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Investment intelligence

Is the US bull market long in the tooth?

March 2019

- What are the characteristics of the longest bull market in history and how does it compare to previous bull runs?
- The shifting focus of the Federal Reserve leads us to question the representativeness of inflation as a good economic indicator
- Where are the potential investment opportunities amidst the market noise?

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This March marks the 10-year anniversary of the longest bull market in history that has been ploughing on in the US since early March 2009. From a low of 677, the S&P 500 hovered just shy of an important psychological barrier of 2,800[1], delivering a staggering 400% in total returns over the decade.

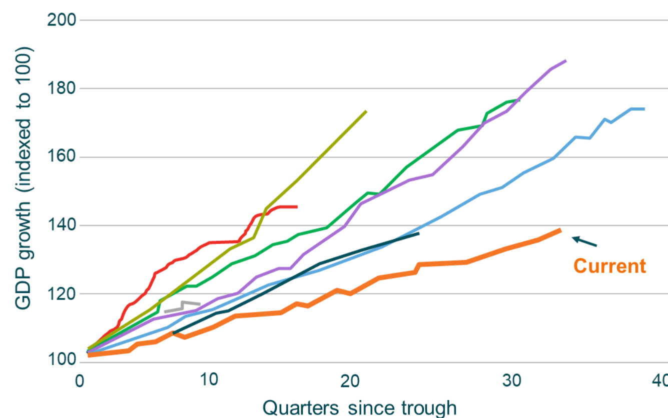
As central banks globally embarked on extensive monetary stimulus programmes, driving up bond prices and bond yields down in the process, investors had to look elsewhere to source income.

In the equities space, the hunt for yield drove investors into reliable 'bond proxies'. However, market leadership began to narrow as high-growth 'tech' stocks gained momentum and became the portfolio 'must-haves'. Technology companies, hailed as beacons of growth in a low-growth environment, saw their share prices soar, courtesy of a boom in mobile technology, e-commerce and online advertising. Investing in the technology sector, which included the behemoths Apple, Facebook and Google, would have returned an impressive 574% over the 10-year period[2].

Apart from technology, the consumer discretionary sector (with big names such as Netflix and Amazon) generated the highest returns, delivering over 650%[3]. By contrast, the main sector laggards included materials stocks, such as chemical companies and cement producers, together with telecommunications groups. The energy sector registered the worst performance over ten years, returning just 83%[4].

History's longest US bull market has been powered by a sustained US economic cycle; the second longest on record since World War Two. However, the narrative has moved on from 2017's synchronised global growth to a 2018 characterised by volatility, the revising down of expectations on economic growth, concerns around peak earnings and the path and pace of monetary policy.

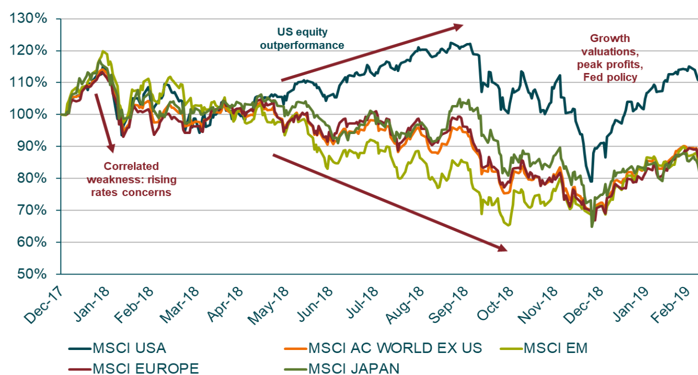
The US economic expansion—cumulative GDP growth post-recessions



Source: Credit Suisse, Haver Analytics, the BLOOMBERG PROFESSIONAL service, NBER as at 24 April 2018. 1949 to present cumulative nominal GDP since trough indexed to 100.

It's also worth noting that this is not your typical recovery, as the pace of cumulative US GDP growth has been the weakest compared to previous post-war expansions. Slowing global growth, trade tariff concerns and the removal of liquidity are all potential causes of market jitters across the globe. However, what stood out in 2018 was the decoupling of the US from the rest of the world, not only in the divergence of growth, but also in policy and stock market performance.

Decoupling of US growth and performance vs the rest of the world



Source: Factset, 12 March 2019.

[1] As at 11 March 2019.

[2] Source: Datastream, 10 March 2009 to 28 February 2019, total return in US$. NB: Facebook and Alphabet (previously Google) moved from the GICS technology sector and Netflix moved from the GICS consumer discretionary sector to the newly created GICS communication services sector in September 2018.

[3] Source: Datastream, 10 March 2009 to 28 February 2019.

[4] Source: Datastream, 10 March 2009 to 28 February 2019.

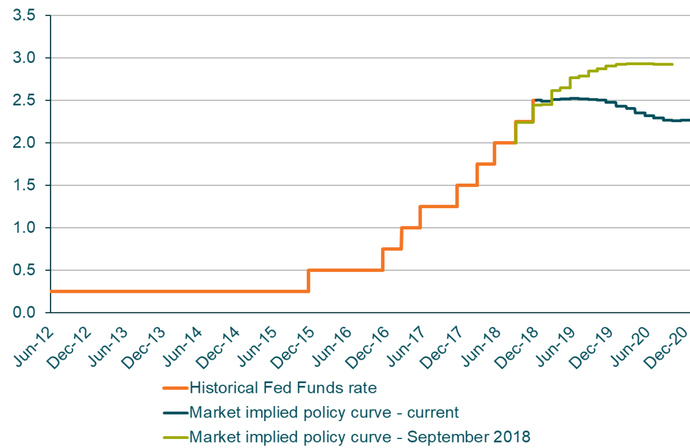
A year on from the $1.5 trillion tax reduction package, which aimed to boost economic growth, the key question now is 'how sustainable is this growth?', particularly given the record amounts of debt in the system, on both corporate and government balance sheets. As seen in 2018, the interest rate hiking cycle has precipitated a global economic slowdown, with the stimulus from tax cuts and deregulation in the US starting to wane.

However, the recently more dovish stance of the Federal Reserve, adopting a more patient approach to interest rate hikes this year, has helped risk assets to rally in 2019, unwinding the losses of the final quarter of 2018. Given this new direction of travel, the US dollar strength has also moderated, which offers a positive backdrop not only for US equities but also for emerging market equities (where dollar-denominated debt benefits from a less strong US currency).

The shifting focus of the Fed

It can be argued that central bank policy is acting as a pendulum capable of driving market swings. The focus of recent debate is around the Federal Reserve's policy of targeting inflation and the validity of such an approach.

US Fed Funds rate



Source: Morgan Stanley Research, 3 January 2019.

When considering the representativeness of inflation as an economic indicator, my colleague, multi asset fund manager Eric Lonergan, perceives this as much more of a structural assessment. What he finds most curious is why it has taken so long for the Federal Reserve to realise it doesn't have an inflation problem. Many of the factors that were expected to cause a spike in this measure in the post-financial crisis era, such as oil moving to $150 a barrel and a tripling of its monetary base, have had a minimal impact. He points to Turkey as being similar to an economy in the 1970s when, for example, oil prices and inflation were more strongly correlated. Turkey has generated inflation as markets are not de-regulated, prices are controlled by oligopolies and monopolists and inflation-indexed contracts are prevalent. This is not comparable to the dynamics in developed economies.

Finding opportunities amidst the noise

Rather than focusing on economic prognostications, for Lonergan it is better to concentrate on valuations and where investor bias throws up opportunities. Notwithstanding its premium to other global markets, the S&P 500 index has de-rated over the last 18 months. When looking at the equity risk premium, similar levels of compensation to that seen in times of distress are available now. This is very much the legacy of 2008, where we saw the highest levels of volatility since the depression.

Lonergan refers to volatility as an "intellectual virus" creating a willingness to forgo returns for reduced volatility. What is priced into the premium? The volatility aversion and worries about a recession, but as Lonergan believes this probability is low, he thinks equities look attractive versus cash and many areas in fixed income.

Looking closer at equities, my colleague and US fund manager, John Weavers, believes there are still many good opportunities to uncover in the US market. There are huge tailwinds to healthcare spending, not just in the US but globally, given ageing populations and increasing life expectancies in developed economies. Despite this, the market is worried about drug pricing and the possibility that regulation will tighten. This has led some areas to slip to price levels not seen since 2016 when markets worried over a potential Hillary Clinton government clamping down.

Weavers believes these fears have been overdone and this provides selective opportunities within the healthcare sector. One sub-sector he likes is managed healthcare. It's an area unique to the US with firms, like UnitedHealth, Anthem and Humana, managing individuals' private healthcare needs. Forward earnings multiples in managed healthcare companies are back down to 12.8 times; perhaps over concerns about public healthcare being introduced for all in the US.

However, Weavers thinks the 'Medicare for All' bill (introduced in February by the Democrats) is unlikely to find enough country-wide support to get passed. This creates an extremely attractive emerging opportunity, from a valuation point of view, in a sub-sector where there are clear long-term growth prospects.

Healthcare- the evolution of valuations

FY 2016:

Healthcare subsector	P/E multiple (Year 2)	EPS CAGR (2 years)
Pharmaceuticals	13.2	9.5%
Managed Healthcare	11.4	24.4%
Healthcare Equipment	15.4	10.3%
Life Sciences Tools & Services	14.8	18.2%

Today:

Healthcare subsector	P/E multiple (Year 2)	EPS CAGR (2 years)
Pharmaceuticals	13.3	8.7%
Managed Healthcare	12.8	13.7%
Healthcare Equipment	19.7	10.0%
Life Sciences Tools & Services	20.7	11.6%

Source: Bloomberg, 1 March 2019.

Weavers has also been focused on finding companies with lower debt-to-EBIDTA levels given the current macro environment. He explains that half of the debt on corporate balance sheets needs to be renewed on a two- to five-year cycle, which could cause headwinds for levered businesses if debt is repriced in the next two to three years. Companies exposed to this risk will have less cash available to reinvest in the business or grow the dividend, which in Weaver's view would make them less attractive investments.

Typically, in the late stages of a bull market and maturing economic cycle, quality companies with strong cashflows and business models that can be resilient in a downturn in the economic cycle tend to be favoured. Microsoft is a good example of a business with recurring revenues. as the company re-orientates its business away from a pure software provider to a subscription-based model. With its healthy balance sheet and net cash position, this is the sort of company that is more likely to ride out the wave of volatility that typically accompanies the late stages of a bull market.

So, will the long bull market run out of steam and what will be the triggers? While changing monetary policy can impact companies and consumers directly, it can also shift perception and subsequent behavioural trends. The metrics by which we understand the economic cycle could be different from what came before and in the same way, we cannot judge the current bull market run in the US in the same light as previous bull markets. What we can, however, turn back to as a reliable indicator is fundamentals, to look through market noise and economic cycles and deliver returns over the long term.

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