

January 29, 2025

Sustaining Profitability Exceptionalism

Profitability growth core to US exceptionalism

- Chinese and European manufacturers struggle with GVA growth
- Profitability growth underscores labour market strength
- US IT strength lifts many boats, DM EMEA continues to struggle

Capital expenditure not the only anchor for equity allocations

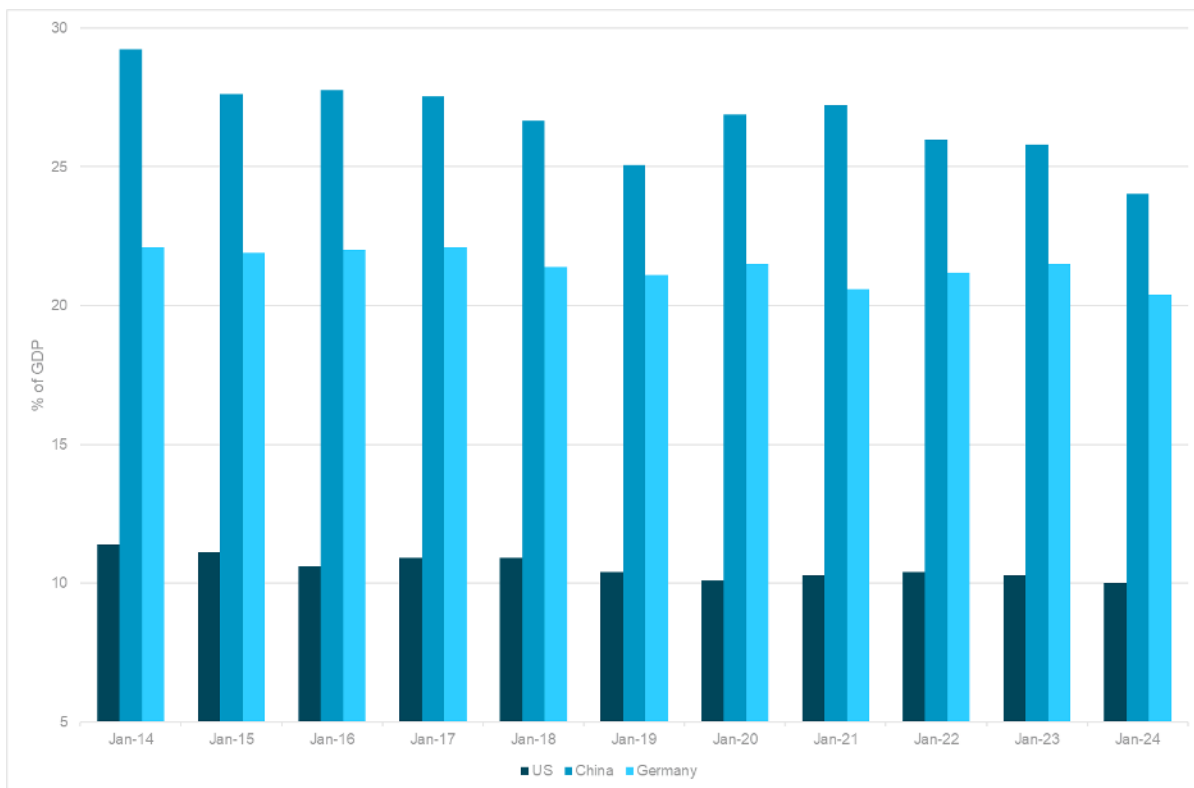
Monday's steep adjustments in US equity markets have given credence to the view that US exceptionalism, especially its leadership in technology and other equity sectors, may have reached a peak. As earnings season picks up, fears of an even deeper correction have come through, to the extent that there could be a knock-on effect on monetary policy. In the near term, any large equity market adjustment will be considered a material tightening in financial conditions, to which the US is relatively more exposed, both through the wealth effect and via corporate financing channels. If extended, there is justification in assessing whether the Fed will need to look at an offset. Over the medium to longer term, technological innovation and productivity gains are generally considered disinflationary as well, which can help bring down terminal rate levels as demand and supply constraints recalibrate.

There are obvious interest rate-related implications for dollar strength, but the US' technological dominance and asset allocation implications could be in play as well. The record-high share of US companies – especially technology-related names – in global equity portfolios has been well documented and the bar is low for an adjustment. Fears over a marked decline in capital expenditures in semiconductors, relative to current expectations, are justified. On the other hand, we note that if productivity gains can come at a lower cost,

global trend growth can re-rate and US companies are well positioned to benefit. Furthermore, we highlight that one of the reasons behind the rich valuations of US tech names and the broader US market is that profitability growth has consistently surprised to the upside. On this front, we believe that it will take more than the erosion of technological advantages, tariff disputes or monopolistic positioning to fundamentally undermine US exceptionalism. The corporate outlook of other economies needs to improve, and this requires deeper structural reform in China and the European Union.

Firstly, even before talking about the tech sector, capex or industry at large, we note that the structure of US growth, and therefore corporate profitability, is extremely different compared to other key economies. Measured as a share of total GDP, industry (ex-construction) in the US barely accounts for 10% of the entire economy and this figure has remained remarkably stable over the past decade. Meanwhile, in Germany, the sector's share is also quite stable at just above 20% and this is indicative of the country's failure to rebalance, leaving it uniquely exposed to a vast array of well-documented external challenges. China, in contrast, has been attempting to shift towards a more services-based economy. While the share of manufacturing has fallen, in recent years there hasn't been any commensurate pick-up in demand, which has led the trade surplus hitting record highs as imports remain subdued. Similarities to Japan's experience over the past few decades remain highly relevant in this respect as exporters struggle to channel savings into better domestically based value-added growth.

Exhibit #1: Manufacturing Share of GDP



Source: Bloomberg, BNY

Meanwhile, this is taking place amid material changes in the US' industrial policy, which is clearly geared towards adjusting supply chains and bringing more production to the US. We note that during the first Trump administration, growth value-added (GVA) from industry (Exhibit #2) in real terms was consistently above 5%. Regardless of the overall challenges to global trade and supply chains, the push to strengthen the industrial and manufacturing presence in the US is palpable. Meanwhile, we can see that the same GVA in China has stabilised and is showing signs of rebounding, in line with the country's new industrial strategy, while it is now contracting sharply in the Eurozone. The lack of a comprehensive industrial strategy in the Eurozone and broader EU is costing the bloc materially in growth terms while China and the US are the clear winners here. This is an important lesson for sceptics of US exceptionalism and long-standing prognostications regarding the dollar's status as a reserve currency: lack of credible and scalable substitutes will continue to hinder any erosion of exceptionalism.

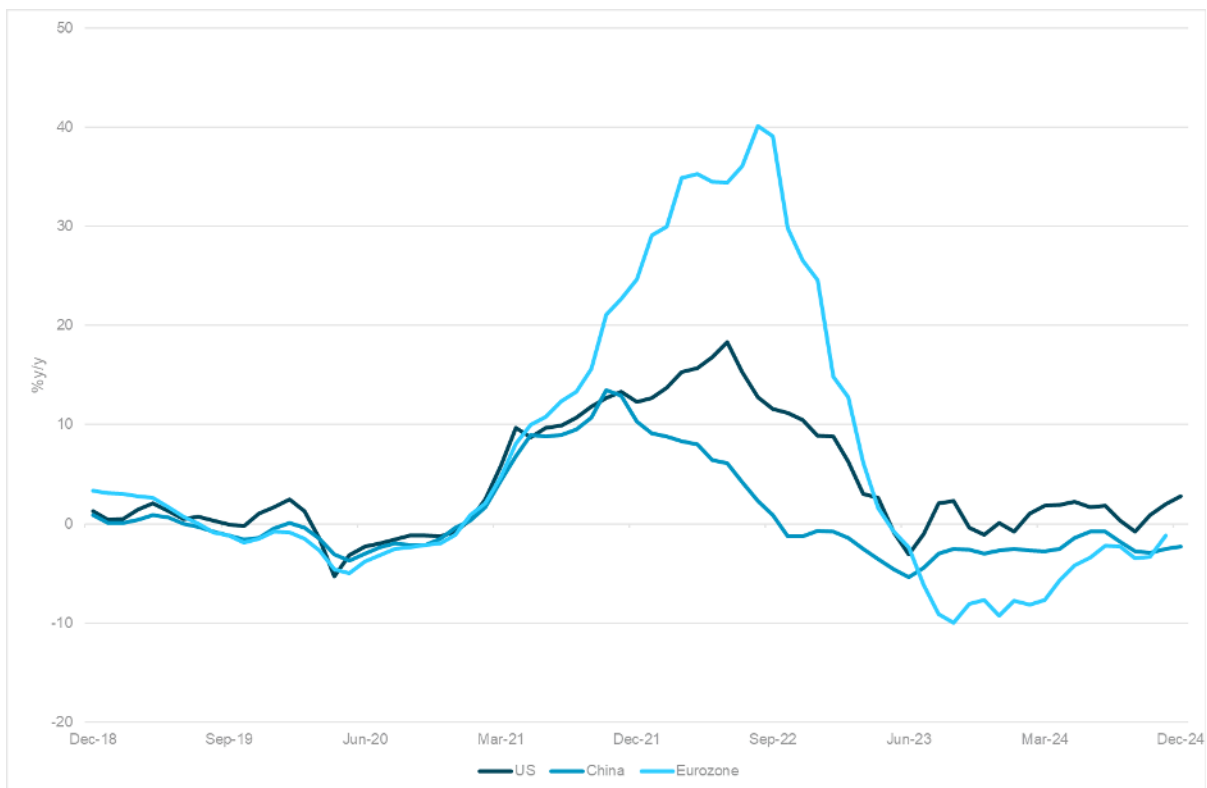
Exhibit #2: Annualised Industrial GVA Change



Source: Bloomberg, BNY

Corporate profitability can be measured in terms of company or sector-level earnings, but allocations also matter for broader price transmission for the broader economy. For most exporters, productivity gains are often synonymous with lower costs but to maintain competitiveness, margins are sacrificed and there is no further improvement in real incomes. Consequently, demand is unable to rise as savings are retained or channelled overseas – often into US Treasury securities – another tenet of US exceptionalism. Post-pandemic, labour supply has been one of the key global price drivers: the ECB has noted labour supply as an ongoing bottleneck even with export orders contracting sharply. Even so, producer prices have been contracting in the Eurozone for two years, and even longer in China. In contrast, the US' PPI situation has all but normalised (Exhibit #3) despite labour constraints and a persistently strong dollar. This is crucial for corporate profitability: it indicates that US companies are comfortable raising prices to retain margins, to help absorb input costs in wages and materials, while not jeopardising market positioning. In the Eurozone and China, declining PPI indicates that either wages are falling, or suppression is taking place to limit competitiveness loss. This stands to become a self-reinforcing cycle as higher retained earnings will support investments to consolidate leading positioning, until valuations become excessive and/or an unexpected disruption to growth fundamentals arises: fears over the latter have been the driving force this week.

Exhibit #3: Producer Price Change



Source: Bloomberg, BNY

Ultimately, valuations and profitability prospects will be reflected in positioning. As of Q1 2025, iFlow indicates that in the information technology space at least, the US' holdings are above peers again (Exhibit #4), which has been the case for 14 out of the past 21 quarters. Even during periods when EM APAC holdings were strong, especially last year, they pertain to economies which could also benefit from being part of the US technology supply chain. In contrast, Europe has struggled to be in a sustained leadership position over the past decade, underscoring the need for deep reforms: the region is but a bystander amid this week's global tumult over artificial intelligence. Equity markets will applaud innovation, but allocations will only adjust once the profit and margin cases are confirmed, in both directions.

Exhibit #4: iFlow IT Holdings



Source: BNY

Please direct questions or comments to: iflow@bny.com

Disclaimer & Disclosures



GEOFF YU
EMEA MACRO STRATEGIST

CONTACT GEOFF



Can't see the email? [View online](#)

iFlow
We can gauge how the world's money moves. Because a fifth of it moves through us.

→ Learn More
→ Contact Us

This email was sent to james.cohen@bnymellon.com, and was sent by The Bank of New York Mellon 240
Greenwich Street, New York NY 10286.

We take our data protection and privacy responsibilities seriously and our privacy notice explains how we collect, use, and share personal information in the course of our business activities. It can be accessed [here](#).

Your [privacy](#) is important to us. You can opt out from receiving future Newsletters by [unsubscribing via this link](#) at any time. You can also select the topics that you want to receive by [managing your preferences](#).

This message was sent from an unmonitored email box. Please do not reply to this message.

[Contact Us](#) | iflow@bny.com

© 2025 The Bank of New York Mellon Corporation. All rights reserved.

This message was sent from an unmonitored email box. Please do not reply to this message.