Northern Trust | Bob Browne: Going Global Pays Off in 2017

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After many years of underperforming their U.S. counterparts, non-U.S. equities-- both developed and developing markets-- are outperforming. Going global in 2017 has certainly paid off for equity investors. But is this trend sustainable?

U.S. equities are up over 9% in the first six months of the year. That is a very good start, but not nearly as good as the 14% plus return from non-U.S. developed markets, let alone the 18% return from emerging market equities. Supported by the synchronized global growth story, continued monetary policy accommodation, a weaker dollar and improving earnings prospects, overseas equities are generating handsome returns for U.S. investors. This is a welcome reversal, after many years of U.S. equity outperformance, when many U.S. investors were asking why they should own anything other than the S&P 500.

But is this change a short term blip or perhaps the beginning of a new sustainable trend? We think this shift in favor of non-U.S. equities should be the long lasting. Our investment strategy team recently published a commentary titled, "The Other Half, Non-U.S. Markets Move to the Fore." In this piece, we highlight the strong relative performance of U.S. equities since 2010, and how it has not been unusual over the past five decades for the U.S. to have multi-year cycles of either strong or weak relative performance.

In the current cycle, U.S. equities have outperformed by an impressive 100% compared to the rest of the world. But U.S. equities have already achieved peak earnings, while non-U.S. equities are only now just beginning to pick up the earnings pace. Valuation metrics, such as cash flow yields and relative value compared to local bond market yields, also favor non-U.S. equities. Relative to what was discounted just a few months ago, we also think the European political scene has material upside risk, while the U.S. political scene is sinking into a quagmire. Finally, overseas equity returns for U.S. investors are also getting a boost from a weaker dollar.

So what does it mean for investors? Well, the benefits of global diversification and exposure to the international equity opportunity set are very apparent this year. We continue to globalize our own exposure and recently increased our recommended allocation to developed ex-U.S. equities, which are now our largest overweight equity position. We also increase emerging market equities. We funded this increase by reducing our exposure to global listed infrastructure equities and global real estate equities, two sectors which we think should be vulnerable to our forecasts of higher interest rates.

We continue to be overweight risk assets overall and think the Fed is doing a good job orchestrating the normalization of its monetary policy. We think rates can go higher, even with well-behaved inflation. And therefore, we are underweight investment grade bonds to fund our overweight equity positions. We believe it is not yet the time to be defensive. It is the time to grow wealth.