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INVESTMENT STRATEGY OUTLOOK – INTERNATIONAL EQUITY

June 30, 2018

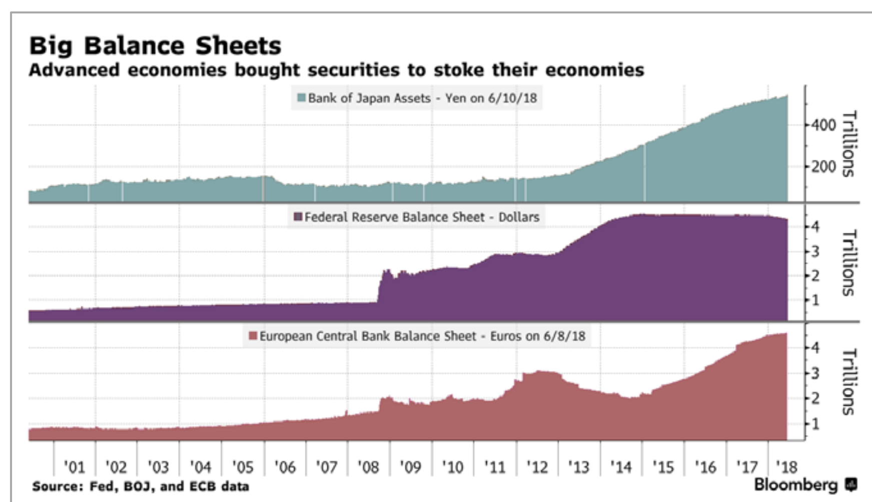
International stock markets rebounded (in local terms) in the second quarter, shrugging off slowing economic growth, tightening monetary policies, and escalating trade tensions. The FMI International portfolios advanced by approximately 2.7% in the period, compared with an MSCI EAFE Index gain of 3.47% in local currency, and a decline of 1.24% in U.S. Dollars (USD). The Finance, Consumer Services and Distribution Services sectors boosted performance results, as Consumer Non-Durables, Consumer Durables, and Electronic Technology each detracted. Top contributors included Nutrien, Smiths Group and Safran, while Electrolux, Adecco Group and Samsung Electronics each declined. Currency hedging was a tailwind due to a strong USD, while an elevated cash position weighed on the results.

For most of our clients, it will come as no surprise that we've been cautious in recent years, expressing great skepticism about the valuation environment and macroeconomic backdrop. In short, we do not believe today's elevated stock and bond prices appropriately reflect the litany of risks that permeate the investment landscape. Considering our vantage point, we are often asked *what we think will cause the next bear market.* In the absence of a crystal ball, unfortunately, this question cannot be answered with certainty. Furthermore, there is never just "one thing" that causes a market correction or a recession, as it is typically a culmination of many items that finally results in a tipping point. Lehman Brothers' collapse in September of 2008 didn't cause the Great Financial Crisis, but it certainly contributed to the fear and panic that ensued, opening people's minds to what else could go wrong. It was one of several important dominoes to fall.

As we look forward from today, our advice would be to expect the unexpected, as there's a good chance that the next bear market will be driven by catalysts that no one sees coming (negative surprises). That said, to try and better answer the question at hand, we've compiled a short list of potential culprits and risk points, any combination of which might help tip the scale in the years to come:

Failed Monetary Experiment

For years global central banks have been conducting experimental monetary policies centered around printing money to conduct massive asset-buying programs (quantitative easing, or QE). These policies were meant to spur economic growth, suppress interest rates (near zero or even negative), and drive up asset prices to create a wealth effect, which would in turn increase consumer spending. The U.S. Federal Reserve (Fed) paved the way, growing its balance sheet to $4.3 trillion, which compares with a $19.4 trillion economy (approximately 22% of the size). Not to be outdone, the European Central Bank's (ECB) balance sheet has ballooned to $5.3 trillion, larger than the Fed's, despite the eurozone's meaningfully smaller economy, at $12.6 trillion



(around 42%). By far, the most aggressive offender has been the Bank of Japan (BOJ), whose $5 trillion balance sheet is huge when compared with a $4.9 trillion economy (about 102%).[1]

These policies have not worked as planned; economic growth has been weaker than historical averages, despite the heavy stimulus. Per the World Bank, "After a decade of recovery from the global financial crisis, [world] economic activity is still lagging previous expansions and is expected to decelerate in the coming years."[2] Unfortunately, printing money does not solve real-world problems. Artificially low interest rates have fostered the misallocation of resources, as there has been excessive risk-taking, pushing financial asset valuations to extremes (i.e., negative-yielding corporate bonds), while allowing for the proliferation of zombie companies (businesses whose interest expense exceeds their earnings before interest and taxes, or EBIT). While Wall Street has benefited tremendously, Main Street has been left behind, with wealth inequality expanding significantly. Businesses have levered up their balance sheets with mergers and acquisitions (M&A), share buybacks and financial engineering (little of which grows the economy), and may struggle to service their debt once interest rates inevitably normalize. Governments face a similar debt problem. As financial market participants slowly come to the realization that QE leaves unintended consequences in its wake, asset value complacency may finally come to an end.

In addition, the tightening of monetary policies also poses a risk. QE was intended to drive financial markets higher, which it did. So why wouldn't the reversal of the same policies (quantitative tightening, or QT) have the opposite effect? Keeping a lid on inflation and interest rates may be a tough task, and beyond central bankers' control. While the Fed has ended QE entirely and started raising rates and shrinking its balance sheet (very slowly), the ECB plans to gradually taper its stimulus program, cutting its monthly asset purchases in half (to €15 billion) in October, before phasing it out by the end of the year. They've signaled that they intend to keep interest rates at record lows until September of 2019, keeping negative rates on deposits at the ECB.[3] The BOJ, however, plans to maintain its easy-money policies well into the future, stating recently that "The bank will continue with its quantitative and qualitative monetary easing with yield-curve control ... as long as it is necessary."[4] Central banks will try to do their best not to rock the boat as they unwind this reckless experiment. Odds are, they will disrupt the peace.

Economic Weakness

Not long ago, investors were cheering on the global economy's "synchronized growth." Today, the bloom appears to be coming off the rose. As illustrated here, the World Bank predicts that global GDP growth will peak at 3.1% in 2017 and 2018, declining to 2.9% by 2020. Eurozone growth is projected to slow from 2.1% this year to 1.5% in 2020, while Japan is expected to fall from 1% to 0.5% over the same period. China, which is the biggest contributor to world growth, is expected to slow from 6.5% to 6.2%.[5]

Real GDP *(Percent change from previous year)*

	2015	2016	2017e	2018f	2019f	2020f
World	**2.8**	**2.4**	**3.1**	**3.1**	**3.0**	**2.9**
Advanced economies	**2.3**	**1.7**	**2.3**	**2.2**	**2.0**	**1.7**
United States	2.9	1.5	2.3	2.7	2.5	2.0
Euro Area	2.1	1.8	2.4	2.1	1.7	1.5
Japan	1.4	1.0	1.7	1.0	0.8	0.5

Source: World Bank

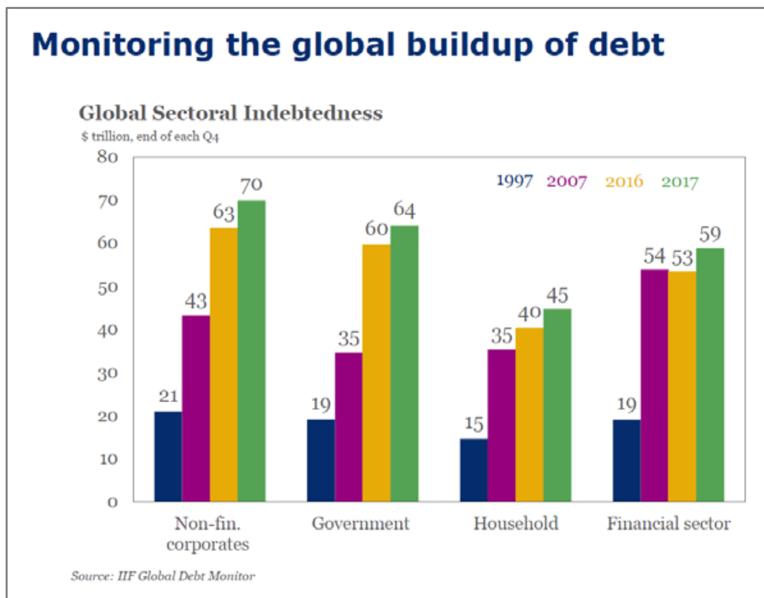
World economies are clearly losing some momentum. JPMorgan's global manufacturing purchasing manager's index (PMI) fell to 53.1 in May, a nine-month low,[6] while the eurozone recorded its slowest growth in 18 months.[7] Per *The Wall Street Journal*, "The Baltic Dry Index, a measure of shipping costs that investors often look to as a proxy for global demand, has fallen 22% from a recent peak last month. Copper prices, another gauge of economic activity, have been

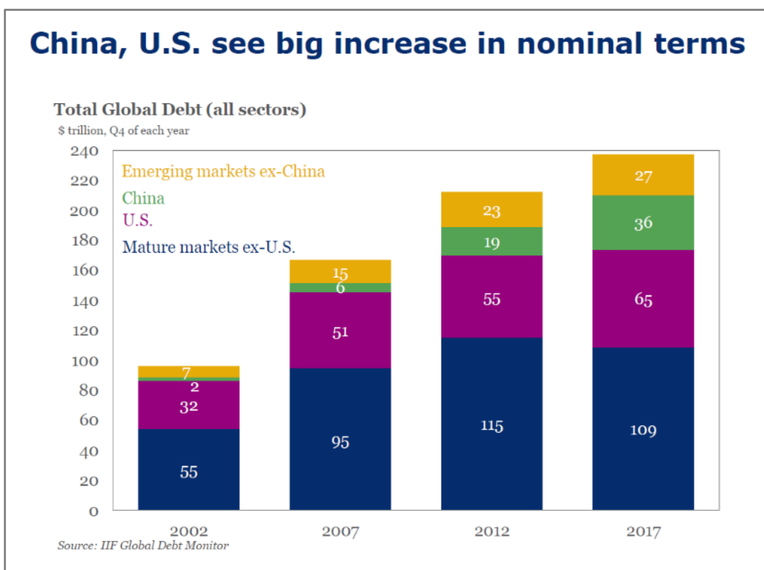
[1] Data source: Bloomberg.
[2] "Global Economic Prospects: The Turning of the Tide?" World Bank, June 2018.
[3] Claire Jones. "Draghi treads middle path in ending stimulus." *Financial Times*, June 14, 2018.
[4] Wataru Suzuki. "BOJ left alone as it maintains ultra-loose policy." *Nikkei Asian Review*, June 15, 2018.
[5] "Global Economic Prospects: The Turning of the Tide?" World Bank, June 2018.
[6] "JP Morgan Global Manufacturing PMI." JPMorgan and IHS Markit, June 1, 2018.
[7] Claire Jones. "Eurozone slowdown stokes concern over resilience of post-crisis recovery." *Financial Times*, May 2, 2018.

on the decline. Among developed economies, data overall have been missing economists' expectations by a wide margin…"[8] Additionally, oil prices have risen significantly, the USD has strengthened, and some emerging market economies (and currencies) have come under significant pressure, including Turkey and Argentina. Layer in the increasing potential for a trade war, and we would not be surprised to see global economic growth disappoint. If corporate earnings eventually follow suit, so too will equity prices.

Debt Levels

Global debt levels continue to climb to historic heights. The Institute of International Finance (IIF) estimates that total global debt reached a record $237 trillion in the fourth quarter, an eyewatering ~318% of GDP. This is up $21 trillion from last year, and over $70 trillion from a decade earlier.[9] This does not include liabilities linked to social security and health care spending, which would more than double the government debt in advanced economies if included, according to the International Monetary Fund (IMF). Deleveraging after the financial crisis was clearly an afterthought. Private debt has grown rapidly, with the IMF estimating that private debt ratios have doubled over the last decade, largely driven by China: "Developments since the onset of the global financial crisis are, however, almost a mirror image of just one country: China alone explains almost three-quarters of the increase in global private debt."[10] We've written at length in prior letters about the massive buildup of credit in China (and related risks) driven by excessive fixed investment in real estate and infrastructure. As illustrated in the chart to the right, China's debt has grown sixfold since 2007, compounding at nearly 20%. With China expected to account for more than a third of global GDP growth in the coming years,[11] the impact of a credit crisis would be felt worldwide.





Likewise, the risk of a credit crisis in Europe and the U.S. cannot be overlooked. As reported by *Financial Times*, "Investors have stumped up half a trillion euros in equity to recapitalize European lenders since the start of 2008, according to data from Dealogic — a number equivalent to half the total market value of the Stoxx 600 banks index

[8] Michael Wursthorn, Daniel Kruger, and Ben Eisen. "Global Economic-Growth Story Fades, Dimming Market Optimism." *The Wall Street Journal*, June 3, 2018.

[9] "IIF Quarterly Global Debt Monitor (GDM)." Institute of International Finance, May 2008.

[10] "World Economic and Financial Surveys: Fiscal Monitor." International Monetary Fund, April 2018. Pages 6-8, 30-31.

[11] Jeff Desjardins. "Half of expected world GDP growth in the next 2 years will come from the US and China." *Visual Capitalist*, June 5, 2017.

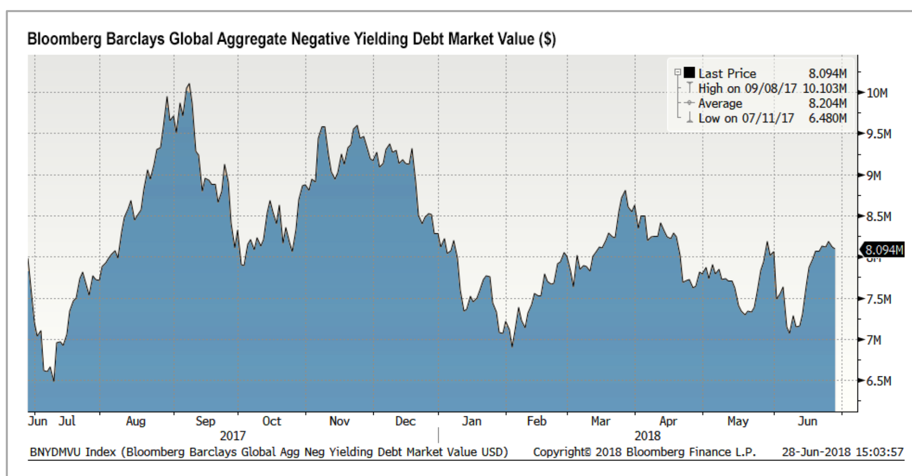
in euros."[12] Yet remarkably, the health of European banks remains suspect, as they still lug around €813 billion ($938.3 billion) of bad loans.[13] Furthermore, credit is clearly not priced appropriately in Europe thanks to the ECB's aggressive QE; sovereign bond yields in countries like Italy continue to trade lower than the U.S. despite facing weak economic growth (lower GDP in 2017 than 2006), a troubled banking system, and a high level of government debt. In the U.S., government debt is at an all-time high, entitlement programs appear unsustainable, and corporate balance sheets are stretched. Debt doesn't seem to matter… until it does.

Japan Sustainability

Despite having an aging and shrinking population and anemic economic growth, Japan carries around the world's heaviest public debt burden, expected to be 236% of GDP this year.[14] Japan's budget figures are staggering. In 2018, with a total budget of ¥97.7 trillion ($860 billion), the government will spend ¥23.3 trillion on debt service costs, which equates to 24% of the budget, and 39% of the expected tax revenue. This assumes interest rates stay at a record low of 1.1%, thanks to the BOJ's negative interest rate policy. New bond issuance will make up over 34% of the budget to plug the hole, a much higher debt dependency than other developed countries.[15] With around 90% of Japan's government debt held domestically, eventually the elderly population in Japan will go from saving to spending, looking to liquidate their assets. As the buyers for Japanese bonds start to dry up, interest rates should gravitate to more normal levels. If debt service were to double to 2.2%, it could cripple the country and the economy. Eventually something will have to give.

Bond Market Bubble

Negative-yielding debt still stands at over $8 trillion globally, which defies logic. As a reminder, a negative bond yield guarantees investors will lose money if they hold the bond to maturity. Investors are apparently banking on a "greater fool theory," with the hope that a greater fool will come along and pay an even more egregious price. Absent this, what rational investor would willingly agree to lend money at a guaranteed loss? As we wrote in our September 2016 letter, it is remarkable (and quite alarming) that we've gone from a world where sovereign debt once provided a supposed "risk-free return," to today when investors are lining up in droves for corporate bonds offering "return-free risk." According to Richard Sylla (co-author of *A History of Interest Rates* in 2005), there is no such precedent *(for negative interest rates)* in at least 5,000 years of banking history.[16] For good reason. Money is not supposed to be free, or in this case less than free. Over time, the inevitable normalization (rise) of interest rates is likely to weigh on both stock and bond prices.



[12] Miles Johnson. "Investors feel the pain as billions provided to recapitalise Europe's lenders goes unrewarded." *Financial Times*, April 22, 2018.

[13] Max Colchester, Patricia Kowsmann and Giovanni Legorano. "Who's Most Vulnerable to Italy's Troubles? Europe's Banks." *The Wall Street Journal*, May 30, 2018.

[14] "Government Debt." *The Economist*, April 18, 2018.

[15] Tetsushi Kajimoto. "Japan's record financial year 2018 budget puts fiscal discipline in doubt." *Reuters*, December 21, 2017.

[16] James Grant. "Hostage to a Bull Market." *The Wall Street Journal*, September 9, 2016.

Housing

It's not surprising that free money and rising financial markets have helped drive real estate asset values up significantly. For a number of years, UBS has published an annual *Global Real Estate Bubble Index* in an attempt to classify real estate markets at risk of a housing bubble. In 2015, they identified three cities – London, Hong Kong and Stockholm -- that made the cut. By 2017, the list expanded to eight cities, with Toronto, Stockholm, Munich, Vancouver, Sydney, London, Hong Kong and Amsterdam all qualifying.[17] Chinese cities are not included in the study, though they would surely have populated the list if they were eligible. With real estate being the core driver of China's economic growth, and well-documented excess in terms of overbuilding, price increases, and a severe lack of affordability, the bursting of China's real estate (and credit) bubble is quite possibly the biggest risk to the world economy. When the U.S. housing market crashed, homeowners lost equity, defaults rose, foreclosures increased, bank balance sheets got hit, banks failed, the financial system nearly collapsed, and the stock market got crushed. The ripple effects spanned globally, as pain spread well beyond the U.S. borders.

Geopolitical Risks

Geopolitical tensions have come to a fever pitch, with U.S. President Donald Trump engaging in tit-for-tat tariffs with a number of trading partners, including China, India, the European Union, Canada, and Mexico. While some believe U.S. tariffs are a powerful negotiating tactic that should yield results, the claim that "trade wars are good, and easy to win," seems misguided. Time will tell. In general, protectionism can lead to higher prices for consumer goods, which is detrimental for global output. Increased uncertainty and geopolitical tension may also put a damper on growth, and a full-blown trade war could have significant global ramifications on trade and business activity. While the U.S. might have a good case that they are receiving the "short end of the stick" in existing trade deals, there is likely a better way to approach the problem. In the end we hope cooler heads will prevail, because if this is not managed carefully, there is potential for sizeable downside risk to economic and business fundamentals.

Additional geopolitical risks include the survival of the eurozone, tension on the Korean peninsula, intensifying strains in the Middle East, and faltering dictatorial political systems and populist governments in regions such as Latin America. Moreover, the risk of unanticipated political outcomes appears to be increasing, with a global rise of populism. In Italy, two rival political parties, the anti-establishment Five Star Movement (M5S) and right-wing League party surprisingly combined to form a new populist coalition government, averting a snap election and potential political crisis. Fears that a new election would be viewed as a de facto referendum on Italy's membership in the eurozone caused Italian bonds to collapse, suffering their worst day in more than 25 years, with 2-year bond yields spiking over 150 basis points.[18] While trouble was avoided for now, it serves as a reminder of how quickly things can change.

Normal Market Cycles

Financial markets move in cycles. Howard Marks, in his 2001 memo to shareholders, illustrated the point: "The market proved – once again – that it can't move in one direction forever. It has to be appreciated in cyclical terms, with increases followed by decreases, and in fact with increases causing decreases." He observed, "The mood swings of the securities markets resemble the movement of a pendulum," which will swing "between euphoria and depression, between celebrating positive developments and obsessing over negatives, and between overpriced and underpriced."[19] Today, we are a lot closer to euphoria, celebrating the positive, and the overpriced end of the spectrum. Value investing has lagged for nearly a decade, as complacency has set in. Greed, not fear, has dominated investor behavior. Eventually the cycle will turn and the pendulum will swing back.

Bear Market in the U.S.

If the U.S. stock market unravels, there is a high probability that other developed markets will follow. In the U.S., the S&P 500 is over nine years into a bull market -- the second longest on record, and second highest in terms of total

[17] Chief Investment Office Americas, WM. *UBS Global Real Estate Bubble Index,* September 2017.

[18] Dhara Ranasinghe and Abhinav Ramnarayan. "Italian bonds suffer worst day in more than 25 years." *Reuters*, May 29, 2018.

[19] Howard Marks. "You Can't Predict. You Can Prepare." Memo to Oaktree Capital clients. November 20, 2001.

return.[20] U.S. stock valuations have been trading in the 9th and 10th decile -- one of the most expensive periods in the market's history.[21] FAANG (Facebook, Apple, Amazon, Netflix, and Alphabet's Google) stocks have led the growth and momentum charge, with passive investing adding fuel to the fire. Money-losing "story stocks," including biotech, have shined. Meanwhile, the quality of earnings has deteriorated, with adjusted earnings (excluding "one-time" items and/or stock compensation) overstating underlying profit growth. S&P 500 companies have levered up with debt to a 50-year high,[22] opting for share buybacks and M&A instead of organic investment. The upside appears limited, as most data points look to be late in the cycle. Now, more than ever, downside protection is paramount.

While most people think there is no bear market in sight, we will continue to keep our antennas up and proceed with caution. Encouragingly, volatility has started to pick up recently. Approximately 31% of the constituents in the MSCI EAFE Index are down 20% or more from their 52-week highs, with 62% down at least 10%.[23] As equity valuations become more favorable, we will look to take advantage.

Thank you for your confidence in Fiduciary Management, Inc.

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[20] Thomas Franck. "On the bull market's ninth birthday, here's how it stacks up against history." CNBC, March 8, 2018.
[21] Source: Leuthold data.
[22] Source: Compustat, Deutsche Bank.
[23] As of 6/21/18.

Fiduciary Management Inc.
International Equity Composite
12/31/2010 - 12/31/2017

Year	Total Return Gross of Fees %	Total Return Net of Fees %	*Benchmark Return %	Number of Portfolios	Dispersion %	Three Year Ex-Post Standard Deviation Composite	Three Year Ex-Post Standard Deviation *Benchmark	Total Composite Assets End of Period ($ millions)	Total Firm Assets End of Period ($ millions)	Percentage of Firm Assets %
2011	-0.78	-1.52	-12.15	1	0.00	n/a	n/a	$ 16.7	$ 12,273.6	0.14%
2012	19.35	18.46	17.31	1	0.00	n/a	n/a	$ 76.3	$ 15,253.5	0.50%
2013	25.89	24.95	26.93	1	0.00	9.78	12.22	$ 165.8	$ 19,705.3	0.84%
2014	5.66	4.87	5.92	1	0.00	7.49	10.33	$ 771.6	$ 21,001.1	3.67%
2015	4.24	3.46	5.33	2	0.00	8.14	11.73	$ 2,832.9	$ 21,042.9	13.46%
2016	11.04	10.23	5.34	3	0.38	7.39	11.53	$ 5,946.2	$ 22,626.7	26.28%
2017	16.51	15.70	15.23	3	0.02	7.04	11.20	$ 8,209.3	$ 25,322.0	32.42%

*MSCI EAFE Net Local Index®

Returns reflect the reinvestment of dividends and other earnings.
The above table reflects past performance. Past performance does not guarantee future results. A client's investment return may be lower or higher than the performance shown above. Clients may suffer an investment loss.

Fiduciary Management, Incorporated (FMI) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. FMI has been independently verified for the periods 12/31/1993 - 12/31/2017. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. The International Equity Composite has been examined for the periods 12/31/2010-12/31/2017. The verification and performance examination reports are available upon request. Benchmark returns are not covered by the report of independent verifiers.

FMI was founded in 1980 and is an independent investment counseling firm registered with the SEC and the State of Wisconsin. The firm manages over $25.3 billion in assets of pension and profit sharing trusts, mutual funds, Taft-Hartley funds, insurance company portfolios, endowments and personal trusts. The firm includes both institutional and mutual fund business. Although the firm has participated in wrap programs, it is a separate and distinct business, and is excluded from firm-wide assets.

The International Equity Composite was created on December 31, 2010. This composite invests mainly in a limited number (usually between 25-40) of large capitalization (namely, companies with more than $5 billion market capitalization) foreign companies.

The International Equity Composite reflects time-weighted and asset-weighted returns for all discretionary accounts. All returns are calculated using United States Dollars and are based on monthly valuations using trade date accounting. All accounts in this composite are fee paying. Gross of fees returns are calculated gross of management fees, gross of custodial fees, gross of withholding taxes and net of transaction costs. Net of fees returns are calculated net of actual management fees and transaction costs and gross of custodial fees and withholding taxes. Dispersion is calculated using the equal weighted standard deviation of all accounts in the composite for the entire period. As of 12/31/2011, the trailing three year annualized ex-post standard deviation for the Composite and Benchmark are required to be stated per GIPS®. For the periods 2011-2012, the information is not available for the International Equity Composite.

Currently, the advisory fee structure for the International Equity Composite portfolios is as follows:

Up to $25,000,000	0.70%
$25,000,001-$50,000,000	0.65%
$50,000,001-$100,000,000	0.60%
$100,000,001 and above	0.55%

The firm generally requires a minimum of $25 million in assets to establish a discretionary account. The minimum account sizes do not apply to new accounts for which there is a corporate, family, or other substantial relationship to existing accounts. In addition, the firm reserves the right to waive the minimum account size and minimum annual fee under certain circumstances. A complete list and description of all firm composites is available upon request. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The MSCI EAFE Net Local Index® 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 EAFE Net Local Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. It is reported in local currency and net of hedges. The International Equity composite uses the MSCI EAFE Net Local Index® as its primary index comparison.