BLACKFINCH GROUP

CIO Outlook - Q1 2025

Will US Exceptionalism Continue?

From Dr Dan Appleby, CIO (Listed Investments)

Last year will no doubt be remembered as the year of politics after elections took place in more than 50 countries accounting for almost half of the world's population. Key elections in the UK, France, India, and of course the US, have the potential to shape policy over the coming years. None more so than Donald Trump's promises for his second term as president. For simplicity, I'll refer to this here as 'Trumponomics', or President Trump's economic agenda as he aims to put 'America First' again.

Sweeping trade tariffs, tax cuts, and tighter immigration policies are all possibilities in the US this year. But the big question for investors is whether this matters for markets. And focusing on the US, will this help or hinder US exceptionalism, a term frequently being used to describe the dominance of the country's stock market.

So, with those elections now over, it is important now to consider how the new political landscape will impact markets. However, as is often the case, underlying economic conditions, earnings growth and company valuations are far more influential than the incumbent government over the long term.

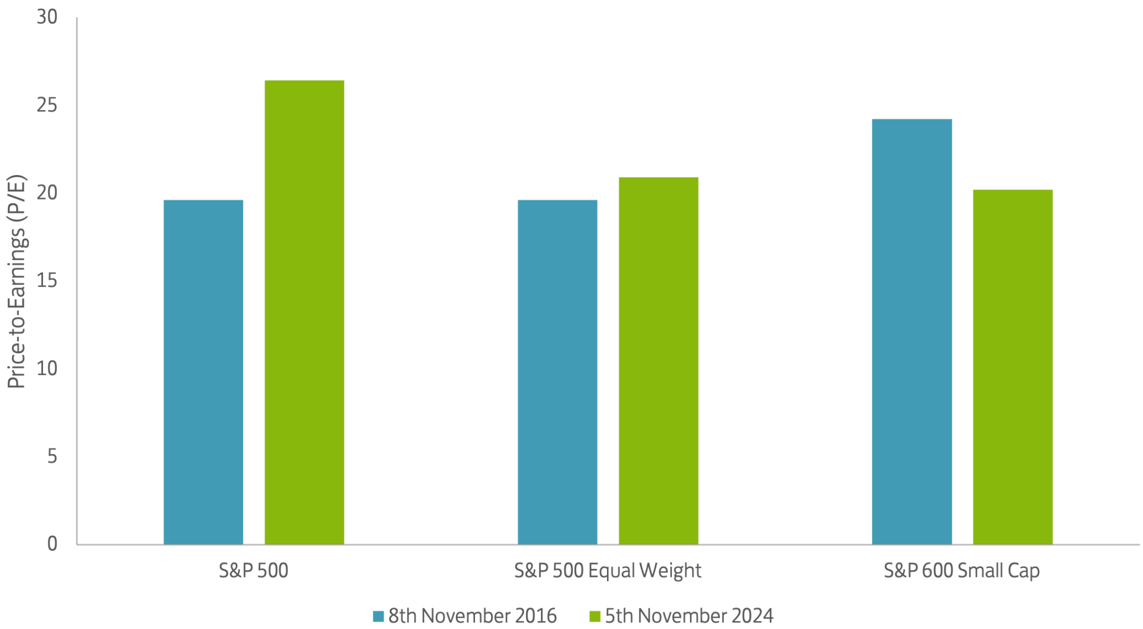
Trumponomics 2.0

I recall two major themes from Trump's first term as president: tax cuts and trade wars. Both of which appear to be a part of Trumponomics 2.0.

Turning to tax cuts first. Trump's policy of cutting taxes, including corporation tax, was part of a pro-business agenda during his first term. He passed the Tax Cuts and Jobs Act (TCJA) through Congress with relative ease as the Republicans controlled both the House and Senate. Given that the Republicans again control both chambers after last year's election success, it is a high probability that Trump will pass an extension to the TCJA. A further reduction to the corporation tax rate, and extending tax cuts that were set to expire, are being considered.

Tax cuts were a major catalyst for US markets early in Trump's first term. The S&P 500 rallied over 20% in 2017, a year marked with historically low volatility. But as Figure 1 demonstrates, large cap stocks were trading at a much lower valuation on the day before Trump's first election victory compared to this time round. Based on price-to-earnings (P/E), the S&P 500 was trading at a ratio of under 20 on 8th November 2016; after last year's election on 5th November, the P/E for the S&P 500 was over 26. If US exceptionalism is to continue, with the catalyst of a second-round tax cut boost, the S&P 600 Small Cap or the S&P 500 Equal Weight indices look more appealing on valuation grounds.

Figure 1: US equity market valuations then and now. Back when Trump first won the presidential election, valuations of large cap stocks were much lower than they are today.



Source: Bloomberg

Then came Trump's trade war with China. After months of negotiations, Trump finally imposed tariffs on Chinese imports in July 2018. We now know the overall tariff applied during this trade war amounted to only 2% on a trade-weighted basis, as calculated by the team at Barclays. The same report shows Trump's new threats would raise this to 17%, a tariff regime not seen since the 1930s. The assumptions used for this calculation are for a 60% tariff on all Chinese imports and a 10% tariff on imports from the rest of the world.

When it comes to markets, the ongoing trade war during 2018 added to what was a volatile year for equities. However, the year was also marked by 'Volmageddon', the sharp reversal in the shorting of volatility by traders, and a Federal Reserve (Fed) that was hiking the base rate from near zero, leading to what some coined the 'Christmas Eve Massacre' as stocks plummeted. Nevertheless, trade wars were also not supportive to market calmness. An aggressive return to trade wars would likely lead to greater volatility this time around.

Lastly, one market force that will likely be influential for markets in the US and beyond this year is the Fed, which will be operating in a very different inflationary regime in Trump's second term. Indeed, it looks like Trump's policies could clash with the Fed's aim of targeting 2% inflation. Taking the three major Trumponomic policies: tariffs, tax cuts, and tighter immigration policies; they all look to be inflationary. As noted, an effective 17% tariff would lead to price rises according to the many economists that are analysing the effects of a trade war. Tax cuts also risk an overheating economy at the time the Fed is attempting to rein-in demand by maintaining elevated interest rates. And any restriction on immigration will likely lead to a tighter US jobs market, and therefore place upward pressure on wages, again risking inflation.

In the Fed's last policy meeting in December, there were two major clues to how policymakers are viewing the consequences of Trumponomics. Although the Fed cut interest rates by 0.25%, the committee now view there being room to cut interest rates only twice this year, which is down from four cuts before the December meeting. The Fed also upped its forecast for inflation in 2025 from 2.1% before Trump's victory, to now 2.5%. The conclusion being that the Fed is incorporating Trump's policies into their projections, and that they are inflationary.

Encapsulating all of this is the dollar. Trump is known to want the dollar to weaken as it makes US manufacturing globally more competitive. But just like Trumponomics appears inflationary, his policies all point to a strengthening dollar. For instance, a booming US economy, led by a pro-business agenda, will attract capital flow and therefore lead to dollar buying. Meanwhile, inflationary consequences result in a Fed maintaining higher interest rates, and in turn a stronger dollar.

Ultimately, Trumponomics may be tempered by how much Trump is willing to let the dollar strengthen. And given it is the world's reserve currency and therefore a major market force, King Dollar may hold the greater influence this year, above any politician.

US Exceptionalism Wasn't Always Thus

Given the potential for politics impacting markets as above, the key question for investors is whether US exceptionalism will continue. Often this is an assumption that the dominant S&P 500 will continue its relentless rally. Indeed, the S&P 500 has trounced the returns of other developed markets as measured by the European Stoxx 600 Index and UK large cap stocks, in addition to the MSCI Emerging Markets Index, since the low set during the Global Financial Crisis (GFC) in March 2009. Including dividends from the GFC low to the end of 2024, the S&P 500's return has been 1077%, the Stoxx 600 returned 462%, the UK large cap stocks returned 317%, and the Emerging Markets Index returned 243%. Hence, investors would have been richly rewarded for simply buying the S&P 500.

It wasn't always thus. Using the decade starting at the turn of the 21st century, a somewhat arbitrary date range but the last significant period not marked by US exceptionalism, the return profiles of the major indices are noticeably different:

	Total return from: ***09/03/09 – 31/12/2024***	*Total return from:* ***31/12/1999 – 31/12/2009***
S&P 500	**1077%**	**-9.1%**
Stoxx 600	**462%**	**-7.7%**
UK Large Caps	**317%**	**4.2%**
Emerging Markets	**243%**	**160%**

Therefore, the S&P 500 underperformed its major developed market peers, and significantly underperformed Emerging Markets. If we expand the markets to US small caps and global bonds, these indices returned 85% and 87.6%, respectively, over the decade to 2009.

Of course, the end of 1999 was almost the peak of the dotcom bubble, and hence a time of extreme valuations in US stocks, particularly the large cap technology companies. There are parallels to today's US stock market due to a boom in Artificial Intelligence (AI) stocks. Yet, this is a reminder for us that valuations do matter over the long term. Or put another way, it matters when we buy. We can refer again to Figure 1 and highlight that there may be better value in the US market outside of the mega caps.

Picking the Right 'Beta'

The terms 'alpha' and 'beta' both get used a lot when it comes to investment selection. Beta describes how much an investment's return moves with the market, indicating its risk level relative to the market. For example, a beta of 1.2 means the investment is 20% more volatile than the market. By contrast, alpha measures the extra return generated by an investment manager's skill picking investments beyond what the market (and the investment's beta) would predict. Positive alpha indicates the manager added value, while negative alpha suggests underperformance.

Both terms are borrowed from mathematics, or more specifically, regression analysis. Alpha is a coefficient that is unrelated to the independent variable (or the market in our investment analysis). Beta is a measure of the slope, or how much the dependent variable (our potential return) changes as a function of the independent variable (the market return).

Either explanation can be quite abstract and difficult to grasp. Hence, very simply, alpha describes how good the investment manager is, and beta describes how influential the market is, to our potential return.

A lot of attention is given to alpha. Picking the right active manager whose job it is to generate outperformance versus the market. The debate of active versus passive management rages on. But perhaps the most important question is picking the right beta: which markets should we choose within our asset allocation to generate the highest potential returns for the risks we're willing to take.

Is picking the right beta still a case of picking the S&P 500, given the potential for continuing US exceptionalism under Trumponomics 2.0?

Reviewing the S&P 500 & Potential Alternatives

For the past two years, the S&P 500 has stormed ahead, rising over 20% in both 2023 and 2024, considerably beating global benchmark peers. A large part of these gains has been due to the mega cap technology companies now named the 'Magnificent 7' – Apple, Nvidia, Microsoft, Alphabet, Amazon, Meta and Tesla.

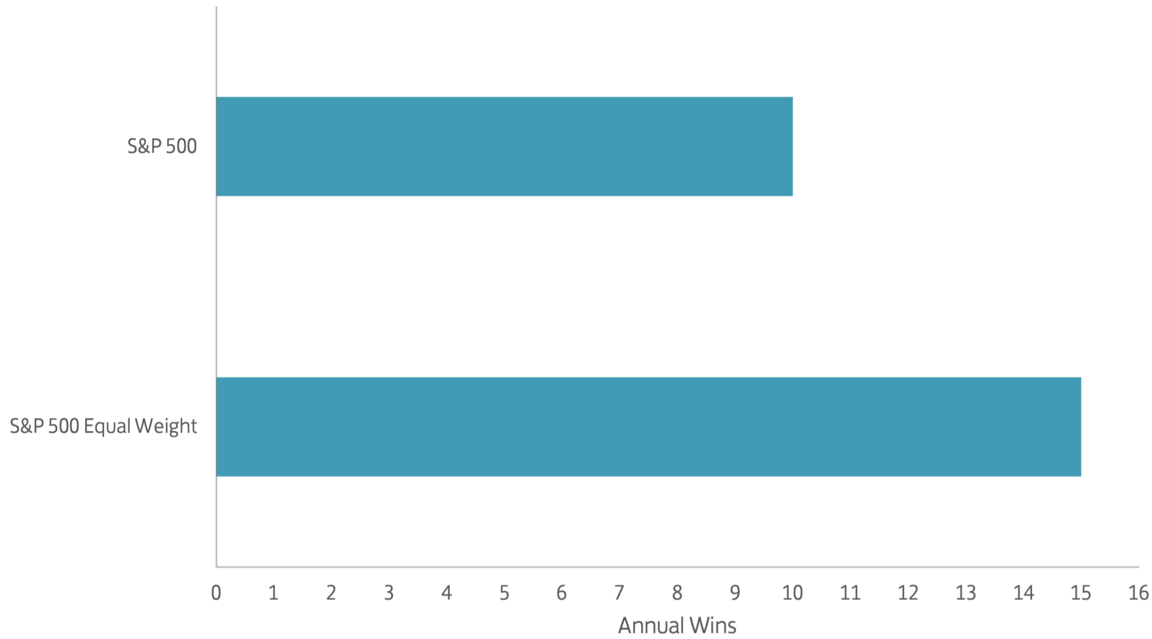
Unlike the reference to the dotcom bubble earlier, these companies are truly dominant across the world and generate significant profits and cash. This year seems to be no different, with estimates for a combined 20% profit growth for the Magnificent 7, and therefore much higher than the aggregate earnings growth forecast for the S&P 500 of 12.5%. Earnings generated from the Magnificent 7 do need to increase at pace given these tech stocks are trading at much higher valuations when compared to the S&P 500. And given the S&P 500's market capitalisation weighting methodology, these stocks now represent over 33% of the overall index. Therefore, investors are significantly exposed to the risks that come from owning these seven companies when allocating to the S&P 500.

The Magnificent 7 share prices – particularly Nvidia's – have also been boosted by the AI thematic since the AI-chatbot ChatGPT was released to the general public in late 2022. This garnered interest in AI like we hadn't seen previously, and with it, great interest in investing in AI. Nvidia, as the prominent graphics processing unit (GPU) developer that enables the crunching of vast amounts of data required for AI software, has benefited hugely from this interest. Investment in this area does not seem to be slowing down this year either. The hyperscaler companies of Meta, Microsoft, Amazon and Alphabet, are all investing massively in new Nvidia GPUs to create the data centres needed to develop AI technology, and are expected to increase capital expenditure in 2025 to an aggregate $262bn, up 15% on last year. A lot of this spend will find its way to Nvidia, while Mark Zuckerberg, CEO of Meta, has been quoted as saying the biggest risk today is not investing enough in AI.

But the biggest risk for investors is whether there will ever be an attractive return on this vast investment. Current indications suggest it is still very early in any AI productivity revolution. Nevertheless, with earnings of the Magnificent 7 expected to be robust this year, and investment in AI showing no signs of slowing, the dominance of these companies does not appear to be waning.

Yet with valuations of the S&P 500 much higher this time around after Trump's election (Figure 1), a lot of the potential for tax cuts and optimism over AI looks to be in the price already. As an alternative, an equal weighted S&P 500 may offer investors exposure to the Magnificent 7 while diversifying across the other 493 stocks in the index. Figure 2 shows that the S&P 500 Equal Weight index has outperformed the standard S&P 500 index in more years since 2000.

Figure 2: The S&P 500 and the S&P 500 Equal Weight indices measured on how many times each respective index outperforms the other on an annual basis throughout the 21st century.



Source: Bloomberg

So, with optimism surrounding corporate America and momentum in the country's stock market, alongside a comparative lack of appeal in other developed markets, US exceptionalism remains the major theme as we enter 2025. Nevertheless, diversification should still play a crucial role in portfolios, with mid and smaller caps in the US offering potentially better value while also standing to benefit from Trump's policies. Bonds are also yielding more than they have in decades, so income can also offer a ballast in portfolios to protect against volatility induced by trade wars and a Fed that stands in the way of Trumponomics.

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