TODD Asset Management

January 22, 2020
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Todd Asset Management

After things go right…

Todd Asset Management International Market Commentary and Outlook

	4Q 2019	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	8.9%	21.5%	9.9%	5.5%	5.4%	5.0%
MSCI ACWI (Net)	9.0%	26.6%	12.4%	8.4%	9.7%	8.8%

* *Annualized Total Returns.*

At the end of September 2019, it appeared investors were very concerned that nothing could go right for the world economy. Stocks were doing OK, but investors worried that Brexit would lead to further weakness in the economic outlook and chaos in the markets. They were also concerned that the Trade War would escalate, and continue to dampen the outlook for economic growth in Europe and (especially) the Emerging Markets. Global manufacturing was slumping. Hong Kong was mired in protests. Finally, the US yield curve was inverted at the start of Q4 2019 and investors concluded that this "Wall of Worry" was sending an ominous message. We thought there was too much gloominess at the time, so our last quarterly review was titled "What if things go right?" With most of those issues being addressed, markets are now figuring out what to do after things go right.

The ACWI ex-US (net) returned approximately 21.5% last year, compared to the S&P 500 return of about 31.5%. While the indexes generally moved in the same direction, the magnitude of the moves was more muted for international stocks. Most of the year, tensions were ratcheting up in the US-China relationship and most central banks were too tight for the underlying economic conditions. As those tensions eased up in the fourth quarter, the ACWI ex-US essentially matched the S&P 500 return and the Emerging Markets Index strongly outperformed the S&P 500. We believe worldwide economic tensions should continue to tone down through 2020 and believe investors may be speaking of globally synchronized growth before long. The single most important concern is the Trade War, and as President Trump seeks re-election, he has the potential to give the US (and global) economy a boost if he tempers his position in the trade war. Multiple trade deals (China, US Mexico Canada, Japan and Korea) are evidence that he is moving in this direction, and we believe this trend continues until after the election.

As always, there are a number of summary points to remember when reviewing 2019 and looking forward to 2020, including:

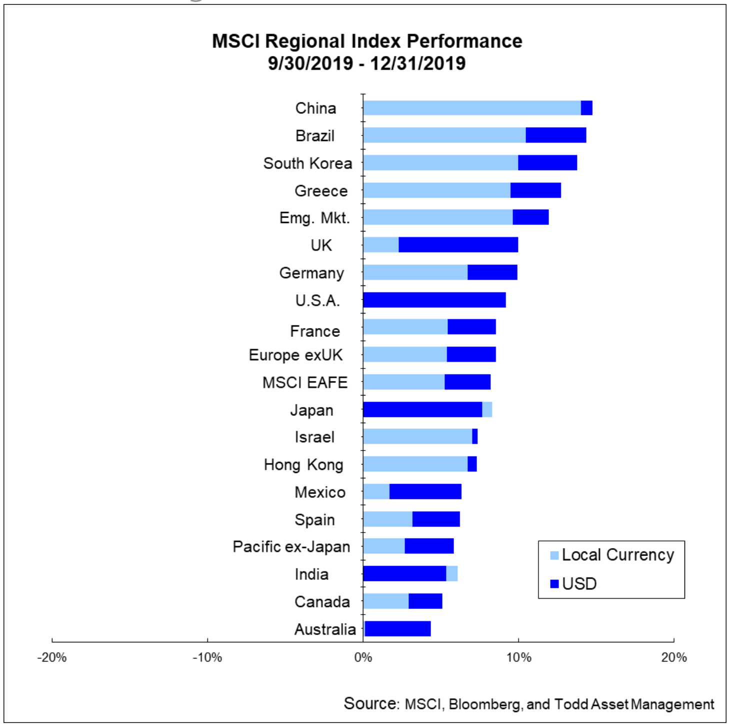
- Manufacturing has been in recession, but may be poised to recover. The tariffs, tight central bank policies and a concurrent Auto slowdown pressured worldwide manufacturing last year. All of these headwinds are easing up. The worldwide economy has gone through three mini recessions since the Great Financial Crisis, in 2012, 2016 and 2019. In each instance manufacturing weakened, and sovereign rates declined to new lows to be followed by recoveries in economic activity and modestly higher yields.
- As trade strains ease and investors adjust to lower Fed rates and a larger US Budget deficit we would expect the dollar to weaken following the safety trade driven strength since the beginning of 2018. This should allow international stocks to outperform US stocks and prompt a rotation to cheaper stocks to occur as confidence grows.
- Emerging market stocks have started to recover. They have historically been the leadership when economic confidence grows, trade recovers and the dollar weakens. We expect a similar pattern to play out this time.
- Many central banks started lowering interest rates again in the fourth quarter. Since then the market leadership has been the Technology, Health Care and Consumer Discretionary sectors. A rotation appears to be playing out towards laggards and economically sensitive stocks.

Early in the year, concerns centered on Parliament's failure to approve Theresa May's Brexit deal and a US Government Shutdown. Those concerns did not sidetrack the market, and after a difficult fourth quarter of 2018, the MSCI ACWI ex-US Index (net) rose 13% from January 1 through early May as some hope of a US/China trade deal emerged. When those hopes dissolved and the US instituted tariffs on $250B of imports from China, the market gave back about half of the year to date gains in May. Following that, the market seesawed for most of the next six months, working through a Chinese devaluation, Hong Kong protests, an inverted yield curve in the US, a new British Prime Minister (with unmistakable hair), a Japanese Value Added Tax and an on again off again relationship between the US and China on trade. Against this backdrop, manufacturing hit a recession and most investors started to whisper about a broader recession.

That narrative changed in August. The Fed lowered rates for the first time since 2008 after they overtightened during 2018. The ECB followed suit in September, lowering rates and re-instituting quantitative easing to spur economic growth. Fiscal stimulus began being discussed in Europe, and France complemented business tax cuts they had implemented over the past two years with personal tax cuts to quell the yellow vest movement. China reduced the bank reserve requirements in September, freeing up capital to go into their economy. Japan indicated they had room to lower interest rates as economic conditions warranted. Pushing back against those developments, the US announced additional tariffs to be implemented in early September, yet the market rose. As the fourth quarter played out, we saw the British population reject socialism and re-elect the conservatives. This gave clarity to how Brexit is likely to play out. The pressure of the tariffs prompted renewed trade negotiations and we saw the US and China announce a Phase One trade deal. Concurrent with lower rates, stimulative fiscal policies began to work on worldwide economies and a nascent recovery in growth seems to be unfolding. Markets have risen in anticipation of this, but it is probably not fully reflected yet.

Emerging Markets moved in tandem with the ACWI ex-US index for most of the year, despite the concerns that a tariffs might disproportionately impact the largest EM country, China. The Trade War did dampen Chinese exports to the US, but we found that other Emerging Markets got most of the exports that China lost. The movement of supply chains from China is real, and that should work to the benefit of the other EM's. Given that the trade war tensions are cooling, and stimulative policies are in place, we expect China to continue their growth path and the other EMs to get more of a tailwind. This resulted in the outperformance of the Emerging markets in the fourth quarter. As China pivots to internal sustainable consumption, they eliminate an imbalance in the world economy that had contributed to slower growth. This may be setting the stage for the next leg in this secular bull market.

The question for investors now is what to expect once we are over the Wall of Worry. We believe the outlook for equity markets remains constructive, though bonds may have a more difficult go of it. Stock markets have had a significant run up recently, so a pullback over the next few months would not surprise us. If that materializes, we would urge investors to realize it is setting the stage for continued rotation in to the cheaper names and (in all likelihood) International stocks as well.



Our analysis of the individual world markets is presented in this chart. Emerging markets topped the list, while some special situations came up as laggards. All markets were positive during the quarter.

Reduced trade tensions and firmer commodities helped China, Brazil and South Korea to leadership positions. All of these countries have exposure to world trade and the Phase One deal, to the extent that it reduces headwinds to world trade should work to their benefit.

Australia, India and Canada were the weakest. In Australia, the economy has been trending weaker, and they are discussing the potential for quantitative easing, something they have not pursued yet. India has also been wrestling with slower growth, exacerbated by a difficult monsoon season. Canada has seen pressure on their export sales, though their consumer wage growth and housing markets remain firmer.

The dollar was declined during the fourth quarter, so if you examine individual country performance in the illustration, dollar returns were generally better than local market returns. As the year progresses, we expect to see continued evidence of accelerating global growth. This would likely foster the confidence required for other currencies to strengthen against the dollar. We believe this would allow a replay of the 2016-2018 period when International markets outperformed the US. There may be setbacks along the way, namely if trade tensions increase or investors expect more political turbulence from either Brexit or the US elections. Absent those, we believe investors could begin to ask the question “What if the phase one deal works?” We think that could contribute to better sentiment and confidence for investors and allow that 2016-2018 analogy to play out.

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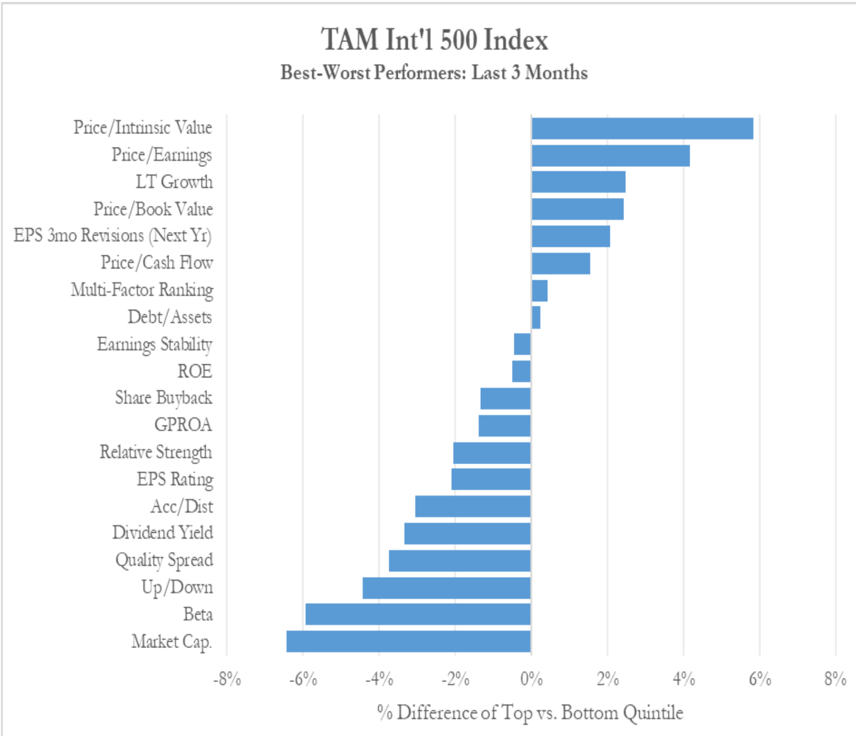
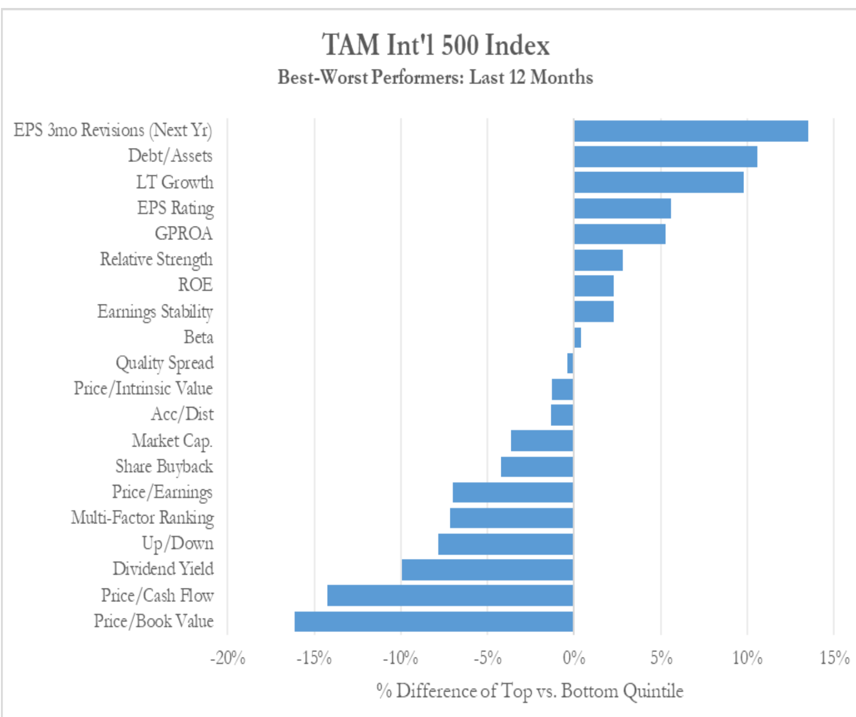
Factor Analysis



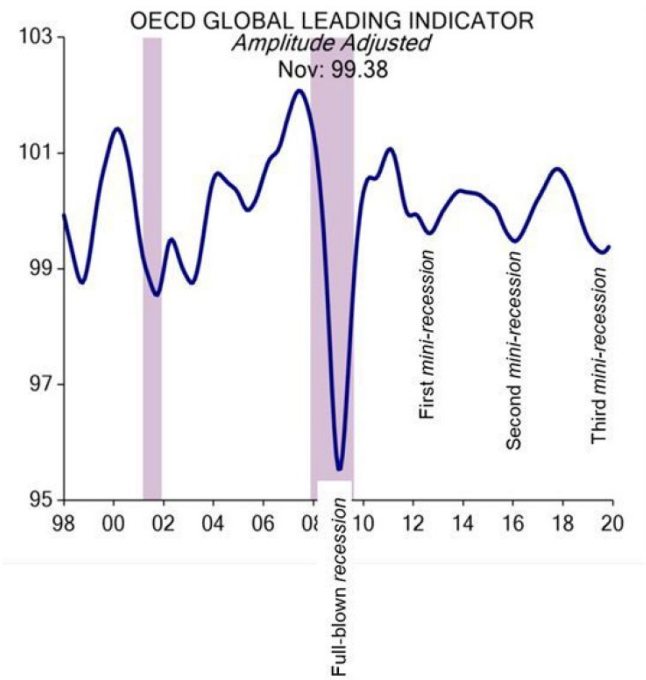


Source: Bloomberg, William O'Neil + Co and Todd Asset Management

Since central banks pivoted to lowered rates, the market has been shifting the factors it is favoring. These two charts are our customary analysis of the factors that are hurting or helping performance within the TAM International 500 Index. For most of the year, we found that value factors were firmly planted at the bottom of the list. In the fourth quarter, that began to change, and you can see that Price to Intrinsic Value added the most value. Price to Earnings, Price to Book and Price to Cash Flow also saw recoveries. The laggards were generally factors favoring volatility, momentum or safety.

We believe this shift to value is likely the beginning of a regime shift as Growth factors have trounced Value factors while economic tensions have risen over the past 2 years. As those tensions ease, investors should be more comfortable buying value.

Interesting Charts We Saw This Quarter



The chart to the left, compliments of Evercore ISI, highlights how Leading Economic Indicators have performed over time. Since the Great Financial Crisis, we have seen three mini-recessions. Economic recoveries followed the last two episodes and we think a recovery will occur this time as well.

The chart to the left, from Evercore ISI, shows how economic activity performed around these mini-recessions. In 2016 activity recovered in response to easier rates and stimulative policies. A recovery appears to be starting now as central banks ease and stimulative policies are occurring.

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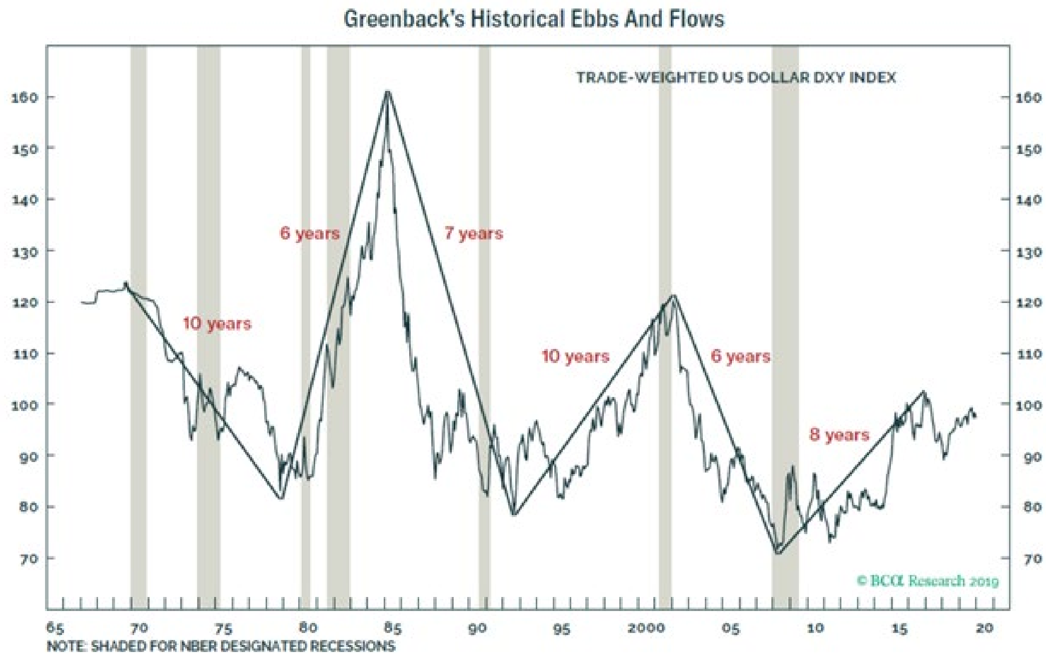
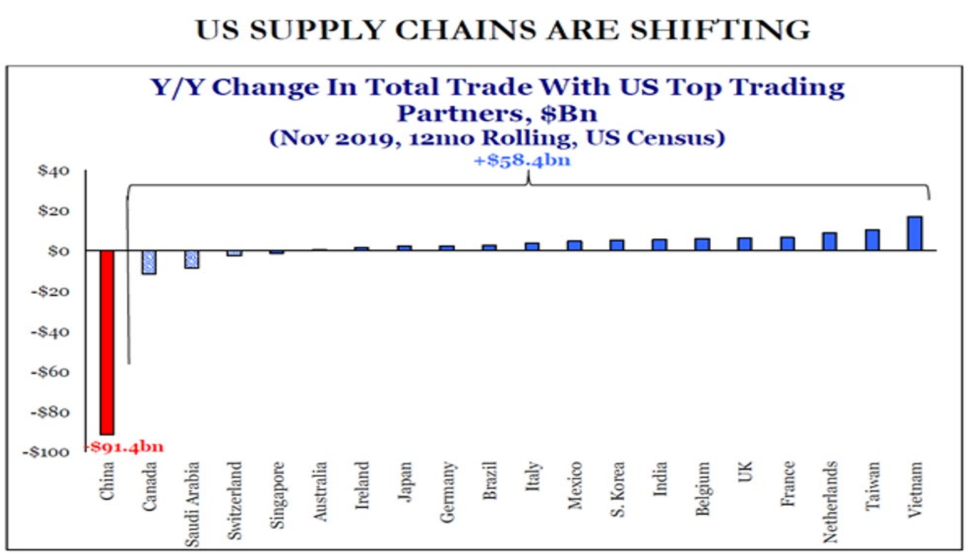
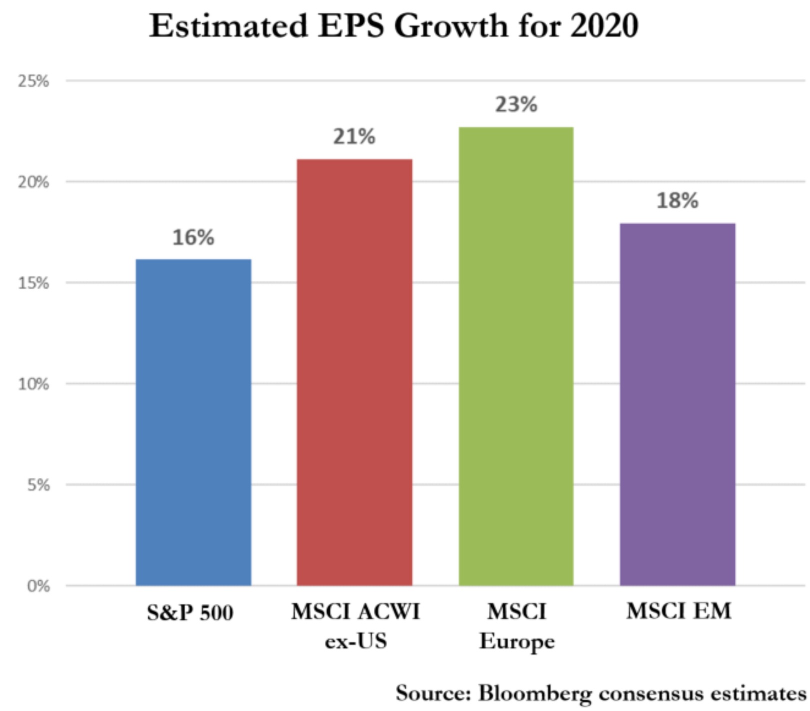


The dollar tends to strengthen and weaken in regular cycles that last from six to ten years. After the Financial Crisis, the dollar strengthened for eight years, peaking in early 2017. A weaker dollar generally coincides with better relative performance for international markets.



Source: Strategas

Tariffs prompted a reduction in US imports from China. The beneficiaries of this have been our other trading partners. Our sense is that the Phase One deal probably will not raise US imports from China again, so other countries have gained at their expense.



Earnings are expected to improve across most markets in 2020 vs 2019. We would point out that international gains are expected to be higher than US gains. International economies are starting from a weaker base, so this makes sense to us.

Summary

Most of the worries investors cited for being bearish last year have been alleviated. Trade tensions are simmering down as we get better clarity on the Brexit situation as well. Manufacturing seems to be bottoming and starting to recover. Central banks have shifted to an easier policy stance as well. The markets are recognizing this and acting well. Markets have had a good run over the short term and may be due for some consolidation. We believe they should act better later this year, especially if we get to a consensus that we are back in globally synchronized growth without prompting central banks to raise rates. That's a tightrope they can walk as long as inflation stays low, so we remain optimistic for the year ahead.

As always, if you need any additional information, please feel free to contact any of us.

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Jack Holden CFA
Shaun Siers, CFA

01/21/2020
MSCI ACWI ex-US (Net) – 253
MSCI ACWI (Net) – 288

Refer to Performance Disclosure on the following page for more information on the performance numbers presented. These notes are an integral part of this letter and should not be reproduced or duplicated without these notes.

MSCI ACWI ex-U.S. (net) Index is a float-adjusted market capitalization index that is designed to measure the combined equity market performance of developed and emerging market countries excluding the United States. The ACWI ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments. The Net Index takes into account the impact of foreign tax withholdings on dividend income.

MSCI ACWI (net) Index is a float-adjusted market capitalization index that is designed to measure the equity market performance of developed and emerging markets.