Market Breadth in International Equities

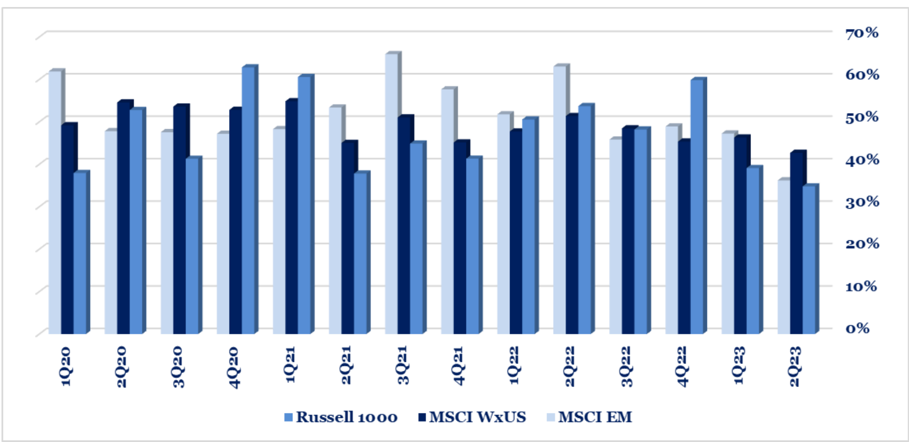
There has been much focus on the recent weak market breadth in US equities driven primarily by mega-caps stocks. There are several ways to calculate market breadth, but the objective is the same and that is to understand whether there is broad participation in the underlying index movement. If an index is rising and most of the underlying stocks are also up, then this indicates a broad healthy market condition. By contrast, weak market breadth signifies that the rally is concentrated amongst a small number of stocks and thus not sustainable.

In this report, we analyze market breadth in international equity markets in comparison to the US. We find that market breadth remains healthy in International Developed markets (DM). Meanwhile, weak breadth in Emerging Markets (EM) was driven by the underperformance of Chinese equities. In our view, weak market breadth in the US as well as high valuations could lead to underperformance relative to international equities.

Weak Market Breadth in the US

In this report we define market breadth as the percentage of constituents that have outperformed the index in a given period of time. In Exhibit 1, we present quarterly market breath in the US (Russell 1000), DM (MSCI World ex US) and EM (MSCI EM) since the pandemic in 2020. The higher the percentage, the higher the market breadth, which means that more stocks are participating in the market rally. A wider breadth is generally considered positive as it means that the rally is balanced and broad-based across multiple sectors driven by a healthy economic backdrop. By contrast, narrow markets indicate high concentration risks and when the bubbles in those few names burst, the broader index also loses most of its gains.

Exhibit 1. Market Breadth in the US, Developed Markets and EM



Sources: Bloomberg, HGP, MSCI

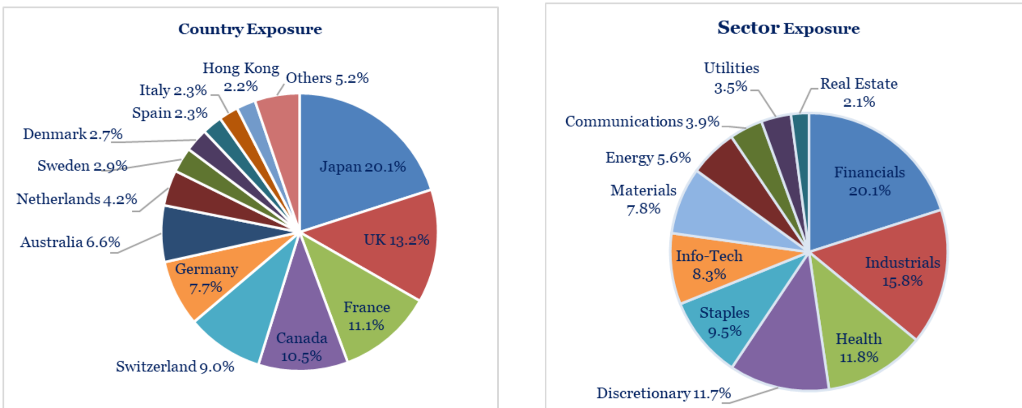
As presented in Exhibit 1, almost 60% of stocks in the Russell 1000 performed inline or better than the market during the fourth quarter of 2022. However, market breadth declined to 39% in the first quarter of 2023 and went down even further to less than 35% in the second quarter, marking the lowest level in the last three years. The Nasdaq market breadth was worse, declining from 55% in 2022 to roughly 24% in the first half of 2023.

There are several reasons why market breadth in the US has been weak. First, the US equity market is highly concentrated with the top 10 companies representing a third of the total market capitalization of the US equity market. Secondly, several mega cap stocks that have come to be known as the Magnificent Seven – Microsoft, Nvidia, Alphabet, Apple, Amazon, Meta, and Tesla – were up 35%-190% in the first six months of 2023, thus heavily influencing the performance of the US market. The Nasdaq rose almost 36% while the broader S&P 500 or Russell 1000 indices rose less than 19%. The Dow Jones index, which is even more diversified and has only two of the seven mega-caps – Microsoft and Apple - was up only 9.4%.

Balanced Market Breadth in Developed Markets

By comparison, market breadth in developed markets outside the US has been healthier, running between 40%-50% over the last three years. The developed markets represented by the MSCI World ex US index is not nearly as concentrated as the US and more balanced with the top 10 holdings representing less than 14% of the equity market. By the same token, as presented in Exhibit 2, the largest country in DM is Japan, which represents 20% of the index. Similarly, Financials is the largest sector at a 20% weight.

Exhibit 2. Balanced Country and Sector Exposures: MSCI World ex USA (June 30, 2023)

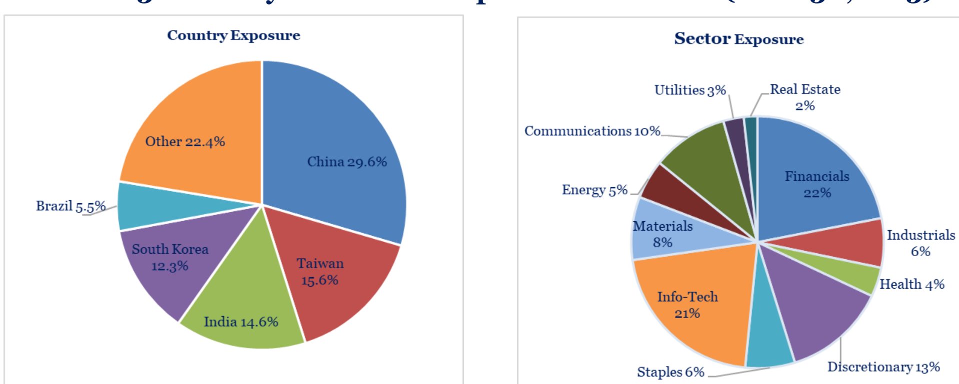


Sources: MSCI

EM Market Breadth driven by China Underperformance

Similar to the DM, the market breadth in EM was consistently above 40% after the pandemic, except in the most recent quarter when it dipped to 36% (Exhibit 1). While there isn't anything like the Magnificent Seven companies in EM and it is fairly diversified from a sector perspective, there is one big country, China that represents 30% of the index (Exhibit 3). Thus, the performance of China can have a significant impact on EM.

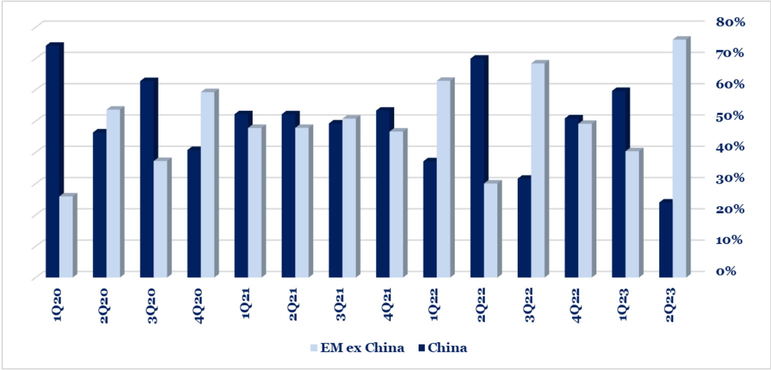
Exhibit 3. Country and Sector Exposure: MSCI EM (June 30,2023)



Source: MSCI

Next, we show that the weak market breadth in EM was driven by the underperformance of Chinese stocks rather than due to a weak market breadth in China. Out of the 36% of stocks that outperformed the MSCI EM index in the second quarter of 2023, only 24% were Chinese companies while 76% of those were domiciled outside China (Exhibit 4). Although China is 30% of MSCI EM, almost half the number of stocks in the index are Chinese stocks. Thus, the recent weak market breadth in EM was driven primarily by a lagging Chinese market. In the second quarter of 2023, MSCI China underperformed the MSCI index by more than 10%. The underperformance of China has been driven by disappointing earnings, a lack of stimulus, policy uncertainty as well as geopolitical headwinds.

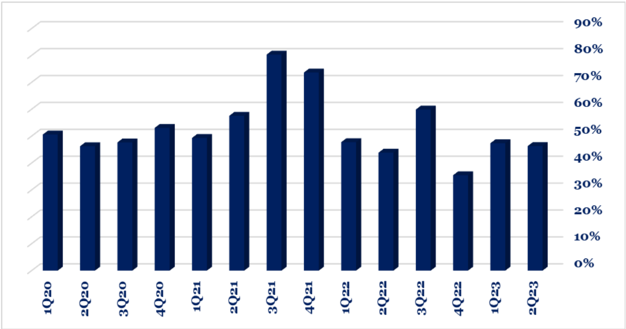
Exhibit 4. Domicile of Outperforming EM Stocks



Sources: Bloomberg, HGP

Although, the Chinese market has underperformed, the market breadth in China has been tracking around 47% in 2023 (Exhibit 5).

Exhibit 5. Market Breadth in China



Sources: Bloomberg, HGP

Nevertheless, considering that almost 30% of EM is China and the top 10 stocks in China make up almost 40% of the market can be a cause for concern. However, from an EM asset class perspective, investors can choose to invest in EM companies outside of China in countries such as Brazil, Mexico, India, etc. Also, the valuation of Chinese equities is attractive, especially compared to those in the US, and Chinese stocks appear to have priced in a lot of the negative news. MSCI China is trading at 10.75x earnings versus the US at 20.8x while the price to price to book ratio in China is 1.2x relative to the US at 4.3x. Thus, in our view, the weak market breadth in the US coupled with high valuations makes international equity markets more attractive.