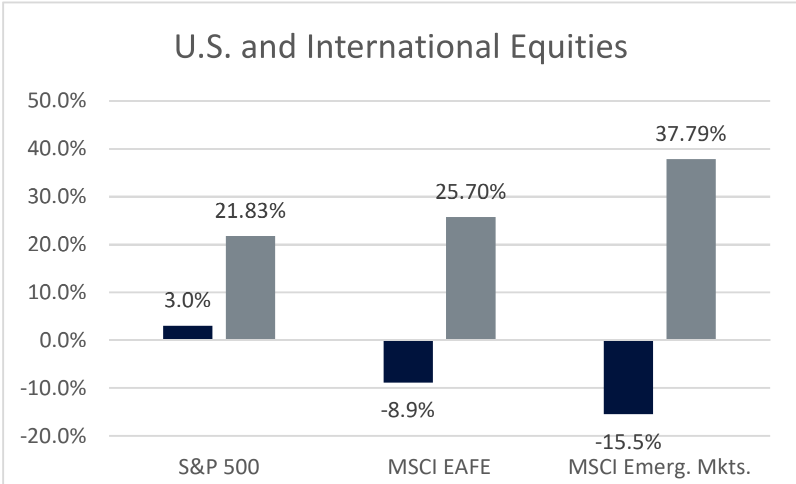
What's Next for International Stocks?

Global Financial Private Capital

- After outperforming in 2017, international equities have lagged domestic equities significantly in 2018. Many investors are now wondering if they should continue to hang on to international stocks in their diversified portfolios. The short answer is still yes.
- Domestic and international stocks have historically moved in a cycle of alternating performance that lasts an average of 7.3 years, according to a study by Hartford Funds. We are now 7.6 years into the current run of U.S. outperformance – suggesting we are due for a turn in the cycle.
- With the recent market sell-off, international equities are trading at a deep discount relative to their peers in the U.S., resulting in a nearly 25% discount – the cheapest relative valuation in over 20 years, according to J.P. Morgan.

International equities – what's next?

As we near the end of 2018, the path forward may seem less clear than at the beginning of 2018. After an exceptionally strong 2017, the broad consensus was that international equities would once again outperform on the back of strong global growth and attractive fundamentals. But with a month left to close out the year, this scenario clearly has not played out. International equities – both developed markets as represented by the MSCI EAFE (Europe, Australasia and Far East) and emerging markets as represented by the MSCI Emerging Markets index – have lagged U.S. equities thus far in 2018, despite their outperformance in 2017. As a result, many investors may be frustrated with the current state of their diversified portfolios and wondering if they should continue to hang on to international stocks. The short answer is yes, but to better address this, let's take a look at the history of relative performance of U.S. and international equities, as well as their relative valuations (i.e., how cheap or expensive they are) after this year's sell-off.



Source: Bloomberg as of 10/31/18.

Historical performance of international equities

History has shown that domestic and international stocks have moved in a cycle of alternating performance over the past four decades. In a study entitled *A Reboot for International Equities*, Hartford Funds researched the rolling five-year returns for international and U.S. equities since the mid-1970s. Hartford observed multiple periods of U.S. outperformance, followed by periods of international outperformance, and then returning to U.S. outperformance again. The average cycle of outperformance was 7.3 years. As we are now 7.6 years into this cycle of U.S. outperformance, it makes sense to question whether the outperformance pendulum is due to swing the other way from a statistical standpoint. While past performance is no guarantee of future results, periods of underperformance have occurred in the past and can be expected to reverse again as well.

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US and International Markets Have Moved in Cycles of 7-Plus Years

US Equity vs. International Equity 5-Year Rolling Returns (1/1/1970-09/30/2018)

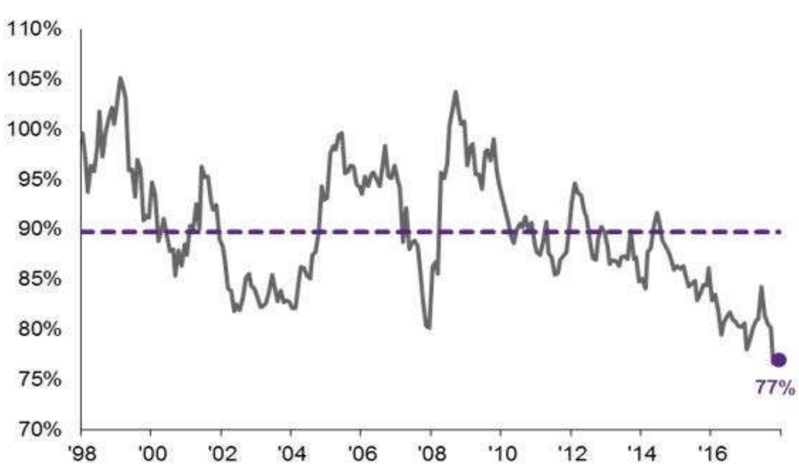
Source: Morningstar; Calculations: Hartford Funds, 10/18. **Performance data quoted represents past performance and does not guarantee future results. The performance shown above is index performance and is not representative of any Hartford fund's performance.** Indices are unmanaged and not available for direct investment. The chart shows the values of the S&P 500 index's returns minus the MSCI World ex USA Index. When the line is above 0, domestic stocks outperformed international stocks. When the line is below 0, international stocks outperformed domestic stocks. US equity is represented by S&P 500 Index; International equity is represented by the MSCI World ex USA Index. Please see the back page for representative index definitions. For illustrative purposes only.

How cheap are international equities?

Looking at current valuation indicators such as price-earnings (P/E) ratios, international equities across developed markets and emerging markets appear more attractive relative to U.S. equities. The P/E ratio gives you an idea of how much you're paying in the current price for each dollar of earnings. The general rule is that a high P/E indicates that investors are paying a higher price for an investment compared to its earnings, whereas a lower P/E indicates investors are earning more for their investment. (In other words, the lower the P/E, the better the value.) Recent market volatility has widened the gap in valuation. According to J.P. Morgan, international equities have typically traded at a 10% discount to U.S. stocks over the past 20 years, as indicated by the dotted line in the chart.

International stocks are trading at a deep discount relative to the U.S.

Relative NTM P/E ratio, International as a % of U.S.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. Indices used are the MSCI All Country World ex-USA and the S&P 500. Valuations are forward looking. Data are as of October 31, 2018.

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But with recent price action, valuations have fallen more dramatically overseas, resulting in a nearly 25% discount – the cheapest relative valuation in over 20 years.

Are there any risks?

Significant risks and uncertainties remain as it relates to international equities that may continue to create headwinds. Some of the risks and uncertainties include, but are not limited to, tariff and trade wars (e.g., the U.S. and China trade war), unrest in certain emerging market countries (e.g., Turkey and Venezuela) and the impact of a stronger dollar as the Fed continues to raise interest rates. Investors can expect elevated volatility given these risks and uncertainties, but there could be attractive investment opportunities for international equities looking ahead over the next 5-10 years.

Conclusion

We live in a global economy and investing globally is important. I live in Colorado and would never invest only in Colorado stocks, or invest only in one-half of the global equity markets. International stocks are an important part of a disciplined approach to global diversification and therefore always belong in a portfolio, good year or bad. Including international equities within a globally-diversified portfolio strategy, where appropriate, seems worthy of consideration.*

*Diversification does not guarantee against loss or ensure a profit.

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