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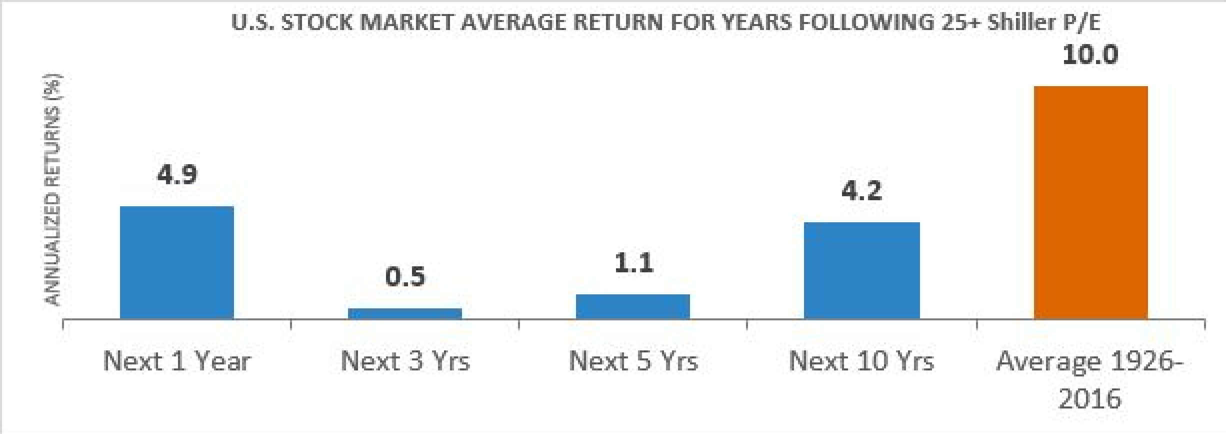
U.S. stocks appear expensive. But where to consider investing instead?

As we entered this year, a common theme ran through many capital market forecasts: *"Expect lower investment returns because equity valuations are high and interest rates are low."*

Interest rate levels and fixed income returns have a direct relationship. The current low rates equate to low yields for fixed income instruments. If interest rates increase during the year, as many (including Russell Investments) expect they will, the combination of subsequent price decreases and low yields will lead to modest fixed income returns.

The relationship between interest rates and equities isn't quite as tight, but high valuations still have a significant impact on expected returns. The U.S. equity market (S&P 500® Index) has experienced a strong run of results since global markets bottomed in March of 2009. This run has created high market valuations within the U.S. Using the Robert Schiller Cyclically Adjusted Price-to-Earnings (CAPE) valuation, the December 2016 CAPE for the U.S. stock market is 28.3 - putting current valuations within the top 6th percentile for the last 90 years. This level of valuations has only been reached twice before: in the late 1920's and 1990's. For those too young to remember, these periods were followed by the Great Depression and the Tech Bust, respectively. History has demonstrated that high valuations tend to be followed by lower than average returns.



*Sources: Shiller P/E data: Robert Schiller website, U.S. equity returns: Ibbotson and Russell Investments; U.S. Stock Market: Ibbotson U.S. Index (1926-1978), Russell 3000® Index (1979-2016). *Yale Professor Robert Shiller calculates a Cyclically Adjusted P/E Ratio based on prior 10-year earnings. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.*

This does not bode well for U.S. equity return projections for the foreseeable future. However, just because U.S. stocks appear expensive, doesn't mean *all* stocks are expensive. If we move outside the U.S. and consider international equity markets, the valuation picture is different.

The two charts that follow show valuation comparisons for some of the largest developed markets and emerging markets, as well as for collective groups, as measured by the MSCI EAFE Index and MSCI Emerging Markets Index.

Sources: Shiller P/E data from Robert Shiller website and Research Affiliates website. PE start dates differ: U.S: 1871; EAFE: 1972; Germany: 1969; France: 1971; UK: 1969, Japan:1969; EM: 1995; Brazil: 1994; Russia: 1996; India: 1994; China: 1995. All ending with December 2016. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are unmanaged and cannot be invested in directly.

A few items standout on these charts - and they don't bode especially well for U.S. equity expectations.

1. The U.S. stock market appears to be the most expensive market at an absolute level.
2. The U.S. stock market is currently the only one of the largest markets with valuations above its long-term average - and it's beating that historical average by a notable 75%.
3. In contrast, the MSCI EAFE Index is currently valued at 40% below its historical average.
4. The MSCI Emerging Markets Index appears to be trading at a similar discount to EAFE relative to individual country and collective histories.

The bottom line

Lower valuations in and of themselves do not guarantee a better future return - at times, they are justified due to market and economic circumstances. However, history has demonstrated that the price paid for an investment has a significant impact on the future return that an investor may earn. Against a backdrop of expensive U.S. capital markets, long-term investors with commensurate risk tolerance may want to consider diversifying part of their portfolio beyond U.S. borders.

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The S&P 500® Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500® are those of large publicly held companies that trade on either of the two largest American stock market exchanges: the New York Stock Exchange and the NASDAQ.

Russell 3000® Index: Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

MSCI EAFE (Europe, Australasia, Far East) Index: A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets Index: A float-adjusted market capitalization index that consists of indices in 21 emerging economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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