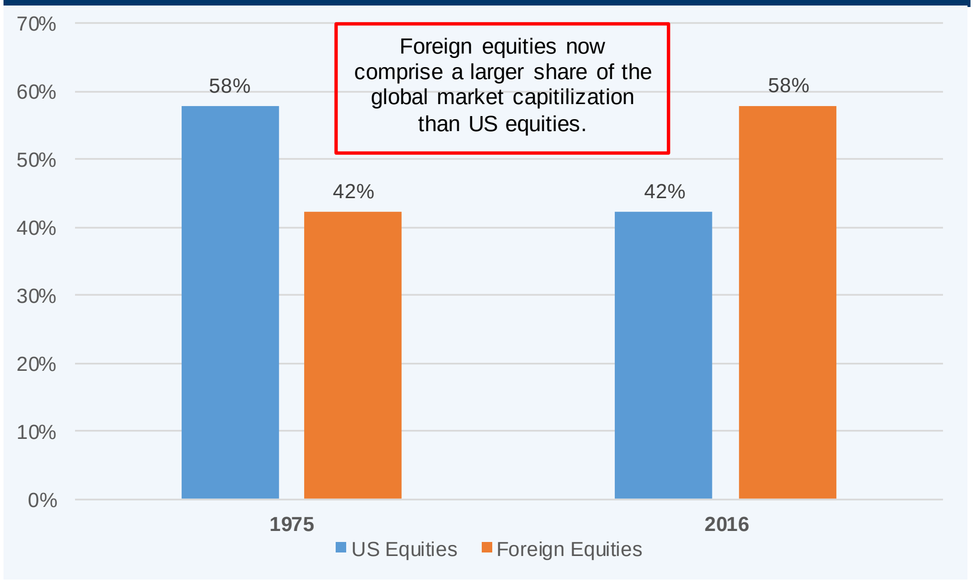
June 2017

The Great Rotation: Why Foreign Equities Are Primed to Move Higher

Over the last five years, US equities have soared while foreign equities have failed to gain any momentum. The divergent performance has left some investors wondering if it is worthwhile to invest abroad. In fact, a study by Vanguard found that the average US investor allocates only 27% of their equity allocation to equities domiciled outside of the US despite the fact that foreign equities now represent 58% of the global market. This means that on average, US investors are 50% underweight to foreign equities. Demonstrating a home bias to domestic stocks has been a successful strategy over the last few years, but over the long-term, historical performance suggests that limiting exposure to foreign stocks decreases your expected return.

Figure 1: Percent Share of the Global Equity Market



In 1975, the global equity market (universe of investable stocks) was worth a mere $1.2 trillion and the US comprised almost 60% of the global stock market. In the three decades since, the global market has exploded by over 5,000% and as of the end of 2016, the total market capitalization was valued at $64.8 trillion. While the US stock market has contributed to the massive increase, the majority of the growth has actually come from outside of the US. In fact, the growth rate of foreign equities over this time period was 7,177%, nearly double that of the US, which increased by 3,786%. Foreign markets, especially in Asia, have undergone significant development during this time and now comprise a larger percentage of the investable universe than US equities.

Investing in foreign equities can be a daunting task for some investors given their lack of familiarity and recent underperformance. However, this ignores the proven benefits of diversification and the fact that macroeconomic indicators are suggesting that the tide could be turning for foreign equities in the coming years.

What are Foreign Equities and How Have they Reformed Relative to US Equities:

Foreign equities are defined as stocks that are listed on exchanges outside the US. While some names, such as Nestle and Toyota, are household names, others can be unfamiliar to the average investor. In general, foreign equities can be broadly classified into two major categories, international developed and emerging markets.

International developed equities - Represent 49% of the global stock market and are defined as economies that have high levels of income and standards of living. Developed economies also generally have well-regulated and efficient capital markets. The five largest international developed markets by market capitalization are Japan (23%), United Kingdom (18%), France (11%), Germany (10%) and Switzerland (9%). The most commonly used index to track the performance of international equities is the MSCI EAFE Index (EAFE is an acronym for Europe, Australasia, and Far East). Compared to the US stock market (S&P 500), the MSCI EAFE has a larger share of the cyclical sectors (financials, materials, and industrials) and a smaller allocation to the technology and consumer discretionary sectors.

Emerging market equities - Represent 9% of the global stock market and are characterized by economies that are progressing towards becoming advanced, but still do not have the same level of market efficiency and regulation as developed economies. Emerging market economies often experience higher growth, but with greater volatility than their developed counterparts. Investing in emerging markets traditionally requires a greater risk premium because their capital markets are less liquid and there is often less political stability in these nations. The most commonly used index to track the performance of emerging markets is the MSCI Emerging Market (EM) Index. The top five countries are China (28%), South Korea (16%), Taiwan (12%), India (9%), and Brazil (7%). Compared to the US stock market (S&P 500), the MSCI EM Index has a larger allocation to technology and financials and a smaller exposure to the healthcare and consumer staple sectors.

Historical Performance:

Historically, the relative performance of US and international equities has varied by decade. Since the 1920s there has been only one instance where one outperformed the other for two decades straight. In the 1930's, international equities were up +4.6% annually, due to strong performance of stocks in Germany and Japan. Meanwhile, US stocks were mired in the Great Depression and were only slightly positive (+1.4%) on an annual basis during the decade. In the 1940s, the relative performance flipped. International equity performance was hindered by World War II and the dislocation that occurred afterwards. US equities enjoyed the wartime boost as the economy finally emerged from the Great Depression. During the decade, US equities outperformed international equities by 13% annually.

Figure 2: Average Annual Growth Rate By Decade

Decade	US Equities (S&P 500)	International Dev Equities (MSCI EAFE)	Emerging Markets (MSCI EM)
1920s	16.0%	7.8%	-
1930s	1.4%	4.6%	-
1940s	3.2%	-9.6%	-
1950s	16.7%	18.2%	-
1960s	5.1%	2.5%	-
1970s	-1.4%	2.5%	-
1980s	11.8%	16.8%	-
1990s	14.8%	4.3%	11.1%
2000s	-1.0%	1.2%	9.8%
Key:			
Best Performer			
Median Performer			
Worst Performer			

US and international equities experienced similar returns in the 1950s and 1960s with international equities outperforming by 1.5% annually in the 1950s and US equities outperforming by 2.7% annually in the following decade.

The US experienced negative annualized returns in the 1970s as the economy was stuck in a period of stagflation (high unemployment coupled with high inflation). International stocks were positive during the 70's, +2.5% largely due to rapid economic growth in Japan. International equities also outperformed US equities by 5% annually in the 1980s.

US equities vastly outperformed in the 1990s in part due to the technology boom of the late 90's. US equities were up almost 15% annually, outperforming international equities by over 10%. In the 2000s, international equities outperformed in part due to strong performance in Europe and Australia (which was boosted by strong commodity returns during this time).

The MSCI Emerging Market Index (EM) was first available in 1988 and its first full decade of existence was the 1990s. As demonstrated by the superior returns in the 1990s and 2000s, emerging markets experienced higher growth rates than international and US equities, but with higher volatility. Emerging markets saw sizeable down years, including 2000 (-30%) and 2008 (-53%). Overall, the standard deviation of emerging market annual returns over the last twenty years is 35% higher than international developed equities and 52% higher than US equities. So while emerging market investors have been compensated with a higher return, it has been a much bumpier ride.

Figure 3: US and Foreign Market Returns Have Diverged During the Post-Recession Recovery

Since the pre-recession market peak of October 2007, the relative performance of US equities and foreign equities has been stark. US equities, measured by the price level of the S&P 500, are now 55% above their pre-recession highs. On the contrary, international and emerging markets are still over 20% below their pre-recession highs. The performance of the different indexes is a reflection of the economic recovery in each region. US GDP has been able to grow at a 2% rate since 2009, which is modest by historical standards, but it is substantially higher than GDP growth in international and emerging market countries. Europe has managed only slightly positive growth and some emerging market economies have undergone significant economic retractions, including Russia and Brazil. As the table above demonstrates, the worst performer in one decade usually becomes the leader of the next. If nothing else, we should experience a reversion to the mean due to the considerable differential in the post-recession performance of US and foreign equities. In addition, macroeconomic trends that have hindered foreign equities over the last decade seem to be reversing, paving the way for foreign outperformance over the next few years.

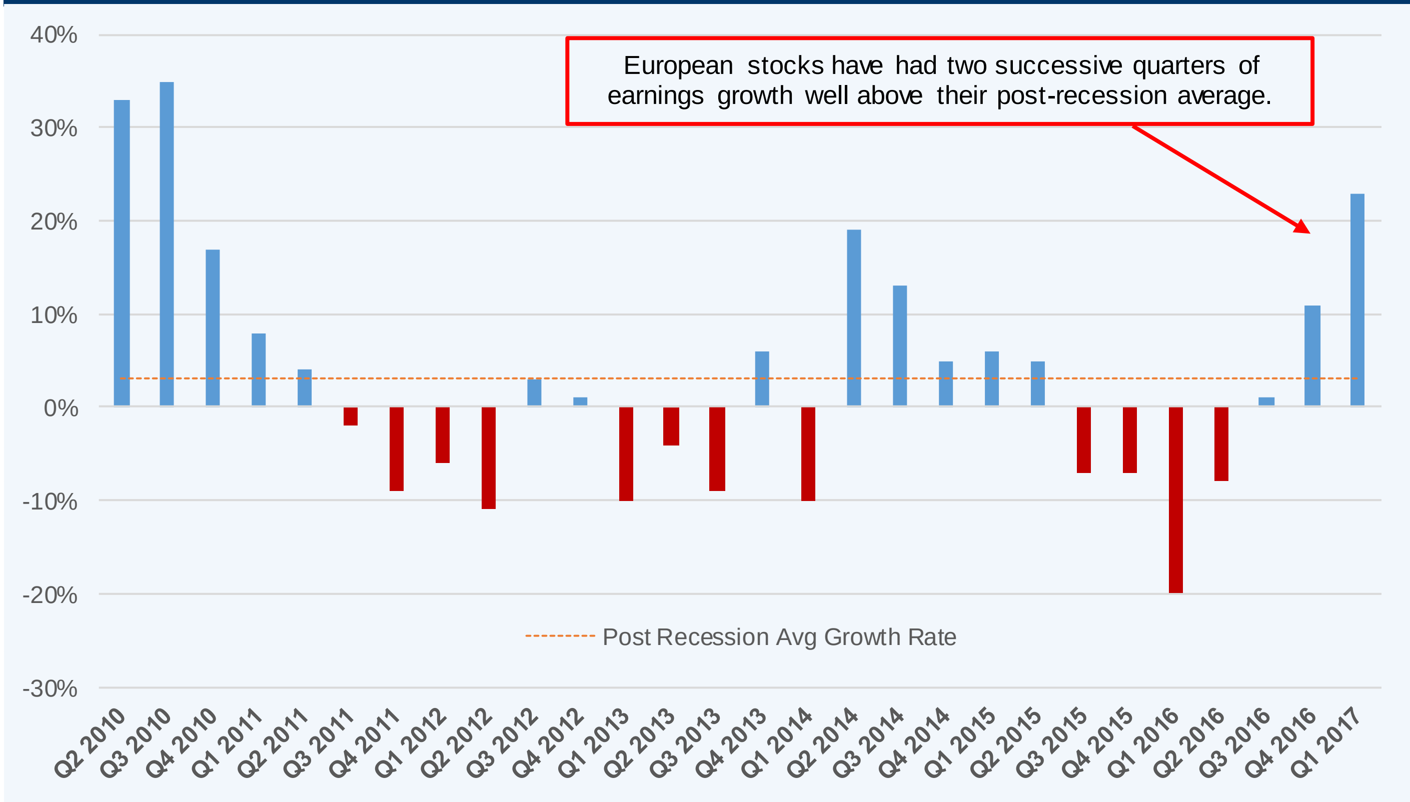
Macroeconomic Indicators Suggest Times are Turning Abroad:

While US markets have enjoyed success since 2009, foreign equities have struggled to gain momentum. Two factors in particular have worked against foreign equities in the recent years: weak earnings growth and a strong US dollar. So far in 2017, these headwinds appear to be receding as earnings growth is strengthening and the US dollar has depreciated.

Higher corporate earnings growth – One of the major contributors to long-term equity returns is corporate earnings growth. Corporate earnings are usually closely correlated with the performance of stocks. Since stocks are a forward-looking instrument, companies with higher earnings or higher expected earnings will usually see the value of their stock increase. The opposite can be said for companies that have slowing or negative earnings growth.

Compared to the US, corporate earnings in international and emerging markets have lagged since 2010. Until this year, European companies remained mired in ultra-low growth with quarterly earnings growth exceeding double digits in only one of the previous ten quarters. In fact as recently as Q1 2016, earnings in Europe shrunk by almost 20%. From Q2 2010 through Q1 2017, European companies had an average year-over-year earnings growth of 3.0%. During the same time period, US companies (S&P 500 companies) had an average year-over-year earnings growth of 5.7%, almost double that of Europe.

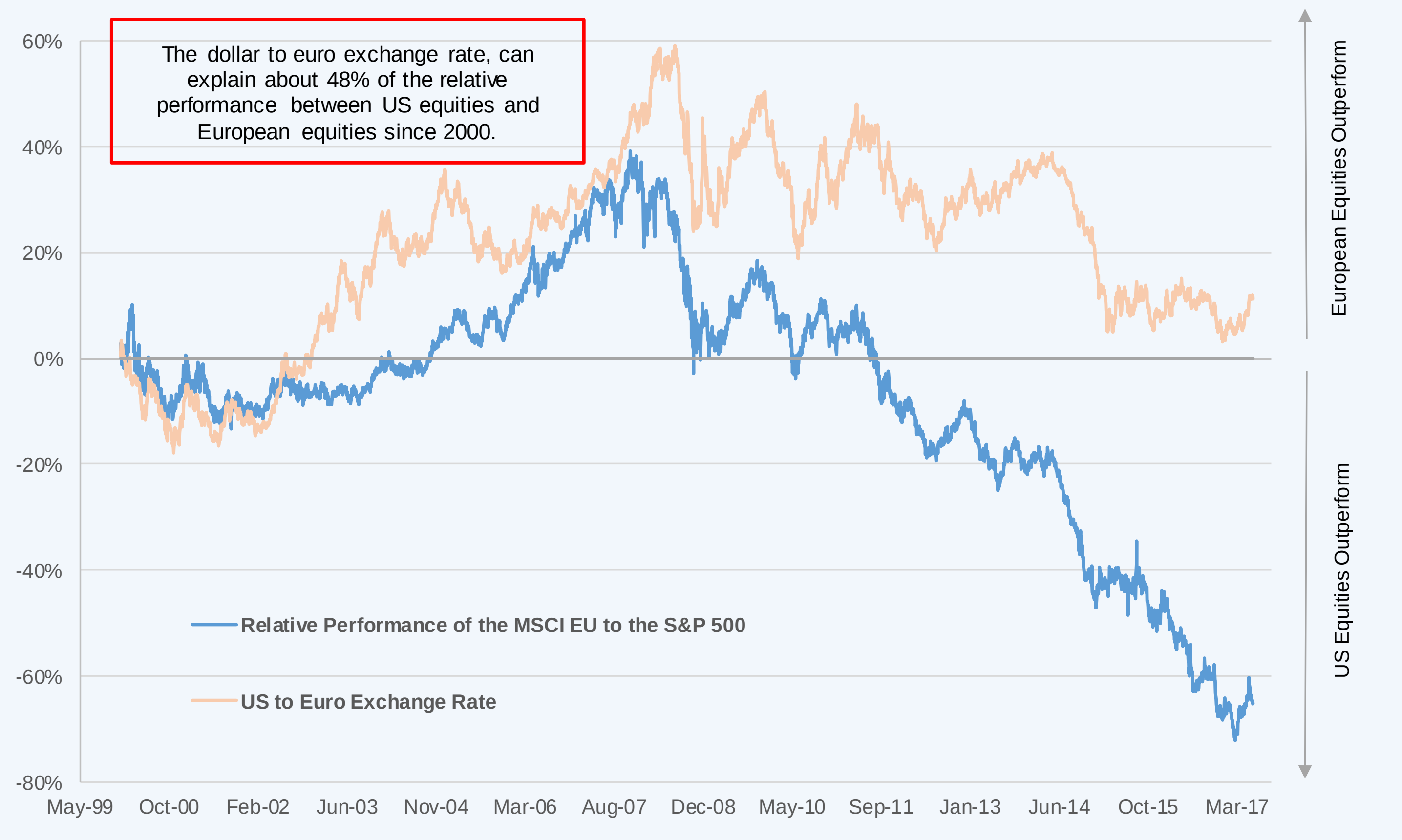
Figure 4: Stoxx600 Quarterly EPS Growth



Earnings growth in Europe has been persistently low since 2010 as the region was heavily indebted following the 2008 recession. Multiple governments within the region have been on the brink of default since 2010, with Greece being the number one culprit. However, in the past two quarters, European earnings have been in the double digits. Economic indicators are picking up with unemployment rates falling to their lowest levels since 2008 and inflation returning to its highest level since 2013. Domestic consumer trends have also been positive as the region continues to recover. This helps top line growth and should help corporate margins improve. Corporate earnings are also improving in Japan, which experienced +28% year-over-year growth in Q1.

Decline of the Dollar - When US investors buy US stocks, there are three major components of return – dividends, corporate growth, and inflation. When investors invest in foreign equities, currency translation becomes an additional driver of performance. When a US investor buys a foreign stock, they exchange USD (US Dollars) for the foreign currency of the stock. When they sell the investment in a later period, they then have to translate their proceeds from the foreign currency back to USD. If the USD has appreciated against the foreign currency in this time period, the investment will be worth less and vice versa if the dollar depreciates. Historically trends in the foreign exchange markets have been strongly correlated to the relative performance of US versus foreign equities.

Figure 5: Currency Trends Are a Major Determinant in the Relative Performance of Intl and US Equities



On January 1st, 2000, the dollar to euro exchange rate was 1.01, meaning that $1.01 could buy €1. Over the course of the next seven years, the dollar depreciated relative to the euro. On October 1st, 2007, almost the peak of the market before the recession, the dollar to euro exchange rate was 1.42. This means that to buy the same €1, you would need $1.42 dollars. The depreciation of the dollar relative to the euro over this time was a major contributor to the strong performance of European equities. From January 1st, 2000 to October 1st, 2007, the MSCI Europe Index outperformed the S&P 500 by 32%.

As the capital markets began contracting in 2007, demand for the US treasuries (often considered a safe haven asset) drove up the demand for the US dollar. From the beginning of 2008 to the end of 2016, the dollar appreciated 40% against the euro. As of the end of last year, the exchange rate was 1.05, almost the same place it was at the start of 2000. The strong performance of the dollar helped US equities outperform European equities by 95% over the time period. Overall, the dollar to euro exchange rate can explain about 48% of the relative performance of US equities vs European equities since 2000.

In 2017, the dollar has depreciated versus the euro which has aided the performance of foreign equities. Weaker demand for the dollar could provide a strong backdrop for foreign equities to outperform over the coming years.

Room to Run – The Valuation Story

Figure 6: Global Valuations	
Country	Shiller Price to Earnings
Russia	5.3
Turkey	10.1
Brazil	10.7
Poland	11.4
Portugal	12.4
Singapore	12.5
Norway	12.9
Spain	13.4
South Korea	13.7
Italy	13.9
China	14.4
Israel	14.5
United Kingdom	15.3
Austria	15.6
Hong Kong	16.0
Australia	17.5
South Africa	17.6
France	19.5
Germany	19.6
India	20.3
Netherlands	21.8
Mexico	22.2
Switzerland	22.9
Japan	24.9
United States	27.5
Ireland	33.7
Denmark	34.1
Legend	
Developed Intl Markets:	
Emerging Markets:	
United States:	

In addition to improving corporate earnings and a weaker USD, global valuations are also more attractive abroad. The Shiller Price to Earnings is one widely used metric to evaluate whether a market is overvalued, undervalued, or fairly valued. It is based on the more commonly used price to earnings (P/E) metric which compares the price of a stock (or market) to its earnings (either projected or trailing). When the P/E ratio is high, it signals that a stock is expensive relative to its earnings while a low P/E suggests that the stock is cheap.

The flaw of traditional P/E ratios is that market fluctuations can sometimes cause the ratio to give conflicting advice. For example, during a recession, stock prices fall but corporate earnings also fall. If corporate earnings fall faster than the stock prices, this can initially increase the P/E of the stock. This increase can give the wrong signal that the market is expensive, when in reality it's a good time to buy. To neutralize this outcome, Robert Shiller developed a P/E ratio that smoothed earnings over a ten-year period. The Shiller P/E, also referred to as cyclically adjusted price-to-earnings (CAPE), has proven to be a good indicator of future market performance.

Currently, most foreign markets have lower Shiller P/Es than the US. In fact, only two major global markets (Ireland and Denmark) have a higher Shiller P/E than the US. This can in part be explained by the underperformance of foreign equities since 2009 and the weak earnings growth abroad. Emerging markets as a group have a Shiller P/E of 14.9, which means they are trading at a 45% discount to US equities. Similarly, international equities are trading at a Shiller P/E of 22.9, or a 20% discount to US equities.

When evaluating valuations, it is also useful to compare a country's P/E ratio relative to its peer group. For example, Russia and Brazil, two countries which are emerging from economic recessions, are trading at very inexpensive levels when compared to other emerging market economies, such as India and Mexico. Earlier this year, we pared back our overweight India exposure, and added exposure to both Russia and Brazil. Within the international developed region, we are overweight to Europe, which has a Shiller P/E of 17.6 and are underweight to Japan, which has a higher Shiller P/E of 24.9.

The Search for Value:

With both the US stock and bond markets near all-time highs, it can be difficult finding value at a reasonable price in the US. US earnings growth is at its highest level since 2013 and a successful tax reform legislation later in 2017 could spur further equity gains. Without these impetuses, it may be difficult for the US markets to trade meaningfully higher, given relatively full valuations. However, expanding the investable universe to foreign equities would find a plethora of markets that have not enjoyed the same recent success as the US. Furthermore, macroeconomic indicators are suggesting that foreign equities could be lined up for a period of extended outperformance. This may be the time for an opportune investor to reduce exposure to a market that has run and increase exposure to a market that has not, or in other words = "Buy low, Sell High."

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Figure 1: Share of the Global Equity Market - Shows the composition of the global market capitalization, broken out by US and foreign equities in both 1975 and 2016. Source – World Bank.

Figure 2: Average Annual Growth by Decade - Shows the average annual growth of US equities, International developed equities, and emerging market equities by decade. US equities are represented by the price return of the S&P 500 index. International developed equities are represented by the price return of the MSCI EAFE Index, and emerging market equities are represented by the MSCI Emerging Market Index. Source – MSCI, ycharts.com.

Figure 3: US and Foreign Market Returns Have Diverged During the Post-Recession Recovery - Shows change in the price return of the S&P 500 Index, the MSCI EAFE Index, and the MSCI Emerging Market Index since October 1st, 2007 through March 31st 2017. Source – ycharts.com.

Figure 4: Stoxx600 Quarterly EPS Growth – Shows the quarterly earnings per share growth of the Stoxx600 Index from Q2 2010 to Q1 2017. The dotted line denotes the average quarterly growth of the time period, which was +3.0%. Source – JPMorgan.

Figure 5: Currency Trends are a Major Determinant in the Relative Performance of Intl and US equities – Shows the relative performance of the MSCI EU Index to the S&P 500 Index since January 1, 2000. When the blue line is above 0%, it means that the MSCI EU Index has outperformed the S&P 500 Index. When the blue line is below 0%, it means that the MSCI EU Index has underperformed the S&P 500 Index. The pink line denotes the percent change in the dollar to euro exchange rate since January 1st 2000. When the line is rising it means that the euro is appreciating versus the dollar and when the line is decreasing, it means that the euro is depreciating relative to the dollar. Source – FRED, ycharts.

Figure 6: Global Valuations – Shows the Shiller price to earnings of different global markets as of 03/31/2017. Emerging markets are denoted by the red shade, developed international markets are denoted by the green shade and the United States are denoted by the blue shade. Source – http://www.starcapital.de/research/stockmarketvaluation.