Morgan Stanley

INVESTMENT MANAGEMENT

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Morgan Stanley Investment Funds

# Global Sustain Fund

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | MONTHLY COMMENTARY | 31 JANUARY 2019

## Performance Review

As the Fund is less than a year old we are constrained from commenting on its performance.

## Market Review

January was an extremely strong month for equities, as markets snapped back from the sharp falls of the fourth quarter. The MSCI World Index was up 7.78% in U.S. dollars (USD) and an only slightly lower 7.24% in local currencies. It was a clear 'risk-on' month with the three distinct laggards the defensive consumer staples, health care and utilities sectors, all up 'only' 5%. At the other end of the spectrum, real estate, energy and industrials were all up 10% to 11%. The rising tide lifted all geographic boats, with Canada (+13% in USD, +9% in local currency) the only market deviating more than 2% from the global index.

## Portfolio Activity

Portfolio activity is reported at the quarter end.

## Strategy and Outlook

***Not Out of the Woods Yet…***

The market ripped upwards in January, with the MSCI World Index rising nearly 8%, and in fairness, there was definitely some good news flow behind the recovery. Arguably, the three main wolves stalking the market in the fourth quarter were the Trade Wars, China and the U.S. Federal Reserve (the Fed), and all three area saw some reasons for cheer in the month. The mood music on the U.S.-China trade negotiations seemed to improve, and China started pressing its stimulus buttons in earnest in a bid to revive growth. Most dramatically, Jerome Powell played the part of the Woodcutter rescuing Little Red Riding Hood from the wolves, as the Fed shocked the market, and even experienced Fed-watchers, with its dovish tone in January, despite a spectacular U.S. jobs report which saw over 300,000 jobs added.

While recognising the improvements, we still remain cautious on all three areas, and suggest that the wolves are not yet slain and Little Red Riding Hood is not yet out of the woods. The last two years have taught us that there is nothing predictable about the progress of U.S. trade policy, and there is some way to go to make enough progress to defuse the 'bomb' of the extra tariffs on China due to come in on 1 March. We would also argue that the main longer-term trade threat is around the technology sector rather than tariffs on industrial or agricultural goods. A deal on tariffs is distinctly possible, but a peace treaty in the technology area is much tougher. Technology is increasingly being seen across the U.S. political spectrum as the battleground between the incumbent U.S. and the challenger China. The arrest of the Huawei CFO in Canada is one sign of this increased tension, which could end with global technology value chains being split into two separate systems, with dramatic implications for the technology hardware sector.

Equally, the success of the China stimulus is not a given. While the Chinese government has always pulled off its reflations in the past, and dragged the world economy with it—most notably after the Global Financial Crisis—the increasing size, complexity and indebtedness of the Chinese economy make it more difficult every time. In addition, the domestic and consumption focus of this year's effort may mean that less benefit is felt overseas.

Finally, while the dovish noises from the Fed are naturally a positive for asset markets, as the threat of automatic tightening has faded, the fact is that the Fed may be forced to tighten significantly as the labour market tightens. Unemployment is now down to 4%, and wage growth is creeping up, particularly amongst the lower-paid.

Our caution about the January surge, and Little Red Riding Hood's safety, is not just around the three fears, or wolves, mentioned above. A further wolf is the fact that the world economy is in a synchronised slowdown. The sugar rush of the U.S. tax cuts is wearing off, Europe is seeing minimal growth, with the forward-looking PMIs (Purchasing Managers' Indexes) at their

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lowest since July 2013,[1] and China has yet to see the benefits of the move to stimulus. The worry is the effect that this existing slowdown will have on corporate earnings. It is aggravated by the margin pressures being felt in the U.S., where first quarter earnings are expected to be down year-on-year as cost pressures bite. The healthy earnings growth expected for this year, with MSCI World Index earnings up 6% in 2019 and the U.S. growing earnings at over 10% by the fourth quarter, may well not be delivered.

Given that earnings estimates drifted down in January, particularly in the U.S., the January market rise was entirely due to rising multiples. The MSCI World Index went from 13.4x next twelve months earnings to 14.5x. This is not particularly high by historical standards, providing the earnings are actually delivered, which is far from certain given the slowing world economy. Markets are certainly not pricing in anything worse than a mild slowdown, and nor are highly levered corporate balance sheets prepared for anything more severe. Given our anxiety about the outlook for earnings, we would continue to advocate owning compounders. The combination of recurring revenue and pricing power should protect revenues and margins, respectively, preserving their profits. They are also likely to be relatively immune from any financial distress if the corporate bond markets have a seizure.

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

**FUND FACTS**

| Launch date | Base currency | Index |
|---|---|---|
| 29 June 2018 | U.S. dollars | MSCI World Net Index |

**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 to see the latest performance returns for the fund's other share classes.**

## Share Class Z 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 company shares 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 funds ability to buy or sell securities.
- Investment in China A-Shares via Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs may also entail additional risks, such as risks linked to the ownership of shares.
- 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 31 January 2019 and subject to change daily.

**INDEX INFORMATION**

The **MSCI World Net 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 index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

[1] Source: IHS Markit. Data as of 31 January 2019.

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