ClearBridge Investments

The Discount Rate Paces the Market Race

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Key Takeaways

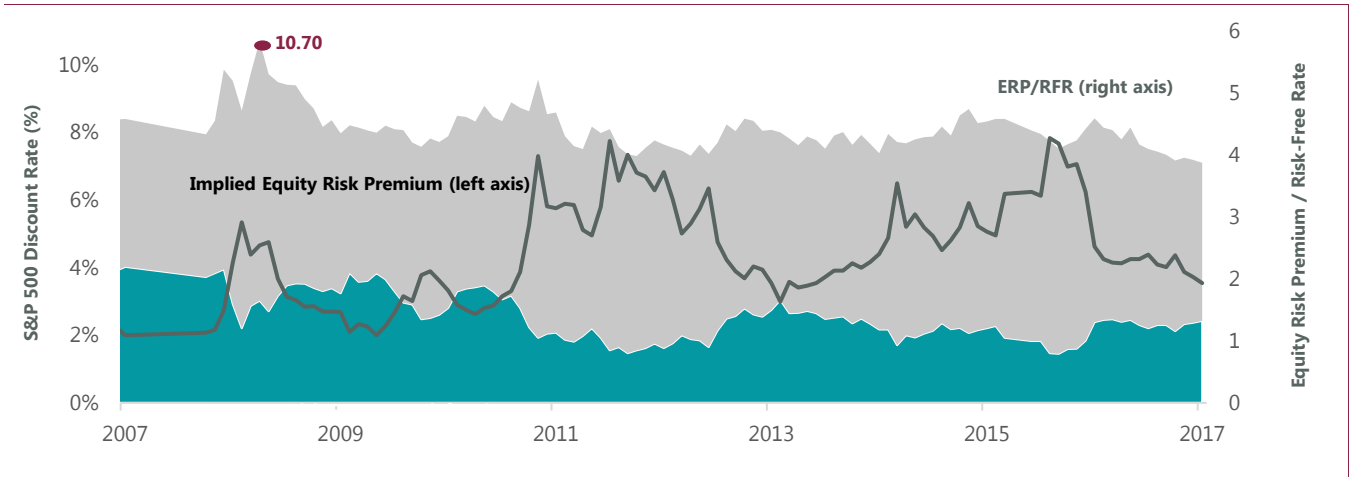
- Economic growth and rising investor confidence are changing the race from a reluctant value-harvesting jog to a momentum-driven sprint.
- Swings in the discount rate directly change a stock's valuation multiple, and multiplier changes can overwhelm changes in fundamentals.
- The longer-term absolute risk from shrunken risk premiums and mounting liquidity risk may outweigh the near-term relative risk from a momentum sprint.

Shrunken Risk Premiums Pose Longer-Term Risks

Market cycles, including the current one as it begins its tenth year, are very similar to endurance races. Investors must understand the crucial role of time and the dynamic nature of the markets, as asset prices arc wildly between exhaustion, as in 2008, slight exhaustion, as in early 2016, and then powerful sprints like what we witnessed in 2017. From year to year, the pace of financial markets is set primarily by changes in the discount rate, which is used to discount earnings and cash flows to value a financial asset. A lower discount rate suggests less systematic stress: there is ample market liquidity and a willingness to pay more for assets. For equities, the growth in earnings and cash flows also plays a major role in driving changes in price and value. However, swings in the discount rate directly change a stock's valuation multiple, and multiplier changes can overwhelm changes in fundamentals.

To measure changes in the discount rate we break its components into a risk-free rate (RFR), the 10-year Treasury yield, and an equity risk premium (ERP). Combining the RFR and ERP provides an estimated total return expectation. Exhibit 1 below shows the RFR in blue and the ERP in grey during this market cycle.

Exhibit 1: S&P 500 Discount Rate (Equity Risk Premium + Risk Free Rate) 2008–2017



Equity Risk Premium: excess return above the risk-free rate that compensates investors for taking on the relatively higher risk of investing in equities. Data calculates implied equity risk premium by using trailing-12-month cash flow for the S&P 500 Index. Treasury rate used is the constant-maturity U.S. 10-year bond including coupon and price appreciation. Source: Aswath Damodoran: http://pages.stern.nyu.edu/~adamodar, ClearBridge Investments.

Not surprisingly, during the intense fear of the Great Financial Crisis in late 2008, the overall discount rate peaked at 10.7%. At this intense level of fear, the combined stressors of massive price volatility and negative price momentum kept most people clinging to risk-free assets. The central banks explicitly wanted to get people back in the market, so began their programs of quantitative easing. Through direct asset purchases they provided massive and much-needed liquidity to markets, as the discount rate declined all the way to roughly 7.5% by the end of 2017. This change in discount rate alone boosted asset prices by over 40%. A policy of monetary doping worked.

One other critical observation from the chart is the ratio between the ERP and the RFR, as measured by the dark grey line. There were two historic peaks in this ratio: in late 2011, during the euro crisis, and during the energy-related stress of early 2016, as the RFR plummeted to record lows and risk premiums spiked. Essentially, central banks got people back in the market, but investors were reluctant, and had a natural inclination to get out at the first sign of trouble.

Things started to change materially in 2017. Whether the market drives the economy or the economy drives the market, economic growth and rising investor confidence are changing the pace of the market from a slow, reluctant value-harvesting jog to a momentum-driven sprint. In 2017, the strongest sprinter of all was the index itself, which had almost a perfect race year. Not only did the index gain almost 22%, but it also generated a positive return every month and maintained record low volatility, with 95% of trading days experiencing less than a 1% price move. This level of return and low volatility perfection is an historic aberration. Nevertheless, a great fundamental backdrop has emerged, with synchronized global growth, S&P 500 earnings growth in the double digits and no increase in inflation. From a discount rate perspective, the ERP declined over 10%, and despite better economic growth the RFR also declined over 2%. The result was a return year bolstered by all three critical drivers: lower risk premiums, lower interest rates and healthy growth.

The challenge and opportunity for investors, however, is that the market is the ultimate test of endurance, as this is a race with no defined finish line, which keeps things interesting by continually rotating winners and losers. What we do have are market cycles that arc between fear and greed. Despite investors' great initial reluctance, optimism is now flowing. Market cycles inevitably end with too much optimism and the central banks taking away stimulants. This cycle will be no different, despite its early anchoring on deep pessimism, and the question for 2018 is will we start to run too hot and fast?

About the Author

Sam Peters, CFA
Managing Director, Portfolio Manager

- 24 years of investment industry experience
- Joined ClearBridge, LLC (f/k/a Legg Mason Capital Management, LLC) in 2005
- Member of the CFA Institute
- MBA from the University of Chicago
- BA in Economics from the College of William & Mary