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Investment Outlook Report

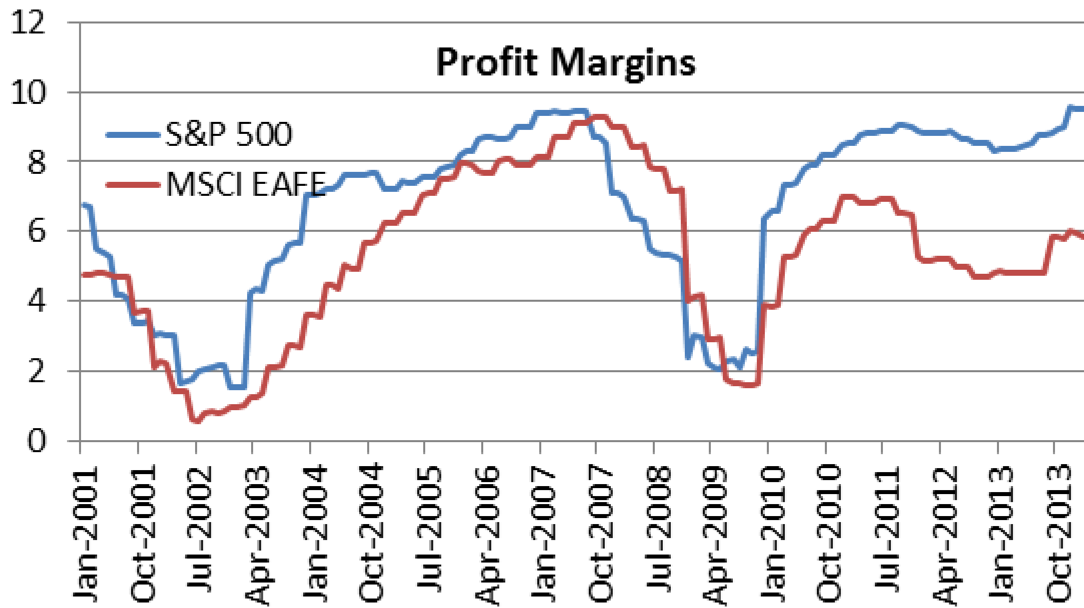
The 2014 2nd Quarter Outlook: A Lesson in Geography

The stock market tends to go through a variety of phases, with separate sets of criteria being important in each phase. During the Technology Bubble of the 1990s, for instance, one of the most important distinctions between companies was their sector--with technology drawing investor attention while other sectors were punished. Today, we believe that one of the most important criteria is geography. It is primarily expressed as the United States vs. Europe and Developed Markets vs. Emerging Markets. This distinction means a lot to investors and their potential for earning a return in each of these markets.

Asset Class/ Index	Price-to-Earnings Ratio as of 3/31/14
U.S. Large Companies / S&P 500	17.3
Foreign large Companies / MSCI EAFE Index	15.7
Emerging Markets Companies / MSCI Emerging Markets	11.1

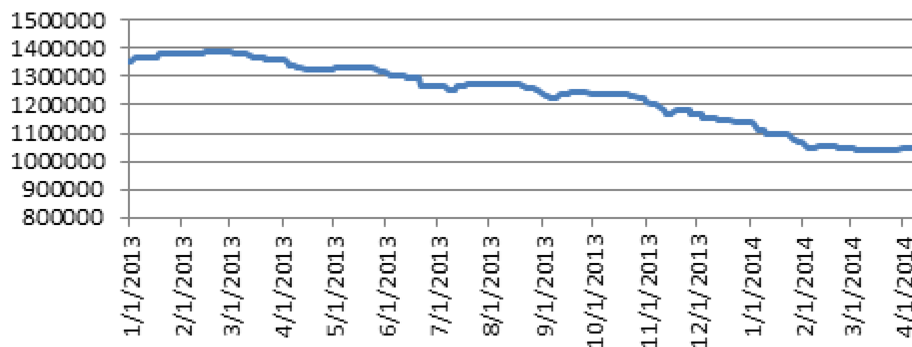
One of the most important distinctions between the different geographically impacted stocks is where valuations stand. One standard measure of value in stock markets is the price-to-earnings ratio (P/E), which compares stock prices to the underlying profitability of businesses. Lower P/Es indicate a less expensive investment and are considered a better value. In 2013, U.S. stocks enjoyed a very strong year and are now valued close to their long-term historical average, with an index P/E of 17.3. Foreign companies based in developed markets, such as Western Europe or Japan, are a slightly better value right now, with an average P/E of 15.7. Emerging-markets companies are some of the best values in the world, and the index tracking them carries a P/E of just 11.1. That's approximately a 35% discount compared to U.S. stocks!

Although foreign companies in developed markets are only modestly less expensive than U.S. companies, they represent one of the better investment opportunities right now. The reason for this has everything to do with profit margins--the percentage of every sale that becomes net income, after accounting for all the costs of doing business. In the United States, many companies have done a great job of refinancing expensive debt at lower interest rates and becoming more productive. Companies in Western Europe and Japan have faced tougher market conditions and have not been able to take advantage of lower interest rates to their fullest. However, we expect companies in Europe and Japan to soon replicate what happened in the United States, which could result in much higher profits for foreign companies.



Emerging-markets companies, on the other hand, represent one of the best investment opportunities in the world, in our view. They combine inexpensive stock prices with healthier economies. What can confuse investors about these stocks is the higher risk of negative information in the news about their regions. In just the first three months of 2014, for example, we saw two big headlines: Slower growth in China and Russia's annexation of Crimea. It's important to remember that the "bad-news risk" is always present in emerging-markets investing, and the headlines can lead to some volatility and potential losses.

Shares Outstanding for VWO (Vanguard FTSE Emerging Markets ETF)



One of the more encouraging developments in the emerging-markets arena is that investors have taken the latest string of negative news in stride. Valuations seem to be so inexpensive that investors are willing to hold and even buy emerging-markets companies in spite of scary headlines. Here's why we say this: A simple way to track investor sentiment for an asset class is to look at fund flows for an exchange-traded fund (ETF) that tracks it. For example, one of the biggest ETFs in emerging markets is the Vanguard FTSE Emerging Markets ETF (VWO). Charting its asset levels helps explain why emerging-markets returns were under pressure last year, in the face of big outflows from investors who capitulated to the negative news. It also helps explain why emerging markets held up as well as they did this year, in spite of the headlines. Outflows stopped in 2014 and have actually shown signs of reversing. If this trend continues, it could help emerging-markets companies close the valuation gap over time.

Investor attitudes can cause different factors to drive the markets each year. The most important factor explaining valuations and opportunities this year is geography. So how have investor perceptions moved the prices of asset classes, and what does this mean about the potential for returns? As mentioned earlier, in the United States we see a fairly valued market trading close to its historical averages. Foreign-developed markets present an interesting opportunity. If they can get closer to U.S. companies in their profit margins, they could see substantial growth and attract a lot of investor attention. Finally, emerging markets have been beset by a series of frightening news items. However, we are starting to see investors take those headlines in stride—probably thanks to just how inexpensive these markets have become. Because of their combination of low stock prices and attractive growth prospects, we believe that emerging markets are one of the best investment opportunities available this year. In addition, changing investor attitudes could make all the difference in these stocks' returns this year.

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Important Disclosure Information

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Index Definitions:

S&P 500: The S&P 500 is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. Each constituent in an index is weighted by its market-capitalization, as determined by multiplying its price by the number of shares outstanding after float adjustment. Total returns for the index include the impact of reinvested dividends.

MSCI EAFE Index: The MSCI EAFE Index is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance in Europe, the Far East and Australia. It is considered representative of large capitalization stocks in developed markets outside the U.S.

MSCI Emerging Markets: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets and which aims to capture 85% of the (publically available) total market capitalization.

Vanguard FTSE Emerging Markets ETF: Shares Outstanding for Vanguard FTSE Emerging Markets ETF – This index measures the total number of shares, in thousands, outstanding for the Vanguard FTSE Emerging Markets Exchange Traded Fund. This exchange traded fund invests in stocks of companies located in emerging markets around the world, such as Brazil, Russia, India, Taiwan, and China and is used by some U.S. investors to access those markets.