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The rise in comovement across national stock markets: market integration or IT bubble?

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Abstract

A stylized fact in the portfolio diversification literature is that diversifying across countries is more effective than diversifying across industries in terms of risk reduction. But with the rise in comovement across national stock markets since the mid-1990s, this no longer appears to be true. We explore if this change is driven by global integration and therefore likely to be permanent, or if it is a temporary phenomenon associated with the recent stock market bubble. Our results point to the latter hypothesis. In the aftermath of the bubble, diversifying across countries may therefore still be effective in reducing portfolio risk.
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1. Introduction

One of the most pronounced empirical regularities in international equity markets has been the low degree of correlation of returns across national stock markets. This empirical regularity has broken down in recent years. As Fig. 1 shows, the correlation coefficient of US stock returns with equity returns in other developed countries has risen from a relatively stable level of around 0.4 from the mid-1980s through the mid-1990s to close to 0.9 more recently. There are several possible explanations for this. First, there may have

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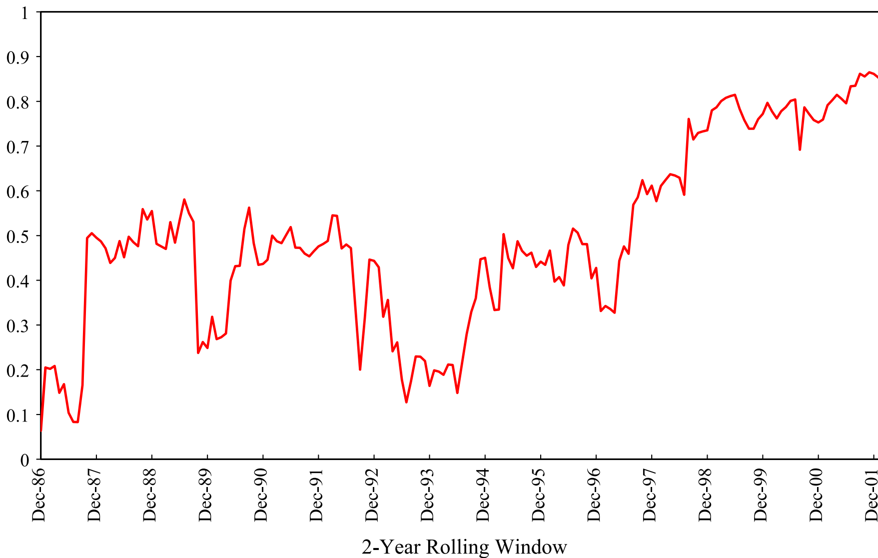

Fig. 1. Two-year rolling window for the correlation coefficient of monthly US dollar-denominated stock returns with returns in other developed markets, based on US dollar-denominated monthly total returns from the Datastream Global Equity indices. The developed markets index excluding the US comprises the United Kingdom, France, Germany, Italy, Japan, Canada, Australia, Austria, Belgium, Denmark, Hong Kong, Ireland, the Netherlands, New Zealand, Norway, Spain, Portugal, Sweden, Switzerland, Finland, Luxembourg and Singapore. The underlying data goes from January 1985 to February 2002.

been a decline in home bias in the portfolio holdings of investors. As a result, the marginal investor in German equities may no longer be German, so that country-specific investor sentiment now plays a smaller role in national equity markets. Second, firms may be becoming more diversified across countries in their sales and financing. As a result, companies around the world may be more exposed than before to the global business cycle, causing national stock markets to move together more. Third, it is possible that the rise in comovement since the mid-1990s is simply a temporary phenomenon associated with the recent stock market bubble.[2]

For the portfolio diversification literature, the question of whether the rise in synchronization across national equity markets is driven by fundamentals, and therefore likely to be permanent, or if it is linked to the recent stock market bubble, and thus more likely to be temporary, is of great interest. This is because recent studies have challenged the widely held view that variation in international stock returns is due mainly to country-specific effects. For example, Heston and Rouwenhorst (1994, 1995) show that country-specific sources of return variation are dominant even in geographically concentrated and economically integrated regions such as Western Europe. Griffin and Karolyi (1998) find

[2] There may be additional reasons why comovement across national equity markets has increased, including convergence in industrial composition and greater policy coordination across countries, or simply that country-specific shocks have declined in importance.

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