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US Equities: Overvalued, Overloved, Overlooked?

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When forming judgments, it is paramount to be aware of one's own biases. I am a long-term sceptic of the lofty valuations we have observed in the US. I wince at Warren Buffett's favoured indicator (total market value to GDP), currently sitting 57% above its trendline, flagging the S&P as highly overvalued. I worry over the inverted treasury yield curve (when short-term (3 month) rates offer higher return than long-term (10-year) rates), which often serves as a harbinger for recession. I look at the historic levels of concentration in the magnificent seven tech behemoths, and well, you can imagine what my instincts tell me. My concerns extend to the dollar's place as global hegemon, and treasuries' place as the 'risk free' asset.

Bearishness is often exacerbated by immersing oneself in the daily financial news cycle which is part and parcel of being a portfolio manager. Listening for breaking news, sudden changes in sentiment, any semblance of cracks beginning to form or shoots beginning to grow allows you to extrapolate how your investments will react, where you may be vulnerable and where you may take advantage. The cold truth however is that bad news does sell, and financial media publications are, on some level, aware of this. Risks and fears make headlines, sensationalism sells papers, and markets 'plunging' will likely generate more clicks. Why? Because a quirk of natural selection, that served us well in the jungle but less so on the Bloomberg Terminal, is that our primitive brains are hardwired to be more attentive to threats.

Another such oddity is our innate desire to be right, which helps satisfy our evolutionary need for tribal belonging. However, emotion isn't much use in investing and such instincts inevitably create biases which need to be accounted for in investment decisions. The bias at play here for bears is confirmation bias: the tendency to seek information that confirms your belief while ignoring anything to the contrary. While bearishness actually stems from another bias, loss aversion: losses feel more painful than equivalent gains feel rewarding, and thus we overvalue downside risk and undervalue return opportunities.

In recent months, the current has swelled around Donald Trump's 'liberation day' announcement and the ripple effect, or what briefly looked like a tsunami effect, of his policies on financial markets. There has been growing negativity around the US across many investment communities and asset allocators, reflected through a large sell-off in equities. It is safe to say my now well-developed US scepticism was gloriously validated, right until the moment it wasn't. Markets recovered weeks of losses in mere hours. Therefore, rather than seek further validation of my increasingly myopic view, I felt compelled to challenge it. So, have I overlooked the bull case for the US?

The natural starting point is with an ostentatious summary of the marvel that is artificial intelligence and its distribution of largesse to American companies. Microsoft, Amazon, Meta, and Nvidia are major winners in the new epoch we are stumbling into, with the latter recently extending its extraordinary track record of smashing earnings targets. AI will redefine how we work, live, create, and solve problems on a global scale and has the potential to be a catalyst for exponential innovation across the whole economy. The above names, plus Apple and Alphabet, are in the enviable position of generating massive free cash flow and having magnificent balance sheet strength through their role in enabling this megatrend. Macroeconomist and member of our quarterly investment committee Alex Dryden delves into the intricacies of this. In short, they are uniquely positioned to defend their gilt-edged market position through M&A and capital expenditure, with the US in an unparalleled position to both deliver and be the beneficiary of widespread productivity gains and consequently buoyed corporate profits.

For every pound invested in the S&P 500, 32 pence is distributed to these six companies. While we keenly debate the merits of active versus passive/index tracking, the massive growth in the latter approach seen worldwide in pension and savings pots, provides regular, deep-pocketed bids at current prices. Team this with the new generation of investors who are both conditioned to believe that buying the dip (equity weakness) works and educated on the long-term benefits of compounding, it amounts to a lot of buying. Simply, stocks go up when there are more buyers than sellers, so a continued growth in passive popularity cannot be understated in its importance.

Worried about the impact of tariffs? Join the club. However, perhaps the fears of a potential reformulation of our globalist order are overblown. Tariffs may not even lead to US inflation increasing. If a good increases in price due to tariff expense being passed on to the consumer, this arguably does not cause inflation because the consumer's spending pot is now reduced and thus there is negative price pressure in other parts of the economy. This balancing effect of course only holds if real wages stay the same. The labour market remains resilient at fairly tight levels, but data is suggesting a gradual weakening which may suppress bargaining power and consequently wage growth. A few too many ifs, buts and maybes for one to be certain, but if you add the very possible real effect of AI on the jobs market, plus a lower oil price, then chances of this outcome increase. Besides, we're witnessing a significant retreat from Trump on tariffs toward a more moderate footing, with the crisis averted for the meantime. It seems the following advice from Trump's former mentor, Ray Cohn, was internalised by the President and will likely continue to prove prescient of the President's strategy: (1) *Attack, attack, attack; (2) Admit nothing, deny everything; (3) Whatever happens, claim victory.*

The market, however, has translated this strategy into a fairly brutal but very tasty acronym: TACO: Trump Always Chickens Out.

Therefore, it seems the market may continue to look through tariff negotiations with their eyes firmly fixated on factors that could send this equity market higher. One such is the Federal Reserve's ability to cut interest rates. Despite Federal Reserve Chair Jerome Powell's reluctance thus far, it would be highly stimulative to the equity market as investors rotate out of record high exposure to money markets. The second is the President's proposed "big, beautiful" tax bill. It seems as if the loose plan was to pay for tax cuts through DOGE (Department of Governmental Efficiency) savings and drastically increased tariff revenue. With the depth of savings yet to be fully established, we can take this with a pinch of salt without fully discounting its significance.

Another potential bias is that our obsession with the 'Magnificent 7' means we have become increasingly conditioned to extrapolate the performance of mega-cap tech stocks to the whole US market. Well, if tax cuts and deregulation pass through the House and the Senate, small and mid-cap US equities present an asymmetrical opportunity. These companies, which generate much higher revenue domestically, are significantly more sensitive to shifts in US economic growth and interest rates. While large-cap tech names have dominated returns and headlines, smaller companies have lagged meaningfully: to the point where they are at a 40% discount to their mega cap peers. Many of these businesses are already down considerably from highs, and with investor positioning light and sentiment low, they offer substantial upside if economic conditions stabilise or improve.

Another underappreciated factor in the bull case is the extraordinary resilience of the US consumer, who's spending makes up two thirds of US GDP. Despite high interest rates, geopolitical uncertainty, and inflationary pressure, consumer spending has remained robust. Household balance sheets, fortified by pandemic-era savings and rising wages, have continued to support economic growth and corporate earnings. This resilience creates a powerful buffer against downside scenarios and reinforces the soft-landing narrative.

While my instincts admittedly lean bearish, and I remain cautious about structural risks such as the ballooning deficit and de-dollarisation, the bull case for US equities is still too compelling to ignore. As is the data. Since 1926 the US stock market has experienced positive returns 75% of the time on any 12-month basis and as much as 95% of the time on any 10-year basis. Plainly, being fully invested in the equity market, as much as your risk tolerance dictates, remains prudent over the long-term. However, there are no guarantees when it comes to the stock market, especially after such a wonderful run for the US. Therefore, we remain diversified across the globe as well as within America. We see considerable value in small and mid-sized companies, dividend payers and are invested in areas where Artificial Intelligence will deliver outsized operational gains. The powerful combination of AI-led innovation, dominant and cash-rich tech giants, relentless passive inflows, easing fears over tariffs, potential tax reform, small-cap valuation support, and, critically, the durability of the US consumer paints a far more balanced picture than headlines suggest. As investors, our job is not to be emotionally attached to one narrative, but to be intellectually honest, and diversify accordingly. Challenging our assumptions isn't a weakness, it's an edge. And right now, that edge may be pointing toward the upside.

If you would like to speak with us about anything in this note, or to discuss our discretionary investment management services in general, please get in touch with our UK business development manager David Terry today.

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