Bull Market Investing

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To be good long term investor, you need courage and you need brains. However, you need them in different quantities at different times. In the depths of a bear market, you mostly need courage since it's almost a "no-brainer" that the economy will recover and will lift financial assets with it. In a bull market, its mostly about brains since, while people are less haunted by economic fears, valuations are higher, increasing the need to be more discriminating in both asset allocation and security selection.

Over the course of the last year, we have been transitioning, both by the numbers and psychologically, from a bear market to a bull market. Economic worries have faded. However, in their place there is an anxiety about stretched valuations and a concern about "missing the boat". Overall, we continue to see investment opportunities. However, it is a narrower set of opportunities than existed nine months ago, making it more important that investors are disciplined going forward.

Fading Worries and Rising Sentiment

Economic data have recently been very reassuring, with CPI inflation falling to 3.0% year-over-year in June, a strong 2.4% annualized gain in real GDP in the second quarter and a solid, although not too exuberant, monthly jobs report for July.

This week, the focus will be on inflation. Following 12 straight months of declines, we believe headline year-over-year CPI inflation rose to 3.3% in July from 3.0% in June, largely reflecting higher gasoline prices. However, core CPI inflation likely continued to moderate, reflecting lower new and used car prices and a decline in housing inflation. A slow global economy, as revealed in last week's composite PMI readings, suggests that goods inflation will ease in the months ahead. Overall, we expect CPI inflation to hover at close to 3% year-over-year for the rest of this year, before falling to close to 2% by the end of 2024. We also expect inflation, as calculated by the Fed's preferred measure, the personal consumption deflator, to fall to the Fed's 2% target by next summer.

With all of this, it looks increasingly likely that the U.S. economy will avoid entering recession in 2023 and might avoid it in 2024 also. Moreover, while it remains a very close call as to whether the Fed will raise interest rates one more time in 2023, lower inflation suggests that the Fed will cut rates in 2024.

All of this has boosted consumer confidence, with the University of Michigan Consumer Sentiment Index registering a reading of 71.6 in July, well above its all-time low of 50.0 set in June of 2022. Moreover, as noted this month by the Director of the Survey, Joanne Hsu, while sentiment was uniformly low across all income levels last summer, sentiment has bounced much more strongly for households in the top third of the income distribution in recent months.

This is important for investing, since historically, very low consumer sentiment has been an excellent predictor of above-average stock market returns, as we show on **page 27** of the *Guide to the Markets*. As of this morning, the S&P500 is up more than 26% from its low of last October, is less than 6% below its all-time high set at the start of 2022, and sports a forward P/E ratio of 19.2 times compared to a 25-year average of 16.8.

In short, investor confidence is no longer dismal and broad valuations are no longer cheap. In this kind of market, courage is less vital and looking carefully at valuations becomes much more important.

A Closer Focus on Valuations

A good place to start is with U.S. equities. The overall market, at 19.2 times forward earnings isn't cheap. However, as has increasingly been the case in recent years, there is a huge difference between mega-cap stocks and everything else. In particular, as we show on **page 11** of the *Guide to the Markets,* while the top 10 stocks in the S&P500 are currently selling at a forward P/E ratio of 27.8 times, the rest of the stocks trade at a much more reasonable 18.0 times. Given the difficulty that mega-cap stocks should have in generating far above trend earnings growth in the long-run, a 50% premium in P/E ratios seems excessive.

An additional problem, of course, is that as their valuations have grown, so has their weight in the index. 10 years ago, the top 10 stocks accounted for 18.3% of the market cap of the S&P500 – today that number is 31.5%. Consequently, high valuations among mega-cap stocks pose a risk not just for those buying these individual stocks but for anyone passively investing in the index itself. A more active approach, that underweights the most obviously over-valued names. would seem to make more sense.

On the fixed income side, the first piece of good news is that, for the first time in a long-time, high-quality bonds are providing attractive yields. Both 10-year TIP yields, at over 1.6% and 10-year nominal Treasury yields, at over 4%, are among the highest seen since the Great Financial Crisis. This provides investors with a reasonable income, for as long as the Federal Reserve maintains a restrictive monetary policy and the potential for a nice capital gain when, inevitably, the economy stumbles and the Fed moves back to a more neutral policy.

While this is an argument for investing in high-quality, long-duration fixed income, the story is more complicated when it comes to high yield. High-yield spreads, at roughly 4.3% over Treasuries, are well below their average of 5.7% seen since 1990. Admittedly, default rates, at 2.3% are also well below their long-term average. However, recovery rates for defaulted bonds are very low and, if and when the economy enters recession, defaults could see a significant surge.

After leading their U.S. counterparts in 2022, international equities are lagging so far this year. The outperformance in 2022 had a lot to do with a late-year tumble in the U.S. dollar. However, having fallen roughly 10% between September 2022 and February 2023, the U.S. dollar has moved sideways since then.

That being said, it appears that inflation will be stickier in other developed countries than in the U.S. and that Europe, the U.K. and Japan should see less monetary easing in 2024 than will be provided by the Fed. This should lead to a resumption of the dollar decline.

Meanwhile, while China continues to face problems, the Indian economy is booming. In broad terms, economic prospects look at least as bright overseas as in the U.S.. It is also notable that that non-U.S. stocks are selling at a close to a record valuation discount to the U.S. with the ACWI-ex U.S. index trading at a forward P/E of 12.9 times compared to 19.2 times in the U.S..

With more than double the dividend yield of U.S. stocks, international stocks can generate significant income in the short run with the potential for a sizable capital gain with a closing of a relative valuation gap, a further fall in the dollar, or both.

Higher valuations among publicly-traded U.S. equities also increase the attractiveness of alternative investments. As we show on **page 58** of the *Guide to the Markets*, adding a sleeve of alternatives to a portfolio can generally provide a better risk/return profile while also generating significant income for a portfolio.

Finally, even with higher valuations, long-term investors should resist the urge to hide out in cash. Cash is, of course, looking attractive, with short-term yields of more than 5% available. However, as we show on **page 67** of the *Guide*, looking at every rate hiking cycle over the past 40 years, at the point of peak CD yields, there have always been better returns available elsewhere over the following 12 months.

This should also be the case today. At his post-FOMC press conference, two weeks ago, Fed Chairman Jerome Powell noted that, when the Fed sees a credible and sustainable decline in inflation towards its 2% target, it can bring the federal funds rate down to a "neutral level". According to the Fed's summary of economic projections, that neutral level is 2.5% in the long run, less than half of

today's rate, and, while we don't expect rates to fall quickly to that level, we do expect to see significant rate cuts in 2024 and beyond.

We feel confident that the next year *will* see a continued reduction in inflation. We are less confident that this can be achieved without a recession or a market correction. All long-term asset classes should eventually benefit from easier monetary policy. However, with broad equity-market valuations now elevated, it is more important than ever that investors be active, selective and diversified as they build portfolios designed to meet the challenges of a bull rather than bear market.

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