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Is US Equity Market Dominance Set to Pause or End?

Our weekly macroeconomic view.

16 November 2020

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The Trend of US Outperformance

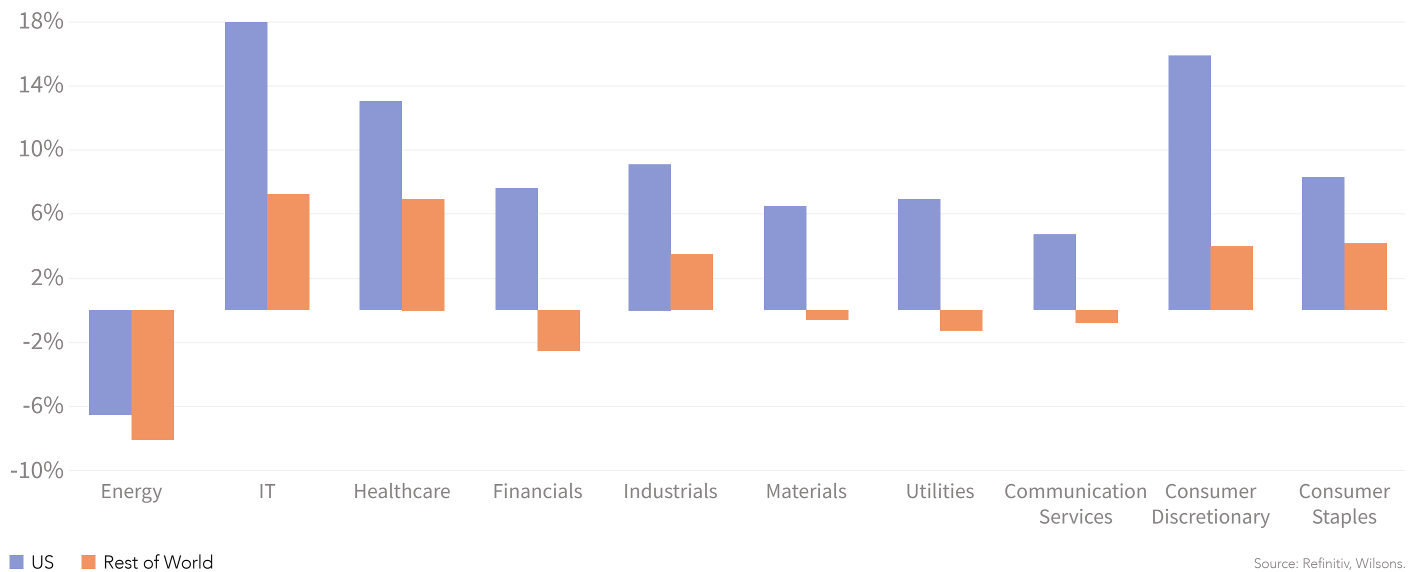
The outperformance of the US equity market has been a significant and persistent trend for much of the past 10 years.

US outperformance is intricately linked to the outperformance of growth over value stocks, or in sector terms, the dominance of the US technology sector over the rest of the global equity market.

Exhibit 1: US outperformance versus rest of world has extended for over 10 years

Refinitiv and MSCI.

Exhibit 2: US versus rest of world - sector price index performance (10yr pa)



Source: Refinitiv, Wilsons.

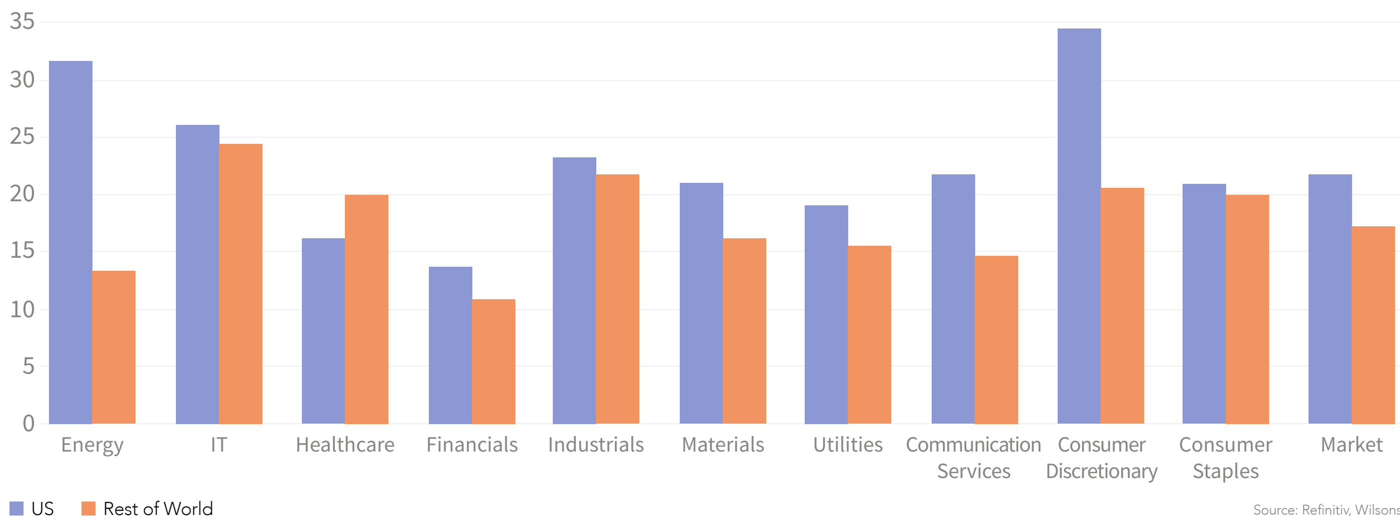
US Equities a Relentless Re-Rating

When examined in aggregate terms, the US market is now trading on a large price-to-earnings (PE) premium versus the rest of the world. This comparatively progressive PE re-rating has been an important contributor to US market outperformance.

Exhibit 3: The US market has seen a sustained relative re-rating

Source: Refinitiv, Wilsons.

Exhibit 4: US versus rest of world sector PE ratios



Source: Refinitiv, Wilsons.

Bond Yields Have Been Important

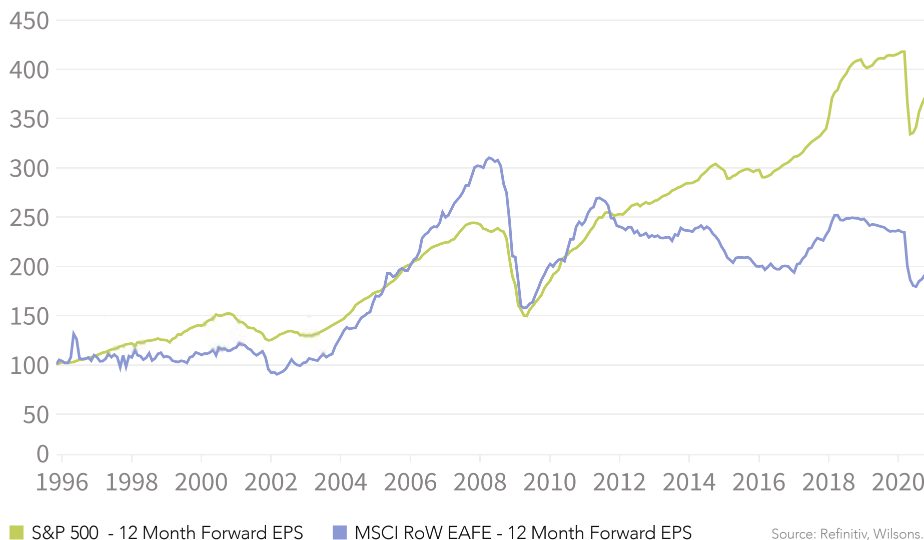
The decline in long-term interest rates is often discussed as the driver of this re-rating, with falling interest rates undoubtedly having an important influence. It is noteworthy how uneven the impact of falling rates has been across sectors, and therefore countries, with bond yields falling to much lower levels in Europe and Japan than they have in the US. The long duration secular growth on offer in the US market appears to have gained a disproportionate benefit from the fall in long rates.

Of course, this begs the question as to how the US market might behave if the downshift in interest rates begins to unwind. We believe we have likely seen the bottom of the bond yield cycle, although the upswing will likely be a gradual one. If we are correct, it does remove one of the key tailwinds for US market outperformance.

The Significance of Earnings Growth Outcomes

While the PE re-rate of the US market (helped by lower interest rates) has been important, we find that over the past 10 years the most significant factor driving outperformance has been the superior earnings growth of the US equity market. The fact that the US has been able to deliver solid earnings growth against a backdrop of falling rates likely "explains" its absolute and relative re-rating. In addition, while the earnings growth dominance has

Exhibit 5: US Earnings have de-coupled from rest of world in the past 10 years



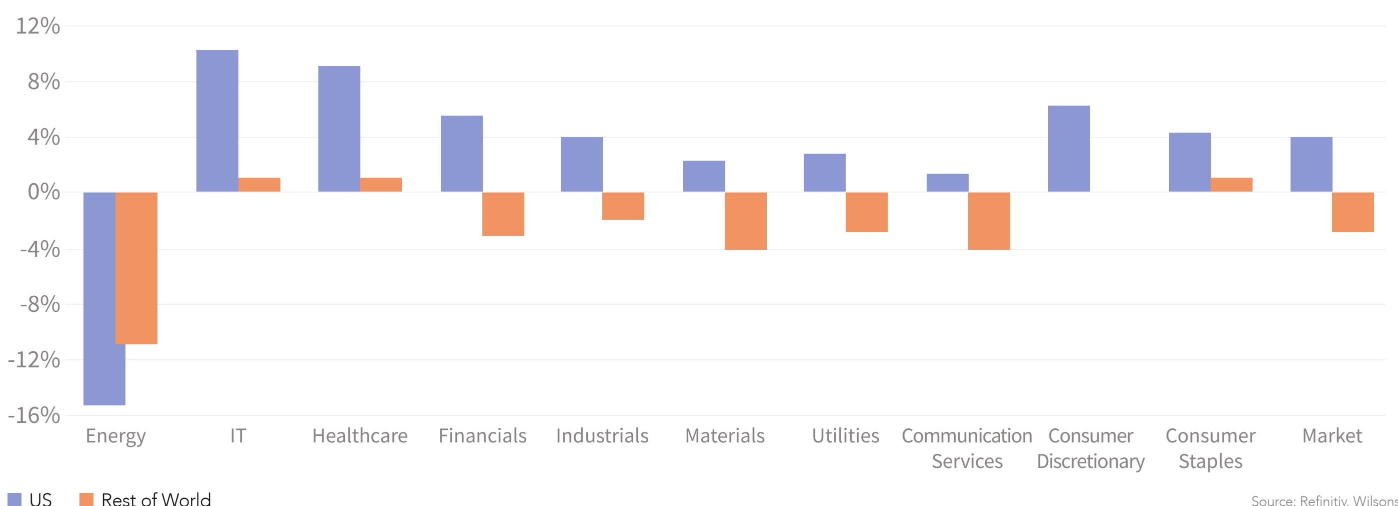
Source: Refinitiv, Wilsons.

been led by US tech, it is actually quite broad-based. US companies have shown dominance in tech, but earnings have been better across the board when measured on a sector basis. While it is difficult to disentangle, superior US economic growth, ongoing share buybacks, significant corporate tax cuts under Trump and the apparent superior shareholder value focus of US companies are all contributing factors.

Can the Rest of the World Stage an Earnings Comeback?

Clearly, to outperform, the rest of the world needs to lift its game in terms of earnings growth delivery in the coming years. It is worth noting that the past 10 years have been a period of lower than average economic growth with a notably stop-start economic cycle punctuated by a number of negative shocks; the Eurozone sovereign debt crisis, the US-China trade war and of course the COVID-19 pandemic. This has undoubtedly hampered the relatively more cyclical rest of world equity markets versus the technology-based secular growth that has driven the US market.

Exhibit 6: US versus rest of world by Sector - 10 year EPS Growth (pa)



Source: Refinitiv, Wilsons.

This year's COVID-19 pandemic and resultant economic dislocation has intensified many of the trends already in place over recent years. The economic contraction has favoured defensive tech over cyclical value sectors such as energy, financials and industrial cyclicals. PE multiples have also expanded for areas perceived to have defensive and/or structural growth. This PE re-rating has, of course, compounded the relative performance divergence.

The Path to Earnings Recovery

The recent news that initial results from stage 3 COVID-19 vaccine trials (Pfizer) are close to the best case (90% efficacy) provides a potential path to economic normalisation over the next couple of years. Given the intensification of the growth/value stretch caused by the COVID-19 dislocation, prospects have risen for a significant rotation back towards value and economic recovery plays. In terms of regional allocations, this should see earnings growth rates lift significantly in non-US markets whose prospects are generally more correlated to the economy, and trigger renewed investor interest.

The impact of a Biden Presidency is also likely to favour the rest of the world versus the US, although the fate of the US senate (to be decided in early January) will be important. A Democratic Presidency but Republic Senate (the most likely outcome) would constrain the Democrats' ability to tax US corporations more, and generally add to global demand but place downward pressure on the US$ via an aggressive stimulus program. Even in the absence of a "blue wave" a Biden Presidency should provide at least a modest tailwind to the rest of the world.

Ultimately, the ability of the rest of the world to stage a performance comeback will be a function of the strength and duration of the economic and earnings revival. Interest rate movements will also be a factor in the size of any growth/value re-alignment. The resolve of central banks to keep a lid on long bonds and keep short rates firmly anchored will likely mean the move in long bonds will be moderate, at least until the global economy gathers enough steam to generate some inflation.

The Start of Something Bigger?

At a minimum, a significant cyclical rally in value exceeding any rotation witnessed over the past 10 years is on the cards over the coming months/quarters. Whether the shift can run into years rather than months is still the subject of considerable uncertainty.

The ability for the rest of the world to regain performance dominance over the US for an extended phase, such as we saw from 2002 to 2007 (see exhibit 1), will likely rest on its ability to move into a sustained growth phase, as distinct from a cyclical rebound from depressed levels of activity.

A multi-year phase of above-trend growth is not impossible, but the world still faces many secular headwinds to growth with poor demographics the most notable. While we are not China bears, we doubt it can provide the same impetus as it did from 2002 to 2007 and the world is unlikely to re-gear (apart from the government sector) as it did in the 2002-2007 period. Strong infrastructure spending and a productivity surge are sources of potential upside surprise. An unwinding of trade protections is another source of positive growth surprise, but this is by no means guaranteed.

A Playable Cycle but Just how Long?

We believe the country and style rotations witnessed over the past week have considerably further to run. Investors who may have missed the sharp swings of the first week still have the scope to reposition for a more gradual, but much longer-lasting phase. Whether a shift of leadership away from the US and mega cap growth stocks proves to be particularly elongated will likely be a function of a number of factors:

1. The success of any global vaccine rollout
2. An orderly rather than disorderly bear market in global bonds
3. Stable US-China relations
4. Further government resolve to commit additional fiscal resources (particularly towards infrastructure)

We continue with a tactical overweight to Australian and emerging market equities, a neutral weighting to Europe and a moderate underweight to the US. We have added value/recovery exposure to equity positions within model portfolios.

Read our monthly Australian equities report - Rotating Towards Cyclical Recovery.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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