



SPECIAL REPORT

THE ECONOMIC CYCLE AND MARKET PSYCHOLOGY

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Equity investors are faced with a dilemma: The economic and earnings outlook is favorable but traditional equity market valuation measures are stretched. Because of these two conflicting factors, investing in the equity market is extremely challenging. A major theme in my investment outlook is that rates of return on common stocks should be positive over the next two years but are unlikely to match the increase in company earnings. Equity market returns in both 2019 and 2020 massively outperformed corporate profits; the exact opposite is likely in 2021 and 2022.

The equity market remains on a strong upward path as it continues to reach record highs on a weekly basis. Since its low in late March of last year, the S&P 500 has risen by more than 75%. The economic and policy backdrop is positive and is consistent with rising stock prices. However, the equity market has a short-term valuation problem: Traditional valuation measures suggest that the equity market is overvalued by as much as 15%.

- Equity investors are faced with a dilemma: The economic and earnings outlook is favorable, but traditional equity market valuation measures are stretched. Because of these two conflicting factors, investing in the equity market has become extremely challenging.
- A major theme in my investment outlook is that rates of return on common stocks will be positive over the next two years but are unlikely to keep pace with the increase in company earnings. Equity market returns in 2019 and 2020 massively outperformed corporate profits; the exact opposite is likely in 2021 and 2022.
- I have discussed on numerous occasions that the equity market has consistently led economic recoveries — by an average of three to five months — with a new cyclical bull market beginning during the recession.
- Lead times were far shorter in the current equity market cycle compared with the long-term historical pattern. What is most unique about the current investment cycle is the extent of investor bullishness so early in the economic recovery.
- The outbreak of COVID-19 triggered a plunge in stock prices of nearly 35% in only five weeks. A V-shaped rally quickly followed, driving stock prices to a new all-time peak within **five months**, one of the shortest recovery periods from an outright bear market in stock market history.
- By comparison, the S&P 500 did not return to its Great Recession peak in 2007 until 2012, a period of **five years**. Similarly, the equity bear market that began in 2000 did not return to its pre-recession peak until 2005, a period of more than **six years**.



- The extent of investor confidence is reflected in valuation measures. At its current price, the S&P 500 is valued at a price-to-earnings (P/E) ratio of 23, which is well above the level consistent with the current level of interest rates. The current dividend yield of 1.6% on the S&P 500 is at its lowest level in nearly 20 years.
- My proprietary valuation model is based upon interest rates and inflation. According to this model, the justifiable P/E ratio for the equity market in an environment of 1% government bond yields and 1.5% inflation is 20, suggesting that stocks are overvalued by 15%.
- Historically, the normal trend in investor sentiment has followed a consistent pattern over the course of a traditional business cycle. Cautious and risk-averse during the early phase of an economic recovery, most investors tend to become increasingly more confident and emboldened as an expansion unfolds and economic conditions improve.
- This tendency toward risk assessment can be quantified using historical data: In the early recovery years following the Great Recession, the P/E ratio for the S&P 500 was less than 12; in the final two years of the expansion — 2018 and 2019 — the P/E ratio had risen to greater than 19. A similar pattern is observable in the 1990s equity bull market, when the P/E on the S&P 500 rose from only 13 in the early in the recovery to a record 28 in 1999.
- What explains the current bullishness at a time when economic conditions are extremely fragile? First, virtually all asset classes are overvalued. Speculative excesses are evident in government bonds, corporate bonds, vacation homes, gold and silver, bitcoin, and numerous high-volatility stocks trading purely on hype, including GameStop, AMC Entertainment, Tilray, and Tesla. Market yields on speculative-grade corporate bonds have fallen below **4%** for the first time in history.
- There are several factors contributing to irrational exuberance in asset markets: Excess liquidity created by world central banks; unprecedented fiscal policy stimulus virtually “ensuring” a strong economic recovery; and an exceptionally favorable outlook for company earnings.
- One can also point to several additional explanatory factors: Growing optimism regarding vaccine distribution; a steadily declining trend in new COVID-19 infections; and market euphoria regarding the thrust of monetary policy.

- The Federal Reserve has pledged to maintain an accommodative posture until inflation exceeds 2% for a sustained period and until the economy returns to full employment, estimated at 4.5%. Neither of these preconditions are imminent.
- The key point is that the typical existential threat to an equity bull market — the onset of a new rate-tightening cycle — appears to be well into the future. In the absence of an *imminent* monetary tightening cycle, investors have become highly complacent. Virtually all measures of investor optimism are flashing red, a negative signal from a contrarian perspective.
- Excessive valuation is a necessary but not sufficient cause for a correction or consolidation phase in the short term. What are the possible catalysts? The first would be a massive outbreak of infections in March and April, caused by the highly contagious UK variant B.1.1.7. Another could be disappointment on the vaccine front, either in terms of efficacy or a shortfall in distribution. Still another could be a political setback in negotiations over President Biden's American Rescue Plan.
- The greatest risk for the equity market is an unexpected rise in long-term interest rates. Investors continue to exhibit a high degree of complacency with respect to the government bond market. Bond investors are convinced that the Fed will be successful in keeping bond yields at depressed levels. However, this is a naïve and misguided understanding of bond market behavior.
- Whereas the Federal Reserve has 100% control over *short-term rates*, its ability to control *long-term rates* is limited. Rather, the direction and level of bond yields are determined by investor expectations regarding economic growth, the demand for credit, and inflation.
- The bond market is forward-looking and typically leads changes in Fed policy by many months, as economic conditions change. Medical experts expect the availability of vaccines to escalate during the spring months, at which time economic confidence could improve significantly, leading to lower bond prices, higher bond yields, and a steepening yield curve.
- The key point is that equity investors should be aware of lofty equity valuations and thus be prepared for a brief consolidation phase or interim correction. Long-term investors should maintain above-average weightings in common stocks but should defer new purchases until there is a more attractive entry point. Balanced portfolios should hold a maximum exposure in bonds.



- Beyond the short term, common stocks should generate positive returns this year and throughout most of 2022. The critical assumption in the outlook is that both company earnings and bond yields will be in a rising trend, but that the growth rate in profits will exceed the increase in long-term interest rates, allowing stock prices to move higher.
- I continue to expect a major shift in equity market leadership during 2021, which would favor value stocks over growth stocks. The rotation may have already begun: From a starting point of September 30 extending through February 15, the total return on the Russell 3000 Value Stock Index of 24.7% comfortably outperformed the Russell 3000 Growth Stock Index of 19.5%.



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Russell 3000 Value Index: is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

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