Opportunities Abroad: Exploring International Equities

April 2024

DeMarche

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Point of Discussion

Abstract

In any portfolio, it is important to determine the allocation between international and domestic equities; however, it may not be as simple as it seems. There are different factors that determine performance for domestic and international markets. This paper will uncover some of those factors and seek to provide insights into how different markets around the world interact. While it is important to have a diversified portfolio, it's also important to have an understanding for how each component will perform in different market environments.

Over time, globalization has linked economies and countries to one another, which has resulted in the interconnection of market returns throughout the world. But, there are still differentiators between U.S. and non-U.S. market returns and valuations in both developed and emerging markets. These factors include, sentiment, central bank policy, currency management, and geopolitics. For context, developed markets are comprised primarily of developed Eurozone countries, the U.K., and Japan, while Emerging Markets have large allocations to China, India, and Taiwan. This paper analyzes these different factors to shed light on the potential performance drivers of non-U.S. markets.

Correlations and Valuations

In the first table, correlation statistics between the indices are relatively high over the last 27 years. However, the differences that do exist in the correlations can be attributed to different macroeconomic factors, as previously mentioned. DeMarche believes strongly in the fact that correlations change over time depending on the current and expected market environment, and although these reflect the last 27 years of data, they are not necessarily a predictor of future market dynamics.

In order to discover valuation differentials between different markets, we compiled historical Price-Earnings (P/E) ratios for broad indices throughout the world. For background, a P/E ratio is a comparison of a company's stock price to their earnings per share (EPS). This provides insight into how expensive a stock is relative to its underlying earnings. The higher the number is, for example, the more "expensive" a company trades. When comparing international small cap versus the broad based international index, we found that the smaller cap indices were undervalued relative to their long term history.

Table 1: Quarterly Performance Analysis; From December 31st, 1996 to December 31st 2023

	MSCI EAFE	MSCI Emerging Markets	MSCI EAFE Small Cap	MSCI EM Small Cap	S&P 500	MSCI AC World Ex-US
MSCI EAFE	1.000					
MSCI Emerging Markets	0.846	1.000				
MSCI EAFE Small Cap	0.921	0.835	1.000			
MSCI EM Small Cap	0.822	0.949	0.856	1.000		
S&P 500	0.880	0.745	0.770	0.714	1.000	
MSCI AC World Ex-US	0.993	0.896	0.923	0.865	0.878	1.000

*Data as of 12/31/2023; Source: Morningstar

This pattern persisted across the U.S. market as well, but not the emerging markets. The reason for the break in this pattern is due to the MSCI Emerging Market Small Cap Index holding substantially less China exposure than the broad-based index. These historical trailing P/E ratios versus their current valuations are found below in Table 2.

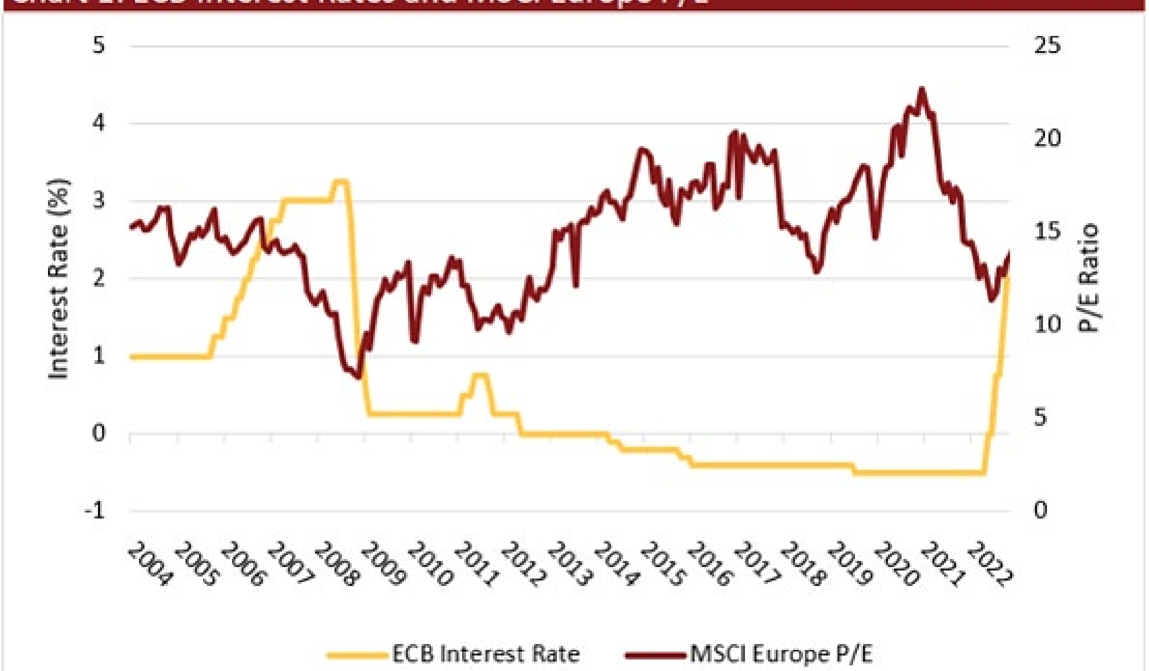
Table 2: P/E Ratios Over the Years (2013-2023)						
	MSCI EAFE	MSCI EAFE Small Cap	MSCI Emerging Markets	MSCI EM Small Cap	Russell 1000	Russell 2000
10-Year Historical Average P/E	15.87	15.04	13.13	12.98	20.53	17.85
Current P/E	13.79	13.73	13.07	14.27	22.93	14.37

*Data as of 12/31/2023; Source: Morningstar

Small-Cap Valuations

So what makes the international and U.S. small caps undervalued to their history? While consumer optimism always plays a role in shorter-term price increases, central bank policies can have a large effect on individual businesses and their profitability. It is a well-known fact that small-cap stocks are more volatile than their large counter parts. Furthermore, small-cap stocks can feel the pressure of rising interest rates more acutely as smaller companies tend to take on shorter-term financing and floating rate debt, leading a small company's balance sheet to be hit hard when rates rise, causing prices and earnings to fall. This idea is illustrated in Chart 1, as there appears to be some inverse relationship between interest rates and P/E ratios, even between Euro Area interest rates and the European index. While central bank policy yields a stronger effect on smaller-cap stocks, policies can affect the broader indices. Similar to personal consumers, higher interest rates increase borrowing costs, making it less likely for companies to make capital expenditures, and therefore generate less growth. This is a significant factor as to why Japan's market has been booming over the last year. While other developed countries have been hampered by higher interest rates, Japan diverged from their peers, maintaining their favorably low policy rate.

Chart 1: ECB Interest Rates and MSCI Europe P/E



*Data as of 12/31/2023; Source: Morningstar

Developed International and Emerging Market Valuations

While Emerging Markets and International large-cap stocks are also undervalued to their historical averages, the conclusion as to why is not as simple as balance sheet structure. To first call out Emerging Markets, valuations can vary greatly based on geopolitical issues, which remain a higher risk in emerging market countries. For example, tensions between China and Taiwan as well as heightened tensions in the Middle East keep sentiment lower. It is of course notable that China's stock market has been in free fall over the last handful of months, depressing emerging market valuations as China makes up approximately 25% of the index. International markets have experienced their share of geopolitical issues as well. A notable geopolitical event that began to drive International valuations versus the US was the outbreak of COVID. As seen in Charts 2 and 3, around 2020 was when P/E differentials really began to diverge. While this originally was attributed to European countries having stricter shutdown policies, supply chain issues, and the more recent, Russo-Ukrainian War have continued to provide a more challenging environment for international companies.

Chart 2: P/E Comparison - MSCI EAFE vs. S&P 500

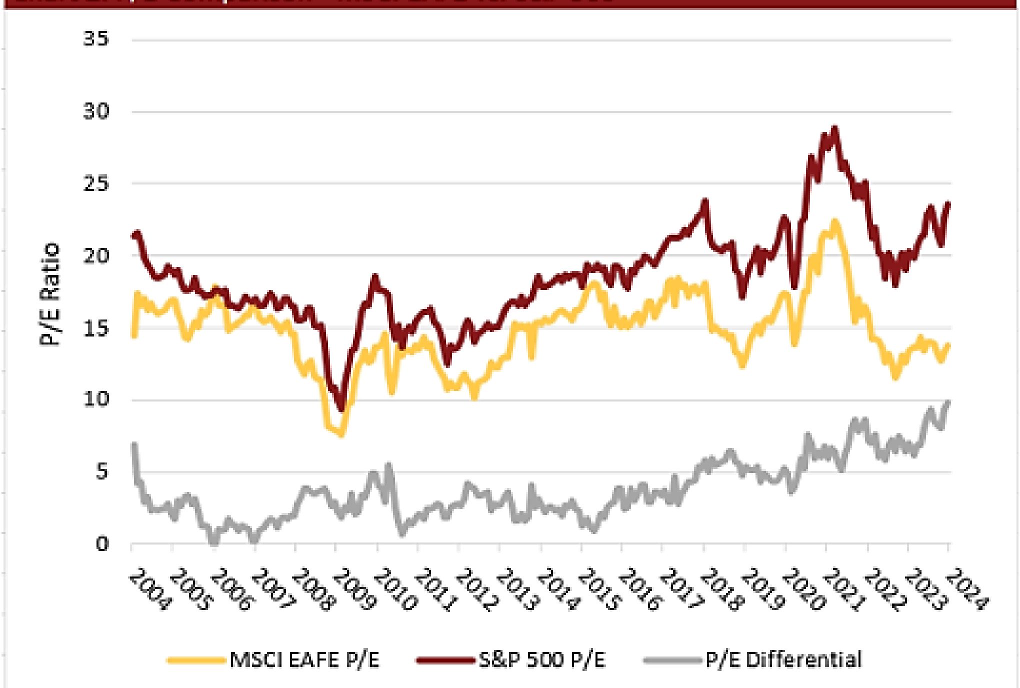
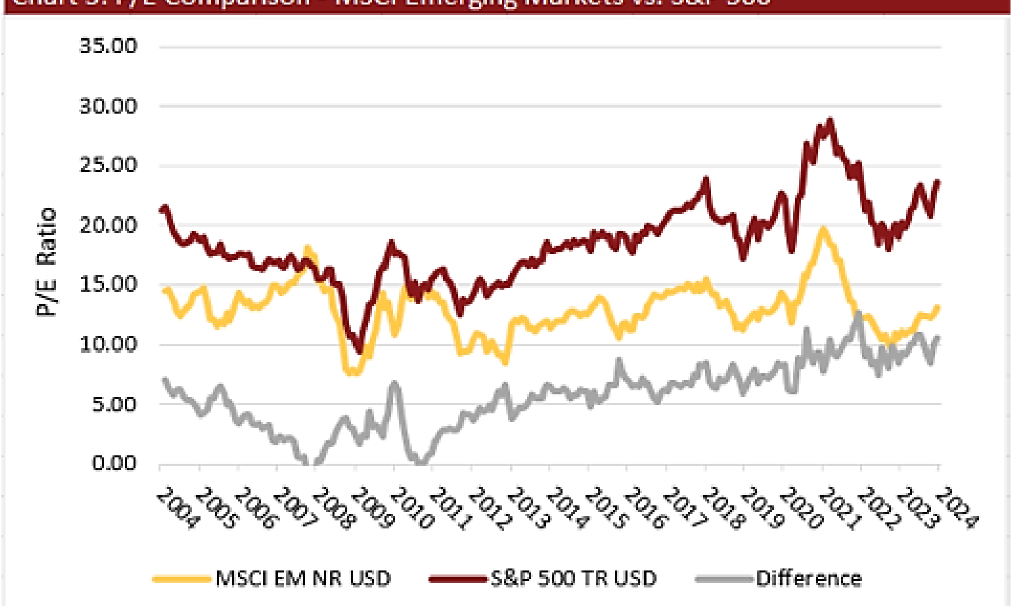


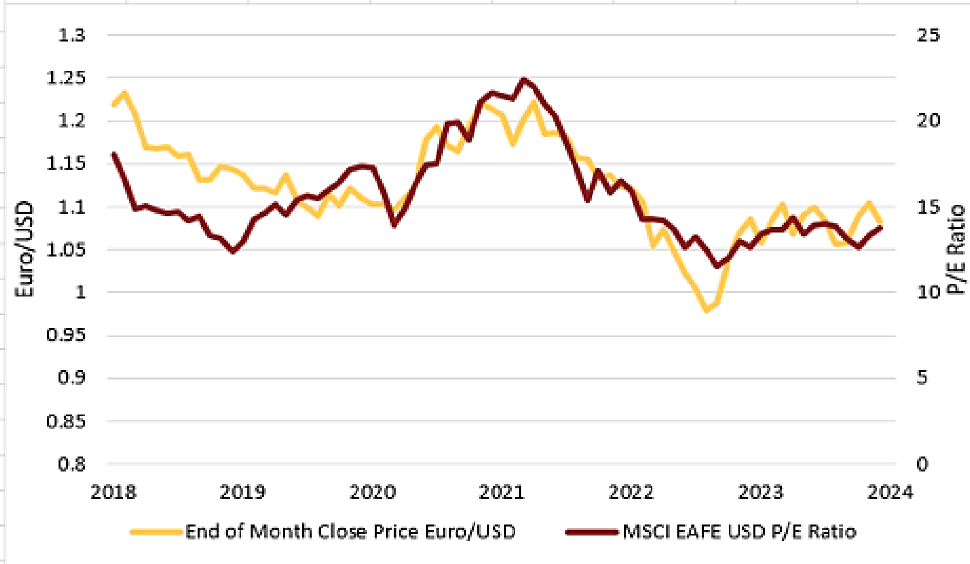
Chart 3: P/E Comparison - MSCI Emerging Markets vs. S&P 500



*Data as of 12/31/2023; Source: Morningstar

Another driving force between prices and returns of major international and emerging market indices are currency

Chart 4: Euro/USD Currency Flucations vs. the MSCI EAFE USD P/E Ratios

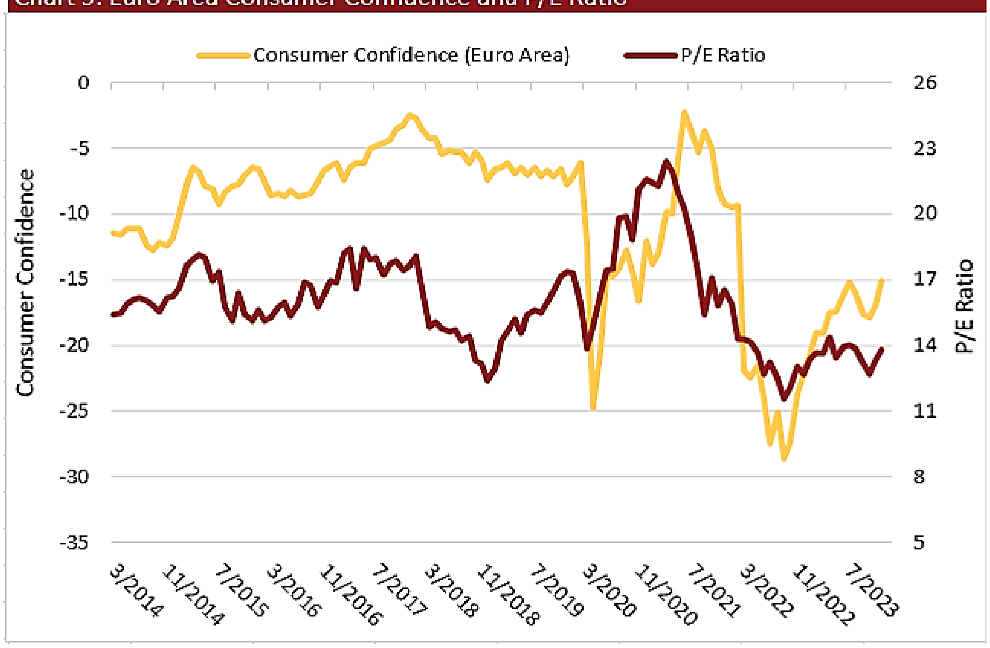


*Data as of 12/31/2023; Source: Morningstar and Investing.com

fluctuations. In Chart 4, when strictly looking at monthly currency closing prices there are remarkable similarities between P/E ratios and currency fluctuations. A large benefit behind currency depreciation against the USD, either from a foreign country's increase in exchange rate or a decline in the value of the USD would make the foreign country's exports more attractive and act as a tailwind in boosting their country's sales. Furthermore, when looking at it from the perspective of the U.S., a weakening dollar will act as a tailwind for international stock returns, while a strengthening dollar will act as a headwind. Notably, the USD is relatively weak currently, meaning international and emerging market economies could stand to benefit from P/E multiple expansion, should the trend hold and the dollar strengthen.

The final factor to explore that impacts valuations and P/E ratios in the short term would be consumer sentiment. While this can be closer to a coincident indicator for how the market moves, consumer sentiment has historically moved in a similar direction to the MSCI EAFE Index. While this in itself will not impact the earnings of the P/E

Chart 5: Euro Area Consumer Confidence and P/E Ratio



*Data as of 12/31/2023; Source: Morningstar and Trading Economics

valuations, it will impact the overall price levels. Take, for example, a bullish market sentiment, this will move investors out of money market funds and into the equity market, boosting the overall price level, and therefore the "price" in P/E ratios. As seen in Chart 5, Euro Area consumer confidence and The MSCI EAFE P/E ratio tend to move in line with one another, with consumer confidence tending to be a bit more volatile. So, while sentiment will not be a headwind nor tailwind for a country's valuations, it can be a good indicator to get a sense of how P/E may have been affected given the general trend associated with the growth or decline in reported confidence.

Conclusion

There are many different leading indicators as well as coincident indicators to help determine the direction valuations. While macro-economic factors play a large role in broad-base index returns, composition of indices also leads to valuation differentials. In emerging markets, China's presence in the MSCI Emerging Markets, while declining, remains significant at approximately 25%, while China's presence in the MSCI Emerging Market Small Cap is substantially lower at 6.8% (with Taiwan and India making up the largest weights). This means China's price levels and economic drivers have the ability to yank valuations around compared to smaller-weighted emerging market countries like Mexico. The same problem is reflected in the MSCI EAFE Index as the large weights of Japan and the U.K. mean their country specific macro-factors will heavily influence the overall valuation of the index. So, while it may be challenging to predict how countries and indices will perform, it is helpful to consider how key factors drive valuations and performance results.

Put Research To Work
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Sources Utilized:

- *Morningstar*
- *Trading Economics*
- *Investing.com*
- *MSCI*