Monthly Investment Perspectives

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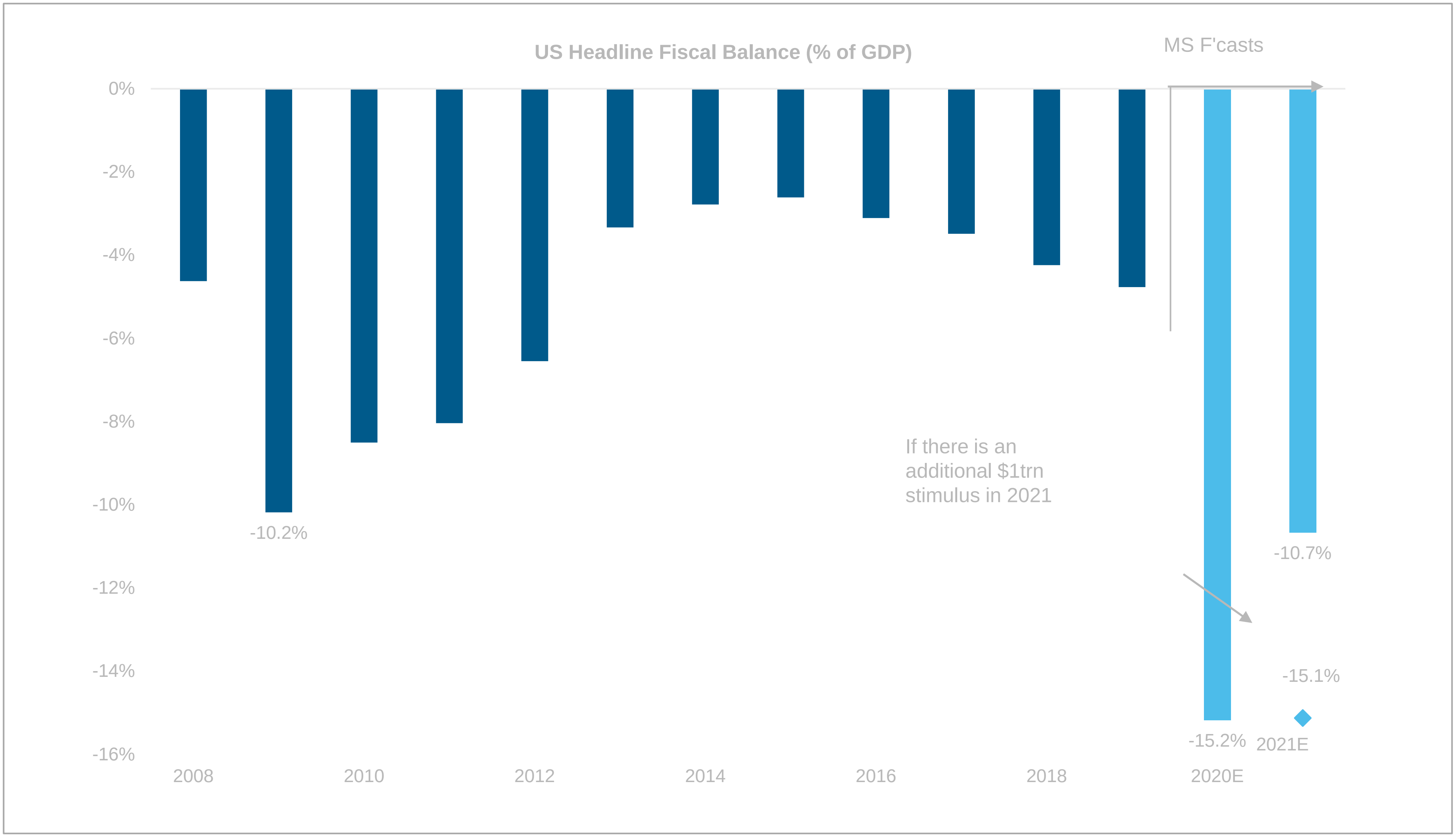
Bond Market Catching up Should Be Catalyst for a Pause, Not End in Bull Market

As of January 13, 2021

- **4 Reasons to Remain Bullish:** (1) new bull markets have begun with a recession and have typically run for years not months. (2) the health crisis has brought unprecedented monetary and fiscal stimulus that is likely to become structural in nature—a policy regime shift; (3) economic data surprises and positive earnings revisions support our V-shaped recovery and forecast for higher equity prices; (4) operating leverage should drive meaningful upside to consensus earnings next year.
- **But, Markets May Be Due for Some Consolidation/Correction:** (1) new administration could order greater lockdowns/restrictions in the coming weeks; (2) interest rate risk growing with Democratic control of Congress and Fed having to contemplate a little less dovishness; (3) institutional positioning appears full and retail sentiment now looks extreme; (4) some speculative assets significantly overvalued.
- **V-Shaped Recovery Is Here.** The Fed's unprecedented response, in conjunction with Congress, has driven a remarkable recovery from the depths of this recession. With Global GDP output having already fully recovered, US economy could be back to pre-COVID levels by 2Q21 and pre-COVID *trend* by 4Q21. US nominal GDP growth could approach 8% this year, a level last reached in 1984.
- **Operating Leverage Is Underappreciated.** Speed and depth of unemployment cycle and cost cutting should drive unprecedented operating leverage this year. *Average* stock could outperform index by 2:1. S&P 500 Equal Weight > S&P 500 Market Weight since the summer as large-cap tech underperforms. We expect that to continue.
- **Barbell of GARP and Cyclicals with a Skew Toward Small/Mid Caps.** In line with our recession/recovery playbook, we continue to recommend a mix of reasonably priced growth stocks (GARP) with the biggest potential beneficiaries of a continued recovery—i.e., cyclicals. Focus on companies that are likely to deliver the strongest operating leverage as business returns. This is likely to include some lower-quality stocks affected the most by the lockdowns **Our US style and sector recommendations reflect this view.** Overweight small/mid over large, Financials, Consumer Cyclicals/Services, Materials, Industrials, and Healthcare. Underweight Utilities and Consumer Staples.
- **Inflation Is the Key to the Secular Bull Market for Stocks and Secular Bear Market for Bonds**. The shift in policy from monetary to fiscal dominance is a significant change that has strong implications for our asset allocation recommendations. A US recession was a necessary condition for this outcome and the health-crisis nature of this event further supports our view for this regime shift. Finally, we remind investors about the other inflationary trends that were well established before this recession began—populism, nationalism, de-globalization, and a sign that the US dollar may either lose or have to share its reserve currency status. Recent US election outcome is an accelerant to this view.
- **We Recommend Being Overweight to Equities and Credit, Underweight Interest Rate Risk—i.e., Duration.** We also recommend owning some commodities as another inflation hedge. Avoid profitless growth stocks and pure bond proxies/defensives. Cash is *not* king with front-end rates at zero and rising inflation. We think the biggest risk to equities and other long-duration risk assets will come from the interest rate channel. A non-linear move in back-end rates will likely lead to an overdue correction/consolidation. Be patient here and use pullbacks around higher rates/less dovish Fed as buying opportunities, led by US cyclicals, international and small/mid caps.

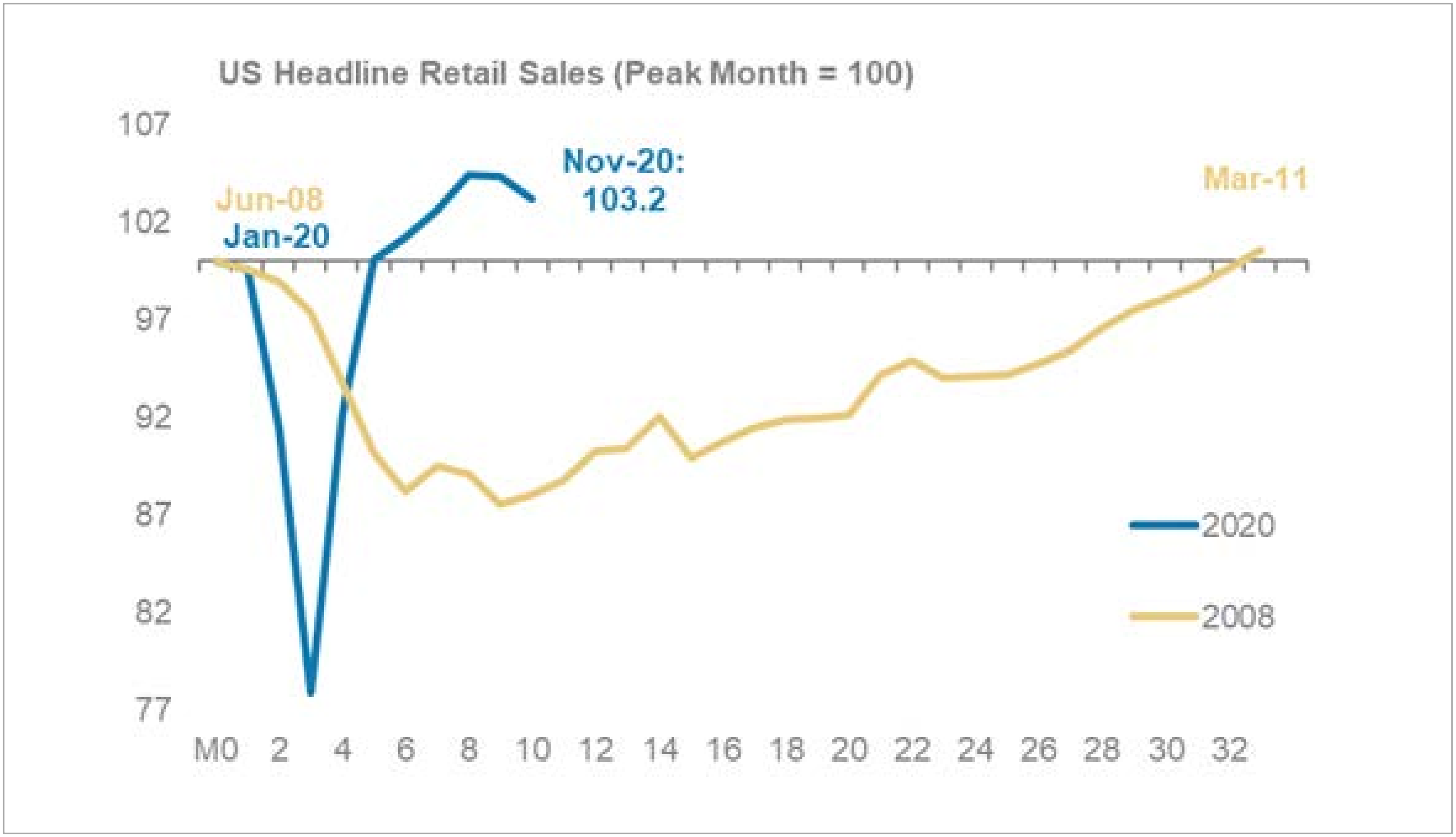
Source: Morgan Stanley & Co. Research

Fiscal Policy Is Different This Time and Suggests "Helicopter Money" Is Here



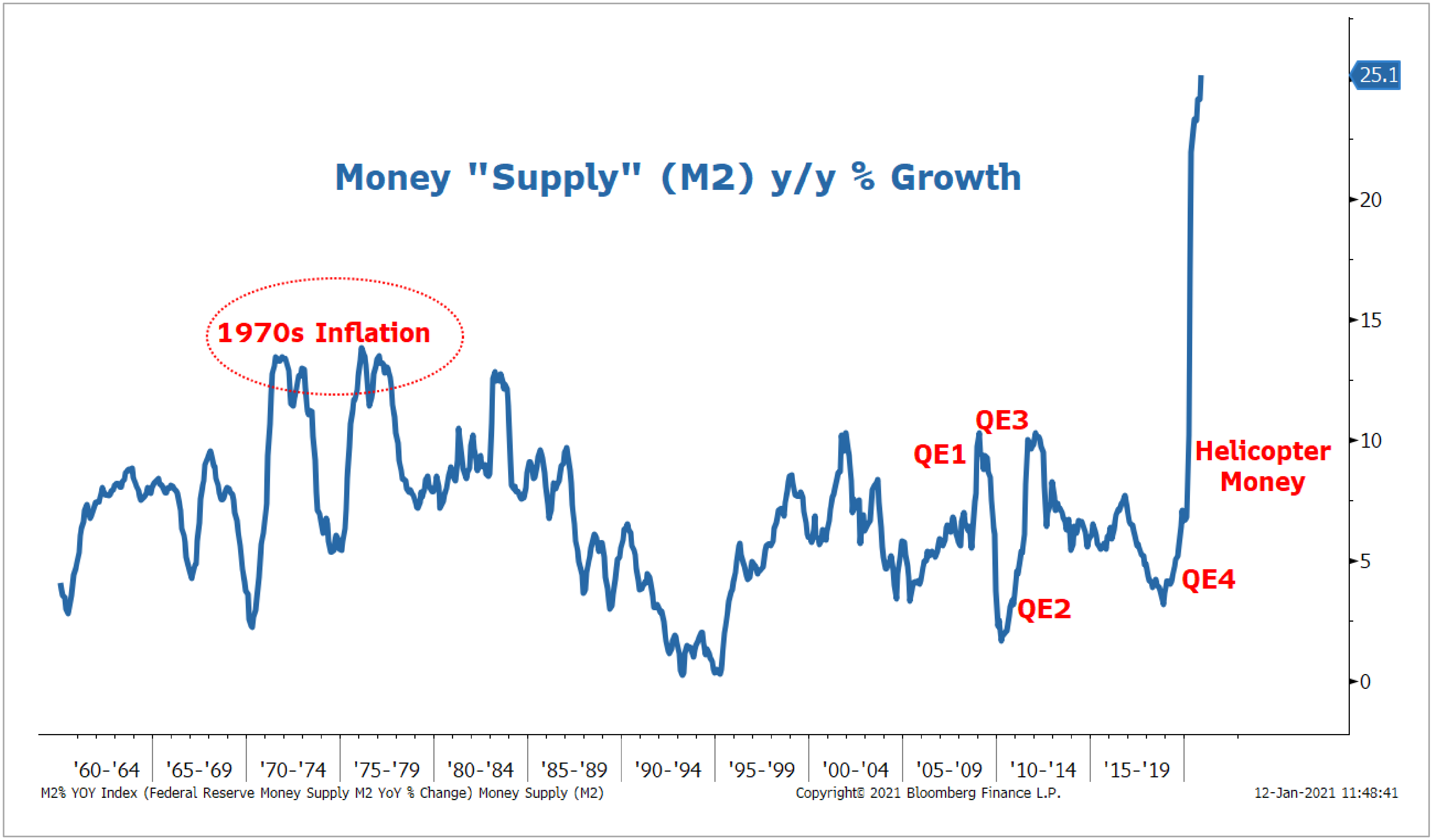
Source: Bloomberg, Morgan Stanley & Co. Research as of December 31, 2020

Fiscal Spending Has Created *Incremental* Demand, Not Just Filling a Hole



Source: Bloomberg, Morgan Stanley & Co. Research as of December 31, 2020

Greater Fiscal Has M2 Growth at Unprecedented Levels—What's the Cost?

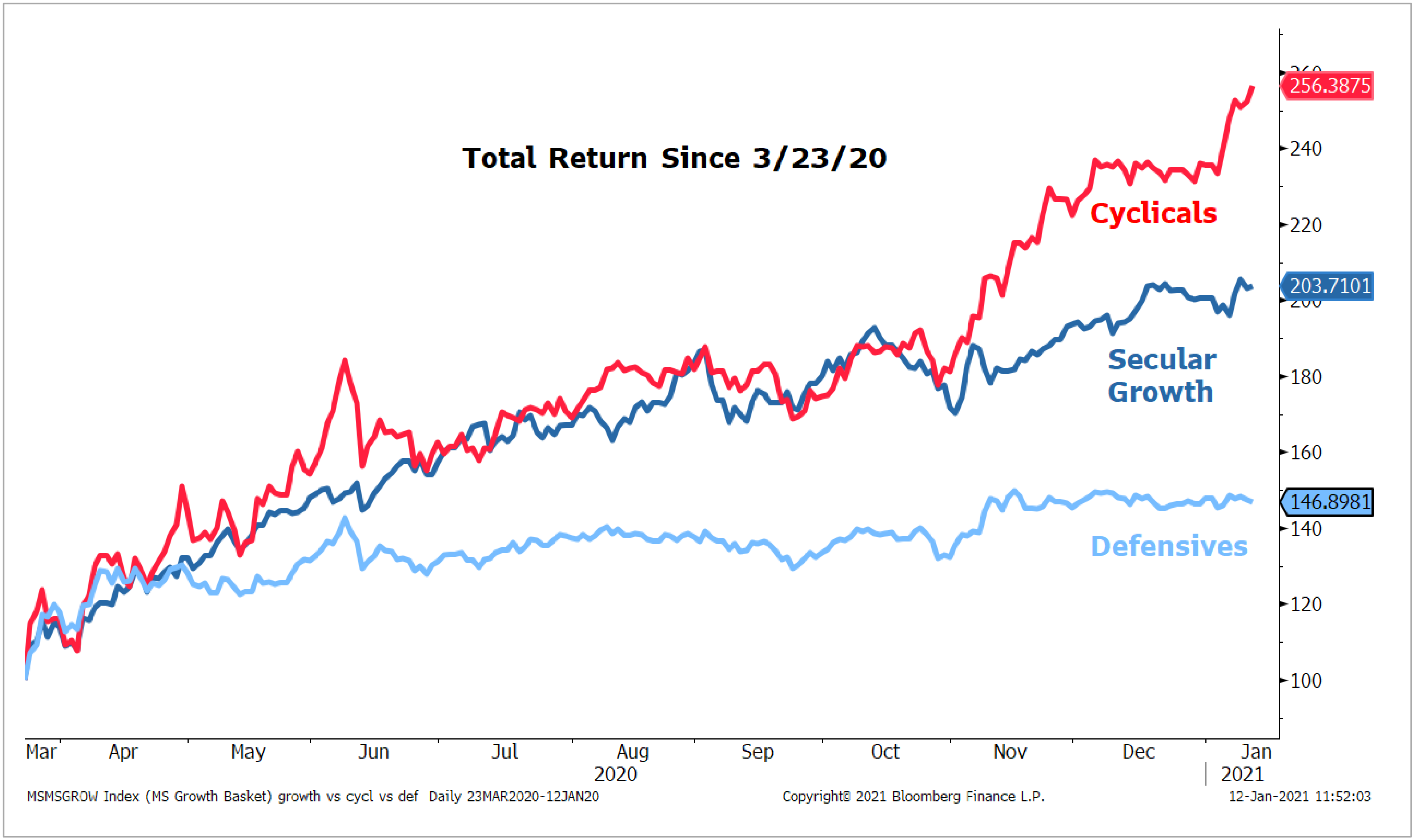


Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021. M2is a measure of the money supply that includes all elements of M1 as well as "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds and other time deposits.

Gold Is Telling Us it's Inflation. S&P 500 / Gold Still down -17% from Highs

Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021

Stocks May Be the Better Way to Play/Hedge Inflation—Especially Cyclicals



Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021

…Which Is Exactly In-line with Our Recession / Recovery Playbook

S&P 500 Total Return Since March 23, 2020 Low

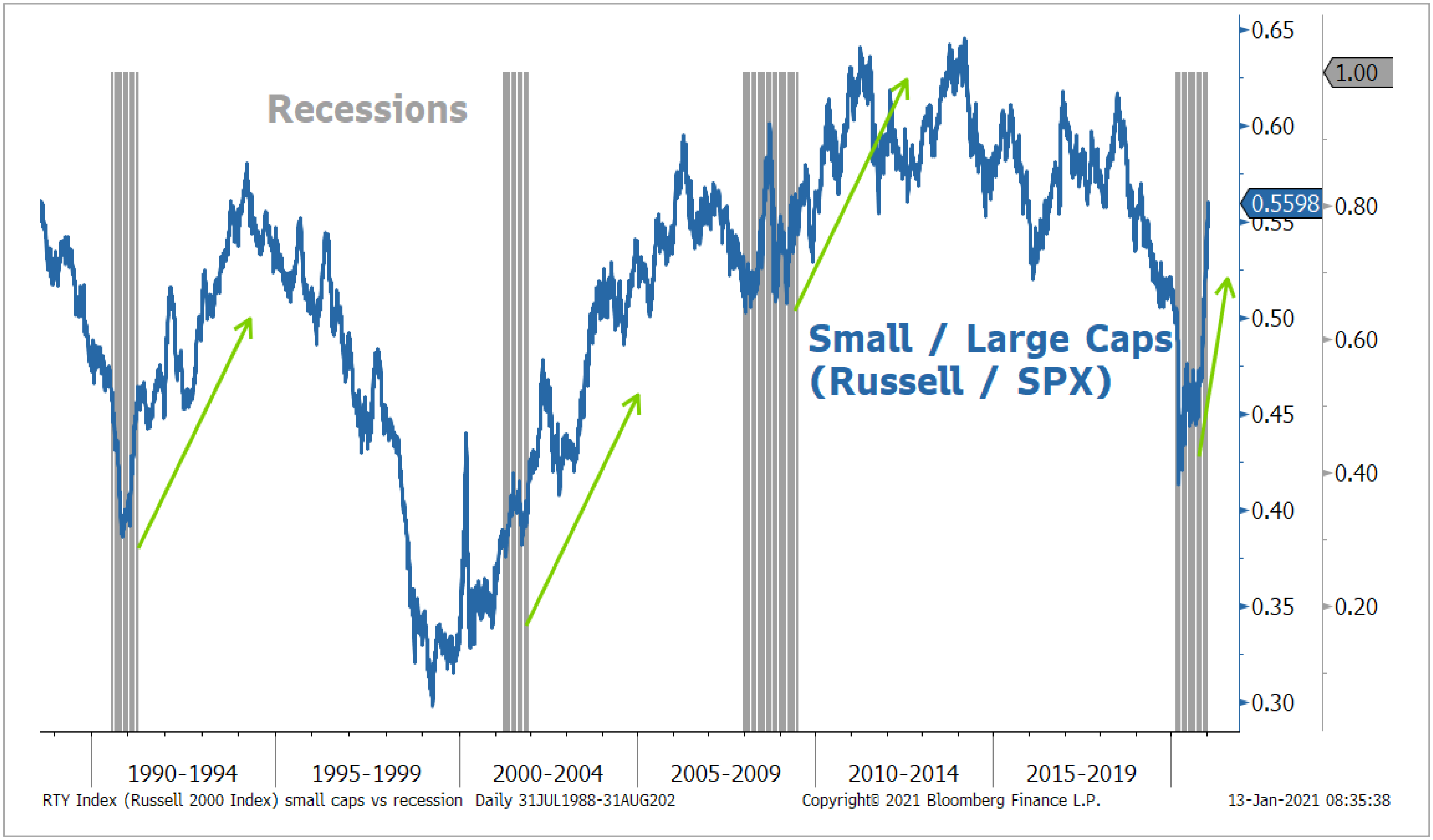
Cap Weight		Equal Weight	
Materials	102%	Materials	123%
Industrials	86%	Consumer Discretionary	118%
Consumer Discretionary	84%	Energy	105%
Information Technology	81%	Industrials	97%
Energy	78%	Financials	95%
Financials	76%	**S&P 500**	86%
S&P 500	70%	Information Technology	82%
Communication Services	59%	Communication Services	81%
Health Care	56%	Health Care	75%
Utilities	44%	Real Estate	49%
Real Estate	42%	Consumer Staples	44%
Consumer Staples	41%	Utilities	42%

Source: Bloomberg, Morgan Stanley & Co. Research as of January 8, 2021

The Bull Market in “Stocks” Appears Intact

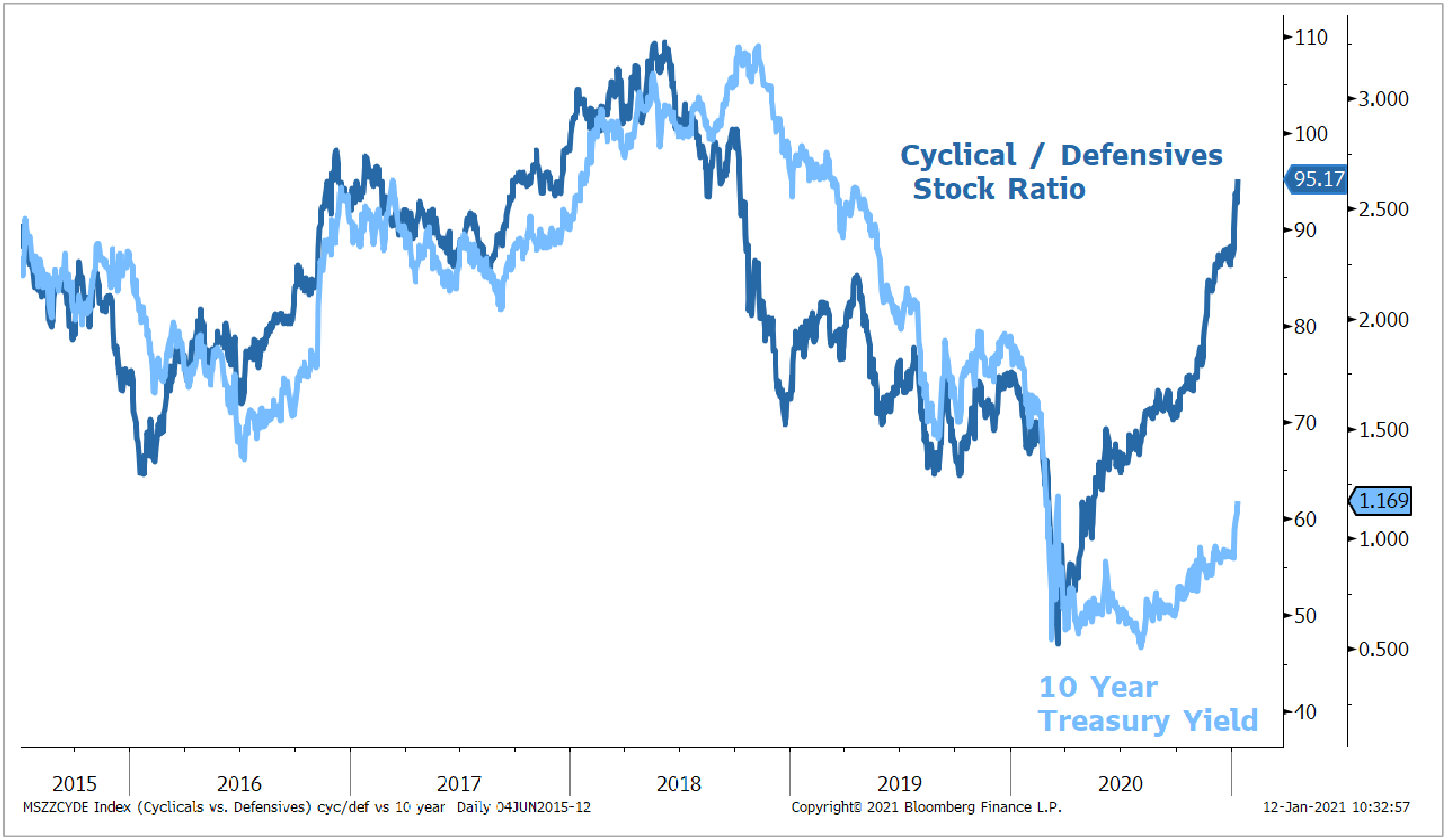
Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021

Small Caps Have Typically Outperformed Large Caps Coming Out of a Recession



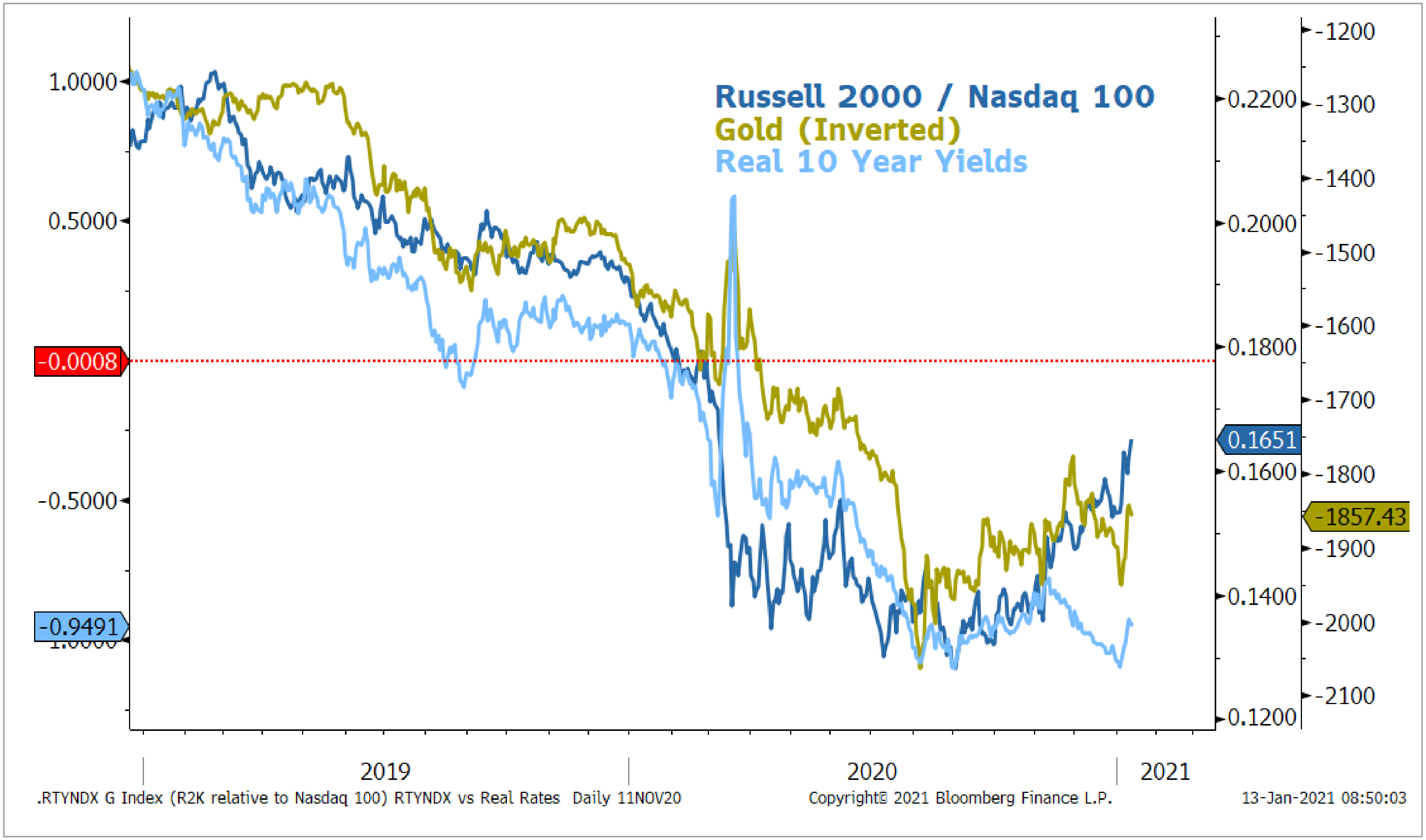
Source: Bloomberg, Morgan Stanley & Co. Research as of January 13, 2021

Most Mispriced Asset Is 10-Year US Treasuries—Time for Catch-up Has Arrived



Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021

Real 10-Year Rates Should Surprise on the Upside, too—Implications?

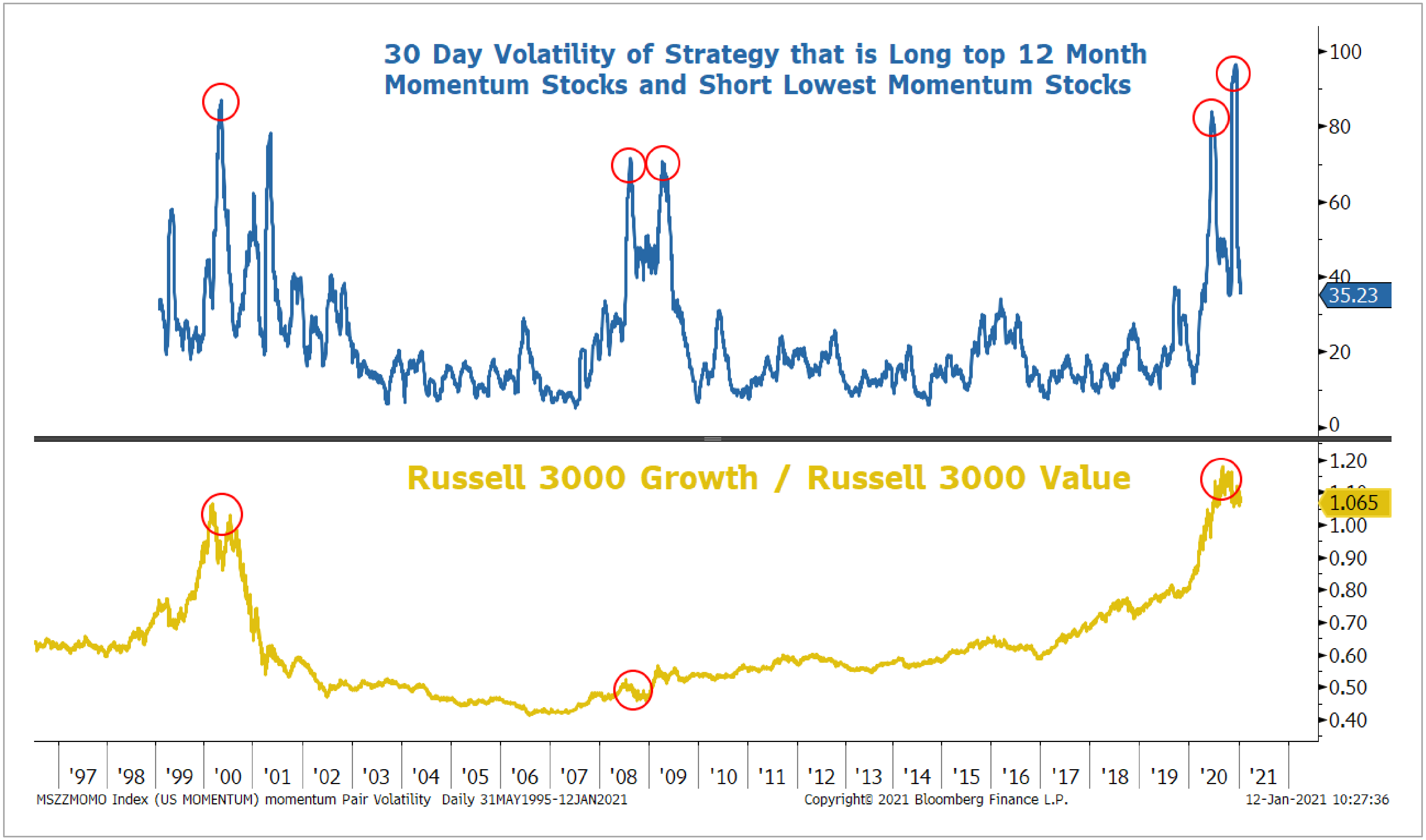


Source: Bloomberg, Morgan Stanley & Co. Research as of January 13, 2021

Banks Are Still Our Favored *Offensive* Play on Rising Treasury Yields

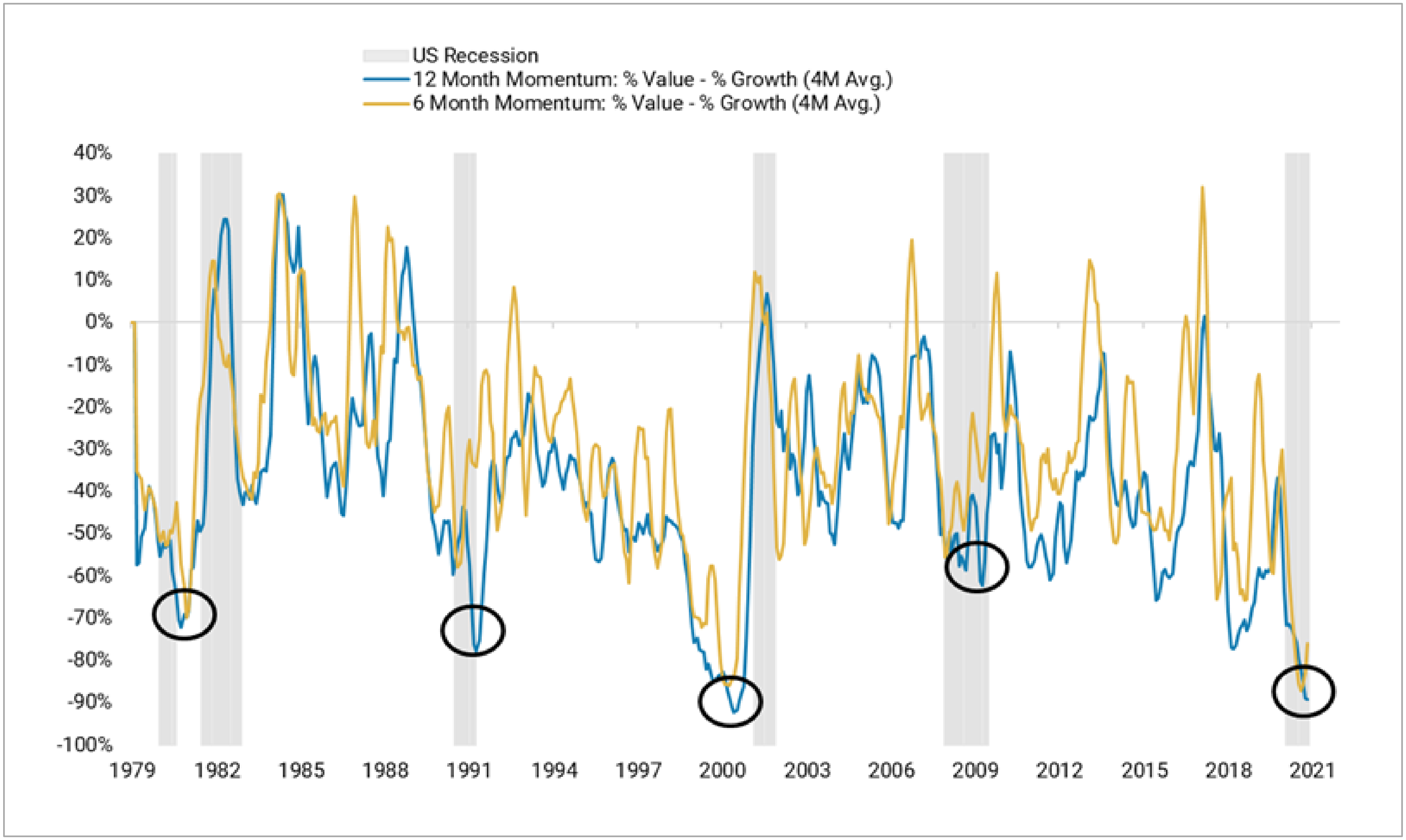
Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021

Volatility of Momentum Has Typically Coincided with a Change in Composition



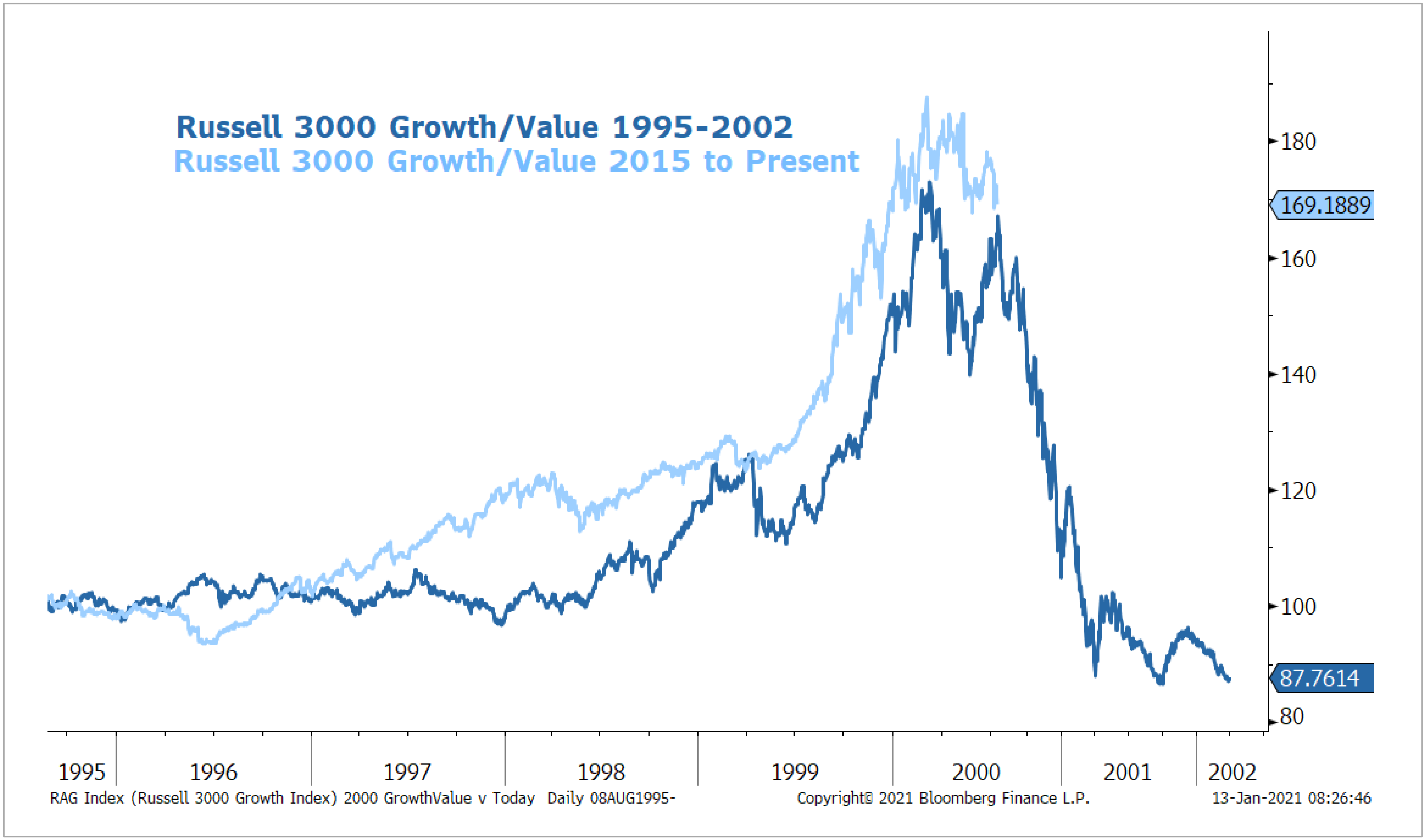
Source: Bloomberg, Morgan Stanley & Co. Research as of January 12, 2021

Growth to Value Could Be Self-Fulfilling and Perpetuating as Momentum Turns



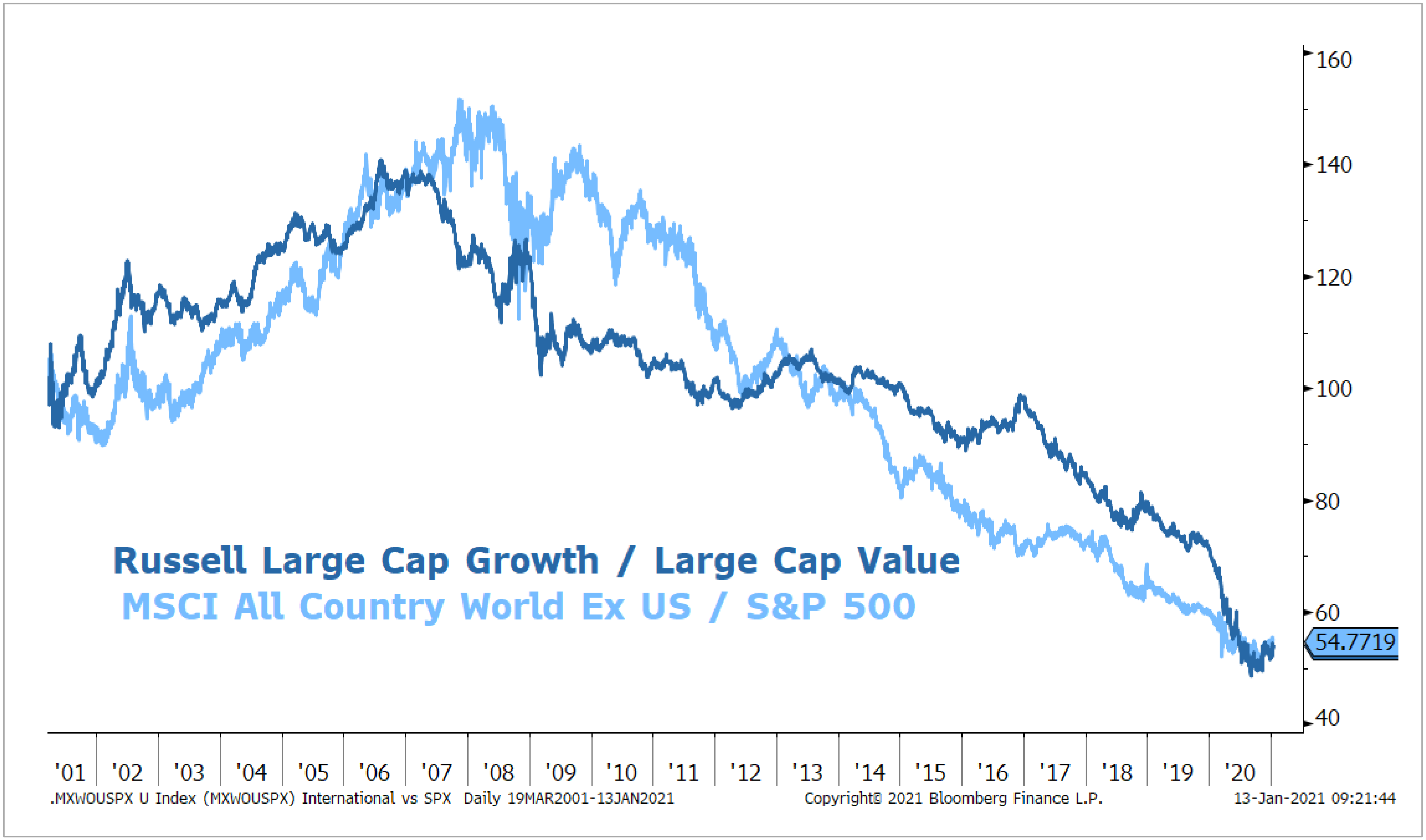
Source: Bloomberg, Morgan Stanley & Co. Research as of January 2021

Value / Growth Extreme, but Turning Now as Rates Start to Normalize



Source: Bloomberg, Morgan Stanley & Co. Research as of January 13, 2021

Value / Growth Is the Same Trade as International / US—Reflation



Source: Bloomberg, Morgan Stanley & Co. Research as of January 13, 2021

Asset Class Risk Considerations

For index, indicator and survey definitions referenced in this report please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Hypothetical Performance

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.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

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.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Investing in foreign markets entails risks not typically associated with domestic markets, such as currency fluctuations and controls, restrictions on foreign investments, less governmental supervision and regulation, and the potential for political instability. These risks may be magnified in countries with **emerging markets and frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

Investing in small- to medium-sized companies entails special risks, such as limited product lines, markets and financial resources, and greater volatility than securities of larger, more established companies.

The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer.

High yield bonds (bonds rated below investment grade) may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk, price volatility, and limited liquidity in the secondary market. High yield bonds should comprise only a limited portion of a balanced portfolio.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

REITs investing risks are similar to those associated with direct investments in real estate: property value fluctuations, lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

Floating-rate securities The initial interest rate on a floating-rate security may be lower than that of a fixed-rate security of the same maturity because investors expect to receive additional income due to future increases in the floating security's underlying reference rate. The reference rate could be an index or an interest rate. However, there can be no assurance that the reference rate will increase. Some floating-rate securities may be subject to call risk.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset Class Risk Considerations and Disclosures

Companies paying **dividends** can reduce or cut payouts at any time.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Any type of **continuous or periodic investment plan** does not assure a profit and does not protect against loss in declining markets. Since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider his financial ability to continue his purchases through periods of low price levels.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

The **indices** are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

The **indices selected by Morgan Stanley Wealth Management** to measure performance are representative of broad asset classes. Morgan Stanley Wealth Management retains the right to change representative indices at any time.

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