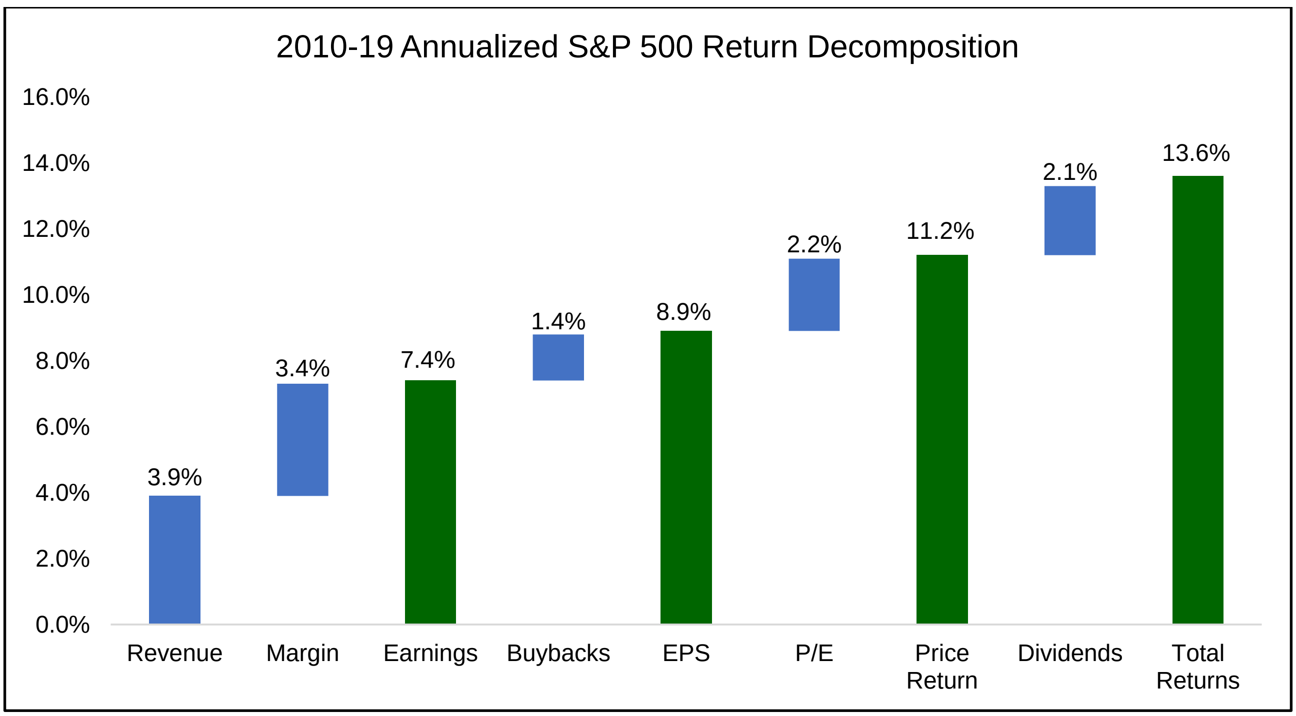
January 2020

What a Decade

The past decade has been very good for US investors, as markets and the economy recovered from the great recession. After taking a back seat to international markets, the 2010s favored US assets. US interest rates fell to all-time lows with the 10-year Treasury averaging 2.4% for the decade, down from 4.5% in the 2000s and considerably lower than the 6.7% it averaged in the 1990s. Many factors contributed to this, including central bank policy, disinflation, demographics, and global money flows. The result was a decade of strong returns for fixed income markets.

This lower interest rate regime proved a boon for corporations. Companies were able to finance their operations at historically low rates. Interest expense as a percentage of sales fell from nearly 5% a decade ago to only 2% today, even with rising absolute levels of corporate debt. Profitability was further boosted by the reduction in federal tax rates from approximately 30% to 20%. Lower interest expense and taxes enabled after-tax profitability to expand at nearly twice the rate of revenue growth. Additionally, access to this very low cost of capital allowed many companies to borrow more and use the proceeds for stock repurchases, further boosting earnings per share growth. Combined with multiples expanding from 15 to 19 times earnings and adding in dividends, the S&P 500 just completed a decade where annualized returns were 13.6%, albeit off a very low base. The chart below breaks down this return into four distinct categories — operating earnings (revenue and margin), buybacks, multiple expansion, and finally, dividends.



Source: Credit Suisse

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Within US equity markets, growth surpassed value by an annualized rate of 3.4% per year or a cumulative total of nearly 40%, as investors have been willing to pay ever-higher prices for companies that have been able to grow during a lackluster period of economic expansion. While annual US economic growth has not been particularly good relative to history at 1.8% compared to a multi-decade trend of 3%, it has been very good when compared to other developed markets such as Europe and Japan. This relative strength, search for growth, and the ease with which capital can now flow across borders has resulted in considerable foreign investment in US markets. In fact, for the decade, the S&P 500 outperformed developed international markets by over 7% per year and emerging markets by almost 10% per year.

The strong performance in domestic markets has attracted foreign capital. As a result, the dollar experienced a decade in which its value increased by nearly 25%. This was another tailwind for the economy as it helped keep inflation low via cheaper imports and a sharp reversal from the 2000s when the dollar weakened substantially as investment across the world increased.

When looking back at the last ten years from '10,000 feet', it would appear to have been smooth sailing for US investors. Having lived through the day-to-day, we know that wasn't the case. Conditions that now seem reasonable, such as muted economic growth, persistently low inflation, and rising corporate and sovereign debt levels, would have given most investors significant pause 10-years ago. In fact, over the past decade, we have lived through some of that indigestion via persistent fears of a "double dip" recession, the downgrade of the US treasury ratings and government shutdowns. While it has been a prosperous time, the journey had more than a few bumps in the road.

Conditions do not immediately change with the turning of a calendar; however we are confident that the next decade will NOT be a rerun. The bull market is now 11 years old. Equity returns will likely regress (we would be happy to be proven wrong!), and interest rates will not head substantially lower unless a new economic crisis arises; this would suggest that returns in fixed income are likely to be limited. Absent the tailwinds of lower interest expense and additional tax cuts, corporate profit margins will struggle to expand, especially considering the very tight labor market. As a result, earnings growth will need to be driven by revenue growth.

Simply put, we have a solid current fundamental backdrop that is being threatened by increasing uncertainty, along with the sheer duration and magnitude of the cycle. Navigating this environment will require nimble management. We look forward to the challenge.