

THE DAILY CHECK-IN WITH GOLDMAN SACHS

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Liz Bowyer: Hi, Christian.

Christian Mueller-Glissmann: Hi, Liz.

Liz Bowyer: You're an asset allocation strategist in Goldman Sachs Research. One of the biggest issues on investors' minds recently is how much of their portfolios they should allocate to equities. How are you approaching that question in your conversations with clients?

Christian Mueller-Glissmann: Yeah, I mean, it's the big question this year. I think generally over longer horizons we find that equities outperform versus bonds. And I think if you look at the starting point right now, bond yields are so low. They have fallen materially with the COVID-19 shock. But actually in the previous years they've been falling as well. So in fact, a large proportion of global bonds are currently having negative yields.

So at the margin, investors are pushed up the risk curve right now and pushed towards equities because this is where you have relatively attractive yields. If you actually look at the yield gap between the S&P, for example, and US 10-year yields, it's one of the highest levels since the global financial crisis and the period after World War II. So as a result of that, naturally investors are currently asking the question if it's time to own more equities. And I think the important thing to keep in mind is that over long horizons, equities tend to outperform bonds. And they tend to outperform more than what can really be justified by fundamentals, which is why people often call that the equity risk premium puzzle.

Liz Bowyer: So your recent research is entitled *The Equity Duration Puzzle*. Tell us about that.

Christian Mueller-Glissmann: Yeah, no, I think it's a new puzzle which we found in our research which is, yes, over the long run we find that equities actually outperform versus bonds. But in the last few decades, there have been a few more mixed results.

And this is the kind of new risk premium puzzle, which is that the equity risk premium has disappeared. So since the '90s, we definitely find that in most equity markets, equities have somewhat struggled to outperform bonds. This has been particularly the case in Japan in the '90s and the 2000s. And it's also been true in Europe. So I think that is a new puzzle, that equities struggle to outperform versus bonds.

But I think the other puzzle we find is that, while on the one hand these higher yields you currently get in equities are pushing you towards equities and they indicate that you should own more equities, we find that with these falling bond yields in recent yards, risk in equities has picked up as well. And that tells you should probably be a bit more careful about increasing equities exposure at this point.

Liz Bowyer: So elaborate on the first part of the puzzle and instances in which equities have performed poorly relative to bonds.

Christian Mueller-Glissmann: Yeah, so if you look over the very long run, the average excess return for equities versus bonds is, like, 4-5%. So equities tend to outperform quite nicely versus bonds. But if you look, in the last few decades, there have been a few more mixed results. In particular, in the '90s and 2000s in Japan and also since the financial crisis European equities have done quite poorly versus bonds.

And the problem is really that the falling bond yields you had in these periods were signaling stagnation and secular stagnation risks. So equities had to kind of de-rate their longer-term growth expectations to really price that new reality. And as a result of that, they had this tailwind from relative valuations, and equity risk premia have been a bit disappointing.

The good news is that the de-rating of long-term growth expectations has been quite significant now. So the embedded expectations are quite conservative. And from here we would expect that this de-rating is unlikely to kind of be much of a drag as well.

Liz Bowyer: So looking at the second part of that puzzle, after the US election and vaccine developments, equities are close to an all-time high. Does that mean equities are getting riskier?

Christian Mueller-Glissmann: Yeah, no, I think you're absolutely

right. You kind of feel like the relative valuations are attractive and the implied growth expectations have de-rated a lot. But on an absolute basis, like, equities are expensive. And in particular, there has been this leadership this year but really in the last cycle of growth stocks. And growth stocks are quite expensive relative to the rest of the market, and they've also become much more long duration. So that means is essentially that investors are paying for cash flows that are further out in the future. And in other words, the lower the dividend yield, the less cash flow you get right now, the more cash flows in the future.

The problem with that is that you become much more sensitive to disappointments, and you become more sensitive to changes in the equity risk premium and equities can become much more volatile and much more risky. So moving closer to the zero lower bound, equities get more attractive from a yield point of view, but they're also getting more risky. And we find this is particularly the case in the US because there you had particularly a strong concentration in leadership by growth stocks, and that makes them more vulnerable from here if you do get volatility in rates. As you were mentioning, you had of course the development of the vaccine, and rates were moving up. And that really weighed on the US equity market.

But generally also volatility on growth can drive more equity volatility as well.

Liz Bowyer: So Christian, given all of this, how should investors be thinking about asset allocation?

Christian Mueller-Glissmann: Yeah, I mean, as I mentioned, the embedded growth expectations are relatively conservative. We find that what return potential bonds can give you from here is quite limited. So at the margin, we are leaning towards equities already. Like, the equity risk premium is high, and we want to kind of be a bit more exposed to equities.

On top of that, you have to consider the outlook we have with regards to the global economy going into next year. So we do expect growth to continue to recover from the COVID-19 shock. At the same time, inflationary pressures and rates volatility should remain relatively limited. And as a result of that, you have a pretty good runway for equities. And we would argue that there's a good time to be overweight equities in at least the next year.

Liz Bowyer: And finally, if investors do decide to own more equities, how should they manage the incremental risk?

Christian Mueller-Glissmann: Yeah, I think one of the big problems as you're at the zero lower bound is of course that bonds cannot buffer equities anymore. So if you construct a portfolio, there is less assets that diversify equity risk. So what we find is that it's better to look at sources of diversification within equities. And as you can guess from what I mentioned earlier and what we find to be the more risky parts is currently the growth stocks.

The growth stocks are not only expensive on an absolute basis, but they're also sensitive to higher rates. And at the margin, they're also sensitive to specific regulatory and taxation risks. So we feel at the margin it's better to think about international diversification and style diversification. So maybe a bit less US equity where you have a concentration on growth stocks. Maybe a bit more international equity where the duration and lower. But also with regards to sectors and styles, we think there's a lot of potential for diversification across sectors that are maybe a bit more cyclical, a bit more value, and mixing them with the kind of big out performers we had this year, which are more growth.

Liz Bowyer: Thanks, Christian.

Christian Mueller-Glissmann: Thanks a lot, Liz.

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