TCW

QUARTERLY COMMENTARY

TCW International Small Cap

FIRST QUARTER 2019

Sector Breakdown*

Sector	%
Information Technology	21.88%
Industrials	14.88%
Financials	13.03%
Consumer Discretionary	12.71%
Healthcare	8.97%
Materials	8.34%
Consumer Staples	5.01%
Real Estate	4.54%
Utilities	3.79%
Energy	3.31%
Communication Services	1.94%

Regional Breakdown*

	Percent of Portfolio	Index
DM Europe	27.74	26.80
Emerging Markets	25.52	25.25
Japan	21.36	22.07
United Kingdom	13.88	13.33
Australia / North America	9.90	12.55

* As a percentage of total portfolio. Cash percentage not shown.

Performance and Positioning

For the three months ended March 31, 2019, the TCW International Small Cap Strategy returned 8.54% gross (8.27% net of fees and expenses) versus 10.26% for the MSCI All Country World ex-USA Small Cap Net Index ("Index").

We found the first quarter environment to be challenging for our quantitative model. The model is designed to look broadly across multiple factors, whereas during the quarter, individual factors were impacting regions disproportionately. For example, higher beta was the main driver by far in Emerging Markets (EM) and resource economies, whereas lower risk stocks outperformed in Developed Europe. However, in March and April thus far, the model's efficacy has improved, with a broader set of factors such as earnings growth and earnings momentum being rewarded in the market.

We have a bias towards cyclicals with high active share. The portfolio remains neutral Developed Markets and Emerging Markets relative to the benchmark. We remain overweight Europe and the United Kingdom while being underweight the resources countries, particularly Canada, given the continuing soft prices for Canadian crude (although we have started reducing this underweight). Within Emerging Markets, we have added further to China (on potential growth stabilization) and reduced India (rising uncertainty before the mid-2019 elections).

Investment Environment

Risk assets had a strong start to the year, including International equities, on the back of 1) improving prospects for a U.S./China trade deal, 2) early signs of China stabilizing as they push through various stimulus measures and, 3) accommodative monetary policy from both the Fed and European Central Bank (ECB).

Looking ahead, we see improving prospects for global growth bottoming out, and scope for international growth to outpace U.S. growth. At this point, the extent of the slowdown in the U.S. remains unclear. We should have more clarity over the next several months whether the U.S. economy is slowing to trend (as we believe) or heading into a recession. U.S./China trade negotiations continue, and we ultimately believe a deal will be completed that reduces the risks of higher tariffs (even if tensions over technology continue). But more importantly, there are early signs of green shoots in China; its strong March PMI print showed broad-based improvement across a number of sectors. If this trend is confirmed over the next quarter or so, in line with our view, it should help stabilize growth both in China and by extension, in Europe, Asia and various commodity-dependent economies. In addition, ECB policy stimulus should help European growth in coming quarters. In Japan, we believe that the consumption tax, which had been postponed, will finally be implemented sometime in the third quarter of this year. The monetary authorities have offset this tax with fiscal and other incentives to consumers, but we believe that demand will be front-loaded, followed by a somewhat negative impact on consumption.

The overall weaker global growth data, combined with the lack of inflationary pressure, should keep global rates low for an extended period and support capital flows into EM. There has been a notable pivot by global central banks. The Fed and ECB have responded quickly to the slower growth environment and trade uncertainties by halting plans for additional tightening, and the ECB has recently indicated plans to provide new liquidity mechanisms. Furthermore, the dovish tilt from developed central banks has allowed EM central banks to turn more dovish as well. We believe this change in stance is quite supportive for international equities.

The other main question is when the dollar turns. Our base case is for the dollar to be under pressure as the U.S. slows and growth in China and Europe stabilizes, which we believe there will be signs of as we approach the second half of the year. Furthermore, with slower U.S. growth the market should start to focus more on the structural issues facing the U.S. economy – a rising U.S. current account and fiscal deficit – which would also be dollar negative. As such, we continue to believe that the second half of 2019 could present opportunities to increase international equity exposure.

We continue to stick to our process of quality growth at a reasonable price. The portfolio has higher ROE and growth characteristics relative to the benchmark at reasonable valuations. Broader market fundamentals, in our opinion, are starting to reassert themselves, which are supportive for our stock model. We have turned more constructive on international markets as the data has started to improve. Differentiating between stocks, however, remains key.

Sincerely,

Ray S. Prasad, CFA
Managing Director
International Equities

Andrey Glukhov
Managing Director
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Source: TCW

It should not be assumed that an investment in the securities listed was, or will be, profitable.

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The full composite performance for the strategy is available on the strategy detail page on TCW.com. Annualized returns can be found in the Performance and Approach table, and calendar year returns are contained in the Performance Disclosure document. You may also contact your TCW Client Relations Officer at 213 244 0000.

This material includes a partial list of past specific recommendations, reflecting the three largest new buys and the three largest sales (complete sales) for the calendar quarter. For a complete list of all representative buys and sells for a given time period, please contact TCW at contact@tcw.com.

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