One of the most prominent trends over the past several years has been the outperformance of the U.S. economy and U.S. asset markets relative to global peers. With many U.S. assets expensive and popular with investors, we consider the timing of an eventual reversal of U.S. outperformance. Our analysis suggests this turning point is likely to come in the next six to 12 months.

From a depressed level, U.S. GDP growth has been improving relative to the rest of the world since 2008. U.S. GDP growth trailed global growth by over two percentage points at the onset of the 2008 recession. From this depressed relative pace, U.S. growth improved, most recently exceeding global growth by half a percent in the second quarter of 2018, an infrequent occurrence in the past 10 years. Growth differentials tend to be a major driver of relative regional performance across asset classes and relative improvement in U.S. growth has led to the outperformance of U.S. assets.

The U.S. dollar is up 6% this year on a trade-weighted basis and up 9.5% from the year-to-date low reached in February, bringing its cumulative appreciation close to 35% since the 2011 low. U.S. equities have outperformed global equities by 7% this year, and the total outperformance since the 2008 low is over 55%, approaching the outperformance of 60-70% seen in prior such cycles in the 1980s and 1990s. Reflecting this optimism, the U.S. 10-year yield rose 170 bps from mid-2012 until the recent peak in May 2018 when yields broke above 3%, making this one of the largest (top five) yield sell-offs over the past 30 years.1

Display 1: U.S. Equities at 45% Premium to Global ex-U.S. Equities

U.S. vs. Global ex-U.S. Equities Relative P/E

Index

Source: MSIM Global Multi-Asset Team Analysis; IBES; FactSet; MSCI. Data as of August 31, 2018.

Shading represents recessions.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results.

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This strong performance leaves many U.S. assets expensively valued relative to their global peers (and bond yields substantially higher) while investor sentiment and positioning data suggest high investor enthusiasm for U.S. assets. The trade-weighted U.S. dollar is 6% overvalued on a real effective basis and our composite sentiment indicator for the U.S. dollar is in extremely overbought territory (Display 2). And many major currencies such as the euro, Japanese yen, and British pound sterling are extremely cheap, as are many emerging currencies (except the Chinese renminbi and the Indian rupee) after the recent sell-off. U.S. equities are now trading at a 45% premium to global equities on trailing price-to-earnings (P/E), having been more expensive only twice in the past for brief periods (Display 1). Meanwhile, U.S. 10-year rates are 250 basis points above G-4 ex-U.S. rates, a spread exceeded only episodically in the past, while investor sentiment towards U.S. Treasuries remains extremely bearish—indicating a strong bias toward even higher rates (Display 3). Flows into European equity funds are now at extreme oversold levels with the latest data showing that investors have redeemed $57 billion from European equity funds since the first week of March 2018, reversing in entirety the $52 billion of inflows since the start of 2017.

Display 2: U.S. Dollar: Extremely Overbought
GMA U.S. Dollar Sentiment Composite vs. DXY Index

<table>
<thead>
<tr>
<th>Year</th>
<th>DXY Index</th>
<th>GMA U.S. Dollar Sentiment Composite</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>85</td>
<td>-0.5</td>
</tr>
<tr>
<td>2011</td>
<td>80</td>
<td>-0.5</td>
</tr>
<tr>
<td>2012</td>
<td>85</td>
<td>-0.5</td>
</tr>
<tr>
<td>2013</td>
<td>90</td>
<td>-0.5</td>
</tr>
<tr>
<td>2014</td>
<td>95</td>
<td>-0.5</td>
</tr>
<tr>
<td>2015</td>
<td>100</td>
<td>-0.5</td>
</tr>
<tr>
<td>2016</td>
<td>95</td>
<td>-0.5</td>
</tr>
<tr>
<td>2017</td>
<td>90</td>
<td>-0.5</td>
</tr>
<tr>
<td>2018</td>
<td>85</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

DXY Index = value of U.S. dollar relative to a basket of U.S. trade partners’ foreign currencies.
GMA U.S. Dollar Sentiment Composite (LHS)
DXY Index (RHS)


It is likely that a broad reversal of U.S. economic outperformance will take place over the next six to 12 months, as the U.S. economy slows while growth in the rest of the world stabilizes and begins to improve. U.S. asset markets will likely turn to underperformers in that environment. Three factors supported U.S. growth in last 12 to 18 months and will gradually reverse over the next year. First, U.S. net exports contributed 1.2% to U.S. GDP growth in the second quarter of this year (after detracting in 2017 and in the first quarter of 2018), on the lagged effect of U.S. dollar weakness in 2017 and a pulling forward of demand in anticipation of U.S. tariffs. This will likely fade given U.S. dollar appreciation year-to-date and as tariffs are implemented. Second, U.S. policy rates will probably approach or slightly exceed neutral levels over the next six to 12 months, assuming the Fed follows its current path of hiking four times a year. We expect that the shift from accommodative to neutral (or even modestly tight) monetary policy will have begun to constrain growth by then. The impact of higher rates is already apparent as housing activity in the U.S. appears to have peaked, and we expect housing will remain under pressure as rates continue to rise. Third, we expect the boost from fiscal stimulus to fade by the end of this year. While we acknowledge that the timing of its impact thus far is unclear and there remains a real possibility of a growth boost from increased federal government spending in the second half of this year, it is unlikely that its impact will be sufficient to offset the drag from lower net exports and tighter monetary policy. U.S. GDP
growth should begin to slow from its current 3-3.5% pace closer to 1.5-2% by the end of 2019. By contrast, we expect growth in the rest of the world to accelerate over the next six to 12 months compared to this year thus far. The eurozone’s GDP growth deceleration from above 2.5% in late 2017 to 1.5% in the second quarter of this year seems exaggerated (though the impact of a stronger euro has likely been a meaningful factor) and we expect eurozone growth to stabilize at a higher level than currently – closer to a 1.75-2% pace. China’s pace of growth deceleration is likely to moderate as authorities there attempt to dial back credit tightening and encourage increased fiscal spending. Based on our analysis, the recent loosening of credit conditions appears sufficient for growth to stabilize by the first quarter of 2019. And while we expect emerging economies ex-China growth to slow to a 2% pace this quarter, it is unlikely that further deceleration will follow. Thus, U.S. economic growth is likely to start slowing just as the rest of the world stabilizes or accelerates.

We expect U.S. assets’ outperformance to begin to reverse as the U.S. growth differential relative to the rest of the world turns. Interest rate differentials will likely compress as U.S. yields stabilize, while in Europe and Japan continued above-trend growth and gradually-rising inflation is expected to lead to a less dovish European Central Bank and Bank of Japan. As rate differentials move against the U.S. dollar, the U.S.’s twin deficits may begin to matter more than they have recently. Historically, U.S. corporate earnings performance has hewed closely to GDP growth differentials between the U.S. and the rest of the world (whether measured in real or nominal terms). We would therefore expect U.S. corporate earnings outperformance to reverse given the turn in relative GDP growth. As discussed above, elevated valuations of U.S. assets and investor enthusiasm may lead to a disproportionately large reaction to such a reversal.

There are risks to this view. S&P 500 earnings and cash flows have disconnected somewhat from economic growth (particularly in 2018 following the tax cut), as margins expanded and capital discipline remained high, and there is a risk that only a moderate slowdown of the U.S. economy relative to the rest of the world will be insufficient to impact relative earnings performance. But we think there is an increased chance that the secular outperformance of the U.S. corporate sector may be at risk. The significant improvement in margins and cash flows has been largely attributed to two factors: increased market concentration, especially in the tech industry, and continued decline of capital intensity of business models. We hesitate to call for a quick reversal of these long-standing trends, but we suspect that the probability of margin stabilization has risen significantly. Increased government oversight or regulation of tech and a moderation of outsourcing of capital-intensive activities seem more likely. Forecasting the exact timing of this pivot is challenging because it depends on how quickly government policies will be enacted and how quickly those already in train affect their respective economies, a difficult factor to predict precisely.

At this point we know that U.S. assets’ outperformance has been relatively large and prolonged, that U.S. assets are somewhat (and in some cases extremely) expensive relative to other assets, and that investors are generally already well-positioned for this trend to continue. In addition, there are good reasons to expect U.S. economic outperformance to have run its course over a six- to 12-month investment horizon. We have begun to position portfolios for the eventual turn while keeping in mind that its timing remains difficult to pinpoint.
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FOOTNOTES
1 MSIM Global Multi-Asset Team Analysis; Haver Analytics.
2 ibid.
3 MSIM Global Multi-Asset Team Analysis; IBES; FactSet; MSCI.
4 GDP weighted.
5 Emerging Portfolio Fund Research, Inc. (EPFR).

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THE EVENTUAL TURN OF U.S. OUTPERFORMANCE?

1 MSIM Global Multi-Asset Team Analysis; Haver Analytics.
2 ibid.
3 MSIM Global Multi-Asset Team Analysis; IBES; FactSet; MSCI.
4 GDP weighted.
5 Emerging Portfolio Fund Research, Inc. (EPFR).
6 MSIM Global Multi-Asset Team Analysis; Bloomberg.
7 Neutral rates based on Fed estimates of long-term interest rates based on the Summary of Economic Projections (SEP).
8 MSIM Global Multi-Asset Team Estimates; Haver Analytics.
9 ibid.

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