U.S. Large Cap Growth Valuations

A Fourth Tailwind Emerges... Wait, What?!?!?!?

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Only experience can alert one to a milestone moment in real time. We just observed one in August when Federal Reserve Chair Jerome Powell described an evolution in the Fed's thinking. In the past, low unemployment and 2% inflation would have triggered rate hikes. Now the Fed is taking a more flexible approach, allowing for moderately higher inflation.

Translation: We will likely have a near-zero Fed Funds rate for the foreseeable future

Implication: Growth stock valuations will likely remain elevated for the foreseeable future

As growth investors, we have a front row seat to the secular forces of deflation caused by the digitization of our economy. Consumer price transparency and the productivity of digital technology are powerful forces to keep costs and prices down. From a cyclical lens, the pandemic has resulted in years of slack in the economy, both in employment and factory utilization levels. It is our belief that we are years away from cyclical pressures driving inflation up to the Fed's threshold and may never get there because of secular forces keeping it down.

In our experience, growth stocks are the biggest winners from a sustained reduction in the risk-free rate. The reason: When interest rates decline, so too does the discount rate for future equity cash flows. Because growing companies have a larger portion of cash flows in the future, they are more impacted by changes in the risk-free rate than value stocks, whose discount rate depends primarily on company-specific risk premium. Said another way, growth companies are generally less risky and therefore benefit more from a reduction in the risk-free rate.

While U.S. large cap growth stocks continue to outperform other asset classes as they have for the past decade, the evidence suggests that they are not yet pricing in the prospect for near-zero rates for many years to come. In looking at the graph on the following page, it seems the market is pricing in a 3% 10-year bond yield, not the current 0.6% yield. This margin of safety may explain why the equity market has not declined as much as many predicted.

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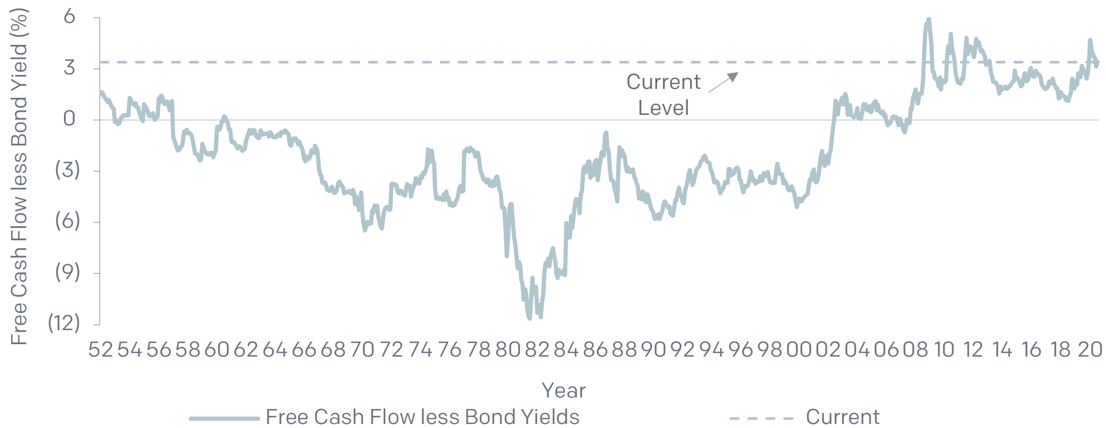
Free Cash Flow Yield Less that of the Ten-Year Treasury Bond

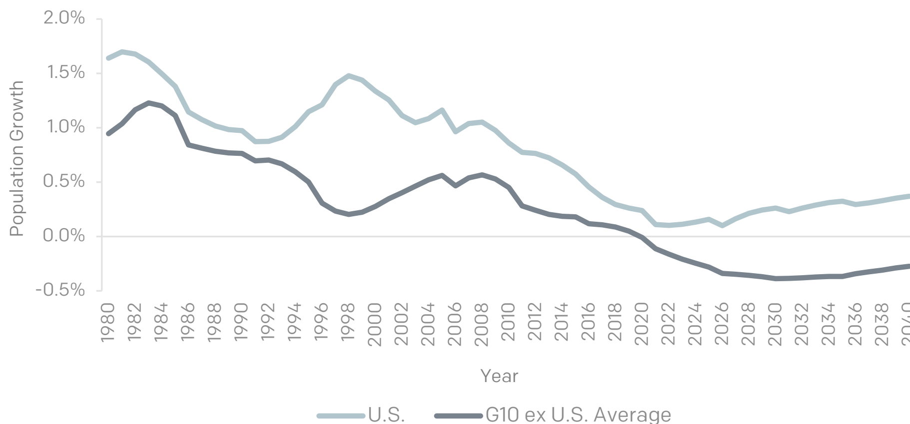


Source: Federal Reserve Board, Corporate Reports, National Bureau of Economic Research, Empirical Research Partners Analysis.
1Excludes financials, REITs and utilities; capitalization-weighted data.

We believe this discount offers a fourth tailwind to U.S. large cap growth stocks. Prior to August, it was not clear whether the reduction in risk-free rate would be mostly cyclical. Powell's aforementioned speech at the Jackson Hole Symposium suggests that a growth premium for growth stocks will persist for the foreseeable future.

We believe a changing perception about sustained low rates will keep growth stock valuations elevated compared to historical levels. However, we do caution that low rates will not last forever. Unlike most other developed economies, the tailwinds the U.S. has from technology leadership and demographics suggest we will again one day exit quantitative easing and the federal funds rate should reach 1% to 1.5% at the next peak. We are not so sure about Europe and Japan ever getting out of rates at the zero bound.

Growth of Working Age Population (20-64)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, Online Edition. Rev. 1. G10 is defined as Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Data shown for the period 12/31/1980 (start of available data) to 12/31/2019. Data includes projected periods. Different assumptions could result in materially different results.

We believe that there are now four very strong tailwinds behind U.S. large cap growth that make it a very difficult asset class to beat.

- There is a substantial growth premium to the average company in a slow growth world.
- The digitization of the economy is a net positive to the majority of growth companies.
- Free cash flow margin advantages are more important in a slow growth world.
- Growth stocks are the biggest beneficiary of a sustained reduction in the risk-free rate.

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A word on risk

All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. It is important to review investment objectives, risk tolerance, tax liability and liquidity needs before choosing an investment style or manager. Equity investments are subject to market risk or the risk that stocks will decline in response to such factors as adverse company news or industry developments or a general economic decline.

In addition, growth stocks or growth investing may fall out of favor and underperform value stocks and other investing styles over any period of time. Certain sectors or growth stocks may shift characteristics over a long market cycle and may not perform in line with stated benchmarks.

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GWP-1409352PR-E1120W