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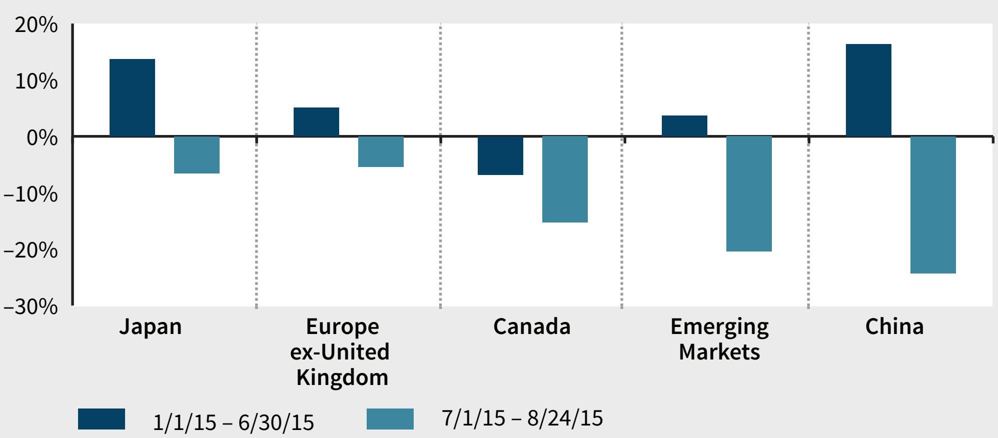
International Equity Markets:

Update and Portfolio Positioning

Global equity markets are facing a summer swoon as concerns about the emerging markets broaden into more generalized worries about the sustainability of global growth and the potential effectiveness of additional central-bank policy.

China's equity market, which began spiking in April amid significant margin lending, has returned to Earth as concerns about its growth trajectory have resurfaced and the government has intervened. As the prospect of slowing Chinese growth has rippled across countries that are key trading partners, corporate earnings have come under pressure across the emerging markets. In addition, foreign bond and equity outflows, coupled with expectations of normalization of U.S. interest rates, have put additional pressure on emerging-market currencies and equity markets. This weakness has translated into a global equity-market correction (figure 1) as investors have grown concerned about global growth prospects amid a slowing China, and as valuations in developed markets have expanded over the past several years.

Figure 1: Index Performance



Source: MSCI as of 8/24/15. Regions and countries are those of the MSCI ACWI IMI. Past performance is not indicative of future returns. A direct investment in an unmanaged index is not possible.

Not all countries have been affected equally.

Trading volumes, which were light globally during much of July and August as investors returned from holiday, accelerated late last week, with Monday seeing the second-highest value traded of the year in the U.S. market. Volatility levels, as measured by the CBOE Volatility Index (VIX), have also increased significantly.

Not all countries have been affected equally. Since the "taper tantrum" of 2013, some emerging-market countries, such as India, have adjusted their fiscal balance sheets, and today they look less vulnerable. Other countries, such as Brazil and Turkey, which have large current-account deficits, have seen their currencies affected more significantly.

These challenges have been exacerbated by weakness in the commodity complex as a result of slowing demand coupled with increased supply. Resources stocks (energy and materials) now represent just 16% of the MSCI Emerging Markets Index, down from 23% several years ago. In this environment, a number of commodity-intensive countries, including Brazil and Russia, and even non-emerging-market countries such as Canada and Australia, have felt the pressure on both growth and currencies. Emerging-market countries such as India and China benefit from lower resources prices, as figure 2 illustrates.

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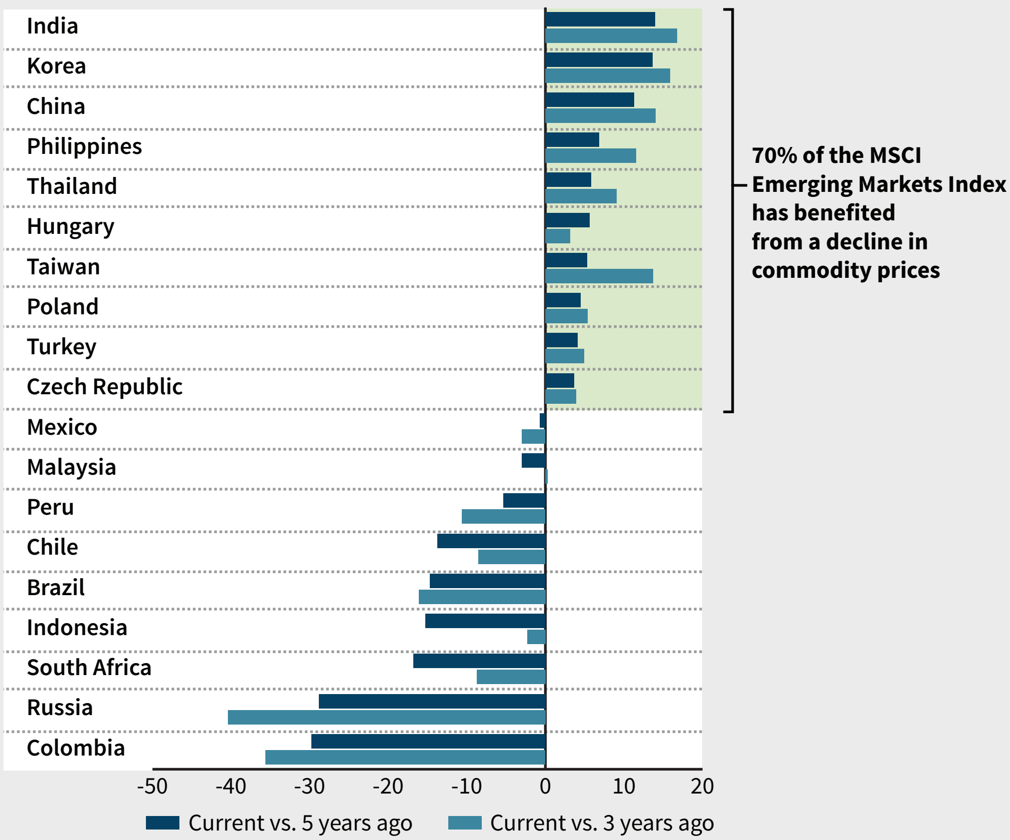
Figure 2: Change in Terms of Trade



Source: JP Morgan Research, Bloomberg and Datastream as of 8/17/14. Country bars shows current value of the Citi Commodity Terms of Trade Index versus three and five years ago. The Citi Commodity Terms of Trade indices measure the relative performance of commodity export and import prices. A positive reading means that export prices have out-performed import prices and a negative reading means that import prices have out-performed export prices. Past performance is not indicative of future returns. A direct investment in an unmanaged index is not possible.

As for developed stock markets, they weathered the storm relatively well until recently, when anything geared toward emerging-market demand (or global growth more generally) felt the impact of the emerging-market correction. Materials, energy, and IT have led the sell-off. The euro and yen also appreciated as part of a "safety" trade.

In light of recent events, then, we must ask: What is the economic reality in the large emerging markets?

China: The Epicenter of the Recent Sell-Off

China is the epicenter of the recent global sell-off. It is in the midst of transitioning its economy from heavy industry-led growth to more balanced economic growth. At the same time, the government is fostering financial liberalization. We believe this is the correct strategy over the long term; however, it can be fraught with short-term policy mis-steps and unintended consequences, particularly given the recent acceleration in China. China is not alone on this front; other Asian "tigers" have faced similar issues in the past.

Looking back, the year began with a tremendous run-up in the China A-share market, which was fueled by margin purchases and euphoria about potential MSCI inclusion. The run-up culminated in a correction in the A-share market. Confidence in Chinese policymakers took a hit this summer as they tried to negotiate these cross-currents, first from the perceived mishandling of the July stock-market correction and later from the August currency devaluation. To the extent that a weaker yuan is seen to reflect China's slower economic growth, many emerging-market currencies—especially those of commodity exporters and Asian economies—have weakened on the expectations of substantial devaluation.

Worryingly, high-frequency indicators of economic activity used by the market to gauge the strength of China's economy have raised concerns that GDP growth may be much lower than officially reported. Electricity, steel and cement production have collapsed, and growth of fixed-asset investment (FAI) has decelerated from 20% year over year in 2013 to 12% year over year today. Property construction volumes continue to decline, and all this is taking place amid widespread producer price deflation.

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While these traditional metrics point to lower growth prospects, we believe they are becoming less relevant over the longer term as China transitions to a domestic-demand-driven economy. In such a rebalancing, metrics that shed light on consumer spending, e-commerce, and services are likely to become more useful indicators of activity as China rebalances. Entertainment and tourism are good examples. Unfortunately, such indicators are notoriously difficult to construct, and China is not unique in this challenge. For example, inflation-adjusted retail sales in China have been growing at nearly a 10% annualized rate since 2013, and readings for the first six months of 2015 suggest acceleration to a 12.5% pace. Yet almost across the board, foreign companies are reporting weakness in revenue growth and margin pressure in China, both of which are being attributed to economic slowdown and the anti-corruption campaign. Left unidentified is the role of overcapacity and competitive intensity, especially from the rapidly growing e-commerce channel. Local Chinese companies continue to move up the value chain in certain industries, with recent earnings trends confirming that they are taking market share.

While a significant negative for consumer sentiment, the recent equity market sell-off may not have as significant of an impact on the Chinese consumer, because equities represent a much smaller portion of household investments than real estate. To that end, real-estate inventory has fallen over the past several quarters, and pricing may be stabilizing—especially in tier-one and tier-two markets. Further downward pressure on rates would improve affordability and provide a potential stimulus to the real-estate market.

Brazil: A Stagnating Economy

Over the past decade, Brazil, one of the world's largest commodity exporters, has benefited from China's industrialization and residential real-estate buildout. But this strong tailwind has dissipated.

Meanwhile, Brazil's current administration has pursued highly interventionist, ideologically driven economic policies, and has expected persistently weak global growth to take care of what is largely domestically sourced high and rising inflation.

Having been proved wrong on all accounts, Brazilian policymakers are now in the unenviable position of having to raise interest rates and increase already high taxes as the economy is slowing. To the extent that some Brazilian corporates accumulated debt in dollars, falling currency and rising yields will prove a further headwind.

In this environment, it is not surprising that President Dilma Rousseff's approval rating is lower than inflation. Her plummeting popularity complicates fiscal adjustment efforts, and the ratings agencies may downgrade the country's debt to junk status.

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All the while, the country's largest corruption scandal, "Lava Jato" (carwash), has expanded from Petrobras to the electricity sector and the second-largest construction conglomerate. The next two to three months will be crucial for Dilma's political prospects for serving her entire second term. It is too early to speculate on possible successors, but the recalibration of economic policies, accompanied by a multi-year period of painful economic adjustment, seems highly likely.

Portfolio Implications

As developed-market growth has accelerated, our global and non-U.S. strategies have been underweight emerging markets versus benchmarks for several years, with weightings currently averaging between 50% and 75% of benchmark emerging-markets weightings. We reduced weightings in China, in particular, after the strong market run, trimming (in some instances selling) positions. While emerging-market valuations are low, particularly compared with expanding developed-market valuations, growth is lower and earnings revisions are negative. This has precipitated our lower weights.

Despite these factors, there are a number of high-quality companies with good earnings prospects in the emerging markets. These companies have strong competitive advantages over their peers, and/or are exporters, benefiting from weak local currencies and strong end-market currencies. Given the recent broad market sell-off, we are opportunistically adding emerging-market stocks to portfolios where corporate quality is high and valuations are supportive. Similarly, in the developed markets, where stocks have more recently followed emerging-market weakness, we are paring back exposure in highly valued, high-momentum stocks and redeploying into high-quality stocks that have lagged.

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Our dedicated emerging-market portfolios also trimmed exposure to China following the significant stock-market run-up, redeploying proceeds across a number of holdings and countries. Now that the prices of many Chinese stocks have fallen significantly, we are adding selectively. However, we remain underweight, with the exception of our Emerging Market Small-Cap strategy, where our position is roughly in line with the benchmark. Meanwhile, our emerging-market portfolios maintain a significant overweight to India, where we continue to find high-quality companies with strong corporate performance. There is also a backdrop of lower inflation and interest rates, which remain supportive of growth. We also maintain a modest overweight to Brazil, where our companies are delivering robust corporate performance despite the difficult macro backdrop.

As part of our process, we continually review portfolio risks and opportunities. Over the past several weeks, we have reviewed overall portfolio exposures and individual holdings to rebase on companies that would be positively or negatively affected by a weaker currency. For example, we have re-examined emerging- and developed-market exporters' exposure to the emerging markets to understand transactional foreign-exchange headwinds. We have also analyzed companies' debt levels and dissected the portion held in U.S. dollars to frame the potential earnings impact.

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As you would expect, our portfolios remain focused on high-quality growth companies that provide protection in difficult market environments. These companies tend to be market leaders, are well managed, have significant financial flexibility, and can capitalize on weak markets to gain market share and outpace weaker competitors.

Summary

Indiscriminate stock market declines provide great opportunities for active managers to buy high quality companies at lower prices, and that is our focus. At this point, we view this summer swoon as a typical cyclical market correction following many years of equity-market strength. While a number of our holdings have net cash or limited debt on their balance sheets, we remain vigilant about the size and structure of debt outstanding, particularly in regard to emerging-market companies with developed-market debt in the event that markets worsen. A significant global credit event could be the tipping point that moves the markets from what we are viewing as a cyclical adjustment to a bigger correction.

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