

[Featured Insights]

Equity Valuations Amid Changing Macro Environments

Interestingly, a robust economy can often be unfavorable for stocks, while a softer economy might boost equity prices. Specifically, when economic activity declines due to previous Federal Reserve tightening, the stock market tends to anticipate a reversal in policy. This anticipation of the Fed easing monetary policy leads to higher valuations. Given that price/earnings ratios and other valuation metrics are currently in the top decile, the pressing question is when these valuations will start to decline faster than earnings growth, potentially leading to a significant market correction.

At the stock level, this correction is already evident, as we see the weakest market breadth since 1965. In essence, most stocks are experiencing a decrease in valuations that outpaces their earnings growth. This makes stock picking increasingly challenging for equity investors trying to outperform the S&P 500. Although this environment offers opportunities for both long and short positions, identifying promising long positions is becoming more difficult, which explains the continued momentum in a select few stocks. This trend suggests that large-cap quality stocks are likely to continue outperforming until there is a significant change in the macroeconomic environment.

Three potential factors could disrupt this seemingly stable outlook for equity markets:

1. **Reacceleration of Inflation and Growth:** If inflation and economic growth pick up, forcing the Fed to reconsider rate hikes, it could lead to a broader equity rally. This rally would likely benefit sectors that have lagged over the past two years, such as small caps, lower quality consumer cyclicals, regional banks, and transports. However, in this scenario, the S&P 500 might perform poorly as higher rates could pressure the valuations of the top-performing stocks. Currently, this scenario appears unlikely, as there is little risk of such an outcome priced into either bond or stock markets.
2. **Liquidity Decline:** A reduction in liquidity, leading to money flowing out of equities, is another potential risk. The main concern here is funding the substantial government deficit. Monitoring the term premium in the bond market, which remains near zero, is crucial. If the term premium rises, as it did last fall, we could see a broad decline in equities, with few stocks performing well. However, this scenario does not seem concerning at the moment, given the current liquidity provisions.
3. **Significant Growth Scare:** A substantial growth scare could turn bad economic data

into bad news for equity valuations across the board. This risk appears most likely to disrupt the current market stability. In this situation, large-cap quality stocks might perform relatively well, but defensive stocks are likely to fare better.

Economic growth surprises have been trending lower throughout the year. So far, the S&P 500 has handled weaker data well, as the market expects bad economic data to still be favorable for large-cap quality stocks, anticipating Fed rate cuts. Meanwhile, weaker indices and stocks have declined, with many now down for the year.

In summary, the present combination of significant fiscal spending and stringent interest rate policy is impacting numerous companies and consumers adversely, creating a situation that cannot be maintained in the long term. Investors have recognized this by driving up the prices of the few companies thriving in this environment. Until the bond market reacts with higher term premiums or growth slows significantly, this narrow market performance is likely to continue.