Do Your Investments Span the World?

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U.S. stocks represent about half the world's total stock market value, but since they are familiar and have performed well recently, some investors make the mistake of ignoring equity opportunities in the rest of the world.

We think international stocks are currently attractive investments due to their better valuations and slowly improving outlook. They also can help improve your portfolio's diversification, so make sure you're not missing opportunities in the rest of the world by keeping your portfolio too close to home.

Pessimism Hides Better Prospects

After a short-term acceleration in global economic growth a few years ago, trade concerns and political challenges – including the U.S.-China trade dispute, Brexit worries, Italy's recession, higher U.S. tariffs and Japan's slowdown – dashed hopes that synchronized global growth would continue. As a result, a pessimistic outlook for international growth has driven low valuations for international stocks. In our view, that's created an attractive opportunity due to three potential catalysts for better growth:

1. **Low rates and easy financial conditions -** Major central banks have continued to keep interest rates extremely low (and negative in some cases), extending asset purchases and continuing other extraordinary measures to help boost economic growth. Less restrictive financial conditions have made loans relatively easy to obtain. We believe central banks will continue to provide liquidity and stimulus until they are more confident in sustained growth.

2. **China's pro-growth policies -** In early 2019, China cut taxes and loosened financial conditions to keep its economy growing near 6%. As those stimulus policies gain traction and U.S.-China trade tensions are reduced, we think these could improve the outlook for Chinese and other emerging-market stocks, as well as for global trade. Because many foreign developed markets are more trade-oriented than that of the U.S., an uptick in global trade would improve their prospects, too. China's economy and stock market have been growing much faster than those of the rest of the world for several decades, increasing its impact. As a result, China is now the world's second-largest economy, and Chinese stocks represent more than 30% of emerging-market equities.

3. **Signs of stabilization -** Slightly better-than-expected growth in the first quarter of 2019 is a sign the global economy is stabilizing at sluggish but positive growth rates. We think ongoing fiscal and monetary support should start to prompt a shift into a higher gear over time. In Q1 2019, the eurozone expanded by 1.5% from a year earlier, Italy rebounded out of recession, and the U.K grew 1.8%. Better growth helped developed-market earnings exceed expectations, and they also rose at a slow pace. China's growth was 6.4%, and manufacturing indicators in most countries improved at the start of the second quarter of 2019.

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As the world recovered from the global financial crisis, the rebound in U.S. economic growth and stocks was earlier and stronger than in most other developed countries. In addition, challenges to the recoveries in Europe and Japan emerged in 2015 and again in 2018. And slowing economic growth in China lowered commodity prices and triggered a sharp pullback in emerging-market stocks in 2018. Pessimistic headlines have focused on slower growth and elevated political challenges, but we think the fundamentals are stabilizing and starting to improve, making developed- and emerging-market equity investments attractive today. International equities can help improve your portfolio's diversification. We believe they currently are better-valued than U.S. stocks and, if leadership rotates as it has in the past, well-positioned to outperform U.S. stocks over time. However, there is no guarantee that past performance will recur.

International Equities Are Attractively Valued

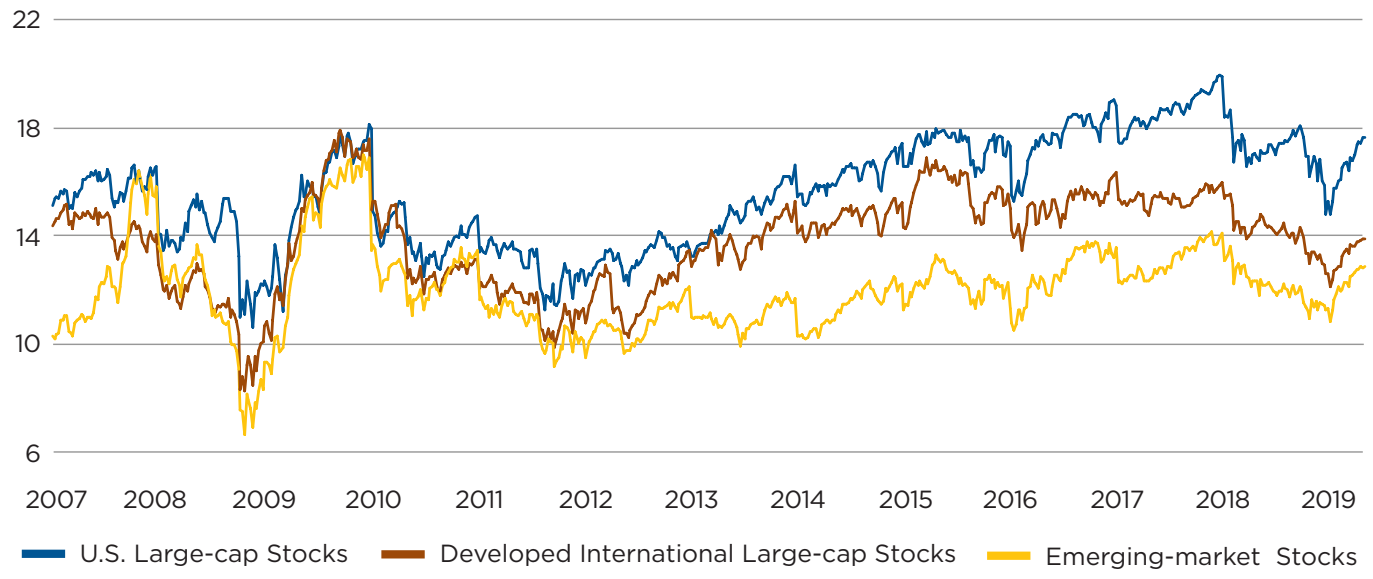
As investors became more pessimistic about slowing global growth, valuations for international developed-market stocks declined in 2018, putting them near their financial crisis lows compared to U.S. stocks. When stocks rebounded sharply in 2019, earnings rose more slowly. As a result, the price-to-earnings ratio for international developed-market stocks remains below its historical 10-year average as well as below U.S. stocks, as the chart shows, supporting our view that they're attractively valued. The chart shows emerging-market stocks are also attractively valued, and both have higher dividend yields than the S&P 500. In the past, periods of below-average valuations have been followed by above-average returns over the following decade.

We think below-average valuations for foreign equity investments make them an attractive opportunity, if needed in your portfolio. Their valuations are below their own historical average and, in our view, already incorporate many long-term reasons they have been lower when compared to U.S. stocks, including:

- A smaller percentage in technology stocks, which mostly have higher expected growth rates and higher valuations, as well as a larger percentage in financial services
- Slower projected economic and earnings growth due to less favorable demographics
- Greater political and economic challenges

Valuations have historically been a better predictor of long-term return potential than short-term results. We believe higher dividend yields and better valuations support the possibility of above-average long-term returns for international equities and position them to outperform U.S. large-cap stocks over time after several years when they've lagged.

Global Market P/Es: International Equities Are Attractively Valued



Source: FactSet, 4/30/2019. U.S. large-cap stocks represented by the S&P 500 Index. Developed international large-cap stocks represented by the MSCI EAFE Index, Emerging-market stocks represented by the MSCI Emerging Markets index. Investment indexes are unmanaged and are not available for direct investment. Past performance of the markets is not a guarantee of future performance.

Leadership Rotates

Over the past decade, U.S. large-cap stocks (measured by the S&P 500) have been one of the best-performing investments worldwide. They've returned more than 400% since March 2009, compared with developed international large-cap returns of 200% (measured by EAFE) and emerging-market equity returns of 193%. As a result, investors have been inclined to keep their portfolios close to home.

However, history shows that performance rotates. International developed-market stocks have outperformed U.S. large-cap stocks following past times when they've lagged, as the below chart shows.

Although we don't know when international stocks might lead performance again, we recommend reviewing your portfolio ahead of that rotation and rebalancing, adding international developed- and emerging-market equities if needed so you own the appropriate proportion based on your comfort with risk, time horizon and long-term goals. Returning to that amount in international equities can help keep your portfolio prepared for any unexpected market moves ahead.

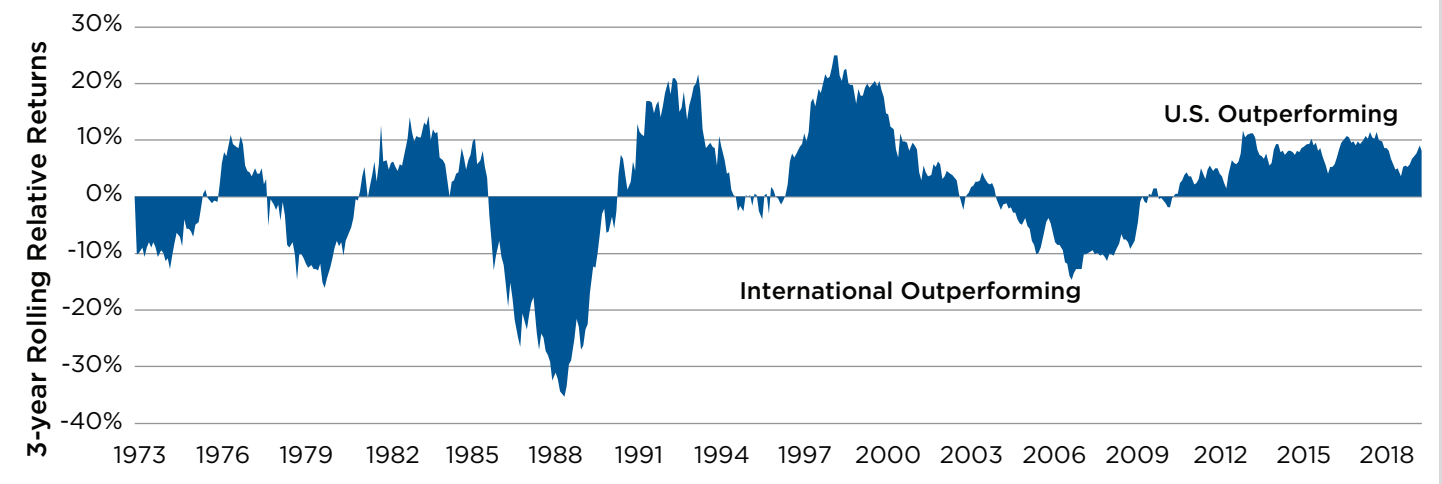
Emerging-market stocks have been much more volatile over time, but since 2001, they also had higher average returns than U.S. and large-cap developed market stocks. And while emerging-market stocks have rebounded from last year's bear market, when they were down more than 20%, we think they're still attractively valued and not yet reflecting policymakers' actions to boost growth.

Stronger or Weaker Dollar?

In four of the past five years, the rising U.S. dollar reduced international equity returns to U.S. investors. We think the dollar is more likely to stay flat or decline as the growth outlook for the rest of the world improves. However, the dollar has frequently risen along with short-term stock market volatility, due to its role as a perceived safe haven from global uncertainties.

Despite its recent strength, the value of the dollar has been trending slowly lower for more than 30 years. We expect the rising U.S. federal budget and trade deficits will keep that trend in place, providing a long-term tailwind for international investment returns.

U.S. vs. Developed International Large-cap Stocks-Leadership Rotates



Source: Morningstar Direct; 3/31/2019, 3-year rolling annualized relative returns. U.S. large-cap stocks represented by the S&P 500 Index. Developed International Large-cap Stocks represented by the MSCI EAFE Index. Investment indexes are unmanaged and are not available for direct investment. Past performance of the markets is not a guarantee of future performance.

Broadly Diversify Your Portfolio

Over time, a broadly diversified portfolio with many asset classes can provide better risk-adjusted performance and reduce swings in the value of your investments because each asset class plays a different role. Adding international developed-market equities to a portfolio of U.S. stocks and bonds increased the chances of making money over time, as the right column of this table shows.

Following several years when U.S. stocks have outperformed, you may need to add international equities to return them to their appropriate weight in your portfolio based on your comfort with risk, time horizon and long-term goals. Since many broad-based international equity investments include appropriate allocations to mid- and small-cap international stocks as well as emerging markets, you may not need to add them separately.

The Benefits of Diversification: Higher Chances of Positive Returns

Time Horizon	100% U.S. Stocks	65% U.S. Stocks 35% U.S. Bonds	65% U.S. & Int'l Stocks 35% U.S. Bonds
1 Month	64.4%	65.8%	66.5%
1 Year	81.3%	84.3%	86.2%
3 Years	87.8%	90.1%	90.3%
5 Years	89.4%	99.1%	99.1%
10 Years	94.0%	99.5%	98.8%

Source: Morningstar Direct, 1/1/1976-4/30/2019. The hypothetical portfolios are for illustrative purposes only. Results may vary for a portfolio with similar holdings. The hypothetical portfolios consist of: 1) 100% stocks represented by the S&P 500 Total Return Index. 2) 65% stocks represented by the S&P 500 Total Return Index and 35% bonds represented by the Barclays U.S. Aggregate Bond Index. 3) 48.75% U.S. stocks represented by the S&P 500 Total Return Index, 16.25% international stocks represented by the MSCI EAFE NR Index, and 35% bonds represented by the Barclays U.S. Aggregate Bond Index. The hypothetical portfolios are for illustrative purposes only. Results may vary for an individual portfolio with similar holdings. Indexes are unmanaged and are not available for direct investment. Investing in stocks involves risk. The value of your shares will fluctuate, and you may lose principal. The prices of bonds can fluctuate, and an investor may lose principal value if the investment is sold prior to maturity. Special risks are inherent in international investing, including those related to currency fluctuations and foreign political and economic events.

How Much Should You Invest in International Equities?

We recommend investing between 20% and 40% of an equity portfolio internationally. That allocation range is smaller than their weight in the global equity portfolio (about half), but our calculations show it's enough to provide long-term diversification.

The Edward Jones Investment Policy Committee thinks international equities are currently attractive due to their below-average valuations and growth prospects. We recommend increasing your allocation to the high end of the recommended range, if appropriate for your situation. In addition, international equities include two different types of markets (developed and emerging), and both look attractive today.

Developed markets – Mature countries with freer capital markets, higher per capita income and fewer restrictions on foreign investments, including the U.K., Germany, Japan and Canada. Just as in the U.S., we recommend including mid- and small-cap stocks as well as large-cap international developed-market equities.

Emerging markets – Countries with lower per capita incomes, generally faster economic growth rates and some capital market restrictions, including China, India, South Korea, Brazil and Mexico. Emerging-market stocks are about 11% of the global equity market.

U.S. companies with overseas operations are classified as domestic, and we don't think they're substitutes for owning international stocks in your portfolio. Most tend to trade more like other U.S. stocks and less like overseas markets, so they don't provide as much diversification for your portfolio. Foreign companies that primarily operate in their local economies offer a greater degree of diversification as well as potential growth tied to those markets.

Keep in mind that investing internationally carries opportunities but also additional risks. Whether they are developed or emerging markets, foreign countries have different demographics, growth outlooks, regulations and potential for economic instability. Furthermore, foreign stocks carry the risks of currency fluctuations and different accounting standards.

