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Equity leadership transition

The case for international equities over US equities is increasingly compelling

Simon Webber
Lead Portfolio Manager
Global and International Equities

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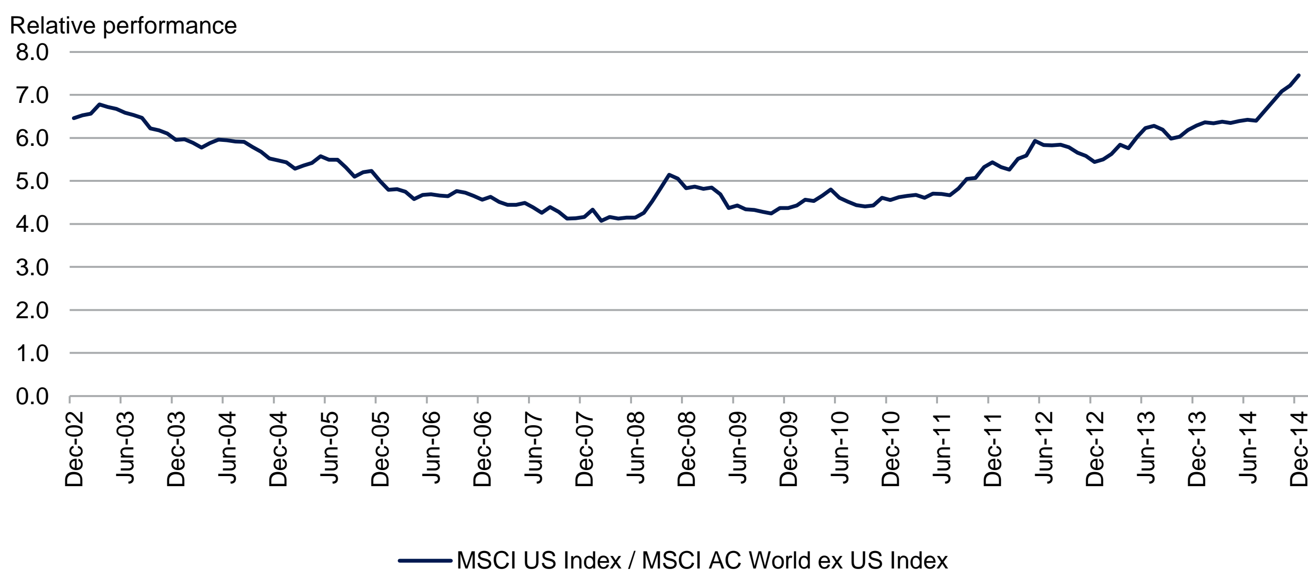
As we enter the seventh year of the US bull market, we have likely reached a tipping point where international equities will begin to generate superior returns to US equities. In recent months our bottom-up fundamental research process has been identifying an increasing number of compelling ideas in non-US equity markets, but there are also several powerful high-level factors that suggest international equities may offer higher future returns. This note argues why increasing competitiveness, the commodities dividend, corporate profit growth, and valuations are combining to make a powerful case for non-US equities. The outperformance of non-US equities over the first weeks of 2015 could be a taste of things to come.

Long-term market returns

2014 continued the trend of stellar outperformance of US equities that began in 2010. Figure 1 shows that this recent trend is a reversal of previous years: six out of the seven preceding years saw international equities outperform US equities. Yet, over 10-15 years, returns are strikingly similar (from the start of 2003 to the end of 2014 the total return in US dollars of both US and international equities were 9.5%), a result that surprises people with short memories.

Figure 1: US equities vs. international equities performance



Source: Bloomberg. February 2015

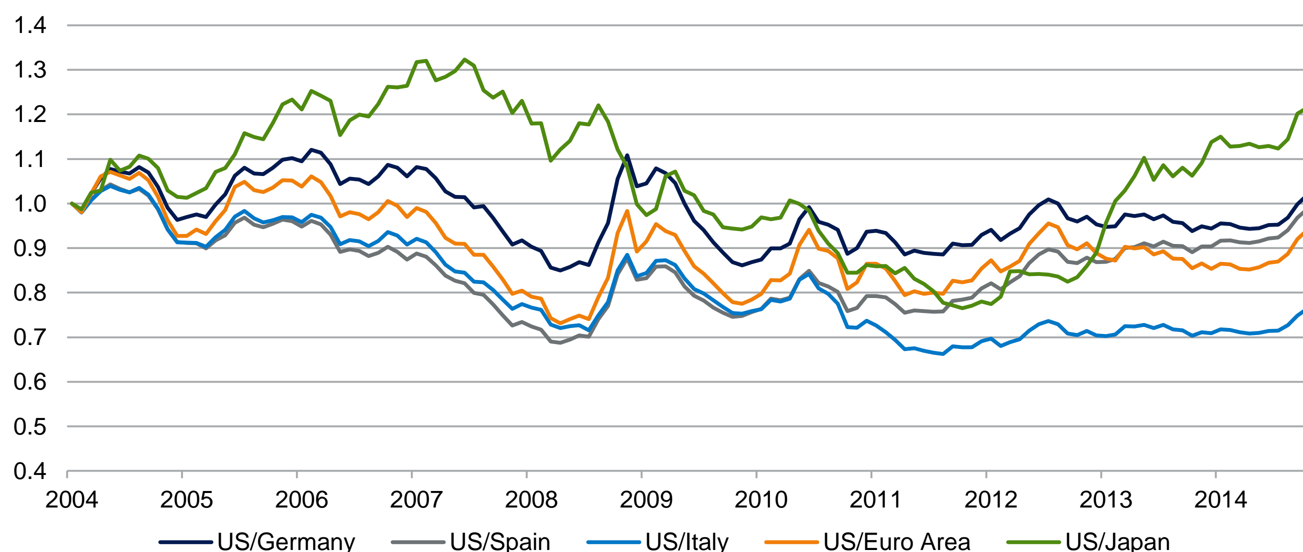
Competitiveness: the foundation of long-term economic growth

Strong US equity market performance is, of course, a function of the extent to which the US economy has responded to stimulus introduced by policymakers in the aftermath of the financial crisis in 2008. It is noteworthy that prompt and, some would say radical, action by the US authorities contributed to US leadership out of recession. However, the strength of the economy and separately, the success of US corporates, have also been built on the foundations of a competitive and flexible US economy. This is especially so when contrasted with Europe's rigid and expensive labour laws.

That said, a combination of wage restraint in Japan and Europe, and the recent strengthening of the US dollar, has had a dramatic effect on relative labour costs, which will begin to influence corporate investment decisions in the years ahead. We can look at this in two important ways: in terms of trend and absolute level of labour costs. Both show a significant shift in favour of Europe and Japan.

Figure 2 shows the trend in the US real effective exchange rate: that is, the exchange rate adjusted for relative changes in unit labour costs. This highlights an extended period of improved competitiveness in the last decade for the US over Japan and Europe through to the end of 2012. Since then, the competitiveness afforded by labour costs has fully reversed in the case of Germany and Spain, and has moved even more in favour of Japan. Italy continues to suffer from uncompetitive labour pricing, highlighting the important differences in the pace of reform within Europe. In addition to this improvement in the price of labour, both Japan and Europe remain in the process of reforming labour laws, which will further improve competitiveness in the years ahead.

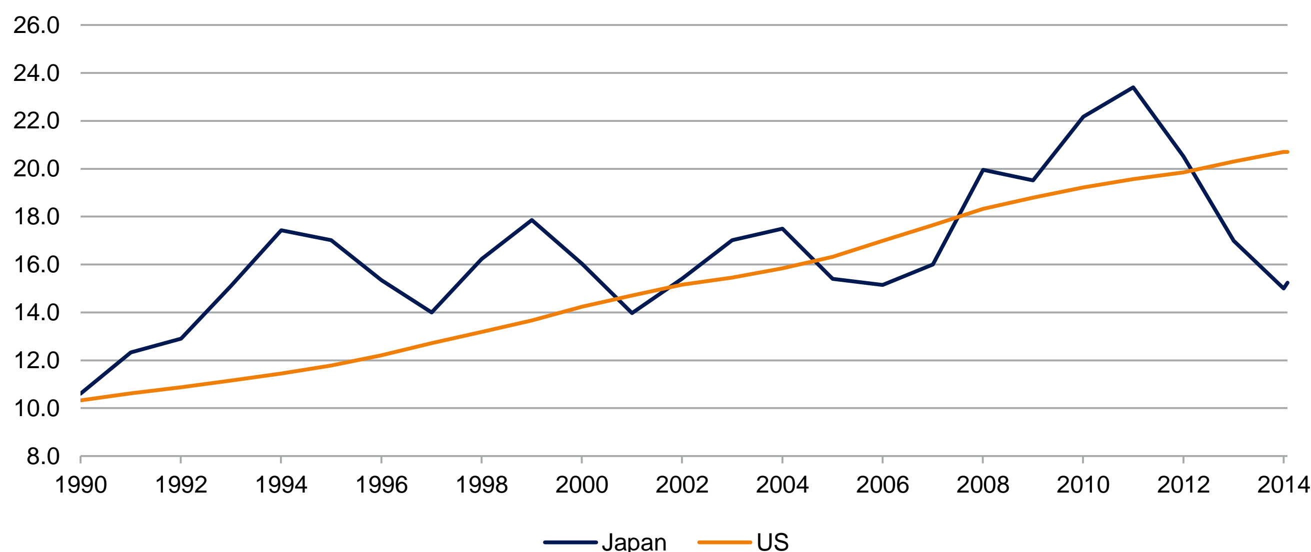
Figure 2: US real effective exchange rate: Unit labour cost basis relative to eurozone and Japan (2004=1)



Source: National Statistics, Bloomberg, Citigroup, Schroders. February 2015

Figure 3 illustrates average hourly wages in both the US and Japan in US dollar terms, and makes very clear how dramatically the shift in the cost of labour has moved between the two highly skilled and developed nations. Japanese average hourly wages have moved from a 50% premium to a 25% discount to the US in the space of 20 years.

Figure 3: Average hourly wages – US and Japan (in US dollars)



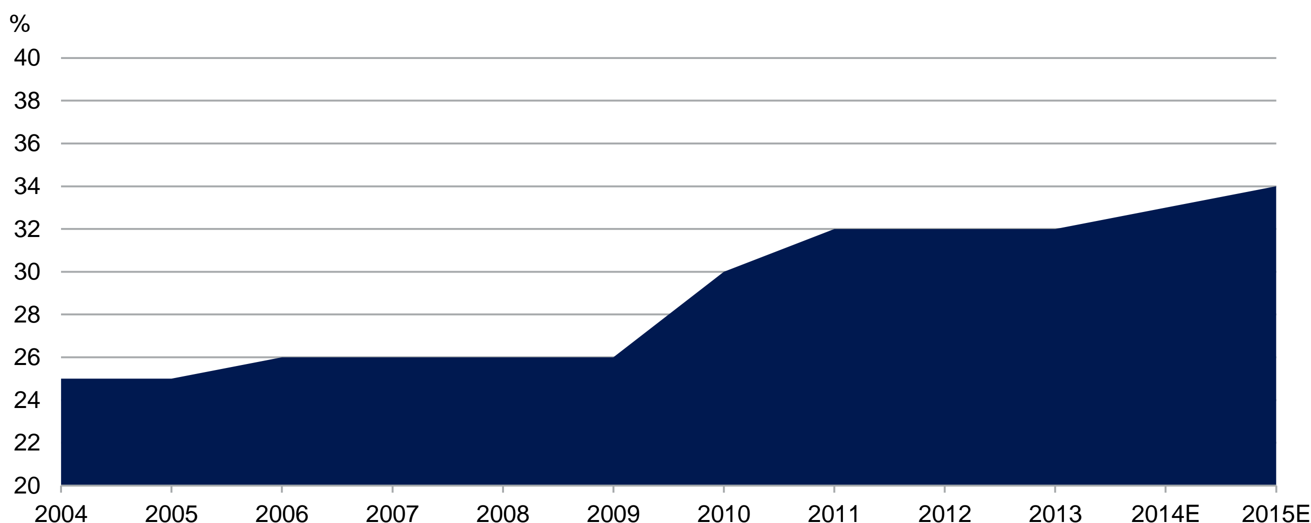
Source: National Statistics, Morgan Stanley, Schroders. February 2015

The impact on companies and economies is now emerging

Economic competitiveness can take a long time to feed through into corporate earnings and investment decisions. Management pre-conceptions can take time to change, and investor time horizons are frequently much shorter than this. However, we are clearly starting to see evidence of this competitiveness reflected in the growth rates of economies and companies.

A perfect example is SMC, the global leader in pneumatic equipment for factory automation. The company has a global distribution reach, yet manufactures a high proportion of its goods in Japan and thus has widened its cost leadership over global competitors in the last 3-5 years. As a result, market share gains have been steady and even accelerating, as shown in Figure 4, with the most impressive share gains taken from US competitors. This is not an isolated case and there are many other examples of Japanese companies in industries such as steel, tyres, autos, and technology that are growing market share through a combination cost competitiveness and superior product quality.

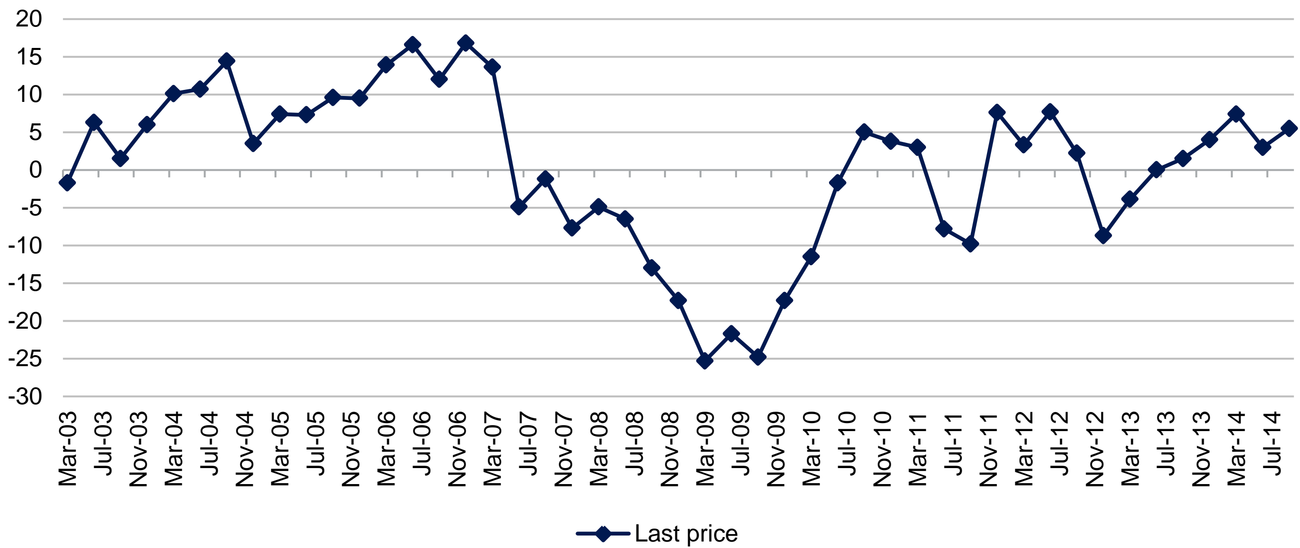
Figure 4: SMC global market share of pneumatic equipment sales



Source: SMC, Credit Suisse. February 2015

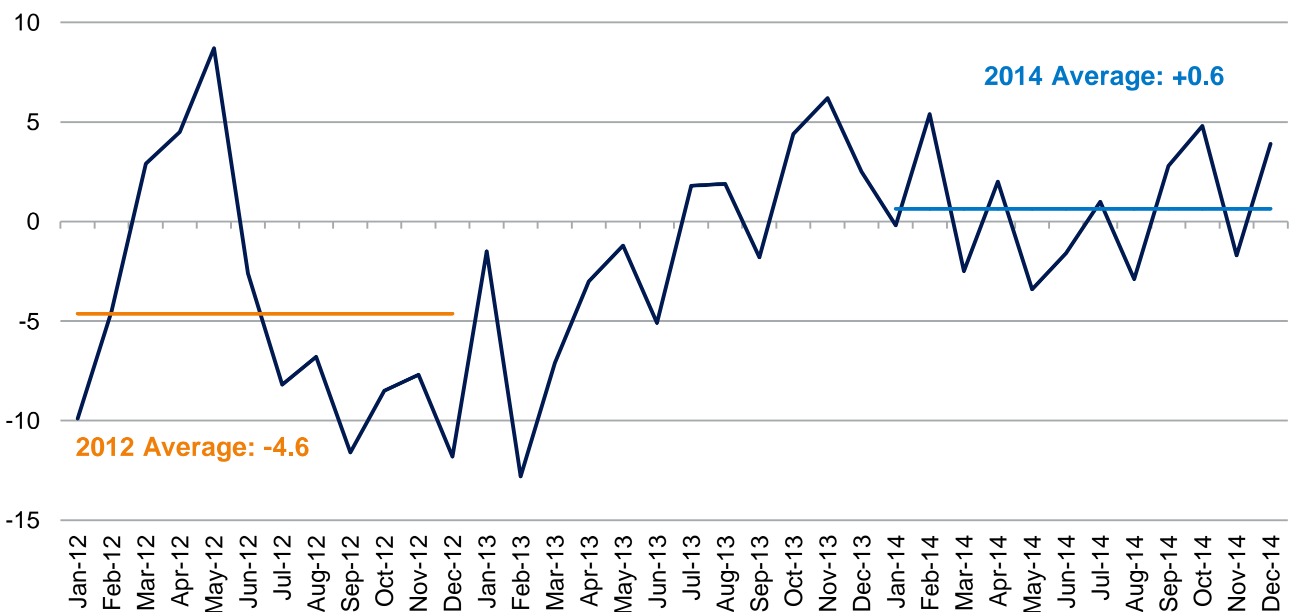
There is also evidence at an aggregate level of re-shoring by corporate Japan. As Figure 5 shows below, Japanese capital spending has picked up markedly since early 2013, and export volume growth has been improving significantly since 2012, with 2015 likely to see a further acceleration (see Figure 6)

Figure 5: Japanese capital investment (year on year)



Source: Bloomberg, Ministry of Finance Japan. February 2015

Figure 6: Japanese exports volume growth (year on year)

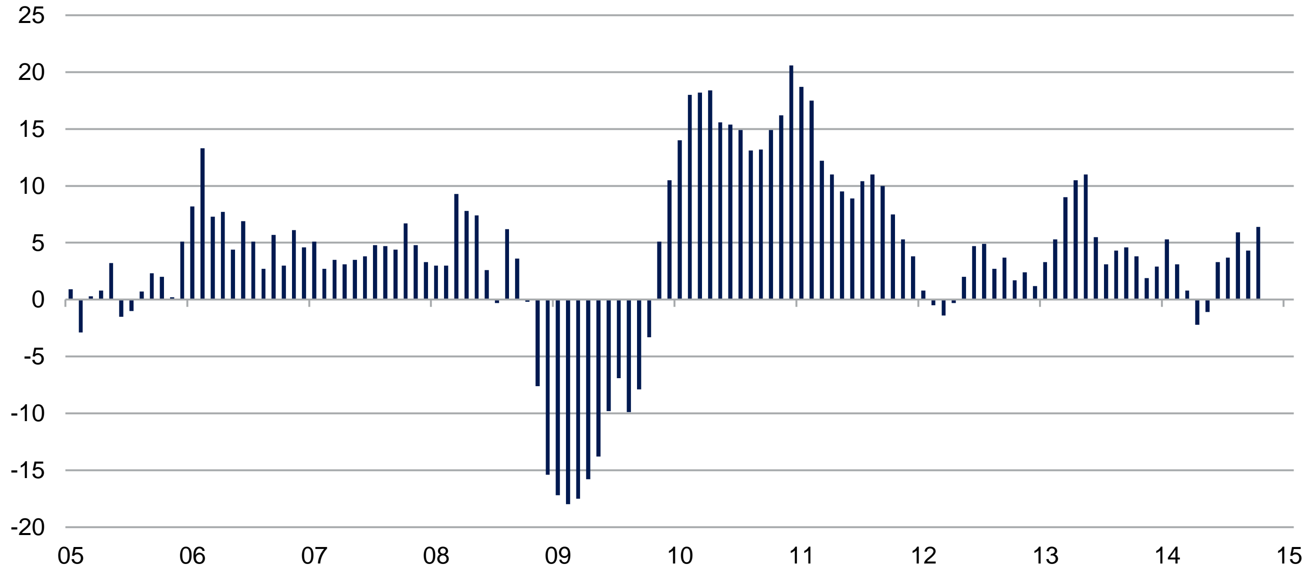


Source: Bloomberg, Ministry of Finance Japan. February 2015

Within Europe, Spanish exports have been growing strongly for several years now (see Figure 7) and along with painful labour market reforms, have now kicked off a virtuous cycle of growth. Who would have thought a year ago that Spain would be seeing the most significant upgrades to GDP forecasts in the developed world (see Figure 8)?

Figure 7: Spain exports

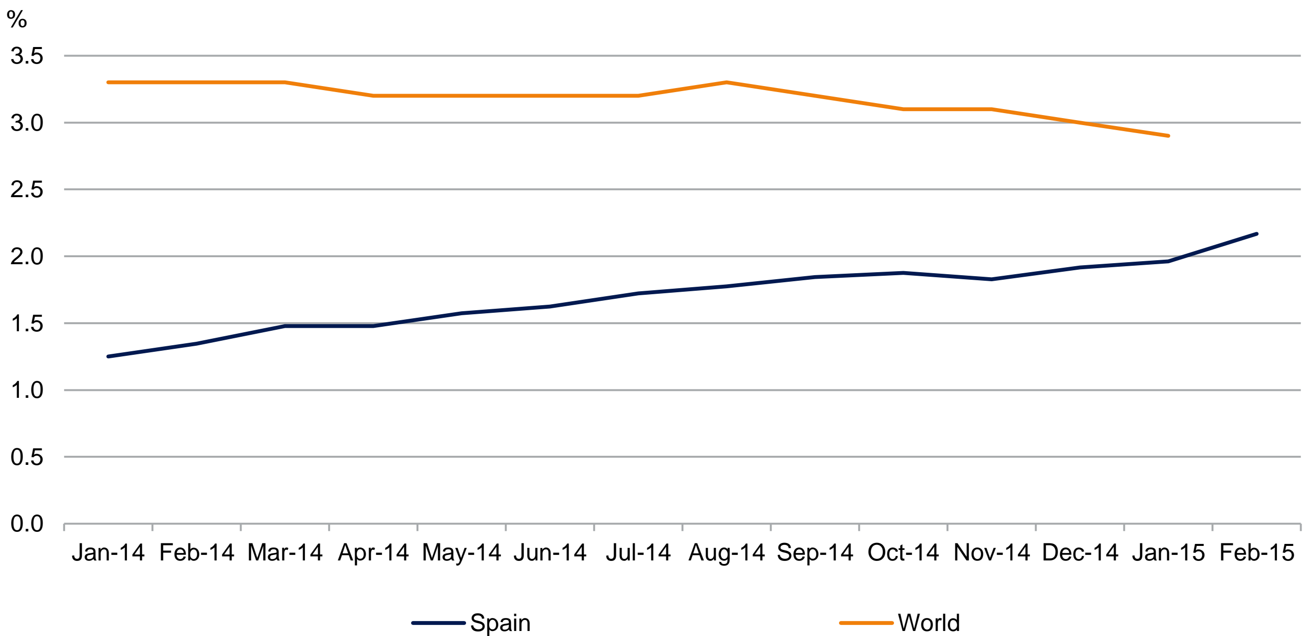
y/y%, 3-month moving average



Source: DataStream. February 2015

Figure 8: 2015 Consensus GDP forecasts for Spain

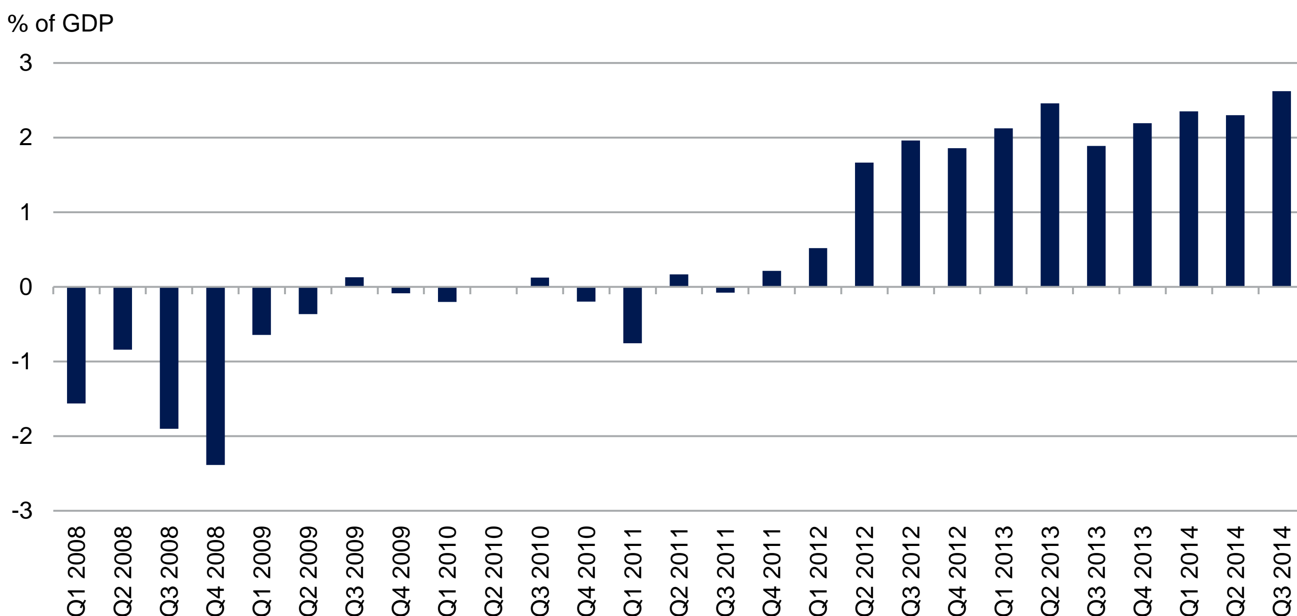
%



Source: DataStream. February 2015

Across the eurozone, the current account surplus continues to grow, highlighting that the region in aggregate remains competitive in international trade (see Figure 9), and this data does not yet reflect the boost to exports that will come from the 10% fall in the euro that has occurred since late 2014.

Figure 9: Europe current account balance

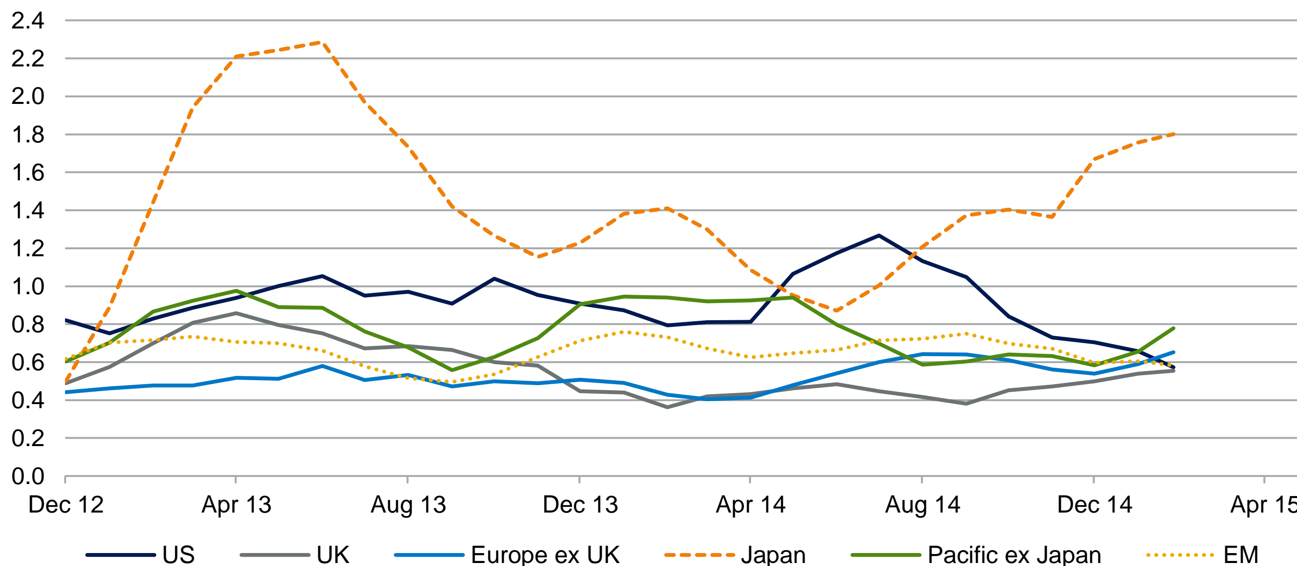


Source: DataStream. February 2015

Corporate earnings also responding

The impact of increased economic competitiveness outside of the US can also be seen in aggregate corporate earnings growth and revisions. As the dust settles on the fourth quarter's earnings season, revision trends are startlingly diverse (see Figure 10) and demonstrate that many large US companies are struggling with more than just the translation effect of the strong dollar. Large companies such as Proctor and Gamble and Microsoft have guided to significant headwinds to margins in 2015 because of a higher relative US dollar cost base. The stronger dollar is now beginning to inflict some pain on corporate America, but these impacts are only just beginning to be felt as a significant part of the currency appreciation has been very recent.

Figure 10: Earnings revision ratio by region (to mid-February 2015)



Source: Schroders,DataStream.

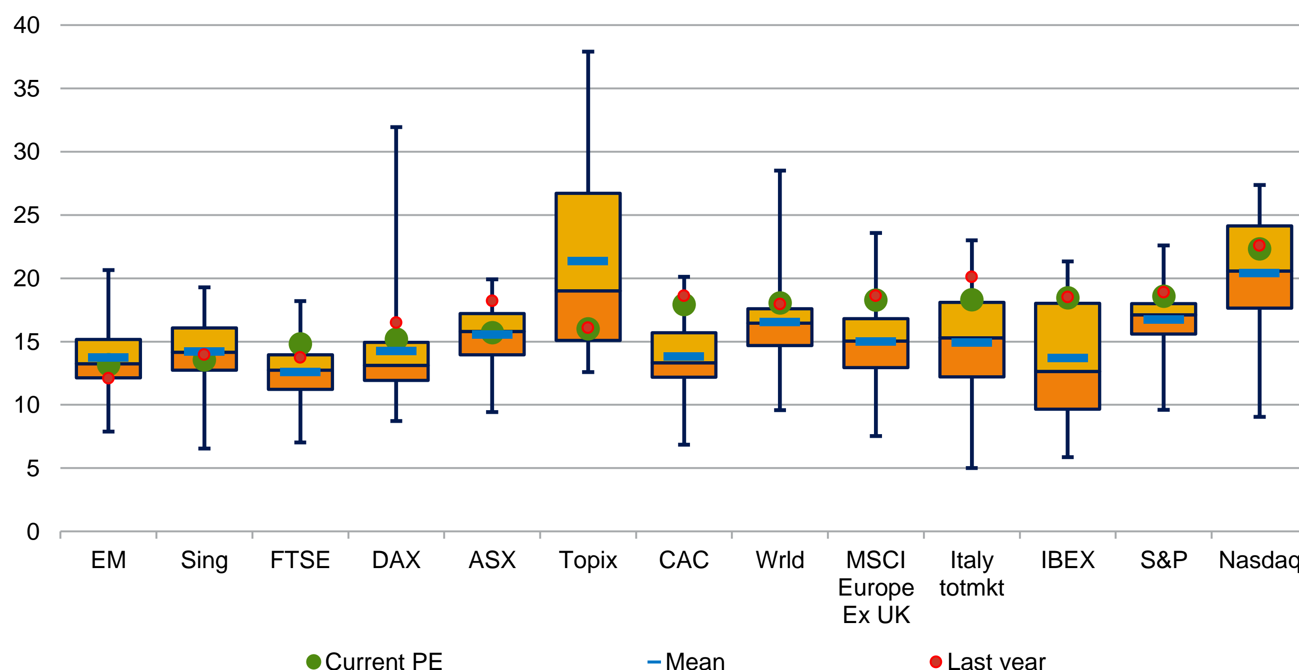
The commodities dividend

In the short-term, global consumption will be boosted by lower energy prices, and longer term lower energy prices will also improve the competitiveness of importing regions. Convention has it that the US consumer, with its well known obsession with gasoline prices, is the biggest beneficiary of lower oil prices. However, most of the major investable markets outside of the US (particularly the large commodity importers such as Japan, the eurozone, China and India) also stand to benefit. Only Russia, Brazil, Mexico, Canada, Australia, and Norway really suffer materially. For example the EU imports 88% of its oil, and net oil imports into Japan alone account for 3.1% of GDP. When all the positive and negative impacts of lower oil prices are combined, including reduced energy sector investment levels, UBS estimate that a $10 decline in the oil price contributes +0.2% to European GDP growth compared to only +0.1% to US growth.

Valuations more attractive outside the US

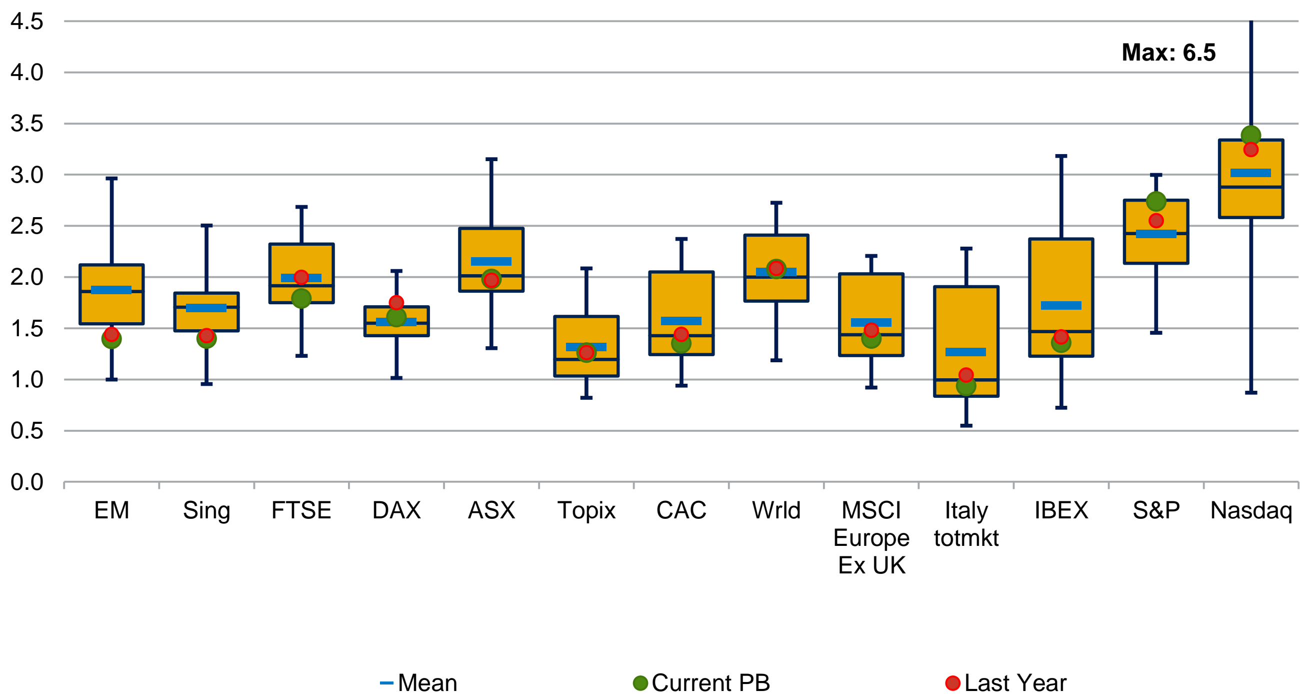
Starting valuation always matters greatly to long-term returns, and there is no need to reproduce that evidence here. Today valuations are clearly more attractive outside the US, both in absolute terms and relative to history on a variety of measures (Figures 11 and 12). These charts highlight that international equity markets are closer to their long-run average valuations than US equities, and this is on a more depressed level of earnings given the economic cycles in the respective regions. While there are of course important differences in industry weights and business models to be accounted for between regions, overall the opportunity for further re-rating in international shares seems higher than for US equities at this point.

Figure 11: Developed market 10-year price-to-earning (PE)



Source: DataStream, Schroders. January 2015. Note: The box and whisker plot compares the current and last month's PE to the distribution of the ratios over the last 10 years for the various indices shown. The whiskers show the minimum and maximum PE values over the period while the orange boxes indicate the 2nd and 3rd quartile of the distribution. The boxes are divided by a line which represents the median value.

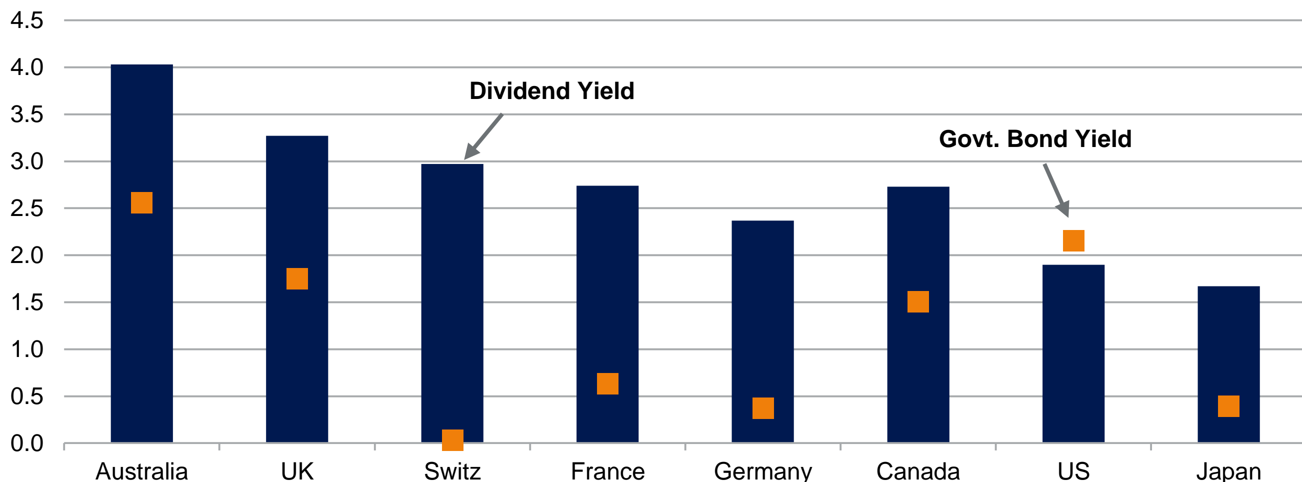
Figure 12: Developed market 10-year price-to-book (P/B)



Source: DataStream, Schroders. January 2015. Note: The box and whisker plot compares the current and last month's PB ratio to the distribution of the ratios over the last 10 years for the various indices shown. The whiskers show the minimum and maximum PB values over the period while the orange boxes indicate the 2nd and 3rd quartile of the distribution. The boxes are divided by a line which represents the median value.

Now that most government bonds yield a pittance across the yield curve, more equity market participants consider the value of equities in terms of the income generation potential and thus the relative yield compared to government bonds. Note that in general we believe that investor demand for these 'equity bond-proxies' are being dangerously distorted by an unnecessary preference for income over capital as a source of return. Nevertheless, it is a valuation comparison many investors use. On this basis too, international equities look much more attractive than their US counterparts, as highlighted in Figure 13 which shows the comparison of domestic equities dividend yield to the relevant 10-year government bond.

Figure 13: Equity market dividend yield vs. domestic 10-year government bond yield



Source: Citigroup, DataStream. February 2015

Fertile ground for stockpickers

Consensus has it that the US economy is largely decoupled from the rest of the world, and that international economies are a source of risk to the US bull market. We see it very differently, with conditions emerging for a change of equity market leadership towards the 50% of equity market value, 75% of the global economy, and 95% of the world population that exists outside of the US. Whilst in aggregate this view may hold true, it is of course, an over-simplification of what is an increasingly complex investment environment which demands much more than a regional perspective.

Across markets we expect shares to deliver a range of outcomes, with returns being driven primarily by company fundamentals and earnings surprises rather than simply based on the rather arbitrary decision about where a company chooses to list its equity. This is fertile ground for bottom-up stockpickers able to exploit a range of opportunities from the breadth of international or global markets.

Please note that stocks and sectors are mentioned for illustrative purposes and should not be viewed as a recommendation to buy/sell.

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