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EM Strategy | Global

Why We (Still) Prefer EM Sovereign Credit to EM Equities

We continue to find EM hard currency debt more attractive than equities. We recommend adding to EM debt positions, taking advantage of the recent weakness to increase the betas of portfolios.

Revisiting the call: We discussed in detail our preference for EM hard currency (HC) sovereign debt over equities in Why We Prefer EM Sovereign Credit to EM Equities, June 14, 2018. We still think it makes sense, and forecast nine-month gains of 7.6% for EM HC debt, against 9.5% downside to our 2Q19 MSCI EM target price. This divergence is explained by our view of different valuations, fundamentals and technicals between the two.

Valuations: We think that EM stocks are 'average' (not 'cheap'), with valuations in line with history, especially when adjusted for RoE. Both spreads and yields for EM HC debt are more extreme. And *relative* to other equity or other fixed income markets, the difference is even more stark; there are plenty of global equity markets that offer similar or cheaper historical valuations than EM stocks: That's not the case for EM fixed income, including both hard currency and local currency debt.

Fundamentals: We think that EM earnings estimates for 2019 remain too high. Escalating trade tensions present a further downside risk. EM sovereign credit, in contrast, remains more closely tied to a better sovereign fundamental picture, including current account deficits that have corrected, sustained growth and expectations of a weaker dollar and lower UST yields into 2019.

Technicals: Fund outflows have been more benign that historical relationships would suggest, given the negative returns in recent months. A pick-up in outflows thus represents an important risk to both asset classes. However, on the debt side, positioning has reduced in recent months, opening up the scope for a near-term rebound, particularly if supply does not pick up as much as expected.

Investment implications: Add risk in EM through EM sovereign credit, not equities. Within sovereign credit, our preferred countries are Russia, Colombia, Chile and Oman in IG while in HY we also like Argentina and Egypt. We dislike Brazil, Indonesia, Lebanon and Pakistan. Within EM equities, we prefer value over growth.

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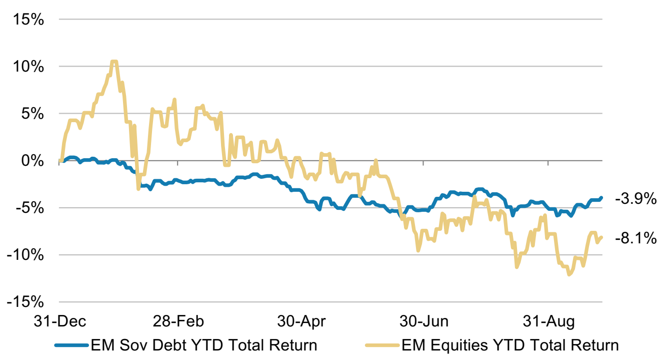
Addressing the follow-up questions

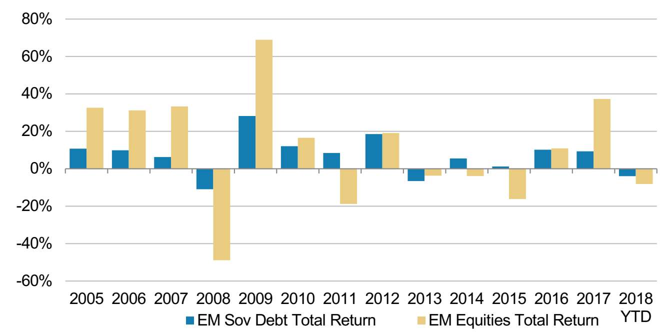
Recap: On June 14 we detailed the five reasons why we favoured EM sovereign debt versus EM equities. This included the upside to our targets, valuations, fundamentals, the impact of the flatter UST curve and flows. The note also reviewed the significant composition differences between the two asset classes, most notably the Asia and tech focus of the equity EM MSCI compared to the more diversified but lower-rated sovereign index that sees LatAm with the largest weight (see Why We Prefer EM Sovereign Credit to EM Equities, June 14, 2018).

Exhibit 1: EM equities have been underperforming EM sovereign debt – particularly in the past three months



Source: Bloomberg, Morgan Stanley Research

Exhibit 2: Negative annual returns more unusual for EM sovereign debt than for equities



Source: Bloomberg, Morgan Stanley Research

Projected returns still favour EM sovereign credit: Since publication in mid-June, amid a very tough external backdrop for EM, the EM sovereign credit index has returned a positive 0.7% while the EM MSCI has seen losses of 9.2% (Exhibit 1). Despite these moves, our return projections still strongly favour EM sovereign credit over equities. We forecast nine-month ahead returns of 7.6% for EM hard currency debt and -9.5% for EM equities (excluding dividends).

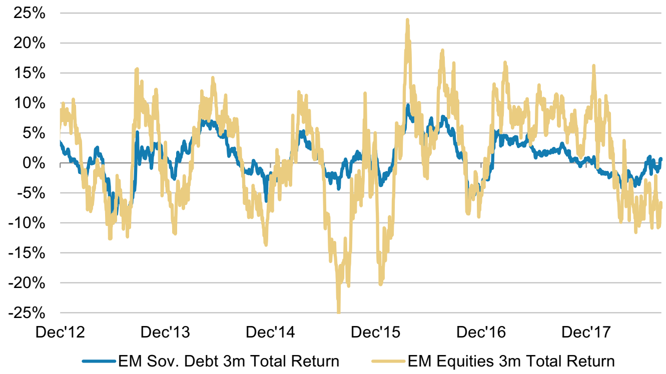
That said, given this sharp move but still seemingly resilient DM markets, we update our views below by answering the most frequent questions we've had in the past weeks.

How long can the equity versus debt divergence continue for?

Simon Waever, Jaiparan Khurana

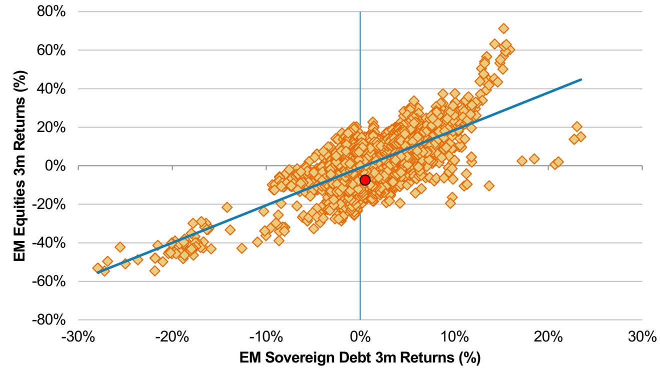
EM equities and sovereign debt total returns trend to track each other closely over longer periods. However, not only do EM equities have a higher beta throughout, but in periods of stress EM equities tend to see much further downside compared to sovereign debt, as for instance shown in 2H15 and early 2016 (Exhibit 3). Since 2012, the average beta of EM equities to debt has been 2, yet this can increase to a high of 4 during stress periods or fall to a low of 0.8 in a contained sell-off. So, while the current EM equity underperformance is unusual and should revert over longer periods, it can easily undershoot further (Exhibit 4).

Exhibit 3: EM equities on average have 2x beta versus EM debt...



Source: Bloomberg, Morgan Stanley Research

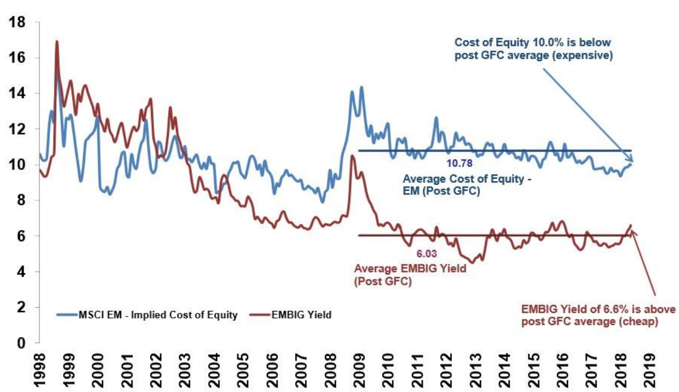
Exhibit 4: ...yet divergences can easily extend further during periods of stress



Source: Bloomberg, Morgan Stanley Research

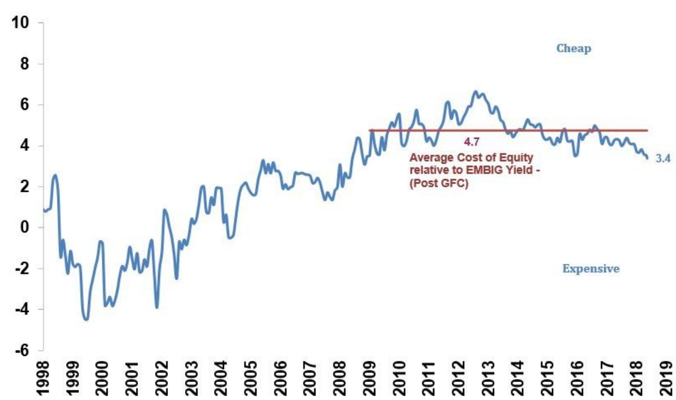
In terms of relative valuations, we use the framework detailed in the earlier note comparing the MSCI EM implied cost of equity (derived from our three-stage DDM) versus the EMBIG yield. This show that the implied cost of equity spread of EM equities to EMBIG remains unattractive despite the relative underperformance of EM equities. This is happening because the deterioration in near-term earnings growth expectations in the first phase of the DDM calculation is offsetting the lower index level. Hence, we conclude that the underperformance of EM equities versus EM USD sovereign debt can easily continue for longer.

Exhibit 5: MSCI EM-implied cost of equity versus EMBIG credit yield: EMBIG yield cheap to post-GFC average while EM cost of equity is at long-run average levels...



Source: Datastream, Morgan Stanley Research. Data as of June 8, 2018

Exhibit 6: ...as a result, the MSCI EM-implied cost of equity premium to EMBIG credit yield is only 339bp, which is the lowest level since December 2008



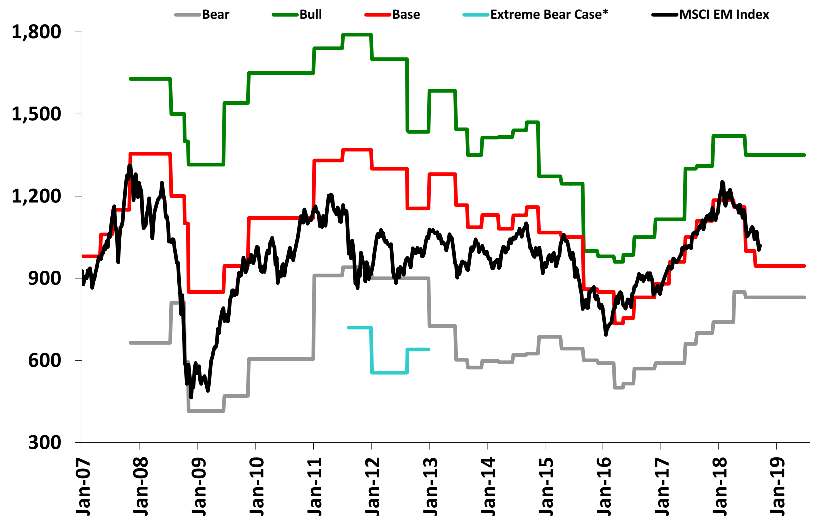
Source: Datastream, Morgan Stanley Research; Data as of June 8, 2018

When are EM equities cheap enough to buy outright?

Jonathan Garner, Pankay Mataney, Guilherme Paiva

Our base case target price for MSCI EM is 945 (June 2019), which is a level at which we would consider buying back EM. This is around 10% below current levels. Within our broad Asia and EM coverage we prefer Japan. We retain a defensive stance as we have all year – preferring value to growth with a focus on sustainable dividend yield. Exhibit 7 plots our price target history for MSCI EM.

Exhibit 7: MSCI EM: Index target history



***Included potential scenario of Eurozone Breakup**

Source: MSCI, FactSet, Morgan Stanley Research forecasts; Weekly data as of September 18, 2018.

Our target price derivation is based on: 1) Our earnings forecast to June 2020; and 2) Our one-year forward P/E forecast for June 2019. These are shown in Exhibit 8.

Exhibit 8: Our target price, top-down EPS, target forward P/E versus consensus table

	Index	Current price	MS Target Price Jun-19	MS Top-Down EPS YoY %			Consensus EPS YoY %			MS Target Fwd P/E (Jun-19)	MS Target P/E Percentile to 10 yr History	Consensus 12m Fwd P/E Current
				Dec-18	Dec-19	Dec-20	Dec-18	Dec-19	Dec-20			
Base Case	MSCI EM	1042	**945** ***-9%***	82.1 *1.4%*	84.2 *2.5%*	90.5 *7.5%*	86.0 *6.2%*	96.1 *11.8%*	106.5 *10.8%*	10.8x	43%	11.2x
	MSCI APxJ	524	**490** ***-5%***	38.0 *1.5%*	39.0 *2.6%*	42.5 *8.8%*	39.7 *6.0%*	43.7 *10.1%*	48.0 *9.8%*	12.0x	40%	12.3x

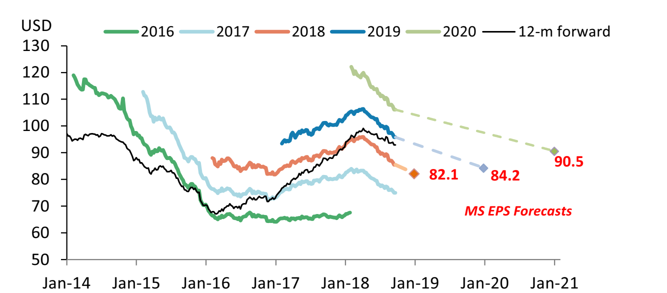
Source: RIMES, IBES, FactSet, Morgan Stanley Research forecasts; Data as of September 25, 2018.

Exhibit 9 provides our forecast trajectory for EM EPS based on a four-factor regression model including the lagged effect on earnings of forecast shifts in global PMI, EMFX, capacity utilisation and the change in the China 10-year yield. The R-squared is currently 78% for this regression. Exhibit 10Exhibit 10 plots the evolution of current consensus expectations. These have begun to soften considerably in recent months – particularly for 2020 – which increases our conviction in our forecast.

Exhibit 9: Our EM four-factor top-down earnings growth model

Source: MSCI, FactSet, Morgan Stanley Research forecasts

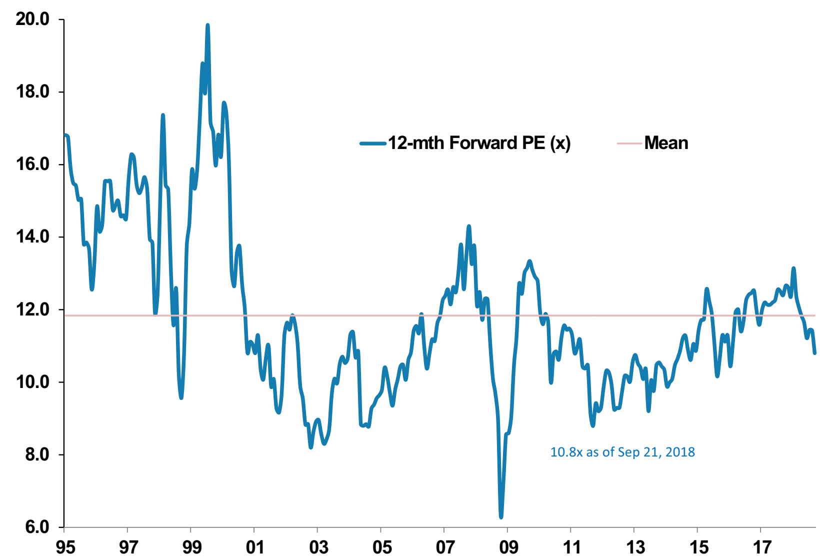
Exhibit 10: MSCI EM consensus EPS trend – December 2019 and 2020 EPS expectations are falling towards our numbers



Source: IBES Consensus, Datastream, Morgan Stanley Research forecasts; Data as of September 20, 2018.

Valuations are also not sufficiently attractive for the deterioration in ROE which EM is currently experiencing both versus its own history and DM peers (including Japan). We already discussed the relative valuations of EM equities to EM debt. We set our absolute EM target forward P/E of 10.8x with reference to forecast ROE. Actual consensus 12-month forward P/E has only recently broken below the long-run (post-1995) average and stands at 11.2x currently versus prior bear market troughs typically in the range of 8-10x.

Exhibit 11: MSCI EM: 12-month forward P/E – not yet at levels consistent with the end of bear markets in the past



Source: IBES, Datastream, Morgan Stanley Research

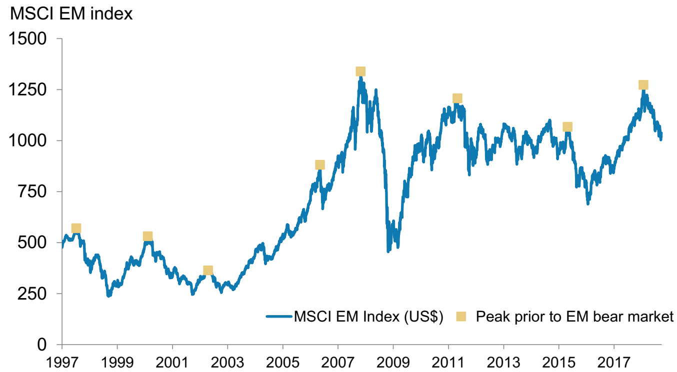
How do typical equity bear markets play out?

Jonathan Garner, Pankay Mataney, Guilherme Paiva

Our EEMEA equity strategy team recently initiated coverage with a comprehensive EEMEA Bear Market Guide: With EEMEA being the worst-performing region globally since the peak in equities on January 26, 2018, the team analysed eight prior EEMEA bear markets over the past 21 years, assessing signposts for stabilisation. Interestingly, they found that in all eight EEMEA bear markets, EEMEA equities did not trough until the S&P corrects, and the trough in EEMEA bear markets typically occurs very close to the trough in the S&P post a correction. This work is discussed in detail below.

We have broadened this signpost analysis for EM overall, analysing seven EM bear markets over the past 21 years: A bear market is generally defined as a correction in which the index has fallen by 20% or more from the peak. There have been seven EM bear markets over the past 21 years including three global bear markets. We have assessed 18 peak-to-trough absolute and relative factors across technicals, valuations, macro indicators and more to identify signposts for stabilisation. We found that across all of these factors, EM is not yet at an absolute trough versus the average EM bear market and even less when compared to the average global bear market.

Exhibit 12: We have studied seven historical EM equities bear markets over the past 21 years...



Source: Bloomberg, Morgan Stanley Research

Exhibit 13: ...including three that occurred during broader global bear markets

Peak	Bottom	Length (months)	EM Peak	EM Bottom	Perf. Peak to Bottom Abs	vs S&P	vs DM
7/9/1997	9/10/1998	14	571	236	-59%	-62%	-59%
2/10/2000	9/21/2001	20	531	246	-54%	-32%	-25%
4/18/2002	10/10/2002	6	364	255	-30%	-2%	-3%
5/8/2006	6/13/2006	1	882	665	-25%	-18%	-15%
10/29/2007	10/27/2008	12	1338	454	-66%	-38%	-32%
5/2/2011	10/4/2011	5	1206	831	-31%	-17%	-11%
4/28/2015	1/21/2016	9	1067	689	-35%	-27%	-22%
Average		10			-43%	-28%	-24%
Average Global Bear Market		15			-59%	-44%	-39%
Current		8			-17%	-19%	-16%

Source: Bloomberg, Morgan Stanley Research

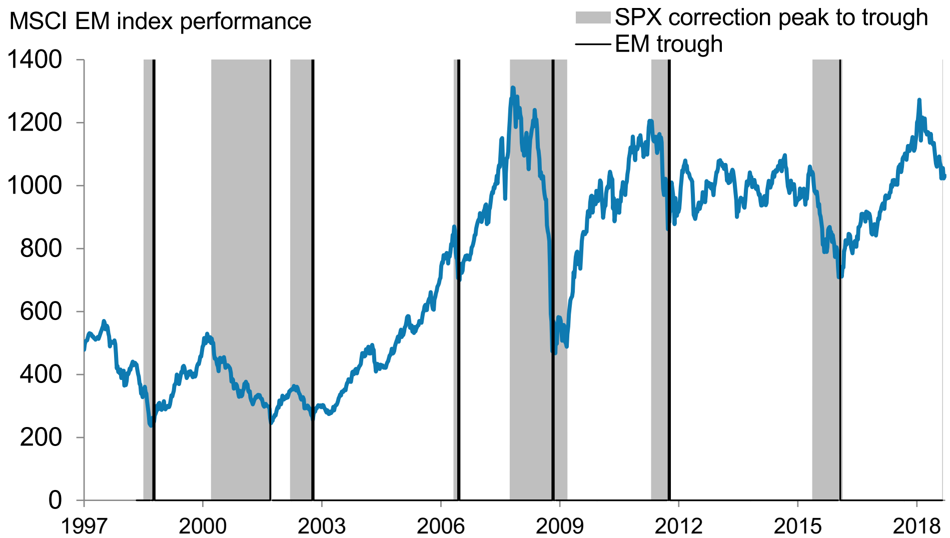
Exhibit 14: Assessing signposts for stabilisation: EM is not yet at the trough versus prior EM bear market averages – across valuations, technicals, macro indicators and more

	Factors	At or near trough vs. EM bear mkt average	Global bear market average	Current	Average levels for.. EM bear market	Global bear market	Magnitude from avg.. EM bear market	Global bear market
	Absolute							
1	Duration (months)	✗	✗	7.9	9.6	15.3	1.7	7.4
2	Absolute decline	✗	✗	(17%)	(43%)	(59%)	(25%)	(42%)
3	RSI min	✗	✗	24	14	13	(9)	(11)
4	Z-score min (absolute)	✗	✗	-2.2	-2.5	-3.0	(0.3)	(0.8)
5	NTM P/E at trough	✗	✗	10.8	9.4	8.9	(13%)	(18%)
6	NTM P/B at trough	✗	✗	1.4	1.2	1.0	(13%)	(27%)
7	NTM DY at trough	✗	✗	3.2%	3.9%	4.7%	(18%)	(31%)
8	NTM EPS (% peak to trough decline)	✗	✗	(2%)	(7%)	(11%)	(4%)	(9%)
9	US 10Y Yield	✗	✗	3.1%	3.7%	4.4%	0.6%	1.3%
10	EM EMBI (bp)	✗	✗	383	763	1,092	380	709
11	EM Market Volatility (3M)	✗	✗	14.2	26.1	31.1	12	17
12	Business Confidence Indicator	✗	✗	100.3	99.6	98.8	(0.7)	(1.5)
	Relative to DM							
13	Decline relative to S&P	✗	✗	(19%)	(28%)	(44%)	(9%)	(25%)
14	Decline relative to DM	✗	✗	(16%)	(24%)	(39%)	(8%)	(23%)
15	Z-score min vs DM	✓	✓	-3.2	-1.8	-2.6	1.3	0.6
16	NTM P/E discount to DM trough	✗	✗	-29%	-32%	-40%	(3%)	(10%)
17	NTM P/B discount to DM trough	✓	✗	-8%	-8%	-15%	0%	(6%)
18	NTM DY premium/discount to DM trough	✗	✗	18%	26%	64%	(9%)	(47%)

Source: Bloomberg, MSCI, Morgan Stanley Research

Notably, over the past 21 years, EM bear markets have not troughed until the S&P has had a correction: Exhibit 16 breaks down the S&P corrections that have occurred around EM bear markets. Interestingly, in four out of seven cases, the trough in EM occurs within one day of the trough in the S&P post a correction. During the S&P correction, in every case except 2000-02, EM continues to underperform.

Exhibit 15: EM bear markets do not tend to trough until the S&P corrects



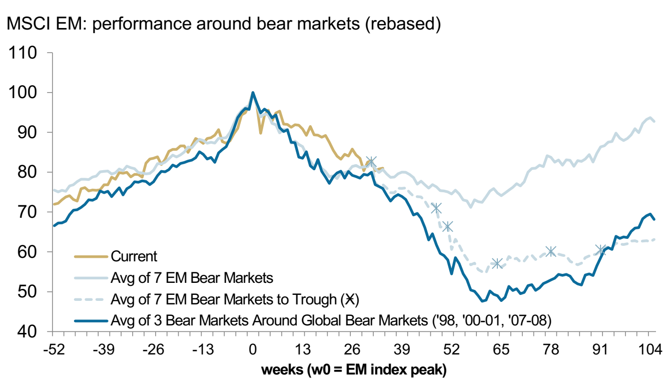
Source: Bloomberg, Morgan Stanley Research

Exhibit 16: S&P has had meaningful corrections around EM bear markets. EM continues to underperform during an S&P correction

S&P Corrections around EM Bear Markets									
S&P Peak Date	S&P Trough Date	Length (months)	S&P Correction	EM Bear Market Trough Date	**Time vs S&P correction trough (days)**	EM Perf During S&P Correction	**EM Rel Perf to S&P During S&P Correction**	DM Perf During S&P Correction	**EM Rel Perf to DM During S&P Correction**
7/17/1998	8/31/1998	1.5	-19%	9/10/1998	10	-33%	-14%	-18%	-16%
3/24/2000	9/21/2001	18.2	-37%	9/21/2001	0	-52%	-15%	-41%	-11%
1/4/2002	10/9/2002	9.3	-34%	10/10/2002	1	-22%	12%	-31%	9%
5/5/2006	6/13/2006	1.3	-8%	6/13/2006	0	-24%	-16%	-11%	-12%
10/9/2007	3/9/2009	17.2	-57%	10/27/2008	-133	-62%	-5%	-59%	-3%
4/29/2011	10/3/2011	5.2	-19%	10/4/2011	1	-29%	-10%	-23%	-7%
5/21/2015	2/11/2016	8.9	-14%	1/21/2016	-21	-31%	-17%	-19%	-12%
Average		**8.8**	**-27%**		**-20**	**-36%**	**-9%**	**-29%**	**-7%**
Average (ex-2000 & 2007)		**8.4**	**-29%**		**-28**	**-35%**	**-7%**	**-30%**	**-6%**

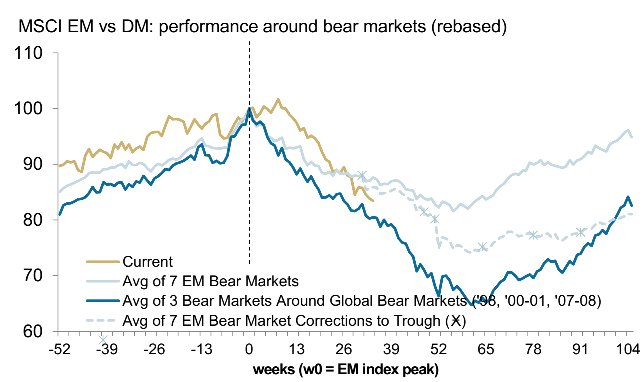
Source: Bloomberg, Morgan Stanley Research

Exhibit 17: Current EM bear market compared to average EM historical bear markets



Source: Bloomberg, Morgan Stanley Research

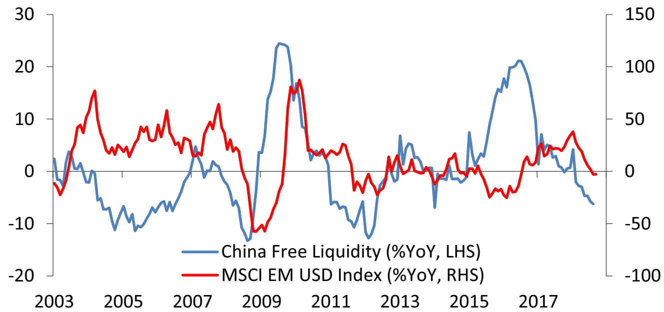
Exhibit 18: Current EM versus DM relative performance compared to average EM bear market



Source: Bloomberg, Morgan Stanley Research

What would make us more constructive on EM equities?

Exhibit 19: China free liquidity* (YoY) versus MSCI EM index performance (YoY, USD)



Source: CEIC, Morgan Stanley Research; Free liquidity data as of August 2018. MSCI EM USD index data as of September 21, 2018. *Free liquidity = M1 growth less producer price inflation less industrial production growth.

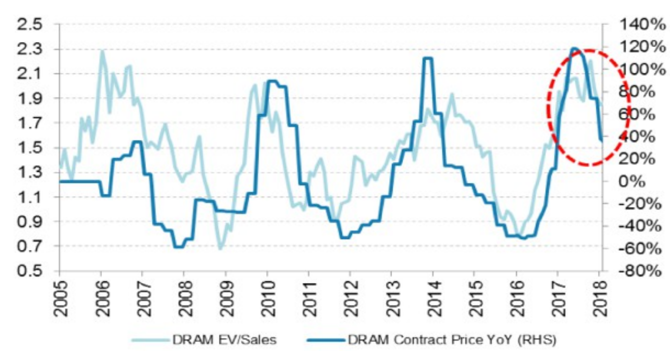
Jonathan Garner, Pankay Mataney, Guilherme Paiva

1) China's policy easing path gaining traction: We are watching to see if Chinese free liquidity (M1 less nominal IP) normalises after recent policy easing announcements by the Chinese government. This metric typically gives a good lead indicator of transmission to the real economy and hence to Chinese and EM earnings and therefore price. We would note though that for EM to re-establish positive year-on-year performance we would typically need free liquidity itself to improve for several months.

2) Whether major EM with external challenges and/or political risk issues are able to navigate their current difficulties: This means monitoring the current situation in Argentina and Turkey but also the outcome of the Brazil presidential election, NAFTA renegotiation, auto tariffs and above all China's trade dispute with the US. For our economists' latest thoughts on the latter topic, see China Economics: US Announces New Tariffs on Chinese Imports, September 18, 2018.

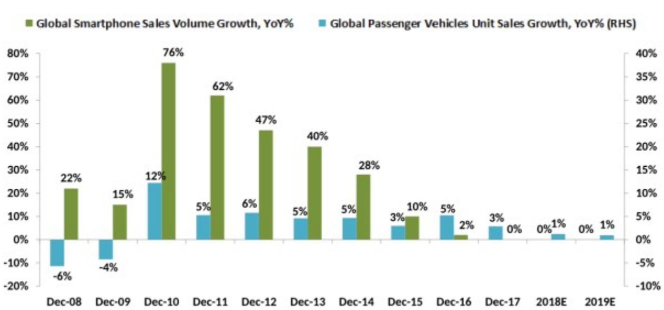
3) The semiconductor and autos cycles, which are of particular importance to EM Asia equities (and Japan) and where our bottom-up teams remain negative. It is noteworthy that even as risk markets were somewhat stronger last year, the SOX (semiconductor) index did not participate in the upside. While Chinese auto stocks did participate to some extent , Korean auto stocks were only very modestly higher.

Exhibit 20: DRAM cycle past its best – DRAM EV/sales at a 10-year high versus DRAM contract price YoY growth rolling over



Source: Bloomberg, DRAMeXchange, Morgan Stanley Research; Data as of August 2018.

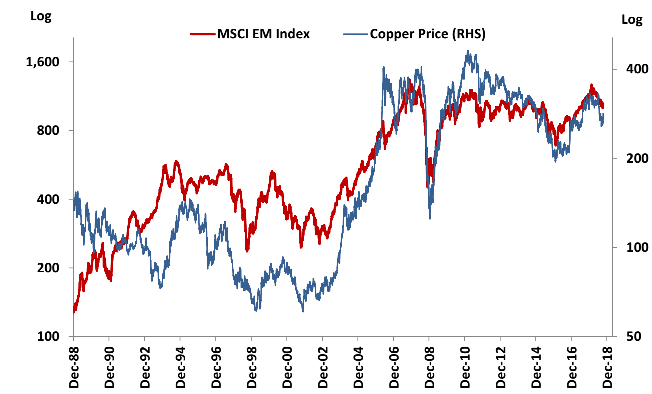
Exhibit 21: Our sector teams forecast lower global sales volume growth for smartphones and autos in 2018 and 2019



Source: Morgan Stanley Research

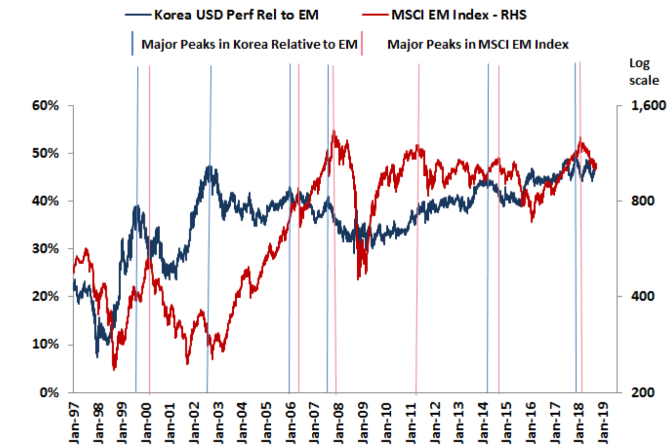
4) The behaviour of the copper price ("Dr Copper") and the relative performance of Korea to EM ("Dr Kospi"): Both gave clear warnings of this year's resumption of the EM bear trend as far back as last November. Of the two, copper is giving the greater encouragement to EM bulls at the moment and has risen around 8% in recent trading sessions. However, it is far from clear that it is re-establishing a positive trend when one looks at the longer-term perspective (Exhibit 23).

Exhibit 22: MSCI EM versus copper price – there was a notable bounce last week but is this the start of a new trend?



Source: MSCI, Bloomberg, Morgan Stanley Research; Data as of September 21, 2018.

Exhibit 23: MSCI Korea's performance relative to MSCI EM peaked last November



Source: MSCI, Morgan Stanley Research. Data as of September 21, 2018

Meanwhile, Korea's performance relative to EM peaked last November and had been rallying modestly since late July. However, in recent trading sessions the Korean market has actually lagged overall EM slightly and lagged Japan significantly.

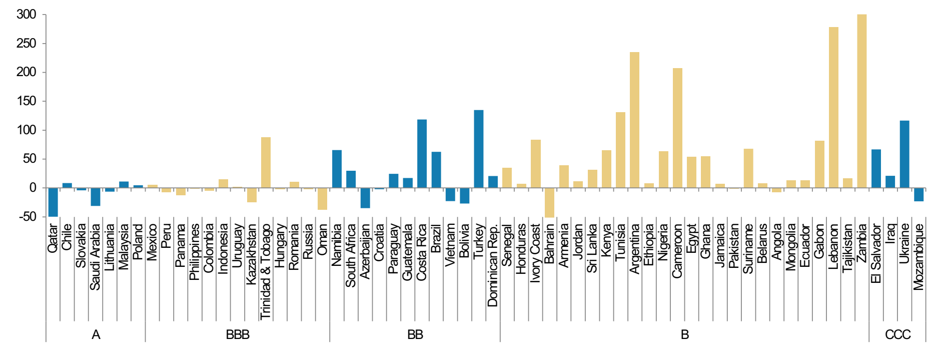
What would cause EM credit spreads to rally?

Simon Waever, Jaiparan Khurana

We expect sovereign credit spreads to tighten in the coming weeks even if already somewhat rich IG spreads and the potential for increased supply are likely to limit the extent of any rally. We now think that high risk premia for trade issues are embedded in EM assets. The policy response from EM central banks has also picked up and DXY should weaken (see EM Strategy Update: Closing the Short, September 24, 2018). Any broad-based rally due to these factors should help the entire sovereign universe.

The backdrop above augurs to increase the beta in portfolios, yet we think that credit selection is important as within HY a few individual stories have been driving a large part of the weakness (Exhibit 24). The EM sovereign credit index (EMBIG Diversified) is 76bp wider YTD. While significant, this move has been largely driven by HY, responsible for 64bp of the move (or 84%), while IG has been much more resilient (see How resilient can investment grade really be? September 17, 2018). In particular, Venezuela (+13bp), Argentina (+10bp), Lebanon (+7bp), Ecuador (+7bp), Turkey (+6.5bp) and Zambia (+3.5bp) are together responsible for 46.5bp of the total index spread widening, or 61% of the total. While some of these credits are taking corrective policy actions, the others still have high funding needs, meaning that they may struggle to rally. This should in turn see index spreads remain somewhat wide compared to the start of 2018 but narrow from current levels. Among these credits, we prefer to be involved in Argentina, where we think that the bulk of the weakness is behind us.

Exhibit 24: 10y credit spread changes since April 18, 2018



Source: Bloomberg, Morgan Stanley Research

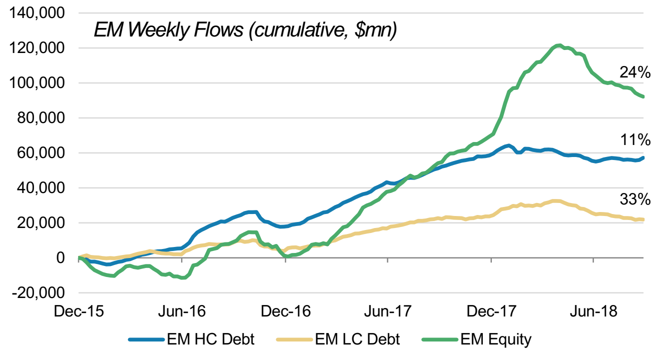
What do EM fund flows tell us?

In line with the weak total returns across EM there have also been outflows from EM-dedicated funds. Comparing both absolute outflows in dollar terms and as a share of the inflows since 2016 that have now been reversed, EM equities comes off worse than EM hard currency sovereign debt (Exhibit 25). EM local currency sovereign debt is in between.

EM debt-dedicated funds (Simon Waever, Jaiparan Khurana, James Lord): We find that there is normally a rotation within EM from local currency to hard currency in stress episodes. This would be supportive of the benign hard currency fund outflows seen in recent weeks. However, the drawdown in returns has been significant recently, particularly given that EM funds underperformed their benchmarked by more than 100bp in August. This has left an abnormal relationship between flows and returns since April, which in turn leaves hard currency debt holdings at risk in case there are further drawdowns (Exhibit 26). See Flows versus returns…who's right? September 17, 2018.

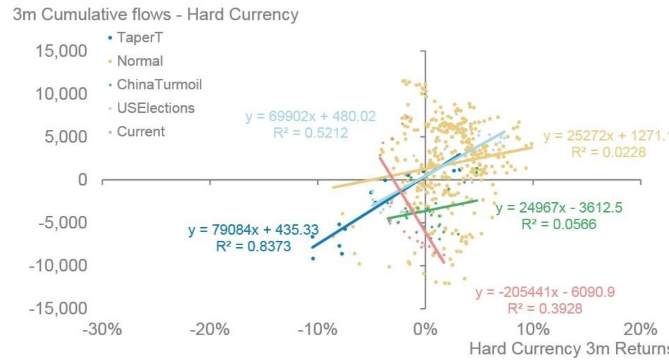
EM equities (Jonathan Garner, Pankay Mataney): We expect to see a period of more sustained outflows from EM equities in the coming months before we are able to turn more constructive. The period from January 2017 to April 2018 saw one of the largest sustained inflow periods in the history of EM with over US$147 billion of inflows to ETFs and actively managed product worldwide. This came as many commentators argued that the EM secular bear market versus DM had finished – which is not our view. Since the peak, only around 19.6% of this fund inflow has reversed. Neither on this basis nor our rolling flow week count of outflows have we seen true capitulation – even though in price terms MSCI EM fell by more than 20% from the peak on January 26 to the most recent trough on September 11.

Exhibit 25: EM equity funds have seen larger fund outflows than debt so far



Source: EPFR, Morgan Stanley Research

Exhibit 26: Unusual relationship between EM sovereign hard currency debt flows and returns



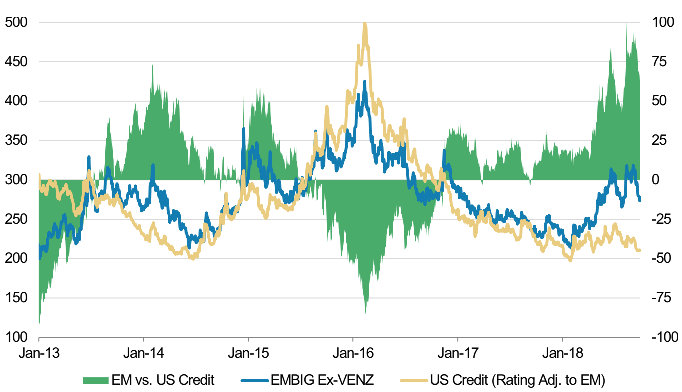
Source: EPFR, Datastream, Morgan Stanley Research

How do ever richer DM valuations affect our preference?

A notable part of the EM underperformance this year, both across equity and debt, has been the resilience of the equivalent DM asset classes. This leads to the questions of i) How much can EM underperform further; and ii) What happens if DM assets come under pressure, as indeed we expect?

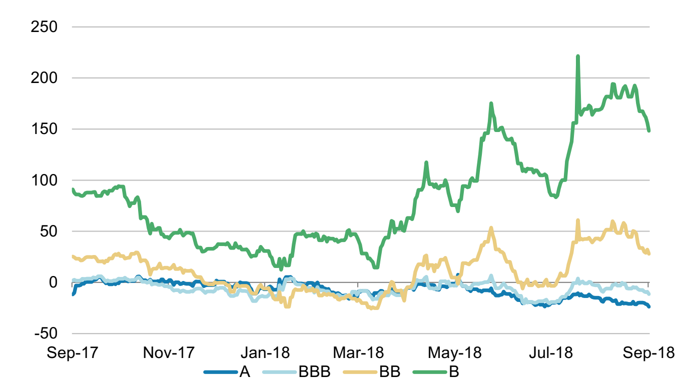
EM sovereign credit (Simon Waever, Jaiparan Khurana): It's clear that EM is now significantly cheap versus US credit (Exhibit 27). Over the coming 12 months, this leaves risk/reward more attractive for EM sovereign credit versus US credit, particularly given our very cautious outlook on US credit. If US credit was to widen significantly, EM spreads will be impacted but with the valuation gap being relatively wide now, EM spreads are also likely to be less sensitive to the move in US credit spreads. Therefore, we think that EM credit should outperform US credit on a relative basis (see How will EM cope with a DM bear market? July 9, 2018). EM IG has in fact outperformed US IG YTD, leaving little scope for this to drive a potential spread tightening, and spread compression will need to come from the single B credits. With EM hard currency outflows being benign so far and some corrective policy actions by a number of sovereigns, EM HY outperforming US HY is likely in the near term.

Exhibit 27: EM credit spreads now trading very cheap versus US credit...



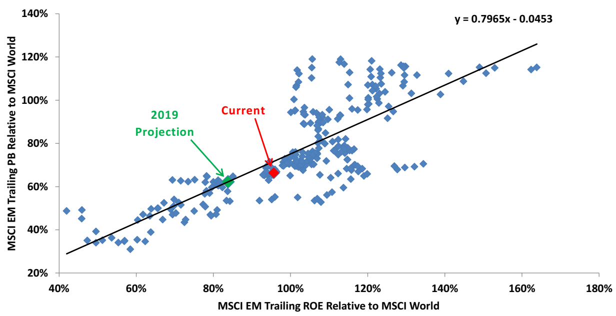
Source: Bloomberg, Morgan Stanley Research

Exhibit 28: ....yet this cheapness is largely driven by B and BB rated credits (EM sovereign versus US credit spreads, bp)



Source: Bloomberg, Morgan Stanley Research

Exhibit 29: MSCI EM P/B and ROE relative to MSCI World



Source: .MSCI, Morgan Stanley Research; Data as of September 25, 2018

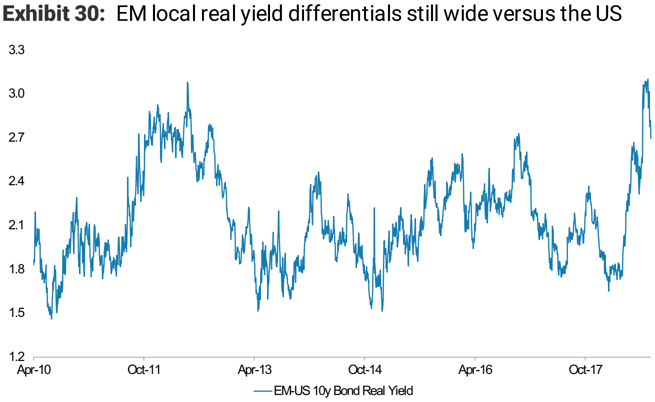
EM equities (Jonathan Garner, Pankay Mataney): We think that valuations are only slightly cheap (<2%) to DM on an ROE-adjusted basis versus current trailing ROE and likely actually expensive versus forecast ROE (Exhibit 29). Higher realised volatility than DM – due to more volatile GDP growth and politics – means that the scatter diagram of P/B valuation relative to ROE relative does not sit on a 45 degree line. However, the R-squared is 62%. Points in the bottom left of the diagram are from the Asian Financial Crisis while the top right contains points from the 2006/07 super-cycle bull top. Currently, EM is almost exactly in line with its typical valuation relative for the ROE which it is delivering. If we are right that ROE relative continues to fall in 2019 then valuations relative will de-rate further.

Why not add EM sovereign local debt instead of EM hard currency?

James Lord

We do think that the case for EM sovereign local debt is a bit stronger than for hard currency. First, the positioning is arguably cleaner on a number of different metrics. The size of outflows from local market-dedicated EM fixed income funds has been larger than seen for hard currency-focused funds. This is shown in Exhibit 25, which illustrates that around a third of the cumulative inflows from January 2016 have exited the market, whereas the equivalent number for hard currency funds is just 11%, with 24% for equity. While the quantity of funds that have exited local markets is consistent with the weak performance of the asset class, fund flows in EM credit have been more stable than the performance would suggest. A second point on positioning relates to the high yield versus low yield exposure that investors have in their portfolios. In local markets, investors are more defensively positioned and, as of end-August, have more exposure to safer low yielders versus high yielders than at any other point in the last couple of years (see GBI-EM Investors Lowdown, September 21, 2018). In credit, the opposite is true, where investors are still overweight the high-yielding, riskier part of the asset class. As such, in any rebound investors may have less appetite to increase their risk exposure.

Exhibit 30: EM local real yield differentials still wide versus the US



Source: Bloomberg, Morgan Stanley Research

Second, we believe that valuations are more attractive in local markets. Real yield differentials versus 10y US TIPS remain attractive, while FX valuations on a REER basis are at multi-year lows. EM credit spreads are wide relative to the US, but in absolute terms spreads are roughly in the middle of the range of the last 10 years. Furthermore, there is a greater breadth of 'cheap' assets within the local markets portion of EM. We discussed this in more detail in Global EM Strategist: How Cheap Is EM Really? September 17, 2018, concluding that a much smaller number of countries in the EMBI Global credit index accounted for a large portion of the spread widening. The IG portion of EM credit has been stable relative to the HY portion of the index. As a result, to make a case for EM credit at the index level investors will be taking a view that the HY portion of the asset class will recover. Meanwhile, in EM local markets, while the weakness has been driven by the high yielders, it is broader overall. As such, there is less diversity in the index and leaves the case to buy less exposed to a handful of more fundamentally challenged economies.

What's the impact of Brazil elections?

After an eventful year for elections in Latin America, arguably the most important one remains in Brazil, with the first round on October 7 and a potential second round on October 28. The Brazilian economy continues to face large fiscal challenges, which will need to be tackled by the next president, most notably pension reform. While the economic outlook could improve materially with an orthodox candidate with governability, alternative combinations could generate a problematic economic outlook in various degrees. In turn, an adverse outcome could have a material impact on the broader asset class (see Brazil Economics and Strategy: Looking Back to Look Ahead: A Defining Vote, September 4, 2018).

Sovereign credit (Simon Waever, Jaipáran Khurana): Brazil makes up a manageable 4% of the index. However, the vulnerability goes beyond this. First, our country allocation statistics show Brazil as the second-largest OW allocation with 1.7% OW. Second, Brazil has one of the largest corporate bond universes in EM. As a result, crossover participation is still high in Brazil, even if lower than pre-2015 when Brazil was still rated IG. As a result, we think that an adverse outcome in the elections would have a material negative impact on the broader asset class, potentially accelerating outflows that have so far been fairly benign despite poor total returns and fund performance.

EM equities (Jonathan Garner, Pankay Mataney, Guilherme Paiva): Brazil makes up a manageable 6% of the index, and we think that the potential impact on EM equities could be contained. First, our Weekly Flow analysis based on EPFR data shows EM funds with an allocation below the five-year historical average. Second, anecdotal evidence from 30 plus meetings we had with EM investors in the US and in Europe over the past two months suggests that portfolio managers have reduced their relative exposure to the country because of the political and policy uncertainty. However, our main concern would be with Argentina – a country which should re-enter the EM universe in mid-2019 and which is already going through a difficult economic adjustment process. Brazil accounted for 16% of total Argentine exports in 2017. Thus, any potential economic slowdown in Brazil after the election would hurt Argentina, especially ahead of President Macri's possible re-election bid in October 2019.

What is our latest country allocation across both sovereign debt and equity?

Sovereign credit (Simon Waever, Jaiparan Khurana): Our positioning has been to favour IG over HY as part of our defensive stance on EM. Within HY we would stick with fundamentally improving and liquid curves. As the index cheapness is largely driven by HY credits, caution and selectivity is still needed when adding back risk. We want to avoid sovereigns which still need to issue bonds as, given the current market backdrop, they will likely need to bring it at attractive levels, in particular given that existing bonds are now trading with much lower dollar prices.

Expecting IG to outperform, we like Colombia, Chile and Russia. However, in order to add beta, we also recently added Oman, a crossover credit, to our like list. South Africa spreads should also do well, given its high beta and as the parliamentary panel report on land expropriation is likely delayed. However, we remain neutral on SOAF credit as spreads are already 45bp tighter from recent wides.

Within single B credits, Egypt remains our preferred pick. With investor positioning in local markets getting cleaner, the technicals for external bonds should also improve. Argentina should also continue to outperform, given its still cheap valuations, even if the rally should slow from here. As the curve steepens, we recommend buying Argentina 2026 versus 2048. Ukraine should see spreads tighter in case a new IMF deal is announced yet risk/reward does not look attractive enough to have a bullish view.

We expect Indonesia and Brazil to underperform. Supply risks should see Indonesian spreads widen, while we think that the recent rally in Brazilian spreads will fade as we get closer to the elections in October. That said, the CDS has lagged the rally to leave the basis very positive, and we recommend selling the Brazil 5Y CDS-bond basis (5Y CDS versus Brazil 2025). We are no longer bearish on Mexico and specifically recommend adding risk via Pemex, including the long end. This leaves us recommending to sell Qatar 2026 versus Mexico 2026 and also to buy Pemex 2047 versus Mexico 2047.

On the HY side, Lebanon and Pakistan remain vulnerable, given their large external financing requirements and net oil importer status. We would look to reduce Lebanon further into any strength and would reassess our stance on Pakistan on the back of news flow after the IMF visit to the country at the end of September. We think that an IMF programme will likely materialise but negotiations may take longer than market expectations, given the upfront fiscal adjustment that would be needed (see EM Sovereign Credit: The Pressure Is On, September 10, 2018).

EM equities (Jonathan Garner, Pankay Mataney): At the country level within APxJ/EM, we prefer India, Singapore, Thailand, Taiwan, Chile and Poland and are Overweight these countries on our country allocation framework. Conversely, we are underweight Korea, the Philippines, Turkey, Colombia, Egypt and New Zealand (see Asia EM Equity Strategy: Downgrading South Africa and Turkey, Upgrading Malaysia and Poland, September 14, 2018).

At the sector level our key OWs are Energy, Real Estate, Financials and Healthcare. We are UW on Discretionary (particularly Autos), Telcos and Staples. Our country framework combines both quantitative signals (valuations, profitability and technicals) with qualitative factors that include macro, currency, bottom-up analyst and top-down strategist views (see Asia EM Equity Strategy: Industry Allocation: Adding More Defense, Upgrading Health Care to OW , July 8, 2018).

Live trades: Rationale and risks

Exhibit 31: Trades

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Buy Mexico 2026 vs. Qatar 2026	24-Sep-18	32	5	50	Potential index inclusion is fully priced in for Qatar, leaving little upside. In Mexico, we anticipate policy continuity in the years ahead, leaving Mexico to benefit from strong US growth and NAFTA uncertainty fading.	The risk to the trade would be announcements on fiscal expansion in Mexico.
Buy Pemex 2047 vs. Mexico 2047	24-Sep-18	222	175	260	Pemex is trading cheap, accounting for fundamental risk and potential supply. Our base case sees no unwinding of reforms.	The risk to the trade is negative announcements regarding the future opening of the Mexican oil sector to foreign investment.
Buy Argentina 2026 vs. 2048 (DV01 neutral)	24-Sep-18	-22	50	-70	A more supportive external backdrop and manageable funding needs should see Argentina spreads rally further, given they're still cheap, and the curve should also steepen further.	The risk to the trade is renewed currency weakness requiring FX interventions and use of FX reserves, which would again question the sustainability of the balance of payment flows.
Sell Brazil 5y CDS-bond basis (Brazil 2025)	24-Sep-18	22	20	85	CDS is cheap in Brazil, both relative to its own history and when compared to the rest of EM. USDBRL moving lower should see CDS tighten as well.	The risk to this trade is local sentiment deteriorating significantly as it may lead to increasing hedging of Brazil risk, which historically has been done via CDS.

Source: Morgan Stanley Research

Exhibit 32: Likes/dislikes

Trade	Date	Entry Level	Target	Stop	Rationale	Risks
Like Chile Hard Currency Bonds	15-Aug-18	NA	NA	NA	Chile now trades cheap for its rating, being wide to the Philippines, Poland and Peru, despite credit metrics still being stronger. We expect copper prices to rebound from here yet limited further falls are also manageable.	A significant sell-off in UST yields or large fall in copper prices.
Like Russia Hard Currency Bonds	25-Jun-18	NA	NA	NA	Stable and slowly improving macro, higher oil prices and reduced positioning should help Russia outperform in a more challenging external backdrop. Russia also trades cheap to BBB, having underperformed recently.	Falling oil prices, new sanctions.
Like Colombia Hard Currency Bonds	26-Nov-17	NA	NA	NA	We think growth has troughed and with now higher oil prices the fiscals also look more realistic over the coming year, which should give Colombia adequate breathing space from the rating agencies. We expect policy continuation following elections	A fall in the oil price, new unknown candidates in the election.
Like Oman Hard Currency Bonds	24-Sep-18	NA	NA	NA	Continued fiscal consolidation and higher oil prices should see Oman outperform, particularly given it's one of the cheaper trading IG credits	Fall in oil prices or signs that recent fiscal consolidation is unwinding, for instance via the re-instatement of year-end bonuses
Like Argentina Hard Currency Bonds	24-Sep-18	NA	NA	NA	A more supportive external backdrop and manageable funding needs should see Argentina spreads rally further given they're still cheap, and the curve should also steepen further	The risk to the trade is renewed currency weakness requiring FX interventions and use of FX reserves, which would again question the sustainability of the balance of payment flows
Like Egypt Hard Currency Bonds	15-May-18	NA	NA	NA	Egypt's twin deficits are consolidating and reforms under the IMF programme remain on track. The sovereign has also completed its planned 2018 global bond issues.	Portfolio outflows from local bond markets could widen the external financing gap.
Dislike Brazil Hard Currency Bonds	15-Aug-18	NA	NA	NA	Brazil cash now trades in line with a BB average, having been up to 50bp cheap in the past two months, thus offering little compensation for upcoming political risks.	Increased chances of a market-friendly candidate winning.
Dislike Indonesia Hard Currency Bonds	15-Aug-18	NA	NA	NA	Still wide double deficits and low reserve coverage leave Indonesia vulnerable to increasing EM risk-off sentiment.	Strong push for tighter fiscal policy.
Dislike Pakistan Hard Currency Bonds	25-Jun-18	NA	NA	NA	FX reserves are moderate compared to total external funding needs. Higher oil prices are also negative for the current account position. Large sovereign supply in 2H18 is also likely.	An IMF programme, if it materialises, will be seen as positive for credit spreads by the markets.
Dislike Lebanon Hard Currency Bonds	9-Apr-18	NA	NA	NA	We think Lebanon valuations are not attractive versus peers, and the benefits of the CEDRE conference will only be over the medium term.	Large concessionary funding in the near term and decline in global oil prices.

Source: Morgan Stanley Research

Exhibit 33: History of recommendations for EM stances

History of recommendations for Colombia Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Dislike Colombia Hard Currency Bonds	23-Jun-17	04-Oct-17

History of recommendations for Russia Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Like Russia Hard Currency Bonds	22-Aug-17	09-Apr-18

History of recommendations for Brazil Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Dislike Brazil Hard Currency Bonds	22-Aug-17	12-Feb-18
Dislike Brazil Hard Currency Bonds	13-May-18	14-Jul-18

History of recommendations for Argentina Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Like Argentina Hard Currency Bonds	14-Jul-16	25-Jun-18

History of recommendations for Oman Hard Currency Bonds		
Trade	**Entry Date**	**Exit Date**
Dislike Oman Hard Currency Bonds	13-Nov-17	30-Apr-18

Source: Morgan Stanley Research

Exhibit 34: History of recommendations for EM trades

Buy Mexico 2026 vs. Qatar 2026

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
MEX 4.125 01/21/2026	21-Jan-26	Buy Mexico 2026 vs Peru 2027	17-Jul-17	53bp	09-Oct-17	50bp	15bp	75bp	USD12.2mn	US91086QBG29	3bp	35k
PERU 4.125 08/25/2027	25-Aug-27	Buy Mexico 2026 vs Peru 2027	17-Jul-17	53bp	09-Oct-17	50bp	15bp	75bp	USD10mn	US715638BU55	3bp	35k
QATAR 3.250 06/02/2026	2-Jun-26	Switch out of MEX 26 into QATAR 26	27-Nov-17	18.00	29-May-18	0.00	-25.00	45.00	$10mx$10m	XS1405782159	18	169
MEX 4.125 01/21/2026	21-Jan-26	Switch out of MEX 26 into QATAR 26	27-Nov-17	18.00	29-May-18	0.00	-25.00	45.00	$10mx$10m	US91086QBG29	18	169

Sell Brazil 5y CDS-bond basis (Brazil 2025)

Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP/ISIN/ BLOOMBERG	Gross P&L BP	Gross P&L US$K
SOAF 5.875 09/16/2025	16-Sep-25	Buy South Africa 2025 vs. Brazil 2025	31-Oct-17	86bp	01-Feb-18	30bp	40bp	110bp	USD10mn	US836205AR58	59	411
BRAZIL 4.250 01/07/2025	7-Jan-25	Buy South Africa 2025 vs. Brazil 2025	31-Oct-17	86bp	01-Feb-18	30bp	40bp	110bp	USD10mn	US105756BV13	59	411
REPSOU CDS USD SR 5Y D14	5y	Sell South Africa 5y CDS vs. Brazil 5y CDS	21-Aug-18	-22.00	28-Aug-18	-89.00	-70.00	10.00	$10m	REPSOU CDS USD SR 5Y D14	67	259
BRAZIL CDS USD SR 5Y D14	5y	Sell South Africa 5y CDS vs. Brazil 5y CDS	21-Aug-18	-22.00	28-Aug-18	-89.00	-70.00	10.00	$10m	BRAZIL CDS USD SR 5Y D14	67	259

Source: Morgan Stanley Research

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Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling Protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying Protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

Like: Based on current market conditions as of the date of this report the analyst expects that the relevant securities of the issuer that is subject of the recommendation will perform favorably over the relevant time period as compared to the overall market of comparable securities by other issuers. This is not intended to be, nor should it be interpreted as a formal fundamental rating of the issuer or its creditworthiness.

Dislike: Based on current market conditions as of the date of this report the analyst expects that the relevant securities of the issuer that is subject of the recommendation will perform favorably over the relevant time period as compared to the overall market of comparable securities by other issuers. This is not intended to be, nor should it be interpreted as a formal fundamental rating of the issuer or its creditworthiness.

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(as of September 30, 2018)
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STOCK RATING CATEGORY	COVERAGE UNIVERSE COUNT	COVERAGE UNIVERSE % OF TOTAL	INVESTMENT BANKING CLIENTS (IBC) COUNT	IBC % OF TOTAL IBC	IBC % OF RATING CATEGORY	OTHER MATERIAL INVESTMENT SERVICES CLIENTS (MISC) COUNT	MISC % OF TOTAL OTHER MISC
Overweight/Buy	**1178**	**37%**	**308**	**42%**	**26%**	**562**	**40%**
Equal-weight/Hold	**1378**	**44%**	**343**	**46%**	**25%**	**625**	**44%**
Not-Rated/Hold	**49**	**2%**	**5**	**1%**	**10%**	**7**	**0%**
Underweight/Sell	**554**	**18%**	**83**	**11%**	**15%**	**224**	**16%**
TOTAL	**3,159**		**739**			**1418**	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis over the next 12-18 months.
Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index or the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index or MSCI sub-regional index or MSCI AC Asia Pacific ex Japan Index.

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