KENDRA SECURITIES HOUSE

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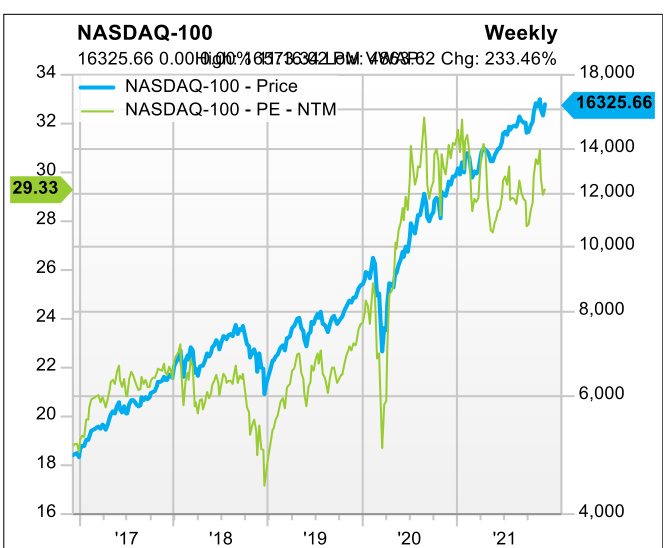
Will the FED spoil the party in 2022 ?

Central banks are cutting interest rates in order to loosen the financial conditions needed for an economic recovery, and they raise them when growth returns to above average levels and/or inflation is moving above their tolerated levels. For the last decade and having been through numerous crises globally, inflation has never been an issue. On the contrary, we have been accustomed to live in a deflationary environment, the product of technological innovation, higher productivity and globalization. The pandemic, however, created a new environment which the world had not faced in more than a century, with countries locking down, manufacturing coming to a stand-still and people having plenty of savings while staying at home. The temporary economic damage was quickly followed by a surge in demand through online channels and a spending spree by global consumers who saw, in most part, that their governments were paying their salaries. As demand for goods surged in a world of reduced manufacturing production, prices started creeping higher. Problems in transportation channels magnified the problem as freight prices exploded higher. The surge in demand for electronic devices and the move into electric vehicles by almost all manufacturers also created bottlenecks in semiconductor deliveries. Commodity prices (metals, oil etc) all exploded higher too. All in all, inflation in most parts of the developed world has now moved into levels not seen in decades and higher than those tolerated by central banks.

With economic growth running at above average levels, employment back to pre-pandemic levels and inflation being less transitory than initially thought, the FED has very few arguments for not to begin its interest rate hike campaign next year. This should naturally lead to higher interest rates in government bonds, especially in the short/mid end of the yield curve. It is no surprise that the 5-year yield has tripled this year, from 0.40% to the current 1.2%. The 10-year yield has moved from 0.80% to the current 1.50%. As equities are a very long duration asset, their valuations are affected by the move of the long-term yield. Higher yields affect valuations negatively as future cash flows are discounted (divided by) the long-term yield. This does not necessarily mean that equity prices will move lower, as part of the valuation equation is the expected earnings and cash flows. It does however provide a headwind since actual earnings will have to exceed the current consensus in order for equity prices to move higher meaningfully next year. In such an environment, the most expensive parts of the markets will face more headwinds in 2022 than the sectors which trade back at less demanding valuations. The flip side is that if economic activity slows down then these “expensive” sectors will again become sought-after and their prices will increase further. As a conclusion, a balanced approach among sectors and regions is best suited.

Figure 1. Nasdaq’s valuation the last 5 years



The blue line shows Nasdaq’s price evolution since 2017 and the green line shows its valuation, as expressed by its P/E. It had been ranging between 20-23 for most part of this period, with equity sell-offs in 2018 and 2020, bringing it down to almost 18. But when people realized that companies primarily in the Technology and Biotechnology sectors will see their revenues and earnings grow at very high levels due to the pandemic, the valuation moved higher to average between 29-32 in the last two years.

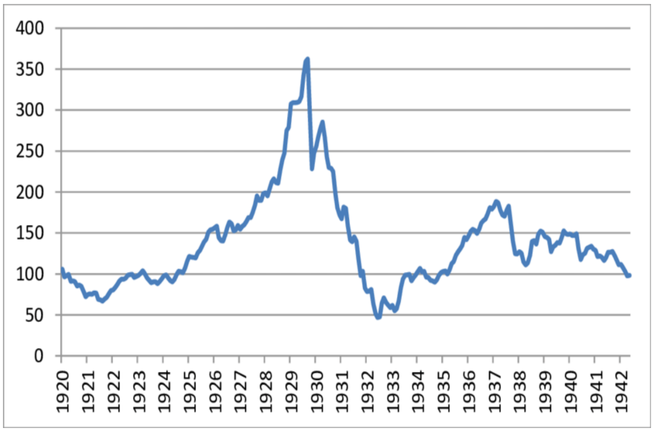
The big question remains whether the ongoing “exit” from the pandemic in combination with the possible interest rate hikes by the FED will make investors demand again valuations closer to the 2017-2020 period. If this is the case, then earnings will have to grow at a much higher rate than currently forecasted for equity prices to move higher.

Are we again in the "roaring 20s" ?

The 1920 decade is also known as the "roaring 20s". It was the period after the end of World War I (and coincidentally after the 1917 Spanish flu pandemic) which was characterized by the demise of authoritarian regimes (Germany) and the advent of liberalism as the successful political/economic system. It is the decade which cemented the status of the US as an emerging super-power. Not only the US provided financial support to Europe and the rest of the world, but it also became the hub of innovation, new technologies, advances in arts and accelerated progress in many other fields. The supercharged economic growth led to excessive behavior in all aspects of human life.

The stock exchange, as a discounting mechanism and a newly discovered place to make even more money, powered ahead for most part of the 1920s. As more people started getting involved in trading, US stocks kept rallying to unsustainably high levels of valuations. What followed was the crash of 1929 which led to the Great Depression and a bear market for almost 4 years. Many behavioral scientists find today's environment very similar to those years, while the 20s "coincidence" makes their argument even more intriguing. Having been through a pandemic, we see similar signs of excessive behavior in consumers, we are witnessing an explosion of technological innovation and the stock exchange has acquired a new generation of participants, youngsters in their 20s who have abandoned video-games to start trading.

Figure 2. Dow Jones 1920-1940



Should that be the case, then perhaps we have ahead of us a few more years of above average equity returns, where valuations and fundamentals will stop playing an important role until we hit the inflection point where the floor disappears below our feet and we crash royally (as in 2000, the most recent example). The bears would say that given the much different speed at which things run these days vs 100 years ago, we are going to reach that inflection point much sooner than the end of the 2020s. Only history will tell.

The "democratization" of Private Equity

Private Equity is investment in companies which are not listed in a stock exchange. They are usually start-up companies with a technological or product niche that require capital from outside investors in order to bring their products or services to the market. There are investment managers who are specialized in this market and allocate capital to the ideas they believe that they can become viable businesses. Of course a plethora of these companies eventually fail, but those who make it are becoming well known and established. In that case, the company usually enters the public markets (stock exchanges) or is bought by another company, and the return on the initial capital invested can be very significant. Successful Private Equity funds have generated returns close to 15%-20% per year, which compares to the 8-10% average annual return of global equities. Investing in Private Equity funds has been up until quite recently the privilege of the very wealthy individuals, the super-rich who had the necessary capital and the long time horizon to invest and wait for several years to reap the results. As financial innovation progresses fast, Private Equity funds are becoming more accessible to the "regular" investor. Advanced electronic platforms have been developed for a relatively easy, but secure, access to a wide range of products, bringing thus the luxury of investing privately to the people. At KSH we will soon be able to add this very attractive offering to our clients.