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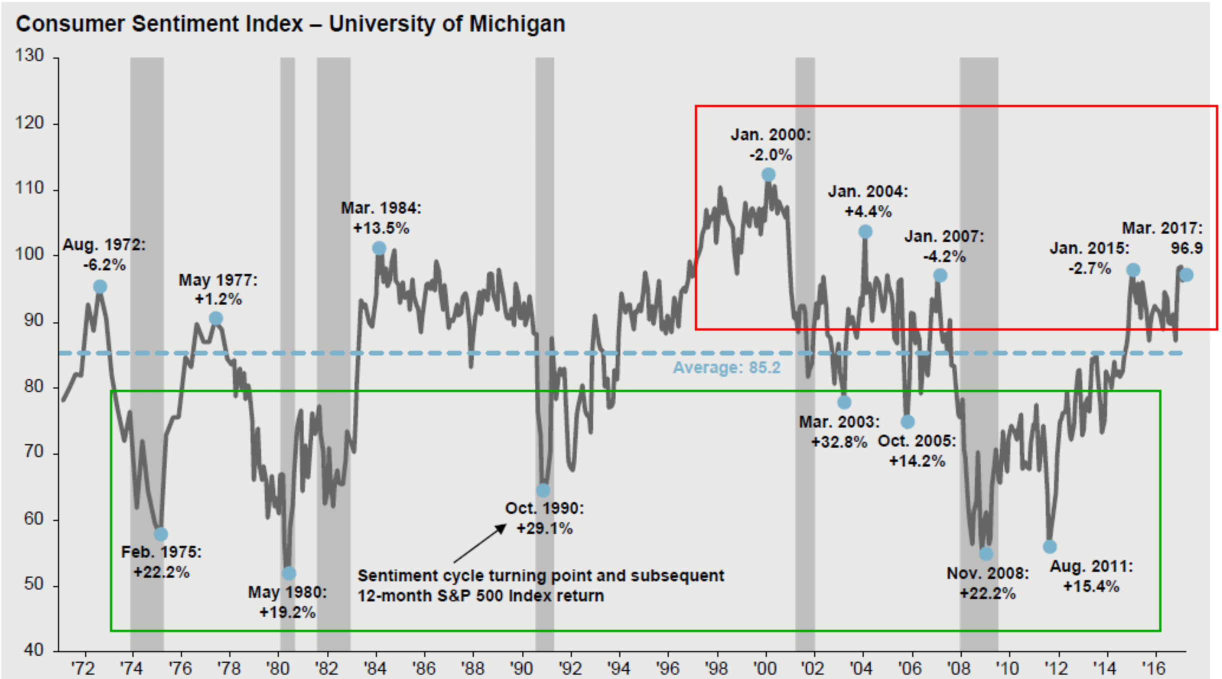
Spanning the Globe: *Looking abroad for market opportunities*

What were you doing 6 years ago? It was the summer of 2011 and amidst a 9.1% unemployment rate, a 1.8% GDP report, a U.S. debt downgrade, European debt crisis (remember PIIGS?), and renewed weakness in housing prices we were busy writing our “Time to Get Patriotic” piece urging investors to buy U.S. stocks *(SEIA Report Volume 4, Issue 2 dated June 2011*). Since then, markets have more than doubled, with the S&P 500® moving from below 1200 to over 2400 as of early May 2017. That’s the good news.

While a boon for net worth statements, the rise in stock prices has come with a host of far less desirable effects. Consider the following:

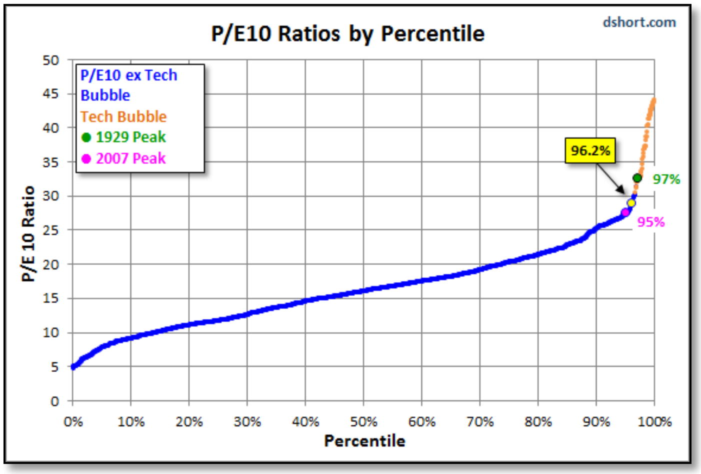
- **Consumer Sentiment**: Not surprisingly, increased wealth makes us more upbeat and optimistic. But Consumer Sentiment, which recently hit a post-recession high, is a contrarian indicator. When sentiment is high, forward stock returns are low (red box). The time for outsized profits is when everyone feels lousy (Summer of 2011 in the green box) and assets are cheap. When everyone feels great, investors already own their stocks so there are fewer buyers ready to step in.



Source: Standard & Poor’s, University of Michigan, FactSet, J.P. Morgan Asset Management.
Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only, which excludes dividends.
Guide to the Markets – U.S. Data are as of March 31, 2017.

- **Investor Positioning:** With the outperformance of U.S. stocks, investors have flocked to the asset class. However, stocks only go up if there is another buyer willing to pay more. While we don't believe we are at 'peak investor' point, it should be noted that according to Brandes Investment Partners, U.S. equities account for 71% of total invested equity assets, yet domestic firms account for only 26% of the world's companies.

- **Valuations:** The economy is not firing on all cylinders. Over the latter part of this business cycle, the increase in corporate earnings hasn't been nearly commensurate with the rapid rise in stock prices. As a result, valuation multiples such as Price/Earnings have risen to historic levels. Other valuation multiples that attempt to smooth out volatile earnings over a business cycle (Shiller, CAPE ratio, P/E10, Crestmont, etc.) sit at a level higher than at any other time in history with two notable exceptions: in 1929 preceding the stock market crash, and in 2000 at the height of the tech bubble.



This is not to say by any means that a significant U.S. market correction is looming on the horizon but the above will serve as fuel if and when a correction starts. While it is difficult to predict the next selloff, if history tells us anything with certainty, it's that markets are cyclical by nature and at some point this second longest bull market ever recorded (over 2,600 days and counting) will come to an end. With this in mind, now may be an opportune time to lock-in some recent gains and bring exposure back to a more neutral level. But where should one go and what is neutral?

International Equities: Why?

The clamor for U.S. stocks is almost deafening and reminds us of an earlier period in the late 1990s when investors coveted Large Cap Growth only to have Small Cap Value outperform over the ensuing decade. We believe we are in a similar period with International stocks poised to outperform. In comparison to US stocks:

- **Consumer Sentiment:** For many investors, investing in overseas markets is less comfortable and familiar. They see a parade of headlines about terror attacks, political and economic uncertainty (e.g., Greece, BREXIT and the recent French elections) and hesitate to take on what they perceive as unnecessary risk when returns have been so strong for so long here at home. But remember, sentiment is a contrarian indicator. Furthermore, political angst is winding down and Populism and anti-euro sentiment appears to be on the wane. In order to sell high, one has to buy low and that is usually when sentiment is terrible.

- **Investor Positioning:** International equity experienced outflows over the last 18 months which represented 5% of the asset class. In other words, there are many investors that will need to reallocate back into the asset class—hopefully after you—and that should push prices higher.
- **Valuations:** As domestic equity P/E ratios push far above their median averages, both overseas developed markets (MSCI EAFE Index) and emerging markets (MSCI Emerging Markets Index) still sit well below their median. Compared to a U.S. CAPE ratio near 30, the overseas CAPE ratio stands at only 16.6. To get more granular, investors can compare the P/E multiples of individual countries to that of the U.S. (18) and conclude that there is value in Japan (15), the UK, France, Germany (all near 14), and Emerging Markets such as China and South Korea (near 11).

Making the case even stronger, current income from dividend yields is nearly 50% greater overseas. And corporate earnings growth is picking up and is projected to be greater than that of the U.S. (but more on that later).

Buying low is hard. Buying a laggard is even harder; and currently International Equities are experiencing their longest streak of underperformance on record! But the good news is that there is precedence for international outperformance in the years ahead. In the aftermath of their previous longest cycle of underperformance (which ended in December 2001) international equities went on to outperform U.S. equities for the *next six and a half years* – providing an 11.2% average annual return compared to a 3.6% return for U.S. stocks.

International Equities: How much?

Quite simply, we urge U.S.-centric investors to reduce their domestic equity allocations down to a more palatable neutral weighting and to overweight overseas assets. But what is neutral? How much International should one own?

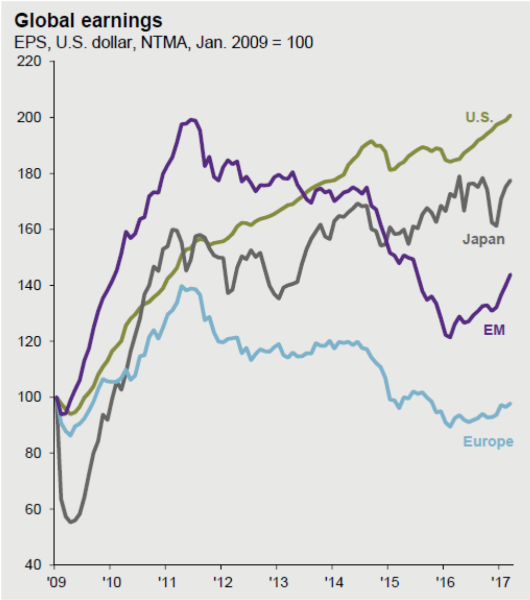
Consider planet earth where 48% of global market capitalization resides overseas. That's seems a reasonable benchmark, so 50% might be the right number. But allocating half of your stock portfolio overseas might be a bit aggressive considering that most U.S. investors earn and spend in U.S. dollars (which isn't necessarily the case in Europe or Japan). The U.S. Dollar is, after all, the world's reserve currency. Based on our analysis, allocating 25% of your equities to overseas stocks will likely provide the smoothest ride when measured over multiple business cycles.

Still not convinced? Consider the future. The inescapable truth is that while still quite large, the role of the U.S. in the global economy is steadily becoming smaller. Today, 96% of the world's population and three-quarters of the world's headquarters (investment opportunities) exist outside of our borders. And although U.S. businesses still generate 25% of the world's GDP, that percentage is expected to drop to 18% by 2020.

Less risk. More opportunities. Although overseas stocks won't guarantee greater returns, they are a critical component of a sound strategy that maximizes investment opportunity while mitigating investment risk. With U.S. markets currently in rarified air, savvy investors may want to consider setting sail for distant shores with a greater portion of their portfolio—all we need now is a tailwind.

International Equities: Tailwind Coming?

As Goldman Sachs recently pointed out, "for the first time in six years, global growth and profit expectations have been revised upwards." Earnings revisions outside of the U.S. are now stronger and we are finally in the midst of the first *global synchronous expansion* since before the Great Recession—now ten years ago! This is a game changer—and we are only in the 2nd inning.



In a global synchronous expansion, not only will earnings for oversees stocks improve but they have the potential to explode higher. Consider that not only are European earnings below their 2007 peak, but they are still below their 2011 peak! In short, European and Emerging Market corporate earnings can grow 40% just to get back to 2011 and double from here to match the U.S. experience.

While immigration and terrorism still pose problems, the political angst and anti-euro sentiment is waning. With more political certainty—global investors will feel more comfortable allocating assets overseas which can then push up valuations similar to what occurred in the U.S. in 2011.

Finally, with a synchronous global expansion helping multiple countries, the flood of capital pouring into U.S. assets will likely wane and the mini-era of a stronger dollar should ebb as overseas currencies begin to appreciate. Thus, assets (stocks) denominated in these foreign currencies may appreciate due to currency movements alone.

Higher yields, stronger earnings growth, rising valuation multiples all in an appreciating currency? Time for investors to grab their passports! Bon voyage!

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