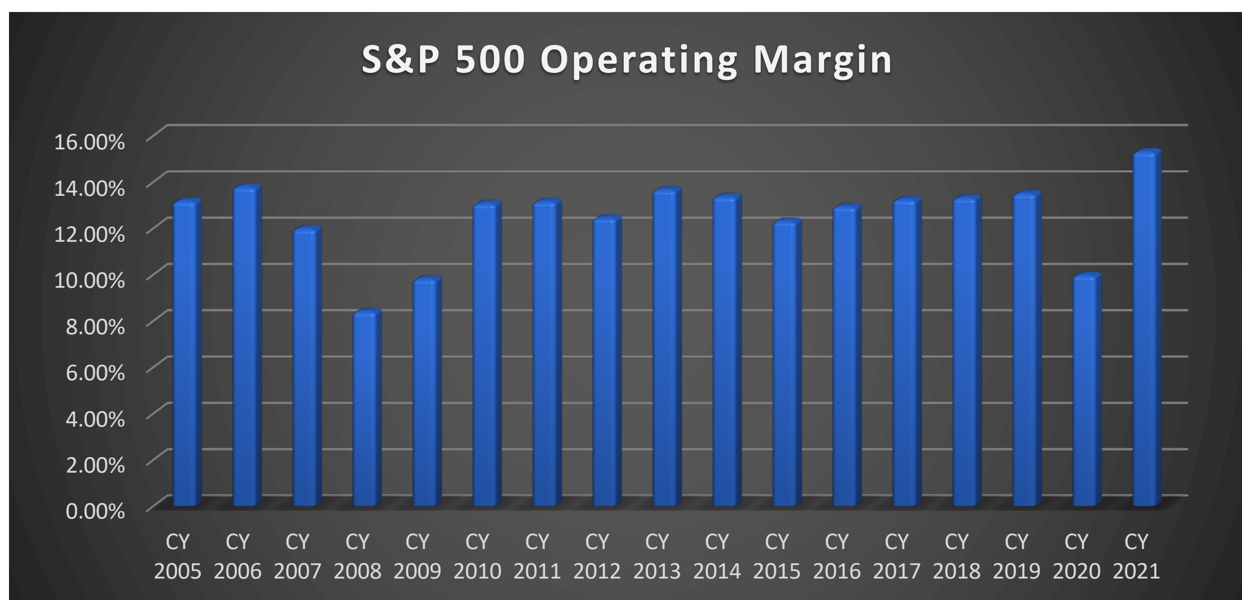
R3 GLOBAL CAPITAL, LLC

Going Global: The world is cheap

- Historically, the relationship between US stocks and global stocks has been cyclical
- In our view, rising costs make broad based margin expansion unlikely. If this is the case, it's much harder for earnings growth to exceed revenue growth
- Global GDP growth expectations are roughly in line with US GDP growth expectations yet US stocks trade at a significant premium to global stocks
- Global stocks are currently cheap relative to US shares and have a better dividend yield

Supply Chain & Inflation

From chip shortages to idle containerships waiting to dock, current supply chain inefficiencies have been well documented. For companies this generally means rising costs, and if you can't pass these costs on to customers, it means compressing margins. According to Bloomberg, the aggregate operating margin for the S&P 500 at the end of 2021 was 15.31%, the highest margin listed for the S&P 500 for over 20 years. While this expansion may be skewed to some extent by the significant growth and high-margin big tech names over the period, and the subsequent larger piece of the index that they make up, we see wide margins in other sectors as well. S&P 500 industrials sector shows the widest operating margin since 2017, same story for consumer discretionary, financials, communication services, the story goes on. Not every sector shows a long-time high, but none are showing particularly low numbers. All this despite high single to low double digit PPI prints for the back half of 2021 and an US unit labor cost growth of over 6% in 3Q21. The point to consider here is that the bar is high for US company profitability coming into 2022.

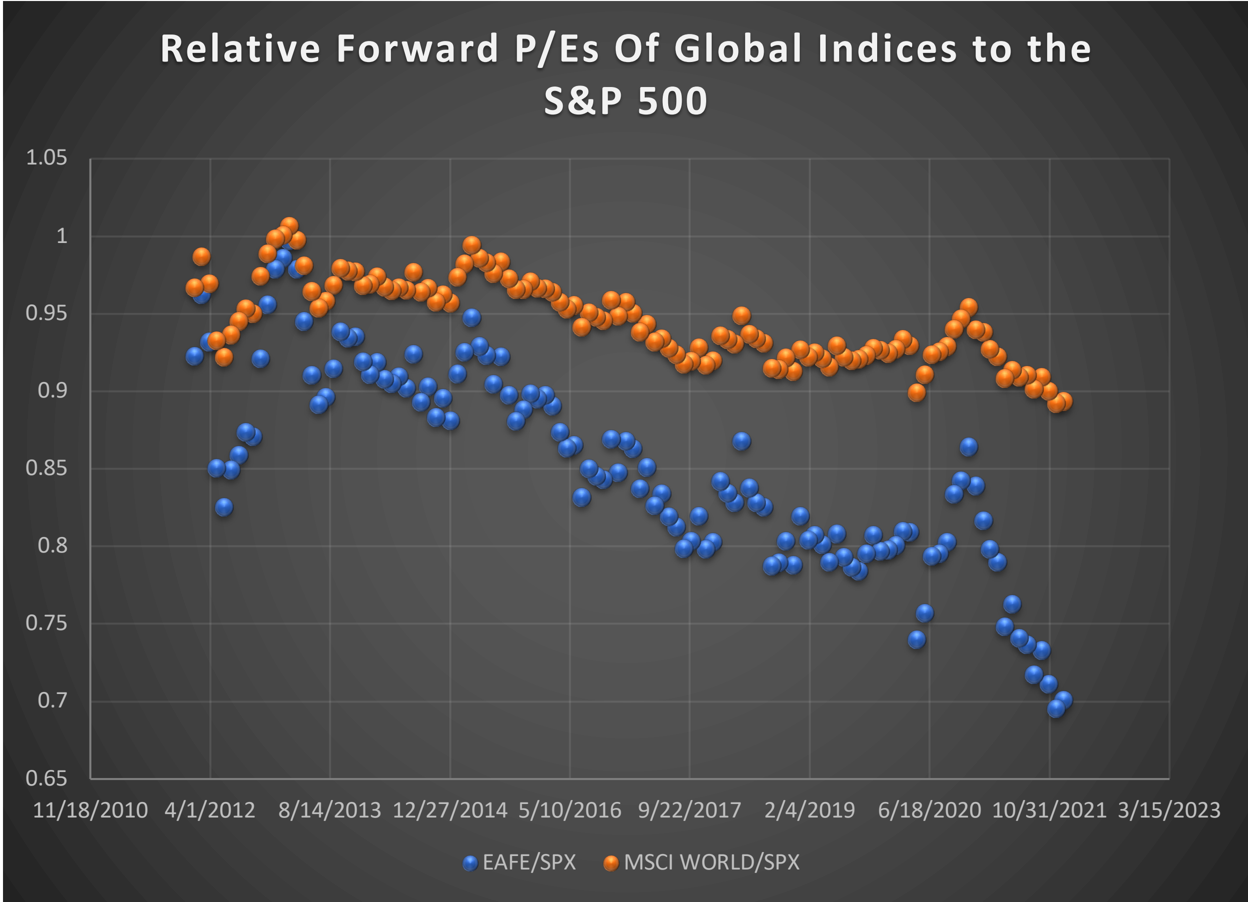


In an environment where companies are seeing contracting margins, assuming a constant number of shares, it follows that earnings cannot outgrow revenue. It becomes useful to look at top-line growth

Source:Bloomberg

prospects as a proxy for earnings growth, and to consider what you are paying for that growth, when allocating capital.

The World Bank projects 2022 global GDP growth at 3.8% with the US slightly behind at 3.7%. The IMF has global growth at 4.4% with the US at 4.1%. At the time of this writing, the MSCI World index (developed markets including USA) trades at 17.9x 2022 earnings. As a proxy we can separate the US from the International components by using the S&P 500 and MSCI EAFE which are trading at 19.6x and 14.6x respectively. US stocks are trading at a significant premium to global stocks. This is not unusual. The US often trades at a premium to global stocks for several reasons. However, despite the disparity in growth expectations, the S&P 500's premium is much larger than average as seen below by the relative multiples of the MSCI EAFE and the MSCI World indices.



Source:Bloomberg

This valuation to growth disparity could be the product of a few things. Perhaps investors expect better growth than that modeled out of the US, or slower global growth or that US companies will somehow manage the global increase in input costs better than other regions. It's possible that US investors are subject to a hometown bias. Maybe the relatively large concentration of big tech in the US is distorting the multiples of the index. Whatever the reason, we think it remains clear that investors are paying significantly more for US earnings growth than they are for global earnings growth. Not to mention that at the time of this writing, the dividend yields on the indices above are 1.36% on the S&P 500, 1.78% on the MSCI World, and 2.73% on the EAFE. Investors in

International companies are paying less for earnings growth vs the US, but also earn a significantly higher dividend yield.

Considering the points laid out above, investors should consider an allocation to international high-quality dividend paying stocks, which is why we currently favor both International (developed markets ex-USA) and global (developed markets with US) portfolios. Furthermore, given the inflationary environment, we think it's a good idea to look for names that can grow their dividends over time to help offset or completelystay ahead of inflationary pressures.

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