Morgan Stanley Institutional Fund

Active International Allocation Portfolio

ACTIVE FUNDAMENTAL EQUITY | ACTIVE INTERNATIONAL ALLOCATION | MARKET COMMENTARY | MARCH 2020

Market Context

Markets have continued to be volatile as policymakers around the world try to not only curb the spread of COVID-19, but also support economies and markets through this unprecedented time. Notably, both intraday and daily market moves have been more similar in magnitude to monthly or quarterly returns.

As efforts to control the virus in Europe and the U.S. have intensified, so too has the economic impact from business closings and restrictions on people's movement. The policy proposals have grown in scale and scope and the number of countries enacting significant packages has expanded. Importantly, the U.S. Federal Reserve (Fed) has enacted multiple measures to provide liquidity and funding including unlimited quantitative easing, expanding the menu of assets they will accept as collateral at the discount window, as well as swap lines. These combined measures, along with fiscal packages, should provide somewhat of a bridge across the depths of this downturn. Importantly, there is a global focus on identifying existing or novel drug therapies that are efficacious against COVID-19.

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Portfolio Positioning

- Active International Allocation (AIA) is a core portfolio with a regional/country allocation process geared toward identifying positive structural change / reform potential as well as employing macro analysis to allocate appropriately through the market and economic cycles. We then conduct fundamental analysis to identify those stocks that best express investment opportunities within this macro framework. As part of our process, we invest to capture long-term themes across sectors and industries.

- In the midst of the COVID-19 pandemic, we are currently employing a barbell approach to our equity allocation. On one side, we are overweight countries, sectors, industries and stocks that we define as long-term structural growth winners. Currently the portfolio is overweight Germany, the Netherlands, Denmark, Singapore and France. Thematic investments we own include stable consumer franchises, e-commerce marketplaces, digital entertainment platforms, and healthcare innovators. The portfolio is currently underweight Emerging Markets, though we expect to add to positions as specific countries and stocks offer attractive growth and reasonable valuations based on our fundamental analysis.

- On the other side of the barbell, we hold positions that should benefit from their relation to the economic cycle, in contrast to the longer-term structural winners mentioned above. Specifically, we have focused on sectors and industries that are currently undergoing a downturn, but where we see consolidation and supply rationalization leading to significantly better industry dynamics, while the underlying fundamental demand outlook is still expected to grow faster than GDP during the eventual recovery phase. These investments include memory manufacturers, semiconductor equipment and foundries, low-cost airlines, online travel companies, copper and gold miners, and select oil services companies. These are higher beta industries that should move more closely with the economic cycle, and today they are trading at trough valuations on trough earnings power, rather than discounting their future EPS growth in the upcycle. We have added to these areas recently, as valuations have become more attractive and industry as well as company fundamentals are going to result in these companies gaining market share through the downturn, ensuring higher earnings power in a normalized economy.

- Structural underweight allocations include commodity countries that also exhibit hallmarks of credit excesses, including Canada, Australia and some parts of Latin America. We are also staying away from countries with credit excesses such as Italy and Japan and sectors such as financials, autos, real estate, telecom and utilities. These sectors have high operational and financial leverage, low margin profiles with little room for error, are more vulnerable to economic downturns, exhibit overcapacity and are challenged by disruption and regulation. Telecom and utilities in particular face significant investment costs from 5G and carbon taxes, respectively, without the benefit of an offset from pricing power.

- We have recently reduced the portfolio's market exposure, particularly in Europe. This has helped portfolio performance on a relative basis as have our overweights in communication services, staples, technology and gold stocks. The cash position has also contributed to portfolio performance. Underweight allocations in Japan and China, an overweight to Germany and positioning in energy have recently detracted from performance.

Market Outlook

- We think it may be foolhardy to make high-conviction forecasts about the likely depth and duration of the economic impact from COVID-19. The range of forecasts, which is normally fairly tight, is quite wide. While we expect a negative impact to growth in 1Q and 2Q, we are also watching the monumental monetary and fiscal stimulus that has been unveiled worldwide. The Fed's actions already appear to be more forceful than during the Global Financial Crisis (2008). We also think the global monetary authorities are likely to continue expanding their toolkit in order to support liquidity in a wide range of asset classes, while fiscal authorities will provide even more stimulus to cushion the economy.

- Equity markets are discounting mechanisms, and have priced in the current crisis in record time. While the growth outlook has been slashed, recent days have seen equity markets rally when policy makers have acted to cushion these economic and market shocks. Equities typically bottom several months before the economic data, and as we witnessed in March of 2003 and March of 2009, sharp rallies off the bottom can take place even when the economic picture looks rather bleak. The massive wall of stimulus, both monetary and fiscal, combined with the potential for a peaking of transmission rates (not to mention potential medical treatment/vaccine breakthroughs) should keep markets underpinned.

- Adding to the recent market turmoil is the volatility in the energy markets and dramatic decline in the price of oil. Credit markets were unnerved due to the high leverage in many energy companies, especially in the U.S. shale segment. The drastic price decline created pressure on credit spreads as COVID-19 pushed yields to record lows, and spreads widened due to both economic concerns from the virus and the plummeting price of oil. As with many things, there is a silver lining to the drop in oil prices as it accrues to the consumer, which should help when spending recovers following this health care shock.

- If we use China and Asia as a template, Europe and the U.S. will emerge from this COVID-19 outbreak, and these economies will eventually stabilize. Looking at previous viral outbreaks like SARS, and other global shocks such as the 9-11 attacks, markets tend to nose-dive quickly as economic growth contracts on a short- to medium-term basis. However, according to our analysis, the period following exogenous shocks tends to produce strong economic and equity rebounds, primarily due to high levels of pent-up demand as well as the lagged effects of extraordinary stimulus.

- We are encouraged by global equity market action in the last week, with markets mostly holding important technical levels and rebounding strongly off of them. We think markets are likely to seesaw as this pandemic continues to evolve and while it is hard to call a market bottom, we think the formidable response by global health authorities, and economic / financial policymakers are all sensible and on the right track. There are a number of long-term structural issues that have made us cautious for some time, primarily the record level of public and private debt. For now we will maintain our barbell portfolio positioning and will continue to monitor the developments and keep you updated.

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