Logan Capital

A Primer on International Equities

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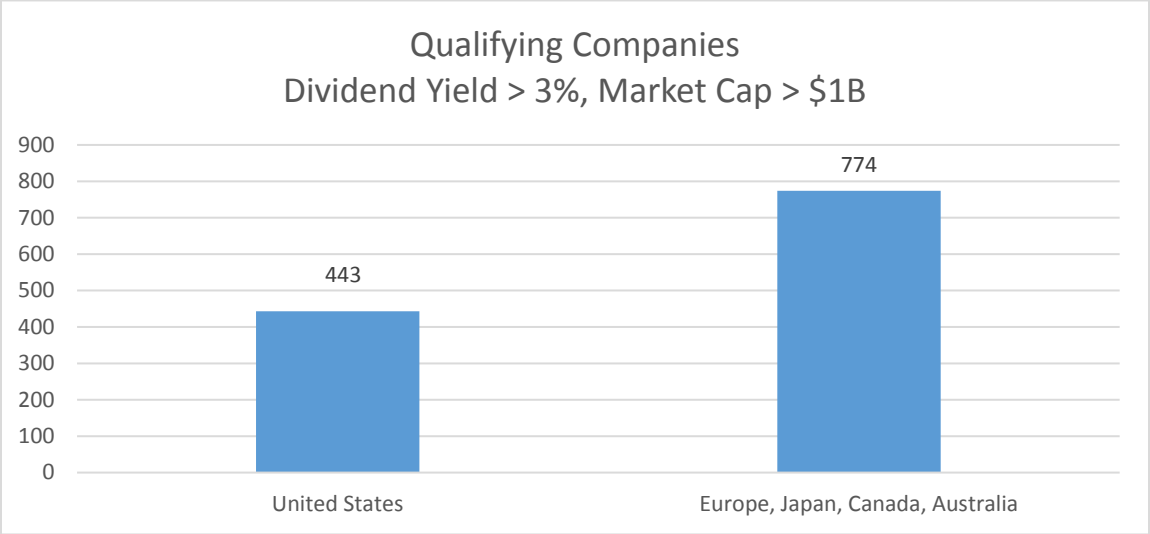
Executive Summary

- Excellent complement to an investor's portfolio of US equity holdings.
  - Great opportunity to gain exposure to a wider set of economic and financial factors.
- Extended period of underperformance versus US equities.
  - International equity returns have significantly trailed US returns for the last twelve years.
- Very attractive valuations today versus US equities.
  - All valuation metrics are supportive – dividend yield, earnings, book value, and cash flow.
- Several tangible catalysts to support international equities:
  - Policy – much more accommodative today versus 2008.
  - Currency – US dollar has weakened since the March market lows.
  - Regulation – bipartisan support in the US to foster greater competition within the technology sector.
  - Improved Governance – signs of improvement in Japan from a very low base.
- Sector level opportunities.
  - Financials and Energy offer compelling total return potential.

International Equities Opportunity Set

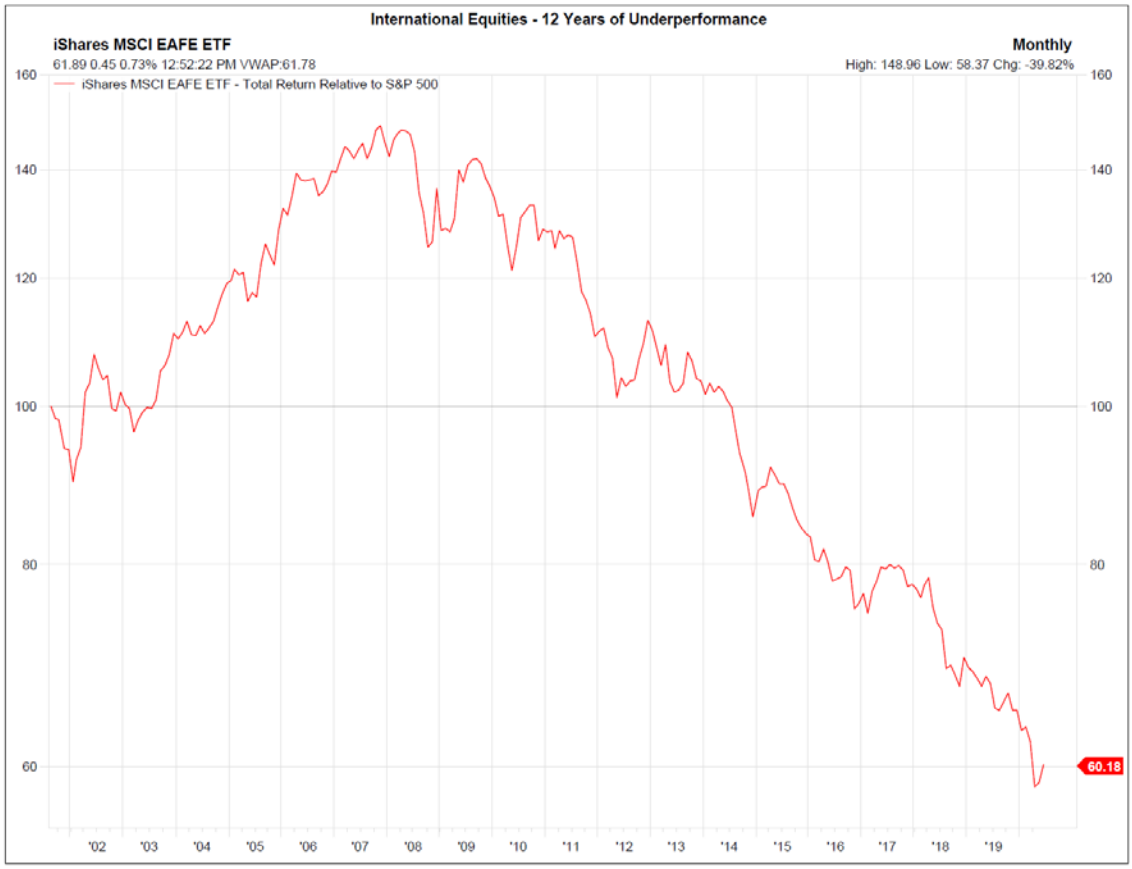
Almost 50% of the world's market cap resides outside of the United States, according to Factset data, offering a sizable opportunity set for US investors to diversify their investment portfolio. Most US investors already consume numerous products from foreign companies, from daily consumer staples to brand-name luxury goods. If you like dividends, you will like international equities in your portfolio. Specifically, there are 6x as many non-US companies paying 3%+ dividend yields than there are US companies (Factset). For the purpose of this paper, and as shown in the chart below, we focus on developed market international equities, which are predominantly in Europe, Japan, Canada and Australia.



Source: Factset 6/17/20.

Performance and Valuation Supportive of International Equities

International equities have significantly lagged US equities over the last dozen years, as the Factset chart below demonstrates. Yes, you are reading the chart correctly – an international investor's portfolio would today be worth $0.60 on the dollar relative to the same investment in the S&P 500 in 2001. How did we get here? A bubble in US equities? No, not by any means. To the contrary, the US rally was driven by fundamentals, with perhaps a boost from accommodative policy. The technological advancements have been a real game changer, and the large US technology firms generate significant and consistent cash flows. International markets, Europe in particular, simply do not possess the same technological presence, and financial market returns have lagged as a consequence. However, as is oftentimes the case, the first mover is not the only beneficiary. Rather, the users of technology can apply the advancements to improve their business performance. We continue to see large multinational companies, most of whom compete with US companies, highlight cost savings and innovations to improve their financial results. These innovations are being applied to a wide spectrum of industries, including banking and industrials, both of which constitute a large chunk of international equity portfolios.

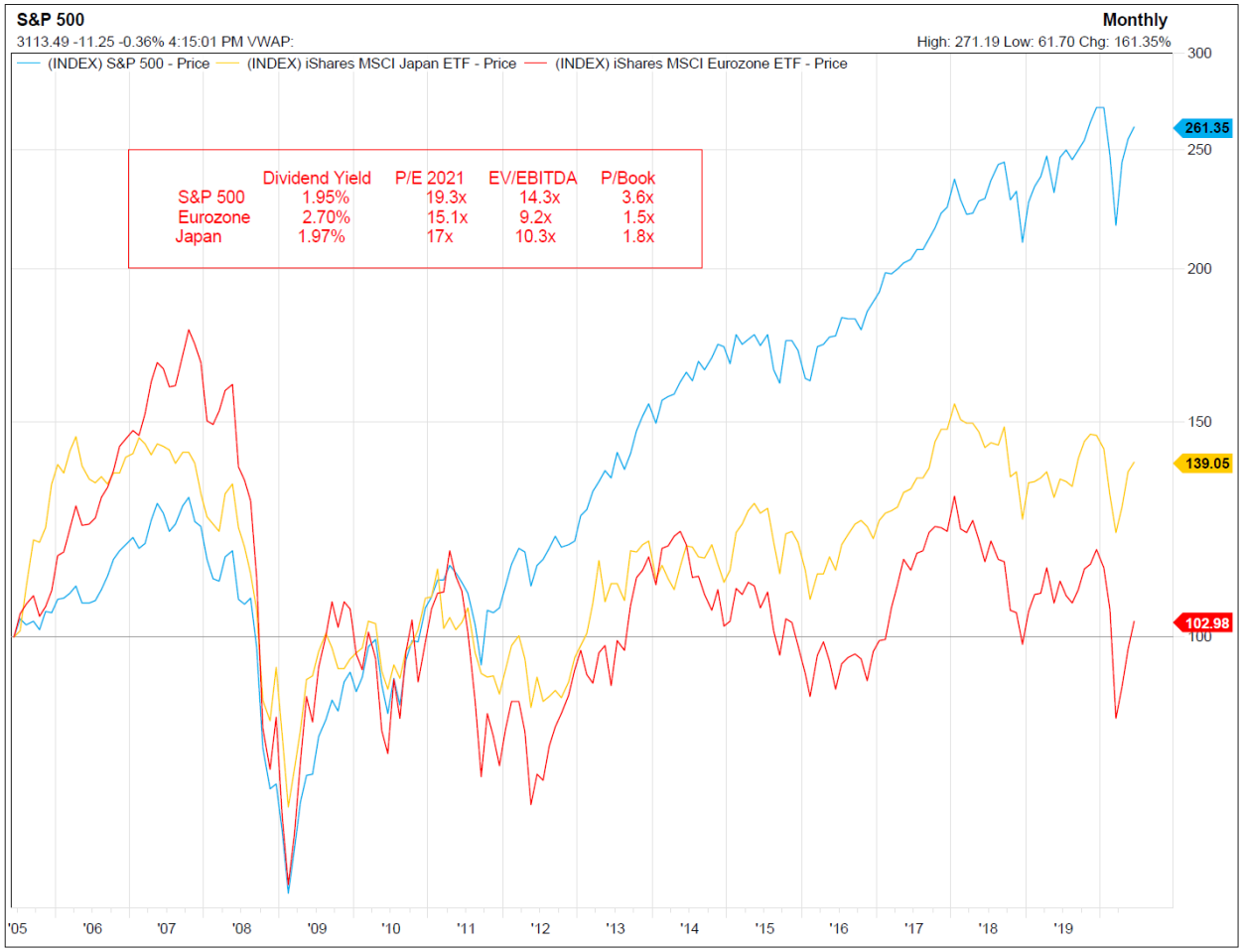


Source: Factset 6/17/20.

Valuation Compelling:

If you only remember one chart in this report, it should be this one. While international equity returns have lagged, mean-reversion is not a sure thing (though it's not far behind death and taxes). The multiple one pays for a given level of earnings or cash flow will determine future returns. At today's valuation levels, the S&P 500 trades at a sizable premium versus European and Japanese equities. While US performance has been justified due to strong fundamentals, we believe several catalysts could trigger a reversal of fortune.

International Equities – Valuations at a Discount



Source: Logan Capital, Factset, Bloomberg, 6/17/20. Eurozone data Euro Stoxx 50, Japan data Nikkei 225.

Catalysts supporting International Equities. What's changed? Quite a bit actually.

Policy.

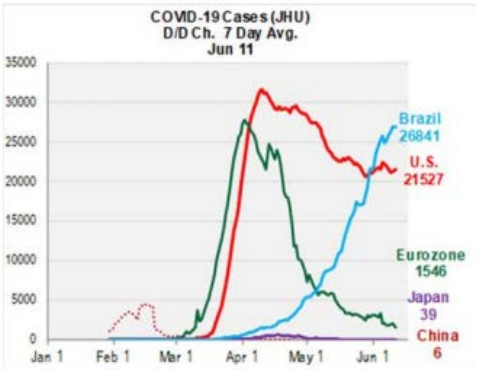
There has been no shortage of stimulus from US policymakers over the last dozen years, and 2020 is no different. However, international policymakers have now embraced the need for government support. This is in sharp contrast to policy behavior in the recent past. Several European countries imposed steep austerity measures following the financial crisis, and Japan implemented an ill-timed increase in its consumption tax from 8% to 10% on October 1, 2019. When Covid-19 arrived, international policymakers got the memo, and more. Fiscal stimulus this year in the Eurozone and Japan now exceeds that of the US, as a percentage of GDP.

	Central Bank Potential		Government		Central Bank Liquidity &	
in trillions of $	Liquidity Injection	% o GDP	Fiscal Stimulus	% of GDP	Fiscal Stimulus ($T)	% of GDP
United States	$6.21	29.0%	$3.30	15.4%	9.51	44.0%
Eurozone	$1.78	13.3%	$4.01	30.2%	5.79	43.5%
Japan	$1.03	20.0%	$2.08	40.3%	3.11	60.3%
China	$1.33	9.0%	$1.22	8.4%	2.54	17.7%
Source: Cornerstone Macro, 6/8/20.						

At a country level, Germany's Angela Merkel has led the charge in terms of accommodative policy and addressing the coronavirus.

- As securities analysts, we like to see inflection points at a company level, and the same can be applied at a macro level, as a sharp ideological shift in Germany is now taking shape. Long considered one of the stingiest members of the European Union, Germany has a long history of demanding no budget deficits and was adamantly opposed to common European debt issuance and a European fiscal union. That is no longer the case today, as Germany and France joined forces in May to launch an aggressive €500 billion EU recovery proposal in response to the pandemic. The Franco-German proposal would distribute the money in the form of grants, not loans, and is a major first step towards shared debt.
- Regarding Covid-19, Germany provided the blueprint for quick and decisive action. Their "track and trace" system was very effective in limiting the spread of the virus, and their death rate, at 4.6% of infected patients according to John's Hopkins University, is below that of other western countries. Merkel, a physicist by trade, was able to declare by April 17th that the pandemic was under control, just six weeks after Germany's first Covid-19 death.

  The final chapter to this story won't be written for quite some time, but this chart from Cornerstone Macro illustrates substantial progress in Europe and Japan in addressing the pandemic.

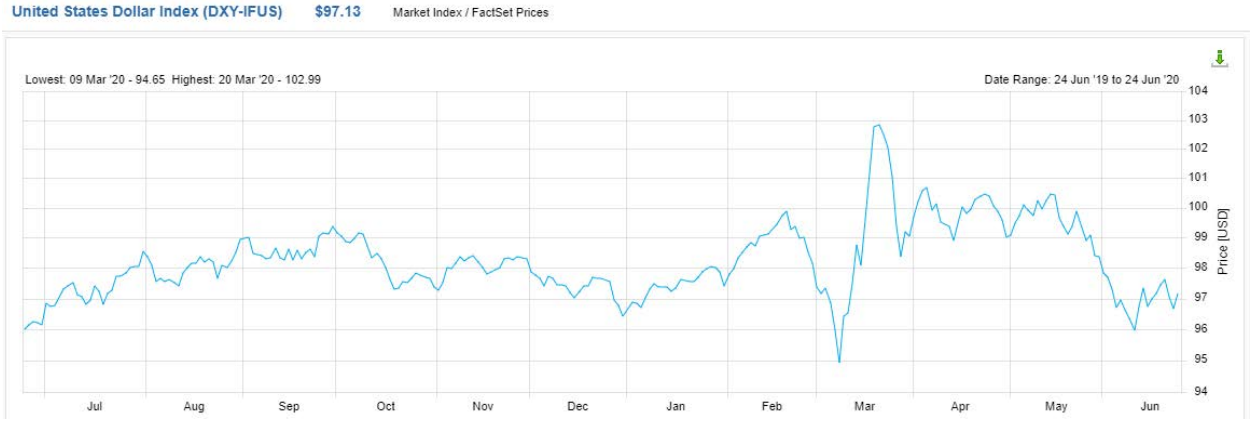


Source: Cornerstone Macro, 6/11/20.

Currency:

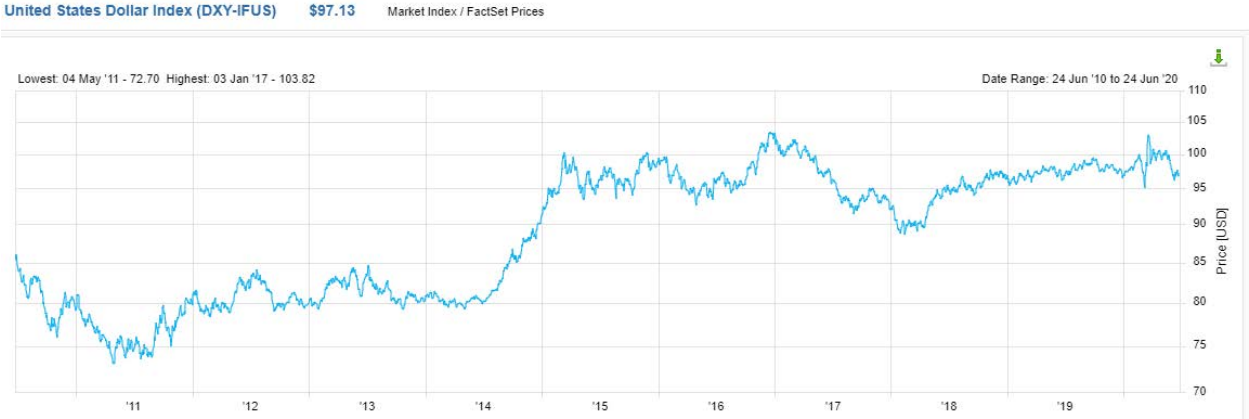
Currency brings an additional element of risk into the international equities landscape. Currency strength and weakness are a function of several factors, including a country's level of interest rates, economic performance, and fiscal position, among others. US dollar weakness over the last three months is noteworthy, as this follows a flight to safe haven status in March when Covid-19 cases began to ramp up. If the global economic recovery accelerates and coronavirus cases continue to ebb, though not a sure thing, we would expect foreign currencies to perform well and aid returns for international investors.

US Dollar Spot Index - One Year Return



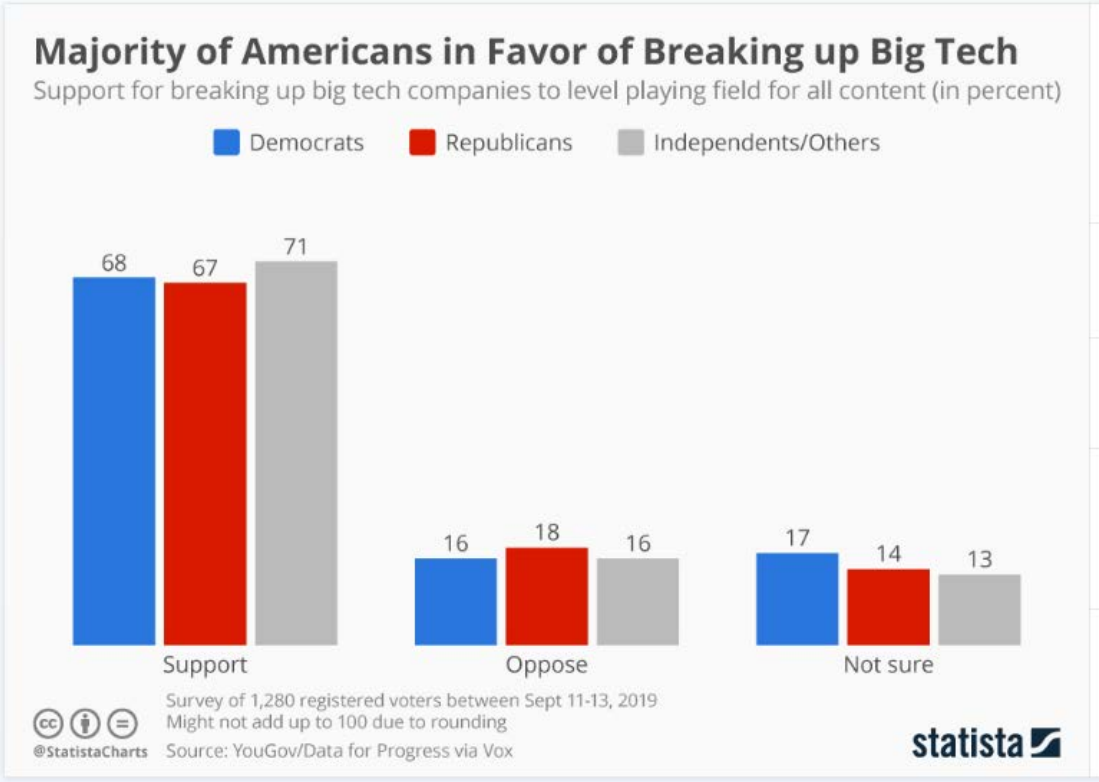
One final chart on the US Dollar, just over a longer time period. The 10 year chart indicates that the Dollar, despite its recent decline, remains elevated versus its trading range from 2011-2015. Given the Federal Reserve's intention to maintain short term interest rates in the 0-0.25% range until at least 2022, the Dollar exchange rate could certainly see more pressure.

US Dollar Spot Index - Ten Year Return



Regulation

There are very few topics in Washington whereby Democrats and Republicans can find common ground. However, regulation of large technology companies is indeed one of those issues, as a bi-partisan consensus has emerged to examine their dominant structures. An in-depth analysis is beyond the scope of this paper but suffice to say these technology companies have experienced limited disruptions over the last ten years. Increased scrutiny is a distraction that can weigh on both business fundamentals and the sentiment towards the industry, as global banks can attest all too well. A regulation overhang can certainly contribute to a rotation out of US stocks, where performance has been aided significantly by technology, and into international markets with a much smaller technology presence, such as Europe and Japan.



Corporate Governance in Japan

Japan's infamous lost decade is now three lost decades, as the Nikkei today trades below where it did in June of 1990. To say their governance has been poor over the last three decades would be an understatement. Fortunately, technological advances have made it difficult to hide such poor behavior, and as a consequence Japan now has massive untapped potential regarding women in the workforce and less stringent immigration requirements. A more diverse and more talented workforce, coupled with attractive valuation and relatively clean balance sheets, provides good opportunities for international investors.

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Japan's all-male boards face gender reckoning

Hundreds of companies without a female director set for mass AGM-season shaming

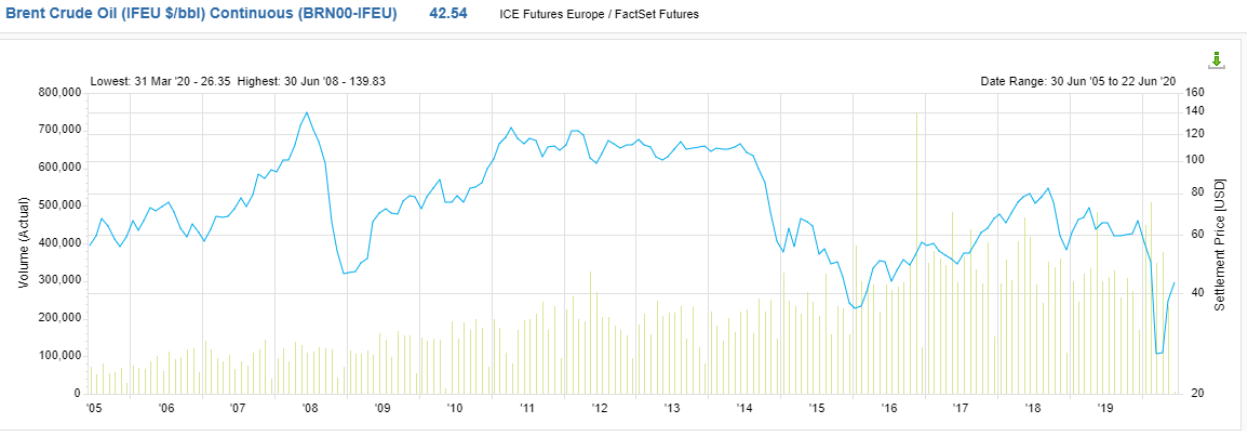
Source: Financial Times, 6/2/20.

Sector Level Analysis:

- International markets will have a hard time outperforming US markets without a robust and well-capitalized financial system.
    - Global banks today collectively hold almost twice the equity capital they did in 2008.
    - The European Central Bank first introduced negative rates in 2014, and there's no indications we'll see a change in course here in year seven. Japan did the same a short time later in 2016.
    - International banks have spent 5+ years adapting their business model to the negative rate environment. They've significantly increased their fee income and enhanced their digital capabilities to reduce costs. Should revenues surprise to the upside, even slightly, those top line improvements should flow immediately to the bottom line due to their slimmed-down cost structure.
    - Most importantly, Japan's largest banks now trade at just 0.4x book value, and many large national champion European banks trade at similar levels. The marketplace clearly has limited faith in each bank's asset levels, despite improved underwriting standards following the financial crisis. If credit quality were to remain stable, the valuation provides nice downside protection.

- Energy
    - Another dividend-friendly sector of the international marketplace is the Integrated Oil & Gas sector. These companies deliver very steady and consistent cash flows due to their integrated business model. Their capital allocations are also shareholder friendly, as many oil and gas companies prioritize the dividend as their primary use of cash.
    - As the chart below illustrates, Brent Crude oil prices have recovered nicely from the March lows but still trade at just a fraction of their 2011-2014 price range.
    - Demand numbers for the second quarter of this year will be weak but are now projected to be much stronger than initial fears.

- A reluctance to ride public transit will also likely push demand for automobiles higher and contribute to higher oil prices.
- Several integrated oil & gas companies now offer dividend yields in the 5-10% range.



Source: Factset 6/22/20.

Honorable Mention – A Few Other Factors to Watch

- No high-stakes elections in foreign markets similar to Trump/Biden.
- No civil unrest like that experienced in the US recently.
- EU breakup concerns have eased. Fiscal integration actually progressing.
- Shareholder activism. Previously more common in the US, activists are now taking aim at international companies and pushing for change, especially where good assets reside and returns are below potential.
- Labor mobility. Previously more of a US phenomenon, more flexible labor laws and more capital optionality will allow foreign countries to shift resources and quickly adapt to changing market conditions.

Conclusion:

We have no special insight into when a rotation in favor of international equities will occur, if at all. In terms of what we can control, we take great comfort in diversifying our portfolio away from one particular region and also the improved valuation metrics. In the meantime, we're paid to wait, in the form of higher dividend yields, and will closely monitor each of the catalysts previously identified.

Disclosures:

Investing internationally carries additional risks such as differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country. This may result in greater share price volatility. Shares, when sold, may be worth more or less than their original cost.

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