WILSONS

Another Dominant Year for the US Stock Market

Our weekly view on asset allocation.

13 December 2021

US Market Continues to Defy the Naysayers

The US market continues to defy the naysayers with another impressive year of performance. The S&P500 has risen 24% YTD total return (31% in A$), a return that is comfortably ahead of both the rest of world equities and our local market. Outperformance has been skewed toward the second half of the year, helped by strong performance from big cap US tech as well as a resurgent US$.

US valuation premium expands in 2021

For some years now, the premium valuation of the US equity market has attracted significant caution from many market analysts. Coming into 2021, concerns were once again raised around the sustainability of US valuations after its very strong rebound from the 2020 COVID lows.

We have been suggesting for some time that the US market valuation is not overly stretched when one considers both the low interest rate backdrop and the underlying quality and dominance of the US mega-cap franchises.

While we were not overly concerned about the overall valuation of the US equity market this year, we have been surprised that PE compression has been significantly greater outside the US.

This would suggest that investors have become less confident about the medium-term growth outlook for the rest of the world, but remain relatively optimistic in the medium-term prospects for US earnings growth.

In contrast to the rest of the world, the US equity market has largely held its PE despite the big upside surprise on US inflation and the Fed's signalling of a more aggressive withdrawal of QE stimulus.

The PE relative to the rest of the world is now 40% – a clear all-time high.

Exhibit 1: US Equities outperformance (versus rest of world) has re-accelerated since mid-year

Source: Refinitiv, Wilsons.

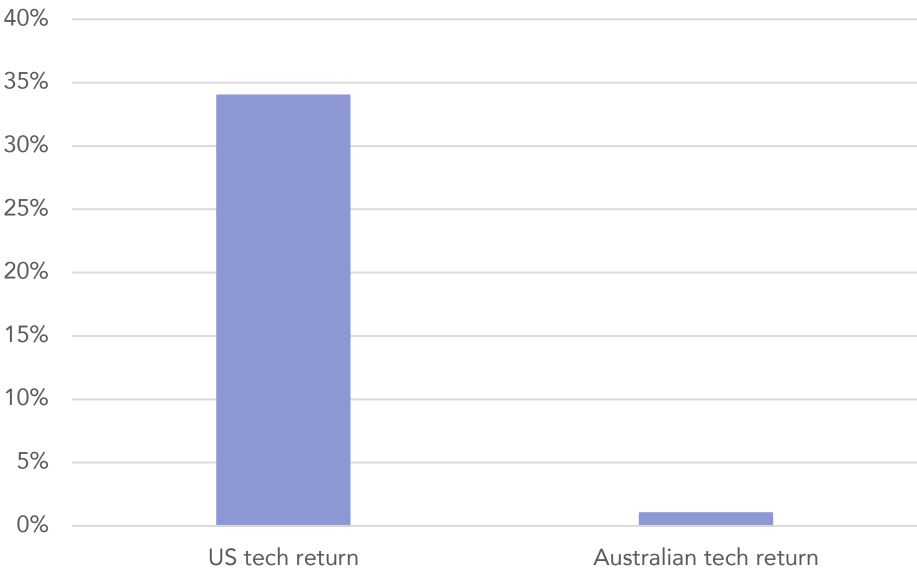
Exhibit 2: US PE premium to rest of world has hit new all-time highs

Source: Refinitiv, Wilsons.

Exhibit 3: The last decade has seen a vastly superior earnings trend for US equities

Source: Refinitiv, Wilsons.

Exhibit 4: US tech has significantly outperformed global & Australian tech in 2021



Source: Refinitiv, Wilsons.

The US Market Continues to Benefit from a Strong Earnings Backdrop

A key point we have been emphasising for some time now is that the US market's stellar run in recent years has not just been about rising multiples. The US market has been underpinned by very strong multi-year earnings performance.

This was once again a key story in 2021, with the US market having now delivered its 18th consecutive month of consensus earnings upgrades.

However, it is interesting that the rest of world has also delivered strong earnings outcomes in 2021, with upgrades in each of the first 11 months of the year.

EPS growth in 2021 is actually significantly stronger in rest of world regions such as the UK and Europe relative to the US (see exhibit 6). Expectations for 2022 look similar for the US versus the rest of world. With the pivot back to US market outperformance over the second half of the year, it appears that either investors think there is less risk (or more upside) in the outlook for US 2022 earnings, or they believe the US secular growth advantage will quickly reassert itself beyond 2022.

While we remain constructive on the US earnings outlook in 2022 and the multi-year outlook, we think the greater leverage in rest of world earnings provides more capacity for an upside surprise in 2022. The current very heavy valuation discount to the US market looks appealing in this context.

US sector skew helping but underlying franchise quality also a factor

The inherent US tilt toward information technology stocks (c40% of the US market) continues to be a performance advantage with US tech (which is now dispersed across the IT, consumer discretionary and communication services sectors) delivering above-market returns. US tech has also outperformed global tech and has performed significantly better than the Australian tech sector in 2021.

US Mega-Cap Tech Doing the Heavy Index Lifting

A fair portion of the US market outperformance can be attributed to its mega-cap (tech) leaders when looked at on an even more granular basis. In 2201 this can be described as the big seven. A theoretical portfolio of the seven largest companies within the US market is up 47% YTD. This means the US market, ex these mega-caps, has delivered around 15%, which is a similar performance to the Australian or European market.

Some commentators have pointed out this lack of breadth as a warning sign for the longevity of the US bull market. Most notably, higher multiple, second-tier tech companies (which includes some very big companies by market cap) have seen big pull-backs this year.

This lack of breadth may be a warning sign, but for now, the US mega-caps backed by ongoing strong earnings growth are keeping US shares resilient.

Exhibit 5: US mega-cap tech has led US performance this year

Company Name	Ticker	Market Cap (US$bn)	YTD Total Return	12mth fwd PE	EPSg FY21	EPSg FY22
Apple	AAPL	2863.9	33%	30.0x	71%	3%
Microsoft	MSFT	2500.9	52%	34.0x	35%	18%
Alphabet	GOOG	1962.9	70%	26.4x	86%	3%
Amazon.com	AMZN	1766.6	8%	68.3x	-2%	26%
Tesla	TSLA	1008.1	51%	124.7x	171%	35%
Meta Platforms	FB.O	917.5	21%	23.2x	38%	2%
NVIDIA	NVID	762.3	144%	60.1x	68%	79%
Mega-cap weighted total return			**48%**			
S&P500 return			**24%**			
S&P "residual" return			**15%**			

Source: Refinitiv, Wilsons

Exhibit 6: Global equities - consensus valuation and earnings growth outlook

	PE (12 Mth expected EPS)	CY21 EPS growth	CY22 EPS growth
US	20.5	50	8
Rest of world	14.7	60	6
Europe	14.8	63	8
UK	12.6	86	4
GEM	12.8	46	9
Japan	15.6	33	8
Australia	17.4	28	4

Source: Refinitiv

What About the US Economic and Policy Backdrop?

US stock market revenues are tilted 60/40 toward the domestic economy, so the performance of the US economy matters for the market. Strong local growth certainly helped the US earnings cycle in 2021.

US economic growth is likely to be a tailwind again in 2022, though the Fed's more hawkish pivot in respect of inflation and policy is introducing some nervousness around the outlook.

Growth has also been good globally in 2021, although it seems the market is currently less confident in the global outlook for 2022 and 2023. This seems to be stemming from a combination of renewed uncertainty around the pandemic as well as the impact of inflation pressure on global monetary policy. Our base case remains for above-trend global growth in 2022, which should be a tailwind for the global earnings cycle.

Europe saw decent economic growth in 2021 despite being book-ended by significant COVID infection waves at the start and end of this year. The pandemic remains a wildcard for Europe. This may partly be why it has been underperforming in recent months. If the pandemic does settle down as a risk factor, it could provide scope for a large catch-up rally for the rest of world versus the US.

In emerging markets, Chinese growth disappointed in the second half of this year, weighing on EM equities in particular. With policy now beginning to be loosened, we expect marginally better China growth in 2022 which should improve sentiment toward EM equities as the year progresses.

The Australian earnings cycle has also been hampered this year by the east coast lockdowns in the third quarter, and the big pullback in the iron ore price as China demand slowed.

We expect Australian economic growth to rebound strongly in 2022, which should provide a tailwind for the earnings cycle. The iron ore call is more difficult though the price has seemingly bottomed as sentiment toward additional Chinese stimulus has improved. We see iron ore as a neutral impact on the domestic earnings cycle in 2022.

2022 Growth Looks Good but Inflation Key Right Now

The US has also led the world this year on upside inflation surprise and this has seemingly pushed the Fed into a more hawkish stance on QE withdrawal. Thus far, this has only caused a blip in the US market at the headline level, and the recent rebound suggests the buy the dip mentality is still strong. The prospect of the Fed lifting rates well before most other major central banks has also buoyed the US$ in recent months with some additional safe-haven buying recently.

The US market could be vulnerable to a more stubborn inflation cycle in coming months. However, any equity weakness is likely to flow across global equity markets and would likely act to put further upward pressure on the safe-haven US$. So, while inflation would send US equities lower in an absolute sense, it is not clear that an inflation-driven risk-off phase would prove a "relative" disadvantage for the US equity market.

A scenario where US equities underperformed the rest of world on a sustained basis would likely be a phase of above-average global growth but moderating inflation fears. This would encourage investors to take a "stronger for longer" view of the expansion, increasing demand for more cyclical sectors and markets while decreasing the demand for safe-havens. We think this is a plausible outcome for the next 12 months, though with the path of both the pandemic and inflation still unclear, it might take some months to come to fruition.

Macro Outlook Cloudy Near-Term but Concerns Should Fade into 2022

Despite a recent wobble around Omicron and a more hawkish Fed, the US equity market has had another extraordinary year pulling well clear of rest of world equities and Australia in recent months.

A solid corporate earnings outlook for US stocks still presents as the key bull point for the US market despite lingering concerns around the US market's premium valuation.

The macro outlook looks cloudy near-term given lingering uncertainties over both the pandemic and inflation. However, our base case is that concerns around both these factors should fade as 2022 progresses. This will ultimately be supportive for the US market in an absolute sense but suggests we keep a moderate preference for the world ex-US on a 12-month view. By implication, this also suggests a preference to value over growth in 2022. We also believe Australia can ultimately eke out a renewed phase of outperformance in 2022, helped by a strong economy and renewed support for the A$.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons Australian Equity Focus List (Focus List) is a weighted list of the Investment Strategy Group's (ISG) preferred companies. The Focus List can hold up to 25 companies, largely taken from the S&P/ASX 300. Stocks may be substituted at any time at the discretion of the ISG. Performance numbers around the Focus List are unaudited, and should be used only as a guide to indicate returns if investors were to follow the Focus List. For further information please contact your Wilsons Advisor.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au