Equity Bubble? No.

The US stock market performed very well during 2013. The S&P 500®’s total return of nearly 33% far outpaced the returns of most asset classes. Interestingly, the rally in US stocks occurred despite a significant increase in longer-term interest rates. The 10-year t-note hit a low of 1.6% in early May and rose above 3% by year end.

We continue to believe that much of the bull market has followed historical precedent despite the unusual magnitude of the monetary and fiscal policy catalysts used in an attempt to right the economy. Whereas some investors have suggested the stock market should not be rising in combination with rising rates, 2013’s performance seems to us to be a normal mid-cycle rally in which the unanticipated improvement in fundamentals typically outweighs the negative effects of rising rates.

A growing contingent of market observers is fearful that the US equity market is in some sort of a bubble. We disagree completely with this notion. A strong market rally that many investors have missed is hardly sufficient grounds for a financial bubble.

High beta stocks are undervalued

It seems to us that a necessary condition for an equity bubble is the overvaluation of the stocks most sensitive to the overall stock market’s movement. It seems very unrealistic that high beta stocks could be selling at historically conservative valuations if there really was an equity bubble underway.

Chart 1 shows the relative valuation of the stocks in the S&P 500® with the highest betas (i.e., those stocks with the highest sensitivity to overall market movements) versus that of the stocks with the lowest betas (i.e., those with the lowest sensitivity). Despite claims that the equity market is in a bubble, it is low beta stocks and not high beta stocks that are selling at rich valuations. High beta stocks are actually close to record conservative relative valuations.
What constitutes a bubble?

In his wonderful book, *Devil Take the Hind Most*, Edward Chancellor demonstrates that financial bubbles tend to follow similar patterns. Most important, his work suggests that valuation alone does not constitute a financial bubble. Financial bubbles go beyond the financial markets and tend to pervade society.

Our interpretation of Chancellor’s work is that there are five common characteristics to a financial bubble. The US equity market does not seem to match these characteristics. The five characteristics are:

1) Available liquidity
2) Increased use of leverage
3) Democratization of the market
4) Increased turnover
5) Record new issues

One could certainly argue that the Fed’s extraordinary efforts to stimulate the US economy have provided tremendous liquidity to the financial markets. However, we find scant evidence that the other four characteristics currently apply to the US equity market. For example, many have noted that volume was weak during 2013, new issues were not rampant, and protection was more important to most investors than using leverage to accentuate performance.
But, isn’t the market’s PE ratio very high?
The absolute valuation of US equities is not cheap. However, the market appears fairly valued if one accounts for interest rates or inflation. After all, shouldn’t the PE ratio be relatively high when inflation is less than 2%?

Chart 2 below shows the 12-month forward returns of the S&P 500® using combinations of valuation (defined using the often-discussed Shiller “CAPE” Cyclically Adjusted P/E ratio) and inflation. Although historical comparisons to the current environment don’t suggest extremely high returns for the S&P 500®, it does suggest roughly “normal” returns.

Chart 2:

The Shiller CAPE, Inflation & Subsequent 12-Month S&P Returns: December 1890-November 2013

Source: Richard Bernstein Advisors LLC, Robert Shiller, BLS
For Index descriptors, see "Index Descriptions" at end of document.

PE-driven versus earnings-driven bull markets

Investors seem to be assuming that every bull market starts with a low PE and ends with a high PE. However, history shows that has not always been the case. There have actually been two types of bull markets. Some have been PE-driven, meaning that interest rates fall and PE multiples expand. Most of the bull markets after 1980 fit this description. Other bull markets have been earnings-driven, meaning that interest rates rise and PEs contract, but earnings growth is strong enough to more than offset the negative effects of rising rates and PE compression. 2003’s bull market would be an example.

We have always thought that the current bull market would turn into an earnings-driven market, and 2013 fit that description. As previously stated, interest rates rose during much of 2013, but the unanticipated improvement in fundamentals far outweighed the negative effects of rising rates. We expect this trend to continue.
Skepticism doesn’t accompany bubbles

While there is no doubt that investors’ fears regarding equities after the 2008 bear market have started to subside, this is a normal occurrence for a mid-cycle environment. The euphoria that is typically present at market peaks has yet to occur.

There are indeed financial bubbles around the world. Credit growth in China would be a perfect example. However, we strongly doubt that US equities should be added to that list.

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor’s or originator’s website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

**S&P 500®**: Standard & Poor’s (S&P) 500® Index. The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

**Inflation**: Consumer Price Index (CPI). The CPI is a measure of the average change in prices over time of goods and services purchased by households. The CPI is based on prices of food, clothing, shelter, and fuels, transportation fares, charges for doctors’ and dentists’ services, drugs, and other goods and services that people buy for day-to-day living. Source: Bureau of Labor Statistics (BLS).

In our Shiller CAPE (Cyclically Adjusted P/E), Inflation and Subsequent 12-month S&P Returns study, we have used the Robert Shiller CAPE and Inflation data series as published on his website (www.econ.yale.edu/~shiller/data.htm). For our S&P Composite Returns calculations, we have used the S&P Composite data series from the Online Data Robert Shiller website for the data prior to 1926. From 1926 on we have used the Ibbotson Large Company Stock Total Returns. The Ibbotson Large Company Stock Index represents the S&P 500® from 1957 on, prior to 1957 it consisted of 90 of the largest stocks in the U.S.
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