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Will we escape the non-U.S. stocks value trap?

From the Field

Key Insights

- We see tactical opportunities in non-U.S. value stocks, even in a highly uncertain environment.
- Amid persistent valuation gaps, stimulus and a banking sector recovery in Europe could be a near-term game changer for non-U.S. equities.
- U.S. tech dominance appears likely over the long run, but this year's market broadening should continue, benefiting value shares outside the U.S.

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The following analysis presents scenarios for relative valuation opportunities. The year-to-date relative return scenarios, although not updated to reflect the trade policy volatility of recent days, remain fairly close and have not moved as much as the market itself.

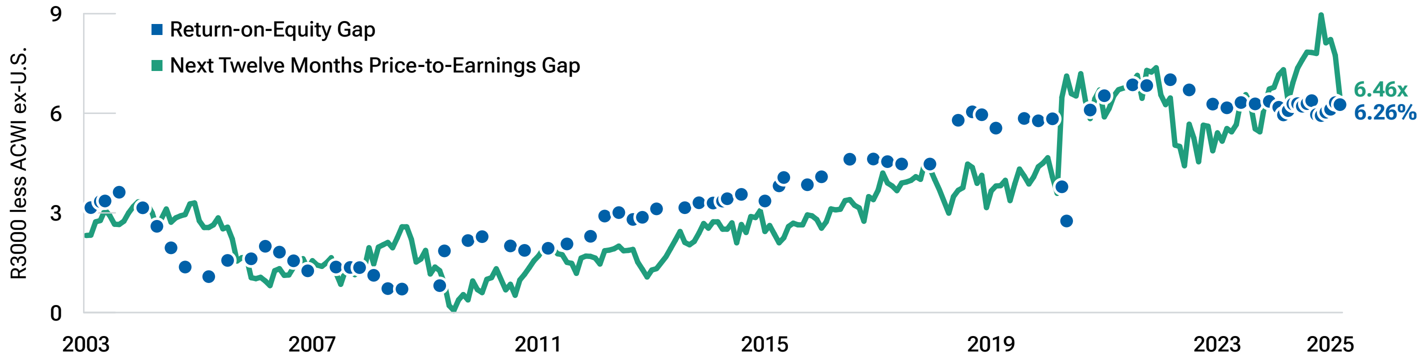
Should investors shift some of their investments from the U.S. stock market to the rest of the world? We used historical scenario analysis to evaluate the impact of two tactical asset allocation trades: (1) from U.S. to non-U.S. stocks—globally, including emerging markets—and (2) from non-U.S. growth to value stocks, within developed markets.

I'm in favor of these trades. Germany's stimulus could be a game changer. European banks were trading at two times book value before the 2008 global financial crisis (GFC); they've recently broken one times book value, and the trend is positive. Our Multi-Asset stock analysts and portfolio managers also see opportunities in industrials and health care stocks outside the U.S.

The valuation gap between the U.S. and the rest of the world appears extreme, as shown in Figure 1. However, this gap has been accompanied by a widening gap in fundamentals, such as return on equity (ROE).

Minding the gap

(Fig. 1) Russell 3000 vs. MSCI ACWI ex-U.S.



Past performance is not a guarantee or a reliable indicator of future results.
Sources: Russell and MSCI. T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. Data are for the period as of January 1, 2003, to March 12, 2025.

In the words of a member of our Asset Allocation Committee: "Some of this is U.S. exceptionalism. Some is fiscal expansion. In the current environment, there is room for compression of this spread."

Also, notice that in Figure 1, the U.S. ROE advantage has flattened. Large tech companies in the U.S. are becoming more capital-intensive as the artificial intelligence arms race continues. Meanwhile, the sustainable growth of European financials has been improving.

Why scenario analysis is helpful in times like these

Uncertainty is the word of the moment. I don't think I've ever heard it mentioned as often in the media as over the last two weeks. The Global Economic Policy Uncertainty Index has reached an all-time high, surpassing coronavirus pandemic levels.

Recently, I heard a strategist say on TV that "uncertainty is worse than bad news." He had a point. Uncertainty means paralysis. At least with bad news, consumers and companies plan accordingly.

But in the upside-down world of financial markets, periods of high uncertainty can be buying opportunities. After storms, markets often rally. In fact, they tend to rally as soon as we reach what one of my colleagues calls the stop-getting-worse moment. What if we've reached that moment? Or, perhaps closer to consensus, what if things get worse from here?

Risk-on, risk-off

(Fig. 2) Major market events of recent decades

Risk-on	**Pre-GFC International Rally** (January 2005–December 2007)
	2016 Reflation (March 2016–December 2016)
	Trump 1.0 (November 2016–December 2017)
Risk-off	**Early 2000's Tech Bubble** (March 2000–October 2002)
	2008 Global Financial Crisis (GFC) (June 2008–February 2009)
	2018 Fed Hikes and Tariffs (October 1, 2018–December 24, 2018)*
	2020 COVID Sell-Off (February 19, 2020–March 23, 2020)*
	Year-to-Date (January 1, 2025–March 13, 2025)*

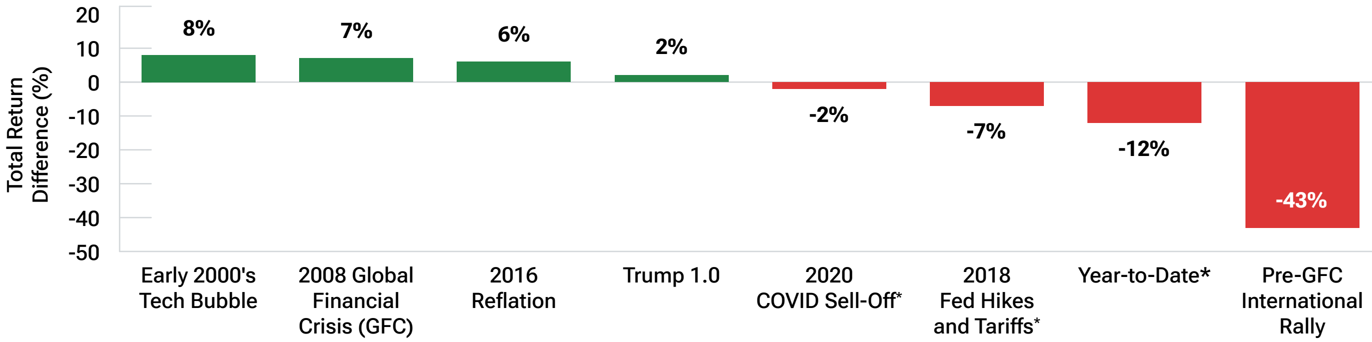
*Used daily data where noted; otherwise, monthly data were used.

Scenario analysis helps answer these types of "what-if" questions. In Figure 2, I outline three historical risk-on scenarios and five risk-off scenarios.[1]

[1] We separate the 2016 Reflation from the Trump 1.0 scenarios even though they're adjacent. During the 2016 Reflation, prior to the election, commodities rebounded from a 2015 drawdown as China passed a stimulus package. Inflation picked up from low levels. The Trump 1.0 rally was focused on tax cuts and deregulation.

Not like U.S.?

(Fig. 3) U.S. vs. global ex-U.S. equities



Past performance is not a guarantee or a reliable indicator of future results.
Sources: Russell and MSCI. Data analysis by T. Rowe Price. This shows the relative performance of U.S. stocks versus global ex-U.S. equities, based on the following benchmarks: U.S. equities represented by Russell 3000 Index, Global ex-U.S. equities represented by MSCI All Country World Index ex-U.S. Net.
*Used daily data where noted; otherwise, monthly data were used.

We used these scenarios to evaluate the benefits of reallocating assets from U.S. to non-U.S. stocks and from non-U.S. growth to value stocks. Figure 3 shows the results for U.S. versus non-U.S. (global ex-U.S.) stocks, ranked by the extent to which the U.S. outperformed the rest of the world.

Are the next 12 months more likely to resemble the scenarios on the left (in green) or on the right (in red) of Figure 3?

First, the pre-GFC international rally reminds us that indeed, believe it or not, non-U.S. stocks can significantly outperform U.S. stocks. Between January 2005 and December 2007, they outperformed by 43%, driven by rising global growth, strong commodities, a weak dollar, and investors' desire to diversify globally.

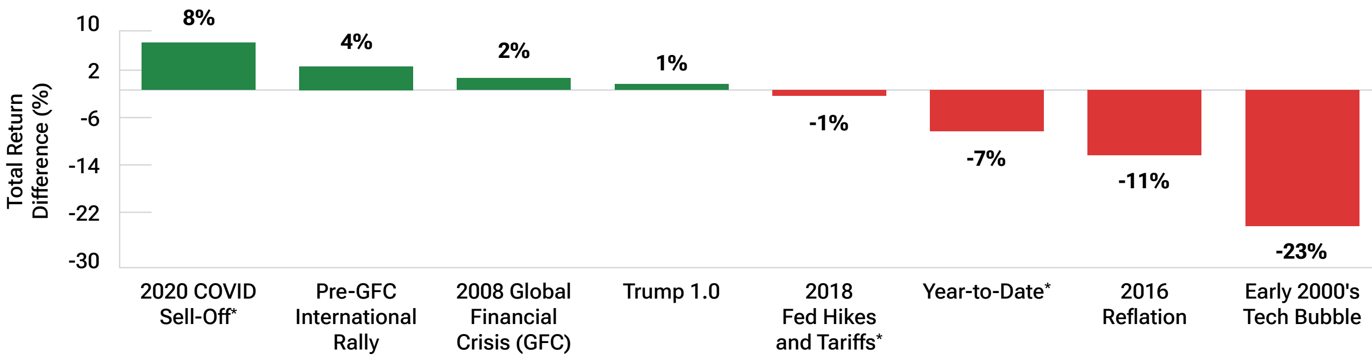
Scenarios such as the tech bubble and 2008 GFC appear unlikely to me (albeit always possible). Leverage among households, corporations, and financial institutions is lower than in 1999 and 2007. Plus, we've just had a meaningful correction in stock prices.

Perhaps some of the most likely scenarios are on the right side of Figure 3. The year-to-date rotation away from U.S. stocks could continue as some of the air comes out of inflated valuations of large-cap U.S. stocks and investors rediscover the benefits of diversification.

The most counterintuitive impact of the trade war so far has been that it has motivated stimulus in Europe—and not just for defense spending. Moreover, now that we've escaped negative rates, European banks have an incentive to lend. During the pre-GFC international rally, non-U.S. stocks benefited from European banks' aggressive lending, leveraging, and investing. (This did not end well but bear with me).

Non-U.S. growth vs. value

(Fig. 4) Performance differences during major market events of recent decades



Past performance is not a guarantee or a reliable indicator of future results.
Source: MSCI. Data analysis by T. Rowe Price, based on the following benchmarks: Non-U.S. Growth represented by MSCI EAFE Growth Index Net and Non-U.S. Value represented by MSCI EAFE Value Index Net.
*Used daily data where noted; otherwise, monthly data were used.

Regarding non-U.S. value stocks, the two scenarios on the right of Figure 4—year-to-date and the early 2000's tech bubble—illustrate the unwinding of growth stock overvaluation, which remains a factor in the current environment. Non-U.S. growth stocks have a price/earnings (P/E) ratio of 21, compared with 11 for non-U.S. value stocks. Based on a start date of December 31, 1997, and end date of March 26, 2025, this relative valuation spread ranks in its 80th percentile.

A caveat

In my view, the U.S. economy remains the most dynamic and innovative in the world. I expect U.S. tech dominance to continue in the long run. The Asset Allocation Committee's analysis supports a tactical overweight to non-U.S. stocks with a 6- to 18-month horizon in the context of a broadly diversified portfolio that includes U.S. stocks.

Takeaways

Non-U.S. stocks are undervalued and gaining momentum: Valuations and recent performance suggest a tactical opportunity to shift from U.S. to non-U.S. equities.

European stimulus and bank recovery could be catalysts: Fiscal expansion in Germany and improving bank fundamentals may unlock value in European markets.

The valuation gap between U.S. and non-U.S. stocks is extreme: While partly justified by stronger U.S. fundamentals, this gap may compress if conditions shift—e.g., U.S. fiscal tightening or slowing tech dominance.

Non-U.S. value stocks are especially attractive: With a wide valuation discount to growth stocks, non-U.S. value offers a compelling relative opportunity.

Our view is tactical, not structural: U.S. innovation remains dominant long term, but a 6- to 18-month overweight to non-U.S. stocks may enhance diversification.

Thank you to Megumi Chen for running this analysis, as well as to Charles Shriver, Rob Panariello, Josh Yocum, and Tim Murray for their valuable contributions.

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Definitions

Forward P/E or the forward P/E ratio (or forward price-to-earnings ratio) or the NTM P/E (Next Twelve Months price-to-earnings) divides the current share price of a company by the estimated future ("forward") earnings per share (EPS) of that company. For valuation purposes, a forward P/E ratio is typically considered more relevant than a historical P/E ratio.

Last Twelve Months Return on Equity (ROE) is calculated by dividing net income by shareholders' equity. Because shareholders' equity is equal to a company's assets minus its liabilities, ROE is a way of showing a company's return on net assets.

Next Twelve Months Price-to-Earnings (NTM P/E) Gap is the difference between the NTM P/E of the Russell 3000 and MSCI All Country World Index ex-U.S.

Return on Equity (ROE) Gap is the difference between the ROE of the Russell 3000 and MSCI All Country World Index ex-U.S.

For additional definitions of terms, please see: https://www.troweprice.com/glossary

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Important Information

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