Staying with US overweight, now favoring Japan within Asia

Our broad regional views remain intact, favoring Developed over Emerging Markets, North America over EAFE, and Asia over Europe. The one change we make is within developed Asia, we now favor Japan over Asia ex Japan.

The US continues to lead other regions by a wide margin on our earnings revisions metrics, and is still outperforming on an equal-weighted, local currency basis. The weakness in the US dollar is a headwind for dollar-based investors favoring the US, but the dollar’s weakness may not last much longer. Japan’s revisions are improving, as are its relative valuations, supporting our new preference for Japan over Asia ex Japan.

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<th>Regional Pair</th>
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<td>Emerging vs Developed</td>
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<td>N. America vs EAFE</td>
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<td>Europe vs Asia</td>
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<td>US vs Canada</td>
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<td>Eurozone vs UK</td>
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<td>Japan vs Asia ex Japan</td>
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Regional allocation recommendations

Exhibit 1 below and at right shows our updated regional allocation framework and our current recommendations. Our hierarchical framework highlights a set of pair-wise regional allocation decisions that capture most of the key decisions that clients are making. It allows for flexibility by providing both simple independent binary (i.e., in or out, over- or underweight) decisions at several levels, as well as a complete set of recommended allocation weights for those looking to see how all of the recommendations combined can fit together.

The benchmark (neutral) weights are based partly on relative capitalization weightings, but simplified and adapted for our purposes. In particular, no region has a benchmark weight less than 10% regardless of the actual cap weighting. Our recommended weights, however, can vary more and will generally be kept in increments of 5%, including zero weights potentially.

At right is a summary list of the views shown below.

**Exhibit 1:** We continue to favor Developed over Emerging Markets, the US over EAFE, and now Japan within Asia.

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Recommended allocations are shown in **bold** in each box, neutral (benchmark) weightings shown in *italics* in parentheses. Favored regions within each pair are highlighted in **green**.

Source: Mill Street Research, Factset, Bloomberg
Estimate revisions globally remain extremely elevated, with US still leading

Global earnings estimate revisions continue to be net positive at a historically high rate, matching previous peak levels over the last two decades.

The extreme swings in estimates this year are driven by the unusual mixture of trends in COVID-19, the policy responses to it, analyst and company behavior, and most recently the news regarding potential vaccines. The shorter-term estimate changes are also helped by better-than-expected Q3 earnings reports, especially in the US.

The US has maintained its wide lead over other regions on our aggregated estimate revisions breadth metrics, as shown in the lower chart at right. Earnings reports for both Q2 and Q3 have been especially strong relative to expectations in the US, and the scope of monetary and fiscal support has also been large in the US relative to many other regions.

In the near-term, the renewed and intensified spread of COVID-19 across the US may cause economic activity to weaken, and the same looks to be true in Europe. Asia, meanwhile, has generally done much better handling the virus, but those export-oriented economies have been hampered by the reduction in global trade and strengthening currencies relative to the US dollar.

Investors’ intermediate-term outlook, however, is more focused on the potential for one or more COVID-19 vaccines to be available next year, a record-setting public health accomplishment.

Among notable changes in the relative regional revisions, we see that Japan is no longer at a disadvantage relative to its neighbors in developed Asia. We also see that revisions breadth for the UK is now slightly ahead of Europe ex UK, though the relative revisions magnitudes (not shown) still favor Europe ex UK. And Emerging Markets breadth has lost some ground relative to the developed markets, including ex-US (EAFE) developed markets.

Overall, the revisions metrics support our overweights in Developed over Emerging Markets, North America over EAFE, US over Canada, and our new preference for Japan over Developed Asia ex Japan.

Exhibit 2: Our aggregated global earnings estimate revisions measures have remained near historical peak levels, led by the US

Source: Mill Street Research, Factset, Bloomberg
US retains relative strength in revisions, local currency returns, and valuations

As we have highlighted here recently, the US continues to stand out among the major regions for the relative strength of earnings estimate revisions.

This is coming through in the broad, equal-weighted relative returns in local currency terms.

As we discuss further on page 6, the weakness in the US dollar (along with the skews caused by cap-weighting) is counteracting the local currency performance trends for the US. Given the extreme negative sentiment toward the US dollar, the dollar’s weakness may not persist much longer.

The US is outperforming in equal-weighted local currency terms versus both other developed markets (our EAFE aggregate) and against Emerging Markets. The cap-weighted returns recently have been more mixed, as this month’s rotation away from the large-cap Technology-related leadership in place for most of this year has been a headwind for the US.

And while the US has outperformed on an equal-weighted basis versus the rest of the world, the relative strength of earnings trends in the US has more than kept up, meaning that the relative valuation of the US has actually improved recently.

As shown in the bottom chart at right, the median forward (next-12-month, NTM) earnings yield for US stocks relative to that of the broad global universe has risen (improved) and is now above its long-term average. The picture is similar but less dramatic when using cap-weighted calculations. So US stocks do not appear to be overvalued relative to ex-US stocks on a historical basis (US stocks have almost always been more expensive than non-US stocks over the last 20 years), whether compared to the long-term average or the most recent two years.

While acknowledging the near-term potential headwinds of the weak US dollar and style rotations that are less favorable for the Tech-heavy US market, the underlying fundamental trends still favor the US, and we do not expect a long-term shift away from the dollar or Growth-oriented sectors. Thus we retain our heavy overweight in the US in our regional allocation recommendations.
Japan now favored over Asia ex Japan

The only change in our recommendations we make this month is our preference within Developed Asia. We shift from favoring Asia ex Japan to favoring Japan.

One key reason is that relative earnings estimate revisions trends have changed. For much of this year, revisions metrics in Japan have been weaker than those in the rest of developed Asia (Hong Kong, Australia, Singapore, New Zealand). Recently, however, the gap between Japan and its neighbors has narrowed to the point that the revisions metrics are nearly equal (top chart at right). If the recent trend continues, Japan’s revisions could outpace those in the rest of the region for the first time since the spring.

The relative performance of Japanese stocks versus Asia ex Japan stocks has been mixed but mostly favoring Asia ex Japan (middle chart at right). The recent underperformance of Japan has been in contrast to the improvement in estimate revisions trends, suggesting it may soon reverse.

Indeed, the relative valuation picture for Japan versus the rest of developed Asia has shifted quickly in Japan’s favor recently. The relative weakness in earnings in Japan had been driving the relative forward earnings yield lower (less favorable for Japan) from April through September, and that is one of the reasons we had preferred Asia ex Japan in recent months.

Since the beginning of October, however, there has been a significant shift in the relative forward earnings yield for Japan vs Asia ex Japan. Price underperformance and better earnings trends have pushed the relative earnings yield back up to where it was in the summer, and it is now considerably closer to its long-run average.

Japan tends to be a lower-beta and lower volatility market than Asia ex Japan overall. So if risk appetite globally remains high in the near-term, our new, and somewhat contrarian, overweight stance may not show immediate results. But if risk appetite eases, or the underlying fundamentals continue to move in favor of Japan as we expect, then we will be well positioned.

Source: Mill Street Research, Factset, Bloomberg
Weak dollar having a significant impact on returns, especially for EM, but sentiment is extreme and money growth differentials are narrowing

Performance of the standard benchmark regional equity indices, and their corresponding ETFs, in US dollar terms clearly show the significant impact of the weakness in the US dollar for much of this year. This is especially true recently for currencies beyond the euro and yen that make up much of the weight in the narrow trade-weighted dollar index (DXY). Emerging market currencies in particular have strengthened versus the US dollar in recent months, capturing the risk-on trend in markets generally (the dollar is a “risk off” currency nowadays) and investor interest in higher-growth and higher-yielding assets outside the developed world where yields are near or below zero, including the US now.

The dollar’s weakness is also likely tied to views on the impact of COVID-19 on the US relative to other countries (currently getting much worse), along with presumed fiscal and trade policy under an incoming Biden administration. All of these factors help explain why there are so many bears on the US dollar. As show in the middle chart at right, the proportion of bulls on the dollar (in Market Vane and Consensus Inc. surveys) is at 10-year lows around 30%, and thus clearly an extreme reading.

And of course, there is the relative supply of US dollars versus other currencies. The US money supply (M2) has surged at historic rates this year amid the combination of the Fed’s massive monetary easing and huge fiscal stimulus. The six-month growth rate of US money supply rose to nearly 20% earlier this year, but is now slowing back down as the initial COVID-driven surge eases.

We now see that the major regions of the US, Europe, UK and Japan have all started to show a peak in money supply growth. And the gap between the US and the other regions is naturally narrowing. This means the supply of US dollars is no longer increasing so much faster than the supplies of other currencies.

These trends do not point to an imminent reversal in the dollar, but argue it may be late in the game for dollar bears and the headwinds for US equity performance in dollar terms.

Source: Mill Street Research, Factset, Bloomberg, Market Vane, Consensus Inc.
Regional ETF Ranking and Top-Ranked Global Large-Caps

Exhibit 6 at right shows the cap-weighted aggregate MAER ranking for the constituents of the seven ETFs that track the major regions that we follow. While there can be a tendency for the aggregate rankings to cluster near the neutral 50% level at times due to the broad, heterogeneous composition of these indices, we can get a feel for where there are areas of bottom-up strength and weakness based on our six-factor composite MAER ranking model.

The regional ETF ranking shows the US now clearly at the top, followed by Emerging Markets. Canada has slipped, while Japan has improved significantly. Europe (both Eurozone and UK) are now the clear laggards on this metric.

Exhibit 7 below is a list of the top 25 largest global stocks that rank within the top decile of the combined universe of all constituents of the seven ETFs shown here. Thus these stocks are some of the most attractive names in our work globally that are also heavy weights in the cap-weighted indices (ETFs). The list still maintains a cyclical tilt, and the US provides about half the constituents, in line with its weight in the global equity market.

Source: Mill Street Research, Factset, Bloomberg
Hypothetical Performance Tracking

Below we show hypothetical performance tracking results for the regional allocation recommendations as published in this report (page 2). See important disclosures below and on the following page.

The allocation weightings were first published July 16th, 2019. Results after March 18th, 2020 will reflect the revised regional framework used in this report. Results for short time periods should always be interpreted with caution.

Returns based on ETFs corresponding to each region using total returns in US dollars.

Note: Results shown here do not reflect any actual trading and are for informational purposes only. They do not include important considerations such as transactions costs, taxes, fees or other expenses. Past performance is no guarantee of future results.
Important Disclosures and Certifications

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