EPIC INVESTMENT MANAGEMENT

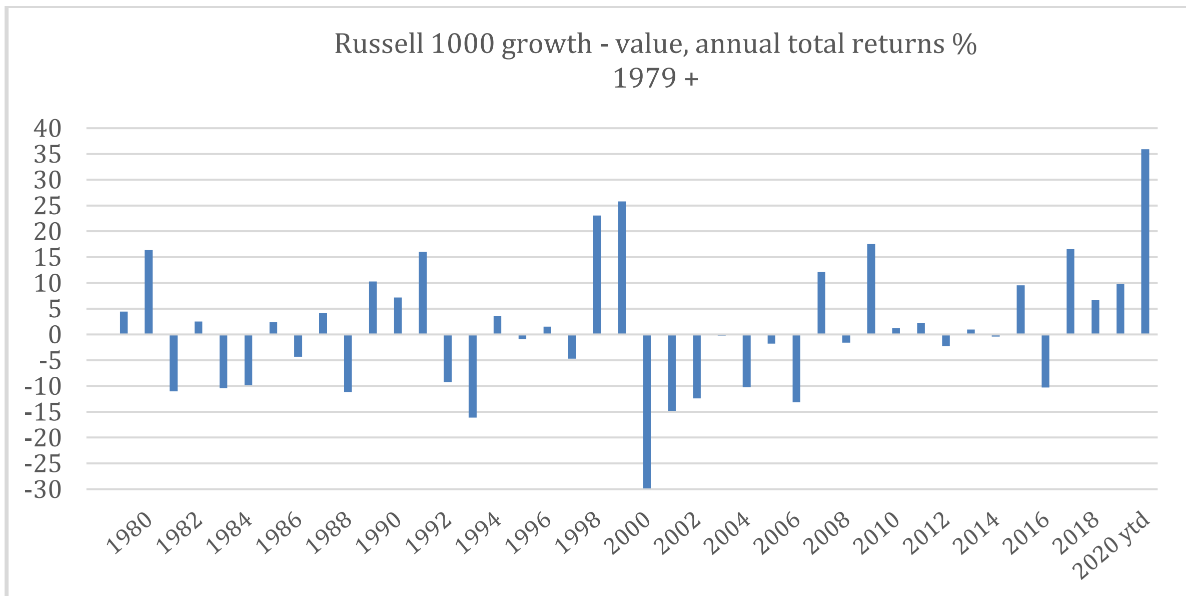
Issue 58 October 2020

Growing To Extremes

The past decade has been marked by a number of investment trends running for so long they almost seem irreversible. Among these are lower bond yields, US markets topping international markets, large cap equities over small caps; and perhaps the most dominant trend of all, growth stocks over value.

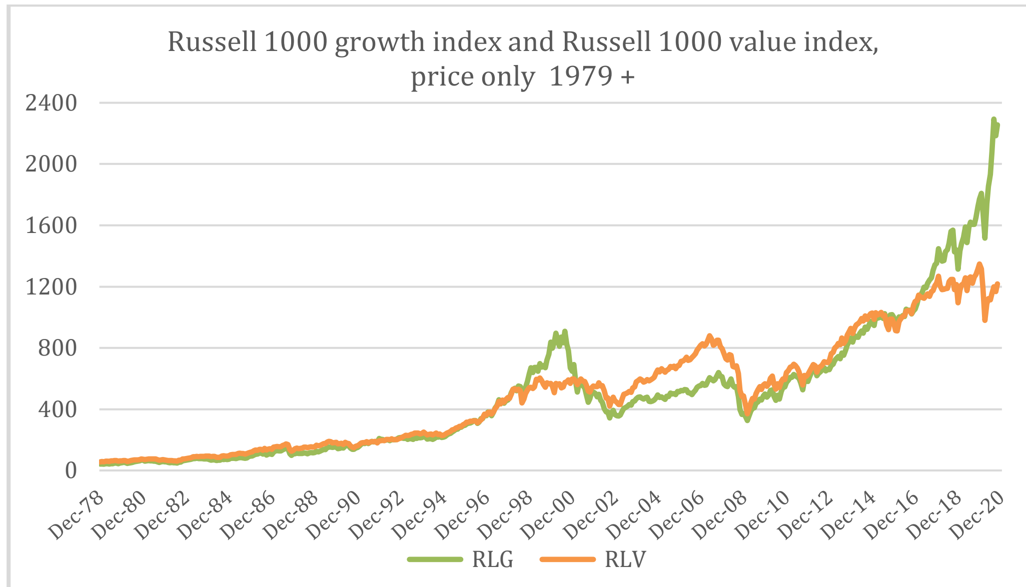
Over the following pages, we document this phenomenon, don't dwell too much on its probable cause (narratives are always written in hindsight), and consider whether the tide is finally turning -- out of a small collection of growth equities and into anything else. 1

Growth stocks have trounced value stocks for most of the past 14 years, the longest extended run in four decades of market history. This year's disparity between growth and value is also the largest on record, in either direction,

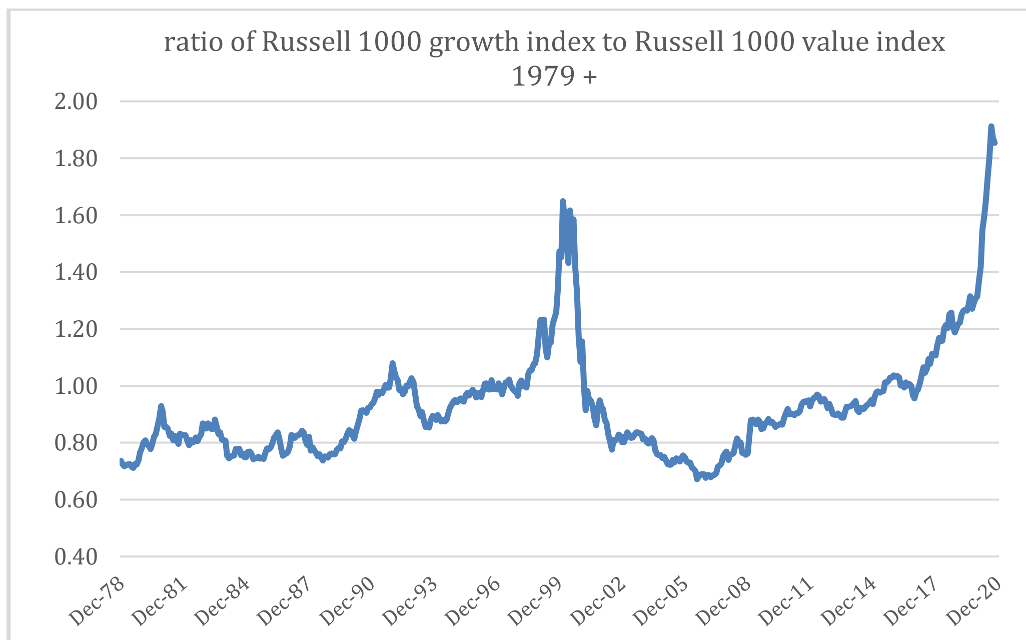


estimated total returns for 1979-1994, actual after 1994

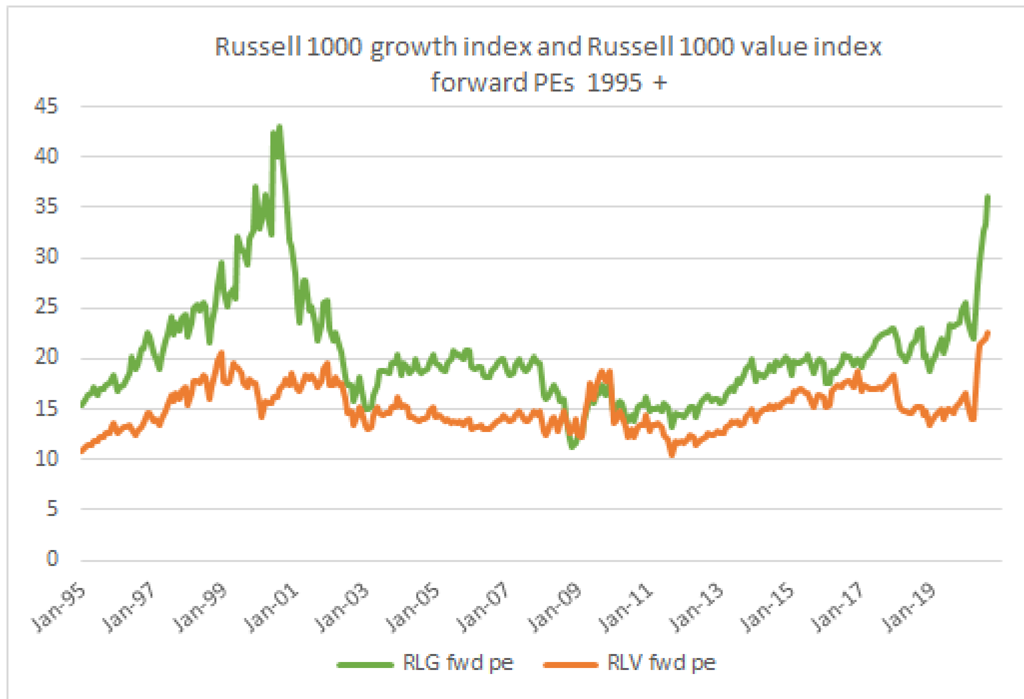
Simply comparing the price of the Russell 1000 growth(RLG) and value(RLV) indices, they were equal in early 2017. Today the growth index is priced at 2256 while the value index is at 1217.



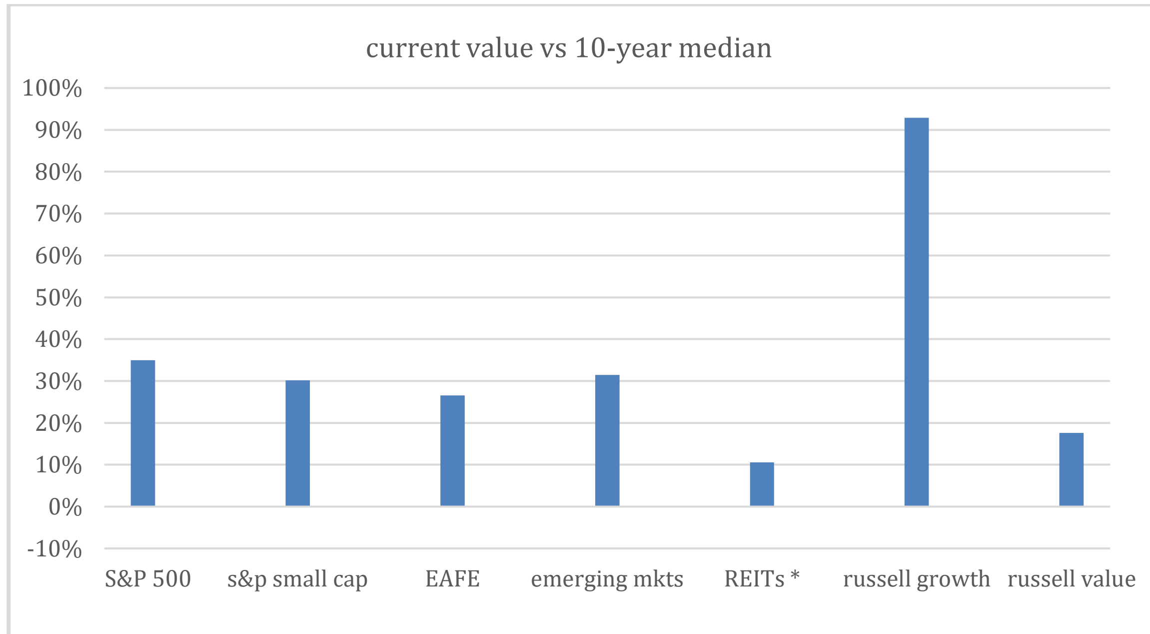
If the market remained indifferent between growth and value every year, growth would appreciate slightly more, while value investors would pick up additional dividend income. Thus, this ratio line should be upward sloping… slightly. This move looks close to parabolic.

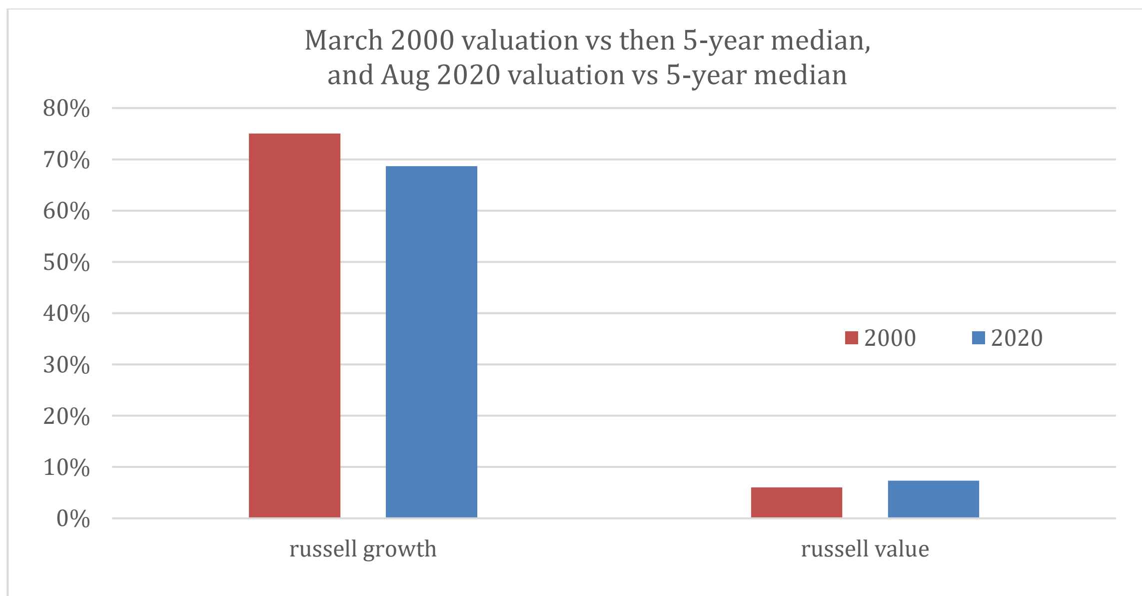


Both growth and value have enjoyed multiple expansion, more so for growth.
In the tech bubble of 1999-2000 the ratio of growth forward PE to value forward PE exceeded 2.5x, whereas today it is at 1.6x.
It can always move higher, even if it shouldn't.



The chart below suggests growth stock valuations are out of control, measured against their own 10-year norm; not so much value stocks. In the second chart we compare today's readings with the peak of 2000, using five-year norms instead.
Close enough?





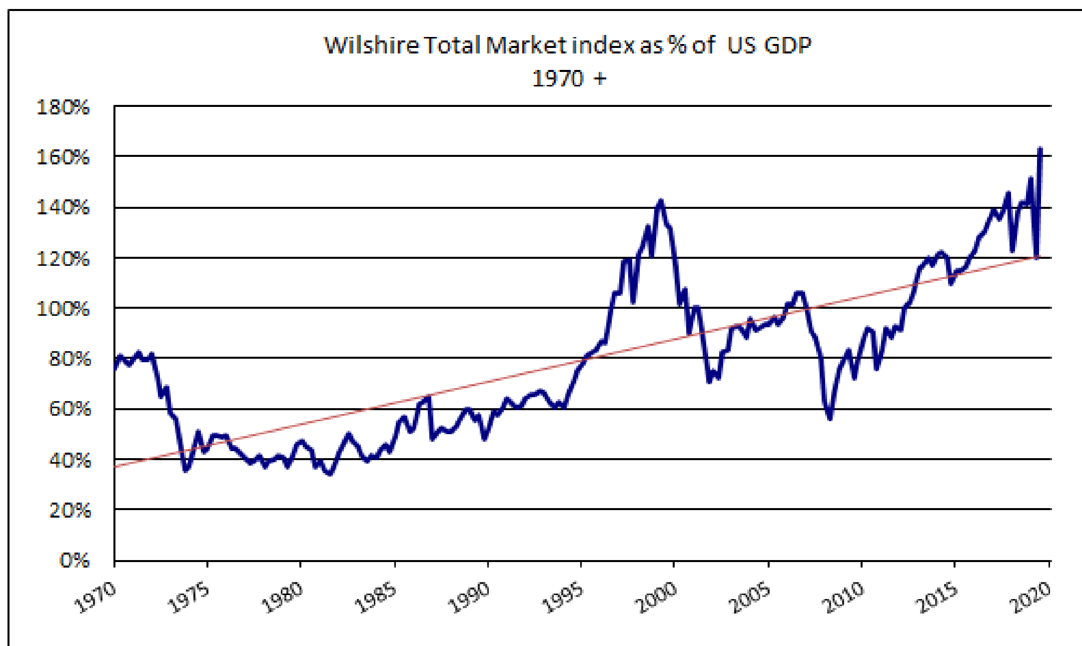
On the overall market picture…
The chart below measures the total US equity market capitalization, as a percent of gross domestic product (GDP). Clearly this is a warning sign about equity over-valuation.

How much so?
Other than this measure, it is nearly impossible to find a broad US market valuation metric above the levels reached in the tech bubble of early 2000. Indeed, one working assumption is that equity prices reached such extremes two decades ago that they set a valuation top, never to be exceeded in any relevant time frame.

But there is always a complication.
At the prior high of early 2000, the 10-year Treasury yielded six percent and the equity risk premium measured negative 255 basis points. Bonds were clearly more attractive than stocks, other than the fact that stocks kept rising.

Now? Bonds are yielding 77 basis points and the equity risk premium is positive 292 basis points. In early 2000, bonds were much cheaper than stocks. Today, stocks are much cheaper than bonds.

No minor complication.



The most recurring question in US equity markets is "when will value regain its leadership over growth?" Or to put it another way, the longest running incorrect prediction is “the turn from growth to value is imminent”.

When does it stop? When enough investors decide to take their money off the table, reversing money flows out of large cap growth and into any alternative investment. What reasons they cite -- valuation, economics, politics, intuition -- is entirely up to them, the collective wisdom of the market.

The investment landscape is littered with money managers who thought they had the timing nailed, only to be proven wrong. Still, if anything we are meant to gather data, analyze it, and form opinions as objectively as possible. Surely, the turn is near?

1

Addendum

The popular explanation for growth's outperformance changes with time.

A.

Two and three years ago it was said that large cap growth stocks were the primary beneficiaries of investor indexing. This concept came without any theory for why the top ten stocks in a market-cap-weighted index (S&P 500) should benefit more than the bottom ten stocks in the same index. After all, index buying should distribute the money flows into these stocks in the same proportion as their weight in the index.

B.

One and two years ago the story changed. Growth stocks were said to outperform in a tepid economy, since the underlying companies had more dynamic businesses and could meet growth expectations even in a slowdown. This makes sense until we examine the data and discover that, for much of the slow-growth segments of the past decade, value companies were often growing earnings in-line with growth companies. In addition, there have been numerous occasions over the decades when value stocks outperformed growth stocks, regardless of each group's growth rate.

C.

This year the narrative claims growth stocks benefit from a lower discount rate (derived from lower interest rates), as growth companies require extended time horizons to produce the earnings and cash flow needed to justify their valuations. The lower the discount rate, the higher the value of those future profits. This concept holds up as classic financial theory and suffices as a partial explanation. It also seems incomplete and implies growth will always outperform in a declining interest rate environment, which is certainly not true.

Even if we accept C as a partial explanation, it leaves us looking for more.

Here is one narrative we seldom hear, yet it always rings true:

Stocks rise when there is more buying pressure than selling pressure. So long as money is chasing hot large-cap growth stocks, that infusion will push those stocks higher. Momentum players pile on, buying anything that is outperforming. History shows that no matter how much 'dumb money' this momentum buying represents, it is typically rewarded.

Musings On The Fed

Our central bank made news recently by adjusting its interpretation of "inflation targeting", indicating it will allow inflation to run above its two-percent goal for a while. This serves as a counterbalance to inflation running below two percent for the better part of a decade.

As background, The Federal Reserve did pretty well for most of a century (ex 1930s, 1970s) without defining an inflation target. In 2012 it stuck a finger in the air and decided two percent was a Goldilocks inflation number... not too hot, not too cold. Since then the Fed has met its inflation target in just one year, all others being too low for its liking. Don't worry, they still get paid for their work.

So now the Fed has decided that short-term interest rates will remain low for an extended time period, even if inflation rises above two percent. And every time they tell us this they seem to think the message falls on deaf ears, so they repeat it ad infinitum. Federal Reserve chairman Powell drives home the point, saying the Fed "is not even thinking about thinking about raising rates".
We get it.

Flexibility in an inflation target is probably a good idea, as it was for a century. So the Fed has taken a round trip, via the scenic route, to a place we know so well... its precise inflation target is not really driving monetary policy. Keeping rates low to boost employment and support an economic recovery is more important. Indeed. Right policy, strange way to get there.

After its most recent meeting, the Fed released updated economic and interest rate forecasts. The widely-cited 'dot plot' of interest rate projections shows a majority of Fed policy makers expect rates to remain near zero through 2023.

The Fed's economic outlook calls for unemployment to range between 5.0 percent and 6.2 percent in the fourth quarter of 2021, with Gross Domestic Product regaining its pre-recession level about the same time, a year from now.

Of note, the Fed's base case forecast calls for inflation to run below two percent for the next couple years, then a target guess of 1.9 to 2.0 percent for 2023, and two percent in the longer run. This suggests the Fed does not really believe its own rhetoric about inflation targets at this point/ aka letting inflation run a little hot, over two percent.

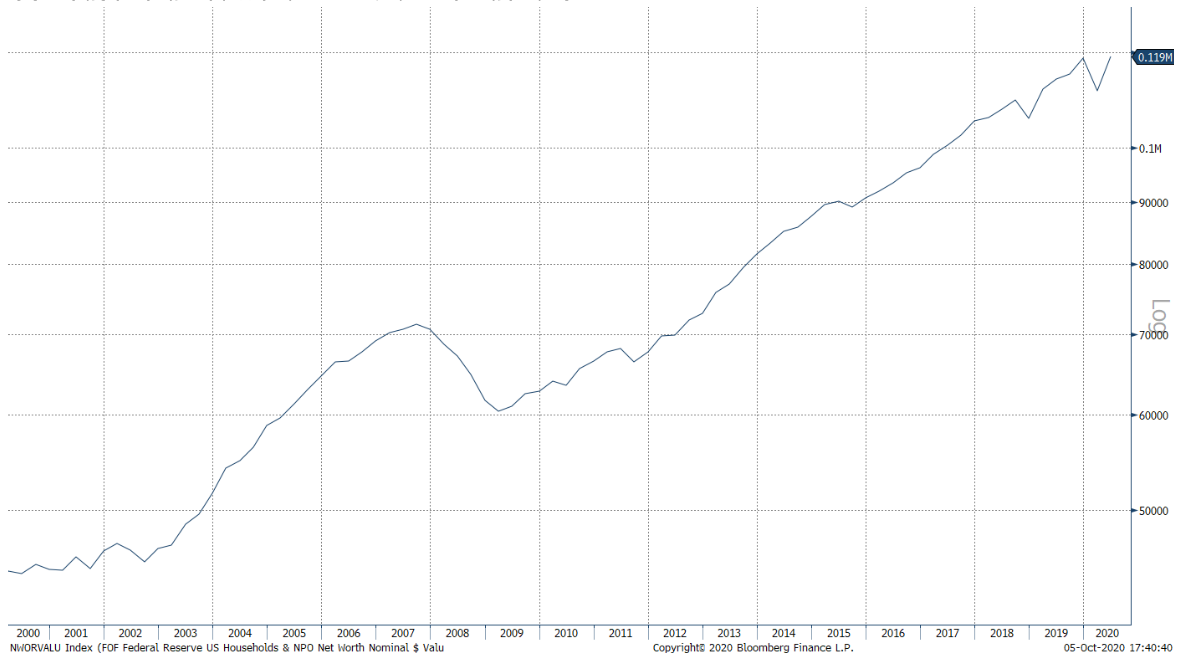
An interesting question (they never ask these) at the Fed's next press conference would be… given most of the slack in our economy should be removed in a year or two, and given money supply's expansive year-over-year growth of 20 to 30 percent… why will this explosion in money supply not eventually prove inflationary?

The Great Wealth Machine

US household net worth (assets – liabilities) dropped a staggering 6.5 trillion dollars in the first quarter of 2020. Well, maybe it is not so staggering, as it was all regained in the second quarter, plus a bit more. The gains were a product of higher stock prices, bond prices, and housing prices. Could there be anything more?

Even recently, news stories warn of dangerous levels of household debt, near 16 trillion dollars. Most likely at the micro level this is a concern. Too much debt is held by low-income households, carrying too many student loans, auto loans, and credit card bills. And the wealth is certainly not equally shared. But on an asset base of 135 trillion dollars, only 16 trillion dollars of debt... really?

US household net worth… 119 trillion dollars



Population Bust

In a recent episode of "guess the future", the Congressional Budget Office cut its already low estimate of long-term growth for the US economy. Whereas Americans are accustomed to growth rates in the two-to-three percent range, the estimate for the next 30 years is a paltry 1.6 percent per annum. If it comes to pass, this will be the lowest growth rate, even for a decade, since the 1930s depression era. And while coronavirus plays only a small role in any three-decade prognostication, the revised number is still down a substantial quarter percentage point from the forecast of a year ago.

All natural skepticism aside, the numbers probably make sense. US economic growth has been in a downward trend for decades, working from a larger base with a slower-growing population. And population growth is a key component in this calculation. In fact, population is one of only two major considerations. As the accepted theory goes, an economy can only grow as a product of two factors -- working-age population growth, and productivity advances.

As our population gain from birth rates has slowed, so too has our growth through immigration. This creates a working-age population below what we would have expected, and these changes carry out into the projections for decades to come.

That leaves productivity enhancement as the sole means of accelerating growth. While this number is impossible to predict, we can guess it will not be enough to carry the entire load. Improved tax and regulatory policy would no doubt help -- businesses respond to investment incentives -- but it is more likely that future administrations will be working against this goal. Raising taxes while imposing stringent government oversight just seems the default case these days, the last four years being a welcome exception. Just do not expect it to help.

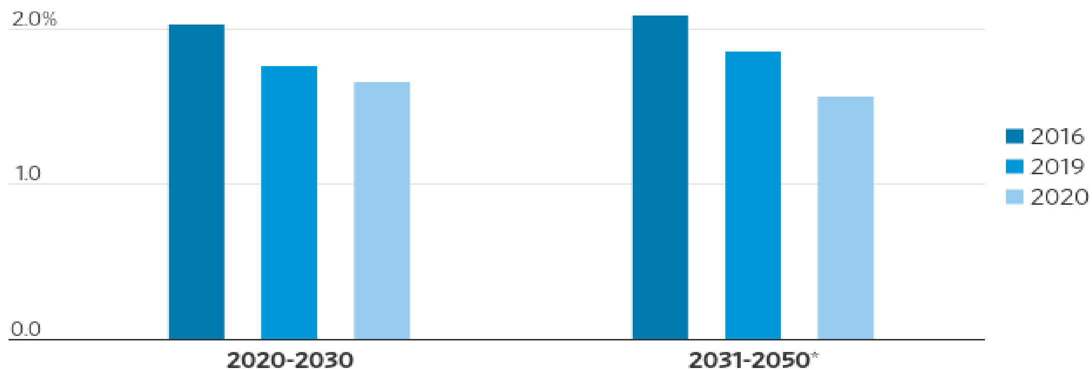


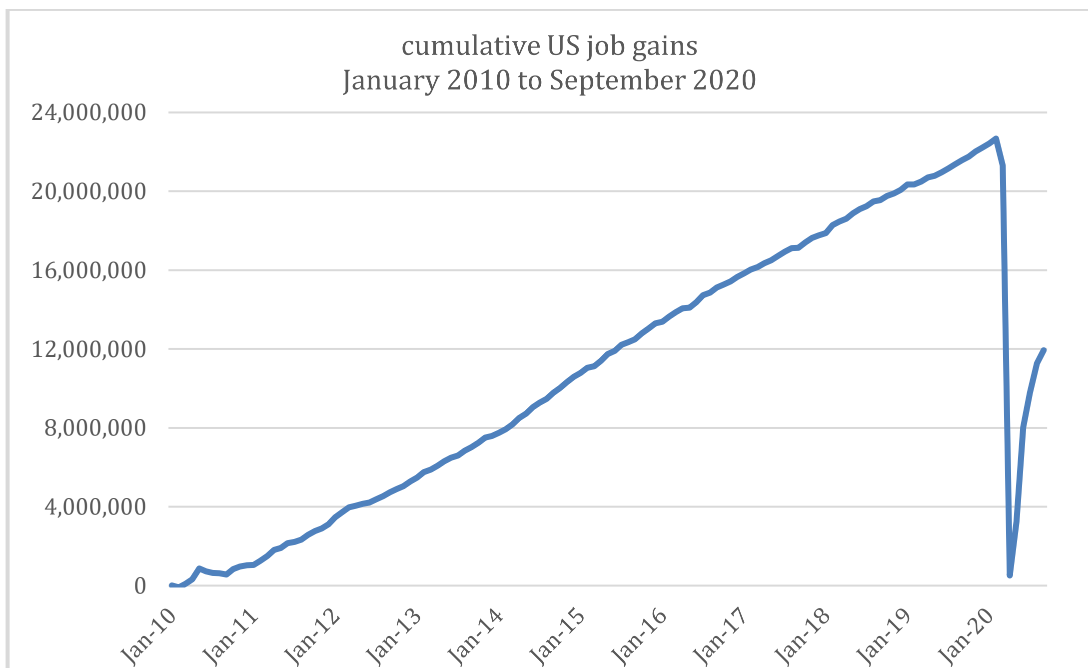
Image source: The Wall Street Journal

The Long Road Ahead

According to economists at the Federal Reserve Bank of Atlanta:

"Data from the Survey of Business Uncertainty (SBU) suggest that the road forward is going to be a tough slog. Businesses hold tepid expectations for year-ahead employment and sales growth.

Expectations are, in fact, so tepid that, based on the latest average projection, it will take firms more than four-and-a-half years to recover their pre-Covid employment levels and about three-and-a-half years to recover their lost sales revenue. In short, the coronavirus pandemic has knocked the economy off its previous robust path and firms don't see us returning to that path anytime in the foreseeable future."



California Feeling The Heat

The wildfires of California are a tragedy of nature and of human suffering. And just as hotter temperatures are no doubt a contributing factor, California is adding to its own misery through misguided government policy.

We will leave the debate over poor forest management and careless power line maintenance to others. The added misery is that California, what should be the richest and most blessed place on earth, cannot even supply its citizens with dependable, low-cost electricity service.

This recent note from Bloomberg:

"This month is the first time California has resorted to intentional outages since the 2001 energy crisis to protect the system from being overwhelmed by demand. Part of the problem is California's rapid shift away from natural gas. About 9 gigawatts of gas generation, enough to power 6.8 million homes, have been retired over the past five years as the state turns increasingly to renewables. That leaves fewer options when the sun sets and solar production wanes.

Electric prices in the western U.S. soared to record highs as California consumers experienced more rolling outages after the state grid operator ordered utilities to cut power to reduce strain on the system during a record-breaking heat wave."

In its zeal to promote green energy, California has begun abandoning what used to be considered "clean energy" -- nuclear and natural gas-fired power plants. The replacement is a mix of unreliable solar and wind power, supplemented through purchases of electricity from neighboring states. It all sounds eco-friendly and offers a glimpse into the more ambitious "Green New Deal".

The obvious problem, among several, is that when the sun sets or the breeze subsides, no electricity is generated by solar or wind plants. A second issue is that when temperatures run hot in California, they tend to run hot in Arizona and Nevada as well. This means California is exposed not just to the heat, but to the free market for scarce electricity from those nearby states. The choice is to either pay up or shut down the power supply.

Two decades ago, California faced a similar problem, along with some energy market manipulation, and it cost Governor Gray Davis his job. Apparently, the state did not learn from history, and is intent on repeating it.

Tidbits...

First in, first out… China is first major economy to resume growth after virus-induced recession, sees second quarter advance of 3.2 percent while western economies contract for one more quarter.

US airlines initiate job cuts in the tens of thousands in response to pandemic woes.
Major US airlines drop change fees as travel demand remains depressed.

OPEC + revises output agreement, expects oil demand to partially recover in late-2020 and 2021.
BP projects global oil demand has peaked, will never return to pre-covid levels.
Amidst oil slump, Exxon Mobil is removed from Dow Jones Industrial Average after 92 years.

30-year mortgage rates dip below three percent, record low.

European Union reaches fiscal stimulus agreement with promise of greater economic integration among member states.

US Senate, House of Representatives still unable to reach agreement on additional stimulus.
With Congress at impasse, White House issues executive orders for ongoing economic stimulus/ support measures.

Federal Reserve extends various market-supporting lending programs through year end.
European Central Bank considers cutting rates further below zero, sees economy below pre-covid levels until end of 2022.

US restaurant closures expected to reach 100,000 in wake of pandemic, twice normal level.
Regal Cinemas closes all movie theater locations indefinitely.

More retail bankruptcies:
Lord & Taylor, nation's oldest department store
Tailored Brands, owner of Men's Wearhouse, Jos A. Bank Clothiers
Stein Mart
Shopping mall owner CBL & Associates expected to file bankruptcy this month

California legislature proposes wealth tax, collected even after citizens leave the state.
California aims to ban sales of new gasoline-powered cars by year 2035.

In a recent survey, 84 percent of corporate finance chiefs say equity prices are over-valued, only 43 percent expect better economic conditions in a year.

Apartment vacancies in New York City reach record highs, triple year-ago levels.

Issuance of high yield bonds reaches annual record, 330 billion dollars, in only nine months.

Source:
Bloomberg
FRBAtlanta.org
The Wall Street Journal