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The Case For a Continued Commitment To International Equities

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KEY POINTS

- *Despite the US dominance over the last decade, we remain committed to international investing.*
- *Gains in U.S stock market valuations have outpaced foreign valuations.*
- *We see potential for a change in the long-term strength in the U.S dollar.*
- *Global equity markets have become more aligned over the years, reducing the diversification benefit.*

After riding through the roller-coaster of 2020 and experiencing first a steep and concerning bear market, followed by the fastest rebound in market history that led into the beginning of 2021, we continue to evaluate the way we view and implement portfolio management. With U.S equities recovering and exceeding return expectations by the end of the fourth quarter last year, asking the question of why we continue to invest parts of our portfolios in international equities is worth considering.

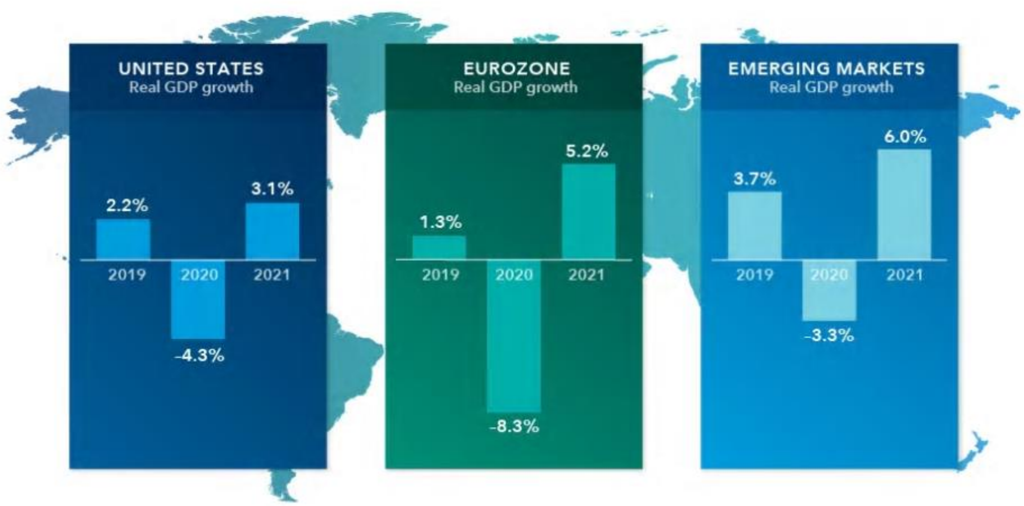
Although many international markets also ended 2020 in the green, U.S equities have outperformed international 7 out of the last 9 years. Despite this, we continue to see the value in foreign equities and are more optimistic than ever about keeping international as a core part of our portfolios. After bottoming out last year, we expect to see worldwide recovery that will bring global opportunities, a possibility for a bear dollar market to occur as well as a continuation in how international equity investing has changed in the last 30 years.

The World and its Economic Recovery

Given the United States' historic propensity to face global challenges head on such as the Great Depression and World War II, we are not surprised to see an economic recovery response to Covid-19 as vast and swift as we saw in 2020. And one of the main results of this response is the S&P 500's Forward P/E projections, measuring a company's price based on their projected earnings. As of March 31st, 2021 (one year after the forced shutdowns), the Forward P/E for the S&P 500 was 21.88. That is almost 2 standard deviations above the 25-year average of 16.64. This tells us that prices may be high for certain sectors or companies throughout the market; therefore, we need to be selective when choosing where value lies.

Although international valuations have historically been lower compared to the U.S., the gap has widened. We believe this is because of the world's recovery response to Covid-19 lagging slightly behind the U.S. Between the access to implement new technology (think Zoom and Uber Eats) and the ability to obtain multiple vaccines inside of a year, the United States has reaped the benefits of allowing its economy to climb out of a deep hole and move forward. However, the rest of the world is not far behind and real GDP growth could be a big factor.

The world is turning the corner toward recovery



Source: International Monetary Fund, *World Economic Outlook*, October 2020. GDP figures for 2020 and 2021 are projections.

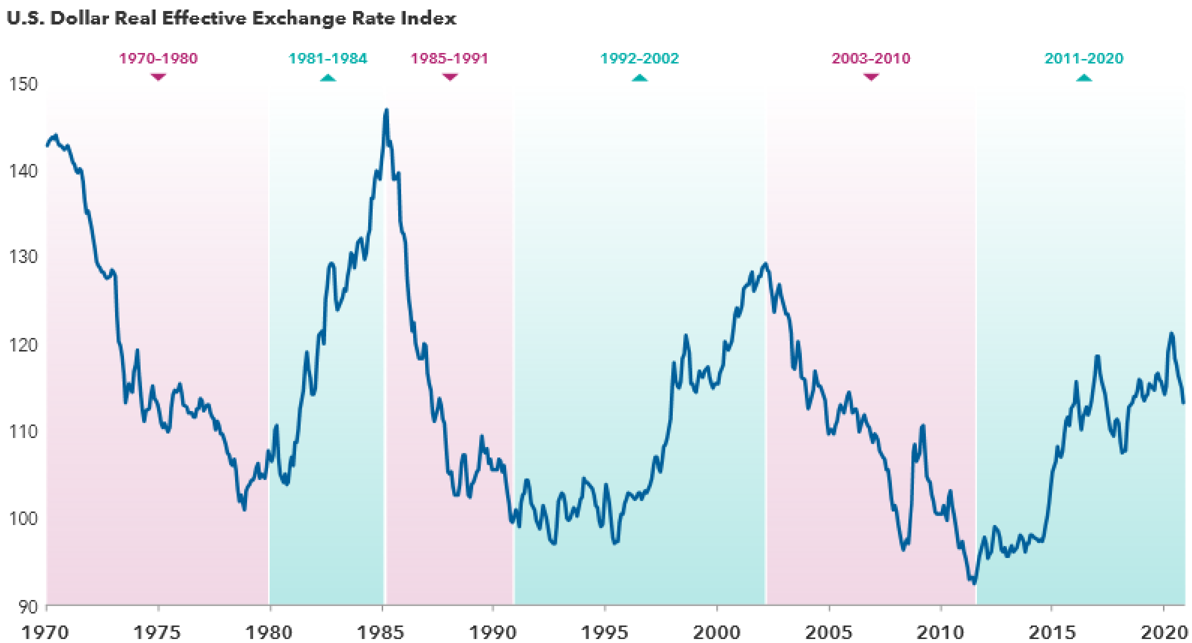
Despite witnessing negative earnings growth in 2020 across the globe, the 2021 estimates show significant improvements as well. According to J.P. Morgan's most recent estimates, the Emerging Markets (37%), Europe (33%), and Japan (33%) earnings are all expected to outpace the United States (26%) in earnings growth in 2021. Combining this with the more reasonable global valuations in those respective territories gives us additional reason to focus attention on international markets.

The Dollar Cycle: Bull or Bear?

A common question is how does the dollar affect international investments?
A bull dollar market is when the U.S dollar is stronger than foreign currencies and therefore, U.S equities tend to outperform international. A bear dollar market is when foreign currencies are stronger than the U.S dollar, benefitting foreign currencies and therefore, international equities.

We have seen a strong U.S dollar trend since 2011 which, along with lagged growth and political uncertainty in developed and emerging markets, has contributed to the underperformance in foreign equities. However, we have seen currency cycles generally lasting 5 to 8 years and we are currently entering year 10 (matching the longest dollar bull cycle in the past 50 years).

U.S. dollar bull and bear cycles since 1970



SOURCES: Bloomberg, J.P. Morgan. As of 11/30/20. Bull and bear cycles are for illustrative purposes only. Data represents the U.S. Dollar Real Effective Exchange Rate Index, which measures the inflation-adjusted relative value of the U.S. dollar against a broad basket of foreign currencies. This report, and any product, index or fund referred to herein, is not sponsored, endorsed or promoted in any way by J.P. Morgan or any of its affiliates who provide no warranties whatsoever, express or implied, and shall have no liability to any prospective investor, in connection with this report. J.P. Morgan disclaimer: https://www.jpmm.com/research/disclosures.

Since the start of the Covid crisis, Congress has passed approximately $5.5 trillion in fiscal stimulus, which is 2.5 times the response for the Great Financial Crisis in 2008. At the same time, the Federal Reserve has added approximately $3.5 trillion to its overall balance sheet after buying up debt. That is $9 trillion in total U.S. stimulus, which is larger than the economies of Japan and Germany combined. Such a large increase in money supply combined with low interest rates and high debt could lead to a weakened dollar. A weaker dollar has historically led to foreign equities outperforming U.S equities.

It’s Companies, Not Countries/Regions

We would like to present a challenge to conventional wisdom on <u>how</u> to invest internationally. Historically, adding international exposure based on country or region to a portfolio that was mainly comprised of U.S equities, provided the proper diversification needed to reduce volatility. However, in the last 30 years the correlation between international and U.S equities has gradually risen and new strategies must be considered. We are a much more global economy now and as markets become more closely aligned (i.e. higher correlation), there is less of a diversification benefit.

It is now multinational companies, not countries or regions that are leading the way in international investing. It's more important to see where a company is doing business, not just where they're located, which is more of a global approach to portfolio management.

> For example, Broadcom Inc., is an American semiconductor and software company headquartered in San Jose, California. Most of their business, however, is conducted outside of the United States with 80% of their overall revenue generated in regions outside the United States in 2020. In fact, many of the largest US-based multi-national corporations have the majority of their total sales outside the United States, including Coca-Cola (70%), Exxon (65%) and Apple (63%) to name a few.

To Summarize

While future economic and investment outlooks are always subject to change, as we look ahead, we are optimistic about the opportunities that a global approach can offer. By approaching international equity investments by company rather than their country of domicile, we believe this is a more adaptable approach in our ever changing and global world. We are also excited about international if we do enter a bear dollar market while the rest of the world recovers from the effects of Covid-19. We remain disciplined and focused on the long-term performance of the portfolios we manage, and committed to the individual goals and objectives of our clients.

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Disclosures