The Corporate Juggernaut

December 8, 2020

As growth equity investors, we are continually challenged to discover investment opportunities where the outlook for growth is above the average growth rate for other equity securities. The landscape for growth can shift quickly as we discovered with the impact of the Coronavirus on the stock market. Suddenly there were winners and losers, and many investors took to the sidelines in the face of the plunge in March of this year. One unexpected divergence was the performance of growth stocks vs. value stocks. The usually safe low P/E, high dividend paying stocks came under severe selling pressure as expectations for the earnings of many of these companies collapsed. The energy sector was particularly hard hit as oil prices collapsed due to the decline in the global economy. Companies across the board reacted as expected by tightening up their balance sheets and shedding costs wherever possible. Corporate managements were intent on staying liquid at a time when no one knew the extent of the virus or the time it would take to discover and implement a vaccine.

The stock market is a good discounter of the future. After the market bottom was reached in March, the rally was “V” shaped with growth stocks leading the charge. During the fourth quarter, major stock market averages achieved record highs even in the face of a resurgence in cases of the virus. Even those sectors of the market that were unpopular rallied strongly with the energy sector leading the way last week.

One important factor contributing to investors’ optimism is a surge in corporate wealth. According to a recent article in the Wall Street Journal, “U.S. companies are sitting on the largest pile of cash ever.” At the end of June, the total amount of corporate cash was $2.1 trillion. The prior peak was $2 trillion in 2017. This improvement in corporate balance sheets is not confined to the U.S., similar increases occurred around the world.

For investors looking out to expected market returns in 2021, growth in earnings may not be the key factor driving stock prices higher. Some of the surplus of corporate cash should be put to good use. Investors expect more mergers and acquisitions, decisions that are likely to drive selected stocks higher. When one company buys one or more companies, investors scour similar companies that could become acquisition targets. Some companies may decide to buy back stock, reducing shares outstanding and pushing earnings higher. Other expected uses of that cash hoard are capital projects and hiring more employees as the recovery picks up steam. If there is another fiscal stimulus program that adds cash to the economy, then corporate cash could continue to increase.

For pessimists who are citing the rise in P/E ratios as the rationale for not buying stocks, a P/E is only one measure of corporate value. Financial strength through a strong balance sheet is another. As the government begins distributing the Coronavirus vaccine in the coming weeks, we expect to see a continuing improvement in economic activity and a stock market rally into next year.

We remain committed to a diversified growth equity strategy for long-term growth and are seeing more and more market forecasters expecting a robust increase in stock prices in 2021.