The U.S. Equity Market After the Crisis – Retrospect and Prospect

U.S. equities have recovered impressively since their March 2009 low, with the S&P 500 index up more than 100% and annual earnings for S&P 500 companies more than doubling. Severe recession and acute financial crisis have given way to a period of slow growth, with unemployment elevated and the government-debt-to-GDP ratio at a peacetime record. Federal Reserve policy remains highly stimulative, with experiments such as asset purchases that are without precedent in U.S. financial history. A relatively fragile U.S. economic recovery is also threatened by risks outside the country, most notably the prospect of financial accidents stemming from Europe's debt crisis. Do these risks and uncertainties mean that the recovery in U.S. stocks must come to an end? What kinds of returns should investors expect from U.S. equities over the next five to ten years?

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Looking forward

Any attempt to gauge prospects for U.S. stocks over the next several years must start with the recognition that the U.S. economy is still far from steady-state equilibrium. We expect, however, that economic activity, driven primarily by a continued revival in domestic demand, will grow rapidly enough over the next several years to permit the unemployment rate gradually to fall back to the "natural rate" determined by structural labor-market conditions. (We estimate this rate at between 6.0% and 6.5%, somewhat above the Federal Reserve's estimate.)

As unemployment falls to cyclically normal levels, monetary policy can and should eventually be normalized as well, neutralizing and ultimately reversing its now highly stimulative posture. We believe that the Federal Reserve has appropriate tools to bring about this reversal, even though many of the steps it has taken in this episode have gone beyond traditional measures.

This move back to equilibrium should also involve a shift in sources of growth between developed and emerging markets. The U.S., Western Europe and other developed economies are likely to rely more on business investment and exports than on consumption and housing as sources of growth. Emerging economies should become less reliant on investment in export-oriented production capacity and derive growth instead from domestic demand, particularly for services, as living standards rise.

On balance, we expect that by 2015–16, the U.S. economy should be growing at a steady-state real growth rate of about 2.5%, inflation should be in line with the Federal Reserve's 2.0% target, and that the Fed will have begun to raise the Fed Funds target rate back to about 4.5%. We also expect the U.S. trade deficit to shrink from about 3.0% to about 2.0% of GDP through the global rebalancing that accompanies this gradual convergence.

Earnings growth

This process sets the context for U.S. financial asset returns over the next several years. The primary drivers of returns should be economic growth and policy normalization, in which moderate GDP growth and low inflation lead to continued earnings growth while short- and long-term interest rates rise. In our view, this environment should be encouraging for equities, but we recognize that many investors are concerned over the prospects for further earnings growth and whether stock prices can rise in the face of higher interest rates.

Historically high levels of the profits-to-GDP ratio and of S&P 500 margins have led many investors to fear that earnings will grow more slowly than revenues in coming years as margins decline back to long-run averages. We dissent from this view. We believe that margins can remain elevated and can indeed widen further from today's levels. Our analysis of the aggregate income statement for the S&P 500 index suggests that, while pre-tax margins for S&P 500 companies have approximately doubled since their 2008 cyclical trough, several components of margins are well below record levels. Compared with earlier levels, we still see room for gross margins to increase further and for firms to leverage selling, general and administrative expenses. Operating leverage has been limited in 2012 because the European recession has restrained sales growth; as Europe recovers in 2013, this should reverse. On a longer term basis, meanwhile, economic history suggests that the profit-to-GDP ratio can continue to increase for decades: In Britain, for example, the profit share of national income rose from about 20% to nearly 50% between 1800 and 1870. After 1870, it declined for about twenty years before beginning to rise again after 1890.

Equity valuations

Standard models of equity valuation, such as the dividend discount model or the Gordon–Shapiro price/earnings ratio model, suggest that stock prices should decline when interest rates rise. Rising bond yields not only create more serious competition for stocks, but also increase the rate at which future earnings and dividends must be discounted back to the present. How can we expect equity prices to continue rising as 10-year Treasury yields increase from about 1.8% today to more than 5% by 2021? The main reason is that, in our view, the equity risk premium remains high as a result of the crisis and the extraordinary uncertainties it produced. As conditions gradually grow more normal, the same process of economic and financial convergence that we expect to lead interest rates to rise should also lead the equity risk premium to contract. The result should net out to higher equity prices and positive total returns.

We thus foresee an annual geometric mean return of about 8% for the S&P 500 index through 2021, or about 6% after inflation. We see moderately higher returns from value stocks as compared to growth stocks, primarily because value stocks tend to perform better in periods of cyclical recovery and because they are more undervalued than growth stocks at present. Small- and mid-cap stocks should also provide moderately higher returns than large capitalization stocks, in line with historic risk premia. Intermediate to long-term Treasury bonds, by contrast, should provide an annual return of only about 1.0%, with negative returns likely for the 30-year bond. We believe that the only U.S. fixed income asset class likely to be at all competitive with stocks is high-yield bonds, which are in many respects a hybrid asset class. For high-yield bonds, the effect of increasing yields on Treasury bonds has normally been offset by declines in spreads. Combined with the level of spread relative to their yield, this suggests that high-yield bonds offer a good chance of cushioning exposure to interest-rate increases.

Short-term technical outlook

In the immediate term, technical factors will obviously influence market movements. U.S. markets rallied to new multi-year highs on the back of September's Fed policy announcement. Except for the Russell 2000, the recent rally has predominantly been driven by larger capitalization stocks. While the move higher confirms the long standing uptrends of most indexes, with successful higher highs and higher lows since the bottom in 2009, many indexes have since paused in the short term to work off overbought conditions and retest key support levels. While we may see additional downside in the short term, we would view any price weakness within a longer term bull market context.

Looking forward, the recent breakout to new highs completed large "cup and handle" formations for the majority of U.S. indexes. Based on the size of these patterns, which began from the highs seen in March and April, upside price targets of 10 to 15% can be expected from current levels (October 2012) over the next two quarters. However, acute risks remain as volume has continued to trend lower while prices have moved higher over the last four years. On the downside key uptrend support should be watched as any violation of trend should be viewed as a breach of the current bull-market thesis and a possible re-emergence of bearish momentum.

Among market sectors, financials and healthcare continue to gain strength as they trade well above their respective uptrends. Utilities, consumer staples, consumer discretionary and technology remain in bullish uptrends but are currently testing trend support. Any major move to the downside should be viewed as a violation of trend and a bearish signal. Materials, energy and industrials, on the other hand, continue to consolidate between uptrend support and downtrend resistance, and until either trend is broken, prices will remain range-bound.

Finally, the 10-year U.S. Treasury yield continues to consolidate between a longer term downtrend off the high from April 2011 and a short-term uptrend off the low from July. As these two trends converge, a break in either direction will occur shortly, setting up price action for the remainder of the year and possibly into 2013. A move higher will be extremely bullish for U.S. equities and may even begin to reverse the dominance of fixed-income fund flows vs. equities. The major yield levels to watch are 1.8% (downtrend resistance) and 1.68% (uptrend support).

Conclusion

We believe that U.S. equities remain attractive on a long-term basis – for investors with a multi-year horizon –, even after doubling in price since their 2009 low. Both on an absolute basis and adjusted for risk, stocks are likely to prove the most attractive U.S. dollar-based asset class over the next several years, offering materially higher returns than almost all types of fixed-income securities or cash equivalents. Although short-term technical aspects may raise concerns, we have good reasons to believe in an optimistic longer term stance on U.S. stocks.

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