Why international equities now?

March 31, 2023

Federated Hermes

- The strong performance of international equity markets in 2022[1] is not a head fake
- Two main factors could give the international rally legs: a historically anomalous valuation gap and a declining U.S. dollar
- We recommend strategic allocations to developed and emerging markets alike

Amid a challenging 2022, one long-overlooked area of the market mounted a comeback: international equity. International stocks outperformed their U.S. counterparts for the first time since 2017—and for just the third time since the global financial crisis almost 14 years ago.

There is a long history of international equities outperforming their U.S. counterparts for significant periods of time. After a 20-year U.S. bull market, we see signs the recent rally in international equities may continue. Two main factors support our view: valuations and the U.S. dollar's decreasing global dominance.

Peak dollar

Signs that the U.S. dollar's international dominance is decreasing:

- Saudi Arabia "open" to trading oil in currencies other than the U.S. dollar (January 2023)
- France and China recently completed the first yuan-settled LNG trade between China's national oil company and France's TotalEnergies through the Shanghai Petroleum and Natural Gas Exchange (March 2023)
- Brazil, Russia, India, China and South Africa continue de-dollarization efforts

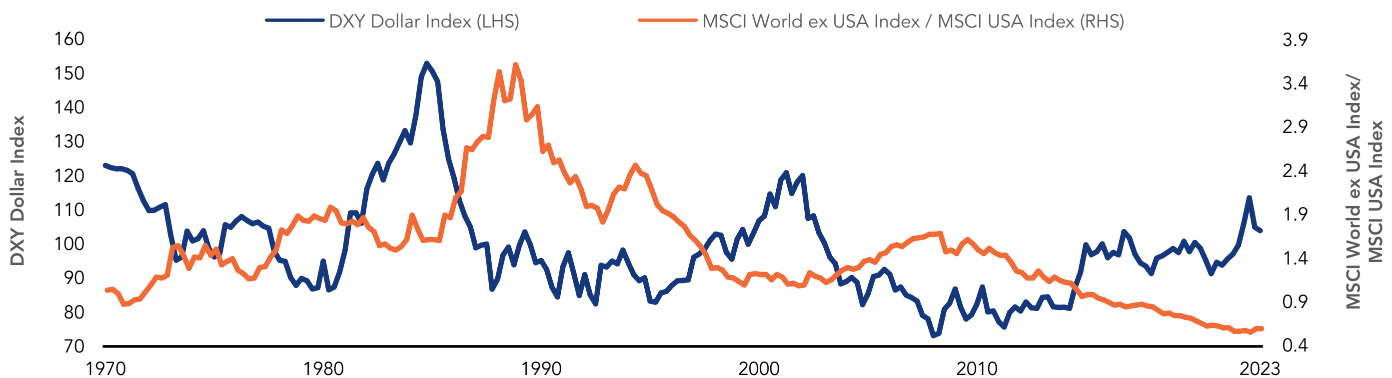
Consider leveraging the U.S. dollar's current relative strength to grow your international exposure.

A falling dollar benefits non-dollar denominated assets, which rise in relative value as the dollar falls. It especially benefits emerging market issuers, which service part of their debt in U.S. dollars.

We believe the U.S. dollar peaked in September 2022 and is now firmly in decline. For perspective, by the end of February, the trade-weighted dollar had fallen approximately 40% at an annual rate since the October IMF meeting. Most of the factors that propelled the dollar higher—including demand for safe-haven assets and Fed tightening—are now either stalling or in reverse. For example, the interest rate differential between the U.S. and the rest of the world is shrinking. The Federal Reserve is at the late stages of its rate hike cycle, while the ECB and BoE have farther to go.

We believe that while periods of dollar gains will occur during flights to quality, for example in March this year, signs that international demand for the dollar is dampening (see sidebar) indicate long-term change.

The dollar is peaking: good for international equities



As of 3/31/23. Sources: FactSet, MSCI.
The above chart is for illustrative purposes only and are not representative of any specific investment.

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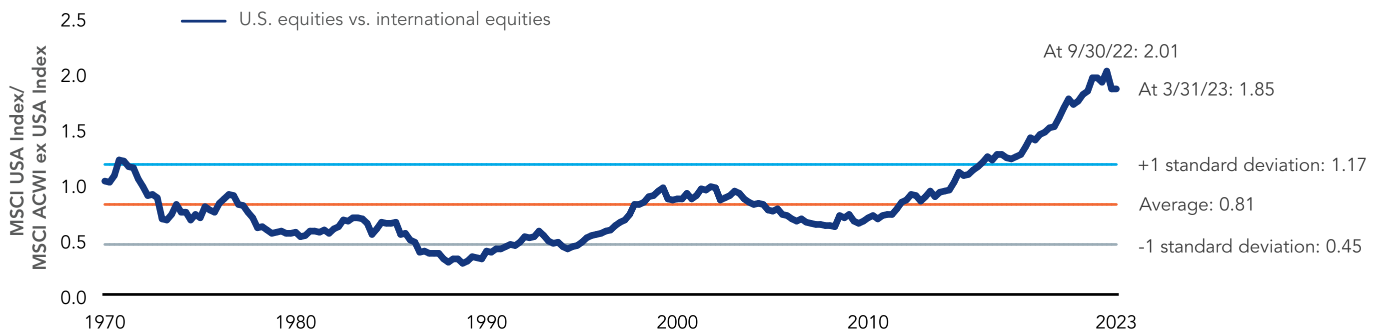
Valuations

We believe elevated valuations, concentration risk and a high likelihood of economic weakness tip the scale toward international markets going forward.

The U.S. market has been a massive outperformer in recent years, creating a vast gap in valuations relative to the rest of the world. The price differential between U.S. and global equities today is high above the historical norm—dwarfing the gap that existed during the dot-com bubble of the early 2000s and the Nifty 50 bubble of the late 1960s and early 1970s.

U.S. is historically expensive relative to the rest of the world

Outsized U.S. outperformance has led to an historically high price differential, as shown below. P/E ratios and P/B ratios indicate there may be more room for valuation expansion overseas.



As of 3/31/23. Sources: FactSet, MSCI.
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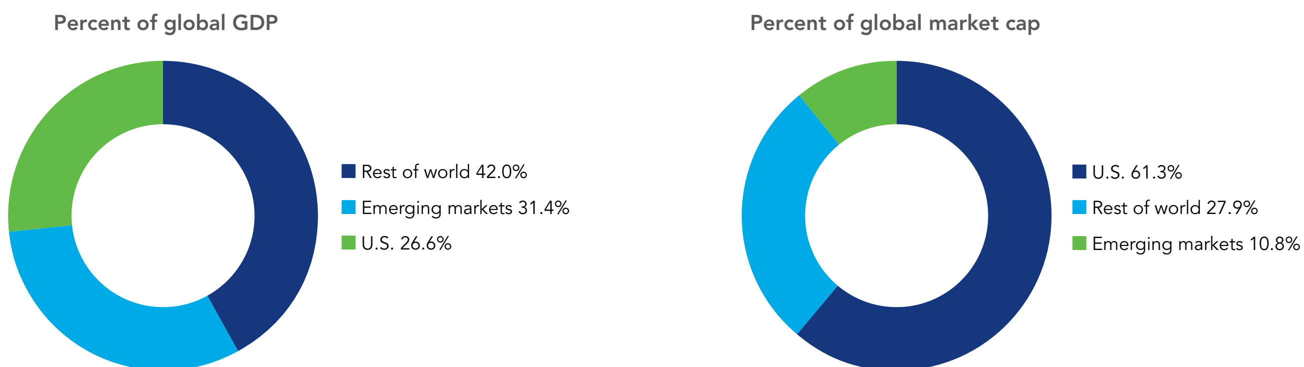
Another way to look at valuations is to compare a given region's share of global GDP to its share of global market cap. Here again, we see a clear indication that the U.S. has grown overvalued.

The U.S. produces 26.6% of the world's GDP, but accounts for an enormous 61.3% share of global market cap. Moreover, that differential has widened considerably over the past two decades: the U.S. share of global GDP has increased just 1.3% from 2000, while its share of global market cap has increased 13.9% over that same time period.

The U.S. market cap is high relative to GDP



Emerging Markets are defined as the 24 markets used by MSCI – in the event of GDP some of those emerging markets did not have data available.
Sources: World Bank and MSCI. Data as of April 22, 2022. Data in charts represent December 31, 2021.

The world's top 10 largest companies by market capitalization

1980	1990	2000	2010	2020
IBM	NTT	**Microsoft**	**Exxon Mobil**	**Apple**
AT&T	Bank of Tokyo-Mitsubishi	**General Electric**	Petrochina	**Microsoft**
Exxon	Industrial Bank of Japan	NTT DoCoMo	**Apple**	**Amazon**
Standard oil	Sumitomo Mitsui Banking	**Cisco Systems**	BHP Billiton	**Alphabet**
Schlumberger	Toyota Motors	**Walmart**	**Microsoft**	**Facebook**
Shell	Fuji Bank	**Intel**	ICBC	**Tencent**
Mobil	Dai-Ichi Kangyo Bank	NTT	Petrobras	**Tesla**
Atlantic Richfield	**IBM**	**Exxon Mobil**	China Construction Bank	Alibaba
General Electric	UFJ Bank	**Lucent Technologies**	Royal Dutch Shell	TSMC
Eastman Kodak	**Exxon**	Deutsche Telekom	Nestlé	**Berkshire Hathaway**

United States Japan Germany China Australia Brazil Netherlands Switzerland Taiwan

As of 12/31 of the shown year. Sources: Gavekal Research and Financial Times.

U.S. companies are massively overrepresented on the global stage, comprising eight out of the top 10 firms worldwide by market cap. Even the top of the market has grown increasingly concentrated, led by the FAANGM stocks. This increased market concentration favors diversification outside the U.S.

With the U.S. now facing the sharpest decline in broad money supply growth on record due to an aggressive monetary policy cycle, this will mean peak U.S. earnings and a high likelihood that the U.S. will have a rougher landing than the rest of the world.

Developed or emerging: Why not both?

All of the themes we've touched on so far—peak dollar, elevated U.S. valuations and U.S. market concentration—bode well for developed and emerging markets alike. Of course, when it comes to international equity, developed markets have traditionally been top of mind for investors. These stocks are considered less volatile than their emerging market counterparts while still providing diversification and upside. While valuations in this space are less compelling relative to emerging markets, we do believe that pockets of opportunity still exist.

In particular, we believe incrementally positive economic data in the Eurozone support a more optimistic outlook. Markets are pricing in a recession sometime this year, but we have below-consensus expectations for the severity of this downturn. Optimism has risen across all sectors except construction, with inflation expectations among consumers and companies both sharply down. China's reopening will likely aid export-driven economies such as Germany and tourism-dependent economies such as Greece, Italy and Spain. In Japan, we remain neutral on equity markets as the Bank of Japan remains committed to maintaining its easing policy amid demand constraints. The U.K. remains a relative weak spot as business investment has been lagging due to lingering uncertainty caused by the 2016 Brexit referendum.

But we think emerging markets deserve special consideration. There's nowhere better than emerging markets when it comes to finding grassroots-level opportunities to invest in innovation. More patent applications originated in China in 2021 (1.6 million) than the rest of the developed world combined, including the U.S.[2] Additionally, relative valuations are attractive after emerging market assets gave back some of their recent gains in February on fears the Fed would stay tighter for longer and tempered expectations for Chinese stimulus.

We also believe the majority of potential economic outcomes in 2023 disproportionately favor emerging markets. In our view, three main scenarios capture the bulk of probabilities:

- U.S. hard landing
- U.S. soft landing and moderate China recovery
- U.S soft landing and vigorous China recovery

Out of these three scenarios, a U.S. hard landing would be the only net negative for emerging markets. If the Fed can pilot the U.S. economy to a soft landing, a weaker U.S. dollar, potentially super-charged by a stronger-than-expected reopening rebound in China, could potentially lead to a virtuous cycle for emerging markets. Improved growth prospects would attract capital inflows, pushing down real rates and pumping up asset prices, which could draw yet more inflows. In this environment, there would be plenty of room for a rerating of relatively cheap emerging market assets.

It's important to note that the factors that are currently acting as tailwinds for international stocks tend to move in cycles. The pattern in which the dollar rises and falls, valuations go from cheap to expensive and markets grow more and less top-heavy is a cyclical one. In turn, the performance of international versus domestic equity is also cyclical. We contend that what we're seeing today may very well be the beginning of the next up cycle for international stocks.

Past performance is no guarantee of future results.

[1] International equities, represented by the MSCI ACWI ex USA index, outperformed domestic equities, represented by the MSCI USA index, by 3.46% in 2022.

[2] World Intellectual Property Organization (WIPO) (2022). World Intellectual Property Indicators 2022. Geneva. WIPO.

Views are as of 3/31/23 and subject to change based on market conditions and other factors. These views are should not be construed as a recommendation for any specific security or sector.

Definitions

FAANGM: refers to six of the most well known U.S. technology stocks: Facebook Apple, Amazon, Netflix, Google and Microsoft

MSCI ACWI ex USA Index: Captures large- and mid-cap representation across 22 of 23 developed markets countries (excluding the U.S.) and 27 emerging markets countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.

MSCI Emerging Markets Index: Captures large- and mid-cap representation across 24 Emerging Markets (EM) countries. With 832 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI USA Index: Measures the performance of the large and mid cap segments of the US market. With 626 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US.

MSCI World ex USA Index: Captures large- and mid-cap representation across 22 of 23 Developed Markets countries, excluding the United States. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

U.S. Dollar Index (DXY Dollar Index): Indicates the general international value of the U.S. Dollar by averaging the exchange rates between the U.S. Dollar and six major world currencies.

Indexes are unmanaged and cannot be invested in directly.

A word about risk

International investing involves special risks including currency risk, increased volatility, political risks and differences in auditing and other financial standards. Prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

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