Notes From the North: Market Outlook

February, 2021

The Gamestop phenomenon will go into the history books for many reasons, but one very important takeaway is how it will serve as a very concrete example of just how dramatically a stock price can become untethered from its underlying corporate fundamentals. When this happens, it's wise to tread very cautiously. While the issues that keep hitting new highs in today's market are rightly deemed to have great growth potential, the calculation of whether that potential is fully discounted in the stock price appears to be an insignificant consideration. More than a handful of initial public offerings and SPACs (special purpose vehicles) have skyrocketed, creating stock gains based on excitement more than good reason.

In our view, about one-third of large cap stocks are unrealistically priced. This group is causing the traditional methods of gauging valuation for stocks in general to make the overall market appear very overvalued. One could easily conclude that stocks should be avoided altogether. One traditional metric, for instance, is the median price/earnings multiple of the S&P 500 Index member companies. Based on trailing earnings, the median P/E is now above 30x. This is 27% higher than its historical average, more than two standard deviations above "normal." It would be easy to arrive at the alarming conclusion that the market would have to fall by 27% to get back to "normal," but that is an oversimplification. A better conclusion might be that this is not a great time to be fully-invested in the S&P 500 Index, as statistics have proven time and time again that returns in the period following high valuations are disappointing.

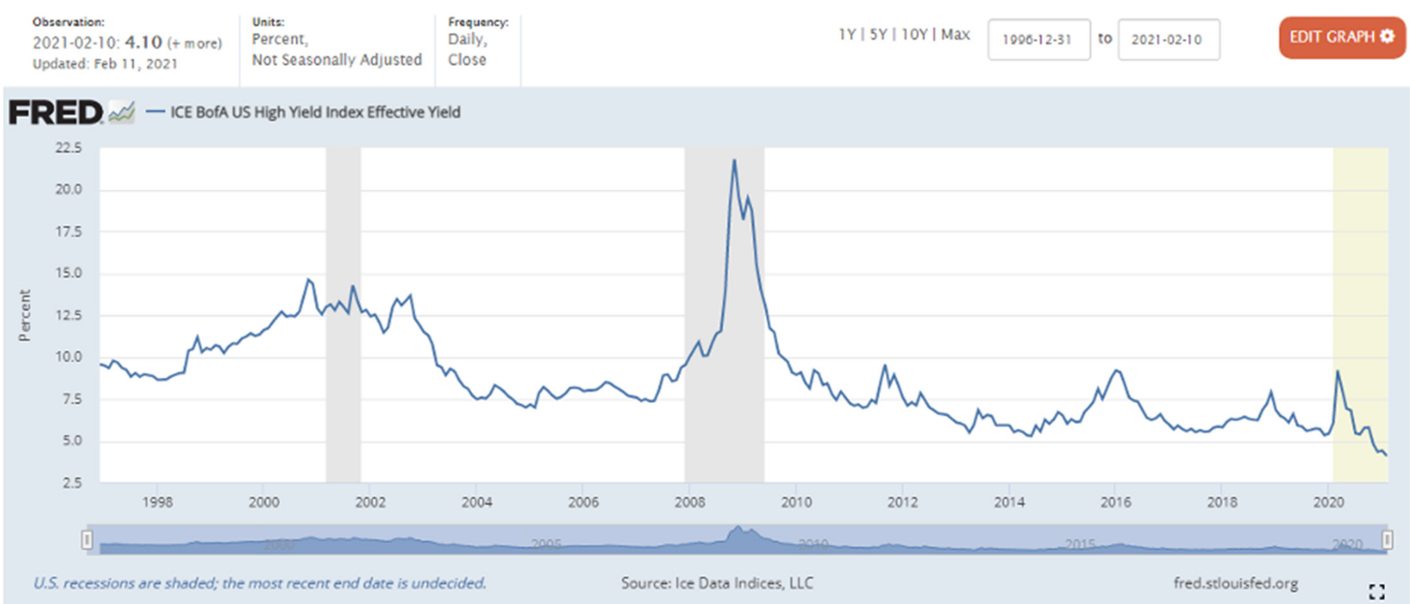
Many small companies, as well as larger companies in Covid-impacted areas such as the travel and hospitality sector, were crippled by Covid-related lockdowns, so trailing earnings are unusually weak. Assuming a general economic recovery, "earnings" may catch up to the "price" before too long. While acknowledging the chorus of voices such as Jeremy Grantham's quite sure that we are in a bubble that is bound to burst spectacularly, we note that strategists at both JP Morgan and BCA are more sanguine. Assuming vaccines work as hoped, GDP growth is expected to be strong in both 2021 and 2022. 79% of companies have thus far beaten fourth quarter earnings expectations, and analysts expect double-digit earnings growth in all four quarters of 2021. Some move towards more normal valuations is certainly to be expected, but a bubble-burst is not a fait accompli.

JP Morgan expects the market to avoid significant trouble until the second half of this year at the earliest. This is the soonest they see that the Federal Reserve might begin to taper its support for the economy and financial markets. The strategy team at BCA holds a similar view, saying that the bull market will end only when the Federal Reserve starts to sound more hawkish. They believe this is not likely to happen for at least another twelve months. JP Morgan does caution that technology stocks, base metals, Chinese equities and U.S. small caps are the most overvalued groups in today's market. JP Morgan suggests a focus on foreign stocks rather than U.S. stocks for anyone looking to add money to equities. Within the domestic market, they favor value stocks, which have underperformed growth stocks for the last ten years. BCA expects inflation to surprise on the upside. It is likely to be inflation concerns that eventually cause the Fed to start raising interest rates, or at least to stop supporting bond markets via their bond buying program. This should cause long term interest rates to rise, and indeed the 10-year Treasury yield has already risen from 0.9% to 1.3% since year-end. BCA sees the yield on the 10-year Treasury rising to 1.5% by the end of this year.

In the past, an investor who became wary of the stock market would typically rotate a portion of their funds into money market funds or the bond market. With bonds today yielding less than inflation expectations, that option is not an attractive long-term prospect. The few areas of the bond market that have yields above the inflation rate are the lower-rated categories that entail considerable risk. Junk bonds, for instance, yield about 4%. While it sounds good compared to money market rates of 0.05%, it may not compensate appropriately for the risks involved. (The chart below from the Federal Reserve Bank of St. Louis provides some long-term perspective on the absolute level of today's high-yield bond yields.) As Steve Blumenthal pointed out recently in his weekly "On My Radar" letter, bond covenants have deteriorated and provide less protection in the event of default. Defaults are quite normal in the junk bond market but typically, collateral protection in a default preserves about 60 cents on the junk bond dollar. Given the covenant erosion in recent years, Blumenthal estimates that future defaults would likely result in preserving just 30-40 cents per dollar after default, i.e. price declines of 60%-70%. Current spreads are lower than normal, and likely do not reflect the risk of weaker covenant protection. Blumenthal jokingly suggests that junk bond owners should hope for a new government program called "Make America's Junk Bonds Great Again."

We have often bought individual corporate bonds for those clients seeking income and preservation of capital. Low rates have made this challenging, but even more frustrating is that bond dealers are not making liquid markets. The spread between the bid and ask price for a bond now takes a measurable chunk of the yield to maturity out of the pocket of the buyer (or seller). It is often more efficient for us to buy bonds now through mutual funds or ETF's.

For some investors who need income, good quality dividend-paying stocks such as some of the electric utility stocks might make more sense than bond funds. We would hope that the best utilities will be able to consistently increase their dividend payments, a feature not available to bond buyers. There has been a great eagerness to buy firms that will manufacture electric vehicles or components for those vehicles while the fact that these cars must be recharged using the services of electric utility firms has been overlooked. The bond market conditions are encouraging us to introduce additional diversification to our fixed income portfolios, but we are maintaining a weather eye on the outlook for higher rates in the not-too-distant future.



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