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Markets & Economies

Charting a Course for Success in Global Equities

A look at the macroeconomic and secular factors that could provide a tailwind for global equities—and the investment approaches that might be best-positioned to capture opportunities in the asset class.

Yuriy Minchuk,
Investment Strategist

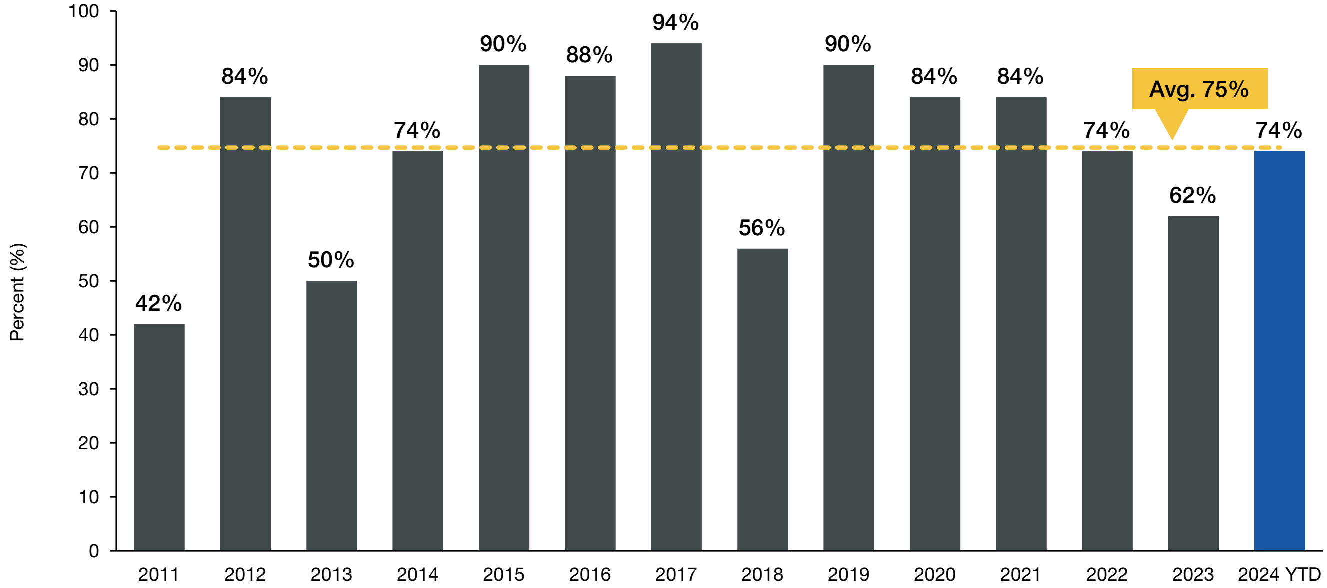
The first half of 2024 is in the books, and global equity markets have continued to rally following their impressive 2023 performance. The S&P 500® Index climbed 15.3% through June 28, its second-best first-half showing since 2000, thanks in part to a resilient U.S. economy, improved corporate earnings, and massive demand for companies participating in the artificial intelligence (AI) supply chain.

Most of this performance has come from the Information Technology and Communication Services sectors, and more specifically from mega-cap tech. NVIDIA was up 10.3% in June alone, bringing its year-to-date gains to 149%. Even that was not the best-performing stock in the S&P 500 in the year's first half. Super Micro Computer, a leading server and storage vendor that is helping enable increased AI capabilities, was up 188.2% in the same period. (Stock and index performance data referenced above are from Bloomberg.)

While the outsized gains from U.S. companies have captured investor attention, 74% of the top 50 best-performing stocks globally (as represented by the MSCI All Country World Index) in the first half of 2024 were from outside the United States—in line with the average over the last 14 years (see Figure 1).

Figure 1. Non-U.S. Stocks Continue to Account for the Majority of the World's Best Performers

Percentage of the top 50 best-performing stocks in the MSCI All Country World Index (ACWI) that are outside the United States, 2011–2024 (through June 30)



Source: FactSet and MSCI. Data as of June 30, 2024.

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Broadening the investment opportunity set to overseas companies can potentially provide significant benefits to a diversified equity portfolio, and we believe there are several trends that could continue to support non-U.S. equities:

- The global disinflation narrative is intact. While the moderating trend in inflation in the United States had plateaued at the start of the year, there have now been two consecutive months of softer price increases, paving the way for a potential U.S. Federal Reserve (Fed) rate cut in September. Many economies overseas are ahead of the U.S. on this front, with headline inflation in the Eurozone, Germany, the U.K., and Canada now at 2.5%, 2.2%, 2%, and 2.9%, respectively, based on reports from the European Union and respective national governments. As a testament to this progress, the European Central Bank (ECB), Bank of Canada, and the Swiss National Bank all reduced their key policy rates by 25 basis points (bps) in June. The end of a historic, global rate-hiking campaign, now followed by the early stages of its unwinding, should continue to support risk assets broadly.

- Growth remains healthy outside of the United States, and consensus forecasts are for the world economy to continue growing at a 3.2% pace during 2024 and 2025, according to the International Monetary Fund. While growth in Europe is not strong in absolute terms, it is in positive territory and has been surprising to the upside. Europe has been helped by a decline in natural gas prices, which have receded to levels last seen before the invasion of Ukraine in February 2022, and a pickup in manufacturing activity.

- Corporate earnings in Europe, as measured by the Stoxx 600, are expected to grow approximately 6% for all of 2024 and 10% in 2025. Earnings for emerging-market companies are also expected to advance strongly, by approximately 17% in 2024 and 16% in 2025 (based on the MSCI EM Index). (Earnings forecasts are as of July 15, 2024.)

- There are several secular drivers that should benefit companies outside the United States. Perhaps the biggest of these is the increasing adoption of AI. While companies like NVIDIA, Meta, and Alphabet dominate AI-related headlines today, as AI investment continues, and the technology grows and is used more widely, the pool of AI beneficiaries will grow as well, especially in Asia. Japan is an economy that is very much centered around technology and robotics, so some of the same trends around AI that are benefiting the U.S. are benefiting Japan as well. Smaller companies that play in other parts of the supply chain outside of chip manufacturing, e.g., servers, warehouses, cooling systems, etc. stand to benefit, and many of them are domiciled outside the U.S. Examples include Taiwan Semiconductor, SK Hynix, Kokusai, and Hon Hai.

- One other secular trend to watch is the increasing use of GLP-1 drugs to treat both diabetes and obesity. This market is expected to grow at a rate of more than 20% annually and reach $133 billion worldwide by 2030, based on a report cited by the American Hospital Association. Currently, this total addressable market is being served largely by two companies—Novo Nordisk and Eli Lilly, based in Denmark and the United States, respectively. Other companies in Europe have been eyeing the space, with Zealand Pharma (also based in Denmark) showing positive weight loss results in its proprietary drug Petrelintide.

An Active Approach to Finding Strong, Global Businesses

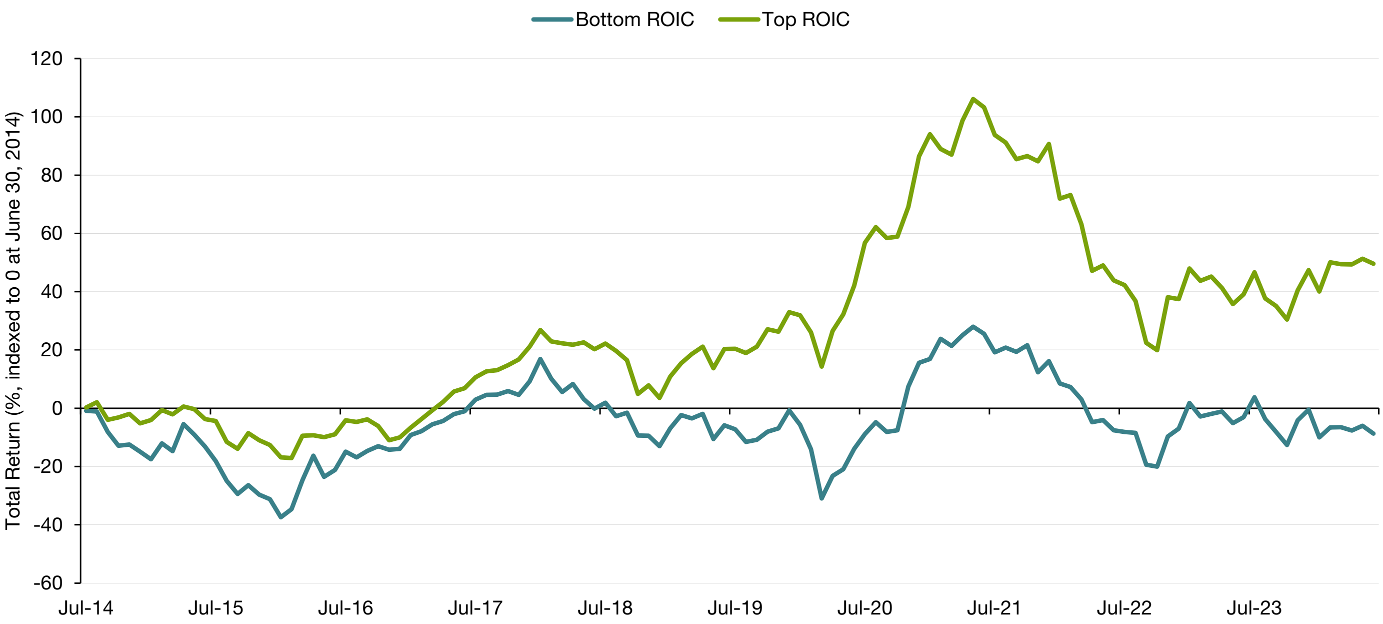
As we have seen, both cyclical and secular drivers present a strong case for global equities. But what might be the best way to access the asset class? Although indexing is a popular way to invest in equity markets, it is not a great strategy for international markets. With such a broad playing field, owning the market means also owning companies that have unattractive fundamentals—including, but not limited to, low returns on invested capital, negative earnings and/or dismal or non-existent earnings growth, and high leverage.

As such, we recommend a heightened level of scrutiny to global equity investing that focuses on finding global businesses with sustainable competitive edges. These advantages allow firms to exhibit strong quality metrics, such as high returns on capital, free cash flow, and solid margins, which are typically indicative of businesses with a competitive "moat."

The importance of earnings should not be understated. While many observers thought the rally in NVIDIA's shares last year was overdone, the advance has continued through mid-2024 as the company's earnings growth and return on invested capital (ROIC) has matched the rise in the stock price. We find the same pattern outside the United States. Over the last decade, the top decile (top 10%) segment of the MSCI ACWI ex-USA Index, based on annual ROIC growth, outperformed the bottom decile by 51.8% (see Figure 2).

Figure 2. Stocks with the Highest Return on Invested Capital Have Shown Sustained Strength

Total return of top- and bottom-decile companies in the MSCI All Country World Index as measured by return on invested capital (ROIC), July 2014–June 2024



Source: FactSet and MSCI. Data as of June 30, 2024. Return indexed to 0% at June 30, 2014.

Return on invested capital is calculated by taking into account the cost of the investment and the returns generated. Returns are all the earnings acquired after taxes but before interest is paid. The value of an investment is calculated by subtracting all current long-term liabilities, those due within the year, from the company's assets.

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In our view, active managers are well-positioned to capitalize on the current trends in global equity markets. The active approach affords them the flexibility to select the best investment opportunities across various geographies, market capitalizations, and sectors. In addition, active managers can adapt and respond to shifting market dynamics. Their in-depth research and security valuation capabilities provide the potential for building portfolios that are not only diversified, but also optimized for growth and stability, while avoiding companies with vulnerabilities.

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Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Glossary & Index Definitions

Cyclical stocks tend to move with macroeconomic conditions such as consumer spending or economic growth. A secular market is a long-term event with persistent conditions regardless of economic slowdowns and cycles.

Disinflation is a decrease in the rate of inflation.

Macroeconomics is the study of large-scale or general economic factors and how they interact in economies.

Market capitalization is the total value of a company's outstanding shares of stock, which include publicly traded shares plus restricted shares held by company officers and insiders.

A **"moat"** is a type of sustainable competitive advantage that makes it difficult for a business' rivals to erode its market share.

Return on invested capital is calculated by taking into account the cost of the investment and the returns generated. Returns are all the earnings acquired after taxes but before interest is paid. The value of an investment is calculated by subtracting all current long-term liabilities, those due within the year, from the company's assets.

Risk asset generally refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

The **MSCI ACWI (All Country World Index)** is a free float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,330 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

The **STOXX Europe 600**, also called STOXX 600, is an equity index with a fixed number of 600 components representing large, mid and small capitalization companies among 17 European countries, covering approximately 90% of the free-float market capitalization of the European stock market (not limited to the Eurozone).

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