

## European Strategy

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### When should we buy? Lessons from the 1994 and 2004 corrections



MORGAN STANLEY RESEARCH

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## Lessons from the 1994 and 2004 'start of tightening' corrections

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**What were the lessons of 1994 & 2004 for investors in 2010? Markets struggled and it was difficult to make money.**

- 1. Expect several quarters of struggling equities but with a choppy profile.** The 1994 episode lasted 13 months with a 17% peak-to-trough correction. 2004 involved a 2-quarter 8% correction. Both 1994 and 2004 saw periods of alternating sell-offs, rallies and range-bound markets. MSCI Europe enjoyed four mid-to-high single digit rallies in 1994 and two during 2004.
- 2. Sector performance broadly good among defensives, poor in financials & TMT.** The biggest outperformers in both periods included energy, pharma, materials and some staples. The biggest underperformers were in the TMT and financials groups. Commodity related groups performed strongly (particularly energy but also materials, both of which we are overweight). Cyclical sectors had mixed performance and many ranked in the middle of the pack. Indeed it was insufficient to make a simple bet on defensives versus cyclials. It is notable that many sectors saw gains on down days offset by losses on weaker days, or vice versa. Two examples: food, beverage & tobacco had cumulative outperformance on down days of 10% in 1994 but cumulative underperformance on up days of 9%. Capital goods had cumulative relative performance of +10% and -9% on up and down days respectively in 2004.
- 3. You had to buy the dip eventually.** Following both the 1994 and 2004 corrections equities enjoyed several strong years. With more clarity on the outlook for policy and growth and a re-basing of expectations, equities may offer such a buying opportunity later this year. The current dip may turn out to be worse as 1994 and 2004 were relatively normal cycles and this one may not be if sovereign trouble escalates and China growth disappoints as some bears expect (not us).

**When should you have bought the market in 1994 & 2004?**

- 1. Leading indicators** deteriorated coincident with both the 1994 and 2004 corrections. On 4 such indicators here is what happened by the time the market had troughed. i) The **ECRI** leading indicator had fallen 10-12 percentage points, in to negative territory but was beginning to stabilize (it peaked in late 2009 but remains at +17). ii) **ISM new orders** had fallen 10-15 points to 52/58 (today it is at a cycle high of 66). iii) The **OECD leading indicators** rolled over and fell to low-to-mid single digit growth rates (today the global LI is at a 34-year high of +11.9%). iv) The **earnings revisions ratio** had slowed at least 5 percentage points and turned (or was about to turn) negative. The FY2 revisions ratio peaked at 7% in February.
- 2. Market timing models were below -0.5.** Our CVI and Combined market timing indicators were both between -0.5 and -0.7 when the market troughed in 1994/2004 (i.e. below current readings of -0.1 and 0.04 respectively today). On the other hand absolute valuation multiples today (16.6x PE and 1.65x PBV) look reasonable relative to the prevailing valuations in 1994 and 2004 (16-18x PE and 1.8-2.0x PBV).
- 3. Sentiment indicators had corrected.** The AAll sentiment survey flagged the local peaks well in 1994 but was less consistent in signaling the troughs. In 2004 a couple of counter-trend rallies followed an AAll reading of net 10% bearish but the AAll was only neutral at the market low. However, it paid to buy when we saw a 3SD net short speculative position on Nasdaq futures. Currently the AAll is at +5 while the speculative position on Nasdaq futures is at -0.04SD.

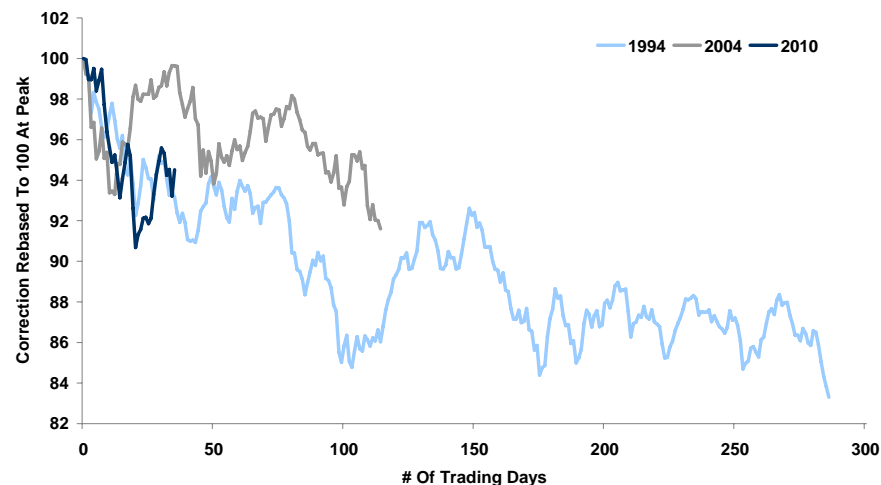
## Summary

*Ronan Carr, CFA*

- **Start of tightening and growth scare just like 1994 and 2004.** Two of the key market themes in 2010 were also prominent in both 1994 and 2004 we believe. First, these are 'start of tightening' years. The Fed started hiking the Fed funds rate in 1994/2004. That has not happened yet but we believe the tightening process has clearly begun, given recent events (e.g. Asian tightening and Fed raising the discount rate and beginning liquidity withdrawal). Despite policy rates not moving yet, such moves combined with sovereign concerns mean the cost of capital is rising. Second, a growth scare is building we believe. Investors are questioning the strength and durability of the recovery and leading indicators are already rolling over. In summary, markets struggle in the face of higher uncertainty, lower growth prospects and tighter monetary conditions.
- **In post-credit bubble world shifts in policy and growth prospects are key.** Gerard Minack has pointed out that the growth in excess credit (i.e. above GDP growth) lead equity markets in the period from early 1980s to late 2000s. We believe post-credit bubble economies are structurally weaker and therefore more vulnerable to shifts in policy. Moreover, interest rate changes are not the only important lever of policy. Stimulus withdrawal itself (or the prospect of it) contributes to a deterioration in business sentiment and lead indicators. Japan was a good example of such an environment. Policy changes marked most of the main turning points in Japanese stocks e.g. swings in fiscal spending, tax increases, QE, FX intervention etc. Fiscal policy will likely play a key role (as it did in Japan). Fiscal policy was much looser in this cycle than in early 1990s or 2000s and we may be close to an inflection point. The US budget deficit is twice the size it was in 1994 or 2004 and is set to contract from 2010. The standardized budget deficit (i.e. adjusted for cyclical and one-off effects) should widen again in 2010 but at a much slower rate.
- **Conclusion today - we think it is too early to buy** and expect the current correction phase to last a few months or even quarters longer. We would like to wait until either fundamentals improve or our valuation and sentiment models give buy signals.
  1. **Fundamental headwinds** remain from policymakers shifting to tightening mode, moderating growth prospects and higher uncertainty generally (including sovereign concerns). We would like to wait for more clarity on these issues e.g. an easing in Asian inflation fears, a change in Fed language being out of the way and some re-basing in growth expectations. We will keep in mind the key 1994/2004 levels on growth indicators such as negative readings on the ECRI and earnings revisions or a 10-15 point correction in ISM new orders.
  2. **Sentiment indicators** have now corrected from elevated levels in January but overall are not showing excessive bearishness. AAll is at +5 (3-week average is 0) net bullish, and there is a negligible net short on Nasdaq futures while defensives remain underowned in aggregate.
  3. **Market timing indicators:** we're watching out for a buy signal (a reading below -0.5) on either the CVI (-0.05 today) or the Combined MTI (+0.04 today). Such a buy signal could come through a combination of lower equity prices, lower bond yields and/or more signs of capitulation in sentiment or liquidity indicators.

## Equities struggled in 1994 and 2004

We expect a market profile similar to 1994 or 2004



Source: MSCI, Morgan Stanley Research

Multiples lower now than in 1994 or 2004 but the CVI/CMTI were below -0.5 at the market lows

	1994 Correction		2004 Correction		Now
	Start	End	Start	End	
PE	27.3	17.6	19.8	15.6	16.6
PBV	2.24	1.78	2.23	2.02	1.65
Composite Valuation Indicator (CVI)	1.0	-0.5	-0.8	-0.7	0.0
Combined Market Timing Indicator (CMTI)	0.3	-0.6	-0.3	-0.7	-0.1

Source: MSCI, Datastream, Morgan Stanley Research

### Comparison between 1994 and 2004 corrections

	1994	2004
Duration (months)	13.1	5.2
Peak To Trough Correction %	-16.7	-8.4
% of Days Up	49	48
Average Daily Return %	-0.1	-0.1

Source: MSCI, Morgan Stanley Research

### Several 4-10% rallies to be expected Main counter trend rallies - 1994 and 2004

#### 1994 Counter-Trend Rallies

Start	End	Size %
27-Jun-94	29-Aug-94	9.2
05-Oct-94	13-Oct-94	5.0
25-Oct-94	16-Nov-94	4.7
23-Jan-95	10-Feb-95	4.3

#### 2004 Counter-Trend Rallies

Start	End	Size %
24-Mar-04	23-Apr-04	6.8
17-May-04	28-Jun-04	4.6
26-Jul-04	03-Aug-04	2.8

Source: MSCI, Morgan Stanley Research

## Sector performance broadly defensive

**It was insufficient to make a simple bet on defensives versus cyclicals.** Making money was difficult and the risk of being whipsawed was high. While there were some consistent winners and losers in both periods it is notable that many sectors saw relative gains or losses on either up or down days for the overall market, largely offset by the opposite outcome when the market moved the other way. Moreover, it was insufficient to make a simple bet on defensives versus cyclicals – one had to be selective within those groups too. The last two columns show the cumulative relative performance of sectors for days either the market was up or down during the corrections. Many industry groups show widely differing performance on strong or weak days for the overall market. About a half or more of the groups each time reversed at least 50% or more of the cumulative out or underperformance on up versus down market days. Two examples: food, beverage & tobacco had cumulative outperformance on down days of 10% in 1994 but cumulative underperformance on up days of 9%. Capital goods had cumulative relative performance of +10% and -9% on up and down days respectively in 2004.

### Sector performance during 2004 correction

	% Performance During Tightening Phase		Cumulative relative performance %	
	Absolute	Relative	Up days	Down days
<b>MSCI Europe</b>	<b>-8.4</b>			
Energy	3.9	13.5	-1	14
Real Estate	3.5	12.9	-16	29
Health Care Equipment & Services	2.4	11.8	-9	21
Utilities	0.8	10.0	-7	16
Retailing	-0.6	8.5	0	8
Pharmaceuticals Biotechnology & Life Sciences	-2.9	6.1	-9	15
Automobiles & Components	-4.2	4.6	17	-13
Materials	-4.4	4.4	4	1
Consumer Services	-5.8	2.9	-4	7
Food Beverage & Tobacco	-6.1	2.6	-14	16
Banks	-7.3	1.2	-1	2
Capital Goods	-7.8	0.7	10	-9
Food & Staples Retailing	-8.1	0.3	0	1
Transportation	-8.8	-0.4	-5	5
Household & Personal Products	-11.5	-3.4	-2	-1
Commercial & Professional Services	-11.8	-3.8	-10	6
Telecommunication Services	-11.9	-3.9	0	-4
Consumer Durables & Apparel	-15.3	-7.6	10	-18
Media	-16.4	-8.7	7	-16
Diversified Financials	-17.5	-9.9	3	-14
Insurance	-18.8	-11.3	8	-20
Software & Services	-18.8	-11.4	20	-32
Semiconductors & Semiconductor Equipment	-33.1	-27.0	16	-47
Technology Hardware & Equipment	-40.7	-35.3	19	-61

Source: MSCI, Datastream, Morgan Stanley Research

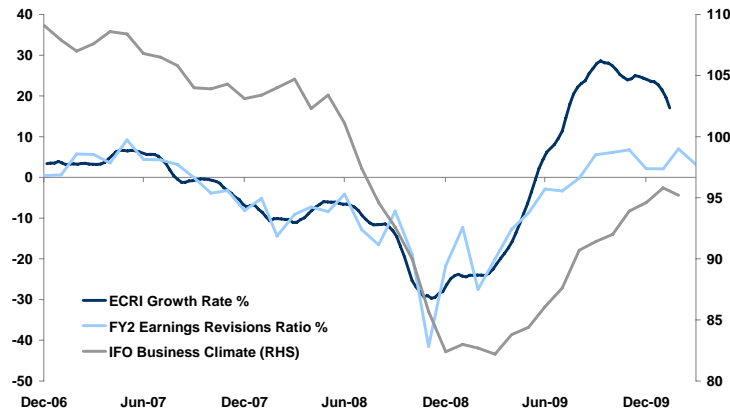
### Sector performance during 1994 correction

	% Performance During Tightening Phase		Cumulative relative performance %	
	Absolute	Relative	Up days	Down days
<b>MSCI Europe</b>	<b>-16.7</b>			
Consumer Durables & Apparel	-1.1	18.8	-4	21
Food & Staples Retailing	-4.7	14.4	3	10
Pharmaceuticals Biotechnology & Life Sciences	-5.9	13.0	-5	17
Energy	-11.3	6.5	5	1
Semiconductors & Semiconductor Equipment	-11.9	5.7	-74	87
Automobiles & Components	-12.0	5.6	8	-2
Household & Personal Products	-12.7	4.8	17	-11
Retailing	-13.4	3.9	-11	15
Materials	-14.6	2.5	-4	7
Food Beverage & Tobacco	-15.7	1.1	-9	10
Insurance	-16.6	0.1	-3	4
Consumer Services	-17.0	-0.3	-9	9
Transportation	-17.8	-1.3	-19	18
Utilities	-18.0	-1.5	-4	2
Capital Goods	-18.0	-1.6	-13	11
Technology Hardware & Equipment	-18.7	-2.4	15	-16
Media	-18.7	-2.5	-11	8
Commercial & Professional Services	-19.6	-3.5	-29	25
Telecommunication Services	-20.7	-4.8	16	-21
Health Care Equipment & Services	-23.5	-8.2	-31	23
Diversified Financials	-23.9	-8.6	-18	9
Banks	-25.7	-10.8	-3	-8
Real Estate	-29.8	-15.7	-39	22

Source: MSCI, Datastream, Morgan Stanley Research

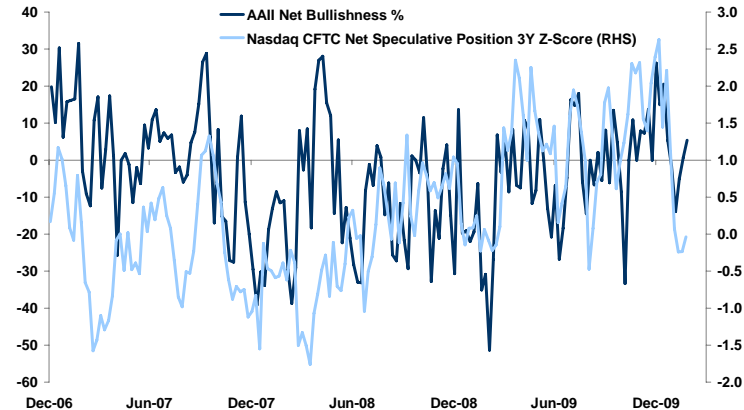
**Too early to buy this correction – wait for clearer fundamentals or bearish sentiment**

**Leading indicators starting to roll over but not at the 1994/2004 buy levels yet**



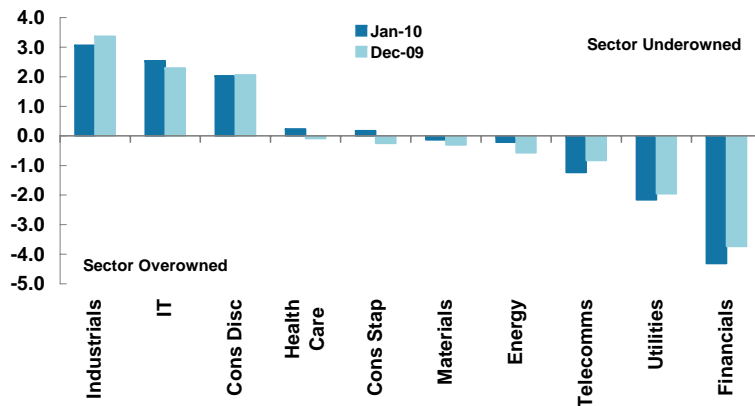
**Note:** Earnings revisions ratio is calculated as the number of earnings estimate upgrades, less downgrades, divided by the number of estimates  
**Source:** MSCI, IBES, ECRI, IFO, Morgan Stanley Research

**Sentiment indicators are correcting but not showing excessive bearishness**



**Source:** AAI, CFTC, Morgan Stanley Research

**Consensus remain underweight defensives: Consensus sector weights (% +/- benchmark)**



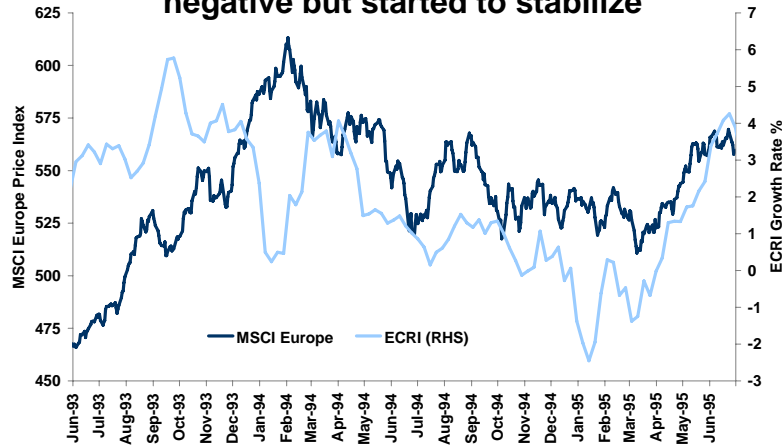
**Source:** MSCI, EPFR, Morgan Stanley Research

**Recent evidence of policy tightening:**

- China raised the reserve requirement ratio
- Fed raised the discount rate
- Fed starts to drain excess reserves by ramping up Supplementary Financing Program
- Fed commentary on the exit strategy; language change imminent?
- Pressure to tighten fiscal policy in Europe

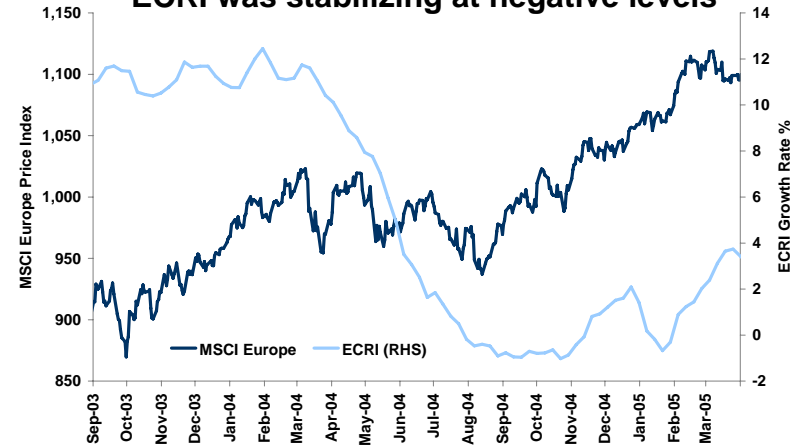
**The time to buy in 1994/2004 was when the ECRI turned negative & started stabilizing**

**At the market lows in 1994 the ECRI had turned negative but started to stabilize**



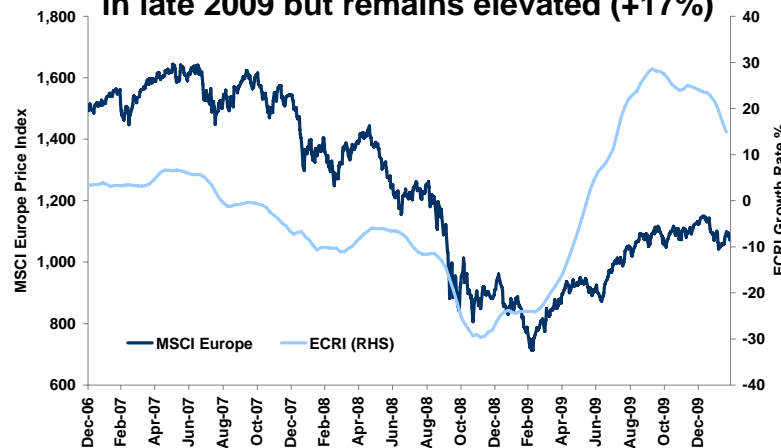
Source: MSCI, ECRI, Datastream, Morgan Stanley Research

**Similarly in 2004 the time to buy was when the ECRI was stabilizing at negative levels**



Source: MSCI, ECRI, Datastream, Morgan Stanley Research

**The ECRI rolled over from its record high in late 2009 but remains elevated (+17%)**



Source: MSCI, ECRI, Datastream, Morgan Stanley Research

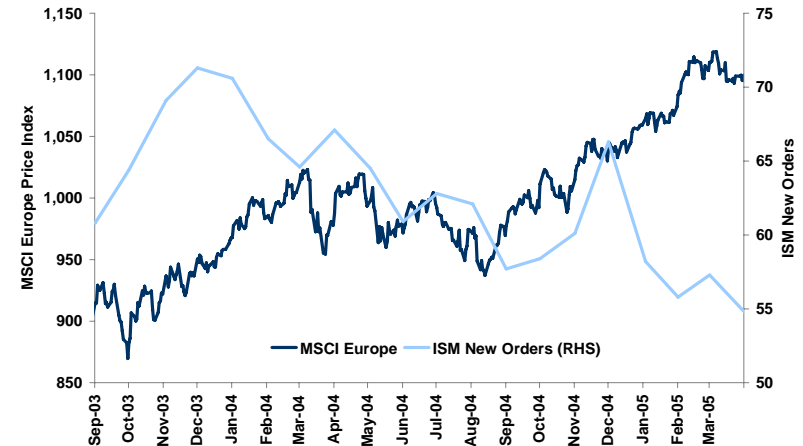
**The time to buy in 1994/2004 was when ISM new orders had fallen 10-15 points**

**At the market lows ISM new orders had...**



Source: MSCI, ISM, Datastream, Morgan Stanley Research

**... dropped 10-15 points to 52 in 1995 and 58 in 2004**



Source: MSCI, ISM, Datastream, Morgan Stanley Research

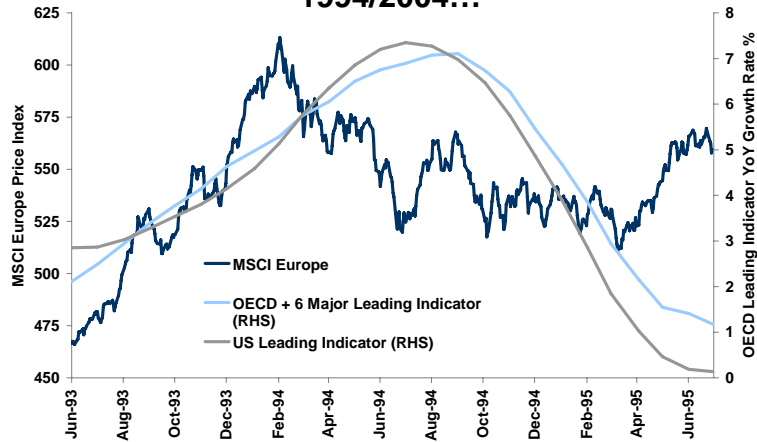
**ISM new orders is today at the highest level in 5 years (65.9)**



Source: MSCI, ISM, Datastream, Morgan Stanley Research

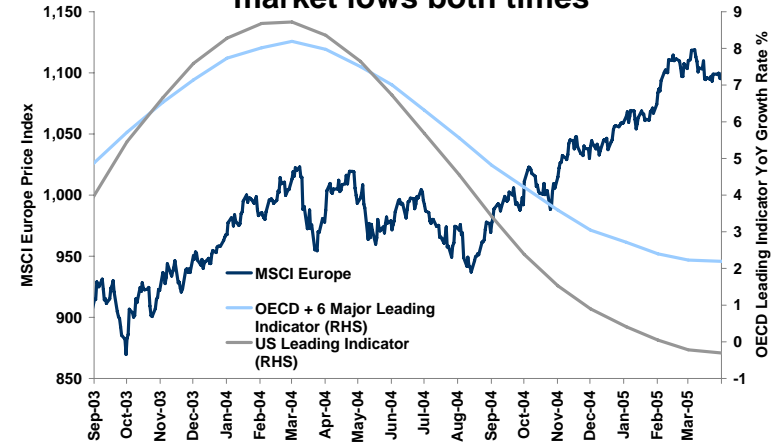
**The time to buy in 1994/2004 was when the OECD LI reached low-to-mid single digits**

**The OECD leading indicator also rolled over in 1994/2004...**



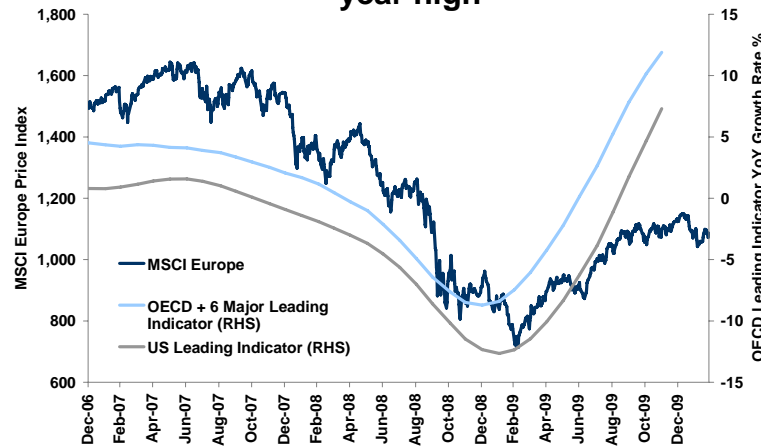
Source: MSCI, OECD, Datastream, Morgan Stanley Research

**... reaching mid-to-low single digit territory at the market lows both times**



Source: MSCI, OECD, Datastream, Morgan Stanley Research

**The OECD leading indicator is at a 34 year high**



Source: MSCI, OECD, Datastream, Morgan Stanley Research

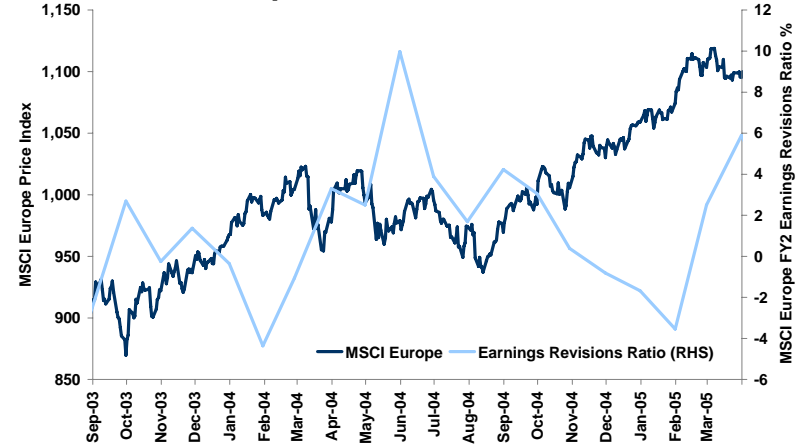
**The time to buy was when earnings revisions had slowed at least 5% points**

**At the lows in the 1994 correction the revisions ratio had turned negative dropping 4-5 % points**



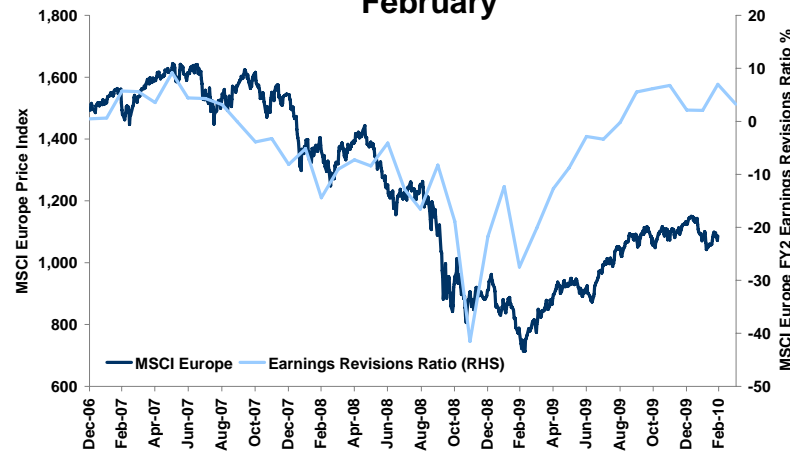
Source: MSCI, IBES, Datastream, Morgan Stanley Research

**The 2004 correction preceded an 11% point drop in the revisions ratio**



Source: MSCI, IBES, Datastream, Morgan Stanley Research

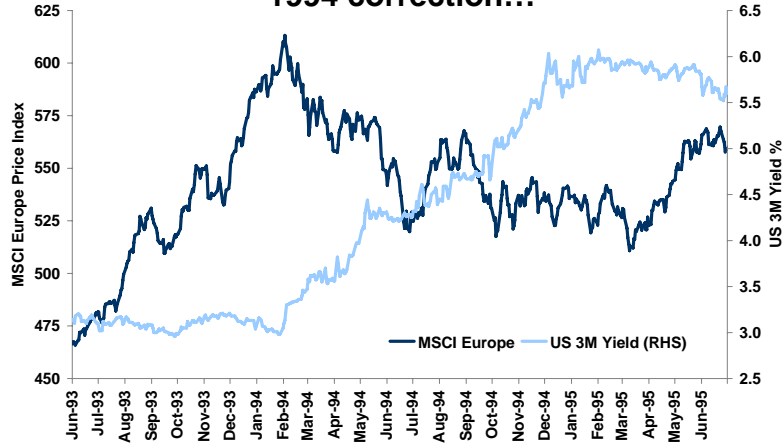
**Earnings revisions ratio peaked at 7% in February**



Source: MSCI, IBES, Datastream, Morgan Stanley Research

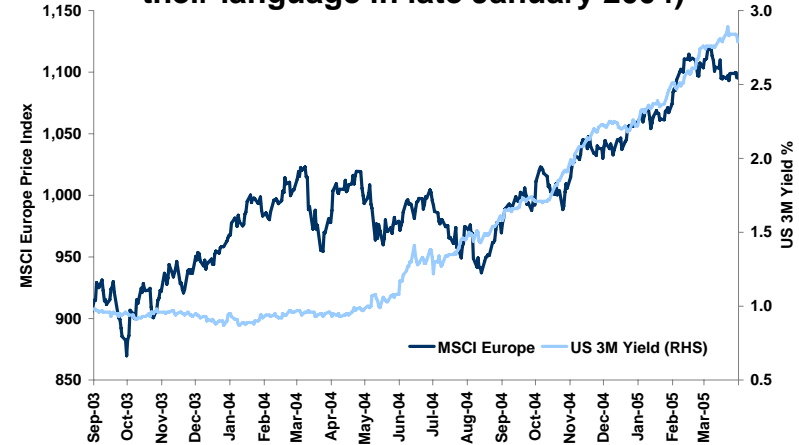
**Interest rates started to move higher in both the 1994 & 2004 episodes**

**The start of tightening triggered the 1994 correction...**



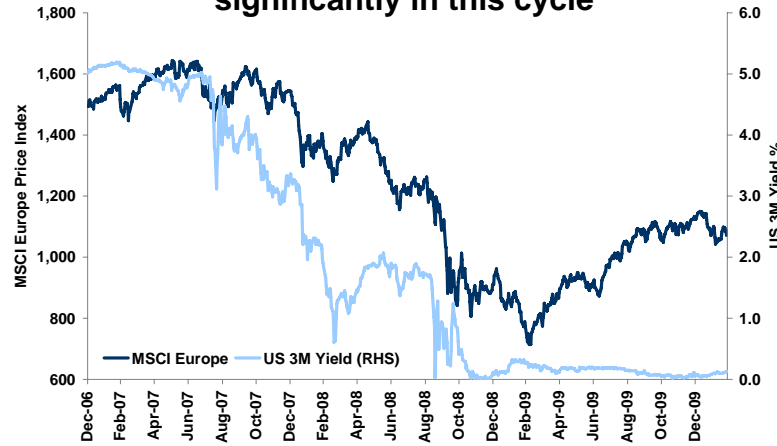
Source: MSCI, Datastream, Morgan Stanley Research

**... and was a key driver in 2004 (the Fed changed their language in late January 2004)**



Source: MSCI, Datastream, Morgan Stanley Research

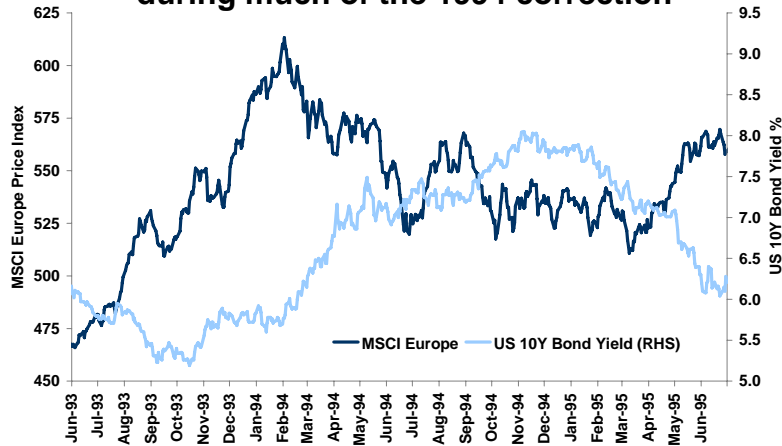
**Short rates have yet to move up significantly in this cycle**



Source: MSCI, Datastream, Morgan Stanley Research

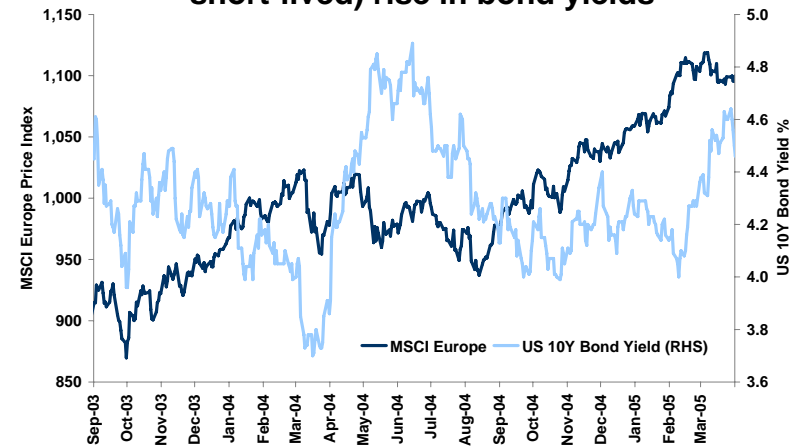
**Bond yields spiked higher during both the 1994 & 2004 episodes**

**Equities moved inversely to bond yields during much of the 1994 correction**



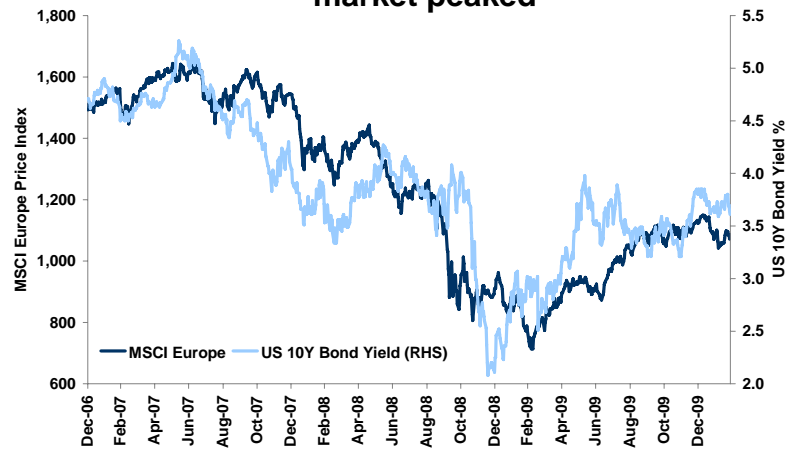
Source: MSCI, Datastream, Morgan Stanley Research

**2004 correction coincided with a big (if short-lived) rise in bond yields**



Source: MSCI, Datastream, Morgan Stanley Research

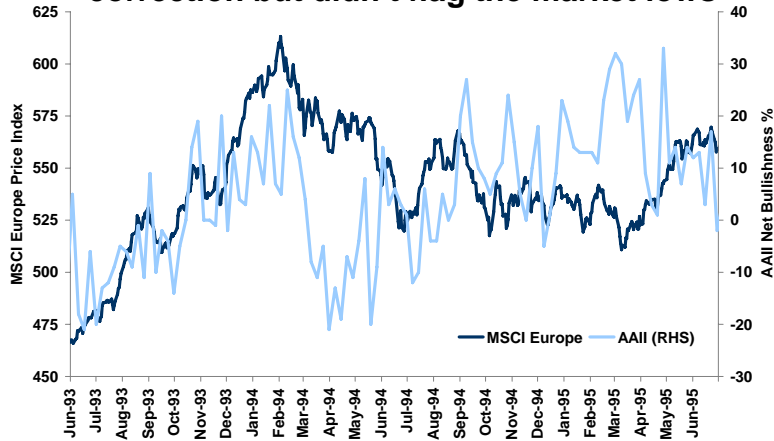
**Bond yields have actually fallen since the market peaked**



Source: MSCI, Datastream, Morgan Stanley Research

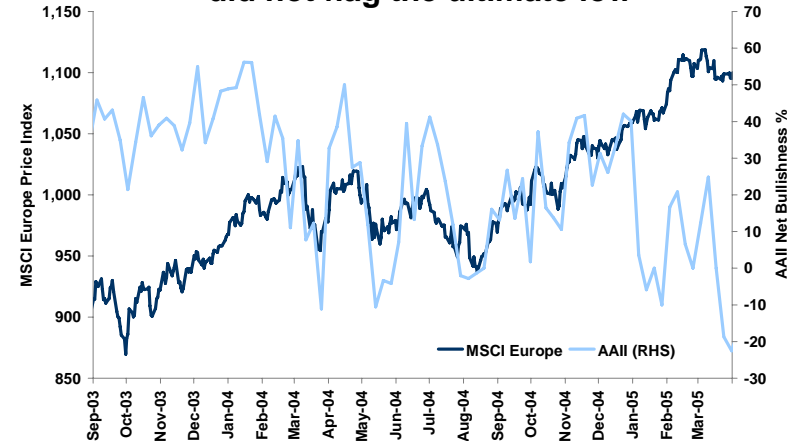
**Sentiment indicators corrected in 1994 & 2004 but were inconsistent at signalling lows**

**AAll in 1994 gave warning of the correction but didn't flag the market lows**



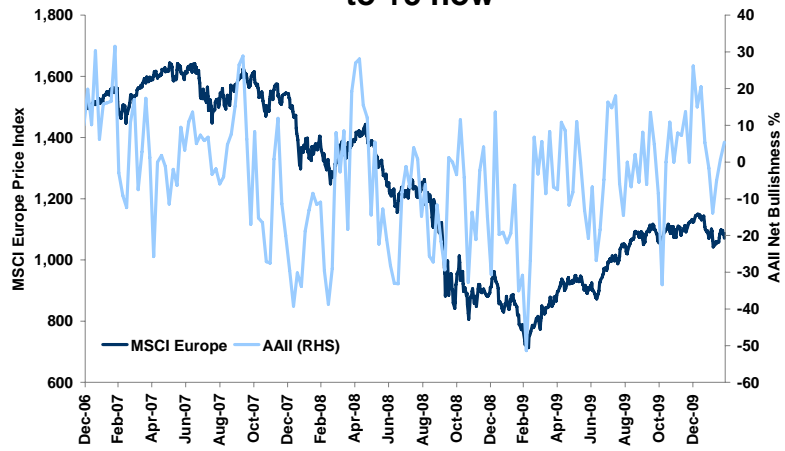
Source: MSCI, AAll, Datastream, Morgan Stanley Research

**In 2004 AAll at -10 signalled two rallies but did not flag the ultimate low**



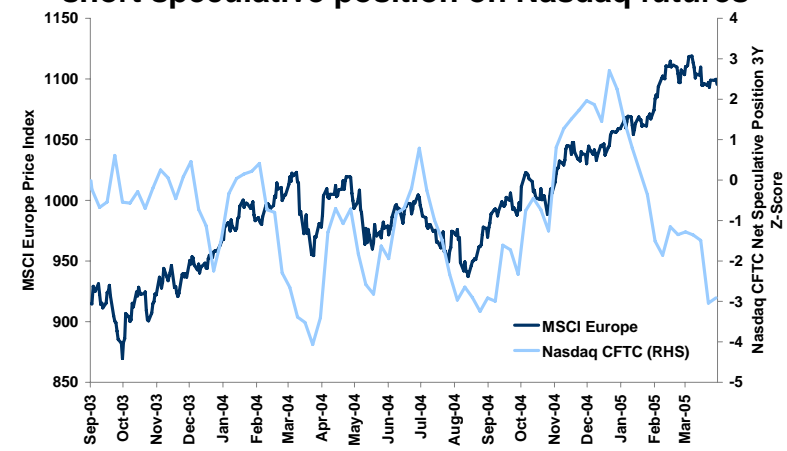
Source: MSCI, AAll, Datastream, Morgan Stanley Research

**AAll corrected from +26 at end 2009 to +5 now**



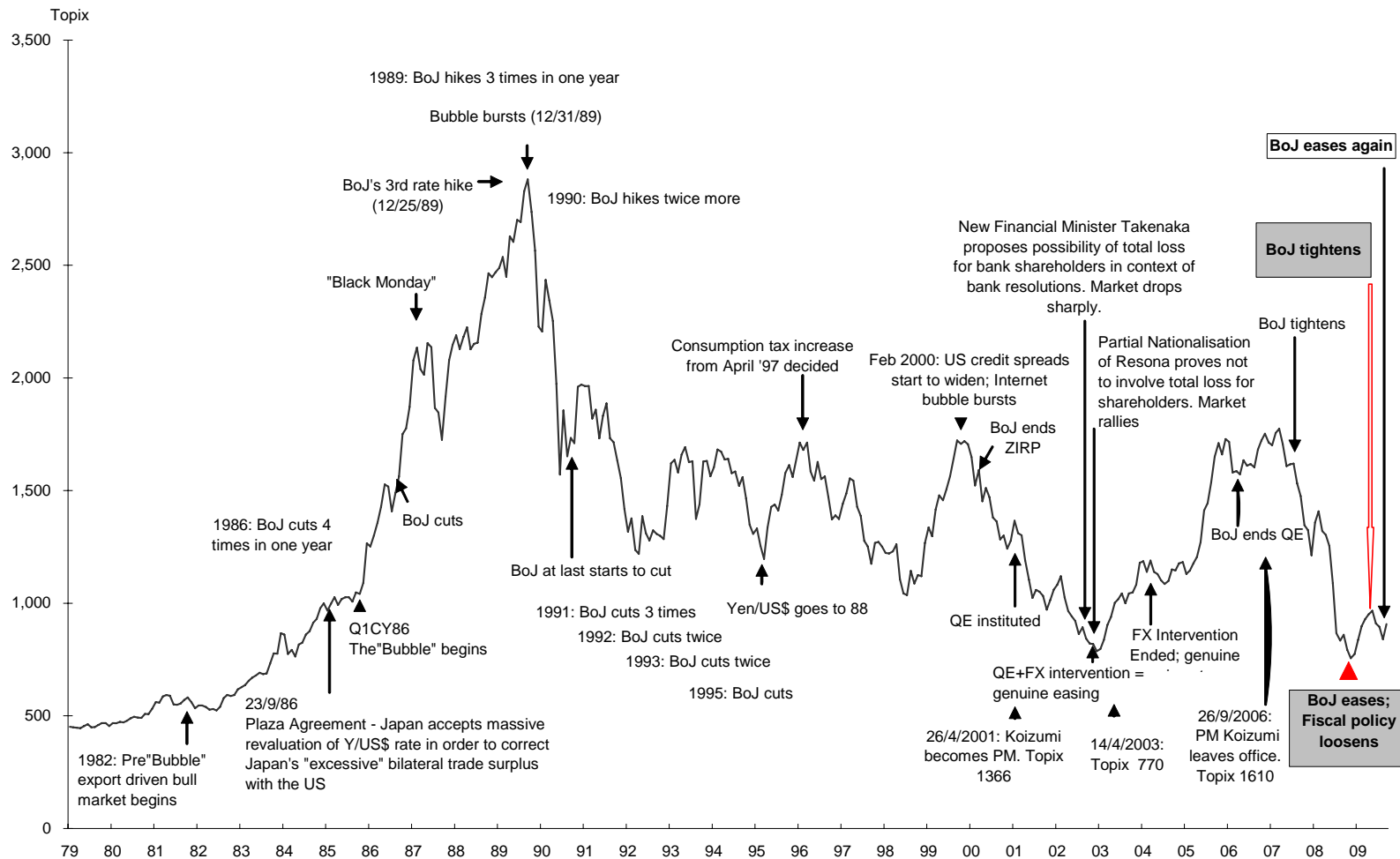
Source: MSCI, AAll, Datastream, Morgan Stanley Research

**2004: it paid to buy when we saw a 3SD net short speculative position on Nasdaq futures**



Source: MSCI, CFTC, Morgan Stanley Research

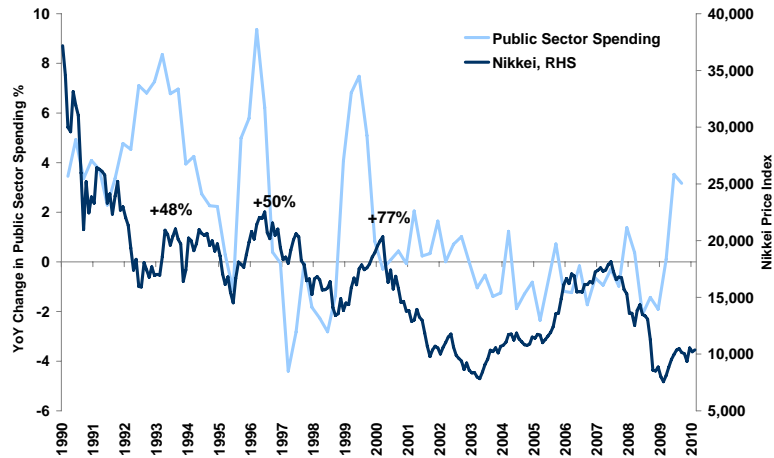
Lessons from Japan - many of the ups & downs triggered by policy changes



Source: Morgan Stanley Research

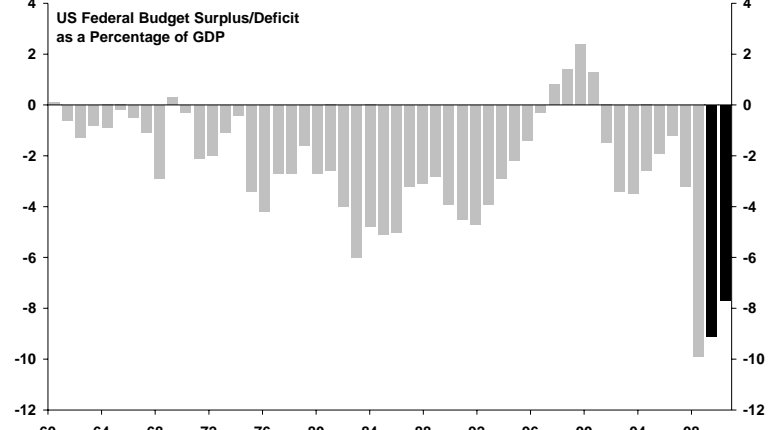
## Fiscal policy may be key this time round

Japan multi-dipped as fiscal stimulus withdrawn



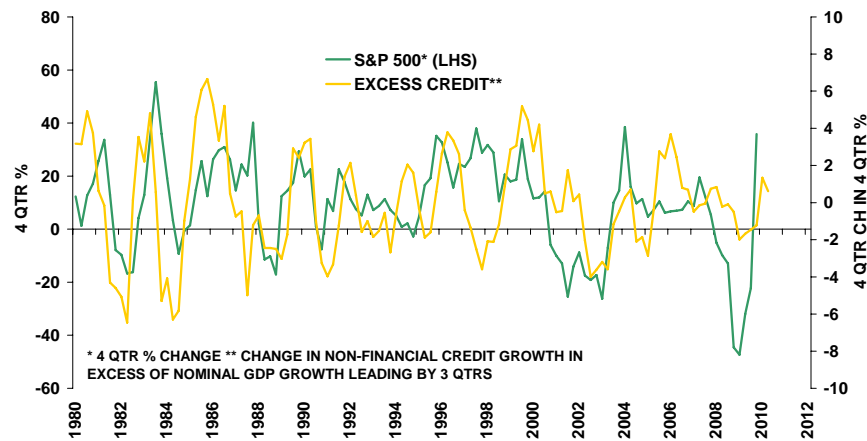
Source: Cabinet Office-Japan, DataStream, Morgan Stanley Research

Fiscal policy much looser in this cycle but budget deficit starts to contract in 2010 & 2011



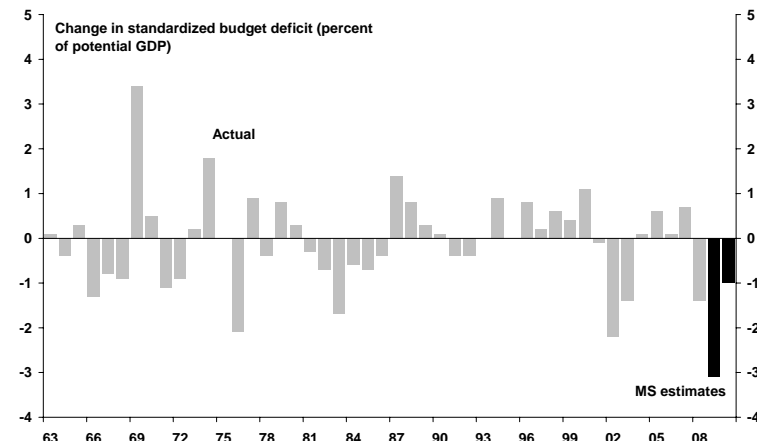
Source: Congressional Budget Office, Morgan Stanley Research

The now impaired credit super-cycle was a key driver of equities in the last 30 years



Source: DataStream, BEA, Federal Reserve; Morgan Stanley Research

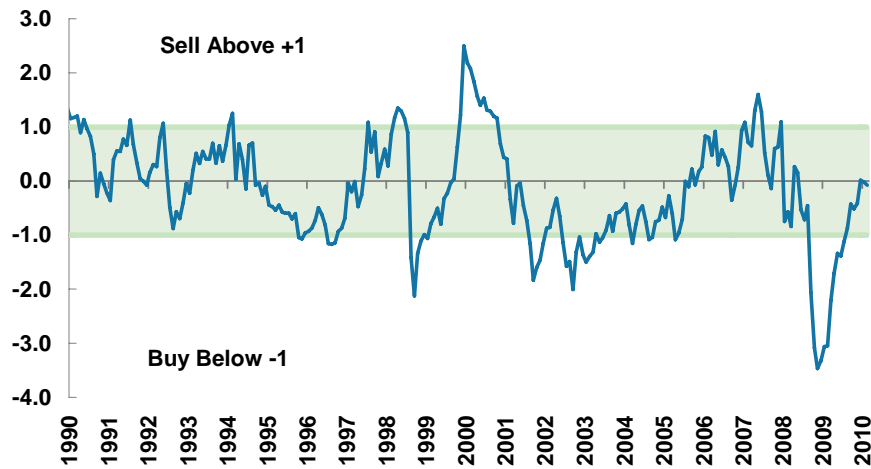
Standardized budget deficit (i.e. adjusted for cyclical and one-off effects) to widen at a slower rate in 2010



Source: Office of Management and Budget, Morgan Stanley Research

**At the lows in 1994 & 2004 the CVI and CMTI were between -0.5 and -0.7 vs. 0.0/-0.1 today**

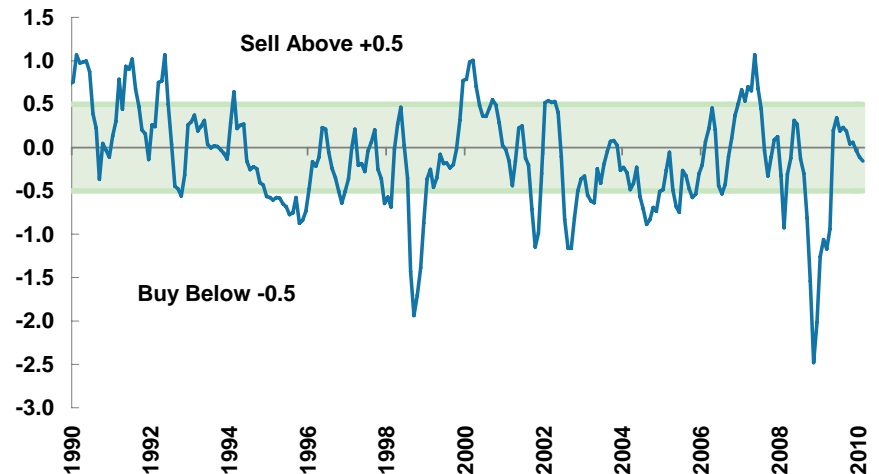
**Composite Valuation Indicator (-0.05 today)**



When the CVI is above / below ...	< -1.5	< -1.0	< -0.5	< 0.0	> 0.0	> 0.5	> 1.0	> 1.5
N6M Perf (%)	9.3	7.9	6.9	7.5	1.8	-1.1	-4.8	-5.8
Hit Ratio (%)	88	84	84	85	59	50	35	31

Source: Morgan Stanley Research


**Combined Market Timing Indicator**  
 Average of CVI, Fundamentals and Risk Indicators (+0.04)



Combined MTI Backtest	Backtest - 6 Mth Subsequent Performance if indicator (Since 1990)												
	< -1.75	< -1.50	< -1.25	< -1.0	< -0.75	< -0.50	< -0.25	< 0.00	> 0.00	> +0.25	> +0.50	> +0.75	> +1.00
Average 6M Subsequent Performance %	22.4	21.2	14.9	6.4	5.4	9.2	8.7	7.7	-0.7	-5.5	-9.1	-6.4	-3.7
Hit Ratio %	100	100	100	71	71	85	86	81	47	28	21	27	0

Source: MSCI, Datastream, Morgan Stanley Research

## Disclosures

 <p>MORGAN STANLEY ModelWare</p>	<p><b>Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.</b> For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.</p>
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	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Not-Rated/Hold	22	1%	5	1%	23%
Underweight/Sell	382	15%	89	12%	23%
Total	2,530		751		

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Stock Price, Price Target and Rating History (See Rating Definitions)

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