R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

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> "The pessimist complains about the wind, the optimist expects it to change, the realist adjusts the sails."
>
> *William Arthur Ward as quoted by David Glennie*

As we gaze out into the near future, the maritime weather forecast for investment assets—more specifically for U.S./Domestic stocks—is deteriorating, with rough seas and gale-force winds.

In our view, the outlook is certainly more dangerous with the risk of a market correction on the horizon. It is an environment best left to experienced mariners, who have been able to adjust the sails and deal with whatever challenges mother nature might throw their way.

When it comes to those adjustments, our group is very eclectic in our outlook and preferences to assets classes. We can be pessimistic when—like today—facts and experience dictate we be so. We can and will be optimistic when the conditions indicate it is more appropriate. Most importantly, we remain realists, striving for making objective decisions based on proven concepts like supply and demand, relative strength, and valuations.

We often use the term, "It is what it is." And in doing so, we always attempt to view the investment landscape as it really is, not how we wish it should be. Hope has never been—nor will be—a successful investment strategy.

Having an unemotional process of making decisions—adapting and adjusting to market conditions based on relative strength—allows us to focus on adjusting the sails in a dispassionate and disciplined way no matter what the forecast has in store.

With a quick review of the first quarter's results, the S&P 500 Index showed a positive return of 7.03% and the Dow Jones Industrial Average was virtually unchanged at +0.4%. Bond yields generally declined as bond prices firmed as interest rates trended lower.[1]

With a move reminiscent of market conditions in 2020 and 2021, a few large tech companies accounted for the majority of the first quarter gains in the S&P 500 Index. To illustrate just how narrow the market index returns were in the quarter, over 91% of the 7.03% gain was the result of just 10 stocks—all in the technology arena.[1]

Apple—which was up +26.9% in the quarter, was responsible for 22% of the Index's gain.[1] In addition, Apple and Microsoft now account for 13.3% of the entire market value of the S&P 500—the highest ever for 2 individual stocks.[1]

What might be even more astounding, is as of April 6th the $4.69 trillion market value of Apple and Microsoft is now $2 trillion higher than the combined market value of all the companies in the Russell 2000 ($2.69 trillion).[2]

After discussing these concentration issues in previous editions of *R Thoughts*, we can summarize our outlook as one of continued caution. Excessive market dominance such as these usually are exploited and arbitraged over time. The sectors, themes, and stocks which have led the market indexes over the past decade, are usually not the leaders over the upcoming 10 years.

It is our view that any upcoming market instability will most likely bring with it a change in leadership, challenging the current popular investment mantra.

Color us surprised that U.S. stock indexes held up well so far in 2023. Many investors have been programed

to “buy the dip” whenever one occurs as—in our view—they believe they will be always bailed out by the Federal Reserve Bank. But as we learned in periods 2000–2003 and again 2007–2009, the stock market indexes can have “anxiety-inducing rallies”[3] within overall difficult and declining markets providing temporary relief for those long the prior decades winners.

As our friends at Cypress Capital recently wrote, “ . . . the weight of all the evidence doesn’t remotely make us ready to embrace this as a new bull, even if it eventually meets the definition technically. We still expect another leg down in the bear market. Markets are running out of new eras to form when it comes to financial market valuations and financial gravity, and the bill for central bankers’ gross reliance on 15 years of quantitative easing appears to be coming due.”[3]

We continue to believe we are in the early stages of a “profits recession” in corporate America with earnings at the Index level de-accelerating from the consensus view, leading to potential moderate drawdowns in the price of many U.S. companies shares.

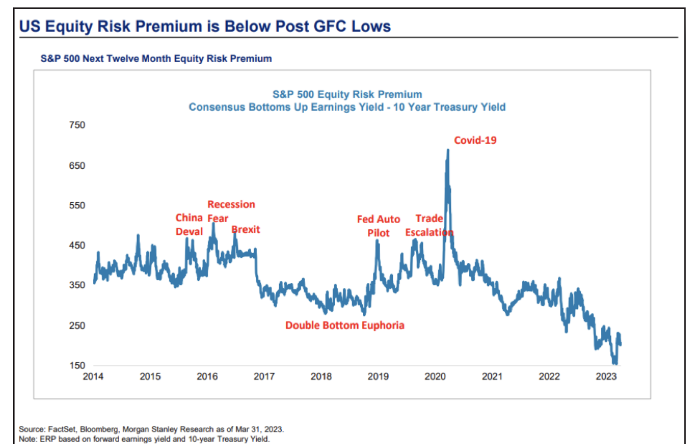
What’s more—unlike the recovery from the COVID-era market decline when U.S. Treasury securities yielded close to zero—those bonds now provide ample competition for stocks.

At current levels bonds may provide less risk and much better valuations than those found in the popular Indexes like the S&P 500 or the NASDAQ.

Although we never take what we read in the *Wall Street Journal* as gospel (nor any other publication for that matter) a recent article highlighted this relationship effectively.

Under the headline, “Stocks Haven’t Looked This Unattractive Since 2007,”[4] the story highlighted the relationship between the earnings yield on stocks—what stocks in the S&P 500 Index would be yielding if all earnings were paid out in cash—and a proxy for a “riskless” U.S. Government security—the 10-Year Treasury Bond yield.

Chart 1



We have tracked this relationship almost daily in recent years. The higher the number the more attractive the investment potential for stocks as compared to bonds. Today that relationship is at 130 (earnings yield = 4.72%–10-Year Treasury yield of 3.42%). We would most likely not get more aggressive with U.S. equity allocations until this relationship moved closer to 350.

To get to that number—using $195 for 2023 S&P 500 earnings—the index would need to decline to 3000 (from 4000) currently and 10-Year Treasuries would need to yield approximately 3%.

But this is only one of several signals we would use to become more constructive on U.S. equity assets. Here are a few others we use as signposts for buying into next bull market:

- New Leadership—a “less concentrated” market and new “Generals”
- Forward P/E multiples move below 15X on earnings that are DOWN in 2024
- Next 12-month earnings estimates on the S&P 500 that crack below $215/share
- Fed pause, end of QT and clear guidance on interest-rate cuts
- Unemployment rate that cracks meaningfully above 4%
- Capitulatory Price Action/Oversold Technicals, investor sentiment and positioning indicators evident

- The Volatility Indicator—VIX—above 28, 36 and 44. Currently below 20
- Dorsey Wright Technicals -NYSEBP—below 30% the "Green Zone." Currently at 44

If our reduced year-end earnings target on the S&P 500 holds true at $195 (consensus estimates are currently around $225) the Price to Earnings (P/E) ratio is around 21X (4110/195). The only reason it is currently trading at that P/E is because the top ten stocks trade at almost a 24X P/E while the other 490 stocks are trading at 15.8x P/E.[5]

The value in the market lies below the surface and when we eventually bring the boat back out on the water, this is the lake we will undoubtably be fishing in.

You might rightfully ask why do we believe earnings at the S&P 500 Index level might decline from $225 to $195 over the course of 2023? That is a 13% decline.

First, many companies—especially in the technology and the consumer discretionary sectors—over-earned through the COVID era. We believe earnings were "pulled forward" over the past few years and will now moderate to more normal levels.

Second, quoting recent comments from ValueLine, consumers' ability to continue spending may be in jeopardy.

> "How much longer can the average consumer keep spending? There are signs that consumers are becoming a bit more cautious, particularly with regard to spending on discretionary goods. Perhaps, the higher borrowing rates are now giving them some pause. It should be noted that six of the seven largest monthly increases in revolving credit in more than 50 years of record keeping have occurred in the last year. This may raise the level of stress in the consumer credit sector, much as we recently saw in the banking industry."[6]

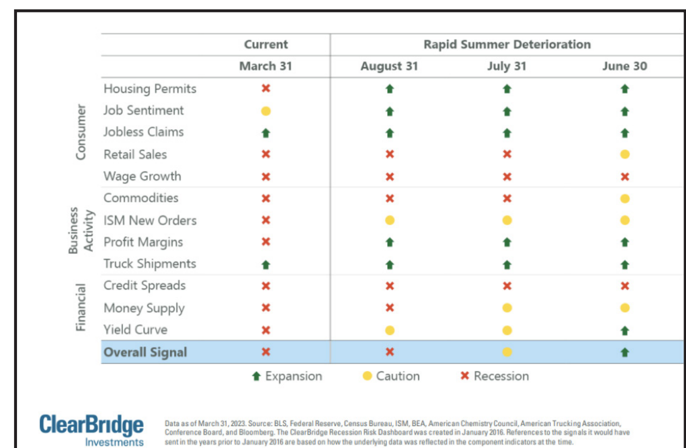
Third, accessibility to credit is also likely to be negatively impacted by the recent minibanking crisis. This will add an additional headwind for continued economic growth.

Next, and perhaps more importantly, it is our opinion the U.S. economy is likely to enter a recessionary phase over the next several months.

Over the years, we have used a data series provided by ClearBridge Investments—now part of the Franklin Templeton mutual fund empire—which highlights and rates quarterly changes in 12 economic recession risk indicators. Titled "The Anatomy of a Recession"[7] it has, through the years, a strong track record in predicting changes in economic activity. As we can see in Chart 2, currently two indicators signal expansion; one signaling caution with the remaining nine signaling recession. The overall dashboard is currently signaling recession.

US Recession Indicators

Chart 2



		Current	Rapid Summer Deterioration		
		March 31	August 31	July 31	June 30
Consumer	Housing Permits	✖	⬆	⬆	⬆
	Job Sentiment	●	⬆	⬆	⬆
	Jobless Claims	⬆	⬆	⬆	⬆
	Retail Sales	✖	✖	✖	●
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	✖	✖	✖	●
	ISM New Orders	✖	●	●	●
	Profit Margins	✖	⬆	⬆	⬆
	Truck Shipments	⬆	⬆	⬆	⬆
Financial	Credit Spreads	✖	✖	✖	✖
	Money Supply	✖	✖	●	●
	Yield Curve	✖	●	●	⬆
	Overall Signal	✖	✖	●	⬆

⬆ Expansion ● Caution ✖ Recession

ClearBridge Investments

Data as of March 31, 2023. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

The average decline in S&P 500 earnings in a "garden variety" recession—using the average drop during the 1990, 2000, and 2020 recessions—is 26-percent decline from peak to trough.[8] We feel $195 is a conservative number should a recession indeed develop.

A recession–which we believe could happen within the next six months—are normal and necessary phases of the economic cycle. It would provide better timing and better pricing on many companies which are currently in our "shopping cart" as potential purchases. We are on the

lookout for the "fat pitches" which are only provided in the more stressful and capitulatory stages of market declines.

Currently we see opportunity in select dated maturity U.S. Treasury obligations, parts of the international markets and Money Market funds. We remain vigilant for developing opportunities in the U.S. equity space.

In terms of relative strength—the "arm-wrestling contest" between the six assets classes we constantly follow and rank—International Equities is currently strongest followed in order by: Commodities, Cash, Domestic Equities, Fixed Income, and finally, Currencies. Into this we continue to remain defensive and in a Capital Preservation mode to manage client assets.

We believe our efforts for trim the sails and minimize luffing will be rewarded in the near future with calmer seas and prevailing winds.

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Sources and Footnotes

1. Birinyi Associates, Inc. Bulletin: Strategy, April 1, 2023.
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2. Charlie Bilello, Chief Market Strategist, Creative Planning, April 6, 2023
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3. Cypress Capital, Market Outlook April 7, 2023
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6. ValueLine – Issue 10 – Economic and Stock Market Commentary – April 14, 2023
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7. U.S. Recession Risk Indicators, ClearBridge Investments, Second Quarter 2023
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8. DataTrek – S&P 500 Recession Math, May 10, 2022.
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Charts

1. Chart 1: Morgan Stanley Research, April 6, 2023, U.S. Equity Strategy Data Pack April 2023, Page 26
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2. Chart 2: ClearBridge Investments, U.S. Recession Risk Indicators, Second Quarter 2023, Page 11
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Investment cannot be made directly in a market index.

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