

## **Markets Update: Inflation and Equities**

**Jake Siewert:** Welcome to our Exchanges at Goldman Sachs markets update for Friday, February 19th. Each week we check in with a leader across the firm to get a quick take on what they're watching in markets. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today we're going to talk about the prospects for inflation and its impact on markets. We're joined by Peter Oppenheimer, Chief Global Equity Strategist and Head of Macro Research in Europe who's going to be talking about his new research. Peter, welcome back to the program.

**Peter Oppenheimer:** Thank you, Jake. Good to be here.

**Jake Siewert:** Nice to see you. So, in the latest research you put out, you say that we may be heading towards more reflationary environment than we've seen, really, since the financial crisis in 2009. What's behind that thesis?

**Peter Oppenheimer:** Well, I think that the main thing to emphasize is that we're entering a period that is likely to be characterized by a combination of factors that we just simply haven't seen in what was a very deflationary-led era post the financial crisis. So, over the last decade or more now, inflation has tended to trend downwards globally. So did bond yields, which reached record low levels. Growth did recover after the financial crisis, but it was not very synchronized globally and it wasn't particularly strong, especially outside of the US. You had the banking crisis, the sovereign debt crisis, the collapse in commodity markets, they were all central to that disinflationary environment that we saw. And so too were the attempts, remember, to tighten fiscal policy and introduce austerity in many countries, particularly in Europe. And bear in mind that also the last decade were very much dominated by the digitization of different industries that also led to more disinflationary pressure.

So, what's changing? Well, if we're right in terms of our forecast, we're going to move into period of much stronger, more synchronized global growth. Our economists are looking at 6.5 percent real GDP growth this year. Over 4.5 percent next year. And this is the strongest synchronized global growth that we would have seen over the last 30 years or so. And bear in mind it's also at a time when we have zero policy rates. And we think that will continue until the second half of 2040 [?] even in the

US. That would imply negative real interest rates. And we have record loose US financial conditions. In other words, record loose monetary policy.

On top of that we're also seeing more fiscal expansion. We're expecting to see a fiscal program of 1.5 trillion dollars approved in the US. And that will be another 6.8 percent of GDP on top of the already 900 billion dollars that was approved towards the end of last year. And we also have very strong savings rates in the household sectors across many of the major economies. And on top of all of that, as we move into a more decarbonization led world, there's likely to be much more capital investment in physical infrastructure that analysts estimate could be in the region of 16 trillion dollars over the next couple of decades.

So, when you take those things together, we're likely to see, not necessarily high inflation, but markets responding with less fears of deflation and more confidence in growth and inflationary expectations.

**Jake Siewert:** So, what implications might the onset of inflation have, or at least the prospects for reinflation have on the bull market in equities over the next few months?

**Peter Oppenheimer:** Well, in general, I think it's positive. Bearing in mind deflation is very negative for real assets like equities, it's very good for nominal risk-free assets like government bonds. So, over the last decade or so you've seen very large amounts of money moving into government bond markets and money market funds. And some of this, I think, could shift back into equities. And we're seeing some signs of that now.

I mean, in the last week alone, net flows into global equity funds were at a record 60 billion dollars. And when you scale that by assets, the size of assets, the inflows were in the 96 percentile of history. So, you're starting to see money coming into equities. I think that could go further as people get more confident about growth and more confident that these deflationary pressures are receding. And maybe inflation starts to pick up.

Also, what we found from history over many decades is that, actually, the best returns of equities are when you're at a point where you have very low inflation and bond yields, but they start to increase. And that, again, is reflective of stronger growth expectations that we tend to get in recessions

as investors start to price a recovery. But interest rates are still low enough to support risk assets.

So, I think in general, this transition into a more growth friendly, synchronized, and maybe slightly more reflationary backdrop will be positive for risk assets like equities.

**Jake Siewert:** Okay. So, let's get a little deeper here. In your research you talk about six specific areas where outcomes could shift materially if investors start pricing in higher inflation expectation. Let's quickly talk through each of these. First of all, you touched on this, but equities relative to bonds.

**Peter Oppenheimer:** Well, I think again, you know, equities will do better as we see a strong rise in profitability. Now, of course we've seen a big collapse in profits in the corporate sector over the last year. We're expecting, globally, profits to grow in the major stock market by about 35 percent. And then double digits again in 2022. And that, with the resumption of dividend growth, I think, makes equities look more attractive relative to bonds, particularly when bond yields are at record lows. And in many countries, they're offering negative yields. So, I think that's a supportive, relative story, for equities compared to fixed income.

**Jake Siewert:** Okay. And how about value stocks relative to growth stocks?

**Peter Oppenheimer:** Well, one of the really interesting things about the post financial crisis era was how much the equity markets were bifurcated. You know, the prospects varied very much according to the types of companies that people were buying. Generally, growth orientated equities, particularly in sectors like technology, did very well as their profits and returns on investment increased. But many other sectors, particularly in the more mature industries, and particularly the lower valuation type of industries did pretty badly. Now, some of that was also because these sorts of industries were very troubled by the effects of the financial crisis, in particular the bank sector, which spent a long time rebuilding capital and struggling with the effects of very low rates, the commodities industry as well, which was suffering from secular falls in commodity prices.

Now as we move forward in time, as you get better growth prospects, rising commodity prices, I think you'll start to find that value parts of the market, which are looking historically

cheap on a relative perspective, start to improve. And we've seen some evidence of that in the last couple of months. And we think it has further to go.

**Jake Siewert:** Okay. And how about cyclicals relative to defensives? I can guess the answer, but I'd love your take.

**Peter Oppenheimer:** Well, in a way it's a very similar argument here. Just as growth, and in particular technology, did much better than the value areas of the market like banks and commodities, so you also found that defensive industries, things that had very predictable, stable cash flows did very much better than those parts of the market which were cyclical or very economically sensitive. Because there were constant concerns about economic weakness, investors put a big premium on those kinds of industries that could ride out any economic weakness with stable cash flows.

Now cyclicals would tend to benefit, of course, if you get a strong economic recovery because they have the most operational leverage. That means that their earnings will rise proportionately more than other industries as growth picks up. And, you know, the classical sectors which are very cyclical in that nature are things like basic resources and chemicals, industrials, oil, financials, building materials - the kinds of things that are very sensitive to the economic cycle. And those, I think, again, tend to look quite cheap at the moment. They have more room for their profits to recover from the low base. So, I think they'll continue to outperform in the near term.

**Jake Siewert:** You mentioned financials, but a bit more specifically, banks relative to staples?

**Peter Oppenheimer:** Yeah, well banks in the last cycle were really the extreme end of the value trade, particularly in those markets which were very value orientated. So, Europe is a very good example of this. It as a stock market very much underperformed the US. That's because it had a higher weighting in sectors that were very value orientated and mature, as opposed to the US which had very high weighting and exposure to faster growing industries like technology.

Now, banks also suffered because, as I mentioned, they had a lot of problems to deal with in the aftermath of the financial crisis. They had to rebuild their capital. And they had to deal with a squeeze in their profit margins and their interest margins as interest rates collapsed. They had to deal with

[UNINTEL] loses from the fallout of that crisis. But over the last decade or so, they have rebuilt balance sheets. And they, too, are very geared to any improvement on global growth. And interestingly, after many years of underperforming, particularly in places like Europe, in the most recent earnings season that we're seeing, banks have been among the areas of the market that have had the biggest positive surprise compared to expectations.

So, if you take Europe, for example, in this latest round of earnings results that we've just been seeing, relative to the consensus going in, the banks have beaten by about 27 percent. So, almost 80 percent of banks have surprised the consensus by more than 5 percent. So, again, it's a mature industry. It's not a high growing industry. But it did get very cheap. And it stands to benefit a lot from any rising interest rates and stronger synchronized growth.

So, again, relative to the more staple, more defensive parts of the market, there is finally an opportunity to see some relative upside, we think, there.

**Jake Siewert:** Okay, and how about volatility? How should we think about high volatility relative to low volatility in this inflationary environment?

**Peter Oppenheimer:** Well, again, low volatility was very much sought after in the post financial crisis era. There were lots of uncertainties. [UNINTEL] uncertainties, economic uncertainties, falling interest rates. And that tended to benefit, not just very long duration assets, in other words, those that had their expected cash flows long into the future. But also, things that were very predictable that had low volatility. And those sorts of assets tended to not just outperform but go to ever higher valuations.

As you move into an environment with greater confidence coming out of this deep recession that we've been in, and people get less worried about the future and see more investment opportunities, they're more prepared to go into higher risky and more volatile parts of the market, I think. So again, this is another example of where we might see more rotation, relative to the experience of the last few years.

**Jake Siewert:** And finally, the last topic you covered was dividends. How should we think about dividends in this new environment?

**Peter Oppenheimer:** Well, dividends, I think, will improve alongside better profit growth. Now we have to, again, put it in context. We've just seen very big flows in profits. And in large parts of many equity markets, dividends have been cut as well. But as we go into this improved economic environment and profit prospects improve, companies will be able to pay out more in terms of dividends. Or those dividend streams will become more dependable. And I think that will be pretty attractive as well.

Now, in the last decade or so, dividend yields have remained pretty stable while bond yields have fallen very sharply. For example, ten-year bond yields, government bond yields, were about 4 percent in the US before the financial crisis of 2008. And then now down to levels of, you know, around 1 percent or so. Over that whole period of time, dividend yields remained about the same. That means that investors demanded a higher yield, a higher income on equities to compensate for their perceived risks.

But as people get more confident about growth and believe that, actually, interest rates might start picking up, that dividend yield can come down as dividend payments increase. And that means that relative valuations for equities can start to rise. So, I think the prospects for dividends are also improving from here. And that's another important reason why investors would be looking at equities as part of their asset allocation.

**Jake Siewert:** Indeed. Well Peter, thank you very much. That was a very comprehensive look at what we're facing. But thank you very much for joining us today.

**Peter Oppenheimer:** Pleasure, thank you.

**Jake Siewert:** That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening. And if you enjoyed the show, we hope you subscribe on Apple Podcast and leave a rating or a comment.

And in case you missed it, check out our other episode this week with Stephan Feldgoise and Mark Sorrell of Goldman Sachs Investment Banking Division. They talked about the M & A landscape for 2021.

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