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The Impact of "Larger Forces"

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The Impact of "Larger Forces"

Among my favorite sayings from friends with military experience is the use of the term "OBE" to describe what happened in a particular situation. "OBE" stands for "overcome by events", meaning that circumstances overwhelmed efforts associated with following a plan. The saying seemed lame when I first heard it, yet seems to describe a lot of things that happen.

Investors in the stock and bond market might often feel their plan was OBE, when evaluating the performance of their investment strategy. Despite lessons from history and careful research, mysterious "larger forces" seem to determine the outcome. In Peter Bernstein's book that traces how modern investors have evolved their approach to managing risk, called "Against the Gods", a transition occurred in the 1700's to more clearly understand why things happened, and what to do about it. Can "larger forces" be identified and managed? Is there anything we can do about it? From experience, how we think about drivers of investment performance is a key determinant of success or failure.

This memo provides charts to focus on the factors that drive returns in the stock market, and how interest rates are one of the "larger forces" driving our outlook for markets.

Table 1 provides a useful way to simplify the factors that have contributed to the performance of the stock market. The "Total Shareholder Return" framework for performance attribution provides a reasonably accurate way to account for performance in any given year. The framework includes only 3 factors to reconcile performance: 1) earnings growth, 2) changes in the P/E valuation multiple and 3) dividend yield. Table 1 compares "estimated total return" with "actual total return" to provide an idea of the accuracy of the system: not perfect but pretty close.

S&P 500 Index — **Table: 1**

			Fundamentals (1) +	Macro (2) +	(3) =	(4)				
Year	Earnings Per Share	Price/Earnings Ratio	Change in EPS (%)	Change in PE (%)	Dividend Yield (%)	Estimated Total Return (%)	Actual Total Return (%)	Beginning 10yr U.S. Treasury Yield (%)	Ending 10yr U.S. Treasury Yield (%)	CPI Inflation
								Round Trip		
2011	89.7	13.8	19.5	-13.1	2.1	8.5	2.1	3.3	1.9	3.0
2012	91.1	14.3	1.6	3.5	2.2	7.3	14.2	1.9	1.8	1.7
2013	98.7	16.5	8.3	15.5	1.9	25.7	32.4	1.8	3.0	1.5
2014	109.1	17.9	10.6	8.4	2.0	20.9	13.7	3.0	2.2	0.8
2015	92.6	18.0	-15.1	0.6	2.2	-12.3	1.4	2.2	2.3	0.7
2016	93.9	20.6	1.4	14.4	2.1	17.9	11.9	2.3	2.4	2.1
2017	108.9	21.9	15.9	6.7	1.9	24.5	20.8	2.4	2.4	2.1
2018	131.9	16.7	21.2	-23.7	2.2	-0.4	-5.2	2.4	2.7	1.9
2019	134.4	21.2	1.9	26.6	1.8	30.3	31.5	2.7	1.9	2.3
2020	101.2	28.7	-24.7	35.7	1.6	12.6	18.4	1.9	0.9	1.4
2021	179.2	25.8	77.0	-10.4	1.3	67.9	28.7	0.9	1.5	7.0
2022	190.2	18.2	6.2	-29.3	1.8	-21.3	-18.1	1.5	3.9	6.5
2023 (est.)	217.1	20.6	14.1	12.9	1.6	28.6	17.6	3.9	4.3	3.2
Annualized Growth	7.65									

Data Source: Bloomberg 09.08.23

Reviewing annual changes in earning growth, and changes in the P/E multiple, lead to the observation that year-to-year changes are significant, helping explain why stock market performance changes so much from one year to the next. The variability in earnings growth and P/E multiples are linked, but in ways that change from one market context to another, from one scenario of economic conditions to entirely different conditions in another year.

This seems like chaos, for investors yearning for stability, but we have a more optimistic view. Over time, the range of key variables, like GDP growth, interest rates and inflation are fairly small. When developing forecasts, we think of where we are in terms of the "economic regime" of low/high economic growth and low/high inflation. Shifts from one economic regime to another often leads to market repricing, which is no small thing, but trends in the magnitude of economic growth and inflation have occurred in a narrow range for decades. Recent inflation trends challenge this view, but we remain attuned to long-term drivers of inflation, and how markets will likely adapt to higher levels of government debt. With this in mind, "base rates" of key variables, like how fast the economy grows each year, and trends in growth and profitability, can help to weigh the upside and downside in the short and longer term. These trends suggest to us that the stock market is capable of providing 10% annual returns in the future.

Despite a rosy long-term view, rising interest rates seem likely to change recent trends, that might lead to market repricing, in particular the relative valuation between stocks and bonds.

Chart 1 compares GDP growth with S&P 500 sales and earnings growth over the past 30 years. GDP growth and S&P 500 sales growth are closely linked, at about 4% per year over the past 30 years. Earning growth has recently been much faster than both GDP and sales growth, and whether the pace of earning growth is sustainable is an important question. What caused the spike in earnings growth? Low interest rates and government stimulus seem likely reasons, yet cloud computing, AI and other technologies may be factors as well. Our view is that higher interest rates will inevitably have a negative impact on consumer and corporate demand, and increase the cost structure of many businesses. Without relying upon elaborate statistics, we simply think earnings growth forecasts will eventually take into account the new reality of higher interest rates.

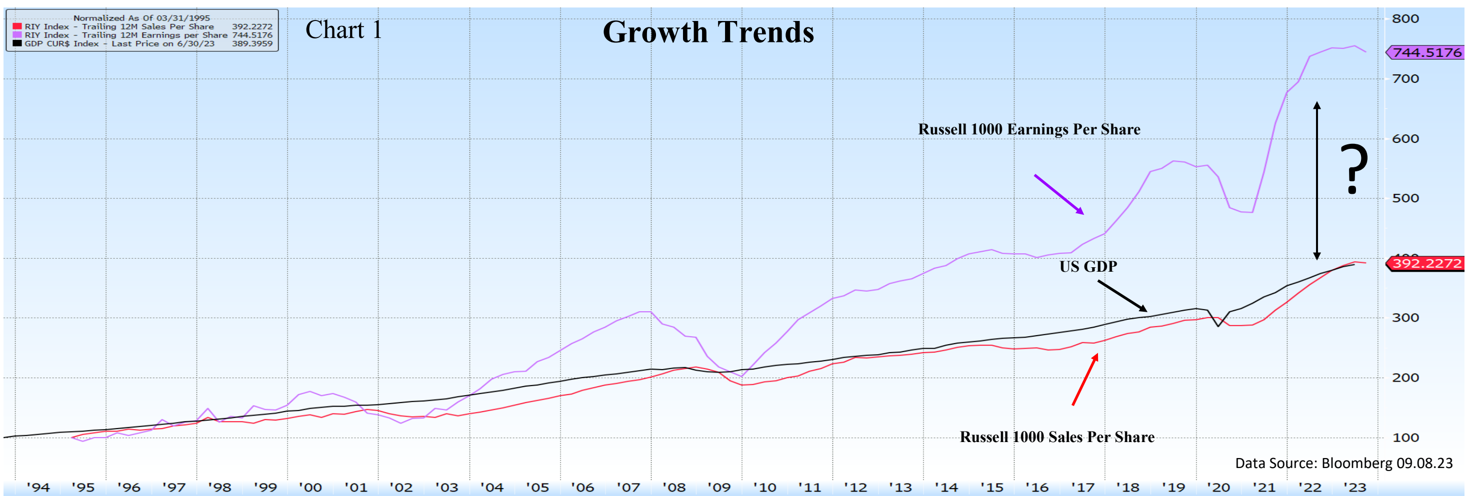
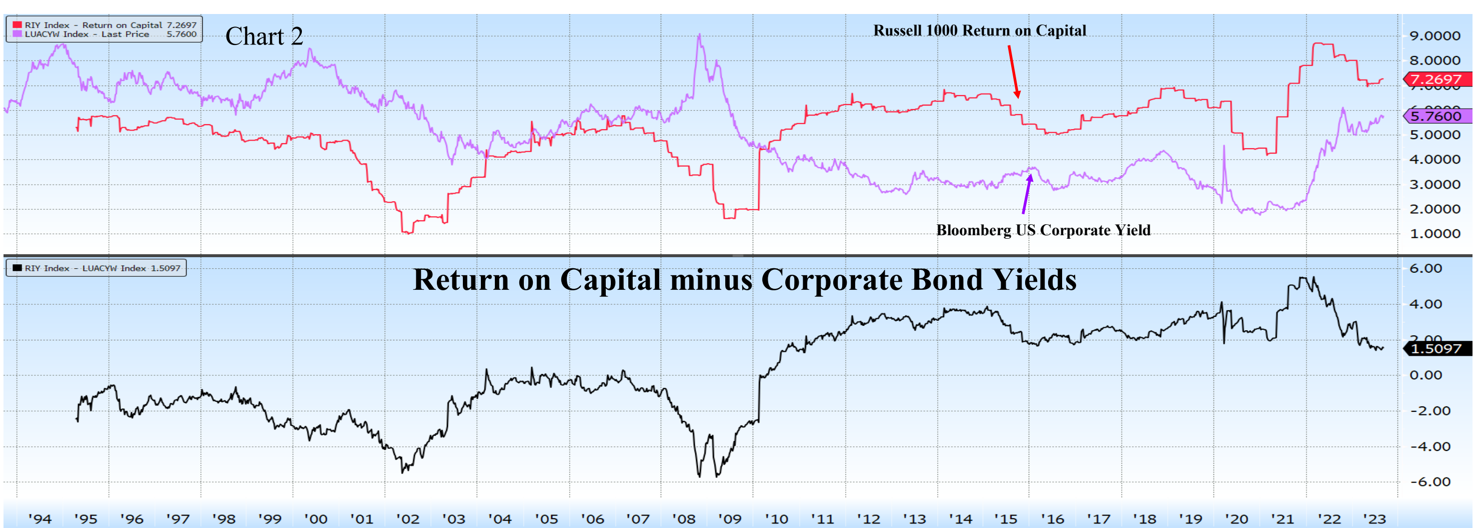
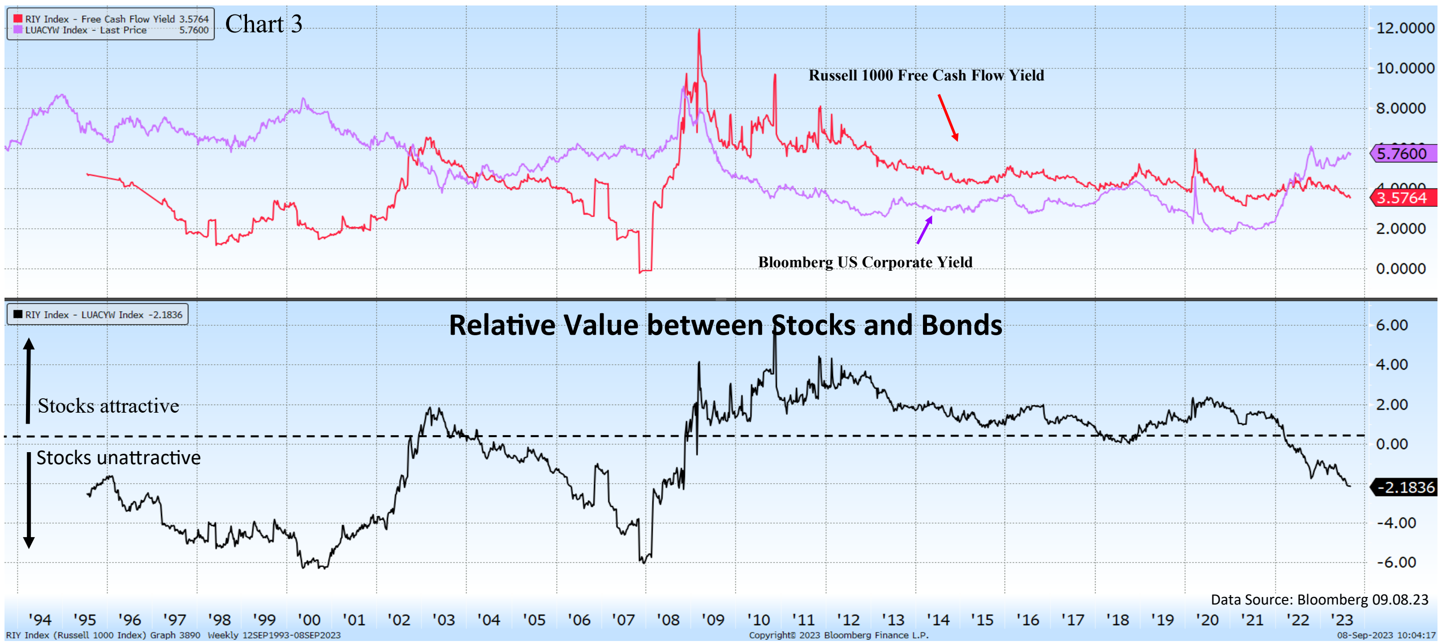


Chart 2 provides a long-term view of "economic profit", the difference between return on capital and bond yields. Low interest rates supports high levels of economic profit. Our view is that higher interest rates will reduce "economic profit", which could influence going-forward P/E valuation multiples. A narrower spread between return on capital and the cost of capital is a consideration in the long-term discounting mechanism provided by the stock market. Mr. Market changes his mind, often, but is generally a realist when it comes to the big picture.



Data Source: Bloomberg 09.08.23

Chart 3 provides a longer-term view of the relative valuation between stocks and bonds. The chart compares the "free cash flow yield" of the stock market with corporate bond yields. In the past decade, stocks offered a generous relative value to bonds, helping stocks to outperform bonds, but the spread has recently narrowed. Today, for the first time in a long time, bond yields are higher than the free cash flow yield from stocks.



We don't think of this so much as a "gloomy outlook" as just a periodic "repricing outlook". The music has changed, and investors need to catch the beat. Don't be OBE.

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