DCM Advisors
Global and International Equity Outlook Q1 2018

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About DCM Advisors

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Current DCM and Lisanti portfolio strategies include Global Equity, International Equity, U.S. Small Cap Growth Equity, U.S. SMID Cap Growth Equity and U.S. Municipal Bonds. In addition, DCM provides research subscription and advisory services to institutional clients related to global and international equities. DCM also provides wealth advisory services to high net worth individuals through its investment adviser representatives.

Contact Us:

For DCM:
inquiries@dcmadvisors.com
www.dcmadvisors.com

For Lisanti:
info@lisanticap.com
www.lisanticap.com
www.dinosaurlisanti.com

475 Park Avenue South, 9th Floor
New York, NY 10016
(917) 386-6260

We are now ten years past the financial crisis of 2008 and five years past the worst of the Eurozone debt crisis. The world economy has substantially recovered over the past several years with forecasted growth close to 3.0% for 2018. Developed markets outside the U.S., including Europe and Japan, are forecasted to grow close to 2.0%, and emerging markets are forecasted to grow close to 4.5%. These numbers are indeed higher than what was forecasted six months ago. Of the 46 markets in the MSCI All-Country World Index, which includes both developed and emerging markets, 39 markets have had upgrades to their 2018 GDP forecasts over the last six months. With the pickup in growth, commodity prices have stabilized from their decline between 2013 and 2015. In addition, earnings growth for 2018 is forecasted to be 10% in developed markets and 13% in emerging markets.

Alongside the positive signs of global healing, there are policy and political uncertainties. Monetary policy in the U.S., Europe, and Japan that has supported this recovery is gradually changing. The US Fed has raised rates five times since the end of 2015, and the ECB has hinted that it is preparing to cut its crisis-era stimulus program. The Bank of Japan has sent a similar message as the ECB. Currently there is little sign of inflation, but given the growth of the world economy, inflation pressures may emerge globally. In the U.S., growth expectations have been promoted by policies such as corporate tax cuts and deregulation, although it is possible that these stimuli may be counterbalanced by growth-inhibiting trade and immigration policies. In addition, in the political sphere, there is no clear course that has emerged yet for an agreement on the terms of Britain’s exit from the European Union.

Given this backdrop of a healing global economy and solid earnings growth, coupled with policy and political uncertainty, what can be said about the equity markets outside of the U.S.?

As of the beginning of 2018, the markets outside the U.S. are generally less expensive than the U.S. The trailing price-to-earning ratio of the MSCI U.S. Index was 24x, while the aggregated price-to-earnings ratio for non-U.S. developed markets was 19x, and the price-to-earnings ratio for the MSCI Emerging Markets Index was 15x. Emerging markets, in particular, offer several positives, including discounted valuations, stabilized growth expectations, and narrowing sovereign risk spreads. Moreover, for emerging market commodity exporters, terms-of-trade trends have been positive because export prices have been increasing relative to import prices. However since the MSCI Emerging Markets Index rose 37% in 2017 and 12% in 2016, it is becoming harder to find inexpensive emerging markets.

Within emerging markets, we favor some of the smaller markets that are less expensive than developed markets and are less correlated and less volatile than the rest of the world markets. These include Malaysia and Thailand in Asia. We also favor some inexpensive markets such as Turkey, which is an unloved market because of its political risks. We continue our overweight view for Latin America.

Although we recommend some exposure to Continental Europe, which comprises 20% of the world's stock market capitalization and where growth is picking up, we are a little more cautious than consensus views. Since we look to the relative rankings of markets to set our overweights and underweights, we would underweight some of the European markets that have become more expensive, including Germany, the Netherlands, Belgium, and Ireland. Also these markets have high beta risk, in that they tend to be highly correlated with world returns and are relatively volatile.

Within Asia, Japan is a market that we overweighted for all of 2017, and continue to overweight. It has reasonable valuations with a trailing price-to-earnings of 16x and a forecasted 2018 price-to-earnings of 14x. It still has an undervalued currency in real terms (which makes exports competitive) and good price momentum. Also in Asia, Australia is another market in which we are overweight, largely due to inexpensive valuations, a positive terms-of-trade trend, and a competitively valued real exchange rate.

In summary, the markets outside the U.S. are generally less expensive than the U.S., offering rising GDP and earnings growth, declining sovereign risk spreads, competitive currencies, and strong price momentum. We expect this to continue for Q1 2018.

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