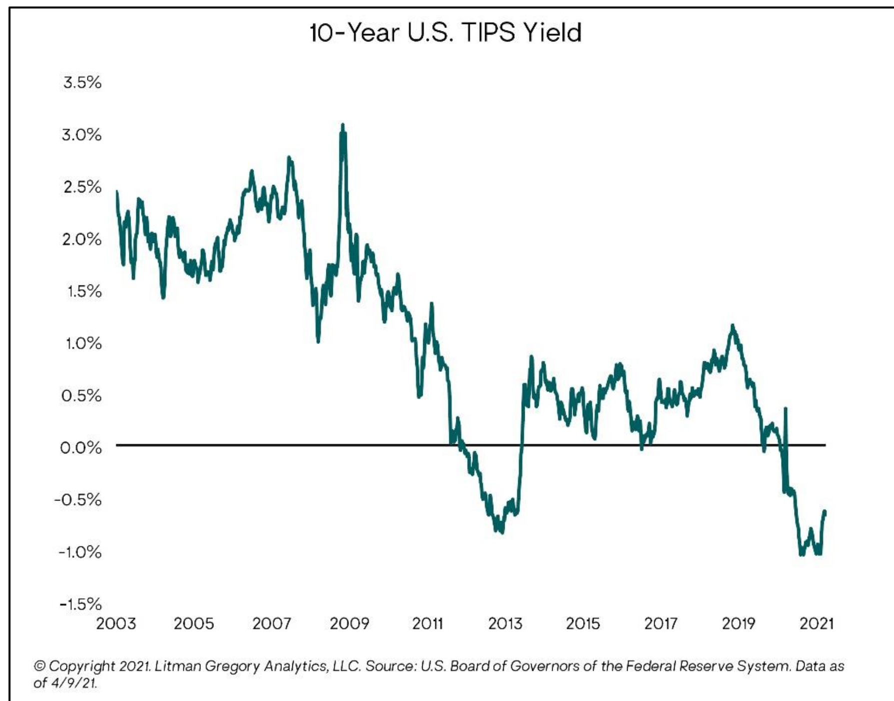
Executive Summary

In the third quarter, we discussed how our updated macro scenarios were leading us to evaluate more positive outcomes for equities. We were considering an expanded range of valuation multiples relative to the past in part because we believed we will likely be in a relatively benign real-rate environment for risk assets. In addition, we wanted to analyze positive earnings growth outcomes after the pandemic. We thought the pandemic may have accelerated forces that are net positive for corporate margins.

Since we wrote the above piece, real rates have risen but they remain quite low. We continue to believe they will likely remain relatively benign for equities and other risk assets even as we expect nominal rates to rise over our tactical horizon of five years.



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Also, the presidential and Georgia elections have strengthened the "reflation" argument. The fiscal stimulus that has been passed appears large relative to history but may not be when you factor in the unique nature of the pandemic. A good chunk of it may go to filling the "income hole" stemming from a virtual stoppage of economic activity. That said, household balance sheets were relatively strong going into the pandemic and their savings have been boosted further. So, that should support overall consumer spending. Also, we will likely get more fiscal stimulus in slow drips over the coming years. So, we think it is reasonable to expect an average reflation environment and a higher growth environment than we observed after the 2008 financial crisis. As we wrote in our recent quarterly commentary, we do not view a sustained and material increase in U.S. core inflation as likely in the shorter term. In the very near term, we may see some inflation, but we think it will likely be transient, as the Fed has been saying.

Weighing the above, we are raising our estimated return range for U.S. stocks. Our base-case expectation is that real rates will rise gradually over the short to medium term. The risk is they rise too fast, tightening financial conditions and causing an economic downturn. In that event, we think it is reasonable to expect the Federal Reserve will act given its track record and what it has been saying for over a year now. Consider the following:

- The Fed changed its mind quickly in the fourth quarter of 2018 when financial conditions tightened. When faced with a similar risk, it is reasonable to expect it will ease more, including taking measures to control the yield curve, as it has suggested it may do.

- The Fed has been clear on what it wants to achieve with regard to its employment goals. It wants to achieve full employment, including discouraged workers and where the benefits of higher wages are filtering down to lower-income populations and minorities.

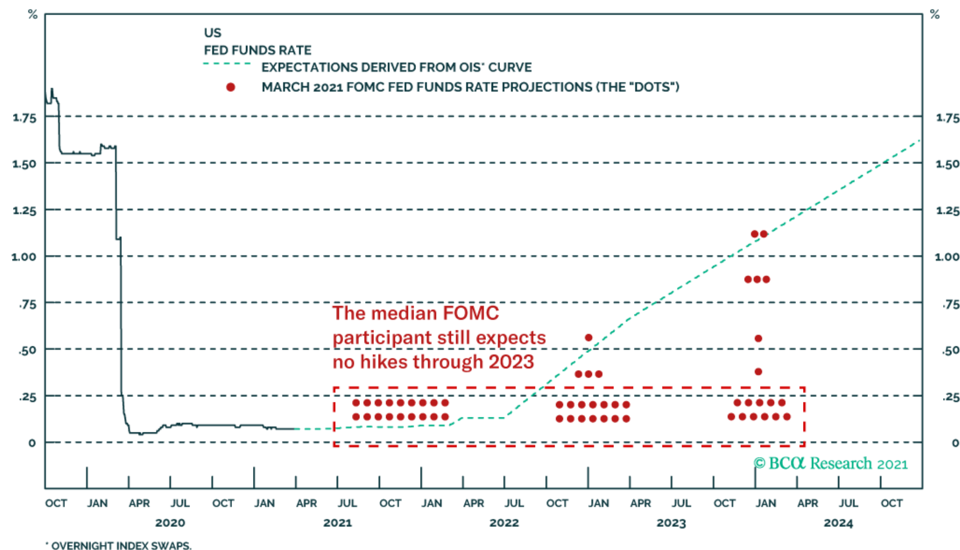
- It is focusing on average inflation or, said another way, it is at least in the shorter term relatively more tolerant of inflation than it is of the idea of not meeting its employment goals. To some extent, the

wealth divide since the 2008 financial crisis (and after the pandemic) has made this a social and political imperative.

All this leads us to the view that the Fed is likely to keep monetary policy relatively easy until it achieves *its* unemployment goals. For how long we don't know, but we suspect it could take longer than what the market expects because the pandemic has accelerated technology trends that are likely unfriendly to labor and friendlier to capital owners, as evidenced by the performance of corporate earnings and the financial markets last year. A year ago, Fed chair Jerome Powell acknowledged, "Our economy has changed."

To us this statement means that it may not be as easy to put people to work in the face of digitalization, automation, and disintermediating forces that may create more unemployment in the shorter term. Overall, we think it's early to dismiss the strong disinflationary tendencies in the economy. The proposed infrastructure bill is large but spread over many years.

If inflation surprises on the upside, though, then rates would likely rise faster than what the Fed currently expects. Currently the market seems to be pricing in that the Fed will start raising rates sooner (see the chart to the right). We are also somewhat concerned about margins compressing more than we currently expect. These risks are reflected in the lower end of our fair-value return range.



Source: BCA Research.

We think the upper end of our fair-value range is more likely though. It factors in slightly higher valuation multiples due to a generally favorable real-rate environment and a positive reflationary economic backdrop where inflation is not sustainably high. In this scenario, earnings will end up doing most of the heavy lifting. However, we pay the price due to high current market valuations.

We estimate an average reflationary scenario is already baked into prices. From current price levels, we think it is reasonable to expect low-single-digit to upper-single-digit returns from U.S. stocks, with outcomes in the mid- to upper-single-digit returns we think being more likely.

From an overall portfolio standpoint, this will not result in any changes. We continue to be underweight to U.S. stocks largely to fund an overweight to EM stocks, which we believe remain attractive and should do well in a positive reflation environment. The fat-pitch hurdle for EM stocks to clear has risen, but we believe the return gap in favor of EM stocks remains attractive. Moreover, we see potentially further upside to our base-case assumptions (we are doing further research to assess whether we should raise EM returns further).

Base-Case Assumptions for U.S. Stocks

The Lower End of Our Fair-Value Range

The lower end assumes:

- The Fed and the Biden administration will be successful in their reflation efforts and we enter a higher nominal growth environment. We should expect to see a higher average nominal growth environment in the upcoming cycle than we have seen since the 2008 financial crisis.

- After the 2008 financial crisis, valuations have been relatively high (certainly higher than we expected on average) considering the poor performance of the "real" economy. However, this time, despite a favorable monetary regime and a more favorable economic backdrop, you may end up at the same place because the economy is running relatively hot. So, we are embedding higher price-to-earnings (P/E) multiple compression in this case.

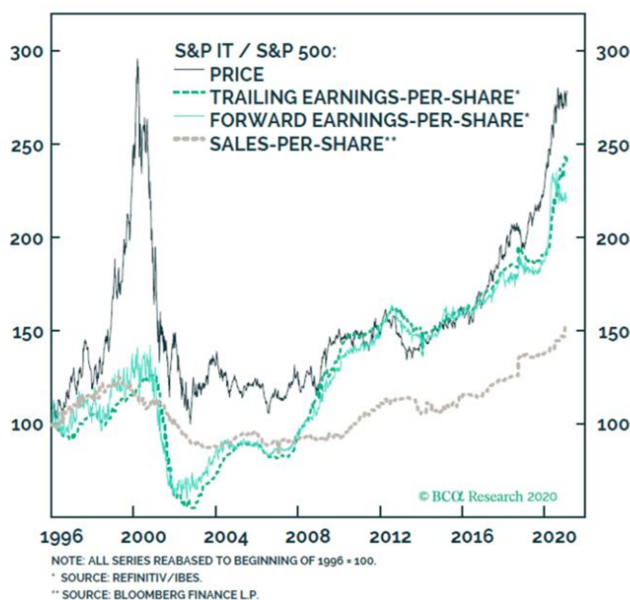
- Margins compress some. There are many forces—such as regulations in favor of labor and against capital owners, rising rates, higher taxes, deglobalization, higher input costs, etc.—that could end up being stronger than we expect and result in net greater margin compression than we think is likely.

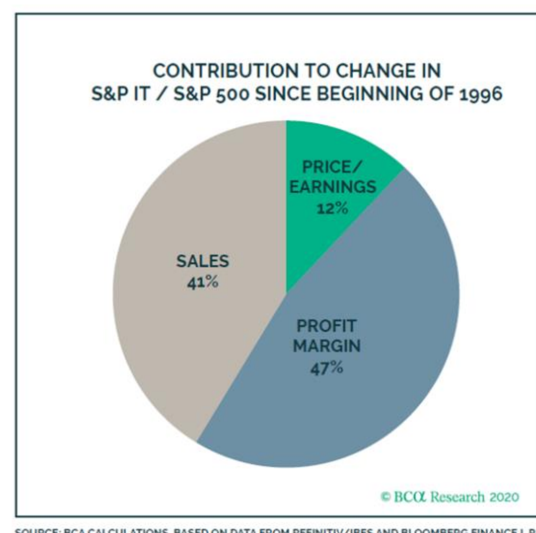
The Upper End of Our Fair-Value Range

The upper end assumes:

- The Fed and the Biden administration will be successful in their reflation efforts (same as our assumption for the lower end).

- The S&P 500 sector composition has changed. It is likely that its members will continue to eke out efficiency gains, especially after the pandemic, which has accelerated many technology trends we think could largely offset many of the margin headwinds we see. The BCA chart below shows most of the tech outperformance has come from better sales growth and margin expansion and relatively little from P/E expansion.





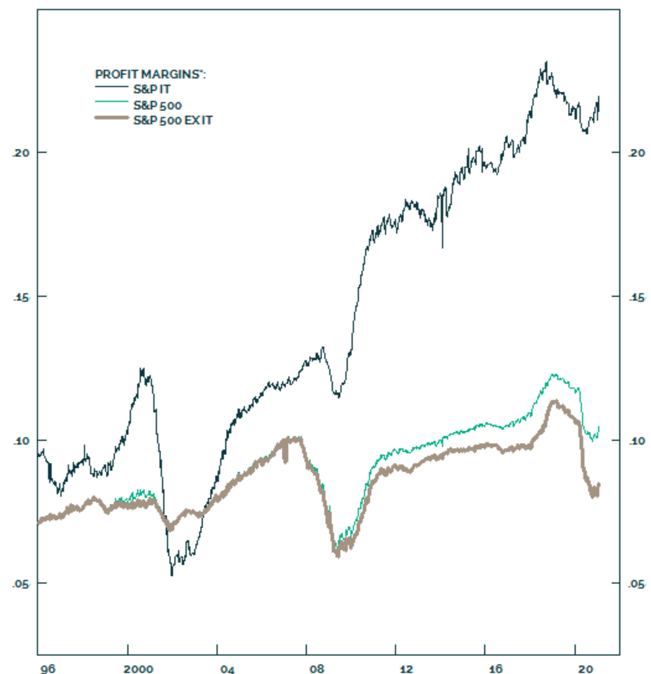
Source: BCA Research.

- We think the odds are good that margins could move up a notch further in this cycle than we assume in our upper-end estimate. This is a topic of further research. We are factoring this into our upside or optimistic case.

- Valuations are likely to average slightly higher than we have seen in recent history. This is driven by our view that the current Fed's policy is likely to lead to relatively low real rates over the short to medium term, which will ultimately force more investors out on the risk curve, especially if earnings remain strong, as we expect, and there is general optimism about the economy. And we think investors will continue to pay a premium for a high-quality asset like the S&P 500. The BCA chart below shows margins have generally been on an upward trend for the past two decades.

Multiples & Earnings Levels

So, our P/E range is 20x to 22x our estimate of normalized earnings. Our five-year normalized earnings range from about $190 to $220. Our estimated current fair-value range for the S&P 500 is approximately 3100 to 3900, bookended by the scenarios discussed above. As an investor, depending upon how one is weighing the downside and upside risks, one could pick any S&P level within this range as their fair-value point, and we'd say it's reasonable. A fair-value point to us is one that today gives us an upper-single-digit return, which we think is fair given the market environment we expect over our tactical horizon. Weighing the upside and downside, including a potential tax hit to corporations, we estimate today the S&P 500's fair-value point to be around 3,800.



Source: BCA Research.

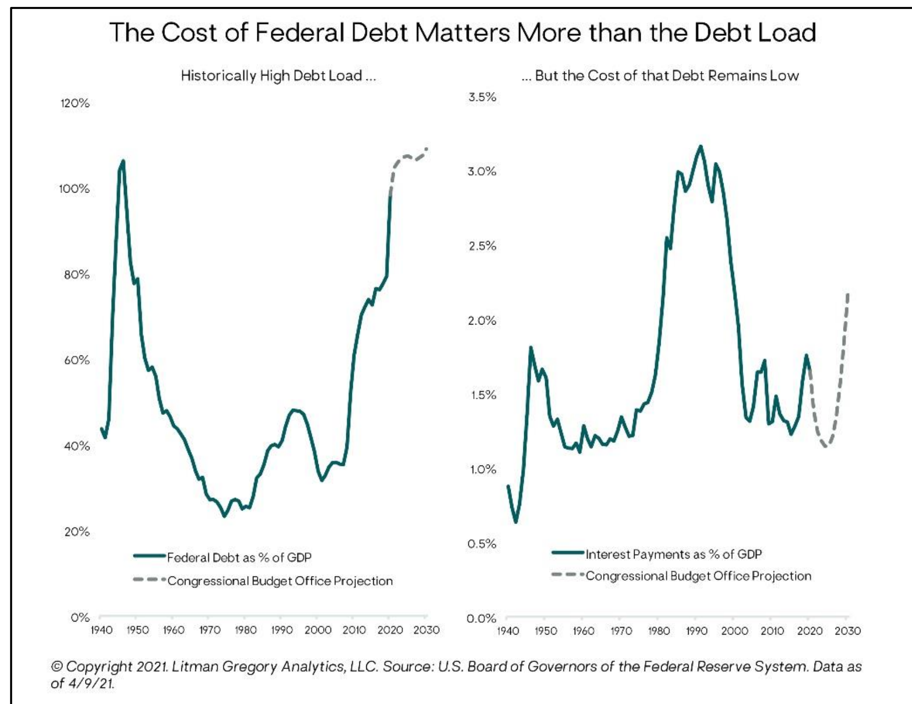
With this fair-value range we are trying to cover a range of reasonable positive and negative outcomes. It means to us in five years it is reasonable to expect the S&P 500 could be in the approximate 3,800 to 5,000 range. To this price return we add a total yield of around 2.5%, which includes a small amount of net benefit from buybacks. This gives us an expected return range of low-single-digit to upper-single-digit returns for the S&P 500 from current levels. At present, we think an outcome closer to the upper end of this estimated range is more likely because we believe we are relatively early in the current reflation cycle and given our positive outlook on S&P 500's earnings growth. As we always say, we will continue to weigh more analyses and data points and our views may change or evolve.

Key Downside Risks

Markets force rates up to a level that crushes the current overvalued markets.

Even the United States cannot borrow and spend as much as it wants. But when markets would "revolt" is an unknown. We do not think it would pay to worry too much about this risk right now. While absolute debt levels are indeed high relative to history, the cost of debt remains low (see the charts below). We think the odds are quite good that the real cost of servicing its debt remains low for the U.S. over our tactical horizon.

The U.S. dollar is still the reserve currency by a distance and is unlikely to be replaced anytime soon. The United States still offers the deepest and most liquid Treasury market, still offers decent yield relative to its developed-market counterparts, and there is a limit to how much investors will be willing to allocate to emerging China's sovereign debt knowing it brings other risks to their capital. Finally, the United States is likely to do enough for markets to believe it is printing money responsibly: the budget reconciliation process and higher taxes for corporations, on capital gains, on high income earners, etc.



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Bottom line, we think it is likely that the Fed will be able to execute on yield curve control if it is needed to buy time for them to achieve their dual mandate. If they are unsuccessful, however, a rapid unwind of valuation excess relative to a more normalized interest rate level could lead to a significant deflationary shock to the economy. If one were to weigh this risk more in one's decision making, then the upside scenario for stocks may not be sufficiently compensatory.

Inflation rears its head and the Fed is forced to raise rates much sooner and faster than it currently expects.

In this scenario, we see downside of up to 25% as a reasonable expectation, which is driven by the lower end of our fair-value range.

U.S. reflation efforts do not yield the expected growth.

This could mean the underlying fundamentals of the economy turn out weaker than we think. If all this spending and technological advancement fails to raise productivity and/or generate nominal earnings growth and at the same time ends up being inflationary and is more bearish for the U.S. dollar, the downside in equities is likely higher. Our downside or bear scenario assumes low growth, in a relatively high-inflation and high-rate environment of almost no earnings growth, where valuations are in line with very long-term averages. This gives us a downside S&P 500 level of 2,100. We think this scenario is unlikely.

Lastly, one risk is the Fed's focus on its employment goals may encourage it to keep monetary policy easy for far too long and *risk financial bubbles*. There are already some worrying signs of excessive risk taking—SPACs, Archegos Capital, anecdotal evidence suggests frothiness in some areas of the market, especially in smaller-cap growth stocks in investors' quest to find the next Amazon. The odds of this scenario increase if acceleration in technology trends makes it difficult to get to full employment or for the Fed to achieve its goals as laid out (they

may modify these goals if they become concerned about financial risks though). At present, we don't think overall markets are close to being in egregious or bubble territory.

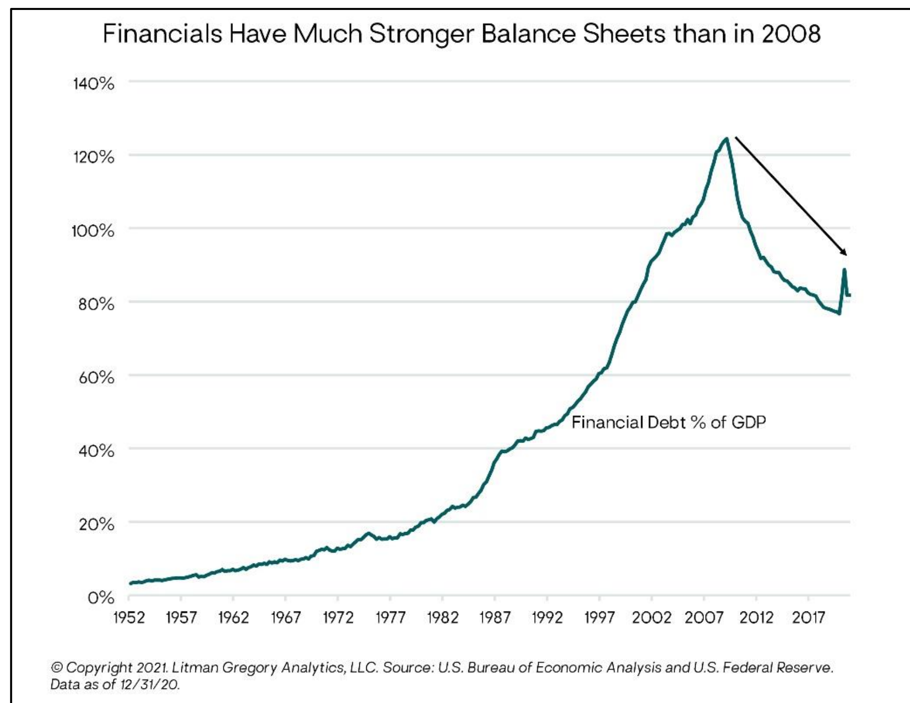
Upside Risks & Optionality

We are assuming the average reflation that has been achieved in recent modern history. But the current coordinated monetary and fiscal stimulus is more akin to post–World War II financial repression *and* reflation. So, nominal growth in the United States may average higher than we expect.

We may be underestimating what the accelerating technology trends may mean for corporate margins and earnings growth, despite factoring in the increase in corporate taxes we think is likely over the short to medium term (assuming the laws pass as proposed, they do not make a big impact based on external research we have seen). We don't believe the world will deglobalize in a major way anytime soon. China is still focused on urbanizing further and still plans on being the dominant factory of the world. It presents, however, both an opportunity and adds another risk layer to developed-market earnings: exporting higher input prices than it did in the past decade or two, especially if the renminbi is appreciating gradually. One mitigant is a good chunk of outsourcing away from China will be taken up by other emerging-market countries, depending upon their infrastructure, education, technical skills, etc.

So, while we acknowledge there will be some pressure on margins, we think, net, the globalization-related benefits for margins remain in place to a good degree. China, however, with its move to higher value-add areas, also brings a competitive, trade- and tech-war-related retaliation dynamic that could start to negatively impact developed-market earnings growth, so that's a risk to this scenario.

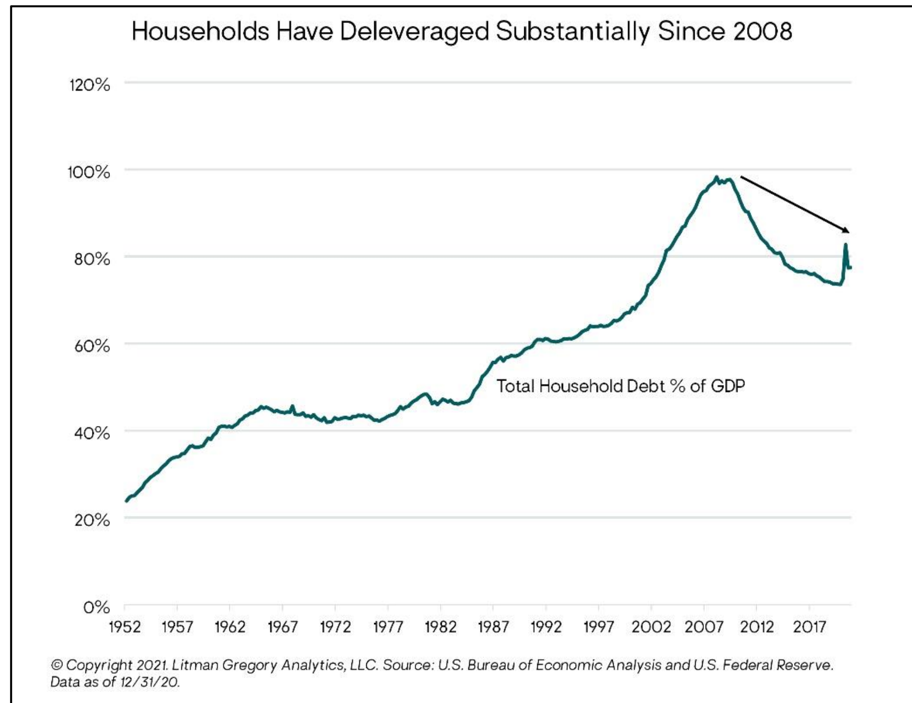
Overall, we think our upside scenario is more likely than our downside scenario today. Since the 2008 financial crisis, both the financial sector and households have deleveraged substantially (see the charts below). Our conversations with fund managers confirm that banks are well capitalized and in a good position to lend. (Of course, risks may lie unseen in the shadows.) It's possible to imagine then a better than average growth environment of more lending and higher consumer spending leading to better earnings growth and where the economy's capacity to absorb higher real rates is also increasing and inflation is not getting out of control. This upside scenario could see the S&P 500 around 7,000 in five years and with monetary policy having regained some semblance of control, and not as dependent on fiscal stimulus, as it is today, to reflate.



Closing Thoughts

The base-case fair-value range presented here lends discipline to our investment process. It also gives us some sense of what the market may be pricing in.

We think U.S. fundamentals and the inherent advantages stemming from being the world's leading economy give U.S. policymakers a lot of fiscal and monetary flexibility. We don't think it is reasonable to assume in our base case that this flexibility will be taken away—it's a risk scenario of course. And we don't believe, and neither does the market we think, that the Fed is giving up on its inflation mandate. So we are factoring in the Fed's expected reaction function in our analyses. The investments proposed in the infrastructure bill and the current low real costs of those investments raise the odds they will be productive for the economy and ultimately positive for nominal earnings growth. This increases our confidence that the upper end of our base-case normalized earnings range is achievable as we look out five years, and the odds are good it may be exceeded.



Despite our increased optimism, relative to a few years ago at least, the fact is that starting valuations are high. This means two things: (1) There is greater downside risk in markets. Markets are particularly susceptible to a sharp rise in interest rates. And (2) if we are right about earnings doing more of the heavy lifting in this cycle, returns are likely to end up being fair but not great in retrospect. U.S. stocks remain relatively less attractive, and we will remain underweight until price levels adjust to offer a better risk-reward.

—Litman Gregory Investment Team (4/12/21)

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