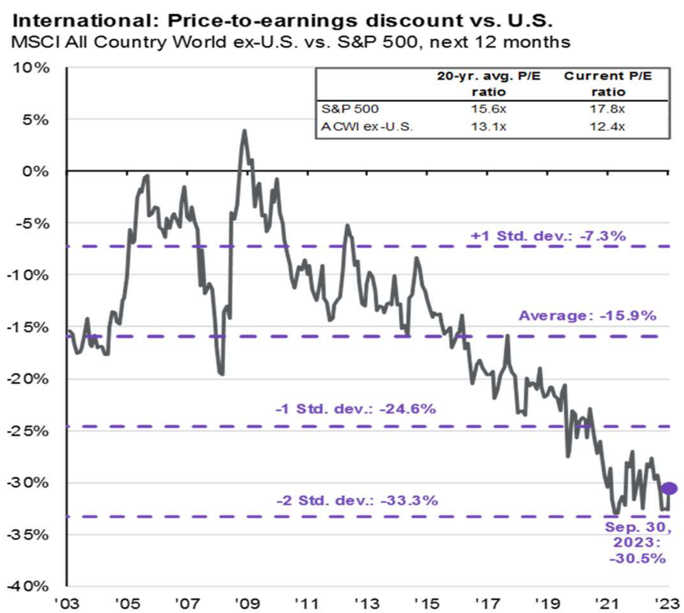
The Case For International Equities

In the 15 years since the 2008 market crash, this is the first market downturn that was not followed by an immediate recovery and return to growth. Historically, such a prolonged downturn often represents an inflection point in the global economy that marks the transition to a new market cycle. While the previous market cycle was defined by low interest rates and extreme monetary and fiscal stimulus, we must use the tools available to us to assess what the new market cycle will look like, and how to best position our portfolios.

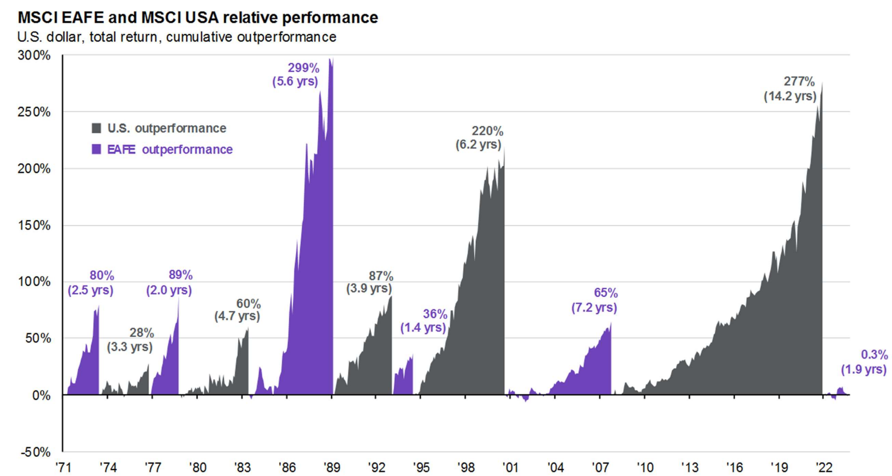
Last quarter we delved into fundamental earnings data, which remains strong despite the bear market. This quarter we will take a deeper dive into what the data tells us about differences within financial markets; specifically how US stocks compare to non-US stocks and how that impacts our future expectations and portfolio construction. Let us start by examining the following chart which shows the relative valuation of non-US stocks compared to US stocks over the last twenty years.



Source: JP Morgan Asset Management

It is important to note that non-US stocks are typically expected to be priced lower than comparable US stocks because they have increased currency risk for US investors. Despite that fact, the chart shows non-US stocks to be hovering around all-time record low valuations relative to US stocks. It is difficult to predict valuation changes, but if and when these relative valuations do revert towards their long-term averages, the sheer magnitude of the differential would likely result in extreme outperformance for non-US stocks.

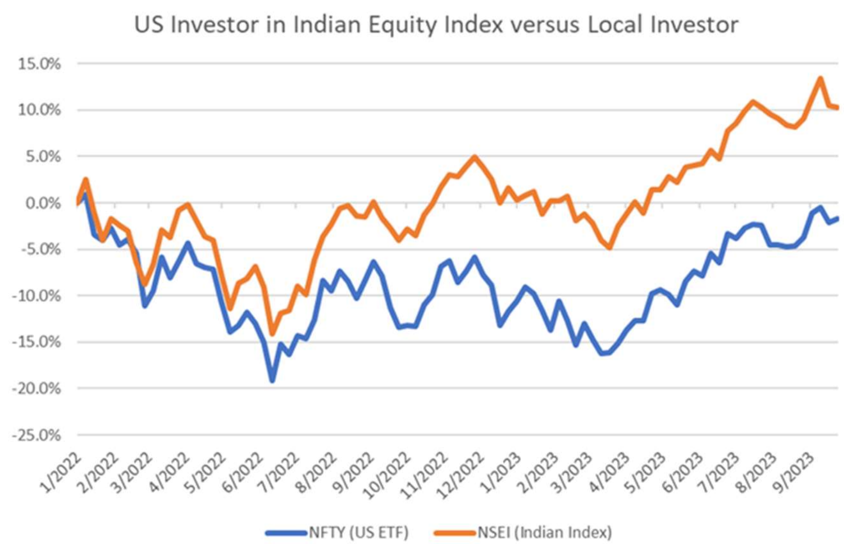
Historically, we have seen these cycles play out before; the following chart shows the relative outperformance of US vs non-US stocks since 1970. (EAFE represents Developed International stocks).



Source: JP Morgan Asset Management

The chart is a good example of why we talk about market "cycles"; demonstrating the regularity and scale of pendulum swings between US & non-US outperformance. We see that the most recent cycle favoring US stocks was extreme both in magnitude and duration, mirroring the US monetary & fiscal stimulus policies that defined the era. It's also noteworthy that the duration of each cycle is unpredictable, ranging from several years to more than a decade.

These cycles of relative outperformance by US & non-US stocks are driven by the ebbs and flows of three primary factors: earnings growth, market valuations, and currency fluctuations. Earnings growth mirrors the growth of the underlying economies and we've already examined relative valuations of US & non-US stocks. This leaves currency fluctuations, which serve to amplify or reduce the returns earned by domestic investors. For example, a US investor who invests in an Indian equity index will earn the underlying return from the index *plus (or minus)* the change in currency valuations over that period. For example, the following chart shows the performance of an index of Indian stocks since the beginning of 2022 for US investors (NFTY) versus Indian investors (NSEI).



Source: Yahoo Finance

The Indian equity index itself has grown 10.2% since January 2022 despite the global downturn. However, because the US dollar has gone up significantly against the Rupee, US investors lost -1.7% over the same period.

Similar to our first two charts, currency fluctuations are cyclical and typically follow multi-year pendulum swings back and forth. While they should eventually revert to long-term averages, the direction the pendulum is swinging can significantly impact short-term returns. The following chart shows the value of the US Dollar relative to a basket of international currencies over the past 25 years.

Source: JP Morgan Asset Management

The chart reveals that the US Dollar has been on a steady upward trajectory for the past 10-15 years, roughly the same period where we saw record outperformance of US stocks. However, it is also near its all-time high, and if/when the pendulum begins to swing the other direction it would create a significant tailwind for non-US stocks.

The market cycle that followed the 2008 Financial Crisis was defined by extremely accommodating and stimulative fiscal & monetary policy in the US. This led to an unprecedented era of outperformance of US stocks relative to non-US stocks, driven largely by inflating valuations and the US Dollar. While the timing is difficult to predict, these are inherently cyclical phenomena that are at or near all-time high levels. If the recent change in Federal Reserve policy or any other events serve as a catalyst to reverse the pendulum swing and push these metrics back towards more "normal" levels, the resulting tailwinds would create significant outperformance potential for international stocks.