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The Future of Stock Returns

Jonathan Golub, Chief US equity strategist, Credit Suisse

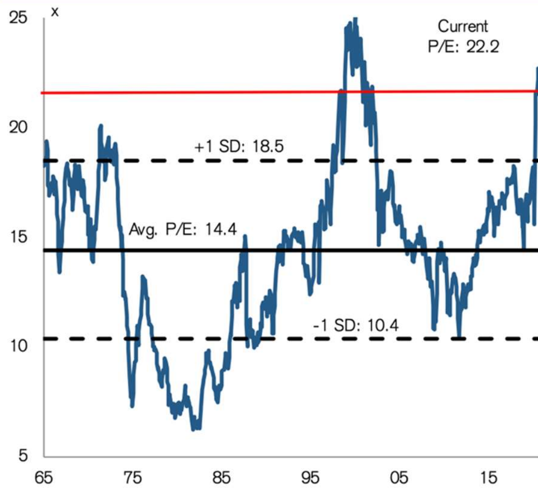
The United States and global economies must be ready for slower growth, and lower interest rates, over the long term. But that isn't necessarily bad news for equity markets, particularly the United States where the rise of technology companies will support Wall Street.
While short term volatility around COVID-19 and Presidential polls is expected, it is much more important that investors understand longer term trends.
"Investment trends tend to work in very long regimes over long periods of time. The idea of an average return or an average interest rate doesn't actually apply as much as we might think," said Jonathan Golub, chief US equity strategist, Credit Suisse.

"The things which made the economic growth slower in the last ten to 15 years are going to be in effect going forward, so we're going to be experiencing a world with slower growth, lower interest rates and weaker inflation."

Interest rates were relatively low in the 1960s, then very high in the late 1970s and 1980s, and then low again after that. Equity markets returned almost 18 per cent for 20 years until 1965, and then almost nothing outside dividends for the next two decades. In the most recent decade growth stocks did well compared to value stocks, but the opposite happened during the prior decade.
"To understand these regime shifts, it's important to understand what's behind economic growth and how that fuels returns. The things which made economic growth slower in the past ten to 15 years are going to be in effect going forward, so we're going to be experiencing a world with slower growth, lower interest rates and weaker inflation."
Two things drive growth in an economy over the long term - either people work more hours, or the population expands. A critical shift in both factors was triggered by the introduction of birth control pills for women in 1960. Females in the United States on average, had 3.5 babies back in 1960. Today that number is below two.

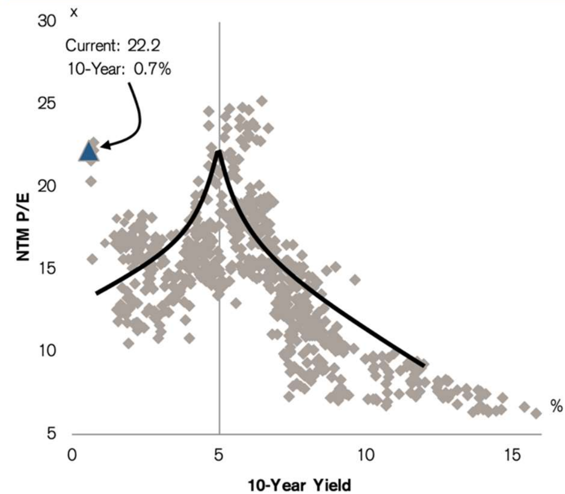
It is a similar story across developed nations, and even developing countries like India, Russia and Brazil have lower birth rates than previously.
The pill has had far reaching implications on the workforce, Mr Golub said.
"Women flooded into the labour market and more people working meant better economic growth. The reason the economy was so good, you could argue, from 1960 to the late 1990s was not new technologies but women working."
Many of that cohort has now reached retirement age. The development of the retirement system has meant older employees have left the workplace, or don't need to work as much. The number of people working is shrinking, and given demographics, that's unlikely to change. The great impetus for economic growth in the developed world – more people working more hours – has dissipated.
Understanding this super-trend is important when considering equity markets, Mr Golub said.
Purely on valuations, history suggests that if price-to-earnings ratios are high, then the following ten years of returns will be low. That doesn't augur well when current PE ratios in the United States are 22 times earnings. Only during the internet tech bubble were PE ratios higher.

S&P 500 NTM P/E



Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

10-Year Treasury Yields vs. NTM P/Es



Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

The counter argument is that the implied value of PE ratios is one over the corporate bond yield, Mr Golub said. "So, if the yield on a 30-year corporate bond is 3.3 per cent … that gives you an implied multiple on the stock market of 30 times. You could argue that multiples in the past have not been in this range, but in the past, we've never had interest rates this low."

So which argument is correct?

"My expectation is that we will see stock multiples in the mid-20s in the US for the next decade, which is a much higher [long term] number than anything that we've seen," Mr Golub said.

Another impact of the low growth, low interest rate environment has been for central banks to grow their balance sheets. The US Federal Reserve used to keep reserves of about five per cent of the size of the economy. After the global financial crisis that went to around 25 per cent.

"There's two parts to this. After an initial jump in 2008, the economy stagnated, and the Fed decided to do quantitative easing and start buying assets. It wasn't the Fed's bond buying during the financial crisis that caused the problem. It was the Fed's action afterwards to try and create economic growth.

"If you look at the kind of economic growth we've had in the last 15 years, not only did we increase the balance sheet, but it didn't actually work. And that's the story in the United States, and Japan and Europe."

Mr Golub said that lower interest rates over time, flowing from lower growth rates, affects the ability of central banks to influence the economy.

"My expectation is that we will see stock multiples in the mid 20s in the US for the next decade ahead, which is a much higher number than anything that we've seen."

"When interest rates go down from a high level …. we borrow more money and that creates economic activity... The economy is more robust because we're spending more money," Mr Golub said.

"But when interest rates keep going down from four to three to two to one to zero a funny thing happens. We start to save more money. When interest go down below a certain point, it actually starts to do some damage."

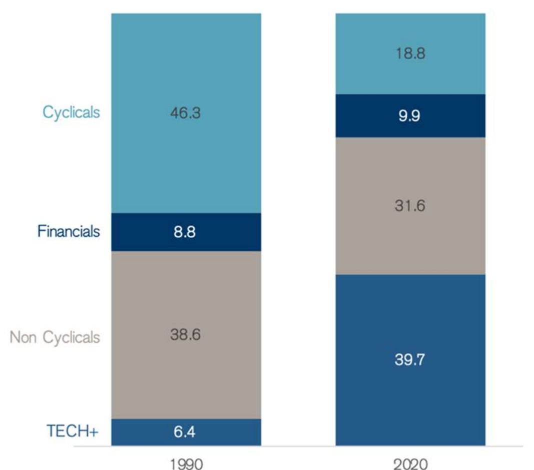
For investors the question is what does it mean for corporate earnings and share prices. On Wall Street at least, the big change in recent years has been the emergence of the technology stocks.

"Tech stocks are 40 per cent of the pie. In other regions likes Australia, Europe, Canada or Japan, tech is a substantially smaller part of the picture.

"What happens in an environment where economic growth is weaker and you have more technology companies is they return more cash to shareholders. They generate more cash flow, are lighter on their feet and use less capital... The more cash flow you have in a slower growth world, the more your assets are worth

"The US market is becoming more new economy…. and is better equipped for this slower environment," he said. It explains the performance of Wall Street since March, where indices have hit record highs, but Mr Golub does not expect a similar performance in other stock markets around the world without a large tech sector.

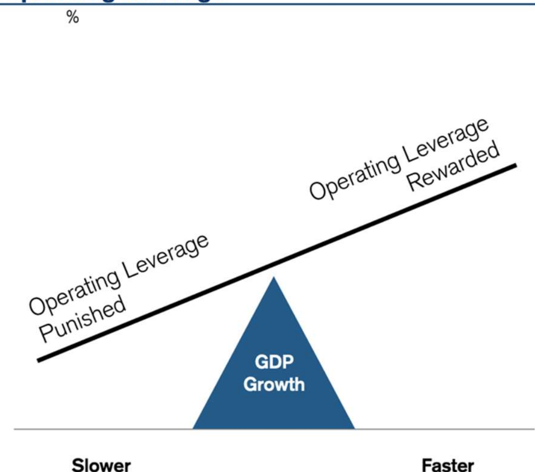
S&P 500 Sector Weights



Source: Standard & Poor's, FactSet, Credit Suisse

Operating Leverage

%



Source: Credit Suisse

The pullback on Wall Street in recent days doesn't diminish his thesis.

"I don't see something fundamentally broken, but there were a lot of companies that were up over 100 per cent. They probably needed to take a cold shower and come back down to earth. I think this is a setup for something that's a bit healthier."

> *"Lower discount rates will lead to higher multiples in a very bizarre and perverse way and that will be positive for stocks, but not all stocks will be created equal. Growth and technology will win versus value and old economy, and the US economy tends to have more of those things."*

The upcoming US Presidential poll on 6 November is not overly worrying investors. Both candidates will want to push economic and jobs growth, Mr Golub said. Only the way they go about it will be different. Of more concern is that post the COVID-19 pandemic, governments will be playing a bigger role in society, and "capitalism works best with less government involvement."

Mr Golub agreed that his central scenario is not a case of history repeating itself. "Lower discount rates will lead to higher multiples in a very bizarre and perverse way and that will be positive for stocks. But not all stocks will be created equal. Growth and technology will win versus value and old economy, and the US economy tends to have more of those things."

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