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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

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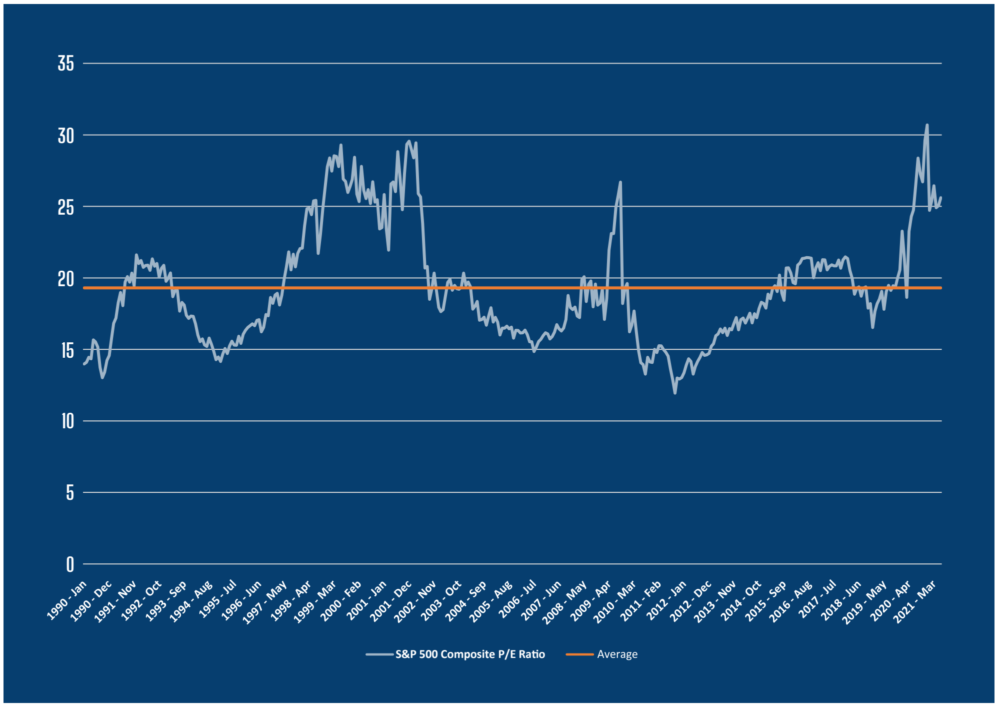
The Problem with Valuations

In recent trading sessions, the S&P 500 set a series of new record high closing levels, real 10-year Treasury yields flirted with record lows and credit spreads remain at some of the tightest levels on record. This has led a number of very smart and respected research professionals to further decrease their prospective forward returns for the intermediate and longer term (five to 10 years) across a broad swath of traditional asset classes. Most of these forecasts are based on traditional, absolute measures of valuations such as the price/earnings ratio. We are firm believers in the concept of "price matters," that what you pay for an asset is a large determinant of future performance. Very simply, when an investor purchases equities at lofty valuations, forward returns historically have tended to be lower and vice versa. However, using these metrics would have had investors leery of equities for much of the last five years.

A quick glance shows that absolute valuations across a variety of asset classes indicate they are expensive. That should be no surprise as bond yields remain near historic lows and equities have performed very well in the decade plus, following the Global Financial Crisis and the strong rebound from last March's swift and severe bear market. Exhibit 1 shows a chart of the price/earnings (PE) ratio for the S&P 500 since 1990. It recently measured 27 times earnings vs. an average of 19 over that span and has been above that average for more than a year. We tend to look at a more comprehensive indicator that combines the PE ratio with other metrics (price/cash flow, price/book value, price/sales), and it shows a very similar pattern across all sizes and styles of equities, with readings well above historical averages.

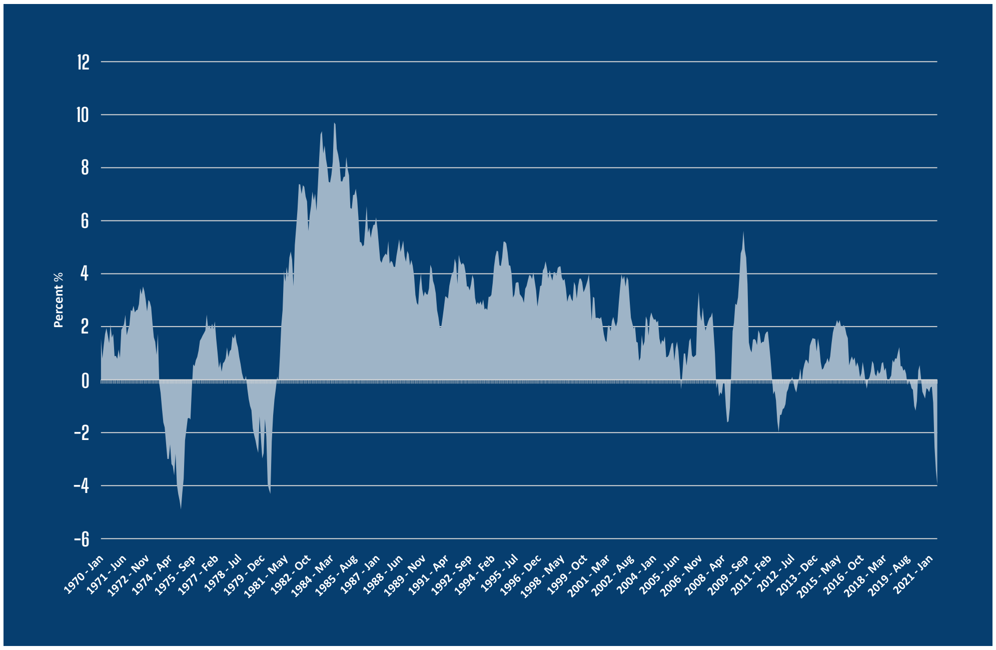
Exhibit 1. S&P 500 Composite Price/Earnings Ratio
1990 - Present



Source: Haver

Valuations in the fixed-income markets are even more extreme as a result of more than a decade of extraordinary monetary policy in the form of a negative real (inflation-adjusted) Fed funds rate and quantitative easing. And the recent increase in inflation has pushed real yields (basis the 10-year Treasury) into territory not visited since the 1970s era of double-digit inflation (Exhibit 2).

Exhibit 2. Real 10-Year Treasury Yield 10-Year Treasury less YOY CPI
1970 to Present

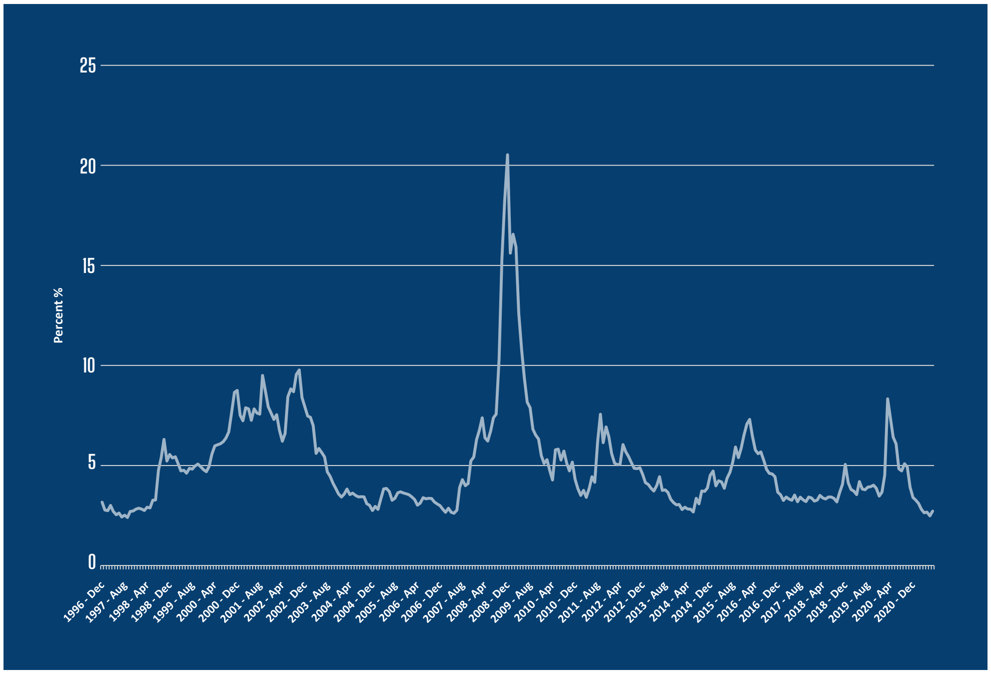


Source: Haver

Within the credit markets, risk premiums remain very narrow because of strong stocks, abundant liquidity and better earnings. High-yield bonds in particular stand out (Exhibit 3), with junk bond yields recently touching record low levels, and trading below the level of inflation.

Exhibit 3. High Yield Spreads ICE/Bank of America/Merrill Lynch HY Master II less 10-Year Treasury

1996 To Present



Source: Haver

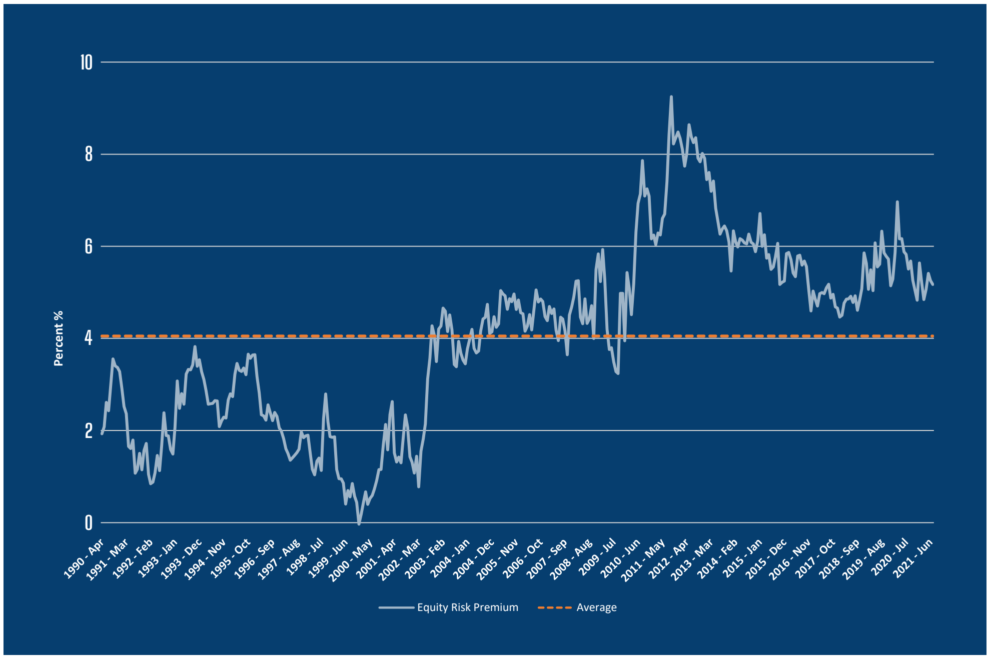
While many investors look at charts like these and are tempted to position cash and equivalents, that also adds significant risk, albeit of a different kind. With inflation (as measured by CPI) running above 5% and cash yields at or near 0%, cash is not viable for any extended period of time.

What should an investor do in this environment? First, one should analyze goals, risk tolerance and time horizon. While none of us like periods of extreme volatility and/or weakness, investors with longer time horizons (retirement, education, legacy investing) always need to remember that to capture the returns of riskier assets (such as equities), one must accept these periods of discomfort. Additionally, think like an allocator as opposed to a market timer. An allocator desires to stay fully invested, using valuation work to weight assets consistent with investment policies and desired asset allocation. For example, while one might have a 60% target for equities, typically there is an acceptable band around that target (i.e., +/- 5%) and valuations can help shape the timing of the decision to rebalance within that band.

In terms of current asset allocation decisions, investors are faced with the markets at or near alltime highs across most asset classes, as outlined earlier. From a strategic asset allocation perspective, we would continue to advise clients to hold at least up to target weight in equities. While absolute valuations of equities remain high, relative to fixed income, they look attractive. Stocks offer the opportunity for positive real returns, dividend yields look attractive relative to fixed-income benchmarks, the earnings yield of equities (the inverse of the PE ratio) is significantly higher than benchmark bond yields, and the equity risk premium* is above its long-term average (Exhibit 4). While the Fed pursues polices of financial repression, equities will offer investors the highest odds of achieving their investment goals.

In closing, our guidance would be little changed. A diversified, panoramic portfolio, with a long-term orientation that has exposure various equity factors (such as the value and size factors) and moderate inflation should be a tailwind for corporate earnings. Bond buying programs, 0% Fed policy and rhetoric have conspired to keep a lid on bond yields and will likely do so until those conditions change.

Exhibit 4. Equity Risk Premium Forecasted Real 10-Year Bond Yield Less S&P 500 Earnings Yield

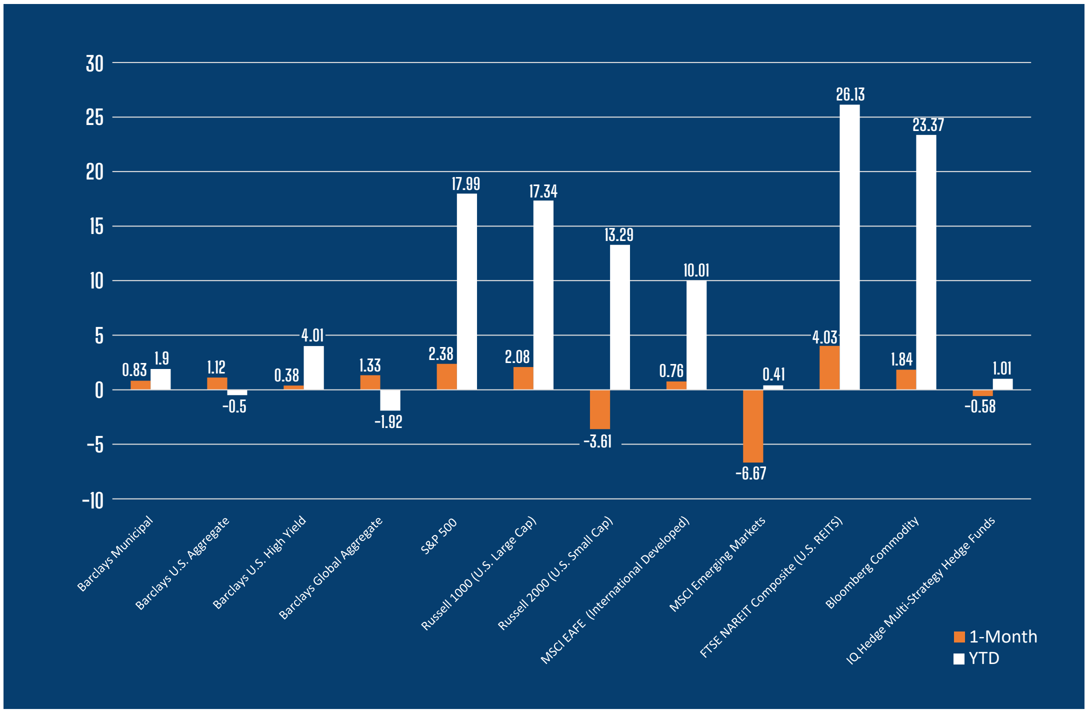


Source: Haver, Benjamin F. Edwards calculations

**Equity risk premium is calculated by subtracting the earnings yield of the S&P 500 from the real forecasted 10-year Treasury yield. The earnings yield is the inverse of the PE ratio while the forecasted real 10-year Treasury subtracts the University of Michigan expected inflation rate, next 5 years, from the current 10-year Treasury.*

Asset Class Returns

Comparing Recent Month and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- Treasury/sovereign debt yields fell sharply in July leading to solid gains in core fixed income and municipal bonds.
- Credit spreads were fairly flat in July leading to mixed gains in credit.
- Currency was a slight tailwind for developed assets and a headwind for EM assets.

Equities

- U.S. equities posted mixed performance in July with gains in large caps and weakness in small caps.
- Within large caps, growth trounced value, but small caps saw little dispersion between styles.
- Higher quality stocks outperformed lower quality ones with cyclicals being the worst performing sectors.
- Non-U.S. developed equities lagged their U.S. counterparts last month with the weaker USD being a slight tailwind.
- Similar to the U.S., growth beat value, but unlike the U.S., small caps outperformed large caps.
- EM equities were particularly weak in July, led by a near 14% decline in China. After starting the year on a positive note, EM equities are flat YTD.

Real Assets

- Real assets continue to perform well as inflation concerns persist.
- Strong REIT performance was led by the residential sector, which benefited from increasing rental prices while lodging and resorts were hurt by the surge in the Delta variant.

July 30, 2021	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.00%	0.00%	0.02%	0.06%	1.22%	1.10%	0.58%
Barclays Municipal	0.83%	0.83%	1.90%	3.29%	5.31%	3.41%	4.27%
BBgBarc US Govt/Credit Intermediate	0.17%	0.17%	0.17%	0.43%	2.99%	1.91%	1.48%
Barclays U.S. Aggregate	1.12%	1.12%	-0.50%	-0.70%	5.73%	3.13%	3.35%
Barclays U.S. High Yield	0.38%	0.38%	4.01%	10.62%	7.19%	6.99%	6.58%
S&P/LSTA Leveraged Loan	0.01%	0.00%	3.28%	9.49%	4.13%	4.69%	4.38%
Barclays Global Aggregate	1.33%	1.33%	-1.92%	0.78%	4.74%	2.46%	1.98%
JPM GBI EM Global Diversified	-0.43%	-0.43%	-3.79%	3.00%	3.32%	3.03%	0.29%
U.S. Equity Indices							
DJ Industrial Average	1.34%	1.34%	15.31%	34.79%	13.72%	16.30%	13.88%
S&P 500	2.38%	2.38%	17.99%	36.45%	18.16%	17.35%	15.35%
NASDAQ Composite (Price)	1.16%	1.16%	13.85%	36.55%	24.13%	23.24%	18.20%
Russell 1000	2.08%	2.08%	17.34%	37.97%	18.63%	17.60%	15.39%
Russell 1000 Growth	3.30%	3.30%	16.71%	36.68%	25.29%	23.32%	18.37%
Russell 1000 Value	0.80%	0.80%	17.98%	39.32%	11.27%	11.41%	12.08%
Russell Mid Cap	0.77%	0.77%	17.14%	42.58%	15.79%	14.77%	13.74%
Russell 2500	-1.75%	-1.75%	14.92%	49.09%	13.83%	14.76%	13.10%
Russell 2000	-3.61%	-3.61%	13.29%	51.97%	11.49%	14.28%	12.34%
Russell 2000 Growth	-3.64%	-3.64%	5.01%	41.00%	13.87%	16.40%	13.56%
Russell 2000 Value	-3.58%	-3.58%	22.16%	63.70%	8.30%	11.61%	10.82%
Non-U.S. Equity Indices							
MSCI World	1.82%	1.82%	15.38%	35.67%	15.09%	14.90%	11.66%
MSCI ACWI	0.72%	0.72%	13.37%	33.75%	14.27%	14.39%	10.74%
MSCI ACWI Ex-U.S.	-1.62%	-1.62%	7.67%	28.30%	8.41%	10.15%	5.90%
MSCI EAFE	0.76%	0.76%	10.01%	30.86%	8.16%	9.87%	6.63%
MSCI EAFE Growth	1.72%	1.72%	8.92%	27.90%	12.72%	12.20%	8.41%
MSCI EAFE Value	-0.23%	-0.23%	10.85%	33.62%	3.31%	7.27%	4.69%
MSCI Europe	1.86%	1.86%	14.37%	33.18%	8.75%	10.48%	6.76%
MSCI Japan	-1.26%	-1.26%	0.17%	25.66%	7.03%	8.92%	6.96%
MSCI AC Asia	-5.33%	-5.33%	-0.90%	21.63%	8.47%	10.69%	6.73%
MSCI EAFE Small Cap	1.71%	1.71%	11.17%	39.21%	9.18%	11.48%	9.05%
MSCI ACWI Ex-U.S. Small Cap	0.82%	0.82%	13.40%	41.66%	10.23%	11.35%	7.49%
MSCI Emerging Markets	-6.67%	-6.67%	0.41%	21.00%	8.31%	10.77%	3.97%
MSCI EM Asia	-8.05%	-8.05%	-2.41%	18.51%	10.01%	12.63%	6.40%
MSCI China	-13.81%	-13.81%	-12.19%	0.39%	6.05%	12.56%	6.42%
MSCI EM Eastern Europe	0.14%	0.14%	18.28%	34.04%	10.52%	14.17%	1.43%
MSCI EM Latin America	-4.05%	-4.05%	4.61%	25.64%	0.93%	4.24%	-2.22%
MSCI EM Small Cap	-1.27%	-1.27%	18.44%	48.42%	11.77%	11.01%	4.54%
MSCI Frontier Markets	-0.26%	-0.26%	14.89%	39.43%	7.74%	9.34%	5.92%
Hedge Fund Indices							
IQ Hedge Long/Short	1.48%	1.48%	6.30%	18.06%	8.34%	7.21%	--
IQ Hedge Multi-Strategy	-0.58%	-0.58%	1.01%	6.70%	4.13%	3.67%	3.50%
Real Assets Indices							
FTSE NAREIT Composite	4.03%	4.03%	26.13%	34.19%	12.71%	8.13%	10.44%
Alerian MLP	-6.31%	-6.31%	38.51%	59.29%	-4.52%	-2.44%	0.61%
Bloomberg Commodity	1.84%	1.84%	23.37%	40.28%	5.29%	3.86%	-4.54%
S&P Global Infrastructure	0.98%	0.98%	6.43%	20.73%	5.31%	5.83%	6.57%
Other							
Oil Price Brent Crude	1.60%	1.60%	47.36%	76.28%	0.93%	12.45%	-4.19%
CBOE Market Volitility (VIX)	15.22%	15.22%	-19.82%	-25.43%	12.44%	8.97%	-3.20%

Source: Morningstar

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