MORNING BRIEFING
May 16, 2017

US Underperforming

See the collection of the individual charts linked below.

(1) Dipping vs. plunging offshore. (2) Go with the flows for now. (3) US fund flows can't explain US underperformance. (4) Global investors must be bullish on global growth, and betting on it with cheaper foreign stocks. (5) Bullish on a world that can deal with gradual Fed tightening. (6) Overseas forward earnings turning up so far this year. (7) Too many eggs in Emerging Markets MSCI basket? (8) The case for actively managing an EM portfolio. (9) Fragile Five are less fragile now.

Global Strategy I: Follow the Money. Joe and I have been advocating a "Stay Home" investment strategy for some time rather than a "Go Global" one. Late last year, we started dipping our toes into offshore waters. With the benefit of hindsight, we should have plunged right in. That's what global investors have been doing over the past year, increasingly so since the start of the year. We would go with the flows for now—the flows of investment funds.

These flows may be increasingly driven by passive investors who are pouring cash into global ETFs. That's not so obvious by looking at flows for US-based ETFs. Over the past 12 months through March, the ones that invest solely in domestic equities attracted a record $230.3 billion, while the ones that invest in equities around the world attracted $64.8 billion (*Fig. 1*). However, there were large outflows out of US-based mutual funds over this period, led by domestic funds with outflows of $163.4 billion compared with a $2.8 billion trickle out of world funds (*Fig. 2*). Altogether through March, US-based mutual funds and ETFs that invest in the US had net inflows of $66.9 billion, while those that invest internationally had net inflows of $62.0 billion (*Fig. 3*).

These flows aren't big enough to explain the outperformance of offshore vs onshore equities. Clearly, investors around the world have concluded that the global economy is likely to continue growing for the foreseeable future without any major risks of a recession. Both world industrial production and the volume of world exports rose to record highs at the beginning of this year, up 3.0% and 2.5% y/y through February (*Fig. 4* and *Fig. 5*).

Apparently, global investors have favored foreign stocks because they are deemed to be cheaper than US ones. Consider the following:

(1) *Major markets.* Joe and I have observed that the forward P/Es of the MSCI stock price indexes for the UK, the EMU, and emerging markets (EMs) have been below the US valuation multiple since the start of the bull market (*Fig. 6*). (Japan has been cheaper since 2014.) It's possible that investors are feeling that at current valuation multiples there is more risk in US equities than foreign ones, and are narrowing the valuation gaps (*Fig. 7*).

(2) *All Country World.* At the start of May, the US forward P/E was 17.8, while the All Country World ex-US was at 14.2 (*Fig. 8*). The ratio of the two was relatively high at 1.25.

(3) *EMU & UK.* At the start of May, the ratio of the forward P/E of the US and the one for the EMU (14.8) was 1.20. That is relatively high, but falling (*Fig. 9*). The ratio with the UK (14.3) is relatively wide

currently at 1.24 ([*Fig. 10*]).

(4) *Japan.* The forward P/E of Japan has often exceeded, and sometimes matched, the one for the US ([*Fig. 11*]). However, since 2014, the US has exceeded Japan (now 13.9), with the ratio of the two currently at 1.28.

(5) *EMs.* The ratio of the forward P/E of the US to the one for the EMs (12.0 now) is currently at 1.48, which is quite high ([*Fig. 12*]).

(6) *Forward earnings.* You may be wondering what sparked the outperformance of the rest of the world over the past year. Obviously, one factor has been the widespread recognition that foreign equities are cheaper than American ones, as we just reviewed. Another important development has been the gradual tightening of US monetary policy, which started in late 2014 without triggering any serious problems for the global economy. Most importantly, forward earnings overseas, which had fallen sharply in late 2014 and throughout 2015, stopped doing so last year and has moved higher so far this year ([*Fig. 13*]).

Global Strategy II: No Contest. Joe and I monitor the relative performance of the US stock market in our daily publication titled *US MSCI Stock Price Index vs Rest of the World.* We see that the ratio of the US MSCI to the All Country World ex-US MSCI peaked at a record on December 27, 2016 in US dollars and on June 16, 2016 in local currency. Now let's drill down to the major equity market indexes abroad, comparing them to the US MSCI stock price index gain of 17.0% y/y and 6.9% ytd:

(1) *Eurozone.* The EMU MSCI stock price index has risen 23.7% y/y in euros and 19.6% in US dollars through Friday's close. It is up 11.5% ytd in euros and 15.4% in US dollars.

(2) *UK.* The UK MSCI stock price index has risen 21.1% y/y in pounds and 8.7% in US dollars through Friday's close. It is up 4.1% ytd in pounds and 8.6% in US dollars.

(3) *Japan.* The Japan MSCI stock price index has risen 18.5% y/y in yen and 13.5% in US dollars through Friday's close. It is up 3.2% ytd in yen and 6.3% in US dollars.

(4) *EMs.* The EM MSCI stock price index has risen 21.7% y/y in local currency and 25.9% in US dollars through Friday's close. It is up 12.2% ytd in local currency and 16.2% in US dollars. The EM MSCI currency index is up 5.5% y/y and 5.4% ytd.

Emerging Markets: Eggs in a Basket. Is now a good or bad time to buy EM stocks? Two *WSJ* headlines offered conflicting answers: "Why Emerging Markets Are Looking Better Than the USA" was the title of a 3/31 article. On 4/17, the other article was titled "This Is a Dangerous Time to Own Emerging Markets." Last week on Monday, at the Sohn conference, DoubleLine Capital's Jeffery Gundlach chimed in, recommending that investors go long on EM exchange-traded funds (ETFs) and short on the S&P 500, reported Bloomberg.

But those might be alternative answers to the wrong question. Sure, US stocks aren't cheap—giving EMs more fundamental appeal at a macro level. Lumping EM opportunities into one basket, however, could be dicey. Cherry-picking among specific countries offers the real opportunity.

As Melissa and I discussed on Wednesday, an analysis from the International Monetary Fund's (IMF) latest *World Economic Outlook* indirectly endorsed actively managing EM investments. The report suggested that countries could "extract" more from growth and minimize downside risk if certain domestic attributes are present—namely, open trade policies, solid legal frameworks, and sound monetary and financial systems. Seeking out those countries for investment and avoiding any that make headlines for political crises or violent uprisings, in our view, seems to be the ticket to maximizing returns and minimizing downside. Consider the following:

(1) *Capital inflows*. According to the International Institute of Finance, EM stocks and bonds realized a net capital inflow of $29.8 billion from foreign investors during March, the highest monthly total since January 2015. Capital pouring into EMs suggests that a search for yield could be "trumping traditional metrics like a country's economic and political outlook," according to the 4/17 *WSJ* article.

(2) *Active wins*. A recent blog post from Columbia Threadneedle's Emerging Perspectives observed: "Although the fourth quarter finished just slightly positive for the EM category as a whole, passive EM ETFs saw inflows totaling +$1.7 billion, while actively managed mutual funds experienced net outflows of almost -$3 billion." Maybe investors have either defaulted to passive EM funds or pulled out of EM assets all together because the group is so diverse and complex.

That's too bad, because those willing to invest actively in EMs could see better performance over the long run. *Pensions & Investments* made the case for actively managing EM investments in a late 2015 article. It highlighted long-term performance data from Mercer Manager Performance Analytics: "The median emerging market active managers have generated, on average, a rolling five-year excess return of more than 200 basis points vs. the MSCI [EM index] in U.S. dollar terms over the 15 years ended Sept. 30, 2014."

A 4/16 *WSJ* article highlighted EM debt opportunities. It pointed out: "[I]n a year when emerging markets are in the spotlight as big winners, underperformance by the ETFs is also raising concerns over whether they are suitable instruments for betting on volatile developing nations." According to data from MorningStar, the average EM bond ETF has returned over a five-year period 1.66% annually, while their active counterparts returned 1.95%. Further, EM ETFs in particular might be prone to tracking errors, discussed an April note in *ETF Trends*.

(3) *Narrow MSCI*. Passive investment in the Emerging Markets MSCI might lead to missed opportunities and unintentionally high exposure to certain countries, sectors, and companies, because the index is somewhat narrow in scope. BRIC represents 47.49% of the MSCI EM index, with this breakdown by country: China (26.98%), India (8.45), Brazil (8.19), and Russia (3.88).

Furthermore, taking a passive approach would mean that investors would have no exposure to EM countries excluded from the index. Investors tracking the index would be limited to the 23 countries represented within it. Compare that to the 69 countries listed in the IMF's table of countries with persistent acceleration episodes (which doesn't even represent all of the countries examined in the *WEO* analysis).

(4) *Small diversity*. A January 2017 *Forbes* article observed that the broader MSCI EM index is heavily concentrated in the top 10 constituent companies, with the top four in the technology sector. The author suggests that one way to increase diversity in EM investments is to track the less concentrated MSCI SmallCap index, with more than double the number of stocks as the broader index. Less than 3% of the SmallCap index is concentrated in the top 10 companies, according to the article, and the sector focus is tilted more toward consumer stocks dependent on domestic demand.

Of course, investing in the EM MSCI SmallCap index technically is still passive investing (despite choosing actively to do so!). Valuations and opportunities vary greatly within the index. For example, EM MSCI Consumer Staples with a forward P/E multiple of 21.4 is priced well above Information Technology stocks at 13.7. (See our *Emerging Markets MSCI Sectors*.) So taking a passive stake in an

EM index is no guarantee of capitalizing on the sectors and companies with the most attractive valuation or conversely avoiding the dogs.

(5) *Buyer beware*. By the way, the 3/31 *WSJ* article warned investors in EMs to be aware of what they're buying. Companies in EMs that do much of their business elsewhere might not be representative of the conditions sought in that economy. For example, one of the largest stocks in India "derives roughly 97% of its revenues from outside its home country." This, therefore, would not be a vehicle for investing in India itself.

(6) *Go Boring!* One strategy for investing in EMs is to "Go Boring" by seeking to invest in countries where political strife and violent outbreaks are relatively less rampant. In retrospect, the EM winner of 2017 so far is a bit of a surprise: Poland, where equities are up 21.4% ytd in local currency and 31.0% in US dollars through Friday's close. *Barron's* wrote on 3/25: "The Central European nation's advance had been helped by projected economic growth of 3.3% this year, following last year's 3.1% gain in gross domestic product."

Poland isn't a country that has made the major financial media news headlines all that often this year. Now that doesn't mean that the country is immune to political crises or drama. But if you google "Mexican politics," for example, you'd get a lot more recent hits discussing greater turbulence. For comparison, the Mexico MSCI has returned 7.2% ytd in local currency and 17.6% in US dollars. In short, we recommend going active and staying as boring as possible when investing in EMs.

(7) *Fragile Five.* When the financial media starts covering a trend, it tends to signal that an opportunity has topped out. Is that the case for EMs? Maybe not. Not all the media coverage on the topic is bullish. Last week, Bloomberg ran an article titled "This Is What Can Kill the Emerging Market Rally." It noted that higher rates, a stronger dollar, weaker commodities, and China's deleveraging could create a less supportive environment for EMs. Despite the apparent risks, we think that EMs offer plenty of opportunities, especially where the valuation is right and domestic attributes are solid or improving.

We aren't alone. In tune with Gundlach's call at Sohn, Pimco and BlackRock are buying "Fragile Five" assets, according to a 5/10 Bloomberg article. In 2013, five EM economies earned the "Fragile Five" distinction as they "struggled to attract foreign capital to finance trade deficits." But now, current account and fiscal deficits in South Africa, Brazil, Turkey, India, and Indonesia have shrunk to "less than half their size four years ago." A Pimco portfolio manager recently said, "They're no longer so fragile." Furthermore, in its *WEO* report, the IMF emphasized that EMs still have plenty of room to catch up to developing nations.

CALENDARS

US. Tues: Headline & Manufacturing Industrial Production 0.4%/0.3%, Capacity Utilization Rate 76.3%, Housing Starts & Building Permits 1.256mu/1.271mu, E-Commerce Retail Sales. **Wed:** MBA Mortgage Applications, EIA Petroleum Status. (Bloomberg estimates)

Global. Tues: European New Car Registrations, Eurozone GDP Flash Estimate 0.5%q/q/1.7%y/y, Italy GDP 0.2%q/q/0.8%y/y, Germany ZEW Economic Sentiment 22, UK Headline & Core CPI 2.6%/2.3% y/y. **Wed:** Eurozone Headline & Core CPI 1.9%/1.2% y/y, UK Employment Change & Unemployment Rate 21k/4.7%, Japan Real GDP (annualized) 1.8%, Japan Industrial Production. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—slipped for the second week during the first week of May, by a total of 1.2%, after rebounding 3.1% the prior four weeks. It's within 1.3% of its record high recorded ten weeks ago. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB retreated by 1.8% the past three weeks after rebounding 5.5% the prior three weeks; it's 2.3% below its record high recorded during the final week of February. Jobless claims edged up for the second week to 243,500 (4-wa) after falling from 254,500 to 242,250 the prior four weeks; it remains close to its recent low of 239,750 in late February—which was the lowest since 1973. The CRB raw industrial spot price index—another BBB component—fell, but appears to be stabilizing in recent sessions. Meanwhile, the WCCI slipped 2.4% after rising four of the prior five weeks by the same amount.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week to record highs for LargeCap and MidCap, but SmallCap dropped for the first time in five weeks. The yearly change in forward earnings is up from six-year lows in early 2016 for all three indexes as y/y comparisons have eased. In the latest week, LargeCap's forward earnings rose to a 64-month high of 10.2% y/y from 10.0%, which compares to a six-year low of -1.8% in October 2015; MidCap's was steady at 11.4%, which compares to April's 31-month high of 11.5% and a six-year low of -1.3% in December 2015; and SmallCap's dropped to a 14-week low of 11.0% from 11.7%, which compares to a 34-month high of 12.8% in mid-March and a six-year low of 0.3% in December 2015. Growth rates now expected for 2017 and 2018 before the impact of tax-rate changes: LargeCap 11.4% and 11.8%, MidCap 10.6% and 13.5%, and SmallCap 8.6% and 20.3%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios were slightly lower for all three indexes last week. Valuations have improved from their more than five-month lows in mid-April, but remain below their multi-year highs in early March. P/Es have melted up since the election, but the "E" still remains low as analysts await legislative changes to the tax rate and its impact on corporate earnings. LargeCap's forward P/E edged down w/w to 17.4 from 17.5 and remains near the 13-year high of 17.8 in early March. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the record high of 25.7 in July 1999. MidCap's forward P/E fell to 18.2 from 18.4, which compares to a 15-year high of 19.2 in late February and the record high of 20.6 in January 2002. MidCap's is up from a three-year low of 15.0 in January 2016. SmallCap's weakened to 19.4 from 19.5, which compares to a 15-year high of 20.5 in early December, when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016 and remains close to SmallCap's record high P/E of 20.9 in April 2002. Looking at their forward price/sales ratios since data became available in 2004, valuations are similarly elevated for the three indexes: LargeCap's P/S of 1.92 and MidCap's 1.27 are close to their recent record highs of 1.94 and 1.37, while SmallCap's 1.02 is down from 1.15 in July 2015 and a record high of 1.17 in November 2013.

US ECONOMIC INDICATORS

Regional M-PMI (*link*): The New York Fed district, the first to report on manufacturing activity for this month, shows activity contracted slightly this month after expanding at its fastest pace since September 2014 in February. The composite index dropped to -1.0 this month, falling steadily from February's 18.7. New orders contracted for the first time in seven months, sliding to -4.4 in May from 7.0 in April and 21.3 in March—which was the best reading since April 2010; the unfilled orders index tumbled 16.1 points this month to -3.7. The delivery time index fell 9.4 points to 6.7, a sign that delivery times continued to increase, though less so than in April. Meanwhile, shipments (to 10.6 from 13.7) continued to expand, though at a slower pace, along with employment (11.9 from 13.9) and hours worked (7.5 from 8.8)—with all three holding near recent highs. Indexes assessing the six-month outlook were close to April's levels, and continued to convey a high degree of optimism about future conditions.

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