RBC Global Asset Management

Is this the beginning of the International Equity revival?

March 2025

Freddie Fuller
Product Specialist

European and International Equities Team

- International equities have reached a pivotal moment as geopolitics reshape markets.
- They have exhibited strong, consistent absolute performance over multiple time horizons.
- Optimism growing in Europe driven by fiscal expansion, corporate earnings, and positive economic data.
- Revitalization in Japan from a reversal of long-standing deflationary pressures, stagnant wage growth, and a renewed focus on shareholder value.

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The one question we have heard from investors more than any other over the last couple of years has been “When should we invest into International Equities?”. The question is in and of itself an informative one: there have been concerns about US equity valuations, concentration, and consensus, for a substantial period of time. Despite this, for years US equities have been if not quite the only game in town, then certainly the source of the best relative returns.

So far, 2025 has seen a dramatic reversal of this performance bifurcation, with non-US equities significantly outperforming the US, resulting in significant shifts in asset flows internationally. As a result, the question now being posed is “How much should we allocate outside of the US?”

We are loathed to enter into a debate around relative allocations given the team are not US equity specialists. However, as investors we believe that international equities, and Europe in particular, has reached a positive tipping point, driven by sentiment and fundamentals. We also see several promising areas that suggest that the playing field may be flattening out.

Due to the often-dominating narrative of US equity market exceptionalism, investors may have missed the fact that international equities have performed strongly across multiple time horizons in absolute terms.

Take Europe for example: over 5, 10, and 15 years, European equities have returned 11%, 6.2%, and 8.3% per annum, respectively – hardly numbers to be sniffed at. Similarly, Japan has returned 13.7%, 8.7%, and 10.8%[1] pa over the same timescales.

But with the trifecta of better earnings growth, higher GDP growth, and higher productivity, US markets have overshadowed this. Encouragingly though, all three of these elements are being reclaimed outside of the US.

Europe is awakening

As a direct result of the policy initiatives being undertaken by the Trump administration, Europe is undergoing a significant shift in fiscal policy, unseen in this century. As the need to re-arm the continent progresses, and the tectonic plates of geopolitics re-align, so the levers of power are being shifted to increase spending in areas of the economy that are inherently more productive. The sectors most likely to suffer are social rather than industrial.

This change is likely to occur across the continent, but nowhere more than Germany. Having seen two years of economic decline and next to no growth, the incoming German government's move to release spending restraints is likely to transform not just its own economy, but that of Europe as a whole. With debt-to-GDP of only 60%, compared with 120% in the US, Germany's prudence over the last few decades has positioned it to release €500bn in infrastructure spending, theoretically unlimited spending on defense, and almost single-handedly push European economic growth higher.

Germany's low growth would normally suggest poor GDP data across Europe given its relative size in the bloc. Encouragingly however, periphery countries such as Ireland, Spain, and Portugal, all recorded real GDP growth above 2% in 2024[2], which only compounds the positive momentum that would occur if economic powerhouses such as Germany and France were to see a significant economic pickup stemming from productive investment.

Europe loosening the rules

If the adage that Europe is forged in crisis is demonstrably shown by the reaction to the euro-crisis and the Covid-19 pandemic, so the recent moves by the EU mirror this concept. Regardless of whether Europe can adopt the mantle of the economic and political behemoth that it so often fails to exploit, there is clearly a central recognition of the need to reassess the often-burdensome fiscal rectitude of the bloc.

This is demonstrated by the EU Commission's exemption of defense spending from fiscal rules as well as the establishment of a €150bn EU loan facility to fund military expenditure.

In conjunction with the interest rate cutting cycle of the European Central Bank remaining ahead of the Federal Reserve, which is already spurring an uptick in the Eurozone bank lending cycle – an important indicator given how integral bank lending remains in Europe – the economic signs for the bloc are improving rapidly.

At a corporate level, several factors are supportive for European equities

Earnings revisions are positive, with a sharp acceleration from the last two years of decline. High-single digit EPS growth appears achievable, even with the potential impact of any tariffs. Although headline figures appear concerning regarding tariffs, diving into the detail demonstrates that the impact to earnings should be relatively subdued given the manufacturing undertaken on US soil, the industries likely to be exempt such as defense and biotech, and especially as the sectors with most exposure have already seen their prices decline.

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Broader valuations remain very supportive for the region even after the recent rally, and total shareholder returns are compelling. As historically has been the case, the dividend yield in Europe has far outshone that of US stocks, although this has often been offset by buybacks in the latter. Conversely the last 12 months have now seen a higher level of buybacks in Europe, and a combined Net Buyback and Dividend Yield of 6.4% versus 2.8% for the US[3].

Is this a false dawn?

Critics may say that there have been false dawns before regarding Europe, and that US equity markets are currently operating from an unassailable position with regards to size and liquidity. We would not dispute the scale advantages of the US. Instead, we would re-emphasize that international equity markets should exist as a component of an equity allocation not just due to the current market conditions, but because these markets are made up of some extremely high-quality businesses that have existed, in many instances, for hundreds of years and continue to generate good returns for investors.

1 Bloomberg, MSCI Europe and Nikkei 225, as of 28th February 2025.
2 International Monetary Fund, 2025.
3 Barclays Research, March 2025.

Europe is undoubtedly undergoing a significant shift as it transitions towards fiscal expansion, regulatory unburdening, and financial cohesion. But this change should be viewed as complementary to the longer-term trend of great global businesses with diversified revenue streams, broad-based markets where returns have not been concentrated into a small number of holdings, and a differentiated sectoral composition that in a shifting environment can offer diversified return streams.

Japan revitalized

Japan is another area of the international market that is entering a new era, one that has already resulted in renewed interest in its equity markets.

Over the past few decades, Japan's backdrop has made the economy less appealing to investors than its developed market counterparts. Challenges such as unfavorable demographics, a heavily indebted economy and a state of deflation since the bubble of the 1980s, amongst other things, have caused headwinds for the economy and put off investors.

However, the three largest historical headwinds – entrenched deflation, demographic challenges and corporate governance (shorthand for a lack of focus on shareholder returns) – are unwinding to various degrees.

The Bank of Japan finally ended negative interest rates in 2024 as the pandemic-induced inflationary impulse was coupled with real wage growth across the economy. The weak Yen continues to support exporters such as autos and machinery companies, a key component of the Japanese industrial base.

The equity market backdrop in Japan is also encouraging; initiatives to reignite ROE are bearing fruit, with a focus on setting targets, competing on a more global view, and governance reforms to think more deeply about shareholder returns have seen markets hit highs not experienced since the 1980s. Japanese corporates remain extremely cash generative, and the deployment of this capital is gaining renewed focus. In a similar way to Europe, buybacks are now being used as a tool by corporates to exploit undervaluation, providing further support to valuations.

EPS growth in Japan continues to climb, with 2025 expected to deliver 11% and with valuations at a reasonable 15 times forward earnings, recent performance should not prove detrimental to the future. If other areas of Asia follow suit with governance reforms, as seems increasingly likely in countries such Korea, momentum may build behind them.

A promising light in an uncertain world

These developments, as well as those in Europe, are palpably substantial. That is not to say that there are not headwinds to these markets. Regulatory burdens, while easing in some regards, need to loosen further to generate competition. The geopolitical volatility and shifting of the transatlantic order may disrupt policy and cause unintended consequences, while tariffs and the war in Ukraine remain known unknowns.

That being said, the long-term nature of many of the investable companies in these markets, their global footprint and strong revenue base, provide a sure footing which we as investors hope will be catalyzed by the changing face of global markets.

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RBC Global Asset Management (U.S.) Inc.
800.553.2143 | **rbcgam.com**