Northern Trust | Jim McDonald: Time to Globalize

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We came into this year with a positive outlook on US growth, but a more cautious growth outlook for Europe and Asia. Things started to change early in the year, as we upgraded our economic outlook for developed Europe and Asia, as domestic demand was showing unexpected strength. This improved outlook, combined with the continued durability of the US expansion, led us to increase our outlook for emerging market growth in March.

While the improved emerging market growth picture has certainly been helped by China, we are also witnessing accelerating growth in India, and commodity intensive economies, like Brazil, Russia, and South Africa. Developed market growth looks set to increase from around 1.5% last year, to 2% this year. While emerging market growth should increase from around 4% to 4.5%.

An important component of this upgraded outlook is our belief that improved domestic growth is being led by organic sources, as opposed to trade restrictions that just take growth from other countries. In the week after the US election, emerging market equities underperformed their developed market counterparts. As rhetoric has cooled in recent months, concerns about debilitating tariff fights have waned. In fact, the Mexican Peso, a favorite proxy of trade risk, has rallied 15% in the last three months, to return to its pre-election levels.

We think emerging markets are the primary beneficiary of this reduced risk. As emerging market companies generate nearly 85% of their revenue from other emerging markets. European companies generate a relatively robust 23% of their revenue from emerging market economies. While US companies have exposure of just 14%.

Our recommendations to increase exposure to equities outside of the US this year are underpinned by both the improved growth outlook, as well as valuations. US equities have handily outperformed most equity markets over the last five years. And that has led to relatively higher valuations.

The broad US equity market is trading about 18 times forward earnings. While Europe is trading at 15 times, Japan is at 14, and emerging markets are at 12 times forward earnings. Even after adjusting for compositional differences. For example, emerging markets have a higher concentration of lower valued financial companies. Markets outside the US have better relative valuations.

So what does this mean for investors? Our improving outlook for growth outside the US has led to several recommendation changes this year. With the end result being an increasing globalization of our recommendations. This month, we recommended an increase in developed ex-US equities and cash, funded by a reduction in our overweight to US equities. Our increase in cash after being underweight for years, is to reflect our expectation the returns on cash may actually beat bonds over the next year.

While the overall impact of these changes on the portfolio is a small reduction in risk, we remain overweight risk overall, and are positive on the outlook for risk-taking over the next year.

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