> **The economic recovery that is underway is likely to see a period of growth we haven't seen in decades**

All eyes on the US

26 July 2021

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*

Market Focus

- **Global equities rose 1.6% last week**
- **Markets in the US and Europe rebounded but inflation concerns and delta variant fears still persist**
- **Brent crude rose 0.7% over the week to $74.1 a barrel**
- **Gold fell 0.5% to $1802.2 per ounce**

US

- US equities rose 2.0% last week.
- The composite PMI reading reached its lowest level since March at 59.7, this is the second monthly decline, supporting the view that growth may have peaked in mid-Q2.
- Initial jobless claims for the week ending 17th July came in at a disappointing 419k against expectations of 350k, marking the biggest weekly increase since March.
- Existing home sales for June came in at an annualised rate of 5.86m against expectations of 5.9m.
- Senate Republicans blocked the immediate debate on the infrastructure bill. Both parties are continuing to work on the deal and expect the vote to pass early next week. The legislation has stalled more recently as the Senators could reach an agreement on how to pay for the $579bn of new spending over the next 8 years.
- The White House announced that it was joining the EU in accusing actors associated with the Chinese government of cyberattacks on the Microsoft Exchange Server.

UK

- UK equities rose 0.2% last week.
- The UK government said that it wanted to make changes to the Northern Ireland Protocol, meaning that goods wouldn't see customs checks when passing between Northern Ireland and the Republic of Ireland but instead be checked when they reached Northern Ireland, meaning that there was effectively an economic border within the UK.
- Encouraging news from the UK, which reported 29,000 new Covid cases yesterday, 40% lower than last Sunday. We have now seen five consecutive days of declines.

Europe

- European equities rose 1.7% last week.
- The July Euro-Area composite PMI came in at its highest level in 21 years at 60.6.
- Germany's composite PMI hit an all-time high of 62.5.
- The ECB's latest inflation forecasts in June pointed to a headline HICP inflation at 1.5% at 2022 and 1.4% in 2023.

Rest of the World/Asia

- The benchmark Global Emerging Markets index returned -2.1% last week.
- Japanese equities fell -1.4% over the week.
- Chinese equities fell -3.7% last week.
- Japan's June CPI reading came in line with expectations at +0.2% year-on-year.
- Japan's preliminary PMI reading for July dropped to 47.7 from 48.9 last month, with the decline mainly driven by weakness in the services PMI which declined to 46.4 from 48.0 last month. The manufacturing PMI was relatively steady at 52.2 vs 52.4 last month.
- Flash numbers from Australia showed a material weakening in the services PMI given the imposition of lockdowns in various regions, which fell to a contractionary 44.2 vs 56.8 last month, and brought the composite reading down to 45.2 vs 56.7 last month. Manufacturing activity remained relatively shielded with the PMI there still in expansionary territory at 56.8 vs 58.6 last month.
- Russia raised its key lending rate by 100bps in response to growing inflationary concerns after recently recording its highest level of annual inflation since August 2016 at 6.5%.

Past performance is not indicative of future returns. Source: Bloomberg Finance L.P., returns in local currency unless otherwise stated.

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Market Summary

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Asset Class / Region	Currency	Cumulative returns: Week ending 23 July	Month to date	YTD 2021	12 months
Developed Markets Equities					
United States	USD	2.0%	2.7%	18.1%	37.8%
United Kingdom	GBP	0.2%	0.1%	11.4%	16.9%
Continental Europe	EUR	1.7%	2.2%	17.6%	26.1%
Japan	JPY	-1.4%	-2.0%	6.7%	23.7%
Asia Pacific (ex Japan)	USD	-1.9%	-3.9%	2.7%	24.0%
Australia	AUD	0.6%	1.1%	14.2%	25.1%
Global	USD	1.6%	1.9%	15.2%	35.0%
Emerging Markets Equities					
Emerging Europe	USD	-0.5%	-2.0%	12.2%	24.2%
Emerging Asia	USD	-2.4%	-4.8%	0.9%	23.0%
Emerging Latin America	USD	-1.7%	-3.1%	5.5%	26.7%
BRICs	USD	-2.6%	-5.8%	-0.8%	14.1%
China	USD	-3.7%	-8.3%	-6.6%	5.6%
MENA countries	USD	0.0%	-1.0%	19.0%	37.6%
South Africa	USD	-2.0%	-3.3%	6.8%	22.3%
India	USD	-0.3%	0.8%	12.2%	43.8%
Global emerging markets	USD	-2.1%	-4.3%	2.8%	23.9%
Bonds					
US Treasuries	USD	0.2%	1.0%	-1.8%	-3.3%
US Treasuries (inflation protected)	USD	0.5%	2.0%	3.6%	6.9%
US Corporate (investment grade)	USD	0.2%	1.0%	-0.3%	1.2%
US High Yield	USD	0.1%	0.3%	3.9%	11.5%
UK Gilts	GBP	1.1%	2.5%	-3.4%	-4.3%
UK Corporate (investment grade)	GBP	0.5%	1.4%	-1.4%	2.4%
Euro Government Bonds	EUR	0.5%	1.7%	-1.4%	0.6%
Euro Corporate (investment grade)	EUR	0.3%	0.9%	0.5%	3.1%
Euro High Yield	EUR	0.0%	0.2%	3.3%	9.3%
Japanese Government	JPY	0.0%	0.5%	0.3%	0.3%
Australian Government	AUD	0.4%	1.9%	-0.5%	-0.2%
Global Government Bonds	USD	0.1%	1.0%	-3.7%	-1.1%
Global Bonds	USD	0.1%	0.7%	-2.8%	0.4%
Global Convertible Bonds	USD	0.8%	-1.0%	0.6%	15.7%
Emerging Market Bonds	USD	-0.1%	0.7%	-2.4%	1.5%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

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Market Summary

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		Cumulative returns			
Asset Class / Region	**Currency**	**Week ending 23 July**	**Month to date**	**YTD 2021**	**12 months**
Property					
US Property Securities	USD	0.5%	4.6%	26.8%	42.9%
Australian Property Securities	AUD	0.8%	-0.1%	7.6%	24.2%
Asia Property Securities	USD	-1.9%	-1.6%	5.4%	13.6%
Global Property Securities	USD	-0.3%	2.5%	16.7%	33.3%
Currencies					
Euro	USD	-0.4%	-0.7%	-3.7%	1.3%
UK Pound Sterling	USD	-0.1%	-0.3%	0.8%	8.0%
Japanese Yen	USD	-0.4%	0.5%	-6.6%	-3.4%
Australian Dollar	USD	-0.6%	-1.7%	-4.2%	3.4%
South African Rand	USD	-3.1%	-3.5%	-1.2%	12.0%
Swiss Franc	USD	-0.1%	0.5%	-3.9%	0.5%
Chinese Yuan	USD	0.0%	-0.4%	0.7%	8.1%
Commodities & Alternatives					
Commodities	USD	0.8%	0.6%	29.1%	52.3%
Agricultural Commodities	USD	-0.1%	-0.3%	19.5%	52.4%
Oil	USD	0.7%	-1.4%	43.1%	71.1%
Gold	USD	-0.5%	1.7%	-4.9%	-4.8%
Hedge funds	USD	0.0%	-0.3%	3.6%	10.0%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

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