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# Turbulence Likely to Continue Given High Valuations and Uncertainty

After the S&P 500 marked numerous new highs throughout August before reaching a record close on September 2nd, the index fell throughout most of September as investors grappled with continued uncertainties around earnings, lockdowns, economic recovery, and upcoming elections. The fall from recent highs that are nearing correction territory—a fall of 10%—reveal a highly uncertain market grasping at limited data to extrapolate about the future.

In February and March, both the Dow Jones Industrial Average and the S&P 500 plunged about 35% marking the fastest-ever fall from a record to a bear market—a drop of 20% or more. After reaching the year's low on March 23rd, U.S. stocks then began an unprecedented recovery with the S&P 500 notching its strongest five-month rally in more than 80 years. The S&P 500 made the round-trip from record high to a bear market to a new high in only 126 trading days, the fastest-ever journey. During previous market declines dating all the way back to 1928, it took an average of more than 1,500 trading sessions—or about six years—for the index to climb back to record levels.

Market movements have been wild this year because trading has been driven almost entirely by speculation in the midst of great uncertainty. During the second quarter, earnings amongst S&P 500 companies dropped 32%, and yet during this time, stocks rapidly climbed based on expectations of a strong economic recovery post-pandemic.

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As earnings were collapsing, many analysts were also projecting that 2021 earnings would surpass those recorded prior to the pandemic. But as fears have again arisen about the ongoing economic costs of lockdowns and changed behavior guesses about the future have grown less optimistic, driving equity markets into retreat.

Speculation is also driving the gap between market losers and winners to even greater levels. The massive technology behemoths have mostly benefited from societal changes forced by the pandemic, and more significantly, the perception of their relative strength has possibly increased even more. Apple investors are willing to pay about twice as much for a given dollar of today's earnings and revenue than just a year ago helping to drive shares up more than 50% in 2020. In mid-September, Apple alone was responsible for over half of the Dow Jones' 4.8% 2020 return. The company is now worth more than all of the small companies in the Russell 2000 index combined or the FTSE 100 index which tracks the biggest companies listed on the London Stock Exchange. Apple, Amazon, Google (Alphabet), Microsoft and Facebook now constitute about 23% of the S&P 500, and they are collectively up about 50% on the year.

Tech and new economy stocks are also favorites with individual investors who are now participating in the market at around double the level of a decade ago. Tesla is up around 400% on the year making it the largest auto manufacturer and the eighth largest U.S. company. Yet, the company now trades at a price to earnings ratio north of 1,100. Simply falling to Apple's inflated P/E ratio would result in an astounding loss of about 97%.

The spread between returns within sectors is also huge. Through late September, annual returns for information tech and consumer discretionary (think Amazon) were up 26.6% and 22.5%. Conversely, the energy and financial sectors were down 48.4% and 21.3% respectively. Outside of big tech, the stocks of most companies in the S&P 500 are down on the year reflecting the broader economy's struggles. As hedge-fund billionaire William Ackman, founder of Pershing Square

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Capital Management LP, wrote in a recent letter to shareholders. "If there were a stock market index of private, small businesses, it would likely be down 50% or more."

So, what does this all mean looking forward? While economic activity remains low, most believe that the worst is past. U.S. manufacturing and services are accelerating, hiring has been up for the past four plus months, and consumer spending keeps rising. Unfortunately, both Europe and Asia are faltering somewhat under new lockdowns, and purchasing-manager surveys in France, Germany and Japan pointed to a decline in activity at businesses that provide services during September, an indication that the global economy is struggling to return to growth.

Longer-term, the Congressional Budget Office projected that the U.S. economy is likely to grow more slowly in coming decades and the public debt burden will increase more than previously forecast, partly due the coronavirus-induced recession. The agency is projecting an average annual GDP growth of 1.6% from 2020 to 2050, roughly a quarter percentage point less than it forecast only a year ago in June 2019. By comparison, growth averaged 2.5% from 1990 to 2019. While COVID has contributed to lower forecasts, the U.S. along with other developed countries faces several headwinds to expansion including lower productivity growth, a greater regulatory burden, and slowdowns in population growth. Muted long-term growth projections suggest poor fundamental support for today's high market valuations largely based on strong growth expectations.

If COVID disruptions were not already creating enough uncertainty, the U.S. faces presidential elections in early November. Traders are positioning for a highly volatile election season by making investments that would reward them for not just high volatility, but also volatility that extends possibly well into December. Strategies and elevated safe-haven holdings reveal much greater anxiety than four years ago.

The winner of the election is also likely to influence market directions. A Trump win likely means more of the same for the economy and stocks, although COVID's influence will be felt for a long time. A Biden win will likely introduce much greater uncertainty. His declared tax and economic policies are decidedly anti-growth, yet it is difficult to discern how much of his platform is political posturing versus actual policy goals. In addition, even with a Biden win, implementing higher corporate, personal and wealth taxes along with various new or tighter regulations faces obstacles and time to implement.

With all the ongoing uncertainty combined with high valuations, the market is very likely to remain volatile, at least through 2020. Long-term productivity headwinds and lower corporate profitability could pull valuations back toward historically common levels, yet incredibly low interest rates and the perceived unattractiveness of bonds could keep investors in stocks indefinitely, maintaining support for even today's lofty valuations. It appears that headwinds make strong market annual returns over the next decade unlikely, but anything can happen in the shorter term, particularly during a contentious election in the midst of a politicized pandemic.

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