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Rhetoric & Capital Markets

Stories of war, terrorism and political turmoil in Eastern Europe and the Middle East are dominating headlines as they have for many decades. Europe is still firmly committed to socialism (as they were for most of the 20th century) and regulatory challenges remain an impediment to faster economic growth. Japan is still struggling with an anemic economy and deflationary pressures (though somewhat recently diminished) even after multi-decade efforts to address the underlying causes. The U.S. has traditionally been held up as an example of what great prosperity could be achieved if people were free, markets unfettered and government restrained by a robust democratic process, but now fears are rising that freedoms are being revoked, that markets are manipulated and that the government's power is growing without the oversight of constitutionally mandated "checks and balances". Opinions vary widely as to the degree and severity of these worrisome issues, but what have the capital markets "thought" about all these variations amongst and between the various global economies over the past few decades?

The Historical Record

Annualized equity returns for the 44 years period from 1970-2013:

Europe	10.7%
Pacific	9.7%
Europe/Australasia/Far East	10.0%
World	9.8%
United States	10.4%

Source: Ibbotson SBBI Classic Yearbook

Despite the many shifts and differences in economic policies, government ideologies, demographics, inflation rates, monetary policies, cultural influences, geographies and countless other events, the difference between the long-term average returns for the major economic regions is not greater than 1% over a period that is just a few years shy of half a century! Admittedly, economic regions such as China, Latin America, Africa, etc. would have likely had much wider variations over that extended period of time because they have gone through even more transformational episodes of change in the many factors that can influence a country's economic activity,

but that is difficult to accurately quantify due to the lack of long-term capital market data for most of the developing countries.

Differences Do Occur on Shorter Timeframes

Even though the long-term averages have been quite close for well-developed equity markets over a very long period in time, they have varied significantly over shorter time periods. A few 5-year period examples:

1984-1988: Pacific Stock Markets Outperform

<u>Year</u>	<u>U.S.</u>	<u>Pacific</u>	<u>Difference</u>
1984	6.3%	13.5%	7.2%
1985	31.7%	39.4%	7.7%
1986	18.7%	93.8%	75.2%
1987	5.3%	39.9%	34.6%
1988	16.6%	35.2%	18.6%
Cumulative	103.9%	479.6%	375.7%
Annualized	15.3%	42.1%	26.8%

2003-2007: European Stock Markets Outperform

<u>Year</u>	<u>U.S.</u>	<u>Europe</u>	<u>Difference</u>
2003	28.7%	39.1%	10.5%
2004	10.9%	21.4%	10.5%
2005	4.9%	9.9%	5.0%
2006	15.8%	34.4%	18.6%
2007	5.5%	14.4%	8.9%
Cumulative	82.8%	185.4%	102.5%
Annualized	12.8%	23.3%	10.5%

2009-2013: U.S. Stock Market Outperforms

<u>Year</u>	<u>U.S.</u>	<u>Pacific</u>	<u>Difference</u>
2009	26.5%	24.3%	-2.1%
2010	15.1%	16.1%	1.0%
2011	2.1%	-13.6%	-15.7%
2012	16.0%	14.6%	-1.4%
2013	32.4%	18.4%	-14.0%
Cumulative	128.2%	69.2%	-58.9%
Annualized	17.9%	11.1%	-6.8%

Source: Ibbotson SBBI Classic Yearbook

The Differences are Becoming Less Different

As globalization and technology advances, there are several key areas where the physical location of a company's headquarters is becoming less and less relevant:

Global Logistics – Companies like UPS, FedEx and their foreign counterparts permit even small businesses to source from vendors, and sell to customers, located around the globe.

Access to Capital – Increasingly, companies and individuals can access debt, equity and other types of “crowd-sourced” forms of capital from both traditional and non-traditional lenders/investors from many countries other than their own.

Technology Transfers – Whether by legal, voluntary cooperation, or illegal pirating, corporate espionage or less obvious patent infringements, information/technology is increasingly capable of being transmitted digitally to almost anywhere in the world from almost anywhere in the world at the speed of light.

Labor Costs and Automation – Automation is steadily leveling the playing field between those countries producing in high cost/tight labor markets and those countries where labor is cheap and abundant.

Small Batch/Custom Manufacturing – Steadily improving additive manufacturing techniques such as 3D printing and laser sintering are allowing smaller manufactures/designers to locally “create on demand” products that would have previously required large, expensive capital investments in machinery, skilled technicians and/or engineers to produce at locations often far removed from the both the designer and/or the ultimate consumer.

Networked Labor Forces – Cloud-based technologies are ever more enabling widely dispersed talent pools to collaborate from many distant locations with increasing ease and efficiency. This not only allows a company to access talent not available in their local market, but also to access individuals to assist in certain aspects of research, engineering, idea generation, marketing or other areas on an “as needed” basis rather than having large permanent staffs all located in one physical location.

Strategy Implications

There is no way to know for sure if longer-term global capital market returns will once again “cluster” around very similar rates of return, but it certainly seems plausible that such an outcome could re-occur given the manner in which countries are becoming more financially/economically intertwined. Assuming that this is the case, wide deviations in global capital market returns occurring over shorter time periods should be expected to “mean revert” (previously outperforming stocks markets start to underperform and vice versa) to a significant degree at some point in the following years.

For much of the past 3-4 years, we have had a significant overweight towards U.S. equities vs. foreign developed and emerging market equities. About 18 months ago we began shifting towards a more balanced approach and we are now more heavily weighted towards non U.S. company stocks/ETFs (exchange-traded funds; the degree of this overweight varies by investment objective/strategy).

Initially, the movement towards larger allocations in foreign equities was achieved via investments in mostly developed, European stock markets, but we are likely to begin shifting towards more emerging market exposure in the coming quarters. It is very unlikely that the stream of bad news from “over there” will abate any time soon as it has never done so previously on a sustained basis. Yet, as the speculation swirls around the many implications of each sobering development, it is important to keep in mind that the global economy is not as segmented as it might appear on a map and that as grey clouds are always hovering, each economic region’s equity market takes its turn at spending its “day in the sun”, many times in almost direct contradiction to what the headlines may seem to indicate.

“Look to the Future, be Optimistic...but Hedge.”

(We want to keep these commentaries brief and focused so as to provide a good “information-to-text-length ratio”, but if you have specific questions/topics you want me to address, please let us know.)

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