## Why we believe that International Equities Could Outperform

The past decade was marked by the dominance of US mega cap stocks with the S&P500 rising more than 360% by the end of 2021. By comparison, the international Developed Market equities and those in Emerging Markets rose just over 250% during the same period. However, the decade prior to the last was led by Emerging Markets while the US and international Developed Market equities underperformed. Over these two decades, $100 invested in Emerging Markets and US equities at the beginning of 2002 would have generated an almost identical return to produce $500 by the end of 2022 (Exhibit 1). By contrast, international Developed Market equities would have grown to only $300 thus lagging their global peers.

**Exhibit 1. Historical Performance (In USD)**

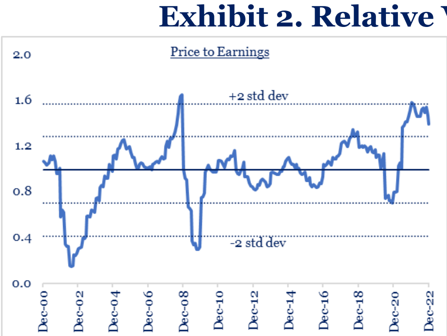

Source: Bloomberg, MSCI

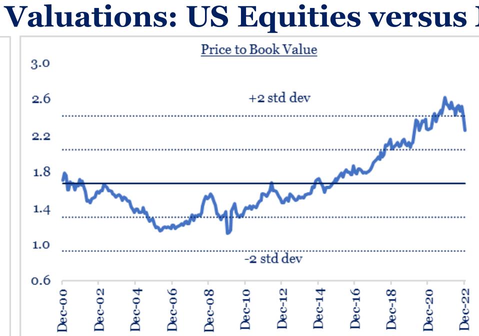
However, going into 2023, we have seen a reversal, with the MSCI World ex US index, which consists of 15 countries in Europe representing 60% of the index, Canada at 10% and the rest coming from Asia, particularly Japan, performing better. In 2022, the MSCI World ex US index was down -14.2% compared with -18.3% and -19.5% for the US and EM, respectively. This outperformance was produced despite an 8% appreciation in the US Dollar, which is even more remarkable since a stronger US dollar is often associated with periods of underperformance in international equities. Since the end of August 2022, international Developed Market equities are up 5.4% while the US is down -2.35%. Could this outperformance hold up in 2023 and could international Developed Market equities close some of the long-term performance gap?

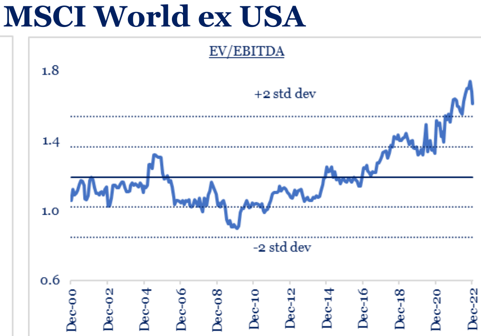
## International Equity Markets Are More Attractively Valued…

In Exhibit 2, we present valuations for the MSCI World ex US index relative to the US market based on price to earnings, price to book value and EV/EBITDA. US equities are currently trading at a P/E ratio of 18.2x vs 13x for the MSCI World ex US index, representing a multiple of 1.4x for the US relative to international equities. This is almost 2 standard deviations above the average of 1.0x, which is when US equities and international Developed Markets equities trade at an equal price to earnings multiple.

**Exhibit 2. Relative Valuations: US Equities versus MSCI World ex USA**




Source: Bloomberg

In Exhibit 2, in the second panel we show the price to book valuation of the US market is again trading close to 2 standard deviations above the mean while the third panel on the right shows the US at more than 2 standard deviations above the mean on an EV to EBITDA basis. We believe that the attractive valuation of international equities provides support for these markets to continue to outperform.

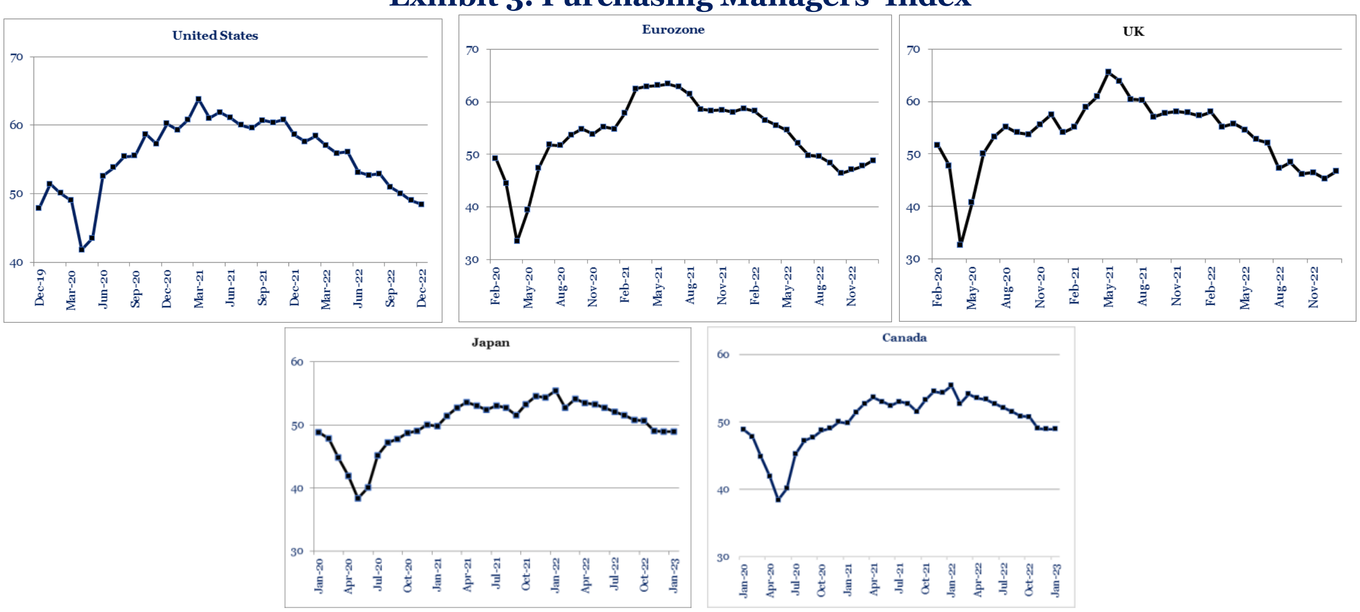
### Upbeat Economic Growth Outlook Outside the US ...

Although global GDP growth is expected to decelerate in 2023, the economic outlook in Europe and Japan has recently improved relative to that of the US. The Conference Board forecasts that economic weakness will intensify in the US leading to a recession starting in early 2023. They forecast GDP growth to be 2% year over year in 2022 slowing to 0.2% in 2023 and then rebounding to 1.7% in 2024. Meanwhile, Jefferies projects that the US is heading for a five-quarter recession starting in the third quarter of 2023.

A survey by Consensus Economics shows that the Eurozone will grow at 0.1% thus avoiding a recession in 2023 helped by lower energy prices, government stimulus and an earlier than anticipated reopening of the Chinese economy, a destination for many European exports. The German government revised up its economic outlook for 2023 projecting a 0.2% growth from the previous forecast of a -0.4% fall. Meanwhile, JP Morgan also raised its 2023 Eurozone GDP growth forecast to show an increase of 0.5%.

Similarly, Japan's government raised its growth forecast for 2023 on prospects of higher business expenditure and robust domestic demand supported by inbound tourism reopening. The Japanese economy is forecast to expand 1.5% in the fiscal year beginning in April 2023.

**Exhibit 3. Purchasing Managers' Index**




Source: Bloomberg, S&P Global

In Exhibit 3, we present the S&P Global Manufacturing PMI data for different geographic regions. Recent data in the Eurozone, the UK, Japan and Canada have either stabilized or are rising, in contrast to a declining trend in the US, which indicates that economic activity continues to rebound in other regions while it is still deteriorating in the US.

### International Equities are Better Positioned to Benefit from Post-Pandemic Spending...

The third reason why we believe that international equities are likely to outperform is driven by the sector composition of these markets. The US equity market has a higher weighting in Info-Tech companies while international equities have more exposure to Industrials, Financials and Materials. Info-Tech companies benefitted from higher spending during the pandemic as mobility was highly restricted and consumers were stuck at home. This, in turn, drove these stocks higher, and thus by default the US market as well. The S&P rose more than 85% from the bottom in March 2020 until the end of 2021 while the even more I-T heavy Nasdaq more than doubled. In a post-pandemic world where economic activity has been gradually restored, I-T companies are feeling the pain of the hangover which followed their pandemic highs. In addition, higher interest rates dictate derating for the valuations of high growth companies, leading to a tougher environment for US equities.

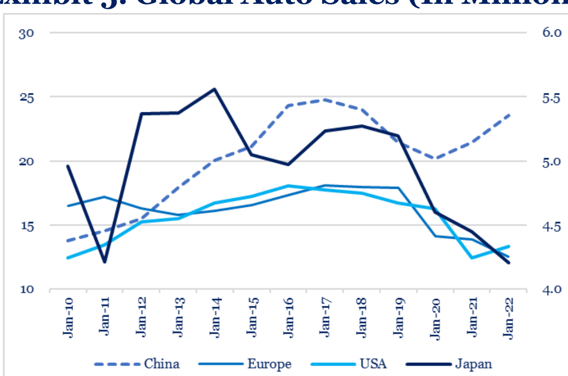
**Exhibit 4. Sector Exposure (Dec 30,2022)**

| | MSCI USA | World ex US | Europe | Japan | Canada |
|---|---|---|---|---|---|
| Communications | 7.4% | 4.3% | 3.3% | 8.5% | 2.7% |
| Cons Discretionary | 9.8% | 10.3% | 10.2% | 17.7% | 3.7% |
| Cons Staples | 7.0% | 9.9% | 13.1% | 6.9% | 4.8% |
| Energy | 5.3% | 6.5% | 6.6% | 0.8% | 18.9% |
| Financials | 11.4% | 20.6% | 16.8% | 12.1% | 36.3% |
| Health Care | 15.7% | 12.1% | 16.1% | 9.9% | 0.0% |
| Industrials | 8.8% | 14.7% | 14.3% | 22.2% | 12.0% |
| Info-Tech | 26.1% | 7.6% | 6.9% | 13.1% | 6.2% |
| Materials | 2.8% | 8.2% | 7.4% | 4.5% | 11.4% |
| Real Estate | 2.8% | 2.4% | 0.9% | 3.3% | 0.6% |
| Utilities | 3.1% | 3.5% | 4.4% | 1.1% | 3.5% |

Source: MSCI

The pandemic was also marked by supply chain issues and travel restrictions, which hurt companies in transportation, airlines, autos, auto-parts companies, etc. In Exhibit 5, we present historical auto sales in the US, China, Europe and Japan. In the US and Japan, 2022 auto sales were at the same level as in 2010-11 while auto sales in Europe remain depressed. While the technology sector experienced a boom during the pandemic, auto sales continued to slide from the recent peak in 2017. However, as supply issues ease and auto sales normalize, although there are some headwinds from higher interest rates, a recovery in auto production is more likely to lift European and Japanese markets, leading to international equity outperformance.

**Exhibit 5. Global Auto Sales (In Millions)**




Source: Bloomberg

In addition to the pandemic effects, European equities, which make up about 60% of the MSCI World ex US index are also positioned to benefit from one of the largest stimulus packages in history. In 2021, the European Union embarked on an approximately €2 trillion stimulus program to help rebuild post-COVID-19 Europe, which consists of EU's long-term budget for 2021-2027 of €1.21 trillion as well as €807bn of NextGenerationEU to make Europe greener, more digital and more resilient. In looking back, the best decade for European equities was in the 1950s, when Europe led global growth driven by post-war rebuilding. We wonder if the stimulus spending through 2027 will rekindle growth in Europe and hence set the stage for the international equities to outperform not only in 2023, but into the next decade.