

Tales from the Emerging World

The Strange Shape of the Coronavirus Crash

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | MACRO INSIGHT | 2020

The global pandemic has triggered the fastest market crash since 1929, but it is unusual for more than its speed and scale.

Normally a sudden bear market punishes the most highly valued investments of the late bull market, the old leaders become laggards, and new leaders emerge. This time, the outperformers are the same countries, sectors and companies that did well over the last decade—namely the United States, tech and mega-caps—while almost everything else continues to underperform.

In part, this upside down market can be explained by the nature of this crisis. Several hot trends of the era Before Coronavirus—including e-commerce, online education and digital leisure—have grown even more popular in the era After Coronavirus. However, the rush to the familiar extends beyond the tech themes, and the gap between the valuations of leaders and laggards has widened to even greater extremes.

In a rare moment of global panic, it may sound premature to look forward to normalcy, and reversion to the mean. But to us, many asset classes, countries, sectors and stocks which looked historically underpriced when the pandemic began are looking even more attractive now.

The 2010s were the worst decade for emerging stock market returns since the 1930s. When the coronavirus began to impact stock markets in mid-February, emerging markets were 18 percent below their long-term trend in absolute terms, while U.S. stocks were 19 percent above their long-term trend. When markets hit their recent lows on March 23rd, both the U.S. and EM were down sharply, leaving the U.S. 22 percent below—and EM 44 percent below—their long-term trends. That low in EM has been matched only once since emerging market records began in the late 1980s, at the bottom of the bear market that followed the tech bust in 2001.¹

AUTHOR



RUCHIR SHARMA

*Head of Emerging Markets and
Chief Global Strategist*

¹ MSIM, Bloomberg, FactSet, Haver. As of April 1st 2020.

Within emerging nations, the same entirely novel process—of bull market leaders still leading—is unfolding in this new bear market. By sheer coincidence, the most overvalued markets were the first hit and first to recover from the pandemic, and have pushed outperformance to new heights.

The striking chart below shows that investors are clustering their bets in countries where the pandemic appears to have peaked or has been contained, led by China, South Korea and Taiwan, which were already outperforming and relatively expensive before the pandemic broke out. And they are shunning emerging countries where the pandemic has yet to reveal its worst intentions, which includes virtually all the rest.

A similar clustering is underway in industries, with investors fleeing to what they see as the relative safety of industries that were doing well before the virus

outbreak, including communications, consumer services, semiconductors, tech hardware and internet retailing. Any industry impacted directly by the lockdowns, including energy, material, autos and transport, has been pummeled. Many of those industries were also underperforming before the pandemic.

In this flight to the familiar, investors are sticking to the same big, liquid stocks they held before the contagion began. Our research shows that one of the most important factors driving the relative performance of stocks since the intense selloff began in mid-February is liquidity.

Ranking companies in the MSCI EM index from most to least liquid after adjusting for market cap, those in the top quintile have outperformed the index by more than 9 percent. The second quintile have outperformed by more than 5 percent. In contrast, less liquid companies have done much worse: the

fourth quintile has underperformed by more than 3 percent, and the bottom quintile has underperformed by more than 7 percent. Since larger caps tend to be the most liquid, they have continued to thrive in this environment.¹

Clearly a market driven by fear of the pandemic has a logic all its own, with this intense focus on the familiar, the safe and the liquid. But that logic will very likely evaporate as the spread of the coronavirus starts to slow.

If the latest forecasts are correct, the world economy is headed for only its eighth recession of the last century, on track to contract by three percent this year.² That would be worse than the contractions that accompanied the Spanish Flu of 1918-1920 and the global financial crisis of 2008, and much still depends on the course of the pandemic. The latest forecasts still assume that a sharp collapse in growth during the first half of 2020 will be followed by a sharp recovery in the second half, as the spread of the virus slows, and nations begin to lift the lockdowns.

We remain wary of any particular pandemic scenario, when real epidemiologists are deeply divided, but it does appear that investors are intensely focused on one number—the rate of growth in new cases. China’s stock market started to rebound when that number peaked in mid-February, and South Korea’s started to bounce back after the spread of the virus peaked there two weeks ago.

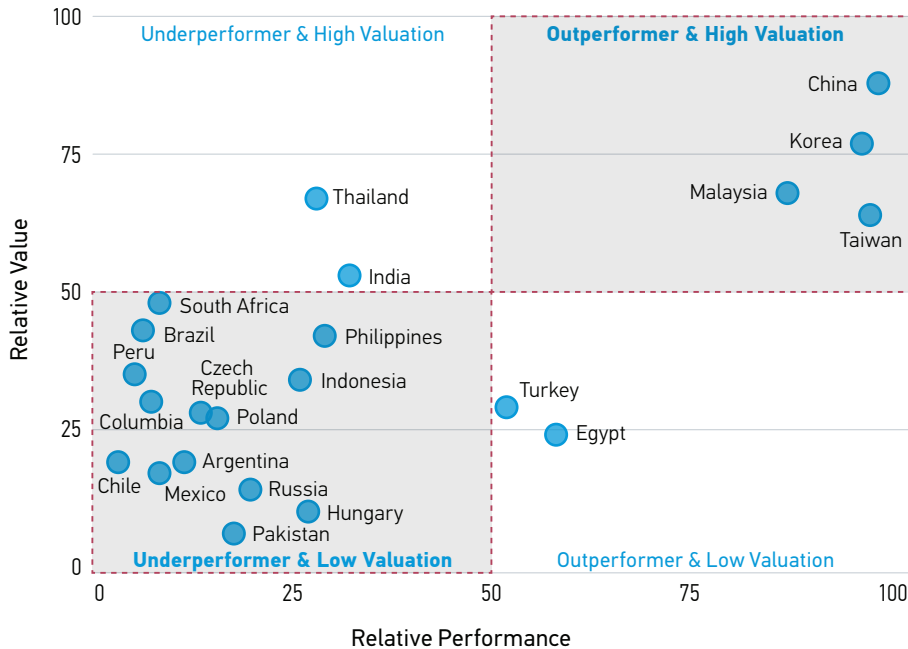
The hope has been that the contagion would soon reach a similar turning point in other markets, and latest reports have offered some potentially good news. Worldwide, the growth rate in new cases slowed to under 10 percent for two days in a row, with growth in both new cases and fatalities falling in the European hotbeds of the contagion, including Italy, Spain and Germany.³

Eventually, investors will start looking beyond the pandemic, return to the

DISPLAY 1

Emerging Markets Now Cluster At Two Extreme Poles

Outperformers with high valuations, and underperformers with low valuations



Source: MSIM, Bloomberg, FactSet, Haver.

² JP Morgan. As of March 20, 2020.

³ MSIM, Haver, JHU, WHO. As of April 1st 2020.

broader fundamental picture, and recognize that many of the countries, sectors and companies that were left behind during the mega-cap driven bull market of the last decade are even more attractively valued now. Indeed, many emerging markets are now so cheap, so deeply ignored in a liquidity-obsessed environment, the snap back could be

both very fast, and nearly as extreme as the fall has been. Ten emerging markets, including Brazil, Mexico and Poland, are now at or below their lows during the global financial crisis of 2008.¹

If over the next five years emerging markets simply climb back to (not above as usually happens in bull markets)

their long-term trend line, it implies annualized dollar returns of 12 percent on average, and much more for the economies that experience the strongest rebound.¹ There will be great opportunity in emerging markets in the After Coronavirus world, and as long-term investors, we are positioning for it.

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. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities 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. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. **Stocks of small- and medium-capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). **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.

About Morgan Stanley Investment Management⁴

Morgan Stanley Investment Management, together with its investment advisory affiliates, has 711 investment professionals around the world and approximately \$552 billion in assets under management or supervision as of December 31, 2019. Morgan Stanley Investment Management strives to provide outstanding long-term investment performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes governments, institutions, corporations and individuals worldwide. For more information, please visit our website at www.morganstanley.com/im. This material is current as of the date specified, is for educational purposes only and does not contend to address the financial objectives, situation or specific needs of any individual investor.

⁴ Assets under management as of December 31, 2019. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

DEFINITIONS: 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.

IMPORTANT DISCLOSURES: The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific MSIM product. Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness.

The information herein is a general communications which is not impartial and has been prepared solely for information and educational purposes and does not constitute an offer or a recommendation to buy or sell any

particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Past performance is no guarantee of future results.

This communication is not a product of Morgan Stanley's Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

DISTRIBUTION: This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung

Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968. **The Netherlands:** Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 11096HA, Netherlands. Telephone: 312-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0)44 588 1074.

U.S.: A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This publication should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"), (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037,

AFSL No. 314182, which accepts responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIM")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIM to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIM accepts such commission. The client shall delegate to MSIM the authorities necessary for making investment. MSIM exercises the delegated authorities based on investment decisions of MSIM, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIM cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIM, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION: EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

Charts and graphs provided herein are for illustrative purposes only.

The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the applicable European or Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.