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THE INTELLIGENT INVESTOR | JASON ZWEIG

The Intelligent Investor: International Stocks Are a Disaster. That May Mean It's Time to Buy.

Markets almost always misprice the obvious.

That's worth bearing in mind as you think about the U.S. stock market's nerve-racking decline this week. It's worth remembering as you size up the behavior of stocks in the rest of the world, too.

If the future unfolds according to the consensus, markets won't move much. Surprise is the source of extra returns, magnifying gains and losses alike.

Enterprising investors—those who are willing to put time and effort into diverging from the crowd—should always be thinking about where the potential for surprise is the greatest. For U.S. investors right now, that could mean venturing abroad.

On just about every dimension, international stocks look and feel miserable. The economic news is dismal, currencies are crippled and returns have been rotten for years. Things are likely to get even worse before they get better.

Europe is caught up in a war that could escalate without warning or limit—as well as a looming recession. Fierce energy inflation will also make European manufacturers less competitive.

Japan has been sluggish for years. In China, economic growth is shriveling. Other emerging markets are suffering from the soaring costs of energy and food.

Meanwhile, the U.S. dollar is dominant. It's near its highest value relative to the Japanese yen in a quarter-century and recently rose past the euro for the first time in two decades.

For unhedged U.S. investors, the dollar's 13% gain so far this year has hammered international stocks. A rising dollar hurts returns on stocks denominated in other currencies; a falling dollar tends to raise returns.

ALEX NABAUM

The MSCI index of all non-U.S. markets is down 20% this year, nearly 3 percentage points behind the U.S. Over the past decade, international stocks lag behind the U.S. by a ghastly average of almost 9 percentage points annually.

Emerging markets have done even worse. "When economies are slowing and earnings have been poor, that's driven down currencies in tandem," says Andrew Foster, chief investment officer at Seafarer Capital Partners, an asset manager in Larkspur, Calif., that specializes in emerging markets. "Investors who held the equities and currencies together have gotten whacked with two clubs at the same time."

At this point, it's obvious: International shares are priced for almost nothing but negativity.

U.S. companies may be so much more innovative that they deserve to be more richly valued than stocks elsewhere in the world. But how much of a premium do they deserve?

By nearly every measure, stocks listed on overseas markets have become much less expensive than those in the U.S. In the late 2000s, international and U.S. stocks were valued at similar multiples of earnings, net worth, cash flow and revenues. Now other markets trade at roughly half the valuation ratios of the U.S.

International stocks are more likely to be in such economically sensitive, "cyclical" industries as banking and manufacturing, while the U.S. market is tilted toward technology and healthcare.

If you think one step ahead, toward the recession that feels so obvious, that's bad news for international stocks. A down cycle will hit them harder. If, however, you think toward an eventual economic recovery, the story changes.

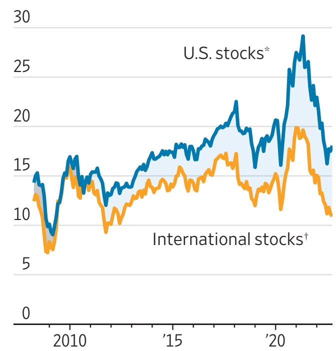
"Once markets reach their nadir, cyclicals tend to perform the best," says Sarah Ketterer, chief executive of Causeway Capital Management, a global investing firm based in Los Angeles. Consider the bounceback over the five years ending in late 2007. U.S. stocks gained an average of 15% annually; international stocks grew by more than 24% annually. The value of the dollar also fell over that period, raising returns for unhedged investors.

That interlude didn't last, and

Mind the Gap

Years ago, investors valued international and U.S. stocks at similar levels. Now non-U.S. stocks are cheaper by comparison.

Ratio of share prices to earnings



*iShares Core S&P Total U.S. Stock Market ETF
†iShares MSCI ACWI ex U.S. ETF
Source: FactSet

the past decade-plus has made a monkey out of anyone predicting a renaissance for investing outside the U.S., including me.

Turning your back on international stocks today, however, is a bet that their lousy performance is pretty much permanent. And not many things in markets last indefinitely.

Over the 10 years ended in December 1986, international stocks outperformed the U.S. by an average of 6 percentage points annually—even though foreign currencies weakened.

Now international currencies, and stocks, are simultaneously depressed relative to the U.S. If the dollar ultimately declines from its recent record highs, that drop would crank up the returns on overseas stocks. I can't tell you when that will happen, but I think it probably will.

With pessimism this pervasive, it wouldn't take many positive surprises to overturn the obvious—and make global diversification lucrative again.

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