



INSIGHT & PERSPECTIVE

Welcome to the Neighborhood

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The relative outperformance of the U.S. equity markets versus the rest of the world is still confounding market participants that point to valuation imbalances.

Is the U.S. really the “best house in a bad neighborhood”?

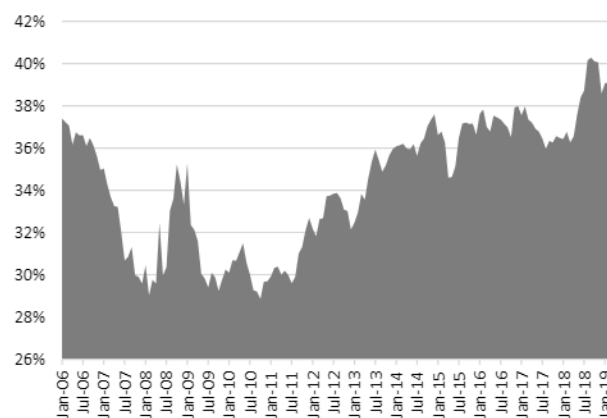
Investors have been happy to come knocking for U.S. equity exposure; raising the U.S. market capitalization versus the rest of the world.

Fresh Paint, Spring Flowers, Warm Cookies

Global equity investors continue to knock on the U.S.’s door and domestic stock markets are happy to let them in. It has been a prevailing trend since the “great recession” and most pointedly over the last year; the U.S. stock market is leading the rest of the world. And in our view, for good reason, although valuations versus foreign developed markets especially are getting stretched. More on that later. As far as the global neighborhood is concerned...we do not think it is that bad fundamentally, but clearly the U.S. house has the best facade. Tax policy changes, corporate earnings, an easy Federal Reserve, and relative strength in the U.S. economy outshine the rest of the world. So there should be little wonder, in our view, that investors are making their way to the U.S.’s front door. The relative fundamentals and the directional change of those fundamentals are indeed hospitable.

Figure 1: U.S. Equity Markets = % of World Market Capitalization

Source: Bloomberg



Simple Rhyme and Reason

What has allowed for the post-recession outperformance in U.S. stocks is a more sustainable improvement in corporate fundamentals and the economy versus the balance of the world. The fundamental illustration here is really very simple and helps justify the case for relative U.S. equity gains. While the U.S. has struggled with periods of slow growth, the foreign developed world has fared worse in this regard and economic

growth rates in emerging economies have, in fact, steadily deteriorated. The latter point is where the concept of directional change really comes in. Market participants often seek exposure to assets or economies which are trending up and reduce or avoid exposure where trends are negative. The absolute value of an asset price or other variable may have a lesser consequence. It is the trend that often matters. An example is emerging market economic growth (Table 1). While the level of EM (Emerging Markets) growth (Real GDP) is more attractive than practically any other place in the world, the trend in EM has been negative. This directional change has been reflected in relative equity prices. Conversely, the generally positive directional change in U.S. GDP versus other developed and emerging constituents is one reason U.S. stocks have outperformed. Monetary policy, tax policy, and the relative efficiency of U.S.-based companies has helped give the U.S. economy and equity markets a leg up.

Table 1: Heatmap - Real GDP YoY % Change

Source: Bloomberg; EM = Emerging Markets

Deep green or light green is the desired shade in the heatmap. Red or deep amber points to a deteriorating trend across the GDP time series.

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
US	3.30	2.70	1.80	-0.30	-2.80	2.60	1.60	2.20	1.80	2.50	2.90	1.60	2.20	2.90
Eurozone	1.70	3.20	3.10	0.40	-4.50	2.10	1.60	-0.90	-0.20	1.40	2.10	2.00	2.40	1.90
Japan	1.30	1.70	2.18	-1.05	-5.43	4.20	-0.13	1.55	2.00	0.38	1.25	0.60	1.93	0.80
EM	7.52	8.57	9.21	6.43	2.86	7.73	6.74	5.36	5.20	4.63	4.44	4.42	4.90	4.95

Table 2: Macro Global Index Returns

Source: Bloomberg

	Date Range: 12/31/2008 - 3/31/2019				Date Range: 12/31/2018 - 3/31/2019			
	Price Chg. (%)	Total Ret. (%)	Diff.* (%)	Ann. Ret. (%)	Price Chg. (%)	Total Ret. (%)	Diff.* (%)	Ann. Ret. (%)
S&P 500 Index	213.8	289.5	174.5	14.2	13.1	13.7	3.5	70.0
MSCI Em Mkts. Index	86.6	145.8	30.8	9.2	9.6	9.9	-0.3	47.9
MSCI EAFE Index	51.6	115.0	(-)	7.8	9.0	10.2	(-)	49.4

*Total return difference between index and the lowest index value. Ann. = Annualized

Valuation and Price Ratio Extremes

To us, the fundamental reasoning behind the post-recession U.S. equity outperformance has been fairly clear. And the case for U.S. equities has been reflected in the willingness of investors to award U.S. markets with premium valuations. Fundamental conditions for equities and returns on equity in U.S. markets, have been better; but how long will that last? In the near-term we see no catalyst that could change the current trend. U.S. economic conditions, relative to the rest of the world, are forecasted to be better through 2019. The Eurozone and Japan are struggling with slow growth and investors seem to be unsure of what an economic slowdown in

China means for their emerging markets investments. With these variables in mind, U.S. equity outperformance, absent a near-term shock, could continue.

Table 3: Global Index Trailing P/E Valuation and Returns on Equity

Source: Bloomberg

	Price-to-Earnings (P/E)					ROE
	Current	High	Low	Average	Variance*	
S&P 500 Index	18.7	24.1	12.6	17.8	5.1%	16.1
MSCI Em Mkts. Index	12.9	23.3	9.6	13.8	-6.5%	12.7
MSCI EAFE Index	15.3	24.5*	11.2	18.8	-18.6%	10.9

Valuations are perhaps slightly extended in the U.S., fair in emerging markets and cheap in non-U.S. developed markets.

A contrarian investor is a person who opposes popular opinions on an investment or the markets.

BRIC is an acronym referring to the countries of Brazil, Russia, India, and China. The reference received significant attention in the mid-2000s when material economic growth in these countries attracted significant investor interest.

Contrarians, however, may have a slightly different view, and we are indeed cognizant of performance extremes that could prove to be significant for global investors. Notably, the S&P 500 Index/MSCI EAFE Index price ratio is pointing to a definitive imbalance, and the S&P 500 Index has also gathered steam versus emerging markets. As for the latter, we believe the market is still correcting some emerging market euphoria that existed when “BRIC” was the investment watchword of the day. Well, the BRIC story has indeed cooled and emerging markets may still have more to go in their descent toward earth. Meanwhile, developed foreign markets may be the place to go for those establishing a global contrarian view. While it will likely take some patience, positioning for an eventual turn in MSCI EAFE sentiment could be something that warrants early investor consideration.

The red lines in Figures 2 & 3 are the ratio averages over each time series.

Figure 2: S&P 500 Index / MSCI EAFE Index Price Ratio

Source: Bloomberg



Figure 3: S&P 500 Index / MSCI Emerging Markets Index Price Ratio

Source: Bloomberg



Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.



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