The End of Asset Price Reflation?

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Why This Matters?

This paper is relevant because it explicitly ties long term returns to real growth. The paper achieves this end through the linkage between real economic growth and cash flow growth. Finally, the paper suggests that extended periods of below-trend real growth should correspond to lower expected asset returns.

Who Should Read This Paper?

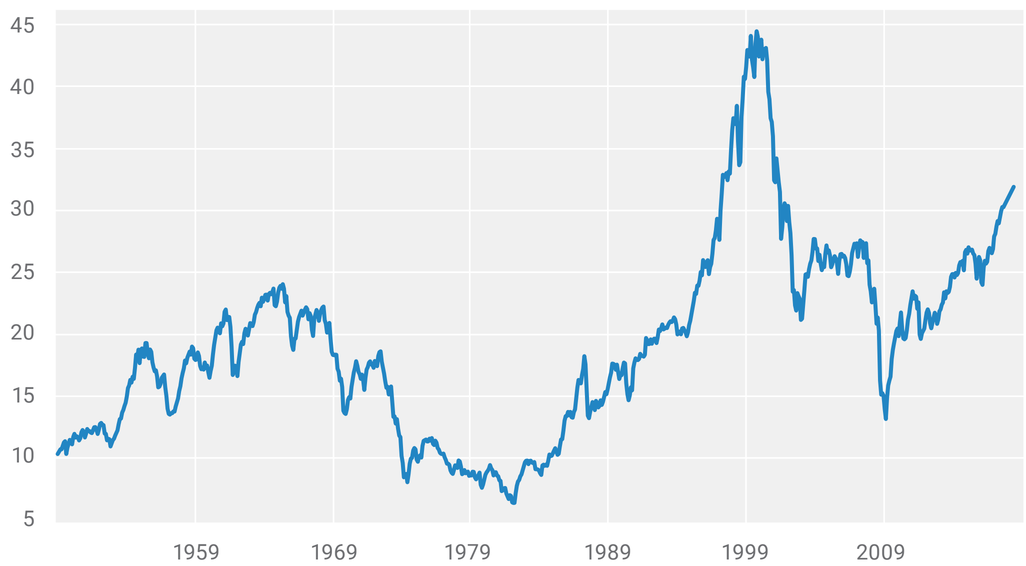
Asset allocators and other investment strategists should find this paper to be of interest.

The End of Asset Price Reflation?

The U.S. stock market has reached new highs relative to earnings, stretching its year-long momentum. Appropriately, investors are concerned about the prospects for equity returns, over both short- and long-horizons. To address these concerns, investors should focus on prospects for real economic growth. Our baseline scenario points to a continuation of below-trend real economic growth and muted inflation. Consequently, investors should expect lower realized returns on equities and diversified, multi-asset class portfolios.

Exhibit 1 shows the value of the U.S. stock market relative to 10-year trailing average earnings. By historical standards, the value of the US equity market is high relative to earnings. Moreover, the current valu-

Exhibit 1 - The Value of U.S. Equities Is High Relative to Earnings



The Exhibit depicts the historical evolution (since 1950) of Robert Shiller's CAPE ratio, measuring the relative price of the U.S stock market to 10-year trailing average earnings.

SOURCE: DATASTREAM, ROBERT SHILLER'S WEBSITE http://www.econ.yale.edu/~shiller/data.htm ation level has only been reached three times in the last 100 years –in July 1929, in June 1997, and January 2007– with all three episodes of significantly higher valuations preceding large stock market crashes.

Is this time any different? To grapple with this issue, investors should go back to basics and focus on future long-term real economic growth. Indeed, real economic growth drives future real discount rates and real cash-flow growth, which in turn drive equity returns. Thus, there seem to be a potential disconnect between asset-price reflation in equity markets and our likely scenario of continuation of slow real economic growth rates.

Exhibit 2 - Navega Strategies 5-Year Ahead Baseline and Scenarios for Growth and Inflation

	Baseline	Growth Revival	Secular Decline	Stagflation
Real Economic Growth	2.0%	2.6%	1.4%	1.4%
Inflation	2.0%	2.0%	2.0%	3.8%

The Exhibit shows our model implied average real GDP growth and inflation rates over the next 5 years for 4 possible scenarios including our baseline scenario. All rates are annualized percentage rates.

SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Exhibit 2 shows our growth and inflation assumptions (5-year ahead average annualized rates) for 4 possible scenarios. The first scenario is our baseline scenario, which calls for a continuation of below-trend real growth and benign inflation. In the second of our scenarios, growth is assumed to return to its pre-2008 long-term average after 5 years, again with benign inflation. Our third scenario continues with benign inflation, but assumes a further deterioration in real growth. Finally, our stagflation scenario supposes low real growth and increased inflation.[1]

What are the implications of each scenario for asset markets? In some respects, the past year's equity market momentum has been fueled by low interest rates and anticipation of a boost in corporate earnings and profits. Low real interest rates are consistent with sluggish real growth, as investors demand insurance and buy US Treasuries. However, the potential for

[1] See our earlier notes for more details on our baseline and the alternative scenarios.

higher earnings in the future does not square with sluggish real growth.[2] As long-term contributions to returns from cash-flows outweigh those from discount rates, slow real economic growth in the future implies a potential valuation correction followed by lower real equity returns.

Exhibit 3 shows our model-implied returns under each scenario. Under the baseline, the equity market returns 7.4% per year on average over the next 5 years. The two other scenarios featuring a decline in growth (Secular Decline and Stagflation) forecast lower equity returns at 5.3% and 6.8% per year. In the stagflation scenario, higher inflation and lower real growth combine to produce a mere 3% annualized real equity return. In fact, higher real equity returns are only possible in our model with a return to pre-crisis average real growth (as illustrated by the second scenario).

[2] This point holds especially if fiscal policies fail to deliver on improved real growth.

[3] The growth-sensitive factor-based strategy allocates to a U.S. value tilted and a U.S. small-cap tilted long-only portfolio in an equal split, while the defensive factor-based strategy equally weights a U.S. high profitability tilted and a U.S. high dividend yield tilted portfolio. The risk-parity strategy has a 50% allocation to 10-year government bonds, and equally weights the growth-sensitive and defensive factor-based strategy.

Exhibit 3 - Navega Model-Implied Nominal Strategy Returns (5-Year Average, Annualized)

	Baseline	Growth Revival	Secular Decline	Stagflation
10-Year Constant Maturity Government Bond Yield	2.3%	2.4%	2.2%	4.2%
Equity Market	7.4%	9.5%	5.3%	6.8%
Growth-Sensitive Factor-Based Strategy	11.3%	14.3%	8.3%	9.8%
Defensive Factor-Based Strategy	6.8%	8.5%	5.0%	6.5%
Risk-Parity Strategy	5.7%	6.6%	4.8%	3.8%

The Exhibit shows our model implied yield for the 10-year U.S. constant maturity nominal government bond, and implied nominal return for the U.S. capitalization weighted equity market and three selected strategies, conditional on 4 possible scenarios.[3] *All yields and returns are annualized, average percentage rates over the next 5 years.*

SOURCE: NAVEGA STRATEGIES LLC RESEARCH

Exhibit 3 also shows the implications of these scenarios for various equity and multi-asset class strategies. Factor-based strategies such as Value and Small Cap have had cash flows that are more exposed to growth risk relative to the broad equity market. Consequently, these growth-sensitive strategies suffer greater losses than the market when economic growth slows (assuming the higher growth sensitivity persists). In contrast, cash flows of defensive factor-based strategies, such as Profitability and High Dividend Yield, have been less exposed to growth, and exhibit lower long-term returns and suffer lower losses in slow growth environments (again assuming the low growth exposure persists).

Unlike equities, government bond returns are mostly driven by inflation, and are negatively exposed to real growth. Thus, they help hedge negative shocks to economic growth, but suffer in times of high inflation. As a result, risk-parity strategies, with their enhanced exposure to bonds, also help hedge negative growth shocks. However, they experience great losses under stagflation, as returns to both bonds and equity strategies decline.

What are the implications for portfolio strategy? Ultimately, investors hold portfolios that combine exposures that are sensitive to growth and inflation. Regardless of whether they are institutional, high net worth or individual investors, they will need to re-examine their portfolio strategy in view of diminished expectations for real growth and the knock-on effect on real equity returns. In doing so, they should focus on long term objectives. We explore the implications for portfolio strategy of low real returns in our next two notes.

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