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Energy, Currency and the Battle Against Lowflation

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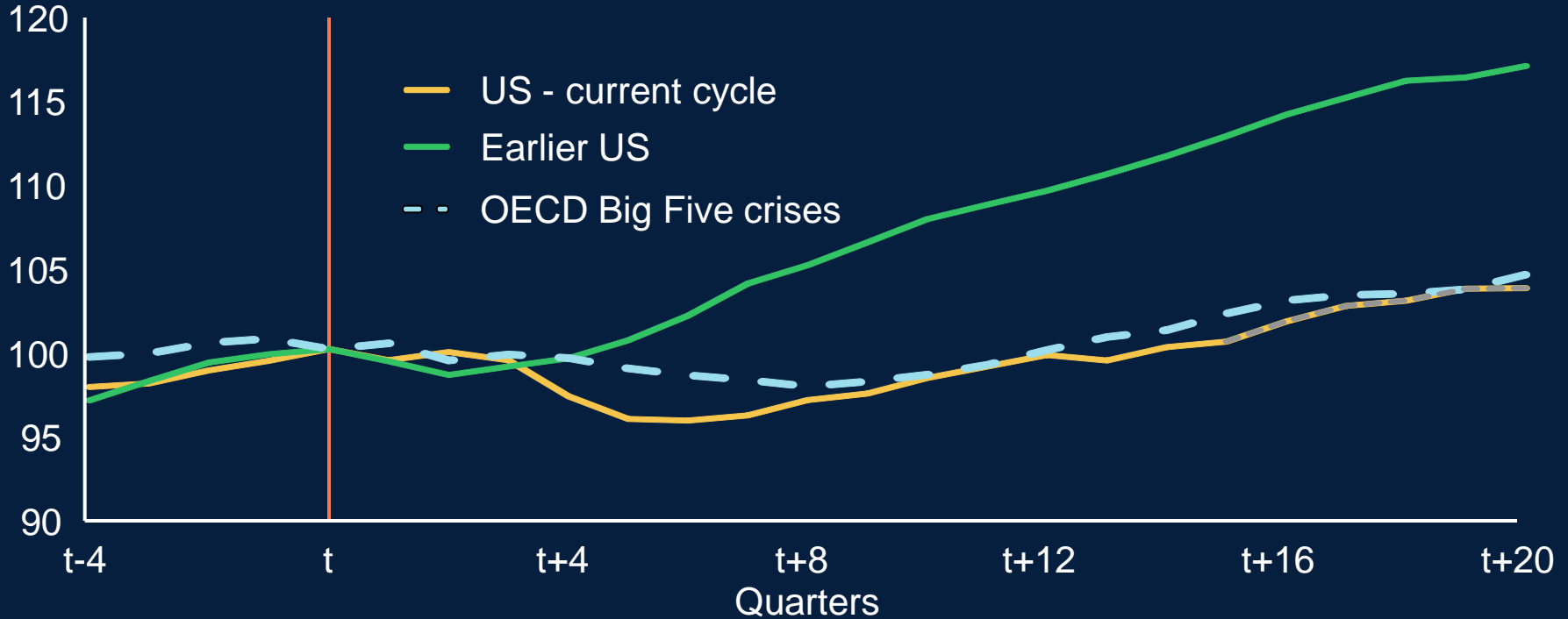
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2020 Vision: Long Live the Expansion

- Business cycles don't die of old age.
- Overheating, CEO hubris, stretched capex and excess inventories tend to put an end to cycles.
- Global economy is not in sync.
- Interest payments on debt burdens are low. Most of household balance sheet is locked in at low rates.
- Broad indicators of the economy just now reaching “normal” expansionary levels.
- 6% per annum EPS growth and a 17x price-to-earnings ratio could see S&P500 peak of near 3000, per our US strategist.

Moderate growth delays overheating...

Real GDP around recessions and financial crises (index, time $t = 100$)

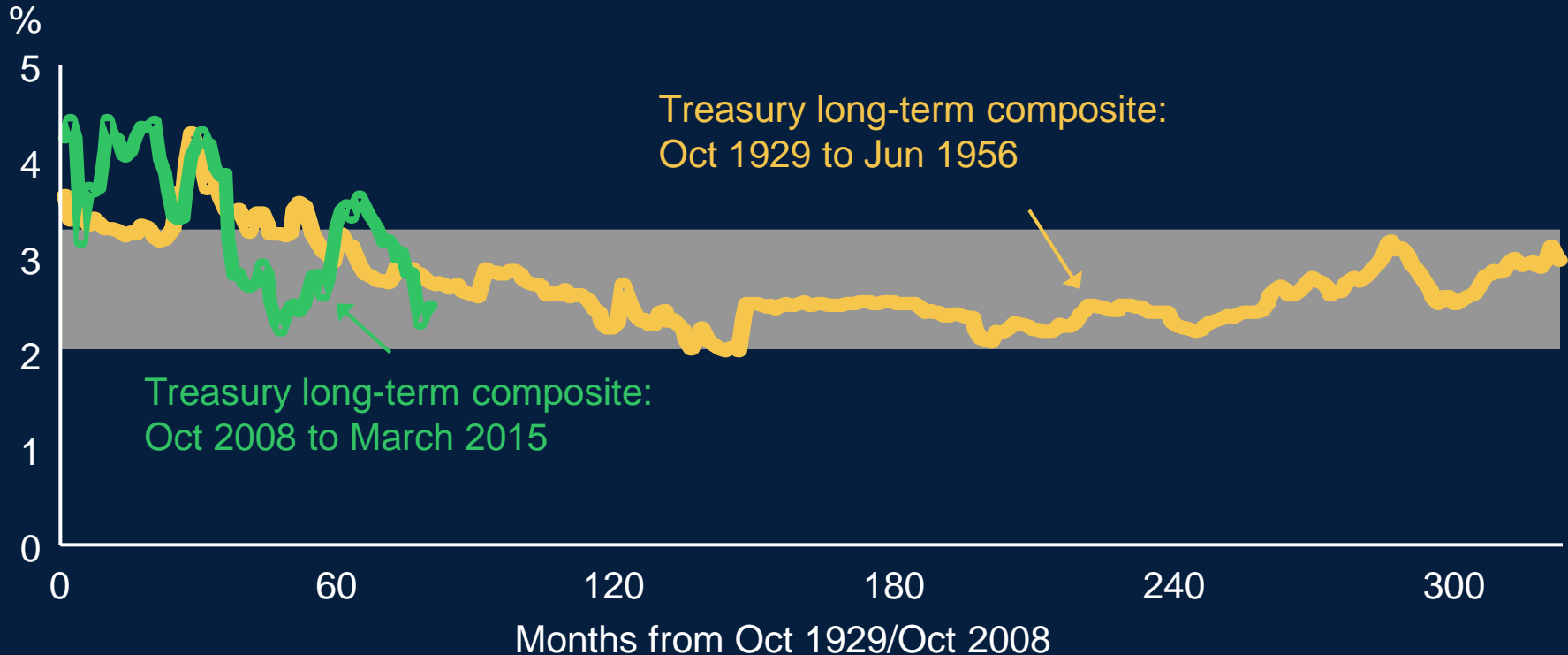


Notes: "Earlier US" represents the average of the last 10 recessions. The "OECD Big Five" financial crises were first identified by Kaminsky and Reinhart (1999) – countries include Spain (1977), Norway (1987), Finland (1991), Sweden (1991), and Japan (1997, as opposed to 1992 as this was the start of the most intense phase of the financial crisis there).

Source: OECD, Morgan Stanley Research

...warranting a low interest rate environment for a long time.

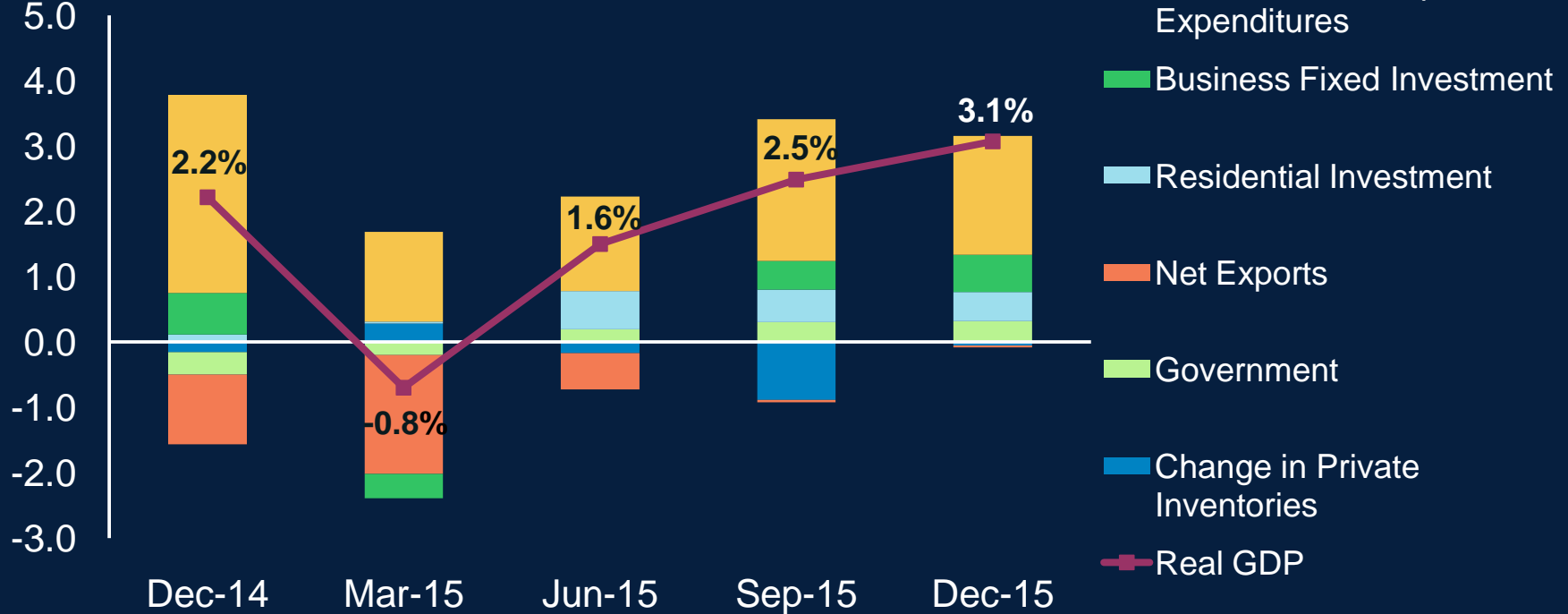
A legacy of past crises – decades of low interest rates



Quarterly growth profile has changed, with a stronger back half

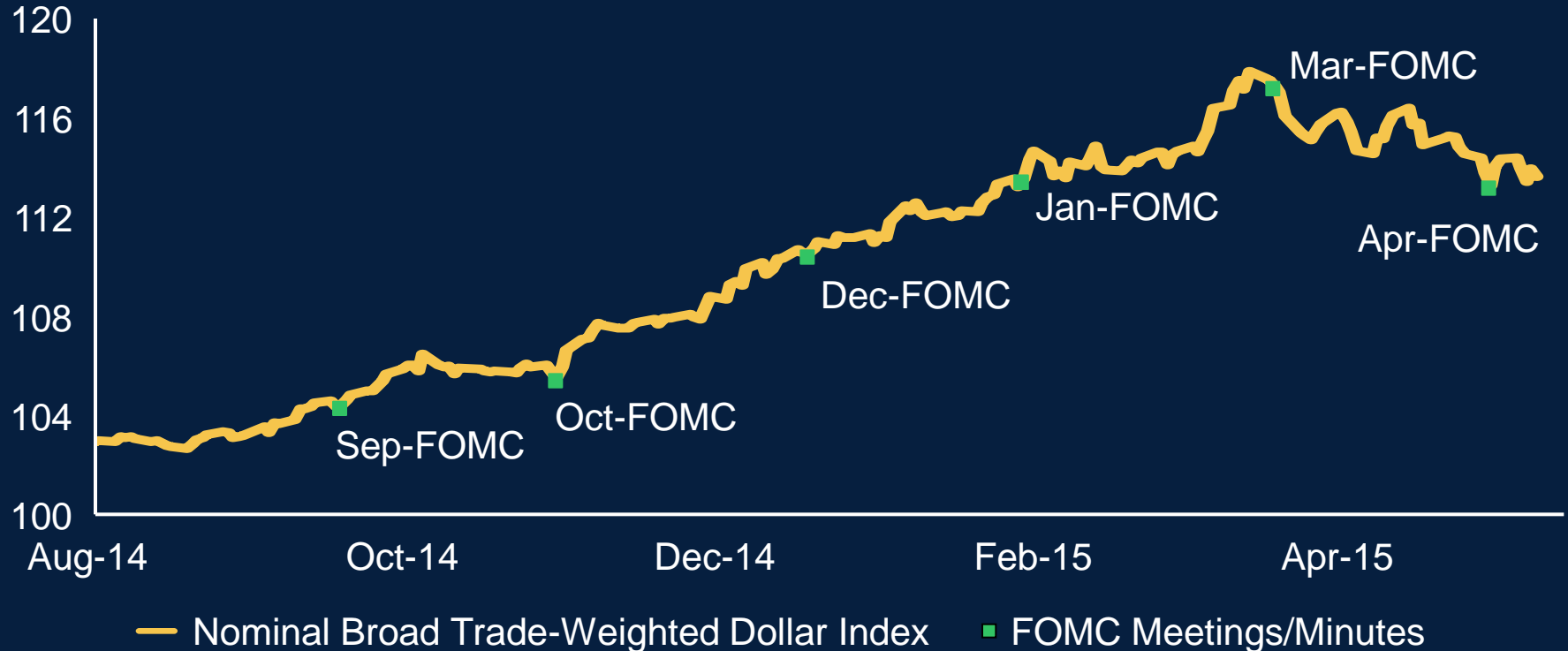
Contributions to % Change in Real GDP

percentage points

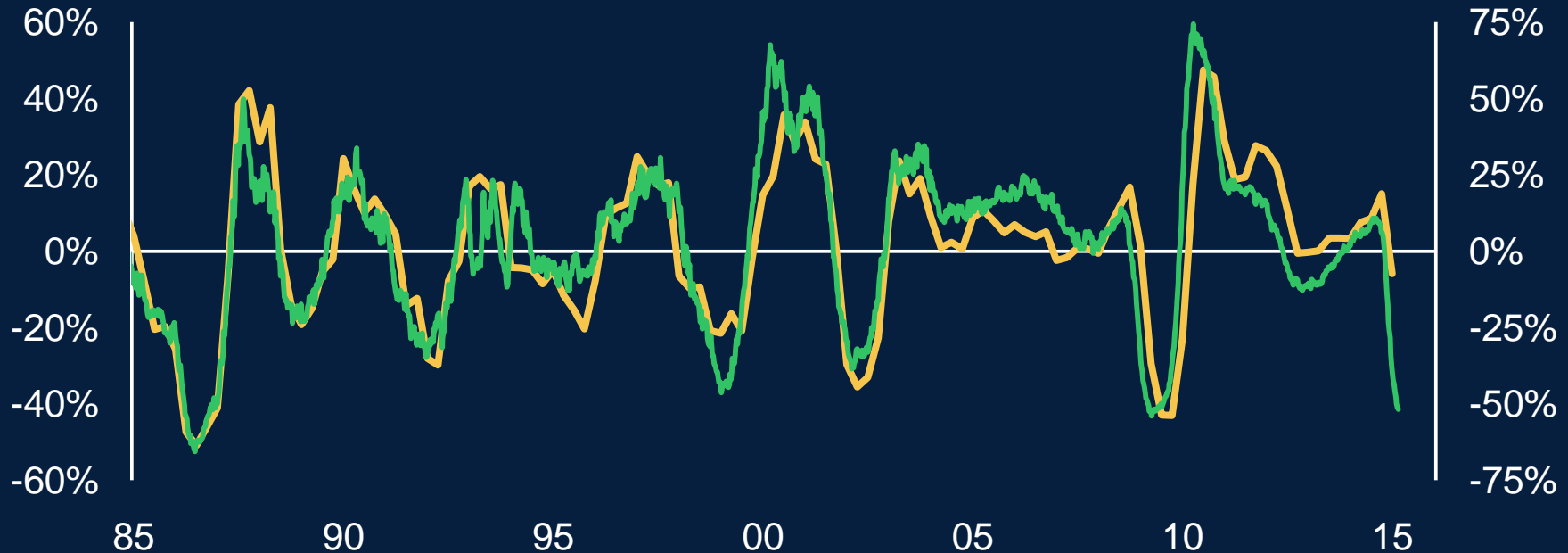


The USD has done some damage

The currency's rapid ascent has worried the Fed and businesses



Drilling counts toward GDP, and falling rig counts suggest a big drag



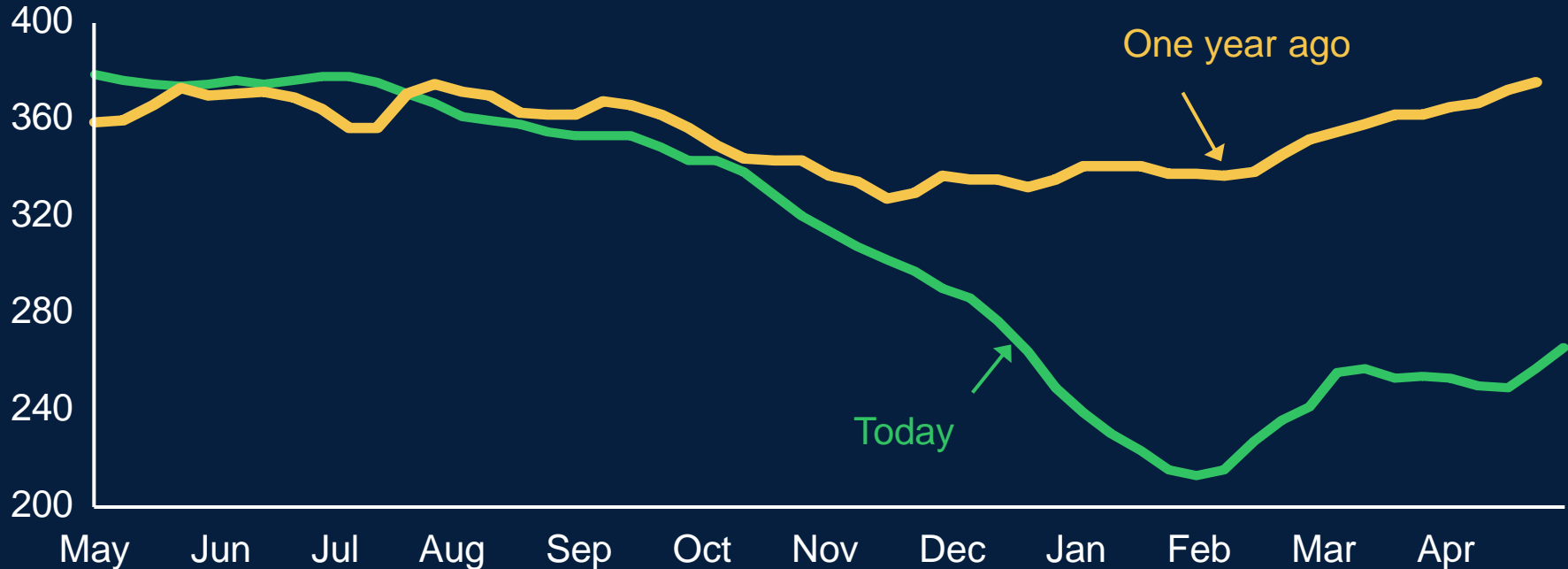
— Pvt Investment: Petroleum and Natural Gas, Explo/Wells (SAAR, Mil.Chn.2009\$) %
Change - Year to Year

— Baker Hughes Active Rig Count: US (Units) % Change - Year to Year (Right Scale)

Lower oil has shifted income from producers to consumers

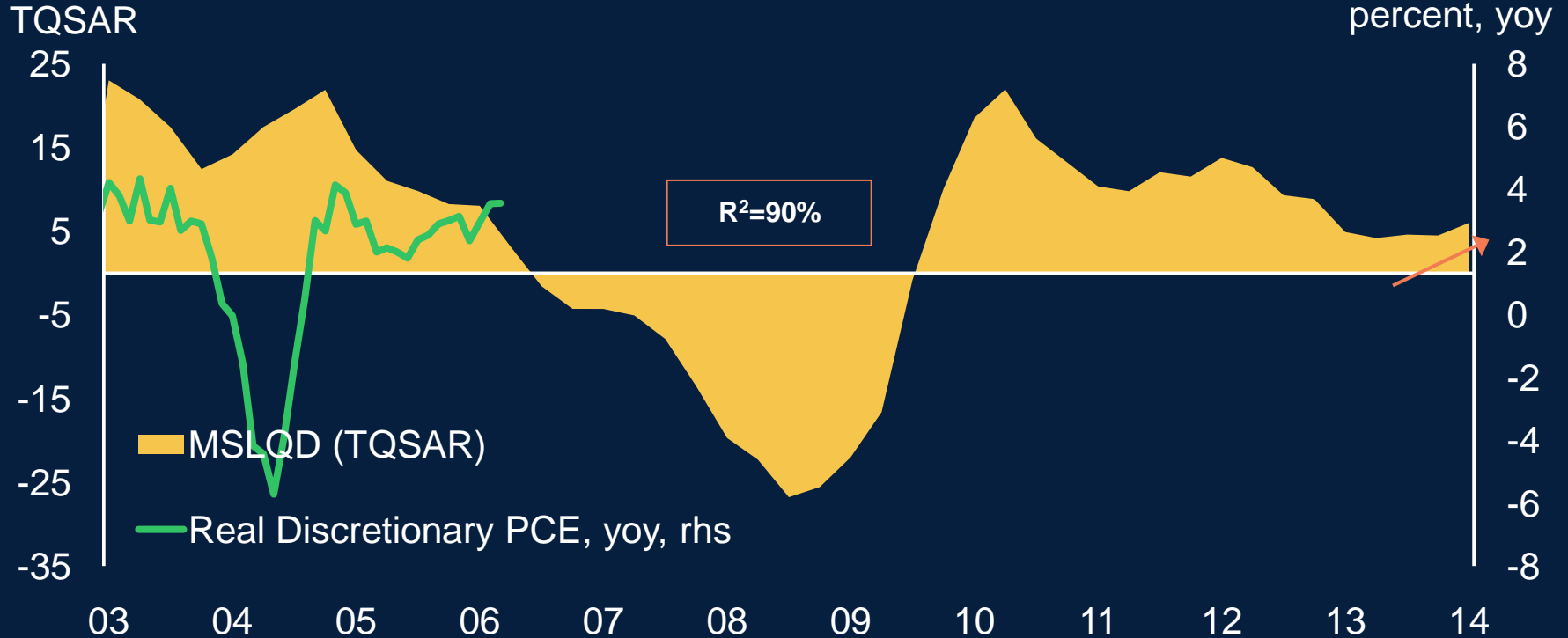
Consumers are enjoying roughly \$170bn in annualized gas savings

Retail Gasoline Price: All Grades
cents/gallon



Liquidity constraints are lifting

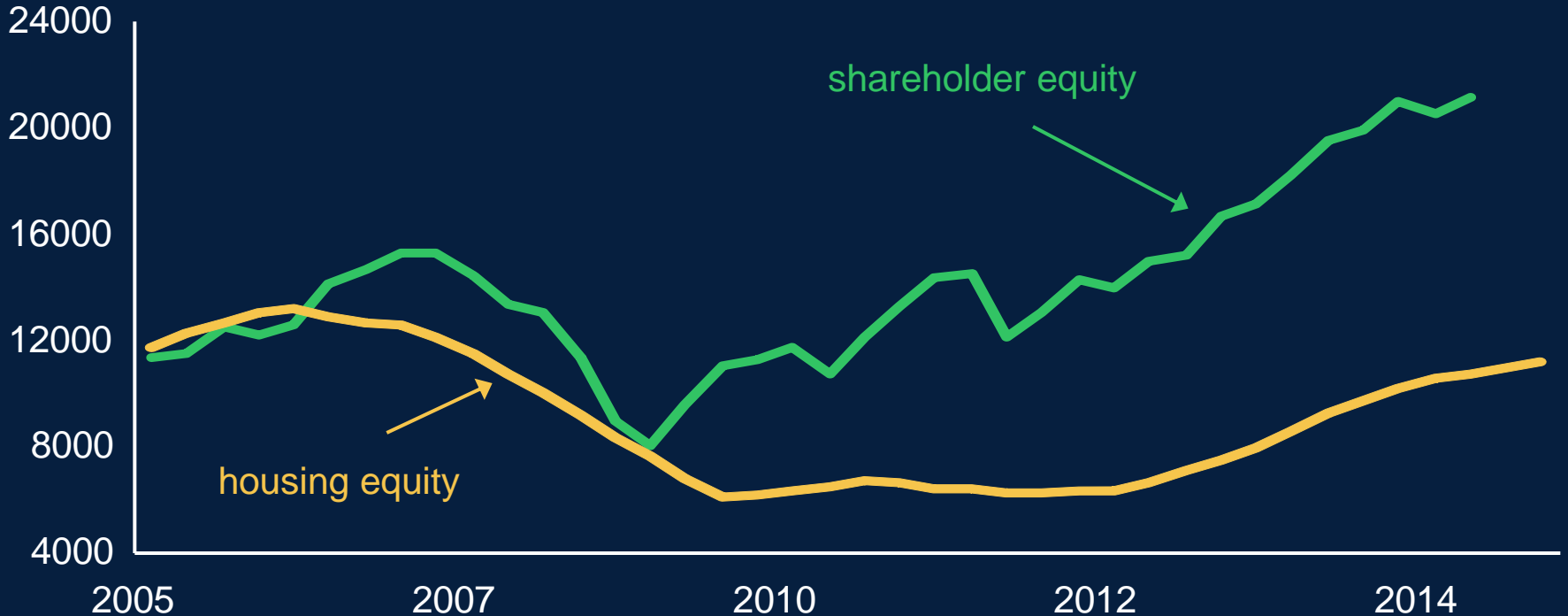
On rising aggregate income, lower expenses (MSLQD Index)



Gains in shareholder equity have long passed the previous peak

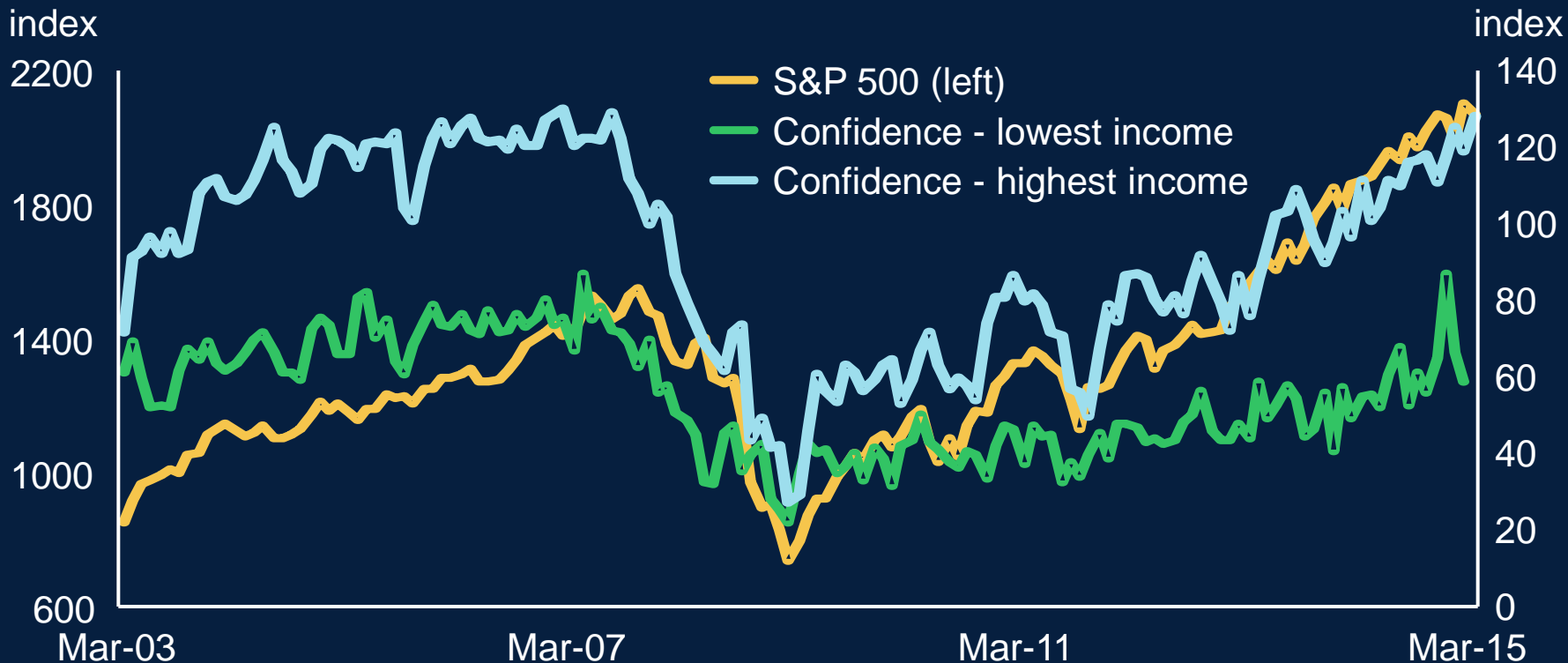
But housing equity is lagging

\$ billions



Are you sure money doesn't buy happiness?

Consumer confidence by income group vs S&P 500



Single strongest category of consumer spending in 2013

Personal aircraft (followed by pleasure boats)

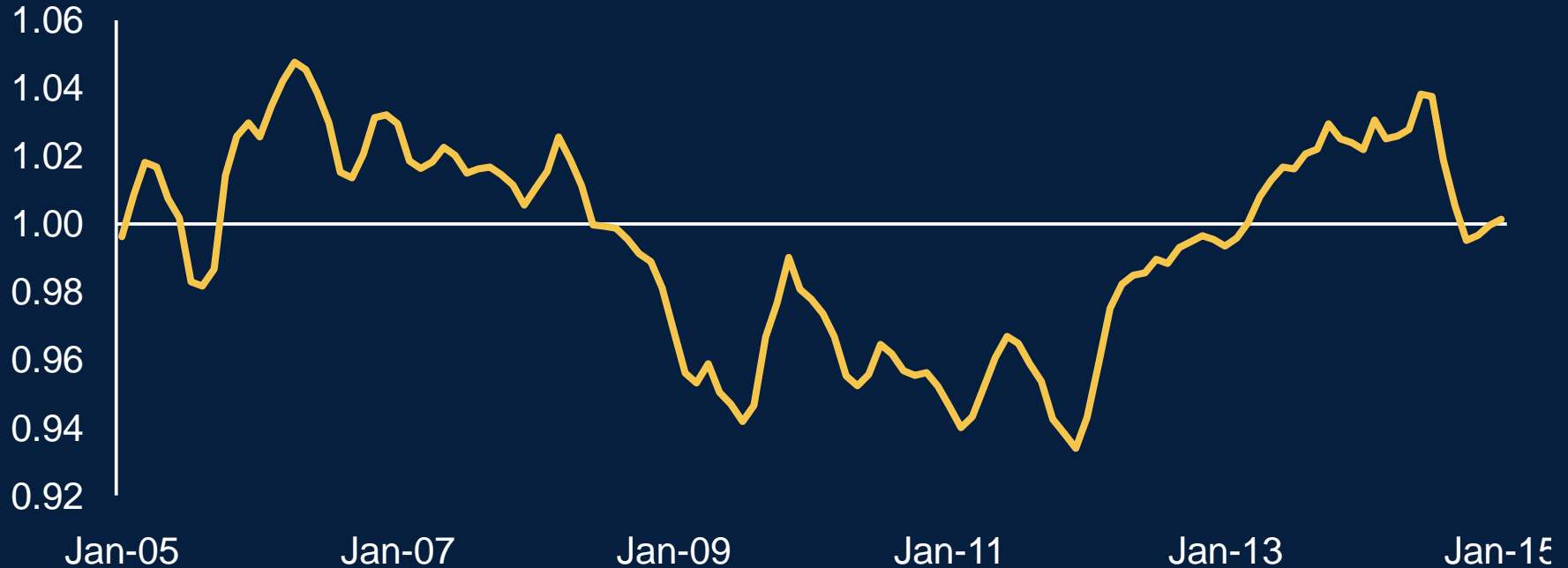
annual percent change



But high-end discretionary slowed in 2014

And middle-to-low end discretionary is picking up (TVs, computers now on top)

high-end v low-end discretionary ratio

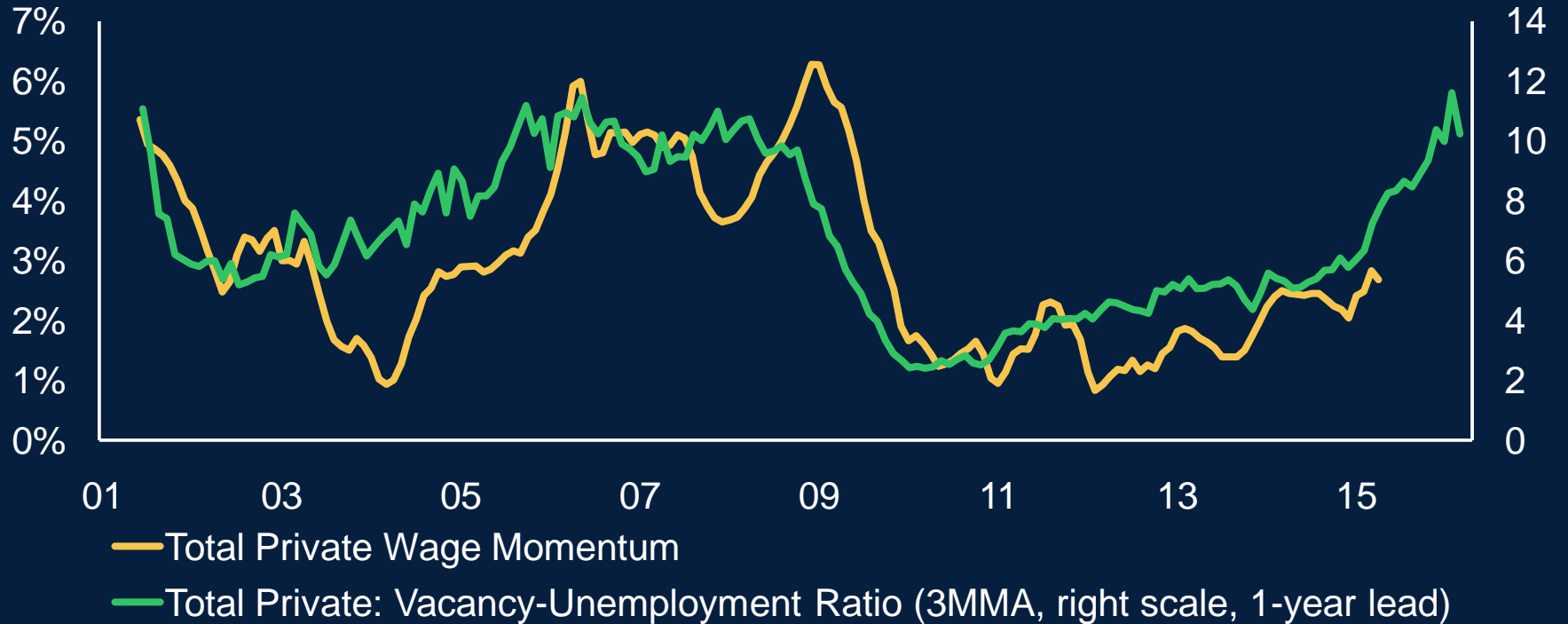


Note: High-end discretionary includes categories of spending such as personal aircraft, pleasure boats, foreign travel, jewelry and watches, and the like. Middle-to-low end discretionary includes categories of spending such as vehicles, televisions, personal care services, child care, cleaning services, and the like.

Source: BEA, Morgan Stanley Research

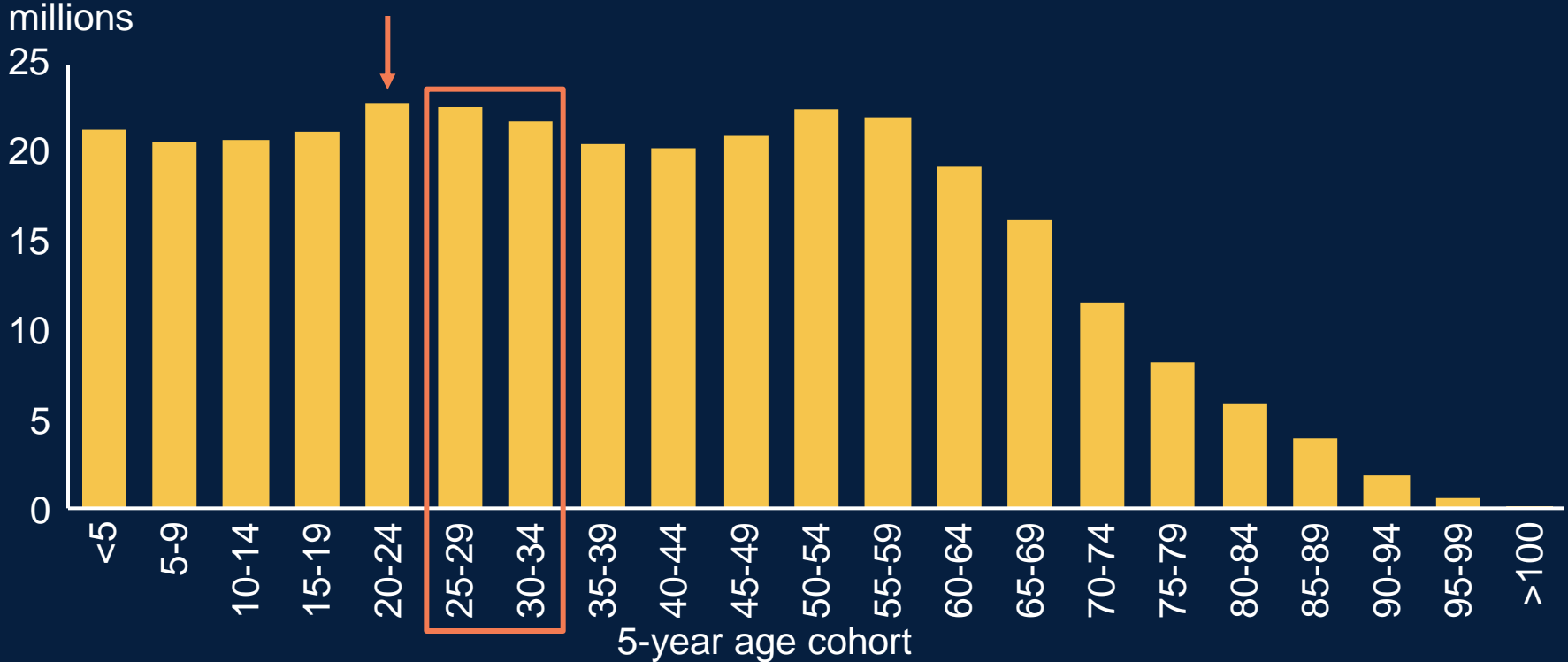
Slack Has Diminished, But Wage Growth Has Not Followed

Wage Growth, Annualized Trend



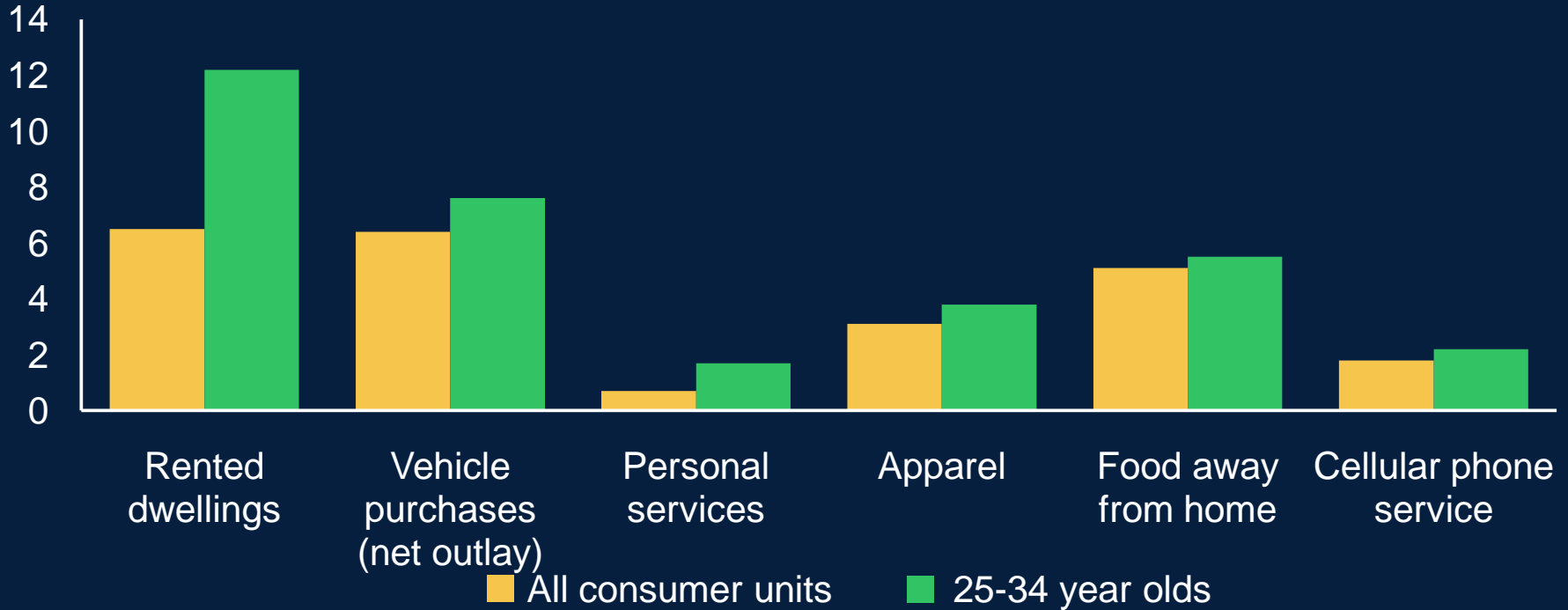
In 2015, 20-24 year-olds are the largest age cohort

Which means another baby boom is on the horizon (and an apartment boom)



Where do Millennials spend?

Categories that garner a disproportionate share of income share of income



Fed Policy: The Beginning of the End

The Fed has sent a strong message that it plans to hike rates this year.

- At its March meeting, the FOMC revised lower its expectation for growth and inflation, yet no policymaker shifted their expected timing of the first rate hike into 2016.
- This sends a strong message of the Committee's intent to hike rates this year, and implies **it would take a sizable negative surprise to alter that course.**
 - The first rate hike “could be initiated prior to seeing increases in core price inflation or wage inflation.”
 - “Further improvement in the labor market, a stabilization of energy prices, and a levelling out of the foreign exchange value of the dollar were all seen as helpful in establishing confidence that inflation would turn up.”

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