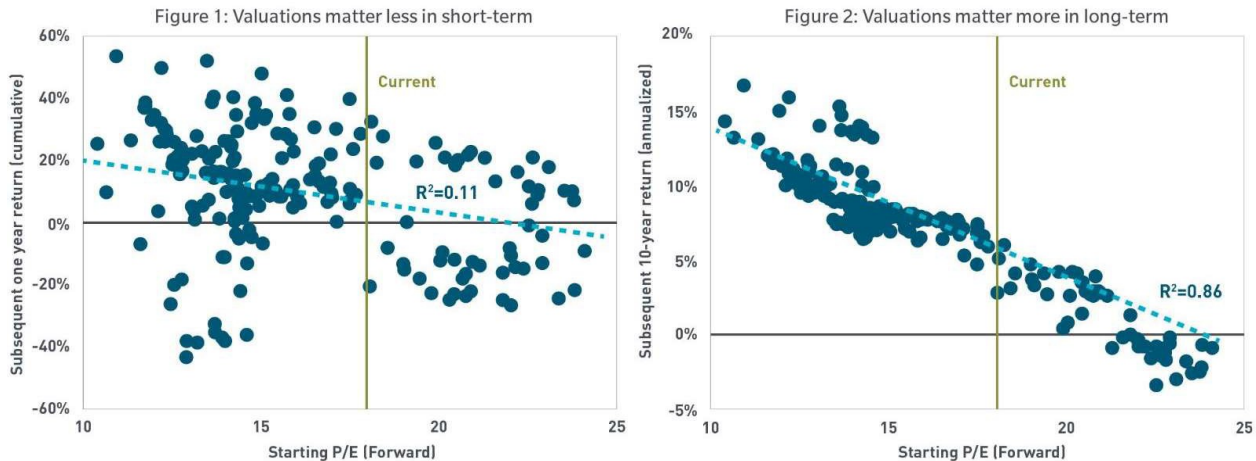


Market Perspective October 2020

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Each quarter, I write these Market Perspectives for an audience of long-term investors. As such, I heavily rely on valuation metrics. While it is abundantly clear that valuation is not a market-timing indicator for short-term trading, there is a great deal of research showing that subsequent long-term (e.g. 10 Year+) returns are negatively correlated to going-in forward P/E ratios. These graphs, from MFS Institutional Advisors, Inc., show that valuations mean nothing for short-term returns, but mean everything when considering long-term returns. (This chart was constructed as of January, 2020. As shown on page two, today's Forward P/E is 20.2x.)



Source: FactSet Market Aggregates and S&P Global. Monthly data as of 31 March 1993 to 31 January 2020. Index data is for the S&P 500 Total Return Index. Returns are gross and in US dollars. Forward price-to-earnings (P/E) ratios use mean broker estimates provided by FactSet using next-twelve-month earnings. R-squared (R^2) is a common statistical measure of fit, which in this instance is meant to quantify the relationship between the independent variable (starting P/E) and the dependent variable (subsequent returns). R^2 ranges from 0.00 (no relationship) to 1.00 (a perfect relationship) between the variables. In other words, R^2 represents the percentage of the subsequent return movements that can be explained by the general movements of the starting valuations.

In today's market environment, investors eschew valuation as a meaningful metric. The sound bites we hear are statements such as:

- "Low interest rates translate into higher equity valuation multiples because of the lower implied discount rate."
- "There Is No Alternative ("TINA") to stocks" or "Investors have a Fear of Missing Out" ("FOMO")
- "Stocks may be richly valued today, but they can stay that way for a long time."
- "The stock market is in a bubble, but the bubble is likely to get bigger."
- "Momentum is the most powerful force driving returns."

If one is investing for the next quarter or year, these views may be accurate. However, for long-term investors, I would unabashedly say that valuation matters. In the last two quarters' Market Perspectives, I made the case that it was curious how economic activity was slowing at the same time as stocks and other risky assets were levitating higher. While the equity market pulled back 6% from the high reached on September 2 through September 30, we remain in an environment of severely extended valuations. Here is the last five years of the S&P 500's forward P/E:

S&P 500 Forward P/E



At 20.2x forward earnings, the S&P 500's valuation has come down from its high on September 2, but still appears to be in rich territory. (Go back to the first graphs on page one and see where a 20.2x P/E falls on the graph of subsequent long-term returns; it is not at the extreme end of historical valuations but it is certainly well above average.) Many will point out that this metric is skewed higher by the five mega-cap Technology stocks that comprise roughly 23% of the index's market capitalization. While this is true, a much broader measure of market valuation draws the same conclusion. Here is Warren Buffett's favorite measure of valuation – Aggregate Market Cap of all US Companies % GDP. For emphasis, I have drawn this graph with data back to the 1970s. Again, we are modestly down from the highs reached in early September, but still in record territory.



While I have heard the arguments that the “market” is looking past next year and into 2022 for earnings and GDP comparisons, I can’t help but wonder how we “know” things will be better in that further-out timeframe. Might not the market reset its sights on the typical year-forward approach?

This dynamic is not confined to the equity market. Shown below are the spread premia to Treasuries for the Investment Grade and non-Investment Grade Bond universes. Just as with equities, bond markets have normalized since the February/March spike in spreads. Looking closely at the BB spreads, we can see a slight widening since September 2. Nonetheless, we would be hard pressed to say that bond’s risk premia are “wide.”

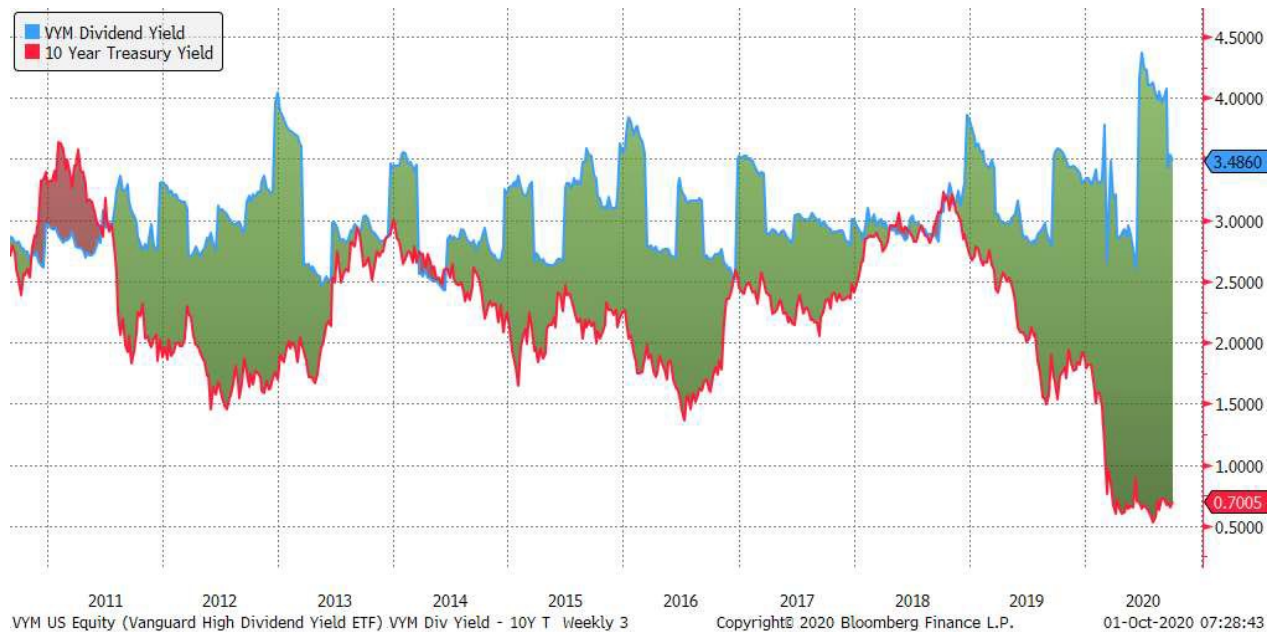
Bond Spreads Over Treasuries



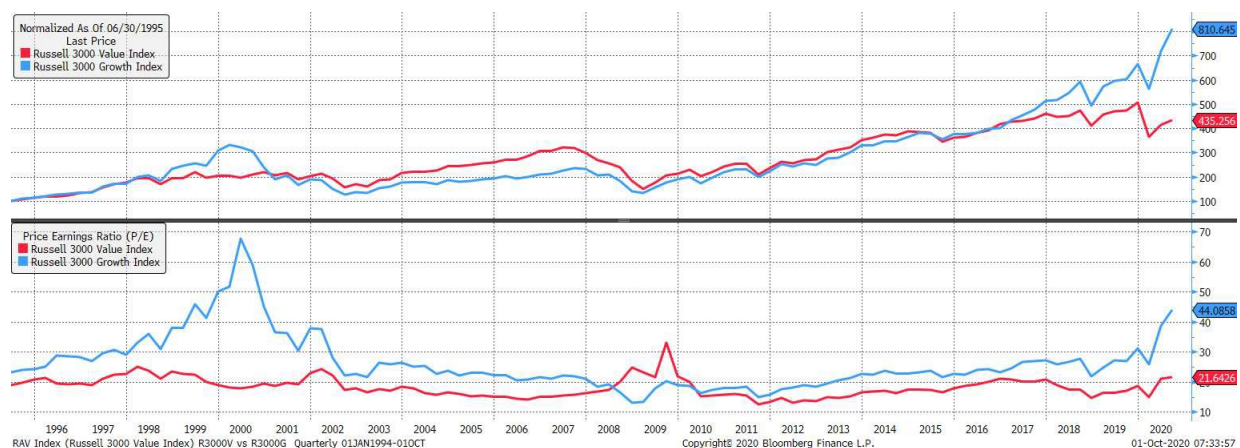
What do we do with that information? Believers in Efficient Markets would say that all knowable information about the economy and the markets is priced into today’s values. So, invest now in a diversified portfolio that matches your risk tolerance. Investors who take a more active approach to asset allocation, particularly those who remain more skeptical of the economic recovery, may want to tilt their portfolios toward the pockets of the market that show less valuation-exuberance.

Where are those pockets of opportunity? Without making specific recommendations, here is my list:

- With the Federal Reserve promising near-zero rates for a multi-year period, investments that can offer sustainable yield will probably attract investors in the coming quarters. Examples include dividend-rich stocks, below investment-grade credit, structured credit, preferred stocks, etc. Of course, these investments must be carefully underwritten, as many of these investments produce an asymmetric risk/return profile (e.g., capture the yield if all goes well, but sacrifice principal if things go badly.) Consider an ETF that holds dividend-paying stocks (“VYM”). Its yield is currently trading at a near record premium to 10 Year Treasury yields (3.5% vs 0.7%). Similar dynamics exist for other “Yield-Oriented Investments”. It seems reasonable to expect investors to be attracted to these types of investments, driving up price and placing downward pressure on yields.



- I would also favor investments priced with a “margin of safety” over those without it. That would imply lower multiple (dare I say Value?) equities over those with nosebleed valuations. Here is a 25-year history of the Russell 3000 index, split into Value vs. Growth. The top panel shows the relative performance of the two indexes, while the bottom panel shows the two P/E Ratios. These graphs make two important points. First, the sustained outperformance by Growth happened once in the run-up to the dot-com era in 2000 and only again beginning in 2017. Second, the current P/E premium of Growth to Value was only exceeded in that dot-com era. Clearly, Growth has been a better place to be for the last four years. The question now is whether that higher relative P/E will prove to be a headwind for Growth going forward.



- On the fixed-income front, we should be cognizant that the yield curve is very flat. The yield pickup of moving up in duration just does not warrant the risk. Shown below is a graph of the difference between 10 Year Yields and 2 Year Yields over the last 50 years. It is clear where we are today versus history. There is little extra compensation for taking on Duration.

10 Year Treasury Yield - 2 Year Treasury Yield



I would be remiss if I ended without commenting on the current macro-economic investing environment. While no one can forecast the near and intermediate-term direction of the markets, we can be aware of the level of risk that confronts us as investors.

Today, two risks loom large to me. The first is that the world could be forced to live with the diminution in economic activity implied by a continuing pandemic for longer than the market currently anticipates. Second, we are facing a potential disputed election, even before the election occurs. Were either of these risks to materialize, I suspect risky asset valuations would suffer. Of course, it is never wise to invest with either the best-case or worst-case scenarios as anchors. It is wise, however, to take all possible risks into account when constructing an asset allocation.

Let me close with a famous quote from Warren Buffet: “Price is what you pay; Value is what you get.” Clearly, being valuation sensitive has not been a winning strategy over the last few years. Then again, as we all learn, past performance is not an indicator of future results.

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