ALGER

Inspired by Change, Driven by Growth.

SUMMER 2018

# Capital Markets: Observations and Insights

## Degrees of Debt

# Degrees of Debt

"Rather go to bed supperless, than rise in debt." – Benjamin Franklin

We have written often about our belief that the largest driver of the economy and real wealth creation is productivity growth. However, economic growth can fluctuate around its long-term trajectory as consumers and businesses spend more than they produce by increasing debt or spend less than they produce as they repay debt. So where are we in this cycle of debt expansion and contraction?

In the U.S. and worldwide, debt has grown significantly as a percentage of economic output over the past decade. But there is no magic limit to debt balances. Rather, debt service, or the share of income used for interest payments and amortizations, typically plays an important roll in governing how much debt consumers or businesses can sustain.

While debt levels around the world are quite high, debt service is generally manageable. With the vast majority of that debt being fixed, it would take a long and sustained increase in interest rates to push debt service into the danger zone. For example, U.S. debt service for the consumer and business sectors is considerably lower than it has been in the peaks prior to the past two recessions. Therefore, we do not believe that investors need to worry about having to skip a meal…

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Chief Investment Officer

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Director of Market Strategy

# Key Observations

- **Global debt levels are high but servicing costs are manageable** and delinquencies remain subdued
- Monetary conditions are tightening but **stocks and the economy should be able to absorb moderate increases in interest rates**
- **Business spending has begun to accelerate** and outpace the broader economy, driven by strong earnings growth, tax reform, solid business confidence, and accommodative lending conditions

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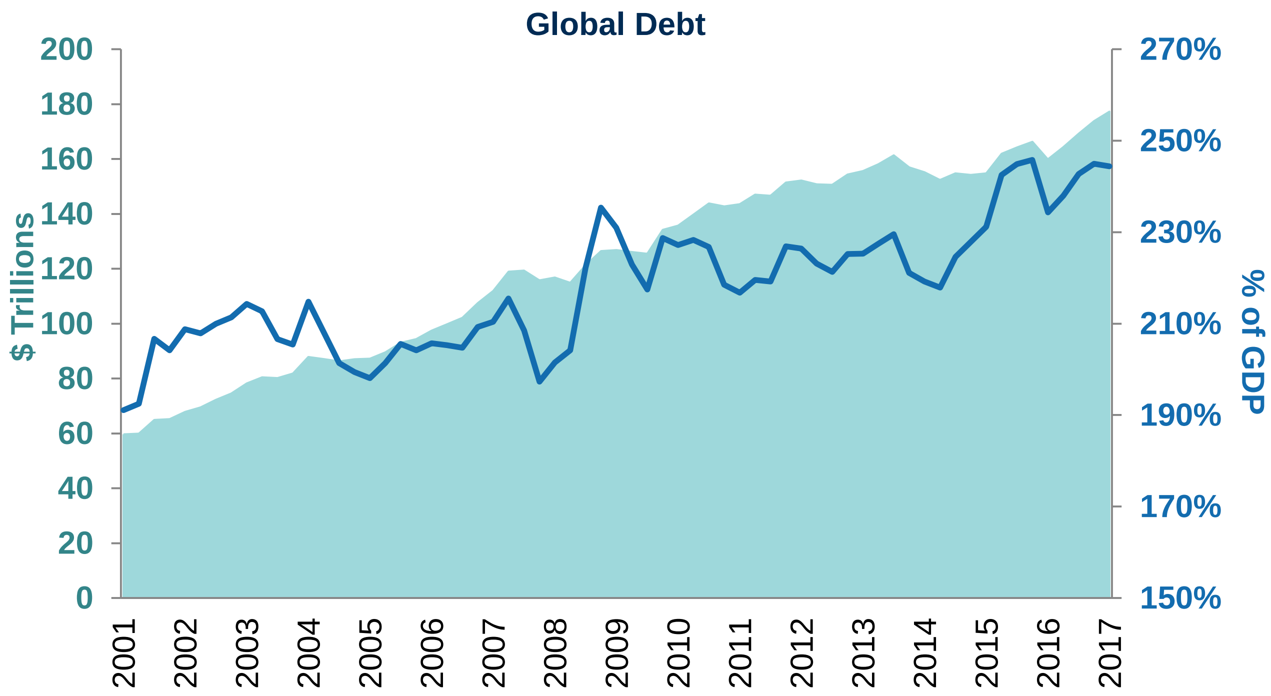
# Degrees of Debt

## The Sea of Debt Rises

- Over the past decade, global debt has grown 5% annually and now exceeds $175 trillion
- The fast pace of credit growth has driven global debt as a percentage of GDP to nearly 245%



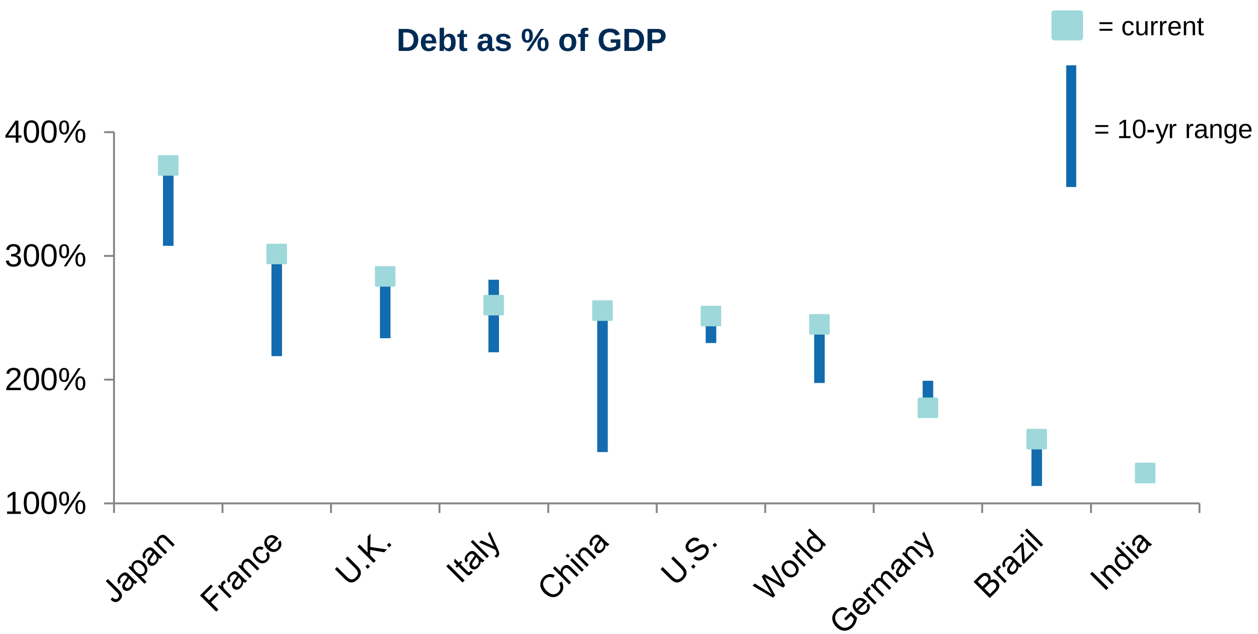

**Debt has been rising in absolute terms and as a % of global GDP**

Source: Bank for International Settlements, June 2018. Debt is credit to non-financial sectors.

# Degrees of Debt

## Some Countries Have Been More Reliant on Debt

- In aggregate, global debt as a percentage of economic output is close to its highest level in the past decade
- For a major economy, Japan has by far the most debt relative to GDP while the U.S. is relatively in-line with the rest of the world
- China has had the largest buildup of debt, which could indicate misallocation of capital

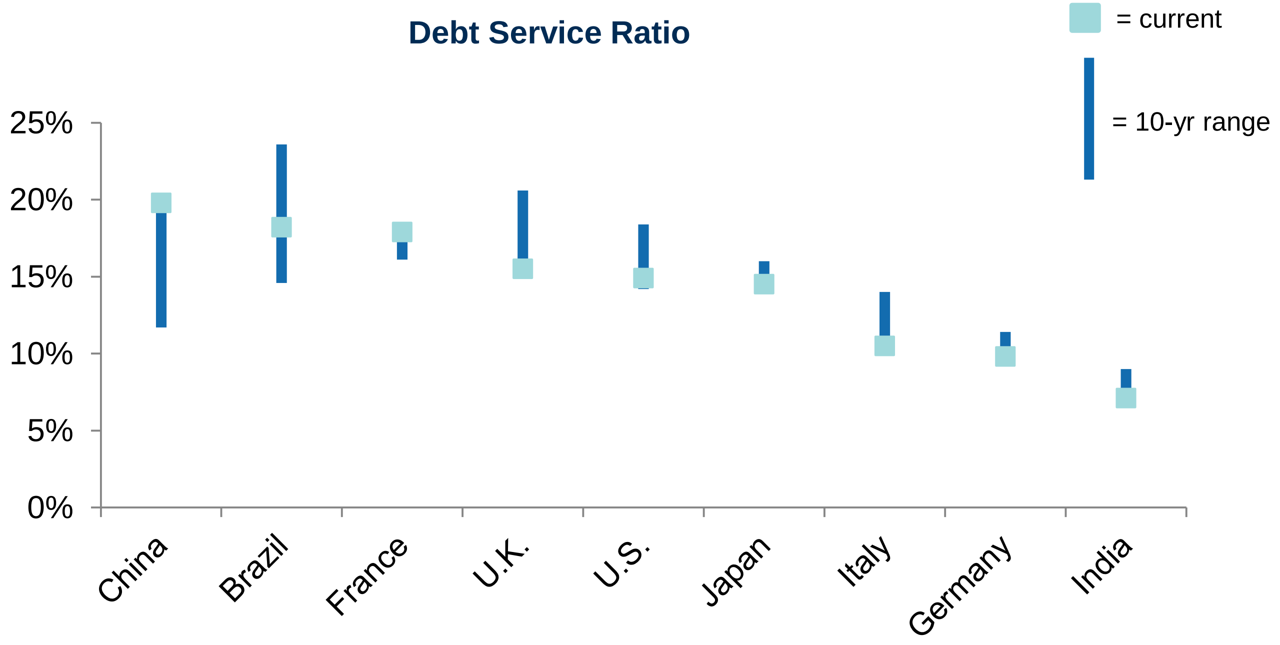



**Debt levels vary but are high relative to history**

Source: Bank for International Settlements, June 2018. Debt is credit to non-financial sectors.

## Degrees of Debt
### But Low Interest Rates Keep Debt Service Down

- Falling interest rates have allowed many countries to reduce debt service ratios
  - China’s debt service ratio is an outlier—up significantly and close to its highs




**In contrast to high debt levels, debt service ratios are relatively low**

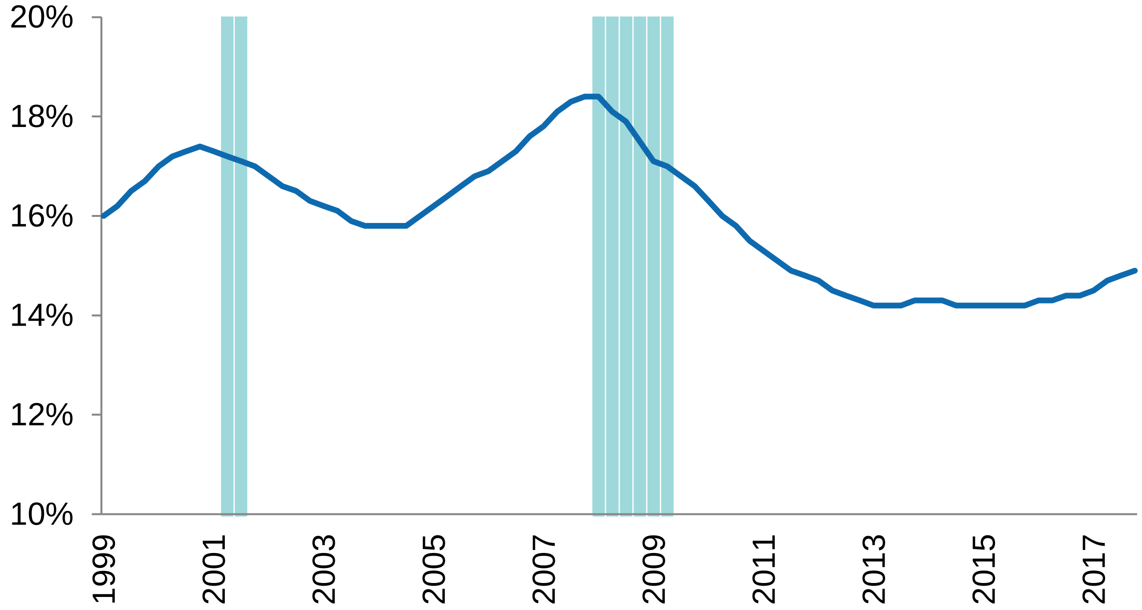
Source: Bank for International Settlements, June 2018. Debt Service Ratio is the share of income used for interest payments and amortizations in the non-financial private sector.

# Degrees of Debt

## U.S. Debt Service Is Historically Low

- Despite higher levels of debt as a % of GDP, the U.S. non-financial private sector debt service ratio is much lower than in the past two recessions
  - Both household and corporate debt service ratios have declined
  - Since more than 80% of U.S. consumer and business debt is fixed, higher interest rates should not have a dramatic impact on service costs

**U.S. Debt Service Ratio**

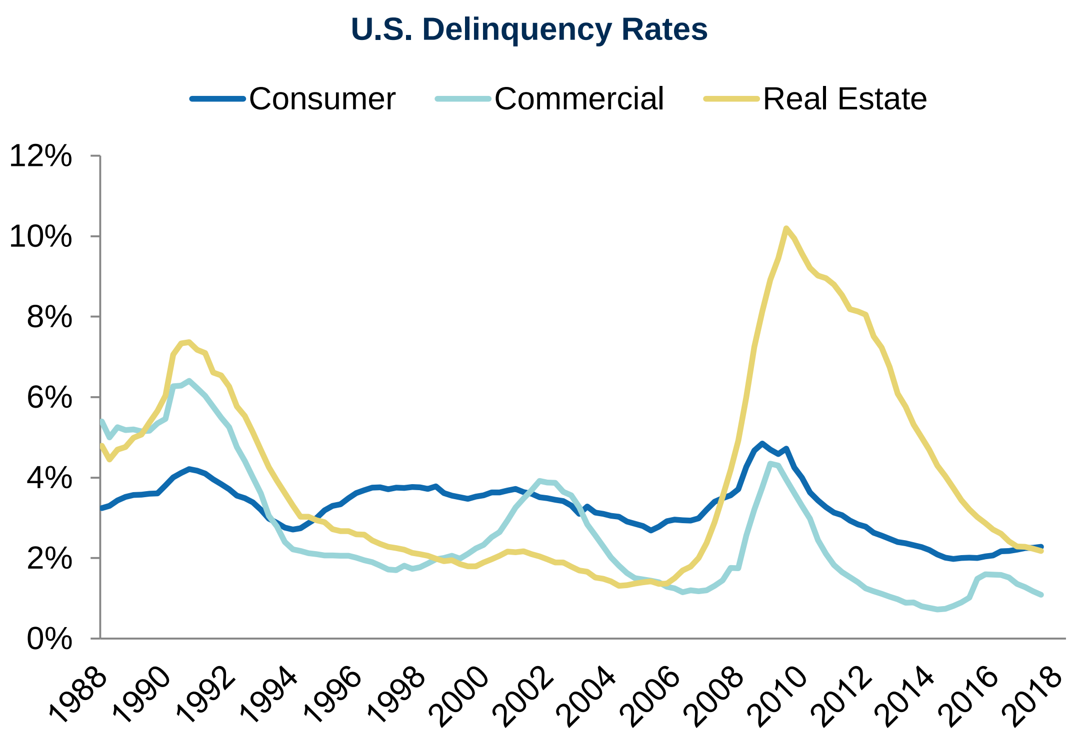



**Debt service ratio indicates households and corporations are not burdened by debt payments**

Source: Bank for International Settlements, June 2018. Debt Service Ratio is the share of income used for interest payments and amortizations in the non-financial private sector. Shaded regions indicate recessions.

# Degrees of Debt
## Default Risk Subdued

- After the Global Financial Crisis, delinquency rates across the U.S. declined significantly
  - Real estate and commercial loan delinquencies have continued to decline, while consumer delinquency rates appear to have bottomed and are modestly rising

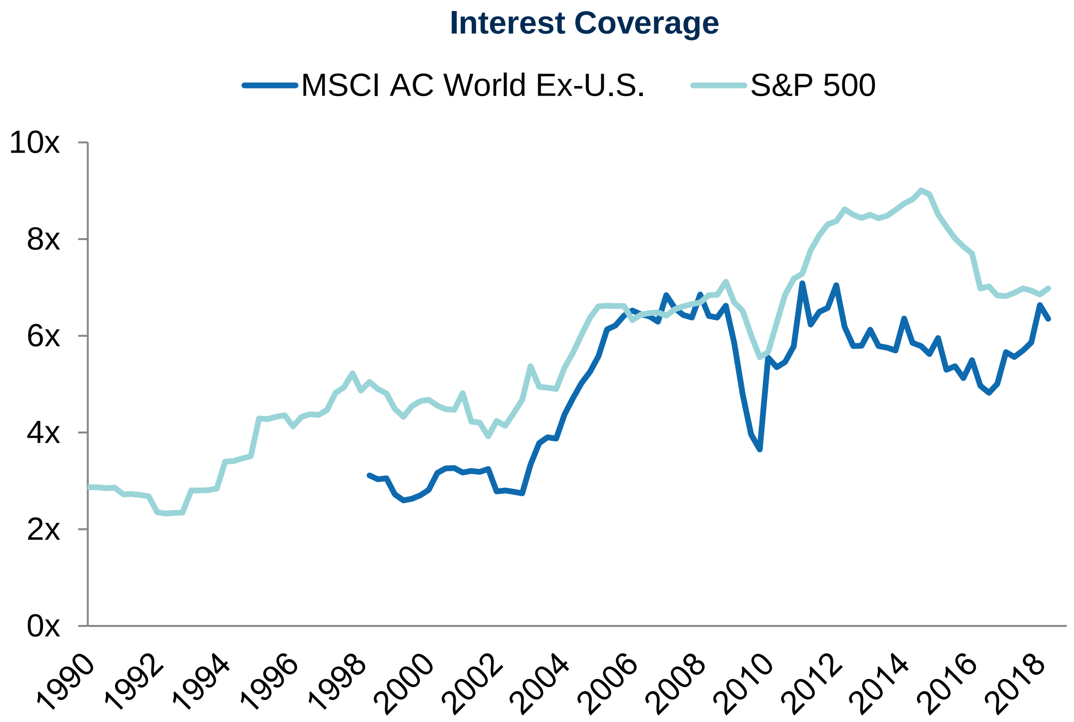



**Delinquency rates do not indicate a significant rise in defaults**

Source: Federal Reserve. Data is for all U.S. commercial banks. Real estate loans represent both consumer and commercial loans.

# Degrees of Debt
## Solid Ability to Pay

- Corporations are generally in a good position to be able to service their debts
  - Interest coverage (EBIT/interest expense) is higher than it has been on average over the past 20 years



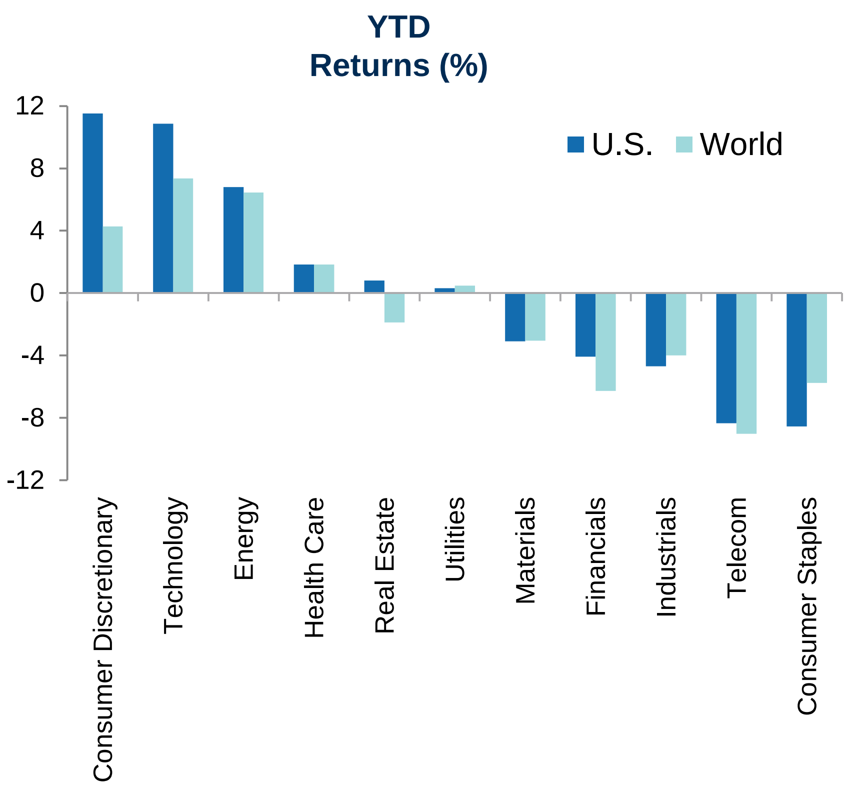

**Global interest coverage is relatively strong**

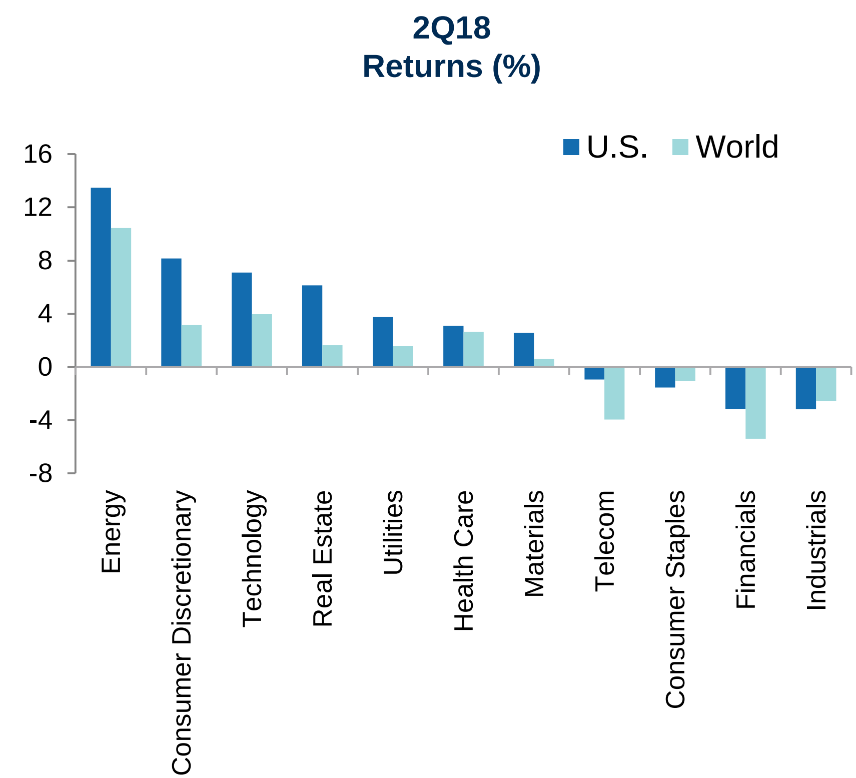
Source: FactSet. Interest coverage is earnings before interest and taxes (EBIT) divided by interest expense.

# Performance

## Technology-Related Companies Lead

- Technology-related equities led this year, with U.S. consumer discretionary performance driven by the market-leading returns of the internet retail industry

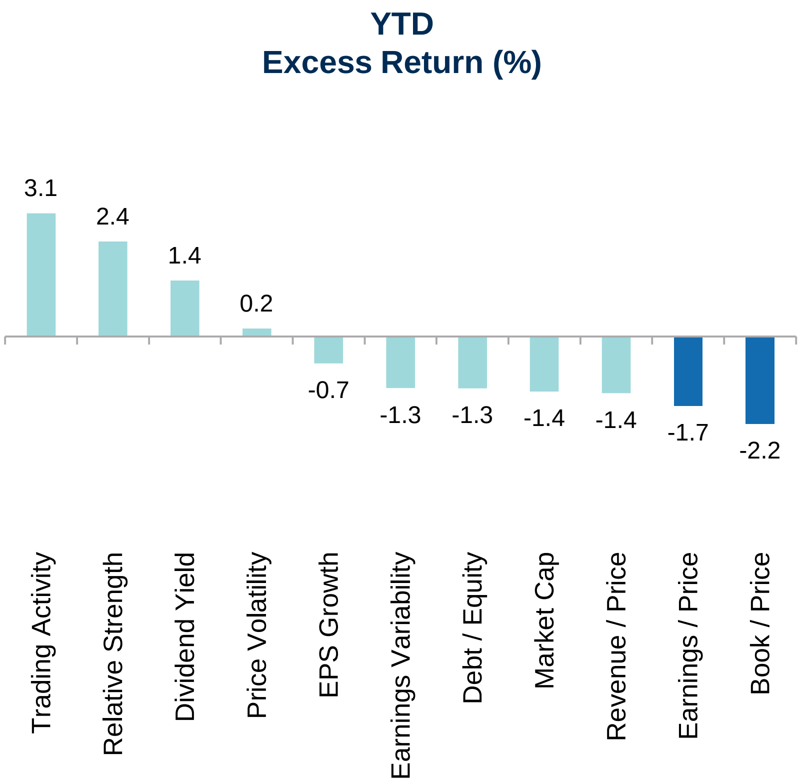


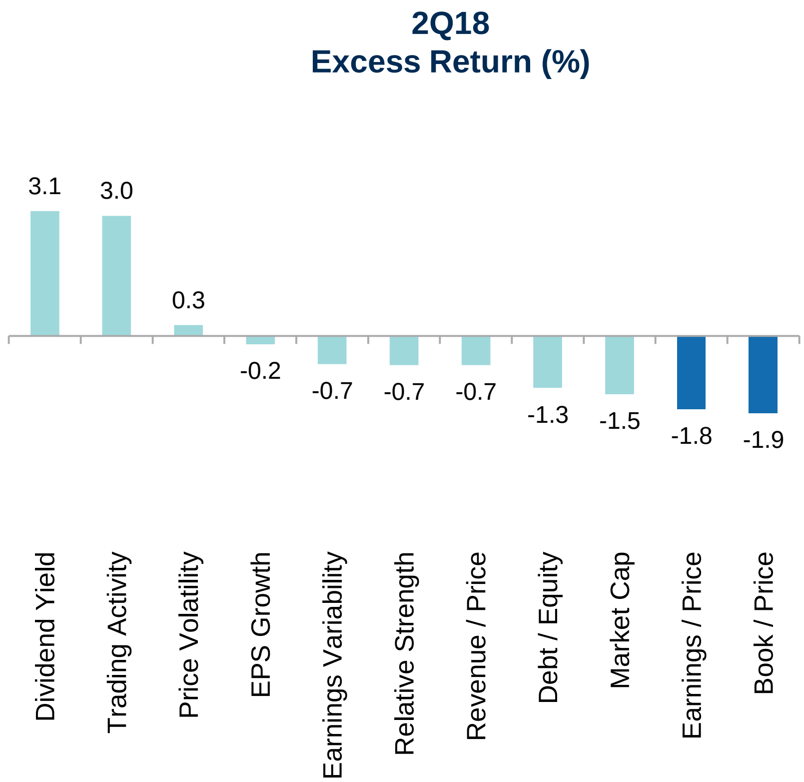




Source: FactSet as of 6/30/18. U.S. represented by S&P 500 and World represented by MSCI AC World Index in USD.

# Value Has Lagged

- Year-to-date, value factors have been the worst performers

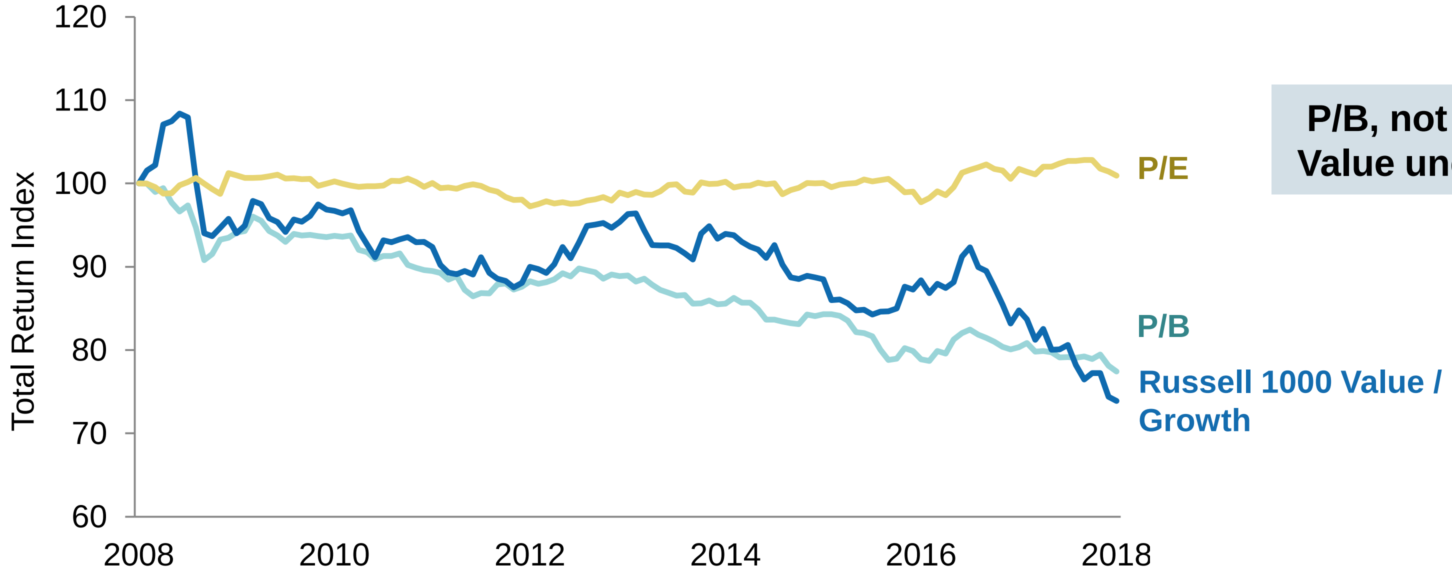



Source: FactSet as of 6/30/18 using Northfield defined quantitative factors for the Northfield broad U.S. market database.

# Structural Issues Driving Growth vs. Value

- Growth stocks have dramatically outperformed (+35%) Value stocks over the past decade
- The culprit for value investors has been the very weak performance of buying low P/B stocks, while P/E strategies have fared much better
- Book value, used heavily in index classification of Growth vs. Value, may no longer be as relevant given changing business models, e.g., R&D is not capitalized in book value



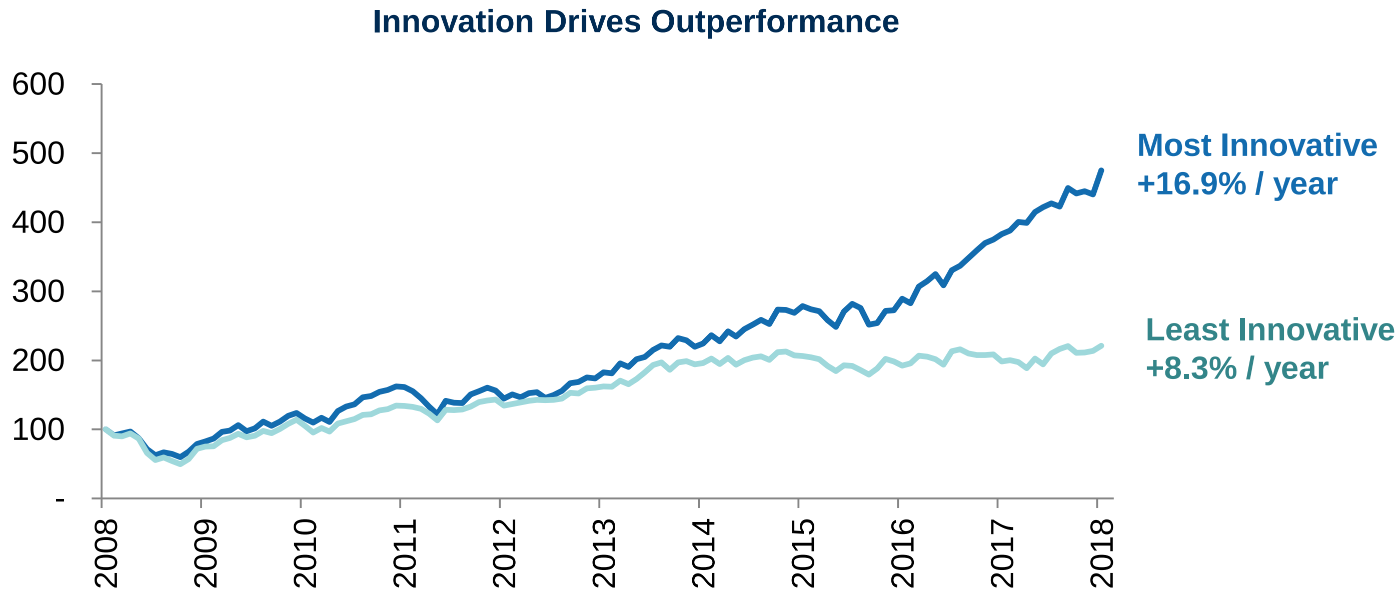

**P/B, not P/E, has driven Value underperformance**

Source: FactSet as of 3/31/18. Price-to-earnings and price-to-book returns are based on the E/P and B/P Northfield factors for the Northfield broad U.S. market database.

# Performance

## Innovative Companies Often Outperform

- Studies have shown, and our research demonstrates, that the most innovative companies grow their sales, earnings, and stock prices faster*



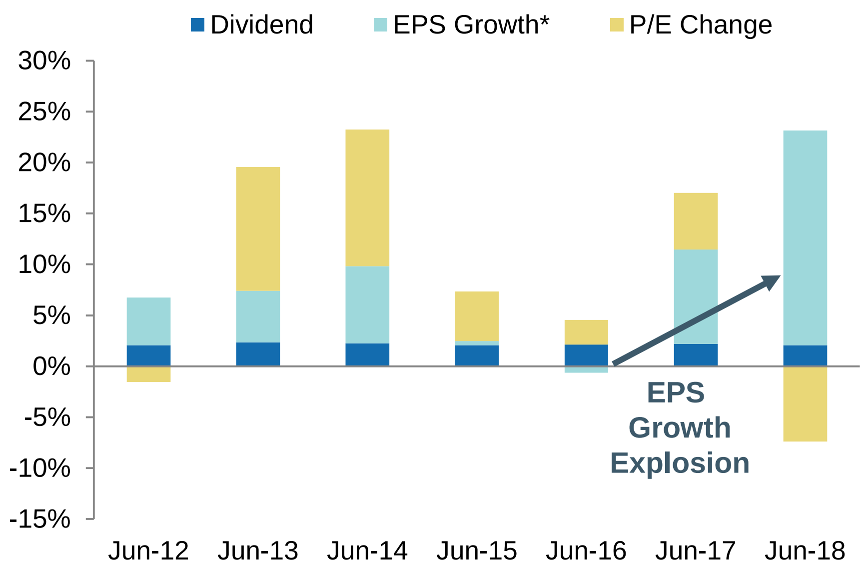

Source: FactSet. Most/least innovative stock performance is derived from highest and lowest S&P 1500 quintiles based on R&D as % of sales, normalized for market value, using one month returns for 10 years ending 4/30/18. *Baruch Lev and Suresh Radhakrishnan, "The Stock Market Valuation of R&D Leaders."

# Performance

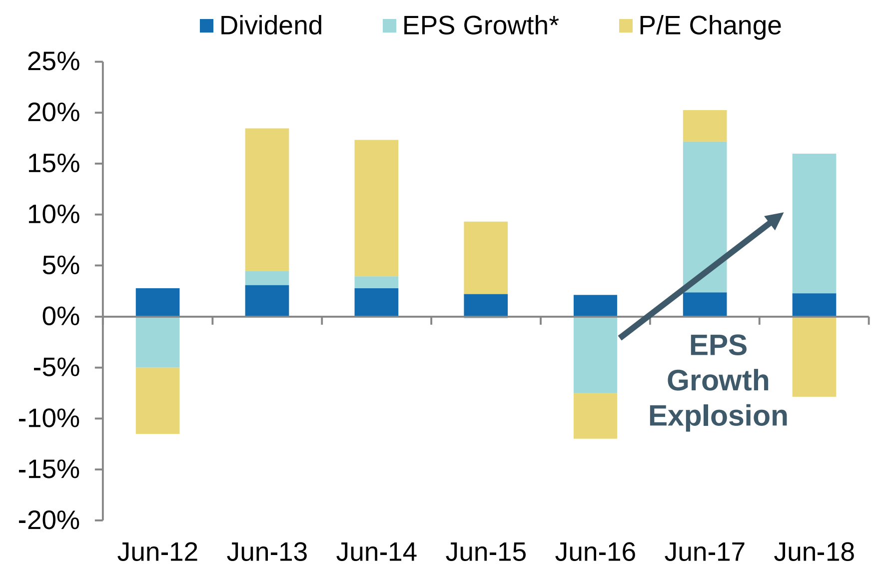
## The Earnings Growth Explosion Is Driving Performance

Total Return = Dividend Yield + EPS Growth +/- P/E Change

### S&P 500




### MSCI All Country World Index ex-USA




| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **12-Month Total Return:** | **5%** | **21%** | **25%** | **7%** | **4%** | **18%** | **14%** |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **12-Month Total Return:** | **-8%** | **19%** | **18%** | **10%** | **-9%** | **22%** | **8%** |

Source: FactSet as of 6/30/18. *Based on consensus estimates of next 12-month EPS. Actual earnings per share might be materially different than shown. MSCI ACWI ex-US performance based on local currency.

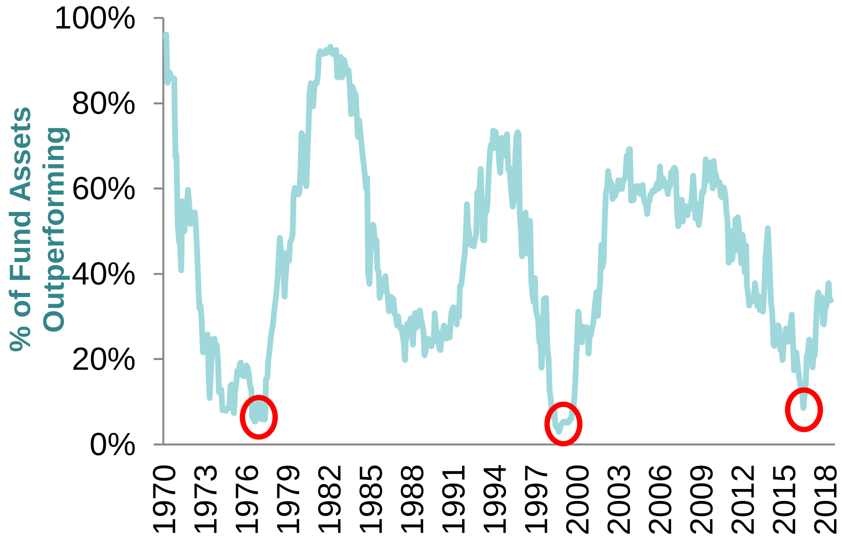
# Performance

## Has Active Relative Performance Troughed?

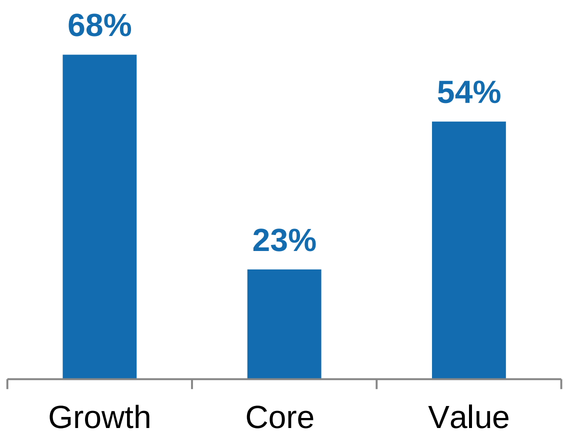
- Powerful cyclical factors impact U.S. active relative performance:
  - Interest rates/bond-like equities
  - Non-U.S. stock performance
  - Small cap performance
  - Overall market performance

- As some of those factors reverse, active management has been doing better
  - Interest rates not declining/bond-like equities not outperforming
  - Non-U.S. stocks have fared better
  - Small caps beginning to outperform
  - Market performance more subdued

**Active Relative Performance Is Cyclical**




**% of U.S. Large Cap Active Managers Outperforming YTD**

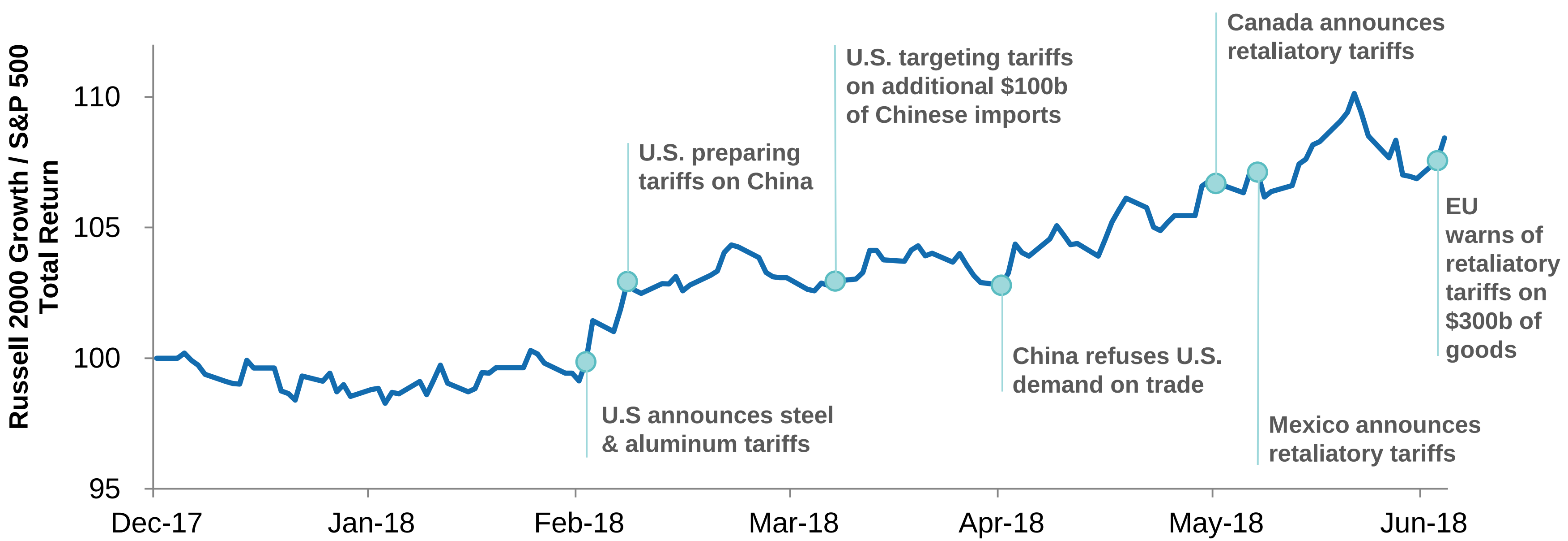



Source: Left chart: Nomura/Instinet, Joseph Mezrich and FactSet through 6/30/18. Fund performance is trailing five-year data of U.S. active equity mutual funds in existence for five years or more and part of the growth, growth & income, and income categories based on CRSP codes. Right chart: Bank of America Merrill Lynch U.S. Equity and U.S. Quant Strategy using Lipper data relative to Russell benchmarks through 6/30/18.

# Where to Hide from Tariffs?

- Small cap growth stocks began outperforming this year after steel and aluminum tariffs were announced, producing solid relative returns throughout the trade war rhetoric
  - Small cap growth may be less affected than the broader market given less international exposure and more secular, as opposed to cyclical, growth drivers

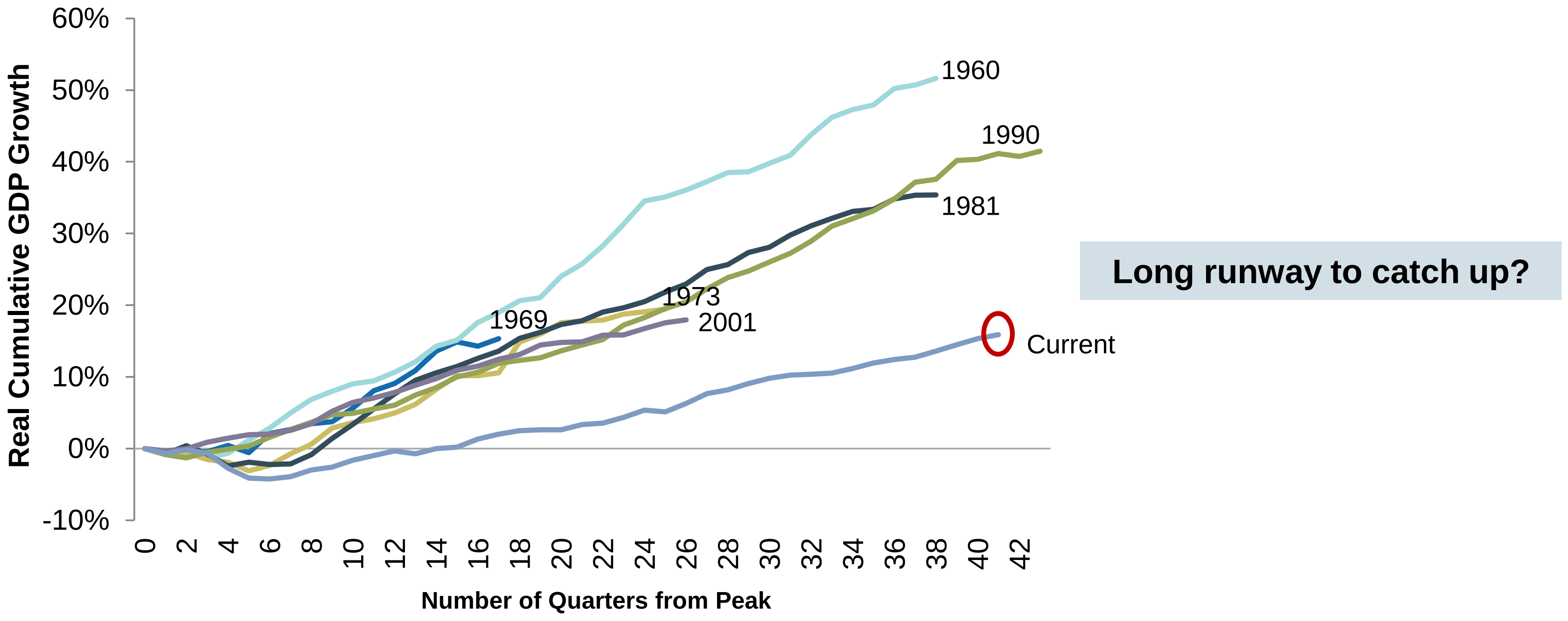
**Small Cap Growth Outperforms Amid Trade Tensions**




Source: FactSet, StreetAccount, and Alger.

# The Upside of Being Slow

- Why has the current economic expansion lasted so long and when will it end?
  - A big part of the answer is the depth of the recession that preceded it and the rate of the recovery thus far
  - Economic recoveries of comparable length have had far more growth than the present one, suggesting a long runway of economic expansion now

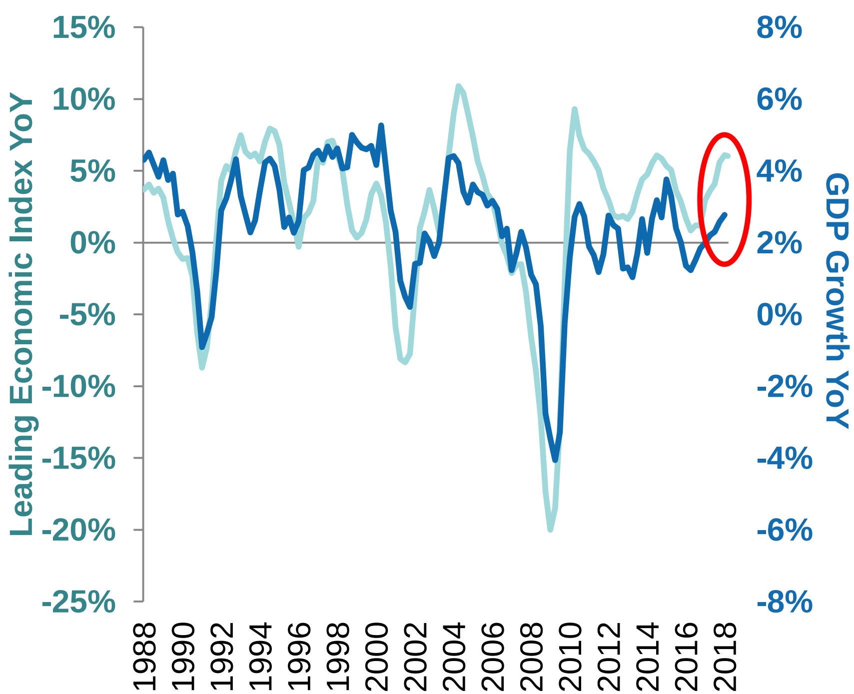


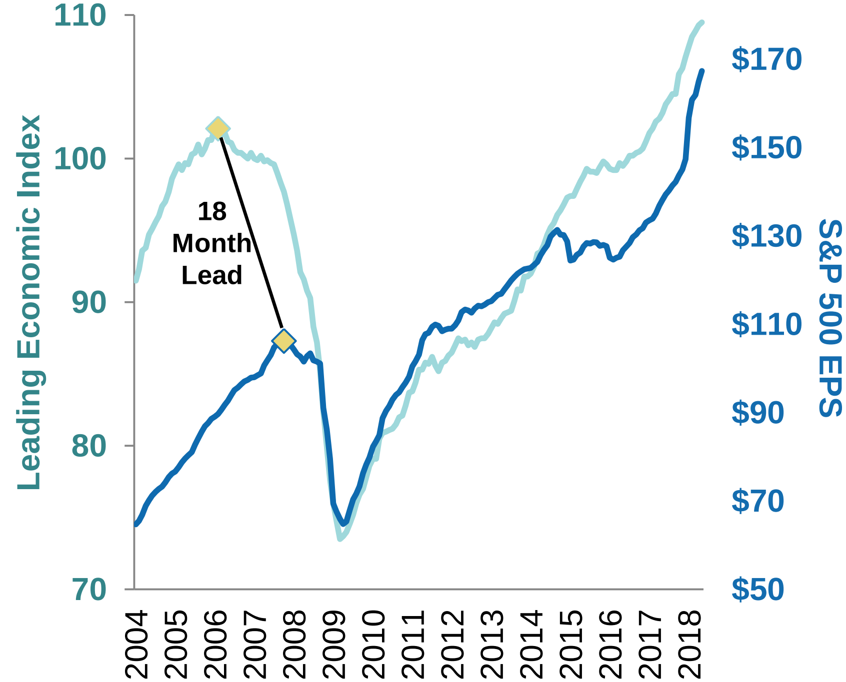

Source: U.S. Bureau of Economic Analysis and Fred Alger, Inc.

# Leading Indicators Suggest Continued Expansion

- Typically, changes in the Leading Economic Index (LEI) have preceded changes in economic growth
- The rate of change of the LEI implies solid economic growth

- The LEI historically leads S&P 500 EPS by 6-18 months
- The record LEI reading in 2Q18 suggests EPS have room to run



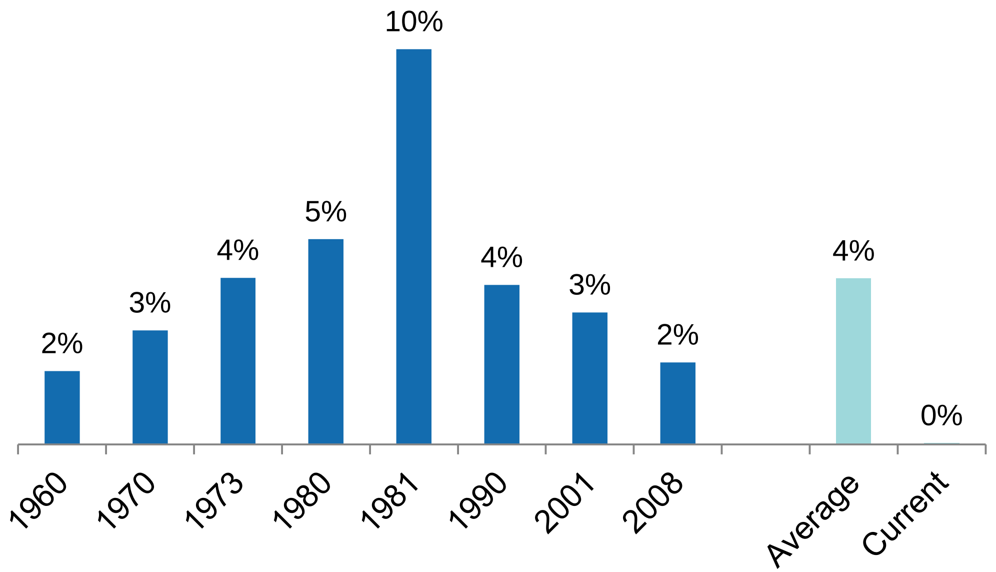

Source: FactSet, Conference Board. EPS estimates based on next 12-months consensus.

# Fundamentals

## Monetary Policy Is Not Restrictive

- Over the past half century, every U.S. recession has been preceded by a significantly positive real Federal Funds rate of 2% or higher
- In contrast, today we have a real Fed Funds rate of about 0%

**Real Federal Funds Rate Prior to U.S. Recessions**



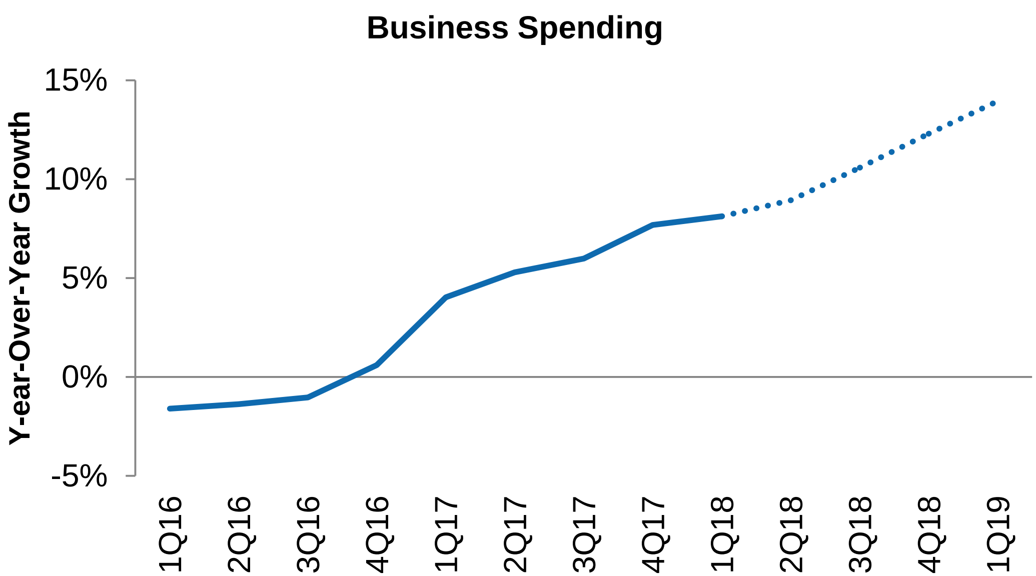

**Today real short-term interest rates are far lower than what induced previous recessions**

Source: FactSet as of June 2018. Inflation represented by PCE Price Index ex-food and energy (year over year). Nominal Federal Funds rate is average of three months prior to recession. Horizontal axis labels denote recession periods.

# Fundamentals

## Business Spending to Accelerate Further

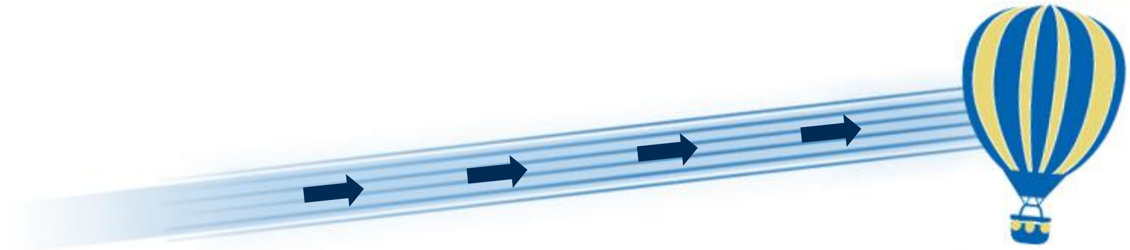
- Drivers of faster corporate expenditures include:
  - Strong profit growth
  - Tax reform—lower statutory rates, foreign profit repatriation, accelerated depreciation
  - Higher business confidence—driven in part by lower regulation and certainty about taxes
  - Accommodative financial conditions—banks' willingness to lend and low credit spreads




**Robust earnings growth should help drive an acceleration in business spending**

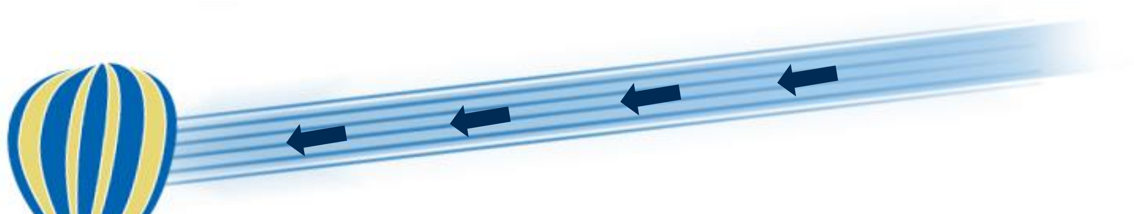
Source:FactSet. Business spending is U.S. private fixed nonresidential investment with estimates (dotted line) based on a regression with S&P 500 EPS.

## Tailwinds



- Robust corporate profits
- Strong business and consumer confidence
- Strengthening corporate spending
- Solid U.S. consumer balance sheet

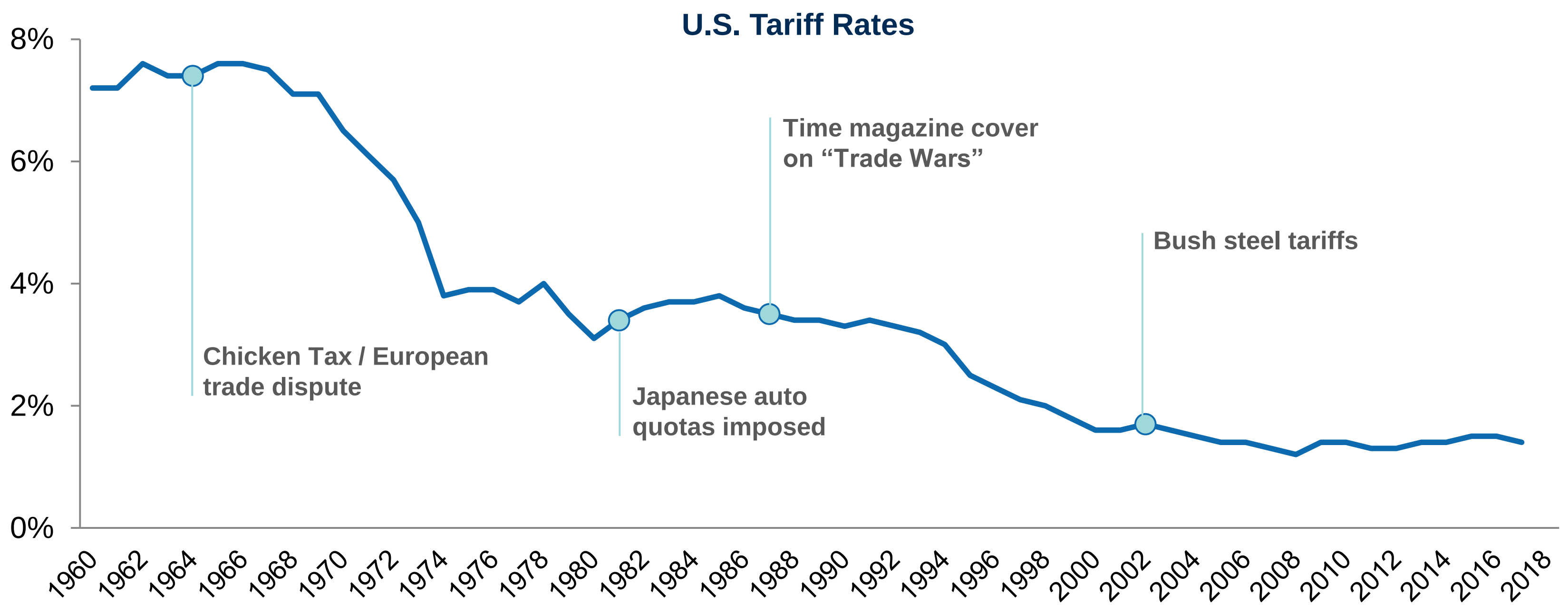
## Headwinds



- Tightening monetary policy
- Rising U.S. labor costs
- Potential trade wars
- China growth slowdown
- Geopolitical risk

# A Powerful Trend

- There have been various periods in history marked by fears of "trade wars"
- Over time, countries have acted rationally and reduced trade barriers
- While there may be more pain to come, ultimately we believe the powerful trend toward lower tariffs will prevail
  - Active management may be able to take advantage of opportunities that arise

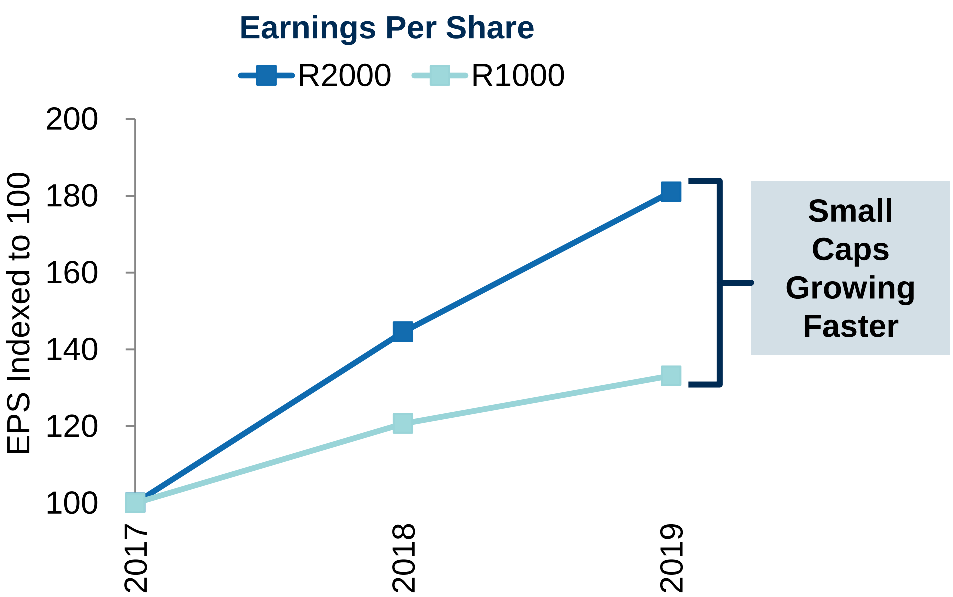


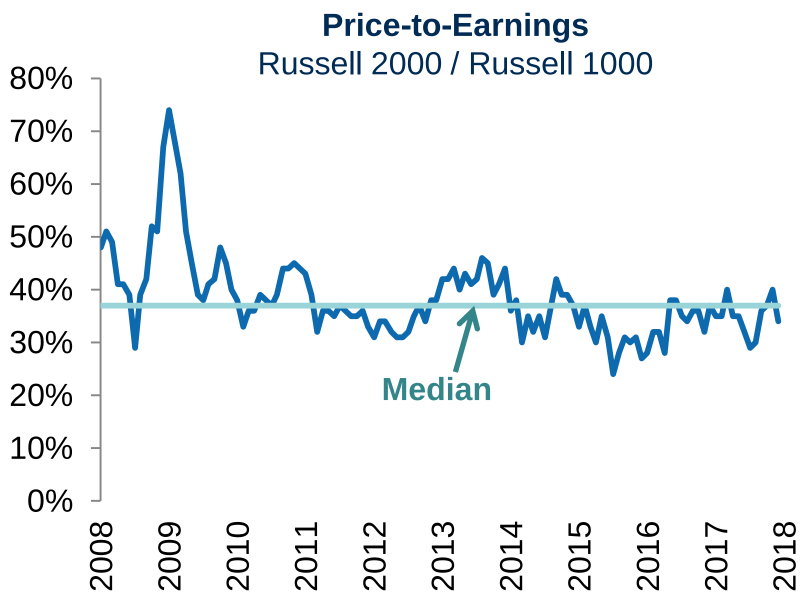

Source: U.S. International Trade Commission and Alger. Tariffs are calculated as duties collected divided by total imports.

## Fundamentals

### Smaller Capitalization Stocks Poised to Outperform

- **Stronger fundamentals**: Estimated small cap EPS growth for '18 & '19 is double that of large cap
- **More levered to domestic economy**: Small caps are more U.S.-oriented and have less exposure to international trade friction
- **Rising interest rates**: Small caps have historically outperformed large caps in rising rate environments
- **Reasonable valuation**: Small cap P/E multiple premium is reasonable relative to history while a large sales multiple discount implies opportunity

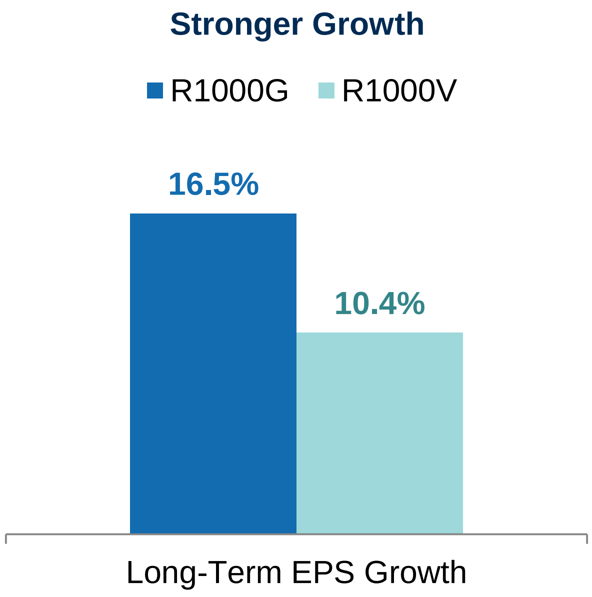


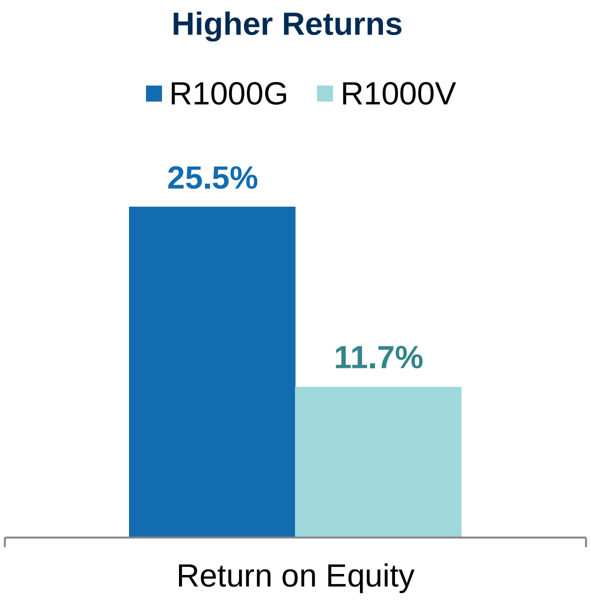



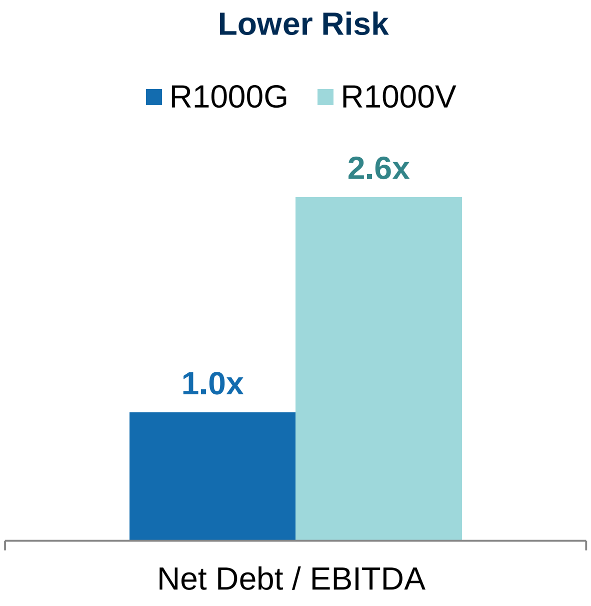

Source: FactSet as of June 2018. EPS for 2018-2019 are consensus estimates and actual earnings per share might be materially different than shown.

# The Growth Advantage

- Three variables drive P/E multiples: growth, returns, and risk
- As compared to the Russell 1000 Value Index, the Russell 1000 Growth Index has higher expected EPS growth, higher return on equity, and lower risk in the form of better balance sheets



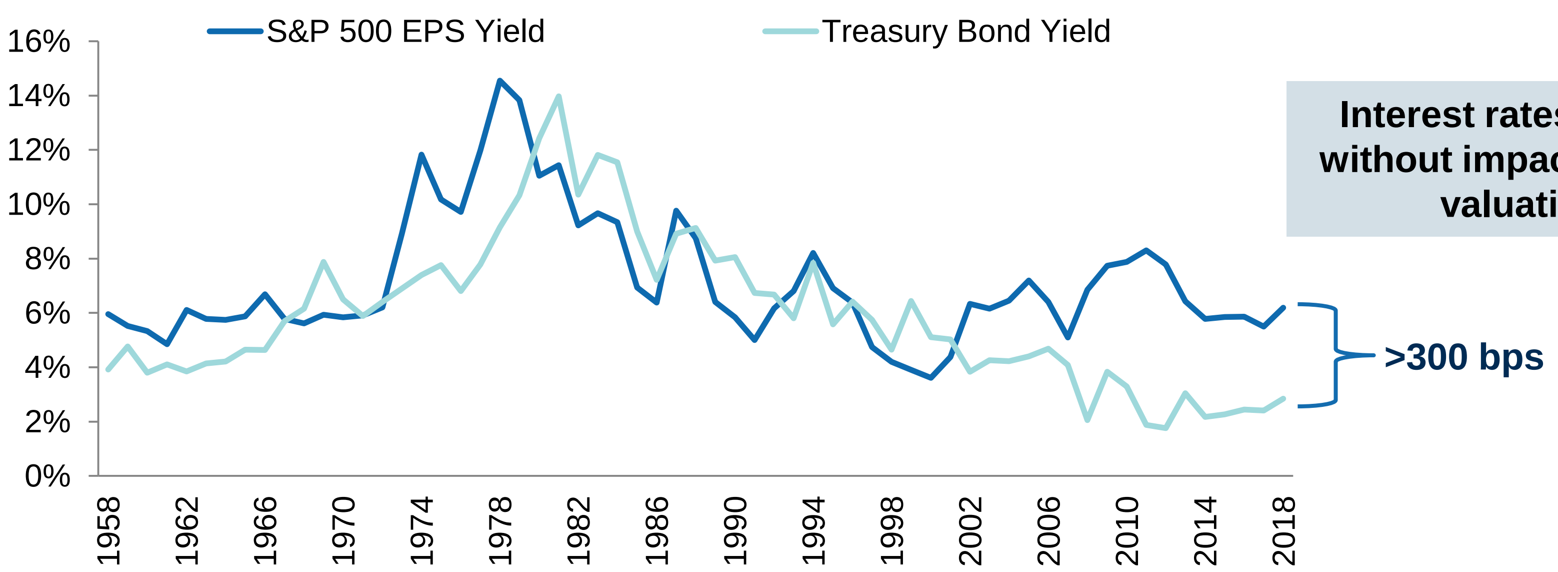




Source: FactSet as of 6/30/18. Growth represents consensus long-term analyst estimates, and actual future EPS growth rates might be materially different than the forecasts shown.

# Addressing Rising Rate Concerns – Valuation

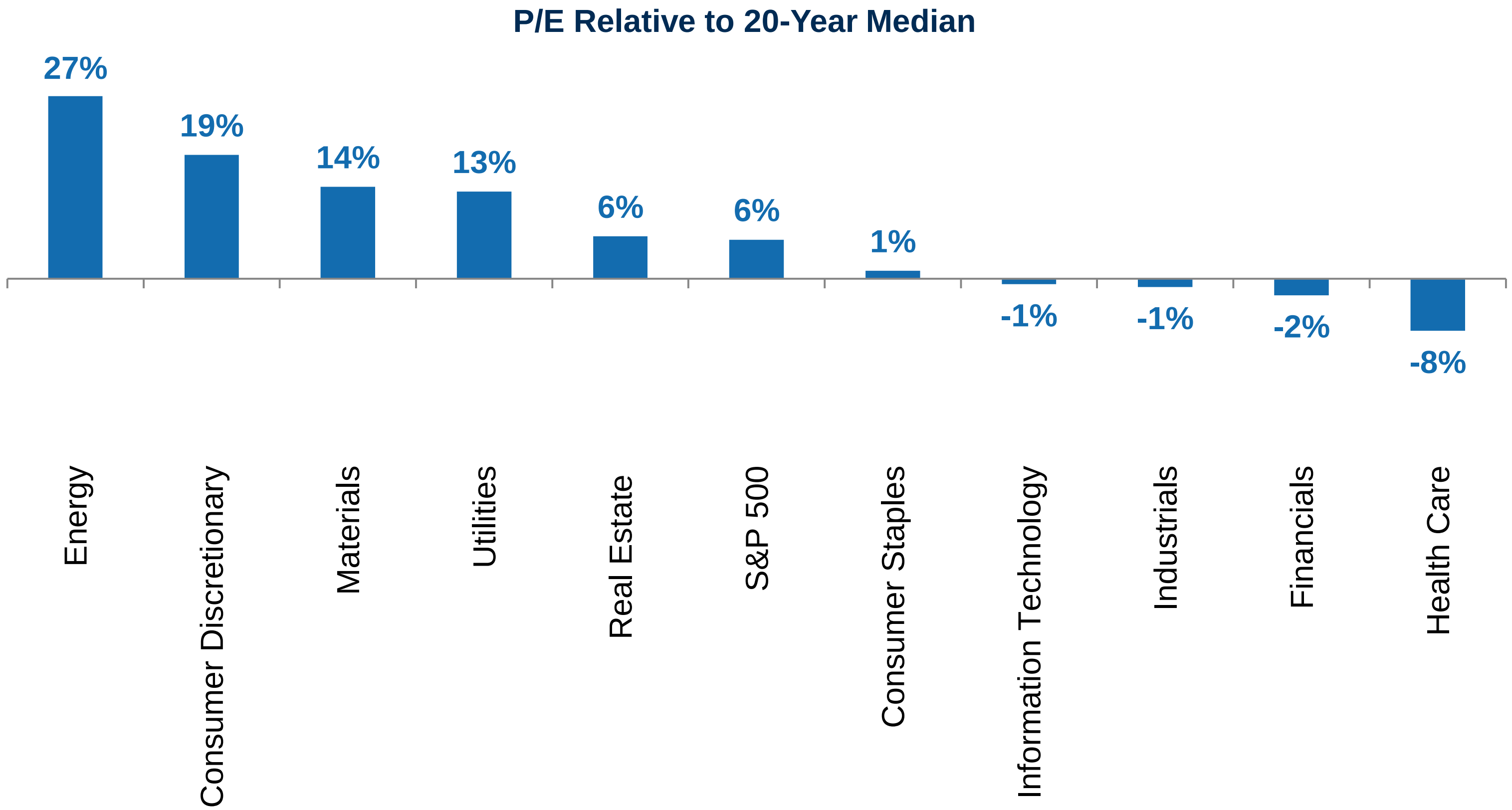
- Concern: Will rising interest rates weigh on P/E multiples?
- Our take: P/Es never priced in how low interest rates had become (see gap below) so we believe earnings multiples may not suffer when rates rise




**Interest rates can rise without impact on stock valuations**

Source: FactSet, Federal Reserve, and S&P, as of 6/30/18.

- Energy appears expensive given relatively depressed levels of earnings while health care looks inexpensive due in part to the perceived threat of pricing pressure



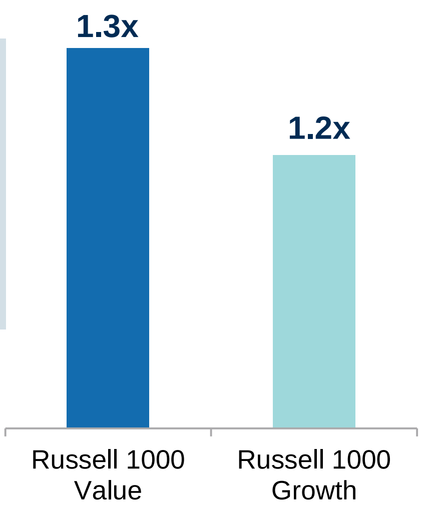

Source: FactSet, based on S&P 500 Index, 6/30/18. Note: telecommunications is excluded given its small number of constituents and pending reclassification. Real estate is a new sector classification, so for the historical data shown above, the industry group category that has nearly 17 years of data was utilized.

# Growth and Value Near Equilibrium

- Despite their recent outperformance, Growth stocks are not expensive compared to their Value equity counterparts relative to expected growth rates or history

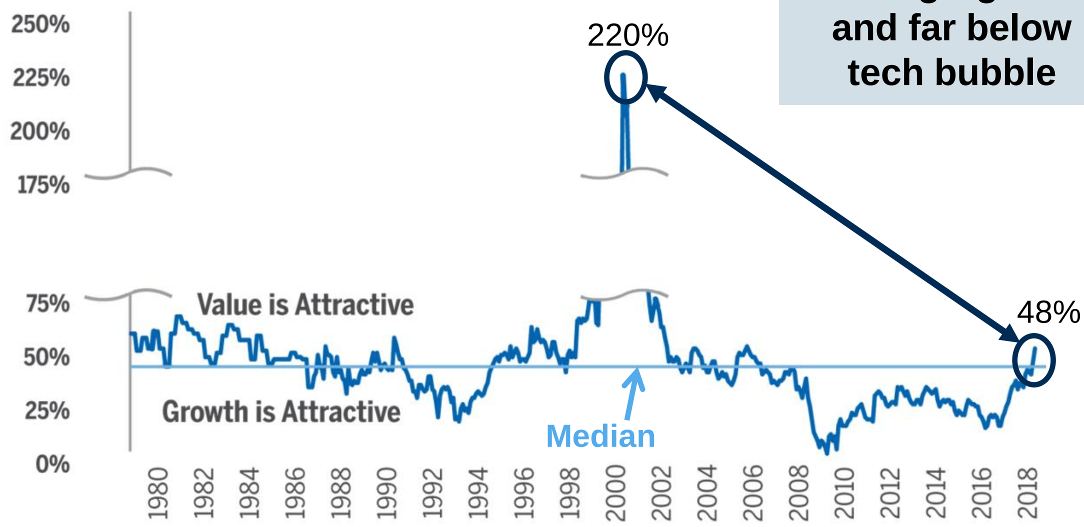
**Russell 1000 Growth vs. Russell 1000 Value PEG Ratio**
**(P/E Divided by Long-Term Growth Rate)**

**Growth stocks are cheaper relative to long-term growth**




**Russell 1000 Growth Relative to Russell 1000 Value P/E**

**Current premium not egregious and far below tech bubble**

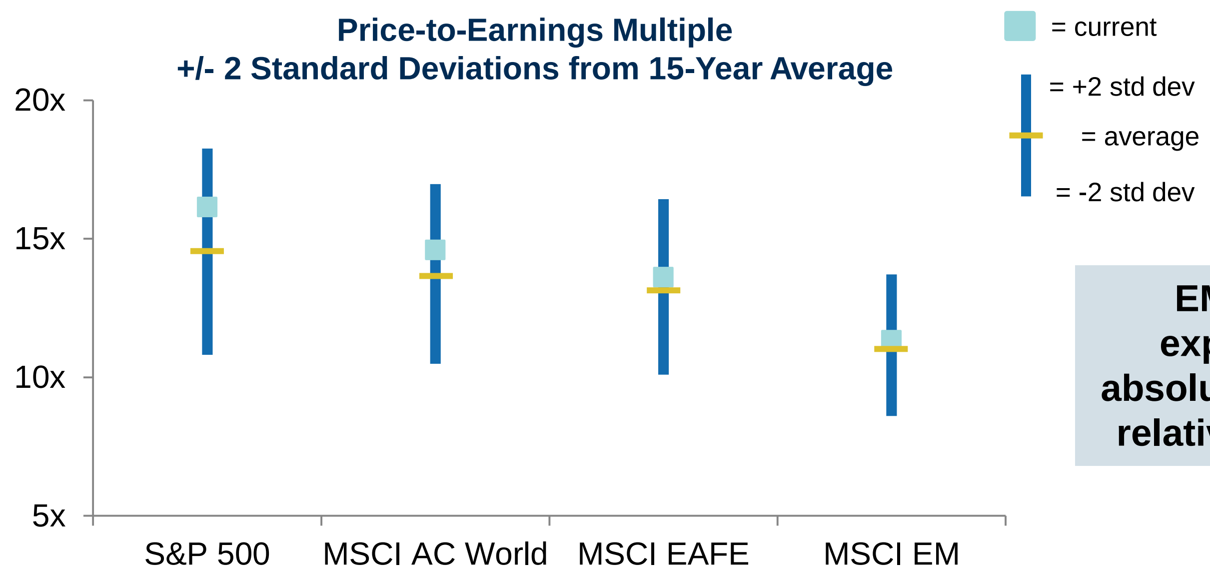



Source: FactSet, Bank of America as of 6/30/18.

# Valuation

## Global Equity Multiples Reasonable

- Price-to-earnings multiples around the world are modestly higher than their historical average, which is reasonable relative to very low global interest rates




**EM is least expensive in absolute terms and relative to history**

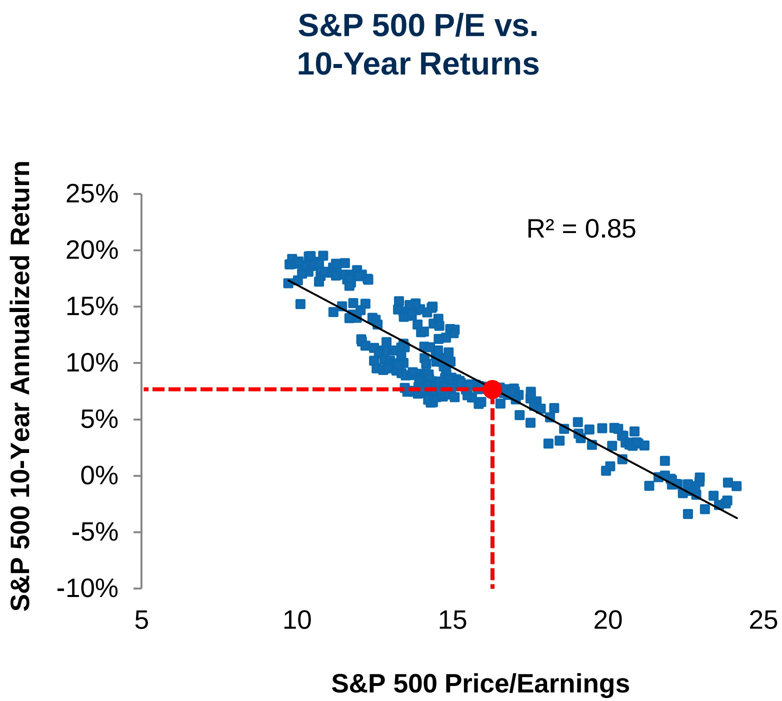
| Z-Score (Standard Deviations Above/Below Mean) | | | |
|---|---|---|---|
| 0.9 | 0.5 | 0.2 | 0.1 |

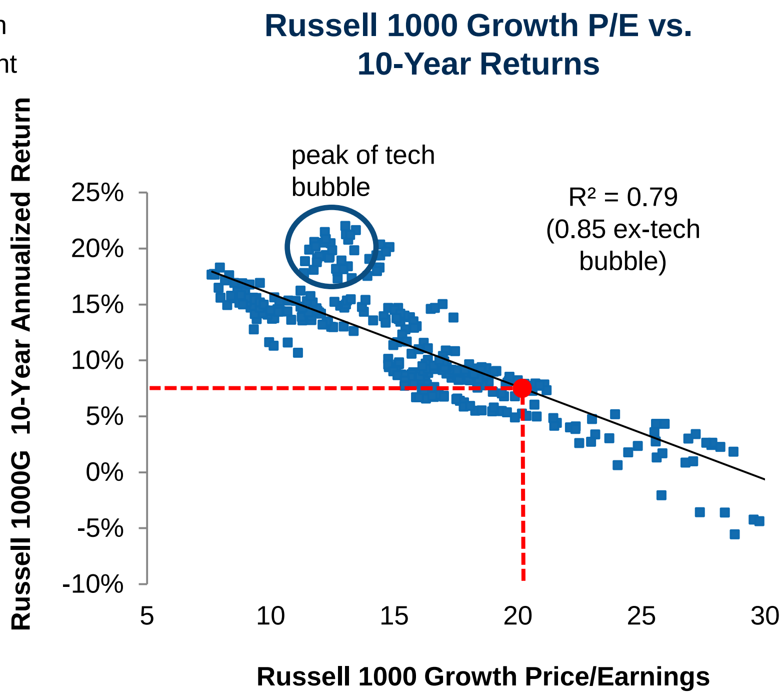
Source: FactSet. Monthly estimates over past 15 years, ending 6/30/18.

# Valuation

## The Single Greatest Predictor of Future Stock Market Returns

- There is a strong relationship between starting valuations and ensuing 10-year returns
- Current valuations suggest equities should materially outperform bonds over the coming decade




Source: FactSet. Monthly data through June 2018 and beginning in January 1986 (S&P 500) and December 1978 (Russell 1000 Growth). The tech bubble, represented by the 10-year returns beginning in April 1987-March 1990 and ending in April 1997-March 2000, skewed the regression by resulting in higher returns for given valuations than the historical relationship would imply.

# Disclosure

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