SCS Financial
Strategic Capital Solutions

INVESTMENT PERSPECTIVES

MAY 2015

MARKETS THEN AND NOW

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OVERVIEW: It's been almost eight years since the US housing market bubble burst, US equity markets fell by over 50% and global financial markets entered a crisis. Market losses were in the trillions. Just prior to the crisis, home prices had been rising rapidly, unemployment was at 5.4% and the S&P 500 was at a record high. The US government ran to the rescue with fiscal stimulus measures, while the Federal Reserve pushed interest rates to zero and announced massive open market securities purchases to do whatever was needed to save the global financial system. As a result of these and other extraordinary actions, markets on many levels are back near pre-crisis conditions. The US economy is on a more normalized growth path. US stocks (*as measured by the S&P 500*) are at new record highs, home prices are rising again and the unemployment rate is back at 5.4%. The questions facing us today are whether all of this is sustainable or are asset prices putting us at risk of another financial crisis? While there are always risks of corrections or significant pullbacks, we do not feel that markets are at unsustainable extremes. Today's market landscape will continue to offer attractive investment opportunities for skilled asset managers.

Main Points

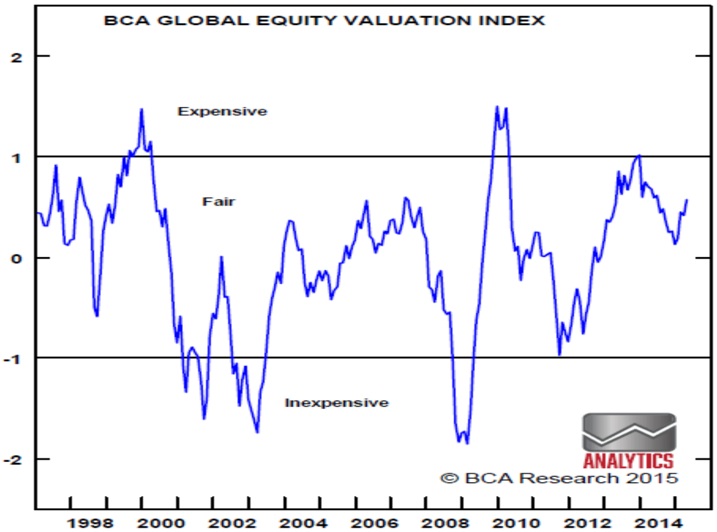
- By many measures, the market conditions today are similar to those seen before the 2008 market crisis.
- Equity prices have reached new highs, home prices are rising and unemployment is low.
- However, we feel that overall market conditions are far more sustainable now than they were then.
- A pullback is always possible but in the absence of unsustainable conditions we feel rising asset prices are likely.

First off, we need to put today's market environment in perspective. While the S&P 500 is substantially higher than its 2009 lows, stocks are only about 35% higher than their 2007 pre-crisis highs. These gains have been supported by higher US gross domestic product, improved profits and only modestly expanded equity market multiples. None of these factors suggests anything abnormal in broad equity market conditions. High asset prices, with moderate expected returns and volatile market conditions, are not in and of themselves evidence of bubbles. In fact, such conditions are "normal" for markets that may be just past the mid-cycle stage of an economic recovery. So, from a broad perspective, we do not see anything terribly threatening in current equity market valuations and do not expect to see a crash, or the bursting of a bubble, any time soon. And it is worth noting that equity market conditions, profits, price/earnings ratios and corporate health in general were not the issues that led to the 2008 crisis. Rather, it was the subprime mortgage market debacle that was the primary cause of that financial crisis. Based on a number of important measures discussed below, we feel that markets are supported by sustainable conditions on many levels, assuming the Fed does not raise rates too aggressively.

SUSTAINABLE MARKETS: To start with, we need to discuss the difference between sustainable and unsustainable market conditions. While it may seem obvious, market bubbles exist when they are supported by unsustainable market conditions while normal markets are supported by sustainable market conditions. To understand what "unsustainability" means, all we have to do is go back to the housing market prior to 2008. Home prices were rising above incomes, loans were being made to unqualified borrowers and unsupervised lending practices resulted in significant amounts of fraud. Sub-prime loans (*the riskiest part of the market*) were interest only loans with near zero rates for two years, but which then re-set to 12% or more. Many borrowers were unable to repay these loans because there was no requirement at the time of origination that their income be sufficient to pay back the loans at their long-term interest rates. Stated differently, for the market to have ***not*** crashed would have required highly improbable events to have occurred: Borrowers' incomes would have had to increase by more than was realistically possible, home prices would have had to continue moving up faster than could be supported by the overall economy, or some new pool of purchasers would suddenly have had to appear out of nowhere. As the old saying goes, if something cannot go on forever, it won't. The housing market was unsustainable and a large enough problem to take the global markets down with it. As Bridgewater recently noted, unsustainability can be tied to a number of readily observable underlying conditions, including excessive bullish sentiment, very high absolute price levels, prices that discount extremely high future price appreciation and prices supported by excessive leverage, among many others[1].

When we look at equity, housing, bond and other markets today, do we find evidence of similar levels of unsustainability that we saw prior to 2008? The answer is that while certain markets, such as US public equities and high quality bonds, may be relatively rich, they do not appear to be at unsustainable bubble levels. For example, while equity valuations are high by a variety of measures, they are still within relatively "normal" ranges. Forward P/E ratios for the US stock market today are at around 18. While slightly above 2007 levels, they are nowhere near their unsustainable levels of nearly 30 seen in March of 2000. The two charts below illustrate this point. The first chart on the left is the BCA Equity Valuation Index[2], which shows stocks as being above fair value, but not yet rich, while the second chart (*from Bridgewater*) shows forward P/E ratios for US stocks since 1975. Neither chart suggests we are in bubble territory. And, as mentioned, it was not valuations in the equity market that led to the 2008 collapse, but the problems in the housing market discussed above. Similar housing market problems are noticeably absent from today's market environment.

Stocks Are Expensive But Not Within Bubble Territory



Source: BCA Research, May 2015

Source: Bridgewater Daily Observations, May 1, 2015

And while recent stock price gains have certainly been strong, their rate of increase (*as measured by a three-year average*) is well below the rate of growth seen prior to stock market crashes of the last century[3]. Recent price gains are reasonable due to the oversold conditions of the stock market in 2009 and the continued growth of the US economy. Finally, equity prices would also appear to be sustainable because they are discounting reasonable real earnings growth of less than +2.0%[4] over the next year, which is a growth rate that is roughly in line with what the economy can produce over the long term. This is unlike the period before the 2000 crash when stocks were pricing in earnings growth close to 7%, which was above the long-term growth potential of the US economy[5].

Looking at other markets and factors, we observe that bubble conditions are lacking:

- US corporate BBB credit spreads are only a bit below their long-term average. They are not at excessively low levels and would appear to be supported by still-strong corporate balance sheets and plenty of cash on hand. At the same time, continued low interest rates mean that corporate debt-service costs remain at low levels relative to earnings.[6] While corporate net leverage is rising, in aggregate it remains at reasonable levels[7].
- Overall growth of credit in the US remains close to zero. There is net positive debt issuance by governments and corporations but no growth in net consumer debt since 2011 and mortgage debt is down by $1.4 trillion between 2008 and today[8].
- Lending standards to individuals by banks remain strong and the subprime mortgage loan market has dried up amid heightened regulatory scrutiny.
- Capital expenditures by US corporations remain subdued, still below the levels seen in either the 1999-2000 or the 2007 periods.
- Corporate buybacks of stocks, while high at around 3% of GDP, are still below their 2007 highs of over 4% of GDP. Buybacks would appear to be sustainable given corporate cash balances on hand.
- Initial public offerings by US corporations at only 0.8% of GDP remain at the mid-to lower end of their two decade range and are nowhere near the 2.5% of GDP highs that we saw back in the 1999-2000 period.

Risks To Our View: To be fair, other factors are more mixed, with some caution signs appearing. Equity margin debt is at an all-time high in absolute terms, though as a percentage of the S&P's market capitalization, it is only at 2.5%, below the 2.82% high we saw in February 2008[9]. US consumer confidence is back at 2006-2007 levels, while equity market sentiment is also back at pre-2008 crash highs. Market participants appear to be complacent about the eventual course of equity prices, as reflected by very low readings in the CBOE Volatility Index (*VIX*). While there is no evidence of stress in current mortgage markets, there is some concern that sub-prime auto loan standards are becoming abusive. Student loans are also being originated at a very rapid pace, without establishing the borrower's ability to repay the loan. Default rates are already rising in the student loan market. And while there are other pockets of stress that are too numerous to discuss in this short of a writing, we don't feel that in the aggregate these are suggestive of pre-crisis market conditions. Of course, if the Fed were to raise rates too aggressively, it could create problems for the markets, but the Fed has indicated that it intends to proceed very cautiously.

Finally, there is the question of the federal deficit and low interest rates orchestrated by the central bank. Concerns are frequently voiced that it is only high debt levels and low interest rates that are sustaining markets. While Fed-induced liquidity has certainly been important to the markets, it is not the whole story. Consider these three factors: first, the low level of nominal interest rates is fundamentally a reflection of very low inflation rates and not merely central bank buying. We have been at risk of a deflationary spiral setting in since 2008, which has been the Fed's primary justification for keeping interest rates near zero. Year-over-year US consumer price inflation is actually at -0.2% as of April, and when applied to different types of borrowers, this means that ***real*** US interest rates are actually quite high — something typically not supportive of financial markets. Inflation is also very low in Europe and Japan. Second, the Fed's quantitative easing ended in October of last year, but it wasn't until late January when US interest rates reached record lows, suggesting that quant easing alone is not responsible for low Treasury yields. This is true in Europe too, where rates are generally higher today than they were in March when the ECB started its bond buying program. And third, there is the issue of servicing all of the debt that the US government has accumulated. While it is true that the Federal deficit now exceeds $18 trillion, the cost of paying interest on that debt (*given today's low rates*) is at low levels rarely seen over the past 45 years**.** Interest costs have fallen from a high of 15.5% of Federal expenditures in the 1990s to only about 6.5% today[10]. If the US can service its debt so easily, then its levels of debt are sustainable. And while we expect that rates will certainly rise from current low levels, we also expect that it will take a very long time before interest expense becomes a sustainability issue for the United States.

Conclusion and Market Implications: Stocks have rebounded with a vengeance since the S&P 500 hit its bottom in March 2009, and we are now poised for a seventh straight calendar year of gains for the blue chip index. Market pullbacks are always possible, and history has shown what can happen when bubbles appear — and when they burst. However, investors should keep in mind that each case of a bubble bursting was caused by different factors, including overly optimistic earnings or growth expectations; excessive use of leverage; real estate speculation; or even outright fraud. In each case, there were clearly unsustainable elements in market conditions that led to the bubble's collapse. Our assessment of today's market has identified sustainable conditions across a variety of measures, including equity valuations, lending practices and credit spreads. While we expect markets will be volatile as interest rates begin to rise, we don't think that we are about to see a bubble bursting as we saw in 2008. Investors should be prepared for pullbacks, and in the absence of clearly unsustainable conditions, expect to see higher market prices in the years to come.

ENDNOTES

[1] Bridgewater Daily Observations, May 1, 2015, Asset Prices Are High, but we Don't Think they are in a Bubble.
[2] The Bank Credit Analyst, Monthly forecast and analysis of the global economy and financial markets, May 2015 – Vol. 66 – No 11, page 2.
[3] Bloomberg data.
[4] SCS internally generated data based on year-on-year reported changes in earnings.
[5] Bridgewater op cit.
[6] Based on internal SCS equity market analysis.
[7] J.P. Morgan Guide to the Markets, March 31, 2015, page 6.
[8] Bloomberg data.
[9] New York Stock Exchange and Bloomberg data.
[10] Congressional budget office data.

IMPORTANT DISCLOSURES

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