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Global Equity Diversification Proving Its Worth

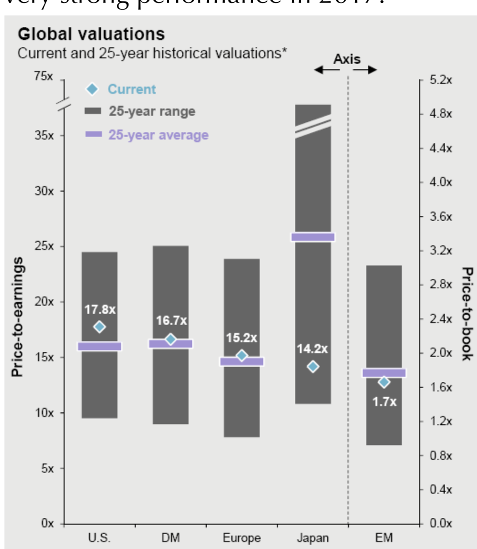
We are staying with our emphasis on emerging and developed international markets.

Last April, we made the case for global diversification as a prudent investment practice. At the time, U.S. equities had outpaced global markets over several years. In 2017 there has been a dramatic reversal, beneficial to United Church Funds' portfolios, as global equities have done better than U.S. stocks alone. As of this writing in early-October, U.S. markets had returned about 15% while developed international markets were up almost 20% and emerging markets had gained over 30%!

Our April rationale was simple. Perfect timing is impossible, and our favorable view towards international markets had to do with the best opportunities for better potential returns. Will the outperformance of international stocks continue? We are staying with our emphasis on emerging markets (think Brazil, China, etc.) and developed international markets (Europe, Japan) because: 1) valuations compared to history are better than those of the U.S.; and 2) the earnings of companies in those countries are growing faster than U.S. companies.

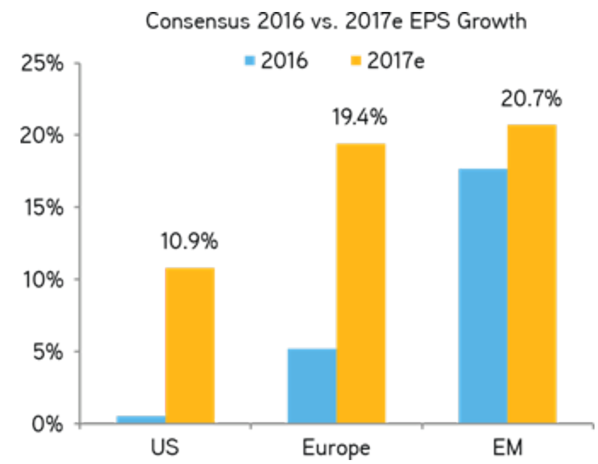
Since 2009, U.S. equity markets have led all global equities. During that time, all parts of the U.S. equity markets have gained well over 300% and more than half have gained close to or over 400%. Now, as a result of those gains, every part of the U.S. market is above their long-term average valuations as measured by price-to-earnings ("P/E", a well-known measure of valuation and is the share price divided by earnings). In other words, all the parts of the U.S. equity market are more "expensive" than their historical averages.

The chart below (from JP Morgan) shows valuation data on the U.S., developed markets and emerging markets. Developed international market's P/E is in-line with its historical long-term average. Emerging markets' valuation is still below its long-term average even with the very strong performance in 2017.



UCF portfolios with global equity exposure have been positioned to benefit from the better performance of international markets.

If "Price" is one side of P/E, the other side is the earnings of companies. If prices are increasing, why aren't emerging market stocks also getting expensive, and why are we still comfortable with the opportunities in emerging markets? Because earnings are growing at higher rates, on average, than U.S. companies. The bar chart below (from KKR) shows the growth rate of EPS, earnings per share, in the U.S., Europe and emerging markets in 2016 and projected for 2017. There's a clear difference between Europe and emerging markets compared to the U.S.



International developed and emerging markets are favored now because valuations are better compared to their historical averages, and because those companies are growing their earnings faster than U.S. companies. Going forward, we anticipate maintaining a healthy dose of international markets because, as illustrated in the below chart, these performance trends tend to persist for multiple years once they start.

Could things go wrong? Absolutely. There are higher risks in emerging market countries, including the possibility that the U.S. dollar could reverse course and appreciate against these currencies, which would detract from international returns for U.S investors, as it did in 2014 and 2015. Year-to-date, UCF portfolios with global equity exposure (Total Equity Fund, BFF Equity Fund, all five Balanced Funds) have been positioned to benefit from the better performance of international markets. To accentuate the point, UCF's Total Equity Fund has outstripped the S&P 500 and U.S. markets.

As always, we thank you for your confidence in us and will continue to work to position your portfolios to benefit from the benefits of global diversification, as appropriate.

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