

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

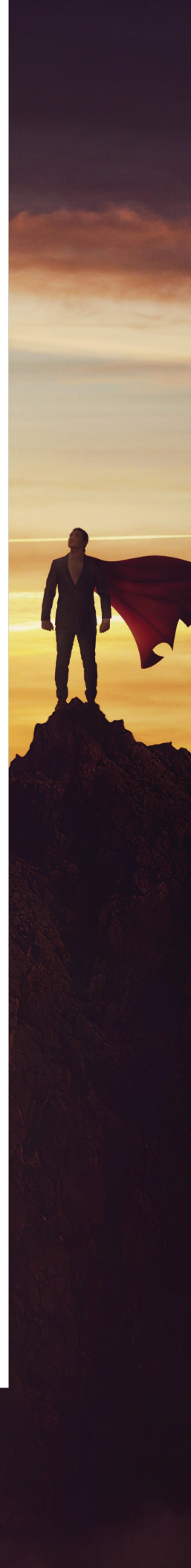
AUTHOR



BRUNO PAULSON
Managing Director

¹ Source: FactSet

² Source: FactSet, MSIM



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 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.

DEFINITIONS

The **MSCI World 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.

IMPORTANT INFORMATION

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index. A minimum asset level is required.

For important information about the investment managers, please refer to Form ADV Part 2.

The views and opinions and/or analysis expressed are those of the author or the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific strategy or product the Firm offers. Future results may differ significantly depending on factors such as changes in securities or financial markets or general economic conditions.

This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability

of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor 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.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

The representative account has employed the investment strategy in a similar manner to that employed in the team's separately managed accounts ("SMAs") and other investment vehicles, i.e., they were generally operated in a consistent manner. However, portfolio management decisions made for such representative account may differ (i.e., with respect to liquidity or diversification) from the decisions the portfolio management team would make for SMAs and other investment vehicles. In addition, the holdings and portfolio activity in the representative account may not be representative of some SMAs managed under this strategy due to differing investment guidelines or client restrictions.

The indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. 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.

This material is not a product of Morgan Stanley's Research Department and should not be regarded as a research material or a recommendation.

The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person's circumstances and purpose. The Firm shall not be liable for, and accepts no liability for, the use or misuse of this material by any such financial intermediary.

This material 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 material in another language, the English version shall prevail.

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without the Firm's express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

DISTRIBUTION

This material 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.

MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC, and Atlanta Capital Management LLC.

This material has been issued by any one or more of the following entities:

EMEA

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM and Eaton Vance materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) 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.

In **Switzerland**, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited ("EVM") 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

Italy: MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. **The Netherlands:** MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 11096HA, Netherlands. **France:** MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain:** MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany:** MSIM FMIL Frankfurt Branch, Große Gallusstraße 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI)

gem. § 53b KWG). **Denmark:** MSIM FMIL (Copenhagen Branch), Gorrissen Federspiel, Axel Towers, Axelstorv2, 1609 Copenhagen V, Denmark.

MIDDLE EAST

Dubai: MSIM Ltd (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)14 709 7158).

EVM utilizes a third-party organisation in the Middle East, Wise Capital (Middle East) Limited ("Wise Capital"), to promote the investment capabilities of Eaton Vance to institutional investors. For these services, Wise Capital is paid a fee based upon the assets that Eaton Vance provides investment advice to following these introductions.

U.S.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Latin America (Brazil, Chile Colombia, Mexico, Peru, and Uruguay)

This material is for use with an institutional investor or a qualified investor only. All information contained herein is confidential and is for the exclusive use and review of the intended addressee, and may not be passed on to any third party. This material is provided for informational purposes only and does not constitute a public offering, solicitation or recommendation to buy or sell for any product, service, security and/or strategy. A decision to invest should only be made after reading the strategy documentation and conducting in-depth and independent due diligence.

ASIA PACIFIC

Hong Kong: This material is disseminated 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 material 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 material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This material is disseminated by Morgan Stanley Investment Management Company and 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. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This material is provided by Morgan Stanley Investment Management (Australia) Pty Ltd ABN 22122040037, AFSL No. 314182 and its affiliates and does not constitute an offer of interests. Morgan Stanley Investment Management (Australia) Pty Limited arranges for MSIM affiliates to provide financial services to Australian wholesale clients. Interests will only be offered in circumstances under which no disclosure is required under the Corporations Act 2001 (Cth) (the "Corporations Act"). Any offer of interests will not purport to be an offer of interests in circumstances under which disclosure is required under the Corporations Act and will only be made to persons who qualify as a "wholesale client" (as defined in the Corporations Act). This material will not be lodged with the Australian Securities and Investments Commission.

Explore our site at www.morganstanley.com/im