Investment Strategy

STRATEGY INSIGHTS | SECOND QUARTER 2024

# International Equity — Gone, but not Forgotten

While U.S. equities have outperformed their international counterparts for more than a decade, we believe there is ample support to include international equity allocations in a fully diversified portfolio.

PNC

Investors, like everyone else, can be guilty of overconfidence. One common misstep is attempting to extrapolate from the recent past to predict far into the future with certainty, a phenomenon that is oftentimes labeled "recency bias." Yet, over the long term, history has proven this to be a fallible strategy, time and again.

In fact, the current market environment reflects a number of circumstances that investors appear content to view as actuality. For example, markets appear to have fully adopted the idea of an economic soft landing, implying that recent, stronger-than-expected economic data is likely to persist. They have also accepted the notion that the Federal Reserve (Fed) and other global central banks are nearing the start of a rate cutting cycle that will lead to easier financial conditions. The combination of expectations for a soft landing and future rate cuts has helped push global equity prices higher — leading to new all-time highs during the first quarter of 2024 for the S&P 500®, Nasdaq-100 and Dow Jones Industrial Average. The valuation backdrop also keeps climbing. In fact, the S&P 500 hit 21.0 times (x) next-12-month earnings earlier this year — a high over the past 12 months. This means investors are willing to pay above-average prices for future earnings, a strategy that assumes the future continues on the current path.

Another prevalent assumption is the continued dominance of U.S. equity market performance compared to non-U.S. equities. While U.S. equities have outperformed their international counterparts for more than a decade, we believe there is ample support to include international equity allocations in a fully diversified portfolio. In this edition of Strategy Insights, we review evidence from the recent past that has caused investors to shy away from international allocations and provide perspective on our portfolio positioning. Importantly, we also highlight what would cause us to revisit our allocations. Change is the only constant, and the future cannot be predicted with absolute certainty; thus, we rely on our investment process to help us navigate financial markets with a long-term lens.

> **"The idea that the future is unpredictable is undermined every day by the ease with which the past is explained."**
>
> **Daniel Kahneman**
> Thinking, Fast and Slow

# U.S. dominance and our home-country bias

Over the last decade, U.S. equities have outperformed international markets. Since 2014, the S&P 500 has generated an annualized total return of 12.7% compared to 4.0% for the MSCI ACWI ex USA Index (**Figure 1**). Furthermore, the S&P 500 has outperformed the international index in 11 of the last 13 calendar years.

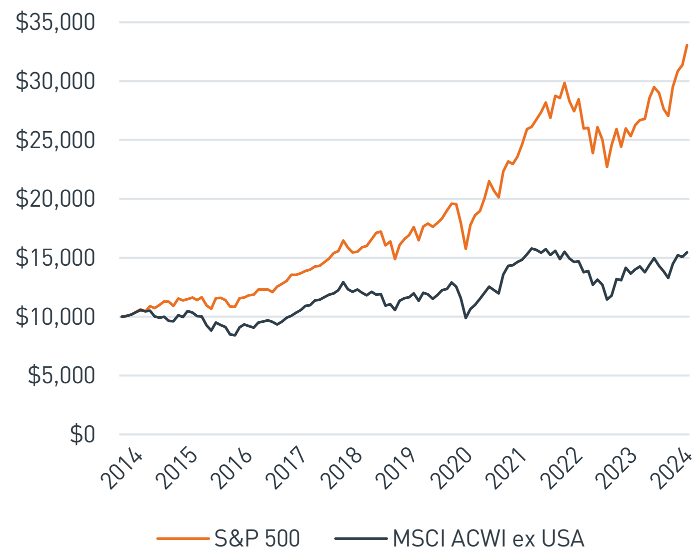
In our view, U.S. equity performance has not been an interest rate or macro-driven phenomenon. S&P 500 constituents, in aggregate, have outperformed due to solid underlying fundamentals. For example, S&P 500 companies have had higher return on equity (ROE) and higher earnings per share (EPS) growth compared to the rest of the world during this period. Specifically, over the past decade, the S&P 500 has grown forward earnings per share by 7.3% compared to 1.0% for international equities. From a profitability standpoint, the U.S. has maintained a comfortable ROE spread between 400 and 900 basis points (bps) over the same period (**Figure 2**). We believe the ability to generate returns greater than the cost of capital and grow earnings at a faster rate largely explains U.S. outperformance.

U.S. corporations' ability to grow earnings and improve profitability at a lower equity multiplier than their international counterparts is even more impressive, in our view. The multiplier, a proxy for financial leverage, quantifies the degree to which companies have used debt to finance their assets. Over the last decade, the average equity multiplier for the S&P 500 was 4.6x compared to 6.7x for companies abroad (**Figure 3, page 3**).

Sector composition differences between U.S. and non-U.S. large-cap stocks also help shed light on the last decade of U.S.-dominant performance. Technology stocks, in particular, have been key drivers of the performance differential. As the post-global financial crisis era was characterized by a prolonged period of subdued growth, low inflation and rock-bottom interest rates, investors sought companies that could grow organically without the aid of a cyclical lift. Technology companies have tended to meet these characteristics.

**Figure 1 — S&P 500 vs. MSCI ACWI ex USA Index, Growth of $10,000**

U.S. equities have outperformed international equities for some time




*As of 2/29/2024. Source: Bloomberg L.P.*

**Figure 2 — U.S. vs International, EPS and ROE**

The U.S. has maintained a wide ROE spread over the last decade relative to international equities

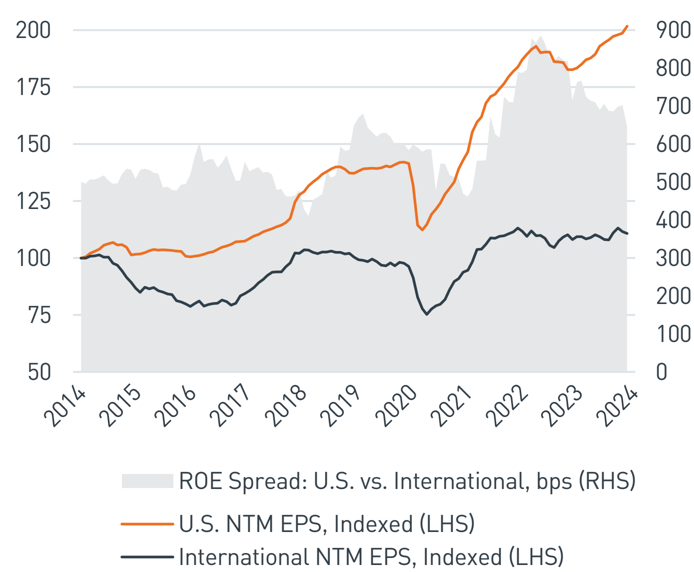



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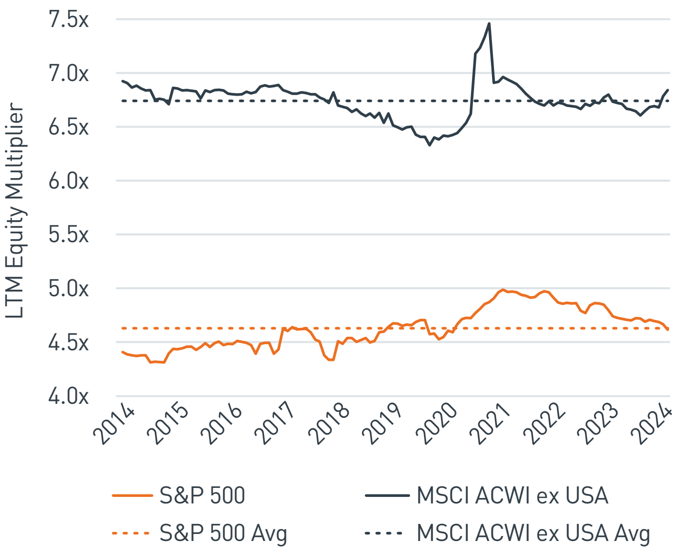
**Figure 3 — U.S. vs International, Financial Leverage**

U.S. companies have grown earnings and improved profitability at a lower equity multiplier than their international counterparts

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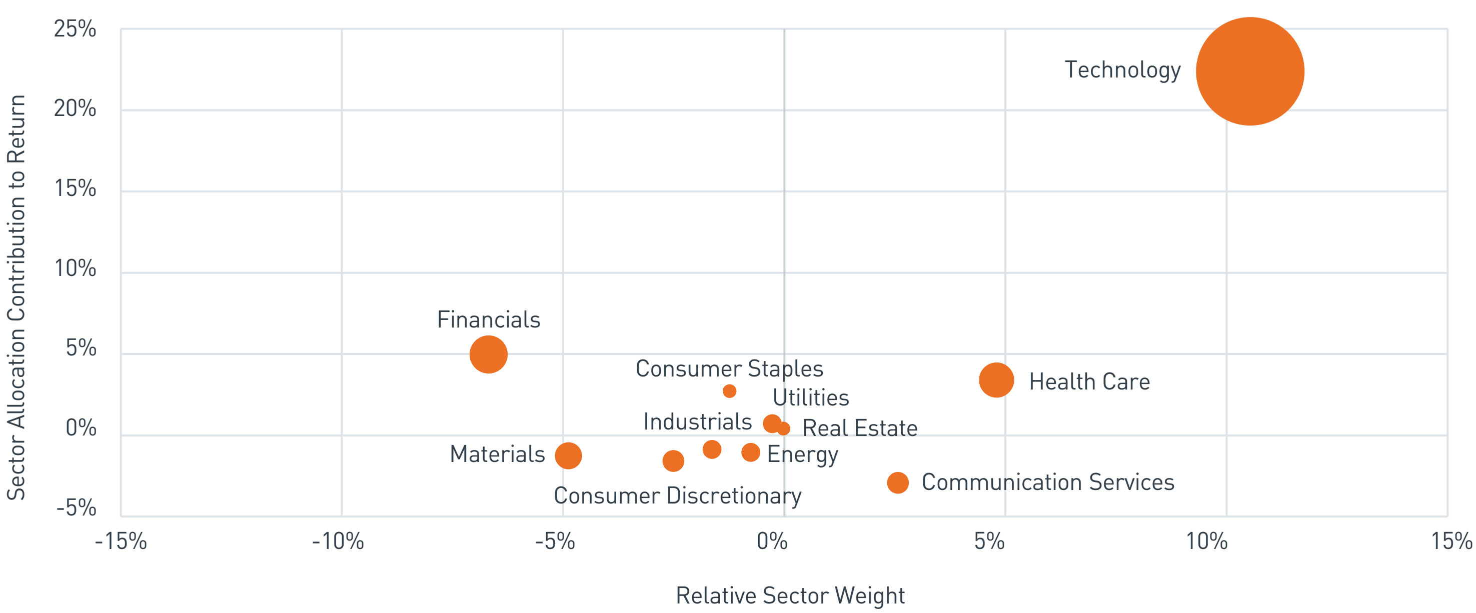
Thus, in the U.S., the Information Technology sector grew from 13% of the S&P 500's market cap in 2014 to 30% today, whereas the MSCI ACWI ex-USA technology sector currently makes up only 13% of the index. As technology stocks have been the primary driver of relative performance between the U.S. and international equities, this compositional difference has and continues to benefit the S&P 500 (**Figure 4**).

Beyond fundamentals and sector differences, the U.S. economy has capitalized on many advantages relative to other parts of the world, which helped its economy achieve faster growth in the last decade. U.S. GDP growth has exceeded the developed markets average over the past 10 years, growing 2.3% per year versus 1.8%, despite starting from a higher income level than most of its peers. Additionally, while much of the global economy has struggled recently with tighter financial conditions, the U.S. has continued to defy odds of a recession.

**Figure 4 — S&P 500 vs MSCI ACWI ex USA, Sector Attribution and Relative Weight**

Technology stocks have been the largest contributor to relative performance between the U.S. and international equities




*Circle size denotes the size of each sector's relative contribution to return over the period. For the period of 2/28/2014 - 2/29/2024. Source: FactSet®.*

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Another important factor, in our view, is that since 2014, the U.S. has been a net energy exporter, helping it achieve energy independence while reducing its trade deficit. The U.S.'s vibrant, deep capital markets and steady flow of innovation make it an attractive investment destination for foreign capital, both direct and through private equity, allowing the U.S. economy to run a budget and trade deficit without hampering growth.

Importantly, the U.S. dollar continues to be the dominant global reserve currency, commanding a safe-haven premium over other major currencies in times of geopolitical and market stress. To illustrate this last point, over the past 10 years, the U.S. dollar's trade-weighted index has risen both in nominal terms and in real terms by 30% and 3%, respectively.

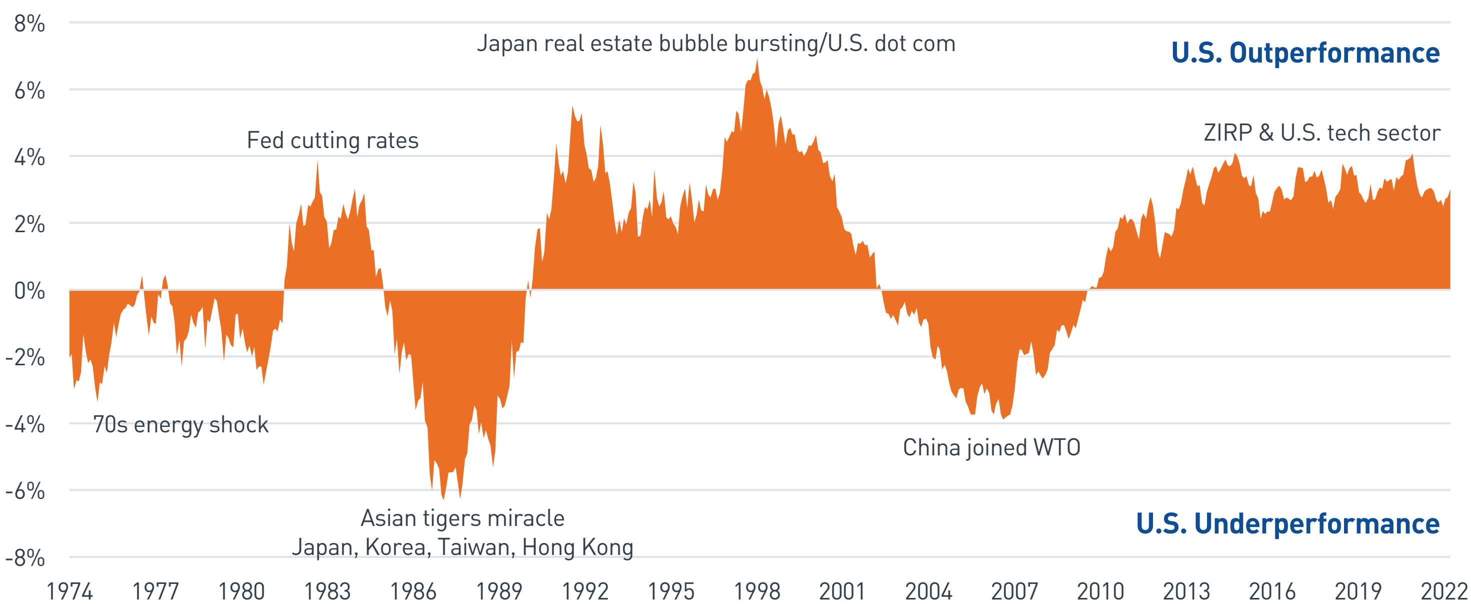
However, U.S. equity performance has not always dominated the rest of the world, and historical data suggests the U.S. outperformance over the last decade might not be repeated (**Figure 5**). Thus, we believe investors may want to embrace a renewed focus on diversification.

While we believe the U.S. remains at the cutting edge of technological innovation, we note U.S. equity market performance has been concentrated, with its strong relative showing owed to a handful of mega-cap companies. The largest seven companies in the S&P 500 by market capitalization — known as the "Magnificent 7" — have risen 84.7% over the last year compared to 18.1% for the rest of the S&P 500 constituents, and 12.5% for the MSCI ACWI ex-USA, as of February 29, 2024.

Increased competition from other asset classes in the current high-rate environment could discourage investors from adding to already hefty equity allocations. With the S&P 500 trading at 20.6x next-12-month earnings, relatively stretched U.S. equity valuations could create a high bar for further asset class outperformance. That said, the upside from technological innovation could have a longer runway, as we believe structural changes in an economy tend to be reflected in asset prices over several years.

**Figure 5 — S&P 500 vs MSCI ACWI ex USA, 5-year Rolling Cumulative Annualized Monthly Relative Returns**

U.S. equities have not always outperformed international




*As of 2/29/2024. Source: Bloomberg L.P., PNC*

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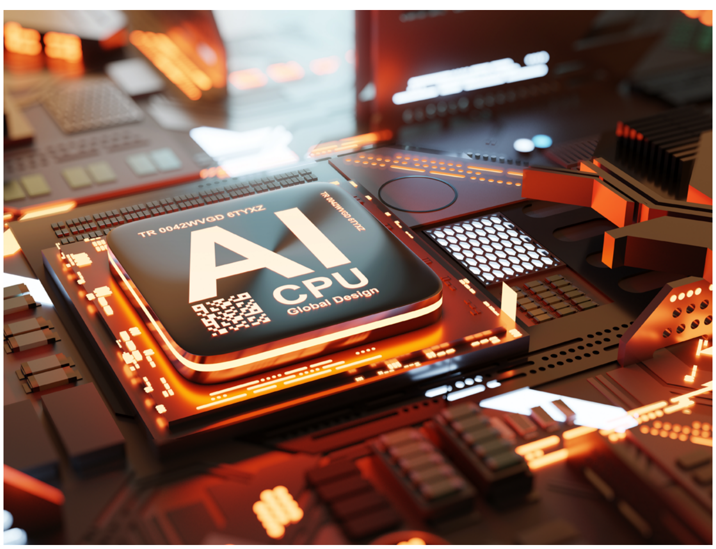
U.S. equity valuations are relatively high — technology valuations are even higher — and ownership of U.S. stocks has increased significantly over the last decade. The home-country bias argument for U.S. investors has fundamental merits, as the broad adoption of generative artificial intelligence (AI) could significantly lift U.S. productivity and, in turn, domestic growth — the dominant driver of equity markets over the long term. However, current market optimism is predicated on expectations that AI helps boost top-line and bottom-line growth. Should AI fall short, there is the possibility that the "AI spring" turns into an "AI winter."

Another risk we see to continued U.S. outperformance is the deteriorating fiscal situation. The current fiscal deficit equates to 5.6% of GDP and, according to the Congressional Budget Office, is expected to grow to 6.1% by 2034. Of note, a fiscal deficit of 6.5% has never occurred outside a deep recession or major military conflict. Meanwhile, policymakers are unable to agree on how to lower spending or increase taxes. From this perspective, we expect fiscal policy will be increasingly constrained, interest payments will consume more of the budget, and more sovereign credit rating downgrades could lie ahead, all of which could drive investors toward risk assets outside the U.S.




*AI could significantly lift U.S. productivity, and in turn, domestic growth*

## The case for global diversification

In theory, diversification reduces risk, as an investor can earn the same expected return with less volatility, or a superior expected return with the same level of volatility. By allocating assets to a variety of investments, the return is less dependent on a single asset class. Instead, returns comprise results from a combination of assets with different risk and return drivers, with the goal of adding flexibility and resilience to a portfolio. From an allocation perspective, we view the globe as one financial market. We divide our asset allocations by taking all geographies and asset types into consideration.

There are important practical considerations to diversification. As it pertains to geography, each country or region has its own business cycle, market valuations and predominate sectors or industries. By diversifying among structurally different geographies, investors should benefit from exposure to other sectors or industries, different stages in the business cycle and different valuations over time, thus reducing correlations and potentially smoothing expected returns.

As all investors are subject to the constant churn of the daily news cycle, it is worth examining financial market history from a wider, longer-term lens. Taking a step back, it becomes more apparent how much global financial markets have changed over the past several decades. For example, Japan's equity market represented more than 40% of the MSCI World Index at its peak at the end of the 1980s, versus the U.S. at 29%. Had an investor focused purely on the dominant market at the time, they would have missed the decades-long trend that saw the U.S. grow to more than 60% of the index, while Japan was reduced to 6% (**Figure 6, page 7**).

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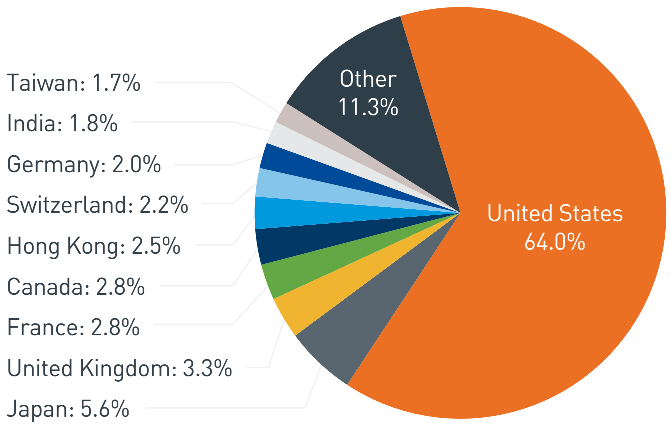
**Figure 6 — MSCI ACWI Composition by Geographic Constituents**

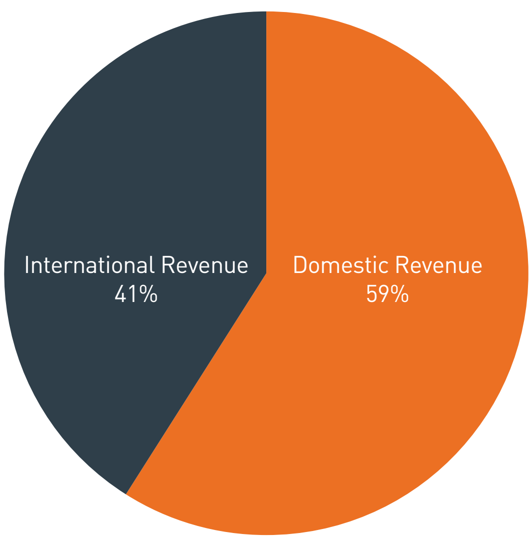
The U.S. currently accounts for the majority of the global index




*As of 2/29/2024. Source: FactSet®*

**Figure 7 — S&P 500, Geographic Revenue Exposure**

41% of revenue in the S&P 500 comes from international sources




*As of 2/29/2024. Source: FactSet®*

Different industries thrive at different times, and being exposed at the right price, at the right time, can benefit investors. Some opportunities are shorter term and more tactical in nature, while others are longer term and strategic. The global opportunity set offers more diverse options when trying to identify sustainable secular trends.

An investor should also have the potential for higher risk-adjusted returns by accessing global opportunities versus the limited set of local options. However, the bigger and more diverse a local market is, the more it resembles the global investable universe. In this case, investors should consider the opportunity cost for going global versus staying local.

The current investible universe of global public equities, as measured by the MSCI ACWI, comprises 64% U.S. and 36% non-U.S. stocks. Within our asset allocation, we have a strategic (long-term) allocation to non-U.S. equity of 33%. Thus, on a relative basis, we are underweight compared to the global benchmark by approximately 8%.

We position our strategic equity allocation this way as 41% of the revenue from the combined S&P 500 is derived from sources outside the U.S., according to FactSet. Thus, just by having exposure to U.S.-based companies, investors get exposure to international markets (**Figure 7**).

While we have a strategic home-country bias, we maintain a healthy exposure to non-U.S. equities, to access diversification benefits and an increased opportunity set.

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# Current Positioning

## Developed International Equity

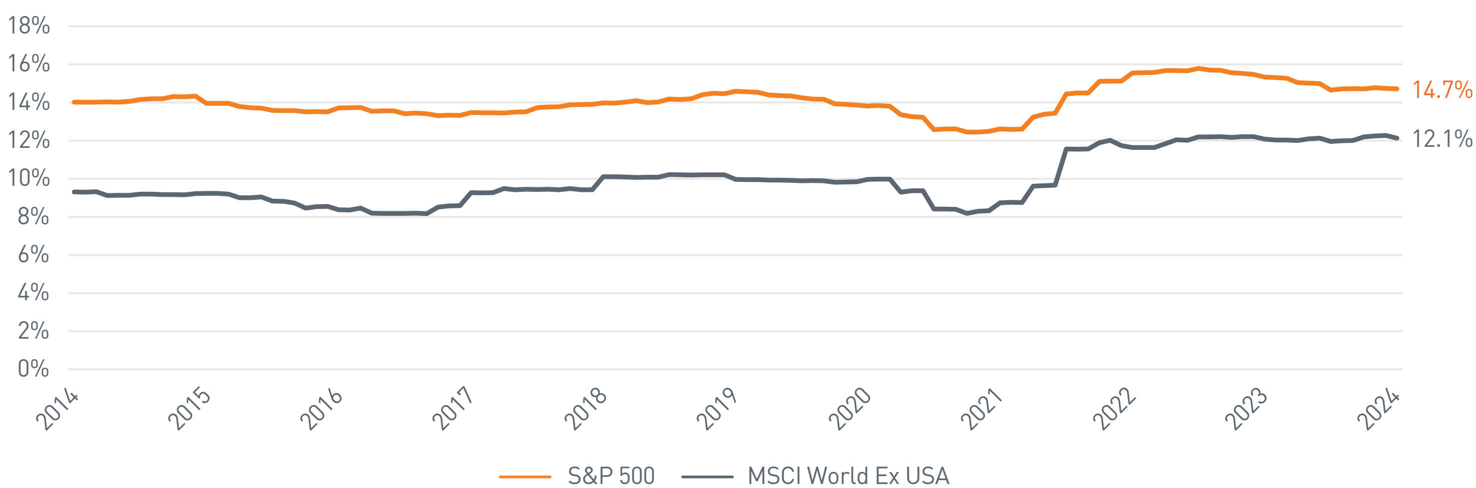
We have been tactically underweight developed international equities in our asset allocations since October 2022. When we initiated our underweight, we identified several major headwinds that supported our rationale that we believe still exist today.

First, we are concerned about Europe and Japan's dependence on imported sources of energy. In the initial aftermath of Russia's invasion of Ukraine, energy prices increased substantially, as sanctions limited Russian energy exports. Because Europe and Japan import 60% and 90% of their energy needs, respectively, there was substantial risk to their economies from rising energy costs. A milder-than-expected winter and slower post-pandemic recovery in China prevented the worst-case scenario of severe supply/demand imbalances and extreme price increases from occurring. However, the underlying challenges to their net-import position remain. Given the ongoing OPEC+ production cuts and multiple wars in the region, there is a continued risk of rapidly rising energy prices.

Next among our concerns for developed international equities is the ongoing battle against inflation, primarily within Europe. Much like the U.S., Europe has been fighting elevated inflation since the onset of the pandemic. But unlike the U.S., many European countries were experiencing low rates of economic growth as inflation began increasing, creating a difficult task for their central banks. Since December 2021, the European Central Bank (ECB) and Bank of England have increased interest rates at a similar pace to the U.S. However, U.S. economic growth has generally remained steady, while some major European economies, such as the U.K. and Germany, have faced contractionary environments. In our view, inflation is an additional concern in these markets as developed international companies' profit margins and profitability metrics are well below those of U.S. large-cap companies (**Figure 8**). Lower profitability puts these companies in a weaker position to defend earnings growth in a rising price environment.

**Figure 8 — EBIT Margin (LTM)**

Developed international market profitability has lagged that of the U.S.

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While developed international markets are more homogeneous than emerging markets, the dynamics in Japan present different potential opportunities and challenges than other developed regions. While the rest of the world was raising interest rates, Japan maintained a negative interest rate until March 2024. By doing so, the yen remained weak, making Japan's exports less expensive to the rest of the world. The export advantage drove Japanese companies' profits higher, leading the Nikkei 225 to break its all-time high set in 1989. However, after nearly a decade of using yield curve control (YCC) to keep interest rates at the Bank of Japan's target level, the central bank now owns a significant portion of the country's debt market. The end of negative interest rates and the gradual unwinding of YCC and its impact on the yen will be a key factor in Japan's economy going forward. At this point, we do not believe the recent shift in Japan's monetary policy warrants a change in our asset allocation stance.

## Emerging Market Equity

Emerging market (EM) equities have traditionally served as a diversifier for U.S. investors. The asset class also maintains a simple, bullish thesis: EM is expected to benefit from higher-for-longer economic growth, fueled by favorable secular and demographic trends. However, risks such as concentration, currency volatility and potential geopolitical instability temper our enthusiasm. As such, we have a neutral near-term outlook on EM equities.

Many EM countries have been experiencing significant growth in middle class consumers, helping to drive increased demand across sectors. In fact, consumer growth has allowed some EM countries to transition toward consumption-driven economies and away from economies driven by commodities and industrial production. These favorable demographic trends are evident in changes in the MSCI Emerging Markets Index over the past 15 years. Commodity-producing countries, such as Brazil, have steadily lost share within the index, while more consumption-driven economies, such as China, India and Taiwan, have increased their proportion of the index (**Figure 9**). Sector weightings tell a similar story as Financials, Consumer Discretionary and Information Technology have grown significantly at the expense of Energy and Materials (**Figure 10**).

**Figure 9 — Top 10 Geographic Domiciles within the MSCI EM Index**

The weightings of consumption-driven economies have increased in the index

| Constituent | 2009 | 2024 |
|---|---|---|
| China/Hong Kong | 18.87% | 23.99% |
| India | 6.31% | 17.94% |
| Taiwan | 11.63% | 17.53% |
| South Korea | 13.31% | 12.57% |
| Brazil | 14.38% | 5.24% |
| Saudi Arabia | N/A | 4.27% |
| South Africa | 7.19% | 2.68% |
| Mexico | 4.40% | 2.58% |
| Indonesia | 1.44% | 1.93% |
| Thailand | 1.30% | 1.58% |

*As of 2/29/2024. Source: FactSet®*

**Figure 10 — MSCI EM Index Sector Composition**

Changes in sector weightings also reflect growth in consumption

| Sector | 2009 | 2024 |
|---|---|---|
| Communication Services | 12.19% | 8.37% |
| Consumer Discretionary | 4.80% | 12.49% |
| Consumer Staples | 5.33% | 5.67% |
| Energy | 15.89% | 5.31% |
| Financials | 20.25% | 22.70% |
| Health Care | 2.79% | 3.58% |
| Industrials | 7.40% | 6.99% |
| Information Technology | 12.37% | 23.31% |
| Materials | 13.40% | 7.17% |
| Real Estate | 1.54% | 1.53% |
| Utilities | 4.04% | 2.87% |

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We believe the technology-focused Consumer Discretionary sector within EMs remains a compelling long-term growth catalyst. The generational shift toward e-commerce is helping transform EMs' technology and telecommunications industries. Additionally, China and other EMs are focused on the long-term shift to renewable energy sources. By adopting renewable energy, these countries could reduce their reliance on fossil fuels, while potentially opening the door to new businesses that could benefit from global renewable adoption.

One concern we have within EM equities is due to China's outsized share of the index. Over the past 15 years, China's correlation with the MSCI Emerging Market Index has been 0.83, significantly larger than India's correlation with the index of 0.69. China's ongoing property market crisis and weak consumer demand, as well as heightened tensions with the U.S., make the index vulnerable to country-specific downside risks.

Another concern within EM is the sensitivity to U.S. interest rates. EM economies generally run current account deficits, which are heavily funded by foreign capital inflows. Due to the increased risks associated with these countries, they must offer considerably higher interest rates than developed markets. Given elevated interest rates in the U.S. and Europe, EMs have to offer even higher interest rates to attract foreign capital, while also potentially increasing their currency volatility.

## What could make us change our stance?

From a short-term perspective, we use our investment process to determine opportunities to tactically underweight or overweight various asset classes across all geographies, resulting in our current home-country bias. From a long-term perspective, we also remain underweight. However, we believe a strategic overweight to international equities could be prudent in the future under several scenarios.

A number of macroeconomic variables, including currency market fluctuations, geopolitical risks and varying business cycles across countries must be considered. Despite the lack of long-term drivers of outperformance over the past few decades, our investment process can help us navigate potential future opportunities.

One key caveat is to avoid the temptation to extrapolate the future from a handful of recent events. A few influences we consider include:

- central bank zero/negative interest rate policies (ZIRP/NIRP);
- developed markets losing manufacturing activity to China's expansion; and
- the rise of U.S. mega-cap technology leaders.

*China and other EMs are focused on the long-term shift to renewable energy sources*

Each of these events derived from specific circumstances, and all were to the detriment of international equities. Therefore, viewing the outlook for international equities relative to these scenarios does not properly account for these regions' current set of circumstances. Should these headwinds recede or even reverse and become tailwinds, investors could stand to benefit.

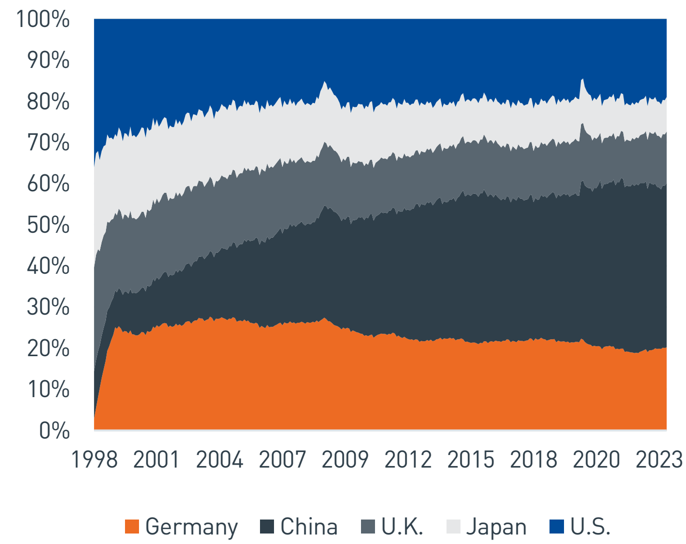
For example, since the ECB ended NIRP in mid-2022, the MSCI Europe Financials sector has outperformed the S&P 500 Financials sector by nearly 600 bps on an annualized basis. This is in stark contrast to the 10 years prior to the end of NIRP. During this period, the performance differential was the opposite, as the S&P 500 Financials sector outperformed by nearly 800 bps annualized. Should central bank policy remain supportive for bank profitability and credit markets, the European Financials sector could benefit over the long term. Furthermore, given potential long-term weakness in the U.S. commercial real estate market, international competitors could have an opportunity to gain global lending market share. Given the size of the Financials sector in international markets relative to the U.S., we believe the long-term trajectory of the respective banking industries could have an outsized influence on equity market performance.

The outlook for international manufacturing remains highly uncertain. Since China joined the World Trade Organization in 2001, data shows that manufacturing across many developed economies has slowed, particularly in Europe (**Figure 11**). Going forward, as manufacturing evolves and deglobalization shifts industrial production away from China, we believe some of that displaced activity could return to traditional developed market hubs, such as Germany, Japan and the U.K.

One such industry driving changes in manufacturing activity could be automobiles, as the shift to electric vehicles (EV) continues to gain traction. For years, China has been the leader in EV manufacturing; however, Europe could emerge as an EV leader as traditional manufacturers refocus on innovative technology within traditional industrial enterprises (**Figure 12**). Additionally,

**Figure 11 — Exports by Country (in U.S. dollars)**

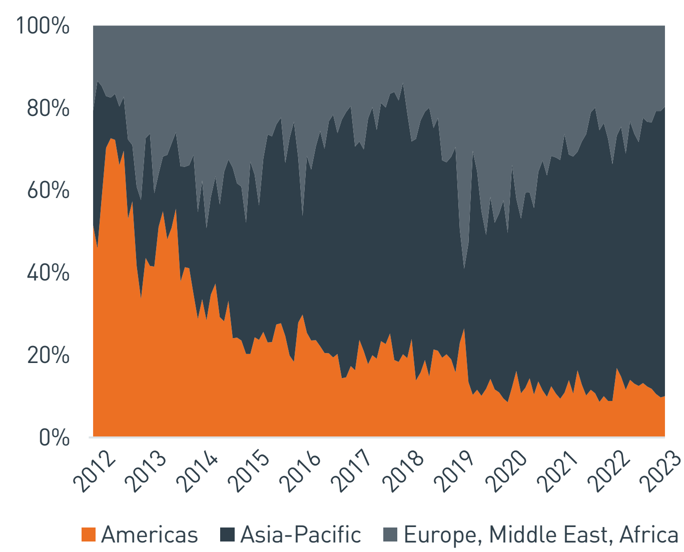
China's manufacturing leadership is at risk as globalization shifts




*As of 2/29/2024. Source: Bloomberg L.P.*

**Figure 12 — EV Sales by Region**

China dominates the EV market in production and sales

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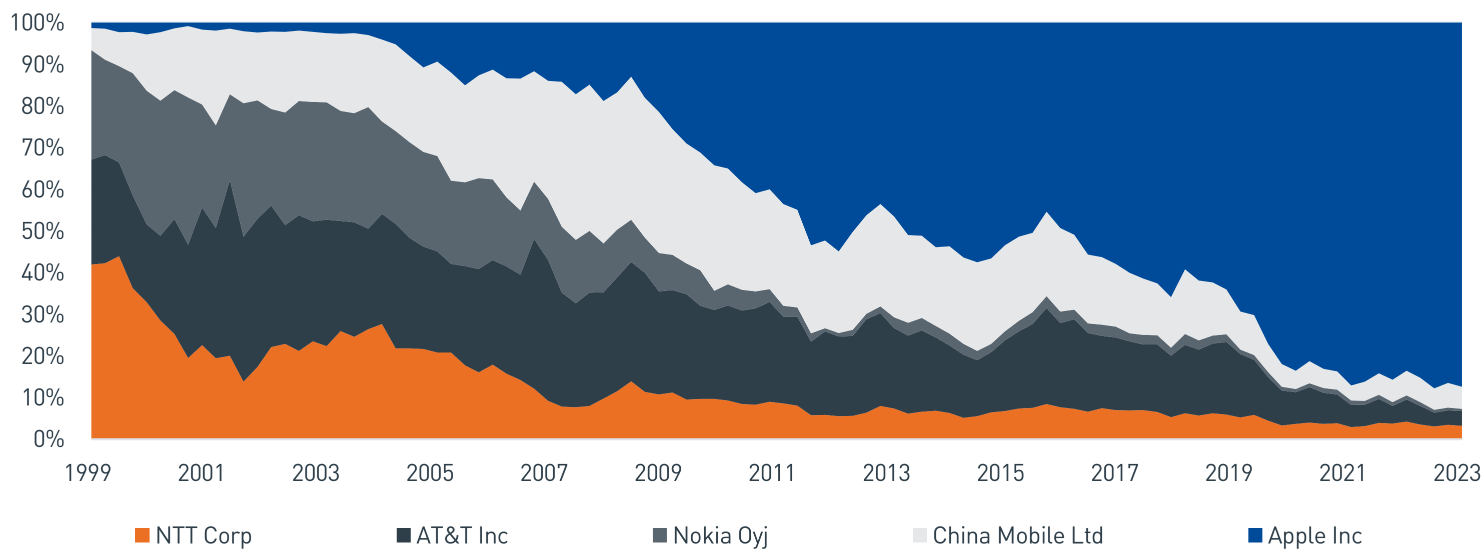
international markets, from Europe to Japan, have shown vulnerability to traditional oil-based energy dependence. Should those regions make alternative energy advancements, the balance of energy security could shift, allowing for yet another significant long-term headwind to dissipate, or even become a tailwind.

AI is expected to enhance innovation opportunities across industries. For Europe and Japan, AI-driven telecommunications innovation could shift back to these regions as they once led this industry before smartphones drastically changed the competitive landscape (**Figure 13**). While the path forward for AI leadership remains highly uncertain, there is a window of opportunity for international firms to gain market share.

For EM, we continue to expect a higher level of economic and consumption growth compared to developed markets, fueled by secular drivers and favorable demographics. The universe of EM equities covers more than 80% of the world's population across 24 countries, offering significant economic potential from a large and growing middle class. While China has been at the forefront of that expansion, government policies during the post-pandemic period have been detrimental to its growth as the country's needs rapidly evolve from its prior heavy-industry, commodity-based economy. Should the second largest economy in the world struggle to transition to a consumer-driven source of global economic growth, we may reconsider maintaining a strategic overweight to EM relative to its share in the MSCI ACWI ex USA index.

**Figure 13 — Market Capitalization of Select Telecommunications Companies**

The next supercycle of AI and cellular network development could shift innovation away from the U.S.

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## This time is no different

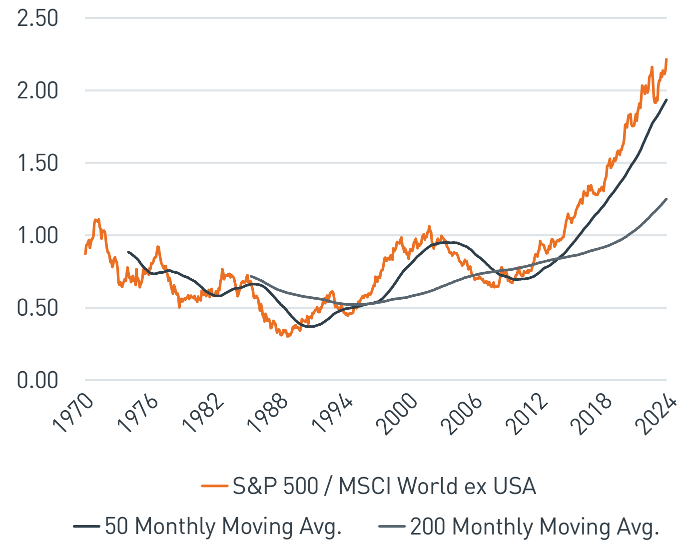
Sir John Templeton is credited with saying the four most costly words in investing are "this time is different." While non-U.S. equity markets have been out of favor in the recent past, we do not believe it is prudent to exclude them entirely from multi-asset portfolio allocations.

In the current market environment, our analysis leads us to maintain a home-country bias within our equity allocation (**Figure 14**). However, we maintain exposure to non-U.S. equities with a tactical underweight because we recognize the increased opportunity set an international allocation provides, as well as the potential for competitive risk-adjusted returns.

As market history has shown, expecting a continuation of the recent past can bias long-term assumptions. Although the U.S. has outperformed its international counterparts in recent years, we believe it would be unwise to treat this trend as immutable fact. Thus, we will continue examining all opportunities that arise through our rigorous investment process, regardless of domicile.

**Figure 14 — S&P 500 vs MSCI World ex USA (price)**

Long-term momentum continues to favor U.S. markets

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