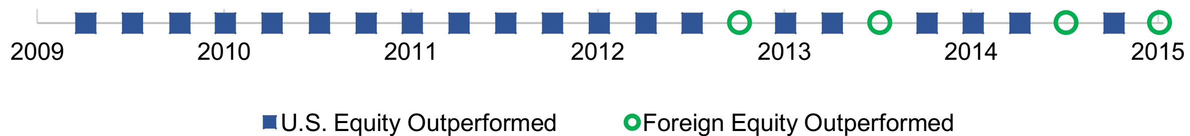
U.S. Equity Market Dominance: Is the Run Over?

May 13, 2015

Foreign equities had a much better quarter than U.S. equities. This is a rare exception to what has otherwise been a remarkably consistent pattern of U.S. outperformance since the end of the financial crisis. Over the last six years, U.S. equities have done better in both up and down markets, in volatile and calm, and when measured in local currency or not. The graphic below illustrates the persistence of this outperformance (Exhibit 1). Quarters marked with a blue square indicate outperformance of U.S. equities, while those with a green circle indicate the U.S. underperformed.

Exhibit 1: Persistence of U.S. Equity Market Outperformance (Q2 2009 – Q1 2015)[1,2]



Strikingly, U.S. equities have outperformed in 20 of the last 24 quarters—an incredible run! While there have been other lengthy periods where U.S. equities did better than those outside the U.S. (for example, 1989-1992, 1996-1999), none have been as consistent as the last six years.

The questions from this historically unique period are at least several: Why did U.S. equities outperform? What impact did this have on the performance of institutional investors, especially in the U.S.? Are the prospective economic conditions similar to those experienced over this period such that this pattern might continue?

The particular macroeconomic reasons for this outperformance are beyond the scope of this short discussion, but from an investment perspective the data are clear: U.S. firms have consistently exceeded earnings expectations while firms outside the U.S. have consistently disappointed.

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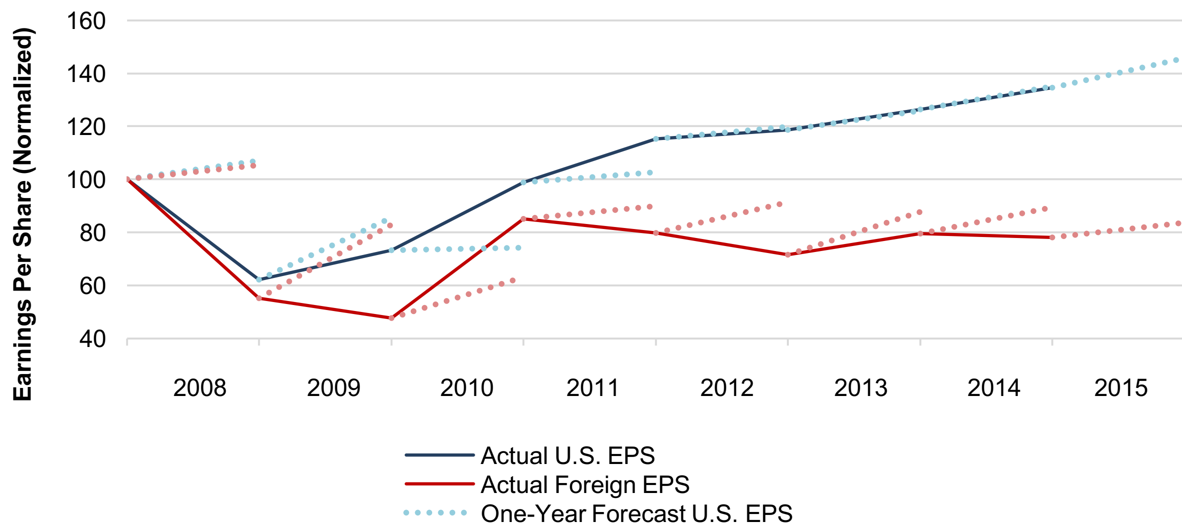
[1] These comparisons are done in local currency to eliminate exchange movements though a similar finding holds when the comparison is done all in U.S. dollars.
[2] Series is Russell 3000 Index for U.S. Equity and MSCI World Ex-USA Local Index for Foreign Equity.

Exhibit 2: Consistent Earnings Disappointments by Foreign Firms[3]



The phenomenon is illustrated in Exhibit 2 through the lens of projected and actual corporate earnings per share (“EPS”). The blue line represents the path of actual EPS for U.S. equities, while the red line represents the path of EPS for non-U.S. equities. The dotted lines in each color represent the one-year consensus forecast for EPS growth for the respective index constituents at the start of each year. Thus each dotted line is the consensus forecast for the solid line of the same color for the same period.

Focusing first on actual corporate earnings growth (the solid lines), we see that U.S. firms did better than foreign firms during the financial crisis even though foreign firms did some catching up in 2009. They then diverged very significantly over the next five years as the earnings of U.S. firms continued to grow while those of foreign equities actually declined.

Importantly, the lower earnings growth for foreign equities repeatedly surprised the markets. Most notably, over the final five years U.S. firms either exceeded (in 2011) or met (in 2012, 2013, 2014) projections of EPS growth, while non-U.S. firms surprised to the downside year after year.

Over time, expectations have adjusted considerably from anticipating identical growth in 2008, to a forecast of at least partial convergence between the U.S. and foreign equities post-crisis, to an even wider divergence between U.S. and foreign equities today. The dotted lines to the far right indicate that the consensus projection for EPS growth of non-U.S. firms in calendar 2015 is lower than it has been since 2010, and certainly nothing resembling convergence with the U.S. forecast. Said another way, the bar on earnings growth for foreign firms has not been this low in a long time; surprising on the upside will take a lot less for foreign than U.S. equities.

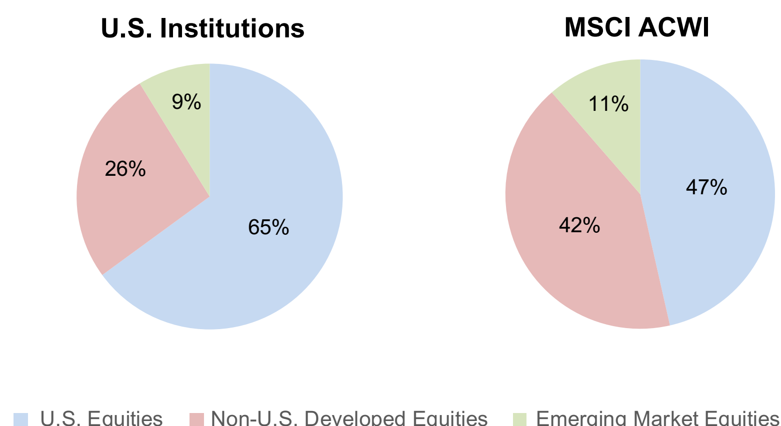
Whether this win streak of U.S. firms matching expectations and foreign firms underperforming expectations will continue is certainly the primary question. While we have no edge in forecasting earnings, we are persuaded by logic and history that the odds makers are not often persistently incorrect, at least not for very long. The period following the global financial crisis was unique in many ways, not unlike many other periods in history when particular sectors, countries, or asset classes demonstrated remarkably consistent outperformance. More often than not, however, consistent outperformance was followed by dramatic underperformance.

[3] Data series is Russell 3000 Index for U.S. EPS and MSCI ACWI Ex-USA Index for Foreign EPS. One-year forecasts are consensus estimates according to Bloomberg.

We continue to maintain a balanced exposure to the world's equity markets. We do not view U.S. equities as extreme from a valuation perspective and are not strongly underweight today. We view our exposures first through a risk lens, and what we see are good reasons to diversify across global equities independent of valuation considerations. In particular the correlation among equities has declined, both between broad areas such as U.S., non-U.S. developed, and emerging markets as well as between countries within those classes. Consequently, the cost of additional risk from leaning too heavily on any country or region is greater than it has been. As the benefit from diversification has increased so too should the bar for making any active "bets" that would favor one region or country over another.

In contrast, many U.S. institutions appear today to have discounted the value of this diversification in favor of an allocation heavily skewed toward U.S. equities. This "home bias" has worked so well in the recent past that there is certainly a risk of creating a false sense of security. Specifically, over the last five years, U.S. institutions on average have had 65% of their equity exposure allocated to the U.S., compared with only a 47% allocation to the U.S. in the global equity index (Exhibit 3). They moreover maintained this overweight consistently over the period.

Exhibit 3: Equity Home Bias of U.S. Institutions[4]



The impact on performance of this home bias has been very positive post the financial crisis: since March of 2009 the overweight in U.S. equities has added roughly 1.5% to return per year. For context this is greater than the difference between the 25th and 75th percentile of endowment performance over the last 10 years. This outperformance stands in contrast to the five-year period leading up to 2009 when the same home bias would have cost these institutions roughly 0.9% per year—a reminder once again that past performance is not predictive of future results.

There may be many reasons—structural, institutional, or otherwise—that a home bias is justified. But a critical part of investing is differentiating between luck and skill, and knowing when to take chips off the table and be grateful for having had good fortune. Without a crystal ball or other reason to strongly skew allocations in any one direction, the safer approach in the long run is to diversify while cognizant of changing market risks.

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[4] Sources: NACUBO, Bloomberg, Cambridge Associates, Preqin. Allocations for U.S. Institutions represent the average (unweighted) allocation over the last five reported years from June 2009 through June 2014 for all NACUBO reporting institutions. Additional assumptions were made for allocations within PE/VC and Absolute Return allocations based on data from Cambridge Associates and Preqin respectively. Country allocations for MSCI ACWI represent the average allocation for the same 5-year period estimated from holdings of the iShares MSCI ACWI ETF.

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