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BLOG POST

Is the Coast Clear?

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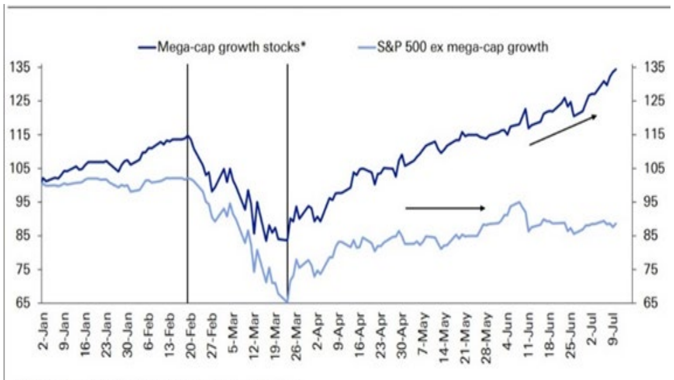
The global stock markets appear to be giving investors the "Coast is Clear" signal, surging to new highs following the pandemic-driven recession and bear market. Many investors have a sense of urgency, concerned that they may be missing out on the next bull market. This month's PCM Report looks at whether the investment waters are safe or if this is a trap that may catch unsuspecting investors off guard.

There are countless ways to calculate valuations on the markets. Some are driven by fundamentals such as earnings or revenue growth while others rely solely on technical indicators like momentum and moving averages. Valuation metrics have become like scientific or medical opinions these days; look hard enough and you will find one that you agree with. Confirmation Bias tells us that we tend to naturally seek out an opinion that agrees with our own outlook or narrative, and tend to ignore (or belittle) data to the contrary.

This is dangerous when it comes to investing because very often the narrative is wrong, painfully wrong. Let's look at some actual numbers that suggest investors should be cautious about throwing caution to the wind. The chart shows that the rally off the March lows on the S&P have been almost entirely driven by "mega cap" stocks or the largest stocks that trade. These 10 behemoths are 35% higher than when 2020 began while the remaining 490 stocks in the index are 10% lower on average. Digging deeper into the numbers, there are approximately 36 companies in the index that are down 50% or more YTD and another 130 companies down between 20% and 49%. That means one-third of the index has lost 20% or more this year and only 35% of the index has positive returns YTD according to CNBC.



*MSFT, AAPL, AMZN, GOOGL, GOOG, FB, V, MA, NVDA, NFLX, ADBE

Source: Bloomberg Finance LP, DB Asset Allocation , DB Global Research

The ultimate question we must answer is if the rally off the March lows is a Bear Market Rally or the start of a new Bull Market. There is compelling data that suggests the initial rally off a recession-driven bear market low has ultimately tended to fade, and testing of the initial low has occurred. According to Bloomberg data, there have been 14 bear market rallies since 1929. These rallies ranged from 133 days to 1,616 days in length with an average of 627 days. It would not be unusual for the markets to rally an entire year from now and still go back and test the March 2020 lows.

The driving factor for the market rally appears to be the fact that the Fed and Congress are attempting to flood the economy with excess liquidity that is finding its way into risk assets. My experience is that rallies dependent on excess liquidity and not fundamental growth end badly when the excess liquidity runs dry. There is a race to buy the mega cap stocks today, but we will likely also see a race for the exits when the market turns.

What is seemingly being overlooked by short-term traders is the impact COVID-19 closures are having on business earnings and employment. Large parts of retail and travel remain closed or are severely impaired as states attempt to get the surge in new virus cases under control. The media may focus on boarded up buildings on Madison Ave in NY or the Magnificent Mile in Chicago, but the real damage is done to the small businesses that simply cannot afford to remain shut for extended periods of time. Many of these businesses, especially restaurants, will likely not reopen by the time a vaccine is approved and available to the masses. According to SBA data, there are over 29 million small businesses of less than 500 employees, and they create 64% of all new private sector jobs and provide 49% of all private sector employment. The impact on jobs and the annual spending associated with profits from small businesses that will likely be lost will ultimately have to be factored into economic growth and the stock market.

The civil unrest occurring across much of America equally appear to be overlooked by investors today. There is a sense that the very nature of our society is changing before our eyes. A segment of the population seems confident they can bring about change through violent protest and property destruction, and the leadership in many of the cities facing unrest appear unable or unwilling to confront this. The ability to enforce the 'Rule of Law' is fundamental to any thriving society and economy. The lack of a rule of law is why companies will not invest more capital in countries that desperately need development. We may be facing fundamental changes to the economy that will not be easy to recover from.