
AUGUST UPDATE

July in Review

- As expected, the **Federal Open Market Committee (FOMC) hiked the Fed Funds target 25bps to 5.25-5.5%**. Powell left open the possibility of an additional hike in September, but most Fed watchers expect the Fed to defer the next hike to the October/November meeting.
- **Inflation continues to moderate in the US**. Unless growth accelerates, we can start to price in “soft-landing” rate cuts next year.
- **The Case-Shiller National Home Price Index declined until January 2023, but has since seen five consecutive months of appreciation, nearly regaining its highs from May 2022**. The total peak-to-trough real decline was about 7.5%.
- **The Conference Board Consumer Confidence Index jumped to its highest level since July 2021**.
- **Economic conditions outside the US remain more tenuous**. Central bank tightening has pushed the eurozone into recession despite continuing inflation.
- Additionally, **despite new stimulus measures, investors remain pessimistic about China’s prospects due to long-term structural growth issues**.

Explaining American (Stock Market) Exceptionalism

Many investors question why they should hold international equities, given their significant underperformance compared to US equities since the global financial crisis (Fig. 1). One way to answer this question is to better understand why US equities outperformed and then ask whether those conditions are likely to persist in the future.

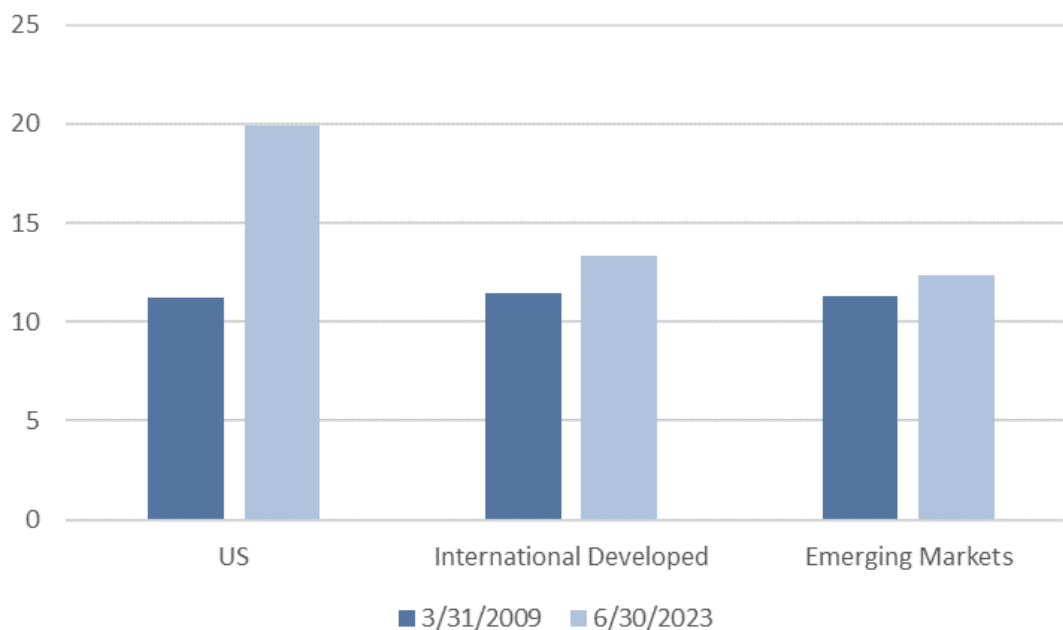
Fig. 1: US equities have outperformed since 2008



Source: Bloomberg, Mill Creek.

US outperformance has been driven by a combination of higher earnings growth and relative multiple expansion. In plain English, US profits grew faster and investors were willing to pay more for those earnings. For example, annualized earnings growth was 8.2%, 3.9%, and 3.2% between March 31, 2009, and June 30, 2023, for US equities, international developed equities, and emerging market equities, respectively. Multiples were similar across regions in March 2009, but expanded substantially more in the US than outside the US over the preceding 14 years (Fig. 2).

Fig. 2: Price-to-earnings multiples expanded in the US relative to international



Source: Bloomberg, Mill Creek.

More fundamentally, why was earnings growth higher in the US and why did multiples expand much more dramatically in the US than internationally? Michael Smolyansky, Principal Economist in the Capital Markets Section at the Board of Governors of the Federal Reserve System, recently published a paper that attempts to answer these questions. It is titled “End of an era: The coming long-run slowdown in corporate profit growth and stock returns.”

In his words:

"I show that the decline in interest rates and corporate tax rates over the past three decades accounts for the majority of the period's exceptional stock market performance. Lower interest expenses and corporate tax rates mechanically explain over 40 percent of the real growth in corporate profits from 1989 to 2019. In addition, the decline in risk-free rates alone accounts for all of the expansion in price-to-earnings multiples. I argue, however, that the boost to profits and valuations from ever declining interest and corporate tax rates is unlikely to continue, indicating significantly lower profit growth and stock returns in the future."

In my words: Smolyansky finds that the outperformance of the S&P 500 was due to increasingly cheap debt and ever-lower tax rates, which pushed up earnings and multiples. If earnings growth

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reverts to a level commensurate with GDP growth and multiples don't perpetually expand (they can't!), inflation-adjusted returns for the S&P 500 will normalize as well.

This analysis can appear very dour, but isn't quite as pessimistic as it seems. *Normal* returns are just fine in equity markets. It's simply a reminder that there were some very specific conditions that drove a lot of US outperformance that are unlikely to be repeated in the future.

This week's contributor: Michael Crook, CAIA

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