Weighing the Push and Pull of Stronger Growth and Waning Liquidity for Equity Markets

MAY 21, 2021

ERIN MILES
NASSIM FEDEL
JASON CHEAL

© 2021 Bridgewater Associates, LP

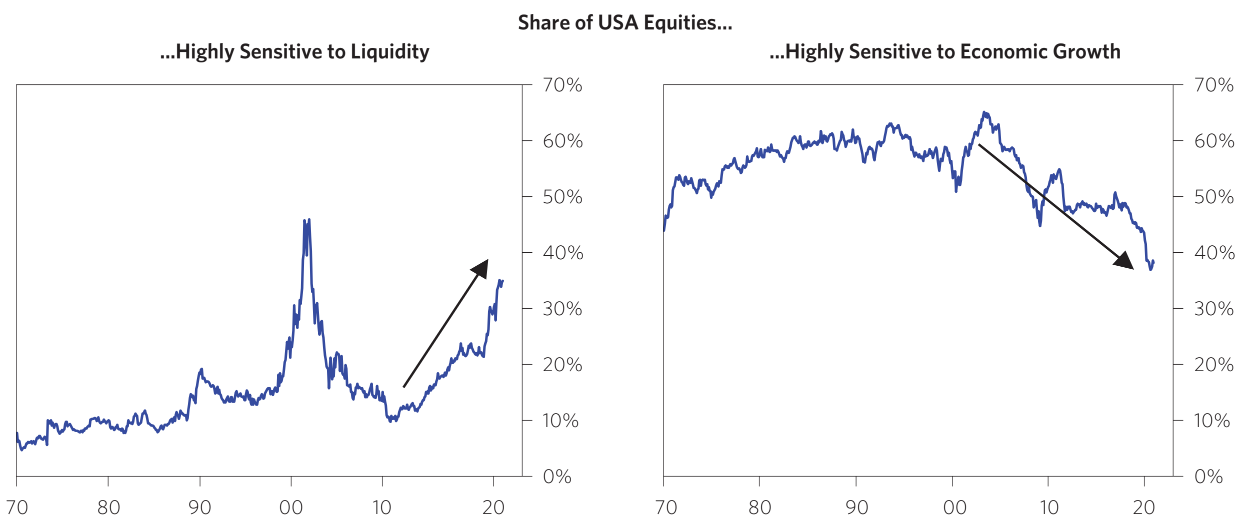
BRIDGEWATER

This stage of a recovery is usually bullish for equities because stronger growth outweighs tightening liquidity. Today may be different. As we look ahead, we see two massive forces pushing in opposition: the boost to spending from the reopening and the fiscal stimulus and a likely pullback of liquidity by the Fed as it becomes less needed.

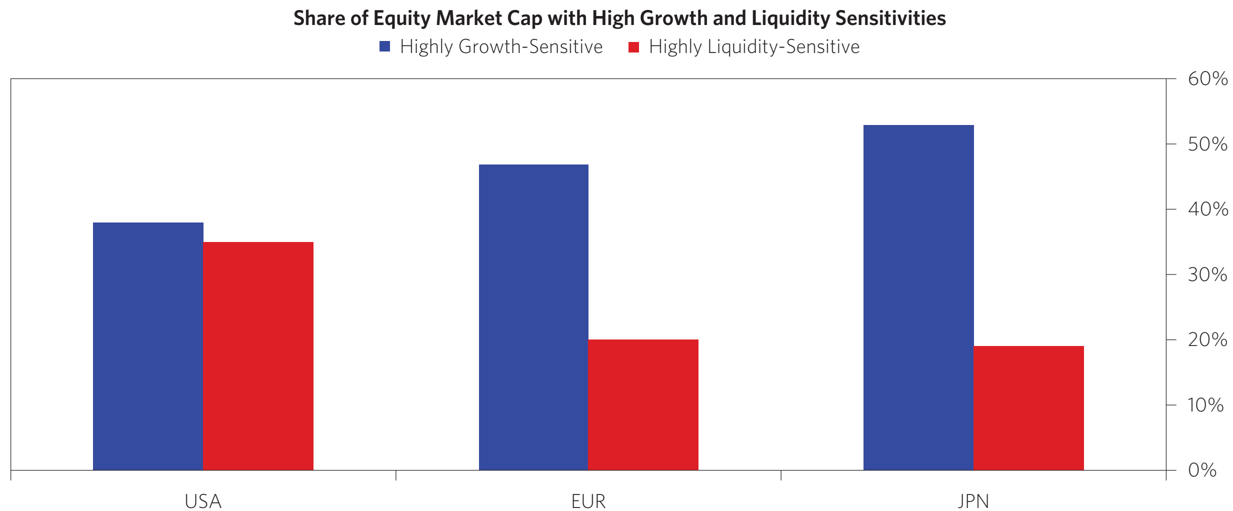
The net will be a strong positive for the real economy but more of a question for financial markets. Equities in particular are caught in the crosshairs, with waning liquidity a significant negative, while rebounding growth supports cash flows. Here, we take a closer look at the relative impact of each, both within and across equity markets.

Typically, in the early stages of economic recoveries, strong growth supports cash flows to a degree that outweighs the impact of central banks beginning to pull back on stimulation. But today may be different. The transition to the later stages of the cycle may be faster than discounted and anticipated by the Fed. And the extraordinary amount of liquidity has driven down equity discount rates to a degree that creates heightened vulnerability, particularly in the frothier pockets of the market. In addition, as we show below, the nature of corporate cash flows has fundamentally changed in ways that reflect greater reliance on liquidity and less benefit from rebounding growth. We capture the sensitivity to liquidity not only from the mechanical vulnerability to interest rates (via duration) but also from the degree to which companies relied on the past decade's extraordinary liquidity to finance earnings-per-share growth. We capture the declined sensitivity to growth by looking at drivers such as the cyclicality of revenues and operating leverage. Overall, a lot of this shift reflects the rise in dominance of tech companies and the fall in importance of industries like banks and resources.

When we look at global equities holistically, we still net out as modestly bullish. But the considerations described above contribute to us liking the US market less on a relative basis.



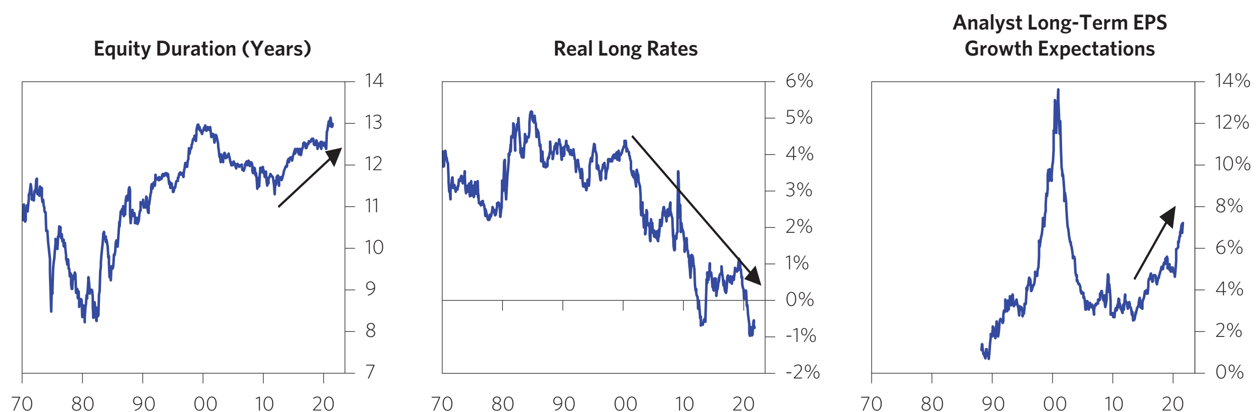
The chart below shows the picture across economies. Compared to the US equity market, Europe's and Japan's have relatively more companies that are highly growth-sensitive and fewer that are highly liquidity-sensitive.



Below, we take a closer look at the underlying drivers behind the shift within the US equity market.

The Decline in Discount Rates and Strong Growth Expectations Supported an Increase in Equity Duration

Today, equity market duration—and thus, sensitivity to liquidity—is close to highs last seen in the '90s tech bubble. This in part reflects the fact that, over the past 20 years, secularly declining interest rates mechanically increased the value of corporate cash flows further in the future. In addition, low interest rates, ample liquidity, and limited alternatives supported a surge in market capitalization of innovative industries. The level of earnings growth expectations for the market as a whole today has increased substantially in recent years, further lengthening duration.

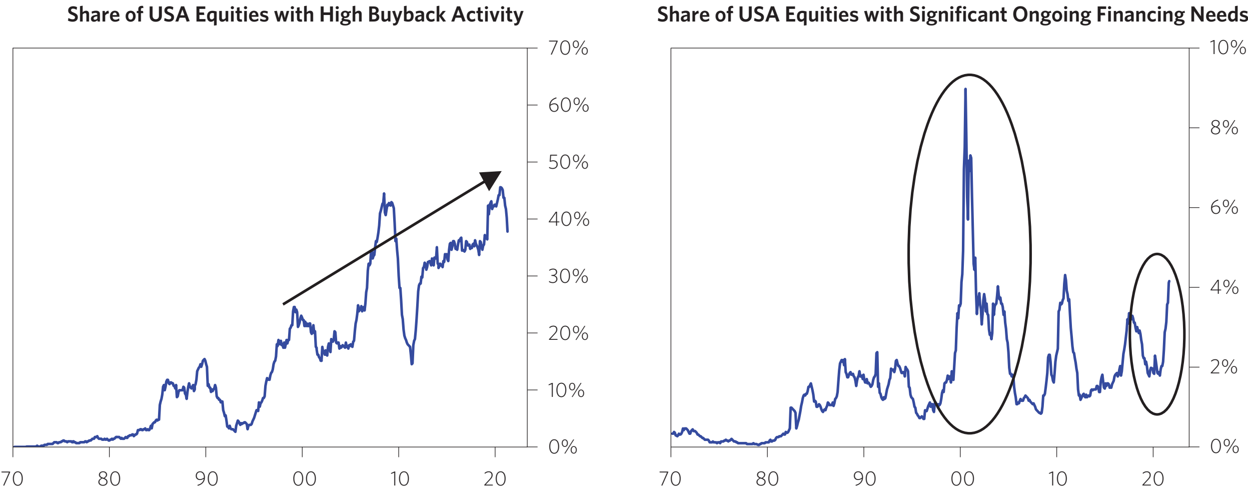


© 2021 Bridgewater Associates, LP

More of the US Equity Market Is Highly Exposed to a Pullback in Liquidity

Over the past decade, massive liquidity production has been enormously beneficial to US companies. Large companies changed their capital structure, issued debt, bought back their stock, and financed M&A, significantly boosting earnings-per-share growth. As shown on the left chart below, the share of US companies that have boosted earnings-per-share via buybacks has increased significantly in recent years.

In addition, liquidity has poured into innovative companies, many of whom seek to "grow at all costs" and run significant cash flow deficits effectively financed by issuing equity. While these companies are still a relatively small share of the listed equity market (about 5%), their share has grown as they have increasingly gone public, and they represent a real vulnerability to the high-flying growth segment of the market.

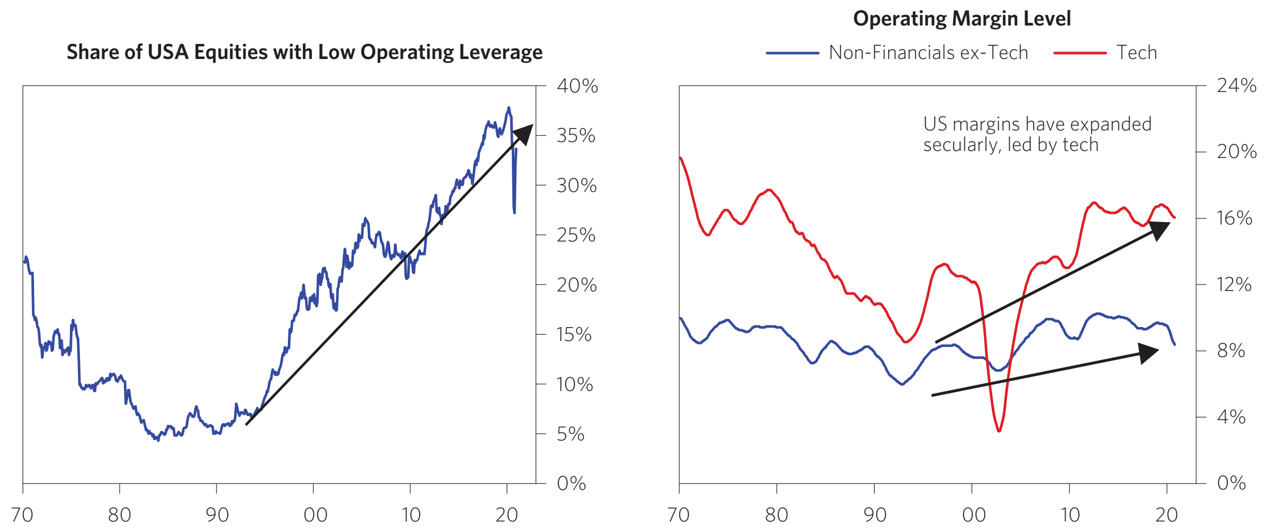


US Equities Likely Have Less Upside in a Rising Nominal Growth Environment Today Relative to History

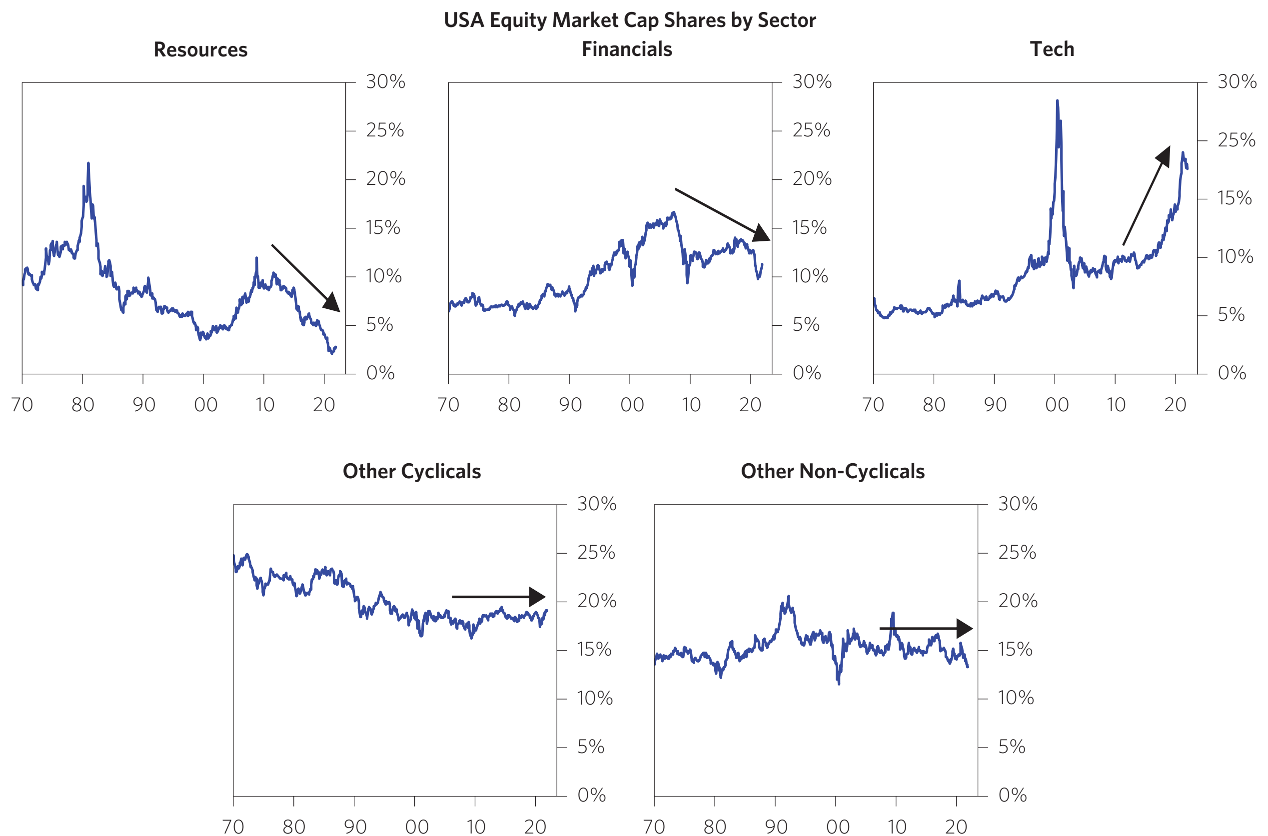
Typically, in the early-to-middle phases of the cycle, the impact of waning liquidity is offset by the support to profits from stronger growth. Today, that support is likely to be less than it has been historically, reflective of the impact of both higher margins and sales that are less sensitive to stronger growth.

Operating leverage is a significant driver of cyclical swings in earnings. The higher the level of margins, the lower the operating leverage effect. For instance, if you assume fully fixed costs, a 1% increase in sales translates to 10% earnings growth for a company with a 10% margin versus twice that for a company with a 5% margin. As shown in the chart on the left, after 30 years of secularly increasing profit margins, the share of companies with low operating leverage now represents a third of market capitalization. A significant degree of the secular increase in margins came from tech companies. This was both because their margins increased markedly (shown in the chart on the right) and because high-margin tech companies gained share.

© 2021 Bridgewater Associates, LP

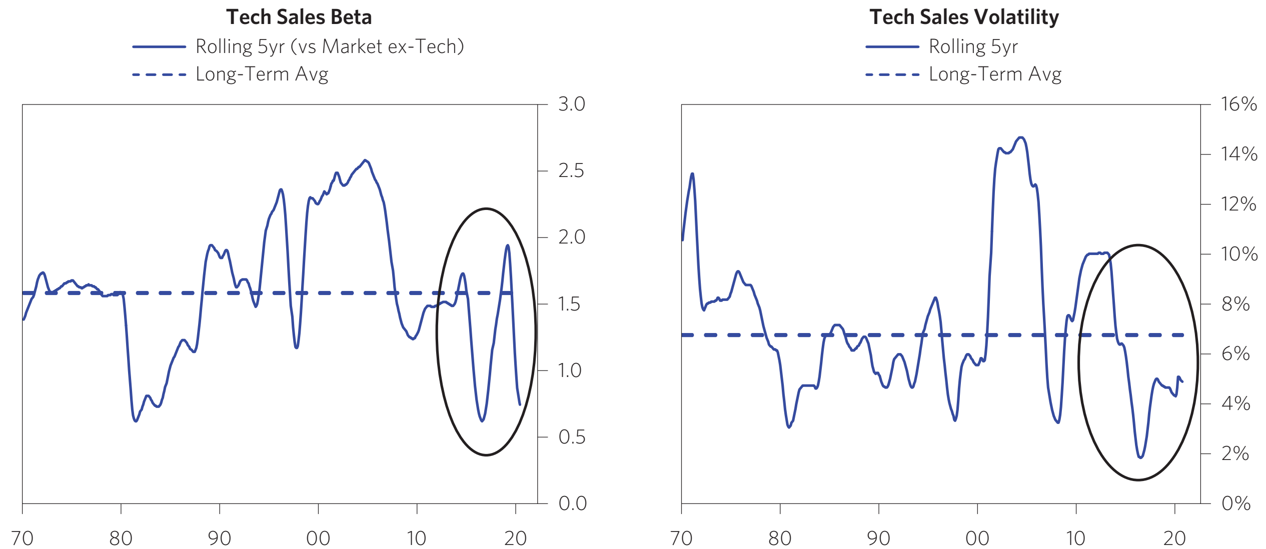


Corporate revenues are also less likely to respond to stronger growth conditions today. Over the past decade, some of the sectors most exposed to rising nominal growth—such as resources and financials—have lost significant share to tech companies. While many tech companies are still more cyclical than the average company, they are not nearly as exposed to real economy spending and credit growth, for example.



© 2021 Bridgewater Associates, LP

Historically, tech sales have been more cyclical than those of the average company, with a beta of about 1.5. However, the nature of tech has shifted significantly over the decades, with tech sales today increasingly composed of software and cloud products rather than electronic capital goods and intermediate inputs, increasing the exposure to stable secular growth. As a result, over the past five years, tech sales have been much less cyclical (about on par with the average listed non-tech company). In addition, the shape of economic growth as we emerge from COVID—more driven by fiscal spending and reopenings—is likely to be less beneficial for many of these companies.



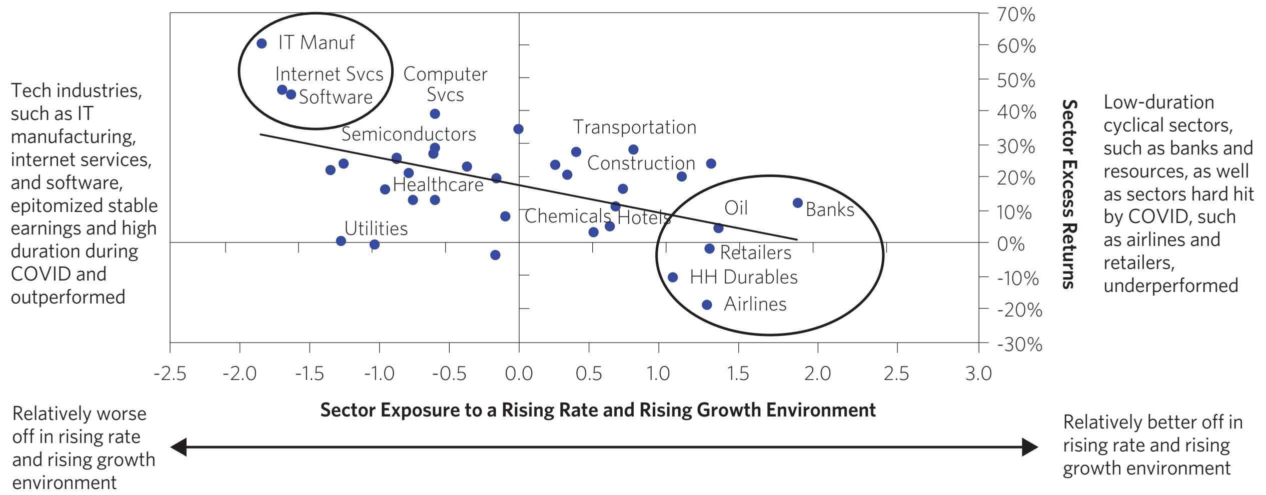
Relative Exposures Across Companies Have Been Clear in Market Action Over the Past Year

As the growth and liquidity environment has shifted over the past year, so too has the complexion of out- and under-performers within the equity market. After underperforming for most of 2020, this year we've seen strong outperformance from companies that benefit most from rising real economy spending—notably rising cyclical demand, rising capex, homebuilders, commodities, etc.—and underperformance from some of the most liquidity-sensitive companies, most notably the high-flying, young, unprofitable segment of the market. It's worth noting that the relationships in the charts below look stronger for the combination of these factors (growth and liquidity) than they would for either alone.

The charts below show sector performance as real yields fell throughout 2020 and then have risen year-to-date in 2021. These returns are shown against our internal measure of sensitivity to a rising rate and rising growth environment. Sectors on the right-hand side are comprised of companies that benefit from such an environment (and are likely to underperform in an expanding liquidity and weak growth environment), and sectors on the left-hand side are composed of companies with the opposite characteristics.

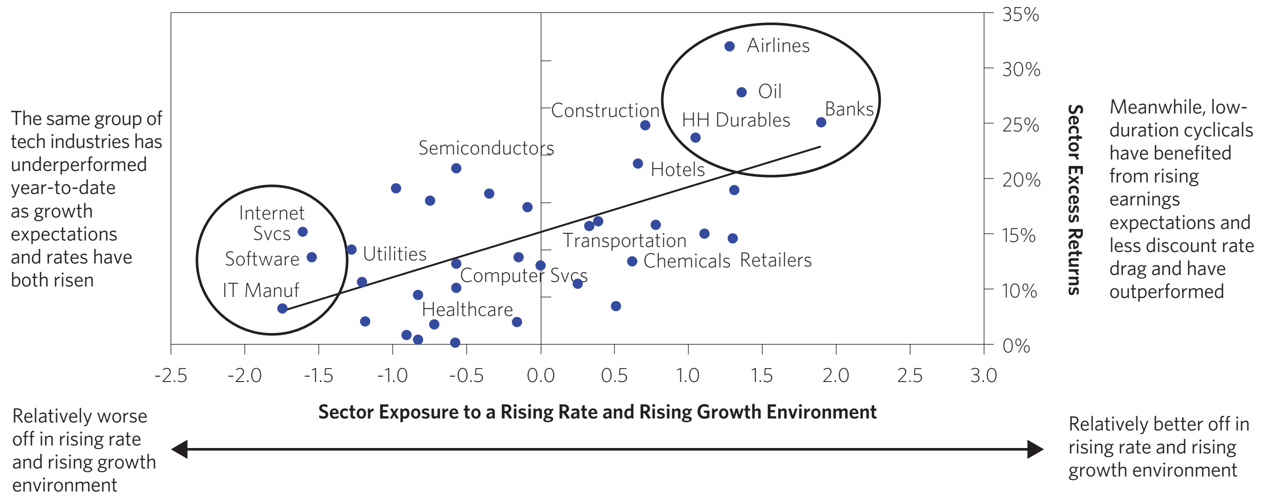
© 2021 Bridgewater Associates, LP

Sector Returns During Falling Real Yields (2020)



Returns in 2021 since the bottom in real yields looked like the mirror opposite of 2020.

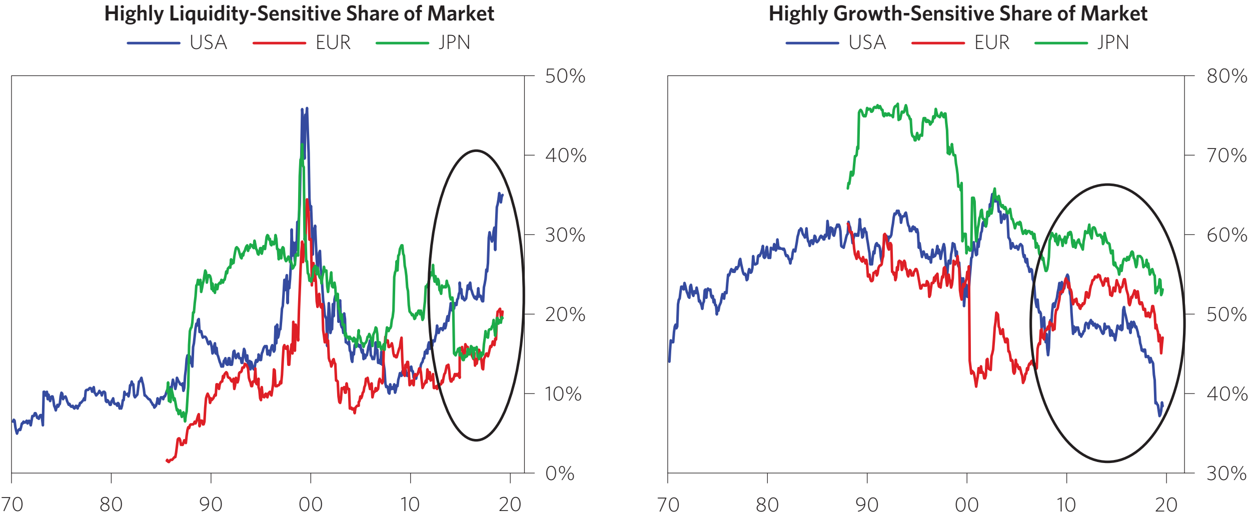
Sector Returns Since Real Yield Bottom (Dec 2020)



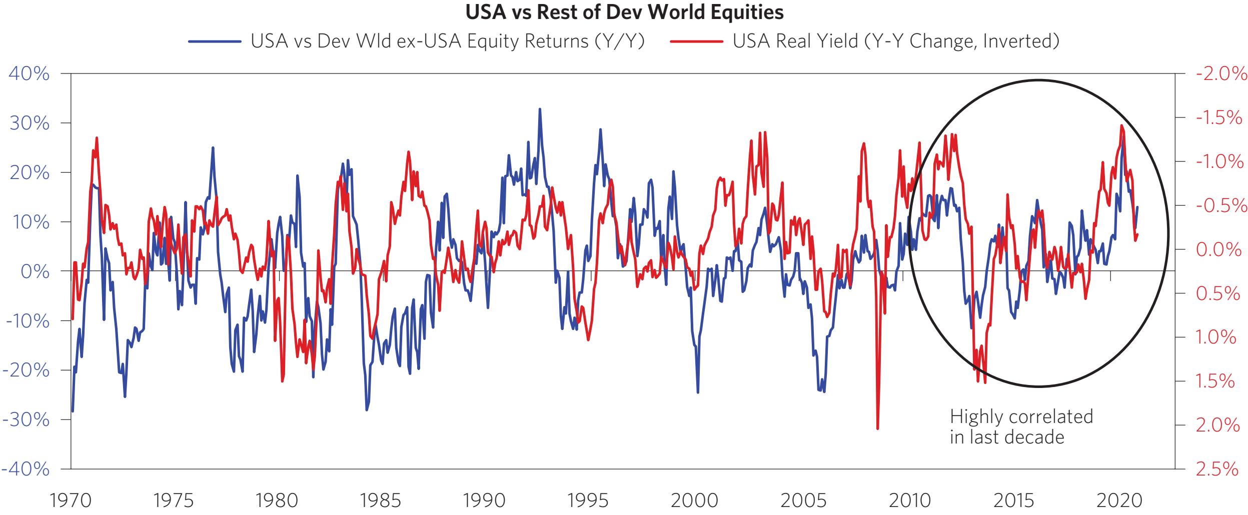
© 2021 Bridgewater Associates, LP

Relative Equity Market Exposures Align with Swings in Market Action

While the US equity market has become far more liquidity-sensitive and far less growth-sensitive, as noted above, the picture is different across economies. Other economies' equity markets have also grown more liquidity-sensitive and less growth-sensitive—they have been exposed to similar underlying structural forces—just not nearly to the same degree as the US. Most other equity markets haven't seen the same degree of secular margin expansion, for instance, nor have they seen the same degree of high-flying tech market share gains relative to other more traditionally cyclical industries.



As shown above, these cross-economy differences began growing substantially at the beginning of the last decade. The chart below shows that this was roughly the same time we started to see differential equity performance line up relatively closely with swings in discount rates. This doesn't mean the same will be true looking ahead; discount rates aren't the sole driver of equities, and cash flow expectations and risk premiums tend to swing significantly at the same time. Still, the recent relationship has been interesting and aligns with the relative exposure we see across these markets.



© 2021 Bridgewater Associates, LP

This research paper is prepared by and is the property of Bridgewater Associates, LP and is circulated for informational and educational purposes only. There is no consideration given to the specific investment needs, objectives or tolerances of any of the recipients. Additionally, Bridgewater's actual investment positions may, and often will, vary from its conclusions discussed herein based on any number of factors, such as client investment restrictions, portfolio rebalancing and transactions costs, among others. Recipients should consult their own advisors, including tax advisors, before making any investment decision. This report is not an offer to sell or the solicitation of an offer to buy the securities or other instruments mentioned.

Bridgewater research utilizes data and information from public, private and internal sources, including data from actual Bridgewater trades. Sources include the Australian Bureau of Statistics, Bloomberg Finance L.P., Capital Economics, CBRE, Inc., CEIC Data Company Ltd., Consensus Economics Inc., Corelogic, Inc., CoStar Realty Information, Inc., CreditSights, Inc., Dealogic LLC, DTCC Data Repository (U.S.), LLC, Ecoanalitica, EPFR Global, Eurasia Group Ltd., European Money Markets Institute – EMMI, Evercore ISI, Factset Research Systems, Inc., The Financial Times Limited, GaveKal Research Ltd., Global Financial Data, Inc., Haver Analytics, Inc., ICE Data Derivatives, IHSMarkit, The Investment Funds Institute of Canada, International Energy Agency, Lombard Street Research, Mergent, Inc., Metals Focus Ltd, Moody's Analytics, Inc., MSCI, Inc., National Bureau of Economic Research, Organisation for Economic Cooperation and Development, Pensions & Investments Research Center, Renwood Realtytrac, LLC, Rystad Energy, Inc., S&P Global Market Intelligence Inc., Sentix Gmbh, Spears & Associates, Inc., State Street Bank and Trust Company, Sun Hung Kai Financial (UK), Refinitiv, Totem Macro, United Nations, US Department of Commerce, Wind Information (Shanghai) Co Ltd, Wood Mackenzie Limited, World Bureau of Metal Statistics, and World Economic Forum. While we consider information from external sources to be reliable, we do not assume responsibility for its accuracy.

The views expressed herein are solely those of Bridgewater as of the date of this report and are subject to change without notice. Bridgewater may have a significant financial interest in one or more of the positions and/or securities or derivatives discussed. Those responsible for preparing this report receive compensation based upon various factors, including, among other things, the quality of their work and firm revenues.