MV CAPITAL MANAGEMENT

Weekly Market Flash

The Underperforming (Non-US) World

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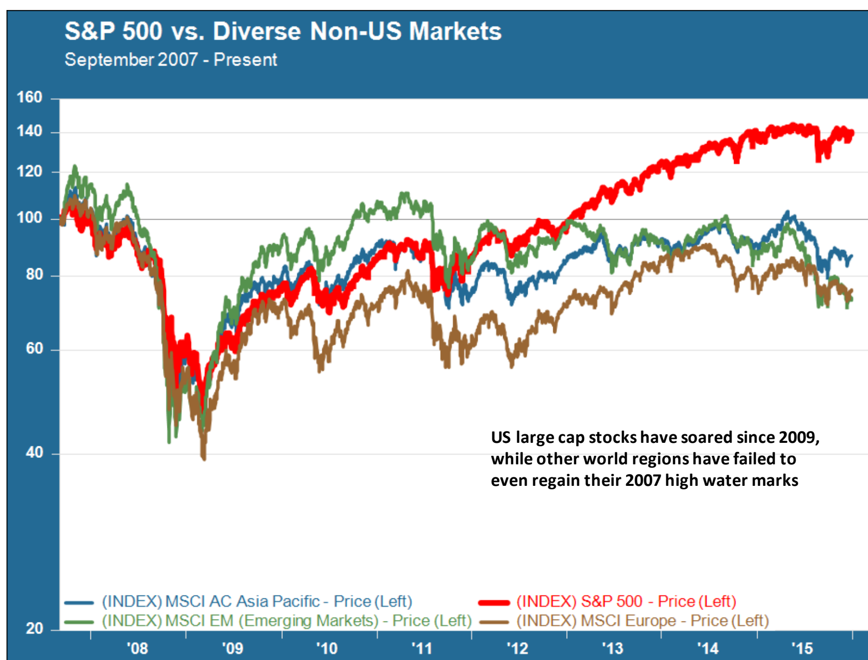
After the three year bear market of 2000 to 2002, stock indexes around the world enjoyed a sustained bull cycle with broad participation across all major regions from the US to Europe, from Latin America to developed and emerging Asia. Most major markets set all-time highs in October 2007. Then came winter, and then another spring.

We broadly think of the period from the 2009 market bottom to the present as another single, uninterrupted bull market. Indeed, as measured by the standard of the S&P 500 or any other major US stock index, that moniker fits. But – unlike 2000-02 and most prior bull markets – the same cannot be said for the rest of the world. For example the MSCI Europe, All Country Asia and Emerging Markets indexes, as shown in the chart below, have all failed to recapture their October 2007 high water marks. For much of the non-US world, the post-2009 period can be divided into two periods: a recovery from the 3/09 trough into the summer of 2011; and then a listless sideways performance from then to the present. In fact, all three of these non-US indexes remain today below their post-recovery 2011 high points.



Source: MVF Research, FactSet

As anybody with a diversified portfolio knows, the S&P 500 has been a devilishly unforgiving benchmark for most of the last four years, the bane of many an asset allocator and active stock picker alike. Is there anything about the unusual contours of this time period that suggests what might lie in store? Is it time to anticipate mean reversion and load up on non-US assets, or is it better to hunker down for ever more years of Pax Americana? We consider three alternative scenarios below.

#1: Central Banks Rule , World Catches Up

This scenario starts with the largely uncontroversial observation that central banks have been the headline story in risk asset markets since 2009 and especially since the Fed announced its second quantitative easing program – QE2 – in 2010, following up with QE3 in fall 2012. QE2 in particular is a textbook case study in how central banks move markets; one can picture then-Fed chair Ben Bernanke simulating an all-net jump shot with a smug "that's how it's done." That year started off poorly for US stocks, with lots of volatility and a handful of pullbacks of 5 percent or

more throughout the spring and summer. In August the Fed hinted that it was considering a second QE program, after QE1 ran out in June. That was all markets needed hear to stage a robust second-half rally (the formal QE2 announcement only came in November). QE2 firmly established the playbook for the Bernanke put: more liquidity from the Fed whenever markets run into trouble. Thus there was no great amount of surprise when QE3 played out in almost exactly the same way, in fall 2012, guiding markets over the so-called "fiscal cliff" and safely into the solid double-digit returns of the next two years.

Other central bankers came later to the stimulus party, but almost all eventually showed up at the punch bowl. The "world catches up" scenario posits that non-US markets will benefit from being in the springtime of their policy stimulus programs while the US settles into autumn. Even with a more dovish Fed stance on the cadence of rate hikes this year, policy divergence is still very much a reality. The key question is whether central bank stimulus today packs the same punch as it did in 2010 and 2012. If not, we may be looking at a second scenario.

#2: Central Banks Wane, World Swoons

It would be fair to say that market reaction to monetary stimulus policies this year has been all over the place, and perhaps nowhere more so than in Japan. When the Bank of Japan moved into negative interest rate territory last month there was a very brief moment when everything went according to plan: stocks up, domestic currency down. That reversed quickly, though. In the week following the BoJ announcement the Nikkei 225 plunged and the yen soared. The currency has set successive twelve month highs against the dollar since the policy decision was announced. Over in Europe, ECB showman Mario Draghi had somewhat better luck with the markets when he announced that the ECB would essentially pay banks to make loans through a loosening of terms for the existing long term refinancing operations (LTRO) policy.

But the ECB's move raises the expectations bar. If cheap LTRO winds up not making much of a dent in real economic activity in Europe it will reinforce a growing belief among investors that central bank stimulus amounts to not much more than a temporary reprieve for risk asset markets. The Fed is in the crosshairs on this point as well. Much editorial chatter has been expended this week on the apparent divisions among FOMC members about the appropriate pace of rate decisions this year. If the market's collective consciousness wraps itself around the idea that central bank puts have slipped out of the money, it will then be forced – heaven forbid – to take stock of growth and earnings prospects in the real economy. That could lead Mr. Market straight to the fainting couch. Or, alternatively, things could start looking up for growth and profits, producing a third possible scenario.

#3: Valuation Matters Again

The US economy is doing okay – not great, but okay. China has not (yet) lived down to fears of a hard landing in its economic transition. Europe is staying out of recession while some Eurozone economies such as Spain are doing quite alright, thank you very much. Brazil remains a basket case, but its neighbor Argentina is coming back into the mix after a long winter. India continues to grow nicely. Commodities markets are recovering. It is not out of the question that the world economy could emerge as a more pleasant place for companies to ply their trade. If this happens, we would expect a closer focus on valuation levels that in turn could favor bargain-hunting in those world markets that have underperformed the S&P 500 in recent years. This would be especially true if a strong dollar continues to be the major revenue and profits headwind for US companies (though we should note that the dollar has lost some of its force as of late, particularly against the yen and the Aussie dollar).

Of course, it is just as plausible that none of these scenarios will come to pass. Associating cause with effect is never easy in financial markets, and this year has been particularly problematic for the professional soothsayers of our industry. The fact is, though, that in a global economy it is unlikely that the asset performance of one country will dominate the landscape forever, even if that country is the largest and most influential. Sooner or later, those geographically diversified portfolios will likely have their day. Some advance preparation may not be a bad idea.

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