Morgan Stanley
INVESTMENT MANAGEMENT

Global Equity Observer

"Nobody knows anything"… but the market thinks it does

INVESTMENT INSIGHT | INTERNATIONAL EQUITY TEAM | January 2024

AUTHORS

BRUNO PAULSON
Managing Director

Writer William Goldman's famous quote was about the film business: "Nobody knows anything…Not one person in the entire motion picture field knows for a certainty what's going to work. Every time out it's a guess and, if you are lucky, an educated one."

Goldman was the screenwriter for a number of classic hits, including "All the President's Men", "Marathon Man", "Butch Cassidy and the Sundance Kid" and "The Stepford Wives". But the wisdom of his saying is shown by the inconceivable failure of his greatest movie, and (in the author's opinion) arguably the greatest movie ever made, "The Princess Bride", which flopped on release but has since acquired cult status.

2023 was a year that supported the idea that nobody knows anything, given the bewildering series of regimes. It started with fears of a recession, followed by expectations of extended high interest rates, with the anticipated year-end federal funds rate in the U.S. rising from 4.5% to 5.5% by March. Silicon Valley Bank blew up in the spring, triggering fears of a credit crunch, but as these fears eased, the markets rejoiced in hopes of an artificial intelligence (AI)-driven productivity boom. By the autumn, "higher for longer" was back even stronger, with the expected year-end 2024 fed funds rate approaching 5% and stocks suffering. The year finished with a "Fed pivot", as the U.S. Federal Reserve (Fed) abruptly shifted its tone and expectations grew for six to seven rate cuts in 2024, resulting in the markets stringing together nine positive weeks in a row.

Physicist Niels Bohr was indeed right when he asserted that "prediction is very difficult, particularly about the future." It is even more difficult than usual right now because of the "long COVID"—the pandemic's lingering impact —still affecting economies. The massive supply-side disruption and huge demand-side intervention by governments are both still causing significant ripples. Spending on goods surged during the pandemic, then switched to services post the reopening, which, along with the supply issues, meant that there was inflation in goods, most notably in automobiles. Later on this was followed by inflation in services, as companies had to pay up to hire the staff they shed during the pandemic. The goods-to-services switch meant that the goods-oriented leading indicators used to forecast recessions wrongly suggested one was coming

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in 2023. At the same time, analysts are trying to calculate how long the “excess savings” piled up in the U.S. during COVID (thanks to the massive government stimulus payments) will allow the current very low savings rates, and associated high consumption, to continue. This is all before we contemplate the uncertainties around the impact of the European energy shock triggered by the Russia-Ukraine war and the possibility of an extended conflict in the Middle East.

Those of a sunny disposition can point to many positives going into 2024. Inflation now seems to be falling fast, without a significant rise in unemployment, which remains below 4% in the U.S.[1] Real gross domestic product (GDP) in the U.S. is now estimated to have grown 2.3% in 2023, compared with the near-zero forecasts in late 2022.[2] The 2024 estimate has risen to 1.3%, twice the growth rate expected back in the summer, while consumer confidence is finally improving, perhaps helped by rising real wages. “Team transitory” seems to be winning the inflation argument, which perhaps explains the Fed’s recent dovish tone. Generative AI seems to be offering the prospect of a productivity boom (which could help reduce inflation), and in the shorter term a capital expenditure boom, as the hyperscalers frantically roll out data centres to deal with demand and the U.S. CHIPS and Science Act and its foreign equivalents incentivise the building of semiconductor fabrication plants. The “Magnificent Seven,”[3] or at least the five of them that grew earnings in 2023, should continue to be drivers of earnings growth.

A cloudier view would suggest that the U.S. has yet to complete the coveted soft landing, with the possibility of the plane undershooting or overshooting the runway. Soft landings are minority events, with three-quarters of U.S. monetary tightening periods since the Second World War ending in recession. The labour market is still tight, with unemployment below 4% and the Federal Reserve Bank of Atlanta’s wage growth tracker still above 5%, which may make service inflation tough to conquer, compared with the goods part of the economy which is already at zero inflation. On the other side of the ledger, the full negative effects of the recent 525-basis point interest rate rise may still materialise, given they have historically had a one- to two-year lag, and something may still break in the financial system as we move away from the “free money” world. Things are also less rosy outside of the U.S.; European economies are close to stall speed, with sub-1% growth pencilled in for 2024 and purchasing managers’ indexes in negative territory. China continues to wrestle with the massive hangover from its decades-long real estate boom, and potentially long-lasting impaired consumer sentiment, as the combination of falling house prices and stock prices further impact household wealth after the recent COVID hit. In addition, continued falls in inflation may pressure corporate margins if companies now struggle to raise prices even if a recession is avoided, particularly if wage rises prove sticky. This is all before considering the volatile geopolitical environment, not least with two billion people voting in elections across 64 countries this year.

We have no clear view as to where the world economy will ultimately land on the sunny/cloudy spectrum. However, we would argue that the market is clearly basking on the sunny side of the street. MSCI World Index earnings are expected to rise close to 10% in 2024 and by 11%+ in 2025.[4] This looks demanding given expected 2024 nominal GDP growth in developed markets of 3%-4%, and seems to imply that margins will have to rise further from levels that are already close to peak. On the negative side, all 11 U.S. recessions since World War II have seen double-digit drawdowns in the S&P 500 Index, with an average fall of 30%.[5] The multiples on these potentially optimistic earnings also look high. The MSCI World Index finished 2023 at 17.3x 12-month forward earnings, and the S&P 500 at virtually 20x. Even without the boisterous Magnificent Seven, the multiple was 15.9x for the MSCI World, over 10% above the 2003-19 average, including the growthy seven.[6] The overall setup strikes us as an unfavourable asymmetry, with upside limited due to the ambitious earnings estimates and high multiples, while there could be plenty of downside if there is a recession. It may be that the 2023 market boom was just stealing returns from the future.

According to Plato, Socrates claimed that, “I am the wisest man alive, for I know one thing, and that is that I know nothing.” We would argue that, had he not been executed by the Athenians but had instead (miraculously) survived to the 21st century, Socrates would have invested in compounders. While arrogant enough to claim he was smarter than everyone else, he would have been humble enough not to make bets on the evolving macro environment, instead investing in companies with the pricing power and recurring revenue to deliver robust earnings in economic downturns like 2020, and with reasonable multiples in case of a multiple compression

[1] Source: FactSet

[2] Source: Bloomberg

[3] Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.

[4] Source: FactSet

[5] U.S. National Bureau of Economic Research

[6] Source: FactSet

such as 2022. This approach to investing does not always match the market's exuberance, and certainly did not in 2023, though the high-teens absolute returns we care about were perfectly healthy. We cannot control the short-term relative returns given our approach to investing, and 2023 certainly did not work out in relative terms. Over the long term, the trick—as always—is to hold on to the healthy long-term absolute returns when markets take a knock.

Investing in compounders in the more defensive consumer staples and health care sectors was costly in 2023, given our global portfolios' combined overweight in sectors that trailed the index by 20% in the year. The flip side of these defensive overweights was the underweight in the Magnificent Seven, which dominated the year, returning over 60%: Only holding one or two of the seven in our portfolios cost us relative performance. Our philosophy currently precludes us from investing in several of the Magnificent Seven. The American multinational technology company focused on e-commerce and cloud computing (amongst other ventures) does not consistently produce significant free cash flow once we deduct share-based compensation, or deliver decent returns on operating capital. The American social media company managed a forward earnings-per-share round trip from $16 in late 2021 to $8 by the end of 2022 and back again last year, quite aside from doubts about the long-term model and governance, while the American multinational automotive and clean energy company doubled its share price in 2023, though its earnings estimates for the year halved from their peak. Elsewhere, the concerns are more about valuation. The American graphics processing unit and chip systems company managed to reach a valuation of 27x times revenue, and the fruity multinational technology company's 30x forward earnings seemed steep for a company that is struggling to grow revenue and is dependent on a single product, even if the rise in recurring services revenue is welcome. That is not to say that these companies will not generate excellent returns from here, just that they do not fit the methodology behind our high quality portfolios, where we are double fussy—worrying about the sustainability of both earnings and multiples. Adhering rigorously to this philosophy and methodology has been the basis of successful compounding for over a quarter of a century, and we fully intend to continue sticking with it. We would encourage you to do the same…along with watching "The Princess Bride".

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

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.

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.

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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).

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CRC 6286638 1/31/2025 10554443_KC_0124 Lit-Link: GLBQOBV-0124 A4