—New Albany—
Investment Management

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Market Insight: US Markets Defy Headlines

Despite the continual litany of issues plaguing the economy, the US financial markets keep marching higher. Almost daily, headlines continue to project a very challenging business environment and the resulting real and potential negative impact on the economy; yet despite this, many stocks market sectors have made new highs. The markets appear to 'defy logic'. Have they become detached from reality?

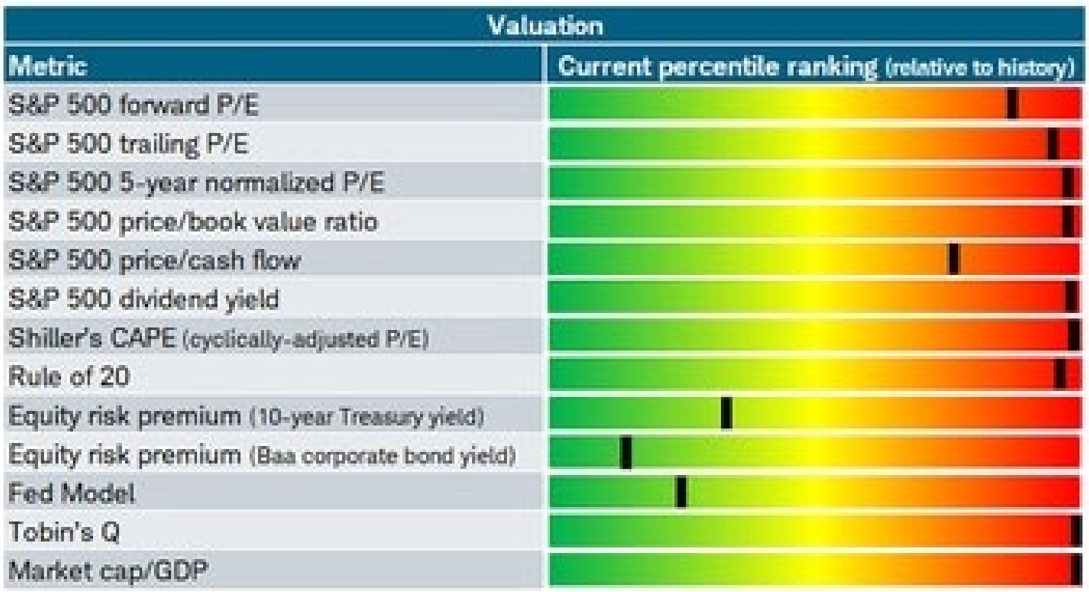
Below is sampling of recent headlines:

- GDP decelerating from 5.6% in 2021 to 4% in 2022. (Goldman Sachs)
- Supply chain bottlenecks expected to continue through at least the middle of 2022
- Labor shortages plague nearly every aspect of commerce and are considered the most 'intractable risk' to businesses. (Reuters, Oct 26)
- Inflation now at 5.4%, a 13 year high.
- Washington still at impasse over dwindling spending plan.
- Earnings growth decelerating from +48% in 2021 to +7.7% in 2022
- Fed expected to begin its bond taper program this month, and raise short term rates in mid-2022

As daunting as these headlines read, there is **more to the story**…

Market Action provides a look into the future: Today's news is really yesterday's news as far as the markets are concerned because the markets are always looking ahead, at least 6 months to 1 year ahead. This is because stock valuation is very much influenced by the *present value of future earnings.* In other words, the price investors are willing to pay now, reflects their view of expected earnings in the future. So today, with the market breaching new highs recently, it is revealing investors' positive sentiment or confidence about future economic growth and earnings. This DOES NOT mean the current outlook is correct, but it explains what investors' expectations are of the future. So, the question is: **Are investors being too optimistic about the future? Are stock prices too high?**

Valuation, an indicator of Market Sentiment: The chart below is a 'Heat Map' of stock valuation metrics. As can be seen, most of the stock metrics are in the RED zone, which means stocks are very expensive. These metrics measure the value of stocks relative to their historical valuation. In other words, a stock to stock valuation. However, there are three metrics that are still very much in the green, indicting stocks look cheap. These metrics look at stock valuation relative to the level of interest rates.



Source: Charles Schwab, Bloomberg, The Leuthold Group, as of 10/29/2021. Due to data limitations, start dates for each metric vary and are as follows: CAPE: 1900; Dividend yield: 1928; Normalized P/E: 1946; Market cap/GDP, Tobin's Q: 1952; Trailing P/E: 1960; Fed Model: 1965; Equity risk premium, forward P/E, price/book, price/cash flow, rule of 20: 1990. Percentile ranking is shown from lowest in green to highest in red. A higher percentage indicates a higher rank/valuation relative to history.

(Please note the metric for stocks is only the S&P 500, which is NOT the entire stock market, but it is a relative representation.)

So which metric is correct? Well, they all are correct in terms of relative valuation. But it appears that today's level of interest rates (extremely low) and Fed policy (extremely accommodative) are the overwhelmingly big factors supporting the markets.

Valuation, not a market timing indicator: The frustrating part of looking at valuation is that it has never been a good timing tool in forecasting the direction of the market. In fact, there is no discernible relationship between any valuation level and subsequent one-year equity market performance. Over a longer time-horizon however, 5-10 years, there is a much closer relationship. This means in the short-term, valuation should be considered as a measure of sentiment. And right now, sentiment is still very positive about the next 6-12 months.

With this in mind, let's take another look at these headlines, but through the lens of the market (green text):

- GDP decelerating from 5.6% in 2021 to 4% in 2022. (Goldman Sachs)
  4% growth is still very strong and supportive for businesses.
- Supply chain bottlenecks expected to continue through at least the middle of 2022
  This is pushing more growth into the future, a positive.
- Labor shortages plague nearly every aspect of commerce and are considered the most 'intractable risk' to businesses. (Reuters, Oct 26)
  Tight labor market is good for employees: higher wages; more confidence to spend money, strong consumer.
- Inflation now at 5.4%, a 13 year high.
  Much of the inflation is 'transitory' (J. Powell) and will resolve once the supply chain issues are worked out.
- Washington still at impasse over dwindling spending plan.
  Fiscal policy will provide some support to the economy in the near future.
- Earnings growth decelerating from +48% in 2021 to +7.7% in 2022
  Earnings are still growing. And +7.7% is still much better return than bonds.
- Fed expected to begin its bond taper program this month and raise short term rates in mid-2022.
  Interest rates are still exceptionally low, borrowing is cheap.

In sum, today's market sentiment, (investors' outlook of the near future), is positive and this means the outlook for stocks is supportive. Of course, this outlook can change in an instant as new events evolve. And it DOES NOT ensure the market will not experience some significant corrections. But the underlying fundamentals, near term, are positive. Longer term, inflation must fall back to around 2% and growth must stay above 3% to keep the market momentum positive.

Portfolio Strategy: Rapid rotation between stock sectors (Value to Growth; Large to Small) continues to be the character of this market and reflects the disjointed but positive nature of the World economies reopening. As such, we are keeping a stock exposure balance across sectors and allocation near the upper end of risk targets. On the Bond side, exposure remains short term to provide liquidity, some income, and a hedge against expected rising longer-term rates.

These are my thoughts. As always, your comments and questions are welcome.

Have a great November, and a wonderful Thanksgiving!
I have never felt more blessed than today.

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