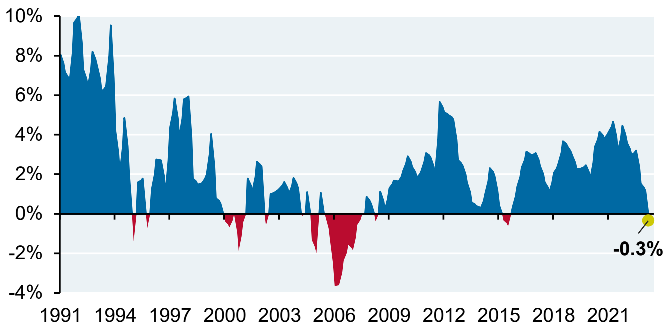
## Too Long at the Fair: Time to retire the US/Emerging Markets barbell for a while

**Summary**. I have recommended since 2009 that equity investors overweight the US and Emerging Markets, and underweight Europe and Japan. The excess returns from such a strategy when applied to regional MSCI equity indexes have been enormous over that time frame. However, the time has come to retire the barbell for a while. I stayed too long at the fair, and should have made this recommendation a few months ago when Europe was trading at a record 35% P/E discount to the US. A modestly brighter picture in Japan relative to China is another reason why it's time to put the barbell aside for now.

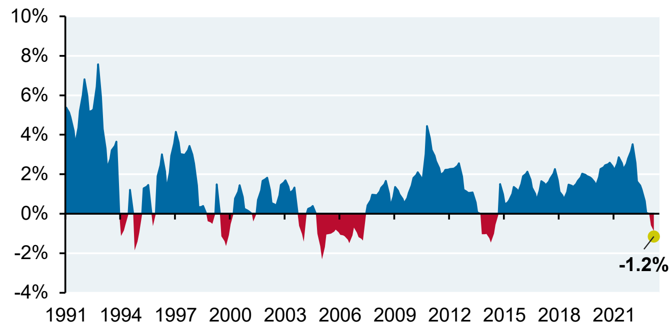
**[1] The barbell's amazing run.** The barbell's performance since 1988 is shown in the first two charts using both a three-year and two-year performance horizon. Before its underperformance this year, the barbell had a remarkable streak[1]. In other words, the -120 bps of barbell underperformance over the last two years is small relative to the consistency and magnitude of prior barbell outperformance. Note that the worst period for the barbell was the golden era for Europe in 2005-2007; more on that below.

**Overweight US & EM, underweight Europe & Japan**
3-year rolling out (under) performance vs MSCI All World Index




Source: Bloomberg, JPMAM. May 2023. All equity portfolio, rebalanced quarterly. O/W US by 10%; U/W EUR by -10%; U/W JPN by -5%; O/W EM by 5%. Assumes no currency hedging.

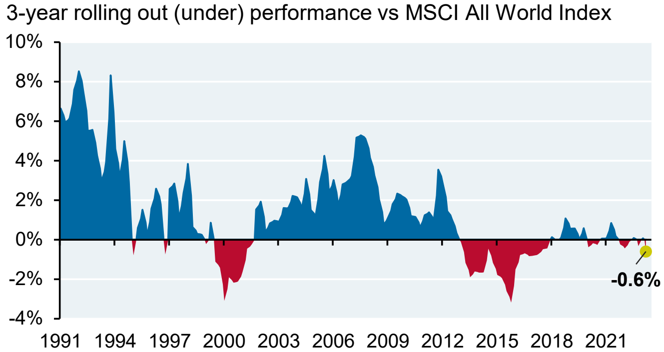
**Overweight US & EM, underweight Europe & Japan**
2-year rolling out (under) performance vs MSCI All World Index




Source: Bloomberg, JPMAM. May 2023. All equity portfolio, rebalanced quarterly. O/W US by 10%; U/W EUR by -10%; U/W JPN by -5%; O/W EM by 5%. Assumes no currency hedging.

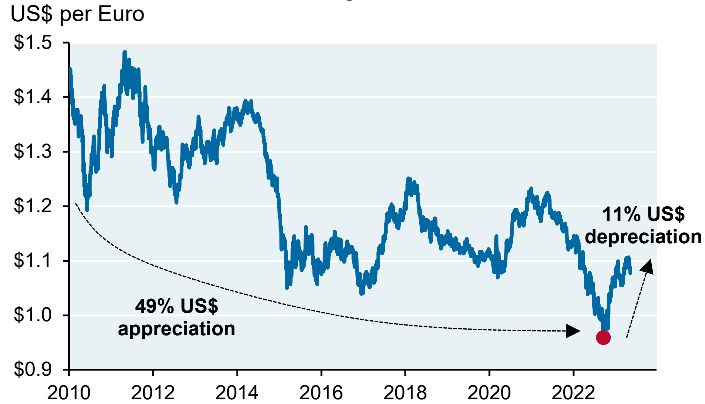
**Most of the barbell outperformance since 2009 is due to US outperformance vs Europe, rather than Emerging Markets outperformance vs Japan.** As shown below, the impact of overweighting Emerging Markets vs Japan was split between positive results from 2009 to 2013, underperformance from 2014 to 2019 and no material impact since 2019.

**Overweight EM, Underweight Japan**
3-year rolling out (under) performance vs MSCI All World Index




Source: Bloomberg, JPMAM. May 2023. All equity portfolio, rebalanced quarterly. U/W JPN by -5%; O/W EM by 5%. Assumes no currency hedging.

**US dollar appreciation through Q3 2022**
US$ per Euro

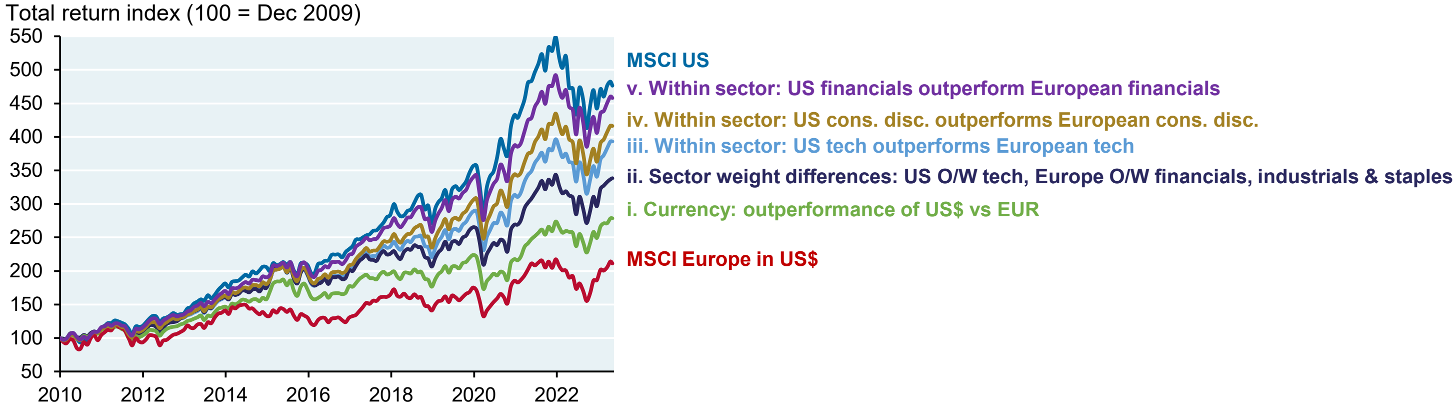



Source: Bloomberg, JPMAM. May 18, 2023.

[1] Professor Elroy Dimson estimates that US equities outperformed non-US markets by ~2% per year from 1900 to 2021, which translates into very large cumulative excess returns. For most of this period, higher dividends explained the difference; since 1990, higher US valuations has been the dominant factor. Jack Bogle argues that excess US returns are not random and reflect US exceptionalism with respect to deeper markets and rule of law.

**[2] Why the US outperformed Europe since 2009**. The next chart decomposes reasons for US outperformance vs Europe over this period. The 5 largest factors: outperformance of the US dollar vs the Euro (illustrated in the chart above); the benefit of US sector weights which are larger in Tech and lower in Financials, Energy, Industrials and Staples; and the outperformance of US tech stocks, consumer discretionary and financials vs their European counterparts. These factors explain almost all US outperformance since 2009; only 7% of the outperformance is unaccounted for.

**Decomposition of US equity outperformance vs Europe since 2009**
Total return index (100 = Dec 2009)



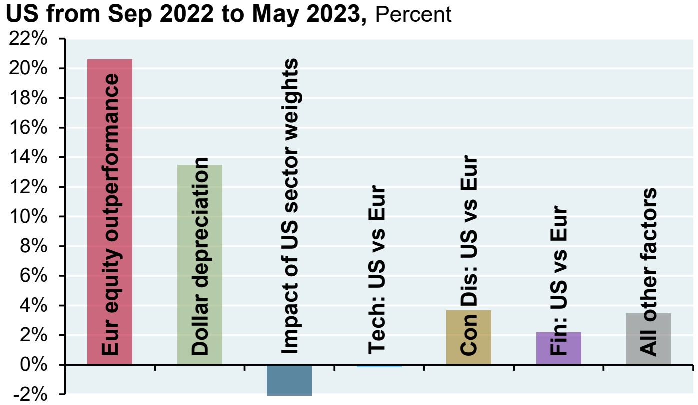

Source: Bloomberg. May 2023.

**[3] What's been driving recent barbell underperformance**. Since September 2022, Europe has outperformed the US by ~20%. As shown below, 2/3 of this outperformance is due **simply to the decline in the dollar vs the Euro**. As we wrote last time (see Archives), while we do not see the dollar's reserve currency status under serious threat, there's room for the dollar to decline due to its prior sharp rise vs other currencies.

**What else explains Europe's outperformance**? The other positive for Europe: outperformance of its Consumer Discretionary stocks vs US counterparts. The next largest factor: relative outperformance of EU financials, but it's small in the context of overall European outperformance. That gap may widen further given US regional bank commercial real estate exposure, which we wrote about on April 10. But I'm reluctant to base a long Europe strategy on the reported strength of its banks. The April 10 Eye on the Market also showed how Credit Suisse ranked at or near the top of EU bank statistics on capital, leverage, liquidity and funding ratios and still failed. Certain risks are just hard to capture in balance sheet ratios.

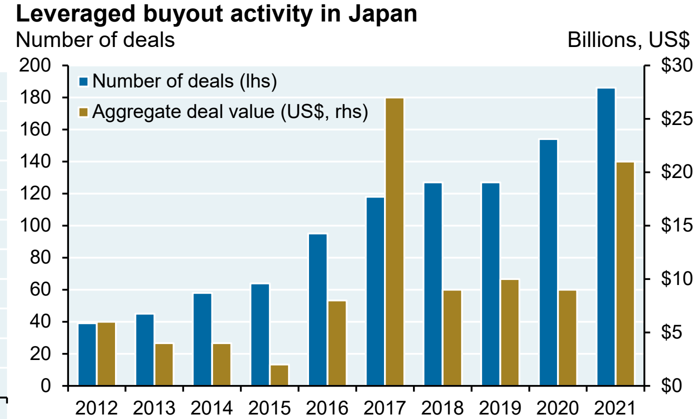
**What explains Japan's 11% outperformance vs EM since last fall**? One factor is a resurgence in M&A activity in Japan, which is unusual. Much of the recent rise comes from foreign investors, which is even rarer: Bain's acquisitions of Hitachi Metals for $5.6 bn, Evident for $3.1 bn and Gelato Pique for $1.4 bn; KKR's acquisition of Hitachi Transport for $5.2 bn; and the Fortress acquisition of Seven & i for $1.8 bn. More on Japan below.

**Decomposition of European equity ouperformance vs US from Sep 2022 to May 2023,** Percent




Source: Bloomberg. May 2023.

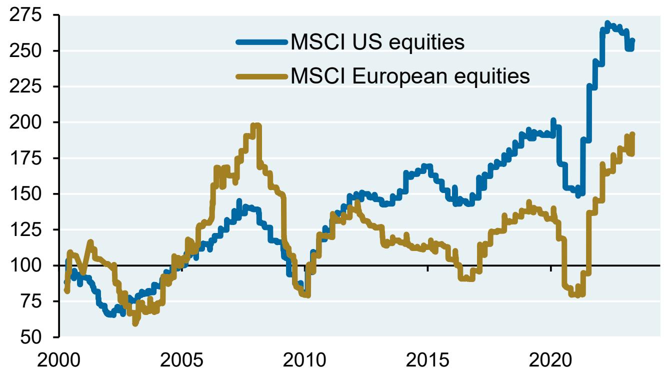
**Leveraged buyout activity in Japan**




Source: Bloomberg, Preqin. October 2022.

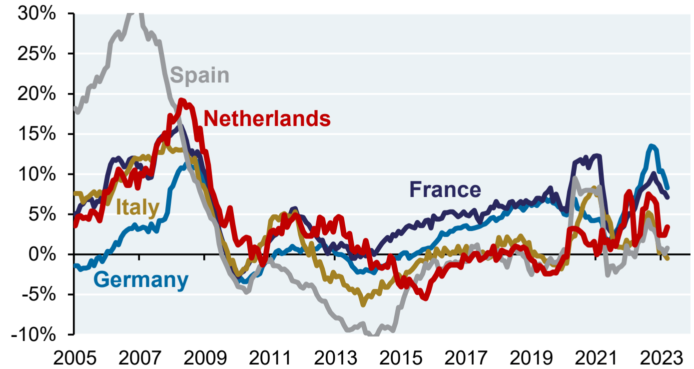
**[4] The 2005-2007 era is not a useful parallel for projecting another period of European outperformance.** I've seen research citing Europe's earnings surge in 2005-2007 as a reason for being overweight Europe, since it could happen again as structural banking and energy constraints fade. But I don't buy that argument: Europe's earnings surge at the time was heavily influenced explosive bank lending that's unlikely to repeat itself. See the charts below: bank lending has picked up in Germany and to a lesser degree in France, but in Southern Europe it never recovered. Maybe there's some other rationale for projecting an earnings surge in Europe; the 2005-2007 period is not it.

**Europe's earnings soared from 2005-2007; the US has led the way since**, Earnings before interest/taxes (100 = Dec 2004)



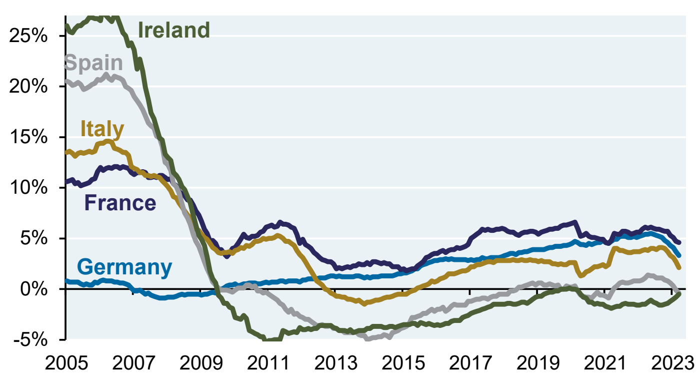

Source: Bloomberg, JPMAM. May 17, 2023.

**Eurozone bank lending to non-financial corporations**
y/y % change, adjusted for loan sales and securitizations



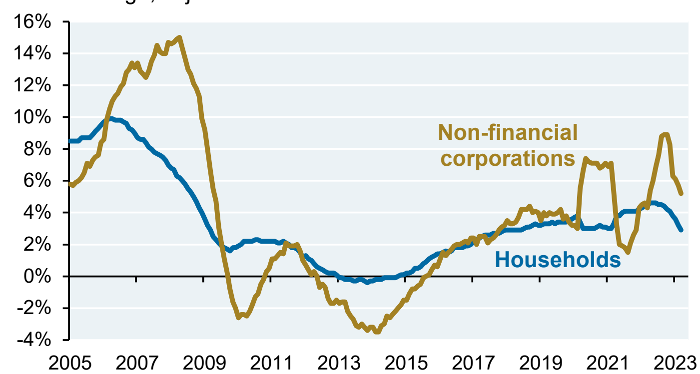

Source: ECB, JPMAM. May 2023.

**Eurozone bank lending to households**
Y/Y % change, adjusted for loan sales and securitizations




Source: ECB, JPMAM. May 2023.

**Eurozone bank lending**
Y/Y % change, adjusted for loan sales and securitizations

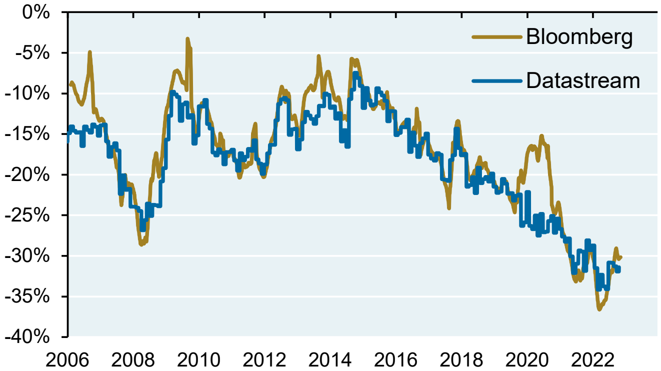



Source: ECB, JPMAM. May 2023.

**[5] Given higher sector weights in staples, financials, energy and utilities, Europe is essentially a value investment. I should have paid more attention to just how cheap it got, particularly after the Euro had declined by 50% vs the US$ since 2010.** By September 2022, Europe's P/E multiple hit a post-2006[2] low relative to the US, as illustrated on the next page. While there were valid concerns at the time about Europe's energy situation, rising inflation and exposure to a shuttered China, investors were receiving an enormous discount for taking European equity exposure, and I should have paid more attention to that. Europe's outperformance is likely to have a ceiling since US companies typically generate higher returns on equity and higher returns on assets, as shown in the table below. **But everything has a price, and a 35% P/E discount was apparently it**. As things stand now, the discount is still large from an historical perspective.

[2] Our European P/E charts start in 2006. Before 2006, IFRS accounting standards required European companies to amortize goodwill, and the amounts involved were at times substantial. As a result, pre-2006 P/E multiples for Europe are not comparable to post-2006 multiples, and can distort time series comparisons vs the US.

**Largest Europe P/E discount vs US in Q3 2022**
Relative P/E discount based on forward earnings




Source: Bloomberg, Datastream, JPMAM. May 16, 2023.

| Return on Assets: Higher in the US | | | | | | |
|---|---|---|---|---|---|---|
| Country | Staples | Con Disc | Tech | Hcare | Comm Serv | Finan |
| US | 7.1 | 5.3 | 10.4 | 6.4 | 4.1 | 1.0 |
| Europe | 5.1 | 4.6 | 8.0 | 6.9 | 3.1 | 0.4 |
| Japan | 3.3 | 3.2 | 7.0 | 5.3 | 1.5 | 0.2 |

| Return on Equity: Higher in the US | | | | | | |
|---|---|---|---|---|---|---|
| Country | Staples | Con Disc | Tech | Hcare | Comm Serv | Finan |
| US | 24.4 | 23.9 | 27.0 | 17.9 | 10.5 | 10.3 |
| Europe | 14.3 | 11.9 | 15.3 | 15.8 | 9.5 | 7.7 |
| Japan | 8.9 | 8.6 | 11.8 | 9.2 | 5.4 | 5.7 |

Source: Bloomberg, JPMAM. May 16, 2023.

**Wrapping up**. Since the valuation discount remains high, there might be some legs left in the anti-barbell trade. Another reason: **Japan looks interesting again** (see box), particularly relative to China which has risen to ~40% of the EM equity index and which still has a lot of problems. I wouldn't argue for a *reverse* barbell, which would overweight Europe and Japan; I don't have enough conviction in European equities for that, particularly with the ECB having more tightening to do. I also think that the US debt ceiling will be raised, one way or another[3]. **But I do think that the barbell's best days are behind it for a while, and believe that investors should proceed with more regional balance in global equity portfolios**.

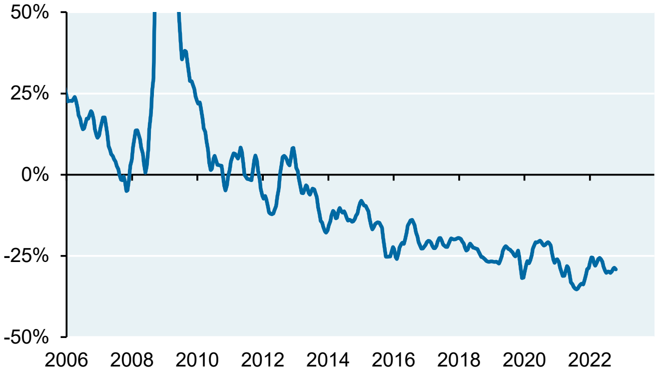
**Japanese equities may benefit from the following catalysts:**

- Japanese equities trade at 25%-30% P/E discount to US, as they have since 2016
- Record increase in stock buybacks driven by corporate governance reforms (i.e., Sony spinoff/buyback)
- Governance reforms: [a] ~50% of companies trade below book value and must outline a plan to maximize shareholder value and comply with shareholder, liquidity and outside director reforms; [b] 10%-20% of companies do not comply with cross-holding and free float criteria and must remedy or face delisting
- Half of Japanese companies have positive net cash positions vs <20% in the US/Europe
- Very low positioning in Japanese equities by non-Japanese investors
- A recent surge in non-Japanese LBO activity in Japan, which is extremely rare (discussed earlier)
- Lower wage pressures than US/Europe, COVID supply chain pressures easing
- Earnings expected to be flat vs contractions in the US and Europe
- The lowest real effective exchange rate in Japan in 50 years according to CEIC; the Yen has also depreciated by 30% vs the Chinese RMB, which is relevant since Japan now exports more to China than to the US

*See charts below*

[3] **Yellen says it would be a calamity not to raise the debt ceiling**. I wonder how she would describe the charts in our Jan 24 piece on inflation adjusted debt per capita since 1790, and on the collapse in discretionary spending due to rising entitlements. Those look like calamities too.

**Japan P/E discount vs US**
Relative P/E discount based on forward earnings




Source: Datastream, JPMAM. Apr 28, 2023. Note: 30-day smooth.

**Japan's Real Effective Exchange Rate**
Index (100 = 2005)


Source: CEIC. April 2023.

**Eye on the Market Archives, 2023**

**American Gothic** **January 24, 2023**
The Federal debt and how the Visigoths may try to break the system if no one fixes it

**Winter Heating** **February 21, 2023**
The large language model battles begin: a look at the future of web search, conventional wisdom machines, hallucinating bears in space, some early application successes and how far they still are from humans in the realm of real intelligence.

**Silicon Valley Bank failure** **March 10, 2023**
One of these things is not like the other, and that thing is Silicon Valley Bank.

**13th annual energy paper** **March 28, 2023**
Renewables are growing but don't always behave the way you want them to. This year's topics include the impact of rising clean energy investment and new energy bills, how grid decarbonization is outpacing electrification, the long-term oil demand outlook, the flawed concept of levelized cost when applied to wind and solar power, the scramble for critical minerals, the improving economics of energy storage and heat pumps, the transmission quagmire, energy from municipal waste, carbon sequestration, the Russia-China energy partnership, methane tracking and some futuristic energy ideas that you can just ignore, for now.

**Frankenstein's Monster** **April 10, 2023**
Banking system deposits and the unintended fallout from the Fed's monetary experiment; commercial real estate, regional banks and the COVID occupancy shock; the wipeout of Credit Suisse contingent capital securities; a market and economic update; and an update on San Francisco, which has experienced the weakest post-COVID recovery of any major city in North America

**Oh, the Places We Could Go!** **April 26, 2023**
A recent article in the South China Morning Post was entitled "End of dollar dominance will also spell demise of US hegemony". Oh, the places we could go with that one! I will resist temptation and focus more narrowly on the question of the dollar as the world's reserve currency. We take a look at trade, foreign exchange, reserve investment, sloppy economics, gold, the impact of sanctions, money supply, the seeds of de-dollarization and the chart that everyone hates. To begin, some brief comments on the US business cycle and the chicken pox party in US regional banks.

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