

6/20/2024

**Summary:** Although U.S. technology stocks continue year-to-date dominance over the broader U.S. equity market, international value stocks have quietly outperformed ex-U.S. developed market indices, led by ex-U.S. developed financials, which comprise a large portion of most value indices. However, this month has witnessed a sharp pullback in global bank stocks as a combination of adverse electoral outcomes and delays in central bank rate cuts have increased the risk premiums of international financials demanded by investors. Despite this month's pullback, international developed financials have maintained year-to-date outperformance over broad market indices. Yet, as is the case with U.S. value stocks, much of the international value segment trades at a sizeable discount to the broader markets. The recent sell-off in financials may be overcompensating for both near-term political and central bank policy risk. Investors who have enjoyed sizeable gains in U.S. equities should consider opportunities overseas, especially in oversold value sectors.

## European and Pan-Asian Financials Weighed Down by Headlines and U.S. Dollar Strength

European bank shares came under pressure following European Parliament elections that saw sizeable gains from populist right-wing political parties, leading French President Emmanuel Macron to dissolve the French National Assembly and call early elections. According to Morningstar, European banks are viewed as political targets by populist parties wishing to impose shareholder-unfriendly measures such as windfall taxes and restrictions on dividend payouts.

Asian financials, particularly Japanese bank stocks, have come under pressure as the U.S. dollar continues to strengthen against local currencies, adding to funding pressures. The Bank of Japan announced plans to reduce purchases of debt securities, such as Japanese Government Bonds (JGBs), while incrementally raising rate caps (so-called Yield Curve Control) to keep up with developed market bond yields. Ongoing purchases of JGBs have put further pressure on the Japanese yen (currently trading at USD/Yen 158) even as such purchases help keep a lid on JGB yields.

With the U.S. Federal Reserve communicating a 'tighter-for-longer' policy stance, market expectations for rate cuts in 2024 have been drastically reduced, barring a major slowdown in economic activity and labor market conditions. This has led to a sharp rise in the U.S. dollar, exacerbated by the European election results and Bank of Japan policy decisions. A strong U.S. dollar can negatively impact international banks through exchange rate losses, reduced revenue, economic strains (especially on emerging markets), higher borrowing costs, and reduced competitiveness.

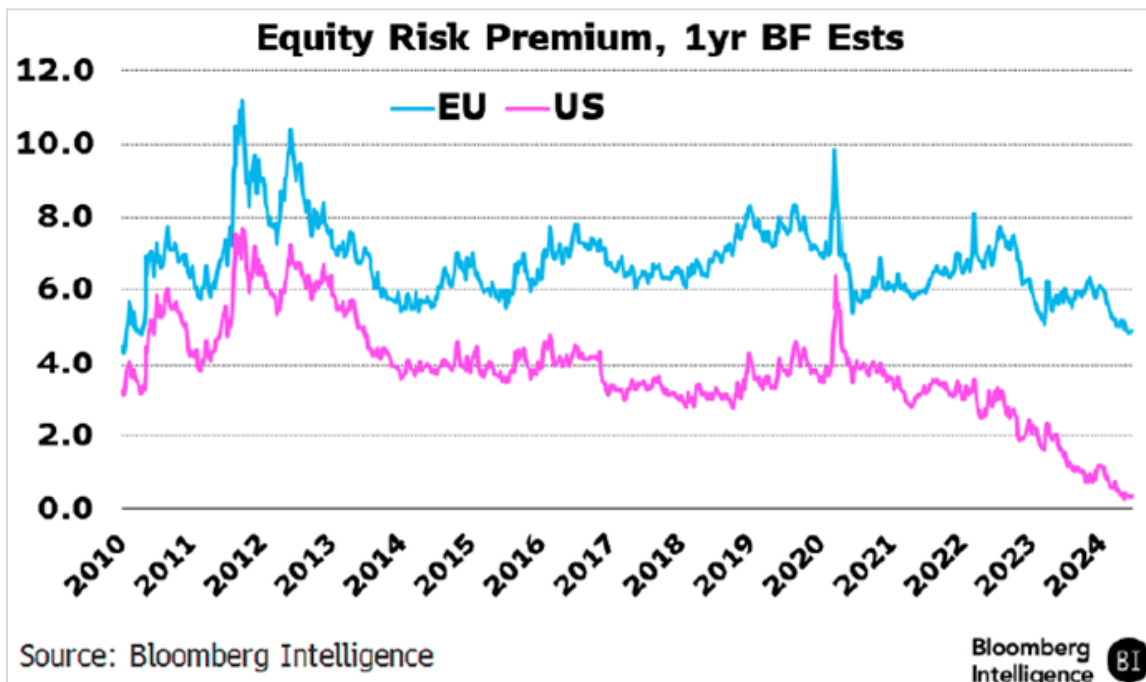
Japanese banks came under further pressure as Norinchukin Bank acknowledged heavy balance sheet losses tied to ultralow-yielding government debt securities, echoing the Silicon Valley Bancshares collapse in March 2023. However, the balance sheet losses are tied more to misaligned interest rate positioning rather than deteriorating credit conditions.



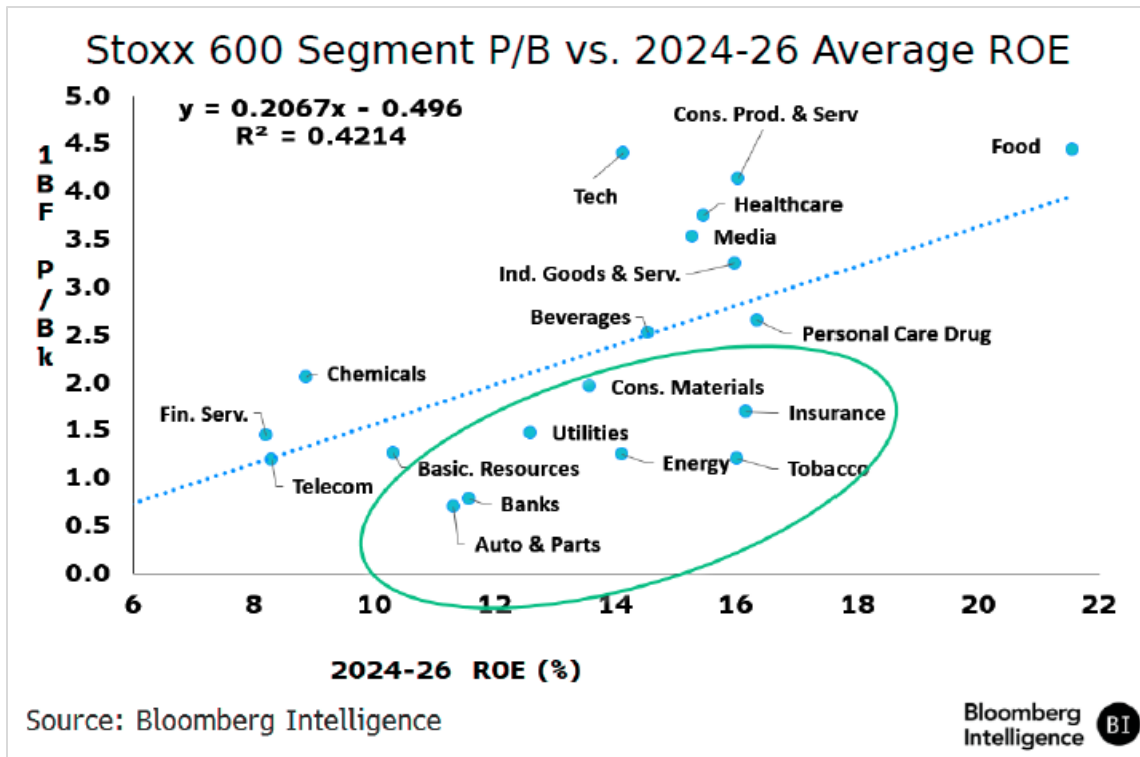
Source: Bloomberg

## Sell-Off Widens the Valuation Gap of Value Stocks Versus the Broader Markets

As U.S. stocks rally, driving embedded equity risk premiums to 15-year lows, the gap between the U.S. and Europe has widened considerably over the post-pandemic period, even though European equities are enjoying post-pandemic low levels in their equity risk premiums.



However, European value companies across financials and cyclicals are trading at even wider discounts to their growth counterparts, even when adjusting for differences in profitability (or return on equity). According to Bloomberg Intelligence, if the pan-European central banks and the Bank of England follow a slower rate-cut path in line with that of the U.S. and economic growth remains supportive of credit conditions, these could be supportive of earnings momentum enjoyed by financials on top of stronger loan growth. In addition, the infrastructure needed to power generative artificial intelligence and energy transitions should be supportive of traditional cyclicals such as industrials and materials.



Source: Bloomberg

Asian financials are also experiencing improving profitability (return on equity) over the post-pandemic period. This improvement has outpaced the increase in market valuations based on book value.

### Seek Opportunities but Be Cautious on Timing

As fallout from political uncertainty and U.S. dollar strength could continue to weigh on investor risk appetite for international financials, investors should seek opportunities but be cautious on timing. Should the growth environment support financial conditions conducive to loan growth and expansion despite higher-for-longer interest rates, global financials will likely benefit from earnings momentum tied to improving profitability.

## Actions for Advisors to Consider Taking Today:

- Advisors desiring to diversify U.S. equity risk, especially megacap technology concentration risk, should consider opportunities afforded by international markets, especially across beaten-down value segments such as financials.
- For managed model solutions that invest in international markets with a value tilt, consider the 3D / DFA Global Equity ex-US Large Cap Model that would complement a large-cap-heavy U.S. equity program, and the Ativo International ADR Model, which holds international banks and financials.

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Except as otherwise specifically stated, all information is as of June 20, 2024.