Strategist's Corner
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What Equity Investors Signaled That Bond Investors Missed

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In brief

- Markets send signals, such as signs of credit stress over a year before the collapse of Lehman Brothers.
- The nearly decade-long outperformance of growth stocks over value stocks has been sending a signal to the bond market that went unheeded until recently.
- Is it possible that growth's unprecedented outperformance over value for much of the last decade has been signaling lower – if not zero – interest rates globally?

Capital markets discount all available information. Asset prices trade based on the push and pull between investors, with varying viewpoints about the underlying assets' future cash flows. In simpler terms, the market is an aggregated view of investor expectations of future cash flows, and consequently, risk. It's a signaling engine. Let's look at a simple example.

In July 2007, the structured credit market (for example, collateralized debt obligations) began to signal cash flow risk, as prices began to discount significant default probabilities. Later in the year and throughout 2008, the broader credit market was similarly discounting cash flow stress — and ultimately — bankruptcy risk. Yet over this time, equity investors ignored a significant signal from the bond market until after the collapse of Lehman Brothers in September 2008.

Is it possible we've witnessed the reverse over the last few years? Is it possible the bond market has missed the deflationary signal that the equity market has been sending? Let's explore.

The outperformance of growth stocks over value has been endlessly rehashed in recent years. Growth investors explain the outperformance based on the superior future earnings power of technology firms. Conversely, value investors explain it as trend following, like the technology bubble of the late 1990s, and they expect mean-reversion with value stocks eventually reasserting leadership. However, I'd like to offer a different perspective.

Is it possible that growth's unprecedented outperformance over value for much of the last decade has been signaling lower — if not zero — interest rates globally? Perhaps bond investors, just like equity investors ahead of the global financial crisis, ignored the signal at their peril.

Let's go back to our finance textbooks. In simple terms, the value of a company is its steady state (*i.e.*, the total value of property, plant, equipment and the like) plus discounted cash flows. Said in fixed income parlance, equities are very long duration assets. More specifically, growth companies are the longest duration equity assets because they generally reinvest cash flow back into the businesses rather than returning it to shareholders over time; whereas mature, cyclically-oriented value companies return capital more consistently to shareholders through dividends or buybacks. As a result, growth stocks have more "duration" than value stocks.

Despite unprecedented stimulus, inflation remains benign, perplexing central bankers and the bond market. Perhaps fixed income investors should stop looking at the symptom, low inflation, and consider what is happening across industries? If they did, they may see how technology has increased the supply of goods and services available for sale, created price transparency and improved product quality awareness. These factors have combined to spark price wars across multiple sectors worldwide, fueling disinflation. Which is why, in my opinion, interest rates may yet have further to fall.

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