Markets

Stocks Are the Default Choice In a World of Bad Options

Investors are opting to hold equities, not because they're attractive, but because everything else is much less attractive.

By Aaron Brown
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The bulls are in charge on Wall Street. *Photographer: Timothy A. Clary/AFP via Getty Images*

At the bottom of the stock market crash three months ago, I wrote:

> There are four big unknowns for investors. First, how long and deep will be the reduction in economic activity from social isolation? Second, how much money will the government spend during that period, and how will it deal with the increased debt afterwards? Third, what will be the long-term public health impact? Fourth, what permanent changes will result?

Even though the S&P 500 Index just had one of its best quarters ever, surging some 20%, the questions remain relevant today. But we have a lot more information about the answers.

I used S&P 500 dividend futures to answer the first question, and concluded the market expected a 20% decline in real activity bottoming in July 2020, followed by faster growth to catch up with pre-virus predictions by the end of 2022. That led me to dismiss diminished payouts as a major worry for stock investors since the present value loss from the missing dividends was less than 3% of stock market value.

Things look quite different today. Dividend futures now suggest a 30% decline in cash flows for members of the S&P 500, with little growth for seven years. Not until after 2027 will cash flows start to expand at the predicted pre-virus rates. Nevertheless, the S&P 500 is up 34% from the March low.

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There are three possible explanations for the divergence between expected dividends and stock prices. First is that investors expect companies to generate good profits, but to use those earnings for reinvestment, cash hoarding, debt reduction and share buybacks, rather than for dividends. Second is that investors expect an exceptional period of growth more than 10 years in the future. Third is that stock investors have decided to accept lower long-term expected returns than they demanded either pre-virus or at the market lows.

The first is probably true to some extent, but nowhere near enough to explain the data. The second is implausible. Therefore, I think the third explains the increase in stock prices while dividend expectations fall.

If dividend futures are accurate, the loss of economic activity due to the virus is pulling stock prices down 15% rather than 3%, and uncertainty about activity is a major risk factor. I don't

think lockdowns or isolation can explain seven years of flat dividends, the culprits are more likely to be long-term disruption of supply chains, reduced global trade, less efficient companies with remote workers, political instability and macroeconomic fallout from crisis spending.

This can also explain why investors are willing to accept lower expected returns from stocks. Yields on other investments have fallen, and the government has taken much of the risk out of stocks with its willingness to support troubled companies. In other words, if the entire economy slows, there are few good investments.

For the second question, current projections indicate that the federal budget deficit will be $5 trillion wider than had been predicted before the pandemic, due to additional spending and reduced revenues in 2020 and 2021. State and local budget shortfalls will add to fiscal stress. It's unclear if deficits will lead to faster consumer inflation, asset price inflation, tax increases, spending cuts, debt problems or all or none of those, but this remains a major uncertainty for investors. It explains the appeal of stocks. Even at reduced expected returns and high volatility, the ability of stocks to recapture most inflation and prosper when nominal assets, real assets and governments are struggling, can make them seem like a haven.

For the third question, the long-term public health impact seems to be on the low end of March fears. Although reported cases have spiked, we're not seeing proportional increases in deaths. The new documented cases are younger and healthier than earlier groups, and treatments have improved. We've had good news on both treatment and vaccine progress (although bad news on how much immunity infection conveys). We're transitioning from emergency measures that could never have been maintained for the long term to effective public mitigation consistent with more or less normal lives. The virus does not seem likely to make a significant permanent change to life expectancy.

On the fourth question, the permanent economic changes now appear larger than they did three months ago. One measure of that is the 25% drop in value stocks relative to growth stocks, with no recovery as the market rebounded. The market is giving less weight to earnings and book value, presumably on the grounds that many pre-virus sources of profit are no longer valuable. Investors are instead betting on companies that are investing for future profits, better tailored to the new world.

In March, people wondered, "How long until things get back to normal?" But over the last three months, people have begun to forget what they used to consider normal, and ask, "How do I want to live in the future?" This is a cultural shift that was triggered by the virus, but not caused by it, and the biggest changes are likely to have no direct connection to the virus.

Investors seem to have opted to hold stocks, not because they're attractive, but because everything else is much less attractive. That makes sense to me–and I have been buying stocks since the end of March–but it's important to consider that returns are projected to be much lower than historical averages.

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