation profits will be decelerating," Richard Bernstein of Richard Bernstein Advisors.[4]

Historically, this combination of events is not typically a positive one for the equity markets. We view this process as a two-act play with the first act being the clarion of significantly higher interest rates and inflation due to easy money policies which were enacted by Central Banks around the world over the previous two years.

We believe that this first act of the play is largely complete with inflation peaking and longer-term interest rates starting to decline.

To quote the well-respected economist, the late Milton Friedman, "There is one and only one basic cause of inflation: too high a rate of growth in the quantity of money. Government controls the quantity of money and as a result inflation in the United States is made in Washington and nowhere else."[5]

This quote from Friedman is from the early 1980s, the last time the U.S. experienced increasing inflation at the levels we are witnessing today and is as accurate now as it was then. Inflation is a monetary and policy problem resulting from too much money chasing too few things.



As we can see in Chart 3, the quantity of money Friedman references' is the gold line—M2 or the Money Supply. Think of it like the amount of wood on a fire—more of it results in a hotter fire but also increases the risk of an unwanted accident—in this case, inflation.

Notice how the wood in the economy—the money supply—increased dramatically in 2020 and 2021 bringing the CPI—the inflation rate—up along with it. From a peak of 27% y/y in March 2020 the wood on the fire—the M2 money growth has collapsed over the past year growing at just 2.5% y/y. This suggests that if the blue line begins to follow the gold line—with a bit of a lag—then the economy might be coming to a screeching halt in the next few months. It also suggests that inflation has the potential to decline rapidly and with-it longer-term interest rates.

Lower interest rates due to reduced economic activity might bring a short-term benefit for the equity markets. However, as we move into the early months of 2023, we believe companies' profits might begin to decelerate and grow at a much slower rate—and thus open up the second act of the play—the potential of additional declines in the market indices like the S&P 500.

This second act of the play—the profit recession which is ahead—is not priced into the market indexes at this time, in our view.

In addition, one of the most accurate indicators when looking at the economic growth over the next 12 months or so—is the yield on the 10-Year U.S. Treasury bond, *minus* the yield of the 90-Day Treasury Bill. When the yield on the 90-Day is *more* than the 10-Year, it is "inverted" and has been a leading indicator of a recession in the next 6-12 months. It has recently inverted with the yield of the 90-Day T-Bill at 4.50% while the 10-Year is at 4.05%.[6]

We are already nine months into this bear market, and this inversion of the yield curve just now suggests a recession is in the cards over the next few months, in our opinion.

If we are indeed moving into a recessionary environment, one of the primary causalities will likely be slowing corporate profits which would normally lead to lower equity prices in the near term. We currently do not believe this second act of the play has yet to start but has the potential for additional price damage when it does so.

To illustrate this a bit further, here is how the S&P 500 Index companies net operating earnings per share change during economic downturns as measured by peak to trough annualized (4 quarter trailing) earnings:[7]

- From Q2 1989 to 4Q 1991 (10 quarters), S&P EPS declined 24.4%
- From Q3 2000 to Q4 2001(5 quarters): -31.6%
- From Q2 2007 to Q3 2009 (9 quarters): -56.7%
- From Q4 2019 to Q4 2020 (4 quarters): -22.1%

Takeaway: assuming a "mild/normal" recession, the S&P 500 earnings could decline by at least 20% from current (peak) levels of $221/share. That would take the S&P earnings down to $177/share and 21X earnings at today's close of 3856.[8] That seems like a pretty rich price to explain if we are indeed heading into a mild recession. Perhaps stocks are simply expecting corporate profits to remain high, regardless of a recession or looking beyond

the profits recession to an eventual recovery. Currently, we don't believe either explanation is valid.

We anticipate that in a recessionary environment, stocks will tend to trade at a much lower earnings multiple than today's 21X. Looking at recent recessions we would use a rule of thumb of about 17X. That's $177 a share in S&P 500 earnings in the next 12 months multiplied by 17X would equate to price on the Index of 3000—more than 20% lower from today's price.[8]

Given this set of facts, we remain relatively conservative in the allocation of your assets in our Portfolio Management models. We maintain we are in an equity markets environment which continues to call for the "preservation of capital" rather than the "appreciation of capital."

Again, as we stated in the last edition of *RThoughts*, moving forward—at least for the foreseeable few months—our emphasis will continue to be concentrated on the management of risk with the belief that at some point we can shift our focus back onto the management of returns.

Morgan Stanley Chief Strategist Mike Wilson recently said, "Bear markets are about price and time . . . price takes your money while time takes your patience."[9] In our observations, the past number of significant market declines have been relatively short in duration. Think of it as a bungee jump—where markets declined rapidly only to spring back quickly and achieve new highs. Our current thinking is that these equity markets have further declines to go both in price and time terms.

Over the next few months, we are going to let the market wear everyone else out and when nobody is calling for the bottom in stock prices, we will finally know it is time to start stepping in and begin to slowly commit capital to some of the ideas which are currently sitting in our "shopping cart." Many of these are higher quality companies which have experienced price declines of more than 40, 50 or 60% from their highs over the past year. We are on the lookout for those invariable "fat pitches" which occur with significant market declines.

In the short-term moving forward, it looks to be an uncertain and difficult market for equities, in our view. In times like these our experience, disciplines and tactical management allow us to effectively manage risk and prepare for the opportunities which we believe lay ahead. It is a responsibility and challenge we all relish.

Please feel to reach out to us with any questions or concerns.

Happy Thanksgiving to you and all those who are important and loved by you. Enjoy!

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Written October 18, 19 and 20,
November 1 and 2, 2022.

Sources and Footnotes

1. Jeffrey Yale Rubin, Birinyi Associates, Inc. September 30, 2022
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2. Wall Street Journal—October 20, 2022
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3. Morgan Stanley Wealth Management—Capital Market Indices—November 1, 2022
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4. Richard Bernstein Advisors—October 24, 2022
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5. Milton Friedman—Goggle quote—November 1, 2022
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6. Cypress Capital—Market Outlook—Mark Dodson, CFA – October 28, 2022
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9. Mike Wilson, MS Investment Strategist, GIC Weekly Call—October 10, 2022
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Charts

1. Jeffrey Yale Rubin, Birinyi Associates, Inc.
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2. Drawdown in Total Market Capitalization of U.S. Equities and Fixed Income Securities, Topics in Portfolio Construction—GIC (Morgan Stanley Wealth Management)—October 18, 2022
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3. Exhibit 4: Morgan Stanley—US Equity Strategy—October 31, 2022
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