R Thoughts

Morgan Stanley

The Diamond Peak Group
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> Red Sky at Night, Sailor's Delight. Red Sky at Morning, Sailor's Warning.
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> Unknown

For the past several years U.S. stock market investors have enjoyed the results of an almost unending stream of red skies at night. Up until recently we have had a decade of very profitable and delightful sailing, especially for those invested in the very popular market indexes that shadow the S&P 500 and NASDAQ.

To illustrate this, we had to look no further than the recent broadcast of the NCAA Men's Final Four Basketball Tournament games where we were bombarded with ads for a passive investment product which was designated as the "Official ETF of the NCAA." And what is this passive investment vehicle? It is an investment vehicle which mimics the performance of the overall NASDAQ market.

Now, knowing a little bit about the NCAA, we are guessing these naming rights did not come cheap and highlight the popularity of one of the more aggressive segments of the investment landscape.

It is also disconcerting to us that, at present, the top 6 components of the NASDAQ market account for more than 46% of its overall market capitalization.[1] Currently, in our view, the stock concentration in portfolios shadowing the NASDAQ is high.

The narrow focus of the past decade has led to high market concentration in those areas that have worked, namely U.S. stocks over International, large companies over small and growth over value companies. Right now, the level of concentration in the stock market is at or near record levels.[2]

In our experience it is a bellwether event when one investment vehicle garners this much attention and popularity. Add in the fact that this passive portfolio—in our opinion—is over-concentrated in the media darlings of the past decade, which increases our pessimism that investment returns over the next decade will approach the results of the past 10 years.

We will also soon address several other "red sky at morning" concerns we have as we progress through our current thoughts, so hold on for that . . .

The Bond Markets

Sometime last year, Leon Cooperman, the CEO of Omega Advisors, coined the phrase "Return-Free Risk" regarding calling bonds or fixed income investments, which is a take-off of the long-held premise of bonds providing "Risk-Free Return."

So far in the first four and half months of 2022 the bond markets in the U.S. did just that—they provided ample doses of "Return-Free Risk."

From the all-time low yield on the U.S. Ten-Year Treasury Bond of 0.38% achieved during the COVID panic on March 8, 2020[3] rates on the Ten-Year gradually increased, hitting 1.51% on year-end 2021.[4] In what can only be described as a "breath-taking" upward move since, the Ten-Year Treasury bond yield traded at 2.93% on Tuesday, April 19, 2022.[5]

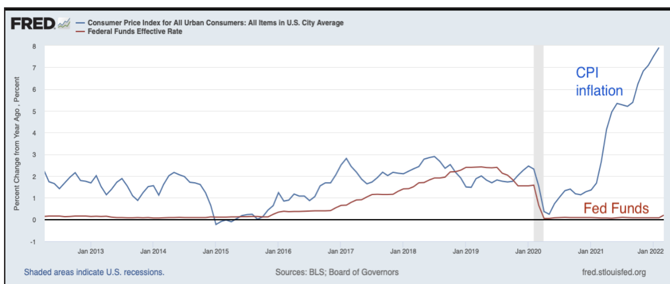
Although stock returns found the first quarter of 2022 difficult, bond returns ranked much worse than stocks

from a historical perspective, with U.S. Treasuries posting their worst quarter in 50 years. As yields increased, prices declined. The quarterly loss neared 10 percent.[6]

In the Winter edition of *RThoughts,* we were on record stating, "Given our outlook for inflation and interest rates over the intermediate time frame, we consider bonds and bond-like investments uninvestable at the present time." That seems prescient, though for full disclosure, we have been calling for higher interest rates for several years now, but we'll allow for our moment in the sun when it's available.

What is really sobering and perhaps another "red-sky at morning" moment is the Federal Reserve has just begun to raise the Federal Funds rate—one of their primary policy levers used to control inflation. And, as we are acutely aware by now, inflation desperately needs to be controlled.

But, as shown in Chart 1 below, CPI inflation has been with us for a year; it is now 8.5% in the last government data released this week, the highest level of inflation since December 1981.[7] On March 15th the Fed finally budged the Federal Funds rate from zero to 0.33% (look very hard) with additional slow rate rises promised to come. Usually, the Fed Funds rates tract inflation with perhaps a small lag. You tell us, looking at this chart, is the Fed behind the curve? We think you might know our answer.



If our analysis is correct here's the "red-sky" moment. We believe the Federal Reserve—if they are truly going to be effective in curbing inflation moving forward—needs to be much more aggressive in raising rates than the market currently expects. The screws of higher rates still need to be applied in order to even remotely start to control and depress the level of inflation already present in the U.S. economy.

To back this up and give more sobering data, read what Bill Dudley, former president of the Federal Reserve Bank of New York, wrote the first week of April:

"It's hard to know how much the U.S. Federal Reserve will need to do to get inflation under control. But one thing is certain: To be effective, it'll have to inflict more losses on stock and bond investors than it has so far . . .

. . . Investors should pay closer attention to what (Fed Chair Jerome) Powell has said: Financial conditions need to tighten. If this doesn't happen on its own (which seems unlikely), the Fed will have to shock markets to achieve the desired response. This would mean hiking the federal funds rate considerably higher than currently anticipated. One way or another, to get inflation under control, the Fed will need to push bond yields higher and stock prices lower."[8]

These are pretty blunt and direct comments from a former central banker. As we said several times recently, inflation is like a Genie in a bottle—once it's out it's really tough to put back in, and in our experience it's nearly impossible to break inflation expectations without breaking something else. The question now is, what's the something else?

Which now transitions into our thoughts about the . . .

The Stock Markets

It was certainly not all calm seas and smooth sailing for equity investors over the course of the first quarter of 2022.

Though perhaps not as pronounced as the drawdowns in the fixed income markets, stock market participants also experienced moderate declines in their holdings.

The S&P 500 Index ended the quarter with a loss of 4.6% which was outpaced by the Russell 2000 (Small

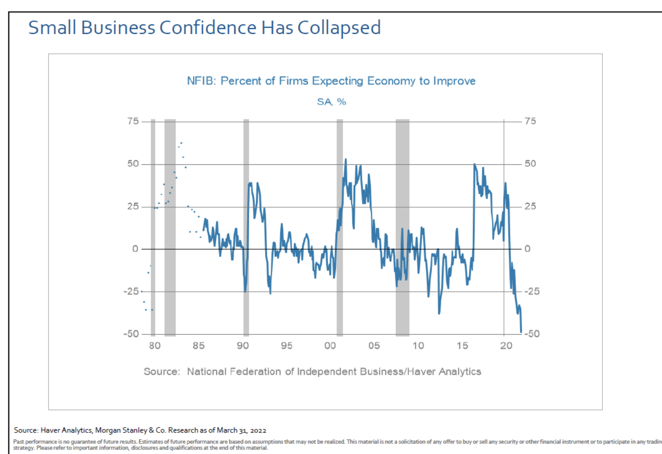
Company Index) which declined 7.5%. The Dow Jones Industrial Average experienced the best relative returns—down 4.1%. The NASDAQ Index was set back 8.9% and International stocks, as measured by the MSCI EAFE Index, declined 6.9% for the quarter.[9]

Early in March the indexes showed even more pronounced declines with the Dow Jones down 11.5% from its recent yearly highs while the S&P 500 was down 13.4% and the NASDAQ declining a more substantial 21.5%.[10]

We believe equity prices—at the index level—could experience additional drawdowns, which may meet or exceed the levels approached in early March.

There are several factors which give us pause in the near term from the view many hold; that stocks will benefit from higher levels of inflation and earnings growth will be unaffected, possibly resulting in stock prices not being subject to downward re-valuations. Here are a number of concerns foremost in our minds:

- Small Business Confidence has collapsed. As we can observe in Chart 2, this is a disturbing development with Small Business Confidence now at 40-year lows. This is another reason why the stock prices of small companies have underperformed their larger company brethren over the past several months, in our view.[11]



- Consumer Confidence has also collapsed. University of Michigan Consumer Sentiment polls are now reaching levels last seen at the depths of the Great Financial Crisis of 2007-2009.[11] Will consumers begin to put off some expenditures due to higher prices? We think it's possible, if not probable . . .
- While at the same time Inventories are growing.[11] This is especially true at companies whose products were popular throughout the Covid crisis. We believe there is possible demand pay-back starting to occur and as inventories accumulate, price discounting becomes probable which can then negatively impact earnings. We see this especially acute in the Consumer Discretionary and Information Technology sectors.
- Higher interest rates are starting to have a meaningful impact on the real economy now.[11] From an all-time low of 2.65% in January 2021, 30-Year fixed mortgage rates recently hit 5%. Wells Fargo in mid-April said their mortgage originations fell 27% from a year ago, while JP Morgan Chase reported their mortgage originations declined 37%.[12] In our view, the potential of a cooling real estate market could spill over to other areas of the economy and dampen overall economic activity.

  One additional note regarding interest rates. With 10-Year Treasury rates now approaching 3.00%, will bonds begin to compete with stocks for investors' attention in asset-allocation models? TINA (There Is No Alternative)—for stocks—has been a popular market mantra for several years supporting equity prices in a near zero-interest rate world—and it is our view is that paradigm may be beginning to shift. The result may be increased competition for stocks from fixed income assets.
- Escalation of the Russia-Ukraine conflict, especially if tactical nuclear weapons are introduced. We have been aware of this possibility for a few weeks now, but it was again discussed on April 18th by CIA Director William Burns, telling Georgia Tech students, "given the potential desperation of President Putin and the Russian leadership, given the setbacks that they've faced so far militarily, none of us can take lightly the threat posed by a potential resort to tactical nuclear weapons or low-yield nuclear weapons."[13] Equity prices worldwide would likely temporarily decline significantly into this development, should it occur.

- The previously discussed high concentration levels present in the popular market indexes and ETFs.[2] If we are looking at a new paradigm of higher inflation and higher interest rates—which we believe is the case—and of slowing corporate profit growth, tightening liquidity and elevated investor sentiment, then what we view as the lack of diversification in these investment vehicles can become problematic. We believe prudent risk-management practices suggest that our portfolios today generally should not look like the overly concentrated and correlated popular market indexes which have been favored among many investors for more than a decade.

Given these concerns one might rationally ask, "Why not sell everything and move entirely to cash?" At present, cash still has very little yield yet would not lose any value in a potential market decline . . .

First, most of our seasoned managed accounts have significant UN-realized capital gains which would be—in nonretirement accounts—subject to taxes on sale. We manage each position separately with its own buy/hold/sell decision rather than a collective market "all-in or all-out" approach. Think of a dimmer switch rather than an on/off switch.

Second, we have and will continue to sell individual positions and raise cash levels in the portfolios as necessary as those individual companies' stock prices violate our pre-established investment disciplines. Often, we may sell only partial positions gradually rather than liquidating the entire position at once reflecting the dimmer switch approach.

Third, there are many quality companies that, in our observations, have already experienced declines of 20-30-40% or more from their 12-month highest price levels. Some of these companies are going into our investment "shopping cart" to perhaps be purchased at more favorable levels or at what we consider a more opportunist time.

Lastly, it's possible we could be wrong—that stock prices are already discounting these factors, and several more, and could continue their almost unabated decade-long increase over the near term.

Moving forward we see the next few months similar to the first quarter of 2022—a three headed hydra of higher interest rates, lower corporate profit expectations and potentially lower stock prices at the index levels.

We believe this is a most opportunist time for disciplined risk-management practices rather than simply relying on the "passive" method of one-decision buy and hold index and mutual funds.

Given this, we would enthusiastically offer to review any 401(k), IRA or investment account balance which is held away from us at Morgan Stanley. It is important to understand exactly what one currently owns, and the risk associated with those investment vehicles in order to navigate effectively into the new investment paradigm we see developing.

We often state our belief that if we are able to manage risk effectively, the returns should take care of themselves over time. We also believe, even in investing, sometimes it's the "defense that wins championships."

There are times when we need to be more concerned with "capital preservation" strategies rather than "capital appreciation" ones. Today we are siding with the former rather than the latter.

Right now, we find comfort in often acting against the crowd and against most conventional investment wisdom. If we are correct, we believe we will have an opportunity to swing at many and more attractive "fat pitches" later in the year with the cash we currently hold, and which potentially might increase. We look forward to that and the hope for forecasts of "Red Skies at Night." ◗

Written: April 15th – 19th 2022

The Diamond Peak Group at Morgan Stanley

Sources and Footnotes

1 DWA—Chart of the NASDAQ Top Positions, April 14, 2022. Apple: 12.49%, Microsoft; 10.13%, Goggle A/B: 7.58%, Amazon: 7.35%, Telsa: 5.08%, Meta (Facebook):

3.47% Total = 46.10%
Return to Article

2 Richard Bernstein Advisors, RBA Quick Insights, Dan Suzuki, CFA, The Biggest Risk to Portfolios Today, April 13th, 2022
Return to Article—Page 1, R column
Return to Article, Page 3, R column

3 Thomsen-One Market Monitor—March 8, 2020.
Return to Article

4 Value Line: Selection and Opinion, April 15th, 2022
Return to Article

5 Thomsen-One Market Monitor—April 19th, 2022.
Return to Article, Page 2

6 Morgan Stanley Global Investment Committee—The GIC Weekly—April 11th, 2022.
Return to Article

7 Wall Street Journal—The Markets Are Glum-Time for Cautious Optimism, Jeff Sommer, April 17th, 2022.
Return to Article

8 Cypress Capital—Market Outlook—April 8. 2022.
Return to Article

9 DWA—Daily Market Report—April 15th, 2022.
Return to Article

10 Thomsen-One Market Monitor—March 8th, 2022.
Return to Article

11 Morgan Stanley Wealth Management—Monthly Perspectives—April 2022.
Return to Article—Page 3, L column middle
Return to Article—Page 3, L column bottom
Return to Article—Page 3, R column, 1st paragraph
Return to Article—Page 3, R column, 2nd paragraph

12 Wall Street Journal—Mortgage Rates Hit 5%—April 14th, 2022.
Return to Article

13 National Review—What Will a Desperate Putin Do?—Jim Geraghty, April 18, 2022.
Return to Article

Charts

1 From the article, Is the Fed Fisherian?—John Cochrane, April 4th, 2022.
Return to Article

2 Small Business Confidence Has Collapsed—Morgan Stanley Wealth Management—Monthly Perspectives—April 2022.
Return to Article

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- *R Thoughts*—Winter 2022
- *R Thoughts*—Fall 2021
- *R Thoughts*—Summer 2021
- *R Thoughts*—Spring 2021
- *R Thoughts*—Winter 2021
- *R Thoughts*—Fall 2020
- *R Thoughts*—Summer 2020
- *R Thoughts*—Spring 2020
- *R Thoughts*—Winter 2020
- *R Thoughts*—Market Update #3—March 25, 2020
- *R Thoughts*—Market Update #2—March 12, 2020
- *R Thought*s—Market Update—February 27, 2020

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