Daniel Wildermuth's
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Market Stumbles Possibly Signaling Larger Weaknesses

The market has taken a step back during September, which is typical for the only month that has generated negative total returns since 1926. Still, the lack of forward progress is notable in a year marked by seemingly unending optimism that has propelled various indices to over 50 new highs on the year and kept valuations at nose-bleed levels. The turn in recent market performance may signal recognition that valuations cannot continue at current levels. Joby Aviation, which plans to begin an electric air taxi service in 2024, is worth more than Lufthansa, EasyJet or JetBlue. Earlier this year, Tesla was worth more than the next nine car manufacturers combined before the stock dropped to a level which valued the company larger than only the biggest six. Beyond Meat, which makes meat from pea protein, is worth more than the entire global market for peas eaten. The Crypto-exchange Coinbase is worth more than the Nasdaq. The NASDAQ!!

In 1989 Tokyo real estate sold for as much as $139,000 a square foot—350 times the value in Manhattan. At that price, Tokyo's Imperial Palace was worth more than all the real estate in California. Tokyo's valuations eventually plunged as fundamentals eventually caught up leaving Japan with lost decades of growth.

Tesla CEO Elon Musk recently tweeted, "I thought 1999 was peak insanity, but 2021 is 1000% more insane!"

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> *'The turn in recent market performance may signal recognition the valuations cannot continue at current levels'*

Stock-market valuations are "historically extreme" by almost every measure. "With the current cycle advancing very quickly, the risk that the correction is hard is growing," wrote Binky Chadha, chief strategist at Deutsche Bank, on September 9.

The S&P 500 appears to be acting like the three wise monkeys – see no evil, hear no evil, speak no evil. The market has gone up since November with nearly no volatility despite many troubling events here and abroad that could each have justified at least a 5% correction. Investors appear to be eerily confident.

A simplistic way to quantify the future return of stocks is to use the earnings yield, the inverse of the forward price/earnings ratio. If companies match current analyst profit forecasts, future returns should be about 4%—only slightly higher than was suggested at the height of the dot-com bubble in 2000. If corporate earnings miss forecasts, future returns could be substantially lower. If valuations also fall, returns would be doubly hit, as they were after the dot-com bubble burst, when returns were negative for years.

Earning a lower reward for the same or higher risk may still be acceptable to some investors, particularly since safer alternatives remain unattractive. But it appears many investors may be fooled into believing future returns will deliver the same strong returns of either 6.5% above inflation over the past century, or the amazing 12% above inflation experienced during the past decade.

The primary justification for investing in stocks appears to be "TINA" – There Is No Alternative – because yields on alternatives such as bonds are so low. Using this approach may work for a while but has always ended badly in the past.

When the selling starts, fear of missing out almost always turns into fear of losing everything as speculators abandon the equity markets like rats jumping off a sinking ship. Today's negative real yields are not a reflection of reality, and the Fed has warned that it plans on tapering bond and mortgage purchases later this year. As the Fed reaches for the

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proverbial punch bowl, a return to fundamentals may be coming.

China is also causing market worries in the U.S. as fears mount on the solvency of Evergrande, the property developer with the largest debt burden of any publicly traded real-estate company in the world. The company missed its most recent debt payments bringing focus not only on the company but also Xi Jinping's growing campaign against private enterprise.

The Chinese Leader – essentially for life – is trying to roll back China's decades long march toward Western-style capitalism while turning future development toward socialism. The recent financial troubles of Evergrande are the largely the result of changes in government policy, a trend seen in many other areas of the economy including companies in technology, retail, education, and cryptocurrencies which are now illegal in China.

The Wall Street Journal recently published its conclusions that Xi Jinping is trying forcefully to shift China back to the original vision of Mao Zedong, who saw capitalism as a transitory phase on the road to socialism. U.S. stock and bond markets seem to be puzzled by this turn, and no one seems to know what is happening in China or how this turn could impact future growth there, or here.

Another concern is inflation. Across the 300 or so separate categories that the Bureau of Labor Statistics tracks, there were more with big rises and big falls in August than in July. The median price fell slightly, but with so much movement, this is likely meaningless.

Fed Chairman, Jerome Powell, and the Cleveland Fed both attempted to smooth results by stripping out factors with more extreme movements…and reached very different conclusions. Neither could present a compelling case that inflation was markedly decreasing. For now, investors continue to believe that while inflation is likely transitory, it is likely more permanent that that Fed hopes.

High valuations, trouble in China, inflation, as well as many other factors, point to a coming market correction, and October is historically a common month for major corrections.

Yet, there are many investors and even some experts who continue to believe – or hope – that the market will somehow just keep moving up without a major disruption. It is certainly possible. The economy remains strong with most areas getting close to their pre-COVID levels if not performing well beyond them. Unemployment is nearing its pre-COVID rates and seemingly every company is looking for employees.

Yet, overly tight employment is also a sign of some of our potential challenges. There are not a lot of variables that can be tweaked to keep pushing the economy forward or the market higher. The Fed is also running short on tools as well, particularly to fight a potential slowdown. It is always conceivable that the market keeps setting new records, it just appears increasingly unlikely.