ClearBridge Investments

International Growth Strategy

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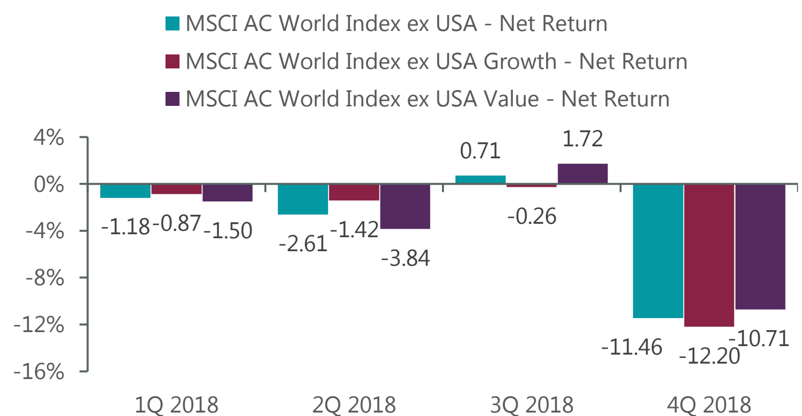
Key Takeaways

- Negative sentiment toward international equities fails to discount solid fundamentals in most of the regions and markets the portfolio targets.
- While most economies are coping with a withdrawal of quantitative easing, China is aggressively stimulating its economy, but we do not expect such actions to re-accelerate growth until mid-2019.
- The fourth-quarter correction provided attractive opportunities to increase our exposure to secular and structural growth companies.

Market Overview

Concerns about slowing global growth, tightening liquidity conditions and political rhetoric escalated through the final three months of 2018, driving international markets to sharp losses for the quarter and the year. The benchmark MSCI All Country World Ex-U.S. Index declined 11.46% in the quarter and finished down 14.20% for 2018. Meanwhile, smaller stocks were punished even more with the MSCI All Country World Ex-U.S. Small Cap Index down 14.38% in the fourth quarter while the MSCI Emerging Market Index declined 7.47%. International growth stocks trailed their value counterparts with the MSCI ACWI Ex-U.S. Growth Index down 12.20% for the quarter compared to a loss of 10.71% for the MSCI ACWI Ex-U.S. Value Index (Exhibit 1).

Exhibit 1: MSCI Growth vs Value Performance



Source: FactSet.

Those concerns were manifested in continued outflows from international equity funds and tax-loss selling after multiple years of gains for global equities. Negative sentiment has exacerbated the underperformance of international stocks compared to the U.S. but as we discuss below, such pessimism fails to discount solid fundamentals in most of the regions and markets we target.

China has been the world's growth engine for the last decade and the trajectory of its economy is perhaps the most important determinant dragging down international equity sentiment. Trade tensions with the U.S. have further raised scrutiny of the country, the policies of its government and the business practices of its companies. China reported year-over-year GDP growth of 6.5% in the third quarter, below expectations and its slowest rate since the global financial crisis, while its manufacturing sector contracted in December, falling to its lowest level in nearly three years.

Commodity prices also derated on growth slowdowns globally. Brent crude prices retreated more than 30% during the quarter as OPEC production cuts were not enough to offset a supply glut coming primarily from U.S. producers. Energy, an area the portfolio is underweight, was the worst-performing sector in the benchmark, declining 16.31%. Cyclical sectors tied to global growth have also been hurt by slowdown fears, with industrials, materials and consumer discretionary stocks as well as information technology (IT) all underperforming.

Financials performed in line for the quarter but have also been hampered by the macroeconomic environment. In the benchmark, banks considered systemically important financial institutions have performed extremely poorly. One of the primary reasons for this weakness has been tightening U.S. dollar (USD) liquidity coming from falling money growth.

Eurozone banks were strong performers in 2017 through early 2018 but were clear laggards for the remainder of the year and continue to face headwinds. The slowing European economy has lowered the likelihood of interest rate hikes and a steepening of the yield curve in 2019, and rates are expected to remain negative even into 2020. Given a flat yield curve, increasing net interest income will be challenging while slower GDP growth will dampen loan growth.

We further increased our underweight to EU banks in the fourth quarter. Our stock exchanges and insurance holdings have outperformed weak sector results. Positive contributors included India's HDFC Bank and Hong Kong Exchanges & Clearing, which benefited from elevated levels of volatility in Asian markets.

We continue to closely monitor credit spreads as a sign of health for the corporate sector and their influence on banks.

With low to negative interest rates and improving economic growth in recent years, the credit cycle has improved dramatically, resulting in very low default rates for an extended time. Renewed volatility in virtually every asset class has widened spreads on corporate credit and increased financing costs for corporations. The normalization of the credit cycle and more normalized loan provisions (i.e., higher) have weighed on the banking sector.

We have been in a global monetary regime unprecedented since the global financial crisis. The magnitude and breadth of quantitative easing (QE) certainly prevented more serious economic downturns, but now we equally have to cope with its unwinding. The U.S. has begun quantitative tightening along with interest rate rises; Europe has stopped further easing and Japan has become more selective in its policy measures. China remains the only large economy that is increasingly stimulating. Their slowdown in 2018 as they restricted monetary policy has caused them to swiftly reverse course over the last two quarters. We expect further stimulus, but these programs take time to filter through to the economy and we do not expect Chinese growth to reaccelerate until the middle of 2019.

After strong relative performance in the first three quarters of the year the portfolio was not immune to the broad selling in international equities during the quarter. Underperformance relative to the benchmark was due primarily to a lack of exposure to the defensive real estate and utilities sectors, areas of the market that lack the growth dynamics we seek in companies, as well as the derating of apparel retailer ASOS following a December profit warning.

With higher rates in the U.S. and a rising cost of capital, strong performance from small caps made them vulnerable to profit taking. German industrial machinery manufacturer Aumann, Irish video game tech services provider Keyword Studios and Japanese industrial staffing firm TechnoPro Holdings were all impacted. Mindful of valuation, we trimmed one of our emerging growth names, Chinese gaming and technology company Tencent, during the quarter.

Japanese stocks were hurt by a confluence of natural disasters that clouded economic data and domestic consumption measures. Domestic confidence, natural disasters and weather issues aside, employment trends, confidence and spending remain firm; unemployment is at a record low. While external demand is weakening, the government is working to keep the domestic economy moving ahead with infrastructure spending plans — the pending consumption tax hike is likely to keep domestic spending conditions in good shape for the first half of the year. However, natural disasters did impact tourist trends and spending, pulling down results for cosmetics and skincare maker Shiseido, the portfolio’s largest holding.

Portfolio Positioning

Despite a difficult performance environment, the fourth-quarter correction did offer opportunities to purchase quality growers at a discount. We increased the portfolio's exposure to secular growth stocks, companies with a consistent record of earnings and cash flow growth, with the addition of L'Oreal and Roche. L'Oreal, in the consumer staples sector, operates a much broader cosmetics portfolio than Shiseido with mass brands like Maybelline as well as premium lines like Lancome. The French firm is the largest and most profitable cosmetics maker globally with a solid record of accretive acquisitions and marketing that elevates regional brands into global ones while maintaining a strong cash position.

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Roche, in the health care sector, is a Swiss biopharmaceutical firm that had sold off on patent concerns of three key oncology drugs. While the patent concerns are known quantities, the company's new product pipeline is underappreciated. The purchase of Roche is part of an effort to increase our health care exposure as stocks have sold off and we continue to research new opportunities in the sector.

In addition to emerging growth and secular growth companies, we also target companies that are structurally changing their forward earnings profiles, relative to their recent history, and that we believe underestimate their growth prospects. Nintendo, in the communication services sector, was a fourth-quarter addition in our structural growth bucket. The video game maker introduced a new console last year, but the market has been pessimistic about its ability to keep up with its in-country competitor Sony. While the stock has lagged, we think Nintendo's growth is just starting to accelerate in hardware and software.

Being conscious of valuation, and remaining disciplined when stocks reach our price targets, is one of the key ways we manage risk in the portfolio. After selling and trimming several of our higher-risk or more expensive portfolio holdings that had run up in the first half of 2018, the recent correction provided a chance to revisit some areas and add to existing holdings like luxury goods group LVMH and financial software maker Temenos at more attractive prices.

Outlook

Given the experience during the global financial crisis and the length of the economic recovery, global markets are behaving like there is a recession ahead. We believe such sentiment overlooks a solid foundation in many regions and in many cases a lack of recovery to previous economic performance prior to the crisis. The strength of the dollar and the reduction of dollar liquidity by the Fed is certainly one reason for underperformance in emerging

markets, coupled with negative trade rhetoric. Europe's political headaches are lessening with Italy having worked out a budget compromise with the EU and Germany electing a new leader with a policy approach similar to that of Chancellor Angela Merkel. The wildcard in Europe remains the ultimate outcome of Brexit.

M1, a measure of global money supply, is at its lowest levels in some time, meaning a lot of cash is not where it needs to be. Companies in both Europe and Japan are cash rich with historically low leverage and we would like to see them put that capital to use in productive ways such as share buybacks or M&A. European companies have been revising earnings expectations upward, yet their equity markets are still down. Given the amount of cash on balance sheets, we believe earnings will be better than forecasts. We continue to be positioned in companies with pricing power and strong balance sheets that are oriented toward increasing shareholder returns.

As volatility has risen, investors have continued to sell out of emerging market and European-focused strategies in favor of the perceived safety of the U.S. But as we have discussed, non-U.S. markets have much more headroom for improvement across measures ranging from valuation to leverage to economic policy.

Portfolio Highlights

The ClearBridge International Growth Strategy underperformed the benchmark MSCI All Country World Ex-U.S. Index for the fourth quarter. The Strategy suffered losses across the nine sectors in which it was invested (out of 11 total), with the primary detractors coming from the industrials, IT and consumer discretionary sectors.

On a relative basis, overall stock selection and asset allocation detracted from performance. In particular, stock selection in the consumer discretionary, industrials, IT and communication services sectors and a lack of exposure to the real estate and utilities sectors hurt relative results. Stock selection in the financials and health care sectors and an underweight to the energy sector were the primary contributors to relative performance.

On a regional basis, stock selection in Europe Ex UK, Japan and the United Kingdom as well as an underweight to emerging markets weighed on results, while stock selection in North America had a positive impact.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Petrobras, HDFC Bank, Linde, Zai Lab and Rentokil. The greatest detractors from absolute returns included positions in ASOS, Shiseido, Suncor Energy, Erste Group Bank and SAP.

During the quarter, in addition to the names mentioned above, we added new positions in Amdocs and StoneCo in the IT sector, Arco

Platform in the consumer discretionary sector as well as Epiroc and IHS Markit in the industrials sector. The Strategy also closed several positions, including Bank of Nova Scotia and Intesa Sanpaolo in the financials sector, Petrobras in the energy sector, Covestro in the materials sector, Coco-Cola Bottlers Japan in the consumer staples sector and Yum China in the consumer discretionary sector.

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