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Investment Views

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Is US Exceptionalism Waning?

The phrase "US exceptionalism" has almost become common parlance in investment circles. It is a term used to reflect the valuation premium ordinarily attached to the US stock market and to justify its continued outperformance versus the rest of the world.

This outperformance has occurred for most of the fifteen years since the Global Financial Crisis (GFC), with the MSCI US index also returning more than double its World ex-US counterpart from 2020 to the end of 2024. Not surprisingly, a recent Goldman Sachs poll confirmed that a record percentage of investors expect the US to outperform and the Eurozone to underperform once again in 2025. These expectations influence investor flows which, in turn, drive already elevated stock prices even higher.

But what do we really mean by "US exceptionalism"?

It encapsulates the notion that America has inherent and long-standing advantages that are difficult, if not impossible, for other nations to replicate. One example is an ingrained entrepreneurial mind-set that has been fostered by the nation's laissez-faire capitalist history, which laid the foundations for prosperity through a decentralised and pro-growth framework. This has birthed key traits like resilience, flexibility and a willingness-to-fail, all of which have been vital contributors to the dominant role the US plays in the global economy today.

America's superpower dominance has also relied upon a strong, yet flexible labour market, robust consumer spending and, at least since the GFC, the willingness and ability to run a sizeable fiscal deficit courtesy of its position as the world's reserve currency. It has maintained technological supremacy for a long period and remains home to many leading and multi-generational technology firms. Names like Microsoft, Google, OpenAI, SpaceX, and Palantir highlight both America's past and future as a technology powerhouse. Furthermore, it has generally been regarded as a pillar of democracy and stability, leaving the US as the preferred destination for long-term global investors. All of which has consistently translated into strong stock market growth and a valuation premium.

Why challenge US exceptionalism now? After all, the same argument could have been made at any point over the past 10-15 years. And predicting America's demise has been a graveyard for many an investor.

Well, since January 1st, the US market has lagged the World ex-US index by a remarkable 10%. US underperformance (over a full calendar year) has only occurred twice in the last 20 years - in 2017 and 2022. If this year is to mark the third such occurrence, it makes sense to be positioned for an unwind of the US premium.

Relative to bonds, US stocks are at their most expensive level in a generation. The equity risk premium (the extra compensation an investor receives for the risk of owning stocks) has fallen into negative territory; a level last seen during the dotcom bust in 2002. Whilst on a standalone basis, US stock valuations are trading at historically high levels, which should limit future returns. The cyclically adjusted price-earnings (CAPE) ratio is also at its peak outside of the dotcom bubble.

Conversely, valuations in most other major equity regions look more attractive and are underpinned by more realistic projections. Surprisingly, if we strip out the handful of Magnificent 7 technology stocks that have been the drivers of US gains, European earnings growth has almost matched the progress in US profits of late. This year, almost half of European and Japanese companies are forecast to deliver double-digit earnings growth, a figure in line with the US but available at a lower valuation multiple.

Next, as the chart below shows, even if we accept that an "exceptionalism premium" remains justified, it currently stands at an uncomfortable 50%. This compares to a historical figure of 10%. Yes, in aggregate, the US has delivered better historic earnings growth but, as mentioned above, a small number of technology stocks account for 40% of the S&P 500 gains and half of the US outperformance compared to international equities. That makes reliance on their continued outperformance more important than ever, not least because their index weightings are now bigger than the next seven biggest countries (that's "countries") combined. When that small cadre of stocks are already significantly more expensive than their own history, there is little margin for error.

So, why not significantly reduce our US allocation? Firstly, we believe the US will avoid a major economic downturn, which is the usual pre-requisite for a period of sustained US equities underperformance. US real GDP growth is forecast to be in the region of 2.5% this year, compared to 1% for Europe and around 1.5% for the UK. Even China's 4% forecast is a slowdown from the previous decade and may be hard to achieve. Furthermore, whilst the headline US price-to-earnings ratio is elevated, the more relevant price-to-earnings-growth (or PEG) ratio, which also reflects the earnings growth an investor expects to receive, remains in line with the Rest of the World.

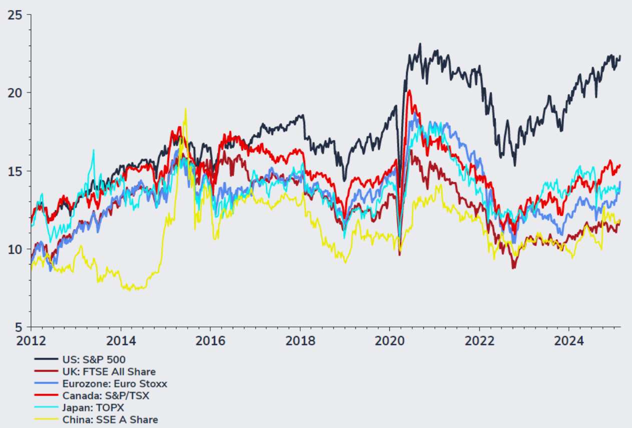
Moreover, trying to time an anticipated temporary period of US underperformance is fraught with danger. We could have made much the same arguments in both 2023 and 2024, to justify a reduction in our US weighting, but would have left significant amounts of money on the table on both occasions.

What we have done, though, is ensure that our Equity Themes and Alternatives allocations are positioned for a potential change in market mood. China A shares, for example, trade based on their own economic outlook, distinct from that of the US. The Biotech allocation is an idiosyncratic small-cap growth opportunity that is independent of the Magnificent 7 story and one that's relatively untroubled by the nascent tariffs war; 80% of US biotech sales are sourced domestically. Despite the headline noise, Sustainable companies operating outside of the US are growing strongly and are trading far cheaper than the megacap US tech stocks. Fundsmith, a high quality global equity fund with a proven long-term track record, could see its substantial holdings in the Healthcare (28%) and Consumer Staples (20%) sectors significantly re-rate relative to the market. As for Alternatives, Catastrophe Bonds continue to offer double-digit yields despite record performance in 2023 and 2024, and they move in accordance with weather-related, rather than economic, events. Trend Followers (or CTA's) can adapt quickly to changes in market direction to benefit from any change in momentum across a plethora of asset classes. Finally, we recently added an equity volatility fund that should benefit from any sustained choppiness in markets; a characteristic that has been notably absent over the last few years.

Overall, as we approach an environment that is likely to become more challenging and volatile, we believe portfolios are well positioned to benefit from much of the remaining upside, whilst avoiding the more extreme downside risks.

US outperformance

Twelve month forward price-to-earnings ratio



Source: LSEG Datastream