GAMMA INVESTING
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2021 Investment Outlook – Part 2

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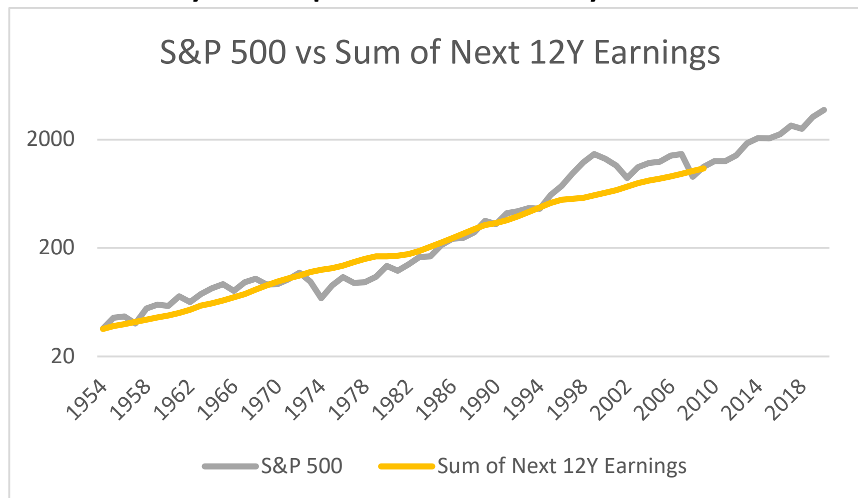
In Part 1 of this article, we drew a few simple conclusions from the historical statistics of the stock market. One, the investment horizon really matters for the outcome. Longer horizon skews returns to the right, i.e. investor is more likely to end up with a positive return. Another way of interpreting this conclusion is to deduce that short term price movements of stocks are more noise than useful information, while longer term moves reflect the earnings of the respective companies. Secondly, we highlighted that entry point is critically important to determine the ultimate return; i.e. aim to buy low so it's easier to sell high.

What can we learn about today's market from history?

Chart 1 reveals a very important relationship: S&P 500 and their earnings stream are highly correlated over longer horizon. Digging deeper into those statistics:

- From 1954 to 2019, the Earnings Per Share of S&P 500 companies grew at compound annual growth rate of 6.35%. However, the year-over-year earnings growth rate was quite volatile.
- Interestingly, over the seven decades, the Nominal GDP also expanded at CAGR of 6.36%. This provides a strong evidence that investing in the earning power of the largest companies has been a great way to capture the benefit of the US economic growth.
- The stock prices in S&P 500 appreciated at CAGR of 7.3%. During the bull markets of 1950-1970 and 1994-2008, the stock market deviated from the trend line but always corrected back to the trend line in subsequent bear markets.

Chart 1: S&P 500 year end prices vs forward 12 year cumulative earnings



What lessons can we draw from history about the prospect of next 10 year's return if one chooses to enter the stock market today? The pattern in Chart 4 would hint at a disappointing outcome.

Many market pundits have observed that today's stock market is quite expensive on historical terms. Measured in a variety of Price Earnings ratios, today's valuation level is second highest since 1950, with only the peak of the Tech Bubble in 2000 surpassing today's level. Based on historical patterns shown previously, the expected returns to be earned over the next 10 years may be less than 5% pa. Based on such historical pattern, 2021 would be an ill advised entry point for making a new investment in the stock market.

On the other hand, bond yields are pitifully low due to the aggressive monetary stimulus being wagered by practically all the central banks the world over. Compounding a 5-6% (3-4% price return plus 2% dividend yield) over the next decade would handily beat holding a 10 year treasury note to maturity.

This is the crux of the debate among some of the sharpest minds on investing: are we standing at the precipice of a market cliff as the valuation bubble is about to burst, or should we stay fully invested in equity as there are simply no better alternatives?

As in so many things in life, the reality is likely to be somewhere in the middle. Scary headlines are catchy but they oversimplify things. First, let's debunk both extreme views which frame both ends of this debate.

To counter the pessimists predicting a market debacle, I would point out that historically expensive markets can stay elevated for a few years. Stocks were valued above 25x trailing PE in 1998-2000 before they buckled. Similarly, stocks stayed expensive for most of the '60s decade. Usually, bear market of 20% or more occurred because of a looming recession (seven out of last twelve bear markets) or due to extreme excess in the economy (2000 and 2008). Neither conditions seem to be present today as the global economy is only beginning to climb out of the Covid abyss.

For the market optimists who see a replay of the 'roaring 1920s' after the Spanish Flu pandemic, the historical data bearing out the inverse relationship between high PE ratio and low subsequent return is a sobering reminder that trees don't grow to the sky. Unless today's companies find new ways to grow earnings much faster than the economy, the S&P 500 earnings series will revert to the 6.3% CAGR and pull the stock prices towards the trendline.

The Middle Way

When in doubt, steering clear of the extremes and staying in the middle lane can be a prudent way to managing one's wealth for retirement. Striking a balance between valuation discipline and staying invested for a decent long term return, my recommendations are as follows:

Lower the overall equity allocation

Establishing a long-term allocation to equity is probably the most important decision of a financial plan. If the long term allocation is 60%, then I would advise lowering today's optimal level to 50%. Historical lessons of valuation reverting to the mean taught us that more likely than not, we will have a better entry point in the next 2-3 years. 2021 is the time to slow down, conserving some fuel to reload at a more opportune moment when market corrects.

Allocate to cheaper sectors which benefit from an economic recovery

The stock market is not homogeneously expensive. Certain sectors such as technology has been growing faster than the general economy, thereby credited with a significantly higher valuation level. Higher PE ratio implies very high expectation, thus setting up for deeper disappointment when correction comes. There are many sectors which have lagged the market valuation and the bar for those sectors' outperformance is low enough that those stocks will likely rebound.

Emphasize the importance of dividend paying stocks

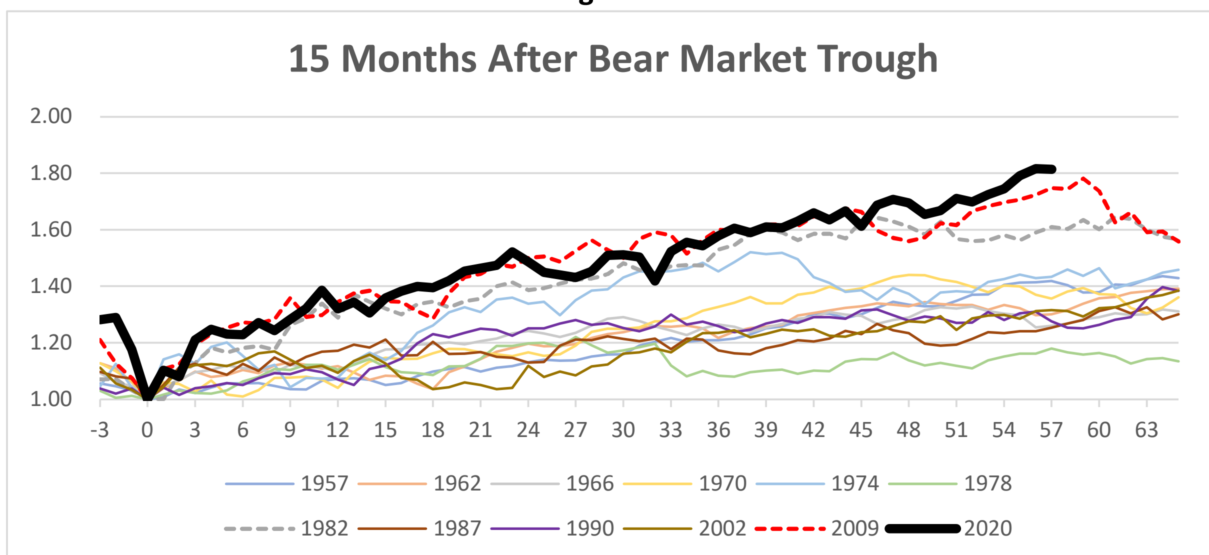
Dividend stocks went out of favor as growth sectors dominated in recent years. I suspect dividends will come back into favor with investors again in the new cycle. As the economy rebounds and interest rate rises, dividend paying stocks behave like higher coupon bonds, which tend to have lower duration (i.e. lower sensitivity to rising rates). Dividend stream tends to buffer total return from stock price variability.

Be Fearful When Others Are Greedy…

Selected from the numerous quotes attributable to Warren Buffett, this quote is a timely reminder of staying prudent in the current state of ever higher expectations. The global economy is recording highest PMI data since the beginning of this century, and most companies are reporting glorious earnings beats after beats. The scary freefall of economic activities during the pandemic is quickly fading into the memory, and financial markets tend to have short memory. This is the moment to begin the fearful phase of prudent investing.

In Chart 2 below, we show the S&P recovery paths in the 15 months after every bear market trough since 1950, as tabulated in Table 1. The recovery from March 2020 lows was the fastest and strongest bounce that we have observed in all twelve bear markets. A close second was the recovery from the Great Financial Crisis of 2008. Interestingly, the GFC recovery began a 15% correction on week 59.

Chart 2: Bouncing off bear market lows



There are many reasons why this bull will ultimately run out of steam. The following is my conjecture of some catalysts which may cause the next 15-20% correction, which would revert the stock prices towards the earnings trend line of Chart 5.

<u>Commodities Boom</u>

The commodities index has already staged a 50% rally from the pandemic trough, with the most economic sensitive commodities continuing to make new highs. The semiconductor industry has reported a widening shortage problem; similar inventory deficit may begin to show up in copper, aluminum, etc. Shortage of key materials may boost further round of price hikes, instilling fear of escalating inflation.

<u>2021 is a Sugar Rush</u>

As 2021 boom hands off to 2022 deceleration, economists may begin to wonder if the boom is merely a sugar rush from the walls of fiscal and monetary stimulus. As governments and central banks begin to lift their feet off the pedal, economic deceleration may leave investors with a painful feeling of hangover.

<u>Unrealistic Earnings Estimate</u>

Peaks of bull markets are the times when investors tend to extrapolate optimism into the indefinite future. Later on, more rational investors will realize that such rampant optimism is unfounded.

<u>Fed Losing Investors' Confidence as an Inflation Fighter</u>

The Fed has clearly stated its focus on keeping the stimulus longer than its past policy, in order to lift employment level for all income brackets. By doing this, the Fed is betting that inflation will not rear its ugly head. Inflation expectation is not a well understood process. If the supply chain bottleneck turns into a chronic shortage which drives further price hikes, then the central bank's hard earned reputation as the ultimate inflation fighter may be eroded.

Asset Allocation in an Expensive Market

While I do not believe in trying to time the market, the following framework based on a study of historical patterns may offer some guidance for investing in 2021:

- A bear market correction of 20% or more is typically accompanied by a recession or Fed tightening monetary. Neither conditions look probable in 2021 or even 2022;
- Historically, bear markets were at least 26 months apart, making the next occurrent fourteen months away, at the very earliest;
- Expensive valuation today will likely punish the next ten years' holding period return;
- Unlike previous market peaks, the bond market does not provide an attractive hiding place;
- The next significant correction may be triggered by valuation concerns, rather than economic imbalances.

Navigating a prudent asset allocation strategy in 2021 is not a choice between equity and bond, but instead, a dynamic decisioning between holding the right level of cash and selecting the right sectors within equity that will prove more resilient when a valuation triggered correction finally arrives. That will be the focus of our next research paper.

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