

Like a Bull in a China Shop

Todd Asset Management International Market Commentary

	2Q 2018	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	-2.6%	-3.8%	7.3%	5.1%	6.0%	3.8%	2.5%

* Annualized Total Returns.

Year to date, most markets are down in dollar terms through the end of the second quarter. During the quarter, the largest driver of markets was sentiment. Markets suffered during the quarter as President Trump negotiated with China and the EU in the press with a goal of reducing the trade deficit with each region. To describe the president's negotiating style, the phrase "Like a Bull in a China Shop" comes to mind. The Chinese and Europeans might describe it as "A Bully in a China Shop."

It feels to us like markets are building a wall of worry. While there are plenty of reasons to worry, fundamentals have been pretty good. The IMF continues to raise worldwide estimates of economic growth, with the most recent upgrade having happened in April, 2018. Corporate results have been strong, as earnings and sales have been bolstered by consumer demand in Emerging Markets and strength in capital spending in Developed Markets. Jobs continue to be created in Europe, China and Japan, bolstering the case for consumption. Central Banks have also noticed this, and we believe THAT is the real source of concerns.

Equities peaked out in January of this year *because* fundamentals looked sustainably good. Evidence of a synchronized recovery made it apparent that the US Fed would keep raising rates. Investors began speculating that the European Central Bank and Bank of Japan would end their extraordinary stimulus, and eventually raise rates. Yields increased along the curve in Europe and signs of stress in funding markets cause short term interbank rates like LIBOR to spike. This occurred while the dollar appreciated against most currencies. International markets underperformed the US in dollar terms, though local results were better. Many Emerging Markets with high amounts of dollar denominated debt got crushed and were forced to raise rates to defend against the dollar strength.

Against this backdrop, economic growth softened slightly during the second quarter. Weather seemed to be the initial culprit for the European and Japanese slowdowns. As US talk of trade tariffs against Canada, Mexico, China and Europe moved to center stage, business confidence started to erode. All of these factors were exacerbated by a populist government in Italy suggesting that perhaps they wished to go it alone and leave the Eurozone. Brexit negotiations also got messy during the quarter as Prime Minister May sought an agreement between opposing sides of her own party about how separate Britain should be from the EU post exit. Additionally, the US did not renew the Iranian nuclear deal and sat down to negotiate with North Korea. Geopolitical and economic concerns weighed on markets.

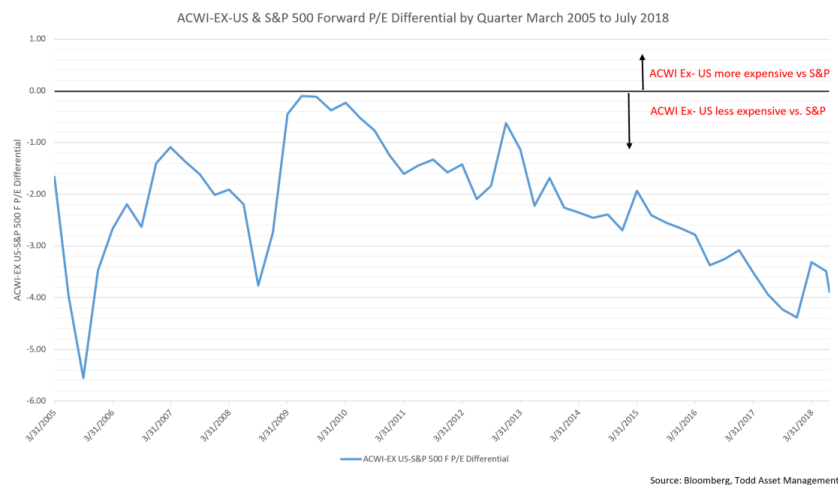
So we are now at a point where concerns have built up, but the reality is probably better than markets are worried about. We believe as the year goes on, markets will work through the wall of worry and allow the fundamentals to work through to valuations.

Why International, Why Now?

Our readers should know that we have been advocates for increasing International Allocations in client accounts. This is still a timely idea, and we would recommend investors use this period of relative weakness in the international markets as a chance to increase their exposure at good prices.

Economic growth estimates have accelerated for international markets compared to the US over the past year. This is what has driven relative performance in the past, and will likely do so in the future. International Monetary Fund estimates of global growth have been accelerating. While the US tax reform may allow the US to grow faster for the short term, the US expansion is nearer to maturity than international recoveries, which are still fairly early in our view. International markets have more pent up demand and consumers are driving sustainable expansions in those markets. Trade concerns may cause heightened concerns over the summer, but we believe the US Administration is negotiating by twisting their trading partner's arms. We also believe there is a strong probability that the US negotiators would like to see some deals struck before the midterm elections. A high profile deal with Canada, Mexico, China or the EU would undoubtedly improve sentiment and restore some confidence that the worldwide economy is in a sustainable recovery.

This potential improvement in fundamentals is complemented by a better absolute valuation and the best relative value between the ACWI Ex-US and the S&P 500 in over 10 years. We were recently asked whether or not international valuations were always better than those in the US. As you can see from the chart below, the ACWI ex-US multiple has ranged from parity with the S&P to a six multiple discount. Currently, that ratio sits at a four multiple discount, the largest discount in over 10 years. US tax reform is boosting S&P earnings, which is impacting this differential currently. As the effect of this one time bump in earnings fades over the coming year, some narrowing in the differential between the indexes is likely.



Following the economic slowdown in 2016, the International economies are earlier in their recovery than the US. Unemployment rates in Europe indicate a lot of slack, and inflation measures remain low, confirming that. We think there is pent up demand in many markets, and those with job growth are seeing better grass roots consumption demand.

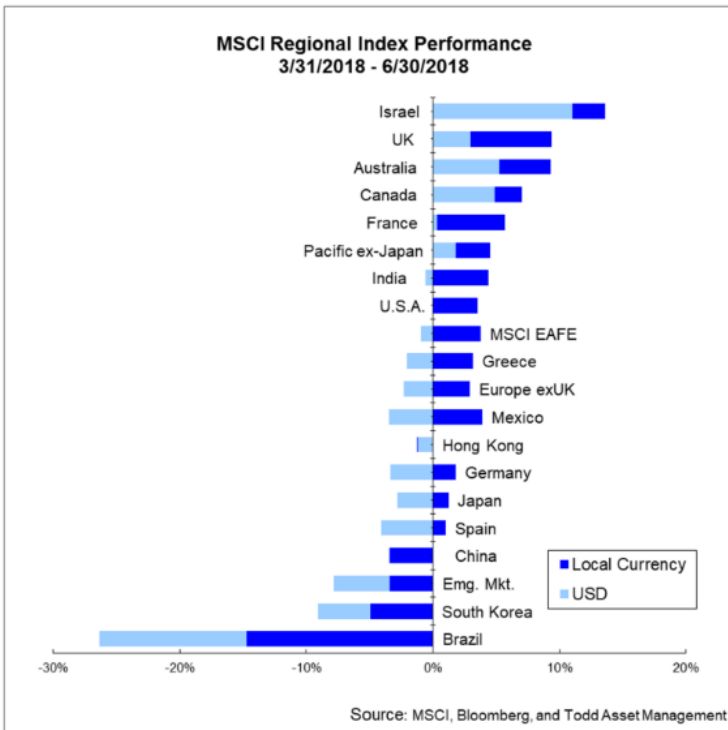
Cyclically, The S&P and ACWI ex-US indexes tend to change leadership every 8 years or so. We believe this cycle changed last year to favor the ACWI ex-US, but recoveries never move in a straight line. We believe now is a good time for investors to increase their allocations to the international indexes. On a rolling 10 year return basis, the ACWI ex-US index is currently near historic trough levels (having returned about 3% per year), while the US is much further along in its recovery (having returned about 10% per year). *Reversion to the mean is the strongest force in investing, and right now the mean is up from here.* The average rolling 10 year return for this index is approximately 6%, well above the current levels. If you project a recovery to that average 10 year annualized return at year end 2020, the ACWI ex- US index has a potential return of nearly 50% over the next few years.

MSCI ACWI ex-US Rolling 10 Year Annualized Total Returns



Source: Bloomberg, MSCI and Todd Asset Management

What happened in the quarter?



Currency significantly impacted the returns for international markets during the second quarter. As you can see from the chart to the left, we illustrate how markets performed in local currency (dark blue) and in dollars (light blue). Almost every line shows that local currency returns were higher than the dollar returns, as a result of dollar strength against most currencies.

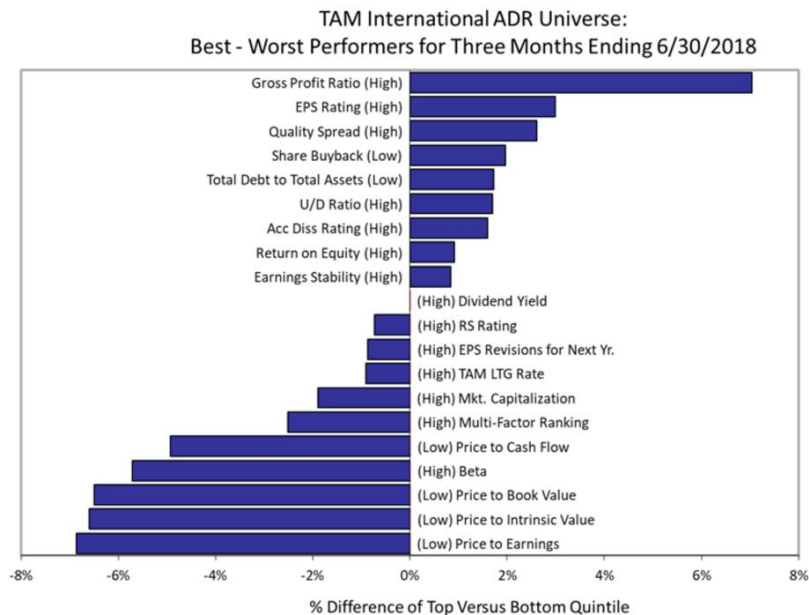
The Brazilian and South Korean currencies weakened fairly dramatically in the quarter, as commodity weakness and concerns over the impact of trade tariffs weighed on those respective markets. South Korea also instituted a 16% hike in the minimum wage that has investors

concerned about economic growth as businesses look to curtail spending. Brazil is suffering from slower economic growth, as analysts have halved their estimate of 2018 growth to 1.5% recently. Developed markets lead, while emerging markets lagged during the quarter. Israel and the UK experienced better growth than investors expected, allowing them to outperform.

There were some concerns that worldwide economic growth slowed in the first quarter, but we think most of that was a short term weather related impact. As you can see from the Citi economic Surprise Index to the right, indicators are starting to hook upwards after this soft patch.

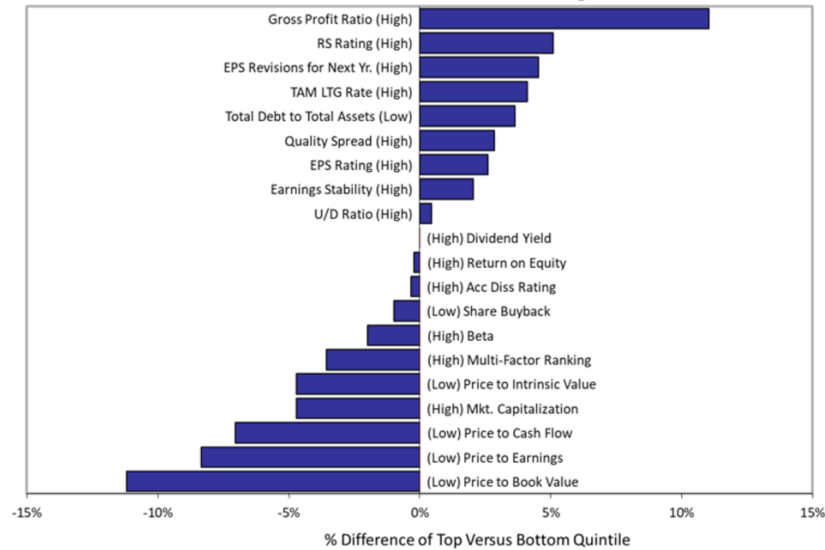


Our customary charts illustrating factors that aided performance and those that detracted from performance are presented in the following charts. The quarter and year to date periods experienced similar trends. Quality indicators, like Gross Profit Return on Assets, our proprietary quality ranking, low debt levels and earnings stability were in demand and outperformed during the quarter. Most valuation measures remained out of favor for the quarter and year. With short term interest rates at generational lows, investors are concerned about economic growth and see no reason to seek value. If we are correct on our economic call, this probably changes over the coming 12 months. With central banks confirming this, value investing should come back in favor over the next year.



Source: Todd Asset Management, Bloomberg

TAM International ADR Universe:
Best - Worst Performers for Six Months Ending 6/30/2018



Source: Todd Asset Management, Bloomberg

Turning to the markets, the best sectors within the ACWI ex-US were the Energy, Healthcare and Materials sectors. The laggards were the Financial, Telecommunications and Consumer Discretionary. The drivers here are diverse, but oil performed well during the quarter and most other commodities were strong until Mid-June when tariff concerns came into focus. Healthcare finally showed a rebound after a few years of seeing pressure on pricing from the US. Rates generally declined during the quarter, hurting the outlook for Financials. Some fear of contagion in the Emerging Markets, and capitalization concerns around Deutsche Bank led investors to remain tentative about the group. As investors become more comfortable that economic growth will continue to show expansion, we anticipate rates moving higher from the current low levels. Many of the other lagging sectors are probably indicating worries about the sustainability of the expansion. We think those worries are misplaced and expect the economic expansion to continue.

ACWI ex-US Sector Performance Q2 2018



Source: Bloomberg



Summary

International markets outperformed the US markets last year as expectations for their growth rates had accelerated compared to US growth rates. That outperformance has paused this year, as investors are bumping up their US profitability figures after tax reform. Additionally, concerns have grown that a trade war is erupting that could cause some slowdown in European and Chinese Manufacturing. Concerns have reached a fever pitch, as you cannot turn on CNBC for more than a minute or two without hearing their news anchors mention it.

We would urge investors to slow down and take a deep breath. The question we ask is “who wins a trade war.” Simply put, nobody wins in any war. We believe there is a strong probability of negotiated settlements occurring that offer the chance for better sentiment in the future. Unfortunately, those may take a few months to hammer out, and concerns may grow between now and then. As such, we are watching over the summer and expecting that concern grow through the end of September. As we move into the autumn, we would expect that international economies see a recovery from the first half slowdown. Additionally, some negotiated settlements are likely to help sentiment surrounding trade concerns. While President Trump may look like a Bull in A China Shop right now, history would suggest he is grandstanding to help his negotiating position. We will probably find out more before the US midterm election.

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

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7/24/18

MSCI ACWI ex-US (Net) - 224

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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.