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Markets: American bulls in charge

John Authers

Prospect of higher rates has not deterred US equity investors but there are signs of complacency

When the US led the world into a catastrophic financial crisis six years ago, few expected the country to be the first to surge out of the mess it had created. But that is what happened. While others remain in the doldrums, US markets power ahead in an unambiguous bet that the American economy can grow even if others suffer a recession.

The S&P 500 has more than trebled since it hit rock bottom after the crisis; it has sailed on for three years without once suffering a fall of as much as 10 per cent; it has done this on the back of economic performance most Americans find terrible; and yet sentiment remains firm that the rally can continue.

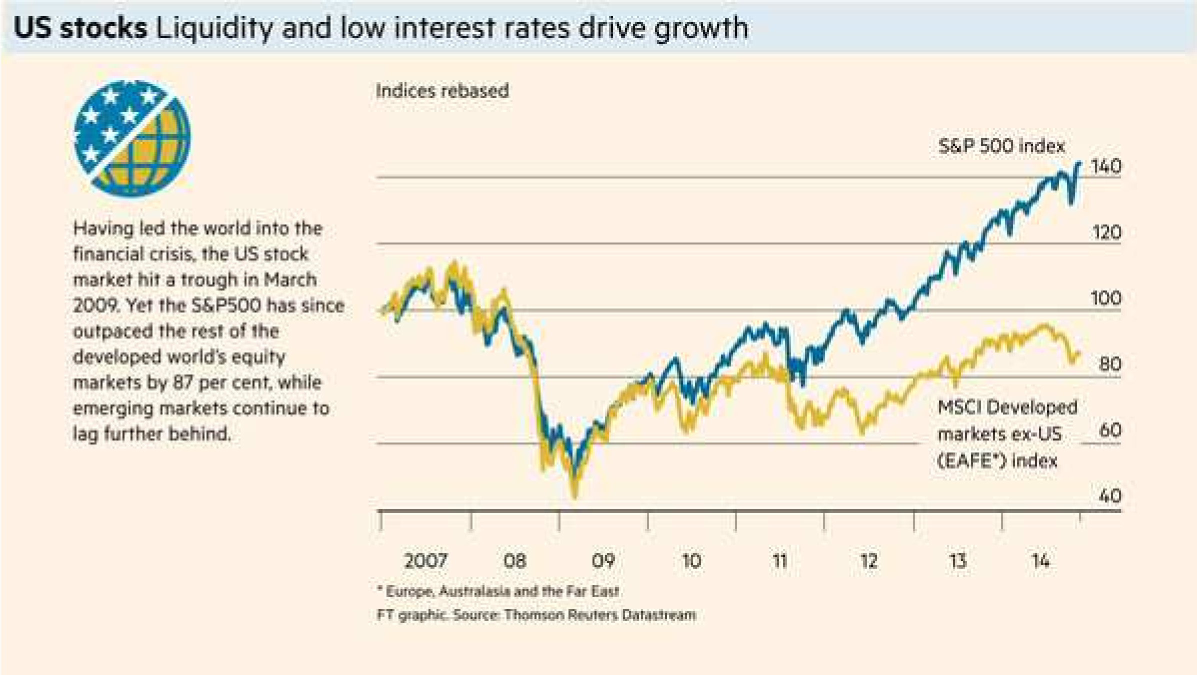
Richard Bernstein, a New York-based investment analyst, said: “We said in 2009 we were probably entering one of the biggest bull markets of our careers, and I think we still are. If you look around the world, it’s very hard to find too many economies that are getting better. In the US, the absolute growth rate is not so strong, but in many aspects the economy is actually improving.”

The logic pushing investors into US stocks is ineffable. Vinny Catalano, of Blue Marble Research in New York, puts the case succinctly: “The main drivers for the bull markets have been strong earnings, interest rates being extraordinarily low and a significant amount of liquidity. That money has got to be invested somewhere. The music is playing and you have to dance.”

But the extent of the turnround when compared to the rest of the world suggests that things may have been taken too far. In early 2008, the total value of European stock markets briefly exceeded US market capitalisation by more than $1tn. Now, Corporate America is worth almost $10tn more than Corporate Europe. Since March 2009, the US S&P has outpaced the developed world’s stock markets by 87 per cent and emerging markets – which had surged before the crisis – by 89 per cent.

Meanwhile, the dollar is enjoying a long upswing while yields on US debt remain historically low, even after the Federal Reserve has ended its quantitative easing programme. That suggests strong confidence that the US will avoid inflation, even as investors are braced for the Fed to start raising interest rates.

Once feared, the prospect of higher rates is now greeted by investors as a sign of returning normality. As Mr Bernstein says, bear markets usually happen not when the Fed raises rates but when it raises rates too much. When worried this is about to happen, the bond market signals its fear by raising short-term rates above long-term rates – something that is far from happening at present.

- 

S&P500 stocks against EAFE stocks

The strengthening dollar, bolstered by higher US rates, encourages foreign investors to buy US stocks, as they can gain from the currency if the underlying equity market goes off the boil. But it also creates a problem. A stronger dollar directly weakens the value of US companies' overseas earnings, which have dropped from a third to a fifth of total earnings since the dollar hit its low during the crisis. As John Higgins of the London-based Capital Economics puts it: "While the dollar's recent strength may partly be a reflection of the relative health of the US economy, it is arguably a reason to be more cautious about the prospects for US equities."

Stocks are already priced on the assumption that the US is to reign supreme. They look expensive compared to their own history, and very expensive compared to other countries'.

The S&P now sells at a multiple of 27 times its average earnings over the past 10 years. This is well above its 10-year average and roughly where it was on the eve of the credit crisis in 2007. Every other major developed market has a long-term price/earnings multiple below its historic average, according to Research Affiliates. The US looks more expensive because it has many tech companies, which command higher multiples, but the gap is wide and stark.

A further issue with valuation concerns profits. S&P 500 companies' earnings per share are at a record and gained more than 10 per cent on an annualised basis in the third quarter. But those profits were buoyed by QE, which enabled financial engineering such as borrowing to buy back stock. Companies also enjoyed the high and perhaps unsustainable profit margins that come from cost-cutting, low interest expense and a compliant labour force. Earnings before interest, tax, depreciation and amortisation are still not back to their 2007 peak. Revenues have been far slower to recover than earnings – even if they did grow at a clip of more than 5 per cent in the most recent quarter, once energy companies are excluded.

That means earnings owe much to profit margins, which are now at historic highs and tend to be cyclical. That they have stayed high throughout the post-crisis period probably reflects stubbornly low wage growth; the US economy is not growing fast enough to give workers much negotiating power. Indeed, some equity analysts say their chief concern is a return to healthy wage growth. That would be good for Main Street but not for Wall Street.

US companies are buying back their own stock at a record rate. So far this year, more than 90 per cent of their announced earnings has gone back to shareholders, either through buying back shares or as dividends – suggesting executives see few promising investment opportunities. Indeed, the biggest buyer of US stocks, by far, is US corporates. Buybacks swamp the total invested by mutual funds and pension funds combined, as companies such as Apple, Intel and Boeing, often under pressure from activists, reduce the number of their shares outstanding.

Finally, much of the "buy US" enthusiasm rests on a view that the Fed is out of kilter with other central banks. The European Central Bank is talking of speeding up its attempt to stimulate inflation, the Bank of Japan has stepped up its own bond purchases, and the People's Bank of China has surprised investors by cutting rates – while the minutes from the latest Fed meeting suggest that the bank is gearing up to raise rates next year. All of this should keep funnelling money into the US.

But if this does pan out, the risk that the US – already expensive – continues charging upwards until it becomes overheated seems very real. As Rob Arnott of Research Affiliates puts it: "The flight to safety brings money into this economy, propelling markets higher. So there are lots of reasons. That doesn't mean that the market is a buy, it just has been fuel for rising markets and it doesn't tell us when this merry-go-round stops."

Perhaps it is the almost uniform confidence in the US that is most worrying. The closest approach to a correction this year, when a spasm in the bond market last month led to a 9.8 per cent dip in the S&P 500, came after a few data points suggested the US economy was weakening. Evidently, many were overexposed to the notion of strong US growth.

The strength of the consensus worries even self-confessed dollar bulls, like Marc Chandler of Brown Brothers Harriman.

He says: "I'm just finishing up a huge business trip that took me through the US and Europe and Asia, and I've not met a single money manager who's not bullish on the dollar, not bullish on US stocks or not bullish on the divergence story. What could go wrong is not that something goes wrong in Europe or Japan, but that the shine goes off the US side of the story."