International Stocks – Opportunity or Landmine?

International stock markets were the star in 2017 and outperformed the U.S. stock markets. However, 2018 paints a very different picture for international equities. Both developed equity markets in Europe and emerging markets remain negative for the year. Many investors are puzzled as to why international stocks are down this year and questioning whether they should remain invested. In this week's Thought for the Week, we explore these questions further.

Why international markets have lagged U.S. stock markets so far

The uncertainty of the ever-escalating trade war and tariffs has weighed on international stocks, and on emerging market stocks in particular. However, there are two additional key factors impacting markets abroad that may be less obvious.

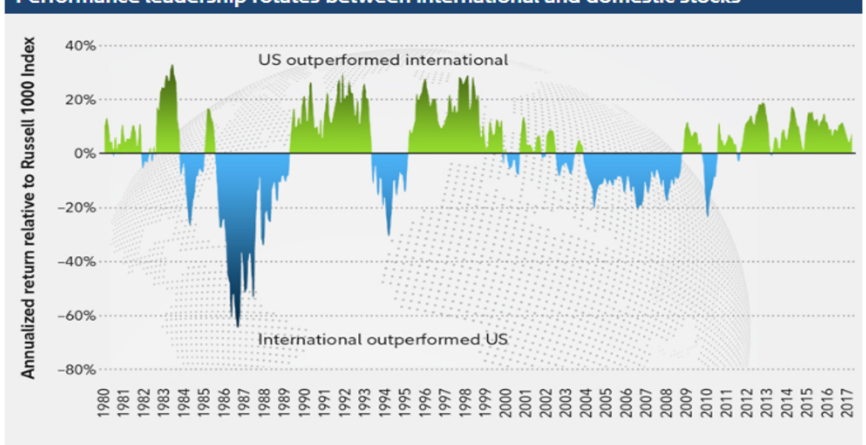
First, the strong dollar has a negative influence, especially on emerging markets, primarily through its impact on commodities and the external debt profile. Commodities are priced in dollars and typically move lower when the dollar strengthens, reflecting its increased purchasing power. Many of the emerging countries are commodity exporters and thus suffer when commodity prices move lower. In addition, emerging market governments, banks and corporations took advantage of low-cost dollar debt to shore up their finances. As the dollar strengthens, the cost of servicing this debt increases, and governments of emerging countries could face additional pressure if they don't have matching revenue or assets.

Another less-discussed aspect of the divergence in returns is the impact of the Federal Reserve's action to raise interest rates in the U.S. You can now get roughly 3% yield on the 10-year Treasury bond, a commonly used reference benchmark. Thus the U.S. is offering compelling yields with lower risk than, say, emerging markets, causing capital to flow out of those countries and come to the U.S. In other words, why would an investor seek out investments in Greece, which offers approximately 4% for its 10-year bond, when one could earn a 3% risk-free return in the U.S.? As capital flows out of these countries, international investments will continue to take a hit until global rates normalize.

Are there reasons to invest abroad?

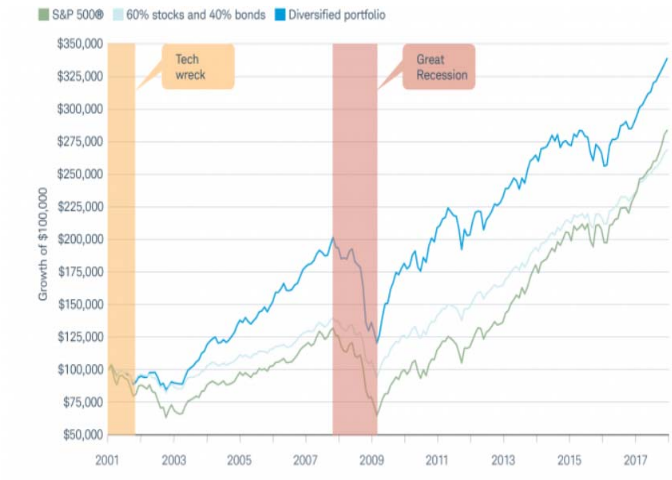
While the U.S. is home to some of the greatest companies in the world, it is important to look at the bigger picture. First, according to MSCI index data, U.S. equities only comprise approximately half of the world's total equities capitalization. As such, investing solely in the U.S. leaves a significant opportunity behind. Second, a study by Fidelity shows domestic and international stocks have moved in a cycle of alternating performance over the past four decades. While past

Performance leadership rotates between international and domestic stocks



Source: Data from Morningstar Inc. Rolling 12-month return. A value greater than 0 shows domestic stocks outperformed international stocks, while a value less than 0 shows international stocks outperformed domestic stocks. Domestic stocks as measured by the S&P 500 Index from January 1979 to January 1987 and Dow Jones Total Market from February 1987 to December 2017; foreign stocks as measured by the MSCI® EAFE from January 1979 to November 2000 and MSCI ACWI Ex USA from December 2000 to December 2017. All indexes are unmanaged and include reinvestment of interest and/or dividends. Investors cannot invest directly in an index. See footnotes for index definitions.

performance is no guarantee of future performance, periods of underperformance have occurred in the past and can be expected to reverse again as well.



Source: Morningstar Direct and the Schwab Center for Financial Research. Data is from January 1, 2001, to December 31, 2017.

The 60/40 portfolio is a hypothetical portfolio consisting of 60% S&P 500® Index Stocks and 40% Bloomberg Barclays U.S. Aggregate Bond Index bonds. The diversified portfolio is a hypothetical portfolio consisting of 18% S&P 500, 10% Russell 2000, 3% S&P U.S. REIT, 12% MSCI EAFE, 8%, MSCI EAFE Small Cap, 8% MSCI EM, 2% S&P Global Ex-U.S. REIT, 1% Bloomberg Barclays U.S. Treasury, 1% Bloomberg Barclays Agency, 6% Bloomberg Barclays Securitized, 2% Bloomberg Barclays U.S. Credit, 4% Bloomberg Barclays Global Agg Ex-USD, 9% Bloomberg Barclays VLI High Yield, 6% Bloomberg Barclays EM, 2% S&P GCSI Precious Metals, 1% S&P GSCI Energy, 1% S&P GSCI Industrial Metals, 1% S&P GSCI Agricultural, 5% Barclays U.S. Treasury 3–7 Yr. Including fees and expenses in the diversified portfolio would lower returns. The portfolio is rebalanced annually. Returns include reinvestment of dividends, interest and capital gains. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. **Past performance is no indication of future results. Diversification strategies do not ensure a profit and do not protect against losses in declining markets.**

Finally, investors who pursue a globally diversified portfolio don't have to attempt to pick winners. Diversifying globally implies an investor's portfolio may not be the best performing relative to any one stock market, but it also means it may not be the worst performing. To illustrate the value of diversification, Schwab conducted a study comparing the growth of $100,000 in three hypothetical portfolios for a period from 2001 through 2017. The portfolio with 60% globally diversified stocks, 35% globally diversified bonds and 5% broad commodities with varied assets was able to weather market turbulence and positioned to take advantage of broader opportunities, and thus outperformed despite the underperformance of broad international markets in recent years.

Conclusion

Thanks to strong corporate earnings, stocks in the U.S. have had a good run in recent years, but they also face higher valuations than their peers globally. In other words, U.S. stocks are no longer offering bargains. According to Fidelity and MSCI, nearly three-quarters of the world's companies are headquartered outside the U.S, and international investment represents nearly half of the global stock markets. As long as international and U.S. stock returns are imperfectly correlated in the long run, a diversification benefit should exist.* While this benefit is generally clear and significant over the long term, it is sometimes not apparent over shorter investment horizons.

*Diversification does not ensure a profit or protect against loss. Foreign markets can be more volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets.