HEALTH WEALTH CAREER

WILL THE DOMINANCE OF US EQUITIES CONTINUE?

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US equities have substantially outperformed non-US-developed equities since the beginning of the financial crisis, which has lifted the US share of the MSCI World Index to a 40-year high.

The performance of US versus non-US tends to move in cycles, and we would not be surprised to see it swing back in favor of non-US equities. Non-US equities have better intermediate-term earnings growth prospects and trade at more attractive valuations. The dollar also appears exposed over a longer-term horizon, which could give a further tailwind to non-US equities in common currency terms.

Mercer's house view is that developed public equity allocations should be implemented through global equity mandates, leaving country allocation decisions to active equity managers. We would not rethink that position for a typical investor.

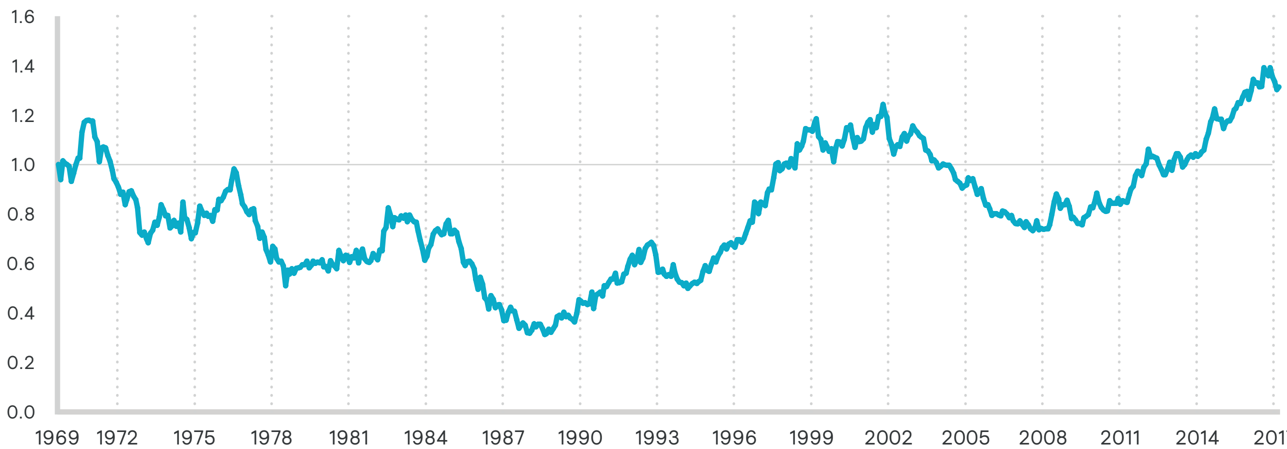
Many active global equity strategies have underperformed in recent years due to an underweight to US equities. Investors should be wary of the temptation to switch to active strategies that have performed better simply due to a higher weight to the US.

For US investors, where it is common to have a bias toward domestic stocks, recent outperformance provides a good opportunity to consider moving to a global market-cap weighting.

Notwithstanding our views on global mandates, investors who are receptive to opportunistic investing could consider implementing an underweight to the US in favor of non-US through portfolio shifts or overlay strategies.

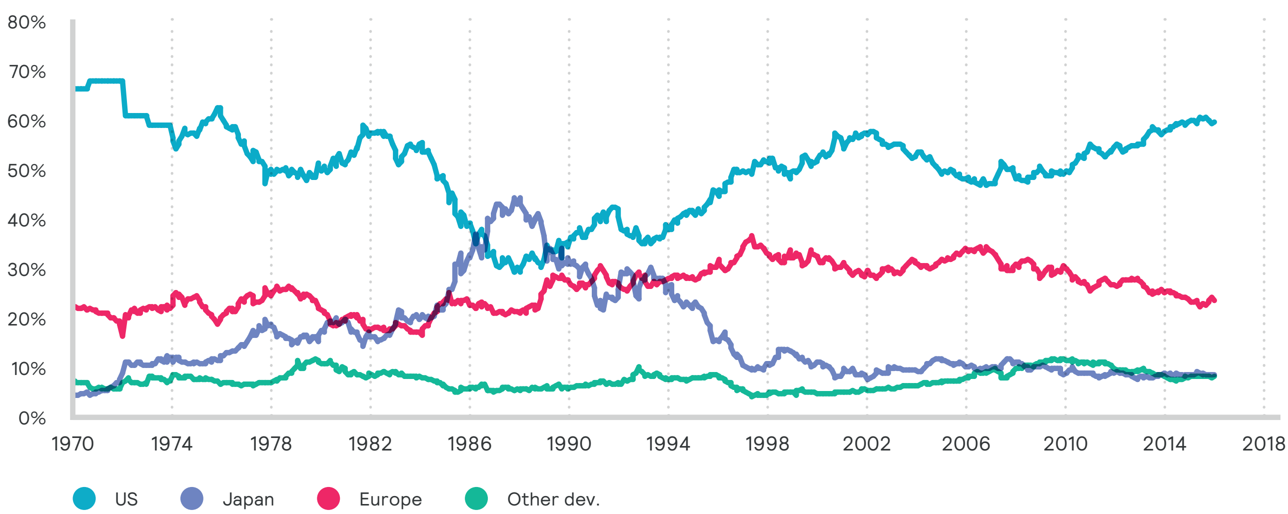
US equities have dominated non-US developed equities since the beginning of the financial crisis nearly a decade ago. Over 10 years (through 6/30/17), the MSCI USA Index earned 7.2% annualized versus 1.5% for the MSCI EAFE Index in USD.[1,2] This has lifted the US weight in the MSCI World Index to 60%, the highest level in 40 years. This performance differential can be explained by better fundamental performance out of US companies, relative valuation expansion and dollar strength. Nevertheless, relative performance between US and non-US tends to move in cycles, and the current cycle appears quite extended.

Figure 1: Ratio of MSCI US to MSCI EAFE Based on Total Return Indices



Source: Datastream

Figure 2: MSCI World Weights



Source: Datastream

We think the cycle could swing back in favor of non-US stocks. Relative to US stocks, non-US stocks have better intermediate-term earnings growth prospects and trade at more attractive valuations. Furthermore, the dollar's rally over the past few years has left it expensive relative to other developed currencies.

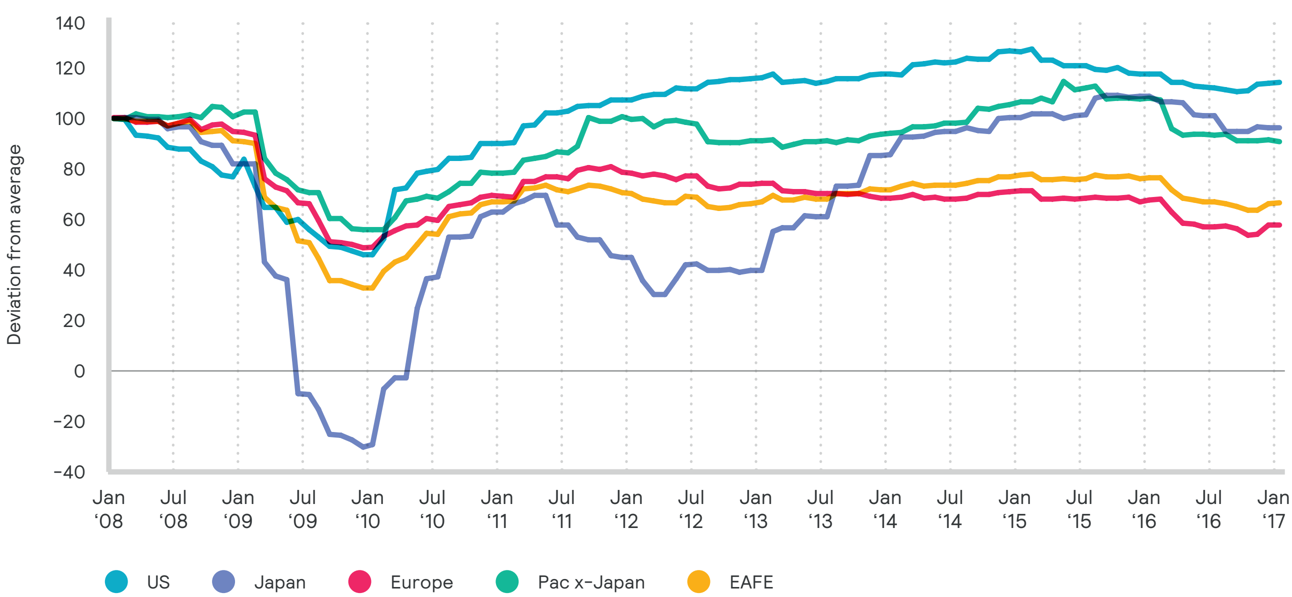
[1] The MSCI EAFE Index includes developed markets in Europe and the Asia-Pacific region.

[2] Source: Datastream.

FUNDAMENTALS

One big reason US equities have outperformed non-US since the beginning of the financial crisis is that the underlying US businesses have performed much better. This can be seen in earnings. US earnings per share (EPS) growth has been significantly stronger than that from EAFE. European equities, which make-up about two-thirds of EAFE, were the primary culprit. Earnings from both the US and Europe plummeted during the financial crisis. However, US earnings recovered quickly as companies slashed costs and now stand 23% above where they were before the financial crisis. Conversely, earnings from Europe have mostly languished and are 37% below pre-crisis levels, a 60-percentage-point underperformance compared to the US.

Figure 3: Earnings Per Share Growth



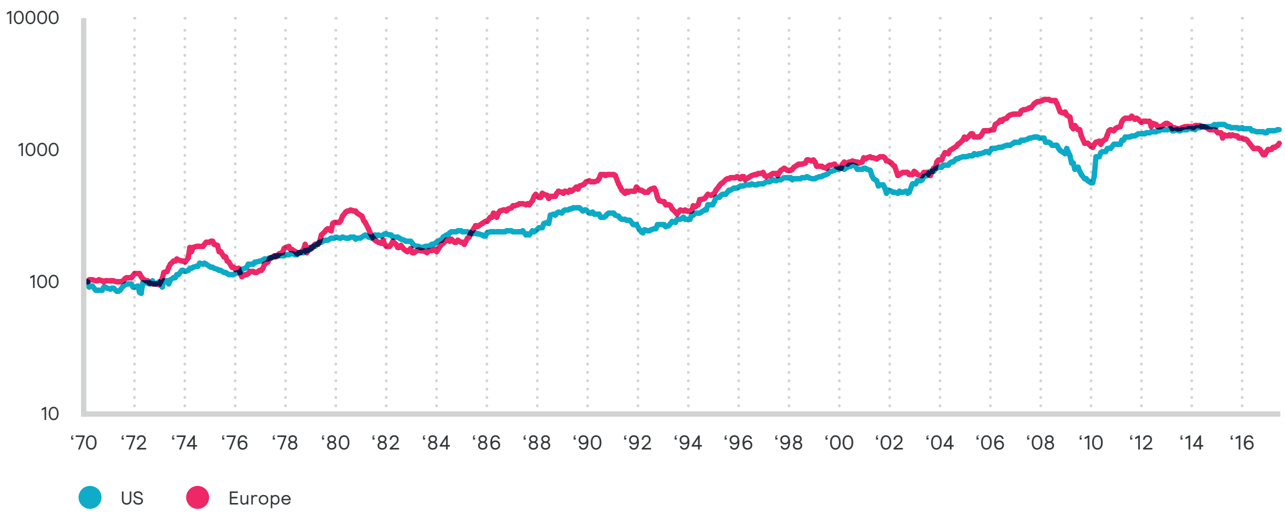
Source: Datastream

It's notable that this is mostly a European story. Earnings outside of Europe have been better. Japanese earnings are up 16% from pre-crisis levels, not far behind the US. Earnings for the Pacific region excluding Japan have returned to pre-crisis levels.

The differential in performance between US and European earnings can be explained by several factors: (1) US corporations were faster to restructure and cut costs in the wake of the financial crisis; (2) the US economy has performed better; (3) European financials were forced to raise substantial capital, diluting shareholders and reducing earnings per share; (4) US buybacks reduced outstanding equity, increasing earnings per share and (5) industry mix — the US has larger weights in sectors with better earnings growth over this period (for example, technology versus financials). The question is whether the earnings outperformance by the US will persist.

This period of outsized earnings performance by the US is not the norm. The long-term growth rates for US and European earnings are similar in common currency terms. It could be that Europe's (particularly the eurozone's) structural challenges (demographics, labor market restrictions, political environment, highly levered banking system) means that the region is facing an extended period of poor growth, not unlike Japan in the 1990s. This, in turn, could lead to much weaker earnings growth from European companies than from US companies. Although this is a risk, we do not believe it is the base case. Economists polled by Consensus Economics expect European growth to be only 80 bps less than the US over the long term (1.3% versus 2.1%). Another consideration is that European companies get a substantial share of their revenue from outside the region, including emerging markets.

Figure 4: Long-term Earnings Per Share Growth (US$, 1970 = 100)



Source: Datastream

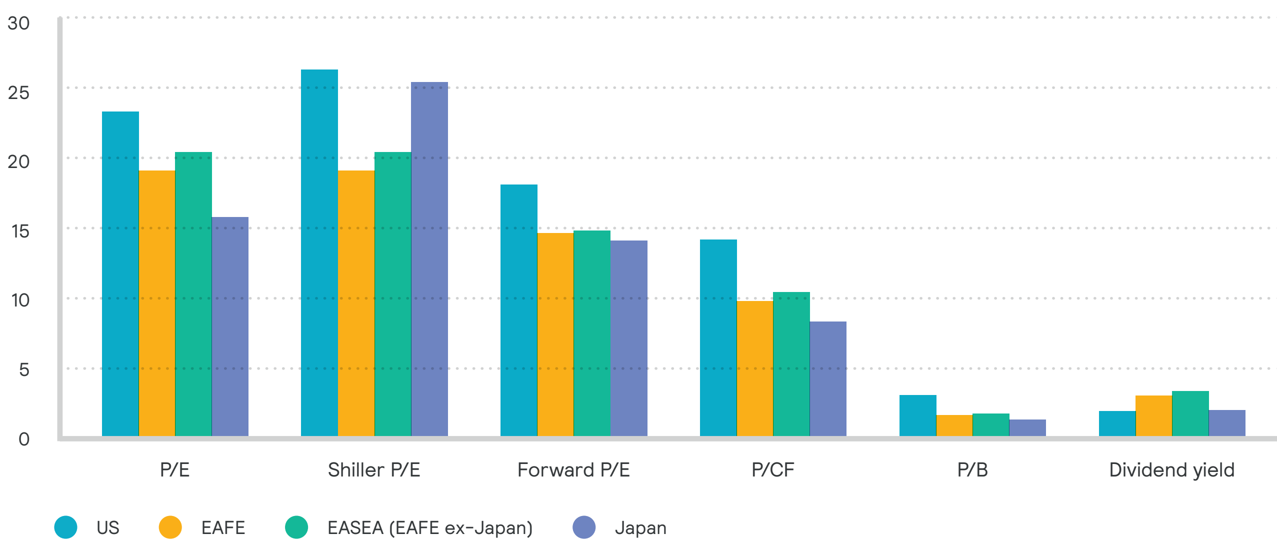
Although it is possible that European earnings will trail the US over the long term due to weaker growth, the divergence since the financial crisis is unlikely to persist, and Europe could recover some lost ground. Profit margins in the US are high by historical standards, whereas margins in Europe are low, and history shows that profit margins tend to be mean-reverting. With the US economy near full employment and productivity growth weak, mounting wage pressures could put downward pressure on margins. Europe, on the other hand, is earlier in its economic cycle. European unemployment is still elevated, and the economy is growing above trend, leading to the potential for margin expansion. In fact, earnings revisions have recently been stronger for Europe than the US. Japanese earnings also have the potential to outperform. Japan has suffered persistently low profitability relative to the rest of the developed world. However, companies are increasingly being run in more shareholder-friendly ways, which could improve long-term earnings potential.

VALUATIONS

The US appears expensive relative to the rest of the developed world on all valuation measures. Compared to EAFE, the US appears especially expensive based on the Shiller P/E ratio (based on 10-year average real earnings). The US is less expensive based on the trailing P/E ratio due to the differential in EPS performance noted in the prior section. Nevertheless, it still trades at a 20% premium based on this measure. The US trades at a 45% premium based on price-to-cash flow.

However, the US usually trades at a premium to other developed markets. Differences in sector exposures help to explain this. The US is overweight to sectors that tend to trade at high P/Es, such as technology and consumer staples, whereas non-US markets tend to have higher allocations to financials, which tend to trade at below-average valuations. For this reason, we also look at current valuation premiums relative to history.

Figure 5: US Versus Non-US-developed Valuations



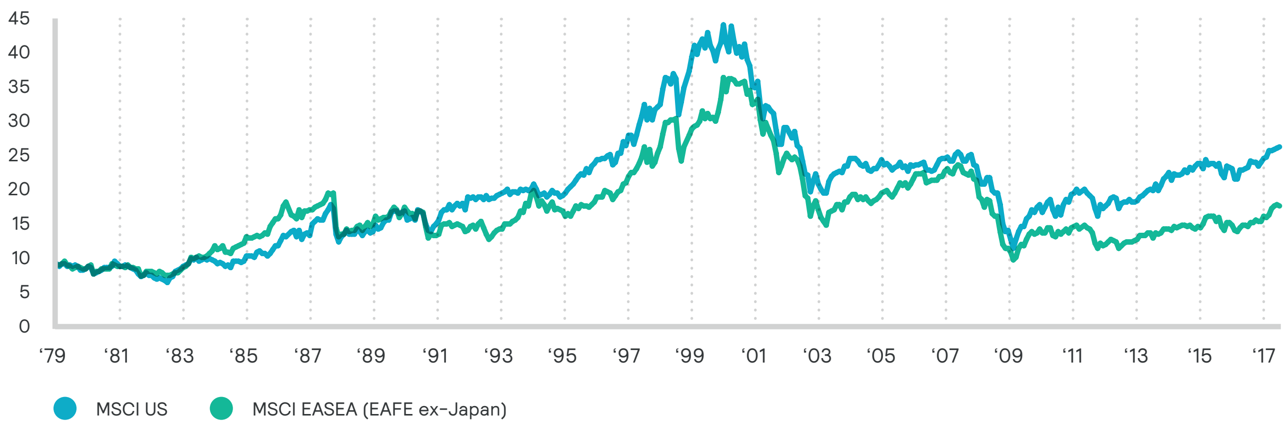
Source: Datastream

When doing historical valuation comparisons, it's useful to exclude Japan from the analysis. Japan's equity market bubble in the 1980s distorted long-term average valuations. (We will revisit Japanese valuations later in this paper.) As of June 30, 2017, the MSCI US Index sported a Shiller P/E of 26 compared to 18 for the MSCI EASEA Index (EAFE ex-Japan), a 45% premium.[3] Historically, the US has traded at a 15% average premium. Thus, the current level is materially wider than usual, suggesting attractive relative valuations in favor of non-US. Other valuation measures are more mixed. Although the US also trades at a larger premium than usual on P/B, based on P/E and P/CF, the current premium is near the long-term average.[4] This is not surprising, since both of these measures are heavily influenced by recent profitability.

[3] This premium is likely to narrow over the next few years due to the moving average calculation on earnings. For MSCI EASEA, strong earnings years compared to current will be rolling out of the 10-year moving average, whereas weak earnings years relative to current will be rolling out of the average for the US.

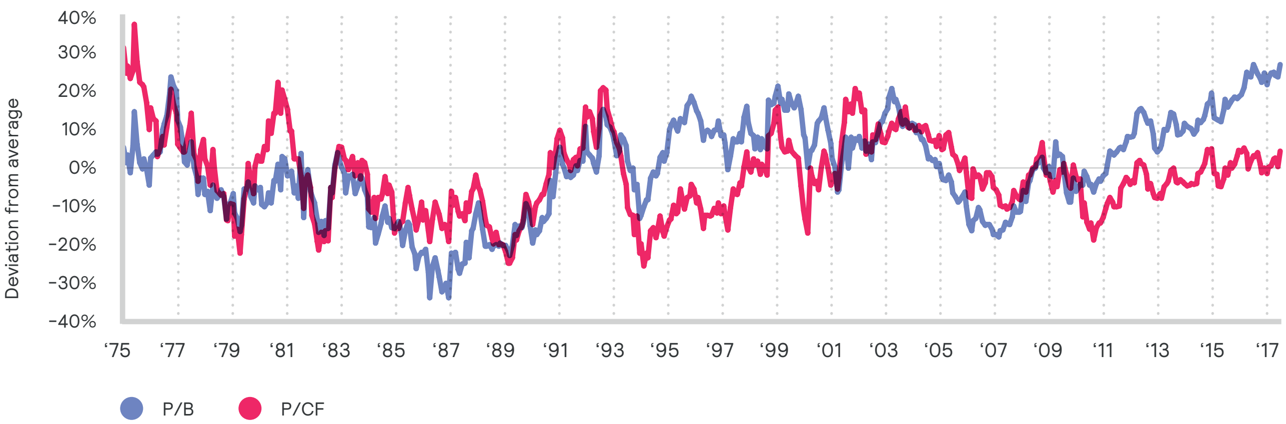
[4] P/B is the price-to-book ratio and P/CF is the price-to-cash flow ratio.

Figure 6: Shiller P/E (10-year Average Real Earnings)



Source: Datastream, MSCI, Mercer

Figure 7: MSCI US/EASEA Relative Valuation



Source: Datastream, MSCI, Mercer

On balance, valuations are more attractive for non-US equities. However, history suggests caution in relying too heavily on valuations, because they have not been strong predictors of future relative returns. Valuations probably need to be at extremes to provide a strong signal on future returns, and we do not consider the current gap as extreme relative to history. Nevertheless, valuations in combination with the potential for fundamental improvements make a stronger case for non-US equities.

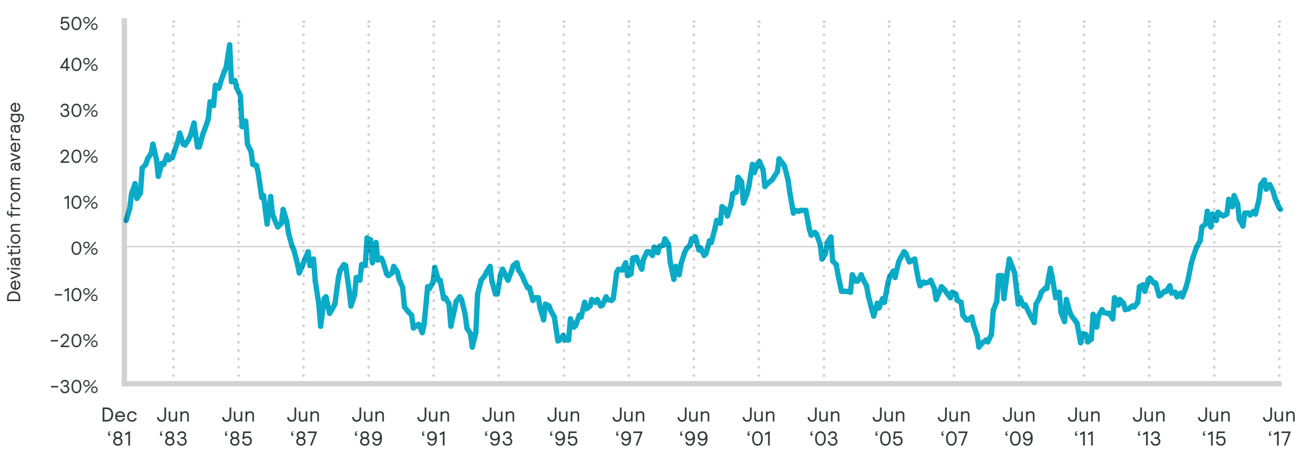
Finally, we return to Japan. Japanese valuations are tougher to evaluate. Japan's massive equity bubble in the 1980s and the subsequent extended period of weak profitability have made historical valuation comparisons difficult. That said, Japan does appear very inexpensive relative to the US. Japan is among the cheapest markets in the world based on P/E, P/B and P/CF. The question for Japan is what happens with profitability. If Japanese companies can maintain or improve profitability, current valuations look relatively attractive. If margins revert to post-bubble norms, then valuations are expensive. As covered earlier, governance improvements in Japan offer the possibility of a shift upward in margins.

CURRENCY

Over the last decade, currency has been a modestly positive contributor to the relative performance of US equities. The MSCI EAFE USD Index has trailed the MSCI EAFE Local index by 100 bps (1.5% versus 2.5%), annualized. A decade ago, the dollar was relatively cheap against the basket of EAFE currencies based on purchasing power parity. After the rally in the dollar that began in mid-2014, the dollar now appears relatively expensive.

Our view is that the dollar could see further modest appreciation over the short term against major currencies due to divergences in monetary policy. However, over the longer term, the dollar is more likely to depreciate given its elevated valuation and persistent current account deficit. Currencies exhibit strong mean-reversion characteristics over the long term, which should give a modest tailwind to unhedged non-US equities versus US.

Figure 8: Valuation of US$ Against EAFE Currency Basket Relative PPP (Avg CPI and PPI)



Source: Datastream

CONCLUSIONS AND IMPLICATIONS FOR INVESTORS

US equities have dominated non-US over the last decade. US companies did a better job of managing through the financial crisis and its aftermath. However, investors might have extrapolated this too far into the future. Although calling the turning points in such trends is difficult, we believe there is a reasonably high probability that relative regional performance will reverse over the next three to five years.

At this point in the cycle, non-US markets have three potential sources of mean reversion working in their favor relative to the US: (1) fundamentals, (2) valuations and (3) currencies. Relative earnings prospects are brighter for non-US equities because profit margins are low by historical standards. On balance, valuations in non-US markets are more compelling than in the US, especially in light of the potential for fundamental improvements for non-US firms. Finally, the dollar is expensive due to short-term monetary policy expectations, but that is likely to reverse over the long term. Although any of these factors alone may not provide sufficient reason to favor non-US stocks, the combination makes a stronger case. A risk to this view is that non-US markets arguably face more significant geopolitical and economic risks, although markets might also be understating those risks in the US.

Investors with patience and a bias toward opportunistic investing could consider underweighting the US in favor of non-US-developed stocks through portfolio shifts or through overlay strategies.

We typically advise that developed public equity allocations be implemented through global mandates, leaving country allocation decisions to active equity managers. We do not view the US versus non-US opportunity as so compelling as to rethink that position for a typical investor. That said, investors with patience and a bias toward opportunistic investing could consider underweighting the US in favor of non-US-developed stocks through portfolio shifts or through overlay strategies. Even for investors who don't wish to go down that path, it's useful to keep this in mind for manager hire-and-fire decisions. We have observed that many active global equity strategies, particularly those with a value bias, have had an underweight to the US in favor of non-US markets in recent years. Naturally, this has contributed to disappointing performance for many. Investors should be wary of the temptation to switch to active strategies that have performed better simply due to country positioning.

In the US, where it is common to have separate mandates to US equity and non-US equity with a bias toward the US, we suggest that the recent outperformance of the US provides a good opportunity to consider moving to the market-cap weight.

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