International markets: What can past events tell us about how international equities are priced today?

Despite challenges the past two years, international markets show promise–especially for stock pickers. Is the U.S. stronghold about to shift?

Key takeaways:

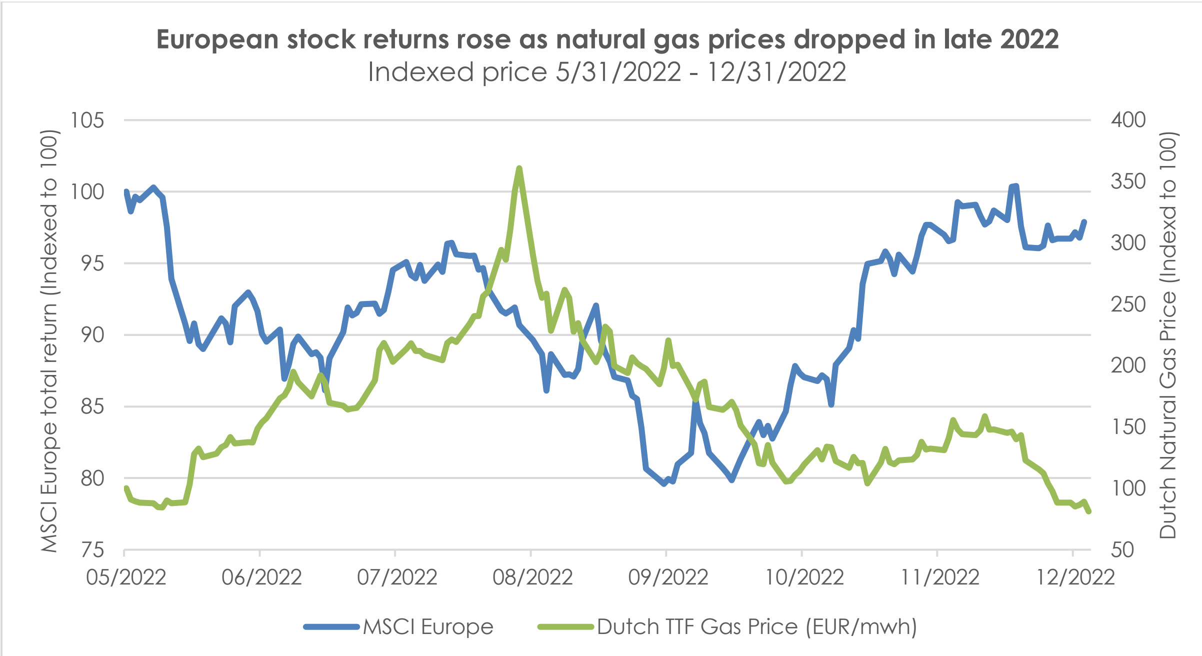
- While the markets tend to focus on macroeconomic themes, often those themes do not apply broadly or do not reflect the corporate fundamentals of specific stocks.
- European natural gas prices didn't prove to be a crisis and interest rates didn't impact the big picture as much as had been predicted, so focusing on the past two years' short-term blips wasn't a productive approach for long-term investors.
- Overall, international markets are trading at a significant discount; we believe the strongest opportunity is in Europe, where the fundamentals of select multi-nationals remain under-appreciated.
- Economists predicted a recession in 2023, leading many to believe industrials and consumer discretionary sectors would suffer, but we remained focused on individual stock valuations.

Two macro themes drove volatility in 2023

Even though macroeconomic events drive stocks' upward or downward movements, these events are often not linked to corporate fundamentals. Over the last two years, the international stock market has focused on two macro themes—European natural gas prices and interest rates. While distinct, each led to strikingly similar extreme 20% drawdowns in 2022 and 2023.

European natural gas prices

Following its invasion of Ukraine, Russia attempted to pressure the European Union into reducing support for Ukraine by cutting off the European Union's natural gas supply. By September 2022, 90% of Russian gas piped to Germany, Austria, the Czech Republic and Poland had stopped flowing. European natural gas prices soared to more than 10 times the levels at the beginning of 2021. As a result, European share prices plunged quickly and priced in an imminent deindustrialization of the European continent.

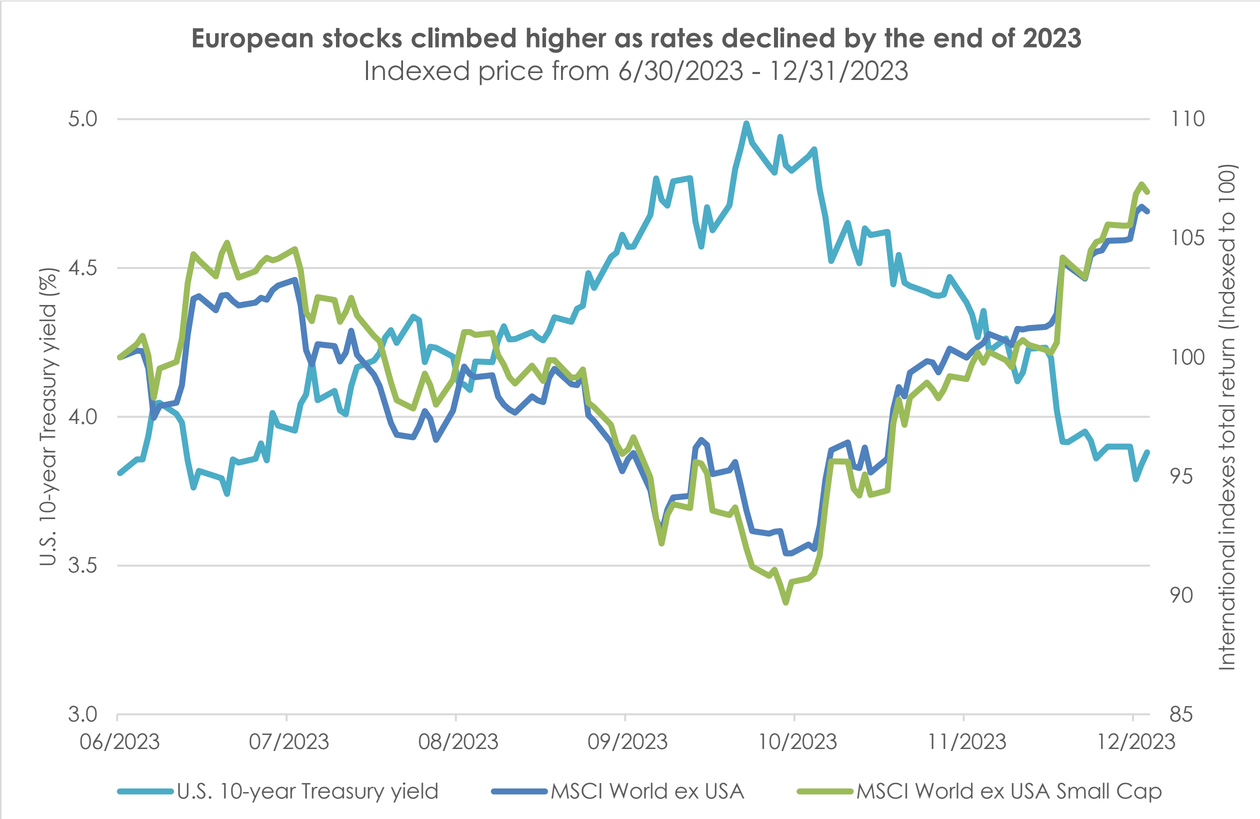


Source: FactSet. Dutch TTF gas price is for monthly near-term contract.

European citizens and corporations adapted remarkably to the new challenge by reducing their demand for natural gas and increasing their sources of supply. When our management teams visited Europe during this time, our in-person research indicated that corporate performance and cash flow generation remained resilient despite the macro events. Since others were wary, it provided us an attractive entry point into European-based companies (luxury goods, global industrials, consumer product companies, etc.) that were in actuality global producers and operators. As we ended the year, this resilience became apparent to the market. Natural gas prices cratered. The draconian scenario failed to materialize, which sent European share prices sharply higher in the fourth quarter of 2022. Hopes of peaking inflation propelled European stocks to outperform other regions.

Interest rates and positive economic data

The “lower for longer” interest rate environment persisted after the global financial crisis, allowing forecasters to trendline more of the same, year after year. But in the summer of 2023, the long end of developed markets’ Treasury curves started to price in higher rates. Especially when economic data signaled strength, consensus abruptly switched to a “higher for longer” interest rate action. The thinking was that a stronger economy meant interest rates would stay higher for longer and higher bond yields would raise the cost of capital for companies and dent consumers’ disposable income. After a 14% six-month rally to start 2023, European stocks fell 12% (exacerbated by a falling euro) between July 31 and October 27 (represented by the MSCI Europe Index (USD)).



Source: FactSet

At the end of October, the narrative shifted once again as the 10-year U.S. Treasury bond reached 5%, its highest level since 2007. International and U.S. stocks appeared to be on track toward a soft landing. Avoiding a recession reduced the risk of a credit event and declining inflation meant the Federal Reserve could pivot from being hawkish to dovish. A sharp decline in interest rates ensued and European stocks climbed higher once again.

Are markets shifting? Will international markets outpace the U.S.?

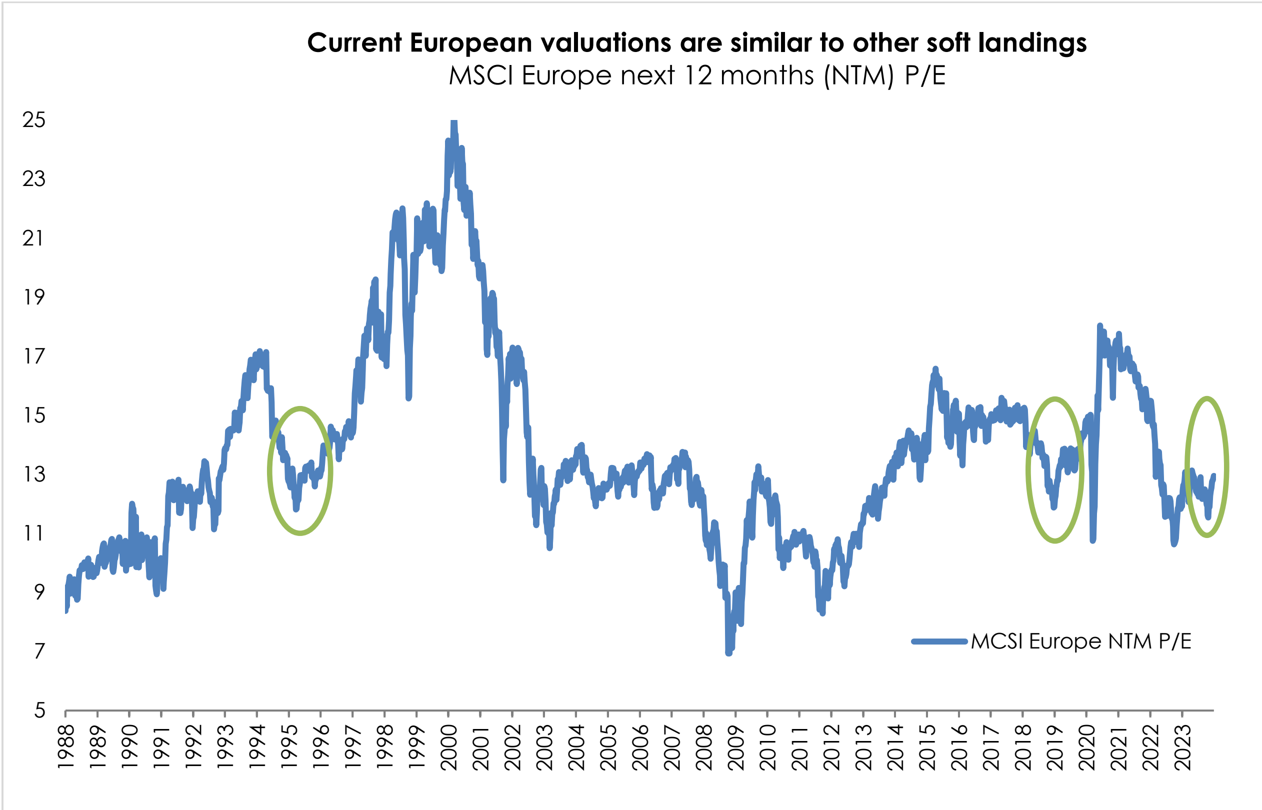
Over the 15-month period that began September 30, 2022, the MSCI Europe Index was up more than 44%, besting the S&P 500 (+36%) and on par with the NASDAQ (44%). To find the drivers and the hotspots, one must look at individual stock valuations. The starting point of business valuation is of high importance. We believe it is a monumental investment error to simply invest in those places that had a good macroeconomic run or impressive recent performance.

Source: Factset. P/E ratios are price of the respective index to the next 12-month earnings (NTM) depicted between October 31, 2007 – December 31, 2023.

International markets are trading at an increasing discount to the U.S. market. Over the last five years, the relative P/E discount has doubled. While stock market returns from the U.S. have outpaced international markets for the better part of a decade, merely extrapolating the recent past can often lead investors to miss the dynamic nature of economic and market systems. Additionally, as exemplified above, historically these macro shocks to equity prices have a very short-term impact on share prices as they often have little or no effect on corporate cash flow streams, which are the true determinant of business value and, ultimately, the price of equities.

Will Europe lead the way?

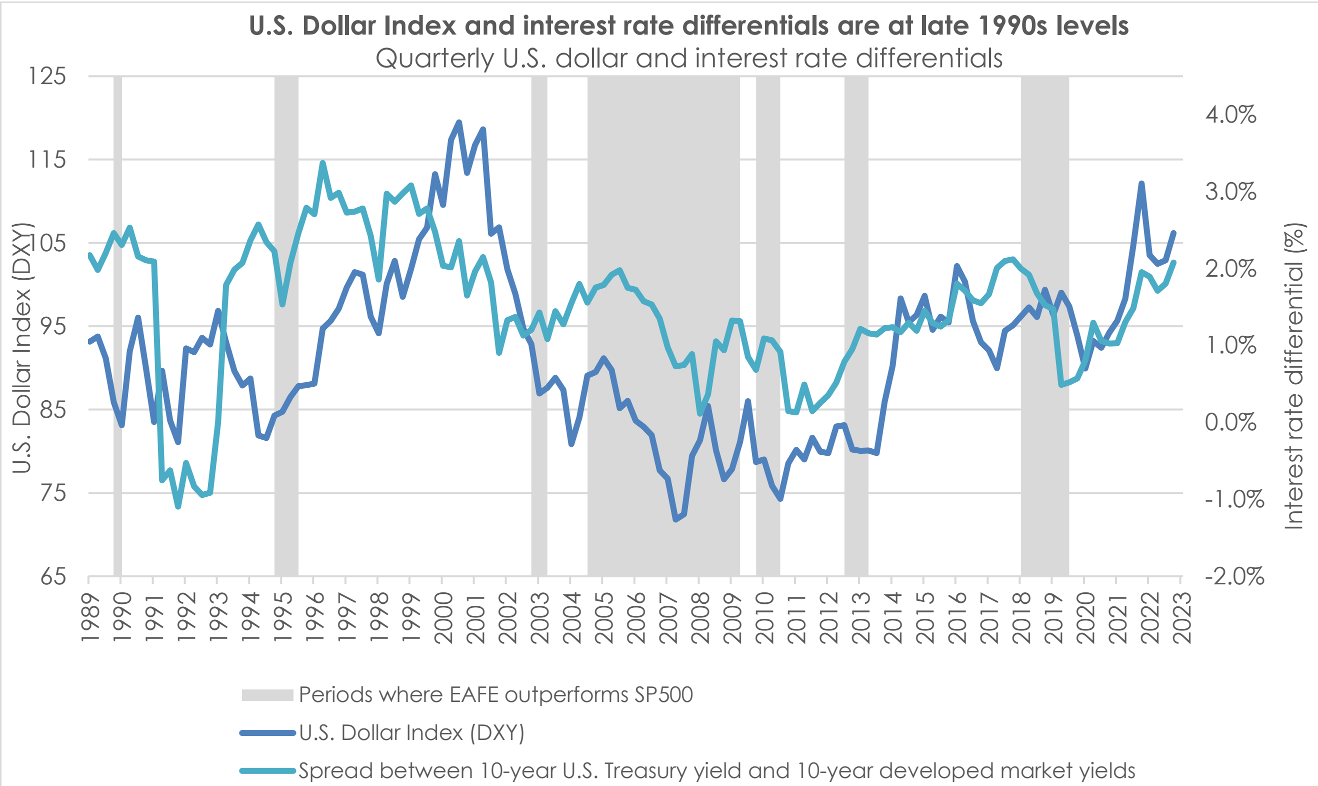
We believe Europe provides a fertile hunting ground for value investors. The MSCI Europe Index trades at just 12.8x next year's earnings, far below the S&P 500 Index, which trades at 18.8x. We often hear valuations are low, but what is the catalyst to prod European stocks? Interestingly, current European valuations are bottoming out at the same level as in 1995 and 2019, the last two times the Federal Reserve pivoted from higher rates and achieved a soft economic landing. In both instances, stock multiples expanded significantly from their lows, propelling European share prices. We believe the end of "lower forever" interest rates should be beneficial to European banks and other financial institutions that have suffered slow earnings growth because of soft monetary policy.



Current represents 10-month period starting February 28, 2023, and ending December 31, 2023.
Source: Morgan Stanley as of December 31, 2023. Price-to-earnings ratio (P/E).

Despite the less than robust economic situation in the eurozone, many businesses are global in nature and have strong prospects for future growth. Europe affords the opportunity to invest in global leaders in areas such as agricultural technology and luxury goods. Given the combination of low company valuation and respectable growth in corporate cash flow streams of our owned investments, we like the risk/reward balance of owning companies headquartered in Europe.

A large factor affecting international stock returns has been currency movement, as the U.S. dollar strongly appreciated during the 15-year period of U.S. stock outperformance as of December 31, 2023. The U.S. Dollar Index increased from 75 to 105 during this period, while U.S. stocks outperformed international stocks by 7% (represented by the S&P 500 and the MSCI World Ex U.S., respectively). The immediate effect of a strong U.S. dollar on foreign share prices is lower U.S. dollar returns of share assets as the currency declines are absorbed. However, over the medium term, the weak currency effect should begin to positively impact the earnings results of most foreign-based multinationals, producing a positive impact on foreign share prices. Additionally, it is our belief that undervalued currencies revert to purchasing power parity over the long term. Cheap currencies today provide tailwinds to total returns tomorrow. For perspective, the U.S. Dollar Index and interest rate differentials are at levels last seen in the late 1990s. After both reversed course then, international markets experienced nearly a decade of outperformance.



Recession? What recession? A thought on extrapolating from the past

All the buzz from talking heads at the end of 2022 was recession, recession, recession. In fact, a poll[1] published in late 2022 revealed that 85% of economists believed there was a 100% chance of a recession in 2023. Clients frequently asked how we could be overweight stocks in industrials, consumer discretionary and other sectors in that environment. Our response was that first we consider the price we pay for businesses, including their end market exposures. We also questioned the wisdom of the recession fearmongering as we believed the global consumer was too strong, and that the private sector, individual and financials sector balance sheets were all at safe levels. Yes, rising rates stifle economic activity, but real recessions are caused by falling incomes and high levels of indebtedness. Recall, financial institutions globally rebuilt balance sheets at capital ratios to record levels after the global financial crisis, and the global consumer left the pandemic near fully employed and with high savings. There will be another recession someday, but the conditions weren't ripe for one in 2023, despite what most economists predicted.

What we make of all this

When macroeconomic events create a market frenzy, instead of being reactionary, we often revert to a "fundamentals of business value" frame of mind. While traders tend to focus on the short term, we believe that both our intensive research process and our focus on the long term help us find opportunities. When the market doesn't separate the macro from the micro, there is an exploitable opportunity for long-term investors.

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[1]Owen, Tyler. 2023. "How Were So Many Economists So Wrong About the Recession?" Bloomberg. https://www.bloomberg.com/opinion/articles/2023-12-26/what-recession-how-so-many-economists-got-it-so-wrong?sref=7wYYxMTY

The price to earnings ratio ("P/E") compares a company's current share price to its per-share earnings. It may also be known as the "price multiple" or "earnings multiple" and gives a general indication of how expensive or cheap a stock is. Investors should not base investment decisions on any single attribute or characteristic data point.

The MSCI Europe Index (Net) is a free float-adjusted, market capitalization-weighted index designed to represent the performance of large- and mid-cap stocks across 15 Developed Market countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe. This benchmark calculates reinvested dividends net of withholding taxes. This index is unmanaged and investors cannot invest directly in this index.

The MSCI World ex USA Index (Net) is a free float-adjusted, market capitalization-weighted index that is designed to measure international developed market equity performance, excluding the U.S. The index covers approximately 85% of the free float-adjusted market capitalization in each country. This benchmark calculates reinvested dividends net of withholding taxes. This index is unmanaged and investors cannot invest directly in this index.

The MSCI World ex USA Small Cap Index (Net) is designed to measure performance of small-cap stocks across 22 of 23 Developed Markets (excluding the United States). The index covers approximately 14% of the free float-adjusted market capitalization in each country. This benchmark calculates reinvested dividends net of withholding taxes. This index is unmanaged and investors cannot invest directly in this index.

The S&P 500 Total Return Index is a float-adjusted, capitalization-weighted index of 500 U.S. large-capitalization stocks representing all major industries. It is a widely recognized index of broad, U.S. equity market performance. Returns reflect the reinvestment of dividends. This index is unmanaged and investors cannot invest directly in this index.

The NASDAQ Composite Index is a broad-based market-capitalization weighted index of all common type stocks on the NASDAQ Stock Market, including common stocks, American depositary receipts, ordinary shares, shares of beneficial interest or limited partnership interests, and tracking stocks. The index includes all NASDAQ listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debentures. This index is unmanaged and investors cannot invest directly in this index.

Performance data presented represents past performance; past performance does not guarantee future results.

Investing in foreign securities presents risks that in some ways may be greater than U.S. investments. Those risks include: currency fluctuation; different regulation, accounting standards, trading practices and levels of available information; generally higher transaction costs; and political risks.

All information provided is as of 12/31/2023 unless otherwise specified.

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