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PEAK CAPITAL MANAGEMENT

Professional Investment Management

BLOG POST

Market Performance Review

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We've highlighted this is previous PCM reports, but the fact that some major market indexes, like the S&P 500 and the NASDAQ, have reached all-time highs during such a turbulent economy is difficult to understand. There seems to be a disconnect between what the market is telling us in terms of valuations, and what we see happening in the real economy. Prior to the onset of COVID-19 in February, unemployment in the U.S. stood at roughly 3.5%. As millions lost their jobs and still remain unemployed, the markets have rallied to new highs.

To be fair, the markets are forward looking. That is, current valuations are based on what economic conditions might be a year or two years from now. Investors seem to be betting that COVID-19 will be in the rear-view mirror by then, thus allowing businesses to reopen and the economy to thrive. The reality today, however, is that roughly 30 million people are collecting unemployment. Furthermore, the stock market rally has been highly concentrated in just a handful of names. Some might argue that based on current valuations, the markets have run too far too fast, and are due for a pullback. But there is plenty of liquidity (thanks to the Fed) and we have record low interest rates (again, thanks to the Fed).

There's little competition for income from other asset classes. Bonds offer meager yields for investors looking for income. This narrative is nothing new, given the long-term secular decline in interest rates. The benchmark 10-year Treasury yield is currently 0.7%, which is little consolation to investors looking for safe income. For the year the BarCap Aggregate Bond Index is up roughly 6% on a total return basis due to declining rates (you can still make money in bonds). But investors generally hold bonds for the income stream they provide.

Another option for income is dividend-paying stocks. However, the risk profile for income producing stocks is much different than your typical bond portfolio. Year-to-date, the return for the S&P Select Dividend Index is roughly -17%, but the yield of roughly 4% is a full 3% above the benchmark 10-year Treasury. Dividend stocks as a group are not necessarily heavily weighted to technology, so the group's performance year-to-date is nowhere close to the broader S&P 500. However, from a valuation standpoint, dividend-paying stocks might now be attractive for long-term investors. Meanwhile, high-yield bonds are more-or-less flat for the year, as measured by the BarCap Corporate High-Yield Bond Index. The current yield is roughly 5% annualized.

International markets have lagged the U.S. so far this year. The MSCI EAFE Index, which measures international developed market performance, is lower by roughly -5% year-to-date, but is well above the lows reached in March. Meanwhile, emerging markets are slightly positive for the year, as measured by the MSCI Emerging Markets Index. Markets in China are higher by roughly 20% for the year.

If we look under the hood and evaluate the U.S. equity market by factors, we see quite a wide range of performance. To no surprise, momentum leads the way as the S&P 500 Momentum Index is higher by roughly 21%. The index maintains roughly 30% in the technology sector and trades at roughly a 35x price-to-earnings multiple. High-quality names have done reasonably well for the year. The S&P 500 High-Quality Index is higher by roughly 10% due mainly to sector weightings in technology and healthcare. The price-to-earnings ratio is currently 22x.

On the flip side, the S&P 500 Value index is lower by roughly -10% year-to-date. The index maintains a meaningful weight to financials, which have not performed well on a relative basis. However, the current price-to-earnings ratio is only roughly 15x. Likewise, low volatility stocks as a group are lower by roughly -5% for the year. The index maintains a large-cap value tilt with a price-to-earnings ratio of roughly 19x. Small-cap stocks are lower by roughly -10% year-to-date, based on the S&P 600 Small Cap Index. It's no surprise that small cap stocks have struggled, given the impact of the COVID-19 pandemic. The index maintains a price-to-earnings ratio of 16x.

If price-to-earnings ratios truly are mean reverting, we could argue that some slices of the market (e.g. sectors, factors, industries) seem expensive while others seem more reasonably priced. Keep in mind that the long-term mean price-to-earnings ratio on the S&P 500 Index is roughly 15x. Markets tend to get overbought and oversold all the time. The ride in technology has been an incredible one off the March lows, but are current valuations sustainable? As the economy recovers, will there be a rotation into other areas of the market? It's difficult to predict if and when these changes occur, which is why, in our view, it's important to maintain a diversified portfolio.