Strategic Global Advisors®

A New Year …an Updated Outlook

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Introduction

We noted in our January 2022 outlook (Reflection & Inflection) that global markets were likely on the cusp of an important inflection point. We postulated that the easy money years post the Global Financial Crisis ("GFC")* were over and a return to positive nominal interest rates and an end of quantitative easing (i.e., securities purchases) by global central banks would make the coming years look different than those past. Little did we know how quickly these differences would manifest.

Though our outlook was not specifically a 12-month prognostication (it was intended to cover a multi-year investment cycle), let's look at how we did – where we were on target, where we fell short and where the verdict is still out.

And then, we will seek to build the case supporting our continued preferences for International over US equity markets.

Let's look at how we did – where we were on target, where we fell short and where the verdict is still out

THE REPORT CARD

- ☑ End of the happy dynamic
- ? Slowing GDP
- ☑ Fixed income drought
- ☑ Don't chase yield
- ? Quality to become important
- ☑ Growth at any price to stumble
- ? Core approach favored
- ? Public over private equity
- ☑ Non-US over US equity

[1]GFC began in December 2007 and ended in June 2009.

Economics

In January 2022 we noted: The end of the happy dynamic (falling debt service costs, increasing issuance) and a reversal in interest rate trends are most likely to be triggered by rising inflation and a pull-back in Central Bank security purchases (i.e., tapering).

☑ Bond issuance fell significantly in 2022 (down nearly 46% year over year "(Y/Y") as inflation hit multi-decade highs in most developed countries. While off the peak in some, it remains well above December 2021 levels (G-7 country comparison below) and while inflation may moderate, we do not see it reaching Central Bank targets (2% - 3%) in the coming 12 to 18 months. Interest rates rose quickly and steadily across the developed markets and while Central Bank balance sheets were reduced, they remain elevated.

Bond issuance fell significantly in 2022

Figure 1: Bond Issuance

Issuance ($B)	4Q22	4Q21	Y/Y
Total Market	**1,676**	**3,091**	**-45.8%**
UST	716	1,241	-42.3%
MBS	331	1,036	-68.0%
Corporates	219	380	-42.6%
Agency	289	151	91.5%
Munis	75	120	-37.3%
ABS	46	162	-72.0%

Source: sifma.org.

Figure 2A: Consumer Price Inflation

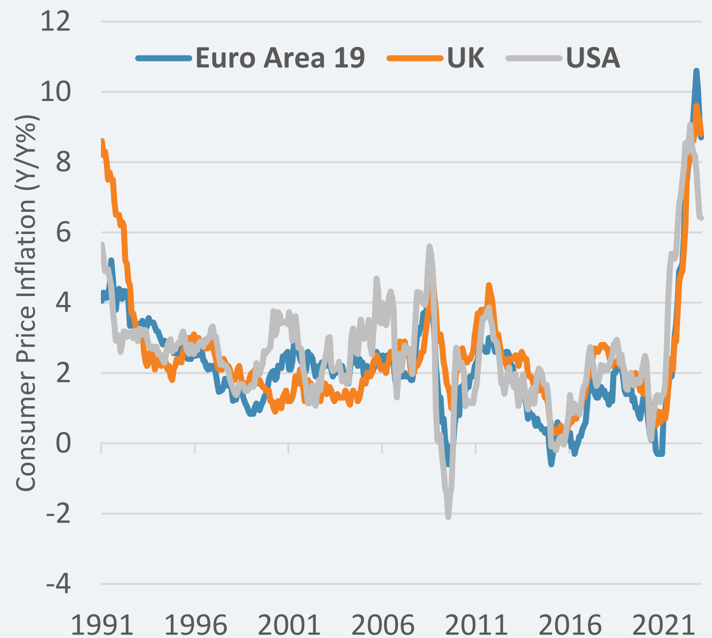
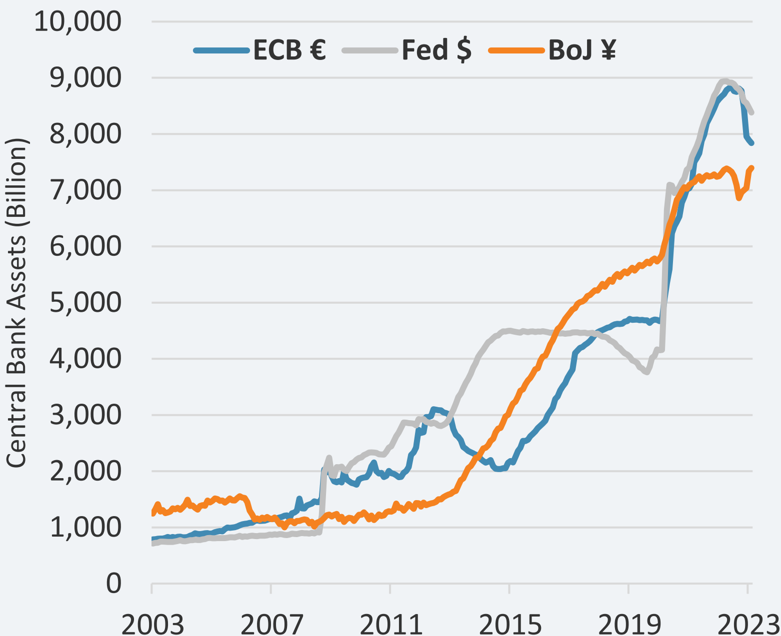


Figure 2B: G-7 Consumer Price Inflation

	DEC 2021	DEC 2022
USA	7.0%	6.5%
GBR	4.8%	9.3%
DEU	5.7%	9.6%
FRA	2.8%	5.9%
ITA	3.9%	11.6%
JNP	0.8%	4.0%
CAN	4.8%	6.3%

Source: Organization for Economic Cooperation and Development, Japan Statistical Agency.

Figure 3: Central Bank Assets



Source: Bank of Japan, European Central Bank, US Federal Reserve.

If rising prices are not transitory, rising debt service costs are certain to have an impact on economic growth while increasing budgetary pressures to raise taxes in a potentially inflationary environment.

❓ Economic growth has slowed across most developed countries in 2022, though we have not seen an outright recession in any. The most recent budget put forth by the White House called for higher taxes on wealthy individuals and corporations in the United States, a pressure we think will persist.

Figure 4: G-7 Real GDP Growth

	DEC 2021	DEC 2022
USA	5.7%	1.9%
GBR	8.9%	2.4%
DEU	1.2%	1.4%
FRA	5.1%	1.0%
ITA	6.9%	2.5%
JNP	0.9%	1.5%
CAN	3.2%	3.6%

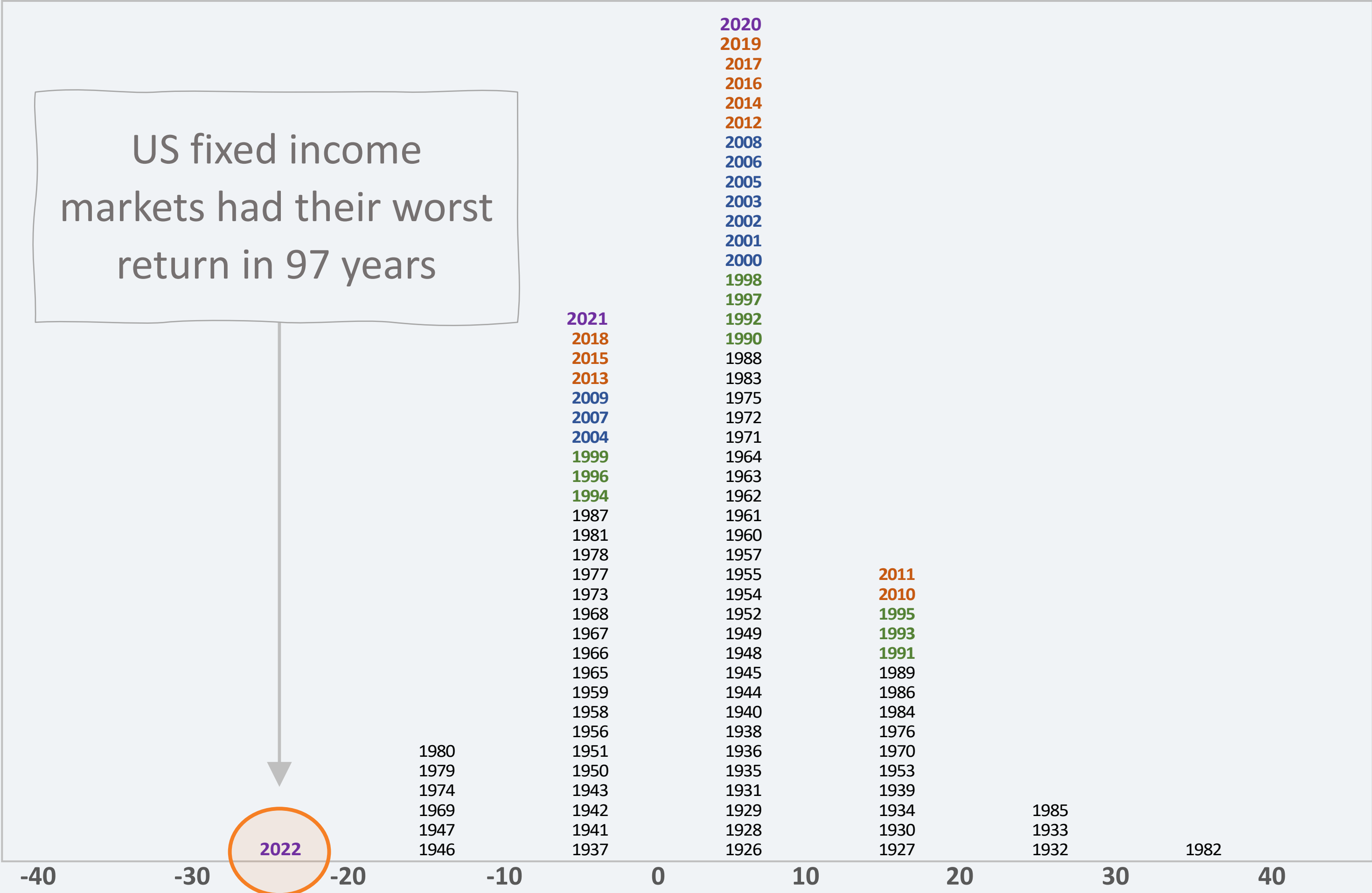
Source: Eurostat, US Bureau of Economic Analysis, IMF, Japan Statistical Agency.

Markets

In the fixed income world, it's going to be tough to make money with yields at (in many cases) century lows.

☑ Fixed income markets in the United States had their worst return in measured (97-year) history. Markets elsewhere also struggled with European Government Bonds (Bloomberg European Government Bond Index) losing 23.5% (in US dollar terms).

Figure 5: 97-Year Return History of Long-Term Corporate Bonds 1926-2022
Average Annual Compounded Real Return = 4%



Source: Target Date Solutions.

Chasing yields by extending down the credit spectrum is less likely to provide as much boost as in the past with spreads now tighter and poor covenant protections raising risk levels.

☑ Bonds of all stripes were down significantly in 2022, while the relative performance of credits were mixed. US Investment Grade credit spreads (Moody's Baa Corp vs UST 10-year) were only 15 basis points ("bps") wider on the year to 199 bps while High Yield bond spreads (Bank of America Merrill Lynch High Yield Index) moved more notably, up 171 bps to 481 bps.

If rates bump higher, quality will become a more important differentiator of stock performance.

[?] This insight is still a work in progress. We have begun to see the quality factor bounce off a relative bottom in our proprietary work – though the timing and magnitude have differed depending on Geography and market cap.

The extremes of Growth at Any Price are likely to stumble.

☑ The Goldman Sachs non-profitable technology index (an equally-weighted index of non-profitable technology shares) was down -62.3% in 2022, far worse than more traditional and diversified equity benchmarks which were, themselves, sharply negative.

We recommend a Core approach, encompassing Quality, Valuation and Growth Factors more than Growth or Value alone

[?] While overall Value has outperformed Growth in the style benchmarks, this has not occurred in a straight line and we have seen, at times, significant reversals as the market negotiates the change in backdrop.

Figure 6: 2022 Relative Returns for Factor Mimicking Portfolios Built on Single Factors Across SGA Strategies

	US LARGE	US SMALL	GLOBAL	INTL LARGE	INTL SMALL
SGA Valuation	5.5%	4.0%	4.0%	4.2%	4.9%
SGA Growth	-4.0%	-0.9%	-3.8%	-4.8%	-3.1%
SGA Quality	1.2%	-0.2%	-0.1%	-0.6%	1.3%
SGA Sentiment	2.2%	1.9%	-1.9%	-5.5%	1.3%

Source: SGA, Alpha Model calculations. See Factor Cumulative Return Disclosure at the end of this paper.

Figure 7: 2022 Index Returns

	2022 TOTAL RETURNS
Goldman Non-Profitable Tech Index	**-62.3%**
US Large Cap (S&P 500)	-18.1%
US Small Cap (Russell 2000)	-20.4%
Global Equity (MSCI World)	-18.1%
Non-US Large Cap (MSCI EAFE)	-14.5%
Non-US Small Cap (MSCI EAFE Small)	-21.4%
Emerging Markets (MSCI Emerging Markets)	-20.1%

Goldman and US indices are gross, MSCI are net.
Source: Standard & Poor's, FTSE Russell, MSCI, Bloomberg.

Figure 8: 2022 Monthly SGA Factor Returns

2022	GROWTH	VALUATION	DIFFERENCE
January	-1.5%	2.5%	-4.0%
February	-0.4%	0.5%	-0.9%
March	-0.5%	-0.5%	0.0%
April	-0.4%	1.3%	-1.7%
May	-1.0%	1.4%	-2.4%
June	0.7%	-0.4%	1.1%
July	0.5%	-0.9%	1.4%
August	0.0%	-0.2%	0.2%
September	0.7%	-0.7%	1.4%
October	-0.4%	0.2%	-0.6%
November	-1.1%	0.4%	-1.5%
December	-0.4%	0.3%	-0.7%

Source: SGA calculations. See Factor Cumulative Return Disclosure at the end of this paper.

We prefer public equity over private equity.

[?] The jury is still out here as well. Private equity tends not to be as obviously volatile as public equity as the fund 's general partner is responsible for "marking to market" their holdings. Often the marks tend to lag that which has been observed in the public markets. Still, the recent developments at Silicon Valley Bank, the lender to many venture companies, raises a cautionary flag over funding appetite in the private capital world – as does the performance of the Goldman Sachs Non-Profitable Technology index which can be viewed as a loose public market proxy for private venture investments. Further, a survey by January Ventures as reported in Grant's Interest Rate Observer (February 24th) shows 81% of early-stage companies had less than 12 months of operating runway before a need of additional funding.

81% of early-stage companies have less than 12 months of operating runway

We prefer non-US markets relative to the US.

[✓] After more than a decade of underperformance, most foreign developed markets beat the US in 2022 (MSCI EAFE outperformed MSCI USA by 530 bps in the calendar year). We think more is to follow after the 7.06% annual compound outperformance of US stocks from the end of the GFC through year-end 2022. We discuss the specifics of why in the following paragraphs.

From Here

We are not walking back on any of our longer term assertions, though we are less negative (that is not to say strongly positive) on fixed income instruments given how quickly rates have risen – Our view is that they are less offensive at low single digit levels than they were at zero percent (or lower in the case of Europe and Asia) and should now be considered in the mix rather than outright avoided. We continue to favor International over US equity markets and public over private markets. We do not yet see a case to take on credit risk in fixed income and would recommend investors focus on the higher end of the credit spectrum.

First, we must start with an understanding of how stock returns are constituted - and for that there are primarily three possible answers.

1) Multiple Expansion (i.e., the Sentiment component). Earnings fall, stay the same or grow, but the multiple an investor is willing to pay for those earnings increases.

2) Earnings Growth (i.e., the fundamental component). Earnings grow and the multiple one is willing to pay for those earnings remains constant.

3) Dividends (i.e., the cash flow component). Companies pay discretionary dividends to holders of their shares. Index-based total return calculations typically assume dividends are used to purchase additional shares of the security from which the dividend was received.

We believe with regards to the above, non-US developed markets are in much better shape.

Non-US developed markets are in much better shape

1) Investors in US domiciled companies (represented by the MSCI USA Index) are willing to pay a multiple more than 40% higher for the same dollar of earnings than that generated by a company domiciled in Europe, Japan or Asia (almost a 100% premium for non-financial companies).

   At year end 2022, the relative PE Ratios were 19.4x for the USA and 13.7x for EAFE (a similar story is told using projected PE's – 17.7x vs 12.2x or Price/Sales ratios – 2.2x vs 1.3x). Such a disparity can only make sense if one expects **substantially** higher, long-term earnings growth from US entities[1].

1) Historically, MSCI USA Index earnings (ex-financials) did grow at a faster rate than those of the EAFE index. (here we focus on ex-financials given the distortions in earnings in that sector coming out of the GFC). However, all is not as it appears given that a fair chunk of the USA advantage came from tax policy rather than operational excellence. Going forward, relative operational growth will likely be the differentiator (as there exists a real risk of a tax rate headwind should US taxes increase as proposed in the most recent White House budget).

2) The MSCI EAFE Index dividend yield was 3.29% at year end 2022 versus the 1.70% on offer for the MSCI USA Index. Therefore, we would expect EAFE index to have a more stable PE ratio than the USA index over time given the higher cash payout, favoring both sentiment (valuation multiples) and cash flow return (dividend yield levels).

Some investors may remain unconvinced and still expect the performance that since the GFC has strongly favored the US will continue.

Figure 9: MSCI EAFE vs. MSCI USA Annual Returns

RANK	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
1	USA 14.8%	USA 1.4%	EAFE 17.3%	USA 31.8%	USA 12.7%	USA 0.7%	USA 10.9%	EAFE 25.0%	USA (5.0%)	USA 30.9%	USA 20.7%	USA 26.5%	EAFE (14.6%)
2	EAFE 7.8%	EAFE (12.1%)	USA 15.3%	EAFE 22.8%	EAFE (4.9%)	EAFE (0.8%)	EAFE 1.0%	USA 21.2%	EAFE (13.8%)	EAFE 22.0%	EAFE 7.8%	EAFE 11.3%	USA (19.9%)

Source: SGA, MSCI.

From the end of the GFC (we use 12/31/2009 as our starting point) and through the end of 2022, the US market returned 11.47% annually compared to non-US shares at 4.41%, while outperforming in 10 of 13 calendar years. Total return for MSCI EAFE over this period was 75% versus 310% for the MSCI USA Index.

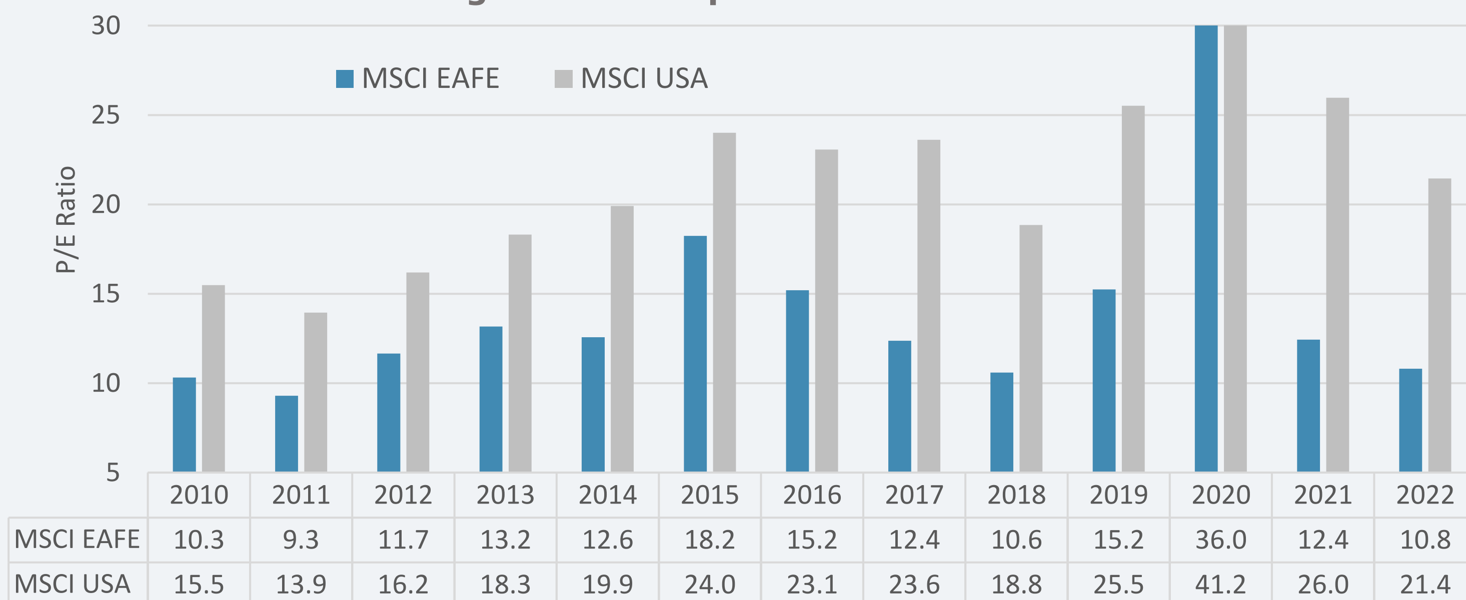
[1]Starting from today's EAFE Index PE ratio of 10.3x (ex-financials) and assuming 3% annual earnings growth, the PE ratio ten years out would be 8.0x. In order for the US PE ratio ten years out to be the same, US Index earnings would have to grow annually at 10.4% - a highly unlikely outcome (since the end of the GFC, the USA Index grew EPS by 6.15% - and that was with some one-time tailwinds).

For the remainder of this note, we focus on each index ex-financials given the distortions to earnings in that sector coming out of the GFC.

1) Simple sentiment explains a large part (roughly one-third) of the difference in historic returns. At year-end 2010, PE valuation levels for MSCI EAFE and USA indices (ex-financials) were 10.3x and 15.5x, respectively. Since then, EAFE investors have remained restrained, willing to pay only a bit more (10.8x) for each dollar of earnings generated by the EAFE index while the same investors have gotten even more comfortable with USA generated earnings, now willing to pay an expanded multiple of 21.4x.

   If multiples had remained constant, USA index returns would have registered at 7.43% annually instead of the realized 11.47%. We propose that future multiple risk is positively skewed for EAFE given its historically low starting point and negatively so for the USA index given its historically higher starting point2.

Figure 10: Comparative Valuations



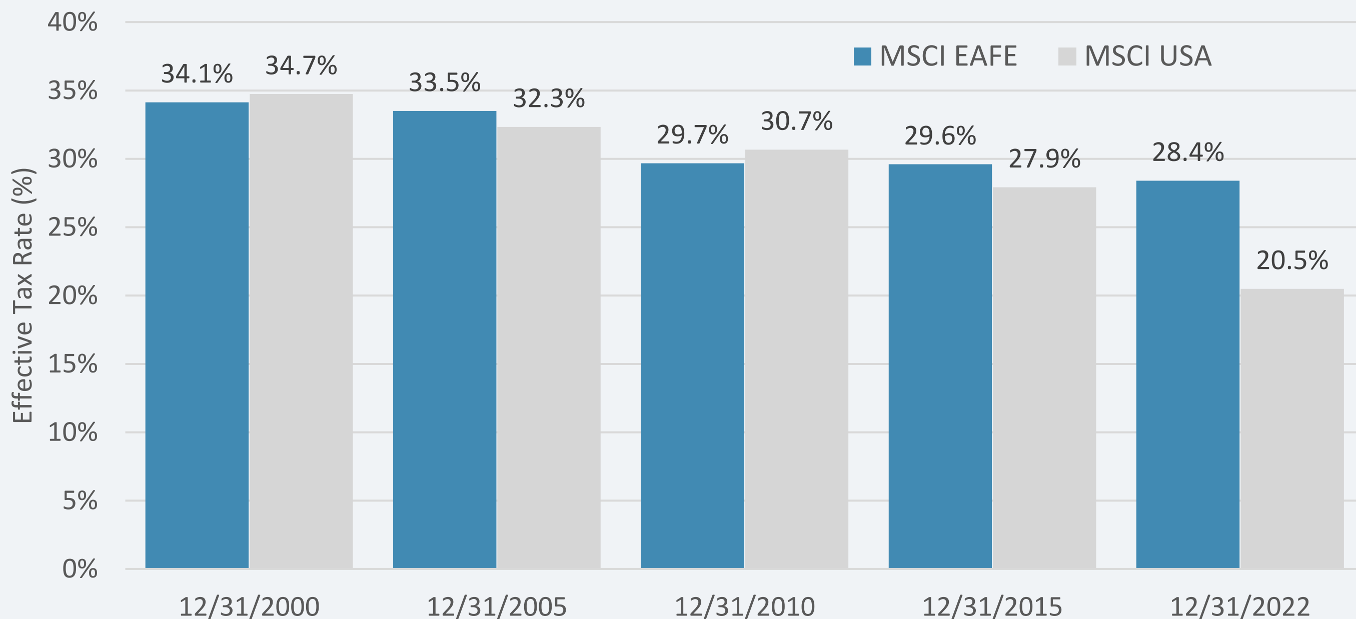
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
MSCI EAFE	10.3	9.3	11.7	13.2	12.6	18.2	15.2	12.4	10.6	15.2	36.0	12.4	10.8
MSCI USA	15.5	13.9	16.2	18.3	19.9	24.0	23.1	23.6	18.8	25.5	41.2	26.0	21.4

Source: FactSet, MSCI, SGA calculation.

2) On the earnings front (since 2010), the USA index EPS growth rate (ex-financials) has been stronger (6.15% annually versus 2.28% for EAFE) – however, not all of that has come from superior operational outcomes, but rather through the discretionary tax policy of the relevant governments.

[2]Based on historical data (1985 – 2022) the median PE ratio for the EAFE index (including financials) has been 15.1x while for the USA Index it was 19.2x. Excluding financials from the calculation, the median EAFE Index PE was 17.3x and the median USA Index PE was 20.4x.

At the end of the GFC, both USA and EAFE index constituents were taxed at an aggregate rate near 30%. Since then, the effective US tax rates (2022) had been cut by over ten percentage points to 20.5%, while the effective EAFE tax rate fell by just 1.3 percentage points. Had tax rates held steady, the USA index EPS growth would have registered 4.94% instead of 6.15% - a decline of 20% in overall USA index EPS growth (and total return at a constant PE ratio).



Source: FactSet, MSCI, SGA calculation.

Conclusion

With non-US developed markets (measured by the MSCI EAFE Index) valued at roughly ½ that of the US (measured by the MSCI USA Index), yielding an additional 159 bps annually and tax policy in the US more likely to become an earnings headwind (rather than the historic tailwind), we believe it will be very tough for the US index to outperform EAFE in the coming decade.

Specifically, we see the scope for the PE in EAFE to move upward toward its longer-term norm, while pressure on the USA PE remains downward. Further, tax policy is unlikely to continue providing a tailwind to US earnings growth and could, potentially, become a negative should tax rates move more toward historic levels. Finally, a consistently superior dividend yield provides a nice (approximately 150 bps annually) head start for EAFE shares and support for PE multiple levels.

It will be very tough for the US index to outperform EAFE in the coming decade

Important Disclosures

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SGA determines the pure factor returns to SGA's Risk and Alpha Factors by constructing a Factor Mimicking Portfolio (" for each alpha and risk factor FMP's are constructed such that the portfolio's exposure (security weights multiplied by exposure, summed up) to the factor in question is 1 and has an exposure of 0 to all other factors relative to the MSCI EAFE (benchmark Returns of the FMPs are calculated monthly and cumulative charts depict the cumulative results of the monthly FMP returns for a given time period For the SGA Alpha Model and Alpha Categories, FMPs are additionally constrained to be long only (no short positions) to better align factor performance to the portfolio opportunity set of SGA's long only strategies An FMP is not a real or hypothetical portfolio and is used strictly to demonstrate pure returns to SGA's Risk and Alpha Factors used in holdings based attribution analysis.

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Mr. Gallagher is President of SGA. Prior to joining the firm, he was a partner and served as Director of Research and Acquisition at Nile Capital Group, a Los Angeles-based private equity firm. Previously, he served as Deputy CIO at Artio Global Investors/Julius Baer Investment Management, Head of Investment Management Asia for JP Morgan Private Bank in Singapore, and Head of Global Equity for Bankers Trust International Private Bank. Mr. Gallagher has appeared numerous times on CNBC, Bloomberg, and Fox Business News as well as having been quoted in The Wall Street Journal. He was also a guest lecturer at Yale University. Mr. Gallagher received his BA in Economics from the University of Virginia and his MBA from The Darden Graduate School of Business. He is currently a member of the Board of Managers and Chair of the Investment Committee for the University of Virginia Alumni Association.