Opportunities and challenges in a less US-centric world

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Investors have come to accept a world where the US and Wall Street drives much of what happens in the global economy and global financial markets – both in the short and long term. We wake up, and a big move up or down on Wall Street normally sets the scene for the day's movement on ASX and other markets in this and following time zones. Commentary on the direction for the US economy and markets, and the actions of its policy makers, influence the debate and outcomes in almost all other major economies. US innovations and business practices have been big drivers of global economic growth in recent decades. US entertainment and media – including the financial media – infiltrates the globe. Technology has expanded this influence and the disclosure of NSA spying showed that the US government's influence was even greater than many knew.

It is hard to contemplate a world not so heavily dominated by the US. After all, given its key position since the end of World War II in 1945, its role as the pre-eminent geopolitical, economic and financial influence spans the adult lives of almost every living person.

However, I believe this dominance is beginning to fade, with this trend likely to accelerate in coming years and decades. If this proves to be the case, it will have significant implications for how investors should best construct and position portfolios.

The underlying reasons for this change are several.

1. Geopolitical – While the US will remain the world's military superpower for some time, there are clear signs that it is increasingly less able and willing to project its power and influence globally. Disappointing outcomes from recent wars and increasing criticism of its various involvements and their fiscal cost has been a major contributor to this changing level of involvement.

2. Economic – The relative position of the US in the global economy is shrinking. China, in particular, has grown dramatically and is likely to surpass the US as the world's leading economy in the next decade or so. This, and the sheer size of China's population, is leading to pressure for a greater role in global political and economic affairs. This also applies to a range of other increasingly important emerging countries which have historically been less influenced by the US, such as India, Brazil, Russia and Indonesia. Indeed, technology that often originated out of the US has been copied and allowed this growth to accelerate.

3. Monetary Policy – US monetary policy has been a major influence on both US and global financial markets over the last two decades. However, the combination of the constraints of near zero rates, questions over the benefits and risks of Quantitative Easing, increasing criticism from foreign governments and the threat of "currency wars" is creating pressure to normalise monetary policy. This suggests US monetary policy is likely to have a lesser impact on global liquidity flows, economies and financial markets in the future compared to this period.

4. Political power of the US finance sector - While the finance sector has managed to hold on to significant levels of power and influence to a greater extent than many expected post-GFC, it does seem to be slowly waning and is likely to do so in coming years.

I suspect that recent new record highs on Wall Street have led many to ignore or downplay these deep seated changes occurring in the background, encouraging complacency that the US will remain the world's most important country and economy for many years to come.

Meanwhile, signs are emerging that the US no longer has the power and influence it once had. From the increasing number of trade and currency deals between countries with no US involvement, to the pressure for reform of global bodies such as the IMF (or even form new ones without the US), pressure for a reduced role for the US and a larger role for many other developing countries is growing.

Even anecdotally, the number of days when even the local sharemarket doesn't react to - or even does the opposite of - a big move on Wall Street seem to have become more numerous. Some of the increasingly important markets even seem to move in the opposite direction of Wall Street. Of course, such inverse behaviour has not been good for all markets. China A Shares, for example, have been in a savage bear market for the last five years while the US equity market has returned almost 200%. However, this will turn. I would not be surprised to see China and some other lagging markets perform well through a time when the US performs poorly, particularly given relative valuations.

I am not suggesting that the US will stop influencing global markets or severe weakness or a crash on Wall St would not lead to big falls on many overseas markets. However, I would expect that any major and sustained weakness for Wall Street does not necessarily have to translate into similar moves for all overseas markets, at least after initial kneejerk falls.

Another related issue is the increasing vulnerability of the US dollar as the world's reserve currency. While there is no immediate threat, the inevitable internationalisation of the Chinese Yuan is likely to challenge the US's claim to the "exorbitant privilege" of having the world's reserve currency. Any loss of that status could have major implications including persistent currency weakness, and higher inflation and interest rates.

If the US does become less important in the global economy and financial markets in coming years, what does this mean? It certainly is not all good.

As I highlighted in my last article on geopolitical risk, the US has been subtly reducing its role in global affairs for fiscal, political and strategic reasons, while the growing power and wealth of many developing countries could make the world a less stable place.

Further, many of the growing economies that are eroding the relative position of the US in the world economy are hardly functional democracies, raising questions of individual and business freedoms in the decades ahead (although some might say that US democracy is hardly functioning well at the moment either).

On the positive side, however, global equity diversification may work better in the future than it has in recent decades. With the US becoming less influential in driving global equity markets, a mix of countries may provide more significant diversification benefits as they become more driven by local factors.

Secondly, given the backward looking nature of many benchmark indices and the current situation where (on some measures) US equities are amongst the most expensive on a global basis, many investors may be overexposed to the US at a time where both the array of other opportunities and the attractiveness of those from a valuation perspective are much greater. Further, the common perception that global equities are expensive (driven by the large index weighting of expensive US equities) may be flawed as long as investors are willing to ignore benchmarks and go where the better value is.

Of course, the US market has been the one with most momentum in recent years and may continue to perform in the near term. It may even develop into a fully-fledged bubble - indeed, on some indicators, it may already be there. But, the ultimate hangover when it comes is likely to be severe. The good news is that, as the influence of the US market reduces, not all markets will experience that hangover, at least to the same extent.

In some respects, the current environment is reminiscent of the lead up to the year 2000. The key US market was overvalued and technology stocks were overvalued wildly. There was concern that any pricking of the internet/technology bubble would pull all listed equities down. However, there were many out-of-favour areas with attractive valuations that proved to be attractive places to hide in the ensuing bear market, including value stocks, resources, gold stocks and REITS.

The number of neglected places to hide from an increasingly expensive and vulnerable US market is more limited today, as the extremely low interest rate environment has forced investors to chase yield, return and risk. But, such areas still do exist e.g. China, Japan, Asia, resources/gold and certain commodities. Even volatility itself is cheap.

It is easy to become complacently trapped in a view that US pre-eminence can last for many decades yet, or that American companies are the best way to get exposure to these changing global dynamics. But there are significant risks to such ingrained and simplistic views. I am not suggesting that US equities should not be part (and a substantial part) of a global equity portfolio, but the current dominance (around 50% of most global indices) is a cause for caution, not complacency. While it seems difficult to envisage a world where the US has a much lesser role than currently, it becomes easier if you're willing to look forward, project recent trends into the future, and consider what the world is going to look like in 10 or 20 years.

So, what specifically does this mean for building portfolios?

1. Don't get obsessed about global equity index weightings. They are backward-looking and increasingly less relevant in a rapidly changing world. Opportunities that are currently a small part or even outside the indices may be significantly more attractive than the current large components of such indices.

2. Global equity market diversification may work better than you expect in the next equity downturn, especially if you're willing to invest where valuations are most attractive and/or the fundamental drivers are more detached from the US.

3. Try to look at the world and investment opportunities from a non US perspective. Read more non-US and non-US-influenced media. The US is unlikely to set the global agenda to the same extent it has in the past.

4. Think about your currency exposure. Even if it makes sense to have significant overseas currency exposures for Australian investors, don't necessarily have all, or even the majority, in US Dollars only.

It is worth remembering the situation back in 1989 when Japan was the world's most expensive market, making up almost 50% of the global equity market benchmarks. The country could do no wrong. The path was a traumatic one for Japan for the ensuing two decades - although the tide now seems to have finally changed and Japanese stocks today look relatively cheap. I doubt the decline of the US will be anywhere near as dramatic but the broad direction will be the same. From the top, there is nowhere else to go but down.

Once again, I don't expect equities outside the US to be immune from any significant US-originated selloff. But investors may be surprised at how the paths of return from different markets vary in the months and years after such an event. While US-centric investors are facing a challenging opportunity set, more adventurous ones can take advantage of more attractive opportunities with more growth potential even if the "perceived" risk is higher.

I therefore believe coming decades will see a world where the US economy - and particularly Wall Street - plays a declining role in global and Australian investment portfolios. To a large extent, this situation should help rather than hinder the ability to build robust, diversified portfolios. Of course, this all comes with the proviso that the world survives major changes to the global power balance without major instability. Unfortunately, history provides no guarantees on this aspect.

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