Morgan Stanley | RESEARCH

UPDATE

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US Equity Strategy | North America

Weekly Warm Up: Back to Reality; Trade "Truce" Changes Very Little; Overpaying for Growth Still the Biggest Risk

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With last week's trade negotiation behind us, we fail to see any meaningful impact on the real economy in the near term and the result may even exacerbate real risks around inventory draw & labor. Friday should mark near-term highs for indices. Meanwhile, growth stocks are not delivering.

We are underwhelmed by what has been called a Phase 1 trade deal with China by the US administration. The bottom line for us is that without a significant roll-back of *existing* tariffs, we don't see how a "mini-deal" will change the currently negative trajectory of growth in both the economy and earnings. In fact, we have long held the view that the *threat* of a deal has been keeping fundamental investors from selling bad news for fear of missing out on a trade deal rally.

We continue to think our original thesis from over 18 months ago holds true—that the fiscal stimulus in the US would lead to a classic boom/bust cycle that must now complete itself. To recall, the fiscal stimulus was enacted at a time when the US economy was finally reaching escape velocity, we were at full employment, and companies were beginning to invest in a healthy manner. The tax cuts then created excesses that would ultimately need to be wrung out.

The extreme two-day rally in global stocks and sell-off in rates came with a noticeable shift in leadership toward the more cyclical parts of the equity market. Specifically, long momentum stocks in the US underperformed short momentum stocks by 2.68%, reminiscent of what we witnessed during the momentum breakdown in September. If such a pattern persists, it could be quite painful to many active and passive equity strategies, which ultimately will weigh on risk taking, in our view.

We characterize the Phase 1 agreement as more of a "truce" than a deal of notable significance. We would also point out that Friday's price action was strikingly similar to what we experienced the last time we had a trade truce on December 1, 2018, at the G-20 meeting in Argentina. The next trading day on December 3 saw a big gap open that faded into the close. What followed was the market slide. We fully expect Friday to mark the near-term highs and the next few weeks/month to resemble what we saw last December, albeit less dramatic given the lower interest rates and easier monetary policy that now prevails.

What to Focus on This Week

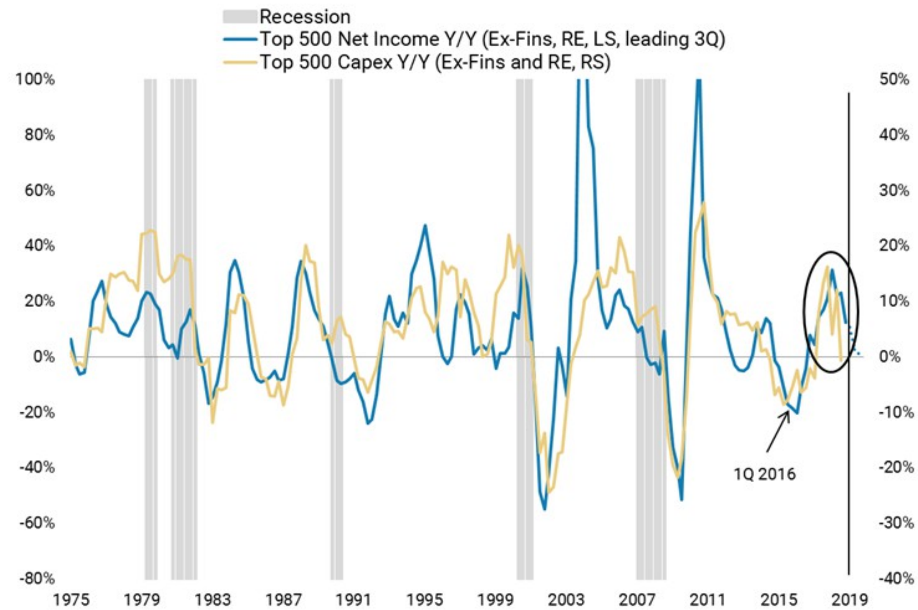
Back to Reality

It will probably come as little surprise to readers that we were underwhelmed by what has been called a Phase 1 trade deal with China by the US administration. The bottom line for us is that without a significant roll-back of *existing* tariffs, we don't see how a "mini-deal" will change the currently negative trajectory of growth in both the economy and earnings. In fact, we have long held the view that the *threat* of a deal has been keeping fundamental investors from selling for fear of missing out on a trade deal rally.

It is not so much that we think a trade truce is not an incremental positive, we just don't think trade has been the primary driver of the slowdown experienced over the past year, as many others seem to believe. Instead, we continue to think our original thesis from over 18 months ago holds true—that the fiscal stimulus in the US would lead to a classic boom/bust cycle that must now complete itself. To recall, the fiscal stimulus was enacted at a time when the US economy was finally reaching escape velocity, we were at full employment and companies were beginning to invest in a healthy manner. The tax cuts then created excesses that would ultimately need to be wrung out.

First is capex. Most people assume capex has slowed this year because of trade uncertainty but our view has always been that capex would disappoint this year because companies overspent last year with their windfall profits and overseas cash repatriation. To prove our point that capex is right on schedule with our view, we note that capex has tracked earnings growth very closely over the past 20 years and appears to be doing that again as our earnings recession call plays out (Exhibit 1).

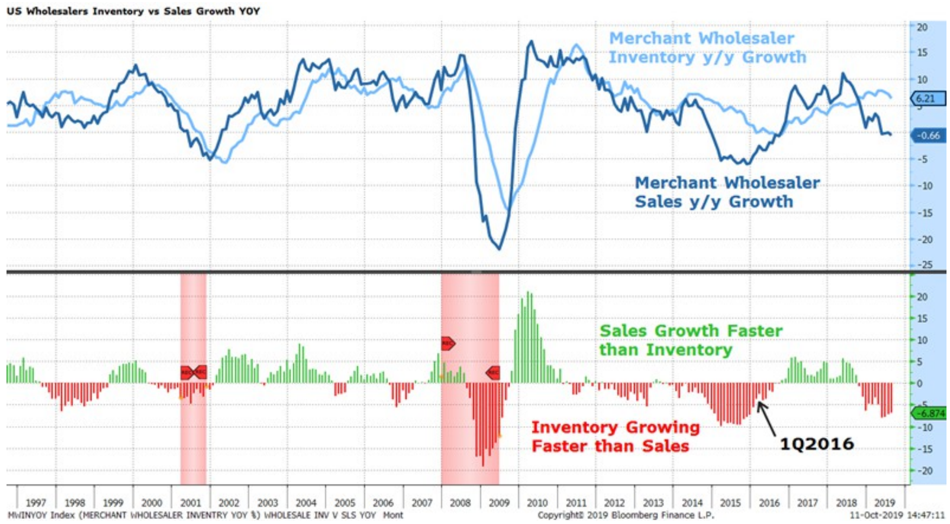
Exhibit 1: Capex Growth Follows Earnings Growth - A Trade Deal Won't Change This Trend



Source: Factset, Morgan Stanley Research. As of 1Q19. Note: The dotted line projection is a linear trend line to 0% net income growth which reflects the output from our leading earnings indicator for the S&P 500 which does include financials and RE.

Second is inventories. When economic activity heats up above trend, companies tend to over order for fear of not having enough product on hand. There is nothing worse than to make a sale and not have the product to deliver. **Given how fast the US economy accelerated last year, there is little doubt we saw double ordering of many items, which of course ended up in inventory when demand slowed from the stimulus-induced levels.** Based on the latest wholesale inventory and sales data from this past week, one can see we are far from completing this inventory cycle by looking at the spread between sales and inventory growth (Exhibit 2). The red bars suggests we are still many months away from where we were in 1Q2016, the last time we had an inventory correction of this magnitude and when markets bottomed. In our view, order rates are likely to remain below sales levels for 3-6 more months given wholesaler sales growth is already at zero. **We also note that trade has likely inspired some companies to hold more inventory than normal due to the risk that tariffs may be increased further. Ironically, a trade deal may actually reduce the desire to hold more inventory now that this risk has diminished.** Look for an acceleration in order cancellations in many areas that are either on the tariff list or were about to be tariffed in December. One area we have been particularly focused on is semiconductors, where inventories are at all-time highs across the industry.

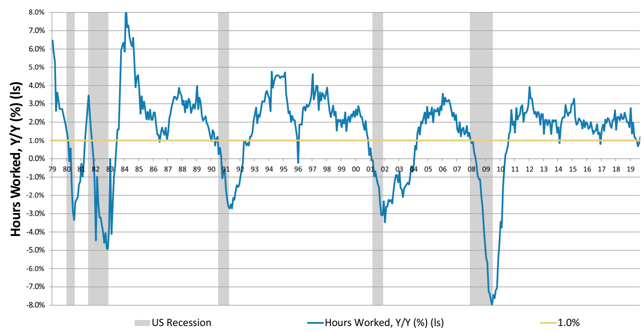
Exhibit 2: Wholesale Inventories Are Growing Faster Than Sales and Will Likely Weigh on Orders for Months



Source: Bloomberg, Morgan Stanley Research

Third is labor. Companies have been reducing capex and opex and have also been trying to reduce labor costs via few hours worked and wage growth, which is now decelerating sharply (Exhibit 3 and Exhibit 4). Until now, they have *not* reduced head count, some of which is due to the fact that firing and re-hiring employees is expensive, especially the good ones. Therefore, companies always want to put this off as long as possible. However, **we think hope for a trade deal may have also been holding back some of these decisions. With the trade deal now announced and additional tariffs postponed, if business does not pick up, there may be less apprehension to make the harder decision on head count.** Recently, many of our industry analysts have been telling us they expect 'restructuring' announcements to become more prevalent during the fourth quarter as companies decide to flush this year's results in hopes of saving next year's.

Exhibit 3: Growth in Hours Worked Has Decelerated to ~1%



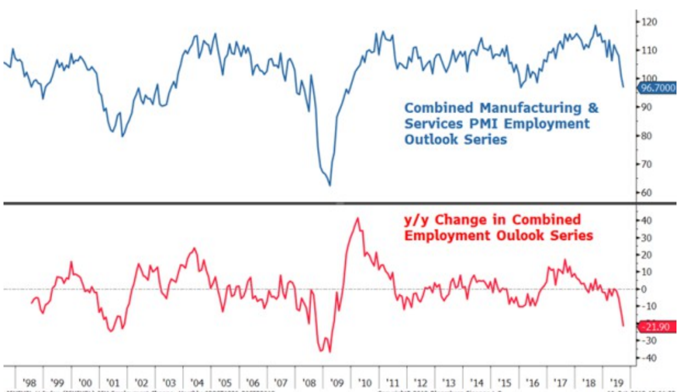
Source: Bloomberg, Morgan Stanley Research

Exhibit 4: Wage Growth Has Decelerated Sharply in the Past 7 Months

Source: Bloomberg, Morgan Stanley Research

There have also been several other leading indicators on labor suggesting we are closer to this decision than perhaps meets the eye (Exhibit 5 - Exhibit 8).

Exhibit 5: Employment Outlook Components of PMIs Are Heading Lower

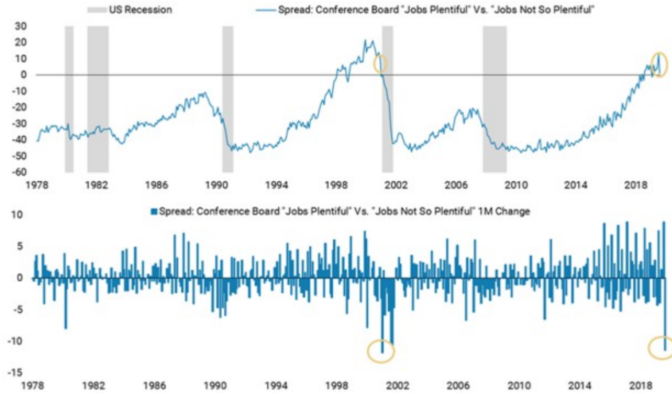


Source: Bloomberg, Morgan Stanley Research

Exhibit 6: Consumer Attitudes Toward Durable Good Purchases Change Before An Employment Cycle

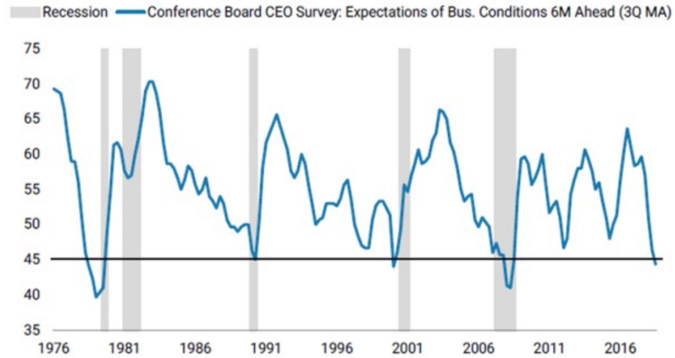
Source: Bloomberg, Morgan Stanley Research

Exhibit 7: Conference Board Surveys Indicated Consumers Are Not Finding It as Easy to Find a Job



Source: Bloomberg, Morgan Stanley Research

Exhibit 8: CEO Confidence Is Falling Rapidly



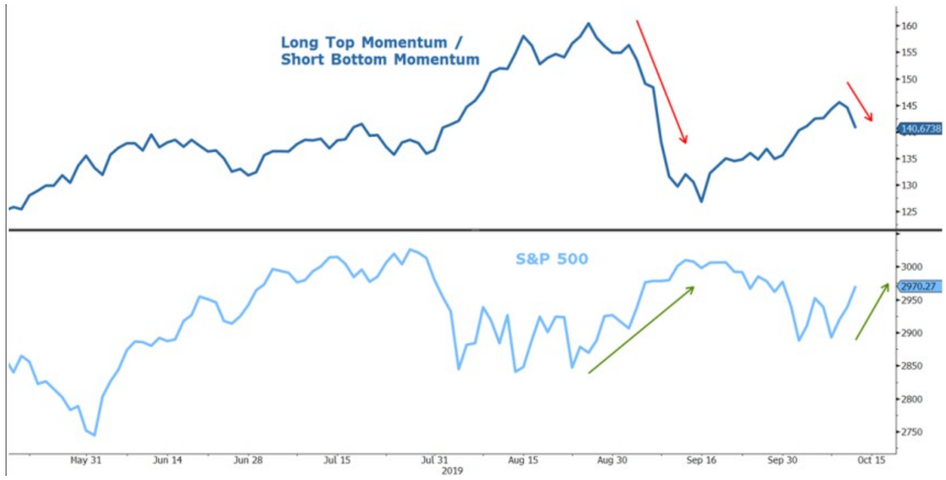
Source: Bloomberg, Morgan Stanley Research

The bottom line for us is that we believe growing trade tensions between the US and China have been used as an excuse by companies and investors for the disappointing growth experienced this year. We think too little attention has been paid to the force of the ongoing business cycle downturn that we saw as inevitable after the fiscally induced boom last year, and which we think effectively set the table for the eventual end of the cycle. **Given the unpredictable path of these trade tensions, we believe they have also been used as a reason by many companies to hold onto employees longer than they normally would for fear of missing out on the potential boomerang rebound from a substantial trade deal. Unfortunately, we think the preliminary agreement announced on Friday will fail to lead to the kind of rebound necessary to change the slowing growth trajectory we have been experiencing all year.**

Trade Truce Part Deux?

The price action on the announcement that the US and China had come to a Phase 1 agreement on trade elicited an extreme two-day rally in global stocks and sell-off in rates. There was also a noticeable shift in leadership toward the more cyclical parts of the equity market. Most of our conversations with clients on Friday were around whether this new leadership could persist—a concern for many of whom are not positioned for such a rotation. Although equity markets rallied sharply on Friday, it was the kind of rally that actually hurt the relative performance of most equity portfolios, both active and passive. It is the ultimate pain trade in an *up* market. To put the move in context, MSCI All Country World Index was up 1.37% while the vaunted and over-owned S&P 500 was up only 1.09%. Drilling down to the US more specifically, long momentum stocks in the US underperformed short momentum stocks by 2.68%, reminiscent of what we witnessed during the momentum breakdown in September. If such a pattern persists, it could be quite painful to many active and passive equity strategies, which ultimately will weigh on risk taking, in our view.

Exhibit 9: The Pain Trade – Index Up with Momentum Down



Source: Bloomberg, Morgan Stanley Research. The index above represents an equal notional pair trade of going long top performers vs short bottom performers from the Russell 3000 over the prior 12 months. The long and short sides are rebalanced to equal notional amounts at the start of each day.

Getting the above trade correct is likely critical to how the rest of the year plays out for most equity managers. Our view is that it will be very difficult for cyclicals to rally meaningfully or sustainably in the face of what we think will remain a deteriorating economic and earnings environment. As noted many times in the past few months, we think growth stocks are more vulnerable than cyclicals given their still elevated growth expectations that are more vulnerable to a cyclical slowdown / recession than appreciated by their lofty valuations and crowded ownership.

Supporting this view is our characterization of the Phase 1 agreement as more of a "truce" than a deal of notable significance. At the end of the day, all of the tariffs that have been instituted to date remain in place. There was no suggestion that any would be rolled back once the final Phase 1 agreement is on paper and signed, which still needs to be done. There was also little suggestion this was even being discussed for Phase 2. **Therefore, as discussed in the first section, we believe markets are likely to focus back on the reality of what's been going on all year—disappointing economic growth and negative earnings results and revisions.**

We would also point out that Friday's price action was strikingly similar to what we experienced the last time we had a trade truce on December 1, 2018, at the G-20 meeting in Argentina. The next trading day on December 3 saw a big gap open that faded into the close. What followed next can be seen in Exhibit 10. We've heard a lot of optimism around this so-called deal but we heard similar things the last time. We argued then, much like we are suggesting today, that such a pause in further tariffs might actually lead to a fall-off in activity in the global economy given elevated inventories and ongoing margin pressure. The positive offset this time is that central banks are now loosening policy, but this is countered by the fact that we are further along in the earnings recession and companies may only have one lever left to pull to save margins next year—head count. **We expect Friday to mark the near-term highs and the next few weeks/month to resemble what we saw last December albeit less dramatic given the lower interest rates and easier monetary policy that now prevails.**

Exhibit 10: Trade Truce Part Deux? If so, get ready for more disappointment

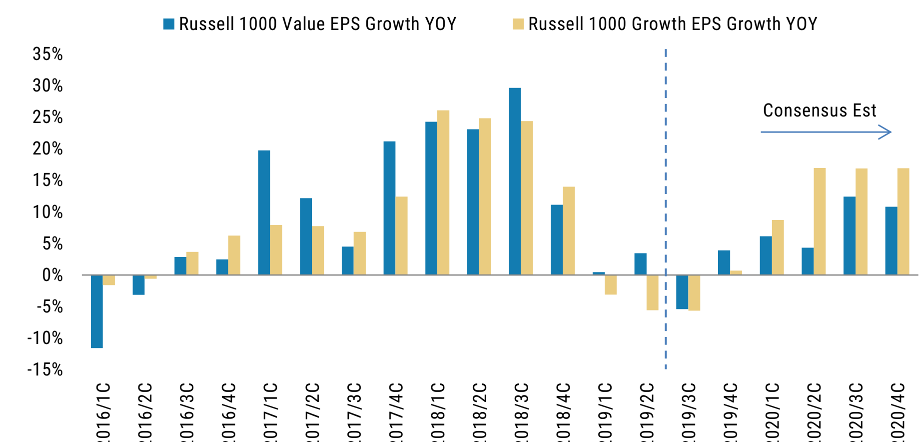
Source: Bloomberg, Morgan Stanley Research

Do You Really Get What You Pay For?

We broke down quarterly earnings results and expectations for the Russell 1000 Growth and Value indices and found that Value frequently has higher earnings growth. We were surprised by this because Growth's valuation premium is usually justified by the prospect of outsized earnings growth. We have not seen this high earnings growth come to fruition recently.

In the first and second quarters of 2019, Value saw modestly positive earnings growth while Growth saw earnings shrink (Exhibit 11). Despite this, consensus is still very optimistic on Growth's earnings prospects in 2020. Growth's estimates in those quarters are 3% - 13% higher than Value's estimates. We think these numbers are unrealistic.

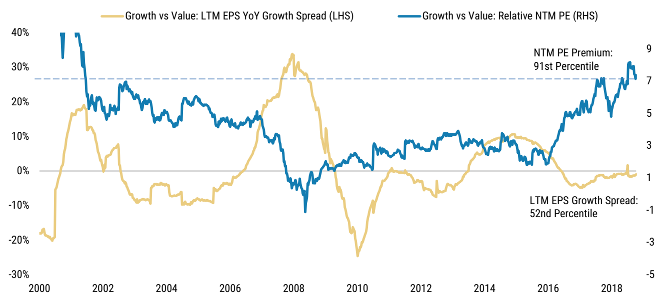
Exhibit 11: Growth vs Value: YOY EPS Growth by Quarter



Source: FactSet, Morgan Stanley Research.

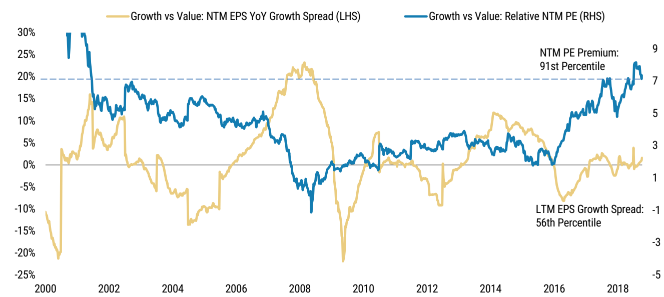
Growth is currently receiving a very large valuation premium; relative NTM PE for Growth over Value is in the 91st percentile. This premium is not justified by the relative earnings growth. Year over year LTM Earnings growth has been higher for Value since mid 2017; the spread in earnings growth between the two groups is currently in the 52nd percentile (Exhibit 12). Expectations for earnings over the next 12 months also don't justify the premium. That spread is currently in the 56th percentile (Exhibit 13). Investors are still piled into growth names, hoping the earnings growth picture improves. However, both the LTM and NTM numbers suggest that Growth's earnings superiority is on hold for now.

Exhibit 12: Growth vs Value: LTM EPS Growth vs NTM PE



Source: FactSet, Morgan Stanley Research. *Tech bubble valuation truncated. LTM = last 12 months, NTM = next 12 months.

Exhibit 13: Growth vs Value: NTM EPS Growth vs NTM PE



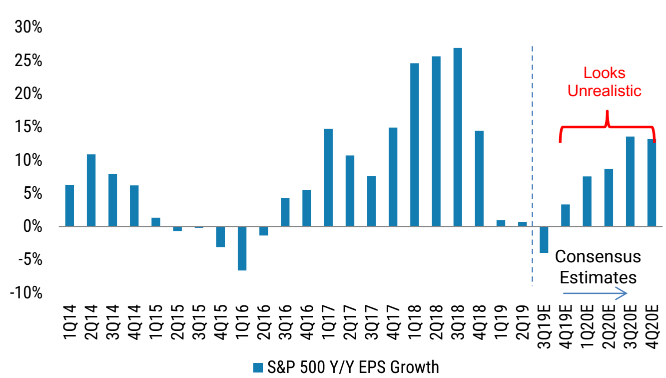
Source: FactSet, Morgan Stanley Research. *Tech bubble valuation truncated. LTM = last 12 months, NTM = next 12 months

3Q Earnings Preview

We are currently in the midst of an earnings recession. [1] and third quarter results are not likely to change that. S&P 500 year over year earnings growth is expected to be -4.8% following two quarters of virtually flat growth. Estimates for the fourth quarter and 2020 look too high to us (Exhibit 14). We will be closely watching guidance for these periods and we think companies will start addressing the clear slowdown in growth.

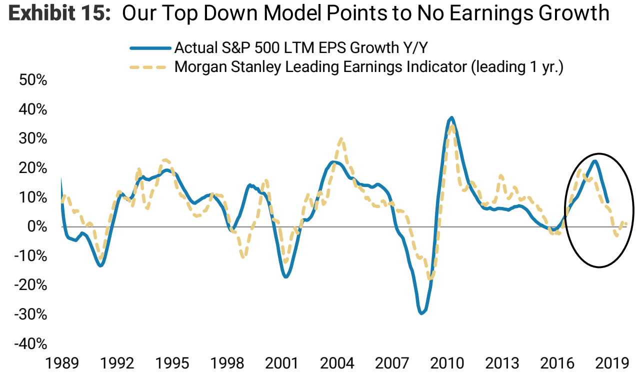
Our top down leading earnings indicator points to growth of around 0% for the next 12 months (Exhibit 15). Our call for a range-bound market has been largely based on our expectation for minimal earnings growth; we see no reasons at this stage to think earnings growth or the market will inflect higher.

Exhibit 14: We Are in an Earnings Recession



Source: Refinitiv, Morgan Stanley Research

Exhibit 15: Our Top Down Model Points to No Earnings Growth



Source: Bloomberg, FactSet, Morgan Stanley Research

The breadth of sectors that are expected to have negative year over year earnings growth is very wide (Exhibit 16). There are few bright spots this quarter and the best sectors will be those that see modest positive results. Only three defensive sectors—

Utilities, Real Estate, and Health Care—are expected to have positive growth. Utilities is expected to have the highest growth at just 4%. Energy and Tech are the two biggest drags on growth; each are contributing approximately -2% to index level growth. Much of the pain within Tech is concentrated in Semiconductors, which have been troubled by the trade tensions with China. They are expected to see earnings shrink by 30%; Tech Hardware is the next most troubled Tech industry group and earnings are expected to shrink 11%.

Anemic topline growth is expected for the S&P, with sales forecasted to grow just 2.9%. Negative operating leverage is expected in all sectors but Materials. Health Care, Communication Services, and Utilities are expected to show the strongest revenue growth. Energy is the biggest drag on index level sales growth, as was the case with earnings.

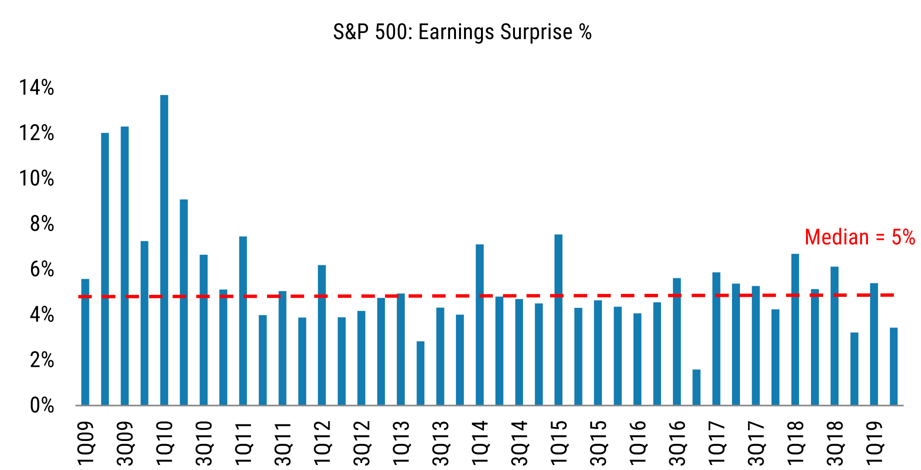
Exhibit 16: 3Q Earnings Scorecard

3Q 2019 S&P 500 Earnings Scorecard				
	Earnings		Sales	
Sector	Growth Blended	Contribution	Growth Blended	Contribution
S&P 500	**-4.8%**	**-4.8%**	**2.9%**	**2.9%**
Communication Services	0.0%	0.0%	9.9%	0.7%
Consumer Discretionary	-1.8%	-0.2%	5.7%	0.7%
Consumer Staples	-2.1%	-0.2%	3.3%	0.4%
Energy	-37.2%	-2.3%	-7.2%	-0.7%
Financials	-3.3%	-0.6%	-1.8%	-0.2%
Health Care	2.1%	0.3%	12.5%	2.0%
Industrials	-0.1%	0.0%	0.8%	0.1%
Information Technology	-10.1%	-2.0%	0.0%	0.0%
Materials	-9.2%	-0.2%	-13.1%	-0.4%
Real Estate	3.2%	0.1%	3.6%	0.0%
Utilities	4.0%	0.1%	5.9%	0.2%

Source: FactSet, Morgan Stanley Research

Earnings results typically surprise 5% to the upside; if the pattern holds in 3Q, earnings growth should come in around 0% (Exhibit 17). However, earnings surprised less than usual last quarter, with results beating estimates by 3.6%. If we see a lower beat rate than usual, numbers should come in modestly negative; either way it would keep the market in an earnings recession.

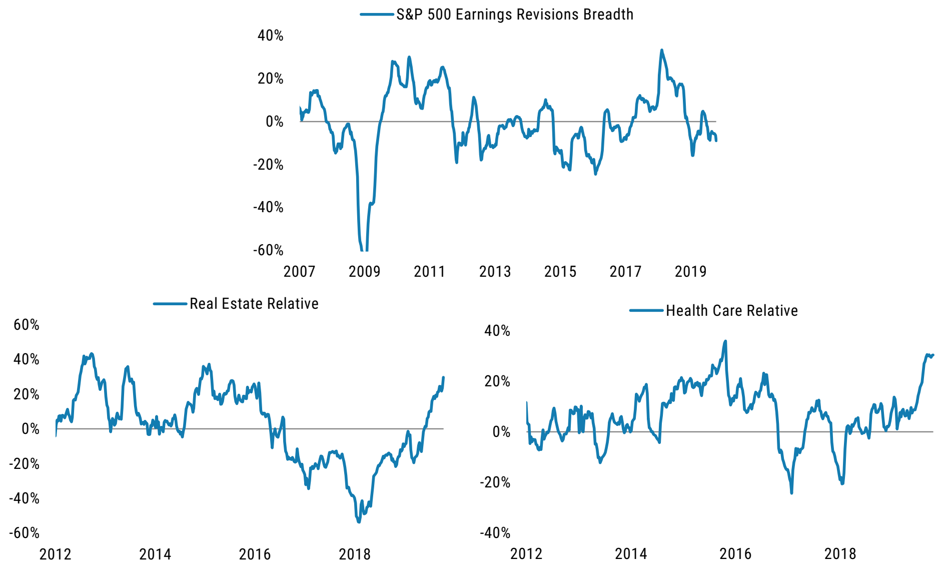
Exhibit 17: Earnings Surprise



Source: Refinitiv, Morgan Stanley Research

Earnings revisions breadth is slipping lower for the S&P and is currently -9% (Exhibit 18). Earnings revisions breadth has remained negative since November 2018, when the market began pricing a slowdown in growth. Relative earnings revisions breadth only looks particularly strong in two sectors, Health Care (30.4%) and Real Estate (29.8%).

Exhibit 18: S&P Earnings Revisions Breadth Is Slipping



Source: FactSet, Morgan Stanley Research.

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 19: Fresh Money Buy List - Stats & 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	$235.8	$130.02	$160.00	23%	Swinburne, Benjamin	3/14/2018	28.1%	17.3%
Humana Inc	HUM	Overweight	Health Care	$36.1	$266.26	$337.00	27%	Goldwasser, Ricky	7/19/2018	(15.2%)	(23.4%)
Iqvia Holdings Inc	IQV	Overweight	Health Care	$30.3	$145.98	$170.00	16%	Goldwasser, Ricky	3/14/2018	38.1%	27.3%
Coca-Cola Co.	KO	Overweight	Consumer Staples	$229.6	$53.30	$60.00	13%	Mohsenian, Dara	8/5/2019	2.6%	0.9%
Microsoft	MSFT	Overweight	Information Technology	$1,079.6	$139.68	$155.00	11%	Weiss, Keith	3/14/2018	51.5%	40.7%
NextEra Energy Inc	NEE	Overweight	Utilities	$110.8	$229.54	$241.00	5%	Byrd, Stephen	3/14/2018	54.2%	43.3%
Philip Morris Intl.	PM	Overweight	Consumer Staples	$121.3	$77.95	$92.00	18%	Kaufman, Pamela	7/29/2019	(7.9%)	(6.5%)
Procter & Gamble Co.	PG	Overweight	Consumer Staples	$318.8	$121.09	$130.00	7%	Mohsenian, Dara	3/18/2019	19.8%	13.4%
Progressive Corp	PGR	Overweight	Financials	$44.2	$75.22	$90.00	20%	Phillips, Michael W.	12/3/2018	18.3%	8.8%
T-Mobile US, Inc.	TMUS	++	Communication Services	$68.4	$79.53	++	++	Flannery, Simon	3/14/2018	22.4%	11.5%
Current List Performance											
Average (Eq. Weight)				$227.5			16%			21.2%	13.3%
Median				$116.0			16%			21.1%	12.5%
% Positive Returns (Abs. / Rel.)										80%	80%
% Negative Returns (Abs. / Rel.)										20%	20%
Avg. Hold Period (Months)											13.4
All Time List Performance											
Average (Eq. Weight)										9.0%	3.0%
Median										7.1%	0.9%
% Positive Returns (Abs. / Rel.)										59%	53%
% Negative Returns (Abs. / Rel.)										41%	47%
Avg. Hold Period (Months)											11.1

++ 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.

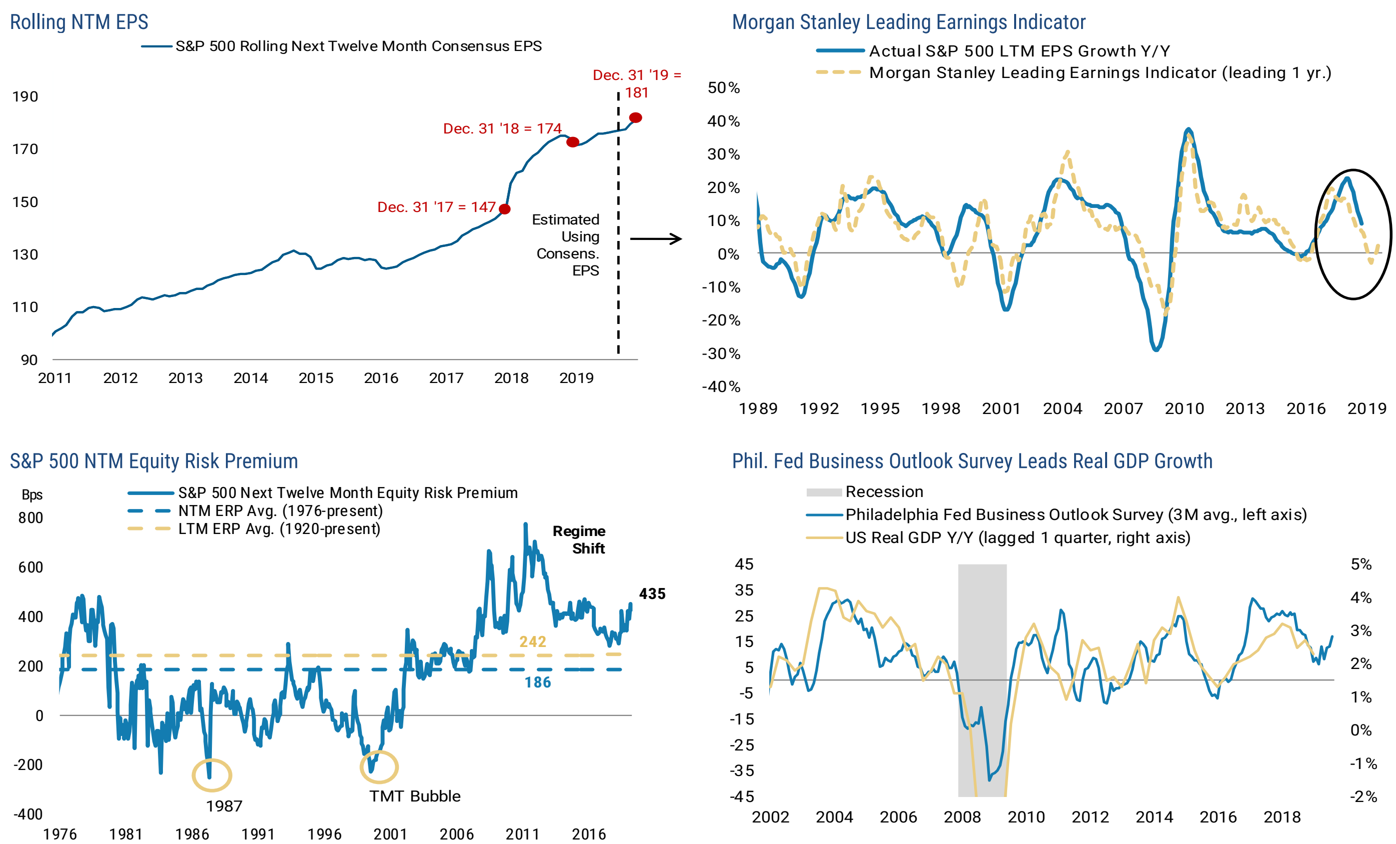
Source: Bloomberg, Morgan Stanley Research

Microsoft (MSFT), Keith Weiss

- **CIO Survey Takeaways Suggest Durable Top-Line Growth** - Our 3Q19 AlphaWise CIO Survey shows macro uncertainty weighing on overall 2020 IT and Software budget expectations, though Microsoft remains well exposed for the secular themes dominating the top of the CIO priority list. We highlight key Microsoft takeaways from the survey; remain OW.

Weekly Charts to Watch

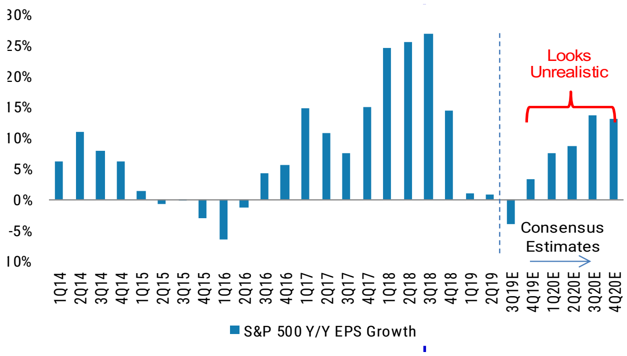
Exhibit 20: Four Charts to Focus On



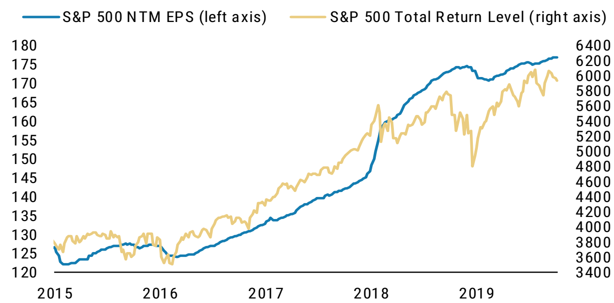
Source: FactSet, Bloomberg, Robert Shiller, Morgan Stanley Research. Top and bottom right: As of September 30, 2019. Bottom Left: As of October 10, 2019. MS Leading Earnings Indicator is a macro factor based earnings model that leads actual earnings growth by one year with a 0.7 12-month leading correlation. 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 21: US Earnings Snapshot

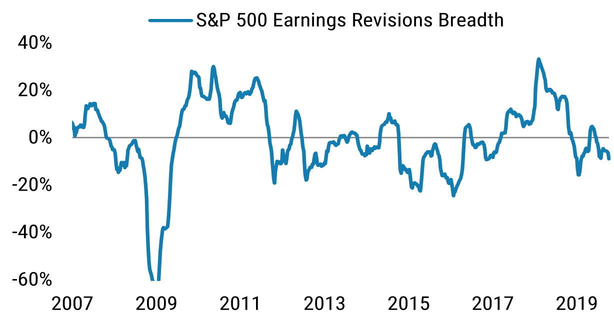
S&P 500 Y/Y EPS Growth



S&P 500 NTM EPS vs. Total Return Level



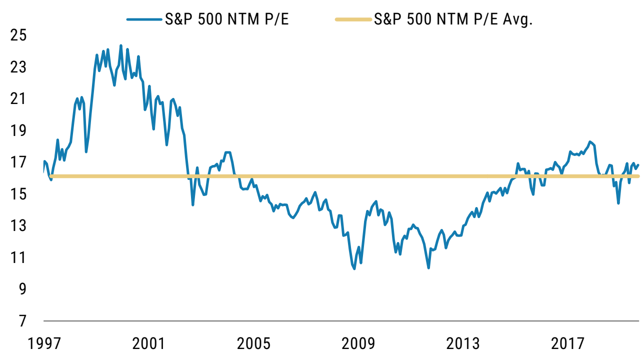
S&P 500 Earnings Revisions Breadth



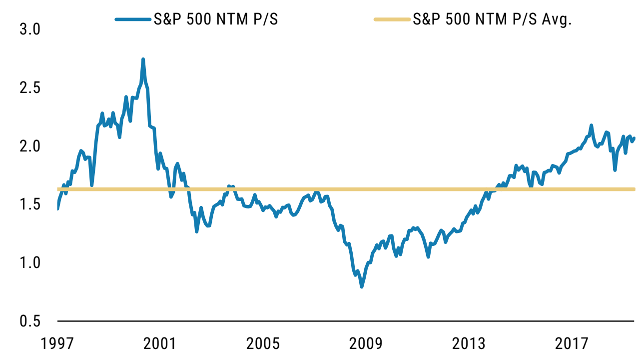
Source: Thomson Financial, FactSet, Morgan Stanley Research. Top: As of: October 11, 2019. Bottom: As of October 9, 2019.

Exhibit 22: US Equity Market Traditional Valuation Measures

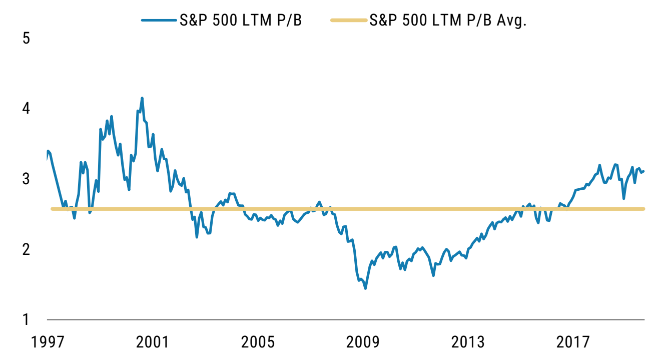
S&P 500 NTM P/E



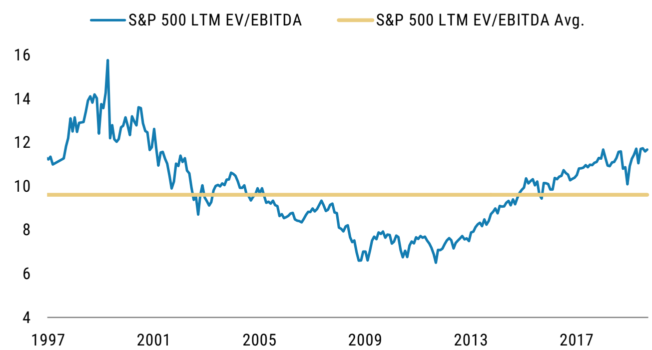
S&P 500 NTM P/S



S&P 500 NTM P/B



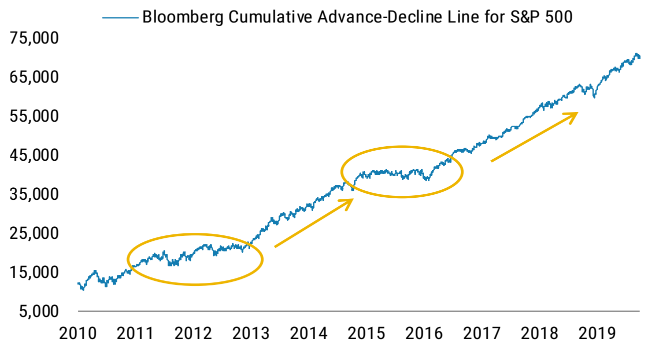
S&P 500 NTM EV/EBITDA



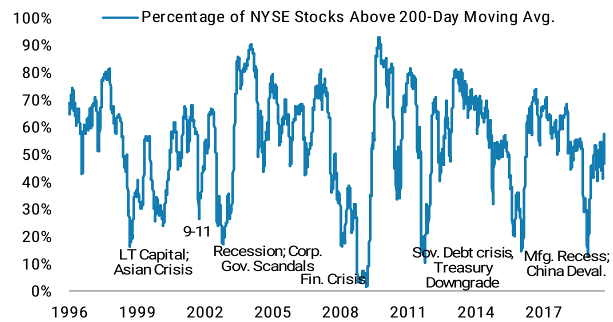
Source: FactSet, Morgan Stanley Research as of September 30, 2019. Monthly Data. Note: S&P 500 fundamental data used post March 1993; Top 500 by market cap data used before 1993.

Exhibit 23: US Equity Market Technicals and Financial Conditions

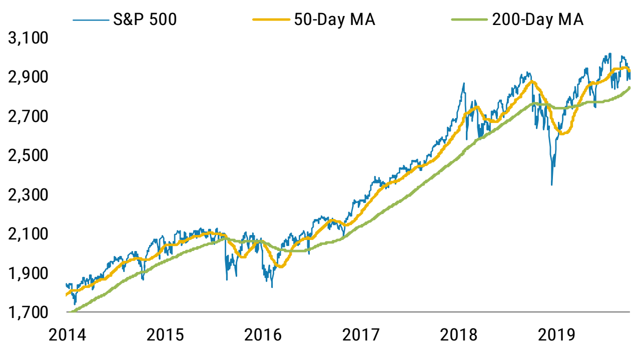
S&P 500 Cumulative Advance-Decline



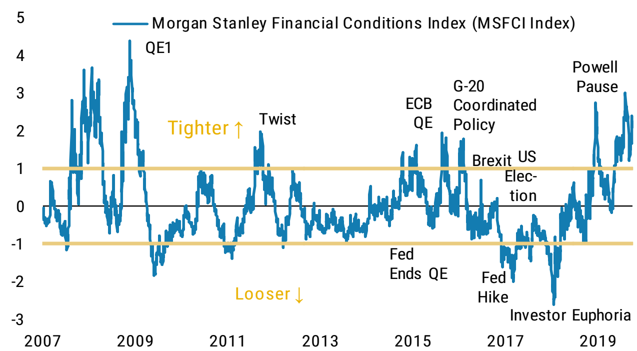
S&P 500 Percent Members Above 200-Day Moving Average



S&P 500 with Moving Averages

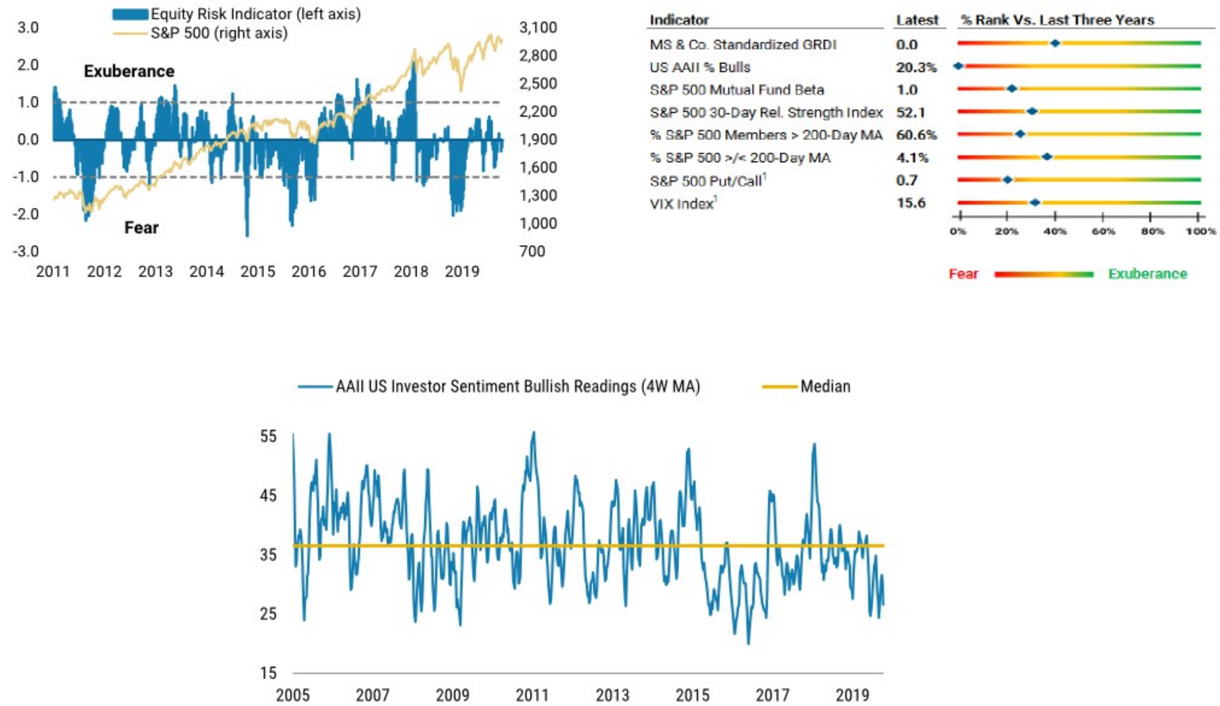


Morgan Stanley Financial Conditions Index



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

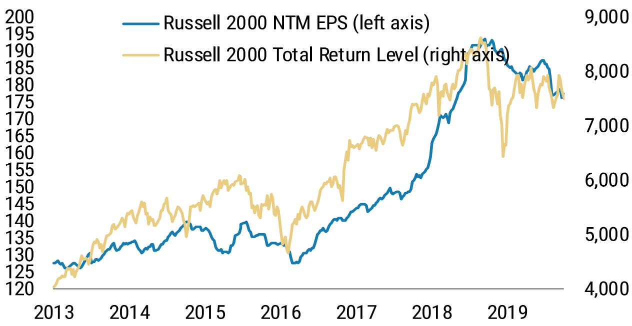
Exhibit 24: US Equity Market Sentiment



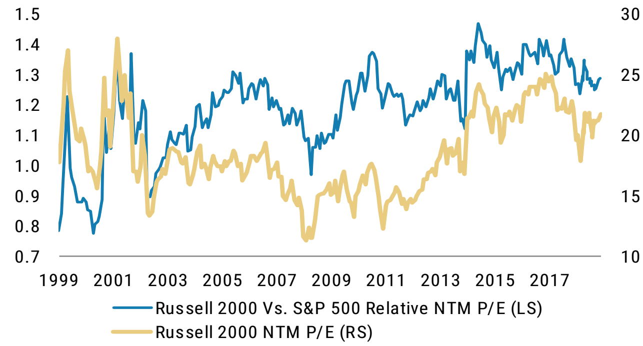
Source: Bloomberg, FactSet, Morgan Stanley Research. As of October 10, 2019.

Exhibit 25: US Small Cap Equities

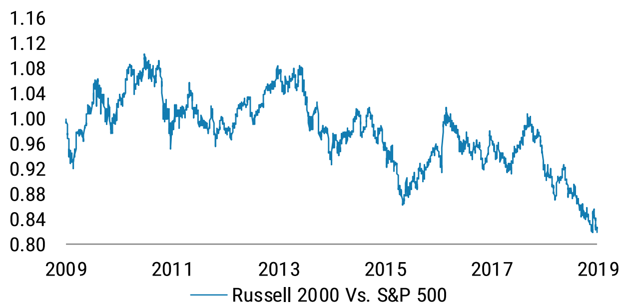
Russell 2000 NTM EPS vs. Total Return Level



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



Russell 2000 Relative Performance vs. S&P 500



Source: FactSet, Morgan Stanley Research. Top Right: As of September 30, 2019. Top Left and Bottom: As of October 10, 2019.

Exhibit 26: We Have a Mid 2020 Price Target of $2,750

Morgan Stanley S&P 500 Price Target: Mid 2020

Landscape	Earnings	Multiple	Price Target	Upside / Downside
Bull Case	$182	16.7x	3,000	2.1%
Base Case	$166	16.5x	2,750	-6.4%
Bear Case	$149	16.1x	2,400	-18.3%
Current S&P 500 Price as of:		10/10/2019	2,938	

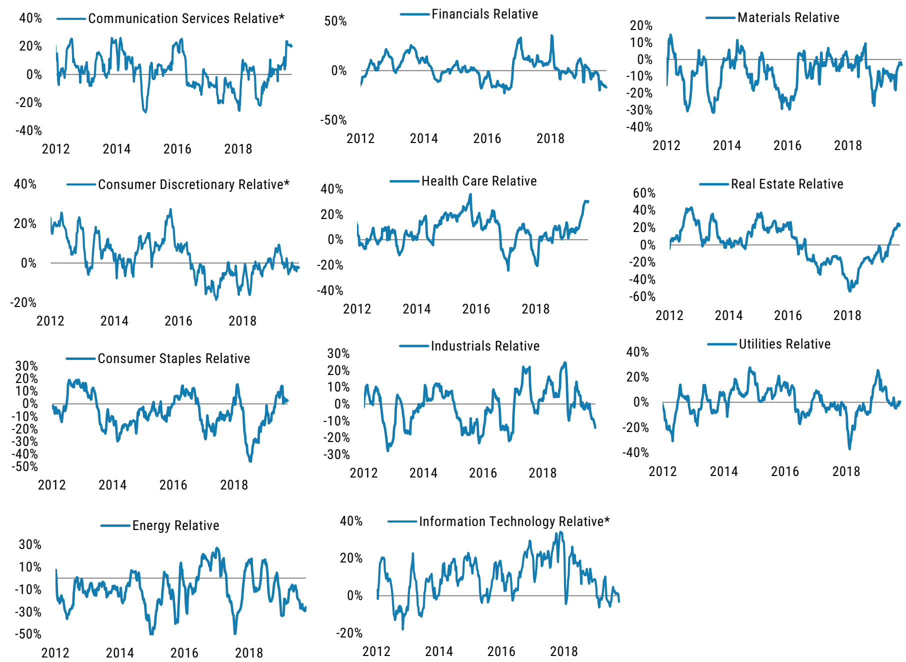
Source: Morgan Stanley Research

Exhibit 27: Sector Recommendations

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

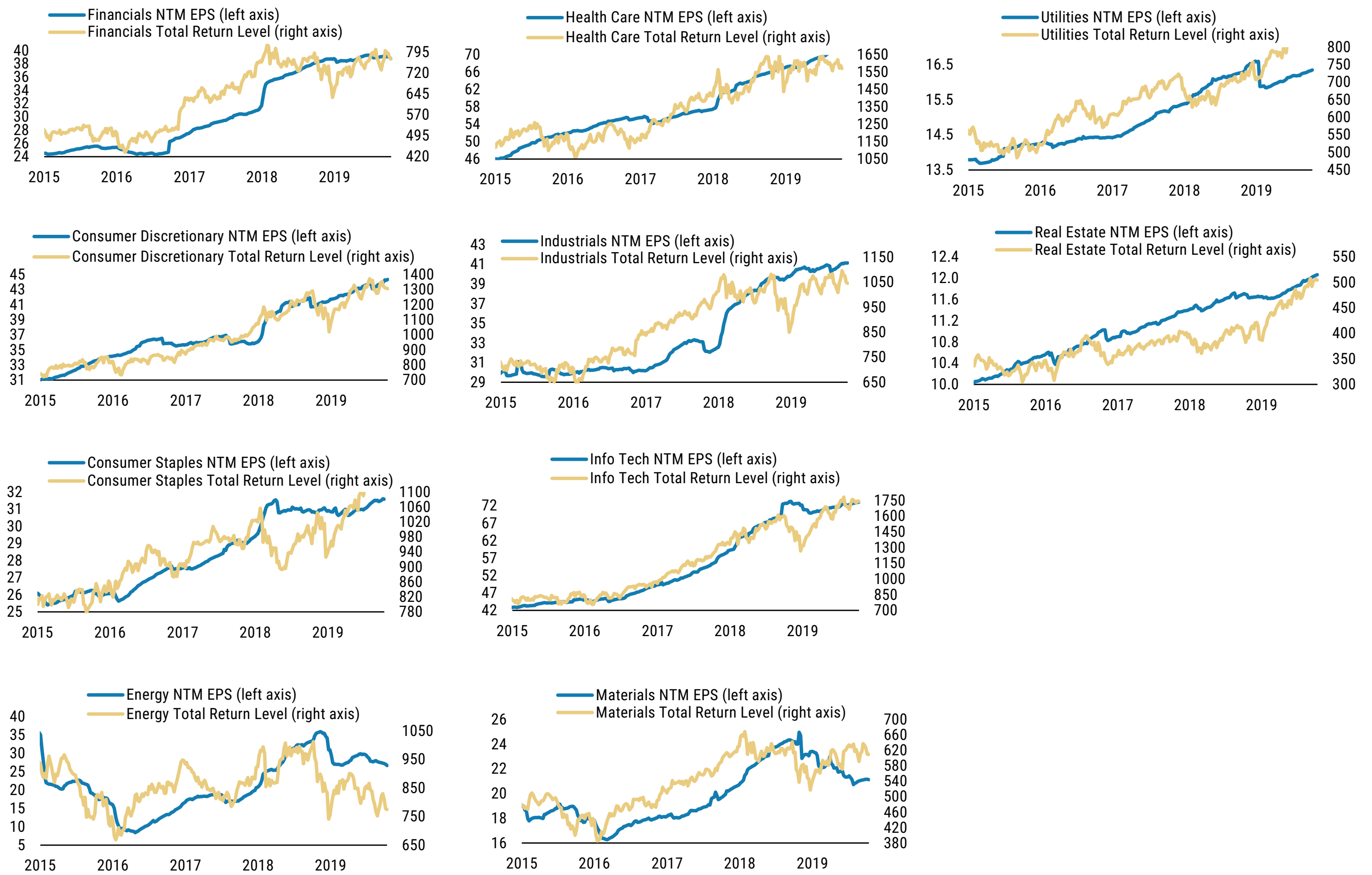
Source: Morgan Stanley Research

Exhibit 28: Earnings Revisions Breadth



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

Exhibit 29: US Sector NTM EPS vs. Total Return Level



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

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Endnotes

1 We define an earnings recession as two or more quarters of flat to negative yoy earnings growth,

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Equal-weight/Hold	**1432**	**46%**	**319**	**47%**	**22%**	**678**	**47%**
Not-Rated/Hold	**1**	**0%**	**0**	**0%**	**0%**	**1**	**0%**
Underweight/Sell	**558**	**18%**	**76**	**11%**	**14%**	**224**	**16%**
TOTAL	**3,146**		**676**			**1435**	

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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