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U.S. Economic Exceptionalism

Can the reign continue?

2024 CAPITAL MARKETS FORECAST

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INTRODUCTION

From the Chief Investment Officer



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The close of each economic cycle and the start of the next carry a unique set of circumstances and challenges. From the vantage point of the depths of the decline, the conditions needed to produce a new expansion can appear daunting. This was the case, for example, in the spring of 2020 as the Covid-19 global health crisis took hold and the country experienced peak economic stress and pessimism. Yet a signal feature of the U.S. economy, one that has persisted since World War II, has been its ability to shake off the troubles of the failing cycle and ably power into a fresh expansion. Typically, some combination of demographics, capital formation, policy intervention, and innovation have converged to underwrite each successive chapter of the nation's economic vitality—strength that has given its equity market a significant and sustained advantage over other asset classes.

Indeed, it is this capacity for reinvention and regeneration that best represents U.S. economic exceptionalism. And as its legacy, the U.S., as but one example, has held its share of global gross domestic product (GDP) steady at roughly one-quarter from 1980 to today, even while China and other emerging markets economies have steadily gained share. Contrarily, the European Union and Japan have each seen their contributions to global GDP roughly halved during the same period.¹

Today we find ourselves amid the latest such episode of U.S. dynamism. In this postpandemic moment, even the savviest investors have been impressed by the U.S. economy's ability to deliver economic growth and disinflation that the rest of the developed world can only envy. This economic success has acted as a magnet of capital for U.S. large-cap equities. What's more, U.S. growth since the economy reentered expansion has exceeded that of even China, the first such sustained

We consider the hopeful possibility that technological innovation may play an outsized role in driving productivity gains that could help the country grow its way out of its current tab and power another wave of U.S. equity leadership.

occurrence in decades.² And make no mistake, if not for the leading role U.S. companies played in delivering breakthrough mRNA vaccines, the world may not have found a ready way out of the generationally crippling pandemic.

Looking beyond the medical miracle, the core seed of the present U.S. economic miracle is no secret. Policy intervention in the form of unprecedented fiscal stimulus not only prevented a depression but also, as of this writing, continues to provide ample prosperity to the U.S. consumer. And now, thanks to dramatic shifts in monetary policy and productivity growth, we believe we are well on our way to containing the inflation monster that this excessive fiscal spending begat.

Based on the foregoing, the reader could be forgiven for concluding that all is well in the house of U.S. economic primacy—that this latest manifestation of exceptionalism has the U.S. solidly and sustainably positioned to again extend its global economic dominance. Sadly, however, the picture is incomplete. The gargantuan federal spending unleashed during the Covid shutdowns and afterward has failed to retreat to sustainable levels. At the same time, the federal income statement is now staring down a debt service burden that threatens to crowd out vital needs, such as education, foreign investment, and even defense outlays. What's more, the political establishment seems unable to shake its deepening dependency on unfunded spending.

The related federal ills of inveterate deficit spending and total debt well in excess of annual GDP,³ coupled with today's elevated interest rate environment, now seriously imperil the virtuous cycle of U.S. economic exceptionalism and equity outperformance. In this year's forecast, we carefully examine these risks. We consider the hopeful possibility that technological innovation, particularly in the U.S.-dominant arena of artificial intelligence (AI), may play an outsized role in driving productivity gains that could help the country grow its way out of its current tab and power another wave of U.S. equity leadership. Despite the structural risk to long-term U.S. prosperity, we continue to see the appeal of allocating to U.S. equities, while also appreciating the time-tested benefits of diversification. Last, we dimension how to best mitigate today the long-term investment risk of a possibly retreating U.S. economy tomorrow.

THEME I

The makings of U.S. economic exceptionalism

The makings of U.S. economic exceptionalism

The U.S. has maintained a roughly **20%–25%** share of the world economic stage over the past 50 years.

The rise and fall of economies

Crack open a series of macroeconomics textbooks describing the causes of economic growth and you are unlikely to find much differentiation. Economic growth comes from accumulation of labor and capital. Early-stage economies grow faster than more mature ones. Long-term economic growth is derived from technological growth, a crucial element of long-term success. Those seemingly simple concepts can explain dramatic achievements. The post-World War II economic boom in the U.S. rode a wave of technological progress and capital investment, driving real growth of 4.5% during the 1960s.¹ It also led to the well-known baby boom that provided labor force growth for decades to come.

The fundamentals of economic growth can explain the ascent of other economies too. Japan's post-war economic miracle was stronger than that of the U.S., with growth registering rates above 7.5% from the 1950s to the 1970s.² The math was "helped" by a low base, in the sense that Japan's economy was decimated by the war, so the initial rebuilding generated large growth figures. But the growth of capital investment and technological innovations continued through the 1980s. In a dazzling performance that decade, Japan's auto industry reached a level of dominance that prompted a trade dispute, leading Japan to voluntarily restrict its shipments to the U.S. to avoid legal trade barriers.³ By 1990, 64% of Americans⁴ viewed investment by the Japanese in the U.S. as a threat to American economic independence.

The surge of China as an economic superpower in the past two decades was similar. After joining the World Trade Organization (WTO) in 2001, the "Dragon" grew over 10% on average until the global financial crisis (GFC) and continued to post growth above 6% until the pandemic.⁵ It was powered by massive state-led investment in capital, as well as a growing and well-educated labor force. The economy multiplied more than fivefold,⁶ carrying it to its status as the world's second largest, behind only the U.S. In echoes of the Japan experience decades earlier, the economic might of China generated fears in the U.S., with one crystallizing and symbolic episode being when a Chinese insurance company bought the famed Waldorf Astoria hotel in 2014.⁷

On the flip side, the fundamentals can also explain why economies fall from grace. Japan's slowdown was triggered by a real estate bubble in the early 1990s,⁸ but that isn't sufficient to explain the multidecade rut of slow growth and deflation. This stemmed from the peaking and subsequent decline in population and labor force, a key pillar of growth. That China's economy was slowing before the Covid pandemic and now looks to be teetering⁹ is also partly attributable to the relatively mundane topic of demographics. Additionally, both Japan and China racked up significant government debt loads, hamstringing Japan's fiscal options in the 1990s,¹⁰ and the same is arguably true for China today.

Figure 1

Drivers of economic exceptionalism

Ranking by country

		Growth pillars					Policy framework			Innovative capacity	
		Capital markets	Infrastructure	Demographics	Education	Labor flexibility	Fiscal state	Fiscal responsiveness	Ease of doing business	Digital infrastructure	Research and development
United States		6	5	8	1	1	14	1	3	2	4
International developed markets (EAFE)	Japan	9	14	21	10	10	16	4	9	14	8
	United Kingdom	13	13	12	2	7	13	2	5	10	6
	France	15	10	17	6	12	15	7	13	13	12
	Switzerland	4	1	15	11	14	3	10	2	4	1
	Germany	18	8	16	7	16	9	5	11	12	5
	Australia	11	11	6	3	4	6	3	6	9	12
	Netherlands	14	4	13	5	7	8	6	10	5	6
	Denmark	7	2	9	12	2	1	17	4	1	11
	Sweden	8	3	10	9	3	n/a	15	8	3	1
	Hong Kong	1	7	20	14	15	n/a	n/a	1	7	15
Emerging markets (EM)	China	16	12	14	8	20	n/a	14	21	11	9
	Taiwan	5	6	18	13	4	5	n/a	7	8	9
	India	12	17	2	19	17	n/a	16	17	16	16
	South Korea	10	9	19	4	10	4	11	12	6	3
	Brazil	17	18	5	18	19	11	9	18	19	18
	Saudi Arabia	2	15	7	17	21	2	18	16	15	17
	South Africa	3	21	1	16	6	12	12	19	21	19
	Mexico	21	20	4	20	9	10	19	14	20	20
	Russia	20	19	11	15	18	n/a	13	20	17	14
	Indonesia	19	16	3	21	13	7	8	15	18	21

Highest ranking

Lowest ranking



Data sources and methodology detailed in the Appendix.

Economies that delivered the most stimulus in a way that did not impair labor flexibility best weathered the crisis. However, that comes at a cost, as it was financed via borrowing and impairs the fiscal state.

The undeniable truth is that the U.S. has been the outperformer among developed economies for the past half-century. The U.S. has maintained a consistent share of the global economy, roughly one-fifth to one-quarter, while other major developed economies have steadily lost share to the faster-growing emerging markets. But even those more quickly accelerating markets have lost out to the U.S. in terms of equity market performance over the past 15 years.¹¹

Dimensioning the U.S. and world economies

We construct a framework to systematically examine the components of capital, labor, and technology growth across the largest global economies. Additionally, there are critical considerations for the Covid pandemic, such as labor flexibility, fiscal responsiveness, and the fiscal state using three broad components: *growth pillars*, *policy framework*, and *innovative capacity* (Figure 1).

We view *growth pillars* as a collection of prerequisites, or table stakes, to compete in the global economy. Each of the subcomponents is important, though we do not address all of them with the same level of detail in this report. Infrastructure is critical for the production, shipment, and delivery of goods and services. Capital markets take the pulse of a country's ability to attract investment, and for demographics, we consider the degree to which retirement-age citizens are dependent on the work efforts of the younger population. In education, we place the greatest importance on higher education and public spending as a share of the economy. Labor flexibility is a combined measure of two considerations, the first being workers' ability to switch jobs, unencumbered by labor market rigidities, such as non-compete contracts or licensing requirements. The second is firms' ability to hire and fire, to create or destroy jobs, impacted by restrictions ranging from unionized labor to labor laws.

Policy framework is crucial for gaining and maintaining a competitive edge, in our view. As we describe here in Theme I, the fiscal responsiveness of economies was a key driver of relative performance during the pandemic and in the years since. Economies that delivered the most stimulus in a way that did not impair labor flexibility best weathered the crisis. However, that comes at a cost, as it was financed via borrowing and impairs the fiscal state, which is each country's debt-to-GDP ratio. On a forward-looking basis, that reduces an economy's ability to support growth in future times of need and also drives up sovereign borrowing costs, hurting private capital expenditures. This echoes the experience of Japan three decades ago, and possibly China today.

The final category, *innovative capacity*, has been paramount in the pandemic, and will become only more important going forward. This is where the rubber meets the road, so to speak, as it drives technological improvement and productivity. Economies with strong digital infrastructure that devote resources to research and development are well placed to compete globally. That has always been the case and has been especially true in the pandemic era that required small and large businesses alike to adapt to a more virtual environment. It is already creating advantages in the race to develop and implement AI, which we believe will be a key growth driver going forward.

The worsened fiscal state will also pose challenges to long-term growth as tax revenues increasingly cover interest payments, and as higher interest rates deal a blow to private capital investment.

How they stack up in 2024

The overall rankings help explain U.S. economic exceptionalism (Figure 1). While the U.S. does not rank highest in all categories, it performs best on average across the board. This largely accounts for why the U.S. showed such dynamism and outperformance in the decade between the GFC and the onset of Covid, and also why it navigated the pandemic better than nearly all others.

Within *growth pillars*, the rankings show the U.S. in the best position, followed by EAFE (Europe, Australasia, and the Far East) countries and then emerging markets (EM), with some exceptions. Although the U.S. has by far the deepest capital markets of any major economy, on a relative basis there are a handful of countries that rank higher, including Hong Kong, Saudi Arabia, South Africa, Switzerland, and Taiwan. These are generally small, export-heavy economies that attract higher capital relative to GDP.

The U.S. ranks highest in education and labor flexibility, which have been critical thus far in the recovery. As home to many of the world's leading universities,¹² the U.S. draws top-level students from around the world, often retaining them to push the boundaries of new, dynamic sectors such as health care and technology. The long-term advantages in education have worked hand in hand with the *innovative capacity* categories to build a U.S. tech sector that is the envy of the world, in our view. This capacity to innovate has enabled dynamism and swift technological change over the past two decades, and especially when Covid struck. The U.S. is already showing its early dominance in the development and implementation of AI, and we expect that to continue.

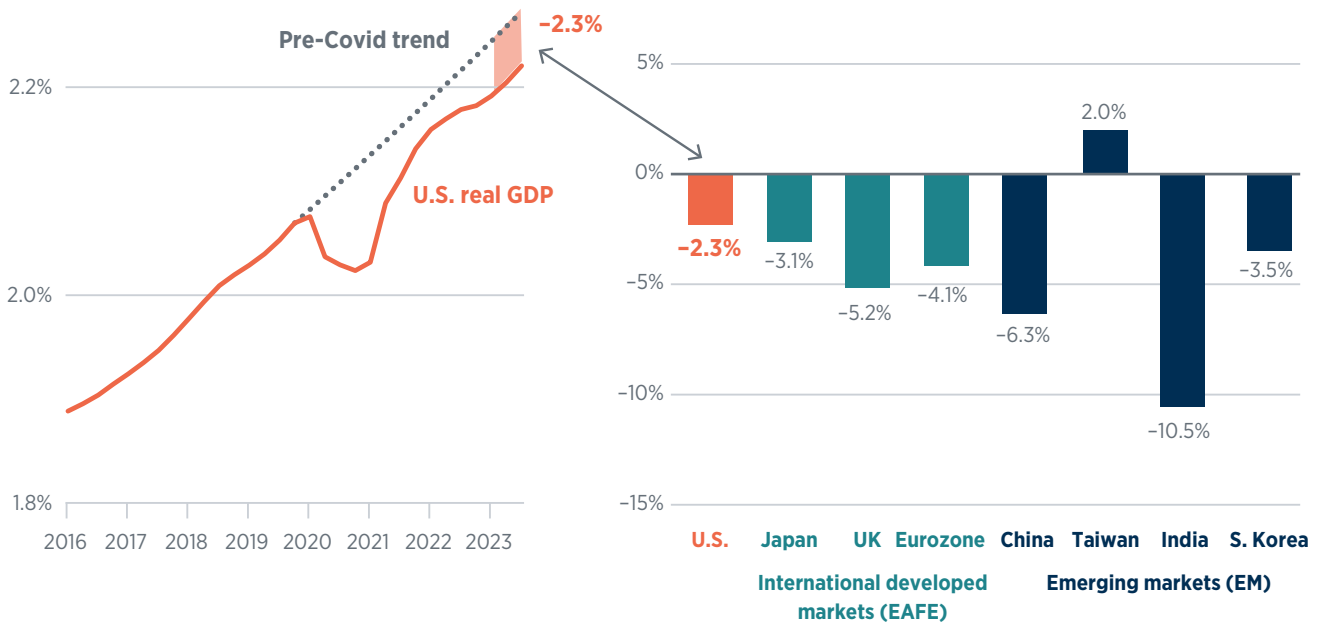
The *policy framework* categories are likely the largest differentiators for the recent Covid experience and, we believe, they will continue to be of paramount importance going forward. Many a nation has fallen under the burden of debt, and the main risk to U.S. dominance comes from its fiscal state. The generous—perhaps overly so—fiscal support during the pandemic has worsened the fiscal position and, by extension, its ability to support the economy through future rough patches. The worsened fiscal state will also pose challenges to long-term growth, as tax revenues increasingly cover interest payments, and as higher interest rates deal a blow to private capital investment. The developments and policy decisions related to these pillars will determine whether the U.S. can hold on to its position of dominance, or perhaps be dethroned in the coming years.

Drivers of post-Covid exceptionalism

The drivers of economic exceptionalism were in place ahead of the pandemic and put the U.S. in prime position to outperform when Covid struck. The pandemic was indiscriminate in the ravage it brought to global economies and health systems. All economies were hit hard, and all received some degree of support. But the U.S. recovery was quicker due to its dominance in three key categories: *fiscal responsiveness*, *labor flexibility*, and *innovative capacity*. The result is an economy that has outshone the rest of the world in the face of seemingly insurmountable challenges.

Figure 2

Relative economic performance during and after the Covid pandemic
Divergence from trend economic growth



Data as of September 30, 2023.

Sources: National statistical agencies of each country via Bloomberg, calculations from Wilmington Trust Investment Advisors, Inc. (WTIA).

Calculated from quarterly real GDP on a four-quarter average basis. Trend is calculated as the five-year average growth rate from 2015 to 2019.

U.S. economic outperformance is illustrated in Figure 2, which compares GDP growth through the third quarter of 2023 in the largest economies to their respective long-term trends. Among those shown, only Taiwan—which has benefited significantly from the surge in demand across high-tech and semiconductor industries—is above its trend. The U.S. is next best at just 2.3% below. There are three key reasons for the U.S.’ overall outperformance: First, it employed larger fiscal stimulus than most other economies in response to the pandemic, and it was more targeted toward income and consumption. Second, its labor markets were relatively more flexible, giving firms more leeway to deal with the shock. And third, innovation in the face of the pandemic was paramount for outperformance after the initial shutdowns and reopenings, leading to multiple years of strength.

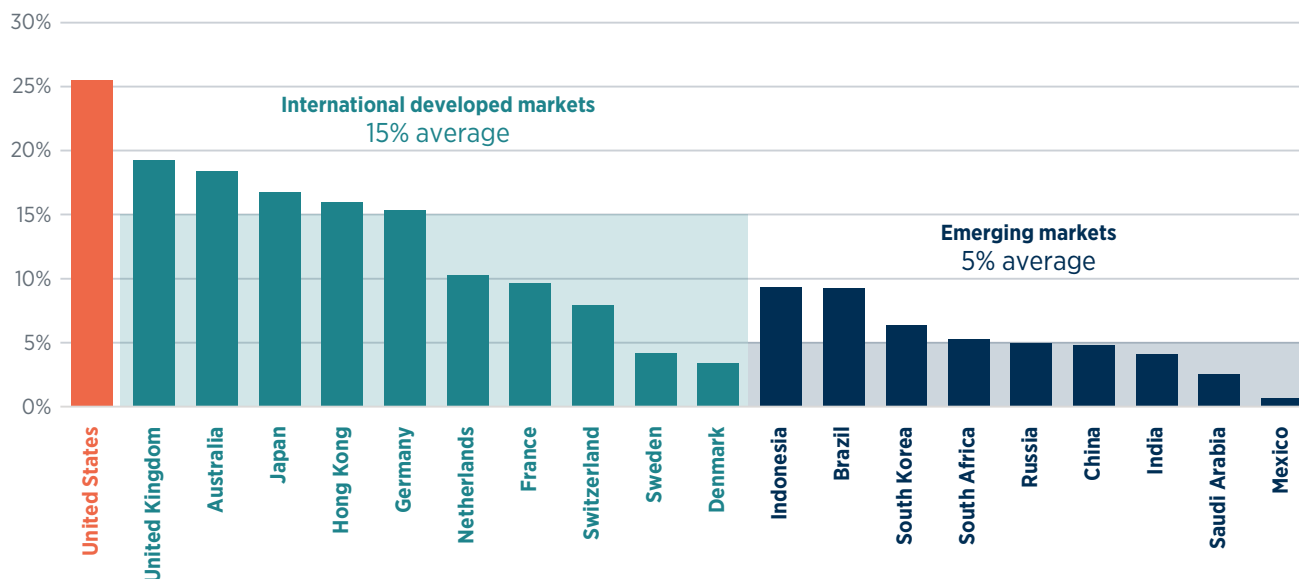
Fiscal responsiveness

The starkest difference between regions from a policy standpoint was the size and nature of direct stimulus in the immediate aftermath of the pandemic. The U.S. response exceeded all others with \$5.3 trillion in new spending, acceleration of existing spending authority, and tax relief, amounting to 26% of GDP.¹³ Much of that was spent in the pandemic year of 2020, but one round was not enacted until 2021 and the impacts are still being felt today. No other country in our framework extended such significant help, with all others below 20% (Figure 3). International developed countries were next highest, with the UK doling out support equivalent to 19% of the economy and Australia hitting 18%. But as a group, international developed economies spent an average of 15% of GDP, well below the U.S. level. EM countries were thrifty in comparison, providing direct fiscal support of just 5% of GDP.

Figure 3

U.S. led all others in pandemic fiscal support

Direct fiscal spending and tax relief as a share of GDP in response to the Covid-19 pandemic



Data as of October 31, 2021.

Sources: International Monetary Fund, WTIA.

It was not simply the magnitude of fiscal support that cushioned the economic damage, but also the implementation. The evidence suggests fiscal measures were more effective in countries that focused to a greater extent on supporting income and consumption. As is well known, the U.S. response included multiple rounds of Economic Impact Payments, more commonly referred to as stimulus checks, that totaled \$814 billion¹⁴ and went directly into the pockets of consumers. Japan’s response was one of the largest, and the majority of non-medical spending¹⁵ was in the form of cash payments to all residents, rent relief for low-income families, payments to small to medium-sized businesses (SMBs), wage subsidies, and vouchers to encourage domestic spending. Germany’s support was sizeable and appears to have been effective but tilted a bit more toward investment for longer-term growth. That included investments in the digital and clean energy areas, intended to be transformative while providing stimulus.

In other countries, particularly in EM, the fiscal response took a less direct form. China’s direct spending and tax relief was restrained on a relative basis, amounting to just 5% of GDP and less concentrated on getting funds into the hands of individuals and businesses. There was accelerated disbursement of unemployment insurance,¹⁶ expansion of eligibility to migrant workers, and tax relief, but no direct payments. Some portion of spending was instead targeted for longer-term investment projects. Similarly, India provided income support to low-income households and low-wage workers, but no direct payments to the broader population. Instead, there was public investment and also support programs for specific sectors.

Our rankings show the U.S. as the leader in labor flexibility, reflecting the greatest ease for workers to switch jobs, and also the ability of firms to restructure their labor force as needed, eliminating positions and creating new ones.

Although the fiscal response was an important differentiator in weathering the pandemic for the U.S. and other countries, it has at least two negative impacts. First, while it supported spending as we described earlier, the Covid-induced supply shock environment also contributed to inflation, the taming of which is still under way. Second, as we discuss in Theme III, the larger the debt-financed stimulus, the more damage done to a country's overall debt position. The U.S. is set to keep running fiscal deficits well above pre-Covid levels despite economic strength.

Labor flexibility

Labor markets represented a second key differentiator in this cycle, making some economies more dynamic than others. The most notable difference came from policies enacted in response to the pandemic, which differed by country.

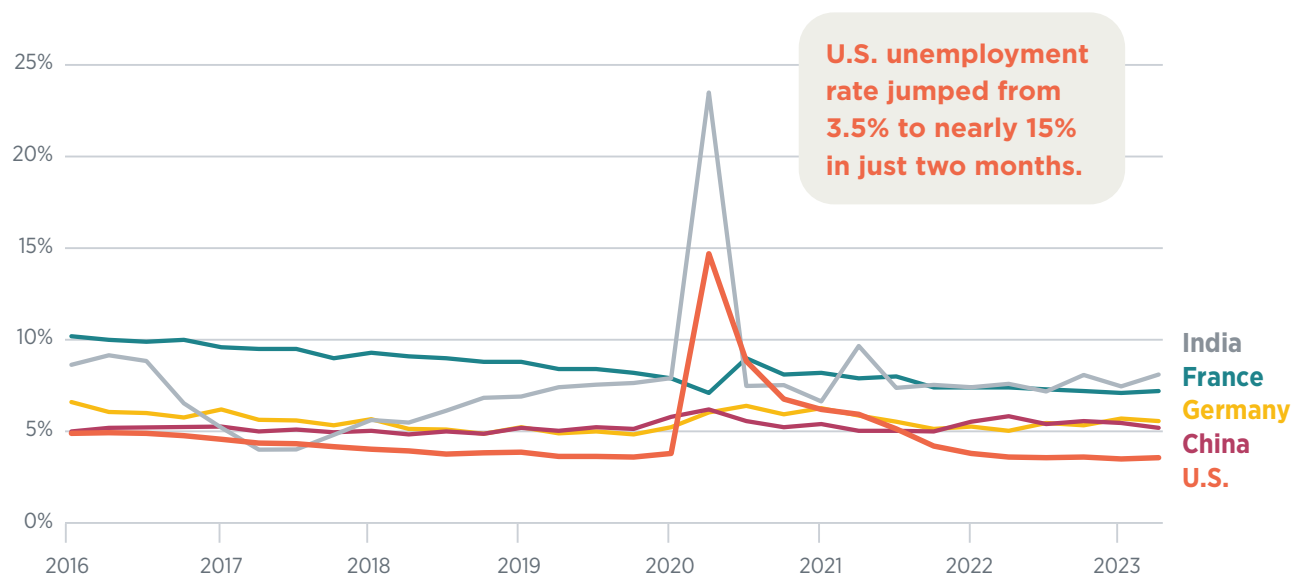
The U.S. was well positioned before the shock. Our rankings show the U.S. as the leader in labor flexibility, reflecting the greatest ease for workers to switch jobs, and also the ability of firms to restructure their labor force as needed, eliminating positions and creating new ones. The next most successful countries include from EAFE the non-eurozone European countries of Denmark and Sweden, as well as Australia (EAFE) and Taiwan (EM). Notably, the heavyweights of the eurozone that are well known for rigid labor market policies, especially France, rank much lower. The U.S.' flexibility positioned it best to deal with the rapidly changing labor market demands that Covid would bring, followed by EAFE and then EM.

As the pandemic hit, policies were enacted that further affected labor flexibility. The aforementioned U.S. stimulus to support consumption by way of stimulus checks—and not tied to labor market experience—totaled \$814 billion. Another \$653 billion was extended¹⁷ through three different unemployment insurance (U/I) programs to cushion the blow for those who lost jobs. The generosity of the programs famously, or perhaps notoriously, meant that many workers had strong incentives to remain out of work until the expiration in September 2021. Whether these will be judged in hindsight to have been good policy or not, the short-term impact was to support incomes and consumption for those who lost jobs and critically did not require firms to keep individuals on payrolls.

Figure 4

Labor flexibility varied greatly by country

Unemployment rate



Data as of September 30, 2023.

Sources: National statistical agencies.

The flexibility for U.S. firms to let go of workers was reflected in the unemployment rate (Figure 4) that jumped from 3.5% to nearly 15% in just two months. After the initial shutdowns, it dropped quickly but still registered 6.7% at the end of 2020, nearly double what it was beforehand.

Contrast that experience with labor markets in Europe, where unemployment rates barely budged despite similar economic lockdowns. This is because many EU countries utilized short-term work¹⁸ (STW) programs, which provide wage subsidies during economic or industry-specific slowdowns. Germany's STW program, *Kurzarbeit*, attracted great attention¹⁹ during the GFC for its success in mitigating labor force disruption, and became a model for other European countries. Labor markets in Europe were also getting hit hard by the pandemic, but STW programs prevented the disruption from showing up as unemployment.

When considered together, European countries experienced larger hits to the labor market than the U.S. In France, more than one-third of workers were either unemployed or on an STW program in the initial months of the pandemic. The figure was close to 30% in Italy and Spain, and nearly 20% in Germany.²⁰

The labor policy differences between the U.S. and Europe have likely already given the U.S. an advantage in the years since the pandemic as a result of higher productivity. Measurement is challenging and not consistent across economies, but a vast body of research supports more flexible labor markets as leading to higher productivity. The European STW programs were well intentioned and effective at keeping people in their positions, but also put an effective freeze on firms' abilities to retool in the face of a new normal. U.S. firms were freer to adapt and rehire as needed, and they have outperformed as a result.

EM economies were similar to the U.S. both in that they did not offer STW programs, and also in that they obscured the visibility of unemployment's impact on the labor market. India's jobless rate tripled from roughly 8% to 24% as the government's meager overall stimulus effort gave just some mitigating unemployment compensation to low-income workers.²¹ China's unemployment rate curiously moved only a percentage point from 5.2% to 6.2%. The most plausible explanation is a massive drop in the labor force, as those who drop out cannot be counted as unemployed. The drop was especially concentrated among migrant workers, some of whom were stranded in their hometowns for Chinese New Year.

Innovative capacity

The third key component that differentiated economic performance in the cycle has been the scale of innovation. The obvious immediate impact of the pandemic forced businesses to innovate quickly, rethinking how to interact with customers and execute transactions as well as deliver goods. Economies that were well placed to innovate and implement did exactly that.

There was a global effort by the pharmaceutical industry to fight the disease directly through treatment and vaccination. The U.S. was the key contributor to the development of the breakthrough mRNA technology and also among the leaders in deploying vaccines to its populace. That bolstered both economic output in the direct sense by the pharmaceutical sector, and enabled the rest of the economy to get back to work.

Outside of the pharma sector, the first move for any business was to accept online payments. Credit card data for SMBs show the rate of first-time online payments tripled in 2020.²² The ability to adapt paid off for those making the change. SMBs able to accept online payments experienced a 5% increase in sales as well as 4.5% higher growth in transaction volume compared to peers. Innovation not only led to a shift to online but also to stronger business creation and increased entrepreneurship. The number of new SMB retailers launched in 2020 was one-third higher than in 2019.

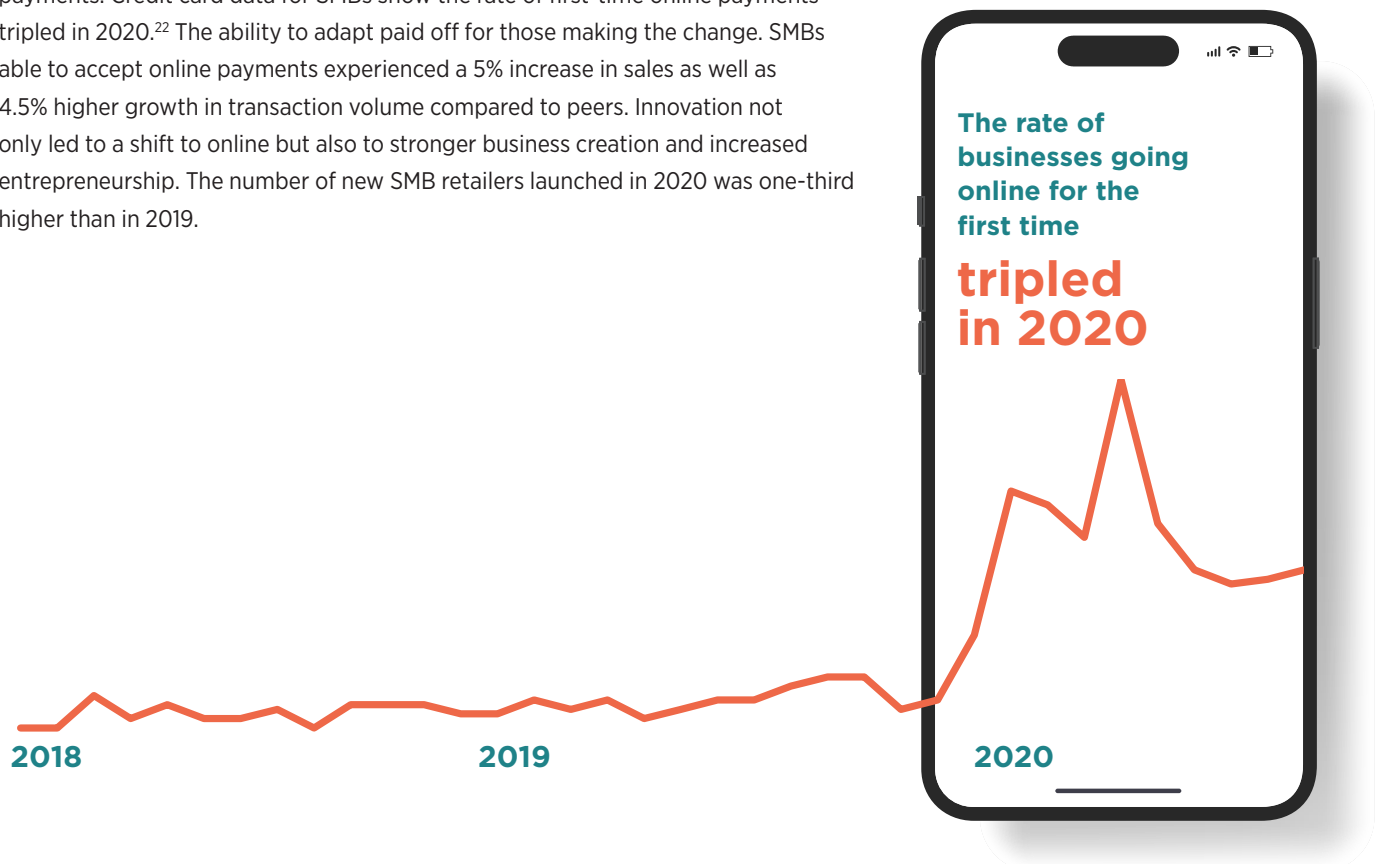


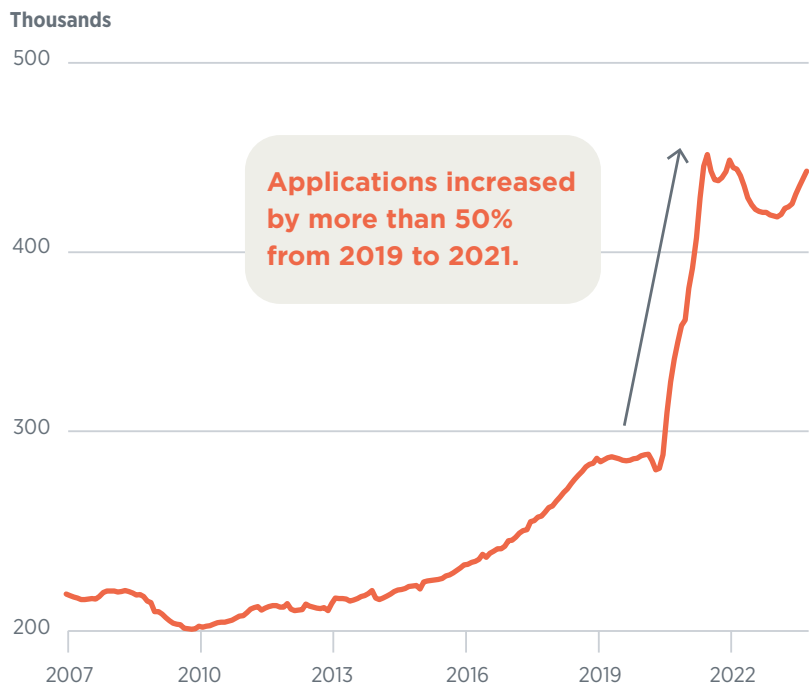
Figure 5

New business creation surged in the pandemic and remains high

Small and medium-sized business formation by country (2020 vs. 2019)

UK	+101%
U.S.	+86%
Australia	+73%
Germany	+62%
France	+40%
Japan	+38%
Brazil	+35%
Mexico	+13%
South Africa	+13%
Indonesia	-2%
Russia	-10%

U.S. applications for new business



Data as of August 30, 2021.

Source for table: [Recovery Insights: Small Business Reset](#), Mastercard Economics Institute.

Source for chart: U.S. Census Bureau.

As detailed earlier, the U.S. and EAFE economies rank highest in the critical innovation criteria, with the U.S. ranking second, behind only Switzerland. Data show new business formation in the U.S. surged during the pandemic. After hovering below 300,000 per month for a decade, the figure climbed quickly at the onset of the pandemic, reaching 450,000 in December 2021, and has remained above 400,000 per month since (Figure 5). Standardized international data on business formations are not available, but estimates of new SMB formation show only the UK exceeded the U.S. during the pandemic.

Looking ahead

We expect the U.S.' competitive advantages to power continued outperformance over the next 12 months, though there are clear risks on the horizon. While the economic impact of fiscal stimulus is waning, the bridge that it built for the economy prevented more serious scarring and was the major differentiator for the U.S. compared to other economies. Although the large stimulus also generated inflation, nearly all economies were beset by price pressures due to the global supply shock.

We also expect greater labor flexibility to benefit the U.S. in the coming year. Although disruptive for workers, the U.S. system encouraged firms to retool their operations for the postpandemic economy. European economies suppressed labor market churn with STW programs that kept workers tethered to their pre-Covid employers. And structurally, many European economies and Japan discourage the dismissal of workers, making them less dynamic. The U.S.' structural advantages supporting innovation and dynamism remain and could boost its fortunes relative to EAFE and EM economies over the next 12 months.

AI should continue to be pivotal, in our view. Much as the development of the personal computer and internet technologies drove monumental change for economies, AI is likely to do the same. The U.S. is already in the lead. For the economy, AI is projected to backfill a slowing labor force driven by aging demographics, a key risk we discuss in Theme III. We anticipate AI technology will drive productivity, which will in turn support higher real incomes while also keeping a lid on inflation. Economies that take the lead in AI development and implementation are the most likely leaders in the next decade.

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THEME II

U.S. stock market superiority

U.S. stock market superiority

For the last 35 years, the U.S. equity market has outperformed the rest of the world by an average of more than 5% annualized.¹

Economic performance can be a powerful but non-exclusive predictor of equity market returns. The U.S.' economic dynamism has contributed to an impressive track record for U.S. equities in contrast to other regions. For the last 35 years, the U.S. equity market has outperformed the rest of the world by an average of more than 5% annualized.¹ The relative size of the U.S. market has grown as a result, attracting investor capital and increasing to 68% of global market capitalization.²

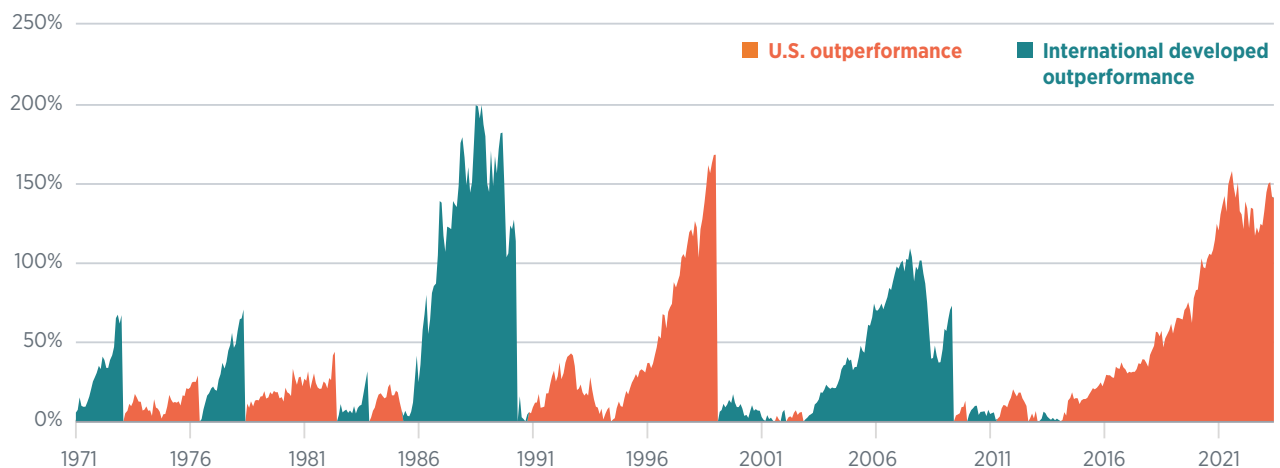
Long-term outperformance does not mean dominating every period, and there have been several multiyear runs of acute U.S. equity underperformance—as well as a prolonged term in which U.S. stock growth was outpaced by the likes of China and other emerging markets. This is critical to remember when constructing portfolios. However, over time, the U.S.' economic strength has translated into higher valuations and profitability than the rest of the world. Will the exceptionalism of U.S. equities continue in the near term, or is this a case of a leadership streak set to revert soon (Figure 1)? In this theme, we analyze the drivers of U.S. equity superiority—all of which tie to pillars of the U.S.' economic leadership—and explore whether they will persist.

While U.S. equities have outperformed on average over a prolonged chapter, the most recent stretch of consistent U.S. outperformance began in 2007, a time that encapsulates two of the deepest global recessions, extraordinary monetary policy experiments, and massive technological change. Since then, U.S. equities have outperformed their non-U.S. counterparts³ by nearly 7% per year, due to

Figure 1

Equity leadership has rotated over time

U.S. vs. international equity cumulative outperformance cycles



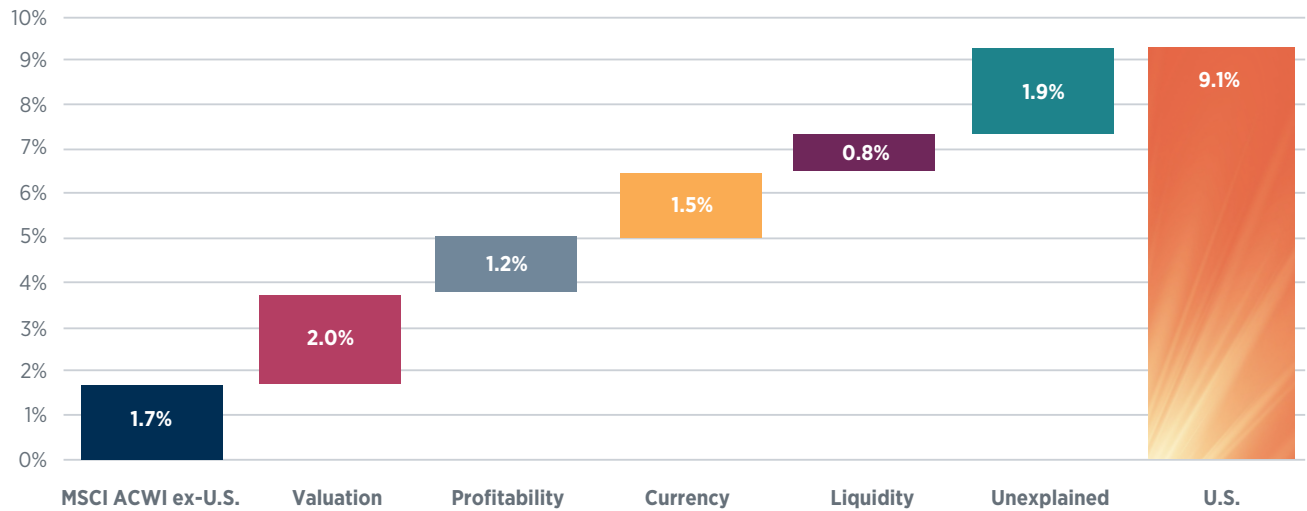
Data as of October 31, 2023.

Sources: Macrobond, WTIA. U.S. equities represented by MSCI USA index and EAFE equities represented by MSCI EAFE index. Both indices are measured as net total return on a monthly basis. Regime change is determined when there is sustained outperformance of one region over the other for a cumulative 12 months. Investing involves risks and you may incur a profit or a loss. Past performance cannot guarantee future results.

Figure 2

Breaking down U.S. equity outperformance

Return attribution of S&P 500 vs. MSCI ACWI ex-U.S. by variable (2007–2023)



Data as of September 30, 2023.

Sources: Bloomberg, WTIA.

Uses monthly total return data with a two-month smoothing factor in a regression beginning November 30, 2007, through September 30, 2023. Measures the difference between annualized returns of the MSCI ACWI ex-U.S. Total Return Index and the S&P 500 Total Return Index. The explanatory variables are measured by the monthly change in the following: Valuations are a blend of price-to-earnings and price-to-book; profitability is a blend of margin expansion and earnings per share growth; currency is the U.S. dollar index spot rate; and liquidity is the M2 money supply. “Unexplained” represents the part of the regression not captured by the other four variables. Investing involves risks and you may incur a profit or a loss. Past performance cannot guarantee future results.

many of the factors described in Theme I. Analysis of U.S. equity outperformance could be accomplished covering many different time periods, as U.S. equities have outperformed non-U.S. equities on an annualized basis over much longer stretches of time than just the past 16 years. Our analysis focuses on the stage beginning in 2007, as not only is this the most recent phase of sustained outperformance, but also because it is emblematic of structural shifts in the U.S. economy related to innovation. We evaluate the factors intrinsic to this era of economic dynamism—factors we expect to continue in the years ahead.

To more precisely understand the sources of U.S. equity dominance, we used statistical regression to isolate variables that best account for the differential between U.S. and non-U.S. equity returns. Our results indicate the bulk of the outperformance can be attributed to “buckets” that all relate directly to economic resilience: valuation expansion, profitability, currency, and liquidity (Figure 2).⁴

Valuation

The largest source of U.S. equity outperformance we identify is relative valuation expansion. At the end of 2007, U.S. and non-U.S. equities traded at roughly the same forward price-to-earnings multiple.⁵ Fast-forward to today, and U.S. equities trade at a 50% valuation premium to non-U.S. equities (Figure 3).

Valuations represent what an investor is willing to pay for expected future earnings and can be correlated with everything from interest rates to irrational exuberance. The latter could certainly have been a contributor over the last few years and could pose a risk going forward (to be explored more in Theme III). We also see the valuation expansion of U.S. equities as warranted by the U.S.’ dominant position in innovation, as well as the swift and dramatic policy response relative to other countries in the aftermath of the past two recessions, all discussed in Theme I.

U.S. innovation has fostered the growth of technology companies, which comprise 28% of the S&P 500, up from 16% in 2007 and higher than any other major market.⁶ Faster-growing technology companies tend to command a valuation premium because of the potential future earnings growth and fatter profit margins. This valuation premium is particularly evident today due to two structural changes in the market: technology and interest rates.

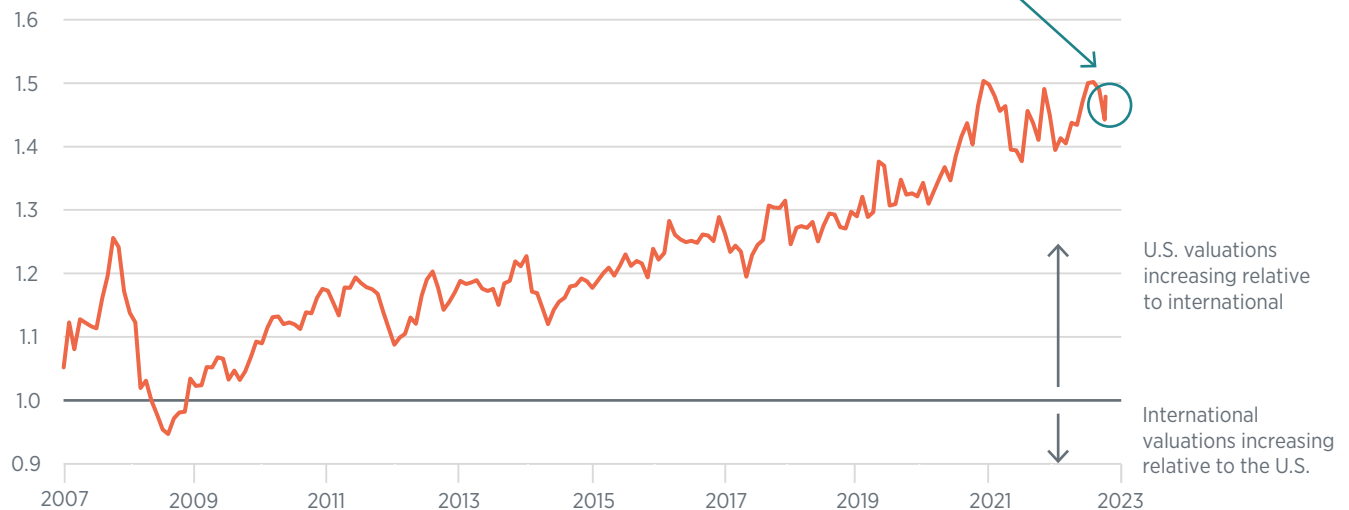
First, many of the largest, most successful technology companies have shifted their business models to rely less on hardware and more on software as a service (SaaS), making their revenue less cyclical. Apple is a perfect example, with the tech behemoth continuing to innovate in its hardware business (mostly phones, tablets, and wearables) but growing its app store and services revenue from 10% of total in 2015 to 25% today.⁷ Even Nvidia, a leader in the most cyclical of technology industries—semiconductors—is rolling out a slew of AI-related services to increase its SaaS business.⁸ Generally, investors are willing to pay extra for the steadier, more predictable, and “stickier” stream of earnings that tends to come from subscription-based models.

AI is also changing the game when it comes to determining what a company is worth. This is a technology that significantly advantages companies with scale and deep pockets due to the amount of data and spending required to make AI algorithms accurate yet also accessible to the average person or business. So far, U.S. mega-cap tech companies hold a considerable advantage in AI development, with Chinese companies like Baidu, Tencent, and Alibaba representing the strongest competition. In some cases, as in the production of chips for use in AI, the technology is so sophisticated and niche that only a couple of players exist in the market and therefore are claiming a valuation synonymous with a monopoly

Figure 3

U.S. valuation expansion relative to non-U.S. equities
Ratio of S&P 500 and MSCI ACWI ex-U.S. next 12 months P/E

U.S. equities trade at roughly 50% valuation premium to non-U.S. equities



Data as of October 6, 2023.

Sources: Bloomberg, WTIA. Chart shows the price-to-earnings (P/E) ratio based on estimated earnings over the next 12 months.

With the eventual size of the AI market opportunity yet to be determined and so much uncertainty around the full long-term potential, what seems to some to be exorbitant valuations could end up being reasonable based on earnings growth over the next five to 10 years.

on that part of the market. U.S.-headquartered Nvidia, for example, controls about 80% of the global AI-related chip market,⁹ so perhaps an earnings multiple of 45x on the next 12 months' earnings estimates could be justified over time.¹⁰ (The S&P 500 currently trades at an 18x multiple.) Well-known companies like Meta have reportedly tried and failed to break into the market for chip production.¹¹ With the eventual size of the AI market opportunity yet to be determined and so much uncertainty around the full long-term potential, what seems to some to be exorbitant valuations could end up being reasonable based on earnings growth over the next five to 10 years.

Second, the post-GFC era was characterized by exceptionally low global interest rates—as a result of depressed growth, anemic inflation, and easy monetary policy from central banks around the world. In the case of the U.S., the country's “safe-haven” status during times of stress, reserve currency status, and (thus far) unfettered ability to borrow has, until this year, kept a lid on interest rates. A lower cost of capital, or discount rate, tends to support valuations, particularly of longer-duration assets—in this case, growth or technology equities expected to receive a greater share of revenue in the future. As such, the tech-heavy S&P 500 has benefited disproportionately from years of low interest rates, relative to global counterparts.

Can the valuation premium of U.S. large-cap equities endure or even continue to expand in 2024, powering another round of U.S. outperformance? Theme III addresses the risks posed by valuations of U.S. large-cap equities, particularly relative to other asset classes. In an absolute sense, we think the prospects for further valuation expansion of U.S. large-cap equities in 2024 must be evaluated on two fronts: technology-related names compared to the rest of the index. Valuations for tech companies are stretched, though, as discussed earlier, the profit potential of emerging technologies could end up justifying current valuations. Nonetheless, we believe that, over the next 12 months, valuation expansion for tech companies will likely require a new catalyst.

This could come in a variety of forms—a less fractious political environment that lifts investor sentiment, proof of additional technological capabilities or leadership for U.S. companies, a surge in productivity, or a sustained move lower in interest rates—all of which are possible in 2024. Meanwhile, valuations for the rest of the S&P 500 outside of the largest stocks by market cap are quite reasonable. A “Goldilocks” (not too hot, not too cold) scenario of slower but sustained growth with continued disinflation that allows the Federal Reserve (Fed) to ease policy would likely result in a valuation rebound for parts of the market that were left behind in 2023—particularly those more cyclical sectors like financials and materials, as well as small-cap equities. This could also be good news for U.S. large-cap equities investors.

Profitability

At the end of the day, investors care most about profits. History shows that a company or market that generates consistently higher earnings will attract more investor capital and, over time, outperform. By our analysis in Figure 2, the superior profit profile for U.S. equities is responsible for approximately 16% of the country's annualized outperformance since 2007.¹² During that period, the S&P 500 has handily beaten the MSCI ACWI ex-U.S. Index on trailing 12-month earnings per share, free cash flow, EBITDA (earnings before interest, taxes, depreciation, and amortization) margins, and return on equity (Figure 4).

Fiscal and monetary policy also are important determinants of profitability. Here the track record of the U.S. is mixed. U.S. corporate taxes have historically been higher than other developed markets economies, but our tax code offers some favorable rules on expensing investment, which can support capital expenditures (capex). A lighter regulatory touch, compared to other countries, ranks the U.S. regulatory environment fifth in the world, according to the Fraser Institute.¹³ Monetary policy has also been accommodative—allowing companies to borrow cheaply—yet not *too* accommodative, as the Fed's avoidance of negative interest rates benefited profitability of U.S. compared to non-U.S. developed banks in the aftermath of the GFC. U.S. banks have outperformed European and Japanese banks by 4.3% and 3.7% per year, respectively, since the European Central Bank and Bank of Japan embarked on their negative rate experiments.¹⁴

Ultimately, higher profits stem most directly from greater productivity—a company's ability to generate efficiencies, exhibit greater flexibility in allocating resources, and innovate. As discussed, the U.S. has more flexible labor markets relative to other countries, especially in Europe, making it easier for companies to hire and fire and giving workers a better opportunity to switch jobs or find a new job quickly after being let go. This has allowed U.S. companies to cut costs more easily during troubled times and realize a greater productivity boost after recessions, translating into an earnings tailwind that has historically helped share

Figure 4

U.S. equities' superior profit profile

Profitability metrics for S&P 500 vs. MSCI ACWI ex-U.S. Index since December 2007

	Trailing 12-month EPS growth (change)	Trailing 12-month free cash flow per share	Trailing 12-month EBITDA margin	Return on equity (average)
U.S.	134%	\$162	19%	14%
Non-U.S.	5%	\$16	18%	10%

Data as of October 9, 2023.

Source: Bloomberg. Free cash flow and EBITDA margin are latest figures. Trailing EPS and ROE are from December 2007 to present. Investing involves risks and you may incur a profit or a loss. Past performance cannot guarantee future results.

The U.S. market benefits from a greater share of highly profitable tech companies, claiming six of the top 10 most profitable stocks globally, many of which are in the tech sector.¹⁵

prices of U.S. stocks rebound faster early in the economic cycle. Profitability and return of capital to shareholders have also been longstanding tenets of U.S. corporate governance, which Japan has recently tried to emulate with some success.

Innovation has and will continue to be at the heart of the profitability story. The U.S. market benefits from a greater share of highly profitable tech companies. In fact, the U.S. claims six of the top 10 most profitable stocks globally, many of which are in the tech sector and have massive cash holdings on their balance sheets.¹⁵ Going forward, the country that dominates the AI landscape will likely reap an outsized share of profits. This pertains not just to AI enablers that could enjoy profit windfalls from demand for chips, memory, and software (evidenced by Nvidia's 2023 results), but also to the non-tech companies that most quickly and strategically adopt AI to improve their bottom lines. We think the U.S. is well positioned to maintain its advantage in technology development and adoption, and profitability is likely to continue to be a positive tailwind for U.S. equity returns relative to other countries.

Currency and liquidity

These last two buckets—currency and liquidity—explain another 31% of the outperformance of U.S. equities (Figure 2).

Currency. Over the past 16 years, the dollar has appreciated 38% relative to a trade-weighted basket of currencies.¹⁶ Dollar strength stems from its role as a reserve currency, the safe-haven status of U.S. assets during risk-off periods, and a history of responsive fiscal and monetary policy during times of stress. (As discussed, avoidance of negative interest rates helped make U.S. stocks and bonds more attractive destinations of investor capital.)

Currency impacts can be tricky, as dollar strength cuts both ways. A stronger currency often results from economic strength, benefiting sales of U.S. companies. It also supports currency-adjusted returns for domestic compared to international equities (for dollar-based investors). However, currency strength can be a significant headwind for multinationals, making goods more expensive for the rest of the world and pressuring sales and margins. It also reduces the value of foreign-denominated earnings when converted back into dollars, something that has presented challenges to some of the largest tech-oriented companies in the S&P 500.

In the year ahead, we expect a more rangebound dollar, as the market has already moved to price three to four rate cuts—each of 25 basis points (0.25%) in 2024. We think it is unlikely that the Fed will ease more than 100 basis points absent a recession. However, a robust recovery in international economic growth could result in dollar weakness (the dollar tends to exhibit countercyclical behavior, meaning it weakens when global growth is strong and strengthens when global growth disappoints). Should the Fed hold rates higher for longer in the face of sticky inflation or above-trend U.S. growth, we would expect the dollar to strengthen.

Liquidity. This last category represents the relative magnitude of fiscal and monetary stimulus and is proxied by the difference in money supply growth for the U.S. as opposed to non-U.S. countries. It accounts for 0.8% of the 7.4% annualized outperformance of U.S. equities.¹⁷ A more responsive and stimulative policy response—both fiscal and monetary—has supported U.S. equity returns. It has also contributed to inflation, which is generally helpful for stocks due to companies' ability to pass along rising input costs and even increase margins in times of moderately rising inflation. Going forward, as we discuss in Theme III, the U.S. liquidity engine is likely to run out of steam. We think the Fed will be in a position to cut its policy rate in 2024 as inflation eases, but fiscal stimulus in an election year—with debt levels as precariously high as they are—is a very small probability.

Looking ahead

Valuations, profitability, currency, and liquidity explain the bulk of the outperformance of U.S. equities in the most recent performance cycle. We believe many of the fundamental pillars of U.S. economic and equity market success will continue in the year ahead, though likely without such unequivocal and uninterrupted dominance over a longer timeframe. Valuation expansion can be explained by the innovative advantage and favorable borrowing environment of the U.S. market, with solid profit potential of U.S. companies offering the opportunity to grow into those valuations in time. Although the U.S. market does not look unduly expensive, further multiple expansion relative to the rest of the world would likely require a new catalyst and should not be counted on as a singular driver of returns.

Currency could be additive to relative performance of U.S. equities if the global economy continues to languish. The advantage provided by policy responsiveness has been notable but could be more limited going forward. When we look at the balance of drivers and recognize the risks to U.S. leadership, discussed in more depth in Theme III, we allocate a higher weight to U.S. large-cap equities in our long-term strategic asset allocation than a “naïve” market-cap-weighted benchmark. We have historically favored an overweight allocation to U.S. large cap and believe it is a position that can continue to do well going forward.

Over the next 12 months, the U.S. could face some economic challenges, as the Fed's ability to stick the soft landing is still in question. However, even in today's uncertain environment, the U.S. remains the best house on a troubled block. A dominant position in technology generally and AI specifically, a more dynamic and adaptable labor market, and a history of realizing greater profitability are expected to continue to serve investors in large U.S. companies during the coming year.



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THEME III

U.S. dominance: Risks and opportunities

U.S. dominance: Risks and opportunities

The U.S. economy has led the world for decades, and U.S. stocks have rewarded investors. At the heart of U.S. exceptionalism is a dynamic economy, the pillars of which largely remain sound and are likely to continue powering the U.S. in the coming years. However, certain growth pillars—for the economy and markets—are running on fumes. Contributing to the most recent stretch of economic and market outperformance was a historic level of stimulus and significant repricing of U.S. equity valuations. Demographics and interest rates pose additional risks going forward—risks that could topple the U.S. from its throne, at least temporarily. While these risks are critical to assess and monitor, at this time we remain optimistic on the long-term trajectory for the U.S. economy, and see compelling investment opportunities.

Economic risks

Debt

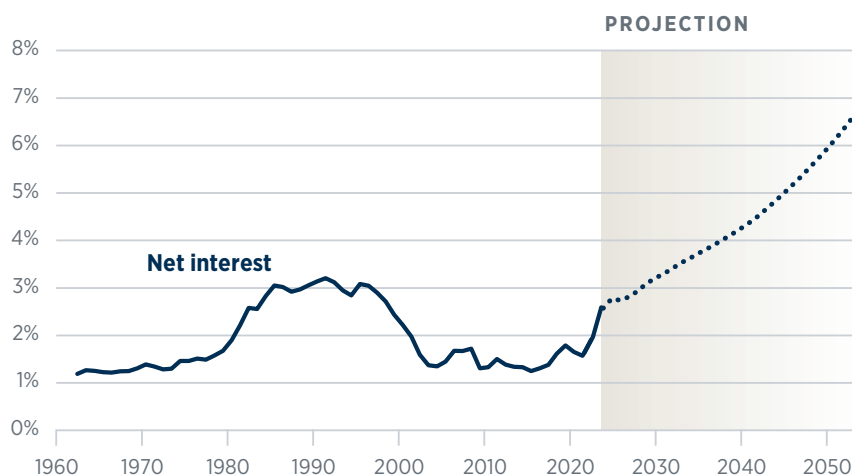
The historic stimulus was a key driver for the U.S. relative to other economies during and after the pandemic as described in Theme I, but it came at a cost. The short-term gain is set to deliver long-term pain in the form of an impaired fiscal state. Under current projections, federal debt is set to surge and interest payments to gobble up an increasing share of spending—all while crowding out private investment and weighing on future growth.

Much like a credit card that can snowball into ever-higher balances if not paid down, U.S. federal debt is set to spiral upward with interest payments taking on an ever-increasing share (Figure 1). From the early 1960s to now, the highest interest cost ever reached as a share of GDP was 3.1% from 1990 to 1992. Going into Covid they made up just 1.8% of GDP, but that jumped to 2.0% in fiscal year 2023. In dollar terms, interest payments have more than doubled over the

Figure 1

Debt service costs set to rise going forward

Interest expense as a share of GDP



Data as of December 31, 2022.

Source: Congressional Budget Office's short-term budget projections.

Will U.S. debt undermine exceptionalism?

The current projections for U.S. deficits and debt are daunting and could weigh on its exceptionalism going forward. What are the options for solving the problem and what are the prospects?

The math of debt is straightforward, but there are many moving parts, all of which will hinge on key assumptions to make projections. To start, this first equation shows a country's debt will grow each year as interest is applied to past debts and more deficit spending is heaped on. The primary deficit results from tax and spending, before adding interest costs. Naturally, if Congress ran a primary surplus, then it would help reduce the debt instead of adding to it.

change in debt =

$$[(1 + \text{rate differential}) \times \text{current debt}] + \text{primary deficit}$$

A critical dynamic is in the rate differential component, illustrated in greater detail below. It shows the interplay between interest rates and economic growth.¹ Ever-higher interest rates will make the rate differential more positive and accelerate the growth in debt illustrated in the equation above. It also shows that stronger economic growth will reduce the differential and therefore slow or reverse the growth of debt. Congress often avoids making challenging decisions to fix the primary deficit and instead argues the country can “grow” out of the problem, focusing on the rate differential component.

rate differential =
$$\frac{\text{interest rate} - \text{GDP growth rate}}{1 + \text{GDP growth rate}}$$

Addressing the deficit

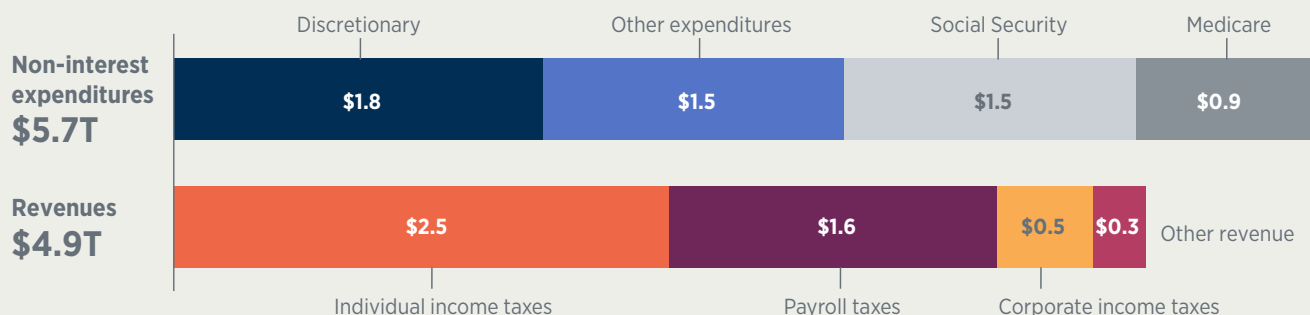
Under current projections, the rate differential component is helpful, working to reduce the debt, because the economy is projected to grow at a faster pace than interest rates. The primary deficit, however, is projected to greatly outweigh that positive impact. To merely hold the debt-to-GDP ratio constant in the next three years, all else equal, we estimate the primary annual deficit would need to be reduced by roughly \$300 billion.² To address the deficit using any single component is unlikely to be effective—due to political reality or the potential impact on economic growth or interest rates. We believe a combined approach on revenues and expenditures is in order.

We look at the following actions and project what would be required:

- **Cut discretionary spending:** 16.4% cut
- **Raise individual income taxes:** 12.2% hike
- **Raise corporate income taxes:** 63% hike
- **Combined approach across all revenue and non-interest expenditure:** 3.1% increase in overall revenue and a 2.6% reduction in non-interest spending, to split the \$300 billion deficit reduction evenly

\$800B primary deficit (FY 2024) must be cut by \$300B just to keep debt-to-GDP from rising

Revenue and non-interest expenditure by line item (\$ trillions)



The CBO projects the U.S. debt-to-GDP ratio to hit 100% in fiscal year 2024. Going beyond 100% is often cited as a key threshold or even a point of no return—if not empirically, then perhaps psychologically.

past five years, from \$325 billion in 2018 to \$663 billion.³ Under current law, they're slated to double again by the end of the decade, hit a new multidecade high at 3.2% of GDP, and climb inexorably thereafter.

Also disturbing is the increased crowding out of discretionary spending by mandatory spending (often called entitlement programs). The combined spending on Social Security, Medicare, Medicaid, and other programs grew 30% in just five years leading up to the pandemic, reaching \$2.7 trillion, about 12.9% of GDP.⁴ That surged to \$4.8 trillion during the pandemic, perhaps understandably, but is projected to only fall to a low of \$3.9 trillion in fiscal year 2024 before climbing again.

Deficits have not returned to prepandemic levels, not even close. At 5.8% of GDP in fiscal year 2023,⁵ the deficit is at its highest since the recovery from the GFC and set to remain unusually high for nonrecessionary periods. The Congressional Budget Office (CBO) projects the U.S. debt-to-GDP ratio to hit 100% in fiscal year 2024. Going beyond 100% is often cited as a key threshold or even a point of no return—if not empirically, then perhaps psychologically. Research shows a clear drag on economic growth from higher debt, as much as -0.25% per year for every 10% increase in the debt-to-GDP ratio.

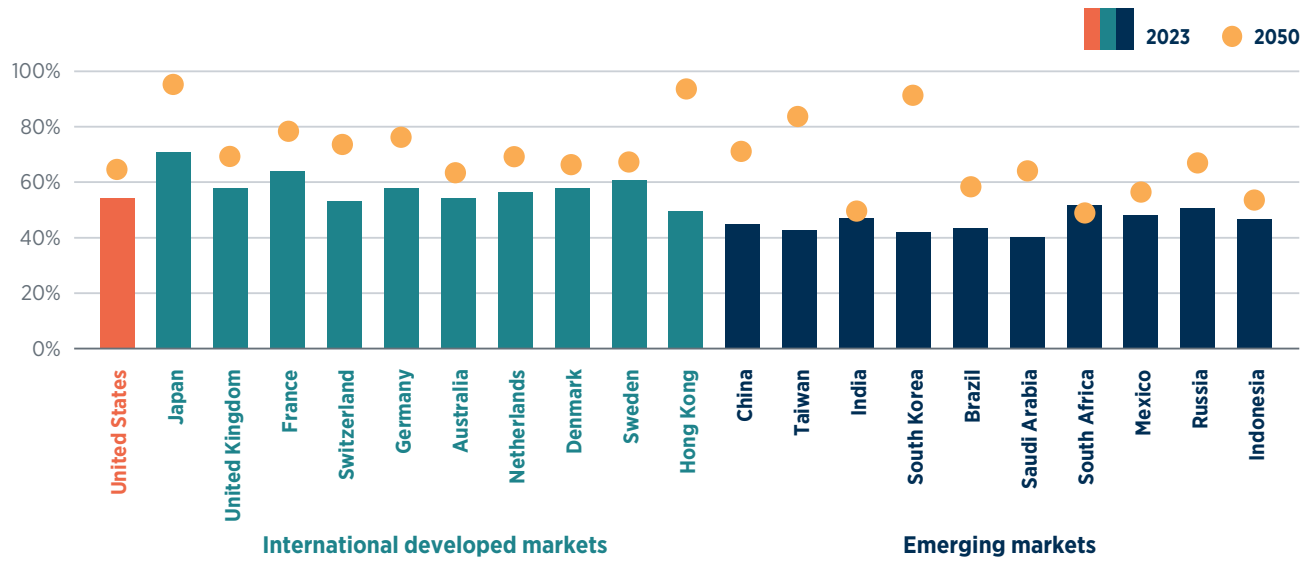
The U.S. debt profile and projections are concerning in their own right, and even more so when compared to Japan's experience. The recent runup in U.S. debt is disturbingly similar to Japan's case when it fell from grace 30 years ago. In the last stage of Japan's dominance in the 1980s to the mid-1990s, it racked up a debt bill that lifted the debt-to-GDP ratio by more than 30%. That hampered its ability to provide fiscal stimulus, and total public debt now stands at 260% of GDP.⁶ The U.S. has done similarly of late, with the ratio rising almost the same amount from 2010 to 2022, also reducing fiscal optionality.

The CBO projections are admittedly based on current law, and those laws could change. But much like a ne'er-do-well credit card user who refuses to align spending with income, the U.S. Congress is increasingly resistant to responsible taxing and spending policy, evidenced by continued government shutdowns and debt ceiling drama. Fitch Ratings said essentially the same,⁷ though in more formal language, when it downgraded the outlook for U.S. debt in August 2023. The message was virtually identical to the one that S&P gave in 2011.

The deterioration in the fiscal state and worsened political climate from the S&P downgrade to Fitch's action 12 years later does not bode well. The U.S.' growing debt burden, along with its impaired ability to respond to future shocks, is the biggest risk to U.S. exceptionalism going forward.

Figure 2

Populations to get more top-heavy going forward
Current and projected dependency ratios*



Data as of 1950–2021, published July 2022.

Sources: United Nations population projections, WTIA.

*Age dependency ratio is the ratio of dependents (those younger than 15 or older than 64) to the working-age population (those ages 15–64).

Demographics

The second risk to continued U.S. exceptionalism is demographics. The U.S. population is expected to become more top-heavy, posing challenges to debt sustainability and labor force growth. According to United Nations population estimates, the U.S. dependency ratio is expected to increase from 54.5% in 2023 to 64.6% in 2050 (Figure 2). That reflects the growing number of older individuals—who are less likely to be in the labor force and must be supported, in an economic sense, by the younger segments. This is part of what drives the steady rise in mandatory spending described previously, as more of the population becomes dependent on Medicare.

The other concern related to demographics is simple: Slower labor force growth will result in slower economic growth. In our rankings table, the U.S. does not look terrible at first glance, ranking eighth out of 21 nations. But a closer examination shows it mostly bests European countries, Japan, and China. Both Europe and Japan are already entrenched in slower structural growth, partly due to their weak demographic pictures. The U.S. is simply following in their footsteps. It's certainly encouraging that the U.S. outlook is better than that of China, its current economic rival. However, the younger, faster-growing emerging markets economies could, as a group, grab hold of the demographic lead in the next 10 to 20 years, much as the BRICS countries (Brazil, Russia, India, China, and South Africa) did two decades ago.

The United Nations population projections are subject to assumptions regarding immigration, mostly following historic patterns. It's important to note that U.S. immigration policy is in a state of flux. These demographic challenges could be significantly lessened by allowing more immigration. By contrast, a clampdown would follow in the footsteps of others, particularly Japan and several European countries, that restricted immigration and accelerated the movement to a top-heavy population.

Market risks

In addition to long-term economic risks, several market factors could turn from tailwinds into vulnerabilities for the U.S. market going forward. Valuations and interest rates pose the greatest risks—threats we see as manageable but sufficient to at least temporarily dislodge the U.S.’ top rank. As such, diversification remains an important tool for the long-term investor.

Valuations

In the wake of the pandemic, U.S. large-cap equity valuations rocketed to the highest levels since the tech bubble. The tough market environment in 2022 took the edge off multiples, but by many metrics, U.S. large-cap equity valuations continue to look expensive relative to their own history. The S&P 500’s price-to-earnings ratio based on next 12 months’ earnings estimates is in the 78th percentile⁸ (with 100 being the most expensive) relative to the past 15 years of history. Based on other metrics—including the cyclically adjusted price-to-earnings ratio (CAPE) and the equity risk premium—prices look even more stretched.

Other equity asset classes have not participated to the same degree, and valuations of non-U.S. and small-cap equities relative to U.S. large cap are depressed. When comparing valuations across asset classes, we look at the relative ratios compared to history, as the U.S. has historically traded at a premium to the rest of the world. The valuations of non-U.S. equities are trading in the fifth percentile relative to the S&P 500.⁹ Even U.S. small cap is priced at an extreme discount relative to larger companies.

This is similar to a rubber band getting stretched. From this starting point, any of the many potential catalysts could set in motion a snap-back period of U.S. equity underperformance that returns relative valuations to historical averages. This does not mean U.S. large-cap equities cannot continue to deliver respectable returns, but the valuation disparity between U.S. large cap and other equity asset classes presents a vulnerability to U.S. leadership in the year ahead.

We do not expect such a valuation reversal to begin in the coming months, and our equity allocation to start the year prefers U.S. large cap to both U.S. small-cap and international developed equities. Furthermore, we believe a recovery in U.S. small cap will take hold ahead of international developed stocks, as U.S. fundamentals appear stronger than in Europe, Japan, and China—three of the largest regional weights in the non-U.S. equity index. U.S. small cap also typically leads other asset classes in an economic recovery—which could emerge in the U.S. in the second half of 2024 after a brief slowdown to start the year—and U.S. small cap is trading at a steeper discount.

Valuations are one of the most oft-cited investment metrics, but the theory behind them is complicated; and empirically, bearish calls on the basis of valuations alone must be taken with a grain of salt. First, they are a poor short-term indicator of potential future returns. Instead, they prove their worth when looking at three- to five-year forward returns.

Second, it is presumed that valuations are mean reverting, meaning they are prone to trend back toward averages over time. However, valuation dislocations can

**We are reminded of the
John Maynard Keynes quote,**

**“Markets can
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persist for long periods of time. We are reminded of the John Maynard Keynes quote, “Markets can stay irrational longer than you can stay solvent.” Importantly, mean reversion tends to “break” when structural market changes occur. For example, the increased relevance of technology in the S&P 500 and a larger share of intangibles, goodwill, or intellectual property may understate traditional GAAP earnings (the denominator of the price-to-earnings ratio) relative to history. Similarly, the necessity of scale and the first-mover advantage in the AI race—which U.S. mega-cap tech stocks currently lead—may justify a higher multiple and also potentially denote tremendous future earnings power.

Interest rates

Related to the risk of a valuation reversal is the risk posed by the recent long-term normalization of interest rates. For more than four decades, interest rates took a one-way trip lower, easing companies’ ability to borrow, padding profit margins, and inflating valuations. During the next 12 months, we expect the 10-year Treasury yield to reverse some of its recent runup as growth and inflation slow and the Fed begins to ease policy. Our base-case forecast is for the 10-year to reach the neighborhood of 3.75% in 2024, unless the economic momentum found in the third quarter of 2023 is somehow maintained and the Fed keeps the fed funds rate at its current level for longer, or even hikes further.

Looking out over the next three to five years, a number of factors will coalesce to keep average inflation at or slightly above the Fed’s target—a very different regime than we experienced in the post-GFC period. A growing debt burden from the U.S. means greater bill supply on the market, while willing buyers in the form of the Fed and non-U.S. investors are stepping back. For the past 70 years, the yield on the 10-year Treasury has averaged approximately 2% above headline Consumer Price Index (CPI),¹⁰ which means the future interest rate environment is more likely to resemble 2000–2009 than what we experienced in 2010–2019 (Figure 3).

The relationship between interest rates and valuations is neither causal nor stable, but if the current level of rates becomes the new normal, that removes one of the key tailwinds that contributed to investors’ readiness to pay ever-higher multiples for stocks. This could limit valuation expansion of longer-duration assets, like growthier stocks (e.g., technology companies with no earnings today but promises of big earnings far in the future).

Investment opportunities

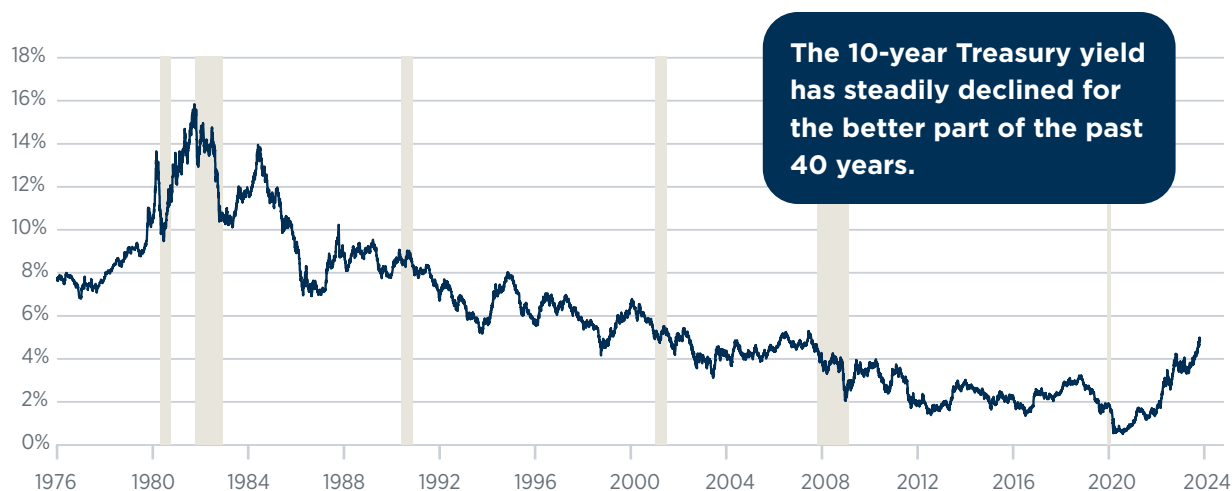
Long-term U.S. tilt

U.S. leadership in growth pillars, policy framework, and innovative capacity has given U.S. equities a structural advantage—one that has proven true over decades. We have held an enduring structural overweight to U.S. equities in our long-term strategic asset allocation (which utilizes five-year economic and capital markets forecasts). We increased our preference for U.S. over non-U.S. equities when we updated our strategic asset allocation at the start of 2023. In particular, the economic importance of technology, the need for scale, and the benefits of large balance sheets for investment all advantage U.S. large-cap equities relative to smaller domestic and international equities.

Figure 3

The interest rate trade is no longer one-way

10-year Treasury yield, 1975–2023



Data as of October 27, 2023.

Source: Bloomberg.

Tactically favoring the U.S.

As of November 30, 2023, we hold a preference to U.S. large-cap equities relative to small-cap and international developed equities. For most of 2023, we held a modest underweight to equities on the view that economic risks were underappreciated. That underweight allocation was expressed with a smaller allocation to U.S. small-cap and international developed equities, both laggards within the equity market for the year. However, we maintained a full allocation to U.S. large-cap equities, which benefited from the contributions of mega-cap tech. In the second half of 2023, that “insurance policy” paid dividends, as the S&P 500 entered a correction of 10% from its July 2023 intra-year high and U.S. small-cap equities continued to deliver lackluster returns, up just 2% for the year.

Going forward, risks of a U.S. economic recession have been reduced but not eliminated. Compelling evidence of continued disinflation alongside a resilient consumer support our base case for a soft landing. We will be looking for opportunities to add to equities, likely by adding to the U.S. and further increasing our total U.S. preference. The risk of “higher for longer” interest rates poses the greatest headwind to U.S. small-cap equities, but the likelihood that the Fed begins to cut rates in 2024 means this asset class could begin to recover lost ground.

Even with a recession, the U.S. economy has the foundational elements to bounce back quicker than other countries facing their own sets of challenges. Within equities, we are maintaining a balanced exposure to growth and value, given uncertainty around the strength of the U.S. economy. We are slightly underweight to size, due to active managers’ tendency to hold less exposure to the largest companies than the index. Perhaps most importantly, we are expressing a preference for the quality factor. We anticipate elevated rates and a slowing economy to continue rewarding companies with fortress balance sheets and stable profits, as it did in 2023.

Diversification still makes sense

Despite some other risks to U.S. equity leadership, including a very concentrated equity market (Figure 4) and a growing political divide in Washington, we remain optimistic on the prospects for U.S. economic and market leadership long term. However, these risks make it more important than ever to focus on what is ahead and avoid driving with only the rearview mirror.

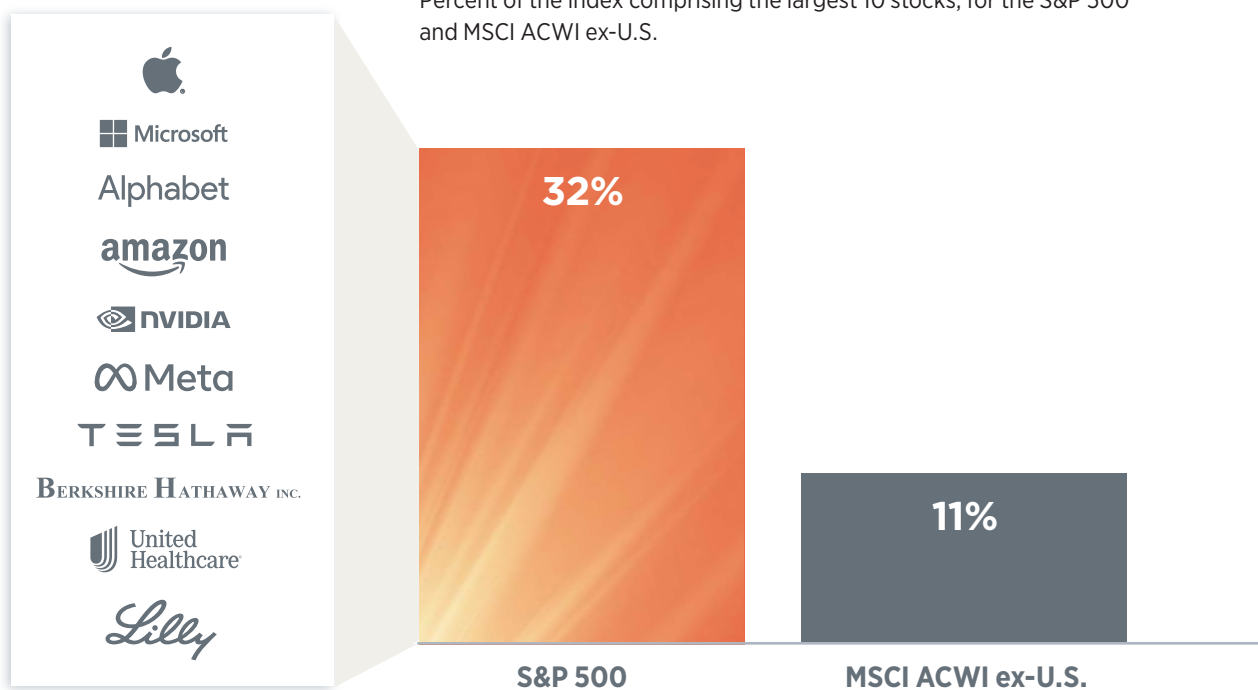
Diversification as a strategy is not about picking the best market and, by construction, a diversified portfolio generally underperforms the top-performing asset class in any given short-term period. Instead, diversifying across asset classes, regions, and factors helps mitigate portfolio risk, creating a smoother return profile that may compound wealth at a faster rate over long periods of time.

There can be long stretches—in fact, entire decades—when markets are unfriendly to the diversified investor. U.S. investors were significantly better off investing in only their home country's stocks during the stunning bull markets of the 1990s and 2010s. However, the past 15 years show several in which U.S. equities lagged other asset classes—in some cases by a wide margin (Figure 5). Regional equity correlations tend to increase in times of market stress, but those times can also present catalysts for change in market leadership. History shows these shifts can happen quickly and are often well under way before the trend is recognized. We firmly believe that the best way to ensure no chips are left on the table is to utilize a prudent diversification strategy.

Figure 4

U.S. stock market is much more concentrated than global peers

Percent of the index comprising the largest 10 stocks, for the S&P 500 and MSCI ACWI ex-U.S.



Data as of October 25, 2023.

Sources: Bloomberg, MSCI. The above companies are listed because they are the top 10 S&P 500 stocks by index weight, noted solely for informational purposes and not intended as investment advice.

Figure 5

Harnessing the power of diversification

Calendar-year returns by asset class, sorted top to bottom by highest to lowest returns

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	(YTD) 2023
5.3%	78.6%	26.9%	13.6%	24.2%	38.9%	13.7%	5.7%	21.4%	37.3%	0.1%	36.4%	38.5%	28.7%	16.1%	34.9%
-2.4%	37.3%	18.9%	7.9%	18.3%	33.5%	13.5%	1.4%	17.4%	30.3%	-1.3%	31.5%	20.0%	27.6%	-7.6%	18.8%
-25.8%	31.8%	17.2%	2.7%	17.6%	32.6%	13.1%	0.6%	12.0%	25.1%	-1.6%	26.6%	18.4%	27.1%	-11.9%	9.1%
-33.8%	30.9%	16.9%	2.2%	17.4%	32.4%	11.3%	-0.9%	11.8%	21.9%	-4.4%	25.6%	18.3%	26.7%	-13.0%	8.4%
-35.7%	27.2%	16.8%	0.4%	16.4%	22.8%	6.0%	-1.5%	11.2%	15.3%	-6.4%	22.1%	13.7%	25.2%	-13.9%	3.4%
-36.9%	26.5%	15.6%	-0.8%	16.1%	16.9%	5.9%	-1.9%	7.8%	14.7%	-8.3%	20.5%	11.0%	14.8%	-15.9%	3.0%
-37.0%	22.4%	15.1%	-4.2%	15.3%	2.3%	4.9%	-2.6%	7.1%	13.7%	-9.8%	18.5%	7.8%	13.7%	-18.1%	2.6%
-38.5%	19.7%	12.3%	-9.1%	11.8%	-2.1%	3.7%	-3.9%	4.7%	9.0%	-11.1%	18.3%	7.5%	11.3%	-19.9%	0.4%
-43.4%	19.0%	7.8%	-12.2%	7.0%	-2.7%	-2.2%	-4.5%	2.7%	3.6%	-11.3%	8.8%	2.8%	5.5%	-20.5%	0.4%
-50.0%	11.5%	6.6%	-13.4%	4.3%	-8.7%	-5.0%	-15.0%	1.6%	3.1%	-13.8%	8.5%	-3.1%	-1.5%	-24.1%	-0.8%
-53.4%	6.0%	6.4%	-18.5%	-1.1%	-9.6%	-17.1%	-24.7%	1.1%	1.8%	-14.6%	7.7%	-9.8%	-2.5%	-29.1%	-4.0%

- U.S. IG taxable
- S&P 500
- Commodities
- Russell 1000 Value
- Russell 2000
- MSCI EAFE
- S&P Dev Property
- Diversified Portfolio
- U.S. ILB
- MSCI EM
- Russell 1000 Growth

Data as of November 15, 2023.

Sources: Macrobond, Bloomberg, WTIA.

Diversified portfolio composed of 35% U.S. large-cap stocks (S&P 500), 10% U.S. small-cap stocks (Russell 2000), 20% international stocks (MSCI ACWI ex-U.S.), 30% U.S. investment-grade taxable bonds (Bloomberg U.S. Aggregate Bond Index), 1.5% U.S. inflation-linked bonds (Bloomberg U.S. Government Inflation-Linked Bond Index), 2% global real estate (S&P Developed Property Index), and 1.5% commodities (Bloomberg Commodity Index). Shows total returns in U.S. dollars.

Past performance cannot guarantee future results. Indexes are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses such as management fees and transaction costs, which will reduce returns. Investing involves risks and you may incur a profit or a loss. There is no assurance that any investment strategy will be successful. Diversification cannot guarantee a profit or protect against a loss.

APPENDIX

ENDNOTES

INTRODUCTION (pages 3–4)

- ¹ Calculations from the World Economic Outlook database, International Monetary Fund, and Wilmington Trust Investment Advisors, Inc. (WTIA).
- ² Calculations from the Bureau of Economic Analysis, National Bureau of Statistics of China, Government of China, Bloomberg, and WTIA.
- ³ Bureau of Economic Analysis, U.S. Department of the Treasury.

THEME I (pages 5–16)

- ¹ Bureau of Economic Analysis, WTIA calculations.
- ² Economic and Social Research Institute Cabinet Office, Government of Japan; Bloomberg; WTIA calculations.
- ³ “How the U.S. outgrew 1980s trade anxiety over Japan,” NPR Marketplace, November 29, 2018.
- ⁴ Michael Oreskes, “Americans Voicing Anxiety on Japan As Concern in Tokyo Seems to Soften,” *The New York Times*, July 10, 1990.
- ⁵ National Bureau of Statistics of China, Government of China; Bloomberg; WTIA calculations.
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- ⁷ Michael Cole, “Chinese Insurer Buys Waldorf Astoria for a Record \$1.95B,” *Forbes Magazine*, October 6, 2014.
- ⁸ *Economy of Japan*, Britannica, as of November 15, 2023.
- ⁹ National Bureau of Statistics of China, Government of China; Bloomberg; WTIA calculations.
- ¹⁰ World Economic Outlook and International Financial Statistics databases; International Monetary Fund.
- ¹¹ Bloomberg, WTIA.
- ¹² QS World University Rankings, Times Higher Education World University Rankings.
- ¹³ *Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic*, International Monetary Fund, as of October 2021.
- ¹⁴ “Three rounds of stimulus checks. See how many went out and for how much,” Pandemic Oversight, February 17, 2022 (updated on February 9, 2023, to include the December 31, 2021 data).
- ¹⁵ Matthew P. Goodman and Dylan Gerstel, “Comparing U.S., Japanese, and German Fiscal Responses to Covid-19,” Center for Strategic & International Studies, October 28, 2020.
- ¹⁶ “Policy Responses to COVID-19,” IMF Policy Tracker.
- ¹⁷ “How much money did pandemic unemployment programs pay out?” Pandemic Oversight, November 1, 2021.
- ¹⁸ Jean-Benoit Eyméoud, Nicolas Petrosky-Nadeau, Raül Santaeuilàlia-Llopis, and Etienne Wasmer, “Contrasting U.S. and European Job Markets during COVID-19,” Federal Reserve Bank of San Francisco Economic Letter, February 22, 2021.
- ¹⁹ “Kurzarbeit: Germany’s Short-Time Work Benefit,” IMF Country Focus, June 15, 2020.
- ²⁰ To complicate matters further, however, the U.S. had the Paycheck Protection Program (PPP) for small businesses, which was similar in spirit to STW programs in Europe. It provided loans to small businesses that included incentives to maintain workers on their payrolls, after which the balances would be forgiven. Loans totaled \$790 billion and \$758 billion were forgiven. But the spending is not tied directly to individual workers, so an STW-type percent-of-workforce figure is not available for the PPP. Businesses reported retaining 89.6 million jobs, a dubious figure as it

would amount to 55% of the prepandemic labor force. <https://www.pandemicoversight.gov/data-interactive-tolls/interactive-dashboards/paycheck-protection-program>.

- ²¹ National statistical agencies.
- ²² “Recovery Insights: Small Business Reset,” Mastercard Economics Institute.

THEME II (pages 17–24)

- ¹ Bloomberg. Reflects total returns in U.S. dollar terms.
- ² Bloomberg, WTIA. The U.S. share of global market cap is calculated as the combined market cap of the Russell 1000 and Russell 2000 divided by the sum of market caps from the Russell 1000, Russell 2000, MSCI EAFE, and MSCI EM. Data as of November 14, 2023.
- ³ As measured by the S&P 500 versus the MSCI ACWI ex-U.S. Index, using quarterly total return data in U.S. dollar terms.
- ⁴ Relative GDP growth as a variable was tested but did not prove statistically significant in our analysis because it is indirectly captured by the other variables.
- ⁵ Bloomberg, using a price-to-earnings multiple based on 12-month forward estimated earnings.
- ⁶ Bloomberg. Technology companies are represented by the S&P 500 Information Technology Sector GICS (Global Industry Classification Standard) Level 1 index classifications. Data as of October 31, 2023.
- ⁷ Apple 10-K company filing, Bloomberg. Represents financial results for Apple’s fiscal 2023 fourth quarter. Data as of September 30, 2023.
- ⁸ Stephen Nellis, “Nvidia releases software tools to help chatbots watch their language,” Reuters, April 25, 2023.
- ⁹ Bloomberg, as of October 31, 2023.
- ¹⁰ Bloomberg. Based on 12-month forward price-to-earnings data, as of November 15, 2023.
- ¹¹ Anna Tong, Max A. Cherney, Christopher Bing, and Stephen Nellis, “Exclusive: ChatGPT-owner OpenAI is exploring making its own AI chips,” Reuters, October 6, 2023.
- ¹² 1.2% divided by 7.4% outperformance.
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- ¹⁴ As measured by the MSCI European financials and MSCI Japanese financials indices compared to the MSCI USA financials index. The European Central Bank first set its deposit facility rate negative in 2014. The Bank of Japan began utilizing negative rates on its excess reserves in 2016.
- ¹⁵ Bloomberg, Forbes Global 2000 List. Profit measured by net income reported for the trailing 12-month period.
- ¹⁶ Bloomberg, Federal Reserve. Represents the Nominal Broad (Trade-Weighted) U.S. Dollar Index, between December 31, 2007 and September 29, 2023.
- ¹⁷ Bloomberg, WTIA. Variable represents the quarterly change in the M2 money supply, with non-U.S. countries weighted according to their weight in the MSCI ACWI ex-U.S. Index, for countries where data are available.

THEME III (pages 25–34)

- ¹ The equation can be expressed in terms of either nominal GDP or real (inflation-adjusted) GDP. We are showing nominal GDP. When expressed in real terms, the interest rate is also expressed in real terms.
- ² This estimate does not incorporate dynamic effects that would otherwise affect the projections for GDP growth and interest rates.
- ³ Congressional Budget Office, WTIA, as of June 28, 2023.
- ⁴ Ibid.
- ⁵ Ibid.
- ⁶ Ibid.
- ⁷ “Markets Still Contemplating the Implications of a U.S. Credit Rating Downgrade,” *Wilmington Wire* blog post, August 7, 2023.
- ⁸ Bloomberg, WTIA, as of October 25, 2023.
- ⁹ Bloomberg, WTIA. Percentiles calculated using monthly data from the prior 15 years. Data as of October 31, 2023.
- ¹⁰ Strategas Research Partners, October 13, 2023.

METHODOLOGY (page 7)

Drivers of economic exceptionalism

Growth pillars

Capital markets: Size of the equity market as a share of gross domestic product (GDP) using data from the [World Development Indicators | DataBank](#) (worldbank.org). For countries not included in the World Bank report (UK, Netherlands, Denmark, Sweden, and Taiwan), values are calculated using Bloomberg data as of December 2022.

Infrastructure: From [World Competitiveness Ranking 2023 - IMD Business School for Management and Leadership courses](#). The ranking is based on 336 criteria selected as a result of research using economic literature; international, national, and regional sources; and feedback from the business community, government agencies, and academics. The report evaluates the quality of infrastructure in different countries, using such factors as physical infrastructure, technological readiness, and scientific infrastructure.

Demographics: Projected dependency ratio in 2050 based on the United Nation’s [World Population Prospects - Population Division - United Nations](#). Dependency ratio calculated as the population between 0–14 and 65+ divided by population aged 15–64.

Education: Calculated using a weighted average score across three categories: spending (25%), higher education (60%), and secondary education (15%). Spending based on total education expenditure as a percentage of GDP (public and private). Data sources: World Bank, National Center for Education Statistics (NCES), and Our World in Data. The higher education score was determined by the [World University Rankings | Times Higher Education \(THE\) for 2023](#) and the [Rankings Released! QS World University Rankings: by Subject 2023 - QS](#). The secondary education score was based on [PISA Scores by Country 2023](#) (datapandas.org).

Labor flexibility: Calculated using an average score across two equal-weighted categories: labor mobility (the ability to change jobs, 50%) and labor freedom (the ability to hire and fire workers, 50%). Labor mobility was determined based on short-term unemployment as a percentage of total unemployment data provided by the Organisation for Economic Cooperation and Development. [Labor Market: Flexibility, Economy from the Index of Economic Freedom](#) (heritage.org), developed by the Heritage Foundation, was used to rank labor freedom in each country. The index is calculated using six equal-weighted factors, including employment regulations, minimum wage requirements, and worker rights. Data sources: World Bank, U.S. Dept. of Commerce, and official national publications.

Policy framework

Fiscal state: Gross and net debt as a percentage of GDP, 2022.

Fiscal responsiveness: Fiscal response to pandemic from the [Fiscal Monitor, October 2021](#) (imf.org). This measures additional government spending or foregone tax revenue, as a percentage of GDP.

Ease of doing business: Ranking determined using the Fraser Institute’s [Economic Freedom of the World: 2023 Annual Report](#) (fraserinstitute.org) index, which measures the degree to which the policies and institutions of countries are supportive of economic freedom and development. Key inputs include the size of the government, legal system and property rights, freedom to enter markets and compete, freedom to trade internationally, and inflation.

Innovative capacity

Digital infrastructure: Ranking determined using the [World Digital Competitiveness Ranking - IMD business school for management and leadership courses](#), which measures the capacity and readiness of 64 economies to adopt digital technologies as a key driver for economic transformation in business, government, and society. The ranking is based on 54 criteria from a combination of external hard data and the IMD Executive Opinion Survey, and split into three categories: future readiness, knowledge, and technology.

R&D: Comprises an equal-weighted average of the innovation input and output subindices from the 2023 WIPO global innovation index (https://www.wipo.int/global_innovation_index/en/2023/). Taiwan is not included in the index calculation and the value for China is therefore imputed.

APPENDIX

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DEFINITIONS

Bloomberg Commodity Index is designed to provide liquid and diversified exposure to physical commodities via futures contracts.

Bloomberg U.S. Aggregate Bond Index is a broad-based, market capitalization-weighted bond market index representing intermediate-term investment-grade bonds traded in the U.S., often used as a stand-in for measuring the performance of the U.S. bond market.

Bloomberg U.S. Government Inflation-Linked Bond Index is designed to hedge the inflation risk of a bond, and tracks bonds in which the principal is indexed to inflation or deflation on a daily basis.

Capex (capital expenditures) is the money an organization or corporate entity spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land.

CPI (Consumer Price Index) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

EBITDA (Earnings before interest, taxes, depreciation, and amortization) is a measure of core corporate profitability. EBITDA is calculated by adding interest, tax, depreciation (reduction in the value of an asset), and amortization (accounting method for spreading out the costs for the use of a long-term asset over the period the asset is expected to provide value).

Earnings multiples are used to quantify a company's growth, productivity, and efficiency, and make comparisons among companies in an effort to find attractive investment opportunities. A multiple may, for example, be used to show how much investors are willing to pay per dollar of earnings, as computed by the price-to-earnings (P/E) ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock, serving as a profitability indicator. It is calculated by subtracting any preferred dividends from a company's net income (amount of money that remains in a reporting period after all cash and non-cash expenses are deducted) and dividing that amount by the number of shares outstanding.

Federal funds rate refers to the target interest rate range set by the Federal Reserve's [Federal Open Market Committee \(FOMC\)](#). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

Free cash flow per share is a measure of a company's financial flexibility that is determined by dividing free cash flow by the total number of shares outstanding.

GAAP (Generally accepted accounting principles) are standards that encompass the details, complexities, and legalities of business and corporate accounting. The Financial Accounting Standards Board (FASB) uses GAAP as the foundation for its comprehensive set of approved accounting methods and practices.

ILBs (inflation-linked bonds) may help hedge against inflation risk because they increase in value during inflationary periods.

Irrational exuberance refers to investor enthusiasm that drives asset prices higher than is justified by those assets' fundamentals.

Large-cap stocks are those from a public company whose total market value, or market capitalization value, is more than \$10 billion. They are generally considered less risky than small-cap stocks.

Market capitalization (market cap) is the value of a company traded on the stock market, calculated by multiplying the total number of shares by the present share price.

M2 money supply is a measure of the money supply that includes cash, checking deposits, and other types of deposits that are readily convertible to cash such as CDs.

MSCI ACWI ex-U.S. Index includes large-, mid-, small-, and micro-cap representation across 22 of 23 developed markets.

MSCI EAFE Index is designed to represent the performance of large- and mid-cap securities across 21 developed markets, including countries in Europe, Australasia, and the Far East, excluding the U.S. and Canada. The index is available for a number of regions and market segments/sizes, and it covers approximately 85% of the free float-adjusted market capitalization in each of the 21 countries.

MSCI Emerging Markets Index includes large- and mid-capitalization emerging market equities from across 24 countries, including 10 with a weight of about 0.9% in the MSCI ACWI Index.

MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. market. With 626 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

Price-to-book value (P/B) is the ratio of the market value of a company's shares (share price) over its book value (value of a company's total assets minus its total liabilities) of equity.

Price-to-earnings (P/E) ratio measures a company's current share price relative to its earnings per share (EPS).

Quality factor refers to the tendency of high-quality stocks with typically more stable earnings, stronger balance sheets, and higher margins to outperform low-quality stocks, over a long time horizon. High-quality stocks generally have the following traits: low earnings volatility, high margins, high asset turnover (indicating efficient use of assets), low financial leverage, low operating leverage (indicating a strong balance sheet and low macroeconomic risk), and low stock-specific risk (volatility that is unexplained by macroeconomic activity).

Return on equity (ROE) is the measure of a company's net income divided by its shareholders' equity. ROE is a gauge of a corporation's profitability and how efficiently it generates those profits.

Risk-off periods are generally characterized by a decrease in stock prices and an increase in bond prices. During periods when risk is perceived as low, investors tend to engage in higher-risk investments. In risk-on periods, when investors feel more cautious, they will tend to sell stocks and buy bonds that are considered safer investments.

Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe.

APPENDIX

DEFINITIONS (CONTINUED)

Russell 1000 Value Index seeks to track the investment results of an index composed of large- and mid-cap U.S. equities that exhibit value characteristics.

Russell 2000 Index is a small-cap U.S. stock market index that is made up of the smallest 2,000 stocks in the Russell 3000 Index.

Safe-haven asset is a type of investment that is expected to retain or increase in value during times of market turbulence or periods of economic downturn.

S&P 500 is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the U.S. It is one of the most commonly followed equity indices.

S&P Developed Property Index defines and measures the investable universe of publicly traded property companies domiciled in developed markets.

Small-cap stocks are those from a public company whose total market value, or market capitalization, is about \$250 million to \$2 billion. Small-cap stocks are generally considered riskier and more prone to wide market fluctuations than large-cap stocks.

Soft landing in the business cycle is the process of an economy shifting from growth to slow growth to potentially flat, as it approaches but avoids a recession. It is usually caused by government attempts to slow down inflation, such as the Federal Reserve raising interest rates just enough to slow the economy and reduce inflation without causing a recession.

Statistical regression is a technique that relates a dependent variable (sometimes called the “outcome” or “response”) to one or more independent variables (sometimes called the “predictor” or “explanatory” variable).

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