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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **April 3, 2024**

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Last week's S&P 500 Index: +0.4%

Cheap for a reason

Key takeaways

- Over the past 17 years, the return on the MSCI Europe, Australasia, and the Far East (EAFE) Index has been close to zero.
- The bottom line is investors pay for earnings growth and Developed Market equities haven't delivered.

We have been leaning toward the U.S. equity market over international markets for the better part of two years. In our view, international equity markets do not appear ready to overtake our domestic market in terms of potential economic and earnings growth as we look out over the next handful of quarters. It may be surprising to some, but a comparison of earnings growth and equity index performance shows a dramatic difference between the S&P 500 Index (SPX) and our Developed Market (ex-U.S.) benchmark, the MSCI EAFE Index.

Looking at Bloomberg data from year-end 2007 through February of this year shows that earnings growth for the SPX is up more than 136% while MSCI EAFE Index earnings over that same time frame are up a mere 2.9%. (That is not a typo; SPX earnings are up nearly 47 times as much over the past 17 years). After trying to absorb and comprehend that magnitude of difference in earnings growth rates, it will be easier to digest the reason why the SPX is slightly more than 247% higher than December 31, 2007, while the MSCI EAFE Index is only 1.4% higher (once again, not a typo). That's right, over the past 17 years, the return on the MSCI EAFE Index has been almost zero. Thinking in terms of the most basic investment principles, equity investors pay for earnings growth and the potential for that growth to continue in the future. And, of course, equities with the perceived most dependable earnings streams tend to carry above-average valuations, all else being equal.

The trend for MSCI EAFE Index valuations, as measured by the price-to-earnings (P/E) ratio relative to the SPX has been down for more than 10 years. Late 2012 was the last time P/E valuations between the two indexes were equal. Prior to that, in our 17-year time frame, the P/E valuation of the MSCI EAFE Index exceeded the SPX for only a brief period of time in 2009. In other words, it has been a long time since investors have preferred Developed Market equities over domestic U.S. stocks, and for good reason. Is this likely to change any time soon? We do not think so.

We argued in last week's Market Commentary that just because the valuation on the SPX is high doesn't mean it can't go higher. We used March 2000, the height of the tech bubble, as an example where valuations were meaningfully higher than now. In this case, we make the argument that just because the valuation on the MSCI EAFE Index relative to the SPX appears cheap doesn't mean that the valuation can't get cheaper. It very well could.

One can bring up a number of points as to why MSCI EAFE Index valuations have trailed the SPX. One is that the SPX leans toward more growth-oriented names that revolve around technology while MSCI EAFE Index has a more cyclical (economically dependent) value bias that tends to carry a lower valuation. But the bottom line is investors pay for earnings growth and Developed Market equities haven't delivered.

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Definitions

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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