American exceptionalism vs exceptional valuations

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In the post-2008 investment landscape, US stocks consistently outperformed markets globally. For those heavily weighted to the trend, it has been a winning strategy, and one that left dollar-based investors with little incentive to look outside of the US. History has brought us to a point where the US has grown to more than 70% of the developed equity markets and 65% of all equity markets globally.

The key factors that contributed to outsized gains were a confluence of drivers that include:

- the Fed's quantitative easing programme and prolonged monetary stimulus
- the global dominance and growth of the US technology sector
- capital flight from Europe after a series of crises
- the rise of shale oil production
- the strength of the US dollar and its role as the world's reserve currency
- US businesses satiating themselves on an endless supply of cheap foreign goods.

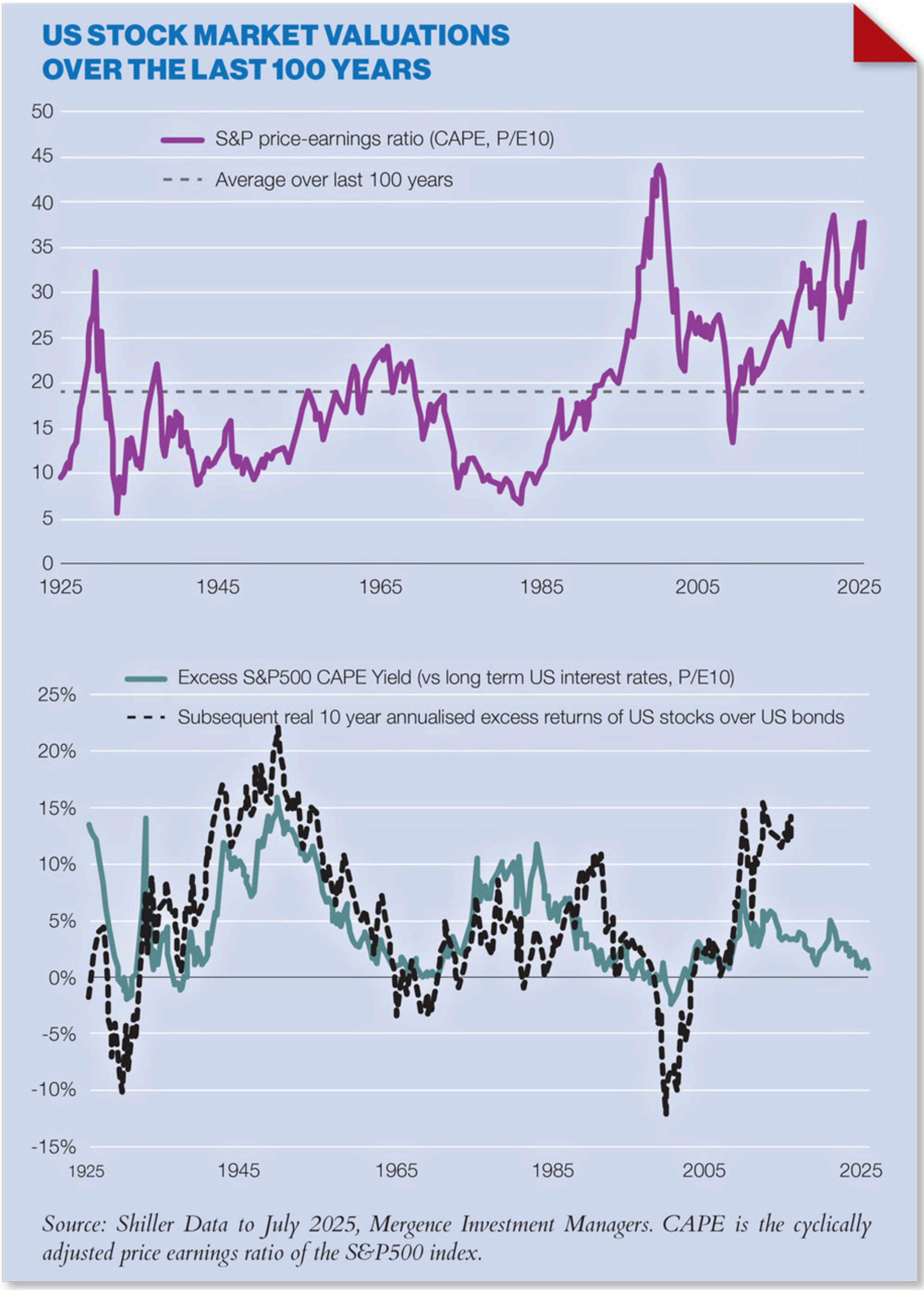
While a few of these are no longer relevant, others are currently being tested by everything from a weaker US dollar to trade tariff uncertainty, the growing unease with US geopolitical strategies, globally accessible crypto currencies, and artificial intelligence competition from China.

Looking to the future, what can we expect next?

The current macro environment is one of persistent uncertainty. Amid diverging global monetary policies and rising fiscal debt levels, historic trade and geopolitical security alliances are being rewritten in real time. These have the potential to amplify macro shocks to both global growth and inflation.

For clearer insights into the potential risks and opportunities, we look to the valuation picture. Our models show that US equities are the most expensive they have been since the turn of the century.

US stock market valuations over the last 100 years



Source: Shiller Data to July 2025, Mergence Investment Managers. CAPE is the cyclically adjusted price earnings ratio of the S&P500.

The CAPE ratio (cyclically adjusted price-to-earnings of the S&P500 index) is now in the high 30s. Over the last 100 years, we have only seen it at these levels during the post-Covid recovery and during the dotcom bubble (chart 1). Additionally, the excess CAPE yield (a measure of the equity risk premium) is among the lowest we have seen over the last 20 years (chart 2).

Today's stretched US valuations are also during a time when macroeconomic uncertainty is higher than in recent history, and growth forecasts, hit by trade headwinds, have been significantly downgraded. The World Bank now expects the US to grow half as fast this year (1.4%) as it did it last year and a large shift from the 2.3% it forecast in January. The bank also adjusted global growth downwards, albeit by a smaller margin of 0.4%, expecting 2.3% in 2025 versus 2.8% in 2024.

The case for continued US dominance of equity markets relies heavily on the assumption of US exceptionalism — the idea that US economic and financial outperformance versus the rest of the world will persist, or as some dream, last forever. This idea has been fully embraced by Trump, as well as the big tech billionaires that have swung right to support him and wave the American flag.

The problem with buying into the performance of nationalism is that leaders and investors risk being blinded. Blinded not just to the risks, but more interestingly, to the lives, hard work, and aspirations of the more than 95% of the world's population that lives outside of the US. We saw a pilot run of this in January this year. Fears about the resilience of US artificial intelligence investments amid competition from China sparked a sell-off of US equities. We may find ourselves in an environment where such volatility is more common, and where a weak equity risk premium will not be adequate compensation to investors.

Global diversification is your friend

Investors should revisit diversification as the long-term benefits are greater than they have been in a long time.

One way of promoting diversification is by employing a systematic multifactor approach, an approach taken in the Mergence Global Quant Equity Portfolio, which launched in January 2024 as a JSE-listed AMC, issued by UBS. The fund seeks to overcome behavioural biases by identifying stocks with the potential for outperformance over different market environments. Essentially what this means is that our models go beyond looking at just value, ie: how cheap or expensive stocks are relative to fundamentals. We research the interaction of multiple market drivers, and score stocks by integrating risk factors like value, quality and sentiment.

What we are seeing is that on a bottom-up basis, even high-quality US stocks look expensive, and global sentiment has shifted. Since late 2024, we have been moving part of our US equity exposure to Europe, Japan, and Asia-Pacific, where we are finding more alpha opportunities.

Additionally, the behaviour of the US dollar and its ability to diversify against shocks in risk-off environments remains a key driver of market performance. Historically a fall in risk assets has been accompanied by a strengthening US dollar. This relationship has recently faltered, and uncertainty and volatility have instead weighed on the currency. A further weakening of the US dollar will likely continue to increase the relative attractiveness of risk assets across Asia and emerging markets.

Reassess your assumptions

An erroneous assumption many investors make is following the "this time is different" narrative while underestimating the risks. Given the historical tendency for valuations to revert to the mean, the probability that the US is going to continue to outpace the world over the next decade is low. Investors should think about how sustainable future gains are. The future, after all, is notoriously hard to predict. We live in an increasingly fragmented world where uncertainty is with us all the time.

At Mergence we manage uncertain futures by looking at the evidence and following a reflective process. We view research as a continuous process that can improve future performance. Each day we gather new information, learn and reassess our assumptions, risks, and opportunities. Our systematic process helps lay the foundation for disciplined investing, helping protect us from the dangers of human nature.

As FED Reserve Chair Jerome Powell said at the 29 January policy press conference: "It is human nature, apparently, to underestimate how fat the tails are… we think of things in a normal distribution and in the economy it's not a normal distribution. The tails are very fat, meaning things can happen way out of your expectations. It's never not that way."

As Powell acknowledges, rare events happen more frequently than people assume, and the world is more unpredictable than simple models suggest. While it is human tendency to assume normal distributions even when data suggests otherwise, for investors, diversification can offer protection in such uncertain times.