VINITY

LOOKING FOR A BARGAIN

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In a Nutshell

Depending on which side of the coin you land, the housing market has been a source of pain or a source of gain. Many homeowners are sitting on substantial equity following the 40% jump in home prices since the end of 2019. Ultra-low interest rates allowed homeowners to reduce borrowing costs, freeing up cash to allocate elsewhere. However, it is not all rainbows and unicorns. With mortgage rates up more than double from their early 2021 lows, on top of the rapid advance in home prices, the same house from December 2019 comes with a mortgage payment 101% higher today. Many homeowners could not afford to buy their current home in the present environment, let alone think about trading up for a more spacious home. So, transactions are limited as potential sellers cannot afford to go anywhere, and potential buyers are priced out of the market. The dynamic has kept home prices from falling precipitously, but that does not solve the affordability problem. On the capital markets front, investors are still infatuated with U.S. large-cap technology stocks and will balk at the view that there may be an alternative. However, we still see significant opportunities outside of U.S. stocks, even though this idea is often met with strong resistance as if it is some crazy notion. I would argue that most consumers buy more non-U.S. brands than they realize. Therefore, investing in international stocks should not be seen as so foreign. Household names like Ben & Jerry's, Jeep, and Samsung Electronics are all brands owned by non-U.S. companies. With U.S. stocks trading at all-time highs and a 30% premium to fair value, looking for alternatives is wise. International developed and emerging markets fit the bill today. The asset classes are trading at fair value on top of the multi-decade low relative valuation to U.S. stocks. As such, we remain exceedingly enthusiastic about the long-run prospects for the non-U.S. asset classes.

Nowhere to Go but Up

The housing market continues to defy expectations. The existing single-family home median sales price is 40% higher today than at the end of December 2019. However, the more important measure to assess affordability is the median mortgage payment, as this figure is more relevant to most homebuyers. Most people are not buying a home but rather a mortgage payment. The median mortgage payment is up 101% since December 2019 due to the swift rise in interest rates on top of an unprecedented increase in home prices. The dynamic is attributable to the Federal Reserve maintaining a zero percent policy rate for two years, suppressing borrowing costs across the economy.

Homeowners and prospective buyers had the opportunity from July 2020 through December 2021 to lock down a sub-3% mortgage. Home prices rapidly advanced as buyers took advantage of this once-in-a-lifetime opportunity. As interest rates fall, a buyer can afford a more expensive home for the same mortgage payment, so buyers do not care about paying unreasonable prices, as the mortgage payment, their true cost, is little changed. For example, the mortgage payment on a $270,000 home with a 4%

mortgage rate and a $305,000 home with a 3% mortgage rate are the same. Buyers were indifferent to "paying" $35,000 more for the same home as it did not result in a higher mortgage payment due to lower interest rates. And so, it was off to the races. Prices moved higher with seemingly no end as buyers rushed to lock in historically low mortgage rates. In 2022, the Fed removed the punchbowl, and the 30-year mortgage rate finished the year at 6.42%, more than double the 3.11% where it began the year. Assuming no change in price, the rise in mortgage rates from 3.11 % to 6.42% increases the mortgage payment by 47%. Conventional wisdom suggests home prices should decline in the face of a rapid rise in interest rates and diminished affordability. Instead, home prices have held steady while mortgage rates continue to rise. So, what gives?

The affordability crisis has priced out many prospective home buyers, limiting demand, while the supply of homes remains constrained as potential sellers either do not want to trade in their sub-3% mortgage rate for a 7% mortgage rate or simply cannot afford to trade up in the current market. Many homeowners could not afford to buy the home they currently live in based on prevailing prices and interest rates. Even in the wake of much higher borrowing costs, the dynamic has sidelined otherwise motivated buyers and sellers, limiting transactions and keeping home prices steady.

First-time homebuyers face a tremendous uphill battle, considering the median starter home will run you $332,900 today. Assuming a 25% mortgage-to-income ratio and the average first-time home buyer's down payment of 8%, qualifying for a mortgage on the median-priced starter home requires an income of $95,600, which is 46% higher than the current first-time home buyer's median income of $65,629. Enter the bank of mom and dad, the unsung heroes propping up demand. According to a survey from LendingTree, 49% of Gen Z homeowners reported receiving assistance from parents, 27% of Millennials received help from parents, and 20% of Gen Xers relied on support from parents to buy a home. However, on the flip side, Baby Boomers are contributing to supply constrictions as they are not selling their homes and are most likely to own homes typically desired by families with children. For example, empty-nest Baby Boomers own 28% of three-bedroom-plus-homes in the U.S., while Millennials with kids own just 14% of those homes, according to Redfin. In summation, this likely means we can expect the dynamic in the housing market to persist for the foreseeable future. Even if interest rates come down, with the backdrop of limited supply and pent-up demand, we expect home prices to rise and affordability to remain constrained.

International Should Not Be Foreign

International developed and emerging markets stocks remain exceptionally attractive, just like last quarter, last year, and two years ago. Can something be exceptionally attractive and remarkably unloved? The answer, unfortunately, is yes. Investors today are so enamored by U.S. large-cap technology stocks that they cannot be bothered with something so silly as non-U.S. stocks. This notion is unintuitive as consumers will happily shop internationally but are uninterested in investing internationally.

Let us take a look at what shopping internationally entails. Consumers who select Gerber baby food for their infants, drink Nespresso coffee by the gallon, sustain themselves with DiGiorno pizza and Haagen-Dazs ice cream, and feed Purina to their four-legged friends are shopping brands from Swiss company

Nestle. Consumers who like Dove's line of personal care products, enjoy the scent of Axe body spray, and cannot stop at just one pint of Ben & Jerry's ice cream are shopping brands of England-based Unilever. If you are searching for new personal care and beauty products, you may find yourself inside a Sephora store owned by French conglomerate LVMH. In the market for a new Ram truck or looking to explore off-the-beaten-path in a Jeep, you are shopping brands of Dutch company Stellantis. Shoppers looking for a new television, smartphone, or kitchen and laundry appliances are sure to come across products from South Korean companies Samsung and LG. I know baby food, shampoo, and washing machines are not necessarily exciting, but the point is that investing in international companies is not as foreign as it may appear.

Valuations for international developed and emerging markets continue trading at increasingly attractive levels, with both asset classes reaching multi-decade low valuations relative to U.S. stocks. International developed currently trades at a two standard deviation discount, and emerging markets currently trade at a one standard deviation discount to U.S. stocks. As depicted in Figure 1 and Figure 2, we are charting the relative valuation between the two asset classes as measured in standard deviations from the long-term average.

Figure 1.

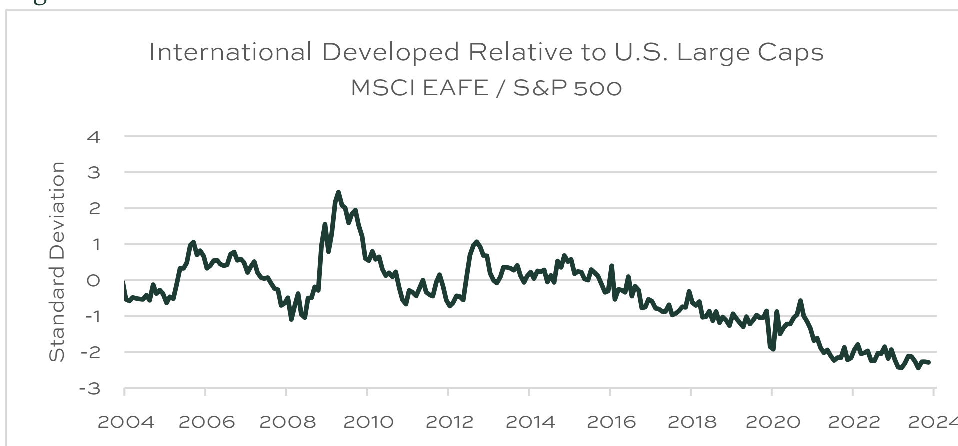
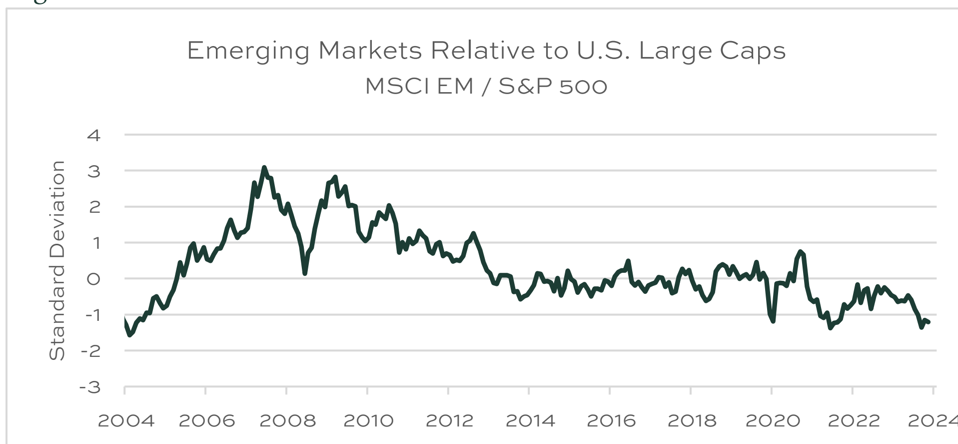


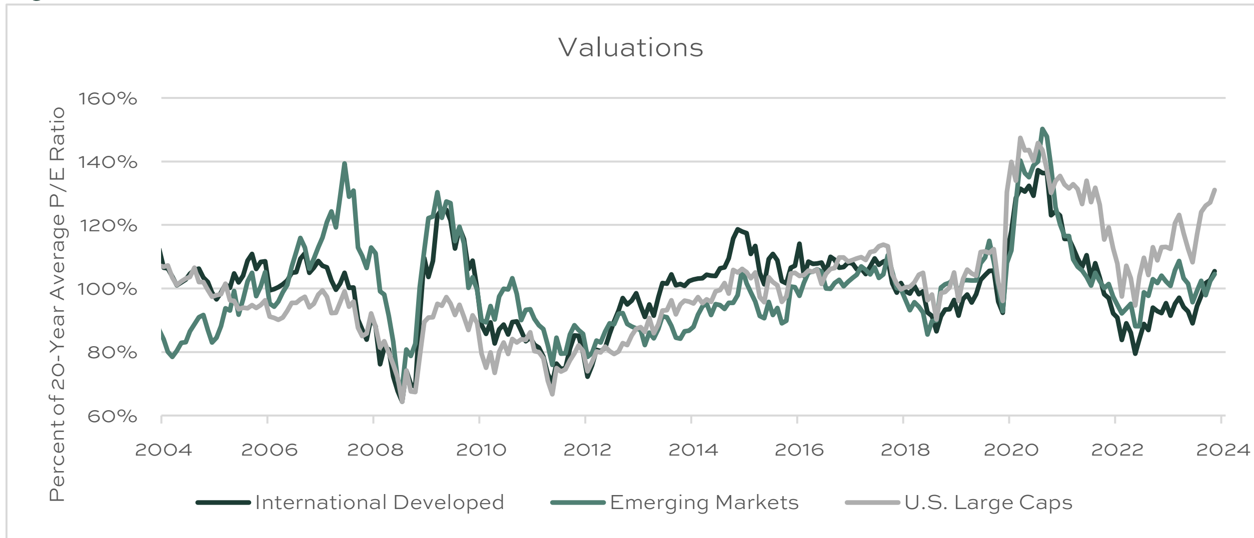
Figure 2.



In Figure 3, we chart the valuation for each asset class relative to its 20-year average. At the end of the first quarter, the U.S. traded at 130% of its 20-year average valuation, while its non-U.S. counterparts

traded at roughly fair value. I will also point out that historically, the asset classes do not spend much time above 120% of their fair value. In this context, we believe international developed and emerging markets are even more compelling when compared to U.S. stocks.

Figure 3.



Assuming U.S. stocks will deliver a 15% annualized total return over the next fifteen years, similar to the past fifteen years, is foolhardy. Starting points matter, and context is essential. Fifteen years ago places us in March of 2009, the S&P 500 hit a nearly thirteen-year low, following a 57% drop in the price level over the previous seventeen months. The environment today could not be more different, with the S&P 500 trading at all-time highs, up nearly 40% over the past seventeen months. History cautions the high starting valuation for U.S. stocks today suggests the asset class is poised to underwhelm. On the other hand, international-developed and emerging markets look exceptionally attractive, and we believe it is just a matter of time before investors wake up and smell the roses.

Figure 1. Relative Valuation (RV) is calculated monthly as the MSCI EAFE Index forward P/E ratio divided by the S&P 500 forward P/E ratio. The dataset is standardized so the values plotted on the chart represent deviations from the mean [RV Deviation = (RV - Average RV) / Standard Deviation of RV]. **Figure 2.** Relative Valuation (RV) is calculated monthly as the MSCI EM Index forward P/E ratio divided by the S&P 500 forward P/E ratio. The dataset is standardized so the values plotted on the chart represent deviations from the mean [RV Deviation = (RV - Average RV) / Standard Deviation of RV]. **Figure 3.** International Developed represented by the MSCI EAFE Index, Emerging Markets represented by the MSCI EM Index, and U.S. Large Caps are represented by the S&P 500.

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Diversification does not guarantee a profit or protect against loss.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **MSCI EAFE Index:** Measures the performance of large- and mid-cap equities across 21 developed markets countries, excluding the U.S. and Canada, and covers approximately 85% of the free float-adjusted market capitalization in each country. **MSCI Emerging Markets Index:** Measures the performance of large- and mid-cap equities across 26 emerging markets countries and covers approximately 85% of the free float-adjusted market capitalization in each country.

Sources: LendingTree, National Association of Realtors, Redfin, WisdomTree, YCharts.

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