Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Another Emerging Markets Wobble?

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AUTHOR

WILLIAM LOCK
Head of International Equity Team

BRUNO PAULSON
Managing Director

DIRK HOFFMANN-BECKING
Executive Director

The world economy grew by $14 trillion between 2010 and 2017 according to the World Bank.[1] While $4.4 trillion of this came from North America and $0.5 trillion from Europe, the emerging markets accounted for the majority of this growth. The biggest contributor was China with $6.1 trillion, but India at $0.9 trillion, Korea at $0.4 trillion and Indonesia at $0.26 trillion were bigger contributors to growth than Germany ($0.26 trillion), for example.

Over the summer, the market seems to have lost confidence in the continuation of this trend. The Turkish lira dropped 43% year-to-date to August 31 and the Argentine peso fell even further. The major Chinese indices have fallen 18% year-to-date and "Dr Copper" is also down close to 20%.[2]

Two notions drive the sell-off. On the one hand, countries with significant capital and trade deficits like Turkey and Argentina are under pressure through a combination of high USD-denominated debt, rising oil prices and inadequate policy responses. On the other hand, countries with significant trade surpluses, like China, find themselves under pressure from a fundamentally remodelled U.S. trade policy.

As always, we do not claim to be able to predict the outcome of these challenges and our investment approach remains bottom-up. Nevertheless, given the portfolio's significant – albeit indirect – exposure to emerging markets, we must consider the risks to these markets and have reviewed the portfolio in light of the challenges.

"This is not the first time emerging markets have experienced a setback. It is unlikely to be the last."

[1] Source: http://wdi.worldbank.org/table/4.2#

[2] All data is year-to-date to 31 August 2018.

This is not the first time emerging markets have experienced a setback. It is unlikely to be the last. Investors may remember the last time this happened, back in 2013. Then, as now, we focus on the fundamentals. We believe the main levers to help protect against the risk of capital destruction are pricing power, long-term structural growth trends rather than short-term shifts, recurring revenues, high sustainable returns on operating capital and valuation:

- **PRICING POWER MATTERS ENORMOUSLY.** When local currencies deteriorate rapidly, prices for imported materials can rise dramatically. Companies that retain pricing power due to, for example, brand strength, networks or ongoing innovation, can pass higher input costs on to customers, though they might experience a short-term volume hit. Without pricing power, however, higher input costs are taken directly out of profits, thereby exacerbating the effect of lower demand.
- **THE OTHER SIDE OF THE EQUATION IS THE TYPE OF GROWTH.** In many industries, including staples, growth in developed markets has been modest as saturation levels have been reached and recovery from the financial crisis has remained sluggish. This has made growth forecasts heavily dependent upon growth in emerging markets, in particular growth in China, India and other Asian economies. When looking at the Asian economies in particular, we believe there have been three separate growth drivers over the last few years: (i) growth in manufacturing for exports, (ii) growth in infrastructure investment and housing, and (iii) growth in private consumption. We believe that even if growth in emerging markets may temporarily slow down, the underlying structural trend of emerging market customers catching up with developed market consumption habits remains intact. Our exposure is heavily tilted towards private consumption and has very little – if any – exposure to infrastructure and manufacturing for export.
- **HIGH AND SUSTAINABLE RETURNS ON OPERATING CAPITAL GENERATED FROM RECURRING REVENUES MATTER MOST IN DOWNTURNS BECAUSE THEY LEAD TO STRONG AND SUSTAINABLE FREE CASH FLOW GENERATION.** This allows companies to keep investing, even in periods of lower demand, since they have the cash to cover both dividends and invest in the business. Being able to invest in challenging periods strengthens long-term market positions and can lead to better margins and returns in the future.
- **LASTLY, AVOID OVERPAYING.** A deceleration of growth usually results in a de-rating of the stock, unless there is already some margin of safety built into the valuation. Valuation remains a key feature of our investment process and we have been wary of the "quality at any price" approach we observe in parts of the market.

We select high-quality companies we believe have (i) pricing power, (ii) high and sustainable returns on operating capital to fund innovation and investment, even in periods of slower growth, and (iii) are reasonably priced. This gives us some comfort that our portfolios will display the level of relative downside protection displayed in the past, should it be needed.

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