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All eyes on the US

by Michael Clough

"Should you be over or underweight the US equity market?" is surely one of the most asked asset allocation questions of the past 5-10 years. Over the 10 years to June end in US dollar terms, the US equity market outperformed the UK, Europe and Japan markets by 255%, 202% and 194%[1], respectively. There are good reasons for this outperformance. Most recently of course, the technology giants that dominate the US equity index were the chief beneficiaries from lockdowns as we all became dependent on, and some maybe addicted to, their services. However, it really has been a trend since the financial crisis that US companies have delivered sustained stronger earnings growth and better profitability than their developed market peers.

Data releases over the past few months have also been encouraging. The all-important services PMI indicator - a closely watched measure of expected future growth - exceeded 60 for four consecutive months to June, far above the 50 mark that separates expansion from contraction. Business confidence is certainly elevated right now and economic activity is evidently picking up too. The number of passengers screened at US airports has returned to pre-pandemic levels, despite collapsing over 96% at the worst point last year. Furthermore, whilst there is some way to go before employment fully recovers (non-farm payrolls are still about seven million shy of pre-pandemic levels) and there are continued concerns from some employers of a shortage of labour supply, the unemployment rate has dropped below 6% for the first time since the pandemic struck.

Whilst the fundamental backdrop appears positive there are risks, chief of which right now is inflation. Producer price inflation is running hot at 9.4% and whilst consumer inflation has jumped higher of late, if businesses can't fully pass these higher costs on to consumers, corporate margins could be squeezed rather aggressively. And, even if they can, then wage pressures might escalate, which would then pose a threat to margins. Another longer term risk is presented in the form of corporate tax reform with a new agenda seeking to claim more of the profits of multinationals. Whilst the reforms will take some time before taking effect, it does pose a risk down the road for the giant tech businesses in particular that operate globally.

Investors cannot forget valuations either. Historic data over the long term shows higher starting valuation multiples have led to lower future returns. Today the US equity market is on a forward P/E ratio of 22.6 times, a 23% premium to Europe and an even larger 44% and 80%[1] premium to Japan and the UK. US valuations are lofty but we do acknowledge the aforementioned negative correlation doesn't necessarily hold over the short term and that index valuations are skewed by a select and concentrated group of mega cap stocks providing opportunities for active investors beneath – don't forget the US equity market share of passive funds now stands at over 50%[2]! Another interesting dynamic is around the tax reforms and if governments do take more of the future profits from certain companies then it makes valuations look even more stretched today.

The stimulus we have seen in response to Covid is certainly worthy of a mention too. On the fiscal side, over the past 16 months we have seen a level of government support that is comparable only in the immediate aftermath of World War II. On the monetary side, the Federal Reserve has been purchasing $120bn of bonds per month which has served to push yields down and justify higher equity valuation multiples by virtue of a lower discount rate. The central bank has begun discussions around tapering the bond buying program and any rhetoric that sparks fears of tighter monetary policy sooner than expected to combat higher inflation poses a risk to equities. As a result, the Fed will be sure to signpost any policy changes as clearly as possible.

The economic recovery that is underway is likely to see a period of growth we haven't seen in decades. A consumer (which don't forget accounts for 70% of US GDP) supported by unprecedented government support, ready to unleash pent up demand with over $2.6 trillion[3] of excess savings will likely trigger an extraordinary spending boom. However, whilst the backdrop in the US is positive, it is in other regions too. The UK and Japanese equity markets are two examples where cyclical sectors and stocks form a higher weight in market indexes. These are set to do well in the years ahead, and this has started to be reflected in earnings expectations. Couple this with valuations that are at wide discounts and we feel these regions justify an overweight position. So, whilst we are constructive on equities overall, we maintain an underweight to the US today on valuation grounds, although less underweight than might otherwise be the case on valuations alone given the supportive backdrop (notwithstanding inflation risks) and opportunities for active managers to add value.

1 MSCI indexes for UK, Europe and Japan. S&P 500 for the US. All performance, valuation and market data from Bloomberg Finance, L.P. Valuation data as of 22nd July 2021

2 https://www.bloomberg.com/professional/blog/passive-likely-overtakes-active-by-2026-earlier-if-bear-market/

3 https://markets.businessinsider.com/news/stocks/us-excess-savings-coronavirus-pandemic-power-economy-recovery-moodys-2021-4

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