Morgan Stanley
INVESTMENT MANAGEMENT

Equity Market Commentary

SLIMMON'S TAKE | APPLIED EQUITY ADVISORS TEAM | December 2024

The following views and perspectives are formed by the work of the Applied Equity Advisors team in managing assets for investors.

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1

Phase three of the bull market has begun: *The optimism phase.*

It's uncanny to me how each phase has lined up about sequentially with the number of years since the October 2022 bear market low:

a. October 2022-October 2023: the *pessimism phase.*

b. October 2023-October 2024: the *skepticism phase*.

c. October 2024: the *optimism phase*.

While I would love to regale you with the facts behind why the first two phases were so consistent with history, I won't.

That's looking backward, and we need to focus on the "*optimism phase*".

2

Before I do that, I want to answer the #1 inquiry we receive: *"Where do I find your strategies?"*

The answer: **MSIM.com**

Using the search finder in the middle of the page, type in "US Core," "Global Concentrated" or "Global Core."

What bears repeating: *I am not a strategist*.

I provide timely high-level market commentary to keep our investors up to date on our views. Thank you to those who have invested in our products.

The market returns are those of representative index performance which is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

3 As I have articulated often in the past, money market funds have been the fastest growing asset category over the last year and since the bear market bottom.[1]

"*Why should I buy equities when I get 5% risk-free?"* was the most common question we received to our bullish call over the past year. *That's because, in the pessimism and skepticism phases of a bull market, 5% looks attractive.*

However, in the optimism phase, 5% does not look nearly as compelling.

That's why I have been convinced that flows would turn positive (which they have recently[2]) and investors would become less enamored with cash as we moved into this next phase.

The pushback to my flow argument is completely logical:

Household stock holdings are up 50% since 2019. Despite $7 trillion in money markets, household cash levels are up only 38% during this period.[3] So, investors' *equity allocations are actually higher*. And therefore, they are not going to move any of that $7 trillion into stocks…or so goes the doubter's argument.

Mathematically that's correct.

If investors always acted rationally then money would not come off the sidelines.

However, if investors cumulatively acted rationally, why did we experience net liquidations from equities in 2023 after the S&P 500 sold off -25% in 2022?[4]

The historical 1-year return of equities off -25% declines is ***2x*** the long-term average annual return.[5] (a great chart we sent in the October 2022 Slimmon's TAKE.)

If investors always acted logically, they would have piled into stocks then and *not* have hit the panic button.

To me, the argument *against* cash being reallocated screams of someone who has never sat on the front lines as a financial advisor or experienced the daily behavioral side of investing.

My view: *The equity market is not a rational beast.* Yet its *irrationality is completely consistent*.

That is why I continue to believe that as we enter the *optimism phase*, investors will use their cash to chase speculation. It's what happens in the *optimism phase*.

4 Here is the good news: I still see 2025 as a very good year for equities.

The bad news is it just might pull forward the good results from 2026 onward.

In other words, the final phase, "*the euphoria phase*", is the danger zone. In that phase, there is simply too much confidence in the expected returns from equities. Historically, that precedes the next bear market.

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[1] Bloomberg.
[2] As of November 19, 2024, $240 billion has gone into Equity ETFs over the last 3 months. Strategas.
[3] RBA Advisors. November 21, 2024.
[4] From October 2022 until October 2023, investors pulled $-243 billion out of equity ETFs and mutual funds. Strategas.
[5] S&P 500 since 1950. Hamilton Lane.

I worry we have three powerful forces that might propel us faster to that final stage:

a) Massive amounts of liquidity on the sidelines. (see #3)

b) Federal Reserve target to lower rates.

c) Incoming President Trump's pro-growth policies.

But don't get too far out in front. It's still only December 2024 and we are just entering the *optimism phase*.

5 Here is why I am confident that euphoria is not immediately around the corner:

Our performance this year has as much to do with what we do *not* own as with what we do own.

As we have articulated all year, Applied Equity has been underweight the defensive sectors of the market. Most notably, consumer staples and health care.

Again, it's for behavioral reasons.

Early in bull markets, investors tend to flock to "downside risk mitigation." Why? Because it's the "*pessimism phase,*" a time when losing less consumes investors.

Hence early in bull markets, defensive stocks tend to get expensive relative to the market and relative to their history.

But the longer bull markets last, investors become less interested in "downside risk mitigation/losing less" and more hungry for "upside opportunities/making money."

That's when the valuation premium for defensives starts to erode.

This has already started to happen. Consumer staples and health care have woefully lagged the S&P 500 year-to-date.[6] However, stocks in other sectors that are perceived as economically resilient have yet to underperform meaningfully.

Therefore, as our co-portfolio manager and chief quant Phillip Kim reminds the team weekly, *the defensive valuation relative to the market has yet to get cheap enough to be consistent with previous "euphoric phases."*

As always, we are agnostic to style bets. We do expect that at some point we will be adding more to defensives. It's simply too early, in our opinion.

[6] Bloomberg.

6 Today we sit between President-elect Trump's election and inauguration. Hence, the front pages/lead stories/research reports are filled with speculation on the impact of DC politics on investing outcomes.

Therefore, it might be worth reminding everyone:

The annualized return of the S&P 500 under both President Obama and President Trump (first term) was ***exactly*** *the same: +16.3%.*[7]

Safe to say that Barack Obama and Donald Trump (first term) pursued very different policies and styles as Presidents. Seemingly, they could not have been more different. Yet the facts are the facts.

Is it just unnecessary complexity and confusion?

Maybe so.

7 Finally, I was reminded recently of a couple of my favorite investment axioms that, in my experience, have stood the test of time and I thought are worth repeating:

1. *Simplicity, while rarely intellectually satisfying, is hard to beat in the investment business.*[8]

2. *The optimist looks detached from reality and superficial, whereas the pessimist sounds like they know what they are talking about.*[9]

Andrew

[7] Bespoke. As measured from inauguration day until next President's inauguration day.
[8] Strategas.
[9] Morgan Housel.

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