LPL RESEARCH WEEKLY MARKET COMMENTARY

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GLOBAL GETS GOING

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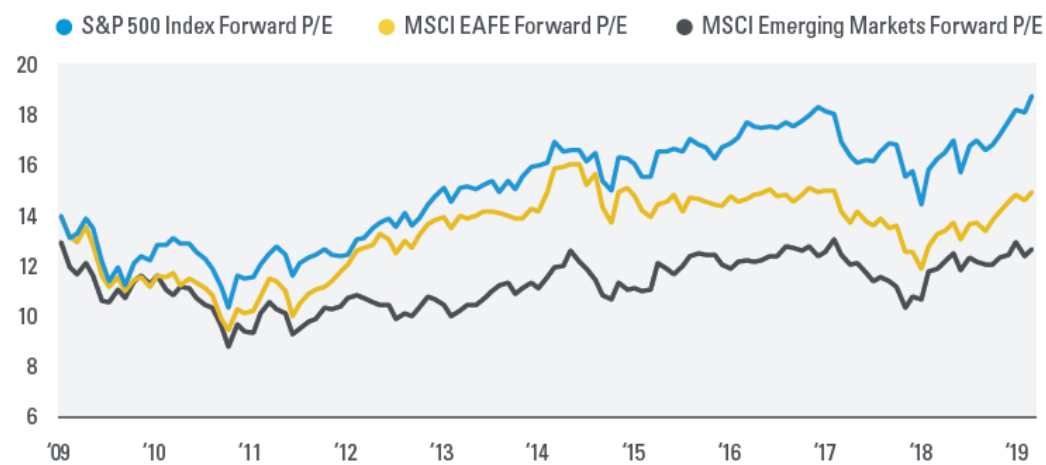
Stocks in developed markets outside the United States have underperformed those in the United States almost without interruption for the last decade. While the long-lasting U.S. stock market dominance has us understandably cautious, we are warming up to international equities. We highlight four main reasons why international equities' performance could be poised to improve.

ECONOMIC BACKDROP

Economic growth in developed international economies continued to slow at the end of 2019 and remained tepid into 2020. Efforts to boost growth through fiscal policy and structural reforms saw little success. The benefits of aggressive monetary policy appear to be exhausted. The exit of the United Kingdom (UK) from the European Union (EU), known as Brexit, and rising populism have not helped.

But there is some good news. We have seen evidence that economic growth has stabilized in developed economies around the world. This overall positive development has garnered our attention, even as the coronavirus outbreak has temporarily reduced economic activity in China.

1 VALUATION GAP BETWEEN U.S. AND INTERNATIONAL EQUITIES HAS WIDENED



Source: LPL Research, FactSet 02/06/20

The MSCI EAFE Index represents equities domiciled in developed international markets. The MSCI Emerging Markets Index represents equities domiciled in emerging market countries.

A forward price-to-earnings ratio (P/E) is the index price divided by the index's consensus earnings per share estimates over the next 12 months.

FOUR REASONS TO CONSIDER GOING MORE GLOBAL

We aren't quite ready to recommend investors move some of their U.S. equity allocations over to developed international markets. However, we highlight four reasons we're starting to think seriously about upgrading our outlook for developed international equities.

Expanding valuation discount. The developed international equity benchmark, the MSCI EAFE Index, has been trading at a forward price-to-earnings (P/E) ratio slightly below 15, which is about 20% below the United States. Right now, stocks in developed international markets are more expensive in absolute terms than they have been over the past decade. However, as shown in **FIGURE 1**, they currently are valued much more attractively relative to U.S. stocks than they have been historically.

Stabilizing global growth. EU gross domestic product (GDP) growth has slowed from near 2% to barely over 1% in the past year. Consensus expectations call for growth of only about 1% in 2020 (Source: Bloomberg). Japan GDP grew north of 1% through the first three quarters of 2019 before slumping to 0.6% in the fourth quarter, and consensus forecasts call for meager 0.5% GDP growth in 2020.

Although growth in Europe and Japan may remain lackluster, we have seen some encouraging signs. The latest Leading Indicators Index from the Organisation for Economic Co-operation and Development (OECD), which tracks leading data from several regions around the world, rose for a third straight month in the latest release, which covered the period ending November 30, 2019. This included an upgraded outlook for the key German economy. More recently, forward-looking purchasing managers' surveys in Europe and Japan have improved, pointing to the potential for stable, if not better, growth in these areas in coming quarters.

Growth leadership may start to wane. The developed markets outside the United States that make up the MSCI EAFE Index (Europe, Australasia, and Far East) are more value-oriented markets. That means when growth stocks in the United States have led a global rally, as they have in recent years, developed international equities have tended to lag. We expect the U.S. growth rally to at least slow this year, or possibly reverse, given its duration and magnitude, which could provide a better environment for international stocks. (Our current view on growth/value style equities is neutral.)

U.S. dollar rally due for a pause. The U.S. Dollar Index has been rising since early 2018, even as the Federal Reserve cut interest rates three times last year. In just the first six weeks of 2020, the dollar has been up more than 2%. Looking ahead, we expect the combination of stabilizing growth in international economies, less aggressive (more normalized) policies from the European Central Bank and the Bank of Japan, and the twin deficits (trade and budget) in the United States to put increasing downward pressure on the dollar.

QUICK THOUGHTS ON EMERGING MARKETS

We maintain our positive view of emerging markets, and we continue to recommend suitable investors consider carving out a small piece of their equities allocation for exposure to the asset class where appropriate. The pace and trajectory of economic and earnings growth appears superior to international developed markets, and the U.S.-China trade deal may help support Chinese growth.

The coronavirus outbreak will hurt economic growth in China, but we are hopeful that China's aggressive containment efforts will soon be successful and limit potential additional drag on its economy. China's central bank has provided fresh stimulus to help offset the impact. We never want to minimize the loss of human lives, but the history of prior outbreaks such as SARS, bird flu, and swine flu suggests we could see a manageable near-term impact on global economic output, as we wrote in last week's commentary.

FOCUS ON THE FUNDAMENTALS

When we look around the world, we still see better economic fundamentals and opportunities for earnings growth in the United States and emerging markets than in developed international markets, primarily Europe and Japan. However, some evidence has emerged that economic growth in Europe and Japan has stopped slowing, and it could begin to improve soon. Current valuations support international investments, and we continue to believe in diversification over the long term in appropriate strategies. Stay tuned.

WEEKLY MARKET PERFORMANCE REPORT

Please see our new *Weekly Market Performance* report with insights on major asset classes.

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