Mondrian INVESTMENT PARTNERS

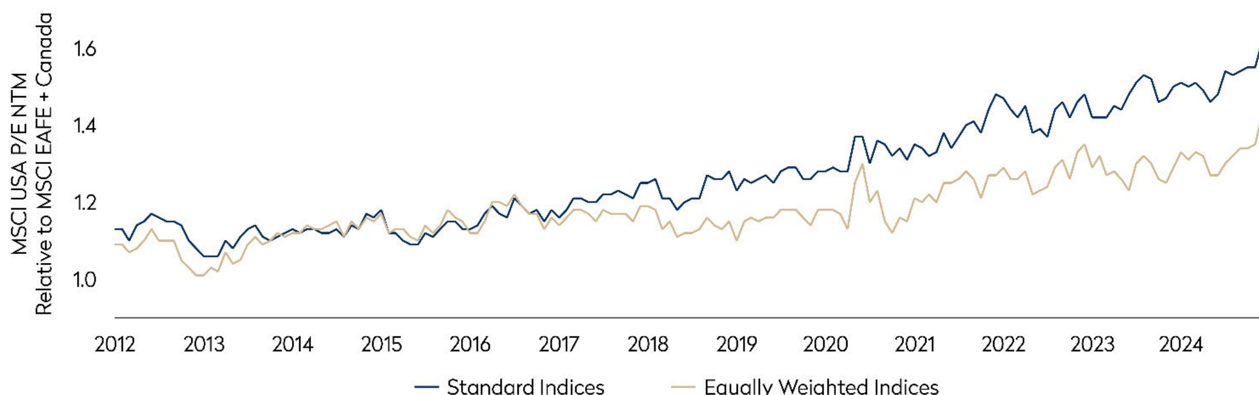
International Equity Investment Outlook

The US stock market has significantly outperformed international markets over the past decade. The robust market, supported by innovative technology giants, a culture of entrepreneurialism and a strong economy, has delivered remarkable returns. Over the past few months, the outperformance of US equities has accelerated. While initial optimism on the US economy faded in the third quarter on weaker jobs data and recession fears, the re-election of President Trump and a turnaround in economic data fueled a surge in both the US market and the US dollar. Increasingly, many investors are questioning the need to allocate capital to non-US equities. This raises a crucial question: are there compelling reasons to diversify internationally? In this paper, we will explore the arguments for investing in markets outside the US.

Valuation is key to long-term outperformance

While valuation doesn't reliably predict short-term returns, it is a powerful tool for long-term investors. Before the COVID-19 pandemic (2015-2019), the US stock market traded at a 20% premium to non-US markets based on forward price-to-earnings ratios. This reflected the dominance of US companies in sectors like communication services and information technology, which commanded higher valuations due to their strong profitability and growth prospects. While it can reasonably be argued that some premium for the US market is justified based on market composition and expected growth, the recent market surge has inflated this premium to almost 60% compared to non-US markets.

MSCI USA vs. MSCI EAFE + Canada P/E NTM

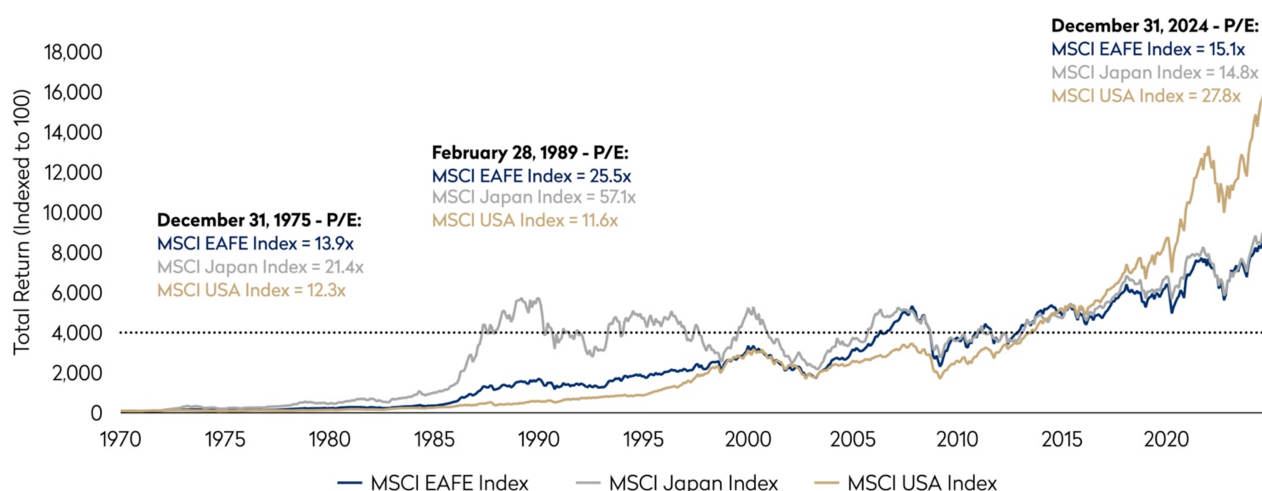


Source: MSCI, FactSet

A striking feature of the current US market is the significant concentration of market capitalization among its largest constituents, often called the "Magnificent Seven." As of the end of Q4 2024, these seven companies account for over 30% of the MSCI USA Index (compared to 8.5% a decade ago), an unusually high level in a competitive market environment. Moreover, due to circular logic, concentration has undoubtedly contributed to the US market's strength. However, as evidenced in the chart above, even when adjusting for the outsized market capitalization of these giants, the US market still trades at a historically high 34% premium to non-US markets. While it is not new for us to write this, as the premium has expanded, ever-higher long-term growth

rates are demanded to justify US equity valuations while the potential return from international equities has also become relatively more attractive. The risks for long-term investors in US equities have increased, creating an unfavorable skew to future outcomes.

We have seen such market exuberance unwind dramatically before. Despite the passage of time, Japan's experience in the early 1990s provides crucial insights into the importance of valuations for long-term investment success. In Japan around 1990, before the economic bubble burst, many investors believed the country's high growth trajectory justified exceptionally high asset valuations. It was commonplace to point to low interest rates, seemingly dormant inflation, and Japan's rising dominance in key sectors like automobiles, semiconductors, and consumer electronics – areas where the US had previously led. While it sounds crazy now, smart commentators were forecasting that Japan was poised to overtake the US and become the world's largest economy. So confident were investors, they felt comfortable applying lower discount rates to Japanese assets compared to other markets.



Source: MSCI, FactSet

The problem, as we framed it in the early 1990s, was that while an investor might be able to provide credible explanations for Japan's premium valuation, in reality the high starting metrics meant that they were likely to be disappointed. For the starting valuation to be justifiable, implausibly high growth would have to be achieved going well out into the future, and while it might have been possible, it is clear today it was not probable. Recognizing the challenges of forecasting long-term supernormal growth, investors often use a lower discount rate, arguing it reflects a lower long-term risk profile. While there is some logic to this approach, a lower discount rate will likely result in a mediocre future return in comparison with long-term historic global equity returns. With the benefit of hindsight, we can see both of these forces at play; arguments supporting the Japanese market's historic valuation sound ludicrous today, but they were widely held at the time.

High starting valuations most likely indicate that future returns have been "brought forward." In Japan's case, this was extreme. As the chart above illustrates, the cumulative total return of the Japanese market only surpassed its 1989 peak in 2017. Investors who bought the Japanese market at the end of the 1980s earned nothing for almost thirty years. The heady growth forecasts built into valuation models never materialized. Conversely, having meaningfully lagged in the period 2000–2010 – a so-called "lost decade" – the US equity market has outperformed over the past decade, and is now trading at much loftier valuation levels.

As history and the chart below demonstrate, markets go in and out of favor. While it is impossible to tell when a market will lag, history will tell us that no single market outperforms in perpetuity.

Annualized 5-Year Returns (USD, Net)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
0.1%	6.5%	15.5%	22.8%	1.9%	3.9%	2.9%	-0.7%	1.1%	17.4%	14.8%	11.8%	13.8%	15.0%	7.7%	11.0%	15.1%	18.1%	8.7%	15.2%	14.0%
-1.1%	4.6%	15.0%	21.6%	1.7%	3.5%	2.5%	-3.6%	-2.0%	13.4%	5.7%	3.9%	7.1%	9.0%	2.7%	7.0%	8.8%	10.1%	1.9%	9.1%	4.9%
-3.6%	3.7%	14.9%	19.0%	1.5%	2.7%	1.8%	-4.7%	-3.7%	12.4%	5.3%	3.6%	6.5%	7.9%	0.5%	5.7%	7.4%	9.5%	1.5%	8.2%	4.7%
-3.7%	0.0%	5.6%	12.4%	-2.7%	0.0%	1.6%	-5.2%	-4.3%	10.9%	5.3%	3.2%	6.3%	7.4%	-0.6%	5.1%	6.8%	8.5%	0.9%	6.5%	4.3%

MSCI EAFE Index · MSCI USA Index · MSCI Europe Index · MSCI Pacific Index

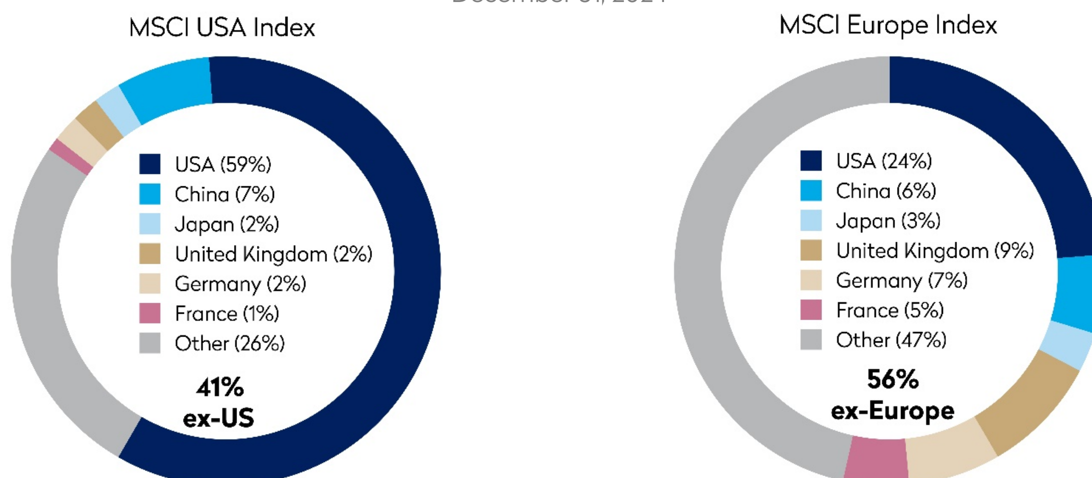
Source: MSCI, FactSet

Differentiated and compelling opportunities in international markets

While investors may laud the virtues of the US economy and business culture, it is crucial to remember that in today's interconnected world, investors can access similar end markets or geographical exposures regardless of where companies are listed. There are plenty of outstanding multinationals domiciled in markets outside of the US: in consumer staples, think of Nestle or Unilever against Procter & Gamble; in autos, Mercedes and Honda against Ford or GM; in healthcare, the likes of Roche and Sanofi against Merck. Despite much of the rhetoric about rising trade barriers and declining globalization, our estimates reveal that US and European corporates currently generate approximately 41% and 56% of their revenues, respectively, from outside their home regions. This proportion has actually grown in the past five years, highlighting the importance of evaluating end market and geographic exposure on a company-by-company basis, rather than simply relying on their country of listing.

Index Breakdown by Source of Revenue

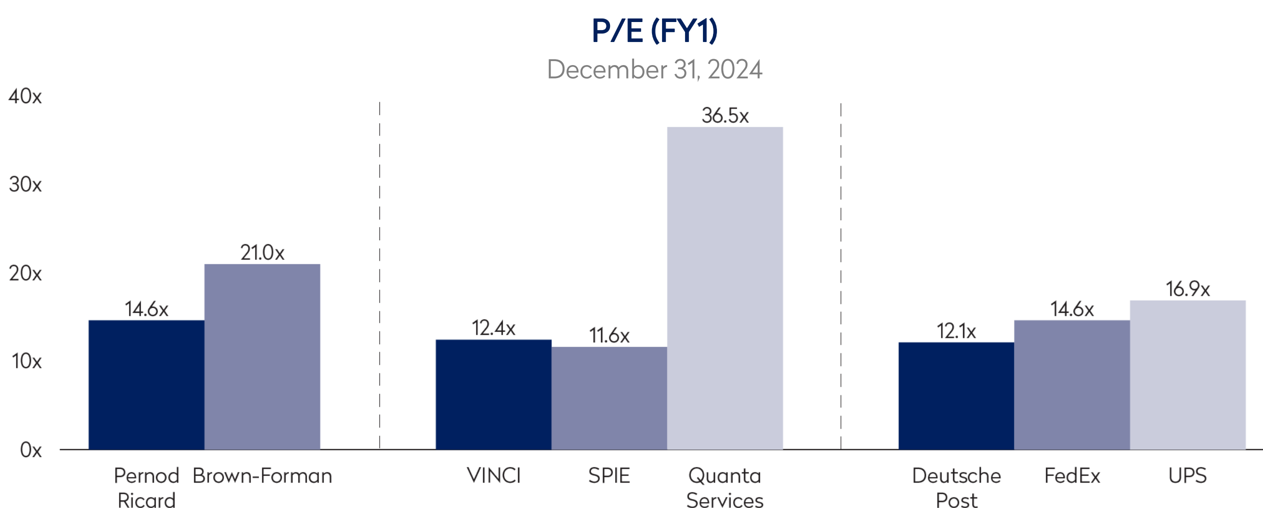
December 31, 2024



Source: MSCI, FactSet

We observe that markets generally assess valuations across regions in a rational way for some sectors, such as large-cap pharmaceuticals, but in other sectors apply a strong and increasingly unjustified premium to US-listed companies, regardless of their fundamentals. The spirits industry provides a compelling example. Brown-Forman (listed in the US) and Pernod Ricard (listed in France) share many fundamental similarities. Both companies boast diversified spirits portfolios (including well-known whiskey brands), exhibit comparable historical sales and earnings growth, and enjoy high margins. Brown-Forman derives a greater proportion of its sales from the US (45% in FY24) compared to Pernod (19% in FY24). While Pernod's forward-looking earnings growth is more attractive, partly driven by its strong competitive position in India and China, the market appears to favor the US economic exposure and listing. This is evident in the disparity in their forward price-to-earnings multiples: Brown-Forman trades at 21x, Pernod Ricard is much cheaper at 15x.

Valuation discrepancies are also apparent in other sectors. For example, despite robust growth outlooks, the energy services companies VINCI (France) and SPIE (France) appear significantly undervalued compared to their US-listed counterpart, Quanta Services. Meanwhile Deutsche Post, despite its German listing, shares key similarities with its US counterparts, FedEx and UPS, particularly in its robust express and freight forwarding divisions. Its geographical diversification also mitigates the threat of Amazon's expanding logistics network, a concern for the more US-centric UPS and FedEx. Despite these strengths, Deutsche Post's forward P/E ratio of 12.1x appears undervalued compared to UPS at 16.9x and FedEx at 14.6x.

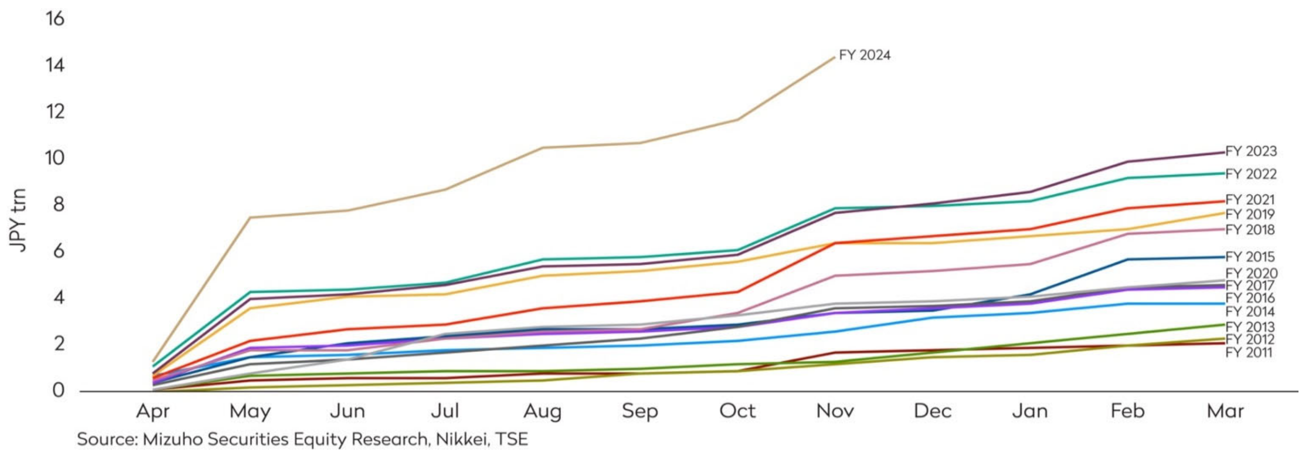


Source: FactSet

Corporate governance improvements unlock significant value opportunities in Japan

One market that we believe demonstrates not only strong value credentials but also significant potential to generate shareholder value is Japan. The country looks to be moving out of a long period of deflation, stagnant nominal growth and negative interest rates. Despite its relatively small representation in the MSCI World Index (approximately 5%), Japan boasts a deep market with nearly 200 listed companies, offering plenty of stock-picking opportunities. The breadth of this opportunity set contrasts positively with the US market, which comprises over 70% of the MSCI World Index yet has only c.590 listed companies. In addition, unlike other developed markets (including the US) which are trying to manage inflationary pressures in their domestic markets, reflation in Japan should support consumer spending and domestic earnings more broadly.

Total Value of Announced Share Buybacks by Fiscal Year



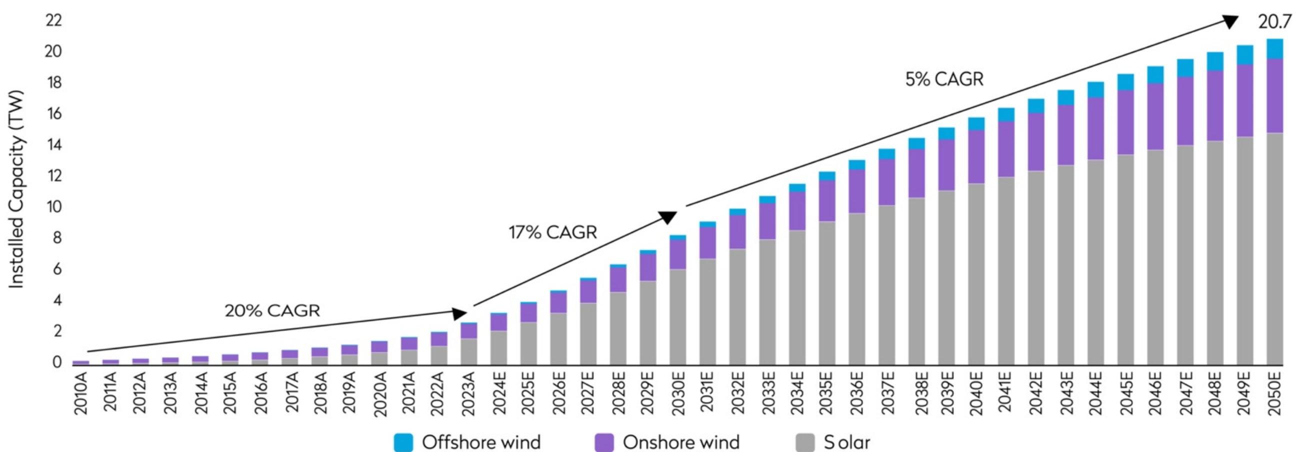
Source: Mizuho Securities Equity Research, Nikkei, TSE

Japan's corporate governance reforms have spurred record-high buyback announcements and increased M&A activity. These trends should continue to support investment flows and returns as the market's valuation discount diminishes. Beyond the attractive headline valuation, we find Japanese equities particularly compelling due to companies' solid balance sheets, which are able to provide downside protection and can support significant upside potential. This contrasts with global trends, where many corporations face rising interest costs. In this environment, the robust financial health of Japanese companies is a particularly valuable asset.

Multi-decade structural growth in infrastructure investments

Renewables capacity is expected to grow strongly. The EU is investing heavily in sustainable infrastructure through the €1 trillion "Green Deal" with a goal of becoming self-sufficient in energy production. Electrification of energy and transport should see electricity demand grow significantly to 2050, requiring substantial upgrades to the energy grid. European regulators are driving investment in grid infrastructure by improving regulatory frameworks and providing additional incentives. This is creating a compelling investment opportunity in European utilities, which currently trade at a discount compared to US utilities.

Growth in Global Renewables Installed Capacity

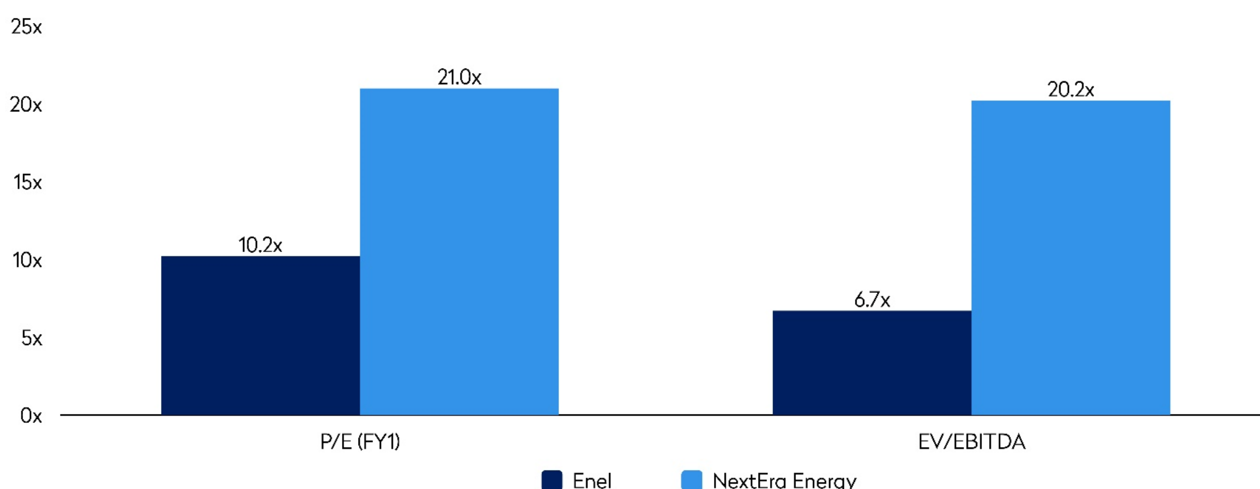


Source: IEA, BNEF, Bernstein analysis and estimates

As an illustration, both Enel, the Italian utility, and NextEra, the US utility, operate with an integrated model, combining regulated activities and renewable energy generation. While Enel boasts the world's largest renewable capacity at approximately 55GW (a material proportion of it in the US), compared to NextEra's 33GW, both derive a significant portion of their earnings from regulated activities. Despite Enel's larger renewable portfolio, greater regional diversification to its earnings streams, and broadly comparable absolute regulated earnings, it trades at less than half the multiple of NextEra, a discrepancy we believe is unjustified. Consequently, we believe Enel presents a compelling opportunity to access growth in global renewables and electricity grids at a significantly more attractive valuation.

Valuation Multiples

December 31, 2024



Source: FactSet

Undervalued international currencies

One reason investors have dismissed non-US markets is the perception of endless dismal returns. While currency movements, corporate earnings and share price movements interact in complicated ways, it is worth noting that the weaker historic returns to international investments are partly attributable to currency weakness rather than mediocre underlying market performance. When measured in local currencies, international returns have lagged the US market, but have been respectable, broadly matching any reasonable long-term market expectations. As we have argued before, currency exchange rates are now trading at extremes against underlying economic realities. We believe historic currency weakness now presents a compelling opportunity for global investors. The table of returns below highlights this dynamic and illustrates how it has accelerated in the past 3 years. Our long-run PPP valuations tell us that the major global currencies are significantly undervalued against the US dollar (see below), particularly the Japanese yen. Given that these levels increasingly stretch economic credulity, we believe that currency represents a potential additional source of future return for investments in non-US markets.

		Total Returns (Annualized, Net)			
		Local Currency	Currency	USD	Upside to Mondrian PPP vs USD[1]
MSCI EAFE Index	3 Years	6.3%	-4.4%	1.6%	c. 30%
	5 Years	7.6%	-2.6%	4.7%	
	10 Years	7.1%	-1.8%	5.2%	
MSCI Europe Index	3 Years	4.0%	-2.7%	1.2%	c. 20%
	5 Years	6.2%	-1.2%	4.9%	
	10 Years	6.6%	-1.5%	5.0%	
MSCI Japan Index	3 Years	14.0%	-9.8%	2.8%	c. 55%
	5 Years	12.8%	-7.1%	4.8%	
	10 Years	9.2%	-2.7%	6.2%	
MSCI USA Index	3 Years	8.1%	0.0%	8.1%	None
	5 Years	14.0%	0.0%	14.0%	
	10 Years	12.5%	0.0%	12.5%	

[1] As of December 31, 2024
Source: MSCI, FactSet, Mondrian

Conclusion

The recent performance of equity markets has been marked by a stark divergence between the US and the rest of the world, significantly inflating the premium attached to US equities. While valuation doesn't reliably predict short-term returns, it is a powerful tool for long-term investors. Market history demonstrates that investor sentiment is inherently volatile, and severely overvalued markets, like Japan in the early 1990s, can suffer prolonged underperformance. Notwithstanding market exuberance, the outlook for President Trump's second term in office remains opaque and expectations for US risk assets are high. Significant uncertainty remains about whether the expectations for the new administration's policies can be fulfilled.

The crucial question now becomes: what price must investors pay to access this US-driven growth, and what assumptions are embedded in current valuations? Expectations are high for the US market and we believe the skew is in the favor of non-US markets. Despite the perceived strengths of the US economy, investors can access similar opportunities and global exposure through companies listed outside the US, often at more attractive valuations and with comparable fundamentals. Furthermore, select non-US markets offer compelling potential due to structural growth prospects, improving governance, and undervalued currencies, creating potentially lucrative investment opportunities. Considering current valuations and the compelling opportunities available outside the US, we believe there is a strong case for investing internationally.

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Unless otherwise stated, all returns are in USD.

All references to index returns assume the reinvestment of dividends after the deduction of withholding tax and approximate the minimum possible re-investment, unless the index is specifically described as a “Gross” index

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