Looking through Morgan Stanley’s crystal ball

By Editor Test *Mon, Jul 30, 2012*

Fiscal policy is tightening in Europe and is likely to tighten in the US as the fiscal cliff approaches, says Morgan Stanley: "We expect the cliff to be addressed after the election."

Morgan Stanley Smith Barney’s Global Investment Committee’s has released its monthly overview of markets, economics and asset allocation. According to the report:

On markets

- Our cautious tactical asset allocation remains in place, given the still inadequate policy response to both the European recession and slower US growth.
- We are overweight cash, short-duration bonds, investment grade bonds and managed futures.
- We are underweight developed-country sovereign debt, high yield bonds, equities, commodities, global real estate investment trusts and inflation-linked securities. We are market weight emerging market bonds.
- Regarding global equities, we continue to overweight both the emerging market and the US while underweighting other developed markets. Within US equities, our capitalization preference is large caps and our style tilt is growth.

On economies

- Europe is in recession and growth is slowing in the US and in most emerging market economies. Still, we expect global growth to remain positive this year and next.
- The policy options to promote growth in developed market economies are variously limited, politically unlikely or too little, too late. Moreover, fiscal policy is tightening in Europe and is likely to tighten in the US as the fiscal cliff approaches. We expect the cliff to be addressed after the election.
- By contrast, fundamentals and policy options in emerging market economies are generally more robust. Globally, we expect inflation to abate.

On profits

- Expectations for 52-week forward earnings per share are mixed. The S&P 500 forward earnings figure is now above $112, up from a low of $107 last autumn.
- However, 52-week forward EPS for global equities has dropped to about $28, down from more than $30 last summer.

On interest rates

- Developed market central-bank policy rates are likely to remain low at least into 2014. The Federal Reserve has extended Operation Twist, given continued tepid US growth; a third round of Quantitative Ease is likely. The European Central Bank (ECB) policy rate is now below 1%. Moreover, the ECB now indirectly supports the EU sovereign debt markets and major European banks. Meanwhile, emerging market central banks have begun easing to offset slower growth.

On currencies

- In the short term, we expect US-dollar strength versus the euro. Longer term, major developed market currencies will likely decline against several emerging market currencies.