

Higher rates and rising capex support international value stocks

From the Field
July 2024

Key Insights

- The new era of higher-trend inflation, higher rates, and rising capex should provide strong support for international value stocks.
- Despite the improving outlook, international value stocks remain very cheap by historical standards.
- International value earnings have improved significantly since 2019, halving the gap vs the S&P500, and are now slightly ahead of U.S. value peers.



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In the decade or so following the global financial crisis (GFC), tepid growth and ultra low interest rates brought significant headwinds for international and value stocks. We believe these headwinds are now fading, however, and that the period ahead will be much more favorable for international value stocks—something that is not reflected in current valuations.

To explain why we believe things are changing, it is helpful to dig a little deeper into why the period between the GFC and the coronavirus pandemic was such a difficult one for both international and value stocks. Typically, recessions are followed by strong rebounds in economic growth that lift the valuations of heavily discounted stocks. However, while there was a recovery of sorts after

the GFC, it was much weaker and more fitful than usual. Monetary authorities sought to combat this weakness through ever-lower interest rates and quantitative easing. However, not only did these measures fail to stimulate a meaningful economic recovery, they also proved to be an additional headwind to the earnings of financial companies. Combined, these factors meant that earnings growth remained subdued for an extended period in many traditional economy sectors.

By contrast, a cluster of technology-driven firms were able to exploit secular growth trends, most notably the internet. This growth was, to a large extent, independent of economic conditions and continued to outstrip forecasts for much of the decade.

Indeed, the low interest rate environment may even have helped to fuel this growth as funds for expansion were plentiful and cheap. It also provided a valuation tailwind to growth stocks as lower discount rates raised the value of future earnings relative to near-term cash flows.

These factors drove a period of dominance for U.S. growth stocks, whose earnings comfortably exceeded those of non-U.S. stocks in the post-GFC era, sending their valuations skyrocketing. However, while this was occurring, the generally weak economic conditions continued to weigh on value stocks and on markets outside the U.S., in terms of both a weaker earnings trajectory and an ever-widening valuation gap.

The post-GFC period is over

Just as the GFC reset the macroeconomic and market environment in 2008, two events in quick succession changed the outlook again in the early 2020s. Within the space of a few years, the coronavirus pandemic and then the war in Ukraine delivered a series of supply shocks to the global economy while significantly reconfiguring world politics. These changes have improved the relative outlook for international and value stocks.

The most dramatic change has been the resurgence of inflation and subsequent rise in interest rates. Although headline inflation has recently subsided and central banks have begun to cut rates again, inflation is expected to remain structurally higher, and there is no realistic prospect of a return to the very low/negative rates that prevailed between the onset of the GFC and the pandemic.

In higher rate environments, current earnings tend to become more valuable and future earnings less valuable, which favors value stocks. Higher rates are also particularly beneficial for financial companies, whose profit margins tend to be greater when rates are elevated due to higher net interest income. In recent years,

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European financials have seen the greatest benefit (as they faced the worst negative rate environment), having seen their earnings grow by 67% from the beginning of the pandemic to March 2024; over the same period, U.S. financials achieved around 8% earnings growth.

As financial services is a value-oriented sector that carries a bigger weight in international markets than in the U.S., any future improved performance in the sector will be welcomed by international value investors.

Non-tech sectors likely to benefit from higher capex

Another factor supporting international and value stocks is the strong prospect of a rise in capex (capital expenditure) in the coming years. The fastest-growing firms in the period following the GFC were U.S. tech companies whose business models were built around intangible

assets. We believe this is changing and expect the period ahead to be marked by a higher-trend level of demand for tangible assets, supporting sectors such as industrials, energy, and materials—which are typically value-oriented and compose a larger proportion of international markets than the U.S. market. During the last period of substantial capex (between the dot-com bubble and the GFC), international markets performed well relative to the U.S.

There are several reasons why capex is likely to rise in the coming years:

- The global push to transition from fossil fuels to renewable energy sources will be a decades-long project that requires trillions of dollars of infrastructure investment every year. At the same time, the rise of generative artificial intelligence (AI) is fueling a major surge in infrastructure spending as companies seek to build models that maximize the potential of the new technology. This is expected to add a further 10%¹ to

¹ Actual future outcomes may differ materially from estimates.

Transitioning to a new paradigm

(Fig. 1) The new era will provide tailwinds for international and value stocks

Post-GFC Era	Post-Pandemic Era	Tailwind to International?	Tailwind to Value?
Benign Disinflation	Higher-Trend Inflation	✓	✓
Low and Falling Bond Yields	Rate Normalization	✓	✓✓
Maintenance-Level Capex	Higher Capital Spending	✓	✓
Max Globalization	Reshoring	?	?
Disruptive Innovation	Disruptive Innovation	✗	✗
Drivers of Performance: Secular Growth, Leverage	Drivers of Performance: Real Assets, Valuations		

As of June 30, 2024.

For illustrative purposes only. **Actual future outcomes may differ materially from expectations.**

Source: T. Rowe Price.

energy demand over time, putting more pressure on stretched capacity to deliver this growth.

- Events such as the coronavirus pandemic and Russia's invasion of Ukraine, combined with rising geopolitical tensions elsewhere, have led to a greater awareness of supply chain risk. This has prompted many firms to begin shifting their manufacturing bases back home, or to countries that are geographically closer or politically "safer." Reshoring—or "friendshoring"—will be a multiyear process requiring a huge investment in domestic industrial bases across the developed world.
- Defense spending is also very likely to increase amid rising concerns over geopolitical tensions, particularly Russian aggression. The "peace dividend" of previous decades is effectively being reversed. Eighteen of NATO's 31 members will meet their target of spending 2% of gross domestic product on defense this year; in 2016, only five countries met the target. NATO's spending surged after Russia's invasion of Ukraine, but President Donald Trump's demand for European members to spend more on defense during his 2017–2021 term in office also had a major impact. The prospect of Trump returning to office will add further pressure on members to continue the upward spending trajectory.

What these challenges have in common is that a major injection of capital expenditure will be required to solve them. The sectors that provide the solutions—chief among them industrials, energy, and materials—are value-oriented and compose a larger proportion of international markets than the U.S. market. These industries are likely to attract enormous flows of investments into physical assets in the years ahead, which would boost returns for international value firms.

The Japanese restructuring story still has some way to run

A perhaps more idiosyncratic earnings driver for international value is the Japan restructuring story. Having been stuck in a deflationary slump since the early 1990s, last year, the country finally awoke from its slumber as prices and wages rose at their fastest rates in three decades. In response, the benchmark Nikkei 225 stock index broke its all-time high in February this year.

Although external supply shocks played a role in these reversals, they do not tell the whole story. Improved corporate governance standards continue to have a tangible—and considerable—impact on company performance, with shareholders now a much higher priority in Japan than they were in the past.

We believe Japan's recovery has further to run. The corporate governance reforms that have swept through Japanese boardrooms continue to gain momentum. Japanese companies have built strong balance sheets over the last few decades, with more net cash than anywhere else in the world and extensive cross-shareholdings. And the indications are that they plan to put this cash to use: Last year a survey from the Bank of Japan revealed that the growth rate for planned capital investments was at its highest level since the survey began in 1983. As in other international markets, value-oriented sectors are likely to be among the chief beneficiaries as companies redeploy resources and improve returns to investors.

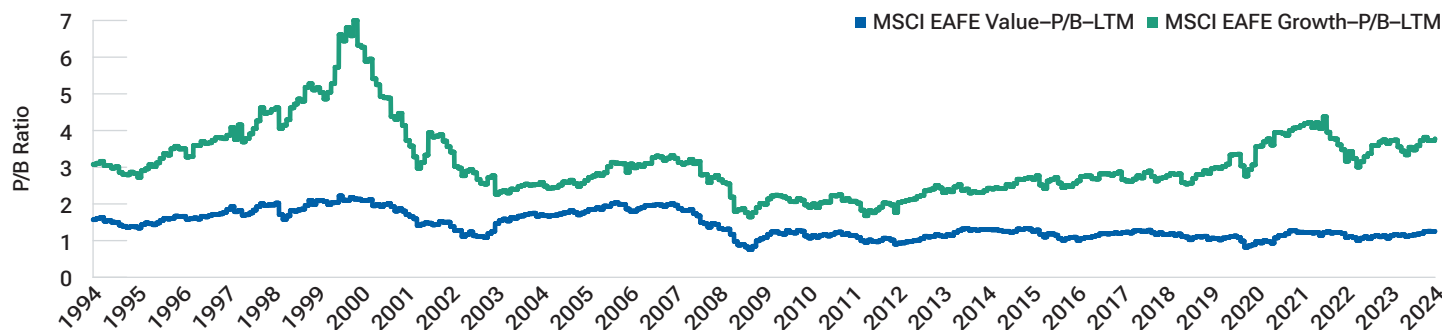
Although it is still early days, South Korea has sought to emulate Japan's success in boosting stock valuations with a corporate governance drive. Tax incentives have been offered to businesses that prioritize shareholder returns, while the new "Korea Value-Up Index" will list firms that have improved capital efficiency.

Valuations have yet to reflect shifting dynamics

The improved outlook for international and value stocks is not yet reflected in valuations. International markets continue to trade at a significant discount to the U.S., even when adjusted for sector mix,

International value is priced well below international growth

(Fig. 2) The gap has widened in recent years



As of June 30, 2024.

Chart compares the last 12 months' (LTM) price-to-book (P/B) ratios of the MSCI EAFE Value and MSCI EAFE Growth indices.

Source: FactSet. T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

and within international markets, value stocks are trading at a wide discount to growth stocks (Figure 2).

But the case for international value is not just a valuation story. Supply chain reconfiguration, infrastructure rebuild, defense spending, and the likelihood of higher energy prices should favor traditional value sectors such as industrials, energy, and materials. Although it is still early days, there has been an improvement in earnings growth for international value stocks since the end of 2019 (Figure 3). Europe, Australasia, and Far East (MSCI EAFE Index) value earnings growth has been outpacing that of U.S. value, and the differential versus the S&P 500 has more than halved, and yet the valuation gap since 2019 has continued to widen.

International value earnings growth has recovered since 2019

(Fig. 3) Earnings are now higher than U.S. value

	Earnings Growth		
	MSCI EAFE Value Index	MSCI USA Value Index	S&P 500
2010–2019 p.a.	0.50%	5.60%	7.80%
2019–Q1 2024 p.a.	4.30%	3.40%	7.60%

As of March 30, 2024.

p.a. = per annum.

Past performance is not a reliable indicator of future performance.

Source: Bloomberg Finance L.P.

The success of U.S. technology stocks over the last decade has also brought an increase in index concentration, with investors in the U.S. market now much more heavily exposed to technology than they would have been a decade ago.²

This strengthens the case for diversification, and given the valuation disparity and improving outlook, investors seeking such diversification may benefit from increasing their exposure to international value stocks.

²Based on a comparison of S&P 500 Index composition between June 2014 and June 2024.

Investment Risks

Diversification cannot assure a profit or protect against loss in declining markets.

International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in **emerging markets**.

The **value approach** to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced.

Because of the cyclical nature of **natural resource companies**, their stock prices and rates of earnings growth may follow an irregular path.

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