R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

Summer 2023

advisor.morganstanley.com/diamondpeakgroup

Especially in investing

“Things can take longer to happen than you thought they should, then, they happen faster than you thought they could.”

Howard Marks, Podcast
The Insight by Oaktree Capital, June 21, 2023

Stock market indices in the United States marched higher in the second quarter of the year—the S&P 500 gained 8.5% while the Dow Jones Average increased 3.41%. This momentum has continued into the third quarter in which the S&P is up 2.4% and the Dow Jones advancing 3 percent through July 25th.[1] Momentum has driven U.S. equity sentiment, valuations, and technical positioning to extremes. The result is increased anxiety for those who—like us—have been in the more cautious camp as our short-term portfolio returns have lagged the popular averages.

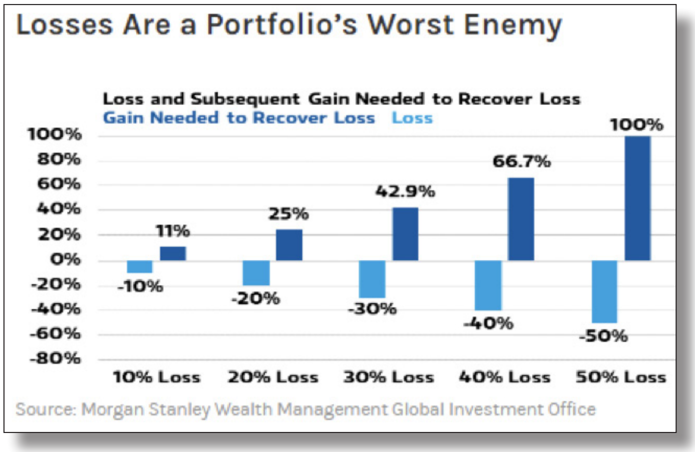
Morgan Stanley equity strategists—who are also cautious campers—consider this a “bear-market rally” which has been “unique in neither duration nor magnitude.” In other words, what has been recently occurring in the market averages is not unusual as we look back in history.

Momentum is determined by the amount of stuff moving and how fast it’s going and an increase in the speed is undoubtedly seductive. This is especially true when it comes to the stock market, as it is equated to a faster pace of financial gains. In our experience as wealth advisors, we are well acquainted with the “fear of missing out,” or FOMO, which sets in among more conservatively positioned investors as markets grind higher.

With the market rally accelerating from a pace of approximately 2 percent gains per month for the S&P 500 Index from October 2022 through May, to now close to 10% over approximately the last six weeks, it is understandable that investors are increasingly anxious.

That is especially true for those who have been cautiously underweight U.S. equities, as we have been in our Tactical Growth Model. Believe me, our group is currently very anxious and frustrated. That said, these are times when a disciplined process is most useful, especially as behavioral finance, not to mention mathematics, reminds us that gains benefit us three-to-four times less than losses penalize us.

Chart 1



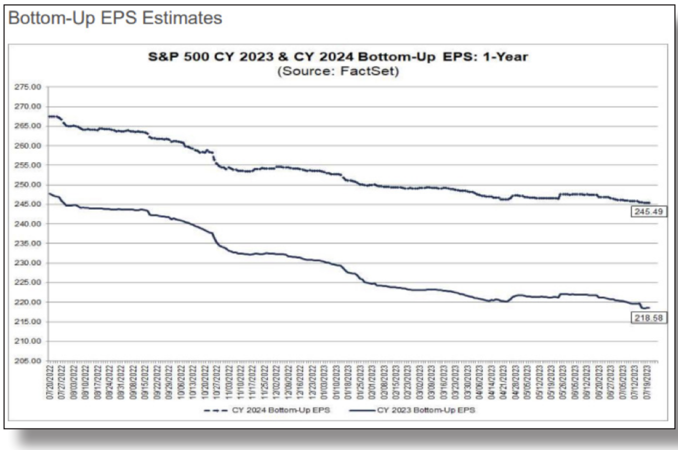
So, from a risk-adjusted and probabilistic standpoint, what is our current thinking?

First, the S&P 500 Index is up about 27% from the cycle bottom in October and roughly 5% off the all-time high of January 2022. Bear in mind, the S&P 500 Index was down more than 18% in calendar year 2022. Importantly, while it might not feel like it, a review of the last 11 nonrecessionary bear market rallies suggests—as we mentioned—this one is extraordinary for neither duration (time) nor magnitude (amount of increase).

Similarly, as independent researchers at Rosenberg Research point out, in all seven bear markets (down over 20%) since 1960, prior highs were retested before the ultimate lows were reached. Again, what is currently happening in the U.S. stock market indices is not unusual in previous bear market declines.[2]

Next, this recent march higher in stock prices has occurred against the specter of lower corporate profits. FactSet reports second quarter 2023 earnings expectations at the end of June was for a decline of 7%.[3] As illustrated in Chart 2, stock prices are increasing into the prospect of potentially lower corporate profits which tells us that investors are simply currently paying more for a dollars' worth of earnings than they were willing to six months ago. That, in our opinion, is FOMO personified!

Chart 2



With interest rates increasing and near-term corporate earnings declining, it is certainly a dichotomy to account for the recent rise in stock prices. It has certainly perplexed and confounded us although we are hardly alone in this regard.

It is our belief the U.S. economy is close to entering into a recessionary phase. If that assumption is correct, corporate profits will continue to decline as we head into the remainder of 2023 and early 2024. We share that belief with many other professionals we trust and respect from both inside and outside of Morgan Stanley.

Brian Wesbury—the head economist at First Trust Advisors recently wrote, "with a 4% 10-year US Treasury yield the fair value of the S&P 500 is about 3,350." (Currently 4575). He also discusses the M2 money supply—which is the amount of cash and cash-like money in the economy—stating, "a decline in M2 should pull the economy into a recession soon." His belief is if the Fed doesn't cut rates until next year and then more than the market is currently pricing in.

He said, " . . . our model says that if the 10-year yield fell to 3.00%, but profits fell 15%, the S&P 500 Index would have a fair value of just 3800. In other words, the Goldilocks future, where the Fed manages everything perfectly, is likely too optimistic. Some stock valuations have become too high in our opinion. More defensive strategies are appropriate at this juncture."[4]

The following two charts—both from Cypress Capital—graphicly depict current stock market investor sentiment at extremes.

Chart 3 indicates investors currently love stocks over bonds to the greatest extent in 24 years. And this flies in the face of U.S. 10-year Treasury bond yields increasing from under 1% in 2020 to almost 4% today. Bonds now—as opposed to 3 years ago—can and will provide diversification, safety, and cash flow and—in our view—are significantly under-valued compared to the popular market averages like the S&P 500 Index.

Chart 3

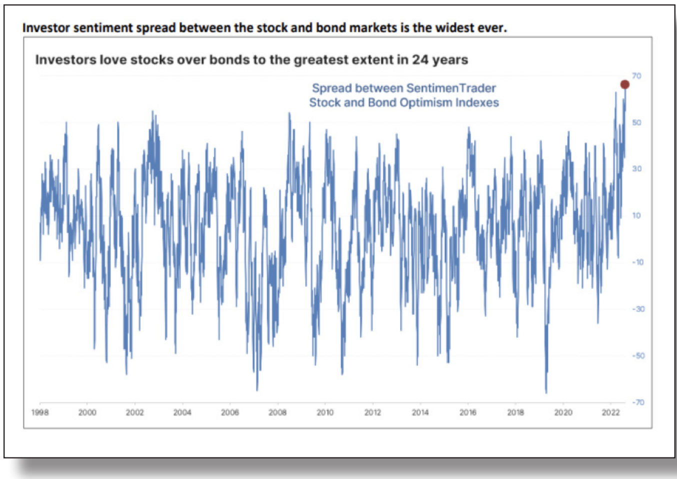
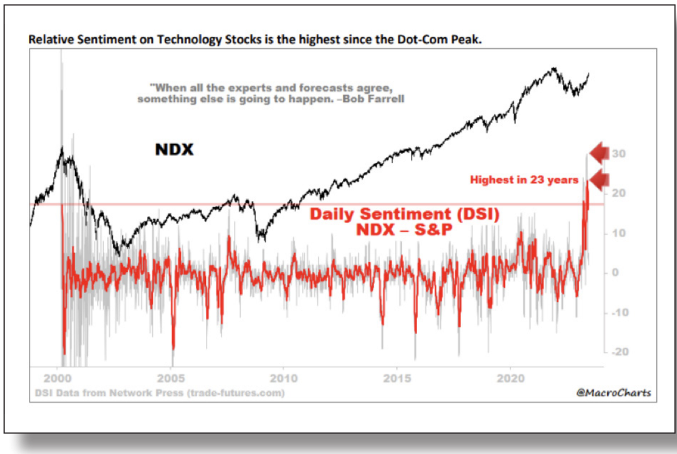


Chart 4 illustrates relative sentiment on technology stocks being the highest since the Dot-Com peak in late

1999—early 2000. Quoting Bob Farrell, "When all the experts and forecasts agree, something else is going to happen."

Chart 4



Additional data which increases our conviction of near-term recession possibilities in the U.S. include the Conference Board Leading Economic Index. The Leading Economic Index (LEI) provides an early indication of significant turning points in the business cycle and where the economy is heading in the near-term.

Most recently released on July 20th, "the U.S. LEI fell again in June, fueled by gloomier consumer expectations, weaker new orders, an increased number of initial claims for unemployment, and a reduction in housing construction," said Justyna Zabinska-LaMonica, Senior Manager, Business Cycle Indicators, at the Conference Board.

"The Leading Index has been in decline for fifteen months-the longest streak of consecutive decreases since 2007-08, during the runup to the Great Recession," Zabinska-LaMonica said. "Taken together, June's data suggests economic activity will continue to decelerate in the months ahead. We forecast that the U.S. economy is likely to be in a recession from 3Q 2023 to 1Q 2024. Elevated prices, tighter monetary policy, harder to get credit, and reduced government spending are poised to dampen economic growth further."[5]

Chart 5 shows graphically the current state of the LEI. Declines of this magnitude have always preceded a recession.

Chart 5

Chart 6 shows the current spread between the yield of the U.S. 2-year Treasury Bond and the 10-year Treasury Bond. Normally, the longer to maturity bond would have a higher yield. When the bond yields "invert"—meaning the shorter-term bond is yielding more than the longer dated bond—this has usually been a harbinger of a future recession. Today this inversion is currently extreme, with the 2-year yielding 4.90% while the 10-year yield is at 3.90%, an inverse spread of 100 basis points or 1%.[6]

(continued on next page)

Chart 6

Chart 7 depicts the New York Federal Reserve—Probability of a recession 12 months ahead. Currently at 67.3% it is flashing the highest probability of a recession since the mid-1980s.

Chart 7

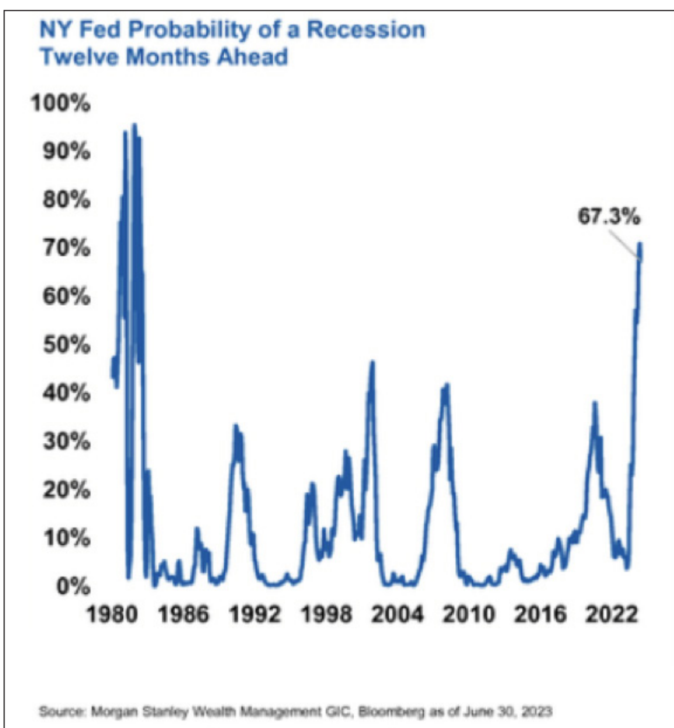


Chart 8 outlines the U.S. Recession Risk Indicators provided by Clearbridge Investments—updated from the Spring edition of *RThoughts*. This report—published monthly—highlights and rates the changes in 12 economic recession risk indicators. Titled "The Anatomy of a Recession" it has, through the years, a strong track record in predicting future economic activity. Twelve of the 14 indicators are currently flashing recession signals while the remaining 2 show caution with an overall sign of recession.

Chart 8

U.S. Recession Risk Indicators

		June 30, 2023
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

Again, quoting Brian Wesbury, " . . . we still think the U.S. is headed toward a recession, but it wasn't in one in the second quarter. Be careful, though. While some others say we can't fall into a recession because the job market is so strong, it's important to realize that the job market is almost always at or near the peak when the economy enters a recession. This doesn't mean the recession has to be anywhere near as severe as the COVID Lockdown or even the Great Financial/Financial Panic of 2008-09. But even a mild recession will bring some pain."[7]

It is our opinion the Federal Reserve will likely need to inflict some pain into the U.S. economy in order to break the back of the inflationary cycle. Yes, inflation is declining however we see rising labor demands and the potential for increasing energy prices for keeping the inflation rate above the Fed's published target over the intermediate term.

Current market conditions are priced for perfection, in our view. Right now, the market is pricing in just one additional rate increase by the Federal Reserve, a declining inflationary environment back to the Fed's target rate and little to no economic contraction in the near future. If by chance any of those reports go against the popular "goldilocks" narrative we would expect the markets to react accordingly.

David Rosenberg of Rosenberg Research recently discusses market conditions in U.S. equities as "Classic signs of a market priced for good news only . . . So as the masses take equity prices higher on the holy grail of momentum chasing, the relative risk-reward in the stock market has only gotten worse."[8]

We have been and continue to be big advocates of momentum/supply-demand/relative strength investing except at what we believe are market inflection points. At those perceived points we become more "contrarians" and look to begin moving against the herd mentality. It is our position that we may be approaching one of those inflection points in the relatively near future. We continue to adhere to our risk management principles as we are much more concerned presently with "wealth preservation" rather "wealth appreciation" at this point in the market cycle.

For us, given our collective experiences and principles, it would be next to impossible to ignore the "trusted professionals" which we subscribe to and who are advocating similar cautionary outlooks and positioning. Straying from the pack is often distressing and anxious in the short run. We remain convinced we are doing the right things at the right time for the right reasons and will ultimately be rewarded with continued and improving risk adjusted returns in the relatively near future.

Please feel free to contact any of us individually if you might have any questions or concerns and, as always, thank you for your continued trust and confidence.

The Diamond Peak Group at Morgan Stanley

Written July 24-27, 2023

Sources and Footnotes

1 Thomson-One, Market Monitor, July 1, 2023
Return to Article

2 Morgan Stanley Wealth Management, The GIC Weekly, July 24, 2023
Return to Article

3 Russell R. Smith, Tony's Hedging Snap Quote, July 25, 2023
Return to Article

4 Brian Wesbury, Monday Morning Outlook, Still Overvalued, July 10, 2023
Return to Article

5 The Conference Board, LEI, July 20, 2023
Return to Article

6 Thomson-One, Market Monitor, July 25, 2023
Return to Article

7 Brian Wesbury, Monday Morning Outlook, Still Growing, July 24, 2023
Return to Article

8 David A, Rosenberg, Rosenberg Research, Economic Commentary, Appetizer with Dave, June 23, 2023
Return to Article

Charts

1 Morgan Stanley Wealth Management Global Investment Office
Return to Article

2 FactSet
Return to Article

3 Cypress Capital Market Outlook, July 15, 2023
Return to Article

4 Cypress Capital Market Outlook, July 15, 2023
Return to Article

5 Monthly Perspectives, Lisa Shalett, Chief Investment Officer, Morgan Stanley Wealth Management, July 2023
Return to Article

6 Monthly Perspectives, Lisa Shalett, Chief Investment Officer, Morgan Stanley Wealth Management, July 2023
Return to Article

7 Monthly Perspectives, Lisa Shalett, Chief Investment Officer, Morgan Stanley Wealth Management, July 2023
Return to Article

8 ClearBridge Investments - Anatomy of a Recession, June 30, 2023
Return to Article

The Diamond Peak Group at Morgan Stanley

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

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

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

Bruce R. Holoubek, CFP®
Senior Vice President
Senior Portfolio Manager
Financial Advisor
503.588.5716
NMLS #1460475

Cade Goff
Financial Advisor
503.588.5714
NMLS #2029073

Jeremiah James
Financial Advisor
503.588.5743
NMLS #2364095

4582 SE Commercial St., Suite 200
Salem, OR 97302
503.581.1511

Links to our recent written newsletters and updates

R Thoughts—Spring 2023
R Thoughts—Winter 2023
R Thoughts—Fall 2022
R Thoughts—Summer 2022
R Thoughts—Spring 2022
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 Thoughts—Market Update—February 27, 2020

Disclaimers

This material is intended only for clients of the Portfolio Management program. It has been prepared solely for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument, or to participate in any trading strategy.

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.

Please contact your Financial Advisor for a complete listing of all transactions that occurred during the last twelve months.

Holdings are subject to change daily, so any securities discussed in this material may or may not be included in your account if you invest in this investment strategy. Past performance of any security is not a guarantee of future performance. There is no guarantee that this investment strategy will work under all market conditions. Do not assume that any holdings mentioned were, or will be, profitable.

The performance, holdings, sector weightings, portfolio traits and other data for an actual account may differ from that in this material due to various factors including the size of an account, cash flows within an account, and restrictions on an account.

Top holdings, sector allocation, portfolio statistics and credit quality are based on the recommended portfolio for new investors as of the date specified. Holdings lists indicate the largest security holdings by allocation weight as of the specified date. Other data in this material is believed to be accurate as of the date this material was prepared unless stated otherwise.

Data in this material may be calculated by Morgan Stanley or by third party providers licensed by the Financial Advisors or Morgan Stanley.

Material in this presentation has been obtained from sources that we believe to be reliable, but we do not guarantee its accuracy, completeness or timeliness. Third party data providers make no warranties or representations relating to the accuracy, completeness or timeliness of the data they provide and are not liable for any damages relating to this data. Morgan Stanley Wealth Management has no obligation to notify you when information in this newsletter changes.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

International investing may not be appropriate 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. Investing in commodities entails significant risks.

Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies,(iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions.

Technical analysis is the study of past price and volume trends of a security in an attempt to predict the security's future price and volume trends. Its limitations include but are not limited to the lack of fundamental analysis of a security's financial condition, lack of analysis of macro-economic trend forecasts, the bias of the technician's view and the possibility that past participants were not entirely rational in their past purchases or sales of the security being analyzed. Investors using technical analysis should consider these limitations prior to making an investment decision.

Asset allocation and diversification does not guarantee a profit or protect against loss in a declining financial market.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. An investment cannot be made directly in a market index.

The NASDAQ Composite Index is a broad-based capitalization weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. Investment cannot be made directly in a market index.

Morgan Stanley Smith Barney LLC. Member SIPC