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TRANSCRIPT

Tonight We're Gonna Invest Like It's 1999?

*Featuring: **Chenlu Zhou**, Executive Director, MSCI Research*

Adam Bass (00:04):

This is MSCI Perspectives, your source for weekly research insights, as investors respond to the COVID-19 pandemic. I'm your host, Adam Bass, and today is October 22nd, 2020.

Adam Bass (00:18):

This week, you might be forgiven for looking at US equity performance since March and assuming investors had no worries. But some are wondering whether valuations are... well, whether they're just too darn high. Fortunately for us, Chenlu Zhou, executive director on the MSCI multi-asset class research team, has looked into it. We asked her to come on and share her insights.

Adam Bass (00:43):

Chenlu, thank you so much for coming back to the program.

Chenlu Zhou (00:47):

Thank you, Adam, for having me back.

Adam Bass (00:49):

When we spoke to you back in early September, toward the end of our conversation, we talked about what was the seeming disconnect between economic data, how the economy is doing, and the performance of the stock market. I recall at the time you talked about how your research pointed to basically two reasons for this. The first was very low interest rates. And second, interestingly, was what you called a lack of fear on the part of investors. Not that they weren't scared about the virus or what would happen to the economy, but there was a confidence you pointed to that the stock market would be supported. And it doesn't seem as if that fear factor has returned, even as we start hearing about second waves in Europe, falling economic numbers in many places around the globe, China a noted exclusion. So I guess my question here, buried in all of that, is, how did we get here? Can you, I guess, walk us through this market rebound over the last seven months?

Chenlu Zhou (01:59):

Yeah, absolutely. Earlier this year, in February, March, the stock market has had a really historic crash. So it tanked over 30% in a matter of couple of weeks. And in the middle of that crash, we here at research team did a study trying to understand how we could explain that crash. So roughly speaking, the idea is that market crash can be attributed to either a really bad economic outlook or some panic in the market. So we developed a range of scenarios that at one end of the spectrum, all the crash is attributed to the bad economic outlook, and at the end of the spectrum, it's completely due to panic.

Chenlu Zhou (02:45):

And in one of the scenarios, which kind of resembles the consensus economic forecast at the time in March, which is a recession quite similar to that we had in the financial crisis. And under that scenario, we believed that the market had a chance to bounce back, if the investors were to become less panicked. Seven months later, that seems like the scenario that has happened. So that's kind of the background.

Chenlu Zhou (03:17):

And that said, according to some traditional valuation metrics, the valuation right now seems really high. And we haven't seen such levels since the late 1990s. Adding onto that, a lot of recovery in the market price has been driven by tech stocks, and that makes a lot of investors quite nervous.

Adam Bass (03:39):

Absolutely. I mean, high price to earnings ratios, tech stocks dominating the market, definitely starting to get some late '90s deja vu here. I'm wondering, should I dust off that Backstreet Boys CD, or is something different going on here?

Chenlu Zhou (03:55):

Right, right. So let's take the example of one of the popular valuation metrics, called the CAPE, as an example. So that's evaluation measure developed by this economist called Robert Schiller, which basically tells us how many multiples is the price compared to a rolling average of the stock earnings.

So the CAPE is at about 30 right now, and that's a level we have briefly seen right before the pandemic. But the last time the market has sustained such a high level of CAPE was actually back in late '90s and early 2000s, particularly right before dot-com bubble burst, that CAPE value has topped 40, so even higher than it is now. Back then in the late '90s, we were in a booming economy, and even then the Federal Reserve chairman Greenspan called it an irrational exuberance, and that bubble eventually burst. Whereas right now, given that the economic outlook seems much more dire, it is very reasonable that people are skeptical about such high valuations.

Adam Bass (05:09):

Right. And that's really the question that you came out with, with this latest round of research. Is this rally sustainable? Now, I know you don't have a crystal ball, but you do have some very intricate tools at your disposal, models, as you mentioned earlier, that can look at different scenarios and estimate different outcomes. So let's spend some time talking about the model you used this time around and how it works, on a high level of course, to help you uncover some possible explanations for what's going on right now.

Chenlu Zhou (05:46):

Sure, yeah. We use a model that connects the equity prices with macroeconomic variables through what we call a discounted cashflow framework. So the idea is that the equity prices are determined by two broad categories of components. One is the cashflow, and then the other is discounting. So cash flows are closely related to the stock earnings and just the overall size of the economy, and discounting, on the other hand, is tied to risk-free interest rate and an equity risk premium.

Adam Bass (06:27):

Okay. Let's take that down just a level, if you could. Maybe Econ 101, stock market 101 type of explanation. The cashflow part you mentioned seems very straightforward, earnings, overall economy. But I'd like you to spend a little more time on the discounting portion. Can you break down the risk-free rates, equity risk premium part of the framework?

Chenlu Zhou (06:52):

Yeah, absolutely. So the way we can think about the discounting part is how much of return is required by the investors when they invest in equity. And the reason why people typically break it down to risk-free rates and equity risk premium is because risk-free rate is what you can gain, almost, by the name of it, risk-free. You can buy a government bond and gain such yield. And then on top of that, an equity risk premium is what the equity investors would require in order to take on more risk by buying equity.

Adam Bass (07:31):

Okay. Thank you. That's clear. Now, let's get back to the model.

Chenlu Zhou (07:35):

Yeah. So for a stock market 101 type of explanation, as you mentioned, we could probably borrow some intuition from the more well-known Gordon Growth Model, or any dividend discount model, where the return on equity minus the growth rate of dividend is equal to the dividend yield. And to take that a step further, as we briefly mentioned earlier, we can separate the return on equity to risk-free rates, plus the risk premium for equity. Now, our model generalizes the Gordon model in several ways, but the basic idea is very similar. So we can back out the implied equity risk premium from the market prices based on our model expectation for future risk-free rate and the growth rate assumption.

Adam Bass (08:34):

Okay. So in either case, trying to measure the equity risk premium going forward. What did the model show?

Chenlu Zhou (08:43):

Right. So our model suggests that even though the traditional price to earnings ratios are quite high, the implied equity risk premium, or ERP, is quite similar to what it had been for the last 10 years. This is actually partly due to that the real interest rate is at a historical low level, and right now that's about -1%. And also according to the Federal Reserve, that is a level that is expected to sustain for the foreseeable future. And that is a key difference between where we are today and in the midst of the dot-com bubble, when the real interest rate were about 5% higher than they are now.

Adam Bass (09:33):

Okay. So if I'm following you correctly, even though valuations, as measured by PE ratios, are definitely high, implying large amounts of risk, the risk premium, the amount that investors are being paid to take on that risk or demanding, in another sense, to take on that risk, that hasn't really shifted. Is that correct?

Chenlu Zhou (09:56):

Yes.

Adam Bass (09:57):

And that seems like a lot less pessimistic a view than we've seen from some other analyses of the market. It's almost politically correct, in a sense, to be pessimistic. So Chenlu, how would you answer someone who said that the outlook described by MSCI, well, it's just too rosy.

Chenlu Zhou (10:21):

Yeah, I think that's definitely a healthy debate that we have out there. And I have two thoughts on that. One is, we want to recognize that we are in an unprecedented era of very low interest rates. So even though the PE ratio is indeed very high, we shouldn't lose sight of how much of that low yield environment has done to prop up the prices. So with that said, I would stand by our model, that this valuation level isn't that crazy, given how low the yield is.

Chenlu Zhou (10:58):

On the other hand, the equity risk premium is only one part of what constitutes the total expected return. At the end of the day, investors care about the total returns, which also include the risk-free rate part. So if the interest rate were to stay low, as what people seem to be expecting now, then that total expected return implied by our model are still going to be much lower than what we have experienced for the last decade.

Adam Bass (11:31):

So still rosier, but you are seeing some possibilities of darker skies.

Chenlu Zhou (11:40):

I think that's a good way to say it, yeah.

Adam Bass (11:42):

Chenlu, we appreciate you coming on to offer your insights. And as this continues to play out, we would love it if you would join us again and offer your views.

Chenlu Zhou (11:53):

Absolutely. I look forward to be back.

Adam Bass (11:56):

That's all for this week. Our thanks to Chenlu and to all of you for joining us. Remember, it takes just a moment to subscribe to the podcast, leave a comment, or share with a friend. Until next week, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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