MORNING BRIEFING
November 16, 2021

Is the Meltup a Bubble?

Check out the accompanying chart collection.

(1) Not everything is in a bubble. (2) Sentiment isn't euphoric. (3) Bitcoin is impossible to value. (4) Home prices overvalued relative to incomes. (5) High stock market valuations supported by strong earnings. (6) SMidCaps may be starting to outperform. (7) S&P 500 P/E inflated by Growth, which is inflated by Mag-8. (8) Alarmingly high Buffett Ratio misleadingly ignores record profit margin. (9) No cause for alarm in Fed's latest *Financial Stability Report*. (10) Biden explains "Bidenflation."

Bulletin Board. You can find replays of this week's webinar and previous ones *here*. A complimentary copy of *In Praise of Profits!* Is available *here*.

Strategy I: The Not-Everything Bubble. Yes, we know: There are lots of signs of speculative bubbles in the broad stock market led by a few big-cap technology, electric-vehicle, and meme stocks. There are also bubbles in the housing, junk bond, and cryptocurrency markets. It's been widely described as the "everything bubble." On the other hand, there aren't bubbles in biotech stocks or in small- and mid-cap stocks. There's no bubble in precious metals.

Sentiment in the stock market is not especially euphoric right now. Investors Intelligence's Bull-Bear ratio was well below 3.00 during the November 9 week, at 2.53 (*Fig. 1*). Consumers aren't euphoric either. Debbie and I derive the Consumer Optimism Index by averaging the Consumer Sentiment Index and the Consumer Confidence Index (*Fig. 2*). During October it was 92.8, which was well below the previous cyclical peak readings that preceded recessions and bear markets.

Bitcoin certainly seems to be in a bubble now that it is back in record territory around $65,000. There is no way to place a value on it. So it could go to a million dollars on its way back to zero (*Fig. 3*). The 12-month average of the mean existing single-family home price has soared 19.1% over the past two years through September (*Fig. 4*). This series divided by mean personal income excluding government benefits, on a per-household basis, is the highest since January 2008, at 2.78 (*Fig. 5*). The record high in this P/E ratio for homes is 3.13, reached during December 2005.

Both the S&P 500 and the Nasdaq have been melting up since they bottomed last year on March 23, with gains of 109.3% and 131.1% since then through yesterday's close (*Fig. 6*).

Strategy II: Slicing & Dicing Valuation. Yes, we know: The S&P 500's forward P/E (i.e., based on forward earnings per share, which is the time-weighted average of consensus estimates for this year and next) is historically high. But this year's bull market has been led by the meltup in the S&P 500's forward earnings—suggesting fundamental support underpinning the elevated valuation altitude.

Even stronger have been the forward earnings of the S&P 400/600 (a.k.a. SMidCaps); but until last week, their valuation multiples were falling—suggesting possible opportunity. Joe and I first recommended overweighting the relatively undervalued SMidCaps in the August 9 *Morning Briefing*.

Let's have a closer look at the valuation multiples of the S&P 500/400/600 indexes, especially those of the S&P 500, or LargeCaps—which suggest that this index may not be as overvalued as it seems:

(1) *The forward P/Es of S&P 500/400/600* rebounded last week from their recent lows to 21.4, 16.9, and 15.8 on Friday (*Fig. 7*). Our Blue Angels framework compares the stock price indexes to their implied values based on their forward earnings multiplied by forward P/Es of 10.0-22.0 in increments of 2.0 (*Fig. 8*). It shows that the S&P 500 stock price index has been melting up along with its forward earnings all year while the index's forward P/E has been ranging between roughly 20.0 and 22.0.

Over the same period, the stock price indexes of the S&P 400/600 have been moving mostly sideways until they broke out to new record highs last week (*Fig. 9*).

As we've previously observed, the forward earnings of the SMidCaps have risen faster than that of the LargeCaps, with their profit margins, rather than their revenues, leading the relative earnings outperformance (*Fig. 10*, *Fig. 11*, and *Fig. 12*). We think all three indexes' forward earnings will grow at slower and similar paces in coming months, still leaving room for the SMidCaps to outperform on a valuation basis.

(2) *S&P 500 Growth valuation* remains high, especially relative to the valuation of S&P 500 Value (*Fig. 13* and *Fig. 14*). Here are the forward P/Es for the S&P 500 and its Growth and Value subcomponents on Friday's close: 21.4, 29.3, and 16.3. Growth's valuation multiple has been hovering around 28.0 since mid-2020. Value's forward P/E has been behaving

more like those of the SMidCaps.

(3) *The Magnificent 8* are the eight stocks in the S&P 500 with the highest market capitalizations. They are Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla. They are all in the S&P 500 Growth index. Collectively, their market cap has soared from $1.2 trillion at the start of 2013 to a record $12.0 trillion during the November 5 week (*Fig. 15*). Over this same period, their market-cap share of the S&P 500 has risen from 8.9% to a record 30.0% (*Fig. 16*).

Their forward P/E was about 15 in early 2013 (*Fig. 17*). Since mid-2020, it has been volatile around 40. The forward P/Es of the S&P 500 with and without the Mag-8 currently are around 21 and 18 (*Fig. 18*). LargeCaps are not overvalued excluding the Mag-8, which may be fairly valued too given their superior ability to grow their earnings.

(4) *The Buffett Ratio* is off the charts! This ratio is the market capitalization of US equities excluding foreign issues divided by nominal GDP (*Fig. 19*). Its level usually nearly matches that of another ratio: the market cap of the S&P 500 to S&P 500 revenues. Both ratios are quarterly.

We prefer a similar ratio that tracks these two very closely but is available weekly: the ratio of the S&P 500 stock price index to its weekly forward revenues, i.e., the forward price-to-sales ratio (P/S). This weekly series rose to a record 2.9 during the November 12 week, well exceeding its levels during the two previous bull market peaks.

Why is the forward P/S much more alarmingly elevated than the forward P/E of the S&P 500? For the answer, we need look no further than the forward profit margin of the S&P 500. Its rise to record highs this year reflects a faster rise in forward earnings than forward revenues (*Fig. 20* and *Fig. 21*). That should be comforting, not alarming.

Strategy III: The Fed's Latest Analysis of Financial Stability. The Fed issued its latest *Financial Stability Report* last week. There was no mention of the everything bubble. Indeed, the word "bubble" was mentioned only once, referring to "the dot-com bubble" that burst in 2001. Keep walking, nothing to see here.

The November 2019 report issued prior to the pandemic raised a warning flag about risk in the corporate bond market. The problem since has been mostly resolved by record-low corporate bond yields: "Moreover, risky firms will need to roll over only about 3 percent of outstanding speculative-grade bonds within one year, as firms have continued to refinance existing debt with longer-maturity bonds at low interest rates." What about leverage loans? Their default rates have fallen even though underwriting standards have weakened.

What about the stock market? The report's finding is "that equity investor risk appetite remained within historical norms." The report includes an interesting discussion about retail investors, social media, and equity trading. The conclusion is a benign one: "To date, the broad financial stability implications of changes in retail equity investor characteristics and behaviors have been limited, as recent episodes of meme stock volatility did not leave a lasting imprint on broader markets." In other words, keep walking, nothing to see here.

Fiscal Policy: The President's Spin. President Joe Biden explained "Bidenflation" in a *speech* in Baltimore on November 10, 2021. Basically, it's what happens when government actions boost demand such that demand exceeds supply, so prices go up:

"And the irony is: People have more money now because of the first major piece of legislation I passed. You all got checks for $1,400. You got checks for a whole range of things. If you're a mom and you have kids under the age of 7, you're getting 300 bucks a month, and if it's over—over 7 to 17, you're getting $360 a month—like wealthy people used to when they'd get back tax returns. It changes people's lives. But what happens if there's nothing to buy and you got more money? You compete for getting it there. It creates a real problem. So, on the one hand, we're facing new disruptions to our supplies. But at the same time, we're also experiencing higher demand for goods because wages are up, as well as—as well as people have money in the bank. And because of the strength of our economic recovery, American families have been able to buy more products."

In his speech, Biden observed that because of Covid, people have been staying home and ordering products online: "Well, with more people with money buying product and less product to buy, what happens? ... Prices go up."

But have no fear, Biden's Build Back Better infrastructure program will bring inflation down. That's according to "17 Nobel laureates in economics" who "wrote a letter to me about 10 days ago saying this is going to ... bring inflation down, not up."

How can even more government spending do that? Infrastructure spending purportedly will end the supply disruptions so that more goods will be available to meet demand. Let's hope so. But are there enough workers available amid the current labor shortage to Build Back Better without inflating wages, thus feeding a wage-price spiral?

By the way, on October 14, White House Chief of Staff Ron Klain endorsed a tweet that claimed that the inflation and supply-chain issues affecting the country were "high class problems." Klain made news for appearing to agree with Harvard professor Jason Furman, who served as chair of the Council of Economic Advisers under President Barack Obama. "Most of the economic problems we're facing (inflation, supply chains, etc.) are high class problems. We wouldn't have had them if the unemployment rate was still 10 percent. We would instead have had a much worse problem," Furman wrote in a tweet that Klain shared.

Calendars

US: Tues: Retail Sales Headline, Core, and Control Group 1.1%/0.8%/1.0%, Import & Export Prices 1.0%/0.9%, Headline & Manufacturing Industrial Production 0.7%/0.8%, Capacity Utilization 75.7%, Business Inventories 0.7%, NAHB Housing Market Index 80, Weekly Crude Oil Inventories, TIC Net Long-Term Transactions, IEA Monthly Report, Barkin, Bostic, Daly. **Wed:** Housing Starts & Building Permits 1.580mu/1.638mu, MBA Mortgage Applications, Crude Oil Inventories, Williams, Bostic, Bowman, Daly, Evans, Waller. (Bloomberg estimates)

Global: Tues: Eurozone GDP 2.2%q/q/3.7%y/y, Eurozone Employment, France CPI 0.4%m/m/2.6%y/y, Italy CPI -0.1%m/m/2.9%y/y, UK Average Earnings Including & Excluding Bonus 5.6%/5.0%, UK Employment Change 3m/3m 180k, UK Unemployment Rate 4.4%, Japan Core Machinery Orders 1.8%m/m/17.4%y/y. **Wed:** Eurozone Headline & Core CPI 0.8%m/m/4.1%y/y & 0.3%m/m/2.1%y/y, UK Headline & Core CPI 0.8%m/m/3.9%y/y & 0.4%m/m/3.1%y/y, UK Input & Output PPI 1.1%m/m/12.1%y/y & 0.8%m/m/7.3%y/y, Canada CPI, ECB Financial Stability Review, Lagarde, Schnabel, Balz, Buch. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): All three of these indexes had forward earnings at a record high last week. LargeCap's was at a record high for a seventh straight week after dropping a hair below in late September due to Match's addition to the index. MidCap's was at a record high for a fourth week after slipping 0.2% the week before that, and

SmallCap's was at a record for a tenth week after dropping in early September for the first time in six months. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 75 of the past 78 weeks, with the down weeks due to Tesla's addition to the index last December, Amazon's earnings shortfall in August, and Match's addition to the index in late September. MidCap's forward earnings is up in 73 of the past 76 weeks, and SmallCap's posted 73 gains in the past 77 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 55.5% from its lowest level since August 2017; MidCap's is now up 107.5% from its lowest level since May 2015; and SmallCap's has soared 173.7% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings dropped to 32.9% from 33.2%, and is down from a record-high 42.2% at the end of July. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings rose w/w to 53.8% y/y from 53.7%; but that's down from a record high of 78.8% at the end of May and compares to a record low of -32.7% in May 2020. SmallCap's rate dropped to 74.2% y/y from 77.7%; it's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (47.4%, 7.6%), MidCap (77.9, 8.6), and SmallCap (122.1, 13.9).

S&P 500/400/600 Valuation (*link*): Valuations fell last week for these three indexes, but remain close to multi-month highs. LargeCap's forward P/E dropped to 21.4 from a six-month high of 21.5 a week earlier, and is up from an 11-month low of 20.3 in early October. LargeCap's forward P/E compares to a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's fell 0.2pt to 16.9 from a 13-week high of 17.1 and is up from a 17-month low of 16.2 in early October. That compares to a seven-month high of 20.5 in early March and is 6.0pts below its record high of 22.9 in June 2020. SmallCap's dropped 0.3pt to 15.8 from a 13-week high of 16.1, but is up 0.4pt from its 17-month low of 15.4 in mid-September. It's still down 10.9pts from its record high of 26.7 in early June 2020 when forward earnings was depressed. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017; MidCap's current 21% discount to LargeCap is near its biggest since 2001. SmallCap's P/E was below LargeCap's for a 65th week. That's the longest stretch at a discount since 1999-2002; SmallCap's current 26% reading is near its biggest since 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 22nd straight week; SmallCap's current 7% discount to MidCap's is near its biggest since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. Those gains endured even through the Q3 earnings warnings season, when forecasts typically decline. With the Q3 earnings reports nearly 92% complete, the S&P 500's Q3-2021 blended earnings-per-share estimate rose 34 cents w/w to $53.59. That $53.59 estimate for Q3-2021 represents a gain of 38.5% y/y on a frozen actual basis and a 41.5% y/y gain on a pro forma basis. That would mark a third straight quarter of double-digit percentage growth and compares to a pro forma gain of 96.3% in Q2-2021. All 11 sectors again have posted positive y/y earnings growth during Q3-2021. Here are the S&P 500 sectors' latest earnings growth rates for Q4-2021 versus their blended Q3-2021 growth rates: Energy (9,985.9% in Q4-2021 versus 1,793.1% in Q3-2021), Materials (63.6, 89.2), Industrials (51.7, 86.8), S&P 500 (21.5, 41.5), Health Care (19.3, 28.9), Real Estate (15.7, 25.6), Information Technology (14.7, 36.9), Communication Services (9.4, 35.5), Consumer Discretionary (5.2, 14.5), Financials (3.0, 36.0), Consumer Staples (1.4, 6.3), and Utilities (0.7, 10.3).

US Economic Indicators

Regional M-PMI (*link*): The New York Fed has provided the first glimpse of manufacturing activity in November and shows an acceleration of growth back toward July's record high. Meanwhile, inflationary pressures remain intense. The composite index rebounded to 30.9 this month after slowing from 34.3 to 19.8 last month; it was at a record-high 43.0 in July. Growth in new orders (to 28.8 from 24.3) remained at a robust pace, while shipments (28.2 from 8.9) showed a noticeable acceleration. The unfilled orders index edged down from

18.5 to 12.7 this month, while the delivery times index (to 32.2 from 38.0) continued to show significantly longer delivery times—though down from October's record reading. Labor market measures showed employment (to 26.0 from 17.1) growing at its fastest pace on record this month, with the average workweek (23.1 from 15.3) also increasing. Meanwhile, the prices-paid (83.0) measure was just shy of its record high of 83.5 in May, while the prices-received (50.8) measure reached a new record high. Looking ahead, firms were less optimistic about the six-month outlook. The future conditions index slumped to a six-month low of 36.9, after climbing four of the prior five months from 36.6 in May to a 16-month high of 52.0 during October. Both the orders (to 34.4 from 51.0) and shipments (32.2 from 52.3) gauges slowed significantly from their October readings, though remained strong. The report notes that longer delivery times (to 12.7 from 5.6), increases in employment (30.6 from 57.1), and higher prices all are expected in the months ahead—with the prices-paid (72.0 from 67.6) and prices-received (55.9 from 50.0) measures accelerating back toward their record highs of 75.3 and 57.6, respectively.

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