# AA View

## What to make of current market conditions

### Summary


- The powerful recovery in US stocks since the brief bear market in March has far exceeded everybody's expectations. The turnaround is a record breaker.
- Risk assets have decoupled from falling profits and rising default rates in extraordinary fashion, a world apart from the last market downturn in 2008.
- This impressive achievement owes partly to the size and speed of stimulus and market backstopping from policy makers, a multiple of that seen in 2008.
- Two challenges to continued decoupling now arise. The popular 'tech trade' through the pandemic has created massive market divergence resulting in overcrowding and excessive valuations in the favoured segments.
- Second, zero-like yields on cash and bonds, usually a reliable friend of risky assets, is now losing power as higher valuations have now priced in the 'relative' case. Thinking relative cannot wish away credit or equity risk.
- Persistently higher volatility now being seen is likely signalling limited market upside. Risks will rise if the summer's retail-driven market gains continue.
- These are favourable conditions for de-risking and building portfolio buffers.


### Markets have run much faster and harder than anyone really expected

The near 60% gain in the US market (S&P 500 index) from its lows of late March has caught just about everybody unawares. Of course, it is quite true that other markets have been far less fortunate. The ex.US MSCI ACWI index gain is approximately half that of the US at the time of writing (the UK still down 25% from its pre Covid-19 onset highs). Equally, though, everybody knows that the US is ever more of an elephant in the room for global stock markets, because of its huge weighting in global market capitalisation and in setting market direction. It is the US market in risk assets broadly – stocks, credit, et.al, that has set the pace and it is this US rally's continuing strength that has confounded. Even Wall Street equity strategists, not known for their pessimism, have had to upwardly revise and then re-revise their year-end targets, in some cases several times, as the market has kept surging.

The asset allocation team's advice was to add to exposures by way of rebalancing into equities in late March when it looked as though markets had overshot. The turnaround was very swift. After the first 25% gain in the US market, our enthusiasm to share in the rebound waned. In common with most market observers, this was to underestimate market strength.

This astonishing and acutely V-shaped market rebound has toppled records. Our COVID-19 updates observed the February/March 2020 falls as the swiftest ever bear market on record (a mere 16 days to drop 20%) but another record has now been set – this is the fastest ever market turnaround in history, a mere 126 trading days to recapture the February 2020 highs. Compare that with the nearly six years it took to recapture the 2007 stock market highs before the global financial crisis, and one gets a sense of the scale of what has happened.

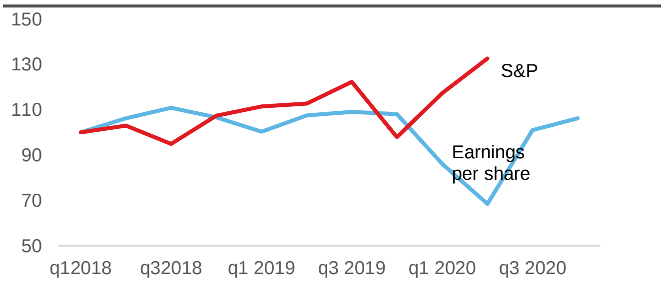
The same applies to credit. February/March was the fastest ever credit bear market in the sheer speed with which spreads rose. The recovery since has been as impressive as that in stocks.

## Awesome decoupling from pandemic's corporate impact

That markets have been able to do this through a pandemic is a triumph, of sorts. The small wobble over the past few trading days does not take away much from the feat to get the S&P 500 index and US high yield spreads to reach the 3500 and 500 basis points (bps) level, respectively, at the start of September.

It is not as though the pandemic's effects on corporate profits and cash flows have been mild. Even if we assumed that next year's optimistic corporate earnings recovery projections from analysts materialise fully, earnings would still be below their pre-COVID-19 onset highs a year from now, i.e. a two-year period will have elapsed just to catch-up. The disconnect between earnings and the market is clear from the chart below. The current 23x next twelve months earnings multiple for the S&P 500 index has only been seen previously in the year 2000.

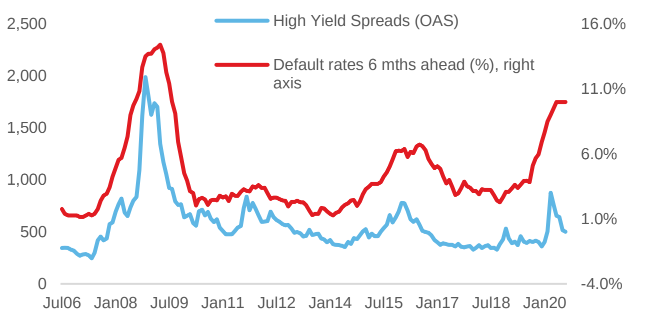
**How the S&P 500 decoupled from profits**
**(Q1 2018=100)**




*Source: FactSet*

High yield is similar. Spreads have fallen back to levels which normally signal benign, not stressed, credit conditions. The last time we saw the current default rate of 7% (end July data from Moody's) was during the financial crisis, but spreads were then at 1500bps, not 500bps as now. Spread markets do, of course, anticipate default rates looking ahead, and Moody's expects the default rate to reach double digits by early 2021 as shown.

**How high yield decoupled from credit default trends**
**(US high yield spreads and default rates)**




*Source: FactSet*

In investment grade credit, the focus of Federal Reserve support for risky assets (and the European Central Bank and the Bank of England too), the 5x ratio of agency downgrades to grades of US corporate bonds by seen for 2020 to date (Bloomberg data) should, on previous downturn experience, have seen spreads of at least double the 130bps we see today.

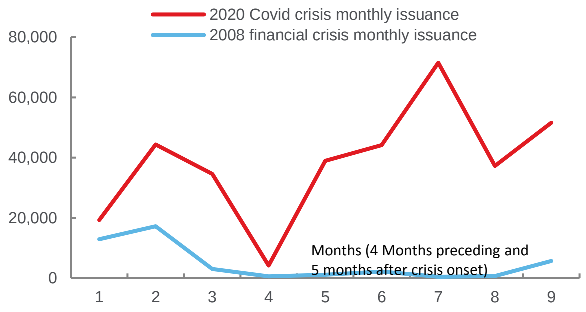
## Stimulus scale and 'backstopping' all important to decoupling success

We do not have to go far to explain this extraordinary market decoupling. The policy response has been very different to the 2008-9 crisis. The rule of '3x' has applied in this crisis; the size of the monetary and fiscal stimulus has so far been about three times the size of that seen in 2008/9. It goes beyond a size factor. It is also about *speed* and the *number* of actions employed. In 2007/8 as the crisis broke, the number of Federal actions in the US amounted to five in the first three months. By the middle of June, the third month of the COVID-19 crisis, some 29 Federal actions had already been seen[1]. Perhaps most importantly, in contrast to 2008, the US central bank stepped into credit markets in a way never seen before or even envisaged. The combination of quantitative easing and announcement of intervention in credit markets from the US central bank closed the market distress loop, at once liquifying, keeping access open even to companies in trouble and backstopping investors' exposures with the promise to bring the weight of its unlimited balance sheet to bear against sellers.

[1] Cogent Strategies, June 15 2020

Eye-catchingly, the credit market backstop has opened the market to record issuance levels – as shown in the chart below, tracking the numbers just before and just after the onset of the crises in 2008 and 2020. The contrast is telling.

**A world apart for credit issuance: 2008 and 2020 compared High Yield bonds (US $ million)**




*Source: Bank of America Merrill Lynch*

We should also note that the declaration of intent to do all it takes by the Federal Reserve has been far more important than the intervention itself. It is no coincidence that risk assets hit their lows on March 23, the day that the Federal Reserve announced its open-ended asset purchases. In fact, Federal Reserve purchases since have been small against market size. This also means that plenty of dry powder now remains for the Federal Reserve to do more, if required. Investors know this.

## Challenges to continued decoupling appear – the 'tech trade' and its limits

Let us look ahead. The Federal Reserve's market rescue initiatives have been wildly successful, but investors know that if corporate woes continue, it is not enough. Central banks cannot take over bankrupt companies. Ultimately, economic conditions matter. So, the investor hunt has been strong in the past few months for areas less exposed to weak conditions. This is where technology and its various spinoffs and offshoots (that extend well beyond the confines of the technology sector index) have come in as many companies in these areas have seemed immune to, or even benefited from the pandemic. Other sectors, most oddly the consumer discretionary sector (though Amazon being near half the sector's capitalisation weight explains it well), also have defensive winners from these trends.

On our estimates, using rules of thumb that assign defensive attributes to each sector's profile of the US market, over 40% of the US market appears more defensively placed relative to the other 60%. This readily explains the year's extraordinarily divergent performance with energy, financials' and real estate deeply in the red, but with IT, consumer discretionary and communication services sectors up well over 20% on average. It is not exactly often that the gap between the best and worst performing sectors in the US has reached 80% in a matter of months![2]. Not all this sector divergence is about the search for shelter in the pandemic, but it has been a key driver.

The snag is that this bidding up of the better placed sectors and companies in this broad 'tech trade' has arguably now gone too far. Some of the large companies that have been key counters here have become overbought and expensive. Though these companies have had years of strong performance, their valuations did not, until recently look that extended, given strong business models and seemingly invulnerable return on equity and margins. These supported price gains over a prolonged period. Ultimately, though, there is a price ceiling for everything. As the table below shows, the pandemic chase may have (finally) raised prices of some of the key megacap tech stocks to levels just too high to keep buyers coming in. The PEG ratio – the ratio of the PE to expected growth in earnings is particularly revealing in showing the extent of the valuation run-up.

**Tech megacaps: Valuation ready reckoner (FactSet data)**

| | | Sep 1 2020 | Pre-COVID 19 high's (Feb 2020) | 10-year median |
|---|---|---|---|---|
| **Apple** | **PE (last 12 months)** | **39x** | **34x** | **22x** |
| | **PCF (Cash Flows)** | **28x** | **21x** | **11x** |
| | **PEG ratio** | **3.1x** | **1.7x** | **1.1x** |
| **Microsoft** | **PE** | **39x** | **35x** | **22x** |
| | **PCF** | **29x** | **27x** | **13x** |
| | **PEG ratio** | **2.3x** | **2.3x** | **1.6x** |
| **Alphabet** | **PE** | **38x** | **32x** | **29x** |
| | **PCF** | **22x** | **20x** | **18x** |
| | **PEG ratio** | **2.4x** | **1.6x** | **1.2x** |

What are the implications if this chase has run up against its logical limits? It does not necessarily mean a big rotation into and outperformance from the trailing value sectors of energy and financials. However, it probably signals much less differentiated sector performance looking ahead[3]. More importantly perhaps, it also suggests that the technology megacaps' valuable anchoring function for the market's recovery and strength is weaker.

This does not on its own presage large market falls, more a pattern of higher volatility. This is already signalled by the way the volatility markets are behaving. Implied volatility signalled by the VIX index had stopped falling some time ago, decoupling from the rising equity market. The gap between realised and implied volatility has been rising in the past month, an early warning signal of the recent market wobble.

## 'Let's be relative' is a powerful support, but limits here are appearing also

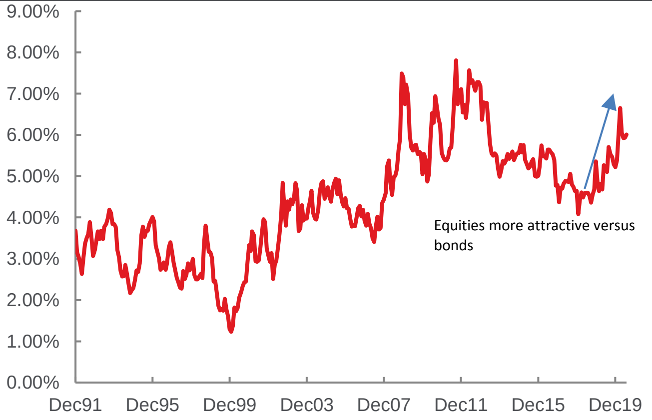
'Don't look at PE's, look at the Equity Risk Premium', has been a recent call from some market bulls. There is something in this –

2 S&P 500 Energy sector down 42.4% and Technology sector up 38.6% in the year to September 1.

3 See AA View: *Will value stocks ever make a come-back*? July 2020, for a discussion of a potential catch-down effect in technology rather than a value stocks catch-up.

and in fact, there has been something in this for a long time. The almost unbroken twelve-year long bull market (the 2020 bear market was so brief as to almost not count in a US market context) has drawn a lot of support from the behaviour of bond yields which have sunk to lower and lower levels. As we have always said, the equity risk premium (ERP), a measure of relative valuation versus bonds has been a loyal friend of the US equity market for a long period, and the pandemic experience is no different. The equity risk premium (see chart) has been rising recently, not because equities have intrinsically become more attractive, but because expected returns from bonds have fallen faster than the valuation increase from rising PE ratios has dented returns from equities. So far so good for the market.

**A rising US equity risk premium is supportive but…**




*Source: Aon, FactSet*

Three problems arise on a closer look. First, the economic exposures of credit and stocks have not gone away, so this relative case works only so long as the corporate ship is on a reasonably even keel. If the pandemic's economic follow through is weak, depressed corporate profits and credit losses from an agency downgrade or default will still matter. Relative value approaches cannot offset corporate fundamentals indefinitely. Second, the fact is that the ERP has not really worked in non-US markets to the same extent. To many, this shows that investors do think about absolute attractions of risky assets rather than just on a relative basis. Thirdly, the relative value argument, which has kept investors engaged in risky assets through the pandemic may also be reaching its limits, i.e. the relative case has now been 'priced in'. When US corporate bond yields have fallen below the rate of inflation as at present, or average stock valuation levels in the areas of the market that investors want to hold have reached very high levels, investors cannot be blamed for baulking at the risk taken to earn a precarious pick up over government bonds.

Institutional investors appear already to be hesitant and the retail driven nature of the recent market gains from June could be an early sign of exhaustion in the relative case for risky assets[4]. If thinking relative has already taken valuations in credit and equities to lofty levels, it is reasonable to think that this cannot be counted on to *keep* markets rising.

## Drawing it together

Where does all this leave us? The decoupling of markets from the pandemic has been hugely impressive. The impact of the vast stimulus and the comprehensive market backstops used by central banks have been far more powerful than we and most others allowed for. The technology trade phenomenon and the power of the equity risk premium have both also strongly supported the market's decoupling from the pandemic's effects on the economy and corporate profits.

However, there are challenges as we look ahead. The economic and corporate risks from the pandemic's follow through have not disappeared; shelter from the tech-trade (and its offshoots) has become too expensive; relative valuation arguments may also have reached an exhaustion point. Although the market's ability to shrug aside the pandemic effects has been badly underestimated, a continuation of the decoupling success seen over the past few months is no longer assured.

This does not necessarily mean large market falls are to come, even though this is possible. Rather, our take-away is that this is an outlook of relatively high volatility with limited assurance of return, i.e. a market more appropriate for taking risk off the table. The incentive to de-risk will be stronger if the current, more retail-driven, market 'melt-up' seen through the summer continues for much longer. If this happens, it should be obvious that risks will rise of much more adverse market outcomes later.

In current conditions of high uncertainty all around on multiple fronts, whether it is the pandemic's course, geopolitics and protectionism and of course, the approaching US election season, the case for strengthening portfolio resilience through diversification into less-correlated assets is strong.

4 Retail trades appear to have gone from 10% of market trades in 2019 to recent levels of about 25% according to some market sources.

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## Aon's Global Asset Allocation Team

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