Global Insights

The Emerging Question: Investing in the European Periphery

In our Nov. 2 Global Insights, we considered the limitations of making investment decisions on emerging markets as a whole and explored conditions in the category that could drive outperformance over the medium term.

What’s known as emerging Europe, much like the emerging markets category, is subject to changes in membership over time. Russia’s removal from the MSCI Emerging Europe Index is a notable change given its outsized contribution before the removal. Therefore, we have shifted our focus away from the narrowly defined emerging Europe and now consider the European periphery as well.

This issue of Global Insights, which is the second in a three-part series, is dedicated to exploring opportunities in emerging markets. In this note, we will focus on the European periphery.
As we head into 2023, investors’ interest in the emerging markets category is unlikely to abate. Although developed economies benefited from better access to vaccine programs, “helicopter money” and more resilient currencies in the early days of the global pandemic, recent inflation pressures, an increase in the cost of capital and dark clouds over the economic outlook for developed market countries are among the many factors that have made it an optimal time for investors to consider tilting portfolios toward emerging markets.

In our Nov. 16 Global Insights, “The Emerging Question: Latin America,” we acknowledged that Latin America is likely underowned in global portfolios. Moreover, given the prevalence of home country bias in equity allocations, this is undoubtedly the case for emerging Europe.

However, looking at the market more broadly, we see greater opportunities in the European periphery, which is composed of countries like Greece, Italy, Portugal and Spain. As a result, in this note, we will shift our focus away from the narrowly defined emerging Europe and consider the European periphery as well. Before doing so, we think it is important to explain why we decided to expand the scope of countries included in our note.

What’s known as emerging Europe, much like the emerging markets category, is subject to changes in membership over time. In fact, until recently, Russia was the largest contributor to the MSCI Emerging Markets Europe Index by market capitalization—a colossal 65% as of Dec. 31, 2021. Poland, Hungary, Turkey, Greece, Cyprus and the Czech Republic were the next largest at 14.8%, 4.6%, 4.5%, 4.0%, 3.9% and 2.7%, respectively. Still, we are mindful that in the broader MSCI World Index, the combined emerging Europe economies maintained a near-zero percent weight.

Furthermore, emerging Europe’s weight in the MSCI Emerging Markets Index has also been reduced. Following its invasion of Ukraine, MSCI stripped Russia of its emerging market status, with a majority of market participants claiming that Russia was uninvestable after the US and EU imposed economic sanctions. The move to reclassify Russia further diminished the region’s significance. To be precise, the remaining constituents currently account for only 1.8% of the MSCI Emerging Markets Index (see Exhibit 1). It is with this in mind that we have decided to widen our focus and incorporate countries belonging to the European periphery in the discussion.

Exhibit 1: Investors Are Probably Underweight Emerging Europe in Their Portfolios

<table>
<thead>
<tr>
<th>MSCI Russia Index</th>
<th>MSCI Emerging Markets Europe Country Indexes</th>
<th>Indexes ex Russia</th>
<th>Other Emerging Markets Country Indexes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>80%</td>
<td>60%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>60%</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>40%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>20%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

Note: Other Emerging Markets Country Indexes is MSCI Emerging Markets Index less MSCI Emerging Markets Europe Country Indexes and MSCI Russia Index.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 25, 2022

We think that Europe could find its way to recession in 2023. In fact, according to Morgan Stanley & Co.’s European economists, risks skew toward their bear case, and they expect a deep contraction followed by a muted recovery. The US, on the other hand, may avoid a recession entirely in 2023. This is not uncommon, and the US and Europe have avoided a synchronous recession many times. Using Federal Reserve Bank of St. Louis data, for the 60 years that we analyzed (see Exhibit 2), we found more months when Europe was in recession and the US was not in recession than periods when both Europe and the US were in recession.
The economic stress in Europe is palpable. In fact, the German yield curve reached new extremes of inversion, touching a level not seen since the early 1990s as the path to a soft landing became narrower. What’s more, according to Bloomberg, the likelihood of Germany being in recession one year from now is 90% (see Exhibit 3). With Europe’s energy crisis far from over, inflation positive and accelerating, and the enduring Russia-Ukraine conflict becoming more entrenched, the continent has lunged from crisis to crisis.

Exhibit 3: German Bond Market Signals Investor Angst

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 23, 2022

Admittedly, the MSCI Europe Index’s 15.2 price/earnings (P/E) ratio reflects economic stress. Still, given Europe’s double-digit inflation rates, we think that investors are not fully pricing in Europe’s outlook (see Exhibit 4) and see room for European margins to decline amid diminished sales and rising costs.

Exhibit 4: P/E Ratio Rerating Could Be Offset by Earnings Per Share Decline

Source: Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of Nov. 18, 2022

One of the biggest mistakes that investors make during times of crisis is thinking that they can navigate a prolonged downturn without updating their asset mix. Europe is facing a crisis, and it is important to stay laser focused on your investment goals.

Investment Implications

Over time Europe has become less monolithic. Still, we recognize that nearly 50% of the MSCI Europe Index consists of four core countries—France, Germany, Switzerland and the UK. Although a recession in Europe is our base case, we are mindful that Europe’s countries face different outlooks heading into and out of the continent’s anticipated recession. Therefore, we analyzed “peripheral” European countries like Greece, Italy, the Netherlands, Portugal and Spain relative to the broader MSCI Europe Index during recessionary periods over the past three decades.

For the analysis, we calculated 30-, 90- and 180-day returns for Spain, Italy, Portugal, Greece and the Netherlands relative to the STOXX Europe 600 Index for the five European recessions since 1998, starting at the beginning and end of each. We found that Italy, Portugal and Greece underperformed over many of the periods that we measured heading into and coming out of recession. Spain and the Netherlands saw better relative performance. The Netherlands, home to some of Europe’s most valuable tech companies consistently outperformed Europe (see Exhibit 5). The most likely source of the Netherlands’ outperformance during recessionary periods is its 14% sector weight in financials, which compares to an average 33% for the other country indexes that we measured.
The impact of recessions varies across different groups of countries. Our expectation is that high energy costs, tighter financial conditions, accelerating inflation (see Exhibit 6) and rising geopolitical risk (see Exhibit 9) put the continent at risk. In fact, Morgan Stanley & Co.’s European equity strategy team believes EPS for European equities will decline by about 10% in the coming months—adding to an already challenging backdrop. In the near term, defensive positioning is appropriate. However, as equities adjust to much weaker growth prospects, we believe that coming out of recession, some economies on the periphery will present compelling buying opportunities.

### Exhibit 5: Recessions Impact Countries Differently

<table>
<thead>
<tr>
<th>Average Excess Returns Relative to Europe</th>
<th>Spain</th>
<th>Italy</th>
<th>Portugal</th>
<th>Greece</th>
<th>Netherlands</th>
</tr>
</thead>
<tbody>
<tr>
<td>From Start of Recession</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 Day Return</td>
<td>2.2%</td>
<td>-2.0%</td>
<td>-0.3%</td>
<td>2.1%</td>
<td>0.1%</td>
</tr>
<tr>
<td>90 Day Return</td>
<td>2.1%</td>
<td>-1.7%</td>
<td>-1.2%</td>
<td>-1.8%</td>
<td>1.2%</td>
</tr>
<tr>
<td>180 Day Return</td>
<td>-0.2%</td>
<td>-3.1%</td>
<td>-5.9%</td>
<td>-19.6%</td>
<td>0.5%</td>
</tr>
<tr>
<td>From End of Recession</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 Day Return</td>
<td>1.3%</td>
<td>1.8%</td>
<td>-2.4%</td>
<td>-0.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>90 Day Return</td>
<td>-2.9%</td>
<td>-0.5%</td>
<td>-7.6%</td>
<td>-2.7%</td>
<td>3.2%</td>
</tr>
<tr>
<td>180 Day Return</td>
<td>0.3%</td>
<td>-2.2%</td>
<td>-8.3%</td>
<td>-1.9%</td>
<td>3.2%</td>
</tr>
</tbody>
</table>

Note: Europe defined as the STOXX Europe 600 Index. Spain, Italy, Greece and Netherlands are MSCI Indexes. Recessions as identified by the Federal Reserve Bank of St. Louis.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 23, 2022
Charts You Can't Miss

Exhibit 6: Prices in Emerging Europe and Africa Are on the Rise

![Graph showing consumer prices in Emerging Europe and Africa and consumer prices in the US and Euro Area.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022]

Exhibit 8: Europe Needs to Reduce Its Dependence on Russian Natural Gas

![Bar chart showing total natural gas production by region.
Note: 2022, 2023 and 2024 are forecasts.

Exhibit 7: Investor Sentiment Toward Eastern Europe Makes Gains Against the Eurozone

![Graph showing Sentix investor sentiment six months ahead for Eastern Europe and minus Euro Zone.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 23, 2022]

Exhibit 9: Buildup of Political Risk Is Evident Across Europe

![Line chart showing GeoQuant political risk score for different countries.
Note: A higher score indicates greater political risk. The score draws on measures of country risk and consists of more than 250 high-quality country risk databases produced by nongovernmental organizations, polling firms and social science literature.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 25, 2022]
Ongoing Development Spotlight

The MSCI Turkey Index is at an all-time high. In lira terms, it is up an impressive 135% for the year to date. Still, from a macroeconomic perspective, Turkey faces strong headwinds. For example, Turkish annual inflation climbed to 85.5% on a year-over-year basis in October—a 24-year high. Moreover, the Turkish lira fell to a record low against the US dollar. The high degree of control that Turkish President Recep Tayyip Erdogan maintains over the country’s monetary policy authority is a catalyst for these extremes. For example, he has fired four of its leaders over the past six years. The often abrupt turnover in policymakers has hurt the central bank’s credibility, and more than a few eyebrows were raised when Turkish policymakers lowered the country’s key policy rate to 9% as global peers were tightening monetary policy to keep inflation under control. Although the MSCI Turkey Index looks cheap, at 4.5x earnings, we recommend that investor’s steer clear. We think a potential catalyst for the rally has been investors trying to beat inflation by shifting from Turkish bonds to equities. For example, Turkey’s five-year bond yields 8.5%, well below the rate of inflation, resulting in negative real interest rates. - Barron Thomas

Exhibit 10: Turkish Stock Market Is World’s Top Performer for the Year to Date

GLOBAL INSIGHTS

Disclosure Section

Index Definitions

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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