Value Harvest Sows Seeds for Opportunities Outside the United States
PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

KEY POINTS

• There is a strong historical relationship between value and equities outside the United States. Over the past two decades, non-US stocks have tended to outperform US stocks when value starts to work. And it has started to work: In late 2015 value rebounded from 20-year lows and in 2016 outperformed growth by a wide margin.

• While the value resurgence represents a strong tailwind for non-US equities, there are also a number of fundamental pillars of support—valuation, performance and a variety of economic and other catalysts—for the non-US investment case.

• Valuation: The last time non-US stocks were this cheap relative to US stocks, it preceded a rally that lasted six years and saw non-US equities significantly outperform their US peers.

• Performance: Optimism has propelled US stocks skyward, leaving markets outside the United States far behind. As contrarian value investors, we continue to look for what we consider the best opportunities among the ignored, unloved and overlooked non-US markets.

• Economic/Corporate Catalysts: The US economic cycle looks vulnerable as post-election reflation euphoria fades, while European growth has accelerated while expectations remain depressed. A developing economic cycle should help bolster corporate fundamentals outside the United States.

• Policy/Political Catalysts: Tightening US policy conditions may represent a headwind for a maturing US bull market, while accommodative conditions outside the United States could help a fledgling recovery gain pace in other regions. Political risk in non-US markets looks exaggerated by depressed share prices, whereas US stocks appear to be fundamentally underpricing the risks associated with one of the most uncertain and divisive political climates of our lifetime.

• While we continue to find select value in the United States, we are exceedingly cautious about the expensive sectors, regions and stocks that have fared so well over this protracted bull market. We believe equities outside the US look exceedingly attractive in the current environment, and have positioned our portfolios accordingly.

Value Update: Where Is the Next Pocket of Opportunity?

In papers dated September 2015 (“Is Value Set to Soar?”) and April 2016 (“Value Unbound”), we argued that unloved value stocks were poised to break out as their historic undervaluation and underperformance mean-reverted and interest rates rose from all-time lows. Our argument was controversial at the time, but in late 2015 value rebounded from 20-year lows and in 2016 outperformed growth by the widest margin in well over a decade.1 The last time value rebounded off of such extreme lows (following the dotcom bust), the style outperformed for seven years (until the global financial crisis). That’s about the length of an average “value cycle” looking back over history (Figure 1).
With the value rally now underway, where is the next pocket of long-term potential opportunity for global investors? At Templeton, we believe equities outside the US look exceedingly attractive in the current environment, and have positioned our portfolios accordingly. The argument for non-US stocks today in many ways resembles the case for value stocks that we’ve been making over the past 18 months. Non-US stocks appear undervalued, have underperformed US stocks and feature catalysts that could help spur a turnaround. There’s also a strong historical relationship between value and non-US equities. Over the past two decades, non-US stocks have tended to outperform US stocks when value starts to work. Possible explanations for this relationship include the higher representation of cyclical sectors in markets outside the United States, the higher operating leverage in these markets attributable to higher fixed costs and less flexible labor, and the recent valuation discount applied to “riskier” non-US equities that creates greater scope for re-rating. Figure 2 highlights the correlation of performance of value and non-US stocks over the past two decades. The wide divergence that has opened up between the two styles recently as value stocks rallied and non-US stocks lagged may represent an opportunity in markets outside the United States similar to the one that emerged in 2000.

While the value resurgence represents a strong tailwind for non-US equities, there are a number of fundamental pillars of support for the non-US investment case as well, which we explore below under the headings “Valuation,” “Performance” and “Catalysts.”
Our experience suggests that US stocks generally look expensive and offer limited long-term return prospects from current levels when measured against their own long history. The cycle-adjusted price-to-earnings (CAPE) in the US stock market currently stands at 25x. CAPE is an important measure because it is theoretically robust and has historically demonstrated a statistically significant correlation with future returns. As Figure 3 shows, today’s US equity market CAPE ratio implies a 10-year total real return (including dividends and inflation) of about 5% annualized. Now compare that to non-US equities. With a CAPE of 11x–12x, both European and emerging markets have traded at levels historically consistent with double-digit real annualized gains over the following 10 years.

Relative price-to-tangible book (P/TB) ratios tell a similar story. As Figure 4 confirms, the last time non-US stocks were this cheap relative to US stocks on P/TB, it preceded a rally that lasted six years and saw non-US equities outperform their US peers by a magnitude of 3x.

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**Figure 3: Equities: Valuation and Subsequent Return**
As of April 30, 2017

<table>
<thead>
<tr>
<th>CAPE</th>
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<tbody>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Europe</td>
</tr>
<tr>
<td>Japan</td>
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<tr>
<td>Emerging Markets</td>
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</table>

Source: Minack Advisors, MSCI, IBES/DataStream, BLS, NBER. Europe represented by MSCI Europe Index. Japan represented by MSCI Japan Index. Emerging markets represented by MSCI Emerging Markets Index. United States represented by MSCI USA Index. MSCI indexes in USD terms. EPS and Price Index deflated by US CPI to calculate CAPE. Total return is in USD, deflated by US CPI. Data from 1980. Japan returns are in yen terms. Emerging-market data from 1998. MSCI EPS series linked to IBES trailing EPS. Dots show current CAPE. Past performance does not guarantee future results.

**Figure 4: Relative P/TB (Non-United States vs. United States)**
March 1998–March 2017

-5% 0% 5% 10% 15% 20% 25% 30% 35% 40% 45% 50% 55% 60% 65% 70% 75% 80%

Source: Bloomberg, MSCI. Non-United States represented by MSCI All Country World ex US Index. United States represented by MSCI USA Index. Past performance does not guarantee future results.
Performance: Time for a Shift?

The outperformance of US equities at the expense of non-US stocks over this past cycle has been historic. As Figure 5 shows, the market capitalization of US equities is now greater than the country’s ~$17 trillion dollar gross domestic product (GDP). By comparison, the market cap of non-US stock markets remains less than one-third the size of non-US GDP. Relative outperformance is particularly stark when compared to Europe. Figure 6 shows that the United States is experiencing the most extreme and sustained outperformance over Europe in at least half a century. In terms of duration, US stocks are experiencing their second-longest bull run in history. The tale is in the tape: Optimism has propelled US stocks skyward, leaving markets outside the United States far behind. As contrarian value investors, we continue to look for what we consider the best opportunities among the ignored, unloved and overlooked non-US markets.

Figure 5: Market Cap to GDP
September 2003–March 2017

Figure 6: Relative Price Performance of US to European Equities
December 1969–April 2017

Source: FactSet, MSCI, Oxford Economics. Non-United States represented by MSCI All Country World ex US Index. United States represented by MSCI USA Index. Past performance does not guarantee future results.
Catalysts: Four Compelling Drivers for the Future

The current case for non-US over US equities supposes an eventual mean reversion in historically divergent performance and valuation trends. But what could be the catalysts for such a move? Encouragingly, we see a number of potential positives coming increasingly into focus. They include fundamental economic catalysts, corporate catalysts, policy catalysts and political catalysts. We address them in turn.

Economic Fundamentals

The US economic cycle looks vulnerable as post-election reflation euphoria fades. The current US recovery, which is now tied for the third-longest on record, has also been the weakest economic expansion since World War II, with an average annual growth rate of just 2%. It may not take much to derail such tepid growth, particularly in light of continued high expectations. On the other hand, European growth has accelerated while expectations remain depressed. In fact, GDP growth in Europe has now matched or exceeded growth in the United States for five of the last six quarters. As Figure 7 highlights, corporations outside the United States offer significantly higher leverage to improving global economic conditions than their US peers. From the current starting point, we assess that the economic cycle now favors non-US stocks.

Figure 7: Beta of Earnings per Share (EPS) to Global Industrial Production
Quarterly Data over Last 10 Years
May 2007–May 2017

Source: Credit Suisse Research.
**Corporate Fundamentals**

A developing economic cycle should help bolster corporate fundamentals outside the United States. Indeed, profit growth for companies in the MSCI All Country World ex US Index is expected to far outpace profit growth in the S&P 500 Index over the next 12 months. This is coming off of a low base; as Figure 8 shows, the share of global corporate earnings attributable to non-US companies is at a 13-year low of 43%. The inverse of that line is US earnings, which means that a single market currently accounts for nearly three-fifths of all corporate profits in the world.

Not since the aftermath of the ill-fated TMT (technology, media and telecommunications) bubble has the United States commanded such an overwhelming share of global corporate profits. The contrast between corporate earnings in the United States and Europe is especially stark. As Figure 9 shows, per-share earnings in Europe are the most depressed relative to the United States in nearly half a century. Such conditions usually don’t last forever, and there are already some signs that relative earnings conditions are normalizing.

**Policy Conditions**

The US policy response to the global financial crisis was early and aggressive, which is at least partially why its economy bounced back so much more quickly than other major developed markets. Yet, with inflation picking up and policymakers increasingly worried about the distortive effect of multiple years of extraordinarily accommodative monetary policy, the US Federal Reserve (Fed) now seems determined to keep raising interest rates. President Trump’s intended fiscal stimulus could help offset monetary tightening in the United States, but it still needs to be devised, approved, funded and implemented, all of which takes time. Meanwhile, Europe is entering a rare period of coordinated fiscal and monetary relaxation. Looking more broadly, while the United States continues to tighten, monetary policy conditions globally remain quite loose (Figure 10). The bottom line is that tightening US policy conditions may represent a headwind for a maturing US bull market, while accommodative conditions outside of the United States could help a fledgling recovery gain pace in other regions.
Political uncertainty in markets outside the United States has long unnerved risk averse investors, and we believe such fears are now excessive in today’s environment. Europe has rolled from one crisis to the next, with the Brexit result last June shocking the pro-euro establishment and raising concerns about a domino effect. Yet Britain, with its separate language, independent central bank, sovereign currency and physical separation from the continent, has always maintained a healthy dose of euroskepticism. While the rise of anti-euro nationalist politicians in a number of countries in the region does represent a threat to ongoing unity, it’s worth noting that the majority in most European countries approve of the euro and want to see it survive. In fact, only 27% of those surveyed in the European Commission’s Eurobarometer poll in 2016 indicated they were against the European project. Recent election results in the Netherlands, Austria and France all suggest continued majority support for the European experiment. Yet even in the event of a crisis, institutional safeguards in Europe are stronger than ever before, and include a €500 billion European Financial Stability Fund that should be sufficient to support the banking system if needed. Meanwhile in China, the world’s second biggest economy, President Xi Jinping has every incentive to maintain stability ahead of this fall’s Party Congress, where he hopes to use a raft of leadership transitions at the top of the Communist Party to consolidate political power. In Japan, Prime Minister Shinzo Abe recently proposed two new governors at the Bank of Japan, who, if elected, would consolidate his influence over central bank policy and ensure fidelity to his stimulative policy agenda.

In summary, political risk in non-US markets looks exaggerated by depressed share prices, whereas US stocks regularly charting new highs appear to be fundamentally underpricing the risks associated with one of the most uncertain and divisive political climates of our lifetime.
But What About the US Dollar? A Brief Rebuttal.

In a recent fund manager’s survey by Bank of America Merrill Lynch, almost half of professional investors surveyed named the “long USD” as the market’s most crowded trade. That was nearly five times the response of the second-most crowded trade (short government bonds). Whenever we put forth a bullish argument for non-US assets, the strong dollar is quickly offered up as a rebuttal. This line of thought is overly simplistic, in our opinion. First, there are several reasons to question the consensus “strong dollar” trade; and second, we think it’s wrong to assume non-US stocks will inevitably underperform in a strong-dollar environment.

To the first point, let’s start with the observation that the sitting president of the United States has called the dollar overvalued and has been actively trying to talk down the greenback to improve export competitiveness. That’s a remarkable shift from the “strong dollar” policy that has dominated US Treasury affairs for more than two decades. Turning to fundamentals, Figure 12 suggests that the real effective exchange rate (REER) of the USD is nearing a cyclical peak. The greenback also looks materially overvalued on purchasing power parity relative to the currencies of the United States’ main trading partners (the Japanese yen, British pound and euro). It’s also worth mentioning that historically the dollar has tended to anticipate future rate hikes, not react to them, leading us to believe that the Fed’s expected rate hike trajectory is already priced in.

We also believe that the default assumption that a stronger dollar equals weaker non-US equity performance is flawed. The notion is likely rooted in emerging-market crises of the past, where excessive exposure to dollar-denominated debt spelled trouble for overleveraged economies once interest rates rose and the greenback strengthened. Today, dollar debt exposure in emerging markets is well below the levels experienced in the 1990s, and current account balances in the region have improved. These factors should give markets outside the United States with dollar debt exposure significantly more breathing room to continue financing their deficits even in the event of a modest backup in US yields. Also worth noting is the competitive boost provided by dollar strength on export-oriented markets like Europe and Japan.

### Figure 12: USD REER
March 1980–March 2017

<table>
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<td>140</td>
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<td>2017</td>
<td>150</td>
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</tbody>
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Source: Bloomberg, Barclays.

Conclusion: Compelling Value in Markets Outside the United States

As the anticipated value rally gains steam, non-US stocks should begin to benefit. Like the value universe a year ago, non-US equities today look to us to be undervalued, under-owned, and exposed to positive catalysts, including improving corporate fundamentals, economic tailwinds, and political and policy support. On the other hand, the US market currently trades at record-high levels and stretched valuations at a time when peak earnings have begun to roll over. US political uncertainty and risk have rarely been higher in our lifetime. Meanwhile, various US economic indicators have been stalling and monetary policy is tightening. While we continue to find select value in the United States, we are exceedingly cautious about the expensive sectors, regions and stocks that have fared so well over this protracted bull market. As ever when market cycles mature, long-term value often emerges among the most unloved and overlooked stocks. Thus we intend to look outside the US for the strongest opportunities.
WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors.

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1. Source: FactSet. Value is represented by the MSCI World Value Index, and growth is represented by the MSCI World Growth Index. Performance of the MSCI World Value Index compared to the MSCI World Growth Index is measured from the inception of the indexes on 12/31/75 through 12/31/16. Past performance does not guarantee future results.
2. Source: Bloomberg.
3. Source: Bank of America Merrill Lynch. Survey period from 1/6/17–1/12/17. An overall total of 215 panelists with $547bn assets under management (AUM) participated in the survey. 176 participants with $455bn AUM responded to the Global Fund Manager Survey (FMS) questions and 102 participants with $212bn AUM responded to the Regional FMS questions.

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