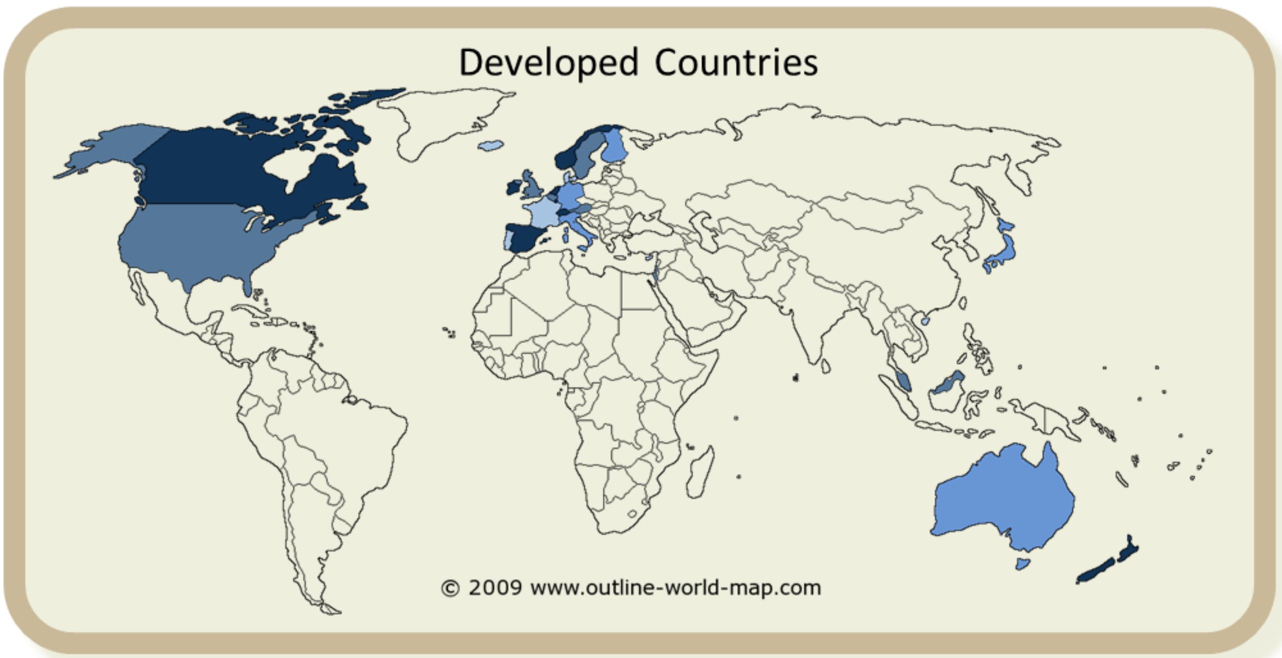
International Markets
Diversifying your Market Risk
By Kevin Chambers

We live in a globalized world and many investors have a significant portion of their assets invested abroad. Since there have been some significant storylines concerning international markets of late, we are going to delve into where most of the money is abroad, what has happened in those markets recently, and what we can expect in the near future.



Source: MSCI

Developed Financial Markets:

Investors break countries outside of the United States into two broad groups: developed and emerging markets. Developed markets are the large established economies. Emerging markets are less developed countries that lack the stability of the developed nations. MSCI, the leading international index provider, lists 26 countries as developed nations: Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Luxemburg, Netherlands, New Zealand. Norway, Portugal, Singapore, Spain, Sweden, Switzerland, UK, and the US. Most of the largest stock markets are in these countries. The list of the top 20 stock markets includes exchanges in emerging economies in only South Africa, Taiwan, Brazil, and two exchanges in China. Thus, most US investment dollars internationally go into developed markets.

Source: World Federation of Exchanges

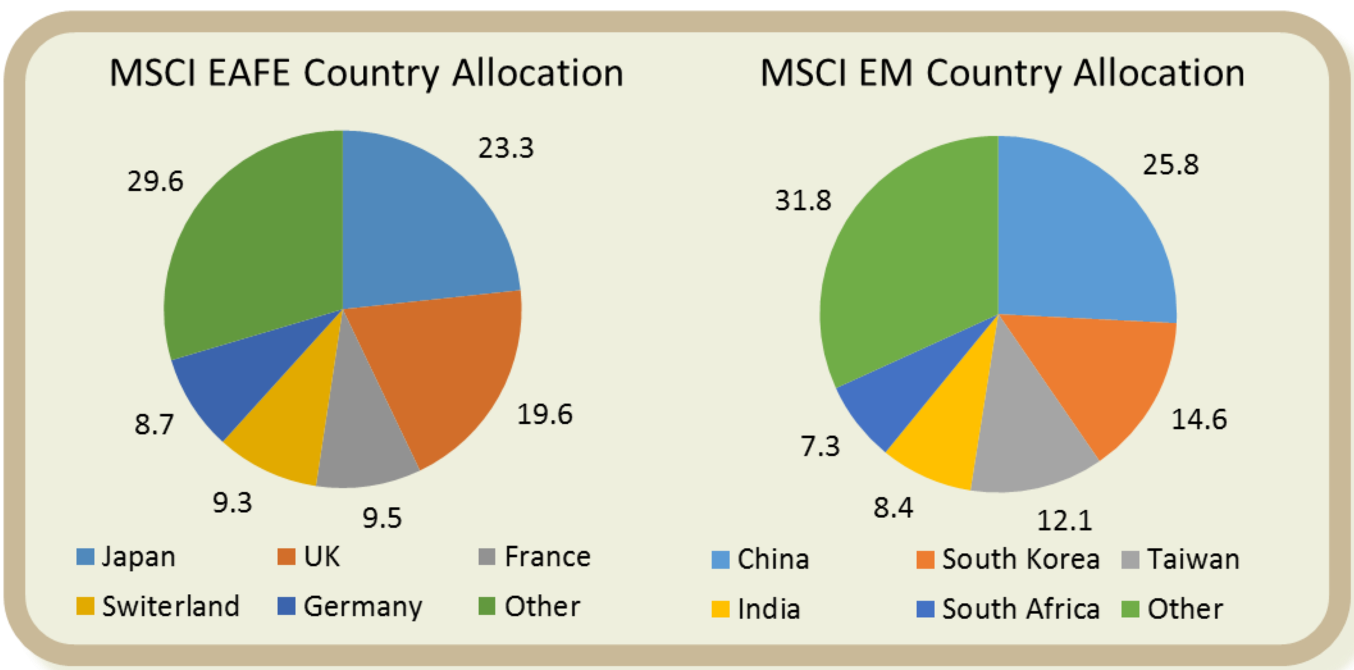
MSCI's headline index, EAFE (Europe, Asia, Far East), captures large and mid-cap stocks in developed countries outside of the US and Canada. Currently, the index is invested 23% in Japan, 20% in the UK, and around 10% each in Germany, France, and Switzerland. Their largest holdings are all companies universally recognized: examples include Nestlé, Toyota, Shell, BP, and Anheuser-Busch Inbev.

Emerging Markets:

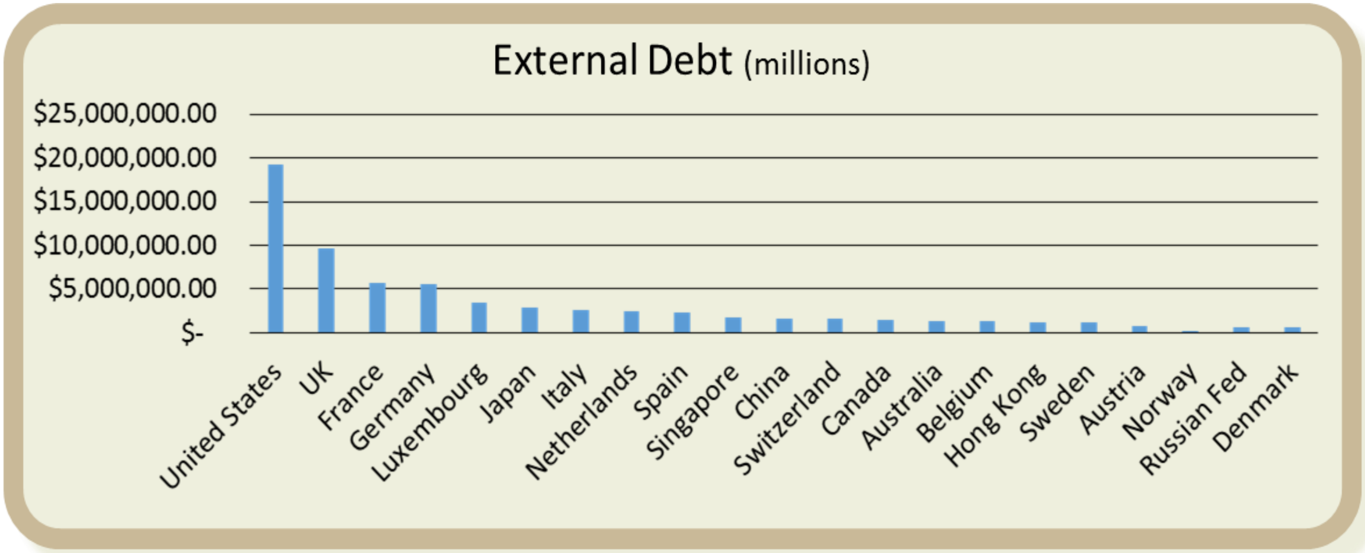
Basically, all other countries in the world are considered Emerging Markets. Developing nations tend to have more volatile stock markets. In general, emerging market investors are looking for countries that are stable and well-funded, although with less liquidity and stability then countries in the developed world.

One of the ways investors determine the size of a company or country, in terms of investments, is by looking at the market value of all outstanding shares of stock, called market capitalization. For countries, this is how many shares of stocks of publicly traded companies are on their stock exchanges. Emerging markets make up approximately 8-13% of global market capitalization. Most investors do not invest all of their money into emerging markets because there is greater risk associated with them. However, emerging market investments offer a strong long-term return and are used as a diversifier in portfolios.

The MSCI Emerging Markets Index gets exposure to about 85% of the available market in the emerging market space. Its largest holdings are in Asia: China, South Korea, Taiwan, and India. Most of the biggest companies in the emerging world are financial companies or information technology companies.



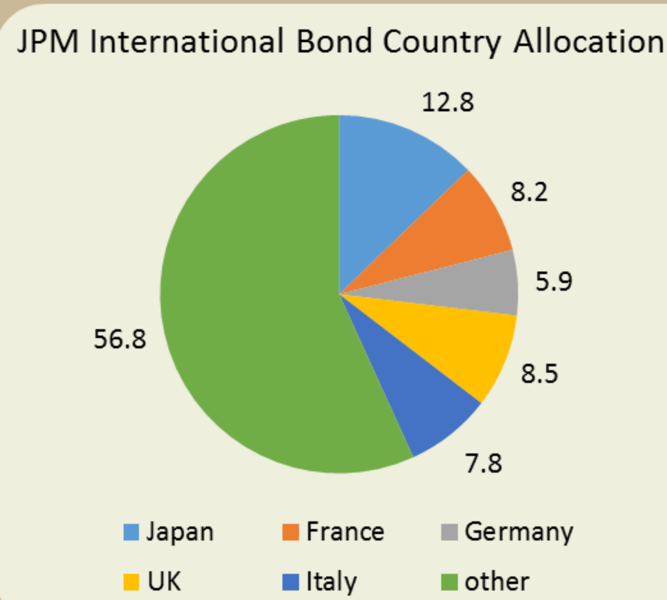
Source: MSCI

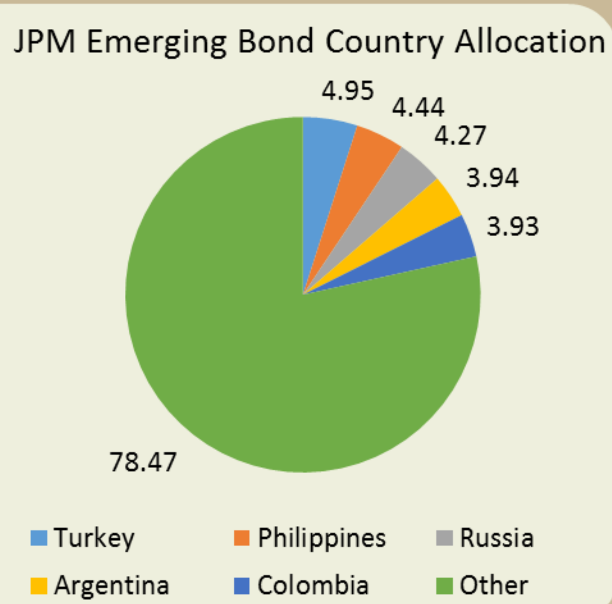


Source: World Factbook

Bond Markets:

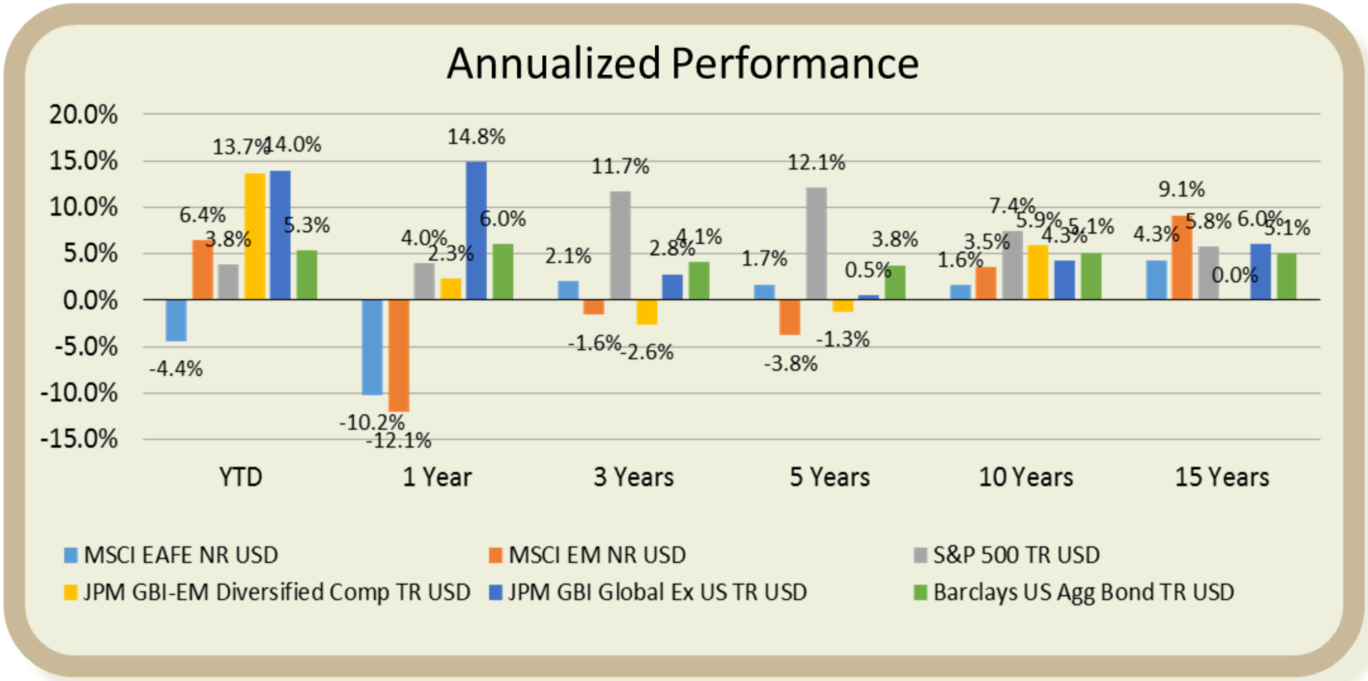
Investors also buy bonds outside of the United States. External debt is the total public and private debt owed to nonresidents. Investors own bonds outside of the United States as a hedge against potential problems with the US government or because they are looking for higher returns in less stable countries. Emerging market sovereign debt pay higher interest rates, acting as an incentive to investors to take on the additional risk due to the political and economic instability in the country.





Source: JP Morgan

The country allocation for fixed income is fairly similar to the equity. The largest allocations are in Japan, France, Germany, and the UK. In the emerging markets, the bond indexes are much more broad, not taking a significant percentage in any one country. The largest allocation in the JPM GBI EM index is just under 5%. The countries are fairly different too.



Source: Morningstar

Recent Performance:

International stock markets have struggled recently. Through June of 2016, the MSCI EAFE index is down 4.4%. Emerging markets have fared better with the rebound of commodity prices; the MSCI EM index is up 6.4% YTD. However, looking further out, both are down in the last 12 months. EAFE is down 10.2%, and EM is down 12.1% over last year. Emerging markets have struggled for the last 5 years, returning an annualized loss over the period. EAFE hasn't done much better returning just 1.7% annualized over the last five years. Over the same time, the US stock market is up 12.1%.

The international slump has been a global phenomenon, with no one country moving out of sync. The European indices are understandably correlated. The last few years have been dominated by problems in the EU as Europe has struggled from crisis to crisis. (Read more about Grexit and Brexit.) The Japanese market acts fairly independently but has been dealing with its own issues of demographics and stagnant growth.

Due to the instability in global financial markets, international fixed income has generated nice returns over the last year. The JPM GBI is up 14% YTD and 15% over the last year. The EM Bond index is up 14% YTD and up 2% in the last 12 months. Yields have plummeted around the world. The German and Japanese 10-year bonds have negative interest rates, so the returns have been mostly driven by market gain, not income.

Going Forward:

We are entering interesting times for foreign financial markets. Slowing growth through all sectors and countries, volatile commodity markets, and global instability has all contributed to volatility internationally. Many of these problems have not been solved. The European Experiment (the EU) has been hit with tough times recently. The restricting of Greece seems to be behind them, but the transition of Britain's removal will be an ongoing dynamic situation. It is in the best interest of both continental Europe and the UK to figure out how to facilitate trade and financial markets. They are interdependent and will likely find a solution over the next two years.

Many emerging markets are stabilizing and acting more like their developed counterparts. Yet it is unlikely any of them will be pushed into the higher category. Many of these countries are still dependent on global commodity prices. They live and die with the prices of precious metals, oil, and foodstuffs. This dependence makes it difficult to compete with the established nations who have strong economies that benefit from lower commodity prices. Investors are still monitoring China, as slower growth trends are realized throughout global economies and the spillover effects become more known.

Headwater Investments believes it is important for our clients to have a portion of their portfolios in international securities. It is wise to diversify your holdings outside of the US. There are many companies and countries worthy of investing in. Some of the biggest and most important companies in the world are located in Europe and Asia. It is also a hedge against a scenario of the US economy stumbling as the world economy strengthens. A lot can change quickly, as the recent Brexit vote taught us. With a big US election later this year, and continued concerns about certain sectors of our economy, this scenario is not out of the question. A strong investment portfolio should have a percentage of the assets in international stocks and bonds, including a portion in the emerging world.

Correlation Matrix

From 7/1/2011 to 6/30/2016

Investment	1	2	3	4	5
1 MSCI UK All Cap NR USD	1.00				
2 MSCI Japan NR USD	0.63	1.00			
3 MSCI Germany NR USD	0.87	0.64	1.00		
4 MSCI France NR USD	0.90	0.58	0.92	1.00	
5 MSCI Switzerland NR USD	0.87	0.69	0.84	0.89	1.00

1.00 to 0.80 | 0.80 to 0.60 | 0.60 to 0.40 | 0.40 to 0.20 | 0.20 to 0.00

0.00 to -0.20 | -0.20 to -0.40 | 0.40 to -0.60 | -0.60 to -0.80 | -0.80 to -1.00

Source: Morningstar Direct