MEKETA

Can Listed US Companies Sustain Earnings Growth?

WHITEPAPER
FEBRUARY 2025

CONTRIBUTORS
ALISON ADAMS, PHD
FRANK BENHAM, CFA, CAIA

The prices of publicly traded companies' shares are understood to incorporate the market's expectations for future earnings growth. Companies that are projected to increase their revenue and profit margins faster than the market typically enjoy higher valuations. With prices for the US equity market approaching all-time highs, the market is discounting significant earnings growth to justify those valuations. The earnings growth rates US stocks have achieved in the post-GFC period could support these valuations if these growth rates are sustainable.

The question of whether earnings growth can meet investor expectations is urgent, but it is not easily answered. This research note provides an overview of some variables that have historically been associated with earnings growth to help predict future earnings growth for the broad equity market. It also addresses differences in these factors between the US and other markets that may be driving disparities in earnings growth and valuations relative to non-US markets.

Key takeaways

- → Historically, there has been a link between economic growth and earnings growth, however this relationship is imperfect. Since 1990, US corporate earnings have grown considerably faster than the broader US economy. The reasons for this are varied and their potential to continue is both important and debatable.
- → US-based corporations have benefited from globalization. Companies have built out extended global supply chains connecting low-cost goods and labor, while also generating significant revenues by accessing new markets in which to sell their goods and services. However, globalization is facing significant headwinds that could diminish US companies' future earnings.
- → Over the past decade, the US stock market has evolved to be dominated by faster growing companies such as those in the technology sector. These faster growing companies such as those in the technology sector. These faster growing industries comprise a significantly larger portion of the market compared to their share of US GDP. This shift, driven by higher earnings growth, supports the market's faster growth relative to the broader economy.
- → Increases in productivity, driven by factors like technological advancements and economies of scale, have led to higher profits and GDP growth. This has shifted economic gains from labor to capital, particularly in industries with favorable productivity characteristics, such as technology and pharmaceuticals.

- Changes in tax policies and low interest rates have boosted after-tax profits in the US. Cultural factors like an emphasis on innovation, shareholder wealth, and entrepreneurial ethos have also driven economic growth.
- By repurchasing shares, US companies have reduced the number of outstanding shares and boosted earnings per share ("EPS"). This trend has been supported by ample cash reserves and a mature venture capital market that reduces the need for R&D spending by public companies in certain sectors.
- These factors explain why EPS in the US has grown faster than the overall economy. Many, though not all, of these conditions are likely to persist, suggesting US companies will continue outperforming economic growth in the near term. If this holds true, the US market should keep exceeding other markets' earnings and thus trade at a premium.

American exceptionalism & US stock valuations

The Economist recently pondered the question: "After so many years of American outperformance, is it time for investors to finally throw in the towel and give up on the rest of the world altogether?"[1] While American stocks have suffered their share of shocks since the 1990s, predictions of future weakness in US equities have proved inaccurate (or premature). The global stock market is dominated by US companies. The US stock market now accounts for about 65% of the MSCI All Cap World Index,[2] and nine of the ten largest companies in the MSCI ACWI index are domiciled in the US.[3]

No matter how they are measured, the valuations for the US market are typically well above those for the rest of the world (see Figure 1). This has been the case for more than a decade, as the average Shiller ratio for US equities commands a substantial premium over non-US equities.

1 Source: The Economist, "Should Investors Just Give up on Stocks Outside America?" November 21, 2024.

2 Source: MSCI ACWI Index factsheet as of October 2024.

3 Source: MSCI ACWI Index factsheet as of October 2024. The only foreign company in the top ten of the MSCI ACWI index is Taiwan Semiconductor Company (TSMC).

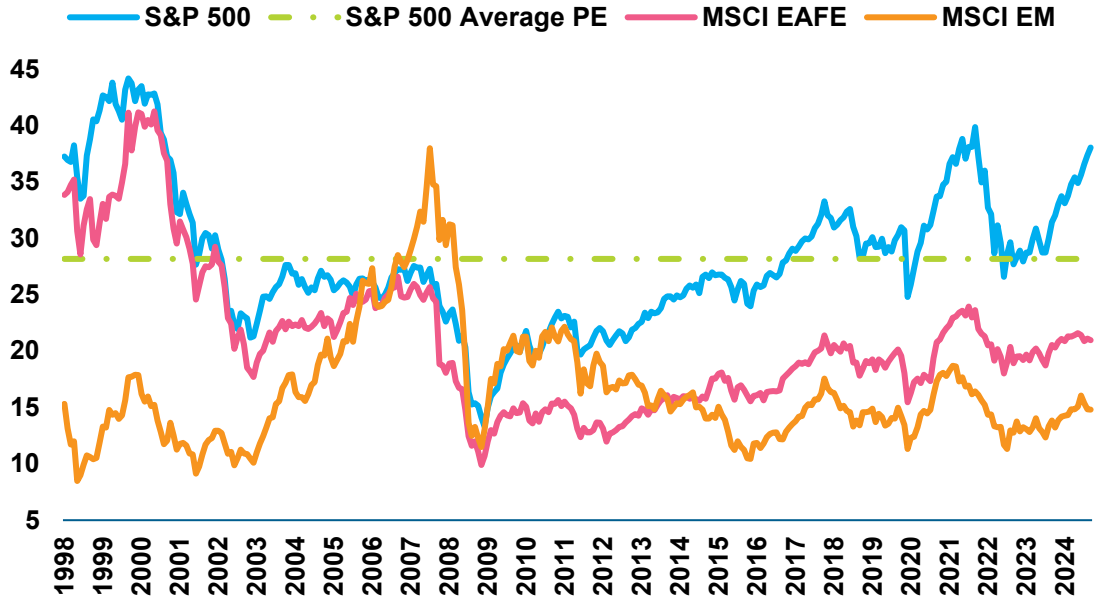

FIGURE 1
Cyclically Adjusted P/E Ratios for S&P 500, MSCI EAFE, and MSCI EM

Source: Bloomberg as of December 2024. US equity cyclically adjusted P/E on S&P 500 index. Source: Robert Shiller, Yale University, and Meketa Investment Group. Developed and emerging market equity (MSCI EAFE and EM index) cyclically adjusted P/E source: Bloomberg. Earnings figures represent the average of monthly "as reported" earnings over the previous ten years. Data is as of October 2024. The average line is the long-term average of the US, EM, and EAFE PE values from April 1998 to the recent month-end respectively.

There are many reasons why investors may be willing to pay a premium for US-based stocks. These include the types of companies (e.g., more exposure to faster-growing technology companies), the quality of management, emphasis on shareholder rights, greater transparency, and a culture focused on delivering value to investors. Perhaps most important of all is the fact that US companies have out-earned their global competitors, particularly since the trough of the Global Financial Crisis (see Figure 2).

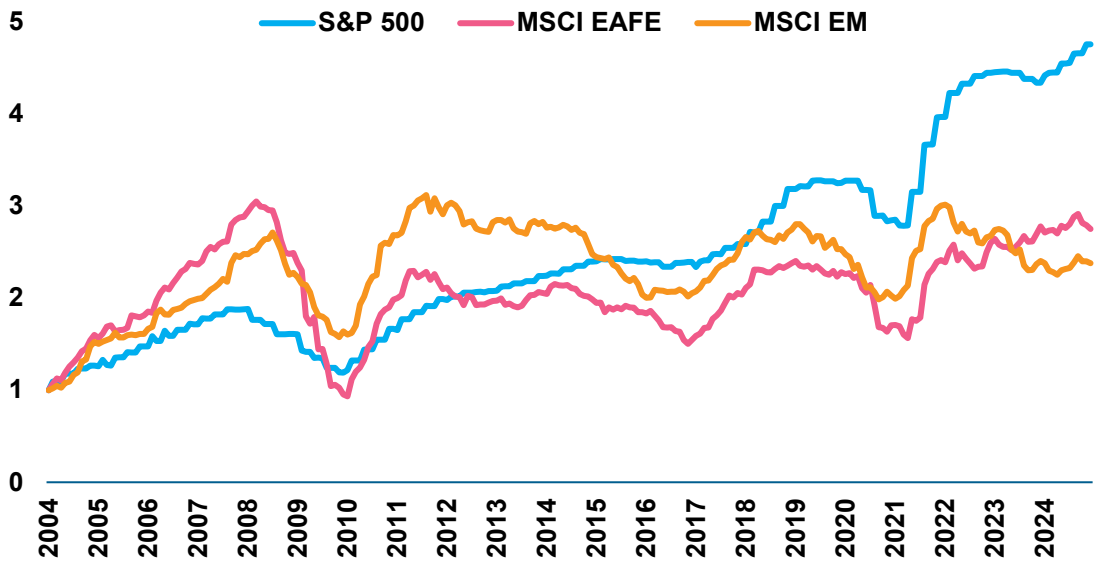

FIGURE 2
S&P 500, MSCI EAFE, MSCI EM EPS Growth, indexed to $1 in 2004

Source: Meketa analysis of Bloomberg data as of December 2024. Note that earnings are in local currency.

Earnings Per Share ("EPS") growth for the MSCI EAFE and Emerging Markets indices has been essentially zero since 2011. Meanwhile, US EPS growth has been strong over the past two decades. Note that this difference in EPS growth for the US versus other global markets cannot be attributed solely to a difference in GDP growth over this time. When comparing the nominal growth rate of national GDPs by region, China and India outpaced the US, while Europe and Japan lagged (see Figure 3).

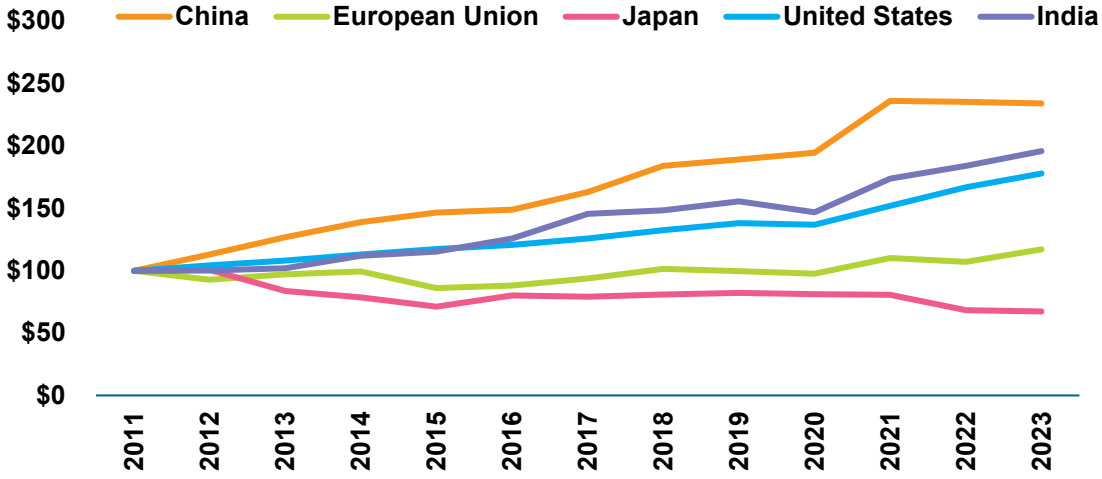

FIGURE 3
Growth of $100 at Nominal GDP Growth Rate 2011 – 2024 (USD)

Source: Oxford Economics as of January 2025. US dollars in present value. Nominal annual GDP increase in terms of constant US dollar terms – seasonally adjusted – are simplified for comparison. However, national statistics cited in other currencies or in PPP-adjusted terms may be different.

Economic growth

There is an intuitive appeal to the idea that long-term earnings growth is linked to economic growth.[4] Corporate profitability is based on factors such as consumption, investment, and spending that are key ingredients of economic growth. Indeed, growth features in the discounted cash flow formula commonly used by investors to calculate the present value of a stock (or any asset).[5]

There does appear to be a relationship between economic growth and earnings growth, at least in the US (see Figure 4). For example, since 2000, there is a positive correlation between the earnings growth of S&P 500 companies and real GDP growth (see Figure 5); however, the the r-squared value of 0.456 is well below the 0.70 threshold typically associated with a strong relationship[6]. This implies that economic growth is partly responsible for earnings growth, but it is far from the full story.

[4] We would expect this relationship to be truer in the long term than the short term. While both can be cyclical, it is not unusual for earnings growth to fluctuate substantially around the long-term trend in economic growth over periods as short as one year. See "The relationship between listed companies' earnings growth and output growth in the economy as a whole" by the European Central Bank, September 2007.

[5] The DCF formula for a perpetuity is present value = cash flow / (discount rate – growth rate) where the cash flow can be represented by earnings per share.

[6] Source: FactSet as of December 2023. FRED as of December 2023. We found that the Russell 3000 has a slightly higher r-squared of 0.4727 relationship to real GDP growth over the same period.

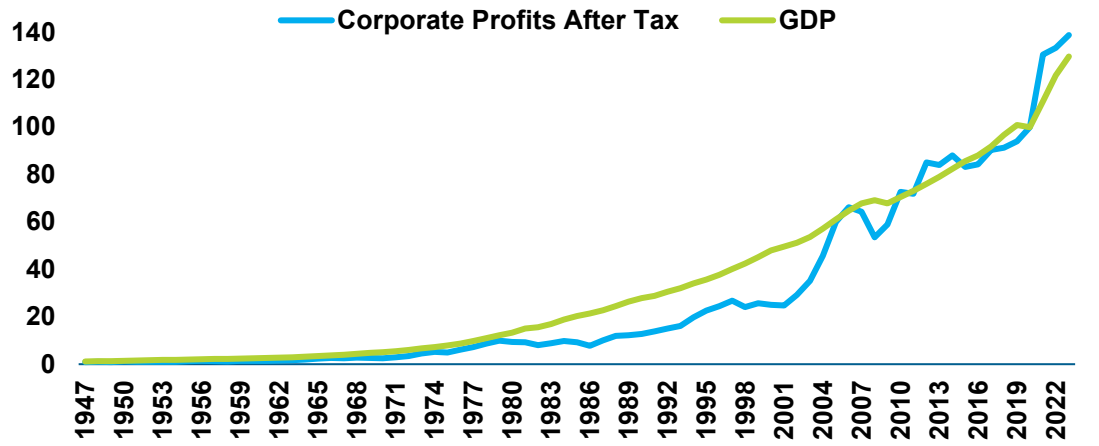

FIGURE 4
Corporate Profits & Nominal GDP 1947-2023 (Index = 100; USD 2020)

Source: FRED as of December 2023. US annual GDP and corporate profits indexed annual growth to March 2020 USD. Corporate profits include both private and publicly traded companies as calculated by the Bureau of Economic Analysis.

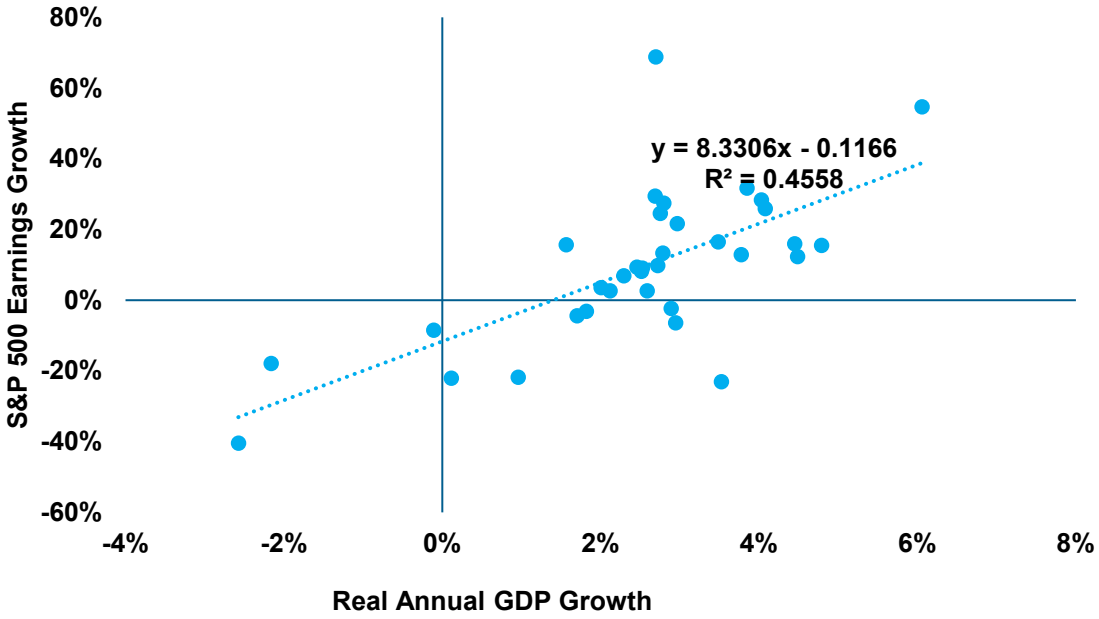

FIGURE 5
S&P 500 Earnings Growth & US Real Economic Growth Relationship

Source: FactSet as of December 2023. FRED as of December 2023.

Corporate profits

In the US, corporate profits (i.e., earnings) have grown considerably faster than the broader economy since 1990 (see Figure 6).

	US Nominal GDP Growth Per Annum	US Corporate Earnings Growth Per Annum	S&P 500 EPS Growth Per Annum
Since 1990	4.8%	7.0%	6.9%
Since 2010	4.9%	5.6%	9.7%

FIGURE 6
Growth of US GDP, Corporate Earnings, and EPS

Source: Federal Reserve Economic Data, S&P. Corporate earnings defined as Corporate Profits After Tax (with IVA and CCAdj). Seasonally Adjusted Annual Rate for Nominal GDP. Data is as of September 30, 2024.

The strong growth in US profits relative to the economy is linked in part to profits consuming a greater proportion of the economic pie. Since 2000, corporate profits – inclusive of private and listed companies – averaged 9.1% of GDP, vs 6.1% prior to that (see Figure 7).

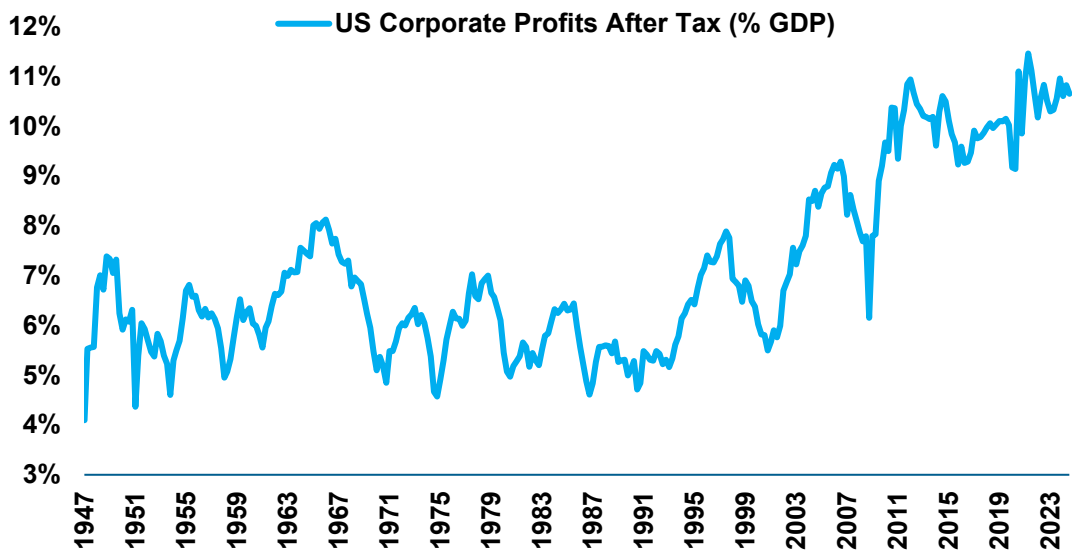

FIGURE 7
US Corporate Profits After Tax (% GDP)

Source: Meketa analysis of FRED data. Series uses Seasonally Adjusted Annual Rate for Nominal GDP and Corporate Profits After Tax with Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj). Data is from 1q1947 through 3q2024.

There are several reasons why profits have likely comprised a higher percentage of GDP, including the global footprint of US-based companies, market composition, technological advancements, labor market dynamics, government policies, and the level of interest rates. Justifying higher future earnings growth for US companies implies that profits will continue to comprise a higher percentage of GDP – consistent with that experienced over the past twenty years as opposed to the previous fifty – and that some or all of these explanations will remain in place.

A global footprint

Many large corporations (i.e., most of the biggest publicly traded companies) operate internationally, typically allowing them to generate significant revenues and profits from overseas markets. For example, the companies in the MSCI USA Index derived an estimated 38.3% of their revenues from outside the US in 2024 (see Figure 8).[7] Many of these companies expanded to international markets in the hope of taking advantage of faster growth in the target market for their product or service. Hence, exposure to faster-growing economies (e.g., many emerging market countries) could help boost US profits to grow faster than US economic growth alone would allow.

[7] Source: FactSet, Earnings Report 2024.

	% Revenues from US	% Revenues from EAFE	% Revenues from EM	% Revenues Frontier
MSCI USA	61.7%	17.1%	19.6%	1.6%
MSCI EAFE	22.9%	52.9%	22.1%	2.0%
MSCI Emerging Markets (EM)	14.8%	7.9%	76.0%	1.2%

FIGURE 8
Revenue Source for the Stock Market

Source: Meketa analysis of data provided by MSCI as of December 31, 2024.

Starting around 1990, the world experienced extraordinary growth in trade (see Figure 9) as countries adopted trade liberalization policies (e.g., the creation of the WTO). Global trade grew from 20% of global GDP in 1970 to a peak of over 50% in 2008. However, it has since plateaued and appears to be declining. As a result, the share of profits for US-based companies coming from outside the US may have peaked. Hence, the tailwind of expanded global trade has likely faded and may even be turning into a headwind if the world continues its recent path of deglobalization.

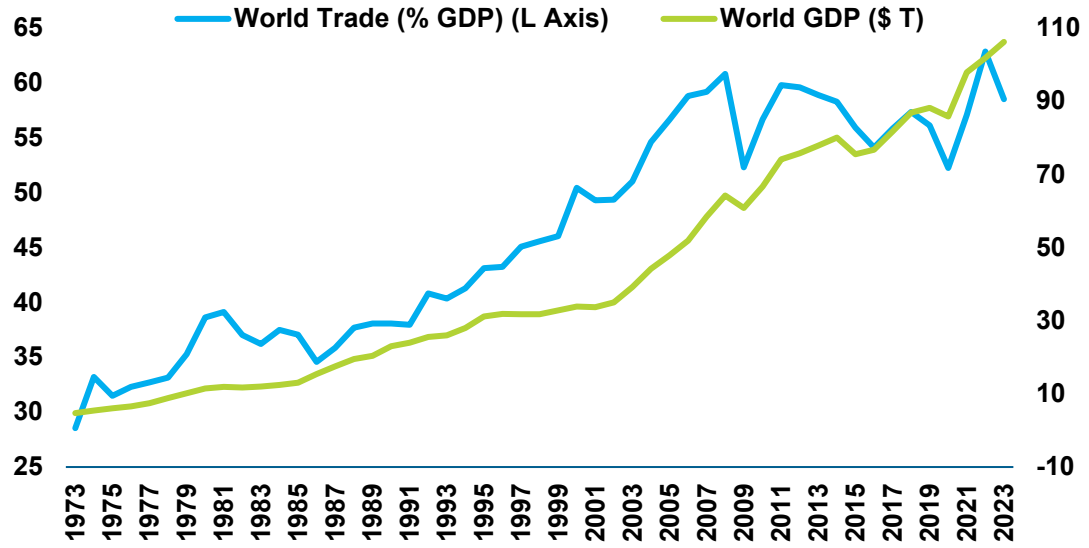

FIGURE 9
Annual Global Trade and GDP (1970 – 2023)

Source: World Bank as of December 2023. World trade shown in current US dollars.

Market composition

The composition of the US stock market is constantly evolving. It is often led by those companies that are driving change in the economy, from the railroad stocks of the late 1800s to the AI-related stocks of today. In the past decade, it has become increasingly concentrated in the information technology sector (see Figure 10).

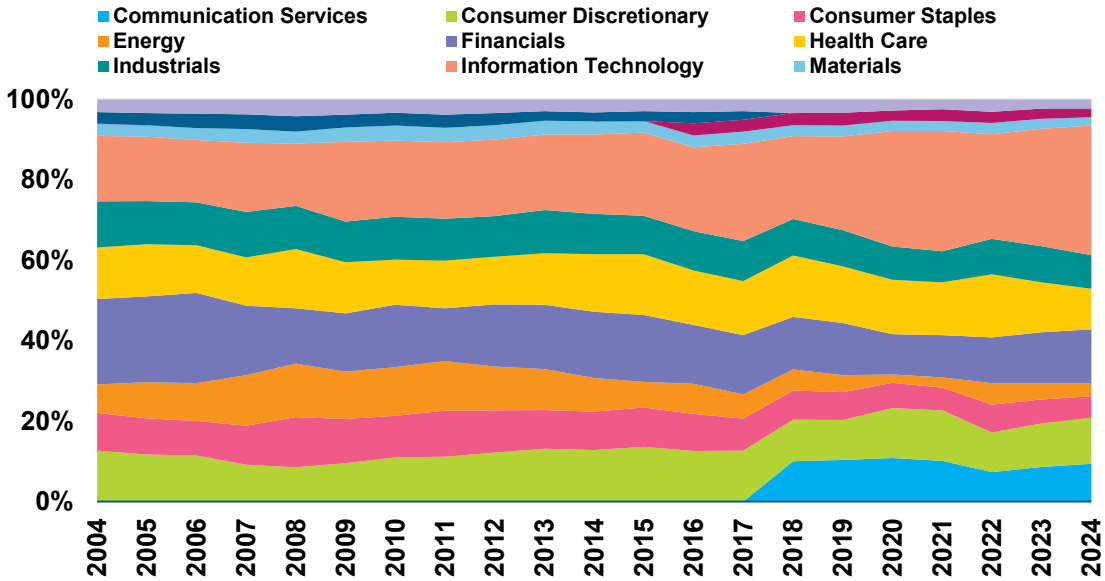

FIGURE 10
MSCI USA Historical Sector Weightings (1991–2024)

Source: MSCI as of December 2024. In 2017, the communications sector was created from the telecommunications sector and some social media companies; adding these "tech adjacent" companies to the IT sector would make technology an even larger segment of the market. The real estate sector was also introduced to the index in 2017.

This evolution in sector composition is important as different sectors have exhibited varied earnings growth profiles. For example, the two sectors that have exhibited the highest earnings growth since 2005 (IT and consumer discretionary - see Figure 11) are now the first and third largest sectors in the S&P 500. While there is a chicken-and-egg aspect to this, if these sectors continue to grow faster than the rest of the market, their larger weighting supports the concept of the equity market growing faster than the broader economy.

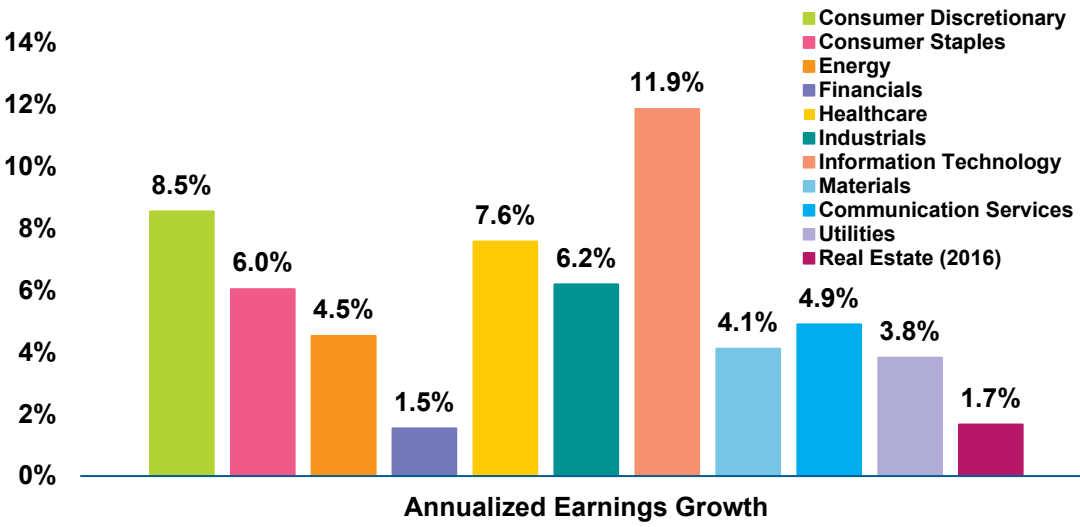

FIGURE 11
Annualized Average US Earnings Growth by Sector

Source: MSCI USA index. Data as for the twenty years ending December 2024. Real estate established in 2016 and showing since inception return. Communication Service sector was announced in 2017 and fully implemented in 2018. Note that Apple, Meta and Alphabet were moved to communication services in September 2018.

Just as important as the changes in the composition of the equity market are the differences between the stock market and the broad economy. For example, the information technology sector comprises a substantially larger portion of the stock market than it does in terms of US GDP (see Figure 12). In the IT sector, a greater share of value add generally flows to capital (i.e., holders of debt and equity) than to labor. In contrast, much of the value added in the consumer discretionary and industrials sectors is done by labor, hence the flow of value add to capital is smaller.

[8] World Bank, Y. Kim et al., "Productivity as the Key to Economic Growth and Development," 2016. Multi-country studies reveal that labor productivity growth is a key variable for economic growth and development where the ability of the same number of workers to do more work contributes to macroeconomic calculation of GDP.

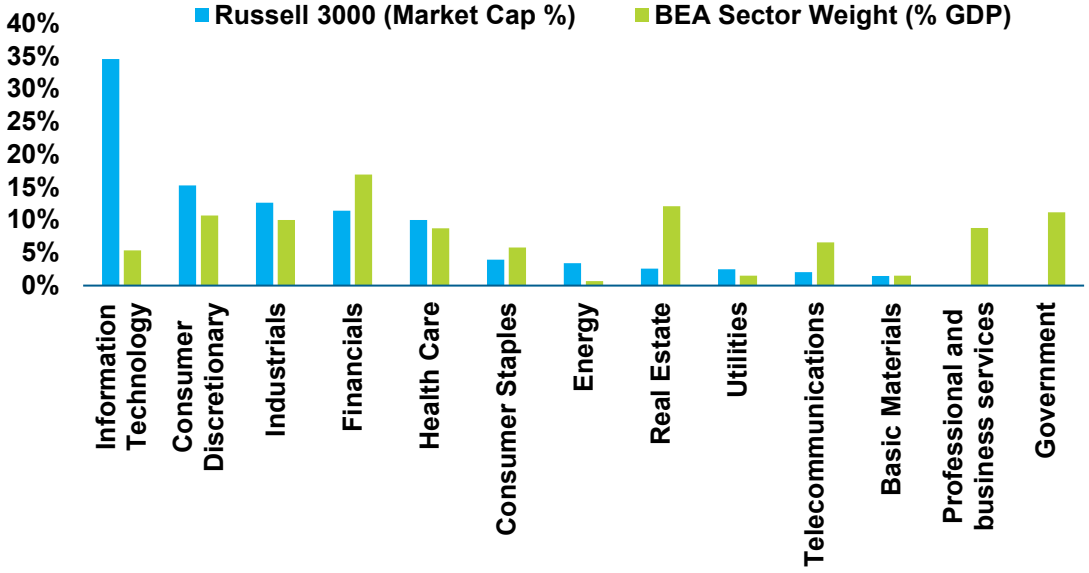

FIGURE 12
Composition of US Equity Market vs US GDP Sectors (%)

Source: Russell 3000 index fact sheet as of December 2024. Bureau of Economic Analysis as of September 2024. For GDP analysis at the sector level, the BEA uses the 'valued added' approach to GDP calculation. Meketa estimated weights for BEA sectors into GICS sectors.

Profitability, productivity, scalability & labor market dynamics

Productivity is a driver of growth at both the macroeconomic and microeconomic levels.[8] Increases in labor productivity, for example, mean that more output is produced per hour worked, which directly contributes to GDP growth (see Figure 13).[9] Likewise, improvements in total factor productivity, often driven by technological advancements and innovation, can lead to significant increases in GDP.[10]

[9] Labor productivity, calculated as output per hour worked, measures how efficiently labor is being used to produce goods and services.

[10] Total factor productivity measures how efficiently all inputs – including labor and capital – are being used to produce goods and services.

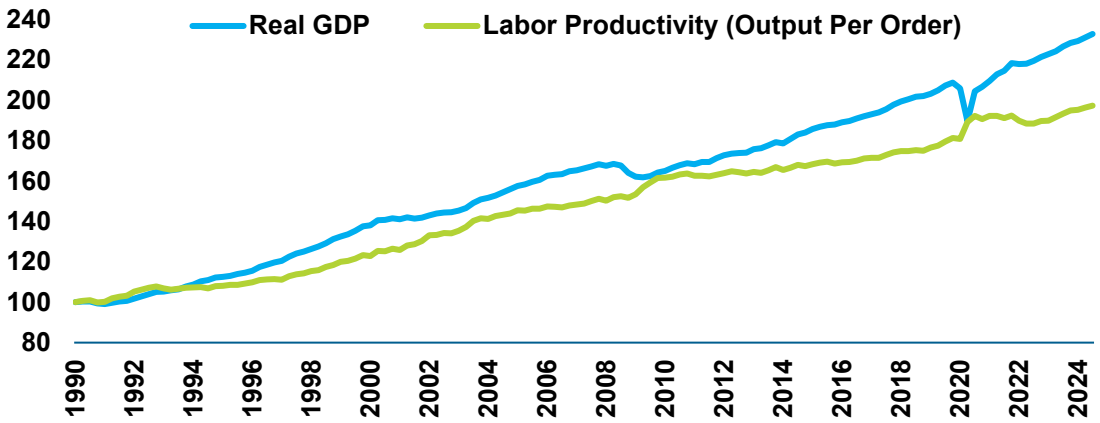

FIGURE 13
Labor Productivity and GDP

Source: FRED. Data is for the period 1990 through 3q2024.

Companies that can increase output without a corresponding increase in labor costs will enjoy higher productivity, leading to higher profits. At the macro level, the US economy has shifted such that labor has less pricing power than it did several decades ago. As a result, a smaller share of economic gains goes to workers, while a larger share goes to corporate profits.

The decreasing share of unionized workers in the US may be both a measure of and cause of this smaller share of economic gains going to workers. The decline of unionization is due to several factors, including the decrease as a percentage of the economy of heavily unionized industries like manufacturing, mining, and transportation. As these industries have shrunk in relative terms, the economy has shifted toward sectors with lower unionization rates, such as services and technology. The offshoring of manufacturing and other "low skill" jobs, as well as the automation of much of those industries, has also played a part. More recently, the rise of the gig economy represents yet another area where labor has limited pricing power.

Productivity can also be driven by economies of scale. For example, companies involved in software development and data centers typically enjoy significant economies of scale. Once the initial development costs are covered, the cost of producing additional "units" (e.g., software licenses) is minimal. Similarly, the pharmaceutical industry benefits from economies of scale in research and development (R&D) and production. High initial costs for R&D can be spread over a large volume of drug sales, reducing the average cost per unit.

If the stock market is more heavily weighted in industries/companies that have more favorable productivity characteristics, it might help explain why the market has been able to grow earnings faster than the broader economy. Indeed, industries that enjoy low comparative labor costs and high comparative economies of scale represent a disproportionate share of the stock market relative to the economy. [11]

Evidence supporting these factors can be found in the profit margins of the stock market. Profit margins for the S&P 500 have proved to be quite steady over the past decade, even during the global pandemic (see Figure 14). This typically implies stable pricing power on behalf of listed companies, no matter the political administration, inflationary environment, or stage of the business cycle.[12]

[11] Source: D. Autor *et al.*, "The Fall of the Labor Share and the Rise of the Superstar Firms," May 2017.

[12] Note that most of the margin expansion, post mid-2016, has come from Technology and telecom service sectors.

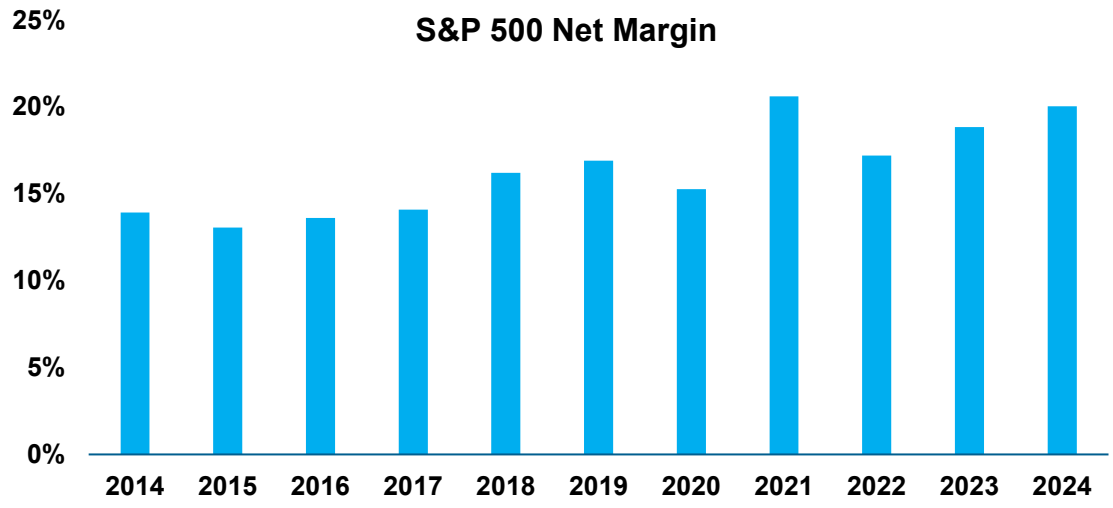

FIGURE 14
S&P 500 Net Profit Margin

Source: FactSet as of December 31, 2024. Data pulled on January 7, 2025.

Government policies & societal norms

Tax policies, regulations, and the role of societal and cultural norms can all play roles in corporate profitability. Some of this is related to supply-side economic theory which emphasizes policies that reduce taxes, increase deregulation, and encourage investment to create a more favorable environment for businesses and ultimately greater profit growth. Societal and cultural norms can shape various aspects of economic activity, from entrepreneurship and work ethics to the prevalence of trust and transparency.

The US has a culture that encourages risk-taking, individualism, and entrepreneurial activities. This is perhaps best exemplified by the venture capital industry, which is unique to the US. Venture capital tends to emphasize sectors that are growing faster than the broad economy, and it has served as the breeding ground for many of the companies that are currently driving earnings growth in the US. It is not too far-fetched to believe that the companies that will be powering earnings growth ten or twenty years in the future will emerge from the US venture ecosystem of today.

In the US, maximizing shareholder wealth has long been the primary goal of the boards and executives that run public companies. Arguably, this results in companies seeking to maximize their long-term earnings per share growth. However, the degree to which shareholder wealth is a primary motivation varies by market, and this changes over time. For example, many European companies are focused on improving outcomes for all "stakeholders" in a company (i.e., stakeholder capitalism), are "national champions," or are primarily family owned.[13]

[13] Family businesses represent 22.4% of listed companies in the US, 46.8% in China, and 43% in Europe. Source: Dauphine Foundation, January 2024 Research Letter #1.

Perhaps less benevolently, intervention by the state and structural inefficiencies such as lack of property rights or clear rule of law, may also affect earnings growth. State-owned or state-controlled enterprises may pursue motives that have little to do with shareholder wealth. State-backed companies may be more willing to tolerate low margins or even operate at a loss to achieve other strategic objectives, such as subsidizing energy costs for consumers or crowding out competition in a nascent marketplace. Likewise, countries that lack clear property rights or rule of law are more likely to be subject to direct intervention by the state that may harm shareholders, such as nationalizing assets or shutting down industries.[14]

[14] See, for example, China's decision to shut down the for-profit tutoring sector in July 2021.

Corruption, graft, and nepotism can affect the link between economic growth and earnings growth. Capitalism, in theory, allows for the efficient allocation of resources and capital, as determined by the marketplace. A culture where corruption is commonplace is more likely to result in the misallocation of resources, where capital is directed from productive to unproductive uses (e.g., bribes), and when this happens within companies it can harm earnings. Emerging economies tend to have the lowest scores on the global Corruption Perceptions Index published by Transparency International.[15]

[15] Source: Transparency International, Corruption Perceptions Index, 2023. The CPI measures the perceived levels of public sector corruption in countries and territories around the world.

A favorable regulatory environment can boost after-tax profits, while a high or unfavorable regulatory environment can reduce them. When comparing the relative ease of doing business, the World Bank finds that regulatory burdens are higher in countries with lower national income (i.e., many emerging market countries).[16]

Declining effective tax rates, combined with lower interest rates, have served as a tailwind for US corporate profitability since the 1990s. In June of 2023, the Federal Reserve published a research note that found that between 1989 and 2019, falling tax rates and borrowing costs accounted for around 40% of corporate profit growth.[17] Indeed, corporate taxes and interest expense have fallen from around 60% of earnings in the early 1990s to about 10% of earnings in February 2024. While the effective tax rate[18] has declined over the last 75 years, the share of GDP that corporate taxes comprise has actually increased (see Figure 15).[19] US listed companies often engage in tax arbitrage to legally minimize their tax liabilities, a process that is made easier when a significant percent of revenue comes from outside of the US, as noted previously.

[16] Source: World Bank Group, "Doing Business 2020: Company Business Regulation in 190 Countries," 2020.

[17] Source: The Federal Reserve, M. Smolyansky, "End of an Era: The Coming Long-Run Slowdown in Corporate Profit Growth and Stock Returns," June 2023.

[18] Source: Congressional Budget Office; The effective tax rates equal the amount of tax liabilities divide by income.

[19] Source: Bloomberg as of January 2024.

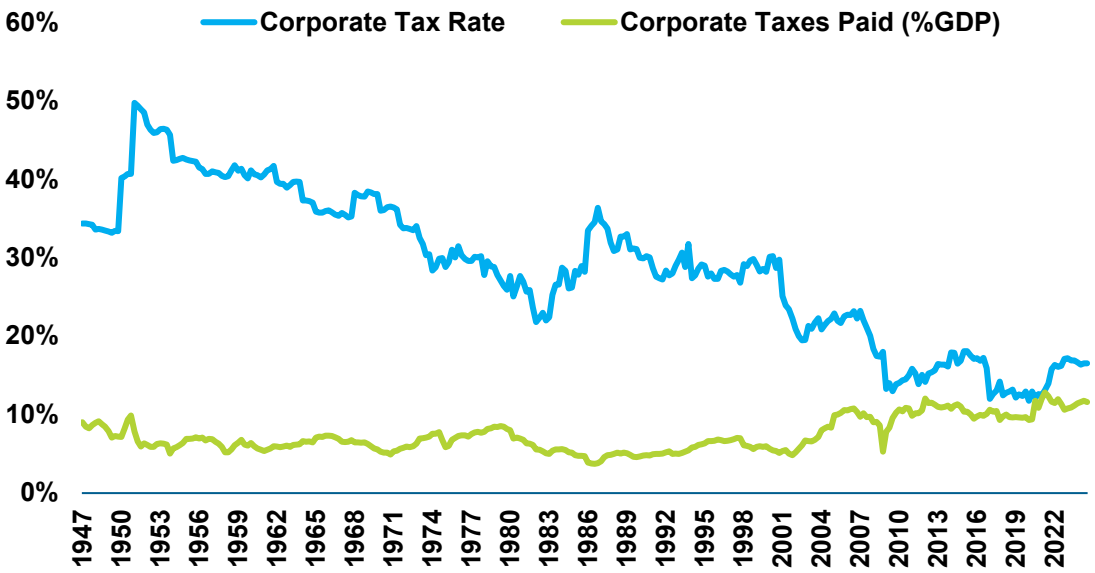

FIGURE 15
US Corporate Taxes Paid & Share of GDP

Source: FRED as of December 2024.

The outlook for the corporate tax burden may depend on which political party is in power at the federal level and whether that includes both the executive and legislative branches. Lower taxes are likely to contribute to profitability, while higher taxes will have the opposite impact. Notably, companies were able to keep most of the savings from lower taxes and interest expense as profit rather than passing them on to labor or customers. This goes back to the concept of whether listed companies will be able to maintain their pricing power regardless of the tax environment.

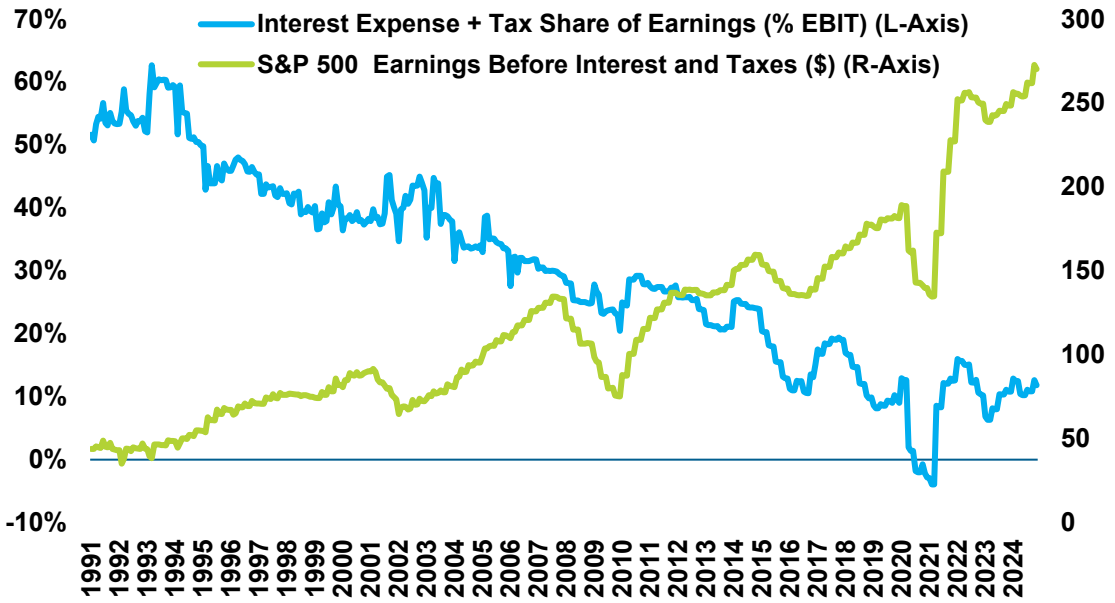

FIGURE 16
Interest & Tax Share of S&P 500 Earnings (% EBIT)

Source: Bloomberg as of December 2024.

Yield tensions: the level of interest rates

Lower interest rates reduce the cost of borrowing, and lower interest expenses improve net profits. From 1980 until 2020, interest rates were on a secular downward trend that reduced the cost of borrowing. As noted previously, a recent Fed survey cited the declining level of interest expense as a key contributor to the growth in profitability over the past three decades.[20] Interest rates have since moved higher, and the prevailing wisdom is that they may settle in at a new, higher equilibrium than was experienced in the post-GFC period. If this turns out to be the case, interest expenses would be higher, potentially harming profits. But higher interest rates may motivate firms to borrow less, hence the impact of higher rates on profits could be neutral. In fact, corporate debt (as a percentage of equity) is at a record low, implying that changes in interest rates will be less impactful than they have been historically (see Figure 17).

[20] Source: FRED, as of 3q2024. Nonfinancial Corporate Business, Debt as a Percentage of the Market Value of Corporate Equities. Bank Prime Loan Rate.

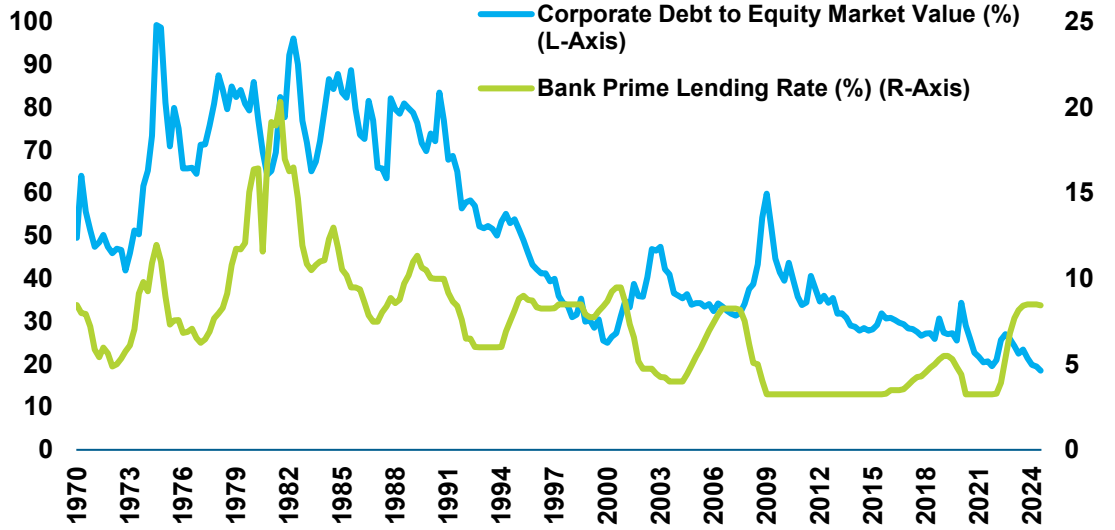

FIGURE 17
Corporate Debt and Borrowing Rates

Source: FRED, as of 3q2024. Nonfinancial Corporate Business, Debt as a Percentage of the Market Value of Corporate Equities. Bank Prime Loan Rate.

EPS growing faster than earnings

Looking back to Figure 6, earnings per share have grown faster than corporate earnings. How is this possible? One explanation is the difference in composition between the stock market sectors and the broader economy that was noted earlier. The other, perhaps more significant, explanation lies in the difference between earnings and earnings per share – namely, the inclusion of the number of outstanding shares in the calculation of the latter.

A meaningful portion of economic growth often comes from new and growing enterprises rather than existing ones. For most of the US market history, companies tended to be net issuers of shares to finance this growth.[21] That is, on average, the market issued more new shares than repurchased existing shares. All else equal, this was dilutive to shareholders, as their shares now entitled them to a smaller percentage of the company's value and earnings.

However, around the turn of the century, a new trend emerged at least in the US.[22] Companies started buying back their shares, often using the excess cash on their balance sheet. This had the benefit of boosting EPS through the "denominator effect" (i.e., EPS increased by reducing the number of shares rather than by increasing earnings). Over ten years, this can have a significant compounding effect (see Figure 18).

[21] Arnott, et al, suggest that net new share issuance occurred at an annualized rate of 2.3 percent a year in the US between 1926 and 2001. See "Earnings Growth: The Two Percent Dilution" by William J. Bernstein and Robert D. Arnott, 2003.

[22] Source: Yardeni Research, "S&P 500 Dividends and Buybacks," January 2025.

EPS with no change in shares	EPS with 2% reduction in shares	EPS with 2% reduction in shares for ten years
$1,578 B / 10.5 M shares	$1,578 B / 10.3 M shares	$1,578 B / 8.6 M shares
= $150.3 per share	= $153.2 per share	= $183.9 per share
No change in EPS	EPS 2% higher	EPS 22% higher

FIGURE 18
Illustrative Example of Impact of Buybacks on EPS

Source: Meketa.

There are several alternatives to share buybacks, such as paying dividends, accumulating cash for a "rainy day," making acquisitions, or investing in property, plant, and equipment. However, investors have generally rewarded US-based companies who have decided that the best use of their "excess" cash is to repurchase shares. So long as markets continue to support this decision, and if companies continue to generate sufficient cash to make buybacks, they are likely to continue to do so.

Moreover, a mature and active venture capital market in the US has allowed companies to fund significant growth without diluting public market shareholders, as the growth is financed while the companies are still private.[23] "As engineering and R&D organizations seek to innovate faster amid a talent shortage, many are opting to outsource and offshore an unprecedented proportion of work once done in-house. Leading companies are using outsourcing to overtake rivals in the innovation race by boosting value creation and accelerating time to market."[24] This contrasts with much of the rest of the world, where growth is often financed through the issuance of new shares.

[23] See Reuters, "Flipping the Drug Development Industry on Its Head," April 4, 2024. See also McKinsey & Company, "CROs & Biotech Companies: Fine Tuning the Partnership," June 9, 2022.

[24] Source: Bain & Company, "The Engineering & R&D Report: The Digital Shift Fuels Outsourcing in Engineering & R&D," 2023.

Adding it up

Taken together, these factors explain why the US market has grown its earnings per share at a substantially higher rate than overall economic growth. Most of these factors are expected to remain in place, supporting the thesis that US economic growth will serve as a baseline for earnings growth and that listed US companies will grow their EPS faster than overall economic growth for the near-term future. Returning to the theme of US exceptionalism, we expect that the US market will continue to "out earn" other markets (see Figure 19).

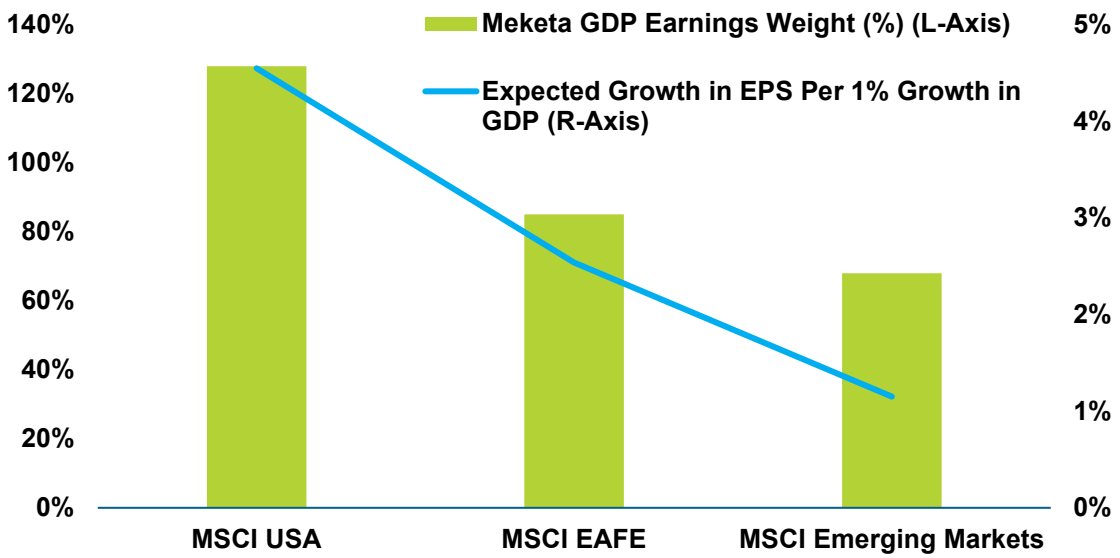

FIGURE 19
Estimates of Relationship Between Growth in GDP and Growth of EPS

Right Axis Data Source: Meketa's Capital Markets Expectations as of January 2025. Note that these numbers may be revised from year to year. Left Axis Data Source: IMF and Bloomberg. Nominal GDP Data from IMF October 2024 World Economic Update. EAFE Estimated as the combined GDP of the Euro Area, Australia, Japan, and Switzerland. Linear regression conducted on earliest available date to present (1992 for US, 1996 for EAFE, 2001 for EM).

Conclusion

While elevated valuation metrics for the US equity market may cause investors to instinctively believe the market is overvalued, these prices may be justified if US companies can continue to grow their earnings at the same rate that they have averaged over the past fifteen years. The sustainability of earnings growth for listed US companies hinges on a multitude of factors. Our analysis reveals that while economic growth and earnings growth are correlated, the relationship is not absolute. US corporations have benefited from their global footprint, technological advancements, favorable tax policies, and a culture that emphasizes shareholder wealth. These elements have collectively contributed to the robust earnings growth observed in the US market, often outpacing the broader economy.

However, the future sustainability of this growth is not guaranteed. Potential headwinds such as deglobalization, changes in tax policies, and shifts in market composition could impact the earnings trajectory. Despite these challenges, many of the factors that have historically supported US earnings growth are likely to persist in the near term, suggesting that US companies may continue to "outearn" their global counterparts. As such, a premium valuation for the US market relative to other markets appears justified, reflecting its unique ability to generate higher earnings growth. How much of a premium is debatable and much depends on how long the historical tailwinds for US corporate earnings persist.

Appendix

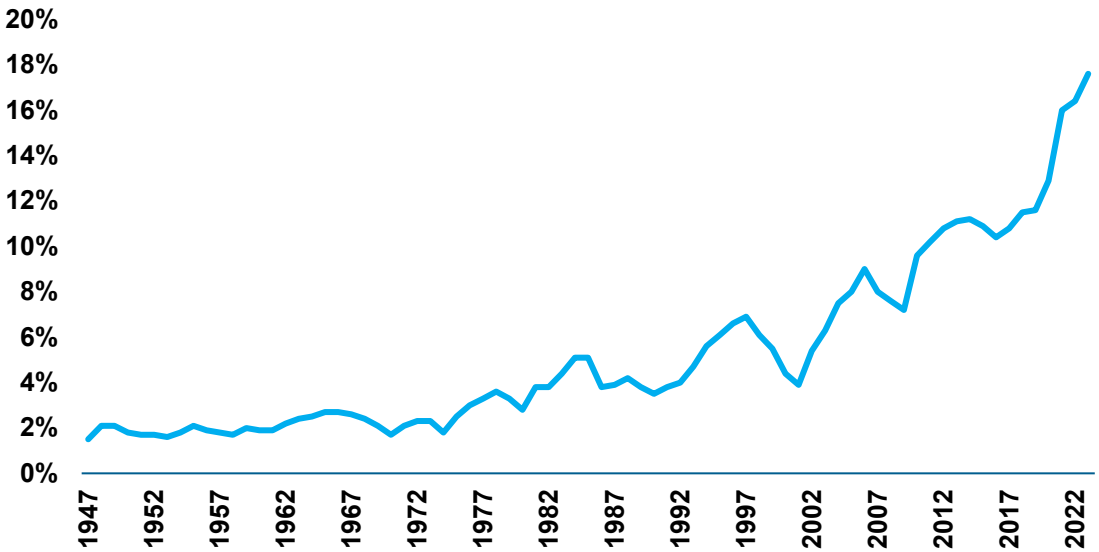

FIGURE 20
US Corporate Profits After Tax (% Per Unit of Real Gross Value Added)

Source: Meketa analysis of FRED data. Profit per unit of real gross value added of nonfinancial corporate business: Corporate profits after tax with IVA and CCAdj (unit profits from current production). Data is from 1q1947 through 4q2023.

Gross Value Added ("GVA") measures the value of goods and services produced in an economy, minus the cost of inputs and raw materials used in production. It essentially captures the net output of different sectors. GDP measures the total monetary value of all final goods and services produced within a country's borders in a specific time period. It includes consumption, investment, government spending, and net exports (exports minus imports). GDP and GVA are related through taxes and subsidies. The formula connecting them is:

GDP = GVA + Taxes on products - Subsidies on products

If taxes on products exceed subsidies, GDP will be higher than GVA, and vice versa.

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