RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Giving Thanks

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In recognition of the American Thanksgiving holiday last week, today's Weekly Digest is breaking out the star-spangled banners, cheerleaders and fireworks in honour of the country that many publicly denigrate but are privately extremely envious of, not least in terms of the fantastic returns that its stock market has generated over the years.

We'll kick off with some market return data (for some of which I tip my hat to

Goldman Sachs's hedge fund desk). Going back to 1945, the odds are very much in investors' favour when it comes to being in the market, with 78% of all years delivering positive returns. The average annual total return since then is 12%.

As we often comment, 12% taken in isolation might not sound spectacular, but we have to remember our old friend compounding. And so, $1,000 invested in the S&P 500 Index in 1945 would be worth $3.4 million today had dividends been reinvested. Much is made of the seasonality of returns (remember "Sell in May"), and there is some truth in that. $1,000 invested only from May to October would be worth just $10,000 today. Being in the market from November through to April would have delivered you $340,000. But if you compound the two you get to that magic $3.4 million. Probably best not to try to finesse that one.

Although the name above the door, as it were, is the same, what's going inside continues to evolve. The S&P 500 has lost 295 of its members since 1999. This will have been from a mixture of takeovers, poor performance and, in extreme cases, bankruptcies. Unlike in the UK recently, few, if any, companies voluntarily decided to relist in other countries.

Just for fun, and by way of comparison, I also looked at the original constituents of the UK's FTSE 100 Index at its inception in January 1984. Allowing for some combinations that have taken place along the way (such as Commercial Union and General Accident now being Aviva, and Distillers and Grand Metropolitan being the core of Diageo, for example), only 27 of the original one hundred companies are extant. Interestingly, the industry with the most survivors is Banks, despite enduring the Great Financial Crisis, although a whole raft of converted building societies came and went along the way (as did almost all the privatised utilities, not to mention some of the fluffier TMT firms that flared out in the technology boom and bust).

Much has been made of the influence of monetary policy in the last few decades. Although it has been a damper on performance in recent times, it has mainly been a booster since the concept of the "Fed Put" was born. This maintains that the Federal Reserve (Fed) will step in with policy support whenever the financial economy wobbles. It was first observed in 1987, when the Fed cut interest rates in response to the market crash of October that year, but not really named until the Fed cut rates aggressively following the demise of the hedge fund Long-Term Capital Management in 1998. Then it was called the "Greenspan Put" after the Fed's chairman at the time. It has since been activated by Ben Bernanke, Janet Yellen and the current Chairman, Jerome Powell, hence the more generic label.

If one goes back to 1997 (the year before the collapse of Long-Term Capital Management), it is interesting to observe the influence of the rate-setting Federal Open Market Committee (FOMC) meetings on the equity market. If you remove from the data the returns from FOMC day and the day before it, the S&P 500 would today be at around 2,000 rather than its current 4,600. Betting on a dovish Fed has been a winning strategy.

Finally, in this data-mining section, it is instructive to compare the relative performances of the world's (now) two biggest economies and their stock markets. Since 1992, China's GDP has increased forty-six fold, while the US economy is four times bigger now than it was then. According to Goldman's data, the total return for China A shares over that period is 700%, while it is almost 2,000% for the S&P 500. That speaks to at least two key factors. One is that it looks as though shareholders have been losing out relative to business leaders in China. The second is that there has been misallocation of capital on an epic scale there.

And it is capital allocation at the aggregate level that I want to focus on now. One can find plenty of data to illustrate how incredibly expensive the US stock market is today relative to history. Two favourites that are rolled out are the ratio of market capitalisation to Gross Domestic Product and the Shiller Price Earnings ratio. The former currently stands at 165%. It's peak of 200% was in 2021 when speculative stock market activity came at a time when the denominator was still a bit depressed (post Covid and pre-inflation). Even at the height of the TMT boom in 2000 it "only" hit 143%, before plummeting to 52% during the financial crisis, a level which itself might have seemed a bit peaky back in the 1970s and 1980s – the trough in 1982 was just 33%.

The Shiller PE, named after academic Robert Shiller, is also known as the CAPE, or cyclically adjusted PE. It smooths out cycles by taking average earnings over a ten year period as the denominator in the PE ratio. It currently stands at around 31x against the more widely quoted 12-month forward PE of around 21x. Doom merchants love to point out that 31x is the level the CAPE reached in 1929 ahead of that year's stock market crash. The cyclical peak has only ever been surpassed at the height of the TMT boom in 2000, when it reached 44x. The financial crisis trough was 14x.

On the face of it, then, time to run for the hills. Not so fast. The world is a very different place to what it was in 2008 and 2000, let alone 1929. Not only do US companies have a much more global outlook now (which would suggest that the relationship between market capitalisation and GDP should not be set in stone), but they are also, in aggregate, a lot more profitable today, at least if one looks through the lens of return on capital versus the cost of capital. The S&P 500 generates a current return on equity of about 17.5% according to Bloomberg, while the rest of the world manages about 11%.

The key players in this respect are the mega-cap companies that dominate the index. They have created platforms that are essential to many people's daily lives and to the smooth running of businesses. They tend to be less capital-intensive because they offer services rather than making stuff and there is a strong positive relationship between the return on capital and the price-to-book value. There is a similar relationship between the margins that a company can generate and its price-to-sales ratio. And these companies generate fantastic margins. The icing on the cake is that they have been growing like weeds too. Work from Empirical Research has shown that highly profitable growth is the sweet spot for equity valuations.

And so, the big questions might be what could undermine the growth rates or lead to a drop in profitability? The structural case for tech-led growth appears to remain strong, especially as generative artificial intelligence (AI) continues to gain traction. And AI could also generate productivity gains in many other areas of the economy as it is adopted. On balance, we believe that AI is a force for financial good. The debate on the social side will have to wait for another day.

Mean reversion of profit margins is a long held theory. It suggests that successful businesses and industries will attract new players and that the competition will erode existing high margins. That has certainly been the case in much of the "old" economy over the years, but it is not inevitable. Many strong brands, for example, have consistently been able to defend their position, relying on the quality, cachet and unique properties of their offering. The big tech companies have so embedded themselves into the fabric of life that it would seem almost impossible for anyone to muscle in on a sustainable basis.

Of course, that does not preclude self-inflicted wounds. Meta/Facebook's detour into Virtual Reality threatened to destroy its returns, collapsing the share price. Management took the hint, refocused on higher returns, and the shares are up 180% this year!

What about regulation? If politicians are worried about the scale and influence of these companies, then might they try to cut them down to size? It's not clear how. I doubt that price caps would work. What if they were broken up like Standard Oil (in 1911), or AT&T (1984)? Well in those cases the sum of the parts ended up being worth more than the whole.

An outlier could be a competitor who has no great interest in making a positive return on capital. China would be the prime suspect here. It has made a pretty good fist of compressing returns in the Western renewable energy industry and seems hell-bent on doing the same for electric vehicles. But it would seem to be lot easier with "stuff" than with services that need strong Intellectual Property.

And so, it seems as though our friends on the other side of the Atlantic have much to be thankful for. That doesn't preclude the risk of further economic slowdown, but that will be more cyclical than structural, and, ultimately, not a bad thing if it cuts out some of the dead wood in the corporate sector... which would probably enhance returns for the survivors. And then there is the political shenanigans of next year's US Presidential election to look forward to. That is almost bound to generate an increase in market volatility, as it has done in the past, but it's another temporary factor. And while we would struggle to make the case that US equities are "cheap", it would require a big leap of faith to bet aggressively against the US continuing to prosper.

Economic Commentary

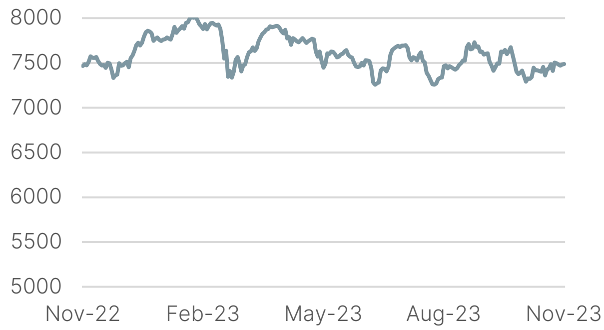
FTSE 100 weekly winners

Sage Group plc	12.1%
JD Sports Fashion Plc	6.8%
Intertek Group plc	4.7%
International Distributions Services plc	4.4%
Intermediate Capital Group plc	4.1%
London Stock Exchange Group plc	3.6%
Halma plc	3.5%

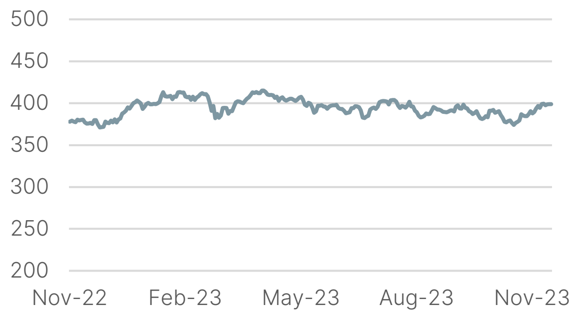
FTSE 100 weekly losers

Ashtead Group plc	-8.9%
Kingfisher Plc	-6.1%
British Land Company PLC	-5.9%
International Consolidated Airlines Group SA	-5.8%
Vodafone Group Plc	-4.4%
Land Securities Group PLC	-4.2%
Glencore plc	-4.2%

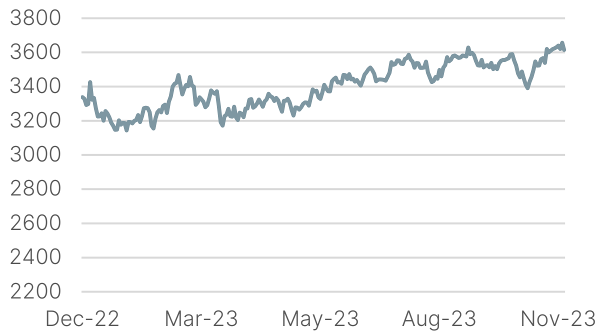
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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