



INSIGHT & PERSPECTIVE

You Get What You Pay For

November 30, 2019

Some investors have repeatedly projected a resurgence in foreign equity prices, relative to the U.S., or have claimed that foreign equities are undervalued.

We disagree. Macro variables, profitability, and innovation may help explain why investors are willing to pay a premium for U.S. equity exposure.

Maybe foreign developed and foreign emerging equities are relatively "cheap" for a reason?

U.S. Equity Performance Leadership - Rhyme and Reason

It has been noted by many (and some have even questioned the variance) that U.S. equity outperformance versus the rest of the world has been material. Since the financial crisis, U.S. equity performance has more than doubled that of foreign developed and foreign emerging markets (see Table 1). While the multi-year equity performance has raised the eyebrows of investors, the equity price divergence has grown even more stark since the end of 2017, when the U.S. embarked on a more friendly tax policy. Meanwhile, pervasively negative interest rates in the foreign developed world has also drawn a contrast between the U.S. and many other economies. And finally, uncertainty over the economic pace in China has slowly let the air out of the emerging market balloon that was so prominent prior to the financial crisis.

These widely-recognized issues have clearly helped to draw a line of favorability between the U.S. and foreign equity markets. That line can be seen via the price-to-earnings multiple U.S. companies (S&P 500 Index)

Table 1: Major Equity Index Returns Since the Financial Crisis Trough

Trough occurred on March 9, 2009; Return data through 11/30/2019

Source: S&P Dow Jones, MSCI, Bloomberg

	Price Change	Total Return	Annualized Total Return
S&P 500 Index	364.3%	480.5%	17.8%
MSCI EAFE	116.6%	213.4%	11.2%
MSCI EM	114.3%	188.4%	10.4%

have commanded relative to their MSCI EAFE and MSCI Emerging Markets counterparts. Simply, investors have been willing to "pay up" for U.S. equity exposure. Why? Well, the reasons just mentioned serve as key arguments for the U.S. equity price-to-earnings valuation premium (see Table 2). However, less widely-reported are such variables as corporate profitability and innovation, which we believe help explain the prevailing disparity in equity performance and valuation. That is, there is in fact rhyme and reason as to why U.S. equities have outperformed. Investors have rightly chosen, in our view, to pay a relative premium for access to the superior profitability and innovation of U.S. companies. As Table 3 shows, most of the top innovative companies call the U.S. home.

We can easily decipher why profitability is important for investors, but the subjectivity of “innovation” is perhaps more nuanced. We believe innovative companies are simply able to enhance or maintain their profitability and sector/industry leadership for longer than most competitors. That may be something for which investors are also willing to “pay up”. More importantly, this relative profitability and innovation superiority is not likely to change materially in the coming years. So, while there may be short periods where foreign equities outperform, we believe U.S. equities could continue to provide global leadership for some time.

Table 2: Major Equity Indices Valuation and Profitability

Source: S&P Dow Jones, MSCI, Bloomberg; Note: ROE = Return on Equity, Op = Operating

Price-to-earnings (P/E) premiums for U.S. stocks can partially be explained by superior U.S. company margins.

	Current PE	Next Year	Op Margin	ROE	Net Margin
	P/E	P/E			
S&P 500 Index	21.5	17.4	12.7%	14.9%	9.6%
<i>Premium vs. EAFE</i>	19%	23%	27%	51%	35%
<i>Premium vs. EM</i>	43%	44%	6%	33%	10%
MSCI EAFE	18.0	14.2	10.0%	9.9%	7.1%
MSCI EM	15.0	12.1	12.0%	11.2%	8.7%

Table 3: 2019 Most Innovative Companies

Source: Boston Consulting Group

The Boston Consulting Group annually selects the world's most innovative companies.

Notice from this list that many innovative companies are U.S.-based.

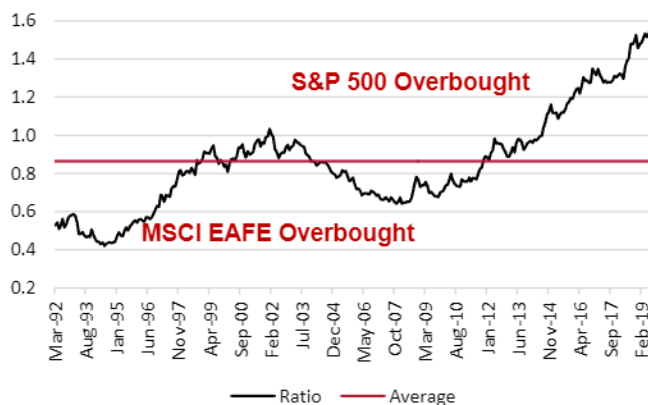
<u>Company</u>	<u>Country of Domicile</u>	<u>Company</u>	<u>Country of Domicile</u>
1 ALPHABET INC	UNITED STATES	14 JOHNSON & JOHNSON	UNITED STATES
2 AMAZON.COM INC	UNITED STATES	15 DOW DUPONT	UNITED STATES
3 APPLE INC	UNITED STATES	16 SIEMENS AG	GERMANY
4 MICROSOFT CORP	UNITED STATES	17 CISCO SYSTEMS INC	UNITED STATES
5 SAMSUNG ELECTRONICS	SOUTH KOREA	18 LG ELECTRONICS INC	SOUTH KOREA
6 NETFLIX INC	UNITED STATES	19 VALE SA	BRAZIL
7 INTL BUSINESS MACHINES CORP	UNITED STATES	20 JPMORGAN CHASE & CO	UNITED STATES
8 FACEBOOK INC	UNITED STATES	21 MCDONALD'S CORP	UNITED STATES
9 TESLA INC	UNITED STATES	22 MARRIOTT INTERNATIONAL	UNITED STATES
10 ADIDAS AG	GERMANY	23 ALIBABA GROUP	CHINA
11 BOEING	UNITED STATES	24 BAYER AG	GERMANY
12 BASF SE	GERMANY	25 AT&T INC	UNITED STATES
13 T-MOBILE US INC	UNITED STATES		

What Could Change?

While fiscal and monetary variables, profitability, and innovation seem to indicate the U.S. outperformance could persist, there are indeed some price imbalances forming. For those expecting some “reversion to the mean” in global equity performance it appears a recovery in the MSCI EAFE index, relative to the U.S., may prove to be the most likely change. Figure 1 shows that the S&P 500 Index has gotten materially extended relative to the MSCI EAFE. We believe some of the imbalance has been due to Brexit uncertainty, which, if resolved, could provide a near-term relative boost to U.K. and European equity markets.

Figure 1: S&P 500 Index vs. MSCI EAFE Index Price Ratio

Source: S&P Dow Jones, MSCI, Bloomberg



If we apply a similar index price ratio comparison to the MSCI Emerging Markets index (Figure 2), the imbalance is not as stark. Why? Because we believe the EM underperformance is simply a long-suffering give-back of the unsustainable EM performance found in the early/mid 2000's when EM investment was all the rage. Only now are U.S. equity markets looking extended versus EM, and we believe the China economic uncertainty may indeed allow this condition to persist. Many label EM markets as "cheap" relative to their historic valuation levels, unfortunately our view is those historic levels, built in the early/mid 2000s, were unsustainable.

The bottom line is we believe investors may continue to do well by shading their equity allocation toward domestic equity exposure. Developed world markets may have a better chance of upsetting the prevailing trend than EM, although we would not expect any upset to materially persist. U.S. companies and the U.S. marketplace have given reason for equity investors to buy American. That motivation could last for the foreseeable future.

Figure 2: S&P 500 Index vs. MSCI Emerging Markets Index Price Ratio

Source: S&P Dow Jones, MSCI, Bloomberg





Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.



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