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Research

The multi-asset essay

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Jingle bulls, jingle bulls, jingle all the way!

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'Twas the night before Christmas and the good folks of America were restless. No one really understood why. Jobs were aplenty and when asked if they expected to be better off in a year's time people were as positive as ever. Yet other surveys revealed a deep malaise. Wise men argued over explanations, not making much sense. Only Father Christmas was optimistic. He had seen this situation before and knew satisfaction levels always rebounded (figure one). This was akin to the darkest hour before Christmas morning. The sharp recoveries in sentiment seen in 1980 and 1994 would be repeated now.

Unconvinced the wise men preferred to blame factory owners for everyone's problems. The taunting of businessmen proved popular, especially the accusation that wilful underinvestment had crippled American growth. Leaflets were distributed. Some showed that corporate spending as a proportion of cash flows was depressed (figure two); others that greedy managers favoured short-term payouts over long-term investment (figure three). Father Christmas tried to convince the wise men this analysis was wrong. But by now it was so widely believed that even he received letters from children bemoaning the capex numbers at his toy shop.

Naturally corporate spending has lagged cash flow growth in America (and in the North Pole). Father Christmas patiently wrote back each time. Cash flows have soared so much in recent years that nothing could possibly match them. He would also politely warn people to ignore the wise men who bear graphs comparing nominal capex to output, or who apply only a general deflator. Instead they should observe the prices of stuff companies are actually investing in, Father Christmas would argue, such as information technology, equipment or transport. They have fallen more in price (or have risen less) than prices in the wider economy (figure four). Apply the correct deflators and businesses are in fact spending like crazy – with the one exception of property and buildings where inflation has been rampant.

The reality is that company managers are not Scrooges. Indeed aggregate real capex as a proportion of output is at or near record levels in America (figure five). It's obvious! – Father Christmas would chuckle to his reindeer. What else has caused the rampant over capacity we observe down those factory chimneys as we zoom about? And clearly too much – not too little – capex also explains why businesses are having such a hard time raising prices and growing their top lines. More than 40 per cent of American companies will have seen no revenue growth this year – globally almost half won't (figure six).

So the wise men were correct to point their fingers at businessmen – but for the wrong reason! Reckless over spending rather than deliberate under spending has led to the lack of growth and general unease. Investors were also oblivious to the decline in revenue growth caused by a profligate expansion of assets. Or maybe they were just not bothered. After all, toy factories were returning sacks of money to shareholders and equity prices were somewhere north of Lapland. This was sustainable, Father Christmas knew, because the erosion in asset-turn (revenues divided by assets) was being off-set by rising margins (figure seven) – thus supporting returns on equity.

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This overlooked dynamic explains everything from anaemic growth and booming equities to the rise of passive funds and lull in corporate deal making. What is more, it is a global phenomenon – especially so in emerging markets where excess capacity is chronic. To most people this looks worrying, given the tailwinds of lower wages, lower rates, and worldwide tax fiddling, which have pushed margins higher, are becoming headwinds. Only Father Christmas understands what an opportunity this is. Margin pressure will force companies to change behaviour for the better – with dazzling repercussions.

And the winds have already turned in America. For example, average hourly earnings growth has doubled since two years ago (figure eight) and keeps rising. Even Father Christmas's laziest elf appreciates that his labour is scarce these days and has demanded more porridge. Meanwhile borrowing costs have turned upwards having declined for most of the millennium (illustration nine). Finally, there is less scope for taxes to fall than everyone thinks – American companies already pay a much lower effective tax rate than they did a decade ago (figure ten).

Margin pressure is the snowball in the face company bosses need to start investing more cleverly. Out with the irrational extra production line, fourteenth systems patch or mindless overseas expansion in order to boast being global. And in with capex that boosts productivity and returns. So ineffectually have most firms been spending money that investment will rise despite being elevated in real terms. The biggest gains will be made by the lowest quality companies. Forget about robots and artificial intelligence; this is about basic new IT infrastructure, client relationship software or logistics systems. So many companies do not do the simple things well because the tailwind of low wages, taxes and interest rates has meant they haven't needed to. Only the top ten per cent of American companies have managed to significantly boost their returns on capital, excluding goodwill, over the past 15 years (figure 11). Other developed countries have similar skews too.

That so many companies are in need of a capex overhaul is what then creates a virtuous economic cycle – with productivity the missing piece. More investment raises aggregate demand because a third of corporate America's revenues are exposed to domestic capex spending. This maintains the upward pressure on wages which are strongly correlated with higher productivity (figure 12). Also note that an appreciating dollar helps make companies more productive. Finally, income growth means more consumption and so the aggregate demand cycle keeps spinning. Which toy maker wouldn't be happy to grant his little helpers a pay rise in this scenario?

But it is not just growth that rejoices. Equity and bond markets would also sing hallelujah. All else being equal, higher productivity allows American workers to make wage gains without labour receiving a greater share of total economic output (in other words, company profit margins do not collapse). Likewise, bond markets can avoid a sell off because productivity growth keeps inflation under control as incomes rise. These are no Christmas miracles; rather both statements are outcomes derived from immutable macroeconomic identities (figure 13).

And should a fiscal stimulus also grace America next year – perhaps an errant sleigh-load of expensive presents is spilled – this would exacerbate the shift in the composition of returns from margins to asset-turn, because revenues would rise even more, as would wage and interest costs. But stimulus or no stimulus there are two groups of citizens in particular that stand to be more satisfied come the holiday season next year. The first are active managers, a cowered bunch that have long suffered besides those who don't even believe in Father Christmas but rather the cult of passive investing (figure 14).

Why should index funds underperform stock pickers from here? Because it will pay to begin sorting the good from the bad. There was no need for investors to discriminate in the past as elevated margins meant even the worst firms could support high payout ratios – with low interest rates making yield even more attractive. For the reasons mentioned earlier it has become harder for these payout ratios to be sustained, yet companies stretched themselves because dividend stocks outperformed (Illustration 15). Hence the fall in dividend yield dispersion and rise in the dispersion of payout ratios (figure 16). Cracks are appearing already. In Europe, for example, more firms are resorting to scrip dividends as they struggle to maintain payouts.

With a falling dispersion in dividend yields ratios active managers cared less about quality, so long as they received their cheque. Even more so with passive funds of course – by definition they buy and sell without prejudice. This explains why the spread of total returns has shrunk over the years, even as the dispersion in company operating metrics rose (figure 17). Put simply, quality differences between firms were ignored. No wonder passive investing thrived. But as margins come under pressure and the gap between winners and losers opens up, expect index funds to lag active managers, reversing years of outperformance (figure 18).

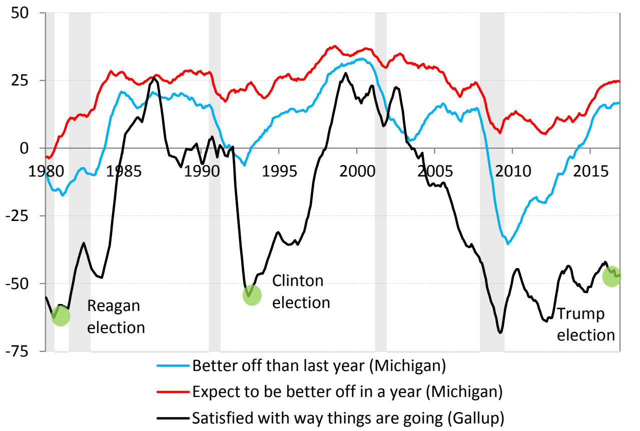
A widening of total returns also means dealmakers are about to see all their Christmases come at once. For too many years poor quality companies have been disproportionally expensive and good ones not expensive enough. This has stymied the mergers and acquisitions market because it makes the numbers harder to add up. As valuations stretch again, however, the better toy makers can go after their poorly run peers. Of course deals still only make sense if potential capitalised synergies exceed the premiums paid – but the latter should become relatively smaller in absolute terms.

Likewise for bankers advising the bottom end of the toy industry, time is running out on a once in a generation opportunity to acquire much higher quality companies that are relatively too cheap. This explains the purchase of Apple shares earlier in the year by Warren Buffett (whose favourite company also designed Father Christmas's costume). Such deals may be hard to pitch to investors, who may fret over lower multiple stocks buying higher ones. But bankers must counter that the gap is only going to widen, making the compensating synergies even more difficult to achieve.

Deals, stock picking, more investment, wage and productivity gains, growth – as Father Christmas gazes down from his sleigh he is as merry as he has been in years. A much welcome cyclical upturn shall bring more presents for everyone, driven by a positive change in business behaviour due to the free-for-all in margins nearing its end. Expect people to be happier, and for the wise men who long questioned America's economic potential to squabble over who predicted the recovery first.

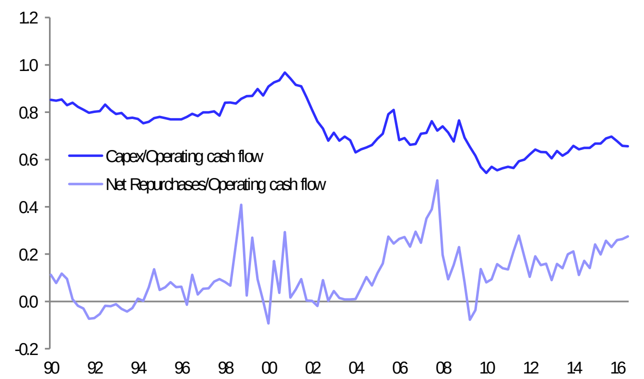
Figures

Figure 1: Consumer sentiment surveys



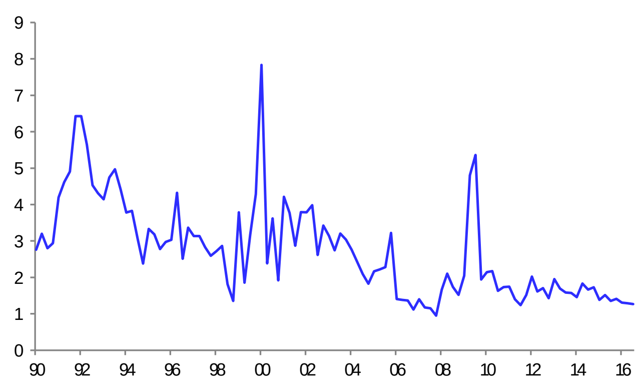
Source: University of Michigan, Gallup, Deutsche Bank

Figure 2: Capex and buybacks



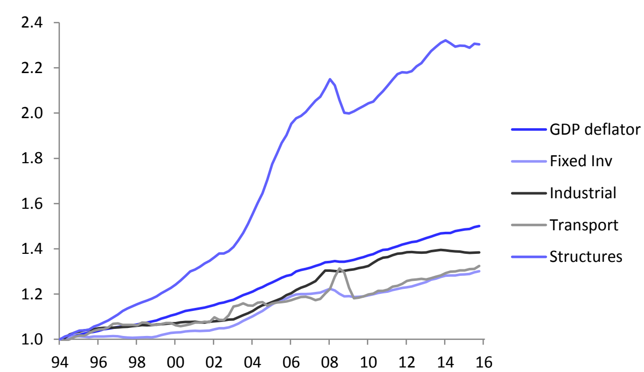
Source: Bloomberg Finance LP, Deutsche Bank

Figure 3: Capex divided by dividend and buybacks



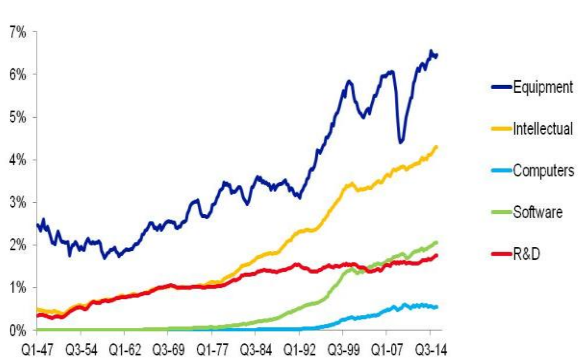
Source: Bloomberg Finance LP, Deutsche Bank

Figure 4: Prices of investment categories



Source: National accounts, Deutsche Bank

Figure 5: Real US capex as a percentage of GDP



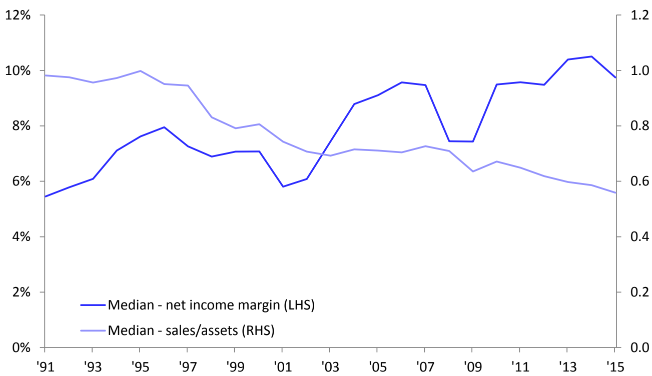
Source: National accounts, Deutsche Bank

Figure 6: Percentage of companies with negative sales growth by region

	2014	2015	2016 est
Europe	46%	35%	41%
US	27%	52%	41%
Japan	17%	41%	79%
Emerging markets	36%	46%	47%
Global	33%	45%	46%

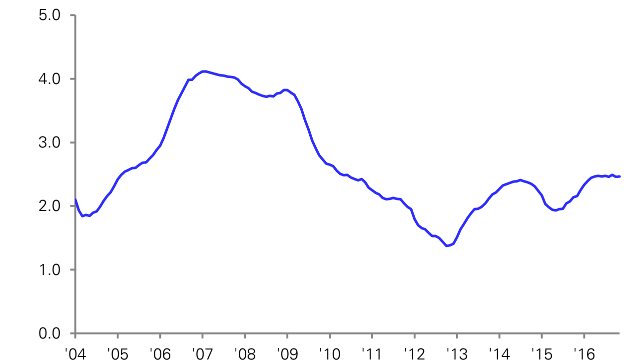
Source: Company reports, Bloomberg Finance LP, Deutsche Bank, CROCI

Figure 7: S&P 500 margins and asset turnover



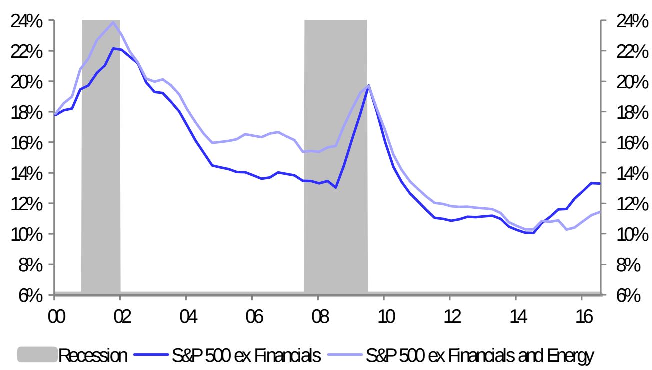
Source: Bloomberg Finance LP, Deutsche Bank

Figure 8: Annual increase in average hourly earnings



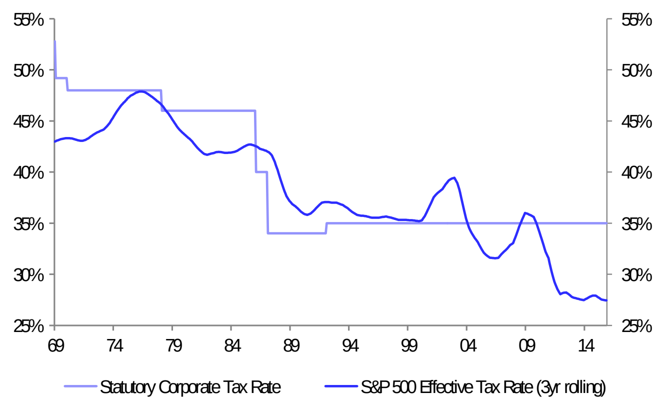
Source: Deutsche Bank

Figure 9: Interest expense as a % of operating profit



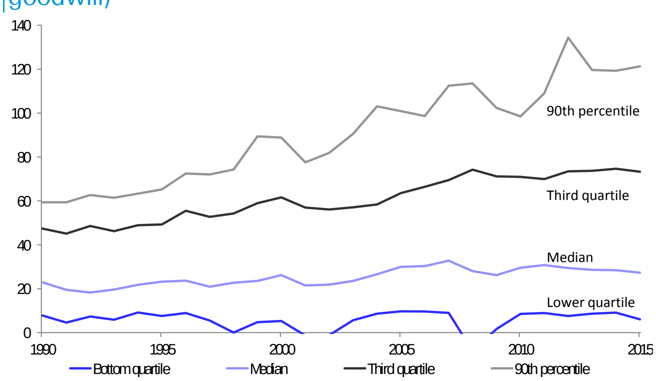
Source: Compustat, Deutsche Bank

Figure 10: Effective tax rate of the S&P 500



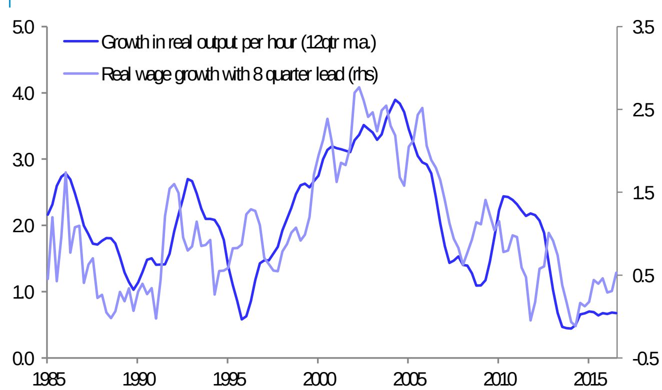
Source: Compustat, Deutsche Bank

Figure 11: S&P 500 return on invested capital (excluding goodwill)



Source: Bloomberg Finance LP, Deutsche Bank

Figure 12: Real wage growth and productivity



Source: Havers, Deutsche Bank

Figure 13: Components of nominal wages and growth

% change in labour share of output

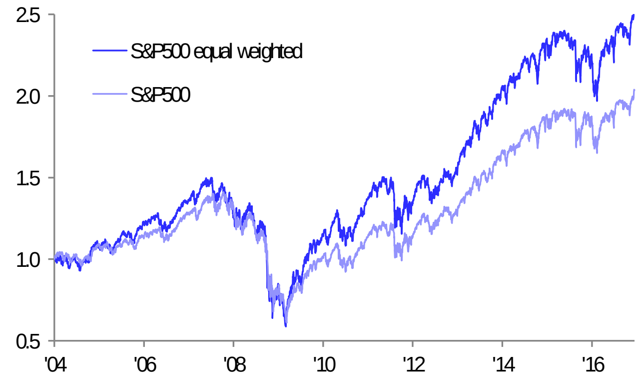
+ % change in prices

+ % change in productivity

= % change in nominal wages

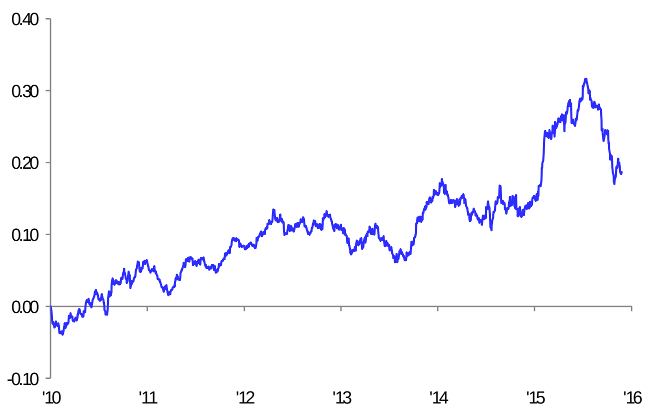
Source: Deutsche Bank

Figure 14: S&P 500 versus equal weighted equivalent



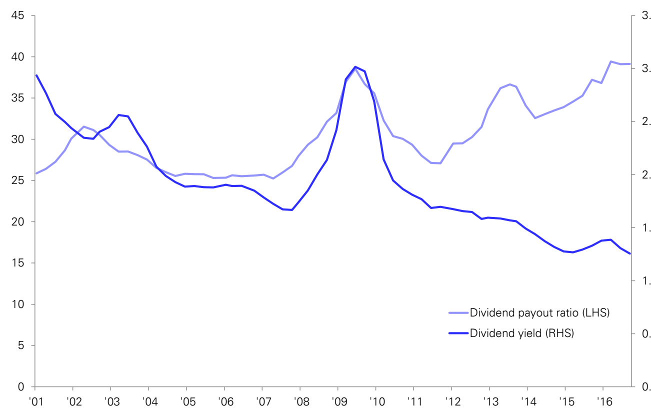
Source: Bloomberg Finance LP, Deutsche Bank

Figure 15: S&P 500 dividend aristocrats v S&P 500 (%)



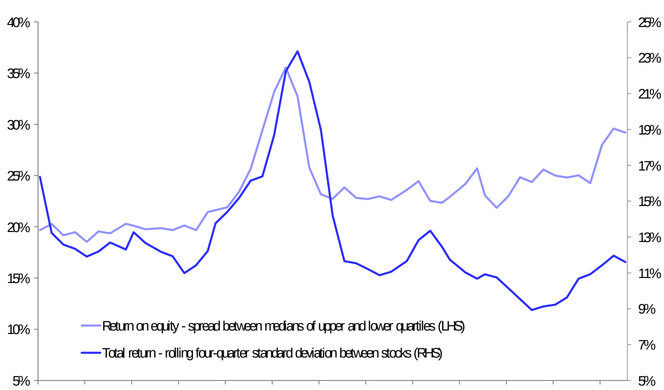
Source: Bloomberg Finance LP, Deutsche Bank

Figure 16: Dispersion of S&P 500 dividend payout ratio and dispersion of dividend yield



Source: Bloomberg Finance LP, Deutsche Bank

Figure 17: Dispersion of total returns and dispersion of returns on equity of S&P 500 stocks



Source: Bloomberg Finance LP, Deutsche Bank

Appendix 1

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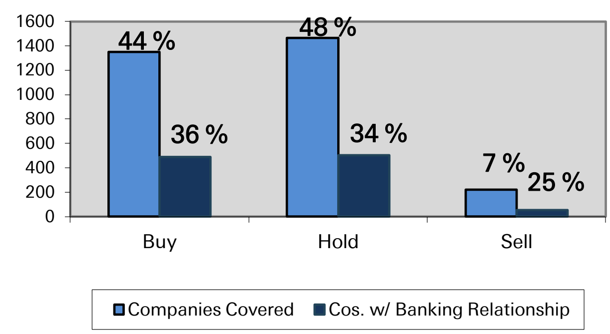

Global Universe

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