May Market Showing Potential Cracks

As May draws to a close, the market hovers near its all-time high with nearly all equity indices having set records in the month of May or late April (Nasdaq). U.S. gross domestic product grew at a 6.4% seasonally-adjusted annual rate in the first quarter, the same as initially estimated.

The U.S. labor market data reported on May 27th that worker filings for jobless benefits fell to a new pandemic low. The same report revealed initial unemployment claims for regular state programs, a proxy for layoffs, fell to 406,000 from 444,000.

Job openings reached a record level of 8.1 million at the end of March, as workers willing or able to accept open positions declined even further. Still, despite April's lackluster hiring numbers, earnings and hours worked continued to rise in April, while the rate workers quitting their jobs, which serves as a proxy for confidence in the labor market, increased to 2.4% in March. This matches a record high and provides additional evidence of a tightening labor market.

Yet, despite further signs of the continuing recovery, U.S. markets have seemed a bit less confident over the past month with most essentially trading sideways, or even down for the tech-heavy Nasdaq.

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Ray Dalio, the head of the world's largest hedge fund, Bridgewater, described current stock-market valuations as a bubble during a May 11th interview with the Wall Street Journal. He went on to say that Biden's economic agenda, including the $1.9 trillion COVID relief bill and his proposed $2.3 trillion infrastructure package, risks adding to the bubble through too much money flowing into the economy. Mr. Dalio also predicted a lack of demand for new government debt which would result in the Federal Reserve continuing its expansionary policies.

The Fed itself has voiced concerns over asset prices. Fed Chairman Jerome Powell has described parts of the market, including equities, as "a bit frothy", and asset prices were also flagged in the Fed's annual Financial Stability Report. With its narrow focus on inflation expectations, the Fed seems to be possibly fighting the last battle. Just because the Fed has not faced big trade-offs in recent decades does not mean trade-offs are not coming or that they no longer exist. The long-term risks from asset bubbles likely dwarf the short-term risk of putting the brakes on a booming economy in 2022.

Not surprisingly, minutes from the central bank's late April policy meeting reported that some Fed officials want to begin discussing a plan for reducing the Fed's massive bond-buying program. Larry Summers, the former US Treasury secretary, sharply rebuked the Federal Reserve for its loose monetary policies, accusing the central bank of creating a "dangerous complacency" in financial markets and misreading the economy.

In addition to concerns about today's high asset prices with price to earnings levels trading nearly two standard deviations above their norms, the last few weeks have seen concerns over inflation rise substantially. Notably, the prices paid diffusion index increased 8

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points to 76.8, its highest reading since March 1980. Nearly 77% of firms reported increases in input prices while none reported decreases. The current prices received index increased 7 points to 41.0, its highest reading since May 1981. Any inflation comparison to 1980, when consumer inflation was at its record high of 13.9%, is potentially a bit scary.

Inflation can be particularly damaging to valuations of growth and technology stocks. Because growth stocks earnings are expected to come further in the future, rising yields decrease the value of these earnings which puts downward pressure on their valuations. Given current valuations and the high representation of richly valued tech stocks in today's indices, a drag on growth and tech stocks could hit markets particularly hard.

In addition to tech stocks, more recently SPACs (special purpose acquisition companies) have also struggled. The Defiance Next Gen SPAC Derived ETF has fallen about 30% in the past three months to a six-month low. Electric-car-battery company QuantumScape Corp and space-tourism firm Virgin Galactic Holdings are down 50% or more during that span. Other SPACs listing splashy firms such as electric-car startup Lucid Motors and personal-finance company Social Finance are down sharply. Cryptocurrencies have also recently struggled with Bitcoin losing more than 50% from its mid-April highs before reversing course near the end of the month. Risk appetites seem to be abating a bit even if it has not shown up in equities.

Much of the recent market dynamics have been driven by individual traders who are holding more stocks than at any time in history. Individuals have used their stimulus checks, their increased savings rates, and more recently, borrowing power to magnify their positions or buy small dips in the market. Stockholdings among U.S. households increased to a record 41% of total financial assets in April, the highest level on record according to JPMorgan Chase and the Federal Reserve. This data goes all the way back to 1952 and includes 401(k) retirement accounts.

Millions of new brokerage accounts were created during the Covid-19 pandemic as investors flocked to new platforms such as Robinhood in addition to adding accounts with more traditional firms. With the market remaining so strong and with so few interruptions outside of COVID since the financial meltdown of 2008, individual clients appear to be growing increasingly comfortable holding stocks. The result has been a relatively smooth ride, but one that cannot continue at the pace it has been following.

Today's financial press has far more articles focusing on current valuations, arguing that they are either overly high and must come down, or that they are justified due to specific facts and could continue up. While either argument could be true, the mere presence of articles arguing about the existence of a potential bubble essentially confirms its existence.

Looking forward, a major question remains how the market will perform as we exit COVID. The market could continue higher carrying prices and valuations to new highs, or individual investors could pull enough of their funds to deflate an overheated market. Regardless, the market seems highly unlikely to continue its upward march in the same manner as the past few years.

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