Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

In Search of a Late-Cycle Buffer

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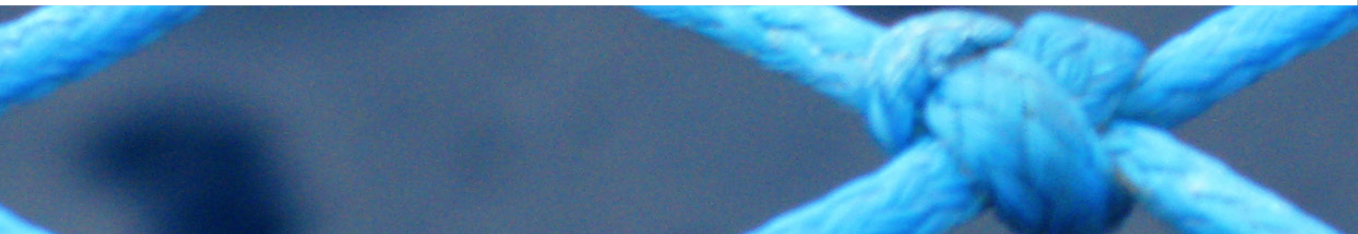
2019 has some worrying echoes of 1999. Markets are up strongly despite soggy earnings, initial public offering-frenzy is back on CNBC as Lyft starts the wave of unicorns heading to market before the music stops and, perhaps most alarmingly, Goldman Sachs has abolished business dress. Even the Backstreet Boys are back. This may be more anecdotal than scientific, but it is all starting to feel rather late cycle and, therefore, arguably a good time to deploy a late-cycle buffer, if one is not in place already.

Applying a bit more rigor, at the start of 2018 we were worried about the elevated level of market multiples. By the end of 2018, which saw a combination of a sharp de-rating and strong earnings rises, our primary worry had shifted over to earnings. After first-quarter (Q1) 2019, which saw double-digit returns despite a global economic slowdown, we are now anxious about both multiples and earnings. We like to say that the good news is that there are only two ways to lose money in equities… if the earnings go away or if the multiple goes away. The bad news right now is that both are under threat.

The multiples are a concern as they have bounced back to September levels, with the MSCI World Index back above 15x the next 12 months' earnings[1] as Q1 2019 has reversed the Q4 de-rating. It is true that some of the fears that stalked Q4 have faded, thanks to the seeming U-turn from the U.S. Federal Reserve and the more positive mood music from the U.S.-China trade talks, but the experience of last year's two market swoons suggests that there is significant downside multiple risk, even without any cyclical earnings shock.

"After Q1 2019, we are now concerned about both multiples and earnings"

[1] Source: FactSet. Data as of March 31, 2019.



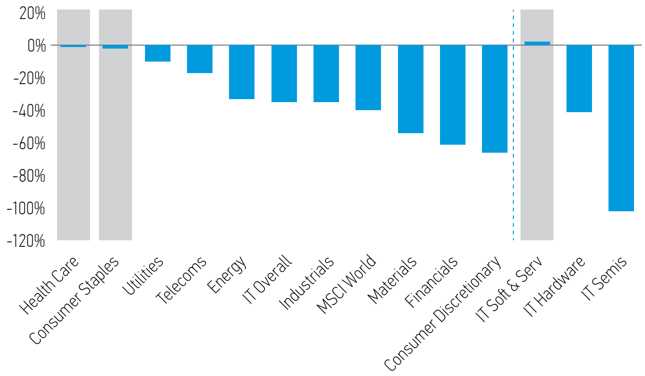
As for earnings, our underlying anxiety is that they may be unsustainably high, particularly in the U.S. Margins are near peak levels, as are profits' share of gross domestic product and the level of earnings per share-boosting leverage. Earnings are also drifting down while the market surges up. The 2019 MSCI World Index earnings estimates are off 6.5% since the start of Q4 2018 and 4.0% down year-to-date.[2] In the U.S., where quarterly data is available, earnings are actually expected to be down around 3% year-on-year in Q1.[3] The interesting point is the source of the U.S. earnings drop. Revenues are still healthy, up around 5% on the year,[4] but the margins are falling. Costs are rising in the U.S., notably for labour, and many companies are having trouble passing them on. The National Association of Business Economics reported that 58% of respondents were facing higher labour costs, but that only 19% had been able to increase prices, presumably the 19% with the strongest pricing power. The market, as per usual, assumes that things will improve. By Q4 2019, consensus has U.S. earnings up nearly 10% year-on-year, as against the Q1 2019 fall.[5] Our fear is that this may be over-optimistic, either due to the late-cycle margin pressure, or the even-later-cycle economic downturn.

"If we are indeed late cycle, then a portfolio of compounders seems a reasonable place to hide"

If we are indeed late cycle and, therefore, vulnerable to late-cycle margin pressure followed by an economic downturn, then a portfolio of compounders seems a reasonable place to hide. We believe compounders have sustainable high returns supported by powerful intangible assets. Importantly, we also require strong pricing power, recurring revenues and limited operational and financial leverage. The pricing power, generally fed by powerful brands and networks, allows companies to protect their margins when costs rise, while the recurring revenues, from repeat purchases or long-term contracts, support the level of sales. The combination of robust sales and robust margins should help drive robust profits, particularly if there is limited operational or financial leverage.

While of course past performance doesn't guarantee future outcomes, we believe the impact of the 2008-09 global financial crisis supports our thesis that compounders can be a late-cycle buffer. Our flagship global equity strategy, Global Franchise, actually saw its earnings rise over the course of the crisis, while the market saw a 40% fall. In addition, the earnings for the core sectors of our global portfolios today (consumer staples, software & IT services within information technology, and health care) which combined are over 80% of our global portfolios, held up far better than their more cyclical peers, as shown in the chart below.

NTM Forward EPS Change During Financial Crisis Drawdown (Oct 2007 - Feb 2009)



Source: FactSet. Data as of February 28, 2019. Chart shown for illustrative purposes only.

On forward price-to-free cash flow, our favoured valuation metric, our global portfolios trade on only an 18-22% premium to the far lower-quality MSCI World Index, despite the far higher return on capital, gross margins and margin stability.[6] We would argue that this is actually an overstatement of any real premium, given the market's chronic failure to deliver the expected forward cash flows and earnings and the habit of tucking any unpleasant news 'below the line.'

Our global products look to compound wealth over the long term, by owning high-quality companies that compound their earnings steadily at reasonable valuations. They look to keep the lights on, rather than shooting them out, and have been described as a get rich slowly scheme. We would assert that compounders should be owned across the cycle… but in particular if the cycle may be coming to an end.

[2] Source: FactSet. Data as of March 31, 2019.

[3] Source: FactSet. Data as of March 31, 2019.

[4] Source: Refinitiv. Data as of March 31, 2019.

[5] Source: FactSet. Data as of March 31, 2019.

[6] Source: FactSet. Data as of March 31, 2019.

RISK CONSIDERATIONS

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

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The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

DEFINITIONS

Earnings per share is the portion of a company's profit allocated to each outstanding share of common stock. **Gross domestic product (GDP)** is a broad measurement of a nation's overall economic activity. GDP is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

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