Strategist's Corner
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Why Non-US Equities May Regain Market Leadership

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In brief

- Correlation isn't causation.
- Liquidity doesn't scale.
- Volatility is the market changing its assumptions.

Two pushbacks I get to the view that non-US equities are likely to outpace US equities over the next several years is 1) US economic exceptionalism and 2) overwhelming capital flows into US passive investment strategies. While I think the former is sustainable, in my view, the latter is not. More important, investors may be emphasizing technicals at the cost of fundamentals.

Correlation isn't causation

The United States is outgrowing the rest of the world. In my recent piece, "A New Capital Cycle Is Driving US Exceptionalism," I highlighted the beginning of a long overdue rise in US tangible fixed investment. This spend is driving economic activity, money velocity and pricing pressures at a time when many developed markets face weak growth prospects.

So while I agree that developed market growth prospects may lag those in the US, it's important to recognize gross domestic product and equity market returns represent different things. GDP is a flow. It measures where and how much capital was allocated in the past, not shareholder wealth. While GDP matters, and its direction often positively correlates with stock returns, correlation isn't causation. For example, investors who chased emerging market equities over the past twenty years — due to their superior economic growth compared with developed markets — learned this lesson the hard way.

Equity prices in fact represent the present value of a probability-weighted estimate of future profits — regardless of the region of the world where they are sourced — plus the liquidation value of assets such as property, plant, equipment and intellectual property. So what affects equity returns is valuation, or how much an investor pays for a claim on future profits, which I will circle back to shortly.

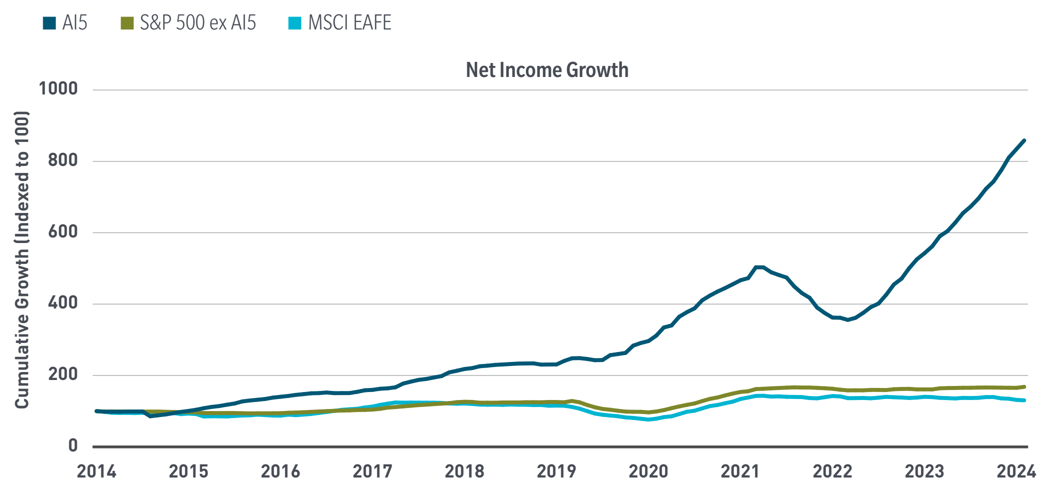
Liquidity doesn't scale

Internet 2.0 began in the early 2000s as technology was transitioning from simple websites with limited interaction to increasingly dynamic applications powered by advances in software and cloud computing. Consistent with other historical periods of innovation, the economic spoils accrued to the small handful of companies that captured massive profit pools. By the mid-to-late 2010s, the network effects these companies created drove a winner-take-all dynamic that sparked a new period of profit concentration in the US and subsequently in benchmark concentration.

Enter artificial intelligence. And as before, investor expectations of profit concentration skyrocketed (as shown in the Exhibit 1 below).

Does this matter in the context of why non-US stocks may outpace US equities? It does, and a lot, I think.

Exhibit 1: Cumulative profit growth over the past decade for AI 5, S&P ex AI 5 and MSCI EAFE



Source: FactSet Portfolio Analysis. Monthly data from 31 December 2014 to 31 January 2025. AI5 (Artificial Intelligence 5) = Amazon, Alphabet, Meta, Microsoft and Nvidia. S&P 500 ex AI5 = S&P 500 excluding the AI5 stocks. Net income is past twelve months.
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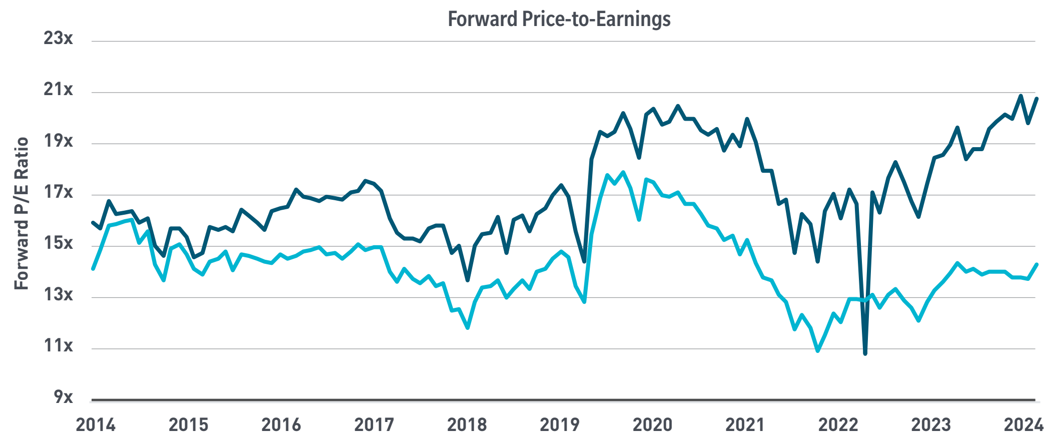
The green line represents net income growth for the remaining stocks in the S&P 500 after stripping out the AI 5 and the bright blue line is the MSCI EAFE. While the US outpaced the MSCI EAFE, a wide valuation gap exists (as illustrated in Exhibit 2 below). I believe one reason for this is that liquidity doesn't scale.

Exhibit 2: Lack of liquidity helps fuel US, non-US valuation gap



Source: FactSet, FactSet Portfolio Analysis. Monthly data from 31 December 2014 to 31 January 2025. AI5 (Artificial Intelligence 5) = Amazon, Alphabet, Meta, Microsoft and Nvidia. S&P 500 ex AI5 = S&P 500 excluding the AI5 stocks. Forward price-to-earnings (P/E) is next-twelve-months. P/E calculated as the weighted harmonic average for S&P 500 ex AI5.
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While every marginal dollar moving into the equity market via passive vehicles has a negligible effect on highly liquid stocks, particularly mega-capitalized stocks, this isn't the case for many of the less liquid stocks in the S&P 495, which has resulted in greater price elasticity because demand has been so great.

As we learned in Econ 101, when demand exceeds supply, the adjustment mechanism is higher prices. Households experienced this with toilet paper and other goods during the initial months of COVID lockdowns. Something similar happened with these stocks, as excessive demand from passive vehicles overwhelmed their liquidity profiles.

This raises a question: What will stop or reverse the flow of funds into US passive vehicles? History has shown that the answer is a change in return expectations for the largest-cap companies in the index.

Volatility is the market changing its assumptions

Unlike with Internet 2.0, where network effects pushed the bulk of profits to a handful of companies, the release of DeepSeek has shown that foundation models are closer to commodity producers than oligopolies with scaling economics. The risk to the S&P 500, and more specifically the AI 5 stocks, is that the market wakes up to this realization and reprices them accordingly.

At the same time, throughout history, technology has largely been deflationary because it has removed bottlenecks and shifted where economic value has been captured. For example, when the printing press was widely adopted, it facilitated the widescale dissemination of information. Economic value shifted from time-consuming handwritten documents to new and larger addressable markets such as mass-produced books, newspapers and more. Of course, over the past 30 years, the internet has shifted economic value again.

This is also important as we think about AI, because whether it becomes a commodity or not, it removes the bottleneck of creation and substantiation and may shift huge profit pools. That will likely have enormous implications for future stock performance of those companies ceding profit share and those taking it. On the taking side, we already see evidence of this in select software companies and solution providers, such as those offering databases and applications. Catching the market's attention are those with AI features that improve customer workflows, deepen the integration of business-to-business processes and expand and improve user experiences.

Conclusion

Not unlike other periods in history, only a few new market leaders will likely capture the lion's share of profits. The equity market has assigned oligopolistic, if not monopolistic, outcomes to a few. This despite declining profit expectations and fears that foundation models are proving more similar than they are different. So where technology gives, it soon takes away, which can upend financial markets as prior assumptions prove false.

When the market begins to discount the future I describe, we may see wildly different performance streams compared with the past 10 years, where passive cedes performance leadership to managers underweight those stocks that lose their oligopoly status.

The second derivative of that will likely be investors shifting, as they typically do, to strategies that have historically navigated this transition better, leading to passive ceding share to active managers. In my view, the consequence of that will be passive vehicles with systematic trading policies putting downward price pressure on less liquid benchmark names, reversing what we saw on the way up. This should bring balance to the valuation disparity illustrated above and help drive non-US equity outperformance.

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