Quay Real Estate Advisors
Preserve + Create

Investment Perspectives

Issue 2
January 2015

Key Points

Low interest rates are often associated with the investment narrative "the search for yield"

The argument follows when interest rates rise the search for yield will moderate

We challenge this notion, and suggest if interest rates do increase, the search for yield could simply morph into the "search for earnings stability"

The search for yield

Cyclical or structural?

Since the recovery from the financial crisis, a common theme has been that artificially low interest rates* have forced investors to search for yield, which in turn has resulted in overpriced assets.

This narrative has been supported by the fact yield sectors, such as Global Real Estate, significantly outperformed the broader global equity indices in 2014 by approximately 10% (in USD terms).

As we enter 2015, consensus is for the US economy to maintain its recovery and the US central Bank to begin the long anticipated increase in interest rates. It follows that the "search for yield" will soon end, causing significant price disruption for yield style assets as we can get back to normal – with growth assets once again outperforming.

In this issue of *Investment Perspectives* we challenge this narrative.

Spectacular profit growth, not just QE, has driven the market

While much of the recent US (and global) share market performance has been attributed to Quantitative Easing (QE), the real reason is far more straightforward. Booming share prices have been matched with spectacular growth in company profits and earnings per share (EPS).

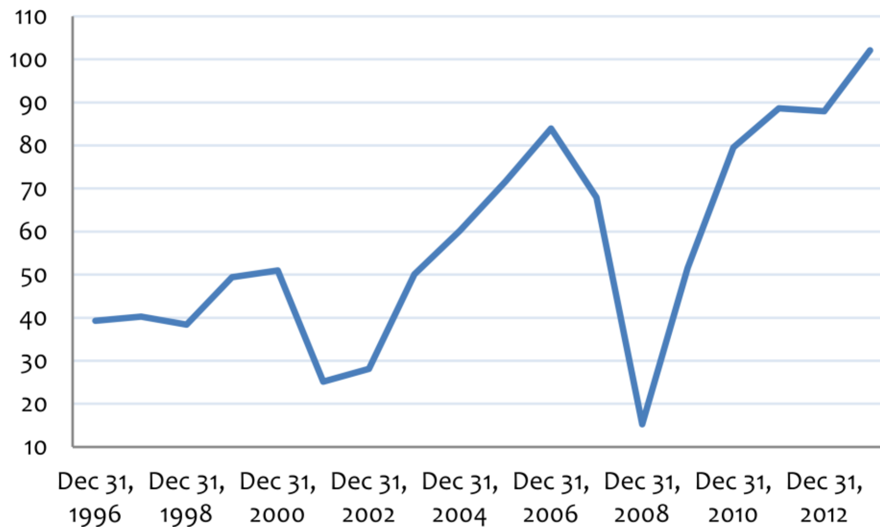
* At Quay, we understand all levels of interest rates are "artificial" for sovereign currency issuers like the US and Australia.

Quay Real Estate Advisors
Preserve + Create

Since 1996, nominal EPS for the S&P500 has increased 160% – but can it continue?

The following chart illustrates this point.

Since 1996, EPS for the S&P500 has increased from approximately 39c per share, to over 102c per share (until 2013). This represents a 160% increase in EPS – broadly matching the 200% increase in the broader equity index over the same timeframe.



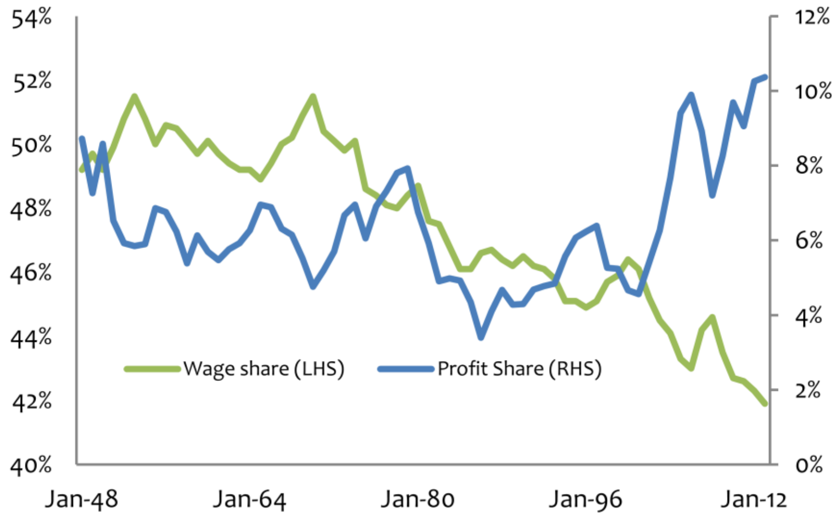
Source: Robert Shiller, Irrational Exuberance, St Louis Fed, Quay Real Estate Advisors Pty Ltd

EPS growth has been particularly strong over the past 5 years (post crisis); somewhat of a paradox considering the US has displayed only moderate economic growth.

Is recent profit growth sustainable?

In our first issue of *Investment Perspectives*, we found long term real EPS growth tends to underperform real long term economic growth. That is because profits tend to grow in line with economic output, plus there is the dilutive impact of ongoing share issuance.

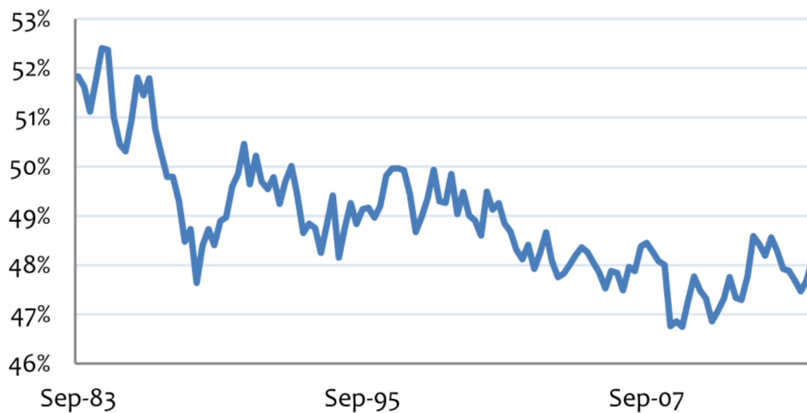
But that has not been the case recently as company profits have increased substantially faster than output since the GFC. How is this possible and is it sustainable? We believe the following chart offers some insight.



Source: St Louis Fed, Quay Real Estate Advisors Pty Ltd

Since the early 1960's wage share as a % of national income in the US has steadily decreased. More recently the share of wage income has reduced significantly since 1996, and even more so since 2009.

This is not just a US phenomenon, but indicative across most western economies. The chart below highlights a similar (albeit more modest trend) in Australia. The more aggressive assault on wage share in the US may go a long way to explaining long run US equity outperformance relative to Australia.



Source: Australian Bureau of Statistics (ABS), Quay Real Estate Advisors Pty Ltd

Profits (along with the external balances and other adjustments) are generally the flip side to wages. The chart above clearly identifies the source of profit – that is squeezing per unit (and real) labour costs has significantly increased corporate margins. And since the (post GFC) starting point of profit share at ~7% is relatively low only a small decline in wage share (~45%) results in a large percentage rise in corporate profits.

As an example, since the early 1990's US wage share has declined by almost 6 percentage points, while profit share has increased by a similar amount. But the percentage increase in profit is much larger since it begins from a lower base.

Near term Implications

In hindsight, the "below trend" economic performance in the US and other major economies during the past few years has been a boon for owners of capital. Sales growth has been "ok", but importantly labour markets have been weak, displaying little or no pricing power. Add low interest rates, and a weak US dollar (good for multinationals), and it is clear equities have benefitted from a near perfect storm.

But *if* the US economy improves, equities may face the following headwinds;

- Improved negotiating power of wage earners, impacting margins
- Higher interest rates
- Stronger US dollar, negatively impacting multinational EPS growth

Longer term implications

The long term implications are far more problematic. It is hard to argue the structural adjustment of lower wages relative to output is sustainable. After all, the wage earner is the ultimate customer. Squeezing nominal wage costs can benefit the bottom line in the near term, but at the extreme, the economy runs out of customers. Therefore, at some point, wage share must stabilise, as will profit share.

Why the "search for yield" may be structural rather than cyclical.

When this occurs, long run profit growth will be similar or lower than nominal economic growth, with EPS growth lower again from ongoing share issuance. True growth companies will be very hard to find and yield will remain an important component of total return.

Yield based assets such as infrastructure and real estate have not claimed ever-increasing share of national income or output. Rental growth rates are often anchored to inflation, and therefore, any mean reversion in profit share is unlikely to negatively impact the earnings of yield style assets – so long as competing supply remains in check.

If the US economy indeed accelerates in 2015, we may see far greater headwinds for corporate profits as both USD and labour market strength crimp margins (along with higher interest rates).

So the search for yield may not end as many expect. The narrative may be simply morph into the search for "income security".

Disclaimer

The content contained in this newsletter represents the opinions of the Authors. The Authors may hold either long or short positions in securities of various companies discussed in the newsletter. The commentary in this newsletter in no way constitutes a solicitation of business or investment advice. It is intended solely as an avenue for the authors to express their personal views on investing and for the entertainment of the reader. In particular this newsletter is not directed for investment purposes at US Persons.