Exchanges at Goldman Sachs With Brett Nelson, Head of Tactical Asset Allocation for the Investment Strategy Group
Hosted by Jake Siewert, Global Head of Corporate Communications
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Jake Siewert: This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today we're going to talk about the outlook for the equity markets in an environment of rising interest rates and potentially higher taxes. To do that, we're joined by Brett Nelson, Head of Tactical Asset Allocation for the Investment Strategy Group, which is part of our Consumer & Wealth Division here at Goldman Sachs. Brett will talk about his views on the current environment for stocks.

Brett, welcome to the program.

Brett Nelson: Thanks for having me.

Jake Siewert: So, Brett, as the economy continues to get a little stronger, interest rates have been rising. And there have been some signs that the stock market might be entering bubble territory. Have we reached a tipping point that might be problematic for stocks?

Brett Nelson: Well, we're definitely not of the view that the market is in a bubble, although, we certainly acknowledge that there are pockets of excess in various parts of the market. But at least in our analysis, we really thought about two ways to analyze the level of bond yields and what level might be problematic for stocks. So, one is to look at the absolute level of bond yields that has caused the markets to kind of struggle in the past. And as a general rule, stocks have typically struggled when the level of the ten-year bond, it's yield exceeded the nominal growth of the economy.

Now, for much of the post World War II period, you had real GDP growth that averaged about 3 percent. And inflation was around 2 percent. So, nominal GDP grew at around 5 percent. And so, when the ten-year bond yield got above 5 percent, that's when you really started to see stocks struggle.

But we know today that real GDP growth is a lot slower. So, maybe today trend, real GDP growth is around 1.5 percent versus 3. And we still have around 2 percent inflation. So, today we think that level of nominal growth or where the ten-year yield would exceed nominal growth is maybe a level at around 3.5 percent. So, that's kind of the level we've been keeping in mind, is that if the ten-year yield were to get up to around 3 or 3.5 percent, it would then be exceeding the level of nominal GDP growth. And we think that's where the market could struggle. Now clearly, you know, where we are today is still quite a long ways from that level.

I think the second approach is to look at yields relative to, you know, bond yields relative to stock earnings yields. And that's what we kind of call the implied equity risk premium. And you can think about this as a proxy for the incremental compensation an investor earns for buying stocks instead of government bonds. Today that level is around 2.9 percent. And that's still attractively high by historical standards. Just to give you a frame of reference, back during the technology bubble in the late 1990s and early 2000s, that implied equity risk premium actually got to negative 2.0 percent. So, negative 2 percent. So, clearly, at a plus 2.9 we're still lightyears away from that, which was a real bubble.

So, our point is that we think that today's implied equity risk premium could really absorb a further backup in bond yields and still provide equity investors with an attractive incremental return. So, for all of those reasons we think that there is still scope for the market to absorb higher rates.

Jake Siewert: So, the investment strategy group, of which you're a part, has long held the view of US preeminence, at least in terms of the markets. And you've urged investors to stay in the market, stay invested. Is that still the case at the levels we've seen today?

Brett Nelson: Yeah. I mean, as we were just talking about the interest rate backdrop, I mean, you can point to all sorts of things, including the ongoing uncertainty of COVID, et cetera. And so, there are clearly no shortage of worries. And we've continued even given that backdrop to recommend that clients stay invested.

And part of the reason for that, and really kind of the anchor reason for that, is that the most important driver for stocks historically has been the economy. And if we think about the growth outlook for this year, we have penciled in a 6.5 percent growth for the US economy. And we think that the odds of a recession are very low at around 10 percent.

So, the reason that's particularly important is that when we've looked back in the past, we've noted that investors have enjoyed about 87 percent odds of a positive one-year return, and a much greater likelihood of large gains than large losses when the economy was in an expansion as it is now. And in fact, if we look back at the historical bear markets, about three quarters of those have occurred during economic recessions. So, again, the advent of a recession is really when you start to see very large losses in the equity market as last year reminded us of that fact. So, we think that given the low odds we're placing on a recession this year, that these investment odds still work in clients' favor to stay the course and remain with their full strategic allocation to equities.

Now, we also know that these gains are not limited to a single year. When we've looked back historically, and perhaps not surprisingly, economic expansions, in general, have been good for stocks. And we've seen over past economic expansions in the post World War II period the average trough to peak gain for equities during those expansions is around 200 percent. So, even though we've had a rally of about 80 percent in the S & P 500 from last year's low, there is still ample scope for further gains based on the historical precedent that I just mentioned.

Jake Siewert: So, the economic recovery after the global financial crisis was pretty anemic, but it was long lived. How does the expansion that we're talking about today, this 6.5 percent growth on the back half of the year particularly, compare with prior ones? And do the conditions support further earnings growth?

Brett Nelson: Yeah, it's a great question. I mean, we know that expansions have been getting longer. The last four expansions lasted nine years. We used to think about expansions as lasting five or six years. And so, clearly, you know, they've been getting a bit longer. And this one is very unique in that we walked into this economic contraction with not a lot of cyclical excesses in the economy. In other words, last year when the pandemic hit, our view was that we had had an elongated cycle. And because it had grown so slow over that period, we hadn't built up the type of cyclical excesses that you typically see, and which typically take a long time to expunge when you end up having a recession.

So, we had this very sharp health related shock in the form of the pandemic. But the economy has been able to bounce back very quickly because we haven't had to work through all of these cyclical excesses. And so that's, you know, in addition to the fiscal stimulus and other measures that we've seen, is part of the reason why we're expecting this very spirited and very sharp recovery. Obviously, we've already seen a good chunk of that in terms of this V-shaped bounce off of the very depressed levels from last year.

Now that, in our view, is very supportive of continued strong earnings growth. And so, as the economy reopens, as we see more widespread vaccinations, we think that the level of S & P 500 earnings is going to continue to rise. And that will provide fundamental support to the market.

So, when we've looked back historically, we've seen that S & P 500 earnings have grown about 7 percent per year in the five years that followed a new high in the level of earnings. And about 10 percent per year during past economic expansions. And we actually think both of those conditions are applicable today.

We also know that there are sizable upside to consensus earnings expectations in the hard-hit S & P 500 sectors that faced significant headwinds from COVID. So, you can think of examples like the financials and the energy sector and the industrial sector. These are all areas which suffered last year. But which we think have a lot of upside to consensus numbers this year. Because in our view, consensus is really continuing to underestimate the operating leverage of these companies. And so, we think as the economy reopens, these companies will continue to surprise in terms of what people are expecting for earnings. And that will, obviously, help support the market going forward as well.

Jake Siewert: So, you mentioned the stimulus. All the packages that have passed so far in the wake of COVID, both under President Trump and now President Biden have not been paid for. They were pure spending or pure stimulus. But now the Biden administration is talking about offsetting the next package, which is focused around infrastructure, with some corporate tax hikes and other tax increases. Would higher taxes be a headwind to stronger earnings growth?

Brett Nelson: I think it's definitely fair to say that higher taxes represent a headwind to earnings growth. When we look at the combination of proposed tax increases, and this is just on the corporate side, under the Biden administration, our work has shown that these could shave about $13 off of consensus earnings, which for next year currently stand at around $203. So, it's obviously a material, potential, decrement to the numbers that are expected.

But we would point out a couple important caveats as we think about the impact and how the market would view this. So, the first is that if you took all of those tax deductions at face value and said, "Okay, we're going to deduct, you know, that $13 from consensus numbers," the resulting $189 of earnings would still represent mid single digit earnings growth from what we expect this year, which is earnings at around $180 or so. So, you already have a potential earnings growth in tow, even with the expected tax increases. And that does not include any offsetting benefits from government infrastructure spending, or any tariff relief were it to come forward.

We also know from speaking to a lot of political experts that they do not believe that all of those tax increases will actually get put through. So, some of them will. Some of them will be watered down. And so, you know, we were deducting the full amount from the conversation we were just having. We think that maybe some watered down version of that ultimately gets passed. And also, any of those increases are likely to be phased in, which would spread the impact over time.

More broadly, we know that just looking at the history of earnings, you know, going all the way back to the early 1900s, it's pretty remarkable that the long-term trend growth in earnings has been fairly stable at around 6 percent. And that's despite dramatically different tax regimes over those various periods of time. So, we know that a change in tax levels will obviously shift earnings in one year or the next. But, ultimately, economic fundamentals, not tax rates, are the key driver of corporate profits. And so, the market tends to look through those shifts at the end of the day.

And so, when we put all of that together, we think that, you know, this would obviously cause some volatility in the market. But ultimately, we don't see it upending our recommendation to stay invested or the broader bull market that we anticipate over the next multi year economic expansion.

Jake Siewert: So, Brett, a lot of reasons for optimism that you've laid out. Talk about valuation levels. A lot of people look at the market and see pretty pretty rich valuations across the board. Why do you think stocks still have room to run as rates are moving a little bit higher?

Brett Nelson: Yeah, so, I think that there's no question that valuations are high. You know, we've highlighted that valuations currently stand in their tenth decile, meaning they've been cheaper about 90 percent of the time historically. So, on an absolute basis, it's absolutely true that stocks are richly priced. But we always have to take into context the macro economic environment in which those valuations exist because at the end of the day they don't exist in isolation. And so, when we've looked at past periods of low and stable inflation, which we've been in since 1996, those periods have historically supported valuations that are about 35 percent higher than just any unconditional period in the post World War II era. And so, we know that we're in an environment where low and stable [PH] inflation supports higher valuations. And then today, the interest rates that we have in this particular instance of low and stable [PH] inflation are considerably lower than what we've seen in those past periods.

So, you know, those past periods were typically associated with ten-year bond yield of around 4 percent. And today, you know, we know that ten-year bond yields are around, you know, 1.7 - 1.8 percent. So, against that backdrop, you'll recall from your finances classes, all else equal a lower discount rate applied to future cash flows increases their present value. And we think that's kind of where the environment we're in today.

And then, you know, earlier we led off the podcast by talking about our view on rising interest rates. And I mentioned there that we often do look at the relative yield between, you know, stocks and bonds. And when we look at that implied equity risk premium or that additional compensation that an investor earns for owning equities today, as I mentioned, that's still an attractive 2.9 percent. Which is high by historical standards. The long-term average is closer to 2 or so when we look at the post 1996 to current average. And so, again, we're still above those levels. And so, we think equities are still reasonably priced given the economic backdrop today.

Jake Siewert: So, historically equities are always a little volatile. And they've been extremely volatile in recent months. One argument you always hear is, "Well, maybe we'll wait for a pullback." Why shouldn't investors just wait for a pullback and a better, more attractive entry point into the market?

Brett Nelson: Yeah, I mean I think it's important to keep in mind that, you know, equities are a volatile asset class. And so, if we just look historically at any one-year period, you've typically had at least one and a half pullbacks of 5 percent or more during the course of the year. And in fact, we've had seven such pullbacks or seven such 5 percent or more pullbacks since the market bottomed last year. And obviously, none of those have upended this new bull market.

I think because of that frequency of pullbacks, investors intuitively have this idea that, well, I know a pullback's coming, so I'll just wait for it and then I'll be able to buy at cheaper prices. But I think the important point to keep in mind is that those pullbacks most frequently actually happen from higher levels. Meaning that the market often first rallies before it pulls back. And so, there's no assurance that even if I told you there's 100 percent probability that we're going to have a 10 percent pull back at some point this year, that doesn't mean you'll actually be able to buy at a cheaper level because the market could first rally 15 percent, then pull back 10 percent. And so, you'd actually be buying at a level 5 percent higher than where we stand today.

And so, for these reasons, you know, we have typically advised clients who are looking to deploy new cash into the market to pick a timeframe, you know, be it three months, six months, nine months, and then allocate your capital into the market in equal installments over that period of time such that you get the benefit of averaging in. And if you do get a pullback during that window, you could accelerate that pace a bit. But again, simply waiting for a pullback which might never come or may come at a higher level we don't think, historically, has been borne out as a good strategy as a way to get invested out the market.

Jake Siewert: Brett, we've been talking in pretty high-level terms about the equity market. Are there particular areas within the market where you're advising clients to be either underweight or overweight?

Brett Nelson: So, as a general philosophy we have a value orientation in the way that we approach the markets. But we think that now is particularly attractive time for value stocks in general. If we think about the last couple of years, we've been in an environment where growth has been very scarce, and we've had falling interest rates. And that's an environment that tends to favor growth stocks in general because when growth is scarce people are willing to pay a premium for organic growth.

And when interest rates are falling, as we talked about earlier, that means that the discount rate that you're applying to future cash flows is going down. And that's going to be mean that these growth stocks which have very high growth rates and a lot of cash flows way out into the distant future, they're going to benefit even more from those falling interest rates.

Well now we're kind of seeing that movie in reverse where we have more plentiful economic growth as the economy reopens. So, that's decreased that premium that people are placing on growth stocks. And you have rising interest rates, which is making the value of those longer duration cash flows that tech stocks and other growth stocks have less valuable. And so, this is an environment in our view, or at least historically, that has been more favorable for value stocks. So, these you could think of as cyclical stocks like in the energy and financial space, which really benefit in the short run from stronger economic growth, are better leveraged to rising interest rates. You think about their financials in particular, they benefit as interest rates increase. And so, then they also have the benefit of being an inflation hedge in investors' minds, which is quite attractive now as people worry about higher rates and higher inflation.

And then, finally, these were areas that were very depressed during COVID. And so, you know, during the COVID pandemic last year. And so, as the economy reopens, we think that they will be disproportionate beneficiaries from that tailwind. And then finally, as I mentioned, these are areas also where analysts are still relatively somber in terms of their expectations for earnings. And we think that these companies are in a position to surprise to the upside.

Jake Siewert: All right, Brett. Thanks for that comprehensive look at the market today. And thanks for joining us on the podcast.

Brett Nelson: Absolutely. My pleasure. Thank you for having me.

Jake Siewert: That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating or a comment.

This podcast was recorded on Monday, March 29th, in the year 2021. Thanks for listening.