Portfolio Perspectives

July 30, 2019

BAIRD

Please refer to Appendix – Important Disclosures.

After U.S. Strength, Global Stocks Poised For Gains

Key Takeaways: **Ten years after the March 2009 lows, U.S. stocks are over-owned and historically expensive. The pace of gains could slow going forward. Better valuations can be found overseas. International markets (both Developed and Emerging) could be poised to take the leadership mantle from the U.S.**

While not unprecedented in overall size, the returns to U.S. stocks (as represented by the S&P 500) since the March 2009 lows reflect a period of robust and remarkable strength. At the anniversary of those lows, the ten-year price return for the S&P 500 approached 280%, a level that has been eclipsed only a handful of times in history. With the 10-year returns for the S&P 500 having peaked (at least, seemingly, for now), a different set of opportunities may be emerging. We are not making a call here about adjusting overall risk in terms of aggregate equity exposure, but rather addressing questions of risk/return profiles within equities and whether investors may be well-served by adjust their exposure. This will be a three-part series, beginning with a look at the equity market dynamics between the U.S. and the rest of the world. Following this will be pieces looking at the size and style questions. As will be shown on the follow pages, U.S. stocks now appear to be overowned and over-valued. International stocks are more favorably valued according to their own historical valuations and could be poised to move into a leadership position relative to the U.S.

Source: StockCharts

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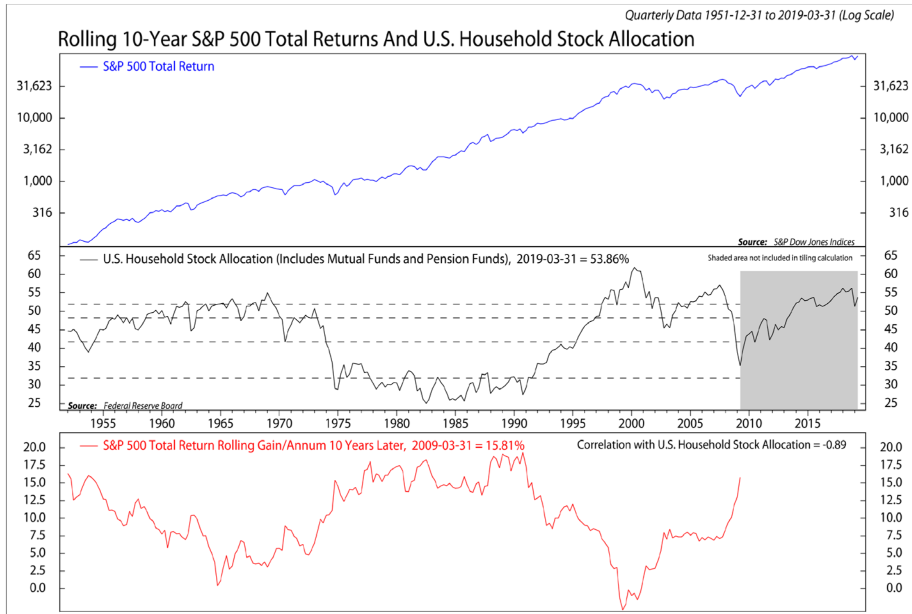
U.S. stocks are overowned. While equity funds have seen pretty consistent outflows over the past year, exposure to equities remains elevated (bond exposure is at its long-term average and cash levels are below average). Historically there has been a strong inverse correlation between household exposure to equities and stock market returns over the ensuing 10-years. Household stock exposure bottomed in March 2009 and has trended higher since. While shy of the peaks in 2000 and 2007, current stock allocations are in the highest quintile of observations going back almost 70 years. In the past this has been associated with subdued forward returns.



Stock Allocation Quintile	Average Stock Allocation	Low GPA% 10 Years Later	High GPA% 10 Years Later	Average GPA% 10 Years Later
Highest 20%	54.67	-3.03	8.43	4.09
2nd Highest 20%	50.15	0.42	10.87	6.90
3rd Highest 20%	45.92	5.46	16.35	10.21
4th Highest 20%	36.19	8.48	18.13	13.23
Lowest 20%	28.91	13.68	19.36	16.41

Middle Clip: The U.S. household equity allocation as a percent of total equites, bonds, and cash (% invested position).

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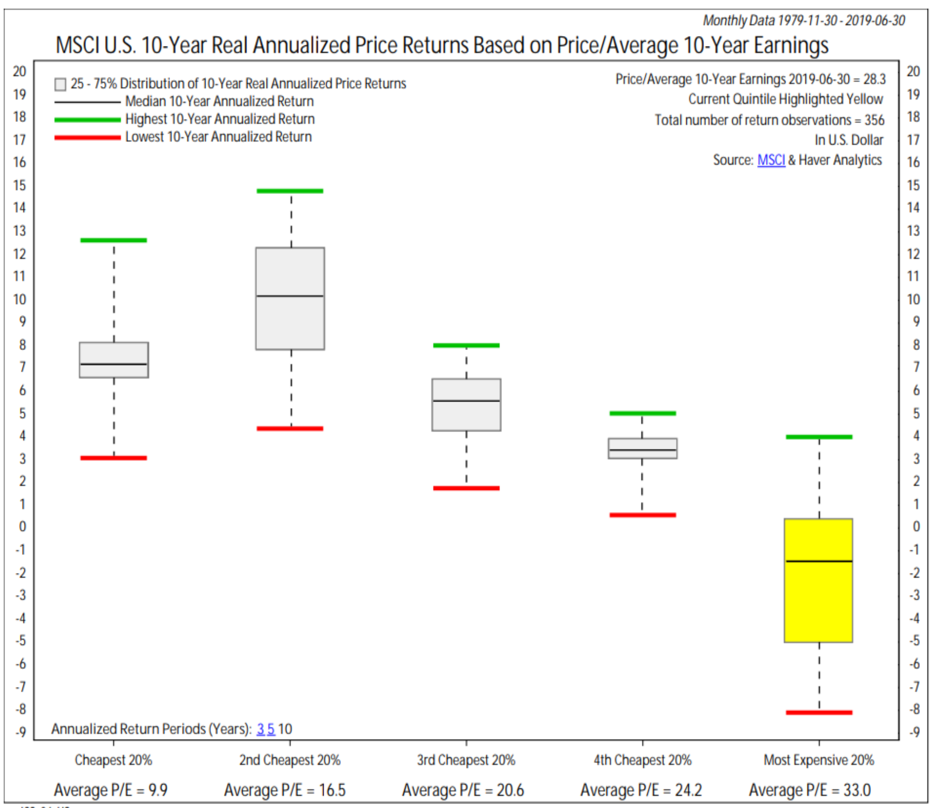
Source: StockCharts



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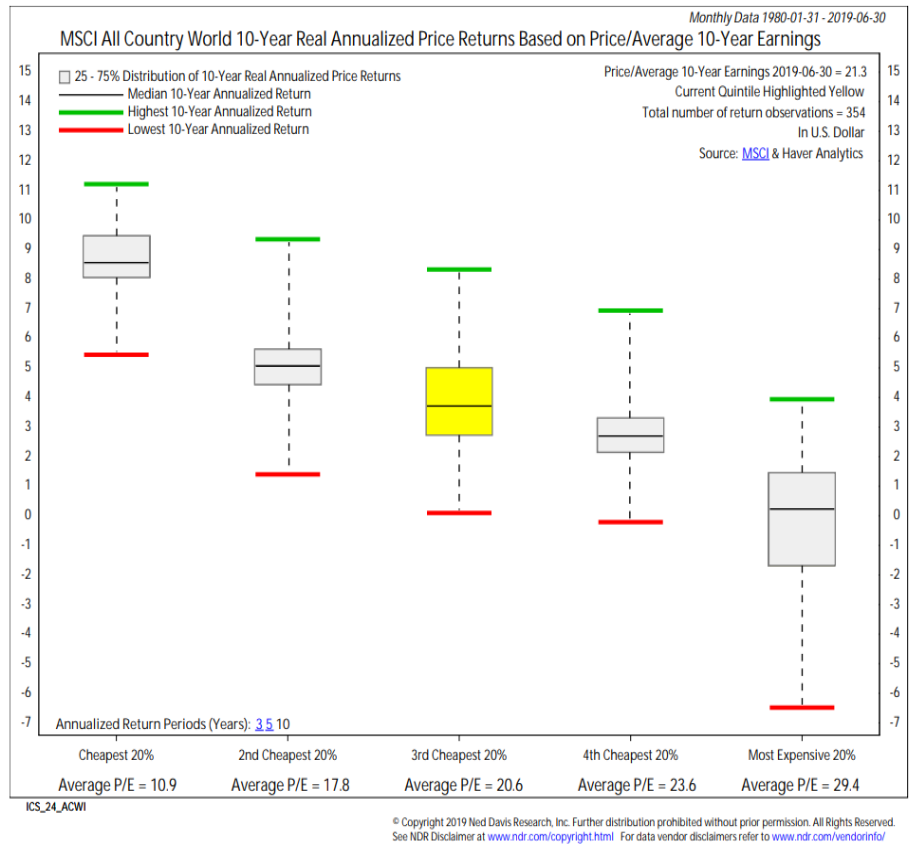
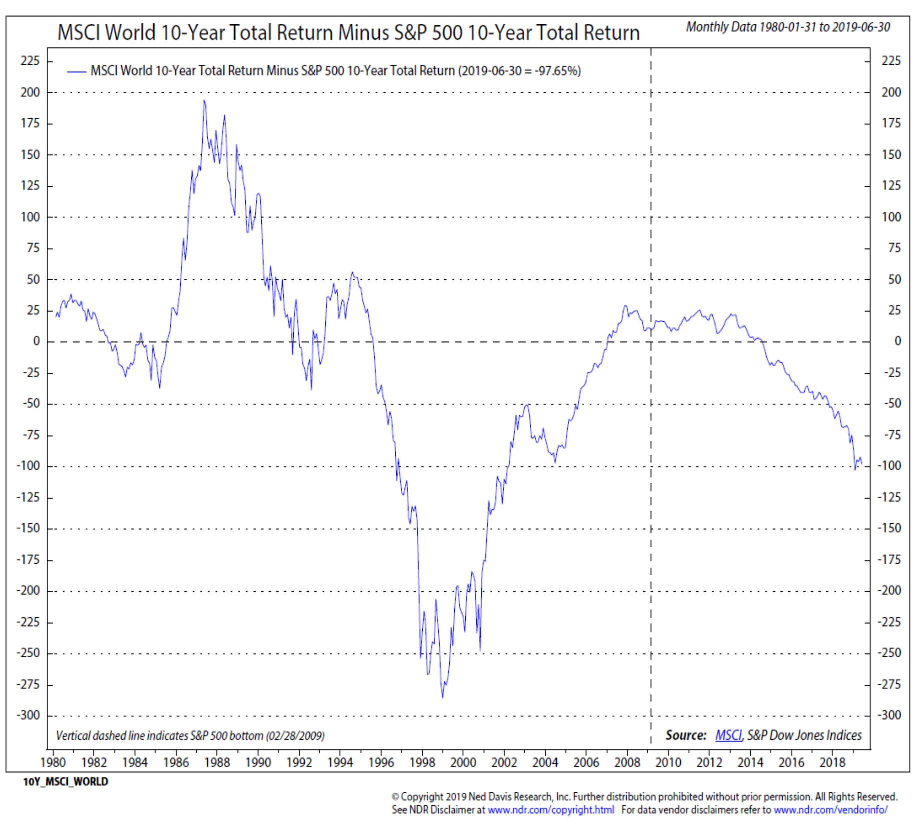
U.S. stocks are expensive. Valuations provide notoriously poor short-term timing signals. A strong relationship, however, develops when viewed from a longer-term perspective. This is one reason that we give consideration to valuations in our [weight of the evidence] framework. There is a direct relationship between initial valuations (price/average 10-year earnings) and stock market returns over the ensuing 10-years. When initial valuations are low, forward returns tend to be robust. When initial valuations are high, as they are now, forward returns tend to be sub-par and the dispersion of returns tends to be great. Current valuations are consistent with the most expensive quintile in terms of valuations, suggesting risks are high and expected returns are low.

World stocks are fairly valued. Given compositional differences at the sector level between indexes of different countries/regions, relative valuation comparisons can get distorted. However, that does not preclude comparing current valuations to their historical distribution (as we did for the U.S. on the preceding page). Using the same price versus 10-year average earnings approach as above but for world stocks, we get a similar return distribution as in the U.S. – lower initial valuations tend to be followed by higher returns and higher initial valuations tend to be followed by lower and more diffuse forward returns. The big difference, however, is in the current P/E ratio. Rather than being in the most expensive quintile, the current P/E ratio for the All-Country World index is in the middle quintile. While valuations are stretched in the U.S., valuations elsewhere are more reasonable.



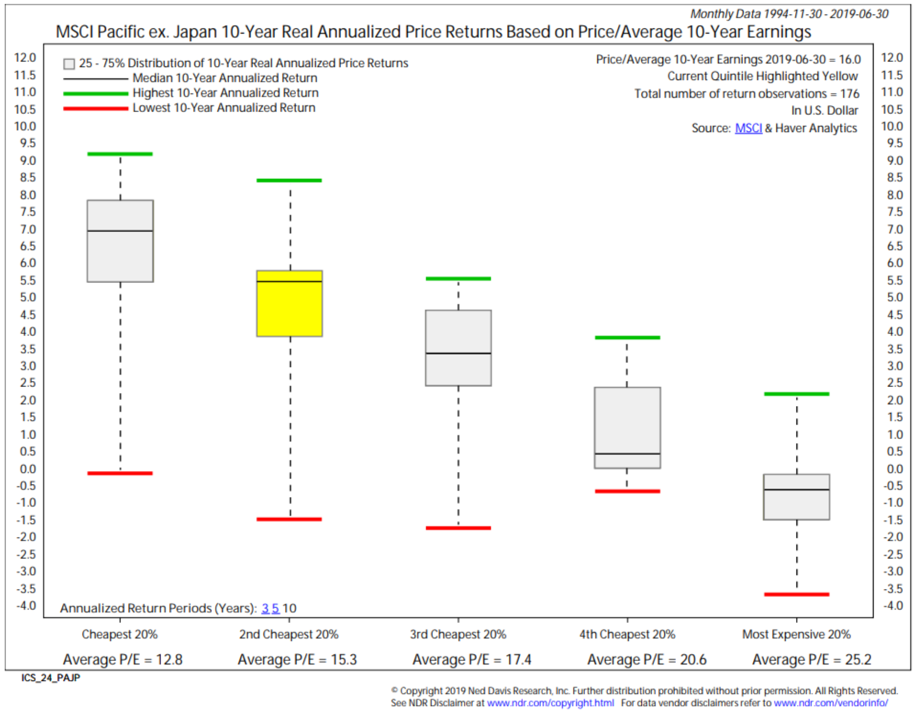
Source: Ned Davis Research



Source: Ned Davis Research

World returns have lagged the U.S. One explanation for the valuation disparity between the world and the U.S. (and one that most investors care about) is price. World stocks have not kept pace with the gains seen in U.S. stocks. Over the past 10 years, the total return of the world index has been nearly 100 percentage points less than the total return for U.S. stocks. In recent years, globally diversified portfolios have provided smaller returns and higher risk than a U.S. dominant portfolio. With U.S. stocks overvalued and overowned, that could change going forward. At a minimum, we would expect the risk-mitigating benefits of diversification to reemerge, though a period of outright global leadership would not be a surprise.

Pacific ex. Japan valuations are compelling. Rather than just tilting equity exposure away from the U.S., investors may want to consider tilting into specific regions. Valuations for the Pacific ex Japan region (with primary exposure to Australia, Hong Kong and Singapore) are in their second-lowest quintile, below the long-term average and historically consistent with above-average returns. Valuations for Emerging Markets are also below their long-term averages.



Source: Ned Davis Research

Source: StockCharts

Watch price and breadth trends for confirmation of opportunities. While valuations may suggest shifting risk/return dynamics, we also want to see evidence that price and breadth are providing confirmation. From a price perspective, the Emerging Market index has made higher lows in 2019 on both an absolute basis and relative to developed markets. Emerging Markets have lagged the U.S. this year, but have not broken below the 2018 relative price low. Breadth has turned more encouraging of late. The equity market recovery in the first half of 2019 was dominated by U.S. strength and marked by poor global participation. More recently the percentage of global markets with rising 200-day averages has crossed above the 50% threshold, a development historically associated with global stock market gains.

Appendix – Important Disclosures and Analyst Certification

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