



WILLIAM STERLING

STERLING'S WORLD REPORT



## Three Reasons to Focus on International Equities

Despite lacklustre action in recent months, the U.S. market has enjoyed a healthy recovery from the bear market of 2000-2002. In our opinion, the U.S. market should continue to advance for some time if the current global expansion turns out to be in its early stages. That said, we have been increasing our global funds' exposure

to non-U.S. equity markets over the past few quarters and believe that these markets have good prospects for outperforming the U.S. for the next few years.

There are three simple reasons supporting this view:

1. Foreign markets generally have more attractive valuations.
2. After the massive stimulus of recent years, U.S. economic policy is likely to be more restrictive.
3. The U.S. dollar remains vulnerable to further declines.

### Lower Valuations Overseas

The valuation story is straightforward. By any number of conventional valuation metrics, non-U.S. equity markets are significantly cheaper than the U.S. market. As we show in Chart 1, for example, the U.S. market is nearly 50% more expensive than the average MSCI EAFE (Europe, Australia and the Far East) market on the basis of price-to-book value and price-to-cash earnings.

A variety of other valuation metrics confirms the same story. On a simple P/E ratio based on 12-month forward earnings,

the U.S. market is trading at around 17 times, while European and Asian markets are at 13 times – a 30% differential in favour of foreign markets. On a dividend yield comparison, the U.S. market offers a dividend yield of only 1.7%, while the average MSCI EAFE stock offers 2.5% – a 47% differential.

Now if such measures were perfect predictors of what stocks will do in the future, there would be a lot more billionaires in this world. The comparative valuation chart did not look remarkably different during the late 1990s when the U.S. market outperformed foreign markets for several years in a row. Other factors obviously matter, with the U.S. economic dynamism and relative stagnation in Europe and Japan having accounted for much of the U.S. performance advantage in the late 1990s.

The U.S. economy came roaring back in 2003, so perhaps that justifies some of the U.S. market's valuation premium. But that's where some consideration of business cycle and U.S. dollar dynamics comes into play. Last year, despite America's strong business cycle recovery, many foreign markets performed better than the U.S. market in dollar terms. Therefore, as far as last year was concerned, relative valuation and currency factors outweighed the business cycle factor.

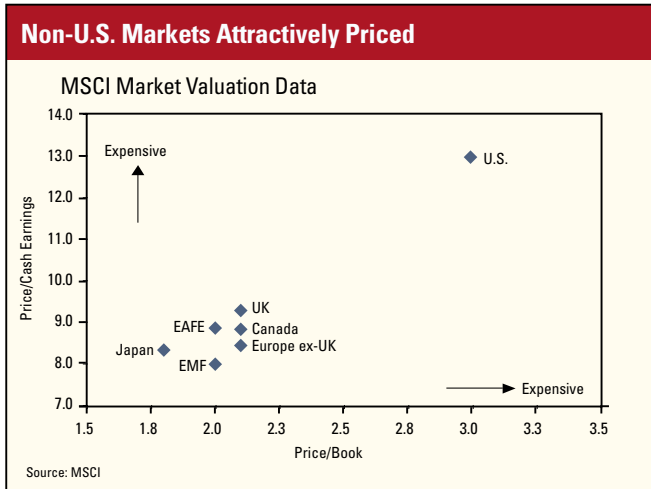


Chart 1: The U.S. market still commands a substantial valuation premium when compared against most foreign markets. How justified this is remains to be seen.

**A Tough Act to Follow**

The U.S. economy is currently posting some of the most impressive growth numbers seen in decades. The ISM purchasing managers' survey – which is the most timely coincident indicator of business activity – has hit its highest levels in more than 20 years. Aggregate corporate profits were up more than 30% from a year ago in the latest quarter. The labour market has improved significantly and most market participants believe that the economy has now started a self-sustaining expansion, where more jobs beget more spending, more spending begets new jobs, and so on.

The stellar profit growth of recent quarters may be a tough act to follow. Looking ahead, it is almost certain that the year-on-year growth of profits will begin to slow in coming quarters. Profit margins have been pushed to the limit over the last year by a combination of stronger-than-expected demand and – until very recently – little job growth and intense cost controls. However, with employment growing, the productivity surge that led to the boom in profit margins will probably begin to fade.

Underpinning the U.S. economy's recovery was an almost unprecedented degree of monetary and fiscal stimulus. The

Federal Reserve's aggressive series of rate cuts brought the Federal funds rate down to 1.0% and meant that real rates (rates adjusted for inflation) turned negative. That created a boom in housing and a huge windfall for consumers, who were able to refinance their mortgages at the lowest rates in over 40 years. On the fiscal policy side, the U.S. shifted from a federal budget surplus of 2.5% of GDP (\$236 billion) in 2000 to an estimated deficit of 4.5% of GDP (\$521 billion) in 2004. That reflects the impact of major tax cuts by the Bush administration and loss of revenues associated with the period of weak economic growth.

Few other major nations pursued economic stimulus as aggressively as the U.S. in recent years. As a result, their business cycle recoveries have generally been more muted. That means that their economies generally have more room to run before they need to withdraw stimulus through raising interest rates or restrictive fiscal policy. With its one-quarter-point rate hike on June 30, the Fed has just started to slowly reverse the degree of monetary stimulus in the U.S. economy. And no matter who wins the presidential election this November, there are likely to be some pressures to begin to curb the U.S. budget deficit.

The no-nonsense folks at the International Monetary Fund (IMF) have become so concerned about the U.S. budget position that they devoted a special section of their recent World Economic Outlook to the topic of "How Worrisome is the U.S. Fiscal Outlook?" The somewhat dry conclusion is worth repeating:

"To date, the U.S. fiscal expansion has supported the recovery from recessions in the United States and elsewhere without apparent adverse effects on long-term interest rates. This expansion provided significant support for the global economy over recent years. However, there are reasons to be concerned that this cannot last. At some point, the support for activity will almost certainly be eroded through some combination of withdrawal of stimulus and/or higher long-term interest rates, as the U.S. government debt rises."

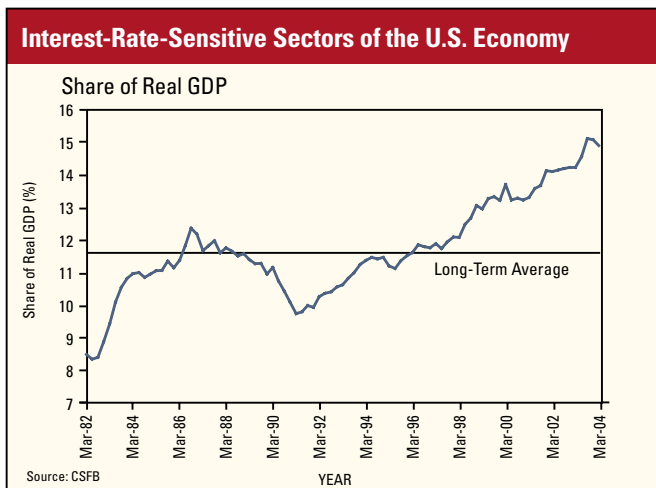


Chart 2: Interest-rate-sensitive sectors like housing and consumer spending have become extremely important to the U.S., suggesting some economic vulnerability as rates rise.

Translation from IMF-speak: “How Worrisome is the U.S. Fiscal Outlook? Pretty Worrisome.” Set against a backdrop of relatively high expectations and relatively high equity valuations, the issue for U.S. equity investors is that long-term growth expectations may well have to be lowered at some point in the future if the U.S. deficit issue comes home to roost. This type of issue can often take a number of years to play out in terms of market dynamics, but is definitely worth considering from an asset allocation perspective.

So too is the fact that much of the buoyancy of the U.S. economy in recent years can be attributed to higher debt taken on by households in response to lower interest rates. As shown in Chart 2, the share of U.S. real GDP accounted for by interest-rate-sensitive sectors has grown dramatically over the last decade. These sectors include autos, home furnishings, home improvement, and new home construction. With U.S. mortgage debt having risen by almost \$1 trillion over the last year, or nearly 10 times the pace of a decade ago, one can question the sustainability of growth in these sectors as U.S. rates begin to rise. Likewise, the fact that financial sector profits now reflect nearly 40% of U.S. stock market profits means that the U.S. market may be more sensitive to rising interest rates than other markets.

### Dollar at Risk?

The U.S. dollar has recovered somewhat this year as investors began to anticipate tighter U.S. monetary policy. However, as we pointed out in our February *World Report*, bear market cycles for the U.S. dollar have typically been multi-year affairs. As shown in Chart 3, bear market dollar cycles in the past have lasted five to 11 years, while this bear market cycle is a little more than two years old.

In the short run, virtually anything can happen in volatile foreign exchange markets. That said, we find it difficult to imagine that the dollar will not resume its downtrend over the next few years. As we show in Chart 4, the U.S. is running a massive current account deficit of nearly 5% of GDP. That is larger in relative terms than the current account deficit of about 4% of GDP posted in the mid-1980s – and that deficit ushered in an 11-year bear market in the U.S. dollar.

As you might expect, the folks at the International Monetary Fund have something to say about this issue as well:

“Likewise, the large U.S. current account deficit, exacerbated by the effect of fiscal stimulus on U.S. domestic demand, will

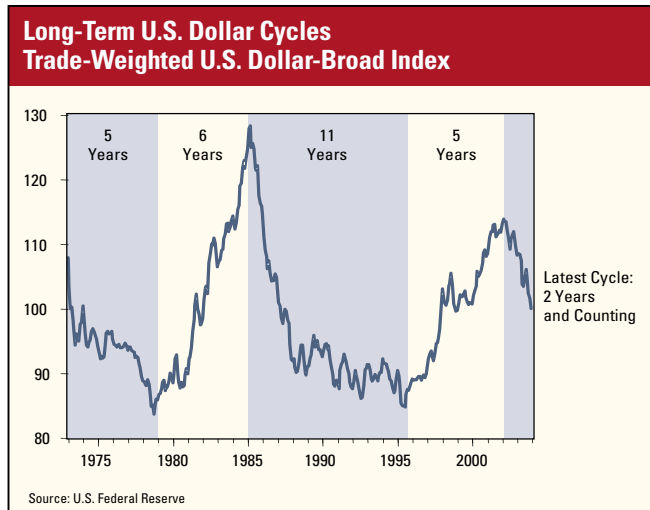


Chart 3: Bear market cycles for the U.S. dollar have been multi-year affairs. At just two years and counting, the current bear cycle could still be in its relatively early stage.

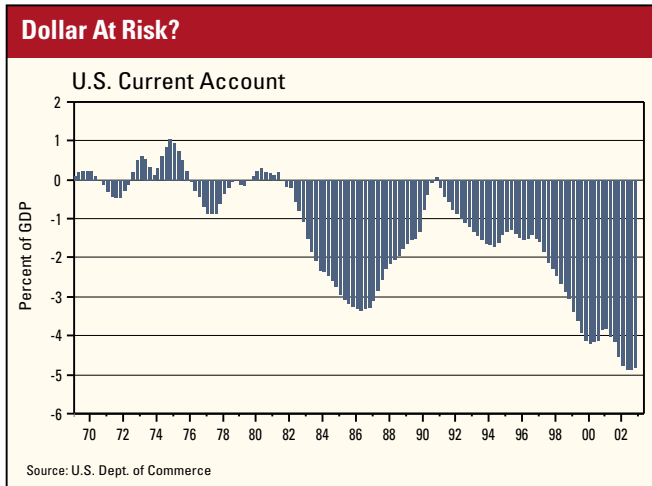


Chart 4: Correcting America's large current account imbalance will require faster growth overseas and a weaker U.S. dollar, especially against Asian currencies.

have to be rebalanced. ... Achieving an orderly resolution of U.S. and indeed global imbalances requires a co-operative strategy that includes medium-term fiscal consolidation in many industrial and emerging market economies; greater currency flexibility, especially in most of emerging Asia; a faster pace of pro-growth structural reforms in the euro area and Asia; and further banking and corporate reforms in Japan.”

Translation: “The U.S. will have to kick its import habit by letting the dollar weaken – especially against Asian currencies. Europe and Japan have to boost their growth.”

From an international investors’ perspective, the message is clear: Positive growth surprises need to come from Europe and Japan. Some fiscal belt tightening, a weaker dollar, and possibly higher interest rates are needed to slow consumer spending in the U.S. In addition, the bear market for the U.S. dollar is far from over. If those major trends play out over the next few years, we suspect that non-U.S. markets will outperform the U.S. market by a significant margin.

How are we reflecting these views in our global funds? We currently have only about 40% of our global equity portfolio in the U.S., compared to a U.S. weight of 55% in the MSCI World universe. We are also tilted away from consumer

discretionary and financial stocks in the U.S. market and prefer to have exposure to those sectors in Europe and Japan, which are at earlier stages in their respective credit cycles. Finally, we are hedging about 10% of our U.S. dollar exposure because of our concerns about further dollar weakness.

Outside of the U.S., we remain broadly diversified. Nearly 30% of our global equity holdings are in Europe, nearly 20% in Japan, and about 6% in the emerging markets. Our exposure to the Japanese market is the highest it has been in many years, reflecting our view that Japan has finally addressed many of its domestic financial sector and corporate restructuring challenges and is poised for a durable expansion.

For fund investors who are nervous about the U.S. market, but find valuations in non-U.S. markets relatively attractive, this may be the time to revisit the distinction between global funds and international funds. Most global funds invest anywhere in the world, including the U.S., and are measured relative to the MSCI World Index or similar benchmarks that have 55% exposure to the U.S. market. In contrast, most international funds invest in foreign markets excluding the U.S. and Canada, and are typically measured relative to the MSCI EAFE or similar benchmarks that have zero exposure to the U.S.

So far this year, the MSCI EAFE Index is up about 8.8% in Canadian dollar terms, while the S&P 500 Index is up 7.3%. While there is no guarantee that the EAFE index will continue to outperform the U.S., our view is that this trend could continue for a number of years.

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