July 2023

From today's WSJ:

S&P Extends Monthly Win Streak to 5

July rally lifted smaller regional banks, the biggest tech companies

BY GUNJAN BANERJI

The S&P 500 rose on the final trading day of July and notched its fifth consecutive month of gains, its longest winning streak since 2021.

The S& P 500 finished up 3.1% for the month, while the tech-heavy Nasdaq Composite added 4%. The Dow Jones Industrial Average clinched a 3.3% monthly gain.

The monthslong rally in the stock market broadened this month, lifting everything from smaller regional banks to the biggest technology companies in the world, a sign that many traders expect continued strength in the U.S. economy. ...

A stretch of better-than-expected data on jobs and inflation has pushed traders to unwind some of their bets on a looming downturn. Some have ditched their gloomy forecasts on stocks and abandoned recession wagers, helping push swaths of the stock market higher alongside bond yields.

Gains in regional-bank stocks ... pushed the KBW Nasdaq Regional Banking Index up 18.3% for the month, its best stretch since November 2016. These stocks were battered earlier in the year, when Silicon Valley Bank's collapse stoked a banking crisis and exacerbated worries about a recession.

Energy companies ripped higher, with stocks such as **Schlumberger** and **Halliburton** gaining around 18% a piece for the month. Meanwhile, tech stocks continued a winning streak that has helped send the Nasdaq up 37% for the year, besting the Dow by its widest margin through July of any year on record, according to Dow Jones Market Data going back to the 1970s. ...

Crude prices inched up and notched the biggest one-month percentage advance since January of last year, as traders braced for cuts by Saudi Arabia and Russia to tighten supplies. Brent crude futures, the global oil benchmark, rose 14% in July to $85.56 a barrel. The rally has snapped oil out of a months-long funk caused by concern about the world economy and a surge in exports from sanctioned producers.

Investors have also been sifting through a wave of earnings results, many of which have been better than expected by Wall Street analysts. Around 81% of companies have been beating earnings estimates, the highest figure of the past seven quarters, according to Société Générale.

Now, analysts forecast that second-quarter earnings will mark a trough for quarterly results before a rebound in profits later this year, according to DataTrek Research. ...

The yield on the 10-year Treasury note ascended for a third consecutive month to 3.956% in July. ...

From Grandeur Peak Funds:

July 21, 2023

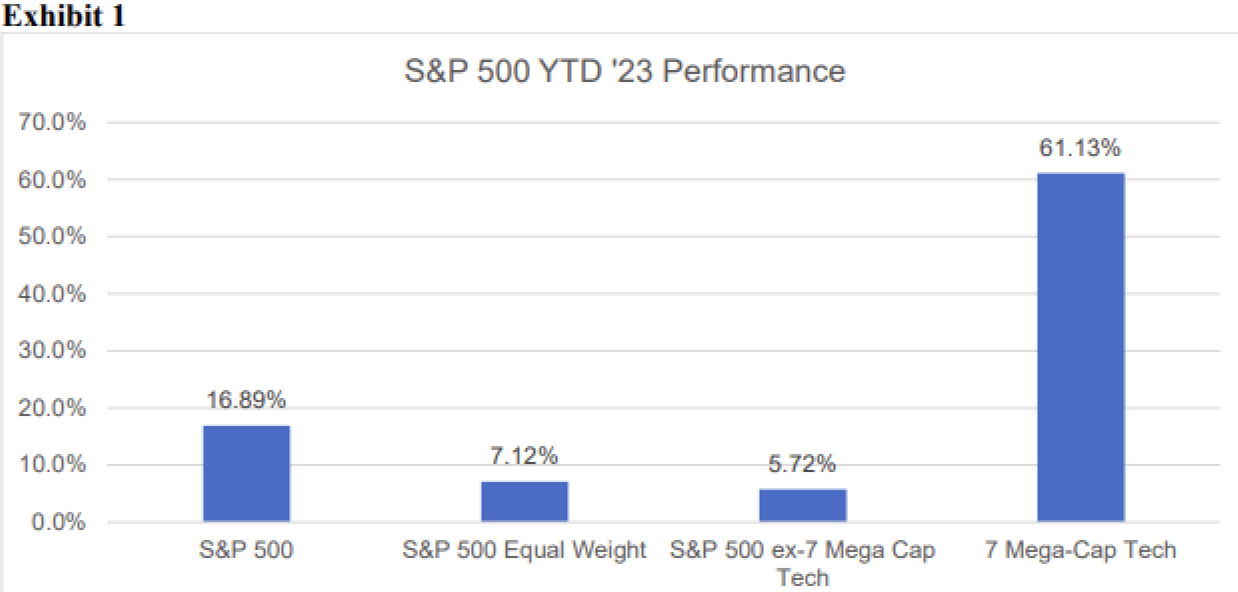
Market Commentary

Key Takeaways

- The S&P 500 Index's year-to-date outperformance has been driven by strong performance from 7 mega-cap tech stocks.
- Those 7 stocks are up +61.13% on a market cap-weighted basis through 6/30/23 and now represent over 27.65% of the index.
- The remaining 493 stocks in the index are up +5.72% year-to-date.
- A key driver in the S&P 500 Index's dominant performance since the 2008 Financial Crisis has been very accommodative US monetary policies.
- Despite favorable monetary policy in the US, Global Small Cap stocks have outearned US Large Cap stocks.
- More restrictive US monetary policies going forward will be a headwind for US Large Cap stocks.
- Global Small Cap stocks are in position to outperform in the future as fundamentally based factors (i.e., earnings growth) drive price performance.

The public equity market has rebounded thus far in 2023 after the abysmal, broad-based sell-off we all endured across asset classes in 2022. The leader of the pack, to the surprise of many, given beginning valuations, has been US Large Cap stocks. The S&P 500 Index turned in an impressive +16.89% in the first half of 2023, but the reasons for the strong return are anything but "broadbased". The seven largest stocks in the index by market cap, all Technology-related names (e.g., Amazon, Tesla, Google), are up +82.51% on average and +61.13% on a market cap-weighted basis. As a result of their strong absolute and relative performance, investors have started referring to these stocks the "Magnificent 7". The remaining 493 stocks in the index have collectively returned +5.72% for the year, much more in-line with most other public equity markets across geographies and

Exhibit 1



Source: FactSet, MSCI
*7 mega-cap tech stocks include Alphabet (Google), Amazon, Apple, Meta Platforms (Facebook), Microsoft, Nvidia, and Tesla.

market caps.

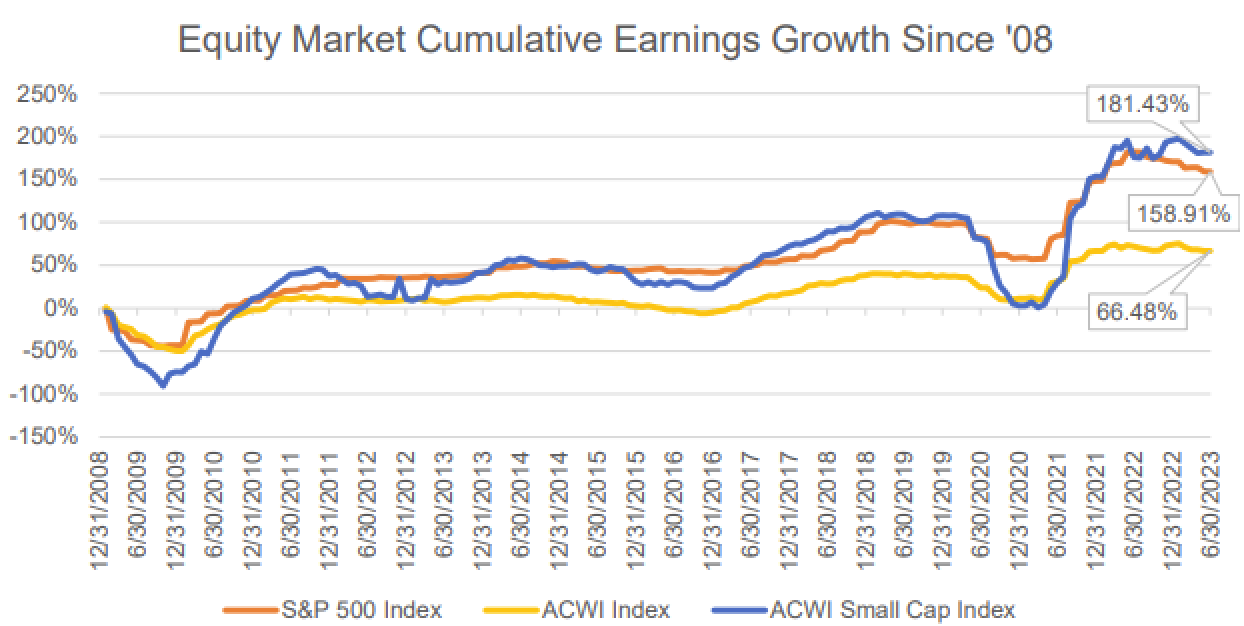
The Magnificent 7 now represent 27.65% of the S&P 500 Index on a market value-weighted basis, and even more on a risk-weighted basis given the price volatility each of these stocks exhibits relative to the overall Index. The S&P 500 Index hasn't been this concentrated, with so much weight in so few names in 40 years. Just a decade ago, the top seven stocks accounted for only 13.71% of the overall Index.

While the strong performance of these stocks and, as a result, the S&P 500 Index, has no doubt been received favorably, it has left many investors questioning what to do now. Does the heavy concentration of mega-cap technology stocks in the S&P 500 Index compromise the diversification benefits assumed when investing in an index? Can the Magnificent 7 possibly live up the earnings growth expected of them? If not, investors are likely to drop "Magnificent" and add "Mediocre" to the group's moniker, if they eventually give back this year's gains and create a meaningful performance drag on the overall Index's return.

As we have noted many times, we believe **earnings growth is the driving factor behind a stock's <u>long-term</u> price performance.** However, this has been less of the case since the Global Financial Crisis. US large cap stocks have consistently outperformed other segments of the global public equity market. **Since 2008, the S&P 500 Index has cumulatively outperformed Global Large/Mid-cap stocks by +217.66% and Global Small Cap stocks by +169.52%.**

However, when compared to Global Small Cap stocks, the S&P 500 Index's outperformance has not been the result of stronger earnings growth. **In fact, Global Small Cap stocks have out earned US Large Cap stocks over this period.**

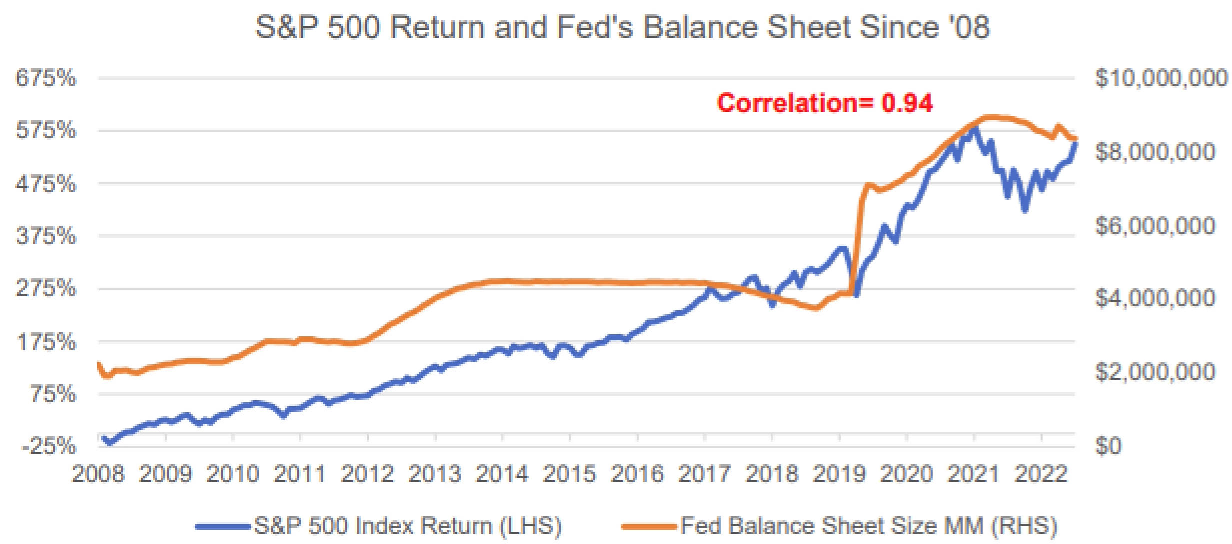
Exhibit 2



Source: MSCI

If the S&P 500 Index didn't have superior earnings growth, then why such dominant performance? While there may be several reasons that factor into a logical explanation, overly accommodative US monetary policy was certainly one of the main drivers. The Fed's zero-interest rate policy, which has been in play for most of the 15-year period since the Financial Crisis, allowed companies and consumers to access cheap capital and encouraged risk taking. Furthermore, the Fed significantly expanded the size of its balance sheet, employing several rounds of quantitative easing aimed at stemming any sign of economic or financial market distress. **These policies dramatically increased investor confidence across the globe to take more risk in US Large Caps in lieu of other markets where organic earnings growth potential was more likely.** As illustrated in Exhibit 3 below, the correlation between the size of the Fed's balance sheet and the S&P 500 Index's return since 2008 has been very high at 0.94.

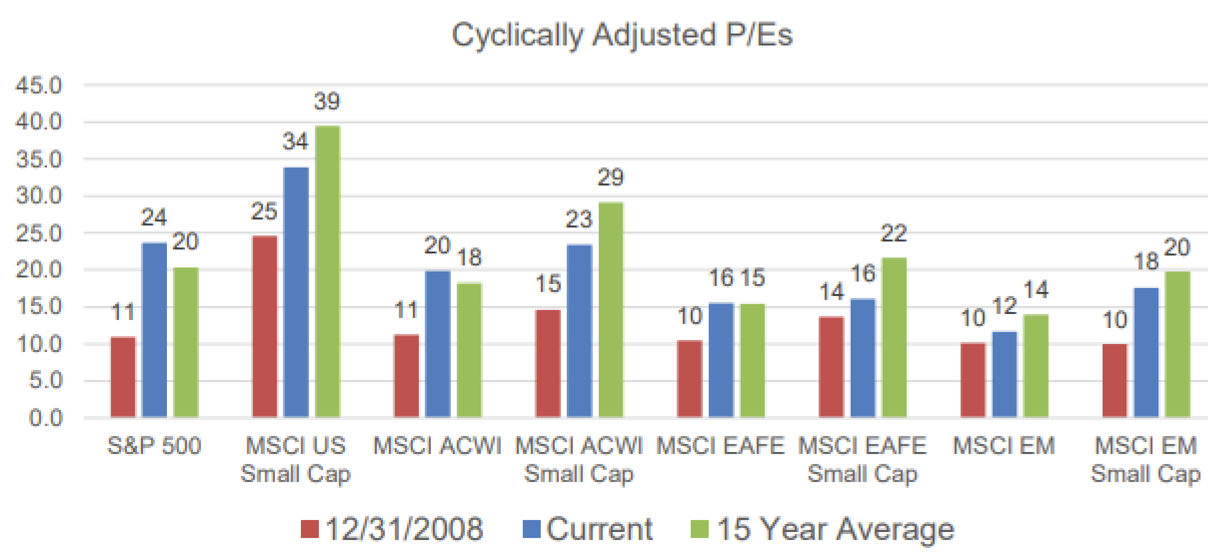
Exhibit 3



Source: FactSet, MSCI

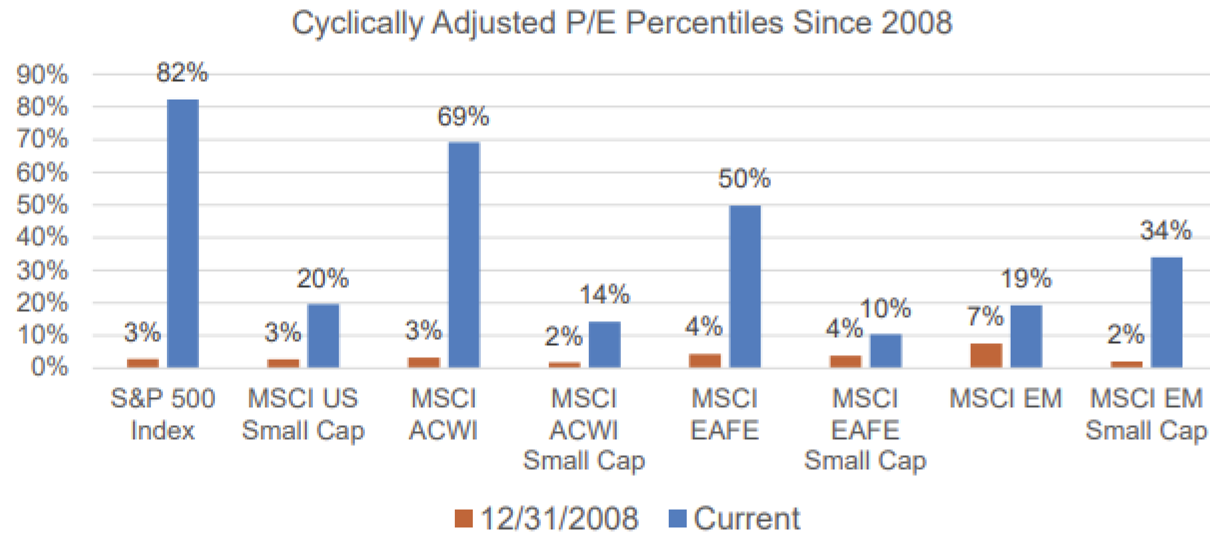
The S&P 500 Index's strong performance has driven its cyclically adjusted price-earnings multiple (P/E) (i.e., the earnings have been averaged out over 5 years and adjusted for inflation) from near its 15-year low in 2008 to the 82nd percentile, as shown in Exhibits 4 and 5 below. On the other hand, Global Small Cap cyclically adjusted P/Es, which were also near their 15-year low in 2008, remain very cheap across the board.

Exhibit 4



Source: FactSet, MSCI

Exhibit 5



Conclusion

The discontinuation of very accommodative, investor-friendly monetary policy in the US, which has already begun with a meaningful increase to the Fed Funds rate, combined with an eventual reduction in the Fed's massive balance sheet and a pullback in US fiscal spending will likely be a major headwind for US Large Cap stocks in the future. While the Magnificent 7 seemed to have saved the day thus far in 2023, they will have limited fire power going forward. Earnings growth must eventually regain traction as the dominant determinant of stock market price performance. When it does, investor flows will be redirected into markets that are fundamentally worthy of investment. **<u>We believe that Global Small Cap stocks, which have collectively proven that they can out earn US Large Cap stocks despite not having the same accommodative policy conditions, will be in position to benefit from this development and potentially deliver superior returns to investors as a result.</u>**

From Friday's Global Investment Strategy:

Too Early To Call An End To The Fed's Tightening Cycle

Data Dependence

If there was one lesson from this week's FOMC meeting and subsequent press conference, it is that neither Chair Powell nor the rest of the Fed know if additional rate hikes are forthcoming. "Data dependence" has been the name of the game all year and will continue to be over the coming months.

The good news for those fearing further rate hikes is that inflation is coming down. The year-over-year change in the core PCE deflator, the Fed's preferred inflation measure, has declined from a peak of 5.4% in February 2022 to 4.1% in June 2023.

Market-based core PCE inflation, which strips out imputed prices, has declined even more than regular core PCE. The 3-month change in so-called supercore inflation (core PCE excluding shelter and used cars) reached 2% in June. An even more refined measure that also strips out volatile financial services fell to 1.8% (**Chart 1**). The Fed expects core PCE inflation to ease to 3.9% by the end of 2023 and 2.6% by the end of 2024. During his press conference, Chair Powell said that the Fed would cut rates "long before" inflation has returned to its 2% target with the knowledge that monetary policy operates with long and variable lags.

Breaking Down the Core

The Fed likes to decompose core inflation into three components: 1) goods; 2) shelter; and 3) services excluding shelter. On balance, all three components still look fairly disinflationary.

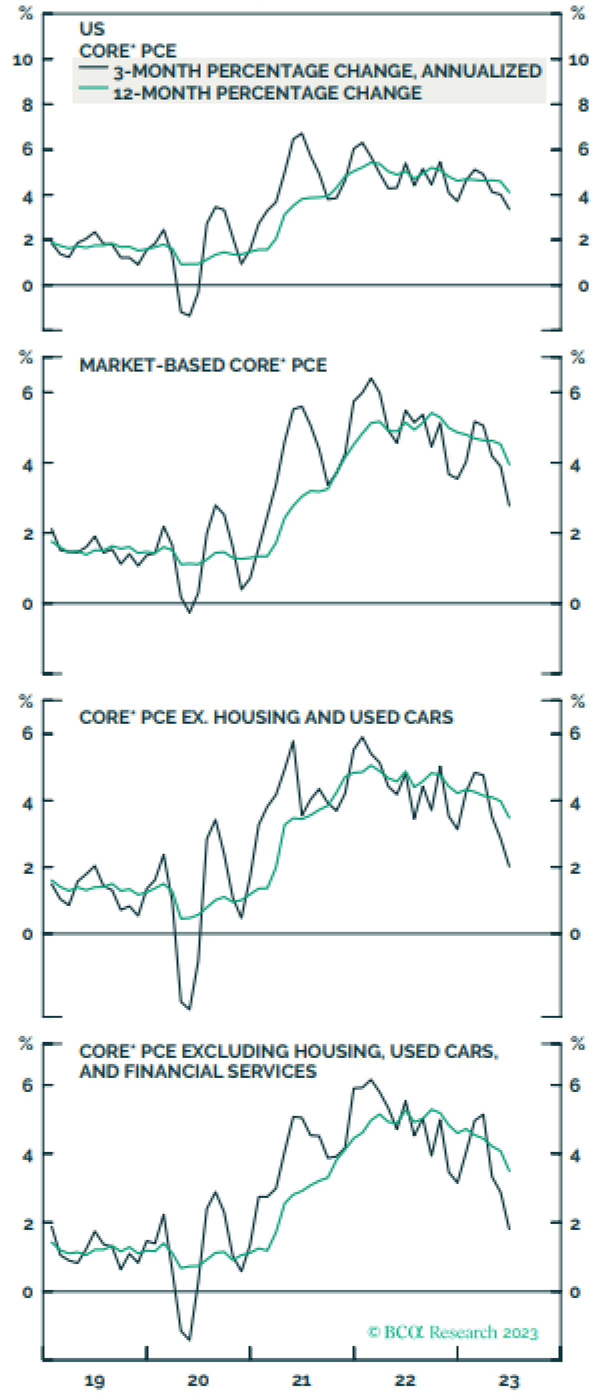
Good inflation remains subdued. The New York Fed's Global Supply Chain Pressure Index has swung from a record high to a record low. Used car prices are falling again, and with auto inventory levels rising, this trend should persist.

Shelter inflation, which accounts for 44% of core CPI and 17% of the core PCE deflator, is set to decelerate further. The Cleveland Fed's New Tenant Repeat Rent index, which leads shelter inflation by 9-to-12 months, has rolled over. Private-sector measures of asking rents produced by Zillow and Apartment List tell the same story.

Apartment List's National Vacancy Index has risen from a low of 4.1% in October 2021 to 7.3% in July 2023, suggesting that it has become easier for would-be tenants to find a place to live.

Wage growth, which is the main driver of services inflation, is slowing. Adjusted for changes in industry composition, the growth in average hourly earnings has decelerated from 7%-to-8% to about 5%, with even steeper declines seen in once red-hot sectors such as leisure and hospitality (**Chart 4**). Today's Employment Cost Index (ECI) report showed that worker compensation rose by 1% in Q2, below consensus expectations of a 1.1% rise and down from 1.2% in Q1.

CHART 1
Inflation Is Coming Down... For Now



* EXCLUDING FOOD AND ENERGY.

The growth in posted wages on Indeed, an online jobs site, has eased from 9.3% in January 2022 to 5.1%. Just as asking rents lead shelter inflation, asking wages lead wage inflation. Other wage surveys tell a broadly similar disinflationary story.

It is worth noting that real wages are still about 3% below their pre-pandemic trend. Thus, somewhat higher-than-normal wage growth should be expected, even if inflation comes back to target.

Why Falling Inflation Could Sow the Seeds of Its Own Demise

Consumption and real income growth are highly correlated. If inflation continues to fall, real wages will rise further. If that were to happen, the resulting increase in consumption could cause inflation to reaccelerate. ...

CHART 4
Wage Growth Has Slowed

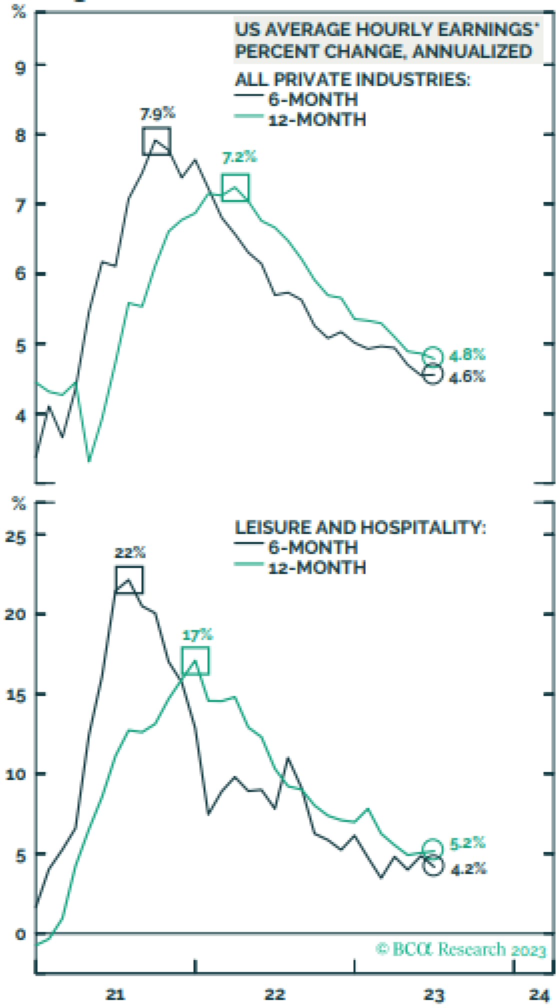
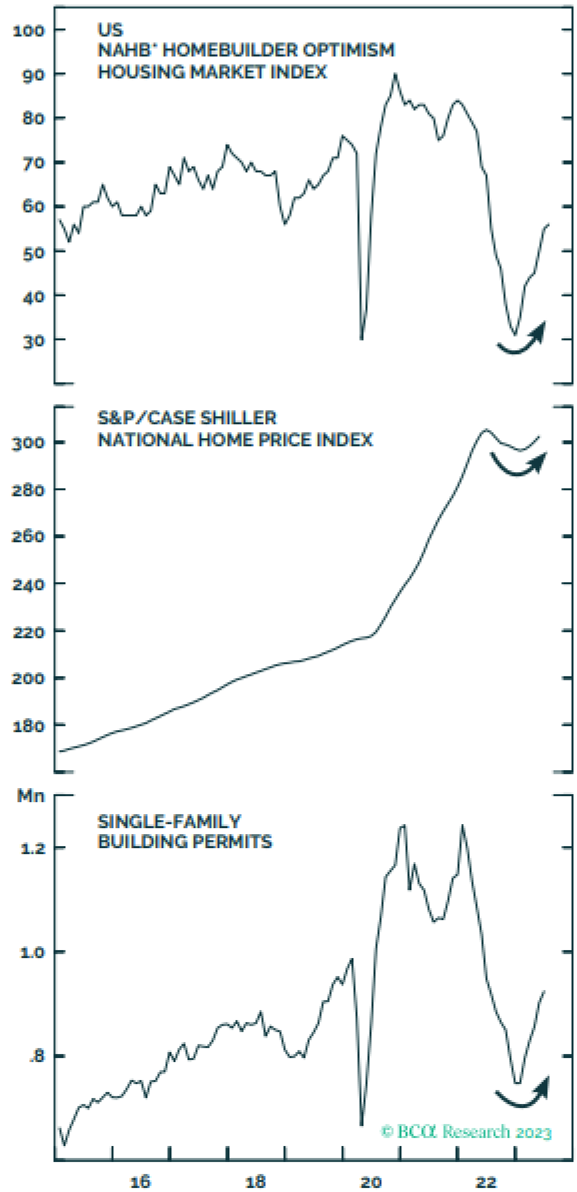


CHART 12
The Housing Market Is Showing Renewed Vigor



* NATIONAL ASSOCIATION OF HOMEBUILDERS.

Timely Indicators of Economic Growth

Real GDP increased by 2.4% in Q2, well above most estimates of potential growth. The New York Fed's Weekly Economic Index has hooked up recently, suggesting that growth momentum remained strong going into the third quarter.

The Atlanta Fed's GDPNow model's initial estimate of Q3 growth is a sizzling 3.5%. Both the Citi and the Bloomberg economic surprise indices are well in positive territory.

The housing market is showing renewed signs of vigor. Homebuilder confidence rose in June, marking the seventh straight month of improvement and the second month where more builders perceived conditions as good rather than poor. The Case Shiller index of national home prices jumped by 0.7% in May and is now less than 1% below its June 2022 high (**Chart 12**).

Single-family building permits increased in June to their highest level in 12 months. The rise in building permits suggests that residential investment – which shrank by 4.2% in Q2, marking the ninth straight quarter of declines – has bottomed.

In contrast to housing, manufacturing remains in the doldrums. Nevertheless, there have been some signs of hope. The forward-looking new orders component of the ISM manufacturing index rose by 3 points in June, with new orders minus inventories registering a 4.8-point gain. New orders minus inventories also appears to have troughed in the S&P survey both in the US and in the rest of the world.

Meanwhile, US manufacturing construction is surging as more companies relocate production back home.

Construction of manufacturing facilities contributed 0.4 percentage points to Q2 GDP growth, the largest contribution since 1981. While much of the recent construction boom has been tech-driven, overall capex intentions appear to have bottomed, suggesting that a more broad-based increase in capital spending lies ahead.

Labor Market Developments

Job openings and the quits rate both tend to lead wage growth and are currently sending conflicting signals: Job openings declined in the May JOLTS, while the quits rate staged a modest rebound.

Although it may just be noise in the data, Indeed's measure of job openings has risen since the start of July.

Perceptions of job availability improved in the latest Conference Board survey, with the spread between households who thought that jobs were "plentiful" versus "hard to get" rising by 4.4 percentage points. This metric also leads wage growth.

Initial unemployment claims have declined from their June peak, although they remain above last year's lows. Continuing claims have been trending lower since April.

Rising labor participation has helped companies fill vacant positions over the past few years. ... the participation rate among prime-age workers (those between the ages of 25 and 54) is now above pre-pandemic levels.

In the absence of slower labor demand growth, firms may find it increasingly difficult to fill job openings. The recent deal between UPS and the Teamsters suggests that labor increasingly has the upper hand in wage negotiations.

Credit Trends, Financial Conditions, and Fiscal Policy

Bank lending standards have been tightening since Q3 2022. Lending standards lead credit growth by about a year. Thus, it is highly likely credit growth will continue to slow further. Rising consumer loan delinquency rates reinforce the message that banks are unlikely to open the credit spigots anytime soon.

Still, the sudden stop in credit flows that many people were worried about in March in the wake of the collapse of Silicon Valley Bank has not materialized. Bank earnings were quite strong in Q2, suggesting that the overall banking system remains in reasonably good shape.

Broad-based financial conditions have been easing for much of this year thanks to rising stock prices, narrower credit spreads, and a somewhat weaker US dollar.

Fiscal policy is also no longer restrictive. According to the Hutchins Center at the Brookings Institution, fiscal policy will have a broadly neutral impact on growth over the next four quarters, after having subtracted more than three percentage points from growth in 2022. In fact, the primary budget deficit has been rising in recent months, implying a modestly positive fiscal thrust.

Pricing Plans and Inflation Expectations

The price components of the ISM and S&P PMIs generally point towards a further easing in inflationary pressure, although the disinflationary trend is more apparent in the ISM indices. The S&P US PMI is slanted towards smaller, more domestically oriented US companies, whereas the ISM is geared towards large multinationals.

Consistent with this observation, the net fraction of small businesses planning on raising prices has risen over the past two months. The series tends to be closely correlated with core PCE inflation. Moreover, so far in July, four out of the five regional Fed surveys that we track showed an acceleration in planned selling prices among companies in their districts (we will get data from the fifth bank, the Dallas Fed, on Monday).

Inflation expectations generally remained well anchored during the entire period when realized inflation was rising. Somewhat worryingly, however, the recent data show a pickup in expectations, even as realized inflation has come down.

Expected inflation 5-to-10 years out in the University of Michigan survey clocked in at 3% in June, near the upper end of the historic range that has prevailed since the late 1990s. The 5-year, 5-year forward TIPS inflation breakeven rate has also risen by 25 bps over the past month to 2.51%, slightly above the Fed’s target range of 2.3%-to-2.5%.

A rebound in oil prices has helped to push up inflation expectations. The WTI oil price has increased by 18% since late June. Agricultural prices have also risen on the back of renewed worries over Ukraine grain shipments, although they remain well below their 2022 peak.

Growth and Inflation Abroad

Growth has generally been weaker outside of the US than in the US. This partly reflects the outsized role that manufacturing plays in some economies such as Germany. In the case of China, it also reflects renewed weakness in the housing sector.

A stabilization in the global manufacturing sector could help revive European growth later this year. How the ECB responds to that remains to be seen. With European headline inflation now coming down swiftly, our guess is that the ECB will stay on hold, even if the manufacturing cycle turns up. That said, stronger growth prints will limit the need for the ECB to cut rates.

In China, while large-scale stimulus is not in the cards, the authorities are taking measures to put a floor under growth. A middling path for growth in China is thus probable. Given that producer prices in China are now falling, the fact that China is exporting deflation is, ironically, a welcome development for other countries still struggling with high inflation.

Investment Conclusions

We have been in the benign disinflation camp all year and continue to see scope for US inflation to fall further in the months ahead.

Nevertheless, against the backdrop of a still-extremely resilient economy, there is uncertainty over how quickly inflation will fall, and if it does fall, whether it will stay down.

Despite today's soft PCE and ECI releases, the more forward-looking data that we track tentatively suggest that inflationary pressures may be starting to build again. As such, we are increasing our subjective odds of a resurgence of inflation later this year or early next year to 30% from our previous estimate, published in our Q3 Strategy Outlook, of 20%.

We continue to see the risk to bond yields as being skewed to the upside in the near term. Moreover, any further increase in inflation risk would likely prompt us to adopt a more defensive stance towards equities. ...

Follow-ups

Why International Diversification Is Still The Prudent Strategy (While Keeping Behavioral Biases, Risks, And Results In A Healthy Perspective)

JULY 5, 2023

... Over the past 15 years, international diversification has hurt U.S. investors compared with investing only in the U.S. market. From January 2008 through May 2023, for example, the S&P 500 Index returned 9.2%, outperforming the MSCI EAFE Index return of 2.7% by 6.5 percentage points and the MSCI Emerging Markets Index return of 1.0% by 8.2 percentage points.

For many financial advisors, the current run of outperformance for U.S. over international equities has made it increasingly challenging to communicate with clients about the wisdom of diversifying globally. And while the numbers from the last 15 years look bad enough on their own, certain behavioral biases such as recency bias (which can cause people to overweight the importance of recent events over those that occurred farther in the past) and confusing the familiar with the safe (which can lead to U.S. investors downplaying how risky U.S. equities really are) have made international diversification look even *worse* in the eyes of the investing public.

The underperformance of international stocks has led some to argue that the global market climate really has changed to the extent that international diversification is no longer an effective strategy to reduce country-specific risk – either because, in times of crisis, the correlations of equities around the globe now tend to rise toward 1 (or in other words, everything crashes at the same time), which means that there's no point in diversifying; or going even further, because global equities are now highly correlated in *any* environment, and that with the increasing integration of global markets the world has truly become 'flat', eroding away any benefits that diversification once had.

Investors with a knowledge of economic theory and financial history, however, can still make a strong argument for international diversification. It's helpful to begin with a trip down memory lane, so we can examine how the world looked to investors *before* the U.S. began its current stretch of outperformance.

Imagine that it's January 1, 2008. Over the prior 8 years (2000-07), the S&P 500 Index has returned just 1.7% annually, while the MSCI EAFE Index of developed market equities has returned 5.6% .... And looking much farther back to the longest period for which there was data at that point (1970-2007), the S&P 500 has underperformed the MSCI EAFE by 0.5 percentage points per year on average (11.1% versus 11.6%) over a 38-year time horizon. In the face of the U.S. underperforming international equities over the short- and the long-term, what investor – at that point in time – would have argued against global diversification?

Looking back over the last 50+ years shows the pendulum swinging back and forth continuously between U.S. and international equities. As shown in the chart below, during the 1970s and 1980s, U.S. equities largely lagged their international ... counterparts ... as they also did in the early 2000s (when the end of the dotcom bubble and the aftermath of 9/11 tipped the U.S. economy into a recession). But U.S. equities outperformed both during the booming economic years of the 1990s and throughout the slow but steady recovery following the 2008 financial crisis.

U.S. Versus International Equities

	S&P 500 Annualized Return (%)	MSCI EAFE Annualized Return (%)	U.S. Outperformance/ Underperformance (Percentage Points)
1970-1988	10.6	16.6	-6.6
1989-1999	19.4	7.7	+11.7
2000-2007	1.7	5.6	-3.9
2008-2022	8.8	2.3	+6.5

While it's easy to see in hindsight which regions have outperformed in the past, unfortunately no one can predict in advance which one will outperform the others over any particular time period. As the above table demonstrate, outperformance over one period tends to be followed by underperformance over the next. One of the main reasons why this occurs is that much of the outperformance of one region during a certain time period tends to be a result of rising valuations in that region relative to the others – and while rising valuations lead to higher realized returns, they also result in lower future expected returns (since that region's valuations will likely regress back towards the mean at some point), at the same time when other regions with comparatively lower valuations can expect to achieve higher future returns, causing the pendulum to swing back again.

While these cycles of out- and underperformance are predictable at a high level, there are no crystal balls allowing us to foresee exactly when each shift will occur. The logical conclusion, then, is that investors should be diversified internationally – i.e., holding a mix of both U.S. and international asset classes rather than betting on one to outperform the other – in order to capture the swings in valuation whenever they occur. In reality, however, many investors instead tend to simply buy what has performed best in the most recent period (at higher valuations and thus lower expected returns) and sell what has underperformed (at lower valuations and thus higher expected returns) – the exact opposite of the Investing 101 motto of 'buy low, sell high'. For investors, weighing recent results over historical evidence would have resulted in overweighting international stocks in 1990, U.S. stocks in 2000, international stocks again in 2008 (all at the wrong time, when each asset class was about to enter a period of underperformance)… and once again, U.S. stocks today.

Beyond the faulty logic of buying after outperformance and selling after underperformance, investing only in a single country or region goes against the basic economic principle that diversification is the only 'free lunch' in investing – in other words, that a globally diversified portfolio can be expected to produce better risk-adjusted returns than any one country. Yet many investors behave as if the opposite is true, specifically as pertains to their home country: Investors in developed markets (including in the U.S.) often believe that their own country not only has higher expected returns than other countries, but is also a safer place to invest.

This home-country bias goes against the most basic investment principle that risk and expected return in a non-diversified portfolio are positively correlated (that is, assets with higher expected long-term returns will also have higher expected short-term volatility). Thus, if you believe the U.S. is a safer place to invest, logically you should expect that U.S. returns will be *lower*, not higher, than the returns of riskier international stocks. Instead, investors who want to reduce risk *without* correspondingly lowering the expected return can do so by adding less-correlated assets with the same expected return (e.g., by adding additional countries to a single-country portfolio).

The Case For International Diversification

Cliff Asness, Antti Ilmanen, and Dan Villalon examined the arguments for and against international diversification in their paper "International Diversification—Still Not Crazy after All These Years", published in the April 2023 issue of *The Journal of Portfolio Management*. In terms of economic theory, they note the following:

Diversification is one of the most fundamental and important ideas in modern finance. It's also a practical result of how markets work.

This is because the only "market-clearing" or "macro-consistent" portfolio is one that's market-cap weighted—one investor's overweight is another investor's underweight ***[author's note: not everyone can overweight U.S. stocks]****. So, if anyone decides they're best off holding mostly their own country's equity market, then it means other investors in other countries must also be more home biased. The trouble with this proposition is that it's simply not logical for investors in every country to believe their home market is going to outperform. It may be patriotic, but it sure isn't rational.*

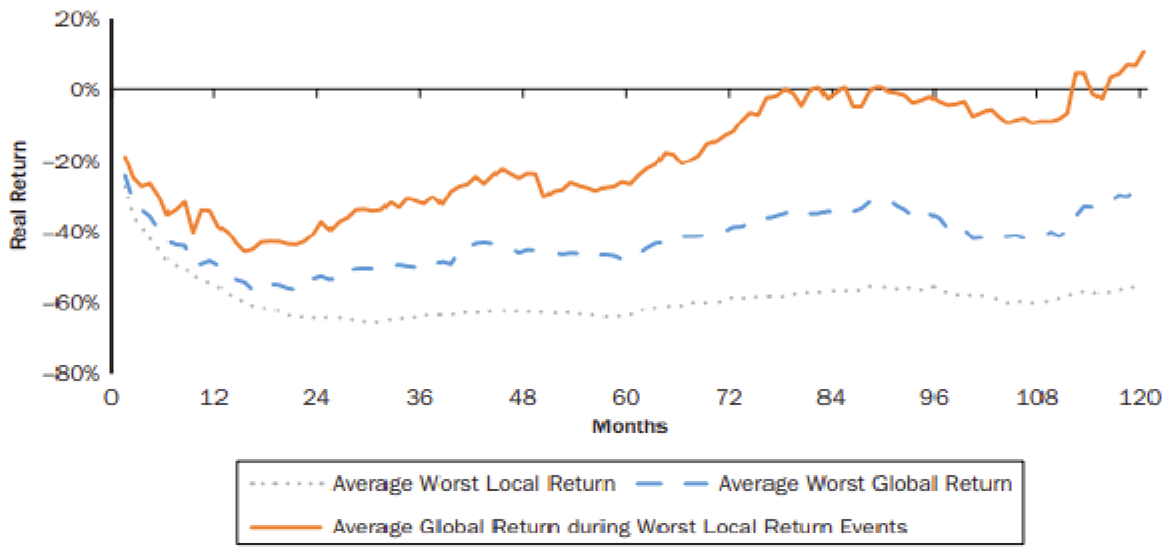
EVERYTHING CRASHES AT THE SAME TIME, SO WHY BOTHER?

The bear markets of 1973–1974 (when the S&P 500 lost 37.2% and the MSCI EAFE lost 33.2%), 2000–2002 (when the S&P 500 lost 37.6% and the MSCI EAFE lost 42.8%), and 2008 (when the S&P 500 lost 37.0% and the MSCI EAFE lost 43.0%) demonstrated that during systemic financial crises, markets tend to crash together. Because the point of diversification, as noted previously, is to add assets to the portfolio that don't all move together at the same time, it's reasonable to wonder whether international diversification really provides any protection when large market declines seem to affect all markets simultaneously.

Addressing this question, Asness et al. concede the point that diversification won't necessarily add protection to a portfolio during any one market crisis: As the authors put it, "worst cases for individual countries are similar to worst cases for globally diversified portfolios." But while global diversification may not do much to reduce risk in the *short term*, they go on to add, "there's an even bigger risk for investors: long-term pain. Extended bear markets are more likely to prevent investors from meeting their long-term wealth goals than short crashes." To better evaluate the true value of diversification, then, consideration must be given to how it performs over longer horizons, as long-drawn-out bear markets can be significantly more damaging to wealth than short-term volatility (particularly for investors in the distribution stage of their investing lifecycle).

The following chart from their paper shows how a globally diversified portfolio has historically provided downside protection. It shows how the 'worst-case' real return for an individual country (represented by the grey dotted line) tends to initially correspond with a severe decline across all countries (represented by the orange line) – but while the average individual country's returns after such an event tend to stay depressed, the global portfolio goes on to eventually recover. In other words, while global diversification doesn't necessarily provide protection from the initial crash, it does create the potential for a significantly faster recovery.

Average Worst Returns Over Various Horizons For Local And Global Partners, January 1950–December 2022



NOTES: This exhibit plots, across the dimension of return horizon, the cross-sectional average worst local returns, the cross-sectional average global returns during the concurrent period of the worst local returns for each country, and the cross-sectional average worst global returns generally (i.e., not necessarily bound to the concurrent periods of worst local returns per country) across 22 countries. Local portfolio returns are expressed in real terms, adjusted for local inflation. The global portfolio represents the portfolio held by an investor who chooses to diversify globally. We use an equal-weighted portfolio of all stock market indices as our proxy for this portfolio and do not hedge foreign currency exposure. The returns to this portfolio are expressed in real terms, adjusted for the home country's inflation. Note that the real returns to this global portfolio are not the same from each country's perspective owing to differences in currency returns and inflation. Therefore, we examined 22 separate global portfolios, 1 from each of the 22 countries' perspectives. All returns are gross of fees and of transaction costs.

SOURCES: AQR, Bloomberg, CANSIM, Global Financial Data, Datastream.

Historical evidence further supports the idea that while international diversification doesn't necessarily work in the short term, with markets moving (mostly down) in tandem during systemic crises, it does often prove to work in the long run. In a 2011 paper published in *Financial Analysts Journal*, "International Diversification Works (Eventually)", Asness, along with co-authors Roni Israelov and John M. Liew, found that over the long run, markets don't exhibit the same tendency to suffer or crash together as they do during short spikes of volatility (when selling is largely driven by fear and panic); rather, they diverge over time based on actual economic factors, meaning that investing in any single country means betting on that country's economic performance over the long run. To put it another way, global diversification protects not against the risk of a single worldwide meltdown, but instead against the risk of any single country's stocks underperforming the global market over a period of decades.

In the 2023 *Journal of Portfolio Management* paper, Asness et al. update the data from the previous paper through 2022 and conclude that "international diversification does a pretty great job of protecting investors over the long term". Their findings are consistent with those of Mehmet Umutlu and Seher Gören Yargi, authors of the May 2021 study, "To Diversify or Not to Diversify Internationally?", who concluded that international diversification is still important and has the potential to reduce portfolio risk because of how "correlations jump during recessions with a tendency to revert in stable periods", even in more recent years when increasing globalization might lead one to expect correlations to be higher in all economic environments.

For a specific example of the long-term benefits of diversification, look to Japan. At the dawn of the 1990s, Japan was coming off of a decade in which it had outperformed both U.S. and global equities as a whole. Focusing just on recent performance would have led investors to believe that Japan would continue to be a good bet going forward, but what has actually happened since then has been a completely different story: From January 1990 through May 2023, the MSCI Japan Index returned just 0.9% per year.

The poor returns Japan has experienced over the last 30+ years weren't a result of systemic global risks. They happened because of Japan's idiosyncratic problems during that time period, such as a high and rising debt-to-GDP ratio and an aging population (both of which the U.S. economy may be facing in the years ahead). An investor in 1990, however, would have had no way of predicting the economic factors that would drive Japan's long-term underperformance (or those of any other country, for that matter); in the same way, today's investors have no way of knowing how economic performance will shake out in the decades ahead, nor which countries – the U.S. or otherwise – will take the lead. And just as Japanese investors would have benefited from diversifying away from their home country, U.S. investors today face the risk that investing in their own country based on recent history will lead to a long-term underperformance of the global market.

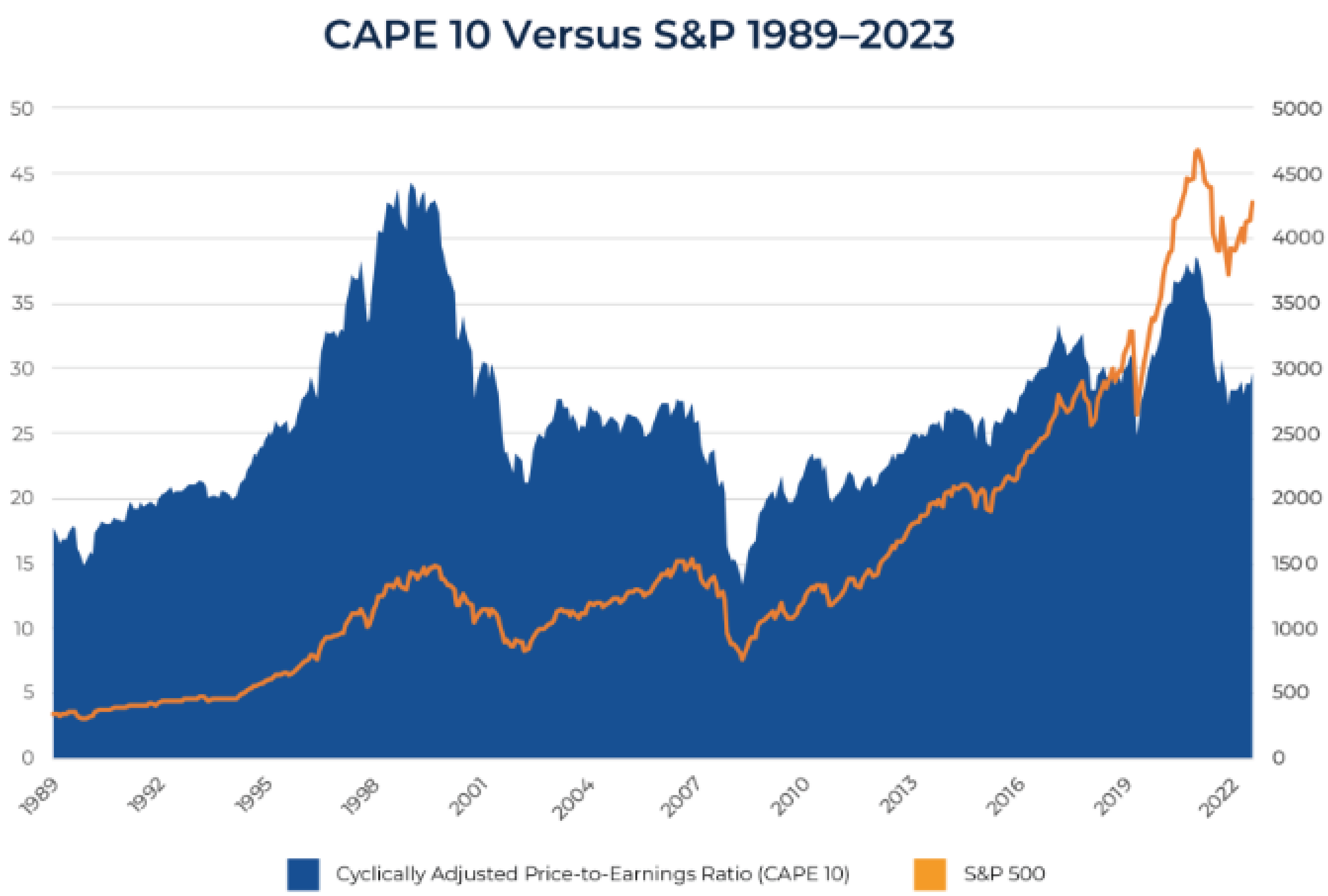
CHANGES IN VALUATIONS CAN LEAD INVESTORS TO MAKE THE WRONG CONCLUSIONS

When forming expectations about future returns, investors' biases towards recent and/or desired outcomes can lead them to fail to consider how past returns were earned. As we saw in the previous section, investment returns can be driven by underlying economic performance – such as through growth in earnings – or by changes in valuations (price-to-earnings multiples), and it makes a big difference for projecting future returns if the past returns were earned through growth in earnings or changes in valuations. In other words, just as trees don't grow up and up to the sky forever, neither do price-to-earnings (P/E) ratios.

Consider the following pattern for the Shiller Cyclically Adjusted Price-to-Earnings Ratio, or CAPE 10. (Note that its inverse Earnings-to-Price ratio or 'earnings yield' is as good a predictor as we have of future *real* returns). The data goes back to 1871, with the historical CAPE 10 mean being 17.0, or an earnings yield of 5.9%.

- At the end of 1989 the CAPE 10 stood at 17.7.
- By the end of 1999, it had risen to 44.2, explaining much of the superior performance of the S&P 500 over that period. Of course, rising valuations predict lower future returns.
- By the end of 2002 the CAPE 10 had fallen to just 23, explaining much of the poor performance of the S&P 500 from 2000 through 2002.
- By October 2007 (just prior to the Global Financial Crisis) the CAPE 10 had risen to 27.3
- By March 2009, the CAPE 10 had fallen all the way to 13.3.
- By the end of 2021, the CAPE 10 had almost tripled, rising to 38.3, explaining the strong performance of the S&P 500 over that period.
- The bear market of 2022 saw the CAPE 10 fall to 28.3.
- As of June 9, 2023 the CAPE 10 had risen back to 30.1, helping to explain the strong performance year-to-date of the S&P 500.

As is clear from the chart below comparing the CAPE 10 from 1989 to the present with the S&P 500 index price over the same time period, the bull markets of the late 1990s, 2003–2007, and 2009–2021 occurred as companies became higher-priced relative to their earnings, while the bear markets of 2000–2002, 2008, and 2022 were marked by steep reversions of those valuations towards the mean level.



Additionally, the chart above shows a clear pattern where high valuations forecast lower future returns and low valuations forecast higher returns (though unfortunately, while the CAPE 10 is as good of a predictor of long-term future returns as we have, timing markets based on its valuations in the short-term has not proven to be a successful strategy).

What does this have to do with international diversification? As Asness, Ilmanen, and Villalon showed in their paper, since 1990 the vast majority of the outperformance of U.S. equities versus the MSCI EAFE Index was due to changes in valuations: "In 1990, US equity valuations (using Shiller CAPE) were about half that of EAFE; at the end of 2022, they were 1.5 times EAFE." And although the U.S. outperformed international equities by 4.6 percentage points per year from 1990 to 2022, Asness et al. conclude that if valuations had remained unchanged over that time, the U.S. outperformance would have been just 1.2 percentage points per year. Understanding that U.S. valuations had risen over 3 times as much as their peers over the last 30 years, driving most of the outperformance of U.S. stocks over that time, the U.S. seems to be a much likelier candidate for a reversion going forward, which would lead to underperformance for investors with a U.S. bias.

It's worth noting that there have certainly been logical reasons for U.S. outperformance in recent years. As Asness et al. noted: "The positive story is that the US is rich for a reason – it is indeed hard to love European or Japanese equities except for valuation reasons." However, valuations matter – as shown above, they are our best predictor of future returns. The rising relative valuation of U.S. equities over EAFE equities to historically rich levels means that, without even considering a potential mean reversion in relative valuations, international equities now offer significantly higher expected returns. As of the end of March 2023, while the U.S. CAPE 10 earnings yield (the inverse of the CAPE 10) stood at 3.4%, the EAFE CAPE 10 earnings yield stood at 5.6%. Thus, if valuations do not change, investors should expect EAFE to outperform the S&P 500 by 2.2% per annum. If valuations reverted toward their historical means, the outperformance gap would be even wider.

INTERNATIONAL DIVERSIFICATION IS ESPECIALLY EFFECTIVE FOR FACTOR-BASED INVESTORS

Asness, Ilmanen, and Villalon note the following in their 2023 research paper:

Country equity markets have offered some degree of diversification even over the short run (0.75 median correlation across markets), and we've already argued how valuable that diversification can be, particularly over the long run. But correlations among long–short factors (e.g., the stock selection value factor in one country compared with the same implementation of value in another country) are substantially lower—0.26 median correlation across countries for the value factor up to 0.42 for the cross-country momentum factor.

They go on to add:

In addition to how diversifying these factors are across countries, they also tend to be fairly lowly correlated to equity markets themselves—that is, not only do these factors tend to be strongly diversifying to each other, they also tend to be strongly diversifying to the main risk in most investor portfolios and to macro risks.

They make the case that the low cross-country correlations of factors provide diversification benefits reducing the tail risk to investors, as do the low to negative correlations of the size, value, momentum and profitability/quality factors not only with the market, but with each other.

Advisor Takeaways

While economic theory and the empirical evidence suggest that the most prudent strategy is to diversify globally, it must be acknowledged that for many investors, diversification can be hard. The reason for this is that even a well-thought-out, diversified portfolio will inevitably go through periods of poor performance. And sadly, when it comes to judging performance, it is my experience that most investors believe that 3 years is a long time, 5 years is a very long time, and 10 years is an eternity.

Yet, as financial economists know, and the evidence in research papers such as Asness et al. bears out, events that take place over 10 years are very likely to be nothing more than noise that should be ignored. Otherwise, instead of following a disciplined rebalancing strategy of buying low (i.e., the recent underperformers) and selling high (the recent outperformers), investors chasing recent trends tend to do the opposite, buying high and selling low. Smart investors know that if they are well diversified, they will almost always have positions that have underperformed. To obtain the benefits of diversification you have to be willing to accept that reality and have the discipline to stay the course.

... Remember, investors cannot run away from risks, they only get to choose which risks they take. Failing to diversify globally creates the risk that the U.S. might follow in Japan's footsteps and be the next country to underperform for the next 30 years. Putting all your eggs in one basket is not a prudent strategy, no matter how familiar you are with, or how closely you watch, that basket.

The evidence has demonstrated that although the benefits of a global equity allocation may have been reduced by market integration, they have not disappeared. While global diversification can disappoint over the short term (as has been the case for those who have diversified away from U.S. stocks in the last 15 years), over longer time periods it is still the free lunch that economic theory and common sense imply.

Before making the mistake of confusing the familiar with the safe, no one knows which country or countries will experience a prolonged period of underperformance. That uncertainty is what international diversification protects against and is why broad global diversification is still the prudent strategy.

... And as Asness and his co-authors pointed out, adding exposure to other factors (such as size, value, momentum, and profitability/quality) provides further diversification benefits. ...

The bottom line is that while the prudent strategy is to globally diversify, unless the mistake of resulting (judging the quality of a decision by the outcome instead of the decision-making process) can be avoided, investors will likely fall prey to recency bias and abandon even a well-thought-out plan, likely at the wrong time. Helping to keep investors disciplined is one of the most important roles of a financial advisor.

Positions

PACW - Our attempt to profit from the market's excessive Regional Bank pessimism by buying this "falling knife" failed as it is now being purchased by BANC. We sold on 7/26, the day following the announcement, for all 6 clients at 9.62, which was just above the all stock offer at the time: