Third Quarter 2018 Knowledge College

The U.S. Equity Freight Train, Can Anything Derail it?

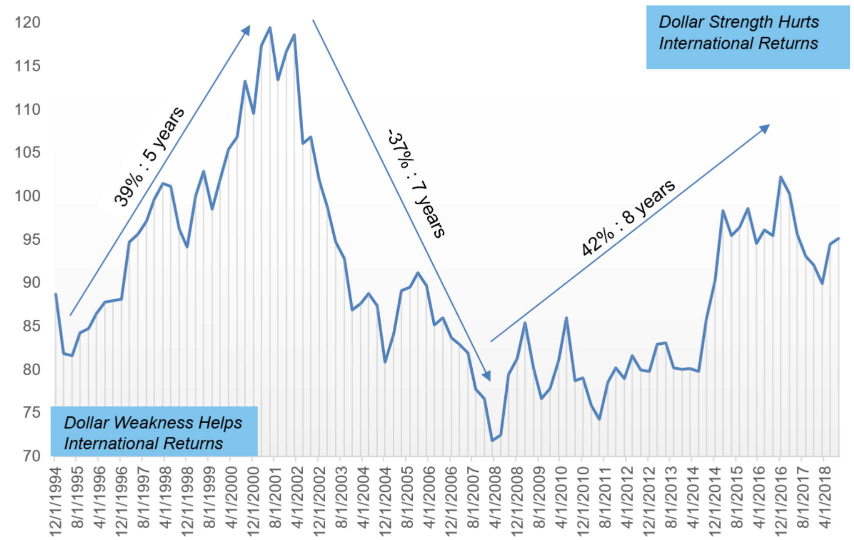
As of the close of the third quarter 2018, the S&P 500 index (U.S. Large Cap equities) has outperformed the MSCI ACWI ex USA index (international equities) in 70% of the past 10 calendar years and by 6.2% on a ten year annualized basis, the widest margin in the last 20 years.[1] So the question investors are rightly asking is: will the U.S. equity freight train ever stop? Let's quickly evaluate historical returns to see how unprecedented recent U.S. Equity success has been. To limit the bias of our starting point and short-term market swings, we have evaluated various rolling periods over the last 20 years. Unlike what the last few years would have led us to believe, U.S. equity markets do go through periods of underperformance. In fact, the U.S. has underperformed both the MSCI ACWI ex USA and MSCI Emerging Markets indexes half the time or more over the last 20 years when evaluating rolling 5- and 10-year periods. Additionally, when it comes to U.S. versus international markets, currency can play an important role. We observed that when the U.S. dollar strengthened, the U.S. equity market outperformed in every trailing period since 1998.[2] Conversely, there are similarly strong statistics for U.S. equities underperforming when the dollar weakened. So if U.S. equities do not consistently stack up as well as you would expect over the long-term, why have they performed so well since the financial crisis?

S&P 500 20-year historical results

	S&P 500 Index Outperforms MSCI ACWI ex USA	S&P 500 Index Outperforms MSCI EM
5-Year Periods	50%	44%
10-Year Periods	36%	27%
Dollar Strengthens 5-Year Periods	100%	100%
Dollar Strengthens 10-Year Periods	100%	100%
Dollar Weakens 5-Year Periods	10%	10%
Dollar Weakens 10-Year Periods	22%	0%

Source: Morningstar returns & Bloomberg dollar data as of 9/30/18

U.S. dollar historical return



Source: Bloomberg as of 9/30/2018

The global financial crisis changed many things and one of the outcomes was that the U.S. market became the darling of the globe. Faster and more aggressive responses to the financial crisis coupled with headwinds unique to international markets like the Greek debt crisis and "Brexit" put domestic markets ahead of global peers. These factors also created a strong tailwind behind the U.S. dollar. Since the beginning of 2008, from trough to peak, the U.S. dollar has strengthened by 42%, its longest and largest period of appreciation since June 1995 when the U.S dollar rallied a similar magnitude of 39% before falling 37% over the subsequent years.[2] As the U.S. dollar strengthens international asset returns are negative while currency effects add to international asset returns when the U.S. dollar weakens.

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DIMEO SCHNEIDER & ASSOCIATES, L.L.C.

Outlook

The U.S. makes up 52% of the global market and just 24% of global GDP.[3,4] A portfolio without international allocations ignores much of the opportunity set and the vast majority of the global economy. Allocations to international markets reduces the reliance on just one country to provide return and have the potential to lower overall portfolio risk while increasing return. But why now?

Valuation – Our allocation philosophy is rooted in the long-term and focuses on finding relative opportunities. We seek these opportunities on a forward-looking basis where a dollar invested offers as much value as possible and with the highest probability of success. Today, valuations are lower outside of the U.S. and it is where we see the greatest opportunity in the public equity markets. Current domestic valuations are above long-term averages and above international peers, while outside of the U.S. the opposite scenario exists. We have broken down the MSCI ACWI ex USA, which includes 22 developed countries and 24 emerging market countries, into developed and developing country indexes to demonstrate lower valuations are not occurring because of one particular region. Both the MSCI EAFE (developed international equity) and the MSCI Emerging Markets (developing equity) exhibit more favorable valuations. Additionally, we care not just about the absolute valuations, but the differences in valuation between regions when allocating capital. Today, the S&P 500 Index trades at a 43% price-to-earnings premium compared to the MSCI ACWI ex USA, the largest premium since 1997.[2] The last time such a premium existed, we observed a reversal where domestic markets fell behind, as international markets outperformed by 4.2% annualized over the next 10-year period.[1]

Current valuations

Index	Current P/E	Historical P/E (10-Years)
S&P 500 Index (U.S. Equity)	21	18
MSCI ACWI ex USA Index (International Equity)	15	17
MSCI EAFE Index (Developed International Equity)	16	19
MSCI Emerging Markets Index (Developing Equity)	13	14

Source: Bloomberg as of 9/30/2018

Currency – "Trees don't grow to the sky" is a proverb intending to demonstrate the natural limits to growth. We do not carry the expectation that the recent strength of the U.S. dollar will continue indefinitely because of interest rate differentials, deficits, and policy. Interest rate differentials, which are an important component of currency returns, are likely to moderate as the U.S. finds a natural top to rates or the rest of the world responds to higher growth by raising their interest rates to keep inflation in line. In terms of deficits, the U.S. currently runs a trade deficit of 2.5% and a budget deficit of 3.5% which over the long-term weigh on the strength of the U.S. dollar.[2] Lastly, the current administration has signaled interest in a weaker dollar favoring the potential for export growth rather than concern for inflation on imported goods which also weighs on the potential for U.S. dollar strength. While none of these factors change the value of the U.S. dollar overnight, they do leave clues to the currency's long-term direction which we believe is more likely to be lower.

 1) Morningstar, 2) Bloomberg, 3) MSCI 4) International Momentary Fund (IMF)