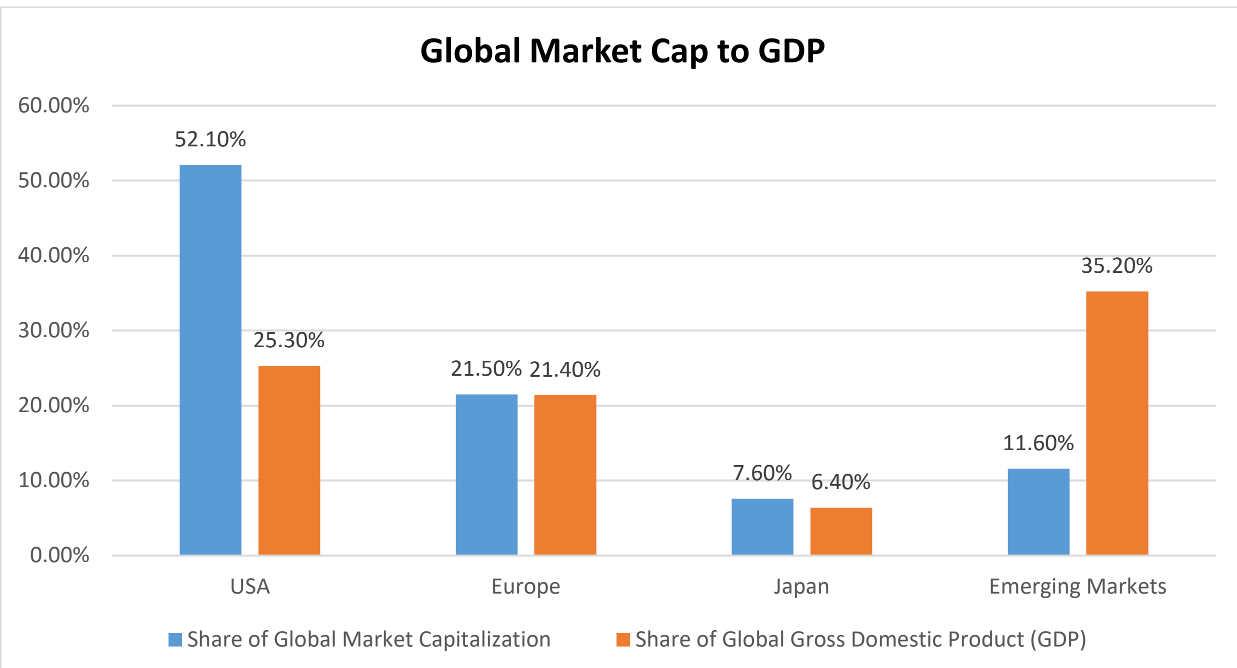
The World is Still Flat

By Robert Okada, CFA

Thirteen years ago, New York Times journalist Thomas Friedman wrote the international best-selling book *"The World is Flat."* The title suggests the world is an integrated global landscape in which we are all interconnected, with businesses and individuals having an equal opportunity to compete, consume, trade, or access information. He was right.

Apple's iPhone, for example, may be designed in California, but nearly every component is manufactured outside the U.S. As individuals, for instance, we can go online and buy a carpet from a vendor in Turkey, sell a pair of boots to a consumer in Hong Kong, or even check out someone's apartment in Vietnam before renting it for a holiday stay. The world is at our fingertips, yet the average U.S. advisors' allocation to international equities is just 22%.[1] In other words, within a 60/40 portfolio (60% equity / 40% bond), just over 13% of the portfolio is invested globally.

To put this number into context, let's use a valuation metric made popular by famed investor Warren Buffet, Market Cap to GDP.



Data: MSCI, IMF, Capital Group, World Bank

The U.S. generates about 25% of global GDP, yet its share of world stock market capitalization represents over half the entire globe, a twenty-year high, suggesting not only a massive over-allocation into U.S. stocks but a home bias among U.S. investors.

[1] Source: Barron's – 9.2017

Home bias is defined as a preference for the familiar. According to The Vanguard Group, "investors generally feel more comfortable with their home market and allocate investments accordingly, even if it results in a poorer risk return trade-off for their portfolio." [2]

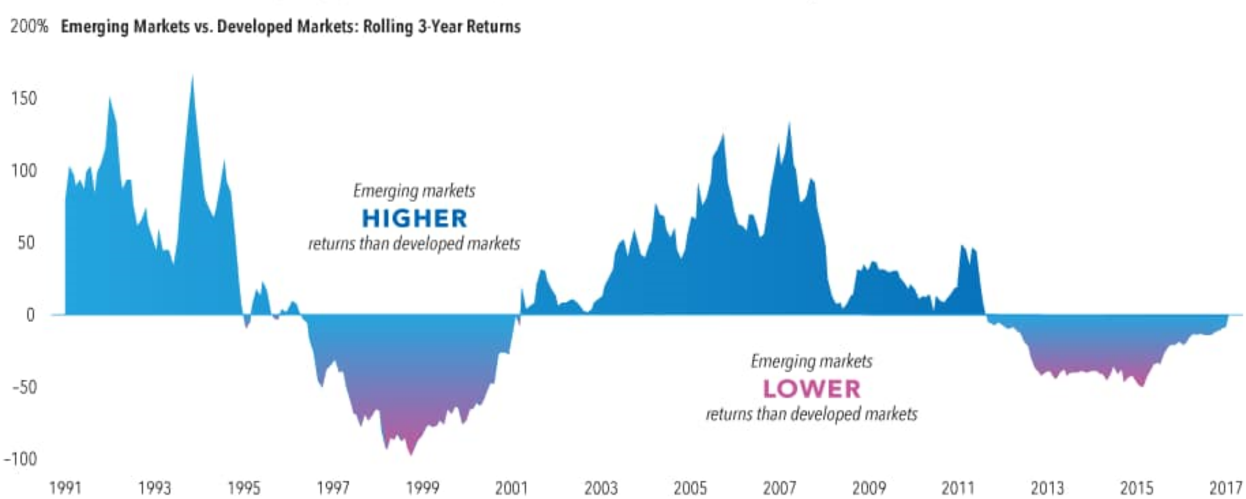
The graphic above also highlights that Emerging Market (EM) stocks are severely under owned and under-valued relative to its share of global output. According to BlackRock Group, U.S. advisor allocations to EM equities is a slight 3.5%.[3] As I wrote in January 2017 ("In 20 Years"), the emerging world, specifically emerging Asian economies, have some of the highest growth rates in the world being driven by highly favorable demographics and a rising middle class, also known as the *emerging consumer*.

According to the IMF (International Monetary Fund), emerging & developing Asia is forecast to grow at 6.5% over 2018-2019, while the U.S. and Eurozone are forecast to grow at 2.7% and 2.2%, respectively.[4]

Some readers of my November 2016 memo "Cambio, Change, Wechsel", will recall that currency risk for a U.S. dollar based investor, is a critical factor that helps drive foreign stock and bond returns. Therefore, it's important to identify both cheap currencies along with being on the right side of the U.S. dollar's trend.

This excellent graphic below shows that emerging market equities and currencies, tend to move in multi-year patterns and that even after a 2-year rally, a period of outperformance in emerging market assets may still be in the early innings.

Until Recently, Emerging Markets Equities Had Been Trailing Developed Markets for Years



Sources: Capital Group, MSCI, RIMES. Data represents cumulative rolling three-year total returns in U.S. dollars of MSCI Emerging Markets Index versus the MSCI World Index through 12/31/17.

[2] The Vanguard Group "The role of home bias in global asset allocation decisions" – 6.2012

[3] BlackRock Investment Institute – 11.2017

[4] IMF.org – 1.2018

Keep in mind, the Trump Administration's policies (and rhetoric) are widely viewed as protectionist, which has contributed toward an 11% decline in the U.S. dollar, just since the election fifteen months ago. According to Pimco, the U.S. administration is engaged in a "cold currency war" that supports a period of sustained dollar weakness.[5] Assuming November 2016 was the start of a new bear trend in the dollar, and historical patterns hold true (as illustrated above), then investors can anticipate a multi-year period of further dollar weakness, and strengthening currencies in emerging markets.

From a valuation standpoint, using a P/E ratio based on trailing 12 month earnings, emerging markets are still very attractive relative to developed markets in the U.S., Europe, and Japan.

Index	**P/E**
S&P 500	22.9
MSCI EAFE	17.6
MSCI Emerging Markets	14.7

Sources: Standard & Poor's; Europe & Japan is measured by the MSCI EAFE Index. U.S. is measured by the S&P 500 Index. Emerging Markets are represented by the MSCI EM Index.

After the most recent ballistic move in most risk assets since the 2016 election, I expect a period of consolidation in global equities as interest rates move higher and assets get re-priced to reflect a higher absolute level of rates worldwide. However, I believe there's a secular shift into emerging market assets from U.S. equities where EM's share of world stock valuation will catch up with its 35% (and rising) share of global GDP, while the reverse holds true for the U.S.

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[5] Source: Pimco – "Winning the Cold Currency War", Joachim Fels - 1.31.2018