ClearBridge Investments

Podcast: Finding Growth Across Global Markets

March 26, 2019

With International Growth and Global Growth Portfolio Managers Elisa Mazen (EM) and Michael Testorf (MT) and Investment Strategist Jeffrey Schulze, CFA (JS)

JS: Hello and welcome to the latest ClearBridge Podcast. This is Jeff Schulze, CFA, Investment Strategist at ClearBridge Investments. ClearBridge is a global equity manager with 125 billion in assets under management committed to delivering long term results through authentic active management. ClearBridge tailors our strategies to meet three primary client objectives in our areas of proven expertise – high active share, income solutions, and low volatility. We integrate ESG considerations into our fundamental research process across all strategies.

So ESG and global equities are popular investment topics currently and I'm pleased to be here today with two of my colleagues that can speak to both of these topics, Eliza Mazen, Head of the Global Growth Team and a Portfolio Manager in our Global and International Growth Strategies, and Michael Testorf, also a Portfolio Manager for our Global and International Growth Strategies. It's almost been a year since we've talked global and international equity investing and with so much happening with the EU, obviously the UK has Brexit's new developments coming out on a daily basis and ongoing talks with trade wars with China, I think we're going to have a lot to catch up with, but thanks for being back in the studio with me.

EM: Well, we're delighted to be here. Thanks, Jeff.

MT: Thanks, Jeff.

JS: How quickly a year goes. (Laughter)

EM: Absolutely.

JS: And the topic of today's podcast is Finding Growth Across Global Markets. We'd love to get your feedback about topics we cover and how we can make our podcast better, so you can contact us with questions, comments, and suggestions by emailing us at podcast@clearbridge.com. So, it's been an interesting three months. I think if you would have asked ten investors back in the Christmas Eve lows what was likely to transpire on Q1 I think you would have gotten nine bearish answers and maybe one bullish answer. I'm glad to say that we were part of the bullish camp, but obviously equity markets have moved up quite a bit both here in the US and internationally. We are seeing some signs of weakness from the economic front.

For example, if you look at GDP Now which is a real time now caster of economic activity here in the US, they're projecting 1.2 percent GDP growth this quarter and then you are seeing some weakness with some of the European data. One of the reasons we had a selloff Friday was, not only did the yield curve invert, but also you had a really weak German PMI number that was close to the lows that we saw in the European debt crisis of 2012. So, what are these mixed signals telling us? Are the equity markets right? Is the economic data right? What's going on?

EM: Well, it's very clear that the market is confused about directionally what's going on based on the economic data that's been coming and has been coming out generally weaker. So, what are the reasons behind why that happened? So, trade disputes that really started from the US with China and other parts of the world, including Europe, have depressed manufacturing expectations and surveys, and then certainly have depressed people's view on any sort of global growth that's driven by trade.

JS: Especially business. You know, if you look at any CEO confidence survey, even though the consumer surveys have bounced.

EM: Correct.

JS: You haven't seen it on the other side.

EM: That's right. Certainly, if you were a more manufacturing forward CEO you will have sort of less good things to say about sort of what's going in your world. One of the things we've seen is rising input costs certainly starting with higher commodity, higher energy prices, but also wages. We've seen very good wage growth around the world. That's also kept a lid on earnings and I think it's really stoked a lot of fear about margin compressions. However, we think that's generally pretty unlikely.

We've also seen FX headwinds rolling through many of the European companies, and frankly, that has depressed what we think is pretty decent sort of constant currency growth. So that should start to roll off by sort of the next quarter and in the back half of the year we think that will have people feeling a little bit better about some of the things going on in Europe.

Frankly, what we think is that higher PPI prices should lead to rising prices, although it will come with a lag, and that pricing power should reassert itself. Frankly, a lot of the things that Michael and I are hearing about is about price increases that will be going through.

JS: They can pass it along to the consumer.

EM: That's right.

JS: Not compress their margins.

EM: So, we do think we'll see better topline performance, along with better operating performance as sort of those price increases go through and we think that'll be throughout the year.

JS: And isn't Europe, they have a lot of operational leverage, generally speaking, as the different indices? Which means every dollar of revenue will have a disproportionate effect on their earnings because they have a lot of high fixed costs.

EM: Yes, they also have a lot of earnings coming from emerging markets and from places outside. So again, we think as emerging markets get to be a little bit better, a little less depressed, again, that should flow through to European earnings which still, and I think we probably talked about this the last time I was here, are still at depressed levels to peak earnings.

JS: An interesting factoid. If you look at the revenues derived from emerging markets in Europe, it's about 18 percent.

EM: Right.

JS: Here in the US it's eight percent. So, they have two-and-a-half times more exposure to EM than we do here domestically.

EM: That's right. The other thing we see is that lower yields around the world will provide leverage companies with some more breathing room. And companies will look, we see, are looking to bolster their organic growth rates and have now continued access to very attractive rates and financing. One of the things that we always watch are the high yield markets for signs of stress and that has been up and down, frankly. It was up in the fourth quarter and that was, I think, a lot of the reason why markets were selling off. There were worries about whether the high yield market was going to continue to sort of see higher rates or not.

JS: Sure.

EM: And whether LBOs and all these other things were going to continue to happen, but frankly, what we've seen with central banks continuing to ease is that the high yield markets look to be pretty good and spreads are compressed.

JS: And if you look at our dashboard here in the US, spreads turned from green to yellow and now they're back to green. As you mentioned, the credit markets aren't really too worried at this point.

EM: That's right. One of the things we saw with the Chinese stimulus last year was that it seems that they went, frankly, just a little bit too far.

JS: With stimulus or deleveraging?

EM: With deleveraging. Sorry. Yes, with deleveraging. So, they really were very interested in containing systemic risk around the marketplace, so they really cramped down on financing, on bank financing, etcetera.

JS: Shadow banking.

EM: Shadow banking, all of those things. And frankly, that really did have an impact on the market and I think there was a realization that they had gone a bit too far. So now what we're seeing is that there are other policy measures that they're utilizing such as VAT, tax reductions, which are stimulating growth, stimulating consumption. We see good wage growth. We see a lot of still very positive signs coming out of that market.

The other thing is Japan. Japan last year was also a strange year. You had earthquakes, you had typhoons, and then, of course, you had negative headlines coming from Chinese tourist trade which had been meaningfully important to much of the consumer spending data that we saw in Japan.

JS: Of course.

EM: And so, there was a lot of concern as the Chinese were putting in a new e-commerce law in the beginning of January. Sales fell. The market started getting very concerned, but frankly, we're starting to see signs of that reverse and consumer spending coming from Chinese tourism continues to be generally robust.

JS: Yes, I think that's good to hear. There are a lot of concerns that global growth is going to continue to deteriorate. I think sovereign bond markets are showing that that's what their expectation is. It's not the first time that you've seen this divergence. If you think about 2016.

EM: Correct.

JS: Equity markets, credit markets continue to heal. The sovereign bond markets inevitably had it wrong and confirmed the sign in June. So, I think that's probably the situation that we're in today. Kind of thinking about the overhang though about the international space, you've got to think about geopolitics. Right? They continue to influence sentiment in Europe and in China. Michael, can you catch us up on maybe some of the developments on this front? The first thing that comes to my mind is the Brexit saga. I think we had a vote today and we'll have a vote tomorrow.

MT: We'll have a vote tomorrow, yes. (Laughter) It is a definitely very messy, and hopefully, ending soon Brexit saga. So honestly, I cannot even hold back my frustration and disappointments about the mess Prime Minister Theresa May and the Parliament have created for the English people, for the economy, and also for the standing of the United Kingdom, to be honest.

But it looks like we will get a solution one way or the other within the next two weeks because that would be the end of the deadline. Tomorrow, meaning Wednesday, the Parliament is meeting and will decide what kind of option the Parliament can get actually a majority in. So, I believe that a hard Brexit is unlikely because the Parliament already voted a kind of, they voted to avoid it. Right?

JS: (Overlap) Yes, they voted to stay.

MT: So, the other part is that general elections, will that happen? I think it will be, currently, also less likely because the Conservatives could lose certain strengths in the Parliament. So, what we are left with

which are higher probability versions, one is acceptance of the existing deal, although it failed already twice, by the way. But May has to win several Parliament PMs over from the DOP or from the Labor Party, or both together better.

It looks very difficult as of today, but the alternative is a hard Brexit. So once Wednesday will pass, meaning tomorrow, and there's no real majority being found for the other solutions, some PMs could actually agree on Theresa May's deal. The second option would be a second option would be a second referendum. That would mean that the extension would be pushed outward by many, many months to go.

JS: And that would be, essentially, a second Brexit vote.

MT: Yes, exactly, that's what we have done three years ago almost. Right? And we would redo the entire Brexit vote again with the big difference now that the people are definitely more educated about what Brexit actually means.

JS: And what the implications are.

MT: And what the implications are. So, the third one would be revoking Article 50 altogether. That means the last three years of uncertainty and pain would have been for nothing.

JS: And they stay in the Union.

MT: And they stay in the Union.

JS: Like it never happened.

MT: Everything stays, and they pay, and they vote as nothing would have happened. Our exposure in the portfolio is relatively minimal to the UK, and particular to the domestic UK industry.

JS: Because they've been beaten up throughout this entire process.

MT: They have been beaten up, but some of the jobs, I think, which got lost out of London in particular might not actually come back that quickly.

JS: Okay.

MT: If they were revoking the Article 50.

JS: Now, with the Brexit process they would like to have some sort of resolution before the upcoming European elections, right?

MT: Absolutely.

JS: Which are, I think, in May of this year?

MT: Yes, April 23rd. And just a few words of how the European election would look like. Assuming that the UK is not voting, we will get a little bit around 700 seats. Seventy percent are projected to stay with the established parties and 30 percent roughly with the right and leftwing Populist Parties. Most of the people are worried about the Populist Parties which, as I said, have 30 percent. The good thing in a way is that the rightwing and the leftwing, they don't like each other. It's very unlikely that they could form a coalition one way or the other.

So, with high probability we stay with the existing established parties which also means lower risk for the market. And the only little drawback is that it will take a little bit longer because we have to find coalitions and with a more fragmented Parliament it would be more difficult to find coalitions.

JS: Now, do you think if you can get over these two hurdles, i.e. Brexit and the upcoming European elections, that could attract investors that have shied away from that area from a Populist perspective?

MT: I think currently the European elections, not that many people would think about it because I think it's less risk to the market currently. Brexit definitely would push the market up if we find a resolution besides a hard Brexit, of course.

The other risk where people will talk about is Italy. I think is my long-term risk, not a short-term risk,

but a long-term risk. Because the Italian economy is the fifth largest and is a big economy which has a lot of debt and is the only economy actually in Europe which hasn't done any kind of reforms in the past. Every single other country, more or less, have done some reforms.

JS: Labor reforms make themselves more competitive.

MT: Particularly labor and pension reforms.

JS: Okay.

MT: Even Greece, right, after the whole crisis, started with reforms. So that means that actually the Italian economy in the long term would be less competitive, and the pressure will be higher.

JS: And they're stuck in the euro, so they can't devalue like they've traditionally done.

MT: That's exactly what it is. So, there's no maneuvering room in case we go into a recession because the debt levels are high. They're on the euro, there's no devaluation chance. So that is where I could see a long-term risk. And besides that, I do expect new elections coming this year because the two Populist parties which are governed right now will separate. Because the leftwing Populist Party is losing ground in every single regional election.

And I do expect that Salvini, which is the rightwing party of the Populist, will form a new coalition, probably less radical than they were before. And that could be slightly positive at least in the short term.

JS: Well, thinking about elections and appointments. One that's been on my mind as a strategist has been Draghi's successor. Right? We're going to get a new ECB President at the end of this year.

The ECB, I think, did what they could in light of not trying to handcuff the successor into a policy decision. They're planning to keep rates lower for longer. They pushed them out to the end of the year. We also have China that continues to aggressively stimulate. So Eliza, since the central banks on average are getting a little bit more dovish, what does this do to equities? Is this going to be a long term positive? Is this why equities have been rallying?

EM: Well, I certainly think that this is why growth equities are rallying. So, when it looks like the economy is starting to moderate a little bit it's a little bit tougher for more value driven strategies, but it does actually do good things for growth investors where people are looking to see rising topline in earnings. Certainly, rising rates are something that we spend a lot of time thinking about.

We are intrinsic value investors and so cost of capital is always a concern for us and when you see rapidly rising rate environments that can be a very difficult period of time for growth stocks. We don't expect that to be the case this year or next and we're relatively optimistic about the prospect for growth stocks. China's spending has been good, and we see signs that that spending is broadening out into consumer discretionary in the staples areas. Auto sales which in absolute terms are quite a large component of discretionary spending are likely to stall or even decline as the market shifts in China to electric vehicles and that significant component of consumption is being spent elsewhere.

One of the things that's interesting when you look at the data is how large auto spending is within China. It's a very large proportion of consumer discretionary. So, we think that that part of the market is probably going to stabilize at pretty high levels, maybe even decline a little bit, but what we're seeing is in areas like furniture, apparel, sporting goods and apparel, cosmetics, appliances, those areas are actually starting to grow.

Again, as I referenced earlier with rising wage growth, that's a positive for consumption. Lower interest rates are also good for M&A activity and this is something that's been very strong globally. If you look at Scadden Arps, they did an interesting piece on M&A and what they talk about is how large M&A has been for 2018. We've seen $3.5 trillion worth of deals globally in 2018.

JS: Three-and-a-half trillion?

EM: Three-and-a-half trillion.

JS: Wow.

EM: It's not an absolute record, but it's up with very high levels that we've seen in the past in, I believe it was '07 and 2017, 1.5 trillion of that was the US. So still predominantly much of it was done outside of the US. We've seen a number of mega deals. Thirty-six deals were mega size. That's ten billion and up in market cap. And what's interesting is they're really being done for very strategic reasons.

So, people looking to augment their existing businesses grow inorganically. Whereas, if you have an economy where maybe organic growth is a little bit tough, you look for new geographical opportunities, you look for new verticals of growth, and that's something that you've been seeing. Those numbers certainly are pretty powerful.

JS: Now, I know that your team likes to navigate through difficult conditions by embracing what you call "the spectrum of growth." Secular, structural, and emerging growth stories. How does this approach help in the current environment? I know we've obviously seen a very stark difference in quarterly performance. Obviously, Q4 was a tough quarter, Q1 has been a very risk young(?) quarter. How does that come into play for the overall portfolio?

EM: Sure. Well, the spectrum of growth approach is one, we believe, keeps us in good shape on risk and provides lower overall volatility relative to many other growth managers providing broad opportunities to access growth in all of its forms. So, we really believe that growth is not a one size fits all approach and we want to have a very modest approach to the portfolio when it comes to risk. So, we take a valuation approach to understand different types of growth stocks and we build a portfolio around stock picking and controlled risk. When we think about risk, our portfolios are designed for volatility that's more aligned with our core benchmarks but have growth characteristics.

So how do we think about that? We bracket our portfolio around three groups. We call it emerging, secular, and structural, and we diversify the portfolio around those three areas. On an overall level we look at what are the min/max of those particular sectors, but also within sectors as well. We don't want to have a technology sector which is full of emerging growth stories which are really interesting, but we also know that they are pretty risky as well.

JS: Well, they give you a lot of volatility.

EM: That's right.

JS: And perform very differently in those two environments that we just talked about.

EM: Absolutely. So, among those three groups, I'll just quickly maybe run through the weightings for people that aren't familiar with our process. So emerging growth is that very high topline growth. These companies are disruptors. They're usually a bit risky. They can also be small cap. So, we will go up to 20 percent of our portfolio in that group.

We keep this weight in check primarily, so it doesn't upend portfolio volatility and performance. Secular growth is always the largest component of the portfolio at 40 to 60 percent and it really provides that portfolio ballast to end lower volatility, yet it still does deliver above market growth. These are large cap companies, steady Eddy compounders, very good business models. They grow above the market on the topline and above the market on an earnings basis.

JS: And I would imagine these types of companies do extremely well in this low growth type of environment.

EM: They have done very well, especially in a down market. So, the down-market capture of those stocks is very good. They really held up very well for us in the fourth quarter.

A bit different is something that we do. We call it structural growth which is sort of the residual of those groupings, 20 to 40 percent. These are companies where we see a future growth path that is markedly different from what recent experience has been. There may be a cyclical component to it. It may be self-help stories, industry consolidation, or it could be a biotech company with a binary income. So, we group all of those very different types of ideas into structural growth and that really does help us provide a really diverse set of ideas in the portfolio and helps differentiate the approach

we have to growth.

In terms of how we're positioning sort of over the past few years, I'd say we've gradually increased our emerging growth stories. Now that means we've gone from, let's say, four or five percent to now eight percent. So, we're not really going sort of off the rails here, but it's something that we're really intrigued by because there's been a lot of very new ideas. There have been some IPOs that we've gotten some seasoning in new businesses that we haven't seen before. So, we're really excited about these companies' long-term growth prospects and we think that this is really going to give the portfolio a nice uplift.

MT: Perhaps, Jeff, one thing which I wanted to add on money supply and central bank policy. So, China in particular, you know, China had a really rough 2018, as we all know, but they have started to introduce stimulus already within '18. And the stimulus is really, really sizable. So, if you were to quantify that as a percentage of GDP, some people calculated actually it would be around 2.8 percent. That's a big, big number. Right?

JS: (Overlap) That's a big number. That's way bigger than the Tax Cuts and Jobs Act that we had here in the US.

MT: Absolutely. And this time the stimulus is not targeting the fixed asset investments which we had like in 2015 and 2016 where all the money went into motorways, and airports, and railways, and all that kind of stuff.

JS: (Overlap) Ghost cities. (Laughs)

MT: Right, exactly, ghost cities. This time, as Eliza said, it was very much targeted to the consumer, to the state-owned enterprises, as well as to the private companies. That comes via tax cuts and lending facilities, but until now we have the consumer has reacted on it or held up very well. But the manufacturing sector …

JS: Services PMI have actually been up over the last couple of months.

EM: That's right.

MT: That's right.

JS: A big divergence than what you're seeing in manufacturing.

EM: And that's not just in China, that's also in Europe as well.

MT: Yes.

JS: Right.

MT: Right. And that is also due to good employment numbers in Europe as well as in China. Or stable employment numbers. The problem child actually in China was the manufacturing sector, as we said before. That is actually because there was not a lot of money supply. Because 2018, the Chinese government declared actually war on the shadow banking system. And the shadow banking system is also one of the ones which supplies liquidity to the overall market.

And besides that, '17 and early '18, the central bank was restrictive and cut the reserve requirements for the banks. Meaning it was more difficult for the banks to lend, which has changed in the middle of 2018. Reserve requirements were lowered again. Meaning banks could easily lend money to institutions.

JS: Lock up some of that capital.

MT: Exactly.

JS: Unlock, I should say.

MT: And what has happened, I mean, until now and really not that much happened until December, but the first positive data which we have seen in lending was in January and in February, which is definitely a positive sign. And also, when you look at the shadow banking system which has declined, if you look

at the trust business, overall AUM have declined double digits in 2018. So since beginning 2019 we see the first little growth. So, will that translated into M1/M2 money supply numbers being positive? I think, yes, but it will just take a little bit of time until it shows.

JS: And there's been a clear change of policy. Right? The President and the Premier both have said that deleveraging is over. They think they've snuffed out a lot of this bad debt already so change of policy should translate to better lending numbers and better economic growth, broadly speaking.

One thing that they've been reluctant to do is to stimulate the property markets. Obviously, their property markets have been on fire for the last ten years, which is a good sign, I think, for the long-term stability of China. Now, I want to switch gears here for just a second and talk about something that we talked about in the last podcast. I'm going to do a shameless promotion of the last podcast.

We talked about ESG and the Impact Report that we recently came out with talking about the engagements and success that we've had with instituting change at a company level, but interest in ESG has been growing not only here in the US, but it's more of a global phenomena. How do you as international managers integrate ESG into the stock selection process and how is that beneficial at the end of the day to our clients?

EM: Well, in order to understand our companies and the risks in their business, as well as their opportunities, frankly, we need to, of course, have a view about their ESG approach. It would really be very incomplete not to consider their environmental, social, and governance, the operating environments, and the attributes of all those things. So, we incorporate looking at those factors, not just as a risk mitigator, but also, we find it really does give us greater insights into how the companies really function from the CIO to the entry level employee.

It's probably fairly obvious to say that you don't want to invest in a company with poor governance. Okay, that is pretty obvious, but that's, frankly, not where it ends. Understanding the social, the environmental aspects of our companies, understanding the relevance of each of those areas, it really does give us a better confidence in management ideals. How well that's incorporated across the organization, we believe it provides better financial performance as well.

We understand that ESG for many companies, and frankly, many economies is still at an early stage, rather than the more developed markets in Europe and the US. However, our shows that companies that start with an appreciation of ESG standards and then work to continuously improve those standards will show meaningful financial performance as a result of that.

JS: Okay.

EM: So, it's not ESG yes or no, it's where are you in the continuum, how much are you really embracing that philosophically, is that information really well understood at all levels of your organization? And then the really high quality ESG companies are actually quantifying what does ESG actually mean for them in terms of financial performance?

JS: Like is it lip service or are you actually implementing this at your core?

EM: (Overlap) That's right. That's right.

JS: Now, do you have any company examples that you can share with us?

EM: As a matter of fact, I do. (Laughter) So one of the things that we do at ClearBridge is we engage with our companies specifically about their ESG programs. And this, I think, sort of brings to light why we think this is important.

So, a really good example for us is a company that we own in the international portfolios and global portfolios which is called Burberry. It's a luxury manufacturer and retailer of handbags, apparel. Their signature product is the Burberry trench coat which was something that was actually invented to go and fight wars in World War I.

JS: Very interesting.

EM: That's where the Burberry trench coat actually came from. So, when we first evaluated the company in

many areas Burberry was far ahead of its luxury peers in terms of things like environmental standards, but we had identified three shortfalls in the company which really prevented us from rating it higher. Employee satisfaction and compensation, there were no specific initiatives on that.

Management compensation was also well ahead of peers and there was really a lack of alignment of compensation around shareholder interests. So, the areas for improvement were acknowledge by their internal reviews, specifically a lot of their retail operations. Employee morale was low. There was a lot of turnover at the C suite. They had a Creative Director that had been there for a long time. He had left. So, there was really a very demoralized workforce.

So, we engaged with the company and their ESG team, and frankly, what they did was … new senior management came in and they really did a 360-degree review of the issues around employees, morale, training, communication coming from senior management. What were the ideas? They put new training programs into place. They've invested in the management of their teams. There is better communication coming from the CEO and it's a constant sort of iterative process from the retail employee to senior management.

They do employee surveys. They have really incorporated a lot of the results of those surveys in their ESG results and that's something we think as being impactful to employee morale. So, their retail performance had been mediocre relative to their peer set. And so, we really believed that an engaged employee at the retail level was going to be vital to delivering new sales from their new Creative Director. The new Creative Director is actually launching his new collections now. So please, everyone, go buy Burberry. (Laughter)

We think that this is something that is getting a lot of brand interest and having an engaged employee at the retail level will allow for better sales, we think, in the stores, and of course, online and so on. So, it's something that we think is very important to understand sort of top to bottom all the issues around ESG that were meaningful, which were a little a bit different than what are the numbers.

JS: I love company-specific examples. Do you have any others that maybe you can share with the listeners?

MT: Sure. From my side, I mean, we do this kind of engagement once a year as a minimum or whenever it is needed, or certain things are happening within a company. So, my latest one was a bank actually. It's called Astor(?) Bank. It's a retail bank located in Austria, but the main business is actually outside of Austria in Eastern Europe. So basically, the countries which are bordering Austria. We go through all the environmental, social, and the governance aspects of the business.

Most important for banks in general is actually governance. And if you look at what happened to the bank in the banking crisis 2008/2009, there was definitely failure on the governance part. Meaning here in particular the problem was that there were so many loans going bad and that means that the Risk Officer definitely had problems in overseeing the loan portfolio correctly.

JS: Sure.

MT: So, we spent quite some time on it and the bank has introduced a lot of checks and balances for the Chief Risk Officer, for the CFO, and for the board to be involved in these kinds of reviews of loans. So, by having introduced that we could expect that loans going bad going forward should be, also with the early warning system which they have introduced over the last years, should actually improve.

Besides that, we look into environmental, and environmental for the banks, I mean the CO2 footprint and all kind of environmental aspects are not as important, but nevertheless, we check on every single little thing. And we had also the CO2 footprint being discussed last time. And here it's more about using of electric vehicles which we have talked about and that we had more company cars being used for electric vehicles and carpooling, also electric, and the chargers were like tripled over that time.

On the social side, we have engaged in. Definitely, it's very important to keep the employees because overall in Eastern Europe to get new employees onboard is very, very difficult and to keep them is also very difficult because wages are increasing very quickly, and people like to jump.

JS: We wish we had that problem here in the US. (Laughter)

MT: Yes. So, retention is very, very important. And also, we have seen some improvements which were made in '17. Eighteen numbers were not out when we made that call, but I assume they look good. And they made also a major push on gender diversity and equality, and they have introduced multiple, multiple things. There was an "Ask the Woman" hub(?). There was a special mentoring for women. There was a campus for young, young schoolchildren for IT purposes, and so on. I mean, we're definitely on the right track for Astor Bank.

JS: And the last question I think I have for you here is investor sentiment towards international stocks may be at pretty low levels. Obviously, the US has outperformed for a long period of time. Europe, China, and Japan, there's a perception that there's a lot of risk there. So, what is it going to take in order for sentiment to finally switch to be a little bit more constructive and positive?

MT: So one, for sure, is positioning. Right? I mean, the last time when we had extreme positionings was in 2016 where everybody was position towards US assets. That means US equity, US bond, US currency. Right? So, what happened in 2009, 2017 we had just a reversal of the whole thing. Right? So international markets did well, currency did well, and bonds were a different issue. So that would be one. There's a contrarian positioning which could yield benefits for international markets.

The second one where I do say, of course, if these big micro uncertainties are disappearing like Brexit, US/China trade talks, even US/European trade talks, if they come to a conclusion, that would definitely help. And then thirdly, what I always look at is currency. As I said, everybody's positioned along US dollar.

JS: And that's part of your total return, right?

MT: Exactly. Very important actually. 2017 was a major part of our return. So, what I would expect for most of the currency, actually, that should be or could be tailwind or at least being neutral for 2019. Right now, we have record interest rate differential between US and German bonds, for example, long term and kind of short term as well.

So, at one point they have to narrow and that would be, clearly, US bearish, Europe or Euro bullish. And then we have, of course, the Fed which kept the US interest rates flat or on hold. This is definitely bullish for emerging market equities and emerging market currencies.

JS: And I think the dollar versus EM currencies have stabilized over the last four months. Right?

MT: That's right and in some cases actually improved in favor of the emerging markets. And the other one, clearly, is the further we go into 2019, the better the comparison on a year-on-year basis becomes on the economic data. Because the trade war data affected already the later part of 2018.

JS: Sure.

MT: So, on a year-on-year comparison we see improvements and I think that will be positively reviewed by investors.

JS: Let's not forget the US is going to have some pretty tough comps after a very robust '18 from the earnings boost from the one-time tax cuts.

EM: That's right. That's right. If you look at earnings growth expectations or at least consensus expectations, what you see is the US actually being at the lowest end for 2019. It goes up a little bit in 2020, but certainly Europe, UK, many other markets are certainly well ahead of US earnings. One of the things that we like actually is low expectations. So why do we like low expectations? Frankly, because generally you also get attractive valuations.

JS: It's priced in. (Laughs)

EM: That's right. If you get attractive valuations and you can have a differentiated point of view as to what's going to happen then you get significant upside, we think, relative to consensus. So, we think actually when we look at our European stocks we actually feel very good about that. We do see progress in the labor markets. We do see unemployment continuing to come down.

Wage growth is still very good. All of those things we think bode well, frankly, for consumption. We know that manufacturing, certainly led by auto, is a bit challenging, but there are a number of other, we think, very interesting areas that we can avail ourselves of outside of the auto space and we think that those will continue to perform. We know that banking is tough. Michael is nodding his head there.

JS: And negative interest rates?

EM: Yes, negative interest rates are not really good for banking and we're not particularly positioned there, but we are positioned in places that we think will continue to grow even in a very low growth environment. Discretionary, staples, and technology.

Outsourcing is a theme and something that we see around the world. Technology is really changing how companies really think about outsourcing, either insourcing sort of certain software, etcetera. So, there are many, many, we think, very interesting growth stories that are really overlooked by sort of this very depressed macro view. We say it's always about stock picking, it's not about necessarily the economic environment. As long as we're not in a very negative environment, which we don't think we are, we think that we're very well positioned in terms of growth.

JS: And I, obviously, think the economic environment will certainly help. If global growth is troughing sometime over the next couple of quarters a pick-up internationally should lend itself to better equity returns. Something that the listeners should probably be aware of is that when you look at US versus international outperformance or underperformance, when one leads, it tends to lead anywhere from three to 12 years.

EM: Right.

JS: Then the pendulum swings back to the other direction and then the other takes leadership for a prolonged period of time. And the US has been leading the international space for the last 11 years since 2007. So, is 2019 going to be the year where that pendulum swings back to the other direction? Maybe a peaking dollar, the Chinese stimulus that we've talked about, and attractive valuations, is that combination that finally does vindicate the international space? Well, Eliza, Michael, thank you so much for joining me in the booth here today.

EM: Thank you for having us.

MT: Thank you, Jeff.

JS: I look forward to having you back in the booth next year. And we hope that you'll continue to join us, listeners, throughout 2019, and welcome any questions, comments, and suggestions. Again, you can email us at podcast@clearbridge.com. Thanks again for joining in.

About the Speakers

Elisa Mazen
Managing Director, Head of Global Growth, Portfolio Manager
- 33 years of investment industry experience
- Joined a predecessor organization in 2008
- BA in Economics and Finance from Douglass College, Rutgers University

Michael Testorf, CFA
Managing Director, Portfolio Manager
- 32 years of investment industry experience
- Joined ClearBridge in 2015
- BA in Business and Economics from the Wirtschaftsakademie Hamburg (Academy of Business and Administration), Hamburg, Germany

Jeffrey Schulze, CFA
Director, Investment Strategist
- 13 years of investment industry experience
- Joined ClearBridge Investments in 2014
- Member of the CFA Institute
- Frequently quoted in the financial media, including the Wall Street Journal, CNBC and CNN
- Lord Abbett & Co., LLC - Portfolio Specialist
- BS in Finance from Rutgers University

Past performance is no guarantee of future results.