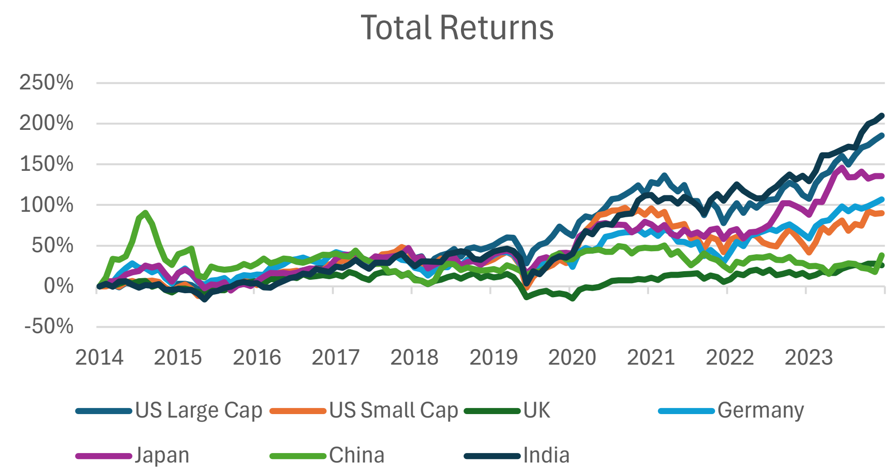
A Look At Global Earnings

Last quarter saw strong growth across global financial markets, buoyed by lower interest rates and a weakening US Dollar. At the macro level, investors remain convinced that earnings and earnings growth are strong despite the pressures of inflation, higher interest rates, and tightening monetary policy. When constructing diversified portfolios, it is important that we differentiate between these various factors that influence stock prices. In the short term, factors such as interest rates and currency fluctuations can influence stock prices up or down by impacting their relative valuations. In the long term, however, these factors tend to average out and it is the fundamental company earnings that drive performance. Since we are long-term, globally diversified investors, we think this is a good opportunity to examine the state of corporate earnings in global stock markets.

While investors are naturally interested in a company's current earnings, long-term investors are also of course highly concerned with seeing those earnings grow over time. The following chart shows earnings growth across global markets over the past decade.

Source: Siblis Research

The prior chart shows robust earnings growth in most markets; China and the UK being the clear exceptions. Now let's look at the performance of these markets over the same period in their home currencies.



Source: Siblis Research

We see a similar story play out here, with strong total returns across the board; China and the UK once again being the exceptions. One noteworthy difference is within US stocks, where US Small Cap saw much stronger growth in underlying earnings than in actual performance, while US Large Cap had the opposite experience. This discrepancy is explained by their respective valuations also going in opposite directions. In the same timeframe, US Large Cap stocks became 37% more expensive (stock prices relative to underlying earnings), while US Small Cap stocks became 48% cheaper. Both categories remain significantly more expensive than virtually all non-US stocks.

We mentioned that the actual performance in the above chart is in each country's home currency. While that is important in demonstrating the correlation between earnings and performance, the performance does not account for currency fluctuations between those home currencies and the US Dollar.

Because foreign stocks are operating in their home currencies, but we are investing with US Dollars, those fluctuations have a direct impact on our returns. While currencies tend to revert to long-term averages over time, they can fluctuate significantly in the short and medium term. This table shows the annualized returns for each country in the previous chart, along with how that country's home currency changed relative to the US Dollar during the same timeframe.

Market	Returns (Annualized)	Currency Change (vs USD)
US Large Cap	11.1%	N/A
US Small Cap	6.6%	N/A
UK	2.3%	-16.3%
Germany	7.5%	-11.0%
Japan	8.9%	-23.9%
China	3.3%	-12.5%
India	12.0%	-25.0%

Source: Siblis Research & Morningstar

Due largely to Federal Reserve monetary policy, the US Dollar has strengthened significantly, as we can see in the above chart. This means that despite strong earnings growth and performance in many foreign markets, US investors have not yet fully experienced those returns due to the decreased value of most foreign currencies relative to the US Dollar. While we do not believe we can predict the timing of future currency movements, we know that currency fluctuations are cyclical, and we expect that over time this headwind for non-US stocks will shift to a tailwind.

In summary, company fundamentals such as earnings are of primary importance for long-term investors, as they are the primary driver of long-term returns. That said, the price you pay for a dollar of expected earnings certainly matters, as cyclical fluctuations in valuations and currencies can significantly impact investor returns, particularly in the short & medium term.

Research Affiliates is a leader in applying Modern Portfolio Theory concepts to real-world portfolio construction. While their models are highly sophisticated, at the core they are based on the same fundamental concepts we have reviewed. Let's look at their 10-year projected returns for each of the asset classes we have examined. This model incorporates current earnings, expected future earnings growth, and current valuations (expensiveness) of various global markets.

Market	10-Year Projected Returns (Annualized)
US Large Cap	4.7%
US Small Cap	7.0%
UK	7.7%
Germany	7.2%
Japan	6.7%
China	7.4%
India	7.4%

Source: Research Affiliates

While this particular model does not account for future currency fluctuations, it is widely regarded as one of the most academically sophisticated models in the industry. While the current high valuations for US Large Cap stocks create lower projected returns, the model otherwise suggests good news and attractive future returns for globally diversified investors. We remain committed to a robust, academic-based portfolio construction process, and we remain optimistic about the outlook for global markets.