StraightTalk

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"Are We in a Bubble?"

I hear the question posed to "experts" on financial news channels every day, asking if we are in a bubble – and if so – how horribly it will all end. As all of us know, financial catastrophism sells, and there are never any shortage of doomsday predictors on television, on the internet, and in printed media. (And, anyone that has stock market predictions that they will only share with you in a paid subscription model should be immediately discounted, or better yet, deleted.) Illustrating this current mania, on the morning I am writing this, a quick google search of "2021 stock market bubble" yielded 72.5 million hits. So…are we really in a bubble?

My answer is that we can only believe that this is a bubble if we have forgotten what a true bubble looks like! But before we delve into some of the classic mileposts of the speculative fervor that creates asset price bubbles, we should first talk about *valuations*. The most widely used tool for arriving at a value for a stock, or a broader market of them, is the price-to-earnings ratio. P/E, as it is referred to, is a measure of a company's price compared to its earnings. As the price to earnings ratio increases, the company's shares are said to be more expensive. For instance, if company A earns one dollar per share, and is trading at $10, the P/E is 10. If company B also earns one dollar per share but is priced at $20, that P/E of 20 makes them twice as expensive, right? Well…maybe. What if company B is growing much faster, and will earn $2 per share next year, while company A will see their earnings drop to 50 cents per share? Now company A is more expensive, based on next year's earnings, what is referred to as *forward P/E.*

To further complicate the math, what if company B had been earning three dollars per share for the last several years, but just hit a one-year pothole with their business model, and earnings only dropped for that one year? Or, what if company A is in an industry that faces new competitive pressures, or new government regulations, or has become unpopular with the consumer? I could go on, but you get the point. Using the price-to-earnings ratio is just one of many tools to decide the best price to pay for a company today. Unfortunately, it is often the only criteria used by the media to decide if a company, or in this case, an entire market of them, are overvalued. And the word overvalued is used to imply "will crash in price soon" in the same way the term volatility always means a drop in prices, not a rise in them. (As an example of this, how many of you refer to last year's outstanding gains in your portfolio as "volatile?")

The current news narrative is that since the P/E of the overall market is high relative to history, the price must come down soon. Obviously, headlines that predict prices falling a lot in a short period of time garner lots of attention, so there are plenty of them. But what if instead of the P coming down, the E rises instead? In other words, after the world hitting the mother of all potholes for earnings last year – as the global economy reopens, the earnings side of the P/E ratio zooms upward? Will stocks be overvalued, or in a bubble then? Of course, that is not nearly as sensational a headline as a bubble in prices leading to a stock market crash, but I believe that kind of earnings growth is what may be in store for us in 2021.

Using last year's earnings as your primary tool for price discovery – or worse, as a timing mechanism for when to buy or sell, is a bit like driving on the highway using only your rear view mirror. For driving and investing – it is much more important what is *ahead of you* in making decisions. And what is ahead is becoming more and more clear with each passing day; increasing vaccination numbers, a system-wide reopening of the economy, a patient Federal Reserve, and a federal government determined to add stimulus to all areas of the economy. So, if that is the factual backdrop, it becomes important to also examine the

emotional backdrop as it relates to past periods of investment fervor that led to stock market bubbles.

Historically a bubble has been defined by one primary emotion, one most easily expressed as FOMO. The *fear of missing out* clouds all rationality, and leads to speculative behavior on the part of investors. “Everybody is making more money than I am” is a common feeling in bubble zones, and the pile-on effect of television commercials and internet ads promising sky-high returns only adds to the toxic mix. Past behaviors I have personally witnessed include: dentists making their back patient room an office for day trading between appointments, hourly paid workers taking out home equity loans to buy dot.com stocks, and six figure redemptions of diversified stock portfolios to fix and flip houses at the height of the real estate boom in 2006. Across the financial system, other notable historic signs of past bubbles building have been an increased amount of leverage (borrowing to buy), savings and money market balances plunging as people invest near the top, and bond fund flows swinging from money pouring in to money pouring out, with the opposite occurring in stock funds. In other words, the short-term emotion of greed swamps all rational decision making.

This has occurred three times in the last century: 1929, 1968, and 1999…four times if you move beyond the stock market to include the real estate bubble in 2006. Given that history, and the consistent behaviors around those historic bubbles, we should take stock of where we are today, and compare. All of the dentists I know are too busy working hard to get back to normal business run rates to be day trading. Loan balances, whether they be on home equity lines or credit cards, have declined in the last year, plus the minimum payment has dropped in the current interest rate environment. As for real estate, there is no doubt that market is hot nationally, but the financing for those that are borrowing is a far cry from the mortgage mania in 2006. According to Ellie Mae, only four percent of mortgages issued in the last three years are adjustable rate. This means that a generation of home buyers are locking in long-term mortgages at extremely low interest rates, which is a far more stable housing situation for whenever the next recession arrives.

Another counter-bubble trends is that savings rates are at all-time highs. Statsita.com reports that the national savings rate moved above 20% in the month of January, and CNBC declares that money market balances have swelled an additional $2.5 trillion since March of last year. And, as for money flowing into and out of investments, according to Morningstar, for the twelve months ending in January, flows <u>out</u> of stock funds hit $255 billion. Over the same period of time, flows <u>into</u> bond funds were $536 billion. *And the stock market is the bubble?* I don’t see it…

Add into this current scenario that interest rates are at zero, and the Fed is committed to leaving them there for the foreseeable future, which makes bonds and CDs far less appealing, and owning the great companies of America and the world much more so. And, in addition to the average American consumer’s balance sheet being in the best shape over the last 40 years, banks are also flush with reserves, and JP Morgan estimates the cash reserves of corporations in the U.S. to be over $3 trillion. It remains my belief that we are in a secular bull market that began in 2012, and has several more years to run. If anything, the Covid freezing of the economy, and the emotional, investor driven reaction that drove the Dow Jones down below 20,000 only added a year or two to the duration of this secular trend.

This does not mean that there won’t be normal routine price corrections. In fact, based on the huge move in the last year in anticipation of the “great reopening” – the overall market is due for a breather. And, in what is a normal evolution, the leadership of the market will rotate from companies that led the market higher in last year’s work, shop, and school from home environment to those that will benefit from a return to normal life. This rotation could happen in an orderly manner, or there could be periodic bouts of price drops as this occurs. But do not fall prey to the siren song of the media that this is some bubble bursting – it is merely a function of returning to a much more normal economy (and market.) Remember that the stock market cannot be consistently timed any more than the economy can be accurately forecasted. After a year of waiting, the return to normal is coming, and the market is merely reflecting that future…

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