Vontobel

Blind Spots Come into Focus; Caution Returns

Geopolitical pressures around the world marked the second quarter of 2019, as the U.S.-China trade war escalated, tensions flared in the Persian Gulf, and mass protests erupted in Hong Kong. Although equity investors faced a rocky ride as sentiment on global trade tensions shifted from concern to optimism, a softer stance by central banks drove share prices upwards. The MSCI All Country World Index (ACWI) finished the quarter 3.61% higher, and all sectors with the exception of energy generated positive returns. Developed markets outperformed emerging markets (EM), with the U.S. and Europe advancing largely in parallel, while EM ended the quarter roughly flat.

MORE THAN ABOUT TRADE

At the time of this writing, world leaders had just returned from the annual G20 Summit. All eyes were on Presidents Trump and Xi, who emerged from the meetings with new promises of trade détente. The news sparked a relief rally that pushed stock markets to new highs, with the MSCI ACWI returning 16.23% for the first half of this year.

Despite the market's positive reaction, few (if any) political problems have actually been solved. News from the Summit regarding trade was perceived as positive just because further escalation was avoided. Some investors are optimistic that if a trade deal is struck in the next few months, the result would be a return to the status quo. In our view, the dispute goes far beyond the trade imbalance between the U.S. and China and encompasses a range of deep-rooted issues with no easy solution, from the protection of intellectual property, to forced technology transfers and national security. Uncertainty from the broader trade conflict will likely linger post any trade "deal."

The U.S.'s hardened attitude toward China will persist through the next U.S. election as both political parties largely share the same view. Ramifications of this adversarial relationship could be felt across a number of countries and companies. Already, in the high-tech space, tectonic changes are happening to divide the supply chain into a U.S.-centric system and a China-centric one. There could even come a point when countries must choose sides—harkening back to the Cold War era.

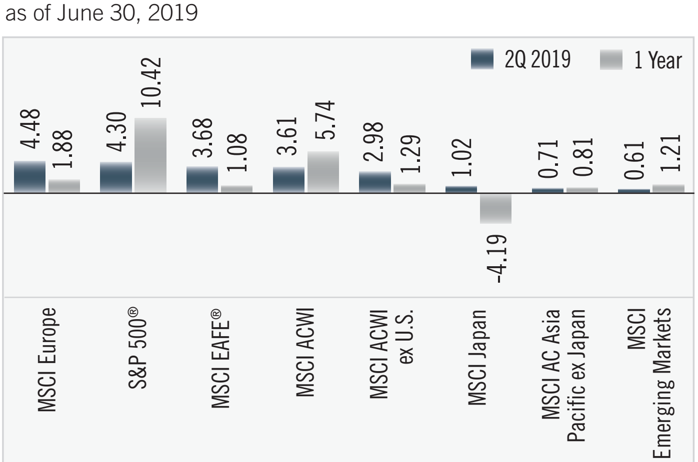
Companies most obviously at risk would be those that manufacture in China and ship to the U.S. and vice versa. Our portfolios are not significantly exposed to exporters. Our Chinese holdings are companies whose growth is driven by domestic demand, and thus not directly impacted. For example, our longstanding e-commerce holding Alibaba's growth is driven by not only the aggregate value of the merchandise sold on its platforms (which would be impacted by slower GDP growth), but also by rising take rates—the percentage of the value of the transactions it facilitates.

We've never believed that competitive advantages stemming from lower-cost supply chains are sustainable in the long run. Instead, we have always favored strong brands with associated pricing power. We like strong local franchises that make the most of their local markets. Quality of management has also always been an important consideration for us. With increasing uncertainty about supply chains, it is even more important now that management is able to navigate in a more challenging operational environment.

ELECTIONS AND POLITICAL RISK

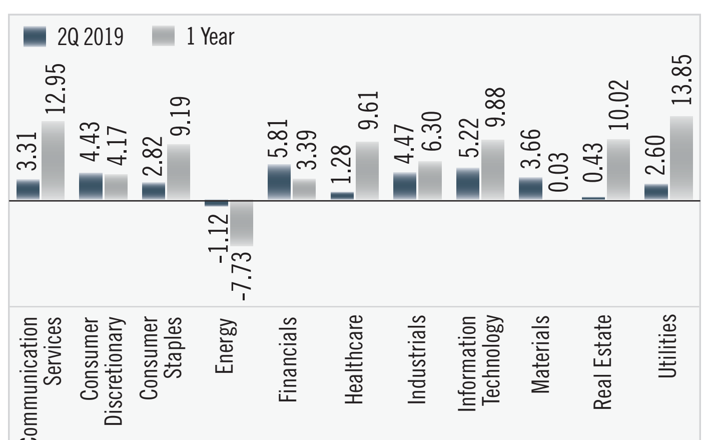
While major elections are behind us in a few large EM countries, some developed markets are potentially more politically uncertain now. Even if one had a good handle on the U.S. administration's

GLOBAL MARKETS PERFORMANCE (%)
as of June 30, 2019



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 June 30, 2019



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.**

actions and goals, presidential elections are less than a year-and-a-half away, with a range of Democratic candidates proposing far-flung solutions. At this point, it is difficult to make a long-term forecast on what policies the U.S. will be pursuing in 2021, let alone what is achievable. We are closely watching this dynamic and the potential impact on the companies we care about.

Brexit continues to confound. Boris Johnson, favored to be Britain's next Prime Minister, is known for his unpredictability. He may just lead the United Kingdom into the hard Brexit many fear. Damage to the economy would not stop at the U.K.'s borders, but would hurt the European Union as well. And if a new election is called for by the Labour Party under Jeremy Corbyn, there are potential policies being discussed that could be detrimental to the economy and investors. We continue to own shares in a few U.K.-based companies, but much of their business comes from outside the country.

In some key developing countries, political risk is receding into the background. Although we are bottom-up investors, we recognize that the election of market-friendly political leaders generally makes for a positive setting for investments in emerging markets. In India, a country where we have a long-standing overweight, the re-election of the BJP government led by Narendra Modi will lead to continuing reforms that are expected to benefit the economy in the long run.

In Brazil, after the election of a new far-right government, President Jair Bolsonaro and Finance Minister Paulo Guedes have been pushing key pension reform through a reluctant and fragmented congress. These measures should make it easier for businesses to operate and expand in Brazil.

Based on recent election results, a general observation may be that EM voters have become less influenced by promises of short-term handouts and are gradually becoming aware that those policies lead to long-term pain. Venezuela is a reminder of what happens when you go down that path. While we continue to watch and assess situations in different countries, such as Mexico where policy direction is less clear, we recognize that political risk has been reduced somewhat in EM and many countries are on a path to reform.

SLOWING GROWTH

Global economic growth is slowing. The International Monetary Fund, for the third time in six months, lowered 2019 economic forecasts to the lowest level since the 2007-08 financial crisis. Even in the U.S., where GDP growth is still holding up, earnings estimates for S&P 500® companies are down significantly from late 2018. There are other potentially worrisome anecdotes in the markets. For instance, there have been a large number of sizable IPOs around the world, which often happens when bankers are concerned that the window to go public may close. And some of those IPOs (e.g., Lyft) were not well received. Also, the recent high-profile failure of funds holding illiquid assets was reminiscent of the days leading up to the financial crisis. And regulators have worried for years how the leveraged loan market (which has experienced explosive growth) will behave in an economic downturn.

As 2019 progresses, we expect to see a lot more discernment in the marketplace between what is cyclical growth (which we eschew) and what is structural growth (which we actively seek out). That's because when the environment gets more difficult, investors start to pull back and better evaluate what they own. Blind spots come into focus; caution returns. The recognition that the world is a little more complicated and tenuous hits home. Some investors will capitulate. And that is when we will add to the companies we know well and hold for the long term and seek out new opportunities.

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.

Distributed by **VP Distributors, LLC,** member FINRA and subsidiary of Virtus Investment Partners, Inc.

2203 7-19