NOTES FROM THE NORTH: MARKET OUTLOOK

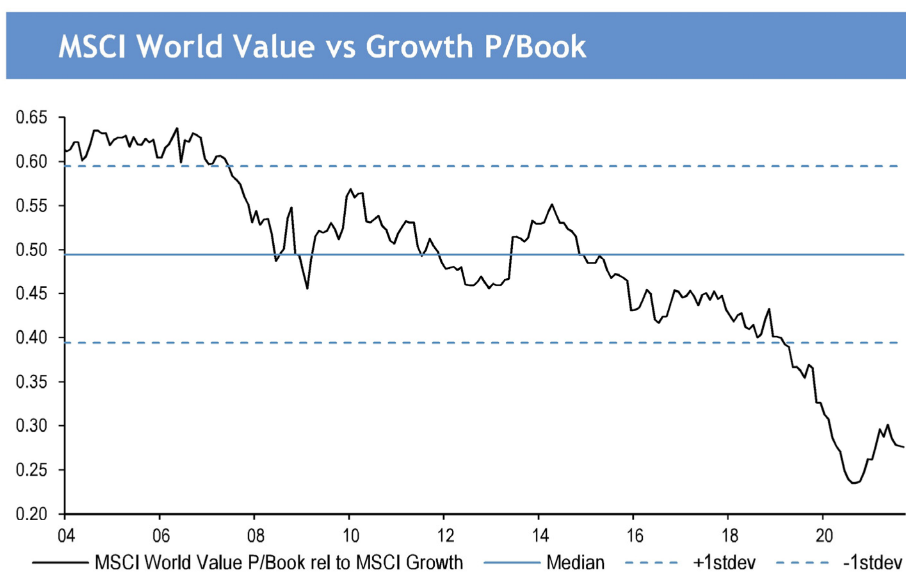
September, 2021

After rising relatively steadily for most of the year, stocks have taken a breather recently. Headlines regarding Afghanistan and the Delta variant of Covid have pushed the economic news to the back pages, but analysts are well aware that most of the recent news has been disappointing. Supply bottlenecks and rising costs have increased concerns that profit margins will come under pressure. China's economy is slowing and the Fed is thinking about tapering its purchases of fixed income securities, and all this at a time of extremely high valuations. One of the simplest measures of valuation, the price-to-sales ratio, is at 3.2x for the S&P 500 Index companies. While the Index has spent most of the last 35 years in overvalued territory based on a very long-term range of this measure, the 3.2x level is almost 50% higher than the last extreme measure seen at the top of the dot.com boom in 1998.

Several prominent firms including Morgan Stanley, Citigroup, Deutsche Bank and Bank of America have cautioned that a significant pullback in stock prices may be imminent. For instance, Morgan Stanley strategists forecast cash to outperform U.S. equities, government bonds and corporate credit over the next 12 months. Not all strategists are pessimistic, however.

JP Morgan acknowledges all of the above problems, but concludes that investors should use periods of weakness to add to their portfolios. They particularly favor energy and mining stocks at their current depressed prices. JP Morgan expects inflation to be transitory and the Federal Reserve to remain accommodative for some time. They highlight that consumer and corporate fundamentals remain robust, and more share buybacks and dividend increases are expected. (For instance, Microsoft very recently announced an 11% dividend increase and a $60 billion stock buyback). Furthermore, Chinese monetary policy is likely to become more stimulative and it is hoped that the Delta variant will not cause significant lockdowns.

Peter Berezin of BCA also remains generally positive on stocks. He does not expect the Federal Reserve to hike rates for at least 12 months. This suggests that we are still in the middle-to-late stages of a business cycle expansion that began following the Great Recession (and was only briefly interrupted by the pandemic). BCA recognizes that valuations are high, but believes this has greater implications for returns over the next 10 years than over the next 12 months. BCA favors value and cyclical U.S. stocks over growth issues and prefers foreign stocks to U.S. stocks. The case for value stocks over growth stocks is supported by the following chart showing the relative price to book values of value stocks versus growth stocks. This measure of valuation for Value stocks compared to Growth stocks is roughly two standard deviations outside the statistically normal range.



Source: Datastream

The case for European stocks lies partly in their concentration of value and cyclical issues which should benefit as Covid is tamed. But it also is supported by the relationship between current and historical price/earnings multiples as shown on the following page.

12m Fwd. P/E across key geographies

	Current	20Y Median	Current vs Median	Current vs Median
US	21.4	15.5	5.9	38%
Switzerland	20.2	14.7	5.5	37%
World	19.6	15.0	4.5	30%
France	16.6	12.8	3.8	30%
Eurozone	16.4	12.8	3.7	29%
EM	13.2	11.1	2.1	19%
Germany	14.4	12.5	2.0	16%
Spain	13.9	12.0	1.9	15%
Japan	15.1	14.7	0.4	3%
Italy	12.2	12.4	-0.2	-2%
UK	12.1	12.6	-0.5	-4%

Source: IBES

We note that the market does not appear to have garnered a significant negative response to the more than 80 tax increases proposed by the Biden administration. Perhaps because it's not clear at all which ones will pass or what form they will take, but it seems likely that some will. One of the most important for stocks is the proposed increase in the corporate tax rate from the 2017 Tax Cuts and Jobs Act rate of 21%. Originally proposed to be returned to a 28% level, it is now thought that a 25% rate is more likely. Bank of America's strategist, Ohsun Kwon, estimates that a 25% corporate rate would reduce 2022 earnings estimates by 5%. That sounds fairly innocuous, but consider that overall earnings are currently expected to rise 5% next year. This one business tax increase could mean no earnings growth for the overall market in 2022.

Of course we are keeping an eye on proposed tax changes for individual taxes, as well. To date, these have included restoring the top tax bracket to 39.6%, raising the capital gains tax to equal the rate on ordinary income for those earning $1 million or more per year, a wealth tax (details unspecified), a reduction in the amount an estate can pass on free of estate taxes, and collecting a tax on unrealized capital gains in estates rather than the holdings getting a stepped up tax cost. Remember, however, that there are swing votes in the Senate seeking to reduce the size of the overall spending bill and demanding negotiations on all of these proposals. The most recent (9/12) proposals coming from the House appeared to reflect this, as they have moderated some of the more extreme of the earlier ideas. We will be watching these developments closely, of course.

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