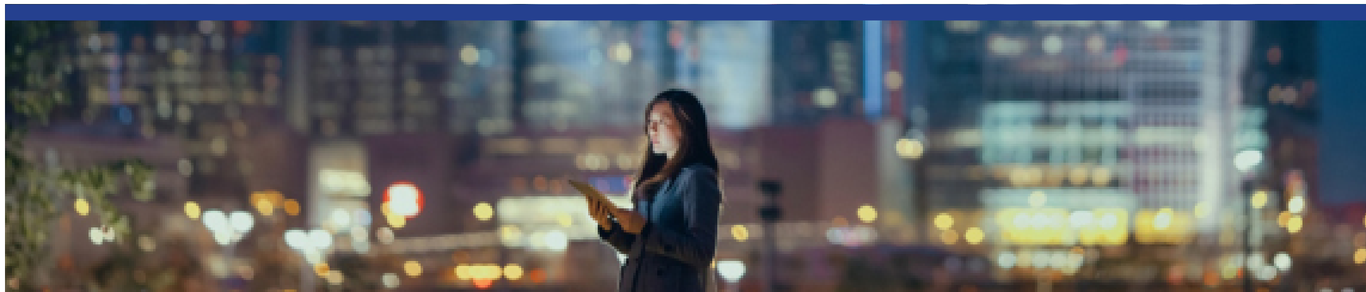

September 24, 2023

CIO Strategy Bulletin

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The Value of Seeking Growth in Global Markets

- Why do US shares trade at a large valuation premium to non-US shares? While the strong dollar plays a role, the largest difference is attributable to earnings and dividend growth. Over the last five years, US large cap growth shares have grown EPS by 9% per annum. In contrast, European large cap growth EPS has risen by just 2% YoY.
- Valuations for the largest growth leaders have skyrocketed, but there are several potential opportunities to invest in companies that may grow earnings quickly as the US and global economies expand into 2025. We discuss where to seek that growth at reasonable valuations herein.
- One of the anomalies within the US market is the 39% valuation discount in SMID[1] growth shares compared to large cap growth shares. Over the past five years, SMID growth has delivered an 11% pace of EPS gains vs 9% for large caps. After a Fed tightening cycle that's driven investors to focus on the largest corporate balance sheets, there are high growth companies left behind.
- At the September 2023 Global Investment Committee meeting, we did not increase our equity allocation. But profitable US SMID growth shares should be on investor's radar screens as a driver of potential outperformance over the years to come.

[1] Indicates companies with small and medium-sized capitalizations

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What Makes the US the Global Equity Market Leader?

The strong performance of US equities over the past 15 years has changed investor dynamics. With the US sitting at a record high 63% of the world's traded market cap, it is logical to ask how we got here and whether this is a sustainable dynamic. It is also useful to consider whether "cheaper" markets elsewhere present possible opportunities given Citi Global Wealth's market outlook.

US markets look like they are peaking as a share of global market capitalization, measured in US dollars (**Figure 1**). The results are a combination of compelling market dynamics. The US dollar has gained 31% relative to a basket of foreign currencies since the beginning of the last decade[2]. Valuations for the S&P 500 have expanded from a 16.3 to 20.0 based on trailing price/earnings multiples. Dividend levels and growth in the US are significantly higher, too. Most importantly, the US has outperformed because its constituent companies have delivered more consistent earnings growth. (**Figure 2**)

Figure 1: US share of global market cap and trade-weighted dollar

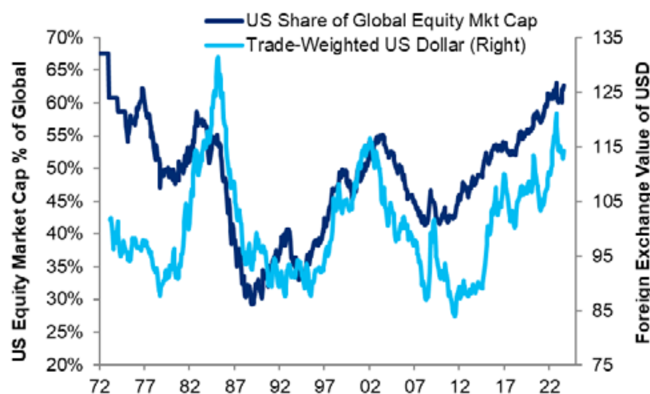
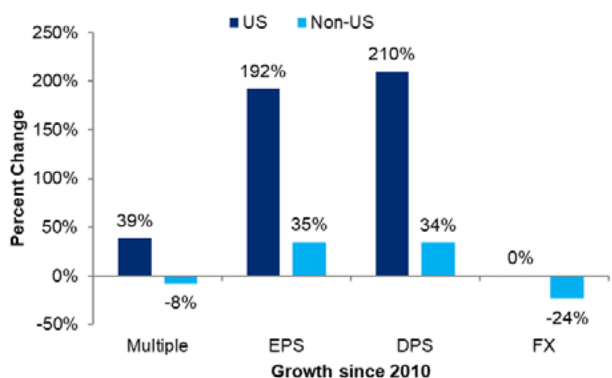


Figure 2: Non-US equity cycle-adjusted valuation discount to the US[3, 4]



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At This Moment

The US equity market is highly diversified by sector and home to innovative companies. And with the Fed holding rates "higher for longer", the US dollar has regained a tailwind. The degree to which the USD benefits or harms US equities varies over time (**Figure 3**).

Last week, the Federal Reserve more than doubled its forecast for US economic growth in 2023 and raised it for 2024 as well. The contours of their forecast look quite similar to our earlier estimates presented in the August 2023 Quadrant. These upward US forecast adjustments were accompanied by downward adjustments for China, leaving the world growing no faster. This is one reason why we are favoring US assets for the time being.

[2] Basket of foreign currencies are trade-weighted US dollar, as calculated by the Federal Reserve. The performance information shown above is hypothetical not the actual performance of any client account. Hypothetical information reflects the application of a model methodology and selection of securities in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading.

[3] US proxied using MSCI US; Non-US proxied using MSCI AC World ex-US

[4] Multiple represents price to earnings multiple, EPS means earnings per share, DPS means dividends per share, and FX means foreign exchange.

Figure 3: Decomposing US and non-US total returns

Source: Bloomberg as of September 18, 2023. Data above is shown in increments of 10 years. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

One Can Find Cheap(er) Growth in the US

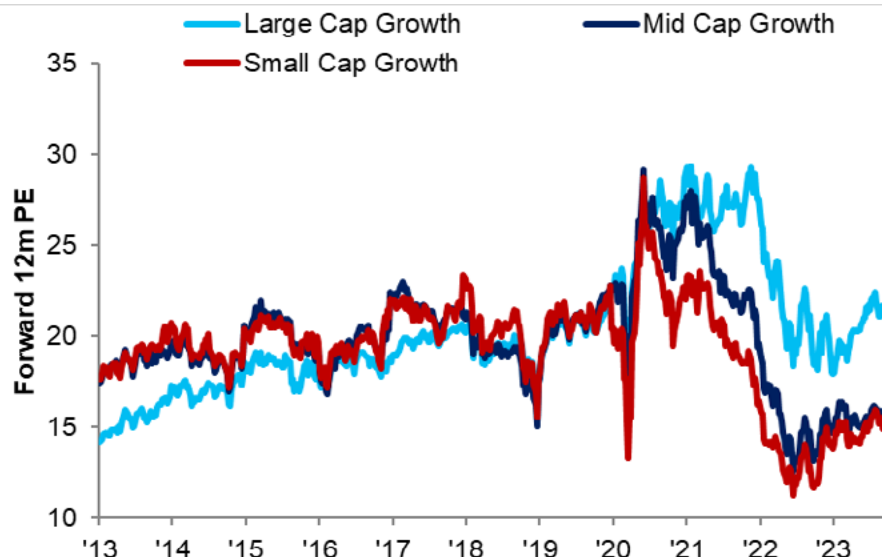
As we noted in this month's Quadrant, the "Magnificent 7" US tech-related shares have grown profits by 18% over the past five years, helping them reach a forward P/E of 36X. Assuming they can sustain this pace of profit growth, these shares can continue to shine.

Yet, looking more broadly at US growth opportunities, the profitable US small and midcap growth shares of the S&P 400 and 600 have seen 11% EPS growth over the past five years. This is greater than the 9% growth rate for the *more expensive* S&P large cap US growth index. And the US large cap growth index overall trades at 27X forward EPS vs 16.5X for SMID growth. (**Figure 4**)

US SMID shares have suffered more during the ongoing Fed tightening cycle. Investors were willing to pay more for the largest and safest corporate balance sheets. We think they have left profitable high growth companies behind.

After upgrading these shares earlier this year, we are presently "neutral" in our allocation to US SMID equities given their cyclicality. Yet, the profitable growth shares within SMID appear undervalued relative to larger firms. They are also likely to grow EPS faster than the world at large with only a slight premium valuation to non-US shares.

Figure 4: US large cap growth vs small and mid cap growth forward P/E[5]



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When May Non-US Shares Shine?

To sustain high relative valuations, the US must outperform to maintain their current premium valuation to non-US shares. So, even though we increased our allocation to US shares tactically as noted in last month's Quadrant, the facts and details associated with the variation between US and non-US performance bear a closer look.

Cheaper equity valuations abroad suggest lower expectations for non-US shares. This points to potentially higher future returns abroad than for the US, assuming a change in sentiment. After the Fed reaches peak rates and declines are more imminent, we believe non-US markets may recover. One factor may be appreciating exchange rates against the USD at that point. But the larger driver will be earnings and earnings growth. That's because highly innovative companies providing the best goods and services may generate rewards for shareholders, regardless of their home country.

A Sterling Sample

We made a screen of firms that were profitable in 2022 and have expectations for 20% or more EPS growth in both 2023 and 2024[6]. Our goal was to identify fast growing companies regardless of where their headquarters sit. It turns out, there are just 76 *large cap* companies across the world that meet these criteria. Of those, 35 (or 46%) were US firms.

At first blush, the fact that the majority of the world's fast growing large companies are *non-US firms* would suggest that there is *excessive* optimism toward the US. However, looking at the share price performance of non-US high growth firms, it has been quite comparable (measured in dollars) to the US high growth cohort. In fact, the performance of the fastest growing 10 non-US firms have outperformed the fastest growing US top-10 (**Figures 5-6**).

These results are in stark contrast to the performance of US and non-US shares generally (**Figure 7**). The post global financial crisis (GFC) performance of growth stocks outside the US have trailed behind most indices, even "US value." Why would this be?

The relative performance of the MSCI Growth indices for the US, Europe and Japan provides insight. Over the past five years,

[5] Proxied using S&P 500, 400, and 600

[6] This data is an illustrative analysis showing that growth is present equally across US and non-US Stocks. It is not meant to serve as the only way to screen for high growth. It was performed based on MSCI AC World constituents and required positive EPS in 2022 as well as consensus expectations for 20% EPS Growth in 2023 and 2024. 20% was chosen as it is double the average EPS growth of the US market in the past 5 years. A smaller threshold would be overly inclusive. 30% would be overly restrictive.

the *actual* EPS growth rates for the companies underlying the US, Europe and Japan indices are 9%, 2% and 6% respectively. Looking closely, we see that the MSCI European Growth Index has had slower actual profit gains than US Value shares (as defined by the MSCI Value index). It appears that there is a lower bar for being defined a "growth" company in Europe.

In contrast, our own screen of *absolute* growth companies shows that being a non-US firm does not keep share prices down. Quite simply, non-US markets have slower EPS growth rates and have not been awarded comparable valuations to the US.

Where to Seek Non-US Opportunities

It appears unlikely that non-US firms broadly will break out of their growth doldrums. That's due to the industry composition of world markets. For example, the Information Technology share of the US market is 28.3% (based on the MSCI Europe Index) vs 6.7% for Europe.

Therefore, to identify fast-growing non-US companies specifically requires use of active management in the context of a diversified global portfolio. And also by investing thematically, seeking fast-growing firms globally ignoring traditional, more rigid, regional allocations.

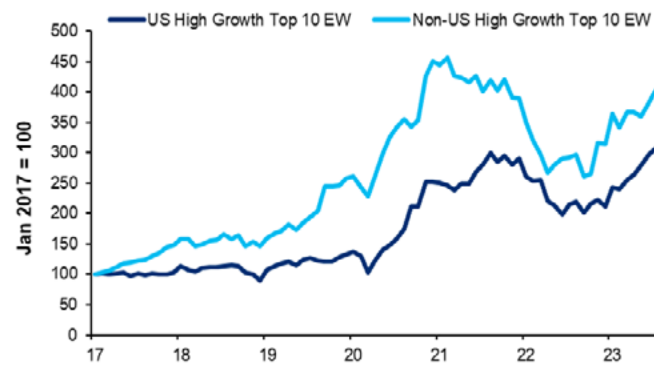
A Reminder about Global Diversification

While we acknowledge that growth and innovation have been drivers of recent US market dominance, there are other factors less likely to persist. Profits for US companies are just 2 ½ percentage points below a record high share of US GDP. US firms have been eradicating costs for decades and "racing lean." While it is easy to argue that faster historic growth rates for the US will continue indefinitely, we think this is a risky assumption. *"Will the faster of two runners always win a race? Not if it is a contest to lose the most weight."*

Though it seems far-fetched today, in the 1980s, investors believed Japanese companies would dominate the world. Taking an indiscriminate view of Japan's success, local and even foreign investors who concentrated portfolios there fell far behind globally-diversified investors for decades (**Figure 8**). Investors can miss the diversification benefits of global investing when a regional crisis hits (**Figure 9**). A home country market or region can have too much concentration in particular industries. This, of course, was not the dominant issue during the very global shocks of COVID, the GFC and the Global Equity Bubble of 1999-2000 as discussed in last week's bulletin.

Figure 5: Performance of fastest growing US vs non-US firm share prices (equal weights)

Figure 6: Top 10 performing US vs non-US firm share prices (equal weight)



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[7] This data is an illustrative analysis that growth is present equally across US and non-US Stocks. It is not meant to serve as the only way to screen for high growth. It was performed based on MSCI AC World constituents and required positive EPS in 2022 as well as consensus expectations for 20% EPS Growth in 2023 and 2024. 20% was chosen as it is double the average EPS growth of the US market in the past 5 years. A smaller threshold would be overly inclusive. 30% would be overly restrictive.

Figure 7: US growth, value, non-US growth long-term total return

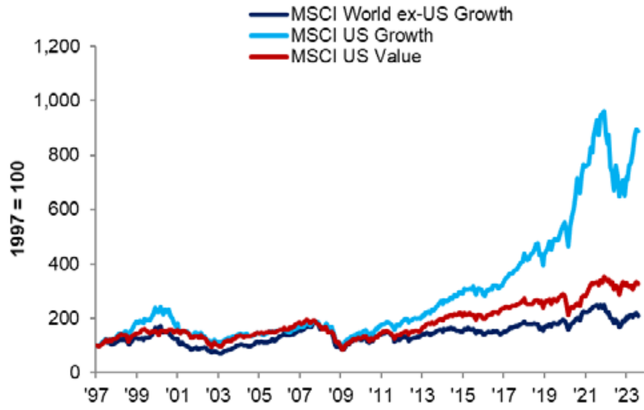

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Figure 8: Japan vs World Equity Total Return

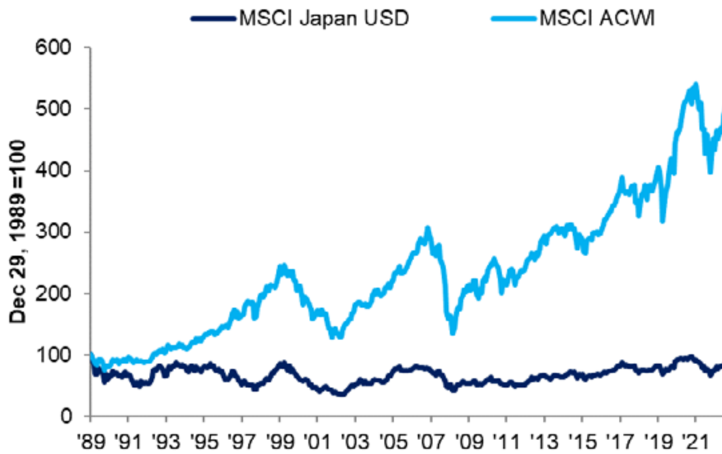

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Figure 9: Returns in periods of Regional Crisis vs Global Equity Total Return[8]

Regional Crisis	Return during first year of crisis	
Asia Crisis 1997[9]	Asia	Global
	-28.3%	15.0%
Latam Crisis 1998	Latam	Global
	-35.1%	22.0%
EU Crisis 2011-2013	Europe	Global
	-10.5%	-6.9%
Commodity Collapse 2015[10]	Latam	Global
	-30.8%	-1.8%
Average of periods shown	**-26.2**	**7.1%**

Source: Factset as of September 22, 2023. MSCI All Country World Total Return Index is used as proxy for global equities. MSCI Asia Total Return Index is used as proxy for Asian equities. MSCI Europe Total Return Index is used as proxy for European equities. MSCI Latin America Total Return Index is used as proxy for Latam equities. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

[8] This exercise is meant to be an illustration that regional crises do not always spill over into global ones. All 4 crises were regional and did not drag down overall global growth.

[9] The Asian financial crisis began in mid-1997 in Thailand and spread to several other countries over the course of that year

[10] Commodity collapse refers to the collapse in crude oil prices in 2015, driven by OPEC's decision to flood the market with supply

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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