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US equities – a pause for reflection or the start of a wider downturn?

On Thursday 13th March, US equity markets[1] fell into correction territory, meaning equity indexes have fallen by at least 10% from a recent high. It's taken only 16 days for the correction to occur.

Before we assess what's driven the heightened volatility and the considerations this might have for your investment strategy, it's worth setting out more about the backdrop.

Putting these market moves into perspective

- Coming into 2025, the S&P 500 had experienced back to back annualised gains in excess of 20%. This was last seen in the mid-1990s.
- Since 1929, there have been 56 corrections from the S&P 500. More recently, on average, corrections occur approximately once per year.
- Bear markets are more severe and occur when an index falls by 20% or more. However, only 22 of the 56 (39%) S&P 500 market corrections have historically evolved into a bear market.
- Of the 56 corrections, this has been the fifth quickest contraction.
- So far, the recent sell off has been relatively contained within US equity markets. However, US equities make up c.70% of the global equity index.

Key market drivers

1. **Escalating trade tensions** – It has been widely accepted that, in the short-term, policies such as tariffs would cause heightened uncertainty. Increasingly, however, there is concern from some market participants that the effects of such policies could spill over into a potential economic slowdown and could cause the level of global inflation to remain stubbornly high. This would leave less room for the US Federal Reserve to cut interest rates. Various forecasters, notably Goldman Sachs, have lowered their US economic growth forecast for 2025 from 2.4% at the start of the year to 1.7%. Investors are concerned that prolonged trade disputes could dampen consumer confidence, disrupt supply chains, and negatively impact corporate earnings, all of which have contributed to the recent market downturn.

2. **Geopolitics –** Conflict resolution or escalation between Ukraine and Russia, and in the Middle East, remain in the minds of asset allocators.

3. **Stock market concentration -** As detailed in our video blog posted last year Equity Market concentration; we discussed the risks involved with a heavy concentration of assets. The previously termed "Magnificent Seven"[2] stocks comprised 31% of the S&P 500 index at the end of 2024. This underscores the substantial influence these seven technology giants have on the overall index performance. A lower forecast of revenue growth in this sector has caused a substantial hit to the

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[1] Us equity market indices include, the S&P500 index (which accounts for approximately 80% of the total market capitalisation of U.S. public companies) the Dow Jones Industrial Average Index (an index of 30 prominent companies listed on various US stock exchanges); and the Nasdaq composite (a barometer of the global technology sector).

[2] Comprising Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia, and Tesla

majority of these stocks. The question weighing on investors' minds is whether AI can be monetised to meet the expectations on corporate earnings.

4. **High equity valuations -** The Cyclically Adjusted Price-to-Earnings (CAPE) ratio[3] for the S&P500 reached 38.1 in December 2024; a level not seen since the peak of the bull market in 2021. Historically, the ratio has been around 17. This elevation has prompted concerns among investors about potential overheating in the US equity market. Following the recent correction, the ratio still remains well above average. Other common metrics to assess whether an index is over or undervalued, such as the price-to-earnings ratio, also suggested elevated levels coming into the year. However, it's worth noting that the dominant companies in the market, including the Magnificent Seven, are very different in nature compared to those of even very recent times - these tech giants have demonstrated resilient earning streams, whilst being viewed by many as high growth stocks.

5. **Base rates and bond yields –** US rates have come under negative pressure as government spending (and therefore borrowing) is reduced, and falling purchaser confidence in the US warrants more encouragement for consumers by way of further rates cuts to come. Meanwhile, across Europe bond yields have pushed higher, due to already challenging budget deficits and a massive increase in government borrowing (permissible only by the removal of centralised EU restrictions) in an attempt to bolster defence spending.

Our view and investment considerations

Of course, the situation is extremely fluid, but if we look at the drivers causing the correction and where US equity markets have come from, it appears rational that such a fall has occurred – after all, the party can't go on forever. It could be argued that the impact of the latest polices is to cause a rebalance of the US economy on the world stage. The US administration has already noted it is prepared for some disruption and a "detox" of the economy would be needed initially, before longer term stability can be seen. The current administration has indicated that it is prepared to look longer-term, and not to alter policy to support shorter-term market movements. If you align with these views, then the recent market fall presents a good buying opportunity.

However, the heightened uncertainty, and persistently high valuations, could certainly warrant a further fall in markets. One of the biggest risks is that trade disputes and conflicts between nations are not resolved in the shorter-term, and recession fears play out, which of course would impact the global economy and cause more persistent falls in US equities, bringing global indices down with them.

On the other hand, we are seeing what could potentially be a shift in regional asset allocation. European and Chinese equity markets have started the year very well (up 9.7% and 4.0% year to date respectively). This is of course in stark contrast to the US, where the S&P 500 is currently down 5.0%. Significant, and historic, fiscal stimulus packages have been announced in Germany (the blocs largest economy) and China and whilst these may not solve some of the more inherent and longer-term

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[3] This valuation metric divides the current price of an index by the average inflation-adjusted earnings over the past ten years, smoothing out short-term earnings volatility. A higher CAPE ratio suggests that stocks are expensive relative to historical earnings, potentially indicating lower future returns, while a lower CAPE ratio may signal undervaluation and the possibility of higher future returns.

structural problems of the two economies (i.e. not fixing the foundations), over the short-term it could lead to equity market outperformance over the US. European equity markets, in particular, have been out of favour with investors over the recent past. The announcement of huge government spending in Germany along with the fact equity valuations look cheaper relative to the US, could provide an attractive opportunity for investors. The question is whether the historical discount applied to European stocks, particularly those registered in the UK, will persist.

As always, we suggest growth portfolios remain diversified, being invested across regions and asset classes. Investments with low equity market 'beta' (sensitivity) such as hedge funds, commodities, private equity and structured credit should be considered. Heightened volatility may also warrant the need to review implementation options, for example, assessing the role that active management could play in your wider portfolio.

Please reach out to your Quantum contact to discuss market events and investment strategy considerations further.