Why Global Diversification Is Important Despite the Coronavirus

Global stocks are in the red this year due to fears of the spreading coronavirus and geopolitical instability. The Chinese stock market, at the epicenter of the public health crisis, and emerging markets more broadly, have taken the brunt of the hit. At the same time, U.S. and developed market stocks have swung in both directions on a day-to-day basis. Given this heightened sense of fear from some investors, staying calm and internationally diversified is as important as ever.

This is true for a few key reasons. First, the Chinese stock market, and emerging markets more broadly, are only components of the larger investment universe. Even today, despite the size of its economy, China only constitutes about one-third of the MSCI Emerging Markets index and about 4% of the All Country World Index. So, while headlines out of China may spark fear, and daily market swings there may be sizable, they can be counter-balanced in a diversified portfolio by the rest of the world. For instance, while the Shanghai Composite Index has fallen by about 10% year-to-date, the impact on the global market is roughly half of one percent.

Second, since holding a diversified portfolio helps investors over longer timeframes, it's important to maintain the right perspective. While global markets are negative year-to-date, they only fell by about 1% through the end of January. At its worst point, global markets were down 4% - much less than the average intra-year market pullback. In other words, the returns of a single month or quarter are nothing in comparison with the long-run returns that matter to patient investors, even if markets do tend to swing in tandem in the short run.

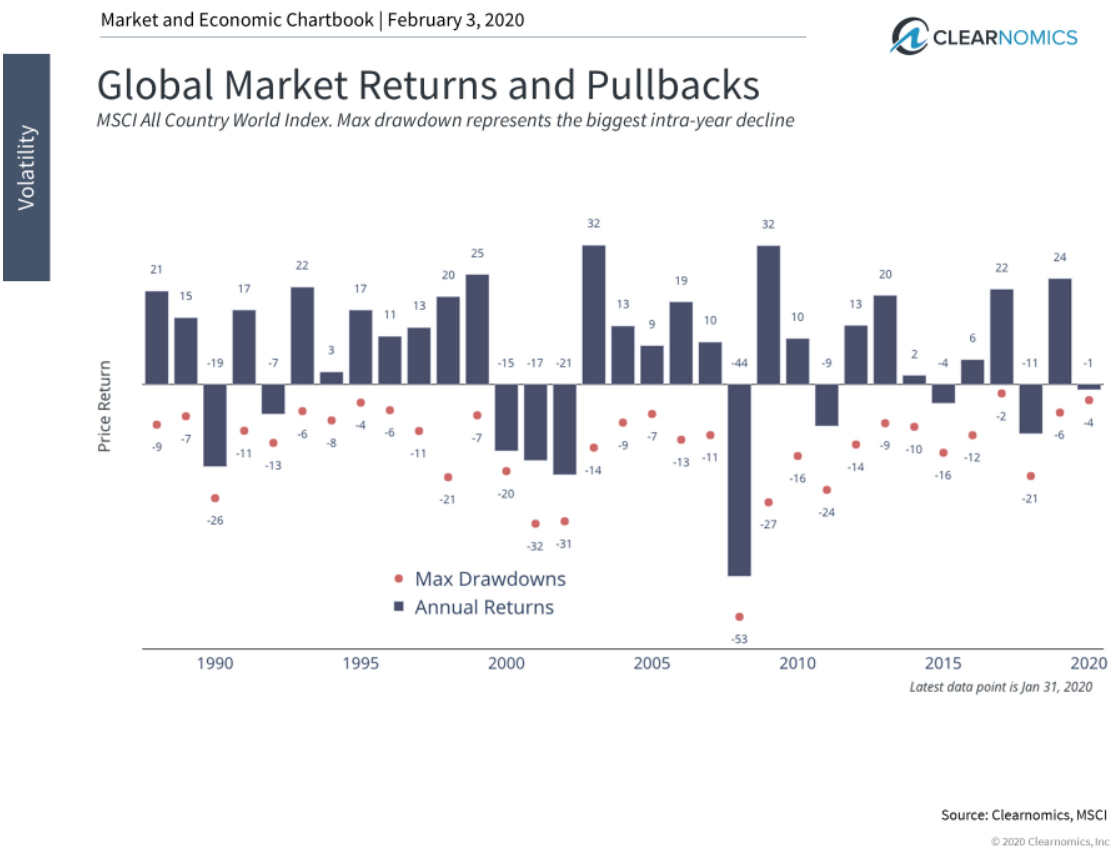
Third, international diversification isn't just about stocks - global bonds can help as well. In fact, with volatility rising and interest rates falling, both U.S. and international bonds have helped to cushion portfolios. This dynamic has been true throughout the market cycle of the past decade with interest rates remaining relatively low, central bank policy being stimulative, and companies taking advantage of debt financing.

Thus, it's important for long-term investors to maintain a globally diversified focus across regions, countries and asset classes. Over the long run, emerging markets may be volatile, but this goes hand-in-hand with higher expected returns. In fact, many international markets are significantly cheaper on a valuation basis than the U.S., despite higher earnings growth expectations. It's important to take advantage of all of these trends in balanced portfolios, regardless of whether markets are up or down over the past 30 days. Below are three charts that put recent global volatility in perspective:

1. Global stock markets have fallen slightly this year

Global Market Returns and Pullbacks

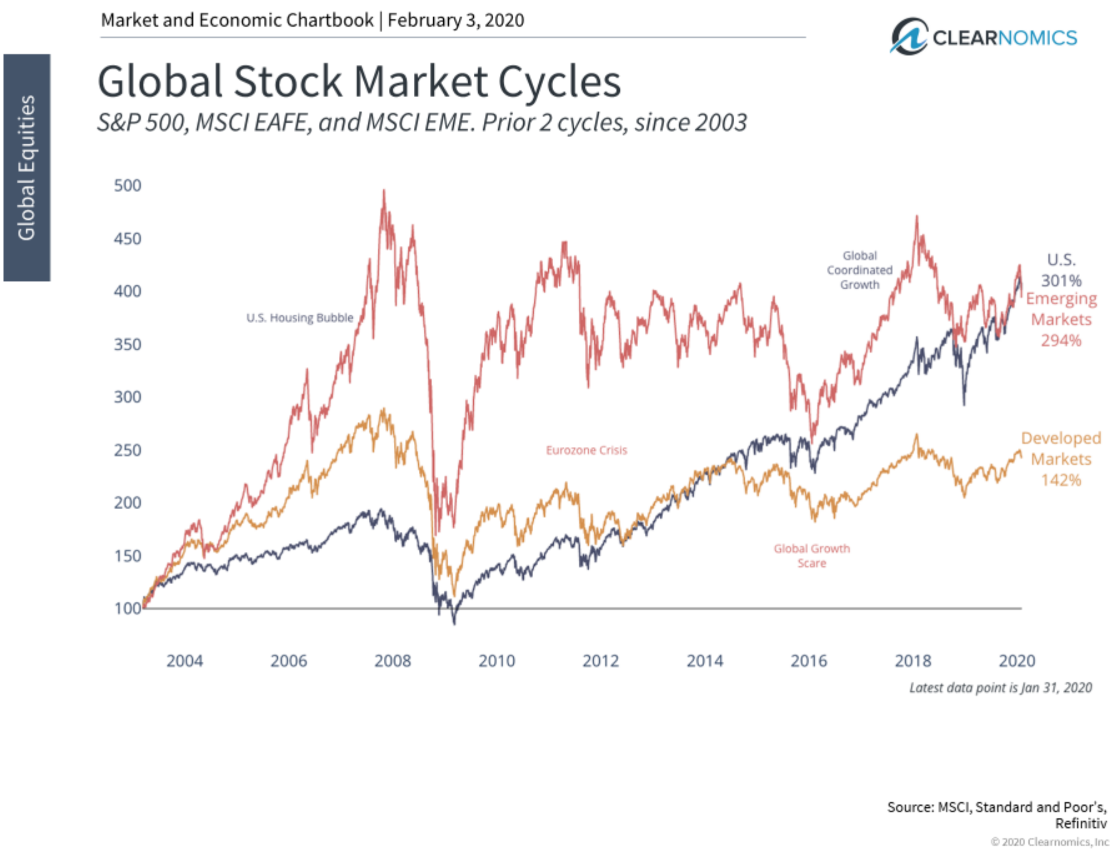
Find this chart under "Global Stocks"



Global stock markets have fallen slightly this year. However, not only has the decline been small, but the largest decline of 4% is minor compared to historical averages. It's important to keep this in perspective as news of coronavirus spreads and as volatility continues.

2. Emerging markets can be volatile but have performed well in the long run

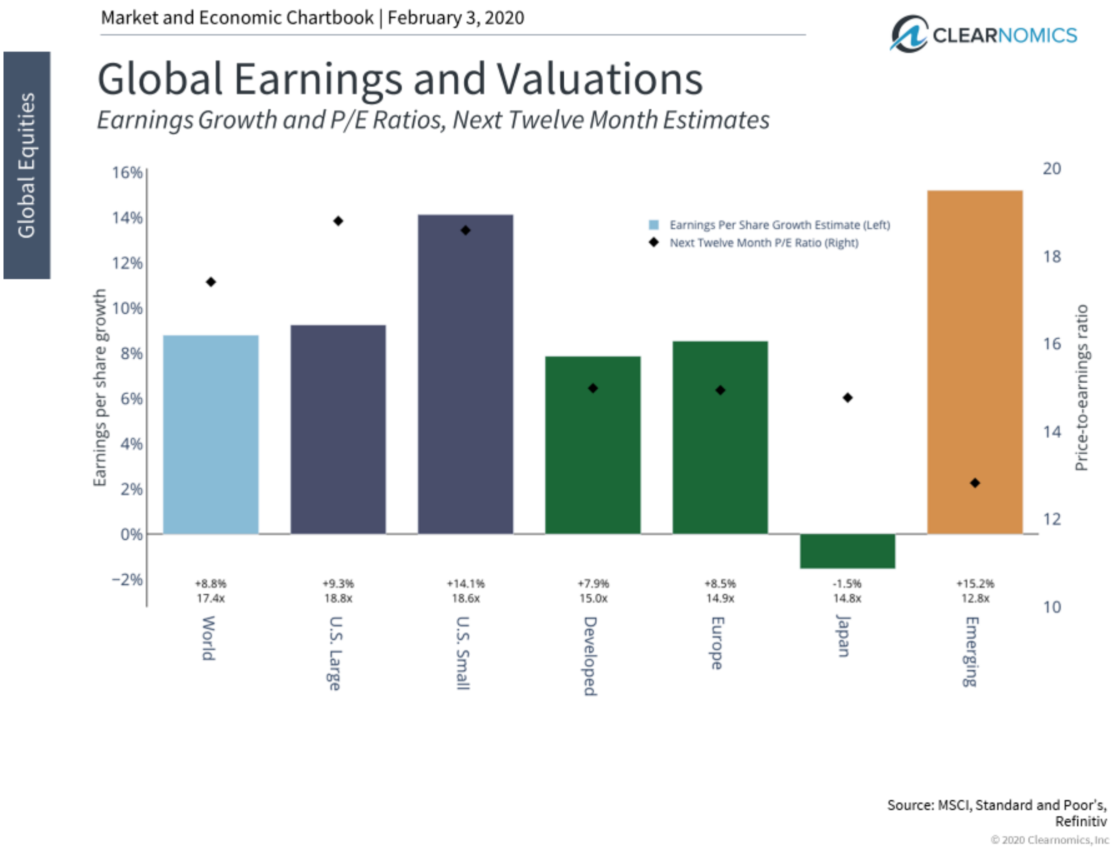
Global Stock Market Cycles
Find this chart under "Global Stocks"



Many international markets, especially emerging markets, are volatile by their nature. Over the past two decades, these markets have swung wildly over short-term periods. However, in the long run, they have performed extremely well for those investors who have been able to stay patient and have diversified properly in their portfolios.

3. Growth expectations are still healthy for international markets

Global Earnings and Valuations
Find this chart under "Global Stocks"



Not only are earnings growth expectations for many international markets comparable or better than those of U.S. large cap stocks, valuations are significantly cheaper across the board. This is because the U.S. stock market has risen steadily and outperformed significantly last year, despite weak earnings growth. Valuation levels are a key factor in future returns over the long run which, coupled with faster growth, suggests there may be growing opportunities in international investments.

The bottom line? Despite global uncertainty, it's important for long-term investors to stay internationally diversified and to focus on longer-term trends.

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