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ILIM's Chief Investment Officer, Anthony MacGuinness, assesses key market influences and their impact on portfolio positioning

US Exceptionalism – can the US continue to deliver for investors

The concept of 'US Exceptionalism' is not a new phenomenon. Whether or not the US is truly exceptional has been a point of debate among scholars, political commentators and, of course, investors like ourselves for some time. In the 15 years to the end of August 2024, the S&P 500 Index has outperformed the MSCI EAFE* index by 470%. This dominance has been underpinned by a number of factors, but with the Presidential election outcome just weeks away and its potential impact on domestic and international policy, clients are increasingly asking us whether it can last? Can US exceptionalism continue to deliver for investors, or will it run out of steam?

Why has US performance been so strong?

Strong fundamentals, such as GDP growth and robust productivity gains have underpinned the US economy. Over the last decade, real GDP has expanded by 25%, compared to 16% in the Eurozone. This is in part due to America's position as a global leader in innovation, spending more in absolute terms and as a share of GDP on R&D than other major developed markets. Meanwhile on the fiscal side, significantly higher government spending by the US since the pandemic has supported more sustained consumer spending in contrast with some of its global counterparts.

Demographics are also a noteworthy long-term, structural advantage. As global populations age and the working age groups' share falls, the US stands out – it is expected to perform better than other major economies with the lowest old age dependency ratio of 49.3% by 2075, aided by strong net migration. This compares to ratios of 63.1% in Germany and 58.8% in China.

The emergence of dominant and highly profitable US tech companies has been a key driver of market returns in recent years. The rise of US mega cap technology stocks is a very pronounced realisation of America's culture of innovation and has allowed the so-called Magnificent Seven (Apple, Alphabet (Google), Amazon, Meta (Facebook), Microsoft, Nvidia and Tesla) to build dominant global positions and strong balance sheets with deep pools of capital enabling further investment and expansion - in 2023, private investment in AI was $67bn in the US compared to just $11bn in the EU and the UK combined. This culture of innovation and investment has led to strong US profit margins, which have been in a range of 8-12% since the global financial crisis, compared to 7-10% for the rest of the world. This greater propensity of the US to innovate, relative to the rest of the world, as well as their deep and liquid capital markets has been supportive in continuing to attract investor flows. All these factors have supported substantial and consistent US equity market outperformance compared to global peers.

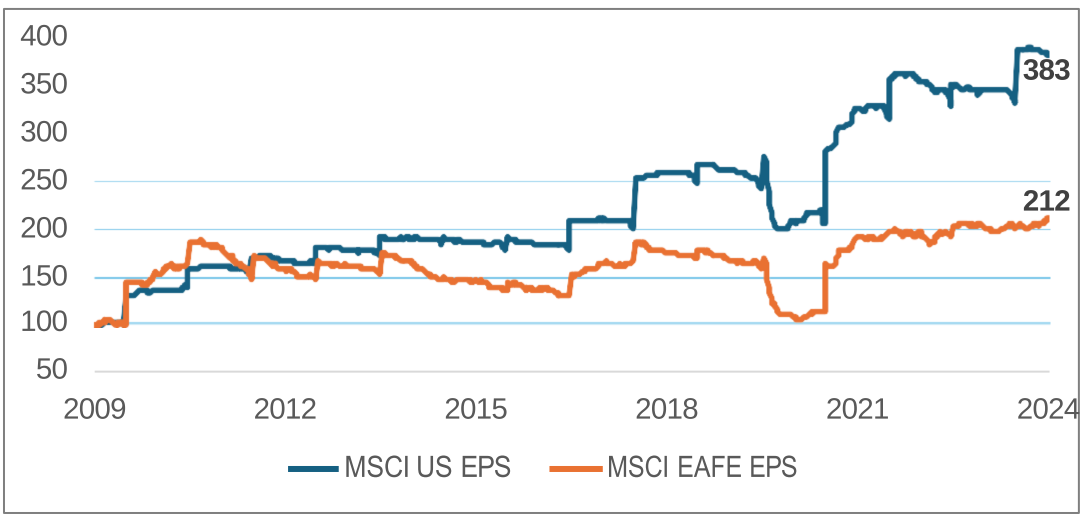
Where to from here?

The latest argument against US stocks continuing their run is that they have, as a group, become expensive, and the performance of the asset class has become increasingly dependent on a small number of technology stocks.

The Magnificent Seven now account for over a third of the S&P 500 index and have accounted for around half the year-to-date rise in the index through July. This has helped push up the US price-to-earnings (P/E) ratio to 21.2 times, above its long-term average in absolute terms and relative to global peers. However, while valuations are somewhat expensive, they are not in bubble territory – this is true both of the market as a whole and the tech sector, where valuations are often flagged as being elevated. Indeed, US tech currently has a P/E ratio of 29.3 compared to a peak of 59.1 during the dot-com bubble. Moreover, continued innovation and market dominance in some cases, leaves the potential for company earnings to grow into these valuations.

Viewing the world purely on a valuation basis, the idea that the US is an attractive investment looks implausible. Exceptionalism comes at a price, and on the face of it, it's a steep one today. However, look closer and value-based true believers have been making this same call about the US being over-valued for years, and have yet to be proved right. Valuation is based on the price divided by expected earnings, but it is these US stocks' ability to beat earnings estimates that have allowed them to justify their valuations and ultimately outperform the rest of the market (Figure 1). While the cheapness of European and emerging market stocks looks attractive on a standalone basis, it doesn't necessary manifest in outperformance, since those companies have simply not grown earnings at the same rate as their American counterparts. As a recent Economist article put it, 'Europe's tendency is to regulate first, and innovate never'.

Figure 1: Earnings of S&P 500 versus Global ex US



Source: ILIM, Bloomberg as of 30th August 2024. Earnings rebased to 100 as of 28th August 2009.

Bottom line

The ultimate question is, can American exceptionalism persist and is it worth paying this premium to own these stocks? There are strong arguments for it to continue – the US has a proven track record of innovation and entrepreneurship, and the growth of AI seems to favour their market leaders. But in the world of investing, we also know that these themes can and do ebb and flow.

While mindful of the risks ahead, including high valuations and uncertainty around the impact of the US elections, given the strong fundamental footing of the US consumer and corporate America we see room for continued US outperformance, especially given the structural growth themes around AI, tech and innovation. We believe it is right to back US exceptionalism, but diversification remains key to investors achieving their long-term investment goals.

* MSCI Morgan Stanley Capital International, EAFE Europe, Australasia & the Far East.

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