Market Continues Up, Driving Valuations Higher

The market seems to be a bit more unsettled than it has been for a while, but the general direction is still up. The size of movements within the market remain fairly large, with moves over 1% fairly common and over 2% not unusual. Despite the ups and downs, the market is trading near or at all-time highs, depending on which day you chose to look at prices.

Yet, from an economics perspective, the market seems somewhat overstretched. Despite a strong rebound in the second half of last year after the dismal second quarter, the economy contracted 3.5% for the entire year. It marked the first contraction in GDP since the 2008 financial crisis and the largest since 1946. Measured against the fourth quarter of 2019, the economy shrank 2.5% in a year-to-year comparison.

US GDP rose at 4.0% (17% annualized) during the fourth quarter which followed third quarter's record 7.4% (33% annualized) increase according to the Commerce Department. Both of these numbers look impressive but came after the second quarter's dismal 9% drop in GDP (41% annualized). While the pace of the recovery slowed considerably during the fourth quarter, corporate and residential investment continued to be strong and potentially sets up the US economy for a very solid 2021.

Among the contributors to the ongoing recovery were the $900 billion COVID aid package signed into law in December and the prospect of another aid package again this year. High household saving rates and hopes for the vaccination program have also provided fuel. Not surprisingly, expectations regarding the size and likelihood of the coming aid package is impacting markets.

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Against the wave of money flowing through the economy, the vaccine has generally been a bit of a disappointment. Slow rollouts and confusion in various states about who should receive the vaccine have so far slowed down distribution. Yet, while this could be a problem if it continues longer term, in the short-term, it has been viewed by most people as simply part of the rollout. However, if the struggles are not addressed fairly soon, they could grow to become a bigger problem and start inflicting yet more pain on the economy.

After struggling for nearly a decade, housing seems to be accelerating with home prices up sharply toward the end of 2020. Much of this also stems from people's desire to have more space as they generally flee cramped downtown apartments and cities. During 2020 through November, the S&P CoreLogic Case-Shiller National Home Price Index, which measures average home prices in major metropolitan areas, rose 9.5%, a level not seen since prior to 2008.

With mostly good news coming out of most markets, it seems quite logical that the stock market would be routinely notching new records. However, valuations that are reaching new highs suggest potentially other phenomena.

This can be understood very quickly by looking at just a couple of numbers. The price to earnings ratio of the largest 10 companies of the S&P500 has mushroomed to 30 versus a historical average of 19.4. Similarly, the entire S&P500 trades at 21.7 versus an average of 16.7. Notably, the 10 largest companies have grown to their current positions because they faired quite well under COVID. Generally, they will likely lose some of their tailwind as COVID eventually winds down.

The difficulty of supporting high valuations was noted by famous stock selector Jeremy Grantham during a recent interview with Bloomberg TV's "Front Row." He

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stated that "We will have a few weeks of extra money and a few weeks of bust…When you have reached this level of obvious super-enthusiasm, the bubble has always, without exception, broken in the next few months, not a few years." While this may or may not happen, it highlights challenges within equity markets. Simply put, valuations are very high, and in his opinion, unsustainable.

His fears have been echoed by others. Recently, Forbes Magazine published an article that claimed that return expectations for a typical 60% stock and 40% bond portfolio over the next decade are only 1-3%. They were advocating adding some additional holdings to a portfolio such as gold and hedge funds. Various other banks have made eerily similar projections. JP Morgan has labeled today's conditions a "return crisis." They have also recommended diversifying a portfolio more broadly as well.

A possibility is allocating some money into more international positions. While international stocks have not faired as well as US equities over the past decade, they now potentially offer significant opportunity. First, their valuations are much lower than in the US although their levels are generally much closer to average versus cheap. In addition, their indexes are generally not as impacted by the effects of COVID which has driven up the shares of the big tech companies to very high levels in the US.

Second, the dollar has weakened substantially and appears likely to continue sliding against most currencies. If the dollar continues down, the shares of companies listed in other countries will benefit as their earnings are worth more. The international opportunities appear to be particularly attractive in emerging markets which have seen their currencies drop from one standard deviation above their historical level to more than one standard deviation below over the past 12 to 15 years.

Looking at today's markets, finding a clear path forward remains difficult. Valuations are high, but there are reasons to believe they could remain high. Yet, given current circumstances, diversifying at least part of your portfolio, or further diversifying into additional assets, would seem wise. The market has been incredibly strong, but today's values appear to be unsustainable, at least in the long-term. Protecting yourself before a potential correction or even crash could be very wise.

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