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The August Outlook

Market Stance

WHY HAVE US EQUITIES UNDERPERFORMED?

Sector performance not Administration policies have been a key factor

Commentary

- An extended period of US equity outperformance was reversed at end-2024
- This underperformance can be attributed to a significant extent to two sectors where ex-US markets have in aggregate significantly outperformed, but for very different industry-specific reasons
- The timing of US underperformance has been uneven, and was more evident last year – since this spring, US equities have outperformed

Upshot

- A range of contingent sector-specific themes have largely driven US global equity underperformance, and in our view the impact of US Administration policies has not been the central factor

THE AI CAPEX CYCLE

AI capex spending now a material global growth driver

Commentary

- We are sceptical that this investment cycle has delivered a widespread bubble in global equity markets, even if there are pockets of speculation associated with it
- The buoyancy of the cycle is likely to extend into next year, although it ultimately remains uncertain
- Equity markets continue to reward the perceived winners, but vulnerable companies and sub-sectors have underperformed significantly

Upshot

- This is not a theme that can be avoided, and Saranac has significant exposure to it – but less than in conventional equity indexes

GLOBAL FIXED INCOME RETURNS

Fixed income returns have been subdued so far this year

Commentary

- The index yield of around 5% remains attractive, real yields have risen at short maturities, and fixed income remains an effective hedge in a deflationary environment
- However, upside risks to US interest rates persist – the economy has significant growth momentum and a low unemployment rate, and there is less transparency over Fed policy under the new Chair
- Corporate spreads remain tight, limiting scope for returns

Upshot

- We retain a significant exposure to fixed income in multi-asset portfolios, but also look to hedge funds and structured products to provide effective portfolio diversification

GLOBAL ECONOMIC CYCLE

Middle East tensions have not delivered a significant global economic downturn

Commentary

- With the exception of China, recent economic releases have consistently been stronger than expectations in all countries
- There is little evidence of sharp downturns
- We do not underestimate the scope for additional adverse shocks, but have become less concerned about the major destabilisation of the global economy

Upshot

- If oil is the 'old' economy negative and the AI capital spending boom the 'new' economy positive, to date the latter factor is predominating, at least in the US

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The Long Read

Why have US equities underperformed other global markets?

SNAPSHOT

Since end-2024, US equities have returned some 30%, against more than 50% for global ex-US markets, ending more than a decade of US leadership on policy, concentration and AI-valuation concerns.

The ex-US outperformance was not broad-based: two sectors did most of the work – a re-rating of ex-US financials from post-2008 lows on rate normalisation and capital discipline, and very strong ex-US IT performance.

Ex-US IT gained because of the concentration in semiconductors in emerging markets, sidestepping the US software sell-off and delivering roughly twice the return of the US sector.

Geographic diversification therefore delivered less than it appears: many sectors are global, EM concentration now exceeds the US, and Administration policy is not the central explanation of US equity market underperformance.

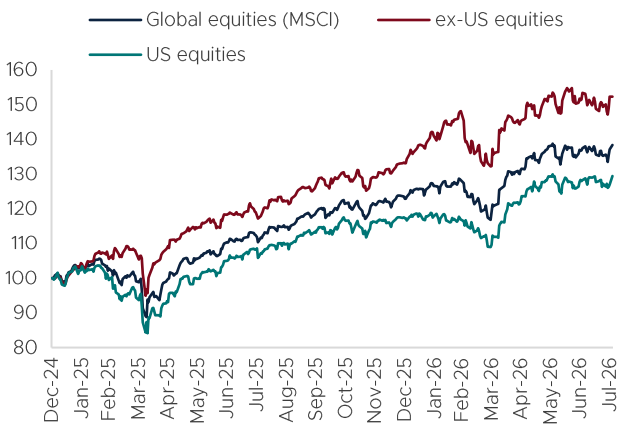
1. The long-run outperformance of US equities is now being challenged

In recent years, a broader range of challenges to US equities has emerged. These include the Administration's economic policies, and the higher concentration arising as single mega cap stocks now account for a significant proportion of market capitalisation. In addition, demanding valuation levels, particularly in stocks associated with the surge in AI spending, represent a further source of caution.

These risks have become more evident. Following over a decade of systematic outperformance of US equities compared to other regions, since the end of 2024 ex-US markets have delivered stronger performance, as set out in chart 1 below. Over this period, the return to US equities has been some 30%, significantly below the dollar return to global ex-US equities of over 50%. The US market still accounts for some two-thirds of market capitalisation, and hence remains by some way the largest single regional block. Nevertheless, its previous position as a market leader in return generation has, over the period as a whole, been compromised.

CHART 1

Regional equity performance



[1]Source: Saranac / Bloomberg

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2. Accounting for US equity market underperformance

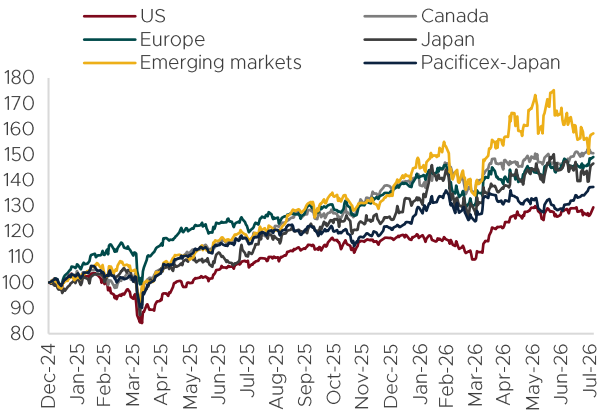
A superficial view would be that the ex-US markets have benefited by avoiding the idiosyncratic risks associated with US equities outlined above, so that geographic diversification away from the US has been a successful strategy. Some data confirm this view: as shown in chart 2 below, all of the major regional blocks have outperformed the US.

- Emerging markets and Canada (a combined weight of over 30% of the global ex-US index) have delivered particularly strong additional returns over the US;
- Japan and Europe (over 50% of the ex-US index) have been comfortable outperformers;
- and Pacific countries ex-Japan (around 10% of the ex-US index) have delivered returns slightly higher than those in the US.

Dollar returns are used in this chart, and the weakness of the US currency since end-2024 means that the ex-US local currency returns are around 5% lower on average. Nevertheless, this currency contribution is far from providing a full explanation of the relative weakness in US equity returns.

CHART 2

Dollar equity returns by regional block



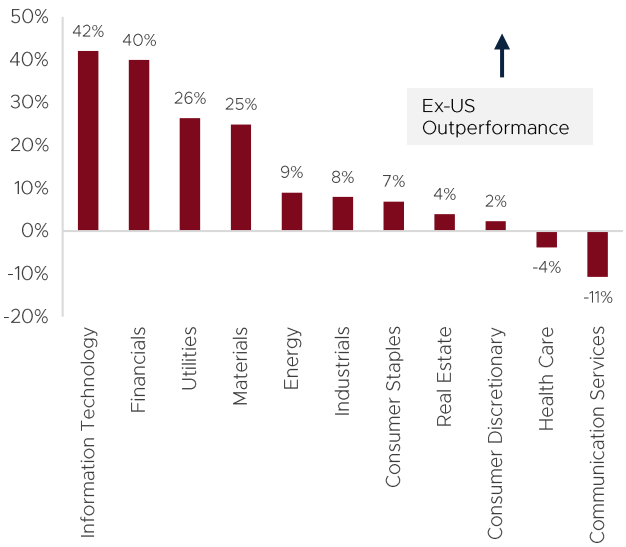
[2]Source: Saranac / Bloomberg

i. Two sectors largely drove the performance gap

On initial analysis, a comparison of sector returns between the US and the ex-US block suggests similar broad-based outperformance in the latter: the US outperformed in only two of the ten equivalent sectors in the ex-US block – healthcare and communication services – as evidenced in chart 3. However, some of these performance differentials are small, and others occurred in relatively small sectors. [1]What matters more is large performance differentials in large sectors. From this perspective, the US/ex-US performance gap was largely delivered in two sectors – financials and IT. Interestingly, the drivers of performance in each case have been very different. The drivers of US equity underperformance cannot therefore be reduced to a single simple narrative.

CHART 3

Performance of ex-US sectors over US equivalent



[3]Source: Saranac / Bloomberg

[1]E.g. utilities and materials account on average for some 8% of average market cap in total across the two blocks. They have both contributed to ex-US outperformance, but by less than the financials and IT sectors, whose combined weight is around 40% on average. The Chinese quoted IT sector, often cited as an effective idiosyncratic investment, has had little or nothing to do with successful diversification away from the US: the sector is small and has underperformed other markets.

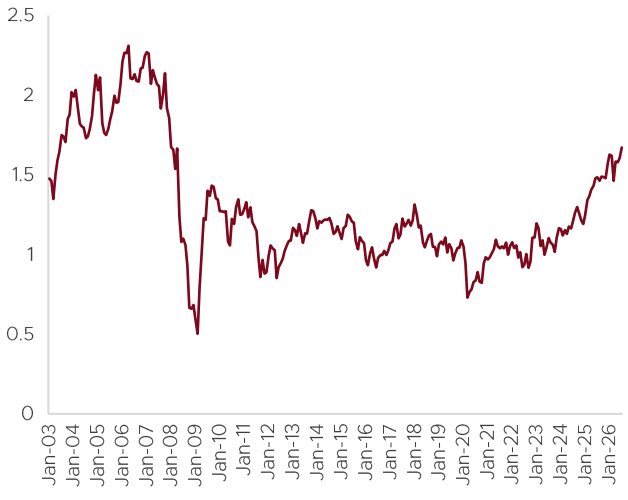
The Long Read

ii. The re-rating of ex-US financials

Since end-2024, financials in all of the ex-US regional constituents (around 25% of the ex-US index) have outperformed their US counterparts. In some respects, this can be viewed as an archetypal successful value theme, as ex-US financials have rebounded from the low rating on which they had traded since the aftermath of the 2008 crash, as illustrated in chart 4. There were clear catalysts for such a move – in particular the normalisation of the interest-rate environment contributing to a more supportive environment for financials' earnings. There is also strong evidence of capital discipline: for example, European banks are likely to return around 10% of their market cap to investors this year, through dividends and buybacks. The virtuous circle has also included significant price momentum effects, which are not just evident for AI stocks. Past performance has been one of the strongest influences of relative performance within the sector: the winners (typically those with low valuations and firm earnings) have continued to win, and the losers to lose.

CHART 4

Price to book value of ex-US financials



[4]Source: Saranac / Bloomberg

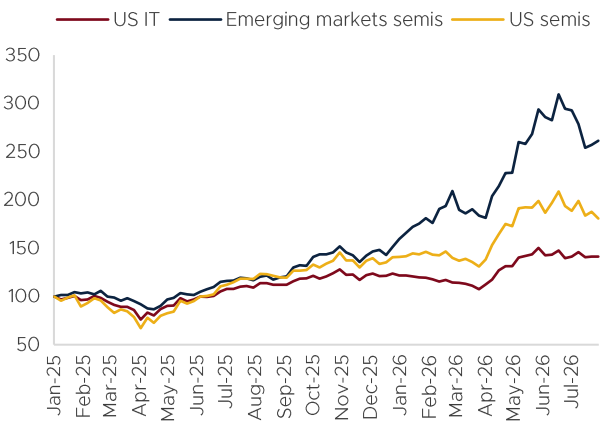
iii. Industry structure of US IT contributes to its underperformance

The other main sector responsible for the outperformance of ex-US equities has been IT. At first sight, this seems curious. The US IT sector accounts for around a third of market capitalisation, well over twice the average weight in non-US markets, and IT has been by far the strongest performing global sector. So why has this not been a source of relative outperformance for the US? The answer lies in the structure of the global IT industry. Outside the US, IT is to a significant extent semiconductor manufacturers, concentrated in Korea and Taiwan. By contrast, within the US the breakdown is more even between software, hardware and the semis.

These different market structures have driven a significant difference in IT returns between the US and other markets. The ex-US IT sectors, with small or negligible software exposures, have avoided the marked software sell-off that has been so evident in the US. Outside the US, exposure has been much more to the semis, the highest performing industry within IT since end-2024, as shown in chart 5.

CHART 5

Emerging market and US IT returns (Dec 2023 = 100)



[5]Source: Saranac / Bloomberg

In addition, semis' returns outside the US have been much more substantial. These influences combined have delivered a return in the ex-US IT sector around twice that of the US sector. This in turn has made a material contribution to the underperformance of the US market when compared to the other major global regions in aggregate.

3. Superficial diversification?

There is a paradox here. Investors have diversified away from the US in part because of concerns about potential speculative influences driving the AI theme. As noted, this positioning has been effective, as US equities have indeed underperformed. However, it has been successful in part because of exposure to aspects of the AI theme which have been still more volatile than the AI theme in the US itself. Moreover, the global emerging markets index now appears more concentrated on some measures than even in the US. The top three companies in the EM index account for over 25% of market capitalisation, whereas in the US the equivalent figure is under 20%.

This argument illustrates the point that geographic diversification across equity markets does not inevitably provide effective diversification when sectors are global, not local. We do not view the emerging market IT sector simply as a direct competitor to US companies, producing similar products. Rather IT is a global sector, and the emerging Asia element, whose performance has been so strong, plays a specific role in global supply chains. It does not dance to a different tune compared with developed markets. On the contrary, it stands or falls as part of a complex network of industries which straddles developed and emerging markets, making location of secondary importance to its performance. This renders the apparent advantages of diversification by geography less helpful, as the additional diversification as measured by sector positioning is of a substantially smaller order of magnitude.

4. Diversification in globalised markets

This analysis highlights three main points. First, global equity markets have been dominated to an increasing extent by global companies whose location is not the prime driver of their performance. Of course, some sectors remain predominantly local – real estate, and some parts of retail and financial services for example – but these have become less important equity market components. A large reallocation from one region to another may therefore appear to provide significant diversification, on the assumption that different regions have different economic dynamics. However, if the allocation is to global sectors, overall portfolio properties may change less than the regional allocation suggests. Moreover, even where the return streams are different across regions, this may simply reflect different exposures within a global industry. For example, as noted software is a significant element of the US IT sector, but in emerging markets semis and IT hardware are more significant.

Second, the argument in this paper has been that industry-specific developments have played a significant role in the underperformance of US equities since end-2024. So where does this leave the argument that the Administration's economic policies have contributed to US equity underperformance? This has clearly been true in specific circumstances, notably the tariff imposition in spring 2025. However, these policies did not contribute to the outperformance of financial stocks outside the US, or IT stocks in emerging markets. This is not to argue that there has been no impact of these policies, not least because the period of US equity underperformance began very close to Trump taking office – this evidence seems more than simply circumstantial.

[2]The Chinese quoted IT sector, often cited as an effective idiosyncratic investment, has had little or nothing to do with successful diversification away from the US: the sector is small and has underperformed other markets.

The Long Read

Moreover, as noted, dollar weakness has contributed to underperformance of US equities, and this weakness seems partly attributable to US macro policy. Nevertheless, this impact seems to account for little of the identified US equity underperformance, and we suspect that the overall influence of the Administration's policies has not central in this respect.

Finally, the central focus of this paper has been to pick out important themes between end-2024 and the present, but there has been significant volatility between the start and the end-points. US equity underperformance was concentrated in two waves. The first was the tariff announcements in spring 2025. The second was the interaction of ongoing financials outperformance and the sell-off in US software over the turn of the year. However, recent months have seen the US market recapture some of this underperformance. Indeed, year-to-date US and non-US performance has been broadly flat.

More generally, the recent short-term period of US outperformance coincided precisely with the outbreak of hostilities in the Middle East, which may simply be coincidental, but it might also dilute claims that US policy has been a central element underlying underperformance over the period as a whole. These hostilities appear to have depressed relative returns in ex-US materials and industrials, which are also large components of the ex-US index. At the same time, the sharp sell-off in semi manufacturers has contributed to US IT outperformance.

These arguments suggest that a wide range of contingent developments in specific industries has driven US/ex-US relative performance, so that the US's relative performance cannot be reduced to a single dominant theme such as 'high valuations' or 'Trump policies'.

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