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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF NOVEMBER 18, 2024

What Could Possibly Go Wrong?

"The one thing we learn from history is that nobody learns from history."
— Warren Buffett, CEO, Berkshire Hathaway

THIS WEEK

- THE BACKBONE OF THE US ECONOMY
- DISINFLATION STALLS
- NO CURE FOR THE BOND MARKET BLUES
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

Trump won, Republicans swept and half the country is deliriously happy. However, I kind of feel sorry for Donald Trump because just like I did for George W. Bush in 2000 because he will be entering the Oval Office at the peak of a massive price bubble in the equity market.

For the past 12 months, investors have been overtly, if not blindly, throwing caution to the wind, willingly taking on equity risk and not getting compensated for it.

The S&P 500 is now up 23% year-to-date. While it's been a euphoric and epic ride higher, the S&P 500 is now grossly overvalued against interest rates, earnings, cash flow, sales and most other metrics that have stood the test of time**.**

Below, I show six graphs that point to just how egregiously overvalued the stock market has become.

The first graph shows that the S&P 500 earnings yield **FELL** below the 10-year Treasury yield for the first time in **22 YEARS**.

Currently, the S&P 500 earnings yield, which measures the S&P earnings yield as a percent of the price, is 3.73%. At the same time, the risk free 10-year Treasury yield is now 70 basis points higher at 4.43%.

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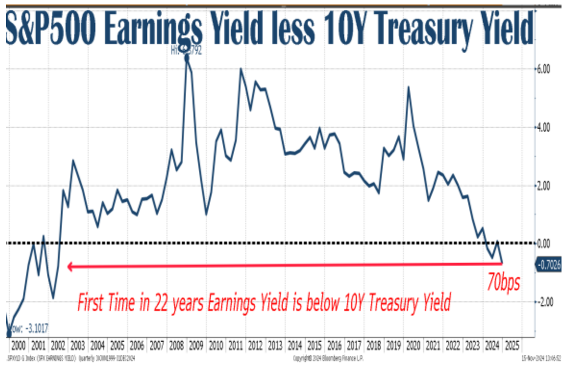
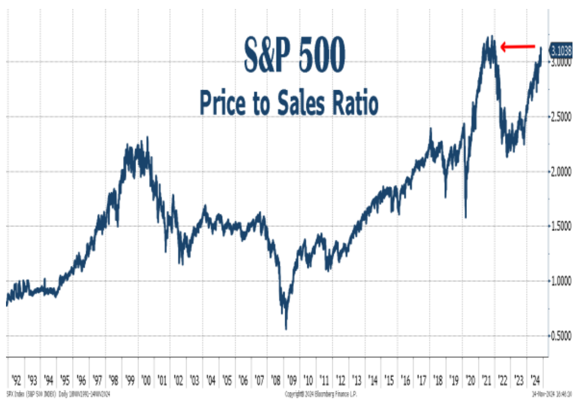
In other words, less risky (theoretically), the 10-year Treasury is paying **MORE** than the S&P 500. This could imply lower than average forward returns for the S&P 500.



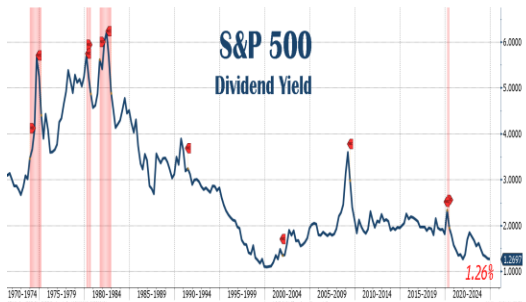
Second, the S&P 500 price-to-sales ratio hit the second-highest level in **THREE DECADES**. A ratio that is higher-than-average could indicate that the stock is overvalued.



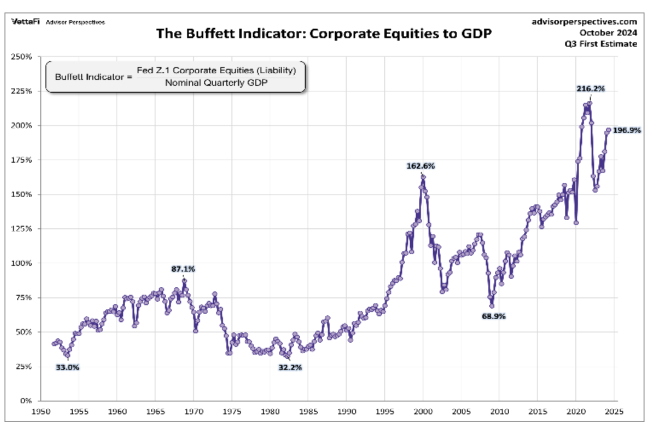
Third, the price-to-book ratio hit the levels seen only during the 2000 dot-com bubble peak.

Fourth, although Q3 earnings expectations have come in better than expected, Q4 and 2025 expectations are coming under the knife. This has taken place alongside a run-up in stock prices to all-time highs that has pushed the forward the price-to-earnings ratio beyond 24 times.

Next, amidst the new record highs, the dividend yield on the S&P 500 hit its lowest level (1.26%) since the implosion of the 2001 tech bubble.



Last, but not least, the Buffett Indicator is the ratio of total U.S. stock market value divided by the gross domestic product (GDP). This is named after Warren Buffett, who called the ratio "the best single measure of where valuations stand at any given moment." Currently, this indicator shows the stock market value now nearing 200% of GDP **—** far exceeding the peak during the dot com bubble in 1991 and fast approaching the highest level ever. As one can glean from the graph below, this is important because if the stock market value is growing much faster than the actual economy, it may be in a bubble.



I should stress that valuations do **NOT** help in "timing the market." Indeed, overvalued markets can continue to rise. Animal spirits, momentum and greed are powerful forces over the short term. However, I can't emphasize enough how valuations are key in assessing expected future returns, which are typically nil when price-to-sales, price-to-earnings, price-to-book multiples and the Buffet Indicator become so over stretched, as is the case today.

It's not just valuations that are stretched, but investor positioning and sentiment indicators are as well. To wit: A recent poll from Bank of America covering the first week of November (including the election) revealed that investor exposure in U.S. equities is sitting at 11-year highs. Further, portfolio manager cash ratios are at unprecedented lows of less than 2%, and fully 70% of the household asset mix concentrated in equities – compared to just 9% for bonds.

We are in the midst of the third most epic price bubble since 1928-1939. Yet, nobody has bothered to take profits or rebalance the portfolio, preferring instead to treat "diversification" as a dirty 15-letter word. Sentiment is wildly bullish as well, to the point of surreal complacency.

But let me ask you a question: What is the chance that Trump will serve four years and there won't be a bear market throughout his entire term?

This is important because, historically, bear markets have occurred roughly once every three to five years. In terms of stock market cycles:

- The **average duration of a bear market** is around one to two years, though this can vary significantly.
- On average, the **stock market** experiences a bear market about **every three and a half years** (S&P 500).

Given this, over a four-year period, the probability of a bear market is somewhat high. The historical frequency of bear markets suggests that the chance of one occurring over a given four-year span could be in the **30–40% range**. However, this is a rough estimate and depends on factors like market conditions, geopolitical events and other economic developments.

"It is always a good time to remind oneself: there is no upside without downside, no reward without risk."
— Doug Kass, Hedge Fund Manager

Unless the world has changed at some point, this bubble will **burst.** This in turn could be the greatest tail risk to the economic outlook. Given the excessively high valuations and how many households, including aging baby boomers, are exposed to equity risk**,** this could provide a tremendous shock to the economy.

It is also important to understand that there have been as many bear markets in the past as there have been bull markets. And I should stress that bull markets do not correct by going sideways. Indeed, I like to say, "bull markets are up by the stairs while bear markets are down by the elevator." While timing is nearly impossible, and no one knows what will prick the bubble, investors should be prepared for the eventuality of a bear market.

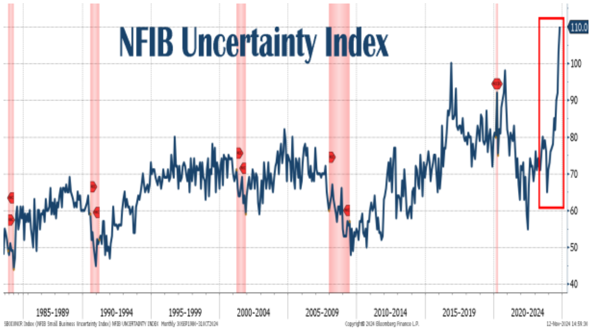
Bottom line: Every tick higher this S&P 500 bubble goes, the more bullish I get on the Treasury market. Why? To repeat, the greatest single risk ahead is not inflation, it is not a global trade war and it is not geopolitical risks, it is what happens when this equity price bubble bursts in spectacular fashion. If the bubble does burst, the flight to safety would likely trigger a safe haven rally with Treasuries being the primary beneficiary.

THE BACKBONE OF THE US ECONOMY

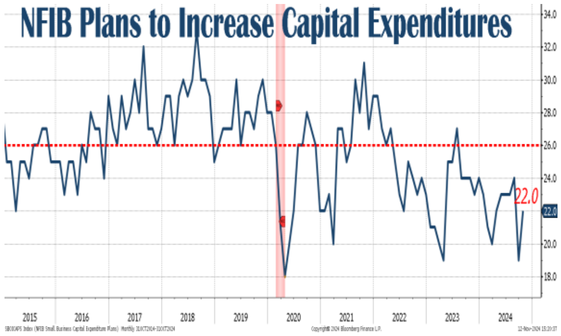
The stock market has soared over the past 12 months on the back of the Magnificent 7. But as I like to say, the stock market is **NOT** the economy and there is more to the U.S. economy than Nvidia and the Magnificent 7.

In fact, small businesses are the backbone of the U.S. economy making up 97% of businesses (fewer than 250 employees) accounting for nearly 50% of GDP and being the largest employer.

Last week, the most recent reading from the NFIB index showed that the small business optimism index improved in October by coming in at 93.7, up from 91.5 in September. But the companion uncertainty index rose a chunky +7 points to 110. This is a fresh record high going all the way back to 1974 (Note: This survey covers the month before the presidential election). Indeed, it will be interesting to see how perceptions shift in the wake of the Trump victory since polls suggest he has a lot of support in the small business community.

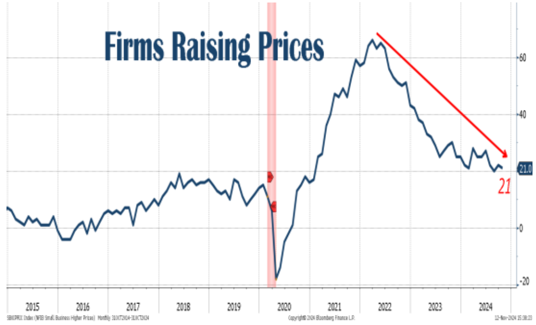


The record high uncertainty is important because when small business leaders feel unsure about the outlook, they tend to hold back on investments and new hires. This explains why there has not been much of a capital expenditure cycle except for the AI-exposed tech, and why the labor market is easing up. As shown below, only 22% of firms plan to make capital outlays. This is a slight improvement from the 19% post-COVID-19 low in September, but hardly encouraging next to the 10-year average of 26% (see the red hyphenated line).

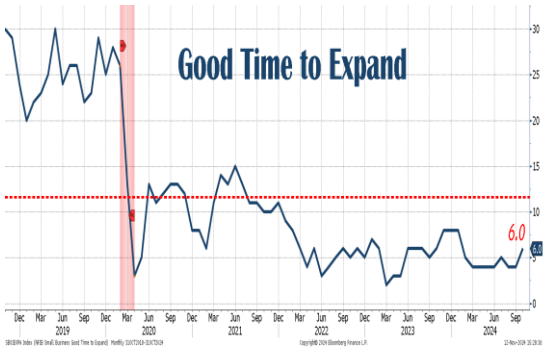


The net share of firms raising wages over the past three months collapsed. Businesses are finding it easier to find the workers they need now than in the year before the pandemic hit, and only 8% see labor costs as their biggest problem. This is quite dovish and disinflationary.

And there is nothing in this report that should cause concerns over inflation. For example: The balance of firms raising selling prices fell to 21% from 22% in September and 30% a year ago.



On the sales front, the news was uniformly negative. The share of businesses reporting poor sales as being their biggest issue shot up from 7% to 9%. This is at its highest level since 2021 and a balance of 4% of firms expect sales growth to be negative. No wonder only 6% of firms agree that "now is a good time to expand." This is not an encouraging sign and belies the weakness on Main Street that investors who focus on Silicon Valley are overlooking.



Bottom line: Small businesses are feeling uncertain about the outlook and worried about sales, however, they are not raising any red flags over inflation or wages.

DISINFLATION STALLS

"Our outlook for the December 18 Federal Open Market Committee Meeting (FOMC) meeting is *that a rate cut is likely but not assured****. Today's CPI data do not affect that outlook.*** *Fed Chair Powell said he was confident that progress toward the inflation target would persist****. So*** *inflation metrics still above target in this report are neither a surprise nor a threat to future rate cuts."*

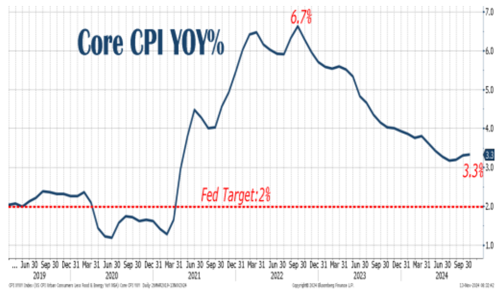
— Carl Weinberg, Chief U.S. Economist, High Frequency Economics

For the month of October, the headline Consumer Price Index (CPI) index came in at consensus expectations. Month-over-month, the index was up 0.2% and 2.6% year-over-year..

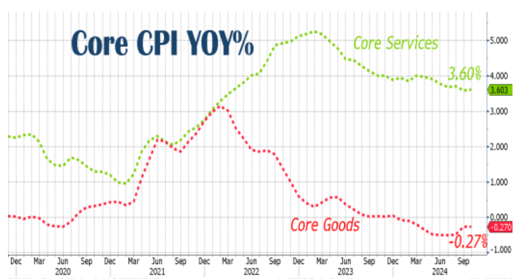
As can be seen in the data below, since the peak of inflation in June 2022 at 9.1%, the rate of price appreciation has slowed dramatically across virtually all sectors.

	Fuel Oil	Gasoline	Used Cars	New Cars	Apparel	Food at Home	Gas Utilities	Overall CPI	Medical Care	Food away from Home	Electricity	Shelter	Transportation
June 2022 YoY	98.5%	59.9%	7.1%	11.4%	5.2%	12.2%	38.4%	9.1%	4.8%	7.7%	13.7%	5.6%	8.8%
October 2024 YoY	-20.8%	-12.2%	-3.4%	-1.3%	0.3%	1.1%	2.0%	2.6%	3.8%	3.8%	4.5%	4.9%	8.2%

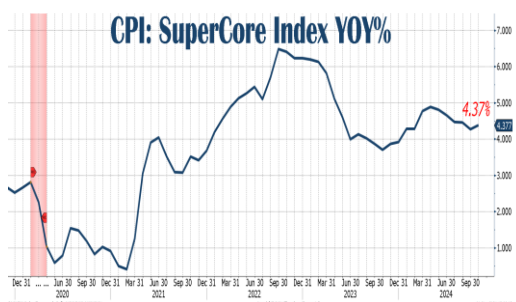
On a month-to-month basis, the “core” CPI – which excludes the volatile food and energy components – rose by 0.28% (+3.4% annualized) in October from September. The last three months have all risen in this range of +3.4% to +3.8% annualized, the biggest increase since March.



The latest U.S. inflation data show that the issue is largely under control, but not that it can now be safely ignored. The core goods CPI was flat and has been stagnant or down in seven of the past eight months — and deflating on a year-over-year basis, but services remain problematic. This leaves overall inflation above 3%, and still too high for comfort.



The Fed Chair Jerome Powell “super-core” index (services excluding energy/rent/Owners’ Equivalent of Rent) came in neutral at +0.3%, but this is not exactly a data point the Fed doves will be crowing over. Year-over-year, the index is higher by 4.37%.



Shelter costs remain a primary source of inflation at +0.4%. The biggest factor in CPI is Owners’ Equivalent of Rent, which accounts for 27% of overall CPI. This metric is based on what homeowners estimate what their home would rent for, with assumption that a homeowner would want to recoup their cost increases by raising the rent. It’s purely guesswork and is a price no one has ever actually paid.

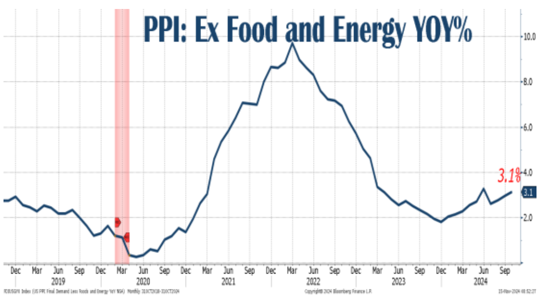
In October, the Owners' Equivalent of Rent accelerated to 4.9% from September and has zigzagged around the 5% line all year. Year-over-year, it rose by 5.2%, which is the same increase as in the prior month.

Bottom line: The worst of the inflation shock is over, but both headline and core CPI inflation are now higher than they were two months ago. The best that can be said is that the excluding shelter CPI index came in at +0.2% month-over-month for the second month in a row and is running at just +1.3% year-over-year. The simple fact is that the inflation progress has stalled out.

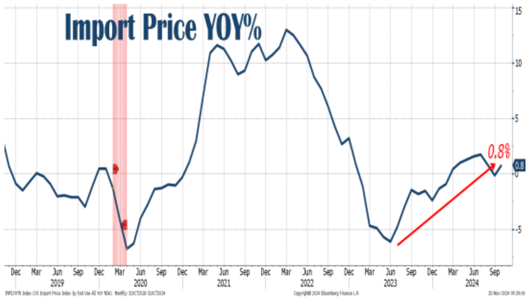
From my perch, the CPI data probably doesn't justify another rate cut next month. However, the Fed has a dual mandate. The latest employment figures showed that the U.S. economy added the least amount of jobs in October since the pandemic in 2020. At this point, a December pause would not surprise me if the November payroll report doesn't show follow through the weakness from October's dud.

NO CURE FOR THE BOND MARKET BLUES

In the wake of the CPI report, Producer Price Index (PPI) came in at an as expected +0.2% month-over-month in October, but September was revised up to +0.1% from flat. The core indices also were a tad above expected at +0.3% sequentially apiece, so not a stellar datapoint by any stretch (this was the highest reading since last April).



The PPI report was followed by the import price data that showed import prices rising higher than expectations at 0.3% compared to a consensus forecast of -0.1%. This took the year-over-year trend to 0.8%, which was well above the consensus forecast of 0.3%.



Bottom line: These two reports did not help bond investor sentiment one iota.

All in, the October inflation data (CPI, PPI and import prices) provided yet another challenge to my constructive outlook on the bond market and dovish Fed policy outlook. While not shaken, I am stirred by these recent developments. We shall await the November employment data and one more round of price reports before acknowledging that the disinflation momentum has totally subsided. For now, there is no official change to my rate view but consider it to be under review.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

November 14, 2024: "The economy is not sending any signals that we need to be in a hurry to lower rates…it may be the case that we slow the pace of what we're doing." *— Jerome Powell, Fed Chair*

Clearly, the bond market has inflation on its mind and may have lost confidence in Powell and the Fed. As shown below, the 2-year Treasury yield has risen 80 basis points since the fed funds rate was reduced by 50 basis points.

Likewise, further out the curve, the 10-year Treasury benchmark yield has risen by 77 basis points to 4.35%.

Further, the biggest problem for the Treasury market of late is investor perceptions. Many see Trump's promise for massive tax cuts, huge tariffs, mass deportation as an inflationary cocktail even though much of what he campaigned on in 2016 never did see the light of day. In other words, this is a classic case of the market shooting first and asking questions later.

A big reason why I remain somewhat constructive is that I believe that very little of Trump's fiscal expansionary campaign pledges will ever get passed in the House of Representatives, where the GOP has a very thin majority and is filled with ultra-fiscal conservatives.

Nothing meaningful gets done without the House, including tax relief of any kind that was bandied about on the campaign trail.

As for tariffs, I also doubt that the President-elect will risk the onset of a multi-border trade war that could trigger a global depression. We will more likely see a case-by-case approach towards foreign trade as we experienced in his first term but that it barely moved the needle on inflation. Hype is hype and reality is reality.

As to deporting all undocumented immigrants. Complete rhetoric. It's simply not going to happen. It may have played well on the campaign trail but I highly doubt Trump is going to deport tens of millions of illegal immigrants. Even if he was truly serious, the cases would get piled up in court and never even be heard. The 1.5 million or so who are criminals? Well, they are gone. Even Obama deported 3 million of these in his tenure.

But Trump will definitely embark on strategies that he can enact through executive order. And as we saw last time, deregulation will be the first thing he does, and that, by definition, will be disinflationary.

So, I understand the fear that has engulfed the Treasury market after bonds have been whacked so hard these past six weeks. However, I will patiently wait for the time when market perceptions morph into reality. I am not sure when that will set in, but I sense this will occur either when Trump comes out and says what he is really going to do as President as opposed to candidate, or when we see (for the first time) any of his budget-busting reflationary policies fail to pass through the House — or quite possibly both.

An exclamation mark for everything I said above came from the editorial piece in the *Wall Street Journal* editorial — the last part in particular:

> *"Republicans are euphoric about their election victories,* ***but the truth is that their margins in Congress are narrow and Democrats don't fear Mr. Trump. They have a year to pass their highest priorities, and they'll need a unified House and Senate to do it."***

Bottom line: As noted last week, until there is more clarity on the policy front, one should anticipate and expect higher volatility than normal over the next two to three months. That said, even though yields could rise from here on fear and speculation**,** the recent bond market sell off looks way overdone.

Stay tuned and have a great week!

MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (630) 276-2753.

As Alloya's Market Strategist, **Tom Slefinger** leverages nearly 40 years of investment strategy expertise to deliver insightful commentary on the economy and market events to optimize balance sheet performance at the credit union level. With thousands of subscribers, Tom's daily and weekly publications are widely read amongst credit union executives.

Prior to becoming the corporate's Market Strategist, Tom served as the Senior Vice President of Institutional Fixed Income Sales at Alloya Investment Services, a division of Alloya Solutions, LLC. In this role, Tom developed and managed operations associated with institutional fixed income sales in addition to developing investment portfolio strategies, identifying appropriate sectors and securities, and optimizing portfolio performance at the credit union level.

Tom holds a B.S. in business administration from the University of Maine. In addition, he holds a Series 7 and 63 through ISI.

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