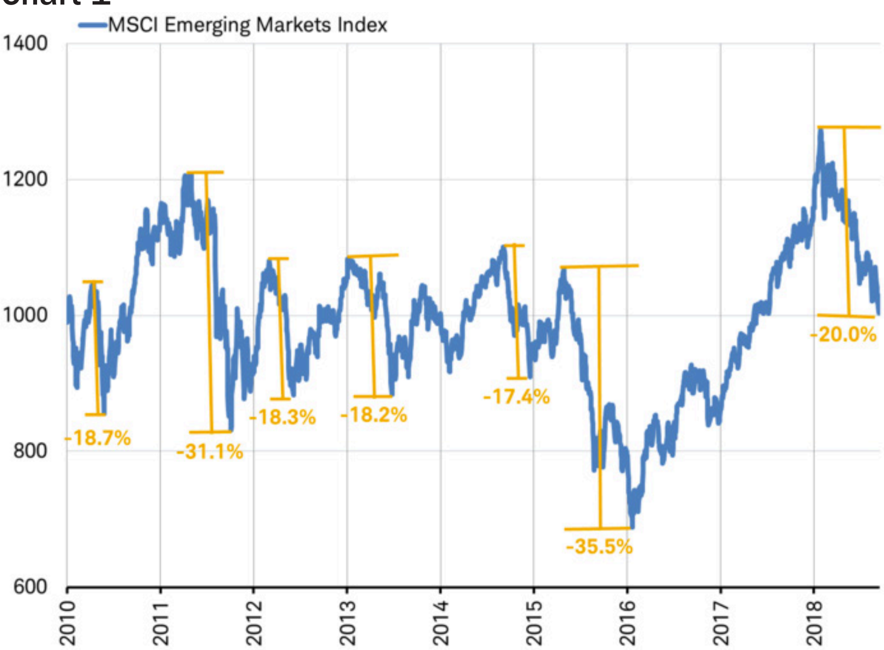
International Equity Market Commentary

"The market is most dangerous when it looks best; it is most inviting when it looks worst" Frank J. Williams – circa 1930's - If you must speculate, learn the rules.

Chart 1

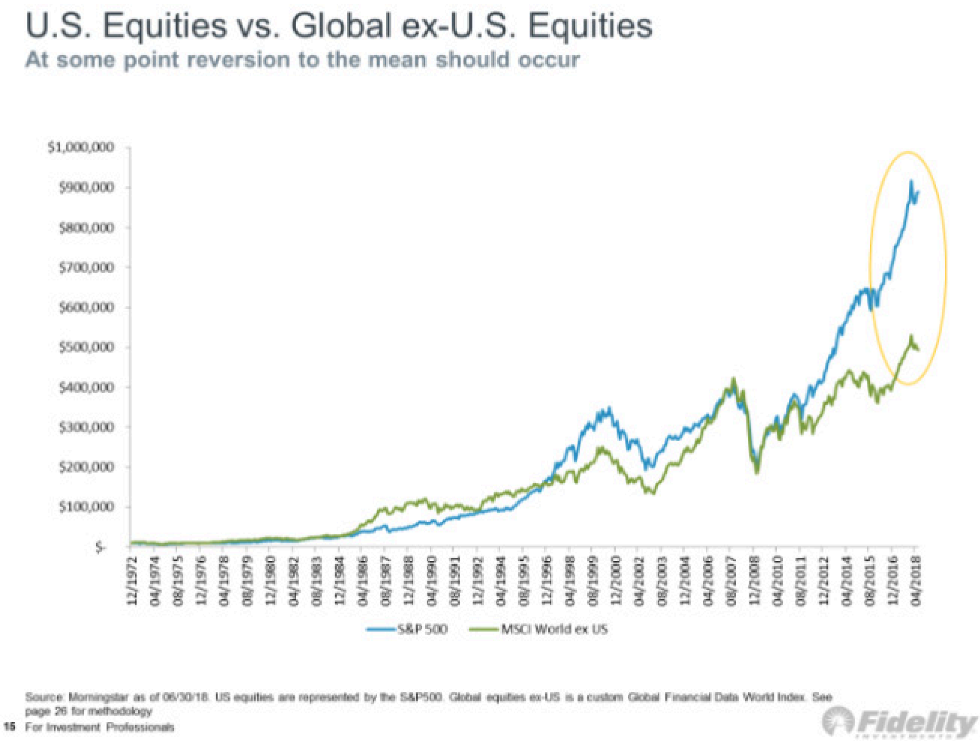


While the above comments on investing are 88 years old, they still hold true today when it comes to investing. Outside the U.S., since peaking in late January, developed International equity markets are by off over 13%[1] (MSCI EFEA Index) and emerging markets are off by over 21%[2] (MSCI Emerging Markets Index). Every day the news bombards us with pessimistic headlines about international markets that make us think about Frank Williams and whether those markets are looking their worst. We have been underweight in international markets in our asset allocation but we feel that with the correction since January, the time to move away from an underweight position could be soon at hand.

Fears surrounding a country like Turkey can spread rapidly as investors worry about a contagion that impacts many others and we have clearly seen that recently. But it's not uncommon for an asset class like Emerging Markets to be volatile. As you can see from Chart 1, per Charles Schwab, since 2010 the MSCI Emerging Markets Index has had seven corrections of 17% or more. The current sell-off seems par for the course for the asset class.

[1] Index Peak January 26, 2018, Through September 7, 2018.
[2] Index Peak January 26,2018, Through September 11, 2018

Chart 2

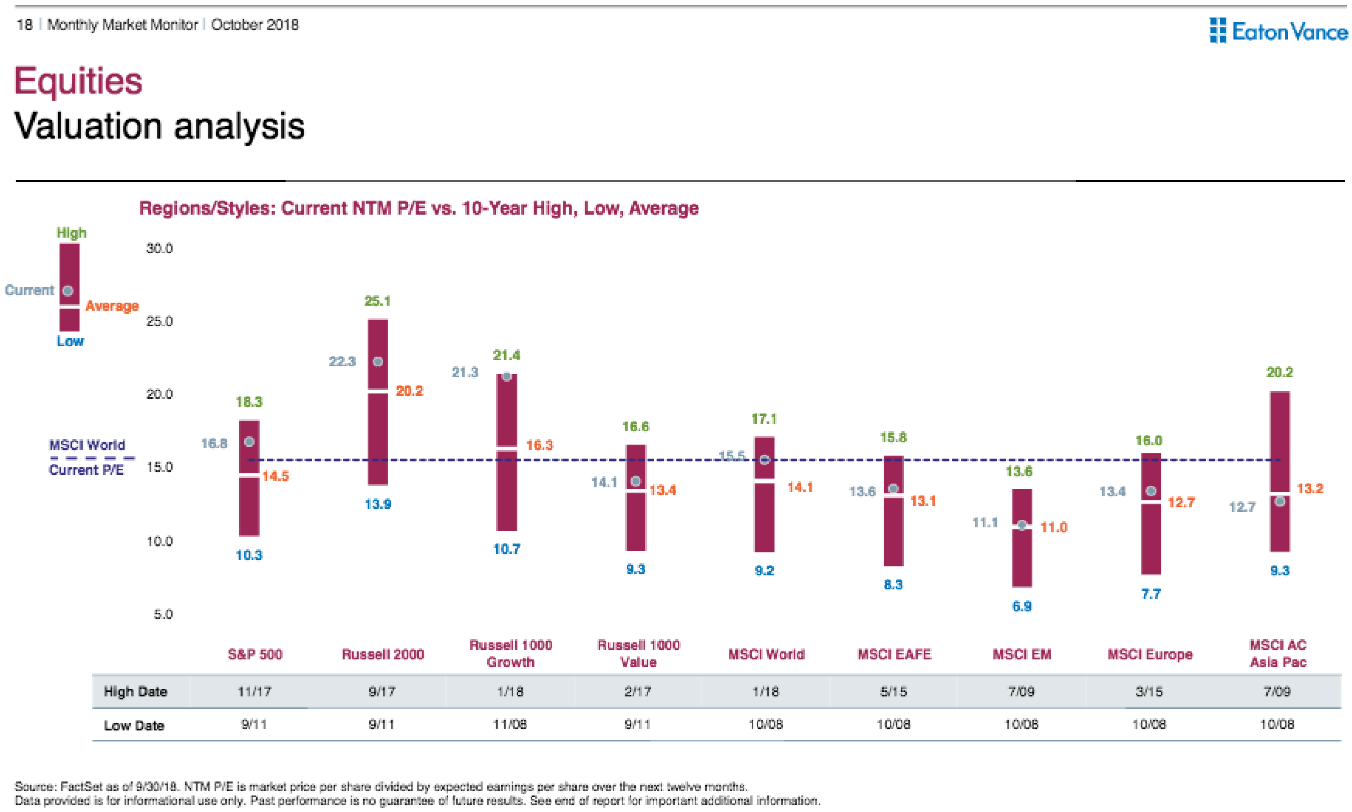


Over the long-term, the U.S. and International markets have traded in the same direction and not that far off from each other. Recently though, as Chart 2 from Fidelity shows, a large gap has formed between U.S. equities and International equities. When we have seen these gaps open up in the past they normally narrow and sometimes reverse. The current gap you see in Chart 2 is just too wide in our opinion. We tend to side with history and believe the current gap will narrow at some point. Opportunistic investors will take advantage of this development.

Relative Valuations

Another compelling factor that has developed with this correction in international markets is that earnings multiples outside the U.S. are now much more attractive. Both International developed markets equities (MSCI EAFE) and emerging market equities (MSCI EM) are trading right near their 10-year average multiples. Contrast this with most domestic equity valuations that are, for the most part, more than a few points above their 10-year averages. Now things can always get cheaper but valuations outside the U.S look interesting from both an absolute and relative basis.

Chart 3

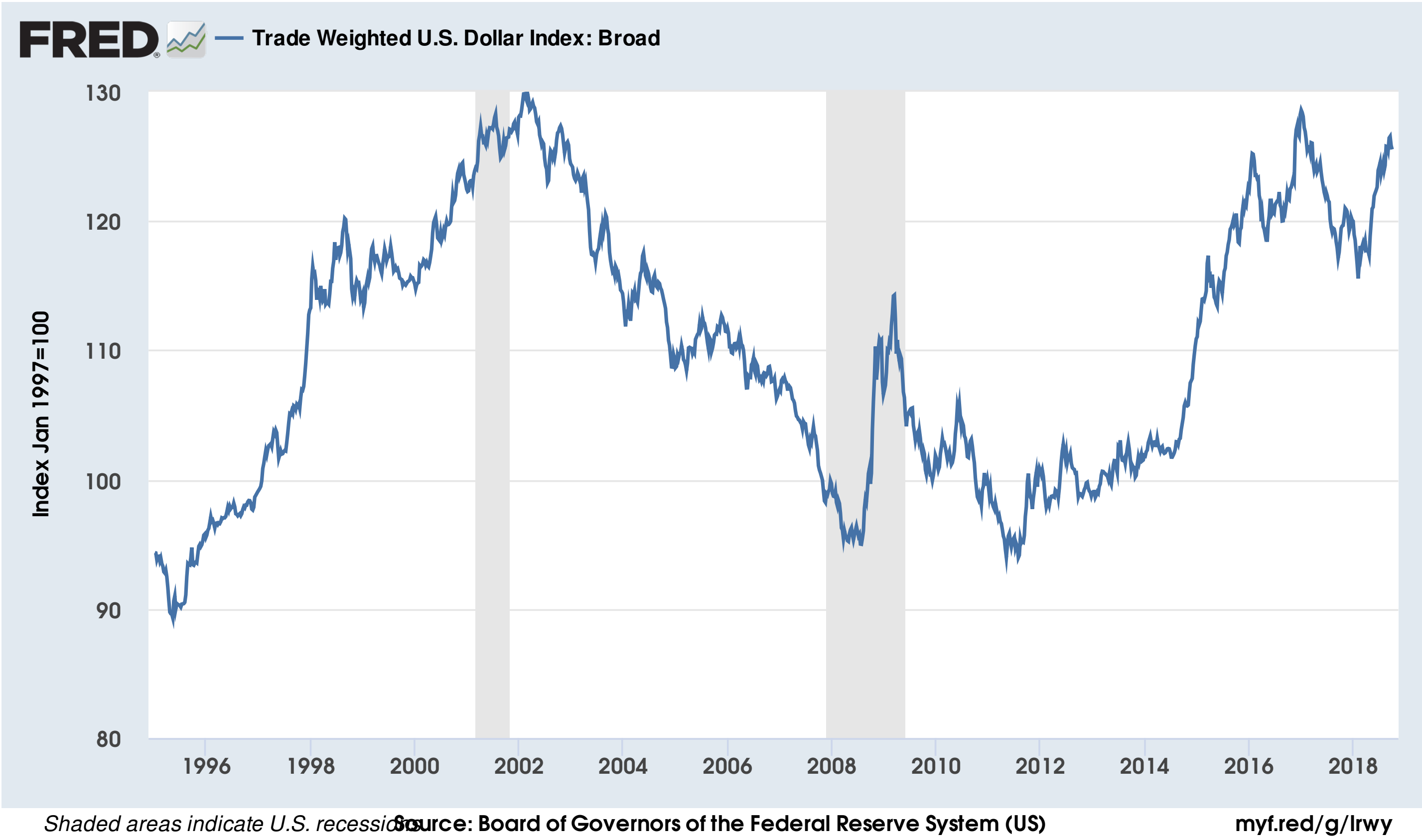


Federal Reserve tightening cycles and their impact on International markets

The U.S. Federal Reserve has been tightening monetary policy for a while now and we have seen seven interest rate hikes so far in this cycle. History has shown that international markets can suffer during a U.S. Fed tightening especially if it's accompanied by a strong U.S. dollar (Chart 4). Countries with large debt loads and a higher percentage of that debt in U.S. dollars struggle as that dollar denominated debt becomes harder to service. We saw this in a big way back in the late 1990s as select Asian countries were almost forced into default. Their outsized GDP growth was financed with U.S dollar based debt and they struggled as the Fed's tightening cycle pushed forward. We are seeing some of the same action today in places like Turkey. The country's recent growth cycle was mostly financed with U.S dollar based debt. When a sovereign's capital structure becomes unbalanced, they are likely to have issues as they had to rely on debt sold in U.S. dollars to attract investors. Again, U.S. dollar strength (see Chart 3) can make it harder for them to service their debt.

As you can also see from Chart 4, the dollar, like a lot of asset classes, tends to move in long cycles, and again those cycles can closely align with whether the Federal Reserve is tightening or loosening monetary policy. Since 2012, the trend has been up for the dollar, relative to other currencies. Widening interest rate differentials between the U.S. and other counties as a result of the Federal Reserve's tightening cycle has caused a flood of cash to move into the U.S. dollar. With the Federal Reserve hiking into next year, we don't see the cycle changing quickly but all cycles do end and when it does, like in 2002 (again see Chart 4), holding a diversified global equity portfolio will be beneficial.

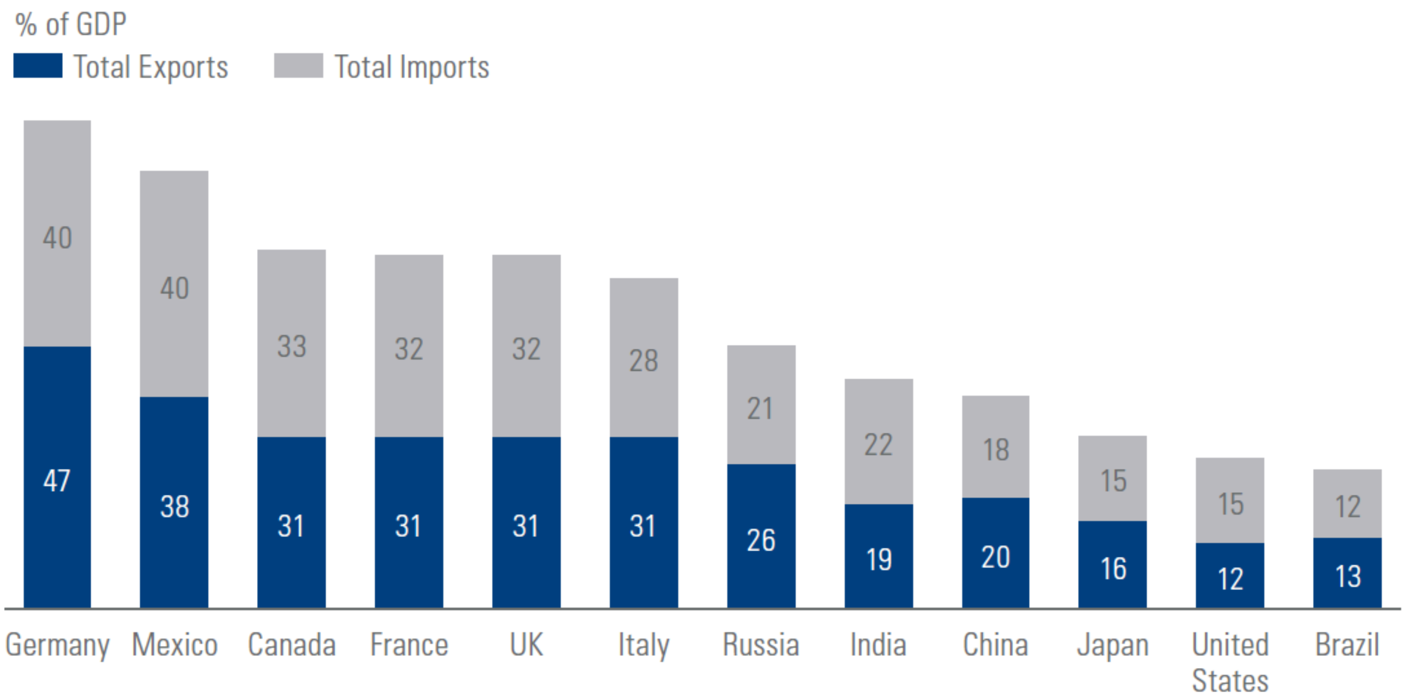
Chart 4



Trade

Sentiment around swirling global trade news has also clearly been a headwind for international stocks. President Trump's desire to introduce a new trade regime with all of our trading partners has clearly increased volatility in international markets. The back and forth between China and the U.S. has been the headline grabber for months now and it appears each side is waiting for the other to blink first. Chart 5 looks at select countries exports and imports per GDP. Clearly trade is a big issue for some countries and those countries are willing to negotiate with the hopes of avoiding painful, drawn out negotiations that could hurt future growth prospects. We have no real prediction on how trade will end up and we do recognize imbalances that are most likely not sustainable over the long-term. However, our hope is rational discussions will lead to reasonable trade agreements. While recent agreements between the U.S. and some trading partners are being struck on a one on one basis, a deal with China seems a long way off and as a result a certain level of volatility will remain in the markets. We continue to monitor these developments and at some level risk will be fully baked into international stock prices and present an attractive entry point.

Chart 5



Source: World Bank and GSAM.

Summary

The ethos of our investment management process here at Shepherd Financial Partners is an optimal balance of return and risk. When we investigate an investment opportunity we must see appropriate return for the risk inherent in any asset class. To compare this to what Frank J. Williams was saying with his quote that opened this piece, when things looks their worst, the risk moving forward is most likely lower than perceived. As the Federal Reserve moves further along it's tightening cycle, we are seeing dislocations appear. History has proven that these dislocations can provide attractive forward returns for investors who are willing to study the risks and see through things that seem at their worst.

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The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.