R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

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“We walk each day into the unknown.”

Peter L Bernstein, author of
Against the Gods: The Remarkable Story of Risk

Without fail, every January rings in not only New Year’s resolutions, but also expectations and predictions from many “so-called” Wall Street investment pundits and their views on what stocks, bonds, and interest rates will do over the next 12 months.

Well-thought-out—well-documented and researched—these forecasts of potential future events and price levels can be controversial and, in our view, often incorrect. In our four decades in this industry, we have come to realize the future is unknowable and, as such, impossible to predict.

For instance, 2023 is an excellent illustration of that point. Dominated by the “Magnificent 7”[1] a small concentration of very large company growth stocks, the S&P 500 powered to a return of 24 percent last year. The Dow Jones Industrial Average (DJIA) followed with a more modest return of 13.7%[2].

However, looking back at the Wall Street strategists estimates for S&P 500 returns last year we found—according to Birinyi and Associates—that, on average, 21 firms published a year-end 2023 target for an average gain of just 6 percent[3]. As Bob Uecker proclaimed in the movie Major League, “Just a bit outside!”

Again, quoting Birinyi, “2023 is the second year in a row where strategists’ forecasting error was 18 percent. In other words, they were unable to distinguish themselves in the down market of 2022 nor the up market of 2023.”[3]

And remember, the same S&P 500 Index which was up 24 percent in 2023 declined 18.1% in 2022[3]. Predicting the future is hard.

We mention this not to throw shade on Wall Street strategists—there are many good ones, and it is a tough job. In retrospect, we too at the Diamond Peak Group were guilty of the being overly cautious throughout 2023. Looking back and given the information available to us at the time I’m not sure we would have altered our allocations and investment disciplines. We walk each day into the unknown and at best it is our philosophy to be committed to adapt and adjust to the conditions present at the time.

The Stock Markets

Fueled by the Federal Reserve’s policy shift or “pivot” in mid-December indicating it would likely shift to trimming interest rates rather than raising them, investment “euphoria” quickly set in powering the S&P 500 Index’s 4th quarter return of 11.2%. The DJIA picked up 12.5% for the quarter—almost its entire yearly total[3].

In previous editions of *RThoughts* we have examined the impact the seven concentrated stock positions have had on the overall return of the S&P 500 Index. Now comprising one third of the overall index, these weightings have never been this high[4]. Lower interest rates supposedly benefit this “elite” group; correspondingly higher rates would be a head wind.

But many well-worn paradigms broke in 2023. We can’t remember a time when a 5.5% rise in interest rates (Federal Funds) have had little or no effect on equity valuations. Especially on those Magnificent 7 whose valuations are anchored to overall interest rate levels.

Even more perplexing, if raising interest rates were of little consequence, how did declining rates prove more effective and drove these valuations higher?

In its current euphoric state, the U.S. equity indexes seem to be discounting a "best-result" market environment of a goldilocks/soft landing economy with inflation moderating, muted real GDP growth and more accommodative monetary policy from the Fed. This is now the consensus forecast of most Wall Street strategists, market participants and macro forecasters for 2024. When markets all seem to discount a specific and singular scenario, history and our experience suggests other things might likely occur.

In the spirit of a quote attributed to hockey legend Wayne Gretzky (actually, it was his father, Walter's, quote), "I skate to where the puck is going to be, not where it's been," the key to successful investing is figuring out where the puck is going . . . we already know where it's been.

We all know the S&P 500 Index and especially those Magnificent 7 stocks have significantly outperformed all other major asset classes for the past 13 years. That, in our opinion, is where the puck has been.

If we were to predict where the puck is headed, currently we would quote Morgan Stanley's Global Investment Committee: "But in this upside-down world of broken correlations, investors are best served by diversification-based risk management. 2024 therefore is a time for balance between stocks and bonds; US and foreign exposure; growth and value; and Megacap and small, medium, and large capitalization companies."[5]

That is an expansive listing, but we would agree that significant diversification away from the capitalization weighted S&P 500 Index and the NASDAQ 100 would be prudent at these levels.

At the risk of forecasting out a few years and trying to attempt anticipating where the puck might be going, let's examine the case for selective international equities. From a valuation standpoint relative to those in the U.S. and specifically those of the S&P 500 cap weighted index, international stocks represent generational discounts to those in the U.S.

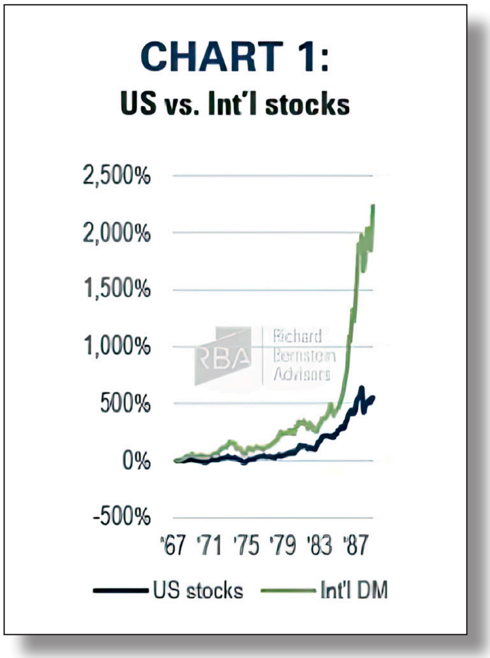
Although important, valuations are not a timing tool and discounts can be observed for significant time periods. However, entry points and prices matter and, in our experience, help reduce risk and potentially lower volatility especially when compared to higher valued asset classes.

Through the years we have found that the "easy trade, the easy story to tell" is already reflected in the price of that asset and that the "overlooked, undervalued, difficult trade to make" is often one which represents more potential value and opportunity. In our view, selective international markets now fit this proposition.

With similar market characteristics as today, there is a previous time frame in which international stocks netted excess returns to that of the U.S. markets.

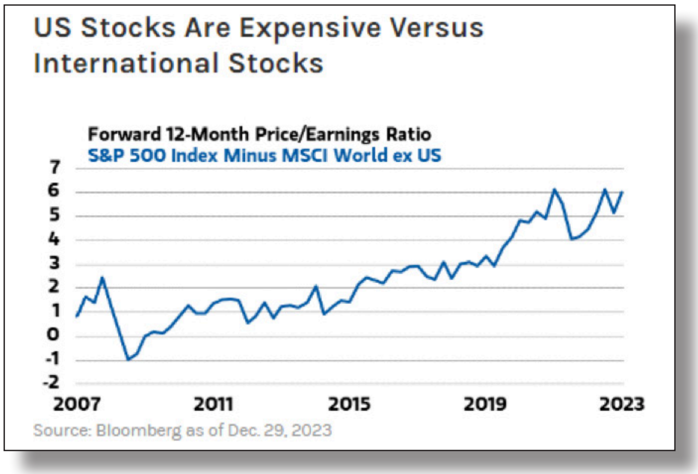
With data compiled from Richard Bernstein Advisors, they examined the period of time between 1967 to 1988. This period, similar to today's Magnificent 7, was previously dominated by the "U.S. Nifty 50" large companies and were also "must own" and infallible at the time and at any price.

Chart 1[i]



Source: Richard Bernstein Advisors

Chart 2[ii]



Source: Bloomberg as of Dec. 29, 2023

As we can observe in Chart 1 "The dominate US Nifty 50 large caps ceased to live up to lofty market expectations, giving way to international stock leadership, especially driven by the ascent of Japanese manufacturing efficiency." This chart shows the outperformance of international stocks against their U.S brethren throughout the 1967 to 1988 era.[6] By the way, has anyone checked up on the Japanese markets performance recently?

Chart 2 shows us U.S. Stocks are expensive versus International Stocks. Again, valuation is not necessarily a timing tool, but selling some of the S&P 500 Cap Weighted Index and investing in the international space would undoubtedly be a difficult trade to make at the current time.

Data supplied in the Kobeissi Letter on January 16, 2024, confirmed these valuation relationships. According to the letter:

- The Price to earnings (P/E) multiple of the S&P 500 Index is now 8 times that of the P/E ratio of international stocks.
- At the last valuation peak for domestic stocks, prior to the 2008 financial crisis, the S&P 500 Index was less than 4 times as expensive as international stocks. It is currently twice as expensive today.
- The valuation of the S&P 500 relative to the international counterparts has never been this high. (See Chart 2).[7]

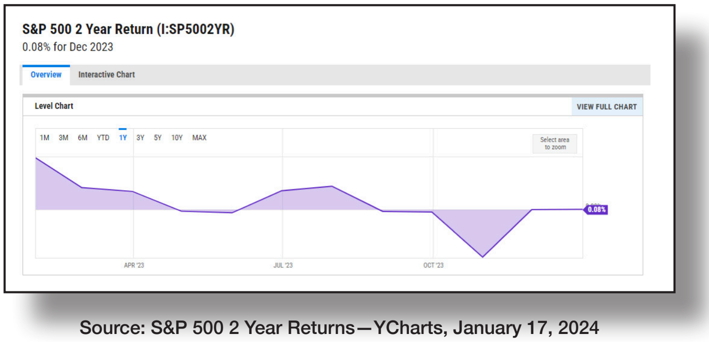
For those of us old enough to remember the old Kmart stores and hearing, "attention Kmart shoppers, we have a 'Blue Light Special' on aisle 15 . . . " well then, this might be a 'Blue Light special.'

Richard Bernstein Advisors Deputy Chief Investment Officer, Dan Suzuki, claims the international markets currently are, "A once-in-a-generation opportunity hiding in plain sight." He adds, "Just as in the wake of the Internet bubble, what part of the market you own could mean the difference between another lost decade of returns for crowded and expensive assets or very attractive [potential] returns from assets where capital is truly scarce."[8]

The only problem with "once-in-a-generation opportunities" is that it takes a generation to truly know if you were right. Regardless of that fact and armed with the knowledge that valuation is not a timing tool—the international space is attracting our attention for potential additional future allocations of capital.

Moving back to the U.S. markets, we observe that the major indexes like the S&P 500 are currently almost unchanged over the past two years as seen in Chart 3.

Chart 3[iii]


S&P 500 2 Year Return (I:SP5002YR)

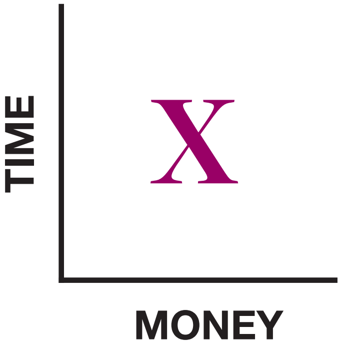
0.08% for Dec 2023

Source: S&P 500 2 Year Returns—YCharts, January 17, 2024

We continue to remain risk adverse in our Tactical Growth Model allocating assets between equities, U.S. Treasuries, and interest-yielding money market funds. This conservative approach resulted in some lost "opportunity costs" over the 2023 calendar year when compared to that of the major U.S. indexes.

While this short-term underperformance has certainly frustrated us, we remain committed to our principles, strategies, and most of all our disciplines. We do not see value in the major U.S. indexes at current levels and remain convinced that with a bit more patience better opportunities and values might present themselves. Managing risk continues to remain our overriding theme.

I found this simple symbol below, emailed from another Morgan Stanley advisor, interesting and thought provoking …



"The axis are time and money. When we're born, we have zero money and infinite time. As we age, the time we have erodes until at the end, we have none left. Meanwhile, the money we have increases and at the end, we have infinite funds … they can't be spent. But it is in the intersection that is of interest. When the value of the time left is less than the value of the money you have or will get, that's when all the thoughts emerge."[9]

"We walk each day into the unknown . . . "

Here is a link to our Team's recent recognition in Forbes, Best In State Wealth Management Teams 2024 (forbes.com)

With appreciation and thanks for your continued trust and confidence through the years.

The Diamond Peak Group at Morgan Stanley

Written January 15th and 16th 2024

Forbes Best-In-State Wealth Management Teams

Source: Forbes.com (Awarded Jan 2024) Data compiled by SHOOK Research LLC based for the period from 3/31/22 – 3/31/23.

https://www.morganstanley.com/disclosures/awards-disclosure.html

Sources and Footnotes

[1] Magnificent Seven: Apple, Microsoft, Amazon, Alphabet (Goggle), Meta (Facebook), Telsa, Nvidia.
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[2] S&P Dow Jones Indices, a division of S&P Global – Market Attributes, U.S. Equities. December 2023.
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[3] Birinyi and Associates, Reminiscences, January 1, 2024
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Return to Article (page 1, top right column)
Return to Article (page 1, middle right column)

[4] Alliance Bernstein, December 20, 2023; "Market Concentration in Magnificent 7 Distorts Index."
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[5] Morgan Stanley wealth Management—The GIC Weekly—On the Markets —"A Year that Broke the Models."
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[6] Richard Bernstein Advisors—RBA Quick Insights—"What does a once-in-a-generation investment opportunity look like?" January 11, 2024.
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[7] The Kobeissi Letter—X post, January 13, 2024.
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[8] Richard Bernstein Advisors—RBA Quick Insights – "What does a once-in-a-generation investment opportunity look like?" January 11, 2024
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[9] Tony Gallea, Morgan Stanley Wealth Management – email, January 14, 2024.
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Charts

[i] Richard Bernstein Advisors—RBA Quick Insights—"What does a once-in-a-generation investment opportunity look like?" January 11, 2024.
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[ii] Morgan Stanley Wealth Management—The GIC Weekly—2024 Outlook: "Starting Points Matter," January 8, 2024.
Return to Article

[iii] S&P 500 2 Year Returns—YCharts, January 17, 2024.
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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.

2024 Forbes Best-In-State Wealth Management Teams
Source: Forbes.com (Jan 2024) 2024 Forbes Best-In-State Wealth Management Teams ranking awarded in 2024. This ranking was determined based on an evaluation process conducted by SHOOK Research LLC (the research company) in partnership with Forbes (the publisher) for the period from 3/31/22–3/31/23. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors paid a fee to SHOOK Research LLC, for placement on its rankings. This ranking is based on in-person and telephone due diligence meetings to evaluate each Financial Advisor qualitatively, a major component of a ranking algorithm that includes client retention, industry experience, review of compliance records, firm nominations, and quantitative criteria, including assets under management and revenue generated for their firms. Investment performance is not a criterion. Rankings are based on the opinions of SHOOK Research LLC and may not be representative of any one client's experience; investors must carefully choose the right Financial Advisor or team for their own situation and perform their own due diligence. This ranking is not indicative of the Financial Advisor's future performance. Morgan Stanley Smith Barney LLC is not affiliated with SHOOK Research LLC or Forbes. For more information, see www.SHOOKresearch.com.

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