Goldman Sachs Exchanges

America Powers On: Why US equities are still poised to outperform in 2024

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Allison Nathan: Despite bearish consensus predictions of the equity market at the start of last year, US stocks powered higher to near record highs in 2023. So, can stocks in the US economy repeat this strong performance in 2024?

Sharmin Mossavar-Rahmani: When people say, do you think this will continue, it depends on whether you're talking about positive returns or if you're talking about this magnitude of returns and this magnitude of US outperforming non-US stocks. And on all of these, our view is we're not going to get these kinds of returns. Our base case for this year for US equities is mid single digit. We're saying about 6 percent for the S&P 500 for example. So,

definitely nothing like what we were expecting last year.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.

[MUSIC INTRO]

Today I have the pleasure of speaking again with my colleague Sharmin Mossavar-Rahmani, who is the head of the Investment Strategy group, or what call ISG within the GS Asset & Wealth Management and the chief investment officer of GS Wealth Management. Sharmin and her team recently published their 16th annual outlook titled "America Powers On," which outlines ISG's investment themes and recommendations for clients for the year ahead.

Sharmin, happy New Year and welcome back to the program.

Sharmin Mossavar-Rahmani: Happy New Year to you too. And thanks for having me.

Allison Nathan: Absolutely. Sharmin, when we last sat down about a year ago, investors, as you might recall, were

very bearish on the outlook for US equities. But you and your team were calling for substantial upside. I think your base case forecast for S&P 500 returns was around 13 percent, if I'm not mistaken. And you had an upside case closer to 30 percent in a good scenario.

So, as we all know, the S&P 500 did have an amazing year. Up 26 percent in 2023. What did you see that others didn't? Why did US equities perform so well despite the many concerns and uncertainties and headwinds that consensus was worried about?

Sharmin Mossavar-Rahmani: When we think of 2023, we need to put it in the context of 2022. So, if you go back and think about the returns in 2022, from high to low we had a drop in the equity markets intraday about 28 percent. So, there was incredible bearishness going into the beginning of 2023 from the market down draft to, if we think about Bloomberg consensus expectations for a recession, it stood at 68 percent. CEOs were bearish. They were all talking about the odds of a recession being very high.

Colleagues in GIR, Global Investment Research, Jan Hatzius and David Mericle actually had a 35 percent

probability. We had a 50 percent probability. And that's not high enough from our perspective to say, oh, a recession is highly likely.

So, while the market still was pricing in a recession, we were not. And when you look at times where you have such big down drafts, just historically, 12 months later, on average, the market is up 23 percent. And 24 months later, the market, on average, is up 32 percent.

So, given that we believe history is a very useful guide, given all the bearishness that existed, we thought, okay, we're going to expect a mid single digit earnings growth. We were expecting GDP of around 1.5 to 2 percent. So, between inflation and GDP, you were having good potential for nominal sales growth. We were not bearish on margins. We thought when you get good sales growth, typically you're going to end up with margin expansion. You put all of that together, and we had a base case for 2023, as you mentioned, of 13 percent for the S&P 500 plus that additional percentage for the upside.

And so, those were the key factors that got us started. And then as we went through the year, one could ask, well,

your base case was 13, why did it end up being off 26? And what happened is, I think, people's probability of recession across the board came down. So, that provided a nice tailwind.

Then you had every quarter earnings ended up being better than where consensus was at the beginning of that quarter. And so, that provided an additional boost. Then we had inflation numbers heading down, so investor confidence improved. And then, of course, later we had the Fed pivot that gave an incredible surge to equities across the board, both in terms of the growth stocks and the rest of the market.

Allison Nathan: So, expectations shifted. And then the data began to shift, and markets were pricing that in. So, the big question on investors minds is, of course, can this outperformance continue in 2024? What do you think?

Sharmin Mossavar-Rahmani: It's a very interesting question. And when people say, do you think this will continue, it depends on whether you're talking about positive returns or if you're talking about this magnitude of returns and this magnitude of US outperforming non-US

stocks. And on all of these, our view is we're not going to get these kinds of returns.

Our base case for this year for US equities is mid single digit. We're saying about 6 percent for the S&P 500 for example. So, definitely nothing like what we were expecting last year.

And our good case is sort of low teens, low to mid teens. And so, even then we're not looking at anything like we experienced in 2023.

Allison Nathan: Because we're already starting at such a high level, of course. And a lot of the positive expectations are now priced in.

Sharmin Mossavar-Rahmani: Exactly. And we're one of the few that actually thinks we're going to get a bit of multiple contraction. There's no doubt equities are expensive. We actually, in the report, talk about lofty levels. When you're looking at a series of metrics, equities are in the tenth decile evaluation, meaning they were cheaper 90 percent of the time in their history for the S&P 500. And so, when you look at that mix, basically you're saying how can

you actually bet on continued multiple expansion?

So, for us, the key driver is earnings. And we have a little bit of, actually, multiple contraction in our base case.

Allison Nathan: A lot of clients, investors, do seem to grab onto that valuation argument as, perhaps, a reason to, even if we see relatively solid fundamentals this year, even if we see some upside, maybe it's time to pair back US positions a bit. Think a bit more about non-US equity positions. Do you think there's any validity to that view and that argument?

Sharmin Mossavar-Rahmani: So, there are two points that you just raised. One is valuations. Do they matter on a short-term basis? And the reality is valuations actually do not explain much of the returns for the next 12 months. So, the fact that valuations are in the tenth decile tells you a little bit about returns. But not that much. Other factors will become much more important, such as the earnings. Such as flow of funds. Such as inflation, interest rate views, what's the discount rate people want to use? So, valuation alone is never a good reason for either going overweight or underweight, unless it's extreme, meaning

extremely cheap equities, for example, would prompt an overweight from us.

Then the next question becomes what about valuations of US equities versus non-US equities? So, as you said, clients are asking that question. Is this time to tactically shift away from US equities into non-US equities, both developed and emerging markets?

In fact, when you look at the numbers, our base case, for example for US equities at six, our all-country world index number is higher. So, when we're looking at returns there, we're looking at, for example let's say Japan, non-US developed. The highest numbers we have are around 8 percent. So, clearly outperforming. But we actually are not recommending clients necessarily switch to those areas and regions.

When we look at valuations, they do look very cheap in those areas, in these different countries and regions. But we tell clients they need to make a major adjustment. You need to adjust these indexes for their sector weights. And we compare and contrast UK equities to US equities, about 30 percent, well, 29 percent of earnings for the S&P come

from the technology sector. If you look at that for UK equities, it's 1 percent. Well, if the technology sector trades at a market multiple of around 27 and energy trades at a market multiple of 11, any index that has a lot more energy like the UK market and a lot less earnings will look cheaper. But that's not because they're absolutely cheaper. It's because they have a bigger allocation to cheaper sectors.

Once you make that adjustment in all these market benchmarks, non-US equities are not as cheap as they appear. In fact, in some parts, in some countries, in some regions if you look at Eurozone, etcetera, in aggregate, in some of them, the valuations increase substantially.

So, first of all, we tell clients they need to think about that. And second, generally the US trades at a premium to all these other places. So, you need to look at the discount relative to history. And it is a little cheap, but not cheap enough to make up for all the other issues.

So, for example, we have US growth at about trend. But we don't have Eurozone or the UK at trend. We have well below trend. And so, we need to be very cautious given the

uncertainty in some of these areas. They could slip into recession.

Allison Nathan: Is that also the case for emerging markets and, I would say, China in particular? Of course, people are focused on China because it does look very cheap. What are your views in terms of clients taking positions in some of those emerging market areas or China?

Sharmin Mossavar-Rahmani: That's an excellent question because when you look across the board, China is, by far, the cheapest market among major markets, major economies. By far. And so, clients are asking the question, shouldn't we be investing there?

So, first, obviously, make that adjustment for the sector. Weight differentials. But even when you make that adjustment, it's still one of the cheapest markets.

And we actually make a case that clients should not invest and not tactically go out of US equities or developed market equities into China. And there are a few reasons. If we look at GDP growth, prior to COVID, the average ten-year

number was 7.7 percent. Our view is going forward for the next ten years, the average GDP is going to be 3.4 percent a year. That's a big downward shift. And continuing on a downward trend till they get to about 2.5 percent. So, in general, GDP is a headwind to earnings growth.

Then you have other uncertainties such as the derisking from Europe and the US towards China. And China also has its own, quote/unquote, "derisking" towards the rest of the world in terms of domestic focus that they have. So, you have those factors.

Then you have regulatory uncertainty about what sector of the market they could suddenly focus on. We know they focused on the technology sector multiple times. And that's driven down the market significantly. We know they focused on the education sector. And so, one never quite knows what the focus could be.

Allison Nathan: So, what I'm hearing from you is stay overweight US equities. But that's the theme you've had for quite some time. I mean, I think it's about 14 years. Talk us through why that theme has had so much endurance.

Sharmin Mossavar-Rahmani: We've actually had two investment themes now for a very long time, as you point out. One is US preeminence. And the other is stay invested.

So, the US permanence theme that we've had for so long is actually something we had from a strategic asset allocation perspective in our recommendations to clients even earlier. But the theme of emphasizing US permanence relative to others really came around during the global financial crisis when everybody was saying this century belongs to China. And the American century is over. And so, the 20th century was that of the United States. The 21st century belongs to China. And we wanted to make a very strong point that that is totally mistaken. And the 21st century still belongs to the United States.

And so, we did a lot of research to say what are the agreements for that? First and foremost, when you're looking at the size of this economy, the wealth of this economy-- and these are factors that endure. So, in fact, if you look at even a year like 2023 and you look at the GDP increase, you look at the GDP per capita increase, because the US starts on such a high base, even smaller incremental returns in absolute dollars just widens the gap

between the US and other parts of the world. So, other countries just cannot compete. They cannot get there with the same level of wealth and GDP per capita.

Then you look at the incredible natural resources of this country, whether it's you're talking about arable land, whether you're talking about oil and gas, whether you're talking about water, it's just incredible. And there are not many countries in the world that can say they have such vast resources across so many different areas. So, it's in the energy sector. It's in the agricultural commodities. It's in metals and mining. So, it's across the board. And these are factors that endure. They don't just disappear overnight. So, that theme is going to be very long tailed. It's going to last a long time because it doesn't look like anybody's going to be able to catch up.

Then you overlay that with incredible labor productivity. People are surprised to hear that the US labor force is the most productive in the world. You add to that corporate management. The quality of corporate management by third party research academic work shows that it is the highest ranked in the world. And so, you put all of that together and there's incredible earnings generation power

here. And so, that's why the US permanence theme, you just look at the innovation. You look at the respect for property rights. You look at rule of law. All of those factors support it.

The US spends the highest dollar amount on R&D. That, again, supports innovation. You have great capital markets that provide liquidity and funding sources for innovation. So, it's all of these factors coming together for the US preeminence theme.

And then the stay invested theme to our clients for US equities is that if you look at this earnings power, generally, it's on an upward trend. Prices follow. So, you have that upward trend in S&P 500 prices as well. So, there has to be a very high hurdle to go underweight equities. And the hurdle has to be either, you know, something that the market doesn't know and hasn't priced in. But that rarely the case.

So, think about 2022. The market quickly priced at a recession. And we actually didn't even have a recession. So, going underweight has a very high hurdle for us. And that's why we focus on these two investment themes.

Allison Nathan: So, you mentioned you have a mid single digit return expectation for US equities. Walk us through some of your expectations for other assets and what the implications are for general portfolio allocation recommendations that you have today.

Sharmin Mossavar-Rahmani: So, we said US at six. Big picture, MSCI, all country world index at seven. And then some of these other places are at eight to make the average seven. For bonds, we typically have 4 to 5 percent returns. Just a tad lower than equities. And then for cash, about 5 percent.

We're saying there's not enough of a difference there for clients to actually move assets around between the various asset classes, especially for taxable investors. So, if you have taxable investors in the US, they have huge capital gain if they own equities. To actually get out of US equities to lock in some of those gains and to go into, for example, bonds or cash, they're going to have a huge tax burden. So, if they, for example, had invested some of these equity assets during COVID, their capital appreciation is huge.

And to break even with the taxes that they have to pay, the equity market has to go down 20 percent if you're a New York or a California resident. So, we're telling clients to stay invested and do not switch around.

Allison Nathan: Interesting. Okay. And so, we talked a lot about valuation. Is there an asset that does look very cheap and compelling in your view?

Sharmin Mossavar-Rahmani: When we look at US sectors, there are no obvious sectors that jump out to us in meaningful sectors, big sectors where we'd want to overweight or underweight. And that actually includes the technology sector. It is marginally more expensive, maybe 20 percent more expensive than its long-term historical average. But that's not an argument for actually going underweight. We need a much bigger dislocation in sectors for an overweight or underweight.

There's one sub-sector we would say in the energy market that we like. And that's master limited partnerships in the infrastructure space. And we've had that tactical tilt, we call it a tactical tilt, actually since 2015. Usually, our tactical asset allocation ideas last about a year, some

shorter, some longer. But this has been a very longstanding one. We like the yield. We like the distribution yield.

And for taxable investors like US investors, it's tax advantaged. So, we actually think it has an attractive risk return profile. And it's tax advantaged. So, within sub-sectors, that's a tactical tilt we've had on that we're going to keep.

In terms of other recommendations to clients, we're saying be at your duration target. Do not be underweight duration, whether it's in the ten year, whether it's in UK deals, whether it's in European bonds we recommend clients be at their full duration.

And then at the margin there are a couple of small tactical tilts. And one big theme that we've had is uranium. We're actually being long physical uranium saying that there is going to be a shortage relative to the increase in demand that is coming from China building more nuclear plants, Japan restarting some of their nuclear plants. And people are recognizing that you need a transition energy source. And it's nuclear and natural gas to get you to better

renewables. And people can't avoid that.

And because of the whole sentiment around ESG, that had been a neglected area. And that's why there was incredible appreciation in uranium last year. And we think there's more to go. And that's a tactical tilt we've had on now as well.

Allison Nathan: How do you go long uranium?

Sharmin Mossavar-Rahmani: Yeah, it's actually not that easy. It's not as if you can go buy uranium on the spot market, a futures contract, etcetera. There's actually a physical structure where you actually physically own it and it's stored elsewhere.

Allison Nathan: Interesting. Okay. Let's talk a bit about risks to the outlook. What are you most concerned or focused on for 2024? What could be the headwinds that derail your relatively optimistic expectations?

Sharmin Mossavar-Rahmani: In our report, our outlook "America Powers On," we list all the risks to our economic and financial market outlook. And from our perspective,

the highest one, the top risk is escalation of the Israel/Hamas war. Obviously, it has escalated over the course of the few months since October 7th, and we've seen some regional involvement. But it seemed contained until most recently where you've had strikes on the Houthis. And so, the question is does it escalate further from here? Or is there enough incentive where both the US and Iran, more than any other country, do not want to see further escalation?

And so, if they actually can hold back, like if the Iranians can hold back and not encourage any activities, then we stay as we are. But on the other hand, if there's any escalation, more escalation from Hezbollah and Israel in the northern border, more escalation with the Houthis, do the Houthis strike at anybody else in the Middle East? Will Iran get involved? The risks are not small. And we think that's probably going to be the one that would have the biggest impact on our outlook and on GDP growth, on risk premium in equities, on oil prices. Even if there's no real disruption, oil prices could go up. So, so far, we haven't seen much, even with the Houthi strike. But certainly, something to keep an eye on. Our view is the Ukraine/Russia war is more of a stalemate.

Allison Nathan: Sharmin, let me end with what is always my favorite question, which has to do with how you choose the image that appears on the front of your report. This year's cover is a beautiful, I would say, illustration of a classic Cadillac with a US license plate on the wide-open road. So, first of all, let me ask you, where did you get that image? Because I honestly think it's a piece of art. But beyond that, how did you choose it and what did you hope to convey?

Sharmin Mossavar-Rahmani: I have to say, I really appreciate what you said because we do spend a lot of time on what the cover should look like. This is actually an artist that we work with. And we give this artist an idea of what we want. And then we iterate multiple times going back and forth till we get the right image that's in our head on paper.

The message of "America Powers On" is one we want to have a powerful car. And so, you have this Cadillac, as you say, and you think about it as a powerful car. Second, these cars were designed at a time where US was building big, powerful cars ahead of everybody else. So, that's one

image that we want to convey.

The second image, as you said, is this vast expansive country that we're looking at. Huge spaces. Big roads. Big mountains. Big desserts. And we're trying to convey the vast expanse of the US because if you think about the US, one of the things we mention in the report is the incredible diversification of the sources of earnings.

If you think about this country, highest GDP per capita of any major country. Highest GDP in aggregate. Largest capital markets in the world by a huge factor. Then you think about the most arable land in the world. So, the biggest exporter of agricultural commodities. Largest producer of oil and natural gas liquids. Now the largest exporter of liquefied natural gas. It's just amazing. So, we want to convey all of that in that image. And that was the point.

And then, obviously, USA and no cars in the neighborhood. So, it's a leader. Nobody ahead. And nobody in the rear-view mirror. And so, that was the purpose.

Allison Nathan: Amazing. Thank you so much for joining

us again, Sharmin. It's always a pleasure.

Sharmin Mossavar-Rahmani: Thanks for having me, I really appreciate it.

Allison Nathan: Thanks for joining us for another episode of Goldman Sachs Exchanges, recorded on Friday, January 12th, 2024.

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