Citi Wealth

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# Rising US Expectations and "Reflexivity"

- In November, US consumer expectations jumped higher. A key survey measure from the University of Michigan showed "expectation for the future" rose above the rating of "current economic conditions" by the largest margin since the survey began in 1974. This has been followed by preliminary data in December showing a jump in current ratings of the economy. [1]
- Similarly, a measure of US small business expectations showed the largest rise in the share of owners expecting the economy to improve since November/December 2016. That jump followed Donald Trump's election to his first term as US President.
- In economics, "reflexivity" is a concept suggesting that reality follows perception. If consumers and businesses *expect* a strong outlook, they will *act* to generate it. With both positive and negative government policy catalysts for US economic growth, we have to consider rising expectations in the mix. An appreciating equity market leads and reinforces consumer spending and business investment.

## Potential Portfolio Implications

- There are portfolio dangers when the dichotomy between expectations and reality becomes extreme. US large cap equity returns this year have been roughly double EPS gains. Of course, the strongest returning equities of 2024 have much larger EPS gains, but many have seen valuations expand faster than EPS.
- As discussed in our latest Quadrant, the outperformance of US equities has persisted for 15 years with a generally rising valuation over that time. This encourages inflows from the broader world, reinforcing the trend "reflexively" (the US dollar has risen over this time too).
- When an exceptional rate of growth requires an ever-more exceptional price, we have to consider the impact on future returns. US large cap equities have returned 13.3% for the past 10 years, more than their 10.2% century-long average. US small- and mid-caps have returned 9.3% despite outgrowing large cap EPS in the past decade (9.7% compounded EPS growth vs 7.1%). Non-US shares returned just 5.1% in appreciating US dollars.
- There's no obvious catalyst for a change in the US equity outperformance trend. The extremes of the past year's outperformance (2020 basis points) and persistence for a record long period should raise attention to the potential of diversification benefits. Investor positioning and sentiment is a contrarian indicator worth highlighting for the coming year.

[1] University of Michigan Surveys of Consumers, December 2024.

# Cursed or Blessed with High Expectations?

The S&P 500 returned 5.9% in November, pushing the year's total return to +29.2%. As we will highlight in our coming *Wealth Outlook for 2025*, we remain optimistic on the economic and corporate earnings outlook for the coming two years. This is even as the incoming US administration is likely to drive higher levels of global market volatility with tariff pressures.

The 54% cumulative return for the S&P 500 over the past two years may seem highly unusual. However, many investors misjudged the outlook for the economy during that time. They needed to consider a 23% drop in the S&P 500 within 2022 as a key pre-condition for the unusual market recovery. Both US equities and bonds suffered losses together in 2022, marking only the third calendar year period with such a combined loss over the past century (please see our Wealth Outlook 2024). In both previous cases (1931 and 1969) the subsequent two years of returns were unusually strong. The same is true for joint stock and bond losses of the past century that did not fit neatly into annual windows of time.

With this said, we must consider the S&P 500's strong performance for the past decade too (13.3% annualized). Its stark outperformance versus most other assets alters the long-term return outlook for large cap US equities. The most naïve of forecasts would "mean-correct" for S&P 500 returns that have been three percentage points above the very long-term average during the past 10 years.

The history of faster EPS growth and higher returns for smaller, profitable US companies hasn't generated similar returns as US large caps. The S&P 400 and 600 have returned a 9.3% average over the past decade. And with the weight of a rising US dollar, non-US equity annualized returns (measured in US dollars) have been even lower at 5.2%.

Of course, US EPS have outperformed the world over the past 15 years, helping US outperformance. However, as **FIGURE 1** shows, market valuation has risen even faster, with the gains concentrated in US large caps (see **FIGURE 2**).

**FIGURE 1:** US share of global equity market cap and earnings

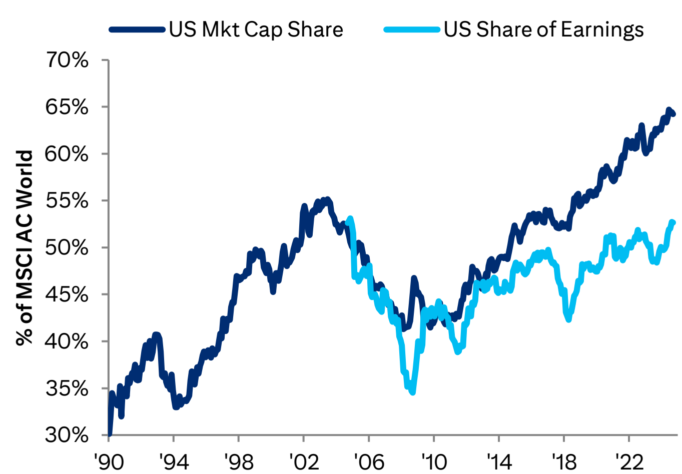
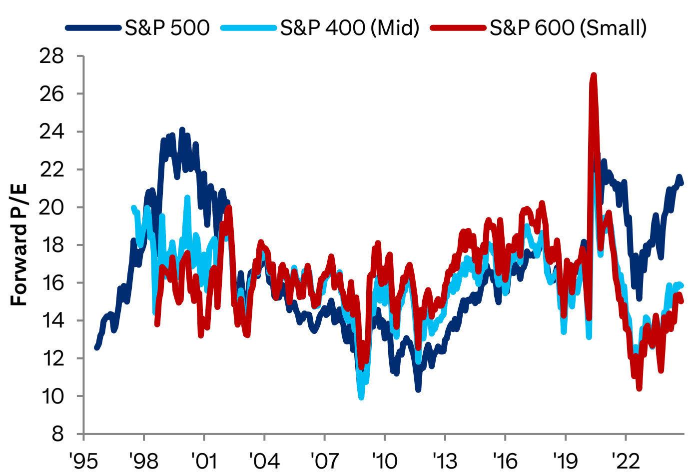



**FIGURE 2:** S&P small, mid, and large cap forward P/E




Source: Bloomberg as of November 25, 2024. MSCI US and MSCI AC World used as proxy. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

## Will greater confidence give the US stronger growth?

“Reflexivity” theory suggests that investors base their decisions on perceptions and expectations that can be off the mark from reality. Nevertheless, their actions can have an impact on fundamentals that can then justify one’s original expectations in a self-fulfilling way. Such dynamics have played a role in sovereign debt crises and “bank runs” for centuries. In the opposite way, they also can play a positive role in economic and market performance.

In the above discussion of US/non-US equity returns, global confidence in the US dollar influenced the return of US and international shares. From the “average” foreign investor’s perspective, US returns, as measured by the index, were 27% higher in the past decade because of the appreciating dollar. While it costs more to purchase US equities in an appreciating currency, the performance incentivized a greater allocation to the US. (In the past 10 years, international direct ownership of US equities has increased faster than domestic ownership.)

What about the expectations for a “return to US economic greatness?” What bearing might expectations have on reality? In last week’s CIO Bulletin, we discussed the potential “toll” new US tariffs on Canada and Mexico might have on the US economy. While we see a strong probability that those conditional tariffs are never implemented, we must see them as a new source of forecast uncertainty and downside risk to our outlook. Conversely, *rising growth expectations* are an upside risk to our forecast for US growth in 2025.

As **FIGURE 3** shows, share prices tend to lead business investment by roughly a full year. Uncertainty over trade regimes may weaken business investment and employment for certain firms. In contrast, the path of US equities in the past year implies *strengthening* capital investment spending in 2025 compared to 2024.

## Precedent for surge in small business confidence, wealth effect

Is the case for stronger business investment more than just stock market exuberance? We think an outlook for diminished regulation justifies stronger expectations for investment growth. As **FIGURE 4** shows, the share of US small businesses surveyed by the National Federation of Independent Business expecting the economy to improve jumped 7 percentage points last month[2]. But this is not likely the endpoint for the rise. History suggests the full impact of US election results on growth expectations is not fully embedded in the early November survey data. Following Donald Trump’s first election in 2016, this share of small business owners – who tend to be tax and regulation averse – surged 38 percentage points in December.

[2] NFIB Small Business Optimism Index, October 2024.

**FIGURE 3:** S&P 500 (leading 1 year) vs US business investment

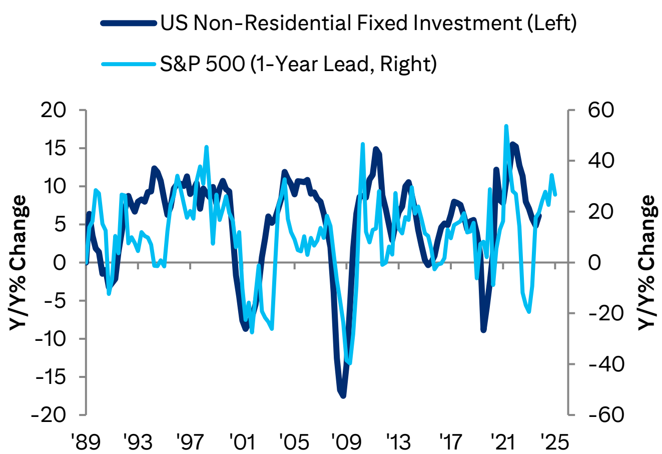
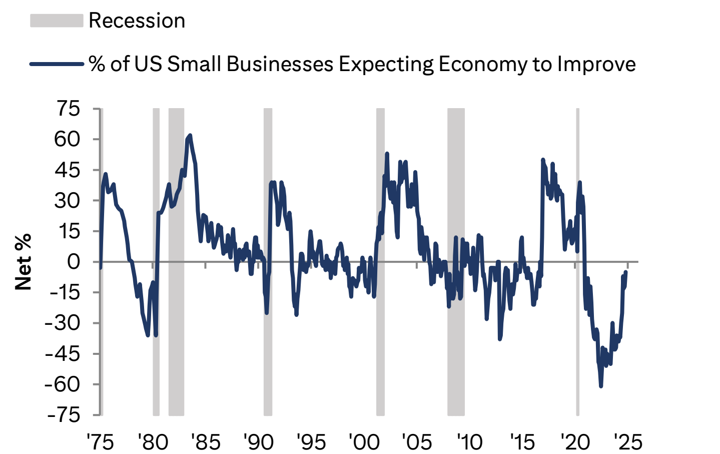



**FIGURE 4:** US small business survey: net % of firms expecting economy to improve




Source: Haver Analytics as of December 3, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

The so-called "wealth effect" also sways the growth of consumer demand. Rising equity and property prices tend to weigh against precaution in consumer spending (see **FIGURE 5**). Income growth powers more "punch" when household wealth is soaring. We believe wealth data for 4Q 2024 will show a much stronger advance than seen in the year-to-date, suggesting upside potential for consumer spending growth. This weighs against other evidence suggesting a likely slowdown.

## Perception/reality: be mindful when they gap

This brings us to a potential gap between expectations and reality. During the past couple of months, US consumer expectations in the long-running University of Michigan survey surged. By November, the gap between expectations and current conditions rose to the highest level in the survey's 50 years of available data (see **FIGURE 7**). "Current conditions" suddenly jumped in December in an early month preminary reading. [3]

History suggests expectations are in fact *better* at predicting the future path of the economy than the ratings of current conditions[4]. Combined with the stronger business confidence readings and likely path for business investment, the rise should be considered a potential upward risk for US growth forecasts for the coming year or more.

With this noted, it is much easier to be disapointed when expectations are high. As we've discussed in a recent CIO Bulletin, expectations that "onshoring" of manufacting jobs will lead to stronger US factory employment largely miss the mark. Automation has had larger negative impacts on factory headcount than international trade. The same is true of the agricuture, energy industries and many others. For those hoping for a return to the labor market of the past, there will be limits in available workers and US infrastructure to consider even away from automation.

For US equity markets, the gap between large cap EPS growth and performance has grown this year. The rise in share prices and "reflexivity" points to upside risk to our own views on future corporate profits. We anticipate high single-digit gains in each of the next two years. As **FIGURE 8** shows, the gap between expected profits and actual corporate profits is a large one to fill. Conversely, non-US markets price in low expectations (see **FIGURE 9**).

[3] University of Michigan Surveys of Consumers, December 2024.
[4] Following empirical tests, expectations rather than current conditions are included in the US Index of Leading Economic Indicators.

With all due respect to “reflexivity” and the “fear of missing out,” we see a strengthening case for diversifying to market segments with lower expectations after the gains of 2024. As the 18th century poet Alexander Pope is credited with saying, “blessed is he who expects nothing, for he will never be disapointed.”

**FIGURE 5:** US household net worth and real consumer spending


**FIGURE 6**: US consumer expectations and current conditions

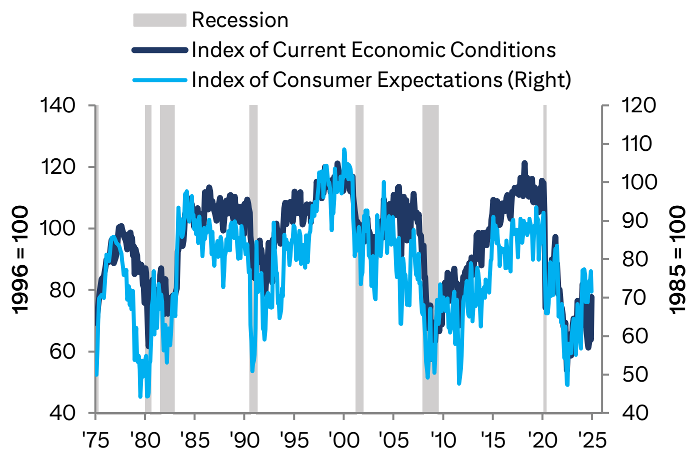



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**FIGURE 7:** Gap in favor of “higher expectations” hit largest since 1974 in November

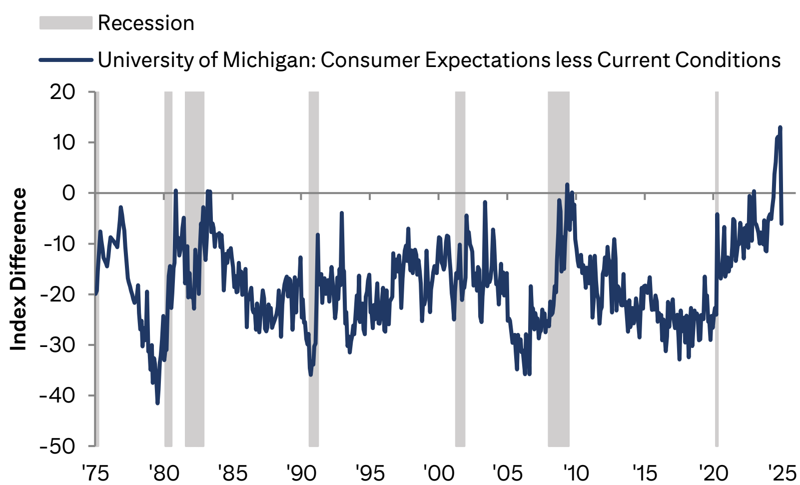


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**FIGURE 8:** S&P 500 (leading 6 months) vs EPS Y/Y% with CWI estimates

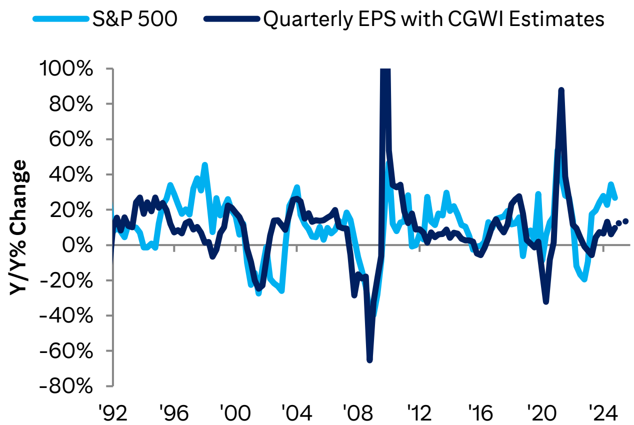
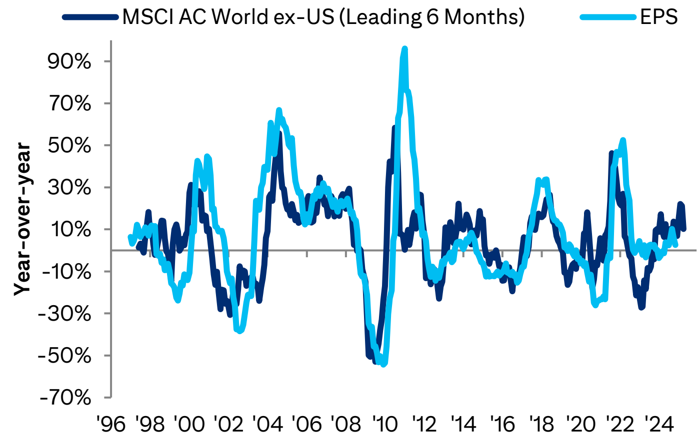



**FIGURE 9**: MSCI World ex-US equities (leading 6 months) vs EPS Y/Y%




Source: Bloomberg and Factset as of December 3, 2024. Circles indicate the difference in earnings expectations between US and international shares. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.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|---|---|---|---|
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| **Investment Grade** | | | |
| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (Strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| **Not Investment Grade** | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

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- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
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