Monthly Investment Perspectives: Video

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- On Wednesday, December 13, 2017 Chief Investment Officer Michael Wilson hosted the Global Investment Committee Monthly Investment Perspectives call/webcast to discuss the current market conditions and outlook.

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Good afternoon, everyone, it's Mike Wilson, chief investment officer for Morgan Stanley, and welcome to the December Monthly Investment Perspectives. Happy holidays to everyone, and it's been a great year for investors. And hopefully we can have another good start to next year, although, I will start out this presentation by saying we do think 2018 is going to be much trickier than 2017.

Not necessarily a big bear market, but clearly more volatility, and that's really what I want to focus on in today's Monthly Investment Perspectives. So, as I said, you know, our call in January was for the strongest global equity market since 2013. I stress the word global because literally every market in the world was up, and up significantly. In fact, the US equity market was the laggard, which I'll get to some of that in a minute. But basically it was a global equity rally driven by earnings and multiple expansion, and we think that will persist in 2018.

But then things could start to change as people start to worry about decelerating growth. So, I mentioned we're not as bullish on global stocks at this time as we were last year. Once again, not a bear market, but hard to imagine we're going to be up 20% again or more in 2018 after this year. And the three things we're really focused on is number one: we do expect a peak in the growth rate and earnings next year, probably in the first half.

That doesn't mean negative growth, it just means that the peak rate of change will come in, in the first half of 2018, particularly in the United States where we're getting a tax reform, where you could get a lot of front-end-loaded activity in the first half of next year. And it's going to create more difficult comparisons in the back half, and then of course as you go into 2019.

The second thing that we're worried about for next year is financial conditions are likely to tighten, okay? So, this is another reason why multiples expanded this year, is because financial conditions were very loose. And two things, in particular, happened in 2017 that drove that: Interest rates actually went down. People thought they'd go up as people got more excited about growth.

That didn't happen. And the second thing is that the US dollar actually weakened this year, which is helpful for financial conditions. And so, next year we think the reason why financial conditions will tighten is that the Fed is moving forward; in fact, they raised 25 basis points today, and the reducing balance sheet, and we're getting later in the economic cycle when things start to get tight, inflation starts to pick up, and we start to see credit markets behave in a less functional way.

So, those are the drivers for financial conditions—tightening, which then, can have a negative impact on multiples. And the last thing is, is that sentiment is much more bullish now than it was a year ago. In fact, I would argue sentiment is much more bullish now than it was even in August—the last time that we were really, really pounding home the idea you wanted to be aggressively buying equities—for a final move this year, which is what we're getting.

But now, people are pretty much on board with the idea that we're in a, you know, a structural bull market, cyclical bull market, whatever you want to call it, and it's being led by all the things we've been talking about. Global synchronous growth—you know, financial conditions are quite loose, and multiples can expand. We think that's now a more, much more of a consensus view, which then, of course, leads to less upside for next year.

We also think that, as I mentioned before, we expect more, a more normal year, just in terms of total return and volatility. So, remember, a normal year, you typically get about 8%, 9% return in equities. So, that's a normal year. This year we're getting 20%, 25%. That's not normal. And we've had very little volatility—one of the lowest drawdowns we've ever seen in a typical year—only 3% in the US equity market, S&P 500.

Typically, you get 10% to 14%. I'll show some data on that in a minute. Now, tax reform. We're not surprised that tax reform's happening in the US, but we are surprised by the timing of it and the potential size. We suspect this may have brought forward returns. Our 2700 target for the S&P 500 was originally for the first quarter of 2018, and we're actually pretty much there now.

And the reason why is because we think tax got done sooner, and it's a little bit bigger than we thought. We thought it would be a 25% rate. It's closer to a 20% rate, maybe 21% for corporates, and so that's a reason why returns have kind of been brought forward. It also means we might be able to extend them a little higher than the original target in the first half of next year, but not necessarily all year.

Okay, so it's getting priced earlier, it doesn't mean it's going to last for all of 2018. So, just a couple more comments here on the home page. Credit markets are, on the other hand, little or no value. We continue to be underweight high yield. And we think credit continues to be a source of funds. That'll be the first market to turn as things get a little bit tougher. Japanese equities have continued to perform very well this year, even though we've only been 50% hedged, and European equities are completely unhedged—have also done very well.

But emerging markets have been the strongest performer this year, year to date, a market that most people hated at the beginning of last year. We've stayed with it. I suspect emerging market's going to be much more of a market next year. It may even underperform in some regions just given how strong they performed in 2017.

All right, let's talk about some of the leading indicators that really tipped us off. The reason we got bullish back here in 2016 was because it was already troughing. But look where we are now. This is developed markets, PMIs—this is the overall number; this is emerging markets, but they're all basically at very high levels. And one thing we know about this is it's mean reverting. So, it's pretty clear to us this is going to roll over in 2018.

It doesn't mean we have to go to a recession, which would be all the way down here. So, you break through there, then you're in a recession. But they're going to roll over. And this gets back to the idea that the rate of change on growth is going to slow at some point, probably in the first half of 2018.

This is MSCI All-Country World, so global, that's the price, and this is consensus forward earnings estimates. The yellow line is the earnings; it's just been going straight up. Now, it's unlikely that that can just continue to go at that pace. So, this is probably going to start to flatten out, at a minimum. Once again, rate of change on growth—we'll have implications for multiples, and just excitement around equities.

But our key insight last year beyond the fact that we thought the earnings were going to be quite good, was that multiples were going to expand. Let's talk about this update. Remember we talked about equity risk premiums rather than PE multiples, and a lot of people thought that was misplaced; although, now I hear a lot of people talking about ERP today because they basically agree with this concept.

The concept is very simply the spread between earnings yields, and 10-year Treasury yields. And as we've talked about now for a couple years, they've been pretty elevated. Okay, they've been elevated up here above the average, which is where the yellow line is, and our whole call was that they were going to come down towards the average line, and that's exactly what's been going on. We've made a lot of progress on that. In fact, we've gone, as you can see, from basically 400 basis points down to 300 basis points.

So, pretty good multiple expansion, okay? Now, it doesn't mean we can't overshoot, okay, and go down into an overvalued area. Okay, it's very possible that could happen. I just want people to understand that that's what you're playing for. If, you know, markets continue to power higher next year at 20%, you're going to be in an overvalued territory.

But this is not a high risk-reward, okay, like it was back here, when everybody was worried about valuation. That was the time you wanted to capture this. We've captured a good portion of that, so let's just, you know, make note of that, and call a spade a spade, and not, you know, talk about how, you know, markets can go up 20% every year.

I notice that sell side commentators now are talking about, you know, 3,000 and the S&P 500 when last year they were thinking the market was going to be flat. So, the market's up 25% and all of a sudden they get more bullish. It doesn't really make a lot of sense to me. That sounds like people chasing performance a bit, and that's what that chart is trying to illustrate, okay?

So I talked earlier about just how abroad, they've seen this chart before but I like to show this because this is not going to happen next year, okay?

In fact, I've never seen a market like this in my career where literally every market, okay, every market, S&P 500, EM, Japan, and Europe, basically it's all up. There's only two buckets that were down last year. It was US Energy, okay, and US Telecom—two areas that were, you know, structurally challenged, potentially. I would argue that Telecom probably is more structurally challenged than energy, but nonetheless, what I think is interesting to point out here is that Tech, okay, outperformed in every region by far.

But you didn't have to own any Tech to do well last year. What I would say about this for next year is that Tech, okay, probably is not going to be the best performer next year. Typically that doesn't—it's not what happens two years in a row. And Energy probably does quite a bit better. Telecom's a little more questionable because their issues really are more structural. But Energy is one of our favorite sectors because of this relative outperformance that's been so significant, and now we're seeing relative earnings revision breadth turn up as we've shown on this deck before, okay?

Now, just, you know, talked about at the onset, but I think it's—I love showing this chart because it's so powerful. What it's showing us is S&P total returns for the last 38 years from January 1 to December 31—those are the blue bars, and basically the S&P 500 is usually up, not every year, but it's up, you know, a majority of the time, 70% to 75% of the time.

The red dots is where I want to focus on. This is the maximum drawdown in the S&P 500 in each of these years, okay? This year, 3%. That's all you got. The only other time we've seen it that low was in 1995. That doesn't mean that next year's going to be a down year because look what happened. We had 34%, and it was up 20% and 31%, 27%, and 20%. I'm not expecting that, obviously. We're not looking for those kinds of returns.

But what I would tell you is that the median drawdown, during this whole 38-year period, okay, is 10%. The average drawdown during this 38-year period is even below that. It's 14%. That's normal. So, when I say we expect a more normal year, we expect positive returns but more normal, meaning sort of mid-single digits, probably. And we expect at least one, if not a couple 10% drawdowns at some point next year.

So, that's what you should be prepared for mentally, is lower returns, and more volatility. So, it's just not going to be as smooth of a ride it was in 2017.

Thanks for joining us for December’s Monthly Investment Perspectives, have a wonderful holiday, and we hope to see you in 2018.

Asset Class Risk Considerations

For index, indicator and survey definitions referenced in this report please visit the following: http://www.morganstanleyfa.com/public/projectfiles/id.pdf

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General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results.

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This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

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