**Exchanges at Goldman Sachs**
**Piloting Through: Why Investors Should Stay the Course**
**Sharmin Mossavar-Rahmani,**
**Head, Investment Strategy Group &**
**Chief Investment Officer, Consumer and Wealth Management, Goldman Sachs**
**Allison Nathan, Host**
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**Allison Nathan:** This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

Today I have the great pleasure of speaking with Sharmin Mossavar-Rahmani, as we always do this time of year. She's got a new report out called "Piloting Through" which is her 14th annual investment outlook. And lays out her team's investment themes for the year ahead.

Sharmin is the Head of the Investment Strategy Group and Chief Investment Officer for the Consumer and Wealth Management division. Sharmin, welcome back to the

program.

**Sharmin Mossavar-Rahmani:** Hello, Allison. Thank you.

**Allison Nathan:** So, coming into the new year by almost every measure, US stocks looked expensive. Of course, we've had a very crazy couple weeks in the markets. But we've been running through a nearly 13-year bull market. So, valuations are still quite elevated. But you argue in your report that valuations aren't good enough of a reason to exit the market. So, why is that?

**Sharmin Mossavar-Rahmani:** You're quite right, valuations are expensive. We use a series of metrics. And based on those equity related metrics, we are in the tenth decile of valuations. So, there are no ifs and buts about the fact that equities are expensive.

The reason we say valuation alone is not a good signal to go underweight equities is, in fact, because we've been in the tenth decile since December 2016. And since then, US equities, as measured by the S&P 500 has been up about 130 percent. So, using that alone to get out of equities

means you leave a lot of money on the table and get out too quickly.

The same thing happened in the mid 1990s. We got into the tenth decile of valuation based on the series of metrics that we look at. In July 1995 equities continued to produce a total return of just under 200 percent before 2000. So, the fact that one is in the tenth decile is not a good argument for going underweight equities.

In addition, we also say that we have to look at equities in the context of the interest rate environment. So, if we look at equities today and look at the earnings yield of equities and compare it to the ten year, we're looking at what is traditionally called the implied equity risk premium. And that is actually above average. So, equities are cheap relative to bonds in this environment. And so, that's another factor where we're saying looking at that alone is not a good reason to underweight equities. You need to look at equities in the context of cash and fixed income rates. And we typically look at the ten-year treasury yield.

**Allison Nathan:** But those ten-year treasury yields are

rising. That is one of the reasons why we've seen such dramatic sell off in the markets, ups and downs, but a sell off coming into this new year. Ultimately, you are still recommending that investors own equities. So, tell us about why you're still recommending them and why some of these investor concerns might be overdone.

**Sharmin Mossavar-Rahmani:** There are a couple of reasons why we've had this investment theme of staying invested. In fact, it's been our investment theme since the trough of the global financial crisis. And we'd like to convey in our annual reports, and we've been saying it now for the last several years, that the hurdle to go underweight US equities should be very high. Generally, if you think of the US economy, we grow more often than we're in recession. So, we're in growth mode more than 80 percent of the time. And when the economy grows, earnings grow. And so, if you're looking at the earnings growth since World War II, on average earnings have grown about 6 percent. And so, with economic growth and earnings growth, generally prices follow.

Obviously, there are times where the prices diverge, and

the prices converge relative to earnings. But in general, they follow. So, to go underweight equities, you are fighting a rising trend, a rising trend of economic growth followed by earnings growth, and the prices following that.

So, to actually go underweight equities, we have to have a lot of conviction that there are many things that are going to drive down equities. So, first and foremost, the hurdle rate, it's high. People need to think about that. The second factor that encourages us to stay invested for our clients is that if one is in economic expansion, equities have positive returns 88 percent of the time. So, if you have valuations that are attractive relative to bonds and you're looking at an economic expansion continuing, which is our base case for 2022, then one has to stay invested because the odds favor positive equity returns. And we expect moderately negative bond returns. So, in that context we also recommend stay invested.

Now that's not to say that we can't have down drafts. In fact, we always include some data on the probability of down drafts. As you mentioned earlier, equities are expensive. So, if we're in the tenth decile of valuations, the

probability of a 5 percent down draft is 100 percent. So, we warn clients that equities are a volatile asset class. Just because we like equities for the long run doesn't mean you can't have a down draft.

The probability of a 10 percent down draft is actually 79 percent. So, let's just round that to 80. So, we warn clients that by investing in equities, it doesn't mean you're not going to have 10 percent down drafts, which is exactly what's happening right now. In fact, now, with this down draft, we are encouraging clients to start slowly leaning into equities and adding to their positions. Conservatively. We're recommending doing that through options strategies. But again, it seems like this is a good opportunity to actually incrementally slowly add to equities.

**Allison Nathan:** Right. So, you're viewing this positively. It's a buying opportunity. But if you think about broader investor concerns about the expensiveness of equities, about just the concentration of some of the indices and the positive returns, we've seen these rallies really being driven by a handful of technology stocks, are investors' concerns about this at all valid? Is there any reason to be concerned,

especially since rate increases tend to impact technology stocks, those types of sectors more than other sectors?

**Sharmin Mossavar-Rahmani:** One of the themes that has obviously dominated the headlines has been the concentration of the equity market. And there's no doubt that if you look at the top, for example five stocks in the S&P 500, there are a much larger percentage of the market cap of the S&P 500 relative to what it has been in the past, including even in the dotcom bubble.

But there are two things to consider. One is equity market concentration of the top, let's say, five stocks or ten stocks actually has no bearing on forward returns. You can run all kinds of analytics, all kinds of regressions and there's no significance. The fact that the equity market is concentrated doesn't tell you anything about returns the subsequent 12 months.

The other thing that's very interesting is when people talk about concentration and whether this bull market, not just last year, but since the trough of the global financial crisis hasn't just been driven by a handful of stocks, what we do

is compare market cap weighted stocks, indexes like the S&P 500, and then compare them to equal weighted benchmarks. And if you look at the returns, they're actually very similar. That means over these various windows we look at, in fact, this equity market rally hasn't just been driven by a handful of stocks.

Take for example last year. Last year, US equities were up 29 percent. If you look at an equal weighted index, it was up about the same. And if you looked at the median stock price, it was up about 27 percent. So, the idea that it was just a handful of stocks that account for this return is actually factually not correct. In fact, the energy sector was the best returning sector last year. And if you look at the data since the trough of the global financial crisis, you will actually see, again, that the median stock and the equal weighted equity indexes would be very similar to market cap weighted. So, I think there's a little bit of a misconception about the risks associated with the market cap weighting of the top five or ten stocks.

**Allison Nathan:** So, given your advice that clients should stick with equities, walk us through some of your return

expectations relative to other assets and what kind of economic environment would need to underpin those returns.

**Sharmin Mossavar-Rahmani:** Obviously, the economic backdrop is one of the most important factors. So, our view is that growth is going to be slower than last year but certainly above trend. So, our growth expectation is somewhere around 3.5 to 4 percent. Let's take the midpoint around 3.7 percent economic growth in the US. And the global backdrop also matters because, obviously, US companies also have a portion of their earnings from outside the US. So, let's look at that. And that's maybe about 4.5 percent. So, generally, US growth and the global backdrop is favorable and above trend, even if slower than last year.

We expect inflation to be high for the next few months, but slowly start to moderate. And we expect continued improvement in the unemployment picture. So, maybe ending up as low as 3.1 percent. So, a very favorable economic backdrop. The Fed's starting to tighten. But slowly and steadily. Three hikes, maybe four hikes. But

very steady and slow. Nothing too dramatic. Because they're going to start seeing inflation head down. So, that makes for a very favorable earnings backdrop.

We expect S&P 500 earnings to be up, actually, about 12 percent. We think the market is going to not be willing to pay as much as they did at the end of 2021 for the same earnings. So, we expect market multiples, the valuations that you highlighted, to actually contract a little bit.

So, our base case for the whole year was about a 6 percent total return, including dividends. Obviously, from today's levels, it's about 16 percent.

One thing we always do for clients is think about a base case, a good case, and a bad case. Our base case has about a 65 percent probability. But we have a 20 percent probability to the good case. That was 12 percent for the whole year. But again, from current levels we're talking about 20 plus percent kind of returns. So, fairly attractive returns from today for equities.

And you made a reference to interest rates rising. Our base

case is the ten year gets to about 2 percent. And obviously, that means bond returns are not going to be as attractive. So, US equities will way outperform bonds in our view.

**Allison Nathan:** So, you mentioned your expectation that inflation should subside. Inflation is such a focus right now. What are you watching? And is there anything you're watching that would make you more concerned that inflation is going to persist for longer?

**Sharmin Mossavar-Rahmani:** We think of inflation in terms of the factors that we need to watch carefully fall into three categories. One driver would be goods: capital goods, vehicles. People talk about the inflation in used cars, for example. Then we look at the inflation for shelter. And then we look at inflation for wages. Those are the three areas that we're focused on and we watch on a regular basis.

We agree with our colleagues in the economics research department that we're going to see the inflation for goods slowly abate and decrease, probably by the middle of the year. Shelter and wages are the areas where we think inflation will be a little bit more persistent. But actually,

with higher home prices and with rates going on up, which means mortgage rates will also go up, affordability will decline. And so, we think that brings supply and demand into balance and we're not going to see the same kind of price pressures. We clearly don't expect the same kind of inflation increases in the energy sector as we saw in 2021.

Wages is where there's uncertainty. Will the labor force participation increase back to the levels we saw before COVID? And there's a lot of uncertainty. Our base case is that as people move through their savings, as jobs become less plentiful, as COVID abates, that we're going to see more people come back into the workforce. And so, the wage inflationary pressures will not come down as quickly but will certainly be headed downward.

**Allison Nathan:** And so, the market though seems very concerned about inflation, concerned that the Fed is going to have to tighten faster, sooner. Obviously, those expectations have been pulled forward substantially. Are those concerns overdone?

**Sharmin Mossavar-Rahmani:** Obviously, whenever the

Fed tightness, everybody's concern level goes up. People start getting worried. The initial reaction is always a bit of a down draft. We saw that when they first started talking about tapering asset purchases after the global financial crisis. So, whenever people think about the Fed embarking on a tightening path, the risks of recession go up.

Since World War II we've had about 15 tightening cycles. Of those, nine led to a recession. But six did not. So, the key is what are the factors that we need to worry about that will prompt us to think that this is going to lead to a recession versus no this will not?

If you think about the last time the Fed started to tighten under Secretary Yellen at the time, she was chair of the Federal Reserve, people started worrying that, wow, this is going to lead to a recession. And it didn't. So, if they're slow and steady and start the process, it's not inevitable that it leads to a recession.

But we have said let's assume it does lead to a recession. What's really important is to know that from the first Fed hike, let's say it happens in March, it takes actually quite

some time before the S&P peaks and before a recession starts. So, typically on average a recession has started 30 months later. And the S&P has peaked 24 months later. So, that means we're looking at the equity market peaking much further down the road. And again, these are just averages and there are ranges around these numbers, but on average the S&P has returned 36 percent from the first Fed hike.

So, again, the issue is not to exit the market too early. That point we made earlier about the hurdle being very high to exit the market is still valid when not every tightening cycle leads to a recession. And even if it does lead to a recession, it's a while before the equity market peaks.

**Allison Nathan:** I must mention that the cover of your report has a tanker, a ship, that says USS Equities on its side. And it's navigating icebergs, which we can only assume are all the risks in the markets. So, beyond this risk of a Fed tightening cycle that goes quite far, what are the risks you're focused on? And which ones are you most worried about?

**Sharmin Mossavar-Rahmani:** Allison, we spent an inordinate amount of time thinking about our cover. We always want to make sure that the cover conveys the exact message that we want our clients to get from the report. So, even if they don't want to go through every single graph and every exhibit and every section of the report, they can just look at the cover and know the message.

So, the message is there's this US Coast Guard ice breaker going through a set of icebergs, as you mentioned. And we call it USS Equities because our point is to reinforce the view that we prefer US equities to non-US equities, whether we're talking about non-US developed equity markets or emerging market equities, we prefer US equities. We think they are best positioned to navigate these icebergs. So, US equities are in a much better position to do that.

And then we're saying that these icebergs pose all kinds of risks. What are some of them? We just talked about tightening. So, the pace at which the Fed tapers and the pace at which they hike rates. The risk of recession from other factors like geopolitical shocks, for example. Risks from COVID is another example. So, there are risks out

there. Because we could have a new mutation, for all we know. And so, there are risks out there. And we're aware of them and we assign probabilities to them. But just like we assign a low probability of recession in 2022, we think that US equities can navigate.

**Allison Nathan:** So, you mentioned this expectation that the US, of course, emphasized, I should say, this expectation that US equities are the place to be relative to non-US developed equities. Even though the latter has had underperformance. So, why are you not more optimistic on non-US equities at this point?

**Sharmin Mossavar-Rahmani:** That is actually one of the most frequently asked questions from our clients for the last several years. They keep on saying, "Well, aren't the equities outside the US getting cheap enough where we should pivot away from US equities towards non-US developed, like Eurozone, UK, Japanese equities and then emerging market equities?" And so far, we have consistently said, "No, we should not pivot away."

Obviously, any well-diversified portfolio should have some

strategic allocation to non-US equities. But our recommendation is it should be much less than market cap weighting indexes would suggest.

Now, why is that? If you go back to, let's say, the peak of earnings in 2007, before the global financial crisis, and looked at US companies' earnings per growth share versus earnings per share growth and you compare it to sectors in IFA indexes in emerging markets, US companies have out earned their counterparts across every single sector with the exception of energy relative to emerging markets. So, US companies actually out earn their peers quite substantially. And we're looking at a long enough window. And we're doing it before the global financial crisis, so then nobody could say we're biasing the data by just looking at the trough of US equities.

And so, US companies actually out earn their peers quite substantially. And so, even though valuations are a lot cheaper and non-US developed and emerging markets have lagged significantly, we still recommend having your strategic overweight to US equities.

**Allison Nathan:** And we can't have a conversation without talking about China in this context. Obviously, a country that's facing a lot of challenges. They are managing a zero COVID policy amid a very transmissible COVID variant. They have been tightening their regulations. And this is all adding up to slowing growth. So, what are you advising clients about exposure to China in their portfolios at this point?

**Sharmin Mossavar-Rahmani:** That's another very frequently asked question. "How should we look at the China given it is such a large economy and top of mind in so many ways?" And you use that top-of-mind expression often in all your reports, Allison. And China's definitely top of mind in so many ways.

We have generally had a somewhat negative view of emerging markets, in general, and that includes China. In fact, in 2013 we published a report called "Emerging Markets as the Tide Goes Out," making a reference to the famous Warren Buffett expression. And our view is that the tide was going out on emerging markets. And the, what we call structural fault lines and weaknesses of emerging

market countries would become much more apparent. And that includes, of course, China.

And on China we published a piece at the beginning of 2016 saying, "Walled In: China's Great Dilemma." That China had no good options and that over time growth was going to slow. And our expectation at the time was it was going to slow to 5 percent, but much earlier than it has actually transpired.

Here's actually a really fascinating set of data. Since the trough of the global financial crisis, US equities have returned just under 800 percent. If you look at the non-US developed markets, they have returned under 300 percent. Emerging markets have returned also under 300 percent. And China is about 230 percent. So, the gap in performance is mind boggling. Even though they've grown very fast, they haven't produced great equity returns.

So, we've had a very small allocation to emerging markets in general. In a moderate risk, diversified portfolio for clients, our allocation is about 2 percent. And so, China is about a third of that.

And so, we say, have that small percentage. But we are very concerned about some of the issues that you raised. The zero COVID policy in China does create problems, not just for China and their lockdowns, but also for the supply chain constraints that we talked about. It's not the only factor driving inflation in the US, but it's certainly a contributing factor at the margin. So, we actually don't think China offers any great investment opportunity.

Last year, US equities up 29 percent. China actually down 21 percent. That is a 50 percentage point gap. So, for people who like to go on and on about how great China is, that tells you what the market is pricing in terms of what they think Chinese equities are all about. And it's obviously a very negative signal.

We're going to be updating our China report quite soon. And we're going to examine these issues again at great depth. But I don't think it'll change our recommendation to have a very small allocation, strategically, to emerging markets and China specifically.

**Allison Nathan:** Thank you so much for joining us, Sharmin. Always so insightful.

**Sharmin Mossavar-Rahmani:** Thank you very much.

**Allison Nathan:** That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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