Don't Neglect Investments Outside the U.S.

Equity investors have both tactical and strategic reasons to combat home country bias and to go global.

Morningstar Inc.
June 2023

Dan Lefkovitz
Strategist, Morningstar Indexes
dan.lefkovitz@morningstar.com

https://indexes.morningstar.com/

An *Economist* cover story could once again signal a market top. In April, the venerable publication led with: "Riding High: The Lessons of America's Astonishing Economy." It noted the United States' sustained record of innovation, productivity, and stock market dominance. Longtime *Economist* readers will recall several covers that turned out to be contrarian indicators—2003's "The end of the Oil Age"; 2009's "Brazil takes off"; or June 2022's "Europe's Winter Peril." Could this one follow suit?

A common theme at the 2023 Morningstar Investment Conference in Chicago was the relative attractiveness of investment opportunities outside the U.S., especially equities. Some speakers pointed to macro factors, including recession, inflation, and the dollar as reasons to be wary of the U.S. market. Stock-pickers cited fundamentals, such as better valuations elsewhere and U.S. market concentration.[1]

The Morningstar Global Markets Index,[2] a broad gauge of equities spanning 48 developed and emerging markets, has been dominated by the U.S. for years. The U.S. share of global stock market value has climbed to near 60%—far out of proportion to its 25% share of the global economy. History suggests a cyclical nature to geographic leadership, for both markets and currencies. Global diversification may not have paid off lately, but U.S. investors have good reason to broaden their opportunity set across borders. The rationale is both tactical and strategic.

Key Takeaways:

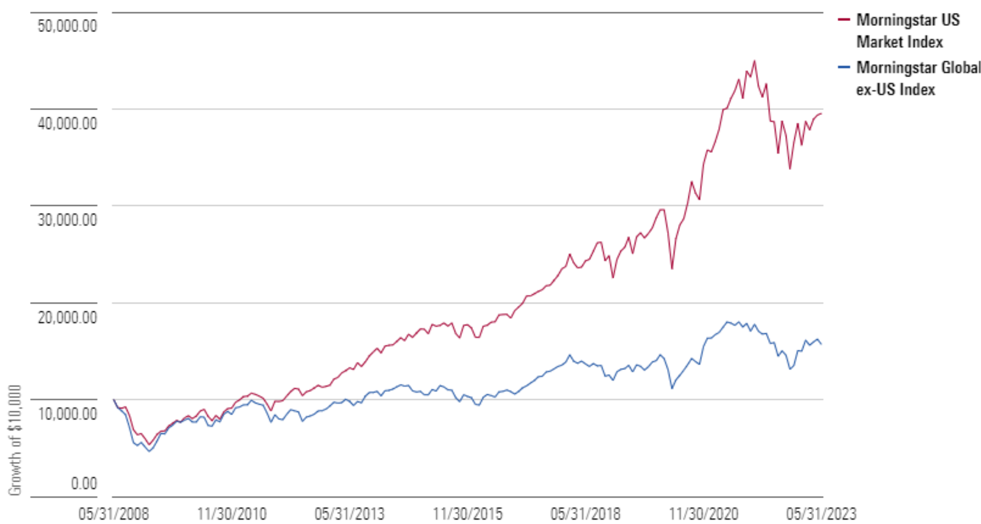
- The U.S. equity market looks high-priced, top-heavy, and low yielding compared with global counterparts.
- Investors would do well to reflect on the impermanence inherent to capitalism. Markets are cyclical; currencies fluctuate; and valuation differentials create opportunity.
- A number of catalysts could favor equities outside the U.S., some macro some micro.
- Ultimately, the strategic case for global diversification is strong. It's less about noncorrelated assets and more about broadening the investment opportunity set to the fullest. Many of the leading global franchises, including companies dominant in the U.S. market, are found across the globe. Great businesses at compelling prices can come from anywhere.

1 Lynch, Katherine. "Which Will Outperform: U.S. Stocks or International?" Morningstar. April 28, 2023.
2 For a full discussion of index methodology, see Morningstar Global Markets Rulebook

An American Equity Epoch

Since the global financial crisis of 2007-09, U.S. equities have led the pack. For the 15-year period through the end of May 2023, the Morningstar US Market Index, which includes large-, mid-, and small-cap stocks, quadrupled in value (with dividends reinvested). The Morningstar Global ex-US Index, which spans developed and emerging markets, has not even doubled, in U.S. dollar terms.

Exhibit 1 U.S. Stocks Have Trounced Their Counterparts Outside the U.S. Since the Global Financial Crisis



Source: Morningstar Direct. Total Return and Gross Return, USD index variants displayed.

How has this happened? Apple, Microsoft, Alphabet, Amazon.com, and Nvidia have joined the "Trillion Dollar Club" on the back of soaring profits. Stocks like Meta Platforms (formerly Facebook) and Tesla came to market after the financial crisis and are now among the world's largest public companies.

Equities outside the U.S., for their part, have stumbled. Chinese internet giants like Tencent and Alibaba had a spectacular rise, but then got kneecapped by a government crackdown starting in late 2020. Corporate Europe was labeled by the *Economist* as "The land that ambition forgot" for its lack of dynamism and old economy orientation—banks, telecoms, and conglomerates. The U.K. is a shadow of its former self. A *Financial Times* op-ed carried the title "London is becoming the Jurassic Park of stock exchanges," thanks to Brexit and other factors. Japan has muddled along, and while markets like India and Sweden have shined, their equity gains are much diminished when translated into U.S. dollars.

"King Dollar" has been dominant. In 2022, the euro fell below dollar parity for the first time in two decades. The yen hit an all-time low against the greenback that year.

U.S. share of the global equities universe—as measured by the Morningstar Global Markets Index—has risen to 59% as of mid-2023, not quite as high as the 61% level at the end of 1999, but a far cry from sub-40% in early 2009. Meanwhile, the U.S. share of the global economy is only 25%, a striking contrast.

Exhibit 2 The U.S Share of Global Equities Grew From Sub-40% 15 Years Ago to Near 60% Today

Source: Morningstar Direct and Morningstar Indexes. Total Return, USD index variant displayed.

Of the largest 20 public companies as of mid-2023, only two weren't American.

Exhibit 3 Only Two of the World's 20 Largest Public Companies Now Come From Outside the U.S.

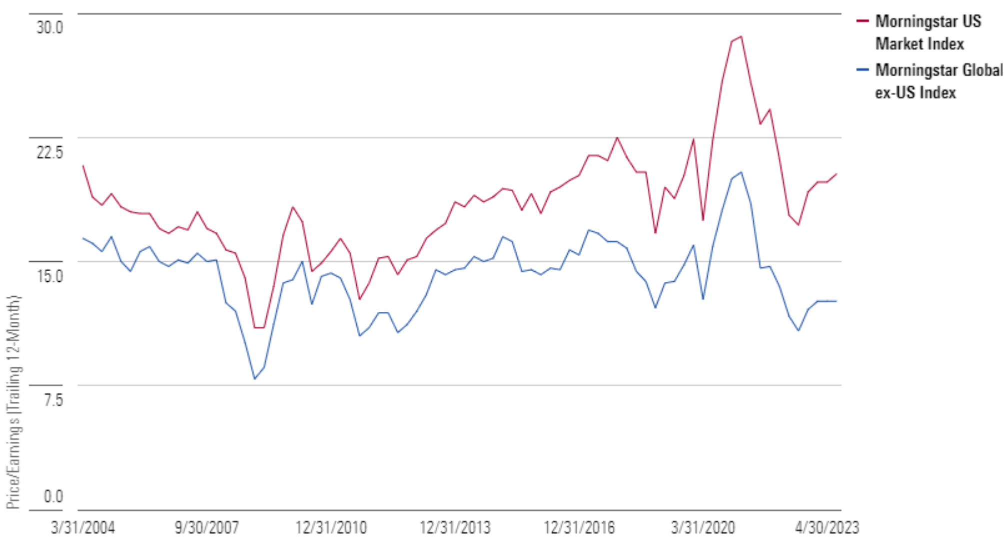
Constituent	Weight %	Country	Sector
Apple	3.9	U.S.	Technology
Microsoft	3.6	U.S.	Technology
Amazon.com	1.6	U.S.	Consumer Cyclical
Nvidia	1.4	U.S.	Technology
Alphabet A	1.1	U.S.	Communication Services
Alphabet C	0.9	U.S.	Communication Services
Meta Platforms	0.9	U.S.	Communication Services
Berkshire Hathaway	0.9	U.S.	Financial Services
Tesla	0.8	U.S.	Consumer Cylical
UnitedHealth	0.7	U.S.	Healthcare
ExxonMobil	0.6	U.S.	Energy
Johnson & Johnson	0.6	U.S.	Healthcare
JPMorgan Chase	0.6	U.S.	Financial Services
Visa	0.6	U.S.	Financial Services
Taiwan Semiconductor Manufacturing	0.5	Taiwan	Technology
Eli Lilly	0.5	U.S.	Healthcare
Broadcom	0.5	U.S.	Technology
Procter & Gamble	0.5	U.S.	Consumer Defensive
Nestle	0.5	Switzerland	Consumer Defensive
Mastercard	0.5	U.S.	Financial Services

Source: Morningstar Direct. Morningstar Global Markets Index Constituents. Data as of May 31, 2023.

Valuation and Concentration Should Be Concerns for U.S. Investors

"The view from the Morningstar Investment Conference is that [international stocks] are looking exceptionally cheap relative to U.S. stocks right now," began a recent article on Morningstar.com.[3] This is certainly true when comparing markets on a price/earnings basis. Though the U.S. has long traded at a premium, justified by the growth and profitability of many of its leading companies, the gap has widened dramatically in recent years. In the 2004-07 time frame, U.S. equities sometimes traded below a 15% premium. U.S. stocks were 60% more expensive as of mid-2023.

Exhibit 4 U.S. Stocks Have Long Traded at a Premium, but the Gap Has Widened in Recent Years



Source: Morningstar Direct. Data as of May 31, 2023.

When global equities are viewed more granularly, the scope of the U.S. premium becomes apparent.

Exhibit 5 U.S. Equities Are Pricey Compared With All Broad Counterparts

Index	Price/Earnings (Trailing 12-Month)
Morningstar US Market	20.3
Morningstar Global ex-US	12.6
Morningstar Emerging Markets	11.4
Morningstar Developed Europe	13.2
Morningstar Japan	13.5
Morningstar Asia Pacific	13.0
Morningstar UK	10.1

Source: Morningstar Direct. Data as of May 31, 2023.

3 Lynch, Katherine. "Which Will Outperform: U.S. Stocks or International?" Morningstar. April 28, 2023. https://www.morningstar.com/articles/1153032/which-will-outperform-us-stocks-or-international?utm_source=eloqua&utm_medium=email&utm_campaign=newsletter_stockstrategist&utm_content=44498

Partly as a result of high prices and partly because of the growth nature of its market, the U.S. compares unfavorably from a yield perspective with its peers.

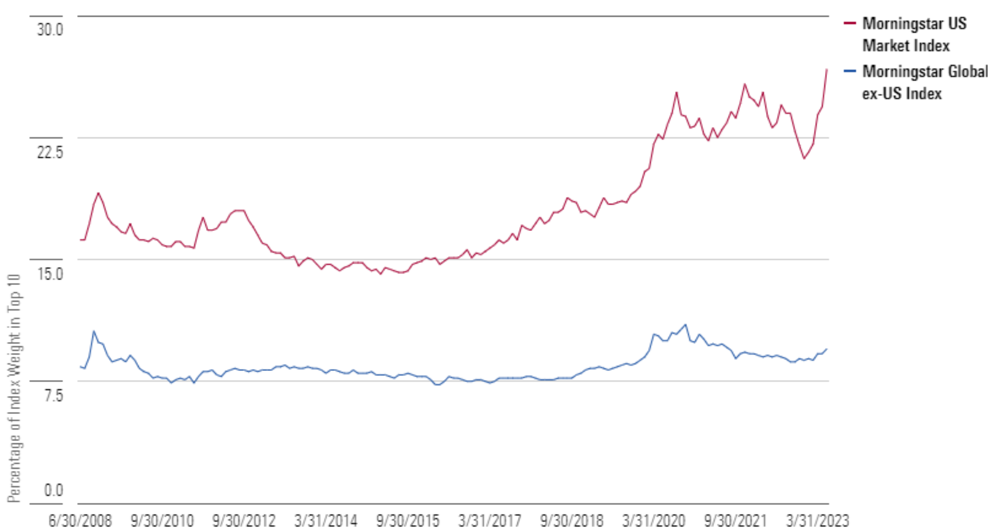
Exhibit 6 Dividend Yields Are Far Higher in Equity Markets Outside the U.S.

Index	Forward Dividend Yield %
Morningstar US Market	1.6
Morningstar Global ex-US	3.2
Morningstar Emerging Markets	3.3
Morningstar Developed Europe	3.2
Morningstar Japan	2.5
Morningstar Asia Pacific	3.0
Morningstar UK	4.0

Source: Morningstar Direct. Data as of May 31, 2023.

Concentration was another issue cited from the Morningstar Investment Conference stage. “The U.S. market is driven by eight companies, and most of their price/earnings ratios are very high, while international stocks trade in single-digit price/earnings ratios,” said Dan O’Keefe, portfolio manager at Artisan. “If you think the U.S. market is going to outperform international equities, which in many cases are at single-digit price/earnings ratios, you have to believe Apple is going to expand its multiple and grow its earnings," O’Keefe said. “I wouldn’t make that bet at all,” he stated.

Exhibit 7 The Top 10 Companies in the U.S. Market Have Grown Their Share Significantly



Source: Morningstar Direct. Data as of May 31, 2023.

As with vaalution, concentration has long been a feature of the U.S. stock market. The U.S. has been consistently more top-heavy than the universe of equities outside the U.S. That's partly a function of it being a single market—the Morningstar US Market Index, which includes, large-, mid-, and small-cap stocks (not micro-cap) contained roughly 1,500 securities as of mid-2023. By contrast, its global ex-U.S. counterpart spanned 47 developed and emerging markets and roughly 6,500 securities. But whereas the largest U.S. companies now consume a far larger share of the market—27% as of mid-2023—concentration outside the U.S. has decreased, to just 9.5% share for the top 10. The U.S. market is now more concentrated than during the late-'90s bubble period.

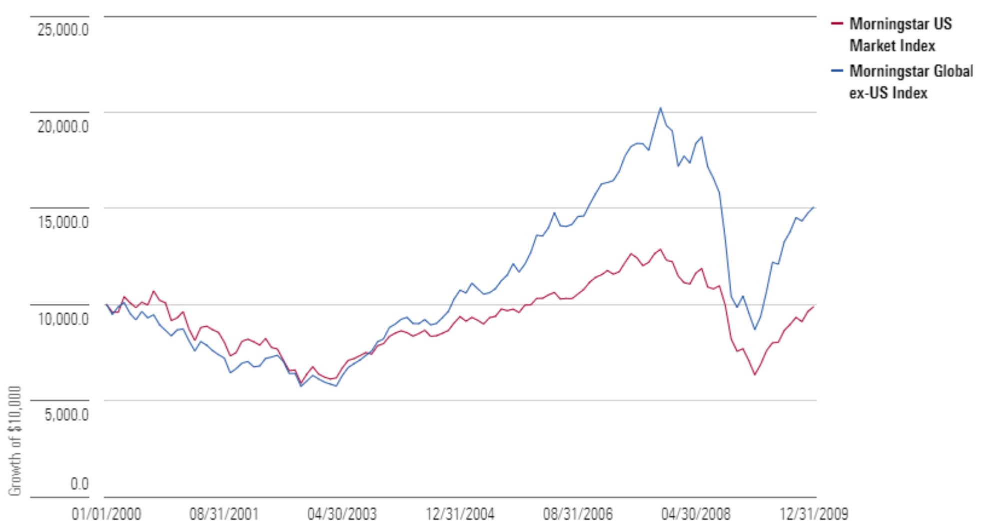
Change Is the Only Constant in Markets

Valuation and concentration are important, but they are insufficient reasons for a leadership rotation. Pricing differentials can persist. So can concentration. Perhaps it's simply a winner-take-all era.

Historical perspective on market cyclicality is important to consider. Think back to before the financial crisis. The first 10 years of the 21st century is referred to as the "lost decade" for U.S. investors. Those who piled into the late-1990s era of "irrational exuberance" saw the popping of the dot-com bubble, then recession and 9/11. Even when the market rebounded in 2003, it was a tepid recovery. In 2008, the market crashed. An investment in the broad U.S. equity market at the start of 2000 was worth less by the close of 2009.

This was not the case for stocks outside the U.S., which enjoyed a boom from 2003-07. Emerging markets were especially strong during those years. China's runaway economic growth drove a "commodities super-cycle." The hottest investment theme was BRICS—Brazil, Russia, India, China, and sometimes South Africa.

Exhibit 8 The Lost Decade for U.S. Stocks Wasn't as Bad Outside the U.S.

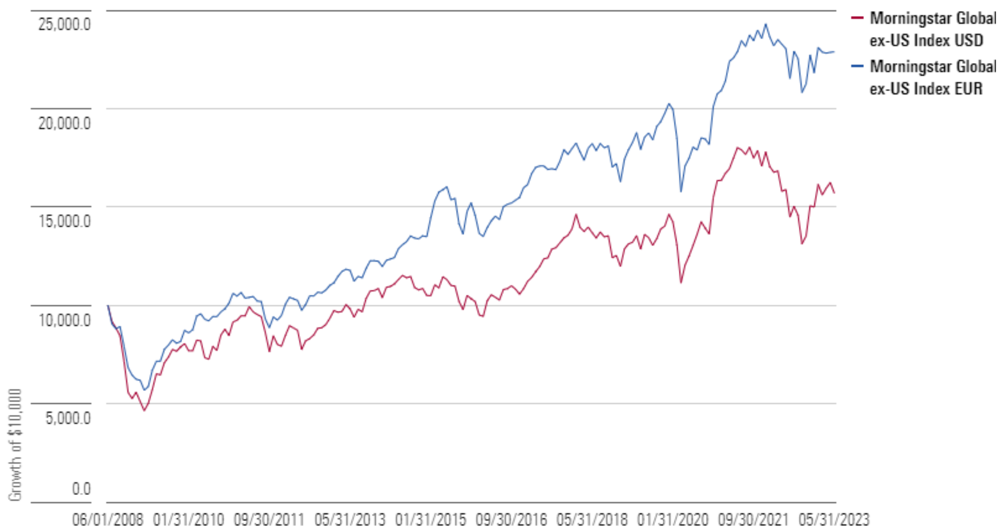


Source: Morningstar Direct. Total Return and Gross Return, USD index variants displayed.

It was by no means obvious in 2010 that U.S. equities would so thoroughly dominate in the years after a crisis that originated in the U.S. housing market and financial system. Impermanence is a feature of capitalism. Old industries fade, and new ones emerge. Some of the largest companies in the U.S. market were not even public 10 years ago.

Currency leadership can also be cyclical. Dollar dominance has diminished returns for equities outside the U.S. when translated into dollars. In euro terms, their performance has been much better.

Exhibit 9 Dollar Dominance Has Diminished Global Equity Returns When Translated Into USD



Source: Morningstar Direct. Gross Return USD and EUR index variants displayed.

Investor Ruchir Sharma wrote about "peak dollar" for the *Financial Times* in January 2023:

> *"The dollar has been the world's dominant currency for 102 years, eight years longer than average for its five predecessors going back to the 15th century, including most recently the British pound. Decline is overdue. Yet the prevailing assumption remains that, lacking serious rivals, the dollar can stay dominant—now and for the foreseeable future.*

> *"The dollar's long rule has been far from a steady climb though, instead rising and falling in long cycles. Its two major upward swings—one starting in the late '70s, another in the mid 90s—last about seven years, yet by October its latest upswing was 11 years old. The greenback is now as expensive as it has ever been, on some metrics."*[4]

Time will tell if Sharma is right. There are good reasons the dollar could stay ascendent and strong. But the risk of dollar decline is worth hedging. A portfolio should be prepared for a range of scenarios.

What about potential catalysts for stocks outside the U.S.? Sure, they're cheap, but could they just be a value trap? Beyond dollar weakening, a few potential tailwinds include:

4 Sharma, Ruchir. "Ruchir Sharma's investor guide to 2023: from peak dollar to better TV." *Financial Times*. Jan. 5, 2023.

- China's noncorrelated economic cycle
- Japan's continued corporate restructuring
- The clean energy transition
- Supply chain reshuffling/reshoring/near-shoring/friend-shoring
- Emerging-markets growth

Emerging markets are a "high conviction" asset class in the view of Morningstar Investment Management. Philip Straehl writes:

> "*[T]he structural story around emerging markets remains intact. Emerging markets represent 80% of the world's population and nearly 70% of the world's GDP growth, but only 10% of the total global equity market cap. A burgeoning middle class continues to develop in emerging markets and should present interesting opportunities for investors, albeit with higher volatility.*"”[5]

At the micro level, companies outside the U.S. are benefiting alongside their U.S. counterparts from trends like artificial intelligence, industrial automation, fintech, and innovative medical therapies. The beneficiaries of these growth drivers will come from across the value chain and across geography.

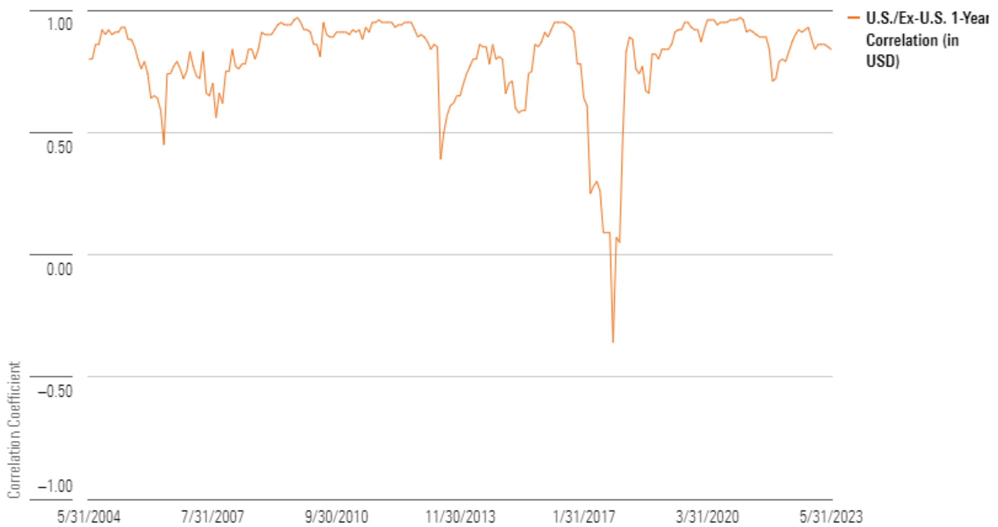
The Strategic Case for Global Diversification

Regardless of what happens in the near term, there's a good strategic case to be made for maintaining global exposure in a portfolio. Diversification has often been called the only free lunch in investing. Combining asset classes with correlations below 1.0 reduces a portfolio's overall risk profile and can contribute to superior risk-adjusted returns.

There is some diversification benefit to global investing, though it's not as if stocks outside the U.S. are an uncorrelated asset class. As displayed below, U.S. and ex-U.S. equities have typically moved in the same direction over the past 20 years. But not always. Correlations bounce around.

5 Straehl, Philip. "Global Convictions: April 2023 Asset Class Research. Morningstar Investment Management." April 27, 2023. https://mp.morningstar.com/en-us/articles/bltfde9e78437d85ee5/global-convictions-april-2023-asset-class-research

Exhibit 10 U.S. and Non-U.S. Stocks Have Tended to Move in the Same Direction—But Not Always



Source: Morningstar Direct. Morningstar US Market TR USD Correlation Displayed Relative to Morningstar Global ex-US GR UD. 5/31/2004-5/31/2023. Rolling Window One Year; One-Month Shift.

Why are equities across geographies more correlated to each other than stocks are to bonds? Several factors are at play, from the influence of global capital flows to the interconnectedness of the global economy. For example, only 61% of the Morningstar US Market Index's revenues are sourced from the U.S., according to Morningstar's revenue by region estimates. For Europe, less than half the index's revenues come from within the region.

Then there are sector dynamics. Energy and basic materials are deeply influenced by global commodities prices; companies in those sectors will respond similarly regardless of geography. Technology businesses across the world benefited from the shift to remote work and e-commerce during the pandemic.

But just because equities in different geographies don't diverge to the same extent as stocks and bonds doesn't mean they don't make essential contributions to a diversified portfolio. Investors everywhere exhibit home country bias, where preference for the familiar local market can leave a portfolio diverging meaningfully from the full spectrum of investment opportunities out there.

The composition of equity markets differs across geography. Below are the sector weights of various Morningstar equity indexes, several of which overlap. The U.S. stands out for its hefty technology stake and its low materials weight. Europe is heavy on financials, industrials, and healthcare. Asia Pacific has a large slug of basic materials and technology stocks, while the U.K. is heavy on consumer defensive and energy stocks. The Japanese market is tilted toward industrials, consumer cyclicals, and technology. In emerging markets, financials and technology are large weights. A U.S.-only portfolio lacks exposure to leading European consumer businesses (luxury goods, food and beverage, and so on), drugmakers, insurers, Japan's innovative manufacturers, miners and banks from Australia and Canada, emerging markets, Indian IT, and China's new economy.

Exhibit 11 Sector Exposures Differ Markedly Across Markets—the U.S., for Example, is Light on Materials and Technology-Heavy

Sectors	Morningstar US Market	Morningstar Global ex-US	Morningstar Developed Europe	Morningstar Asia Pacific	Morningstar UK	Morningstar Japan	Morningstar Emerging Markets
Cyclical							
Basic Materials	2.4	8.1	6.5	7.9	7.7	5.6	9.0
Consumer Cyclical	10.7	11.1	10.6	13.3	7.4	15.7	11.8
Financial Services	12.2	19.2	16.2	18.3	17.2	10.2	22.0
Real Estate	3.0	3.1	1.7	4.3	1.8	4.4	2.2
Sensitive							
Communication Services	8.1	5.5	4.0	6.9	3.7	6.1	8.7
Energy	4.2	5.2	5.3	3.0	11.7	0.7	4.7
Industrials	8.7	14.9	16.2	14.1	12.6	24.8	9.0
Technology	28.3	12.0	8.0	17.5	1.5	15.6	19.3
Defensive							
Consumer Defensive	6.4	8.2	11.9	5.8	17.7	6.5	6.0
Healthcare	13.5	9.5	15.2	6.8	13.1	9.1	4.3
Utilities	2.6	3.1	3.9	2.1	4.1	1.3	3.0

Source: Morningstar Direct. Year to date data as of May 31, 2023.

Drilling down to the security-level, leading global franchises can be found across the world. Dominant franchises—companies with economic moats or competitive advantages in the view of Morningstar's global team of equity analysts—are abundant outside the U.S. Many of these companies earn substantial revenues from the U.S. market. So, while it's true that U.S. investors can obtain global exposure by investing in U.S. multinationals, they may also neglect dominant players in the U.S. market if their portfolios are exclusively domestic.

The list below is a small subset of wide-moat ex-U.S. companies that traded at discounts to their long-term intrinsic values, as of May 31, 2023. The 20 stocks are listed in no particular order.

Exhibit 12 Great Companies at Compelling Prices Can Be Found Around the World

Company	Country	Sector
GSK	U.K.	Healthcare
Royal Bank of Canada	Canada	Financial Services
Kao	Japan	Consumer Defensive
ANZ	Australia	Financial Services
Barry Callebaut	Switzerland	Consumer Defensive
Toronto Dominion Bank	Canada	Financial Services
Taiwan Semiconductor	Taiwan	Technology
Safran	France	Industrials
Imperial Brands	U.K.	Consumer Defensive
ASML	Netherlands	Technology
GEA	Germany	Industrials
Tencent	China	Communication Services
Nabtesco	Japan	Industrials
Ambev	Brazil	Consumer Defensive
Elekta	Sweden	Healthcare
Chr. Hansen Holding	Denmark	Basic Materials
Airbus	Netherlands	Industrials
Westpac	Australiia	Financial Services
Yum China	China	Consumer Cyclical
Roche	Switzerland	Healthcare

Source: Morningstar Direct. Morningstar Global Markets Index Constituents. Data as of May 31, 2023.

Are Sunnier Days Ahead for Equities Outside the U.S.?

After years of U.S. market dominance, many investors have forgotten the benefits of global exposure. But markets are cyclical, currencies fluctuate, and valuation differentials can create opportunity. It may be hard to imagine today, but it's worth remembering that from 2003 to 2007, stocks outside the U.S. outperformed by a wide margin, with emerging markets leading the charge.

When the financial crisis hit in 2007, with the U.S. as its epicenter, it was by no means obvious that U.S. equities would dominate the subsequent 15 years. The U.S. was said to be entering a "new normal" of low growth, a "secular stagnation." Emerging-markets strength looked inevitable—a "rise of the rest." In 2011, the U.S. sovereign credit rating was downgraded.

The U.S. may continue to dominate global equity markets, but even the possibility of a shift toward other geographies is reason enough for investors to examine their allocations. Then there's the long-term strategic rationale for global exposure. Even if diversification benefits aren't the strongest, exposure to the broadest possible investment opportunity set makes sense.

About Morningstar Indexes

Morningstar Indexes was built to keep up with the evolving needs of investors—and to be a leading-edge advocate for them. Our rich heritage as a transparent, investor-focused leader in data and research uniquely equips us to support individuals, institutions, wealth managers and advisors in navigating investment opportunities across major asset classes, styles and strategies. From traditional benchmarks and unique IP-driven indexes, to index design, calculation and distribution services, our solutions span an investment landscape as diverse as investors themselves.

Please visit indexes.morningstar.com for more information.

Contact:
indexes@morningstar.com

© 2023 Morningstar. All rights reserved. The information, data, analyses and opinions contained herein (1) include the proprietary information of Morningstar, (2) may not be copied or redistributed, (3) do not constitute investment advice offered by Morningstar, (4) are provided solely for informational purposes and therefore are not an offer to buy or sell a security, and (5) are not warranted to be correct, complete or accurate. Morningstar has not given its consent to be deemed an "expert" under the federal Securities Act of 1933. Except as otherwise required by law, Morningstar is not responsible for any trading decisions, damages or other losses resulting from, or related to, this information, data, analyses or opinions or their use. Past performance does not guarantee future results. Before making any investment decision, consider if the investment is suitable for you by referencing your own financial position, investment objectives, and risk profile. Always consult with your financial advisor before investing.

22 West Washington Street
Chicago, IL 60602 USA

©2023 Morningstar. All Rights Reserved.