ClearBridge Investments

# What Can Go Right in International Markets

August 27, 2018

## Key Takeaways

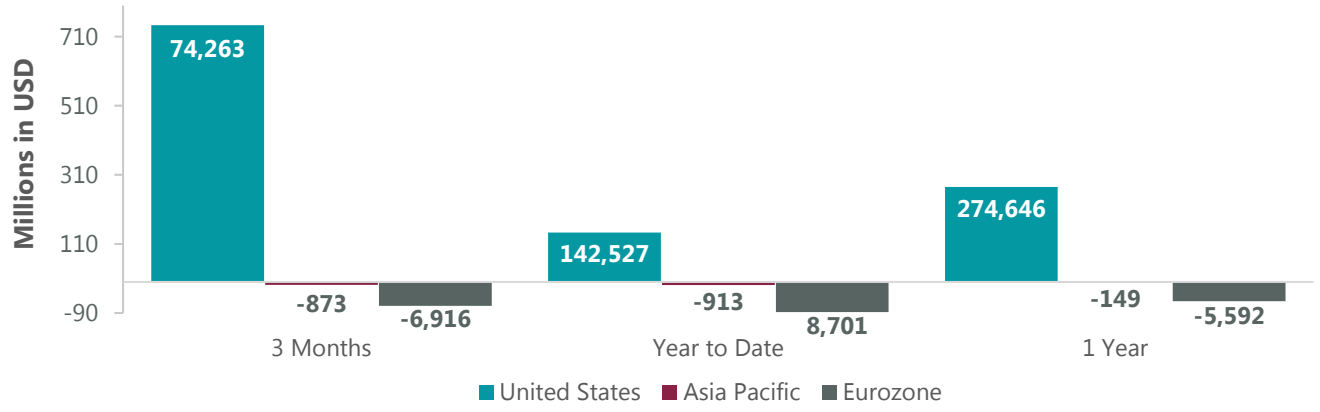
- Returns in U.S. and international markets have diverged year-to-date, driven primarily by negative sentiment around economic growth and geopolitical risks.
- Economic and earnings fundamentals remain healthy in Europe and Japan while a policy shift toward easing in China has yet to be discounted.
- A softening of U.S.-China trade rhetoric and a weakening dollar could spark a new wave of international outperformance.

## Growth Drivers Across Regions

Currency headwinds from a strengthening U.S. dollar (USD) and a moderate slowing of growth have weighed on international equities in 2018. The escalation of global trade tensions, meanwhile, have hurt investor sentiment, causing weaker flows to non-U.S. equities (Exhibit 1) and leaving the asset class in what we consider an oversold position.

As we discussed in our most recent commentary, negative headlines are underestimating the many positive drivers supportive of companies in developed markets. Economic fundamentals are solid, beginning with the consumer. Wages are rising in many countries where we are invested, unemployment is at low levels, consumer balance sheets have improved materially and confidence is near historic highs. Although unemployment is a lagging indicator, we could see eurozone unemployment fall to 7% in 2020 (from 8.3% currently), which would be the lowest level since before the global financial crisis. Japanese unemployment is around 30-year lows, causing more women to enter the workforce to fill jobs.

Exhibit 1: International Equities Have Seen Outflows in 2018

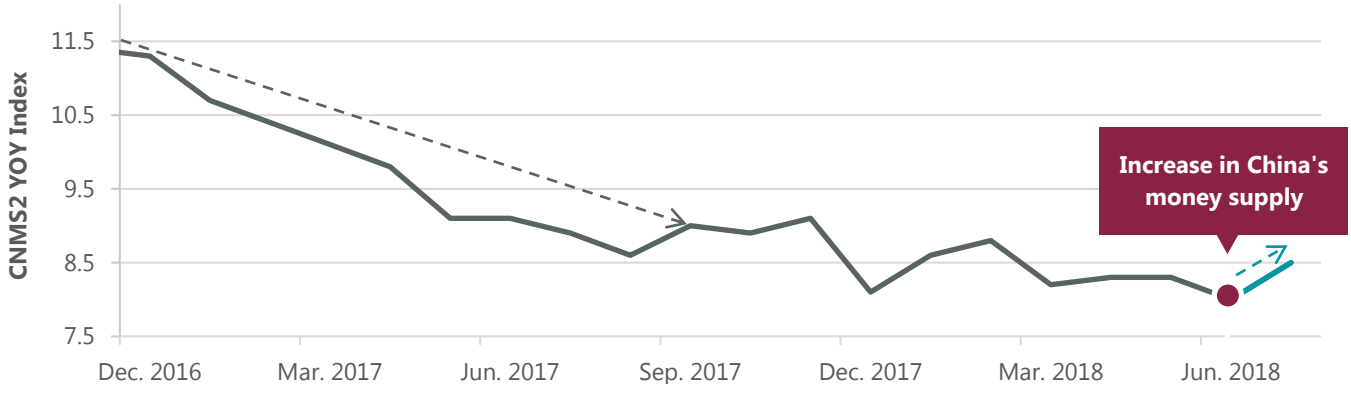



ETF flows as of July 31, 2018. Source: Bloomberg.

The corporate picture is also encouraging. Global PMI levels remain well above 50, indicating healthy industrial activity. Capacity utilization rates are around 84%, a level which normally leads to more capex investments; it's simply a question of when the spending will commence. Corporate balance sheets in Europe are strong while Japanese companies are flush with cash. But the strong level of cash flows for international companies have not been deployed into share buybacks as much as we have seen in the U.S., so buybacks could be another potential tailwind in Europe and Japan.

While the U.S. is well into its interest rate tightening cycle, central banks in Europe and Asia remain mostly accommodative. We expect the European Central Bank will maintain QE through the end of this year, be neutral in 2019 and not commence rate hikes until 2020. The Bank of Japan is expected to keep rates close to zero to stimulate inflation. The big wild card here is China. After beginning a program of deleveraging that caused growth to slow, the Chinese central bank has opened up the money supply through their reserve requirement ratios for the banks and is starting to pump money into the economy. We saw that particularly in July. Now the question is: will the banks lend that money out? We think the answer is yes.

Exhibit 2: China Is Increasing Money Supply Again




As of July 31, 2018. Source: Bloomberg.

Valuations remain compelling in the markets we target and we could see multiple expansion from here. P/E multiples normally do not de-rate if earnings are growing and earnings in Europe, for example, remain 18% below their 2008 peak. Southern Europe, in particular, is lagging and has room for improvement. Over the next several years, earnings growth in emerging markets should be slightly better than the U.S., while the eurozone should see growth similar to the U.S. as tax reform benefits there recede.

## Risks We Are Monitoring

A trade war and tariffs are counterproductive for global markets. Tariffs will hurt economic growth and could spark inflation and higher interest rates. To deal with tariffs, companies will need to alter their supply chains, which is time consuming and leads to higher costs. Once they do so, it is very difficult to bring them back quickly. We expect to see more companies complaining about the trade war and the impact on their businesses. We are watching the tone of trade rhetoric as we near the midterm U.S. election and hoping for a reversal or easing of the current pressure being applied by the U.S.

Italy is a hotspot right now due to political uncertainty. We view it as a bigger potential risk than even Brexit because Italy is a large economy (15% of eurozone GDP and 23% of public debt) and the last one in Europe to take measures to improve growth. The Italian election in May resulted in a compromised candidate, Prime Minister Giuseppe Conte, and two vice prime ministers from anti-establishment parties. The political situation creates uncertainty and will likely postpone business and consumer spending, which will hurt GDP growth. The new government also must present a new budget by October and it will likely cause debt levels to rise again,

bringing Italy in conflict with the EU. We expect a lot of negative headlines coming out of Italy in the next month but overall, the government will find a way to manage. We believe most Italians still want the euro and to remain part of the EU.

What happens on the trade front will have the most immediate impact on international equities. If the trade rhetoric eases, the USD should weaken and emerging markets should benefit. This could provide a pathway to the next wave of performance in international markets.

## About the Author

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- 31 years of investment industry experience
- Joined ClearBridge Investments in 2015
- BA in Business and Economics from the Wirtschaftsakademie Hamburg (Academy of Business and Administration), Hamburg, Germany