The Case for Staying in US Equities

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Stock markets have come a long way from the nadir of the COVID-sparked sell-off, even as the virus itself is still surging around the world, and the remarkable and almost tone-deaf rally that global markets are experiencing has investors wary. In a blissful pre-COVID world where we were still in the longest-running bull market in history, expensive valuations were becoming a deterrent to asset flows – nowhere more so than the US markets, where global tech companies reigned supreme. The COVID dip marked a rerating that broke the cycle of ever-rising prices, but after the fastest market rebound since 1938, investors are once again asking if US equities are worth the cost.

The rest of the market

As the largest five companies in the US market, Microsoft, Apple, Amazon, Alphabet, and Facebook get a lot of attention, and subsequently, a lot of capital flow. Their dominance of the market as expensive stocks creates the impression that the tech industry is driving the US equity market to unsustainable levels. This is misleading for several reasons.

For one, only Microsoft and Apple are classified as IT stocks by the S&P 500. Alphabet and Facebook were both reclassified as Communication stocks, and Amazon reclassified as a Consumer Discretionary stock in 2018. An analysis that substitutes the performance or valuation of tech stocks with the big five market leaders is, therefore misrepresented.

Source Data: Morningstar

While technology price-to-books and price-to-earnings multiples are elevated relative to market averages, there are other parts of the market trading at attractive valuations. As shown below, financials are trading at particularly attractive price-to-book values. Considering that interest rates are meagre, which has compressed banks' incomes, the banks are generally in a much healthier place than they were during the financial crisis. Hence they are an excellent buying opportunity for investors in search of value in the US market.

Although not as cheap as financials, the communications sector also indicates a buying opportunity. Its price-to-book ratio is at the level of the overall market (even including Facebook and Alphabet), but it has seen significant downside and sideways movement over the past few years. Furthermore, the sector's price-to-book is skewed by Facebook and Alphabet's valuations, which are over 35% higher than the sector average. This tells us that among the other firms in the communications sector, there are value picks below the market average for those wary of the FAANGs.

An index fund would contain the prominent market leaders and hold them in the same proportion as their weight in the major indices (over 20% in the S&P 500), but an active manager can look for value beyond the big names, and it is clear there is still value to be found.

Is the market delusional?

It is evident that some stocks, as well as the market as a whole, seem to be charging on despite fluctuations in the news of late. While some see this as a sign that speculative buyers are driving the market to indefensible levels, there is some justification for a sustained market run.

First, let us concentrate on who the coronavirus downturn has impacted the most – lower to middle-class income earners and small businesses. In 2016, the 'wealthiest 10% of Americans owned, in dollar terms, 84% of the total stock held by US households', suggesting that instead of being 'detached from reality', markets rather 'reflect the reality of those most heavily invested in it'.1 Small businesses, while affected in an outsized way by the economic shutdown, are not represented in the major stock indices, and thus the closure of Main Street did not manifest to such a degree on Wall Street.

Instead on Wall Street, we saw the companies that reign over the stock market 'positioned to become even more dominant than they were before the crisis', both in terms of less competition in the marketplace as well as the push towards greater digitalization that the global lockdowns necessitated.1 In anticipation, stock prices rose to reflect that new paradigm.

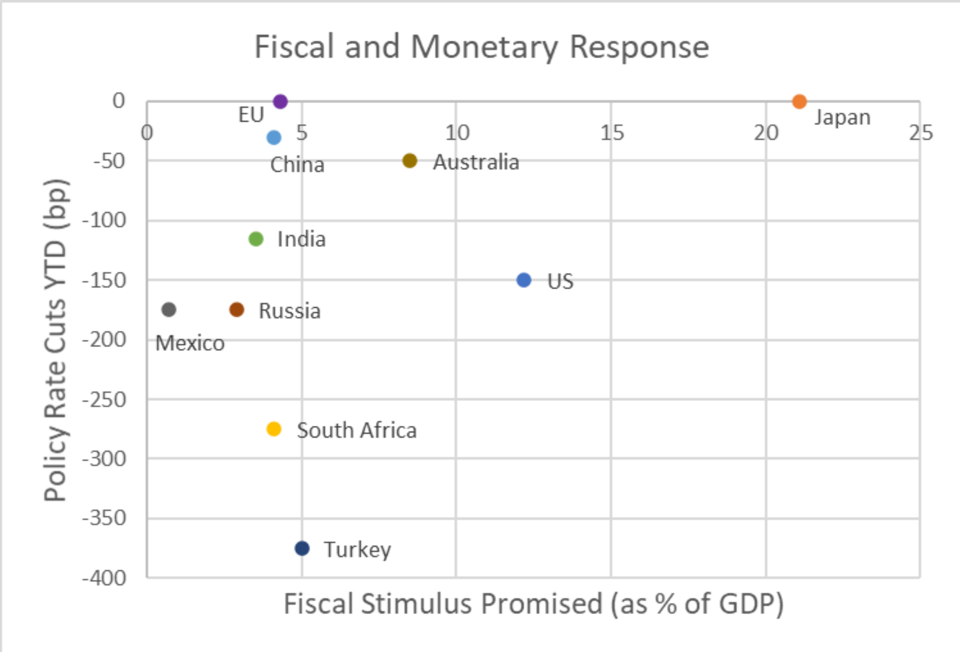
The safety net

Further to the argument that certain firms, while expensive, are still expected to grow based on the market share they've been able to capture during the COVID crisis, is the escalating importance of policy in evaluating today's markets. While volatility and uncertainty command global markets among the pandemic, the range of valuation outcomes widen, and fundamentals no longer seem to drive prices. Instead, stimulus promises by central banks and governments are the basis on which the market falls one day and surges the next. The foremost of these plans is the one outlined by the Fed, which has announced trillions of dollars in handouts, bond-buying programs – including corporates, and loans. Speculation suggests that it is possible a stock-buying program could be next. To be sure, the US is not alone with its stimulus package, nor is it the most substantial relative package as compared to its GDP. However, the US had firepower that other developed markets did not have. It was able to cut rates this year to facilitate liquidity, and the market rewarded investors with a surge

[1] New York Times (2020). 'What is the Stock Market Even for Anymore?'

over the quarter. As seen below, many countries have announced a combination of policy actions to tackle the economic downturn. Still, so far it looks like the US has been able to enact the strongest mix that intends to propel markets regardless of their fundamental characteristics.

Between that and the firm footing the US economy entered the pandemic on, investors should be far from disregarding US equities.



Source Data: Statista and Central Bank News

Conclusion

Although heightened valuations may drive some investors to reconsider a US allocation in their portfolios, when one looks at sectors and individual firms in the US, it is clear there are still opportunities for return. Even on a broad basis, you cannot discount the US as a source for growth based solely on the strength of the economy entering the COVID crisis and the determination of the Fed to keep the market going at whatever cost. The Great Financial Crisis stimulus jumpstarted the longest bull market of all time, and the efforts enacted then pale in comparison to the money we see being pumped into the economy now. It seems dubious in this time of ambiguity that we will see the same kind of record-breaking returns again. Still, foregoing exposure means to discount the determination of the most powerful country and central bank in the world.

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