We believe the 10% outperformance from May 29, 2020 through the end of 2020 marks the end of a five-year range-bound purgatory for emerging equities and the beginning of a multi-year upcycle. Both the near-term cyclical outlook as well as certain longer-term structural trends appear supportive of this. We expect emerging markets to outperform relative to the MSCI World Index (i.e. to developed markets) in 2021 and see substantial room for further outperformance thereafter, consistent with previous upcycles (See Display 1).

For a growth-sensitive asset such as emerging equities, the near-term case is relatively straightforward. As we have previously written, we expect global growth to accelerate in 2021 as COVID-19 immunity is attained later this year and activity returns to normal. With goods and resource exports playing a dominant role in emerging economies, they stand to benefit from continued growth acceleration. We expect emerging economies to grow at 6.9% in 2021, mildly exceeding advanced economies’ pace of 6.5%, even in the absence of comparably large fiscal policy support, and on a stronger comparable base (developed market GDP contracted by -4.6% in 2020, versus -1.0% for EM).\(^1\)

As has been the case historically in environments when global growth is accelerating, in 2021 emerging equities are likely to continue to benefit from the growth upswing as their exposure to cyclical sectors is nearly 10% higher than for developed equities (See Display 2).\(^2\) Excluding China, emerging equities have a 15% higher weighting in cyclically sensitive sectors than developed equity markets.

We expect continued appreciation of emerging market currencies to support emerging equity outperformance. Unlike developed markets, where equity and currency returns tend to be negatively correlated, emerging market equity performance tends to be positively correlated with abroad.-

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1. Cap weighted based on MSCI EM.
the respective currency returns, and is typically supported by currency strength. We remain bearish on the U.S. dollar broadly (we presented our case in our June letter and believe it still largely holds), and see emerging currencies as a play on the U.S. dollar’s apparent weaknesses (lower real rates, persistent twin deficits) as well as beneficiaries of favorable rate differentials, higher commodity prices, and improved balances of payments. As of the third quarter of 2020, the current account of emerging economies in aggregate improved to a surplus of nearly +3% of GDP, from a roughly +0.5 to +1% surplus over the past 10 years.

Emerging equities absolute valuations are similar to those of developed markets: the MSCI Emerging Markets Index is 17% expensive relative to the historical average valuation, while the MSCI World Index is 21% expensive on 24-month forward price-to-earnings (P/E). Thus, on a relative basis, emerging markets are averaged valued relative to developed markets, trading at 0.74x the 2-year forward P/E multiple of developed equities, versus 0.75x the historical average and yielding 1.1x the dividend yield of developed equities, about in line with history. Historically, relative valuations of emerging equities have been closely linked to growth, so from a cyclical point of view, better global growth is likely to lead to relative multiple expansion.

Real rates convergence between emerging and advanced economies has the potential to be even more significant for emerging equities’ relative multiple re-rating. While developed market equities re-rated as real bond yields fell to zero and below this year, emerging equities have not yet fully benefitted from this development. Emerging real bond yields have fallen by less and are currently at about 2%, off the high of nearly 3% in the past five years, but with substantial room to fall relative to developed market real yields. Emerging real bond yields can fall by another -50 basis points to be in line with their historical average relative to developed real bond yields, or -100 basis points if they were to revisit the 2004-2013 average. Clearly such a convergence of rate differentials, brought about in part by policy rate cuts in certain emerging countries, would depend on disinflationary forces remaining in place. We expect this to be the case in many major emerging economies given large output gaps, improved external balances, and a strong export growth outlook. Assuming the historical relationship between real bond yield differentials and equity valuations holds, emerging equities could rerate by 20% if the real bond yield differential were to compress by -50 basis points, or potentially by much more if it compresses by -100 basis points (See Display 3).

Stronger commodity prices are likely to continue to benefit emerging equities, consistent with the historical pattern. Although many larger emerging economies are importers of commodities (such as China, Korea, India and Taiwan), commodity prices are an essential driver of growth for many of the smaller economies which often lack other growth drivers. As such, a global growth pickup that lifts commodity prices is likely continue to work to transmit the cyclical acceleration across emerging economies. We expect additional gains in oil prices and precious metals in the near term as global travel resumes and inflation picks up in the U.S., further depressing real rates.

Many smaller emerging economies that are dependent on tourism have been disproportionately hit by travel restrictions. In countries such as Thailand, Malaysia, Mexico, and Turkey, tourism accounts for between 11% and 23% of GDP, and thus growth declines in 2020 in many of these countries have been some of the most pronounced. As normalcy returns later in 2021, we expect that these countries and their economies will benefit disproportionately.

Display 2: A Recovery in Global Growth Drives Outperformance for EM Earnings

Display 3: Relative Yield Compression Warrants a Higher Relative Equity Multiple
From a longer-term point of view, we believe there is a strong possibility that emerging equities are in the beginning of a multi-year upcycle. Since 1975 there have been six cycles of emerging equities performance, each lasting 7-8 years on average, with the average downcycle seeing -59% underperformance and the average upcycle +206% outperformance. Several new trends that have been accelerated by the events in the last year would have the potential to fuel a continued growth upcycle in emerging markets. First, it appears that supply chain diversification is a clear priority for multinationals after the fragility of their logistics was exposed during the pandemic. As a result, many are planning to, or already are, relocating out of China to other countries in Asia, and to some degree closer to end and home markets. This is likely to lift growth for the recipients of this investment. Second, emboldened by their increased activism during the pandemic and supported by the public’s acquiescence around this shift, many Western governments (in particular, the U.S.), appear likely to continue to seek to play a larger role in economic management. While up until now fiscal spending has focused mostly on income support, future spending is likely to shift to infrastructure, which, in addition to supply chain diversification, may contribute to the investment cycle. This potential sustained acceleration of fixed investment growth would benefit the commodity and materials sectors as well as many emerging economies and equity markets. Third, developments that would be negative for corporate profitability in developed economies would lift emerging equities on a relative basis. The Biden platform calls for increases in corporate tax rates and the introduction of additional taxes. If implemented in full, this could reduce S&P 500 Index earnings by 8%-9%. Additionally, the UK is also considering raising corporate taxes this year. Clearly if some of these supportive longer-term forces come through, the 10% outperformance of emerging market equities since May 2020 could be seen as just the beginning of a long term multi-year upcycle.

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 values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equity securities’ values fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Fixed-income securities are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income.

Longer-term securities may be more sensitive to interest rate changes. Mortgage- and asset-backed securities (MBS and ABS) are sensitive to early prepayment risk and a higher risk of default and may be hard to value and difficult to sell (liquidity risk). They are also subject to credit, market and interest rate risks. Certain U.S. government securities purchased by the Portfolio, such as those issued by Fannie Mae and Freddie Mac, are not backed by the full faith and credit of the United States. It is possible that these issuers will not have the funds to meet their payment obligations in the future. The issuer or governmental authority that controls the repayment of sovereign debt may not be willing or able to repay the principal and/or pay interest when due in accordance with the terms of such obligations. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than risks associated with investments in foreign developed countries. Real estate investment trusts are subject to risks similar to those associated with the direct ownership of real estate and are sensitive to such factors as management skills and changes in tax laws. Restricted and illiquid securities may be more difficult to sell and value than publicly traded securities (liquidity risk). Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio’s performance. Trading in, and investment exposure to, the commodities markets may involve substantial risks and subject the Portfolio to greater volatility. Nondiversified 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. By investing in investment company securities, the portfolio is subject to the underlying risks of that investment company’s portfolio securities. In addition to the Portfolio’s fees and expenses, the Portfolio generally would bear its share of the investment company’s fees and expenses.

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7 MSCI Emerging Markets Index.
DEFINITIONS

The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® index companies with higher price-to-book ratios and lower forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

The Russell 1000® Value Index is an index that measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The S&P 500 Total Return Index is an index that consists of 500 stocks chosen for market size, liquidity and industry group representation. The S&P Index is a market value weighted index with each stock’s weight proportionate to its market value. The S&P Index is one of the most widely used benchmarks of U.S. equity performance. The performance of the S&P Index does not account for any management fees, incentive compensation, commissions or other expenses that would be incurred pursuing such strategy. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend.

The S&P GSCI® is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The returns are calculated on a fully collateralized basis with full reinvestment. The combination of these attributes provides investors with a representative and realistic picture of realizable returns attainable in the commodities markets. Individual components qualify for inclusion in the S&P GSCI® on the basis of liquidity and are weighted by their respective world production quantities.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Volatility is a measure of the price fluctuations of an asset or portfolio.

The S&P U.S. Treasury Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year U.S. Treasury note or bond.

The MSCI USA Energy Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Energy sector as per the Global Industry Classification Standard (GICS®).

The MSCI USA Materials Index is designed to capture the large and mid cap segments of the US equity universe. All securities in the index are classified in the Materials sector as per the Global Industry Classification Standard (GICS®).

The S&P GSCI Gold Index, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future. Treasury Inflation-Protected Securities, or TIPS, provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index.

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