Caveat Emptor (Let the Buyer Beware)

Financial markets have continued to rally, constantly reaching new all-time highs, boosted by massive amounts of monetary and fiscal stimulus. This has come despite a Covid-19 pandemic that is still ongoing around the globe, and the appearance of new strains of the virus that are apparently more contagious and potentially deadlier. Nonetheless, the expectation of an imminent economic normalization brought on by the inoculation of the global population with one of the many vaccines, coupled with additional stimulus packages (e.g. $1.9 trillion package making its way through the US Congress) to protect the economy from long-lasting scarring, continues to provide significant tailwinds.

However, the constant increase in equity prices, which has not been met by growth in revenues and earnings, has taken traditional valuation metrics, such as price to earnings or price to sales, to near record high levels. Some market analysts have suggested that the recent surge could be indicative of a market bubble, which could be bursting soon. The worries have been exacerbated by other recent events such as the GameStop and other "meme" stock frenzy, the IPO market continuing to run on a frenetic pace, and the strong appetite for blank check companies, better known as SPACs (Special Purpose Acquisition Company).

In the present Thinking Man, we will explain the current state of the economy, expand on the potential bubble warning signs, and explain why we believe that even though we may be in the middle of a bubble that it is unlikely to burst in the short-term. We believe that timing the market is currently much more relevant than ever, as it will become necessary to effectively differentiate between short-term corrections and a sustained crash after the bubble bursts.

Economic and stimulus activity

Since the end of the Great Financial Crisis, we have seen an impressive rally in financial markets, fueled by monetary and fiscal stimulus. The massive stimulus successfully stabilized and boosted financial markets, but had a lackluster result in promoting economic growth and inflation than during the previous decade. Nevertheless, even as global central banks had previously been tapering asset repurchase programs, and raising reference rates, the arrival of the pandemic forced them to instantly reverse course,

The Thinking Man's Approach

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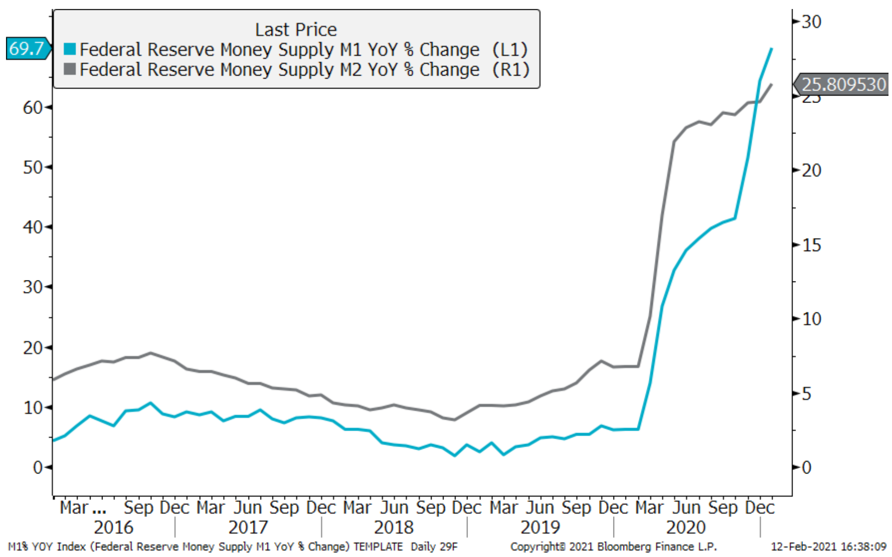
- As we progress in the new year, the equity market continues to advance. Although we are seeing bubbly segments of the market that are detached from fundamentals, we do not see bubble conditions broadly speaking.
- Comparing with the dot-com bubble of 1999, this time is different. Firstly, Central Banks have distorted the investment landscape by slashing rates – depressing yields and creating a pro-risk environment.
- Secondly, stimulative Fiscal and Monetary Policies, in contrast to tight policies in the 1990s, continue to support the economy today.
- Thirdly, equity valuations are not as high as in the dot-com bubble. Today's Equity Risk Premium (ERP) is very much in line with the historical S&P 500 average, indicating that overall market is not in a bubble yet.
- In conclusion, we have a stock market that is trading at a premium to historical valuations, partially justified by extremely low bond yields, a shift in composition towards higher-valued growth sectors, supportive monetary and fiscal policies, and cheaper access to markets.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com further stimulating the economy and protecting financial markets. We are currently in a world where there has been an accumulated global stimulus of approximately $24 trillion dollars, for a total global equity market of approximately $75 trillion. Most of this stimulus has gone to or will eventually end up in the equity market, likely providing further upside.

Furthermore, as Covid-19 was not a typical financial crisis, but rather a global pandemic that permeated the economy and financial markets, the solution seemed more straightforward. In fact, analysts are predicting an economic normalization throughout this year, as vaccination programs are quickly gaining pace. In the U.S., it is estimated that all individuals in the high-risk population will have been vaccinated by the end of the first quarter, with remaining adults receiving the vaccine throughout the summer.

The economic normalization will provide an important tailwind for the market, as there is a huge pent-up demand for the services and experiences industries, which have been the hardest hit over the last 12 months. As a result, some economists are starting to predict that the economy could have a spectacular year, with some suggesting GDP growth of over 7%, potentially constituting the highest yearly growth since 1983.

Meanwhile global central banks will continue to stimulate the economy and inflate security prices through asset repurchase programs. Nowhere is the asset inflation more evident than in the fixed income market. Currently there is over $16 trillion in negative yielding debt. Despite the recent increases in the nominal yield of 10-year Treasuries, real rates remain significantly depressed at under -1%.



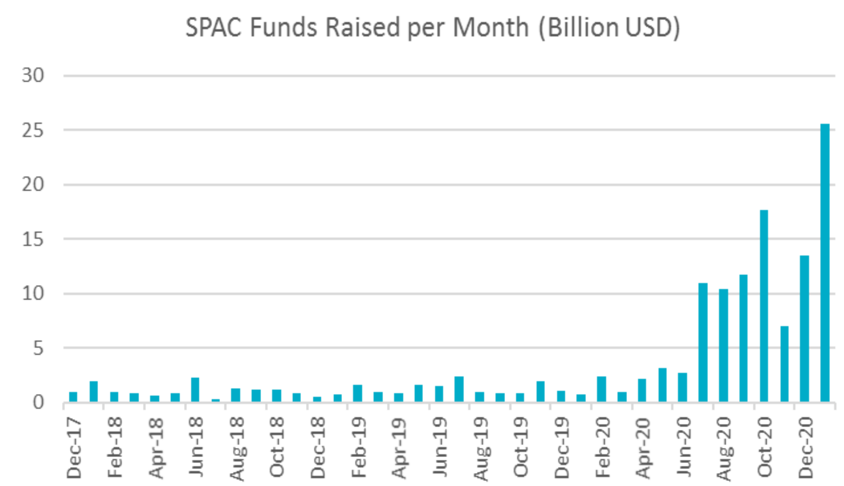
Nevertheless, liquidity in the market will only continue to grow. M2[1] grew in January at a 26% annual rate and it is not expected to slow anytime soon, because of heightened levels of savings by households, further flows to money market funds, and the proposed additional stimulus checks. We strongly believe that eventually, all this heightened liquidity will find its way to the equity market, providing additional support for valuations.

[1] M2 is a calculation of the money supply that includes all elements of M1 as well as "near money." M1 includes cash and checking deposits, while near money refers to savings deposits, money market securities, mutual funds, and other time deposits.

Bubble signals and previews of the main event

Using traditional valuation metrics such as price to equity, or price to book value, it is hard to argue that the equity market looks cheap. However, it is important to remember that global central banks with their monetary stimulus and quantitative easing programs have completely altered the investment landscape to a pro-risk, zero yield, tight credit spread and low volatility environment. For example, over the last decade, realized volatility has been almost half of implied volatility. Hence, market volume is currently dominated by volatility control, commodity trading advisors, risk parity, quantitative and momentum strategies. With risk-free rates at near historical lows and abundant liquidity in the market, valuation multiples have readjusted to what could be the new norm, at least for the time being.

Even as we believe that the case for investing in equities remains strong, we see some frothiness in the market that could be an early indication of the formation of a bubble. First, there has been significant IPO activity that is reminiscent of the exuberance of the late 1990s, in companies such as Airbnb, Doordash, and Palantir among others, for which investors paid lofty valuations.



Source: Dealogic

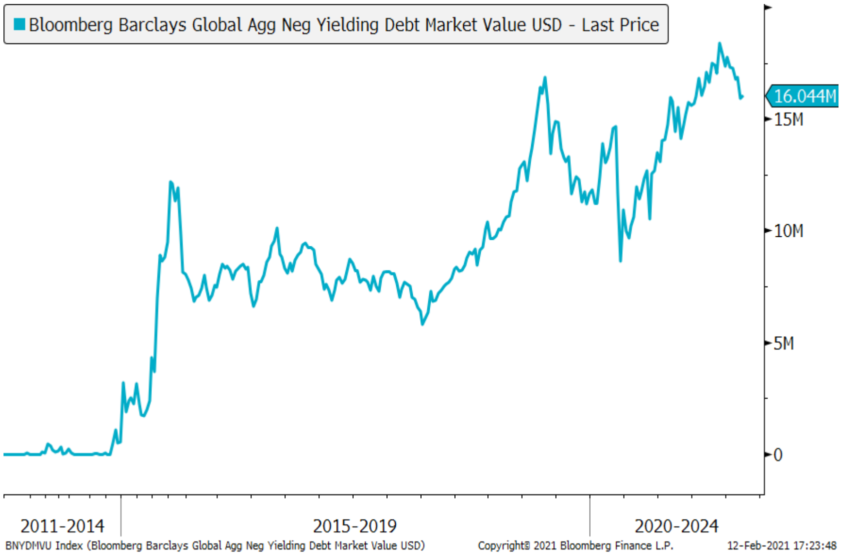
Second, there has also been a tremendous appetite for SPACs, which in essence are blank checks given to investors to pursue almost unrestricted M&A deals, but in the absence of a deal, they are just empty shell companies. Finally, we have seen heightened speculative activity in cryptocurrencies, such as Bitcoin, and electric vehicle companies, like Tesla, which might not necessarily be fundamentally driven.

It is still too early to tell if or when the current apparent bubble will burst. However, we have seen some previews of what could be in store around the corner, such as: the 10-sigma factor moves, the Covid-19 selloff of 2020, the year-end crash of 2018 and the taper tantrum correction of 2013. The most recent preview was the volatility caused by the “meme” stock and Wallstreetbets saga, in which thousands of millennial retail investors artificially inflated the prices of several cheap stocks that were held by several hedge funds with outsized short positions. We believe that these previews will only get stronger and more frequent as the bull market continues to run untamed.

The bubble is not about to burst

As mentioned above, some signals point towards a bubbly equity market. Even so, we do not believe that this potential bubble could burst in the near term. Monetary and fiscal policy will remain accommodative in the near future which will effectively continue to support the bull market. What was widely discussed as the Fed put that occurred in 2020 is now likely to get a complement with a fiscal put, now that the Democrats control the US Government, and former Fed Chair, Janet Yellen, is the Secretary of the Treasury. Hence, the following tailwinds should continue to drive the market higher.

- Volatility will remain artificially low. The spread between realized and implied volatility is likely to converge, with implied volatility falling and not the other way around.
- The Fed and other global central banks will continue to print money to finance the latest and any subsequent rounds of asset repurchase programs.



- Global negative yielding assets will only continue to expand from the current $16 trillion+, forcing fixed income investors to look for alternatives, most likely in the equity market.
- Money market funds expanded by approximately $1.2 trillion at the height of the pandemic. These funds currently have assets of around $4.3 trillion, which is $500 billion less than the number at the height of the pandemic. This translates to $700 billion waiting to be deployed, which will again most likely make its way through the equity market.
- Finally, the combination of the fiscal and monetary put will remain in place until there is significant evidence that the economy is in a sustained growth trajectory, and that unemployment has fallen close to pre-pandemic levels.

Technical indicators also point to a continuation of the bull market

Technical indicators also remain supportive of the equity market, pointing to a continuation of the rally. There are two indicators and one signal that show us the strength of the current bull market. Probably the most important is market breadth, which is an indicator that analyzes the number of stocks advancing relative to those that are declining in a given index. For the S&P 500, that number is approximately 91%, which means that almost 9 in 10 stocks in the index are currently advancing. This is very different from the recovery during the spring and summer months of 2020, where the market was being pushed by a handful of stay at home tech stocks.

When equities are showing such a high breadth, it is a sign of a likely consolidation of the bull market, rather than of an imminent crash. The story is similar when looking at mutual fund and ETF flows into fixed income and equity markets. Contrary to what could be expected, over the recent years there has been a huge inflow into the fixed income space, while equities have suffered great outflows, which only accentuated with the pandemic. With this information, it is difficult to argue that equities are in a bubble, different to what can be said regarding fixed income securities.

On a final note, the "Meme" stock and GameStop saga, revealed the resilience of the equity market. Several over leveraged hedge funds, which suffered massive short squeezes, were forced to quickly de-lever. The sell-off caused a short-lived correction, but not the massive crash that could have blown-up the market as many had feared. Clearly, it was not a systemic issue, but rather a buy-the-dip situation. The S&P essentially respected the 50-day moving average support, and the subsequent recovery has been rapid and broad.

Conclusion

Although there are bubbly segments of the equity market that are detached from fundamentals, we do not see bubble conditions broadly speaking. In the below table we summarize the fundamental differences between 1999/2000 and Today:

Fundamental Differences between 1999/2000 and Today

Rates	1999/2000	Today	Notes:
Treasury Nominal Bond Yields (10 year)	6.40%	1.10%	• There are globally $17.2Trillion in negative yielding government bonds; US is a high yielding government bond market - and high grade investors consider it the "safest place to be"
Treasury Real Bond Yields (10 year)	+4.2%	-1%	
High Grade Bond Yields (10 year)	7.90%	2.10%	• Central Banks have distorted the investment landscape by slashing rates - creating a pro-risk environment;
High Yield Bond Spreads	4.70%	3.20%	• High grade Tresuries, Corporates and Mortgage-Backed Securities were the natural hedge/ portfolio "ballast", not anymore.
High Yield Bond Yields	above 10%	below 4%	
Policy-Making	**1999/2000**	**Today**	
Yield Curve	Flat	Steeply Upwards Sloping	• This reflects the accomodative Monetary Policy today vs the tight one in 1999/2000;
Monetary Policy	Tight	Super Accomodative	• Quantitative Easing by the Fed and other major central banks;
Fiscal Policy	Tight (with budget surpluses)	Super Expansive (with huge deficits)	
Equity Valuations	**1999/2000**	**Today**	
Median P/E forward looking	31.0X	23.6X	• Overall Market is not in a bubble yet;
Equity Risk Premium (ERP)	2.05%	4.75%	• Today's ERP is very much in line with the S&P500 historic ERP, but was much tighter during 1999/2000
ERP/ Risk Free Rate	32%	432%	• Today's ERP is normal but bond yields are not- is there a bubble in Government Bonds?

Source: Bloomberg

Valuations are lower than the nosebleed ones of two decades ago. According to Strategas, in March 2000, the 50 largest stocks traded at a median price/earnings multiple of 31 times the next 12 months' expected earnings. On the same basis, the 50 largest stocks last month traded at a 23.6 times multiple. Longer term historic averages are around 18 times multiple. However, while absolute multiples are on the expensive side, relative valuations are not.

For example, equity-risk premiums (ERP) or the premium an investor is expected to get for investing in stocks over risk free rates (Rf) are at 4.75% - very much in-line with historic ERPs and more than double that of 1999/2000. Treasury yields were around 6% in the tech bubble era, as were short-term interest rates, compared to just above zero currently. As a result, the ERP as a percentage of the Rf is over 10 times higher today than in the 1999/2000 stock market mania.

The yield curve in 2000 was roughly flat, a sign of tight monetary policy, while the currently steeply upward-sloping yield curve signals an accommodative policy. After adjusting for inflation, real interest rates now are negative, with 10-year Treasury inflation-protected securities yielding less than minus 1%. On the fiscal side, the contrast is even starker. Fiscal policy during 2000 produced a record $236 billion federal budget surplus. Alan Greenspan, the Federal Reserve chairman at the time, worried that there wouldn't be enough Treasury securities for the central bank to buy. In 2020, the budget deficit is reaching 19% of GDP and is routinely in the trillions. The Congressional Budget Office this past week raised its fiscal 2021 red-ink forecast to $2.3 trillion, or 10.3% of gross domestic product and that doesn't include the $1.9 trillion stimulus package sought by the Biden administration.

Bubbles have not historically burst with the arrival of bad news, but rather when rallies begin to lose steam after hitting their peaks. Market participants begin to anticipate the actual event, with savvy investors positioning portfolios with the expectation of a potential crash, leading to an almost self-fulfilling prophecy. Hence, the most important role currently of an investment advisor in our view is to be able to differentiate between a short-term market correction, where investors should take the opportunity to buy the dip, and a long-term crash, where investors should turn defensive in order protect their portfolio and capital.

Today we have a stock market that is trading at a premium to historical valuations. However, this is partially justified by extremely low bond yields, a shift in composition towards higher-valued growth sectors, supportive monetary and fiscal policies, and cheaper access to markets (digitization and lower transaction fees).

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