Perspectives

JAN 2019

2019 Market Preview: Non-U.S. Equities

CAN THEY GET BACK ON TRACK?

After a strong 2017 performance in which most broad benchmarks returned more than 20%, non-U.S. equities produced negative returns in 2018. Developed markets (-13.8%) outperformed emerging markets (-14.6%). Large-caps outperformed small-caps in both developed (-17.9%) and emerging markets (-18.6%). Why the sudden reversal in performance between the two calendar years? The strong economic and earnings momentum in 2017 certainly slowed in 2018. Additionally, major macro-risk factors hung over global equity markets throughout the year. Monetary policy issues in Argentina and Turkey led to currency declines of 54% and 45% versus the dollar at each respective trough. The ongoing Brexit negotiation saga kept uncertainly levels high throughout Europe. Additionally, Italy and the European Union kicked up dust on the country's proposed budgets. Last but certainly not least, the U.S. embarked on a trade war with China. Looking ahead to 2019, the question is "can non-U.S. equities get back on track?" While this year's outlook is definitely cloudy, valuations and earnings at current levels remain supportive of the asset class.

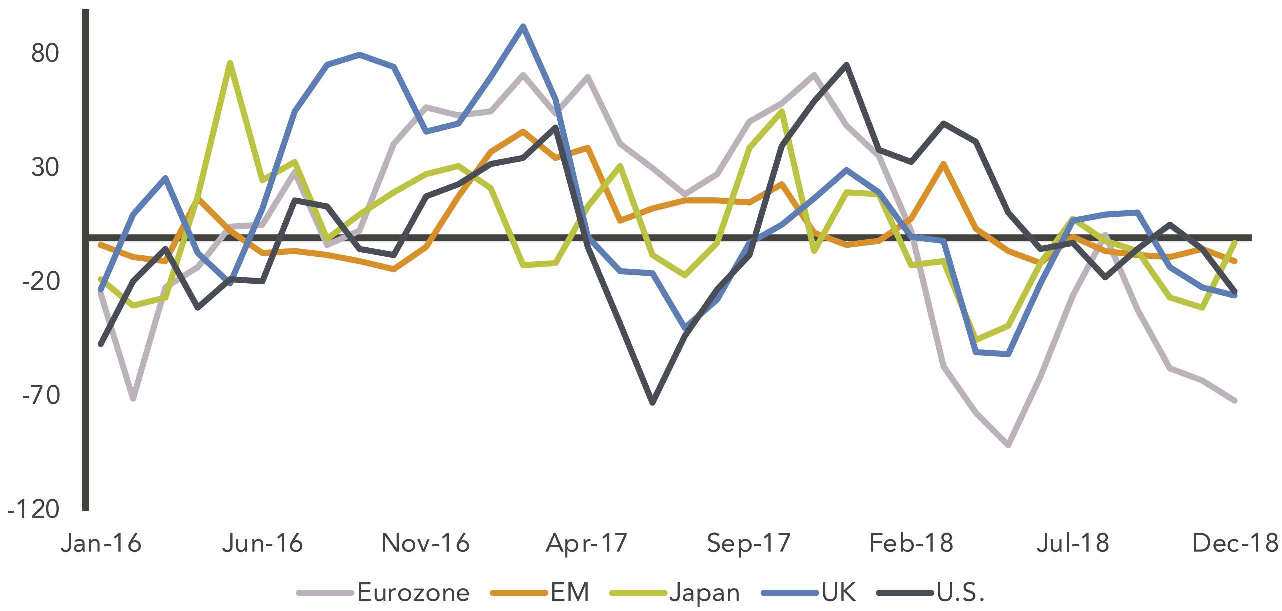
David Hernandez, CFA
Senior Research Analyst,
Non-U.S. Equities

Nicole Johnson-Barnes
Research Analyst

ECONOMIC UPDATE

Throughout the second half of 2018, there were strong signals of waning global economic momentum, and we anticipate that momentum will continue to gradually slow in 2019. The OECD's composite leading indicator index has fallen to its lowest in almost two years, at 99.4 as of October 2018,[1] which is at a level indicative of a momentum downturn. Also, as detailed in Exhibit 1 on the next page, the Citigroup Economic Surprise Index turned directionally negative for both developed and emerging markets at year end, showing that recent economic releases have fallen short of consensus estimates.

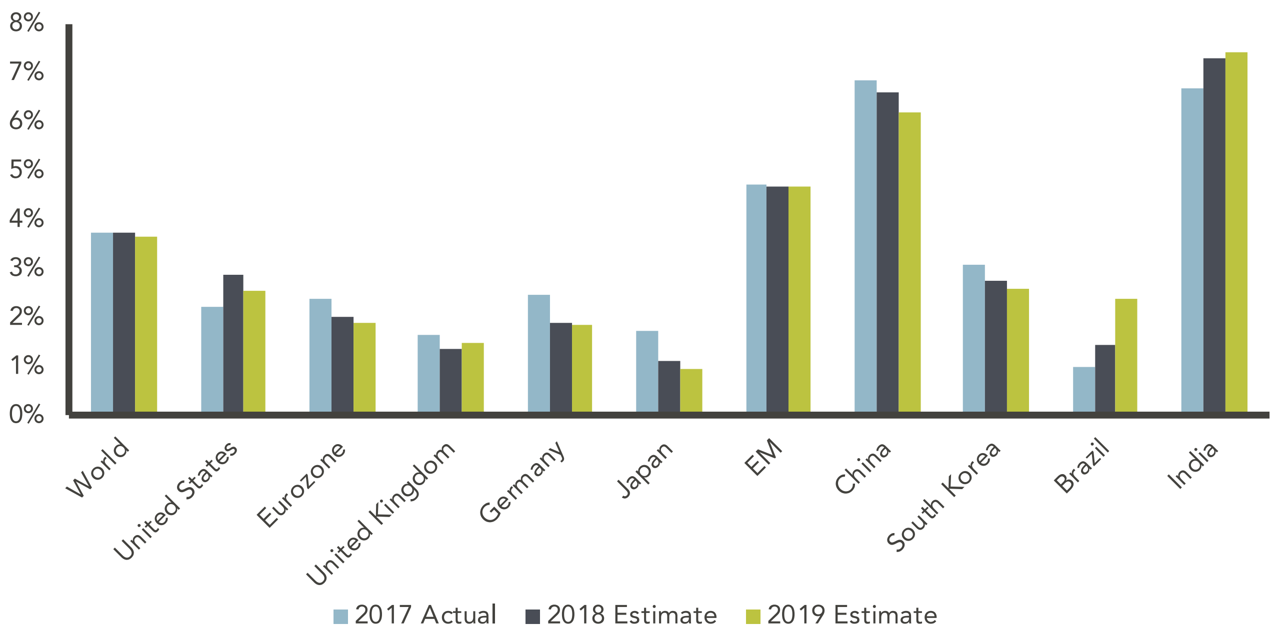
Exhibit 1: Citigroup Economic Surprise Index



Source: Bloomberg

Looking specifically at aggregate production, the world GDP growth rate is expected to remain flat in 2019 at 3.7%. From a developed non-U.S. markets perspective, both the Eurozone and Japan are expected to experience a slight drop in GDP growth rate. It is also anticipated that China's GDP growth rate will decline from an estimated 6.6% in 2018 to 6.2% in 2019. Emerging markets GDP growth rate, as a whole, is expected to be flat.

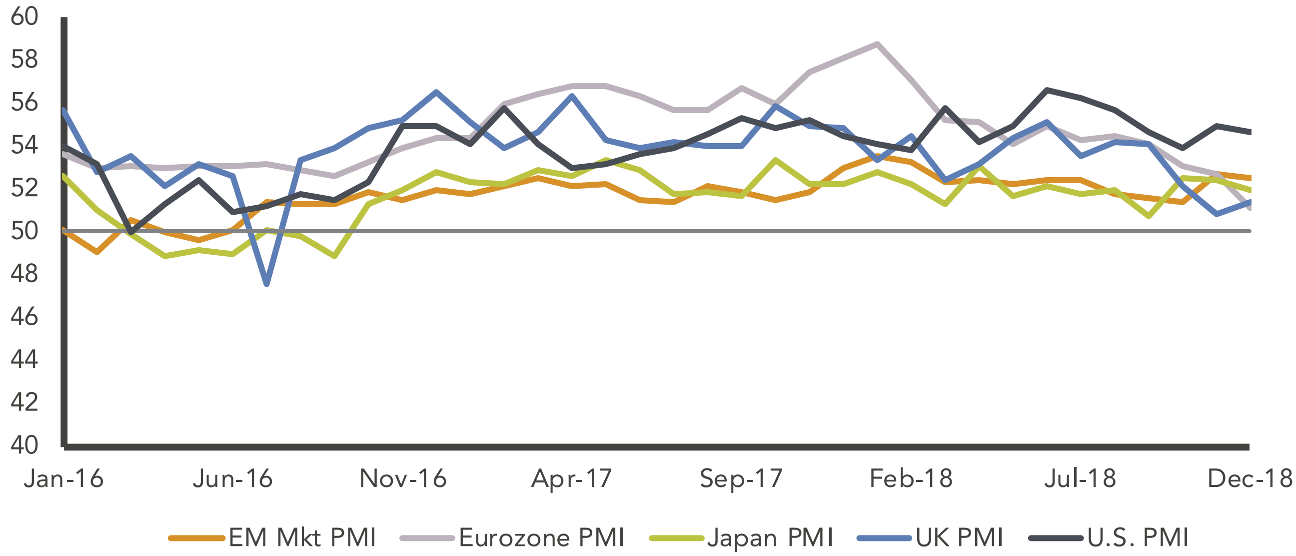
Exhibit 2: GDP Growth Expectations



Sources: International Monetary Fund, World Economic Outlook Database, October 2018

While purchasing managers' composite indices remained above 50 for the major economic regions outside of the United States throughout 2018, the downward trend line for the Eurozone and United Kingdom may further support market contraction in 2019. The Eurozone Composite PMI fell to a four-year low in December 2018, dropping to 51.1, which is the lowest reading since November 2014. Both France and Germany, the two largest economies in the Eurozone, experienced notable PMI lows, posting 48.7 (a 30-month low) and 51.6 (a four-year low) respectively. The United Kingdom Composite PMI also tiptoed close to the 50 threshold, posting 50.8 in November 2018 and slightly improving to 51.4 at year end.

Exhibit 3: Purchasing Managers' Index



Source: Bloomberg

Adding to the Eurozone's decelerated growth outlook, the European Central Bank ("ECB") officially halted quantitative easing ("QE") measures on December 13, 2018. The ECB has accumulated a portfolio of EUR 2.6 trillion in assets through the QE bond buying program. While the end of QE can be viewed as monetary tightening, the ECB intends on keeping conditions accommodative by reinvesting principal payments from maturing securities "for an extended period time." The ECB is also expected to proceed slowly with a gradual normalization of monetary policy, with interest rates expected to remain unchanged until the end of summer 2019.

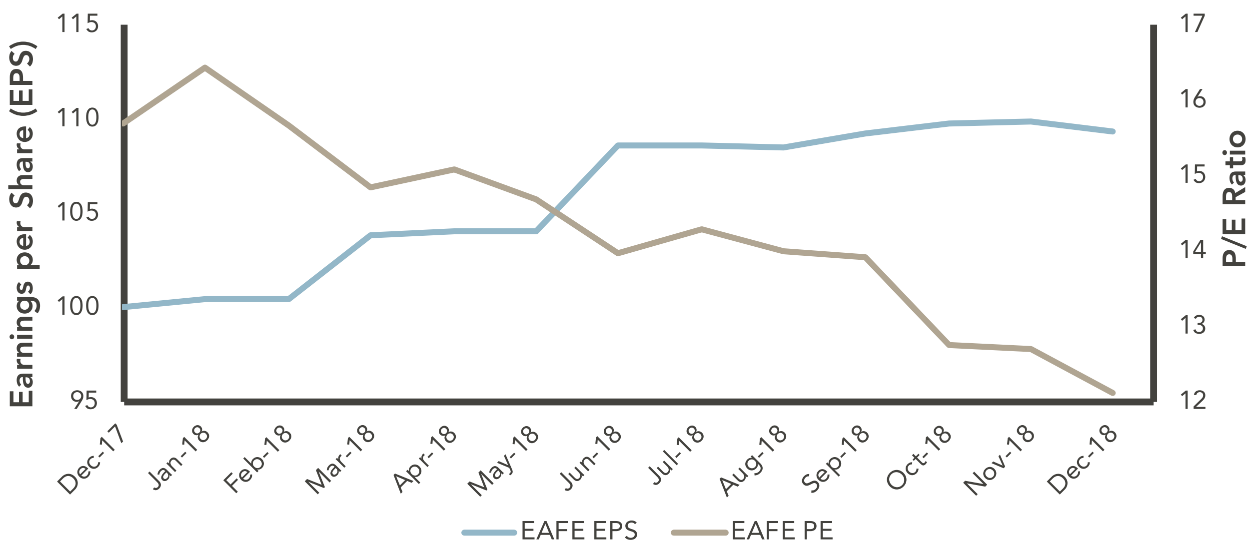
Turning to Asia's largest emerging market, China's economy has been under the spotlight for potential economic slowdown since 2011, when its GDP growth rate trended firmly below double-digits. In 2018, the focus was magnified by the trade war rhetoric between China and the United States. While GDP growth is still at a respectable 6.6% and the year closed with a 90-day trade tariff cease fire, we are still anticipating a continued soft slowdown in China as suggested by a few leading indicators. Specifically, manufacturing is showing signs of weakness, with industrial production growth hitting a three-year low at 5.4% in November 2018.[2] Consumer spending statistics are also falling, and we expect to see a short-term drop in personal consumption in conjunction with the proposed October 2019 consumption tax hike.

To summarize, a marked slowdown in economic momentum occurred in 2018. To be fair, expectations moved considerably higher in 2017, making it tougher to surprise to the upside. Still, the absolute level of economic growth remains positive through much of the investable world.

EARNINGS GROWTH MOMENTUM

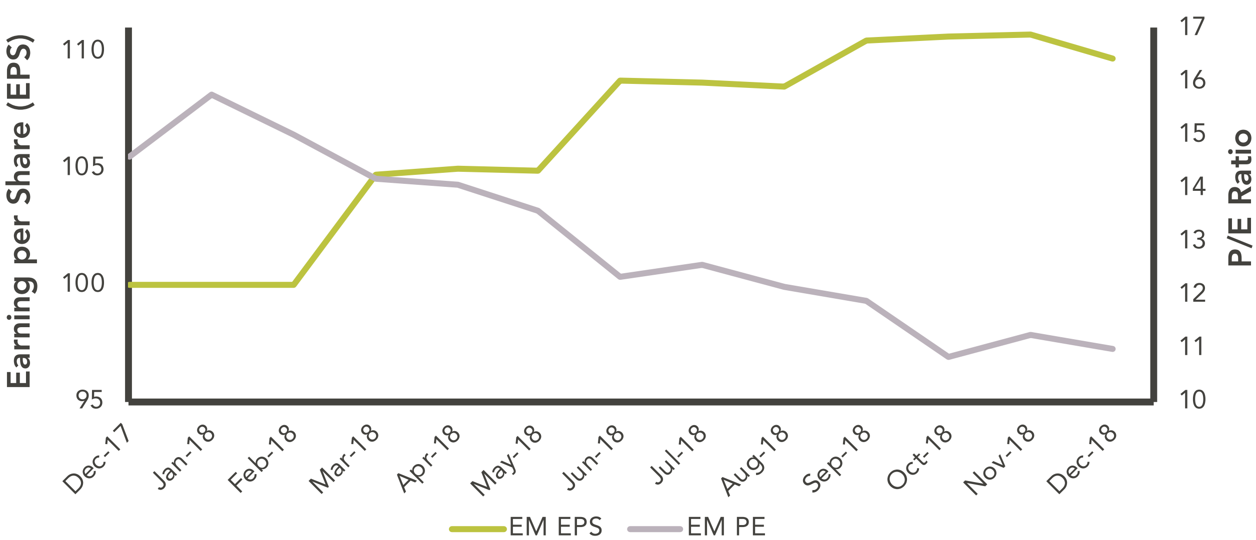
In 2017 earnings growth was strong across the world and momentum pushed higher throughout the year; earnings revisions for emerging markets and non-U.S. developed markets also increased as 2017 unfolded. In 2018, however, earnings revisions moved downward - a more normal occurrence for markets - as analysts typically start the year more optimistic. While momentum reversed, the absolute level of earnings growth remained positive. In 2018, the aggregate earnings for the MSCI EAFE and MSCI EM indices grew by 9.3% and 9.6%, respectively. What happens when prices come down but earnings go up? You get better valuations and that is what we see in Exhibits 4 and 5, where P/E ratios have come down dramatically from the start of 2018. The MSCI EAFE and MSCI EM trailing 12-month P/E ratios fell by 22.8% and 24.5%, respectively.

Exhibit 4: 2018 EAFE Valuations and Earnings Growth



Source: Bloomberg. EPS indexed to 100 as of December 2017. P/E is trailing 12-month and adjusted for negative earnings

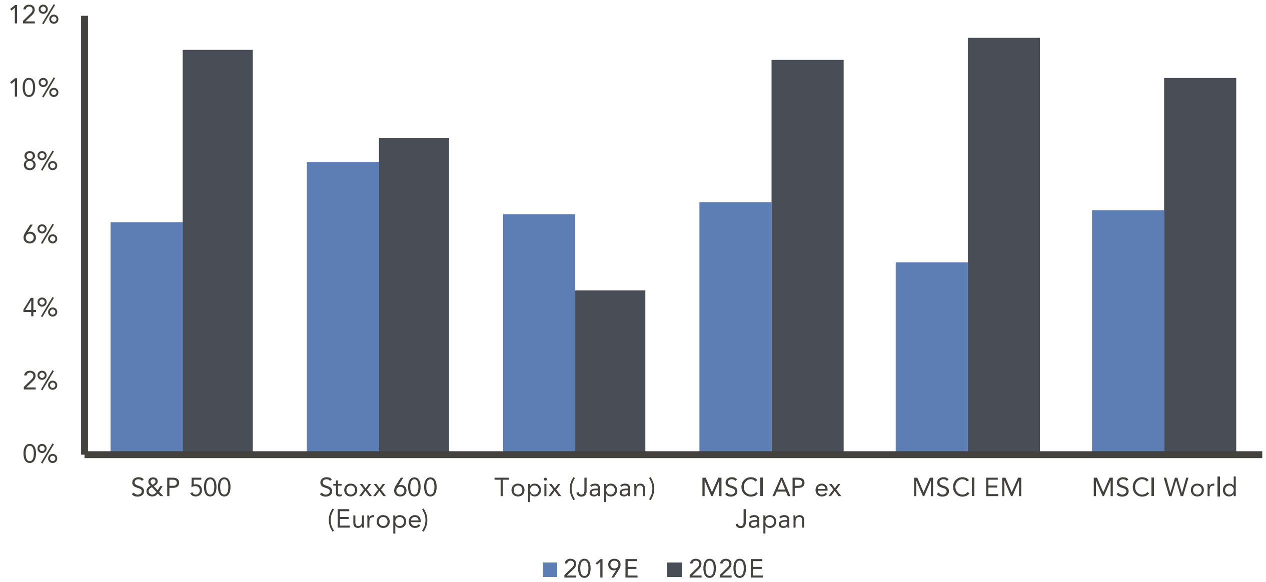
Exhibit 5: 2018 EM Valuations and Earnings Growth



Source: Bloomberg. EPS indexed to 100 as of December 2017. P/E is trailing 12-month and adjusted for negative earnings

Looking forward to 2019, earnings are projected to remain positive and we think this is supportive of equity returns. While U.S. markets outperformed on this front in 2018, due largely to President Trump's tax cuts, 2019 is expected to be much more balanced. Earnings growth for emerging markets, Europe and Japan are projected to be in the 5-8% range. It is important to note that these are projections, and as stated earlier, it is common to see projections come down through the year. With high levels of global uncertainty, the future earnings outlook can be much more cloudy. For example, a company's inability to predict outcomes in the Brexit or U.S.-China trade relationship will have an impact on future capital expenditures and thus affect its earnings potential. Additionally, a break down in trade relationships can lead to less global trade and therefore reduce sales for multi-national companies. Unlike wage growth, which can also hurt a company's profitability, tariffs do not provide any offsetting boost to consumer spending. With this in mind, should the Brexit and U.S-China issues be resolved, it would clear away some of the uncertainty surrounding earnings potential.

Exhibit 6: 2019 Global Earnings Growth



Source: Bloomberg

VALUATION

For investors looking for attractive pricing, non-U.S. equities provide lower valuations compared to U.S. equities. For our return readers, you will remember last year us likening global equities to shopping on Michigan Ave. in downtown Chicago, where nothing is cheap, but some things are less expensive. Well this year non-U.S. equities are starting to look cheap, which should not be too surprising given the dramatic negative returns in 2018. Exhibit 7 on the following page displays five different valuation metrics along with their historical percentiles. Non-U.S. equities now trade below their longer-term averages, but investors will have to balance the valuation perspective with the overarching geopolitical risks and their overall risk and return objectives.

Exhibit 7: Global Equity Valuations

Valuation Metrics	S&P 500 Current	S&P 500 Historical Percentile (%)	MSCI EAFE Current	MSCI EAFE Historical Percentile (%)	MSCI EM Current	MSCI EM Historical Percentile (%)	MSCI EAFE SC Current	MSCI EAFE SC Historical Percentile (%)
P/E	17.0	42	12.1	9	11.0	29	12.8	22
Forward P/E	15.4	44	12.7	26	11.3	37	15.9	28
P/B	3.0	71	1.4	11	1.5	30	1.3	41
P/S	1.9	79	1.0	48	1.1	51	0.8	77
P/CF	11.3	50	8.5	33	7.6	51	9.7	60
EV/EBITDA	11.8	58	3.4	12	7.6	54	9.6	16
Average		57		23		42		41

Source: Bloomberg through December 31, 2018; as of January 7, 2019. P/E is adjusted for negative earnings; percentiles are based on data going back to 1999 except for FP/E which goes back to 2005.

RISKS

Continued geopolitical and trade tensions plagued both international developed and emerging markets throughout 2018, particularly in the third and fourth quarters. These tensions have largely remained unresolved, and in some cases compounded, creating an increased level of uncertainty heading into the new year. There are two major concerns that will directly impact the level of market volatility experienced in 2019: global trade tensions and European political instability.

Global Trade Tensions

Protectionism led the way in all major trade conversations and disputes between the United States and its trading partners in 2018, as the Trump administration charged ahead with attempts to replace long-standing trade agreements. The market appears to have digested, or at a minimum factored in, the broad U.S. steel and aluminum tariffs imposed in March and the new NAFTA deal (aptly titled the United States, Mexico, and Canada Agreement) that is awaiting Congressional review.

What looms as an unknown in 2019 is how the U.S. and China trade battle will progress and whether a resolution can be found. After the 90-day cease fire lapses, the U.S. still has $700B+ in proposed tariffs at its disposal to enact should the February 2019 conversations end poorly. Additionally, there has been a material shift in the trade debate away from purely tariffs and towards U.S. intellectual property protections, particularly in the information technology space. Adding potential fuel to the fire, in December Canada aided its U.S. ally in detaining a Chinese Huawei executive on charges of violating bank laws and U.S. trade sanctions. In response, China has resorted to arresting Canadian nationals, and we anticipate that there may be ongoing — and potential retaliatory — actions between the three nations in 2019.

Exhibit 8: U.S.-China Trade Tariffs

January 22
U.S. introduces tariffs on washing machines and solar cell imports

March 9
U.S. imposes steel and aluminum tariffs on most countries

March 23
China introduces tariffs on $3 billion worth of U.S. imports in response to the steel and aluminum tariffs

April 4
China announces an additional 25% tariff on U.S. imports, including soybeans and automobiles

May 20
U.S. and China issue a joint statement, U.S. agrees to hold off on tariffs while China offers to increase purchases of U.S. goods

June 15
U.S. introduces tariffs on $50 billion of imports from China, China responds with matching $50 billion worth of tariffs

September 24
U.S. announces an additional tariff on $200 billion in Chinese exports at a 10% rate, set to increase to 25% on Jan. 1, 2019. China retaliates with $60 billion worth of tariffs ranging 5%-10%

October 30
U.S. reportedly planning to announce tariffs on all remaining Chinese goods, worth $257 billion

December 2
U.S. and China agree to not increase or impose new tariffs for 90 days, China offers to crack down on intellectual property rights violations

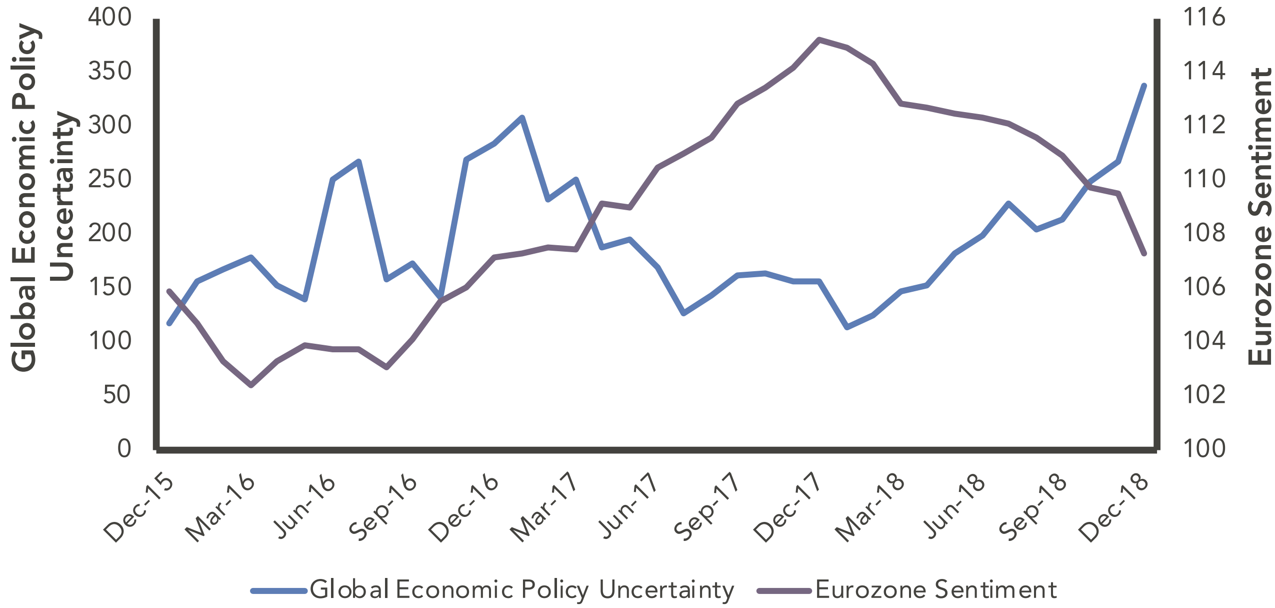
Source: The Wall Street Journal

Political Instability in Europe

Across the pond, political instability in relation to Brexit and European Union fiscal policy were the main 2018 headlines which dragged on investor sentiment throughout the year. Starting with Brexit, UK parliament passed the EU Withdrawal Act in June, setting in motion rounds of debates and negotiations between Prime Minister Theresa May and the EU regarding the withdrawal agreement and transition period terms. While a draft of the withdrawal agreement was penned in November, many members of Parliament objected to the underlying provisions and expressed no-confidence in PM May. Expecting a loss in parliament, the UK government postponed the December 11th withdrawal deal vote. Heading into 2019, May has been sent back to the drawing board with EU negotiators, increasing the possibility of a soft Brexit or no deal in March 2019.

Elsewhere in the Eurozone, the newly-formed, right-wing populist Italian government closed the year by reaching a compromise with the EU over its 2019 budget. While decreasing the deficit target from 2.4% to 2.04% of GDP has averted EU sanctions, it remains unclear as to whether the proposed large-scale spending efforts will produce material improvements in Italy's economy. In France, protests erupted on the Champs-Elsyees in November, as the "Yellow Vests" movement took to the streets to demand lower fuel taxes, minimum wage increase to address higher living costs, and Emmanuel Macron's resignation as President of France. In December, Macron promised to increase minimum wage by Euro 100 (per month) in 2019 to qualm the protesters. However, it is too early to suggest that the unrest will subside, as the "force majeroe" movement continues to spread within and outside of France. As evidenced in Exhibit 9 (next page), uncertainty regarding global economic policies has risen over the course of 2018, while overall Eurozone sentiment has dropped.

Exhibit 9: Global Economic Policy Uncertainty Index vs Eurozone Sentiment



Source: Bloomberg

CONCLUSION

After showing such promise in 2017, non-U.S. equities disappointed in a major way in 2018. Many of the strong positive trends that started in 2016 reversed course last year leaving investors concerned for this year, and there are several significant issues to be concerned with. For example, the outcomes of the Brexit event and U.S.-China trade relations can have a major impact on market performance and unfortunately it is impossible to predict how either of these issues will play out. Fortunately, valuations have come down considerably with markets attempting to price in the high level of uncertainty. Additionally, in contrast to the start of 2018, market expectations at the start of 2019 are low, making upside surprises more easily attainable. Ultimately, we are optimistic for positive returns in the coming year as current valuations and earnings levels remain supportive.

[1] Organization for Economic Co-operation and Development (2019), Composite leading indicator (CLI) (indicator). doi: 10.1787/4a174487-en (Accessed on 07 January 2019). The OECD composite leading indicator (CLI) is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long-term potential level. CLIs show short-term economic movements in qualitative rather than quantitative terms. There are 36 OECD member countries: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

[2] Bloomberg, National Bureau of Statistics of China

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO I BALTIMORE I PHILADELPHIA I ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

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