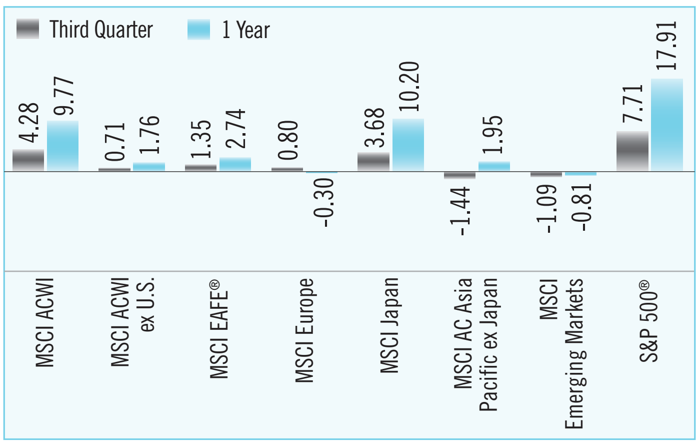
Proceed with Caution

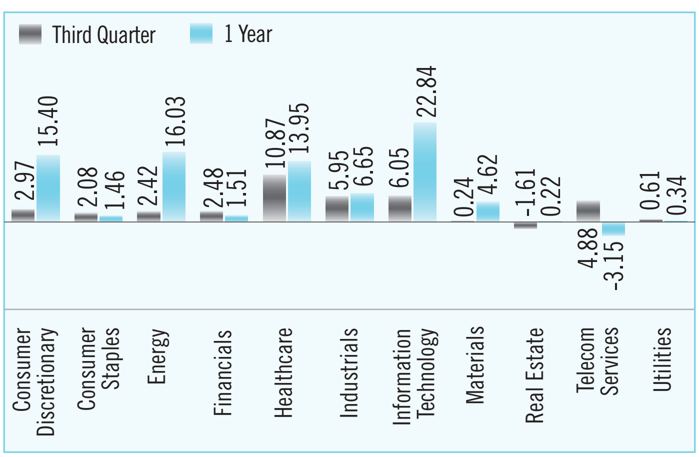
Despite rising macroeconomic and geopolitical risks stemming from different corners of the earth, global equities, as measured by the MSCI All Country World Index (ACWI), returned 4.28% for the third quarter of 2018. Developed market equities proved more resilient than those in emerging markets, with the U.S. leading the pack by a wide margin. As we look around the world, global GDP growth continues to show momentum, but we are cautious about its staying power in a number of countries.

GLOBAL MARKETS PERFORMANCE (%)
as of September 30, 2018



Source: Vontobel Asset Management, citing data obtained from FactSet, MSCI, and Standard & Poor's. Index definitions are found on page 2. Expressed in U.S. dollars. **Past performance is not indicative of future results.**

MSCI ALL COUNTRY WORLD SECTOR PERFORMANCE (%)
as of September 30, 2018



Source: Vontobel Asset Management, citing data obtained from FactSet and MSCI. Net returns, expressed in U.S. dollars. **Past performance is not indicative of future results.**

LATE-CYCLE CHALLENGES AHEAD IN THE U.S.

The U.S. is riding out the longest bull market in recent history, and there are some late-cycle challenges ahead. With the economy working close to full capacity, the Federal Reserve is in the process of hiking rates to contain inflationary pressures. The balancing act is well underway. If the Fed removes accommodation too slowly, then inflation can accelerate too rapidly. But if the Fed tightens policy too quickly, the economy could dip into recession. This could put pressure on the Trump administration to back off the trade war with China and lighten up on tariffs.

While China's economy is still generating 6%-plus GDP growth, the authorities have taken measures to loosen their previous plans of debt reduction. China's leaders clearly are not keen on the prospects of a full-on trade war. The Chinese Communist Party, like the Trump administration, also has its stakeholders and it does not want the public to panic and sell equities or investment properties. Although we have not seen indications of this alarm on the part of the public, the odds of a sudden slowdown by the world's two largest economies continues to rise.

EUROPE: DIVERGING ECONOMIC PATHS

There is uncertainty across the Atlantic. Brexit remains a risk, with speculation over the final outcome ranging from a hard Brexit to no Brexit at all (if one is to believe recent reports of there being a second referendum). Furthermore, the opposition Labour Party is discussing a transfer of 10% of public companies' ownership to workers should they gain power. This is something we are watching, even though the likelihood of the Labour Party gaining power is decreasing. Predictability on rules, regulations, and even ownership, is diminishing.

While no single issue is responsible for Brexit, immigration is a major driver that has given rise to nationalists and populists elsewhere, the most serious instance being in Italy. Italy has high debt levels and a weak banking system. While populists may have risen to power because of the immigration issue, once in power, they are expected to push against European bureaucrats to loosen the purse strings. We saw that in the government's recent proposal of a sharp increase in the fiscal deficit, which spooked the markets.

We also expect to see pushback against some of the moves at the European Central Bank (ECB). While the German economy is growing and has an unemployment rate of 3.4%, unemployment rates vary across the continent. For the euro area as a whole, unemployment is 8.2%. Italy at 10.4% actually looks reasonable when set alongside Spain at 15.1% and Greece at 19.1%. With the low unemployment in Germany and inflation beginning to reappear, the ultra-loose monetary policy that Europe has pursued is coming to an end. The ECB will be looking to raise rates, which is suitable for Germany, but not for Italy. And without fiscal transfers, the appropriate level of interest rates for the region is debatable. Structural reform of the European Union will likely continue at a snail's pace. And newly elected populists will not take well to outsiders tightening fiscal and monetary conditions.

NAVIGATING A BUMPY ROAD IN EMERGING MARKETS

An old adage asserts that a successful stock picker has to be both a contrarian and an optimist. With emerging market (EM) equities plummeting this year, we have ample opportunity to be both. Where some see the end of a performance run in EM equities, we see the current climate as just another headwind in a decades-long pathway of growth.

For roughly a decade, emerging markets benefited broadly from low interest rates, low inflation, large flows of direct foreign investment, and, for a while, a boom in commodities. Now, higher U.S. interest rates have strengthened the dollar and triggered currency devaluations across the board. Where there is extreme economic or political dysfunction, currency declines have been particularly acute. And the highest oil price in four years, as measured by Brent crude, complicates the picture even more. What's more, global trade wars and contentious elections in places such as Brazil continued to produce dramatic headlines. Following a strong showing in 2017, and in contrast to a roaring U.S. market, emerging markets have got a case of the jitters.

We anticipate that the performance of more troubled frontier markets (where we have no exposure) will be isolated from, rather than lumped together with, the broader class of EM stocks. Until then, the baby is getting thrown out with the bathwater. We see fear in some markets leading to lower valuation multiples on quality companies despite expectations for continued earnings growth.

India and Indonesia are two countries where GDP is growing in the mid-to-high single digits. China's economy, despite a pullback by some of its largest technology companies this year after a strong 2017, is still generating 6%-plus GDP growth. Elections and trade war fears failed to dampen Mexico's growth trajectory. Even Brazil, with its scandal-plagued government and stymied reforms, managed to turn out positive GDP growth so far this year. It's also important to understand that the correction we've seen so far in 2018, in our view, is not emblematic of a major crisis, such as the Mexican peso crisis or the Asian Contagion of the 1990's.

QUALITY GROWTH: A PATIENT AND CONSISTENT APPROACH

Against this backdrop of rising risks, we believe that it is increasingly important to protect against economic turbulence. Quality growth companies, especially those that are less sensitive to GDP growth, should help protect investors in a downturn, as has been the case historically. We have sought to invest patiently and consistently in quality growth companies for more than 20 years, and do not plan to alter our approach. We were not drawn in by the cyclical rush of the past couple of years, and refrained from investing in oil companies in Russia and banks in China. Instead, our goal is to maintain a portfolio of companies with robust underlying earnings that can participate in a strong economy, but also offer fundamental protection during times of economic weakness.

Authored by:

The Vontobel Quality Growth Investment Team

Vontobel Asset Management believes that long-term, stable and superior earnings growth drives investment returns over time. We pursue this by seeking sensibly priced high quality companies that can grow earnings faster than the market on a sustainable basis.

Index definitions: MSCI All Country (AC) World measures equity performance of developed and emerging markets. **MSCI EAFE®** measures developed foreign market equity performance, excluding the U.S. and Canada. **MSCI Europe** measures equity market performance of Europe's developed markets. **MSCI Japan** measures performance of the Japanese market's large and mid-cap segments. **MSCI AC Asia Pacific ex Japan** measures equity market performance of Asia's developed and emerging markets (excluding Japan), Australia and New Zealand. **MSCI Emerging Markets** measures equity market performance in global emerging markets. **MSCI AC World ex US** measures equity performance of developed and emerging markets, excluding the U.S. **S&P 500®** measures performance of 500 of the largest U.S. companies. All indexes are free float-adjusted market cap-weighted and calculated on a total return basis with dividends reinvested.