Our View

January 2020

Preface

We have now started the third decade of the 21st century. This gives us the opportunity to examine, decade by decade, performance of investment markets, in an attempt to determine whether there are patterns in the past that might give us some insight into the future. The primary conclusion that we reach is that what worked in one decade is unlikely to work as well in the next one, and conversely, what didn't work in one decade is quite likely to work well going forward. Ten-year slices of performance data may seem arbitrary and calendar specific, but they are long enough to eliminate short-term trading patterns.

Geography

In the decade of the 1990s, driven by speculative over-enthusiasm for anything related to technology, U.S. markets significantly outperformed Asian and EAFE markets (see Chart 1); the difference was measured in multiples. However, in the first decade of the 21st century, markets in all geographies underperformed, reflecting both a collapse in enthusiasm for technology stocks and the cataclysmic effect of the 2008 financial crisis triggered by the Lehman Brothers bankruptcy. However, Asia's performance was acceptable, while the U.S. had a net decline over the decade, which was most unusual.

Chart 1: Geographic Total Returns[1]

1980s	1990s	2000s	2010s
Japan 949%	U.S. 431%	Asia 92%	U.S. 256%
EAFE 496%	Asia 131%	EAFE 18%	Japan 100%
U.S. 404%	EAFE 85%	U.S. -9%	Asia 84%
	Japan -12%	Japan -34%	EAFE 81%

In the second decade of the century, the U.S. outperformed substantially, rebounding from its significant underperformance in the previous decade. Asia's performance from decade to decade was remarkably consistent, while EAFE markets recovered, but certainly didn't boom.

A statistical analysis would lead to the conclusion that significant out-performance or under-performance, usually for a decade, often produces a contrary result for the following decade. An interesting example is the Japanese market, which appreciated by an astonishing 949% in the 1980s, but then suffered twenty years of losses.

Table 1: U.S. Sector Returns[2]

	2000s	2010s
Energy	147%	38%
Basic Materials	58%	132%
Utilities	57%	200%
Consumer Staples	39%	212%
Health Care	13%	291%
Industrials	11%	259%
Consumer Discretionary	6%	387%
Financials	-24%	213%
Technology	-54%	371%

Sectors

Similar patterns are observable by examining market sectors. Table 1 sets this out clearly. Again, one sees that the over- or under-performance for a decade usually results in the opposite for the following decade. Standard and Poor's implemented U.S. sector indices in 1998, but market historians will recall that there was substantial outperformance by technology companies in the second half of the 1990s which ultimately led to a major decline in the 2000s and then a huge recovery in the 2010s. Also worth noting is the strong performance of energy in the 2000s and its relative weakness in the 2010s, as well as the under-performance of consumer discretionary in the 2000s and its significant out-performance in the 2010s. The rotation of performance is not a rule, and markets

[1] Source: Bloomberg. Total cumulative return is price appreciation plus dividends. Returns are in US$. US = S&P 500, EAFE = MSCI EAFE, Asia = MSCI Asia ex-Japan, Japan = Topix. EAFE is Europe, Australasia, Israel and the Far East. The Asia Index was incepted in 1988, precluding a full decade of data.

[2] Source Bloomberg. Standard and Poor's added the Real Estate sector in 2015 and the Communications sector in 2018, they are excluded from this analysis due to an incomplete decade.

may become more efficient over time, but behavioral tendencies for exuberance and excess fear remain a factor in market returns.

Style Factors

Russell invented its growth and value style factors in the mid-1990s but based on the last five years of the 1990s which coincided with a "technology bubble," we know that growth stocks significantly outperformed. It is not surprising that value stocks thus led in the 2000s, and growth stocks outperformed in the 2010s (see Table 2).

Table 2: Growth vs Value[3]

	2000s	2010s
Growth	-32%	306%
Value	33%	203%

What do we learn from all of this? First, the substantial outperformance of the U.S. market we have seen in the past decade is unlikely to continue for the next decade. To argue that "this time is different" would be easier if the U.S. wasn't already experiencing advantageous conditions, some of which are unlikely to get better, and all of which have helped support the strong returns of the last decade:

- **Misery Index:** This index is a combination of U.S. inflation and unemployment; it now stands at the lowest level since 1956. Importantly, both components of the index are at very low levels, making further improvement a significant challenge. It is also noteworthy that the S&P 500 has performed well when the Misery Index is declining (e.g. 1980s, 1990s, and 2010s) and does less well when it is rising (e.g. 1970s and 2000s).

- **Interest Rates:** Inflation is low and stable, as a result U.S. interest rates are low. Admittedly, rates can go lower (e.g. Japan, Germany, Switzerland), but there is a growing concern that very low and/or negative interest rates, for an extended period, is not healthy for economic growth.

- **Corporate Tax Rate:** The U.S. corporate tax rate (21%) is now at its lowest level since 1940 (just prior to an increase due to World War II) and has been on the decline since 1968 when it peaked at 52.8% due to the Vietnam War and spending for the Great Society. With the annual U.S. federal deficit at record levels post the 2018 corporate tax cut it seems unlikely tax rates will be cut further. In addition, depending on election outcomes in 2020, 2024 and 2028, it is possible that taxes could increase in the next decade.

- **Valuations, Margins, and Stock Buybacks:** The S&P 500 has appreciated more in the last decade than its underlying earnings growth. This has led to the expansion of the equity market's valuation multiple, currently in the 9th decile toward expensive.[4] In addition, operating and profit margins are at, or near, peak levels, suggesting that much of the benefit of lower taxes, low inflation, and low interest rates has been well utilized by corporate management. Significant stock buyback programs have further accelerated U.S. equity returns, much of which has been funded by additional corporate debt.

- **U.S. Dollar:** The U.S. dollar has been strong over the last decade, appreciating 22% versus a basket of major currencies.[5] This could persist, but the current administration has been on record that the strong dollar is hurting U.S. corporate competitiveness, and the Federal Reserve has recently begun to expand its balance sheet, much like QE, although they are not calling it that. If, or when, the U.S. dollar weakens it is likely that foreign investors will sell some of their U.S. based investments.

All of this reminds us of a dialogue between two investors. The first investor says, "Have you seen the data? I don't think it can get any better than this!" The second investor replies, "That is exactly what I am worried about!" Our conclusion is that investors should be balanced in their asset allocation -- across geographies, asset classes, and style factors. Specifically, this means owning international investments, energy investments, and other investments/strategies that have been out of favor for an extended period. A final takeaway from this analysis is that the prudent investor should have a long timeframe when reviewing investments. Stay patient, investing works over the long-term when one stays true to a thoughtful investment strategy.

[3] Source: Bloomberg. Data is of the Russell 3000 Growth and Russell 3000 Value Indices.

[4] Source: Bloomberg. Forward 12-month P/E, since 1975.

[5] Source: Bloomberg.