

Market Perspective January 2020

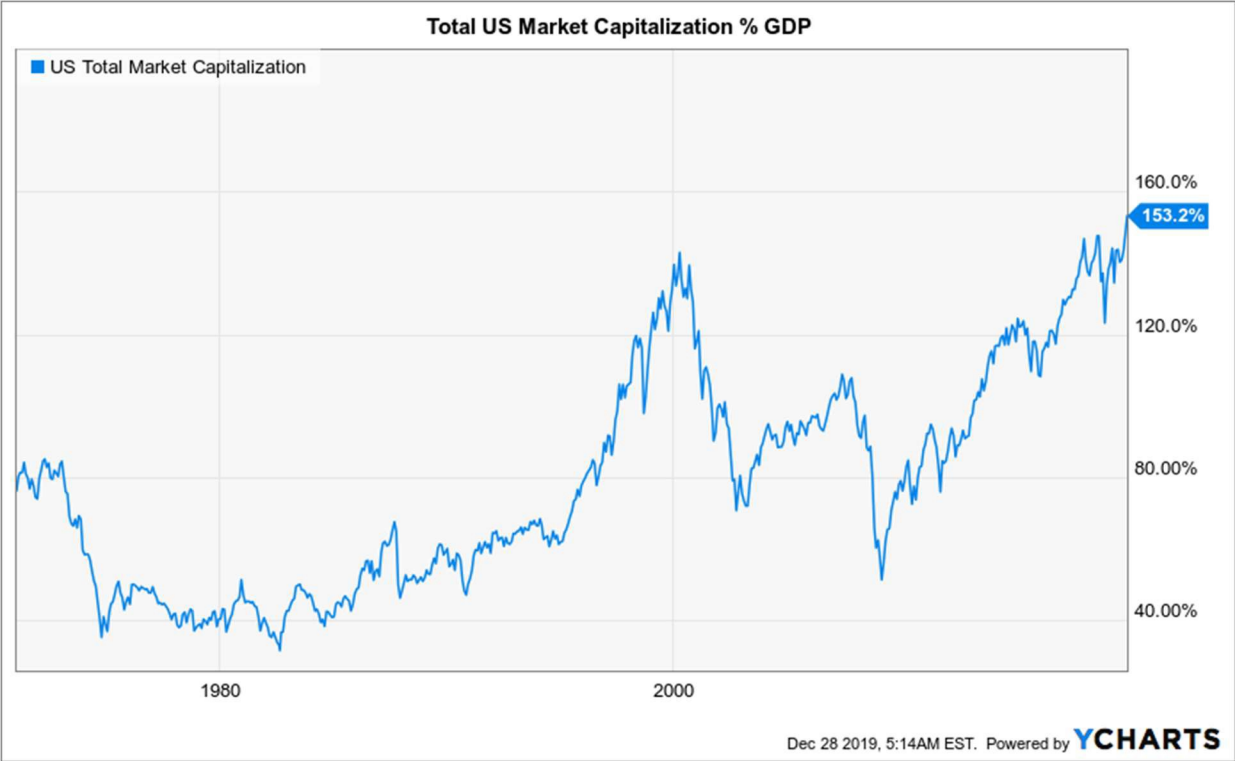
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At the end of the third quarter, I cautioned that risk assets were overvalued in comparison to the economic prospects that laid ahead at that time. I ended that Market Perspective by stating: “Now is not the time to embrace risk assets. Investors should only take on risk judiciously and selectively.” I believed that this mispricing extended to many asset classes.

While I always emphasize that my advice is intended to inform long-term asset allocation, my concerns are only exacerbated by the continued appreciation of risk assets. During the fourth quarter, stocks (as measured by the S&P 500) delivered a total return of an astonishing 9%. At the same time, the risk premium demanded by investors for holding “B” High Yield Bonds declined from 4% to 3.6%, generating a total return to those holding these risky bonds of 9% for the quarter. These returns to risk assets were mirrored in many corners of the capital markets, from real estate “capitalization” rates to multiples paid by private equity for acquiring companies.

The question that faces us as investors is what do we do now? I believe that the valuation of risk assets is even more stretched today than it was then, as compared to historical norms. Of course, there’s always the potential that “this time is different” and that valuations won’t regress to the mean. In other words, we might be able to buy high and sell higher. I would argue that such a strategy isn’t consistent with prudent capital management.

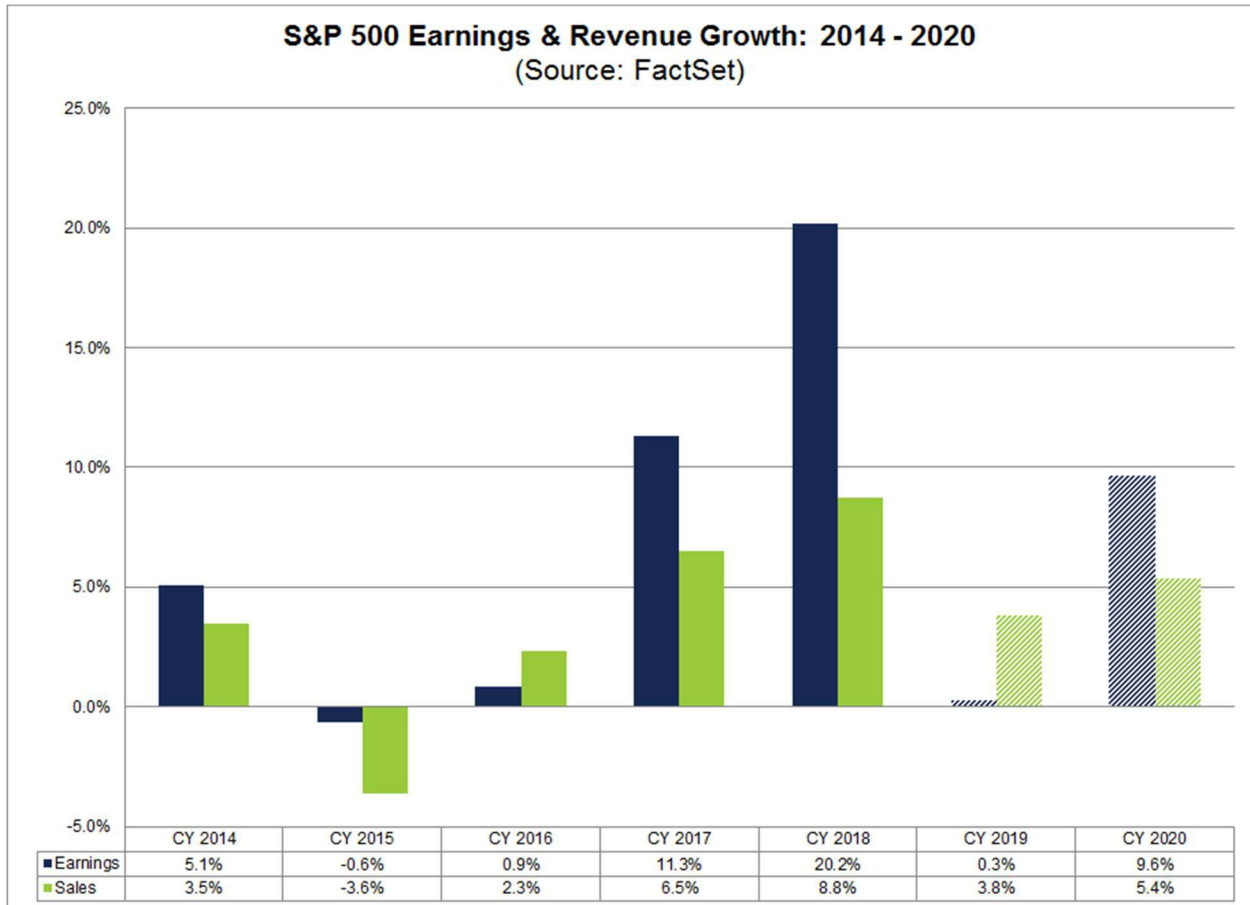
Let’s look at the data. First up are equities. The price the market is valuing a unit of economic output (GDP) continued to increase in the fourth quarter. Note that we closed the quarter with the total US Market Capitalization valued at 153% of GDP. By just about any read of the historical graph, this makes today’s market overvalued by at least 50%. As of year-end, we have now exceeded the level that this measure recorded at the highs of 2000.



Look below to see how much this measure increased in just the last year.



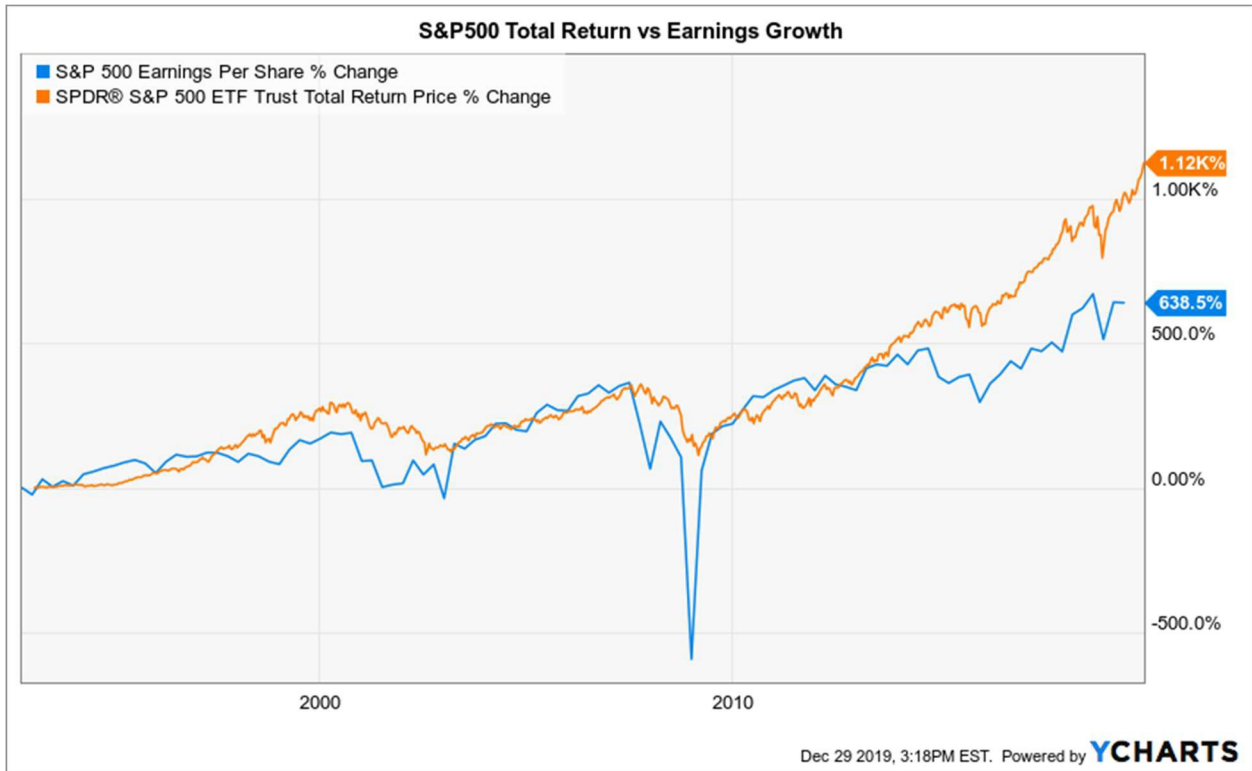
In last quarter’s Market Perspective, I made the point that typically, stock prices increase or decrease with corporate earnings and that analysts weren’t expecting much in earnings growth in 2019. Today, see a chart by FactSet, which tracks S&P 500 earnings growth over the last few years, and shows analysts estimates for the coming year.



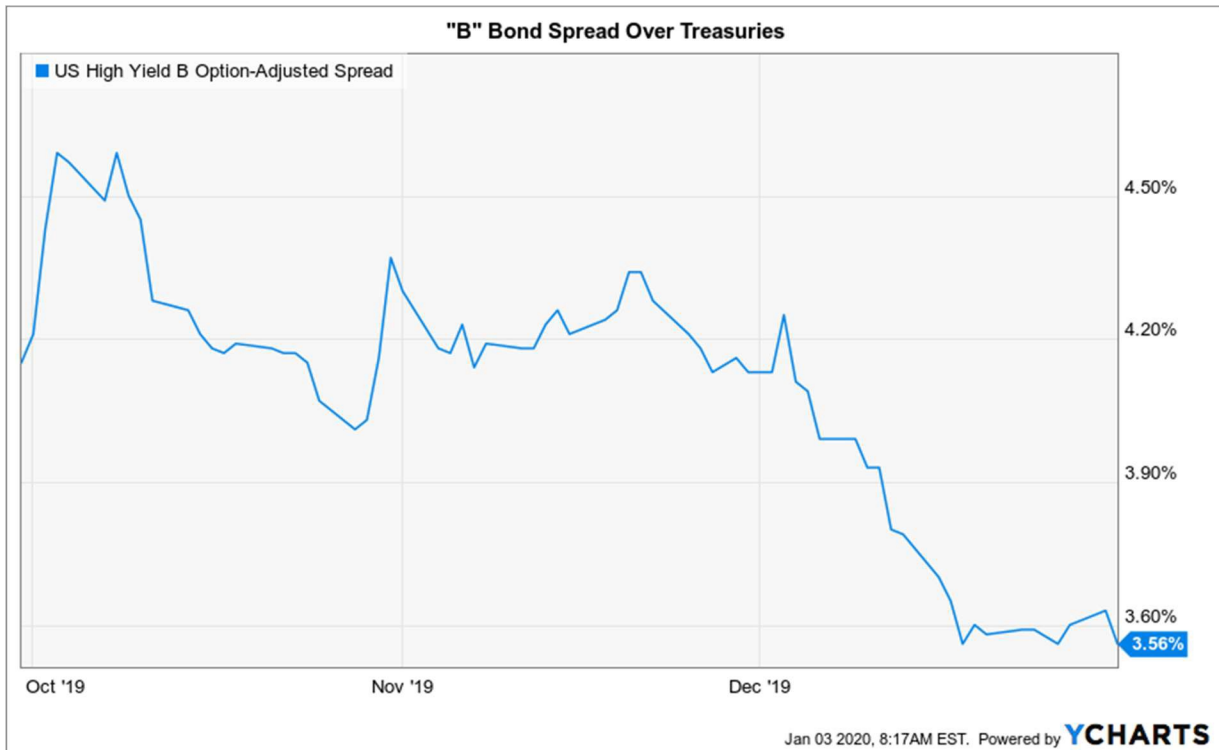
As expected, earnings for 2019 will be essentially flat (up only 0.3%) with 2018. While analysts currently expect a better than 9% increase in 2020, remember that according to FactSet, analysts on average have overestimated the final EPS number by about 10% one year in advance.

Let’s look at this another way. Over a long period, the total market value of corporate America has closely tracked the earnings of the underlying companies. This relationship, however, began to disconnect in 2015. In the graph below, note the divergence beginning halfway through the 2010s. (This is the dynamic that creates above-norm measurements of market P/E ratios.) Will this be a permanent variance? Will earnings accelerate to match equity prices? Or will equity prices come down to be consistent with earnings? This, perhaps more than any other question, will be the determinant of future stock prices. I stand clearly in the “reversion to mean” camp,

though I must acknowledge that the length of this diversion is testing even the steeliest among us.



In other risk markets, the return premium demanded by holders of high yield bonds declined precipitously, ending the quarter at 3.6%, down from 4% at the beginning of the quarter.



Before concluding, I want to introduce two shorter-term metrics to the conversation. The first, the “VIX”, is one I’ve written about before. Often called the fear index, this is a measure of “implied volatility” of S&P 500 index options. In short, this measure captures the degree to which market participants view the future with uncertainty. The VIX closed the year at 12.5, near the low-point in its three decade-long history. This low level is typically associated with complacency – i.e., most investors are not concerned with future volatility.

A similar, but more robust, measure is the CNN Fear & Greed Index. This index tracks seven key indicators of investor sentiment (of which the VIX is one). Note where this indicator stands today, and where it stood twelve months ago, just after the precipitous market declines of last year’s fourth quarter. The implication of this measure is that one wants to invest when fear abounds and rein in risk when greed dominates.

Fear & Greed Index

What emotion is driving the market now?



It’s important to take all these measures in perspective and to juxtapose them against both the horizon and the risk tolerance of the “owners” of the capital. For risk-tolerant investors with the preponderance of their investments deployed in a long-term strategy, perhaps the only takeaway from this Market Perspective is that future returns are highly likely to be less than past returns. After a move like this, it’s always prudent to check allocations against targets. Conversely, for risk averse investors not already invested, this may be a good time to keep some powder dry.

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