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Economic Review & Outlook

SECOND QUARTER | 2021

Are We in a Bubble?

The latest U.S. bull market arose quickly from the short-lived, coronavirus-induced bear market of early 2020, celebrating its first birthday on March 23 with a 12-month gain of nearly 80%. The previous bull market lasted 11 years before COVID-19 shut the world down, booking a 400% return. Although equities have come a long way in the last year (and the last decade), the economy is far from rolling, despite signs of a post-pandemic rebound. Several well-known investors are calling this a bubble, and many investors are wondering whether the pundits are right and what to do next.

In this issue, we look back at a momentous first quarter and question if we're actually living through a bubble. Then, we look ahead with our thoughts on how we're positioning our portfolios in the current environment.

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Economic Overview

SPLIT GOVERNMENT, HAPPY MARKET

When Joe Biden was inaugurated on January 20 after a drawn-out election, key U.S. equity indexes recorded all-time highs. Biden's political experience, a Democratic majority in the House of Representatives, and a down-the-middle split in the Senate lifted hopes for more stimulus, which eventually arrived in March. Republicans' retention of 50 Senate seats also bolstered equities, amid a sense that a still-divided Congress would limit large-scale policy changes.

Two weeks earlier, on January 6, the U.S. Capitol was placed under lockdown and partially evacuated when rioters occupied and vandalized parts of the building. The storming of the Capitol took place as Congress was ratifying the election results. Investors shrugged off the events of the day, as U.S. markets recorded new highs.

ROLLING OUT VACCINES AND STIMULUS

The $1.9 trillion coronavirus relief package, the American Rescue Plan, was signed into law on March 12, raising expectations for a speedy economic recovery after a year in which the pandemic's spread led to school closures, business restrictions, and the reported deaths of more than 500,000 Americans. The package delivered $1,400 checks for many Americans, extended jobless benefits, and provided more aid for schools, vaccination distribution, and state and local governments. Once again, stocks touched all-time highs. Meanwhile, new COVID-19 cases, hospitalizations, and deaths trended steadily lower from early January highs, while vaccinations ramped up above two million per day.

CONCERNS RISE SURROUNDING INFLATION AND HIGH VALUATIONS

In the midst of massive stimulus (now totaling $6 trillion in the last year) and rising expectations for reopening and economic growth as vaccinations roll out, concerns surrounding inflation and high equity valuations came to the forefront. Benchmark 10-year U.S. Treasury yields, which started the year below 1%, climbed as high as 1.8% nearing pre-COVID levels, though short-term rates remain muted.

The U.S. Federal Reserve (Fed), aiming for full employment, has expressed a willingness to tolerate moderate levels of inflation, while continuing its massive bond-buying program and efforts to keep interest rates low. Investors started to worry about the potential for rising rates, which can weigh on stock valuations and contribute to notable market pullbacks in highly valued areas of the market—particularly the technology-heavy Nasdaq Composite Index.

Asset Class Performance

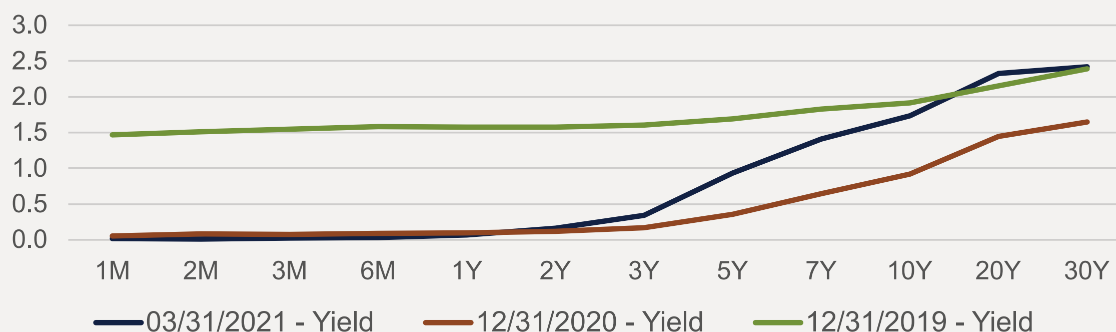
January	February	March	YTD
Commodities 4.5%	Commodities 10.7%	U.S. Stocks 4.4%	Commodities 13.6%
Emerging Market Stocks 3.1%	U.S. Stocks 2.8%	Int'l Developed Stocks 2.4%	U.S. Stocks 6.2%
Diversified Bonds -0.7%	Int'l Developed Stocks 2.3%	Gold -0.9%	Int'l Developed Stocks 3.6%
U.S. Stocks -1.0%	Emerging Market Stocks 0.8%	Diversified Bonds -1.2%	Emerging Market Stocks 2.3%
Int'l Developed Stocks -1.1%	Diversified Bonds -1.4%	Emerging Market Stocks -1.5%	Diversified Bonds -3.4%
Gold -2.6%	Gold -6.6%	Commodities -1.8%	Gold -9.8%

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index,Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect thededuction of advisory fees, transaction charges, and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Despite some volatility, equities broadly advanced during the first quarter, with most prominent indexes continuing the upward trend in place since markets bounced back in the second quarter of 2020. Quarterly stock returns were positive globally, with the U.S. (+6.2%) outpacing international developed (+3.6%) and emerging markets (+2.3%).

Commodities were among the quarter's strongest performers, rising more than 13%, driven by advancing oil prices as COVID-19 restrictions eased and optimism for a recovery in demand grew. Slower-growth assets, such as gold (-9.8%) and bonds (-3.4%), declined as a result of the accelerating economic growth expectations.

U.S. TREASURY YIELD CURVE



Source: www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

Our Perspective

WHAT IS A BUBBLE?

Broadly speaking, a bubble occurs when asset prices reach much higher levels than traditional economic or valuation metrics would typically justify. In short, bubbles tend to occur when higher prices actually increase demand for the asset, fueled by speculation that prices will continue to rise. When that happens, as former Fed Chairman Alan Greenspan famously said, "irrational exuberance" takes over, driving prices even higher as growth expectations become exaggerated and investors get carried away. Bubbles often form during periods of historically low interest rates, as the search for returns pushes stock prices higher. Investors, often driven by the fear of missing out, pile into the stocks, and prices can reach illogical levels. When investors start to worry about the possibility of a bubble bursting, profit-taking usually follows. Eventually, the bubble pops, often with a wave of panic and a rush to sell. When that happens with enough investors at one time, prices drastically decline, resulting in a severe correction.

BUBBLES THROUGH HISTORY

Bubbles happen periodically and have occurred for hundreds of years. One of the first happened in the 1630s in the Netherlands with tulip bulbs. The flowers, introduced from Turkey decades earlier, became a sensation that grew into a frenzy as speculative financial contracts were built around them, lifting prices for some rare, single bulbs to the value of a house or more. The market collapsed in 1637, as prices fell 90%.

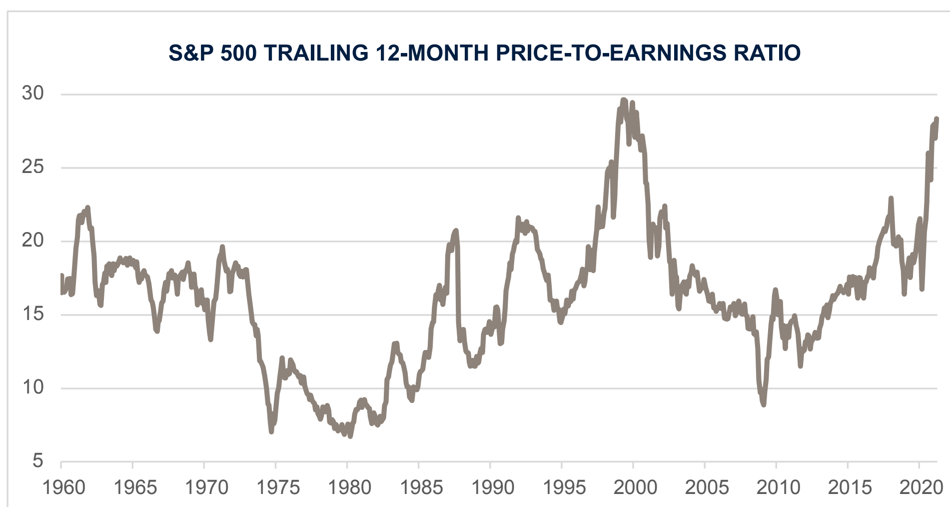
The South Sea bubble struck Great Britain less than a century later. The South Sea Company, which held a monopoly on British trade with South America, was at the heart of a bubble that played out somewhat like a Ponzi scheme. Share prices rose about 650% in six-plus months, pulling other companies' shares—especially dozens of start-ups—along a similar path. The bubble burst a few months later, with a 90% fall from the peak.

We've also seen some notable bubbles in recent decades. In the late 1990s, as internet use proliferated, the Nasdaq rose five-fold from 1995-2000 before falling more than 75% over two-plus years as the dot-com bubble burst. The index would not regain its peak until 2015. Speculation and venture capital funding for start-ups drove the frenzy at a time when money was cheap, investors were overconfident, and anything with a ".com" attached saw its market capitalization (or market cap, the term representing the dollar value of a public company's total shares) rocket higher.

The last major bubble is familiar to most investors, as it led to the Great Recession. It started with a housing bubble as U.S. home prices doubled from 1996-2006, rising rapidly over the latter few years. Amid rampant speculation, consumer debt rose sharply, banks sold too many mortgages (some fraudulently), and most ignored the credit deterioration in mortgage-backed securities. When prices fell in 2006, a wave of defaults eventually infected mutual funds and other investment vehicles, triggering the global financial crisis and the worst economic contraction since the Great Depression.

WHY THIS COULD BE A BUBBLE

At the moment, there are certainly some "bubbly" signs out there. While most interest rates have risen materially over the past year, they remain extremely low by historical standards, especially short-term rates, which continue to be held down by central bank policy. Valuations of stocks and other risk assets (including bonds) are very high, bordering on extreme. One standard valuation metric, the trailing 12-month price-to-earnings ratio (P/E), reached levels not seen since the height of the dotcom bubble.



Source: FactSet

While this trend looks concerning, it's important to note that trailing earnings currently reflect the COVID-19 lockdowns and many expect earnings to start catching up with price over the next year. Even so, it's hard to deny that U.S. stocks look quite expensive from this standpoint.

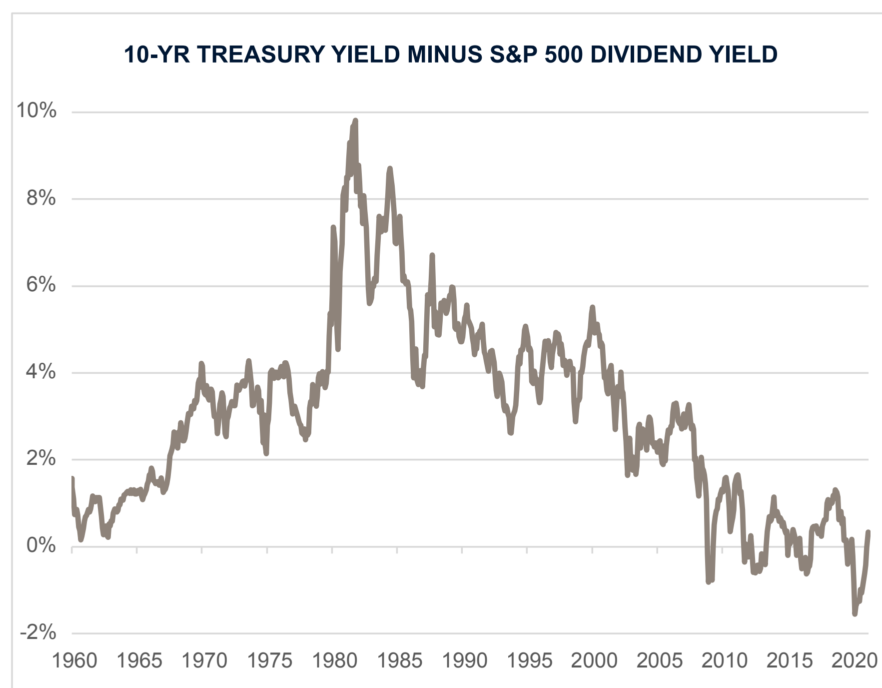
Recent events, such as the explosive rise of GameStop shares and other "meme" stocks, also imply speculative fever, with investors on the social media platform Reddit boasting of great fortunes in much the same way people talked up their South Sea gains in that day's news medium—the newspaper.

We've also seen a broad shift toward more concentrated investing. The handful of tech giants that led the market through much of the pandemic rose to constitute nearly 25% of the S&P 500's market cap. Certain investment themes, such as electric vehicles or innovation-focused ETFs, have seen massive investment flows and increasing valuation spikes.

Then, there is the cryptocurrency craze. Trading volumes shot up during the quarter, reaching nearly $3 trillion, while bitcoin touched record highs near $60,000 (from about $8,000 in March 2020) and at least temporarily surpassed a market cap of $1 trillion. Prior to hitting $20,000 in late 2020, bitcoin last flirted with that barrier in 2017 before falling to just above $3,000 in approximately 12 months.

WHY THIS MAY NOT BE A BUBBLE

Strong returns, for a year or a decade, don't necessarily point to a bubble. Markets trend up over time, driven by human productivity and the need to compensate investors for taking on risk. Some valuation measures (like price-to-earnings) point to overheated equity markets relative to the past; however, when looking for bubbles, we must examine whether what we are seeing is irrational. As we consider the current environment of rising growth expectations—along with stimulative fiscal policy and facing the alternative of low-yielding bonds—you can make a case that expensive equity prices could be justified. An alternative way to gauge the attractiveness of equity markets is to contrast them with bonds. As seen below, when comparing current dividend yields to Treasury yields, stocks seem like a bargain as their income alone is now in line with what you would get owning 10-year Treasuries.



Source: FactSet

To put this another way, equity markets can be expensive in absolute terms but cheap compared to bonds. The caveat here is that equities tend to have far more downside risk in the event of a market correction.

What could look like a bubble may just be a series of paradigm shifts. We have many emerging new technologies right now—e-commerce, renewable energy, 5G networks, bitcoin—and it is not unusual for the market to need time to figure out how to properly price innovation. Of course, we also heard a lot of that rationale in the late 1990s, and everyone now agrees—that was a bubble.

Another truth about bubbles is that there's always a crowd arguing that "this time, it's different." Bubbles are most prevalent when nobody sees them coming, when optimism dominates to the point that markets become overly frothy. In 2021, those voices are out there, but broadly speaking, the media and prominent prognosticators seem worried. Maybe more importantly, consumers appear concerned, and they've been parking cash. The U.S. Bureau of Economic Analysis' personal saving rate topped its previous high from 1975 numerous times in the past year, and consumers in the world's eight largest economies gathered nearly $3 trillion in extra savings during the pandemic, more than half in the U.S., according to Bloomberg Economics. Those funds could support a continuing bull market.

SO, ARE WE IN A BUBBLE NOW?

One of the hallmarks of bubbles is that they're very easy to spot—in hindsight. In the aftermath, we ask ourselves, "How did we not see that coming? It was so obvious!" But a bubble is much harder to see from the middle. People are always predicting bubbles and impending market crashes, and sometimes they're right. More often, they're wrong. In this long rise, the market has faced threat after threat, but responded each time, even to a paralyzing pandemic. Even if the market is in a bubble, there's no telling how long it will last.

It is also easy to generalize about "the market," treating it like a single entity. In reality, there are many markets, asset classes, and industries, which collectively make up the investment universe. It's natural for investors to speculate on the future, as well as overshoot in either direction, based on current narratives. Therefore, we should expect to see some areas of the market looking "bubbly," while others seem like buying opportunities.

Markets are inherently unpredictable, and no one truly knows what's coming next. It is entirely possible that bitcoin may continue to gain acceptance over time and become a type of "digital gold." It could also flame out and become worthless. Whether we can look back and call it a bubble is almost entirely up to how future events play out. We can't know the future, but we can speculate about the potential opportunities while taking note of the risks.

While bitcoin is an extreme example due to its novelty, investing in traditional markets also carries uncertainty about the future and the need to weigh potential risk and reward. In the following section, we will speak to how we make these decisions and what we are seeing now.

Our Investment Strategy

Nobody wants to be caught in a bubble when it bursts; however, staying out of the market and completely missing any benefit isn't a viable solution. So, what should we do? Our first rule: Don't try to time bubbles. While tempting, trying to get in and out at the right time rarely ends well. Many in the financial services industry imply or even claim to have special insight around short-term market moves, either due to superior resources or having the "smartest person in the room." Isaac Newton, one of the most brilliant minds in history, was also an early investor in the South Sea Company and originally sold his shares as he saw prices rise, only to buy back in near the peak of the bubble. This example illustrates that intelligence is not enough to protect against the risk of shifting sentiment, leading Newton to supposedly quip, "I can calculate the motions of the heavenly bodies, but not the madness of the people."

Just because we cannot see the future does not mean we are powerless to act. One way to get caught in a bubble is to get so tied up in the narrative surrounding an investment that you completely lose sight of its price. A key pillar to our investment process is to consider the current economic landscape while remaining keenly aware of market prices in our portfolios and making adjustments along the way as conditions change. Today, this approach means increasing exposure to parts of the equity market with strong growth prospects and reasonable valuations, such as emerging market equities and value stocks.

Perhaps the greatest defense against a bubble is limiting potential exposure. Since bubbles tend to occur in narrow market segments, an investor can accomplish this through diversification. While intuitive, this is easier said than done. Diversifying means you will not fully participate in the rapid gains of the highest-performing market; however, we believe this is a prudent step to managing risk and helping you achieve your long-term goals. For our bond portfolios, we limit potential bubble exposure by diversifying our sources of risk to things like high-quality corporate and consumer debt. This technique allows us to decrease our sensitivity to rising rates while still maintaining a competitive yield.

Conclusion

Whether this is a stock market bubble or not is difficult to know right now. Predicting when that bubble, if it exists, will burst is nearly impossible. That's a challenging place to be for investors, but we do know some foundational truths. We know what works over time: Seeking out areas of the market positioned for faster economic growth, buying assets that are appropriately priced, and diversifying to reduce risk and match your time horizon and needs. It's a simple answer to a difficult question, which can help provide perspective. More than that, we believe it's the best way to reach your long-term investment goals.

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