The current and long-term case for overseas investing

Executive Summary

• Market cycles often have different start- and end-dates in different places. As a result, market values and risks vary, across industries and geographies.

• Sensible portfolio rebalancing should take into account both upside potential and downside risks.

• Diversification with dedicated overseas exposures can offer both lower correlation to U.S. markets and higher growth opportunities abroad.
Opportune Times for Tactical Positioning: Valuation Polarity; Earnings Outlooks; Cheap Oil; QE Fuel

Financial intermediaries and their clients could be forgiven for putting more money into U.S. stocks. After all, the S&P 500 Index has materially outperformed the MSCI EAFE Index, the international equity benchmark, in five of the last six years, lagging only marginally in 2012. It has gained in each of the last seven years, five of those with double-digit advances. Since the March 2009 financial crisis nadir through the beginning of February 2016, the U.S. blue-chip benchmark produced a total return of around 180%, for a near-20% annualized gain, handily outperforming the MSCI EAFE and MSCI Emerging Markets Indices, annual returns of which were running at roughly 9% and 7%, respectively. The U.S. economy has been growing faster than other major developed economies and even many emerging markets. Prevailing U.S. interest rates are still low, unemployment has fallen, and the slide in oil prices acts like a tax cut for consumers whose spending largely drives about 70% of the economy. No wonder many U.S.-based investors appear to sympathize with Jack Bogle, the retired founder of The Vanguard Group, who declared: “I wouldn’t invest outside the U.S.,” and asserted that overseas markets lack “excitement” while emerging markets have “great potential” but “fragile institutions.”

For tactical and strategic reasons, though, investors would be well advised to retain meaningful exposure to international equities, including emerging market stocks. Yes, U.S. equities have done exceedingly well in recent times (Figure 1), markedly outperforming overseas stocks. But for tactical asset allocators, that’s just one compelling reason to rebalance, booking profits on the now more richly valued securities and putting proceeds into those that have greater upside. By a variety of valuation metrics, the U.S. market backdrop appears priced in: In late February, the consensus forward price/earnings estimate for the S&P 500 Index was running close to 16, versus less than 14 for the MSCI EAFE Index, and around 11 for the MSCI Emerging Markets Index. Other common valuation metrics, including price-to-book, price-to-cash flow, and price-to-sales, tell the same story.

A CAPE to Survey the Ebb and Flow

Perhaps most striking is the cyclically adjusted price/earnings (CAPE) ratio, which averages annual earnings of an equity index over a 10-year period and adjusts for cyclical effects to avoid the distortions that can arise in a single year. Also known as the Shiller P/E, the CAPE has a relatively good record in predicting long-run returns by signaling when current markets have become over- or under-valued in historical terms. According to Research Affiliates, the CAPE on the S&P 500 Index at the end of January 2016 was 24, far above its median 16 multiple, implying smaller returns ahead amid likely reversion to its mean. By contrast, the CAPE on the MSCI EAFE Index amounted to 13, well below its 22 median multiple, while that of the MSCI Emerging Markets Index lagged at 10, nearly half its 18 median multiple. That suggests mid- to high-single-digit potential returns over the next decade in both indices. Contrasting the CAPE levels between the S&P 500 Index and the MSCI EAFE and MSCI Emerging Markets Indices reveals that overseas stock markets have hit discounts to U.S. equities not seen in years.

As U.S. corporate earnings have recovered much faster than Europe’s since the global financial crisis and U.S. profit margins were running above average in recent years, the outlook for earnings growth in Europe appears much brighter than it now does in the United States. Indeed, after a few years of double-digit earn-

Figure 1 | World Equity Indices, Annual Returns for 2006-2015 (ranked in order of performance)

<table>
<thead>
<tr>
<th>Year</th>
<th>Emerging Markets</th>
<th>EAFE</th>
<th>U.S.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>32.59%</td>
<td>26.86%</td>
<td>15.79%</td>
</tr>
<tr>
<td>2007</td>
<td>39.79%</td>
<td>11.63%</td>
<td>5.49%</td>
</tr>
<tr>
<td>2008</td>
<td>U.S. -37.00%</td>
<td>EAFE -43.06%</td>
<td>Emerging Markets -53.18%</td>
</tr>
<tr>
<td>2009</td>
<td>Emerging Markets 79.02%</td>
<td>EAFE 32.46%</td>
<td>U.S. 26.46%</td>
</tr>
<tr>
<td>2010</td>
<td>Emerging Markets 19.20%</td>
<td>U.S. 2.11%</td>
<td>EAFE 8.21%</td>
</tr>
<tr>
<td>2011</td>
<td>Emerging Markets 18.63%</td>
<td>U.S. 16.00%</td>
<td>Emerging Markets -4.48%</td>
</tr>
<tr>
<td>2012</td>
<td>U.S. 32.39%</td>
<td>Emerging Markets -1.82%</td>
<td>EAFE -0.39%</td>
</tr>
<tr>
<td>2013</td>
<td>U.S. 13.69%</td>
<td>Emerging Markets -2.27%</td>
<td>Emerging Markets -14.60%</td>
</tr>
<tr>
<td>2014</td>
<td>U.S. 1.38%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
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</tbody>
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Source: FactSet: MSCI.com and Standard & Poor’s. U.S. is the S&P 500 Index, other regions are MSCI indices. Returns are gross index USD. Past performance does not guarantee future results.
ings growth, 2015 proved challenging for the S&P 500 Index, aggregate earnings growth of which was slightly negative. It’s expected to recover in 2016, with forecast earnings per share growth in the U.S. seen running around 8%. But that’s roughly a third of the 26% expected EPS growth in the MSCI EAFE Index.

By moving into attractively valued stocks with more upside potential, as Benjamin Graham’s “margin of safety” precept has long suggested. This common sense investment principle may be why the S&P 500 Index and the MSCI EAFE Index have taken turns outperforming each other over the last four-and-half decades. So while the the MSCI EAFE beat the S&P 500 by roughly 60% from the end of August 2000 through November 2007, the S&P 500 then outperformed the MSCI EAFE by just over 62% over next eight years, through the end of 2015 (Figure 2).

**Fed Mops Up—Peers Abroad Open Spigots**

Apart from the significant valuation differentials, the monetary backdrop abroad also favors the tactical case for overseas equities. The U.S. Federal Reserve ended its asset purchases in late 2014, and in December 2015 raised its key short-term interest rate for the first time in nine years. By contrast, the European Central Bank (ECB) began its own “quantitative easing” (QE) program last March with monthly purchases of official and private sector bonds, and is provisionally scheduled to end it in March of 2017 if the ECB inflation target of just below 2% is met. It recently increased its monthly asset purchases by EUR20 billion to EUR80 billion, cut its key interest rate to zero from 0.05% and cut its deposit rate still deeper to negative 0.4%, effectively paying banks to borrow interest-free money from it in a bid to prompt them to make more

Monetary tightening in the U.S., amid the easing abroad, has become clearly evident in foreign exchange markets, as the dollar has strengthened dramatically, while the euro, yen, and a number of emerging market currencies have become much more competitive in recent years, notwithstanding partial reversals of those trends in early 2016. That benefits their exporters and local market producers by creating a currency headwind for their U.S. competitors. It’s also easy and cost-effective for international strategies to hedge their developed world currency exposures. Given attractive valuations, the incipient monetary easing and generally early stages of economic recovery abroad, medium-term equity returns among international companies may well be stronger than those of their U.S. peers.

Yet quite apart from the tactical reasons to invest more abroad at this point in time, the strategic rationale for doing so longer-term is equally compelling.

As U.S. corporate earnings have recovered much faster than Europe’s since the global financial crisis and U.S. profit margins were running above average in recent years, the outlook for earnings growth in Europe appears much brighter than it now does in the United States.
Strategic Drivers for Long Horizons: Home Bias in a Growing World; Europe’s Girding for Growth; FDI, Trade Augment EM; Political Risk/Potential Reward

United States’ Shrinking Shares of Growing Global Pies

Although the U.S. still boasts the globe’s biggest economy and deepest capital market, the world has rapidly evolved over recent decades. The U.S. share of global economic output stood at 26% in 1980, while that of emerging markets and developing countries was 25%, and China's just 2.8%. Fast forward to 2015, and the U.S. share has shrunk to an estimated 22%, while emerging markets and developing countries accounted for some 40% of world gross domestic product, and China’s economy grew five-fold to 14% of global GDP.² (Figure 3). Back in 1970, the U.S. share of global stock market capitalization stood at a towering 66%. At the end of 2015, its share declined to 57%, as the rest of the world gained it.³ (Figure 4)

Despite the downward trends in U.S. shares of global economic output and market capitalization, U.S. equity mutual fund investors still display an exceedingly high degree of home bias, with nearly three-quarters of their stock fund allocations in U.S. stocks.

Given the developing world growth trends, it’s hardly surprising that MSCI first launched its MSCI Emerging Market Index back in 1988. “Strong economic growth combined with the development of financial markets has led to the expansion of investment opportunities in emerging markets and has reshaped the equity universe,” MSCI notes in its description of the index, which captures 13% of world market capitalization.⁴ Wrapping in both emerging and developed country markets, the MSCI All Country World Index ex-U.S. sports 1,859 constituents covering approximately 85% of the global equity opportunity set outside the U.S., the index provider notes.

The growth of overseas capital markets, especially in emerging markets, isn’t surprising, given GDP growth differentials. While the International Money Fund (IMF) expects the United States to grow 2.6% both this year and in 2017, it forecasts emerging-market and developing-country growth of 4.3% this year and 4.7% next year.⁵ Even China, which is now slowly moving to rebalance its economy toward more consumption and less investment, is still poised to grow 6.3% in 2016 and 6.0% next year, according to IMF projections.
Europe’s Growth Renaissance

Europe, too, is beginning to see signs of growth. The ECB’s January euro area bank lending survey, which covers the fourth quarter of last year, reported that “credit standards and loan demand continue to support a recovery in loan growth, particularly for enterprises.” It added that those for housing also returned to a net easing. At the same time, “banks reported a further strengthening of their capital positions and a reduction in risk-weighted assets predominantly related to riskier loans in the second half of 2015.” Both observations suggest the early 2016 market fears about euro area banks’ financial positions may be overblown, certainly for those not based in Europe’s southern periphery.

Other data also indicate growth in Europe has taken hold. Through January 2016, the Markit Economics’ Purchasing Managers’ Index had been coming in at 52 or above since March of 2015; a reading above 50 indicates growth. Unemployment in the euro zone has been falling since September 2013, from 12% then to 10.40% in December 2015. The IMF forecasts eurozone real GDP growth to expand to 1.7% this year from 1.5% in 2015. The eurozone economic recovery and equities. The ECB is slated to buy up to EUR1.7 trillion in assets through March 2017, while keeping its key refinancing rate on the floor and deposit rate deeply negative. The Japanese, Danish, Swedish, and Swiss central banks have negative deposit rates, and near- or meanwhile, supports growth in the energy-importing region.

Going with FDI and Trade Flows

Meanwhile, foreign direct investment (FDI) is helping fuel European and developing country growth. FDI inflows to the latter hit a new record high of $741 billion in 2015, up 5% from the previous high $703 billion set in 2014, according to the United Nations Conference on Trade and Development, or UNCTAD. The European Union attracted FDI flows of $426 billion, a 68% jump from 2014. Developing Asia drew the largest inflows of any region in the world, with a 16% increase to $548 billion accounting for a third of global FDI flows in 2015. Thanks to “a surge in equity investments and a sharp increase in M&A sales” the U.S. received $384 billion in FDI flows, but because it largely involved “corporate reconfigurations,” i.e, tax inversions, there was “little movement in actual resources,” UNCTAD noted. While a stronger U.S. economy and dollar should prove beneficial for overseas exporters, beyond currency cycles the long-term global trade trends speak to the opportunities abroad.

As globalization gives rise to greater trade and direct investment flows, deeper overseas capital markets, and a growing share of global GDP among many demographically vibrant emerging markets, U.S. investors would do well to consider overseas opportunities, where dividend yields also tend to be higher due to the U.S.’s double taxation of dividends.

Economic Sentiment Index, meanwhile, was running around 105-106 in the last quarter of 2015 and early 2016, well above its long-term average of 100.

After several years of stumbling along, a number of drivers are now aligned that together should support both Europe’s sub-zero key interest rates. Currencies across the continent are quite competitive versus the dollar. ECB QE seems to be cushioning any potential ripple effects from Europe’s southern periphery, as recent 10-year sovereign bond yields of 3.0% and 1.6% out of Portugal and Spain, respectively, attest. Much cheaper oil,
Like FDI, global trade flows over the years have also reflected the ascension of emerging markets, and somewhat surprisingly, even Europe. The “old continent” has been “the leading destination of (goods) exports over the past 20 years, followed by Asia, which has greatly increased its importance as a trading region,” the World Trade Organization reported (WTO).9 “In 2014, world merchandise exports to Asia amounted to $5.465 trillion, almost a third of the total of world merchandise trade.” Exports to developing countries rose to 39% in 2014 from 26% in 1995, while exports to developed economies as a whole fell to 56% in 2014 from 68% in 1995.

And it’s not just merchandise exports to emerging markets, but increasingly, services exports from them, as well. “Emerging economies, in particular in Asia, have become increasingly import exporters of computer services,” which ranks as the most rapidly growing service export sector over the last two decades, the WTO noted in its International Trade Statistics 2015 report. “The region’s share in world exports rose from an estimated 8% in 1995 to 29% in 2014, as India’s and China’s exports multiplied,” it added. “North America has lagged behind and its participation in world exports has dropped. However, Europe remains the largest exporter of computer and information services, accounting for 58% of global exports in 2014.”

As globalization gives rise to greater trade and direct investment flows, deeper overseas capital markets, and a growing share of global GDP among many demographically vibrant emerging markets, U.S. investors would do well to consider overseas opportunities, where dividend yields also tend to be higher due to the U.S.’s double taxation of dividends. Overseas markets offer important return and risk diversification benefits, and not just in equities. The global debt market rounded $100 trillion by the beginning of 2014,10 of which U.S. Treasuries comprised less than one-tenth. “Similar to stocks, the composition of the global bond market has shifted and is currently 35% U.S. and 65% rest of the world,” reported Portfolio Evaluations, Inc.11 Yet consumer and government debt levels in a number of foreign countries, particularly among emerging markets, are lower than they are in the United States, making it easier for them to sustain faster economic growth for years to come.

**Gauging Political Risk, Potential Reward at Home and Abroad**

As for “fragile institutions,” political risk, it should be noted, exists the world over, including the United States. Financial sector regulation, for example, continues to expand under the 2010 Dodd-Frank law, and several big banks have been repeatedly sanctioned by various government authorities for the same alleged infractions. The 2010 Affordable Care Act remains on unsteady footing, given precarious insurer participation in state and federal health exchange programs, not to mention its uncertain prospects if a Republican wins the White House in 2016 elections. The implementation of “Net neutrality” under a Depression-era legal framework remains a work in progress, as does the Environmental Protection Agency’s Clean Power Plan, which would effectively enable the EPA to usurp state control over power generation in an apparent regulatory push to change the nation’s energy mix. Investors must always measure regulatory and political risk against potential reward—both at home and abroad.

Some may argue that U.S. investors can obtain sufficient overseas economic exposure simply by investing in U.S. portfolios focused on companies within the S&P 500 Index, as roughly half of their revenues come from foreign markets. But are U.S.-based investors gaining sufficient exposure to overseas growth and diversification benefits through investing mostly in U.S. large-capitalization stocks? They can better derive such benefits, including lower correlation with U.S. markets, through dedicated international and emerging market strategies.

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**Footnotes**

1 Bloomberg.com, Dec. 8, 2014.
2 Research Affiliates.
3 World Bank.
4 MSCI.
5 MSCI.
6 International Monetary Fund, World Economic Outlook January, 2016.
7 ECB, The euro area bank lending survey January 2015.
9 World Trade Organization, January 2015.
11 Portfolio Evaluations, Inc. 2014.
Important Information

The views expressed by the authors reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity, volatility, and political and economic risks.

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

The MSCI Global Investable Market Indices include large-, mid- and small-cap segments and provide exhaustive coverage of these size segments by targeting a coverage range of close to 99% of the free float-adjusted market capitalization in each market.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The MSCI All Country (AC) World ex-US index is a market capitalization weighted index representative of the market structure of 45 developed and emerging market countries in North and South America, Europe, Africa, and the Pacific Rim, excluding securities of United States' issuers. The index is calculated with gross dividends reinvested in U.S. dollars.

The MSCI country indices are free float-adjusted market capitalization indices that are designed to measure equity market performance in that specific country in U.S. dollars.

Margin of safety – The difference between the intrinsic value of a stock and its market price. Margin of safety doesn’t guarantee a successful investment, but it does provide room for error in an analyst’s judgment.

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company’s current share price compared to its per-share earnings. P/E equals a company’s market value per share divided by earnings per share.

Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean.

Price/Book ratio (P/B ratio) – A ratio used to compare a stock’s market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter’s book value per share.

Price/Cash Flow – The measure of the market’s expectations regarding a firm’s future financial health. It is calculated by dividing price per share by cash flow per share.

Price/Sales – A ratio for valuing a stock relative to its own past performance, other companies or the market itself. Price to sales is calculated by dividing a stock’s current price by its revenue per share for the trailing 12 months.

Foreign Direct Investment – A direct, longer-term investment usually by a company from one country in a company or entity in another country that represents a significant or controlling stake in the recipient firm.

Quantitative Easing (QE) – A monetary policy used to stimulate the economy.

Gross Domestic Product (GDP) – A country’s income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

Past performance does not guarantee future results.

Before investing, carefully consider the Fund’s investment goals, risks, charges, and expenses. For a prospectus or summary prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read them carefully before investing.