

R Thoughts

Morgan Stanley

The Diamond Peak Group
at
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“Markets can conspire to make you do things you shouldn't do.”

Mike Wilson
Morgan Stanley Chief Equity Strategist

Hi everyone, Jim here, doing a little trip down memory lane. I began my career in the investment services industry in March of 1981 with Foster & Marshall, one of the predecessor firms of Morgan Stanley. Back then I'm not sure I really understood the difference between a stock and a bond, however I did soon figure out the deleterious effects of inflation and the correlation between inflation and interest rates.

I bring this up because very few investors have experienced the magnitude and speed of the increases in rates we have witnessed over the past two plus years. But it's giving me flashbacks!

Using the 10-year U.S. Treasury bond as a proxy for the level of interest rates, the all-time low in yield was in March of 2020 at 0.318%. At the time of this writing in mid-October 2023, the current rate hovers around 5%. (4.97%)¹

To add some perspective, in 1981—my rookie year—the 10-year Treasury hit its all-time high with a yield of 15.84%.

Economist John Kenneth Galbraith coined the term “the extreme brevity of the financial memory.”

Most of today's investors have only known the downward trajectory of interest rates. “Most everyone who has come into the business since 1980—in other words, the vast majority of today's investors—has, with

relatively few exceptions, only seen interest rates that were either declining or ultra-low (or both).”²

The interest rates of more recent years have been kept—in our opinion—artificially low by the Federal Reserve. This was done to offset first the effects of the Great Recession of 2008–2009, and then to attempt to prop up the economy through the COVID shutdown crisis of 2020–2021.

It takes those of us with more than 40 years of experience to remember times when interest rates were either higher and stable or rising. And this is the market environment we find ourselves in today. We do not believe interest rates are likely to approach the lows seen in the past couple of years. We'll call it—higher for longer.

And with the higher for longer mantra now in place there are consequences in terms of investment choices—the ultra-low or declining interest rates are unlikely to be the norm in the years ahead. This is important because, now quoting Howard Marks, “. . . the investment environment has been fundamentally altered—you shouldn't assume the investment strategies that have served you best since 2009 will do so in the years ahead.”²

If we are indeed in a higher-for-longer interest rate world and the easy-money period of the past 15 years is behind us, we agree with Mr. Marks that some of these consequences seem probable:

- economic growth may be slower
- profit margins may erode
- default rates may head higher
- asset appreciation may not be as reliable

- cost of borrowing will not be as predictable and will not trend downward consistently
- investor psychology may not be as uniformly positive
- businesses may not find it as easy to obtain financing²

In our view, the ramifications of the higher-for-longer cycle are that investors will now have the potential opportunity to access close to equity like returns in the credit (bond) markets—those of which haven't been available for the past 15 years.

We called the bond market “un-investable” in late 2020. It is now anything but. We see that many bond-like investment can now offer potential returns that can compete with equities—the TINA (There Is No Alternative) to stocks is no longer valid.

During the summer, the increase in interest rates have left yields at their highest levels in more than 15 years.³ The 100-basis point (1%) increase in just 10 weeks was historic and epic. We believe there are many reasons for this increase. Among them are the U.S. deficits and debt sustainability, a rating downgrade of U.S. debt by the rating agency Fitch, the higher-than-expected supply of Treasury issuance (new bonds), and less than expected demand from U.S. regional banks, Japan, and China.

And with this—as seen in Slide 1—U.S. Treasury values have been more volatile than gold for the first time in 45 years. Unusual times indeed.

Additionally, 31% of all U.S. Treasury issuance rolls over and matures within the next 12 months.⁴ That's almost a third of the national debt. With interest rates increasing significantly, there is good reason to believe the net interest cost to finance this maturing debt as it is refinanced will also correspondingly balloon upward.

We believe that credit, bond-like investments now warrant a significant allocation percentage in investors' long-term portfolios.

We remain broadly overweight credit and fixed income like investments, given the possibility for double-digit total returns over the next year, especially if the Fed pivots to cutting rates in the face of a slowing economy.

From the perspective of the stock market, we continue to remain uber defensive. This market and its performance—in our view—continues to break the mold on how the major indexes such as the S&P 500 and the NASDAQ continue to be oblivious to the higher interest rate and potentially lower earnings environment which now confronts us.

Normally as rates increase as they have the past 18 months, the value of higher volatility growth stocks, which are more dependent on future earnings expectations, would be negatively impacted. This is just the opposite to what has occurred.

As we have highlighted in several previous *RThoughts*, there are seven stocks which are now and have been accounting for the lion's share of the returns in the market indexes like the S&P 500. Those few companies also now represent historically high concentrations in the market capitalization of the index.

Chart 1

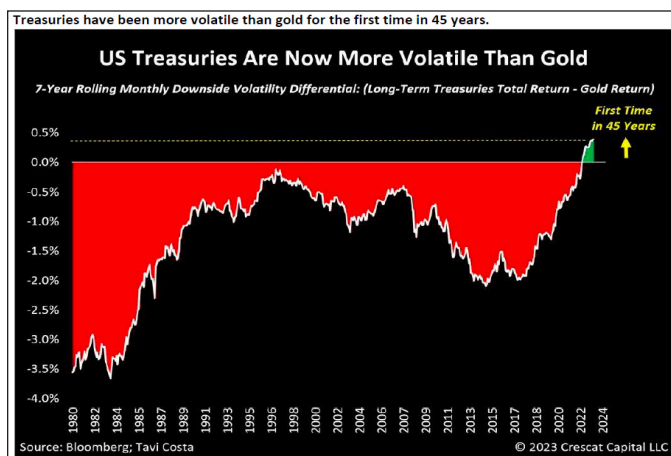
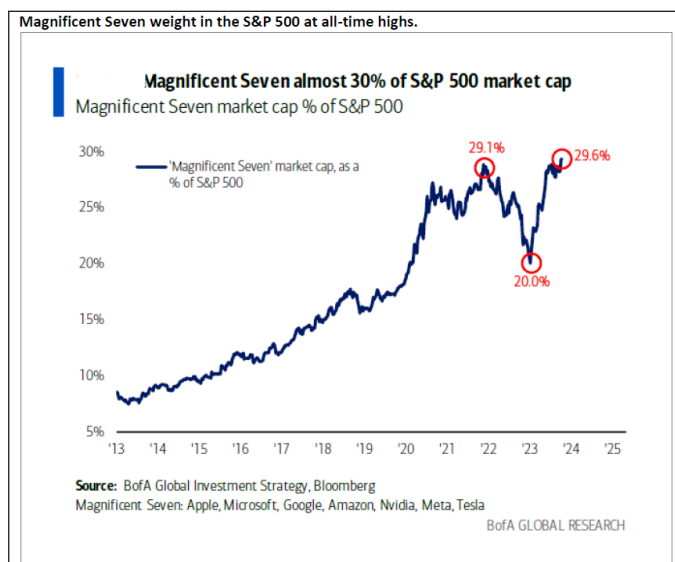


Chart 2



As of date, October 13, 2023

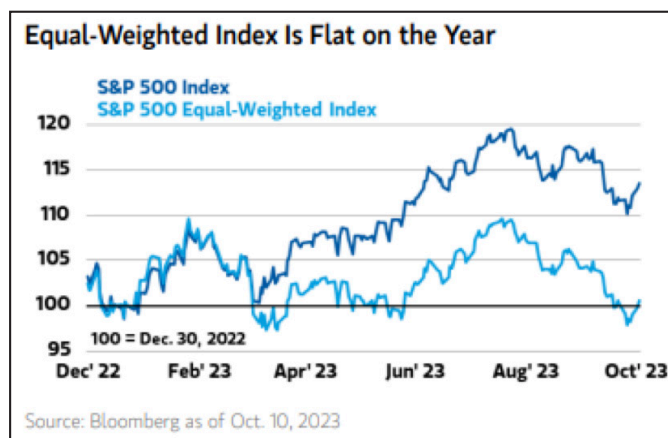
This graphically illustrates the point. When investors resort to looking in the rear-view mirror to what has outperformed almost all other asset classes over the past 15 years, they see the S&P 500 Market Capitalization Index. An investment in these securities comprised in the index today buys almost 30% into these 7 companies.

If history is a guide, then investors would be wise to take a more nuanced approach, in our opinion.

In 2022—when the concentration approached 29.1%—the S&P 500 Index declined more than 18 percent and lowered the weighting of those 7 stocks down to 20 percent. When similar concentration levels were reached with Tech stocks (albeit several different companies) in the early 2000s, the Index declined for a prolonged period until it bottomed eight years later in March 2008.⁵

In our way of thinking the market dynamics today look eerily similar as they did in 2000. The market weighted indexes have outperformed significantly, buoyed by a small sub-set of companies. According to Richard Bernstein Advisors, “the Magnificent 7 story is price momentum and hype but not actual growth. Last reported quarter there were over 130 U.S. companies with earnings growth greater than 25 percent. BUT . . . only 1 of the Mag 7 passed the screen.”⁶

Chart 3



As we can observe in Chart 3—with the EXACT same companies in the Index—only now each company is equally weighted to 1/500th of the Index versus the total size of the company determining the weighting—the S&P Equal Weight Index is virtually unchanged over the course of 2023. These seven companies and with their concentration in the Indexes are masking what is happening to the “average” stock which isn’t as rosy as the media makes things out to be.

Our view is that we continue to be in an equity bear market in the U.S. and the indexes will trade in a wide range (3900-4700) for the next twelve months. The economy is slowing, and earnings estimates are now too high. Rates will be higher for longer however we believe Treasury rates can decline over the next 12 months as the economy slows. With rates now at 16-year highs we see rates normalizing at *Pre*-Great Recession levels but nowhere near the levels they were *Post*-Covid.

We consider these conditions to be one of—if not the most—difficult market environments we have had to navigate in our respective careers. And as such the emotional investor in all of us screams, *do something!*

But at times like this, we are reminded of being in heavy traffic on 4 lanes of Interstate 5. Our lane of traffic is not moving while invariably the lane on the right or left seems to be temporarily moving smoothly. Our passenger in the car pleads with us to move into the faster lane of traffic. And this dance continues all the way up the

freeway—dogging in and out of traffic—until just before we reach our destinations’ offramp—we observe the car which was originally next to us and who had remained in one lane throughout the entire journey—arrive at the destination at the exact time in which we did and with it—significantly less risk.

Sometimes its better to stay in your lane and manage the manageable.

Just as we started we will finish with the quote, “Markets can conspire to make you do things you shouldn’t do.” And we would add, usually at the precisely wrong time. We remain vigilant to the inherent risks we currently observe in the equity markets—especially at the Index level. Many other stocks (the S&P Index 493) are becoming more attractive from a valuation standpoint.

Today, as always, our primary goal is first to manage risk and if we effectively manage risk we believe the returns—over time—will take care of themselves. With that thought in mind, we will remain in our lane of traffic.

Please feel free to reach out to any of us individually with any questions or concerns. As always, we appreciate your continued trust and confidence. Be well.

The Diamond Peak Group at Morgan Stanley

Written October 17–29, 2023

Sources and Footnotes

- ¹ Thomson-One, Market Monitor, October 19, 2023
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- ² Further Thoughts on Sea Change, Howard Marks, Oak Tree Capital, October 2023
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- ³ Morgan Stanley—Monthly Perspectives—October 2023
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- 1 Cypress Capital, Market Outlook, October 13, 2023
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- 2 Cypress Capital, Market Outlook, October 13, 2023
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- 3 Morgan Stanley, GIC Weekly, Charts in Focus, Equal-Weighted Index is Flat on the Year, October 16, 2023
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Investment cannot be made directly in a market index.

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