Strategist's Corner

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The Wisdom of Earnings: Why EAFE's Past Holds Lessons for its Future

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In brief

- Market analysts often highlight that the last time the MSCI EAFE outperformed the S&P 500 was pre-GFC. While accurate, it's not helpful information.
- Performance depends on earnings.
- A new era of higher spending and prices is setting the stage for a new paradigm of EAFE outperformance.

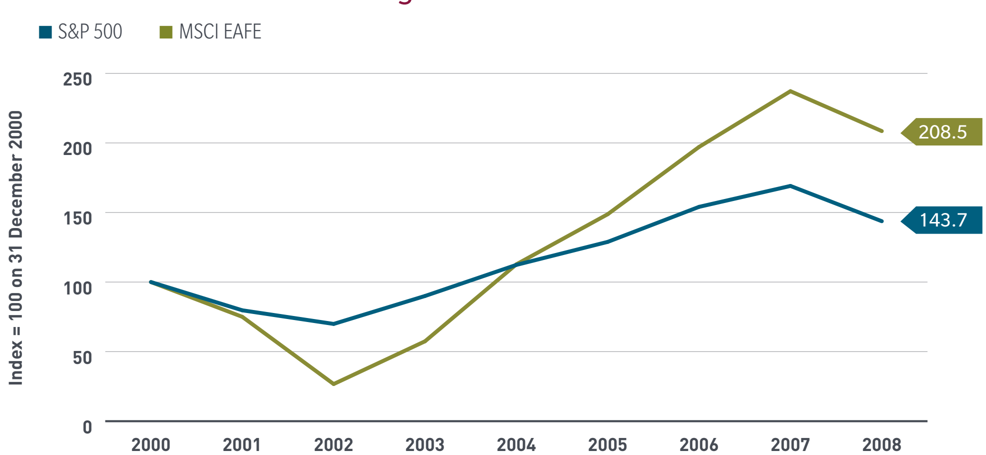
Knowledge is a process of piling up facts; wisdom is the ability to simplify those facts. Take the old adage about the tomato: Knowledge is knowing it's a fruit; wisdom is knowing not to put it in a fruit salad. This distinction has never been more apt in a world where the constant and growing flow of information often obscures simple truths.

Consider the recent emphasis by market pundits that the last time the MSCI EAFE Index outperformed the US market was pre-global financial crisis (2008). This piece of knowledge, while accurate, often fuels unhelpful narratives; it's not particularly relevant on its own. Outperformance, whether by a region, asset class, industry or a stock, does not die of old age. Knowledge is knowing the extent of performance differentials; wisdom is understanding why and, more importantly, what can change.

The Earnings-Driven Truth

The MSCI EAFE outperformed the S&P 500 from 2000 to 2008 because EAFE companies outearned their US counterparts (Exhibit 1). Since a stock represents the residual value of a company's assets and cash flows, EAFE's superior earnings per share during this period was the source of outperformance versus the S&P 500.

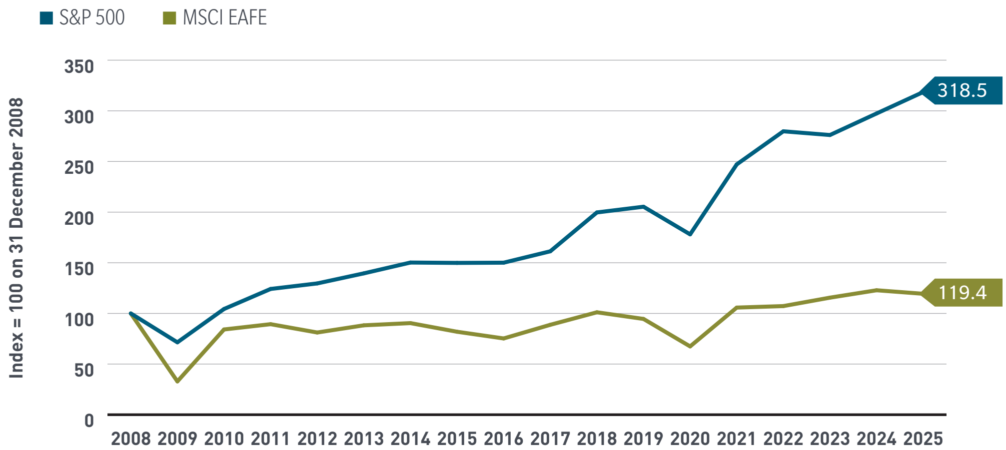
Exhibit 1: Cumulative Earnings Per Share Growth 2000–2008



Source: Bloomberg. Annual data from 31 December 2000 to 31 December 2008. Earnings per share are last-twelve-months.

Conversely, earnings are the same reason why EAFE stocks lagged over the past 15 years—weaker earnings (Exhibit 2).

Exhibit 2: Cumulative Earnings Per Share Growth 2009–Present



Source: Bloomberg. Annual data from 31 December 2008 to 31 December 2024. Most recent data point is through 31 July 2025. Earnings per share are last-twelve-months.

After we exhaust ourselves analyzing index concentration, duration and magnitude versus past periods, the simple takeaway is it's always about earnings. Index concentration and market cycles are merely symptoms of earnings, not causes.

While the specific conditions of these two vastly different periods in the past (almost) 25 years might seem irrelevant to the current moment, they offer valuable context:

- **2003–2008: The Global Growth Engine**: This period saw the global economy in a robust growth phase, driven by the emergence of China and other developing markets, alongside a burgeoning US housing bubble. This fueled immense demand for capital, labor and commodities, which disproportionately benefited EAFE companies. Their businesses, relative to US companies, have a higher revenue multiplier to GDP, and when juxtaposed against a more fixed cost basis, generate greater profit torque to changes in economic growth. This works in reverse too when growth is slowing. This dynamic is much like how value companies often outearn growth companies during periods of rising growth — because they are more mature businesses that have greater revenue sensitivity to the economy versus those with secular growth characteristics seeking to take share from market incumbents. The economic environment enabled EAFE companies to outearn US companies, and stock prices followed suit.
- **Post–2008: The Era of Secular Stagnation**: Following the 2008 recession, global banks curtailed lending, consumers tightened their belts, developed companies cut expenditures and shifted manufacturing to Asia, and China/emerging markets began a deceleration that combined for one of the weakest business cycles in over a century. This environment benefited companies, predominately US technology firms, less dependent on the overall economy or business cycle. These businesses were adept at taking market share from "melting icebergs and cubes" and evolved into massive oligopolies, monopolies and monopsonies, thriving and aggregating profits even amidst broader economic stagnation.

Outlook: The Winds of Change for Earnings

Looking ahead, we believe that conditions are ripe for another shift.

GDP growth is fundamentally a function of spending and prices. Both are currently higher than during the 2009 to 2020 period and are likely to remain so as demand for tangible fixed investment should be higher versus the 2010s. For example, for years, global supply chains were increasingly prioritized for efficiency and return. However, COVID, a land war in Europe, fighting in the Middle East and, more recently, tariff policies have reprioritized resiliency over cost minimalization. Additional demands for capital stem from the buildout of artificial intelligence, increasing energy demands, national security, defense and more.

At the same time, an era of abundance has ended. Everything from capital, labor and goods needed for production costs more than it did in the post-2008 years.

While economic growth may decelerate due to other factors, the combination of new investment cycles across different sectors, higher input prices and new businesses emerging for market share combines for potential earnings headwinds for US businesses relative to EAFE companies. Together with the valuation discount, we believe this forms a compelling algorithmic case for EAFE outperformance.

Conclusion

The wisdom derived from the knowledge of past cycles points us squarely to earnings as the ultimate driver. As the global economic landscape shifts, so too will the fortunes of different market segments. In our view, investors focused on the underlying fundamentals — with a vast research infrastructure that can help differentiate between the growing avalanche of noise and financially relevant truths — will likely be best positioned to navigate the path ahead.

MSCI EAFE (Europe, Australasia, Far East) Index (net div) - a market capitalization-weighted index that is designed to measure equity market performance in the developed markets, excluding the U.S. and Canada.

Standard & Poor's 500 Stock Index - a market capitalization-weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance.

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