October 19, 2018
Intrinsic Value Team
Todd Asset Management

Resolving Issues One by One

Todd Asset Management International Market Commentary

	3Q 2018	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	0.7%	-3.1%	1.8%	10.0%	4.1%	7.3%	5.2%
MSCI ACWI (Net)	4.3%	3.8%	9.8%	13.4%	8.7%	11.6%	8.2%

* *Annualized Total Returns.*

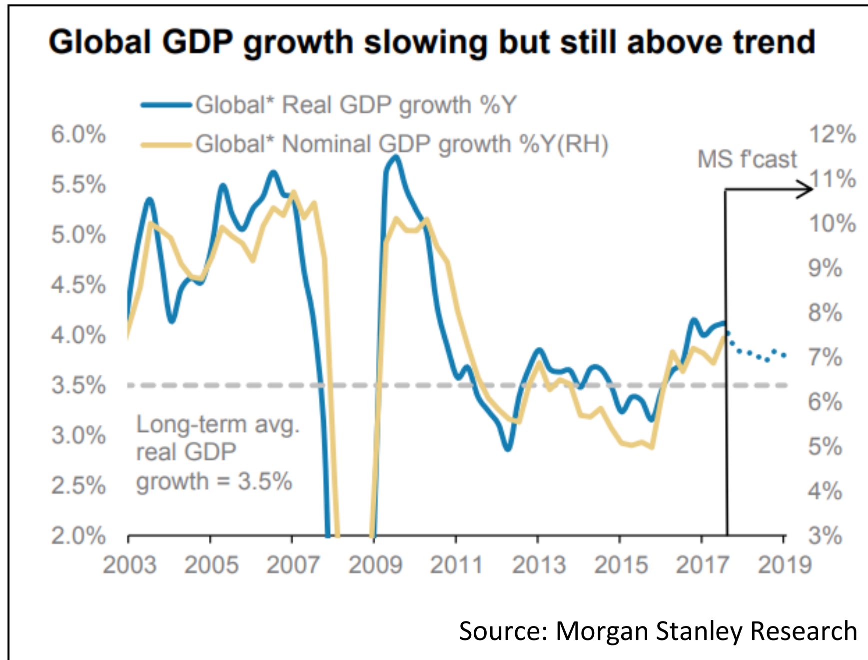
International Investors sat on their hands last quarter, with the MSCI ACWI ex-US Index rising less than 1%, compared to S&P 500 gains of over 7%. Year to date, the comparison is more stark, with international stocks down about -3%, compared to S&P 500 gains of nearly 11% (total return) through the end of the third quarter. The annual performance differential is at record levels according to JP Morgan, and they believe a snapback is likely. This performance lag is a distinct turnaround from last year's international outperformance and has many investors asking whether 2017 was the beginning of a longer term change in trend favoring international over US investing, or a head fake. We think the international underperformance is likely a temporary phenomenon, and would expect those markets to resume outperforming over the next couple of quarters.

We think now would be an opportune time to add to international stocks for a recovery from depressed levels as issues are resolved, one by one, over the next few quarters. There are several items that have hampered international results that are likely to be resolved over the relatively short term. Let's look at the primary factors weighing on International results:

- Globally synchronized economic growth has been questioned.
- Trade tensions/tariffs lead to concerns on world trade. Hawkish comments from US VP Mike Pence rattled investors in early October.
- Fears of a disorderly Brexit from the EU have increased
- The US dollar strengthened because of fiscal stimulus and some Emerging Market problems, dampening international results.
- Continued interest rate increases from the US Fed as well as less monetary stimulus from the European and Japanese central banks have investors concerned.

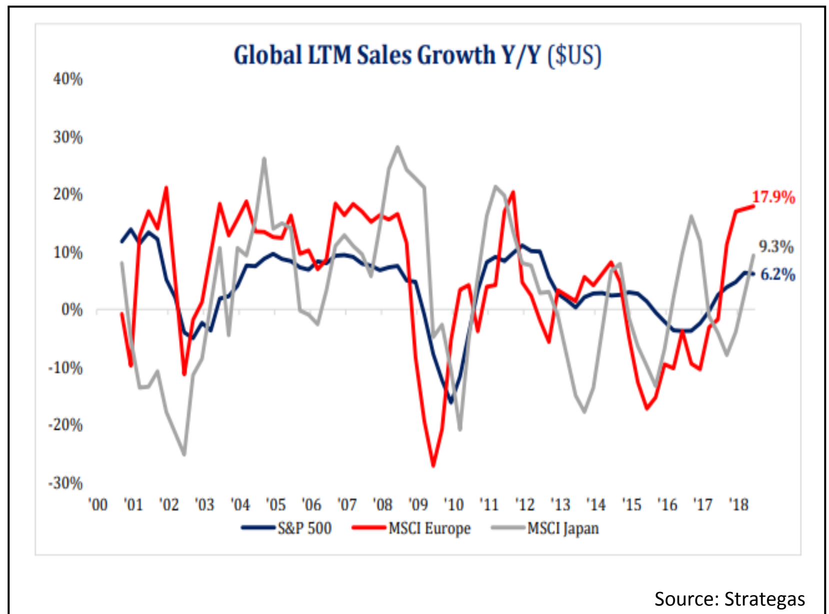
We believe several (though not all) of these concerns should dissipate as we move through the next couple of quarters, which should lead to better results. With the issues identified, we should take a harder look at each underlying concern to see if they hold up under scrutiny.

Synchronized global growth was the key to international markets outperforming US markets in 2017. The premise was that because international markets were coming off recessions in 2016, they would have a longer runway for growth. There have been concerns recently that European growth might be slowing after a 2017 surge, or that the trade concerns could impact China. To put it in perspective, there was an excellent chart from Morgan Stanley Research that highlights how Global GDP growth remains above its' long term trend. After a period of strong growth in 2003 to 2007, growth moderated after the Great Recession. We refer to the post crisis slowdown in growth as the "Great Reset". This period worked off several of the excesses that led to the financial crisis, culminating in a slowdown in 2015-2016. Since then, capital spending has picked up in developed markets and China continues to promote consumption over manufacturing. While growth may moderate somewhat as we move through 2019, it should remain positive. We think it is likely that other countries will pursue supply side reforms and stimulate like the US has, especially if populist politicians continue to be elected. We would also note that the US Fed, European Central Bank and Bank of Japan are all trying to tiptoe away from Quantitative Easing. They would not be doing that if they thought the economy was in fragile shape.



Source: Morgan Stanley Research

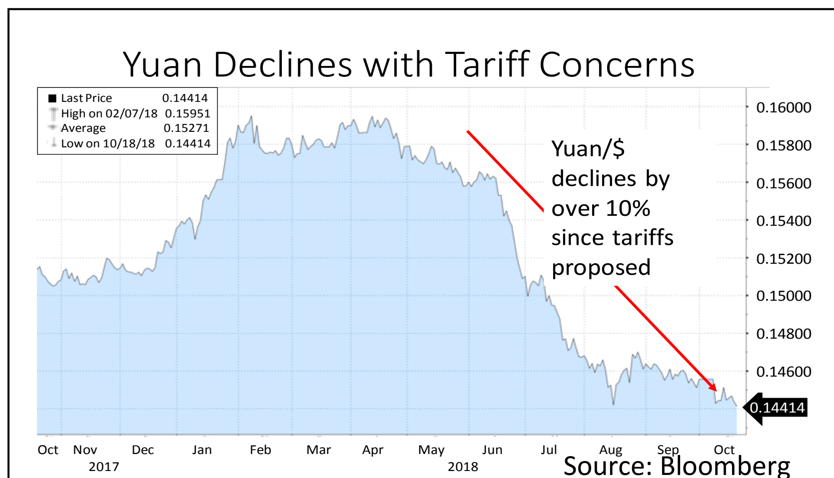
For those who worry that European or Japanese fundamentals are under pressure, we would suggest you look at the chart to the right, illustrating year over year last 12 months sales growth for the S&P 500 compared to MSCI Europe and MSCI Japan indexes. Europe has seen sales growth of nearly 18% year over year, compared to Japanese growth of 9.3% and US growth of 6.3%. All of these are very robust comparisons and the best comparisons we have seen in years for Europe and the US.



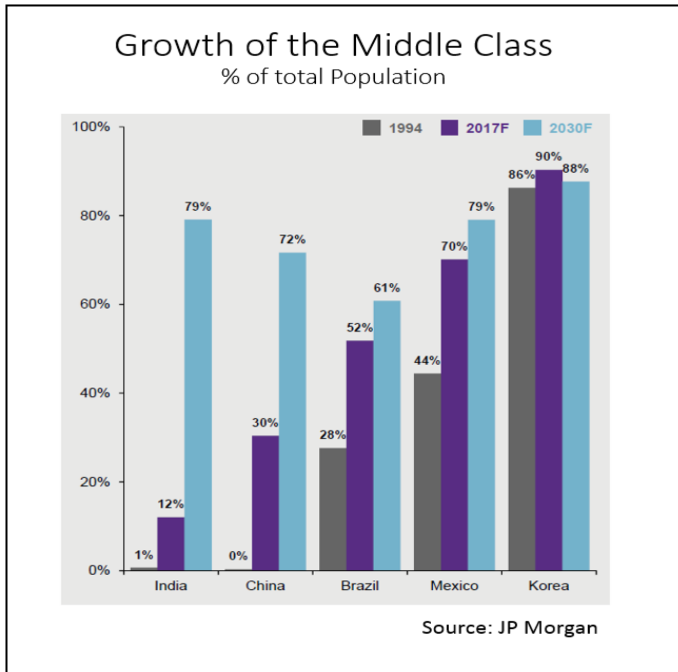
Source: Strategas

This suggests to us that fundamental should remain positive for most developed market companies as sales growth should allow for good earnings growth. The EBITDA comparisons exhibit similar patterns.

Tariffs are uncharted territory for us, and worries about the US/China trade spat are spilling into political and military areas. Most observers thought that the threat of tariffs on Chinese products was a negotiating ploy, and would lead to a negotiated settlement. Recent actions have led investors to start believing this may be a much more protracted process. A military incident in the South China Sea where a Chinese ship came within 45 yards of an American ship was the first incident, followed closely by a very hawkish speech by US VP Mike Pence. Some pessimists believe this could be the beginning of a Cold War between the US and China. There are a few items to note though. First, the US is about one fifth of China's exports. Hong Kong is almost as large a destination for their goods. If exports to the US were to slow, it would only be for a portion of their exports, not all of them. Second, the Yuan has been steadily declining since the announcement of tariffs. This rise in the dollar of over 10% versus the Yuan (chart above) is likely to have some provide some offset to tariffs. We still believe China and the emerging market consumer offers the best long term growth story globally. The near term outlook is somewhat murky until we figure out if a negotiated settlement is possible or not.

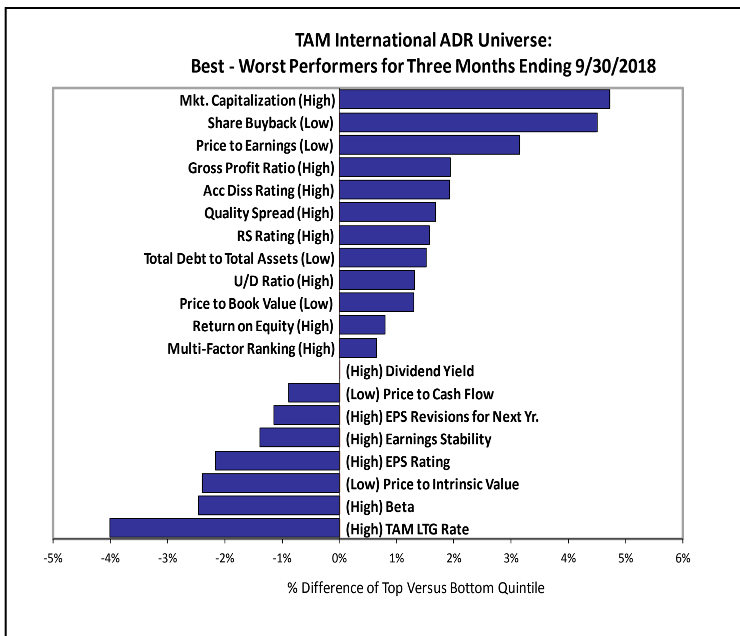


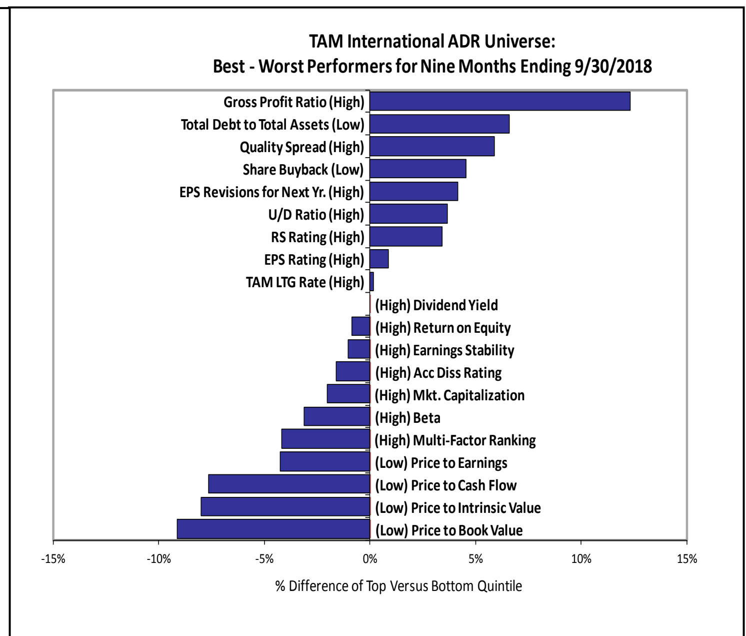
Emerging markets have been hard hit by the uncertainty presented with higher US rates and fluctuating currency values. We experienced some significant problems with Argentina and Turkey during the quarter as they were each forced to raise rates to defend their currencies. Investors have been worried about the potential for other countries to experience this, but we would point out that both of these countries have large amounts of dollar denominated debt and significant current account deficits. As we look at other emerging market economies, most have stable external debt and more positive current account balances than Turkey and Argentina. There are likely to be concerns on contagion, but we think the reality will be less dire.



Balancing these concerns, the long term growth of the EM middle class is expected to be tremendous. The chart to the right presents JP Morgan's estimates of how the size of the middle class has changed from 1994 to 2017 and an estimate for 2030. Note that the two largest markets, India and China, are expected to have over 70% of their population in the middle class over the next 13 years. While there will undoubtedly be stumbles along the way, the growth of this cohort is going to drive consumption trends in consumer products, infrastructure, health care, financial services and many other areas. While emerging markets overall are likely to be volatile, the companies that can capitalize on this growth are probably going to be the winners.

Market Trends

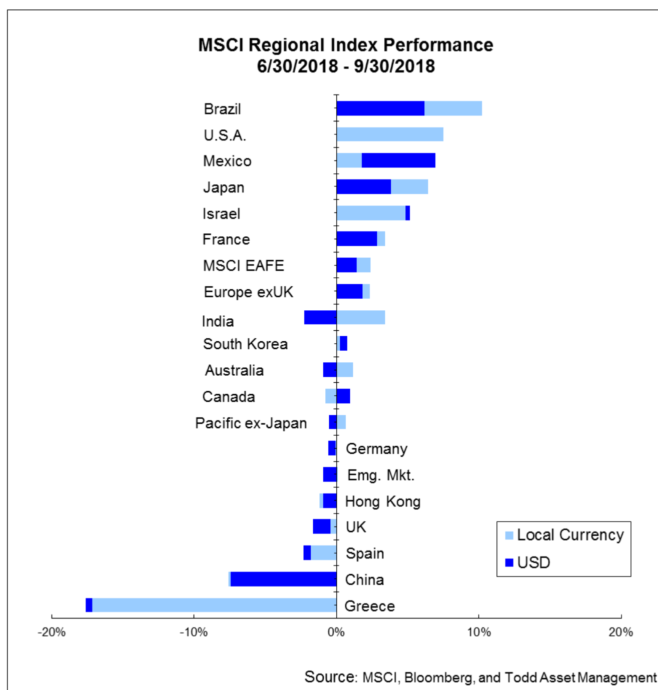




Source: Todd Asset Management, Bloomberg

We present our customary factor analysis work above for the past quarter (left) and year to date (right) periods. For the year to date period, the best factors have related to quality, financial strength and technical indicators. We have seen that most of the valuation factors and our proprietary multi factor rating have been under pressure. Investor preference for growth stocks has been a global phenomenon. For the quarter, most valuation measures continued to detract from returns, except for the traditional P/E ratio. The markets favored very large companies with low P/E's and higher quality in general. Anxiety surrounding higher rates and the problems we noted in the emerging markets likely impacted these preferences.

As we noted earlier, Emerging Markets underperformed developed markets for the quarter, and the US outperformed most developed markets. Much of these trends can be tied back to the pressure that rising US rates placed on some of the weaker international economies that borrow in dollars or the tariff concerns. Indications from the US central bank are to expect them to methodically continue increase rates to something near a "normal" level. Despite that, two of the best markets were Brazil and Mexico. As commodities have improved and their political situations have become clearer, investors were much more willing to put money to work in those markets. We believe that is a good harbinger for other Emerging Markets as well. Core European markets were a mixed bag as contentious negotiations between the UK and European Union for the British exit have not come to a conclusion yet. Trying to get a compromise between all of the members of the EU is probably akin to "herding cats". Still, Brexit is scheduled for March 29, 2019 and talks are continuing. It appears to be in everyone's interest to come to a negotiated withdrawal, and there are likely more announcements forthcoming about that process. Stay tuned.



Summary

Many contentious issues have arisen this year that derailed the nascent recovery of International markets versus the US. We still believe that a global expansion is continuing and international markets are earlier in their recoveries than the US market. Trade concerns have weighed on many markets and strength of the US dollar versus other currencies has impacted results for most major markets. We would note that trade deals between the US and Mexico eased pressure on

the Peso. We anticipate progress on a trade deal for the EU. This may raise the visibility of their growth and allow their currency to appreciate as well. It is difficult to see a near term resolution to the Chinese trade spat, though markets are forcing the Dollar to rise versus the Yuan, which should provide some buffer and make their products cheaper. Uncertainties about Brexit are likely to be cleared up one way or the other before year end, providing better visibility there as well.

Against that backdrop, the central banks continue to raise rates in anticipation of better economic growth and a more normal inflation outlook. Oil prices and commodities are also getting a better bid in anticipation of a firmer economic outlook. As uncertainties are resolved, we would expect the US Dollar to weaken a bit, international currencies to firm up and international markets to post a recovery in performance compared to the S&P 500.

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

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10/19/18
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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.

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