# FREQUENTLY ASKED QUESTIONS

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*The equity bull market that began one year ago will reach its apex with the end of the economic expansion cycle and onset of the next recession. Stock prices tend to peak within a range of three to six months prior to recessions. While exact timing is impossible to predict now, investors can and should begin to contemplate the specific economic and policy conditions that could bring the bull market to an end. By a wide margin, the most important independent variable with respect to the equity market cycle is the future path of inflation and the conduct of monetary policy.*

## Summary and Major Conclusions:

- The current investment cycle that began in March of last year is less synchronized compared with all previous cycles. The equity market has been more anticipatory as investors have front-run the good economic news expected over the next two years.
- The practical effect is that prospective equity market returns this year will likely lag the positive economic data and profit data expected in coming months, insofar as future returns have already been pulled forward, as investors have borrowed from the future.
- A major shift in global equity market leadership appears likely over the next two years. Non-US stocks should outperform those of the US consistent with faster growth of international companies relative to those in the US.
- The S&P 500 is a defensive equity index because it is dominated by shares of predictable high-quality growth and rapid-growth technology companies. Conversely, stock indexes in Europe, Japan, and emerging markets are dominated by stocks in economically sensitive sectors.
- During periods of rapid world economic growth — as is expected this year and in 2022 — earnings in cyclical stocks tend to outperform stable growth and defensive sectors. The positive economic outlook will bias global investors toward more risky assets with more favorable cyclical growth prospects.
- The extent to which rising bond yields impact stock prices is predicated upon the absolute level of bond yields, the pace of rate increases, and the direction of corporate earnings. Stock prices and bond yields can rise simultaneously in an environment of rapid earnings growth and moderate rate increases.
- The extremely favorable fundamentals of the housing market are inconsistent with the notion of a classic asset bubble. Asset bubbles occur when the price of an asset greatly exceeds its economic or intrinsic value. House prices are rising rapidly because of a fundamental shortfall in supply relative to demand.
- At a current level of only one million, the number of existing homes for sale is at an all-time low and represents only two months' supply at the current selling rate. This compares with a long-term average of 5.5 months. Prices will continue to rise until the supply of homes for sale equates to demand.

- The US labor market has been significantly affected by the pandemic, both in the short and long term. In the short term, there has been considerable shrinkage in the workforce, as many jobs have been permanently eliminated and long-term unemployment has risen.

- The manner in which work is performed has changed forever. Even after the population reaches herd immunity and the economy has fully reopened, many employees will continue to work remotely. The work-from-anywhere employment model could persist for many years.

- The major impact on employment involves a greater availability of technology, automation, and robotics for workers. Digitization of the workforce was already under way prior to the pandemic but has rapidly accelerated. The result is a striking bifurcation of the US labor force between skilled and semi-skilled workers.

- There has also been a massive widening of the gap in wage rates among workers, based upon education and skill levels. This wage gap can be remedied only by large education and job-training programs implemented by both the public and private sectors. Transformation of the labor force resulting from these various trends should result in a notable increase in productivity.

- The equity bull market that began one year ago will reach its apex with the end of the economic expansion cycle and onset of the next recession. Stock prices tend to peak within a range of three to six months prior to recessions.

- By a wide margin, the most important independent variable with respect to the equity market is the future path of inflation. In theory, the equity bull market could persist for many years in an environment of a sustained trend of 2% inflation.

- Conversely, a steady rise in inflation to a range of 3% to 5% would be a significant negative because it would trigger a severe tightening in monetary conditions by the Federal Reserve.

This week's *Economic Perspective* addresses questions regarding the outlook for economic growth, labor markets, residential construction, corporate debt, long-term interest rates, and international equity markets.

## WHAT IS THE PRIMARY DIFFERENCE BETWEEN THE CURRENT INVESTMENT CYCLE AND PREVIOUS CYCLES?

Historically, the classic investment cycle has been roughly synchronous with the classic business cycle, with a six-month lead time. *The current investment cycle that began in March of last year is less synchronized in that lead times between financial markets and the economy are far greater*. The equity market has been far more anticipatory than in all previous cycles, as investors have front-run the good economic news expected over the next two years.

The practical effect is that prospective equity market returns this year will likely lag the very positive economic and profit data expected in coming months, insofar as the favorable outlook is already substantially discounted in current prices. In other words, *returns have been pulled forward, as investors have borrowed from the future*. Statistically, the implication is that *equity price appreciation could lag earnings growth by a very large margin over the next two years*.

## COULD YOU EXPLAIN THE RATIONALE BEHIND YOUR EXPECTED SHIFT IN EQUITY MARKET LEADERSHIP FROM THE US TO NON-US MARKETS?

There are several factors to consider. First, equity market leadership is normally based upon *relative earnings growth*. US stocks have outperformed non-US stocks over the past decade because earnings of US companies have outperformed those of non-US companies. The sole exception during the past decade was 2017, when the global stock index (+25%) outperformed the S&P 500 (+22%), owing to superior economic and profit growth in non-US companies.

A major role reversal is likely over the next two years, whereby earnings of international companies should outperform those of the US. The primary consideration is the composition of the various stock indexes. The S&P 500 Index is defensive in nature, dominated by consistent growth and technology stocks. Conversely, stock indexes in Europe, Japan, and emerging markets are dominated by cyclical stocks, primarily in the financial, capital goods, and manufacturing sectors. During periods of rapid global economic growth — as is expected this year and in 2022 — company earnings in economically sensitive sectors tend to outperform stable growth and defensive sectors.

## HOW VULNERABLE IS THE EQUITY BULL MARKET TO A RISING TREND IN GOVERNMENT BOND YIELDS?

It seems virtually inevitable that long-term rates will remain in a rising trend over the next two years, at a minimum. Rising bond yields are a negative for stocks because they offer higher expected returns and therefore competition for stocks in multi-asset global portfolios. A rising trend in long-term interest rates also exerts downward pressure on valuations for common stocks. Therefore, equity investors must be prepared for rising bond yields over the next two years.

The extent to which rising bond yields impact stock prices is predicated upon three factors: (1) The pace of increase in bond yields; (2) The absolute level of bond yields; and (3) The direction of corporate earnings. As a generalization, stock prices and bond yields can rise simultaneously in an environment of rapid earnings growth. History shows that stock prices typically remain in an uptrend until earnings expectations reach a peak.

Moreover, common stocks can rise simultaneously with bond yields when the rise in government bond yields is moderate and orderly. Conversely, a sudden spike in long-term interest rates would be disruptive to financial markets and likely trigger a sell-off in stocks. The absolute level of yields is also relevant: Market yields in excess of 3% on ten-year Treasury bonds — currently at 1.58% — could threaten the sustainability of the equity bull market.

Finally, investors must differentiate between an increase in yields caused by a rise in inflationary expectations and a rise in real (inflation-adjusted) yields. The latter would simply reflect a stronger economy, while the former would be a genuine threat to equities because it would trigger an aggressive tightening response by the Federal Reserve.

## HAS THE US HOUSING MARKET ENTERED A BUBBLE?

No. The current extremely favorable fundamentals of the housing market are inconsistent with a classic asset bubble. The definition of a bubble is a rapid rise in the market price of an asset unwarranted by underlying fundamentals of supply and demand. Stated differently, the term asset bubble describes a market in which the price of an asset greatly exceeds the intrinsic value of the asset. Bubbles typically result from exuberant demand as opposed to a genuine and sustained shortfall in supply.

The current market for single-family homes is at an extreme imbalance because of a massive shortfall of homes for sale (supply) relative to the demand for single-family homes. At a current level of one million, the number of existing homes for sale is at an all-time low and represents only two months' supply at the current selling rate. This compares with a long-term average of 5.5 months.

According to mortgage-finance company Freddie Mac, the current stock of single-family homes is 3.8 million below the level needed to meet the country's demand. As a result, house prices nationwide are currently rising at a 12% annual rate, the fastest rate of gain since 2005. When will this acceleration in house prices end? Prices will begin to flatten when the supply of homes available for sale rises to a level equivalent to the current demand for homes. This will require a heightened level of construction over the next several years.

The scarcity of homes for sale can be attributed largely to the enormous underbuilding since the real estate bust in 2008. *Construction of single-family homes during the decade ending in 2019 was the slowest on record*. Construction has also been constrained by widespread shortages of labor, materials, and developed land, all of which have contributed to a rising cost of construction and higher selling prices.

## HAS THE US LABOR MARKET BEEN PERMANENTLY IMPACTED BY THE PANDEMIC, AND WHAT ARE THE BROAD ECONOMIC IMPLICATIONS?

The US labor market has been significantly affected by the pandemic, both in the short and long term. In the short term, there has been considerable shrinkage in the workforce, as many jobs have been permanently eliminated and long-term unemployment has risen. Even after the population reaches herd immunity and the economy has fully reopened, employees will continue to work remotely, to a greater or lesser extent. The work-from-anywhere employment model could persist for many years.

Perhaps the major impact involves a greater application of technology, automation, and robotics in the hands of workers. Digitization of the workforce was already under way prior to the pandemic but has rapidly accelerated during the past year. The result is a striking bifurcation of the US labor force between skilled and semi-skilled workers and a massive widening differential in wage rates among workers, based upon education and skill levels. This wage gap can be remedied only by effective education and job-training programs implemented by both the public and private sectors.

The transformation of the labor force should result in a notable increase in *productivity*. A sustained increase in output per hour would be a game-changer for the US economy in the form of faster growth, greater efficiencies, and lower inflation, culminating in rising living standards. Output per hour in 2020 increased at the fastest pace in more than a decade. My forecast assumes productivity growth of 3.5% and 2.5% in 2021 and 2022, respectively, well above the meager 1% average of the past decade.

## US CORPORATIONS ADDED TO DEBT IN 2020 AT THE FASTEST PACE ON RECORD. HOW BIG A PROBLEM IS CREDIT QUALITY?

US corporate debt rose by more than 10% in 2020 to $11.2 trillion, the highest level on record, and an all-time record of 50% of GDP. All else equal, record levels of corporate debt should be of concern for investors. However, there are six countervailing factors:

- **Economic Growth:** High debt levels become problematic during periods of economic weakness. The US economy is expected to expand at the fastest pace in 40 years over the next two years.

- **Profitability:** Credit quality improves when earnings and cash flow are expanding at a faster pace relative to debt, which should be the case throughout 2022.

- **Motivation:** As the pandemic became widespread, corporate cash flow plummeted, causing companies to issue debt for ***precautionary*** reasons. Record-low borrowing costs also incentivized firms to raise cash through debt issuance.

- **Cash Holdings:** Companies used the proceeds from bond sales to bolster liquidity. Corporate cash holdings for companies in the S&P 500 Index increased by 45% in 2020 to an all-time high.

- **Paydown of Bank Loans:** Much of the record issuance of long-term debt served as a replacement for bank debt, as companies wisely locked in very low borrowing costs.

- **Refinance:** It is highly likely that companies will pay down liabilities by substituting low-cost equity for debt.

The bottom line is that it would be premature for investors to be concerned over high levels of debt on corporate balance sheets. Corporate financial tensions are unlikely to build until economic and profit growth slow markedly and interest rates are on the rise, all of which is not likely until 2023.

## UNDER WHAT CONDITIONS WILL THE CURRENT EQUITY BULL MARKET END?

The equity bull market that began one year ago will reach its apex with the end of the economic expansion cycle and onset of the next recession. Stock prices tend to peak within a range of three to six months prior to recessions. While exact timing is impossible to predict now, investors can and should begin to contemplate the specific economic and policy conditions that would bring the bull market to an end.

*By a wide margin, the most important independent variable with respect to the equity market is the future path of inflation*. In theory, the equity bull market could persist for many years in an environment of a sustained trend of 2% inflation. Price stability would provide the Federal Reserve with the necessary latitude to maintain an accommodative monetary policy without endangering economic growth. Conversely, a steady rise in inflation to a range of 3% to 5% would be a significant negative because it would trigger a severe tightening in monetary conditions by the Fed. The real economy would respond to progressive monetary restraint with slower growth in output and business profits.

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**Bloomberg Barclays US Aggregate Bond Index:** is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

**Bloomberg Barclays High-Yield Corporate Bond Index:** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

**Dow Jones Industrial Average:** is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

**NASDAQ:** is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

**Russell 2000 Index:** is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

**Russell 3000 Growth Index:** is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

**Russell 3000 Value Index: :** is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

**S&P 500® Index:** Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.