International and Global Markets Commentary & Investment Outlook

CHAUTAUQUA CAPITAL MANAGEMENT
A DIVISION OF BAIRD

2018 MARKET COMMENTARY

Global equity markets sold off sharply in the fourth quarter, capping off a tumultuous year for stocks. For the first three quarters, non-U.S. stocks declined, while U.S. stocks appreciated by double digits. Rising interest rates in the U.S. pressured valuations for financial assets worldwide. Furthermore, interest rate differentials weakened foreign currencies, especially those of emerging markets. From an economic standpoint, the U.S. benefited from front-end loaded tax cuts and stimulative infrastructure spending measures instituted earlier in the year. Consequently, the U.S. grew faster while global peer growth had been slowing.

Therefore, despite continual downward pressure on asset prices due to the Federal Reserve's rate hikes, the U.S. market managed to grind higher for most of the year. In fact, this pattern of strong market performance in the U.S. has been the case every year since former Chairwoman Janet Yellen initiated the Federal Reserve's first rate hike following the Great Financial Crisis in December 2015.

Issues surrounding trade policy further complicated the picture. The trade war between the U.S. and China exacerbated a weakness in consumption and industrial production in China that was already in place due to deleveraging and a softening property market. Meanwhile in Europe, the European Central Bank (ECB) indicated a loss of economic confidence due to the E.U.'s (European Union) own trade war with the U.S. and stalled negotiations with the United Kingdom (U.K.) regarding Brexit.

In the fourth quarter, despite the constancy of these factors, several markets reacted noticeably different. First, the sell-off pulled the U.S. stock market into a deep decline for the first time this year. Second, the emerging markets, which arguably have suffered the most from trade war fallout and a stronger dollar, managed to outperform developed markets. A notable group of emerging markets even appreciated in price. India, Indonesia and the Philippines are fast growing economies that import oil; they stand to benefit from oil's price decline and a probable reversal in dollar strength. Brazil has continued a shallow recovery from recession; there is enthusiasm for the newly elected right wing President Jair Bolsonaro's slate of pro-business reforms.

The U.S. economy was still robust. Gross Domestic Product (GDP) grew 3.5% in the third quarter, the labor market remained at full capacity, and inflation hovered near the target of 2%. In spite of greater market turbulence this past quarter, the Federal Reserve raised bank borrowing rates for the fourth time this year, to a range between 2.25% and 2.5%, and upgraded its forecast for GDP growth in the fourth quarter to 3%.

On the contrary, economic data in China and Europe deteriorated further, and trade policy with the U.S. is still an overhang. Chinese industrial production continued to weaken and has been hurt by soft automotive and property markets. Annual growth in retail sales has been more resilient and grew 8%. Remarkably, this is the slowest pace in the last fifteen years. As a result of the trade war, weaker industrial production and consumption in China caused the government to reprioritize economic policies towards stabilizing growth rather than enacting reforms to control the growth of debt. This is a major policy shift. The People's Bank of China (PBOC) infused Chinese banks with

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capital and cut reserve ratio requirements to encourage lending, and the Politburo restarted pro-growth infrastructure and railways projects.

The trade war between the U.S. and China remains unresolved. Implementation of higher tariffs has been delayed, giving the two countries until March to negotiate a deal. Success, or even the skeleton of an agreement, is hardly certain. Multiple complex issues will need to be negotiated such as purchase guarantees of U.S. goods, forced technology transfer, intellectual property protection, and market access. Prior negotiations made little progress because China refused to make structural changes to its business practices. A full settlement of trade disputes will require big changes from both governments. Should the talks fail, U.S. tariffs on $200 billion of Chinese goods would increase from 10% to 25%. Chinese retaliation is a certainty.

In Europe, the deceleration in economic growth continued. GDP grew only 0.2% in the third quarter, the slowest pace of expansion in the last five years, and ECB President Mario Draghi made a third straight cut to economic forecasts. German and French economies both contracted in the third quarter and the Italian economy showed no growth. In the U.K., Prime Minister Theresa May survived a leadership challenge; however, the fate of Brexit remains uncertain and increasingly looks like it will not be decided until close to the March deadline.

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INVESTMENT OUTLOOK

In an acknowledgement of rising interest rates, global financial markets have de-rated. Non-U.S. markets, in particular, declined as dollar strength weakened foreign exchange rates and forced central bankers to crimp economic growth to maintain currency stability. Furthermore, growth stocks, which are justifiably priced at premium valuation multiples and whose cash flows can be long-dated, were the worst performers as rising interest rates caused multiple compression.

Where do we go from here?

Business uncertainty resulting from trade frictions will continue to put downward pressure on economic growth. As a result, investor confidence may remain fragile (recent price declines appear to reflect this). Concerns are unlikely to dissipate soon, but we contend that international growth stocks represent a good investment opportunity.

First, we are closer to the end of a U.S. tightening cycle than the beginning. Members of the U.S. Federal Open Market Committee (FOMC) broadly maintain that the direction of interest rates in 2019 will be higher, but the consensus forecast within the group now predicts just two more rate hikes instead of three. Chairman Jerome Powell has indicated that the benchmark rate is already near the neutral level, and the Federal Reserve will likely stop when they have achieved a modest cushion to allow for future stimulus. Such a development will relieve pressure from a principal factor depressing asset valuations. International equities specially stand to benefit as the ECB and Bank of Japan (BOJ) have both signaled that they are far from raising their own interest rates. Furthermore, central banks in emerging markets, which have had to raise rates instep with the U.S. to maintain a dollar peg, will get a reprieve.

Second, should U.S. economic growth slow, international markets would look relatively more attractive. The strength of the U.S. economy has been bolstered by high consumer confidence and low unemployment. It was also inflated by fiscal stimulus and stockpiling ahead of new tariffs. These temporary benefits make 2018 a tough future comparison. In 2019, U.S. economic growth may appear to collapse as one-time benefits fade and inventories are worked down. The result could be a technical recession, though the underlying economy may be fine. By comparison, non U.S. economies and currencies would likely appear more attractive.

Resolution of trade tension is also more likely to be a relative tailwind for international markets. The negative impact of the trade war has been greatest for Western Europe, Asia and emerging markets. Therefore, positive developments between the U.S. and its trading partners will offer a bigger boost to foreign economic growth and exchange rates.

Third, the U.S. equity market is more expensive. As compared to international equities, U.S. equities are trading at multi-year highs and near their highest relative premiums to international equities on both forward earnings and book value. Moreover, the U.S. market has outperformed consistently over the extended nine-year bull market, as well as this past year. Therefore, given high valuations and extended outperformance by the U.S., international equities should outperform.

It is entirely possible that things get worse before they get better, or that markets grow disconnected from fundamentals. Uncoordinated monetary policy, demographic headwinds, migration, nationalism, and widespread excessive indebtedness are apt to stress the global economy. But our faith in our investment process remains firm. Therefore, we continue to invest in businesses that benefit from secular trends and are structurally well-positioned to grow over time. Typically, they sell mission-critical and high value-added products and services. Such companies can generate wealth for shareholders even in challenging times.

Respectfully,

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Robert W. Baird & Co. 777 East Wisconsin Avenue, Milwaukee, Wisconsin 53202
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