Morgan Stanley

INVESTMENT MANAGEMENT

2019 Market Outlook

After Tech Corrects, What Next?

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ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS

The correlation between U.S. and Emerging Markets (EM) tech sector returns has been rising strongly for three years. As a result, imbalances in EM market returns have reached extreme levels. Broken down by sector, tech has contributed around 40% of EM returns over the past three years, a share matched only by energy in 2007.[1] In the past, when the country and sector leaders in MSCI EM accounted for anywhere close to this large a share of returns, it signaled a return to a more normal balance—and a change in leaders.

The infatuation with big tech stocks has driven the relative performance of small and medium caps (on an equal weighted index) to nearly two standard deviations below its historical trend in the emerging markets, as shown in *Display 1*. This is highly unusual. EM small and medium caps have never fallen this far in the 20-year history of the equal weighted index and came close only once, during the rage for large U.S. tech stocks in 2000. In the United States, by the same measure, the relative performance of small and medium caps has fallen by two standard deviations only three times in the last 100 years, during the Great Depression, the Nifty Fifty Bubble of the 1970s and the tech bubble of the late 1990s.[2] In all these past cases, small and medium caps started to outperform when mega caps began to falter, or even before.

Our argument, for some time, has been that when market imbalances grow this extreme, they don't persist, as a rule. Now that we have begun to see major falls in tech and the tech-heavy MSCI China index, the question is how the rebalancing is likely to play out. After the busts of 2000 and 2008, beaten-down sectors recovered, small and medium caps came back to life, and forgotten countries were rediscovered.

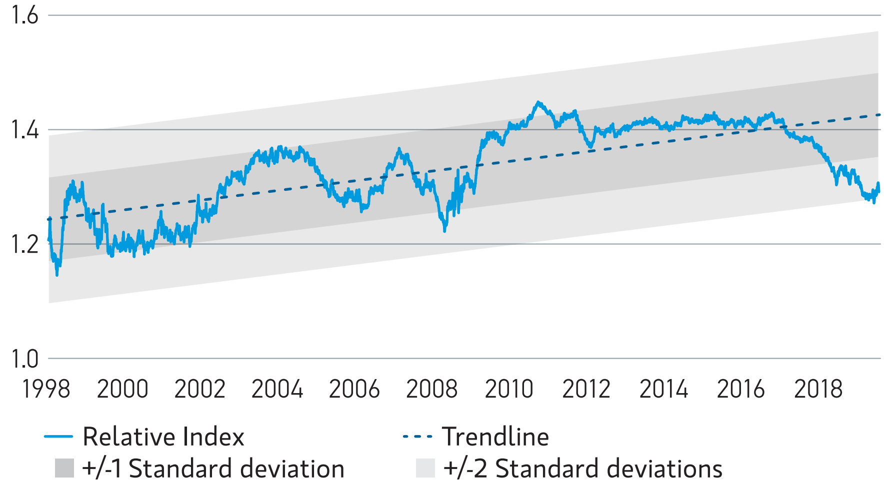
Over the past few years, investors became so focused on the tech-heavy Asian markets, they appeared to ignore the fundamentals of economic growth. Beginning with the launch of the MSCI EM index in 1988, the best returns had come in the fastest growing economies. But after 2016, economies with the highest growth rates underperformed the MSCI EM index, and those with the lowest growth rates outperformed. Many of the outperformers were tech-heavy.

Even after the recent declines, markets are still valuing big tech companies more highly than entire clusters of major emerging economies. After becoming the first $1 trillion company, Apple is down under $900 billion, but still in the same range as Indonesia and Malaysia combined, and nearly three times more than Poland.[3] The last time we saw companies overshadow countries this way was in Asia after the crisis of 1998, when for example, GE was valued more highly than the crisis-hit economies of Russia, Malaysia and South Korea combined. The big difference this time: many of the battered countries face no crisis and are growing rapidly.

DISPLAY 1

MSCI Emerging Markets: Equal-Weight Index/Cap-Weighted Index

Log Index



Data as of November 28, 2018. Source: MSIM, Bloomberg, Factset, Haver.

Now, some of them are starting to come back. As investors sell out of tech, they are rediscovering some overlooked markets of Eastern Europe and Latin America. Those markets had been battered in part by the strong dollar, which always sucks money out of EM, but may not last this time. Since the early 1980s, the dollar has rarely traded more than 15% above or below its long-term range, and it is now at the high end of that range.[4] Dollar bear markets have tended to last around seven years. Our view is that the dollar's rise in 2018 is a temporary rally within the downtrend that began in early 2016 and could prove long-lasting.

Some of the hardest hit EM currencies have stabilized, and we see no reason to expect the broad collapse to resume. As a group, emerging markets have strong external balances. Current account deficits are low on average, having fallen significantly since the "taper tantrum" of 2013 rattled countries like Brazil and India. Though many analysts are worried about emerging market debt, this risk is a threat mainly to China. While the rest of EM has seen its nonfinancial debt climb by 20 percentage points as a share of GDP since the global financial crisis of 2008, China's debt has grown by more than 100 percentage points.[5] Tellingly, the China market too had been driven largely by tech stocks, until the recent correction.

The question, then, is how to think about emerging markets as an asset class as the mania for tech passes?

Go back to the fundamentals that have driven markets over time. Our "rules of the road" zero in on the 10 most important factors for identifying countries likely to post high or

[1] MSIM, Bloomberg, FactSet, Haver, data as of November 28, 2018.

[2] MSIM, Bloomberg, FactSet, Haver, data as of November 28, 2018.

[3] FactSet, Haver, data as of November 28, 2018.

[4] MSIM EME Team Research, FactSet, data as of November 28, 2018.

[5] FactSet, BIS, IMF, Haver, MSIM EME Team Research, Bloomberg. Data as of November 28, 2018.

accelerating growth, and thus most likely to outperform the markets over the next three to five years. Right now, some of the most beaten down markets are in promising economies such as Poland, Indonesia, the Philippines and even Mexico.

One of our most important rules says that a cheap currency is a good sign, and this is particularly so for countries that have seen currencies plummet this year even though they face no threat of crisis. Analysts who worry about Mexico's new leftist president, Andrés Manuel López Obrador, overlook the fact that his impact was priced into the peso even before his July election victory. By our composite measure, the Mexican peso is currently the cheapest currency in the world.[6]

EM stocks now look relatively cheap (based on price to book) compared to Developed Market (DM) stocks on average, and historically cheap in some cases. In dollar terms, Mexico's market is now near a two decade low. Poland, with its beaten-down zloty is near a 25-year low. Both suffer mainly from the lack of major tech stocks in their index.

Looked at more broadly, the entire EM class was in some sense overlooked even before this year's drawdown. As of last December, only about 4-6% of global equity investments were allocated to emerging markets, a share that is too low based on any of the three standard approaches to asset allocation. Basing investments on the EM weight in global equity markets would imply an allocation of 12%;[7] using the EM share of global GDP would imply an allocation of at least 15% and using an optimal portfolio approach would suggest an allocation of 30%.[8]

The upshot is that we believe many emerging markets look like compelling long-term buys. Many of the beaten down countries are well-insulated from crisis and are caught in an anti-bubble—gasping in a vacuum of attention because even now investors are focused on tech and tech-heavy markets like MSCI China. As a sense of normalcy returns to markets, other sectors and countries are likely to pick up momentum. While trying to time markets is a fool's game, the time to make long-term investments is in periods like the current one, when stock prices in many high-growth emerging markets appear to be cheap for no good reason.

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[6] MSIM EME Team Research, Haver, data as of November 28, 2018.

[7] FactSet. Data as of December 2017.

[8] FactSet, MSCI, HSBC, MSIM Estimates. Data as of December 2017.

DEFINITIONS

Current account deficit is a measurement of a country's trade in which the value of goods and services it imports exceeds the value of goods and services it exports. **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. It includes all private and public consumption, government outlays, investments and net exports. The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective. The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. **Price-To-Book Ratio (Price/Book)** compares a stock's market value to the book value per share of total assets less total liabilities. This number is used to judge whether a stock is undervalued or overvalued.

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