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INVESTMENT MANAGEMENT

All we are saying is give EAFE a chance

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | 2021

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The U.S. market (MSCI U.S. Index) crushed EAFE again in 2020, gaining 21% versus the MSCI EAFE Index's +8%, even if the fourth quarter (Q4) saw a rare marginal win for EAFE, which rose 16% versus the U.S. gain of 13%. This extended the last decade's rampant outperformance by the U.S., which has delivered 252% since 2010 (13.4% per year), while EAFE only managed 71%, or 5.6% per year.

Valuation has contributed to the U.S. outperformance, as the multiple of next 12 months' earnings has expanded from 13.3x to 23.5x, while EAFE trails on a "mere" 17.5x. That said, the main driver has been sharply better earnings performance, with forward earnings up 73% for the U.S., but actually down 13% for EAFE over the 10-year period.

The stretched U.S. valuation might give EAFE a chance to outperform, but what is really required is for EAFE to "out-earn" the U.S., in contrast to the experience of the 2010s. While we would not be nearly brave enough to make this a definitive forecast, there are some reasons to believe it may be possible. Until the middle of last year, the strengthening dollar had been a relative tailwind for U.S. earnings, as revenues earned outside the U.S. were worth a falling amount of dollars. But if the second half 2020 dollar weakness continues, this process will go into reverse.

"There are reasons to believe it may be possible for EAFE to "out-earn" the U.S."

More broadly, the U.S. may not sustain the faster economic growth it managed over the last decade. The International Monetary Fund forecasts average annual gross domestic product growth of 2.8% for Europe over the next five years, versus 2.4% for the U.S., helped by a steeper recovery in 2021 given the deeper European trough in 2020. If accurate, this would contrast with the 2010-19 period, where the U.S. outgrew Europe, with the U.S. having grown 2.3% while Europe grew 1.7%. In addition, EAFE's sector mix may benefit more from the post-COVID-19 recovery. Using hard cyclicals (industrials, materials and energy) plus financials as a proxy for cyclicality, EAFE is far more exposed to the macro cycle, with 43% of the index in these sectors, versus only 24% in the U.S.

U.S. profits were helped over the last few years by the Trump tax cuts, as well as broader business-friendly policies, not least around anti-trust, in contrast to the more environment, consumer and labour-focused policies in Europe. It is not yet clear how much of a challenge the Biden administration will offer to corporate profits, but it is likely to cleave closer to the European model. More broadly, U.S. governance has been seen as vastly superior to that of the European Union (EU). Given the successful passing of the EU's €750 billion recovery plan supported by jointly issued debt, and the less-than-optimal current functioning of the U.S. polity, it is rather less clear that this advantage remains.

> "Dependence on a few large companies is a potential source of growth for the U.S. market, but also a potential source of vulnerability."

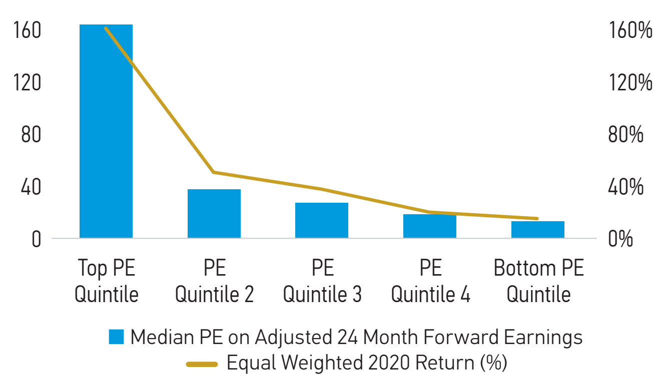
One extra U.S. edge since the Global Financial Crisis has been the far higher technology weight, with information technology now 28% of the MSCI U.S. Index, versus only 9% in the MSCI EAFE Index, even before counting "pseudo-tech" companies in e-commerce, streaming, electric vehicles, and social media, which add another 11% to the U.S. exposure. This has been a major engine of performance, returning 533% over the decade. Indeed, the information technology sector alone delivered 62% of the MSCI U.S. Index's 21% 2020 return, while adding in five pseudo-tech companies (regarded by most people, if not MSCI, as technology companies) takes this share to 96%, meaning that the rest of the U.S. market only delivered 4% of the index performance. Another way of looking at it is that over half of the total MSCI World Index performance in 2020 was delivered by five U.S. companies, and 78% by the top 25 companies in the index, of which only one is listed outside the U.S. This dependence on a few large companies, mainly in the tech area, is a potential source of continued growth for the U.S. market, but also a potential source of vulnerability. Unlike in the 1999 tech bubble, these are real companies generating massive earnings with significant runways for growth, but there are significant regulatory threats across the globe, around anti-trust, publishing rules and privacy. Any significant threat to their earnings power could have a severe effect on overall U.S. market returns.

> "The euphoria in the growthier end of the market can be seen in the MSCI World Index's information technology returns."

The other technology issue is at the more speculative end of the market. 2020 saw a spectacular 480 initial public offerings, amongst which there were 248 SPACs (special purpose acquisition companies), also known as "shell" or "blank cheque" companies. The euphoria in the growthier end of the market can be seen in the MSCI World Index's information technology returns. Splitting the sector into five quintiles by adjusted 24-month forward earnings shows, as in the chart below, the seeming exuberance. The top quintile has a median price-to-earnings ratio (P/E) of 166 times adjusted earnings. This P/E is arguably generous, as using pure GAAP/IFRS numbers, i.e., deducting share-based compensation, takes the majority of this quintile into loss, even two years forward. This elevated valuation was helped by the group's average 2020 return of 163%. Even the relatively sober second quintile has adjusted P/Es from 33 times to 56 times, and saw a return of over 50%. Any deflation here could crimp the U.S. market as well, while EAFE would be far less affected.

DISPLAY 1

2020 Return by Information Technology Valuation Quintiles



Source: FactSet and Morgan Stanley Investment Management

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There are only two ways of losing money in equities: either earnings have to go away or the multiples have to go away. We would argue that the U.S. is at higher risk of both compared to EAFE, given fairly elevated earnings and multiples, even outside technology. The dowdy EAFE markets look less glamourous but less risky, particularly given the potential revival of Europe.

Indeed, a 17.5x multiple for MSCI EAFE certainly looks less frightening than a 24x valuation. Now more than ever, it is time to focus on keeping the lights on, rather than attempting to shoot them out, and a quality-biased portfolio in less fashionable markets does seem a reasonable way of limiting the risk of a plunge into darkness.

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