ARE EQUITY INVESTORS OPTIMISTIC OR PESSIMISTIC?

by **Robert F. DeLucia, CFA**
Consulting Economist

The key point is that the strong rebound in the S&P 500 from its March 23 low is very misleading and deceptive, in my judgment. The powerful rally in the S&P 500 is a sign of weakness — rather than strength — as investors pile into a relatively small group of stocks perceived as safe and invulnerable, while avoiding stocks in cyclically sensitive sectors. In effect, the leading mega-cap growth stocks in the S&P 500 have become a refuge for US equity investors, in a manner similar to US Treasury securities being a safe haven for global investors.

Summary and Major Conclusions:

- The most commonly asked question by investors and the media in recent weeks has been "Why is the stock market rising at a time when the economy is in a deep recession?" The common reference for the stock market is the S&P 500 Index and its spectacular recovery to within 10% of its previous all-time high.

- This is a nuanced and complex issue and worthy of deeper analysis. The first issue is the fundamental relationship between the stock market and the economy. Investors should understand that, in principle, the stock market predicts the economy. The question posed by the media implies that the economy predicts the stock market.

- The equity market is the quintessential leading economic indicator. Stock prices have an excellent track record of signaling both recessions and economic expansions with a lead time of several months.

- The second issue is the benchmark used for this analysis — the S&P 500. While it is the most closely watched index for professional investors, the S&P 500 has a unique composition, based upon the capitalization-weighting of its 500 constituents. Capitalization-weighted indexes are susceptible to various distortions.

- Because of its composition, the S&P 500 should be viewed as a large-capitalization growth stock index. Three of the most heavily weighted sectors within the index — health care, technology, and consumer staples — consist of traditional growth stocks, representing nearly 50% of the overall index.

- The five largest constituent stocks in the index comprise nearly 20% of the total market cap, while the 50 largest stocks comprise nearly 50%. This means that a mere 10% of individual stocks have an equivalent impact on changes in the S&P 500 as the other 90% combined.

- *The key point is that a very small number of stocks within the S&P 500 have the potential to greatly influence its direction*. Stated differently, general perceptions of actual stock market behavior can vary significantly depending upon the index used.

- One way to eliminate this bias is to calculate rates of return for equal-weighted stock indexes, such as the S&P 500 Equal Weight Index (EWI) and the Value Line Index. The year-to-date decline in each of these indexes is more than double that of the traditional S&P 500.

- In my judgment, rather than reflecting investor optimism as is commonly believed, the "surprising strength" of the S&P 500 reflects investor risk aversion, fear, and caution as investors crowd into those stocks perceived as safe and defensive. Portfolio concentration in these darlings of the market is reminiscent of the technology bubble in 1999 and the "nifty fifty" craze in 1972.

- Consistent with this evidence of fear and risk aversion is the avoidance of sectors and individual stocks with large cyclical exposure, including financials, industrials, and transportation stocks. Small-capitalization and international stocks have also been shunned.

- Virtually all measures of consumer sentiment are depressed. The most recent Bank of America survey of institutional investors revealed that fully 68% of participants believe that the recovery in stock prices is merely a "bear market rally."

- The most compelling indicator of investor sentiment is derived from data showing portfolio cash flows, which currently reflect unambiguous investor caution and risk aversion. Record amounts have flowed out of equity mutual funds and into money market and government bond funds.

- There is currently an unprecedented mountain of cash on the sidelines earning next to nothing. In addition to government bonds and money market funds, commercial bank deposits have increased from $12 trillion to $14 trillion in less than three months. Private equity funds have more than $2 trillion in cash reserves.

- Broad data for exchange-traded funds (ETFs) also reveal a sense of fear and pessimism among equity investors. There has been a stampede into sector funds perceived as safe — such as technology, health care, and consumer staples — and massive outflows from cyclically sensitive ETFs.

- A shift in leadership will occur when there is convincing evidence of a decline in economic risk. Value stocks will begin to outperform growth stocks on a sustained basis when economic data begin to signal a sustained economic recovery. Virtually all new bull markets dating back to 1960 were led by value stock groups.

- Classic signs of improving investor sentiment include a sustained rise in government bond yields; a steepening of the Treasury yield curve; a compression in credit spreads; rising commodity prices and a falling US dollar; and most importantly, a shift in relative equity market performance in favor of value stocks.

"Tellingly, though, the recent rise in share prices has been uneven. Even before the pandemic, the market was lopsided. And it has become more so. In America, investors have put even more faith in a tiny group of tech darlings — Alphabet, Amazon, Apple, Facebook, and Microsoft — which now make up a fifth of the S&P 500 Index. There is little euphoria, just a despairing reach for the handful of businesses judged to be all-weather survivors."

The Economist
May 9, 2020

This week's *Economic Perspective* addresses questions regarding the underlying health and strength of the US equity market. My conclusion is that headline stock market trends are misleading by suggesting that equity investors are optimistic, when in fact the overwhelming flow of stock market data point to a very cautious and risk-averse mentality.

EVERYONE IS ASKING WHY THE STOCK MARKET HAS BEEN SO STRONG IN THE FACE OF WEAK ECONOMIC DATA. WHAT IS YOUR RESPONSE?

To begin with, this is the wrong question, in my judgment. The question implies that the economy predicts the stock market when in principle, the stock market predicts the economy. The stock market is the quintessential leading indicator and has consistently "predicted" recessions and economic recoveries with a lead time of several months. Under normal circumstances, the stock market discounts economic conditions three to six months in advance, often looking beyond current economic news.

HOW CAN STOCK PRICES RISE WHEN GDP AND UNEMPLOYMENT ARE SO WEAK?

The decline in GDP was self-induced as a necessary step to save lives, and should be temporary. The economy hit rock bottom in April. Second quarter GDP will be released in late July and could show a decline of 10% from the first quarter, or 40% on a seasonally adjusted annual rate. Most economists expect GDP to expand in Q3 and Q4, and during all of 2021. *The current recession is likely to be the deepest — but also the briefest — in US history*.

The surge in unemployment is tragic in human terms. However, it should be remembered that the unemployment rate is a ***lagging indicator***. *The fact is that stock prices and the unemployment rate are inversely correlated*. Economic history since 1950 is very clear: The equity market performs best during periods of high and falling unemployment, and performs less well during periods of low and stable unemployment. The unemployment rate should peak in May at close to 20% and begin a long decline that could extend for many years.

DO YOU BELIEVE THAT THE EQUITY MARKET IS AHEAD OF ITSELF?

There are two problems with this question: First, forecasting the stock market is tantamount to speculation. It has been proven that it is not humanly possible to predict the direction of stock prices. Second, the observed behavior of "the stock market" is very much dependent upon the specific index used in the analysis.

COULD YOU ELABORATE ON THAT SECOND POINT?

The various stock market benchmarks both in the US and globally are highly inconsistent with each other. There are wide divergences between large-cap and small-cap indexes, domestic and global indexes, and capitalization-weighted and equal-weighted indexes. There is also an enormous divergence between growth- and value-stock indexes.

Because of its unique composition, the S&P 500 Index should be viewed fundamentally as a ***large-capitalization growth stock index***. Three of the largest sectors within the overall index — technology, health care, and consumer staples — are comprised of traditional growth stocks, representing nearly 50% of the overall index. The five largest constituent stocks in the index comprise nearly 20% of the total market cap, while the 50 largest stocks comprise nearly 50% of the total index. *This means that a mere 10% of individual stocks have an impact on the direction of the S&P 500 equivalent to the remaining 450 individual stocks in the index, or 90% of stocks combined*.

The key point is that a very small number of stocks within the S&P 500 have the potential to greatly influence its direction. Stated differently, general perceptions of actual stock market behavior can vary significantly depending upon the index used. One way to eliminate this bias is to calculate rates of return for equal-weighted stock indexes, such as the S&P 500 Equal Weight Index (EWI) and the Value Line Index.

WHAT DOES THIS STATISTICAL EXERCISE REVEAL?

The year-to-date decline in each of these indexes is more than double that of the traditional S&P 500, which means that the year-to-date *relative performance* data are staggering. While the S&P 500 has declined by a modest 5% since yearend, the equal-weighted S&P 500 has declined by 11%. The equal-weighted Value Line Index of 1700 stocks has declined by nearly 20%, while international stocks have declined by 15%. Meanwhile, the Russell 1000 Growth Stock Index has a ***positive*** return of nearly 5%, and the NASDAQ 100 has ***risen*** by nearly **10%.**

WHAT IS THE MESSAGE FROM THE VARIOUS STOCK INDEXES?

Recent "strength" in the US equity market is misleading because its advance since March has been extremely selective and concentrated. *In its broadest form, the equity market is signaling a high degree of investor uncertainty, and therefore highly risk-averse and defensive portfolio strategies*. The S&P 500 has demonstrated considerable resilience since its March 23 bottom, but only because of the extraordinary leadership of a small group of mega-cap growth stocks. A close analysis of the broader market reveals heightened fear and caution among equity investors.

The central conclusion of my analysis is that investors are not optimistic, but rather highly pessimistic. If one closely examines the behavior of financial markets, broad measures of portfolio asset allocations, mutual market flows, and surveys of investor sentiment, it becomes clear that investors are highly cautious and risk averse and have implemented an extremely defensive investment posture.

Chart 1: Massive Exodus From Equity Value Funds
Total Assets in Value-Style Equity Funds ($ Thousands)
Source: Investment Company Institute

Chart 2: Large Redemptions of High-Yield Corporate Bond Funds
Total Assets High-Yield Corporate Bond Funds ($ Millions)
Source: Investment Company Institute

WHAT DATA WOULD YOU CITE TO SUPPORT YOUR CONCLUSION?

Within the equity market, investors have practiced extreme selectivity, concentrating on those sectors and individual stocks deemed safest. Mutual fund data show that retail investors have been exiting domestic equity funds at an unprecedented pace, especially value stock funds (see chart 1). There has also been a mass exodus out of speculative-grade corporate bond mutual funds (see chart 2).

From a historical perspective, the current concentration into a relatively select group of market darlings is reminiscent of the “nifty fifty” craze in the early 1970s and the technology/internet bubble in the late 1990s. Each of these episodes ended very badly for the individual bubble equities that were favored at the time. Looking beyond the equity market, *the unprecedented mountain of cash on the sidelines earning next to nothing* should also be an unambiguous sign of investor fear and pessimism.

Chart 3: Unprecedented Mountain of Cash on the Sidelines
Money Market Fund Assets ($ Billions)
Source: Investment Company Institute

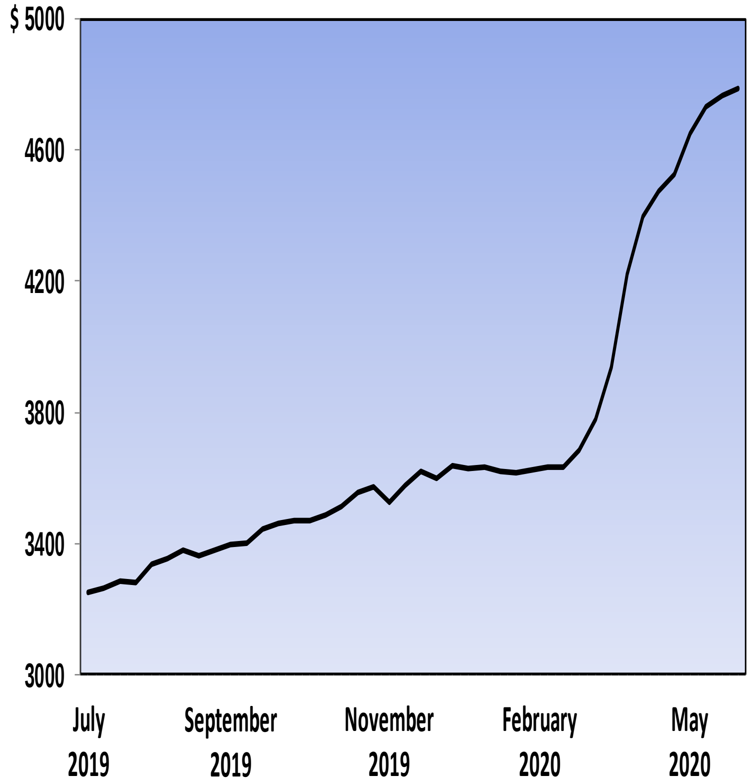
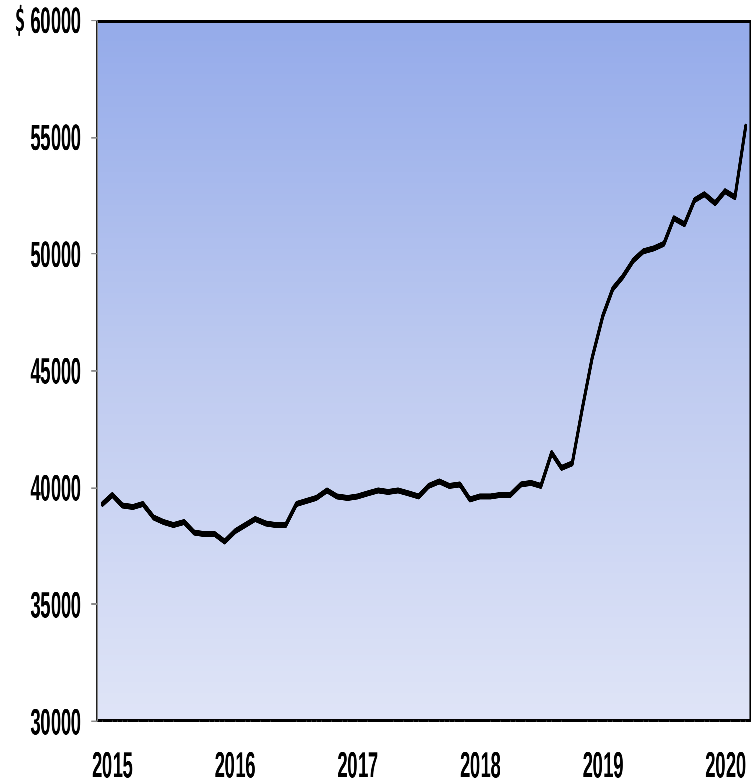


Chart 4: Investor Stampede Into US Government Money Market Funds
Short-Term Government Bond Funds ($ Millions)
Source: Investment Company Institute



COULD YOU QUANTIFY THE LEVEL OF CASH RESERVES?

The surge in investor liquidity since the pandemic is unprecedented. There has been a frantic stampede from equity funds into safe assets of all types:

- Assets in money market funds have jumped from $3.5 trillion at yearend to nearly $5 trillion (see chart 3).
- Assets in short-term government bond funds have jumped to nearly $6 trillion, up from only $4 trillion one year ago (see chart 4).
- Commercial bank deposits have increased from $12 trillion in January to $14 trillion at the end of May (see chart 5).
- Private equity funds have more than $2 trillion in cash reserves

In short, there is a mountain of cash on the sidelines, earning next to zero. From a contrarian point of view, this is very positive for prospective equity market returns (see chart 6).

Chart 5: Sharp Acceleration in Commercial Bank Deposits
Total Deposits US Commercial Banks ($ Millions)
Source: FDIC

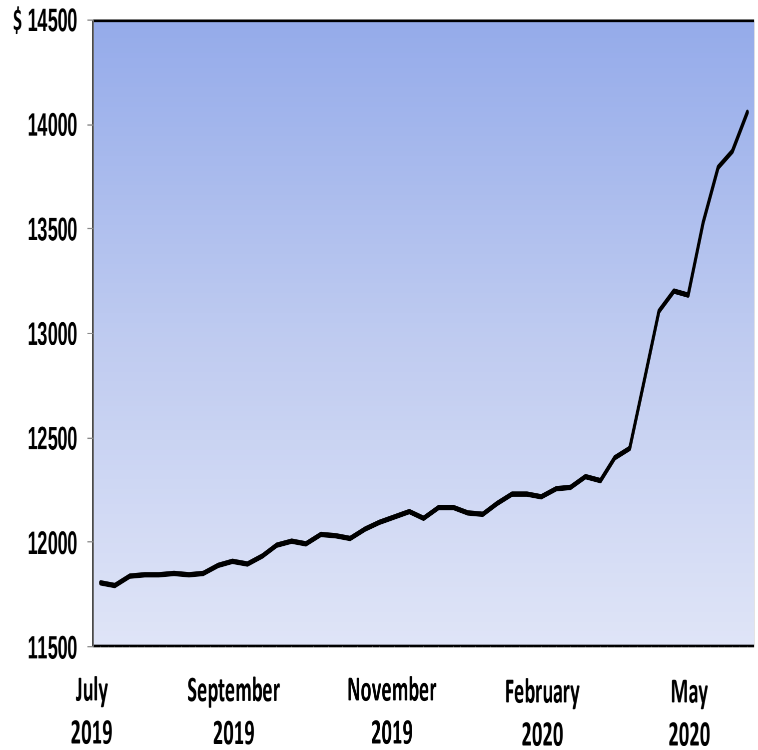
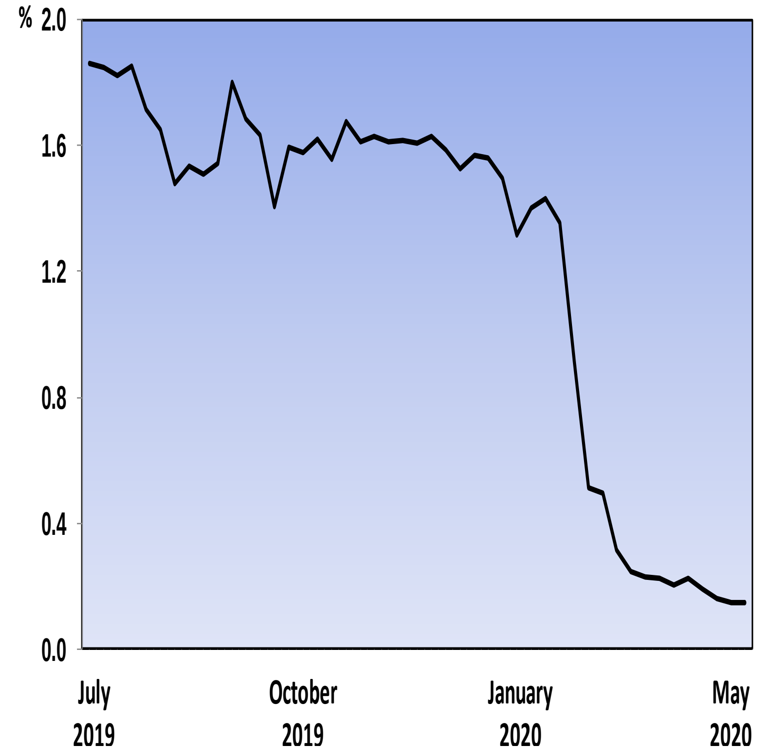


Chart 6: US Treasury Note Market Yields at All-Time Low
Market (%) Yield, Two-Year Treasury Note
Source: Federal Reserve



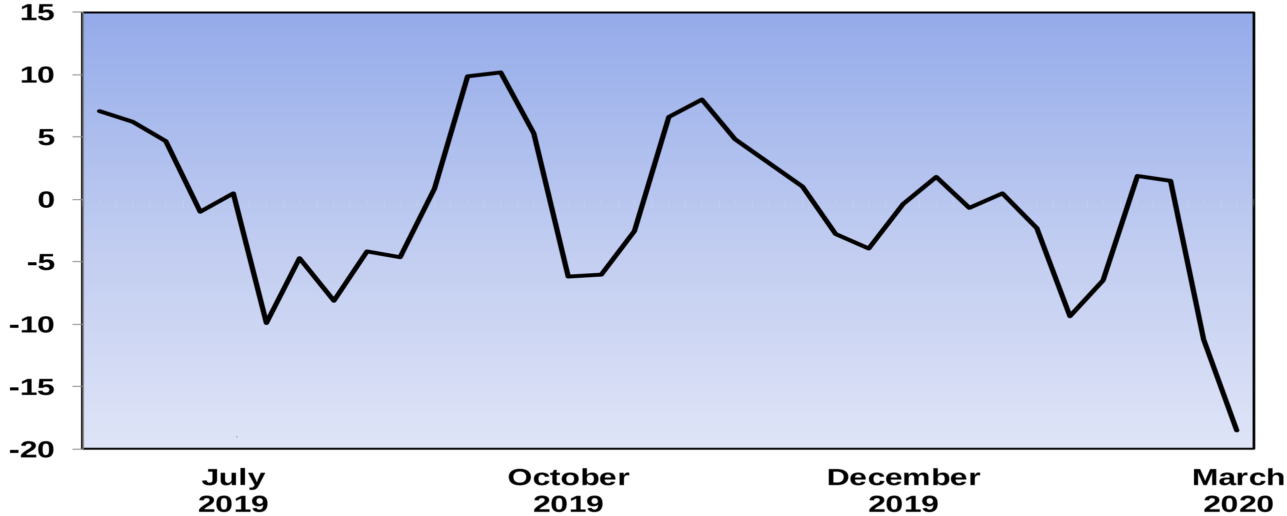
ARE THERE ANY OTHER INDICATORS OF FEAR AND INVESTOR CAUTION?

Yes, evidence of caution can be found in the price of gold, the strength of the US dollar, and a variety of investor surveys. The price of gold has risen by 20% since December of last year to an all-time high. The US dollar (USD) has risen by nearly 10% from yearend, and is also at an all-time high. As a classic countercyclical indicator, the USD tends to rise during periods of economic risk and decline during periods of economic calm.

Finally, virtually all surveys of investor sentiment reflect fear and caution on the part of investors. The most recent Bank of America survey of institutional investors revealed that 68% of managers believe that the equity market is in a "bear market rally," rather than a fresh new cyclical bull market (see chart 7).

The key point is that the strong rebound in the S&P 500 from its March 23 low is very misleading and deceptive, in my judgment. The powerful rally in the S&P 500 is a sign of weakness — rather than strength — as investors pile into a relatively small group of stocks perceived as safe and invulnerable, while avoiding stocks in cyclically sensitive sectors. In effect, the leading mega-cap growth stocks in the S&P 500 have become a refuge for US equity investors, in a manner similar to US Treasury securities being a safe haven for global investors.

Chart 7: Plunge in Investor Sentiment
Index of Investor Confidence, Institutional Investors
Source: Bloomberg



WHEN DO YOU EXPECT THESE MARKET TRENDS TO REVERSE?

A shift in leadership will occur when there is convincing evidence of a decline in economic risk. Value stocks will begin to outperform growth stocks on a sustained basis when economic data begin to signal a healthy and durable economic recovery. *Virtually all new bull markets dating back to 1960 were led by value and economically sensitive stock groups*.

We had a sneak preview of this expected reversal on May 18, when the market rallied on the news that biotech company Moderna's COVID-19 vaccine had shown good progress in early clinical trials. The S&P 500 rose by **3.2%**, but the Russell 1000 Value Index jumped by nearly **5%**, far in excess of the **2.4%** return on the Russell Growth Index.

HOW LONG COULD VALUE OUTPERFORM GROWTH?

Although impossible to predict, we can look to history as a guide. Looking back to periods of value stock outperformance — 1975 to 1979, 1982 to 1984, 1991 to 1994, and 2000 to 2004 — a sustained period of three years or more seems like a reasonable prospect.

It is important to note that value stocks have outperformed growth stocks by a wide margin during these periods of value stock dominance. An extreme example is calendar year 2000: Following the technology/internet bubble in 1999, the growth stock index declined by 22.5% in 2000, pushing the S&P 500 down by 9%. ***The value stock index rose by 8.5% in 2000, resulting in an unprecedented outperformance of value over growth by a staggering 31%***.

The catalyst for a rotation out of growth stocks and into value stocks will be unambiguous signs of a sustained economic recovery. The most telling signal of a shift from investor pessimism to optimism will be a sustained shift in market leadership from growth to value. Another notable sign will be a rise in government bond yields and a steeper yield curve.

News of a medical breakthrough involving a vaccine and/or one or more therapeutics could also trigger a shift in equity market leadership. I continue to expect economically sensitive stocks to outperform the market over the next several years, led by industrials, financials, materials, and the transportation sector.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

S&P 500 Equal Weight Index (EWI) Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Value Line Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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