Are We Nearing a Regime Change?

CALAMOS INVESTMENTS

Solutions for the next decade: Finding income and risk-managed equity opportunities in a changed world

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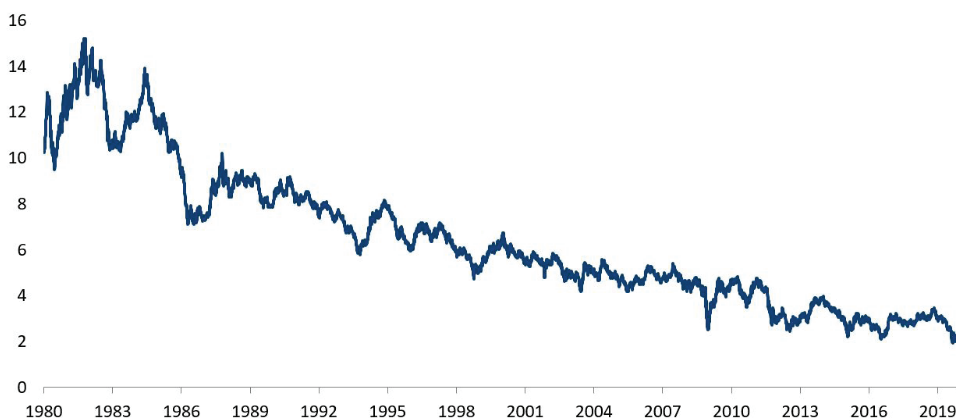
The U.S. equity cycle of the past decade should be understood as the derivative of the larger, artificially induced bull market in bonds. Specifically, the bull market of all risk assets has rested upon the extraordinary policies of central bankers. Led by the Federal Reserve, prolonged capital subsidization has suppressed interest rates and credit risk across the developed world.

Historically low interest rate environment: The result of extraordinary central bank policies



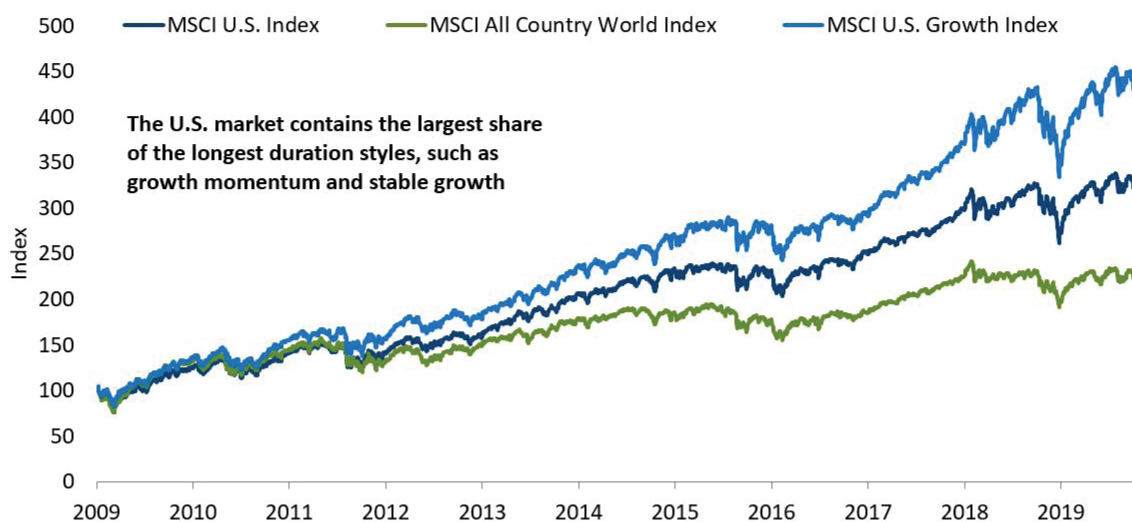
Past performance is no guarantee of future results. Source: Macrobond.

This policy has become the publicly institutionalized insurance policy for all risk assets. It is why there is still no sign of genuine panic in the financial world, despite gathering signs of economic vulnerability.

The equity themes have all been derivatives of this phenomenon—the leaders have been the longest-duration equity assets. For investors, duration is a measure of how long it takes to be repaid in earnings, dividends or interest. By suppressing interest rates, central bankers ensured that investors were happy to be paid in the far future rather than the near future.

For example, the growth style has notably outperformed the shorter duration and value-oriented parts of the equity world. The U.S. market contains the largest share of these longest-duration styles, such as growth momentum and stable growth, and has thus stood out for its resilience while equities everywhere else have struggled.

Leadership dominated by the longest duration equity assets



Past performance is no guarantee of future results. Source: Macrobond. The **MSCI USA Index** is designed to measure the performance of the large and mid cap segments of the U.S. market. With 637 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US. The **MSCI ACWI Index** captures large and mid cap representation across 23 Developed Markets (DM) and 26 Emerging Markets (EM) countries. With 2,852 constituents, the index covers approximately 85% of the global investable equity opportunity set. The **MSCI USA Growth Index** captures large and mid cap securities exhibiting overall growth style characteristics in the US. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

These leadership styles have all been the beneficiaries of a deflationary price regime and a low cost of capital. This has been equally true for one of the longest duration businesses of them all: the disruptive start-up that typically generates years of losses as management exploits new and disruptive business practices.

With the Fed's capitulation in 2019, we have again witnessed a virtual frenzy of long duration assets. The year-over-year gain, for example, in U.S. Treasuries has been the strongest since the wake of the 2008 financial crisis, despite a U.S. economy that—so far—appears resilient and benign.

Investors have concluded that, once again, central banks will be forced to subsidize capitalism with various conventional and radical monetary policies.

In contrast, we believe this decade-long reliance upon excessive monetary activism is climaxing, with decisive implications for the winners of the past decade. Interestingly, in August and September, investors witnessed a substantial and rapid rotation out of these growth momentum leaders.

The question now is how to interpret that reversal.

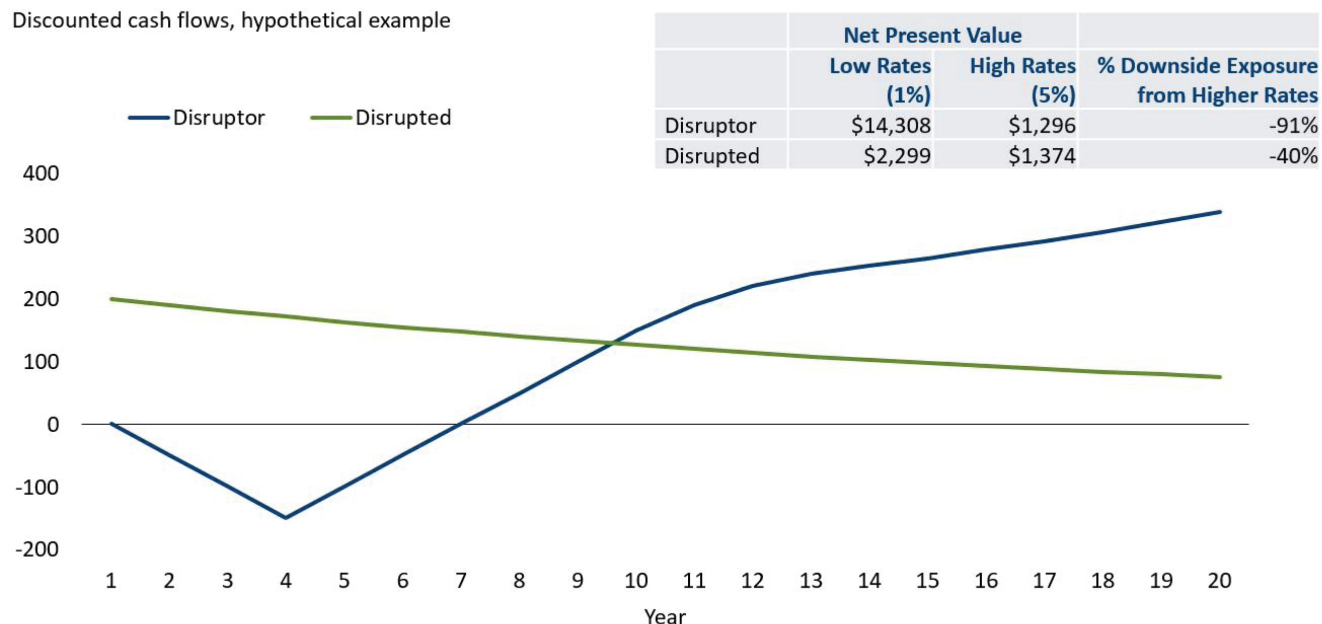
Historically, these drawdowns have occurred during periods of market dislocation, such as the Internet bubble in 2000 and the financial crisis in 2008. Investors might recall the "Quant Quake" of August 2007.

Momentum equities are known for their risk of severe drawdowns. It is intriguing that they occur at inflection points in the investment cycle, implying that previously successful stocks are struggling to maintain their outperformance.

The equity regime of the past decade has favored the disruptors and disfavored the incumbent disrupted. Investors have eagerly supported the new business models that disrupted incumbents, while viewing incumbent profitability as less sustainable. These "new" businesses often take years to develop the profitability demanded of their incumbent peers.

The key is how a regime of artificially low interest rates has encouraged the emergence and dominance of the early disruptors. In short, low interest rates are critical because they allow disruptors to establish a market position before monetizing it.

Artificially low interest rates encourage the emergence of early disruptors



	Net Present Value		
	Low Rates (1%)	High Rates (5%)	% Downside Exposure from Higher Rates
Disruptor	$14,308	$1,296	-91%
Disrupted	$2,299	$1,374	-40%

Source: Calamos. This is a hypothetical example for informational purposes only. It does not represent the performance of an actual investment.

By its nature, disruption requires an unusually low cost of capital. For example, absorbing five or 10 years of a loss-making enterprise is a radically different proposition when the risk-free rate is 1% versus a world where it is 5%.

The value factor has underperformed partly because one is implicitly buying the disrupted businesses, not the disruptors. After a decade of this performance chasm between emerging growth models versus the value incumbents, the glaring question is whether we have reached the limit of valuation spreads.

In September, the high profile failure of WeWork to come to market implies that the valuation cycle for disruptor start-ups has reached limits. Investors' willingness to fund loss-making, cash-flow-negative businesses has been pushed too far.

The implication is that we may be near the beginning of the end of this regime of growth momentum. The secular direction of interest rates in the coming decade will be critical.

For now, the sharp rotation out of growth momentum and into value of late summer 2019 looks like a technical event related to rising bond yields. This lifted some value sectors such as Financials and led to an unwind by passive momentum strategies. History argues that these momentum drawdowns are an early sign that the investment regime is entering transition.

Looking to the next decade, policymakers will increasingly seek non-monetary tools for reflating economic activity. The surprise could be higher rather than lower interest rates, assuming policymakers can achieve their objectives. These non-monetary tools will include fiscal policy, tariffs and trade policy, currency intervention and new ideologies such as Modern Monetary Theory.

This implies a dramatic shift of what has worked across the equity universe. We may not be there quite yet, because the prospect for U.S. recession in 2020 has yet to be resolved. Also, some parts of the value opportunity have assumed excessive corporate debt.

The final stage of this remarkable feature of the equity bull—the leadership of growth momentum—will reach its zenith when recession in the U.S. has been fully discounted, likely by early 2020. Between now and then, we look for more rapid leadership rotation of the kind which investors are troubled to deal with.

For now, investors should seek a balance of style factors across their portfolios. The value style, including many dividend-yielding traditional businesses, could be favored in the next investment regime.

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