Touchstone Investments®
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International Equities

Currency Backdrop

Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Brian Cheyne, CFA, CIMA

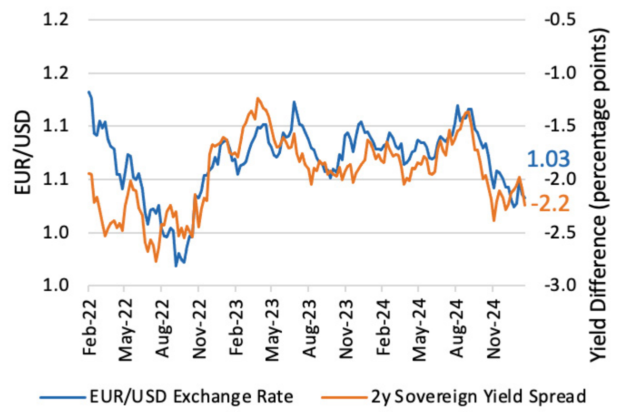
February 14, 2025

- The U.S. dollar is nearly flat year-to-date, as Trump's tariffs have mostly been threats (so far) as opposed to actual actions and Treasury yields have shifted lower. However, we believe that the dollar may retest its 2022 highs in 2025. Near-term drivers include a Fed that remains on hold while other central banks cut rates, alongside political initiatives such as deregulation, lower taxes, and potential tariffs, all of which could strengthen the dollar.
- Looking back at Trump's first term, the dollar gained nearly 15% after tariffs were introduced in 2018. While tariffs weren't the sole driver, they played a significant role. This time around, tariff proposals are more aggressive, raising greater concerns. That said, it remains unclear whether they will be implemented as proposed.
- It is still unclear what approach the Trump administration will take with tariffs. Instead of a blanket 10% tariff as pitched on the campaign trail, the latest announcement was to instead impose reciprocal tariffs. On the surface, reciprocal tariffs would be less impactful than the blanket 10% tariff increase as most advanced economies have tariff rates that are more closely aligned with U.S. levels. However, if a VAT is treated as a tariff, the impact would be much larger and more generalized (175 countries levy a VAT, including all of Europe).
- Beyond tariffs, interest rates have also been influencing the dollar. Most developed countries and many emerging countries' interest rates tend to track Treasury yields. If U.S. rates remain high, global economic growth could face additional pressure.
- Our cautious stance on international currencies reflects uncertainties surrounding policy implementation and monetary responses. Much will depend on how closely the Trump administration adheres to its policy proposals.

U.S. Dollar Index

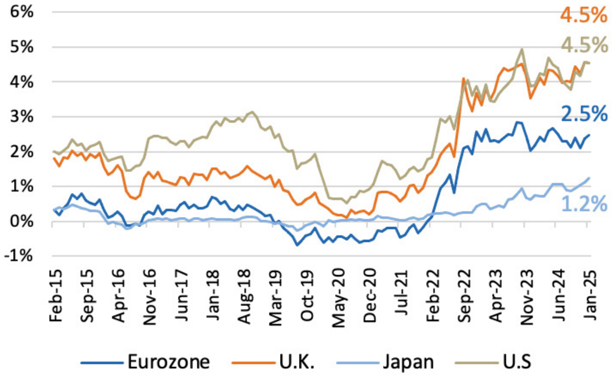
Source: Bloomberg. 1 year of daily data through Feb 11 2025

Euro/Dollar and Yield Spread



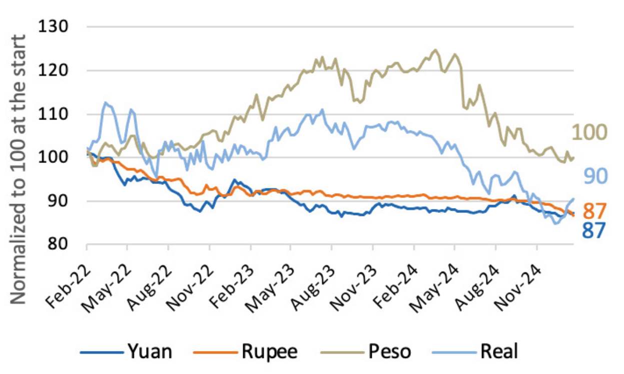
Source: Bloomberg. 3 years of weekly data through Feb 07 2025

10 Year Government Yields



Source: Bloomberg. 10 years of monthly data through Jan 2025

Emerging Market Currencies versus the Dollar



Source: Bloomberg. 3 years of weekly data through Feb 07 2025

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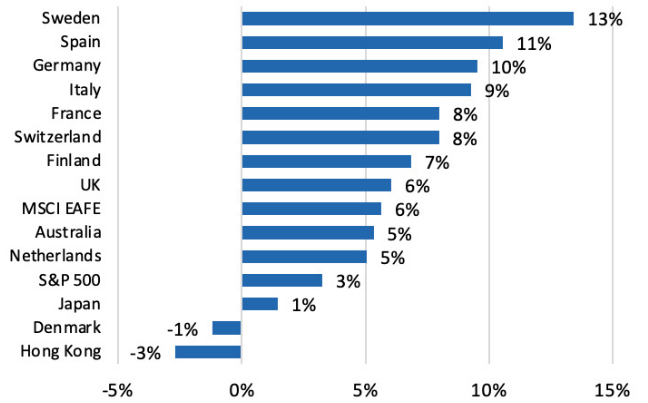
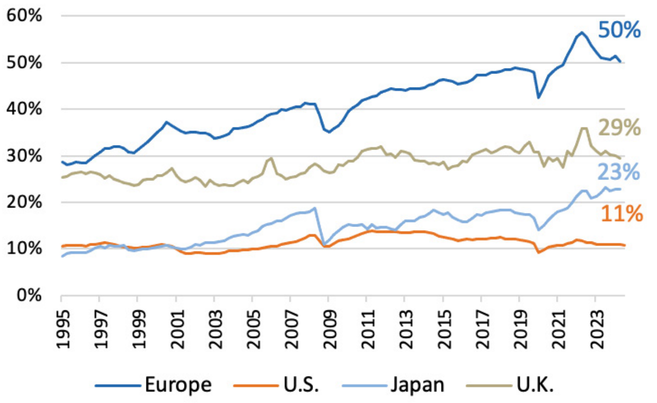
- We are slightly underweight developed international markets, as we see more currency and growth risks compared to the US.
- European equities have started the year strong, led by banks and luxury goods. However, the rally appears to be more sentiment-driven than fundamentally justified. So far, relief has come from the absence of tariffs and earnings reports that have not disappointed. Other positives include France avoiding a no-confidence vote, a potential loosening of Germany's strict budget rules, and early signs of a possible peace path in Ukraine.
- Despite these positives, we remain cautious on Europe. Tariffs still seem likely, and exports are critical to the region's economy. Additionally, inflation and wage pressures limit the ECB's ability to cut rates aggressively, even as economic conditions remain weak. Foreign direct investment (FDI) trends are also concerning for Europe. The U.S. share of global FDI soared to a record high in 2024, with 62% of U.S. FDI projects originating from Europe. Meanwhile, Europe's own FDI share has fallen sharply. That said, while near-term conditions are unappealing, additional currency weakness, lower interest rates, and an end to the war in Ukraine could improve Europe's investment outlook later in 2025.
- Japan's headline inflation hit 3.6% in December, surpassing rates in the U.S., EU, and UK. And for Japan, that was good news. Wages grew at an even faster rate (+4.8% YoY), fueling consumer spending. While it is still early, Japan may finally be emerging from its three-decade deflationary slump. However, significant challenges remain, they have accumulated massive government debt and entitlement burdens, and their population is in decline, which could weigh on long-term growth.
- With few catalysts for outperformance, we maintain a slightly underweight position. However, current valuations reflect many of our concerns. The MSCI EAFE index trades at just 15x 2025 EPS estimates, compared to 22x for the S&P 500.

YTD Total Return by Country (in USD)



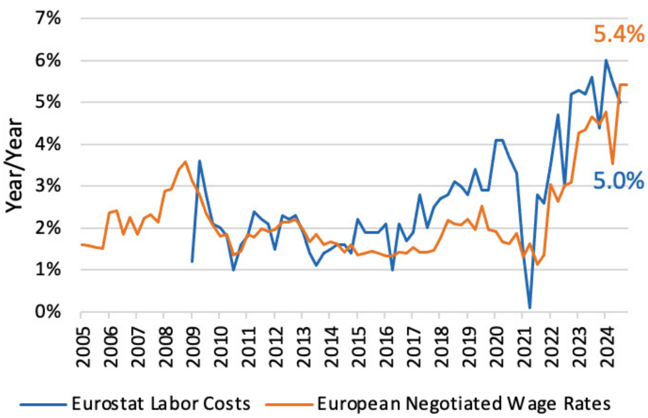
Source: Bloomberg. Data as of Feb 10 2025

Exports as a Percent of GDP



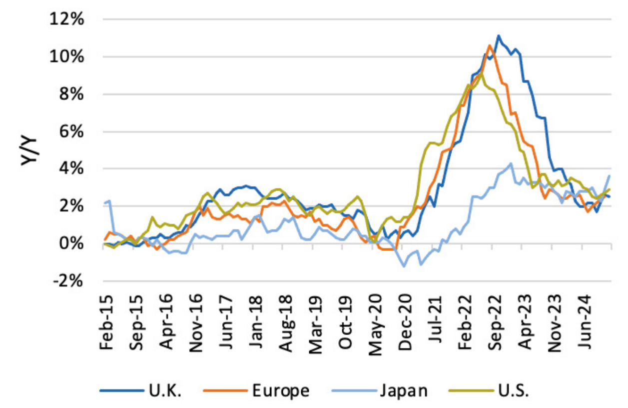
Source: Bloomberg. 30 years of quarterly data: Europe through Sep 2024, U.S. through Dec 2024, Japan through Sep 2024, U.K. through Sep 2024.

European Wage Growth



Source: Bloomberg. 20 years of quarterly data: Labor Costs through Dec 2024, Negotiated Wage Rates through Sep 2024.

Headline Inflation (CPI by Region)



Source: Bloomberg. 10 years of monthly data through U.K. through Dec 2024, Europe through Nov 2024, Japan through Dec 2024, U.S. through Dec 2024.

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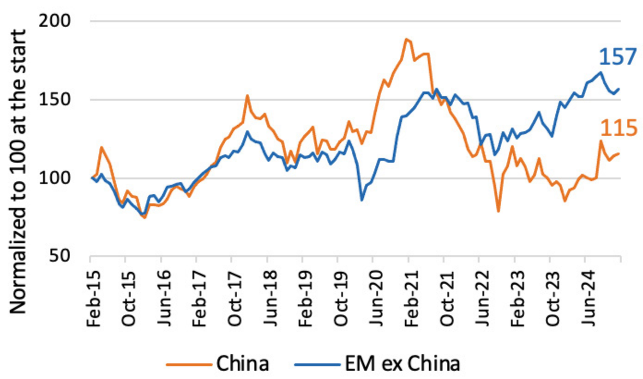
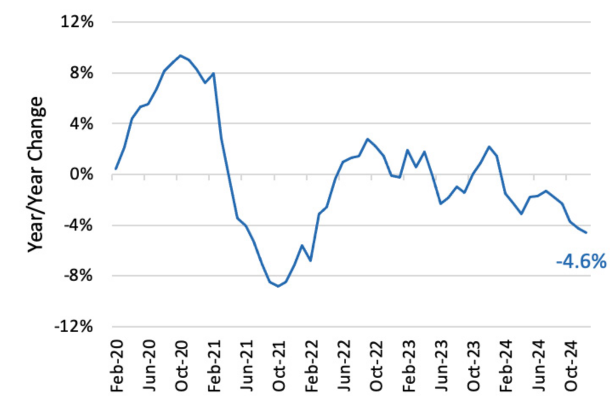
- We shifted to a slight underweight in EM following the U.S. election. Tariff risks and slower Fed rate cuts create headwinds, particularly for China. A more hawkish Fed could deter foreign investment, while Trump's broader tariff proposals could impact EM economies beyond China.
- **Insight on China.** Our EM benchmark includes China, but many new EM funds and ETFs now exclude it. If we could exclude China, would we?
- China faces some significant long-term headwinds, including a heavily overbuilt property sector, shrinking demographics, and an apparent shift away from free-market capitalism. In the shorter-term China's economy has slowed due to weaker exports and sluggish consumer spending. And finally, the U.S. has started a new tariff war with China.
- However, there are positives. Valuations already discount a lot of the headwinds, and the government is likely to continue supporting the economy (a "Xi put"?). China also retains global leadership in key industries and has a vast internal market to sell into. Ultimately, we believe the risk/reward is relatively balanced.
- Another consideration is what the EM index looks like without China. It becomes a more concentrated index with Taiwan, India, and Korea representing 65% of the index and Taiwan Semiconductor alone representing 15%. While the index becomes more concentrated, expected EPS growth is slightly higher, albeit at a slightly higher valuation.
- Honestly, we struggle with the EM index, with or without China, due to concentration issues and heavy representation of state-owned enterprises. We believe there is tremendous opportunity within emerging markets, though much of this is hidden beneath the surface.

Total Returns in USD using MSCI Indexes



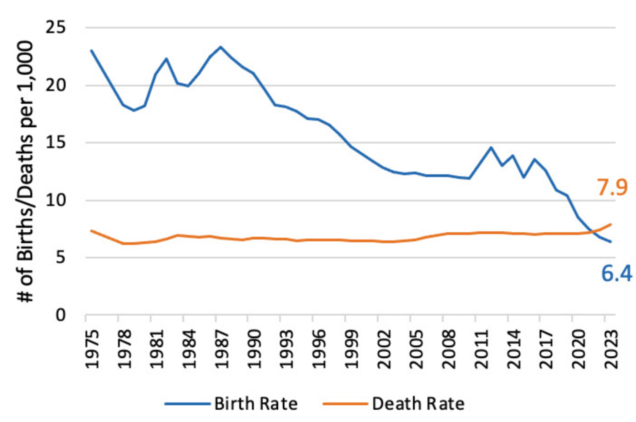
Source: Bloomberg. 10 years of month;y data through Jan 2025

China Credit Impulse



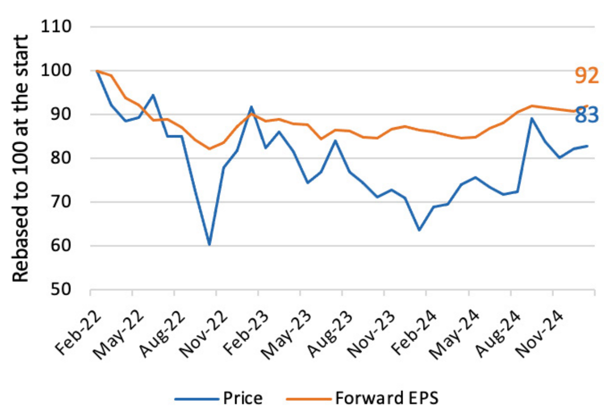
Source: Bloomberg. 5 years of monthly data through Dec 2024. The credit impulse measures the change in new credit issued as a % of GDP.

China's Population Now Shrinking



Source: Bloomberg. Annual data from 1975 through 2023

MSCI China Index (local currency)



Source: Bloomberg. 3 years of monthly data through Jan 2025

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Market Characteristics

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The Indexes mentioned are unmanaged statistical composites of stock market or bond market performance. Investing in an index is not possible.

Total Net Returns in USD							EPS Growth Estimate	
	January 2025	YTD	2024	2023	2022	Index Weight	2024	2025
MSCI EAFE	**5.3%**	**5.3%**	**4.3%**	**18.9%**	**-13.9%**	**100%**	**-3%**	**4%**
MSCI United Kingdom	5.2%	5.2%	7.5%	14.1%	-4.2%	14%	-11%	5%
MSCI Japan	1.6%	1.6%	8.7%	20.8%	-15.7%	22%	23%	-1%
MSCI Europe	7.4%	7.4%	1.0%	22.7%	-16.7%	53%	-6%	6%
MSCI EM	**1.8%**	**1.8%**	**8.1%**	**10.3%**	**-19.2%**	**100%**	**13%**	**14%**
MSCI China	1.0%	1.0%	19.7%	-11.0%	-21.8%	25%	17%	10%
MSCI India	-3.5%	-3.5%	12.4%	21.3%	-6.2%	18%	50%	15%
MSCI Taiwan	3.3%	3.3%	35.1%	31.3%	-29.5%	20%	39%	18%
MSCI Korea	6.3%	6.3%	-23.1%	23.6%	-28.9%	9%	33%	18%

Valuations	P/E (TTM)	Percent Rank	P/E (FTM)	Percent Rank	P/CF	Percent Rank	P/S	Percent Rank
MSCI EAFE	**15.8x**	**33%**	**14.9x**	**66%**	**10.2x**	**78%**	**1.5x**	**94%**
MSCI United Kingdom	13.5x	32%	12.2x	38%	8.4x	34%	1.5x	83%
MSCI Japan	14.8x	26%	15.3x	53%	8.9x	57%	1.2x	98%
MSCI Europe	16.4x	39%	15.4x	77%	11.1x	87%	1.7x	95%
MSCI EM	**15.3x**	**65%**	**12.3x**	**69%**	**10.3x**	**86%**	**1.5x**	**70%**
MSCI China	13.1x	43%	10.5x	30%	10.6x	66%	1.2x	37%
MSCI India	25.8x	89%	19.0x	86%	19.4x	94%	2.7x	86%
MSCI Taiwan	21.1x	67%	16.8x	89%	13.8x	80%	2.3x	86%
MSCI Korea	11.4x	45%	7.4x	20%	5.7x	42%	0.8x	81%

Fundamentals	Dividend Yield	Percent Rank	Profit Margin	Percent Rank	ROE	Percent Rank	Net Debt / EBITDA	Percent Rank
MSCI EAFE	**3.0%**	**51%**	**8.3%**	**90%**	**11.0%**	**72%**	**1.8**	**12%**
MSCI United Kingdom	3.7%	51%	7.7%	63%	10.4%	35%	1.2	17%
MSCI Japan	2.2%	76%	7.2%	97%	9.8%	94%	-0.9	12%
MSCI Europe	3.0%	52%	8.6%	91%	12.2%	71%	3.4	11%
MSCI EM	**2.7%**	**66%**	**9.3%**	**65%**	**11.7%**	**49%**	**2.0**	**79%**
MSCI China	2.9%	76%	9.7%	28%	11.3%	31%	3.5	100%
MSCI India	1.2%	24%	9.9%	60%	15.4%	43%	2.7	61%
MSCI Taiwan	2.2%	32%	9.6%	76%	14.3%	83%	0.2	10%
MSCI Korea	2.2%	81%	6.2%	71%	7.3%	33%	2.7	46%

For Index Definitions see: TouchstoneInvestments.com/insights/investment-terms-and-index-definitions

Source: Bloomberg. Percent ranks are based on 30 years of monthly data as of the end of January; EPS growth estimates based on consensus bottom-up analyst estimates.

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The Touchstone Asset Allocation Committee (TAAC) consisting of Crit Thomas, CFA, CAIA – Global Market Strategist, Erik M. Aarts, CIMA – Vice President and Senior Fixed Income Strategist, and Brian Cheyne, CFA, CIMA – Senior Investment Strategy Specialist, develops in-depth asset allocation guidance using established and evolving methodologies, inputs and analysis and communicates its methods, findings and guidance to stakeholders. TAAC uses different approaches in its development of Strategic Allocation and Tactical Allocation that are designed to add value for financial professionals and their clients. TAAC meets regularly to assess market conditions and conducts deep dive analyses on specific asset classes which are delivered via the Asset Allocation Summary document. Please contact your Touchstone representative or call 800.638.8194 for more information.

A Word About Risk

Investing in equities is subject to market volatility and loss. Investing in foreign and emerging markets securities carry the associated risks of economic and political instability, market liquidity, currency volatility and accounting standards that differ from those of U.S. markets and may offer less protection to investors. The risks associated with investing in foreign markets are magnified in emerging markets due to their smaller economies. Events in the U.S. and global financial markets, including actions taken to stimulate or stabilize economic growth may at times result in unusually high market volatility, which could negatively impact asset class performance. Banks and financial services companies could suffer losses if interest rates rise or economic conditions deteriorate.

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