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Market Perspective
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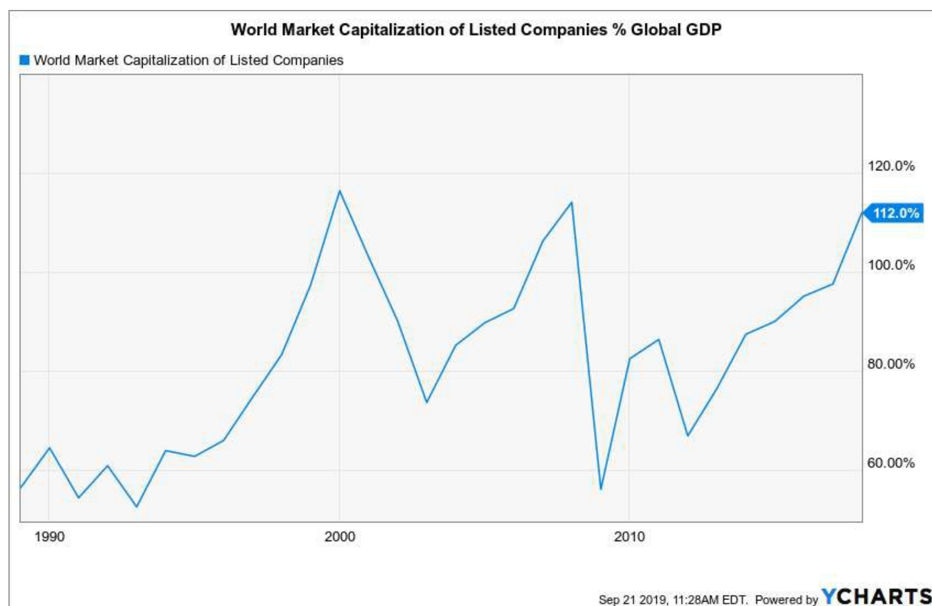
Markets are forward looking. Stocks are priced based on expectations of future earnings and the multiple to be applied to those earnings. Interest rates are set based on expectations of future economic activity. Commodity prices are set based on expectations of supply and demand. We've heard all this during our entire investing career. If we invest in a market portfolio of stocks, bonds and commodities, we will receive the market return of those asset classes in proportion to our investment.

The only way to get "one-up" on the market is to have our own expectations deviate from those of the consensus and then to be correct. This is not a trivial accomplishment and, in general, I would argue that "market" returns are all anyone should expect. Keep your costs down, minimize taxes (in taxable accounts) and hold assets in proportion to their weight in the overall market.

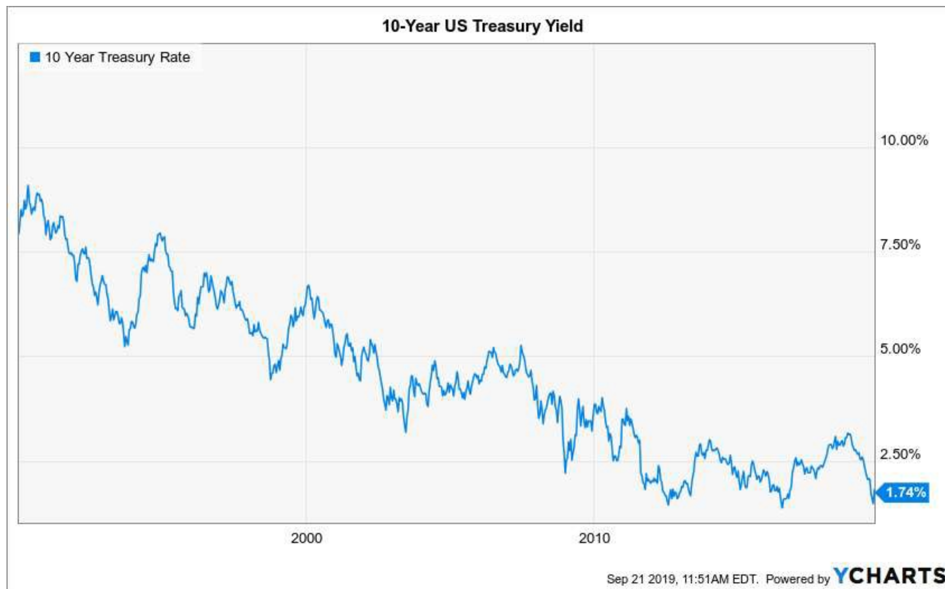
While that advice holds for normal market conditions, today's environment is unusual. Valuations for risk assets are elevated, corporate profit margins are at all-time highs and there are signs that global economic growth will be softening. These dynamics cause me to believe that the prospective return on risk assets will be considerably lower than historical norms.

I've talked about valuation in the past, but let's update my favorite graph: the ratio of the Global Stock Market Capitalization to Global Gross Domestic Product.

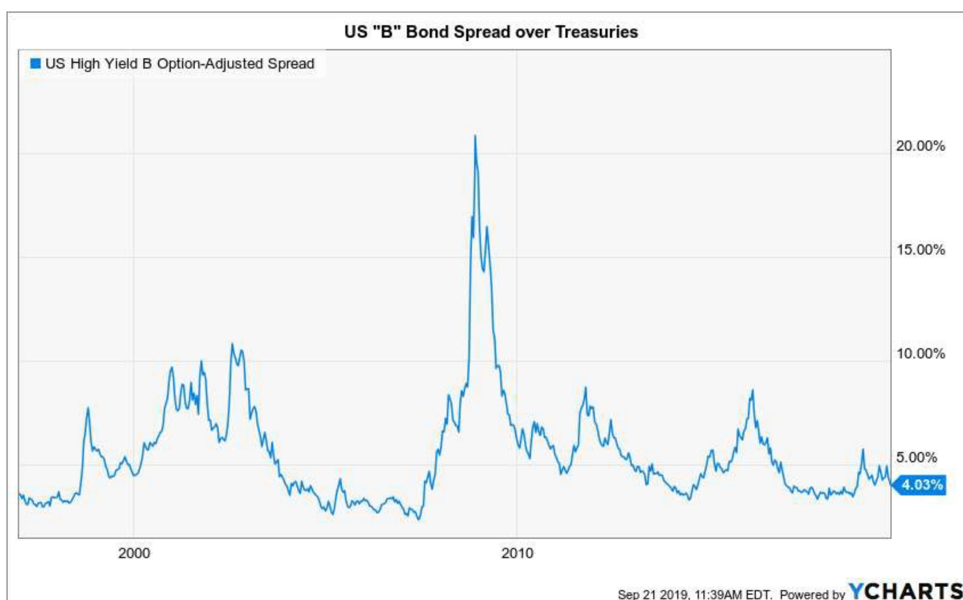


Except for 2000 and 2007, where the market subsequently declined significantly, this measure is considerably higher than it has been at any time in the last three decades. (That's as long as this data series extends; however, a US-only version of this measure dating back to 1970 shows the same dynamic.)

Much like stocks, it's hard to argue that bonds aren't richly priced. The dramatic reduction in yields that we've experienced in the third quarter has many market commentators scratching their heads. Add to that the $17 trillion of foreign bonds that carry negative yields! Few can make sense of the current rate environment, unless we conclude that we're headed for a substantial economic slowdown.

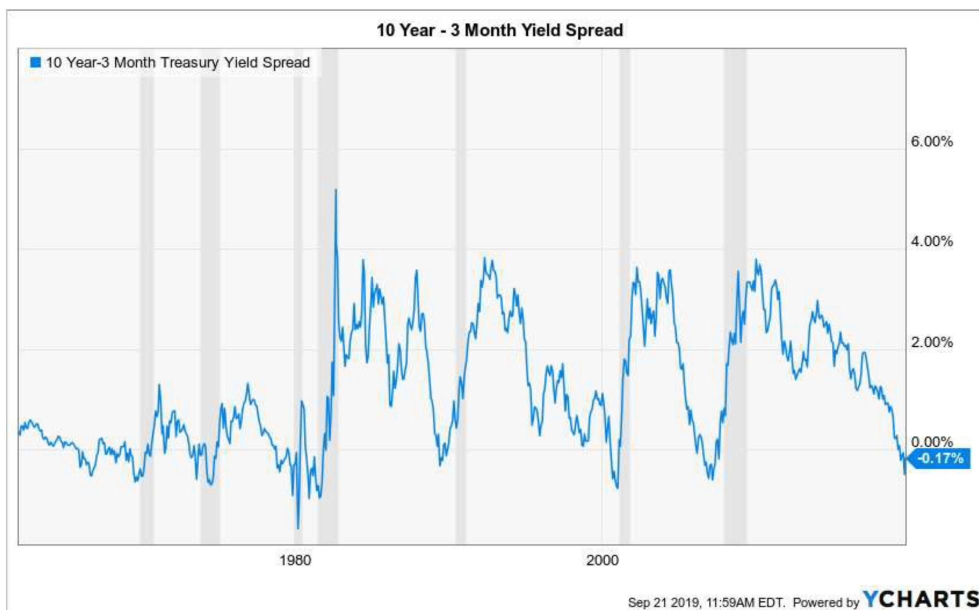


Risky bonds show the same conclusion. This graph of "B" Bond spreads shows investors are requiring less return over treasuries than historical averages. This manifests itself in higher prices for junk bonds. In turn, spreads are used as the basis for much of the credit industry's pricing.



So, we've established that security prices are elevated. That's not sufficient to warrant altering our asset allocation. We also need evidence that the economy won't be so robust as to prove these prices justifiable. Here, I offer two data points: the inverted yield curve and future corporate earnings.

Since May, the market yield on the 10-Year Treasury Bond has been lower than the yield on the 3- Month Treasury Bill. This condition is known as an "inverted" yield curve, as a "normal" yield curve provides higher yields on longer-term instruments than on shorter-term ones. Note how every recession (depicted with the shaded bars) dating back to 1969 has been preceded by a yield curve inversion.



If history's patterns hold, we should expect a recession sometime in the next year. Recessions are contractions in economic activity, resulting in lower corporate profits, higher unemployment and greater business distress. Record levels of corporate borrowing are likely to exacerbate any downturn. We've just seen the first sign of capital markets stress when the FED had to step into the overnight lending market with liquidity when rates spiked several percent above the FED's target.

Which brings us to corporate profits. Elevated stock valuations are often explained (justified?) by expectations for higher than average earnings growth. This is why, for example, many rapidly growing technology firms are priced at premium P/E ratios. When we look at the market as a whole, however, there should be some correlation between the aggregate expectation for corporate profit growth and the relative valuation of the market. At elevated valuation levels, we should be expecting above average earnings growth.

Zack's Investment Service tracks the earnings estimates for all companies, as expressed by all research analysts. Total Q3 earnings for the S&P 500 index are expected to be down -4.8% from the same period last year. This negative expectation manifested itself during the third quarter; at the beginning of the quarter, analysts were only expecting a -1.3% decline.

Total 2019 earnings for the S&P 500 index are expected to be down -.5%, which would follow the +23.1% earnings growth in 2018 which was largely due to the corporate tax cut. Analysts expect growth to resume in 2020, with projected earnings growth of +9.8%. It's that one-year out expectation that's feeding into today's market valuation. The question is whether analysts are being too optimistic about next year's earnings?

To answer that, we can look at history. According to FactSet, which also analyzes earnings estimates, analysts on average have overestimated the final EPS number by about 10% one year in advance. If that pattern holds true, it implies no earnings growth for 2020. Accordingly, it would seem we need to question today's premium valuations.

This Market Perspective is shorter than usual because my conclusion is clearer than usual. Now is not the time to embrace risk assets. Investors should only take on risk judiciously and selectively.

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