Demystifying & Decomposing Global Stock Price Movements in the 2010s

Understanding the Difference in U.S. and non-U.S. Equity Performance Since the 2008 Financial Crisis

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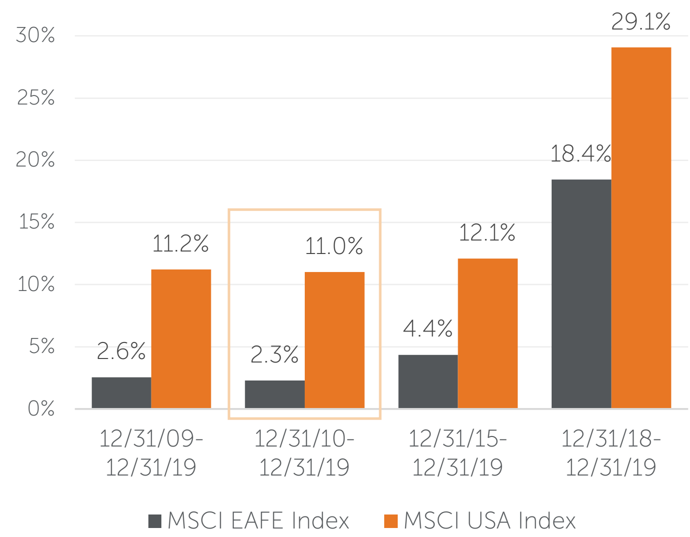
Since the Global Financial Crisis ("GFC"), markets have seen a noticeable return disparity, with U.S. equities delivering superior returns to their non-U.S. peers (Figure 1), outperforming by 8.72% per year. The difference has been so clear-cut and consistent that market participants could be forgiven for thinking this might become a permanent state of affairs and that there is no longer a compelling reason for traditional global diversification.

One possible explanation for this viewpoint is that the U.S. has simply become a more dynamic market than its international counterparts, full of entrepreneurs and risk takers who fostered the unmatched success of innovative ventures like Facebook, Amazon, Apple, Netflix and Google (i.e. the "FAANG" stocks). While these companies certainly had a phenomenal run (average annualized return over the full period of 26.5% - 2.4x that of the benchmark), and the fundamentals of U.S. companies in aggregate were stronger than their non-U.S. peers, we will show that these are not enough to explain the full performance differential.

Figure 1: Annualized Price Return

As of December 31, 2019



Source: SGA, FactSet, MSCI

In this note, we look to quantify both fundamental (operating) as well as external (sentimental) drivers of price performance and examine which of these might persist, and which are more likely to be at risk in the coming decade. So, before reaching any conclusions on investing in non-U.S. companies, it is instructive to understand how the returns were generated and whether the component drivers can be sustained.

Fundamentals - Revenue Growth and Margin Improvement

For the purists, the only explanation for sustainable stock price movements is when the fundamentals underpinning those prices move in a similar fashion. Examining price returns over the past decade, we see that while fundamentals do explain some of the difference in performance of U.S. vs non-U.S. shares, they fall well short of adequately explaining the bulk of the overall differential.

Figure 2 on the next page shows MSCI EAFE annualized revenue growth measured post-financial crisis (from December 2010) was relatively flat (+0.08%). Margins were also largely stable, translating 0.08% revenue growth into minus -0.19% pre-tax income growth.

On the other hand, MSCI USA revenue growth compounded at 3.59% per year for the full period. Margins also improved slightly, resulting in a 3.93% annual growth in pre-tax profits.

So, while U.S. fundamentals were stronger, it is important to note that EAFE pre-tax margins remain depressed and a little more than two-thirds that of MSCI USA, allowing for room to close some of the gap in the future.

All said, fundamental drivers of revenue growth and margin expansion explain less than half the price return of each benchmark index. Therefore, we must look closer at the external drivers of return.

External Drivers - Tax Policy and Investor Preference

Alternatively, Figure 2 shows we can compare Pretax Income Growth and Net Income Growth – the difference between the two driven by taxation. EAFE's -0.19% pretax income growth translated into +0.09% bottom line growth as effective tax rates for non-U.S. companies fell somewhat during the period. However, in the U.S., the difference was starker, as 3.93% pretax income growth translated into 5.94% post-tax.

Figure 3 to the right details how effective tax rates have declined globally, particularly in the U.S and particularly over the past 5-years, reaching a record low at just above 18%.

Put simply, one pre-tax dollar of income provided U.S. and non-U.S. investors with approximately $0.65 and $0.67 in profits (respectively) in the year 2000, given the tax rates in effect at the time. By 2010, those same investors received $0.69 and $0.70 in profits at rates of 31% and 30%. The effect was a fairly similar tax-driven boost to earnings growth over the 10-year period in both regions.

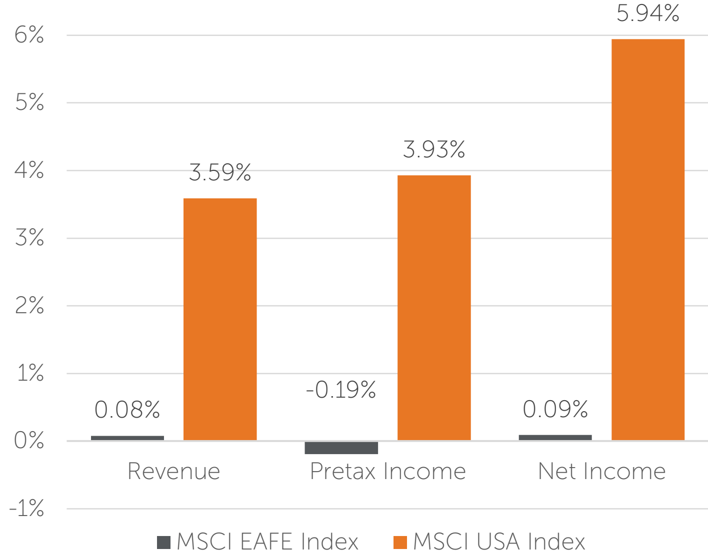
In the most recent period ended December 2019, EAFE constituents received very little boost from falling tax rates, while U.S. firms enjoyed a strong tailwind. That same pre-tax dollar now renders $0.82 for investors in U.S. equities and just $0.71 for investors in non-U.S. companies on a post-tax basis.

Finally, investors considering the future sustainability of this factor will have to address whether they believe there is more room (or appetite) to continue with corporate tax cuts in the U.S., or whether non-U.S. companies may have room to close the gap. We believe the best case for the U.S. will be the status quo, with a reversal in trend more likely than a continuation, while international firms may have more scope to maintain, if not reduce, their tax rates.

Investor preference was also a significant, non-fundamental factor in explaining equity returns over the past decade. This preference, the difference between net income growth and price return, refers to how much an investor is willing to pay for a given dollar of income at a given point in time.

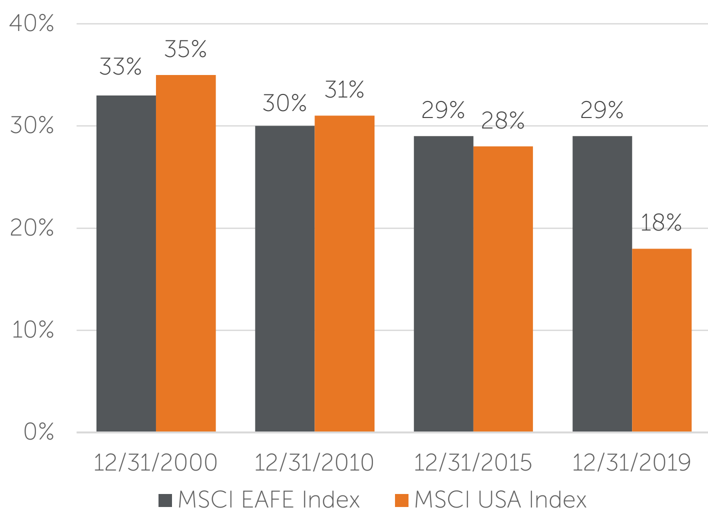
Figure 2: Comparative Annualized Growth

December 2010 – December 2019



Source: SGA, FactSet, MSCI

Figure 3: Effective Tax Rate (%)



Source: SGA, FactSet, MSCI

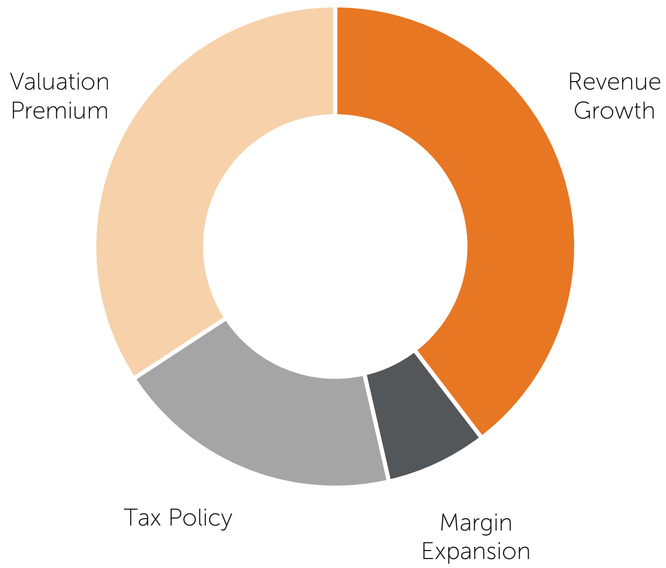
The overall 2.29% USD price return on the EAFE index since December 2010 is due almost entirely to this specific factor (0.08% revenue growth, - 0.27% margin deterioration, 0.28% tax benefit and 2.01% from PE expansion).

For the U.S. benchmark, investor preference was also the single largest driver of stock price returns. Of the 11.01% annual return since the end of the GFC, 3.59% was due to revenue growth; 0.34% due to margin improvement; 2.01% due to the tax effect and 5.07% due to Investor Preference.

In other words, nearly two-thirds of the return on U.S. equities since the GFC was due to simply the non-fundamental factors of tax policy and investor preference.

From a go-forward perspective regarding investor preference, the question is whether investors will continue to be willing to pay a 54% premium for a dollar of U.S.-generated earnings, compared with a dollar of non-U.S. firm earnings. In our mind, sustaining this gap for the coming decade will be a tough ask.

Figure 5: Sources of U.S. Equity Outperformance (2010-2019)



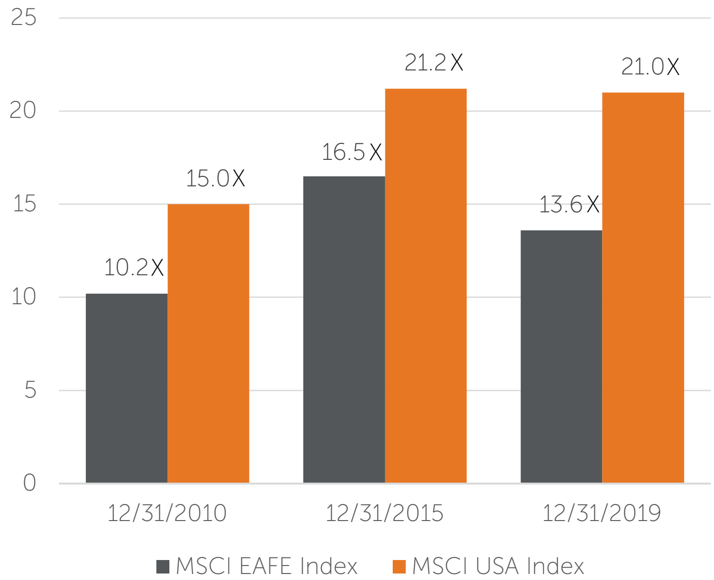
Source: SGA

The Potential to Close the Gap Going Forward

MSCI USA outperformed MSCI EAFE by 8.91% annually from December 31, 2010 to December 31, 2019, as shown in Figure 4. With less than one-half of the price return differential explained by stronger fundamentals (revenue growth, margin expansion), Figure 5 shows the most important drivers were tax policy (falling tax rates in the U.S.) and investor preference (investors more willing to pay a premium for a dollar earned by U.S. companies).

What we did not explicitly further account for in this analysis was the appreciation of the U.S. dollar over this same period. The difference in the Local vs USD return of the EAFE index was 2.19% annually. This difference could be considered embedded in the revenue and margin components of the equation (hard currency translation effect), further reducing the United States' fundamental advantage within our decomposition analysis.

Figure 4: Price to Earnings



Source: SGA, FactSet, MSCI

While beyond the scope of this paper, the carry trade (borrowing in low yielding, or negative interest rate currencies [e.g. the Euro or Yen] and investing in higher interest rate currencies [USD] appears to have supported the dollar's previous appreciation). Whether these interest rate gaps will be sustained enough to further grow the size of the carry trade may be important as to whether the dollar strengthens, stabilizes or weakens in the coming years.

To Summarize

- U.S. companies did show stronger revenue growth than non-U.S. firms when measured in U.S. dollar terms, however removing the currency effect eliminates approximately 60% of this differential.
- U.S. companies showed slightly better margin expansion than did EAFE companies, though one should note that EAFE margins are still about 2/3rd the US level
- U.S. corporate earnings benefited from a significant tax policy tail wind that is unlikely to be repeated.
- Finally, U.S. companies benefited from a greater expansion in the price/earnings multiple, and today a dollar's worth of earnings in the U.S. commands a 54% premium multiple over EAFE.

As investors look at their go-forward plan allocations, we believe it would be wise to keep in mind that companies outside the U.S. seem to have greater scope to improve both fundamental (margin) and external (tax policy, investor preference) levers than their U.S. firm counterparts.

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