

Global Equity Observer

Superpowers to the Rescue?

INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | OCTOBER 2022

Nine months into 2022, and the MSCI World Index has fallen by more than a quarter, not helped in recent days by the Russian annexation of four provinces of Ukraine and the currency and bond crises in the U.K. Remarkably, the year's fall has still been all down to derating, rather than any drop in forward earnings, which are actually up 3% this year, boosted by the boom in energy profits.

The market's earnings have edged down a little in the last quarter (off 2%), but this is a U.S. dollar number,¹ and thus easily explainable by the currency's continuing strength, which reduces earnings earned in weaker currencies. Margins remain very close to the all-time record levels seen earlier in the year.

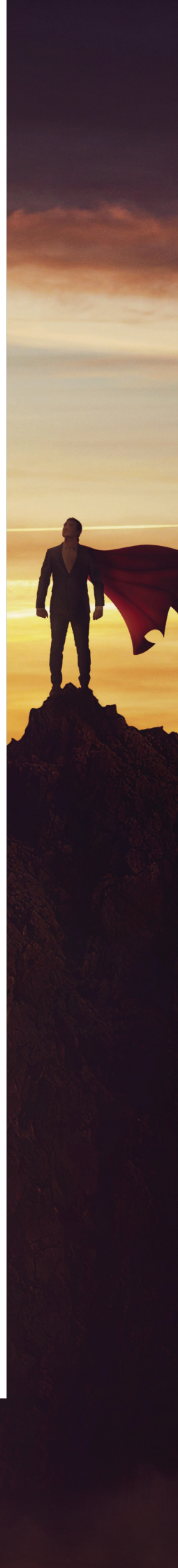
The market's earnings numbers are clearly not anticipating a significant slowdown, let alone a serious recession, with forward earnings expected to rise over 5% over the next year, despite the dollar headwind, and only materials—affected by recent falls in metals prices—facing an earnings fall. The classic cyclical industrials sector's earnings are expected to outperform the overall market over the next year, up 8%, while double-digit growth is anticipated for consumer discretionary stocks.²

The fall in the market multiple does suggest more wariness about future prospects than the earnings estimates do, with the MSCI World Index forward multiple dropping from 19x at the start of the year to sub-14x at the end of September. However, the new level is only 3% below the 2003-19 average, with the approximate 20x multiples of

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¹ Source: FactSet

² Source: FactSet, MSIM

2020-21 looking like the outlier. The defensive sectors have outperformed, as consumer staples, health care and utilities have “only” dropped 14-17% this year, but the worst-performing sectors—information technology, communication services and consumer discretionary, all off over 30%—were the most expensive at the start of the year, rather than the most cyclical, as growthier multiples have contracted most.³

In this environment, our global portfolios have not shown their historic relative lack of downside participation, falling roughly in line with the market. Indeed, the derating has been only marginally less severe than that of the market. The bias towards defensive sectors mitigated the derating, but the portfolios’ exposure to more expensive sub-sectors—i.e., software & services within information technology and life sciences & equipment within health care—largely cancelled that out. The strategies’ forward earnings have been roughly flat this year, as the dollar strength balanced the stocks’ steady compounding. This earnings performance has been slightly behind the market. A mechanical explanation of the gap is the lack of exposure to energy, which drove the bulk of the market’s earnings rise; but a more fundamental explanation is that the portfolios’ two “superpowers”, pricing power and recurring revenue, have not helped in a world of inflation and excess demand, with recurring revenue arguably being a handicap right now.

We value pricing power (the ability to pass on costs to consumers) and recurring revenue (the propensity towards

repeat purchases, either due to long-term contracts or consumers’ force of habit), supported by brands. The combination of the two “superpowers” means that both margins and revenues are robust in a downturn, supporting profits. However, at the moment, pricing power seems fairly universal given all the supply shortages, not least in staff, which have fed into inflation, shrinkflation and the dreaded skimpflation (the deterioration in services we have all suffered), meaning that fundamental cross-cycle pricing power does not currently provide an edge. The situation is arguably worse for recurring revenue. Long-term contracts prevent providers from exploiting high spot prices and can also cause short-term problems in passing on inflationary cost rises, at least until the contracts expire, when pricing power allows the company to catch up.

We still regard pricing power and recurring revenues as superpowers, key for compounding, i.e., the ability to grow earnings in both good times and tough times. This is crucial as we worry that the current good times for corporates may well turn into tough times in the next few quarters, with any slowdown or recession threatening the record corporate margins as the current excess demand turns into a potential excess supply. We are less worried about the portfolio’s earnings vulnerability as the two superpowers should again provide downside mitigation, as seen by the resilience of earnings during the pandemic. History suggests that a fall in the market’s earnings has been accompanied by portfolio outperformance alongside resilient earnings.⁴

³ Source: FactSet

⁴ Source: FactSet, MSIM

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- and mid-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. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). 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. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

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