# American Exceptionalism

Last month, a massive $140 billion flowed into US equity funds as investors embraced the re-election of Donald Trump. This "Trump trade" was driven by investor expectations that the new Trump administration will unleash sweeping tax cuts, deregulation and aggressive fiscal policies that will generate a further boon to corporate America. There is now a strong belief that President Trump will foster a lengthy period of corporate optimism and opportunity.

**Investors rush into US equities**

Monthly net flows into US equity funds ($bn)

150
100
50
0
-50
2020 2021 2022 2023 2024

*Source: EPFR, Financial Times*

The recent "Trump trade" reinforces a trend, established in the late 2010s, whereby global investors are moving increasing amounts of capital directly to the US financial markets. There are two primary reasons for this movement of capital.

Firstly, akin to a type of "flight to safety", rising geopolitical uncertainty has motivated international investors to forsake their domestic capital markets and protect their capital under the umbrella of the US financial markets. Under the new Trump administration, this strategy appears to also allow investors to be invested "behind the wall of US tariffs".

These enormous US capital inflows are displacing capital investments within the rest of the world. For smaller economies, like Canada, capital outflows weaken the currency, imperil possible interest rate cuts and weaken domestic economic fundamentals. For emerging market countries, with a less robust financial market

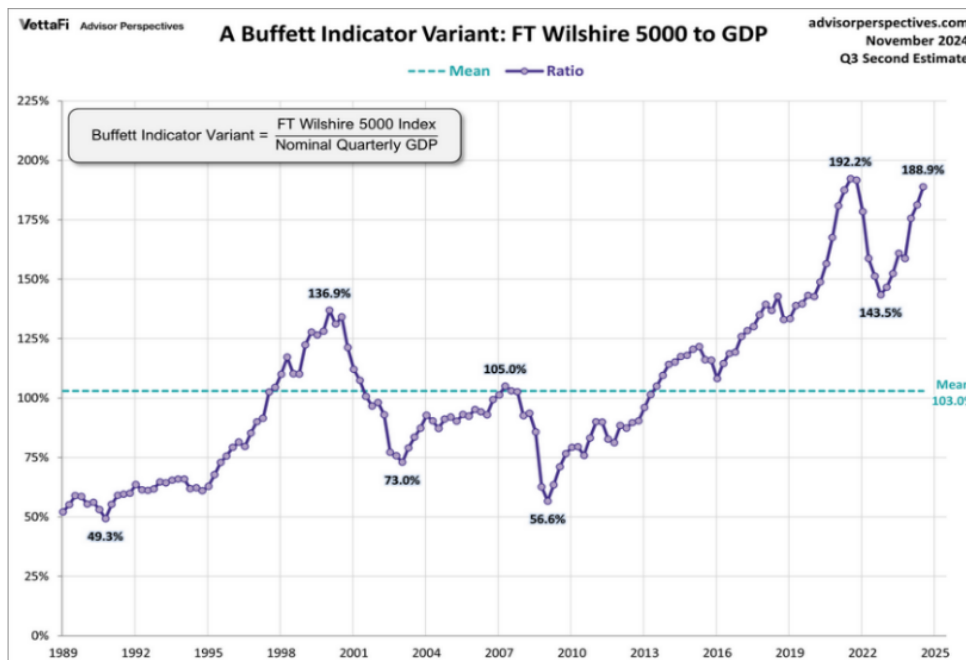
landscape, the lack of foreign investment leaves their capital markets even more exposed to financial uncertainty.

The second reason for these international capital flows is because of the superior performance of the US economy and the US stock markets. Driven by rising technology-based labour productivity, the growth of the US economy has outpaced all other developed world economies. Since 2019, the US has seen double the labour productivity growth of the next-fastest major comparable economy, the UK. Canada has had virtually no labour productivity growth during this period.

Global investors now fully embrace "American exceptionalism". The influx of global capital has caused US asset prices to "float" above the rest of the world. With a capitalization value over $60 trillion, the US stock market accounts for nearly 70% of the global stock index. 40 years ago, a comparable number was 30%.

To some degree, the gap between the US other global stock markets can be justified by US innovation, technology leadership (specifically artificial intelligence) and the earnings power and global reach of major US companies. Despite these justifications, US stock market valuations look stretched. Currently, the US represents one-third of total global economic Gross Domestic Output (GDP). Should one-third of global GDP account for 70% of global market valuation?

Often called the "Buffett Indicator", because it has been referenced by Warren Buffett for a number of decades, the ratio of total US stock market capitalization to the GDP of the US economy has been a good representation of stock market valuation. As can be seen in the chart below, the ratio of US market capitalization (represented by the combine valuations of the largest 5000 US companies - Wilshire 5000 index) to the size of the US economy is comparable to the 2020 pre-Covid high of 192%.



*Source: Advisor Perspectives*

Does the historic high of this Buffett Indicator indicate a stock market bubble? On a broad-based level, it may appear so, but it is also important to evaluate further. The concentration in the US stock market has reached levels never seen before. The top 7 largest companies in the US (Apple, Microsoft, Google, Amazon, Meta, Tesla and Nvidia – collectively known as the "Magnificent 7") now account for over 30% of the major US stock index. These are mainly technology companies that are considered leaders in artificial intelligence (AI). They are spending billions of dollars trying to maintain an edge in AI – so far with little return on this investment. The market believes AI is a solution to a vast range of problems, most of which have yet to be discovered. We are skeptical.

But these high valuations don't apply exclusively to the Magnificent 7 or other AI companies. Many companies that are considered leaders in their given industry have seen their valuations rise significantly. The age-old adage in investing has been to "buy great companies at good prices". US exceptionalism seems to adhere to a new adage – "buy great companies at any price". Costco, undoubtedly a great business, has been the poster child of this phenomenon and now trades at over 50 times its expected earnings next year.

Is the US stock market over-valued, over-owned and over-hyped? Or is there an impending model shift whereby equities are analyzed and approached in a different manner? Currently, there seems to be an almost unanimous consensus towards the latter. This is only further reinforced by the business-friendly policies that President-elect Trump pledges to enact. While traditional valuations have never been a means of timing market peaks, they are a good predictor of future returns. The gravitation towards leaders has left many good companies in less exciting industries trading at depressed valuations. While it remains to be seen how long sentiment and momentum can continue to trump fundamentals, we look favourably upon the long-term risk-reward profile of these companies.