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Weekly Warm Up: Fiscal Cliff + Peak Fed = Second Leg of Correction

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Fiscal negotiations have made little progress and the Fed failed to appease the doves on QE. The combination means lower equity prices before the correction, led by the Nasdaq, is over. Continue to favor operating leverage stories and "GARPy" stocks. We screen for ideas & add ALLY to our Buy List.

Fiscal cliff meets peak Fed. We believe much of the recent correction is due to the rally simply exhausting itself into long-term resistance.However, we also think it coincided with disappointing progress on the passage of CARES 2 and a very clear message from the Fed that it does *not* plan to enact yield curve control as they implement average inflation targeting. The Fed followed up that messaging this past week with further disappointment for bond bulls by not providing any formal guidance on their plans for QE. This weighed on interest rate sensitive stocks disproportionately – i.e. Nasdaq/growth stocks.

The market is now faced with two potential outcomes: 1) Congress fails to pass the bill and the recovery stalls, or 2) Congress does pass CARES 2, which is good for the recovery but bad for the long end of the bond market. The equity market appears to have been looking past near-term risk on CARES 2 passage as it tilted in favor of cyclicals. However, the unexpected death of Supreme Court Justice Ginsburg adds another element of risk to the timing of the outcome, and could weigh on the market overall in the near term.

The technical picture has deteriorated, especially for the Nasdaq 100. The S&P 500 and Nasdaq 100 both closed below their respective 50-day moving averages for the first time since late April. Furthermore, the NDX is breaking down *on a relative basis* for the first time since the rally began in March. While corrections in bull markets are to be expected, the 200-day moving average is still 10-20% lower for many of the leading and most crowded stocks. We believe the S&P 500 and Nasdaq 100 remain vulnerable to a test of their 200-day moving averages, which are 7% and 14% lower, respectively.

Bull market intact but focus on stocks, not the major averages. We stick by our view that we are still early days in a new bull market. However, we think the major averages may struggle through year end to make new highs as valuations come down faster than EPS estimates can rise. The equal-weighted S&P should hold up better during this transition and may be at the beginning of a multi-year period of relative outperformance.

Screening for earnings-driven upside. We screened for stocks where earnings rolling forward offer enough upside to offset multiple normalization. Our list has

trailed the market but we think earnings inflecting into next year will bring relative upside for the group. Ally Financial (ALLY), Baker Hughes (BKR), Boston Scientific (BSX), Capri Holdings (CPRI), Discover Financial (DFS), Elanco Animal Health (ELAN), Evercore (EVR), National Vision (EYE), Five Below (FIVE), Harley Davidson (HOG), JP Morgan (JPM), Phillips 66 (PSX), PVH Corp (PVH), Ross Stores (ROST), and Yum China (YUMC) are among the stocks that screen as OW-rated by our analysts. **We're adding Ally Financial to our Fresh Money Buy List in place of Procter & Gamble (PG), skewing our list toward consumer cyclicals, earnings upside and a more benign default credit cycle, while locking in an 18% relative gain.**

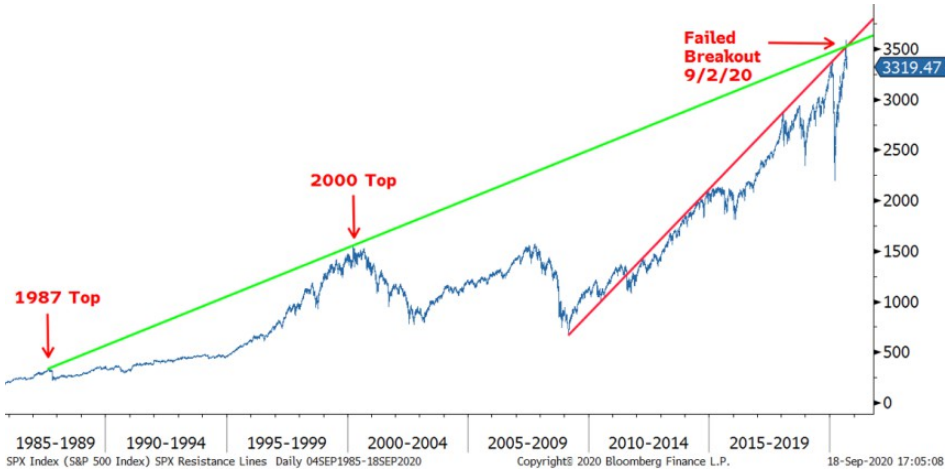
What to Focus on This Week

Fiscal Cliff Meets Peak Fed

Over the past few weeks, US equity markets have experienced their largest correction since the new bull market began. As discussed in our weekly warm-up two weeks ago, we believe part of this correction is **due to the rally simply exhausting itself** into long-term resistance (Exhibit 1). We also think it coincided with **disappointing progress on the passage of CARES 2 and a very clear message from the Fed that it does *not* plan to enact yield curve control** as they implement average inflation targeting. The Fed followed up that messaging this past week with further disappointment for bond bulls by not providing any formal guidance on their plans for QE.

We don't fault the Fed, by the way. In fact, we agree that the strategy is called for if the Fed is to achieve its goals of full employment and 2% inflation *over the cycle*. Keeping short-term rates lower indefinitely should help in the former goal while letting the curve steepen should assist in the latter. If there is any doubt about the last part of this statement, we would look at what a flat curve has done to Japan's banking system over the past 10 years to answer the question of whether it's been helpful or an inhibitor to the BOJ achieving its inflation goals. **As discussed in prior research, we believe Money Supply (M2) growth is key to getting sustainable inflation and that means higher velocity. Commercial banks are critical to that outcome and a steeper curve should help the cause. Pinned back end rates, in our opinion, will not. We think negative *short-term* rates will help the economy. Having said that, negative long-term rates help asset valuations but as we learned over the past decade, higher asset prices do not drive inflation in the real economy.** In many ways, negative long-term rates suppress it as companies focus on financial arbitrage rather than real investment. Maybe this is why the Fed has continued to suggest it will not employ yield curve control, nor will it be committing to any long-term QE targets.

Exhibit 1: Rally Exhausted Itself at Long-Term Resistance Near 3550, Highs That Likely Hold for Rest of Year



Source: Bloomberg, Morgan Stanley Research

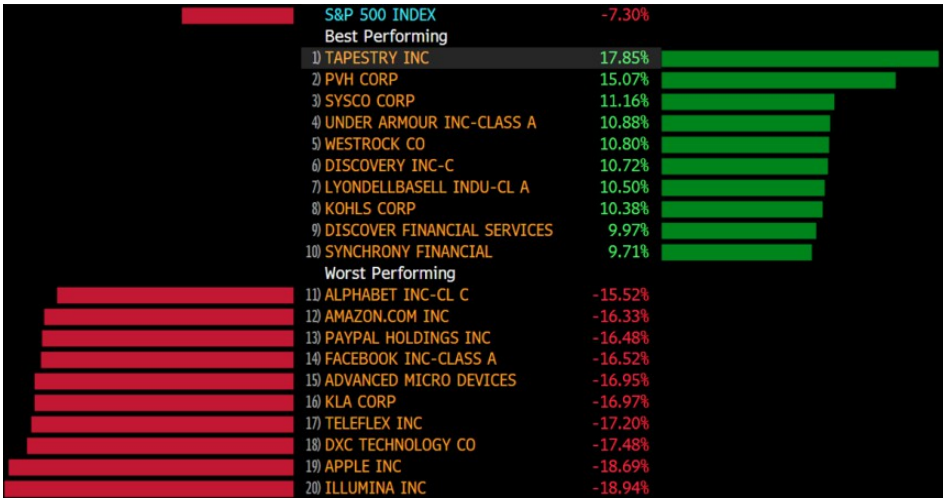
With this as the set-up, we think the market is now faced with the following two potential outcomes: 1) Congress fails to pass the bill and the recovery stalls or 2) Congress does pass CARES 2, which is good for the recovery but is also bad for the long end of the bond market. In our view, the second outcome is more likely, while the first outcome would be a much greater threat to the bull market. Markets will be forced to watch and wait. At the end of the day, markets wobbling will be part of the pressure required to get a deal done. The question is *how much* pressure will be necessary.

As noted above, **this correction began on September 2, when equity markets failed to break through formidable longer-term resistance. The *reasons* are often unimportant at such junctures as the technicals simply take over,** much like in August when markets went seemingly parabolic for "no reason." Speaking of August, at this point, we think everyone understands the speculative drivers from both retail and certain institutional buyer(s) of call options in large cap technology stocks. The subsequent reversal of that speculation was naturally concentrated in those stocks too (Exhibit 2).

Perhaps even more interesting is the fact that the best performers this month have been stocks most levered to a continued economic recovery. In other words, the market does seem to be looking through the near-term risk of congressional legislative wrangling and expects something to get done. This means sustainable growth but higher back end rates – i.e. cyclicals over growth and defensives. Implicit in such a conclusion is our view that higher back end rates due to better growth and higher inflation should dissuade the Fed's decision to engage in yield curve control.

Finally, the unexpected death of Supreme Court Justice Ruth Bader Ginsburg could stall passage of CARES2 in the near term as Democrats may back away from the bill if the President nominates his Supreme Court choice prior to the election. In short, **we believe the odds of scenario 1 may have just gone up,** at least with respect to the timing of the next stimulus, and that could weigh on all equities *and* rates in the near term.

Exhibit 2: S&P 500 and Top / Bottom 10 Performance Since Market Top on September 2nd

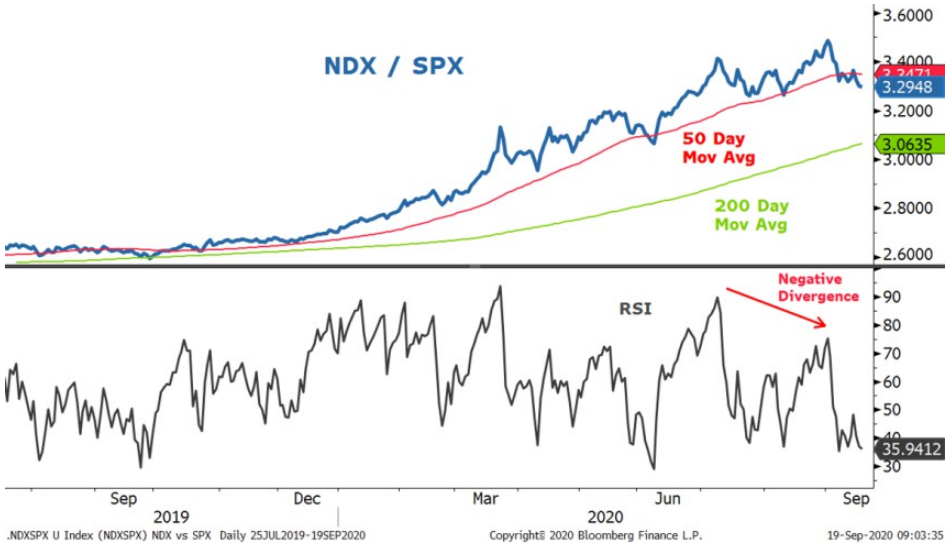


Source: Bloomberg, Morgan Stanley Research

As we study the correction from a technical standpoint, we can't help but notice how the NDX is finally breaking down on a relative basis. We think the breakdown began in early July. In fact, the NDX/SPX ratio broke down in July during earnings season as

investors "sold the news" on the basis of valuation and very high forward expectations. However, the ratio quickly regained its 50-day moving average and then made new highs in what can be described as a blow off top in August. That same ratio is now breaking down in a way that is different than the recent past. First, it took out the 50-day moving average in the first leg of this correction and then failed to recapture it on the subsequent rally. Instead, it rolled over again and is now making new lows. Furthermore, the negative divergence on the blow off top was significant. This all suggests to us the correction isn't over. **While corrections in uptrends are to be expected and healthy, the next line of defense/support is considerably below Friday's close (Exhibit 3).** This what happens when stocks get so extended – corrections can be much bigger while remaining in an uptrend.

Exhibit 3: NDX/SPX Breakdown Is Different This Time. Downside Remains.



Source: Bloomberg, Morgan Stanley Research

The same logic applies to both the Nasdaq and S&P 500 on an absolute basis (Exhibit 4 and Exhibit 5). Both got too extended in August on speculative behavior from novice investors. We believe that speculation needs to be wrung out before the bull market can continue. Our QDS team notes that the declines are turning more orderly as short gamma exposures moderate – 5-day realized vol for QQQs fell to 27% this week from 56% on Sept 9th. Nevertheless, speculation remains rampant in some areas, as witnessed by first-day performance of tech IPOs and other "spec" stocks.

Exhibit 4: NDX Still More Than 15% Above 200 Day ...

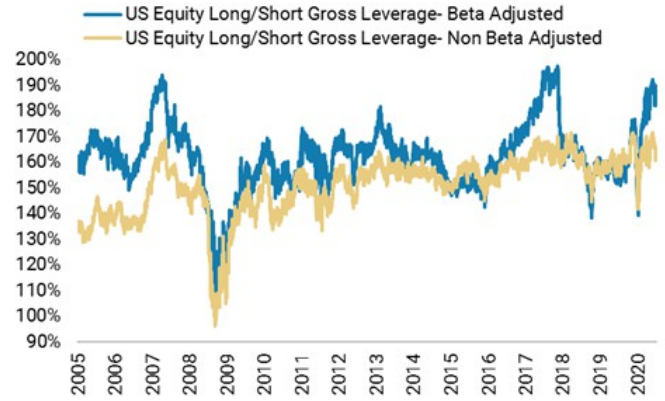
Source: Bloomberg, Morgan Stanley Research.

Exhibit 5: ... While SPX Is "Only" 7% Above

Source: Bloomberg, Morgan Stanley Research.

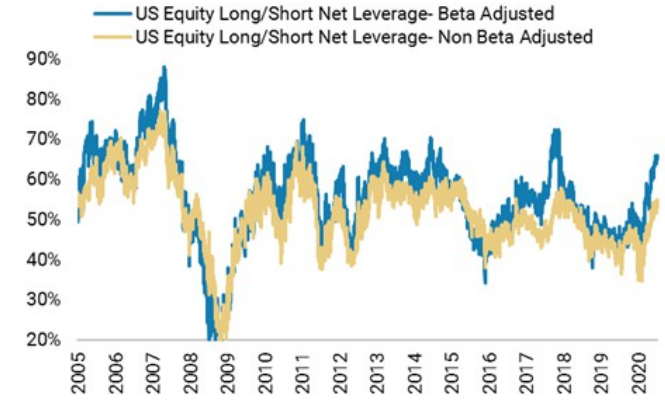
Meanwhile, **institutional exposure remains remarkably high, particularly in the context of higher realized volatility.** According to our PB Content Team, both Net and Gross Exposures are near the top decile of the past decade and when it is beta adjusted, it is even higher (Exhibit 6 and Exhibit 7).

Exhibit 6: Gross Exposure Near All-Time Highs



Source: Morgan Stanley Prime Brokerage Content.

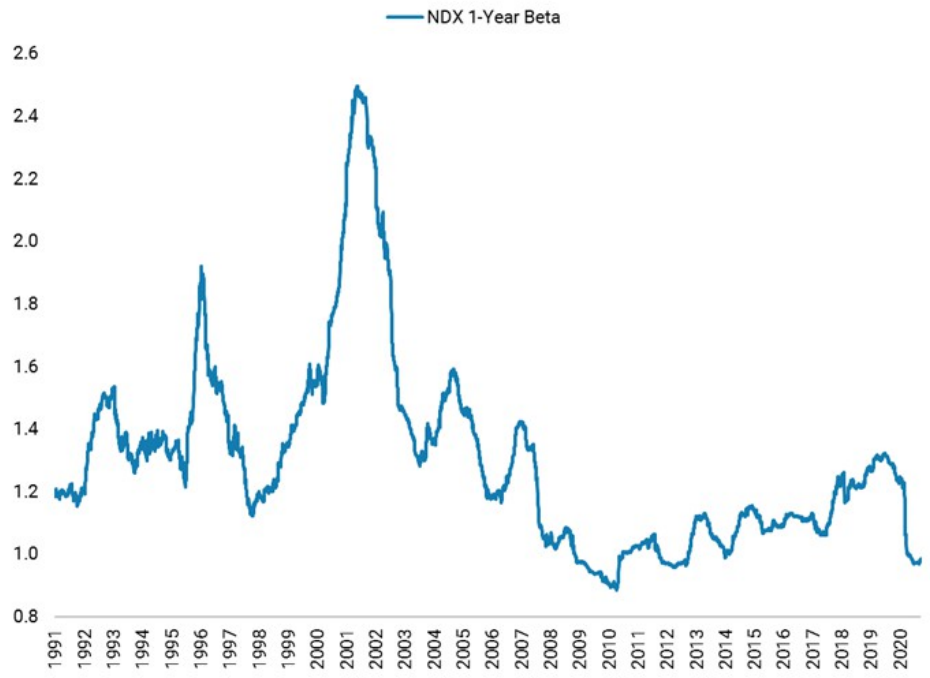
Exhibit 7: While Net Exposure Is Still Increasing



Source: Morgan Stanley Prime Brokerage Content.

From a sector and style perspective, hedge funds remain decidedly long tech/growth, which explains many hedge funds' relatively strong performance YTD – at least relative to the S&P 500 (+4% YTD), if not the Nasdaq 100 (+26%). It may also explain why both gross and net exposure remain high even with realized volatility also near the highest levels of the past decade and expected to remain so through the election. **Many funds that are long tech/growth have significant P&L to play with and are letting it ride, not to mention this has been the right strategy for the past decade. We think that may come into play and provide some fuel for this correction to go a little further than most are expecting.** Supporting this view is the fact that the beta for the NDX has declined sharply over the recent past, making many portfolios appear less risky than they might be should that revert back to "normal." With the NDX 1-year rolling beta at just 0.91, that reversion could be swift and meaningful. The long-term average beta for the NDX is closer to 1.25 and is being artificially suppressed in our view by the fall in real long-term interest rates and pull forward demand for many tech companies due to the COVID lockdown. **We think a further reopening of the economy and higher nominal and real rates (our view) will be the trigger for this reversion in beta and could feed into more aggressive reductions in both gross and net exposures given how many portfolios are currently skewed toward tech and growth stocks.**

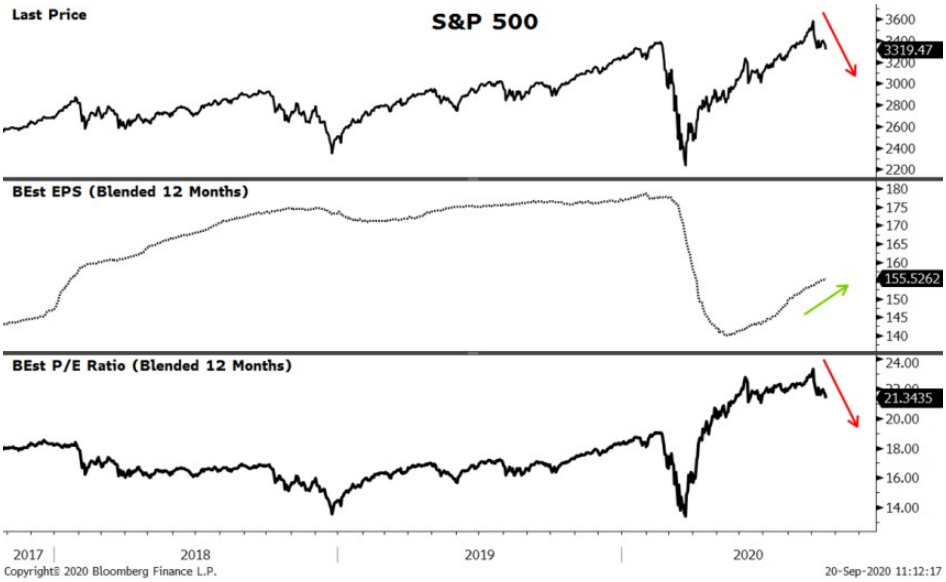
Exhibit 8: NDX Beta has recently declined sharply thanks to lower real rates and pull forward demand



Source: Bloomberg, Morgan Stanley Research

Much of this fits with our recent narrative on the overall market and sector recommendations. First, **as discussed a few weeks ago, we are expecting the overall market (S&P 500) to experience a modest correction (10%) in valuations partially offset by a continued risk in NTM EPS forecasts.** Since then, we have seen this play out (Exhibit 9) and we think there is more to go, especially with CARES2 not guaranteed before the election.

Exhibit 9: P/Es likely to fall further and faster than EPS forecasts can rise in the near term



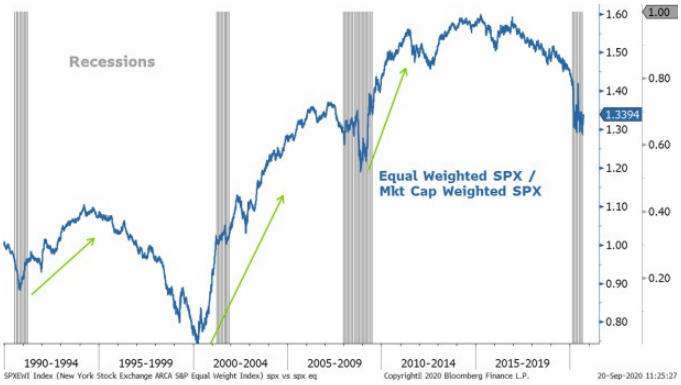
Source: Bloomberg, Morgan Stanley Research

Second, we think this also supports the other key part of our narrative, which is that the average stock remains in a bull market that is still early days. While the Market cap weighted S&P 500 remains vulnerable to further downside due to valuation and led by the Nasdaq 100, the average stock may not. As a result, **owning the equal-weighted S&P 500 over the market cap-weighted S&P 500 remains an attractive risk reward.** Over the past few weeks, as the overall market has corrected, this ratio has gained approximately 4% and based on what happens in a new economic cycle, it may have years to run. That suggests stock picking will be much more important from here, and that opportunities should be plentiful. **We don't focus as much on the major indices as we think they are likely to be capped for awhile at recent highs until forward EPS can really begin to move higher next year when the economy is fully reopening. This also argues for skewing one's portfolio toward those stocks where EPS forecasts are likely to increase more than the overall market multiple declines and/or where multiples are more reasonable.**

Exhibit 10: Equal Weight vs Mkt Cap Weight S&P 500 is making its move....

Source: Bloomberg, Morgan Stanley Research

Exhibit 11: Which should be the beginning of a multi-year run in our view



Source: Bloomberg, Morgan Stanley Research

Earnings Driven Upside & Fresh Money Buy List Changes

We believe the best return opportunities lie in stocks where NTM EPS estimates are likely to increase more than 10% over the next 3-4 months. Two weeks ago - US Equity Strategy: Weekly Warm Up: Big Drop Signals Changing Dynamics (8 Sep 2020) - we suggested that investors pick stocks where NTM EPS estimates are likely to increase more than 10% over the next 3-4 months. We have been fielding requests for stock-specific screens to illustrate stocks that offer the kind of upside mentioned. Exhibit 12 shows a screen that puts this approach to work.

Higher earnings on a normalized multiple in a new rate environment. We started with stocks over $2B in market cap within the Russell 3000. From there, we ran a stylized screen that assumes NTM EPS rise into year end to match current consensus expectations for 2021 EPS. For multiples, we looked at each stock's average premium/discount to the S&P 500 from Jan 2017- Feb 2020, the most recent expansion period, and assumed a reversion to that average premium/discount with a base S&P 500 multiple of 20x. We note that 20x is higher than the average multiple for the S&P during the last few years, but we needed to credit multiples for the generally lower rate environment. 20x is our target multiple for the market into 1H21 and represents a ~10% *decline* from current levels given we expect that the current ~22x is not sustainable as (1) rates should rise from current levels while remaining lower than pre-Covid levels and (2) multiples on highly cyclical stocks should mean revert. **In other words, we screened for stocks where rising forward earnings estimates can more than offset multiple normalization. Our screen below shows stocks where this scenario-based target price offered at least 5% upside with 10%+ increases in NTM earnings.** We also excluded stocks where the average multiple was over 3x that of the S&P to strip out high-growth stocks "growing into" a multiple that are unlikely to see a reversion and stocks where the current fwd multiple is lower than the prior average to better capture cyclicality and avoid re-rate stories.

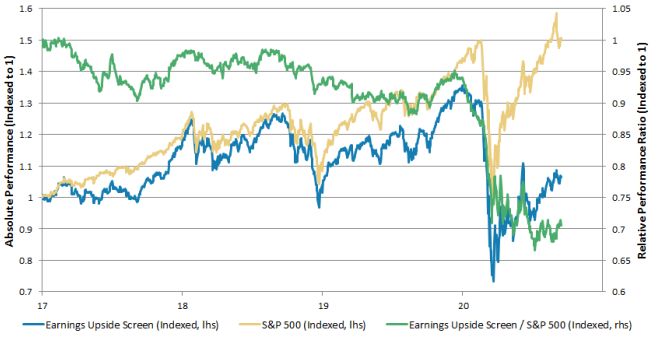
Exhibit 12: Upside Screen: Higher Earnings on Normalized Multiples

Ticker	Name	Mkt Cap ($M)	Sector	Ind. Group	Price	Current NTM EPS	2021 EPS	Upside to 2021 EPS	% to Normalized Multiple	Scenario Return
CPRI-US	Capri Holdings Limited	$3,133	Consumer Discretionary	Consumer Durables & Apparel	$20.84	$1.60	$2.88	79.6%	-12%	58.8%
AXS-US	Axis Capital Holdings Limited	$3,920	Financials	Insurance	$46.50	$3.44	$4.77	38.4%	9%	50.3%
RF-US	Regions Financial Corporation	$11,436	Financials	Banks	$11.91	$1.02	$1.21	19.4%	17%	40.1%
TMHC-US	Taylor Morrison Home Corporation	$3,202	Consumer Discretionary	Consumer Durables & Apparel	$24.69	$2.91	$3.44	18.4%	17%	38.4%
NUVA-US	NuVasive, Inc.	$2,541	Health Care	Health Care Equipment & Services	$49.58	$2.04	$2.47	21.4%	13%	37.2%
RL-US	Ralph Lauren Corporation Class A	$5,540	Consumer Discretionary	Consumer Durables & Apparel	$75.83	$3.50	$5.85	67.1%	-19%	35.8%
WWW-US	Wolverine World Wide, Inc.	$2,123	Consumer Discretionary	Consumer Durables & Apparel	$25.93	$1.75	$2.02	15.3%	15%	32.8%
ACIW-US	ACI Worldwide, Inc.	$2,964	Information Technology	Software & Services	$25.47	$0.85	$0.97	13.8%	15%	31.2%
PSX-US	Phillips 66	$26,123	Energy	Energy	$59.82	$3.92	$5.17	31.9%	-1%	30.9%
DRI-US	Darden Restaurants, Inc.	$11,703	Consumer Discretionary	Consumer Services	$89.97	$3.75	$5.62	49.7%	-13%	30.9%
SSB-US	South State Corporation	$3,642	Financials	Banks	$51.35	$3.10	$3.79	22.2%	7%	30.7%
LIVN-US	LivaNova Plc	$2,176	Health Care	Health Care Equipment & Services	$44.71	$1.93	$2.22	14.9%	14%	30.5%
FCX-US	Freeport-McMoRan, Inc.	$24,688	Materials	Materials	$17.00	$0.98	$1.29	31.8%	-1%	30.4%
EVR-US	Evercore Inc Class A	$2,693	Financials	Diversified Financials	$66.35	$5.16	$5.74	11.2%	17%	29.6%
HBAN-US	Huntington Bancshares Incorporated	$9,858	Financials	Banks	$9.69	$0.83	$0.93	11.9%	15%	28.8%
BKR-US	Baker Hughes Company Class A	$9,956	Energy	Energy	$15.17	$0.38	$0.45	19.6%	8%	28.6%
HOG-US	Harley-Davidson, Inc.	$3,868	Consumer Discretionary	Automobiles & Components	$25.24	$1.98	$2.47	24.8%	3%	28.2%
OLED-US	Universal Display Corporation	$7,733	Information Technology	Semiconductors & Semiconductor Equipment	$164.18	$3.32	$3.87	16.5%	10%	27.8%
ULTA-US	Ulta Beauty Inc	$13,052	Consumer Discretionary	Retailing	$231.74	$8.02	$10.73	33.9%	-5%	27.4%
ENS-US	EnerSys	$2,939	Industrials	Capital Goods	$69.18	$4.91	$5.54	12.8%	12%	26.2%
FL-US	Foot Locker, Inc.	$3,736	Consumer Discretionary	Retailing	$35.79	$3.02	$3.81	26.3%	-1%	25.1%
TXT-US	Textron Inc.	$8,586	Industrials	Capital Goods	$37.65	$2.26	$2.56	13.0%	10%	24.0%
EEFT-US	Euronet Worldwide, Inc.	$4,929	Information Technology	Software & Services	$94.27	$4.57	$5.66	23.7%	0%	23.5%
CRI-US	Carter's, Inc.	$3,796	Consumer Discretionary	Consumer Durables & Apparel	$86.99	$5.60	$6.23	11.2%	10%	22.6%
ELAN-US	Elanco Animal Health, Inc.	$10,587	Health Care	Pharmaceuticals Biotechnology & Life Sciences	$26.54	$0.91	$1.02	12.4%	9%	22.2%
JPM-US	JPMorgan Chase & Co.	$299,731	Financials	Banks	$98.35	$7.86	$8.72	10.9%	10%	21.7%
CNMD-US	CONMED Corporation	$2,218	Health Care	Health Care Equipment & Services	$77.63	$2.57	$3.00	16.7%	4%	21.6%
AMD-US	Advanced Micro Devices, Inc.	$87,972	Information Technology	Semiconductors & Semiconductor Equipment	$74.93	$1.49	$1.65	10.7%	10%	21.5%
CMA-US	Comerica Incorporated	$5,652	Financials	Banks	$40.65	$2.98	$3.43	15.1%	5%	20.6%
ENPH-US	Enphase Energy, Inc.	$8,602	Information Technology	Semiconductors & Semiconductor Equipment	$68.27	$1.57	$1.73	10.0%	10%	20.5%
ILMN-US	Illumina, Inc.	$43,143	Health Care	Pharmaceuticals Biotechnology & Life Sciences	$295.50	$6.13	$6.81	11.0%	6%	18.0%
SKX-US	Skechers U.S.A., Inc. Class A	$4,861	Consumer Discretionary	Consumer Durables & Apparel	$30.79	$1.78	$2.23	25.6%	-6%	17.6%
SAFM-US	Sanderson Farms, Inc.	$2,679	Consumer Staples	Food Beverage & Tobacco	$120.45	$4.09	$4.83	18.3%	-1%	17.2%
MOS-US	Mosaic Company	$7,301	Materials	Materials	$19.26	$0.79	$1.01	27.2%	-8%	16.9%
HLI-US	Houlihan Lokey, Inc. Class A	$4,050	Financials	Diversified Financials	$58.04	$3.00	$3.54	18.2%	-3%	14.7%
XRX-US	Xerox Holdings Corporation	$4,030	Information Technology	Technology Hardware & Equipment	$18.92	$2.00	$2.29	14.4%	0%	14.2%
SYF-US	Synchrony Financial	$15,896	Financials	Diversified Financials	$27.23	$2.58	$2.98	15.6%	-2%	13.5%
GMED-US	Globus Medical Inc Class A	$4,998	Health Care	Health Care Equipment & Services	$51.13	$1.69	$1.92	13.5%	0%	13.3%
DAN-US	Dana Incorporated	$1,901	Consumer Discretionary	Automobiles & Components	$13.16	$1.35	$1.79	32.6%	-15%	13.0%
ALGN-US	Align Technology, Inc.	$25,288	Health Care	Health Care Equipment & Services	$320.97	$5.51	$6.81	23.7%	-9%	12.7%
PVH-US	PVH Corp.	$4,868	Consumer Discretionary	Consumer Durables & Apparel	$68.48	$2.30	$5.47	137.3%	-53%	12.7%
COLM-US	Columbia Sportswear Company	$5,904	Consumer Discretionary	Consumer Durables & Apparel	$89.25	$3.45	$4.07	18.0%	-6%	10.5%
CHNG-US	Change Healthcare, Inc.	$4,482	Health Care	Health Care Equipment & Services	$14.73	$1.35	$1.56	15.6%	-5%	10.2%
WFC-US	Wells Fargo & Company	$103,537	Financials	Banks	$25.13	$1.50	$2.09	39.3%	-21%	10.0%
PLNT-US	Planet Fitness, Inc. Class A	$4,592	Consumer Discretionary	Consumer Services	$57.39	$1.25	$1.65	32.2%	-17%	9.7%
EYE-US	National Vision Holdings, Inc.	$3,084	Consumer Discretionary	Retailing	$38.35	$0.63	$0.78	24.9%	-13%	9.2%
FIVE-US	Five Below, Inc.	$7,632	Consumer Discretionary	Retailing	$136.68	$3.04	$3.74	23.0%	-12%	8.7%
KWR-US	Quaker Chemical Corporation	$3,264	Materials	Materials	$183.35	$5.83	$6.64	13.9%	-5%	8.4%
XRAY-US	DENTSPLY SIRONA, Inc.	$10,123	Health Care	Health Care Equipment & Services	$46.33	$1.89	$2.20	16.7%	-7%	8.4%
ALLY-US	Ally Financial Inc	$9,604	Financials	Diversified Financials	$25.69	$2.29	$2.85	24.4%	-13%	7.9%
MDT-US	Medtronic Plc	$144,638	Health Care	Health Care Equipment & Services	$107.60	$4.70	$5.75	22.4%	-12%	7.7%
BSX-US	Boston Scientific Corporation	$55,052	Health Care	Health Care Equipment & Services	$38.48	$1.48	$1.67	13.2%	-5%	7.5%
YUMC-US	Yum China Holdings, Inc.	$19,350	Consumer Discretionary	Consumer Services	$51.30	$1.77	$2.02	14.1%	-6%	7.2%
ST-US	Sensata Technologies Holding PLC	$6,825	Industrials	Capital Goods	$43.41	$2.73	$3.08	12.8%	-5%	7.1%
USFD-US	US Foods Holding Corp.	$5,578	Consumer Staples	Food & Staples Retailing	$25.28	$1.11	$1.39	25.2%	-15%	6.6%
BWA-US	BorgWarner Inc.	$8,083	Consumer Discretionary	Automobiles & Components	$39.00	$3.09	$3.49	12.9%	-6%	6.6%
AEO-US	American Eagle Outfitters, Inc.	$2,432	Consumer Discretionary	Retailing	$14.64	$0.60	$1.10	84.7%	-43%	6.0%
ROST-US	Ross Stores, Inc.	$32,849	Consumer Discretionary	Retailing	$92.27	$2.99	$4.23	41.4%	-25%	5.9%
CACC-US	Credit Acceptance Corporation	$5,641	Financials	Diversified Financials	$319.64	$19.93	$23.43	17.6%	-10%	5.8%
LB-US	L Brands, Inc.	$8,381	Consumer Discretionary	Retailing	$30.16	$1.83	$2.23	21.8%	-13%	5.6%
DFS-US	Discover Financial Services	$18,088	Financials	Diversified Financials	$59.03	$4.38	$5.73	30.8%	-19%	5.3%

Source: FactSet, Morgan Stanley Research.

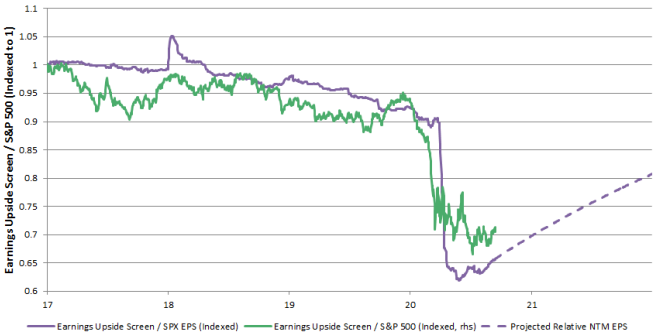
Our screen has lagged the market, but relative earnings ahead suggest upside. As with any purely quantitative screen, we'd play this upside as a group to help diversify risk, and we think the group is set to inflect vs the market. Exhibit 13 shows how the stock screen above, on an equal-weighted basis, has underperformed the S&P 500. Exhibit 14projects out the relative earnings of the group vs the S&P and shows how relative performance has tended to track relative earnings. Earnings meeting consensus expectations over the next year suggests material relative upside ahead for the group.

Exhibit 13: Equal Weighed Screen Has Lagged the S&P 500 ...



Source: FactSet, Morgan Stanley Research.

Exhibit 14: ... But Higher Projected Relative Earnings Suggest Upside Over the Next Year



Source: FactSet, Morgan Stanley Research.

Our screen results skew toward Discretionary, Financials, and some Health Care among sectors, and toward cyclicals, value, lower quality, and higher volatility among factors. The following exhibits break down our screen results by industry group and across various factors.

Industry Skews: Exhibit 15 shows that our screen heavily favors Consumer Discretionary with almost ⅓ of the stocks coming from the component industries - Consumer Durables, Apparel, Retailing, Consumer Services, and Autos. Financials make up just over 20% of the stocks, largely Banks and Diversified Financials. Health Care Equipment and Services has ~15% of the stocks. Scenario returns across most groups is in line with the overall group average of about 20%.

Exhibit 15: Earnings Upside Screen Tilts Toward Discretionary, Financials, and HC Services

Industry Group	% of Total (Count)	Average Scenario Return
Health Care Equipment & Services	14.8%	16.6%
Consumer Durables & Apparel	13.1%	28.7%
Retailing	11.5%	12.6%
Banks	9.8%	25.3%
Diversified Financials	9.8%	12.8%
Consumer Services	4.9%	15.9%
Capital Goods	4.9%	19.1%
Materials	4.9%	18.6%
Semiconductors & Semiconductor Equipment	4.9%	23.3%
Automobiles & Components	4.9%	15.9%
Pharmaceuticals Biotechnology & Life Sciences	3.3%	20.1%
Software & Services	3.3%	27.4%
Energy	3.3%	29.8%
Insurance	1.6%	50.3%
Technology Hardware & Equipment	1.6%	14.2%
Food & Staples Retailing	1.6%	6.6%
Food Beverage & Tobacco	1.6%	17.2%
Total	**100.0%**	**19.9%**

Source: FactSet, Morgan Stanley Research.

Cyclical/Defensive & Value/Growth Skews: Exhibit 16 and Exhibit 14 show that our screen heavily favors Cyclicals and Value with 51% and 46% of the stocks respectively coming from these styles. The screen results are underweight Growth, at only 16% of the group. Average scenario returns across these styles are all fairly consistent at ~20%.

Exhibit 16: Earnings Upside Screens Tilts Toward Cyclicals...

Industry Group	% of Total (Count)	Average Scenario Return
Cyclical	50.8%	18.7%
Defensive	29.5%	20.3%
Neither	19.7%	22.5%
Grand Total	**100.0%**	**19.9%**

Source: FactSet, Morgan Stanley Research.

Exhibit 17: ... and Value

Industry Group	% of Total (Count)	Average Scenario Return
Value	45.9%	22.0%
Neither	37.7%	19.1%
Growth	16.4%	16.0%
Grand Total	**100.0%**	**19.9%**

Source: FactSet, Morgan Stanley Research.

Lower Quality. Exhibit 18 and Exhibit 16 show that our screen modestly favors lower-quality stocks with 45% of the group in the lowest 2 quintiles of profitability. The group is fairly evenly distributed across financial leverage quintiles. Again, scenario returns are roughly in line with the group broadly across quintiles.

Exhibit 18: On Quality Factors, Earnings Upside Screen Tilts Lower Quality, Namely Lower Profitability ...

Profitability	% of Total (Count)	Average of Scenario Return
Q1 - Highest Profitability	9.8%	19.5%
Q2	27.9%	21.7%
Q3	18.0%	18.6%
Q4	24.6%	20.2%
Q5 - Lowest Profitability	19.7%	18.6%
Total	**100.0%**	**19.9%**

Source: FactSet, Morgan Stanley Research.

Exhibit 19: ... and Higher Financial Leverage

Financial Leverage	% of Total (Count)	Average of Scenario Return
Q1 - Highest Financial Leverage	14.6%	14.0%
Q2	27.1%	18.9%
Q3	14.6%	27.6%
Q4	22.9%	22.1%
Q5 - Lowest Financial Leverage	20.8%	15.7%
Total*	**100.0%**	**19.9%**
* Note, Financials excluded		

Source: FactSet, Morgan Stanley Research.

Higher Volatility and Smaller Size: Exhibit 20 and Exhibit 18 show that our screen favors higher volatility stocks with 45% of the stocks respectively coming from the highest 2 quintiles of volatility. The lowest volatility stocks on the screen also have the smallest average scenario based upside. At an average/median market cap of $20B/$6B, we note that the group skews smaller than our screening universe ($30B average, $8B median).

Exhibit 20: Earnings Upside Screens Tilts Toward Higher Volatility...

Volatility	% of Total (Count)	Average of Scenario Return
Q5 - Highest Volatility	21.3%	18.7%
Q4	24.6%	24.2%
Q3	24.6%	20.9%
Q2	21.3%	18.1%
Q1 - Lowest Volatility	8.2%	12.2%
Total	**100.0%**	**19.9%**

Source: FactSet, Morgan Stanley Research.

Exhibit 21: .... and Smaller Market Cap

Market Cap ($M)	Screen Results	Universe
Average	$20,219	$30,199
Median	$5,993	$8,191

Source: FactSet, Morgan Stanley Research.

A Quick Note on Stay At Home Vs. Reopening Beneficiaries Relative Performance

We thought it was worth noting that stay at home beneficiaries sold off post earnings and sales beats in 2Q (down -0.3% and -0.1%, respectively, on a median stock basis; see Exhibit 22). In contrast, reopening beneficiaries rallied by 1.6% post both earnings and sales beats in 2Q. This cohort also rallied post earnings and sales *misses*. This dynamic was not present post 1Q earnings, as stay at home beneficiaries outperformed reopening beneficiaries post earnings and sales beats. This dynamic indicates that 2Q beats, in aggregate, were sell the news events for stay at home beneficiaries. Reopening beneficiaries reacted positively to beats, indicating that better than expected earnings results had not already been discounted by this cohort.

Exhibit 22: Stay At Home Beneficiaries Sold Off Post Earnings Beats in 2Q; Reopening Beneficiaries Rallied

	Performance: + 3 Days Post 1Q				Performance: + 3 Days Post 2Q			
Industry	Earnings Beat	Sales Beat	Earnings Miss	Sales Miss	Earnings Beat	Sales Beat	Earnings Miss	Sales Miss
Stay At Home	0.5	0.7	-2.8	-3.7	-0.3	-0.1	-0.4	-2.5
Reopening	0.3	-0.7	-0.9	-0.6	1.6	1.6	0.8	0.9

Source: FactSet, Morgan Stanley Research.

Fresh Money Buy List Update: Adding ALLY, Closing PG. In line with our view to skew cyclically in the recovery stage of the cycle and our earnings upside screen above, we are adding auto lender Ally Financial (ALLY) to our Fresh Money Buy List. Our analyst Betsy Graseck has an Overweight rating on Ally, her top pick in Consumer Finance, with EPS up close to 100% in 2021 thanks to more jobs, more driving and more auto sales, which is reducing credit risk and driving up used car prices. Credit quality is outperforming given elevated consumer savings from government stimulus and a quicker than expected decline in unemployment rate. We believe the market is pricing in a ~7% cumulative auto loss rate vs MSe ~5%. We have also seen a quicker than expected bounce in consumer demand for autos since late April, coupled with a slow ramp in auto production supportive of used car prices, driving further support to credit results, NIM. We think valuation is attractive at ~0.6x 2021 book value per share on ROE of 9%. As we adjust more cyclically, we are also closing out Procter & Gamble (PG), locking in an 18% relative gain to the S&P since addition (+39% absolute return). Our analyst, Dara Mohsenian, remains OW the stock in the context of his Staples coverage. Large Cap Banks & Consumer Finance: Aug '20 Auto Trusts: Ally Looks Primed for a Big 3Q Beat (16 Sep 2020)

Key Themes from The Industrials Conference

This week was our Industrials Conference which included presentations from companies in autos, aerospace, airlines, machinery, multi-industry, and transportation. The tone of the conference was positive with management teams showing faith in the industrial recovery.

- **Aerospace & Defense:** Downside budget risk from a Biden win is limited, with expectations for flattish levels rather than scenarios similar to Obama and Clinton administrations, which saw deep cuts. Growth opportunities remain for higher-end technology such as hypersonics, cyber, space, and analytics as priorities shift to

align to the National Defense Strategy (NDS).

- **Airlines**: There are some signs demand is coming back across airlines but it is still quite small and they anticipate that the recovery will be led by leisure, with business and international following.

- **Machinery**: Commentary continued to highlight a more resilient North America Large Ag environment, as CNHI said it was seeing Ag tracking towards the high end of its guidance and DE indicating that it 'has never felt better' about its inventory position entering '21. Construction commentary was more mixed. Short cycle commentary continued to improve sequentially (per LECO), albeit with pockets of cyclical concern emerging for the '21 outlook.

- **Multi-Industry**: Companies with non-residential exposure are doing better than feared and changing customer modernization needs (e.g., building health and efficiency) appear more prominent than secular risk to new activity. Inventory is not driving improvement yet. Distributor restocking was universally low among presenters. While some suggested there simply won't be a restock and customers have enjoyed the lower working capital commitment, distributors have a long history of making bets on demand with inventory.

- **Transportation**: Rails continued to flag the volume recovery from the 2Q bottom as well as the structural cost savings achieved through the downturn though CN and KSU in particular also highlighted medium/long term growth opportunities. Trucking noted that extremely tight conditions are likely to tighten further from here.

For more on our analysts top picks from the conference please see US Equity Strategy: Industrials Conference: Strategy Sector Views + Analyst Stock Picks (14 Sep 2020).

Recap Notes from The Global Health Care Conference

- Healthcare Services: 2020 Global Healthcare Conference Day 1: What Mattered for Our Services Coverage
- Healthcare Services: 2020 Global Healthcare Conference Day 2: What Mattered for Our Services Coverage
- Healthcare Services: 2020 Global Healthcare Conference Day 3: What Mattered for Our Services Coverage
- Healthcare Services: 2020 Global Healthcare Conference Day 4: What Mattered for Our Services Coverage
- Medical Technology: HC Conference Day 1: Procedure Recovery & Capital Trends in Focus
- Medical Technology: HC Conference Day 2: Ortho in Focus
- Medical Technology: HC Conference Day 3: What Will Normalcy and Margins Look Like?
- Biotechnology: Top Takeaways For Large Caps From Day 1
- Biotechnology: Top Takeaways For Large Caps From Day 2
- Biotechnology: Top Takeaways For Large Caps From Day 3
- Biotechnology: Top Takeaways For Large Caps From Day 4
- US BioPharmaceuticals: Conference vaccine keynote with Scott Gottlieb

Fresh Money Buy List Updates

Each week, we will use a section of our Weekly Warm Up to provide brief updates on select stocks on our Fresh Money Buy List and the exhibits below shows performance stats around our list. The table below shows constituents before today's change.

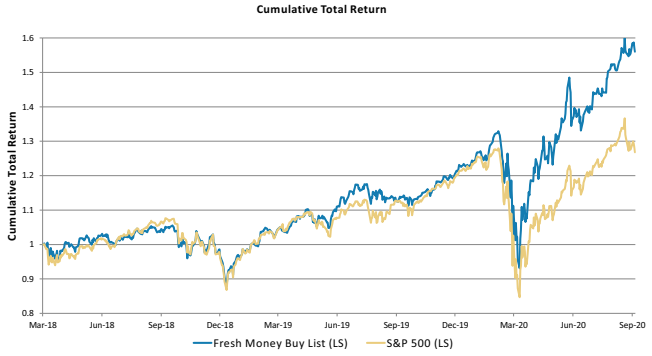
Exhibit 23: Fresh Money Buy List - Stats & Performance

Company Name	Ticker	MS Rating	Sector	Market Cap ($Bn)	Price	MS PT	% to MS PT	MS Analyst	Date Added	Total Return Since Inclusion	
										Absolute	Rel. to S&P
Citizens Financial Group, Inc	CFG	Overweight	Financials	$11.6	$27.16	$33.00	21.5%	Zerbe, Ken	4/20/2020	41.3%	24.9%
Walt Disney Co	DIS	Overweight	Communication Services	$232.4	$128.63	$135.00	5.0%	Swinburne, Benjamin	3/14/2018	27.5%	1.4%
Humana Inc	HUM	Overweight	Health Care	$53.3	$402.63	$500.00	24.2%	Goldwasser, Ricky	7/19/2018	28.9%	5.8%
Johnson & Johnson	JNJ	Overweight	Health Care	$392.8	$149.18	$170.00	14.0%	Lewis, David	2/3/2020	2.2%	(2.0%)
Linde PLC	LIN	Overweight	Materials	$129.3	$246.10	$275.00	11.7%	Andrews, Vincent	3/23/2020	64.0%	18.7%
MasterCard, Inc.	MA	Overweight	Information Technology	$335.6	$335.26	$338.00	0.8%	Faucette, James	3/2/2020	15.8%	2.3%
Procter & Gamble Co.	PG	Overweight	Consumer Staples	$342.0	$137.37	$144.00	4.8%	Mohsenian, Dara	3/18/2019	39.4%	18.3%
PVH Corp.	PVH	Overweight	Consumer Discretionary	$4.9	$68.48	$87.00	27.0%	Greenberger, Kimberly	4/20/2020	52.6%	36.2%
S&P Global Inc	SPGI	Overweight	Financials	$84.6	$351.01	$383.00	9.1%	Kaplan, Toni	3/23/2020	68.8%	23.5%
T-Mobile US, Inc.	TMUS	Overweight	Communication Services	$137.1	$110.72	$124.00	12.0%	Flannery, Simon	3/14/2018	70.7%	44.6%
Current List Performance											
Average (Eq. Weight)				$172.4			13.0%			41.1%	17.4%
Median				$133.2			11.9%			40.4%	18.5%
% Positive Returns (Abs. / Rel.)										100%	90%
% Negative Returns (Abs. / Rel.)										0%	10%
Avg. Hold Period (Months)											14.3
All Time List Performance											
Average (Eq. Weight)										29.5%	11.5%
Median										28.2%	4.1%
% Positive Returns (Abs. / Rel.)										75%	58%
% Negative Returns (Abs. / Rel.)										25%	42%
Avg. Hold Period (Months)											11.7

Performance returns shown above and below represent local currency total returns, including dividends and excluding brokerage commission. Returns are calculated using the closing price on the last trading day before the date shown in the "Date Added" column through close on the last trading day prior to publication of this report for stocks currently on the list and through close on the day of removal for stocks formerly on the list. These figures are not audited. Past performance is no guarantee of future results.

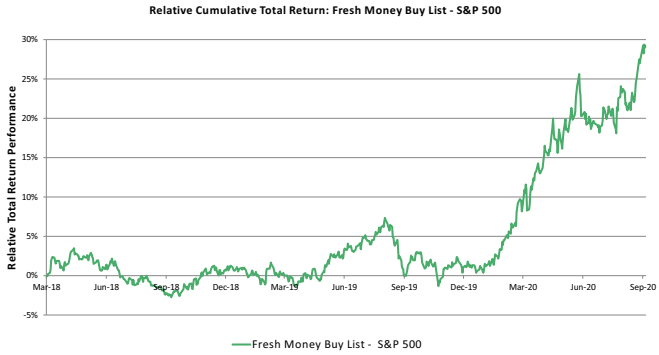
Source: Bloomberg, Morgan Stanley Research.

Exhibit 24: Fresh Money Buy List & S&P 500 Cumulative Total Return



Source: Bloomberg, Morgan Stanley Research.

Exhibit 25: Fresh Money Buy List / S&P 500 Cumulative Relative Return



Source: Bloomberg, Morgan Stanley Research.

Citizens Financial Group (CFG), Ken Zerbe

- **Mortgage Mania Driving Higher EPS Estimates** - We are raising our 3Q20 mortgage

banking revenue estimates by 28% on continued strength in the mortgage market. For banks with large mortgage operations, our 3Q20e EPS rises by an average 2.8%. Banks best positioned to benefit from strong mortgage banking revenues are CFG, BOKF, MTB, HBAN & FITB.

Humana (HUM), Ricky Goldwasser

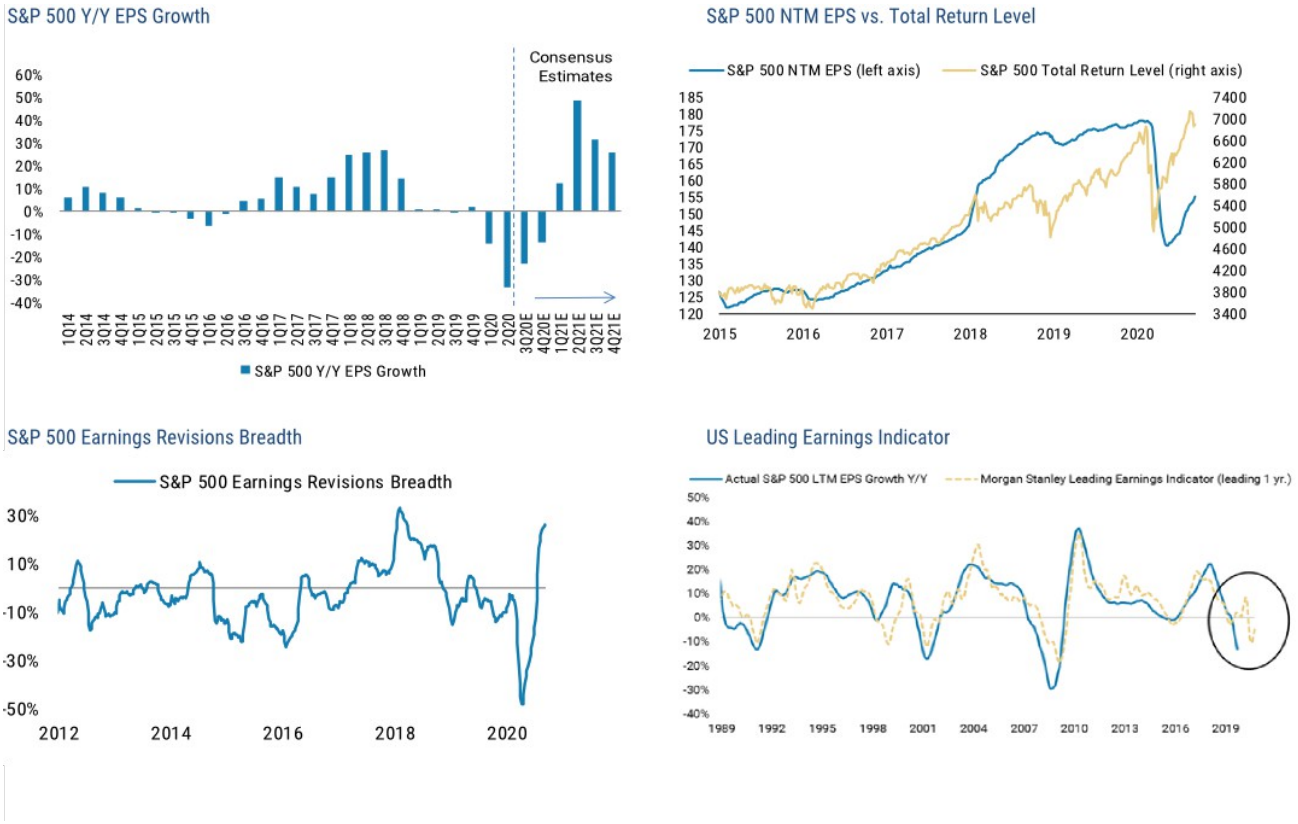
- **Takeaways from the Health Care Conference on HUM**: 1) Core utilization trending somewhat below but when accounting for COVID related costs, trend is in-line with expectations; 2) Omnichannel strategy is paying off as COVID is leading to an accelerated shift to in-home care for seniors; 3) Enrollment led by individual market with group MA growth lower as it is lumpier and more dependent on timing of bids; 4) As Humana looks to continue to innovate its offerings, partnerships are a key priority allowing management to scale new businesses while maintaining focus on core business; 5) Management is taking a wait and see approach towards exchanges pending election outcomes whereas Medicare expansion, if it materializes, is an opportunity to leverage existing infrastructure and value based approach in a younger population (see our note on Medicare buy ins here); 6) Medicaid growth should continue to be measured as Humana invests in improving its procurement capabilities and executes on select regional M&A.

(PVH), Kimberly Greenberger

- **Top Takeaways from 2Q20**: Softlines SG&A expenditures declined -14.9% y/y on average (vs.-6.5% 1Q), driven by temporary store closures, employee furloughs, lower variable expenses, and other cost saving measures. Some retailers/brands (eg. PVH, LB, and LEVI) have implemented restructuring plans that could generate permanent cost savings beyond 2020. 5 of 22 stocks trade below 5-year median FY2 P/E multiples (JWN, TPR, PVH, FL, and CPRI).

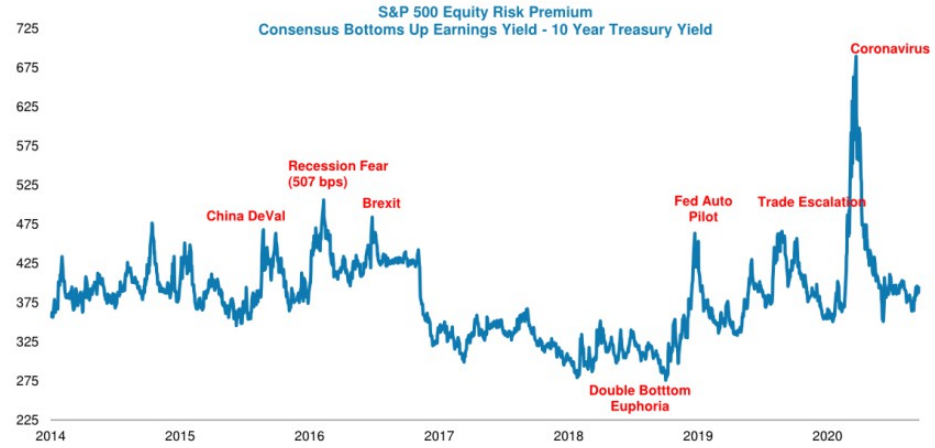
Weekly Charts to Watch

Exhibit 26: US Earnings Snapshot



Source: Thomson Financial, FactSet, Morgan Stanley Research. Top and bottom left: As of September 17, 2020 Bottom right As of August 31, 2020. MS Leading Earnings Indicator is a macro factor based earnings model that leads actual earnings growth by one year with a 0.7 12-month leading correlation. Note: S&P 500 fundamental data used post March 1993; Top 500 by market cap data used before 1993. LTM equity risk premium average is since 1920. ERP based on forward earnings yield and 10-year Treasury Yield.

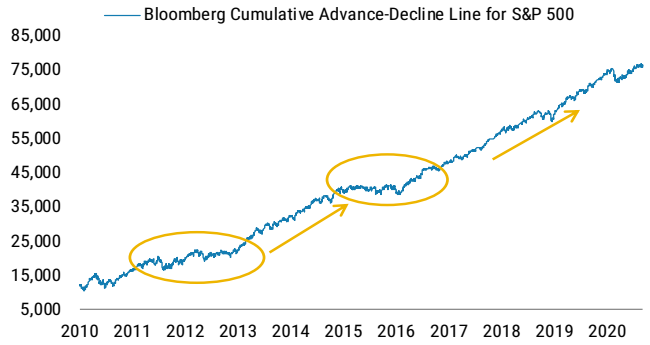
Exhibit 27: S&P 500 Equity Risk Premium



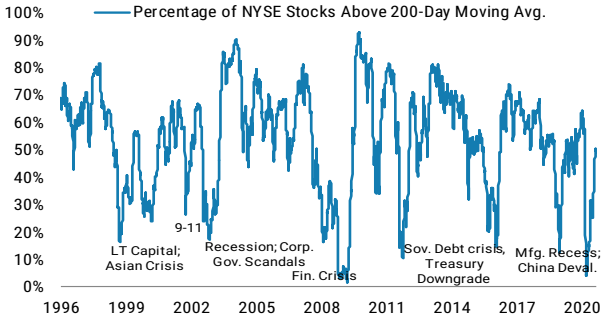
Source: Bloomberg, Morgan Stanley Research. As of September 17, 2020.

Exhibit 28: US Equity Market Technicals and Financial Conditions

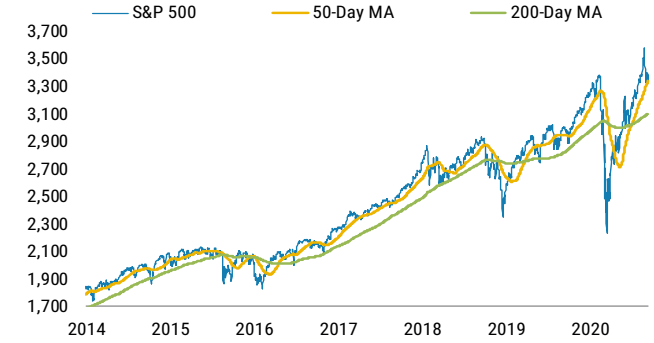
S&P 500 Cumulative Advance-Decline



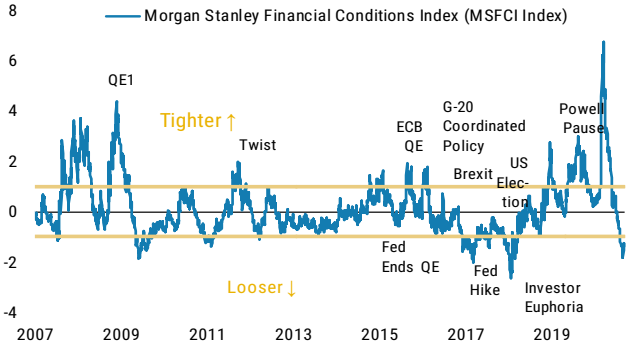
S&P 500 Percent Members Above 200-Day Moving Average



S&P 500 with Moving Averages

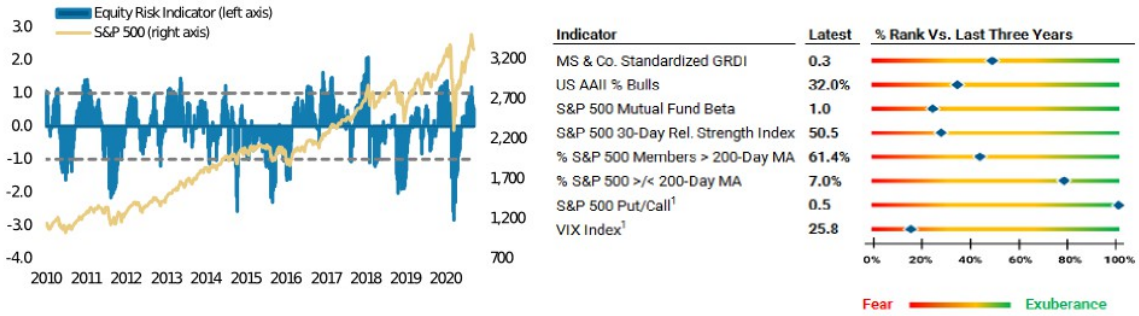


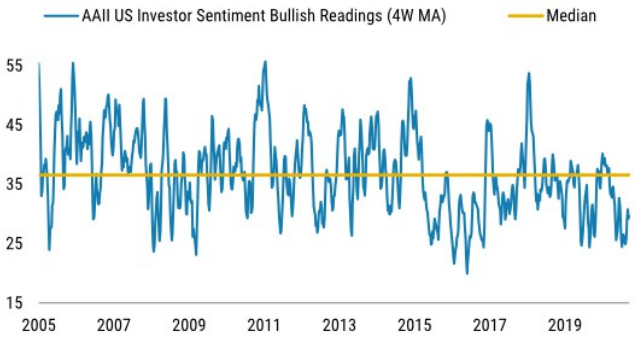
Morgan Stanley Financial Conditions Index



Source: Bloomberg, Morgan Stanley Research. All: As of September 17, 2020

Exhibit 29: US Equity Market Sentiment

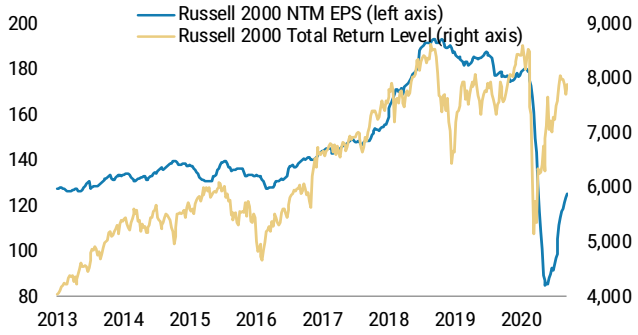




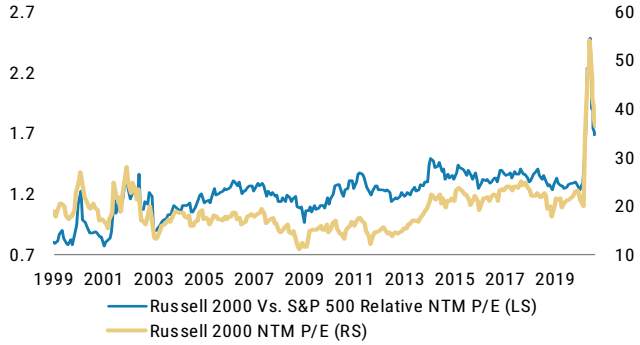
Source: Bloomberg, FactSet, Morgan Stanley Research. As of September 4, 2020.

Exhibit 30: US Small Cap Equities

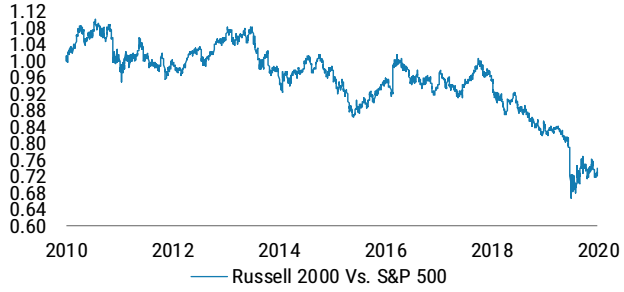
Russell 2000 NTM EPS vs. Total Return Level



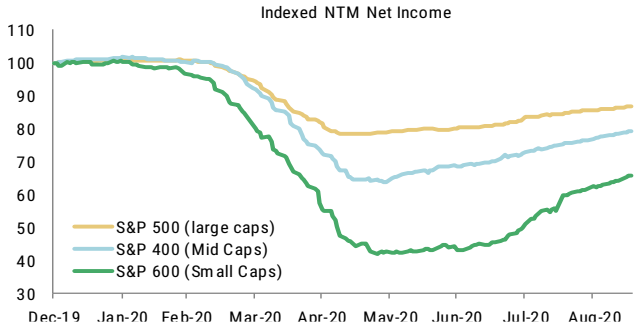
Russell 2000 NTM P/E and Relative NTM P/E vs. S&P 500



Russell 2000 Relative Performance vs. S&P 500



NTM EPS by Cap Size



Source: FactSet, Morgan Stanley Research. Top Right: As of August 31, 2020. Top Left and Bottom: As of September 17, 2020

Exhibit 31: We Have a Price Target of 3350

Morgan Stanley S&P 500 Price Target: June 2021

Landscape	Earnings	Multiple	Price Target	Upside / Downside
Bull Case	$176	21.0x	3,700	10.2%
Base Case	$168	20.0x	3,350	-0.2%
Bear Case	$152	19.0x	2,900	-13.6%
Current S&P 500 Price as of:		9/17/2020	3,357	

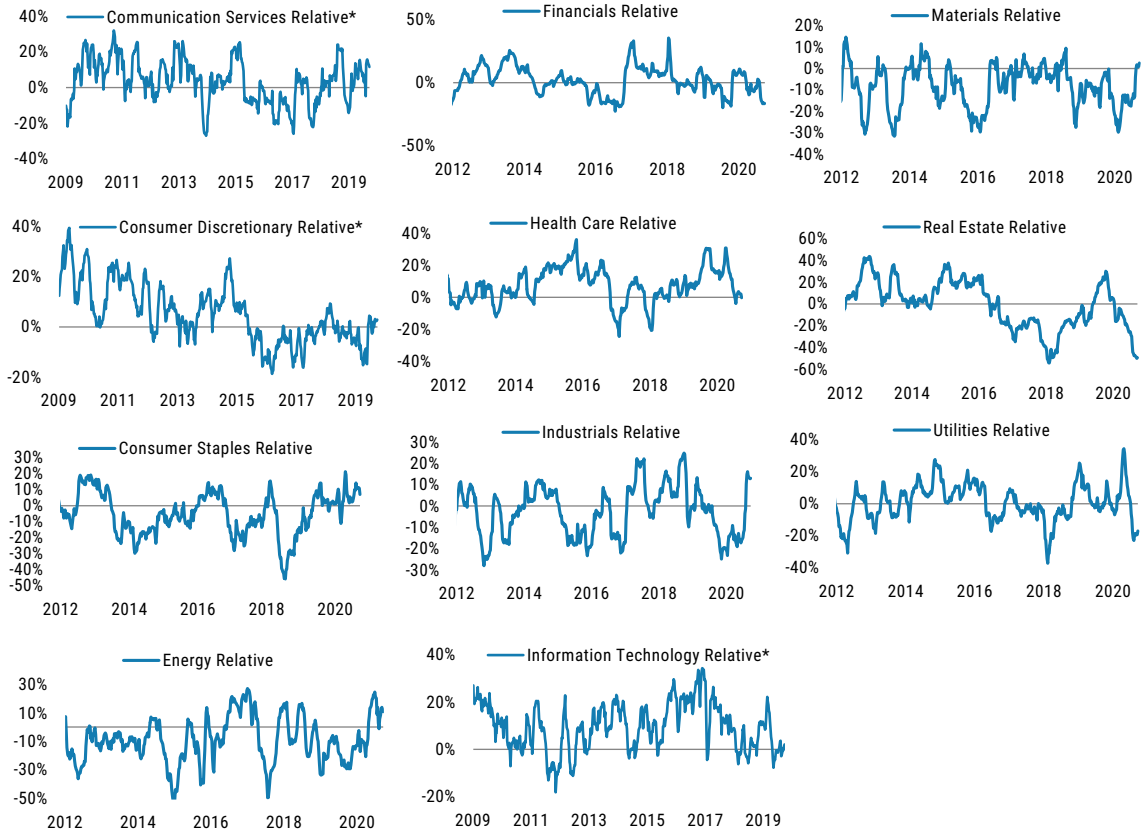
Source: Bloomberg, Morgan Stanley Research

Exhibit 32: Sector Ratings

Morgan Stanley Sector Recommendations			
Overweight	Financials Industrials	Health Care	Materials
Neutral	Comm. Services Real Estate	Discretionary	Energy
Underweight	Staples	Technology	Utilities

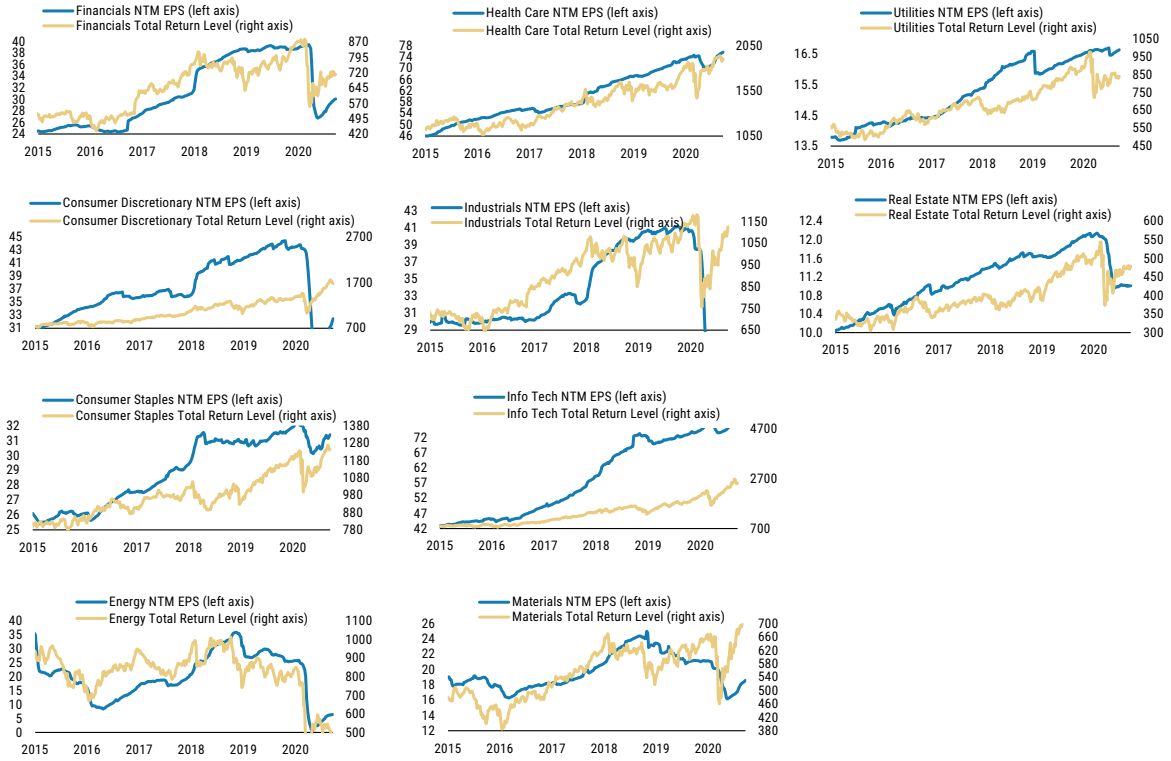
Source: Morgan Stanley Research

Exhibit 33: Earnings Revisions Breadth



Source: FactSet, Morgan Stanley Research. As of September 17, 2020. Sectors with * use current, fixed constituents.

Exhibit 34: US Sector NTM EPS vs. Total Return Level



Source: FactSet, Morgan Stanley Research as of September 17, 2020.

For valuation methodology and risks associated with any price targets referenced in this research report, please contact the Client Support Team as follows: US/Canada +1 800 303-2495; Hong Kong +852 2848-5999; Latin America +1 718 754-5444 (U.S.); London +44 (0)20-7425-8169; Singapore +65 6834-6860; Sydney +61 (0)2-9770-1505; Tokyo +81 (0)3-6836-9000. Alternatively you may contact your investment representative or Morgan Stanley Research at 1585 Broadway (Attention: Research Management), New York, NY 10036 USA.

Disclosure Section

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(as of August 31, 2020)

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	COVERAGE UNIVERSE		INVESTMENT BANKING CLIENTS (IBC)			OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC)	
STOCK RATING CATEGORY	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MISC
Overweight/Buy	**1282**	**39%**	**339**	**44%**	**26%**	**568**	**39%**
Equal-weight/Hold	**1426**	**44%**	**340**	**45%**	**24%**	**676**	**46%**
Not-Rated/Hold	**4**	**0%**	**1**	**0%**	**25%**	**3**	**0%**
Underweight/Sell	**555**	**17%**	**83**	**11%**	**15%**	**224**	**15%**
TOTAL	**3,267**		**763**			**1471**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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