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Portfolio Tactics

Why We Continue to Underweight Non-US Equities

June 26, 2019

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Intro

Since the Great Financial Crisis ("GFC") in 2008, we have maintained little exposure to non-US equities and no direct exposure to emerging markets. Read on for our thinking.

World Equity Markets

The equity world has three parts: the US; International Developed Markets ("IDMs") like the EU and Japan; and Emerging Markets ("EMs") like Brazil, Russia, India, and China – the "BRICs". Many investors or computer-driven asset allocation models divide money between the three based on a rigid formula. Our approach is different. If we don't like a non-US market or aren't confident that it will outperform the S&P 500, we leave it in the dust. This makes us active asset allocators.

Absolute vs. Relative Returns

All investments can be evaluated on both an absolute and a relative basis. The *absolute* component of returns is straightforward – "What percentage gain or loss did an investment return?" The *relative* component asks; "How did an investment perform vs. its foregone alternatives?"

As active managers, we have goals within both these categories. Our primary goal is *positive absolute returns*. However, we try to minimize the amount of volatility that must be endured to achieve this goal – so we're actually seeking favorable *relative risk-adjusted returns*.

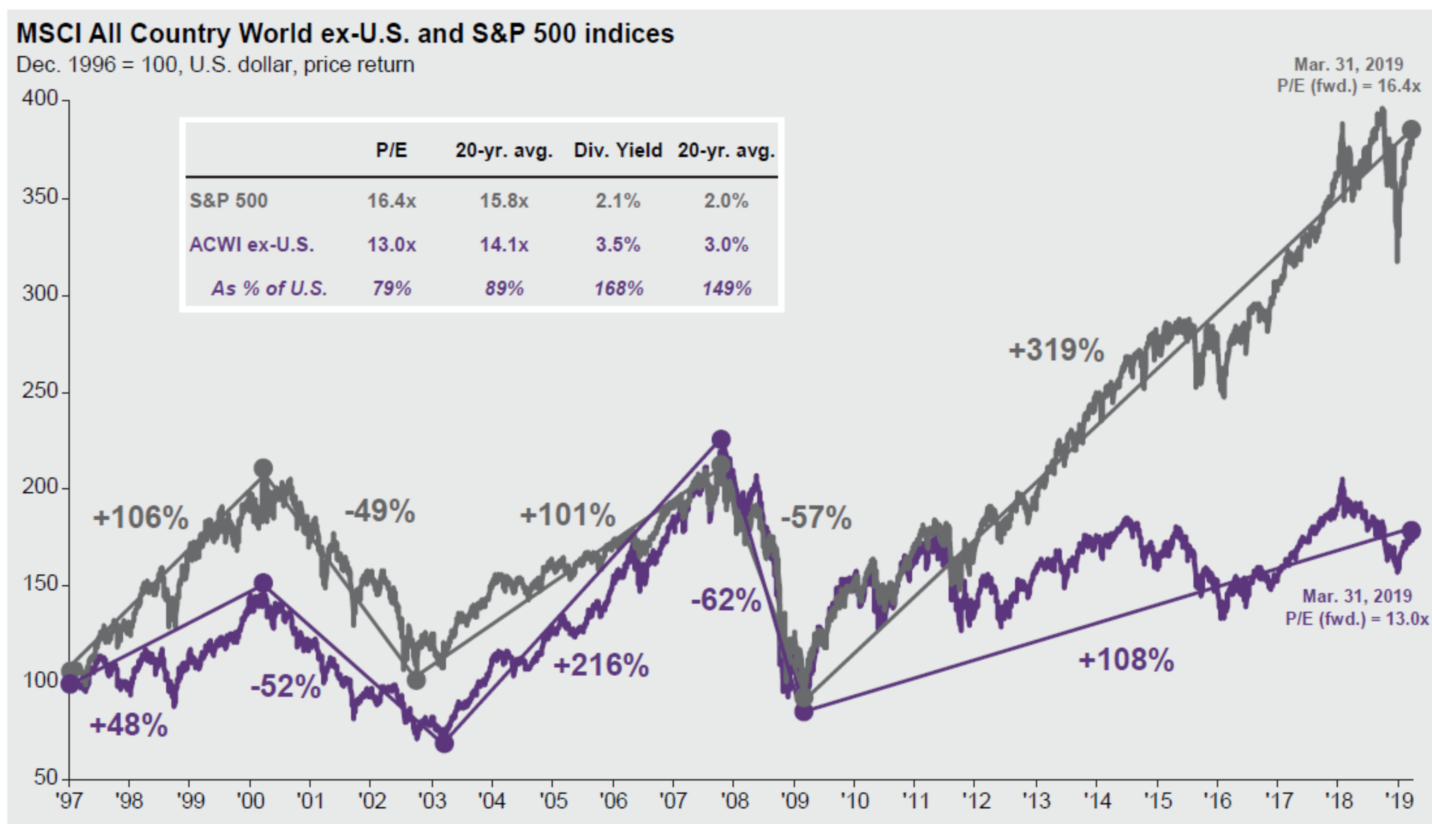
We do this by avoiding markets that don't present attractive near-term return possibilities compared to the volatility they're likely to experience. We examine each market's fundamentals, evaluate economic data, and tally strengths and weaknesses. In the case of non-US equities, higher opportunities are required due to the foreign currency exposure.

Our ultimate goal is to shun traditional asset allocation models and avoid markets that appear likely to underperform – to maximize relative returns within this constraint.

The Results

As we can see from this graph, US equities have dramatically outperformed since the GFC.

MSCI ACWI (All World ex-US) vs. S&P 500 Cumulative Price Returns



Source: JP Morgan Guide to the Markets, Q2 2019

US vs. International Developed Markets

Europe and Japan never recovered from the GFC. The reason is a combination of hobbled banking systems, pre-existing structural headwinds, and over-extreme attempts at market manipulation.

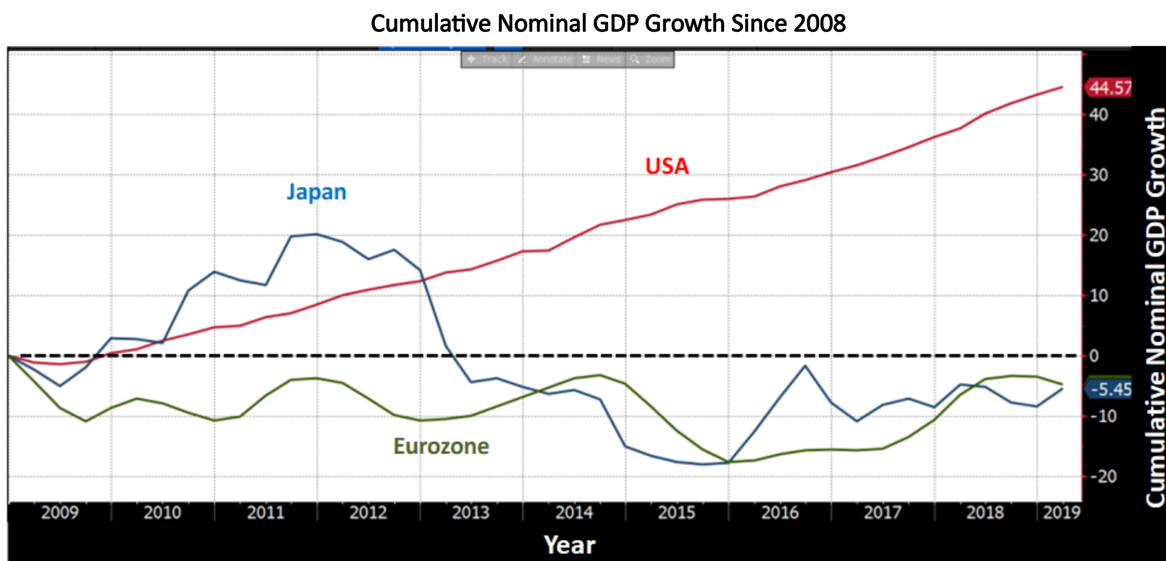
- **Bad Banks.** The GFC hit all economies hard, but the American response was uniquely comprehensive and effective. The US quickly enacted coordinated monetary and fiscal stimulus (including 2009's American Recovery and Reinvestment Act and Troubled Asset Relief Program, or "TARP") that injected trillions of dollars into its economy. The US also structurally reformed its banking system, providing lenders with a "clean slate" to reestablish healthy loan books. The result? The US is enjoying its second-longest-lasting economic expansion on record, while major banks' balance sheets are stronger and better capitalized than pre-2008.

  The story in Europe is bleaker. The EU suffers from a structural coordination problem. The US has 1 fiscal and 1 monetary policy; the Eurozone has 1 monetary policy and 19 separate and un-coordinated national fiscal policies. The European banking system never benefitted from a US-style synchronized rescue effort and as a result remains weighed down with non-performing loans. This has acted as an anchor on the region's economic growth. Recovery has been slow, and many economies (Italy, for instance) have never made it back to their pre-crisis GDP levels.

Japan has fared even worse. It's fair to say the Japanese economy never fully recovered from the bursting of its equity and real-estate bubbles in 1989. The negative effects of 1989 were enhanced by structural headwinds, including a rapidly ageing population and no net immigration. Despite the Japanese central bank's frequent and aggressive attempts at monetary stimulus, Japan's GDP has remained stagnant since the mid-1990s.

The chart sums it up. Since the GFC, the US economy has grown 44%, while the EU and Japan didn't even make it back to the starting line.

Cumulative Nominal GDP Growth Since 2008



Source: Bloomberg

- **Have You Ever Heard of a Negative Interest Rate?** Negative rates are a modern experiment in "emergency" stimulus. In theory they are temporary, an extreme intervention to force investors into riskier ventures, spurring economic growth and inflation.

  In practice, while they may have changed behavior, they haven't delivered growth. Today, over a decade since the crisis, many IDM government bond yields are at or below zero. The Bank of Japan ("BOJ") and European Central Bank ("ECB") maintain headline policy rates below zero. Both the BOJ and ECB have gone well beyond the initial stage of quantitative easing and also own a significant proportion of their investment-grade corporate bond markets. The BOJ is even the largest owner of Japanese equity ETFs.

Developed Economy Sovereign Bond Yields

Green = Positive Yields, Red = Negative Yields

Country	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year
Belgium	-0.54%	-0.52%	-0.44%	-0.14%	0.07%	0.45%
Denmark	-	-0.60%	-0.44%	-0.39%	-	0.09%
Finland	-0.54%	-0.52%	-0.46%	-0.29%	-0.14%	0.33%
France	-0.55%	-0.55%	-0.46%	-0.25%	-0.01%	0.36%
Germany	-0.57%	-0.59%	-0.57%	-0.42%	-0.30%	0.00%
Italy	0.11%	0.53%	1.14%	1.51%	1.97%	2.59%
Japan	-0.16%	-0.16%	-0.17%	-0.17%	-0.17%	-0.05%
Netherlands	-0.57%	-0.58%	-0.59%	-0.41%	-0.14%	0.18%
Spain	-	-0.34%	-0.21%	0.16%	0.51%	1.01%
Sweden	-	-0.58%	-	-0.32%	-0.14%	0.14%
Switzerland	-0.74%	-0.76%	-0.73%	-0.64%	-0.51%	-0.31%
United Kingdom	0.74%	0.74%	0.73%	0.82%	0.96%	1.15%
United States	2.40%	2.29%	2.27%	2.31%	2.42%	2.53%

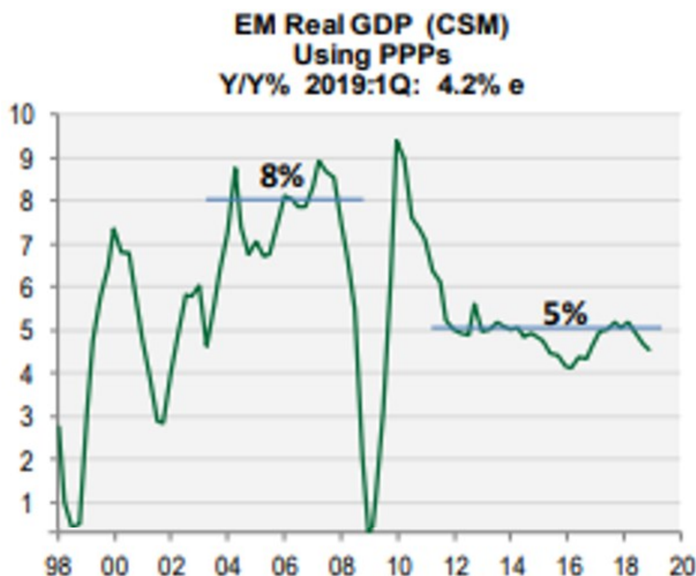
Source: FactSet and Treasury Partners as of 5/31/19

US vs. Emerging Markets ("EMs")

The EM's have their own "Big Three" problems. These are: structurally lower growth, vulnerability to US dollar shifts, and rising correlations.

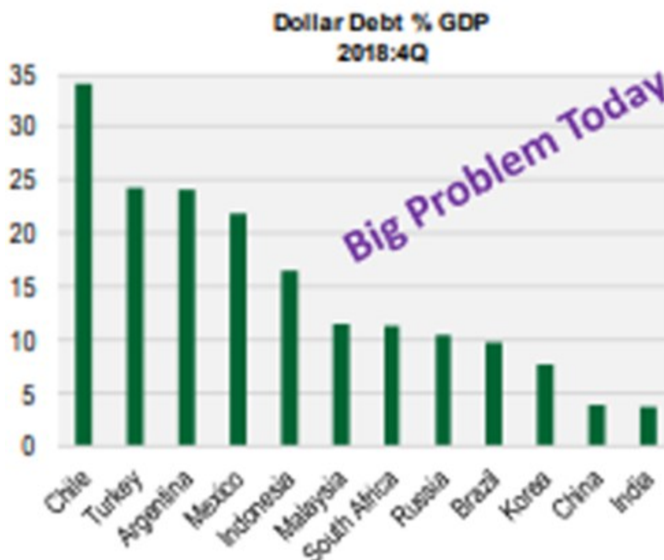
- **Structurally Lower Growth.** In the past, EMs offered higher average growth in return for higher volatility. A healthy risk premium compensated for risks including exchange rate fluctuations, challenging rule of law, uncertain property rights, and the potential for expropriation.

  However, post-GFC, EM growth rates have dropped. By Cornerstone Macro's calculations, aggregate real EM GDP growth has settled around 5% annualized, down from the pre-crisis average of 7-8%. While 5% is still relatively high, it's not high enough to offset the risks.



Source: Cornerstone Macro

- **Dollar Dependency.** As of 2018, GaveKal calculates over 60% of global trade was denominated in USD. And many EM countries have a significant amount of their debt denominated in USD as opposed to their own currencies.



Source: Cornerstone Macro

For EMs, their ability to keep trade flowing and service their debt depends on continued access to dollars, access which is impacted by the overall supply of USD in the global economy. That supply is provided by the Federal Reserve, which has a solely domestic legal mandate. As Treasury Secretary John Connally told European finance ministers in 1971, the "dollar is our currency and your problem."

Fed rate hikes reduce the global supply of dollars, putting pressure on EMs. The pressure builds until a weak link breaks, leading to currency devaluations and debt defaults. In our view EMs are more dependent on USD access now than they were before 2008.

The risk here is elevated and we will continue to avoid these markets.

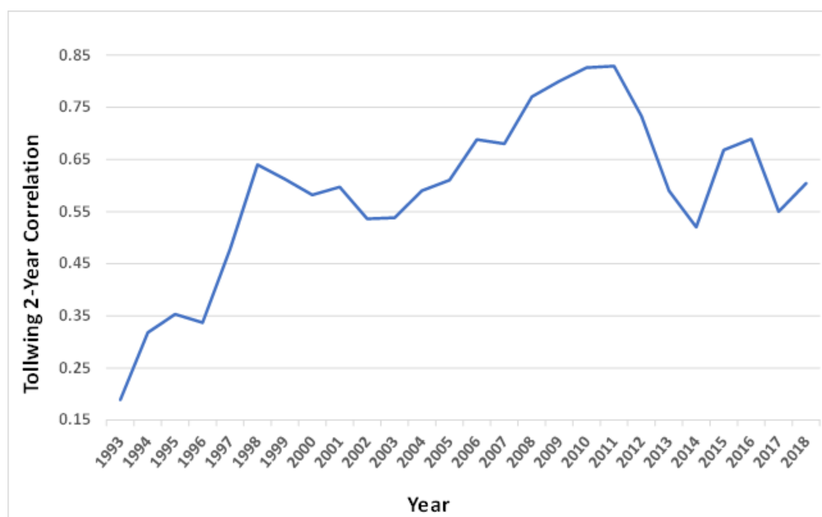
- **Higher Correlations with Developed Markets.** "Correlation" is the term used to describe how one investment's price moves relative to another. For example, if index A falls by 1% in a week while index B falls 0.95%, they have high **positive** correlation: they moved in the same direction by almost the same amount. If, by contrast, index B had *risen* by 0.95% when A fell, it would have high **negative** correlation. Alternatively, if index A falls by 1% while B remains approximately flat, they are **uncorrelated.** Correlations can be calculated and assigned rating numbers ranging from -1 (exactly negatively correlated) to 0 (completely uncorrelated) to +1 (exactly positively correlated).

  A well-diversified portfolio should contain assets that are relatively uncorrelated (i.e. closer to 0 than either -1 or +1). After all, if your assets are all correlated and move together, why bother diversifying? But if assets are uncorrelated, gains in one investment may offset losses in another.

  In the past, EM equities were uncorrelated with developed markets. This is no longer the case. The below chart shows the trailing 2-year correlation between EM equities and the S&P 500 over the past 25 years. The trend is clear: correlation has increased, to the point where the post-crisis average fluctuates around 0.6-0.65. This is a fairly high positive correlation which implies EM equities move roughly in tandem with the S&P 500 60-65% of the time. And note the spike in correlations around the time of the 2008 crisis-- this supposedly diversifying asset class followed US equities down 75-80% of the time during the calamity, when uncorrelated returns were most needed.

S&P 500 and iShares MSCI Emerging Market ETF

Rolling 2 Year Correlations



Source: FactSet and Treasury Partners

Market Results

Since the GFC we've underweighted IDM equities and maintained no direct exposure to EM equities. This was the right decision. The S&P 500 has outperformed global sectors for the last 1, 2 and 5 years.

	Trailing 1 Year Returns (5/31/18 - 5/31/19)		Trailing 3 Year Returns (5/31/16 - 5/31/19)		Trailing 5 Year Returns (5/31/14 - 5/31/19)		2019 YTD Through 5/31/19
Name	Cumulative Total Returns	Annualized Total Returns	Cumulative Total Returns	Annualized Total Returns	Cumulative Total Returns	Annualized Total Returns	Total Returns
United States *SPDR S&P 500 ETF Trust*	3.1%	3.1%	39.1%	11.6%	58.0%	9.6%	10.8%
Japan *Nikkei 225*	-6.4%	-6.4%	22.4%	6.9%	40.8%	7.1%	2.9%
Eurozone Large Caps *STOXX Europe 600*	-4.3%	-4.3%	5.6%	1.8%	7.2%	1.4%	9.3%
Emerging Markets *iShares MSCI Emerging Markets ETF*	-8.8%	-8.8%	31.0%	9.4%	6.5%	1.3%	4.4%
Non-US Developed Markets Combined *iShares MSCI EAFE ETF*	-6.4%	-6.4%	18.0%	5.7%	5.8%	1.1%	7.8%
Eurozone *iShares MSCI Eurozone ETF*	-8.9%	-8.9%	17.1%	5.4%	-1.0%	-0.2%	8.0%

Source: FactSet and Treasury Partners, return data through 5/31/19

Outside the US, in most cases cumulative gains don't even reach double digits. Diversifying more of our clients' equity exposures to these markets would have depressed returns.

Looking Forward

Investing is a forward-looking business. While we've benefitted from this tactical allocation for the past five years, what's important is what comes next.

The basic situation in the Eurozone, Japan, and the EMs has not changed.

- Europe and Japan remain stuck in a low-growth equilibrium despite the ECB's and BOJ's best efforts. These economies are already saddled with negative policy rates while heading into a slowdown.
- Europe and Japan continue to suffer from a long-running demographic crisis. Both regions are ageing rapidly and have low net immigration rates. This leads to stagnant labor pools, reducing productivity and increasing the burden of funding pensions.
- In Europe's case, the problem of 1 monetary policy and 19 separate fiscal policies challenges the benefits of the Eurozone's integration. The system is rigid and subject to multiple stresses.
- The Fed tightening cycle hasn't yet tipped EM economies into a dollar shortage, but that doesn't mean it won't. These dislocations can happen suddenly; we're continuing to monitor those EM economies with the highest proportion of USD-denominated debt.
- The US-China trade war will prove costly to EM economies. Cornerstone Macro calculated that approximately 20% of Chinese exports to the US have their value added outside of China's borders – primarily in East Asian countries including Taiwan, Malaysia, Thailand, and South Korea. In the long run they may benefit as investment shifts outside China, but for now they're integrated into the Chinese supply chain. Falling Chinese exports will reverberate.

Compare this to the story in the US:

- Growth that may be slowing but is still solid.
- Strong corporate earnings and profit margins.
- Rising capital expenditures.
- Record low unemployment.

The American economy remains strong. Until sentiment and data deteriorate and begin signaling recession, we believe US equities will continue to outperform the competition.

Disclosure

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