

Exchanges at Goldman Sachs

With Peter Oppenheimer, chief global equity strategist and head of Macro Research in Europe

Hosted by Jake Siewert, Global Head of Corporate Communications

Recorded March 26, 2021

Jake Siewert: This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Jake Siewert, Global Head of Corporate Communications here at the firm.

Today we're going to talk about whether global markets are experiencing a bubble, a big topic today. And what signposts investors should be watching. We're joined by Peter Oppenheimer, Chief Global Equity Strategist and Head of Macro Research in Europe. And Peter's going to talk a little bit about a new research piece he has out on that very topic.

Peter, welcome back to the program.

Peter Oppenheimer: Thank you so much, Jake.

Jake Siewert: So, Peter, a lot of chat about bubbles. You've just completed an analysis looking at stock market bubbles and the history of it. What exactly constitutes a bubble?

Peter Oppenheimer: Well, I think the first question is what do we define as a bubble? Because not every period where prices of assets rise rapidly are bubbles. I think a reasonable working definition might be a rapid acceleration in prices and valuations that makes an unrealistic claim on future growth in returns. And, you know, typically these bubbles, therefore, are developing not reflecting actual fundamentals, but purely on hope and possibility. So, I think that's a reasonable definition.

And what we find looking back at bubbles, and this study looks at some of the very well-known ones going back over 300 years, is that there are some very typical conditions that are prevalent around nearly all of them. First of all, of course, excessive price appreciation and very extreme valuations. That's at the core of it. But also, you tend to get a kind of new era type of narrative that builds up. And that leads investors to justify new valuation approaches. That because it's different, you can justify these extreme valuations. You tend to get, of course, increased market concentration as investors really focus on these new areas of potential high growth. And with it, you

tend to get frantic speculation, very strong investor inflows. And usually this is happening also in a period of very easy credit, very low interest rates. And as a result of that, you tend to get rising leverage, particularly in the private sector. Bank leverage, household leverage, and corporate leverage.

We also find that you tend to get very strong corporate activity. Mergers and acquisitions, IPOs, generally very strong corporate activity. And, typically, a kind of new era narrative around new innovations in technologies. Most of these bubbles have been late in the cycle, after a long period of economic boom. And, finally, you tend to get the emergence of accounting scandalous and irregularities. Although, that doesn't typically tend to reveal itself until the bubble bursts. So, those are the things that we found in the past that are very common characteristics.

Jake Siewert: Well, so, some of that sounds familiar. But how many of these characteristics that you've outlined do you see reflected in today's market?

Peter Oppenheimer: Well, generally, quite a lot. I think of the nine, you know, you could argue that seven of them are present to some degree. But I think that's the key point. In nearly all of them, I think you would have to qualify and say that in aggregate you don't really have the full level of bubble activity that would suggest that there's anything systemic as a risk that's building up.

So, to give you an example, you know, I've mentioned easy credit, low rates. We've certainly got that. We've got amongst the lowest interest rates in history. Credit conditions very easy. But unusually, we aren't seeing sharply rising leverage in the private sector. Quite the opposite. You know? Banks' balance sheets are now very strong. Household balance sheets are very strong, indeed. If you look at the US, households have accumulated around \$1.5 trillion in excess savings during the pandemic. And that's probably going to rise to about \$2.5 trillion, over 10 percent of GDP by the time the economy's really opening up around the middle of this year. So, that would suggest, really, not a bubble. You know? We're not late in an economic cycle, which is normally what you would have in a bubble type situation.

And while you have seen rising valuations in assets like equities, a lot of that is a function of having interest rates which are extremely low and very supportive policy conditions.

So, most of these, you could say that there are signs of them. And we go through this, of course, in some detail in the piece. But I would say, in aggregate, not to the levels we've seen in other bubbles.

Jake Siewert: So, let's chat a little bit about the cycle. How does the current market cycle compare with some of the more famous bubbles that you've looked at?

Peter Oppenheimer: Well, I think the starting point is really the intense speculation that's built up around famous bubbles in the past and in some really extraordinary price increases, which we're not seeing broadly at the moment. You know, give a couple of examples. If you think of the tulip mania in 1636/1637, you saw the price of some tulips, just in that year, increasing 20-fold. And at the height of the bubble, a single bulb, a single tulip bulb would have cost the same as a luxury townhouse in Amsterdam. That gives you a sense of the scale of it.

More recently in history, during the famous Japanese bubble of with late 1980s, which was actually more extreme in the real estate market than in the stock market, but the Imperial Palace in Tokyo was reportedly then worth more than the entire value of France or California, for example. The value of land in Japan in 1988, theoretically, was about four times that the land of the United States. That was the scale of the bubble then.

And similarly, in the late 1990s, you know, when you look at the tech bubble, it wasn't just a few small companies. You had something like 13 major large cap stocks that all increased by over 1,000 percent just in a single year in 1999. So, we're not seeing that scale of price appreciation. We're seeing pockets of it. And there are a growing number of companies in the stock market that had very high valuations and enterprise value above 20 times, for example, [UNINTEL] sales above 20 times. We're seeing a higher proportion of those companies than we've seen since 1999. And that's true in the US and in Europe. But it's not the breadth of this kind of speculation that we're seeing at the moment that would have been typical in the past.

Jake Siewert: Let's dive deeper on one of those pockets where we've seen some high valuations. We've seen increased market concentration with the mega cap tech companies making up a huge portion of the market. Does the concentration in that sector raise concerns?

Peter Oppenheimer: Actually, this is a very interesting point

that we looked at. Because if you take the really big mega cap tech names which, of course, have been very dominant over the last decade, I would say this is not reflective of a bubble because, as I mentioned earlier, you know, a bubble really is about the promise of potential growth or the hope of potential growth long into the future. That's certainly what happened during the technology bubble in the late 1990s.

But these dominant technology companies have become very big, but extremely profitable. Now if you look at the FAANG, they often describe the big five dominant companies in the S & P. They are huge. They may be twice the size of the market capitalization of the Topics Index in Japan, for example. Roughly three times the size of the annual GDP of India. Certainly, very, very large. But that concentration in leading innovative companies is actually not unique in history, as we show in the piece. It's been true when you look at the electrification revolution in the past. The oil exploration revolution. It's happened in telephony, happened in mainframe computing, and software as well. So, I would say these are not really bubbles.

Worth also mentioning that if you take those five companies, they seem roughly three times the average sales growth of the rest of the market, and roughly twice the average net income growth over the last few years. And they've also proved to be quite defensive in this pandemic. You know? If you look at the revenue growth, for the rest of the market in the US, which contracted about 4 percent last year, these companies, in aggregate, saw revenues actually growing about 20 percent. So, absolutely, they've become very large. That's not unique in periods of significant technological innovation in history. But being large and seeing strong price appreciation is not the equivalent of being a bubble, I think, because these have actually been very profitable parts of the market.

Jake Siewert: So, typically around bubbles there's a lot of chatter about widespread retail activity. And when the taxicab drivers are investing in startups and the like, people get worried. Obviously, a big story this year has been the impact of huge retail flows into the markets. To what extent is that a factor that could spill over into a bubble?

Peter Oppenheimer: Yeah, this a very good point. And you're right. You know, wide speculative inflows have definitely been one of the classic characteristics. And it's a real sense of the herd fear of missing out. And typically, I would just say that

in previous bubbles there's evidence that very prominent people become real, sort of, cheerleaders of the bubble. And that grows confidence.

Just to give you a sense of this. You know, if you go back to the period of the railway boom in the 19th century, Kentucky had some very prominent, famous people who were investors. Charles Darwin, Benjamin Disraeli, the UK Prime Minister. Even Sir Isaac Newton was a well-known investor during the South Sea bubble, for example. So, it's worth just thinking about that from a historical perspective.

But yes, we have seen massive inflows. You know, if we look at the global equities, they've just lodged their largest quarterly inflow on record. So, over 300 billion dollars worth of flows into global equities over that period. And we have seen, you know, very rapid increase in brokerage accounts opened online and retail flows as well.

But again, I think we need to think about the context here. You know, if you look at the the last ten years in the US, for example, most investors were actually net sellers of equities. That included, you know, pension funds, insurance companies, and households. In fact, the only net buyer over that whole period was the corporate sector itself. And it was buying back stock. And you know, we do have very strong and large amounts of money still sitting in cash balances so, despite these large outflows of money market funds into equities, in the US there's still around \$5 trillion of money sitting on money market funds. And that's about a trillion dollars higher than we saw at the start of 2020.

So, you know, I think that we are seeing very strong flows. And that's a reflection of increased confidence in the potential recovery, as well as these very low interest rates and the central banks telling us that the prospects are that that will continue. But there's still plenty of money sitting in cash. And again, I think that that's something to watch, but not really telling us we're at a tipping point yet.

Jake Siewert: So, another characteristic you talked about is an upsurge in corporate activity. And obviously, there's been a boom in IPOs, SPACs, other corporate activity, M & A. How does the level of activity compare with what you've seen in prior stock market bubbles?

Peter Oppenheimer: Well, this is starting to rise very, very

sharply. You know, you've seen nearly 500 billion dollars, roughly, worth of transactions announced in the US and Europe by acquirers this year. That's the highest we've seen since 2000. So, very strong indeed. We've also seen very strong issuance. So, if you look at equity linked issuance, traditional IPOs, SPACs, follow-ons, we've also seen the strongest rise since 2000.

But I would say if you look at those flows, or the scale of those deals relative to market capitalization, it isn't actually that high. And not as high as we've seen in the past. So, I think, again, what we're seeing here is a big increase in optimism. But it's coming from a relatively low base. It's, again, something to watch for and may not be sustainable, particularly if interest rates rise a lot. But I don't think, yet, it's at the sorts of levels that we've seen in some of these classic bubbles in the past.

Jake Siewert: Finally, let's talk about valuation. Where does the market stand today in valuation? Are we near an inflection point? Or is there still room to run up, especially as economies emerge from lockdown and economic activity picks up?

Peter Oppenheimer: Yeah, I think valuations in absolute terms of all financial assets are very high relative to history. And that is partially a function of reaching, you know, record low bond yield and interest rates that are close to zero in real terms, or even negative. And that, of course, has pushed up valuations of credit markets and equity markets too. And it is notable that if you look at the global equity market capitalization relative to global GDP, this has reached an all-time record high. And I think this is something to be watching for. And we certainly think that over the longer run these high valuations suggest that returns are going to be much lower in the future than they've been, for example, in the last ten years. But the high absolute valuations in things like equities are partially a function of these low rates. And not yet comparable with other bubble periods.

For example, if you look at the late 1990s during the technology bubble in the US, the confidence was so high in the equity market in that period that investors were happy to buy the S & P offering a dividend yield of 1 percent when the risk-free rate at that time, the ten-year government treasury yield, was about 6.5 percent. So, that was a real sense of optimism about the future.

Now if you look at it today, even after this huge rise in equities that we've seen in the last year, the dividend yield and the bond yield are roughly about the same. And in some other areas like Europe, for example, the bond yield is still negative and dividend yields are about 3 percent. So that gap, that difference between the two is showing that there isn't, really, the exuberance broadly that you've seen in other bubble periods that have the prospect of really deflating and causing significant systemic damage.

So, I think high valuations are a concern. It does tell us something about the prospect of longer-term returns, which will likely be lower. But I don't think we've got the kind of broad, excessive valuations which would suggest any imminent, likelihood of a major collapse in markets.

Jake Siewert: All right, well, it may not be time for a new edition of Kindle Burger quite yet. But Peter, thanks for joining us today.

Peter Oppenheimer: Thank you, Jake.

Jake Siewert: That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating or a comment.

This podcast was recorded on Friday, March 26th in the year 2021.