Biweekly Investment Insights: Equity Resilience

Yanni Angelakos, Head of Investment Insights, Nasdaq Capital Access Platforms

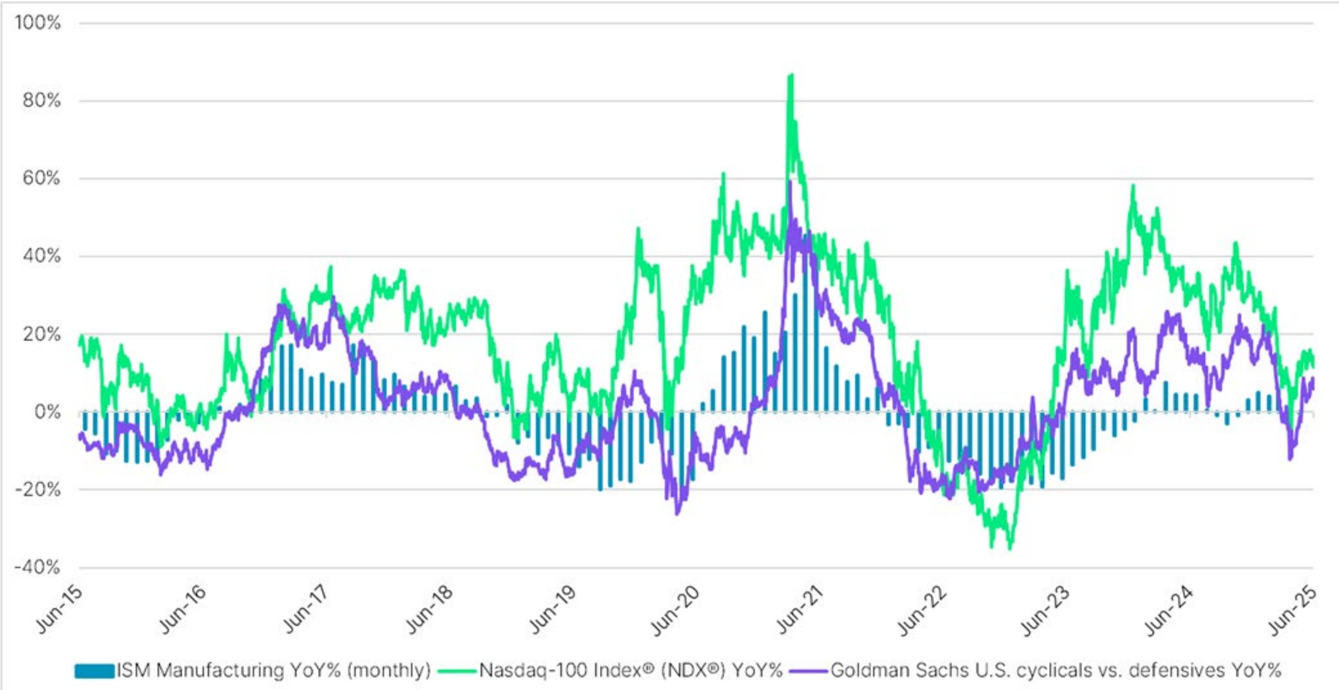
Key Points:

- While geopolitical and trade policy uncertainties remain, equities are pricing in a stabilization in business confidence
- Markets attempting to broaden out while major U.S. indexes approached all-time highs
- U.S. equity risk premium is negative, but that doesn't necessarily portend equity weakness

Summary

As markets closely follow the latest escalation in the Middle East, Bloomberg's Global Trade Policy Uncertainty Index hit its lowest since the end of January. The U.S. and key trade partners continue trade tariff discussions ahead of the end of the U.S.'s 90-day tariff pause on July 8th. The more negative impact on the U.S. employment landscape and economic hard data from trade policies will likely come on a lag. While policy uncertainties will persist and macro data has softened, the backdrop remains relatively steady and continues to underpin the U.S. consumer and economy. Equities—specifically the more economically-geared cyclical areas—have priced in a stabilization in business confidence. Investors are also looking for signs of a sustainable broadening out of equity returns. The equity risk premium remains negative given higher equity valuations and Treasury 10-year yields. Yet historical equity returns going forward are still solid from these levels.

Biweekly Chart in Focus: Equities Pricing in a Stabilization in Business Sentiment



Source: Bloomberg. Notes: ISM manufacturing based on monthly data. Cyclicals vs. defensives equity proxy represented by a pair trade of going long Goldman Sachs U.S. cyclicals and short Goldman Sachs U.S. defensives, ex-commodities. As of June 13, 2025.

Details

"It's the Economy, Stupid!"

Political strategist James Carville famously coined this phrase during the 1992 U.S. Presidential race. Headline noise can and does drive daily market moves. Over the decades, though, this has become a catchphrase that the longer-term trajectory for risk assets is ultimately driven by the outlook for economic and corporate fundamentals.

Consumer and business sentiment indicators weakened materially given the uncertain outlook due to trade policies. As noted in our prior piece, it can take time for confidence to reset amongst consumers and companies which can dictate business activity.

The markets typically react to the reported absolute levels of business and consumer sentiment measures. However, the rate of change is also an important trend to monitor. Our biweekly chart in focus above shows that the ISM Manufacturing Index (as a proxy for business confidence) has stabilized on a year-over-year basis after a decline amidst peak trade policy concerns. This recent stabilization is reflected in the Nasdaq-100 Index® (NDX®) and, more so, in a gauge of U.S. cyclical versus defensive equities. The notable relative performance reversal of cyclicals versus defensives indicates that markets have continued to price out recession concerns which spiked in early April.

Markets Attempting to Broaden Out Amidst Ongoing Cautiousness

Whether managing index-based or active equity strategies, diversification across geographies, sectors, factors, and market caps becomes paramount for total portfolios amidst a likely continuation of increased macro volatility, policy uncertainties, and market dislocations.

Over the past two months the iShares Russell 2000 ETF (IWM) is marginally outperforming the Vanguard S&P 500 ETF (VOO) by 0.7% (through June 16th). This spread had reached 2.7% prior to the Israel-Iran conflict escalating. Despite the recent outperformance of U.S. small versus large cap equities, small caps are still underperforming by over 7% YTD. Also, U.S. small caps are -13% from their most recent highs at the end of November 2024 (post the U.S. elections and expectations of a more favorable business environment) while the Nasdaq-100 and S&P 500 are within 2% of their all-time highs. And as for forward 12-month EPS estimate growth rates, they are -2.3% for the Russell 2000 Index versus 10.3% for Nasdaq-100 and 7.2% for the S&P 500.

For a broadening out to sustain in the more economically sensitive small cap and value (which has continued to lag) cohorts, investors will need to be convinced of a reacceleration in economic and business activity and confidence amidst the evolving global construct.

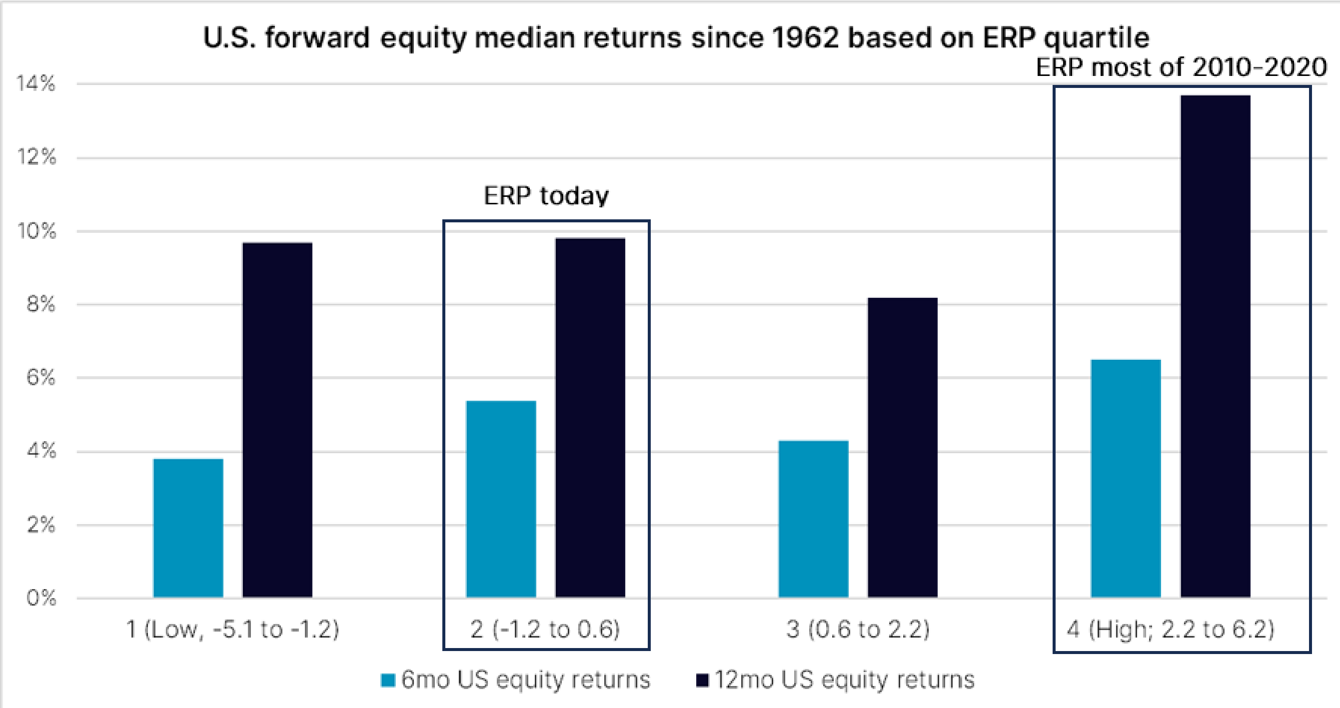
Also per our prior piece, international equities have outperformed U.S. equities by over 13% the past six months—equivalent to +3.2 standard deviations versus the 10-year average. Though relatively stretched in the near-term, this is also illustrative of a broadening in the markets. The Nasdaq U.S. Benchmark™ Index (NQUSB™) has outperformed the Nasdaq Global ex-United States™ Index (NQGXUS™) by over 136% the past 10 years and U.S. corporates maintain their best-in-class stature. Yet investors have increasingly been searching for opportunities in other geographies given fiscal and monetary policy divergences, growth dynamics, and relative valuations (amongst other drivers). See Nasdaq Dorsey Wright's recent report which ranks international equities as first in its asset class ranking framework for the first time since 2023.

Coupled with trade and fiscal policy concerns, and U.S. dollar weakness, U.S.-domiciled equity mutual funds and ETFs saw outflows of $24.7 billion in May 2025, the largest in a year. Contrarily, European equity funds saw inflows of $21 billion in May taking YTD inflows to $82.5 billion—highest in four years (per LSEG Lipper).

Equity Risk Premium Remains Negative, Yet Forward Equity Returns Have Still Been Positive at These Levels

The U.S. equity risk premium (ERP)—the additional compensation to invest in more volatile equities versus a risk-free asset, measured by the spread between the S&P 500 earnings yield (earnings-to-price; E/P) and the Treasury 10-year yield—has been in negative territory for more than two years per Bloomberg data. As E/P is the inverse of price-to-earnings (P/E), a byproduct of elevated equity valuations is a lower earnings yield. Coupled with higher Treasury yields, taken onto itself, today's ERP of -44bps indicates that investors are not being compensated for taking the additional risk associated with equities.

The current negative ERP reading is juxtaposed by the ERP being in the fourth quartile of history (going back to 1962) for most of 2010 to 2020 (chart below)—a period of extreme monetary stimulus by central banks globally which drove bond yields lower, with some in negative territory. Appreciating that the ERP cannot be viewed in a vacuum as context for each cycle is important (e.g., inflation dynamics and monetary policies, equity leadership in a particular cycle), the current reading of -44bps is at the same levels as in 2002 and ranks in the second quartile relative to history. This suggests more muted equity returns going forward. However, the chart below shows that the median equity returns over the next six and twelve months for this quartile are still relatively healthy.



Source: Bloomberg Intelligence. Notes: based on monthly S&P 500 returns since 1962.