America is Great. Home Country Bias Ain't.

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"Life isn't one thing after another – it's the same thing again and again." -EDNA ST. VINCENT MILLAY, American poet and playwright

"I believe the market is extremely overheated… If more respected investors had warned about the market in '07, we might have avoided the crisis in '08." -CARL ICAHN

INTRODUCTION

The US has been a terrific place to invest since 2009. In fact, looking at one of the charts we presented in last week's Infographic EVA, the S&P 500 has outperformed MSCI Asia Pacific by 101%, MSCI Europe by 107%, and MSCI Emerging Markets by 132% during that timeframe.

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This gravity-defying act is quite remarkable and only eclipsed in length and gain by the 113-month bull run in the 1990s. However, despite (and in some cases because of) this outperformance, there are some very real threats facing this audaciously exuberant market.

Evergreen's near-term concern is that an accumulation of threats (the Fed raising interest rates, weak economic data, policy gridlock in Washington, rising consumer loan delinquencies, overheated speculative positioning and a market being driven by a small group of high profile "story" stocks) will lead to a sharp market correction at some point this summer. The fact that almost no one seems to be expecting a serious pull-back is another reason to be prepared for one in our contrarian-inclined minds.

Reminiscent of the summer of 2015—when the Dow took an intraday plunge of 1,000 points on August 24th over fears of an economic slowdown in China and a looming Fed rate hike for the first time since the Great Recession—the upcoming months could also see a correction of somewhere between 10-15%. (What's astounding is that even if US stocks contract by that amount, they will still be very pricey on a historical basis.)

As we highlighted last week, one way to protect against downside risk is to invest internationally—i.e., in the same markets that have underperformed the US so dramatically over the last eight years. The reality for the average US investor is that, by-and-large, most exhibit home country bias when selecting stocks. In other words, people stick to investing in what they know, and that would be America.

In this week's guest EVA, Rick Friedman, of money management giant GMO, argues that US stocks are overpriced and that, because foreign markets offer better value, investors should ignore home country bias and look internationally.

While we concede that a US market correction will probably pull down markets globally (similar to how fears around an economic slowdown in China undercut all stock markets in the summer of 2015), we believe the impact overseas relative to the US should not be as severe. Additionally, if we do see a correction of that magnitude, it will provide an even better opportunity to accumulate foreign shares at bargain prices, as opposed to buying what would still be fully-, if not over-, valued US issues.

(*Note*: For those of who are interested in where Evergreen stands on the topic of overseas investing, we largely concur with the GMO views expressed below. As a result of our partnership with Gavekal, one of the leading independent global research firms in the world, foreign investments aren't all that foreign to us! In other words, we believe the Gavekal connection helps us at least partially overcome our own home country bias. As noted in past EVAs, we have positioned our non-international portfolios defensively to minimize downside risk in the face of an impending summer correction. This includes overweighting cash, gold, and high grade corporate bonds. Internationally, we continue to invest in what we believe to be undervalued bond and equity markets.)*

**Please see important disclosure following this piece.*

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AMERICA IS GREAT. HOME COUNTRY BIAS AIN'T.

By Rick Friedman

It is a well-known fact that investors skew their equity exposures toward their home country – that is, they exhibit a home country bias. According to data from the IMF's Coordinated Portfolio Investment Survey, US investors allocated over 70% of their equity assets to the US even though based on market capitalization the US represents less than 50% of the opportunity set.

This by no means is a US-only phenomenon. Canadian and Australian investors exhibit similar levels of concentration of equity exposures (60%-70%) in their domestic markets despite these markets representing only 3.3% and 2.4% of the global opportunity set based on their respective weights in the MSCI ACWI index. The recent strong returns of US vs. non-US stocks is most certainly at the top of the list in explaining the strong preference many currently harbor for US equities.

US and non-US stocks have traded leadership over many cycles and decades. The yellow portions of the graphs in Exhibit 1 indicate periods in which US stocks have outperformed their overseas developed brethren. In particular, as the far-right side of the first graph suggests, both the magnitude and duration of the US outperformance over the last nine and a half years have reached extreme levels. The US and emerging equity markets have displayed similar leadership cycles, though over shorter periods of time and with even more dramatic relative performance cycles.

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Certainly, a portion of the US outperformance is warranted. US equities did not need the recent election to make them “great.” While the economic recovery from the 2009 recession has been muted, US companies have delivered stronger and more consistent fundamental growth relative to developed and emerging companies, especially during the last few years. Policymakers in the US took aggressive steps during the GFC (Global Financial Crisis), helping the US economy and market to recover more quickly. One such step was to require banks to recapitalize their balance sheets (often through painful dilution and write-downs). The same could not be said outside the US. The Eurozone remains exposed to sovereign credit issues and more levered banks. In Japan, aggressive fiscal and monetary actions came eventually but failed to stimulate the slow-growing nation, which continues to face persistent demographic and other structural challenges. Emerging countries (and their currencies) initially benefited as China responded to the GFC aggressively through debt-supported infrastructure spending, but over the last few years emerging countries have seen their expensive currencies reprice and have had to adjust for slower growth in China and its subsequent adverse impact on commodities prices.

Exhibit 2 indicates the strength and steadiness of the earnings recovery in the US vs. EAFE and emerging markets. US earnings stand 21% higher than at the beginning of 2008, while EAFE earnings have been cut in half and emerging earnings are flirting with being flat.

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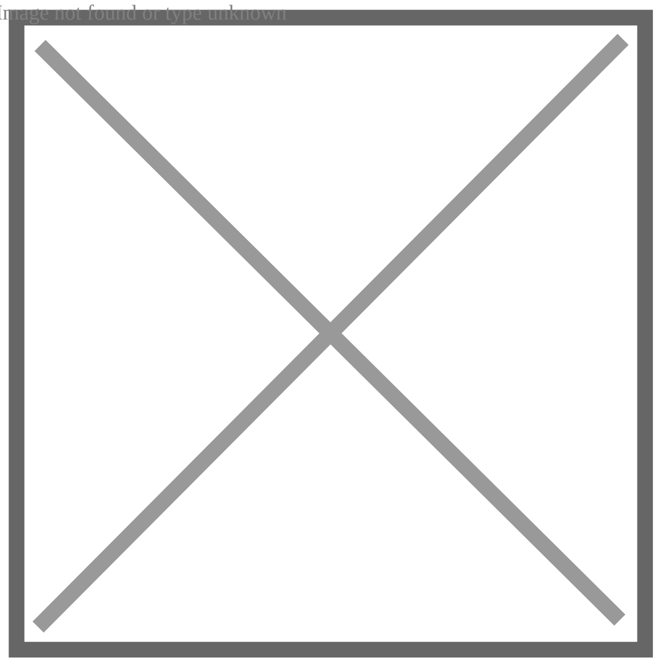

In response, investors drove equity prices significantly higher in the US than outside the US. From the end of February 2009 through March of this year, the S&P 500 has returned an impressive 18.0% per year, while the MSCI EAFE and MSCI Emerging Market indexes have delivered 10.8% and 11.2% per annum, respectively. On a cumulative basis over this 8-year period, US stocks rose about 170% more than non- US equities. That is 1.7x more wealth to sit comfortably within the confines of the United States! It is no wonder that many investors have been reluctant to shift equity exposures away from the US. We would argue this is a classic case of recency bias: Investors are extrapolating the excellent returns US stocks have provided of late far into the future. While most assets appear expensive after many years of strong gains, US equity valuations currently stand far higher than non-US valuations.

Using Shiller's cyclically adjusted P/E (CAPE) ratio, one of many valuation measures, Exhibit 3 illustrates both the expensiveness of US stocks and the relative attractiveness of developed and emerging equities. A yawning gap has opened up in the relative multiples for these various geographic exposures. Today's CAPE of 29x for US equities does not look too stretched in this exhibit. The second chart below, however, puts the expensiveness of the US markets into broader perspective. The market is trading in the most expensive ventile* in history! The only other times US equities have been this expensive on this measure include 1929, the peak of the Internet bubble, and in 2008, just before the GFC. For those inclined to dismiss CAPE, other valuation metrics such as the Price/Sales ratio have soared to dizzying heights as well.

**Evergreen Note: the 5% most overvalued markets in US history based on the cyclically-adjusted P/E ratio.*

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Investors have clearly rewarded US companies for their higher earnings growth by paying significantly higher prices for them. Perhaps, though, the market has gotten ahead of itself. Equities are long-duration assets – investors are not just buying stocks for the next few years of earnings, they are buying an earnings stream stretching out for decades. In competitive economies and markets, both valuations (price multiples) and profit margins (return on capital) tend to mean revert. Our founder and Chief Strategist Jeremy Grantham, however, points out a number of reasons why US profit margins may stay elevated and take longer than prior periods to mean revert (see “This Time Seems Very, Very Different,” Jeremy Grantham, 1Q 2017). While valuation has been a great predictor of return, it unfortunately does not tell us much about the timing in which assets will mean revert to fair or normal levels. We still believe, though, that the price you pay for an asset is the biggest determinant of the return you will make. The more you pay, the less you will make.

Rather than buy the comfortable asset, investors should ask, “What’s in the price?” We would argue that the relatively good news in the US is more than reflected in asset prices. Emerging and developed ex-US stocks look to be more attractively priced (even accounting for higher fundamental risks). In fairness, nothing looks cheap. The best we can say is that value stocks in emerging markets look to be near fair value and that the spread between expected returns for emerging market value and US stocks is quite wide. In addition, emerging markets offer modestly attractive currencies. We believe long-term investors able to ride out the invariable market swings should fight their home country bias and buy emerging.

OUR CURRENT LIKES AND DISLIKES

Changes highlighted in **bold.**

LIKE

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Canadian REITs
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12%
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Select blue chip oil stocks
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Mexican stocks
- Solar Yield Cos on a pull-back
- Long-term municipal bonds
- **Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)**

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Short yen ETF
- Emerging market bonds (local currency)
- Short euro ETF
- Canadian dollar-denominated bonds

- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Floating-rate bank debt (junk)
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Investment-grade floating rate corporate bonds
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds

DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Large-cap value