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The Return of the Comeback: Is 2015 the Year for International Stocks?

For several years, many professional investors and advisers have been bullish about the prospects for investing outside the United States. Calls to overweight European stocks or global stocks have been typical each January for the past years, and this year is no different.

Famed Nobel Laureate Robert Shiller made some waves recently when he suggested that he might sell his holdings of U.S. stocks and instead buy European equities. The reason? "Europe is so much cheaper."[1]

Well, it is a bit cheaper, with a forward earnings multiple just under 15, versus a forward multiple for the S&P500 that is approaching 17. But European equities were also cheaper two years ago when many strategists and pundits were urging more investments in European stocks relative to U.S. equities. And that call at each point over the past few years has been, bluntly, wrong.

The question is: is this the year that the call is finally right, or should we take some lesson from the past few years and conclude that as tempting as international equities might look, they will once again disappoint?

The pros

The case for emphasizing international equities over the United States has several angles. First is an argument based on valuation, which is what Shiller meant when he called European equities "cheap." He could just as well have included other global markets. The MSCI EAFE index (which includes larger companies in developed markets

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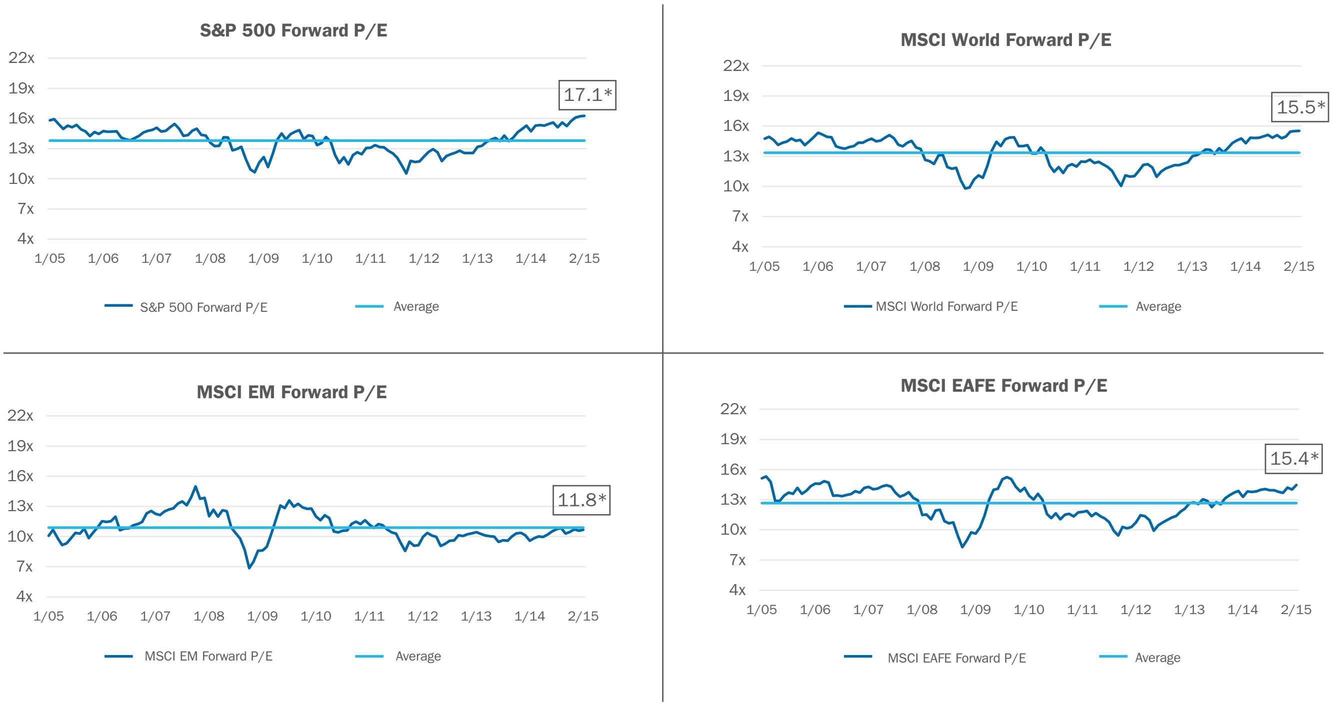
[1] Source: Portia Crowe, "ROBERT SHILLER: I'm thinking about ditching US stocks for European stocks", *Business Insider*, 18 February 2015.

Figure 1:
Valuation Analysis: P/E Multiples have expanded globally



Source: Eaton Vance Monthly Market Monitor, Feb 2015
* Data from FactSet as of 2/20/15

such as Europe, Australasia, and the Far East) is lower than Europe's alone, while emerging market stocks are barely trading at 10 times price-to-earnings (P/E) (Figure 1). These valuation gaps between the S&P500 (which tends to be the proxy for U.S. equities) and the rest really started to open up in 2013; hence one reason for the multi-year tendency of market mavens and strategists to urge investors to overweight international stocks.

Valuation is sometimes treated as some scientific absolute: if stocks trade below their "historic" average, they tend to be viewed as inexpensive, and if they are above, then they are seen as costly. The same idea pertains to relative valuation.

The problem is that valuation doesn't exist in some neat statistical vacuum. People buy and sell whatever they buy and sell based on a whole range of factors, both relative and absolute. Interest rates, housing prices, GDP growth, how a specific company is doing and is expected to do—all of these factors shape decisions, as they should. How stocks behave is less mechanistic than you would think given much of market analysis, and nowhere is that more evident than in valuation discussions.

Another argument that is put forth in favor of international equities is that the future growth prospects are favorable. It is true that the growth prospects of many national economies outside of the U.S. were quite favorable in the past few years, ranging from China to India to Brazil to multiple Asian, Latin American and a smattering of other countries such as Poland (Figure 2).

Figure 2:
GDP Growth: % increase over previous year*

	2013	2014	2015	2016
United States	2.2%	2.4%	3.4%	2.5%
Europe	-0.4%	0.9%	1.4%	1.6%
China	7.7%	7.4%	7.2%	6.8%
Japan	1.6%	0.0%	1.3%	2.0%
India	5.0%	6.0%	6.6%	6.7%
Brazil	2.5%	0.1%	-0.5%	2.0%
Latin America	2.7%	1.4%	1.5%	2.4%

* Source: Economist.com. 2015 and 2016 are forecasted GDP growth.

The argument is somewhat different heading into 2015: now, with growth poised to surpass 3%, the U.S. is looking rather strong compared to many parts of the world that are seeing slowing GDP growth. Some of that global slowing is a direct consequence of the changing nature of China's economic growth, which has been an anchor of many emerging market economies that have either benefitted from its formerly insatiable appetite for raw materials or from its outward investment. Now, with China shifting more toward a domestic consumer-based economic system, raw materials around the world are in high supply and less demand, which has negatively impacted many countries. But those countries are also shifting to greater focus on the domestic consumer, especially in India, Mexico, Indonesia, and Brazil, which have more than 2 billion people amongst them.

The Eurozone is still barely hovering above a recession, but the argument in favor of European stocks is that the cycle is heading towards a modest recovery, with evidence of the same "green shoots" that were prevalent in the U.S. in 2009-2010 as the worst of the financial crisis subsided. Given that equities tend to price in future growth early rather than later, the time to buy is before the cycle has fully turned. Hence why now would be the time to buy the Eurozone.

Finally, there is the relative performance argument: since U.S. stocks have been so strong the past few years while international names have lagged (Figure 3), it is time for a rotation. Even with U.S. economic growth trending up, earnings growth for many public companies appears to be slowing down. Time, therefore, to shift away from American stocks and towards the rest of the world.

...and the cons

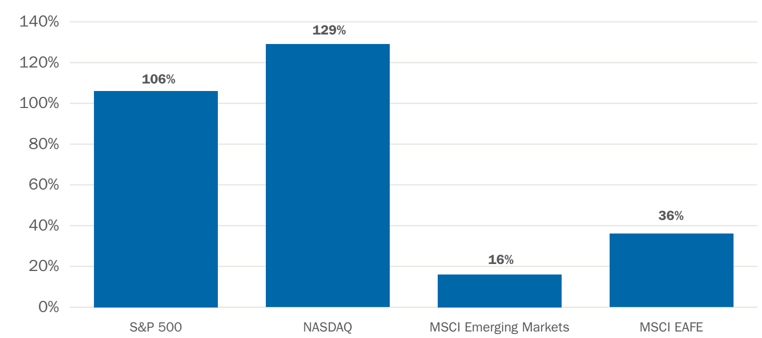
Many pros have made the pro argument. But there is also a contrary argument that even though U.S. stocks have had a great run, it isn't time to emulate Shiller or the market mavens.

The first argument against can be reduced to one word: Greece. Three years after the last tremors of the Greek crisis and the waves of fear that Greece would depart the Eurozone and lead to an unravelling of the unified currency, we are back to the "Grexit" issue again. Now, however, markets and mavens are treating the prospect of a Grexit with equanimity. That may be appropriate, given that the overall size of Greek debt is about $400 billion and much of that is not held on a bank balance sheet. But Greece was never about its absolute size; it was about its symbolic position as the first country to leave the Euro, which could then embolden disenchanted populaces in Spain and Italy to do the same. And no one would deny that a domino effect dissolving the Eurozone or throwing it in to turmoil would have anything but substantially negative effects on equity markets.

It's not that a Grexit is likely, or that its effects are known. It's that a Grexit presents a risk so substantial that if the worst-case comes to pass, you would not want to be long European equities when it happens.

Another con (and we mean that only in the sense of a negative, not in the sense of a scam) is that the macroeconomic fundamentals are weakening in

Figure 3:
Equity markets: 5-year index returns



Source: Bloomberg

Figure 4:
Global markets outperformed U.S. markets in 2015 YTD

	2009	2010	2011	2012	2013	2014	YTD 2015
Higher	Emerging Markets 78.51	Small-Cap 26.85	Growth 2.64	Emerging Markets 18.22	Small-Cap 38.82	S&P 500 13.69	International 5.17
	Mid-Cap 40.48	Mid-Cap 25.48	S&P 500 2.11	Value 17.51	Mid-Cap 34.76	Value 13.45	Growth 4.74
	Growth 37.21	Emerging Markets 18.88	Value 0.39	International 17.32	Growth 33.48	Mid-Cap 13.22	Mid-Cap 3.91
	Global 34.63	Growth 16.71	Mid-Cap -1.55	Mid-Cap 17.28	Value 32.53	Growth 13.05	Global 3.37
	International 31.78	Value 15.51	Small-Cap -4.18	Small-Cap 16.35	S&P 500 32.39	Small-Cap 4.89	Emerging Markets 2.94
	Small-Cap 27.17	S&P 500 15.06	Global -7.35	Global 16.13	Global 22.80	Global 4.16	S&P 500 2.25
	S&P 500 26.46	Global 12.67	International -12.14	S&P 500 16.00	International 22.78	Emerging Markets -2.19	Small-Cap 1.96
Lower	Value 19.69	International 7.75	Emerging Markets -18.42	Growth 15.26	Emerging Markets -2.60	International -4.90	Value 0.46

Source: Morningstar. Data as of 2/20/2015. Small-cap is represented by Russell 2000 index; Emerging Markets is represented by MSCI Emerging Markets Index; Value represented by Russell 1000 Value Index; Mid-Cap represented by Russell Mid-Cap Index; Global represented by MSCI ACWI Index. Growth represented by Russell 1000 Growth Index. International represented by MSCI EAFE Index.

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much of the world outside of the U.S. As mentioned above, some of that represents a positive transition to domestic demand, but the bear case is that the macroeconomic outlook is less rosy globally. While it is a mistake to perfectly equate macro trends and equity trends, the softening of economic growth around the world could present some challenges for global companies.

The final con is that in a global world of commerce and trade, the U.S. and its companies are the best proxies for what is happening internationally. To put it differently, if international opportunities seem better, then U.S. listed companies, especially the S&P500, are the best way to access that theme. About half the earnings of the S&P500 come from outside the U.S., and if you take out healthcare service companies and some consumer staples and utilities, that percentage goes up even more. Hence buying larger and mid-sized U.S. companies is the best way to invest internationally.

If you add in the degree to which the dollar remains the sole viable global currency, the perceived stability of U.S. financial markets, and the effects of a stronger dollar possibly making investments outside the U.S. less effective for dollar-denominated accounts, the case against emphasizing international markets looks stronger.

What to do

The wrongness of the overweight international call for the past years should give all of us pause. But it is also true that past performance is no guarantee of future returns, and that this may indeed be the year that the call is right. The first two months of 2015 have seen substantial outperformance of non-U.S. equities (Figure 4), which is either a proverbial head fake or evidence that the year of international equities is finally here. And if risks such as a Grexit do not unfold, then the turn in the macroeconomic cycle and the shift to domestic demand around the world could be very positive for companies that sell to those markets and for investors who focus on them.

Here as in many things, the best course is to avoid the extremes. If you are going to overweight international, overweight, but not to the extent of selling U.S. and going all in. Themes matter as well: energy names are likely to be pressured regardless of national domicile; retail companies that sell to an emerging middle class are likely to be in strong position, all things beings equal. Valuation arguments that dominate many investing discussions may matter less than fundamentals.

And finally, even with the massive hiccup of the financial crisis, many industries are primarily global and hence the international versus U.S. dichotomy makes little sense. That is certainly true for semiconductors and luxury goods and oil service companies.

The best approach, then, is to start with where one thinks the best opportunities exist. Relative valuations, macroeconomics, political risk—those should be considered, but can also lead one into cul-de-sac after cul-de-sac. What is being bought where, what markets are expanding, and which companies are thriving—those questions will never lead us astray. ■

Advisor Take-Away:

Will 2015 finally be the year for international stocks? Year-to-date performance suggests yes, as do proclamations by renowned market experts. But the case is far from clear or settled. European and emerging stocks may offer bargains galore. But on the flip side, there is the possibility of a "Grexit" and its fallout (whether or not Greece actually withdraws from the Euro) and questionable economic fundamentals. Of course, decisions about investing are not "either/or" and portfolios should never go "all in" one area or theme. What's more, even if you choose to overweight or stay completely in U.S. equities, that still means significant international exposure because many, if not majority, of the mid-sized and larger U.S. companies are already global in nature. Finally, fundamentals may still be the key to identifying the best opportunities rather than relative valuations, macroeconomics, and geopolitical risks.

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