Michael Friedman, CFA | Chief Investment Officer

In a Nutshell

As the bulls are tripping over themselves, racing to raise their price targets, we sit here and ponder if anything could derail the market. The positive sentiment is endless and silly behavior aplenty. You do not have to look hard to find hot stock recommendations and get-rich-quick schemes. Most destructive is the ploy of convincing individuals to band together and not sell a stock, causing financial harm to someone with a different opinion. Bidding up asset prices for no reason is dangerous, and at some point, the bottom will fall out. An overvalued market is just one of the problems evident today. Temporary fixes like additional unemployment benefits and various moratoriums are making the health of the economy unclear. We are concerned asset prices will continue higher on a false sense of hope. While it is true, there will likely be a surge in consumer spending, that can only go so far. Once Uncle Sam's tap runs dry, the economy will be back to the pre-pandemic slow growth posture, although now the market will be even more overvalued.

The Roaring Twenties, Be Careful What You Wish For

Recent commentary has compared the current economic environment to the 1920s, proclaiming this decade will be the new "Roaring Twenties." The parallels are convenient as the effects of the 1918 pandemic subsided shortly after the start of the decade, similar to the timeline of the current pandemic with increasing normalcy expected toward the end of this year. History repeats itself, but never in the same way. That would be too easy if the path forward mimicked the experience from the preceding century.

The 1920s, characterized by strong economic growth and an even stronger stock market, was aided by advances in technology, leading to a new consumer class. From the September 1921 low to the September 1929 peak, the annualized return for the S&P 500, excluding reinvested dividends, was 21.6%. Money invested in the stock market over the eight years just about quintupled in value, fueled by excess leverage and speculation (A $10,000 investment at the start of the period would have been worth $48,527 by the end of the period). The party was fun while it lasted but not worth the destruction that followed. The Roaring Twenties resulted in the Great Depression, so the proposal that we could be in the new roaring twenties is quite concerning, as it would mean we have learned nothing from history. From October 1929 through June 1932, the S&P 500 fell 84.8%. From 1930 through 1933, real GDP fell more than 25%, and the unemployment rate spent 110-months during the 1930s decade in the double digits, including 27-months above 20%. The decline wiped out everything from the 1920s, and then some. In the end, people were worse off, so the roaring twenties do not invoke excitement from our perspective.

Pent-up demand and a high level of government spending will spur near-term economic growth, but that can only go so far. Also, keep in mind, just because we see economic growth does not mean the stock market must follow suit. Remember how the stock market soared as cities shut down and layoffs escalated. Future economic growth is already priced in the market, many times over. At the end of 2020, the Cyclically Adjusted Price to Earnings (CAPE) ratio on the S&P 500 was 33.8, compared to a long-term average of 17.1. At the start of 1920, the S&P 500 CAPE ratio was only 6.2. The market had not priced in the returns for the remainder of the decade as in today's environment. Throw in speculation through SPACs, reckless behavior through GameStop, and it certainly appears like we are much closer to 1929 than 1920 today.

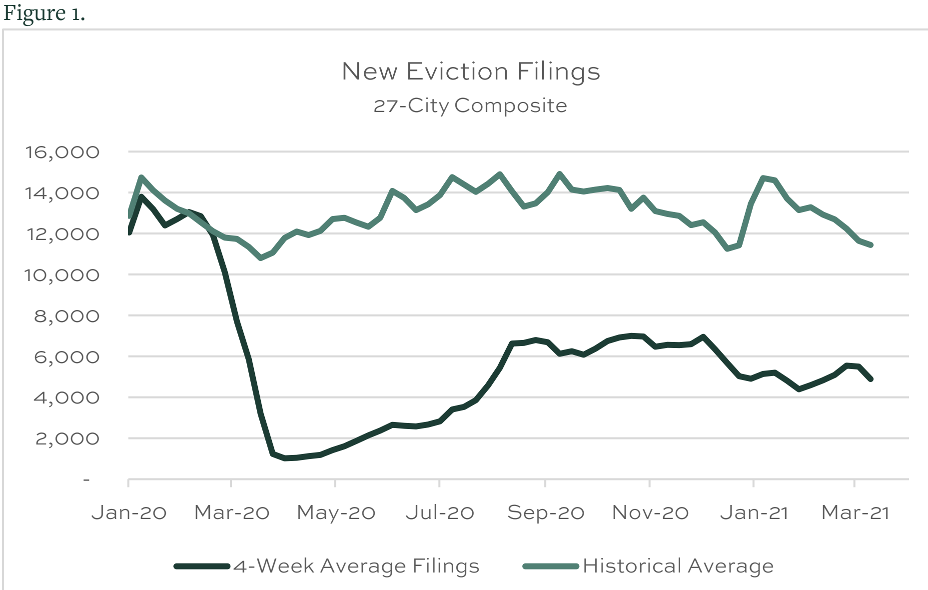
When the Tide Goes Out

The economy finds itself in a peculiar situation rebounding from the pandemic-induced drop in economic activity with an unprecedented level of stimulus and other aid. The federal government's support has propped up the economy, mitigating what could have been a much deeper and prolonged recession.

Many pundits forecast a supercharged economy in the second half of the year fueled by consumer spending and a return to normal, pointing to a war chest of personal savings built up over the past year and considerable demand for travel and leisure activities. Sure, this sounds nice but ignores the part about how it is made possible by the trillions of dollars doled out by the government and special programs to assist those impacted the most. Since this is not Monopoly money, we will eventually need to settle the bill, likely through higher income taxes reducing the discretionary income available to spend on goods and services.

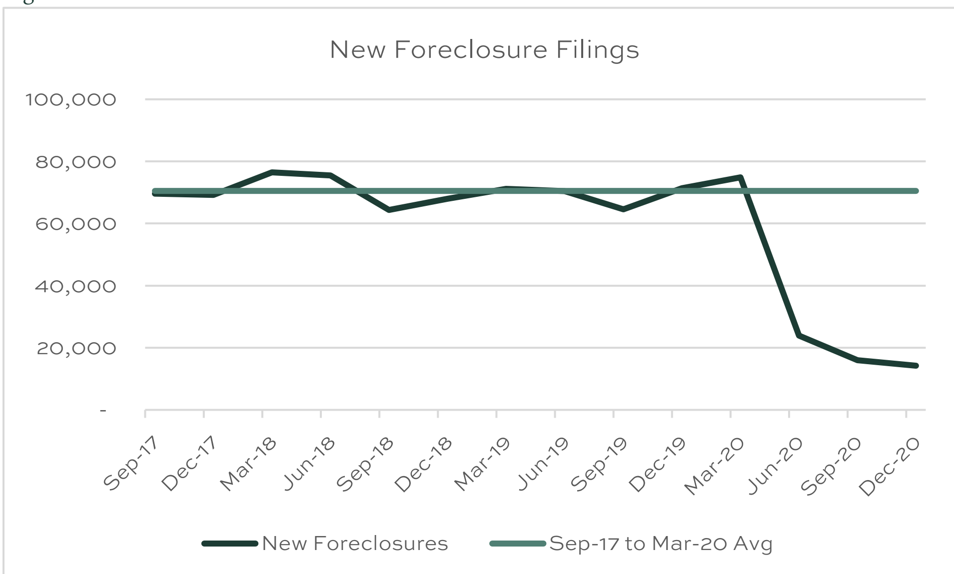
We are worried about what will happen when the federal assistance ends, like enhanced unemployment benefits and the eviction and foreclosure moratoriums. According to data compiled from Princeton's Eviction Lab, which tracks data from 27 cities, eviction filings since the beginning of 2020 averaged just 45% of their historical average. The gap between current filings, and the historical trend, indicates once the moratorium ends, there will likely be an uptick in evictions.

Figure 1.



Mortgage delinquency and foreclosure data also paint an opaque picture. Foreclosures have steadily declined following the great recession of 2007-2009 before leveling out in the third quarter of 2017. In Figure 2, foreclosure moratoriums enacted during the second quarter of 2020 caused a drop in new filings creating what is likely to be a backlog of foreclosures once withdrawing the restrictions. To a certain degree, this has played a role in boosting home prices by lowering the supply of homes for sale.

Figure 2.



We are concerned that we do not have the whole story as moratoriums and forbearance plans make it hard to understand what is truly going on under the hood. Intuitively, with over eight million fewer people employed since January 2020, one would expect an increase in evictions and foreclosures, not a sharp drop as has been the experience.

Boom Before the Doom?

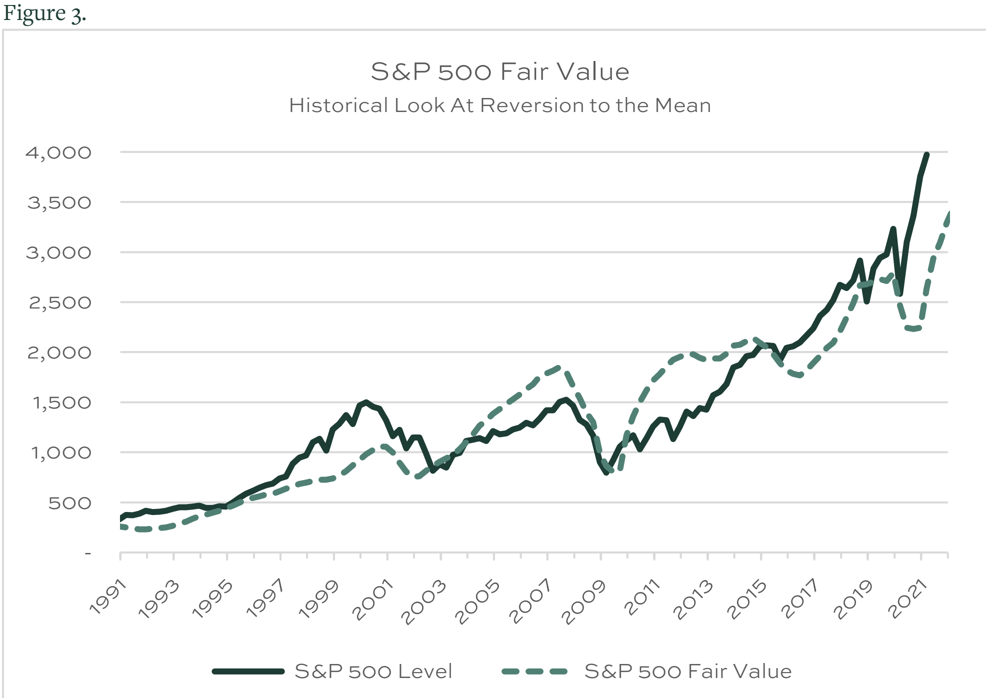
There is another side to this coin complicating the situation and making it unclear where the economy stands. The longer the government assistance extends, the rosier the current picture is going to look. Between the paycheck protection program, enhanced unemployment benefits, and direct payments to individuals, the government has disbursed over $2 trillion. The assistance is the primary driver of the $1-trillion rise in personal savings during 2020, an 86.7% year-over-year increase. We know there is pent-up demand from those not experiencing financial hardship brought on by the pandemic, so a near-term economic boost is apparent. Consumers spending down their savings on leisure and travel is sure to generate positive sentiment for the stock market, especially as companies report massive growth off last year's artificially-low base.

The timing, as always, is challenging, so we will not pretend like we have the answer. Based on valuations, a correction at any time would not be surprising. A high level of normalcy and winding down of special government assistance will help paint a better picture of the path forward. The data indicates over half the U.S. population could be fully vaccinated by July, lining up with a second-half spending boost and relaxation of government programs. As pent-up demand is satisfied and excess savings exhausted, the economy will need to stand on its own two feet again.

Mr. Market, however, has no qualms. The S&P 500 is trading at all-time highs with a rich multiple, more than 1.5 standard deviations above the 25-year average. According to consensus estimates, earnings will exceed pre-pandemic levels this year, calling for double-digit earnings growth in 2021 and 2022. Considering our base case is not unicorns and fairy dust, we believe the market is yet to recognize a tremendous amount of downside risk. Higher taxes and interest rates, along with an uneven or slower than anticipated recovery, are just a couple of items that could result in headwinds for the market.

Today, the market is trading well above fair value. To illustrate, we calculated the historical fair value for the S&P 500 using realized earnings and applying a 15-year rolling average multiple. Over the past 30-years, the market has spent periods overvalued and undervalued before eventually crossing through fair value, on average, every five to ten years. Utilizing the consensus earnings estimates, we arrive at a fair value of 3,300 on the S&P 500 at the end of this year. On 3/31/2021, the index closed at 3,973. The S&P 500 will cross through fair value at some point; how dramatic that point will be is based on where we go from here, since ignoring reality and continuing higher will only result in more future pain.

Figure 3.



Caught Between a Rock and a Hard Place

Our challenge remains to navigate the fine line between how the market should behave versus what is likely to occur. We believe the market is prone to move higher even though it should not before an eventual correction ensues. Just the kind of conflict that causes sleepless nights. To balance our belief that the market is overdue for a pullback with the possibility the market remains mispriced longer than expected, we like hedged equity strategies, providing marginal upside participation with downside risk mitigation. If the market continues higher in the short run, we may look to trim equity exposure and boost our hedged-equity allocation. We believe this will provide a superior risk and return profile compared to traditional bonds which are subject to the pressure from higher future interest rates.

Figure 3. The S&P 500 Fair Value estimate is calculated quarterly and based on the realized operating earnings from 1/1/1991 through 12/31/2020 and based on the consensus forecast operating earnings from 1/1/2021 through 12/31/2021. The provided S&P 500 Fair Value estimate solely depicts the historical relationship between the S&P 500 price level and a theoretical S&P 500 fair value level. The S&P 500 Fair Value estimate does not represent actual historical forecasts or current forward-looking forecasts for the S&P 500 price level.

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Past performance is not indicative of future results. Indexes are unmanaged and you cannot invest directly in the index.

Diversification does not guarantee a profit or protect against loss.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization.

Sources: Committee for a Responsible Federal Budget, Eviction Lab, FRED, J.P. Morgan Asset Management, NBER, YCharts.

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