Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Journey Into The Unknown

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It is probably fraught with peril to make any forecasts about U.K. politics, given the turbulence of the last few years. However, it does seem that the room for a compromise deal between the U.K. and the European Union (EU) is closing. The European elections saw the rise of the two 'extremes' in the Brexit debate, with the 'No Deal' parties dominated by Nigel Farage's new Brexit Party getting 35% of the vote and the explicit 'Remain' parties, led by the Liberal Democrats, scoring 40%. This left less than a quarter of the vote for the two major U.K. parties who were pushing for a compromise deal, with Labour getting 14% and the Conservatives 9%, a collapse versus the combined 82% they accounted for in the General Election only two years ago.

While Conservative leadership elections are notoriously difficult to forecast, it is looking likely that the next party leader, and thus the next Prime Minister, will favour No Deal, or at least rule out an extension beyond October 31, which effectively amounts to the same thing, given that the EU will be tied up with selecting the new Commission for the next few months. The issue is whether the British Parliament will be able to block this outcome, given its current majority against No Deal. This is a journey into the unknown, as the U.K. enters uncharted constitutional waters. Ultimately, it is looking increasingly like a binary choice between No Deal and a decision to Remain, be it via a General Election, a referendum or even a revocation of Article 50… unpredictable indeed.

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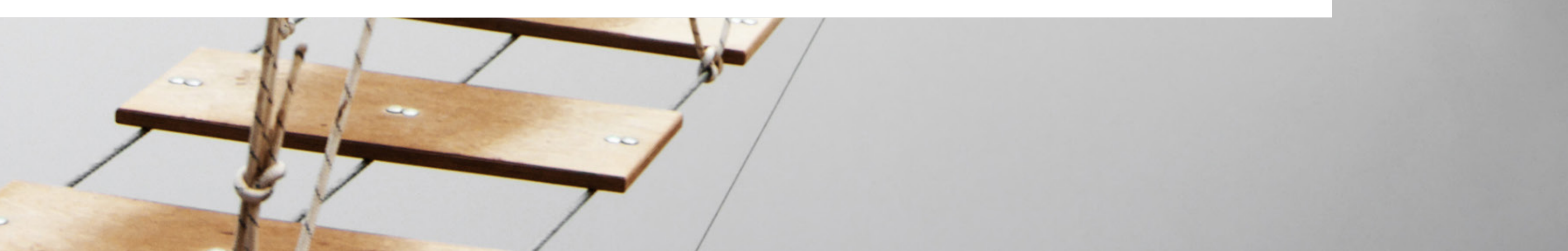
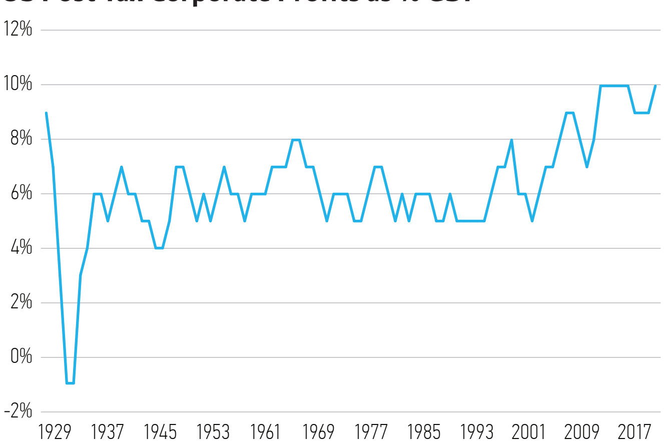


Without wishing to be accused of participating in 'Project Fear,' No Deal is likely to be a significant economic shock for the U.K., and also a bump for Continental Europe. The extent of any damage will depend on how long it takes for some sort of accommodation to be reached, i.e. No Deal to be replaced with some kind of deal. There is also likely to be a sharp depreciation of sterling. While far from optimal for the U.K., the impact on our global portfolios is likely to be relatively minor. Optically, there is plenty of exposure, with 19-22% of the portfolios listed in the U.K. But, these U.K.-listed companies are global, meaning that the actual economic exposure is far lower, with only 3-4% of the portfolios' revenue U.K. exposed. As such, any sterling weakness is likely to be matched by sterling share price appreciation in the U.K. listed stocks, as was the case after the 2016 referendum result. In the case of a British-based multinational tobacco company, it can be argued that any sterling weakness will be a positive, as it would effectively reduce the strain from the debt load (40% sterling denominated) and the dividend (100% sterling denominated), helping the company de-lever, and making the company a 'No Deal hedge' of sorts! There is a similar argument that a distinctly cheaper sterling will help with GlaxoSmithKline's U.K.-centric cost base.

The further issue is whether a No Deal outcome would be a general 'Risk Off' event. Unlike the aftermath of the 2016 referendum, there is unlikely to be any fears of contagion or a domino effect, as the U.K.'s experience over the last three years has definitely dimmed enthusiasm for similar moves elsewhere in Europe. However, there will be concerns about the impact on U.K. and Continental European growth. Our global portfolios invest in companies with plenty of recurring revenue and pricing power, which should make their economics more robust in any downturn, as both sales and margins tend to be insulated, and history suggests that this is likely to be recognised by the market.

US Post Tax Corporate Profits as % GDP



Source: BEA, MSIM Analysis; as of December 31, 2018.

While we are relatively sanguine about the effects of Brexit and/or No Deal on the portfolio, we are less relaxed about political risk in general. The Brexit process can be seen as a symptom of the shift of the global environment away from business-friendly policies; after all, for good or ill, it was far from supported by large corporates. It can be argued that the last few decades have seen governments favour capital over labour, be it around globalisation, workplace regulation, taxation or attitudes to consolidation. This is reflected in corporate profitability, which is at very high levels as a share of gross domestic product, particularly in the U.S., where its share is at around 10% as against the post-war norm of around 6%.

There are three broad and overlapping strands of political threat to the current high levels of profitability: right-wing populism, left-wing populism and the environmental movement. Between them, they are the main structural challenge to the current elevated levels of profitability, as opposed to the cyclical threat from any downturn or recession.

> "There are three strands of political threat to the current levels of profitability: right-wing populism, left-wing populism and the environmental movement."

Right-wing populism is the one that has already started to bite. Brexit is in this strand, as are the threats to free trade and globalisation. Trump is often seen as the personification of the anti-globalisation backlash, but it has been far broader than that. According to the World Trade Organisation, 2008-2016 saw 1,300 trade restrictive measures introduced globally, even before Trump's election. Pressure has risen since then. In the absence of the pricing power to pass the incremental costs on to customers, the U.S. tariffs are already hitting profitability, and the uncertainty is not ideal for business investment. Arguably, the potential splitting of global technology value chains into separate U.S. and China-centric realms could have more serious long-term implications than higher tariffs. There are also rising constraints on international migration, making recruiting more difficult for corporates in countries with tight labour markets and/or skill shortages.

It is notable that right-wing populism has been far more successful than the left since the Global Financial Crisis. In fact, the centre-left has really struggled in most Western countries, seeing its vote fall sharply, or even collapse below 10% in the case of France. This failure is driving more radical policy ideas on the left, notably amongst many of the Democratic candidates for the U.S. Presidential election in 2020. Ideas include reforms to the labour markets around higher minimum wages or expanded workers' rights, a revival of anti-trust policies to fight increased market concentration and even, in the U.K., renationalisation of some industries without full compensation for the current owners. In addition, the rise of unorthodox Modern Monetary Theory is providing some intellectual cover for sharply higher government spending funded by printing money, which may threaten the low inflation that underpins equity valuations. The prospects for the introduction of any of these policies are unclear, but an economic downturn could raise the risks.

The third strand is around environmental pressures. Scientific consensus is that actually delivering the undertakings of the 2016 Paris Agreement to keep the rise in global temperatures less than two degrees centigrade above pre-industrial levels could have severe implications for carbon-intensive industries. What is notable is the increasing traction that environmental parties are having electorally, winning close to 10% of the seats in the recent European elections. The unknown is how fast this electoral progress will translate into policies that constrain corporate action.

It is far from clear that current market valuations fully incorporate these risks to the equity markets. An MSCI World Index trading on close to 15x the forward earnings for the next 12 months does not seem to be pricing in many of these structural threats to corporate profitability, even putting aside any cyclical concerns. Moving down to the portfolio level, these threats emphasise the importance of the Environmental and Social lenses within ESG analysis. These need to be primarily considered at an individual stock or industry level, but there are some general guidelines.

"Scrutiny of corporates is rising sharply, managements need to be aware of the ESG risks facing their businesses"

The most important is the existence of pricing power. This is a key characteristic for the compounders in our portfolios, but is particularly important where companies' cost bases may experience shocks, be it due to tariffs, higher labour costs or more expensive energy. The ability to pass these input costs on to customers is crucial for preserving margins and thus profitability. Amongst the other factors to look for, we would point to the advantage of relatively short and simple supply chains in a world where globalisation is under threat, and the need to avoid dependence on carbon-intensive processes. More broadly, in a world where scrutiny of corporates by both governments and consumers is rising sharply, managements need to be aware of the Environmental and Social risks facing their businesses and proactive in dealing with them. There is clearly no room for complacency in this emerging political environment. However, our view is that our investment process, focussed on compounders with full ESG integration, delivers a portfolio of companies that are relatively well placed to deal with these risks, be it due to their pricing power, their carbon-lightness or the quality of management.

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