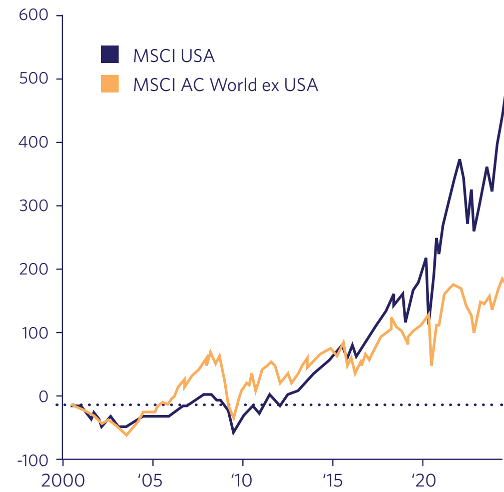
American Exceptionalism

It has been Lyell Wealth Management's view since our 2016 founding that we should concentrate our equity investments in U.S. companies. This investment strategy has been emphasized frequently in our client communications and publications. It has not been based on patriotism, but on the insight that an overwhelming percentage of the best global companies across industries are U.S. headquartered, albeit not infrequently led by foreign born CEOs and/or founders. Lyell's October 2018 Perspective, *This Side of the Pond*, focused on this theme. This U.S.-centric focus has been rewarded, as the S&P 500 has outperformed the international stock benchmark, the MSCI EAFE, by almost 10% per year over Lyell's existence (Chart 1).

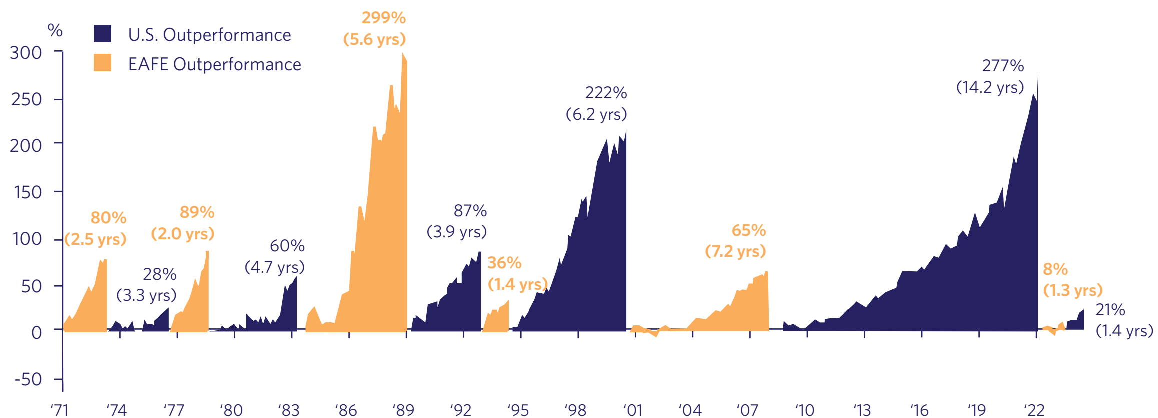
Relative performance between U.S. and international stocks has come in waves over the past fifty years, with the U.S. increasingly outperforming. It is not a coincidence that U.S. outperformance started to accelerate in 1995 when the Netscape web browser launched the commercial internet, nor again in 2007 after the Apple iPhone enabled social mobile networking (Chart 2).

CHART 1
Cumulative Total Return
In U.S. dollars.



Source: FactSet, Wall Street Journal

CHART 2
MSCI EAFE and MSCI USA Relative Performance
U.S. dollar, total return, cumulative outperformance



Source: FactSet, MSCI, JP Morgan Asset Management

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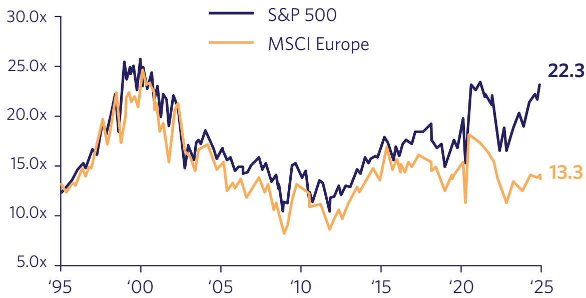
CHART 3

S&P 500 vs. MSCI Europe NTM PE



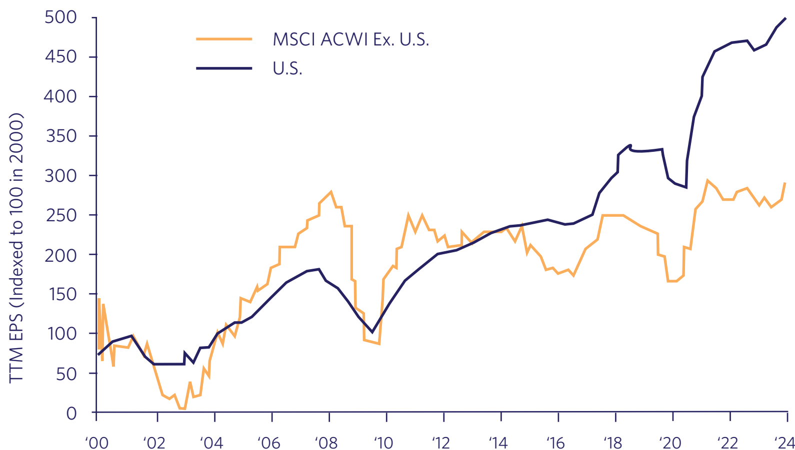
Source: Strategas Securities, Factset

We have noted over this timeframe that it has been common for many investment firms to allocate as much to international stocks as to U.S. equities, citing lower valuations. The most typical destination for international stock investments by U.S. investors is Europe. Certainly, over the past decade, European stocks have consistently had lower Price/Earnings ("P/E") multiples which continues today (Chart 3).

There are several reasons for this performance gap and why P/E multiples are deservedly lower overseas. One explanation is that steady U.S. corporate earnings growth has significantly exceeded stagnant international earnings over the past decade (Chart 4).

CHART 4

U.S. vs. Rest of World Earnings Growth Since 2000



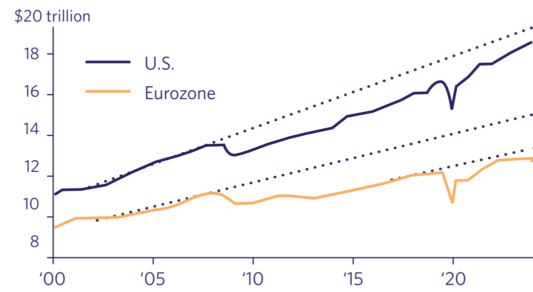
Source: Bespoke Investment Group

CHART 5

Real Gross Domestic Product

Dotted lines indicate previous trends.

Annualized quarterly data in 2005 U.S. dollars.



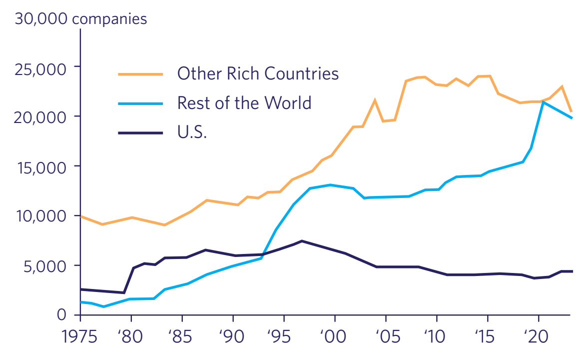
Source: FactSet, Wall Street Journal

European economic growth has significantly lagged the U.S, particularly after the Global Financial Crisis and again after the pandemic. Europe's challenges are widely acknowledged. The European Commission, chaired by Mario Draghi, the respected former President of the European Central Bank, issued a comprehensive report in September 2024. This report cited the primary culprit in Europe's GDP gap with the U.S. as its slowdown in productivity growth. Real disposable income has grown almost twice as much in the U.S. as in the European Union (E.U.) since 2000. A $2 trillion annual GDP difference has widened to over $6 trillion and the trendlines are not favorable for the E.U. (Chart 5).

Despite E.U. efforts to create a common market, nationalism has not disappeared. This has reduced industry consolidation across borders, as Italians, Germans and Spaniards hesitate to allow their national companies to be acquired. This has led to smaller, less efficient companies even within more mature industries. The U.S. has experienced consolidation across almost every industry, leading to more formidable, productive, and profitable competitors. These U.S. companies operate globally using their size and scale to compete. The number of U.S. publicly listed companies is very small, and hence their average size larger, as compared to overseas companies (Chart 6).

CHART 6

Number of Listed Domestic Companies



Source: World Bank WDI, Wall Street Journal

Two important financial metrics which indicate corporate productivity and profitability are "Return on Assets" and "Return on Equity." On these metrics, U.S. companies significantly outperform their European counterparts across every industry with the exception of Healthcare (Table 1).

TABLE 1

Other than Healthcare, U.S. ROE and ROA higher than Europe across sectors. (Percentages)

	Return on Assets		Return on Equity	
	U.S.	Europe	U.S.	Europe
Consumer Staples	7.2	4.4	24.7	13.3
Consumer Discretionary	7.8	4.4	30.0	11.8
Technology	12.6	5.8	28.9	11.4
Healthcare	4.4	6.3	12.7	15.1
Communication Services	7.2	2.0	17.8	6.9
Financials	1.4	0.7	12.9	12.5
Industrials	6.6	4.9	23.2	16.5
Real Estate	3.0	-1.8	7.2	-4.7

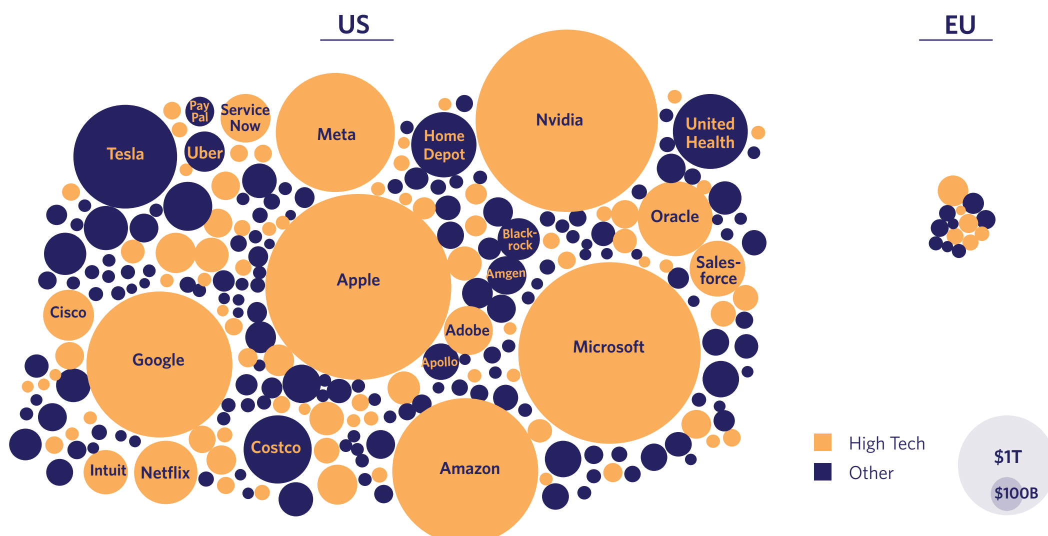
Source: Bloomberg, JP Morgan Asset Management

As the Draghi report identifies, Europe has largely missed out on the digital revolution fomented by the internet and its associated productivity gains. Only four of the world's top 50 tech companies are European. Almost all of Europe's largest companies are in more staid industries like financial services, manufacturing, pharmaceuticals and consumer goods. Europe is stuck in a static industrial structure with few new companies disrupting existing industries or developing new growth engines. Apple is worth more than the 30 largest German companies combined. No E.U. company with a market capitalization over EUR 100 billion has been started within the last 50 years, and there are only 14 founded within that timeframe worth more than $10 billion; the combined market value of those 14 companies is $400 billion. In contrast, all eight of the U.S. companies valued over $1 trillion today were founded less than 50 years ago. Nearly 250 U.S. public companies worth more than $10 billion have been started within the last half-century. These represent more than $30 trillion in combined value, the largest of which are digital-centric (Chart 7).

CHART 7

Public From-Scratch US and EU Companies Less than 50 Years Old with $10B+ Market Cap

Note: "From-Scratch" not the result of a merger, acquisition, or spinoff

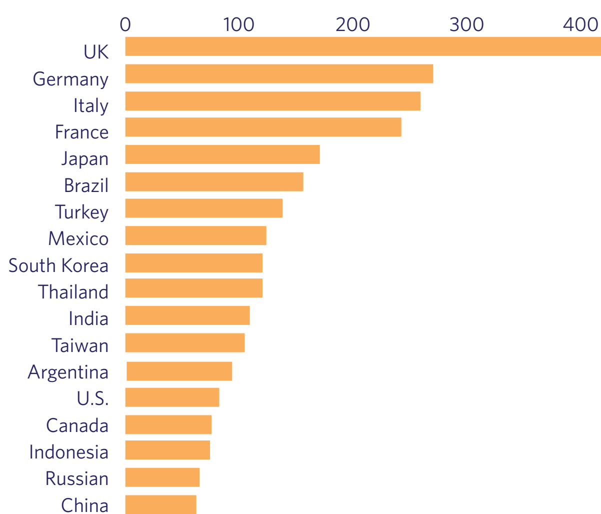


Source: Andrew McAfee, MIT

Europe faces many challenges in addition to its lagging entrepreneurial business creation. Bloc-leader Germany has an export-driven economic model in a world less amenable to global trade. China's weak economy and growing industrial base lessens its appetite for European exports. U.S. budget concerns will force Europe to spend more on its own national security. Its energy costs are significantly higher than other regions, which puts it at a competitive disadvantage (Chart 8).

CHART 8

2023 Average Electricity Prices for Industrial Users ($ per MWh)

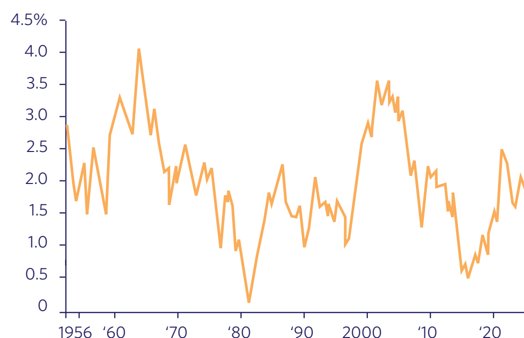


Source: 13D Research, Financial Times, Bloomberg NEF

The digital advantage disproportionately rewards U.S. companies and its economy through enhanced productivity. We may be on the cusp of a productivity boom similar to the one unleashed by the internet in the 1990s. Productivity growth has been above 2.0% in each of the past five quarters, which compares favorably to the 1.6% trend for the five years prior to the pandemic. The pandemic labor shortage encouraged companies to invest in labor-saving technologies which translate into higher output per hour worked.

CHART 9

Five-year Labor Productivity Growth, Annualized:



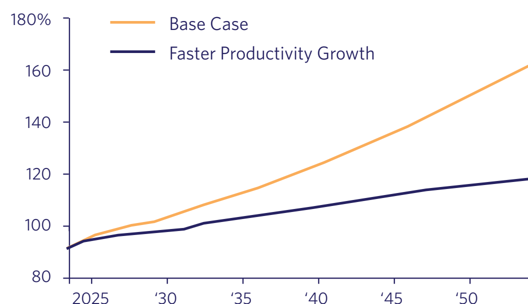
Source: Yardeni Research, Wall Street Journal

Artificial intelligence ("AI") offers the potential to enhance or replace humans across many industries. Google's CEO recently said that 25% of new code was already being written by AI. Elon Musk's vision of humanoid robots, if fulfilled, would result in dramatic productivity gains. Productivity typically comes in waves, and we could be in the beginning of a major upswing (Chart 9).

In addition to higher profit margins, greater corporate profitability, and standard of living improvements derived from stronger productivity, there could also be a pronounced impact on the U.S. accumulated debt. The Congressional Budget Office ("CBO") released a paper in May 2024 projecting that the federal debt held by the public will rise from 99% of GDP in 2024 to 116% in 2034. The CBO assumed 1.1% productivity growth in its analysis. If productivity growth were to instead increase by 1.6% over the next decade, the federal debt-to-GDP ratio would increase to only 108% by 2034 (Chart 10).

CHART 10

Projected Federal Debt as Percentage of GDP



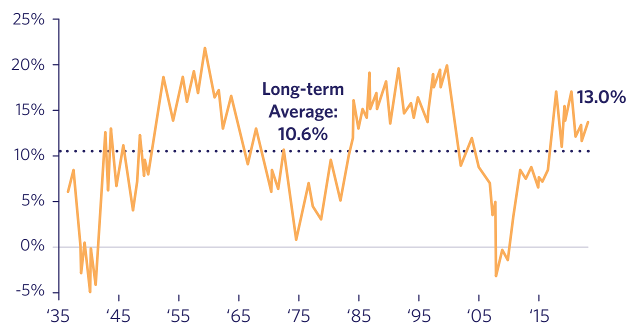
Source: Congressional Budget Office, Wall Street Journal

Strategist Ed Yardeni has pointed out that productivity booms in the late 1950s, the 1960s, and late 1990s all peaked at 3.5% to 4.0%, which is much higher than the CBO's forecast. Higher productivity leads to strong economic growth, which would reduce the federal debt burden, all else being equal.

There are understandable questions about U.S. stock market valuations, given that the S&P 500 has increased over 20% in each of the past two years. There have only been three instances in modern America in which the stock market returned over 20% in two consecutive years: 1935-36, 1954-55, and 1995-96. There isn't a pattern to suggest performance for the following year, although it is interesting to note that 1997 was the only instance where performance was strong in the third year as the S&P 500 returned 31%. There may be parallels in terms of market returns between the mid-1990s and today. The pattern of NASDAQ returns from the Netscape internet browser release in December 1994 and from the ChatGPT release in November 2022 are almost identical (Chart 11). It is worth noting that the bull market was far from over at this point in the 1990s after the Netscape release.

CHART 12

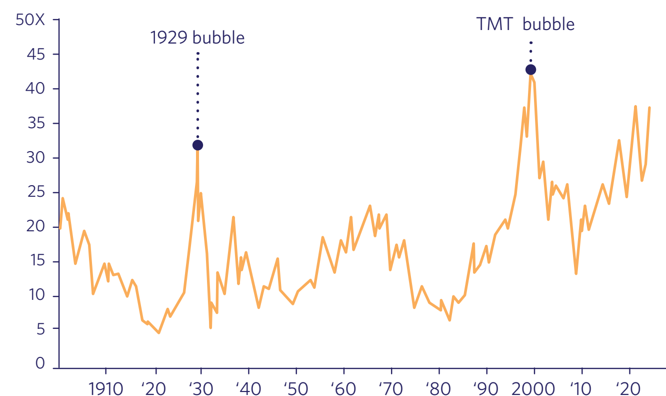
S&P 500 Rolling 10-Year Returns



Source: Strategas Securities, S&P Dow Jones Indices

CHART 13

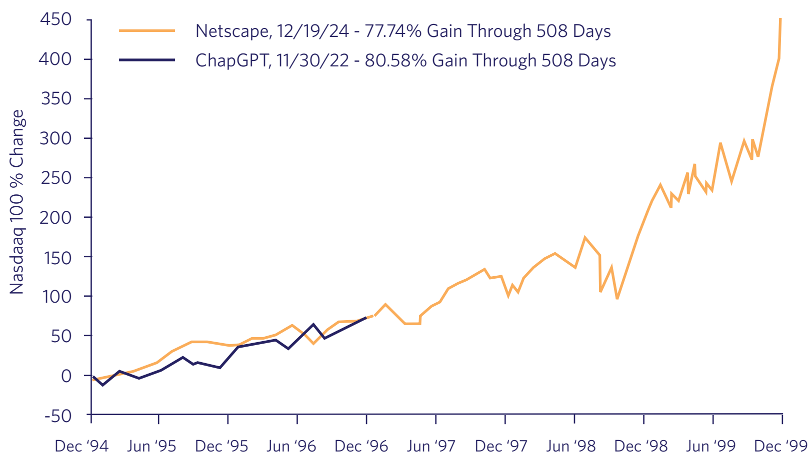
Cyclically Adjusted Price-to-Earnings Ratio



Source: Professor Robert Shiller, Wall Street Journal

CHART 11

Nasdaq % Change in the 5 Years After Netscape Release vs Chat GPT Release



Source: Bespoke Investment Group

Lyell prefers to view returns over longer-term timeframes to gain perspective. Although the past two years' strong returns have increased rolling 10-year returns, they are not as extended as one might think (Chart 12).

U.S. stock market valuations are historically high on almost every measure, including those by famed economist and Nobel laureate Robert Shiller's cyclically adjusted P/E ("CAPE") ratio (Chart 13).

However, it is broadly accepted that valuation is a poor market-timing predictor. Markets can push higher before they decline, or earnings and other financial metrics can increase to justify prior price levels. It is worth noting that in July 1996 Professor Shiller wrote "it is hard to come away without a feeling that the market is quite likely to decline substantially in value over the succeeding ten years; it appears that long run investors should stay out of the market for the next decade." Instead, the S&P 500 rose an annualized 8.8% over the next ten years (a period that included the popping of the dot-com bubble). In a June 2015 article Professor Shiller said "I think that it's common sense to lean away from current high-CAPE countries like the United States and lean toward low-CAPE regions like Europe." This Perspective has already addressed how European stock markets have performed as compared to the U.S. market over the past decade.

We agree with Warren Buffett's 2012 shareholder letter that delivered a message not to let short-term uncertainty or the predictions of "experts" keep an investor out of the market. In his words, "the risks of being out of the game are huge compared to the risks of being in it." However, Lyell also stresses that clients have sufficient liquidity and reserves to manage through inevitable market volatility and the emotions that come with it.

We are mindful that economies and markets are dynamic. No single investing strategy is sustainable over time. Lyell Wealth Management does not believe that U.S. exceptionalism in the corporate arena is necessarily eternal. However, given that the global economy rewards technology prowess and scale enabled by inexpensive energy, we don't expect the current paradigm to change soon.

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