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INVESTMENT MANAGEMENT

Market Musings 04/25

For Professional Investors only

Mind the gap!

The gap in valuation between the US and the rest of the world has been discussed at great length, and explanations as to why such a gap exists are plentiful. Some of the more common explanations include the higher exposure in US to leading tech companies, and the US economy being in an almost perennial state of higher growth. Both are true, and both justify a higher valuation, and for this reason, assuming that the valuation gap between the US and the rest of the world will fully close is a stretch.

And focus on the unremarkable

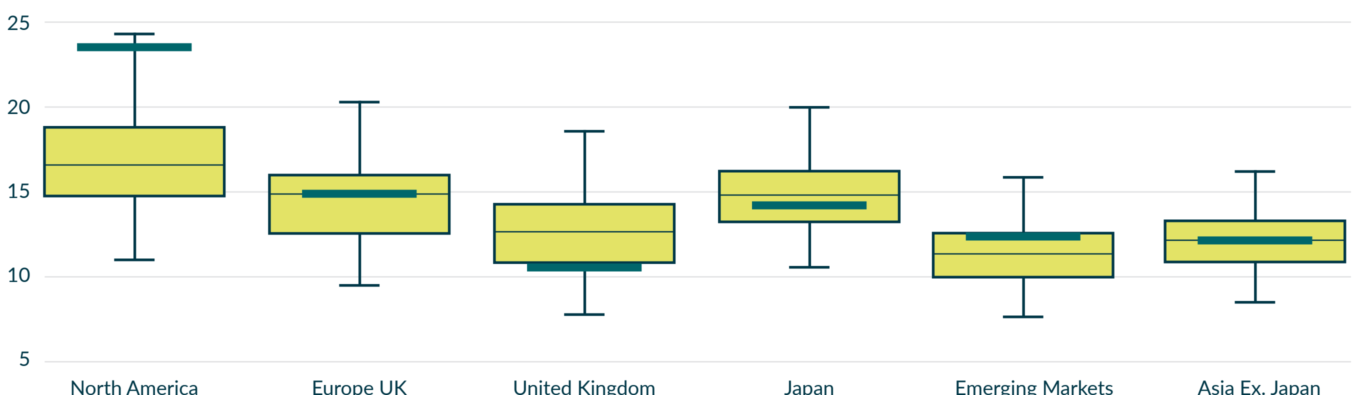
What we concern ourselves with, is how extreme the gap has become recently. This is often explained away by saying it's because of the success of US big tech companies that such a premium is deserved. However, what we show is that it's not just the exceptional companies making the real difference, it's also the unremarkable ones.

A structural gap

We can't simply compare valuation levels across markets and conclude that one is more expensive than the other. We have to account for differences between them in terms of higher - or lower growth, and their exposure to different industries. The graph below shows the distribution of forward price-to-earnings ratios per region over the past 20 years, and at what level each region is currently trading. So, instead of comparing the current levels across markets, we compare each region individually versus its own history. And, by taking prices to expected earnings, we control for different rates of earnings growth.

The boxes show the middle half of the historic trading range, and the horizontal line is the median valuation over the past 20 years. North America (which is dominated by the US market, so will be referred to as the US going forward) stands out, it has historically traded at a premium to the rest of the world, based on the arguments above. Due to the higher growth and a more technology-focused market, that premium is most likely well deserved. Other regions have notably different trading ranges, with lower normal levels which reflect for example their higher risk or lower growth.

Current forward P/E verses historic distribution, per region



Source: Bloomberg – Forward P/E based on consensus estimates, historic distribution per region based on monthly data, indices are MSCI indices per region, as of 1 Jan 2025

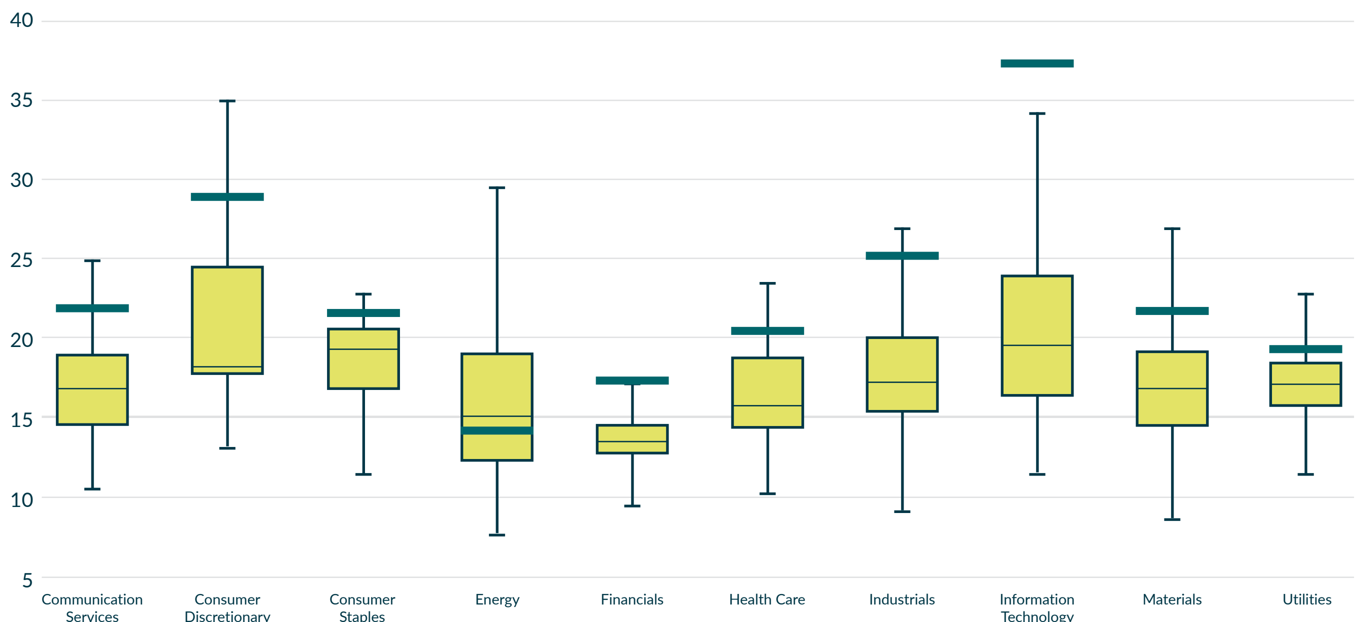
What matters most of course, is where we currently fall within these ranges. At the moment it makes a striking picture: global markets outside the US trading around or below their median historic valuation, while the US is at the top-end of its historic valuation range.

To explain the current difference, the same arguments are applied as for the structural difference: the US is growing faster, and the US tech companies (better known as the Magnificent Seven) are dominating the market. We cannot extend this argument perpetually though; as not every company is a tech company and not every company in the US grows faster than its international counterpart. And even the Magnificent Seven are not so dominant that they alone can fully account for that gap in valuation. In our view, the US market as a whole has grown much more expensive.

Expensive across the board

To account for the effect of a handful of big names boosting the level of market valuations, we did the same exercise as above: by looking at how current valuations compare to their own history in the US and Europe, but split out by sector. If it really is due to a handful of big, exceptional companies bringing the market up, this is where it should show, and in which case, the more benign sectors should still be trading at normal valuations. The graph below however, confirms our view: it's not simply due to an expensive US tech sector, every sector - with the exception of energy but including the much more unremarkable ones such as consumer staples or financials, is trading well in its upper quartile in terms of valuation.

North America forward P/E verses historic distribution, per sector



Source: Bloomberg – Forward P/E based on consensus estimates, historic distribution per region based on monthly data, indices are MSCI sector indices for North America and Europe respectively, as of 1 Jan 2025

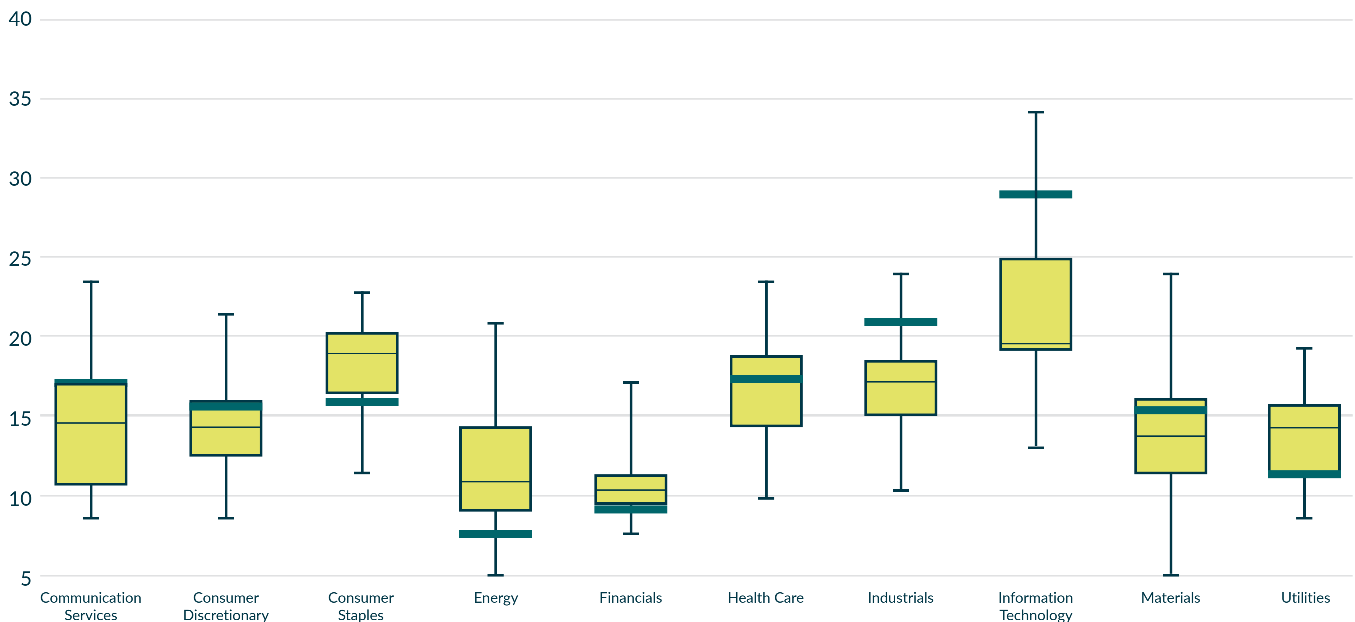
A lower bar

The picture is much more balanced when we look at Europe. On aggregate it's trading on an average valuation compared to its history. And while there are some sectors where valuations stand out on the high-end (European tech is also expensive, for example) there are many that appear quite attractive, and that is taking into account a lower normal level of valuation.

It appears the bar for European companies is much lower. There is little expectation priced into markets, so even small positive market surprises may be enough to generate a positive share price response. So from a valuation perspective, even taking into account the structural differences between markets, it appears there is greater opportunity in Europe.

Comparing these sectors side-by-side across markets raises some interesting questions. Take consumer staples for example. This is not a particular technology-driven, high-growth market. With that in mind, it's much harder to explain why you pay about 6x earnings more for a US staple company compared to a European one. And the same goes for financials, which we previously argued are in good shape in Europe. To summarise, this is where our concern lies and where we believe the opportunity is; comparable, unremarkable companies with wildly different valuations.

Europe forward P/E verses historic distribution, per sector



Source: Bloomberg – Forward P/E based on consensus estimates, historic distribution per region based on monthly data, indices are MSCI sector indices for North America and Europe respectively, as of 1 Jan 2025

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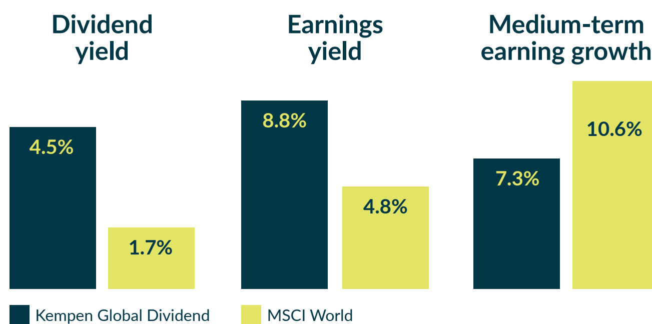
A better balance

Finally, we have to answer the question; what do we do with this information? Simply highlighting that a market is expensive is not particularly useful for an investor, whereas knowing that there are large parts of the market that offer better value for money is. Especially when taking into account that global benchmarks tend to be highly exposed to the more expensive US, it should be possible to construct a portfolio that has a better risk-reward profile than the benchmark.



Source: Factset – weighted average dividend yield, harmonic average earnings yield and est. 3-5yrs EPS growth, as of 1 Jan 2025

This article isn't an argument to not invest in the US, or to invest fully into Europe, or any other region. It's simply stating the case that one needs to be aware of differences across markets. Even when we identify markets and sectors on aggregate as being expensive, there are still opportunities at the individual level in every region and sector. Because in the end, it all comes down to the individual company in which you invest.

Within our dividend strategy, we search for the most interesting opportunities across global markets, and our focus on dividend yield forces us to always be disciplined in terms of valuation. With higher exposure to more attractively valued markets, we are able to target a portfolio with nearly three times the dividend yield, twice the earnings yield, and only a 1/3rd lower expected growth rate. And perhaps most importantly right now, more equally spread across different sectors and regions.

P.S.

We are well aware we could just as well have written this letter a year ago, and since then we've seen a blistering market rally in the US regardless. This shows that valuation is a far from ideal tool for timing markets, but for long-term returns, it's pretty much the only thing to think about: Looking at the relation between the forward P/E of the S&P 500 and the subsequent 10-year returns, and where the US currently stands, really says it all. **Past performance provides no guarantee for the future.**

Source: Bloomberg – Forward P/E based on consensus estimates, monthly data. Returns are annualised total returns for the 10 years following each observed forward P/E, as of 1 Jan 2025

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