Perspectives

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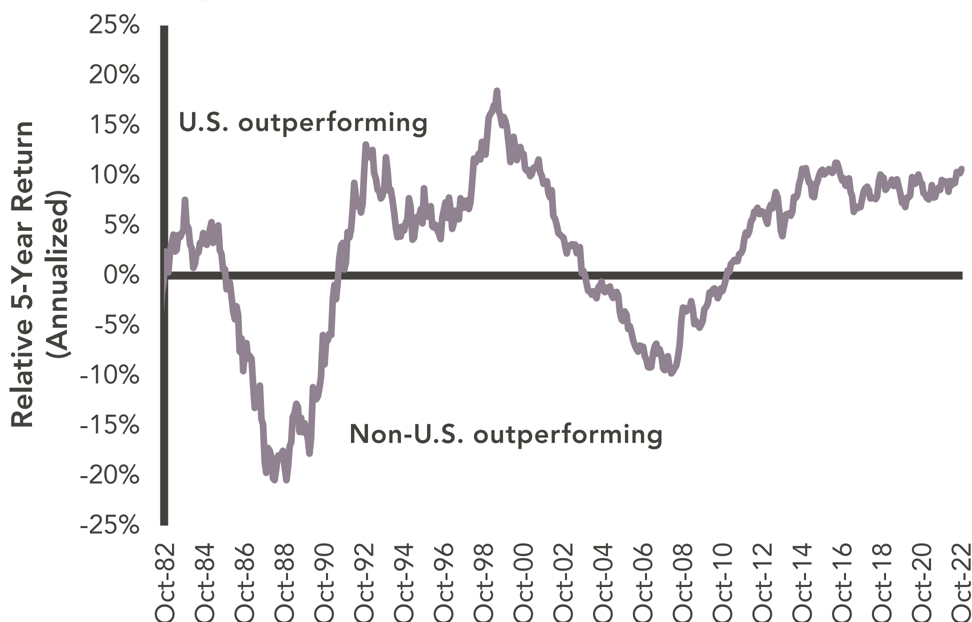
International Equities: Waitin' on a Sunny Day

In recent years, international stocks have underperformed their domestic counterparts by a significant margin. Specifically, the MSCI ACWI ex-US index has compounded annual returns at just 3.3% over the last decade through the end of October, compared to an annualized return of 12.8% for the S&P 500 index. As shown in Exhibit 1 below, this current stretch marks the longest period of relative outperformance on a trailing 5-year basis for either index since the early 2000s.

Evan Frazier, CFA, CAIA
Senior Research Analyst

Julia Sheehan
Research Associate

Exhibit 1: Over the last decade, domestic equity indices have outperformed their international counterparts on a rolling five-year basis

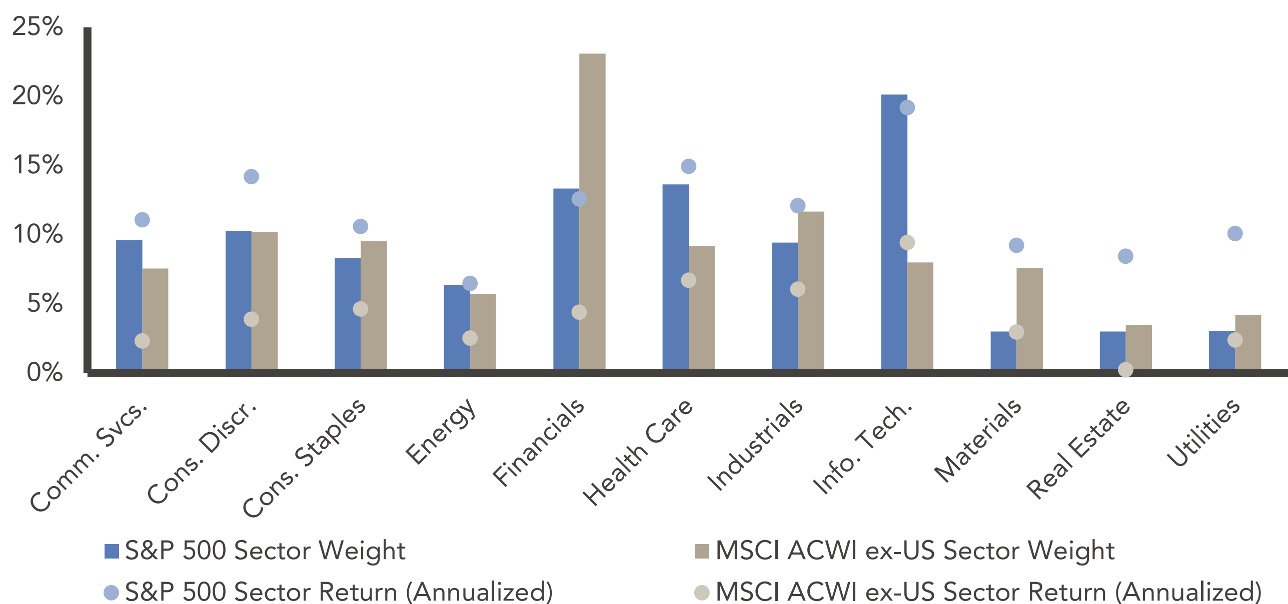


Source: Bloomberg as of October 31, 2022. S&P 500 index represents U.S. equity market and MSCI World ex-USA index represents non-U.S. equity market (MSCI ACWI ex US index launched January 1, 2001).

There are a host of factors that have contributed to this pattern of performance, including differences in composition between U.S. and international equity indices. Though sentiment has shifted in 2022, recent years have seen technology-oriented assets significantly outperform the broad market. To that point, the S&P 500 index has averaged a roughly 20% weight to the Information Technology sector over the last decade, compared to just 8% for the MSCI ACWI ex-US index. With global technology stocks[1] up 16.3% on an annualized basis over the last 10 years, this allocation differential has led to robust relative performance for domestic benchmarks. Stock selection effects within the technology space have also contributed to the outperformance of U.S. equity indices, particularly within the large- and mega-cap spaces. Led by the "FAAMG" companies (Facebook, Apple, Amazon, Microsoft, and Google), the IT sector of the S&P 500 index has returned 19.2% on an annualized basis over the last 10 years, well in excess of the 9.4% annualized return for the technology sleeve of the MSCI ACWI ex-US index over the same time period.[2]

Sector allocations and stock selection outside of the IT sector have also weighed on international developed and emerging market indices. Equity benchmarks outside of the U.S. are more heavily weighted toward more value-oriented sectors that have lagged the broader market over the last decade amid a period of historically low interest rates and fiscal policy stimulus. In the last 10 years, the Financials, Materials, and Industrials sectors, on average, made up a combined 42% of the MSCI ACWI ex-US index, as opposed to 26% in the S&P 500. Stock selection within these sectors has also detracted from relative performance for non-U.S. equities as seen in Exhibit 2, which highlights both the average weights and annualized performance for each sector within the U.S. and international equity markets over the last 10 years.

Exhibit 2: U.S. equity benchmarks have exhibited stronger allocation and selection effects in the last decade relative to their non-U.S. peers



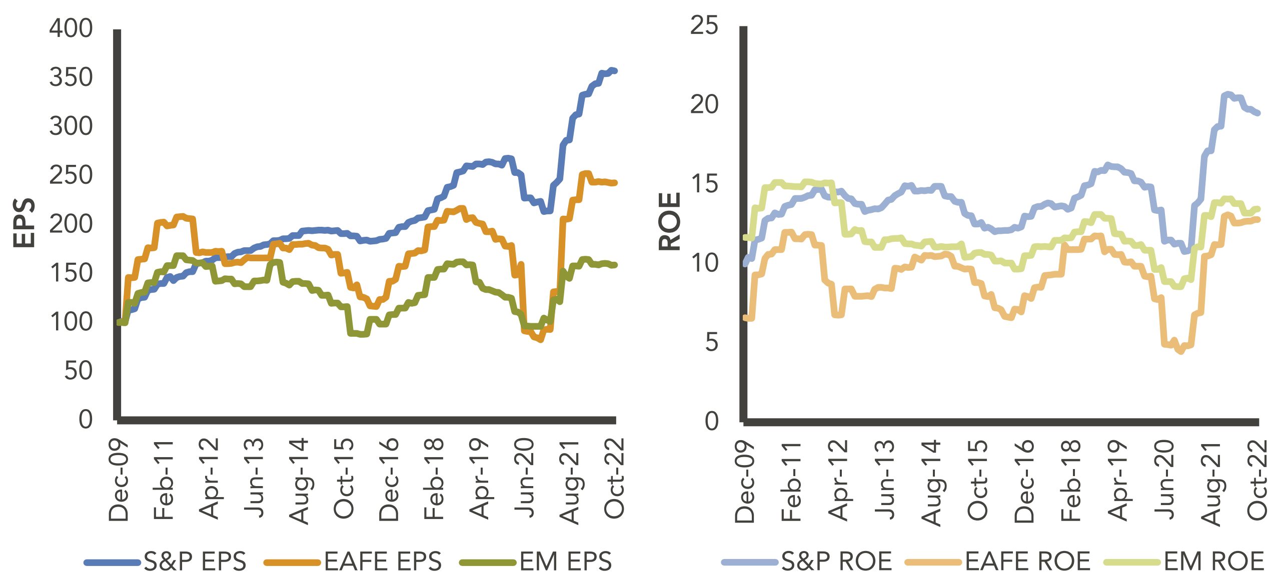
Source: eVestment as of September 30, 2022

The positive stock selection effects detailed above are a result of stronger fundamentals for U.S.-based companies. Earnings, revenue, and profitability metrics have been stronger for domestic businesses than their international counterparts in recent years and, as a result, have been a key driver of performance

[1] Information Technology sector within the MSCI ACWI Index
[2] Source: FactSet

dispersion between the two groups. As seen in Exhibit 3, since the beginning of 2010, companies in the S&P 500 index have grown earnings at a faster rate than both the MSCI EAFE and EM indices — 19.8% per year on average vs. 11.0% and 4.5%, respectively. Similarly, profitability measures like return on equity have been consistently higher for domestic companies throughout the last decade, thanks in part to massive fiscal and monetary stimulus in the wake of the Global Financial Crisis that bolstered U.S. consumer and company balance sheets. These trends, along with a robust share buyback environment in the U.S. facilitated by lower corporate tax rates and the availability of cheap financing, have certainly contributed to outperformance of domestic companies in recent years.

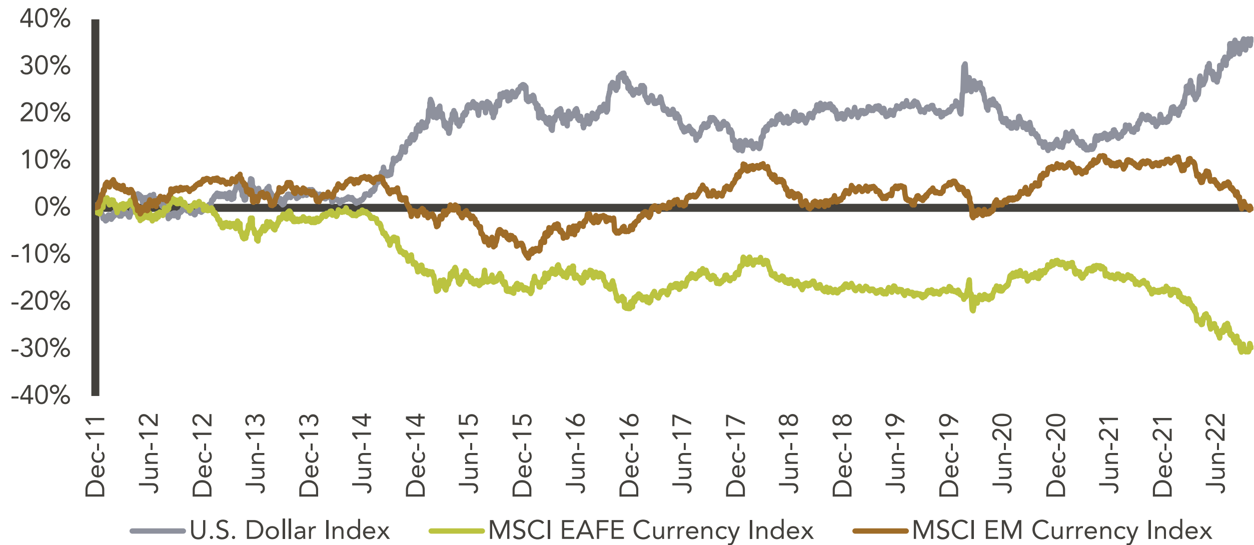
Exhibit 3: EPS growth and ROE has been more attractive on the U.S. side since the Global Financial Crisis



Source: Bloomberg as of October 31, 2022. S&P 500 index represents U.S., MSCI EAFE index represents EAFE, and MSCI EM index represents EM.

Currency movements can also impact the performance of foreign investments for U.S. investors. For instance, a rising dollar will detract from the returns of non-U.S. equities for domestic investors (and vice versa), since the stock's local currency must be converted into dollars. Fluctuations in the foreign exchange market have proved to be yet another headwind for non-U.S. equities in recent time. As seen in Exhibit 4 on the next page, since the end of 2011, the U.S. dollar index has risen by nearly 40%, while MSCI EAFE and EM currency indices are flat-to-significantly negative over the same span. The impact of currency movements has been particularly pronounced over the last several months, as an increasingly hawkish Federal Reserve, as well as the widespread notion that the dollar is a relative safe haven, has helped spur the greenback to multi-decade highs. In contrast, foreign currencies have faced major headwinds of late due to central banks around the world opting for less restrictive monetary policy compared to the Fed. For example, the Japanese yen reached a three-decade low last month, while the pound sank to its lowest recorded level ever in September following the announcement of a since-failed plan to cut taxes and increase spending in the UK. These and other movements in foreign currencies account for roughly half of the total loss notched by broad international equity benchmarks in 2022, many of which are down more than 30% on a year-to-date basis.

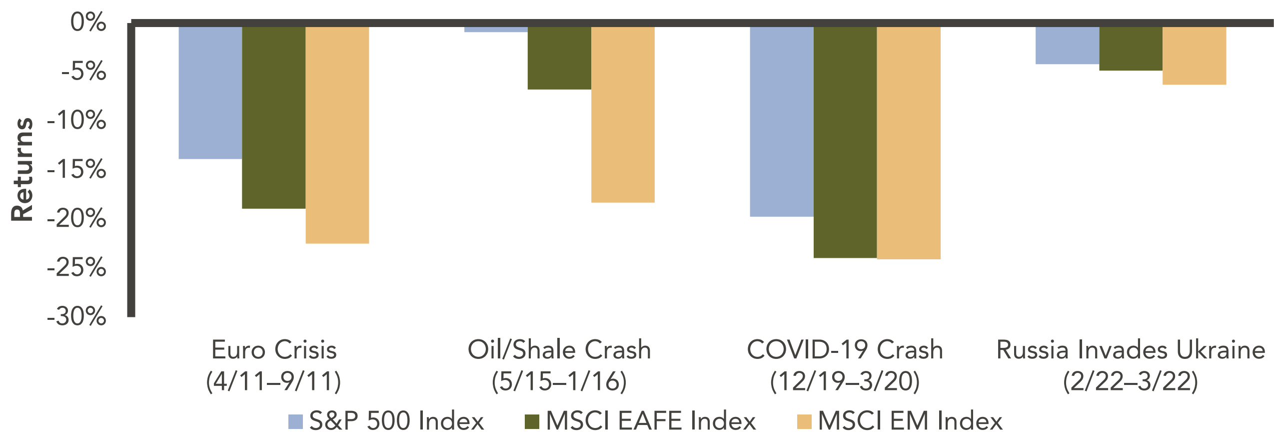
Exhibit 4: Currency movements have detracted from the total return of international stocks in recent years



Source: Bloomberg as of October 31, 2022

Finally, there is the notion that U.S. companies have been more insulated from geopolitical turmoil and exogenous market shocks than their international counterparts over the last decade. Indeed, since the Global Financial Crisis, major domestic equity indices have held up well relative to non-U.S. benchmarks during periods of crisis. In four major financial and geopolitical crises since 2011 (European debt crisis, oil/shale crash, COVID-19 drawdown, and Russian invasion of Ukraine), the S&P 500 index has averaged a drawdown of roughly -9.8%, compared to -13.7% and -17.8% for the MSCI EAFE and EM indices, respectively *(Exhibit 5)*. Most recently, the Russian invasion of Ukraine, combined with escalating tensions in the Asia-Pacific region, has been particularly painful for international developed and emerging market equity indices, while domestic benchmarks have been less directly affected. Even today, European countries like Germany continue to face headwinds due to increased energy costs stemming from the conflict in Ukraine, while China battles a property market collapse and fallout from its restrictive zero-COVID policies. These factors weigh significantly on both the fundamentals and valuations of international equities and are reflected in recent performance of the asset class.

Exhibit 5: U.S. equity benchmarks have held up relatively well during recent periods of crisis



Source: Bloomberg as of October 31, 2022

While the last decade has been challenging for investors in international stocks, it is worth pointing out that non-U.S. equities have provided both solid returns and strong diversification benefits over longer time periods. For instance, since the beginning of 1970, a portfolio with a 70% allocation to U.S. stocks and 30% to non-U.S. stocks has exhibited annualized standard deviation of 14.5%, compared to 15.3% for a portfolio comprised entirely of U.S. stocks. This 70/30 model portfolio also delivered a higher annualized return per unit of risk than the 100% U.S. equity portfolio — 0.74 vs. 0.70 — over the same time period. Moreover, there is reason to believe some of the headwinds plaguing international equity markets may start to abate. For instance, many believe the current trajectory of the dollar is unsustainable, and its strength relative to other currencies could reverse in the future, especially when the Federal Reserve concludes its current rate hiking cycle. The strengthening of non-U.S. currencies vs. the dollar would serve as a tailwind for U.S. investors in international equity markets. Recent share buyback trends may also reverse in the U.S. in the near future, as higher interest rates change the math on debt-financed share repurchases and the new non-deductible excise tax created by the Inflation Reduction Act is imposed on certain corporate buybacks. It is also important to remember that relative performance across different equity asset classes tends to exhibit mean-reverting characteristics over time. Exhibit 6 below highlights this phenomenon by assessing index performance since 1999, underscoring the notion that geographic leadership within global equity markets tends to rotate on a regular basis.

Exhibit 6: U.S. benchmarks have led during the last four calendar years, but more mixed results occur over a longer horizon

	Best performing				Worst performing
1999	66.5%	27.0%	21.3%	21.0%	19.7%
2000	-3.0%	-7.6%	-9.1%	-14.2%	-30.8%
2001	2.5%	-2.6%	-11.9%	-12.5%	-21.4%
2002	-6.2%	-7.8%	-15.9%	-20.5%	-22.1%
2003	61.4%	55.8%	47.3%	38.6%	28.7%
2004	30.8%	25.6%	20.3%	18.3%	10.9%
2005	34.0%	26.2%	13.5%	4.9%	4.6%
2006	32.1%	26.3%	19.3%	18.4%	15.8%
2007	39.4%	11.2%	5.5%	1.5%	-1.6%
2008	-33.8%	-37.0%	-43.4%	-47.0%	-53.3%
2009	78.5%	46.8%	31.8%	27.2%	26.5%
2010	26.9%	22.0%	18.9%	15.1%	7.8%
2011	2.1%	-4.2%	-12.1%	-15.9%	-18.4%
2012	20.0%	18.2%	17.3%	16.4%	16.0%
2013	38.8%	32.4%	29.3%	22.8%	-2.6%
2014	13.7%	4.9%	-2.2%	-4.9%	-5.0%
2015	9.6%	1.4%	-0.8%	-4.4%	-14.9%
2016	21.3%	12.0%	11.2%	2.2%	1.0%
2017	37.3%	33.0%	25.0%	21.8%	14.7%
2018	-4.4%	-11.0%	-13.8%	-14.6%	-17.9%
2019	31.5%	25.5%	25.0%	22.0%	18.4%
2020	20.0%	18.4%	18.3%	12.3%	7.8%
2021	28.7%	14.8%	11.3%	10.1%	-2.5%

U.S. Large-Cap	S&P 500
U.S. Small-Cap	Russell 2000
Non-U.S. Large Cap	MSCI EAFE
Non-U.S. Small-Cap	MSCI EAFE SC
Emerging Markets	MSCI EM

Source: Bloomberg as of October 31, 2022

Current valuations also represent an opportunity for investors within the international equity space, as forward price-to-earnings ratios for both the MSCI EAFE and EAFE Small Cap indices are within the cheapest quartile of historical levels for each benchmark dating back to the early 2000s. The MSCI EM index currently trades at roughly 10X forward earnings, near the 30th percentile for the benchmark over the same time period. In addition to being discounted relative to their own histories, non-U.S. stocks are also cheap relative to U.S. indices. As shown in Exhibit 7, the S&P 500 index is currently more expensive than each of the international equity benchmarks across several popular valuation metrics.

Exhibit 7: Non-U.S. equities appear cheap relative to their own histories, as well as to domestic stocks

	S&P 500		MSCI EAFE		MSCI EM		MSCI EAFE SC	
VALUATION METRICS	CURRENT	HIST. PERCENTILE (%)	CURRENT	HIST. PERCENTILE (%)	CURRENT	HIST. PERCENTILE (%)	CURRENT	HIST. PERCENTILE (%)
P/E	18.2	53	10.6	4	8.6	6	9.0	3
Forward P/E	16.3	74	11.4	25	10.1	32	11.5	20
P/B	3.9	86	1.5	15	1.3	4	1.1	11
P/S	2.3	89	1.1	62	1.0	17	0.7	55
P/CF	13.0	63	6.0	10	7.0	28	8.3	35
EV/EBITDA	13.0	77	7.2	4	7.1	28	7.9	3
Average		**73**		**20**		**19**		**21**

Source: Bloomberg as of October 31, 2022. P/E is adjusted for negative earnings; percentiles are based on data going back to 1999, except for FP/E which goes back to 2005.

In spite of headwinds faced by non-U.S. equities of late, it is important for investors to remain disciplined and avoid recency bias when making portfolio allocation decisions. Equity market leadership tends to be cyclical in nature, whether along style, size, or geographic lines, and even factors that have displayed the most prolonged periods of outperformance tend to mean revert in the long run. In the case of international stocks, data suggest this mean reversion could occur in the coming years, which, combined with the diversification benefits offered by this asset class, should give investors reasons to maintain allocations to the space.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO BALTIMORE MILWAUKEE PHILADELPHIA ST. LOUIS

PHONE 312-527-5500
WEB marquetteassociates.com

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