INVESTMENT MANAGEMENT

Morgan Stanley

MONTHLY COMMENTARY | DATA AS OF JULY 31, 2017

Morgan Stanley Investment Funds
Frontier Emerging Markets Equity Fund

FOR PROFESSIONAL CLIENTS ONLY.

Fund launch

March 2013

Investment team

Timothy Drinkall, Pierre Horvilleur

Location

New York

Base currency

U.S. dollars

Benchmark

MSCI Frontier Markets Index

PERFORMANCE REVIEW

In the one month period ending 31 July 2017, the fund's Z shares returned 0.27% (net of fees) while the benchmark returned 2.11%.

Stock selection contributed positively to performance, while country allocation detracted. Our overweight allocation to the United Arab Emirates contributed the most to returns, followed by our stock selection in Argentina. Our stock selection in Morocco also contributed. Our overweight allocation to Pakistan was the biggest detractor during the month, as well as our stock selection in and underweight allocation to Kuwait. Our underweight allocation to Nigeria also hampered returns.

From a sector perspective, our stock selection in and overweight allocation to Information Technology was the biggest contributor to returns. Our stock selection in Consumer Discretionary also added to returns, though was partially offset by our overweight allocation to the sector. Our stock selection in Financials and Materials detracted from returns.

MARKET REVIEW

The MSCI Frontier Markets Index returned +2.11%, and underperformed the MSCI Emerging Markets Index (+5.96%) this month. Estonia (+19.58%) led market returns, followed by Romania (+10.58%), Nigeria (+9.07%) and Slovenia (+8.19%). Laggards were Argentina (-6.85%), Sri Lanka (-2.35%) and Jordan (-1.29%).

PORTFOLIO ACTIVITY

During the month we added to our position in YPF, a long-term beneficiary of policy liberalisation in the oil and gas sector. Regulatory and policy changes implemented earlier this year – including more clarity on PlanGas pricing, removal of 15% export tax on oil and a new labor agreement – have been positive for the industry and should help to attract foreign investment. We believe that the stock will benefit from macro reforms and reforms in the oil and gas industry.

We initiated a position in Coca-Cola Içecek (CCI), a Coca-Cola bottler with key operations in Turkey, Pakistan and Kazakhstan. CCI's Turkish business has developed market profile in terms of penetration and consumer trends away from soft drinks, and management is using the business to fund growth in other countries. We are seeing accelerating consumer demand in Pakistan and Kazakhstan. Management wants to continue expanding the company's long-term growth trajectory, looking to enter new markets in other large countries.

We continue to reduce our holdings in Pakistan as the country moved from the MSCI Frontier Markets universe to the MSCI Emerging Markets universe at the end of May. Pakistan is facing a few headwinds, notably an overvalued currency, a sliding current account and uncertainty in politics surrounding former Prime Minister Nawaz Sharif's involvement in the Panama Papers. However, we still remain positive on the banking system as it has healthy loan deposit ratios and private credit to GDP ratios against the other Frontier countries.

STRATEGY AND OUTLOOK

There are many growth levers providing tailwinds to Frontier economies such as strong demographics with labour force growth sufficient for high GDP growth, an underpenetrated credit cycle, a relatively low level of private debt to GDP and healthy domestic demand.

Contrast this to Emerging Markets where there is widespread declining labor fource growth, an over penetrated credit cycle, especially in some of the largest countries such as China, and high exposure to interest rate hikes given the level of private debt to GDP held by both the corporates and consumers.

From a thematic perspective, we continue to own and seek companies benefiting from healthy domestic demand, particularly in regard to healthcare, and select consumer discretionary and staples. We also see demand for financial services in countries with low credit penetration. We are seeking to minimise our exposure to countries highly dependent on trade as protectionism is increasingly part of the platform on new populist leaders.

We have become more positive on oil-dependent countries in the Middle East, including the UAE and Saudi Arabia, as growth is turning upwards and fiscal consolidation is supportive. Longer term tailwinds including demographics and political reforms are also positive, in addition to the market announcement by MSCI that Saudi Arabia was added to the watch list for index inclusion.

We are also more positive on oil-dependent Kazakhstan, following ongoing post-devaluation recovery combined with the recent wave of structural reforms. It presents one of the strongest macro investment cases in the frontier universe in terms of change. The Kazakh banking sector has been deleveraging since the crisis and now looks attractive.

We are turning positive on Egypt. While an oil-importer, we are seeing positive macro drivers including a pickup in tourism, investment and domestic demand. The strong demographic profile also provides a tailwind to growth. The country's deficit remains high but we continue to see notable fiscal consolidation: while inflation is also high, it is trending downward.

We are cautiously optimistic on Nigeria, where previously economic deterioration and the political environment kept investors away. While inflation has been roughly 20%, cheaper dollars are helping to bring it down, and we are seeing stabilisation in the currency with the new NAFEX window repatriation system. We are also seeing PMI activity improve as manufacturers are sourcing dollars at lower rates and GDP growth appears to be bottoming.

We remain positive on Argentina as the government moved aggressively last year to adjust economic policy by removing capital controls, devaluing the currency and decreasing subsidies. The government's message was that the unpleasant medicine of 2016 would give way to a strong recovery. After the economy contracted by over 2.5% in 2016, we are starting to see some green shoots of economic activity; meanwhile inflation is coming down.

We see potential for high levels of sustainable economic growth in Tanzania. Growth in 2016 weakened as the economy adjusted to the new president's reforms. We expect to see acceleration in growth toward the end of 2017 moving into 2018, driven by better implementation of the government's budget. The most significant risk in the short-term is a continuation of the tight fiscal stance. The trade structure is quite different from Kenya's and more supportive of the Tanzanian shilling in our view.

We remain constructive on Vietnam with stable economic growth and increasing reform momentum. Near-term growth is supported by strong domestic consumption and rising private and foreign direct investment into manufacturing sectors. There are risks to exports around global trade but export growth remains healthy and recent central bank changes have helped currency flexibility. In addition, an increase in foreign reserves has helped FX stability. GDP growth will likely flatten out for the next three years, with manufacturing still the main driver of growth.

We have a cautious view on the Kenyan economy and an underweight position within the portfolio. Our only remaining position in Kenya is Safaricom, a purely bottom-up quality growth story. Safaricom is the largest mobile operator in the country. The most interesting part of Safaricom is MPESA, the largest mobile money transfer network in Kenya and one of the largest in the world. MPESA's growth has continued to accelerate through the economic weakness. We are concerned by Kenya's slowing GDP growth and rising inflation. Public investment is slowing as the government nears completion of the reformist president's large infrastructure programs (i.e. the Standard Gauge Railway). We do not expect any new positive reforms from the government in the near term with presidential elections scheduled for August of 2017.

For further information, please contact your Morgan Stanley representative.

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