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ON OUR MINDS

Are Stock Investors Too Complacent?

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A few days ago, CNBC's Joe Kernan asked me whether a stock market correction might be imminent. Another Squawk Box guest, Mark Ruschini of Janney Montgomery Scott, had just suggested that stock investors are riding for a fall, noting that prices are elevated and that many of President Trump's signature pro-growth initiatives may not be enacted in a timely manner. Perhaps stock prices may fall, I responded, but investors should still maintain a full equity participation; the cost of exiting too early can be painful.[1]

Why stay fully invested when a 10% dip (or even more) might be imminent? Because market timing simply doesn't work. Mr. Ruschini, no doubt a talented professional, has already missed a 6% gain year-to-date because he has been concerned about a possible correction. His clients may have sold some stock, creating unnecessary taxable gains. And having exited at the wrong time, he may compound his error by returning to stocks at the wrong time as well. By staying invested, we have avoided these pitfalls and potential tax liabilities. Investing is a long-term endeavor.

Besides, the case for stocks is still solid, resting as it does on a healthy outlook for corporate earnings. After five straight quarters of declining earnings, the S&P 500 finally posted a barely positive comparison last September, up about 2%; the pace of earnings growth picked up a notch in the just-reported December quarter, to 6%. Looking ahead, oil prices have doubled from a year ago and the rise of the dollar has slowed, giving corporations a boost to nearly double-digit earnings growth through the first half of this year. Possible infrastructure investment or tax reform legislation could spur further growth as well. As Buddy Holly sang, "it's so easy to fall in love [with equities]. People tell me stocks are for fools, so here I go breaking all the rules."[2]

I don't think Mr. Ruschini's caution is due to fears of collapsing earnings, though. I think he's more concerned that stocks appear to be expensive and that investors appear to be complacent. Both are true but not necessarily indicative of problems ahead. At 17.6 times year-ahead earnings, the S&P 500 is indeed above its long-term average of about 16 times, but with good reason given accelerating growth and low interest rates. When interest rates are low, future earnings are worth more money today, so a modest increase in the P/E ratio is justifiable.

Even so, equity investors have become disturbingly complacent – after all, a pro-growth regime is settling into Washington, good earnings growth is anticipated, and the Federal Reserve is reticent to move aggressively. Greed is trumping fear, but in an orderly way. The stock market today is nothing like the pedal-to-the-metal exuberance of the late 1990s or mid-2000s.

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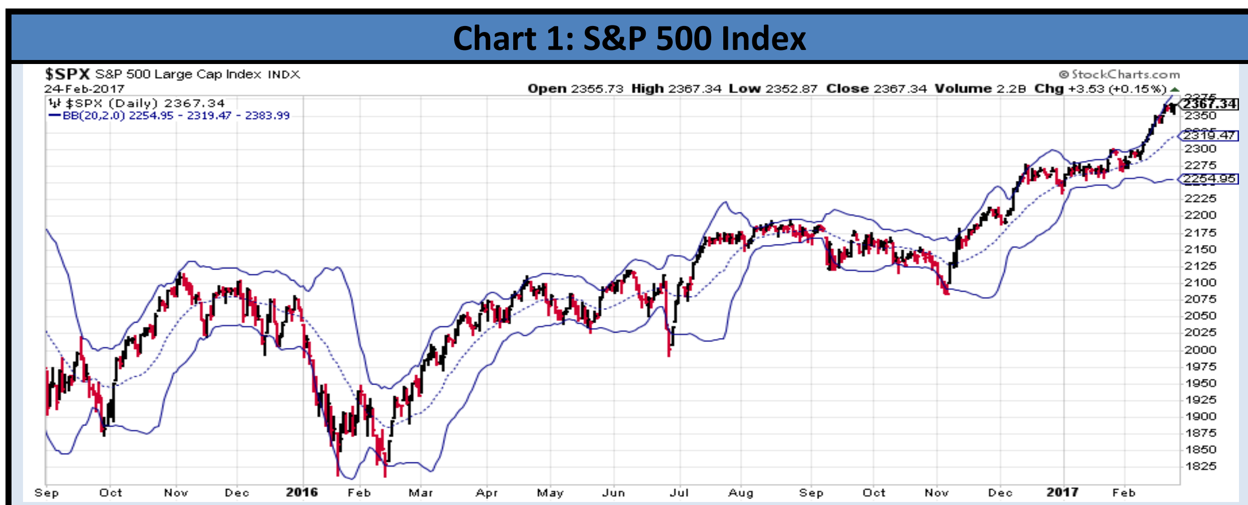
[1] You can see the entire exchange here: https://youtu.be/JN_Nf_Cpo-o.

[2] This is not, contrary to popular belief, the source of the "greater fool" theory of investing, namely that one can buy an expensive security confident that a greater fool will pay you a higher price when you want to sell it.

Chart 1 shows the S&P 500 index over the past 18 months, and Chart 2 shows the VIX volatility index over the same period. The VIX is a measure of implied volatility, calculated by comparing prices of put and call options on the S&P 500; when the VIX is low, investors anticipate lower volatility and are generally bullish; conversely, a high level indicates bearish bets in the options markets (leading to the “fear gauge” sobriquet).

In both cases, the level of each index is at or near unprecedented levels – record highs for the stock market, and near-record lows for the VIX. This suggests that investors are highly optimistic, willing to pay higher prices and not concerned about the risk of a bear market.[3] Contrarians might well interpret this as a sign to head for the exits.



Source: StockCharts.com

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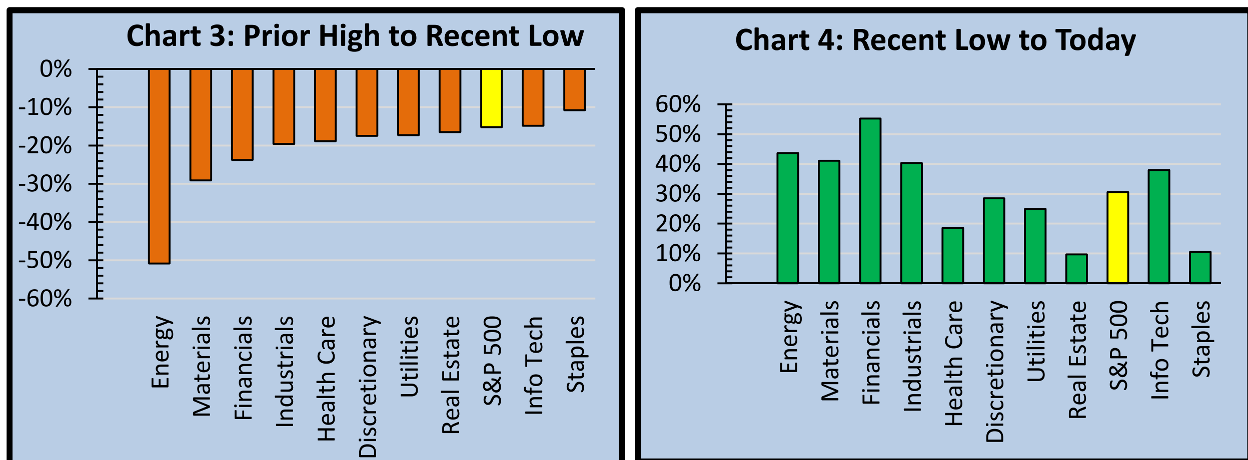
[3] Chart nerds might also note the thin blue lines that bracket the thicker price lines. These “Bollinger Bands” show the prices that would be within two standard deviations of the actual price, given recent trading data. Not only is the VIX low, but the Bollinger Bands around the VIX are also quite narrow; in other words, the anticipated volatility of volatility itself is subdued. That’s about as complacent as markets ever get.

The problem with contrarian sentiment is that, by definition, it violates the old adage of "the trend is your friend." Stocks are in a solid uptrend, and they can easily overshoot "fair value" rather substantially until some exogenous catalyst forces a return to equilibrium. Stocks aren't yet so expensive that their mere price scares investors, so the trend upward can remain in place.

It's also worth bearing in mind that the broad S&P 500 index behavior masks substantial variation among different industry sectors. Individual sectors have been considerably more volatile than the market as a whole, and several sectors have endured their own bear markets or severe corrections – just not all at the same time. Chart 3 shows that seven of the S&P's 10 sectors (as measured by SPDR sector funds) have dropped by more than 15% in just the past two years. Chart 4 shows what happened since the most recent lows in each sector, with recoveries ranging from only 10% to above 50%. In this respect, although the overall bull market is old,[4] individual sectors are in several cases just coming out of their own bear markets.



Source (both charts): FactSet

At some point, earnings growth may no longer be able to support rising prices, but that point is not imminent. Absent any exogenous shocks, then, it's fair to expect that domestic stock prices can continue their gradual ascent upward for at least the immediately foreseeable future.

What keeps investors awake at night is that phrase "exogenous shocks." Any of several events could undermine investors' confidence in either the trajectory of earnings growth or the valuation appropriate for those earnings – or, perhaps, both. Such is the birth of bear markets. Four risks, in particular, could flip the mood from complacency to panic:

- **Short-term interest rates.** Investors anticipate that today's historically low short-term interest rates will rise only gradually; futures contracts imply only two quarter-point hikes this year. If the Federal Reserve determines that economic conditions merit more aggressive action (due to a sharp increase in inflation, unsustainably lower unemployment, or excessive borrowing – all of which are well within the realm of the possible) investors might be spooked into cashing out.

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[4] Its eighth birthday is next Thursday, March 9. It is now the third-longest bull market since World War II. In general, market cycles have been lengthening in recent decades, so this by itself is not surprising or concerning.

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- **Long-term interest rates.** Yields on long-term bonds globally have been held down by aggressive quantitative easing (bond purchases) by the European Central Bank and the Bank of Japan, among others, as these central banks attempt to stimulate their economies with cheap money. Investors seeking better yields have turned to American corporate and government bonds, which have kept prices up and yields down here. If the ECB or BOJ were to reduce their bond purchases, capital might start flowing out of the U.S., which would push up longer-term interest rates here and damage stock prices.

- **Trade policy.** While the Trump Administration has talked about more protectionist policies, it hasn't yet delivered. Most economists have cautioned against higher tariffs or border-adjustment taxes. Import tariffs don't prevent Americans from buying imported goods; they simply mean we pay more for them, raising inflation rates. Similarly, border-adjustment taxes would cause the dollar to soar in value, offsetting any benefit the new tax regime would provide to exporters. Protectionism of any sort tends to discourage global trade, depressing GDP growth and inviting retaliation from abroad.

- **Immigration policy.** Economic growth can only come from more workers or more output per worker. History has shown that GDP growth correlates closely with growth in the labor force.[5] Our population growth rate has gradually been falling from 2.0% just after World War II to about 0.8% today (about 2.5 million people each year recently). If we deport millions of undocumented immigrants each year, the country's overall population growth could actually become negative – we would literally be depopulating ourselves. The effect on the labor force would be worse, since proportionately more undocumented immigrants are of working age and employed than is true of the native-born population. A draconian immigration policy could throw the U.S. into recession.

None of these risks is yet affecting investor sentiment, which has allowed stocks to continue their upward climb. But all of them are realistic concerns. Fed Chair Janet Yellen's recent testimony to Congress was widely interpreted as turning more hawkish, and President Trump has issued several executive orders to expand deportation of undocumented immigrants.[6] We will continue watching these issues closely; but for now, the burden remains on the bears to make their case.

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[5] Please refer to "The U.S. Economy: Why 2.0% is the New 3.5%," an *On Our Minds* commentary published May 23, 2016, for a deeper analysis of the relationships of population, labor force, and economic growth.

[6] President Trump's address to Congress last night was gratifying inasmuch as he appeared to be ratcheting down the rhetoric of deportation. Actions will ultimately speak louder than words.