

## International Equities: More Bang for Your Buck

The campaign against inflation launched in early 2022 shook up the hierarchy of financial markets after years of relatively steady leadership. Among the more notable—and potentially most durable, in our view—developments resulting from tighter financial conditions globally has been the outperformance of non-US stocks relative to US names.

The chronic underperformance of international stocks since the global financial crisis had many domestic investors questioning the value of global diversification, which already faced a headwind due to a general tendency toward home-country bias. This is unfortunate, in our view; not only are domestic-heavy portfolios failing to make the most of the diversification benefits that historically have been gained through exposure to foreign markets—including potentially better risk-adjusted returns over the long term—they are missing out on opportunities to own great international businesses with what we view as impressive fundamentals.

While it can be tempting to judge the global opportunity set in the context of a single post-global financial crisis time block, a look at long-term cumulative returns reveals many decades of alternating leadership between domestic and international stocks. In fact, it wasn't until mid-2014 that US dominance emerged in earnest, as pronounced dollar strength and an outsized rally in long-duration stocks such as those comprising the NYSE FANG+ Index provided a significant boost to domestic investment. Discounting the impact of these factors, relative outperformance amounted to only 1.2% per year.<sup>1</sup>

The tailwinds supporting US outperformance moderated late last year, providing a potential glimpse into a less-binary future in which quality and valuation are more important than style box or domicile. And while the opportunity to gain exposure to a wide range of quality businesses has always been an attractive characteristic of international equity markets, in our view, current relative valuation multiples suggest that more “bang for your buck” may be available outside the US.

### KEY TAKEAWAYS

- US equities surged ahead of their international counterparts beginning in mid-2014, driven by a strong dollar and low discount rates that favored investment in long-duration stocks such as those comprising the NYSE FANG+ Index. Excluding the effect of these factors, relative outperformance was far less significant.
- Market dynamics began to shift with the onset of the Fed's aggressive rate-hike campaign in 2022, prompting a rotation in leadership toward international stocks as the dollar weakened and NYSE FANG+ performance grew volatile.
- In our view, investment success likely will be predicated less on exposures to particular styles or geographies and more on identifying quality companies globally whose tangible and intangible attributes position them to navigate what seems likely to be a complicated and volatile environment.
- The rapid expansion of valuation multiples in the US suggests international markets currently may offer more “bang for your buck,” or a lower cost per unit of profit.

1. Source: FactSet; data as of April 30, 2023.

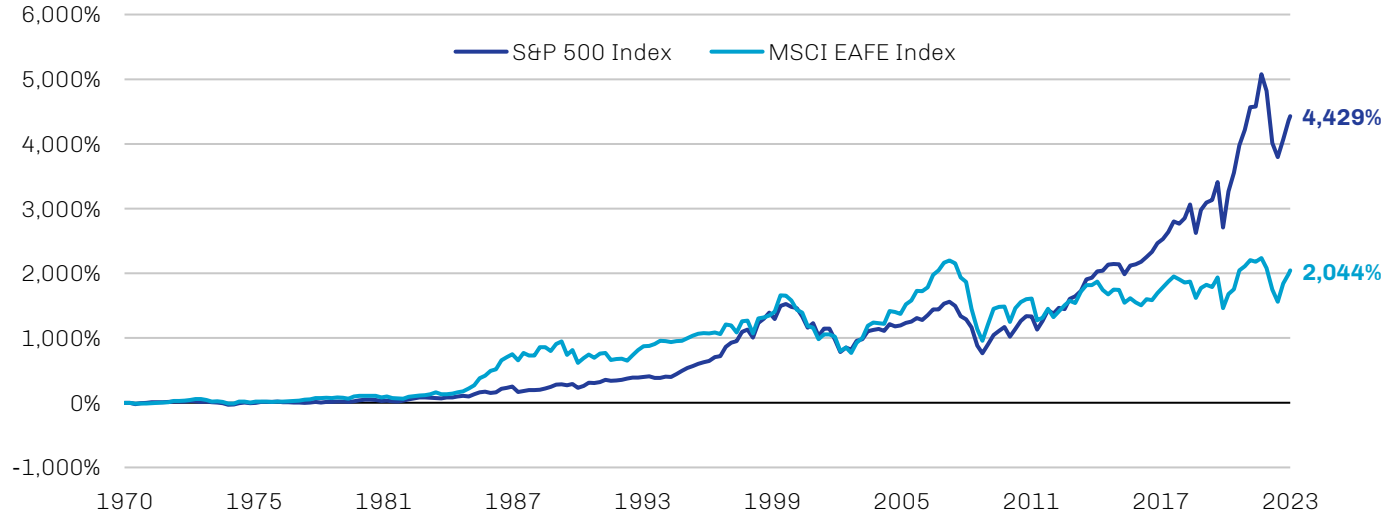
## The Extraordinary Circumstances that Fueled Domestic Equity Outperformance ...

Given the dominance of US equity markets over the past decade or so, it can be easy to overlook that the relative performance of domestic and international stocks over time has been far more

balanced. In fact, as depicted in Exhibit 1, the cumulative returns of the S&P 500 Index and MSCI EAFE Index were nearly identical from 1970 through mid-2014 before US equities raced ahead.

### Exhibit 1. US Equities Surged Past Non-US Stocks in Mid-2014

Cumulative Return, January 1970 through April 2023



Source: Bloomberg; data as of April 30, 2023. **Past performance does not guarantee future results.**

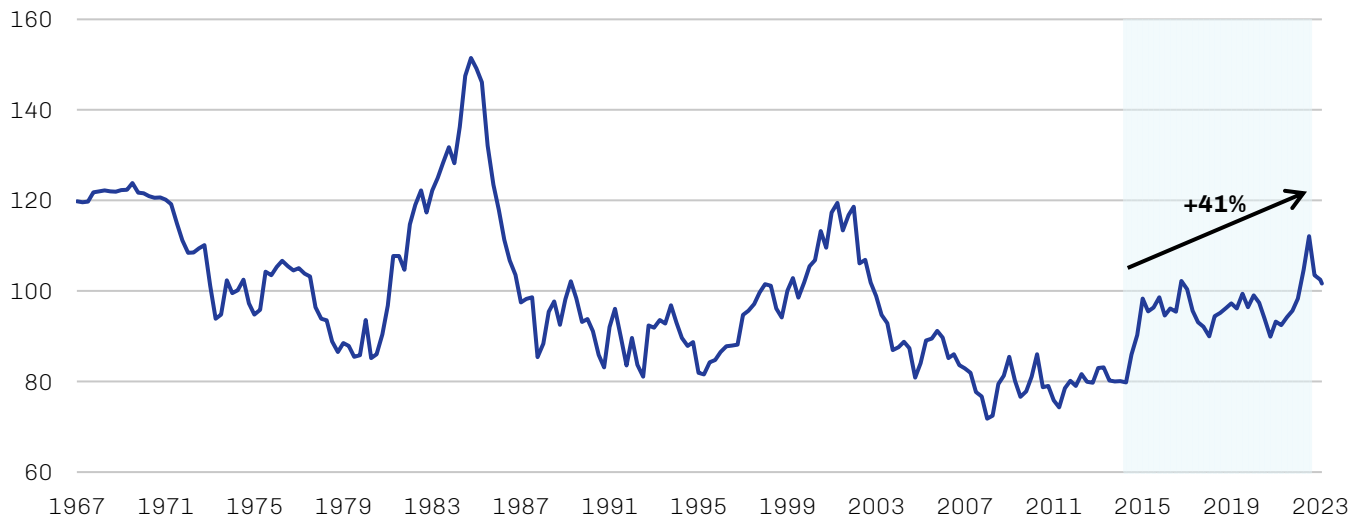
From June 30, 2014, through April 30, 2023, the S&P 500 outperformed the MSCI EAFE by 104%. Impressive for sure, but in our view this pronounced bifurcation in return can be attributed primarily to two—likely temporal—factors:

- US dollar appreciation.** Having declined precipitously throughout the early 2000s following the bursting of the dot-com bubble, the US dollar was range-bound for about a decade before breaking higher in mid-2014. As shown in Exhibit 2, the dollar rallied about 41% from June 30, 2014,

to its current-cycle quarterly peak at end-September 2022. Dollar appreciation can be attributed to a variety of factors that attracted capital into US markets, including the interest rate differential that emerged due to the Fed's relatively tight monetary policy. A strengthening dollar represents a headwind for US-based investors in international securities, as the translation of a stock's local-currency performance back into dollars eats into net return.

### Exhibit 2. Dollar Strength Has Been an Obstacle for International Equities

US Dollar Index, January 1967 through April 2023



Source: Bloomberg; data as of April 30, 2023.

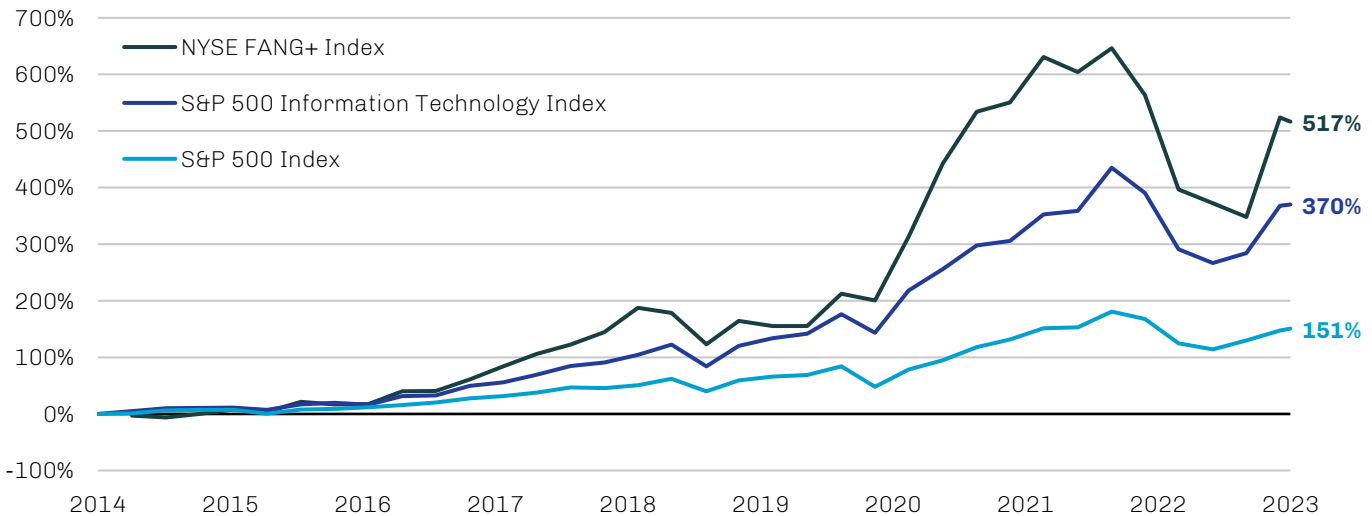
- FANG+ supremacy.** Nearly half of the S&P 500's gain during the period was fueled by the performance of technology stocks in general and the mega-cap constituents of the NYSE FANG+ Index in particular.<sup>2</sup> Very low discount rates throughout this period heightened the appeal of the future cash flows of long-duration growth stocks, and the valuation multiples of these "new economy" names received an additional boost in 2020 from the Covid-fueled virtualization of day-to-day life. As shown in Exhibit 3, the NYSE FANG+ Index swamped the S&P 500 Information Technology Sector Index by 159%—and that was after 2022's

selloff in FANG+ names closed the gap somewhat. With an aggregate weighting of 25% in the S&P 500, FANG+ stocks have an outsized impact on the index's overall performance; none of these stocks are included in the MSCI EAFE Index, which has only about an 8% exposure to information technology.

Nearly half of the S&P 500's gain during this period was fueled by the performance of technology stocks.

### Exhibit 3. Tech Was Strong; FANG Was Stronger

Cumulative Return, June 2014 through April 2023



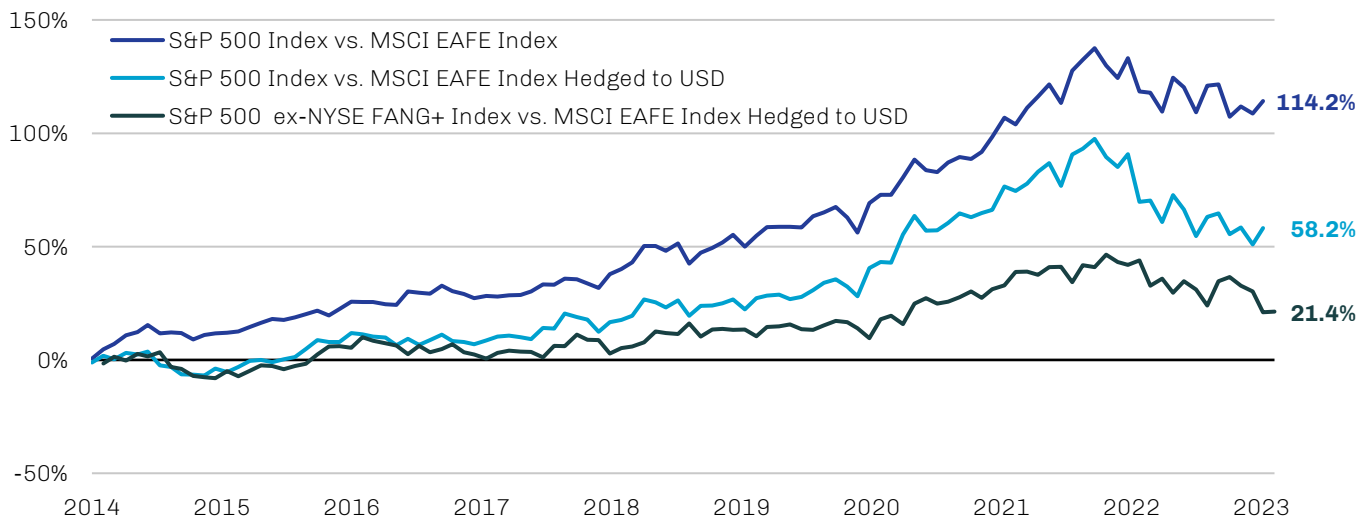
Source: FactSet; data as of April 30, 2023. **Past performance does not guarantee future results.**

Exhibit 4 deconstructs the impact of these two facets. Excluding the effect of the US dollar's strength and the sharp rally in FANG+ stocks from the cumulative return of the S&P 500 reduces its

outperformance over the period to about 19%, or 1.2% annualized—not too dissimilar from periods of EAFE outperformance seen in the mid-1980s/90s and mid-2000s.

### Exhibit 4. Excluding the Impacts of the Dollar and FANG+ Presents a More Balanced Picture

Excess Return, June 2014 through April 2023



Source: FactSet; data as of April 30, 2023.

2. As of April 30, 2023, the NYSE FANG+ Index comprised AAPL, AMD, AMZN, GOOGL, META, MSFT, NFLX, NVDA, SNOW and TSLA.

## ...Began to Wane as the Fed Took on Inflation

With the onset of the Fed's aggressive rate-hike campaign in early 2022, the dynamics that had driven relative equity performance since mid-2014 began to shift, inspiring both a broad equity market selloff and a rotation in leadership. Exhibit 5 examines

equity market performance in the disparate regimes of the past six quarters. Without the simultaneous headwinds of dollar appreciation and FANG+ strength over this period, international stocks have outperformed.

### Exhibit 5. Shifting Dynamics Have Favored International Stocks

Returns

	2022	4Q22	1Q23
NYSE FANG+ Index	-40.0%	-5.2%	39.2%
US Dollar Index	8.2%	-7.7%	-1.0%
S&P 500 Index	-18.1%	7.5%	7.5%
MSCI EAFE Index	-13.9	17.4	8.6

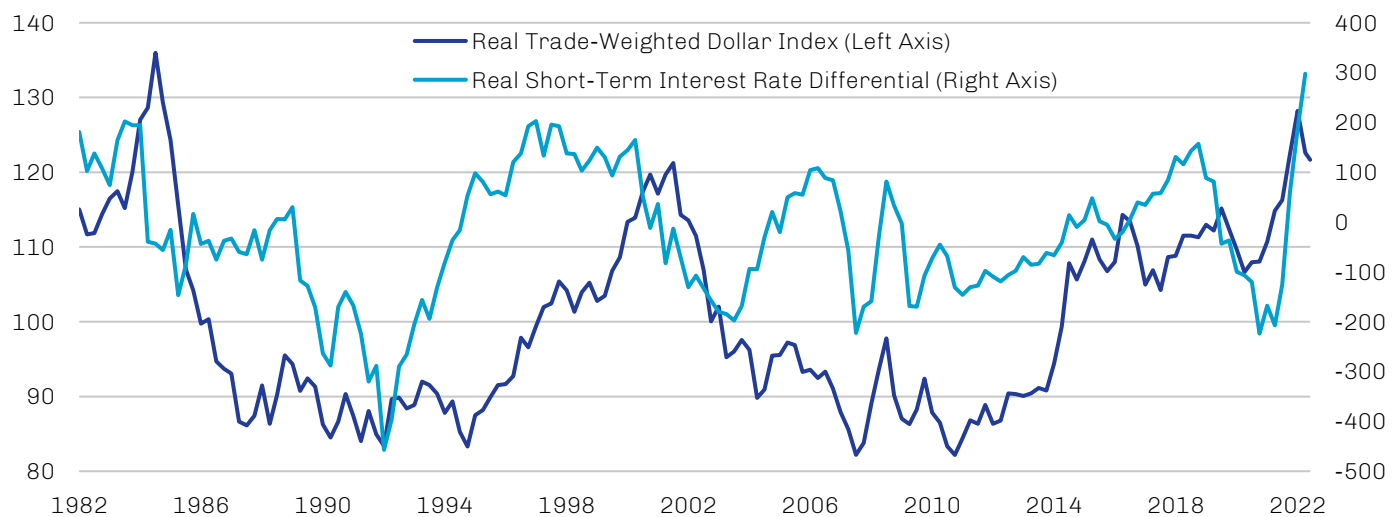
Source: FactSet, Bloomberg; data as of April 30, 2023. **Past performance does not guarantee future results.**

- US dollar depreciation.** Though all major central banks raised their benchmark rates in 2022, the Fed was among the earliest to act and certainly the most aggressive.<sup>3</sup> As a result, the difference between domestic and foreign short-term interest rates—which, depicted in Exhibit 6, historically has been a key driver of the dollar's relative value—widened and by September 2022 had pushed the US dollar index to a 20-year peak. This differential also supported the relative outperformance of domestic equity markets in dollar terms for the first three quarters of the year. Signs near year-end that the Fed may be prepared to slow its pace of hikes fueled a rebound in risk assets and raised expectations that interest rate differentials would narrow, and international stocks outperformed as the dollar's strength receded over the next six months.

It's reasonable to think the trend of interest rate convergence may persist as the US nears its terminal rate while hikes in other major central banks persist. The Fed raised the upper bound of the federal funds rate to 5.25% following its May meeting, though the 25 basis point hike and its accompanying messaging was widely interpreted as dovish and suggestive that the peak of this cycle could be near.<sup>4</sup> In contrast, the European Central Bank's key policy rate remains biased higher, with European Central Bank (ECB) President Lagarde acknowledging that "we are not pausing" following the bank's May hike.<sup>5</sup>

### Exhibit 6. Interest Rate Convergence Historically Has Pulled the Dollar Lower

January 1982 through February 2023



Note: The dollar index is versus other advanced-economy currencies. The interest rate differential is the federal funds rate deflated by 12-month trailing PCE inflation less the GDP-weighted blended policy rate of other advanced economies deflated by the 12-month trailing GDP-weighted CPI in these economies.

Source: Haver/Federal Reserve, Bureau of Economic Analysis, First Eagle Investments; data as of February 2023.

3. Source: Bloomberg; data as of April 30, 2023.

4. Source: *The Wall Street Journal*; data as of May 3, 2023.

5. Source: European Central Bank; data as of May 4, 2023.

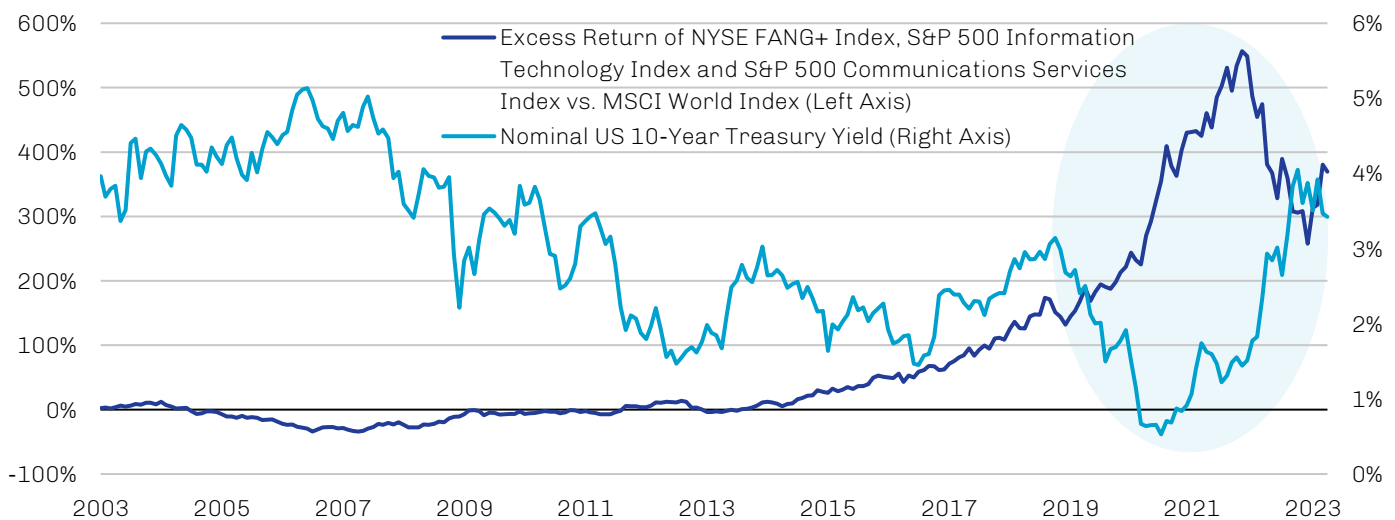
- **FANG+ weakness.** As noted earlier, long-duration equities such as those that populate the tech sector and the FANG+ Index were the primary beneficiaries of the “lower-for-longer” interest rate environment enabled by below-average inflation. As higher discount rates began to weigh on the present value of future cash flows, valuation multiples for FANG+ stocks, in particular, compressed, and the index suffered a peak-to-trough drawdown of nearly 50%—perhaps not surprising for an index with a 25% standard deviation of returns since inception. Notably, the FANG+ Index was one of the few risk-market cohorts that did not participate in the fourth quarter 2022 rebound, though it has reclaimed some of its losses in 2023 on the back of range-bound

interest rates. With the dollar weak, however, the MSCI EAFE has continued to outpace the S&P 500 despite the contribution of FANG+ stocks.

The MSCI EAFE continued to outpace the S&P 500 year-to-date 2023 despite the rebound in FANG+ stocks.

### Exhibit 7. Treasury Yields Shifted From Tailwind to Headwind for Long-Duration Stocks

January 2003 through April 2023



Source: Bloomberg; data as of April 30, 2023. Past performance does not guarantee future results.

### Get What You Pay For in Global Markets

We’ve often warned of the dangers of extrapolating short-term trends, and we are not about to cite two quarters of international equity outperformance as evidence that the era of US market dominance is over. At the same time, an imminent return to the conditions that bolstered domestic outperformance through a strengthening dollar and massive gains in FANG+ stocks seems even more unlikely. The combination of still-high inflation, robust wage growth and very low unemployment suggests investors may be tasked with navigating a more nuanced macroeconomic landscape than has been the norm in recent years. In such an environment, we believe investment success will be predicated less on exposures to particular styles or geographies and more on identifying quality companies whose tangible and intangible attributes position them to navigate what seems likely to be a complicated and volatile environment.

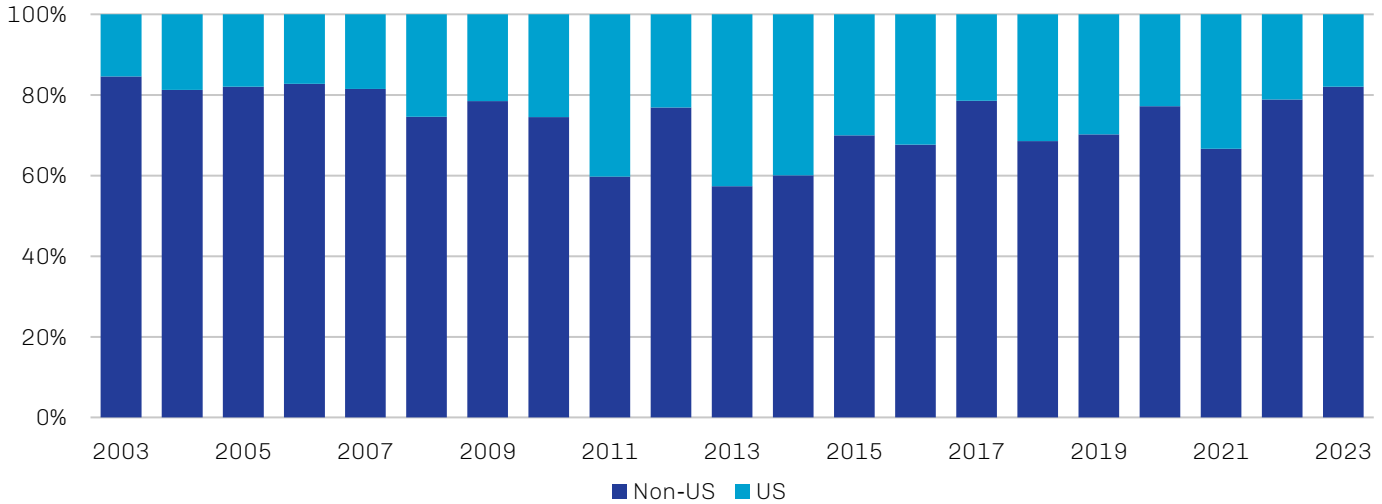
In our view, this necessarily includes businesses outside the US. Not only do non-US stocks represent a massive potential opportunity set equal to 78% of the MSCI ACWI Index in terms of number of securities, many of these companies have been strong performers over the years, as shown in Exhibit 8. Combined with much lower return correlations,<sup>6</sup> international markets represent fertile ground for investment managers seeking outperformance through active and selective stock picking.

An imminent return to the conditions that bolstered domestic outperformance seems unlikely.

6. Source: FactSet; data as of April 30, 2023.

### Exhibit 8. Ample Opportunities for Outperformance in International Markets

Number of Companies in MSCI ACWI Index Outperforming the S&P 500 Index Annually, 2003 through YTD 2023



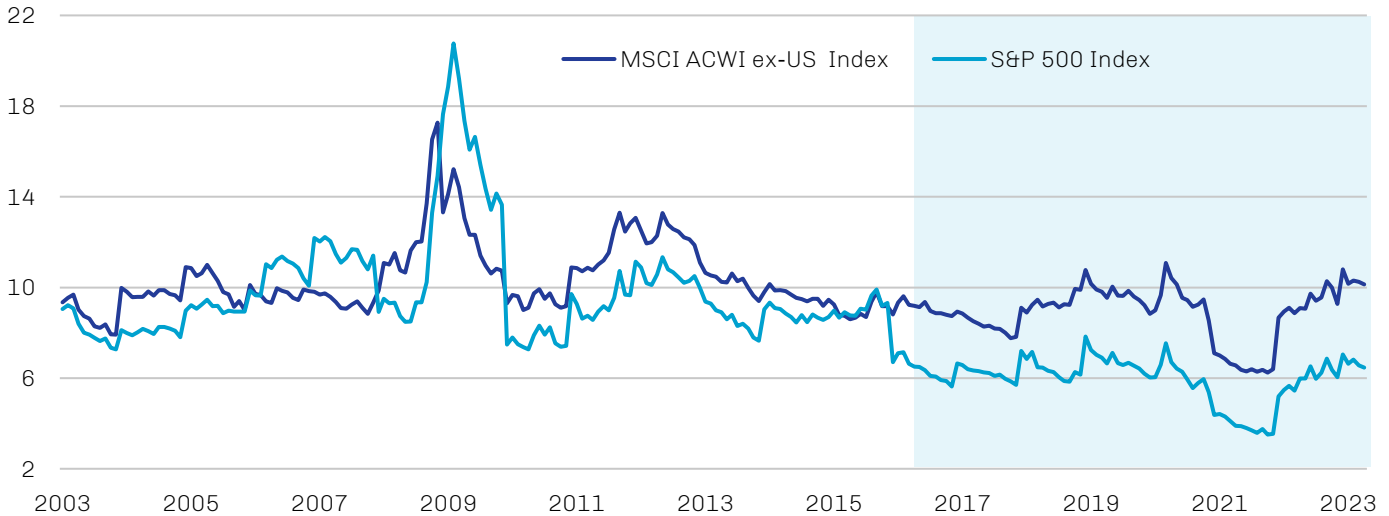
Source: FactSet; data as of April 30, 2023. **Past performance does not guarantee future results.**

While we’ve long advocated the potential benefits of strategic exposure to stocks outside the US, the current environment appears particularly hospitable to a global perspective. Exhibit 9 depicts what we refer to as the “bang for your buck” ratio of the S&P 500 and MSCI ACWI ex-US indexes, which compares profitability (EBIT margin) to valuation (price-to-sales ratio). Leadership in terms of this metric traded between the two indexes for most of the twenty-first century until 2016, at which point non-US equities

began to demonstrate a consistent and increasing “bang for your buck” profile. Though profitability was increasing globally, outsized multiple expansion in the S&P 500 meant investors were paying more per unit of profit for US companies than for non-US names. This bigger “bang for your buck” ratio has been broad-based; health care is the only sector of 11 in which the S&P 500 appeared advantaged, and conditions suggesting particular value in international stocks could be found in energy, materials and real estate.

### Exhibit 9. International Equities Currently Offer More “Bang for Your Buck”

Ratio of EBIT Margin to Price-to-Sales Ratio, January 2003 through April 2023



Source: FactSet; data as of April 30, 2023.

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## Quality over Trend

Though it's possible that a more supportive environment for international stocks may have emerged, First Eagle's investment process remains unchanged. We continue to seek to construct resilient, all-weather portfolios from the bottom-up that help clients avoid the permanent impairment of capital with the goal of generating long-term real returns across market cycles. We target quality companies globally whose tangible and intangible attributes position them to generate persistent cash flows over the long term—and suffer through short-term challenges if necessary—and wait for such stocks to become available at prices that represent a meaningful "margin of safety."

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#### **Risk Disclosures**

All investments involve the risk of loss of principal.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

There are risks associated with investing in foreign investments (including depository receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments; fluctuations in the value of foreign currency and exchange rates; and adverse changes to government regulations.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Strategies whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than strategies whose investments are diversified and may not be suitable for all investors.

The "**bang for your buck**" ratio evaluates what you get (profitability) relative to what you pay for (valuation).

**Federal funds rate** is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

**Margin of safety** is defined by First Eagle as the difference between a company's market value and our estimate of its intrinsic value, which is based on a judgment of what a prudent and rational business buyer would pay in cash for all of a company in normal markets. An investment made with a margin of safety is no guarantee against loss.

**Standard deviation** is a statistical measure of a security's volatility, or variability in expected return.

**Volatility** is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk.

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

**MSCI ACWI Index** measures the performance of large and midcap representation across 23 developed markets countries and 24 emerging markets countries

**MSCI ACWI ex-US index** measures the performance of large and midcap representation across 22 of 23 developed markets countries (excluding the US) and 24 emerging markets countries.

**MSCI EAFE Index** measures the performance of large and midcap securities across 21 developed markets countries around the world excluding the US and Canada.

**MSCI World Index** measures the performance of large and midcap securities across 23 developed markets countries around the world.

**NYSE FANG+ Index** measures the performance of a segment of technology and consumer discretionary sectors consisting of highly-traded growth stocks of technology and tech-enabled companies such as Facebook, Apple, Amazon, Netflix and Alphabet's Google.

**S&P 500 Index** is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

**S&P 500 Communications Service Index** measures the performance of companies included in the S&P 500 that are classified as members of the GICS communications services sector.

**S&P 500 Information Technology Index** measures the performance of companies included in the S&P 500 that are classified as members of the GICS information technology sector.

**US Dollar Index** is a geometrically averaged calculation of six currencies (euro, Japanese yen, British pound, Canadian dollar, Swedish Krona and Swiss franc) weighted against the US dollar.

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