Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The great distortion

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"Events, dear boy, events"…so said Harold MacMillan, former Prime Minister of the United Kingdom, when asked by a young journalist what politicians feared most.

We're in a charged and unpredictable landscape. East-West tensions simmer, the Middle East remains a powder keg, and the Russia-Ukraine war looks set to enter another harsh winter as tensions escalate. Meanwhile, former President Donald Trump is to return to the White House, backed by an emboldened Republican party holding both the House and Senate. All eyes are on the potential economic and societal shifts this new administration may bring.

We saw markets swiftly respond to Trump's victory with a "risk-on" rally in the U.S. and a stronger dollar, driven by expectations for deregulation, corporate tax cuts and an "America First" agenda. While there may well be positives for U.S. markets from the "Trump agenda", there are also many potential negatives, not least the inflationary risks inherent in many of his proposed policies. For example, tariffs could push up consumer prices and corporate costs, while mass deportations could increase labour costs in the U.S. Should an inflationary environment result, the U.S. Federal Reserve may need to alter its current path and hold interest rates higher for longer, potentially constraining economic growth and pressuring weaker balance sheets. In addition, tax cuts may boost corporates' profits at the expense of a higher government deficit, intensifying long-term concerns about U.S. fiscal sustainability. Whatever the resulting policies and their ramifications, markets are facing greater uncertainty; uncertainty that does not seem to be reflected in prices, not least in the VIX index—the measure of expected S&P 500 Index volatility—which is currently trading below 15.[1]

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The great distortion

Any current unusual happenings are not just confined to politics. As we have previously covered, investors are having to contend with an increasingly narrow market environment. While the MSCI World Index is designed to be globally representative, capturing large- and mid-cap stocks across 23 developed markets, its market-cap weighted methodology has led it to become increasingly distorted, with the dominance of U.S. tech giants (aka the "Magnificent Seven"), propelling the U.S. to 70% of the overall index.[2]

[1] Source: FactSet. Data as of 29 November 2024.
[2] Source: FactSet. Data as of 29 November 2024.

Index distortion impacts valuation. The 10 largest companies in the index, which account for 25% of MSCI World's total market capitalisation and are nearly all tech or tech-adjacent, trade at an average 34x next 12-months (NTM) earnings.[3] If you compare this to the broader MSCI World Index, which trades at a near historical high of 19x NTM earnings, the equal weight index at 15x, and the ex-U.S. segment at just 14x, it becomes glaringly obvious that size and geography matter.[4] The valuation gap between the MSCI USA Index and the MSCI World ex-U.S. Index is now at its widest this century, with the U.S. trading at more than a 50% premium to the rest of the world.[5]

Index huggers beware

For managers closely tied to the index, a tracking error-focused approach driven by recency bias may be far riskier in absolute terms than it may appear. In our experience, markets tend not to worry about high multiples so long as strong earnings growth perseveres. However, any knock or fade to earnings may spell trouble, particularly for a distorted index which seems to be priced for perfection.

As we explained in our June Global Equity Observer "Independent Thinking", we've always been cautious about the index. Though it appears diversified, it can steer investors toward a concentrated set of today's winners, chasing where the pendulum has swung, rather than to where it may swing. The index disregards quality and valuation and prioritises size over conviction. With this you own everything—indiscriminately, an approach that doesn't align with our long-term absolute investment approach.

The case for active

As active managers, recent market distortions have presented opportunities that we've been able to take advantage of for our portfolios. This has resulted in several new purchases, all at attractive valuations. Together, these companies' forward price-to-earnings ratio aligns with that of the broader market, yet they boast more than double the market average in both return on operating capital and gross margin (our key quality characteristics). Examples include the leading auto parts retailer in the U.S., which demonstrates an exceptional capital allocation record, and the leading U.S. futures exchange with incredibly high barriers to entry due to its network effects.[6] Turning to sales, increased valuations this year, combined with careful reviews of companies' fundamentals, have led us to exit certain positions where we felt either the multiple or business quality no longer justified ownership.

Our benchmark-agnostic approach is grounded in rigorous fundamental research. Over more than a quarter of a century of high quality investing, we have weathered it all—from recessions and wars to credit crises, pandemics, inflation and deflation, and now five U.S. presidents. Over these 28 years, we have remained committed to our disciplined investment philosophy focusing on the relentless pursuit of quality and a commitment to avoid overpaying. In these unusual times, our focus remains on what drives strong long-term performance—the compounding of high quality company fundamentals.

[3] Source: FactSet. Date 29 November 2024. NTM earnings are estimated.

[4] Source FactSet. Date 29 November 2024. NTM earnings are estimated.

[5] Source FactSet. Date 29 November 2024.

[6] Source: FactSet, MSIM Research. All information is provided for information purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned. The holdings identified do not represent all securities purchased.

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 USA Index (USD)** is designed to measure the performance of the large and mid cap segments of the US market.

The **MSCI World ex USA Index (USD)** captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries.

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.

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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.

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