Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

Time for some high quality defence?

INVESTMENT INSIGHT | INTERNATIONAL EQUITY TEAM | October 2024

At the end of June, we expressed our concern that the markets were at high multiples of high earnings, as they were "dominated by the twin beliefs in the invulnerability of the U.S. economy and the massive impact of GenAI". At the time the MSCI World Index was on 18.5x forward earnings, and those earnings were expected to surge at 13% in 2025 and 10% in 2026.[1]

Two months on, after a burst of volatility, we are roughly back to where we were. The market is slightly higher, as the forward multiple has inched up to 18.7x, with double-digit earnings growth still expected. However, the July-August squall did provide us some comfort about the defensive nature of our global portfolios in the downturn.

There were a few weeks during the third quarter when the market seemed to share our worries. The second quarter results season triggered questions about the returns on capital that the "hyperscalers" were earning on their fast-accelerating generative artificial intelligence (GenAI) capital expenditure, causing some air to escape the GenAI balloon during July. There was also a general growth scare in early August, given weak U.S. job numbers and the Services PMI (purchasing managers' index) joining the Manufacturing PMI in contraction territory. On top of this, a 12% single-day collapse in the Japanese market on the back of an unwind of the yen carry trade and a violent spike in the VIX Index[2] to an intra-day peak of 60 added to the general sense of malaise. According to the New York Times, Google searches for the word "recession" rose to levels comparable to the Global Financial Crisis. At the trough on 5 August, the MSCI World Index was down 7% from its July peak, with the mighty Nvidia off by over a quarter, though the hysteria would have suggested that the fall was much worse.[1]

Calm has returned over the last few weeks. The MSCI World Index has bounced back to all-time highs, and the VIX Index has dropped back to

[1] Source: FactSet.

[2] Source: Bloomberg L.P. The VIX Index, often known as the Fear Index, measures the market's anxiety level, or rather its expectation of volatility.

AUTHOR

BRUNO PAULSON
Managing Director

"The good news is that our global portfolios behaved as they should have during this sell-off, appearing resilient in the face of fears around both GenAI and the overall economy."

normal calm levels at 15.[3] Even the bruised Japanese market has recovered close to its level at the start of August. Admittedly the "tech-y" sectors have not bounced back quite as far; for instance, Nvidia has recovered "only" around 60% of its recent fall, leaving it up a "mere" 140% in 2024 so far.[1]

This recovery means that the concerns we expressed at the end of June remain. As mentioned earlier, the market remains expensive, at a high multiple of forward earnings, with the S&P 500® Index looking particularly stretched at over 21x, and the assumed double-digit growth in those earnings requires margins to improve further from what are already record levels.[1] While an imminent recession looks unlikely, economies worldwide are facing negative economic surprises, according to the Bloomberg indices.[3] It is also far from clear that the recent spurt of optimism about interest rate cuts, with nine or 10 pencilled in by the end of 2025, is fully supported by the inflation and wage data, or is compatible with the kind of economy which will drive double-digit earnings growth. Overall, the benign scenario is priced in again as though the scare never happened.

In addition, despite the mild underperformance of the "Magnificent Seven" so far this quarter, the market still remains extremely concentrated, with 27% of the S&P 500® Index accounted for by just five companies, while the U.S. makes up more than 70% of the global index.[1] Owning the index does not offer the diversification that many think it does. The situation has reached the point that FTSE Russell and S&P Dow Jones, two of the main index providers, are contemplating capping the weights of individual stocks in the index, which would effectively make them active managers by default.

The good news is that our global portfolios behaved as they should have during this sell-off, appearing resilient in the face of fears around both GenAI and the overall economy. Looking at the period from 10 July—where the tech names peaked—to 5 August—the trough amid the Japan carry trade panic—the MSCI World Index fell 7%. During this period, our global portfolios were actually UP by around 1%, demonstrating their ability to provide reduced downside participation.

Much of the portfolio's outperformance was "given back" as the market bounced back over the rest of August, though the portfolios are still ahead of the index for the quarter so far. Looking forward, if the bulls are right, with a continuation of the AI boom and the bumper earnings growth seemingly assumed by the market, then the portfolio's relative performance is likely to be mediocre. However, if there is either a cooling of GenAI frenzy or a failure to deliver fast earnings growth for the market, both of which are distinctly possible, then a portfolio delivering resilient earnings at a reasonable valuation may well offer some high quality defence, as it did during the recent squall. There are only two ways of losing money in equities, if the earnings go away or the multiple goes away. Right now, both risks look elevated for the market, but less so for our defence portfolios.

[3] Source: Bloomberg L.P.

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

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

Return On Capital (ROC) is a measure of a company's efficiency at allocating the capital under its control to profitable investments, calculated by dividing operating income by total capital.

Forward to price earnings (P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation

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.

The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy.

The **Volatility Index (VIX)** is the ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. It represents one measure of the market's expectation of stock market volatility over the next 30-day period. The VIX is quoted in percentage points and translates, roughly, to the expected movement in the S&P 500 index over the next 30-day period, which is then annualized.

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 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.

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 24-26 City Quay, Dublin 2, DO2 NY19, 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 ("EVMI") 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 1 1096HA, 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, Axeltorv2, 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).

This document is distributed in the Dubai International Financial Centre by Morgan Stanley Investment Management Limited (Representative Office), an entity regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for use by professional clients and market counterparties only. This document is not intended for distribution to retail clients, and retail clients should not act upon the information contained in this document.

This document relates to a financial product which is not subject to any form of regulation or approval by the DFSA. The DFSA has no responsibility for reviewing or verifying any documents in connection with this financial product. Accordingly, the DFSA has not approved this document or any other associated documents nor taken any steps to verify the information set out in this document, and has no responsibility for it. The financial product to which this document relates may be illiquid and/or subject to restrictions on its resale or transfer. Prospective purchasers should conduct their own due diligence on the financial product. If you do not understand the contents of this document, you should consult an authorised financial adviser.

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.

Japan

For professional investors, this material is circulated or distributed for informational purposes only. For those who are not professional investors, this material is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This material is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

RO 3899840 Exp. 10/31/2025 24Q30739_KC_1024 Lit-Link: GLBQOBV-1024 LTR