



Fourth Quarter 2019 Outlook and Commentary

After setting an all-time high in late July, the S&P 500 Index cooled off a bit and closed the quarter up slightly. Stock markets seem to be in a “trading range” of late. Whenever indexes appear poised to move higher, weaker economic data rekindles worries about a possible recession. As discussed in these pages three months ago, we don’t see a U.S. or global recession on the horizon, but some investor concern lingers.

On-again, off-again recession fears have impacted the bond market more dramatically. Longer term bond yields began a protracted decline last November in anticipation of the end of the Federal Reserve’s interest rate hike cycle. From a bit over 3% a year ago the yield on the benchmark 10-Year U.S. Treasury declined to around 2%, paused for a couple of months, and resumed its decline when the U.S.-China trade war heated up in early August. The yield has yo-yoed within a range of 1.50% to 2.00% over the last six weeks and currently sits in the middle of that range.

Movements in bond yields and interest rates merit close attention. Lower interest rates will, over time, give the economy a boost. Consider mortgages and home purchases. In the fall of 2017 the Fed was steadily hiking interest rates. Mortgage rates began to climb and peaked at 4.94%¹ in mid-November of last year. Housing became less affordable, demand fell, and weaker housing construction was a drag on the U.S. economy. With mortgage rates coming down for most of the last twelve months—now a much more affordable 3.65%—home construction seems to have turned around. Housing starts in August were at a ten-year high. If interest rates remain at or near current levels, homebuilding should give the U.S. economy a lift for the foreseeable future. Over time the two Fed rate cuts (with a third expected in October) will work their way into the economy in other ways as well, as businesses and consumers reap the benefits of cheaper loans of all kinds.

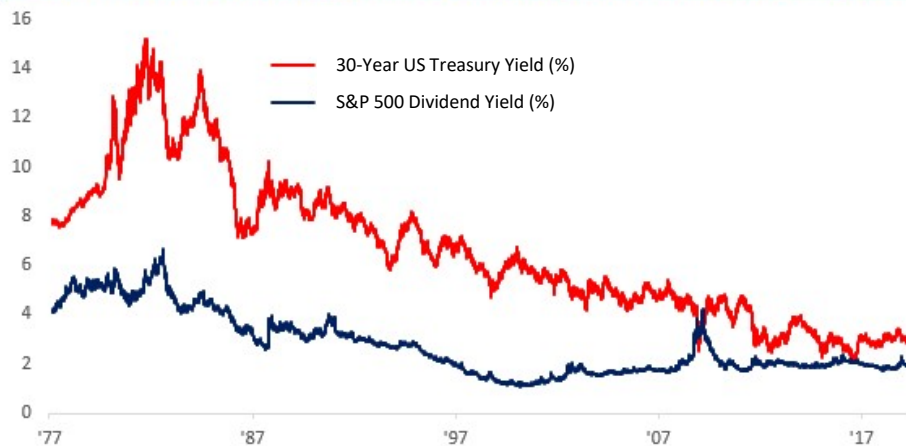
None of this is to say that the U.S. and global economy won’t continue to weaken. Some countries and sectors—Germany and U.S. manufacturing for example—are probably in a mild recession right now. But lower interest rates, triggered in part by concerns over a weakening economy, should provide much of the cure. That’s how economic cycles work.

Lower interest rates could also help push the stock market higher. In late August, the dividend yield on the S&P 500 Index was higher than the 30-year U.S. Treasury yield for the first time in twelve years. As shown in the chart on the next page from CNBC, if you exclude a brief inversion during the depths of the 2008-09 bear market, it was the first time in well over four decades. Restoring the historical relationship would probably require significant stock market gains in order to lower the dividend yield on the S&P 500 Index.

Comparing today’s investment grade corporate bond yields with the dividend yield on blue-chip stocks is also instructive. Investment grade corporate bonds currently yield less than 3.5%. It’s

¹ The weekly average rate on 30-year fixed rate mortgages.

30-Year US Treasury Yield and S&P 500 Dividend Yield: 1977 - 2019



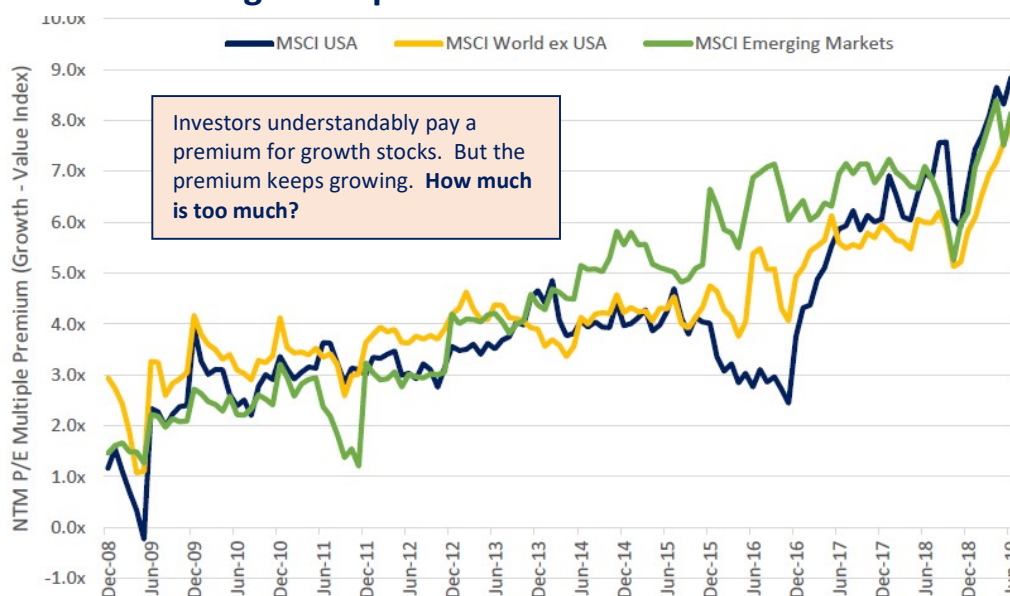
not hard to put together a diverse portfolio of blue-chip stocks with a dividend yield of 3.5%. While dividends are discretionary and subject to being cut, stocks also offer the possibility of share price appreciation. As long as interest rates and bond yields remain near current levels, stocks will look attractive by comparison.

Of course the stock market always has downside risks, and there will be no shortage of scary headlines in the months ahead, whether the subject be Brexit, impeachment, conflict in the Middle East or the 2020 presidential election. Perhaps more relevant to stock markets, the global economy faces a number of long term challenges. The current trade dispute with China may well be the opening phase in a lengthy struggle to establish a new world economic order. Central banks continue to have difficulty in reaching inflation targets. Outside of India and a few other countries, growth in the global labor force will continue to decelerate. And corporate profit margins, near record highs, may revert to historical norms. But these are long term issues that will play out over many years, if not decades. And despite all of these challenges, the long-term profit making capabilities of companies around the world remain intact. After a decade of very strong performance, U.S. stock market returns in the next ten years will likely be lower than historical averages. Even so, they should be considerably higher than bond market returns, which will be weighed down by persistently low interest rates. Investors with a long term time horizon would do well to ignore worrisome headlines and maintain their stock exposure.

Stocks are often divided into two groups, “value stocks” and “growth stocks².” Precise definitions are elusive, but the general idea is that value stocks are selling at a discount to some measure of fair value, while growth stocks are increasing revenues and earnings at a faster clip than the overall market. Over very long periods of time, value stocks have had better returns than growth stocks, but that has not been the case over the last ten years. During that span, investors have been willing to pay an increasingly high premium for stocks with better earnings growth prospects. The graphic on the next page illustrates the increase in the “growth premium” by comparing the price-to-earnings ratio for various growth indexes vs. the comparable value index.

² The concepts of “value” and “growth” actually make a bit more sense as applied to investing styles or strategies. Whether a specific stock is appealing to someone using a value strategy or a growth strategy may change based on specific circumstances. The advantage of dividing the universe of stocks into value stocks and growth stocks is that it allows organizations like MSCI to create indexes and that in turn results in a lot of useful data.

The growth premium looks unsustainable



Note: Chart plots the monthly difference in next twelve months P/E multiple between the MSCI USA Growth Index and the MSCI USA Value Index, the MSCI World ex USA Growth Index and the MSCI World ex USA Value Index, and the MSCI EM Growth Index and MSCI EM Value Index from December 2008 through June 2019. Source: MSCI, FactSet, Causeway Analytics

The chart goes through June 30, but more recent numbers are even more dramatic³: at the end of September the P/E ratio of the MSCI USA Value Index was 17.0 as compared to 27.7 for the growth counterpart. If you divide earnings by price, this turns into an earnings yield of 5.88% (e.g., \$5.88 in earnings on a share price of \$100) for value vs. 3.61% for growth. That's a very large difference which can only be justified by the expectation of dramatically higher earnings growth over a very long period of time.

To see just how much higher earnings growth would have to be, consider a "value stock" with an earnings yield of 5.88% and a "growth stock" with an earnings yield of 3.61%. Investors buying the growth stock accept lower earnings now on the assumption of higher earnings later. But the payoff has to come eventually, right? At some point, cumulative earnings on the growth stock should catch up to cumulative earnings on the value stock. How quickly does that happen? **If the growth stock increases earnings 10% a year vs. 5% a year for the value stock, cumulative earnings won't catch up for 22 years!** Even if you assume an implausible difference of 15% vs. 5%, it would take a bit over ten years.

Ironically, at the same time that the growth premium is surging, analysts have been lowering estimates of long term growth rates for stocks like Amazon and Alphabet (Google's parent). By all rights, trimming those estimates should have brought the growth premium down! It's hard not to conclude that investors are overvaluing growth stocks or undervaluing value stocks or some of each. Investing tends to go in cycles. The current ten-year cycle of growth outperforming value may not have too much longer to run.

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Boston, MA

³ The chart is based on forward earnings. Since these rely on analyst estimates, we prefer to look at trailing twelve month earnings (what actually happened). The September 30 P/E ratios cited above are for trailing twelve month reported earnings.

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