Exchanges at Goldman Sachs

As Rates Reprice and Stocks Sell Off, What's Next?

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Allison Nathan: This is Exchanges at Goldman Sachs where we discuss developments currently shopping markets, industries, and the global economy. I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

In today's episode, we're going to take a closer look at how the recent jump in bond yields is battering stocks, and in particular, shares of tech and other high growth companies. For perspective, we're sitting down with David Kostin, Chief US Equity Strategist in Goldman Sachs Research, and Jonathan Shugar, who manages equity sales on the cross-asset sales team in our global markets division. David, Jon, welcome to the program.

David Kostin: Thanks, Allison.

Jonathan Shugar: Thanks, Allison. Great to be here.

Allison Nathan: Jon, let's just start with you. Can you just give us a sense of, really, what is going on in the markets? What is the market pricing right now in terms of rates?

Jonathan Shugar: So, Allison, I think it's important that you remember where we start from. We've been on a wild roller coaster. When I was talking to clients back in September of last year, '22 was actually supposed to be a very accommodative year from the Fed where you were just seeing some taper and no rate hikes. Flash forward to January. We've now placed in four rate hikes this year. And I think something like one spot 75 percent Fed funds by the end of next year.

So, the question really is, has that done enough of the hard work for equities in terms of repricing? For a lot of these growth stocks, it's been a great story on the way up and a lot of hard math on the way down.

Allison Nathan: So, rate markets, obviously, have repriced dramatically here. And you know, as you just said, we've had a big equity sell off. It's not been a straight line. We know we're having some ups and downs. But David, talk to us a little bit about what your key takeaways are from the price action that we've generally seen over the last few weeks in the equity markets as rates have repriced.

David Kostin: Well, as bond yields have increased, equity prices have declined. But that masks a lot of the changing dynamics beneath the surface. And for example, energy stocks are up since the start of the year and that's on the back of much higher oil prices.

On the other hand, technology stocks, broadly speaking, have declined. But I think the real issue that has gravitated so much attention for fund managers has been a particular part of the technology sector. And those stocks are basically the ones that have very fast expected revenue growth, but low or in some cases negative profit margins, losing money. Those stocks have been severely punished in the valuation market.

And the reason for that is exactly what Jon just mentioned, which is the idea of a higher interest rate environment reduces the value of that future expected growth. And that's really important for these companies where their margins are very thin.

On the other hand, there are companies where there is still very rapid forecast revenue growth. But they are currently operating with very high margins. Those stocks have been comparatively less negatively affected. They have still come down on the back of the higher interest rates. But it has been much more muted in decline. That's been the significant component of the client dialogue that I've been having as a research analyst with fund managers on that topic.

Jonathan Shugar: Yeah. And Allison, I think it's really important to understand for these high growth stocks, no one can really decide yet if they're cheap enough. Is six times the right number? Is being back at valuations you were at pre pandemic the right valuation framework for these? Or should you actually be at something cheaper?

And that's a huge outstanding question that our client base and investors are wrestling with on a day-to-day basis.

Allison Nathan: David, do you have a view on that? I mean, do you think this gap between these two buckets can get wider?

David Kostin: So, our analysis would suggest that the relative valuation between high growth and high margin stocks, and high growth and low margin stocks, which is around two multiple points in terms of enterprise value to sales, that's back to where it was pre pandemic. All the way back to the early part of 2020. 2020. And so, from that perspective, we have now reverted back to that more historic relationship, if you will. And it also would seem that these high growth but low margin stocks are trading at levels that would be consistent with a further increase in real interest rates, which is part of the Goldman Sachs economics forecast.

And so, to a certain degree, it has certainly been priced into the market. Anything's possible. So, it certainly could go lower. But a dramatic repricing, almost 50 percent from

where it was in early December to now has gone a long way to come back to more normal valuation. But as Jon indicated, it doesn't mean it can't go lower. But our view is a lot of that is priced in the market.

Allison Nathan: If we take a step back, David, you know, we've just come off a year where companies have dealt with so many headwinds. We've had the supply chain disruptions. We've had labor shortages. We've had new variants of the virus. Spike in commodity prices as you mentioned. But broadly speaking, obviously, you've talked about this bucket where margins are thin. But broadly speaking, profit margins have been pretty good. So, as companies start to report their fourth quarter results in this rising rate environment and we're in the throes of reporting season right now, what are you focusing on when it comes to margins and your outlook there?

David Kostin: So, the forecast that we have is that net margins for US publicly traded corporations will be increasing slightly by approximately 40 basis points to bring them to around 12.5 percent, which would be a record high level. Now, margins starting point is already at

record high levels. And that's on the back of really impressive nimbleness by management in 2021 when confronted with a delta variant, supply chain disruptions, challenges in the labor market, surge in commodity prices, all these headwinds that would normally be associated with lower margins, managements were able to manage around that and actually increase margins in pretty much every sector to record high levels.

And so, looking forward as we come into the fourth quarter earnings season and more importantly some guidance and focus on the 2020 outlook, we're going to be focusing on company commentary regarding cost push inflation. The idea that higher input costs, supply chain, all those incremental costs that are built into the system, that managements are going to be pushing through price increases or looking to raise prices. Hopefully the volumes will then stick. But the idea of pushing through these higher prices to then maintain their margins, number one.

And then number two, to understand the operating levers that may exist with more technology. So many companies in the pandemic have used that as an opportunity, almost

forced by circumstances, to incorporate, embed, and use more technology to try to improve their productivity. This, again, is in the publicly traded sector of the market where, broadly speaking, companies have high margins—and to try and keep those margins improving. And that's more of a challenge for some of the smaller companies and private companies that maybe don't have quite as many levers to pull.

So, those are some of the things we're looking at. In the next, about three weeks or so, we'll have the bulk of publicly traded companies in the United States will be releasing their fourth quarter year end results. And we're expecting pretty strong season earning season expectations. Nearly 20 percent earnings. But really, the focus for investors is going to be much more on the outlook for 2022. And there we're expecting profit growth of around 8 percent, largely a function of steady improvement in margins.

Jonathan Shugar: Yeah, Allison. The guidance point is super important because no one knows how much of these companies were overearning from the last two years given

the pandemic. You had a ton of stimulus. David and I both have kids. I'm sure he had cardboard boxes from ordering online outside his door every day the same way we did. Does some of that go away as people get back to a more normal course of life? Does that sustain our enterprises who had to enable their entire workforce to work from home going to do the same amount of tech spending in the year ahead? Those are the big questions that people are kind of wrestling with on their portfolios right now.

Allison Nathan: So, lots of questions out there. Margin vulnerability a key focus. The increase in bond yields a key focus. Jon, you speak to clients every day. How are investors thinking about their strategies, changing their strategies to take account of this evolving environment?

Jonathan Shugar: Yeah. So, the number one thing that we've seen this year is actually what people own is different than when we started going through this roller coaster back in November.

So, if you look at the Goldman Sachs prime brokerage data, investors are the most underweight TMT stock, and the

most overweight energy, materials, industrials, and banks versus the S&P 500 weightings in the last five years.

The other big thing is investors are just much more cognizant of all of the other players out there in the market and what that may be doing to their portfolio. So, those are things like CTAs, passive, and quant flows, which have really been driving a lot of these moves on the way down in a lot of people's opinion.

How we make returns this quarter year, defined catalysts are really in huge focus. So, that would be things like merger arb spreads or anything that is a definitive date that people can look in, say, "Hey, a spin's going to happen. A cash return is going to happen." That's going to have a lot of value to the stock.

And what's actually interesting on the flip side where last year everyone was in dip buying mode for most of the year, on the GARPY side, everyone's doing work. But the sense of urgency that you need to add high quality companies is actually relatively low to go in and buy now. People feel like you're going to have a long path ahead of rates hitting

markets. And so, there's no sense of urgency to act. Which is interesting because if you went back to the start of the pandemic where we had a massive sell off and then a recovery, a lot of people felt that they hadn't taken advantage of those opportunities quickly enough.

Allison Nathan: Just for those who don't know. GARPY, Jon, can you just define that?

Jonathan Shugar: Oh, sure. So, you know, David can give you the technical definition. But, like, good high-quality companies that are growing their revenue and are trading at a reasonable price where you could try to put it into a financial model and walk into your CIO or PM's office and say, "Hey, here's what the valuation actually looks like, and the growth looks like. Let's put this in the book."

Allison Nathan: So, we touched a little bit on sectors in this conversation. And David, you're really breaking this out between companies' growth opportunities and profitability versus sectors. But is there something to, say, about some sectors performing in this environment? Some lagging?

David Kostin: Well, ahead of an interest rate hiking cycle that the Fed has anticipated to begin in March, history and the playbook would suggest that more cyclically oriented stocks traditionally have done well, outperformed in that runup to the beginning of the tightening cycle. That would suggest some of the more cyclical companies being some financials would be one at the top of the list, which generally have done well in a rising rate environment. That's a big area of focus.

Part of it has to do with why is the Federal Reserve likely to be increasing interest rates and the idea of the economy growing, say, more rapidly. You know, if we're above trend. We've also seen that associated with energy prices, oil prices. And oil stocks and energy stocks have particularly outperformed as I mentioned earlier. And that's an area that gets a lot of focus.

The technology sector, which is a big area of focus for fund managers because of the rise in rates that we've been talking about on this podcast and had such a negative effect on their valuation, those companies in the tech

sector are operating now with 25 percent net margins. Twice as high as the rest of the market. And what that does is it leaves a lot of free cash flow for these companies to be repurchasing stock.

And so, as Jon indicated, one of the measures that we think about is where is the source of demand? In this particular case, we have seen about one and a quarter trillion dollars of authorizations by company boards to repurchase stock. That was authorizations last for year. Much of that is going to be executed in the course of this year. And so, there's a certain bid to the shares that are likely to come from corporate buy backs.

But in response to the specific question on the lead into higher interest rates and a tightening cycle, that would be some of the more cyclically oriented stocks traditionally have outperformed.

Jonathan Shugar: Yeah, Allison. The crazy thing is tech, as you get through some of these rate hikes, may actually be a huge beneficiary if people think there's going to be some type of policy misstep. In that as we start

lapping some of these inflationary comps, if GDP growth starts to slow, then secular growth should start to trade at a premium again. We just don't know how that's going to play out yet.

David touched on energy, but the commodity sector in general, everything within metals, the inflationary environment is great for those stocks. And given some of the longer-term trends that you see with ESG in terms of the ability to put money into the ground and build a new copper mine being quite challenging these days, we think that is something that's going to be a durable trend to the outside.

Allison Nathan: And you know, just to clarify, we're not just talking about a Fed tightening cycle here. We're talking about a flattening yield curve environment. So, are there particular implications to that? David, maybe you can take that one.

David Kostin: Well, the idea of a flattening yield curve is the concept that the Federal Reserve will be raising interest rates on the short- and near-term interest rates.

And the forecast for Goldman Sachs economics is around ten hikes over the next several years. Four, in particular, this year followed by three in 2023 and then another three in 2024. So, that is the path of a higher short-term interest rates.

And the idea that long-term interest rates, in this case we'll look at ten-year US treasury yields, will be increasing at a more modest pace. And so, as a result of that flattening yield curve, that does lead to some questions about which stocks will do better, which stocks will do worse. Obviously, from a sector point of view, the financials would tend to do well when rates are rising. That net interest margin that they have actually will diminish if the yield curve flattens, which is what we are anticipating over the next couple of years.

And so, there's an example where it's about near-term investment strategy versus a little bit longer term investment strategy. So, near term, a lot of focus on the exact timing and the pace of the tightening cycle of the Fed. Whereas the ten-year treasury yields, both in nominal and in real terms have already had a huge move, enormous

move in the first couple of weeks of the year. And so, perhaps, there's less upside on the risk of longer-term rates. The idea of a flattening curve is an important part of sort of a strategic concept as we look out for the balance of 2022.

Allison Nathan: And are there any other strategic areas that you think this macro environment will generate activity in if we think about a rising rate environment, you know, flattening yield curve, M&A and so forth?

David Kostin: So, the idea of improving corporate margins is a singular focus for the portfolio strategy team at Goldman right now. And the idea for company managements in a deaccelerating economic growth environment, it's often challenging to have accelerating top line revenue growth. Therefore, a lot of focus is going to be put on the idea of improving margins. And the idea of improving margins, one way to achieve that would be to spin out a division, whether that is in the form of a sale of a business to a SPAC, special purpose acquisition corporation, or a sale to a private equity fund. Or that could spin out as a fully formed public company. That is

likely to be a theme that many managements are going to be exploring in 2022. And we expect that's a big area of focus as a method or a vehicle for companies to try to improve the margins for the remaining business. And I think that's going to be a key theme for the year ahead.

Jonathan Shugar: Yeah. As David said, it's very much about corporate self-help. So, on the credit side in anticipation of interest rates going higher, and no one necessarily knew it would happen this quickly in terms of market expectations, you saw really record issuance last year with a lot of corporates prefunding credit needs. So, how they use that cash is going to be very interesting.

And then also you're actually going to have, I think, negative net issuance this year. So, within credit, some of the high yield companies who are now in a better position as David said on the margin side getting upgraded to investment grade, there's going to be a lot of currents under the surface that are going to provide opportunities for investors.

Allison Nathan: We've talked a lot about this

environment changing in interesting ways for investors. And Jon, you've talked about how investors are navigating this. What are they doing in terms of managing the overall risk in their portfolios at this point? Are they hedging? Are they hedging in a different way? What does that look like?

Jonathan Shugar: So, everyone has to start closer to home. So, what does that mean? It means you run a lower net exposure and a lower gross exposure on your book. You have more cash to take advantage of these dislocations. And I think most investors are coming around to the view that you have to be a lot more tactical in this market. So, buying and selling a lot more frequently as opposed to riding structural themes higher, which was the predominant trend over the last few years.

I think one of the big changes which we saw start last year in January with the retail frenzy on some of the highly shorted names, is just investors are a lot more mindful of the short side of their book. And so, we have a lot of clients coming into us and saying, "Hey, our index hedges aren't working versus what we own. What are you able to do to put together something that more accurately mimics our

risk to our portfolio?" So, that's one really interesting thing.

In the business where I sit, which is cross asset, simply what is left that is cheap to hedge with it? And that's very different now than it was last year. Last year we actually spent a lot of time talking to investors that the US rate market, who knew when rate hikes were going to come? But nothing was priced in. And so, this is probably a pretty cheap heading that you might want to take a look at.

We think there are similar opportunities on a global rates basis. So, markets like Japan, because inflation is really a global problem, a lot of the things that drove it here we're seeing overseas.

And then number two is just what else is really tight relative to history? So, credit spreads, for example. Despite the positive margins that David has cited for corporates, who knows whether these companies were overearning? And in a rising rate cycle, should they be wider? And what's the right way to hedge those risks? That's probably the number one discussion we're having with people right now.

Allison Nathan: So, if we think about all of these various forces that are pulling us in different directions, what are investors watching that would signal to them, or give them confidence at least, that the market is going to be moving higher from here, lower from here? What are the main things that people are watching?

Jonathan Shugar: On the corporate side, I would say forward guidance because this question of overearning, if people are actually hitting their targets as you move through the year, we think that's something that would be a really positive signal for the market in terms of durability of some of these cash flows.

In a lot of the stuff that's sold off, it's really M&A. Whether it's strategic, whether it's private equity, it doesn't really matter as much. This way there may be regulatory concerns within tech for large cap M&A. But looking at it, they want someone else to come in and help set the floor to valuations. And that would have a really bullish effect for the rest of the space.

The inflation picture is a lot more complicated. People will be watching that very closely. You're starting to [UNINTEL] much more inflationary comms from last year. And you should see some supply chain clean up. So, that should have a dampening effect on inflation. But whether investors are going to live with 3.5 or 2.5 percent inflation going forward, and how that impacts your portfolio, that's a whole different set of companies that you own depending on what environment that is. And really no one has the right answer as to what that's going to be at.

David, I don't know, what do you think?

David Kostin: I think your point is an excellent one. In the next several weeks, Allison, we have 400 or so companies that will be releasing their fourth quarter results. But more importantly, comments and discussions about the outlook for 2022 will help drive the near-term sentiment in the market, in my opinion. That's a key issue.

The inflationary data is coming in. it's expected to be above trend and a particular reason why the Fed is anticipated to be hiking rates. So, the inflation data, people are poised for

and prepared for some negative news on that front. So, it's really about the corporates and whether they'll be able to push through their higher operating expenses and their higher input costs, and can they push that through to the ultimate customers without having too much volume degradation? If they're able to achieve that, then the earnings will be there and the valuation ends up with a situation that there's not a lot of alternatives to equities in the sense that bond yields rising would suggest that bond portfolios, broadly speaking, will decline in value. So, equities become a pretty attractive area of focus.

If we look at all of the investment, all the investor classes, the households, the mutual funds, the foreign investors, the pension funds, if you look at all those major categories that comprise the primary owners of US stocks, they are allocated right now 53 percent of their assets into equities. 20 percent into bonds. And 12 percent into cash. It's a record high level of equity allocation right now. The balance would be commodities, real estate, gold, things like that. But the principal areas of equities, bonds, and cash already have a huge equity allocation. But the other alternatives aren't particularly attractive at this juncture.

And so, when we have conversations with chief investment officers, the idea of asset allocation becomes a singular discussion point about what else there is, which non-US equities perhaps may be more attractively valued. But other than US equities, that becomes a discussion. What else is chief, if you will? That's at the more macro asset allocation, chief investment officer level.

And then you get to the individual fund, whether that's a mutual fund or hedge fund, and the conversation is much more tactical as Jon was indicating about how to position around a flattening yield curve, around the Fed hike, around higher commodity prices, which companies or industries would be beneficiaries? And, ultimately, coming back to the real issue on the table, which is the idea of the big jump in bond yields, which has made equities near term more challenge does lead to a question about the largest, fastest growing companies that have negative margins, that are losing money. You know, they've come down so dramatically. And finding when is the time to catch the proverbial falling knife in that [UNINTEL].

Jonathan Shugar: David, you're just even talking about the public market ones. Let's talk for a second about private markets where you've had this ever-increasing valuation for these private companies. Does capital flow there this year? Are those companies able to take up rounds? Do they have to take down rounds or other solutions? Because for investors, a lot of whom have had companies IPO in the last 12 months, they now see the companies they know the best, that are the farthest in their life cycle, trading really cheap in public markets.

So, there's actually an argument that if you're private investor, there's better value for you in public markets today than deploying more capital privately.

Allison Nathan: So much to consider. We'll be watching it all. David and Jon, thank you so much for joining us today.

David Kostin: Thanks, Allison.

Jonathan Shugar: Thanks, Allison.

Allison Nathan: That concludes this episode of

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