2017 will be remembered for strong equity returns and extremely low volatility; the S&P 500 total return was +21.8%, non-U.S. equities returned +27.8%[1]. The primary driver of this goldilocks scenario was a global economic expansion and synchronized earnings rebound, the first time we have seen this broadly since the financial crisis. In addition, fears that quantitative easing would destroy economies via severe general price inflation have proven to be unfounded. We believe global equities are likely to continue to appreciate in an environment where there are few signs of excessive inflation and global monetary policy still remains loose.

The Case for Non-U.S. Equities

The largest change to portfolios in recent quarters has been a significant increase in non-U.S. investments, primarily moving equity exposure from the United States to Europe and Asia. Our reasons are as follows:

- Monetary policy outside the U.S. is highly likely to remain more accommodative than in the U.S. The Federal Reserve is raising rates, with three increases in 2017 and a Fed median projection of three more in 2018. Outside the U.S., major central banks continue to employ accommodative policies, especially in Japan and Europe. In each of the last four cycles where the Fed raised rates U.S. stocks had positive returns. It is noteworthy that non-U.S. stocks outperformed in three of them.

- The recovery in U.S. equity earnings is much more mature than the non-U.S. equivalent. Current S&P 500 earnings are 41% higher than the previous peak achieved in 2007. Conversely, non-U.S. earnings are still 25% below their prior peak. The most recent year represents a long awaited turning point for non-U.S. earnings growth, which is expected to rise 22%, more than twice the projected S&P 500 growth rate1.

- U.S. corporations are at, or near, peak profit margins. The recent tax cut will help U.S. net margins this year, but operating margins may face pressures from higher labor costs and interest rates. Non-U.S. equity margins have recovered from the financial crisis but still remain well below peak levels, implying the potential for more upside.

- Nowhere are stocks statistically cheap; however, valuations in the U.S. remain elevated and well above historical averages, with the S&P 500 trading at 20x forward twelve month earnings. Non-U.S. equities trade at 14.6x forward earnings1, a substantial discount.

Risks

Investing, by definition, requires ascertaining risks and weighing probabilities. We are cognizant that geo-political risks are omnipresent and often unanalyzable. In many cases, even if one could predict an eventual outcome, one has to recognize that the timing of market-moving geopolitical events is often unknowable, and resolutions can take far longer than anyone originally imagined. Our focus, therefore, is on looking for misallocations of capital, signs of significant excess, and signals of the next economic recession.

Our list of excesses is still relatively small. The daily price volatility of Bitcoin exhibits an immaturity and level of speculation that is excessive, if not bubble-like. We are also watching for excesses in indebtedness, both at the sovereign and corporate level. We do see some signs of excess here, which have been aided by globally low rates. If or when global rates increase significantly, some debtors will surely have problems.

As for U.S. recession indicators, we don't see cause for alarm yet. We are watching closely for signs of inflation and see future sources of that potentially coming from a number of areas:

- The labor market has strengthened significantly, as evidenced by the unemployment rate and initial jobless claims, and it is highly anticipated that there will be wage inflation in the U.S. exceeding current modest levels of 2.5% year over year.

- The price of oil has recovered substantially (+12.5% in 2017)[2]. At current levels we think oil will be a benign inflationary force, but a return to $80 to $100 per barrel oil would likely be counterproductive to global economies, not to mention corporate profits outside of the energy sector.

- Easier fiscal policy (e.g. the tax cut in the U.S.) could stimulate consumer spending and business investment. Recent surveys highlight that corporate America is planning increased capital expenditures. These forces could be inflationary which ultimately has the potential to lead the Fed to raise rates faster than current expectations.

How soon such conditions develop, and with what degree of seriousness, cannot yet be projected, but we think that their advent is increasingly probable. The most common negative catalyst to an equity bull market is an increase in interest rates that goes too far and kills the economic expansion, which is why we monitor interest rates and central bank policy closely.

Current Positioning

Our view is that client portfolios should have allocations which are neutral relative to long-term strategic asset allocation targets. We are continuing to increase international exposure, and currently have a target of 45-50% of a portfolio's Long-Term Growth Investments coming from outside the U.S. We remain highly selective in terms of opportunities in private equity; our preference today remains focused on strategies with non-U.S. or global exposure, and in either case we continue to require a substantial risk premium above the public market equivalent to justify the illiquidity of the asset class. Our primary focus on hedge funds continues to be on a select group of high conviction long/short equity managers. Our ongoing work in this area continues to emphasize managers who have proven short-selling capabilities as we are likely in the later part of the cycle in the U.S. In Fixed Income, we are emphasizing short duration bonds, in anticipation that interest rates will continue to go up. After a year of low volatility complacency can creep into markets, we are guarding against that and will remain nimble to what may be a rapidly evolving landscape.

[1] Source: Bloomberg. Non-U.S. equity is represented by the MSCI ACWI ex-US index, total return is in US$.
[2] Source: Bloomberg. West Texas Intermediate, generic first (CL1) contract.