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INVESTMENT MANAGEMENT

The U.S. Versus the Rest of the World: Divergence and Correction

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Since late spring, there has been a sharp divergence in performance between the U.S. and the rest of the world, with investors flocking into the U.S. equity market. But as General George S. Patton observed, "If everyone is thinking alike, then somebody isn't thinking." Investors tend to realise this eventually, which is why the sort of divergence we have seen since May when trade tensions between the U.S. and China escalated, may be short-lived.

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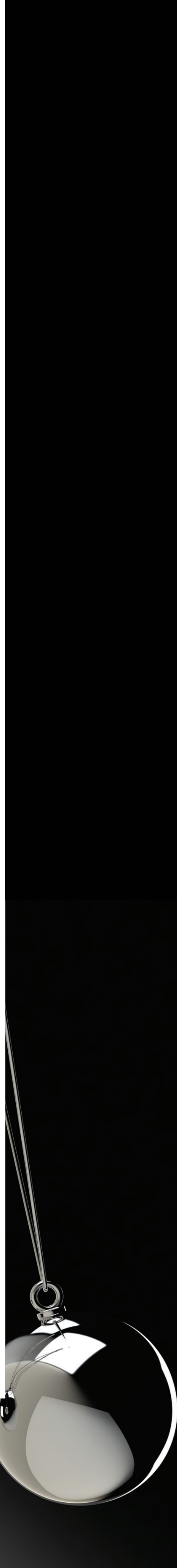
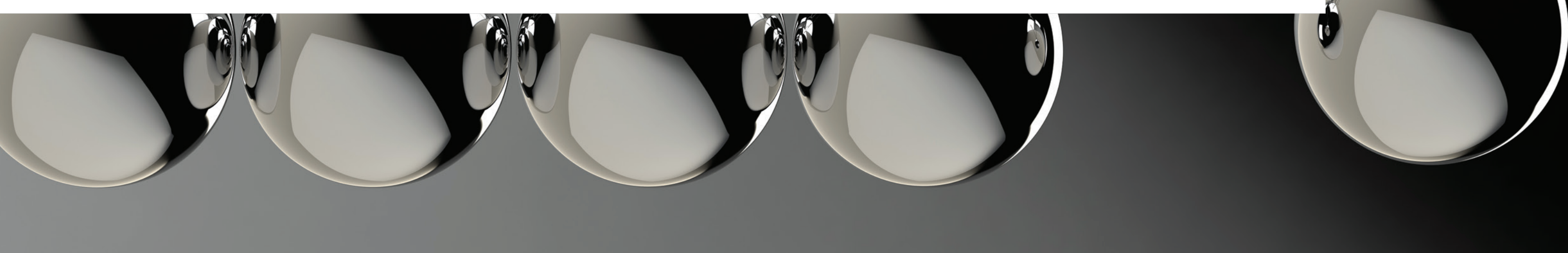
Looking at the S&P 500 versus the MSCI All Country World ex U.S. *(Display 1)* highlights just how large that performance gap has been: as much as 15% from May to September. An investor who gradually moved out of the U.S. as valuations started to go up, or who was positioned in a diversified portfolio with significant exposure to the rest of the world, would have underperformed compared to those positioned exclusively in the U.S. who captured the full force of that big rally in U.S. equities and the U.S. dollar.

The U.S. started to diverge from the rest of the world around May, when the trade war began to gather momentum. There are additional factors which have made the rest of the world relatively less attractive from that point, including weaker data, the first confidence shocks from Italy and the emerging market (EM) FX sell-off. However, it is likely that amplified trade rhetoric triggered the divergence. Although President Trump may have ramped up trade tensions in order to motivate his political base for the midterm elections, during periods of uncertainty the market tends to seek the safest haven, which is still the United States. We believe this helped drive a self-reinforcing momentum that has pushed relative valuations to extreme levels from which they may be unraveling now.





Extreme divergence is unsustainable

How long can this divergence last? We can look at past instances where the U.S. diverged from the rest of the world. They are generally correlated above 0.8, but we do periodically have downward spikes where the correlation disappears—and the current spike is the most extreme that we have seen since before 2002 *(Display 2)*. The divergence, which was particularly evident between May to September 2018 was amplified by the appreciation of the US dollar.

While the spikes of divergence can be significant, historically they have been short-lived and have corrected quickly. This suggests we are likely to return to a more normal relationship between the U.S. and other Developed Markets, and the recent correction has provided signs of this.

The trade tensions between the U.S. and China in particular that have driven this divergence may get resolved after the U.S. midterm elections, if they are in fact politically driven, or through some development in negotiations or politics. So far though, neither side seems willing to make concessions. However, extended trade tensions and the uncertainty associated with this can have an adverse impact on the underlying global and U.S. economy.

The direct impact on China is already noticeable in the recent growth slowdown to 6.5%. Less obvious, but also significant is the potential negative impact that trade uncertainty may have on U.S. business fixed investment, that has been a key driver of U.S. growth. Any slowdown in this can lead to lower growth with negative implications for U.S. and global markets.

With lofty relative U.S. valuations, it has always been possible that a U.S. tumble could occur. Our focus is on the discrepancy itself, which we see as extreme. However, correcting the regional divergence does not necessarily

DISPLAY 1

Unsustainable gap

Source: Bloomberg, MSIM. As of 28 September 2018.

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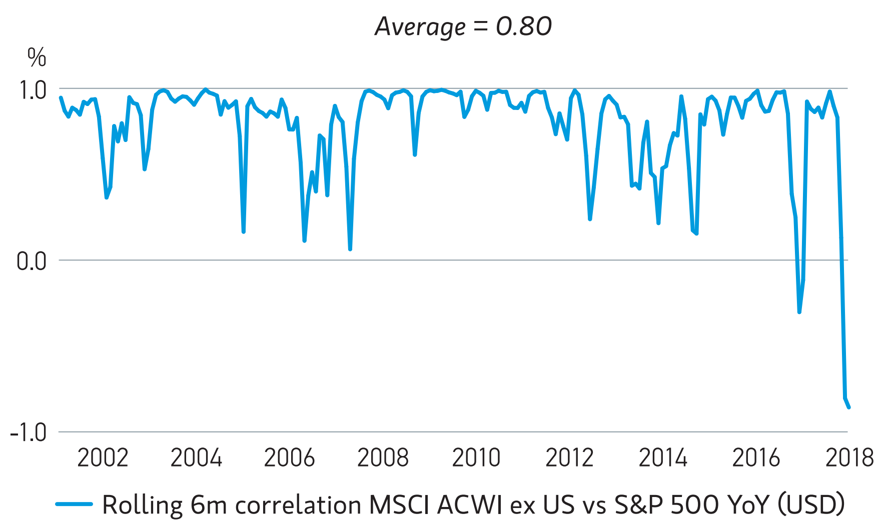
DISPLAY 2

Correlation between the U.S. and the rest of the world has fallen sharply



Source: Bloomberg, MSIM. As of 28 September 2018.

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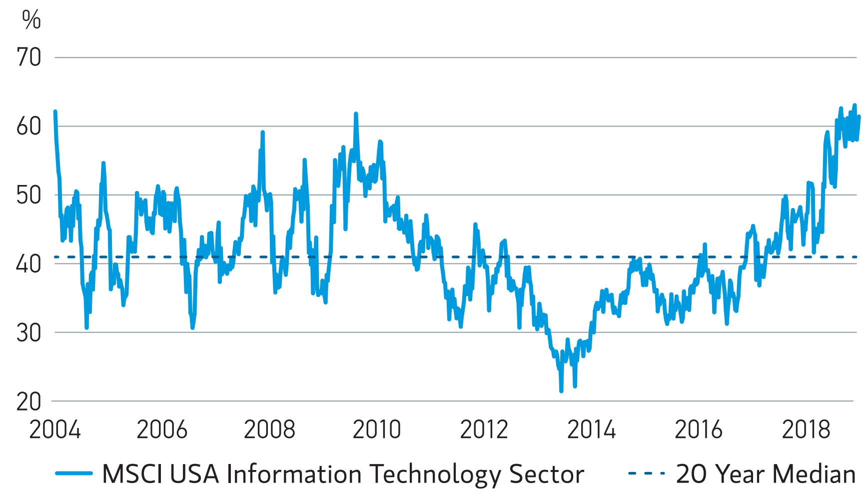
DISPLAY 3

Technology sector valuations hit a new high

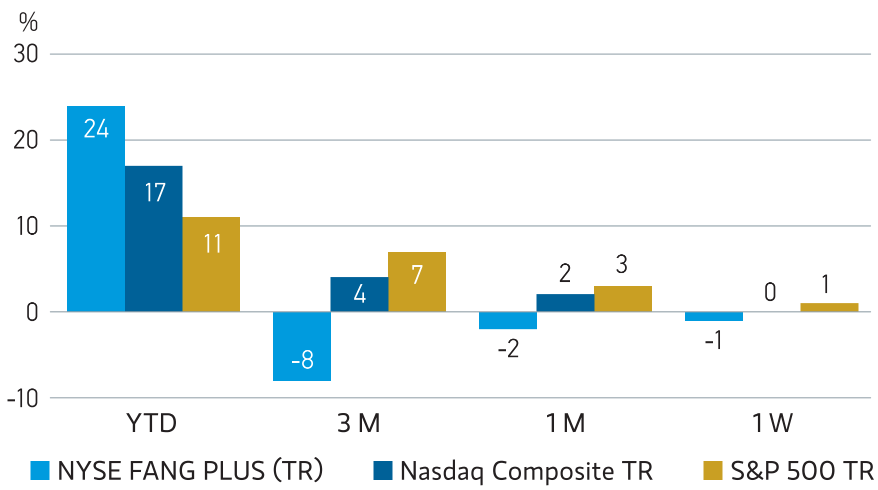
Relative Valuation - Average Premium on PE, PBV & PS



Source: Datastream, MSIM. As of 2 October 2018. Relative valuation is calculated as the average premium of the Technology sector relative to the MSCI US Index on forward price-to-earnings, price-to-book and price-to-sales.

DISPLAY 4

Tables appear to be turning for tech stocks



Source: Datastream, MSIM. As of 28 September 2018.

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imply that the U.S. will trip and fall. Europe and Japan could also catch up with the U.S. or they could meet somewhere in between. Recent market developments suggest the more volatile downward move in global equities may be the most likely outcome.

Tariffs: Consumer pain

Any ramp up of the tariffs is likely to be painful for the U.S. consumer. Of the $200 billion of Chinese goods most recently hit by U.S. tariffs, $78 billion are consumer products—which may be why the Trump administration has chosen to increase tariffs by only 10% before the U.S. November midterm elections, with the bump to 25% happening only after, in early January 2019.

The cost of switching to other countries for these imports is likely to be considerable, which means that the tariffs are unlikely to significantly decrease Chinese production. Instead, most of the burden will likely be borne by U.S. consumers simply paying more, and thus buying less.

Weakness in the "new safe haven" assets

A primary component of the U.S. outperformance since the beginning of the year has been the surge in technology stocks. Looking at relative values—including PE, PBV and PS ratios, for much of this year US technology stocks have traded at a premium to other sectors *(Display 3)*.

However, we have already started to see some weakness in the stocks that have led the rally. Year-to-date to end September, the NYSE FANG Plus Index was up 14%, outperforming NASDAQ's 17% and the S&P's 11% *(Display 4)*. Since then over subsequent periods the order has reversed and it looks like a technical reversal is occurring.

Investment implications

Our expectation that the divergence between the U.S. and the rest of the world will correct makes us wary of overexposure to the U.S., relative to the rest of the world. Non-U.S. markets provide possibilities that avoid the risk of a further correction in the U.S. and/or capture potential benefits from a correction that manifests through the rest of the world surging rather than from the U.S. market falling.

The key insight here is the relative discrepancy, which we believe will continue to correct. But it is rare for a big valuation discrepancy to correct without a significant degree of volatility, so a modest exposure to equities would be prudent, whilst still allowing for scope to capture opportunities. We maintain a moderate amount of risk with a relatively low weight in the U.S. and an overweight to other developed markets.

Emerging markets: Look at FX coverage ratios

Volatility is likely to continue in the emerging markets so long as trade tensions go on, but investors who are comfortable with the risks may want to position in those markets that have been oversold. Countries like Brazil and Mexico, for example, have comfortable FX coverage ratios.[1] They have more reserves than their external debt. By contrast, Argentina and Turkey have insufficient reserves. Because a lot of the weakness in EM has been driven by the strong dollar, the weakness in Mexico and Brazil looks overdone given their ability to cover their foreign debt obligations. So the volatility in EM markets is creating opportunities in some countries.

China and Asia ex-Japan: Vulnerable

The trade tensions directly hit China at a time when the Chinese economy is vulnerable, as the government tries to transition from an investment to a consumption driven economy. Although this shift is positive in the long run, it causes a lot of dislocation that weakens the economy while the change is occurring and inefficient companies go bankrupt.

The tariffs also impact the rest of Asia, as about half of the goods China sells to the U.S. include imported parts that are generally purchased from neighbouring Asian nations. To the extent that tariffs weaken China, they also weaken the countries that export these components to China.

Conclusion

Given spikes of divergence are generally short-lived, we expect the U.S. and the rest of the developed markets to return to a more normal relationship relatively soon. Whichever form the correction takes—whether by the U.S. rising less or falling—there is good evidence that the U.S. is likely to decline relative to these other regions.

Corrections in significant divergences rarely occur quietly and there may be some fundamental damage to the global economy from the trade tensions. A prudent investor may wish to keep risk exposure low and be prepared for a longer period of weak markets until the divergence fully corrects.

[1] Morgan Stanley Research. External coverage ratio = FX reserves versus 12-month external funding needs; 12m funding needs = current account + short-term external debt + next 12 months amortisations from long-term external debt.

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There is no assurance that the strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked** notes involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall. In general, equities **securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. Stocks of **small-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other Investment Funds, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and **Investment Funds** may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio. **Diversification** does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

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