Market Perspective
December 2020

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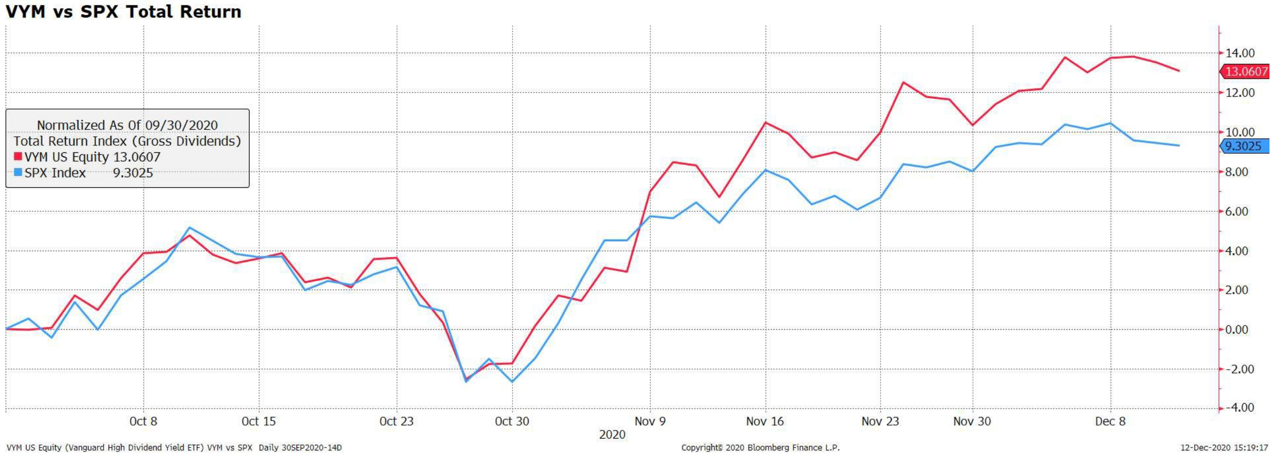
This has been a challenging year, both for life and for investing. There are many issues associated with the current investment environment to discuss, but before I get to my main observations for this Market Perspective, I would like to reflect on last quarter's analysis. Specifically, I would like to look at the three investment observations I made on October 1st. First, I indicated that everything with "yield" would do well, owing to the extraordinarily low rates induced by the Federal Reserve. As an example, I highlighted an ETF of dividend-paying companies ("VYM") sponsored by Vanguard. Here is how it did since the end of last quarter, in comparison to the S&P 500.

VYM vs SPX Total Return

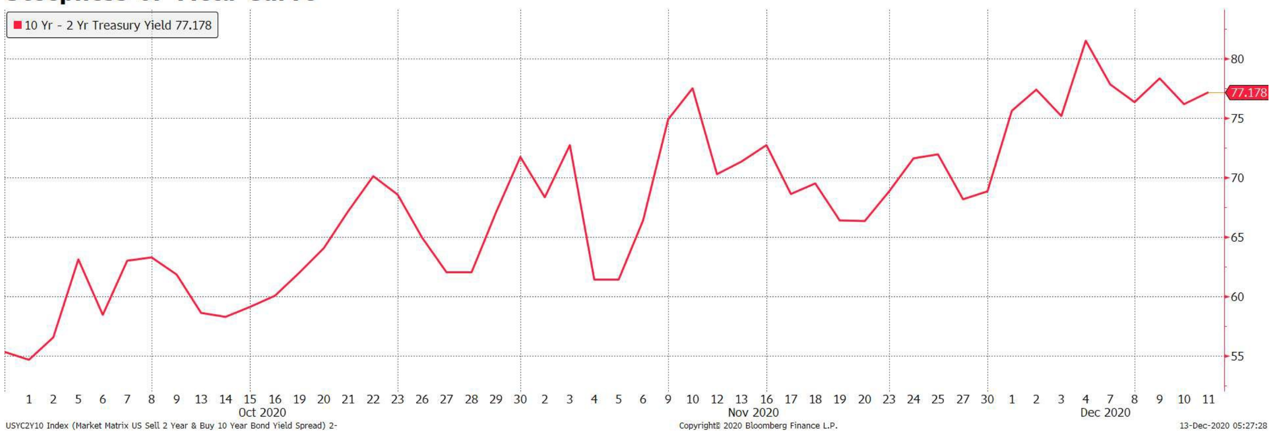


Second, I indicated that I would favor investments with a larger margin of safety (value stocks, as an example), over those with higher multiples. I used the Russell 3000 Growth and Value to measure this. Here are how those two indexes did since the end of the quarter. (I acknowledge there is some correlation to the above observation):

Value vs. Growth

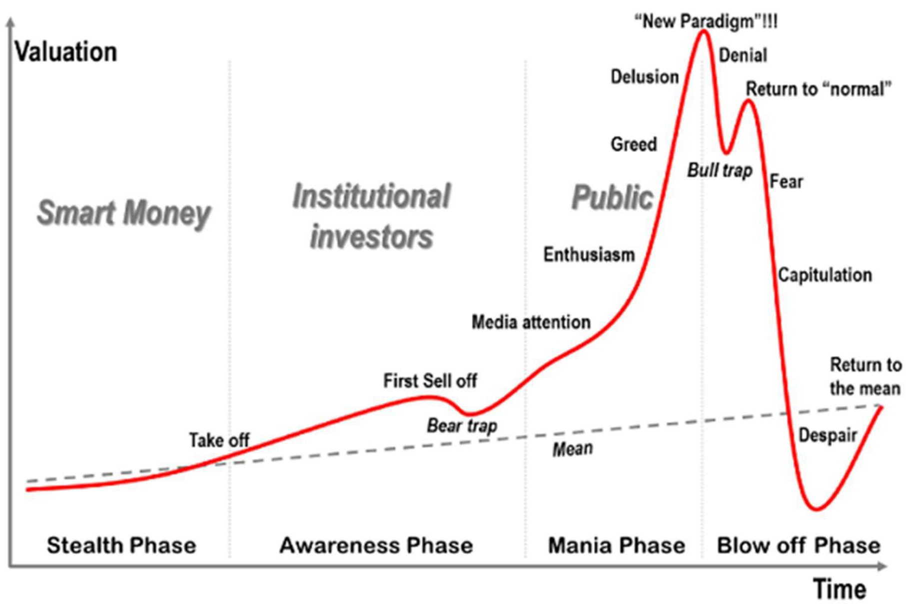
Finally, I suggested that low duration fixed income would outperform strategies with higher duration. In other words, the yield curve would steepen throughout the quarter. Here is how the spread between 10-Year Treasuries and 2-Year Treasuries performed:

Steepness of Yield Curve



For the record, I suspect that all three of these trends will continue for some time. This quarter, my observations are more macro and are directed to the overall compensation available for taking risk.

Many strategists have long used a conceptual model to depict where we are in a market cycle. Shown below, this model tracks the valuation of the "market" ("Y-Axis") against the milestones and emotions of investors over time ("X-Axis"). The confounding aspect of this model is that it is nearly impossible to know which phase we are in at any point. Further complicating matters, it is likewise impossible to calibrate time along the X-Axis. Sometimes phases are short; others last long. However, we do have tools to assess where we are on the Y-Axis of valuation. I will devote this quarter's Market Perspective to pursuing the elusive goal of placing us in a general location within the model. My thesis is that we are currently entering the "Delusion" stage of the "Mania" Phase.



The most popular measure of market valuation is the Price/Earnings ratio on the S&P 500. The specific measure that I am using is Bloomberg's the current value of the index divided by the consensus analyst estimate of the next four quarters' earnings. Using this metric, we can clearly see that the market's valuation is the same as it was at the height of the dot-com boom.

S&P 500 Price/Earnings

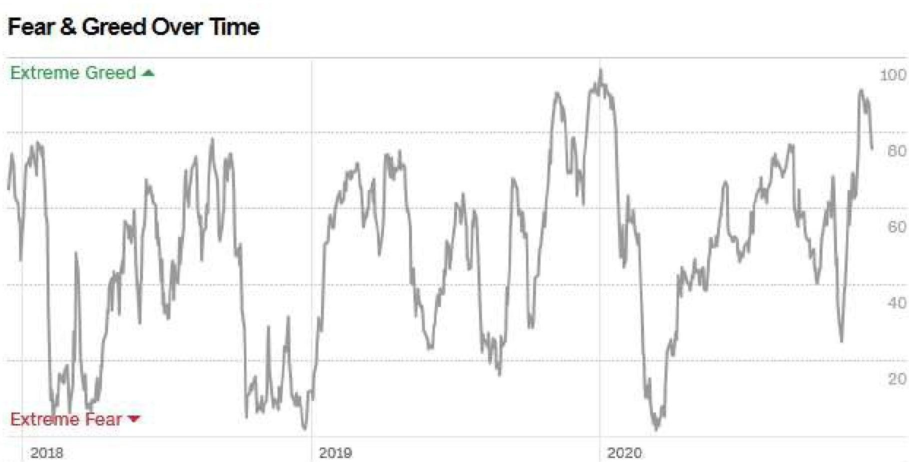
Critics of drawing a conclusion from this chart include those who indicate the coming four quarters' earnings will be depressed, due to the economic effects of COVID-19, so the market is necessarily looking past the coming year to when a full recovery takes place. Other critics include those who say the current valuation is skewed high, due to the very high valuations of a handful of large cap tech stocks that have persistently higher growth rates than historical market comparisons. Finally, there are those who argue today's P/Es should be higher than history because today's interest rate levels are so low.

We have an analytical method to deal with the first of these objections. Shown below is a graph that depicts the P/E Ratio, over time, based on three different denominators. The top line (orange) uses expected this year's earnings. The second (blue) line is the consensus of next year's earnings, while the third (green) line is the consensus of earnings two years from now. No matter which year of expected earnings we use, the ratio is in elevated territory. So, even if earnings return to "normal" by 2022, we are paying more for those earnings today than at any time in the last 15 years.

To those who may justify an elevated multiple of 2022 earnings based on today's low interest rates, I would wonder out loud whether it is reasonable to expect (long-term) interest rates to still be this low in 2022.

Let's turn to other measures of market health. CNN publishes a "Fear/Greed" Index, updated weekly. Calibrated to seven underlying measures of market sentiment, this index attempts to measure the emotions of the "market". These measures include stock price strength, stock price breadth, CBOE Put/Call Ratio, market momentum, junk bond demand, market volatility and safe haven demand. Here is where we stand now:

It is instructive to see how this gauge behaves over time:



Note how it accurately captured the extraordinary fearful sentiment (and consequent market lows) of both December 2018 and March 2020. Those would have been times to increase portfolio risk. What should be the implication of today's opposite readings?

Looking at broad measures of the market is one way to analyze the degree to which investors are embracing risk. However, I think it would be useful to look at an individual large-cap, high quality company to see the extent of the euphoria over potential growth. Walt Disney Co. ("DIS") is a broadly diversified entertainment company. There is no question that they are doing a great job of diversifying into streaming services. While the impact of that diversification on Disney's future profitability is uncertain, the market has embraced it as a game-changer. Consider the performance of Disney's stock, vs the S&P 500 since the March 2020 lows. Note how they tracked very closely until November. Then, the exuberance of the market for all things digital propelled Disney upward, with straight-up vertical movement after Disney's Investor Day on December 10 where Disney unveiled its ramped up digital focus. The stock is now up over 100% since March, in comparison with 64% for the S&P 500.

Okay, perhaps this move is justified by a jump in expectations for future earnings. Unfortunately, a quick survey of analysts does not support that thesis.

While this graph is a little busy, it provides a great deal of insight. The white line is Disney's stock price over the last five years (read on the left Y-Axis). The three colored lines (read on the right Y-Axis) are the consensus analyst estimates, over time, for 2021 (blue), 2022 (red) and 2023 (green). Note that each of these estimates has trended down over time. Analysts start out very optimistic and then adjust their estimates down as time passes and more information is available. Note, too, that there is no increase to estimates in the recent months owing to the streaming diversification. Perhaps that has yet to show up in the numbers, but consider how much of an increase would be required to justify the stratospheric rise in the stock price of the last two months.

The credit market is also flashing warning signs. Typically, investors require a premium promised yield on bonds from higher risk companies. This is because default rates from these companies are higher than safer ones. Today, the "spread" over Treasuries offered by below-investment grade firms is at back to the all-time low reached just before the recognition of the pandemic in February. In their quest for yield, investors have bid up prices and are accepting lower promised yields. This seems optimistic when we know that many leveraged businesses are struggling.

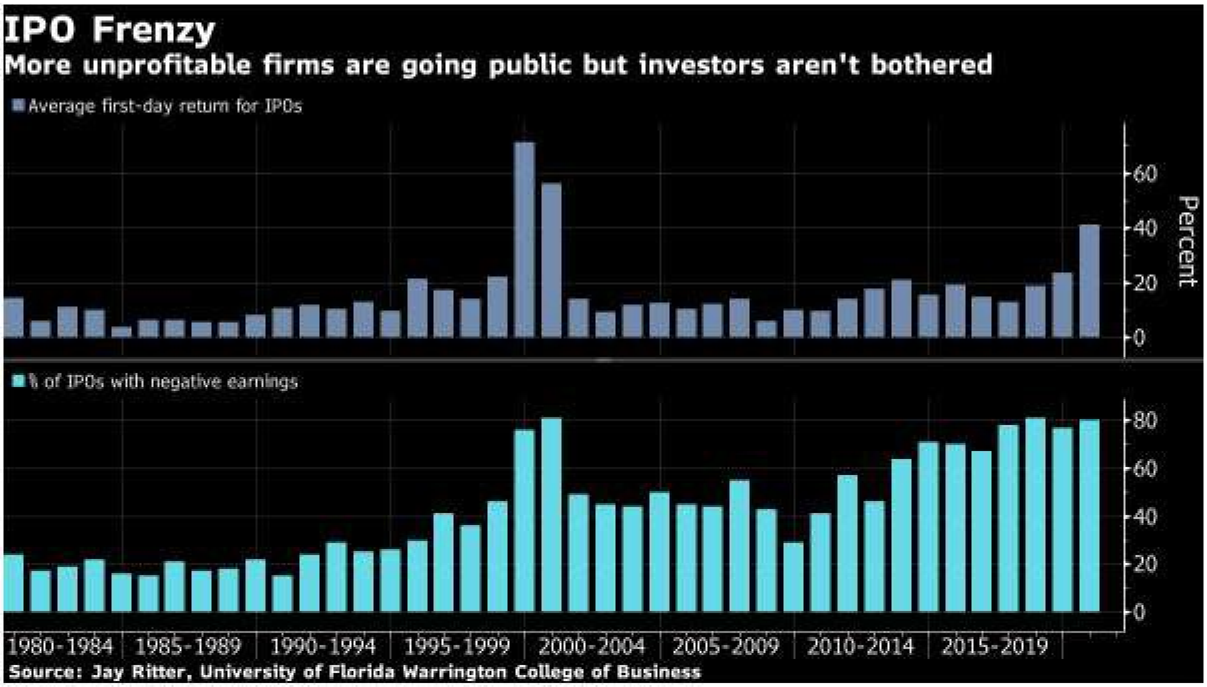
High Yield Spreads

So far, I have focused mainly on established markets. However, nowhere is there more speculation today than in the new-issue, or IPO, market. Let's look at a few data points:

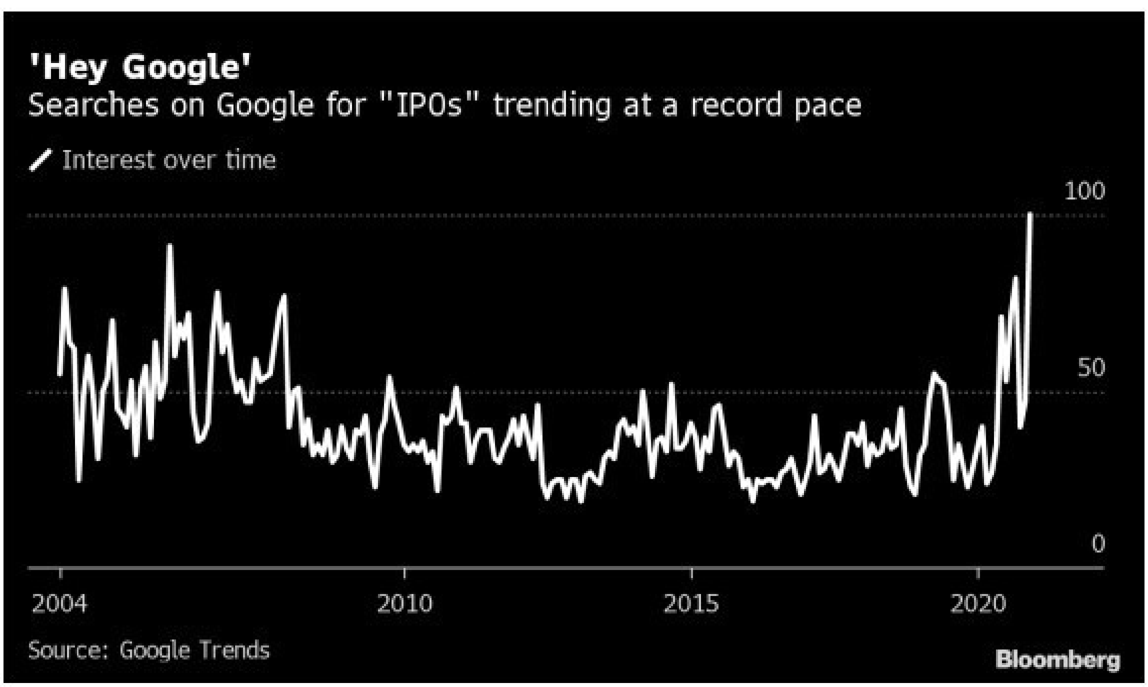
1. According to data from Bloomberg, in the last week, three IPOs had their prices roughly double the aggressive values set by the underwriters. While it is always the aspiration of companies and underwriters for a first day "pop," clearly they underestimated the demand for these shares of perceived high growth companies.
    a. Doordash ("DASH"), a food delivery service, surged 86% above its offering price. At week's close, it traded at 12x estimated next year's sales (and 550x estimated earnings).
    b. Airbnb ("ABNB"), a home rental company, more than doubled, to achieve a market capitalization of $100 billion. It closed the week at 10x next year's estimated sales (expected earnings are negative).
    c. Software firm C3.ai Inc rose 120%. Its market capitalization closed the week at "only" $11.7 billion. However, next year's revenues are only estimated at $121 million, putting the company's Price/Sales (next year) ratio at 97x. (earnings estimates are not yet available).

In the aftermath of these IPOs, underwriters and companies are asking themselves whether they are leaving too much on the table (i.e., whether the IPO price should be even higher). Indeed, over the weekend, two prospective IPOs (Roblox and Affirm) were shelved until next year, so that they could get a better handle on the extent of public market demand.

2. According to Professor Jay Ritter, from the University of Florida, whose research on IPO performance stretches back decades, in 2020, 80% of companies that went public were unprofitable in the 12 months prior to their IPO. That is more than any time in the last four decades, other than 2000 and 2019. At the same time, the first day returns from investing in them is also going up:



3. A classic data point, the number of Google searches for an item (in this case, “IPOs”), has soared, indicating heightened “mom and pop” interest in these speculative offerings:



4. Within the IPO category, Special Purpose Acquisition Companies (“SPACs”), also known as Blank-Check companies, have been all the rage in 2020. According to the *Financial Times*, there have been a record 182 SPAC IPOs that have raised $70 billion this year. A Stanford Law and Economics Paper last month (“A Sober Look at SPACs”) estimates that fees and expenses (including the sponsor’s “promote”) consume one-third of the capital raised for SPACs that successfully close an acquisition. No wonder the average return in the 12 months following an acquisition are -34.9%, according to the authors. Nonetheless, the optics-oriented opportunity to invest alongside “star” investors continues to fuel investor interest in this structure.

In this Market Perspective, I have looked at:

- broad equity market valuation
- an example of the extraordinary valuation increase of an established large cap stock due to the perception of it becoming a digital behemoth many years in the future
- a composite of market sentiment measures
- the low levels of compensation required by investors in risky credits, and
- the speculative nature of the current market for Initial Public Offerings

These apparent indicators of speculation lead me to believe that we are closer to the top than the bottom of the conceptual market cycle model that I introduced at the beginning of this piece. Of course, no one can forecast with certainty how long the current phase will last. The combination of today’s low interest rates and the flood of cash that has been generated by unprecedented monetary easing certainly continue to provide fuel for the rise of risky assets.

However, if the model is a guide, a regression to the mean of valuation in risky assets seems likely somewhere on the horizon.

With best wishes for a healthy, happy, and prosperous year-end.