

Norbert Keimling on country valuation differences caused by divergent sector structures

Market valuation determined by sectors?



The old business adage “the profit lies in the purchase” also applies to financial markets. Numerous studies show that undervalued equity markets appreciate significantly more than highly valued ones over the long term. For investors, it is therefore an obvious step to compare the valuation levels of

different countries and invest primarily in countries with attractive valuations while avoiding expensive markets. For example, if one compares all established equity mar-

kets based on the price-to-book ratio (PB), Asian markets such as Singapore and South Korea currently stand out due to their particularly attractive valuations, while Denmark and the US seem expensive. But is it really the case that all countries are comparable with each other in equal measure?

Special case Denmark

In particular, the case of Denmark raises doubts since the healthcare sector dominates the country’s equity market in an exceptionally strong way. While this sector accounts for just 9 percent of the global equity market, it repre-

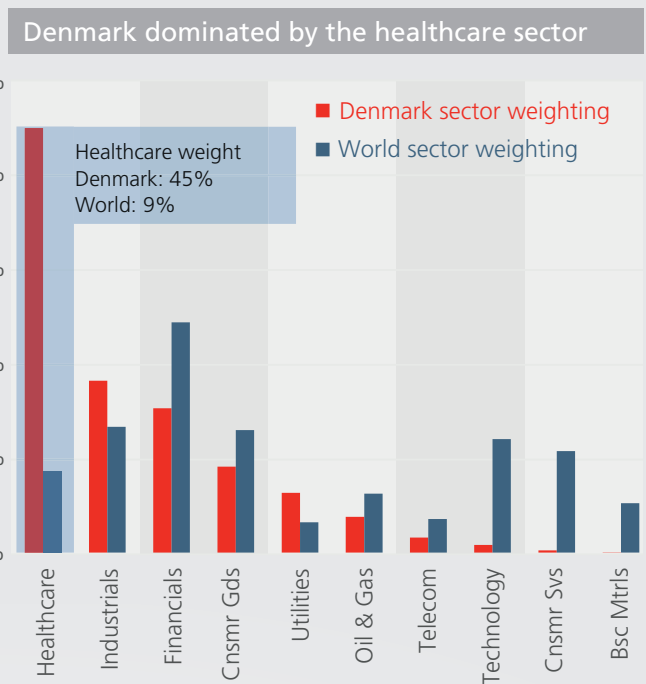


Chart 1: The chart represents the sectoral weighting of the Datastream Denmark Index compared with the Datastream World Index. Source: Thomson Reuters Datastream and StarCapital as of 28/02/2018.

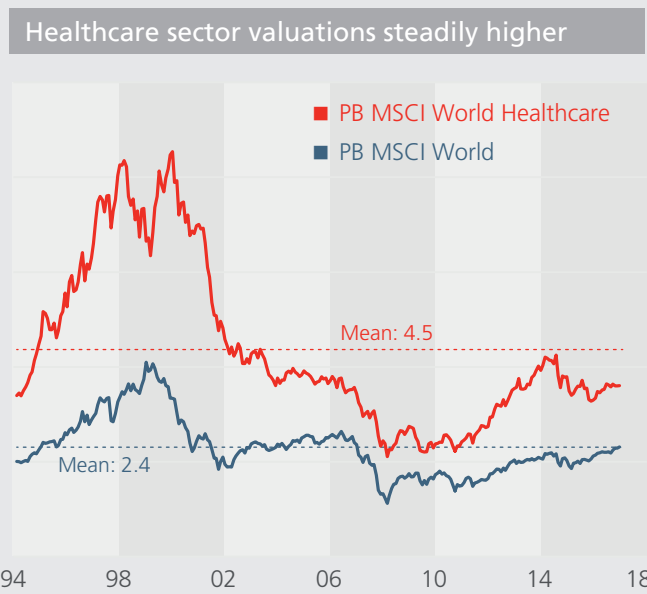


Chart 2: Thomson Reuters Datastream as of 28/02/2018.

sents almost half of the Danish market (see Chart 1).

Healthcare raises market valuation

The fact that the global healthcare sector has consistently traded at a significant premium – 85% on average – to the global equity market in the past few decades raises the question of whether the Danish equity market with such a high weighting in a traditionally expensive sector will ever be able to return to an average valuation level (see Chart 2).

Valuation – classical vs. sector-adjusted					
Country	PB	PB World	PB World sect.-adj.	Discount World	Discount sect.-adj.
Australia	2.0	2.1	1.7	-3%	19%
Austria	1.4	2.1	1.5	-35%	-6%
Belgium	2.0	2.1	2.5	-5%	-20%
Brazil	2.1	2.1	1.6	-1%	27%
Canada	1.8	2.1	1.6	-14%	12%
China	1.1	2.1	1.3	-47%	-14%
Czech	1.5	2.1	1.4	-27%	9%
Denmark	3.2	2.1	2.5	50%	28%
Finland	2.2	2.1	2.0	6%	12%
France	1.8	2.1	2.3	-16%	-23%
Germany	1.8	2.1	2.0	-13%	-10%
Hong Kong	1.7	2.1	1.8	-18%	-6%
Hungary	1.5	2.1	1.5	-27%	5%
India	3.1	2.1	1.9	46%	61%
Ireland	1.9	2.1	1.9	-11%	0%
Israel	1.5	2.1	1.7	-26%	-9%
Italy	1.3	2.1	1.6	-38%	-20%
Japan	1.4	2.1	2.1	-35%	-35%
South Korea	1.1	2.1	2.1	-47%	-48%
Malaysia	1.7	2.1	1.8	-17%	-3%
Mexico	2.3	2.1	2.2	7%	4%
Netherlands	2.0	2.1	2.3	-5%	-12%
New Zealand	1.9	2.1	2.1	-8%	-10%
Norway	1.7	2.1	1.6	-18%	11%
Poland	1.3	2.1	1.5	-36%	-8%
Portugal	1.6	2.1	1.6	-26%	-3%
Russia	0.9	2.1	1.4	-57%	-35%
Singapore	1.2	2.1	1.6	-43%	-25%
South Africa	2.0	2.1	1.7	-4%	19%
Spain	1.6	2.1	1.7	-26%	-8%
Sweden	2.0	2.1	2.0	-4%	1%
Switzerland	2.5	2.1	2.3	20%	9%
Taiwan	2.0	2.1	2.2	-7%	-13%
Thailand	2.3	2.1	1.7	12%	39%
Turkey	1.5	2.1	1.6	-30%	-8%
UK	1.8	2.1	2.0	-15%	-9%
US	3.2	2.1	2.5	53%	30%

Chart 3: "PB World sect.-adj." refers to the sector-adjusted world valuation, i.e. the PB ratio of a notional global equity index that has the identical sector composition to that of the relevant country. Source: StarCapital as of 28/02/2018.

Systematically lower PB ratio in financial sector

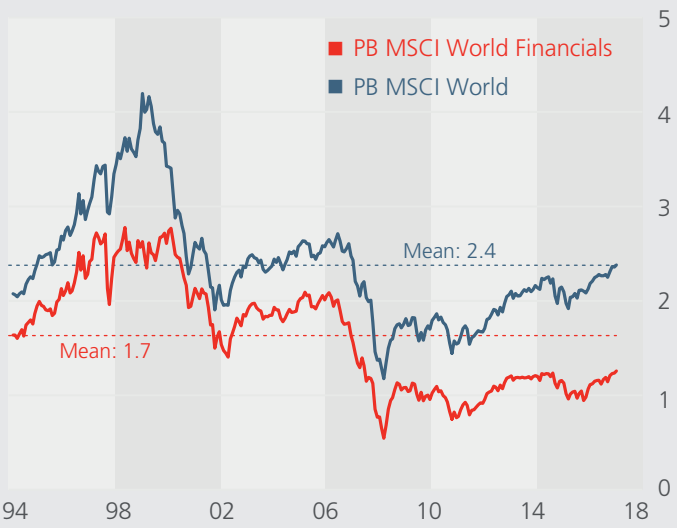


Chart 4: Thomson Reuters Datastream as of 28/02/2018.

Assuming that different sectors – e.g. due to industry-specific balance sheet structures – will also have different valuation levels in the future and that the sector structure of a market won't change dramatically in the medium term, it appears worthwhile to analyse the extent to which Denmark's overvaluation is simply the result of a higher healthcare weighting.

This effect can be quantified by comparing Denmark's valuation level with that of a sector-adjusted benchmark. For example, if the global equity market had the same sector composition as Denmark – including the high healthcare weighting – its price-to-book ratio would rise from 2.1 to 2.5. The Danish equity market would no longer be valued 50 percent higher than the global equity market, but only 28 percent (see Chart 3). As a result, about half of Denmark's overvaluation is attributable to a divergent sector composition.

Worldwide sector adjusted valuation

For all other established equity markets, it can be concluded that undervalued markets generally show undervaluations even after a sector adjustment, and vice versa. However, some undervaluations must be put in perspective, for example in Singapore, whose low PB ratio is

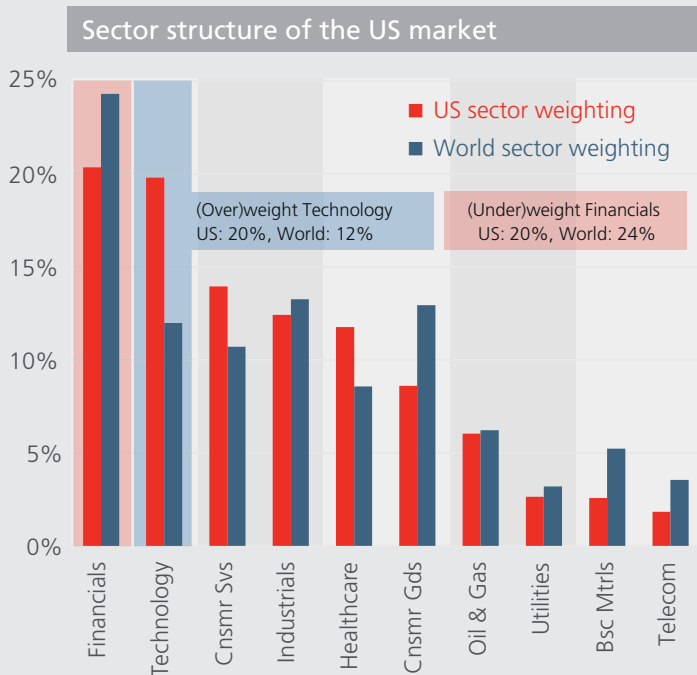


Chart 5: The chart represents the sector weighting of the Datastream US Index compared with the Datastream World Index. Source: Thomson Reuters Datastream and StarCapital as of 28/02/2018.

largely due to a high weighting of (historically attractive) financial stocks (see Chart 4).

In the seemingly attractive markets of Norway, Canada and Australia, the undervaluation actually turns into an overvaluation after a sector adjustment due to their high weightings of basic materials stocks and financial stocks. This means that equities in these countries are even valued higher on average compared to their competitors from other countries. However, this remains concealed in a classical PB country comparison.

US overvaluation partially explainable by sectors

The sector structure also has an effect on the high US valuation. Lower exposure to attractively valued financial stocks and an overweighting of comparatively expensive technology stocks inevitably cause the valuation of the US market to rise (see Chart 5).

If the global equity market had the same sector structure

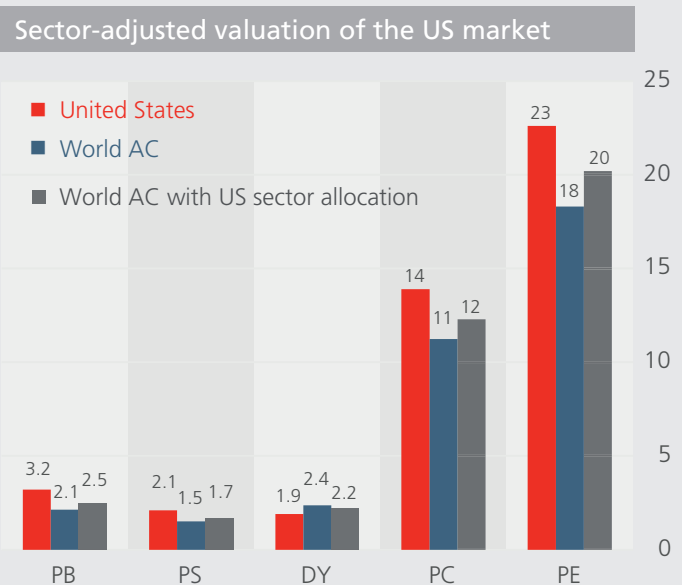


Chart 6: To determine to what extent valuation discounts and premiums of the US market can be explained by its sector weights, we adjust the world's sector weights to match those of the US for five frequently used valuation ratios. United States refers to all US stocks whereas World AC includes all stocks in the Datastream universe. Source: StarCapital as of 28/02/2018.

as the US market, its PB valuation would rise from 2.1 to 2.5. As a result, about half of the overvaluation is attributable to a divergent sector composition. This effect is similar for other valuation indicators (see Chart 6).

Conclusion

Investors should therefore scrutinise undervaluations, particularly in smaller countries or in countries with a very divergent sector structure. An equity market with a comparatively attractive valuation does not always include attractive equities.

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Published by: StarCapital AG, Kronberger Str. 45, 61440 Oberursel, Germany
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Place of publication: Oberursel, Germany

Source references: Unless otherwise stated, tables and charts produced on the basis of Thomson Reuters Datastream and Bloomberg.

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