CAPACUITY

Market Perspective
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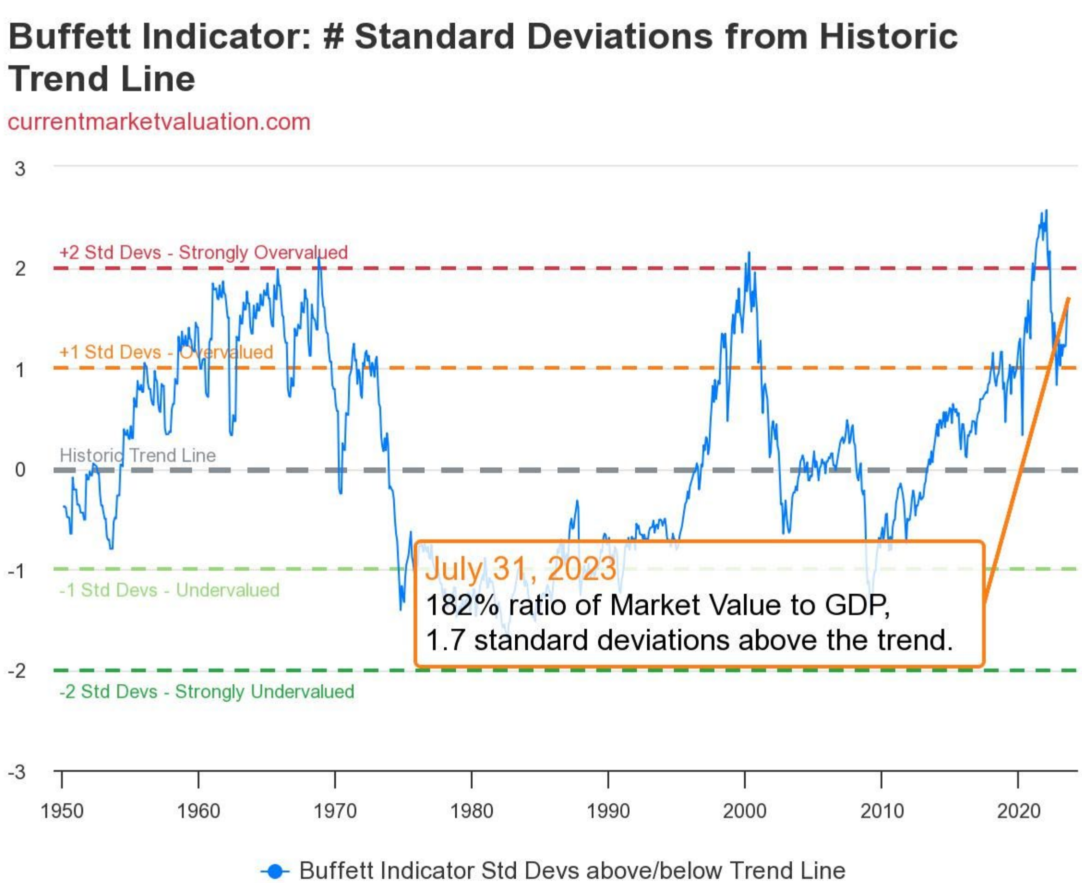
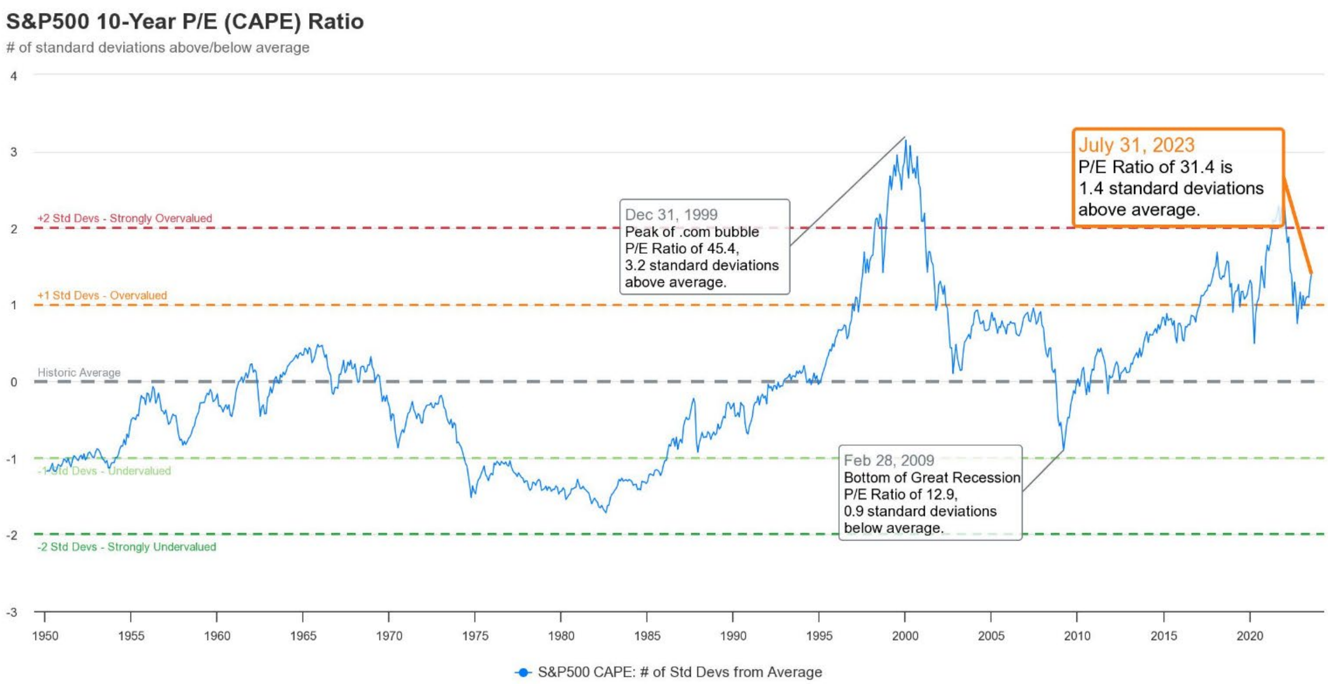
The bull market of 2023 is impressive. Through August 4th, the S&P 500 has posted a total return of 17.7% this year. The NASDAQ 100 has returned 40.3% in the same period. Both indexes are close to their all-time highs, having recovered the bulk of last year's drawdown. Note that these returns have been earned as corporate earnings are largely flat to last year. The question that investors must ask themselves today is whether this upward momentum represents a new paradigm in the market or whether valuations will, once again, undergo a regression to the mean.

I've often written about the "Buffet Indicator" of stock market valuation. Calculated as Market Cap of US Market / GDP, it shows the current valuation accorded to our collective economic output. This is an interesting metric to track during three recent periods: the pandemic run-up in stock prices (2020 - 2021), the subsequent decline (2022) and current market resurgence (2023).

Shown below is a chart of this measure since 1950, annotated with bands showing the market's valuation one and two standard deviations away from the long-term trend. What struck me about this perspective is that while the 2022 decline did take some of the froth out of the market, the nadir valuation remained one standard deviation above the long-term historical trend line (i.e., still expensive). All that has happened in 2023 is to increase the market's valuation into already stretched levels. As shown, we are now back to 1.7 standard deviations above the trend line. It is even more noteworthy that this rise in valuation was coincident with rising interest rates that usually portend equity valuation decreases.



The other academically lauded market valuation method is the Cyclically Adjusted P/E Ratio ("CAPE Ratio" or "Shiller Ratio", after its creator.) This measure smooths and inflation-adjusts earnings over a 10-year period. Here, we are back to a valuation of 1.4 standard deviations above average.



There are many reasons to believe the U.S. will now escape anything more severe than a mild recession. There are also many reasons to believe that corporate earnings may be more challenged going forward than is priced into current valuations. While valuation is never a short/mid-term timing indicator, it has often proved to be (inversely) predictive of long-term returns.

Notwithstanding the 2022 decline, asset price valuation never touched the historic trend line. The gains in 2023 have pushed valuations even further from that level. While it is impossible to predict any short-term direction of these indicators, the natural weight of "regression-to-the-mean" suggests that equity valuation won't always retain these lofty levels.