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Indisputable Trends and Unrecognized Themes

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Like many animals, investors often move in the comfort of packs. At any moment, certain trends are accepted by most as indisputable. Likewise, there are typically a few important themes, which are either unrecognized or underappreciated by the pack. Combined, indisputable consensus trends and unrecognized themes can represent potential shocks to the investor mindset. Should an indisputable trend surprisingly end in discord or if an underappreciated theme suddenly becomes a market focus, a pack of investors are forced to alter positioning usually resulting in financial market turbulence.

Stock market vulnerability, therefore, can sometimes be judged by the strength of consensus convictions and the lack of popular attention toward what may prove to be important events. We highlight five contemporary indisputable trends and three current underappreciated themes that have the potential to destabilize the stock market.

Indisputable trends

Often during bull markets, certain financial trends persist long enough to become indisputable among the consensus. Today, five strong trends are widely expected to continue and consequently could become problematic for the stock market if any prove vulnerable.

The U.S. dollar can only go higher (right?)

This may be today's strongest and most widely accepted indisputable trend. Very little dispute about which way the U.S. dollar is going. The strength of this conviction, however, it what makes the U.S. dollar a significant risk factor for the financial markets. Conventional wisdom accepts that with the U.S. Fed beginning to tighten policy just as most other global policy officials are getting more accommodative ensures the U.S. dollar is a freight train going higher. We think economic policy differentials are less important in establishing currency values than are the impacts of those policies. In our view, the U.S. dollar strengthened last year because real economic growth abroad slowed more than it did in the U.S. If the accommodative economic policies recently employed abroad are successful, the pace of foreign economic growth relative to the U.S. is likely to diminish and force the U.S. dollar lower.

As Chart 1 illustrates, the real broad U.S. Dollar Index has risen about 10% since last summer. However, most of this gain occurred last year. Indeed, the trade-weighted U.S. dollar against major developed economies (Chart 2) peaked in early March and has since declined about 4%. If the U.S. dollar continues to advance, most investors and policy officials are prepared. However, should the U.S. dollar shockingly fall, financial turmoil may result. A weaker dollar would leave many investors overexposed to the U.S. markets. It would likely boost the U.S. manufacturing sector and commodity prices aggravating dormant inflation fears, particularly if this occurs as wage pressures emerge. Finally, it would pressure bond yields and challenge the slow and steady tightening approach advertised by the Fed.

Chart 1

U.S. Trade-Weighted Real Broad Dollar Index

Chart 2

U.S. Trade-Weighted Dollar Index*

*Based on major U.S. developed economies

Inflation is dormant (right?)

As Charts 3 and 4 suggest, inflation has been absent throughout this recovery. Indeed, with wage inflation stuck near a postwar recovery low and with consumer price inflation unable to reach and sustain the Fed's modest goal of 2% inflation, most worry more about the potential for deflation. Even those who suspect it may soon bottom do not anticipate inflation to become so pronounced that the Fed will need to accelerate its tightening cycle.

However, the likelihood of at least a modest acceleration in inflation is probably higher now than at any time in this recovery. The U.S. economy is nearing full employment, it is growing faster than the available labor supply, productivity is extremely weak, and economic policies remain remarkably accommodative compared to historic norms. Additionally, most global officials have augmented economic stimulus in the last year and the lagged response to these policies may be the first synchronized global economic bounce of the recovery. If the U.S. dollar were to weaken just as global economic growth improves, inflation pressures in the near fully employed U.S. economy could intensify.

Primarily, inflation is a market risk because three decades of chronic disinflation has a created a strong conviction that inflation is dead. The strength of this widespread belief is displayed by a Fed which is still debating whether to raise short-term interest rates from zero despite entering the seventh year of a continuous recovery with the unemployment rate nearing 5%. By a 10-year bond yield which is only slightly above the current core inflation rate (historically this yield has averaged about 2% above core inflation) and is about 2% below the annual rate of nominal gross domestic product (GDP) growth in recent years. With so few expecting inflation to be problematic, how would the Fed respond if both core consumer price inflation and wage inflation finally rose even modestly? Would it be forced to quicken its tightening strategy? How would bond vigilantes react? Can the stock market continue to trade at about 18.5 times trailing earnings if inflation and bond yields start rising faster than expected? What happens to the U.S. dollar should inflation expectations adjust higher?

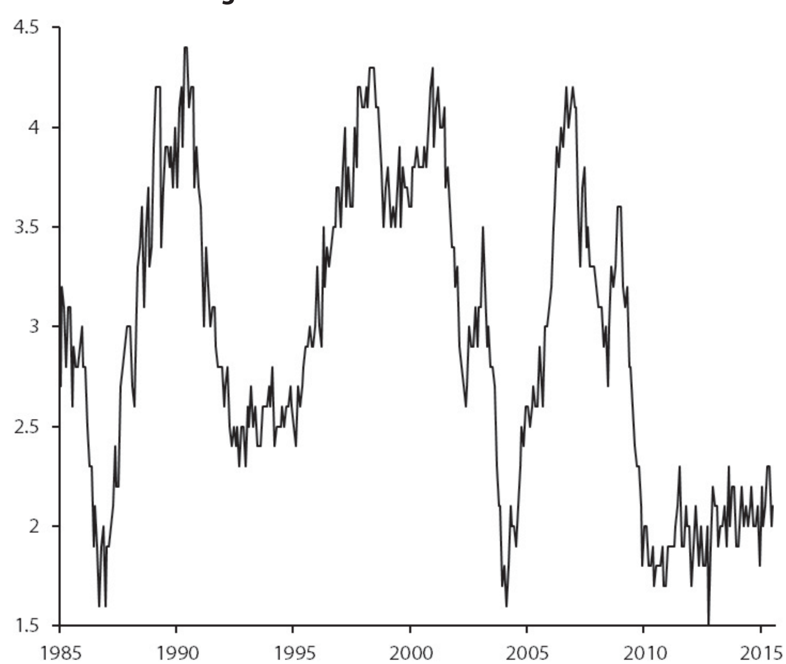
Perhaps the indisputable trend of dormant U.S. inflation will remain predominant in the next few years, but if it surprises, many economic and financial behaviors will be altered.

Chart 3

Annual U.S. Core Consumer Price Inflation

Chart 4

Annual U.S. wage inflation



Stay with momentum (right?)

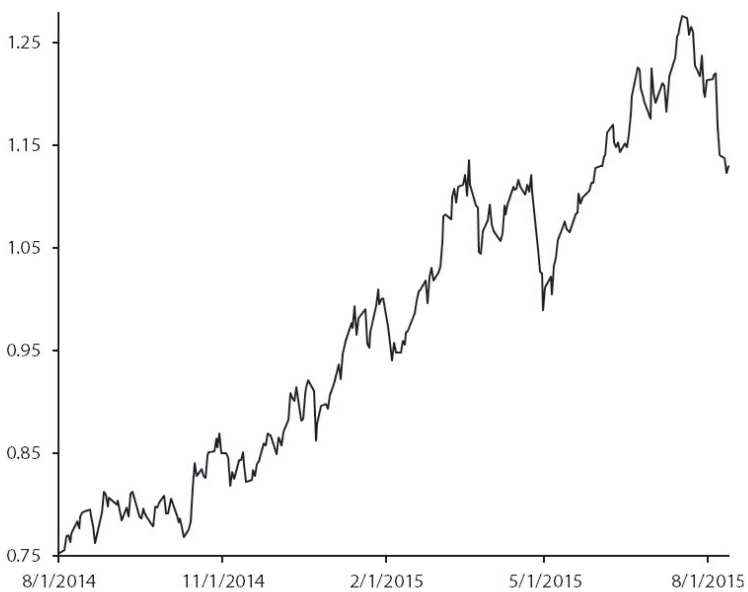
Stock market leadership, represented by those stocks with the best momentum, always draws a pack. The longer the indisputable leadership persists, the more exposed the pack becomes. This has been evident in the contemporary bull market. In recent years, two sectors have consistently led the stock market—health care (primarily biotech) and consumer discretionary. Charts 5 and 6 illustrate how well both biotech and discretionary stocks have done in the last year. The persistent outperformance of these two sectors is gaining even more attention because, as shown in Chart 7, stock market breadth is thinning. Headline stock market indexes are being held up by a smaller and smaller number of well performing stocks.

As participation in this bull market diminishes, momentum stocks are becoming even more coveted. Increasingly, portfolios are trending toward overweight positions in these popular sectors. The indisputable leadership of a diminishing subset of momentum stocks is a common historical risk. Two of the biggest postwar examples include the Nifty Fifty era in the early 1970s and the dot-com era in the late 1990s. In both cases, headline stock indexes continued to rise far beyond the point when most stocks were still participating as leadership became highly concentrated among a relatively small number of momentum stocks.

Chart 5

S&P Biotech ETF

Relative (to SPY ETF) total return performance



Today, this risk is not nearly as large as it was when a handful of mega consumer franchise stocks dominated the market in 1972 or when an exciting new-era story was enough to drive a start-up tech stock considerably higher in 1999. Nor do indicators suggest an imminent break in the current indisputable leadership of popular momentum stocks. However, the essence of this risk (i.e., a narrowing of stock market participation increasing the popularity of a small subset of momentum stocks) is evident today. Given that market breadth has recently separated from price action (Chart 7), how would the overall stock market react should leadership among the popular biotech and consumer discretionary sectors suddenly end (Charts 5 and 6)?

Chart 6

S&P 500 Consumer Discretionary Sector Index

Relative (to S&P 500) price performance

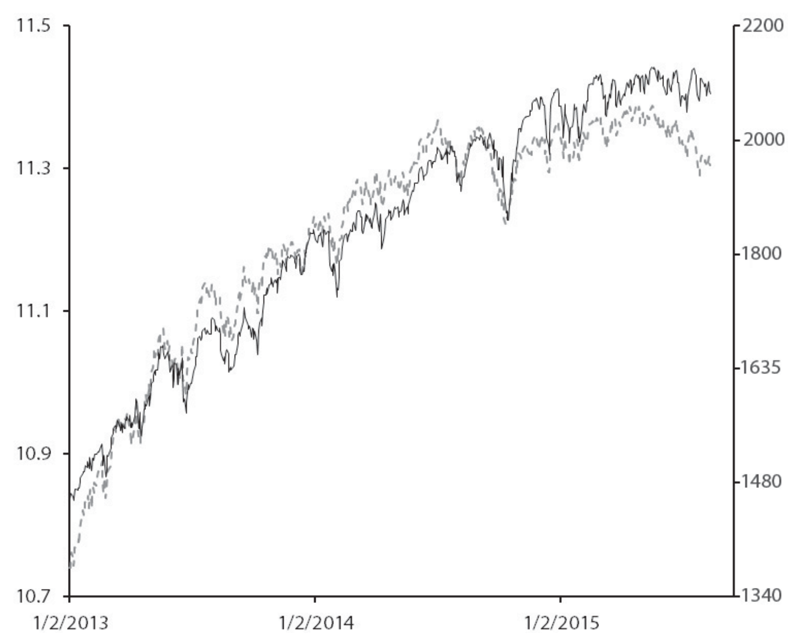
Chart 7

S&P 500 Stock Price Index versus stock market breadth

Left scale—Cumulative advance decline for NYSE stocks (Dotted)

Right scale—S&P 500 (Solid)

Natural log scales



Buybacks will bail you out (right?)

Most corporations are dripping with liquidity and they have not been afraid to use it—at least to buy themselves! Recently, as shown in Chart 8, serial buybackers have been excellent stocks to own. In a slow growing economic recovery, investors have rewarded buybacks because they augment scarce earnings growth. But have investors become too reliant on the indisputable buyback trend?

If global economic growth does bounce some in the next few years, many corporations may find better uses for cash. Cash hoards may also diminish should inflation pressures emerge and as interest rates rise. Finally, with the stock market up about two-thirds in the last three years, many companies may find buyback values less appealing.

What would be the impact of a sudden end in the buyback craze? Have investors pushed the values of these stocks beyond their fundamentals? Are price/earnings (P/E) multiples based on an earnings growth rate which simply cannot be sustained should buybacks diminish? Have investors become too comfortable with companies regularly bolstering quarterly earnings results with constant buybacks? Just how much have buybacks bailed out investors?

It's an M&A tsunami (right?)

The underlying support for the current wave of mergers and acquisitions (M&A) is indisputably favorable. Right? Corporations possess massive liquid reserves, interest rates remain near record lows, the stock market is in a solid upward trend, and the subpar pace of economic growth necessitates consolidation in many industries.

However, could the deal surge slow significantly in the next few years eliminating an important foundation of this bull market? U.S. M&As are on a record pace this year, and as shown in Chart 9, the level of activity is getting quite high relative to overall economic activity. Moreover, capital spending needs may begin to reduce funds available for mergers. The stock market has risen significantly in recent years, reducing the number of cheap buyout candidates and increasing the attractiveness of building rather than buying capacity. Finally, a broadening and quickening of global economic activity should stimulate capital spending and reduce consolidation trends.

If capital spending does begin to crowd out M&As, how would the stock market be impacted? Have price/earnings multiples and earnings expectations been artificially elevated by persistent consolidations and surging M&As? Historically, at least, the stock market has often struggled once an M&A wave peaks.

Chart 8

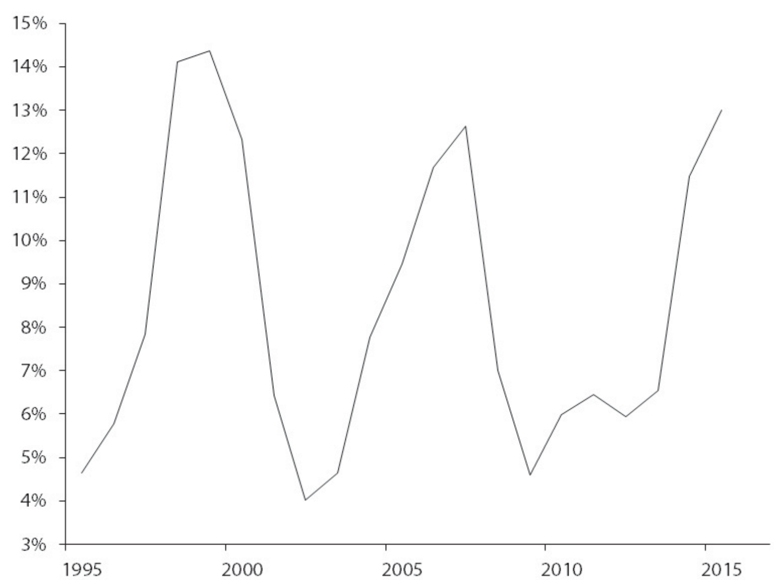
S&P 500 Buyback Index*
Relative stock price performance

*S&P 500 Buyback Index meausres the performance of the top 100 stocks with the highest buyback ratio within the S&P 500 Index (cash paid for common shares buyback in the last four quarters divided by the total market capitalization of common shares).

Chart 9

U.S. mergers and acquisitions

Dollar value of annual global U.S. mergers and acquisitions as a percent of U.S. nominal GDP
Source: Factset Mergerstat and Bloomberg



Unrecognized themes

While the stock market is susceptible to indisputable trends which surprising fail, it also could be unfavorably impacted by underlying themes which are unrecognized or underappreciated. Investors should remain mindful of three such themes which could become problematic.

An aging earnings cycle

The current economic recovery recently began its seventh year and already represents one of the longer recoveries in U.S. history. While this economic cycle will most likely last several more years, aspects of the recovery are already getting old.

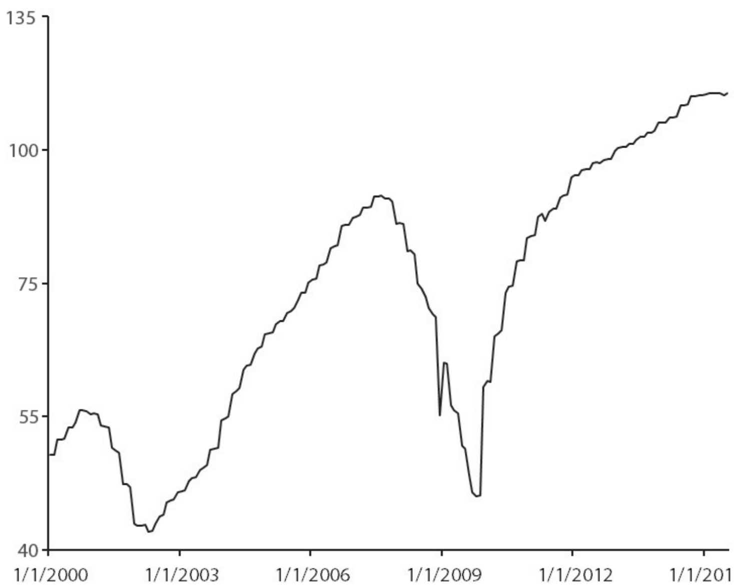
Chief among these is a rapidly maturing earnings cycle. Chart 10 shows the trailing 12-month earnings per share for the S&P 500 Index. Corporate profitability recovered smartly during the early years of this recovery, but similar to past cycles, has slowed in recent years. In the last three years, S&P 500 earnings per share have risen only slightly more than 5% per annum and less than 4% annually after inflation. Indeed, total U.S. corporate profits (from the National Income & Product Accounts) have been essentially unchanged for the last three years!

Earnings performance is well past its best for this recovery and investors need to consider whether earnings growth will prove sufficient to support current stock market valuations. The rapidly aging earnings cycle is perhaps best illustrated by an economy nearing full employment with corporate profit margins near record highs. Should global growth remain tepid and overall sales results modest, since profit margins are unlikely to rise much, earnings trends will also likely prove disappointing. Conversely, should global growth and corporate sales results accelerate, because the U.S. is nearing full employment, companies may soon face cost-push pressures and margin erosion which will likely offset improved sales results.

Essentially, it is difficult to see how earnings growth will be adequate during the rest of this mature recovery to support current price/earning multiples. Is a relatively modest earnings growth against a backdrop of rising inflation and higher interest rates sufficient to support the current 18 to 19 times price/earnings multiple?

Chart 10

S&P 500 trailing 12-month earnings per share



Investor sentiment and valuation

Neither investor sentiment nor stock market valuations appear extreme today, but "together" they have seldom been more extended. Chart 11 overlays the S&P 500 price earnings (PE) multiple with the trailing three-year return per unit of risk generated by the stock market. The return per unit of risk is a measure of consumer sentiment. When this rises significantly, the stock market typically provides investors with solid returns and low volatility, the two market characteristics which breed complacency and confidence.

As shown, the P/E multiple is currently about 18.5 times trailing earnings. Although high by historic standards, it is not at the exorbitant levels sometimes reached in the past. Likewise, while investor sentiment is probably calmer and more complacent than it has been at any other point in this recovery, it certainly is not as giddy as it was, for example, in the late 1990s.

Chart 12, however, shows that valuation and sentiment have seldom simultaneously been higher than they are today. Stock market valuations may be only slightly above average today. However, what may be underappreciated, is how high valuations are at a time when investor sentiment is also complacent.

Recently, many have voiced that this is "the most hated bull market ever" suggesting investor sentiment is still far from being troublesome. However, after three straight years of solid stock market returns without a correction or even much volatility, investor complacency has most likely increased significantly. Moreover, a few years ago when this bull market really was hated by most, nobody was saying it was the most hated ever! Although valuations and sentiment may be above average today, as illustrated in Chart 12, "together" they appear quite extended and probably represent a market risk not widely appreciated.

Chart 11

U.S. stock market
Valuation versus investor sentiment

Left scale—U.S. stock market trailing 12-month P/E muliple (Solid)
Right scale—Trailing three-year average annualized return per unit of risk (average monthly return divided by standard deviation) (Dotted)

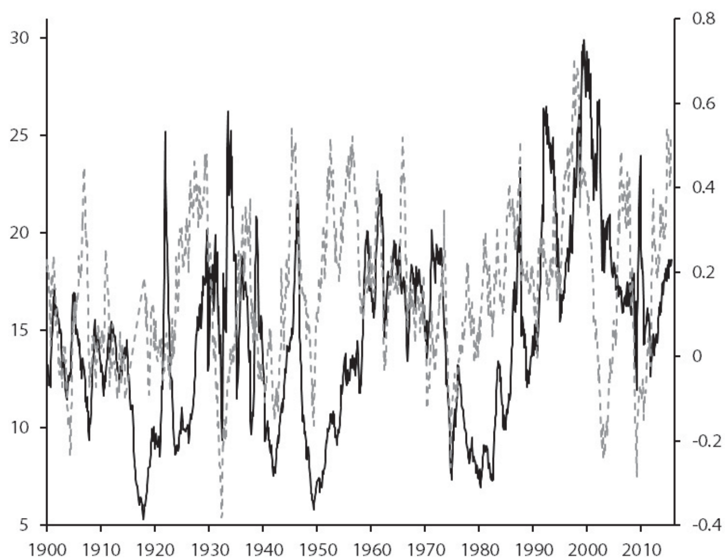
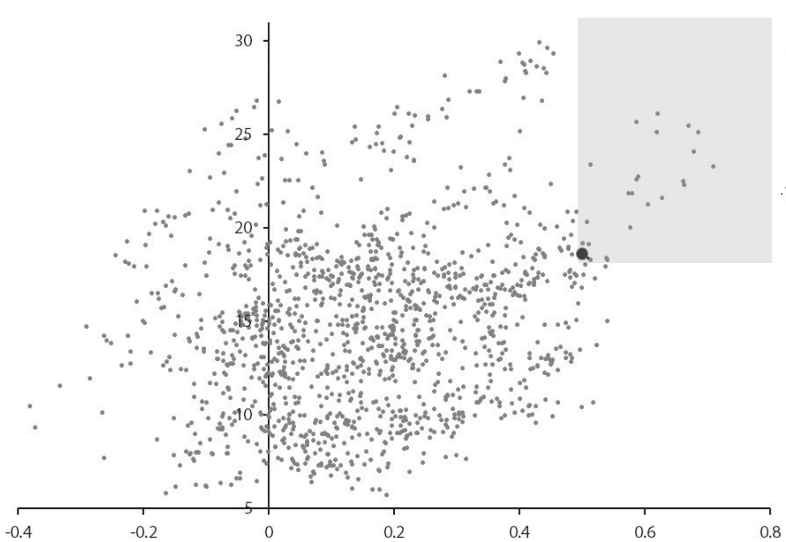


Chart 12

Stock market valuation versus sentiment
Scatter plot 1900 to date

Vertical axis—Valuation
Horizontal axis—Sentiment
Black dot represents current point
Shaded area shows all periods since 1900 when "both" valuations and sentiment were higher than it is today.



An overvalued bond market at full employment

In the postwar era, the U.S. has only rarely exhibited, as it does today, an overvalued bond market at full employment. Currently, as shown in Chart 13, bond yields remain significantly below any reasonable equilibrium level relative to an economy growing at about 2.5% with about 1.8% core inflation and nearing full employment.

On average since 1948, the 10-year yield has traded about 2% above the core rate of consumer inflation. The dotted line in this chart shows the level of the 10-year Treasury yield less the core rate of consumer price inflation plus 2%. When the dotted line is at zero, Treasury yields are in long-run equilibrium with the economic cycle. When the dotted line is above zero, yields are high relative to the economy and when it is below zero, as it is today, bond yields tend to be below equilibrium levels.

Chart 13

Unemployment rate versus bond yield equilibrium

Solid—U.S. unemployment rate
Dotted—U.S. 10-year Treasury bond yield less 2% more than the core rate of consumer price inflation

Many investors believe since yields are so low today the stock market should not be badly impacted once they finally begin to rise. However, what is underappreciated, is not just that yields are at very low levels, but rather that U.S. yields will rise soon from levels significantly below equilibrium in an economy nearing full employment. In 1948 and 1949, bond yields were significantly below equilibrium when the unemployment rate was near full employment. The U.S. stock market was flat to down in this era. Similarly, bonds yields were quite low throughout the 1950s and 1960s but when they did rise, they typically increased from an equilibrium or an above equilibrium level (i.e., yields usually increased when the dotted line was at or above zero). Between 1952 and 1954, however, bond yields rose from a deeply cheap disequilibrium while the unemployment rate was at full employment below 5%. During much of this time the stock market struggled even though bond yields were very low. Similarly, the bond market was way below equilibrium levels in the late 1960s and early 1970s with a very low unemployment rate and again the stock market struggled.

Today, bond yields are again far below equilibrium values and the unemployment rate appears poised to decline below 5%. If yields do soon rise, it will represent only the fourth time in postwar history yields have risen from deep disequilibrium levels with the economy nearing full employment. Each time, during the postwar era, the stock market has struggled when this condition has existed.

Summary

The contemporary bull market will most likely last for several more years. However, challenges are mounting and perhaps the stock market is finally headed for a correction before the bull market continues.

Sometimes the biggest risks faced by investors are what they know for sure and what they do not know. Several indisputable trends (i.e., the U.S. dollar will continue rising, inflation will remain dormant, momentum stocks will continue to lead, and buybacks and M&As will continue pushing stocks higher) have become popular among the investment pack and portfolios are increasingly becoming exposed to the continuation of these trends. At the same time, the pack seems either unaware or is simply ignoring a few themes (i.e., an aging earnings cycle, an alarming sentiment-valuation character, and a deeply discounted bond yield as the economy nears full employment) which could produce turbulence in the stock market.

Investors should reflect on these growing risks and appropriately moderate portfolio exposures. However, we caution against becoming too defensive since a lone wolf with imperfect timing sometimes gets run over by the pack!

Thanks for taking a Look!!

Written by James W. Paulsen, Ph.D.

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