R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

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> "The truth is malleable; you just need to pick the right expert."
>
> *Gone Girl* by Gillian Flynn

To say this another way, the truth can be whatever someone wants it to be—just find the right "expert" to confirm your beliefs. There is a term called confirmation bias—"the bias that results from the tendency to process and analyze information in such a way that it supports one's preexisting ideas and convections"—which can be especially problematic to investor's long-held beliefs, emotions and disciplines.

Through our years of industry experience, we have learned—sometimes the hard way—that so called "experts" can often be wrong and sometimes spectacularly so. We vigorously guard against confirmation bias, no matter how sure we might be in our current beliefs. Our investment disciplines take in information from many different and impartial sources—what we like to call the weight of evidence—which form our current outlook on investment allocations and assets.

"It's ok to be wrong, however it's not ok to stay wrong" is one of our basic investment tenets and one we constantly use to offset perceived truths which can soon become malleable.

The Bond Markets

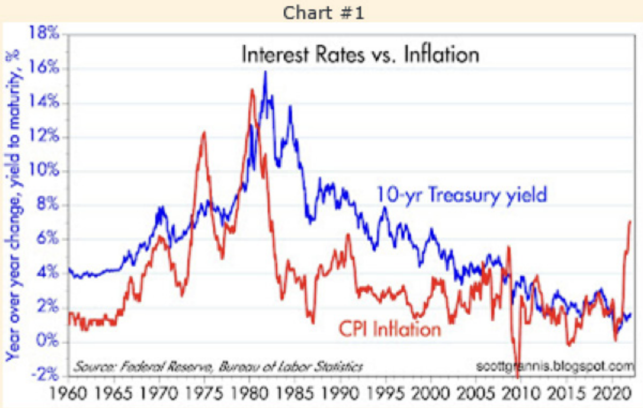
Given our outlook for inflation and interest rates over the intermediate time frame, we consider bonds and bond-like assets almost uninvestable at the present time. Bond basics is that the relationship between bonds and interest rates is an inverse one—as interest rates rise the value of existing bonds generally decline and as rates drop the opposite occurs, bond prices go up. The longer the period to the bond's maturity—the duration—will amplify the change in value given a stated change in interest rates. Said another way, a bond with 10 years to maturity will generally exhibit more volatility in its value than a bond with a 5-year maturity given a stated change in interest rates. All bonds, assuming they are still credit worthy, pay-back 100 percent of the bonds value at maturity.

The interest rate—or yield—on the 10-year Treasury bond is important because it's considered the proxy or the bell-weather yield that most all other fixed income—bond-like investments are priced off. As the 10-year Treasury interest rates changes it affects the price of all other asset classes from bonds, high yield debt, foreign currencies, stocks, commodities and the amount you could earn off of your savings accounts and money market funds.

Until recently we have believed the bond market was priced to perfection. We stated several times in previous editions of *RThoughts* that the most mispriced asset in the world was the 10-year U.S. Treasury bond. To help in understanding our concerns please refer to Chart 1[1] on the following page.

Historically, increasing inflation is anathema to interest rates and bonds—it erodes the future value of the cash flows and final maturity value of existing bonds. Increasing inflation expectations normally lead to increasing interest rates—usually first evident in the 10-year Treasury bond yields.

Chart #1



This chart compares the yield on the 10-year Treasury to the overall yearly change in the Consumer Price Index. We've never seen such a huge difference between the two, as interest rates are normally nearly always as high or higher than the rate of inflation. Not today. Something will eventually have to give and it's our belief that interest rates will, at some point, increase to reflect a more reasonable expectation of the current inflationary environment.

We also believe the Federal Reserve, to control growing inflation expectations, may assume a more "hawkish" or aggressive posture to increase interest rates more than investors expect over the course of 2022. To reflect this more "hawkish" interest rate environment Morgan Stanley strategists recently increased their rate forecast for the 10-year U.S. Treasury up to 2.30% by the 2nd quarter of 2022.[2] The 10-year closed 2021 trading at a yield of 1.52% [3] and is currently yielding 1.84%.[4] With a potential move to 2.30% in the next 3 months or so, the 10-year Treasury will only partially start retracing the red CPI Inflation line in the chart above.

Although we don't believe we are heading back into a runaway inflationary period á la the 1970s, we do see the CPI and inflation indicators poised to stay above 2 percent in the foreseeable future due to the overuse and abuse of monetary and fiscal policies. Two percent has been the Fed's target rate for inflation for the rest of this recovery.[5]

In the words of Jim Paulsen, Chief Investment Strategist for The Leuthold Group, "We expect the annual rate of consumer price inflation to end 2022 near 3.5 percent and the ten-year U.S. Treasury bond yield to possibly reach as high as 2.25 percent. With a current yield of less than 1.5 percent longer term bonds hardly seem a viable investment. . . . ultimately, if the pace of consumer inflation persists around 3% after supply chains normalize, the terminal ten-year bond could reach as high as 4% before this recovery ends. In the coming year, we recommend keeping bond exposures near minimal parameters."[5]

The Stock Markets

A quick look back in time shows the S&P 500 Index returned about 28% in 2021, which is better than the 18% return in 2020 but less than the very strong 31.5 percent achieved in 2019. The Index doubled between the end of 2018 and the end of 2021 for a compounded annual return of 26%. For comparison, the S&P 500 Index provided a compounded annual return of about 16% since the end of 2008.[6]

These are impressive numbers especially when compared to longer term return averages for the S&P 500 Index over the past 64 years. The index has returned a historic annualized average return of around 10.5 percent since its 1957 inception through 2021.[7]

A note of caution for those expecting average annual returns moving forward to replicate the Index's past three years of 26%. We have always been advocates of the term "regression to the mean" which states that all returns—over time—tend to revert to their long-term averages. Although we would be surprised and thrilled to experience those market returns over the next three to five years, our intuition tells us to plan for results likely being significantly lower than the recent three-year period.

In the Fall 2021 edition of *RThoughts*—written in mid-October—we opined, "Into this increasing interest rate environment, we believe the U.S. markets could correct 10-20% at the index level. And we believe this potential decline would present opportunities to buy. Thus, our cautious optimism."[8]

As of this writing—January 25th—the S&P 500 Index has entered the "correction" phase, declining from a high of 4818 on the 4th of January to 4320, a 10.3 percent drawdown.[9] Concerns about the direction and scope of upcoming Federal Reserve's policies, potential slowing of corporate profits, low consumer confidence and unrest in Ukraine are all weighing on investors' minds at the present time, in our opinion.

Into this new market environment, we continue to be mindful of managing risk in the portfolios while holding above average cash reserves. Sometimes it's the defensive side of the ball which wins championships.

In our mind, risk management is also paying close attention to the price one pays for an asset. We have heard it many times in the past . . . this is a great company with a great future, but the biggest questions not asked often enough are—what is the price you are paying for that asset? And is that price reasonable? Does it provide a margin for error? And how will I know if I'm wrong?

We believe in the principle that sometimes it's not what you own, but what you don't own which produces effective risk-management principles. Often it is the discipline to eschew the popular investment ideas that are trendy, hyped, flamboyant and fashionable, which allows the potential to achieve above average risk adjusted returns, in our view.

We like to say that "Selectivity is Key." This is true in the selection of the companies we invest in, the price we pay for those assets and also in the allocation of the broader asset classes we over or under weight based on our principles of relative strength.

Speaking of relative strength, Domestic Equities—at least for now—remains the strongest of the six asset classes we monitor and rank. We are noticing Domestic Equities currently losing relative strength to other asset classes - most notably Commodities which is now firmly in the second position. International Equities, Fixed Income, Cash and Currencies round out, in order, the remaining four positions.

We remain cautiously optimistic on the prospects for risk assets moving into 2022. Although we still believe a robust correction is still a distinct possibility in the near term, we observe no evidence of a potential recession on the horizon in the U.S. economy which would normally produce more significant drawdowns in equity prices.

We notice a significant malaise in consumer confidence over the past few months, likely a result of COVID exhaustion and increasing inflation concerns. Consumer confidence is lower today than in March 2020 after the pandemic first hit the U.S. Perhaps this might be the reason consumers currently hold $2.2 trillion of excess savings and $18 trillion in zero-return deposit balances.[5] Might these dollars be "dry powder" for investment in higher earning assets like Domestic Equities given an improved consumer' psychology?

COVID is the biggest current risk for the economy and investors. Although we feel like we are certainly in the later innings of this dismal game, it is anyone's guess as to when case counts fail to be daily front-page news. Mutations are possible but again one might argue these threats always exist. Trying to invest rationally while attempting to predict the next COVID variant—if any—is foolish, in our view.

Finally, inflation seems likely to moderate in the second half of the year in our opinion. If it happens to remain white-hot longer term, the response from both the stock and bond market might be exceedingly difficult.

In our view the path of the stock market is apt to be much more volatile this year. As seen in the chart below, Morgan Stanley's S&P 500 Year-End 2022 price targets have recently been updated. As we can see, MS is on record with a base case of 4400, a more negative case of 3900 and an optimistic case of 5000. Chief Equity Strategist Mike Wilson has said he would not be surprised to see the S&P 500 Index trade at each of these levels throughout the year highlighting the potential for increased volatility over the course of 2022.[10]

Morgan Stanley S&P 500 Year-End 2022 Price Target

Landscape	Earnings	Multiple	Price Target	Upside / Downside
Bull Case	$265	18.8x	5,000	7.3%
Base Case	$245	18.0x	4,400	-5.6%
Bear Case	$225	17.2x	3,900	-16.3%
Current S&P 500 Price as of:	1/13/2022		4,659	

Source: Bloomberg, Morgan Stanley Research

In such a potentially variable situation it's good to be malleable in your approach. ◗

Written January 24–26, 2022.
The Diamond Peak Group at Morgan Stanley

Sources and Footnotes

1 Chart: Interest Rates and Inflation. Scott Grannis – Calafia Beach Pundit—The Bond Market is Wrong About Inflation. January 13, 2022
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2 Global Macro Conference Call. Michael Zezas, January 10, 2022.
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3 Value Line Selection and Opinion. Model Portfolios, January 14, 2022.
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4 Thomsen-One quotes. January 26, 2022.
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5 James Paulsen, Chief Investment Strategist, The Leuthold Group, LLC. 2022 Outlook?, January 4, 2022.
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6 Palouse Capital Mgt., Inc., 2021 Commentary, January 2022.
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7 Investopedia, J.B. Maverick, January 13, 2022.
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8 *RThoughts*, The Diamond Peak Group at Morgan Stanley, Fall 2021.
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9 Thomsen-One quotes, January 25, 2022.
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R Thoughts—Spring 2021
R Thoughts—Winter 2021
R Thoughts—Fall 2020
R Thoughts—Summer 2020 (cont'd next page)

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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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.

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