International Growth Equities

A brighter outlook for international earnings

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Key takeaways

- Despite the soft patch in certain macro indicators, there is a broad expectation that most major regions may deliver solid earnings growth in 2019.
- We believe equity valuations remain vulnerable to higher bond yields and discount rates, particularly among the technology names.
- Trade and geopolitical tensions are the primary threats to the growth outlook.

As 2018 draws to a close, strong US corporate cash flow has been well-supported by tax cuts and increasing fiscal spending. This may continue to underpin reasonably healthy capital expenditures and support economic growth and earnings delivery in the US – but the big question is, will growth pick up around the world?

The big picture: Earnings and valuations

Earnings

In late 2018, key regions outside the US have seen a softening in gross domestic product expectations, industrial production and purchasing manager indices. There are many moving parts here: higher oil prices, higher US interest rates on dollar-denominated debt, weaker currencies, trade tensions undermining confidence, etc. And yet, despite the soft patch in some of these macro indicators, there is a broad expectation that all major regions around the world (with exception of Japan) may deliver high-single-digit to low-double-digit earnings growth in 2019.[1] The region that stands out the most is the eurozone, with consensus expectations for earnings growth to pick up from about 6% this year to 10% next year.[2] On the other hand, expectations are for US earnings growth to decelerate from more than 20% this year to about 10% next year.[2]

Valuations

Despite the stock market sell off in early October, we believe equity valuations remain vulnerable to higher bond yields and discount rates, particularly among the technology names. US stocks continue to trade at a premium to non-US stocks, a fact which many have come to dismiss given relative earnings progression of the past several years. And yet, non-US markets indices have been trading at discounts on earnings and book multiples not seen in 15 years, with emerging markets (EM) discounts pushing to new extremes in late 2018 and the International Monetary Fund downgrading growth in many EM markets. Yet, specific names are starting to look appealing to long-term investors like ourselves.

Regional highlights

Europe

- Eurozone growth has moderated, but is still near a decade high, and it feels like expectations are low.
- In Europe, there is a reasonable possibility we could see accelerating earnings growth in 2019 despite lower GDP growth because of pent-up demand growth.
- We started to see a mild breakdown in expensive momentum names in the third quarter, which makes us more constructive on our quality growth holdings.

China

- Although the outlook can change quickly, at this point there has been no break-through in regard to US-China trade tensions.
- Expectations are that the Chinese authorities will continue to provide stimulus to keep the economy and the consumer on track.
- Now that stock prices and valuations have come down, we are evaluating some of the high-quality names that are now more attractive from a valuation perspective.

Emerging markets

- Emerging markets clearly have been weak in 2018, with some disparity among regions. For example, Brazil and Mexico have started to strengthen, while China is weakening and Turkey looks to be bottoming.
- The weak appetite for risk has led to weaker markets as well as currency pressure dampening US dollar returns. However, this is as much a function of the US being in a hiking cycle versus country weakness.
- Our outlook for EM equities is mixed. Unfortunately, the trade dispute between the world's two largest economies adds a degree of unpredictability.

1 Source: FactSet Estimates, as of Oct. 15, 2018
2 Sources: FactSet Estimates, MSCI, as of Oct. 15, 2018. Non-US stocks represented by the MSCI EAFE Index, US stocks by the S&P 500 Index, and emerging markets stocks by the MSCI Emerging Markets Index.

Three points to consider

- In our view, the high growth/high momentum reset is healthy. The October correction has so far inflicted the greatest damage to the share prices of high growth/high momentum areas of the market – particularly technology, where our team has chosen not to chase performance and high valuations. To the extent that some of these businesses continue to de-rate, we would expect to avoid much of the pain and potentially find some good long-term opportunities.
- The recent rise in the 10-year Treasury yield is positive in the near term, in our view, so long as inflation remains subdued. The rise in bond yields (discount rates to equity cash flows) has been driven primarily by higher real growth expectations from still low levels in the US. At the same time, weaker currencies relative to the dollar coupled with still negative real yields abroad remain stimulative to global growth.
- Trade and geopolitical tensions are the primary threats to the growth outlook. Ongoing trade/tariff disputes between US and China are problematic, as is the uncertainty that remains around Brexit, Turkish prospects and the disruption imparted by the new Italian government's fiscal spending intentions, to name a few. China is the wildcard and is more difficult to handicap given the uncertainty associated with the Chinese leadership's unwillingness to be seen as weak in the face of tweets from Trump and aggressive tactics from his administration. At the same time, we should not dismiss the probability that the US administration may negotiate hard on the front-end with China, only to reach agreement in the final hour as was done with Canada and Mexico in the early-October USMCA trade deal.

In conclusion

Our team takes a three- to five-year view of Earnings, Quality and Valuation (EQV). And yet, given that we're in a momentum market that reminds us of the late 1990s, we feel a stronger-than-normal need to have confidence in short-term earnings. That's because we are witnessing more violent moves in shares when companies just slightly miss expectations. In an environment where US growth might be peaking, we believe our quality growth style is moving back into favor.

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