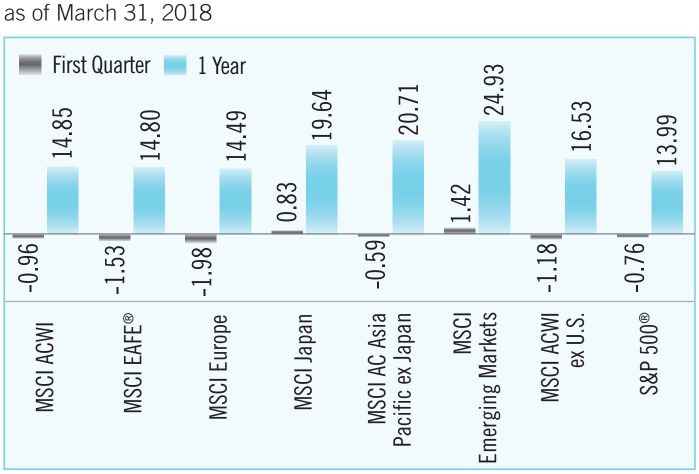
May You Live in Interesting Times

While the origin of this old Chinese curse may be uncertain, it does feel as if we live in such times. Economies around the world look strong on the surface and we are seeing synchronized growth, but we also see clouds on the horizon. Monetary policy in many countries has either started to normalize or will soon. Politics in many countries are reflecting a rise in nationalism and anti-globalization, and trade wars have become a distinct possibility. At the end of the first quarter of 2018, the markets started to recognize some of these issues and volatility increased. So, while from a business perspective the current economic backdrop is good, we are wary of what may lie ahead. Our view is that in strong markets, fundamental risks don't show, and fundamentals have not mattered much in the markets for a while. We feel this happy state is set to change and fundamental risks will become more apparent.

The U.S., under the Trump administration, is reversing many decades of foreign policy, and this has increased uncertainty around the world. Specifically on trade, the administration has targeted China, Canada, and Mexico. However, we wouldn't be shocked, based on the size of Germany's trade surplus, if Germany, too, will be in the crosshairs. If that happens, what would it mean for Europe? What concessions would have to be made in exchange for continued access to the U.S. consumer cash machine?

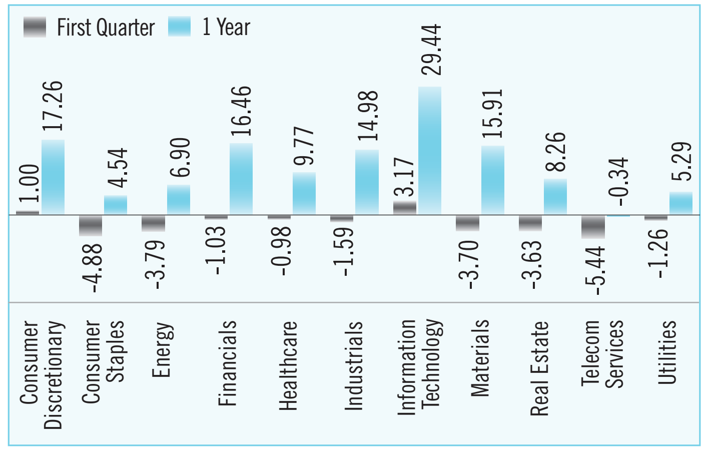
Energy is also starting to cause ripples in the world economy. Over the past quarter, higher energy prices have supported markets that are large exporters, such as Russia and Brazil. The offset effect on energy importers, such as China and India, has not yet been reflected in the markets. So far, we have not yet seen higher oil prices translate into less consumption of other goods, but it is something we are watching.

GLOBAL MARKETS PERFORMANCE (%)
as of March 31, 2018



Source: Vontobel Asset Management, citing data obtained from FactSet, MSCI, and Standard & Poor's. Index definitions are found on page 3. Expressed in U.S. dollars. **Past performance is not indicative of future results.**

MSCI ALL COUNTRY WORLD SECTOR PERFORMANCE (%)
as of March 31, 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.**

The current monetary policy tightening should not be a surprise. Reduced quantitative easing and increased interest rates after a decade of ultra-loose money are based on deflation worries disappearing, improvements in employment conditions, and inflation starting to appear. When inflation comes back, even active central banks cannot prevent an overshoot. And when that happens, it's important to be invested in companies that can handle inflationary times. For that, you need pricing power, which is one of the key attributes we look for in many of our businesses. Pricing power lets companies pass through increased costs and earn a satisfactory return, even in inflationary environments.

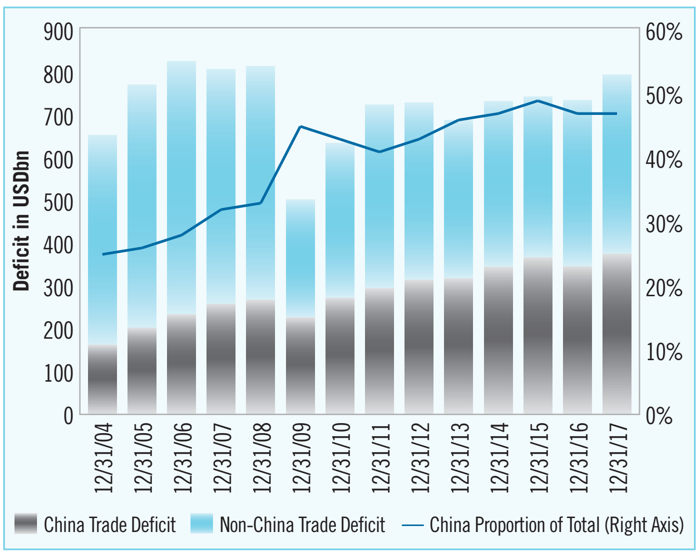
REBALANCING THE TRADE DEFICIT

While President Trump has been unpredictable in whom he likes, he has been consistent in his goals. We see him as following through on the pledges he made in his election campaign and looking to deliver a result…a deal. One of his big pledges on the trail was to rebalance the deficit with the goal of bringing jobs back to the U.S. He warmed up with a shot at two friendly neighbors, both running a surplus with the U.S., by shaking up the North American Free Trade Agreement (NAFTA). NAFTA negotiations have moved from an antagonistic start to what appears to be a smoother process headed towards an improved deal for the U.S., yet acceptable to Canada and Mexico. Next on the list is the U.S.'s giant trade deficit partner, China.

Negotiating for change against a strong partner who is comfortable with their position is unlikely to be done without both sides sensing risk to their current trade arrangements. Globalization has worked very well for some companies and poorly for others. Ultimately, while negotiations with China will be tougher than with Canada and Mexico, the U.S. holds strong cards. We look for the trajectory towards a deal to be jerky, but the end goal is an amicable future relationship with better terms for the U.S. Yes, there is a risk of no change and notable damage reaching that conclusion, but we see this as less likely—both partners have a lot to lose and China has not been straightforward. Challenges include Chinese firms slipping their deficit out of China with no benefit to the U.S. by moving production to other low-cost producing countries, such as Vietnam.

At the same time, however, the process of a trade tit-for-tat with China could lead to a number of negative effects for companies. The simple initial view is that U.S. companies that manufacture in China for export to the U.S., or U.S. consumer companies selling in China, are at risk of disruption. Over the past year, we have seen the Chinese authorities dramatically slowing the business of South Korean companies operating in China following a fallout over the Korean deployment of the THAAD anti-ballistic missile system. The Chinese authorities used a variety of tools to lever their view, including slowing the passing of goods through customs, closing stores through fire and safety checks, and actively encouraging tourists not to travel to South Korea.

U.S. TRADE DEFICIT – CHINA AND THE REST OF THE WORLD



Source: U.S. Census Bureau

WHERE WE SEE OPPORTUNITIES AMID VOLATILITY AND A NEW FOCUS ON RISK

Despite the recent volatile environment, we would remind investors of the many advantages of the U.S. equity market. It is well developed, deep, and wide, with an abundance of businesses that are diverse in terms of quality, valuation, and business exposure by operation and geography, including multinational exposure. And compared to some emerging and other international markets, the U.S. has clearer corporate governance standards and shareholder-friendly environments. We believe there are still many opportunities to be found in the U.S. In short, we think a dose of skepticism returning to the markets is a good thing. Valuations should be at one level in a positive or low-risk environment, but should shift to a lower level when uncertainty rises.

In Europe, analysts have downgraded their earnings estimates this year. That's partly related to the 15% appreciation of the euro versus the dollar in the first quarter. That won't help reported sales and earnings—or inflation. On the positive side of the political landscape, the Spanish government appears to have won the fight against the Catalan separatists, an outcome that reduces risk. And for the first time in a decade, France has brought its public budget deficit below the 3% limit mandated by the European Union. This should help give President Emmanuel Macron credibility as he helps steer the EU forward. Britain and Italy are more of a mixed bag. In grappling with Brexit, the U.K. is making progress in some areas only to find new issues popping up elsewhere. Uncertainty would not be good for long-term investments in the U.K. The Italian election, meanwhile, was indecisive. From the standpoints of both business and European-wide stability, we do not expect major changes.

We continually seek to hold quality growth companies, or rotate into good trade-offs, if we believe the market is offering a fair price for a company's future profits. We are bottom-up stock pickers so the state of the macro environment is less important. However, regulatory and political stability matters in order for companies to operate consistently. In China, for example, we remain holders of e-commerce companies Alibaba and Tencent. If the Chinese financial market were to experience turmoil, the government may need to step in to stabilize. And even in that hypothetical scenario, we expect that Chinese consumers will still use Alibaba's Tmall to shop online, as e-commerce is increasingly penetrating lower-tier cities and rural areas.

In India, we continue to see stable growth opportunities for our holdings, although with inflation inching up we see a fork in the road ahead: either stable 7% growth with further reforms or slower growth until some of the country's myriad of regulation and distribution bottlenecks are widened.

Across Latin America, we see optimism helped by the recent rise in commodity prices. We remain confident in Brazil's medium-term outlook, despite the politics and need for pension reform.

And, like much of the rest of the world, we are watching South Africa with great interest. We believe a number of high-quality management teams and franchises operate in South Africa, but the government of Cyril Ramaphosa has much work to do before we feel comfortable that the economy is stable enough, and government policies are sensible enough, to deploy much further capital beyond our current holdings.

Fundamentals are an important cornerstone investment tenet for us, and we have been in a market where fundamentals haven't mattered as much for a while. In our view, the key to handling today's markets is going to be a return to basic investing fundamentals.

continued

While current business prospects around the world seem positive overall, we see areas of concern. When those risks will manifest themselves in the real economy is unclear. But we do know that it is during such times that high-quality companies really shine. While the earnings of low-quality, cyclical companies could pull back, high-quality companies are likely to experience lower earnings volatility. We believe this earnings protection should lead to downside protection for these high-quality businesses—the kind of businesses in which we seek to invest.

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.

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