TODD Asset Management

July 17, 2020
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Todd Asset Management

The Path to Recovery

Todd Asset Management Q2 2020 International Market Commentary

	2Q 2020	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	16.1%	-11.0%	-4.8%	1.1%	2.3%	3.7%	5.0%
MSCI ACWI (Net)	19.2%	-6.3%	2.1%	6.1%	6.5%	7.8%	9.2%
MSCI ACWI ex-US Value (Gross)	13.1%	-19.1%	-14.7%	-3.3%	-0.6%	1.6%	3.5%

* *Annualized Total Returns.*

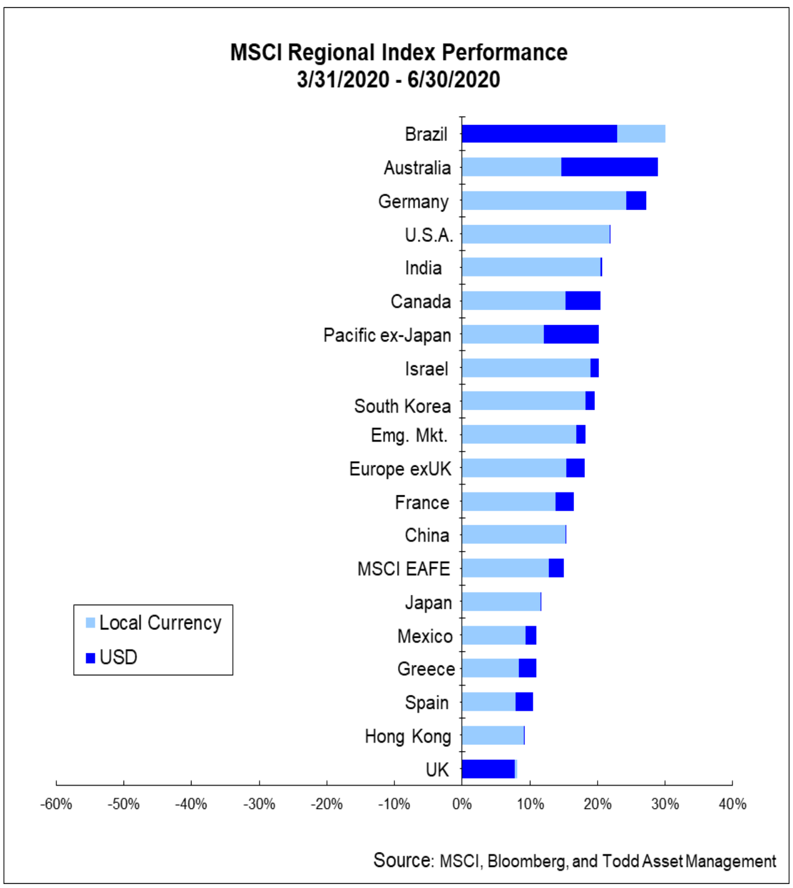
Despite international markets lagging the S&P year to date, it appears that re-openings in many developed markets as well as China are going much better than the US experience. While China and Asia were the first economies to experience the pandemic, Europe followed closely on their heels, followed by Latin America and the US. Reinfections and flare-ups of Covid-19 are occurring, but most European and Asian countries are dealing with it in a selective fashion and preventing widespread outbreaks. Economic activity is recovering in the reverse order of the pandemic hitting, and there are many stimulative programs being pursued to ensure the recovery takes hold. While the tone of the economy in the US is better, but still not good, global activity measures appear to be firming ahead of the US, and are being led by a Chinese recovery.

A number of important developments occurred during the quarter:

- International indexes rose 16% during the quarter, posting good returns as anticipation of an economic recovery took root. Emerging markets outperformed developed markets as financial conditions eased for most of them.
- Europe proposed a European Recovery Fund. The proposed 750 B Euro funds is designed to offer grants and loans backed by European Commission Bonds. This is the first time Europe has fiscally banded together to provide assistance to needy countries in the EU, and is a clear step towards becoming a true European Union. This could be a game changer.
- Britain and Europe have passed the point of extending the transition period for Brexit. A trade agreement of some sort will need to be reached before the end of the year, or Britain will exit the customs union and revert to World Trade Organization rules.
- Trade has been curtailed due to the virus. Some estimates of World Trade volume have declined as much as during the great recession. Weak end market demand for their export products has China working to stimulate domestic demand.
- Economies are starting to recover after significant Covid related weakness. Mobility trends for most of Europe have improved more than for the US. Europe went into a deeper contraction than the US did, but their recovery has been sharper as well, aided by the recent reopening of borders within the EU.
- The dollar has started to see some pressure. US stimulus will require tremendous bond issuance over the coming year, and the Federal Reserve is starting to ease back on their purchases, so investors have been selling the dollar. The Euro has appreciated versus the Dollar as the joint effort on the recovery fund has convinced investors the risk of the EU disbanding have declined.

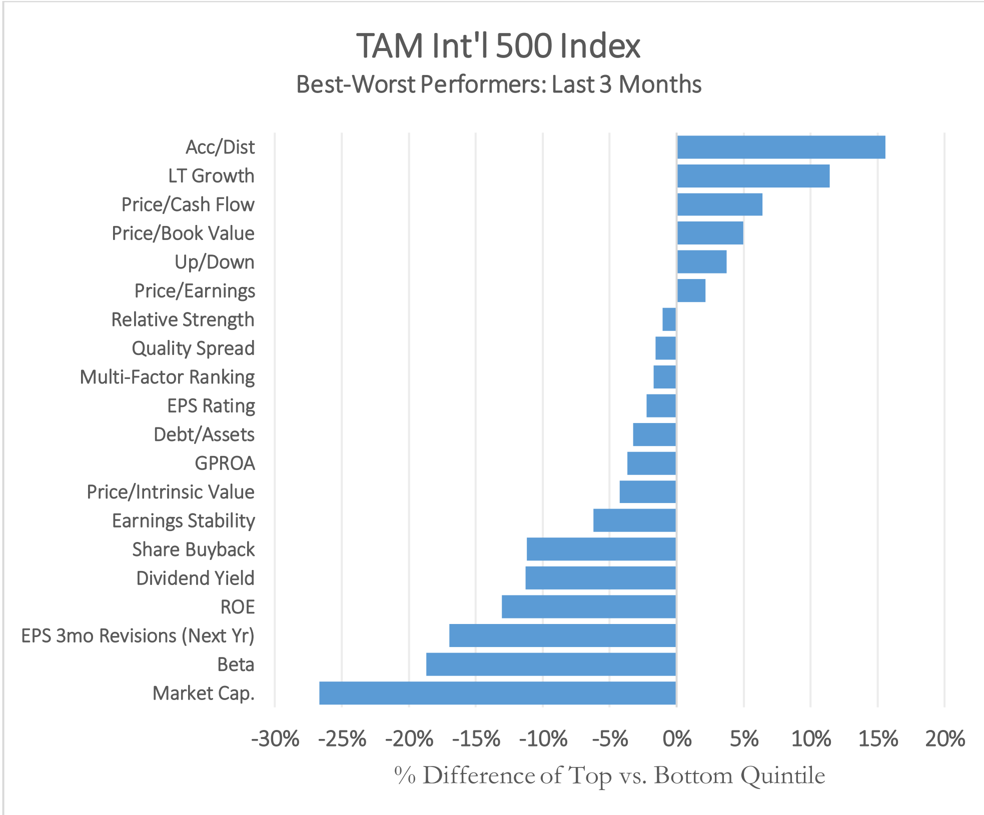
- Geopolitical pressures are increasing. Tensions between China and the US are heightened as the South China Sea and technology issues have become a point of contention. China also effectively ended the "two systems, one country" approach to dealing with Hong Kong.

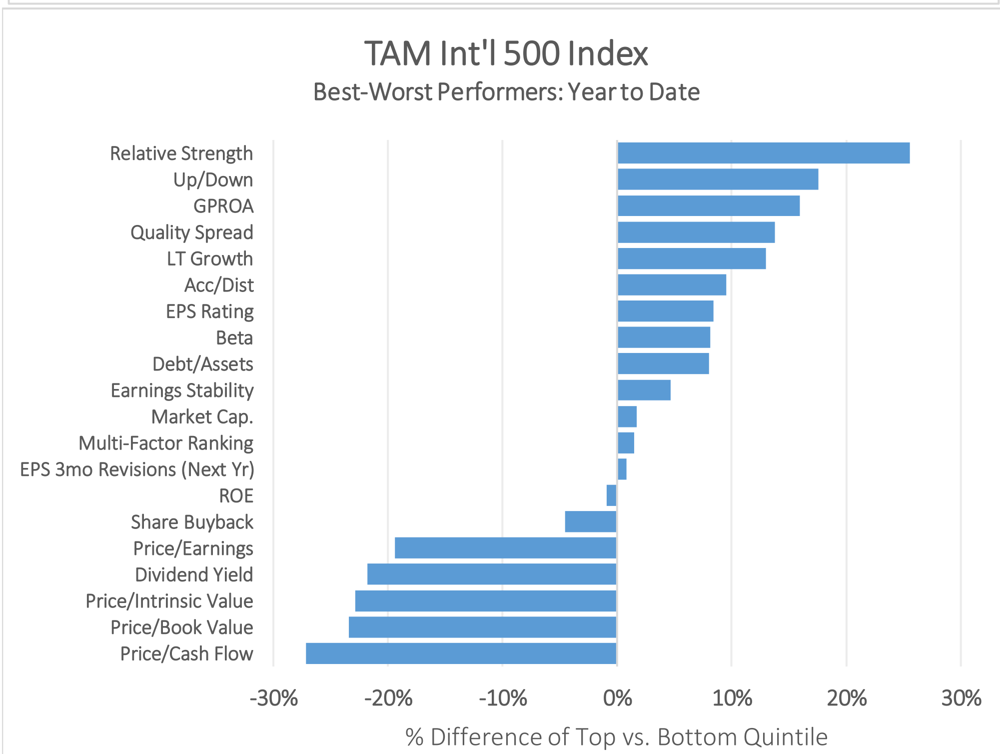
Heightened uncertainty over the economy led international value stocks to underperform their growth counterparts (again!). Bear markets typically result in leadership changes as recessions wipe away excesses of the prior expansion. This episode is different than prior recessions, because the cause of the recession was not correcting an excess but rather dealing with a pandemic. As such, value stocks have remained in the "doghouse" and investors have grown infatuated with the growth stocks because of low rates and economic uncertainty. We suspect this bear market is going to result in a rotation, just like others did. The stocks that have suffered the most over the recession (and the years leading up to it) have been the cheaper cyclical stocks. Investors have been preparing for a recession for the past five years by focusing their interest on the growth stocks which were perceived as safer bets. Having finally gotten a recession, we believe the decks are cleared for investors to start expanding their interest beyond solely the growth stocks. Normally, this should begin as confidence in the economy grows, which should occur in the coming quarters.



Looking at the country by country performance, the best performers were natural resource producers of Brazil and Australia. Commodity prices have started to act better as we have seen significant rallies in copper and oil. The next best markets were the large developed economies of Germany and the US. Those economies were benefitting from re-opening. On the flip side, the UK remains mired in both the pandemic lockdown and the Brexit negotiations which led that market to trail the group. Hong Kong is also suffering from political turmoil as a new Chinese security law was forced upon them. This has resulted in the US revoking their special status, and the conclusion that China just ended the "One Country, Two Systems" arrangement.

<u>Factor performance</u>

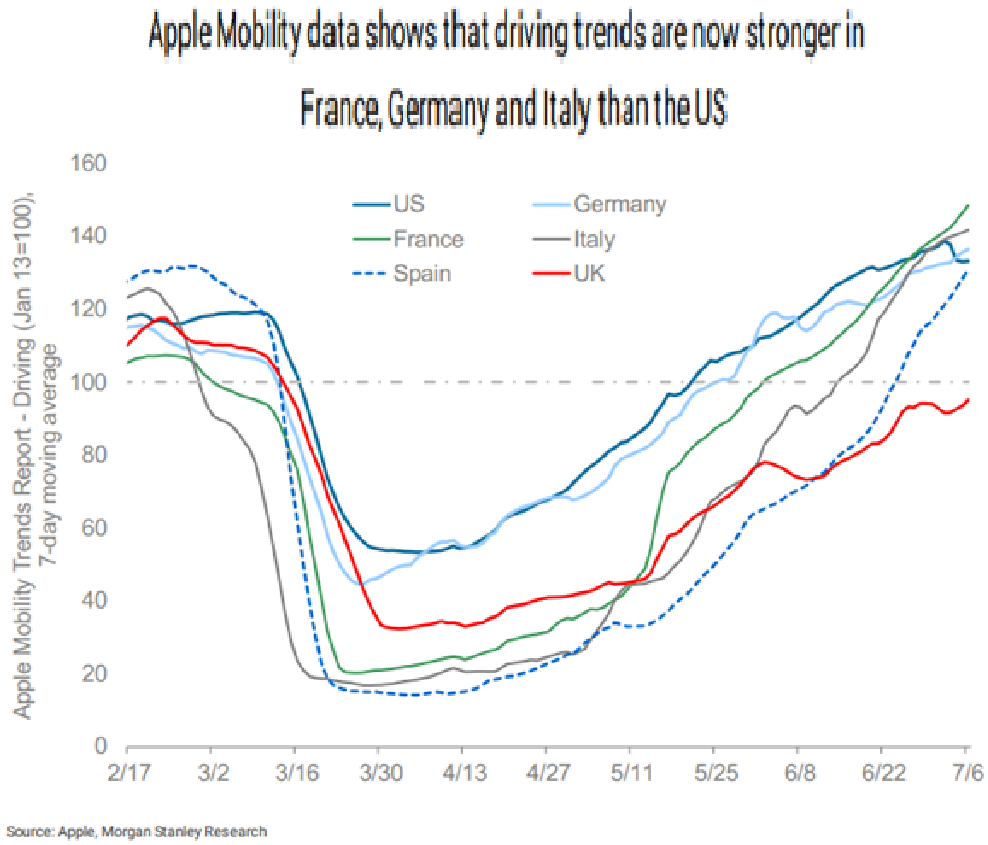




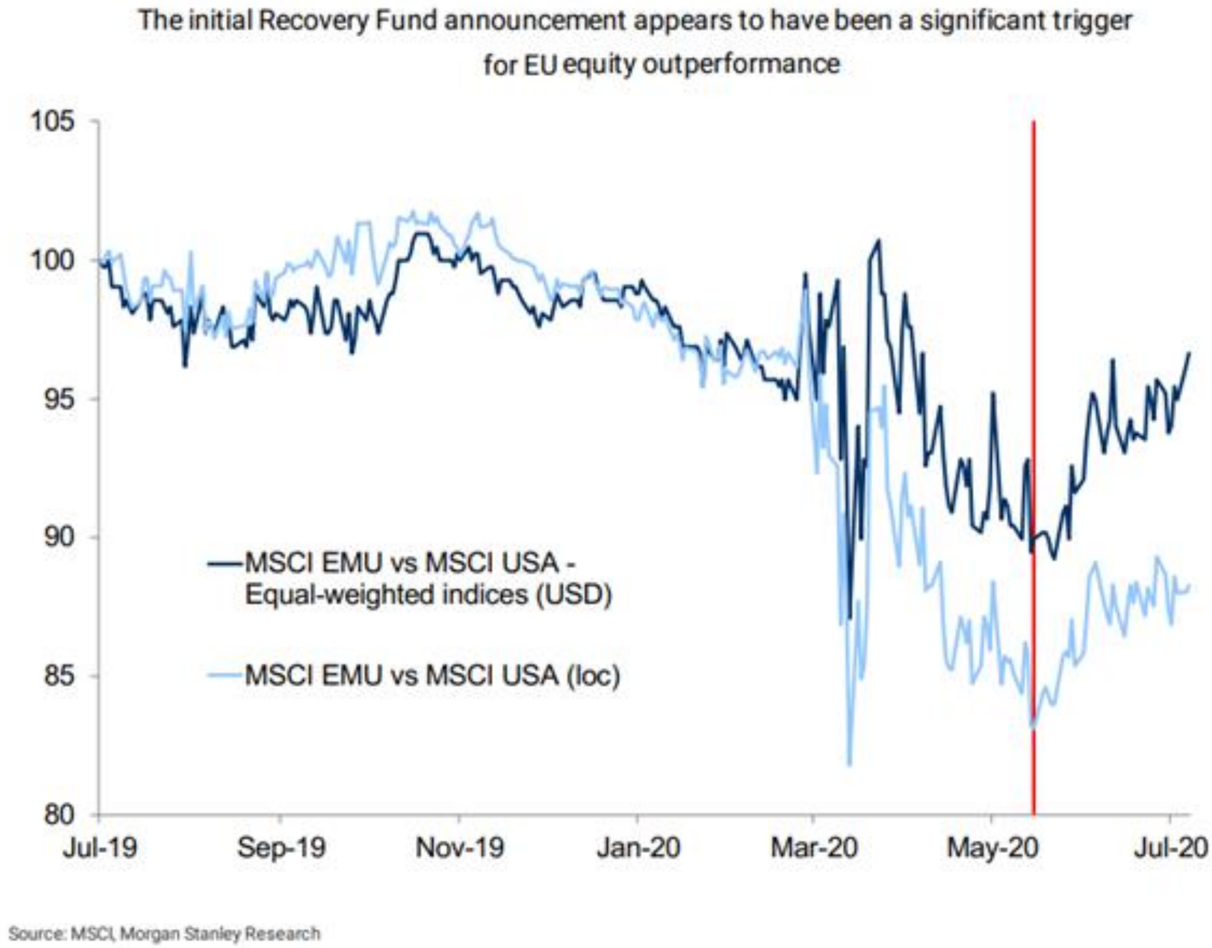
Source: Bloomberg, William O'Neill + Co. And Todd Asset Management

What a difference a quarter makes! While Value indexes lagged Growth indexes for the quarter, we saw a dramatic shift towards value factors being rewarded. The best performing sectors since the market low have been Materials, Information Technology, Consumer Discretionary, Energy and Industrials. This feels like a barbell, with the best factors in the quarter showing a mix of growth and value characteristics.

Interesting Charts We Saw this Quarter

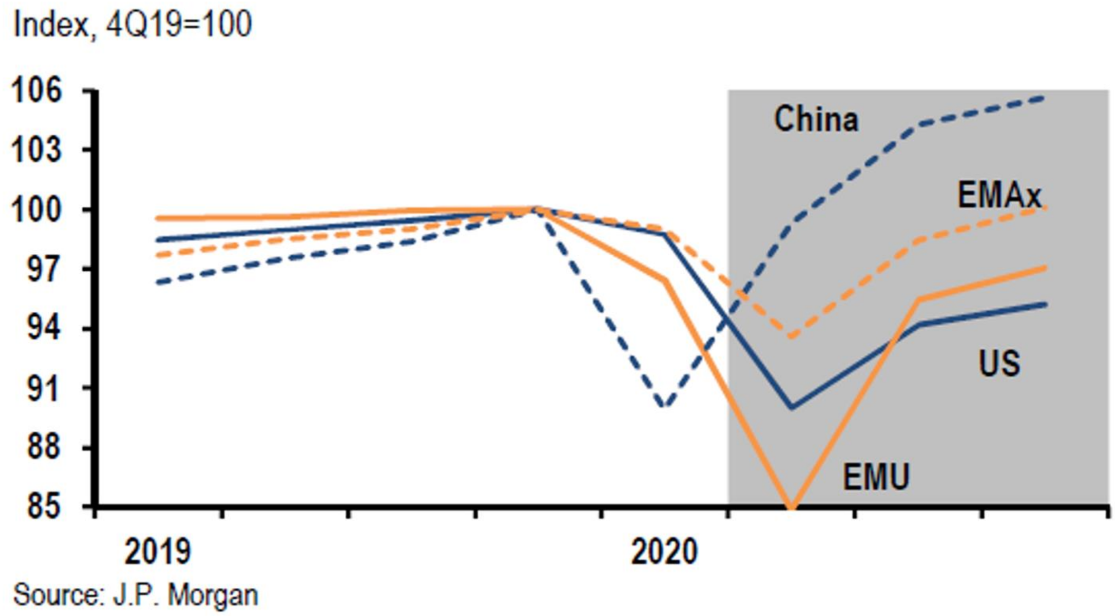


Apple's Mobility Data measuring driving activity has shown that many regions have recovered from the depths experienced during March. European activity dropped much more significantly than the US levels did, and have seen a better recovery than the US. US Driving trends appear to be flattening out as virus flare ups occur, while the European activity continues to gain. European containment and tracing measures appear to have been more effective at halting the virus. The UK has had a more lackluster recovery as their reopening has been slower than the US and the rest of Europe.



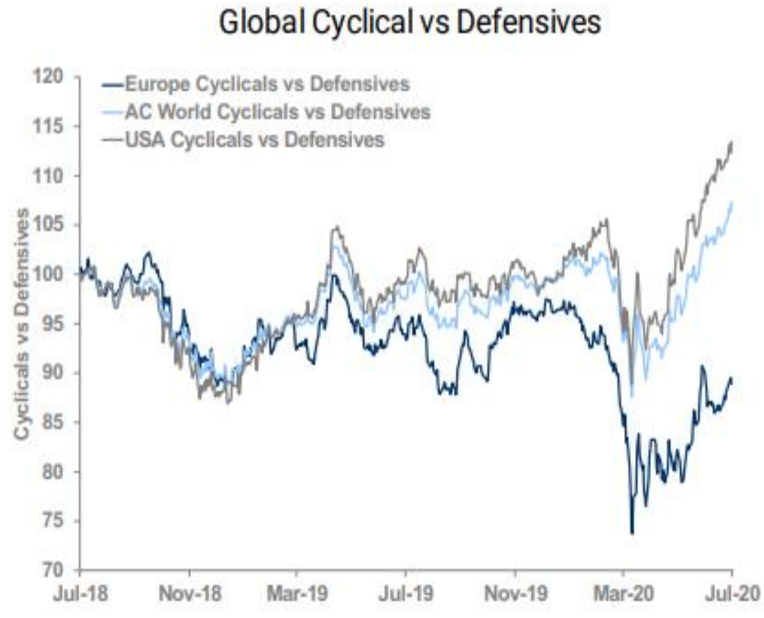
European stocks have started to outperform their US counterparts. One concern investors have had regarding Europe is that they portray themselves as a unified block, while the reality is a lack of a unified fiscal policy has resulted in worries about the block breaking apart. During the crisis, this appears to have changed. France and Germany are leading the charge for a 750 Billion Euro EU Recovery fund that would result in grants of 500 Billion Euros to member states that were impacted by the virus as well as approximately 250 Billion Euros in loans. It also proposes a Eurobond backed by the block instead of individual nations. This is a game changer on a number of fronts. First, it would set up the European Union as a unified group for some aspects of fiscal policy. Second, and possibly more important, it would move the EU away from the austerity they've embraced since the 2008 financial crisis. More stimulus and a move towards deregulation should allow economic growth to recover there. The risk premium required by investors for fear of an EU breakup should decline. We are watching for developments on approving this plan and believe it could help the EU outlook fairly dramatically.

V- Shaped Recoveries in Real GDP are Expected



JP Morgan's economists expect continued V-shaped recoveries to develop as we progress past the Pandemic. China and the Emerging Markets are expected to show the fastest recoveries, followed by the EMU and then the US (as illustrated in the chart above). Government stimulus in the form of Infrastructure projects has been a mainstay of the Chinese recovery, along with restarting production that had been shuttered during the Pandemic. The Emerging Markets should benefit from restarts of supply chains as well as the improvement in commodity pricing and demand. The US and Europe are providing support to consumers, helping their recoveries. In the US, the government offered payroll support, and the European unemployment rate did not skyrocket as government programs supported employment.

Even with these recoveries, it is going to take some time for most global economies to regain their prior levels. We are monitoring reopening progress to ensure these do not turn from Vs into square root signs, W or L shaped recoveries.



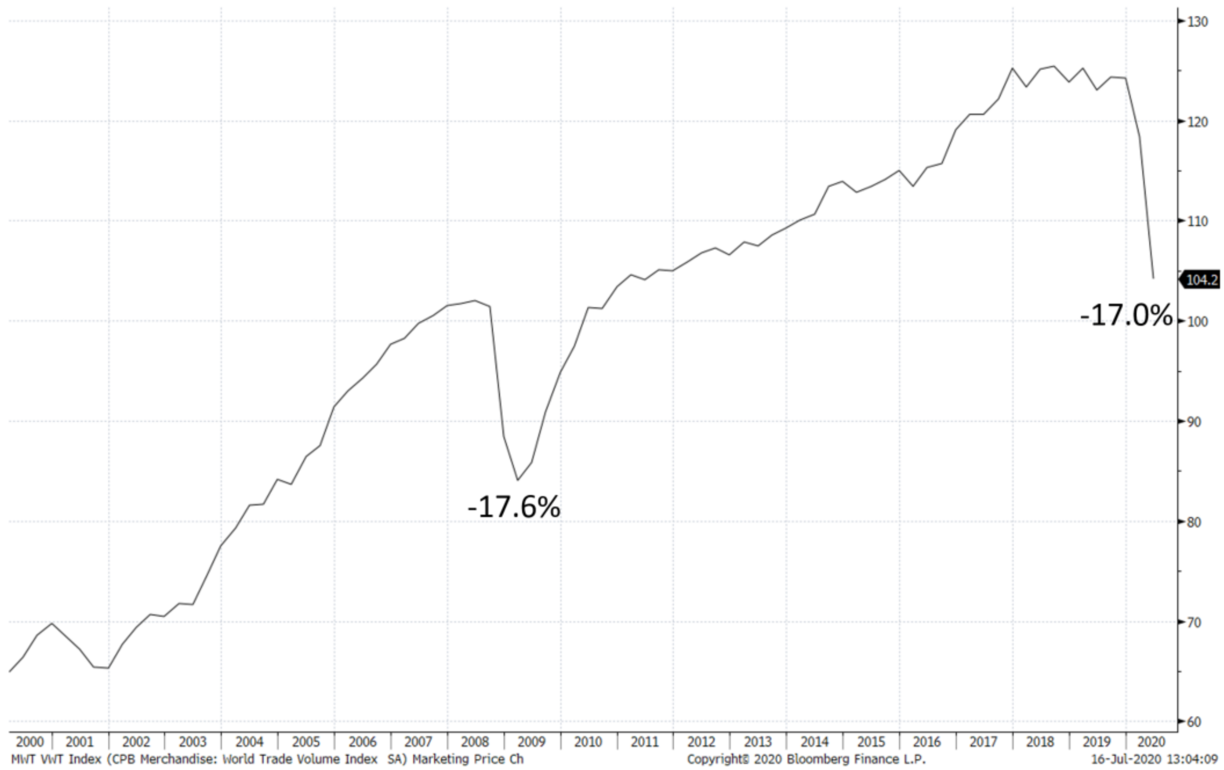
Source: MSCI, Morgan Stanley Research

Confidence in the outlook can be measured by comparing the spread between High Yield Bonds and Government yields. These measures blew out to new highs In March, as seen in the chart below, indicating poor confidence. When stress runs that high, Cyclical Companies tend to underperform defensives, as seen in the chart above. Cyclicals have been recovering with high yield spreads declining as confidence in the outlook has increased. This increase in confidence has more room to run, so a rotation to cyclical sectors should last for some time.

Source: Bloomberg, Morgan Stanley Research

World Trade Volumes

as of 4/30/20



World trade has been a casualty of both the trade war and Pandemic. Volumes have declined almost as much during this episode as they did during the Global Financial Crisis. Trade peaked in September, 2018, and flattened during the trade war. Optimism grew that the phase one trade deal would help, but then the Pandemic destroyed demand. With production restarting and economies reopening, some recovery is likely. Geopolitical tensions (between US/China, Europe/UK, US/Europe) have been rising. Developments in the US elections and the Brexit negotiations will bear watching to see how trade recovers.

We believe the global economy is entering a new expansion. The pain of the recession is very real, and can be seen in the weak GDP numbers experienced by many countries and the decline in world trade. Recessions are followed by recoveries, and we believe the actions taken by governments and Central Banks are likely to support demand going forward. Pent up demand exists, consumers were not overextended going into the recession and government stimulus is forthcoming.

Bear markets and recessions usually result in a change of leadership in their aftermath. This episode is different than prior recessions though, as it was brought on by a pandemic, not from glaring excesses that required a recession to cure them. We still believe that a rotation is likely, and as the US has opted for taking on a large debt load, International economies may be poised to grow relatively faster than the US. If a rotation occurs, we believe International Markets could regain much of the ground they lost to the US over the past 10 years.

Uncertainties surrounding geopolitics and the potential for a second wave of the virus could be headwinds over the summer, but we would not want to fight every central bank on the planet over the next few years. We believe the secular bull market is intact, and we are probably at the beginning of a long economic expansion.

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

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07/16/20
MSCI ACWI ex-US (Net) – 234
MSCI ACWI (Net) – 277
MSCI ACWI ex-US Value - 144

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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.

The MSCI ACWI ex-U.S. Value (gross) Index captures large and mid-cap securities exhibiting overall value style characteristics across 22 Developed and 26 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.