VIEWPOINT

Unknown pleasures: a new era for equity investors

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- For 20 years from the mid-1980s we saw strong growth, falling interest rates and value dominating in stock markets. But problems that emerged in property markets swiftly turned into a global financial crisis (GFC)
- From the GFC to the pandemic, low/zero interest rates meant that, despite no earnings growth, stock markets recovered as growth companies erased all the gains value had made over the previous decades
- Now, with the biggest tightening in monetary policy since the 1980s, it's all change again and we believe equity investors with diverse portfolios can prosper

I entered the financial industry in the autumn of 1986, by which point the tight money regime of Paul Volker at the US Federal Reserve had set the tone for the first 22 years of my career[1]. Obviously, there was volatility, but the secular trends in inflation, interest rates and bond yields were all down (Figure 1). The cost of capital fell continuously with a few exceptions and the 1987 crash at the end of my first year in the business still sticks in the memory.

Figure 1: US 10-year Treasury yield

Source: Bloomberg, as at November 2023

So, what did declining interest rates mean for these 22 years?

Click below to learn more

The great deflation	The global financial crisis	Post-pandemic	The next decade
1986-2008	2008-2020	2020-2023	2024 onwards

The great deflation

Economically, it was a period of strong GDP (gross domestic product) growth. Forgive the schoolboy economics, but an interest rate is a price of something, and if the price goes down rational consumers desire more. So it was that debt in the world rose inexorably. This borrowing from the future funded stronger economic growth and longer economic cycles, and instead of trend GDP, trend GDP-plus emerged.

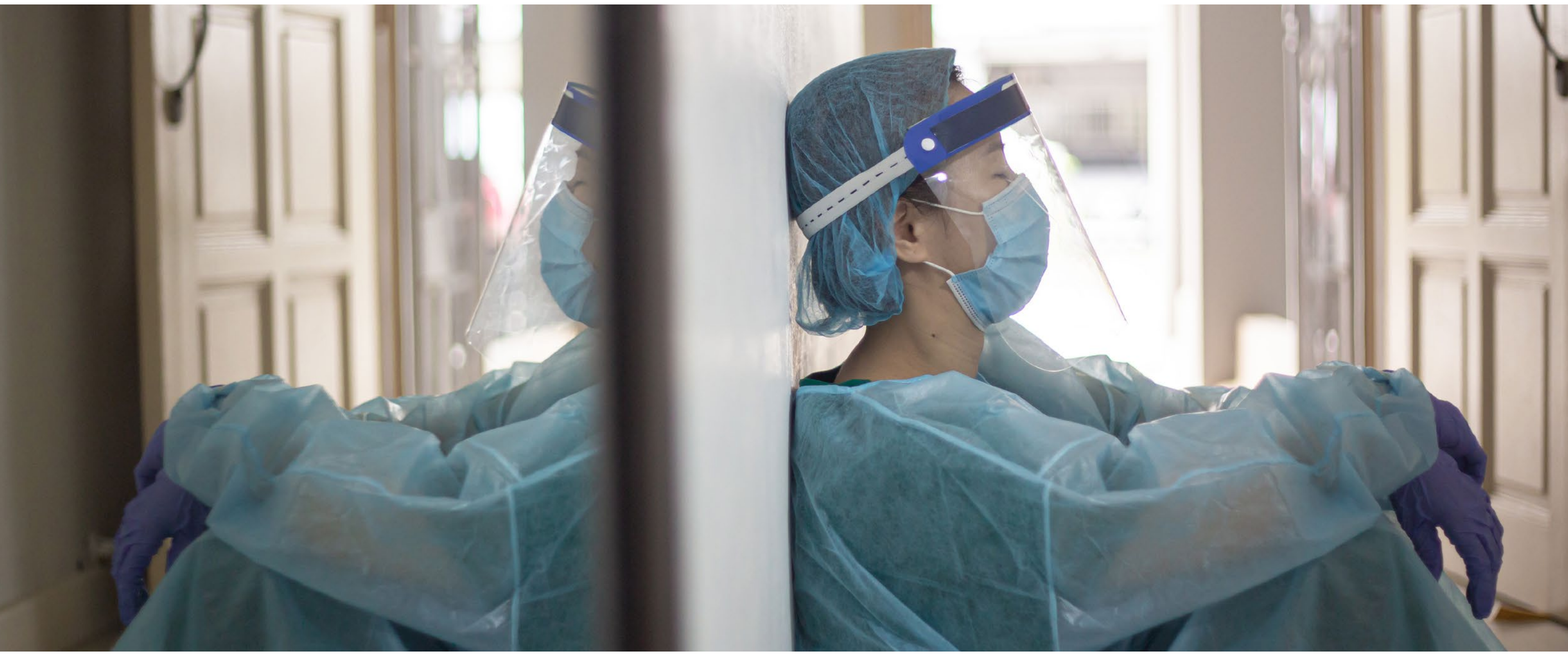
For equity investors this meant a far superior growth inflation trade-off, which helped drive valuations higher as the cost of capital fell. Greater leverage in companies without the penalty of higher interest costs helped drive above-average profits growth. This trend was reinforced as governments cut corporate taxes. All companies benefitted from earnings growth and so why not just buy the cheapest valuations?

Surprisingly in a period of falling interest rates, value comfortably beat growth in terms of equity style. This was supported by the prevailing business model of the time, which was restructuring. Businesses adopted Stern Stewart's economic value added (EVA) model[2], which was published in 1982. Coca Cola was the first major client to implement it, in 1988, closing down high-cost western manufacturing sites and replacing them with low-cost emerging market-based factories. As supply chains became more sophisticated, it obviated the need for capital expenditures. Suppliers would build factories and with the reduced capex burden could generate free cash flow and buy back some stock. This arbitrage of international wage rates was enabled by the increased use of technology to manage lengthening supply chains, which in turn further reduced imported inflation.

So for 22 years, there was a combination of stronger growth, falling interest rates and value beating growth in the stock market. The aberration during this time was the tech bubble of 1999/2000 as the market got a sense of what was to come with the internet age. Then, perhaps as this goldilocks period was threatened, the largest labour force in the world entered the global economy – China. The country acceded to the World Trade Organisation (WTO) in December 2001[3], which added a huge new consumer market for companies to enjoy, resulting in more growth and a source of low inflation for the world.

However, after 22 years of debt accumulation with declining interest bills, it all became unsustainable. What started as a problem in the housing market quickly became a banking crisis and the sector at the heart of the buy-now-pay-later economy was fatally wounded.

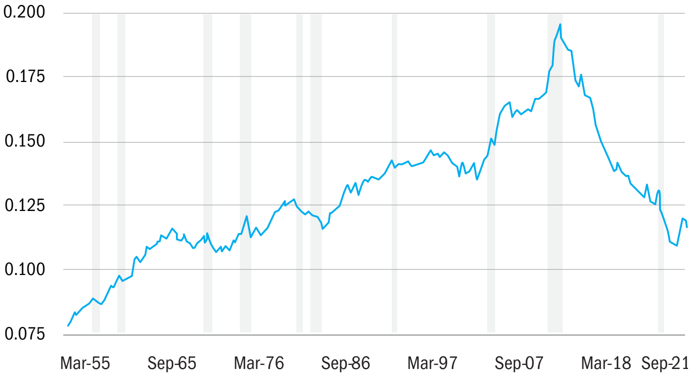
[1] Vox, How the Fed ended the last great American inflation – and how much it hurt, 13 July 2022
[2] https://sternvaluemanagement.com/economic-value-added-eva
[3] https://www.wto.org/english/thewto_e/acc_e/a1_chine_e.htm



The global financial crisis and its aftermath: debt deleveraging

The Reinhart and Rogoff paper "Growth in a Time of Debt" became the roadmap for the post-global financial crisis (GFC) world[4]. The global economy had to go through a protracted period of debt deleveraging. Debt paydown necessarily reduced economic growth, and instead of the trend GDP-plus of the great disinflation era, trend GDP-minus occurred. Low growth and continued low inflation became the order of the day for the next 13 years. Events such as the euro crisis – centred on Greece, Italy and other peripheral European nations – cemented the low growth environment.

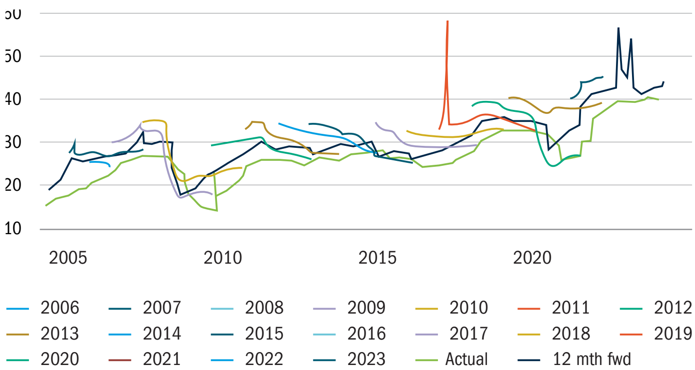
Figure 2: household liabilities to assets (debt/asset ratio of the US household sector)



Source: Haver, FRB, Apollo Chief Economist, as at May 2023

Between 2012, after the initial rebound from the GFC, and 2021, there was essentially zero growth in earnings within the MSCI All Country World Index (ACWI). That's right, zero – for 13 years point to point. Indeed, from 2007 until the recovery from the Covid-19 pandemic, there was no earnings per share (EPS) growth in the world (Figure 3, focus on the dark line), despite huge contributions from the tech sector.

Figure 3: MSCI ACWI earnings per share expectations



Source: MSCI, as at October 2023

Nonetheless, the stock market recovered from its 666 S&P intraday low on 6 March 2009 to a level of 4796 at the end of 2021 in the midst of the pandemic. Why? Because interest rates didn't just stay low post-GFC, they went to zero, and although they were starting to move away from zero from 2016 onwards, in 2020 the pandemic struck and back to zero they went. In the 13 years post-GFC the US Fed Funds interest rate was at zero almost 70% of the time[5].

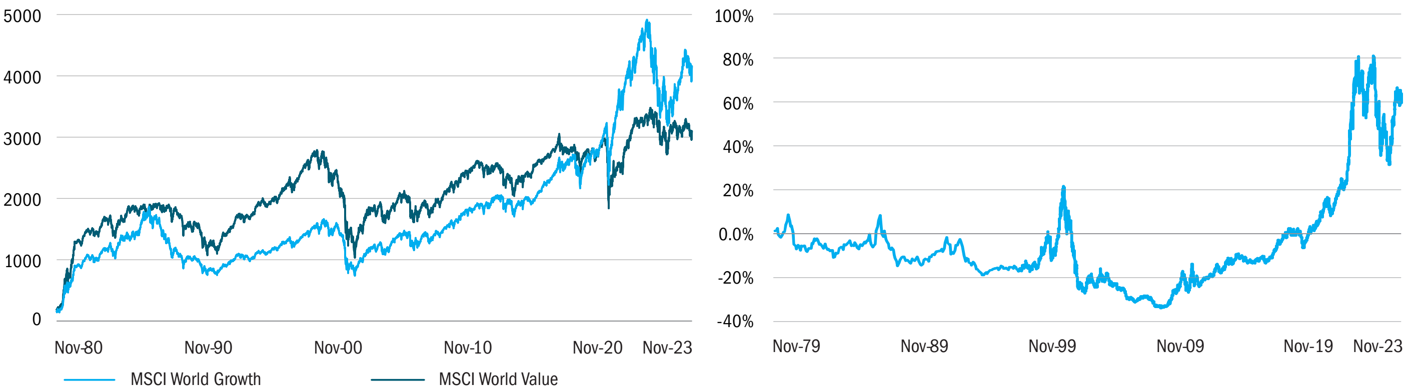
[4] Harvard University, American Economic Review: Growth in a Time of Debt, Papers & Proceedings 100, 573–578, May 2010
[5] Bloomberg, as at November 2023

How do you beat a market where there is no earnings growth and interest rates are locked at zero? You find something that grows (Figure 4). This coincided with the big S curve of adoption of the tech trends that the market had sensed in 1999/2000 – the internet, social media, online advertising, e-commerce and smartphones. All these trends generated huge growth over the period. But it wasn't just tech, though at times it seemed like it. Areas such as medical tech, communications, payments, exchanges and certain consumer goods (mainly luxury) all felt the benefit. Conversely, areas like energy (oversupplied relative to weak demand) and life insurance (where declining bond yields stymied earnings growth) could be safely ignored in portfolios while adding little risk.

This period was defined by growth beating value, with growth erasing all of value's gains over the previous 22 years. At the same time, buy-and-hold was the best strategy; nothing else was growing earnings (the denominator posed little risk) and interest rates kept dropping, supporting ever higher valuations. On the Global Equities team, some of the worst mistakes made during those years were selling out of names because they were just too expensive only to watch the stock double again. Fortunately, the team held on to the important ones – the ones that defined the era.

As with China in the early 2000s, just when we thought that the growth beating value trend was ending, the pandemic struck. The physical world was closed, the online world was the only thing open and e-commerce as a percentage of US retail sales went from 11% to closer to 16%. Tech earnings surged as real-world earnings collapsed, and rates went back to zero.

Figure 4: LHS: MSCI World Growth and MSCI World Value total return ($). RHS: Ratio between MSCI World Growth and MSCI World Value



Source: Bloomberg, as at November 2023

Post-pandemic – all change

It turns out that after you switch off the world economy it is difficult to turn it back on again. Restocking the shelves takes time and bottlenecks occur. Covid spacing rules see factories operating at reduced capacity. Everything is in the wrong place and there are not enough ships in the world to move it.

Consumers' bank accounts are also full of pandemic savings and they are eager to get out there and spend on goods and services. When robust demand meets inadequate supply only one thing can happen: prices rise. For the first time in years companies found it was acceptable to raise prices and recoup cost pressures. As real incomes were squeezed, employees in a tight labour market demanded wage rises and so the wage price spiral started.

Central banks eventually responded with the biggest tightening in monetary policy since Volker in the early 1980s. As things stand today, inflation has been falling and the economy has resisted recession – so far.

The next decade

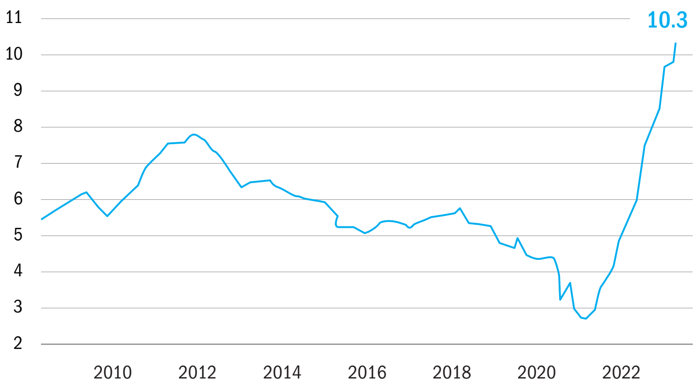
So, what can we say about the shape of the economy in the next decade, in the new era?

Inflation
While the 10% inflation of the post-pandemic world was likely transitory, there are reasons to think inflation will be higher going forward than it was in the 13 years after the GFC. China has run out of workers, and geopolitical tensions coupled with the pandemic experience of long supply chains make labour arbitrage less appealing. Onshoring or nearshoring is the new path and despite all efforts to automate, labour costs will be higher. The process of replacing our energy sources with low carbon versions has begun. While many of these sources have near zero marginal cost, the upfront capital cost is large and potentially inflationary. Technology and the promise of artificial intelligence will drive productivity, but will that be enough to offset the falling number of workers around the world?

Economic Growth
GDP=C+I+G+(X-M) is a formula representing aggregate demand. Ignore X-M (net exports); as for the world, it must sum to zero, though it is likely that trade will not outpace the world economy as it did up to the GFC. As mentioned before, the consumer balance sheet is healthy and while higher interest rates will trouble consumers, the cost of servicing debt is at manageable levels. With shortages of workers wage growth should remain healthy, and consumption should develop at least in line with wages, possibly a bit better. Investment prospects for the coming decade appear strong. When thinking about global problems, the solution seems to be capital expenditure: geopolitics/nearshoring – capex; decarbonising the world – capex; worker shortages – capex; crumbling infrastructure – capex; shortage of housing – capex; war – capex (sadly). Investment should be a significant contributor to GDP growth, though who pays for all this capex may be an issue.

Government
The G in the above equation deserves special consideration. If there is an imbalance anywhere in the system it is here. The GFC followed by the pandemic has seen a massive jump in government debt, while the private sector/households have delevered massively. From 2008 to now the US has gone from 45% to 110% debt/GDP, the UK is not far behind, and Italian debt is now 140% of GDP[6]. Japan at 224% is another level entirely and servicing that debt burden even at ultra-low interest rates is already the number one element of government expenditure. The UK spends more on interest costs than it does on education, and as debt matures and is replaced with higher cost debt the bill is only going one way (Figure 5).

Figure 5: what percentage of revenue does the UK spend on debt interest payments?



Source: PNS and LGB, as at 12 June 2023

As such, rising interest rates are likely to lead to a crisis in government bonds as the path is deemed unsustainable by markets. There was austerity post-GFC, and judging from all the problems in health, education, social care etc the solution this time around is unlikely to be massive spending cuts. The answer must be increased taxation – but politicians need to face a crisis to change direction and do unpalatable things. Maybe Liz Truss's 50 days in office are a precursor the world should worry about. Against that backdrop equities look pretty good!

Rising interest rates are likely to lead to a crisis in government bonds

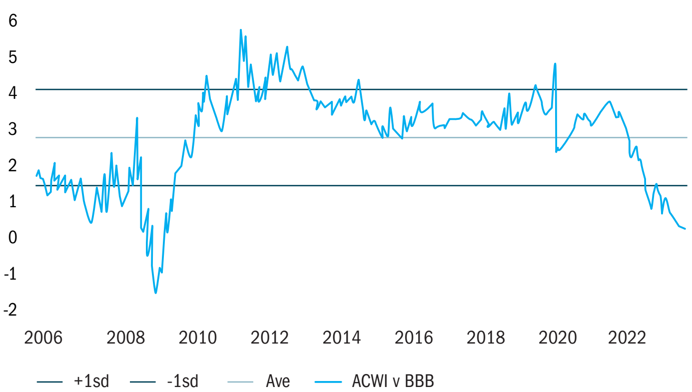
[6] Bloomberg, as at November 2023

Despite the fear of recession in the next year, the economic outlook for the next decade should be better than the past 13 years – possibly in real terms, definitely in nominal terms as inflation will be higher. For equity investors that is an important change.

Equities versus bonds

Equities should trade richer to bonds than they have in the post-GFC period. Higher nominal GDP growth implies higher sales growth for companies – and hopefully cash flows and profitability. After 13 years of no profit growth, the coming decade offers better prospects. The average company will grow earnings, though there will be headwinds from the cost side – labour may claim a bigger piece of the pie in the form of wage growth, interest costs will rise, and governments may come calling for more taxes. Combine this with crisis risks in government bonds and equities appear ever more appealing – although as equity investors we are biased!

Figure 6: ACWI versus Global BBB yield-to-worst



Source: Bloomberg, as at November 2023

Much of the shift in equity valuation relative to bonds has already occurred – look at the equity risk premium chart (Figure 6). Yes, equities look expensive relative to the post-GFC experience, but they are appropriately valued given the higher nominal GDP growth prospects.

Diversification

If the post-GFC environment was all about concentration, the coming decade is likely to value more diversification. In the 13 years following the GFC there was no earnings growth in aggregate, so portfolios were concentrated where growth could be found. Global equity portfolios with 20 stocks were feted. Going forward, earnings growth for the market will be higher (zero is not a high bar) and will be more evenly distributed. For life insurance companies the yield on their portfolios is going to be rising each year, but could their earnings growth now be competitive? Is it safe to ignore the sector completely? Oil companies have changed, they have been underinvesting for an extended period of time raising the prospects of a tight oil market. It will still be a cyclical sector, but managements' focus is free cash flow and cash returns to shareholders. Is it safe to ignore the sector completely? Are there other long-forgotten corners of the market that deserve a rethink? I doubt a 20-stock global portfolio is a sensible idea in the new era.

Quality

Columbia Threadneedle's philosophy is quality growth. A quality business has competitive advantages which translate into high profit margins, strong cash flows and predictability. Significant loss is very hard to recover from in a portfolio and sticking to quality reduces that risk – it also helps protect against sleepless nights, premature greying/baldness, high blood pressure or any of the other afflictions of the non-quality value manager. One aspect that will be critical in the coming decade is balance sheet quality. Low interest rates made it attractive for some low growth/ROIC (return on invested capital) stocks and sectors to employ leverage to be competitive in the stock market. These companies face year-by-year rises in their interest costs as their bonds mature. Unless they have the free cash flow to pay down that debt, they will face a troubled future.

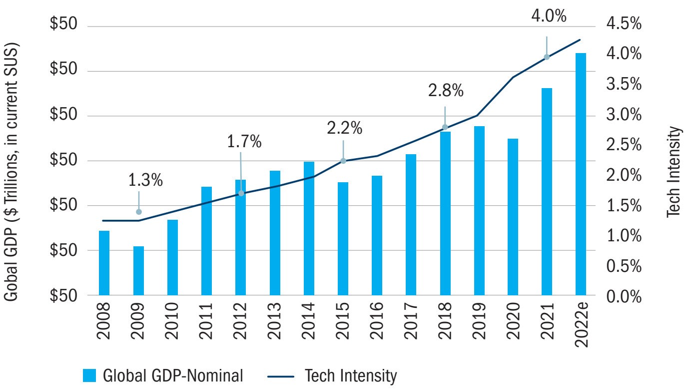
Growth versus value

Before the GFC this wasn't really a debate. While there were differences, they were not the defining ones of the period. Excluding the tech bubble, the returns of MSCI World Growth and MSCI World Value showed a correlation of 0.88. In the post-GFC period that correlation fell to 0.72 – now you can start to make a career out of that difference, if you can predict it. The correlation could be meaningfully higher in the coming decade. As the maturity of the S curve of adoption slows, the growth of certain mega cap tech names will slow, just as the denominator of the average company improves – as such the gap in earnings growth will be materially lower going forward. That said, quality businesses that can compound are very tough to beat over time. Investors just need to be conscious of not paying too big a premium for these businesses because valuation uplift will no longer bail you out.

Technology

The sector has been at the heart of our global equity portfolios for a very long time. The rising tech intensity of GDP is a secular trend and one we believe could continue, perhaps even accelerating over the next decade (Figure 7).

Figure 7: tech intensity of GDP



Source: Columbia Threadneedle, as at December 2022

On top of that, competitive advantage in tech can be so compelling, leading to the emergence of oligopoly or even quasi-monopoly situations. The durability of these competitive advantages is more debatable – they are not Coca Cola and run the risk of The New New Thing[7]. However, the amount of value added that they produce during their period of dominance is extreme. The typical software business has gross profit margins of more than 70%, and the incremental cost to serve the next customer is low, which makes these exponential businesses. They don't inhabit the linear world of the industrials and consumer sectors, which is why it is often said that the value add accrues to the software layer in an industry.

Tech is likely to remain at the heart of Columbia Threadneedle Investments' portfolios in the coming decade, though the names will likely change as new product trends emerge to replace the smartphones and online advertising of the past decade.

There are many secular trends, the majority of which don't carry the emotive debate that tech does. Examples include big picture themes like decarbonising the world, but the ones we are attracted to are better defined and where we believe we can find a competitively advantaged company that can profitably exploit that trend:

- more spirits consumption; less beer
- more chips with everything (semiconductors)
- more electrification
- more plastic payments; less cash
- more video games; less TV
- more insurance cover in Asia
- more market share for private banks in India
- more healthcare
- more renting/sharing; less buying
- fewer potholes in our roads
- more social media; less real world (I didn't say they were all good)
- less obesity (I can always dream!)

Conclusion

After Volker's intervention back in 1981, fixed income became an exciting new area, and one with the prospect of capital gains. As we stand today, the prospect of secular capital gains in fixed income is probably not there (again, this is an opinion of a biased equity investor). Now, the hurdle of the interest rates available on cash and the yields on bonds are a challenge to equity markets, but equities have the backing of higher nominal GDP growth going forward (immediate recession prospects aside). As a result, successful equity portfolios are likely to be more diversified than in the post-GFC era, but quality compounders will still form the core of the portfolio. While the growth versus value debate may fade in intensity, with narrowing growth differentials, there will remain a soft spot for tech given their unique characteristics as businesses.

Following the GFC zero interest rate environment, many took on risks and structures in portfolios to preserve returns. Now with "normal" interest rates, are all these alternative assets needed?

Good luck in the new era.

[7] https://www.supersummary.com/the-new-new-thing/summary/

Get to know the author

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Before joining the company, Neil worked as a portfolio manager at companies including Martin Currie, Barings and Citibank. In addition, he was Head of Global Equity at Pioneer Investments from 2003 to 2009. He has an Economics degree from the University of Bristol.

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