Mutual funds

White paper

Global investing: What's ahead?

The case for portfolio diversification with international equities

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KEY HIGHLIGHTS

- U.S. stocks have outperformed international stocks since the market bottom in 2009, but current valuations appear to favor developed and emerging international stocks.
- Sectors and industry exposures in international stock indices are substantially different than the S&P 500®, offering different diversification and income benefits.
- Growth in international economies and equity markets has generally lagged the U.S. in recent years, but once current geopolitical uncertainties are resolved these markets may be poised for strong relative performance when the U.S. growth cycle peaks.

SUMMARY

The U.S. equity market has consistently outperformed international stock markets since the end of the financial crisis due to faster economic growth, expanding price-to-earnings multiples and greater exposure to the technology sector. Because of the structural, geopolitical and demographic challenges facing international markets, many investors are wondering if the time for international exposure in a diversified portfolio has passed. While the duration and magnitude of underperformance has been severe, exposure to international markets may continue to provide diversification benefits.

PERFORMANCE: GLOBAL STOCKS POISED TO REBOUND

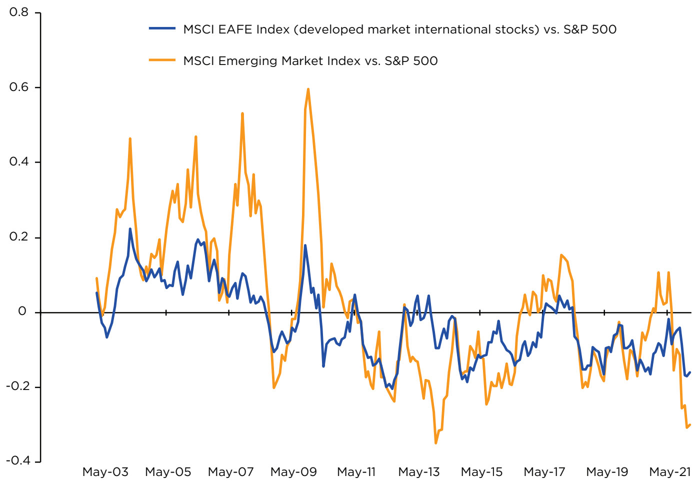
As 2021 came to a close, U.S. equities continued the trend of strong outperformance against developed and emerging international stock indices. From the end of the global financial crisis in 2009 through March 2022, international equity index returns were above their long-term averages but the S&P 500® Index still outperformed, exceeding the MSCI EAFE Index (developed international stocks) by an average of 8.1% per year (17.2% for the S&P 500 vs. 9.1% for the MSCI EAFE Index) and the MSCI Emerging Markets Index by an average of 8.1% per year (17.2% for the S&P 500 vs. 9.1% for the emerging markets index). On a rolling annual basis, the international stock indexes have mostly underperformed the S&P 500 (see Chart 1 on following page).

The global equity landscape changed dramatically in Q1 2022 with the Russian military invasion of Ukraine. All three major stock market benchmarks slid into correction territory (losses of 10% or more) during the quarter. As of this writing, it is too soon to tell if the trend of U.S. stock market outperformance relative to international stocks will remain in place.

Periods of out- or underperformance of international stocks relative to U.S. stocks tend to be lengthy. The last period of extended outperformance for international stocks occurred after the technology bubble of the late 1990s and early 2000s. There are similarities to that period in the current market, including elevated valuations in the technology sector and substantial outperformance of growth stocks relative to value. International equity markets tend to be dominated by cyclical and traditional value sectors, including financials, industrials and consumer cyclicals, while the S&P 500 is dominated by technology. If value sectors begin to catch up to growth, international equities are likely to follow suit.

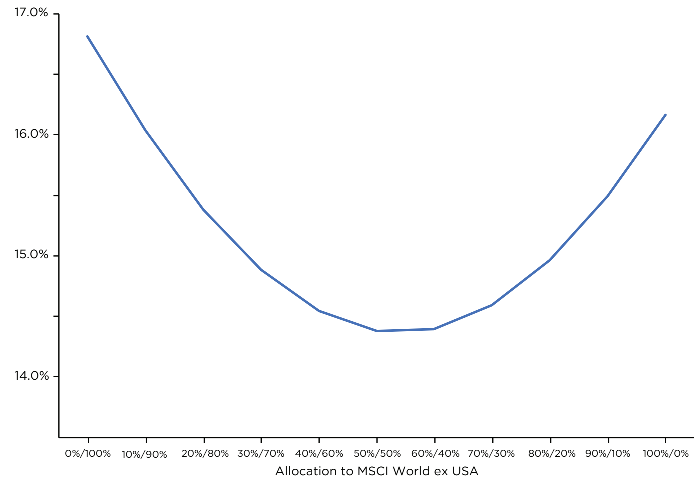
Despite the extended period of underperformance, exposure to international stocks in a diversified portfolio has lowered volatility relative to a portfolio solely comprised of U.S.-only stocks. As illustrated (see Chart 2), a portfolio with a 40% allocation to the MSCI World Index had a 14.4% standard deviation over the 51-year period from 1970 to 2021. In comparison, the standard deviation of the S&P 500® over that time was 16.2%. Moreover, the balanced portfolio had a better Sharpe ratio, reflecting the diversification benefit of investing internationally.

Chart 1: Relative performance vs. S&P 500 Index (trailing 12 mos.)



Source: FactSet, 03/31/22.
Past performance does not guarantee future results.

Chart 2: Portfolio standard deviation, 1970-Q1 2021



Source: Morningstar, 03/31/22.

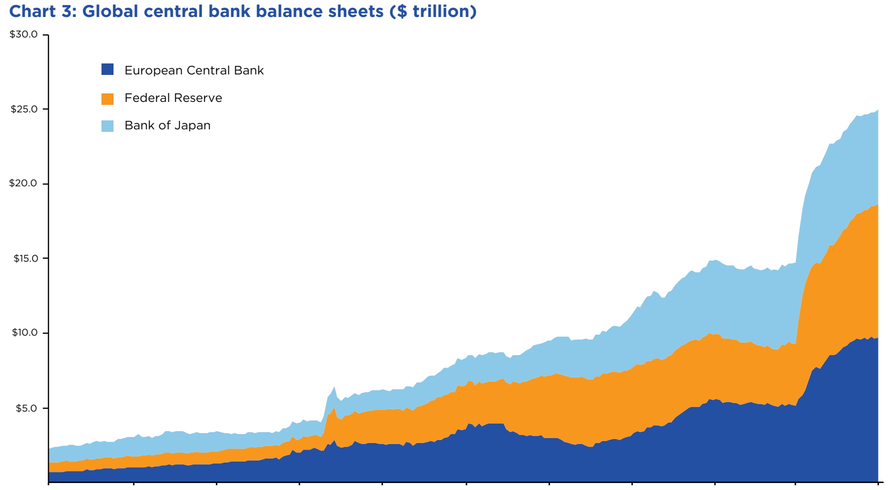
RECOVERY: GLOBAL STOCKS SHOULD CLOSE THE GAP

The global economy has recovered significantly from the early stages of the pandemic, though challenges from geopolitics, commodity markets and COVID uncertainty remain. While the Federal Reserve has turned hawkish in removing monetary support, by raising interest rates and curtailing asset purchases, central banks in most advanced international economies remain accommodative (with the exception of the Bank of England, which raised its key bank rate by a quarter-point in February 2022, see Chart 3.)

It's not unusual for the U.S. to lead the rest of the world out of recession, as historical patterns show the U.S. is often among the strongest economies in the early stages of a global recovery. But as the U.S. economic recovery matures, the rest of the world often catches up, performing better in the mid-to-late phases of a global expansion. This is particularly true for emerging markets that are reliant on developed market consumers and businesses to drive their economic growth.

While the U.S. tends to lead the rest of the world, there are a lot of moving parts in the current environment.

Chart 3: Global central bank balance sheets ($ trillion)



Source: Federal Reserve Bank of St. Louis (FRED data), 02/28/22.

For example, the Chinese economy remains complicated, with the Chinese government balancing elevated property valuations with the continued impact of the country's "zero COVID" policy. This volatility has continued to drive supply chain disruptions, while worries about China's relationship with Taiwan add to geopolitical uncertainty.

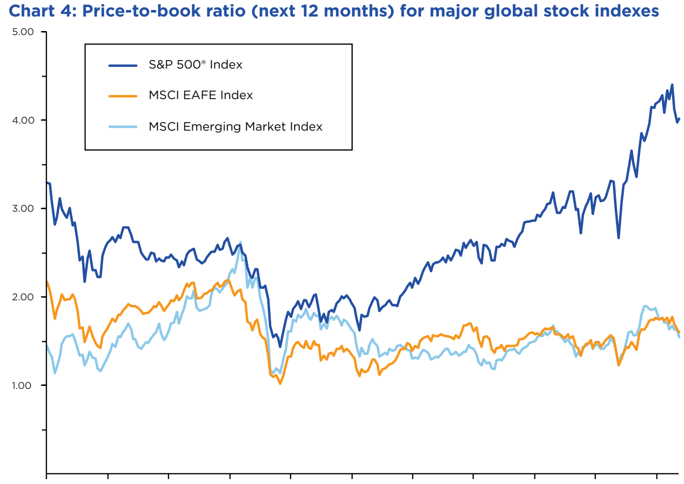
VALUATION: OPPORTUNITIES AT A RELATIVE DISCOUNT

International stock indices have substantial sector and industry exposure differences to the S&P 500® Index. For example, the MSCI EAFE Index is comprised of more pro-cyclical and value factors; as of March 31, 2022, the financial, industrial and consumer discretionary sectors comprise 45% of the MSCI EAFE Index. Conversely, the S&P 500 is more exposed to growth factors, with technology, consumer discretionary and health care comprising 53% of the U.S. index's weight. The differences in sector exposure tends to lead to extended periods of outperformance and underperformance, but also provides a diversification benefit to investors.

The post-financial crisis period is notable for the strong performance of growth stocks versus value and domestic U.S. equities versus international. This outperformance has created a stark valuation difference between U.S. and international stocks. The price-to-book ratio for the S&P 500 tripled from 1.4x to 4.0x since 2009, while the price-to-book multiple expansion for the MSCI EAFE and Emerging Markets indices has been far more modest (see Chart 4). Valuation is traditionally a poor predictor of near-term returns but has strong inverse correlation with longer-term results; stocks purchased at modest valuations have historically produced better returns. This occurred following the technology bubble, where international markets enjoyed an extended period of outperformance.

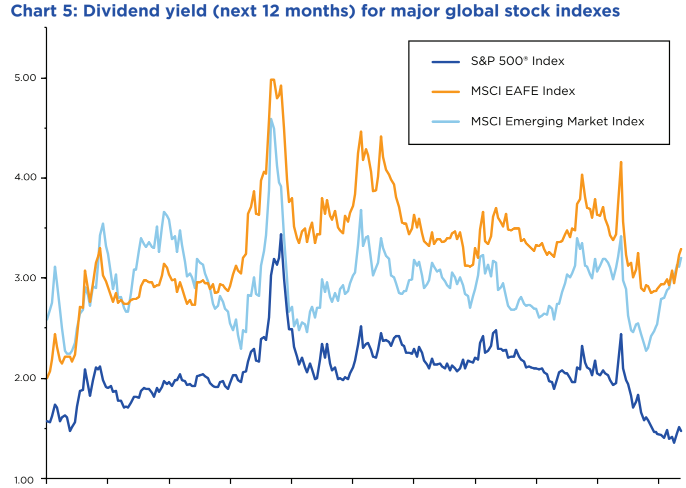
Sector exposures also lead to a substantial yield advantage for international equities over U.S. stocks. As of March 31, 2022, the MSCI EAFE and Emerging Market indexes yielded 3.3% and 3.2% respectively, a solid advantage over the 1.5% dividend yields for the S&P 500 (see Chart 5). In periods of strong price returns, investors pay less attention to dividends. But as the cycle matures and returns become more difficult to achieve, a 100-basis point advantage in yield will provide a tailwind for relative returns.

Chart 4: Price-to-book ratio (next 12 months) for major global stock indexes



Source: FactSet, 03/31/22.
Past performance does not guarantee future results.

Chart 5: Dividend yield (next 12 months) for major global stock indexes



Source: FactSet, 03/31/22.
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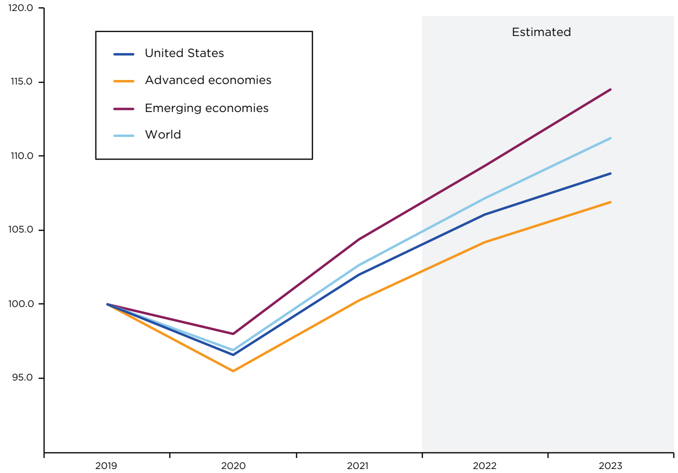
GROWTH: EARNINGS WILL LIKELY BE KEY

Economic growth for developed international markets has been sluggish since the global financial crisis. From 2013 through 2019, the U.S. grew at an annualized rate of 2.5%, slightly ahead of the 2.2% annualized rate of growth for advanced economies (which includes the U.S.) but below the 4.3% annualized pace of growth for developing economies and global pace of growth of 3.3% annualized (see Chart 6). Between 2019 and 2022, the United States is forecast to grow a cumulative 6.1%, compared with 4.2% estimated growth for advanced economies and 9.4% estimated growth for emerging economies. While population growth and other demographic trends may continue to push domestic growth above that of the developed world, U.S. growth is likely to lag the developing world.

Earnings growth will likely be key in determining the long-term relative performance of domestic U.S. stocks versus international markets. The recovery in earnings in 2021 was strongest for international developed markets (see Chart 7), but that trend appears to be weakening in 2022. Longer-term forecasts point to expected growth rates that are similar among U.S. and international stocks indexes, highlighting the substantial valuation gap and opportunity available from international equity markets.

Chart 6: Cumulative real Gross Domestic Product growth (2019-2023 est.)



Source: FactSet, 03/31/22.
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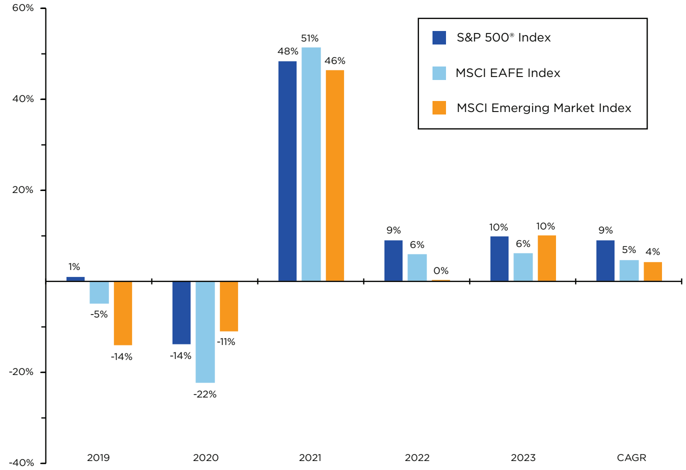
Chart 7: Earnings growth of major global stock indexes



Source: FactSet, 03/31/22.
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CONCLUSION

The sharp rise in geopolitical risk this year may present an opportunity for global financial markets to reset after several years of U.S. outperformance. The U.S. is generally ahead of other economies in the growth cycle and in shifting to tighter monetary policies and higher interest rates.

But as other countries and regions catch up with the U.S., equity markets are likely to reflect the opportunity for economic expansion. Given the significant valuation and performance gaps, international stock markets could see an extended period of outperformance that has not been seen since the late 1990s and early 2000s. Additionally, given the greater dividend yield and diversification benefit, exposure to international equities is important for a well-balanced portfolio.

Key takeaways

1

At current valuation levels, international stocks **appear to offer better potential** relative to U.S. stocks for future return opportunities.

2

Adding international stocks to a portfolio of predominantly domestic U.S. stocks offers **potential for greater diversification and lower risk.**

3

Once geopolitical uncertainties between Russia and Ukraine are resolved, **global markets may be in a good position** to close the gaps in growth with the U.S.

ABOUT THE AUTHOR

Mark Hackett serves as Chief of Investment Research. As a leader for Nationwide's capital markets analysis, Mark develops content to educate financial advisors and their clients on financial markets and implications for investors. In this role he is responsible for asset class research, market commentary, white papers and topical market pieces. Mark brings more than 20 years of experience in the asset management industry, including roles in research for both Nuveen and Vanguard Group and as a portfolio manager for Nuveen. He began his investment career at the Vanguard Group as a research associate in the fixed income group.

Mark has been interviewed by and quoted in numerous media outlets, including The Wall Street Journal, CNBC.com, CNN Money, The Associated Press Money and several others. He also contributes weekly market commentary to the Nationwide Advisor Advocate Blog.

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S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

MSCI EAFE® Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large-cap and mid-cap stocks in developed markets as determined by MSCI; excludes the United States and Canada.

MSCI Emerging Markets® Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large-cap and mid-cap stocks in emerging-country markets as determined by MSCI.

MSCI World® Index: An unmanaged, free float-adjusted, market capitalization-weighted index that is designed to measure the performance of large-cap and mid-cap stocks in global developed markets as determined by MSCI.

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