

Quarterly Insights

Is U.S. Outperformance Sustainable?

By Brian Katz, CFA



Investors entered 2024 anxious. Pundits wondered whether the economy would stall or continue to grow while having to endure higher interest rates. It did not stall, and for now it looks like Chairman Powell orchestrated an elusive soft-to-no landing. As a result, the S&P 500 posted its second consecutive year of greater than 20% returns, a feat only accomplished four other times and for the first time since 1991.

Performance over the last decade plus has some investors questioning the merits of investing internationally. U.S. equity market returns have significantly outperformed their international counterparts by an unprecedented magnitude. As a result, a term has moved into the investment lexicon: American Exceptionalism. This expression promotes the belief that U.S. stock-market outperformance is a function of its superiority.

What is American Exceptionalism?

Equity investors are acutely aware that the U.S. has outperformed most other countries and regions by a wide margin over the past decade plus. They should also understand that stocks have gone through several cycles throughout history with different segments moving in and out of favor. The last meaningful cycle of outperformance for international stocks occurred from the early 2000s through 2008, following China's admission into the World Trade Organization.

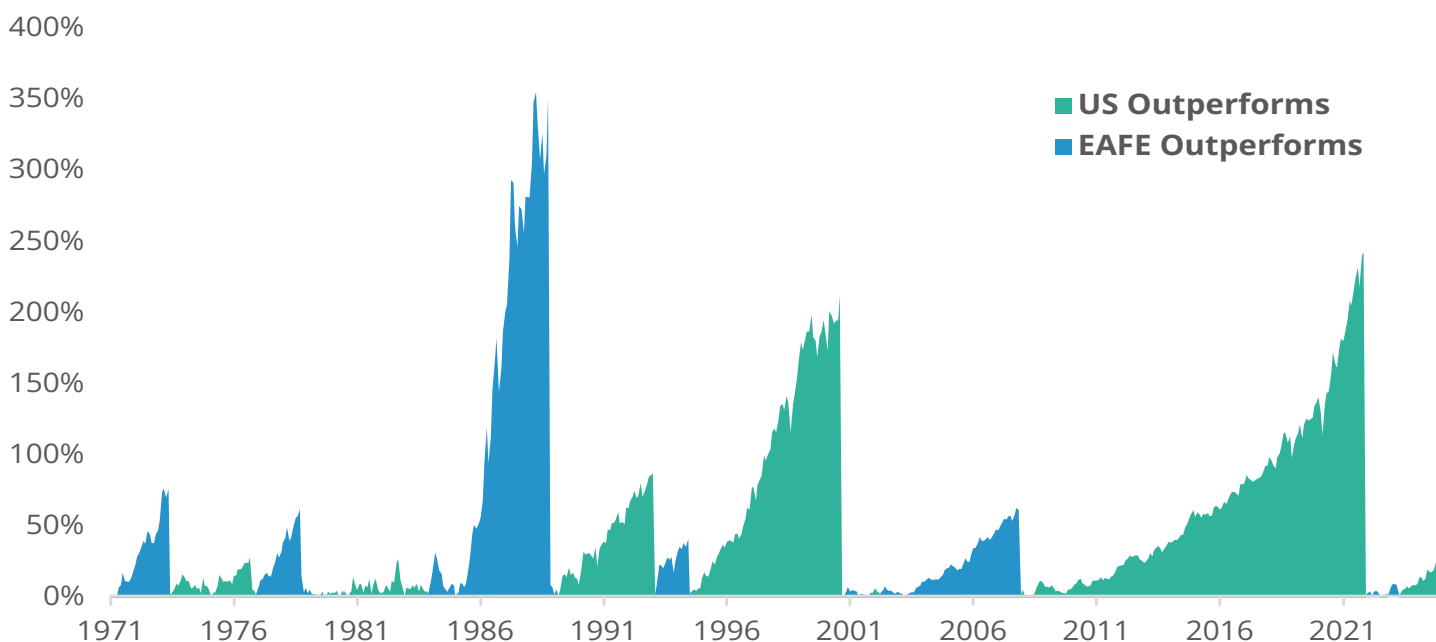
In fact, this has been one of the longest periods of outperformance between domestic and international stocks in history, pushing the U.S. to a jaw-dropping 66% of the world's total stock market capitalization, its largest share ever. For some context, the U.S. comprises only 4% of the world's population and 26% of the world's economic output as measured by GDP.

Most would agree that U.S. outperformance has been well deserved. In aggregate, U.S. companies have typically generated stronger earnings growth, are more profitable, have stronger balance sheets, and generate more cash flow than their foreign counterparts. Indeed, U.S. public companies have generated meaningfully higher returns on invested capital relative to most other developed regions, including Europe, Japan, the U.K., and Canada, of approximately 15% versus 10% for the next highest country (Japan). This could partly be a reflection of a stronger rule of law and lighter regulatory environment. Another factor driving stronger performance is that the U.S. equity market is more concentrated in growing sectors, such as technology and communication services, while other countries' stock markets have higher exposure to the more mature natural resource and utility sectors.

Is U.S. market dominance at risk?

Some signs suggest that U.S. market outperformance may not be sustainable. For starters, nearly one-third of U.S. stock market outperformance since 2010 was driven by multiple expansion (Narayan and Greene 2024), an industry term that essentially means that the valuation of U.S. stocks grew more rapidly than their foreign peers. Stronger growth rates certainly support richer valuations but there are limits to how much more an investor will pay for each dollar of earnings. Moreover, growth rates are starting to converge, with earnings forecasts expecting a more level playing field in 2025.

MSCI USA and MSCI EAFE Relative Performance Cycles



Source Data: Morningstar Direct January 2025. US represented by the MSCI USA Index NR USD and EAFE represented by the MSCI EAFE Index NR USD. Past performance is not indicative of future results. EAFE-Europe, Australasia, and the Far East.

Another concern involves the U.S. budget deficit, which is expected to grow to \$1.9 trillion (6.2% of GDP) at the end of 2025 and debt-to-GDP is projected to reach 120% by 2034. Economists question what the ultimate impact will be of unfettered indebtedness, but we are certain it cannot go on forever. Finally, the status of the U.S. dollar as the world's reserve currency is tenuous. BRIC countries (Brazil, Russia, India, China, and South Africa) recently announced a payment system called BRICS Pay to compete with the U.S.'s Society for Worldwide Interbank Financial Telecommunications (SWIFT) system, and the dollar has been losing share of the foreign reserves held by central banks, which has fallen to below 59% from more than 72% at the start of the millennium.

What does this mean for investors?

A look back in history reveals distinct cycles between the performance of U.S. and non-U.S. equities. While U.S. dominance may appear unassailable today, many said the same of Japan in the 1980s or China in the early 2000s. These examples are reminders that long cycles often shift rapidly.

And the winds of change appear to be blowing harder today than ever before. There is friction on multiple fronts. Seldom seen shifts in trade, geopolitics, technology, and innovation support the notion that there could be a new world order. In fact, this is arguably the greatest combination of transformative events since the end of the Cold War. As much as current trends may point toward continued U.S. exceptionalism, it does not seem timely for an investor to put all their eggs in one basket.

How can investors stay protected?

The recoveries from both the Global Financial Crisis and pandemic produced a period of strong growth and low interest rates. It is not always this easy. Investing environments like today are fertile ground for a change in the status quo. That change is generally uncomfortable but navigable with the right advice. To be clear, we are not trying to say something bad is coming for investment markets. In fact, many indicators are still pointing upward. Nevertheless, leaning out too far in any one direction is never a good idea because global markets don't move in perfect lockstep. Correlations between domestic and international markets vary over time, providing a natural hedge against country-specific economic downturns.

By holding international stocks, investors can spread risk across different economies, monetary policies, and geopolitical environments. This diversification enhances risk-adjusted returns. Global diversification protects against the uncertainty of which economies will outperform in the future. Bottom line: a globally diversified portfolio is a more resilient portfolio, in our view.

Sources: MSCI, JPMorgan Research, United Nations, International Monetary Fund, FactSet Research, Bridgewater Associates, and Congressional Budget Office.

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How Could Tariff Policies Affect the Economy?

By Jason Blackwell, CFA and Aaron Huey, CFA

The Trump administration has made good on the President's campaign promises to wield the threat of tariffs on allies and adversaries alike as leverage to advance both economic and national security agendas. The administration has said it is prepared to levy hefty taxes on goods coming into the country from its largest and most crucial trading partners, including Mexico and Canada. The frequent developments surrounding the implementation of Trump's trade policies have left markets oscillating with each headline.

What's a tariff?

Simply put, a tariff is a tax on goods imported into the country. When U.S. retailers and manufacturers purchase goods from other countries, a duty (similar to a sales tax and paid to the federal government) is added to the cost of the goods before delivery. On the surface, the buyers pay the tax.

However, the tariff's impact likely extends beyond the original buyer. To compensate for the additional cost of goods, the foreign seller may lower their prices, squeezing their own profit margins. As buyers shift toward other supply chains, the currency of the seller falls and thus lowers the effective price (and raises the cost of U.S. exports). Finally, the buyer often passes on the additional cost to the consumer to preserve their profit margins.

Trade hawks argue that tariffs make domestic producers more price competitive. Historically, however, domestic manufacturers have raised their prices in concert with the tariffs, reducing the relative benefit to consumers while increasing their own margins.

Are tariffs inflationary?

This is an area where economists disagree. While the expected outcome of an increase in tariffs is higher prices, destructive inflation is generally associated with a persistent increase

in price levels rather than a one-time increase. We have a recent historical example from the first Trump administration. In January 2018, the U.S. imposed tariffs on residential washing machines. While the initial reaction was an increase in prices for the U.S. consumer, the long-term deflationary trend in place for household appliances quickly reverted. In our view, the Federal Reserve and most investors will likely overlook these one-time price adjustments. However, if the initial tariffs are followed by further escalations, the cumulative impact of one-time price adjustments could become undistinguishable from true inflation, compelling the Fed to further slow its pace or even reverse course on interest rate policy.

How should investors be positioned?

Economic policy never happens in a vacuum. The administration has also promised lower corporate and individual tax rates and decreased regulations, which have the potential to offset some of the trade-related pressures. Given the uncertainty around the magnitude and duration of proposed tariffs, the ultimate impact on corporate profits and economic growth is difficult to assess. Investors with broad, globally diversified portfolios are likely to be positioned to capture returns from regions and sectors that are less sensitive to the effects of tariff policy.

Sources: Consumer Price Index, Major Appliances, Bureau of Labor Statistics.

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