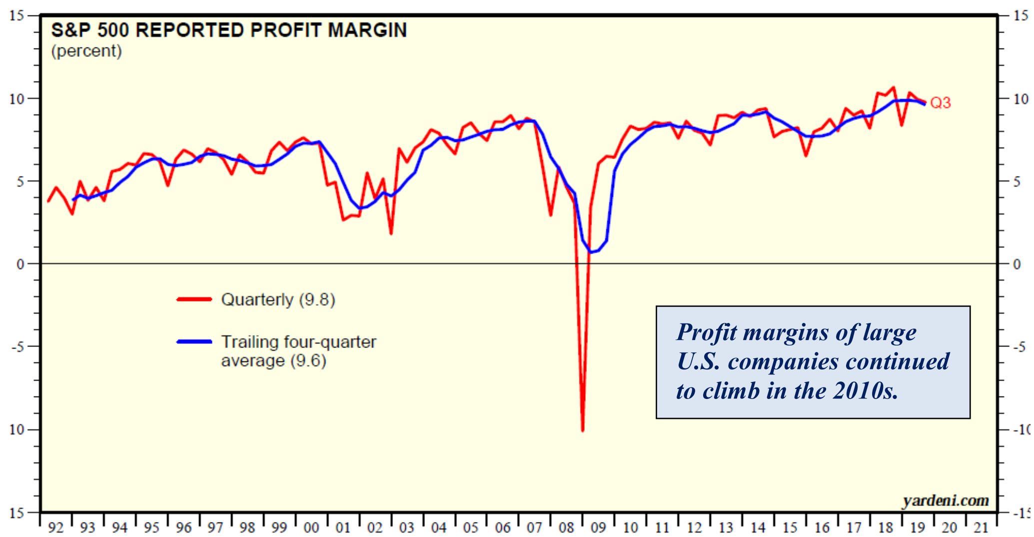
First Quarter 2020 Outlook and Commentary

The U.S. and other stock markets ended 2019 on a strong note, capping a decade in which the S&P 500 Index of U.S. stocks returned 13.6% per year (annualized total return). The outstanding returns from 2010 through 2019 were a sharp and welcome reversal from the previous decade's negative returns of -0.9% per year. As we look ahead, it's worth better understanding what happened in the decade just ended and trying to discern implications for future performance. We'll focus on three key factors propelling U.S. stocks in the 2010s: it was a great decade for corporate profits; interest rates declined significantly; and starting valuations were attractive.

It was a great decade for corporate profits

As the chart below from Yardeni Research, Inc. shows, profit margins continued to climb over the last ten years[1].



Source: Standard & Poor's Corporation.

If analyst estimates hold true, 2020 reported earnings per share on the S&P 500 will be more than double 2010's. That goes a long way to explaining the near tripling of the Index over the course of the decade, from 1115 to 3231.

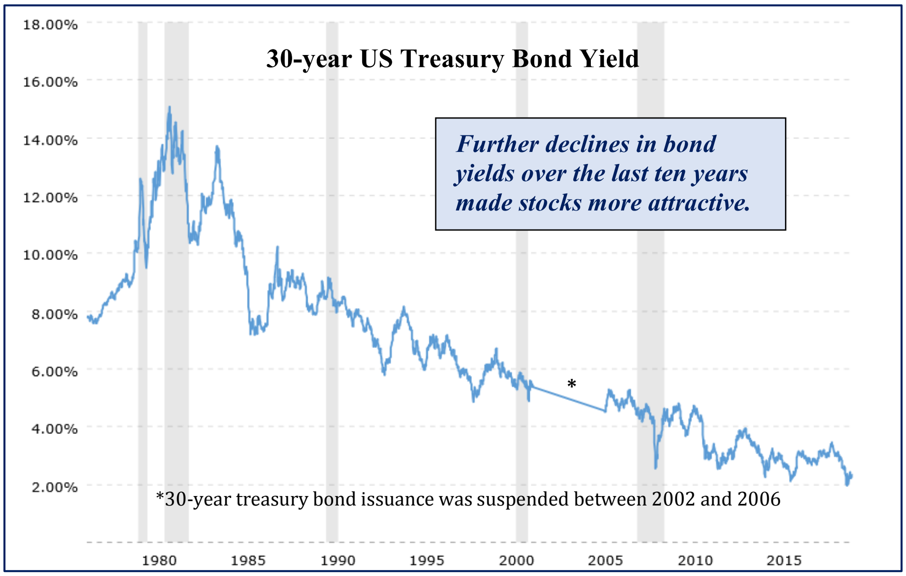
Two factors account for the continued rise in profit margins. First, the composition of the U.S. economy and the S&P 500 changed significantly in the last ten years. Tech giants Alphabet (Google), Apple, Facebook and Microsoft constitute a much greater share of the S&P 500 than they did 10 years ago: 14.1% as compared to 6.1%. While profit margins for the rest of the S&P 500 are under 9%, margins for these four companies range from the mid-teens to the low 30s. Their increased weighting in

[1] It's worth noting that the bump in margins from around 2005 to 2007 was probably illusory; the increase was based on paper profits from the housing bubble that were subsequently unwound during the Great Recession. If you adjusted the chart to take this into account the blue line would flatten out in the mid-2000s and today's levels would look even more impressive.

the index makes a big difference. The late 2017 reduction in the statutory federal corporate tax rate had a significant impact as well, likely boosting corporate profits by around ten percent.

Interest rates declined significantly

As the chart below from Macrotrends shows, long-term bond yields have been declining for nearly forty years. Just prior to the Great Recession the 30-year U.S. Treasury yield was around five percent; the



downward trend has continued since then, and the yield has remained below 2.5% since last July. Bond yields have a direct impact on stock prices. Lower yields make bonds less attractive, which in turn makes stocks relatively more appealing. Even with the surge in stock prices in 2019, it's not difficult to find blue-chip stocks with dividend yields over 3%. With the opportunity for share price appreciation on top of the yield, that makes stocks look attractive in comparison to investment grade corporate bonds which have similar or only slightly higher yields[2].

Starting valuations were attractive

By January 1, 2010 stocks had recovered significantly from the March 2009 lows, but the S&P 500 Index was still 30% below the 2000 and 2007 peaks. Over the last four decades the forward operating P/E ratio[3] of the S&P 500 has been around 15. At the beginning of the last decade it was just a bit over 13. In other words, U.S. stocks entered the 2010s undervalued. Under- or overvaluation based on metrics like P/E ratios is very predictive of long-term future returns. The fact that the P/E ratio of the S&P 500 was below historic averages on January 1, 2010 suggested a decade of very solid returns and that's the way it played out.

What didn't matter

It's also helpful to consider what didn't hold back ten-year returns. A partial list includes: the European sovereign debt crisis of the early 2010s (remember Grexit?); the debt-ceiling crises of 2011 and 2013; the collapse of oil prices in late 2014 that led to a serious recession in the energy sector and plunging share prices in China; the Syrian refugee crisis and the ensuing rise of populism around the

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[2] We probably sound like a broken record on this point. We'll stop making it one of these days, but not yet.

[3] Careful readers will note that P/E ratios cited in these pages are usually based on trailing earnings. Since they represent what really happened, actual earnings are usually more informative than future estimates. In the immediate aftermath of a recession though, recent earnings are distorted. That was the case in 2010, which is why we cite the forward P/E ratio here.

world; Brexit (unlike Grexit, it appears certain to happen); and, the U.S.-China trade war. While geopolitical turmoil gets headlines, the fundamentals of corporate profits and interest rates tend to drive long-term stock market returns. Sometimes geopolitics affects the fundamentals but not nearly so often as we're inclined to think. **This will be important to bear in mind as 2020 unfolds**.

Speaking of fundamentals, mediocre economic growth (at least by historical standards) didn't get in the way of stock market performance either. Over the decade just ended, U.S. GDP grew by a bit over 2.2% per year, significantly below the 2.8% per year of the three decades prior. The stock market doesn't like recessions, which tend to slash corporate profits. But slow and steady growth, especially when accompanied by strong earnings and low interest rates, suits the stock market rather well.

What lies ahead?

If rising corporate profits, declining interest rates and propitious starting valuations drove returns over the last ten years, what does that suggest going forward?

For corporate profits the key question is whether they will revert to historical averages or remain elevated. The bad news is that a significant pullback in margins would have a painful impact on the stock market. The good news is that although current margins are high relative to decades past, they may well be sustainable. The four stocks cited above—Alphabet (Google), Apple, Facebook and Microsoft—should continue to generate outsized margins. And they could grow a bit larger as a percentage of the S&P 500. If the corporate tax cuts were ever undone, earnings would take a hit. But even though a Democratic administration might look at pushing corporate tax rates back up, it would be a lot easier said than done, and the prospect of an ensuing stock market decline would provide significant disincentive. In sum, while there may not be much room for profit margins to go up, the current levels could well represent a "new normal."

The decline in interest rates has been underpinned in recent years by two trends—slower growth in the global labor force and weak inflation. Interest rates are roughly tied to nominal (not adjusted for inflation) GDP growth. Weaker expansion of the working population and low inflation tamp down nominal GDP growth. Adverse labor force trends, a direct result of declining birth rates, are predictable and virtually certain to continue for a decade or more. Weak inflation is less well understood, but the failure of the Fed and other central banks to boost inflation significantly—despite years of vigorous effort—suggests that inflation won't dramatically accelerate any time soon. If interest rates stay low, which would keep investment grade bond yields near current levels, dividend yields on stocks will continue to be relatively attractive and provide support for stock prices.

The final driver of strong returns was the undervaluation of U.S. stocks entering the 2010s. Unfortunately the situation is now reversed. P/E ratios that were about 10% below historical averages are now 50% above the historical norm. Extremely low bond yields may well justify recent P/Es. Still, as the decade unfolds, there is a risk that they will trend closer to historical averages. And even if low bond yields keep P/Es elevated, the upside from here is limited.

The risk of "reversion to the mean" in U.S. P/E ratios is the primary reason we expect non-U.S. developed markets stocks and emerging markets stocks to outperform U.S. stocks in the decade ahead. Low interest rates have driven P/E ratios up globally but much less so in foreign markets. One might think that U.S. stocks would be more attractive than European and Japanese stocks because of stronger economic growth, but one of the lessons from the analysis above is that stocks can do extremely well in an environment of slow and steady growth if interest rates are low and starting valuations are reasonable. As we start the new decade, stock markets outside the U.S. come closer to that auspicious formula.

January 10, 2020
Boston, MA

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