Morgan Stanley
INVESTMENT MANAGEMENT

Remain Calm and Carry On

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | 2018 EQUITY MARKET OUTLOOK | JANUARY 2018

When the dust settles on 2018 roughly a year from now, it's likely we will be reviewing 2018 as another rewarding one for equity returns, albeit probably a bit more muted than 2017. But will 2018 be good for equity investors? That is one of the key story lines for the year.

We think there is a high likelihood that the spread between how the equity markets do and how investors do should widen considerably in 2018. Why? Investors tend to overreact more in volatile markets:

> *Investors willingness to "hedge" against changes in their level of uncertainty makes them **overeact to bad news in good times**…making the price of the asset more sensitive to news in good times than in bad times.*[1]

Let's face it; 2017 was a pretty easy year to keep the Advil on the shelf. But as you can see below, in comparison to each of the past 37 years, 2017's annual maximum drawdown (in red), was an exception. Next year's drawdown will likely cause more headaches, even if the overall trajectory of the market is higher.

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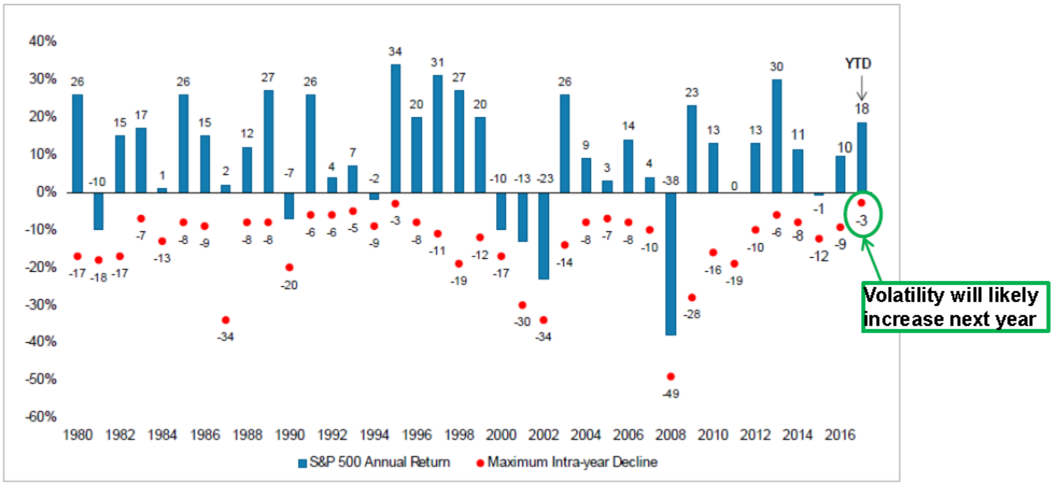
DISPLAY 1

S&P 500 Annual Returns and Max Drawdowns



Source: Factset, Bloomberg, Morgan Stanley & Co. Research as of December 8, 2007.
Note: Price return used. Drawdown is the peak-to-trough decline during a specific period.
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And my fear is that with increased drawdowns, *behavioral investing mistakes will increase as well*, chasing some investors out of stocks at the wrong times in 2018.

As I have articulated often, short-term trading the markets is a fool's game. Yet strategists, and media experts when articulating their short-term views, consciously or subconsciously, tend to encourage investors to overreact. And investors should be easy prey next year:

> *As the yield curve flattens out, as we get into late cycle, people are going to start forecasting recessions, **they are all going to be too early in the recession calls which is usually what happens** but you are going to get some scares and nervousness which will lead to more VIX spikes (in 2018).*[2]

So 2018 is fraught with danger that calmer heads will **not** prevail.

But why do we think it will be a head fake? Why do we think the market will end higher?

First, let me reiterate what I wrote a year ago in my 2017 Outlook piece: *Follow the Earnings Trend*. As of December 21st, the 2017 S&P 500 consensus earnings estimate for 2017 was $131.77. Next year (2018) is $146.50, up 11%. Not bad. But very little tax reform is imbedded in that number. How do I know? Because look at the change in the 2018 estimate since the beginning of this 2017 year. Estimates have come down this year, not up.

DISPLAY 2

No Tax Reform Appears to be Built into Estimates Yet

	S&P 500 2018 Consensus Estimated Earnings Per Share
As of 12/31/2016	$148.80
As of 12/21/2017	$146.50

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
Source: FactSet

It is possible the analysts built in some tax relief as early as 2016. But not to the magnitude of the actual tax cuts we are about to experience. And that tells me analysts will be forced to raise estimates. Stocks rarely go down when overall revisions are going up (and likewise rarely go up when analysts are slashing numbers).

More important is the need to focus on the eventual end of an economic cycle. Those are the big drawdowns we care about. Markets tend to peak in front of recessions. We do not anticipate a recession in 2018.

DISPLAY 3

Recessionary Indicators Have Not Turned Overly Negative Yet

Start of Recession	Yield Curve	Inflation Trends	Labor Market	Credit Performance	ISM Manufacturing	Earnings Quality	Housing Market
Nov 1973	↓	↓	↓	↓	↓	--	↓
Jan 1980	↓	↓	↓	↓	↓	--	↓
Jul 1981	↓	↑	↑	↓	↓	--	↓
Jul 1990	↓	↓	↓	↓	↓	↓	↓
Mar 2001	↓	↓	↓	↓	↓	↓	↔
Dec 2007	↓	↓	↔	↓	↓	↓	↓
Present[1]	↑	↑	↑	↑	↑	↑	↑

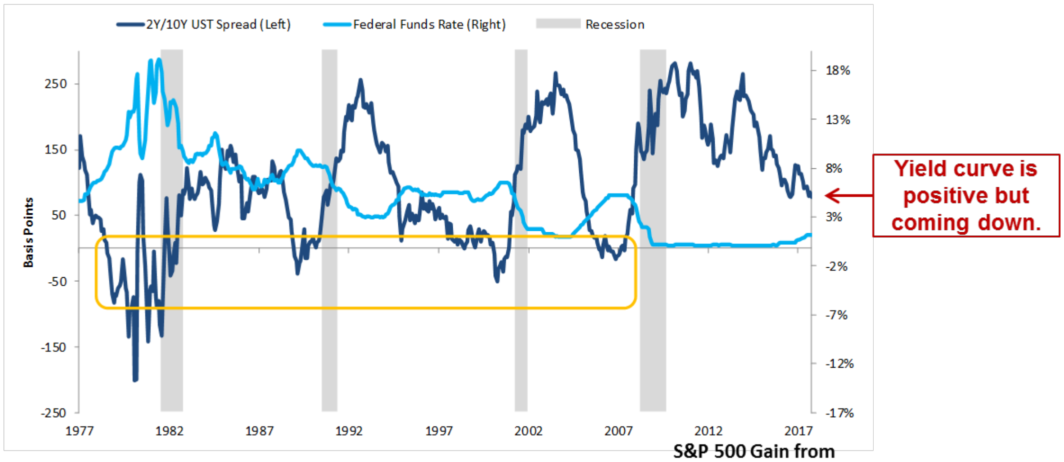
↓ **Recessionary**
↑ **Expansionary**
↔ **Neutral**

As of December 21, 2017.
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.
Source: Credit Suisse; Standard & Poor's, Federal Reserve, Bureau of Labor Statistics, National Statistical Agencies, National Bureau of Economic Research, ISM, Census Bureau, Haver Analytics

As shown above, there are plenty of forward indicators to give us clues about where we are in a cycle, but the yield curve remains the most powerful. If history is a guide, as the chart below shows, once the yield curve (10 year yield minus 2 year yield) goes negative (inverts), the market continued to power higher with very strong equity returns. At least for a while.

DISPLAY 4

Fed Raises Rates →Inverted Yield Curve → Recession Are We There Yet?



Initial Inversion	Stock Market Peak	Time Difference	S&P 500 Gain from Inversion to Peak[1]
8/17/1978	11/28/1980	834 days	51.57%
12/14/1988	7/16/1990	579 days	41.46%
4/24/1998	9/1/2000	861 days	41.60%
12/27/2005	10/9/2007	651 days	28.80%
	Average:	**731 days**	**40.86%**

Average is 2.0 years

1. Total Return

Source: Bloomberg as of October 31, 2017

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The yield curve has not even inverted yet. We do expect an inversion to occur later in 2018 at which time there will likely be a flurry of recession calls, causing a surge in volatility in the market and plenty of nervous investors. I suspect I will be trotting out this chart again as a reminder to ***remain calm***.

There does appear to be some consistency to the types of stocks to own leading up to and post a yield curve inversion. Leading up to a yield curve inversion, the market has historically favored *value* and *higher risk* stocks. What tends to get hurt are *the bond proxy/dividend yielders*.[3] In my mind, that makes sense. The economy is accelerating, and therefore the market rotates into the cyclicals, which tend to be value stocks. At the short-end of the bond curve (2 year), yields move higher which begin to challenge the attractiveness of higher yielding stocks.

DISPLAY 5

What Has Worked Leading Up to a Yield Curve Inversion?	What Has Not?
Value	Bond Proxies / Dividend Yields
Beta	
Momentum	
Earnings Revision	

Based upon Factset data looking at 2005 and 1998 inversions, and Fama/French CRSP data for last four Yield Curve Inversions, 6 months prior to an inversion.

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What I did not list as stocks to own leading up to and post yield curve inversion are growth stocks. Their outperformance historically tends to moderate, but they do not lag significantly either. It seems to me that should be consistent in 2018. As per the FANG stocks, Morgan Stanley Research wrote "large cap leaders in bull markets do not sustain outperformance from one year to the next."[4] Strategist Tom Lee pointed out on CNBC the

"curious case to be made for FANG, based on its history of disappointing in 'even' years. Since 2006, $100 invested in FANG in odd years would have turned to $1,487 (15x) and $100 in even years would have fallen to $70.[5]

From my perspective, this suggests that after a big run-up year like the FANG stocks experienced in 2017, they are due for some consolidation in 2018. That is unlikely a reason to sell, unless one is tremendously overweight in those positions.

Consistent with this analysis of history, we remain positioned in both growth and value stocks, but equally important, underweight the interest rate sensitive bond proxies, often called "the defensives". From a sectoral standpoint that means overweight technology, financials, industrials and underweight staples, utilities and telecoms.

At least for now. Although the market may power higher after a yield curve inversion, the leaders tend to rotate. The more defensive sectors tend to begin to outperform. We suspect as the market embraces an accelerating economy more fully, we will need to de-risk the portfolio somewhat. But that is likely later in 2018.

DISPLAY 6

What Has Worked After the Yield Curve Inverts?	What Has Not?
Quality / Low Volatility	Growth
Bond Proxies / Dividend Yield	Small Cap
Value	Beta

Based upon Factset data looking at 2005 and 1998 inversions, and Fama/French CRSP data for last four Yield Curve Inversions, 6 months prior to an inversion.

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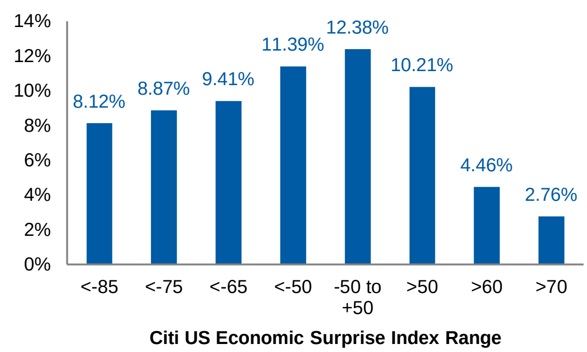
So what are the risks? As I said, it's the next recession we need to be worried about. But what could be the catalyst for 2018 volatility? In my opinion, *it's the interpretation of events* that could unnerve investors. First, while analysts have yet to raise earnings (and I do believe that will happen), I am concerned that *expectations of economic acceleration* and *expectations analysts will raise numbers is very high*. The Citibank Economic Surprise Index (CESI) is at one of the highest levels ever, which means any economic data less than stellar could be interpreted more negatively than it should be. Why? Because historically when the CESI is at these lofty levels (at 77.10 as of 12/27/2017), the six month returns are more muted than when the CESI is very low (and hence expectations are low) as you can see below.

DISPLAY 7

Average Annualized Forward 6-Month S&P 500 Total Return

January 2003 to December 2017 (daily data)



Source: Leuthold Group[6]

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Second, I expect that when the yield curve *does* invert, the pundits will scream "the end is near". Don't believe them. Third, moves by the Fed to raise rates would come with "the Fed kills bull market" calls (which is true, but likely still way too early). How about the mid-term elections? Any decisive Democratic victory and the commentary should support the rise of the far left portion of the Democratic Party to power. I don't think the market could possibly swallow the thought of President Elizabeth Warren. I still doubt that is possible but again, that would be the kneejerk reaction. Finally, what about Bitcoin? While Bitcoin's entire market cap is less than Apple's, my 34 years in this business have taught me that extremely volatile speculation in one asset eventually bleeds into the stock market. And whenever that bubble pricks, it always takes down stocks more than what is initially expected. Premature for now? Absolutely. But definitely something to keep an eye on.

Finally, before touching on opportunities outside the US, I wanted to review a chart I started using in the spring of 2016. Unlike current conventional thinking, I believe equities are **breaking out of a long-term bear market cycle**. In the chart below, each bear cycle has started at a very big market top, such as we saw in March 2000. Over the next 16 years we experienced two very difficult bear markets resulting in very anemic compounding of returns. But just as with the end of the previous bear cycle in 1982, we seem to be entering a period that is more pro-business than we have previously had. Said another way, it took 13 years for the market to regain its 2000 high and "the longer the sideways move, the bigger the breakout".[7] One caveat to this chart, these are long term cycles, with recessions occurring along the way. The last big end of a bear cycle came under Reagan and that resulted in big returns from 1982-2000, but we did have a nasty decline in 1987 and a decline plus a recession in 1990-1991. Time will tell whether this is right, but I can tell you, of all my charts, this one received the biggest hoots and howls last year by the bears. And yet one year into the beginning of the next bull market cycle, the market seems to be on cue. The environment sure is different than what it was in 1982, but these numbers do line up in an eerie way.

DISPLAY 8

Fiscal Policy Reform Has Often Contributed to the End of Long-Term Bear Market Cycles

Annualized S&P 500 Total Returns

Inception of S&P 500 March 4, 1957

BEAR CYCLES					BULL CYCLES			
START	END	YEARS	ANNUALIZED RETURN		START	END	YEARS	ANNUALIZED RETURN
1/19/1906	8/24/1921	15.6	1.97%		8/24/1921	9/3/1929	8.0	29.78%
9/3/1929	6/13/1949	19.8	1.00%		6/13/1949	2/9/1966	16.7	17.21%
2/9/1966	8/12/1982	16.5	4.26%		8/12/1982	3/23/2000	17.6	20.22%
3/23/2000	11/4/2016	16.6	3.88%	?	**11/7/2016**	**Today**	**1**	**25.35%**
Average		17.1	**2.78%**		Average		14.1	**22.40%**

Inception of S&P 500 March 4, 1957[1]

Source: Bloomberg / Robert Schiller as of December 22, 2017
The data prior to the inception of the S &P 500 (3/4/1957) date constitutes backtested data based upon Robert Schiller's work. Backtested results have inherent limitations, such as decisions were made with the benefit of hindsight and not under actual market conditions. Therefore, results cannot completely account for the impact of financial risk in actual trading. No representation is being made that any investment strategy or portfolio will or is likely to achieve similar results to those being shown.

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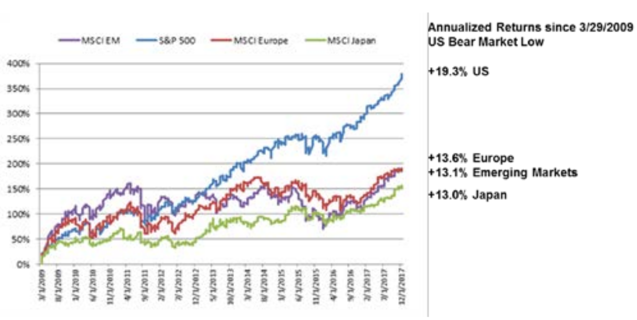
As we move to the non-US markets, what's amazing to me is that the developed markets performed pretty much in line with the US despite the endless discussion and repositioning out of US equities and into other parts of the world. And that's with the benefits of the weaker dollar. MSCI Europe in local terms lagged the US market by over 1,000 basis points and Japan a bit under 200 in 2017. Why? *Because growth outperformed value in 2017 and Europe and Japan are more cyclically exposed value indices than the US.*

This appears to be the biggest reason Europe and Japan could finally actually outperform the US in 2018, not just in USD, but in local terms as well. Remember what has worked leading up to a yield curve inversion? Value. Europe and Japan equity markets' higher exposure to value should assist in these markets' relative performance. Not to mention, as shown below, Europe and Japan have woefully lagged in this current bull cycle and therefore are much cheaper than the US.

DISPLAY 9

Total Return in USD

3/9/2009 – 12/21/2017



Source: Factset

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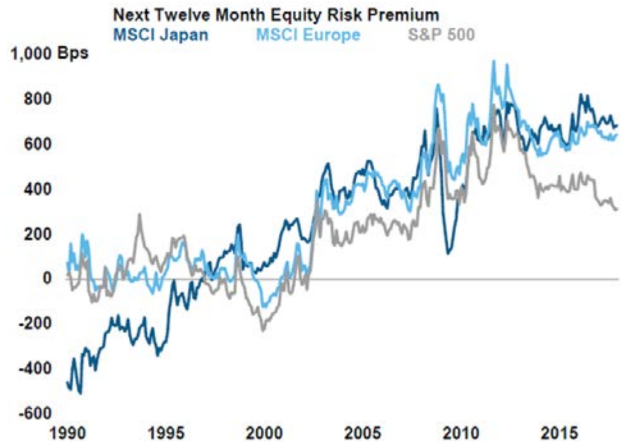
DISPLAY 10

Developed Markets Equity Risk Premium



Source: Factset, Bloomberg, Morgan Stanley & Co. Research as of December 8, 2007

Equity risk premium is the excess return that an individual stock or the overall stock market provides over a risk-free rate. The risk-free rate represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

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Finally, emerging markets have been the 2017 star, up 37%. Yet overall, the index remains below its 2011 highs, arguing for potential further gains. But clearly, the inflows into Emerging Markets and into EM Asia in particular have been red-hot recently, making them potentially the most vulnerable to significant pullbacks as market volatility increases in 2018.

DISPLAY 11

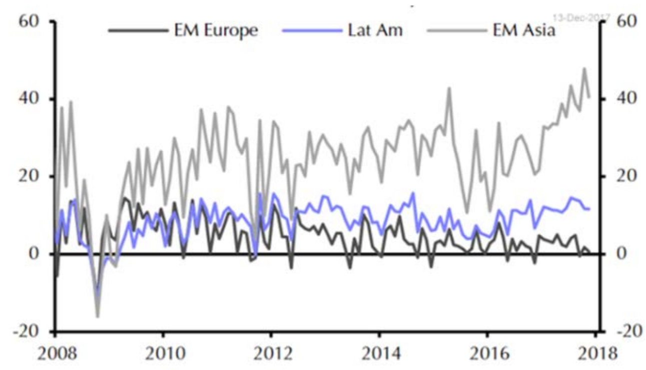
EM ETF Assets

Source: Wall Street Journal, August 21, 2017

DISPLAY 12

Capital Economics Investment Flows Tracker

($bn, Monthly)



Source: Wall Street Journal, December 13, 2017

So volatility once again rears its head in the commentary for 2018, the story of the year. Can investors capture the returns of the markets, which I believe will remain pretty good in 2018, or will the urge to react become too great? Remain calm.

Andrew

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[1] Stock Market Overreaction to Bad News in Good Times: A Rational Expectations Equilibrium Model. Pietro Veronesi, University of Chicago.

[2] David Zervos, Jeffries LLC, Bloomberg TV, December 26, 2017

[3] Based upon Factset data looking at 2005 and 1998 inversions, and Fama/French CRSP data for last four yield curve inversions.

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[5] Other tech stocks could outshine FANG in 2018. CNBC. December 15, 2017

[6] CNBC. When the Economic news is this good, history shows the gains are smaller for stocks. December 27, 2017

[7] Chris Ciovacco, "Extremely Rare Long-Term Setups for Stocks 2028-2017. December 15th, 2017