Market Commentary
December 31, 2016

The Big Picture…

The concept of global diversification continued to frustrate US investors in 2016. For the fourth year in a row, US equities outperformed international stocks in both developed and emerging markets (in US$ terms), and have now done so in 7 of the last 10 years.

Global equity markets, broadly speaking, were down slightly for the Q4 (MSCI World ex-US down 0.36%) and slightly positive (+2.75%) for the calendar year. By comparison, the broad US equity market was up 3.82% and 11.96% on a total return basis for Q4 and 2016 respectively.

The United States…

The Presidential election – and its surprise outcome – dominated the news and preoccupied investors during the quarter. Recall how stock futures plummeted on election night as results came in and Trump compiled a lead in Electoral votes. But by the open the following morning, markets had turned positive and have barely looked back since.

In a year that began with the worst two weeks in the history of the stock market, we ended with the full-year broad market performance comfortably ahead of modern day long-term averages. Furthermore, US value stocks handily outperformed growth stocks in 2016, with the US MSCI Value Index up roughly 17% in total return terms versus a gain of only 6% for the US MSCI Growth Index.

The "animal spirits" that were ignited by a Trump victory (not to mention Republicans retaining control of the House and Senate) were rooted in hopes for a more business friendly political environment (lower corporate taxes, regulatory relief, etc.), which should theoretically lead to higher after-tax earnings and justify higher P/E's.

Also driving optimism is the expectation for fiscal stimulus, which has raised inflation expectations and helped push the yield on the 10-year Treasury bond to the 2.45% range by year-end. That's about a 0.60% rise since the election.

We won't argue the merits of the investment rationale which is driving equity markets higher in the US. But suffice it to say, with the Fed raising rates and the job market near "full-employment", fiscal stimulus as contemplated by a Trump administration could very well lead to inflation rather than higher output or higher productivity. Furthermore, while markets seem convinced reform is a done deal, the reality of the political environment would suggest otherwise. The Democrats are poised for a fight on all fronts to protect a progressive (Obama) legacy.

Europe...

The Euro area economy has suffered several shocks this decade, including regional housing bear markets, banking system strains, and a sovereign debt crisis (or two). This has left investors worried about the state of the regional economy, but perhaps too much so.

The current economic expansion looks remarkably similar to that of the US almost four years ago, when the latter was broadening and becoming increasingly durable. The Euro-area economy is still vulnerable to major political and/or economic shocks, but it is more resilient than generally perceived by investors – in our opinion. This is encouraging for the global growth outlook and risk asset prices.

The much anticipated reform referendum vote in Italy was rejected in early December – and the event came and went with little fanfare. But Renzi did resign and the "No" vote reduces the likelihood of Italy enacting meaningful structural reforms to close the economic performance gap with Germany. 2017 will bring national elections in the Netherlands (March), France (May), Italy (December) and Germany in the fall of 2017.

The British economy appears to have weathered the initial shock of the "Brexit" vote, although the pound hovers near a 30-year low. Share prices have recovered to levels prior to the vote. But uncertainty remains until the negotiations with the EU play out, after Prime Minister May invokes Article 50. This process could take up to two years.

Overall, the Euro area is better but GDP growth is still below trend at 2%.

Japan…

We have little to report on Japan that is not redundant (i.e. inflation has not materialized; therefore we continue to hold the view that the primary objective of "*Abenomics*" has not been achieved). In any event, the MSCI Japan index rose 2.73% in 2016, trailing the broad developed world by some 600 bps. The good news…since the BOJ altered its policy approach in September, Japanese equities have outperformed. The change in policy was an attempt to steepen the yield curve without additional monetary easing and weaken the Yen. We feel this was a tacit admission that monetary policy alone is not the solution to Japan's economic woes and that fiscal spending must be part of the policy mix. However, a relatively weak Yen (due more to US$ strength) is good for the exporters. Late in the year, we increased our relative exposure to Japan, which is now much closer to a market weight than we have been in some time.

Emerging Markets…

EM equities suffered in Q4 after the US election due to the stronger dollar and the harsh rhetoric from Trump on trade policy.

Growth in China continues to slow. GDP growth was 6.7% through the first nine months of 2016. China's problems include industrial overcapacity, weak private sector fixed investment, and a consumer sector that struggles to be competitive, because many of the sub-sectors are dominated by inefficient State Owned Enterprises (SOE's).
In the face of these weaknesses, China's economic first-aid tactics—liquidity provision and government stimulus—aren't working. To generate long-term domestic growth and remain a driver of global growth, China needs to get serious about reforming its services sector, allowing for increased competition and reducing inefficiencies in government-heavy industries such as healthcare and telecommunications. Its leadership needs to focus less on stimulus and more on production and efficiency.

Brazil's economy appears to have bottomed out. Projections are for meager growth (less than 1% GDP in 2017 per the IMF) and the road to recovery will be long. The PMI index was down in November and December as was consumer confidence. Combined with the political upheaval and we are at a loss to explain the 66% rise in Brazilian equities in 2016 (which followed a 44% decline in 2015).

A final note…

If there was ever a time to be relatively optimistic about international stocks, we think that time is now. Home country bias has become too acute in light of the streak of US equity outperformance versus the rest of the world. No one country offers full global stock market exposure (despite what John Bogle says!). We suggest avoiding recency bias and ensure your client's portfolios are globally diversified.

Furthermore, the global economy is heating up. The flash Manufacturing PMI numbers for December suggest that this may have been the best month for manufacturing around the world in over five years. Moreover, both Europe and emerging markets have far more room to grow over the next few years than the US due to still high unemployment in the former and stronger natural productivity growth in the latter.

International stocks are generally cheaper. The forward P/E ratio of the MSCI-EAFE index of developed country international stocks is 14.7 times compared to a 25-year average of 16.4 times. The price-to-book ratio of the MSCI-EM index is 1.40 times compared to a 25-year average of 1.67x.

The dollar is probably too high. In the third quarter, the US ran a current account deficit of 2.4% of GDP. Our sources estimate that this should rise to roughly 3.3% of GDP by the end of 2018 or over $670 billion. This growing deficit should push the dollar down in the long run, amplifying un-hedged international equity returns.

The Gratry Investment Team

Sources*: Gratry Research, JP Morgan, MSCI, Standard & Poors, Forbes, IMF*
Performance of all indices referenced includes net dividends.
It is not possible to invest directly in any index referenced above.
All data are believed to be reliable, but we cannot guarantee their accuracy.