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Economic Review & Outlook

FOURTH QUARTER | 2021

Buy American?

Over the last 10 years, equity markets faced down many challenges and obstacles: Wars, unprecedented central bank activity, massive regulatory and tax changes, and now a pandemic that won't seem to go away. Every time, the market won, posting strong results despite some short-term blips. The biggest winner of all has been U.S. stocks. The S&P 500's 16.6% annualized return over the decade dwarfs both international developed markets (8.6%) and emerging markets (6.5%). The U.S. continues to boast the biggest, most diversified economy in the world. Ours is the global reserve currency, and we continue to be a leader in both innovation and economic freedom.

Today, China is our biggest global competitor. However, as China recently plunged into a bear market, surrounded by concerns about bubbles, human rights, and a government crackdown that shaved billions from the world's portfolio, it's tempting to ask: Is there any reason to invest in foreign markets at all?

Here, we'll answer that question by looking at the dominance of U.S. stocks, the issues facing the rest of the world, and whether investors should fill their portfolios with U.S. investments. There's no one-size-fits-all answer to any investing question, of course, but we will share our perspective and thoughts on the risks and opportunities to come.

Economic Overview

AFGHANISTAN WITHDRAWAL

The United States' 20-year war in Afghanistan came to an end in August 2021, as the Taliban seized power and the president fled the country, followed by a hasty airlift evacuation of over 6,000 Americans and more than 100,000 others. The war, which began shortly after the 9/11 attacks on the U.S., cost more than $2 trillion and 170,000 lives, leaving behind a refugee crisis. The geopolitical fallout will reverberate across the world for a long time. Almost immediately, China and Russia spun the narrative as something of a victory over the West as well as a U.S. in decline. However, as neighbors to the troubled state, they will undoubtedly be forced to help manage a destabilized Afghanistan. In terms of U.S. foreign policy, the withdrawal signals a pivot away from military engagements and nation-building toward a new focus on competing with China, restraining Russia, limiting cyber threats and global terrorism, and protecting American interests through diplomacy and sanctions, backed by our military strength.

INFLATION REMAINS HIGH

Back in May, inflation reared its head for the first time in a while, launching an ongoing debate as to whether the recent spike is temporary (driven by economic reopening) or a more persistent threat. Inflation numbers cooled a bit in August, with the consumer price index (CPI) rising 0.3%, or one-third of the pace of June's 13-year high. Over the last 12 months, the CPI rose a total of 5.3%, which was slightly lower than the 12-month rise ending of June and July. Core inflation followed a similar path. Price increases for some of the reopening inflation drivers (i.e., used cars and travel) eased, but others (i.e., gasoline and groceries) continued to accelerate. The rapid economic recovery, rising demand from consumers, ongoing semiconductor shortages, and trillions of dollars in government stimulus remain the drivers of inflation, which weighs on purchasing power. So far, the Federal Reserve characterizes the surge as transitory, but they—and investors everywhere—are keeping a close eye on the situation.

THE INFRASTRUCTURE DEBATE CONTINUES

The battle to pass more than $4 trillion in new federal spending raged on through September. The $1 trillion bipartisan infrastructure bill, which would invest in transportation as well as broadband and utility infrastructure, was passed by the Senate in August. The bill also required approval by the House of Representatives, which approved a $3.5 trillion budget resolution in August. Still taking shape, the bill would likely increase taxes on the wealthy and corporations, expand childcare and paid leave, invest in green energy, and offer universal pre-K and free community college. However, working out the details and satisfying the ideological wings of the Democratic party, with centrists wanting to limit spending and progressives aiming for maximum impact in order to back the smaller bill, has proven to be a challenge.

Asset Class Performance

Equity returns were mixed in the third quarter, as investors balanced strong corporate earnings, the global reopening, and economic recovery against concerns surrounding the spread of the coronavirus delta variant and its potential to slow the recovery. Commodity prices (+6.6%) had another strong quarter after outperforming other major assets in the first half of the year, while gold was down 1%. International stocks declined, particularly emerging markets, which lost 8%, weighed down by China's regulatory crackdowns and concerns over property developer Evergrande's mounting debt burden. Bonds (-1.6%) also experienced declines as yields rose during the period.

The dispersion of returns between stock markets has grown, with U.S. equities outpacing emerging markets by nearly 17% year-to-date. The continuing economic recovery has caused commodities to lead all asset classes and gold to sputter. Overall, bond returns remain negative amid the prospect of the Fed potentially raising rates and slowing bond purchases in the near future; however, certain sectors, like high yield and TIPS, have posted gains through the last three quarters.

Q1	Q2	Q3	YTD
Commodities 6.9%	Commodities 13.3%	Commodities 6.6%	Commodities 29.1%
U.S. Stocks 6.2%	U.S. Stocks 8.5%	U.S. Stocks 0.6%	U.S. Stocks 15.9%
Int'l Developed Stocks 3.6%	Int'l Developed Stocks 5.4%	Diversified Bonds 0.1%	Int'l Developed Stocks 8.8%
Emerging Markets Stocks 2.3%	Emerging Market Stocks 5.1%	Int'l Developed Stocks -0.4%	Emerging Markets Stocks -1.0%
Diversified Bonds -3.4%	Gold 3.2%	Gold -1.0%	Diversified Bonds -1.6%
Gold -9.8%	Diversified Bonds 1.8%	Emerging Markets Stocks -8.0%	Gold -7.9%

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.

Our Perspective

HISTORY SAYS OUTPERFORMANCE IS CYCLICAL

Conventional wisdom suggests that emerging markets should outperform international developed markets, which in turn should outperform the U.S. because of perceived risk. However, recent data tells a different story as the U.S. market has outperformed international developed stocks by over 7% and emerging market stocks by nearly 17% so far this year. Including 2021, U.S. stocks have surpassed international stocks in eight of the last nine calendar years. Altogether, the S&P 500 index has outperformed the MSCI All Country World Index Ex-U.S. (ACWX) by 8.7% annualized over the past 10 years. Is this significant underperformance proof that the theory of international diversification is dead, or does it present a buying opportunity? In this section, we will weigh the evidence and give our perspective on the outlook for international markets based on the current environment and what tends to drive future returns.

LEGITIMATE CONCERNS

One reason U.S. stocks have outperformed is that there are things going on in much of the rest of the world that make investors worry—and rightfully so.

Europe's lagging recovery.
Early in the pandemic, European countries experienced some of the world's highest infection rates, prompting pandemic-induced restrictions that weighed on economic growth. The continent's vaccination campaigns were slower, and its stimulus efforts were weaker than the U.S., extending the restrictions that limit consumer spending and economic growth. Europe's gross domestic product (GDP) data, along with such measures as industrial activity, have lagged, throwing the region into a double-dip recession in early 2021 (its worst downturn since World War II). Second-quarter data showed that Europe exited that recession. However, while the U.S. returned to its pre-pandemic level of output, Europe is not expected to reach that point before the end of 2021. Obstacles to recovery remain in place, including concerns that governments are scaling back stimulus and aid programs too soon.

Some countries lack the ability to fight the pandemic.
Every month, Bloomberg publishes COVID resilience rankings, measuring reopening progress, infection and death rates, and quality of life measures, such as community mobility and health care coverage. Month-after-month, the bottom of the list is filled with developing markets, from Malaysia and the Philippines, to Argentina and South Africa. Latin America, with just 8% of the world's population, recently accounted for approximately one-third of global pandemic deaths. Many Asian countries had problems securing vaccines, and their early containment success led to vaccine hesitancy. Even wealthier countries, such as Japan and Taiwan, saw record surges in infections this summer, alongside India. The efficacy and safety of China-made vaccines, available to many poorer countries through a global vaccine sharing program, has been called into question. The market, it is often said, hates uncertainty, and the coronavirus remains a source of just that.

Far-ranging issues in China.
The long-running list of issues in China includes everything from allegations of human rights violations to unfair trade practices. This year, the government's regulatory crackdown on technology companies, education firms, and various other industries hurt market returns, erasing billions of dollars from investors' portfolios. That blip could be temporary, but there are signs—including the country's new five-year plan, announced in August—that regulatory tightening could continue for years. In addition, China's lack of transparency on matters ranging from the start of the COVID-19 pandemic to human rights, and even the simplest economic data (such as GDP growth), proves there's still plenty of risk in the only major economy to grow in 2020.

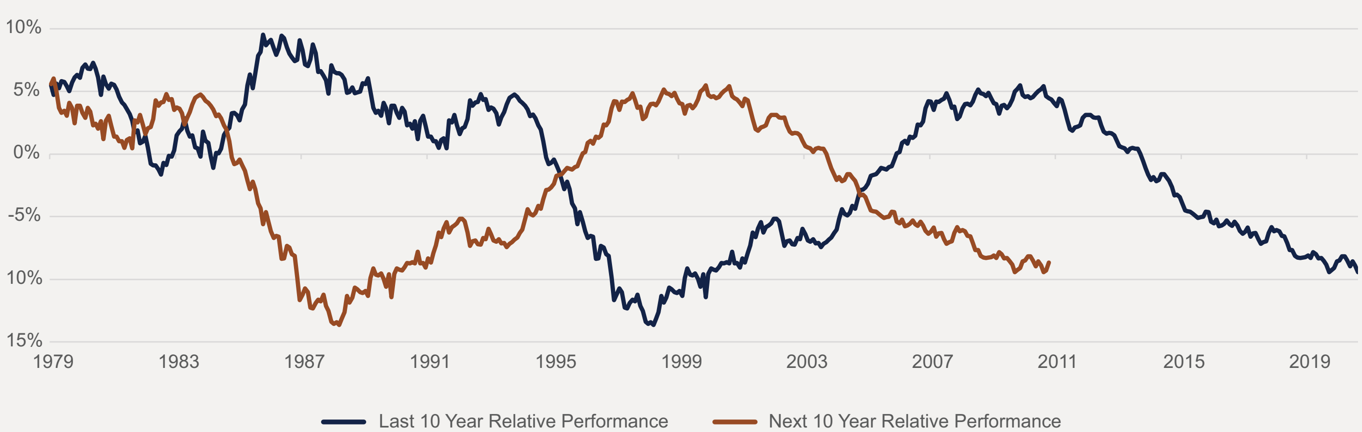
INVESTING EVERYTHING IN THE U.S. MAY HURT YOUR CHANCES TO MEET YOUR LONG-TERM GOALS

Given the events of the past decade, investors may want to lean toward the example of Jack Bogle, the Vanguard founder and father of low-cost index funds. In 2018, the year before his death, Bogle famously held only U.S. stocks, and said he didn't believe there was any need to diversify globally. Warren Buffett, the Oracle of Omaha, also limits his international exposure, and famously said, "Nothing can stop America when you get right down to it. Never bet against America." Those experts show that investing 100% (or close to it) of your portfolio in the U.S. has worked at times. However, we believe that strategy is a risky long-term bet in the current environment. Here are a few reasons why:

Past performance comes at a price.
While many of us have heard that past performance is not indicative of future returns, it's easy to make investment decisions based on one market outperforming all others, especially as its success continues and deepens. The problem with this approach is that it has a poor track record, as you can see in the chart below.

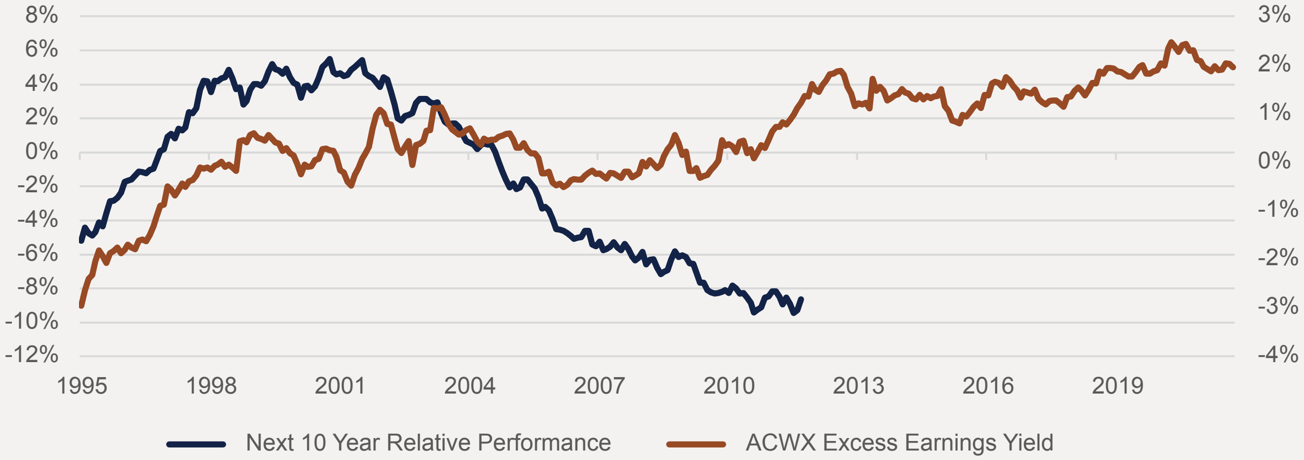
Since market performance is cyclical, after long periods of a market outperforming is precisely the wrong time to invest in it. The greater the market is performing, the larger the reversal has been during the following years. While this, once again, is no guarantee of the future, it does cast serious doubt for the prospect of looking backwards when making allocation decisions.

INTERNATIONAL EQUITIES' PERFORMANCE RELATIVE TO U.S. STOCKS



Source: FactSet. Indices Used: U.S. – S&P 500, International – Prior to 1988: MSCI EAFE Index, 1988 to Present: MSCI All Country World Index ex US

INTERNATIONAL VS U.S. VALUATIONS AND SUBSEQUENT PERFORMANCE



Source: FactSet. Indices Used: U.S. – S&P 500, International – Prior to 1988: MSCI EAFE Index, 1988 to Present: MSCI All Country World Index ex US.; Earnings Yield measured as (1/normalized 5-year moving average P/E)

If investing in past winners isn't the right approach, then what is? One clue offered by the chart above is that markets that have outperformed tend to become more expensive over time. While no indicator is perfect, looking at valuations gives us better historical data, lending credence to a popular investment mantra: Buy low, sell high.

In the chart above, we measure the difference between International and U.S. earnings yields (the inverse of the P/E ratio) over time and how they relate to ensuing long-term relative performance. Based on the dataset available, there was a relationship historically, though that relationship has somewhat broken down in the years since the global financial crisis of 2007-2008.

Many believe that the record levels of fiscal stimulus and Fed intervention we've seen in the U.S. have contributed to this effect, and it probably has. Based on this theory, we can either conclude that 1) valuations no longer matter, or 2) the current environment has offered a substantial discount for international stocks, which we will feel once the current cycle ends.

Our view is that valuations do, in fact, still matter, but it's clear that they do not tell the whole story. Things are often cheaper for a reason and when evaluating investment decisions, we must also examine the relative risk and opportunity set of markets, which we will do next.

International markets, and especially emerging markets, are expected to drive global growth going forward.
The World Bank's latest forecast calls for emerging market GDP growth to outpace the U.S. and advanced economies over the next three years, including double the expected growth in 2023.[1] A recent study by PwC, "The World in 2050," predicts that the seven largest emerging economies, which were just half the size of the seven leading developed industrial nations (the G-7) in 1995, will grow twice as large as the G-7 by 2040.[2] Economists tend to agree that over time international and developing markets will likely outpace the U.S. in terms of economic growth. Most large asset managers also agree, projecting significantly higher returns for international and emerging markets than U.S. stocks over the next five to 10 years.

The rise and fall of empires—and markets.
History shows us that countries fall in and out of leadership and prosperity on a regular basis. Concentrating in any one market could leave you exposed to a really poor outcome if something negative occurs. Likewise, it could cause you to miss out on a great outcome if a country or region outside your portfolio experiences rapid success. Great Britain, Spain, and Portugal all dominated the world at times, but they all took major steps back. The best example might be Japan. In December of 1989, the Nikkei 225 hit an all-time record, just shy of 39,000. It was the largest stock market in the world at the time. Nearly 32 years later, it's never reached that level again. The index plunged below 8,000 as recently as 2009 but rose to hover around 30,000 at the end of the third quarter, after sharply recovering from a dip below 20,000 in the early days of the pandemic. There were times in the 1980s when the Japanese market's cyclically adjusted price-to-earnings ratio nearly reached 100, compared to about 30 today.

It's a risky world right now.
Many investors are concerned about the unprecedented level of fiscal stimulus and accommodating monetary policy in the U.S. and elsewhere. It's a trend that started in the wake of the global financial crisis, with aggressive stimulus and low interest rates. It climbed to a different level altogether as officials worked to minimize the economic damage of COVID-19, with interest rates lingering near zero. One benefit of a regionally diversified portfolio is that it provides exposure to foreign currencies, which often move in different directions than the U.S. dollar.

OUR VIEW

It all comes down to the three pillars of our investment approach. We seek areas of the market, and the world, that are growing faster than others. Historically, faster-growing countries and regions tend to have higher equity returns, and we don't believe that's going to change. Of course, we won't overpay for that growth. Companies with low valuations relative to their book values tend to outperform over time, and the same holds true for market regions. Finally, we believe diversification is a great way to balance risk and return. That approach doesn't mean that a diversified portfolio will outperform any one asset class—the U.S. might continue to beat the rest of the world for decades to come. Although it can feel exciting to chase the best of all outcomes, by doing so, you increase the risk of a less desirable outcome.

1 https://thedocs.worldbank.org/en/doc/600223300a3685fe68016a484ee867fb-0350012021/related/Global-Economic-Prospects-June-2021-Global-Outlook.pdf

2 www.pwc.com/gx/en/research-insights/economy/the-world-in-2050.html

Our Investment Strategy

We still believe that U.S. market exposure is a key building block to portfolios, but the total amount of exposure will depend on your time horizon and how you define success. If your goal is preserving short-term capital and reducing volatility, foreign equities (or equities in general) might not be the best place to start. We would instead favor diversified, high-quality, U.S.-based fixed-income assets with limited interest rate exposure. For your longer-term cash flow needs, the objective tends to shift from preservation to growth, and from fixed-income to equity-based portfolios. In this case, we prioritize diversification, including outside the U.S., while observing the economic landscape and (of course) valuations.

As we head toward 2022, the U.S. remains our single largest country exposure. That's not unusual, and it's not likely to change. The U.S., after all, accounts for nearly 60% of the MSCI All Country World Index. Japan is the next country on the list, at less than 6%, with China third at about 4%. Based on current conditions, including valuations, we tend to overweight international equities, particularly emerging markets. Even within international and emerging markets, we tend to spread our exposure to avoid concentration and enjoy the benefits of diversification. For example, within the MSCI Emerging Markets Index, China represents more than a third of exposure (as of 8/31/2021), even though the volatility in Chinese markets since their February peak has dragged on the index. Investing heavily in such a passive index could lead to overexposure to China or other countries.

Our client's individual preferences also play a role in geographic exposure. Some clients are more comfortable with U.S. markets, tracking closer to U.S. benchmarks. Others might prefer avoiding exposure to certain countries, such as China, for ethical reasons. We have solutions for every client, tied to individual time horizons, goals, and beliefs. We work to understand clients' priorities and to construct resilient portfolios that will help them accomplish their goals, whether it is a concentration in fixed income or equities, domestic or international markets, or something in between.

Conclusion

From a purely investing perspective, the last decade-plus has been a good one, especially for U.S. equity investors. No matter what obstacles have threatened the market, it has pushed its way through and persevered—from the immediate aftermath of the global financial crisis through the first 18 months of the lingering pandemic. Many of us, like the Buffetts and Bogles before us, believe in the exceptionalism of the U.S.—its financial markets and its global impact. Still, there is a reason that "don't put all your eggs in one basket" has become a cliché: It is usually wise advice. Diversification is at the heart of our investing philosophy. While there are no guarantees, we believe it is the most effective way to address uncertainty and instability—or risk—while increasing the probability of positive investment outcomes over time.

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