May 2015 Investment Publications Highlights

Market Valuations at the Start of US Rate-Hike Cycles

Charles Himmelberg et al., Goldman Sachs, April 26, 2015

The Federal Reserve's expected decision to hike rates later this year has prompted questions about the impact on the market, particularly given the prolonged period rates have effectively been held at zero. In a recent article, Goldman Sachs compares current market valuation metrics to metrics ahead of past tightening cycles and concludes fears of a Fed-induced market correction this year are likely overblown.

The authors review four prior rate hike cycles (1988, 1994, 1999, and 2004) and find that while current valuations for US credits look reasonable, US equities and long-term Treasuries look expensive. In fact, the current US equity forward price-earnings ratio is higher than all recent rate cycles except during the technology bubble, and Treasury term premiums are at record low levels. Even though equities and Treasuries seem stretched, investors should not be overly concerned about an abrupt correction. This is partly because the speed and size of the rate hike will play a larger role than the initial timing and Fed officials have alluded to a "relatively shallow," data-dependent cycle.

Rich US equity and long-term Treasury valuations also may not be as worrisome as they seem in the context of current market fundamentals. Regarding equities, expensive valuations could be justified by a higher expected growth rate, a lower equity risk premium, or a lower risk-free discount rate. While none of these reasons account solely for the current elevated valuation, the authors find the last reason the most compelling, as the risk-free rate is currently historically low.

Regarding Treasuries, while the ten-year term premium is currently 150 bps lower than the minimum of the previous four cycles, it is not a perfect valuation metric, as it is not adjusted for factors such as QE, equity-bond correlations, and trend inflation. If adjusted, the Treasury term premium would likely seem less stretched.

The authors note it is natural to be concerned that market valuations have been distorted by Fed actions, but they further downplay the risks for a correction by suggesting current macroeconomic data do not call for overly tight monetary policies. The unemployment rate, for instance, is only now comparable to the level at the beginning of the last two cycles, and long-term unemployment is structurally much more challenged. Similarly, inflation indicators are low relative to all four prior cycles. These two points are likely to contribute to the Fed's cautiousness as it begins the next tightening cycle.

A Great Deleveraging

Jonathan Glionna et al., Barclays Capital,
April 22, 2015

Leverage among S&P 500 companies has declined every year since the global financial crisis (GFC), marking the longest sustained downward trend in over 40 years. The authors argue that despite the low interest rate environment, companies are not likely to re-lever to pre-GFC levels in the near future, a fact that could limit US equity market advances.

Regulatory changes in the financial sector are behind much of the deleveraging trend in the S&P 500. Higher capital requirements, aimed at ensuring banks can better withstand financial stress, have prompted many firms to raise equity capital, shed debt, and reduce the size of balance sheets. Overall, the financial sector's debt-to-equity ratio declined from 571% in August 2008 to 161% in March 2015. In addition to structural changes in financials, sectors with low leverage now constitute a greater portion of the S&P 500. For instance, the technology sector, now the largest sector by market capitalization, has the lowest level of leverage.

With corporate credit yields near historical lows, why would a company not take advantage of cheap financing to lever up and attempt to enhance shareholder returns? Not only does debt have tax advantages, but the market has historically rewarded leverage. The authors note that ranking non-financial companies based on leverage ratios and leverage trends over the past 15 years shows a consistent relationship between high ratios or ratio increases and outperformance.

Ultimately, leverage is unlikely to return to pre-GFC levels because with interest rates low, the tax advantage of debt is reduced, curbing a primary incentive to add debt. More highly indebted companies also have less financial flexibility, constrained by higher interest and principal payments. Scarred by the GFC, executives have valued adaptability.

The reluctance to add debt has led businesses to rely on equity, with non-financial companies increasing equity capital by more than 70% since 2008. The new financing mix has changed the S&P 500's return on equity ratio and sales-to-equity ratio, the latter of which has fallen from 2.7 20 years ago to 1.6 today. Structurally lower ratios could negatively impact equity returns, and although companies could unlock nearly $1 trillion of excess equity capital to boost shareholder value, the authors argue the trend of less leverage is likely to remain. ■

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