



INVESTMENT FOCUS



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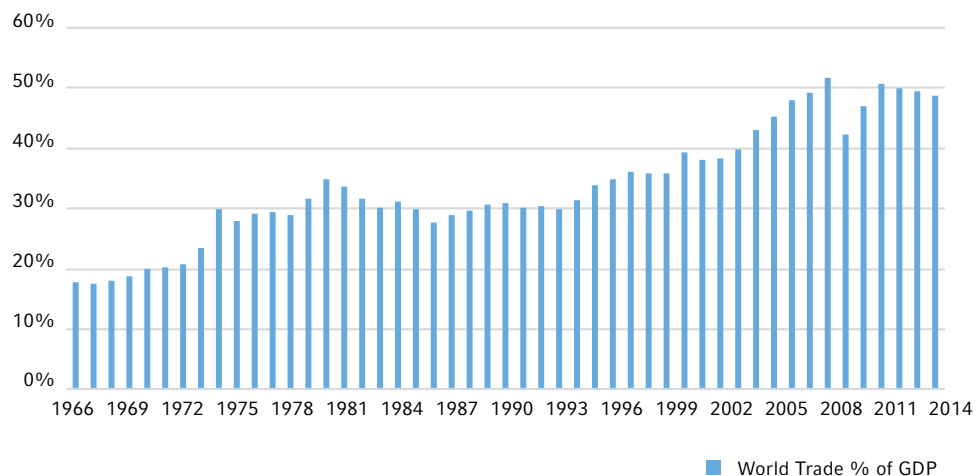
Should investors stay home or go global in 2017?

By: Erik Ristuben, Chief Investment Strategist

The cause of global integration took some hits in 2016. We saw the United Kingdom vote to leave the European Union and the U.S. presidential election won by Donald Trump largely on the back of a promise to close America's borders and attacks on free trade deals such as the North American Free Trade Agreement (NAFTA), which he called "the single worst trade deal ever approved in this country."¹ These are not isolated cases: anti-global sentiment is finding a voice in many other countries around the world.

This is a long way from where we seemed to be headed prior to the financial crisis of 2008, when world trade as a percentage of GDP had grown from sub-20% to greater than 50% over a 50 year expansion, which had shown no signs of reversing. But the trend in recent years has been downward (see Exhibit 1 below).

Exhibit 1: World trade as a % of GDP



¹ Quote from the first presidential debate, September 26, 2016

Source: World Trade Organization Statistical Database. Data as of: February 17, 2016.

What does this mean for investors? Does it undermine the strategic case (a case we've been making for decades) for a global outlook on investment? And even if the strategic case remains intact, are there tactical landmines that should cause investors to pause in this new environment?

I believe the strategic case remains strong. And, even though the possibility of a strengthening dollar merits some caution, there is not a strong tactical case against international investment right now. Let me explain why I say that.

THE STRATEGIC CASE

The global integration trend may have stalled, but it would take a lot to reverse the integration that has occurred in the past 50 years. The largest company in the world (by market capitalization) is Apple.² Apple is US-listed and US-headquartered, but it derives around 60% of its revenues from other countries. And Apple's sourcing and manufacturing processes are truly global. The main competitor for its flagship product, the iPhone, is built by Samsung (of South Korea).

And what could be more American than a Jeep? It turns out that Jeep, along with the other Chrysler brands, became partially owned by Italy's Fiat in 2009. In 2014, that ownership became complete, at which point the companies merged into a holding company, Fiat Chrysler Automobiles, which is incorporated in the Netherlands, headquartered in London, and listed in Italy and New York. It's enough to have an all-American couple reaching for a cold can of Budweiser (owned by Inbev of Belgium) and a tub of Ben & Jerry's (owned by Unilever of the UK/Netherlands).

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global GDP. By the way, the U.S. is only 4% of the world's population.

With global markets being so integrated, only a global approach can access the full investment opportunity set. A global approach also reduces concentration in domestic risk factors, which has historically led to a less volatile return pattern,³ and gives exposure to the potential high-growth areas of emerging and frontier markets.

Of course, non-domestic investment can mean moving into unfamiliar territory (although that's more of an issue for individuals than for institutions). It can introduce new risks (currency fluctuations or increased political risk, for example) and higher costs (some non-reclaimable taxes on dividends; higher fees). Although those considerations may cause many investors to decide against full market-cap weighting, we don't believe they fundamentally alter the story: The strategic case for global investment diversification remains intact.

CURRENT MARKET CONDITIONS

Let's look at the current environment. Are current market conditions favorable for international exposure from the perspective of the U.S. investor?⁴

U.S. stocks have certainly enjoyed a strong run in recent years. Indeed, the S&P 500 index returned an annualized average 14.7% of over the five years to the end of 2016: some 4.3% above its average from 1970-2016 – while every other major market saw a five-year return that was below its 1970-2016 average; the MSCI world ex-USA index, for example, had a five-year average return of 6.6%: roughly 2.7% below the longer term number.

This has left U.S. stocks looking overpriced relative to many other markets. For example, one commonly-used indicator of valuation is the

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² All statistics quoted in this article are based on December 31, 2016, unless otherwise stated.

³ Past performance is no guarantee of future results.

⁴ Although similar considerations apply for investors based elsewhere, the details of the analysis and the conclusions will differ in many cases. Space does not permit us to cover these perspectives here.

cyclically-adjusted price earnings ratio (CAPE). At the end of 2016, this stood at 28.3 in the United States, compared to just 12.4 in Europe and 11.2 in the emerging markets. A higher valuation is not a guarantee of weaker future returns, but in the past, current valuations have been a good predictor of intermediate term (five to seven years) future market returns. The challenge for investors is that it can take a very long time for the valuations to revert back to more typical levels.

And perhaps even more important right now even than the relative valuation of the markets is the strength of the dollar. If the dollar strengthens, historically investors in international assets suffer; if the dollar falls, they win. And the dollar ended the year as highly valued as it has been since 2003. Again, that doesn't guarantee a reversion – especially after a year that taught us to take nothing at face value in global politics – but it can be a factor.

The currency picture is complex (and changes quickly – the comments here are based on the position at year end). More detailed analysis can be found in our global strategist outlook, but while valuation may be high, other factors do support that strength. Most notably, the prospect of looser fiscal policy (and tighter monetary policy) point to a continued interest rate differential and potential dollar strengthening. As a result, Russell Investments' model portfolio begins 2017 slightly underweight in U.S. stocks, but overweight the dollar.

So – as always – tactical considerations may come into play as the details of portfolio positioning are worked out. But the wider story remains the same: For investors, a global outlook remains appropriate, even against 2017's altered political backdrop.

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