April 18, 2019
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Return of the Bond Vigilantes

Todd Asset Management International Market Commentary

	1Q 2019	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	10.3%	-4.2%	8.1%	2.6%	4.7%	8.9%
MCSI ACWI (Net)	12.2%	2.6%	10.7%	6.5%	8.4%	12.0%

* *Annualized Total Returns.*

Two deals, a China/US Trade deal and a Brexit Deal, captured investor attention during the first quarter. Bond Vigilantes worry about the possibility of deals not being reached and growth deteriorating. The "Bond Vigilantes" have been hard at work driving rates down (and stopping Central Bank tightening) in anticipation of a deflationary bust. During the Clinton Administration, bond vigilantes drove rates up as they worried about inflationary spending. This lead President Clinton to allegedly complain to his cabinet "You mean to tell me that the success of the economic program and my re-election hinges on the Federal Reserve and a bunch of… bond traders?" This time around, the Market vigilantes are driving rates down, not up as they worry that Europe is becoming Japan and will not be able to get their economy robustly growing again.

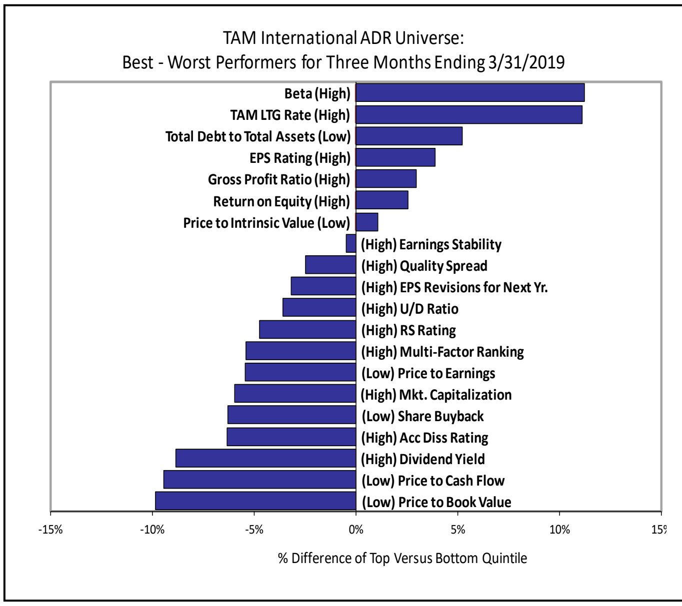
Stockholders seem to be taking the "glass half full" approach, assuming everything will be OK. The ACWI ex-US rose over 10% in the first quarter posting a rebound of nearly Biblical proportions after a fourth quarter that ended in tears. Against that backdrop, global economic activity slowed pretty dramatically and bond yields dropped as manufacturing activity softened along with business confidence during the first quarter. Central banks have stepped away from any ideas of normalizing rates to a higher level, and the ECB in particular has extended their timeline for considering any rate hikes. Additionally, the ECB is planning to provide lending facilities to banks to spur loan growth. These actions, coupled with weaker Purchasing Manager Indexes globally has encouraged equity investors that rates are not moving higher and scared bond markets into predicting a recession.

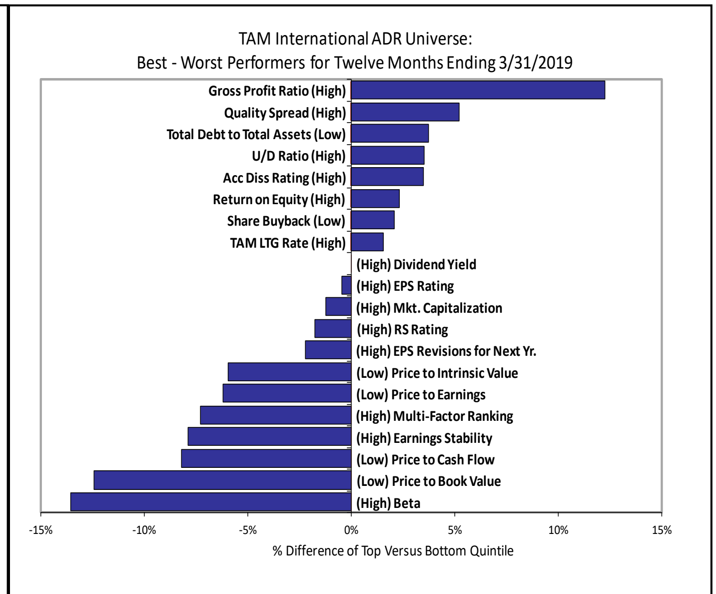
We believe the outlook is not as grim as bond investors worry it is. The US/China trade war has impacted more global trade than we would have anticipated. If there is a trade resolution (which we expect) while China is providing fiscal and monetary stimulus, expect a resurgence in their economy by the second half. We think that is what equity investors are anticipating. The European economy is geared toward an export trade with China, much like the Japanese economy. If Chinese demand recovers, that would provide a cyclical tailwind for both of those regions, as well as the resource based economies of Australia, Canada, South America and Russia.

The other issue at hand is Brexit. Having failed to ratify a deal, the British Parliament is still wrangling over what they want out of a Brexit. The pound remains firm, indicating the market expects some form of a deal, but the recent extension of the deadline until October means uncertainty continues. Most observers expect the extension to lead to an exit deal or a second referendum.

We would not be surprised to see stock markets take a breather as there is a lot of good news baked into their outlook right now. Our base case is still that this growth scare works out just like the one we experienced three years ago, with fears easing and stocks marching upward. Fears of an economic collapse probably are overblown. As investors get comfortable with the outlook for a recovery, markets should rally and bond fears should dissipate like they did in 2017. To get there though, we need two deals to get completed, a US/China trade deal and Brexit resolution. Until then volatility will remain high, and markets may not advance.

Factor Analysis





Source: Todd Asset Management, Bloomberg

The customary analysis we use to identify which factors added or detracted value from portfolios over the past three months (left chart) and trailing year (right chart) are presented above. A couple of observations are in order. First, more factors detracted value over both time frames than added value. Investors have been edgy, as the market has declined over the past 14 months while economic growth underperformed and concerns about Central banks moving to neutral from ultra-easy positioning cropped up. Strength early in 2018 was followed by a 23% drawdown from the peak through Christmas last year. A strong rebound followed as Central banks deferred any further tightening and progress on trade talks got baked into expectations.

Investors are still worried that economic growth is likely to be lower than anticipated. In response to this, several factors consistently outperformed over the past year, including high expected growth rates, low debt, high gross profitability and attractive return on equity ratios. Investors stayed away from most measures of attractive valuation, good technical strength measures or larger market capitalizations. It looks like a flight to safety that persisted throughout the year. Growth stocks outperformed value stocks over the past year and quarter, while Emerging Markets beat Developed Markets. We also found the International Small caps began outperforming in the first quarter, while lagging over the prior year.

This suggests to us that there are crosscurrents at work that have led investors to be risk averse, quality conscious and growth seeking over the past year, but the concerns may be starting to ease up as they are

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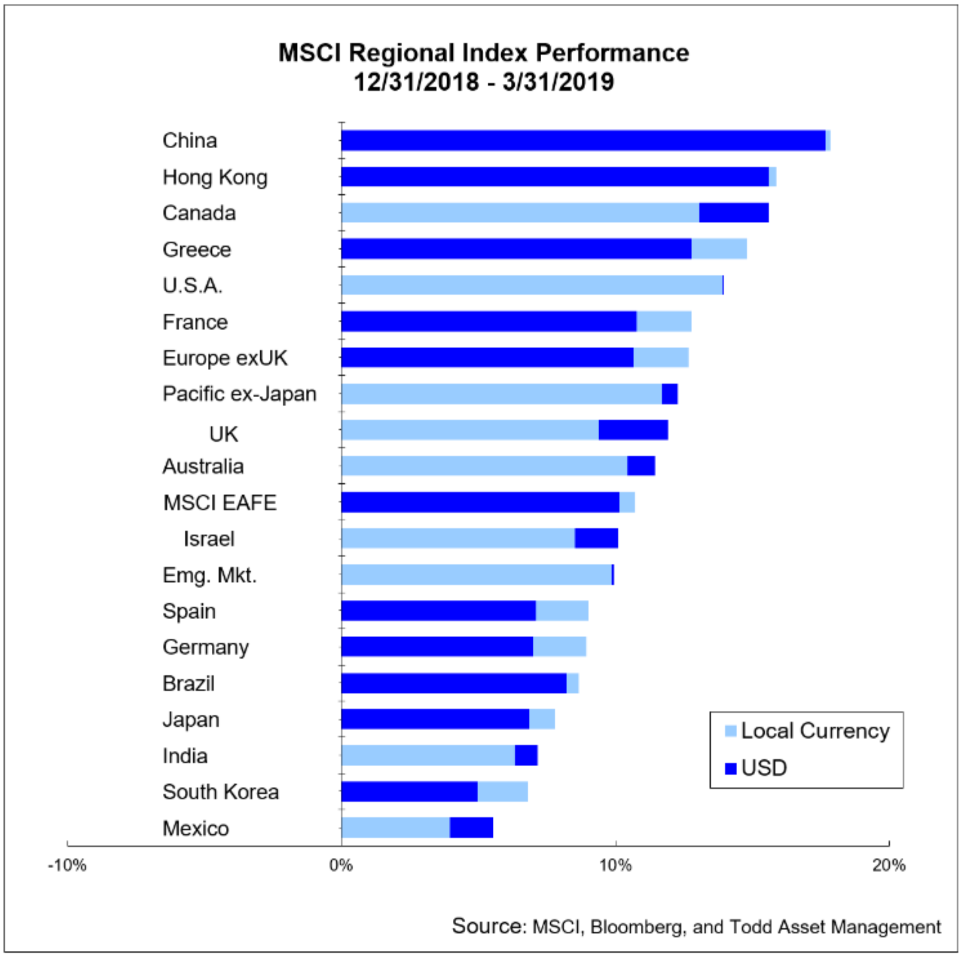
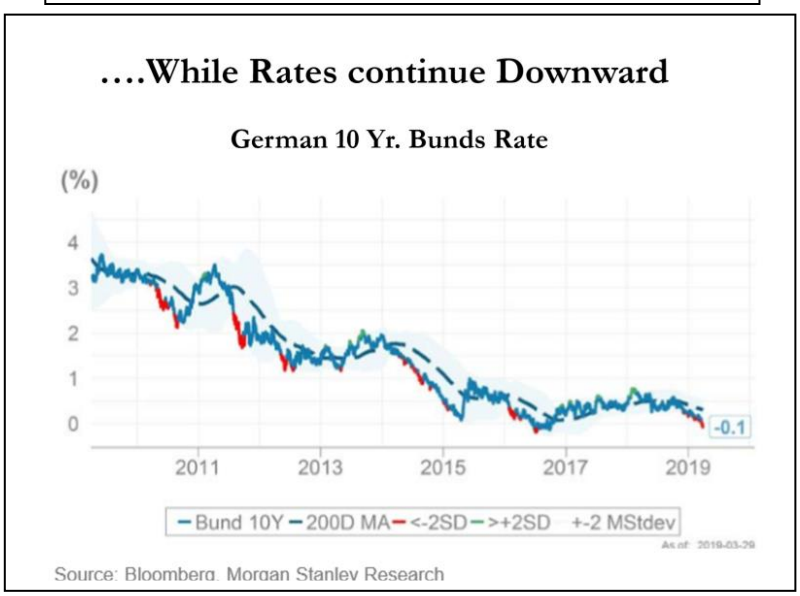
becoming more interested in Emerging Markets and small capitalization stocks. This feels very much like how markets acted during the 2015-2016 growth scare. Back then, investors narrowed the factors that were rewarded and focused only on Dividend Yield. While the number of factors in favor might be higher this time around, the sentiment is very similar.

As investors' concerns get resolved, i.e. China/US Trade negotiations yield an agreement, Brexit is completed or delayed, Central Banks stop tightening and general late cycle fears ease up, there is likely to be a rotation towards some of the laggards that are value oriented stocks or offer good economic sensitivity. The US dollar is likely to weaken as these concerns fade and focus turns to the rise in the twin deficits. We believe that is starting now, and expect 2019 to play out much like 2017 with International stocks outperforming the US and economically sensitive stocks outperforming the more defensive sectors.

Examining country performance, we see that China and Hong Kong were the leaders, gaining about nearly twenty percent in the quarter. This was a rebound after a fourth quarter decline of over 10 percent. Rounding out the top five markets, Greece, Canada and the US were leaders during the quarter. The lagging markets were Mexico, South Korea, India, Japan and Brazil. With four out of the five laggards being emerging markets, the overall EM results balanced out to be approximately the middle of the pack. The European markets that would be impacted most by Brexit were generally bunched up in the middle of the pack. All markets were up during the quarter. Equity markets were very positive despite the fact that Bond markets seemed to be pricing in expectations for weaker growth.



Interesting Charts We saw in the Quarter



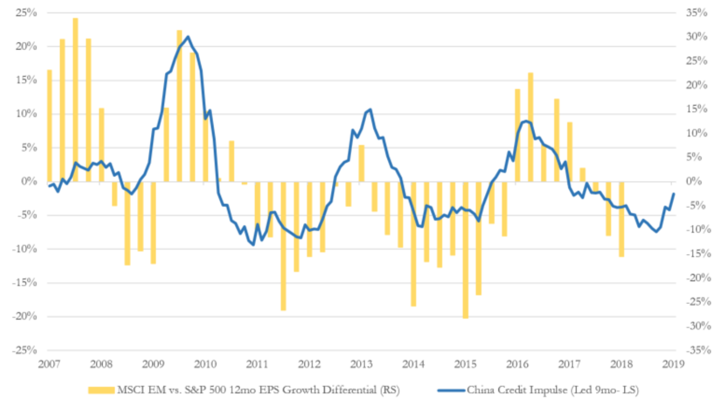
Reconciling these two charts is difficult. While employment is growing in most developed markets, worldwide bond yields have plummeted as illustrated by the German Bund yield chart below. Bond investors are pricing in continued economic deterioration, political risks and lowered inflation expectations. While manufacturing has been softer, the service sector is strong. As a result, while more jobs have been created in developed markets, deflationary/recessionary concerns are prompting more negative rates in Europe. This is dragging rates down worldwide.

China has been reducing shadow banking since 2016, which has resulted in less credit availability. Those efforts have contributed to the Chinese growth slowdown that was then amplified by the trade war with the US. China's Credit Impulse has declined since then (blue line in the chart) and led to EM earnings growth lagging the US (gold bar in the chart).

China has ceased that effort recently to stimulate their economy and the credit impulse line has hooked up. Expect a Chinese growth recovery later this year. That should help world growth, especially if a truce is called to the trade war. Follow your (China Credit) Impulse!

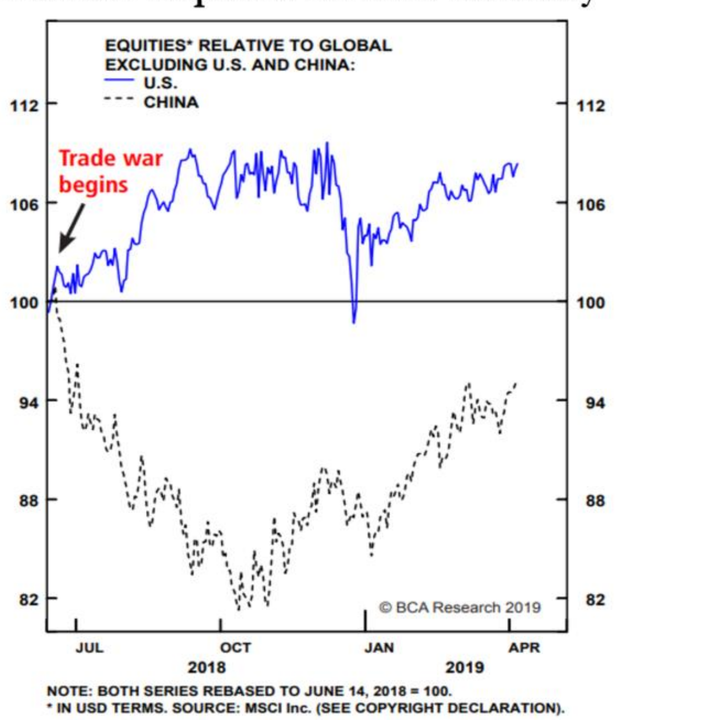
Follow Your Impulse

China Credit Impulse and EM vs. US Earnings Growth



Source: Bloomberg, MSCI, S&P and Todd Asset Management. Data as of 3/31/2019
Credit Impulse measures the 12mo percent change in social financing as a percent of nominal GDP. This series is then led by 9 months.

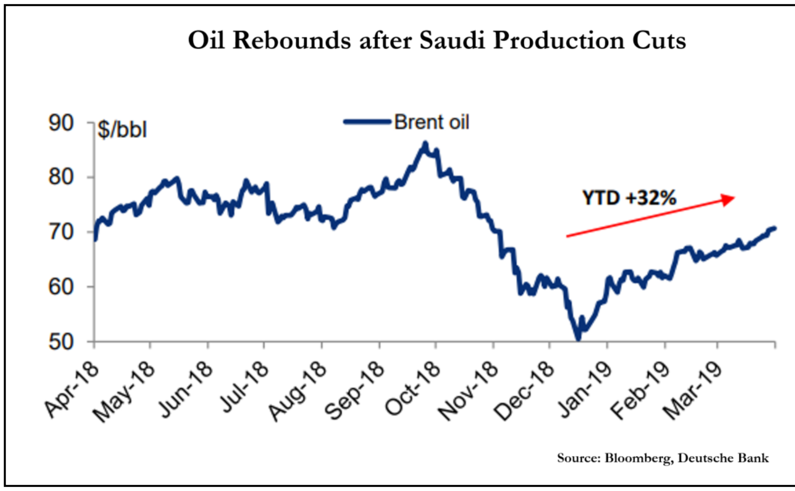
Markets Expect a Chinese Recovery



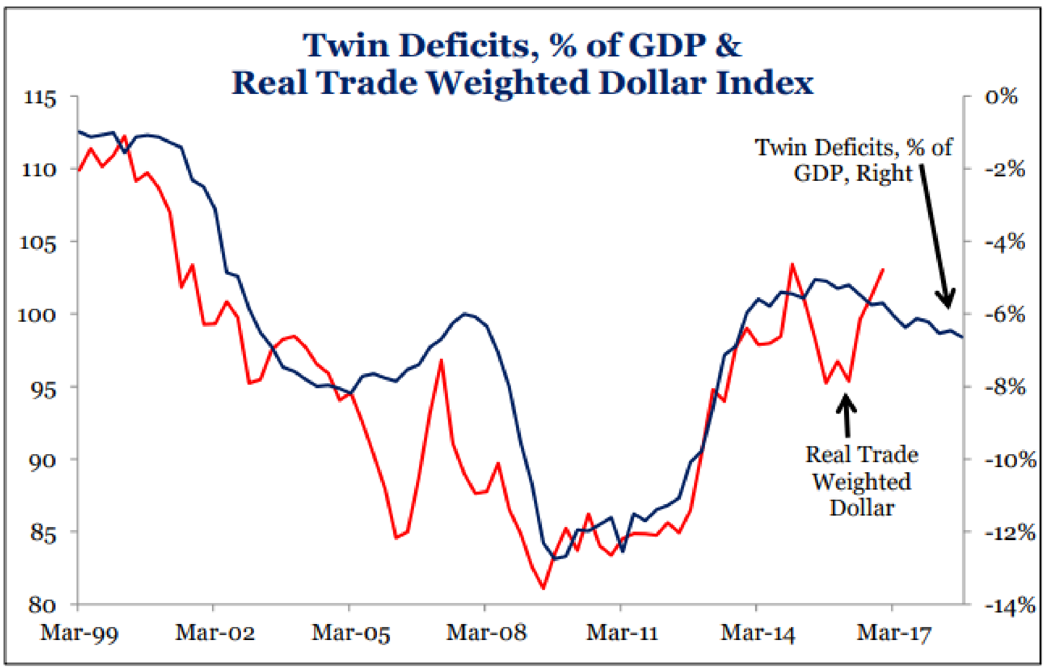
US performance relative to the world index has outperformed since the imposition of the first round of tariffs. Chinese stocks underperformed for the first few months of the trade dispute, but bottomed in October and have been recovering since then.

We think the combination of aggressive stimulus programs and a potential for a trade deal have coupled to support Chinese markets. China is reducing their required reserve ratio for banks, and lowering both value added taxes and income taxes to stimulate the economy.

Despite being the best performing market in Q1 2019, Chinese shares have not yet recovered what they lagged during the initial stages of the dispute. We believe that market has more upside if a trade deal is struck and stimulus gains traction.



Oil prices have rebounded strongly in Q1 2019 after the Saudis and Russians agreed to production cuts. This rebound coupled with continued low rates, and the stimulus programs we note above reminds of a similar period, namely 2017. As investors shifted from a synchronized slowdown mindset in 2016 to synchronized growth in 2017, we saw good markets. We think 2019 could bear some similarities to that.



Source: Strategas

We expect the dollar to weaken over the coming year. This would have a positive impact on returns for US holders of International assets. The combination of the budget and trade deficit tends to lead movements in the dollar. The forecast for those deficits is to deteriorate as tax cuts widen the budget deficit and our trade deficit remains high. We would expect dollar weakness, especially if trade deals are struck with China and/or the EU.

Summary

We just wrapped up the best quarter for the ACWI ex-US index since 2012, a liftoff period after the European Financial Crisis. Much of this is a result of a rebound from the fourth quarter, which was the worst since 2015. We do not believe a recession is likely anytime in the next couple of years. The market was very concerned that one was occurring during the fourth quarter as synchronized slowdowns in growth between China, Europe and the US concerned investors. The major concerns investors had about the outlook, namely the US/Chinese trade dispute, Brexit Concerns and aggressive tightening from the US Fed are all in the process of being resolved. We believe a second half economic acceleration is likely as stimulative measures from China should bolster worldwide economies. We would not be surprised to see markets bide some time and consolidate though until we get some formal agreement on the US/Chinese trade dispute or an economic reacceleration. We are still in a secular bull market that we think will last for many years to come.

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

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04/18/19
MSCI ACWI ex-US (Net) – 235
MSCI ACWI (Net) - 257

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.