The case for a structural equity bull market

Anatole Kaletsky | GaveKal| 29 July 2014

It's almost three months since I recommended a Buy in May strategy for US equities. At roughly the same time, Charles reiterated his balanced portfolio call for a long position in US equities hedged with long-dated US treasuries. Since then, both equities and bonds have performed well. The S&P 500 has risen almost 6%, while 30-year US Treasury bonds have gained about 3% in price.

The question now is whether both these asset classes can continue to rise together. Gavekal's last Quarterly Strategy Chartbook and a clutch of our recent Daily notes have emphasised the risks that a disappointing economic performance and an eventual monetary tightening could pose to stretched equity valuations. At our London and New York seminars, and at dozens of client meetings across the US, Europe and Brazil over the last couple of months, I've taken a different tack. After a five-year bull run in equities which has broken out decisively to set new highs on all the US indexes, I've suggested that investors should be asking not whether they should take profits, but whether the equity market gains of 2009-13 were merely the prelude to a longer term upswing in equities.

THE END OF A BOUNCE OR THE BEGINNING OF A BREAKOUT?

For the benefit of readers unable to make our seminars or client presentations – and, with apologies to those already bored with my Panglossian views – I've decided to set out my bullish arguments in a series of Gavekal reports. I begin today by posing the key question that every investor must ask after an uninterrupted five-year bull market: Are equities at the end of a five-year cyclical bounce or are they at the start of a 15-year structural breakout?

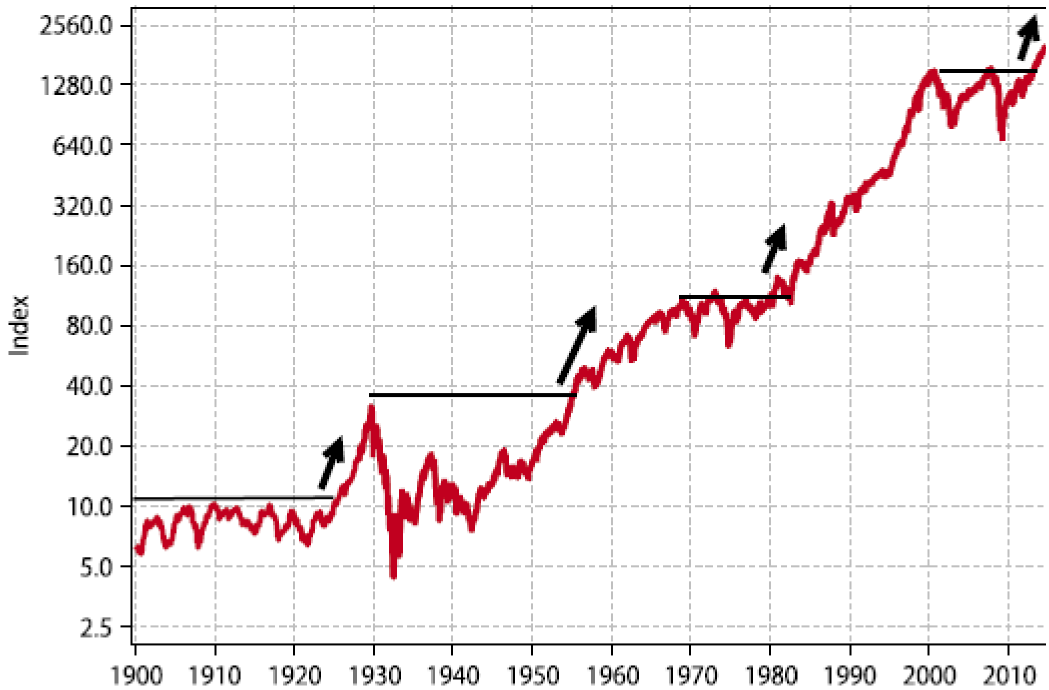
The question intimately concerns all investors, whether they allocate assets strategically between equities, bonds and cash, or manage individual asset classes and have to choose between adding risk to boost returns or taking profits to preserve capital.

History suggests two directly contradictory answers, illustrated in Figures 1 & 2. On a 20-year view, it is time to take profits because the market has reached the top of an established trading channel, which means the emphasis should be on capital preservation. By contrast, the 120-year view suggests investors should stay long, following a sustained breakout from a decade-long trading range – the opportunities for capital growth are just beginning.

Figure 1: S&P 500 - a 20-year view

Sources: GaveKal Data/Macrobond

Figure 2: S&P 500 (linked to earlier indexes) - a 120 year view



Sources: GaveKal Data/Macrobond

The bullish breakout view is becoming more plausible. But, to prove it right will require a structural improvement in economic conditions over the coming decade, relative to the bear-market period from 2000-13. Even to suggest such a possibility would have seemed ridiculous a few years ago, because everybody 'knew' that the post-2008 'new normal' would be much weaker and more unstable than the previous era. To support their structural pessimism, bears cited phenomena including deflation, excess leverage, monetary manipulation, government deficits, demographics, income inequality, underinvestment, collapsing productivity growth and the exhaustion of natural resources.

SEARCHING FOR NEW STRUCTURAL IMPROVEMENTS

How then could anyone believe in a structurally bullish story? Yet some must have believed it, since global stock markets have kept going up. One likely answer is that the structural headwinds have been fully recognised, and that some have gradually subsided or even turned into tailwinds that portend stronger and more sustainable global conditions. As time goes by, it is becoming increasingly apparent that each of the bearish structural arguments can be countered by an equal and opposite question pointing the other way:

- Will deflationary pressures cause permanent stagnation? Or will they ensure that interest rates stay low for years or even decades to come?
- Will low interest rates cause capital misallocation? Or will they encourage households and businesses to re-leverage balance sheets that are now quite strong?
- Will fiscal deficits and debts suppress economic growth? Or will they let governments take advantage of cyclically improving budgets to provide more fiscal stimulus?
- Will deteriorating demographics reduce trend growth? Or will ageing populations encourage global migration, improving income and consumption opportunities for Asian, Latin American and African middle classes?
- Will widening income distribution cause under-consumption and excessive saving? Or will political pressure to narrow income inequalities increase consumer demand?
- Will the under-investment which has prevailed since 2000 continue? Or has it created a backlog of investment opportunities and pent-up demand for capital goods?
- Will the slowdown in productivity growth seen since 2008 persist? Or is productivity about to accelerate as breakthroughs in artificial intelligence, robotics and biotechnology are incorporated in new products, services and production techniques?
- Will the world run out of energy and resources, as feared during the 2011 'peak oil' panic? Or will global growth benefit from structurally declining commodity prices and new energy supplies?

To decide between the cyclical bounce and the structural breakout stories, investors must form a view on questions of this kind. The problem is that nobody can be sure of the answers because structural trends can take many years to emerge and decades to play out. And, by the time the answers on technology, energy, demographics or capital misallocation are completely clear, it will be too late to profit. There is, however, one thing we can confidently say today about the tug-of-war between structural obstacles and opportunities - financial and business opinions about these long term structural questions will be strongly influenced by whether medium term cyclical economic conditions are improving or getting worse.

CYCLICAL CONDITIONS DETERMINE STRUCTURAL VIEWS

As an example, consider the way majority opinion has shifted on the last two issues - energy and productivity growth. In 2011, when investors and businessmen believed almost unanimously that the world was running out of energy, shale oil had already been discovered and fracking technology already had a long track record. Yet the promise of these discoveries and technologies was ignored because the world economy seemed to be stuttering on the brink of a double-dip recession. For similar reasons, the opportunities from robotics and other new technologies were disregarded, as investors assumed that a cyclical slowdown in productivity growth was a permanent structural consequence of technological exhaustion, as argued by Robert Gordon and other productivity pessimists.

This experience suggests that, whatever the ultimate truth about the balance between structural opportunities and obstacles, the market's view will be strongly influenced by what is happening to the global economic cycle. This brings me to the other questions I plan to address in this series of articles:

- What are the prospects for the global economic cycle? It is now clear that a cyclical expansion is firmly under way, at least in the US and UK, and that it still has several years to go. The prospects for the US and UK are particularly important because it was these countries that pioneered the ultra-expansionary monetary policies that everyone else is now following.
- If the cyclical improvement does continue will it trigger an earlier than expected monetary tightening in the US and UK? I believe the answer is no. Interest rates will remain 'lower for longer' than almost anyone expects today.
- Even if the cyclical expansion and loose monetary policies continue, won't the upswing be overwhelmed by deflationary structural forces? There are real structural problems, but they mostly reflect weak demand, not supply-side weakness in productivity. That is one of the main reasons why monetary policy will remain more expansionary for longer than generally believed.

- If the economic and monetary outlook turns out to be as stable and predictable as suggested, what will drive asset prices? The Gavekal framework has always argued that asset prices depend on three separate forces: economic growth, monetary policy and the valuations that apply to expected cash-flows. Since markets are made at the margin the main driving force will be the one that is least predictable. Over the next year or two this will be valuations.
- If the transition from monetary and macro-driven markets to valuation-driven markets continues, what will be the investment implications? In equities we should expect continuing sector rotation from growth to value and geographical rotation from the US to emerging markets, Japan and Europe (probably in that order). In bonds the value rotation is the other way: from JGBs and Bunds to US treasuries and British gilts.
- Finally, what risks threaten this benign state of affairs? The main risk is that my expectations of steadily improving cyclical conditions turn out to be wrong. The most likely cause would be an exogenous shock from geopolitics or from China. The latter, at least, now looks less likely than it did a few months ago. The other big risk comes from within the market. If macroeconomic and monetary conditions remain as predictable and bullish as I am suggesting, then valuations will keep rising until prices are so over-extended that even a small shock is enough to trigger a big correction. In this sense the situation today is completely unlike 2007 but quite reminiscent of 1987. The question is whether today's situation is more like the autumn of 1987, just before a 30% correction, or more like January 1987, before stockmarkets gained 40% in eight months.

Anatole Kaletsky is co-founder and GaveKal Research, GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.
