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GLOBAL RESEARCH

The Carlyle Compass

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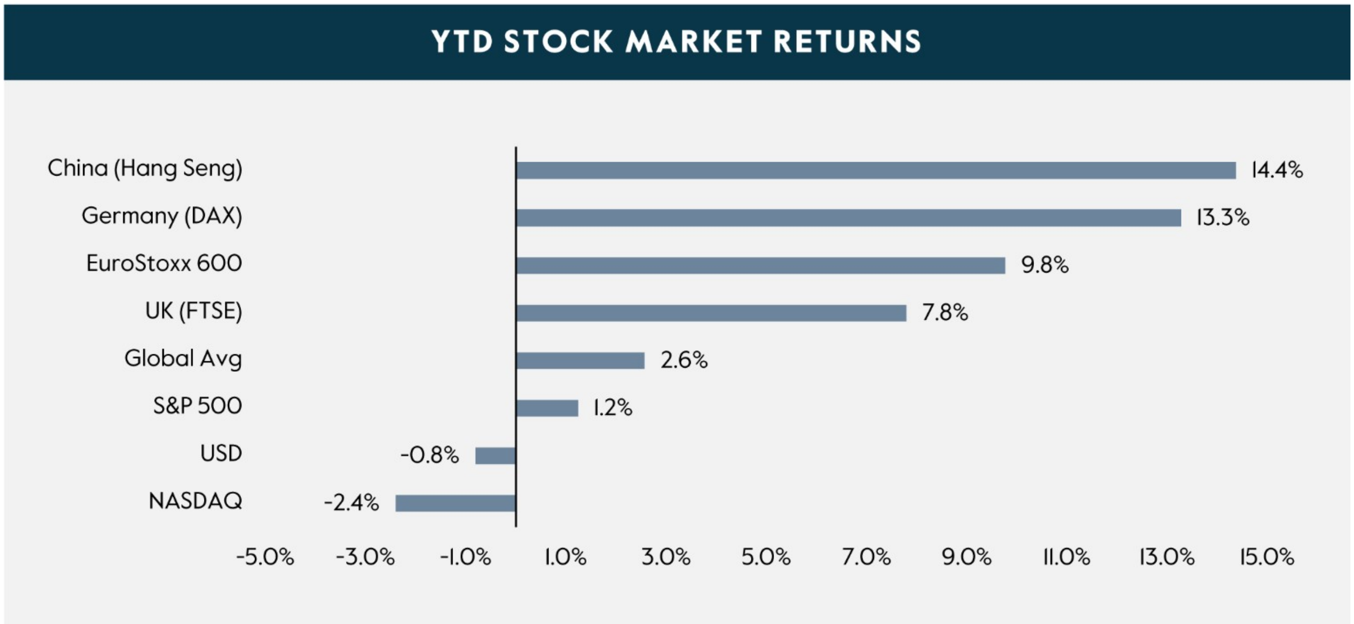
Welcome back to ***The Carlyle Compass****, your weekly newsletter that brings together the latest research and market insights from our global team.*

U.S. stocks find themselves in an unfamiliar position: trailing global benchmarks. Through the first two months of the year, the S&P 500 has returned 8.5 and 13 percentage points *less* than its counterparts in Europe and Greater China, respectively (Figure I). Is this just a blip on the screen or have domestic policy uncertainty and geopolitical upheaval caused stock investors to sour on the U.S?

Figure 1: U.S. Stocks Lag After Years of Outperformance



Source: Carlyle Analysis; Bloomberg, March 2025. There is no guarantee any trends will continue.

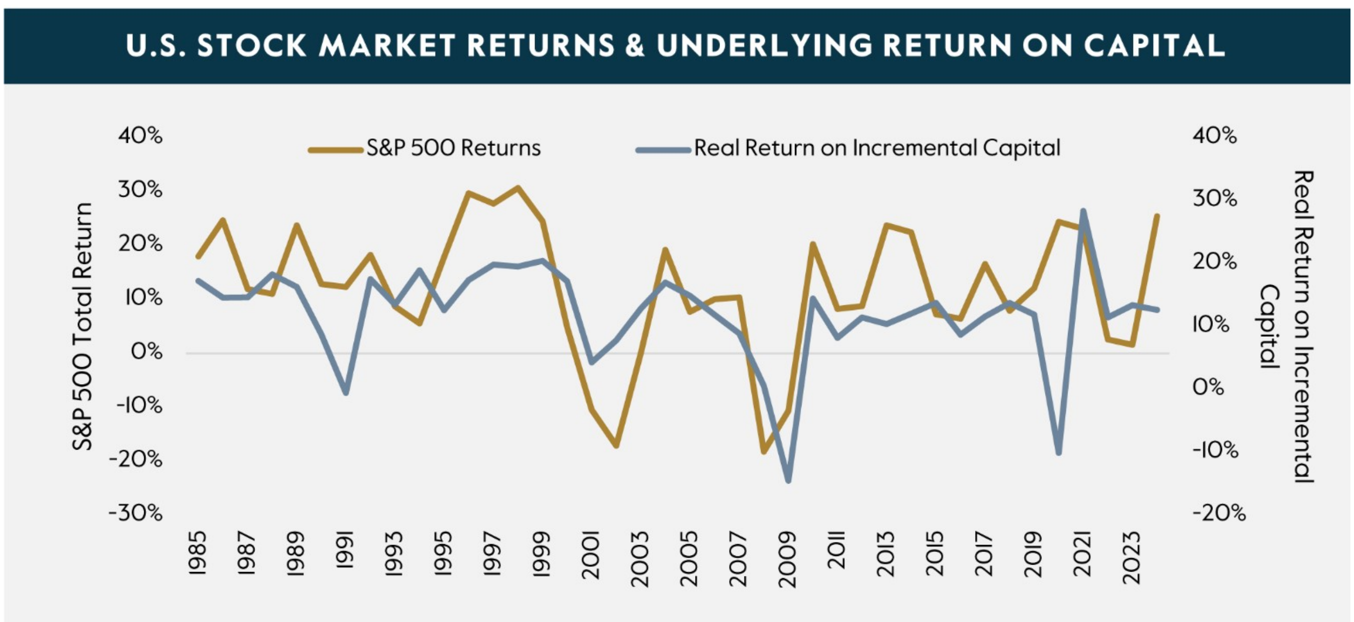
Capital Productivity & Stock Returns

If the return on individual equities depends on the real return that company earns on its capital stock (growth in sales and earnings per unit of invested capital), then the average returns on all stocks in an economy should be related to the economy-wide real return on capital (output generated per unit of fixed investment). And just as individual companies often exhibit decreasing returns to scale, it's reasonable to think that the economy-wide returns would also decline beyond a certain point of capital development.

After the Global Financial Crisis (GFC), many investors piled into Emerging Markets precisely because it seemed that profitable capital deployment opportunities had been exhausted in the developed world. Once the "low hanging fruit" of industrial development and educational attainment had been plucked, high wage economies seemed to face a diminished investment opportunity set. Why allocate capital to older, advanced economies that sustained themselves through property market bubbles and debt-fueled consumption when lower wages, more favorable demographics, and underdeveloped infrastructure created the potential for outsized returns in much of the rest of the world?

As it turned out, inferences drawn from the housing bubble and financial crisis badly misjudged the potential of the U.S. economy. Since 2010, the real return on incremental capital in the U.S. has averaged over 11%, a 400bps increase relative to 2001-2009. And more productive capital translated directly to higher stock returns; the S&P 500 returned an astonishing 14% per year over the same period (Figure 2), about 7 percentage points per year more than stocks in the rest of the world.

Figure 2: Strong U.S. Stock Returns Supported by Fundamentals



Source: Carlyle Analysis; IMF WEO Database, NYU, March 2025. There is no guarantee any trends will continue.

Investors' post-GFC suspicions weren't entirely unfounded. Economy-wide returns on fixed investment averaged only 3.7% in Japan and 5.3% in Europe since then. There was just something "exceptional" about the United States, related not only to its tech sector but also the speed with which new technology diffuses across the rest of the economy, that allowed it to defy the diminishing returns to scale observed in other advanced economies. And that sense of “American exceptionalism” has increasingly become the defining asset allocation heuristic of this era, with U.S. stocks accounting for nearly two-thirds of investors’ portfolios at the start of the year, up from less than half in 2010 (Figure 3).

Figure 3: U.S. Consumes a Growing Share of Stock Allocations

Source: Carlyle Analysis; AQR, March 2025. There is no guarantee any trends will continue.

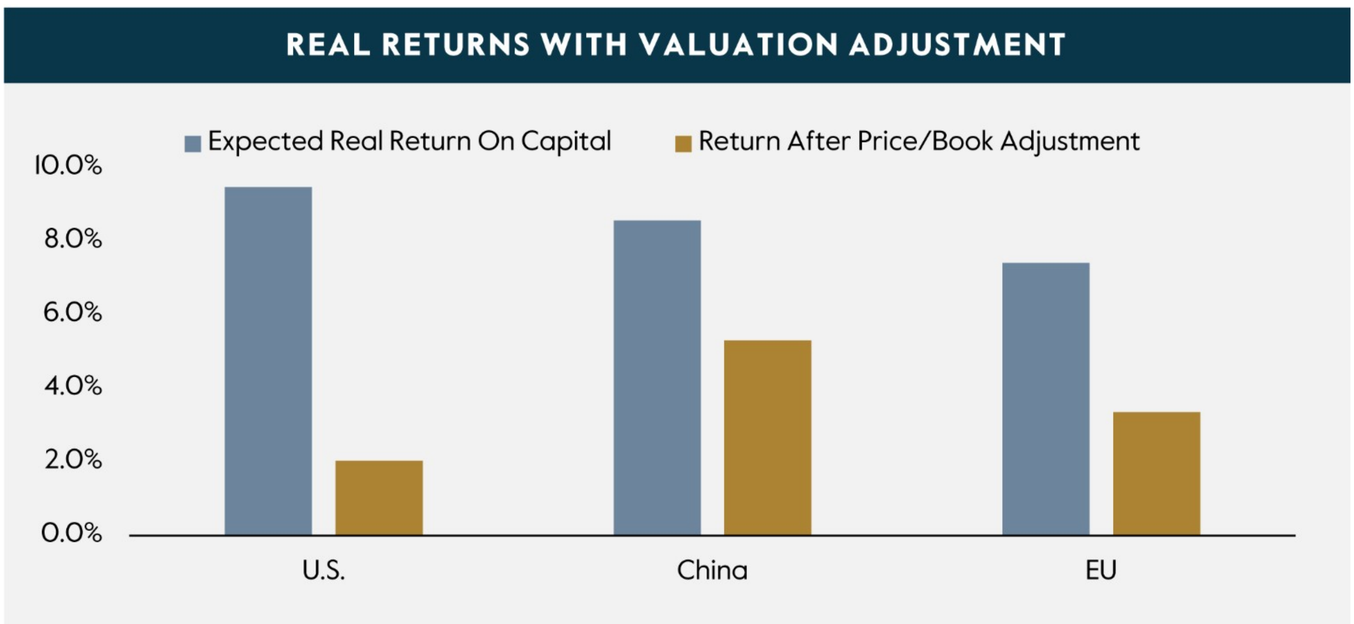
Questions About Stock Valuations, Not Economic Fundamentals

Current macro forecasts anticipate that U.S. economic exceptionalism will continue, with returns on incremental capital exceeding those of other advanced economies by 400bps per year, on average. But that may not be sufficient to sustain U.S. stock market outperformance.

Implicit to these real return measures is the assumption that capital is acquired at cost. In other words, $100 of cash today buys $100 of capital. Unfortunately, investors do not have the option of buying stocks at their current cost or “fair value,” but must instead contend with whatever valuation premiums (or discounts) they embed. And it's when accounting for the U.S. stock market's valuation premium to the rest of the world that one can understand the year-to-date rebalancing towards Europe and Asia.

While there's no reliable way to measure the "fair value" or current cost basis of corporate assets, company book values, or the depreciated historical cost basis of assets, provide a proxy. On this basis, U.S. stocks are valued at a 2.1x premium to those in Europe and a 2.7x premium to those in Greater China. And after adjusting the expected real return to capital by the market-to-book premium one must pay to acquire those assets in their respective stock markets, the U.S. return differential vanishes (Figure 4).[I]

Figure 4: High U.S. Stock Valuations Headwinds to Returns



Source: Carlyle Analysis; IMF WEO Database, Bloomberg, Blackrock, CEIC, March 2025. There is no guarantee any trends will continue.

Implications

In retrospect, the past always looks like it was easier for investors to navigate than it was. From the vantage point of 2025, it seems hard to believe there was a time, not long ago, when it was common to assume incremental capital would be more productive when deployed outside of the U.S. economy than in it. This misperception planted the seeds for one of the most spectacular bull markets in history, with returns on broadly-diversified U.S. stock portfolios exceeding virtually every investor's expectation.

U.S. stock valuations have not only caught up to realities of "American exceptionalism" but seem to be running a bit ahead of them. Increased allocations to markets with less-productive, but cheaper, capital make sense, as do alternative strategies to capture the U.S. productivity edge outside of listed equities.

1. A number of caveats are in order. First, these adjustments do not account for capital structure, tax policy, or the quality of governmental institutions. Some of the valuation gap could reflect differences in risk perceptions or factors that increase equity's share of the expected return on assets. Second, book values do not account for excess inflation, which may overstate the size of the market premium relative to the current cost basis of the assets. Finally, book values do not account for intangible assets, like data, brand, and proprietary technology, which could make the tech-rich U.S. market appear more "expensive" than if there were full accounting for the value of those assets on company balance sheets. But since those assets undoubtedly increase the real return generated by a given amount of fixed capital, this effect should mostly be a wash.

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