

Morgan Stanley Investment Funds

# Emerging Europe, Middle East & Africa Equity Fund

ACTIVE FUNDAMENTAL EQUITY | EMERGING MARKETS TEAM | MONTHLY COMMENTARY | 28 FEBRUARY 2018

## Performance Review

In the one month period up until 28 February 2018, the Fund's I shares returned -0.27% (net of fees<sup>1</sup>), while the benchmark returned 0.33%.

The biggest contributor to performance in February was our stock selection in South Africa. Our zero weight allocations to Qatar and Greece also contributed for the month. Our positions in South African consumer goods company AVI and South African quick service restaurant company Famous Brands were the top contributors from a stock perspective.

The biggest detractor from performance for the month was our overweight allocation to Poland. Stock selection in Russia and our underweight allocation to South Africa were additional detractors. Our position in Polish shoe retailer CCC and South African holding company Imperial were the top stock detractors.

## Market Review

MSCI EMEA Index equities were up +0.33% in euro terms in February, outperforming both the MSCI World Index (-2.09%) and the MSCI Emerging Markets Index (-2.57%). Russia (+3.09%) was the top-performing market for the month, followed by South Africa (+1.88%) and Egypt (+1.67%). Poland (-7.98%), Greece (-6.22%) and Hungary (-5.69%) were the laggards.

## Portfolio Activity

We made a few changes to the portfolio during the month. We established a new position in Russian steel producer Novolipetsk Steel. We expect the Central Bank of Russia to continue with a "weak ruble" policy, which should allow commodity price gains to fully translate into ruble earnings, which is a material change from prior cycles. We also like the global low-cost position of Novolipetsk, which is supported by the weak ruble and also its vertical integration into low-cost energy and low-cost iron ore. Management has been pursuing a disciplined growth strategy, a focus on operational efficiency and strong free cash flow, which has been paid to shareholders. Steel demand in Russia has been weak but is beginning to rebound, and based on our industry analysis, we believe earnings will be driven by the combination of global prices, the domestic rebound, the weak ruble and – at the margin – volume growth. We funded the trade by rebalancing some overweight positions in Poland, which have grown due to relative outperformance, as well as rebalancing some domestic overweights in Russia, which have also grown due to relative outperformance.

Elsewhere in Russia we continued adding to our position in Lukoil, where our company research supports our belief that the company's focus on Russian production and on increasing production from lower-taxed, higher-margin barrels will lead to a steady increase in EBITDA and dividend yield. We also exited our position in Russian internet company Mail.RU following strong performance and risks associated with the Countering America's Adversaries Through Sanctions Act, known as CAATSA.

We exited our position Polish furniture manufacturer Forte during the month. We think Forte's revenues, profitability and leverage will remain under pressure as the company moves forward with its vertical integration, and we are focusing the portfolio on names with better risk-reward profiles.

## Strategy and Outlook

We continue to overweight the Central and Eastern European region. We think that growth in Central and Eastern Europe should remain healthy, driven by strong consumption, which has been supported by increases in both employment and real wages. We also now expect fixed investment growth to accelerate, which will bolster overall growth and improve its quality. Finally, there are now consistent signs that inflation is returning to the region, which should lead to a normalization of interest rates, which remain negative in real terms throughout the region. In sum, we see the region as offering attractive investment opportunities through a combination of this solid economic growth, emerging reflationary trends, still attractive currencies and overlooked equity markets. We continue to like stocks that are exposed to secular growth opportunities in consumer markets in the region. And we have built a substantial position in financials in the region, which we believe will particularly benefit from the emerging reflationary trend after having suffered from tighter regulation and low rates.

After visiting Russia in December, we have increased our positions in Russia and now are neutral the market overall. We think that the current economic recovery in its early stages and is likely to gather pace in 2018. We also think the fiscal and monetary policies of the Russian government have not only brought inflation to post-Soviet lows, but also are effectively reducing materially the sensitivity of the Russian economy to oil. We think this is particularly true given the weak ruble policy being followed by the Central Bank. In terms of our portfolio, we are invested in

<sup>1</sup> Source: Morgan Stanley Investment Management Limited. Data as of 28 February 2018.

companies which should benefit from these macro policies, specifically commodity producers who could experience earnings upgrades (as stronger commodity prices are no longer offset by a strong ruble) and potentially a valuation rerating (as the risk-free rate declines). We also continue to like select names for their secular growth opportunities, which should gain additional support from the emerging recovery. In particular, we see a recovery in overall advertising spending adding to the existing secular trend of online ad growth, which in turn should help the internet stocks. We also see opportunities for market share gains in sectors that have struggled during the past recession, such as X5, which has continued to benefit from ongoing consolidation in the food retail industry. We also have a position in Sberbank as we believe, based on our industry analysis, it is positioned to benefit from the budding recovery, especially given its dominant retail franchise and the opportunity it has in payments.

In South Africa, the recent election of Cyril Ramaphosa as president of the African National Congress party has improved sentiment in the country and we think will bolster the limited recovery which has been unfolding. In particular, we think the election of Ramaphosa can buttress this recovery through a sustained recovery in confidence (particularly business) and much needed macro reforms. While we are still underweight the market, we have a significant absolute weight in South Africa stocks and continue to see compelling opportunities from a bottom-up perspective. After operating in an economy with 0-1% growth over the last three years, we think most of these stocks could also benefit from a more sustainable recovery in South Africa and – in particular – a stronger rand.

The political and economic outlook remains negative in Turkey, in our view. Although political uncertainty is now reduced, we believe the continuing erosion of checks and balances by President Erdogan ultimately hurts the investment and innovation climate in Turkey and thus the structural outlook for the economy. Economic growth surprised positively in 2017, but we think it was bolstered by unsustainable monetary and fiscal policies. We are concerned about the country's large current account deficit, which could be further accentuated by higher commodity prices and become a source of greater stress on economic growth. In effect, each year of deficit adds to the cumulative external debt burden of Turkey, in turn increasing its vulnerability to any material increase in global interest rates. As such, we continue to underweight the market and are positioned in stocks exposed to either the export market or to longer-term secular growth stories within Turkey.

**For further information, please contact your Morgan Stanley Investment Management representative.**

#### FUND FACTS

##### Launch date

16 October 2000

##### Base currency

Euro

##### Index

MSCI Emerging Europe, Middle East and Africa Index

#### 12 Month Performance Periods to Latest Month End (%)

	FEBRUARY '17 - FEBRUARY '18	FEBRUARY '16 - FEBRUARY '17	FEBRUARY '15 - FEBRUARY '16	FEBRUARY '14 - FEBRUARY '15	FEBRUARY '13 - FEBRUARY '14
MS INVF Emerging Europe, Middle East & Africa Equity Fund - I Shares	13.49	23.96	(10.75)	8.64	6.62
MSCI Emerging Europe, Middle East and Africa Index	10.67	28.31	(23.22)	15.17	(11.09)

**Past performance is not a reliable indicator of future results.** Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management. **Please visit our website [www.morganstanley.com/im](http://www.morganstanley.com/im) to see the latest performance returns for the fund's other share classes.**

## Share Class I Risk and Reward Profile

Lower Risk

Higher Risk



Potentially Lower Rewards

Potentially Higher Rewards

The risk and reward category shown is based on historic data.

- Historic figures are only a guide and may not be a reliable indicator of what may happen in the future.
- As such this category may change in the future.
- The higher the category, the greater the potential reward, but also the greater the risk of losing the investment. Category 1 does not indicate a risk free investment.
- The fund is in this category because it invests in shares of companies from emerging markets and the fund's simulated and/or realised return has experienced high rises and falls historically.
- The fund may be impacted by movements in the exchange rates between the fund's currency and the currencies of the fund's investments.

This rating does not take into account other risk factors which should be considered before investing, these include:

- The fund relies on other parties to fulfill certain services, investments or transactions. If these parties become insolvent, it may expose the fund to financial loss.
- There may be an insufficient number of buyers or sellers which may affect the fund's ability to buy or sell securities.
- There are increased risks of investing in emerging markets as political, legal and operational systems may be less developed than in developed markets. Due to the nature of the markets in which the fund invests, there might be circumstances where the safekeeping and custody arrangements of the fund are not as secure as those of more developed markets.
- Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. The value of investments and the income from them can go down as well as up and investors may lose all or a substantial portion of his or her investment.
- The value of the investments and the income from them will vary and there can be no assurance that the Fund will achieve its investment objectives.
- Investments may be in a variety of currencies and therefore changes in rates of exchange between currencies may cause the value of investments to decrease or increase. Furthermore, the value of investments may be adversely affected by fluctuations in exchange rates between the investor's reference currency and the base currency of the investments.

Please refer to the Prospectus for full risk disclosures. All data as of 28 February 2018 and subject to change daily.

### INDEX INFORMATION

The **MSCI Emerging Markets EMEA Index** captures large and mid cap representation across 10 Emerging Markets (EM) countries in Europe, the Middle East and Africa (EMEA). With 163 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. EM EMEA countries include Czech Republic, Egypt, Greece, Hungary, Poland, Qatar, Russia, South Africa, Turkey and United Arab Emirates.

### 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. In particular, the Shares are not for distribution to US persons.

**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)4 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (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 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. 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.

**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. **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. 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.

### 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.

This document contains information relating to the sub-fund ("Fund") of Morgan Stanley Investment Funds, a Luxembourg domiciled Société d'Investissement à Capital Variable. Morgan Stanley Investment Funds (the "Company") is registered in the Grand Duchy of Luxembourg as an undertaking for collective investment pursuant to Part 1 of the Law of 17th December 2010, as amended. The Company is an Undertaking for Collective Investment in Transferable Securities ("UCITS").

Applications for shares in the Fund should not be made without first consulting the current Prospectus, Key Investor Information Document ("KIID"), Annual Report and Semi-Annual Report ("Offering Documents"), or other documents available in your local jurisdiction which is available free of charge from the Registered Office: European Bank and Business Centre, 6B route de Trèves, L-2633 Senningerberg, R.C.S. Luxembourg B 29 192. In addition, all Italian investors should refer to the 'Extended Application Form', and all Hong Kong investors should refer to the 'Additional Information for Hong Kong Investors' section, outlined within the Prospectus. Copies of the Prospectus, KIID, the Articles of Incorporation and the annual and semi-annual reports, in German, and further information can be obtained free of charge from the representative in Switzerland. The representative in Switzerland is Carnegie Fund Services S.A., 11, rue du Général-Dufour, 1204 Geneva. The paying agent in Switzerland is Banque Cantonale de Genève, 17, quai de l'Île, 1204 Geneva. The document has been prepared solely for informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy.

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 views and opinions expressed are those of the portfolio management team at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole. Holdings, countries and sectors/ region weightings are subject to change daily. All information provided is for informational purposes only and should not be deemed as a recommendation to buy or sell securities in the sectors and regions referenced. Information regarding expected market returns and market outlook is based on the

research, analysis, and opinions of the team. These conclusions are speculative in nature, may not come to pass, and are not intended to predict the future of any specific Morgan Stanley Investment Management investment. Past performance is no guarantee of future results.

All investments involve risks, including the possible loss of principal. 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.

**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. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If you are a distributor of the Morgan Stanley Investment Funds, some or all of the funds or shares in individual funds may be available for distribution. Please refer to your sub-distribution agreement for these details before forwarding fund information to your clients.

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.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.