

January 16 2018

GLOBAL EQUITY MARKET OUTLOOK

FAVOR U.S. AND EM

John Lynch *Chief Investment Strategist, LPL Financial*Jeffrey Buchbinder, CFA *Equity Strategist, LPL Financial*

KEY TAKEAWAYS

2017 was an excellent year for international equities, particularly EM.

We favor the United States and EM equities for tactical global asset allocations based on our outlooks for economic growth, earnings, and political stability.

We expect strong economic growth and attractive valuations to help EM offset tighter global monetary policy in 2018.

We favor U.S. and emerging market (EM) equities for tactical global allocations. After reviewing our thoughts on the U.S. equity markets in last week's [Weekly Market Commentary](#), we thought we'd expand our 2018 equity outlook with a focus on global markets. As discussed in our [Outlook 2018: Return of the Business Cycle](#) publication, from a regional perspective, we favor the U.S. and EM over developed foreign markets broadly, although the improving outlook in Japan is noteworthy.

INTERNATIONAL EQUITIES PERFORMANCE REVIEW

The year 2017 was excellent for international equities, especially for EM. The MSCI EAFE and EM indexes returned 25.6% and 37.8%, respectively, both ahead of the S&P 500 Index's 21.8% return. International equity market gains were broad based, as only two MSCI World countries saw their markets decline in 2017 (Russia and Israel). In general, overseas equity markets benefited from U.S. dollar weakness, improving and better-than-expected global growth, a rebound in earnings, and commodity gains.

Within the developed international benchmark, Europe slightly outperformed while Japan slightly underperformed. Within EM, where strength was led by China, some of the risks carried more bark than bite; U.S. trade relations with China and Mexico soured less than feared, while EM generally shrugged off Federal Reserve (Fed) rate hikes and the start of balance sheet normalization.

INTERNATIONAL EQUITIES 2018 OUTLOOK

We evaluate regional allocation opportunities by looking primarily at the following factors:

ECONOMIC GROWTH

From a regional perspective, our 2018 economic growth outlook favors the U.S. and EM over developed international economies. For 2018 we forecast gross domestic product (GDP) growth of 2.75–3% in the United States,

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

after factoring in the potential impact of the new tax law, and 4.8% in EM, compared with 1.8% in international developed economies, and 3.7% globally [Figure 1].*

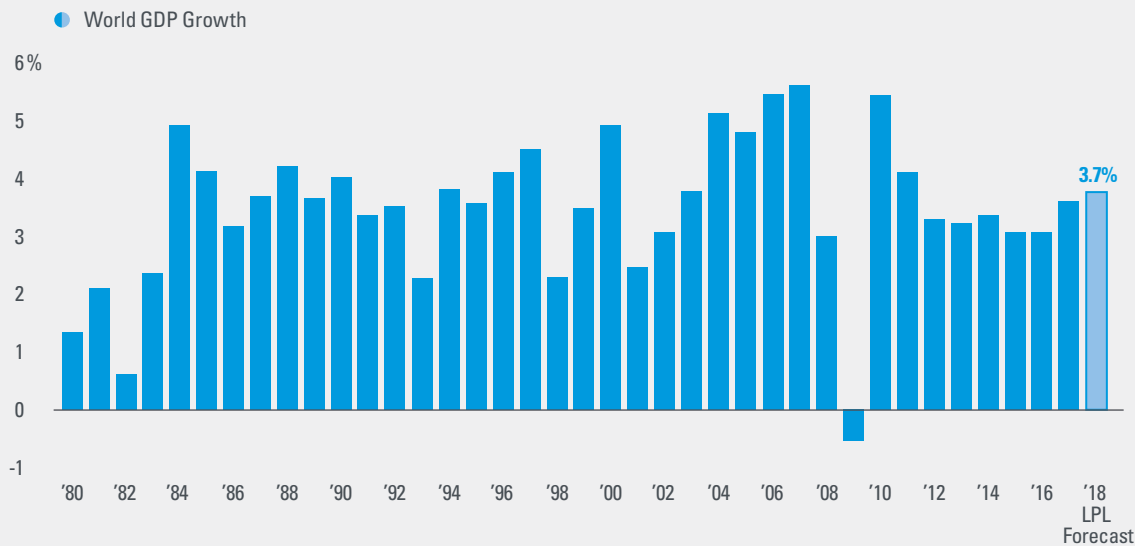
Growth in the Eurozone gained traction over the past year, with improving business confidence leading to higher investment as the worst of the political fears failed to materialize. However, uncertainties remain amidst the surge in nationalism, Brexit negotiations, and the upcoming elections in Italy. Considering these challenges, along with a reduction in European Central Bank (ECB) monetary support, it is conceivable that European growth may have peaked.

*Please see our [Outlook 2018: Return of the Business Cycle](#) publication for additional descriptions and disclosures.

In Japan, economic growth prospects have brightened. The combination of government spending and monetary accommodation has pulled GDP higher for seven consecutive quarters. While GDP growth is expected to hover around 1.0%, inflation is projected to remain well below the Bank of Japan's (BOJ) 2.0% target, which may keep the zero percent target for the 10-year Japanese government bond in place for the next year or two. Prime Minister Abe has a mandate for more stimulus and structural reforms after his election victory last fall.

We expect economic growth near 4.8% in emerging economies. Advantageous demographics, stable commodity prices, and early-cycle acceleration should help offset slowing but stable growth in China. We expect China's GDP to expand near 6.5%, down

1 GLOBAL GROWTH EXPECTED TO ACCELERATE IN 2018



Source: LPL Research, Bloomberg 01/12/18

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

GDP – Gross Domestic Product (GDP)

Expected global GDP growth may not develop as predicted.

slightly from 2017 estimates of 6.9%, supported by the powerful combination of gains in retail sales and industrial production.

EARNINGS GROWTH

Consensus estimates are calling for strong earnings growth in developed international markets (+9%), based on the MSCI EAFE Index, according to FactSet. But earnings growth expectations in the U.S. (+14%) and EM (+13%) are both higher. Moreover, revisions to 2018 estimates over the past month have been more positive in the U.S. and EM than in developed international. Although solid earnings growth is anticipated in international

developed economies, it is difficult for those earnings to stand out when compared to the acceleration driven by the tax law in the United States and faster growth rates in EM [Figure 2].

VALUATIONS

Valuations are lower in developed international and EM than in the United States by virtually any measure. While this factor is perhaps the strongest one in favor of developed international allocations, and points to a healthy strategic allocation because valuations matter more longer term, we see potential for better value tactically in EM given the macroeconomic backdrop [Figure 3].

2 U.S. AND EM EXPECTED TO PRODUCE STRONGEST 2018 EARNINGS GAINS

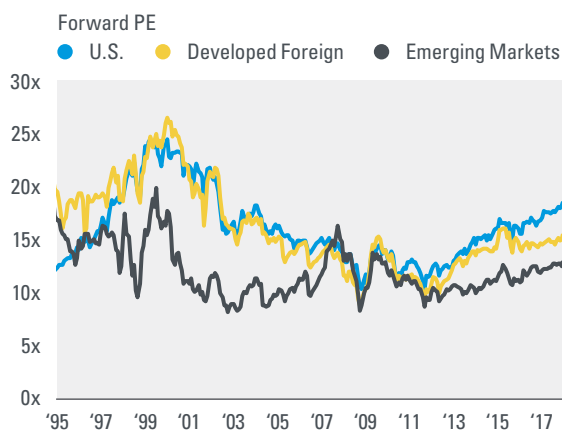


Source: LPL Research, Bloomberg 01/12/18

Indexes: U.S.—S&P 500, Developed International—MSCI EAFE, and Emerging Markets—MSCI EM.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

3 INTERNATIONAL EQUITIES VALUATIONS REMAIN RELATIVELY ATTRACTIVE



	Forward PE	Forward PE	
U.S.	18.4x	Developed	15.3x
Europe	15.2x	EM	12.9x
Japan	15.3x	Global	16.5x

Source: LPL Research, FactSet 01/12/18

Indexes: U.S.—S&P 500, Developed International—MSCI EAFE, and Emerging Markets—MSCI EM.

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. Estimates may not develop as predicted.

Forward Price-To-Earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

All performance is historical and no guarantee of future results. Estimates may not develop as predicted.

Relative to their long-term histories (25 years) on a forward price-to-earnings basis, the United States is trading at a 25% premium, developed international is trading at a 4% discount, and EM is trading at an 8% premium. However, low valuations in Japan are skewing international developed—Europe is trading at a 23% premium and Japan is trading at a 33% discount.

POLITICAL STABILITY

Relatively speaking, we believe political stability favors the United States, Japan, and China over Europe. Republicans aligned to pass the new tax law and the United States continues to have among the most stable business environments. Japanese President Abe and Chinese President Xi have both consolidated power. President Abe is pursuing market-friendly structural reforms while President Xi is emphasizing balance between market-driven forces and state-owned enterprises. Elsewhere in EM, India is becoming the “new China” under a generally pro-business Prime Minister Modi regime, and Brazil is emerging from political scandal and recession, although an unusually active election season throughout Latin America in 2018 bears watching.

Political stability in EM is atypical, but the picture is relatively encouraging at this point. The political backdrop in Europe will be important to watch and could change dramatically depending on developments in the United Kingdom (Brexit), Italy (March elections), and Germany (in the process of formalizing a governing coalition).

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

WATCHING FOR U.S. DOLLAR REVERSAL

Currencies are also an important consideration in regional allocation decisions. Last year, a 15% gain in the euro relative to the U.S. dollar helped drive the outperformance of the MSCI Europe Index relative to the S&P 500.

We expect modest upward pressure on the U.S. dollar in 2018 as the Fed gradually hikes interest rates and allows maturing securities to roll off its balance sheet, pushing market interest rates higher, against the backdrop of ECB tapering and continued aggressive monetary policy stimulus from the BOJ. For appropriate investors, we suggest hedging currency exposure in developed international markets when possible, given our expectation that the U.S. dollar may rise.

CONCLUSION

We favor U.S. and EM equities over their developed international counterparts in 2018. In the United States, a slight pickup in economic growth and fiscal stimulus, including the new tax law, are supportive of a continuation of the bull market. We expect strong economic growth and attractive valuations to help EM offset tighter global monetary policy in 2018. In developed international markets, though our outlook for Japan is positive, growth in Europe may be peaking while structural concerns remain. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

DEFINITIONS

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI All Country World Index is an unmanaged, free-float-adjusted, market capitalization-weighted index composed of stocks of companies located in countries throughout the world. It is designed to measure equity market performance in global developed and emerging markets. The index includes reinvestment of dividends, net of foreign withholding taxes.

The MSCI EAFE Index is made up of approximately 1,045 equity securities issued by companies located in 19 countries and listed on the stock exchanges of Europe, Australia, and the Far East. All values are expressed in U.S. dollars. Past performance is no guarantee of future results.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 8665 0118 | For Client Use | Tracking #1-688144 (Exp. 01/19)