LPL RESEARCH
WEEKLY MARKET COMMENTARY

January 23 2017

INTERNATIONAL STOCKS
WE LOOK EAST TO JAPAN

Burt White *Chief Investment Officer, LPL Financial*
Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*

KEY TAKEAWAYS

Corporate earnings drive stock prices; when looking at international markets, it's tempting to focus on macro factors, but earnings are still the most important driver.

After years of stagnation, profits in almost all foreign markets have been growing. We expect this growth to continue in 2017, despite global economic risks.

The Japanese market has experienced significant changes over the past few years, warranting further consideration by suitable long-term investors.

After years of earnings recession, improving corporate earnings and relatively low valuations are making overseas investments more attractive. For the all consternation over and discussion of geopolitical and macro-economic issues, what ultimately drives stocks everywhere are corporate earnings, and earnings almost everywhere are increasing. Furthermore, analysts' estimates of future earnings have also been increasing, despite lingering uncertainties around the impact of the Brexit vote and the U.S. election. We have already seen a dramatic increase in earnings for emerging markets (EM) in 2016, while 2017 expectations for both EM and developed market stocks, as measured by the MSCI EAFE Index, continue to improve. The biggest positive surprise may be coming from Japan as its market climate restructures. Valuations are generally attractive on both an absolute and relative basis across most markets. We have been relatively constructive on EM for most of 2016 and are now looking at other international markets.

END OF THE DROUGHT

Before something can go up, it must stop going down. Corporate earnings have been declining since Q2 2011 for both the MSCI EAFE Index and MSCI Emerging Markets Index [Figure 1]. Note that what gets referred to as the earnings recession for the S&P 500 was very shallow by comparison, and only began in Q3 2014. Only a handful of companies in the MSCI EAFE Index have reported Q4 2016 earnings as of January 20, 2017. However, expectations are for a strong quarter and for calendar year 2016 earnings to end with just over 1% growth. While hardly inspiring, if the year should show positive growth as expected, it would be the first annual growth since 2011. Some of this growth

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging market.

EARNINGS ESTIMATES

All earnings expectations discussed reflect consensus opinion from FactSet and Thomson Reuters.

will come from the energy and energy-related industrial sectors, in which earnings have been declining along with oil prices in 2015 and early 2016. The positive impact of oil over $45/barrel will be evident in Q4 2016 earnings, but it will not be until 2017 that the effect is more fully apparent.

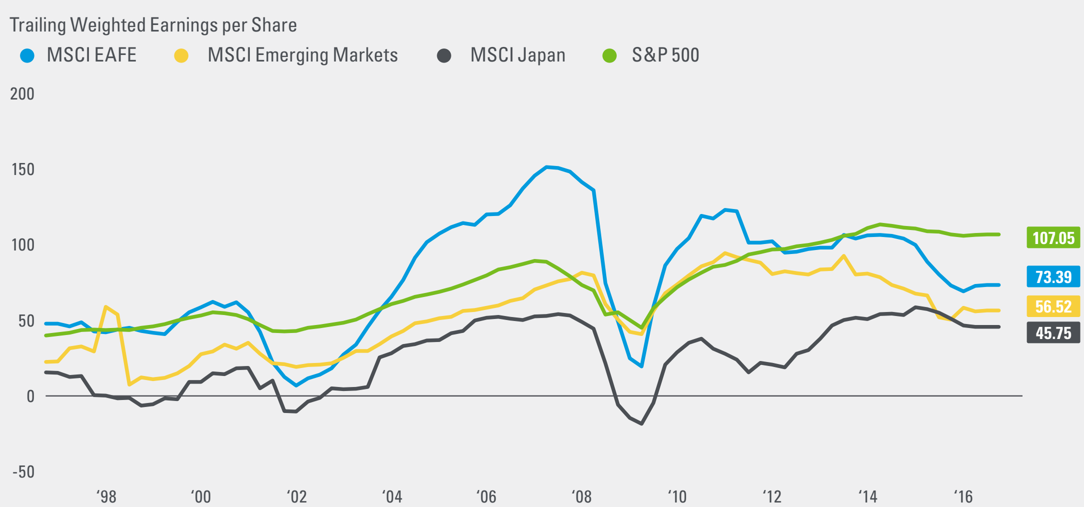
The drought in EM earnings growth turned in Q1 2016. Though less than 3% of EM companies have reported earnings yet for Q1 2017, market expectations are for over 17% earnings growth for the index for 2016. As in developed markets, earnings for energy, but also materials stocks have been rebounding with higher prices globally.

WHEN IT RAINS, IT POURS

We often say it's earnings that determine stock market performance in the long run. However, we are also very interested in the shorter-term impact of estimate changes for future earnings. For almost all international markets, earnings forecasts for 2017 have increased since September 30, 2016 [Figure 2]. A number of major geopolitical events have occurred since then, including the likelihood the U.K.'s departure from the European Union will happen with more substantive changes (the so-called "hard Brexit"), an anti-European vote in Italy, and the election of Donald Trump, who has promised a more protectionist U.S. trade policy. Each of these events could have dampened earnings forecasts and they still may diminish earnings as the year unfolds. Yet despite these events, and others looming on the horizon, analysts have been increasing their 2017 estimates.

Valuations continue to be attractive in overseas markets [Figure 3]. Typically, we look at this sort of data over a shorter time frame. This longer perspective shows how harmonized global equity markets (including the S&P 500) have become.

1 LONG-TERM EARNINGS TREND: THE DROUGHT IS ENDING AND REGIONS SHOWING RECOVERY



Source: LPL Research, Bloomberg 01/23/17

All indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price.

Market movements are more synchronous now than they used to be, which is a negative for investors looking for increased diversification overseas. However, if markets are indeed more correlated to each other, that implies that buying when markets are attractively valued may be even more important. The earnings acceleration overseas, combined with lower valuations, strengthen our conviction on emerging markets, despite the heightened risks, and suggest that developed markets may be looking more attractive as well.

THE EAST LOOKING MORE WESTERN

The Japanese economy, and for the most part its stock market, has been waning for so long it's hard to remember that Japan used to matter to global investors. However, even after years of stagnation Japan is still the world's third-largest economy and second-largest stock market by overall capitalization at approximately 8% of global stock markets combined. Japan may finally represent a long-term investment opportunity. Why? First, there is earnings growth potential, likely to be 4.5% for 2016 and expectations for 11.7% growth for 2017.

The bigger issue for Japan is the potential change in how investors view the country and its stocks as a result of a significant change in how the country and the companies in it operate. This shift usually only happens in emerging markets. Japan has seen major changes since its equity market peaked in 1989. Historically, the Japanese market had features that made the market relatively unattractive. Many of these attributes have evolved [Figure 4] in some ways making the Japanese market more conventional, and therefore perhaps more attractive to foreign investors.

Japan used to be an expensive market with price-to-earnings (PE) ratios regularly above 70, and at times in the hundreds, during some of the market peaks, such as 2002 and 2008. Valuations in Japan were high for two reasons. First, Japan had extraordinary low interest rates for years, but Japan

2 EARNINGS GROWTH EXPECTATIONS HAVE IMPROVED IN THE PAST FOUR MONTHS

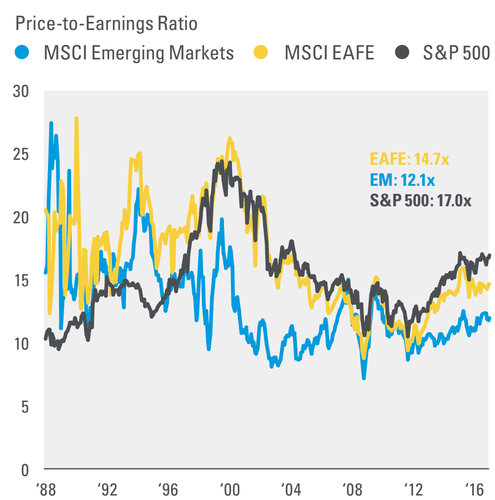
	2016 Growth Expected 1/20/17	2017 Growth Expected 9/30/16	2017 Growth Expected 1/20/17
MSCI EAFE	1.27	13.07	14.68
MSCI EM (Emerging Markets)	17.57	12.63	13.77
MSCI Japan	4.46	8.66	11.65
MSCI Europe	0.46	16.00	17.03

Source: LPL Research, Thomson Reuters 01/20/17

All indexes are unmanaged and cannot be invested into directly. Past performance is not indicative of future results.

Earnings estimates may not develop as predicted.

3 VALUATIONS BECOMING IN SYNC ACROSS GLOBAL MARKETS



Source: LPL Research, FactSet, Thomson Reuters 01/20/17

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

is no longer alone in having low or negative interest rates. Second, for all their success in gaining market share and creating major global brands, Japanese companies were not as efficient, as measured by statistics like return on equity (ROE) and were not as profitable as similar companies based in other countries.

There were many reasons for why the Japanese market was different from western markets, and many of these reasons are changing. Japanese companies often offered lifetime employment; firing or laying off workers was a rare concept in Japan, even during periods of recession or changing business conditions. Today, fewer than 10% of Japanese companies still use lifetime contracts. Being able to lay off workers has had several impacts on business in Japan; they are now more profitable because they are able to react to economic changes. But also, Japanese companies are more inclined to hire and Japan's workforce is growing, despite an overall aging population. This increase in workforce has increased consumer spending, and therefore boosted Japanese consumer stocks.

4 NOT YOUR FATHER'S TOYOTA—THERE HAVE BEEN MAJOR CHANGES IN THE JAPANESE MARKETS

	12/01/89	12/01/16
Market Capitalization (Total Stock Exchange)	590	591
Cross Holdings	50%	6%
Foreign Holdings	4%	31%
Price-to-Earnings (PE ratio)	61x	16x
Earnings per Share (EPS)	21	80
Return on Equity (ROE)	1.90%	8%
Number of Companies	1,165	1,885

Source: LPL Research, Tokyo Stock Exchange, Wisdom Tree 01/20/17

Data as of 12/01/16.

Cross Holdings is a system where Japanese companies own shares of each other.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability.

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

The final structural component in the potential Japanese equity revival is the undoing of the system of cross holdings across Japanese companies, known as the *keiretsu*. Under the keiretsu system, Japanese companies often own shares of each other. This suggests that sometimes corporate decisions are made for the benefit of other companies under the umbrella, rather than profit maximization or shareholder return. The number of shares held within the keiretsu system has declined dramatically. As a result, the percentage of Japanese shares held by foreigners has increased, as investors gain confidence that corporate managers are working for them, not for themselves, their employees or other companies within the keiretsu.

CONCLUSION

Improved earnings oversees are motivating global investors to examine areas that have been out of favor, either for the past few years, like emerging markets, or the past few decades, like Japan. What they are finding are improving expectations for future earnings, more attractive valuations, and in the case of Japan, positive structural changes in the way companies operate. LPL Research has been positive on emerging markets for some time, and are now looking to the more developed markets for opportunities.* ■

*As noted in our Outlook 2017: Gauging Market Milestones, we expect mid-single-digit returns for the S&P 500 in 2017 and the continuation of the nearly eight-year-old bull market, consistent with historical mid-to-late economic cycle performance. We expect S&P 500 gains to be driven by: 1) a pickup in U.S. economic growth partly due to fiscal stimulus; 2) mid- to high-single-digit earnings gains; 3) an expansion in bank lending; and 4) a stable price-to-earnings ratio (PE) of 18–19. Gains will likely come with increased volatility as the economic cycle ages.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indexes that represent developed markets outside of North America: Europe, Australasia, and the Far East.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Japan Index is a free float-adjusted, market capitalization-weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ, and Nagoya Stock Exchange.

RES 5757 0117 | Tracking #1-574747 (Exp. 01/18)