When is this Bubble Going to Burst?

This has been a common question posed by our clients and the broader marketplace in recent months as the S&P 500 has begun to set new all-time highs and most asset classes have enjoyed strong returns over the past five years. Plagued by memories of the tech bubble in the late 90s and the housing bubble of 2007-2008, investors are understandably concerned that new highs in the market could signal that it is time to bail on stocks. In this month's Insights, we will provide evidence that refutes the idea of a market bubble and offer what we believe is the more accurate interpretation of today's market highs.

Bursting the Bubble

There is no disputing that the returns in the U.S. equity markets since the bottom in 2009 have been simply outstanding, especially compared to the lackluster recovery in the broader economy. The stark contrast between the performance of Wall Street and Main Street has led many to question whether the market's returns are "real" or just another bubble that will inevitably deflate. In our view, however, the sharp rebound in corporate profits since 2009 offers sound fundamental underpinnings to the market's ascent. In fact, S&P 500 operating profits began hitting new highs in 2011, well before the stock market, and are now 17% higher than their previous peak in 2007. This explains the vast majority of the 24% gap between today's S&P 500 level of 1,940 and its previous peak in 2007. If we assume market prices follow earnings over the long run, which they do, there is no sign of a bubble here. Turning to valuation, investors are currently paying just over 16 times the consensus earnings estimate of $119 for 2014. This multiple is right on top of the 15-year average paid on S&P 500 earnings. The market also looks fairly priced compared to other metrics such as book value, sales, and cash flow. Following a year in 2013 where most of the 30%+ return came from multiple expansion, it would be easy to conclude that the market was getting bubble-like; but in reality, equity multiples appear to have just caught up with profits and returned to their historical average valuations.

In addition to profits and valuation, most of the metrics that gauge investor behavior, such as retail fund flows, cash on the sidelines, and leverage, are also not pointing to a market bubble. Historically, the buying behavior of retail investors has been a reliable contrarian indicator for the markets as they tend to be the last group to get back into a bull market before the end of the cycle. In this light, the fact that retail has been largely absent from the rally since 2008 gives us some comfort that current equity prices are rational. In fact, 2013 marked the only year of the market recovery in which equity fund flows exceeded that of bond funds and this was apparently short-lived as the trend has already reversed course again in recent months. Another metric that helps illustrate the continued risk aversion in the market is the record amount of cash sitting on the sidelines. Between retail money market funds and deposits, institutional money market funds, and cash in IRAs, there is nearly $11T in cash on the sidelines, or a record 64% of US GDP. Prior to the financial crisis (when cash actually earned a decent return of 3-5%) the amount of cash in the economy relative to GDP averaged around 50%. Considering that we have a significantly higher level of cash today despite zero interest rates and negative real returns after inflation, it appears investor sentiment remains far from exuberant. Lastly, although there has been some concern regarding record levels of margin debt (borrowings against investment portfolios), the overall amount of leverage in the system is not yet a cause for alarm. As it relates to margin debt, given that every other indicator from investors is pointing to a lack of enthusiasm about equities, it seems likely that margin is being used to finance purchases other than stocks and/or that higher margin levels are partly a function of the continued growth in hedge fund assets. Looking at leverage on an overall basis, consumers and corporations have actually de-leveraged in dramatic fashion with household debt service (relative to income) having dropped to its lowest level since 1980 and S&P 500 corporate leverage now half of its pre-financial crisis level. While it is true that most of this leverage has been transferred to the government via bailouts and stimulus measures, the current lack of leverage in the private economy reduces the odds that financial markets are becoming overheated.

Tempered Expectations

Although we do not believe the market is showing signs of a bubble, we do believe investors would be wise to temper their expectations for equity returns starting from today’s market highs. From a valuation standpoint, equities may not be overpriced but they are certainly not cheap either, and it is difficult to foresee significant multiple expansion from here unless inflation and interest rates remain lower for longer than the market believes. From a profit standpoint, we expect earnings to be somewhat restrained by meager revenue growth and already high profit margins, which leads us to a forecast of 5-7% earnings growth this year. After tacking on dividends and assuming no multiple expansion, our return target for the year is 7-9% - a large portion of which has already been achieved in the first half of 2014. While lower than historical averages, a high single digit return for stocks is still pretty attractive in a 2.6% 10-yr Treasury, sub-2% inflation environment.

Within the fairly valued equity market, we are actively identifying pockets of opportunity. In the U.S., we like growth industries such as network security, housing construction, and energy infrastructure, all of which are supported by unique long-term tailwinds. Outside the U.S., we are favoring European multinationals in the short-term due to the combination of attractive valuations and the backstop of liquidity from the European Central Bank and favoring Emerging Markets for the long-term due to the investment opportunity available in countries with very little debt, young demographics, and rising standards of living.

Over the past two years, investors have enjoyed a very smooth rise in the markets with very little volatility. This could continue in the short-term, but we would not be surprised to see a 5-10% correction simply because there is less of a cushion for the market to absorb bad news. For long-term investors, we would continue to view this type of correction as a buying opportunity until the market cycle shows further signs of maturation.