Four Reasons Why the Odds May Be Stacked Against US Equities

Non-US equities have underperformed for the past decade, but we may now have reached a turning point in this cycle.

US EQUITY OUTPERFORMANCE ISN’T JUST A RECENT PHENOMENON. For the past 10 years, US stocks have beaten non-US stocks by an average of 8.7% per year.*

However, we may have reached a turning point in this cycle. Since November 2020, non-US equities have outperformed by 5.2%, as the rollout of COVID-19 vaccines bolsters optimism for a global economic recovery.

So, are we approaching the end of America’s stock market exceptionalism? Here are four reasons that suggest we might be:

1. Cyclical Opportunities Lie Outside the US

During the pandemic, investors have sought the refuge of defensive growth stocks, which make up a large segment of the total US stock market capitalization. These companies have soared in value amid lockdowns and increased demand for digital services.

However, if you believe that an economic rebound is now imminent, then it makes sense to start allocating outside the US. That’s because non-US equities have far more exposure to cyclical sectors such as energy, industrials, and materials, which tend to perform well in a recovery.

For example, whereas the US equity market only has a 37% market-cap weighting1 in cyclical sectors, the rest of the world has a 55% weighting. This lower cyclical exposure for US stocks means they are unlikely to rebound as much as their global peers once the pandemic has ended.

Insight from sub-adviser
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Key Points

- Non-US equities have far more exposure to cyclical sectors such as energy, industrials, and materials, which tend to perform well in a recovery.
- US equity valuations are now at their peak. Relative valuations suggest non-US equities are likely to perform better than their US peers.
- Much of US equity performance in 2020 was explained by the dominance of Big Tech. But new regulations, if enacted, could slow future merger-and-acquisition expansion, an important ingredient for their success.

* US equities = MSCI USA Index; global equities = MSCI ACWI ex USA Index. Past performance does not guarantee future results. Indices are unmanaged and are not available for direct investment.

The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 620 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in the US.

The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Market countries (excluding the US) and 27 Emerging Market countries. With 2,342 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.
FIGURE 1
Non-US Equities Are Poised to Outperform in a Cyclical Recovery
Cyclical sector exposure

Past performance does not guarantee future results. Sources: Datastream, Refinitiv, and Schroders. Data from 1/31/01-12/31/20. Notes: cyclical = energy, industrials, materials, financials, real estate, and consumer discretionary.

2. US Valuations Are at Their Peak
One consequence of US outperformance is that valuations are now stretched to levels that would have historically foreshadowed low returns relative to the rest of the world.

For example, US share prices currently trade at 33x their cyclically-adjusted historical earnings (CAPE) compared to 18x for global equities. That’s the most expensive they’ve ever been in relative terms in 50 years (see FIGURE 2).

To be clear, equity valuations are expensive everywhere. But that doesn’t mean a global stock market crash is imminent. It just means future long-term returns could be lower. And even if that is the case, relative valuations suggest non-US equities are likely to perform better than their US peers.

FIGURE 2
Valuations Imply US Equities Are Likely to Underperform Over the Coming Decade
Subsequent relative 10-year annualized total return, US vs global (ex US) equities, %

Past performance does not guarantee future results. Sources: Refinitiv, Datastream, and Schroders. Data from 1/74-1/20. US equities = MSCI USA Index; global equities = MSCI ACWI ex USA Index.
Insight

3. President Biden Could Prove to be a Tailwind for Emerging Markets
Emerging-market (EM) equities have suffered as a result of US-China trade tensions under former US President Trump’s tenure. But under a Biden administration, analysts expect economic relations to be less fractious and for alliances to be restored with US allies.
This improvement in international relations and its positive spillover effect on global trade activity should support export-oriented emerging markets.
Corporate tax rates are also expected to increase under President Biden, which may deliver a sizeable blow to US earnings.
Against this backdrop, investors have started to favor overseas markets. For example, EM equities have now overtaken the US in terms of cumulative performance since January 2020, as shown below.

FIGURE 3
EM Equities Have Recovered All of Their 2020 Underperformance
Cumulative total return, %

![Graph showing EM and US equities performance]


4. Tech-Market Concentration May Hinder Future US Performance
The largest US technology companies—Apple, Microsoft, Amazon, Facebook and Google (Alphabet)—known as the “FAMAGs”, have benefitted enormously from the economic fallout of the crisis, as more people rely on technology to work and shop from home.
However, their market capitalizations have become so large that they are essentially driving the market. From 1/1/20 to 1/29/21, the MSCI USA Index has returned 23%, but only 15% if we exclude the FAMAGs.
While the last decade has belonged to the US, conditions now seem increasingly ripe for a reversal toward the rest of the world.

FIGURE 4

2020 US Equity Performance Was Explained by the Dominance of Big Tech

Cumulative total return, %

- MSCI USA
- MSCI USA ex FAMAGs


The problem with such index concentration is that it can drag returns lower for the overall US market if confidence in Big Tech deteriorates for any reason.

One of the ways this could happen is through regulation. The Democratic party, which now controls both houses of the US Congress, has been especially vocal about curbing their anticompetitive practices and multiple antitrust investigations are already underway against Facebook and Google.

Although unlikely in the near term, new regulations could slow down future merger-and-acquisition expansion, which has been an important ingredient for their success.

The Worst Is Probably Behind Us

While the last decade has belonged to the US, conditions now seem increasingly ripe for a reversal toward the rest of the world.

There is no guarantee this will happen. New variants of COVID-19 may undermine any nascent economic recovery. Investors may continue to favor the US.

But this is bound to end at some point. US cyclical exposure to a global recovery is limited, relative valuations look stretched, market concentration has increased, and EM equities are playing catch-up.

With this in mind, investors may be wise to diversify their equity portfolio outside the US over the coming decade.
A capitalization-weighted (or cap-weighted) index, also called a market-value-weighted index, is a stock market index whose components are weighted according to the total market value of their outstanding shares. Every day, an individual stock's price changes and thereby changes a stock index's value.

CAPE is an acronym for cyclically adjusted price-earnings ratio, a valuation measure that uses real earnings per share over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle.

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Global and International Funds

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