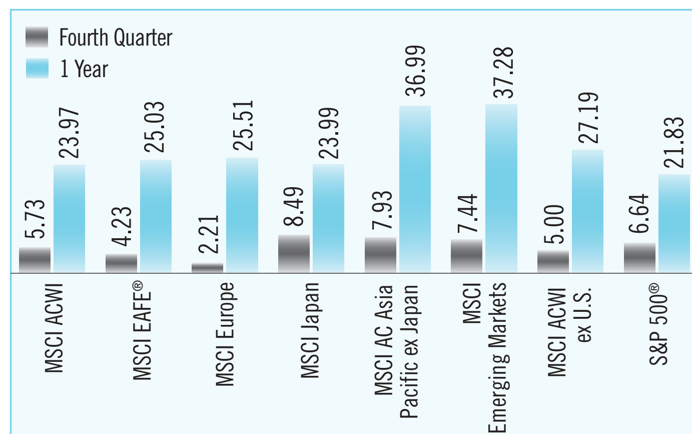
Can We Really Have Our Cake and Eat It Too?

Macroeconomic and earnings growth across the world's major economies was surprisingly strong in 2017. Equity markets soared despite heightened geopolitical headline risk and historically low volatility. In the fourth quarter, performance was positive across all major markets — with emerging markets the top performers, led by Asian equities, and followed by the U.S. and Europe.

U.S. tax reform dominated the headlines throughout the quarter. President Trump signed the $1.5 trillion tax overhaul bill into law at the end of December, driving equities even higher. In addition to optimism around tax reform, solid economic numbers also bolstered U.S. markets over the quarter, including favorable housing data, an increase in consumer confidence, and the upward revision of third quarter GDP growth from 3% to 3.2%. As widely anticipated, the Federal Reserve ("Fed") raised rates at its December meeting — the third 25 basis points hike in 2017 — and the Fed kept its rate outlook unchanged for 2018. Fundamentals were good as earnings per share for S&P 500® Index companies increased by 6.4% in the third quarter (on a year-over-year basis), although earnings growth was in the double digits for the first half of the year.

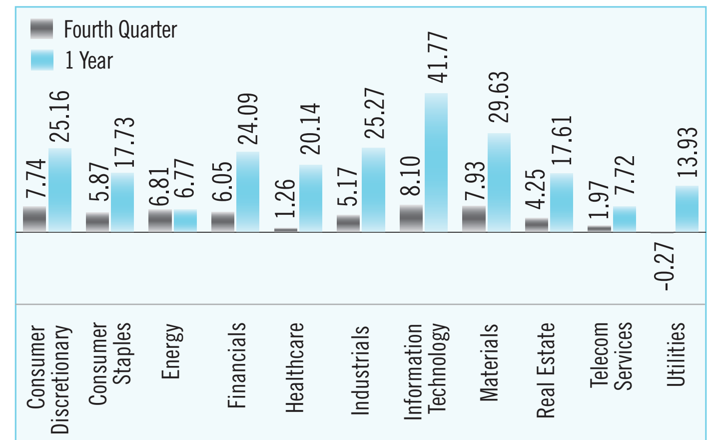
While European equity markets lagged U.S. and emerging markets, economic data released over the quarter indicated the region's recovery still has momentum. Real GDP in the euro area continued to grow, increasing by 0.6% in the third quarter of 2017. The eurozone posted its highest manufacturing output since 2011 and its lowest unemployment rate since 2009. The European Commission indicated that the eurozone is set to expand at 2.2% in 2017, upwardly revised from 1.7%. In October, the European Central Bank ("ECB") left interest rates unchanged and extended its quantitative easing program to September 2018, although monthly purchases will be reduced from €60 billion to €30 billion.

GLOBAL MARKETS PERFORMANCE (%)
as of December 31, 2017



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 December 31, 2017



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.**

Emerging market equities consistently performed well throughout 2017 and the fourth quarter was no exception. Returns were driven by an increased demand for higher risk assets, rising commodity prices, and a corporate earnings recovery across the developing world. Stocks in the healthcare and consumer discretionary sectors outperformed. Asian equities led returns with India, Korea, Indonesia, Malaysia, and China all outperforming.

OUTLOOK: CHALLENGING CONSENSUS

From a macro perspective, the political and economic scene around the world is generally stable to moderately improving. That stability provides an attractive backdrop for stock picking, particularly within a high quality universe.

In the U.S., unemployment at 4.1% is at its lowest level in 17 years and wage growth has remained in check at around 2.5%. It's worth noting that the labor participation rate remains stubbornly low at around 63% — similar to levels seen in the early 1980s. This means that structural unemployment is high and there is still plenty of slack in segments of the economy, which should theoretically keep a lid on wage inflation.

With respect to inflation, it's still running below the Fed's target of 2% but that shouldn't prevent the Fed from continuing on its gradual path of two to three more rate hikes in 2018. While we need to keep a close eye on the risk of hikes increasing at a faster-than-expected rate, the risks at this point in time seem in check.

Much is being made about the Trump administration's tax law and the impact it will have on corporate profits and growth. We don't believe that the tax law and the cuts themselves will have a material profit impact on the majority of our investments, nor will it fundamentally change the quality of the businesses we do or don't own. Coupled with the continued regulatory rollback

under Trump, the cuts will at least continue to have a favorable impact on something very important, however: business sentiment. The power of animal spirits on an economy should never be underestimated. So with that in mind, we view the new tax legislation as a positive development.

It's also worth spending some time on valuations. While valuations for U.S. stocks are broadly elevated, with the S&P 500 Index trading at around 18.5x one-year forward earnings (a premium to its 10-year average), we are finding that there is valuation dispersion within sectors. We are finding high quality names that are impacted by shorter-term issues, making them cheap relative to their growth and relative to history — particularly in areas such as consumer discretionary.

In Europe, we note that the 2017 elections in France, Austria, and the Netherlands have moved these countries towards more centrist governments. That should provide for a more stable euro currency and more predictable economic and business policy. The political risk now is certainly lower than it was at the start of last year and the extreme eurozone break-up scenario has dissipated for now. Italian elections in 2018 will still provide an element of uncertainty as no party running has strong enough support to form a majority that could stall any future reforms; and anti-euro parties such as the Five Star Movement may still have some momentum. We are mindful of the still-heavy monetary accommodation that is being provided to the markets by the ECB and will watch carefully how markets react once that accommodation is finally withdrawn. Brexit negotiations are underway; however, there is still considerable uncertainty around the final outcome, which will take years to resolve. Ultimately, the negative impact on investment and employment in the UK economy is yet to be felt. All the same, we see that macro indicators have generally been turning more positive, particularly in Germany and even more recently in France.

Turning to emerging markets, we are much more mindful about valuations after the sharp rally since the market bottom in 2016. We see the tides beginning to turn there for active managers like ourselves as more discriminate gains will go to companies that demonstrate actual growth.

While some of the macro indicators in China have stabilized, and supply-side reforms in coal and steel have been positive, we are still wary of the impact of the surge in overall debt levels over the last ten years and the resulting levels of misaligned investment. The government's push to slow credit growth and the ensuing rise of wealth management products, as well as property price increases in the highest ranked Tier 1 cities, is likely to have some negative impact on growth over the next year. That's why in China we still believe we can find the best opportunities in the technology space, and in Alibaba and Tencent in particular. These companies are showing accelerating revenue growth on a larger base as they continue to find new growth drivers and improve monetization levels on their core businesses.

The growth story in India has been impacted by recent reforms including demonetization (November 2016) and the Goods and Services Tax (July 2017). The dust from these reforms is beginning to settle and we see signs of some pent-up demand returning, which bodes well for the economy. Recent state bank recapitalizations should also provide an incremental boost to overall growth on the margin.

As we look out into the future, particularly with respect to analyzing potential investment risks, one rule of thumb we use is to focus on what well-established (or so-called "knowns") are aggregating, or where the biggest groupthink is occurring. We, as human beings (and investors), tend to be very social creatures and as a result have a tendency to act as those around us act. This can lead to unappreciated dangers if the consensus opinions around which we've clustered over time turn out to be wrong or untrue.

The herd mentality now believes that technology is no longer the cyclical industry it once was, with unending and unabated growth prospects forever. Many believe inflation will never return. And what about economic cycles — can they really continue on unendingly? Are stock valuations more attractive when they are higher than they were just a few years ago? Our plan is to stay focused on our clients' behalf and make sure that we challenge these consensus opinions so that we are not trampled in the herd when the unexpected inevitably happens.

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.

The commentary is the opinion of the subadviser. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

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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