Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

Navigating certain markets in an uncertain world

INVESTMENT INSIGHT | INTERNATIONAL EQUITY TEAM | January 2025

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2024 was a very strong year for markets overall, with the MSCI World Index up 19% in USD, making it five out of the last six years with returns above 15%.[1] However, this success was far from equally shared, with the "Magnificent Seven" stocks delivering close to half the global index's returns, and the "Magnificent One", Nvidia, generating 20% of them all on its own. There was also a serious variation by geography, with the U.S. returns of 24% a full 20 percentage points ahead of MSCI EAFE Index's (EAFE) 4%.[2]

Earnings explain much of this hierarchy in 2024 returns. The S&P 500 Index's forward earnings rose 12% in the year, but this was made up of the "Magnificent One's" 38% earnings' surge alongside a mere 6% for the "S&P 493". However, even this long tail of the U.S. market was well ahead of EAFE's 2% earnings fall. The strength of the dollar helped the U.S., as did the country's stronger economic growth. U.S. gross domestic product (GDP) growth reached a very healthy 2.7% in 2024, in contrast with the shrinking German and Japan economies.[3] There was also a significant multiple gap: the U.S. market rerated by 10% to almost 22x forward earnings, while EAFE's multiple edged up by just 3% to 13.8x, a record 36% discount to the U.S.

Looking forward, the U.S. economy continues to look healthier than other developed markets. Its 2%+ expected GDP growth for 2025 is twice that of EAFE, despite the continued softness in some areas such as low mortgage issuance and weak manufacturing PMIs (purchasing managers' indexes). However, positive surprises for the U.S. economy may be tougher to find than in the last two years, given the higher starting base for economic growth. Optimists point to the potential for further corporate tax cuts, deregulation,

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[1] Source for market and stock performance, multiples, earnings and revenue data cited: FactSet, as of 31 December 2024.

[2] U.S. and EAFE market performance is represented by the MSCI USA Index and MSCI EAFE Index.

[3] Source for GDP and Treasury rates data cited in this commentary: Bloomberg L.P., as of 31 December 2024.

and M&A liberalisation to boost corporate profitability under the Trump presidency. The flip side is fears that his policies may aggravate already sticky inflation, be they tariffs increasing consumer prices or deportations raising labour costs. The U.S. policy environment is unusually fluid at present, with a lack of clarity about the incoming administration's plans, never mind their ability to actually implement them.

The economic factor not receiving as much attention as it should is the U.S. budget deficit, which is running at an unprecedented 6%-7% of GDP at a time when the economy is close to full employment. The macro purists cite the Kalecki-Levy equation, pointing out how U.S. fiscal profligacy boosts corporate profitability. To put it less abstractly, either the U.S. budget deficit will be cut significantly by the new DOGE's (Department of Government Efficiency) efforts outpacing tax cuts, which could suck demand out of the economy, acting as a major dampener on economic growth and thus corporate profits, or the deficit will remain very high, growing debt further from the current $36 trillion, which could put pressure on long-term Treasury yields and even the mighty dollar. The 10-year Treasury rate rising 100 basis points as the U.S. Federal Reserve has cut policy interest rates by 100 basis points is perhaps an ominous sign.

Our real concern is how the expected 2025 earnings growth of 15% for the U.S. gets delivered. The expectation is not that we are dependent on the "Magnificent Seven" to deliver this but that the earnings growth will be broad-based, with the "493" stocks, excluding the "Magnificent Seven", growing earnings at 13%. Given revenues are only expected to grow 5%, in line with nominal GDP growth expectations, this double-digit earnings per share (EPS) growth implies a sharp further improvement in margins from what are already at near-record levels, even excluding the "Magnificent Seven".

It has not been the easiest time to invest in steady, high quality compounders in relative terms, due to the twin issues of GenAI excitement and the elevated level of profitability in lower quality companies. In 2024, the challenge for our global portfolios was around multiples. Our high quality, global portfolios saw their forward EPS grow either in line or ahead of the overall index, but performance lagged the MSCI World as the portfolios did not rerate to the same extent. The good news is that the portfolios are now relatively well placed on valuation, despite their far higher quality and better top-line growth prospects.

Credible earnings growth given healthy top line

The portfolios also looks well placed in terms of earnings. They are very likely to be far more resilient than those of the index in any economic downturn, given their holdings' strong pricing power and recurring revenues, as was shown most recently in the COVID crisis, the only recession in the last 15 years. Arguably more importantly, the portfolio looks well placed in both absolute and relative terms even in the absence of a downturn. For our global portfolios, consensus EPS growth estimates for the next two years look achievable, with decent annual revenue growth helped by some modest gains from operational leverage, acquisitions and buybacks. This seems much more credible than the margin-driven double-digit annual EPS growth expected for the index, which is supposed to come off relatively lower revenue growth—a noteworthy delta when margins are already close to peaks.

The claim that "prediction is very difficult, particularly about the future" is attributed to both the Nobel Prize winning physicist Niels Bohr and the baseball Hall of Fame member Yogi Berra. Despite their differing backgrounds, they would probably both agree that prediction is particularly difficult in 2025 given the heightened geopolitical and U.S. policy uncertainty combined with wildly varying prognostications for GenAI. However, the markets do not seem to be afflicted by any such doubt, given the elevated equity multiples, modest VIX and, most starkly, BBB-rated bond spreads at their lowest this century. Given this market obliviousness to the world's volatility, we believe a strategy that seeks to deliver steady compounding through decent top-line growth and resilient earnings, which is trading at a reasonable multiple, offers an important role to play in clients' portfolios.

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 **Magnificent One** refers to Nvidia, one of the technology companies known as the "Magnificent Seven".

The **Magnificent Seven** technology companies are Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla.

The **MSCI World Index (USD)** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets.

The **S&P 500® Index (USD)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada.

The **Chicago Board Options Exchange (CBOE) Market Volatility (VIX) Index** shows the market's expectation of 30-day volatility.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

IMPORTANT INFORMATION

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RO 4183370 Exp. 01/31/2026 25Q10112_KC_0125 Lit-Link: GLBQOBV-0125 LTR