DIMEO SCHNEIDER
& ASSOCIATES, L.L.C.

The U.S. Equity Freight Train

Can Anything Derail it?

October 2018

Bradford Long, CFA
Principal, Research Director – Global Public Markets

As of the close of the third quarter 2018, the S&P 500 index (U.S. Large Cap equities) continued to show dominance over international equity peers. In fact, over the past 10 years, the S&P 500 index has outperformed the MSCI ACWI ex USA index (international equities) in 70% of the calendar years and by 6.2% annualized, 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?

"History doesn't repeat itself, but it does rhyme" - Mark Twain

We do not often look to past returns to build future forecasts, though it can be a helpful exercise to provide a reasonable baseline when setting future expectations. Today, we are sitting atop the most outsized 10-year return period of domestic vs international equities over the last 20 years. How do we use history to take stock in that fact and to set a foundation for future expectations? First, let's start with the elephant in the room, do U.S. equities ever underperform? A comical question to some, but when you look back over recent years, the anecdotal evidence would suggest they do not. To limit the bias of our starting point and short-term market swings, we evaluated various rolling periods over the last 20 years. That means we look back in time and we evaluate longer trailing return periods such as 5- or 10-years, rather than just a single calendar year. 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 on a rolling 5- and 10-year basis. There are many components to return such as dividends, valuation and earnings growth. However, when it comes to U.S. versus international markets, currency can play an important role. To that end, we evaluated returns over periods of U.S. dollar strength and U.S. dollar weakness. In 100% of the trailing periods since 1998, when the U.S. dollar strengthened, the U.S. equity market also outperformed[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

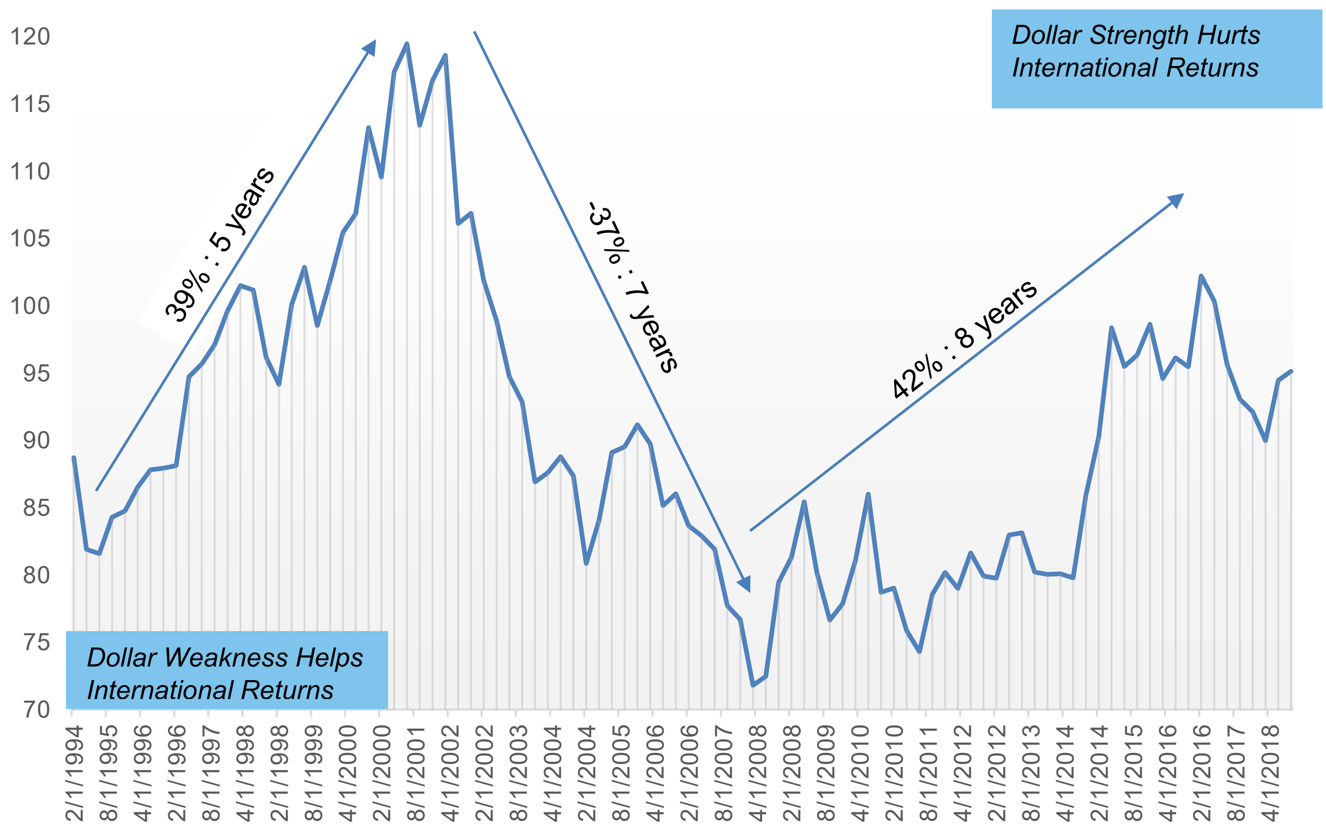
	S&P 500 Index Outperforms MSCI ACWI ex USA	S&P 500 Index Outperforms MSCI EM
5-Year Periods	50%	44%
10-Year Periods	36%	27%
Dollar Strengthens 5-Year Periods	100%	100%
Dollar Strengthens 10-Year Periods	100%	100%
Dollar Weakens 5-Year Periods	10%	10%
Dollar Weakens 10-Year Periods	22%	0%

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

The Modern Regime

The global financial crisis changed many things, but one of the unintended results was 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, "Brexit" or political unrest, 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 percent, its longest and largest period of appreciation since June 1995 when the U.S dollar rallied a similar magnitude of 39 pecent before falling 37 pecent over the subsequent years[2]. As you can see from the chart below, the U.S. dollar tends to go through prolonged periods of strength and weakness. As the U.S. dollar strengthens, that typically detracts from international asset returns; conversely, as the U.S. dollar weakens, it adds to international asset returns.

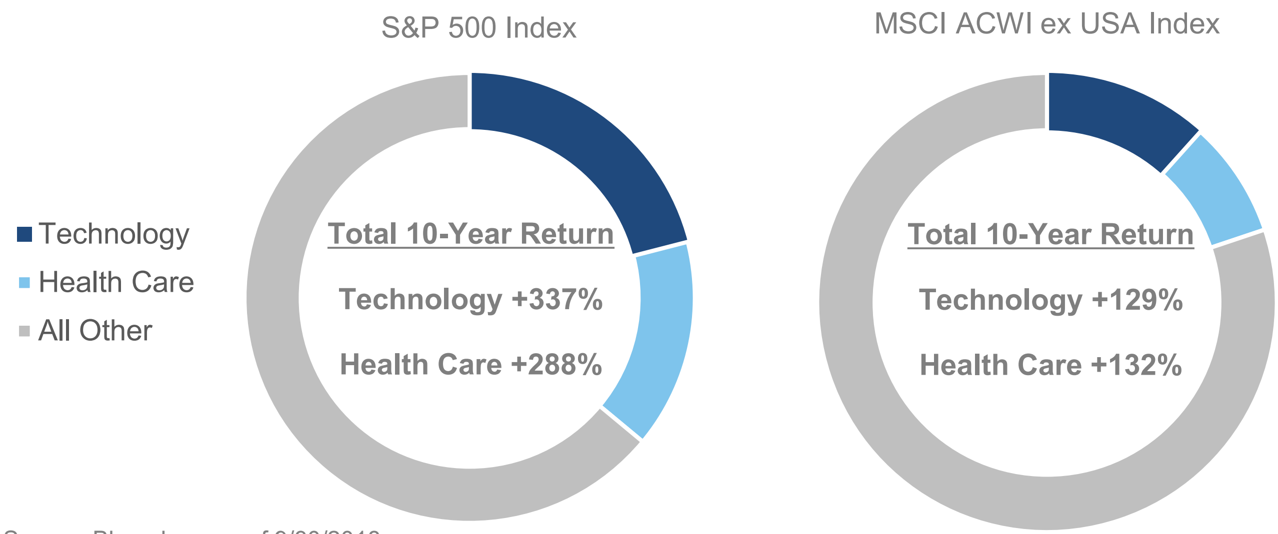
U.S. dollar historical return



Source: Bloomberg as of 9/30/2018

In addition to the strength of the U.S. dollar helping domestic markets, sectors that led the way since the financial crisis have had a much greater impact in the U.S. than they have outside its borders.

Sector Tailwind for U.S. Over International



Source: Bloomberg as of 9/30/2018

Technology and healthcare have been leading sectors since the financial crisis and contributed meaningfully to return. The U.S. not only has more exposure to these sectors, but there has been a divergence in success between each sector over the last ten years. U.S. technology returns have outperformed their global peers by a factor of 2.6x[2]. While the above total returns include the effect of a stronger U.S. dollar over the last ten years, domestic sectors have nonetheless produced outsized return premiums above their foreign peers. So where do we go from here?

Outlook

First, the basics of why to own any assets outside of the U.S. The U.S. makes up 52 percent of the global market and just 24 percent 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 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 going forward. 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

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

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 percent 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 percent annualized over the next 10-year period[1].

Currency – "Trees don't grow to the sky" is a proverb stating there are natural limits to growth. We do not carry the expectation that the recent strength of the U.S. dollar will continue indefinitely for the following three reasons; interest rate differentials, deficits and policy. Interest rate differentials, 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. The next factor is deficits. The U.S. currently runs a trade deficit of 2.5 percent and a budget deficit of 3.5 percent 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.

As investors, we may all have the tendency to become comfortable with what has been successful rather than looking forward to see what may be successful. This inclination can lead us to extrapolate the recent success of the U.S. markets as a permanent state. However, with ever-evolving markets, opportunities and risks develop with them. At DiMeo Schneider & Associates L.L.C. we continue to believe allocating capital with a global mindset gives investors a greater opportunity to achieve their goals while taking the least amount of undue risk. As the U.S. and international markets diverge more than they have in the past, remembering to look ahead and not behind for opportunity is as important as ever.

For more information and assistance, please contact DiMeo Schneider & Associates, L.L.C.

[1] Morningstar
[2] Bloomberg
[3] MSCI
[4] International Monetary Fund (IMF)

About the Author:

Bradford Long, CFA
Principal, Research Director - Global Public Markets

Brad joined DiMeo Schneider & Associates, L.L.C. in 2012. As Principal and Research Director, he directs the firm's Core Investment Strategy Group, overseeing investment research across global equity, global fixed income and global real assets. He is a member of the firm's Investment Committee, Discretionary Committee and all Research Teams. Additionally, Brad leads the firm's efforts in mission-aligned investing across both public and private markets as well as chairs the firm's Target Date Committee. Prior to joining the firm, Brad worked in various research capacities at Citigroup and Wells Fargo in New York. He received a BA in Finance and Minor in Economics from The University of Colorado and is a CFA® charterholder and member of the CFA Society of Chicago and CFA Institute. Additionally, he is active with Greenhouse Scholars, a nonprofit providing financial and personal support to under-resourced college students. In his free time, Brad loves cooking and spending time with his wife and young sons.