INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

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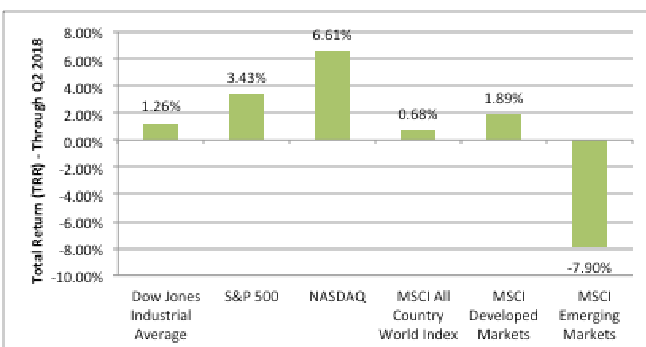
Despite Sustained Global Growth Expectations, Equity Markets Diverge

In our May 2018 Investment Update, Senior Portfolio Manager Julie Bryan, CFA, focused on the backdrop and opportunity for the U.S. economy and equity markets. She noted that key issues in focus include concerns on inflation, trade restrictions, oil prices, interest rates, consumer spending, and geo-political risks.

Despite the ebbs and flows of the current environment, at the midway point in 2018, leading U.S. equity indices all finished up. The Tech heavy Nasdaq finished up +6.61%, followed by the S&P 500 which posted a gain of +3.43% (see Exhibit 1). In our view, these equity market results are consistent with sustained U.S. economic performance which supports the earnings growth outlook and valuation.

On the other hand, international equity markets diverged relative to U.S. equity markets. In the second quarter of 2018, the MSCI All Country World Index (ACWI) finished up +0.68%. Within the MSCI ACWI there was a significant gap in performance as the MSCI **Developed Markets** Index finished up +1.89%, while the MSCI **Emerging Markets** Index declined -7.90% during the quarter.

Exhibit 1: Total Return (TRR) – Global Equity Markets



Source: Bloomberg data (closing prices 3/30/2018-6/29/2018).

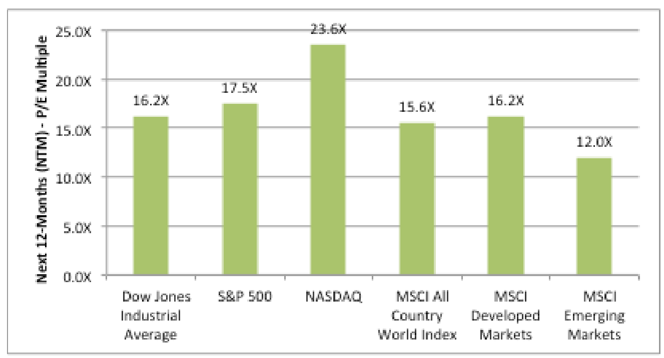
A recent Bloomberg Intelligence report noted that, "since the U.S. bottomed in early February, the US MSCI Index has risen 5.3%, pushing the developed-world index up almost 2%. Excluding the U.S., however, developed world equities markets have fallen more than 3% over the same period."[1] More significant, emerging markets "have dropped 9% over the same period in dollar terms as emerging market currencies remain suppressed.[2]

What Ails Emerging Markets?

From a macro perspective, the International Monetary Fund (IMF) Global economic growth expectations for 2018 remain intact at +3.9%, with medium-term growth projected to settle in at +3.7%. Importantly, emerging market economies are forecast to grow +4.9% in 2018 and forecast to sustain +5% growth over the medium-term. From a contribution perspective, China and India remain significant economies, with each expected to deliver growth of +6.5%-6.6% in 2018 and sustain medium-term growth rates of +5.5%-5.6%.

Despite this positive global macro backdrop, emerging markets have been weighed down by a series of cross currents including higher U.S. rates, a strong U.S. dollar, as well as increased trade tensions. This in turn has driven emerging market valuations lower. Based on next 12-months earnings, the MSCI Emerging Markets Index P/E multiple is down to recent lows marked in early 2016, and trades at a discount to its global peers (see Exhibit 2).

Exhibit 2: P/E Next 12-months – Global Equity Markets



Source: Bloomberg data (closing prices 3/30/2018-6/29/2018).

Although our current asset weighting is low in terms of exposure to emerging markets, we do see this segment as an important component of global portfolio asset allocation and risk diversification. In addition, our U.S. equity view and constructive stance also considers that global economic growth remains intact. In our view, these drivers underpin our expectations for sustained earnings growth and valuation of global equity markets.

While recent emerging markets headwinds are not expected to abate, the balance of already low expectations, domestic growth, sustained earnings growth, and intact secular growth drivers, keeps us constructive on this international segment. On a relative basis, we acknowledge that emerging markets are exposed to a global recession or less synchronous growth. Against this scenario, we believe that the U.S. would likely hold up better given strong internal demand and growth drivers.

[1] Bloomberg Intelligence, Kevin Kelly & Gina Martin Adams, The Week in Charts, July 6, 2018.

[2] Ibid.