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INVESTMENT SERVICES

Weekly Relative Value

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Market Strategist

WEEK OF DECEMBER 2, 2024

Peak Euphoria

" Be fearful when others are greedy." — Warren Buffet

What do you call a melt-up layered on top of the third most extreme price bubble of the past century?

The S&P 500 is on track for two straight years of over 20% yearly back-to-back gains for the first time since 1998-1999. Amazingly, after the market bottomed out in October 2022, the S&P 500 rallied a mind-blowing 57% in the past two years.

Record buybacks and record domestic and foreign inflows have fueled the equity market higher this year.

Since the election, the market has gotten another boost based on the potential impact of the “Trump Trade” and expectations of tax cuts, tariffs and deregulation.

In November alone, U.S. equity exchange-traded funds (ETFs) and mutual funds recorded the largest monthly intake on record. Year to date, the cumulative U.S. stock inflows have hit $448 BILLION, a new all-time high.

THIS WEEK

- HOUSING MARKET UPDATE
- BUILD IT AND THEY WON’T COME
- AS ADVERTISED
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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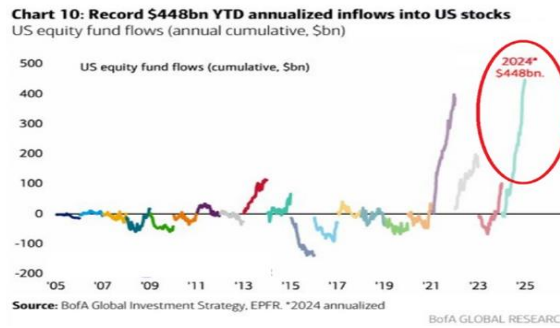
Market euphoria has almost never been so wild!

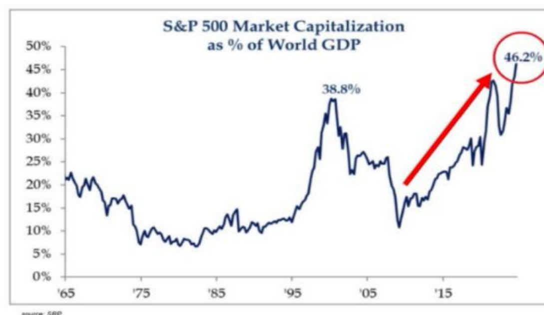


The U.S. stock market has now reached $62 trillion, which makes it more than TWICE the size of the U.S. economy. That's a ratio that the Oracle of Omaha explicitly warned about in 2001:

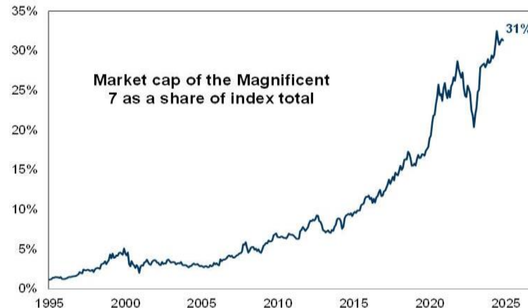
> *"If the percentage relationship (between market cap and GDP) falls to the 70% or 80% area, buying stocks is likely to work very well for you…If the ratio approaches 200% — as it did in 1999 and a part of 2000 — you are playing with fire. — Warren Buffet*

The equity market is also TWICE as large as the Asian and European markets COMBINED.

Here's another fun fact. S&P 500 market cap as a share of world gross domestic product (GDP) hit 46%, a new record. As shown below, this has even exceeded the peak of 42% seen before the 2022 bear market. To put this into perspective, at the 2000 Dot-Com Bubble high, the ratio was 39%.

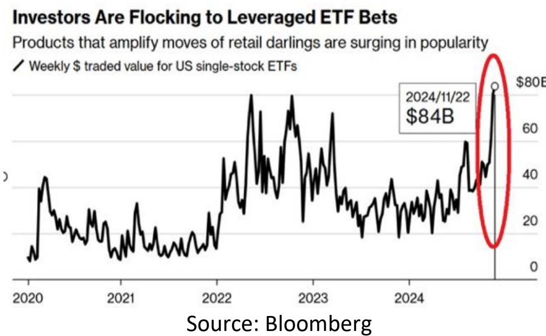


And oh, by the way, Uncle John and Aunt Sally — Did you know that 31 cents of every one dollar allocated to the S&P 500 in your 401(k) goes into the Magnificent 7 stocks? Never before has the S&P index been so heavily concentrated in a handful of stocks. Let's just hope the artificial intelligence craze doesn't disappoint…



Meanwhile, risk appetite continues to grow. Leveraged trading has seen a surge in volume. U.S. single-stock-leveraged ETFs saw a record $84 billion in volume last week. Volumes have DOUBLED in just two months and now stand above the previous record seen in 2022. For the uninitiated, this is how leveraged ETFs work. ETFs that are three times leveraged means if a stock goes up by 20%, you gain 60%, but if it drops by 20%, you LOSE 60% of your invested capital.

What could possibly go wrong?



Source: Bloomberg

Despite the record euphoria on the stock market, valuations remain extremely elevated by virtually all metrics. Below, I show the Shiller cyclically adjusted price-to-earnings (CAPE) ratio.

The CAPE ratio, based on 10-year average earnings, hit 38x, the highest since the Dot-Com Bubble. The ratio is at levels seen before the 2022 bear market. By comparison, its long-term average is 17x. Suffice it to say, stocks are very expensive at the moment.

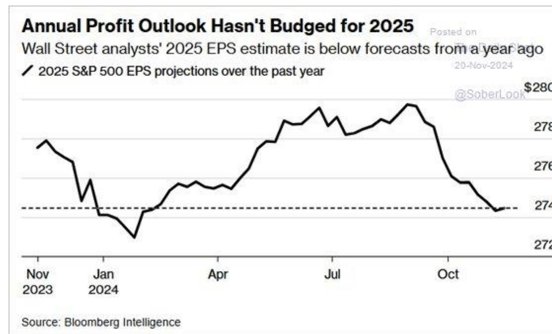
Source: Robert J. Shiller, Apollo Chief Economist

While not helpful in "timing" the markets, this index is arguably one of the best ways to determine if the market is "rich" or "cheap" over a full market cycle.

This is why when growth is strong, corporate earnings are high. When growth is weak, corporate earnings are low. This makes it difficult to find out if companies are cheap or expensive. However, the CAPE index removes the business cycle by taking the 10-year average of earnings and essentially smoothing it out.

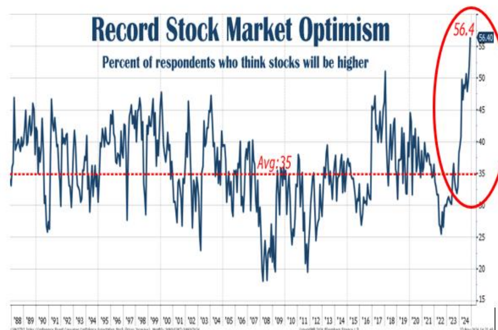
So, while sentiment can move the markets in the short term, the ultimate driver of market prices over time is "earnings." When looking at price-to-earnings ratios, valuations on both a forward and trailing basis are significantly elevated. In other words, earnings have not kept up with investors' expectations.

Further, with future earnings already being revised lower for 2025, as seen below, and corporate profitability at risk due to less government stimulus and fiscal support, the risk of current market forecasts being overly optimistic is likely elevated.



Despite all of the above, fear and doubt has left Wall Street. The bullish consensus on bubble vision is now universal and unopposed. Investor sentiment and confidence have reached unbelievable levels as caution has been thrown to the wind while the fear of missing out, or FOMO, has become top of mind.

In fact, investors are currently the least worried about a stock market crash since June 2006. In addition, 56% of U.S. investors also expect higher stock prices over the next 12 months, the HIGHEST since this question was first asked in 1987. (See graph below.)



What comes to mind is Bob Farrell's Rule 9, which states:

"When everyone agrees…something else is bound to happen."

Meanwhile, the ever bullish and highly conflicted Wall Street pundits and analysts are nearly universal in their view that the stock market will continue to rise next year. There is nary a bear in sight. To wit, Goldman Sachs and the Bank of Montreal have already forecasted that the S&P 500 will rise to 6,500 and 6,700, respectively, by the end of 2025. Even long-time bear Michael Wilson of Morgan Stanley is forecasting a base case of 6,500 with a bullish case of 7,400.

Finally, before you load up the portfolio with overpriced stocks, consider the following:

Irving Fisher was described as the greatest economist that the U.S. has ever produced. But his reputation during his lifetime was irreparably harmed by his public statement that stocks had reached a “permanently high plateau,” just nine days before the Crash of 1929.

Something tells me Irving Fisher would be in there buying today.

But not me…I’m sticking with Mr. Buffet.

Bottom line: It’s forever true that valuations don’t matter until they do. Yet, unquestionably, valuations are significantly elevated. While this does not mean the market is about to crash, it does suggest that earnings have not kept up with investors' expectations. The problem with elevated valuations is the risk an event occurs that causes investors to realign expectations with actual reality.

It’s also true that many investors base their investment decisions on emotions rather than rational analysis. Indeed, “animal spirits” (aka sentiment and hope), momentum and FOMO are powerful forces that can catapult an overpriced stock market to even higher levels. And it surely appears that over the recent weeks, we have reached extremes in this behavior.

Let me reiterate that none of this suggests a market crash is imminent. However, investors should be aware that given the current market conditions, the risk of disappointment in the future is much greater today than it was just two years ago.

With households having a record-high exposure to equities, risk management is key. Should the market plunge, the reversal of the “wealth effect” could be quite damaging to the real economy. As such, I believe the bursting of the stock market bubble is the single largest risk to the economy and a big reason why bonds could end up being the primary beneficiary.

So, will 2025 turn in another positive performance for the stock market? Maybe. But honestly, I don’t know.

On the other hand, I am sure of two things: What happens next will be what people least expect, and stocks are not going to go up forever, regardless of what people think.

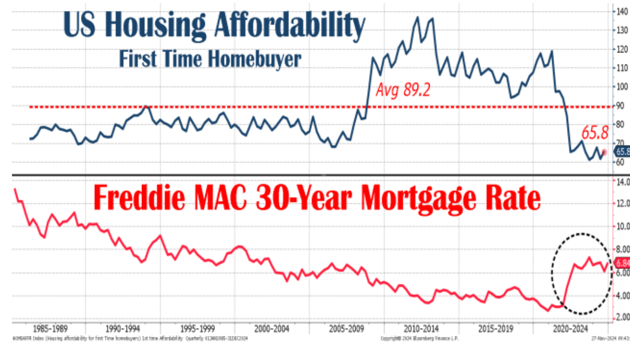
Caveat emptor.

HOUSING MARKET UPDATE

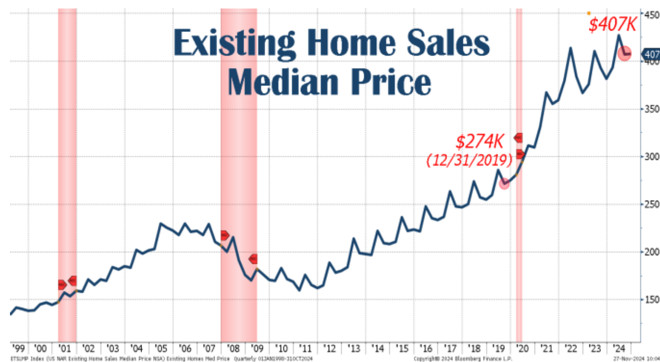
The back up in Treasury yields has wreaked havoc on the housing sector, the quintessential leading indicator of the economy.

Rising mortgage rates have crippled affordability ratios further. With mortgage rates at 7%+, the monthly repayment on a median-priced home eats up over a quarter of the median U.S. household income. That is more than even the peak of the 2008 housing bubble.

It's been especially difficult for first-time homebuyers, who have already commanded a record low 24% of home sales activity because the "American Dream" for them has turned into a nightmare.



The median home price for resales remains at extremely high levels since the pandemic home prices have soared 48% from $274,000 to $407,000.



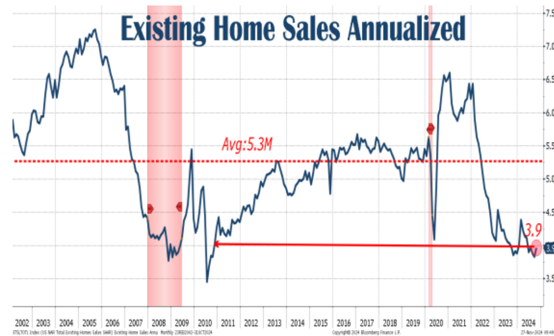
According to Reventure, an analytic tool to analyze housing trends, a near-record 84% of Americans believe it is a bad time to buy a home. That's the most pessimistic home buyers have ever been about the housing market. By comparison, at the peak of the 2006 housing bubble, 40% of Americans thought it was a bad time to buy a home.

What's amazing about these sentiment readings is that they are even worse than the early 1980s, when mortgage rates were 18%. Back then, it was a peak of 79% who said "bad time to buy." Simply put, homebuyer sentiment has never been worse.

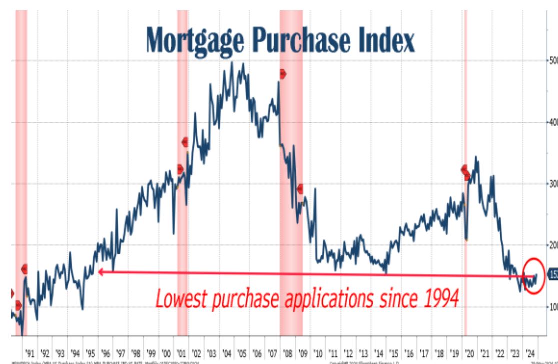
The housing market is another deviation in the economy, as older existing homeowners have made out like bandits because of limited inventory. This is because so many mortgage borrowers are locked in at the generational 2020-2021 interest rate levels and have essentially become prisoners in their own homes.

Nearly 70% of existing borrowers are sitting with a mortgage rate right now of below 4.5%, and if they choose to move or refinance, their borrowing cost will shoot up more than 250 basis points!

This is why resale market activity is no higher now than it was 14 years ago. In fact, it is nearly at the lowest levels experienced during the Global Financial Crisis.



It all has to do with cost and affordability. Most buyers simply cannot afford to pay the prices and mortgage payments in today's market. The result is the lowest mortgage application level for homebuyers since 1994. Mortgage apps are down 50% from their pre-pandemic levels. We are still at rock bottom lows for homebuyer demand.



In essence, there is a massive standoff occurring right now between buyers and sellers. Buyers are out, and they have been out the last 18 months. But sellers don't care. They are still pricing their houses extremely high, leading to the worst market for transactions in decades.

While older Americans who own a home can watch their real estate values balloon along with their 401(k) plans, the situation for younger home hunters and renter households aching to become homeowners is dire.

So, to the extent that this interest rate backdrop is due to of all the government spending programs and fiscal deficits unveiled these past four years in the name of the so-called “greater good” (chips subsidies, debt relief for students, stimulus checks, green-energy initiatives and the like), there has been an equal and opposite reaction in the form of a pervasive housing affordability crisis.

The best thing the incoming Trump administration can do for the economy is to support a lower interest rate environment. But sadly, the tax cuts being proposed and the prospect of sharply higher tariffs and perhaps even more deficit spending will only serve to frustrate that objective.

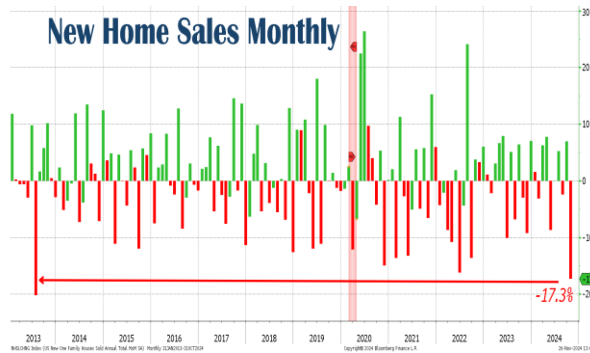
But here’s the thing. Donald Trump cannot be the “debt king” and promote a lower interest-rate environment at the same time. My hope is that the most damaging aspects of his economic plan (tax cuts for overtime tips, social security and a move to a 15% top corporate marginal rate along with massive tariffs) will be averted.

Bottom line: Housing affordability remains at unsustainably stretched levels, with high mortgage rates trapping homeowners in their houses and locking renters out. Housing needs lower rates. Period.

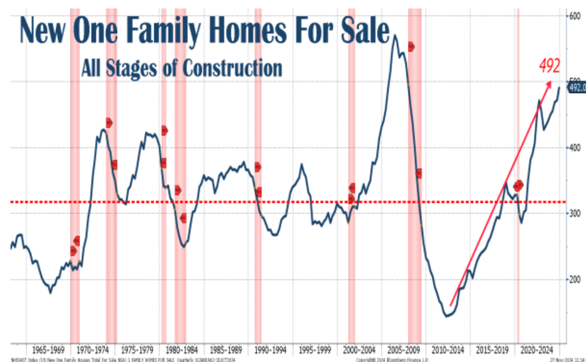
BUILD IT AND THEY WON'T COME

Big homebuilders have to do what it takes to build and sell homes to keep their businesses intact and keep their shares from tanking. So, they're building at lower price points, buying down mortgage rates and throwing in other incentives at a substantial expense to them. Still, that may not have been enough.

Even with incentives thrown in, new home sales plummeted -17.3% month over month in October to a 610,000 unit annual rate. That massively missed the consensus estimate of 725,000. It was the biggest drubbing for any month in over eleven years and now sits at the lowest since November 2022! A year ago, the year-over-year sales trend was +16.6% — it is now running at -9.4%.

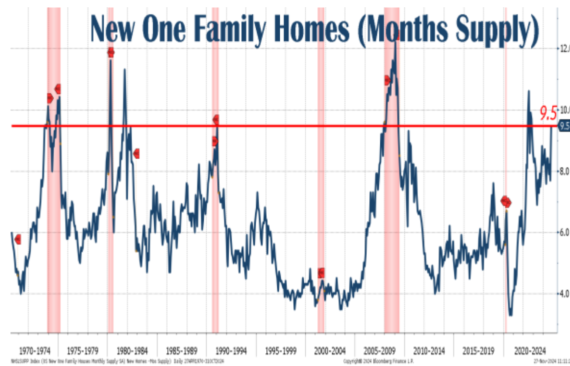


As sales plunged, unsold inventories of new single-family houses at all stages of construction — from not yet started to completed — jumped by 9.3% year over year to 492,000 houses — the highest since December 2007.



Notably, unsold inventory of completed new houses (aka "spec houses") spiked by 53% year over year to 116,000 houses, the highest since July 2009 during the depth of the housing crisis, when homebuilders were trying to survive.

Because sales have plunged and inventory has surged, the monthly supply of new houses has spiked to a rare level of 9.5 months. This is the highest supply since November 2014, and before that since 2012.

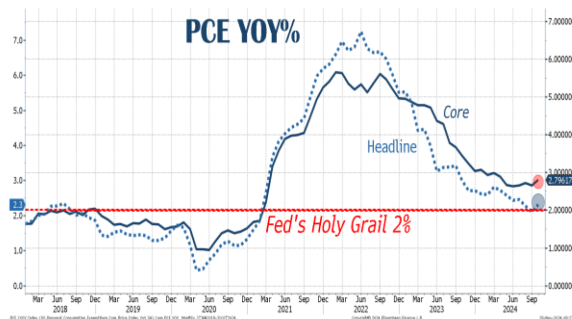


Bottom line: The imbalance between the supply of new homes for sale and current demand is high and rising. This is a good thing for the housing market. Rising inventory encourages builders to lower prices and offer deals, which will help resolve the mindboggling dislocations in prices that we've seen across the housing market. If this doesn't reverse over the next few months, homebuilders will need to start some serious price cutting to get their inventory moving.

AS ADVERTISED

On the macro front, real GDP growth in Q3 was left unchanged at a +2.8% annual rate, but there were some component shifts. There were upward revisions to private inventories and nonresidential fixed investment, but consumer spending was revised down a touch to a +3.5% annual rate from +3.7%.

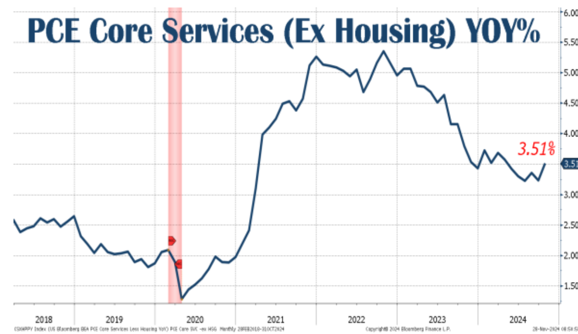
The Fed's preferred price indices, Personal Consumption Expenditures (PCE), were also as advertised at +0.2% month over month for the headline and +0.3% for the core index. The year-over-year trend for the former ticked up to +2.3% from +2.1% (as expected) and to +2.8% from +2.7% for the core (ditto).



Goods prices fell (-0.1%) for the sixth month in a row (-1.0% year over year), but once again with the services sector (+0.4% month over month and +3.9% on a year-over-year basis).

The Powell "Supercore" index (services ex-energy and housing) rang in at +0.4% month over month after a +0.3% reading in September.

This is the highest level in seven months, and the year-over-year pace in this measure hooked up to +3.5% from +3.2% and is the highest it has been since last April, when the Fed was public about its lack of confidence in the inflation outlook.



Bottom line: All in all, this data on a standalone basis would suggest that those on the Federal Open Market Committee (FOMC) backing a pause in the rate-cutting cycle are going to have their voices heard.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

***"The economy looks more and more like 2008, when for many the economy appeared to be just fine. Then came the downward revisions**. When all was said and done, the NBER determined the cycle peak was December 2007. **The deep revisions are continuing just as sixteen years ago**." — Lacy Hunt, PhD*

Downward economic data revisions have become the new normal.

So far, U.S. industrial production data has been revised down in nine out of the last 10 months.

As for the all-important labor market:

- Job openings have been revised downward in 15 out of the last 20 months.
- The monthly jobs reports have been revised down in 14 months since the beginning of 2023.
- The Labor Department revised down 12-month job growth by a massive 818,000 jobs. At the heart of these revisions is a horribly flawed birth-death model used by the Bureau of Labor Statistics.

Revisions have been massive over the past 12 months. I expect more negative revisions to come.

On top of negative revisions, the key driver of job growth —immigration — will end. So, job growth is slowing, and now we have a migration shock just as nearly everyone has given up on the recession idea.

If the labor market is weakening…the economy will follow.

That's because if jobs are overstated, income is too. And last Wednesday, we found out the Bureau of Economic Analysis overstated wages by a massive **$91.8 billion**, from $156.8 billion to $65.0 billion.

And out of nowhere...the savings rate was revised sharply lower for 2024 and some **$140 billion** in personal savings was magically erased.

Meanwhile, continuing jobless claims continue their slow climb toward two million. It's increasingly hard to find another job if you lose one. So, whatever you do, don't lose your job. I do not say this with even a scintilla of sarcasm.

It's important to note that while the Fed has a dual mandate to maintain "price stability" and "full employment," the number of FOMC members who think the risk to their forecast for the unemployment rate is weighted to the upside is always much higher than the number of FOMC members who think the risk to their unemployment rate forecast is to the downside. In other words, the Fed has a very asymmetric view on its dual mandate, putting much more weight on low unemployment than on getting inflation to stay at 2%.

This, in turn, suggests that any further weakening in the labor markets, even with inflation above 2%, may persuade Powell and company to maintain a bias towards lowering rates.

Possibly this helps to explain why bond traders raised the odds of a quarter-point rate cut at the Fed's December meeting to 70% from about 60% even though the core PCE inflation rate decline has completely stalled out, including the Powell Supercore measure (services ex-energy and housing), which actually has begun to turn up again.

And after a drubbing since mid-September, last week the Treasury market regained a strong bid with the benchmark 10-year Treasury yield falling to 4.17%. At 4.17 %, the 10-year Treasury yield has done more than just pull a round trip. It is now 10 basis points lower than it was on election day. Since mid-October, the yield has declined a whopping 40 basis points!

We shall see what happens next, but what is clear is that the outlook for the progression of interest rates through 2025 hangs critically on the next few labor market reports. Of note, the November payroll report will be released this Friday.

Bottom line: As noted last week, until there is more clarity on potential policy changes from the incoming Trump Administration, one should anticipate higher volatility than normal over the next two to three months. The most

prudent approach to investing excess cash reserves is to continue to maintain a risk appropriate ladder strategy. Buying the periodic selloffs is highly recommended.

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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