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Ground Control to Major Tom

US unemployment is the lowest it's been in five decades, consumer credit is at its strongest levels since the early 2000's and the S&P 500 has recently been flirting with all-time highs. Yet, economy sensitive stocks like autos, homebuilders and banks remain significantly below their 2018 peaks. If investor expectations for major beneficiaries of economic growth appear to be floundering, how does this correlate with what appears to be a strong US economy?

Growing contradictions in market and economic data have required some head scratching as of late. While we are wary of placing too much weight on our macroeconomic insights, we're happy to have some company in the apparent confusion. To paraphrase a recent interview with Warren Buffett:

10 years ago, I couldn't have conceived of a world where there was full employment, 5% fiscal deficits, low inflation and the long bond at 3%. The convergence of these factors in a stable situation seems impossible. Generally, if something feels impossible, it will change. It looks like we've achieved nirvana: money doesn't cost anything; you can print money and have low inflation. If you believe that 3% on the 30 year bond will prevail over the next 30 years, stocks are incredibly cheap.

When outcomes seem unknowable and uncertain, refocusing on what is knowable and important is a useful grounding mechanism:

Investor risk-taking is readily apparent but asymmetrically distributed: Most evident are the bitcoin bubble, the cannabis mania and recent multi-billion dollar IPO's of loss-making silicon valley unicorns.

Asset prices are high, but not uniformly so: The S&P 500 is expensive vs long-term averages on numerous metrics. The highest valued decile of US stocks trade at over 80x earnings relative to an average closer to 40x since 1950, while the cheapest decile trades closer to long-term averages of 10x. [1]

Interest rates are flashing hazard signs: There is now more than $11 trillion of negative-yielding global debt. The US yield curve (10 year treasury yield less the 3 month treasury bill yield) has been toying with inversion. Nearly all major developed countries' 10 year bonds yield less than US treasury bills. The US 2 year bond yield has fallen below 3 month treasury bill yields, signalling an expectation that the Fed will have to cut interest rates.

The business cycle is extended: For example, US corporate debt has approached all-time highs at greater than 45% of GDP, while credit ratings have meaningfully deteriorated. This elevates risk and reduces companies' ability to fund future growth. Consumer confidence is also quite high. Historically, this condition has coincided with maturing cycles.

Corporate earnings growth expectations and market return prospects look diminished: Share repurchases and a lower US corporate tax rate have propelled what would have otherwise been unimpressive earnings growth in recent years. Among the biggest drivers of future stock returns are profit margins, which are near historical highs, and interest rates, which determine equities' relative attractiveness and are near historical lows. If these factors persist, index returns may continue to be reasonable. If rates start to rise or margins fall, return expectations would deteriorate quickly.

Despite conflicting data, the relevant indicators firmly suggest we are in the latter stages of what has been an unusual, elongated economic and market cycle. The timing and probability of what follows remains unknown. As JP Morgan CEO Jamie Dimon pointed out on the company's first quarter conference call, the cycle "could go on for years. There's no law that says it has to stop".

The prescription for such uncertainty remains consistent. Own good businesses and manage risk of loss. Recessions and long-tail shocks can and do happen - estimates of earnings power (and thus valuation) should be cyclically adjusted to account for this. Amidst latent risk, there is hidden value in stable, sustainable earnings streams and strong balance sheets - preference these. Remaining firmly tethered to core tenets of one's investment process is critical, as is being open to the potential implications of structural changes intersecting with cyclical forces.

1. Bernstein Research