

Market Bulletin

August 23, 2017

International equities: Tourist trap or hidden gem?

In brief

- International equities should always be a key component of investors' portfolios, as they broaden the opportunity set, enhance diversification benefits and should result in a better risk and return profile.
- Like with traveling abroad, certain fears hold U.S. investors back from having meaningful international exposure, but many of these concerns can be readily addressed.
- The case for international is particularly appealing now given the acceleration in growth outside of the U.S., faster earnings growth abroad, more attractive valuations and possible currency tailwinds.
- While in general international is worthwhile, investors should think of investing like planning a trip: know which countries and cities are particularly worth going to. The Eurozone and emerging markets, and cyclical sectors in particular, stand out.



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U.S. portfolios should always travel overseas

Only 45% of American citizens have a passport¹, which implies that 55% of Americans only travel domestically. Several factors may explain why many Americans shy away from traveling abroad, from the United States' own diverse cultural and geographical offerings, to fear of the unfamiliar. However, there is a lot to be said about experiencing other cultures first hand, from local customs to historical sites, as well as the thrill of navigating an unfamiliar land. Slowly, Americans are warming up to the virtues of international travel: 2016 was a record year for Americans traveling overseas². However, there is still plenty of

¹Based on valid passports in circulation data from the U.S. State Department and native born population data from the U.S. Census Bureau; as of 2015.

²Based on available data of U.S. citizens' air travel to international regions from the National Travel and Tourism Office of the U.S. Department of Commerce.

scope for foreign travel to become ingrained in American culture.

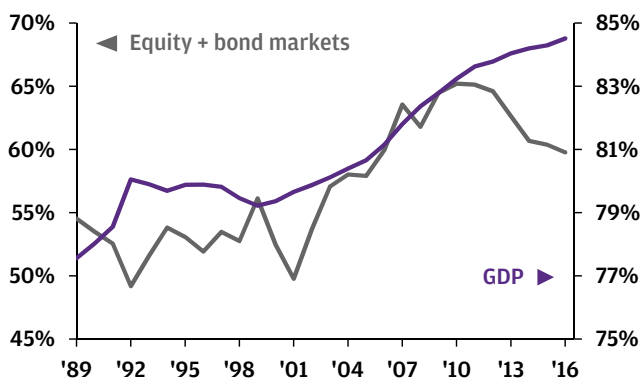
Similarly, many U.S. investors are disinclined to look outside of the U.S. for investment opportunities. The U.S. economy is the single largest economy in the world and the depth and breadth of its capital markets are notable, which makes investors feel there is little to gain from venturing elsewhere. However, there are three crucial reasons why investors should ensure they have a meaningful allocation to international equities in their portfolios.

1. The world is a big place

The share of the global economy found outside of the U.S. has been steadily rising, from 78% in 1990 to 85% in 2016. The ability to invest in that overseas growth has also increased, with international markets now representing 60% of global public capital markets, compared to 53% in 1990 (Exhibit 1a). This trend is set to continue. However, U.S. investors still have very low exposure abroad, with international equities and bonds representing only 21% of portfolios³. While some home bias makes sense, the degree to which U.S. portfolios skew to the U.S. is akin to eating only a very small slice of a large, delicious pizza and throwing the rest out (Exhibit 1b).

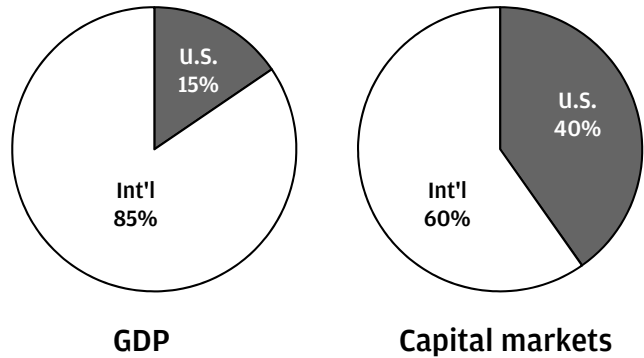
The international piece of the pie has been getting larger

EXHIBIT 1a: INTERNATIONAL GDP & CAPITAL MARKETS
% of world total



The U.S. is only a piece of the global pie

EXHIBIT 1b: GLOBAL GDP & CAPITAL MARKETS
% of world total, 2016



Source: BIS, IMF, The World Bank, World Federation of Exchanges, J.P. Morgan Asset Management. International capital markets and GDP is defined as the world total excluding the United States. GDP is based on purchasing power parity. Data are as of August 23, 2017.

2. Go straight to the source

Investing internationally helps to diversify a portfolio. Overseas markets move up or down based on local developments that affect domestic company fundamentals; what may affect a U.S.-based company may not be relevant to a Brazil-based company, for example. As a result, the correlation between U.S. and international equities tends to be fairly low outside of crises (Exhibit 2). After the Global Financial Crisis, global markets moved similarly for a while, reacting to common risk-on and risk-off headlines. However, those days are behind us and markets are increasingly responding to local developments again. This is even more evident when looking at small-cap companies, which tend to be more domestically-oriented.

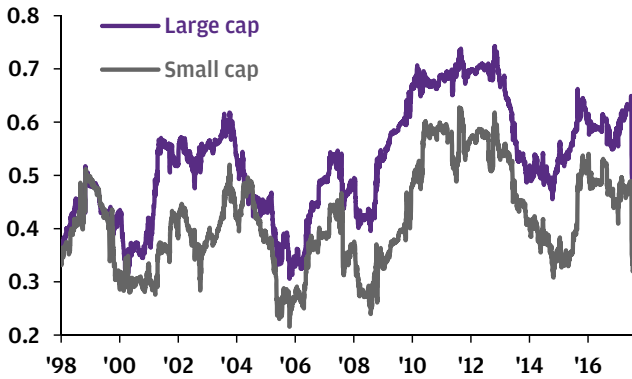
While there are outstanding Italian restaurants all over the U.S., there is nothing quite like eating a fresh out-of-the-oven Neapolitan pizza in Naples. And the crucial part is that Italian waiters will not allow you to order a cheap American lager while doing so. Investors should apply a similar mindset when looking at international: while investing in U.S. companies that have a significant portion of their revenues coming from abroad may sound like a solution, the only way to truly

³ Based on all active and passive open-end mutual funds and exchange traded funds domiciled in the United States, as provided by Strategic Insight Simfund; as of July 2017.

be insulated from U.S.-specific fluctuations is by investing in international directly.

Markets around the world increasingly trade on local factors

EXHIBIT 2: U.S. AND INTERNATIONAL EQUITY CORRELATIONS
Daily price return, local currency, 1-year rolling



Source: MSCI, Russell, Standard & Poor's, FactSet, J.P. Morgan Asset Management. International small caps, international large caps, U.S. small caps and U.S. large caps are represented by the MSCI ACWI ex-U.S. Small Cap Index, MSCI ACWI ex-U.S. Index, Russell 2000 Index and S&P 500 Index, respectively. Data are as of August 23, 2017.

3. Variety is the spice of life

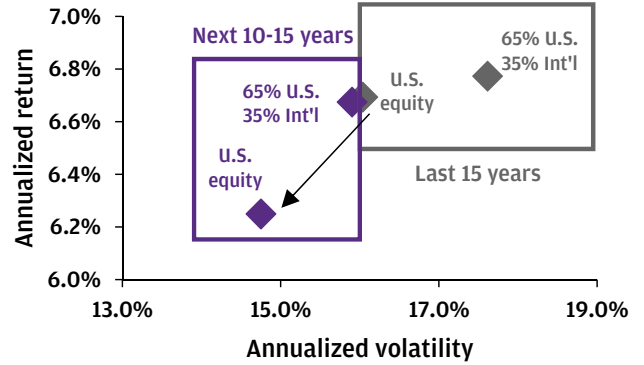
An equity portfolio which has both U.S. and international should have a better risk and return profile than a U.S. only portfolio because it taps into a wider opportunity set and has lower correlations between assets. However, over the past 15 years the result was not particularly encouraging, with the addition of international equities not providing enough additional return to justify the higher volatility (**Exhibit 3**). This was due to the poor performance of developed markets ex-U.S. during this time.

The next 10 to 15 years should look dramatically different. U.S. equity returns will likely be lower than in the past given a continued low-growth environment and current elevated valuations. A possible way for investors to achieve similar returns to those provided by U.S. equities in the past is to have a meaningful allocation to international (**Exhibit 3**). Otherwise, equity returns will likely be substantially lower going forward. In the ninth year of a U.S. equity expansion, the U.S. pizza has been fully cooked for a while - there

are fresher pies in the overseas ovens.

International is crucial to maintain same risk/return going forward

EXHIBIT 3: EQUITY MARKET RETURNS AND VOLATILITY
Annualized total return, USD, quarterly annualized std. deviation



Source: Standard & Poor's, MSCI, FactSet, J.P. Morgan Asset Management. International piece of sample portfolio is comprised of 10% MSCI Emerging Markets Index and 25% MSCI EAFE Index. U.S. equity is the S&P 500. Figures for next 10-15 years are based on synthetic returns and volatility using J.P. Morgan's 2017 Long-Term Capital Markets Assumptions. Data are as of August 23, 2017.

Putting fears aside and buying that plane ticket

Despite these three compelling arguments, some common fears get in the way of larger international exposure.

1. Why would international actually deliver?

Investors may wonder whether the future will look different for international investing, or whether it is a tourist trap. Four factors suggest that international equities are actually a hidden gem: growth, earnings, valuations and currencies. Investors should remember to *Go Explore Vibrant Countries*.

Go: Growth

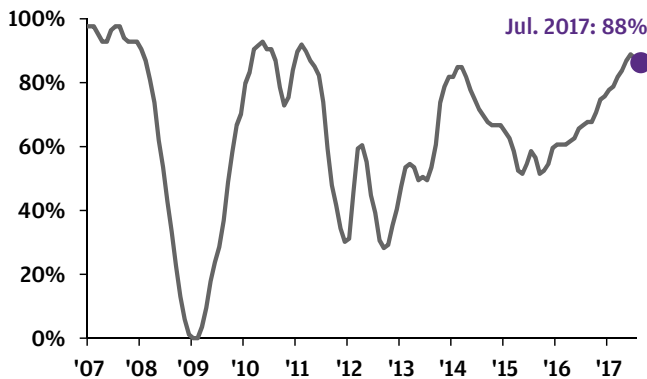
Investors have gotten used to thinking that the U.S. is the only worthwhile place to visit. Indeed, the U.S. economy has seen steady growth for eight years since the Global Financial Crisis, while other regions were beset by issues such as a double-dip recession in Europe caused by the sovereign debt crisis and a

slowdown in emerging markets as a result of the commodity price collapse. However, after several improvements, many regions are now looking like attractive places to visit once again (**Exhibit 4**). In fact, the greatest acceleration in growth is happening outside of the U.S. in regions in earlier stages of their expansion relative to the U.S.

Growth is picking up speed around the world

EXHIBIT 4: PMI DIFFUSION INDEX

% of manufacturing PMIs above 50 vs. below 50, 3-month moving average



Source: Markit, J.P. Morgan Asset Management. The 50 level indicates acceleration or deceleration of the sector. Data are as of August 23, 2017.

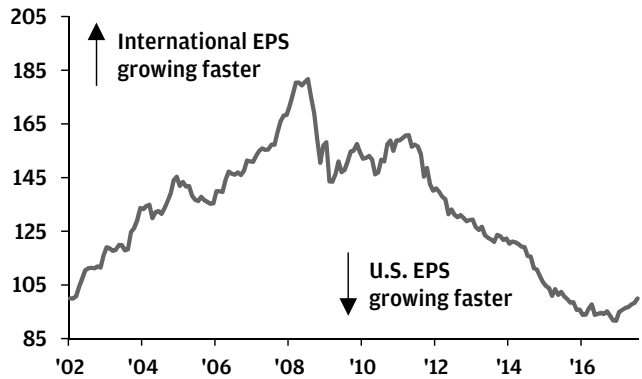
Explore: Earnings

From 2011 to 2016, the challenges faced by other economies resulted in U.S. earnings growing faster than international ones. However, with the improvement in global growth beginning in early 2016, international earnings are now starting to grow faster than those in the U.S. (**Exhibit 5**). While U.S. companies have been reporting record-high earnings since 2011, emerging market earnings are still 32% below their previous peak, and Eurozone earnings are still 74% below theirs. With the encouraging acceleration in economic growth, we can expect these gaps to continue to close.

After years of U.S. earnings outpacing international, a reversal is taking shape

EXHIBIT 5: INTERNATIONAL VS. U.S. EARNINGS

MSCI ACWI ex-U.S. vs. S&P 500 forward EPS, USD, Jan. 2002 = 100



Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of August 23, 2017.

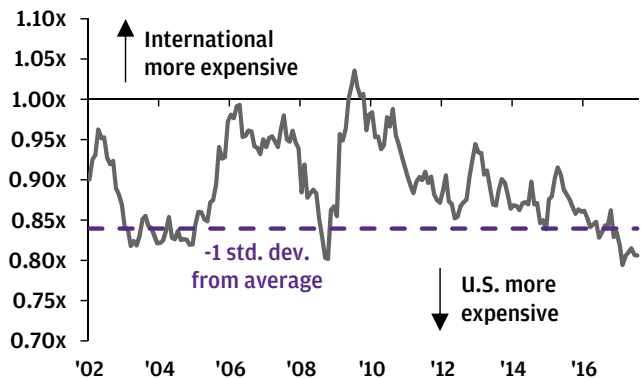
Vibrant: Valuations

With the U.S. bull market now well into its ninth year, U.S. equities are no longer cheap, both in absolute terms as well as relative to other equity markets. In general, overseas markets tend to trade at lower valuations than the U.S., but international is close to the cheapest it has been relative to the U.S. in fifteen years (**Exhibit 6**).

International is at almost record cheap levels relative to the U.S.

EXHIBIT 6: INTERNATIONAL VS. U.S. VALUATIONS

MSCI ACWI ex-U.S. vs. S&P 500 forward price-to-earnings ratio



Source: MSCI, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of August 23, 2017.

Countries: Currencies

From mid-2011 to late 2016, the U.S. dollar strengthened close to 30% against developed and emerging currencies (**Exhibit 7**). For U.S.-based investors, this meant that converting their foreign returns into U.S. dollars resulted in lower numbers because the foreign currency had gotten weaker. Looking forward, we believe we are at the beginning stages of a long move down for the dollar, as a result of better global growth, narrowing interest rate differentials, more stable commodity prices and a persistent U.S. current account deficit. This weaker dollar environment would provide a boost to international returns.

U.S. dollar looks set to continue declining, providing a boost to foreign returns

EXHIBIT 7: U.S. DOLLAR PERFORMANCE
U.S. dollar real trade-weighted index, Mar. 1973 = 100



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management. U.S. dollar represented by the Federal Reserve real trade-weighted exchange rate index, broad definition. Data are as of August 23, 2017.

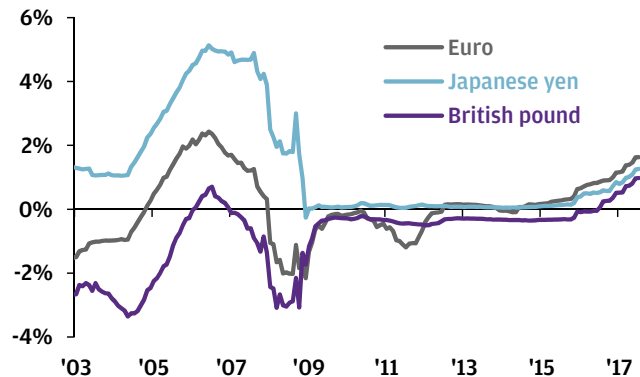
2. What if the dollar gets stronger again?

While the U.S. dollar is likely to weaken over the next few years, currencies are notoriously difficult to predict. For investors hesitating to invest internationally purely because of currency concerns, hedging the currency risk is an option. This cost is basically determined by the difference between short-term interest rates in two countries. When hedging, an investor borrows in a foreign currency and invests in

U.S. dollars. Short-term interest rates in the U.S. are higher than those in Europe, Japan and the U.K. (**Exhibit 8**), so investors can pick up an additional yield of between 1.0%-1.5% by hedging these currencies (minus the extra management and transaction costs). Thus, at the moment U.S. investors are actually getting paid to hedge their developed market currency exposure. What an investor gives up is the potential for the foreign currency to strengthen. The crucial point is that unlike with traveling, a fear of currency fluctuation is not a reason to stay domestic.

Investors are currently being paid to hedge their DM currency exposure

EXHIBIT 8: COST OF CARRY
%, difference between 1-month USD LIBOR and 1-month international LIBOR rates



Source: ICE Benchmark Association, FactSet, J.P. Morgan Asset Management. Data are as of August 23, 2017.

3. Have I missed the flight?

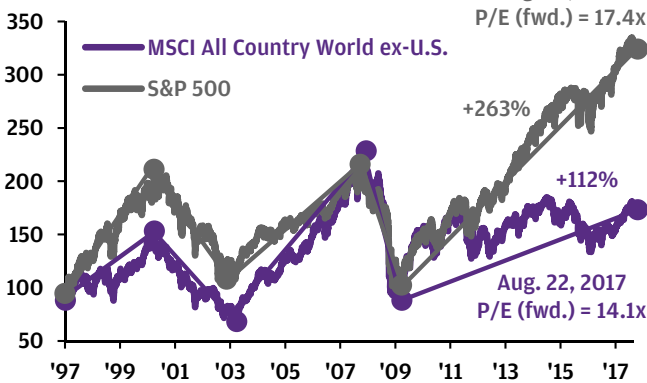
The strong run in international markets over the past year may leave investors wondering if they are too late. We believe we are still in the early stages of international equity outperformance. Comparing U.S. and international equity performance since the Global Financial Crisis, it is clear that the recent move up in international is still only a drop in the bucket (**Exhibit 9**). U.S. equities have returned over 150% percentage points more than their international counterparts during this time, with international not yet having recovered to its pre-crisis peak. Given the improvement in international economic and earnings

growth, international equities should finally escape their sideways trend, just like the U.S. did four years ago.

It is not too late to invest in international equities

EXHIBIT 9: MSCI ALL COUNTRY WORLD EX-U.S. AND S&P 500 INDEX

Dec. 1996 = 100, U.S. dollar, price return



Source: MSCI, Standard & Poor’s, FactSet, J.P. Morgan Asset Management. Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next twelve months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns. Data are as of August 23, 2017.

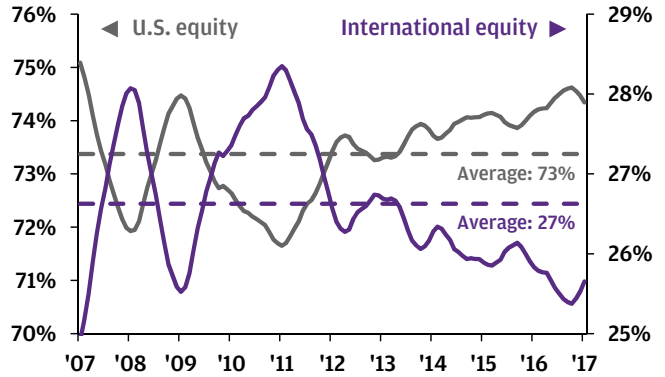
4. But everyone is talking about international now; isn’t it already packed?

Increasingly, positive international developments are receiving the attention they deserve. As a result, investors worry that international equities are already a “consensus trade”. However, U.S. investor equity positioning has barely changed: investor portfolios are still overly concentrated in U.S. equities, at 74% of the total (**Exhibit 10**). While investors may be more aware of the improving international story, they have yet to take action.

U.S. portfolios remain heavily concentrated in U.S. equities

EXHIBIT 10: U.S. INVESTOR EQUITY PORTFOLIO POSITIONING

% weight in equity funds by U.S. investors, 6-month moving average



Source: Strategic Insight Simfund, J.P. Morgan Asset Management. Represents all active and passive open-end mutual funds and exchange traded funds domiciled in the United States. Data are as of August 23, 2017.

Investment implications

While opportunities still exist in U.S. equities, investors should ensure they have enough exposure to international equities. Over the next decade, a meaningful allocation to international will be crucial to improve overall equity returns. Many investors still underestimate the strength of the global economy and overestimate their exposure to international. U.S. portfolios are still overly concentrated in U.S. equities at a moment when international economic and earnings growth is accelerating, valuations are cheaper abroad and the currency may provide a tailwind to returns. The outlook for overseas markets as a whole is looking brighter; however, investors should make sure to prioritize, just like when traveling abroad. Fundamentals suggest that the Eurozone and emerging markets⁴, and specifically cyclical sectors within these regions, look particularly attractive.

⁴For more on the emerging market story please see *Investing in Emerging Markets: Why EM and which EM?*.

<https://am.ipmorganc.com/us/en/assetmanagement/gim/adv/insights/investing-in-emerging-markets>

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