NEW PROVIDENCE

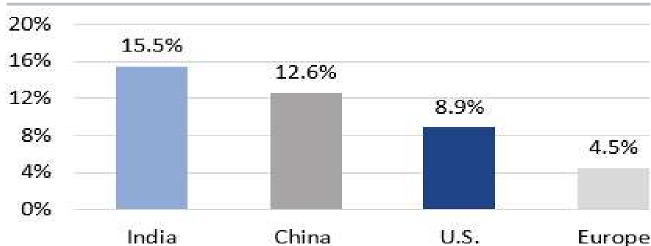
Investment Outlook Series
October 2020

Our View

Preface

The global equity markets continued to generate strong returns in the third quarter, especially in Asian markets such as India and China (Chart 1). The continued strength has seemed counter intuitive to some investors who have strictly focused on current valuations or negative pandemic and economic news. After two very strong quarters it is also normal for investors to think about taking some profits. Certainly, there is a list of common concerns including: economic growth prospects, central bank policy, and valuations. Added to that is U.S. election uncertainty, and the implications for taxes, regulation, and numerous policy implications. As a result, market volatility is likely, but for long-term investors equities provide better returns than traditional fixed income or cash, and in our view, equities should continue to represent a meaningful allocation in client portfolios.

Chart 1: Q3 2020



Source: Bloomberg. Total returns include dividends. Indices are S&P 500 (U.S.), MSCI India, MSCI China, and MSCI Europe.

The Rationale for Equities

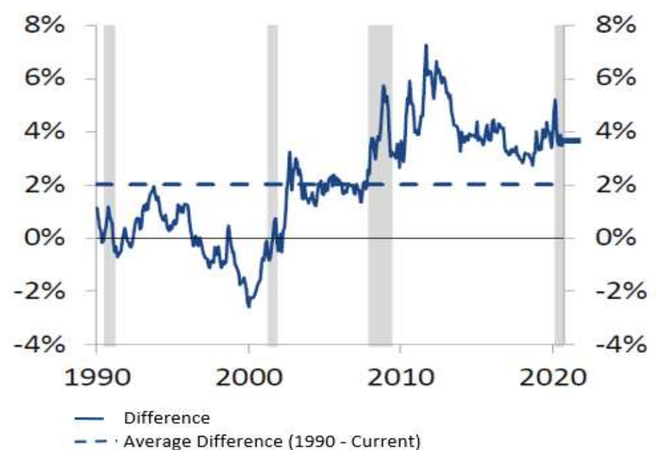
Global economic growth troughed in the second quarter of the year and is beginning to improve as countries around the world begin to lessen or remove some of their harshest local lockdown restrictions. It will take several years for a full economic recovery but that provides a positive backdrop for equities which will benefit from improving earnings as growth recovers. Also, the pandemic means that benign inflation will likely persist for the foreseeable future, allowing central bank monetary policy to remain extremely accommodative. Low interest rates are supportive of higher equity valuations and equity risk taking.

A significant wildcard for the pace and timing of the recovery is the approval and mass distribution of vaccines that will be widely utilized. One should remain optimistic about the global scientific community's massive effort to resolve the health crisis in an unprecedented time frame with the first publicly available vaccines available as early as next year. In the event there are delays it seems probable that additional fiscal stimulus will be made available both in the U.S. and in many economies around the world to help manage through the economic effects of the continuing pandemic.

Valuations

Critics of the market rally often point to high equity valuations. However, one must look at the appropriate discount rate to apply, and over the last 30 years the U.S. 10-year Treasury bond yield has averaged 4.4%; today that yield is less than 0.7%. In that context, current valuations should be meaningfully higher than the average S&P 500 P/E multiple of 15.5x forward earnings. More specifically, the spread between the U.S. equity earnings yield and Treasury yield today is in the top quartile of attractiveness (Chart 2). We are not arguing equities are statistically cheap relative to historical averages, our observation is that equities are attractive for investors with a long-term timeframe when compared to cash or traditional fixed income.

Chart 2: S&P Earnings Yield Less Treasury Yield



	Current	Average
S&P 12M Forward Earnings Yield	4.36%	6.43%
10-Year Treasury Yield	0.69%	4.39%
Difference	3.67%	2.05%

Source: S&P, Bloomberg.
Treasury data as of 10/1/20.
S&P earnings data (released monthly) as of 9/30/2020.

If earnings growth for U.S. companies is roughly a combination of inflation plus real GDP growth it equates that long-term

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U.S. corporate earnings per share growth could be around 4-5%. What valuation multiple does one then apply to high quality companies that have sustainable earnings growth rates of 10% to 15%, or higher? While it depends on how "sustainable" the earnings growth rate is, one must conclude that the valuation multiple for sustainable growth companies should be materially higher than the broad market averages. Today the 2021 P/E multiple of the S&P 500 is 21.8x, elevated in part by some of the largest and fastest growing companies (FAANGM) which comprise roughly 25% of the index.[1] Apple, Facebook, Google and Microsoft trade at 26x to 32x expected 2021 earnings. The other two, Netflix and Amazon, are more expensive at 58x and 71x respectively, and have very high expected earnings growth rates of 30% to 40% for the next several years.

The challenge for active managers today is what premium should the equity market garner due to lower interest rates for the foreseeable future; and then, how sustainable are the growth rates of the fastest growing companies, and what premium to the broad market valuation should they receive? Our view is that the market may not be as irrational as it appears to some investors based on valuations for the high quality, durable, and rapidly growing businesses.

In Search of Investment Alternatives, in a world of TINA:

The acronym TINA (there is no alternative), was coined for equities relative attractiveness versus cash and fixed income. Cash yields a meager 0.1%, so its true value is the optionality one has to invest in higher returning assets when it is timely to do so. Treasury bonds, as we have stated, have yields only modestly higher than cash, and higher duration bonds run the risk of principal loss if, or when, interest rates increase. Investment grade corporate bonds are in the lowest decile of historic yield, and the same is true for U.S. high yield bonds.

This leaves investors with the question, where else can one invest? In equities we think **Asia** is very attractive. A combination of better growth prospects, lower valuations, and less efficient markets, which offer active investors opportunities to outperform broad indices. We have also been researching and investing in **diversifying alternatives** that are uncorrelated to equity and fixed income markets – life settlements, reinsurance, music royalties and litigation finance, to name a few. For the investor who is willing to invest with a longer time horizon, select opportunities within these niche areas of investment can provide a complementary addition to portfolios, via a combination of a higher yield, capital appreciation, diversification, and low correlation. These characteristics should be attractive to investors as they review classic portfolio construction and realize that the traditional 60/40 or 70/30 portfolio construct leads to a significant allocation to investments producing negative real yields.

[1]Source: Yardeni Research. FAANGM is Facebook, Apple, Amazon, Netflix, Google and Microsoft.