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International Equities

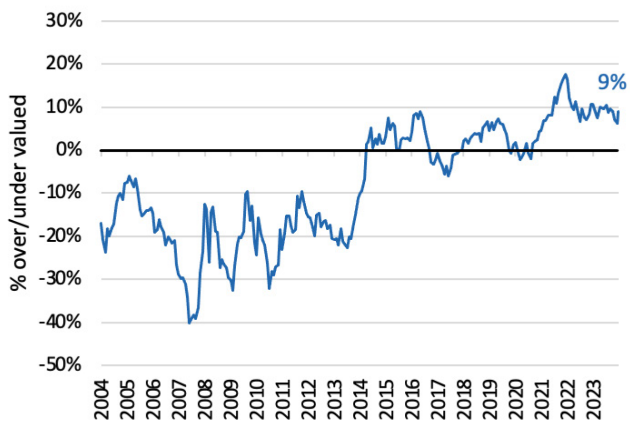
Currency Backdrop

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

October 23, 2024

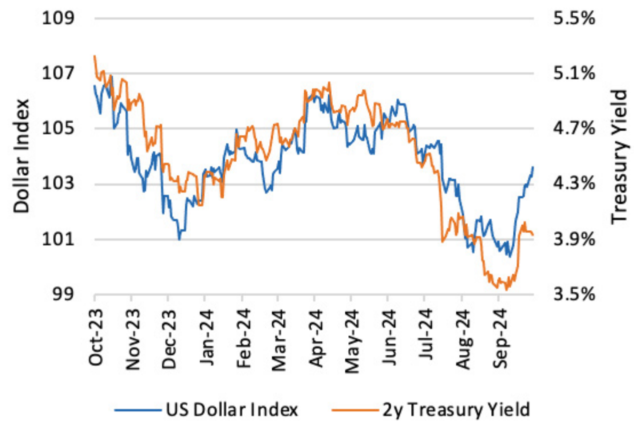
- We believe that the nearly 15-year rally of the US dollar has likely come to an end. Long-term factors, such as fair value measures and the widening budget deficit, do not favor the dollar. Additionally, short-term drivers like the Fed funds rate have begun to decline as the Fed moves into an easing cycle.
- Could a Trump presidency challenge our forecast? It's possible. The dollar has shown sensitivity to changes in polling and PredictIt betting data, often rising and falling with Trump's election prospects. His tariff proposals have been a key factor. Higher tariffs typically weaken the currency of the targeted country, strengthening the currency of the country imposing the tariffs. Trump's support for lower taxes could also be a positive for the dollar, as tax cuts might stimulate economic growth. We may revisit our dollar thoughts should there be a republican sweep.
- The broad dollar rallied in October, primarily driven by a near-term change in the direction of interest rates that directly influence the return on holding dollars. The two-year Treasury yield increased in October following stronger-than-expected economic data. Meanwhile, yields for other regions such as Europe and China decreased due to weaker economic indicators. Europe and China are our largest trading partners.
- We are not suggesting that the dollar is entering a period of secular decline, rather, we believe the prolonged rally has come to a close. We expect that the dollar will become more range-bound than trend-driven moving forward.

U.S. Dollar Purchasing Power Parity



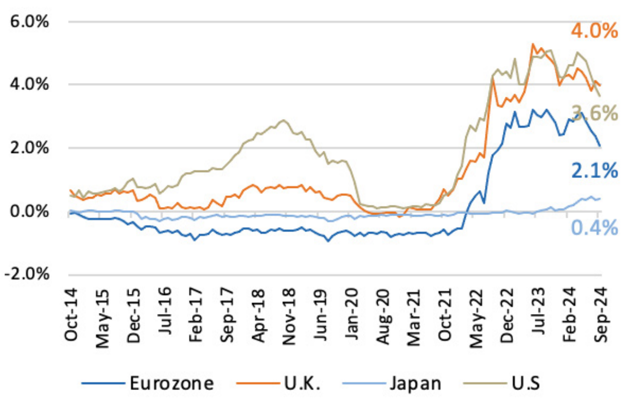
Source: Bloomberg. 20 years of monthly data through Sep 2024

US Dollar and Treasury Yields



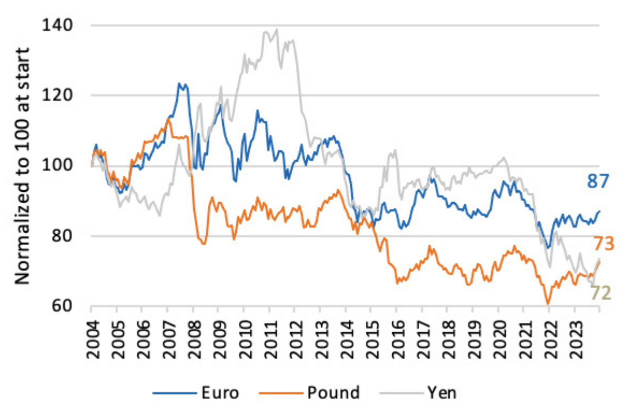
Source: Bloomberg. 1 year of daily data through Oct 16, 2024

2 year Government Bond Yields



Source: Bloomberg. 10 years of monthly data through Sep 2024

Developed Currencies versus the Dollar



Source: Bloomberg. 20 years of monthly data through Sep 2024

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Developed Ex-U.S.

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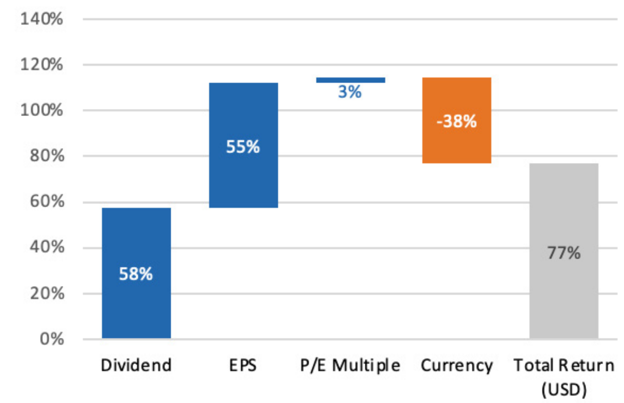
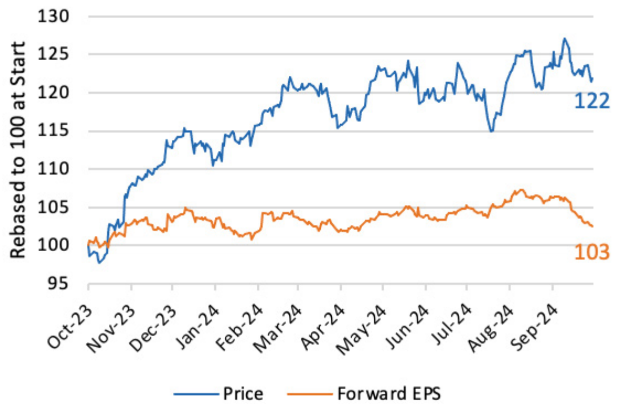
- We are currently slightly underweight in our allocation. Although we had been moving toward a neutral allocation and considered shifting to an overweight later this year, that now appears less likely.
- Over the past decade, the strength of the U.S. dollar has been the main headwind affecting MSCI EAFE performance for U.S. investors. While the absence of a currency headwind would create a more level playing field, international stocks would still need to outperform. This would likely require improving fundamentals compared to U.S. stocks. We had anticipated progress in the second half of this year, particularly in Europe, but recent signs of weakness are concerning. We are also considering U.S. election risks, given the potential negative impact of tariffs.
- Although it is early in the earnings season, reports from European companies have generally fallen short of expectations, even with downward estimate revisions in recent months. Economic softening in China appears to be contributing to this weaker outlook.
- The ECB lowered rates for the second time by 25 basis points in October. Headline inflation data for the UK and EU has dipped below the 2% target. However, when excluding food and energy, inflation in the EU remains above target at 2.7% in September, and services inflation is at a still high 3.9% year-over-year. Tight labor conditions, indicated by wage growth, are likely to keep the ECB on a moderate path for rate reductions.
- Japan has experienced strong equity performance this year, driven by earnings. However, earnings estimates for next year are declining, with analysts currently forecasting just 2% growth. In mid-October Japan's central bank made dovish comments, citing a stronger yen and slowing global demand as reasons to moderate their pace of rate increases. The BoJ tightening bias contrasts with most other central banks.
- Overall, we expect to maintain a slight underweight position, as a catalyst for outperformance is currently lacking.

MSCI EAFE Index Return Composition



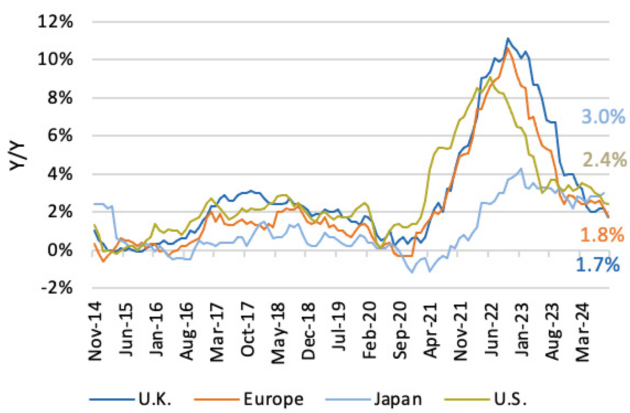
Source: Bloomberg. Cumulative total returns over the last 10 years through Sep 2024

MSCI European Union



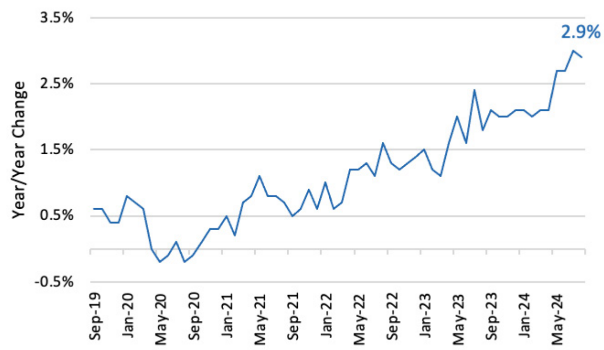
Source: Bloomberg. 1 year of daily data through Oct 16 2024

Headline Inflation (CPI by Region)



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

Japan Labor Survey: Wages



Source: Bloomberg. 5 years of monthly data through Aug 2024

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Emerging Markets

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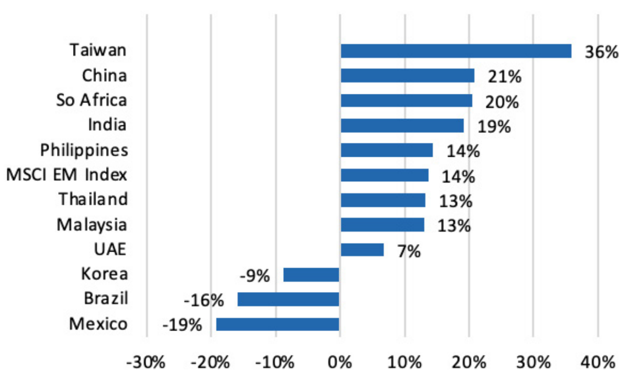
- We maintain a neutral weighting in emerging market (EM) equities, but the outlook is mixed due to several cross currents.
- In late September, China announced a stimulus package that was significantly larger than previous ones. We view this as a positive sign, indicating that China is beginning to acknowledge the extent of its economic challenges. The government also indicated that more stimulus is on the way. Last month, we cautioned that without further government intervention, China risked falling into a deflationary spiral.
- Was the stimulus package enough? We don't think so. However, as the adage goes, the first step to solving a problem is recognizing that you have one. It will likely take years for China to balance its housing and debt issues. That said, valuations are attractive, and the government appears willing to provide additional stimulus as needed.
- The growth picture for emerging countries near China looks quite different. The World Bank recently upgraded its growth forecast for South Asia, including India, labeling it the fastest-expanding region in the world. This upgrade was based on stronger domestic demand and a resurgence in tourism. Southeast Asian countries like Indonesia and the Philippines are also seeing robust economic growth bolstered by foreign direct investment. Unlike China, though, many of these markets have high valuations.
- Mexico and Brazil have underperformed in 2024. Mexico's struggles are primarily due to currency weakness, with the peso down 15% year-to-date against the dollar. The decline is linked to the ruling party's landslide election and the subsequent judicial reforms that raise concerns about the rule of law. Brazil is grappling with political issues and a worsening fiscal situation. Additionally, weak demand from China is impacting Brazil's resource-rich exporters. The country is facing a resurgence in inflation and recently raised rates for the first time in two years. We would tread lightly in Latin America.
- One positive development for EM in general was the dovish Fed rate cut, which has provided many emerging markets with the flexibility to lower their own rates. While EM equities have performed well to date, we remain comfortable with an equal weighting given the current complexities.

YTD Total Returns (in USD) by Country

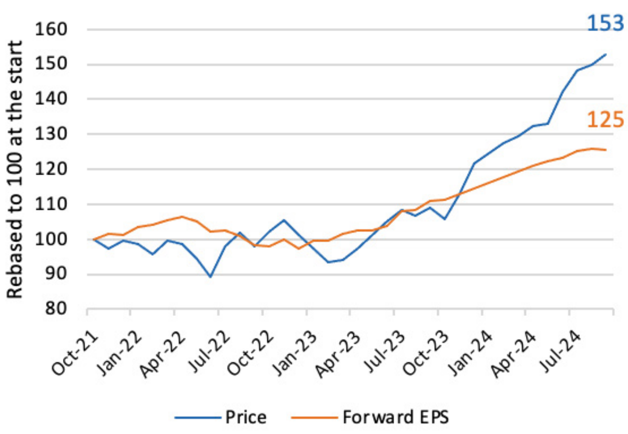


Source: Bloomberg. Data as of Oct 17 2024

MSCI China Index (local currency)

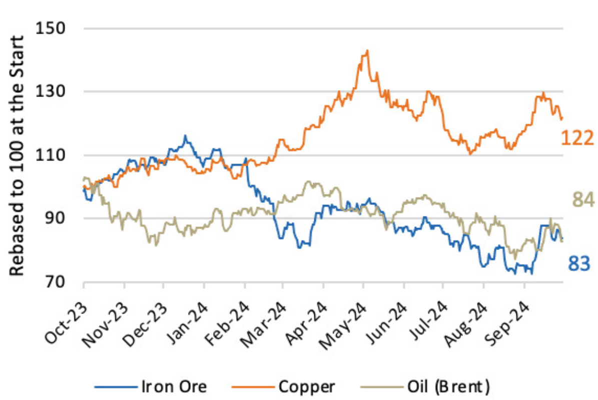
Source: Bloomberg. 3 years of monthly data through Sep 2024

MSCI India Index (local currency)



Source: Bloomberg. 3 years of monthly data through Sep 2024

Commodity Prices



Source: Bloomberg. 1 year of daily data through Oct 16 2024

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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

	September 2024	YTD	2023	2022	2021	Index Weight	EPS Growth Estimate 2024	EPS Growth Estimate 2025
MSCI EAFE	**1.0%**	**13.5%**	**18.4%**	**14.0%**	**11.8%**	**100%**	**1%**	**6%**
MSCI United Kingdom	0.3%	15.4%	13.0%	-4.8%	18.5%	14%	-11%	4%
MSCI Japan	-0.4%	12.7%	21.5%	-16.3%	2.0%	22%	20%	2%
MSCI Europe	0.4%	12.8%	21.6%	-17.3%	16.5%	46%	-7%	9%
MSCI EM	**6.7%**	**17.2%**	**10.1%**	**-19.7%**	**-2.2%**	**100%**	**17%**	**15%**
MSCI China	23.9%	29.6%	-11.3%	-21.8%	-21.6%	25%	18%	10%
MSCI India	2.1%	25.8%	21.3%	-7.5%	26.7%	20%	33%	17%
MSCI Taiwan	1.6%	30.6%	31.3%	-29.1%	26.8%	18%	35%	17%
MSCI Korea	-2.9%	-4.9%	23.6%	-28.9%	-7.9%	10%	22%	25%

Valuations

	P/E (TTM)	Percent Rank	P/E (FTM)	Percent Rank	P/CF	Percent Rank	P/S	Percent Rank
MSCI EAFE	**15.5x**	**28%**	**15.1x**	**57%**	**10.0x**	**73%**	**1.6x**	**99%**
MSCI United Kingdom	12.9x	23%	12.3x	35%	8.2x	29%	1.3x	71%
MSCI Japan	14.9x	27%	15.4x	42%	8.8x	56%	1.1x	96%
MSCI Europe	16.1x	34%	15.7x	67%	10.8x	83%	1.6x	93%
MSCI EM	**16.3x**	**77%**	**13.9x**	**81%**	**11.0x**	**93%**	**1.6x**	**80%**
MSCI China	13.6x	48%	11.1x	45%	11.5x	74%	1.4x	45%
MSCI India	29.1x	96%	26.8x	100%	22.0x	99%	3.2x	97%
MSCI Taiwan	22.9x	73%	19.9x	89%	14.0x	83%	2.1x	83%
MSCI Korea	13.7x	68%	10.2x	11%	6.5x	56%	0.8x	87%

Fundamentals

	Dividend Yield	Percent Rank	Profit Margin	Percent Rank	ROE	Percent Rank	Net Debt / EBITDA	Percent Rank
MSCI EAFE	**3.0%**	**55%**	**8.0%**	**84%**	**10.5%**	**64%**	**1.5**	**7%**
MSCI United Kingdom	3.9%	63%	7.0%	44%	9.6%	29%	1.1	14%
MSCI Japan	2.2%	76%	6.8%	94%	8.9%	77%	-1.1	10%
MSCI Europe	3.0%	53%	8.5%	90%	12.1%	69%	2.7	5%
MSCI EM	**2.5%**	**47%**	**8.8%**	**52%**	**11.1%**	**34%**	**2.0**	**88%**
MSCI China	2.3%	43%	8.9%	17%	10.6%	26%	2.9	97%
MSCI India	1.1%	11%	9.9%	62%	16.3%	55%	2.3	41%
MSCI Taiwan	2.4%	34%	9.3%	70%	13.7%	79%	0.3	12%
MSCI Korea	1.8%	58%	5.7%	60%	6.6%	25%	2.9	59%

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 September; 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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