Morgan Stanley

# The Boulevardier

A QUARTERLY INVESTORS REPORT FROM **THE VECTOR GROUP AT MORGAN STANLEY**

**JULY 2021**

## EXECUTIVE SUMMARY

### Second Quarter 2021

- ***Equity Markets***[1]*: In a strong second quarter the S&P 500 finished +8.55%, EAFE +4.37%, and Emerging Markets +4.42% on the quarter.*
- ***Bond Markets***[2]*: High Yield continued to lead returns as Sub-Investment Grade bonds saw spreads fall by 51 bps to 2.68% over treasuries, while Investment Grade spreads fell by 14 bps to 0.80% over Treasuries. The US 10-year bond saw yields contract by 23 basis points to 1.47% following Q1s meteoric rise. The yield curve, measured by 30 and 2 yr. rates, flattened by 33 bps throughout the quarter as the Fed held at the 0.00 lower bound and the 2-year rate rose 10 bps.*
- ***Economics***[3]*: The second quarter moderated following 1st quarter strength as most areas of economic indicators fell below previous highs but remained firmly in growth territory. Housing, Manufacturing, Services, and Industrial Production, all performed well throughout the quarter but fell from Q1 highs. Retail Sales oscillated between growth and contraction against historically strong comparables. Consumer Confidence continues to be a bright spot. Employment and Inflation have developed into the largest questions marks. The US has added back a significant number of jobs but growth has been short of expectations. Inflation is elevated but may be transitory as base effects from Covid shut down inflate readings.*
- ***Oil***[4] *ended the quarter at $73.47/barrel WTI, a +24.19% increase from last quarter's close..*
- ***Gold***[5] *futures closed at $1771.60/oz., a +3.26% increase for the quarter.*

### Outlook 2021

- *Transitory or not, inflation takes center stage.*
- *Yields and Value digest large Q1 moves, Growth reaccelerating.*
- *Economic growth moderates but expansion continues.*

> **"Winners are happy to make unpopular types of plays, and to trust their own understanding of the game rather than try to imitate fashion and cutting-edge theory."**
>
> — Walter Trice
> on the game of Backgammon

ALSO IN THIS ISSUE:

**Advisor's Perspective: Technology and the Same Old Model**


THE VECTOR GROUP *at* MORGAN STANLEY

1290 Avenue of the Americas, New York, New York 10104 • 212 893-7516 • **https://advisor.morganstanley.com/the-vector-group**

# Tactical Ideas for Consideration

*for the Appropriate Investor*

| ASSET CLASS CHOICE | SUB CLASS | IDEAS | CONVICTION[1] |
|---|---|---|---|
| **US Equity/Debt/ Cash** | Equity | Attractive | |
| **US Equity Size** | Larger | Attractive | |
| **Equity Investment** | Sectors: Info Tech, Communications, Financials | Attractive | |
| **Developed Int'l Equity** | EuroZone | Unattractive | |
| **Emerging Markets** | China | Attractive | |
| **US Gov Bond Market** | Long Term | Unattractive | |
| **Municipal Bonds** | Medium Duration | Attractive | |
| **High Yield Debt** | Various | Unattractive | |
| **Preferred Stock** | QDI Financials | Attractive | |
| **Mortgage Bonds** | Agency | Attractive | |
| **Precious Metals** | Gold | Attractive | |

***NOTE: We have discontinued ranking currencies and alternative investments as a group.***

NOTES:

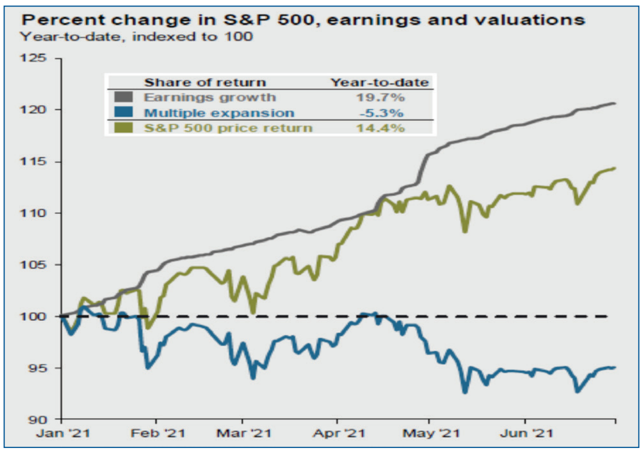
[1] Lowest, Highest *[Increasing number of top hats indicates increasing conviction to the idea]*

If you are interested in exploring any of the ideas mentioned above, please call. We will discuss if it is appropriate for your specific situation as well as the different investment choices available to gain exposure.

# Q II 2021

Over the past two issues we've spoken adnausium about the importance of the market growing into its valuation. The only way for an expensive market to justify itself is for earnings growth to materially outpace expectations and price return. Throughout the second quarter this has begun to materialize.

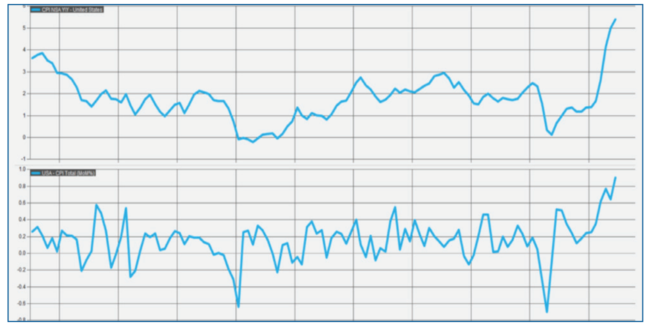
The S&P 500 increased by 8.55% on the quarter but the forward price-to-earnings ratio fell to 21.53x13. This was a function of year-to-date earnings growth of 19.7% outpacing the index's 14.4% price return, resulting in -5.3% multiple compression; the majority of which occurred in the final two months of the second quarter[13].



[13]

This is important because it starts moving the market towards more favorable return expectations. As forward valuations improve, so too does return expectations over the next five years. Continuation of this trend is vital into the second half of the year.

Changing course, inflation has become the topic du jour amongst most financial participants. It is for good reason as CPI rose 0.77%, 0.64%, and 0.90% on a monthly basis or 4.16%, 4.99%, and 5.39% on an annual basis for the months of April, May, and June respectively[3]. This readings well overshoot the Federal Reserve's long term target of 2.00%, which would normally give way to increase in the Fed Fund's rate.


[3]

The Fed, however; has made it clear that they are willing to let inflation overshoot in order to give employment the necessary amount of time to rebound. It is important to remember that some inflation is a necessary aspect of growth, but that too much inflation, especially when it outpaces aggregate growth (known as stagflation), becomes harmful.

So why isn't the Fed reacting? For one, Q2 GDP is expected to grow at 9.50%[3]. A number that far outpaces price growth. Stagflation is not yet a concern. Secondly, CPI readings are experiencing significant base effects, or low comparables, where April and May of 2020 saw brief periods of deflation, -0.37% and -0.07% respectively, and June saw a moderate reading of 0.24%[3]. These low comparables have led many, the Fed included, to believe that the high inflation readings we're seeing are transitory in nature. This is not to say the Fed has completely brushed aside inflation. In his most recent press conference Chair Powell was adamant that inflation is a high priority, but in the short term job growth is the most immediate concern.

Adding to this belief has been the market's reaction to high inflation readings. Counterintuitively, following the first quarter's significant increase in the 10-year yield, as inflation picked up in the second quarter, rates fell back into the 1.40% range, pushing real rates deeply negative. As a result, the reflation trade that dominated Q1, where small capitalization, cyclical, and value stocks outperformed, gave way to higher valuation growth stocks. This is a cumulative reaction one would expect from lower inflation readings, not higher.

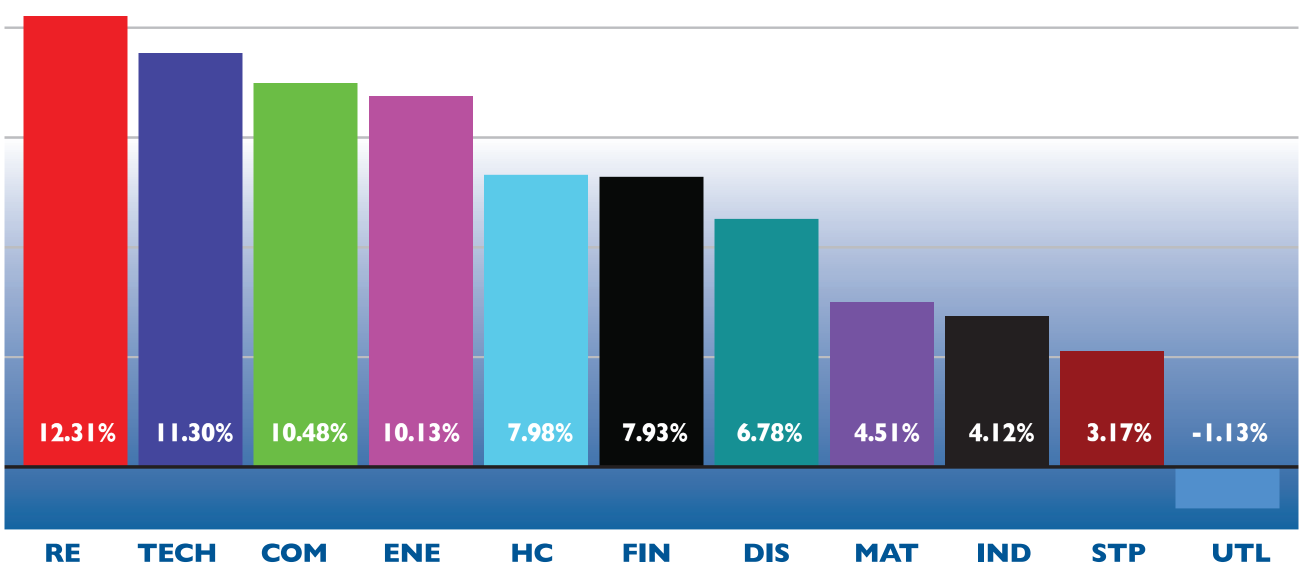
However, the market is a forward looking mechanism. Following a first quarter where reflation dominated and yields rose while inflation reading were muted, and a second quarter where rates fell and growth outperformed as high inflation materialized, it stands to reason that the market is in agreement with the Federal Reserve that high current CPI readings are important to monitor but will moderate in the coming quarter and should not yet be reacted too.

## *US Equity Markets*

### S&P 500 - Q2 2021[6]


The S&P 500 rose +8.55% in the second quarter of 2021[1]. Outperforming sectors include Real Estate, Information Technology, Communication Services, and Energy while Materials, Industrials, Consumer Staples, and Utilities underperformed.

### S&P 500 - Sector Performance Q2 2021[7]



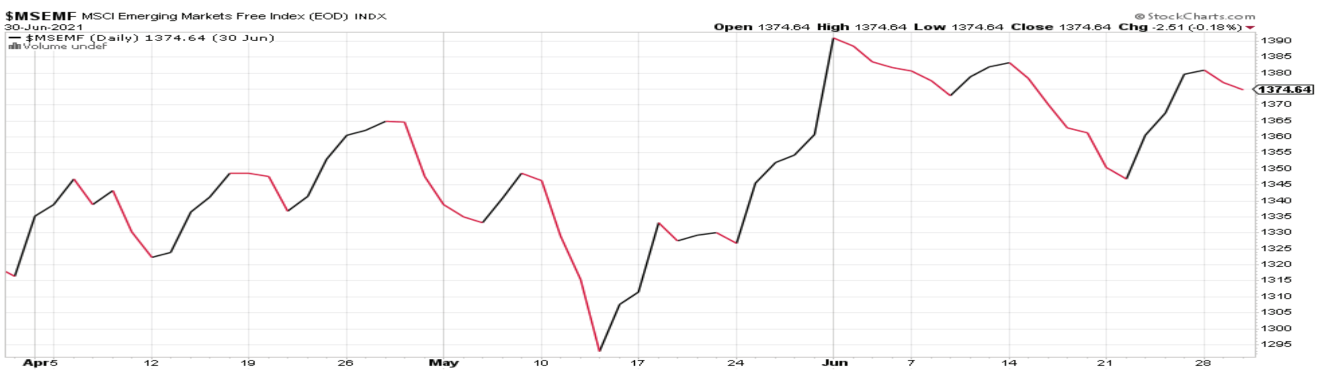

*(Expanded: Real Estate, Information Technology, Communication Services, Energy, Health Care, Financials, Consumer Discretionary, Materials, Industrials, Consumer Staples, Utilities)*

## *Other Equity Markets*

MSCI EAFE underperformed the US by 418 basis points in the first quarter, rising +4.37%[1].

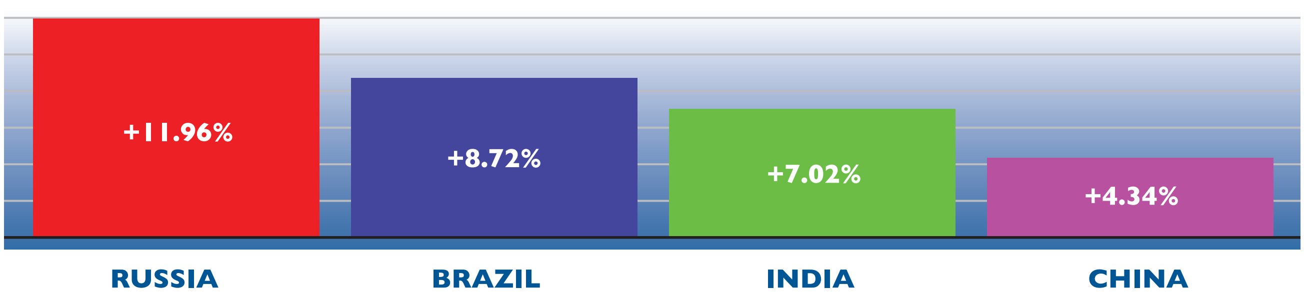
### EAFE - Q2 2021[8]


### Emerging Markets - Q2 2021[9]




Emerging Markets underperformed the US by 422 basis points while also underperforming Developed International Markets by 88 basis points in the first quarter, rising +1.95% by the MSCI EM Index[1].

### Russia, Brazil, India & China - Q2 2020[10]



## *Energy Markets*

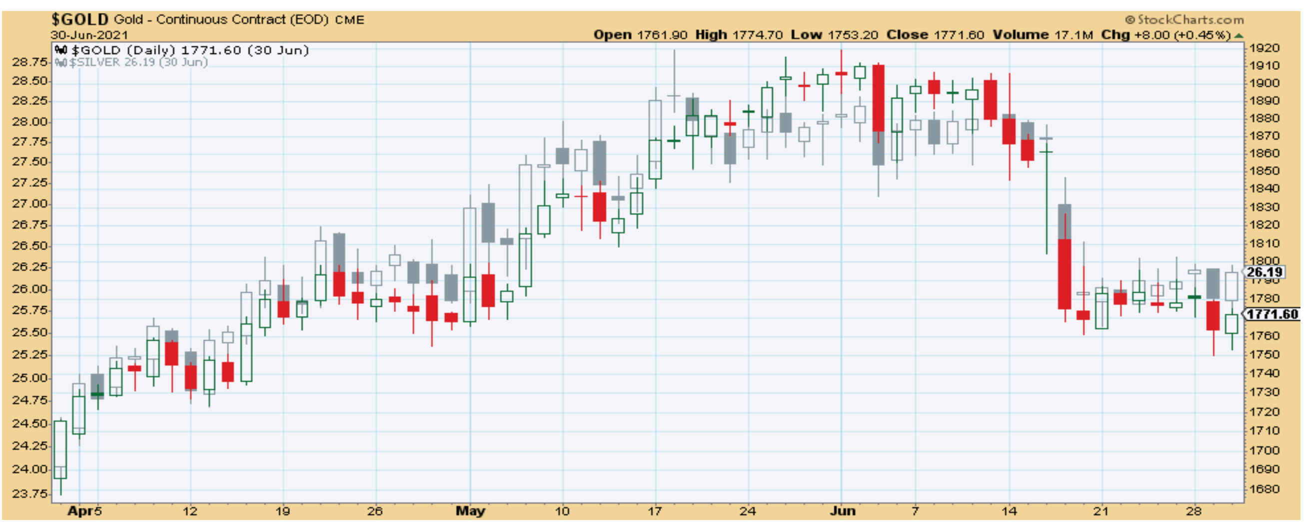
### WTI Crude Price/Barrel & Gasoline Price/Gallon Q2 2021[4]


Energy prices rose in the fourth quarter as WTI rose +24.19% while Gasoline futures rose +14.29%[4].

## *Precious Metals*

Gold ended the quarter with a +3.26% increase while Silver ended with an increase of +6.77%[5].

### Gold & Silver - Q2 2021[5]



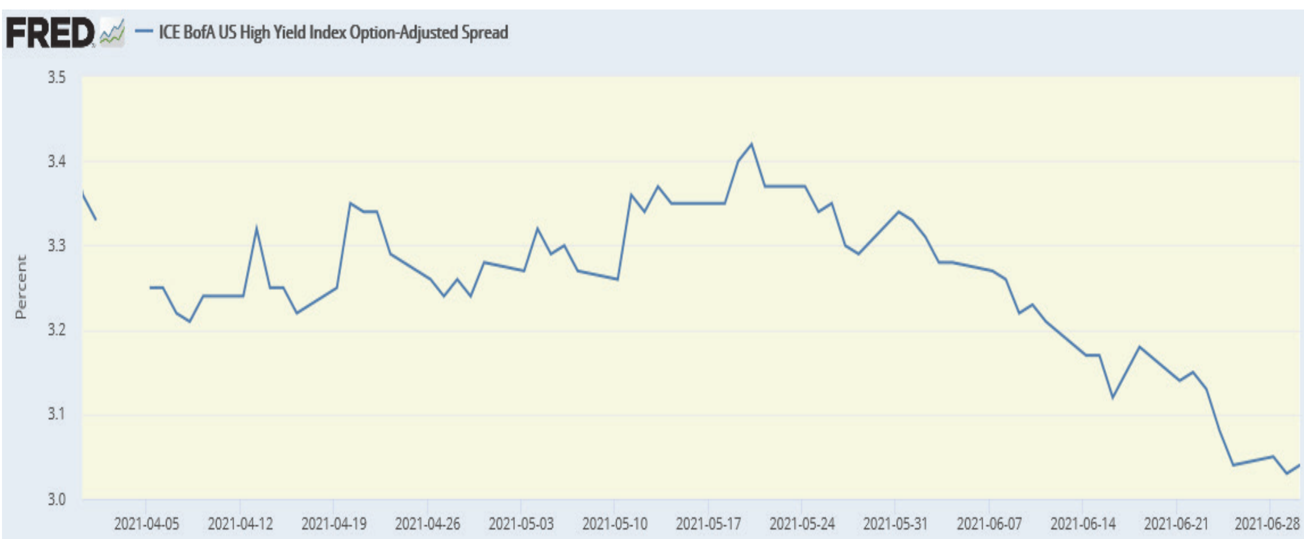
## *Bond Markets*

Ten Year Treasury Yields fell to 1.47% throughout the quarter while the Two Year Rate rose to .25%[2].

### Ten Year & 2 Year Treasury Yield - Q2 2021[11]


High Yield rallied on the quarter as spreads fell by 51 bps[3].

### High Yield Corporate Debt Option-Adjusted Spread - Q2 2021[12]



# Advisor's Perspective: Technology and the Same Old Model

If we look at the definition of the word "technology" we have essentially three concepts:

❶ *A branch of knowledge dealing with development of technical means and their applications in life.*

❷ *The application of the knowledge for practical application.*

❸ *A scientific or industrial process.*

Early examples of technology include the cotton gin, factories and the wheel. As Man has evolved, so have his technologies and they have in turn shaped the human world and evolution.

Since the nascent era of mass production (starting in the late 19th century) local business and industry were threatened by cheaper and faster production methods met with greater demand for products from a newly wealthy plurality. Production methods evolved so rapidly, it was feared that massive amounts of unemployment would ensue and income levels would drop, thereby threatening this new virtuous cycle of cheap production/distribution and ever higher consumption.

But what occurred was the expansion of the industry of business – the process of getting products and services from ideas through development and production into the hands of consumers. We have all heard the "quote" of Calvin Coolidge: "the business of America is business." (It is ironic that this was in fact paraphrased from a presentation to the American Society of Newspaper Editors on the subject of the risks/evils of propaganda in the media). What this phrase embodied was the fact that the business structures around the mass production in the early part of the 20th century were at the center of business itself. Logistics, planning, distribution, acquisitions, expansion, development – all part of what got the new product to the consumer. The creation of the middleman and access points that cost more in production, and distribution. Brokers and log-jams of information or special access points.

Fast forward to the information revolution accelerating in the late 1980s to today. The information age takes aim at the heart of business: middleman, special access, information use and production simplicity.

But this in turn creates the need for support systems that enable the processes: SAAS, Cybersecurity, ad-tech, process review systems, out sourcing necessary functions such as HR, payroll, financial, bookkeeping and many more. So this information architecture grows in the same way "business" grew with the handling of mass production and the industrial revolution. We have now created the infrastructure to serve the technological community.

When I started in investment banking in the early 1980s, we had just left the era of rows of accounting machines to evaluate balance sheets and financial statements. The era of the mini-computer was upon us and shortly thereafter, the personal computer. What the PC could do in minutes it took literally hours to complete by hand or with the antiquated tools of the previous era.

So when PCs were introduced, I remember thinking – aha! I'd be able to leave before 10pm on Friday since this shiny new toy could do the work in 1/10th the time! But no… as use of these devices became more prevalent, new dimension of analysis were sought, sometimes multiple scenarios run and not for the least reason than because our competition was doing it! Technological advances tended and do tend to fill the time it seems to replace. I think this should be a corollary to Moore's Law.

But given this evolution, the whole infrastructure of technology requires a full expansion of supporting facilities to enable all the new processes and volume of work needed. SAAS, Ad Tech, etc. What's more, as these processes become more standardized and people/businesses begin to rely on them, a new paradigm of reduction will surely ensue. And the cycle continues.

When we began to engage in the computer era, the first definition of technology applied: a branch of knowledge with development of these means. But today it seems that there should be no "technology" sector, because every entity engaged in business has adopted this "new" platform from the tools of technology. This interface requires definition 3) a scientific or industrial process and works through definition 2) the applications of this knowledge.

This is all a long way of saying, our focus on the various areas of growth related to applications of technology appear to be working as these platforms are here to stay. Thus, it appears it would take a major paradigm shift to derail our thesis of growth through further application of not just big tech and communications, but the newish businesses that support, replicate and mass produce the old business model.

***—MDS***

NOTES:

1 Morgan Stanley Investment Resources. Month-End Asset Return Analysis published 1 July 2021. Sources: Morgan Stanley & Co. Research, Bloomberg, and FactSet. Index returns reflect total return as of 6/30/2021.

2 Morgan Stanley Research. US Credit Strategy Chartbook published 7 July 2021. Sources: Morgan Stanley & Co. Research, Bloomberg, Citigroup Index LLC, and iBoxx. Index returns reflect total return as of 6/30/2021.

3 Factset Research Systems. Economics: United States. Data as of 6/30/2021.

4 StockCharts.com, Inc., Market data provided by Interactive Data Corporation, StockCharts.com, SharpChart of ($WTIC) Light Crude Oil – Continuous Contract (EOD) and ($GASO) Gasoline Unleaded – Continuous Contract (EOD), data as of 6/30/2021.

5 StockCharts.com, Inc., Market data provided by Interactive Data Corporation, StockCharts.com, SharpChart of Gold ($GOLD) Gold –Continuous Contract (EOD) and ($SILVER) Silver - Continuous Contract (EOD), data as of 6/30/2021.

6 StockCharts.com, Inc., Market data provided by Interactive Data Corporation, SharpChart of S&P 500 ($SPX), data as of 6/30/2021.

7 StockCharts.com, Inc. Market data provided by Interactive Data Corporation, StockCharts.com, PerfChart of S&P 500 Information Technology Sector Index ($SPT), S&P 500 Consumer Discretionary Sector Index ($SPCC), S&P 500 Health Care Sector Index ($SPHC), S&P 500 Information Utilities Sector Index ($SPU), S&P 500 Consumer Staples Sector Index ($SPST), S&P 500 Materials Sector Index ($SPM), S&P 500 Industrials Sector Index ($SPI), S&P 500 Financial Index ($SPF), S&P 500 Communication Services Sector Index ($SPTS), S&P 500 Energy Sector Index ($SPEN), and S&P 500 Real Estate Sector Index ($SPRE), data from 3/31/2021 through 6/30/2021

8 StockCharts.com, Inc. Market data provided by Interactive Data Corporation, iShares MSCI EAFE Index ($MSEAFE), StockCharts.com, data as of 6/30/2021.

9 StockCharts.com, Inc., Market data provided by Interactive Data Corporation, SharpChart of MSCI Emerging Markets Free Index ($MSEMF), data as of 6/30/2021.

10 PerfCharts of Shanghai Composite Index ($SSEC), Brazil Bovespa Index ($BVSP), Nifty 50 Index ($NIFTY), and Russia TS Index ($RTSI), data from 3/31/2021 through 6/30/2021.

11 StockCharts.com, Inc., Market data provided by Interactive Data Corporation, StockCharts.com, SharpChart of CBOE 10-Year US Treasury Yield Index ($TNX) & ($UST2Y) 2-Year US Treasury Yield (EOD), data as of 6/30/2021.

12 FRED. ICE BofA US High Yield Index Option-Adusted Spread. Data as of 6/30/2021.

13 JP Morgan Asset Management. Guide to the Markets U.S. 3Q 2021. Data as of 6/30/2021.

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Morgan Stanley

# THE VECTOR GROUP *at* MORGAN STANLEY

**M. David Sherrill, CFA®, CMT®**
*Managing Director*
*Senior Portfolio Management Director*
*International Client Advisor (ICA)*
*Private Wealth Advisor*
*212 893-7515*
*M.David.Sherrill@morganstanley.com*

**Daniel Sheldon, CFA®**
*Vice President*
*Financial Advisor*
*212 492-6934*
*Daniel.Sheldon@morganstanley.com*

**Greg Waldman**
*Senior Vice President*
*Financial Advisor*
*212 705-4561*
*greg.waldman@morganstanley.com*

1290 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10104 • 212 893-7516

**https://advisor.morganstanley.com/the-vector-group**