With rate cuts on the agenda for most major central banks this year, global stocks and small-caps should benefit from a lower-rate environment. (UBS)

Look beyond US large-caps in equity exposure

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US equities have made multiple new records this year, with the S&P 500 registering 13 all-time highs and the Nasdaq 100 hitting new heights 12 times. Investor sentiment has been buoyed by a combination of solid growth, the rapid adoption of artificial intelligence (AI), and the prospect of loosening monetary policy in the US.

While the S&P 500 has rallied 6.7% so far this year, the performance of other markets and smaller US companies is less impressive. The MSCI All Country World ex-US index is up 1.6% year-to-date, and the Russell 2000 is down 0.5%.

But while we believe investors should keep a core allocation to US large-cap stocks in their portfolios, we also think exposure to other developed markets, emerging markets, and small-caps helps ensure investors don't miss out on potential future growth drivers.

The US market hasn't always led. Historically, market leadership has rotated over time. For example, while the S&P 500 has outperformed substantially since 2007, it returned just 38% between 1999 and 2007—compared with 97% for the MSCI EAFE index (which includes developed markets in Europe, Australasia, and the Far East) and 420% for the MSCI Emerging Markets index. A shift in regime can't be ruled out in the future—and in case of such a rotation, international markets that have lagged in recent years could benefit.

Favorable growth backdrop and lower rates provide tailwinds. Many leading companies in sectors including semiconductors, pharmaceuticals, consumer goods, automobiles, engineering, and renewable energy count Europe or Asia Pacific as their home. Economic growth and favorable demographics in emerging markets also create a fertile backdrop for growth for local firms in the years ahead. With rate cuts on the agenda for most major central banks this year, global stocks and small-caps should benefit from a lower-rate environment. Since 1989, emerging market stocks

have delivered an average of 10% and 20% total returns in the six and 12 months, respectively, following the first Fed cut. Smaller companies' higher use of floating rates in their debt means they should feel the easing of financial conditions faster than their larger peers.

Valuations are cheaper. Equity valuations in most markets outside the US are currently cheaper based on their 12-month forward P/E ratios. The MSCI EAFE index is trading at 13.7 times forward earnings, a 5% discount to its 10-year average, while the MSCI EMU index is at its cheapest level relative to the S&P 500 in almost four decades. For MSCI Emerging Markets, its valuation of 11.6 times is an unusually deep 44% discount to US stocks. Valuations are appealing for small-caps too: The forward price earnings ratio for the S&P SmallCap 600 index is only 14 times, lower than its 10-year average of 17 times and a 30% discount to the large-cap S&P 500 valuation. In the Eurozone, the ratio for small- and mid-caps is at 11.1 times, the largest discount to large-caps in more than 20 years.

So, for investors looking to boost portfolio diversification, we see a broad range of opportunities outside of US large-caps. For example, we have identified high-quality growth stocks in Europe that, in our estimates, offer similar earnings growth prospects as the Magnificent 7 in the US, while India is among our most preferred region within emerging markets. We also see value in US small-caps and small- and mid-caps in Europe.

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