Secular Over Cyclical Growth

Greg Woodhams, CFA
Co-Chief Investment Officer
Global Growth Equity

"Where do you go for sustainable corporate earnings growth? It seems to us the answer is to buy secular growers."

Growth-oriented stocks have performed very well of late, leading to questions from clients about the sustainability of the growth rally and a flurry of articles about whether or not we are experiencing a growth stock bubble. In this edition of CIO Insights, we argue that there are some broader secular economic and company-specific conditions that might justify growth's outperformance and suggest why these stocks might remain attractive over the medium term.

GROWTH IN CONTEXT

Investing isn't something you do in isolation, it's a series of choices you make in relation to a range of competing investment opportunities. So, when someone asks if growth is expensive or attractive, you have to ask, relative to what? Here we want to talk about the availability of corporate earnings and revenue growth in the marketplace and contrast secular and cyclical growers.

First, many growth stocks are experiencing secular increases in revenues and earnings—as opposed to cyclical growth, which is dependent upon the broader economy. Examples are abundant in the tech space, where shifts toward artificial intelligence, big data, software as a service, and mobile computing, among many others, are powerful trends transforming large parts of the economy independent of the rate of broader gross domestic product (GDP1) growth.

Second, growth-oriented stocks tend to do best when earnings and revenue growth are comparatively scarce in the broader economy. The flipside of point two is this—growth tends to underperform when revenue and earnings growth are abundant and when there is a large reservoir of untapped earnings power in companies whose earnings ebb and flow with the economy.

COMPELLING GROWTH FROM SECULAR, NOT CYCLICAL, STOCKS

The U.S. economy is eight years into a period of economic expansion, with many cyclical companies realizing profit margins typically characteristic of the mid-point in the cycle. As a result, we don't see that there is a deep reservoir of cyclically driven earnings growth yet to be tapped. Were we in the early stages of an economic recovery, we'd feel different. At present, we're approaching 100 months of economic expansion, making this one of the longest growth cycles going all the way back to the 1850s. How much gas is left in the cyclical growth tank?

Next, consider headwinds facing certain segments or areas of the economy which have historically provided sources of sustained earnings growth. Specifically, we see deflationary trends in place in the energy, materials, and retail sectors.

For example, in energy, the shale oil and gas revolution in the U.S. has completely remade energy markets, rendering finding and development costs as the most critical factor in energy. Many commodity markets are similarly beset with issues of oversupply or costs of production that limit profitability absent a strong new commodity price cycle. These are important and unique considerations relevant to the current situation—robust earnings growth is difficult to sustain during periods of commodity price deflation. Retail is another area where the ease of internet shopping and the "Amazon effect" are spreading to groceries, automotive parts, traditional malls, and retailers. All are having to adjust to declining revenues and margins and increasing competition.

Given those conditions, where do you go for sustainable corporate earnings growth? We believe the earnings growth advantage lies with companies with secular growth, i.e., those that are able to grow earnings independent of the economic cycle, independent of areas of the market subject to deflationary conditions, as well as in areas of the market where growth tends to be concentrated, demonstrable, and sustainable.

[1] A measure of the total economic output in goods and services for an economy.

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