

Goldman Sachs Exchanges

Why global equities are poised for “fat and flat” returns

Peter Oppenheimer, Chief Global Equity Strategist,

Head of Macro Research in Europe, Goldman Sachs

Research

Allison Nathan, Senior Strategist, Goldman Sachs

Research

Date of recording: June 27, 2023

Allison Nathan: Equity markets have performed relatively well in the first half of the year, but can this performance last?

Peter Oppenheimer: Because we have high valuations, particularly in the US equity market, and we've got relatively low profit growth and we have an alternative in pretty attractive cash rates, or interest rates, we think that the index prospects remain relatively flat from here.

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

Joining me to discuss the recent equity market performance and what to expect from here is my colleague

in Goldman Sachs Research, Peter Oppenheimer, who's our chief global equity strategist and head of macro research in Europe. Peter, welcome back to the program.

Peter Oppenheimer: Thank you so much, Allison. It's great to be here.

Allison Nathan: So Peter, just to start us off, give us an update on equity performance year to date.

Peter Oppenheimer: Yes. It's an interesting year so far because it really does depend a little bit on what you're measuring. If you look at most equity markets, they've made progress. But even in the US, for example, the Dow Jones Index, which is equally weighted and represents the broad economy, is flat. There's been no change at all. If you look at the S&P, it's up about 13%. And if you look at the NASDAQ, which of course is very heavily focused on technology, it's up about 28%.

Other markets have also done quite well, but it has depended again on what you've been focused on. The European market in dollar terms is up about 16%, so a little bit ahead of the S&P. Japan, which has been a success story, we've been overweight there, is up about 25% in local currency terms. But when you convert that back into dollars, it's also about 13%, so similar to the S&P.

So I would say, broadly, we've had a good year to date, but it is also worth emphasizing that, if you look at the last year, the last 12 months, there's been less progress. For example, the S&P is pretty much the same level today as it

was in the summer of last year. There was a full backer's [?]. Investors really worried about rising inflation and interest rates, and some of that tension and fear has eased in recent months, which has helped equities to make progress.

I think it's also worth noting that, in the last few weeks in particular, volatility has come down in equity markets, and that really reflects a sense that some of the worst tail risks have been moderating. So things like the US debt ceiling has passed without problem. Concerns about the US regional banks, for example, have faded a little bit. And also concerns about high energy costs in Europe.

Allison Nathan: So if you think back to 2022 and the last time we had you on this podcast, there was a lot of discussion about interest rates driving equity markets. That seems to be, as you just mentioned, coming a bit to an end, as many of the major central banks move towards ending their hiking cycles. What do you foresee as the main drivers of equity returns ahead?

Peter Oppenheimer: I think when we last spoke or certainly our focus over the last year or more has been on

rising interest rates because it's important to really take a moment to think about the perspective, where we came from. In the decade or so after the financial crisis, interest rates in most countries fell to zero or even, in Europe, below zero. Just two years ago, about a quarter of all government debt around the world had a negative yield. Investors were actually paying for the privilege of lending money to governments.

Now, interest rates by long-term historic standards are still quite low, but the speed of the rise that we see since that trough is one of the fastest in many, many decades. And so really, the key driver of both bond markets, credit markets, and equities over the last year and a half has been that rise in interest rates, and that's really what's kept overall returns and valuations somewhat lower.

Now, as you rightly say, we're getting closer to the end of that cycle. We don't think we're there yet, by the way. We think interest rates have a little further to rise. Perhaps a quarter of a point or so in the US. A little bit more than that across Europe. But they won't likely start to fall until perhaps the second quarter of next year, so we have some way to go yet. But ultimately, when we look at equities,

aside from moves in interest rates, which obviously reflects the discount rate and the cost of capital, growth is really the central driver. And this year, we've seen very little in the way of underlying profit growth. What's going to be crucial really as the driver moving forwards is expectations about whether we can avoid recession and what kind of economic and profit recovery we'll see over the next one or two years. And I think that will be increasingly the focus of investors in the second half of the year.

Allison Nathan: With that backdrop in mind, I just want to go back to a point that you had made about the extraordinary leadership of a small segment of the US market, tech stocks in particular. As you mentioned, NASDAQ has performed quite extraordinarily, but much has been made about the narrow characteristic of this rally. Talk to us a little bit about what that narrow leadership really means as you think about returns ahead.

Peter Oppenheimer: Yes, again, it's worth perhaps spending a moment really digging into some of the data here. If we take the US equity market, in the S&P, the main index of 500 largest companies, 85% of the return in the index this year so far has come from the biggest 15

companies, which is pretty extraordinary. So those 15 very large companies, many of them technology companies, have, on average, gone up about 35%. So fantastic return.

The median company is pretty much flat on the year. So massive difference. When we look at other equity markets, the narrowness of breadth or leadership has not been quite as extreme. So actually the median company, the average company, if you like, has done a little bit better in other markets, particularly in Europe and Japan. But again, there have been very big differences, depending on what companies you look at. And that has been, again, one of our themes, that increased dispersion within the index or a greater focus on what we call alpha rather than beta. So idiosyncratic risk rather than indexed directional risk has really been very important.

Now, when you look historically, of course there have been other periods of very narrow leadership as well. This is not the first we've seen. If we go back to the 1980s, for example, a look at the nine or ten previous occasions when you've seen this characteristic, generally speaking, equities do make further progress over the next 12 months or so. And the way that happens is that the returns start to

broaden out. In other words, that leadership starts to fade, and you get generally other parts of the market picking up a little bit in relative terms. And that's what we would hope to see happening, which is why we think that there are some opportunities outside of that very narrow leadership space, particularly in the technology sector.

Allison Nathan: So you believe that the recent rally could broaden out, but are we really at the start of a new leg of the US exceptionalism, given that a lot of these narrow leadership has been led by the generative AI focus, where there's a lot of investor enthusiasm? And do you see that extending a period of US outperformance in terms of equities?

Peter Oppenheimer: Well, I think the US certainly has some great advantages in its focus and leadership in the AI space, particularly at the moment. However, if you look at the period of significant US equity outperformance, which really dominated the decade or so after the financial crisis, it really was a combination of the success of US technology companies but also the fact that US corporate profits overall hugely outgrew that that we were seeing in other markets.

So to give you an example in that 10-year period, S&P profits overall grew more than 90%. At the same time, overall, they grew around 5% in Europe and a little bit more than that in Asia. Now, one of the reasons why these other markets saw very little profit growth over that decade is that economic activity was weak, they didn't have much exposure in the fast-growing technology companies, and, in Europe's case in particular, they did have a lot of exposure in areas that were suffering greatly after the financial crisis. Things like commodity, areas of the market where commodity prices were falling or indeed banks which were suffering from deleveraging.

Now, as we look at the last couple of years actually, that difference in underlying fundamental profit growth between the US and other regions has faded. In fact, over the last couple of years, overall, European profits have actually outgrown those in Europe in the US a little bit. That being said, I do think that US technology companies are still going to remain very dominant and will be an important part of the US market. But I do think it would be wrong to believe that this potentially very transformative area of technology will see all the benefits residing purely in a

small number of existing US technology companies.

The reasons for this are two fold. Firstly, as these technologies develop, just as we saw with the Internet, some of the big beneficiaries will probably be in companies that don't yet even exist as the technology generates new opportunities for new entrants. But also, with AI in particular, as our economists argue, we do believe that it has the opportunity of really raising productivity across economies. But to do that, some of the big winners will actually be in non-technology companies. Companies that are embracing AI to improve efficiencies and improve costs. And not all of those, of course, will be in the US.

So I think, again, the focus for us as we move forwards in time is to be more diversified geographically, more diversified by industry, and really look at the opportunities at a stop-by-stop level because there will be some great growth prospects moving forwards. Many of it will emanate from the opportunities of new technologies, but it won't all reside I think in the technology space itself.

Allison Nathan: And as you said, a lot of this will depend on the profitability of these companies, so talk to us a little

bit more about your expectation for profits across regions.

Peter Oppenheimer: Yeah. Well, actually, as I said earlier, this year has not been a good year for profit growth. Equity markets have made progress, so a lot of that progress, again, has actually been through valuations going up. In other words, people paying more for companies with about the same level of profitability. If we look across the major markets, the US for example, overall corporate profit growth is pretty flat this year, and we think it will rise for the whole market on average about 5% next year. About the same in Europe. We're expecting a bit more than that in Japan, as you get the benefits of some restructuring coming through and better growth finally in the economy after many years of relative stagnation. And in Asia, a bit stronger growth as well, albeit coming from a lower base.

So I think the broader picture to be thinking about here is a process of somewhat improving profitability but at a relatively modest pace. And one of the key reasons for this is that, although revenues are holding up quite well in line with economies which are continuing to grow and we do believe that we'll avoid recessions, at the same time, we are

seeing some squeezing of margins for the corporate sector. And that reflects I think two things. Firstly, that you have seen higher input costs of course for many companies -- energy prices and wages as well, which is starting to squeeze the margins that they are enjoying and keeping profit growth positive but a little bit more modest than we've seen in previous recent years.

Allison Nathan: So we don't expect substantial profit growth. What about valuation? Is there any scope for multiple expansion ahead?

Peter Oppenheimer: I think it's unlikely that, for the big indexes, we'll see much in the way of valuations going up from here. If, again, we look at the US, the biggest and most important equity market is now trading at a PE ratio, or price earnings ratio, of about 19 times. That's well above actually the 20-year average that we've seen, so it is quite expensive. And on other valuation metrics we look at, it's quite expensive as well.

Now, again, it's important to emphasize that that partly reflects a narrow part of the market that has seen particularly significant increases in valuation around

technology, for example, where people believe the growth will come. But overall, we don't really think that valuations will rise very much.

Now, we have argued over the last year that valuations in some other markets do have prospects to improve because they've been at a much lower level. If you look at Japan and Europe, for example, their equivalent price earnings ratios are around 12 or 13 times. Now, we don't expect them to rise to the levels that we're seeing in the US, but we do think that they have the opportunity of picking up a little bit, which again really makes the argument not so much for other markets outperforming the US but for investors to look at a more diversified approach to investment, perhaps with a greater spread across different regions.

Allison Nathan: And if we take a step back, you've done a lot of work on market cycles and where we are in the market cycle, and that tends to be one of the biggest questions we have today, given the economic uncertainty. And you have determined that we are entering into a period of fat and flat returns. So give us a little bit more context about what you mean by that and where we are in this

market cycle.

Peter Oppenheimer: Absolutely. I think it's worth saying that, in the way that we look at things, there are cycles which tend to repeat themselves and there are kind of broader trends of returns that markets tend to go through. So if we stick, firstly, with cycles, what do we mean by that? Well, if we look at the history of equity markets, you do tend to get repeating patterns around business cycles or periods of expansion or contraction, recessions and booms.

And broadly, we think that equity cycles are split into four distinct phases. There's a bear market phase usually around a recession or what we call despair. And then there's the beginning of a new growth cycle that we call hope. And the reason we call it hope is because that's the period where investors start to anticipate a new recovery. It tends to be the shortest but strongest phase of the cycle with valuations going up a lot. And that's really what we saw following the pandemic through 2021. Very strong market returns indeed.

Typically, this is followed by the longest phase, what we call the growth phase, where profits actually do start to

recover and grow and dividends improve. And that period tends to be associated with rising equity prices but at a slower rate and valuations start to come down again.

That's really what we were seeing through much of last year. I think from the end of last year and through the beginning of this year, we've entered a bit more of what we call the optimism phase. Sort of later cycle as valuations start to go up again despite perhaps rising interest rates.

So we think we're in that sort of later phase of a typical cycle. Now, the fat and flat idea really comes from the context of some of these cycles having lower average returns with a wider trading range. And that's really a description of what we've seen in the last year. Most equity markets haven't made a lot of progress at the index level, but we have seen quite big moves upwards and downwards as investors have moved from fear of recession and rising inflation to hopes that those risks are moderating.

Because we have high valuations, particularly in the US equity market, and we've got relatively low profit growth and we have an alternative in pretty attractive cash rates, or interest rates, we think that the index prospects remain relatively flat from here. And we've just reasserted that in a

piece that we've put out called "Fat and Flat Strikes Back," this idea that, having seen some real optimism in the last few weeks building up, particularly with a focus on the narrow part of the market that's seemed to benefit most from AI, we're starting to see slower returns coming through again.

Now, that doesn't mean to say that equities can't make progress; we think they will. But not nearly the kind of progress on average that we were seeing, for example, in the decade after the financial crisis when they were recovering from a very low base, when interest rates fell to zero, and valuations expanded very dramatically.

Now, over the medium term, we think that investors can get good returns in equities but probably not as good as we've seen in the last decade or two. And some of the longer term structural changes that we're seeing may well contribute to those lower returns. So for example, interest rates being at a higher level than we've seen in the last perhaps 20 years, that means less room for valuations to go up. Being in a period where commodity markets and labor markets are tighter. So higher input costs, lower margins. And also the implications of things like

regionalization, less globalization than we've perhaps been used to. There are some positives that will accrue from these geopolitical shifts, but obviously supply chains become less global, a little bit more local, you're seeing rebuilding of these sorts of supply chains which will probably mean somewhat higher costs.

So I think if we take a lot of these things together, we're probably looking at a flatter index environment over time, but one in which a focus on particular opportunities within markets and more diversification and perhaps a longer time horizon to reap the benefits of compounding returns should really be the focus of investors.

Allison Nathan: And given the higher yields on cash and bonds in the market today, you've broadly noted a shift in the overall investing environment from one of TINA, There Is No Alternative, to TARA, There Are Reasonable Alternatives. What are some of the implications of that shift?

Peter Oppenheimer: Well, again, Allison, I think this comes back a little bit to the point about diversification. Generally speaking, in the decade or so after the financial

crisis, diversification didn't really pay off for investors. Theoretically, it should. If you diversify geographically or across asset classes or industries, you should get a better risk-adjusted return. It didn't work for a long time, partly because the US considerably outgrew other markets. But also because interest rates were pretty much at zero, it forced investors to really focus increasingly on risky assets like equities.

Now, we're in a world where there is an alternative to risk assets, as you said. You know, the world's risk-free asset class, if you like. US dollar cash is yielding 5% or more. And that is an attractive thing to have in a portfolio, perhaps with some bonds which are also yielding much more than they were, as well as equities. So again, I think it suggests that more diversification across asset classes should start to pay off. And indeed, more diversification across regions as well as across different sectors. So I think that's probably the main implication of having higher interest rates that are attracting people to save more and to get a sort of risk-free return for the first time for a very long time.

Allison Nathan: So what are you watching that would

leave you more positive on equity returns and even less so?

Peter Oppenheimer: Well, I think the next big focus in a positive way is that, in our view, we will avoid recession in this downturn. Many investors have worried there would be recessions, and we think that's not likely. And that itself should be a positive.

But also, I think that we'll be moving towards an environment, as you said, Allison, where interest rates, having gone up quite sharply in the last 18 months, reaching a peak. We'll still have to wait I think a while before they start to come down. But as that begins to happen, hopefully through next year, that could be a positive catalyst for all financial assets because all financial markets are impacted by the cost of capital of the level of interest rates.

On the negative side, we should be aware that there are obviously risks, some that are known about and others less so. The regional banking problem in the US is not resolved. The risks have moderated, but there are also concerns about things like commercial real estate and adjustments in prices there as a reflection of these higher

interest rates. There is also the prospect potentially of things like energy and gas prices rising again, particularly in Europe as we move into the winter. All of these things could bring back into focus at least the risk of weaker growth, even if that is not the central path.

So I think, because there are obvious downside risks to our central view but there are potential positive tailwinds that we think investors may benefit from next year, again, I think being invested and being diversified to reduce risks is probably the best approach as we tackle these various different crosscurrents over the coming months.

Allison Nathan: Thanks very much, Peter.

Peter Oppenheimer: Thank you, Allison.

Allison Nathan: And before you go, we'd like to introduce a new podcast from Goldman Sachs Exchanges. It's called "The Markets." Each week, in just 10 minutes or less, we'll be breaking down the key issues moving markets that week, giving you the information you need to stay ahead. Search for "The Markets" and follow wherever you get your podcasts.

Thanks for listening to another episode of Goldman Sachs Exchanges, recorded on Tuesday, June 27th, 2023. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

This podcast should not be copied, distributed, published or reproduced, in whole or in part. The information contained in this recording was obtained from publicly available sources, has not been independently verified by Goldman Sachs, may not be current, and Goldman Sachs has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of recording. This podcast is not a product of Goldman Sachs Global Investment Research and the information contained in this podcast is not financial research. The views and opinions expressed in this podcast are not necessarily those of Goldman Sachs and may differ from the views and opinions of other departments or divisions of Goldman Sachs and its affiliates. Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this podcast. The information contained in this podcast does not constitute investment advice or an offer to buy or sell securities from any Goldman Sachs entity to the listener and should not be relied upon to evaluate any potential transaction. In addition, the receipt of this podcast by any listener is not to be taken to constitute such person a client of any Goldman Sachs entity. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this podcast

and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. This transcript should not be copied, distributed, published, or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this transcript and any liability therefor (including in respect of direct, indirect, or consequential loss or damage) are expressly disclaimed. The views expressed in this transcript are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this transcript. In addition, the receipt of this transcript by any recipient is not to be taken as constituting the giving of investment advice by Goldman Sachs to that recipient, nor to constitute such person a client of any Goldman Sachs entity. This transcript is provided in conjunction with the associated video/audio content for convenience. The content of this transcript may differ from the associated video/audio, please consult the original content as the definitive source. Goldman Sachs is not responsible for any errors in the transcript.