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International Equities: Through A Cracked Looking Glass

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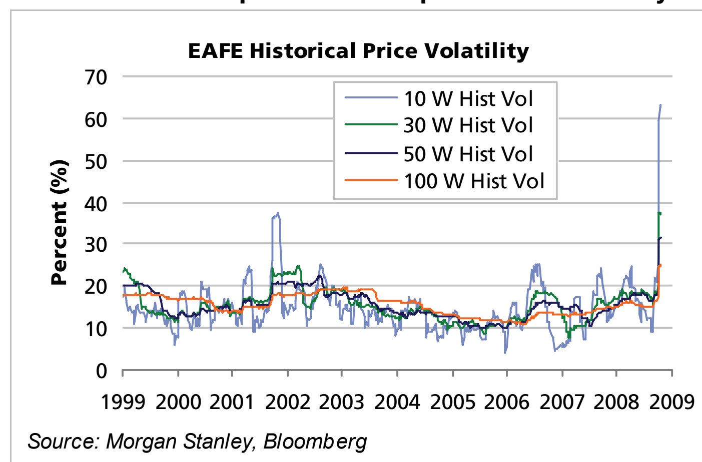
The nature of the spectacles or looking glasses worn by investors has long been used as a colorful way to describe the risk tolerance of the markets. Periods of optimism are associated with "rose-tinted glasses." When this gives way to a gloomier outlook, the glasses become "dark." The spike in market volatility, to levels not seen since the 1930's, seems to beg for a description other than "dark." At least a dark tint still allows for the definition of some image on the other side of the lens. A cracked looking glass is perhaps a better analogy to describe the current dilemma; if the cracks are widespread and deep enough, the image becomes contorted to a point beyond recognition.

The graph below of the weekly volatility of the MSCI EAFE Index (a good proxy for developed international markets from a U.S. perspective) back to the early 1980s is a dramatic illustration of how atypical this correction is. The current reading of more than 60% (annualized) renders prior crises rather pedestrian in comparison. Prior "crises" peaked in the 30-40% range – the 1987 October meltdown, 1990 Gulf War, 1998 LTCM collapse, and 9/11 in 2001 all saw volatility peak well short of current levels. While the resurgent U.S. dollar against the Euro and Pound Sterling (the bulk of EAFE) in recent months has added to the volatility, the questions nonetheless arise: are we in a new, higher, and sustained volatility regime, and if so, what that implies for markets. In particular, higher average volatility implies by definition a sustained, more risky environment, and would argue for lower valuations to compensate for this higher risk. What factors could contribute to higher equity risk premiums?

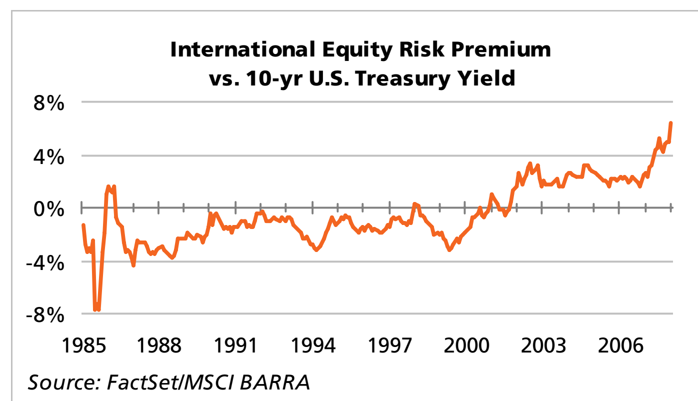
International Developed Markets: Unprecedented Volatility



Source: Morgan Stanley, Bloomberg

In the short-term, massive intervention by global central banks to provide liquidity and capital to a battered financial system appears, finally, to be unfreezing dysfunctional credit markets. Inter-bank spreads have fallen in the past week but have farther to go. While this positive trend has not enabled equity markets to gain traction after the low on October 10th, shrinking spreads in their own right should reduce overall risk. So markets are ripe for a bounce, and, in that wake, lower volatility. For the intermediate-, if not the longer-term, there are a number of factors that should keep volatility elevated. The extent of the global slowdown in 2009 (with global recession a strong possibility) suggests that more exogenous shocks, this time from the real economy, are likely. The geo-political backdrop remains risky. Perhaps the most important restraint is the secular period of deleveraging that is only a year old after three decades of juiced up returns through ever more leverage. Recent measures have controlled the rate of deleveraging, but are not likely to arrest the need for lower debt levels and more prudence. Reducing debt levels and unexpected shocks tend to be handmaidens, at least until the process is substantially complete.

On the positive side, as the graph below (a proxy for the equity risk premium, i.e., the forward earnings yield on the EAFE index minus the U.S. 10-year Treasury yield) illustrates, the current risk premium of 600 basis points is very elevated. From a valuation perspective, the international markets are factoring in the potential for both high risk and lower earnings if a global recession really bites. At the very least, investors need to take into account that longer term earnings growth is likely to fall well short of the 8-10% they are accustomed to. The echo of the damage done to investor confidence in this brutal bear market is likely to be with us for a long time.



Source: FactSet/MSCI BARRA

In time, the severely cracked eye-glass is likely to be fixed, but a return to the carefree days where rose tints rule is an improbable scenario. A dark tint will be an improvement on a contorted cracked glass, and will help regenerate savings and capital generation without resorting to excessive debt and risk. That in turn should reduce volatility and ultimately the risk premium, but this newfound virtue will need some time to heal the wounds. ■

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