Market and Economic Outlook

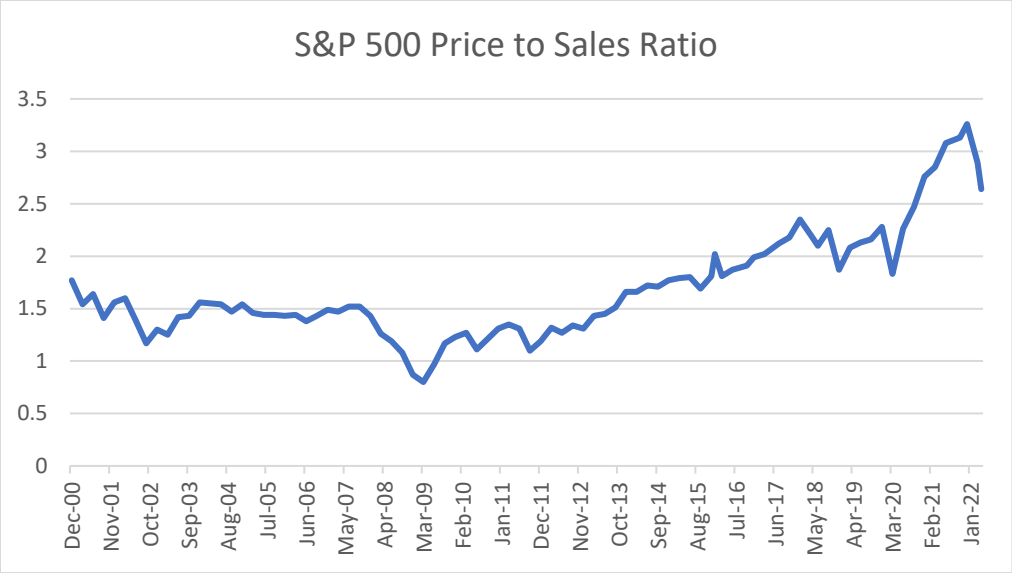
The start to 2021 has been interesting. Investment markets seem to have flipped from everything going up to almost everything going down. The big question investors should ask is, "Have we weathered the storm, or is this just the beginning. Perspective is important. I often hear people look at a recent price much higher than today's price as evidence that now is a good buying opportunity. While I appreciate the glass half full mentality, it is the logical fallacy of anchoring – without more data we don't know whether the current price or the previous price (or neither) is correct. For example, if the market goes up 100% and then falls 10%, it is cheat because it is down 10% or expensive because it is up 80%? It is better to look at long-term sensible metrics to get a sense of where we valuation.

Economist and investor Dr. John Hussman looks at five different measures of market valuation (Price/normalized forward operating earnings, Margin-Adjusted P/E, Market capitalization of non-financial equities/nominal GDP, Price/Revenue and Nonfinancial market cap/Gross value-added). Importantly, each of these measures is more stable and more predictive of future returns than the commonly used Price/Earnings ratio. Even with the recent market decline, each of these measures is roughly three times its normal level (down from about 3.6x) and higher than even the tech bubble. Indeed, the recent decline looks quite small on the chart. He notes that while valuation is a good predictor of long-term returns, it does a poor job of guessing short-term trends. An overvalued market can become more so. According to Dr. Hussman, the time to step aside is when attitudes toward risk begin to change. Increasing risk aversion in an overvalued market can start a significant decline in valuation. He believes we are there now, and predicts "a long, interesting 10-20 year trip to nowhere for the S&P 500."[1] I agree, and I also agree that there will still be opportunities to make money during this time. Managing risk will become very important, after being a drag on performance until recently. Rather than removing risk during corrections, buying each and every dip and aggressively using leverage has been the way to outperform over the last few years, at least until just recently. This is not normal, and I do not expect it to persist.

While the metrics that I track are not quite as extreme, they paint the same basic picture. The Shiller P/E ratio (which adjusts for cycles by looking at ten years of inflation-adjusted earnings) is currently at a 72% premium to its 50-year average and a 40% premium to its 20-year average. This, like the other data points I track is as of 3/31/22, but even as of the end of April, the Shiller PE of 32.53 is still at a premium of 55% and 26% to its 50 and 20 year averages, respectively, and higher than any time in history other than the late 1920's and the late 1990's and into the year 2000. Price to book value is at a 60% premium to its last 22 years of history, and only slightly lower than during the tech bubble.

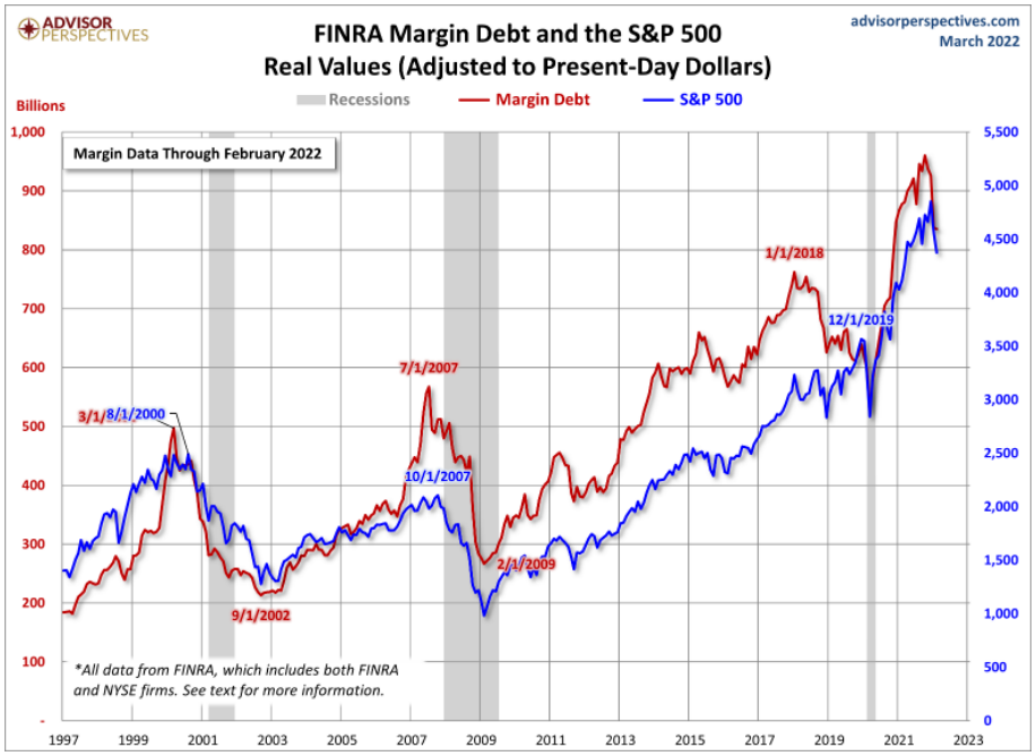
Likewise, the price/sales ratio, which is not impacted by cyclically high profit margins, closed the first quarter at 2.89, down about 10% from where it ended 2021, but still 88% above its long-term average. The chart graphically puts the decline into perspective. I updated this through the end of April. While the decline is significant, it gets us nowhere close to a normal level.

[1] (Hussman, 2022)



Source: http://www.multipl.com, Rothman Investment Management

Is Hussman correct about risk aversion picking up? We will only know for sure in retrospect. There are some clues, however. The amount of money borrowed by investors to purchase securities has fallen steeply.



Some of the highest flyers that led the market up and that had the most of their value far off in the future (by virtue of little to no earnings today) have been leading the way down. The so-called FANMAG stocks carried the market for a while, before giving way to even more speculative stocks during the pandemic. FANMAG have been leading the market lower as well. Relative to their 52-week highs: FB -46%, AMZN -34%, NFLX -73%, MSFT -21%, AAPL -14%, GOOG -24%. I find it noteworthy that the oldest and least speculative two of this group did the least bad. Even more speculative names may give us more clues about risk appetite. Global tax subsidy giant, Tesla is down 30% from its 52-week high. Ark ~~Speculation~~ Innovation, a fund that makes concentrated investments in (mostly unprofitable) companies it believes will be disruptive some day has dropped almost two thirds from its peak. Investors on balance have yet to lose faith in the fund, which is still seeing inflows[2], which argues against euphoric speculation being done, but the underlying holdings are collapsing. Meme stocks AMC and GME are down 79% and 64% from theirs. I checked on some of the pandemic darlings whose stock prices rose to dizzying heights – TeleDoc, Peleton, Uber, Air BnB, Snowflake, Lemonade, Carvana and Robin Hood are down an average of 65%. I did not look for stocks that had fallen the most – these are stocks I have been watching on the way up and on the way back down to try to understand market psychology, and I did not exclude any I looked up to make the numbers look worse. While some may see these price declines as a generational buying opportunity, I am skeptical. Market capitalization is still in the billions to tens of billions, and the hopes of viable and profitable business models is yet to be realized. Also of note – tech-heavy NASDAQ as underperformed the S&P 500 by about 9 percentage points year to date (through April), while the Vanguard Value Index has outperformed by about 7 percentage points. This points to a shift away from speculative future investments to companies that are making money now.[3]

One could argue that companies with earnings further out in the future losing more value than those which have more near-term cash flows is simply a function of interest rates. Higher interest rates today decrease the value of money far off in the future. This is a reasonable explanation, and is probably at least partially correct, but I suspect declining risk aversion is also a contributing factor. Consider that the 30-year treasury bond is down about a third – much less than the popular story stocks. Consider also that the Volatility index, or VIX – a measure of traders' expectation of stock market volatility has doubled year to date. This shows much greater uncertainty, which correlates to higher risk aversion. Finally, consider the experience of new stock market investors, or more accurately, speculators. For the last two years up until a few months ago, almost everything went up in value. New investors dumped money into the most risky stocks and borrowed against their paper gains to buy more. People who had no business using options bought far out of the money short-dated call options (the most speculative type available) to magnify risk and were rewarded with fast profits. They were trained to maximize risk, lever up, double down and expect fast and easy money. I do not believe they carefully projected future cash flows of early-stage companies and discounted these back to today at the current fed funds rate. This situation is similar to the housing bubble of the mid-2000's, typified by a bartender owning five houses, purchased with borrowed money and more money borrowed against the paper gains of the previous houses. As that did not end well, I do not expect this to end well. The problem with using leverage, and even more so with using out of the money call options, is that it does

---

[2] (Capul, 2022)

[3] Price data is from Yahoo! Finance. Nasdaq returns are measured by the tracking ETF QQQ, while S&P 500 returns are measured by SPY. The Vanguard Value Index Fund (VTV) is used here as a proxy for large cap value.

not necessarily require a large drop in the value of the underlying securities to bankrupt the investor. Even price stability can be devastating when one has bet on much higher prices. It is very possible that this initial market decline spurs forced selling, which then generates further margin calls, as happened in the last "Roaring Twenties."

Economic trends

A recession is not a necessary condition for stocks to fall, and sometimes the recession can be caused by the stock market first crashing. Market returns can be poor based on a so-called earnings recession where the overall economy keeps growing but corporate earnings stall out as profit margins move lower. Rising tax, interest and wage rates can pressure profit margins. Still, most major market declines do coincide with recessions. While most forecasters are still not calling for a recession this year, it is noteworthy that Gross Domestic Product (GDP – a measure of the size of the economy) did contract in the first quarter by 1.4%, after adjusting for inflation. Expectations were for a slight increase of 1.1%.[4] Note that this is the advance estimate and will be revised a few times before it becomes official, and it is only one quarter. There are a lot of things going on in the world that can affect economic activity, including supply chain disruptions, changing COVID policies, and the war in Ukraine. Investors would be wise to not read too much into one data point. On the other hand, these factors do increase the risk in the economy and the risk to corporate profitability.

Other economic trends are negative as well. Leading economic indicators are slowing, though year over year growth is still positive.[5] Looking forward, I see continued risk to supply chains globally as the war in Ukraine continues and as China pursues an aggressive zero-COVID policy. I have read unsubstantiated reports of major regional lockdowns in China and of regional authorities preventing farmers from using their tractors (alone!). If true, this could lead to food shortages in China that could impact the rest of the world. Russia and Ukraine are both major wheat exporters. I remember hearing years ago that the only place with soil as good as that in Iowa is Ukraine. Russia and ally Belarus are major exporters of potash – which is used for Potassium fertilizer. With some countries trying to increase biofuel production to offset lost Russian oil and gas, worries about food shortages are being exacerbated. Doomberg noted that Indonesia just banned the exporting of palm oil, which accounts for 35% of all cooking oil produced last year. Indonesia produced 60% of that.[6] Food insecurity can lead to political upheaval, as was witnessed with the Arab Spring the last time food prices soared significantly.

Finally, inflation continues to persist. Even if home prices stabilize, rents and owner equivalent rents could continue to rise due to much higher interest rates. As of today, bankrate.com shows the 30-year fixed mortgage national average at 5.4%, up from 3.3% at the end of last year. Hussman notes that a $1000 monthly payment on a thirty-year mortgage would have enabled a home buyer to purchase a $245,000 house in 2020, but now only enables a $180,000 purchase. While this has yet to stop home prices from rising, logically it should, since homes are typically bought with mortgages.[7] Most likely, locked in mortgage rates on pre-approved loans and a rush to buy before rates go even higher is

---

[4] (Mislinski, 2022)
[5] (Mislinski, ECRI Weekly Leading Index Update, 2022)
[6] (Doomberg, 2022)
[7] (Hussman, 2022)

delaying the decline in price. Rising housing costs, rising fuel prices, rising food prices and potentially less opportunity to use one's house as a source of debt capital if home prices quit rising will pressure other consumer spending and investment flows. Some note that inflation is measured year over year, so it should naturally revert to its mean as prior year comparisons become more extreme. Further, used car prices probably will not keep rising. These are good points, but one of the drivers of inflation historically is inflation expectations. As workers see the cost of everything rising, they demand raises. As businesses see input costs and wages rising, they increase prices. Once inflation becomes embedded in expectations, it can feed on itself.

Conclusion

Ultimately, it is interesting to watch various data points and to try to connect the dots, but making macro investment decisions based on economic predictions is tricky. While I find economic context helpful, my risk positioning is mostly driven by data. I continue to use the systems I implemented last year, while looking for ways to keep improving my systematic approach to risk management. I am optimistic that focusing on strong companies that sell for reasonable prices is going to work going forward, and that systematically controlling risk will help protect clients. In good times, almost any approach will do, but in challenging times, it is important to have a plan, and helpful to have someone keep you to the plan.