Equities: After 10 Years, How Durable Is the Bull Market?

Featured Expert

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[Note: The following is an edited transcription of a podcast interview that was recorded on July 8, 2019. The podcast recording can be accessed here.]

Will Andrews: Growth stocks have an enviable record of long term strength [based on past performance]. *[Note: Past performance does not guarantee future results.]* And yet many financial advisors continue to avoid growth equities and mutual funds that invest in growth [in spite of this history]. What might be causing this reluctance? And more importantly, what might investors be missing as a result? Here to address these questions is Lord Abbett equity investment strategist Brian Foerster. It's great to have you here again, Brian.

Brian Foerster: Great to be here, Will.

Andrews: Before we tackle the riddle of investor skittishness around equities, a topic you touched on in an earlier podcast, give us some background on the current bull market and why it's characterized as a secular bull market.

Foerster: Sure. Just even defining a secular bull market, or a secular market, bull or bear, it really has to do very simply with the length—so, many, many years—and also the forces that are driving the direction of that market. We believe that we are in a secular bull market today because there are very powerful forces such as low interest rates, low inflation, but also a positive business environment, and also a very favorable macro backdrop.

Now, that last one, a favorable backdrop has been heavily debated for the past 10 years. Whether you think about those first few years after the great financial crisis [of 2008–09] and the extraordinary amounts of stimulus that were poured into the economy as well as into the banking system—and whether that was sustainable, [or] if that was going to create a hyperinflationary environment—and then you move ahead to two [U.S.] political regimes that are very different from one another and a lot of the doubt that's surrounded both of those regimes. So, even though there has been a good amount of debate about the macro forces, we do believe that today we are still looking at a very favorable [U.S.] business environment. You're still looking at a very favorable [U.S.] tax environment. And you're still continuing to see earnings growth and revenue growth, at least in some segments of the market. And that's really been powering this bull market.

Andrews: So during this bull market, how have growth equities fared—that's obviously your area of focus, and you follow them closely. How has growth performed during the secular bull?

Foerster: I would say for real innovation parts of the growth [equities] asset class, you've seen enormous gains. You've seen the FAANG stocks or the FAMGA stocks experience sustained periods of outperformance.

Andrews: Just to to briefly interrupt—for our listeners who might not be familiar with FAANG or some of the other acronyms that we've been throwing around, what are the FANG stocks?

Foerster: Facebook, Amazon, Netflix, and formerly Google or Alphabet. And then the FAMGA stocks are Faceboook, Amazon, Apple, Microsoft, and again, Google.

Andrews: Okay, well, now that we've got that out of the way, let's resume.

Foerster: So we've seen this mega cap rally for a number of years primarily because [FAANG/FAMGA stocks] were just so dominant in their respective industries. And they continued to surprise on the upside, both on the top line and bottom line growth.

That may not last. But certainly you saw this period where innovation was really dominating in terms of organic growth at the company level and then the stock price appreciation at the stock level. So in terms of just the asset class of growth versus, say, value—you've certainly seen a widening disparity in recent years.

I would argue that it's really been driven mostly by fundamentals. There certainly was a technical part of it, as well, or a momentum aspect to it. But clearly you've seen from an organic growth standpoint that areas like information technology, healthcare, and consumer discretionary—you've really seen the strongest earnings growth in those sectors.

And those sectors tend to dominate in the growth indexes versus the value indexes. [In] value [indexes], you tend to see overweights in areas like financials, industrials, materials, and energy. And you have not seen as robust growth there.

Andrews: This long-lived bull market tends to bring out the doubters, or as you memorably referred to them in an article for lordabbett.com, the "dystopians." Give us a brief sketch of their arguments against the bull's continued existence.

Foerster: I remember I wrote that article in 2013. It's probably one that I've been most right about. And I'm not saying that I'm always right, but that was certainly one that, thinking back to when we wrote that article, you were hearing a lot of doubt even in those first few years after the financial crisis that [the equity rally] was not sustainable, that it was driven by liquidity, it was driven by enormous amounts of stimulus, as we referred to. But really, there are a few things that you really hear as to why this market can't continue. And we've been hearing this for a number of years. The first is, "look, this is the longest bull market ever and it's going to end badly, right, just as it did in 2000 and then again in 2008." Those were periods that were the result, or the culmination, of what turned out to be very obvious, but also very massive bubbles.

You had the tech stock bubble of the late 1990s. If you recall, Qualcomm went from $20 to $1,000 a share in one year. And the NASDAQ [composite index] was trading north of 100 times earnings. That was a very hyped-up period of stock prices that was clearly unsustainable. It was built on hope, not on actual earnings or revenue growth.

And then in 2008, of course, we had the global financial crisis, with an enormous amount of interconnected issues. We don't see anything like that today. And also there have been many recessions that were not crashes; they were just the end of a cycle, not caused by some massive bubble collapsing. Now, there could be small bubbles out there. Certainly there have been references to the auto industry or auto lending, or student loans. Some might call out the U.S. Government as a potential bubble in terms of the debt it's taking on. But we do not see anything currently that would spell an end like those two periods.

Secondly, you hear about valuation. [Some observers say] equities are overvalued, especially tech. You hear this is looking like 1999 all over again. It clearly is not, if you're actually looking at the numbers. If you look at small-cap technology stocks, which [back in 1999 were] trading in the hundreds in terms of price to earnings multiples. I mentioned the NASDAQ. When you look at valuations today, it is a very different story. When you look at the S&P 500, [it is] just trading around 17 times forward earnings [as of July 8, 2019], while mid cap stocks [are] trading below 16 times forward earnings. And small caps [are] trading right around 16 times earnings as well. That does not sound, at all, like a massive bubble, or that stocks have gotten way ahead of themselves. Plus, when you look at the interest rate environment that you see the 10-year [U.S. Treasury note yield] at 2%, those [indexes] actually look to be quite cheap, not sort of middle of the road.

And then the third rationale we hear as to why this might end badly, or that this is not a sustainable bull market, is that dysfunctional global politics and economic uncertainties make risk assets unattractive. I'm still waiting to find that time in history when we had economic certainty or functional global politics. But this is certainly something that is an overhang. And I think it's something that's also kept a lid on valuations, because there is such concern about things like the trade war, and its impact on the economy, its impact on prices, and its impact on inflation, even, down the road.

And certainly these types of concerns are not to be pushed aside. They are certainly important. And they are important to a secular bull market. We do feel like there are other forces, though, like upcoming elections that are going to probably keep a lid on the trade war, itself. We certainly have a [U.S.] president, today, who wants to get re-elected, and is probably addressing a lot of these trade concerns this year as opposed to next year. But certainly we will see. And it's also certainly a risk that you have to price in.

And then lastly, I often hear that bonds and low-vol [low-volatility] investments are just much safer places to invest. And that certainly was a theme—we talked about it in the last podcast a little bit. But certainly, low-vol equities experienced a great run in terms of multiple expansion over the past decade, especially during the period of 2010 to 2016. You saw at the end of 2016, utilities were trading at a higher P/E [price-to-earnings] ratio than tech stocks, which doesn't make a whole lot of sense given that they have, 2% to 3% revenue growth versus 15% to 20% revenue growth in some areas of tech.

So that was potentially a very fear-driven trade that investors were pouring money into just dividend payers-- almost blindly, just looking for yield and not thinking so much that those stocks could ever go down. Today, there is a good argument to be made that that might be the riskiest area of the market, those sort of low-vol or "safety" stocks that have seen such enormous multiple expansion, but really no change in their underlying organic growth.

So when you talk about what [may be] safer places to invest--if you're thinking in decades instead of thinking in six to 12 month increments, you could argue that innovation is a lot safer area to invest for the next 10 to 20 years. *[Note: In this context, "safer" refers solely to the speaker's opinion of relative investment opportunity, not investment risk.]*

Andrews: This is all very well known, so why the persistent risk aversion of investors? Why do they flock to the low-vol strategies, given everything that you've said? And why do they not really think about growth strategies when they're making their allocation decisions?

Foerster: First I would say, I'm not arguing against owning dividend-paying stocks or value stocks. What we are arguing is that the amount of allocation to growth, to innovation, has really seen a sharp decline, at least in mutual fund statistics [as tracked by Lipper].

Now, certainly hedge funds are probably part of the big reason why the individual names have done so well-- the FAANG stocks, the FAMGA stocks. But in terms of mutual funds, which really is the individual investor, as well as separate accounts for pension plans, you have definitely seen a marked decline in allocation to growth and innovation.

On the pension side, it's been more forced upon them by regulation, moving more towards mark-to-market accounting each year. You don't want to take true investment risk. You know, pensions have almost been forced to not be true investors anymore, because if they have an under-funded status, they have to make that up on a year-to-year basis. So they are disincentivized to own innovation or sort of risk assets.

In terms of individual investors, it's a much different story. They don't want to open statements anymore and see any red, right? Month to month. They're kind of thinking very short term. And the true nature of investing is thinking for the next 10 to 20 years. That [concept] has really gone out the window for many after losing large chunks of money in 2000 and then again in 2008. Tom O'Halloran, the [Lord Abbett] portfolio manager for growth strategies likes to say, that [investors' reaction was like] Roberto Duran saying "no mas." A lot of investors basically said, "no more risk, I would rather just own cash or cash equivalents or low volatility investments" as opposed to equities that could deliver much greater wealth creation over the longer term.

Andrews: Let's zero in on growth—what are you finding in the current relative valuation of growth equities? And what does that say about their relative attractiveness?

Foerster: Yeah. You know, just even a couple of the comments I made earlier just about the broad market valuation—certainly even within that. So the price the forward price to earnings multiple of the tech sector today [July 8, 2019] is below 20. It's about 19 and change. That, too, is nothing like it was in 1999 or 2000. But we think about it, a lot more importantly, in regards to the "E" and not so much the P/E. Because the P/E is just a nominal number. You do care about it, especially at extreme levels.

But what's been most interesting is even after this really strong 10-year bull market, you have not really seen a whole lot of expansion in the P/E of these areas of innovation that we really focused on, especially within the growth space. And so when you break down some of those segments of the growth space, like e-commerce, I think a lot of people would be surprised that only about 12% of retail today is e-commerce. I think a lot of people would think that most of retail now has moved to e-commerce.

But there is still a lot more of the retail space to, so to speak, be conquered by e-commerce. So there's still tremendous growth in that space. And not just Amazon. When you look at areas like biotech today—the pace of drug discovery, the pace of FDA [U.S. Food and Drug Administration] approval for drugs has accelerated dramatically.

So from conception of an idea to getting FDA approval, the amount of time is now six or seven years when it used to be 20 years. And a lot of that has to do with the decoding of the human genome, being able to identify the efficacy of a drug much more quickly through rigorous trials.

So we expect that space to only continue to accelerate its growth over the next two decades. So, clearly in what we would call a secular bull market just within biotech. And certainly areas like cloud software, information security, we are not seeing the slowdown that you are hearing about across the broader equity market today.

Andrews: Brian, this has been a fascinating conversation. And it's allowed us to use the word "dystopians" again. That is such a great word. To wrap things up, what would you tell an advisor or investor about the length of the current bull market, its future prospects, and how they should be thinking about their equity allocations, especially growth stocks, in that context?

Foerster: Well, sure. So just in terms of the length of the bull market—I'm not coining this phrase on my own, but I think it's a very valid one: I think that in terms of length, [the bull market is] chronologically older. But we think it's biologically younger or middle age.

We do believe that there is a lot of organic growth out there. And there are a lot of reasons to believe that there could be a continuation of this secular bull environment, of a positive interest rate environment, a positive inflation environment.

A lot of the concerns about whether the Fed is going to cut, or increase, by a measure of a quarter point. You know, we think as you take a 30,000-foot view, it's actually not as relevant as the market is indicating today [but rather that] these secular forces are much more powerful than a lot of investors are pricing in today.

So [there is] a lot of opportunity for upside and then as you think about innovation and growth and how under-allocated advisors are today; again, we're not out saying that you should not be in value or you should not be in dividends. What we are saying is you need to balance that out with these areas of innovation and opportunity that could really be the growth engine of your client's portfolio.

Andrews: Brian, thanks so much for joining us today.

Foerster: Great. Thanks, Will.

Andrews: Be sure to check out a related article from Brian on lordabbett.com, publishing soon.

IMPORTANT INFORMATION

FAS 158: An accounting standard that covers defined benefit pension and other post retirement plans.

Fed refers to the U.S. Federal Reserve.

The **price/earnings ratio (PE)** is the ratio of a company's stock price to the company's earnings per share. The ratio is used in valuing companies.

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