

ARE INVESTORS OVER-ALLOCATED TO THE U.S.?

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Last week on Behind the Markets we spoke with Karthik Sankaran, a former emerging markets hedge fund currency trader and Eurasia group strategist. Sankaran studied modern Europe during his training and generally focuses on the intersection of geopolitics, the economy and financial markets when evaluating investment opportunities.

Sankaran pivoted 10 years ago from being a deep euro-skeptic to believing that not only would Europe survive, but potentially thrive. Heading into the 2016 [Brexit](#) referendum, people worried that Brexit would increase centrifugal forces for others to leave the European Union. Sankaran, by contrast, believes the U.K. leaving instead increases forces for staying within the EU—with remarkable unity amongst the bloc's 27 countries.

Sankaran's euro-skeptic mentors suggested the euro would fail as a political project, and Sankaran believes politics are stepping in and keeping it alive. Bringing the politics to a currency view, Sankaran is [bullish](#) on the euro and sees it increasing toward 1.35 versus the U.S. dollar in the future during the currency up-cycle.

The first force driving the euro higher is a general understanding that the eurozone is a viable project and will survive. The second force is an increasing recognition in Europe that its [current account](#) surpluses are being caused by depressed fiscal spending. Sankaran sees two actions that countries can use to stimulate a depressed economy. One is to depreciate a currency to make goods more competitive, which angers and annoys the rest of the world, particularly the United States. The other is to employ more fiscal stimulus, and Europeans are coming to focus on this.

In the 2002 to 2008 cycle, the euro went from 81 cents to \$1.60. Sankaran doubts we will get back to those levels given the U.S. balance of payment developments spurred by the U.S. shale revolution. Once the U.S. became self-sufficient in energy, the U.S. current account deficits went from 6% to 3%. High external funding requirements required much higher [interest rates](#) to attract capital.

Sankaran believes investors are under-allocated to foreign markets and that U.S. dominance goes in long cycles of relative performance. Allocations to Europe and emerging markets are derided. But the U.S. weight in the [MSCI All Country World Index](#) was around 43% back in the early 2010s and today it is closer to 60%. We discussed a positive view on Europe above, but since 2014, a strong dollar weighed on emerging market allocations, and its recent pivot could lead to better dynamics for developing economies.

Dollar Bear in Cyclical Terms: With the U.S. engaged in relatively loose [fiscal](#) and [monetary policy](#), the mix is not dollar positive. The Fed also changed their reaction function. Starting in 2014–2015, the [Federal Reserve \(Fed\)](#) moved to a monetary conditions approach, suggesting explicitly that a 1% move in the trade-weighted dollar is equivalent to a 10-[basis-point](#) move in the [Fed Funds rate](#). The Fed, under former chair Ben Bernanke, thought of a strong dollar as something that would help global economies export more to the U.S., though the new Fed seems more concerned about tightening financial conditions from a strong dollar.

Going to emerging markets debt, Sankaran sees a strong case for emerging market local currency debt. During past emerging market crises, EM faced a double whammy of rising rates and currencies going down, which tightened financial conditions. But many EM countries, particularly Southeast Asian and Eastern European countries, run large manufacturing surpluses and are able to cut rates because they have lower external financing requirements. There is also a view that they can depreciate back to prosperity. In total, these countries are better positioned today to fight weakness.

For those interested in global macro and market dynamics, this was a great conversation, and we thank Karthik for coming on our program!

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DEFINITIONS

Brexit : an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Bullish : a position that benefits when asset prices rise.

Current account : The difference between a nation’s total exports of goods, services and transfers, and its total imports of them.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

MSCI All Country World Index : a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed and emerging market countries.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Basis point : 1/100th of 1 percent.

Fed fund futures : A financial instrument that lets market participants determine the future value of the Federal Funds Rate.