# Still a Good Time for International Equities?

## Business cycle approach favors international equities, though there are differences with prior cycles.

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### Key Takeaways

- Global economic activity may be reaching peak levels, but the synchronized global expansion continues to provide a supportive backdrop for international equities.
- Recession risks in the U.S. remain low, and the traditional business-cycle playbook recommends favoring international equities even when the U.S. fully transitions to the late cycle.
- We believe there are upside risks to global inflation that will likely translate into greater market volatility, and potentially boost foreign currencies.
- Because commodities now represent a smaller percentage of the emerging-markets universe, emerging-market equities may not benefit as much from the typical inflationary pressures and rising commodity prices seen historically when the U.S. has drifted into the late cycle.
- Overall, we remain constructive on international equities on a cyclical basis, with smaller portfolio tilts and exposure to inflation-resistant assets warranted at this juncture of the business cycle.

The synchronized global expansion has been perhaps the primary driver behind the exceptional performance of global equities over the past two years. The acceleration in global industrial activity and trade volumes underpinned a widespread increase in corporate profit growth and business sentiment. In 2017, international equities outperformed U.S. markets for the first time in five years.

The typical business-cycle road map for asset allocation—based on historical patterns—has tended to favor international equities over U.S. stocks as an economic expansion becomes more mature. Traditionally, the U.S. economic cycle has generally matured more quickly than the rest of the world, implying other economies have tended to maintain more mid-cycle properties even as the U.S. drifted into the late-cycle phase. The U.S. late cycle has traditionally been characterized by growing inflationary pressures and rising commodity prices, which have tended to boost emerging-market (EM) equities due to their exposure to commodity exports and strong global growth. As the current U.S. expansion pushes toward the end of its ninth year, a key question is whether those historical patterns are still a worthwhile guide to making cyclical equity allocation tilts within a diversified portfolio.

## Global business cycle in solid expansion, though activity likely peaking

We begin, as always, with a look at the current state of the business cycle. Currently, almost all of the world's major economies are in an expansionary phase of the cycle, as 2017 rendered the most synchronized global reacceleration in several years (Exhibit 1). This expansion has occurred across both developed and emerging economies—leading economic indicators for nearly 80% of the world's largest 40 countries are rising—and recession risks around the world are extremely low.

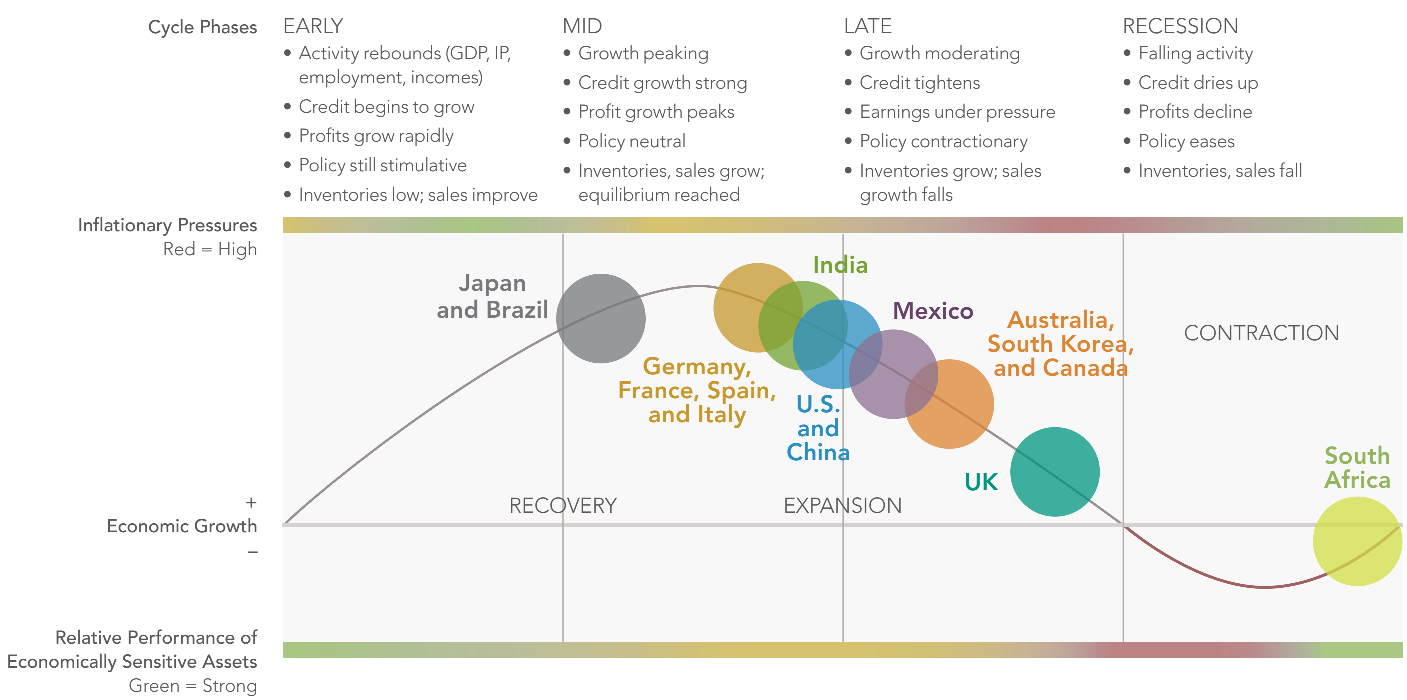
Many countries in core and peripheral **Europe** are enjoying above-trend growth, with the eurozone as a whole in a solid mid-cycle expansion.

- Initially bolstered by reaccelerating manufacturing sectors, the eurozone expansion has broadened. Labor markets have tightened somewhat, and various surveys of both consumer and business sentiment have risen to cycle highs.
- Company profitability reaccelerated during the past year, with earnings growth bouncing from double-digit year-over-year percentage declines in late 2016, to up more than 25% at year-end 2017.

The **U.S.** is experiencing a mature expansion, with mid-cycle dynamics and some hints of late-cycle trends.

**EXHIBIT 1: The world's largest economies are in expansion, though at various phases of the business cycle.**

Business Cycle Framework




Note: The diagram above is a hypothetical illustration of the business cycle. There is not always a chronological, linear progression among the phases of the business cycle, and there have been cycles when the economy has skipped a phase or retraced an earlier one. Source: Fidelity Investments (AART), as of January 31, 2018.

- Company profitability has reaccelerated meaningfully in the past year, and the tax cut legislation is providing an additional boost to earnings, cash positions, and business confidence.
- However, tighter labor markets continue to support growing wage pressures, suggesting profit margins have peaked.
- The Federal Reserve will likely have confidence to continue tightening monetary policy in these conditions, and we expect over time this will translate into less benign financial conditions and other later-cycle trends.

In **China,** policymakers have increasingly taken a tighter stance.

- With stated objectives of reining in excess leverage and improving the quality of growth, policymakers have dialed back fiscal, monetary, and regulatory stimulus that helped drive the Chinese and global reacceleration in 2017.
- Measures of industrial activity and credit growth have decelerated materially in recent months, which makes us concerned it may begin to negatively dampen global manufacturing and trade activity over time.

With China showing early signs of deceleration and most major economies in more mature phases of the business cycle (latter mid-cycle phase or beginning of late-cycle phase), our view is that global activity may be peaking. We believe that the likelihood of an upside surprise in global **inflation** in 2018 is higher than an upside growth surprise:

- In the developed world, disinflationary pressures appear to have receded, and inflation is even showing signs of firming. Core inflation in the eurozone has been on a steady rise over the past year, and Japan is beginning to see early signs that tight labor markets are pushing up core inflation.
- Commodity prices are on the rebound as well, with oil prices rising more than 50% since June 2017. Even if they do not continue to rise and stay at current levels, they would likely push up headline inflation in the U.S. to around 2.5% by mid-year 2018.
- While we don't expect a dramatic acceleration in inflation in 2018, global inflation appears firm and there are upside risks given low investor expectations.

## Does higher technology weight make emerging markets less attractive in the late-cycle phase?

For most of its nearly 30-year history, the EM equity universe has sported a hefty direct exposure to commodity-producing companies in the energy and materials sectors. While the exact weight in the MSCI EM index has oscillated, energy and materials stocks have generally accounted for between 20%-30% of the overall index. The widespread impact of commodity prices on the broader economies, financial flows, and fiscal balances of emerging markets has further cemented a tight correlation between commodities and the performance of EM equities.

During the past five years, however, the importance of the technology sector—particularly large Chinese tech companies—has grown dramatically. Technology stocks now account for 28% of the EM equities universe, roughly twice as much as commodity-linked sectors (Exhibit 2).

Due to the changed sector composition of the EM universe, it's possible EM equities as a whole may not react in a manner perfectly consistent with prior cycles. Less direct commodity exposure implies that EM stocks could potentially benefit less from a traditional U.S. late cycle phase filled with inflationary pressures and rising commodity prices. In addition, the valuation of the EM technology sector is near an all-time high. This makes EM more susceptible to any deterioration in current growth-stock momentum or a softening in cyclical tech industries that often occurs during the latter stages of expansion. As a result, if the U.S. moves more fully into late cycle, we may be less inclined to hold a cyclically overweight position in EM equities than the historical playbook recommends.

## Will a weaker U.S. dollar boost foreign equities?

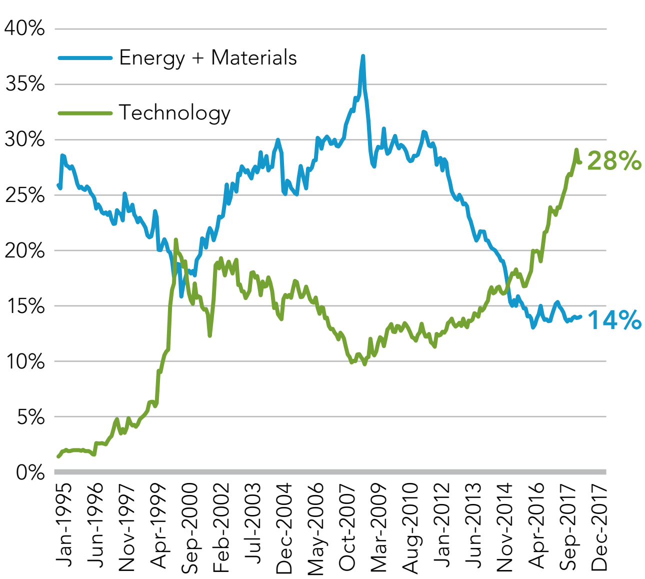
A year ago, we believed the U.S. dollar was overvalued and foreign currencies were poised to rise in value given the under-appreciated trends of firming global growth and inflation. After the dollar has dropped roughly 10% against major currencies over the course of the past 12 months, the dollar is more fairly valued, although it remains relatively expensive compared to its average over the past two decades (Exhibit 3).

Exchange rates are influenced in part by the relative rate of return on investments, such as bonds, in different countries. These rates of return are influenced by anticipated movements in bond yields and monetary policies. A possible supportive factor for foreign currencies is that bond yields and monetary policies in some major countries have been slow to respond to firming growth and inflation trends.

For example, short-term interest rates in the eurozone are still expected to remain around today's levels for the next 12 months, and below zero for the next three years. The market's outlook for European monetary policy is in contrast to the U.S., where futures markets suggest two

**EXHIBIT 2: Technology stocks now represent twice as much of a sector component as energy/materials stocks in the emerging-market universe.**

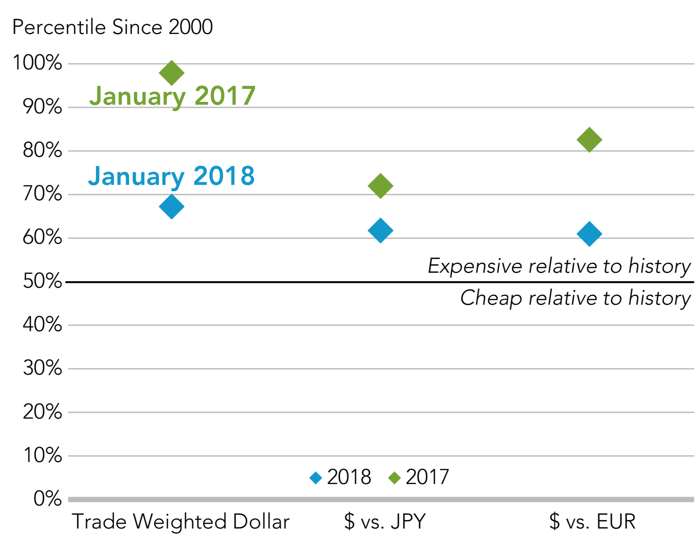
Emerging Markets Universe: Information Technology and Commodity Sector Weightings




Source: MSCI, FactSet, Fidelity Investments (AART), as of Dec. 31, 2017.

**EXHIBIT 3: The dollar is not cheap, but it is less expensive relative to history compared to the beginning of 2017.**

U.S. Dollar Valuation




Trade Weighted Dollar is the broad index of a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares. Source: Haver Analytics, Fidelity Investments (AART), as of Jan. 23, 2018.

to three additional hikes from the Federal Reserve (Fed) in 2018. The two-year U.S. Treasury yield, a good proxy for the market's expected future path of policy rates, has continued to widen versus German two-year bond yields and are near all-time highs (Exhibit 4).

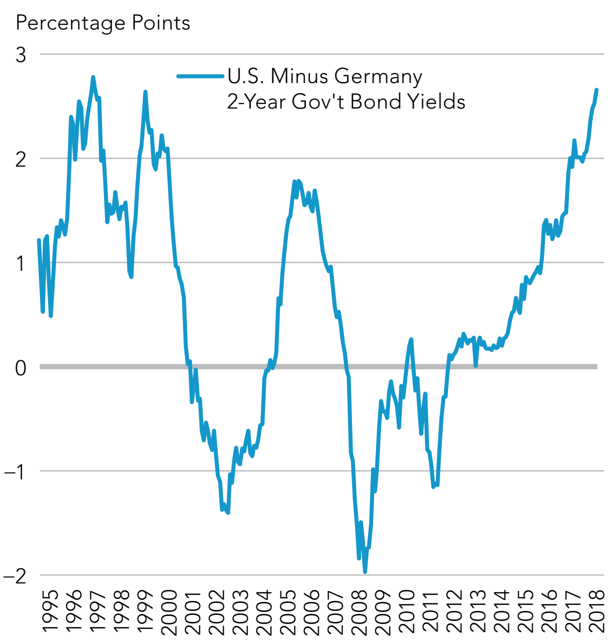
We think the market may be expecting a slower shift away from monetary easing in Europe and Japan than will actually occur. Growth in both Europe and Japan is above trend levels, inflationary pressures are rising, and these conditions appear firm enough to warrant a move toward policy normalization that would generally support currencies. We're not sure that currency movements will provide a significant boost to the returns of international equities (for U.S. investors), but we're not expecting a strong dollar to be a headwind.

## Secular thoughts: Valuations, growth, and diversification still supportive

Beyond the intermediate-term cyclical view, our long-term perspective remains that a global equity portfolio should have a healthy exposure to non-U.S. stocks. Price-to-earnings ratios of international equities are well below those of the U.S., and valuations are an important driver of long-term returns (Exhibit 5). We expect GDP growth in emerging-market countries to outpace the U.S., providing a favorable secular backdrop for EM equity opportunities. Meanwhile, while international markets have grown more correlated with U.S. stocks in recent decades, the diversification benefits of owning global equities would rise if political threats to globalization manifest themselves by breaking down some of these linkages.

**EXHIBIT 4: The market expects interest rates to rise more slowly in Germany than in the U.S.**

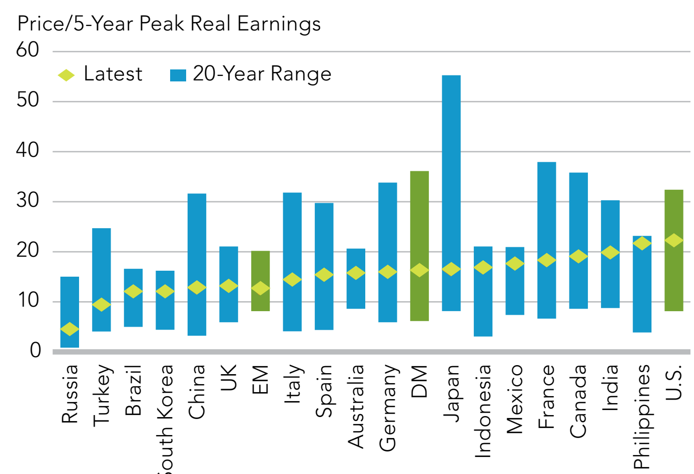
Interest Rate Differential (U.S. vs. Germany)




Source: Bloomberg Finance L.P., Fidelity Investments (AART), as of Jan. 23, 2018.

**EXHIBIT 5: International equities are attractive relative to the U.S. on a valuation basis.**

Price/Earnings Ratios of Developed-Market and EM Stocks




Past performance is no guarantee of future results. Price-to-earnings (P/E) ratio (or multiple): stock price divided by earnings per share, which indicates how much investors are paying for a company's earnings power. Five-year peak earnings are adjusted for inflation. Source: FactSet, countries' statistical organizations, Haver Analytics, Fidelity Investments (AART), as of Nov. 30, 2017.

## Asset allocation outlook

Financial markets have entered 2018 with impressive momentum in the global corporate and economic backdrop. We believe growth and inflation are firm enough to keep global policymakers moving toward a reduction in monetary accommodation. While this process is likely to happen gradually, the neutralization of extra liquidity growth that has provided fuel for asset prices in recent years is likely to provide an impetus for market volatility to rise from currently low levels.

From an asset allocation standpoint, this expectation for potentially higher volatility implies that smaller cyclical portfolio tilts are warranted at this stage of the business cycle. We remain constructive on global equities and still favor international equities (both developed and emerging) relative to U.S. stocks on a cyclical basis. However, we are less confident that emerging markets will be a beneficiary of a full late-cycle environment as the typical business-cycle playbook suggests, and we believe exposure to inflation-resistant assets is important.

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

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Stock markets, especially non-U.S. markets, are 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.

**Investing involves risk, including risk of loss.**

**Past performance is no guarantee of future results.**

**Diversification and asset allocation do not ensure a profit or guarantee against loss.**

All indices are unmanaged. You cannot invest directly in an index.

The Business Cycle Framework depicts the general pattern of economic cycles throughout history, though each cycle is different; specific commentary on the current stage is provided in the main body of the text. In general, the typical business cycle demonstrates the following:

During the typical early-cycle phase, the economy bottoms out and picks up steam until it exits recession then begins the recovery as activity accelerates. Inflationary pressures are typically low, monetary policy is accommodative, and the yield curve is steep. Economically sensitive asset classes such as stocks tend to experience their best performance of the cycle. • During the typical mid-cycle phase, the economy exits recovery and enters into expansion, characterized by broader and more self-sustaining economic momentum but a more moderate pace of growth. Inflationary pressures typically begin to rise, monetary policy becomes tighter, and the yield curve experiences some flattening. Economically sensitive asset classes tend to continue benefiting from a growing economy, but their relative advantage narrows.
• During the typical late-cycle phase, the economic expansion matures, inflationary pressures continue to rise, and the yield curve may eventually become flat or inverted. Eventually, the economy contracts and enters recession, with monetary policy shifting from tightening to easing. Less economically sensitive asset categories tend to hold up better, particularly right before and upon entering recession.



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