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Economic Review & Outlook

FIRST QUARTER | 2020

Does a Global Approach to Investing Still Make Sense?

With the U.S. having one of the most robust and diverse economies in the world, strong freedoms and property rights, as well as the dominant run of the U.S. stock market compared to the rest of the world since the global financial crisis, where do international investments continue to fit in? Is investing overseas in potentially less stable markets too risky?

In this quarter's Economic Review & Outlook, we will examine whether recent U.S. outperformance is likely to continue or reverse in the future and evaluate the investment merits of international and emerging economies from a risk and opportunity standpoint. We will then give our outlook for global equities, the role they play in a diversified portfolio, and how to "right size" your asset mix based on your specific goals.

First, we will outline the major economic events and markets returns for both the fourth quarter and 2019 as a whole.

Economic Review

TENSIONS WITH CHINA CONTINUE

No topic has moved the market more over the past year than the China trade war. Positive developments have usually been followed by threats and further tariffs. As we have outlined in previous editions, the situation is further complicated by issues deeper than trade – such as intellectual property theft and the Hong Kong independence protests – that have the potential to play an even larger role in future discussions.

In December, it was reported that the U.S. and China had reached a "phase one" deal in which the U.S. agreed to reduce tariffs in exchange for China's commitment to purchase more American agricultural products. While this deal would mark a new level of progress, several obstacles remain before a more comprehensive deal can be reached. Many have speculated that a deal will almost certainly be reached before this year's presidential election; however, recent comments from President Trump hint that this could drag on beyond 2020.

SLOW BUT STEADY ECONOMIC GROWTH

Recession fears have been fueled by concerns of more restrictive trade policies and that the current U.S. economic expansion is the longest in history. Indeed, business activity has slowed, consumer confidence appears weak, and some market indicators show signs of a further slowdown. However, as seen in the graphic below, many indicators (especially around employment) remain quite strong. Macro data, such as GDP and inflation levels, point to an economy that is growing slowly, but still within a normal range.

Looking ahead, we expect recession fears to remain strong, especially leading up to the election. Although a breakdown in trade negotiations, political unrest, or something unexpected could lead to a further slowdown, it's important to remember that nothing is certain. We could even see a jump in growth if some of these issues are resolved.

FED PUMPS BRAKES ON RATES

Since late 2015, the Fed has been steadily raising rates from zero with the goal of eventually getting back to more normal levels. However, trade, lower global interest rates, and growth concerns put pressure on the Fed's plan. In late 2018, Fed Chairman Powell signaled that they were likely finished raising rates for the time being. In fact, in 2019 the Fed actually cut rates three times, the last setting their target rate to 1.5-1.75%.

While Powell has suggested a willingness to step in if economic or market conditions deteriorate, "lower for longer" seems to be the consensus expectation for rates; we do caution that market interest rate projections have been notoriously unreliable in recent history.

SURVEYING THE ECONOMIC LANDSCAPE

Source: FactSet. All data series begin 12/31/99. Colors are based on the percentile rank of each data point's latest release (as of 1/2/20). Consumer Confidence: 12-month change in Conference Board's Consumer Confidence Index. Retail Sales: Year-over-year % change in retail sales, ex-auto. Housing: Year-over-year % change in 12-month average of housing starts. Wages: Year-over-year % change in AHE (production & nonsupervisory). Unemployment: U-3 unemployment rate. Manufacturing Sector: ISM Manufacturing PMI. Services Sector: ISM Non-Manufacturing Index. Corporate Earnings: S&P 500 NTM EPS/LTM EPS. Yield Curve: Treasury spread (10y-1y). Credit Spread: BBB credit spread. Financial Conditions Index: Chicago Fed's Adjusted NFCI. Economic Growth: Real GDP (q/q, SAAR). Inflation: Headline CPI (y/y)

Asset Class Performance

Q1	Q2	Q3	Q4	2019
Commodities 13.8%	Gold 9.0%	Gold 3.8%	Emerging Markets Stocks 11.9%	U.S. Stocks 31.5%
U.S. Stocks 13.6%	U.S. Stocks 4.3%	Diversified Bonds 2.3%	U.S. Stocks 9.1%	Int'l Developed Stocks 22.7%
Int'l Developed Stocks 10.1%	Int'l Developed Stocks 4.0%	U.S. Stocks 1.7%	Commodities 8.5%	Emerging Markets Stocks 18.9%
Emerging Markets Stocks 10.0%	Diversified Bonds 3.1%	Int'l Developed Stocks -1.0%	Int'l Developed Stocks 8.2%	Commodities 18.9%
Diversified Bonds 2.9%	Emerging Markets Stocks 0.7%	Commodities -3.3%	Gold 3.3%	Gold 18.0%
Gold 0.9%	Commodities -0.4%	Emerging Markets Stocks -4.1%	Diversified Bonds 0.2%	Diversified Bonds 8.7%

Source: FactSet. Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

The fourth quarter was one of increased optimism around trade, leading to a bounce back from the third quarter in riskier assets. All equities were positive; emerging markets led the way, gaining 11.9%. Defensive assets, like gold (+3.3%) and bonds (+0.2%) were more muted, despite having a strong year overall. For the year, U.S. stocks led all asset classes, gaining 31.5%; international developed (+22.7%) and emerging market (+18.9%) equities also had a strong 2019.

Looking back at the past two years, it's striking that while the economic themes were very similar (trade, slowing economic growth, and rate policy), the market's reactions to them were quite different. 2018 returns were negative almost across the board, but 2019 results were universally strong. As we look towards the rest of the year, we anticipate we will still be talking about some of these issues, as well as an election, but we can't predict how the market will interpret these developments.

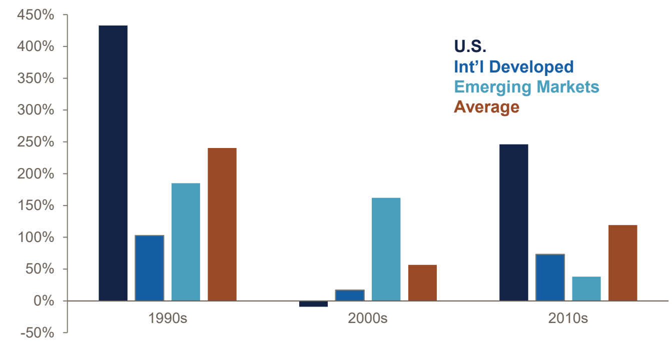
Our Perspective

A DECADE OF U.S. OUTPERFORMANCE

In many ways, last year was a microcosm of the past decade. Absolute returns have been phenomenal; major equity markets finished the year up strongly; and bond returns have been solid. U.S. stocks have dominated the rest of the world for the better part of the current bull market, which began in early 2009. Despite these companies becoming more expensive over the years compared to their earnings, the trend did not reverse; it got stronger. In 2019 alone, the S&P 500 gained over 30%, while international and emerging markets equities were "only" up around 20%.

At first glance, there are many compelling reasons to continue to favor U.S. stocks. We are the global leader in innovation, have the largest and arguably freest financial market, and the U.S. dollar remains the world's reserve currency. It would be easy to pair these facts with recent performance and conclude that America has "stacked the deck" against the rest of the world. However, although these characteristics are nothing new, market outcomes have not always been the same:

STOCK MARKET CUMULATIVE PERFORMANCE BY DECADE



Source: FactSet.

As you can see, large divergences between equity regions are normal. In many ways, the 2010s most resemble the 1990s where the rise of the U.S. technology sector, and a few economic crises overseas, led to an even wider gap between the markets than we see today. But as the tech bubble popped and valuations came back to earth, we saw a decade of negative U.S. performance which came to be known as the "lost decade." However, it wasn't a lost decade for a diversified investor as international markets fared much better.

What we are seeing in today's market is nothing new. A global stock investor is likely to experience more consistent outcomes over time. However, they will also observe long periods of U.S. dominance along the way. This can be difficult, but it's important to remember that prior long-term returns have been a poor indicator of the future.

IS NOW A GOOD TIME TO INVEST INTERNATIONALLY?

As we observe the historical benefits to diversifying overseas, it may be tempting to look at the current landscape and wonder if it still makes sense today. After all, with the trade war with China and elevated political unrest, the U.S. has proven to be a relative haven of late. It may seem reasonable at first glance to stick to U.S. investments until these situations improve, but there are a few issues.

One, with greater uncertainty often comes greater opportunity. While emerging markets might be more exposed to downside volatility if trade negotiations deteriorate, they also stand to gain more if things improve. Two, it's hard to predict how markets will respond to outcomes. For example, Trump winning the election in 2016 was viewed as a risk. Despite widespread belief that his victory would lead to a selloff, stocks rallied once the market opened the next day. Finally, uncertainty is a constant, as you would be hard pressed to find any period where there wasn't something that could go wrong.

It is true that many foreign markets pose a greater potential for volatility; however, we do not see the current environment as any riskier than normal. Many of these emerging economies are more resilient now than ever, with a growing middle class and more sound financial institutions. Compared to the U.S. right now, they also carry more attractive valuations, faster economic growth, and allow for broader diversification. We believe now is as good a time as ever to own international stocks, as long as you are comfortable with returns that may potentially stray from U.S. markets.

WOULD I BE FUNDING "BAD ACTORS" BY INVESTING IN LESS DEVELOPED ECONOMIES?

Some investors are concerned that if they buy stock in a country with a poor human rights record that is currently at odds with the U.S., they're implicitly supporting that government and its practices. China is a great example of this, as they are at odds with the U.S. on a number of issues, including trade, intellectual property rights, and various human rights metrics. It's no surprise that some investors are hesitant to invest in China or similar nations.

Although "values-based investing" seems great on the surface, its implementation can be complicated and the answer is not so straightforward. First, it's an inherently subjective process as we don't all have the same standards on what is ultimately acceptable. Realistically, you could make a compelling case against just about any country or company, depending on your criteria. Second, since buying stocks almost always occurs on the secondary market (buying from another investor), the decision to not buy a particular stock doesn't have a direct impact on these companies and countries. The most direct way to influence them would be to stop buying their products. Finally, shutting them out could be counterproductive. Many nations have improved their economic freedom scores over time through partnering with foreign investors who seek to educate and help them become more integrated with the global economy.

While we believe that the exposure to potentially higher economic growth, better valuations, and broader diversification makes it a wise decision for most equity investors to invest in less developed countries, we acknowledge that the decision is a personal one. Therefore, our primary focus is to build portfolios to help clients reach their financial goals and work with clients who have convictions against owning a certain company, industry, or country.

Our Investment Strategy

Our current long-term outlook for international equities is strong as we see both greater growth potential and more attractive valuations, especially in emerging markets. We believe some international exposure is prudent for most equity investors, but the amount of exposure should vary based on the investor's investment horizon, comfort with volatility, and definition of success. An investor not concerned with tracking closely with U.S. markets may be able to handle a larger international allocation than one who is highly concerned with outperforming a benchmark like the S&P 500. Likewise, we believe that it is important to also maximize diversification within one's international bucket. Common international indexes tend to be concentrated towards countries with the largest markets. Most of our strategies seek a more balanced allocation as a way to limit our exposure to any one country, giving us a more diverse international exposure and allowing us to lean into more attractive markets instead of defaulting into the largest (and often most expensive) ones.

The cost to leaning further into international stocks or increasing country diversification can include more short-term volatility and periods of underperformance when common benchmarks are in favor. Therefore, we do not believe it is appropriate for everyone, and the best portfolio for an individual is one that they can stick with over time.

Conclusion

The U.S. has dominated foreign markets during the past decade. Credit for this has been largely attributed to our healthy, innovative, and diverse economy. However, these advantages have been in play for decades with varying results. In fact, markets tend to cycle in and out of favor, and it is very difficult to know who will come out on top in the future. Because of this, we believe that the way to build a robust portfolio is to pay attention to valuations, always be diversified, and take a long-term approach. These things point to the merits of including international equities, despite concerns about recent performance, market risk, and social and political concerns. We cannot guarantee outcomes, but we believe this approach will better align your investments with your financial plan and help you reach your long-term investment goals.

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call us at **800.841.0362**, or visit our website at **www.ronblue.com**.