

# The Case for International Equities

FROM THE

**YARDARM**

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Saturna Capital, manager of the Amana, Saturna Sustainable, and Sextant Funds, uses years of investment experience to aid investors in navigating today's volatile markets. Founded in 1989 by professionals with extensive experience, Saturna has helped individuals and institutions build wealth, earn income, and preserve capital.

We are long-term, values-based, and socially responsible investors. We view consideration of environmental, social, and governance (ESG) factors as essential in forming portfolios of high-quality companies that are better positioned to reduce risk and identify opportunities. We believe that companies proactively managing business risks related to ESG issues make better contributions to the global economy and are more resilient.

At Saturna, we believe in making your investment dollars work hard for you and that your interests always come first. Saturna strives to not only offer the best investment opportunities from mutual funds to IRAs, but to match those sound investments with superior customer service.

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Saturna Sdn. Bhd. is the wholly-owned Malaysian subsidiary of Saturna Capital Corporation, resulting from the 2010 purchase by Saturna Capital of Alpha Asset Management located in Kuala Lumpur. Saturna Sdn Bhd holds an Islamic Fund Management Licence (IFML) with the Malaysian Securities Commission. Saturna is the first conventional asset manager to be converted to an Islamic asset manager.

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*Following the Global Financial Crisis (GFC), European and Japanese equity markets have consistently underperformed the US. Since the onset of the coronavirus pandemic, this performance gap has widened to a historical high. As the dust settles and the global quantitative easing cycle comes to an end, it is important for investors to evaluate which markets offer the best relative value.*

Over the past few years the global economy has experienced one of the most jarring economic cycles in modern history. Equity investors have endured many lessons in humility: A once-in-a-hundred-years pandemic, disruptions to the global supply chain, and unprecedented levels of monetary and fiscal stimulus. Toward the end of 2021, the pandemic seemed to be ending, and the reopening of the economy was well under way. Unfortunately, this optimism was short-lived, as sharply rising inflation delivered another demoralizing blow to risk assets.

Entering into 2024, after evaluating where equity prices have settled across different sectors and regions, international equities appear attractive on multiple fronts. Active investing involves using stock analysis to buy and sell stocks based on the individual merits of the company, sector, or region, with the goal of outperforming a respective benchmark index. Passive index investing involves purchasing a basket of securities that replicates the entire market performance of the benchmark or specific segments of the market. If an active investment strategy is deployed, the opportunity set looks even more interesting. This article will focus on the merits of international equities relative to domestic equity peers.

## Valuation

When discussing valuation, it is important to acknowledge that international equities have generally traded at a discount relative to domestic equities (although prior to 2014, Japan traded at a premium). The United States is home to many of the highest quality companies with the best management teams and most cutting-edge technologies. Such companies typically trade at a premium.

As of January 2024, the forward price/earnings of the S&P 500 Index stood at 19.5x, the STOXX Europe 600 Index was 12.5x, and the Tokyo Stock Price Index, or TOPIX, was 13.5x. This means that US equities traded at 56% and 44% premiums to European and Japanese equities. The 10-year median forward P/Es of the S&P 500, STOXX, and TOPIX were 17.8x, 15x, and 14x, respectively. The historical premium of US equities were only 18.7% (STOXX) and 27.1% (TOPIX), significantly lower than the current valuation gap.

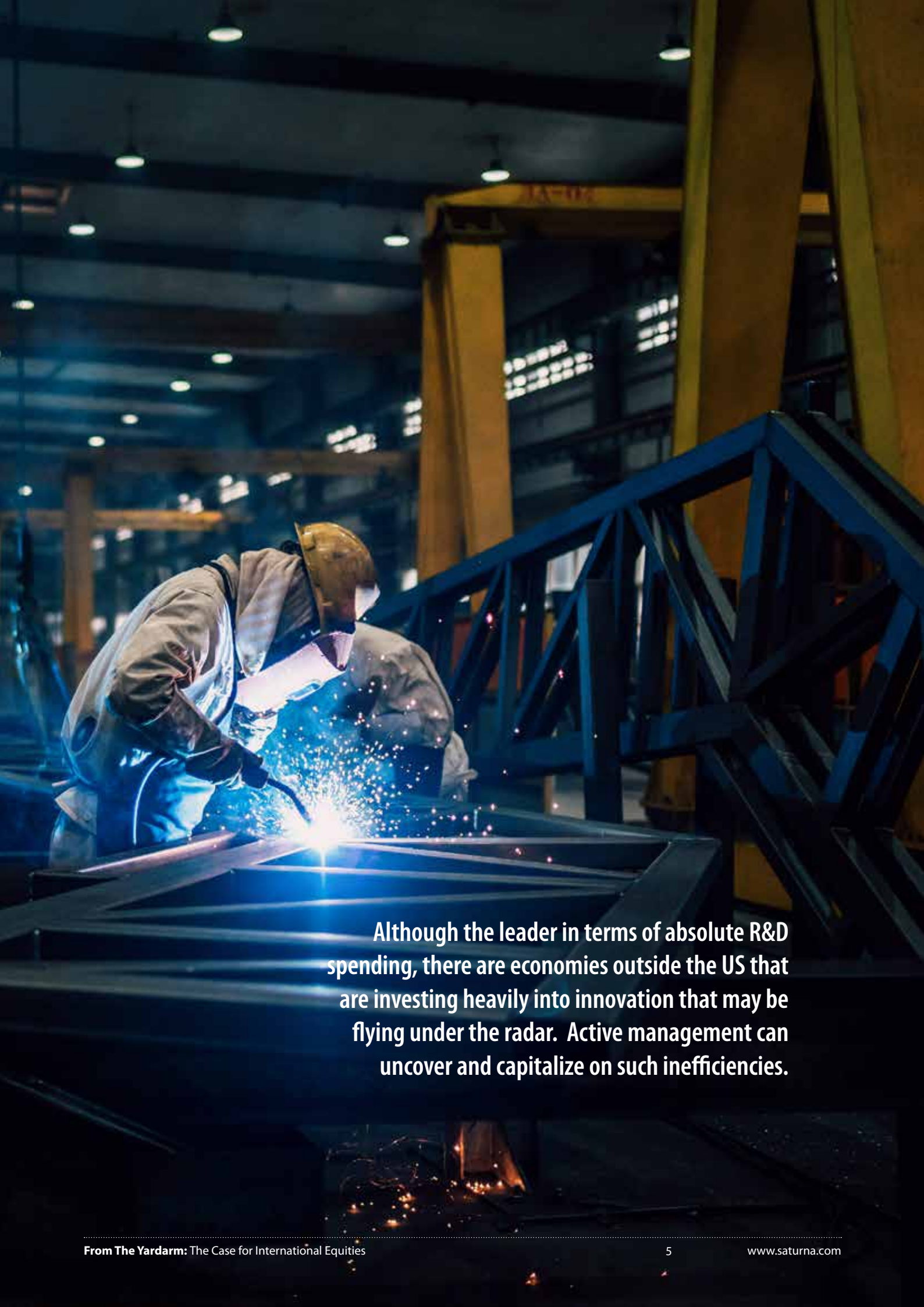
For income investors, the statistics are also compelling. As of January 12, 2024, the projected 2023 dividend yield for STOXX was 3.4%, TOPIX was 2.2%, and S&P 500 was 1.9%.

Dividend Yields (CY2023 average)	MSCI EAFE Index	S&P 500 Index	Difference
No Dividend	2.3%	22.2%	-19.9%
> 0 - 1.5%	22.5%	36.1%	-13.6%
> 1.5 - 3.0%	29.1%	23.7%	5.5%
> 3.0 - 4.0%	16.5%	10.6%	5.9%
> 4.0 - 5.0%	9.0%	3.8%	5.2%
> 5.0%	20.0%	3.6%	16.4%

Source: Refinitiv, 2023 year-end

One metric associated with whether a country's valuation is justified is how much it reinvests in research and development (R&D). In 2019, the US spent a colossal \$668 billion in total R&D out of an aggregate of \$1.56 trillion. Drilling down further by dividing gross domestic R&D expenditure by total gross domestic product (GDP), the R&D intensity of the US was 3.13%, behind Germany (3.19%), Japan (3.2%), Taiwan (3.49%), and South Korea (4.64%). Although the leader in terms of absolute R&D spending, there are economies outside the US that are investing heavily into innovation that may be flying under the radar. Active management can uncover and capitalize on such inefficiencies.





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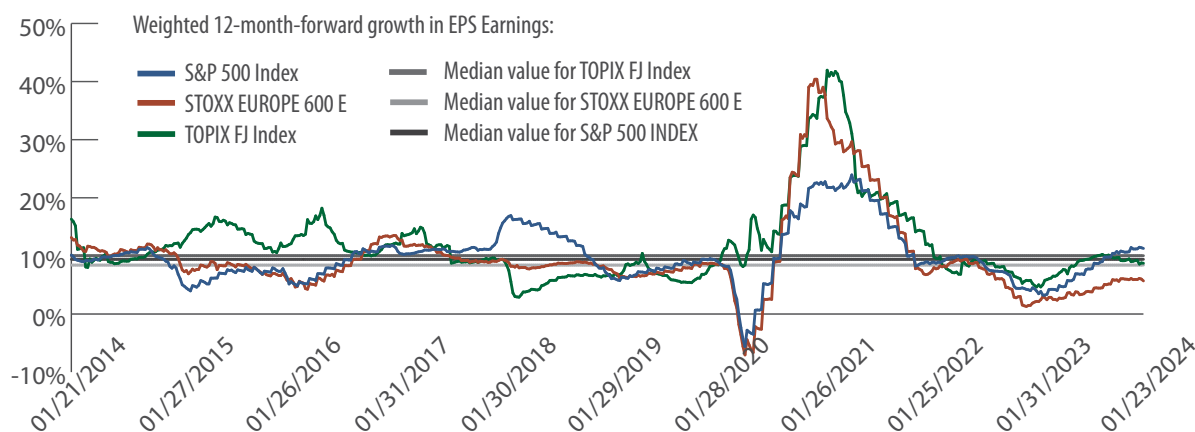




## Growth matters

Another important factor that influences valuation is expected earnings growth. The faster the economy, sector, or stock is expected to grow, the more an investor is likely willing to pay for that asset. The 12-month forward earnings per share (EPS) expectations for the US, Japan, and Europe, as of writing, stand at 11.4%, 8.8%, and 6%, respectively, and their 10-year historical medians are 9.4%, 10%, and 8.5%, respectively. This means that relative to its own history, the expected earnings growth for the US is 200 basis points (bps) above median, Europe 250 bps, and Japan 120 bps. Relative to current expectations, the US valuation premium appears at least partially explained, while Japan and Europe's discounts are also somewhat justified.

### Forward EPS Growth Comparison between US, Europe, and Japan over the 10-year period



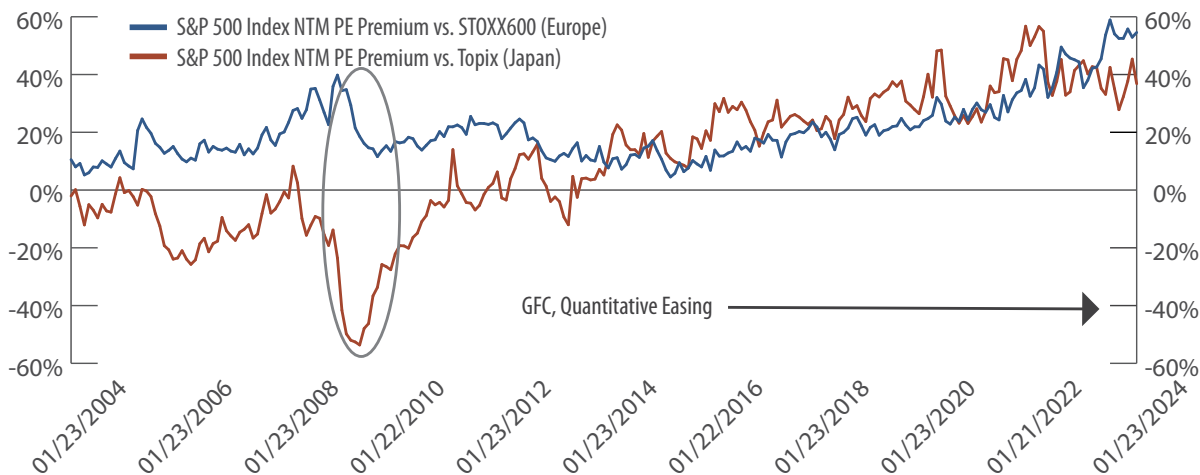
Source: LSEG Datastream

## Mo money, no problems

To better understand how equity valuations have evolved, we look at how the US to international gap has trended over the past 20 years. A noticeable inflection took place from late 2008 through mid-2009, coinciding with the GFC and the US Federal Reserve beginning its historic quantitative easing monetary policy. This money printing party was great while it lasted. However, fast-forwarding to today, quantitative easing has largely come to an end. What this means for markets remains to be seen.



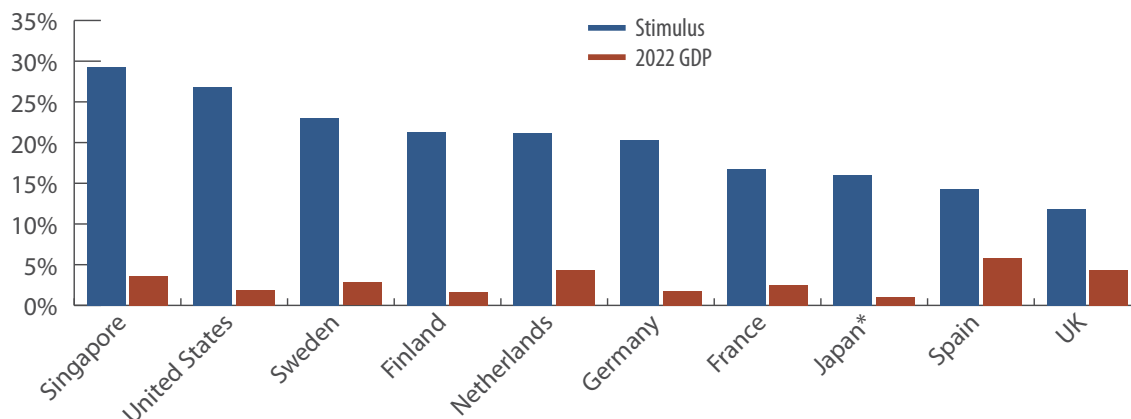
### US Equity Premium vs. Europe and Japan



Source: LSEG Datastream

When the US injected even more stimulus into the economy in response to the pandemic, this liquidity mismatch was pressed further, which helped trigger a painful inflation cycle that we still must address. In the COVID Economic Stimulus Index, 166 countries were ranked according to their fiscal responses to the pandemic as a percentage of GDP. The US ranked second at 27%, just behind Singapore at 29%, and ahead of its broader, developed European peers.

### Stimulus Spending as % of GDP, 2020-2021



Source: Elgin, C., Yalaman, A. (2021), "Covid Economic Stimulus Index"

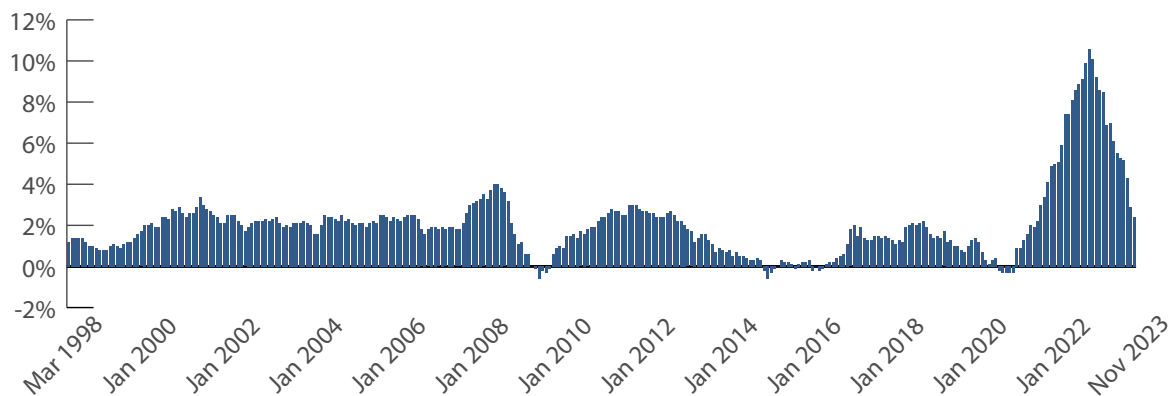
\*Japan's official figures read 54.9% of GDP. However, the Peterson Institute for International Economics estimated that after adjusting for private sector expenditures and other non-government spending, the apples-to-apples comparison is 16%.



## Economics

One of the most obvious risks threatening the global economy is inflation. The combination of record stimulus, a surge in demand post-reopening, and troubled supply chains created an inflation cycle that is frustratingly difficult to predict. Finally, after two years of monetary tightening led by the Fed, coupled with the normalization of supply chains and goods demand, the economy has reached a point where the risk of a 1980s Volker-era inflation cycle appears significantly reduced.

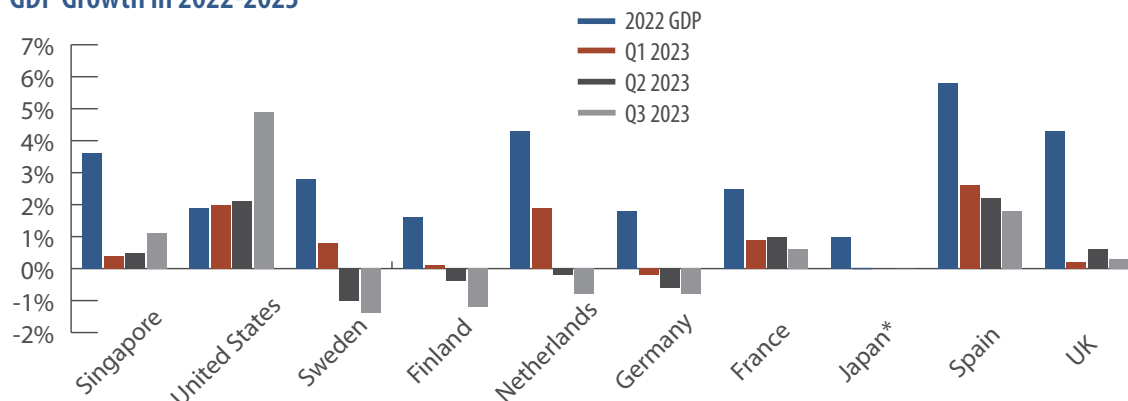
### Harmonised Index of Consumer Prices (European CPI) Year-Over-Year%



Source: Refinitiv

In a more normalized inflationary environment (circa 2%), large ex-US economies such as Europe and Japan are net beneficiaries. The Japanese economy has fought to create a reasonable level of asset deflation since the 1990s so that equity investors would welcome a normalized inflation trajectory. Following the sovereign debt crisis and the pandemic, the European Central Bank (ECB) has also had to fight deflation through its own quantitative easing program.

### GDP Growth in 2022-2023



\*Japan reports GDP on a sequential (q-q) basis.

Source: Refinitiv

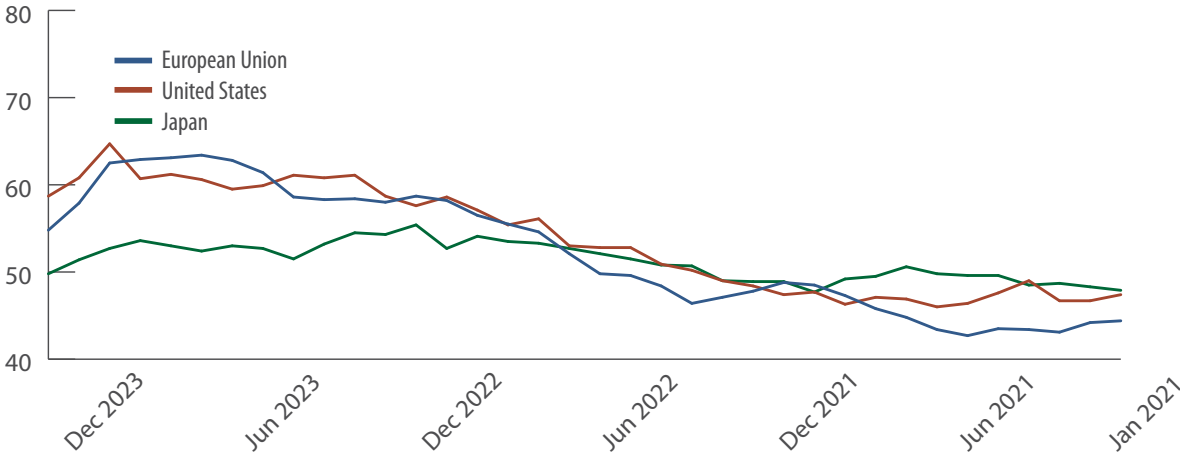




After an ugly 2023 and still far from rosy, Europe's future economic growth is at least directionally encouraging. The European Council, in its winter publication, recently upgraded its outlook for 2024 GDP growth from 1.3% to 1.6%. Inflation is projected to decline from 6.5% in 2023 to 3.5% in 2024 and to 2.4% in 2025. Natural gas prices in Europe fell below pre-war levels, aided by a continued diversification of supply. Conversely, the US Congressional Budget Office projects economic growth to slow from 2.5% in 2023 to 1.5% in 2024. Growth for 2025 was downwardly revised to 2.2% from 2.4% in December.

Looking at manufacturing, the US, Europe, and Japan are each going through their own bottoming processes. Europe's downturn seems the most severe, likely influenced by the geopolitical conflict between Russia and Ukraine. The other big detractor to international activity was China's lackluster performance and sloppy post-pandemic reopening process. That said, after hitting a recent bottom of 0.4% in the second quarter of 2022, China's GDP since rebounded to 4.9% in the third quarter of 2023. A broader economic recovery in China will asymmetrically benefit economies in Asia and Europe; the US has distanced itself from the Chinese economy (particularly relating to technology).

### Manufacturing PMI, Developed



Source: Refinitiv

## Secular Themes

Another factor supporting US stock performance is that several mega-cap stocks, also known as the Magnificent Seven, have soared due to their first mover and leadership positions within hit investment themes such as artificial intelligence (AI) and digital transformation. As first movers, these companies rightfully deserve attention and share price appreciation. But after all the news and media that this cohort has received, it is safe to say these companies have been discovered and a lot of good news has been priced in.


### *Les Sept Magnifiques*

But what about the foreign equivalent to the Magnificent Seven? Many international peers, also handsome beneficiaries of the same attractive end markets as America's mega-cap darlings, are less well-known and still in the earlier innings of growth. To put this into context, we take a look at specific stocks that play into some of the cutting-edge themes mentioned above. The comparisons are not apples-to-apples, nor are they meant to recommend one stock over another. They do, however, help illustrate a broad, high-level discrepancy seen in valuations between the two markets.

In enterprise software, US-based ServiceNow (exposed to digital transformation, cloud, and AI) trades at a forward P/E multiple of 59x for fiscal 2024, going to 48.8x for fiscal 2025, while German-based SAP trades at 33.1x going to 26.4x. Intel (semiconductor integrated device manufacturer, or IDM, and foundry, digital revolution, AI) trades at 31.2x in fiscal 2024 and 19.4x the following year. Taiwan's champion, Taiwan Semiconductor, the global leader in foundry (although not an IDM) trades at 16.9x going to 13.7x. Within analog semiconductors (digital revolution, auto electrification), we compare US-based Microchip at 17.3x going to 27.7x with French-based STMicroelectronics, which trades at 13.5x going to 10.4x.







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## Other Factors

### Home bias

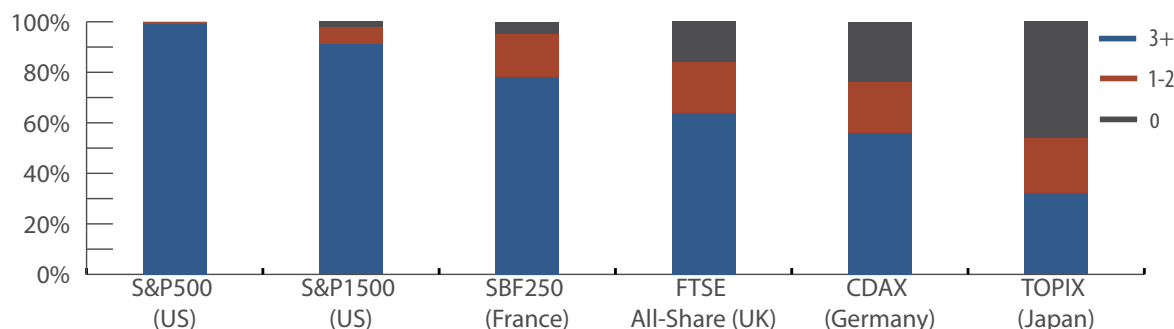
For a lot of US investors, domestic equities are the only game in town due to familiarity bias, a behavioral phenomenon in which investors tend to rely on information that is already familiar to them when making decisions. This makes sense, given the strong returns generated following the GFC. It is common for equity accounts to hold less than 10% in international stocks, and frequently none at all. Meanwhile, international stocks make up roughly 40% of global market capitalization. Those that do hold exposure outside the US often use broad market index funds or ETFs. This means everything in the index is purchased with a broad brush, regardless of individual company, country, or sector merits, and may open the door to more relative inefficiencies.

A substantial portion of US corporate earnings can be tied to overseas demand, and vice versa. However, the stated revenue of origin is not always where the final consumption resides. A technology firm in the US, for example, may book 40% of its revenues from China, but this may represent unfinished intermediary that is packaged and sent back to the US as a finished product. The other factor is that if a significant source of US earnings (~40%) is generated internationally, this revenue stream is subject to all of the macroeconomic, geopolitical, and idiosyncratic qualities of markets outside the US – which may warrant an “international” discount.

### Too efficient

More does not always mean better when it comes to sell-side research. Generally speaking, international stocks have less research analyst coverage than their US peers. Starting from the US and heading east around the globe, research coverage per company tends to trail off (see “Research Analyst Coverage Per Company.”) With less analyst coverage and less media hype, active investors are generally able to uncover more opportunities that may not have been discovered by the broader market, leading to greater upside opportunities.

### Research Analyst Coverage Per Company



Source: JPMorgan





Insurance company TIAA compared the performance of actively managed US large cap funds against European, Australasian, and Far Eastern (EAFE) funds.<sup>1</sup> While the percentage of active funds outperforming the benchmark in the US saw lows in the 10% range, active strategies in international markets fared much better over time. In other words, active international investment managers were able to outperform the broader markets much more consistently than their US peers. In fact, international managers were able to outperform the US benchmark more than 50% of the time.

### ***Japan Inc.***

In recent years, the Japanese financial markets have undergone several important regulatory reforms to incentivize companies to boost valuations and earnings, while potentially delisting companies that fail to show efficient capital allocation. Other measures to improve corporate governance, such as the unwinding of cross shareholdings, also bode well for asset valuations.

For active stock pickers, Japanese equities exhibit interesting quirks that can be exploited. Each fiscal year-end, most companies offer fairly detailed full-year guidance. In Western markets, guidance is generally limited to more established companies. As the majority of stocks in Japan are covered by three or fewer analysts, guidance tends to play an outsized role in the formation of market expectations. Given Japan's extra-conservative corporate culture, this guidance is often much more cautious than what would be considered normal under Western standards, which opens the door to large divergences in earnings outcomes.

### **Conclusion**

Over the past few years, a succession of shocks have jumbled the world's economy, supply chains, and asset prices. After a painful but necessary process of normalizing the cost of capital, we have entered a new economic paradigm, and opportunities and risks have emerged.

Today, multiple economic inflection points are occurring simultaneously, catalyzed by disruptive forces such as AI and the digital revolution. Many US firms have jumped on these trends early to emerge as first movers, but their international counterparts are also exposed to these themes and in the earlier stages of growth, which could lead to a better relative upside.

US equities have had a spectacular run and continue to be an important asset class for long-term investors. However, taking a holistic view of the unique post-pandemic economic cycle in which we find ourselves, international equities offer attractive relative valuation, dividend income, and macroeconomic positioning. In addition to this setup, active investing in international markets have historically outperformed the broader benchmarks with compelling consistency. Conditions seem ripe for investors to branch outside their comfort zones and take advantage of what international markets have to offer.

## About the Author



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Senior Investment Analyst and Portfolio Manager

Dan Kim CFA<sup>®</sup>, Senior Investment Analyst and Portfolio Manager, joined Saturna in March 2023. Mr. Kim is an experienced investment professional with more than 19 years of experience in managing institutional capital in global equities. Mr. Kim is the portfolio manager of Sextant International Fund. He founded Blackcrane Capital, LLC, a global investment management firm, in 2012. At Blackcrane, he served in multiple functions including as a portfolio manager. Prior to founding Blackcrane, Mr. Kim worked for Mastholm Asset Management, LLC in Seattle as a portfolio manager and director of research, and at Samsung Electronics Co., Ltd. in Seoul, Korea as an investor relations officer.

Mr. Kim obtained his bachelor's degree from Cornell University, where he studied Operations Research and Industrial Engineering with a concentration in electrical and computer engineering. He then attended Cornell's Johnson Graduate School of Management, where he earned a master's degree in Financial Engineering.

## Footnotes

<sup>1</sup> Wang, Peng. "Endowment Management: The Benefits of Active Investing." TIAA Endowment & Philanthropic Services, 2018. [https://www.tiaa.org/public/pdf/teps\\_endowment\\_management\\_and\\_benefits\\_of\\_active\\_investing.pdf](https://www.tiaa.org/public/pdf/teps_endowment_management_and_benefits_of_active_investing.pdf)



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