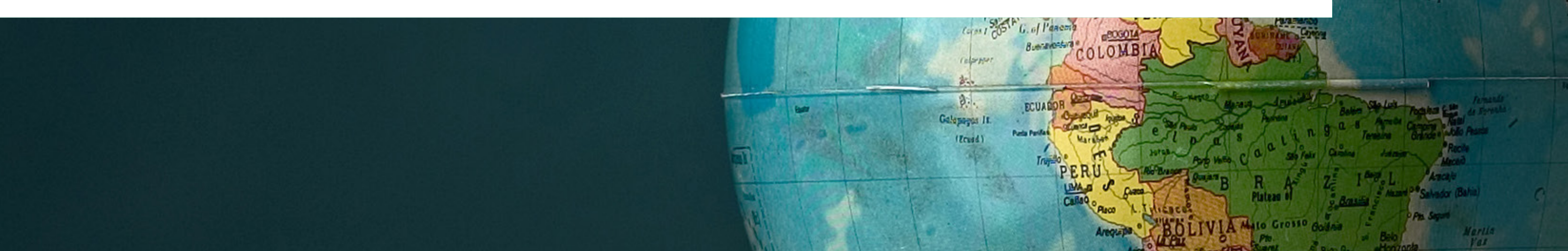
Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The End of the World As We Know It?

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | JUNE 2018



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The MSCI World Index returned 0.4% in USD over the last six months – and in local currency is up 1.3%. Judging by the outcome, it looks as dull as the England-Belgium World Cup football match, but the reality could not be more different. A number of conditions that shaped the investment environment between 2009 and 2016 have changed quite fundamentally over the last 18 months. Gradually, these changes are now making their way through the markets:

EARNINGS, NOT MULTIPLES, MATTER NOW

From 2011 to 2016, earnings for the MSCI World Index remained mostly flat, if not downward sloping. Earnings per share (EPS) were supported by share buybacks –predominantly in the U.S. – while everywhere else EPS fell. This did not stop the market from rising, since multiples expanded from a forward price-to-earnings (P/E) of 10.5x in September 2009 to 17.2x in April 2015. From 2016, earnings have become the main driver of index appreciation, while P/E multiples contracted back to a one-year forward P/E of 15.1x.

Assuming a gradual winding down of the monetary stimulus, and still historically high valuations, it is likely that earnings will remain the dominant driver of performance for the market going forward. The earnings outlook for 2018 benefitted from U.S. tax reform – a one-time effect now absorbed into the numbers.

"A number of conditions that shaped the investment environment… have changed fundamentally…"

If the windfall from tax reform was to be re-invested in capital expenditure (capex), we may see some mid-term benefit from higher productivity. For the time being, however, the main driver of earnings upgrades has to come from consumer spending, not only in the U.S. but also in Europe and Japan. This, in turn, would be much more sustainable if it was based on wage growth rather than increased borrowing. The failure of the Phillips curve to predict wage growth indicates that we are seeing some change in the wage pattern that is not yet fully understood, making earnings predictions more volatile.

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CHINA IS DELEVERAGING

The largest credit impulse we have seen in the last 10 years did not come from the U.S. Federal Reserve, the European Central Bank or the Bank of Japan. It came from China, where the authorities have the luxury of ordering banks and corporates to lend and borrow, while elsewhere monetary stimulus often got stuck within the plumbing of the financial system. The two peak credit injections happened in 2009 and 2015-2016, and both were driven by the desire of the Chinese government to maintain targeted gross domestic product (GDP) growth rates in the face of slowing export demand and consumer demand (which had shrunk to just 35% of the economy).[1] As of 2017, private consumption had grown to 39% of the economy and contributed more than 60% of GDP growth.[2] This, together with the recognition that corporate leverage has become excessive and inefficiently allocated in some parts of the economy, makes it less likely that the Chinese government would embark on a stimulus on a similar scale should global growth fall behind expectations.

THE SIMULTANEOUS TIGHTENING BY OIL AND CENTRAL BANKS

Over the last decade we have seen periods of rising and falling oil prices. These influenced the relative performance of industries but not the overall market direction. In part, we believe this is because the tightening impact of rising oil prices on liquidity was offset by the central banks printing money. In 2018, we have a situation where the price of oil has risen whilst central banks are gradually exiting their quantitative easing strategies.

POLITICS OF DE-GLOBALISATION

Following the financial crisis, we saw governments across the globe working hard to maintain the global supply chain that had fuelled the expansion of the world economy up to that point. The common notion amongst the G7 and G20 was that a slide into protectionism, as happened in the years after 1929, should be avoided. This consensus is gradually falling apart. Donald Trump has a democratic mandate to implement protectionist policies for the U.S., and we are seeing more and more countries electing governments with "My Country First" programmes – most recently Italy and Mexico. At the same time, multilateral political structures such as the European Union (EU) and World Trade Organisation find it increasingly difficult to get their messages across. While for the moment the new trade tariffs may not have much immediate impact on U.S. and global GDP growth given their size, the question is whether corporate earnings will sustain a material impact as efficient global supply chains get replaced by national or regional solutions. Recent announcements by Daimler, Harley Davidson and Brown Foreman indicate that this may take place more quickly than expected.

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THE DATA PRIVACY BACKLASH

The last item on our by-no-means comprehensive list of material shifts is the change in attitude toward data protection. Data ownership has not only become increasingly concentrated but, most importantly, the ability to use this data is increasing exponentially. This will ultimately require a new set of rules that will most likely change the way not only the technology industry operates but also how most consumer-facing industries will interact with their customers. The EU's General Data Protection Regulation, known as GDPR, is likely only a first step in this transition.

TINA IS DEAD

Over the last 10 years, the market downplayed a lot of these changes, since holding cash was a terrible investment strategy with real returns close to zero or in some cases negative. This is no longer the case, and hence the adage of "There Is No Alternative (T.I.N.A.)" no longer exists. U.S. 12-month Treasuries now yield 2.3%, up from zero in September 2015. With one-year inflation expectations at 2.1%, this is the first time since 2007 that moving to cash preserves real value.[3] This changes the picture fundamentally, as market participants do not have to stay invested if they feel the reward is unlikely to outweigh the risks.

QUALITY AND CHANGE

Market environments always change and sometimes this change is more violent than others. What matters from a long-term sustainable return perspective is not whether one can predict the outcome of each or any of these trends, but whether the companies we have invested in are well placed to weather even the more severe potential outcomes.

[1] Source: UBS, 2018.
[2] Source: Bloomberg, 30 June 2018.
[3] Source: Bloomberg, 30 June 2018.

"Good management teams rarely fail to understand what change is needed to manage a shift in market conditions."

In our quality framework, we aim to find companies that produce sustainable and high returns on operating capital on the back of strong pricing power and low capital intensity. This means that cash flows should remain sufficiently robust even in periods of falling volumes. Robust cash flow means these companies retain the optionality to adjust their strategy and business portfolio to a new environment. We strive to avoid companies that find themselves at the epicentre of the tail risks we identified.

We believe good management teams rarely fail to understand what change is needed in order to manage a shift in market conditions. What holds them back in a crisis is more often the pressures of servicing excessive leverage and/or the lack of funding for the fundamental repositioning or restructuring required. By investing in businesses with healthy balance sheets and strong cash generation we hope to avoid these truly intractable situations. This leaves us with the task of properly vetting the management team, something we've been doing for over 20 years as a key pillar of our investment process and ESG (environmental, social and governance) framework.

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.

INDEX INFORMATION

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 (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability. **Gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. **Price/earnings (P/E)** is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

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