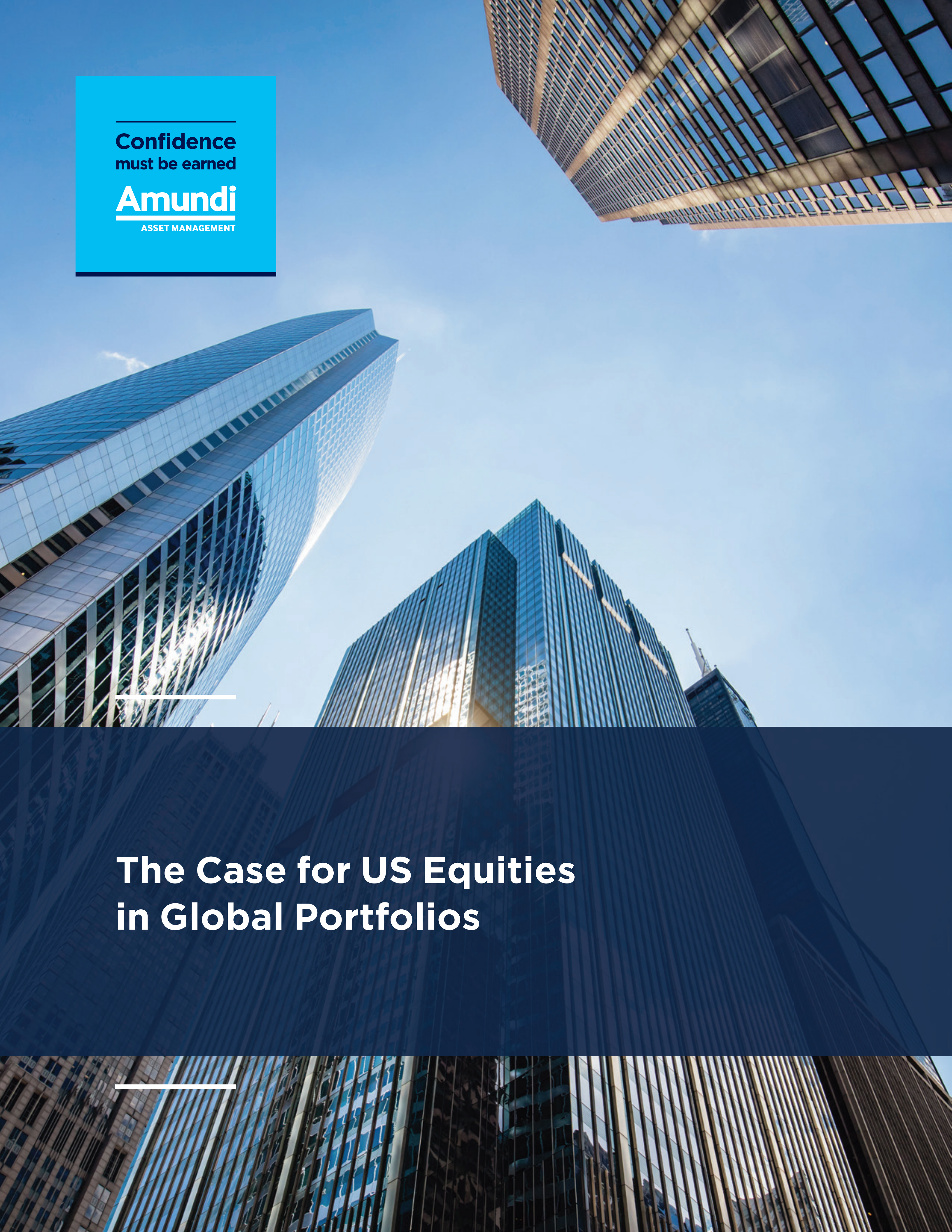
Confidence must be earned

Amundi ASSET MANAGEMENT



The Case for US Equities in Global Portfolios

Preface

As you construct and monitor client portfolios, we hope you find our Blue Paper informative, insightful and rather complementary to your ongoing due diligence and asset allocation endeavors – both for the balance of 2020 and in the long-run. Recognizing the presence of potential constraints you might encounter through the lens of existing investment guidelines, the composition of your benchmarks, regional exposures, or investment styles, we believe the findings of our research suggest the consideration of US equities for inclusion in either regionally or globally-focused portfolios, to help raise the odds of longer-term risk-adjusted outperformance in client portfolios. The latter is informed by our analysis and what we deem secular—rather than merely cyclical—tailwinds for US equity markets.

Executive Summary

The post-pandemic market reality accentuates the attractiveness of the US stock market. Similar to the period after the Great Financial Crisis, we believe the medium-to-long-term landscape once again favors companies with records of large-cap secular growth, stability and defensiveness. These characteristics define a much higher proportion of the US market relative to the rest of the world resulting in what we believe may be a more optimistic outlook for US equities.

Specifically, *The Case for US Equities in Global Portfolios* is built on the premise that unlike other markets, the S&P 500 is not particularly analogous to the US economy. Rather, it is a collection of the best and most profitable companies in the world. The US economy is not the US stock market!

While the US economy has certainly suffered from the COVID-19 shutdown, sectors that comprise over 75% of the S&P 500 have had neutral-to-positive implications, and we expect many of the themes to persist in the post-pandemic economic landscape.

- Technology: work from home; accelerated digitalization; cloud adoption (27% of S&P 500).
- Health Care: the upshot of COVID-19 is that the sector is part of the solution and not only a health care cost problem (15% of S&P 500).
- Communication: remote working accelerated 5G deployment; social media and search; streaming (11% of the S&P 500).
- Consumer Staples: increased consumer product purchases; Walmart and grocery stores meaningfully increased volumes (7% of the S&P 500).
- Real Estate: the majority of the index weight is comprised of wireless tower operators (5G), data centers and e-commerce logistics warehouses, all of which have had increased activity; note commercial real estate and shopping malls total less than 20% of the sector (3% of the S&P 500).
- Utilities: definition of stability (3% of the S&P 500).
- Consumer Discretionary: Amazon.com and the home improvement retailers, such as Home Depot, have meaningfully benefited, and they are over half the sector (11% of the S&P 500).

The economically sensitive sectors of Financials, Industrials, Energy and Materials, which have had negative impacts, make up the other 30%.

Importantly, the weight of companies in the S&P 500 is a function of profit levels and, thus, valuation, and not the number of employees. This further demonstrates that the US stock market is not the economy. Case in point:

- American Airlines, Macy's and Marriott that collectively employed 430,000 people, mostly in the US, at the end of 2019 had a combined market cap of about $38 billion or less than 14 basis points (bps) in the S&P 500.
- Apple, Microsoft, Alphabet/Google and Facebook collectively had almost the exact same number of employees at year-end 2019, but have a combined market cap over $4.5 trillion, or about 17% of the S&P 500. Moreover, about half the revenues of these four global titans, and a significant proportion of employees, are outside the US, yet the market capitalization is all in the US market.

The composition of the US relative to other markets has evolved over time and can be attributed to several factors:

- US equities have generally outperformed other developed market equities over time, resulting in greater wealth creation.
- The return on invested capital has been superior for US companies, contributing to their higher profitability and supporting the valuation premium of the US market.
- The effect of historically higher profitability on the performance of US equities is evident.
- The drivers of the innovation, growth and profit gap between the US and other markets have been structural and are durable.
- Drivers of public policy are different and affect composition, innovation, growth and performance across regions.
- The economic structure of lower taxes and flexible labor markets has provided US companies with business model advantages.
- More effective recycling of capital has provided further fuel for growth and innovation.

History paints a compelling picture for US stocks

The "creative destruction" that has powered innovation in the US has also driven greater, more sustainable, secular growth.

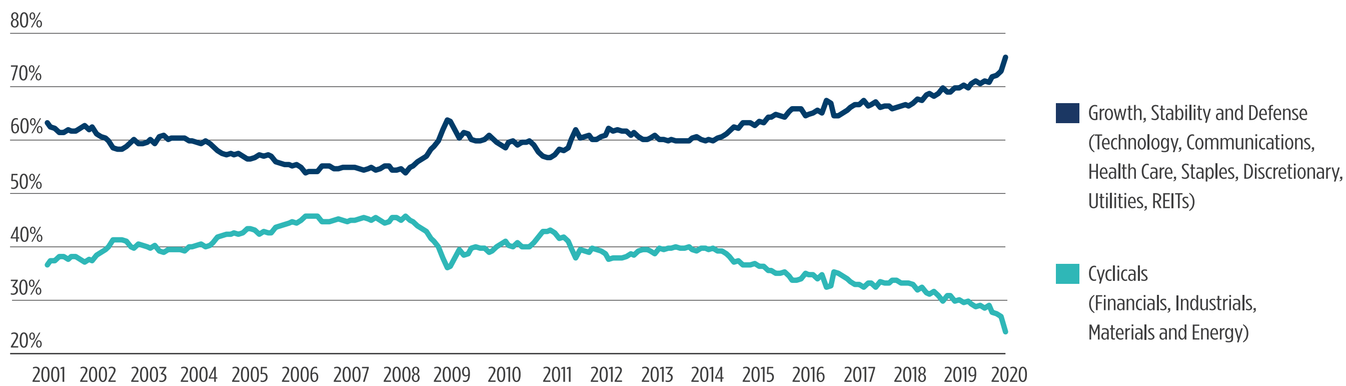
US equities have historically outperformed other developed market equities in most periods, resulting in greater wealth creation over time. US equities (as measured by the S&P 500 Index) outperformed other developed market equities (as measured by the MSCI EAFE Index) in 19 of the past 30 calendar years. For the past 30 years, US equities delivered cumulative returns of 1574% compared to 235% for the MSCI EAFE Index. We believe the long-term outperformance of US equities is explainable and likely to persist.*

The relative composition of equity markets has shifted in favor of the US.

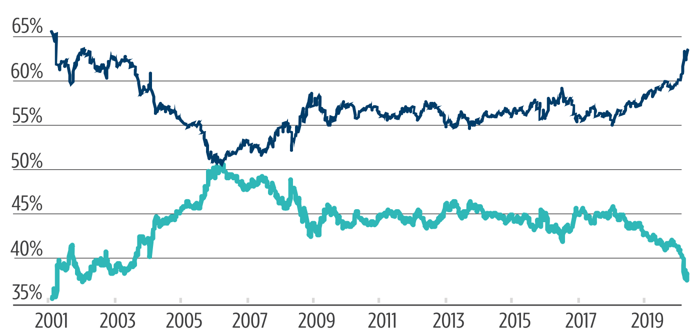
Differences in the drivers of public policy and economic structure have resulted in a shift in the composition of equity markets over the past several decades. The US market is now meaningfully skewed towards more growth-oriented, stable and defensive companies, particularly when compared to Europe and Japan. We believe investing in companies that are driven by innovation, especially in technology and health care, offer more potential for stability and growth to help investors pursue higher returns over time.

The Composition of the Market Changes Over Time

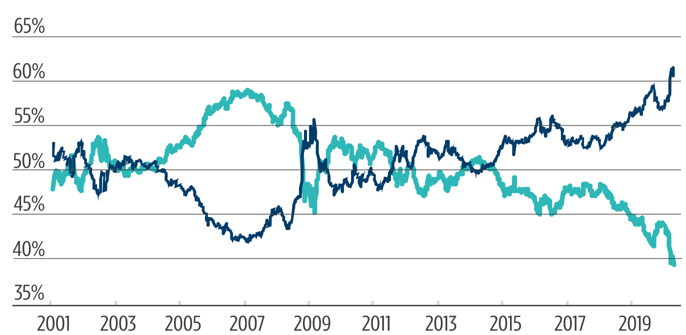
US Equities



European Equities



Japanese Equities



Source: Cornerstone Macro. Last data point for all three charts is 3/31/2020. US equities are represented by the S&P 500 Index, European equities by the MSCI Europe Index and Japanese equities by the MSCI Japan Index.

* Source: Morningstar. 1/1/90 to 6/30/20. All index returns are total returns in USD.

Return on capital has historically been greater for US companies

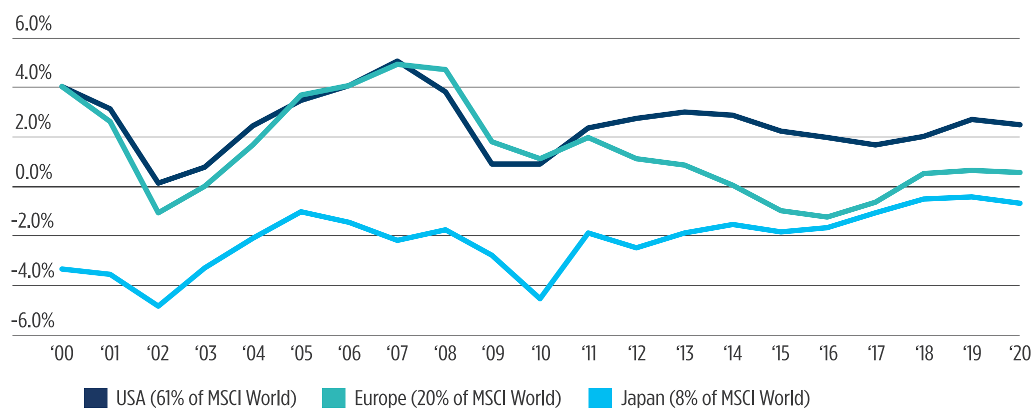
Beyond a more favorable composition of business skewed towards growth and stability, there are other reasons US companies have historically exhibited greater profitability over time.

Beyond a more favorable composition of business skewed towards growth and stability, there are other reasons US companies have historically exhibited greater profitability over time.

Return on capital is a measure by which companies and/or investors can determine whether an investment may be worthwhile. The cost of capital typically represents the weighted average of a firm's cost of debt and cost of equity blended together. Companies earning a return on capital above their cost of capital are effectively creating economic value.

As the chart below shows, US companies in the MSCI World Index have generated a return on capital that is more than 2% higher than their cost of capital. By comparison, European companies in the MSCI World Index have achieved returns barely above their cost of capital (less than 1%). Japanese companies, meanwhile, have perennially achieved returns below their cost of capital. Notably, the spread in return on capital between US and European companies has widened significantly since the Great Recession, as Europe has continued to struggle with economic malaise.

Spreads Above Cost of Capital



Source: ISS EVA. Last data point 1/31/2020.

As we consider the aftermath of the pandemic and recession, we believe the economic uncertainty has created a lack of clear earnings visibility, which will likely impair low-return companies even more. Beyond the lower investment in innovation, technology and health care inherent in non-US equity markets, structural and economic pressures persist as growth capital expenditures are restrained.

Higher debt burdens, which have ballooned during the pandemic crisis, can hinder a full recovery and many business models may become obsolete. We believe that companies with stronger balance sheets and sustainable growth, such as many of those found in the US, can benefit from easier credit conditions, enabling them to further consolidate market share.

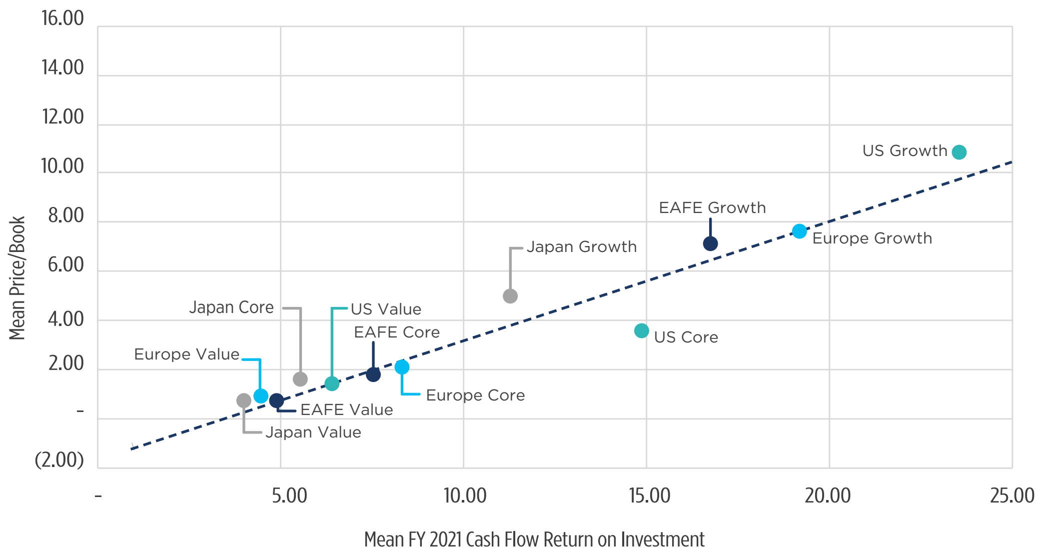
Investors in US equities get what they pay for!

The valuation premium for US equities is warranted because of higher profitability

Valuation

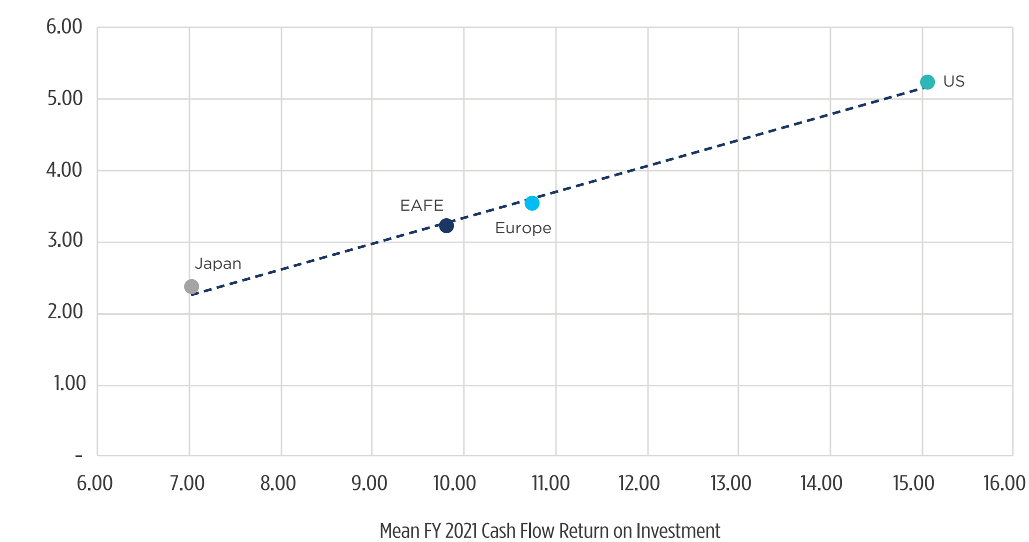
Some argue that much of the greater market emphasis of innovation, growth, stability and defense is reflected in valuations. While it is true that the US trades at a valuation premium to Europe and Japan, the higher profitability levels warrant such a premium when measured against 2021 estimates for return on invested capital. Investors in US equities get what they pay for!

Regional Averages by Price/Book Tercile



Source: Credit Suisse HOLT

Regional Averages by Price/Book Tercile



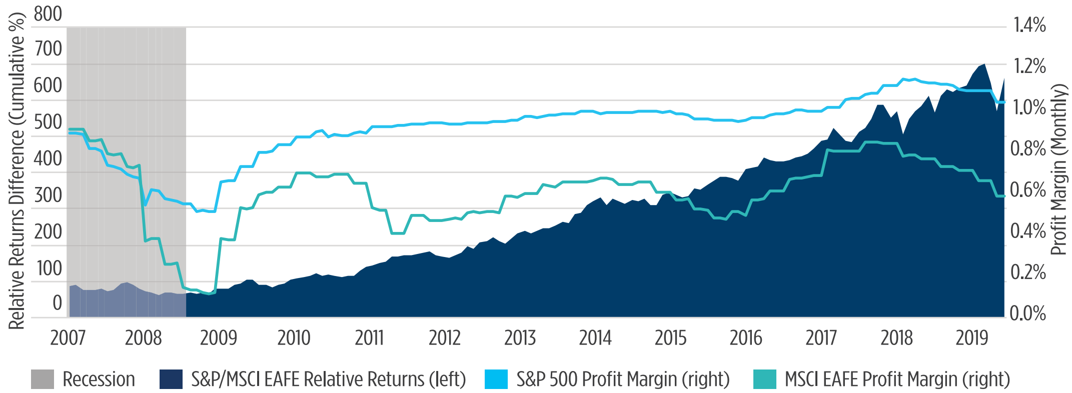
Source: Credit Suisse HOLT

The post-COVID environment only further supports an emphasis on the US market dominated by innovation, growth, stability and defense over the higher cyclical European and Japanese markets.

The effect of higher profitability on the performance of US equities is evident

Since the Great Recession, profit margins of companies in the S&P 500 Index have been consistently higher than those in the MSCI EAFE Index. The higher level of profitability has contributed to the steady outperformance of US stocks, as shown in the chart below.

US has Outperformed Due to High Profitability



Source: Bloomberg and Amundi Pioneer. Last data point 4/30/2020. **Past performance is no guarantee of future results.**

We believe this trend will likely continue into the aftermath of the pandemic and recession. Importantly, recessions typically accelerate pre-existing trends, such as working from home or the preference in recent years for online retail. This may increasingly challenge traditional business models and favor innovative and technology adoptive businesses that we believe could gain market share.

Near-term post-COVID earnings picture furthers higher US profitability paradigm.

As we demonstrate in this paper, the gap between the US and the rest of the world is structural and we do not expect any mean reversion. Further, key short- to medium-term indicators such as 2020-21 earnings estimates and valuations do not suggest anything otherwise. The post-COVID environment only further supports an emphasis on the US market dominated by innovation, growth, stability and defense over the higher cyclical European and Japanese markets.

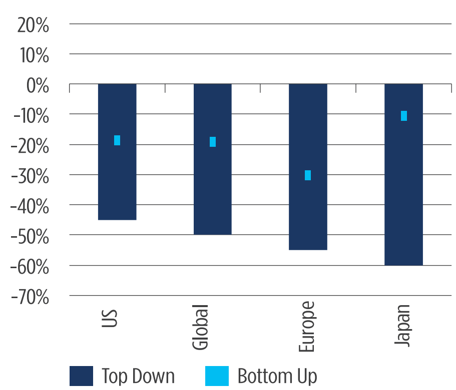
EPS estimates are expected to drop 50-60% in Europe and Japan versus about 45% in the US.

2020 and 2021 Earnings Estimates

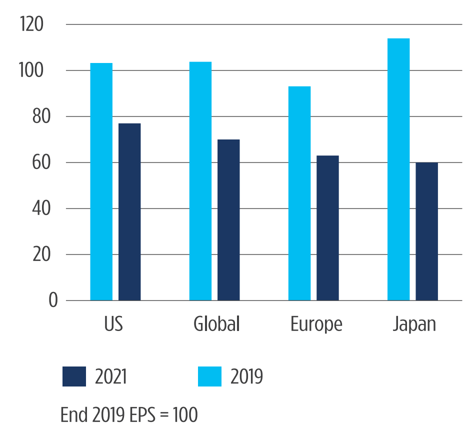
Earnings-per-share (EPS) estimates are expected to drop 50-60% in Europe and Japan versus about 45% in the US. Moreover, according to Citi Research, 2020 earnings estimates still have room to fall the most for Europe and Japan as the rest of the year unfolds. This is demonstrated by the gap between top-down, macro-driven forecasts and bottom-up, analyst-driven forecasts. We also observe that for 2021, more of an earnings recovery versus pre-pandemic 2019. Similar to 2020, analyst estimates must still come down more for Europe and Japan than the US.

2020 and 2021 Earnings Estimates Comparison

Top Down vs. Bottom Up EPS Estimates



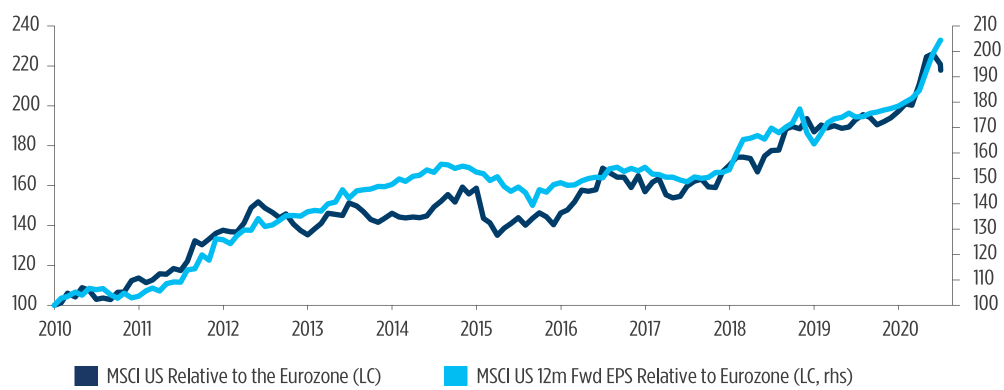
2021 EPS Estimate Comparison to 2019



Source: Citi Research, Factset.

There is a strong relationship between relative earnings and market performance. Relative 12-month forward EPS suggests further US outperformance.

US vs. Eurozone and Earnings Relative



Source: JP Morgan

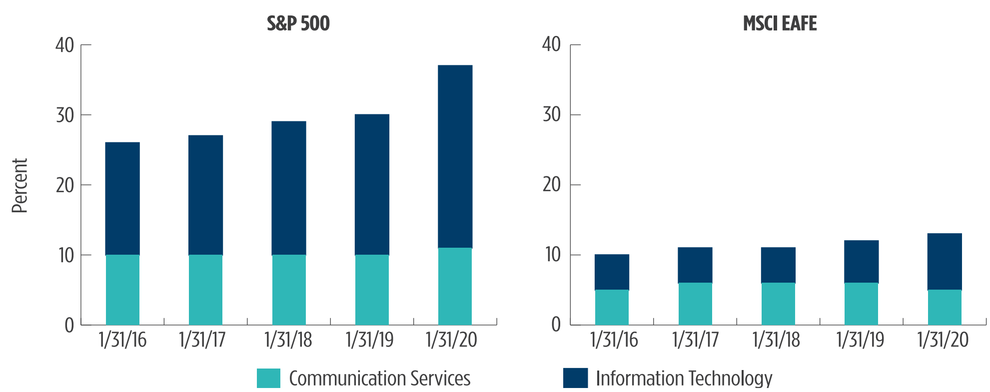
A primary driver of innovation, growth and greater profitability has been the dominance by the US in sectors such as communications services and information technology, which have higher profit margins than others.

The drivers of the innovation, growth and profit gap between the US and other markets are structural and durable.

A primary driver of innovation, growth and greater profitability has been the dominance by the US in sectors such as communications services and information technology, which have higher profit margins than others[1]. As shown below, communication services and information technology account for over one third of the S&P 500 Index, compared with approximately 15% for the MSCI EAFE Index. Adding in Amazon.com and Booking.com that reside in consumer discretionary, the likes of which do not exist within other developed markets, further increases that gap.

Innovation and growth are also found in the health care and industrials segments of the US market. The S&P 500 has over $600 billion in market cap of biotechnology, which is over four times the amount in the MSCI EAFE. In addition, companies such as $185 billion+ market cap Tesla and $50 billion+ market cap Uber Technologies sit in the auto and industrials sectors, respectively. While the longevity and sustainable profitabilty of those companies has yet to be determined, at the very least, they can provide real-time examples of innovation that can be leveraged globally within virtually all sectors. Moreover, the communications services sector includes innovators such as Netflix, Facebook, and Alphabet/Google in the US. Outside the US, the sector largely consists of slower growing "old economy" companies such as Deutsche Telekom, Nippon Telegraph & Telephone.

Growth and Innovation Sector Allocation - US versus Non-US



Source: Factset. Last data point 4/30/20.

We believe that it is unlikely the US will lose its competitive advantage in communication services and information technology in the foreseeable future. The combination of world-class universities that develop technology and serve as launching pads for start-ups to commercialize it, a well-developed venture capital industry, and a cultural willingness to take risk make it difficult for other regions of the world to surpass the US. So far, only China has proven to be a viable global competitor in these sectors. Moreover, the US has provided far greater pay and an equity culture for entrepreneurs, which, while imperfect, can continue to attract top talent from all over the world.

[1]The S&P 500® information technology sector GICS Level 1 Index return on capital in 2019 was 17% versus 5% for the S&P 500® Financial Sectors GICS Level 1 Index. Source: Bloomberg, February 24, 2020.

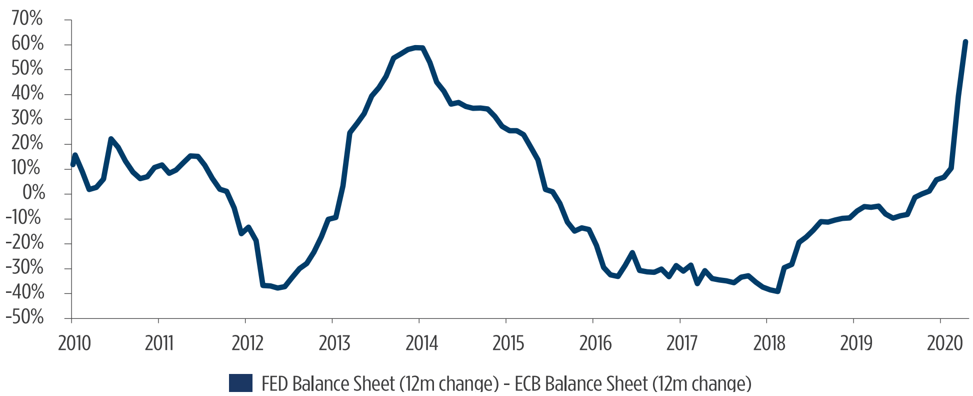
Public policy drivers are different and impact the composition, innovation, growth and performance across regions

Public policies in the US typically consider the stock market as an important component in their calculus, whereas in Europe and Japan, a heavier focus has been placed on government bonds. As a result, central bank and legislative policies in the US have been more supportive of, and concerned with, equity markets, while other countries and regions consider their equity markets more of an afterthought.

Liquidity

The COVID-19 driven policy support in the US demonstrates the point that US public policies place more consideration on the stock market as an important component of their calculus.

Fed vs ECB Balance Sheet



Source: JP Morgan

The threats of shareholder activism and M&A on under-earning companies are far less common outside the US, potentially compromising financial and business discipline. Moreover, governments, particularly in Europe, support the concept of industry "national champions."

For example, the tables below look at how many companies incorporated in the past 50 years populated the top ten market cap stocks in Europe and Japan, where companies tend not to die.

	US Top Ten	Decade Founded
1	Microsoft	1970s
2	Apple	1970s
3	Amazon.com	1990s
4	Facebook	2000s
5	Alphabet	1990s
6	Johnson & Johnson	1980s
7	Berkshire Hathaway	1830s
8	Visa	1950s
9	JP Morgan	1870s
10	Procter & Gamble	1830s

	Europe Top Ten	Decade Founded
1	Nestle	1870s
2	Roche Holding AG	1910s
3	Novartis AG	1910s
4	Astrazeneca PLC	1910s
5	ASML Holding NV	1960s
6	SAP SE	1970s
7	Novo Nordisk	1920s
8	Sanofi	1920s
9	LVMH Moet Hennessy	1740s
10	HSBC Holdings	1860s

	Japan Top ten	Decade Founded
1	Toyota Motor Corp	1930s
2	Sony Corp	1940s
3	Softbank Group	1980s
4	Keyence Corp	1970s
5	Takeda Pharmaceutical	1780s
6	KDDI	1980s
7	Mitsubishi UFJ Financial Group	1870s
8	Nintendo	1880s
9	Recruit Holdings	1960s
10	Honda Motor Corp	1940s

Source: Bloomberg. Data as of April 30, 2020. The US is represented by the S&P 500 Index, Europe by the MSCI Europe Index and Japan by MSCI Japan Index. Note: Nippon Telegraph & Telephone as an incorporated government monopoly prior to the 1950s.

Private equity and venture capital firms have raised $2 trillion this decade, an unprecedented amount in the history of the money management industry.

The economic structure of lower taxes and flexible labor markets has provided US companies with business model advantages.

In the US, lower taxes can help increase economic returns that drive innovation and growth investment. Flexible labor markets have enabled the outsourcing of low value-added, higher labor and/or capital-intensive components of a business model, thus freeing up capital across the economy for higher value investments such as research and development, while maintaining the higher knowledgebase, value-added jobs to innovate and drive growth.

The robust recycling of the capital within the US economy can lead to innovation and growth that avoids the “trapped capital” syndrome of Europe and Japan

A higher level of profitability has enabled US companies to dedicate more capital to share repurchases (or buybacks). A key advantage of share repurchases is that they enable the recycling of capital throughout the economy, so capital may end up in the most innovative hands and not trapped inside of less efficient, more mature companies. We believe buybacks optimize capital allocation for companies unable to invest at a higher rate of return than their cost of capital, particularly when agency costs exist between corporate management and investors.

While perhaps controversial to some, we disagree with those who argue that buybacks are shortsighted and lead to less innovation and investment, suppress job growth and exacerbate income equality. While the aftermath of the pandemic and subsequent recession will certainly lower activity, we expect share repurchase programs in the US will rise to their previous levels when conditions normalize.

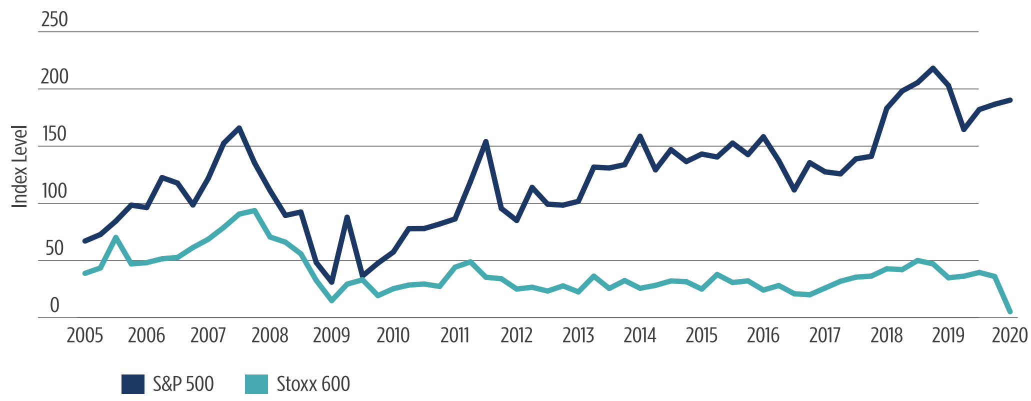
We agree companies should not assume irresponsible amounts of leverage to buy back stock. However, in reality, the aggregate amount of buybacks represents a small percentage of total capital returned to investors. Given the likely challenges associated with assuming additional leverage and corporate models that may shift to more commoditized, lower return businesses in the aftermath of the pandemic, we expect that the recycling of high-return capital to innovation and secular growth will simply sustain itself.

While we acknowledge that companies with large buyback programs have tended to invest less in innovation, our findings suggest the US economy has done an efficient job of recycling the proceeds from share repurchases through venture capital and private equity firms. In turn, these firms have effectively transferred capital to the most innovative businesses, which are seldom big, mature mega-cap firms. Private equity and venture capital firms have raised $2 trillion this decade, an unprecedented amount in the history of the money management industry. These firms have made total investments of $5 trillion, an amount that far outweighs the retained earnings of public companies. This has had a meaningful impact on innovation and growth of the US economy. Further, technology has captured over 25% of private equity and over 40% of venture capital flows, which in total outweighs the retained earnings of the technology sector.

Share repurchases have steadily increased in the US over the last 20 years and the gap in buybacks between the US and Europe has widened in the last 10 years, both in nominal and relative terms. In Europe, barely 20% of Stoxx 600 corporations have executed share buybacks versus more than 80% of its S&P 500 peers.

While post COVID-19 momentum for buybacks may resume, we believe the level of share repurchase programs in Europe is unlikely to be as pervasive as in the US.

Quarterly Buybacks in USD (Billions) 2005 to 2020



Source: Bloomberg Barclays, Amundi Research. Data as of 3/31/19

The sharp acceleration of US buybacks in 2018 is largely attributable to one-off factors, such as reduced corporate income taxes and the relaxation of conditions for offshore cash repatriation. Regardless, even if part of this buyback gap is due to temporary factors, it is nevertheless striking to note the amount of buybacks carried out by S&P 500 companies in 2019 was one-third higher than the level recorded during the previous peak in 2007, but 50% lower for Stoxx 600 companies.

While buybacks may meaningfully decline for a year or two, due to the earnings recession resulting from the response to the COVID-19 pandemic, it is important to point out that companies with the largest share buybacks are, for the most part, not among the financially stressed. Moreover, in the past four years, the share of total S&P 500 buybacks contributed by the top 20 companies with the largest buybacks has averaged over 40%.

So why hasn't Europe pursued more share repurchase programs?

Before the pandemic, buybacks in Europe were expected to increase given their very low starting point, increasingly less restrictive taxation and growing interest amongst certain market European companies. While post COVID-19 momentum for buybacks may resume, we believe the level of share repurchase programs in Europe is unlikely to be as pervasive as in the US, due to a number of ingrained differences relative to the US that would limit their use, including:

Different corporate funding methods: In Europe, corporations still rely predominantly on banks (70%) for funding, versus the financial markets for their US peers. In return, to please their bankers, European companies prefer to preserve their balance sheet rather than buy back shares. Conversely, US companies use buybacks to boost returns on equity (ROE), particularly in low interest rate environments.

More acceptance in the US: In Europe, with the exception of corporate executives, companies rarely use shares as a form of payment, whereas share-based payments are more widespread in the US. As executive and employee interests are more aligned with repurchase plans in the US, buybacks are naturally more acceptable.

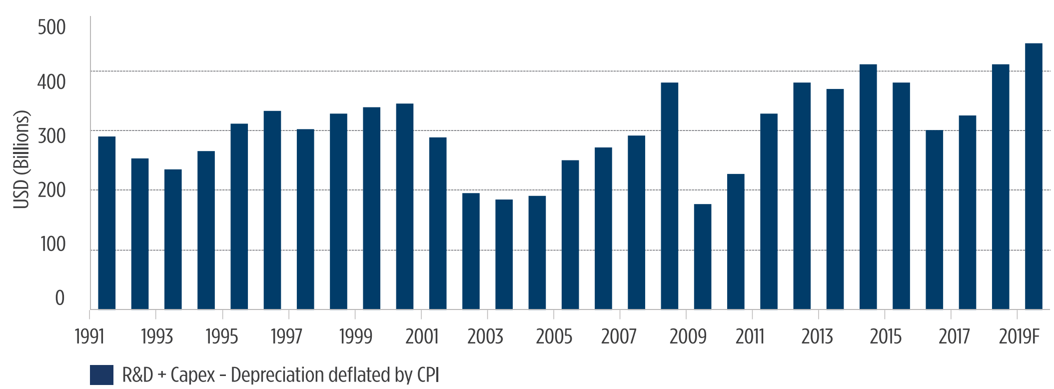
Specific preferences of European shareholders: Some of Europe's most stable financial shareholders—namely insurers and pension funds on the one hand, and retail investors on the other—tend to have a preference for dividends. For the former group, this is largely due to asset liability management constraints, and for the latter, because of the favorable tax treatment given to the vehicles in which their funds are generally held.

US companies are better at capital allocation compared to their non-US counterparts. This should allow US companies to maintain a profit advantage.

More stringent legal restrictions in Europe: In Europe, with the exception of the UK (early 1980s), buybacks were legalized much later (late 1990s) than in the US (1982). Even post-legalization, restrictions on buybacks remain more stringent in terms of size (percentage of shares repurchased) and delays.

Critics of share buybacks argue that the increase in share repurchases in the US has led to less investment in growth initiatives. This is simply not true. As shown below, growth investments among S&P 500 companies reached all-time highs in 2018, in real terms.

S&P 500 Growth Investment in Real Terms at Record High

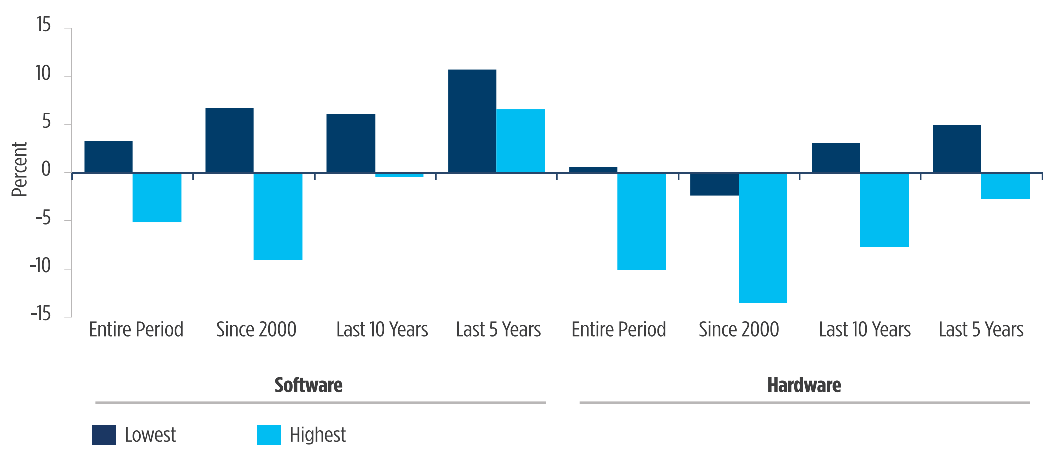


Source: Factset, Amundi Research. Last data point 10/10/2019.

It is true, however, that US companies are better at capital allocation compared to their non-US counterparts. This should allow US companies to maintain a profit advantage.

The chart below captures this theme quite well, demonstrating how the lowest quintile of capex growth in the technology sector meaningfully outperformed the highest quintile of capex growth over time. Thus, we have evidence that innovation may be best optimized through the recycling of capital via venture capital and private equity.

Large Cap Technology Stocks' Relative Returns to the Lowest and Highest Quintiles of Capital Spending Growth*



*Equally-weighted returns.
Source: Empirical Research Partners Analysis, Amundi Research. Last data point 6/30/19. Monthly Data Compounded to Annual Periods 1952 through June 2019.

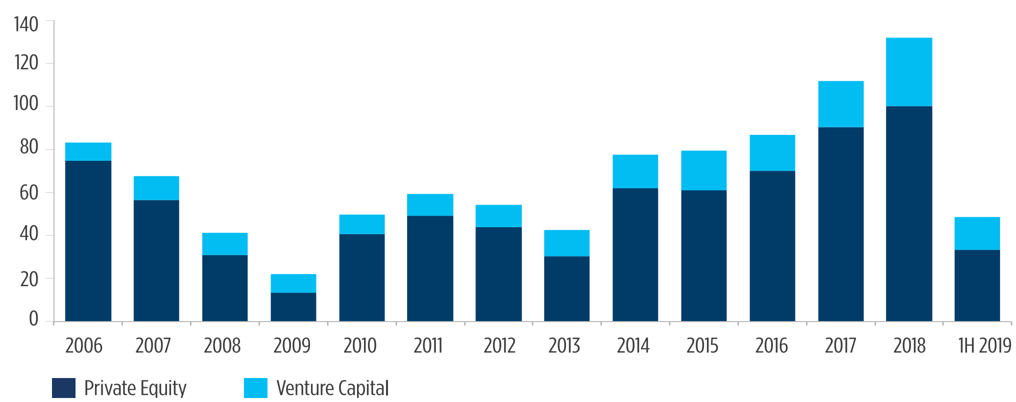
In the past two years, private equity and venture capital investments targeting health care have totaled over $100 billion, a magnitude roughly equal to the retained earnings generated by the listed companies in the US health care

Occasionally, mega cap companies get it right. For example, Microsoft returned $80 billion since 2011 via buybacks (and announced another $40 billion in September 2019), while building up its Azure cloud business, which has been a revolutionary innovation (along with Amazon Web Services). However, this was after years of poor execution on innovation and acquisitions (e.g., Nokia's handset division). We contend Microsoft is an anomaly among mega-caps.

Apple, which repurchased more equity than any other firm in recent years, provides an example of how shareholders benefited from a company's efforts to "stay in its lane." Apple has limited its investment in unnecessary deployment of R&D resources unlikely to benefit shareholders (i.e., initiatives such as electric vehicles, solar panels, etc.). In examples such as this, the capital from buybacks that is targeted towards innovation gets recycled efficiently into venture capital. In our view, the sheer dollar volume of buybacks in the US in recent years strongly supports the likelihood that the next generation of technology and growth will come from the US market.

We also observed this innovation advantage in health care, where we have seen an explosion in innovative therapeutics for diseases such as cancer/immunotherapy, diabetes, gene therapy and many other areas. In the past two years, private equity and venture capital investments targeting health care have totaled over $100 billion, a magnitude roughly equal to the retained earnings generated by the listed companies in the US health care sector (according to Empirical Research Partners.) Without buybacks to recycle capital, we would have to count on mega cap pharmaceutical firms to innovate, an area in which they have not proven adept over time. Perhaps it is better to have private equity and venture capital funnel innovation dollars to motivated entrepreneurs. With the pace of new biopharma products developed over the past several years, and expected new product launches in the pipeline, it is hard to argue this is not working. The biotech industry barely exists outside of the US.

US Health Care Companies Private Equity and Venture Capital Deal Value*
(USD Billions)



* Includes estimates for deals with undisclosed values

Source: Pitchbook, Empirical Research Partners Analysis, Amundi Research. Last data point 6/30/19.

Summary

We contend the outperformance of US equities over time is not happenstance or accidental. We believe that a more favorable composition of US businesses favoring innovation and growth, as well as higher return on capital and profitability relative to non-US developed markets, has contributed to this outperformance.

We believe the drivers of the innovation, growth and profit gap between the US and other markets are structural and durable, giving confidence to many investors that these results may persist over time. For example, drivers of public policy are different and impact composition, innovation, growth and performance across regions. The economic structure of lower taxes and flexible labor markets provides US companies with business model advantages. More effective recycling of capital continues to provide further fuel for growth and innovation.

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Index Definitions

The **S&P 500® Index** is a commonly used measure of the broad US. The **Morgan Stanley Capital International (MSCI) EAFE** (Europe, Australasia, and Far East) Index is a commonly used measure of international stocks. The **MSCI World Index** is designed to measure the performance of stocks in developed markets. The **Stoxx Europe 600 Index** represents large, mid and small capitalization companies across 17 countries of the European region. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

Additional Information

Capex are capital expenditures used by a company to acquire, upgrade, and maintain physical assets such as property, buildings, an industrial plant, technology, or equipment. Capex is often used to undertake new projects or investments by the firm.

Dividends-per-share (DPS) is the sum of declared dividends issued by a company for every ordinary share outstanding.

Earnings-Per-Share is the portion of a company's profit allocated to each outstanding share of common stock.

Price/Book (P/B) is the ratio of a stock's price to its book value per share.

Price/Earnings (P/E) refers to the price of a stock divided by its earnings per share. It reflects weighted average of trailing 12-month price-to-earnings ratios of portfolio holdings.

Return on Equity (ROE) is the amount of net income returned as a percentage of shareholders equity.

Return on Invested Capital (ROIC) is a ratio to measure the profitability and value-creating potential of companies, relative to the amount of capital invested by shareholders and other debtholders.