January 19, 2021 05:01 AM GMT

US Equity Strategy | North America

Weekly Warm-up: More Stimulus May Mean Less for Markets

Last week President-elect Biden proposed a larger COVID relief package. Some version is likely to be passed and potentially lead to higher back end rates. With ERPs so low, any move higher in rates means lower P/Es, a different outcome than many are expecting.

The reflation trade got another boost last week from President-elect Biden's Covid relief plan. In that plan, he proposes to spend an *incremental* $1.9T to help bridge the economy from its current state to when it can fully reopen later this year. Combined with the $900B bill passed last month, this amounts to roughly 15% of GDP. That's a lot of money chasing fewer goods and services that aren't even available yet.

The end game is higher growth and inflation. Such an outcome is getting priced in equity and other markets most affected (commodities, etc.). The rotation to cyclicals is well advanced at this point and may take a break if rates don't start to adjust to this new reality. We think the answer lies in between with rates moving higher and PEs moving lower. The offset is earnings estimates which means the speed of the move in rates will determine how much equity valuations and prices decline, if at all.

The set up is very similar to 2013 but with lower ERPs. Should rates start to adjust more abruptly like during 2013's taper tantrum, the equity market has less wiggle room to avoid a material correction with ERPs so low today relative to then. We think this is worth consideration as investors try to gage portfolio risk in the event the bond market catches up to other asset prices faster than expected.

Extreme market concentrations are breaking down. The concentration of the US stock market, as measured by a Herfindahl-Hirschman Index (HHI), surged past the prior Tech-bubble peak last year. This concentration was largely driven by multiple appreciation in mega-cap tech rather than earnings concentration. Since August though, concentration looks to be falling quickly as the average stock outperforms the index. The change in trend supports our view for a reinforces our view on a broadening of market performance and the importance of stock selection for alpha as 2021 is increasingly about a "market of stocks", rather than a "stock market".

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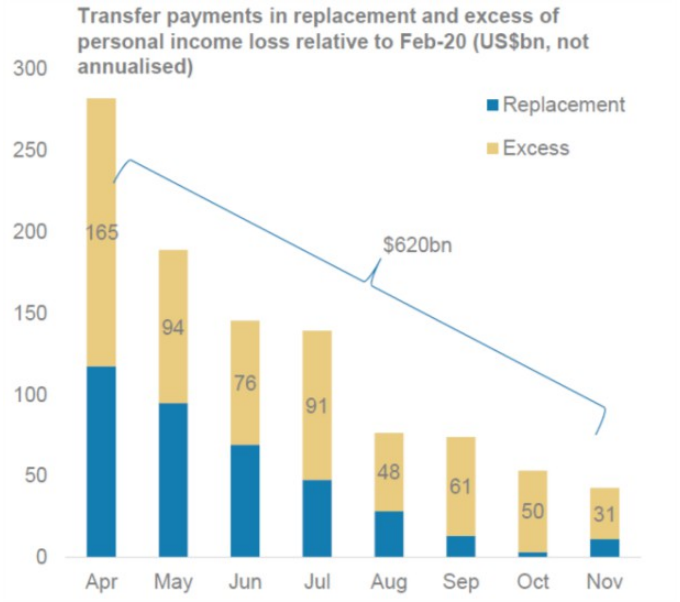
What to Focus on This Week

More May be Less

With equity markets off to a fast start in 2021 led by the beneficiaries of reflation, the market got another boost last week from President-elect Biden's Covid relief plan. In that plan, he proposes to spend an *incremental* $1.9T to help bridge the economy from it's current state to when it can fully reopen later this year. Combined with the $900B bill passed last month, this amounts to roughly 15% of GDP. That's a lot of money chasing fewer goods and services that aren't even available yet.

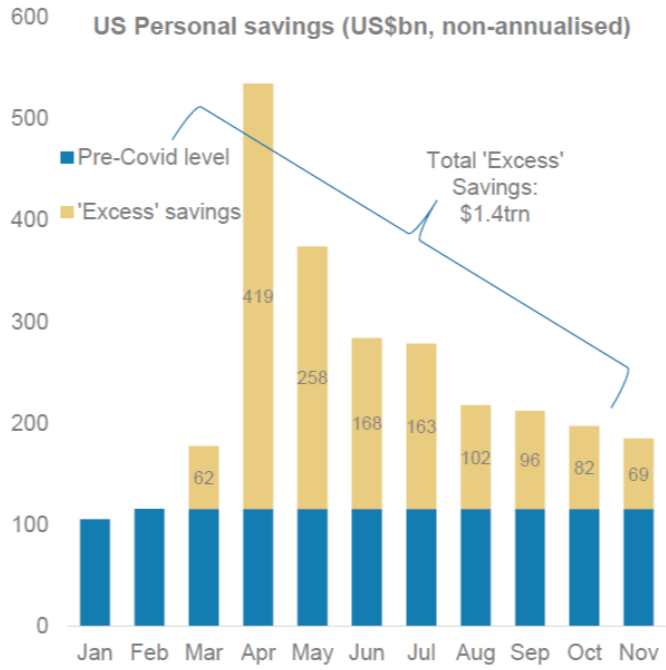
Morgan Stanley economists calculate unemployment cost US households US$330 billion in wage income. However, they have already received US$1 trillion in aggregate in transfers, a figure that will rise significantly as the second round of fiscal stimulus kicks in (Exhibit 1). The excess savings of about US$1.4 trillion should provide the fuel for pent-up demand to drive a sharp rebound in growth once the economy is fully reopen. Our economists forecast GDP growth of 5.9%Y for the US in 2021, a full 2 percentage points above the consensus. This forecast does not yet include the additional aid proposed by President-elect Biden which we think will ultimately end up adding US$1.1 trillion for COVID-19 aid and other items.

Exhibit 1: Households have lost $330B from unemployment but already received transfers of almost $1T



Source: BLS, BEA, Haver Analytics, MS Research

Exhibit 2: US households already hold $1.4T in excess savings before next stimulus.



Source: BEA, Haver Analytics, MS Research

With such excess, it seems straightforward how inflation is likely to surprise on the upside once this money starts going into the economy, rather than investments. Yet, we continue to hear many clients push back on this idea with the consensus still arguing lower for longer on long term interest rates. The argument now is that whatever inflation we get this year as demand exceeds supply will prove to be transient and/or temporary. This will allow the Fed to keep its guidance on rates and current asset purchases unchanged. Another way of thinking about it is that there is still quite a bit of skepticism about the Fed's ability to reach its goal of above trend inflation for any sustainable period of time. Ironically, it's exactly this complacency around policy that should allow inflation to surprise on the upside.

Having said that, **10-year inflation breakevens *have* moved meaningfully higher and currently sit above 2% for the first time in over two years**, a time when the economy was growing about 2 percentage points lower than what we are forecasting for 2021. The disconnect is with nominal and real 10 year yields, not breakevens, and that is the biggest risk and opportunity for equity investors in our view. Equity markets seem to agree with stocks levered to inflation and higher back end rates outperforming significantly since the lows last March and especially since the announcement of vaccines in early November. Additional stimulus recently passed and proposed on the back of what is now a Democratically controlled Congress has simply turbocharged the trends we have been favoring — i.e. small caps, cyclicals, commodities and rate plays.

Exhibit 3: Pro-cyclical leadership since March...

Source: Bloomberg, Morgan Stanley Research

Exhibit 4: Turbocharged by vaccines and election

Source: Bloomberg, Morgan Stanley Research

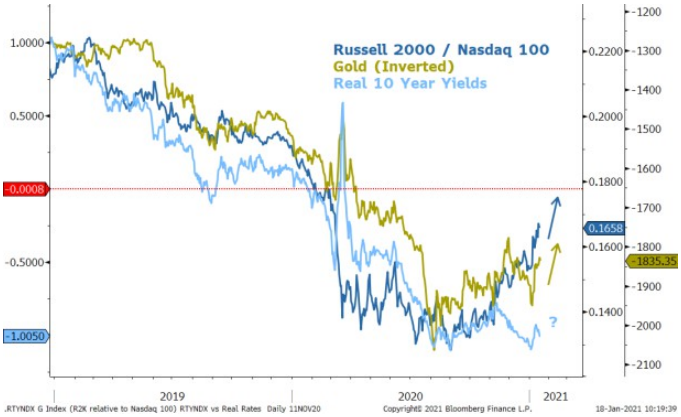
When looking at the equity markets relative to rates specifically, we can see that a wide divergence has opened up. Using our cyclical/defensive ratio, it's very clear that **equity markets are trading ahead of rates markets**, as they normally do (Exhibit 5). However the spread has become so wide, something has to give — either cyclicals need to go through a period of underperformance or rates need to catch up in a hurry. We have been in the latter camp and while rates have finally started to move higher, it's happening more slowly than we expected which may be the best outcome for stocks more broadly as we will discuss later.

In addition to nominal rates lagging, we think *real* rates have more upside as well. To make our point, we compare the moves in small caps relative to the Nasdaq and Gold as two good examples of other markets moving ahead of real rates much like cyclicals/defensives versus nominal 10 year rates (Exhibit 6). **Bottom line, we believe that higher rates are only a matter of when, not if.** Furthermore, much of this has already played out in the equity markets, suggesting some give back of relative performance in cyclicals, small caps and other assets levered to higher rates if they don't catch up soon.

Exhibit 5: We continue to think higher back end rates remain biggest surprise to come

Source: Bloomberg, Morgan Stanley Research

Exhibit 6: Meanwhile, RTY/NDX and Gold suggest real rates have upside as well



Source: Bloomberg, Morgan Stanley Research

Most of our key calls have been very focused on the internal dynamics of accelerating growth and inflation discussed above. With that rotation having traded ahead of rates, the question now becomes what happens if rates finally do move higher as we expect? One could argue that cyclicals, small caps and other areas we prefer may not continue to outperform. They may even give back some performance if the rate move is very slow and gradual as most are expecting. In short, while we continue to recommend many pro-cyclical themes, the risk reward of adding to these ideas now is much lower than it's been in quite awhile. As such, we would not be surprised if they start to tread water and consolidate. In that sense, the announcement last week of more stimulus coming from the Biden administration could represent a "sell the news" moment.

As for the primary market index, the S&P 500, the risk of a rate move comes down to the speed with which it occurs. As noted already, if it's a nice gradual progression to 1.5% by year end, the index should be able to avoid any meaningful correction. The multiple compression should be (more than) offset by rising NTM EPS forecasts as we discussed in our year ahead outlook (Show me the Money!). **However, should the rate rise adjust quickly, in a non-linear fashion, the multiples compression will be too fast and the index could fall meaningfully before earnings revisions have time to offset.**

The best historical comparison to today may be 2013. Similar to then, markets and the Fed are likely to be surprised by the strength of the economy and inflation. Back then, the Fed reacted by hinting at tapering which caught markets off guard. While it's unlikely the Fed makes that kind of mistake this time (Fed Chair Powell in fact said as much), markets have a way of moving ahead once the evidence becomes overwhelming. The proposed stimulus last week could be exactly the kind of evidence to swing it more

meaningfully. At a minimum, it's part of the mosaic.

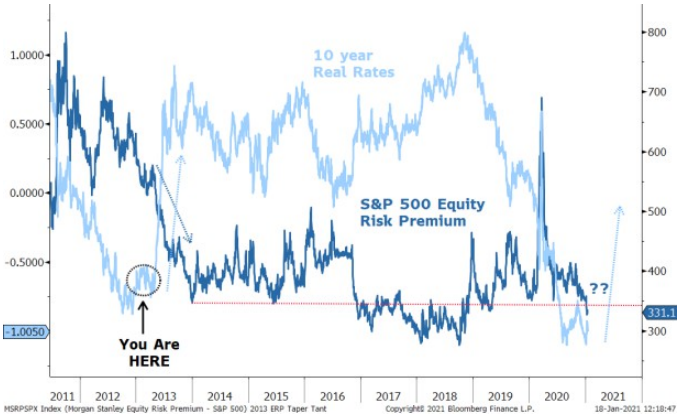
Back in 2013, real 10 year yields moved higher by a remarkable 140bps in a matter of weeks. However, when examining RTY/NDX or Gold prices, the markets were moving well ahead of this "surprise" announcement, just like today. Even real rates had already moved 50bps off the lows before Bernanke's memorable testimony to Congress on May 23, 2013 (Exhibit 7). If there is one thing every investor should appreciate after the past 12 months, markets don't wait around until it is obvious what is happening. **They discount the outcome as the odds of that outcome increase. With the events of the past 30 days, it's fair to say the odds of our above consensus views on growth and inflation have increased materially.**

Exhibit 7: Today's Set-Up Looks Similar to 2013 when the Rates Markets Quickly Adjusted

Source: Bloomberg, Morgan Stanley Research

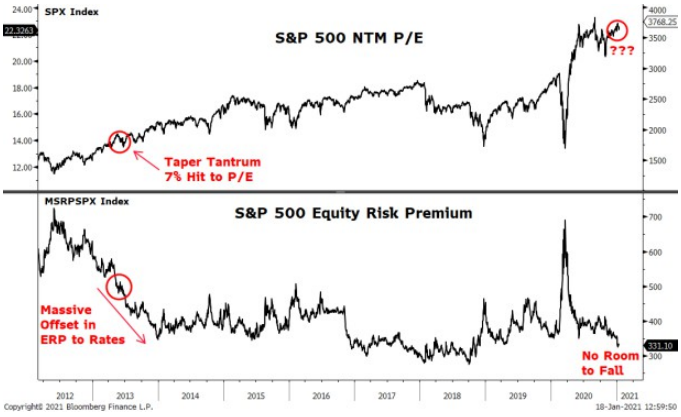
One final observation for equity investors to contemplate as this dynamic plays out this year is that the equity risk premium is much lower than it was in 2013 prior to the taper tantrum. More specifically, in 2013, the Equity Risk Premium was quite elevated precisely because real rates were so low. At the time, we recognized this as the equity market's way of saying it was concerned that the US could be headed down the path of Japan and Europe — i.e. well below trend growth and inflation for the longer term (a balance sheet recession and debt trap). As shown in Exhibit 8, the equity risk premium was lower than it had been in 2011-12 but was still well above what we deemed to be appropriate during normal times (i.e. 300-400bps). When rates spike higher in the spring of 2013, the ERP had to room to fall and absorb some of the blow. Today, that is not the case, as we've been discussing in our research. In 2013, a 150bps increase in rates led to only a 7% hit to P/Es as ERPs fell (Exhibit 9). This time around, **if rates were to rise 100bps without any offsetting decline in ERP, the hit to the P/E for the S&P 500 would be 18 percent.** With that kind of sensitivity, investors may want to hedge it.

Exhibit 8: ERP in Much Different Position Today Versus 2013 Taper Tantrum….



Source: Bloomberg, Morgan Stanley Research

Exhibit 9: Which Means P/E Much more Vulnerable to a large Rise in Rates



Source: Bloomberg, Morgan Stanley Research

A Concentrated Market Broadening Out

All time high market concentration ... In past notes we have shown that the top 5 stocks (the top 1%) in the market have reached an all time high percentage of market cap as has the weight of tech and internet stocks (now 40%+). To measure market concentration a bit more broadly, we built a time series of the Herfindahl-Hirschman Index (HHI) for the top 500 stocks in the US market (Exhibit 10). The prior peak concentration was March 2000, but from January 2020 - August 2020, concentration surged to almost 50% above the prior peak.

... driven by price appreciation in mega caps rather than earnings concentration ... At the August peak the top 5 stocks in the US market were responsible for ~130 points of the 150 point reading on the HHI, or roughly 85%. Importantly the market cap concentration was more a function of relative valuations rising than it was of concentrated earnings. Exhibit 11 shows the ratio of the HHI built around market cap share to the HHI built around net income share. In other words, the ratio of cap concentration to earnings concentration. That ratio also peaked in August at a level of ~1.4x, meaning market cap concentration on this measure was roughly 40% above net income concentration. A surge in the relative valuations of mega-cap tech explains the moves

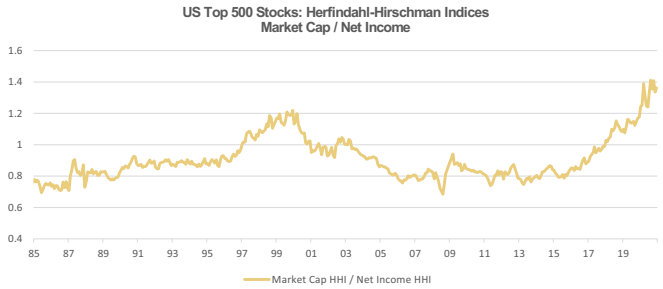
... is breaking down. From August 2020 though market concentration has been falling rapidly. Net income concentration has also fallen, but not as quickly, meaning the cap HHI / earnings HHI ratio also peaked in August. We see this breakdown in concentration supporting our view that a new bull market means broadening performance. Among our key themes over the last year has been that a recovery and new cycle would bring a broadening of market performance. That preference has informed our preference for the equal weighted S&P 500 over the market cap weighted and small caps over large.

The bottom line: Market concentrations are falling off all time extremes as the average stock outperforms the index, a trend we expect to continue, and one that places increased importance on active portfolio management.

Exhibit 10: US Market Concentration Is Falling Off All Time Highs

Source: ClariFi, Morgan Stanley Research.

Exhibit 11: Cap Concentration / Earnings Concentration Is Also Falling As Performance Broadens Faster Than Earnings



Source: ClariFi, Morgan Stanley Research.

What is a Herfindahl-Hirschman Index (HHI)?

The HHI, commonly used as a tool for measuring market concentration in anti-

trust cases, is calculated as the sum of squared market shares across market participants. In the extreme example of a monopoly with 1 participant having a market share of 100%, the HHI would be 10,000 (100^2). A market with many firms each having small share would approach an HHI reading of 0. In this case our calculations use percentage of overall market cap and percentage of overall net income to measure concentration of market cap and profits respectively.

For more information, please see here.

Fresh Money Buy List

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.

Exhibit 12: 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
Ally Financial Inc	ALLY	Overweight	Financials	$15.3	$40.88	$47.00	15.0%	Graseck, Betsy	9/21/2020	60.3%	46.2%
Citizens Financial Group, Inc	CFG	Overweight	Financials	$17.4	$40.63	$47.00	15.7%	Zerbe, Ken	4/20/2020	114.5%	81.7%
Walt Disney Co	DIS	Overweight	Communication Services	$310.4	$171.44	$200.00	16.7%	Swinburne, Benjamin	3/14/2018	70.0%	26.1%
Humana Inc	HUM	Overweight	Health Care	$53.8	$406.81	$500.00	22.9%	Goldwasser, Ricky	7/19/2018	30.6%	(9.8%)
Johnson & Johnson	JNJ	Overweight	Health Care	$422.0	$160.30	$178.00	11.0%	Lewis, David	2/3/2020	10.6%	(8.3%)
Linde PLC	LIN	Overweight	Materials	$135.1	$258.09	$281.00	8.9%	Andrews, Vincent	3/23/2020	72.7%	6.8%
MasterCard, Inc.	MA	Overweight	Information Technology	$322.3	$323.26	$353.00	9.2%	Faucette, James	3/2/2020	12.0%	(17.6%)
PVH Corp.	PVH	Overweight	Consumer Discretionary	$7.1	$100.28	$104.00	3.7%	Greenberger, Kimberly	4/20/2020	123.4%	90.7%
T-Mobile US, Inc.	TMUS	Overweight	Communication Services	$158.0	$127.28	$143.00	12.4%	Flannery, Simon	3/14/2018	96.2%	52.4%
Current List Performance											
Average (Eq. Weight)				$160.1			12.8%			65.6%	29.8%
Median				$135.1			12.4%			70.0%	26.1%
% Positive Returns (Abs. / Rel.)										100%	67%
% Negative Returns (Abs. / Rel.)										0%	33%
Avg. Hold Period (Months)											17.1
All Time List Performance											
Average (Eq. Weight)										42.6%	16.0%
Median										37.5%	6.8%
% Positive Returns (Abs. / Rel.)										76%	52%
% Negative Returns (Abs. / Rel.)										24%	48%
Avg. Hold Period (Months)											13.0

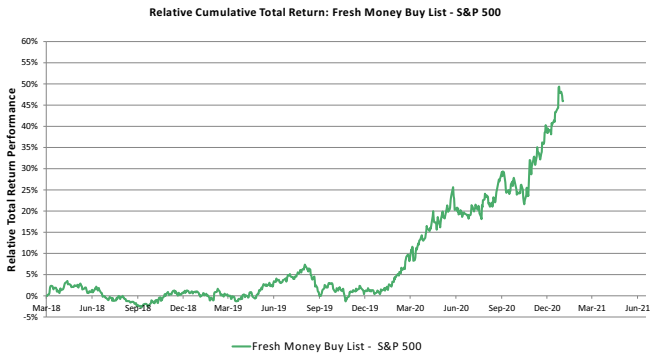
Performance returns shown above and below represent local currency total returns, including dividends and excluding brokerage commission. Returns are calculated using the closing price on the last trading day before the date shown in the "Date Added" column through close on the last trading day prior 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 13: Fresh Money Buy List & S&P 500 Cumulative Total Return

Source: Bloomberg, Morgan Stanley Research.

Exhibit 14: Fresh Money Buy List / S&P 500 Cumulative Relative Return



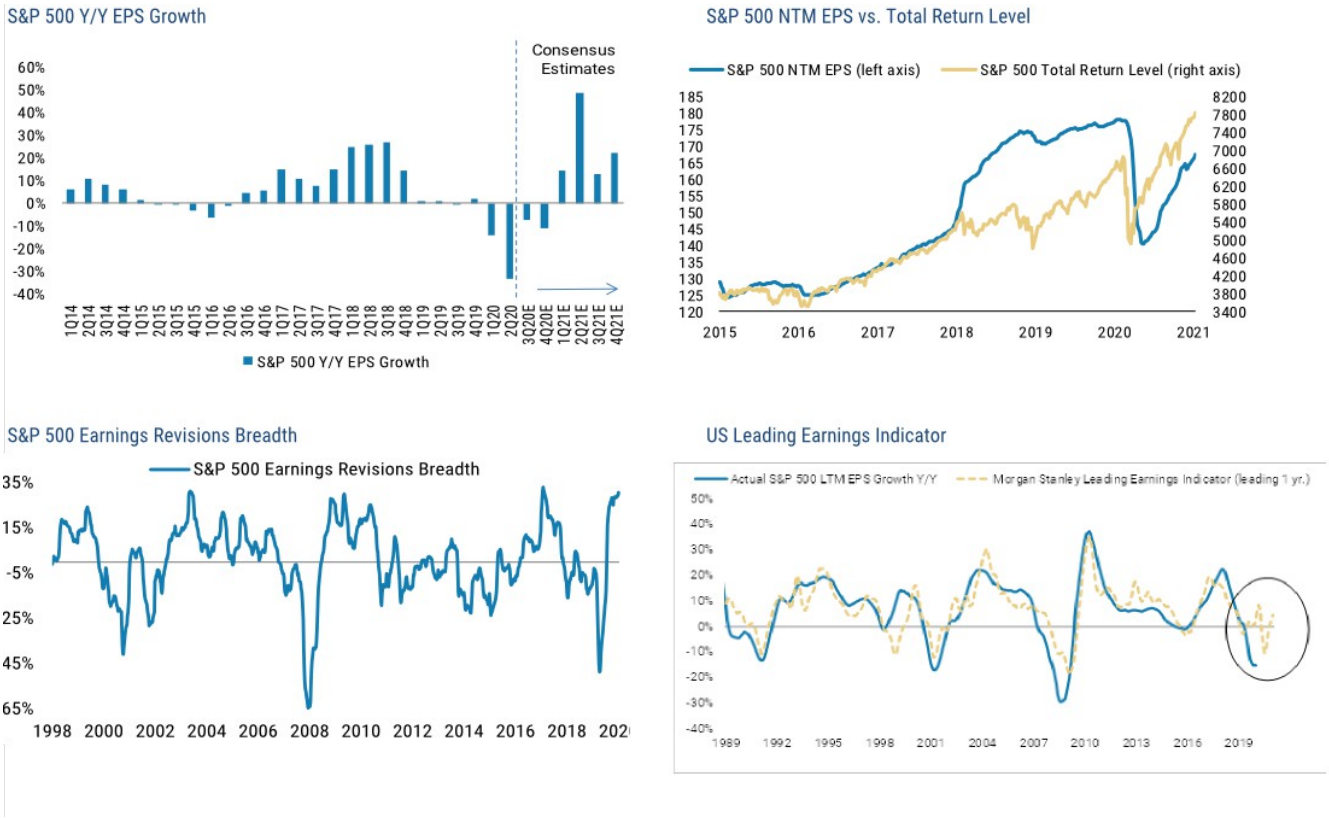
Source: Bloomberg, Morgan Stanley Research.

Johnson & Johnson (JNJ), David Lewis

- **What Does J&J Interim Data Tell Us?** - Interim Phase 1-2a results from J&J's vaccine trial demonstrated a strong safety profile for Ad26, with the vaccine immunogenic after a single dose. Efficacy remains the outstanding question and we expect interim Phase 3 data to read out within the next two weeks. Where can efficacy shake out? As we previously stated here, we continue to take the view that while efficacy of J&J's single-dose regimen could exceed AstraZeneca's, potential pre-existing vector immunity likely limits Ad26's ability to deliver efficacy rates seen with Pfizer/BioNTech and Moderna (~95%). If J&J's Ad26 platform is able to confer 80%+ efficacy via a single-dose regimen, given the vaccine's favorable handling requirements and significant manufacturing scale, we would view this as a compelling outcome. Outstanding questions include: (1) relative efficacy of a single-dose Ad26 regimen vs. a two-dose regimen; and (2) long-term vaccine durability, an outstanding question for all COVID-19 vaccine platforms.

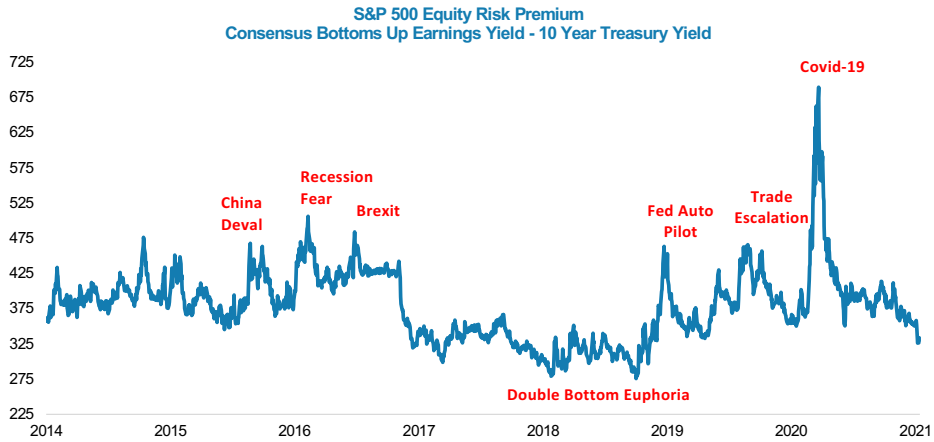
Weekly Charts to Watch

Exhibit 15: US Earnings Snapshot



Source: Thomson Financial, FactSet, Morgan Stanley Research. Top and bottom left: As of Jan 14, 2021 Bottom right As of Dec 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.

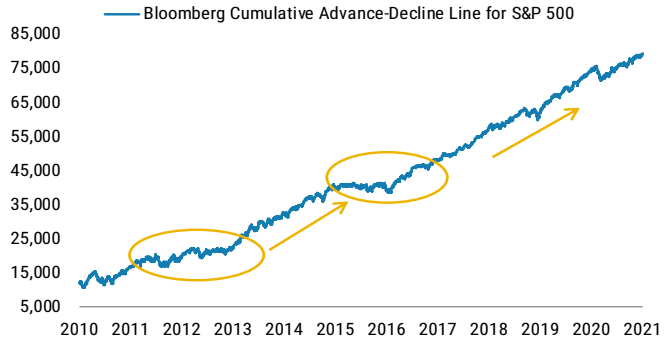
Exhibit 16: S&P 500 Equity Risk Premium



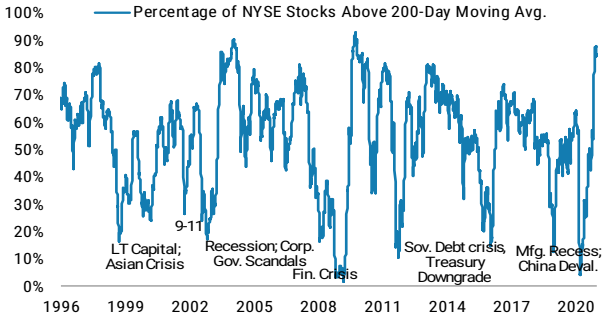
Source: Bloomberg, Morgan Stanley Research. As of Jan 14, 2021.

Exhibit 17: US Equity Market Technicals and Financial Conditions

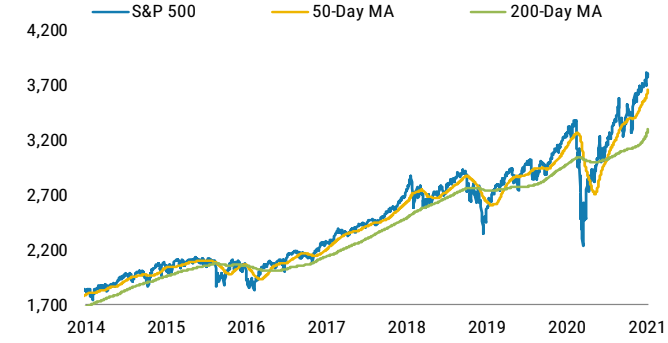
S&P 500 Cumulative Advance-Decline



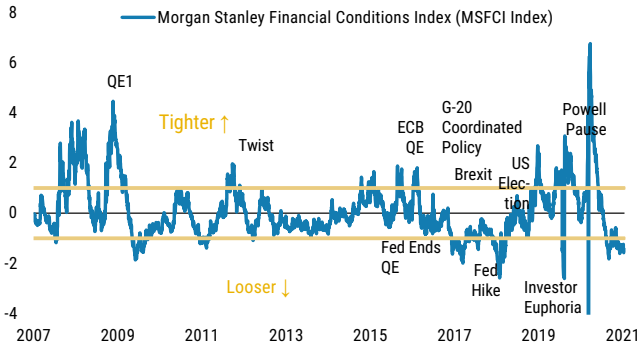
S&P 500 Percent Members Above 200-Day Moving Average



S&P 500 with Moving Averages

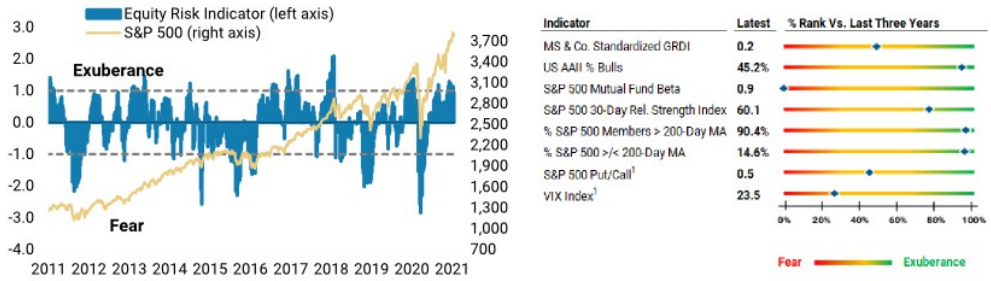


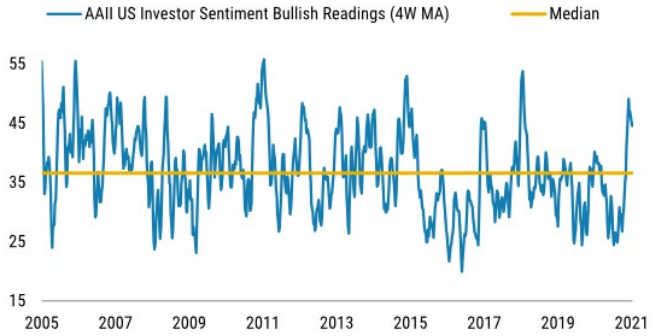
Morgan Stanley Financial Conditions Index



Source: Bloomberg, Morgan Stanley Research. All: As of Jan 14, 2021

Exhibit 18: US Equity Market Sentiment

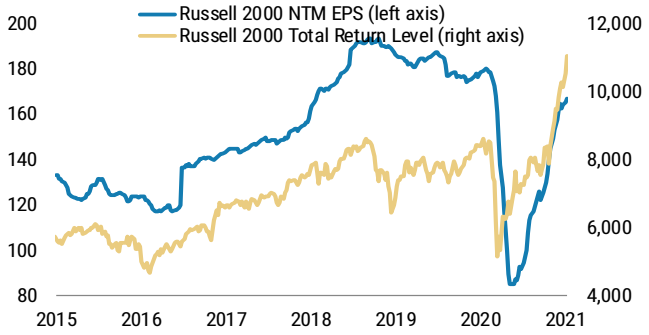




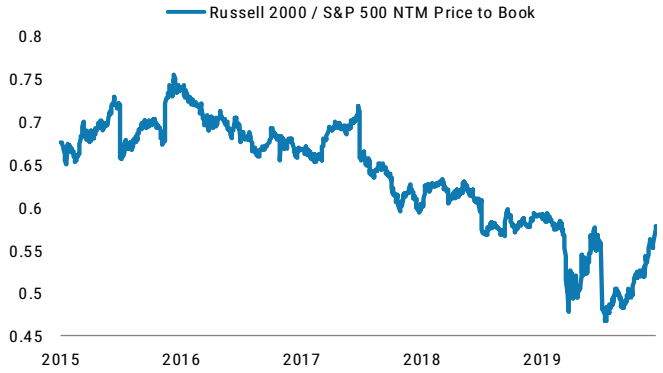
Source: Bloomberg, FactSet, Morgan Stanley Research. As of January 15, 2021.

Exhibit 19: US Small Cap Equities

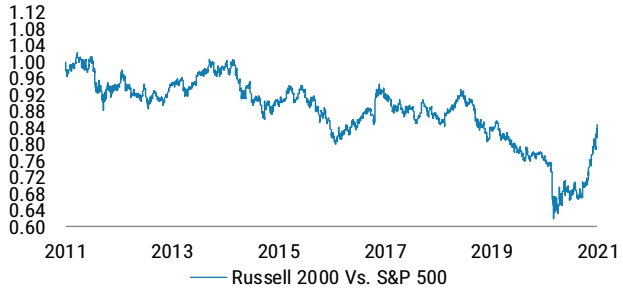
Russell 2000 NTM EPS vs. Total Return Level



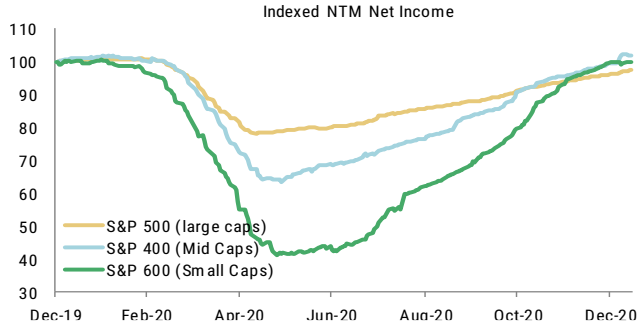
Russell 2000 NTM P/B and Relative NTM P/B vs. S&P 500



Russell 2000 Relative Performance vs. S&P 500



NTM EPS by Cap Size



Source: FactSet, Morgan Stanley Research. Top Right: As of Dec 31, 2020. Top Left and Bottom: As of Jan 14, 2021

Exhibit 20: We Have a Price Target of 3900

Morgan Stanley S&P 500 Year Ahead Price Target

Landscape	Earnings	Multiple	Price Target	Upside / Downside
Bull Case	$202	20.75x	4,175	10.0%
Base Case	$193	20.25x	3,900	2.8%
Bear Case	$176	19.25x	3,375	-11.1%
Current S&P 500 Price as of:		1/14/2021	3,796	

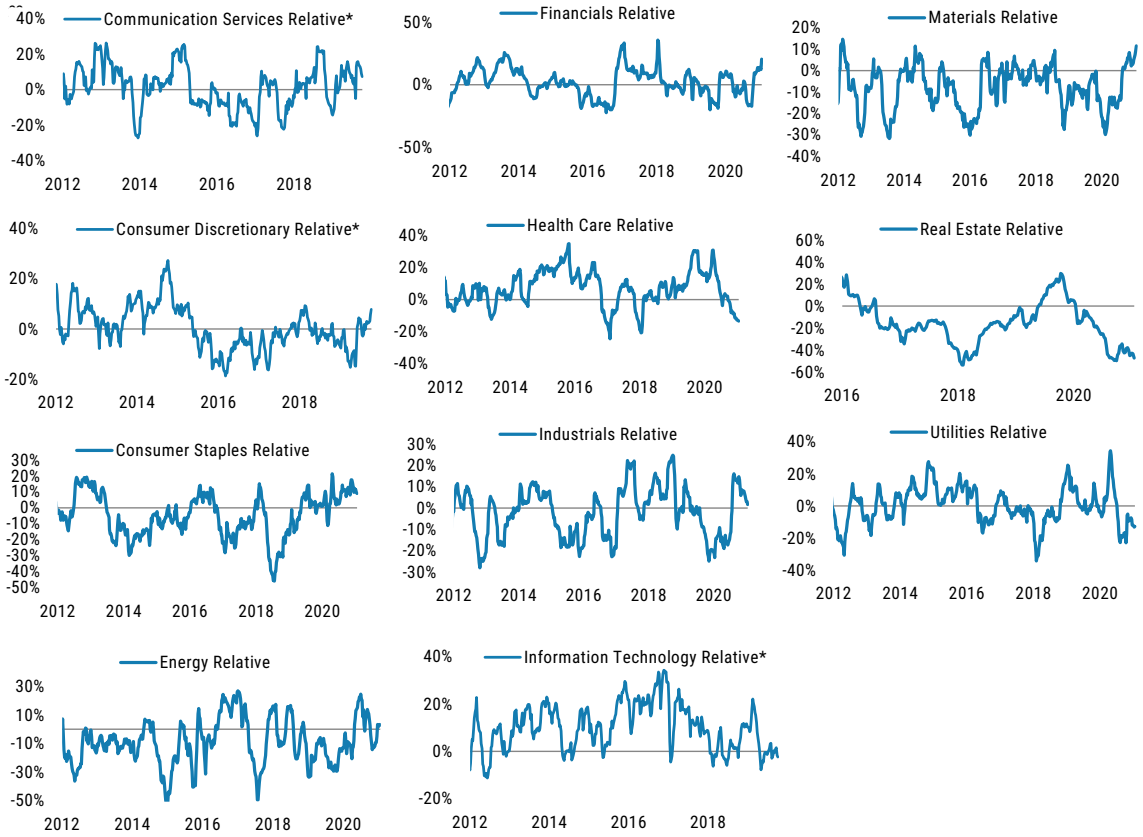
Source: Bloomberg, Morgan Stanley Research

Exhibit 21: Sector Ratings

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

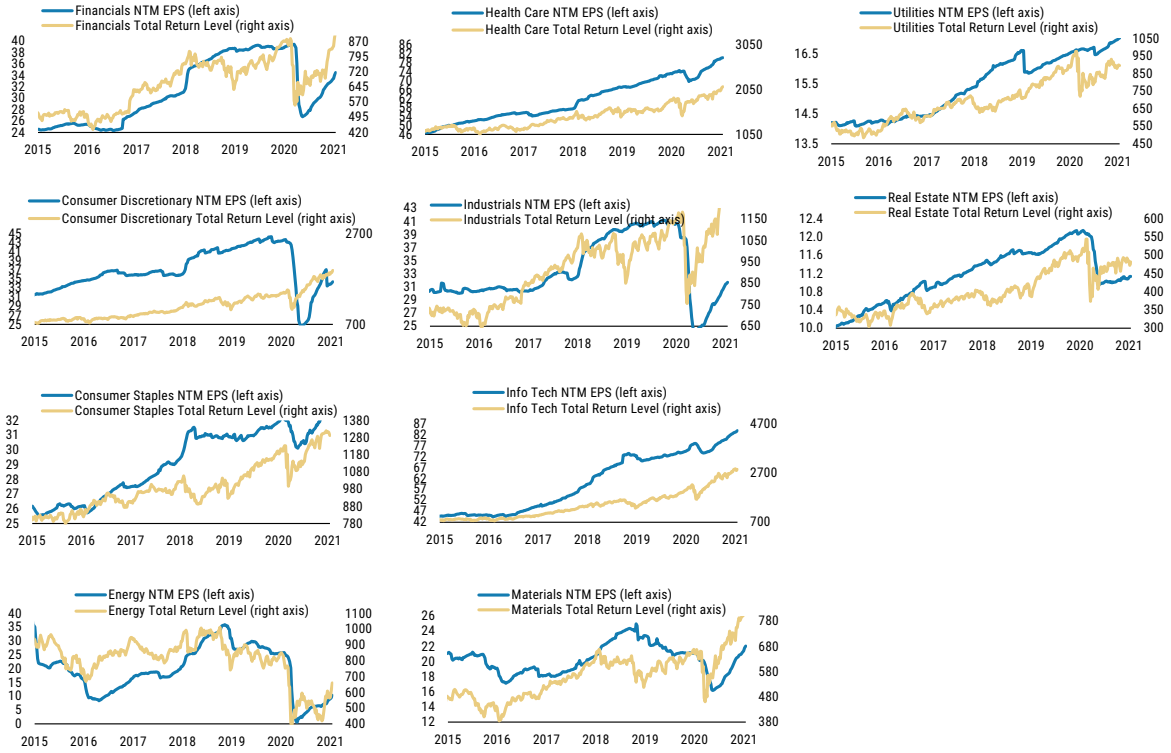
Source: Morgan Stanley Research

Exhibit 22: Earnings Revisions Breadth



Source: FactSet, Morgan Stanley Research. As of Jan 14, 2021. Sectors with * use current, fixed constituents.

Exhibit 23: US Sector NTM EPS vs. Total Return Level



Source: FactSet, Morgan Stanley Research as of Jan 14, 2021

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(as of December 31, 2020)

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STOCK RATING CATEGORY	COVERAGE UNIVERSE COUNT	COVERAGE UNIVERSE % OF TOTAL	INVESTMENT BANKING CLIENTS (IBC) COUNT	INVESTMENT BANKING CLIENTS (IBC) % OF TOTAL IBC	INVESTMENT BANKING CLIENTS (IBC) % OF RATING CATEGORY	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) COUNT	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) % OF TOTAL OTHER MISC
Overweight/Buy	**1450**	**42%**	**378**	**47%**	**26%**	**646**	**42%**
Equal-weight/Hold	**1449**	**42%**	**347**	**43%**	**24%**	**648**	**43%**
Not-Rated/Hold	**5**	**0%**	**1**	**0%**	**20%**	**4**	**0%**
Underweight/Sell	**521**	**15%**	**81**	**10%**	**16%**	**223**	**15%**
TOTAL	**3,425**		**807**			**1521**	

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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