Morgan Stanley

INVESTMENT MANAGEMENT

2021 Market Outlook

The Year Ahead: The Roaring 20s or The Scary 20s?

We're at the dawn of a new decade. Will it be a repeat of the Roaring 20s or something more subdued? Hear more from our International Equity Team's Bruno Paulson.

BRUNO PAULSON
Managing Director

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM

November was a spectacular month for markets. The 13% rise in the MSCI World Index was the best monthly result since January 1975. There was some spectacular news though, with three vaccines achieving efficacy way in excess of the 50% that was deemed the minimum viable level. This opens up the genuine prospect of a world returning to something like "normal" in the second half of 2021, potentially ending the ominous cycles of flare-ups and lockdowns which had returned for the U.S. and Europe in the Northern Hemisphere's autumn. In addition, the world breathed a sigh of relief that the U.S. seems on track for a peaceful transition of power, with the added bonus that the absence of a clear Democratic "Blue Sweep" makes significant corporate tax rises or radical regulation less likely, which may protect U.S. corporate profitability, particularly for the tech giants.

> "Vaccines can open up the genuine prospect of a world returning to something like normal in the second half of 2021"

While the news was clearly positive in the month, the issue is whether the market has moved too far too soon. The MSCI World Index was roughly flat year-to-date (YTD) at the end of October, before the "month of miracles", and is now up over 50% from its lows in March, bringing us to a 12% annualized return through the end of November—a higher-than-average annual return. This would seem to imply that the long-run outlook for corporate profits is better than at the start of the year, despite the impact of the pandemic, which is forecast to shrink global gross domestic product (GDP) by 4.4% this year according to the International Monetary Fund, and has driven forward earnings down 9% YTD.

It is important to point out that this is not a market that was remotely cheap at the start of the year, on the back of a market rise of 26% in 2019, all of which was rerating, as earnings fell slightly. This has left the MSCI World Index's current multiple of the next 12 months' forward earnings above 20x, a metric that had never been above 17x before this year, in a history going back to 2005. Allowing another year of earnings recovery, the two years' forward multiple is 17.7x, still 15% above the pre-2020 high of 15.4x. Risk definitely seems to be "on".

> "COVID-19 will still have left a major legacy, as seen in the acceleration of three existing trends: technology, government intervention and the growth of debt"

Even if we assume that the direct effects of the pandemic, the lockdowns and the voluntary self-isolations have faded by the second half of next year as the vaccination spreads across populations, COVID-19 will still have left a major legacy. This can be seen in the acceleration of three major existing trends.

The first is the step change in the adoption of technology. E-commerce has surged, along with remote working, while cash spending has shifted to cards and corporates are shifting their on-premise technology infrastructure to the cloud. This march of technology clearly creates winners and may give corporates in general the opportunity to cut some costs on a permanent basis, for instance, around office space or sourcing newly remote labour from cheaper locations. But it also exposes losers, be it traditional retail without a unique selling proposition, real estate plays or IT services companies that manage on-premise infrastructure.

> "Action on climate change may be the most important shift"

The second is the growth in government intervention. The unprecedented scale of support during the pandemic is likely to have added to governments' already growing taste for involvement in the economy. The era where economies were run for the benefit of large corporates already seemed to be coming to an end, given the attacks on free trade, the revival of anti-trust activity, pushes to raise corporate taxation and the start of moves to rebalance the relationship between labour and capital, for instance, through raising minimum wage levels. The action on climate change may be the most important shift, with moves towards pricing carbon and constraining polluting activities. Optimists will point to the probable gridlock in the U.S., and even the potential for a wave of lucrative green infrastructure investment. But on the downside, much of the carbon-heavy status quo may become uneconomic or even forbidden.

The final trend that has been boosted is the growth of debt. Admittedly, the personal sector savings rate has risen sharply, given the large transfer payments by governments and the suppression of social consumption, be it holidays or eating out. The same is not true of the corporate sector, which has seen a further step up in leverage. Moody's estimates that investment grade debt issuance will be up 60% this year, and even high yield is expected to see a 25% increase. This is dwarfed, though,

by the increase in government debt given the actions to shield economies from the pandemic. The U.S. alone has seen a $4 trillion increase in its national debt so far this year, which has now reached 107% of GDP.[1] Again, there is an optimistic scenario, where newly freed consumers spend heavily in 2021 and 2022, reducing their high savings rates, while governments continue to support demand by running heavy deficits, helped by accommodating central banks and the relaxed attitudes of bond markets so far. Growth would therefore bounce back strongly, but hopefully without the significant rises in inflation or interest rates that might spook the markets. The less positive scenarios are either side of this Goldilocks outcome: either too cold, because of consumer caution or government cutbacks, or too hot, with the recovery driving up inflation and rates.

"Ebullient commentators suggest a second "Roaring '20s" may be the result; we would argue that investors should now be looking to preserve capital"

There are positive potential pay-offs from all three trends: corporates become more efficient, green infrastructure investment offers a boost and low interest rates allow governments to continue to spend. Along with the potential for consumers to spend their savings, the more ebullient of commentators suggest that this can set off a second "Roaring '20s", presumably unworried by what happened at the end of the '20s the last time round. All these positive scenarios are possible, and some may even be probable, but the issue is that the current 20x plus multiple of earnings may be effectively taking them as a given. Given how much can go wrong, we see this multiple as the "Scary 20s". Equally, growth investors may well be looking to the benefits of the acceleration of technological disruption to justify elevated valuations, without worrying about the potential curbs on the tech giants, while value players may be looking forward to the imminent reflation without taking sufficient account of the disruptive or environmental challenges.

In this "risk-on" world, after the spectacular market rises over the last eight months, we would argue that investors should now be looking to preserve capital, or to keep the lights on, rather than attempting to shoot the lights out. To quote Warren Buffett, "Be fearful when others are greedy." As such, we would be advocating the benefits of compounders. The idea is that these companies' pricing power and recurring revenues allow them to grow earnings across cycles, making them far more resilient in tough times like 2020.

Our global portfolios have indeed managed to deliver this resilience, growing forward earnings by 3-5% so far in 2020, on the back of 8%-11% growth in 2019—a sharp contrast to the -9% and -1% that the MSCI World Index managed in 2020 and 2019, respectively. Interestingly, this 22-27% relative gain in earnings over the two years has not resulted in any significant outperformance over the period, given the violence of the recent value rally. As a result, the portfolios have sharply derated versus the index and are now only on a 9%-16% forward earnings premium to the MSCI World Index—a premium that vanishes in free cash flow terms, despite the massive gap in terms of quality, making compounders a relatively cheap insurance policy.

[1] Source: U.S. Department of the Treasury

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. 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 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-capitalisation 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.

DEFINITIONS

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. 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. 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 **MSCI World Health Care Index** is a capitalization weighted index that monitors the performance of health care stocks from developed market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

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: MSIM Fund Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. Registered in Ireland as a private company limited by shares under company number 616661. MSIM Fund Management (Ireland) Limited is 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, authorised and regulated by the Financial Conduct Authority. **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:** MSIM Fund Management (Ireland) Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** MSIM Fund Management (Ireland)Limited, Milan Branch (Sede Secondaria di Milano) is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) 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 11488280964. **The Netherlands:** MSIM Fund Management (Ireland) Limited, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. **France:** MSIM Fund Management (Ireland) Limited, Paris Branch is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Paris Branch with seat at 61 rue de Monceau 75008 Paris, France, is registered in France with company number 890 071 863 RCS. **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 appropriate 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 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 document 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. 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 accept 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.

BRAZIL. This document does not constitute a public offering of securities for the purposes of the applicable Brazilian regulations and has therefore not been and will not be registered with the Brazilian Securities Commission (Comissão de Valores Mobiliários) or any other government authority in Brazil. All information contained herein is confidential and is for the exclusive use and review of the intended addressee of this document, and may not be passed on to any third party.

CHILE. Neither the Fund nor the interests in the Fund are registered in the Registry of Offshore Securities (el Registro de Valores Extranjeros) or subject to the supervision of the Commission for the Financial Market (la Comisión para el Mercado Financiero). This document and other offering materials relating to the offer of the interests in the Fund do not constitute a public offer of, or an invitation to subscribe for or purchase, the Fund interests in the Republic of Chile, other than to individually identified purchasers pursuant to a private offering within the meaning of Article 4 of the Chilean Securities Act (la Ley del Mercado de Valores) (an offer that is not "addressed to the public at large or to a certain sector or specific group of the public").

COLOMBIA. This document does not constitute an invitation to invest or a public offer in the Republic of Colombia and is not governed by Colombian law. The interests in the Fund have not been and will not be registered with the National Register of Securities and Issuers (el Registro Nacional de Valores y Emisores) maintained by the Financial Supervisory Authority of Colombia (la Superintendencia Financiera de Colombia) and will not be listed on the Colombian Stock Exchange (la Bolsa de Valores de Colombia). The interests in the Fund are being offered under circumstances which do not constitute a public offering of securities under applicable Colombian securities laws and regulations. The offer of the interests in the Fund is addressed to fewer than one hundred specifically identified investors. Accordingly, the interests in the Fund may not be marketed, offered, sold or negotiated in Colombia, except under circumstances which do not constitute a public offering of securities under applicable Colombian securities laws and regulations. This document is provided at the request of the addressee for information purposes only and does not constitute a solicitation. The interests in the Fund may not be promoted or marketed in Colombia or to Colombian residents unless such promotion and marketing is carried out in compliance with Decree 2555 of 2010 and other applicable rules and regulations related to the promotion of foreign financial and securities related products or services in Colombia.

Colombian eligible investors acknowledge that the interests in the Fund (i) are not financial products, (ii) are transferable only in accordance with the terms of the Fund's constitutional documents and (iii) do not offer any principal protection.

Colombian eligible investors acknowledge Colombian laws and regulations (in particular, foreign exchange, securities and tax regulations) applicable to any transaction or investment consummated in connection with an investment in the Fund, and represent that they are the sole liable party for full compliance with any such laws and regulations. In addition, Colombian investors acknowledge and agree that the Fund will not have any responsibility, liability or obligation in connection with any consent, approval, filing, proceeding, authorization or permission required by the investor or any actions taken or to be taken by the investor in connection with the offer, sale or delivery of the interests in the Fund under Colombian law.

MEXICO. Any prospective purchaser of the interests in the Fund must be either an institutional investor (inversionista institucional) or a qualified investor (inversionista calificado) within the meaning of the Mexican Securities Market Law (Ley del Mercado de Valores) (the "Securities Market Law") and other applicable Mexican laws in effect.

The interests in the Fund have not and will not be registered in the National Registry of Securities (Registro Nacional de Valores) maintained by the Mexican Banking and Securities Commission (Comisión Nacional Bancaria y de Valores). The interests in the Fund may not be offered or sold in the United Mexican States by any means except in circumstances which constitute a private offering pursuant to Article 8 of the Securities Market Law and its regulations. No Mexican regulatory authority has approved or disapproved the interests in the Fund or passed on the solvency of the Fund. All applicable provisions of the Securities Market Law must be complied with in respect of any sale, offer or distribution of, or intermediation in respect of, the Fund interests in, from or otherwise involving Mexico, and any resale of the interests in the Fund within Mexican territory must be made in a manner that will constitute a private offering pursuant to Article 8 of the Securities Market Law and its regulations.

PERU. The interests in the Fund have not been and will not be registered in Peru under Decreto Legislativo 862: Ley de Fondos de Inversión y sus Sociedades Administradoras or under Decreto Legislativo 861: Ley del Mercado de Valores (the "Securities Market Law"), and are being offered to institutional investors only (as defined in article 8 of the Securities Market Law) pursuant to a private placement, according to article 5 of the Securities Market Law. The interests in the Fund have not been registered in the securities market public registry (Registro Público del Mercado de Valores) maintained by, and the offering of the Fund interests in Peru is not subject to the supervision of, the Superintendencia del Mercado de Valores. Any transfers of the Fund interests shall be subject to the limitations contained in the Securities Market Law and the regulations issued thereunder.

URUGUAY. The offering of the Interests qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Interests will not be offered or sold to the public (Individuals or Companies) in Uruguay, except in circumstances which do not constitute a public offering or distribution through a recognized Exchange under Uruguayan laws and regulations. Neither the Fund nor the Interests are or will be registered with la Superintendencia de Servicios Financieros del Banco Central del Uruguay. The Fund corresponds to an investment fund that is not an investment fund regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

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. ("MSIMJ")'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 MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, 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, MSIMJ 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 MSIMJ, 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 MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. MSIM Fund Management (Ireland) Limited is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

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.

A separately managed account may not be appropriate 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.

This material is a general communication, which is not impartial and has been prepared solely for informational 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 information herein has not been based on a consideration of any individual investor 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.

Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

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 Morgan Stanley Investment Management product.

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 appropriate 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.

Explore our new site at **www.morganstanley.com/im**

© 2021 Morgan Stanley Smith Barney LLC. Member SIPC.

9952748_KC_1220 CRC 3370805 Exp. 12/31/2021