International Investing

For many investors, the investment universe begins and ends with the U.S. stock and bond markets. Investing outside of the U.S. may add a layer of diversification to an investment portfolio, but along with the potential for added returns comes certain risks. In this issue we take a look at factors that currently affect investors in international markets. Understanding the nuances may help investors make more informed decisions when managing their portfolios.

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No more ‘Wild East’: China’s Stock Market Is Growing Up Fast

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The Chinese stock market is changing at breathtaking speed and is on track to reach maturity faster than any other in history. Global investors have been reluctant to dive in, but there are good reasons to get acquainted with the companies serving the world’s second-largest economy.

A Stock Market’s Adolescence

Many investors prefer mature markets, where they can invest relatively easily, the government leaves the market more or less alone and provides consistent oversight, and companies disclose their finances, operations and risks so investors can make informed decisions.

China’s current A-shares market, which is composed of stocks that trade on the mainland exchanges, looks a lot like the U.S. stock market circa 1965. It’s still unevenly regulated, marked by patchy governance of its listed companies, and dominated by retail investors, whose tendency to buy high and sell low can exacerbate volatility.
Those traits make many global investors nervous, but are changing fast, thanks in large part to the inclusion of Chinese stocks in the MSCI Emerging Market Index (the “EM Index”) in 2018. Regulators had to make sweeping (and beneficial) changes to enable China A-shares to be included, and foreign and institutional participation has already increased as funds that track the index buy Chinese shares to match its holdings. Institutional investors, driven less by emotion than fundamentals, tend to lend stability to retail-dominated markets.

MSCI expects to continue adding Chinese stocks to the EM Index, with the next proposed addition coming in August 2019, bringing A-shares from 0.7% of the index to 2.8%. We expect A-shares to be fully included—comprising 16% of the index—in just three to five years. That’s half the time it took South Korea (six years) and Taiwan (nine years) to reach full inclusion. (Overall, Chinese assets—including those that trade on Hong Kong exchanges—would make up 42% of the EM Index.)

Three Steps Toward Maturity

China first started moving toward market maturity by simplifying access for foreign investors. In 2014, regulators launched Stock Connect, allowing foreign investors to buy stocks traded on the mainland from Hong Kong without a license or quota. Recently, it widened another access road by doubling the quota for foreign capital investment in Chinese markets through the Qualified Foreign Institutional Investor (QFII) program.

Another sign of a mature market is that it operates more or less freely and efficiently. On that score, the government has been much less prone to meddling in the A-shares market compared with a few years ago. In July 2015, when equity markets grew turbulent, around half of Chinese companies suspended trading to avoid major hits to their share prices. Some suspensions dragged on for months. In response to investor protests, in 2016 regulators limited suspensions to three months. While months-long suspensions would be unheard-of in the U.S. or U.K., China is moving in the right direction in this regard. In November 2018, Chinese regulators announced that they would further reduce the duration of suspensions.

The government has also stopped directly intervening to support domestic equities. In 2015, regulators instructed state-connected investment firms to shore up markets by buying stocks. Their silence in 2018 during another bout of volatility spoke loud and clear.

Third, for good governance and transparency, companies in mature markets must hold up their part of a contract with shareholders. Toward that end, Chinese securities and environmental regulators announced last year that listed companies must disclose the environmental, social and governance (ESG) risks to their businesses by 2020.

Those risks have abated somewhat recently, largely due to the Chinese government cracking down on corruption and bad corporate behavior. That means punishing companies that pollute the nation’s air and water, including by shutting factories down indefinitely and even jailing executives.

Forget the “Wild East”

Investors in A-shares still face volatility risks and exposure to geopolitical and trade uncertainty. Economic imbalances, including the rapid growth of debt in the financial system, wasteful infrastructure development and sky-high prices in parts of the housing market, are a continuing concern.
No more ‘Wild East’: China’s Stock Market Is Growing Up Fast (continued)

But the market is no longer, as many investors seem to think, the Wild East. It’s a maturing market that allows investors to tap into the world’s fastest-growing consumer market as well as industry-leading technology companies. It’s not just that China will be too big to ignore; it’s that investors won’t find this kind of potential anywhere else.

The views expressed herein do not constitute research, investment advice or trade recommendations and do not necessarily represent the views of all AB portfolio-management teams.

2 BREXIT and the International Investor

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Background

United Kingdom (UK) voters approved a referendum in June 2016 on whether Britain should leave the European Union (EU), a political and economic consortium of 28 countries, which the UK has been a part of for decades. This is uncharted territory for both the UK and EU, and there are significant tensions associated with the divorce proceedings. The UK is trying to depart with the best deal possible, while the EU is trying to make sure the departure is not so easy that other EU members are tempted to follow suit. The UK was scheduled to leave the EU on March 29th, 2019, but has been granted two extensions by the EU after the UK Parliament repeatedly failed to ratify the terms of the exit. At the time of this writing, the UK is scheduled to leave the EU no later than October 31, 2019.

Main issues

The government of British Prime Minister Theresa May and the EU have negotiated a withdrawal agreement that sets out the terms under which the UK will depart. However, the British Parliament has failed to ratify the agreement three times. Without an agreement, the status of EU citizens living and working in the UK will become uncertain, as will the status of UK citizens living and working in the EU. Trade between the UK and EU could be disrupted, as the UK will no longer be a member of the EU’s single market. The most difficult problem, absent an agreement, is the handling of border issues between Northern Ireland and the Republic of Ireland. In order to avoid a “hard border” requiring customs checks on goods moving across the border. Some members of May’s Conservative Party fear that a political workaround designed to avoid a hard border could leave the UK inextricably intertwined with the EU indefinitely, rather than cutting ties, as voters expected when they voted to leave the EU.

Investment and economic implications

So far, the investment and economic implications of Brexit have been milder than expected. UK unemployment is the lowest in nearly a half decade, and real wage growth is increasing. However, uncertainty around Brexit has contributed to a notable fall in business investment in recent quarters. Financial market volatility has been confined largely to currency markets, where the British pound has remained relatively weak relative to the dollar and other major currencies. Economic uncertainty has seen UK government bonds trade in a directionless fashion in recent months. While it will likely be years – and perhaps decades – for the full investment and economic implications to play out, short-term uncertainty can often lead to opportunity for long-term, fundamental investors.
Over the past year, trade tensions have been at the forefront of investors’ minds. In total, the U.S. Department of Commerce has slapped tariffs on goods ranging from lumber to solar panels, amounting to approximately $300 billion of US imports, representing 9.6% of all U.S. imports and 1.5% of U.S. GDP. While the lion’s share of tariffs have been applied to imports from China (25% tariffs on $50 billion and 10% tariffs on a further $200 billion), the U.S. and China have agreed to a pause implementing further tariffs to allow for negotiations to continue. Elsewhere, there are clouds on the horizon. Negotiations between the U.S. and Europe have been progressing, but there are some concerns over the auto industry; the new USMCA agreement between the North American economies appear to be facing some congressional hurdles; and negotiations with Japan show little signs of meaningful progress. Given the sensitivity of global growth to swings in trade, investors must assess the potential impacts trade has on the global economy and capital markets.

When considering the investment implications of all these trade actions, investors should first recognize how tariffs impact economies. From a macroeconomic perspective, tariffs could have a stagflationary effect, causing both high inflation as companies pass on higher costs to consumers, and high unemployment as tariffs disrupt supply chains, creating uncertainty and discouraging corporate investment and job growth.

While the economic impact of tariffs will be different on a country-by-country basis, from an investment point of view, the relative winners should be markets in which their fundamentals are less dependent on trade and exports, and more domestically focused. As shown in the chart, an assumed 5% decline in year-over-year export growth would cause forward 12-month earnings growth estimates to come under significant pressure in markets like China, Korea and Taiwan, but less so in markets like Canada and Australia. Exports as a share of economic output account for a much larger percentage (and therefore bigger driver of GDP), in many Emerging Asia and Latin American economies, whereas more closed-off economies tend to be less dependent on trade to drive growth. For example, exports as a share of GDP account for 57% in Taiwan, but only 18% in Australia.

Naturally, investors should be cognizant of the makeup of investible asset markets versus their economic fundamentals; not all benchmarks are representative of a country’s underlying economic drivers. While exports account for only 8% of GDP in the U.S., roughly 55% of US-based companies’ revenues are generated from abroad making export growth a key driver of earnings growth. However, given the defensive characteristic of the U.S. market relative to international markets, it’s likely the U.S. will fare better in a significant slowdown in global trade. Nonetheless, in markets where earnings growth is much more sensitive to export growth, investors may want to take a cautious approach until there is more clarity on future trade policy. While it does appear that trade tensions are easing across the globe, investors need to remember that lower tensions are not the same as resolutions to often intractable trade issues.

1 Based on total imports and nominal GDP for 2018.
Impact of a 5% decline in domestic exports on forward earnings estimates
Based on 3-month moving average of year-over-year change in goods exports and year-over-year change in NTM earnings growth estimates

Source: Ministry of Finance-Taiwan, Bank of Korea, People’s Rep. of China, Australia Bureau of Statistics, Statistics Canada, Statistics Singapore, Standard & Poor’s, Census Bureau, MSCI, Korea Exchange, Taiwan Stock Exchange, J.P. Morgan Economic Research. NTM is next twelve months. NTM earnings growth are in local currency. Sensitivities are based on regression analysis using monthly data over the past 20 years except for Korea and Taiwan which begin in 2006; Australia which begin in 2001 due to data availability; and China which began in 2002 after they joined the World Trade Organization (WTO). Indices used are as follows: MSCI USA (United States); S&P/TSX Composite (Canada); S&P ASX 200 (Australia); MSCI China (China); MSCI Singapore (Singapore); TAIEX (Taiwan); KOSPI Composite (Korea); MSCI EM Latin America (Latin America). MSCI China index includes both A-listed (onshore) and H-listed (offshore) shares. Data are as of April 23, 2019.

International Bonds and Currencies
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One of the areas that should be considered by investors looking to do more with their fixed-income allocation is international fixed income and its related exposure to currencies other than the U.S. dollar. There are many ways to break down the international bond markets, but one of the most straightforward ways would be to consider the sovereign debt of non-U.S. countries. Sovereign debt is effectively the U.S. Treasury equivalents issued by foreign governments. This debt can be thought of in two ways: developed-market sovereigns and emerging market sovereigns, with the developed markets generally being thought of as “safe haven” bond markets (similar to the U.S. Treasury market), and the emerging market sovereigns generally being regarded as risk-seeking investments. The chart below shows the current and historic valuations of both developed market sovereign bonds and emerging market sovereign bonds, based on the real yields of their 10 year bonds in local currency terms.

Historical Sovereign Real Yield Ranges (%)

Real Yield = Nominal Yield - Inflation

Source: Brandywine Global, as of 2/28/2019
There are a few interesting takeaways from this chart. First, you will notice that the developed markets have a low level of real yield (i.e., the nominal yield on the bonds, less the rate of inflation) across the board, with most lower than 2%, and many falling into negative real-yield territory. Second, you will notice that most of these countries have their current real yields at the lower end of their historic ranges, meaning their bonds are expensive based on history. Neither of these tidbits are particularly encouraging, and they introduce a paradox in that the “safe haven” bond markets across the world currently seem to be some of the riskiest investment in fixed income.

Emerging markets, by contrast, offer a different story. Their real yields are fairly high today, and if you look at those yields versus their historic ranges, they are fairly lofty, meaning they appear cheap from a fundamental perspective. The macroeconomic story backing emerging market local currency bonds is also fairly supportive, with many emerging market central banks having increased rates in 2015 to stop their respective currencies from plummeting on the back of strong dollar rallies in 2014 and 2015. This was painful at the time for emerging markets, but today they have (with a few notable exceptions) largely broken the back on inflation and seen it begin to roll over. Thus, you are left with treasury equivalents that offer significant yield premiums amid stable or falling inflation outlooks, which should lead to return potential from both the income component and the duration component of the bonds. This means that emerging markets (and peripheral European markets to a degree) offer some of the best value in the global bond space, and the ability for significant return.

The last piece of the puzzle that needs to be considered when discussing investments outside of the U.S., is foreign currency exposure. Currencies can move hard and fast, and while they offer the potential for enhanced returns, they can also very quickly erode gains and introduce heightened volatility. Having said that, now seems to be a particularly interesting time to consider investments that are tied to non-dollar currencies. The chart below show a current snapshot of relative valuation for myriad currencies, and the value of the U.S. dollar vs major trading partners over time, respectively. In this chart, you will notice that the U.S. dollar (shown on the far right) is the most expensive currency on the list.

**Percentage Deviation From BGIM PPP**

![Graph showing percentage deviation from BGIM PPP]

Source: Brandywine Global, as of 2/28/2019
This chart shows that the U.S. dollar is quite strong relative to its own history, having been this strong only two times since the U.S. came off the gold standard. When currencies get too strong or too weak, they have a fundamental effect on the economies that they govern. Thus, they tend to be mean-reverting over time, and may move back to some level long-term average. Right now, the dollar is significantly expensive, which means that, for U.S. dollar-based investors, taking prudent exposure to currencies outside of the U.S. dollar could be an attractive investment as the dollar falls back to some level of fair value.

Each of these markets comes with idiosyncratic and dynamic risk and return profiles. Given the return challenges that investors are currently facing in the U.S., however, international bonds and their related currencies can offer a potentially attractive complement for investors looking to glean more potential return out of their fixed-income investments.

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Three key takeaways from four days in Europe

Kristina Hooper, Chief Global Market Strategist, Invesco Blog 4/8/2019

Last week I had the pleasure of traveling in Europe, meeting with colleagues and clients in several different countries. It was a whirlwind tour, but it was well worth the jet lag to get an in-person account of the various issues facing Europe today. Below, I share three key takeaways from my trip.

1. A silver lining to Brexit.

It’s clear that Brexit is nothing short of a disaster. The UK Parliament again rejected all options put forward by its members in a series of indicative votes last week. Then after a seven-hour cabinet meeting, Prime Minister Theresa May invited Jeremy Corbyn (the leader of the opposition) to help find a solution. As of this writing, nothing has resulted from the meetings, and the government seems unwilling to make any compromises. Don’t be misled by the UK manufacturing Purchasing Managers’ Index (PMI) reading. While it went up in March, it’s likely due to an inventory buildup resulting from uncertainty around Brexit. More appropriate to pay attention to is UK service sector PMI, which fell into contraction territory in the month of March.
However, there is a silver lining. It appears that the UK has become a cautionary tale for other countries with antipathy towards the EU. For instance, the concept of a “Quitaly” is no longer a popular idea in Italy — in fact, the possibility of leaving the EU is really no longer being discussed in Italy. That’s not to say that Italian government is not facing difficult issues; it’s just that whether or not to leave the EU is not one of them. And it’s important to have that distraction out of the way, as it enables Italians to focus on other pressing issues that require their full attention, such as budget deficits and debt levels.

2. Unintended consequences of experimental monetary policy

The European Central Bank’s (ECB) policies, as with other central bank experimental policies, have created a number of undesirable and unintended consequences. When I was in Austria last week, I was fascinated to learn that there are a number of ongoing lawsuits against banks by borrowers whose mortgage rates have technically gone negative — the borrowers are attempting to force their respective banks to pay them for loaning money to them. No wonder banks are desperate for even the slightest normalization of monetary policy. Interestingly, ECB President Mario Draghi recently suggested that the ECB should consider alternative monetary policy measures that could deliver the benefits of negative rates but without the downside of negative rates.¹ This implies to me that the ECB may be pondering experimental forms of monetary policy beyond what has already been utilized.

There is another problem with experimental, very accommodative monetary policy, and that is the dual mandate it creates for central banks. These central banks need to normalize monetary policy so there is enough “dry powder” to combat the next crisis — but without choking off the current expansion in the process. Some central banks seemed to be concerned that, in attempting to normalize in 2018, they may have tightened too much — and they are now backtracking. That certainly seems to be what is happening with the ECB given its change in posture this year. That also seems to be what is happening with the US Federal Reserve and the Bank of Canada. For example, during a speech last week, Bank of Canada Governor Stephen Poloz refused to commit to the possibility of further rate hikes (reinforcing the recent language change in the meeting policy announcement). In addition, he suggested that the neutral range was not an appropriate target for investors to have in mind when it comes to the future direction of monetary policy. That seems to reflect a further dovish shift from the central bank. But these policy shifts beg the original question of what monetary policy tools will be available to use in the next crisis — and it suggests these tools could become increasingly experimental.

Experimental, accommodative monetary policy also encouraged the taking on of debt in the last decade because of ultra low rates. It’s no surprise that Christine Lagarde, head of the International Monetary Fund, warned last week that years of low interest rates and high public debt since the Global Financial Crisis have left limited fiscal dry powder with which to act in the event of the next downturn. This only complicates the lack of monetary policy dry powder. I will discuss more on this in a future commentary.

3. Hope for the eurozone

Eurozone economic data has generally weakened, but I believe there is the potential for stabilization and a recovery in economic growth. First of all, there’s a significant difference between manufacturing, which has been disappointing, and services, which has held up better. For example, the manufacturing Purchasing Managers’ Index (PMI) for the euro area was 47.5 in March versus 49.3 in February, the lowest since April 2013.² However, services PMI for the euro area actually improved from 52.8 in February to 53.3 in March.³

¹ Source: Bloomberg L.P., Draghi Says ECB May Need to Soften the Impact of Negative Rates, March 27, 2019
² Source: IHS Markit as of April 1, 2019
³ Source: IHS Markit as of April 3, 2019
The data implies that much of the current weakness can be attributed to the economic slowdown in China, which appears to be reversing. Consider that China’s manufacturing PMI for March has rebounded from February and is back in expansion territory. And China’s services PMI, which has remained in expansion territory, also improved for the month of March. This nascent trend was confirmed by the Caixin PMI data, which showed similar improvement for March over February. This suggests that if China continues to see improvement in its economic growth — which I expect — then that could likely impact the eurozone’s economic growth picture, albeit with a lag.

In the meantime, unemployment is relatively low compared to historical levels for most eurozone countries. While I was in Paris, I was encouraged to see that the “yellow vest” protesters’ numbers are not only dwindling, but that they only protest on weekends — something many outside observers may not realize — because these protesters are reportedly employed during the week. It seemed that media coverage had exaggerated how problematic the protests are. In addition, while the protesters have shown great persistence thus far, I can’t help but wonder if they are likely to succumb to “protest fatigue” given that they are employed. However, we will want to follow the situation closely as a significant hike in electricity costs is planned — which might provide a jolt in the arm to yellow vest protesters.
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