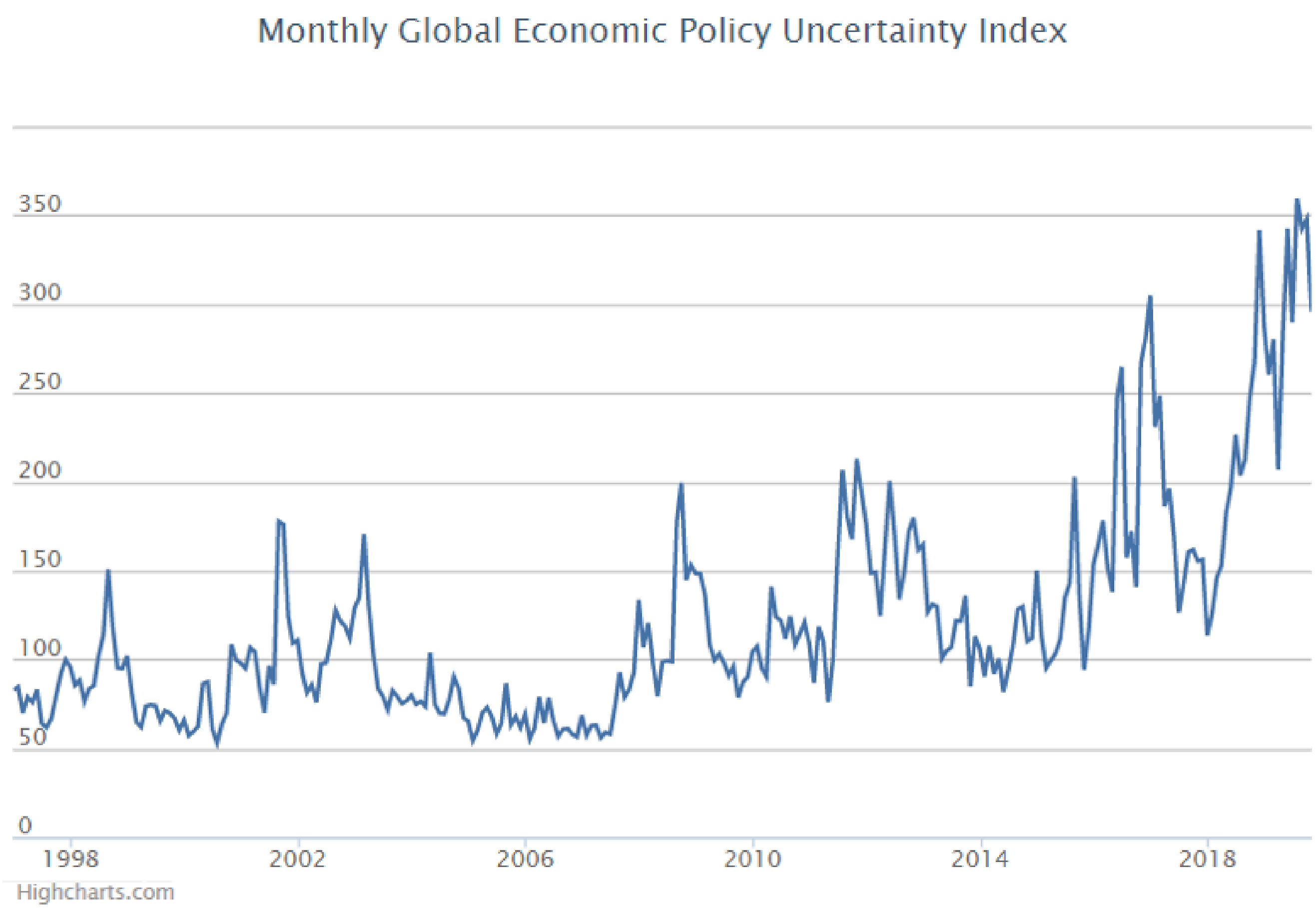
Hopes emerge!

The Bottom Line:

Markets rallied higher this week as global uncertainty levels fell. The US Fed expects no change to interest rates for all of 2020, Trump and China announced a “phase one” trade deal, and the British handed the conservative party a sweeping majority and a Brexit mandate. Risk assets rallied worldwide with the largest gains recorded in long-forgotten emerging markets. A quick quantitative analysis of emerging market currency and equity values reveals that they reside at the lowest comparative levels globally while their expected earnings growth rates rank among the highest. Should this week’s array of policy proclamations permeate 2020, emerging market equity outperformance may once again… emerge.

The Full Story:

Markets rallied to new highs this week on a significant reduction in investor confusion! Over the past year, the global markets have been bedeviled by monetary uncertainty (rates, QE), trade uncertainty (US vs. China, no NAFTA) and political uncertainty (Brexit, impeachment). It’s no wonder that the Global Economic Policy Uncertainty Index sits at atmospheric levels:

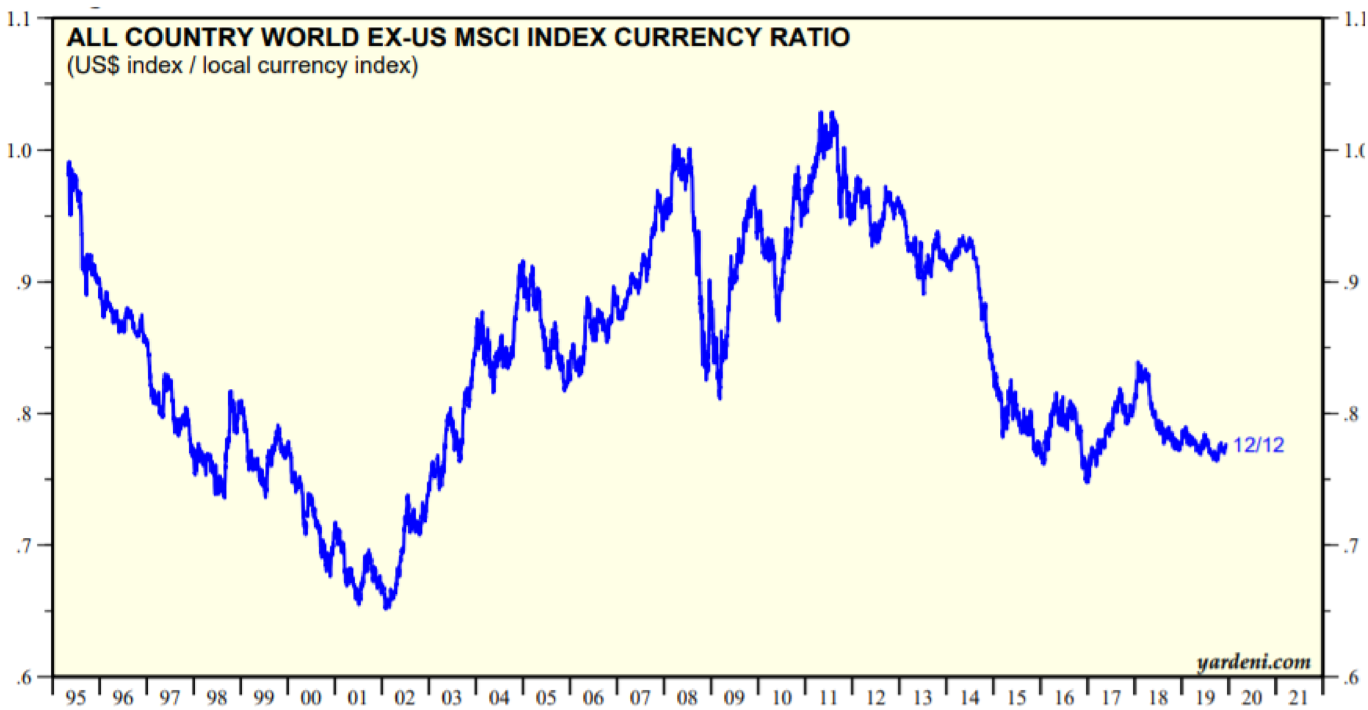


However, within this week, the Fed clarified its do-nothing position on rates, Trump & China shook hands on a skinny "phase one" trade deal and the Conservative Party claimed victory in the UK, which all but assures Brexit on January 31st. Global markets reacted bullishly:

Asset Class	Symbol	1 Week Return
Chinese Equities	FXI	3.78%
UK Equities	EWU	3.40%
Emerging Markets	EEM	3.23%
European Equities	VGK	1.87%
US Equities	SPY	0.71%
US Dollar	DXY	-0.53%

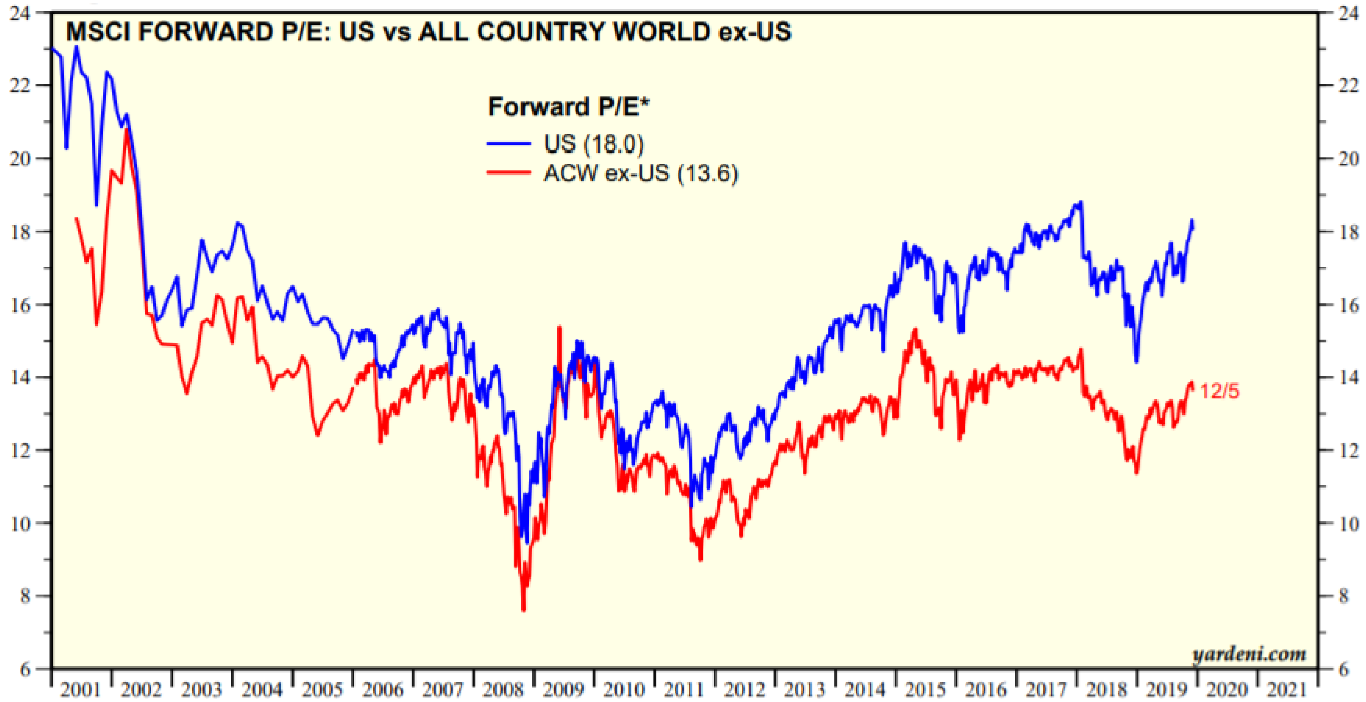
Clearly, Chinese investors benefitted the most from the news. Economically, the US imports $500 billion from China while China imports $100 billion from the US. This puts the US in a much stronger negotiating position, making any trade war cease-fire disproportionally more beneficial to the Chinese economy. UK equities outperformed as citizens resolved the Brexit debate by awarding pro-Brexit incumbent Boris Johnson the largest conservative majority since Margaret Thatcher. Whether the UK economy can survive decoupling from the EU remains debatable by some (not us), but the simple removal of the Brexit uncertainty led to a 2% move higher in the pound and a 3.5% move higher in UK stocks. For the emerging markets, which rely heavily on global GDP growth and rising trade volumes, de-escalation of trade frictions brightens outlooks. Not only did we get news of an interim China/US accord this week, but House Democrats announced an agreement with President Trump on USMCA, the NAFTA replacement bill. European equities also disproportionately benefitted from reductions in global uncertainty, quietly extending their recent uptrend. Lastly, rising risk appetites continued to pressure the safe-haven US dollar as currency investors reconsider offshore offerings. Sooo…in summary, a reduction in global uncertainty thanks to central bank policy stasis, trade negotiation progress, and Brexit resolution led to a rise in confidence globally, which inspired investors to venture offshore. Let’s take a moment to ponder the international investment landscape.

Any comparison of US vs. international investment opportunities must begin with currency. A strengthening US dollar adds a tailwind for US assets, while a weakening US dollar adds a tailwind for foreign assets. This chart highlights the relative strength and weakness of the US dollar since 1995.



When the line descends, domestic currency and therefore domestic stocks hold advantage. Conversely, then the line ascends, international currencies and international stocks hold advantage. To test the theory, the last time offshore currencies caught a bid was 2017. In 2017, emerging market equities returned 37% while US equities returned 21%. Conversely, the US dollar surged in 2015, with US equities returning 1.5% and emerging market equities falling 15%. More durable shifts in currency regimes tend to persist for years. Should trade tensions retract while global economic growth brightens, we could see more than a short-term blip higher in offshore currency values.

Valuations tell you nothing about near term market timing, but they do reveal longer-term relative opportunities. Currently, the US trades at 18x forward earnings while the ex-US markets trade at 13.6x.



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, then weekly.
Source: MSCI.

Advantage non-US. Digging even deeper, the emerging markets trade at an even more advantaged P/E of 12.1x. Winner, winner! But before blindly hitting low valuation bids, investors must also consider earnings growth rates. Using MSCI earnings data, US corporations grew earnings 24% in 2018 and 1.1% in 2019. Compare this to developed and emerging market corporations, which grew earnings 3% and 8%, and -2% and 1% respectively. Advantage USA. However, in 2020, MSCI predicts earnings growth of 9% in the US, 8% across ex-US developed nations and 15% across emerging nations. In sum, for 2020 the emerging markets have the lowest currency and equity valuations alongside the highest expected earnings growth. Should this week a year make, investors may want to spend 2020 venturing abroad.

Have a great weekend,

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Sources: Yardeni Research