The **PACER PERSPECTIVE**
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Investment Crossroads - U.S. vs International — *International Equity Investment Part 1*

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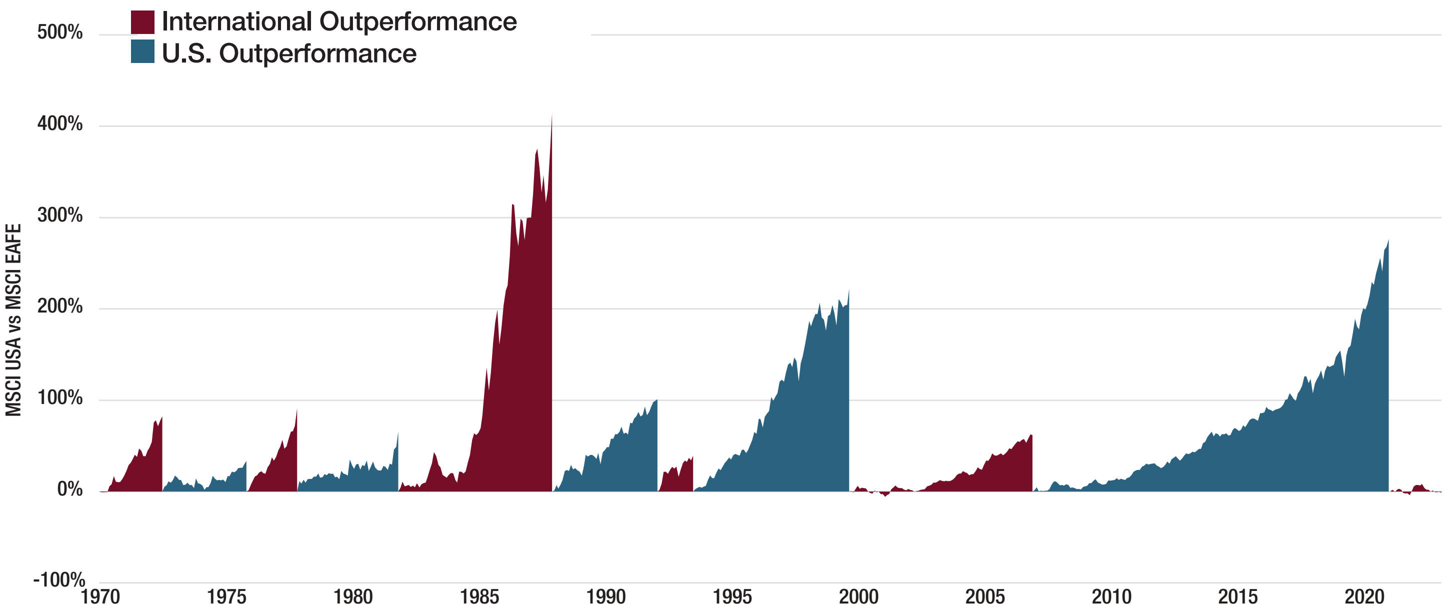
2024 may be a good time to look for opportunities in international stocks. Anticipating uncertainties and a possible uptick in market volatility, we expect international stocks may offer the potential for attractive returns as well as provide diversification for U.S. investors' portfolios.

Key Takeaways

1. Despite the U.S. market outperforming international equities in 2023, certain factors including valuation and the U.S. dollar still favor international equities.
2. Unlike the U.S. market, non-U.S. markets are less concentrated, suggesting they may offer a broader range of opportunities.
3. With the exclusion of the Magnificent Seven, international stocks actually outperformed the broader U.S. equity market while still maintaining a substantial valuation discount.

Over the past 50 years, we have observed the different periods of U.S. and international equity markets outperforming each other. The most recent regime of U.S. outperformance started at the end of 2007 and lasted for more than 14 years. Such has been the longest U.S. outperforming cycle while the average duration is about five years.

U.S. and International Equity Markets Change Leadership Position
12/31/1970 - 1/31/2024



Source: Pacer Advisors, Bloomberg

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. YOU CANNOT INVEST IN AN INDEX.

Historical patterns show us the relative performance between U.S. and international markets tends to be cyclical. After the previous prolonged stretch of U.S. outperformance, there's been speculation about whether a new turning point may be on the horizon.

In retrospect, the U.S. outperformance peaked in December 2021 before high inflation and rising rates sent the U.S. equities into a bear market. While the entire global market felt the impact of inflation and an economic slowdown, the relative performance of U.S. and international stocks took a notable turn. In Q4 2022, amidst the global market rebound, the international equities represented by the MSCI EAFE Index outperformed the S&P 500 Index by almost 10%. The setup for international equities remained favorable as we entered 2023, and by the end of April, the MSCI EAFE Index further outperformed the S&P 500 Index by another 2.6%. Initial indications suggested that the U.S. was poised to trail behind other developed and emerging markets.

However, a review of the performance throughout 2023 reveals the anticipated continuation of international outperformance did not materialize as expected. The sudden catalyst of the AI passion and the rally from the Magnificent Seven, comprising notable technology companies, contributed to a shift in dynamics. From the end of April to the year-end, the S&P 500 Index rallied and outperformed the MSCI EAFE Index by more than 9%, concluding 2023 with a yearly return of 26.29%. Despite achieving its best calendar year performance since the pandemic, the international market once again fell short of catching up with U.S. equities.

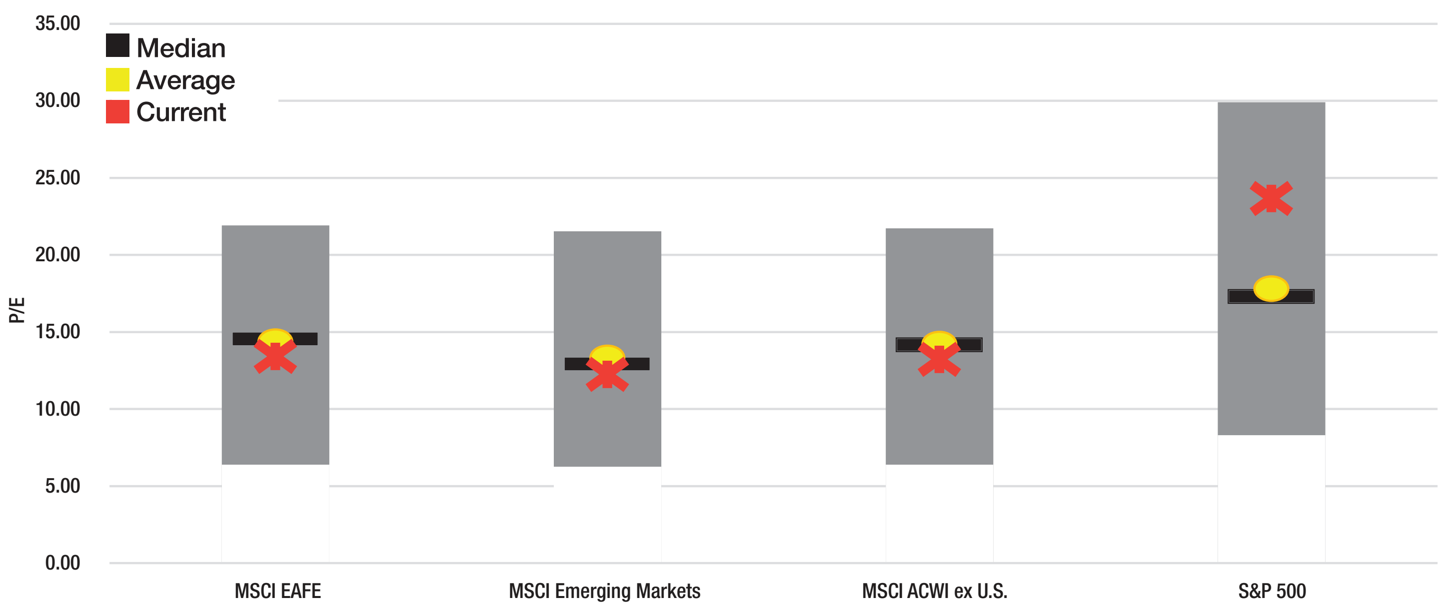
Since the beginning of 2023, we have highlighted several factors that could potentially trigger a shift in the performance dynamics between the international and U.S. markets. These factors remain present and continue to support the investment case for international equities.

Relative Valuation

As of the end of January 2024, the S&P 500 Index is priced at approximately 23x earnings, presenting a valuation that is 33% higher than the historical average of 18x. What are the implications for U.S. investors?

Valuation (P/E) vs Historical Range[1]

12/31/2003 – 1/31/2024



Source: Pacer Advisors, FactSet

(1)Note: MSCI EAFE Index includes large and mid cap companies across in the Developed Markets (DM) countries excluding the US and Canada.
MSCI ACWI ex U.S. Index includes large and mid cap companies in Developed Markets (DM) countries (excluding the U.S.) and Emerging Markets (EM) countries.
MSCI Emerging Market Index includes large and mid cap companies across Emerging Markets (EM) countries.

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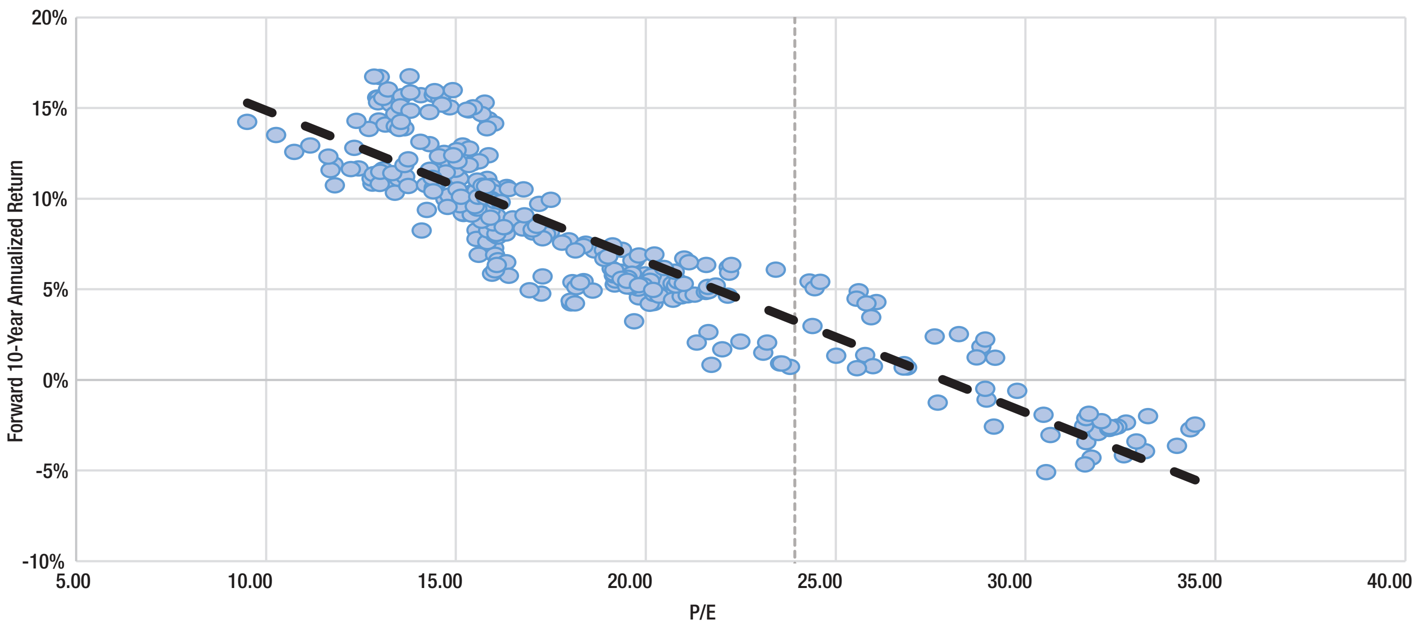
Currently, an above average U.S. equity valuation reflects the market's anticipation of a potential easier monetary policy, and strong earnings growth. According to FactSet, analysts project a considerable year-over-year earnings growth of 11.2% from the S&P 500 Index in 2024. However, this optimism introduces a potential contradiction, as it is challenging to envision a scenario where the Federal Reserve opts to cut interest rates amid strong corporate earnings driven by a strong economy. Thus, given the uncertainty entering 2024, the high valuation of the S&P 500 Index underscores the challenges and risks confronting U.S. investors in the current market environment.

For example, in an in-depth analysis of the S&P 500 Index's normalized price/earnings (P/E) ratio, which is based on the long-term earnings per share trend, we observe the current value of 23x only implies a potential yearly annualized return of less than 5% over the next decade according to the historical relationships between valuations and forward returns. In a way, U.S. equities do not seem as attractive as they were.

10-Year Forward Return vs Valuation

12/31/1987 - 1/31/2024



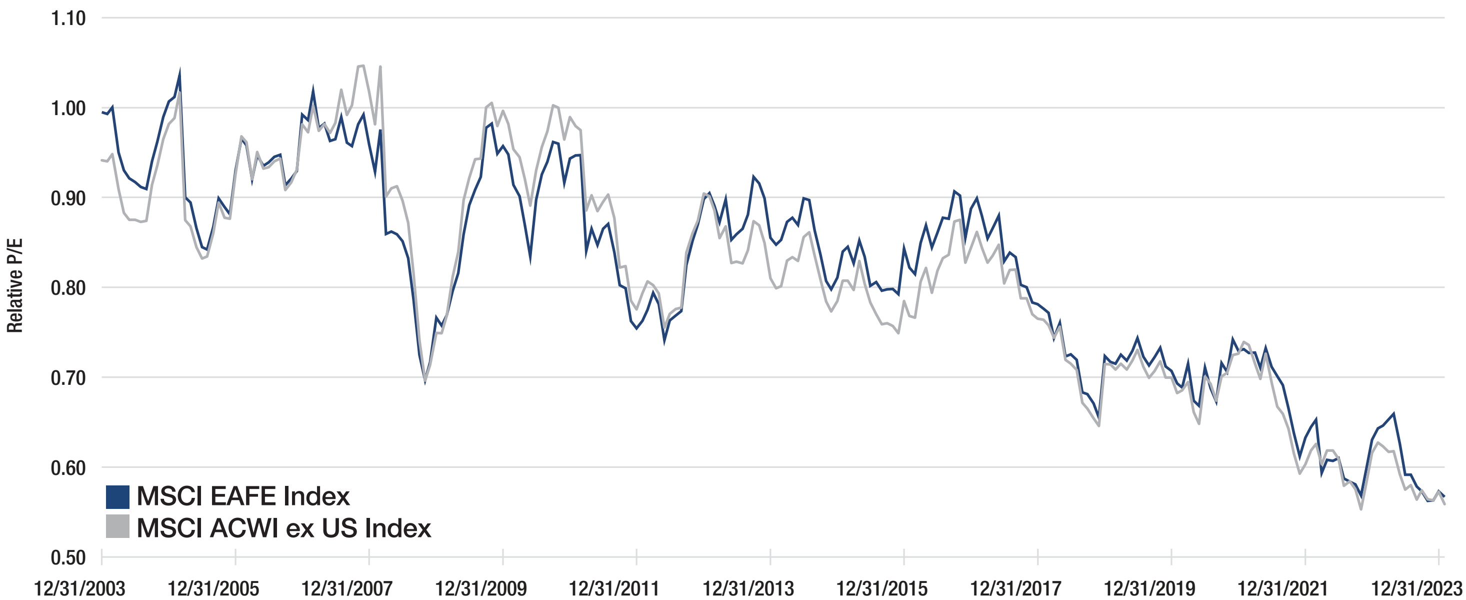
Source: Pacer Advisors, FactSet

On the other hand, international equities are currently presenting more attractive valuations. Not only do international equities trade in line with the historical averages, but also the valuation establishes a notable contrast with U.S. counterparts.

As of 1/31/2024, international equities trade at a substantial discount compared to the U.S., marking one of the largest gaps since the early 2000s. The MSCI EAFE Index, for example, is trading at a P/E discount exceeding 40% when compared to the S&P 500 Index – a level near the highest observed in the past decade.

International P/E Relative to the U.S. (S&P 500 Index)[1]

12/31/2003 – 1/31/2024



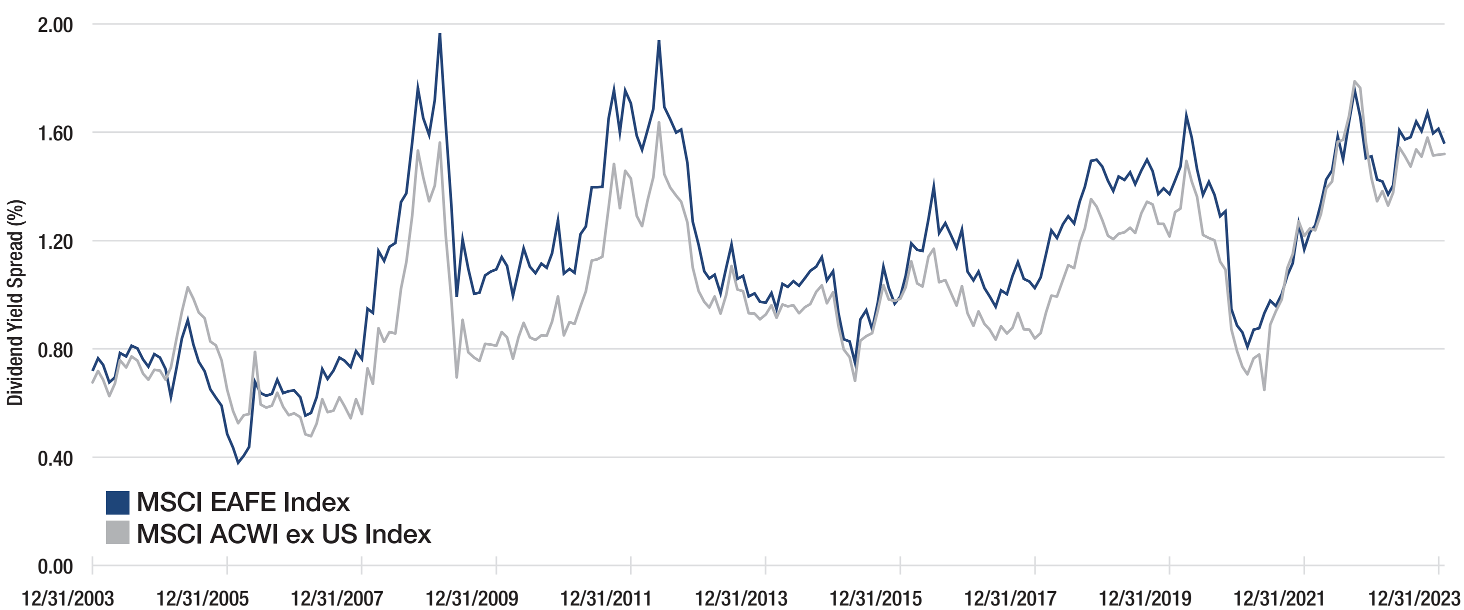
Source: Pacer Advisors, FactSet

(1)Calculated as P/E ratios of international indexes divided by the S&P 500 Index P/E

Simultaneously, international equities offer an enticing investment opportunity for income-seeking investors by providing a yield premium of over 1.5% relative to their U.S. counterparts. This yield advantage further accentuates the attractiveness of diversifying portfolios with international equities.

International Dividend Yield Spread Over the U.S. (S&P 500 Index)[2]

12/31/2003 – 1/31/2024



Source: Pacer Advisors, FactSet

(2)Calculated as dividend yields of international indexes minus the S&P 500 Index dividend yield

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The U.S. Dollar

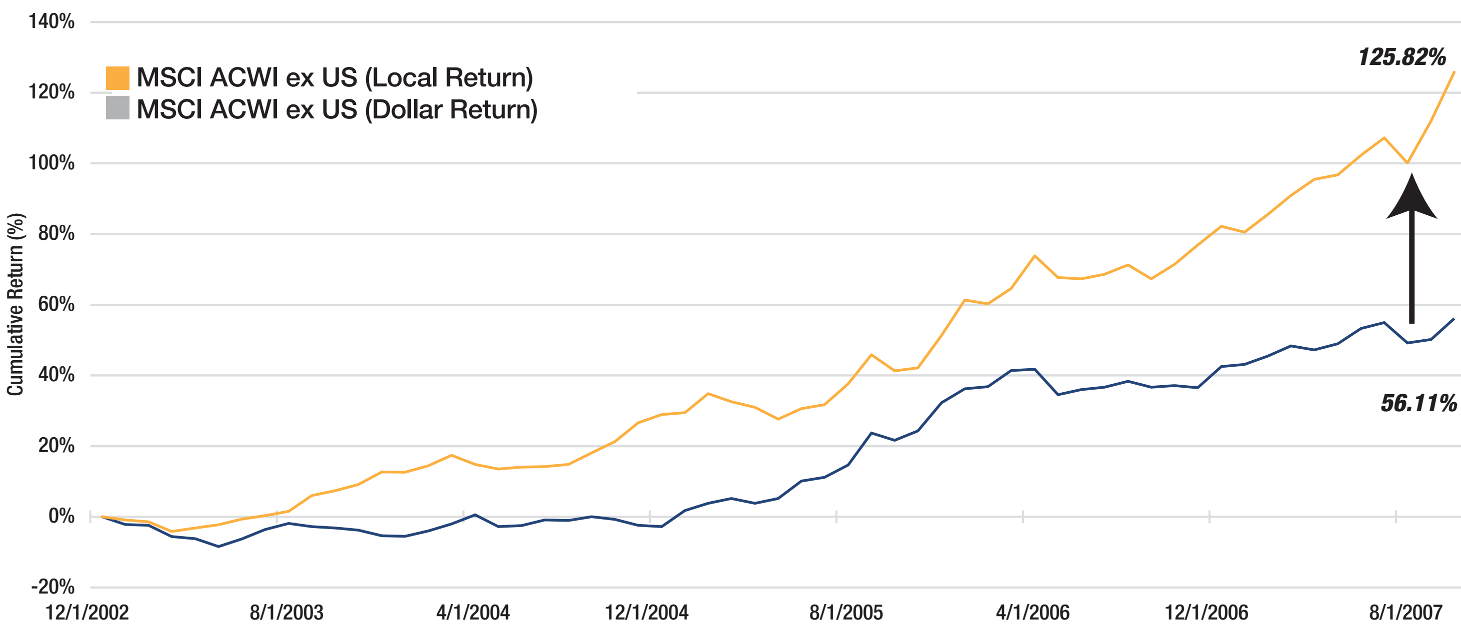
The strength of the dollar plays a pivotal role in shaping investment returns of international equities. A robust dollar implies a depreciation of foreign currencies, resulting in a translation of investment returns to a lower value in dollar terms. Consequently, an international portfolio may experience underperformance even if there's a strong return denominated in the local currencies. Conversely, a weak dollar signifies that foreign currencies are valued higher in U.S. dollars, leading to positive currency returns for investors.

Reviewing historical returns of the MSCI ACWI ex U.S. Index in both U.S. dollar and local currencies, we may easily find regimes in which the U.S. dollar had a large impact to the relative performance of the international over the U.S. market.

For example, from 2002 to 2007, about 49% of the outperformance of the MSCI ACWI ex U.S. Index over the S&P 500 Index came from the currency movement. Then the following period of international underperforming U.S. markets was associated with dollar appreciation which contributed to approximately 28% of the performance gap.

Cumulative Relative Performance Over the S&P 500 Index

12/31/2002 – 10/31/2007



Source: Pacer Advisors, Bloomberg

According to the DXY U.S. Dollar Index, which averages the exchange rates between the U.S. dollar and major world currencies, the U.S. dollar sits among the highest levels since the end of 2002 when the international markets' outperformance over the U.S. equities took off.

As the Federal Reserve has held off on raising rates since late 2023 and is expected to potentially cut interest rates later 2024, downward pressure could exist on the dollar, which may provide a tailwind for international investing.

U.S. Dollar Index
12/31/2002 – 1/31/2024

Source: Pacer Advisors, Bloomberg

The Market Concentration and the Magnificent Seven

In 2023, the emergence of AI turned out to be the primary driver of the U.S. market. The Magnificent Seven: Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft, and Tesla, took the central stage. Collectively, these companies demonstrated impressive performance throughout 2023, constituting 62% of the S&P 500 Index's 26.29% overall return.

Currently (1/31/2024), the Magnificent Seven represents 28% of the S&P 500 Index market cap, while the top ten holdings weight is among the highest percentage of the S&P 500 Index since the tech-bubble period, accounting for 31% of its composition.

The Magnificent Seven currently boasts an average P/E multiple of 40x. Such robust valuation of these prominent stocks significantly influences and contributes to the overall valuation of the S&P 500 Index, which has expanded by more than 30% over the course of 2023.

S&P 500 P/E Ratios
12/31/1991 – 1/31/2024

Source: Pacer Advisors, Bloomberg

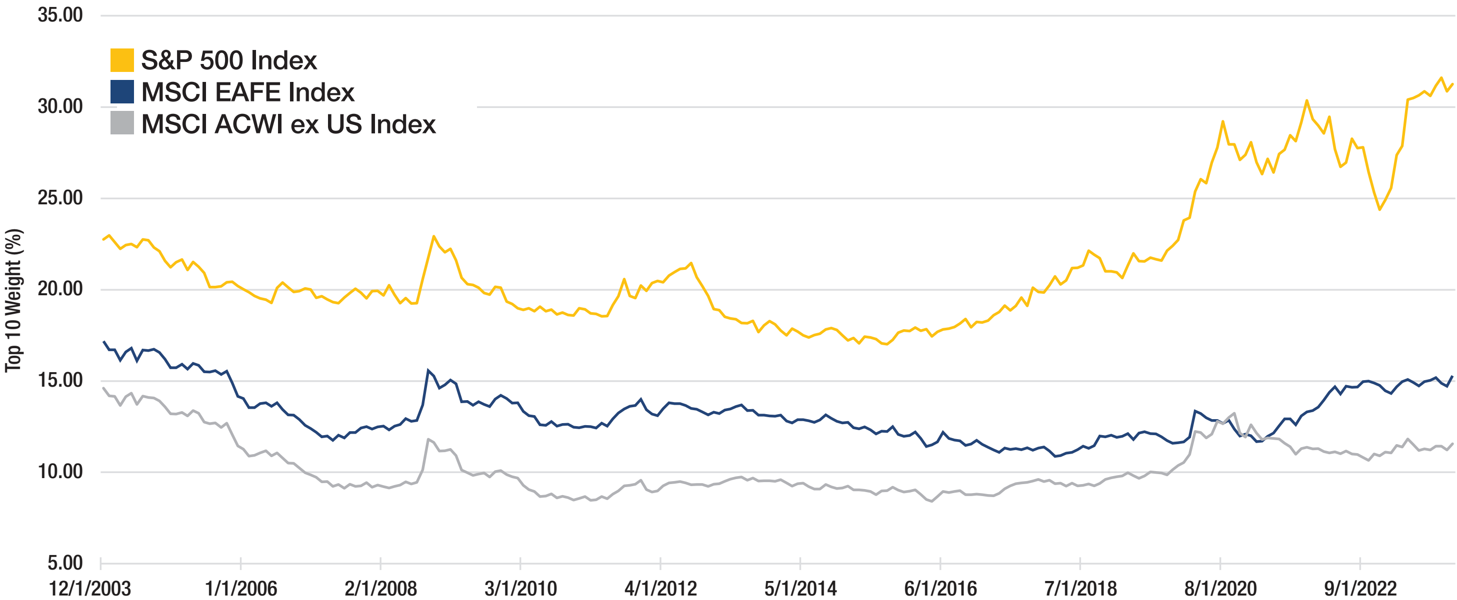
Concerns over the narrow market breadth have become a prominent issue for many U.S. equity investors. The dominant presence of the Magnificent Seven raises questions about the sustainability of their market influence. Investors are contemplating the necessary actions to navigate this market environment.

While it is difficult to predict when a broadening of the market will materialize, numerous equity strategists advise investors to reduce their exposure to these top-heavy names and embrace a more diversified approach within the broader market.

Interestingly, market concentration is not as pronounced in the international markets. In the MSCI EAFE Index, the top ten stocks constitute only 15% of the weight at the end of January 2024, and the top names contributed less than 16% to the index's 18.85% total return in 2023. Similar patterns are observed in the MSCI ACWI ex U.S. Index.

Index Top Ten Weighting Over Time

12/31/2003 – 1/31/2024



Source: Pacer Advisors, Bloomberg

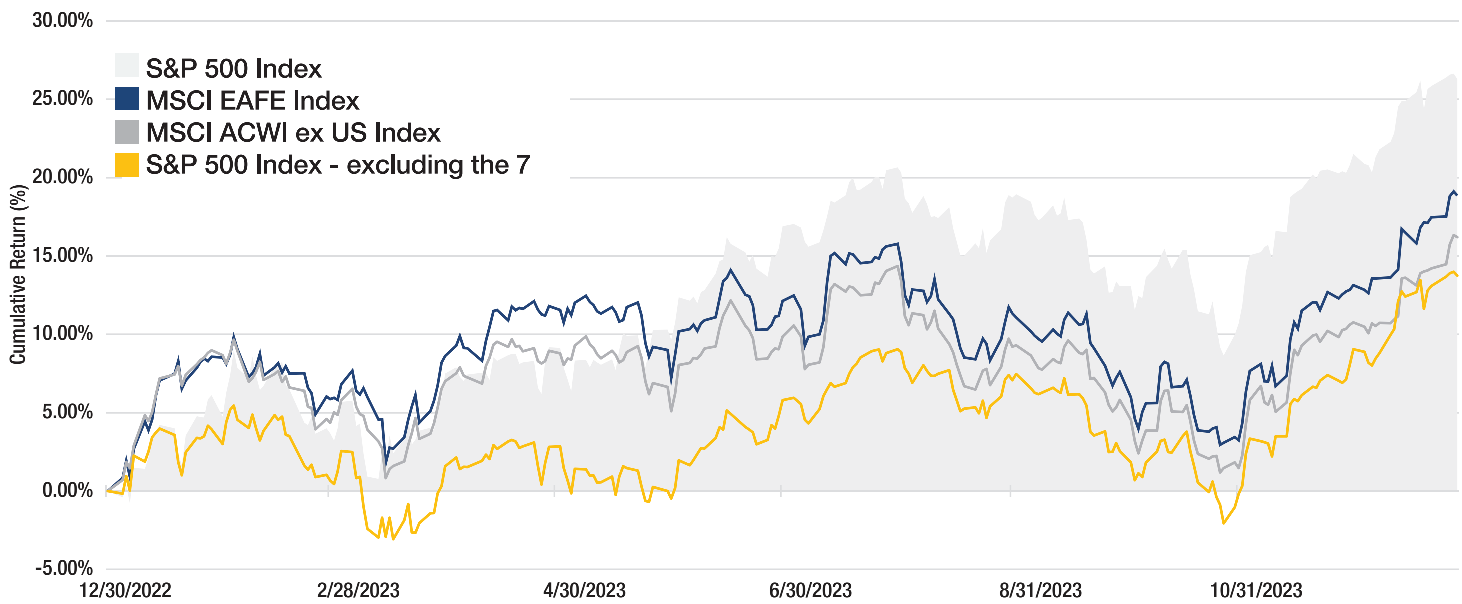
In 2023, international equities underperformed the U.S. equities, as the dominance of the Magnificent Seven stocks skew the U.S. market performance to the upside. Now an intriguing question arises: what if we exclude the Magnificent Seven stocks from the analysis?

If we segregate the S&P 500 Index into two sub-indexes - one comprising the Magnificent Seven and the other encompassing the remaining 493 stocks ("S&P 500 – excluding the 7") - we observe that the Magnificent Seven surged by 76.22% in 2023, while the "S&P 500 – excluding the 7" delivered a more modest performance of 13.75%. In comparison to the 18.85% return from the MSCI EAFE Index, excluding the Magnificent Seven from our analysis might lead to a significantly different conclusion regarding U.S. versus international market cycles. It turned out in 2023 the broader U.S. equities market indeed exhibited weakness against international equities, validating the trend we anticipated at the onset of 2023.

Performance in 2023

	MSCI EAFE Index	MSCI ACWI ex US Index	S&P 500 Index	S&P 500 Index excluding the 7	Magnificent Seven
2023 Returns	18.85%	16.21%	26.29%	13.75%	76.22%

Performance in 2023

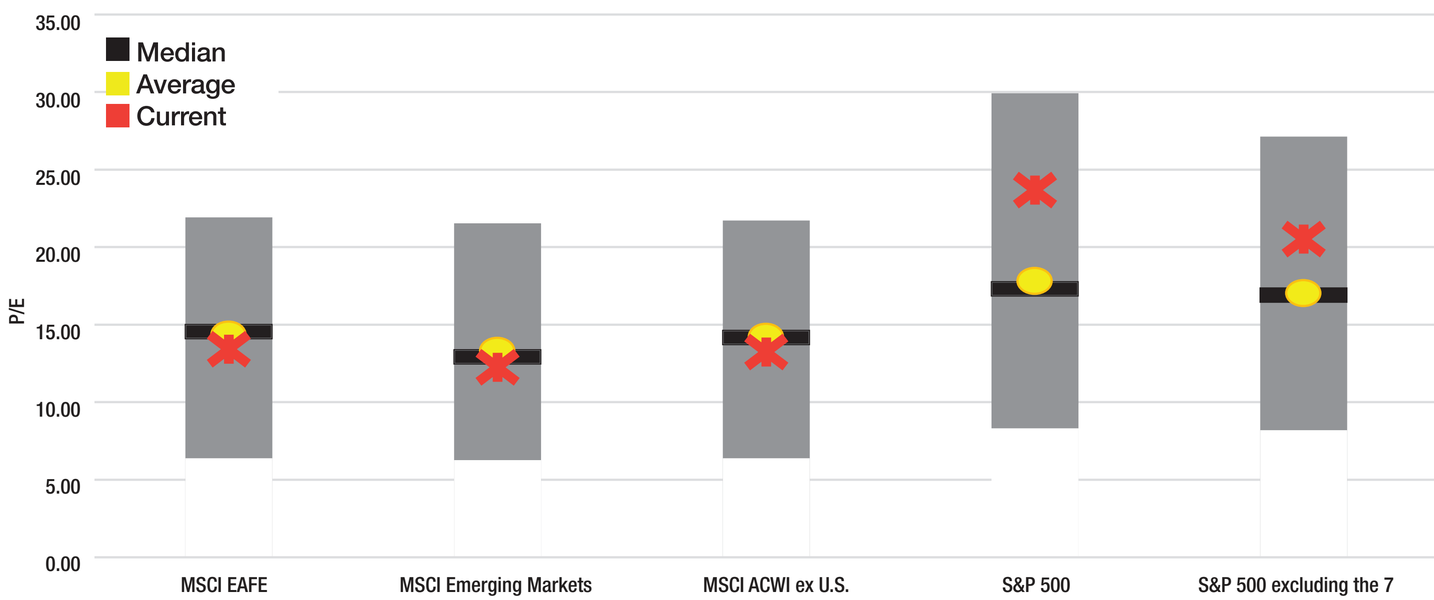


Source: Pacer Advisors, FactSet, Bloomberg

In addition, even with the exclusion of the notable impact from the Magnificent Seven, the overall valuation assessment remains relatively unchanged. When these stocks are excluded from the analysis, the broader perspective continues to indicate the U.S. market still retains a relatively expensive valuation. The "S&P 500 – excluding the 7" now trades at a P/E multiple above 20x, reflecting a 21% premium over the long-term average spanning 20 years.

Valuation (P/E) vs Historical Range

12/31/2003 – 1/31/2024



Source: Pacer Advisors, FactSet, Bloomberg

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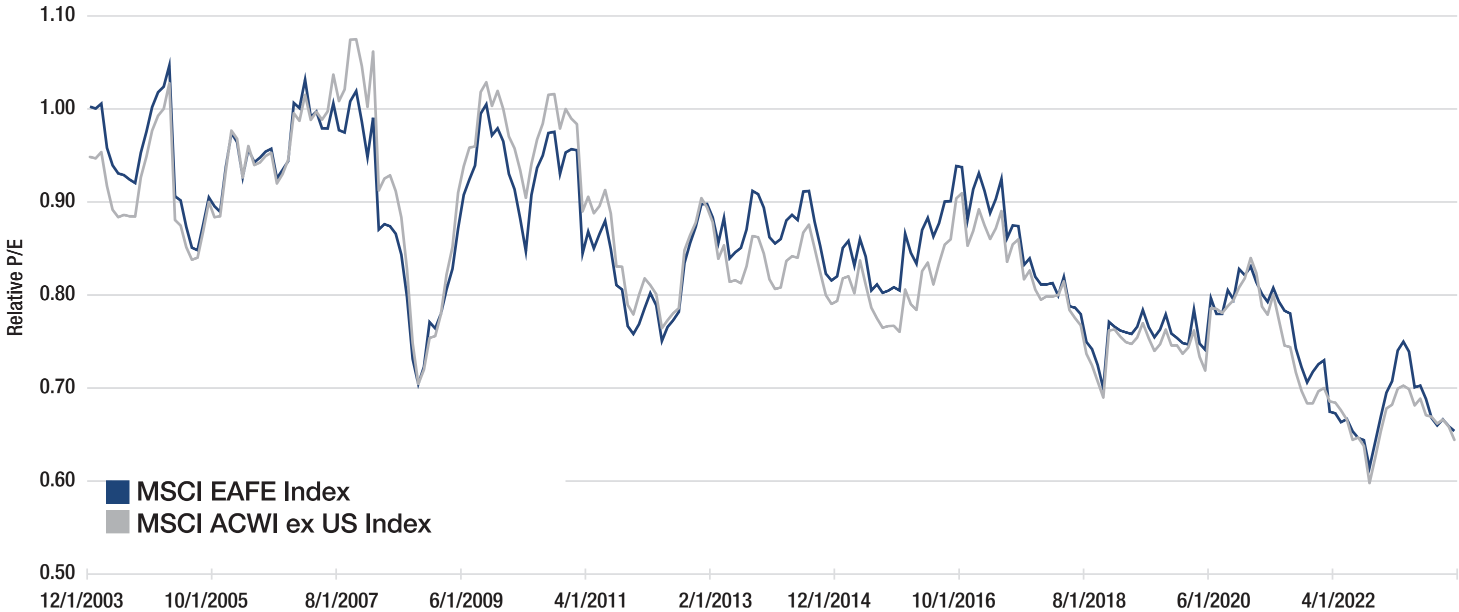
Meanwhile, when comparing this trimmed version of the S&P 500 Index to international stocks, the same conclusion arises that international equities continue to trade at a historically significant discount relative to the broader U.S. equity market.

Relative P/E, International vs U.S. (S&P 500 Index excluding Magnificent Seven)
12/31/2003 – 1/31/2024



Source: Pacer Advisors, FactSet, Bloomberg

To summarize, although international equities seemed to have a favorable backdrop around a year ago, U.S. stocks ultimately outperformed the global market for 2023, propelled by the influence of the Magnificent Seven. While it is almost impossible to predict the exact timing of a trend reversal of the relative performance, the appeal of international equities endures, supported by factors like attractive valuations, favorable currency dynamics, and a broader market breadth. Particularly, international stocks indeed outperformed the broader U.S. equity market (excluding the Magnificent Seven) while still maintaining a substantial valuation discount. This positions international equities as a compelling consideration for inclusion in investors' portfolios, offering the potential for diversification and enhanced returns in the face of evolving market dynamics.

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Pacer Emerging Markets Cash Cows 100 ETF

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S&P 500 Index: The index includes 500 leading companies in the U.S. and covers approximately 80% of available market capitalization.
MSCI EAFE Index: The index captures large and mid cap representation across 21 Developed Markets countries around the world, excluding the US and Canada.
MSCI ACWI ex U.S. Index: The index captures large and mid cap representation across Developed Markets (DM) countries (excluding the U.S.) and Emerging Markets (EM) countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.
MSCI Emerging Market Index: The index captures large and mid cap representation across 24 Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.
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P/E: price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).
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