A Secular Turning Point: The End of the Great U.S. Cycle

And the Dawn of a New Bull for International Investing

Bottom Line:

- The MSCI U.S. index has outperformed the MSCI World Ex. U.S. index by 89% since the end of 2007.
- The relative valuation of U.S. stocks is as high as it was at the peak of the Internet bubble.
- This U.S. cycle was driven by "the great economic disenchantment" of the New Normal.
- The U.S. would need to outgrow Germany by 1.9% annually to justify the current valuation gap.
- Economic momentum has switched: the U.S. disappoints while Europe and EM exceed low expectations.
- The U.S. premium is inconsistent with long-term earnings expectations.
- The 2002-2007 and the late 1960s are good historical precedents.
- U.S. assets fare poorly in periods of reflation, bitter partisanship and large deficits.

As G. W. F. Hegel and Morpheus observed, "fate, it seems, is not without a sense of irony." The great financial crisis initially seemed to embody the demise of the U.S. Century. The country's ethos of capitalism had been contaminated by pervasive greed. Its consumption and finance-driven economic model had inflated deficits and bubbles, while "real" production had relocated overseas. The American Dream of home ownership had turned into a nightmare, and the bills from a decade of addiction to debt seemed to come due all at once.

In retrospect, 2007 marked the beginning of a new secular cycle for U.S. assets. Buying U.S. stocks against a basket of international stocks returned 7.6% a year in the following decade, with almost no volatility. The U.S. economy experienced a "beautiful de-leveraging" from its financial excesses, while Europe and Emerging Markets were stuck in never-ending crises.

This report will argue that this secular cycle of U.S. outperformance is coming to an end. First, valuations price-in an absurd growth differential in favor of U.S. assets. Second, a wave of economic data signals that U.S. growth has been overestimated, while Europe and Emerging Markets are surprising to the upside. Third, historical precedents suggest that U.S. assets fare very poorly in periods of reflation, bitter partisanship and large deficits.

Investors seem convinced that nothing really bad can happen to U.S. assets due to the country's status as a global safe haven. But the experience of the late 1960s and early 1970s shows that the U.S. currency and stock market can become risky assets in periods of relative economic decline.

U.S. Assets Just Experienced an Extraordinary 10-Year Bull Market …

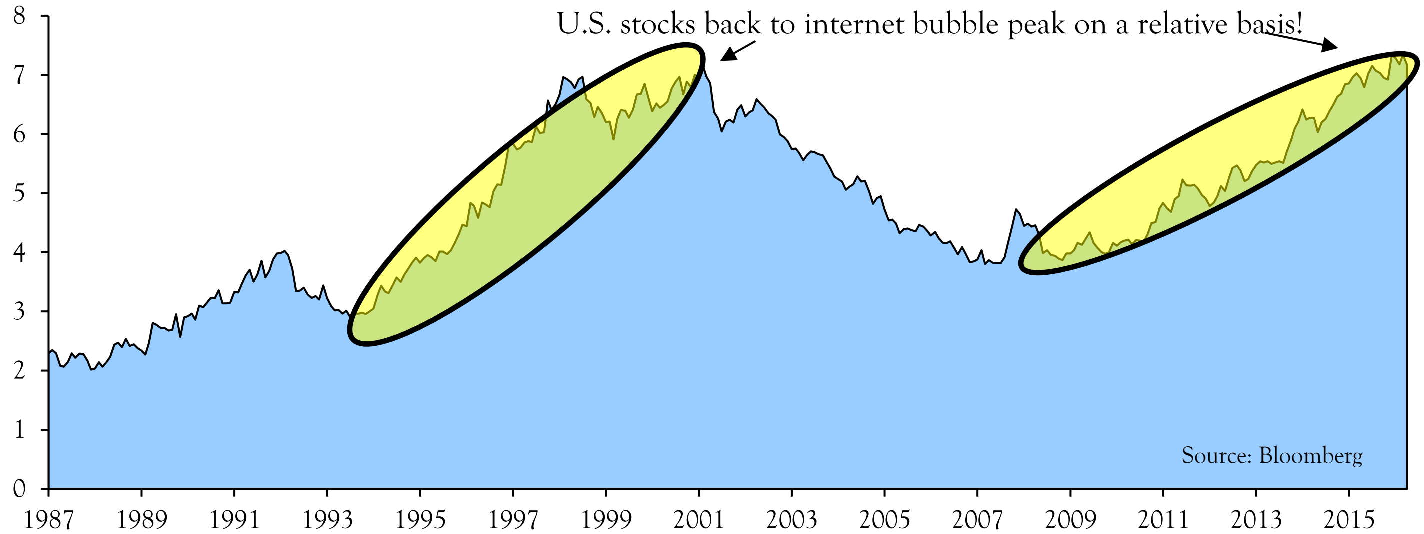
The past 10 years encompass three very different periods: a savage global financial crisis, a very slow recovery characterized by deflationary headwinds, and finally the current "goldilocks" moment of broadening global economic growth. Yet, there was one consistent trend: U.S. assets outperformed in every environment. An investor who would have held the MSCI U.S. index against the MSCI World ex. U.S. index between February 2008 and December 2016 would have earned 7.6% per annum. This market-neutral portfolio would have experienced a fraction of the volatility of global equities. Overweighing U.S. stocks and the U.S. dollar was the single most important decision for global asset allocators, much to the dismay of value investors who consistently underperformed in foreign value traps (European banks, emerging markets material and energy companies, etc).

The Great Asset Allocation of the Decade
Total return in USD, Feb 2008 to Dec 2016

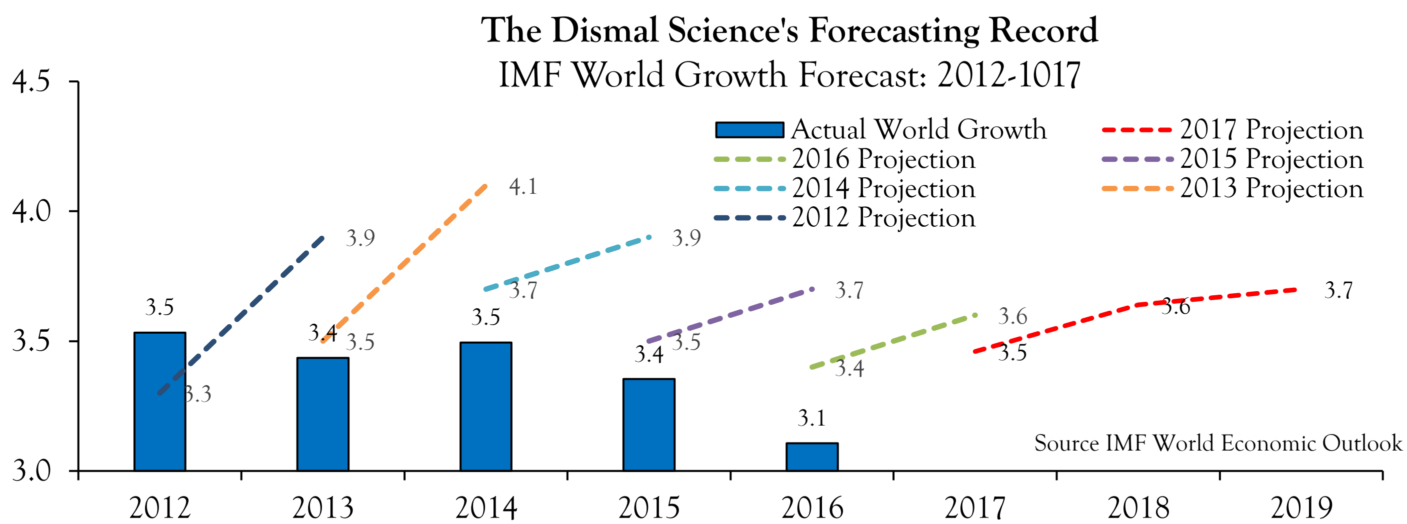
	Gain per Annum	Annual Standard Deviation	Sharpe Ratio
Long US, short world ex. U.S.	7.6%	8.8%	0.87
MSCI U.S. Index	8.4%	15.7%	0.54
MSCI World ex. U.S. Index	0.7%	19.5%	0.04

The rally of U.S. assets has been almost as impressive as that of the 1990s. Back then, the U.S. enjoyed an exceptional geopolitical moment as the uncontested world superpower after the fall of the U.S.S.R., demographic tailwinds as boomers enjoyed their peak earnings, and the productivity miracle of the "New Economy". Relative to the rest of the world, U.S. stocks are matching their Internet Bubble peak.

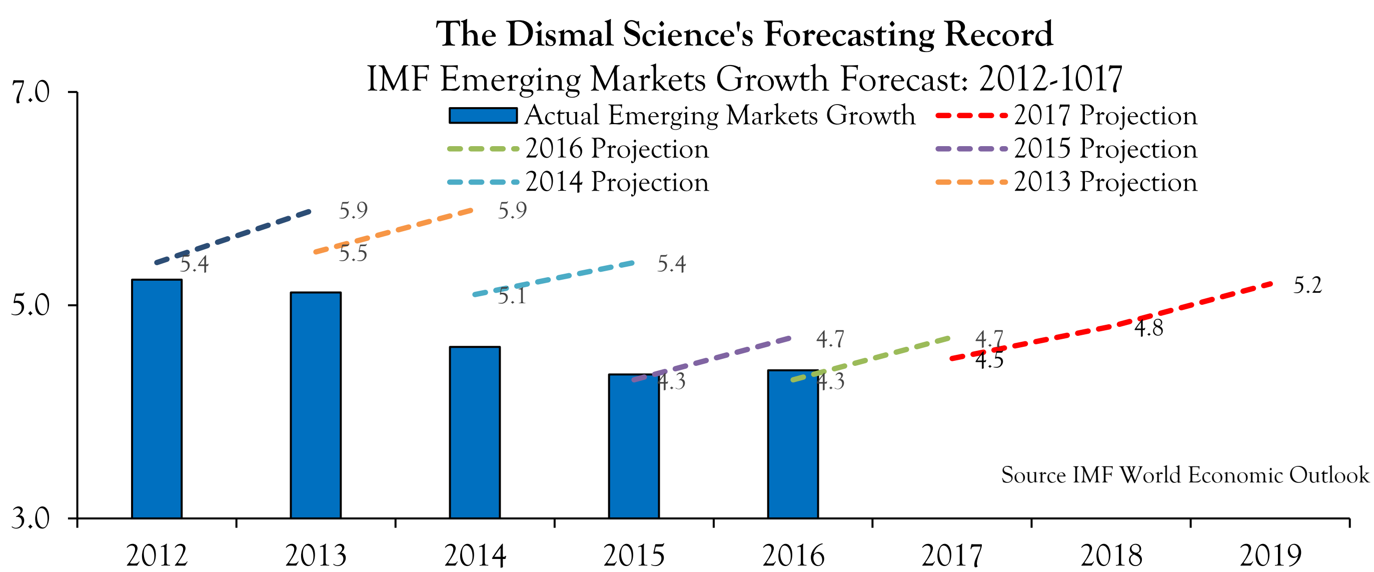
Relative Strength of U.S. Equity versus the Rest of the World
MSCI U.S. Index and MSCI World ex. US Index, Total Return in USD



Back then, the rally in U.S. assets was justified by better economic fundamentals: Strong productivity gains led to a new paradigm of "great moderation". On the other hand, the latest bout of U.S. over-performance has been driven by a great economic disenchantment. In the chart below, the dotted lines show the [IMF's January forecast of world GDP growth]() for the next two years, and the blue bars show actual GDP growth. A familiar pattern of disappointment for investors (and humiliation for economists) emerges: global growth was systematically overestimated, and economists could not cut their forecasts fast enough to catch up with this disappointing reality.

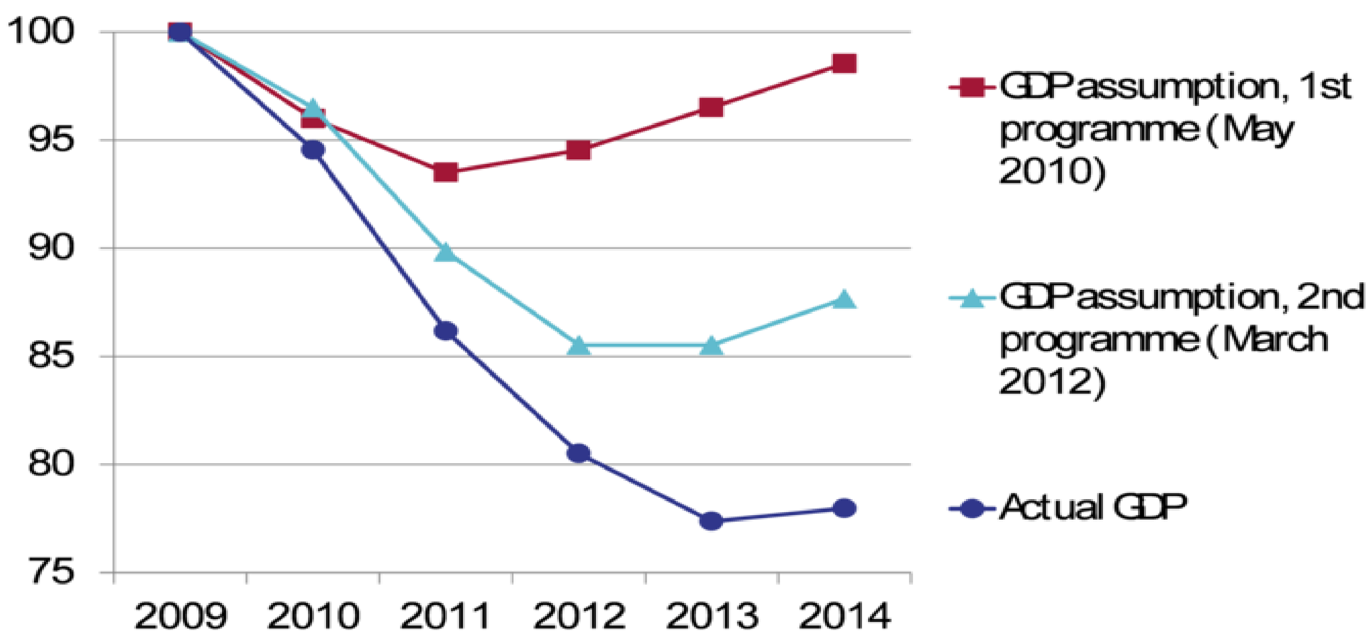


This growth disenchantment was especially strong for emerging markets. Following the 2009 Chinese fiscal stimulus, emerging markets economies initially rebounded much faster than their developed peers. Alas, the "sugar high" of China-driven commodity inflation waned by 2011, and the structural weaknesses of emerging markets resurfaced: excessive debt, low productivity, corruption, and an unhealthy reliance on basic resources led to brutal recessions in Russia, Brazil, Argentina and Nigeria, among others.



Europe did not fare much better. I have spent most of the past decade lamenting the mostly self-imposed tragedy of the sovereign debt crisis, so I will only feature one chart on Europe's economic suicide: the performance of the Greek economy versus the forecasts penned in the IMF-ECB-European Commission *troika*'s "rescue" packages. Professional economists overestimated GDP by 22 percentage points over a five-year period! Leather-clad former Greek economic minister Y. Varoufakis finds this miss so astounding that he accuses the *troika*'s economists of nefarious intentions – namely hiding the tragic reality of the Greek economy to preserve creditors' interests. He is probably partially right, but I am convinced that even the most cynical European bureaucrat was surprised by the devastation of the continent's Southern economies.

Greek GDP Growth versus IMF/ECB/European Commission Assumptions



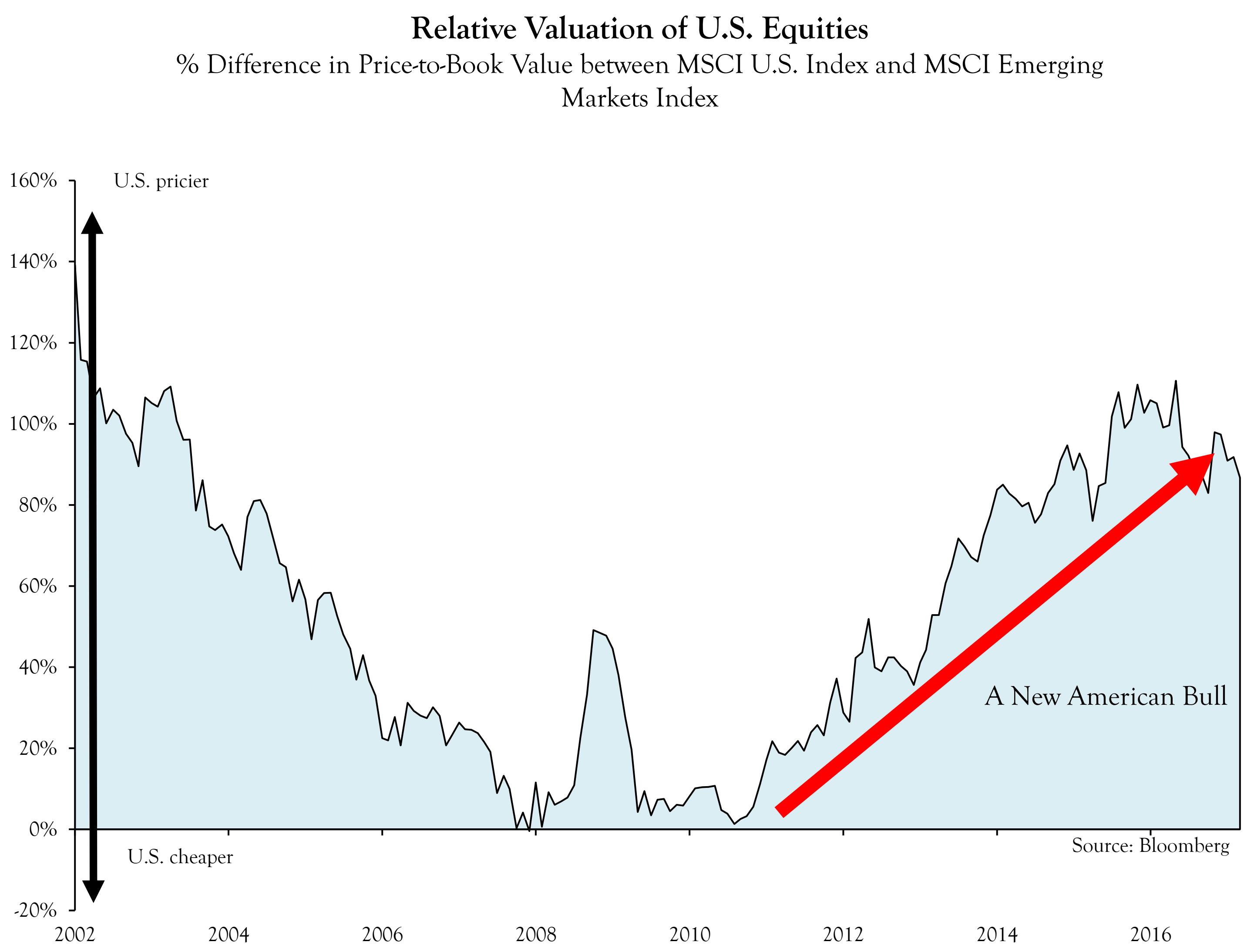
Compared to these low standards, the U.S. economy was a haven of stability and an oasis of growth. Contrary to Europe and East Asia, its demography generated robust demand as the large millennial generation finally entered the workforce. Contrary to emerging markets, the U.S. had no external constraints. The euro, the yen, and the Chinese yuan failed to challenge the U.S. dollar's role as a reserve currency, providing the U.S. economy with the exorbitant privilege of global *seignorage*.

Economists and politicians lamented about the weakness of the recovery, but he U.S. economy added 15.5 million jobs between 2010 and 2016. Deficits shrank. Households reduced their debt. As Ray Dalio observed, the U.S. was executing a "beautiful de-leveraging". The real estate market recovered steadily from the depth of the financial crisis. A manufacturing renaissance provided long-awaited hope to some rustbelt cities. Fracking and horizontal drilling created a gold rush-like boom in shale basins. 3-D printing, big data and artificial intelligence carried the promise of technological breakthroughs. Visionary entrepreneurs promised a new industrial revolution where the bright minds of America's leading universities would replace fossil fuels as the engines of economic growth.

… Resulting in an Enormous Valuation Gap …

The end of 2007 marked a low point for U.S. exceptionalism. On a price-to-book basis, U.S. stocks traded at a *slight discount* to emerging markets stocks as investors seemingly ignored centuries of default, nationalizations and devaluations. In the September 2007 music video for Blue Magic, Jay-Z flashed 500 euro notes, instead of the customary "Benjamins". In perhaps the worst-timed currency trade in history, Brazilian super model Gisele Bundchen demanded to be paid in euros instead of dollars on November 6, 2007. They do ring a bell at the top, after all.

The relative valuation of U.S. equities has climbed almost un-interruptedly since this low point. By the end of 2016, U.S. stocks commanded a 68% premium over their European peers, and 97% premium over Emerging Markets equities.



This U.S. premium has become so large that it defies traditional fundamental analysis. In the exercise below, I imagine that Benjamin Graham and David Dodd come back from the dead and try to estimate the implied growth premium baked into the current valuations of U.S. equities. The dividend discount model states that the value of a stock or an index should equal its future dividend, divided by the required rate of return of equity capital minus the long-term growth rate of earnings. Additionally, we know that the required rate of return of equity capital is equal to the sum of the equity risk premium and the risk-free rate.

P = Exp. DPS/ (r-g)

So we can express 'g' as a function of the equity risk premium, the risk-free-rate, dividends, and prices

g = [(P*(ERP+risk-free rate)-Exp.DPS)]/P

Of course, the equity risk premium is unknown *a priori*, but investors would arbitrage differences in equity risk premia in a regime of free movement of capital. Hence, we can use the dividend discount model to solve for implied differences in growth rates between countries because the equity risk premium "drops out" of the equation.[1] Using market data as of the end of April, I found that the long-term growth of U.S. earnings would need to be 2.8% greater than that of Germany to justify the current valuation gap.

Germany as of Apr-28	
10 year treasury yield	0.3%
Expected Dividend per Share (Dax)	357.64
Last Price (Dax)	12438.0
Equity Risk Premium*	6%
Implied g	**3.4%**

U.S. as of Apr-28	
10 year treasury yield	2.3%
Expected Dividend per Share (S&P 500)	48.6
Last Price (S&P 500 Index)	2385.7
Equity Risk Premium*	6%
Implied g	**6.3%**

Trumponomics Growth Premium	**2.8%**

**level of ERP exogenous and irrelevant for comparisons*

For the sake of the argument, let's assume that analysts' expectations of U.S. dividends do not reflect the impact of the promised cut in the U.S. corporate income tax rate from 35% to 15%. Let's assume that the White House's one-page 2017 Tax reform for Economic Growth and American Jobs sails through Congress without any amendment and that it gets implemented this fiscal year. Let's also assume that deficits do not need to be financed, that there is no "Ricardian equivalence," and that the money just magically appears. Better yet, let's say that Mexico just pays for the tax cut, in the same way that it will pay for Mr. Trump's border wall.

[1] Specifically, the difference between the long-term growth of U.S. earnings and German earnings can be expressed as follows

G_{us} = [(P_{us}*(ERP+Rf_{us})- $Exp.DPS_{us}$)]/ P_{us}

G_{de} = [(P_{de}*(ERP+Rf_{de})- $Exp.DPS_{de}$)]/ P_{de}

G_{us} - G_{de} = [[(P_{us}*(ERP+Rf_{us})- $Exp.DPS_{us}$)]/ P_{us}] - [[(P_{de}*(ERP+Rf)- $Exp.DPS_{de}$)]/ P_{de}]

Let's also assume that U.S. corporations' effective tax rate does drop by 20 percentage points, even though most U.S. companies do not pay the full income tax rate, thanks to many existing tax loopholes.[2] With these heroic assumptions, we can increase our estimate of U.S. dividends by a permanent 30% boost.[3] While we are at it, let's also assume that Donald Trump convinces U.S. multinationals to repatriate all the foreign earnings they stash abroad. According to The New York Times, that is about $2.4 trillion. These foreign earnings would get taxed at the lower corporate income tax rate of 15%. That leaves U.S. companies with $2 trillion, or 9% of the S&P 500 index market cap, to pay out as a special dividend. Let's then reduce the current price of the index by 9% to reflect this upcoming special dividend.

Despite these very aggressive assumptions, we are still left with a permanent U.S. growth premium of 1.9%. At this pace, the U.S. economy would double its size relative to Germany every 36 years. As a European migrant to the U.S., I would be fine with this scenario, but it goes against all the evidence collected over two hundred years of modern economic history.

As of Dec 16 (Post Trump, 20% tax cut, 9% special dividend)	
10 year treasury yield	2.3%
Expected Dividend per Share (S&P 500)*	63.22
Last Price (S&P 500 Index)**	2171.0
Equity Risk Premium	6%
Implied g	**5.4%**

Trumponomics Growth Premium	1.9%

* Dividend permanently increased by 30% to reflect corporate income tax rate cut

** Price reduced by 9% to reflect special dividend payment on repatriation of foreign earnings

[2] Over the past eight quarters, the effective tax rate of about 10% of U.S. companies was already below the promised 15% rate.

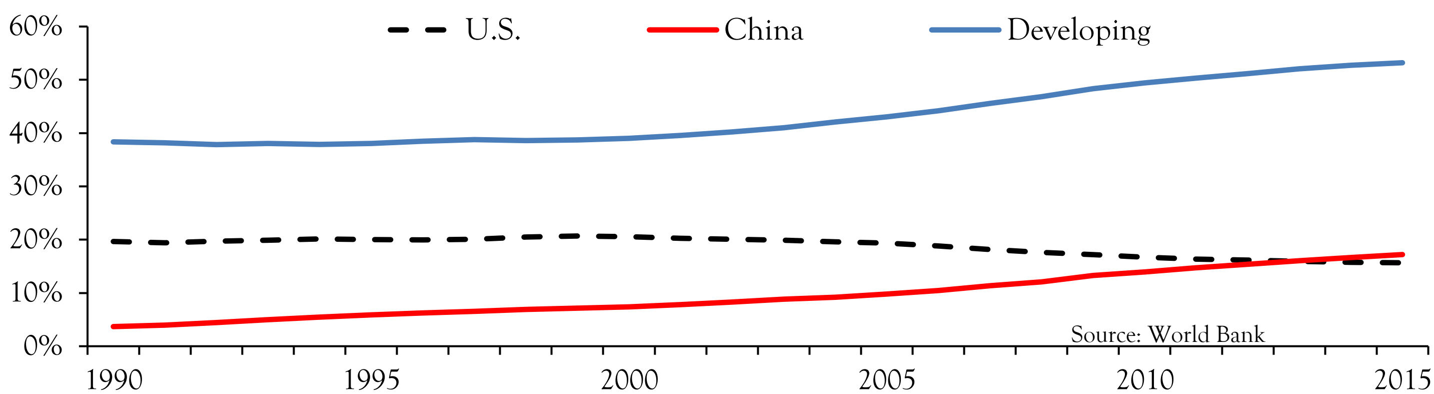
[3] Consider a company with earnings of $100 and a 50% retention rate. At a 35% tax rate, it can pay: 100*.65*.5 = $32.5 in dividends. At a 15% tax rate, it can afford to pay: 100*.85*.5 = $42.5 in dividend, a 30.7% increase.

… Even Though Fundamentals Have Not Changed All that Much.

With the benefit of hindsight, there was certainly some excessive hype in the emerging markets craze of the mid-2000s: It was a lot easier to *raise* money for Chinese ventures than it was to *make* money in China's brutally competitive markets. Yet, Jim O'Neil's famed [white paper on the BRIC economies] was not far off the mark. China accounted for 3.6% of world GDP when "Building Better Global Economic BRICs" was published in 2001. O'Neil forecasted that China's share of world GDP would rise to a range of 5.6% to 16% of GDP by 2011. In 2011, China accounted for 10.3% of world GDP. By the end of 2015, China's share of world output had risen to 15%.

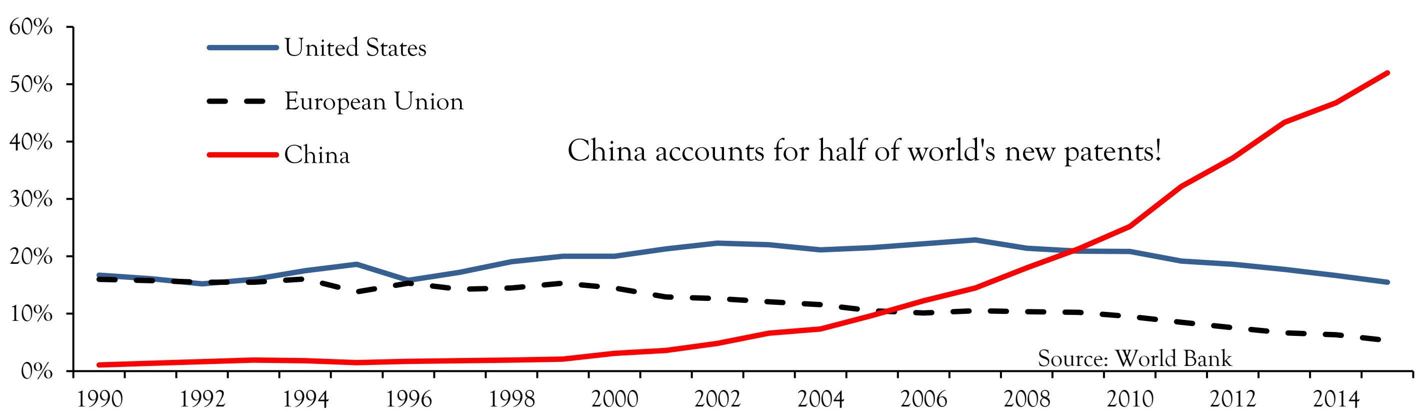
On a purchasing power-parity basis, China overtook the U.S. as the largest economy in 2013, and more than half of the world's output is now produced in developing economies.

Share of World GDP on a PPP Basis



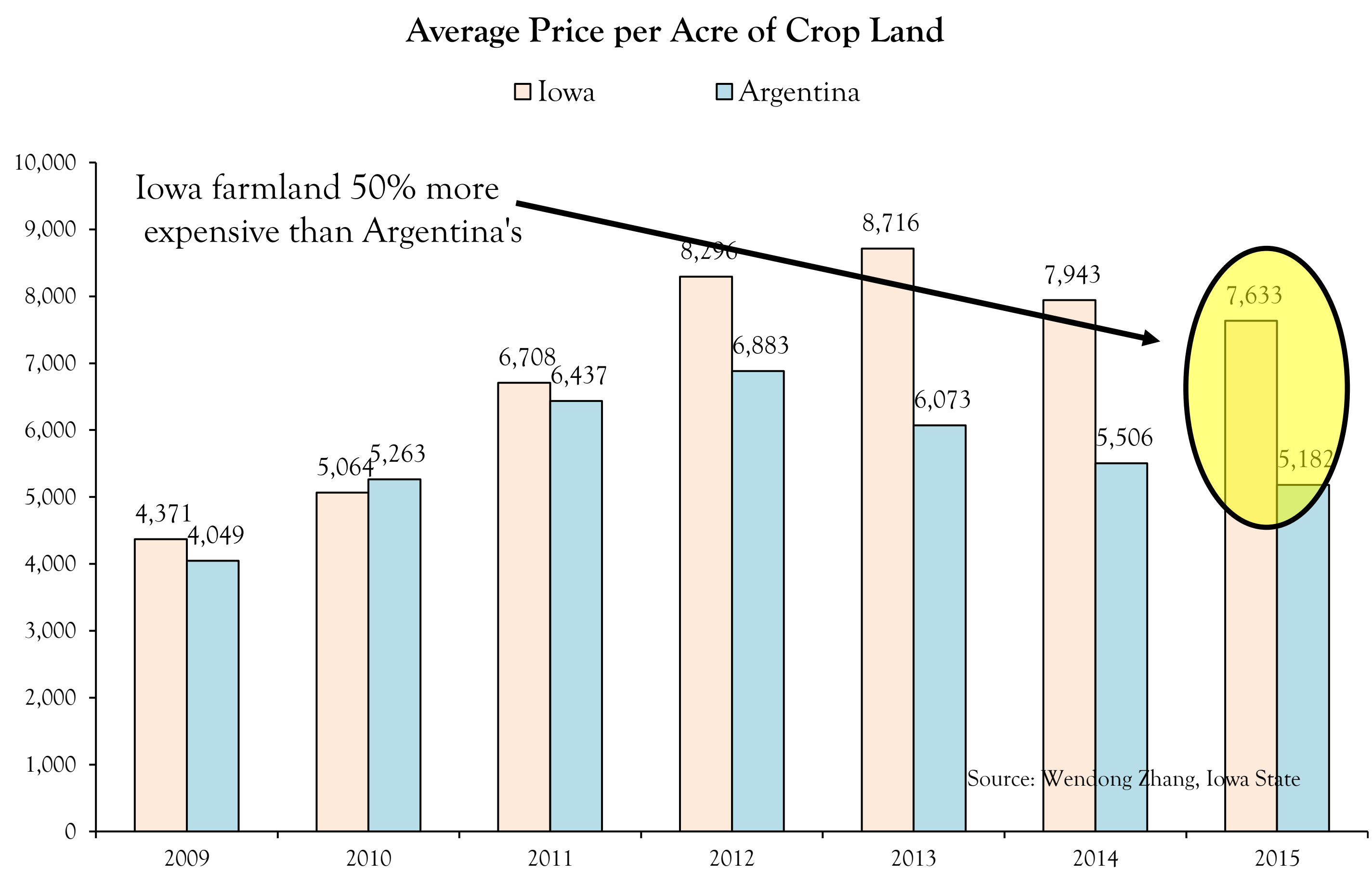
These "rising global middle class" charts filled economists' presentations ten years ago,[4] so I will not spend too much time restating the concept of economic convergence. Perhaps the most spectacular chart for a knowledge-based economy is the steady rise of China's share in global patent applications.

Share of World Patent Applications



[4] The fact that these charts have now been replaced with slides on shale gas, 3-D printing, and artificial intelligence suggests that the pendulum has swung too far in the other direction.

The “old economy” has also suffered from asset price inflation and the strong U.S. dollar. Iowa cropland prices have risen by 318% between 2002 and 2013, but yields have increased just 31%. The recent correction of U.S. land prices has been immaterial from an international perspective: Iowa land prices have dropped by 17% between 2013 and 2016, but the U.S. dollar has appreciated by 100% versus the Russian ruble and 143% versus the Argentinian peso over the same period.

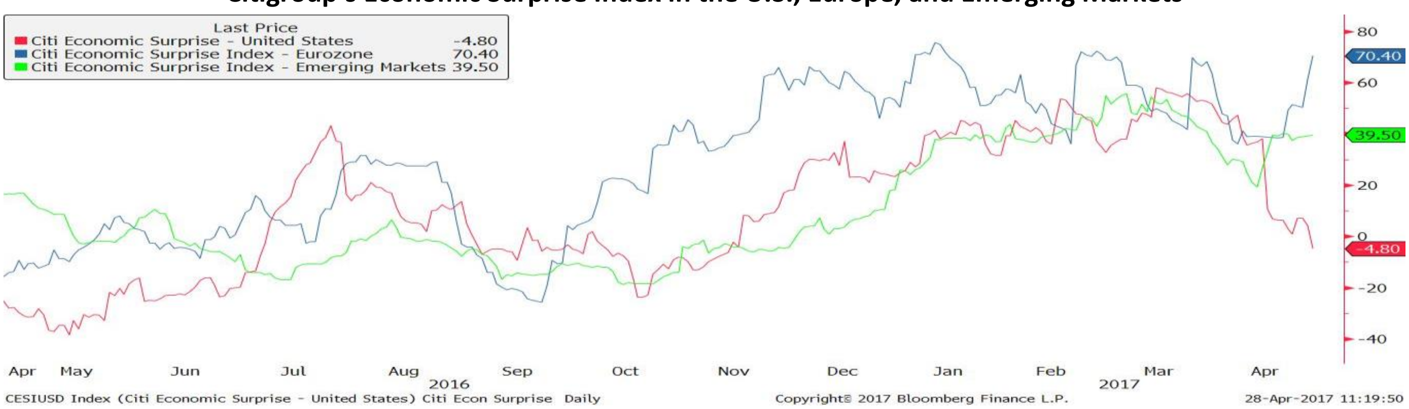


Why Now?

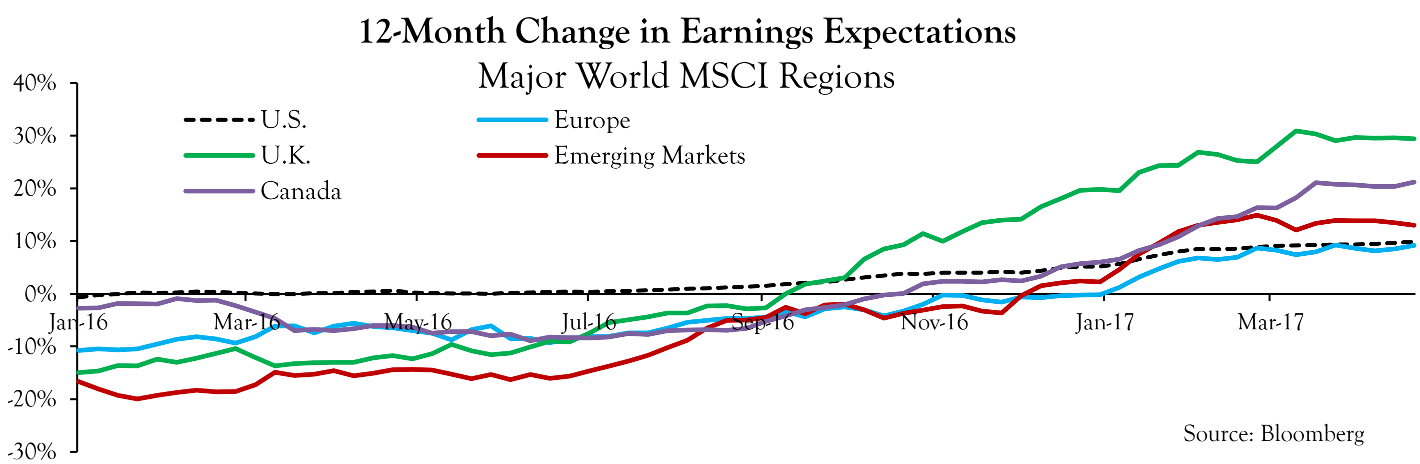
I hope that the valuation case that I have presented is compelling. Yet, most value managers are painfully aware that betting on a closing of the U.S. premium has been a losing trade in the past four years. Identifying mis-pricings is not enough; an asset can remain overvalued longer than a short-seller can stay solvent. A trigger needs to force the convergence between price and value.

I believe that the recent divergence between U.S. and international economic data will force a re-alignment of investors' perceptions. Consider the Citigroup Economic Indices: In Europe, the index is close to a five-year high of 71. The emerging markets economic surprise index stands at its highest level since the great financial crisis. Meanwhile, the U.S. economic surprise index has plummeted to a post-election low of -4.8. In the first quarter, U.S. GDP growth fell to a three-year low of 0.7%, just as the European Central Bank acknowledged that "that the cyclical recovery of the euro-area economy is becoming increasingly solid and that downside risks have further diminished."

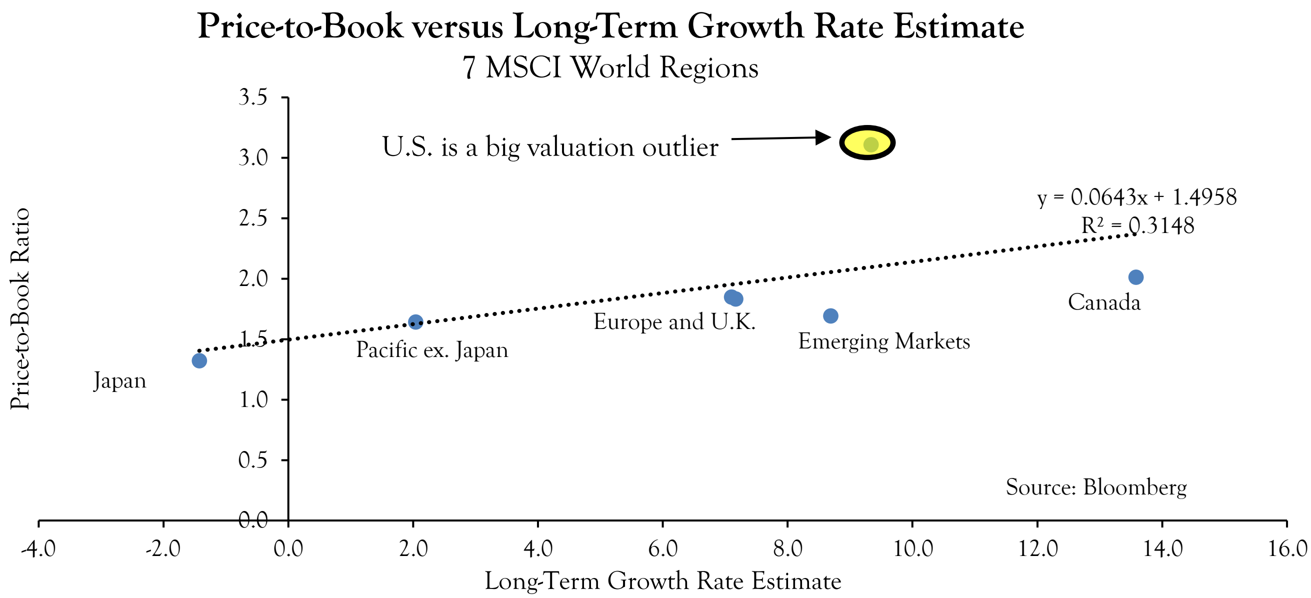
Citigroup's Economic Surprise Index in the U.S., Europe, and Emerging Markets



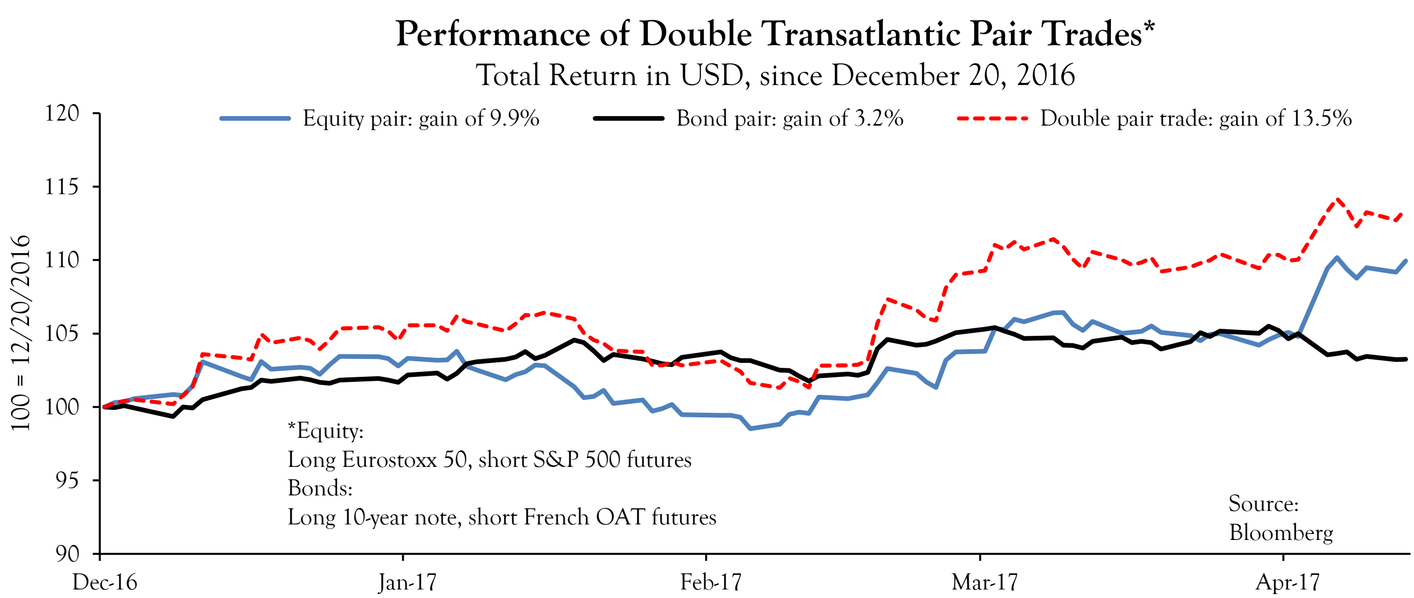
Analysts are slowly adjusting to this new reality. While U.S. short-term earnings expectations have only marginally improved this year, they have soared from extreme pessimism in the U.K., Canada and emerging markets.



The gap between valuations and growth prospects is especially shocking if we look at analysts' estimates of long-term earnings growth. There is a near-perfect relation between the price-to-book ratio and the expected long-term growth rate of earnings for six of the seven MSCI regions. The U.S. is a massive outlier: Its stock market is about 50% more expensive than what its long-term growth prospects could justify.



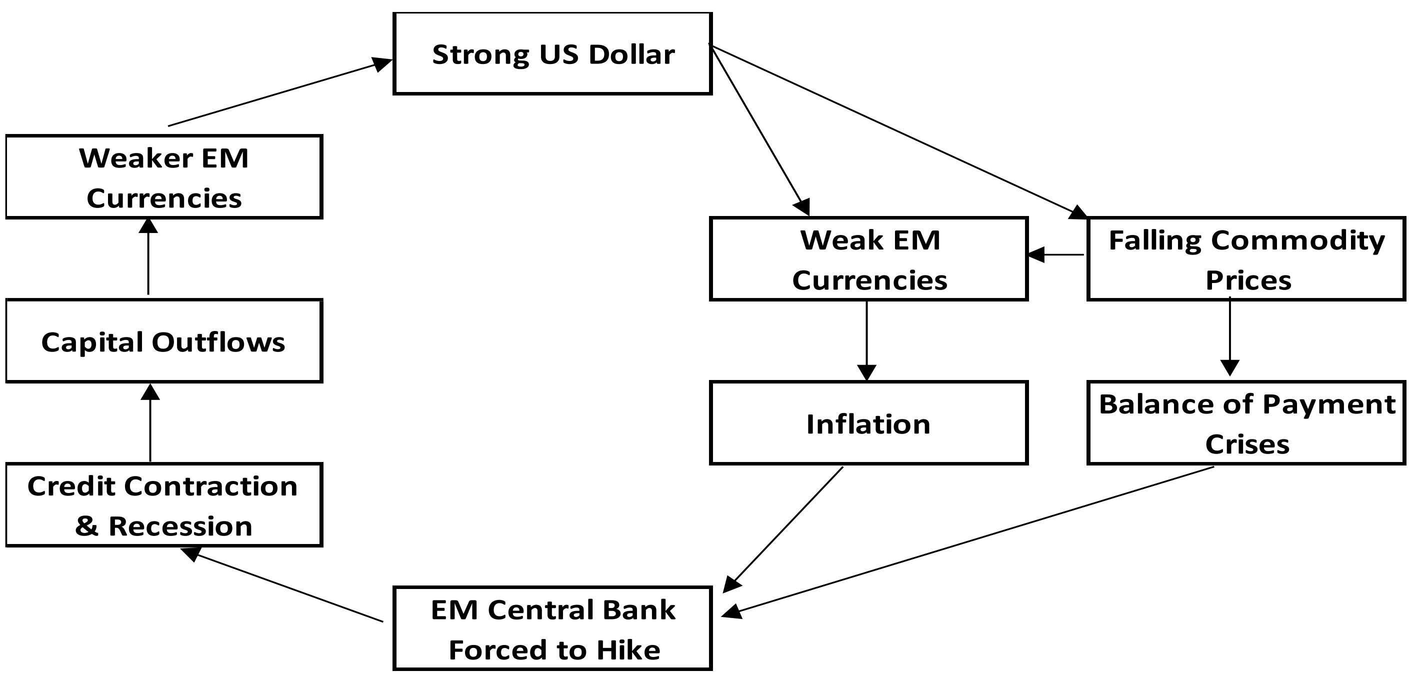
In December, I had suggested a [double pair trade]() to capitalize on unrealistic growth expectations in the U.S., and excessive pessimism in Europe: long Eurozone stocks / short U.S. stocks; long U.S. Treasuries / short Eurozone sovereign bonds. As of May 2, the trade is up 13.5%. Both the equity and the fixed income legs have contributed to the gains as investors are finally re-pricing growth prospects on the two sides of the pond.



The Secular Perspective

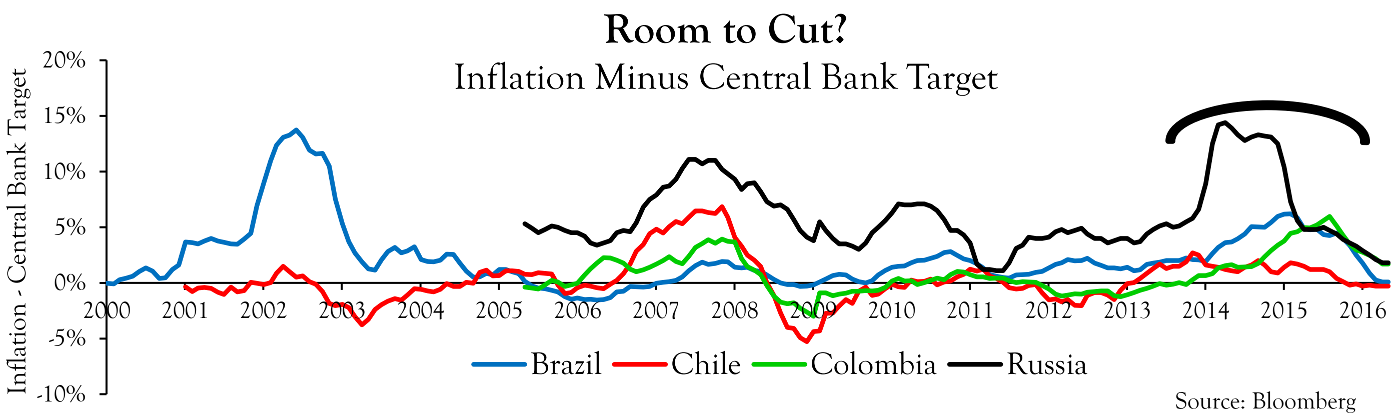
To conclude this report, I would like to explain why I believe the relative performance of U.S. assets is a *secular* call, as opposed to the many cyclical fluctuations of asset prices. For most markets, the cure for high prices is high prices. For example, a temporary shortage in the production of chicken will lead to price hikes, which will incentivize farmers to invest in new equipment. It takes about eight weeks for a chicken to grow to market weight, so new supply comes in relatively quickly to balance the market.

In contrast, secular trends do not have self-correcting mechanisms: higher prices beget higher prices. The diagram below summarizes the vicious cycles experienced by many emerging markets in the past three years. Weaker growth in emerging markets led to an appreciation of the U.S. dollar, which in turn depressed commodity prices. Many commodity-exporting countries who had borrowed in U.S. dollars got squeezed. Repayments became more expensive, just as the value of their exports dropped. Currency depreciation fed inflation. Nervous investors started to repatriate capital. Central banks responded to these threats by hiking rates, further depressing the local economy. This contraction of local demand weakened global commodity prices, exporting the crisis to other emerging economies.

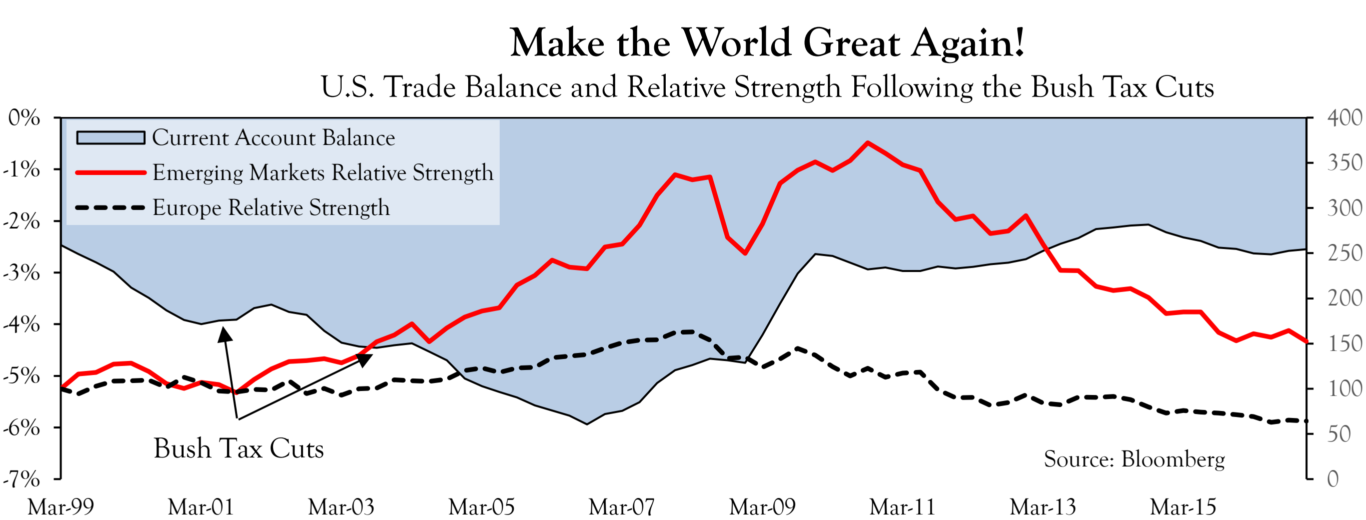


The fact that most emerging markets are characterized by a pro-cyclical feedback loop between currencies, interest rates and capital flows also means that virtuous cycles are possible. A weak dollar, or at least a stable dollar index, would invert this vicious dynamic. Stronger local currencies help tame inflation. Lower inflation allows central banks to cut rates. Lower rates encourage credit growth, which results in higher economic activity. Better growth drives in capital inflows, which further strengthen local currencies.

Most of Latin America and Russia have already entered this virtuous cycle, as local currencies are recovering from the dollar shocks of 2014 and 2016. Inflationary pressures have receded, allowing central banks to cut rates, further strengthening the local recoveries. In the coming years, investment flows will likely come back to capitalize on a self-sustaining recovery.



Another characteristic of secular cycles is that they are repeated over time. The closest example would be the 2002-2008 precedent. Then, as now, the world was emerging from a deep recession. Central bankers had slashed rates to zero and were slowly normalizing policy. Then, as now, U.S. assets were relatively overpriced, as the U.S. was coming out of an exceptional decade of great moderation and unchallenged global supremacy. The 2001-2002 bear market corrected some of the valuation excess, but the U.S. premium over international assets did not close due to a strengthening U.S. dollar. Then, as now, a relatively inexperienced U.S. President promised the greatest tax cuts in the country's history. He was helped by a dovish Federal Reserve that was more concerned about growth than inflation and did not care about asset bubbles. The result? Twin deficits, a massive accumulation of foreign reserves in Asia and the Middle East, soaring commodity prices, and a stunning period of outperformance by international assets: Europe and emerging markets outperformed U.S. equities by 100 percentage points and 290 percentage points, respectively, between 2002 and 2008.



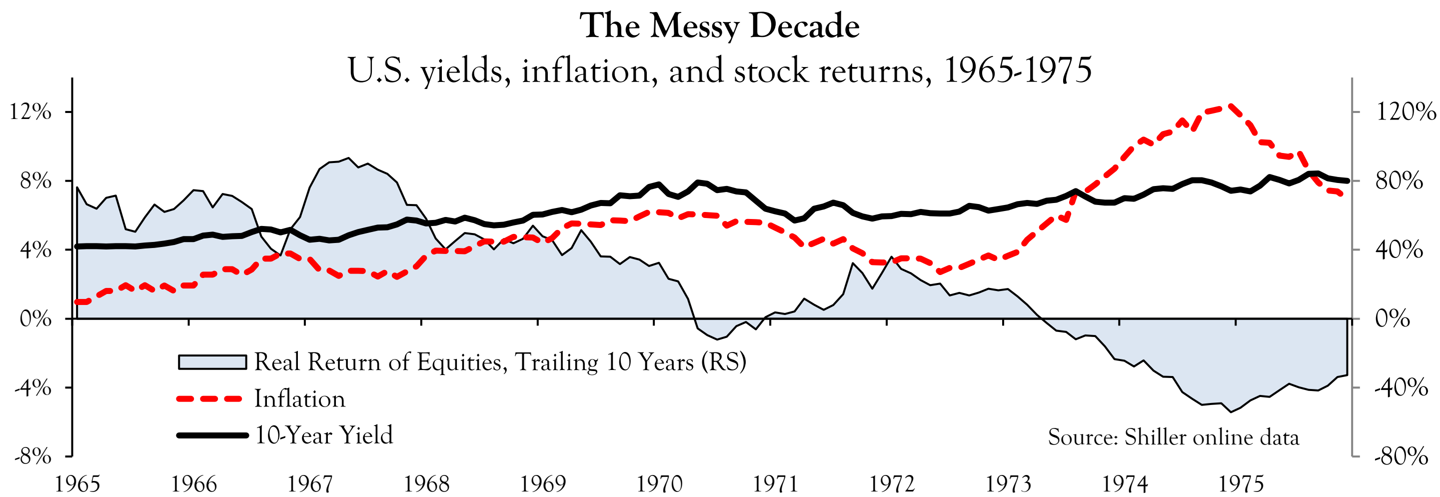
The 1960s offer another interesting precedent. Then, as now, excessive levels of debt had led to a decade of severe financial repression. 10-year treasury yields averaged just 2.7% between 1941 and 1960. The great moderation of the 50s was characterized by low inflation, high savings rates and fiscal austerity. By the mid-60s, all these trends were reversing, and inflation was creeping above the Fed's comfort zone.

The U.S. post-war social consensus was increasingly questioned by a rebellious young generation. Then, as now, university campuses were the stage of violent confrontations. Then, as now, traditional political lines were shifting: Barry Goldwater's Southern strategy essentially reversed the traditional electoral map. Richard Nixon won the Republican primary by harnessing the anger of rural white southern voters against the traditional coastal elites of the Republican Party, and ended eight years of Democratic presidency. The last years of Nixon's mandate were characterized by extreme partisanship, bitter ideological divide, and a sense of moral decay. The President was so weakened by the Watergate scandal that he was forced to leave the office to his ineffectual Vice President, Gerald Ford.

The 1960s and 1970s marked a period of unprecedented relative decline for the United States. A resurgent Japan and Europe challenged the extraordinary economic supremacy that that the U.S. had enjoyed after the War. U.S. multinationals were in retreat and the country's current account surplus turned into a deficit in 1968. In 1960, Japan's GDP per capita was 16% of that of the U.S. Two decades later, it was 80%.

In the developing world, nationalist leaders in developing countries forced better trading and investment terms on U.S. majors. Small Asian countries started an extraordinary process of economic convergence. Oil exporters created OPEC to defend their interests. The power of the new organization was displayed by the 1973 oil embargo.

U.S. assets fared very poorly. Inflation and rate hikes decimated treasuries and municipal bond returns. The Dow Jones posted an astounding 51% loss in real terms between 1965 and 1975, and the U.S. Dollar lost more than 80% of its gold value as the Bretton Woods system collapsed.



Many investors are currently caught in a Catch-22: They believe that the overvaluation of U.S. assets will eventually result in a violent correction. Yet. U.S. assets have benefitted from their "safe haven" status in all recent corrections. As a result, the more one is worried about U.S. valuations, the more one allocates to U.S. assets. Logic and the precedent of the late 60s suggest that this position is untenable. If the U.S. is about to experience another decade of reflation, bitter partisan divide and soaring deficits, the U.S. dollar and domestic equities will be the new risky assets.