2024 Outlook: International Equity

By: Bruno Paulson | December 15, 2023

Compounding Through the Hype with High Quality Equities

KEY POINTS

1. MSCI World Index's current forward multiple does not look cheap, particularly as it is based on an arguably optimistic, double-digit earnings growth assumption for 2024. Our view is that the possibility of a downturn is not reflected in today's earnings expectations, nor in the current market multiple.

2. We seek to avoid the permanent destruction of capital by focusing on high quality,[1] reasonably priced companies with earnings resilience and by resisting the urge to get caught up in potentially detrimental speculative bubbles.

3. Looking beyond the "Magnificent 7" stocks, we believe there will be "slow burners" for whom the benefits of generative artificial intelligence (GenAI), and AI in general, will take longer to emerge but could be significant over time. We believe these GenAI model users will be able to generate value for customers and/or reduce costs by virtue of their "Walled Gardens."

What We Are Seeing

The market has been all about multiples for the last couple of years, with re-ratings and de-ratings driving returns, while earnings have remained roughly flat. Margins remain elevated at close to peak COVID levels, adding to earnings risk.

Higher bond yields raise concerns for equity markets: Can the already indebted system deal with more expensive credit? Importantly, what is the impact of yields on the relative valuation and attractiveness of equities versus bonds, with the gap between the market's earnings yield and the risk-free U.S. Treasury rate at the lowest level seen in 20 years?

Even ignoring the fixed income alternative, MSCI World's forward multiple does not look cheap, particularly as it is based on an arguably optimistic, double-digit earnings growth assumption for 2024. Our view is that the possibility of a downturn is not reflected in today's earnings expectations, nor in the current market multiple.

Given the vulnerability of high earnings and high multiples in the event of an economic slowdown, we would argue that high quality equities are a relative safe haven. Very high quality, well-managed companies with strong intangibles, such as brands, licenses and networks, should hold on to their customers and margins if and when the downturn comes. Historically, companies with earnings resilience have delivered strong performance over the long term.

What We Are Doing

We don't start from a particular macroeconomic viewpoint in our investment process, but rather focus bottom-up on the fundamentals of world class companies.

One of our mantras is that there are two ways of losing money in equities: either the earnings go away, or the multiple goes away. We seek to avoid the permanent destruction of capital by focusing on high quality, reasonably priced companies with earnings resilience, and resist the urge to get caught up in potentially detrimental speculative bubbles.

This discipline, historically, has served our clients well. As Charlie Munger suggested, a focus on wonderful companies at reasonable valuations is typically a more rewarding path than reasonable companies at a discount or wonderful valuations!

An increasingly polarized market has allowed for some opportunistic additions within our portfolios, particularly in the hard-hit life sciences industry and consumer staples sector. COVID destocking and reduced demand from biotech customers, particularly in the U.S. and China, has led to a sharp compression in the valuation of certain life sciences stocks, while the consumer staples sector has lagged in this momentum-led market rally. On the other hand, the multiple expansion of some of our portfolios' "growthier" names, notably the immediate AI beneficiaries, has influenced reductions.

What We Are Watching

We continue to observe ongoing market euphoria around the potential benefits of GenAI. To date, this excitement has been concentrated in a handful of names, notably the so-called "'Magnificent 7," whose forward earnings estimates have soared to elevated levels.

However, we believe there are others, the "slow burners," for whom the benefits of GenAI, and AI in general, will take longer to emerge, but could still be significant over time. These GenAI model users should be able to generate value for customers and/or reduce costs by virtue of their closed systems, or "Walled Gardens." Importantly, pricing power should allow them to retain a decent proportion of the benefits for their shareholders.

With the full impact of AI still unclear, high earnings expectations means there is potential risk to valuations if the current excitement dissipates, or indeed if these earnings expectations aren't met. With markets often overemphasizing short-term factors, such as next quarter's earnings or earnings-per-share (EPS) growth, it would be wise to remember that stock prices can fail to reflect a company's long-term intrinsic value. We aim to manage this earnings risk by focusing on reasonably priced, high quality companies that can steadily grow at sustained, high returns on operating capital over the long term.

1. Higher quality companies typically have consistent earnings, strong balance sheets, significant free cash flow generation, growing revenues and meaningful competitive advantages, whereas the opposite is true for their lower quality counterparts.

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Bruno Paulson
Portfolio Manager
International Equity

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