**Mamma Mia!**

Here we go again. Recent volatility in the stock market was driven by troublesome politics in the Eurozone. The latest cause for anxiety is the newly elected, anti-Euro populist government in Italy, a nation with both the third largest economy in the Eurozone and the third largest bond market in the world. European stocks and the Euro currency declined in late May over fears about “Quitaly” – the possibility of Italy withdrawing from the European currency, or even the European Union. Italians do have a reason to be upset with the Euro. They have not benefited from the single currency system to the same extent as Germany or even France. Italian income per capita remains near the same level as twenty years ago. Although a break-up of the Eurozone remains a remote outcome, it is not inconceivable, as the UK “Brexit” from the EU demonstrated just two years ago. In addition, the unilateral imposition of steel and aluminum tariffs by the Trump administration upon allies in Europe and North America provoked tit-for-tat responses against American goods. According to the US Chamber of Commerce, this may result in the loss of up to 2.6 million jobs across various US manufacturing industries.

What does this mean for investors? On the surface, the Eurozone turmoil and nascent trade wars seem to threaten the current bull market in stocks. However, as a sage Italian put it 505 years ago,

> “The great majority of mankind are...often more influenced by the things that seem, than those that are.”

Niccolo Machiavelli

We point out both US and European stock markets are within 5% of their all-time highs in January. Both corporate and economic growth trends still remain intact. Most global bond markets yield more than they did a year ago, indicating that investors expect these growth trends to continue. The recent decline in international stock markets and foreign currencies relative to the US, have made those assets even more attractively valued. We are comfortable keeping our clients’ current allocations to international and emerging markets in light of what the fundamental values are, rather than reacting to how dire short-term events may seem.
Double Dutch – The Intertwined Performance of US and International Stock Markets

Like Double Dutch jump ropes turning in opposite directions, the performance differences between different regions of the world rise and fall in an almost synchronized manner. This is due to the normal divergences in growth among businesses operating in different industries and in different corners of the global economy. Corporate profits in one country may be accelerating due to population growth, improved technology, credit growth or new terms of trade. Others may get weighed down by a recession, a shrinking population, excessive debt or falling export earnings. At a global level, financial markets discount these differences. And, as the different fortunes change, markets adjust pricing, with yesterday’s dogs becoming new performers and today’s stars fading from prominence.

The chart below shows how the relative values between international and US stock prices have risen and fallen over nearly the past 50 years. US stocks (as measured by the S&P 500 index) have traded on average at 0.7x the prices of international stocks (as measured by the MSCI EAFE index). International stocks have traded on average at 1.5x US stocks prices (1.3x if one excludes the massive Japan stock bubble in 1986-1991). Today, US stocks are valued at 1.4x international stock prices – the highest relative valuation ever and more than twice the long term average.

Source: Morningstar database. US Stocks are the S&P 500 Price Index. INTL Stocks are the MSCI EAFE (Net) USD Index. Ratios based on monthly closing prices, Dec 1969-May 2018.
What should investors expect when one region is at an extreme valuation over another? There have been only a few occasions like today when either the US or international market massively outran the other. In those instances, the previously stronger stock market went on to significantly underperform for the next five years. For example, at the end of the dot-com and telecom bust in early 2002, US stocks traded at more than 1.1x international stock prices. Over the ensuing five years, from Jan 2002 to Jan 2007, US stock prices (excluding dividends) gained +4.9% on an annualized basis. However, this was swamped by the +13.8% annualized return that international stocks delivered over the same period. As the table below demonstrates, reversing fortunes played out after other levels of extreme valuations of one region over another. Today’s apparently overvalued US stock prices may not foretell an imminent stock market crash. However, looking forward several years, portfolios that hold non-US stocks have better odds of out-performing those that hold only US companies today.

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### US STOCK OUTPERFORMANCE IS FOLLOWED BY INTERNATIONAL STOCK OUTPERFORMANCE, AND VICE-VERSA

<table>
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<tr>
<th>INTL vs. US Valuation</th>
<th>Date</th>
<th>What Was Happening</th>
<th>Next 5 Year Annualized Gains</th>
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<tr>
<td></td>
<td></td>
<td></td>
<td>US Stocks</td>
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<tr>
<td>3.5x</td>
<td>Nov 1988</td>
<td>Japan Stock and Property Bubble</td>
<td>+11.0%</td>
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<tr>
<td>1.6x</td>
<td>Feb 2008</td>
<td>Euro and Oil Bubble, Subprime Crisis</td>
<td>+2.6%</td>
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<td><strong>US vs. INTL Valuation</strong></td>
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<tr>
<td>1.1x</td>
<td>Feb 1971</td>
<td>&quot;Nifty Fifty&quot; US Stock Craze</td>
<td>+0.6%</td>
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<tr>
<td>1.0x</td>
<td>Oct 1976</td>
<td>End of Oil Embargoes and Vietnam War</td>
<td>+3.4%</td>
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<tr>
<td>1.0x</td>
<td>Jan 2002</td>
<td>Dot-Com and Telecom Bust</td>
<td>+4.9%</td>
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<td>1.4x</td>
<td>May 2018</td>
<td>US Tech Stock Rally</td>
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Conclusion – The Path Forward

Italian populist politics and recent trade barriers by the US have caused more gyrations in the stock market than we believe is warranted. Volatile days will probably come and go as anti-Euro politics and trade negotiations remain in the headlines. The European Union has demonstrated both motivation and capacity to defend the currency and we believe any true threat will be dealt with effectively. Any reorganization of trade terms will produce different winners and losers, yet both stock and bond markets recently have shrugged off the impact of such policies on the economy’s current growth.

While these issues have changed some investors’ thoughts on the path forward, we recommend no adjustments to our portfolio strategy at this juncture, given that economic growth trends are still intact globally. If anything, the recent weakness in markets outside the US encourages us to shift client Equity allocations towards international and emerging markets, as they represent better values of earnings, assets and dividends. The fact that some markets have fallen already means they may have even less potential downside than US stocks today. History has shown that, when values separate as extremely as they have now between the US and international markets, investors who rebalance into cheaper global markets are compensated with higher returns in the subsequent years. The manner in which this adjustment is made is unique to each client portfolio, depending on its tax, liquidity and risk objectives. As always, we encourage you to continue your dialogue with your personal Portfolio Manager at Webster Private Bank. We remain accountable to you and want you to reach your objectives successfully.