Thornburg

Global Equity

2024 Outlook – Global Equities: Time for International and Income?

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2023 was the year of the Magnificent Seven. However, we expect increased volatility may lead investors to rebalance toward income and international stocks.

Global equity markets (and risk assets in general) were surprisingly strong in 2023, helped by moderating inflation, resilient economies, lower interest rates, and a pause by major central banks towards the end of the year. The recession so many anticipated at the start of the year never materialized. Risk markets responded well, with the S&P 500 Index up more than 20% by mid-December, the NASDAQ up more than 40%, developed international markets (MSCI EAFE Index) up more than 15%, and emerging markets, dragged down by China, returning only about 7%.

Despite predictions by many market participants, including us, that the relative setup for international equities was favorable entering 2023, the U.S. looks set to turn in outperformance versus the majority of other developed and emerging markets. However, we note that many indicators that led us to last year's prediction remain stretched and that the MSCI EAFE Index has outperformed the S&P 500 since markets began rebounding in October 2022.

China was the exception to the rule, with major Chinese indicies down double digits as of mid-December. Chinese equities saw one positive quarter in 2023, following its long-delayed re-opening from overly restrictive COVID closures—pressures emanating from the nation's bursting property bubble overwhelmed post-COVID enthusiasm.

The Charge of the Magnificent Seven May Continue in 2024

The primary driver of U.S. index returns in 2023 was the emergence of AI as a significant market driver and the resulting charge of the Magnificent Seven: Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft, and Tesla. As of mid-December, the Magnificent Seven had contributed about two-thirds of the S&P 500's roughly 25% return, and the S&P's remaining 493 stocks about one-third. As of mid-December, the top 10 stocks in the S&P 500 made up one-third of the index, a new high for the period of U.S. outperformance. The comparable numbers for the MSCI EAFE and ACWI ex USA indices are approximately 15% and 11%, respectively. ChatGPT emerged a little over a year ago, on November 30, 2022. With that announcement and the emergence of other AI platforms, these seven stocks fueled AI mania.

The Magnificent Seven began 2023 with a price-to-earnings ratio of about 20x and are wrapping up the year with a PE in line with their long-term average of about 28x. In other words, these companies began 2023 at a steep discount, which has been closed. Of their year-to-date return, more than half derived from the increase in their PE ratio and the remainder from robust earnings growth anchored in the explosion of interest and adoption of AI.

A Cost of Capital Normalization Has Begun

Chart

Line chart with 3 lines.
The chart has 1 X axis displaying Time. Data ranges from 1982-12-31 00:00:00 to 2023-12-13 00:00:00.
The chart has 1 Y axis displaying values. Data ranges from 0 to 12.
Chart annotations summary

- 1982-2008 Average: 5.34%
- 2008-2023 YTD Average: 0.87%

End of interactive chart.

Source: Bloomberg

U.S. Equities Face a Conundrum with the Fixed Income Market

Heading into a new year, we see a disagreement between the U.S. equity and fixed income markets. As of late 2023, U.S. equities are priced at approximately 20 times earnings, which is 33% more expensive than the historical average of about 15 times earnings. Moreover, the financial markets anticipate earnings growth of about 12% this year. In other words, optimistic equity investors are willing to pay above-average valuations in anticipation of above-average growth.

However, the fixed income market is pricing in about 125 basis points of Fed easing in 2024 in anticipation of slower economic growth and perhaps the delayed recession many thought was possible in 2023. Market expectations for rate cuts were boosted in mid-December due to the dovishness surrounding 2023's final FOMC meeting.

We find it difficult to reconcile these two outcomes: a robust economy supporting solid earnings growth and expensive valuations, but not an easier monetary policy. Or you have a weakening economy and likely recession that supports about 125 bps of Fed rate cuts but not robust earnings growth and historically expensive valuations. You can't have it both ways.

This dichotomy, equity markets calling for growth and fixed income markets for recession, needs to be resolved, and investors may want to seek active equity returns until this situation settles. Given the mixed messaging from markets, we believe that quality and cash flow will be key for equities, and we favor businesses with durable models and the ability to navigate an environment with elevated levels of uncertainty and recession risk. Additionally, we believe active managers may be more agile in adapting to change through the coming year as financial markets rectify this bifurcation of expectations.

With a Higher Cost of Capital, Expect Income to Play an Enhanced Role in Total Return in 2024

As the growth vs. recession situation resolves, and markets continue to digest a more normalized cost of capital (see the illustration above), we expect more modest returns for equity investors and an environment that may favor steadier income-generating stocks. While inexpensive capital of the past decade was a tailwind for companies with less cash flow today, but higher potential growth rates, the rapid rise in rates that began in March 2022 should support more mature companies with consistent cash flow profiles, strong moats and the ability to self-fund future growth. If this plays out as we expect, income will likely play an even more significant role than usual in total equity returns.

Income-Generating Equities Present Attractive Value

Chart

Line chart with 2 lines.
The chart has 1 X axis displaying Time. Data ranges from 2006-01-31 00:00:00 to 2023-09-30 00:00:00.
The chart has 1 Y axis displaying values. Data ranges from -54 to -4.
End of interactive chart.

Source: Bloomberg

Investors are just emerging from a period of devastating inflation and performance in fixed income, and we believe equity income portfolios that have produced growing income streams are an excellent hedge against stubborn inflationary pressures in the U.S. and overseas. With fixed income markets still struggling in 2023, equity income has emerged as an attractive opportunity for investors, and we believe it offers attractive relative value and the opportunity to deflect any volatility stemming from the standoff between growth and a slowdown or even recession.

International Stocks Beckon with Attractive Valuations and an AI Hook

U.S. equities have outperformed international equities for much of the last 15-plus years. But we know from history that relative performance between U.S. and non-U.S. markets is cyclical.

At the end of last year, we noted several factors that in past markets (notably in the early 2000s) had led to a turn in international vs. U.S. performance. While that didn't happen in 2023 due primarily to the catalyst of AI and the performance of the Magnificent Seven, we note that those factors are still present and at stretched levels:

1. Relative Valuations: The MSCI ACWI ex USA Index trades at a 33% 1-year forward P/E discount to the S&P 500, near the widest levels of more than 15 years of U.S. outperformance. While research has shown that although valuation differentials may have a low correlation to short-term returns, they have an increasing impact the longer the holding period.
2. The U.S. Dollar: The dollar is a significant factor in the relative performance of international equities, contributing about 40% of international outperformance in 2002-2007 and half of its underperformance since then. The U.S. Dollar Index (DXY) sits at its highest level since late 2002, around the last time international began to outperform the U.S.
3. Market Concentration and Breadth: As noted above, just seven stocks contributed roughly two-thirds of U.S. performance in 2023, and the top 10 stocks now constitute 32% of the S&P 500. The comparable numbers for the ACWI ex USA Index are about 20% of the total return from the top seven stocks and 11% of the market cap in the top 10 companies.

While we can't time a turn in relative performance, we think it makes a strong case for rebalancing by U.S. investors who hold roughly 14% of their equity portfolio in international companies versus a 38% weight in the MSCI ACWI Index.

While Value has outperformed in international year to date as opposed to the U.S., where growth has outperformed due to AI and the impact of the Magnificent Seven, there is no shortage of interesting Growth and Value investment themes outside the U.S. In AI, many leading "picks and shovels" investments are outside the U.S.—companies such as Taiwan Semiconductor and SK Hynix and semiconductor equipment makers ASML, BE Semiconductor Industries, and Disco. In the booming market for weight loss medications, Ozempic manufacturer Novo Nordisk's headquarters are located in Denmark.

Relative Valuations Support Non-U.S. Assets

Chart

Line chart with 4 lines.
The chart has 1 X axis displaying Time. Data ranges from 2013-07-31 00:00:00 to 2023-11-30 00:00:00.
The chart has 1 Y axis displaying values. Data ranges from 9.39822229 to 23.47665054.
End of interactive chart.

Source: Bloomberg

We like these names because we don't have to select the "winners" but focus on the firms providing the tools all players need in the AI revolution. We believe many of the best firms and most attractive valuations are outside the U.S.

Outlook

Macro

Despite broad-based calls for a recession, an unexpectedly resilient economy drove strong performance for stocks across regions and sectors. While the possibility of rate cuts and the potential for a soft landing could fuel a continued rally for equity markets, we believe a more normalized capital and loftier valuations will temper investor expectations in 2024.

U.S. Equities

Optimistic investors are pricing in above-average valuations in anticipation of above-average growth in 2024. The dichotomy of equity markets calling for growth and fixed income markets for recession needs to be resolved, and investors may want to seek active equity returns until this situation settles.

International Equities

While slowing growth has pressured sentiment for non-U.S. equities, valuations remain compelling. Undervalued currencies relative to the USD could also be a longer-term cyclical tailwind.

Emerging Market Equities

Despite a lag in recovery versus developed markets and equal exposure to inflation and macroeconomic uncertainty, many long-term structural drivers remain intact. A China rebound may be a catalyst for global growth.

Positioning

Macro

The combination of an improving but uncertain economic picture is likely to spur market volatility. We expect more modest returns for equities and an environment that may favor quality and income-oriented stocks.

U.S. Equities

U.S. multiples remain broadly elevated relative to international markets versus historical averages. We continue to be selective and favor firms we believe can effectively navigate an environment of lower growth and more normalized interest rates.

International Equities

Relative valuations, especially in Europe, remain attractive for bottom-up stock picking despite concerns over slowing growth.

Emerging Market Equities

Economic growth potential appears more robust than in many developed markets. Select emerging market countries provide pockets of opportunity not currently reflected in valuations.

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