Economic Factors for Investing in International Equities – February 18, 2025

David Hagee: Hello and welcome to Conversations with Commerce Trust. Our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust.

Today we're discussing international markets with Matt Schmitt, our Director of Equity Strategy here at Commerce Trust.

Welcome to the podcast, Matt.

Matt Schmitt: Thanks for having me, David.

David: Great to have you here. We're talking about international markets today. It's a subject we really haven't covered before.

I think it'd be helpful if we spent a little bit of time on history here. So investors clearly have a choice of investing domestically versus internationally and let's take a second to review what's going on over, say the past, inside this century (21st) if you will. What have the returns been of the US market versus the international market if you're looking longer term?

Matt: Yeah, the U.S. markets have really dominated really for the last decade. If you go back longer than that, they have shifted over time, right? You've had periods of outperformance from the international markets, but looking at the last decade in particular, you're seeing returns from the U.S. equity markets that are three and four times what you were able to get out of the international equity markets during those same time periods. So really a pretty dominant leadership from U.S.-based equity investments over that time period.

David: I'm struck by the fact that really the first decade of this century (21st), always weird to say this century, but the first decade of this century international markets did extraordinarily well, beating the S&P (500 Index) for seven out of ten years.

But of course, inside the U.S. we had the dot-com era transforming into the "dot-bomb" era, and we also had the Great Financial Crisis that helped international markets outperform the U.S. a little bit over that time period. Where in the teens (2010-2019) we've seen the exact opposite. And to your point, Matt, we've seen this acceleration of U.S. dominance in international equity investing really over the past 15 years or so.

One of the other factors that I always like to look at when we're taking a peek inside markets is the economic picture. I'm struck by the fact that economic growth in the U.S. over the past 15 years has been very robust. Really post-Great-Financial-Crisis of 2008 and 2009, the size of the European economy was 10% larger than the U.S. 15 years ago. However, by 2022 it was 23% smaller. The European economy was 23% smaller than the U.S. just because you've seen this dynamic growth.

What are the factors you're thinking about in terms of how the U.S. has been able to outperform European economies over this time period?

Matt: You really have to turn and think about the structure of where that growth is coming from in the U.S. economy versus what you're seeing overseas. And the dominant position that technology and communications, in particular, those areas have had for our economic engine here in the U.S. versus when you look overseas. If you stop and think about Europe, in particular, being much more industrial-focused and even financial-based in terms of the leading sectors within their markets.

And the same would apply to a country like Japan. You think about their kind of technology leadership once upon a time, but today that technology is more about industrial tools and equipment, auto manufacturing, and consumer electronics. All which have really in a lot of ways seen margin compression versus the leadership from the U.S. around the technology growth there.

Whether it's the Apples (Apple Inc.) and things like that of the world or the NVIDIA (NVIDIA Corporation) and as you start to then think about AI (artificial intelligence) and the influence that it's having on the domestic growth side of the market.

David: Yeah, definitely a more dynamic economy inside the U.S. I'm always kind of left with the impression that Europe's economy is a little more rigid, maybe not able to move as quickly or to be able to adjust their labor markets as quickly. I think Japan falls in that same category too.

That brings up an interesting topic though, as we're talking about international markets. Certainly there's a wide variety of differences there. Could you walk us through a couple of segments of the international market?

Matt: Yeah, in terms of that sector breakdown if you think about Europe, excluding the U.K. (United Kingdom) now with them really having been removed from the Euro (EU- European Union), look at their information technology sector weighting as a percentage of their market capitalization they sit at 10% today. I keep throwing communication services in there as that's another big area in the U.S. and it sits at 4.3%, so cumulatively you're at 14.3% compared to the U.S. at 41.6%.

You can see the infotech at 32% and communication services at another 9.6%, so pretty big differences there when you look at that. A country like Japan that I mentioned earlier sits at 14.4% in information technology and 7.3% in communication services, so even on a combined basis there you're at a half-weight relative to the United States sector breakdown. Pretty massive differences.

David: Yeah, certainly. And I think that impacts the next couple areas to talk about in terms of the factors in international investing.

[That] would be interest rates and trade policy. Certainly here inside the United States with the new administration coming in, tariffs have really come into focus. As you talk about some of these industrial sort of leanings inside Europe and Japan those tariffs are just much more impactful over there as they can kind of slow down the economy a little bit more.

So just another factor to consider in international investing are going to be these tariffs and maybe some of this ties back to interest rates as well. So as we look globally at interest rates, the U.S. has had interest rates move up substantially over the course of the past four years, even though we've trimmed them back by about 1% since September of 2024. Could you walk us through a little bit on the interest rate side where things are at in Europe?

Matt: The U.S. interest rate environment is, post-2022 when we saw the big move up in interest rates, you look at the U.S. overall level of interest rates compared to Europe. We're running at a premium, so to speak, in terms of yield and I think that draws capital towards the U.S. And Europe's still dealing with some economic weakness that they're trying to process through, so they haven't been able to lift their interest rate levels to the same point that the U.S. has.

Come back to Japan again, they operated with a negative interest rate environment for what seemed like decades. They now have positive interest rates at a still very, very low level relative to the U.S. The U.S. capital markets are still attractive and still drawing capital into the U.S. which just has further supported that strong dollar.

David: As you talk about this differences in interest rates here, certainly that can affect the currencies of these different countries and ties back to trade as well. A stronger dollar versus, say a weaker Euro or weaker Yen can lead to trade differences here. As we're talking about currency, maybe not focusing on the actual currency itself, but what sort of impact does currency have on international investing?

Matt: For a U.S.-based investor as they think about investment in a mutual fund or an exchange traded fund overseas, the return earned on that underlying investment has to outpace the appreciation or depreciation of the currency difference. So, to the extent that say the U.S. dollar outperforms the Euro by 5% or 8% over any given time period, that's a direct headwind towards that return coming back to the investor.

So, equal investment, same investment in the U.S. versus the same investment in Europe, the European investment is going to have to outperform by that currency difference in order for the U.S.-based investor to break even between the two. So, the strong dollar has proven to be a real headwind for U.S.-based investors over the past decade plus.

Really going back, the U.S. dollar has been on a pretty strong run since about 2009 kind of post-Great-Financial-Crisis. That's been one of the key drivers for better returns out of their U.S.-based investments.

David: So, as we have a clearer picture of this economic backdrop that underpins international investing, let's talk a little bit about how international investing is organized**.** I'm seeing a broader structure. Today we've talked mostly about Europe and Japan. We would loosely define those as developed markets in investing. What other pieces should we be thinking about from a structure of investment vehicles in international investing?

Matt: I think China, obviously, and the emerging markets are a key part of what needs to be considered and that's really where you've seen more perhaps economic volatility, but also perhaps a little more economic growth driven from those emerging economies. And specifically China for a long time was that growth engine for the emerging economies. They're certainly in the crosshairs of these tariffs as well, so it'll take a little time to see how it all plays out.

David: Now that we have a good understanding of sort of the playing field, if you will, looks like for international investing, let's talk a little bit about why we want to always keep an eye out for international investing. As we mentioned, the returns have been lagging for the past decade plus. But as we're thinking about international investing, we mentioned perhaps some green shoots of some more recent outperformance there. But what are the reasons why we like to look at international investment?

Matt: Yeah, their valuations are very attractive. They were sitting kind of at or near historical levels and so that would argue that the markets are fairly valued where a lot would argue that the U.S. equity market is overvalued or richly valued today. So valuation matters.

I think dividend yield is another measure that gets looked at and when you look at the dividend yields on U.S. equities versus the emerging markets yields which are probably double that of the U.S. And then you see the Europe, Australia, Far East or kind of that EAFE market (MSCI EAFE Index) is also, yield-wise, pretty attractive on a comparable basis. So I think all of those factors certainly lead us to want to continue to include [international investments] in our portfolios.

David: So the other piece that I'm looking at as well when we're starting to talk about vehicles, you can invest in international stocks in a couple of different ways. Certainly the vehicles are going to be mutual funds, exchange traded funds, or individual securities. But inside of that there's this idea of European companies listing on American exchanges, or you can invest locally inside different overseas markets. What are the pluses and minuses of using this sort of ADR (American Depository Receipt) versus local currency?

Matt: I think the biggest advantage to the U.S.-based investor would be that currency translation. So as you think about it to the extent that you can invest in an ADR locally and use U.S. dollars, then you eliminate that currency translation issue. So, to the extent that the U.S. dollar is, say, 8% stronger than the euro over a 12-month period, if you've invested locally in Europe, that investment's going to need to outperform the same U.S.-based investment by 8% just to break even. So I think the currency translation advantage is the big one that comes to mind there, David.

David: Yeah, certainly just another factor to consider as you're investing internationally. That's very helpful. I think that as we unpack the opportunity set there, certainly over the longer term there is a place inside the portfolio. But there will be times that we want to look at opportunities outside of international investments for possibly some more or additional returns.

Thanks for the interesting discussion today. For more on this topic, please visit www.commercetrustcompany.com and download our 2025 Economic and Market Outlook titled "An Economic Balancing Act," or our "Look at the Markets" first quarter book offering a concise look at the economy and financial markets.

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