CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 16, 2021

Expect Excitement

Stock market valuations are useful, but they do not tell us what will happen in the short term. By most measures stocks are very overvalued, but over-valuation has persisted before and may persist now.

Against what I consider significant stock market risk, Core has reduced its equity investments.

By

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As you may be aware from observing the trade confirmations that came your way from Schwab in the last week, I have acted on my view that stock markets are exceptionally overvalued and at risk of substantial declines. I will review some of the elements of this overvaluation and the risk it presents below, but first a synopsis of recent investment activity.

Beginning in the late summer last year, I began to build a position in stocks in East Asia, primarily in South Korea, Taiwan and Japan. The notion was that this region had done well in the pandemic, had largely managed to avoid shutting things down, had a range of important and necessary technology manufactures, and traded at levels below American stocks. The investments flourished. Early this month, I began to sell these positions and concluded the sales last week.

Valuations in stock markets. There are many ways to measure valuations of stocks and stock markets as a whole. A prominent one is the so-called Shiller CAPE (for 'cyclically adjusted price-earnings' ratio) developed by Robert Shiller, a Yale economist who was awarded a Nobel prize for his work. It adjusts price-earnings ratios over a ten-year period, to smooth the ratio that swings widely over the course of the business cycle. At present, the ratio is at 37, a level far exceeding that of 1929 before that historic market crash. The present level is only exceeded by that in 2000 before the dot.com bubble burst. One did not want to be holding too many stocks at those CAPE levels. From the dot.com peak to the market's low in 2009, the decline was 57%; from the 1929 peak, the S&P fell by 86%. I am not predicting anything like that, but we should remember that in last year's sell off, before the Fed came to the rescue, the S&P's decline was 35%. (On the next page is a long-term chart of CAPE.)

Among other stock market valuation measures that are excessive at present are these: Margin debt is very high, meaning that investors are borrowing from their brokers against the value of their accounts to make new investments. Portfolio managers for equity mutual funds recently held in cash only 1.68% of the assets managed, an exceptionally low level that provides little cushion against requests from underlying fund holders to close their accounts. When and as equity markets turn lower, the rush for the narrow exit will itself generate more selling and exacerbate the sell off.

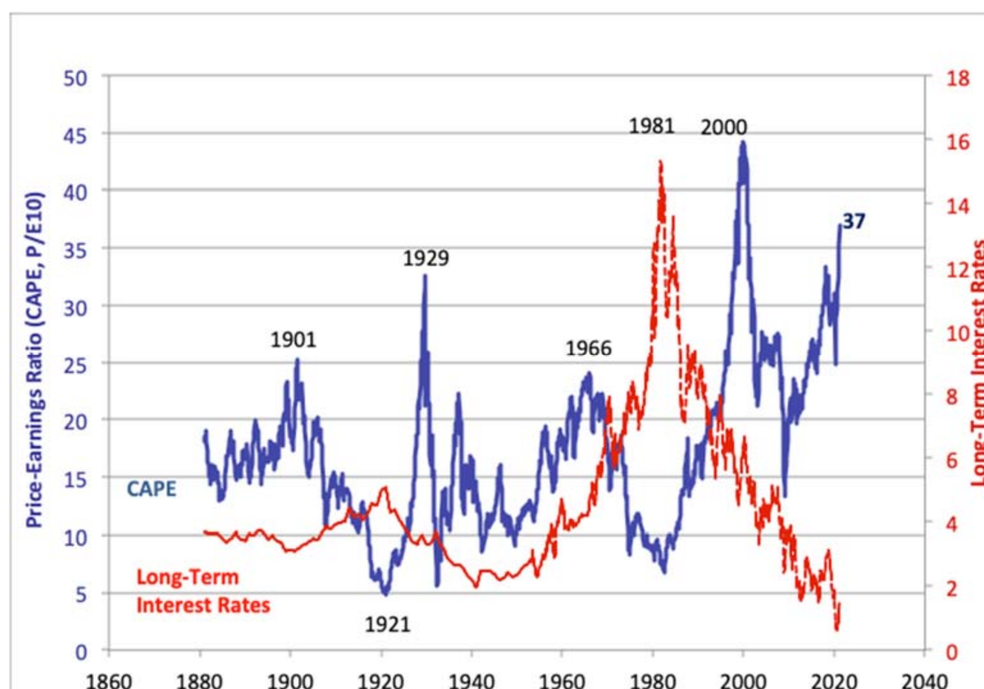
Two of our defensive investments, gold and long-term Treasury bonds, having declined from their high levels in the autumn, have resumed their appreciation since mid-March. Questions about prospective inflation bear particularly on the prices of Treasury bonds. There is wide-spread talk that inflation is on

The chart below comes from Robert Shiller's site, showing the CAPE ratio from 1880 to the present in blue (Long–term US interest rates are shown in red.)

As the chart shows, the present CAPE ratio exceeds every other reading except that in 2000 before the burst of the dot.com bubble.

It is a serious warning that stocks trade at dangerously high levels.

the rise and that it will continue to rise. The Federal Reserve Board governors emphatically state their view that inflation increases are transitory. I believe they are correct. A year ago, when much of the US locked down and the fear was that Covid would be like the Black Death, people, cloistered in their homes, spent less money. As demand for goods and services fell, suppliers cut prices and, for a three-month period, US inflation fell at an eight percent annual rate. As the months went on, supply and demand came back into balance, deflationary pressures eased and inflation returned to the range that has prevailed for a decade, that is, somewhat below two percent per year. Now, with huge government transfers to people and with the so-far successful vaccine campaign, demand for goods and services rises against still-constrained supply. So prices rise. It is likely that demand and supply will again return to balance in months ahead and inflation will again subside to what has become its normal level.



The strength in the bond market in the last couple of months, while inflation fears have been widely advertised, suggests that the bond market understands the temporary nature of this inflation spike. At the very least, it is too early to conclude that inflation is a serious risk that can damage bond investments.

Whether we will soon experience a significant stock market decline, whether higher inflation will persist, whether our defensive investments will continue to appreciate are matters known to the gods only. Because of my views on these questions, I have reduced risk in the portfolios Core manages by selling the Asian equity positions.

One prediction in which I have some confidence is that the day-to-day and week-to-week price changes in the stock market will be higher than those that prevailed before the pandemic. This is a measure of the uncertainty surrounding this extraordinary period that the Coronavirus has ushered in. Pandemics are rare events, thankfully. The pandemic has disturbed all manner of things profoundly. The uncertainties it creates warrant a cautious investment approach.

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