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Why International Now

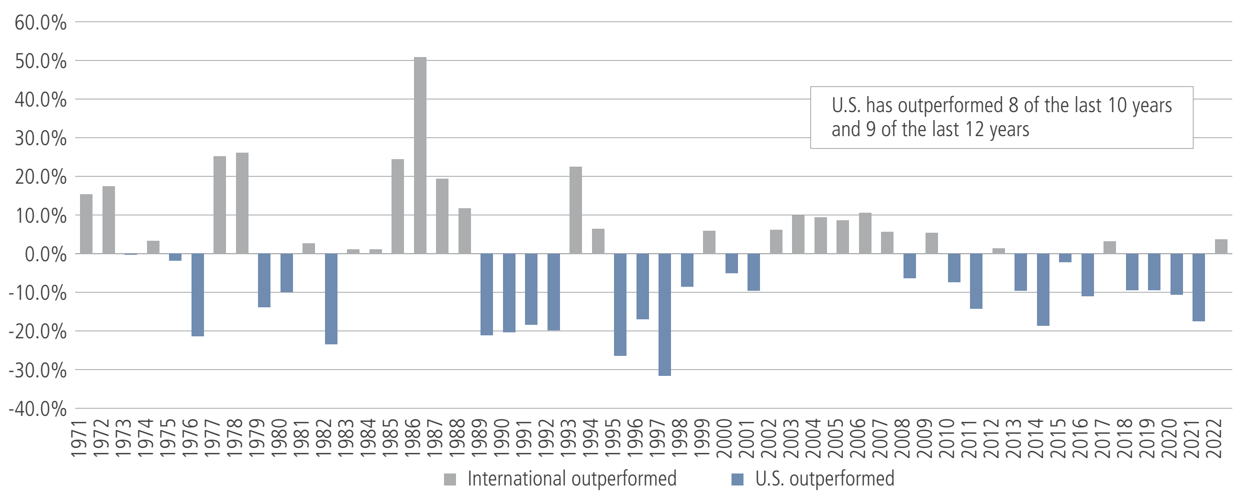
The traditional home market bias of U.S. investors has served them particularly well in the last decade with substantial outperformance over international markets. However, no single country market has ever been the top-performing market globally in consecutive decades since the Second World War. In fact, prior examples of spectacular returns in each decade are often followed by much weaker returns in the following decade. Some examples include Japan's 253% return in the 1980s, followed by a -26% return in the 1990s. Or, indeed, a 300% return in the U.S. in the 1990s was followed by a -5% return during the 2000s, clearly not helped by the Global Financial Crisis at the end of the decade.

In the 10 years to December 31, 2002, the S&P 500's 12.5% annualized return has dwarfed the MSCI EAFE's 5.3% annualized return. Recent developments, however, appear to have shifted the landscape in favor of developed international equities for the coming years. The era of low rates and low inflation that helped the growth-dominated U.S. markets appears to be over, ushering in a possible return to the old normal of higher rates and higher inflation. Here are a few of the key reasons why, in our view, diversification should help provide better results for investors in the next decade than in the prior decade:

1) Developed International Equities Outperformed the S&P 500 in 2022

For only the second time in the last decade, the MSCI EAFE Index outperformed the S&P 500 Index (see figure 1 below). This outperformance occurred despite the outbreak of war in Eastern Europe, the resulting energy crisis in the region, inflation spiking to 40-year highs, a fiscal crisis in the U.K., and the U.S. dollar rising by 8%. Looking at historical returns, however, it is perhaps less surprising that International outperformed given that in prior periods when inflation and interest rates have been higher (e.g., the 1980s and 2000s), U.S. equities tend to underperform.

INTERNATIONAL VERSUS U.S. STOCKS: PERFORMANCE DIFFERENCE FOR EACH CALENDAR YEAR (1971 – 2022)



Source: Morningstar as of December 31, 2022.

2) Greater Exposure to Real Economy Sectors Is a Key Advantage for International

The last decade, which has been characterized by low rates and low inflation, has boosted asset-light, long-duration growth stocks where future cash flows discounted at low rates appear very attractive. In our view, the new regime or 'old normal' of higher inflation and higher rates is likely to be a headwind for those companies, but a tailwind for the types of real economy sectors that international markets have far greater exposure to. Figure 2 below shows a comparison of the sector breakdown between the MSCI EAFE Index versus the S&P 500 Index. We think that sectors such as Financials, Industrials and Materials should be better positioned, while IT and Communications Services could remain challenged.

Sector	MSCI EAFE	S&P 500	MSCI EAFE Overweight/Underweight
Communication Services	4.5	7.3	-2.8
Consumer Discretionary	11.1	9.8	1.3
Consumer Staples	10.5	7.2	3.3
Energy	5.0	5.2	-0.2
Financials	18.7	11.7	7.0
Health Care	13.6	15.8	-2.2
Industrials	15.1	8.7	6.4
Information Technology	7.8	25.7	-17.9
Materials	7.8	2.7	5.1
Real Estate	2.6	2.7	-0.1
Utilities	3.5	3.2	0.3

Data as of December 31, 2022.

3) The Three R's (Reinvestment, Reshoring, Reenergizing) Are a Boost for International Firms

The era of austerity in Europe post-financial crisis appears to be over. The joint fiscal response ('NextGenerationEU') to the pandemic—which is aimed at modernizing, digitizing and greening the European economy—committed close to $1tn in loans, grants and subsidies to the countries suffering the most adverse effects from the pandemic. Also, we believe that the war in Ukraine and the energy crisis in the region, together with structural forces such as labor supply bottlenecks and deglobalization, are likely to result in massive public and private investment for securing energy supply, energy transition, infrastructure and defense spending, and reshoring. Major beneficiaries could include Energy, Materials and Industrials (across sub-sectors such as capital goods, machinery, electrical equipment, aerospace & defense), areas where we think that International markets have a preponderance of opportunities, and often at steep discounts to equivalent U.S. peers.

Conclusion

Investors waiting for a rotation into international stocks have been disappointed over the last decade as much anticipated 'catalysts' such as cheaper valuations, economic catch-up potential and a weakening U.S. dollar failed to materialize—aside from brief spells in 2012 and 2017. While short-term drivers of international outperformance such as falling energy prices and the weaker dollar may be volatile, in our view the transition to a new economic regime, characterized by higher inflation and higher rates is a more constructive environment for international markets and prudent diversification could yield better results over the coming years.

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