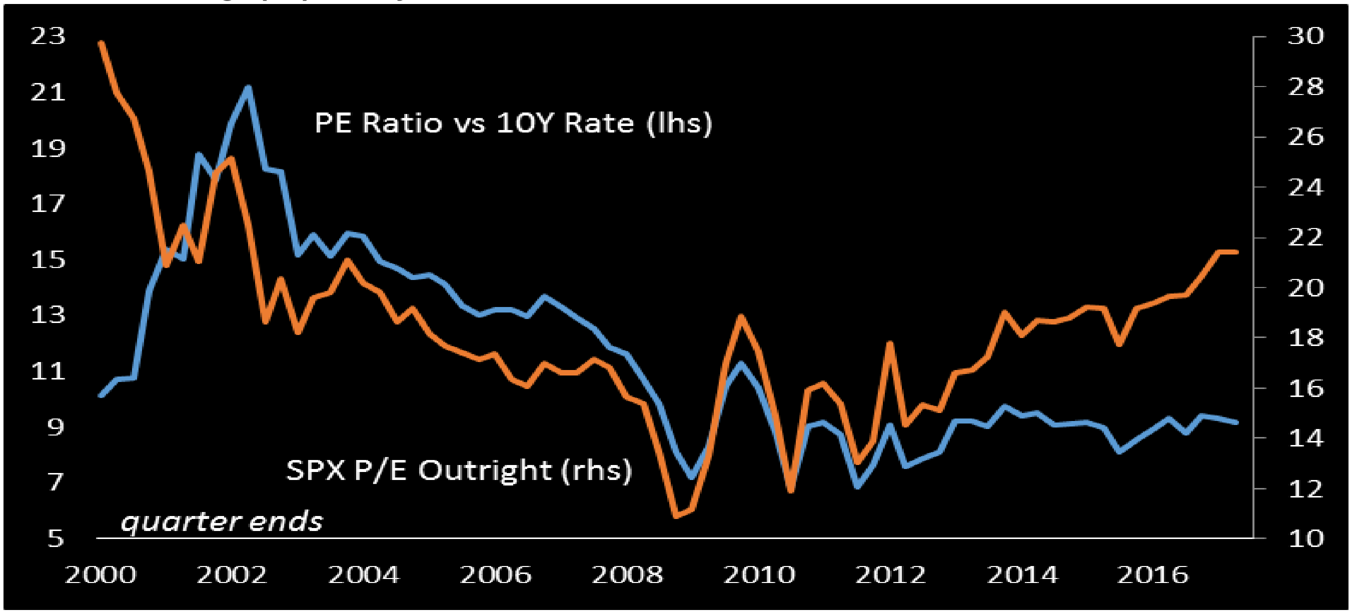
July 2017

Bubble Bubble Are Stocks in Trouble?

After drifting lower for the past month, the SPX rebounded, once again confounding the naysayers by making yet another new high. Widespread belief that stocks were overpriced has made investors skeptical and wary of this rally for much of the last year. For example, in April Robert Shiller – a recognized expert on market bubbles and the author of *Irrational Exuberance* – said the market was dangerously "overvalued". In the April Market Voice it was outlined that the stock market's post-election surge had taken P/E ratios to near 20-year highs, the primary source of the perceived overvaluation. But this is too narrow a prism to view stock prices, stocks may be expensive compared to their own history, but they are not so expensive relative to other asset pricing. As was noted in April, the P/E ratio, when scaled by the still relatively low level of long-term bond yields, remains within recent historic ranges. The bottom line was that there was some risk of giveback of the "Trump bump" in prices if promised policies were not delivered – especially, tax revisions and banking deregulation – but valuations were not at levels that created risk of more substantial downside.

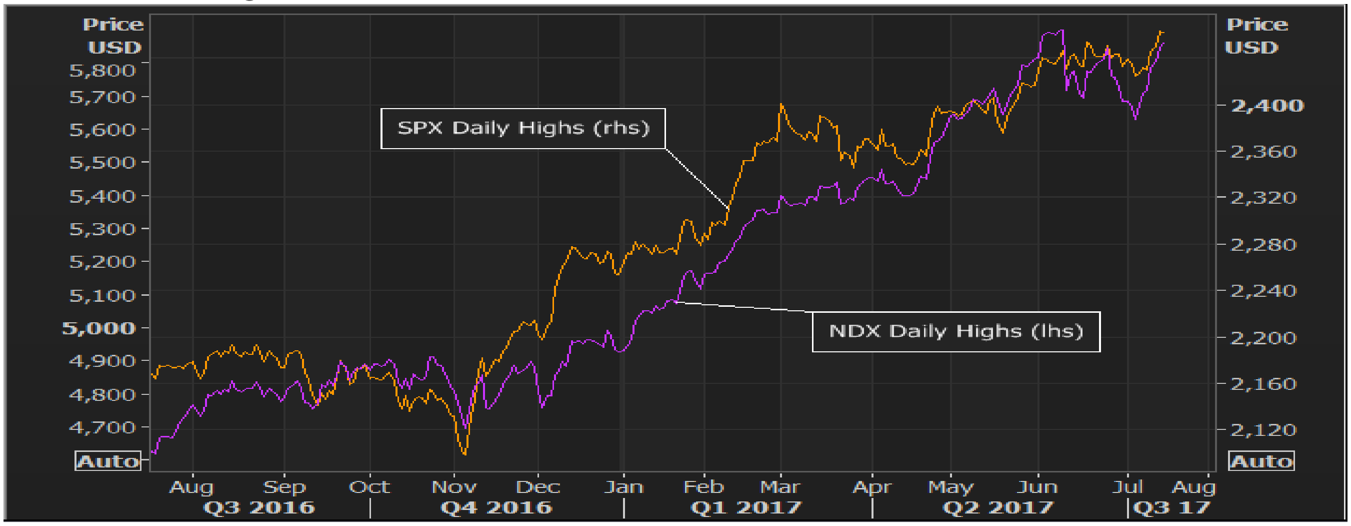
The July rebound has the SPX roughly 5% higher than April but as shown below, the outright P/E ratio remains roughly flat so the gain is supported by improved earnings. Indeed, the interest-rate adjusted P/E ratio has moved slightly lower so, by this measure, stocks have become modestly cheaper. That said the adjusted P/E ratio remains relatively close to levels that have served as a cap since the financial crisis. If stocks continue to rally in the absence of comparable earnings improvement or declines in bond yields, at that point, it would be appropriate to start thinking of the market as moving into bubble territory.

SPX Price/Earnings (PE) History



Source: Thomson Reuters Eikon

SPX vs. NDX During the Past Year



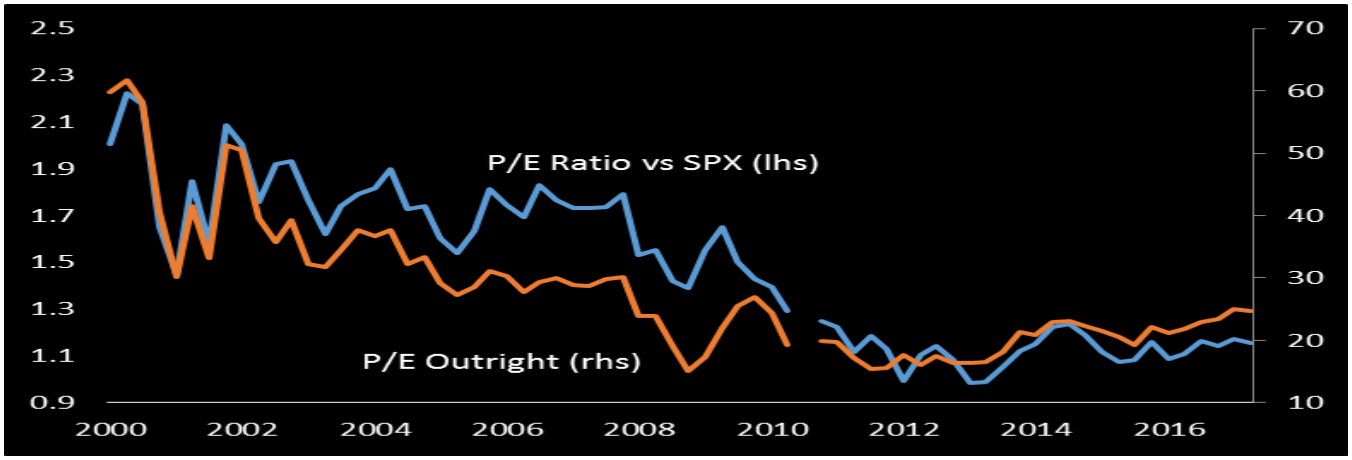
Source: Thomson Reuters Eikon

What About the High-Flying Tech Stocks?

The claims of overvaluation have focused most intensely on tech stocks. As shown above, the more tech-heavy NDX (the NASDAQ 100) index has led the SPX higher and, more importantly is now up more than five-fold from the financial crisis – compared to an impressive but more modest three-fold plus gain for the SPX. And the press is regularly reporting on the outsized valuation of blue-chip tech stocks.

The NDX P/E ratio, as shown in the chart below, does appear to be getting into a danger zone. While still well below the levels of the 2000 tech bubble era, the ratio is at a level that has not been seen since 2009. But as with the SPX, valuation is only meaningful in comparison to where other markets are priced. For all the claims of overvaluation of high tech stocks, the NDX P/E ratio vs the SPX ratio is trading roughly mid-range. While it may be that some individual tech stocks are trading at extreme valuations, the sector as a whole cannot be said to be overpriced in the absence of an overpriced SPX.

NDX vs SPX Price/Earnings (PE) History

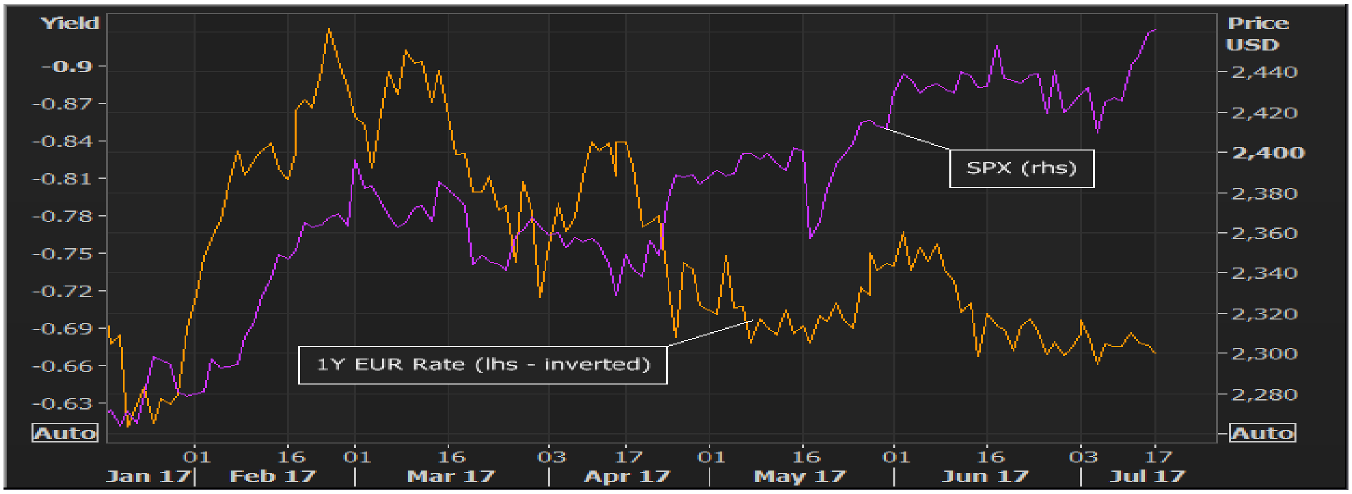


Source: Thomson Reuters Eikon

Has The Central Bank Put Expired?

The main rationale that outright P/E levels are not extreme is based on comparisons with historically low bond yields (i.e., high bond prices). A significant pick-up in bond yields would potentially put equity pricing into bubble territory. Views that the major central banks are shifting away from zero interest rates and quantitative ease may be contributing to perceptions that equity prices are overvalued. As evidence for this, shown below, the firming of the 1-year EUR rate (i.e., became less negative) in March and April in response to comments from the ECB suggesting they may shift to tighter policy interrupted the SPX uptrend – putting it into a trading range for much of March and April. The rally then resumed in May as the 1-year rate stabilized at around -0.69%.

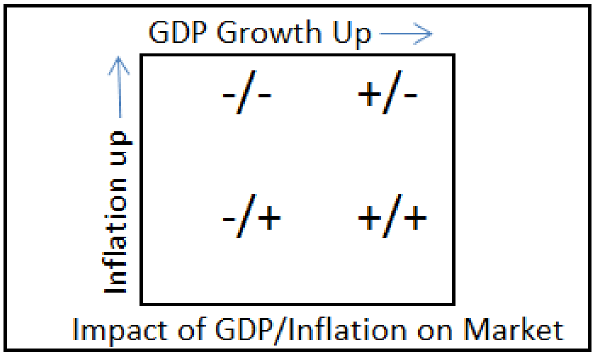
Expectations on ECB Tightening and Stock Market Performance



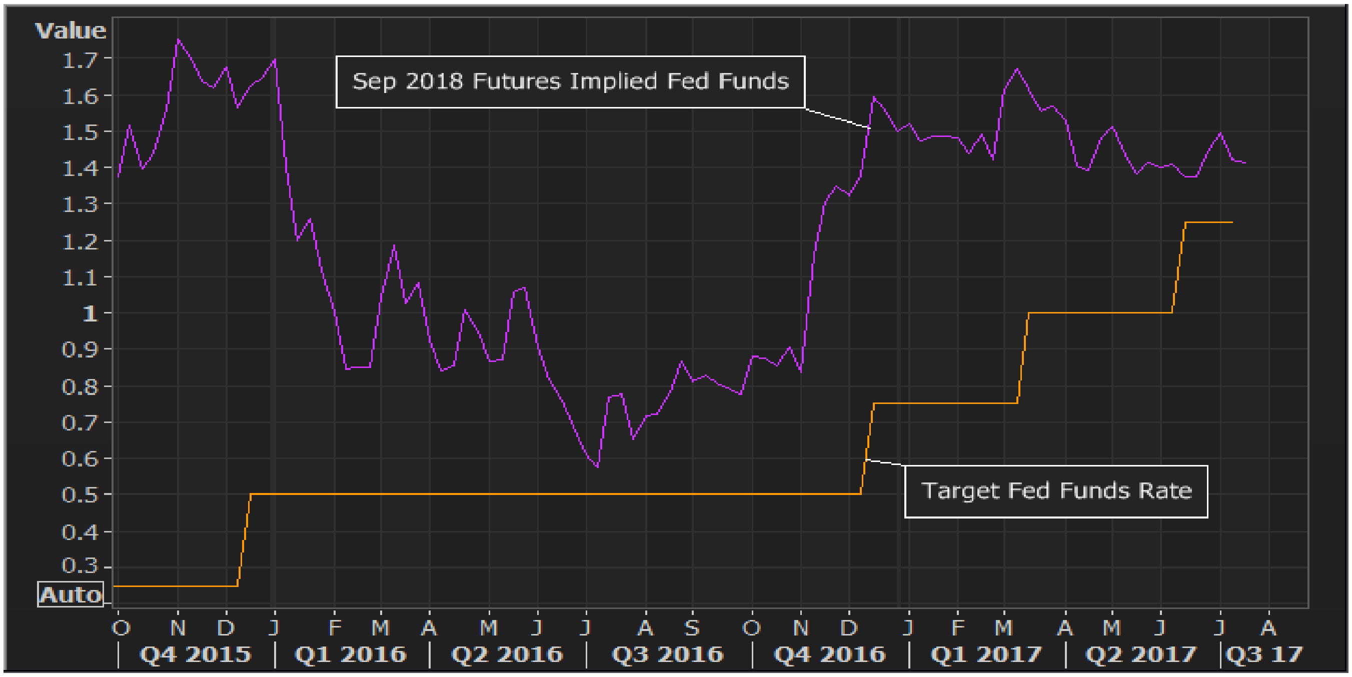
Source: Thomson Reuters Eikon

It is not so much the actual rise in rates that may be affecting market sentiment as the potential shift in central bank priorities. In the 2015 September Market Voice we were confident that a downturn in the stock market at that time was temporary, in part, as a consequence of the relationship shown in the chart below. Low inflation allows the Federal Reserve and other central banks to put a priority on supporting equity prices. (The primary vehicle for quantitative ease to generate stimulus is the wealth effect of higher asset prices.) So the only circumstance where equities would become substantially vulnerable is if economic weakness was accompanied by high enough inflation that it constrained the Fed's ability to provide ease – the upper left corner. The Fed is clearly now in tightening mode and, as signaled by the ECB other central banks may also soon shift course. But as long as inflation remains low, central banks would almost certainly go back to ease in the event of significant equity market weakness. The environment is still characterized by somewhere between the lower left and right corners of the box – e.g., at least modestly, supportive of equities.

Market vs Inflation and Growth



Market Expectations for Federal Funds Rate



Source: Thomson Reuters Eikon

Because it Worked in 2015 Will it Still Work Now?

The belief that market confidence in the Fed's willingness to put a bottom on equity prices – as long as inflation remained subdued – was an important basis for seeing little downside risk in equity prices in 2015. The same argument also played out in the market downturn in August 2014. But is this a valid argument for support when actual interest rates are significantly higher than they were in 2015? In fact, as shown above, although rates have been rising since the Fed started hiking in December of 2015, the expectations for where Fed funds will be in September of 2018 is virtually unchanged from the fall of 2015. With market expectation for Fed behavior unchanged and inflation still low, the argument of the Fed "put" providing support to the market is as valid now as it was two years ago.

Conclusions

The move of stock prices (SPX) to all-time highs and P/E ratios to post-crisis highs seems to be engendering concerns that equity markets are moving into bubble territory making them vulnerable to a major downturn. But when the P/E ratio is scaled by long-term yields they look – at worst – high within the post-crisis range but not extreme. So it does not appear that equity prices are high enough to qualify as "irrational" or bubble like. Moreover, while the Fed is now tightening and other major central banks are moving in that directions, it appears that with inflation still low, the perceptions of a "Fed put" should limit downside. That said if equity prices were to move higher without support from earnings or lower bond yields, a case could be made that the early stages of a bubble were emerging.

Market Voice

Send comments or questions on this publication to trading@thomsonreuters.com.

Visit financial.tr.com