EQUITY

Why We Think the US Equity Bull Market Could Keep Running into 2019

August 28, 2018

Grant Bowers
Vice President, Portfolio Manager, Research Analyst,
Franklin Equity Group®

Now that the US equity bull market has officially hit the history books as the longest on record, some observers are concerned it could soon stumble. Grant Bowers, vice president and portfolio manager, Franklin Equity Group, outlines why he thinks it could keep running into 2019.

Hear more from Bowers in our latest "Talking Markets" podcast.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of Grant Bowers' views in the podcast:

- There's been a lot of discussion about the duration of the US bull market. We don't expect markets to keep climbing forever, but bull markets don't typically die of old age alone.
- Even with policy changes that may have accelerated growth, when we look deeper at the health of the two key pillars of the US economy—the consumer and corporate earnings—they are both performing well and not showing signs of stress that would indicate to us the economic cycle is nearing an inflection point or a recession is on the horizon.
- Comparisons to the late 1990s "Tech Bubble" are not rational. Tech companies today have been highly profitable and are much less levered. Revenue is less economically sensitive and more focused on software and services, which have the potential to bring recurring revenue that would likely be more stable in an economic downturn.
- Despite near-term outperformance of value as an investment style, many traditional value industries are facing significant competitive challenges from faster-moving competitors or new well-funded entrants. When we look across the investment landscape, we see the pace of disruption is accelerating, and many traditional value industries face rapidly changing competitive landscapes.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I'm your host, Richard Banks. Ahead on this episode, the US bull market carries on, even hitting a new record high. Grant Bowers, vice president and portfolio manager with Franklin Equity Group, speaks with Franklin Templeton's Tim Ramsey. Tim, take it away!

Tim: Thanks, Richard. Grant, the US economy continues to perform well, according to a variety of metrics, but we have seen volatility return to the equity markets in 2018. Looking ahead to the rest of the year and beyond, what is your outlook for the US economy and the stock market, generally?

Grant: We have seen volatility return to the market after really an unusually calm 2017. The synchronized global growth environment that prevailed the last two years has really started to show some cracks, with many global markets seeing growth moderate. Bucking that trend is the US where we have actually seen growth accelerate in 2018 with GDP [gross domestic product] growth hitting 4.1% in the second quarter. This is the fastest rate of growth in nearly four years. While this healthy rate of growth is impressive, it's really driven by a combination of tax cuts and increased federal spending that may have pulled growth forward into 2018; meaning, it may be hard to replicate these levels of growth in the future. Even with policy changes that may have accelerated growth, when we look deeper at the health of the two key pillars of the US economy—the consumer and corporate earnings—they are both performing well and not showing signs of stress that would indicate to us the economic cycle is nearing an inflection point or a recession is on the horizon.

Tim: You mentioned a strong US consumer and a healthy corporate America; can you elaborate on that a little bit?

Grant: The consumer continues to benefit from a very strong employment market, continued low inflation, and interest rates are low by historical standards. This is keeping consumer confidence and spending healthy despite moderate global growth and increasing trade concerns. On the other side of the equation, on the corporate earnings side for the S&P 500, earnings were up over 20% in the second quarter of 2018.[1] While this growth rate was boosted by lower corporate tax rates, the resulting higher profits which I think will drive increased capital spending. This should add life to the aging economic expansion as profits are reinvested and the cap-ex cycle drives improved productivity. For many companies, these benefits I think will last well into 2019 or even into 2020.

Tim: The bull market is approaching the longest in post-war history at this point. This comes with ongoing speculation that a correction may be coming, or in the offing. What factors do you look for to herald a change for the current cycle?

Grant: There has been a lot of discussion around the duration of this bull market. It's in the headlines every day, and while we don't expect markets to climb higher forever, history has shown us that bull markets don't generally die of old age alone. Historical triggers that bring about the end of a bull market have been rapidly rising interest rates or inflation, the buildup of speculative excesses or bubbles, or a geopolitical shock that impacts demand. This current bull market has been long by historical standards, but investors should remember that it has also been very shallow and slow compared to past periods of economic expansion. This slower rate of growth is really the result of the severity of the financial crisis that we saw in 2008, but it's also the combination of low inflation and low interest rates that followed that financial crisis. Given the modest rate of growth this recovery has generated over the last nine years, it is not surprising that it has lasted longer than many expected and not generated levels of excess that typically begin to show this late in the cycle. We don't see any of the classic signs of the economic cycle turning or a recession is on the horizon at this time. You did ask what are we watching? At the macro level, inflation, interest rates, employment levels and credit-defaults are all something we are paying attention to, but we are also constantly talking to company management teams about end-market demand, global competition and the health of their customers.

Tim: So, as an investor, can you prepare for the end of the bull market?

Grant: Well to be clear, we still think the US economy is strong and equities will likely do well in the coming years. That said, preparing for an economic downturn or market pullback is something that is done over time as we build our portfolios stock-by-stock. Our rigorous fundamental research focuses on companies that are not just growth businesses but companies that meet our quality criteria with strong competitive positions, great financials and innovative management teams. These high-quality companies we believe should be able to outperform the market over the economic cycle and be structural winners over time.

Tim: You know, in my mind, you have highlighted a strong case for the US economy and market near-to-medium term. Can you identify some potential challenges or risks you see for US markets in the coming year?

Grant: Well, there's a lot of risks in the market these days. First and foremost is a trade war. Tariffs and trade restrictions continue to be in the news and probably are the biggest uncertainty for the markets right now. It is a complex topic that can have significant implications on global trade and economic growth. We are watching the negotiations cautiously and understanding our companies' potential exposure. Not to diminish the risk, but we do think trade tensions should be viewed through the lens of American politics, meaning more of a trade dispute or negotiation versus an all-out trade war.

The second risk I would highlight would be rising inflation and interest rates. As economic growth has accelerated this year, we are seeing a modest pick-up in inflation and the Federal Reserve (Fed) has grown more hawkish. The market appears comfortable with the current pace of rate increases given the strong economic growth, but there are concerns that the Fed could overshoot its targets, especially if growth moderates in 2019. The last challenge I would highlight is probably more political. The mid-term elections here in the US are front and center as we enter the second half of 2018. Elections always bring some uncertainty and volatility as the market reacts to a potential changing political and regulatory landscape. The mid-term elections here in the United States get a lot of press, but realistically, a change to a more divided Congress would not have a huge fundamental impact on the economy or the broad investment landscape, in our view. The pro-business, lower regulatory backdrop that started in late 2016 would likely continue. We would just have more gridlock in Washington which has historically been good for markets that don't like uncertainty.

Tim: So, separate from the elections, which are still several months off now at this point, there is a lot of daily noise investors are taking in regarding US politics. How do you view this noise?

Grant: The current news cycle really has accelerated. We tend to focus on long-term fundamentals of our investments and really not worry about the day-to-day headlines in the news. We view much of it to be political and much of it really to be headline-grabbing news that doesn't really affect our long-term fundamental outlook.

Tim: Earnings growth for US companies has well outpaced price appreciation for the market this year. As a result, valuations have actually moderated a bit from their January highs. How do you see current valuations for the market generally?

Grant: The S&P 500 [Index] currently trades at 16.5x next year's earnings.[2] This is right about at the five-year average and modestly above the 10-year average which covers the depths of the financial crisis. You are right that valuations have moderated this year. The US market is cheaper on a price-to-earnings basis than it was at the end of 2017. Part of that is the rapid earnings growth we have seen in 2018, but some of that is also a reflection of increased risks that I mentioned that are being priced into the market. Our view is that overall valuations for the US equity market appear fair at current levels, reflecting the strong economy and bright corporate earnings outlook balanced against the risks of trade and rising interest rates.

Tim: And how do you see valuations for some high-profile sectors? I'm thinking about technology in particular.

Grant: We see some pockets of rich valuations that grab headlines, but when we look at the sector broadly, technology stocks are trading at a slight price-to-earnings premium to the overall market, about 18x vs 16.5x for the S&P 500.[3] We see that premium as well-deserved given technology companies have delivered the best growth over the past three years and should likely continue to see strong growth in the coming years.[4] Additionally, from a quality standpoint, I think the technology sector has some of the highest margins and best balance sheets in the market.[5] It is also worth noting the technology sector has changed dramatically over the past 20 years, and comparisons to the late 1990's tech bubble are not rational comparisons, in our view. The companies today are highly profitable and much less levered to hardware and economically sensitive revenue, and more focused on software and services that bring recurring revenue that would be more stable in an economic downturn.

Tim: So-called growth style investing has outperformed value investing since the end of the financial crisis, and many are calling for a shift back to value. In your mind, what has driven this outperformance, and should we expect a shift back to value over growth in the coming years?

Grant: Growth has outperformed value since the end of the financial crisis as the market has rewarded companies that produce consistent earnings and cash flow growth in, what has been until recently, a modest GDP-growth environment.[6] The low-interest-rate backdrop additionally created a tailwind for growth equities where you are often looking out 3-5 years at a company's growth potential and discounting those profits back to measure a company's fair value today. In recent months, we have seen value stocks performance pick up, this coincided with economic growth accelerating in the first half of the year and short-term interest rates rising in the US. Despite this near-term outperformance of value, I think many traditional value industries are facing significant competitive challenges from faster-moving competitors or new well-funded entrants. When we look across the investment landscape, we see the pace of disruption is accelerating, and many traditional value industries face rapidly changing competitive landscapes. In my view, much of this risk is not captured simply by a low valuation multiple, and investors may risk falling into a trap.

Tim: Can you give us some examples?

Grant: You know, the transportation sector where cheaper and faster competitors are rethinking how we move people and goods. The retail sector where online competition is driving down price for consumers and in turn limiting pricing power for traditional brick and mortar retailers. And, in the industrials sector, we are seeing companies that are embracing digital transformation and utilizing data analytics, robotics and artificial intelligence are shifting long-held cost advantages in the industrial world. The question is not whether value equities have periods of outperformance. They absolutely will, but is that outperformance sustainable in this world where many industries are being disrupted at an increasingly rapid pace? I don't believe investors should not be debating growth versus value but really focusing on sustainability and quality—growth or value—for long-term investments.

Tim: Thanks a lot Grant, we really appreciate your insights.

Richard: And thank you for listening.

The comments, opinions and analyses expressed herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What Are the Risks?

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Investing in fast-growing industries, including the technology sector (which has historically been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement. Value securities may not increase in price as anticipated or may decline further in value. Growth stock prices reflect projections of future earnings or revenues, and can, therefore, fall dramatically if the company fails to meet those projections.

1. Source: FactSet Earnings Insight, as of August 10, 2018. See www.franklintempletondatasources.com for additional data provider information.

2. Source: FactSet, as of August 17, 2018.

3. Source: Factset, as of August 17, 2018. Technology sector as represented by the S&P 500 Technology Sector Index. Indexes are unmanaged and one cannot invest in them. They do not include fees, expenses or sales charges. The price-earnings (P/E) ratio is a valuation multiple defined as market price per share divided by annual earnings per share (EPS).

4. Ibid.

5. FactSet, based on three years through August 23, 2018.

6. Source: FTSE. Calculation period December 31, 1988 through January 1, 2018. Growth stocks represented by the FTSE Russell 1000 Growth Index. Value stocks represented by the FTSE Russell 1000 Value Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. Past performance is not an indicator or guarantee of future performance. Additional data provider information available at www.franklintempletondatasources.com.

© 2017. Franklin Templeton Investments. All rights reserved.