The Worst Kind of Anticipation

Todd Asset Management International Market Commentary

	4Q 2018	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	-11.5%	-14.2%	4.5%	0.7%	4.9%	6.6%
MCSI ACWI (Net)	-12.8	-9.4%	6.6%	4.3%	8.4%	9.5%

* *Annualized Total Returns.*

International markets suffered significant declines in 2018 as investors suffered from the worst kind of anticipation, namely worrying about a potential recession. Emerging Markets suffered more than Developed, with a peak to trough decline of -26% vs. -23%. Emerging Markets did bottom two months before the developed markets, and actually were the best performers globally in the fourth quarter. Most Central Banks and Economists are not predicting a recession, but investors have long memories and appear to be inclined to anticipate the worst after the Great Recession experience. As we look at it, this episode feels like an Echo of 2016, another period that was trying for markets. Our sense is it probably plays out the same way, i.e. no recession and a recovery in stocks with good fundamentals.

The past six months feel like an "echo" of 2015-2016. There are many parallels, but also some indications of market shifts as well. The most important of these is that the Emerging Markets outperformed EAFE and International outperformed the S&P 500 for the fourth quarter after underperforming dramatically through the third quarter. It appears investors are starting to rotate to the International Markets, but we will need to see if there is any staying power to the move.

The worries investors are most focused on include:

- Global growth concerns- International growth has weakened. China's growth slowed on financial reform and trade concerns. Europe suffered from a one-time item that caused European car sales to decline. Japan suffered through earthquakes and hurricanes that slowed activity.
- Central Banks are becoming less accommodative- The ECB ceased buying bonds, and the Federal Reserve has been raising rates. Against that, China has become stimulative to counter slowing growth.
- The Dollar strengthened for most of the year and that hurt marginal players like levered EMs.
- Trade barriers, tariff concerns, Brexit, French and Italian populism have all combined to make investors feel less secure.
- Commodity weakness has been prompted by oversupply concerns in oil, and lingering growth concerns for international economies.

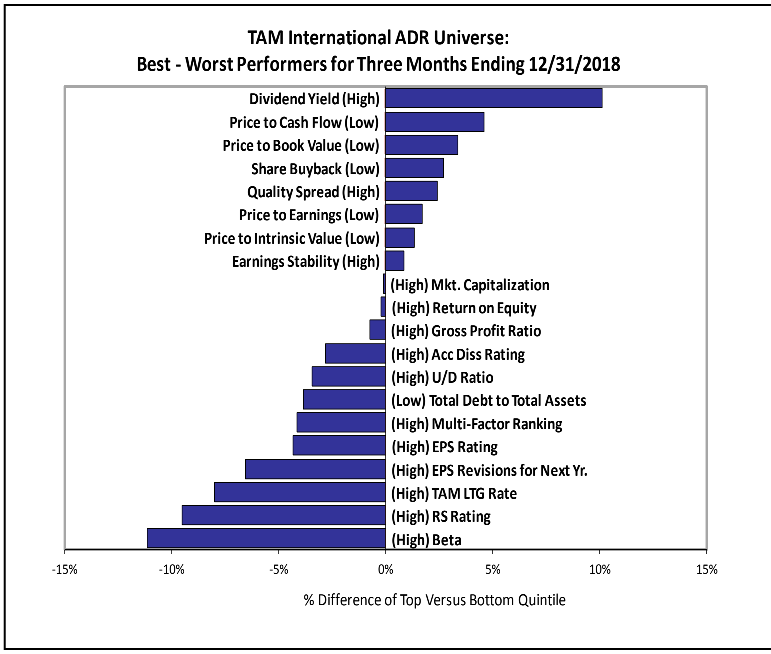
With these concerns, investors have concluded there is an imminent recession. Yield curves generally do not support this, as most international yield curves remain fairly positively sloped. The US yield curve is flat, prompting these fears. International investors have rewarded the traditionally defensive sectors of Staples, Utilities and REITs since March, despite the fact that they have higher valuations than the cyclical sectors.

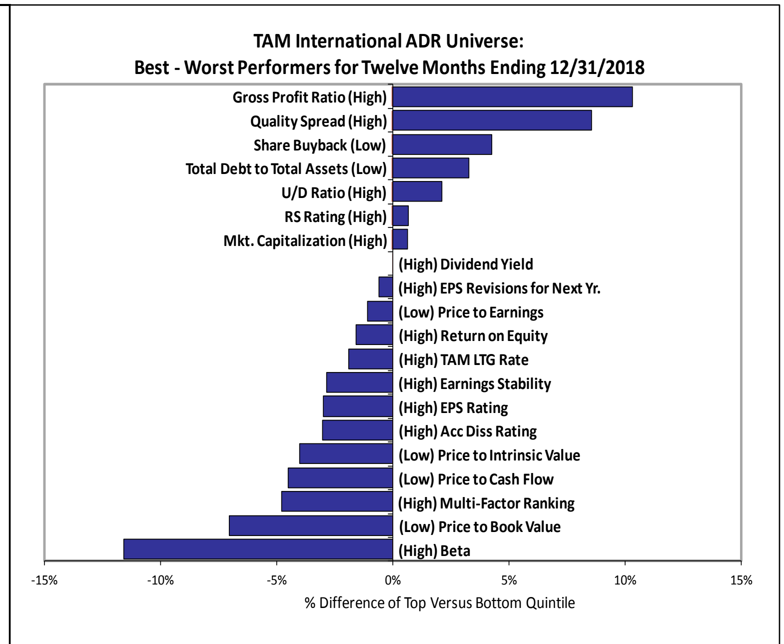
There are several potential developments that could reduce uncertainty, improve economic visibility and generally help confidence within markets. Those potential developments would include:

- Progress on trade and tariff concerns. The US is working on EU, UK and Japanese trade deals, and negotiations with China are beginning to yield small steps that indicate some progress.
- Fiscal Stimulus in China, Europe, and Japan. We are seeing populist politicians promote spending and supply side reforms.
- Resolution to Brexit. By definition, we will know whether it is an orderly, disorderly or delayed Brexit as Parliament votes on the issue.
- Italian budget cooperation with the EU. The recently revised budget was a step in that direction.
- A Federal Reserve pause. The reaction to December's statement was poor. It was more dovish than prior statements, but not dovish enough for markets. We will see what future meetings hold.
- Oil prices firming. Indicate a reduction in current oversupply and/or better global growth outlooks. The Saudis and Russians agreed to a reduction in output, which should help.
- Strength in the Euro, Yen or Renminbi- would indicate the markets are less concerned about a global growth slowdown.

In all, we think 2019 will prove to be a better year for investors than 2018, but markets may not be out of the woods just yet. There are still many things that need resolution as you can see from the list above. We do think several of these developments should occur and yield a better backdrop for markets.

Market Action



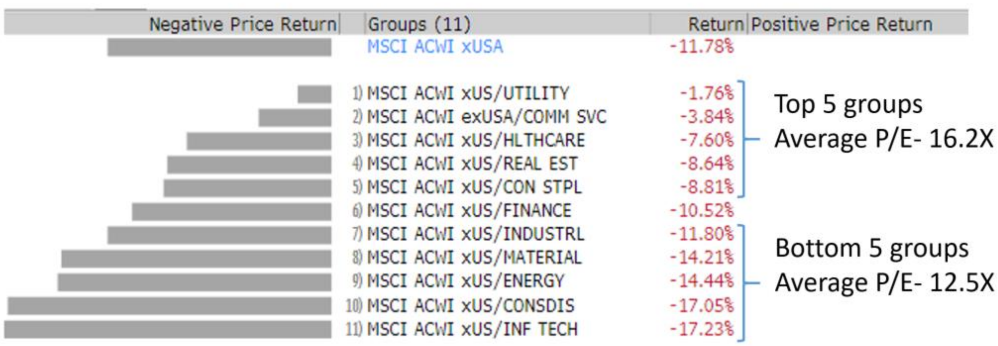


Source: Todd Asset Management, Bloomberg

We present our customary factor analysis for the fourth quarter (chart left) and year to date (chart right) above. International investors sought the safety of dividend yield, low valuations and quality during the fourth quarter. For the full year the factors favored centered on quality more than valuations. As was the case in 2016, the list of factors that helped performance narrowed significantly. Only five of the factors added any meaningful advantage for the year to date. This narrowing usually characterizes periods that investors are fearful.

We present the sectors that have lead for the last six months of 2018 in the next chart. The safety trade we referenced above is illustrated clearly in the sectors that lead performance for the second half. The leaders were Utilities, Telecoms, Health Care, Real Estate and Consumer Staples. All of these groups are historically considered defensive and most offer good dividend yields. As investors began to worry about economic growth, they flocked to these groups despite the fact that they are a lot more expensive than the laggards. The laggards were the economically sensitive areas of Technology, Consumer Discretionary, Energy, Materials and Industrials. Earlier in the year, the mix of leaders was more balanced, but as commodity prices declines, energy fell from the leadership position it had during the first part of the year.

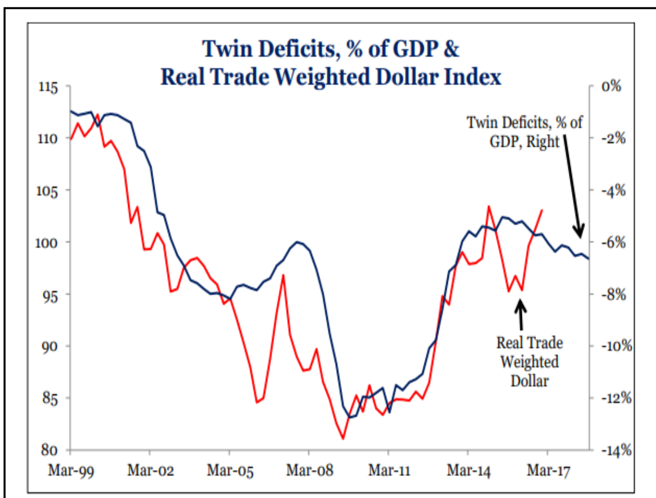
MSCI ACWI ex-US Sector Returns 06-30-18 through 12-31-18



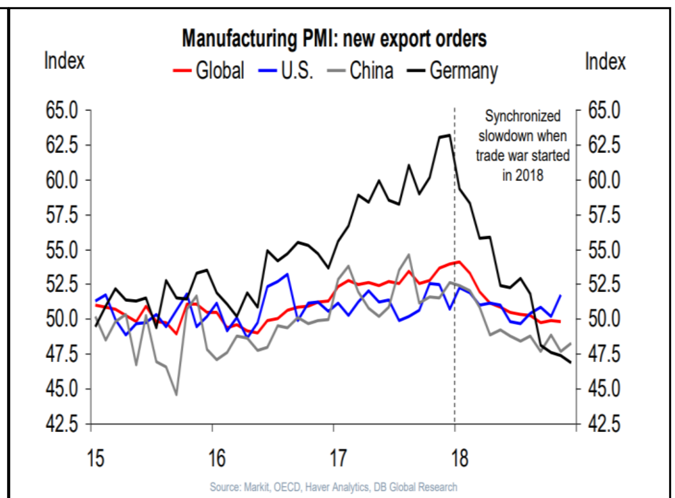
Source: Bloomberg

Looking forward, if any developments occur that reduce uncertainty about the economic outlook, we would anticipate a shift in the leading sectors. This would mimic the recovery markets experienced in 2017.

Interesting Charts We Saw During the Quarter



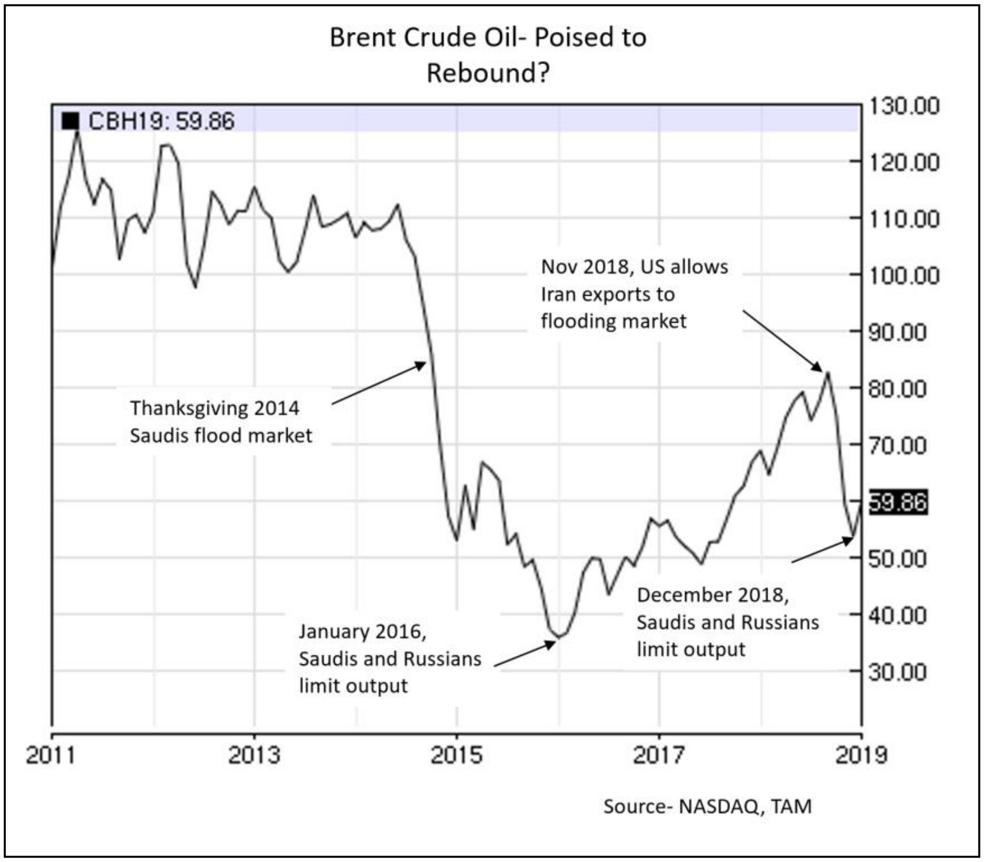
Source: Strategas



Source: Deutsche Bank

Currency and an economic slowdown have been large concerns for investors this year. Dollar strength has coincided with International markets underperforming the S&P 500 (as seen in 2018), and vice versa. The current account and budget deficits tend to lead the dollar exchange rate (chart left). Those are expected to deteriorate in coming years which should allow for better international returns for US investors.

New export orders, a component of the global Purchasing Managers Indexes (PMIs), began to soften globally as trade concerns cropped up (chart right). That coincided with the first bout of International underperformance earlier in 2018. Any progress or deterioration on the trade negotiations should impact the outlook for new orders.

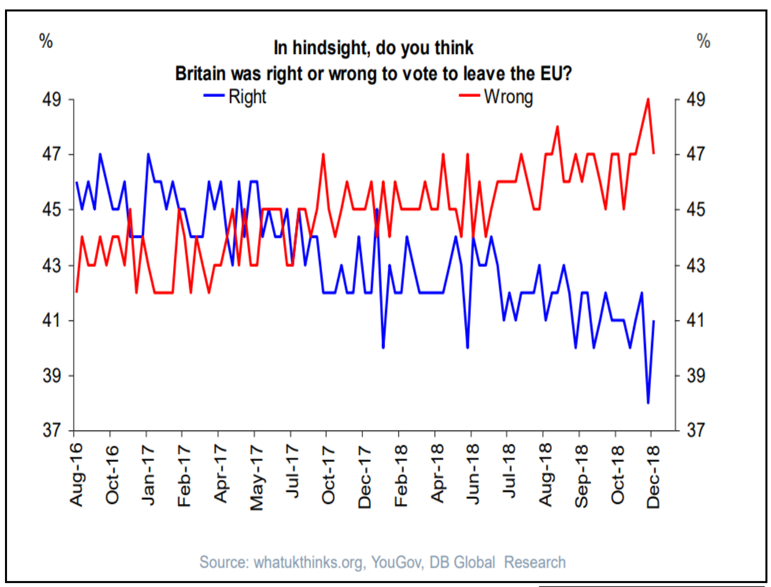


Oil prices entered a free fall late in the year, as you can see from the chart to the left. If you examine prices over the past five years, the largest declines were accompanied by signs of oversupply. The Saudis flooded the market in 2014, and an anticipated US embargo of Iranian oil never truly materialized in 2018.

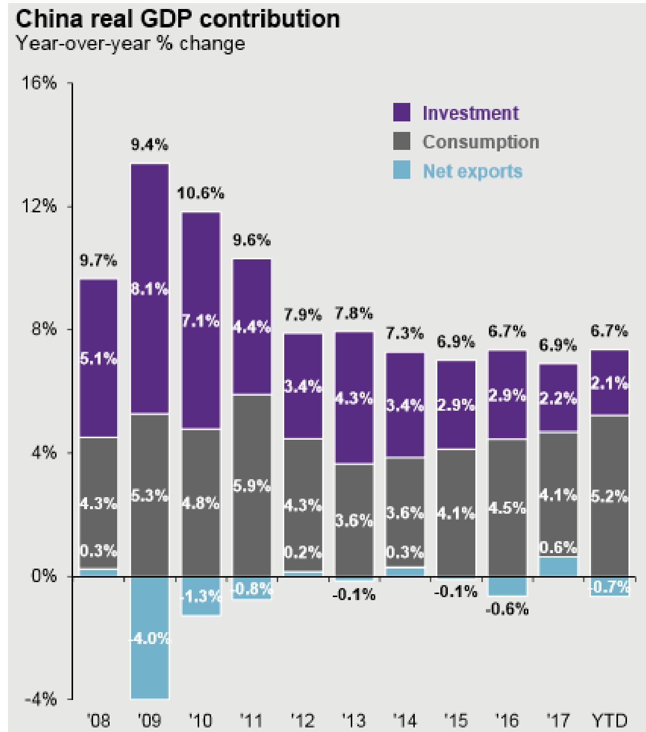
The 2014-2016 weakness was only stopped when the Saudis and Russians agreed to curtail production. With a similar recent agreement, we expect some recovery in prices

Brexit is on investors' minds again, with Parliament's recent vote adding uncertainty. How it turns out remains a question. The existing proposal has been roundly criticized, and public support for leaving the EU has deteriorated (chart right).

We do not claim to be experts on the politics, but our sense is that the options moving forward should become clearer post vote. That could work to reduce uncertainty and investors may become less sensitive to developments on that front.



Source: Deutsche Bank



Source: FactSet, J.P. Morgan Asset Management; CEIC;

Investor fears center on the two charts above, illustrating European and Chinese GDP Growth and the proportional contribution from domestic demand (broken into investment and consumption for China) and net exports. Growth in both regions has been firmly positive, although it has slowed from prior peaks. The concerns about slowing world trade would show up in net exports. They have declined recently for China and the most recent European reading was neutral.

Growth should remain positive for both of these regions. Any agreements that are reached on trade could prove positive for their economic outlooks.

Summary

Most asset classes did poorly last year, but international equity investments performed worse than most for US based investors. That was in stark contrast to 2017, where the international markets outperformed most other asset classes for US investors. Investor worries are well known, but most center on a potential economic slowdown becoming a recession. Those qualms, coupled with Dollar strength, resulted in international markets underperforming the S&P.

Nobody can be certain when markets bottom, but we believe they are in the process of doing so. This is likely to be a multi-month process. As we see this play out, we believe the Dollar is poised to weaken this year. If agreements are reached on trade, or the Fed pauses while the ECB creeps closer to normalizing rates, or global growth rates even out as the US slows, or the growth in the US twin deficits rises we would expect dollar weakness instead of strength. That could be a turning point that international investors are waiting for. When international markets start to outperform the US, they usually do so for the better part of a decade.

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

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01/18/19
MSCI ACWI ex-US (Net) – 215 (Intraday)
MSCI ACWI (Net) – 234 (Intraday)

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.

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Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.