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US Equity Strategy | North America

Weekly Warm Up: Don't Fear a Potential Recession; Embrace It

The S&P 500 reached our Bear Case (2400) late last year as we believe it embraced our earnings recession call. We expect upcoming negative data will prove 2600-2650 to be a good sale before a proper retest of the December lows. Wait for the retest and look to buy the cyclical.

We always expected the S&P 500 to visit the low end of our consolidation range (2400-3000); however, we thought it would be in 1Q2019, not at the end of 2018. While there was a confluence of technical factors that conspired to create one of the worst Decembers in history, we also think the market embraced our earnings recession call as earnings revision breadth rolled over. In short, the market is discounting our out of consensus views on growth and it may have even discounted a modest economic recession.

Could our earnings recession turn into an economic one? Risks are rising, and we don't have a crystal ball, but we also don't really care about such an outcome if it's already priced. A few metrics we like to look at—y/y change in the S&P 500, PMIs, market implied pace of rate hikes (MSPOKE Index), front-end of the yield curve, and the Fed's recession probability models—have all signaled elevated risk of an economic recession. From an equity perspective, we think a retest of the December lows driven by more earnings and economic data disappointments would seal the deal on our earnings recession call. We are equity strategists, not economists, and we've said all along that an earnings recession amounts to the same thing as an economic one for investors.

Momentum: Defensive skew sending same message as the index. The long side of 3, 6, and 12 month momentum is very crowded in Defensives, while the short side skews heavily toward Cyclical. The situation is especially concerning in short- and medium-term momentum strategies where nearly a fifth of the long side is in Staples, while nearly a third of the short side is in Energy. This is simply another example of the market anticipating the slowdown. Therefore, we want to buy Cyclical if the market retests the December lows when cries for recession are likely to be loud, and irrelevant.

We are seeing early signs that our margin thesis is playing out. 2019 EBIT margin estimates have contracted by ~50 basis points since the beginning of October 2018. This is the most significant negative revision during this period (beginning Oct.-beginning Jan.) since the Financial Crisis. Both sales growth and earnings growth estimates for 2019 have also come down materially in conjunction with this margin estimate de-rate. We expect margin pressure to be a pervasive theme throughout 2019.

MORGAN STANLEY & CO. LLC

Michael J Wilson
EQUITY STRATEGIST
M.Wilson@morganstanley.com +1 212 761-2532

Adam Virgadamo, CFA
EQUITY STRATEGIST
Adam.Virgadamo@morganstanley.com +1 212 761-1376

Andrew B Pauker
EQUITY STRATEGIST
Andrew.Pauker@morganstanley.com +1 212 761-1330

Michelle M. Weaver
EQUITY STRATEGIST
Michelle.M.Weaver@morganstanley.com +1 212 296-5254

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What to Focus on This Week

No More Swishes

Calling the market's direction this past year reminds us of one of the greatest commercials of all time - 1993's *The Showdown* - where Michael Jordan and Larry Bird compete to make a series of successively harder shots through a basketball hoop. Their final shot attempt is "off the expressway, over the river, off the billboard, through the window, off the wall, nothing but net." After making a series of accurate calls in 2018, we realize it's only going to get harder in 2019. As such, we aren't calling "swish" at this point and we'll be happy if we can hit the rim.

As noted last week, we think the market completed its de-risking of our concerns late last year; specifically, tighter financial conditions and an earnings recession in 2019. Some sectors and stocks have even discounted a full blown economic recession, in our view. The bond market also appears to be in agreement regarding these concerns, having removed any further hikes by the Fed this year according to our proprietary market implied pace of rate hikes indicator.

When we published our outlook for 2019 in late November, we fully expected the S&P 500 to hit our bear case of 2400 sometime in the first half of 2019. We did not expect it to occur before year end 2018. We thought the market would need to actually see the earnings and economic data disappointments before reaching 2400. However, a confluence of exogenous events--perceptions of Fed miscommunication, Government shut down, poor year end liquidity and performance pressure--conspired to take the stock market to valuations we hadn't see since the post-Brexit reaction in 2016, culminating in what the press called the "Christmas Eve Massacre." Initially, **it appeared as if equity markets sold off for technical reasons more than fundamental ones. However, on further inspection we think the market was simply pricing in the more growing risk of an earnings, and even an economic, recession. After all, if we could see that risk increasing, surely the market could too.**

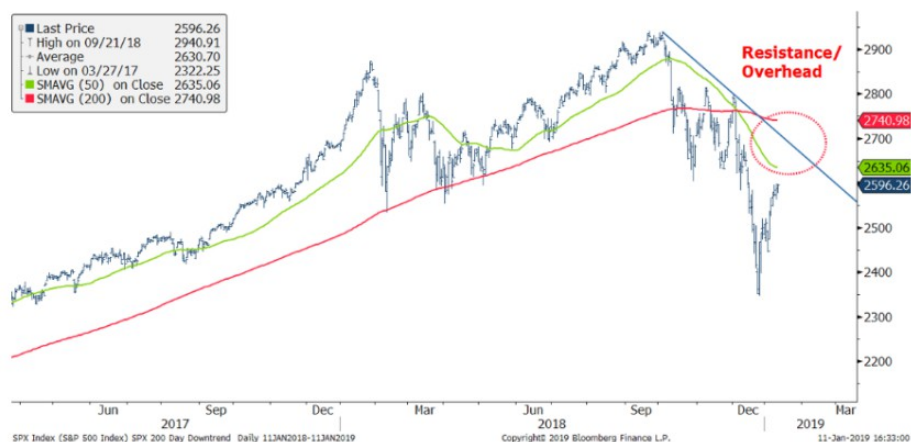
Sentiment and positioning also got washed out to levels we typically see during good buying opportunities. The issues we still need to deal with include the fact that we are in the midst of a fairly steep and broad negative earnings revision cycle, and there is significant technical resistance/overhead not far above current prices. From here, we think the risks are greatest at the stock level where either (1) valuations are still too high or (2) where earnings downside is even greater than what has been priced. **(We published a stock screen last week as an example of how to begin looking for stocks with elevated risk). As we deal with these issues during 4Q earnings season and perhaps see some further deterioration in US economic data, we think the S&P 500 will suffer a re-test of the lows we experienced in December, but on less negative momentum and better breadth.**

We've been vocal that we are aggressive buyers anytime we get near our bear case of 2400. So, **if we actually suffer the re-test we are expecting, we would be buyers of that**

almost regardless of what is going on, assuming it happens on less momentum and better breadth. We've also been advising clients to look at areas of the market that were hit the hardest and the earliest during last year's rolling bear market as a place to start. Our view is that we are likely to experience a rolling bottom as a prelude to the next bull market on a FIFO (first-in, first-out) basis. That means early cycle stocks and regions that tend to do well once a recession is priced.

To sum up, we think the broader market achieved our downside targets on valuation as well as on sentiment and positioning. However, the fundamentals remain murky at best with earnings visibility deteriorating and revisions decidedly negative at the moment. Economic data surprises have also turned negative and we think it could get worse in the near term, especially if the government shutdown persists. We are also wary of the significant overhead resistance created by the 4Q sell off, and the lack of a weekly positive divergence during the December capitulation ([Exhibit 1](#)). As such, **2600-2650 on the S&P 500 is a good level to start lightening up as we enter what is likely to be a period of negative news flow on earnings and the economy.**

Exhibit 1: Nearby Technical Resistance/Overhead Is Formidable. We Did Not Get a Weekly Positive Divergence on December Sell Off, Suggesting a Re-Test Coming.



Source: Bloomberg, Morgan Stanley Research

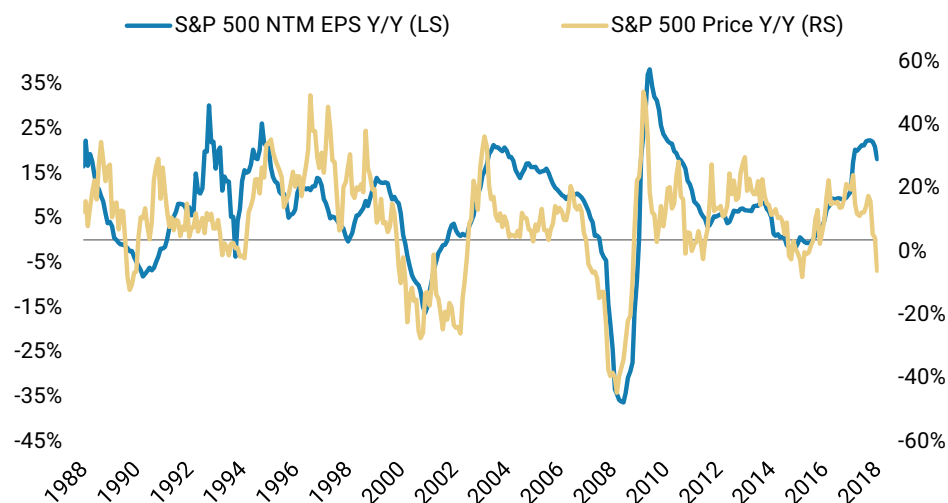
How Are Markets Discounting Recession Probabilities?

While clients are aware of our Earnings Recession call for 2019, many have been asking us what happens if this turns into a full blown economic recession? The honest answer is that we don't know, but we're not convinced the distinction is that important for investors. Below, we show a few charts we think suggest the markets have already priced further deterioration in the data, and possibly a shallow economic recession.

First, the sell off in December brought the S&P 500 down almost 10% on a y/y basis, a very rare occurrence and something that historically has happened only when there is either an earnings recession, an economic recession, or both. In 2001-02 and 2008-09, the decline was much more severe but those were recessions accompanied by either a valuation bubble (2001-02) or a financial crisis (2008-09), neither of which we would expect this time around. We would argue that the next recession, whenever it arrives, will likely be more like the 1990 episode, shallow and brief. As you can see in [Exhibit 2](#), the recent y/y decline in the S&P 500 is close to what we observed in 1990; and if we

get a full re-test and break as we expect in the next few months, it will likely be equivalent. In other words, between here and there, the S&P 500 would be pricing in our earnings recession and perhaps a shallow economic recession. Consistent with our 2019 earnings call, we are expecting the blue line in [Exhibit 2](#) (NTM EPS growth) to rapidly catch-up (to the downside) to the yellow line (price change) as markets lead the fundamentals. **We suspect such rapid decline in forward earnings will provide a reason for stocks to revisit the December lows, but of course, that's the trap and the time to buy, not sell.**

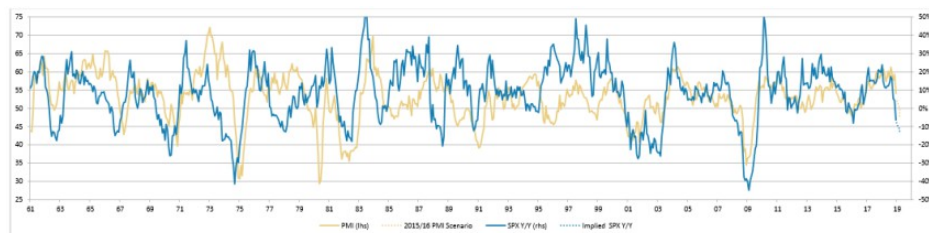
Exhibit 2: Recent Decline in the S&P 500 Suggests A Steep Fall in Earnings Growth Is Imminent



Source: Factset, Morgan Stanley Research

Second, the December manufacturing PMI showed the largest decline since 2008, the beginning of the last economic recession in the US. As noted last week, part of the reason why the S&P 500 sold off so sharply in November and December was that it anticipated the PMIs were about to roll. [Exhibit 3](#) below plots the S&P y/y vs. the ISM Manufacturing PMI and shows a pretty tightly linked relationship. In fact, based on the 10% y/y decline in the S&P 500 in December, we should expect a break of 50 on the downside for the Manufacturing PMI which implies an economy that is slowing and maybe even contracting--i.e., a recession. **Once again, such a collapse in the manufacturing PMI would provide another reason for the re-test of the lows and a time to buy, not sell.**

Exhibit 3: PMIs vs. S&P Y/Y - The December Lows Discount Some Contraction Readings



Source: Bloomberg, Morgan Stanley Research.

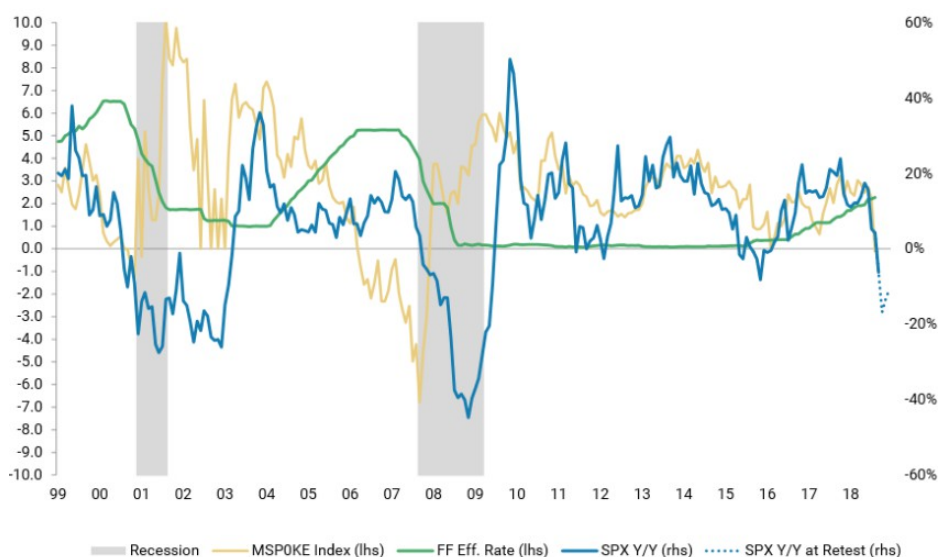
Fixed Income Markets - Likelihood of Rate Cuts and Front End of the Curve

In addition to equities, we are also paying attention to signals from fixed income markets. Specifically, the implied path of rate hikes/cuts and front end of the yield curve.

One of the more intuitive tools we have for looking at what fixed income markets are saying regarding the path for the Fed is **our Rates Strategy team's MSPOKE Index which simply shows the number of Fed hikes/cuts implied by the fixed income markets over the next twelve months (Exhibit 4).** Here too, we are currently testing the 2015/16 lows following one of the more rapid declines in the series. As recently as November, the market was pricing in 3 hikes and on January 3rd it was down to almost pricing in one full *cut* (difficult to see on monthly time series below). Looking at the S&P y/y vs. this index, we can see the track record is mixed - sometimes leading, sometimes coincident.

We would argue that much of the most recent drop in the MSPOKE was market and volatility driven--i.e. tightening financial conditions--which means there is a bit of circularity in this signal. If the fixed income market's read is that the Fed is reacting to lower equities and higher volatility, and if the Fed's subsequent dovish tone helps calm equity markets, does the rebound in equities then give the Fed room to become incrementally more hawkish? **Chair Powell's greater willingness to consider a pause in rate hikes and balance sheet reduction has undoubtedly helped to bring some stabilization to the markets including the expected path of rate hikes/cuts over the next 12 months. However, should the hard data deteriorate further, as we expect, we think the markets will quickly return to pricing in a recession and rate cuts much like it did at the end of the year and very early in 2019. In other words, a more dovish Fed likely can't prevent an earnings or economic recession at this point if the die has already been cast.**

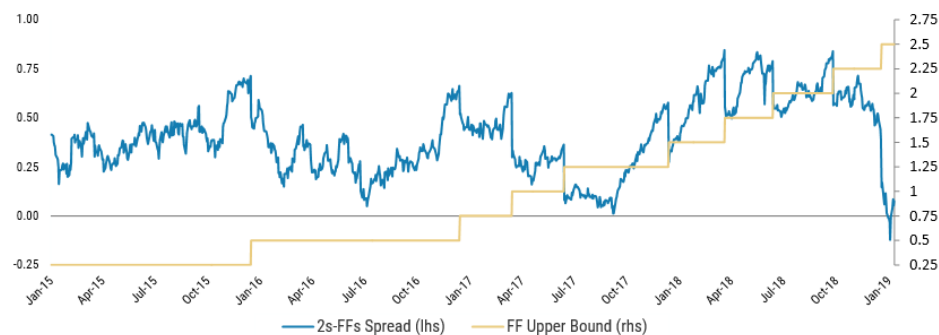
Exhibit 4: A Retest of S&P Lows Should More Than Match Fixed Income Market Bearishness



Source: Bloomberg, Morgan Stanley Research.

One of our other preferred signals is watching for inversion at the front end of the curve - the spread between the 2-year yield and the Fed Funds rate. Exhibit 5 shows this spread since the start of 2015. We prefer to focus on the short end of the curve because inversion here is a very strong signal from the bond market that over the next two years, the Fed Funds rate is moving lower. With every hike in the Fed Funds rate, the spread mechanically moves lower, but over the last two years, the spread has generally recovered to within a narrow range. With this last Fed hike, the spread plummeted and even saw a modest inversion for the first time since 2011--the last time we had a true economic recession scare. Though this part of the curve is (just barely) no longer inverted, the signal bears close watching.

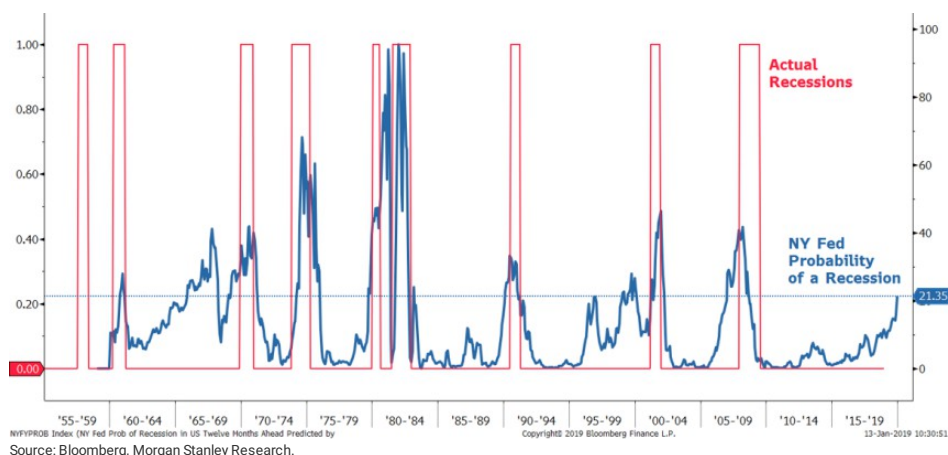
Exhibit 5: 2s - Fed Funds Spread Recovering Post Inversion, But Signal Getting Louder



Source: Bloomberg, Morgan Stanley Research.

Recession Probability Rising to Highest Levels Since the Crisis

A final metric we highlight here is the NY Fed's model showing the probability of recession in the next 12 months. As shown in Exhibit 6, this is hardly a precision instrument, but directionally, it does give some idea on when a cycle may be nearing its end. The metric has been on the rise for the last two years and now sits at post-crisis highs. The fact that this metric is higher than it was during the last earnings recession in 2015-16, suggests the risk of an economic recession this time around is greater and aligns with our view that the market's sell off in December was justified for fundamental reasons and there is a good chance we aren't out of the woods. **Including the most recent spike, this metric has reached a level this high 11 times going back to 1955. Only 3 (27%) of those occasions (1965, 1996, 1999) were associated with a false positive, while 8 (73%) led to a full blown economic recession.**

Exhibit 6: Recession Probability Risk Highest Since 2006. Only 27% Chance it's a False Positive

The bottom line for us is that we don't know if an economic recession is coming or not. However, that's not really the important question for investors. Our economics team has been much more bearish on US growth than the consensus and they are modeling a severe deceleration in US GDP growth from 4.2% in 2Q18 to 1% in 3Q19. While that's technically not a recession, that kind of deceleration will feel like a recession to the market and will help our earnings recession call come to fruition--which is really what matters to us, and the market. In other words, by the time investors figure out we are in a recession it may be too late to do anything about it and, quite frankly, it's more likely time to buy than sell. Investors need to anticipate rather than react.

Given the swift and steep decline in the stock market, the ISM, and the front end of the yield curve, we think the odds of an earnings *and* economic recession have increased materially. Once again, that's not really what's important. Instead, **focus on the fact that the market is discounting a real fall in earnings growth which now looks obvious even to the casual observer and the media. In that context, we think it's premature to blow the all clear whistle as earnings appear likely to come down sharply over the next month. As such, we want to wait for the re-test at which point the calls for recession will likely be louder, and irrelevant.**

Momentum Weights A Bit Unbalanced

This week, we take a look at the composition of 3, 6, and 12 month momentum strategies – the 3 and 6 month groups have no lag while the 12 month version has a 1 month lag. The tables below show sector weights for the different versions of momentum vs. market weight which is based off of the Russell 3000 ([Exhibit 7](#) and [Exhibit 8](#)).

Should it materialize by the end of 1Q, a short term cyclical bounce would likely cause a violent move in momentum: the long side of all versions of momentum is very crowded in Defensives while the short side skews heavily toward Cyclical. The situation is especially concerning in short and medium term momentum strategies where nearly a fifth of the long side is in Staples while nearly a third of the short side is Energy. Even if investors employ a sector cap in their strategy, those caps are likely "maxed" out on either side of the Cyclical/Defensive spectrum.

Sector and Industry Group Details

Over both the short and medium term, Consumer Staples is a massive overweight in long momentum (23.4% in 3 month and 18.8% in 6 month vs. a 6.5% weight in the Russell 3000). Utilities is very overweight over the short term and moderately overweight in the medium term (15.1% in 3 month and 5.3% in 6 month vs. a market weight of 3.2%). Energy is a huge underweight across all time horizons with near 0% weights. It is also a major component of the short momentum bucket; its weight is ~30% in 3 and 6 month momentum while it is 11% in 12 month momentum. Tech is also a substantial underweight across the board on the long side.

On the long side, Financials are very underweight over the long term and short term and are slightly underweight over the medium term. A lot of this has to do with banks; its weight is near zero across the different horizons. However, Financials have little representation on the short side and have not been among the worst performers.

Health Care is a very big component of long 6 and 12 month momentum (35% in 6 month and 25% in 12 month vs. a 15% weight in the Russell 3000). This overweight has been driven by Pharma, the most defensive part of the sector. Its weight has faded recently and is now just below market weight though Pharma is still overweight. If politicians focus on Health Care and drug pricing as a key issue in 2019 that could potentially create problems for healthcare stocks.

The dramatic skew toward defensively oriented sectors and stocks over the past 3-6 months is just another piece of evidence that the market is very nervous about growth. Once again, that is a good thing and supports our view that a lot of bad news has already been priced. Once again, as the hard data deteriorates and is explicitly revealed, we expect equity prices to revisit the December lows. As noted above, we want to buy that decline and we want to lean toward the more cyclical parts of the market and lighten up on the defensive areas. We think the relative outperformance of cyclicals versus defensives during the most recent rally is indicative of this underlying momentum shift. On that note, we would not be chasing cyclicals here because they have bounced too much near term and are likely to underperform on a re-test of the broader equity market.

Exhibit 7: Long Momentum Composition by Time Horizon

Long Momentum				
Sector	3 Month	6 Month	12 Month	Market Weight
Communication Services	8.4%	5.8%	13.1%	9.3%
Consumer Discretionary	11.6%	8.5%	38.2%	10.6%
Consumer Staples	23.4%	18.8%	3.4%	6.5%
Energy	0.2%	0.0%	0.5%	5.2%
Financials	4.3%	12.6%	0.8%	13.8%
Health Care	14.2%	35.0%	24.9%	14.8%
Industrials	2.4%	3.2%	2.8%	10.0%
Information Technology	11.3%	6.9%	14.6%	19.7%
Materials	1.0%	0.7%	0.5%	3.0%
Real Estate	8.1%	3.2%	0.4%	3.8%
Utilities	15.1%	5.3%	0.8%	3.2%

Overweight: Underweight:

Source: Bloomberg, Morgan Stanley Research. *Note, Amazon's presence in 12 month momentum skews Discretionary's weight higher.

Exhibit 8: Short Momentum Composition by Time Horizon

Sector	Short Momentum			Market Weight
	3 Month	6 Month	12 Month	
Communication Services	9.0%	9.1%	2.8%	9.3%
Consumer Discretionary	10.3%	11.8%	14.9%	10.6%
Consumer Staples	2.9%	2.5%	9.3%	6.5%
Energy	30.6%	28.3%	11.2%	5.2%
Financials	2.6%	2.0%	9.9%	13.8%
Health Care	10.9%	8.6%	14.1%	14.8%
Industrials	8.3%	12.1%	16.1%	10.0%
Information Technology	22.0%	17.7%	13.9%	19.7%
Materials	2.2%	4.6%	4.5%	3.0%
Real Estate	0.2%	2.2%	0.8%	3.8%
Utilities	1.1%	1.0%	2.7%	3.2%

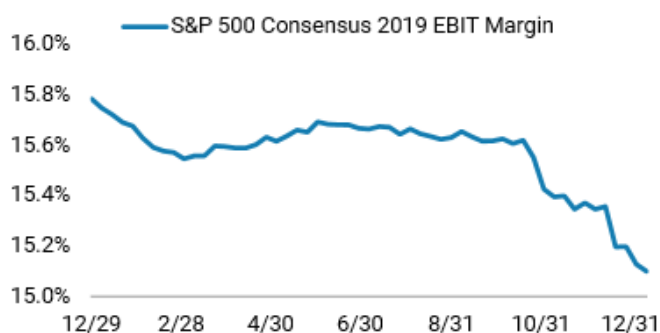
Overweight:

Underweight:

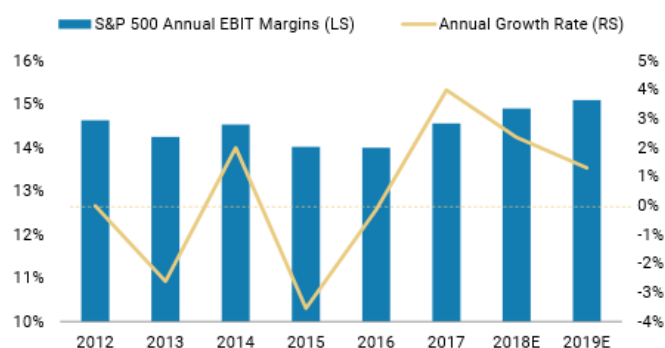
Source: Bloomberg, Morgan Stanley Research

Margin Estimates Are Deteriorating

In [No Margin for Error](#) (October 11, 2018), we laid out the case for operating margin deterioration in 2019 as macro cost pressures build and demand slows. We viewed 2019 consensus EBIT margin estimates as being overly optimistic and expected downward revisions to occur. As [Exhibit 9](#) shows, **EBIT margin estimates have declined by ~50 basis points since the beginning of October 2018** (when 3Q earnings season began in earnest). Expectations for 2019 operating margins are now just slightly higher vs. 2018 margins ([Exhibit 10](#)). We view this as a positive development and it helps set the stage for a more durable low when we re-test the lows.

Exhibit 9: 2019 EBIT Margin Estimates Have Declined Materially Since Early October

Source: FactSet, Morgan Stanley Research as of January 9, 2019.

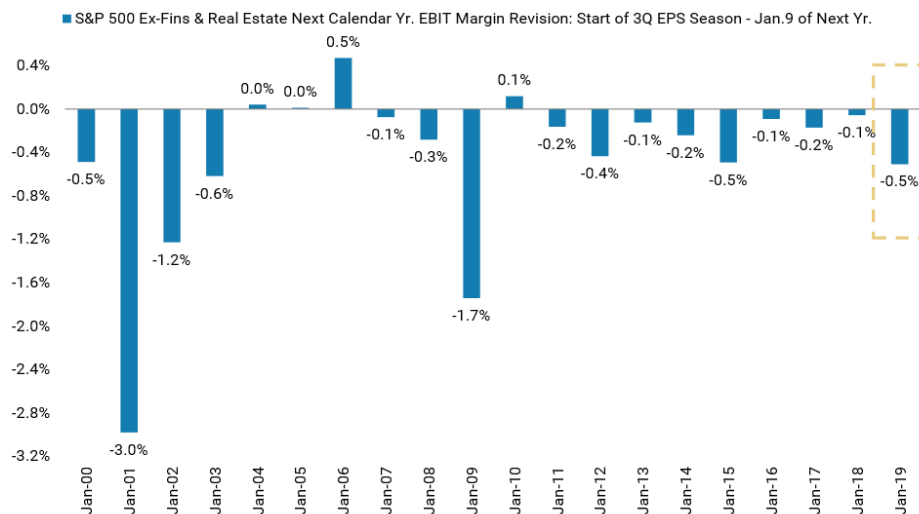
Exhibit 10: 2019 EBIT Margin Estimates Now Expected to be Just Slightly Higher Vs. 2018

Source: FactSet, Morgan Stanley Research as of January 9, 2019.

[Exhibit 11](#) shows that **this downward revision in margin estimates is the most significant since the Financial Crisis**. While this decline has been severe, we expect further cuts from analysts as we receive full year guidance from companies during 4Q earnings season. This dynamic of rolling margin/EPS estimate cuts should continue throughout 2019—a typical development during earnings contractions. As [Exhibit 12](#) illustrates, the cut to EBIT margin estimates since early October has been largely driven by Energy, Communication Services and Tech. Within Communication Services, negative revisions

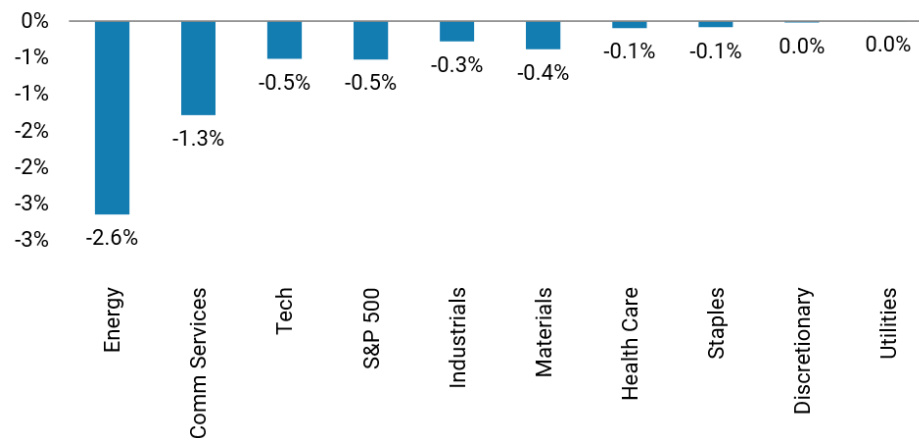
were concentrated in the Tech-oriented stocks as opposed to the Media-oriented ones. Once again, such a speedy decline in these estimates is a good thing and we would compare it to ripping off a bandage. It's better to just get it over with.

Exhibit 11: The Negative Revision in Next Calendar Year EBIT Margins We Have Seen Since Early October Is the Worst Since the Financial Crisis



Source: FactSet, Morgan Stanley Research as of January 9, 2019.

Exhibit 12: This Negative Revision Has Been Driven by Energy, Comm Services, and Tech
2019 EBIT Margin % Change from Start of 3Q EPS Season - Today



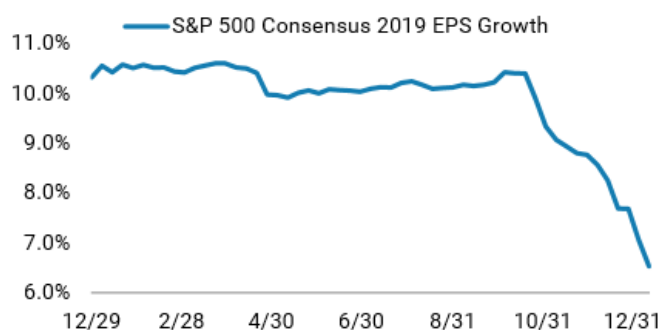
Source: FactSet, Morgan Stanley Research as of January 9, 2019.

This downward revision in margins has coincided with a downward revision in EPS growth from 10.4% at the start of October to 6.5% today (Exhibit 13). Sales growth estimates for 2019 have also declined since the start of 3Q earnings season (Exhibit 14). However, as recently as two weeks ago, they were still flat relative to where they were at the start of 2018. In conjunction with our bearish margin call, we have been highly skeptical that sales growth could rise at a mid single digit clip in 2019 given that our economists have called for US GDP growth to slow so meaningfully in 2019 as already discussed above.

As Exhibit 14 shows, sales growth estimates took another leg down since the beginning of January 2019. A big driver here was Apple's guidance cut (2019 sales growth expectations went from 4.5% on Jan. 2 to -2.3% on Jan. 10). **We are doubtful that AAPL's**

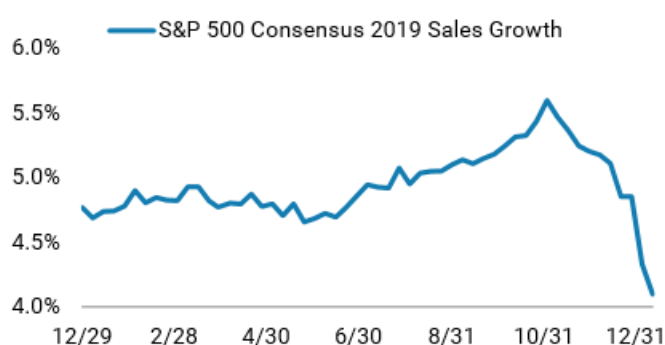
cut is an isolated incident given our pessimistic view on demand and margins for 2019. Thus, we would expect negative guidance revisions to be a persistent theme during 4Q earnings season. We would expect AAPL-like price reactions to guidance cuts in stocks where relative valuations remain elevated vs. history (i.e., a cyclical slowdown is not priced). Many of these equities are concentrated in Tech, Comm Services and pockets of Consumer Discretionary. Exhibit 15 and Exhibit 16 show the sector-level drivers of 2019 EPS and sales growth revisions since the start of 3Q earnings season. Energy, Comm Services and Tech have been negative drivers of the '19 earnings growth estimate. Energy, Tech and Financials have been negative drivers of the 2019 sales growth estimate.

Exhibit 13: Downward EBIT Revisions Have Coincided with Downward EPS Revisions



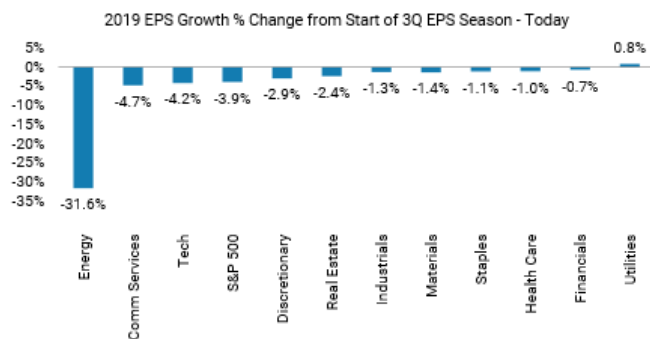
Source: FactSet, Morgan Stanley Research as of January 9, 2019.

Exhibit 14: Negative Sales Growth Revisions Have Accelerated Recently



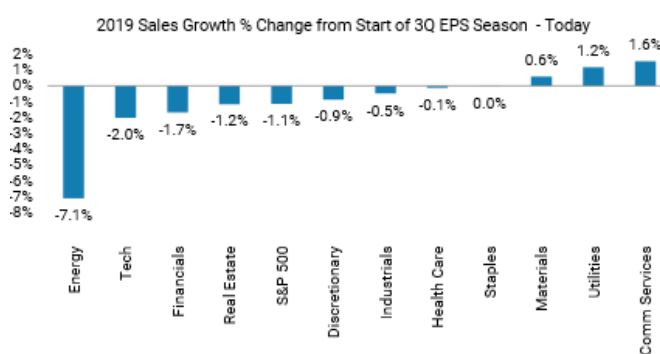
Source: FactSet, Morgan Stanley Research as of January 9, 2019.

Exhibit 15: Energy, Comm Services and Tech Also Driving Downward EPS Revision Story



Source: FactSet, Morgan Stanley Research as of January 11, 2019.

Exhibit 16: Energy, Tech and Financials Fueling Downward Sales Growth Revision Story



Source: FactSet, Morgan Stanley Research as of January 11, 2019.

Note: Slight adjustments were made to constituents due to mergers since we previously published margin charts. As a result, absolute margin levels are slightly different.

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](#).

Exhibit 17: Fresh Money Buy List - Stats and Performance

Company Name	Ticker	MS Analyst Rating	Sector	Market Cap (\$Bn)	Price	MS PT	% to MS PT	MS Analyst	Date Added	Total Return Since Inclusion	
										Absolute	Rel. to S&P
Walt Disney Co	DIS	Overweight	Communication Services	\$168.3	\$112.65	\$135.00	20%	Swinburne, Benjamin	3/14/2018	10.3%	14.9%
Humana Inc	HUM	Overweight	Health Care	\$39.2	\$283.47	\$418.00	47%	Sopcak, Zack	7/19/2018	(10.3%)	(3.4%)
Iqvia Holdings Inc	IQV	Overweight	Health Care	\$25.4	\$122.81	\$145.00	18%	Goldwasser, Ricky	3/14/2018	16.2%	20.8%
LyondellBasell Industries N.V.	LYB	++	Materials	\$33.9	\$86.00	++	++	Andrews, Vincent	3/14/2018	(19.8%)	(15.2%)
Microsoft	MSFT	Overweight	Information Technology	\$799.1	\$102.80	\$130.00	26%	Weiss, Keith	3/14/2018	10.3%	14.8%
NextEra Energy Inc	NEE	Overweight	Utilities	\$84.8	\$175.71	\$184.00	5%	Byrd, Stephen	3/14/2018	15.9%	20.4%
Occidental Petroleum Corp	OXY	Overweight	Energy	\$50.1	\$66.22	\$73.00	10%	McDermott, Devin	7/19/2018	(18.4%)	(11.5%)
Progressive Corp	PGR	Overweight	Financials	\$36.2	\$61.68	\$84.00	36%	Pan, Kai	12/3/2018	(7.0%)	(1.2%)
T-Mobile US, Inc.	TMUS	++	Communication Services	\$59.01	\$69.00	++	++	Flannery, Simon	3/14/2018	6.2%	10.8%
Current List Performance											
Average (Eq. Weight)				\$144.0			23%			0.4%	5.6%
Median				\$50.1			20%			6.2%	10.8%
% Positive Returns (Abs. / Rel.)										56%	56%
% Negative Returns (Abs. / Rel.)										44%	44%
Avg. Hold Period (Months)											8.2
All Time List Performance											
Average (Eq. Weight)										(1.5%)	1.5%
Median										(4.6%)	(1.2%)
% Positive Returns (Abs. / Rel.)										46%	46%
% Negative Returns (Abs. / Rel.)										54%	54%
Avg. Hold Period (Months)											7.7

++ Rating and other information has been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time.

Performance returns shown above 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.

Microsoft (MSFT), Keith Weiss

- **CIO Survey Gives Confidence Secular Can Trump the Cyclical at Microsoft** - Our 4Q18 AlphaWise CIO Survey shows impressive spending intentions for Microsoft's cloud and on-premise solutions, with CIOs' expectations for on-premise server products improved vs. prior surveys and Microsoft well positioned to garner IT budget share with shift to Public Cloud. Reiterate OW.

NextEra Energy (NEE), Stephen Byrd

- **2019 Outlook: Investor Feedback on our Views** - We highlighted NEE as a potential beneficiary in the event of a market downturn, as well as offering strong growth prospects at reasonable valuations. We found that investors are concerned about longer-term wind market growth for NEE particularly in light of the stock's premium valuation. We believe the market under-appreciates the magnitude of future US wind growth, given significant improvement in wind turbine technology, and we believe NEE will continue to be the leader in generating significant shareholder value from wind project development.
- **Monthly Meter Reading** - Price target lowered to \$184 from \$194 as MS coverage

multiples were marked to market.

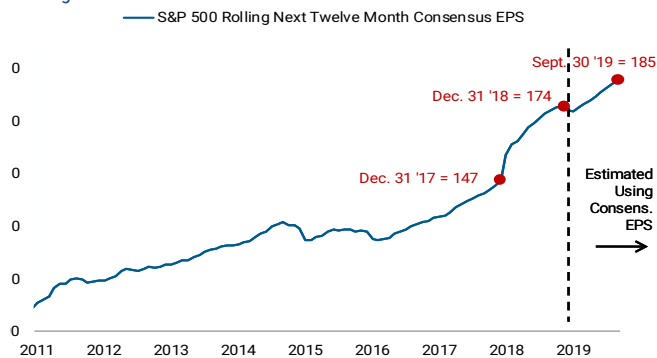
T-Mobile US (TMUS), Simon Flannery

- **T-Mobile Prereleases Strong 4Q Subscriber Performance** - T-Mobile prereleased 4Q18 subscriber results that were ahead of expectations. The 2.4m net adds were the highest in T-Mobile's history, while the 1.4m postpaid net adds was the best 4Q ever, and the 1.0m phone net adds was the best 4Q performance in four years. Importantly, postpaid phone churn (0.99%) was down 19 bps Y/Y, and below 1.0% for the second time this year, and 5 bps better than consensus (1.04%).

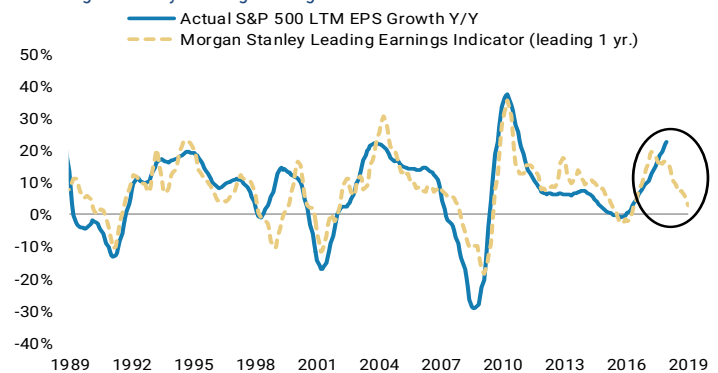
Weekly Charts to Watch

Exhibit 18: Four Charts to Focus On

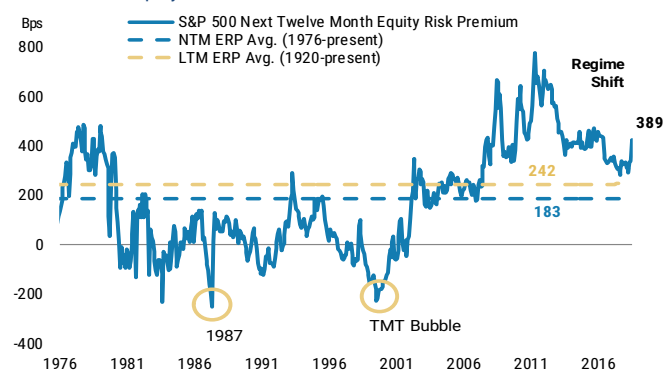
Rolling NTM EPS



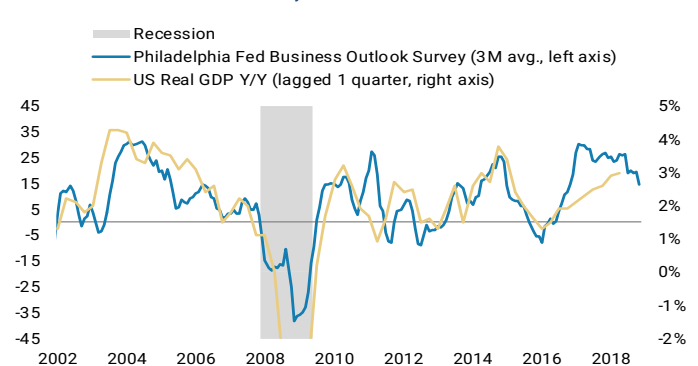
Morgan Stanley Leading Earnings Indicator



S&P 500 NTM Equity Risk Premium



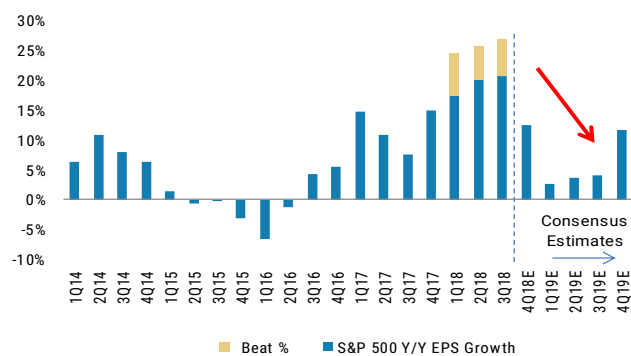
Phil. Fed Business Outlook Survey Leads Real GDP Growth



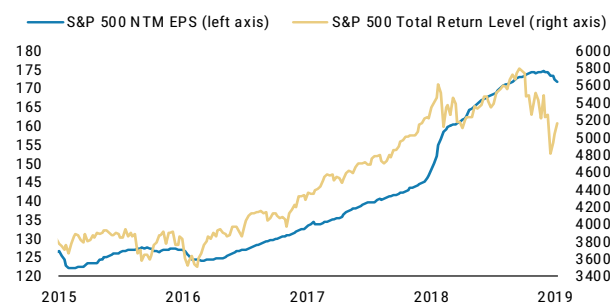
Source: FactSet, Bloomberg, Robert Shiller, Morgan Stanley Research. Top two and bottom right: As of December 31, 2018. Bottom left: As of January 10, 2019. MS Leading Earnings Indicator is a macro factor based earnings model that leads actual earnings growth by one year with a 0.7 12-month leading correlation. 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 19: US Earnings Snapshot

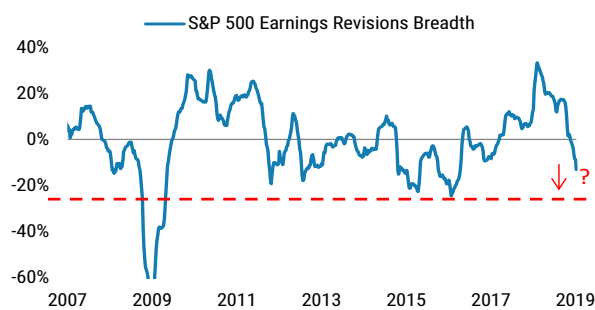
S&P 500 Y/Y EPS Growth



S&P 500 NTM EPS vs. Total Return Level



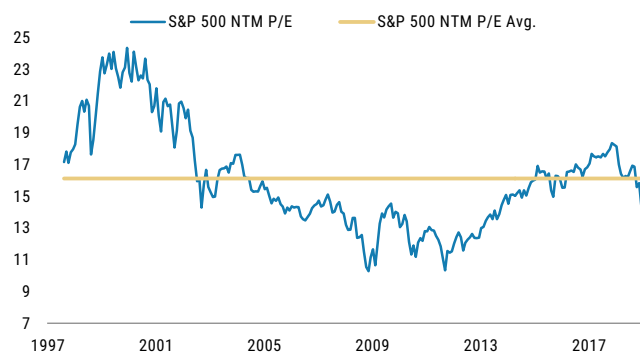
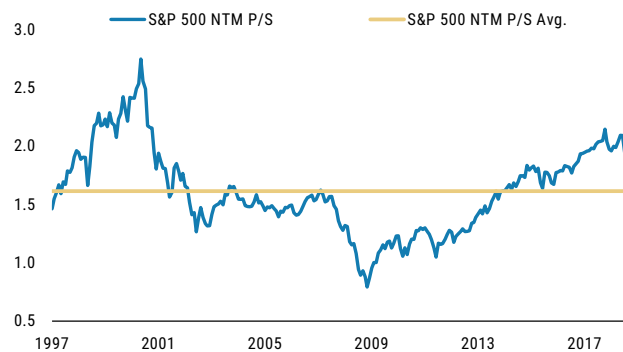
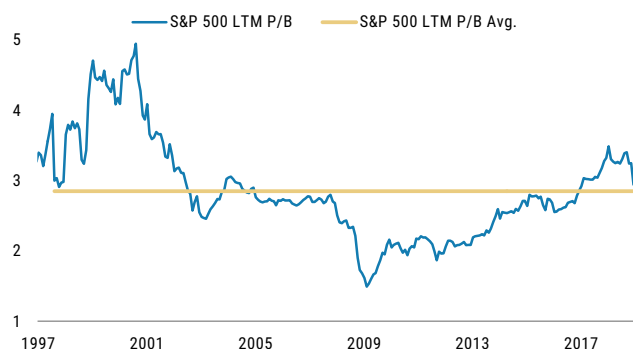
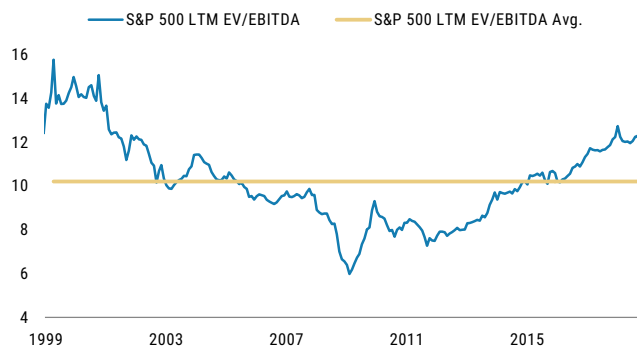
S&P 500 Earnings Revisions Breadth



S&P 500 Earnings Revisions Breadth

Sector/Index	Current NTM EPS Revisions Vs. Prior Periods			
	3/31/2017	6/30/2017	9/30/2017	12/31/2017
S&P 500	27.6%	23.6%	21.2%	17.0%
Comm Services	29.7%	28.9%	24.9%	21.8%
Consumer Discretionary	22.7%	20.0%	20.2%	20.0%
Consumer Staples	12.2%	9.9%	7.2%	5.3%
Energy	50.3%	47.5%	59.7%	32.7%
Financials	32.1%	28.3%	25.8%	20.2%
Health Care	23.9%	21.0%	18.3%	17.1%
Industrials	28.6%	21.8%	20.5%	22.7%
Info Tech	30.7%	24.3%	19.3%	12.0%
Materials	28.3%	23.8%	19.9%	13.4%
Utilities	13.4%	11.3%	9.4%	7.9%
Real Estate	6.4%	4.8%	3.3%	2.1%

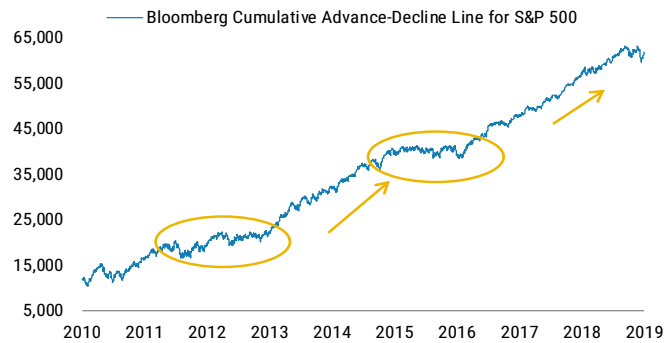
Source: Thomson Financial, FactSet, Morgan Stanley Research. Top: L: As of January 11, 2019 R: As of January 3, 2019 Bottom: L: As of January 9, 2019. R: As of January 10, 2019.

Exhibit 20: US Equity Market Traditional Valuation Measures
S&P 500 NTM P/E

S&P 500 NTM P/S

S&P 500 LTM P/B

S&P 500 LTM EV/EBITDA


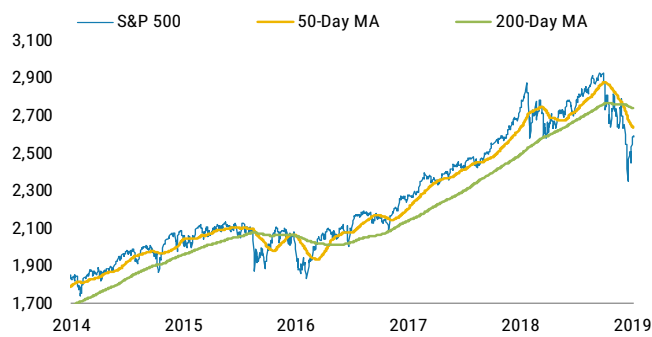
Source: FactSet, Morgan Stanley Research as of December 31, 2018. Monthly Data. Note: S&P 500 fundamental data used post March 1993; Top 500 by market cap data used before 1993.

Exhibit 21: US Equity Market Technicals and Financial Conditions

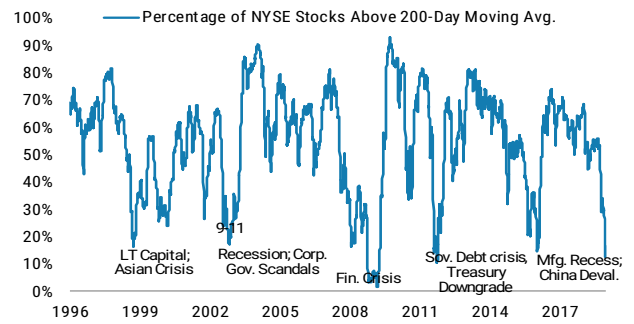
S&P 500 Cumulative Advance-Dcline



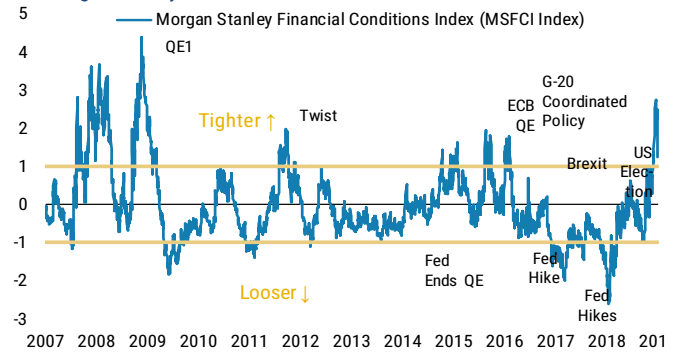
S&P 500 with Moving Averages



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

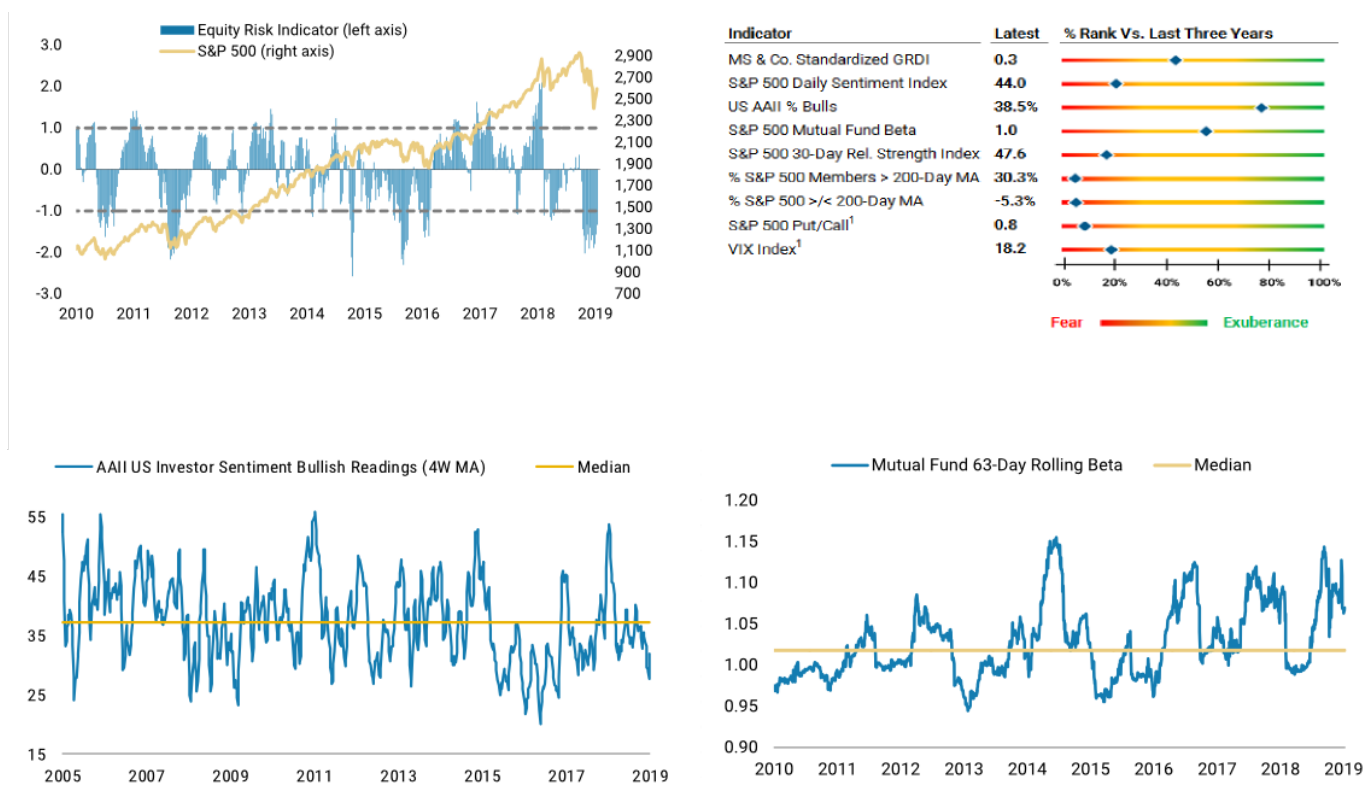


Morgan Stanley Financial Conditions Index



Source: Bloomberg, Morgan Stanley Research. All: As of January 10, 2019

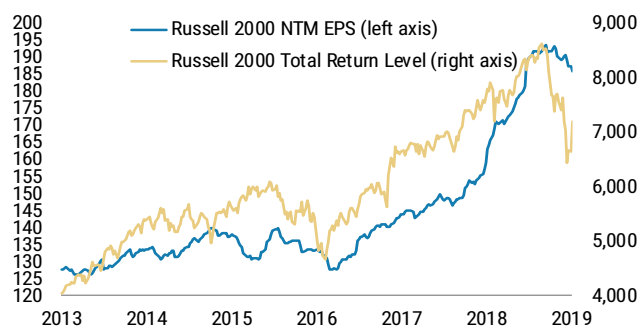
Exhibit 22: US Equity Market Sentiment



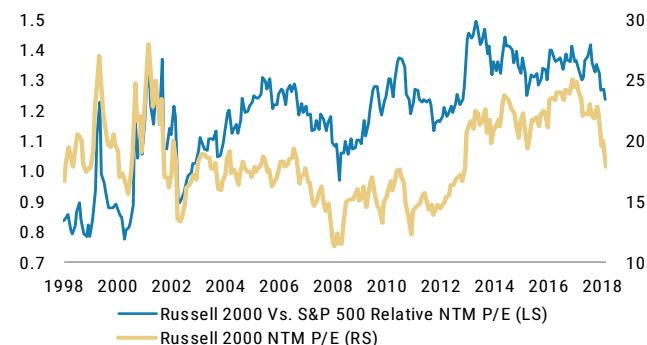
Source: Bloomberg, Factset, Morgan Stanley Research. As of January 11, 2019.

Exhibit 23: US Small Cap Equities

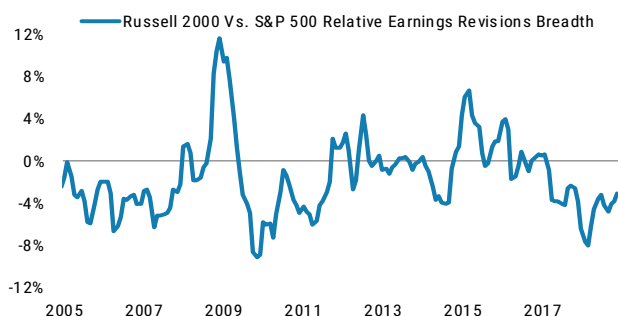
Russell 2000 NTM EPS vs. Total Return Level



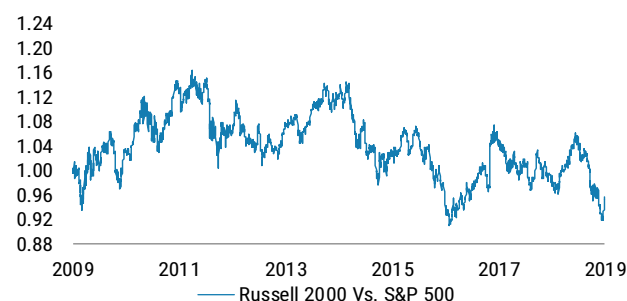
Russell 2000 NTM P/E and Relative NTM P/E vs. S&P 500



Russell 2000 Relative Earnings Revisions Breadth



Russell 2000 Relative Performance vs. S&P 500



Source: Factset, Morgan Stanley Research. Top Right and Bottom Left: As of December 31, 2018. Top Left and Bottom Right: As of January 10, 2019.

Exhibit 24: We Have a Year End 2019 Price Target of \$2,750

Morgan Stanley S&P 500 Price Target: Year End 2019

Landscape	Earnings	Multiple	Price Target	Upside / Downside
Bull Case	\$185	16.0x	3,000	15.5%
Base Case	\$176	15.5x	2,750	5.9%
Bear Case	\$161	15.0x	2,400	-7.6%

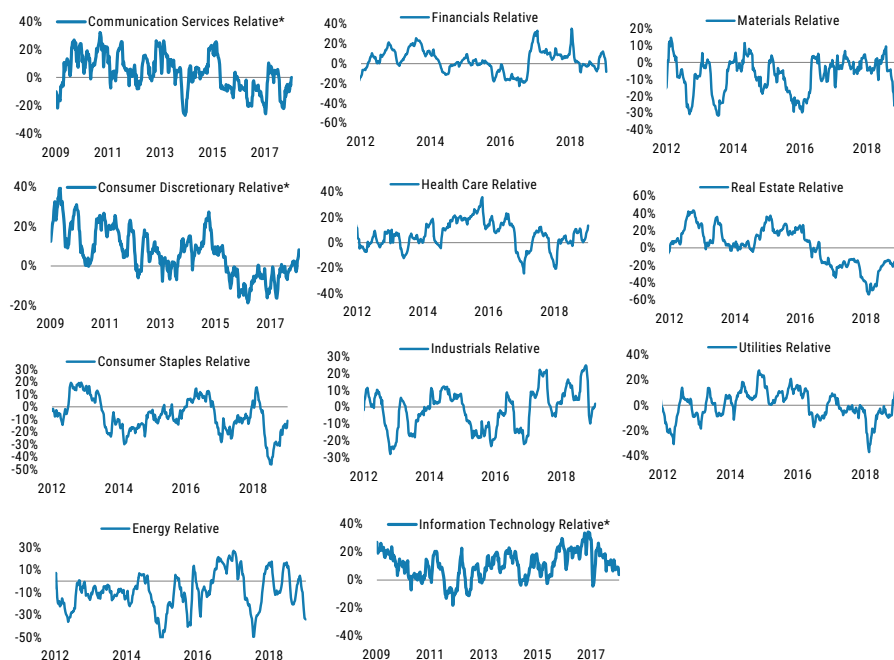
Current S&P 500 Price as of: 1/10/2019 2,597

Source: Morgan Stanley Research

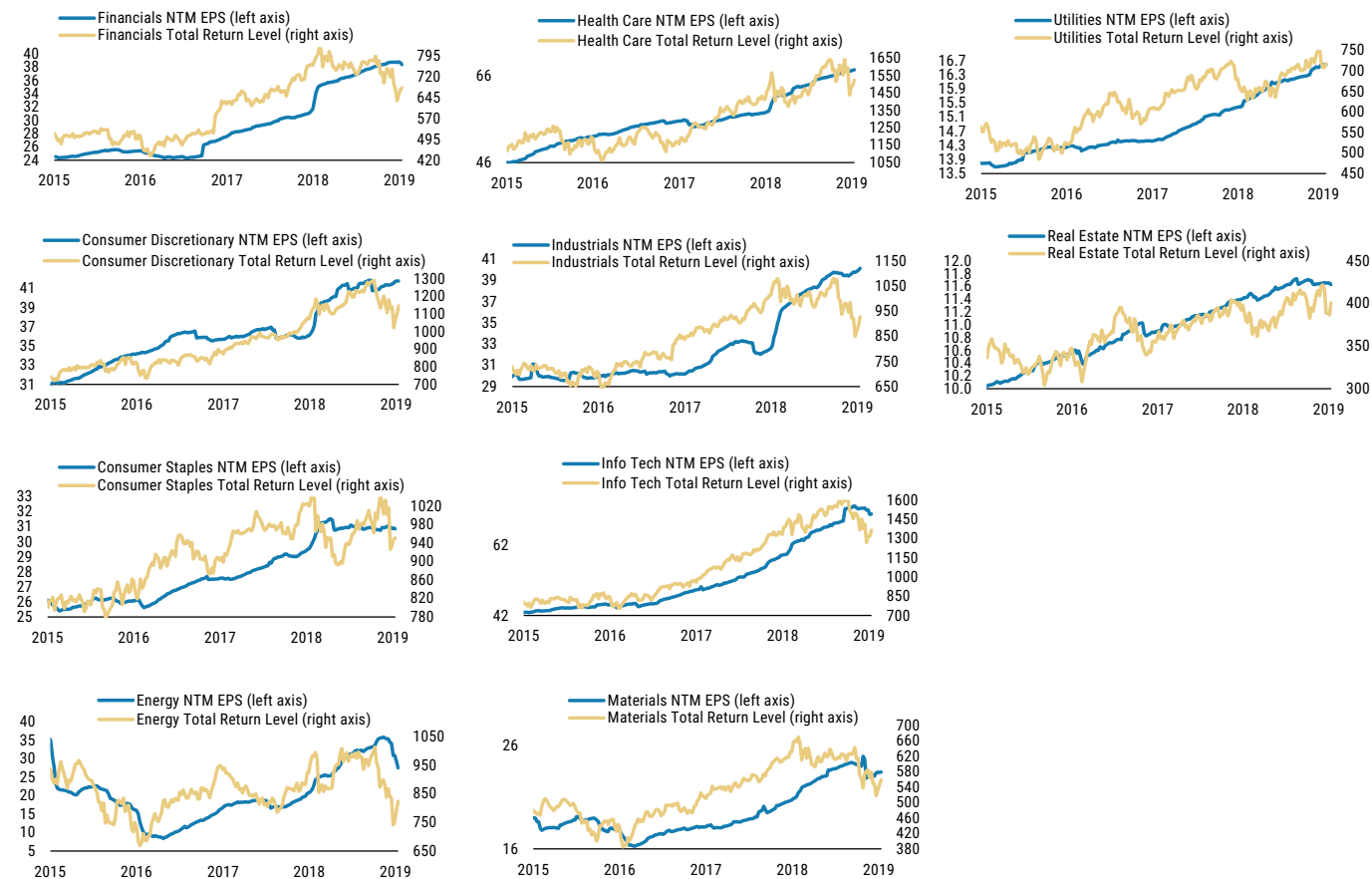
Exhibit 25: Sector Recommendations

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

Source: Morgan Stanley Research

Exhibit 26: Earnings Revisions Breadth

Source: Factset, Morgan Stanley Research. As of January 9, 2019. Sectors with * use current, fixed constituents.

Exhibit 27: US Sector NTM EPS vs. Total Return Level


Source: FactSet, Morgan Stanley Research as of January 10, 2019.

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(as of December 31, 2018)

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	COUNT	% OF TOTAL	COUNT	% OF TOTAL IBC	% OF RATING CATEGORY	COUNT	% OF TOTAL OTHER MSC
Overweight/Buy	1143	36%	282	40%	25%	540	38%
Equal-weight/Hold	1428	45%	336	47%	24%	651	46%
Not-Rated/Hold	46	1%	6	1%	13%	6	0%
Underweight/Sell	566	18%	86	12%	15%	232	16%
TOTAL	3,183		710			1429	

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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