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Equity Strategy (Citi)
North America | United States

Monday Morning Musings

The Building Blocks of Valuation Explain So Much

- **Investors often confuse relative global market valuation without considering sector constitution.** While the US equity market has commanded premium P/E multiples in the past, possibly due to better corporate governance or returns, not to mention trading liquidity, it is no longer doing so in any meaningful way despite a somewhat better economic outlook relative to Europe, for instance. However, a few of the differences can be attributed to the composition of the various global MSCI indices.

- **Certain businesses are valued more highly than others by an often growth oriented investment community.** Traditionally "growthier" sectors have been accorded superior valuations as investors wanted to participate in the opportunities while more cyclical economically sensitive groups or debt laden ones have suffered from lower P/E ratios. For example, the Energy sector typically trades at a significant discount to Technology stocks. Similarly, stable industries with less demand volatility such as Consumer Staples are treated better by fund managers than others with volatile cash flow trends.

- **The S&P 500 has large IT representation while Asia ex Japan and EM are much more heavily weighted towards Financials.** When one considers the ways in which to partake in any sector's opportunity, index composition can be very instrumental especially compared against global MSCI weights. The Financials sector market cap weight globally is roughly 21% but captures less than 16% in the US relative to Australia's 50% and China's 40%. Technology accounts for about 10% globally, 18% in the US, 1% in the UK and approximately 4% in the rest of Europe. The UK's 17% Energy market cap exposure is larger than Brazil's 16% and 11% in the US. Thus, the Street needs to understand more detail than just aggregate P/E ratios around the world.

- **Surprisingly, sector valuation can sometimes be quite different globally as well.** The US has been given a higher Energy sector valuation than seen elsewhere in the world (excluding Australia) and may reflect shale gas and tight oil developments as well as more transparent Financials plus less government involvement. While one might believe that forward P/E multiples would benefit US Tech names, higher industry valuations can be seen in the UK, Europe, Latin America and Australia, which may reflect the scarcity of local market cap in those areas. Note that the US has far less Materials exposure than the rest of the world and the bulk of US Materials' market cap is in chemical companies not Metals & Mining.

- **US stocks could overshoot in 1H13 and then give back some ground in 2H13.** In the face of a 3% or so pullback for the S&P 500 off of its most recent high, tied in part to recent disappointing economic data and the tragic events in Boston, a rebound is likely due to respectable earnings, credit conditions that argue for better business and revenue trends, as well as delayed tax refund checks buoying consumer activity in the next couple of months. In this context, a jump of better than 100 S&P 500 points is plausible by summer, but European related demand weakness, Fed policy concerns and possibly new fiscal battles in Washington could cause more volatility in the back half of the year.

- Equities

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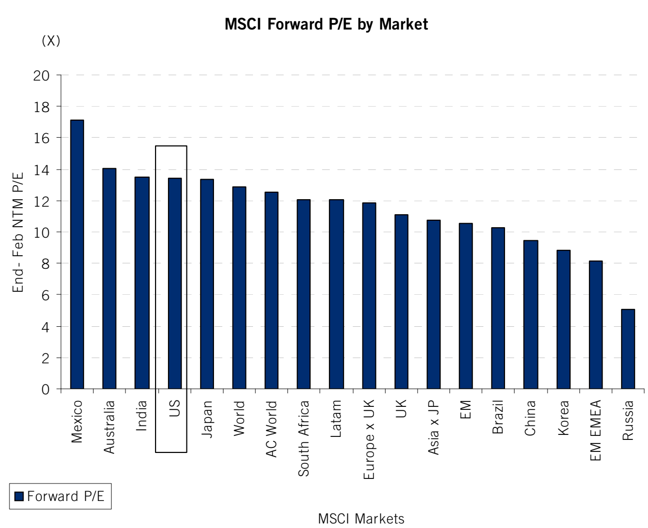
Delving into Differences Versus Accepting the Absolute

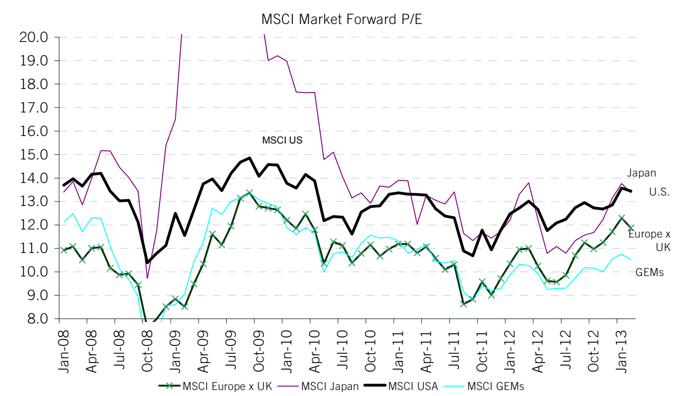
Too many people see things as either black or white without studying the grey in between and that clearly shows up in a great deal of the almost simplistic view of valuation as one group is seen as attractive and the other as expensive. Indeed, the US stock market has been viewed similarly in the past as global fund managers argued that the S&P 500 was rich relative to other regions in the world generally citing P/E ratio differentials. Yet, in many instances, the differences were justified on a ROE basis, on margins and even growth prospects, not to mention more transparent markets, less government interference and trading liquidity. But a recent review of sector constituency around the various major MSCI markets also may explain much of the disconnect as well. Currently, there is not that much valuation differentiation of major global markets (see Figure 1) but that has not always held true in the past (see Figure 2).

Figure 1.



Source: MSCI, Factset and Citi Research – US Equity Strategy *End- Feb P/E

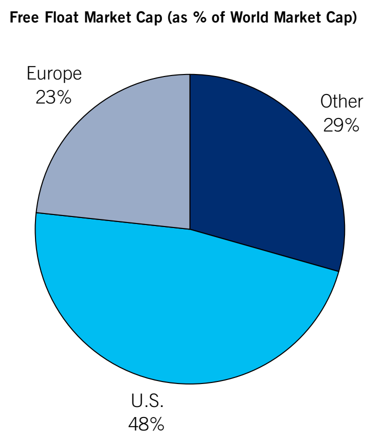
Figure 2.



Source: MSCI, Factset and Citi Research – US Equity Strategy

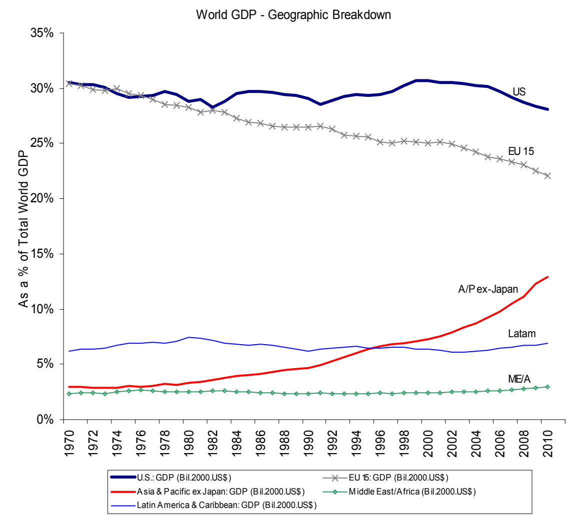
Note that the US comprises 48% of global market cap compared to only 23% for Europe (see Figure 3). But, critically, the US has maintained its representative proportion of global GDP over the past 30-40 years, for the most part, while Europe has slipped in relevance. Asia-Pacific (excluding Japan) has experienced growth as a percent of the global economy while this is not as obvious when looking at Latin America or the Middle East (see Figure 4).

Figure 3.



Source: Factset and Citi Research – US Equity Strategy

Figure 4.



Source: Haver Analytics and Citi Research – US Equity Strategy

Figure 5 provides some additional insight by laying out the proportional market cap weights by sector in each region according to MSCI and some stark comparisons can be seen around the world. For instance, the Energy sector has very low representation in Japan and, in comparison, makes up a very large component of the EM EMEA market. IT is much bigger in the US (particularly compared to the UK) and Financials are quite significant in Australia, AC Asia ex Japan and Latin America.

Figure 5. MSCI Sector Market Cap Weight

MSCI Sector Weights (%)	AC World	World	Europe x UK	UK	Japan	US	Australia	EM	Asia x JP	Latam	EM EMEA	China	Korea	India	Brazil	Mexico	SA	Russia
Energy	10.3	10.0	6.3	17.2	1.3	10.9	5.9	12.2	6.8	11.7	25.3	16.7	2.8	12.0	16.0	n/m	9.8	55.0
Materials	6.9	6.3	8.1	10.4	6.5	3.4	19.6	10.8	6.1	18.9	11.1	4.3	9.6	6.7	17.1	22.0	15.2	9.3
Industrials	10.5	11.1	13.7	6.9	19.6	10.2	4.6	6.4	9.0	5.6	3.7	6.2	12.0	4.6	5.4	7.1	4.8	n/m
Consumer Disc	10.9	11.3	10.3	6.5	20.9	12.2	1.7	7.7	9.2	5.2	7.8	5.0	17.1	6.2	4.5	7.7	17.8	n/m
Consumer Staples	10.7	10.9	14.0	17.7	6.4	10.7	9.8	9.0	5.5	18.6	6.3	5.3	4.9	10.5	15.6	31.3	6.9	5.1
Health Care	9.8	10.9	14.7	8.1	6.9	12.2	4.2	1.4	1.1	0.8	1.7	0.9	0.8	5.9	1.4	n/m	4.2	n/m
Financials	21.4	20.5	20.0	20.9	21.0	15.8	50.3	27.6	33.6	25.1	30.5	40.1	13.4	30.0	29.1	12.8	27.8	18.9
IT	11.9	11.7	4.2	1.0	10.7	18.3	0.4	14.0	18.3	1.3	0.1	6.4	37.1	17.9	2.3	n/m	n/m	n/m
Telecoms	4.2	3.8	4.8	7.0	4.2	3.0	2.0	7.4	6.3	6.8	10.7	11.4	0.8	2.0	3.2	19.1	13.5	8.7
Utilities	3.4	3.4	3.9	4.2	2.5	3.4	1.5	3.6	4.0	6.0	2.6	3.6	1.5	4.0	5.5	n/m	n/m	2.9

Source: MSCI, Factset and Citi Research – US Equity Strategy

Moreover, since each of these areas have wildly different growth potential and cyclical considerations, the underlying indices can end up being valued differently, given the inherent sector makeup. For example, the UK may trade at a lower multiple than the US since the Energy sector is much larger in the UK and this sector generally is accorded a lower P/E ratio (see Figure 6). This becomes especially clear when scoping out the valuations in Russia. It is fascinating to look at the IT sector's multiple in the UK, for example, and compare it to that found in the US, which could reflect some sort of scarcity value. As a reminder, one of the reasons investors rushed to the US markets in the late 1990s (which coincided with US dollar strength) was the desire to partake in the TMT bubble and there was far more market cap available for fund managers in America than elsewhere.

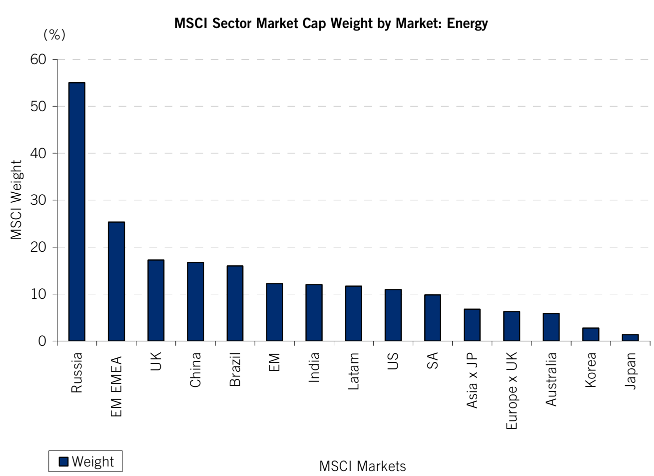
Figure 6. MSCI Sector and Market Forward P/E

Current (end Feb)	AC World	World	Europe x UK	UK	Japan	US	Australia	EM	Asia x JP	Latam	EM EMEA	China	Korea	India	Brazil	Mexico	SA	Russia
NTM PE	12.5	12.9	11.9	11.1	13.4	13.4	14.0	10.5	10.8	12.0	8.1	9.5	8.8	13.5	10.3	17.2	12.1	5.1
Energy	10.0	11.3	8.8	8.6	9.9	12.1	16.6	6.0	9.8	8.1	3.8	9.4	9.2	10.4	7.1	n/m	3.1	3.1
Materials	12.6	13.1	14.0	12.5	15.1	13.3	13.0	11.1	12.3	10.8	9.4	10.6	10.3	8.7	8.1	23.0	12.2	12.2
Industrials	13.7	13.7	13.8	15.1	12.2	13.9	18.4	12.9	12.9	19.1	10.7	11.5	11.0	13.1	18.8	20.2	n/m	n/m
Consumer Disc	14.1	14.5	11.7	14.2	13.3	16.0	17.7	10.7	10.3	17.5	15.6	12.9	6.8	12.3	15.0	20.2	n/m	n/m
Consumer Staples	16.5	16.1	17.1	15.0	16.9	15.9	18.2	21.5	19.3	23.3	19.9	22.0	15.8	27.9	22.2	25.4	21.2	21.2
Health Care	13.9	13.9	14.4	11.8	19.6	13.7	21.6	20.2	20.4	24.2	17.8	17.3	20.1	19.5	24.2	n/m	n/m	n/m
Financials	11.5	11.9	9.7	12.4	13.9	12.0	13.5	9.8	10.9	11.2	9.2	7.6	8.9	13.2	10.3	16.3	6.1	6.1
IT	12.6	12.9	18.0	31.9	14.5	12.4	17.0	11.0	11.0	16.3	9.7	21.1	8.1	16.4	16.3	n/m	n/m	n/m
Telecoms	12.3	12.6	9.0	10.6	10.0	18.3	15.0	11.4	13.4	8.7	11.0	11.4	8.8	22.8	6.7	9.6	9.5	9.5
Utilities	14.1	14.6	9.5	13.2	n/m	15.3	16.2	11.7	14.2	11.6	8.7	13.5	13.2	10.9	9.5	n/m	8.4	8.4

Source: MSCI, Factset and Citi Research – US Equity Strategy

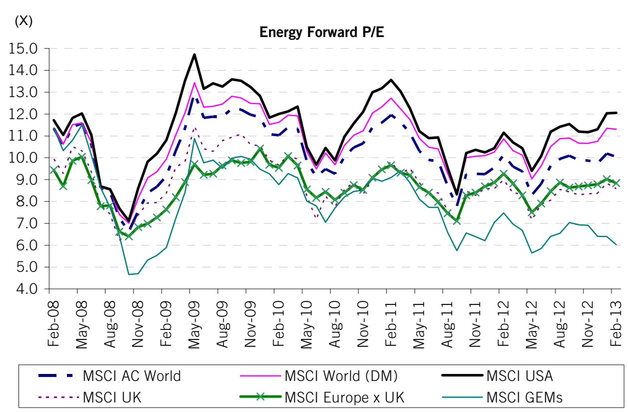
Indeed, it is intriguing to study several of the sectors where differences are quite prevalent. Figure 7 outlines the Energy sector and Figure 8 in related fashion provides some P/E multiple perspective, with the US garnering the second highest valuation in this sector globally. Figure 9 shows the Materials market caps alongside Figure 10 which illustrates the valuation challenges possibly for some European entities in this sector as the commodities super cycle seems to be ending according to Citi's commodities research team. While our focus is on the US, it is crucial to understand that 70% of the S&P 500's Materials sector's market cap is found in chemical stocks and thus should not necessarily be confused with the metals & mining dominance of the Materials sector elsewhere.

Figure 7.



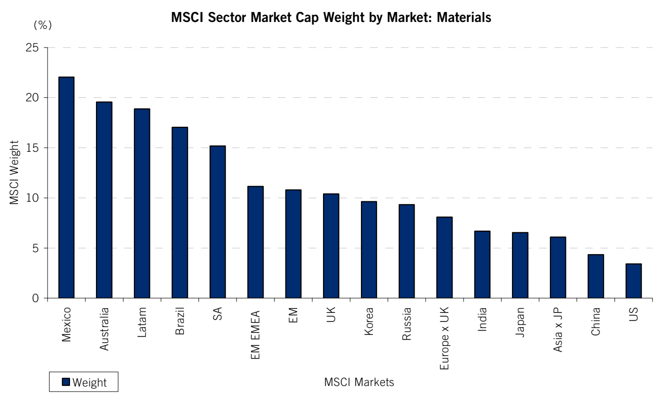
Source: MSCI, Factset and Citi Research – US Equity Strategy

Figure 8.



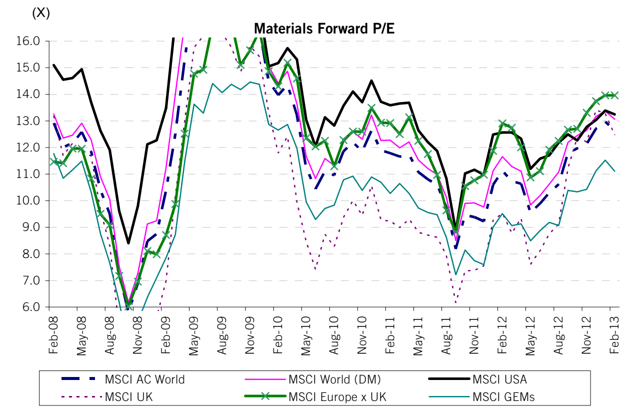
Source: MSCI, Factset and Citi Research – US Equity Strategy

Figure 9.



Source: MSCI, Factset and Citi Research – US Equity Strategy

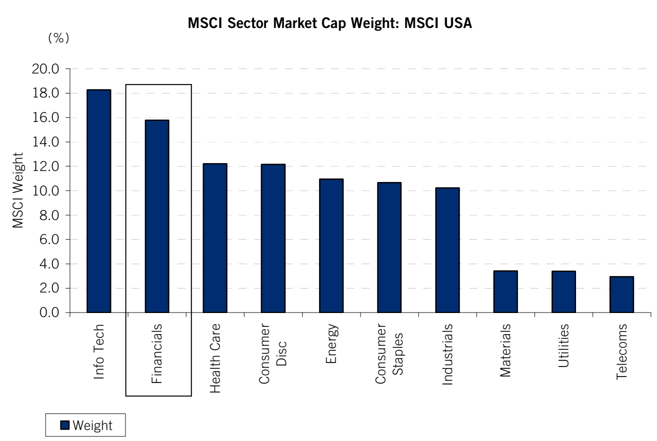
Figure 10.



Source: MSCI, Factset and Citi Research – US Equity Strategy

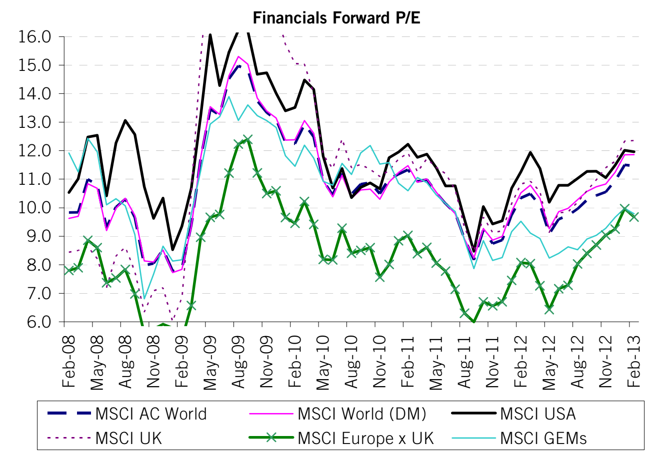
In addition, it may surprise investors that despite a great deal of focus on US financial companies post the 2007-09 crisis, the S&P 500 Financials sector comprises less than 16% of the overall index market capitalization and that is trumped by the sector's representation in other regions around the world (see Figure 11). Interestingly, the UK and the US are accorded a higher multiples amongst Financials (see Figure 12). Furthermore, we suspect that readers may not be as aware that Japan has far greater Industrials exposure than the US as does Europe x-UK (see Figure 13), while Mexico and Latin America have large Consumer Staples market cap (versus an AC World-like average for the US) but multiples for Global Emerging Markets Staples are quite high relative to other areas of the world (see Figure 14). Thus, a global view is helpful in assessing America's place in markets.

Figure 11.



Source: MSCI, Factset and Citi Research – US Equity Strategy

Figure 12.

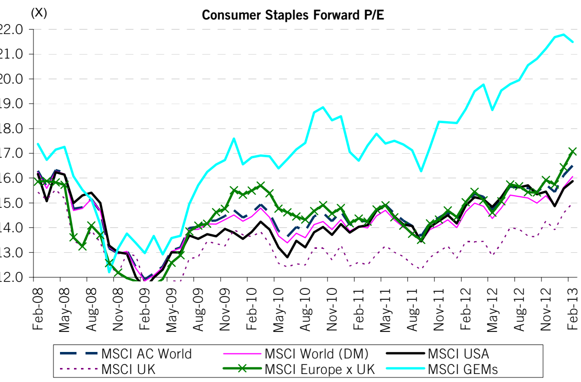


Source: MSCI, Factset and Citi Research – US Equity Strategy

Figure 13.

Source: MSCI, Factset and Citi Research – US Equity Strategy

Figure 14.



Source: MSCI, Factset and Citi Research – US Equity Strategy

Our sense is that US markets can rebound from the recent drop in index prices as economic data should be sustained by healthy credit conditions (which lead employment, capital investment, industrial activity and S&P 500 sales) as well as the benefits of delayed income tax refunds boosting domestic consumer spending data not to mention the very recent dip in oil prices. As noted last week, we envision an overshoot to 1,650-75 for the index most likely by summer and then some backing off in 2H13 driven by probable further European economic weakness filtering in to US companies' earnings forecasts, potential Fed policy shifts on quantitative easing and plausible new political battles around US government budgets at the end of the US fiscal year. To be fair, the market is a complex beast and the global perspective above may add to the need for deeper dive analysis and not making very simplistic P/E multiple arguments that are often cited without much meaning.

Appendix A-1

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