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No alternative to equities

While political risk, a second Covid-19 wave, lower economic activity and suppressed inflation might trigger a short-term sell-off, in the medium term a high equity risk premium and low rates will support equities

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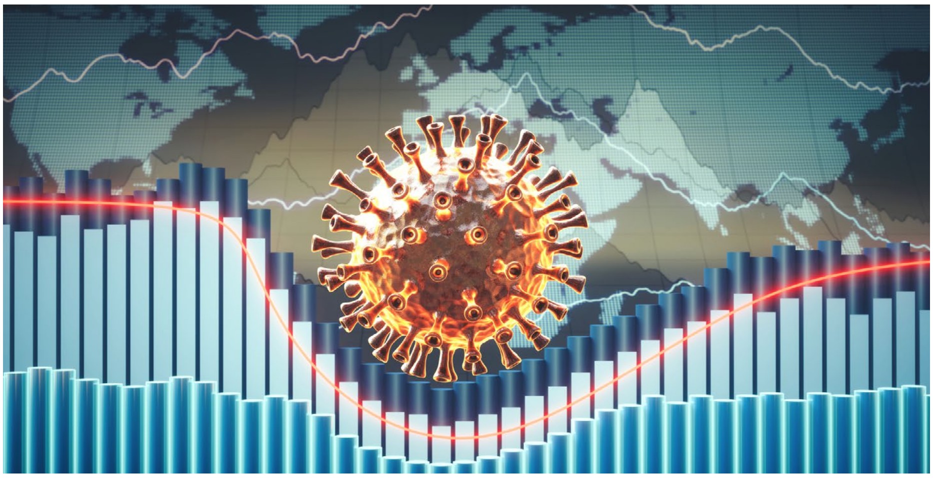
After a very strong bounce off their March low points, equity markets are now looking stretched. As we experience a second Covid-19 wave the uncertainty is beginning to have an impact on the earnings recovery, and although the US presidential election is now behind us – albeit with the potential for a difficult transition – the newly elected president is likely to continue to put pressure on China.



Corporate earnings revisions have been rising in the US but may now be peaking. In Europe they are flat.[1] At Columbia Threadneedle Investments we expect a more modest bounce back in earnings next year than many other commentators. Consensus numbers look too high.

What is indisputably positive is the US Federal Reserve's new policy framework, with an explicit plan to let inflation overshoot. Even if inflation rises the Fed will look through it. Eventually that will steepen the interest rate yield curve. Yet the biggest determinant of long-term interest rates is the direction of short rates. If short rates are going to be stuck at low levels for the next four to five years, how can long yields go up?

New Covid-19 lifestyle restrictions, together with less fiscal support, will weigh on economies towards the end of the year. At the time of writing the emergency US federal unemployment package has lapsed and a new fiscal package has not been agreed. Taken together, delays in the enactment of such a stimulus and a sell-off in US technology stocks have all heightened the short-term risk in markets, although the vaccine news is hugely welcome.

Short-term monetary stimulus, as measured by six-month credit flows, reached an all-time high over the summer, but this is fading. In the US and China such flows peaked at $700 billion and $800 billion respectively in May. In the eurozone the peak was more than $1 trillion in July. Together, these flows were even bigger than during in the global financial crisis (GFC). Six-month credit flows have recently fallen to about $200 billion each in the US and China.[2]

While we have yet to see the latest numbers for Europe, the picture must be similar. With this happening, fiscal stimulus will take on a more important role.

Watch the equity risk premium

Apart from in the very short term there is no alternative to equities, since the global equity risk premium – the difference between the equity earnings yield and real government bond yields – remains so large. The dividend yield for the S&P 500 Index is currently 1.6%, below its long-term average of 4.3% but way above the 0.7% yield on the 10-year US Treasury bond. If dividends paid were to remain at current levels for the next 10 years, the S&P 500 would need to fall 9% just to equal the return from the 10-year Treasury. If inflation were to average 2% over the same 10-year period the S&P 500 would need to fall 25% to match the 10-year Treasury.[3]

- The scenario is even more dramatic outside the US: eurozone equities would need to fall 30% in real terms, and UK equities would need to fall 50%, to match the return from bonds.[4] None of these scenarios is likely. While the US earnings yield is well below average, the equity risk premium is still high because real bond yields are well into negative territory.

Indeed, the equity risk premium remains around its March level when equity prices hit their lows. Although equity prices have rebounded and dividend yields fallen, the fall in real bond yields has been similar. While the market priced in the temporary Covid-19-linked fall in corporate earnings, which will eventually rebound, it has also priced in the 94bp drop in the risk-free 30-year bond yield since the start of the year.[5] While the earnings effect is temporary, the discount rate effect is permanent. So in spite of short-term worries, equity prices actually should be higher.

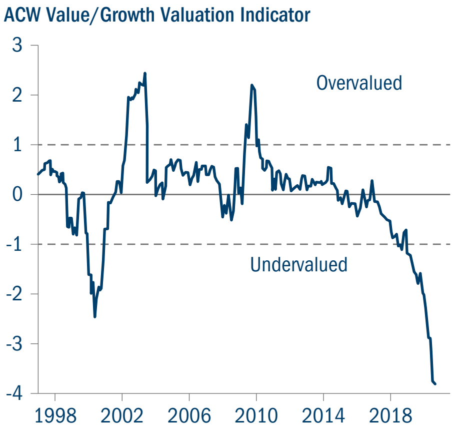
Meanwhile, monetary policy is exceptionally loose. The Fed has promised to keep rates on hold until the economy has reached “maximum employment” and inflation is “on track moderately to exceed 2% for some time”. A majority of the Federal Open Market Committee does not expect to move rates before at least the end of 2023. While bond yields are unlikely to rise in the next few years in the absence of inflation, they are unlikely to fall further given how low they are already. The equity risk premium is high enough that equities can still go higher – even if bond yields rise a little.

Growth versus value

This prolonged period of low interest rates suggests parallels with the “nifty 50” era of the 1960s and 1970s when 50 quality growth stocks dominated US equity market performance.

Even so, if bond yields only stabilise rather than go up, this could remove a major headwind for banks. Value stocks are now cheaper versus growth stocks than at any point in history – even cheaper than at the height of the dotcom bubble in 2000 (Figure 1).[6] But they need a catalyst to prompt a rebound. A new fiscal deal and a successful, fully approved and rapidly distributed vaccine might provide that, but we are not there with either quite yet. There are a number of vaccine candidates in phase three trials, and three which so far look to be successful – but we still need some time for final approval, manufacturing and global distribution.

Figure 1: Value stocks are extremely cheap relative to growth stocks



Source: BCA Research Inc, September 2020. Based on relative price/book, price/earnings and dividend yields/IBES/Thomson Reuters and MSCI Inc.

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Value tends to outperform growth when the US dollar is weakening and global growth accelerating. Growth stocks did well in the late 1990s when the dollar was strong, while value performed better from 2001-07 when the dollar was weak. If the dollar weakens in the coming months, it could help lift all those value names currently in the doldrums.

Support for risk assets

With the US election behind us, vaccines should accelerate recovery. It is unlikely that current policy support will change as authorities want to run economies hot to sustain the recovery. That will push equities higher.

Until now, there has been a lot of uncertainty over long-term growth, which has counterbalanced the positive effects of lower rates. It has also reflected deflationary tail risks and fears about the future of the EU and the euro. Now that we are at the beginning of a new cycle, with moderate growth but low inflation and interest rates, policy support should help to reduce the risk of another recession.

The resumption of a zero-interest rate policy will support risk assets for the foreseeable future. In the near term though, the current rise in Covid-19 infections, continued lockdowns, lower economic activity and suppressed inflation expectations (ie, higher real rates) may cause equities to sell off again.

[1] Columbia Threadneedle analysis, September 2020.
[2] BCA Research Inc, September 2020.
[3] Bloomberg/Columbia Threadneedle analysis, September 2020.
[4] Bloomberg/Columbia Threadneedle analysis, September 2020.
[5] BCA Research Inc, September 2020.
[6] BCA Research Inc, September 2020.

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