BearBull
Global Investments Group

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Irrational exuberance or just excessive optimism?

Extreme valuation of the S&P 500 (PE 22x). Risk premium once again irrational. Historic volatility at its lowest since 2007. Tax reform failure could make Wall Street plummet.

Key Points

- Irrational exuberance or just excessive optimism in the short term?
- Extreme valuation of the S&P 500 in 2017
- The GAFAs and Microsoft accounted for 61% of the rise in the S&P 500 in October
- Implied volatility points to high levels of complacency and risk
- The contraction of the risk premium on interest rates demonstrates irrational confidence
- Ongoing indifference to political, geopolitical and institutional risks
- Economic forecasts are perhaps already too optimistic
- Keep a close eye on the economic surprises index
- Failure of, or even a delay in adopting tax reform could cause Wall Street to nosedive

Irrational exuberance, or just excessive optimism in the short term?

"Irrational exuberance" was the title of the book by Robert Schiller, a professor at Yale University. It was published in 2000, at the height of the dot-com bubble, right before stock market prices collapsed by more than -50%. In 2005, the second edition described the irrational exuberance which he believed was shaping the real estate market before the subprime crisis struck. In a way, the title was a tribute to Federal Reserve chief Allan Greenspan, who was the first to have used this expression in a speech in 1996, speaking of the risks of overvaluation of equity markets.

The term *irrational exuberance* specifically describes the mechanisms that can lead to temporary overvaluation of financial assets, which must then inevitably correct back down to a "normal" market valuation. These periods of overvaluation of assets are by their very nature short-lived and characterised by extremely high investor confidence.

This excessive confidence prevents objective analysis of the risk of a correction to the valuation of stocks that are increasing in price, even when the valuations linked to stock market rises hit extraordinary levels, seemingly defying the laws of gravity at times. A real sense of stock market euphoria develops, and leads to overvaluation of financial markets, which may seem entirely reasonable given a particularly auspicious and prosperous economic situation. This description can absolutely be applied to the current situation on the equity market in the United States.

Excessive confidence and copycat behaviour fuel and exacerbate trends until valuation bubbles form. These are sometimes identified as likely to be speculative bubbles, but it is difficult to break away from them, such is the strength of the desire to partake in the euphoria. Nonetheless, speculative bubbles always end up bursting just when we are least expecting it, often correcting their excesses very abruptly and quickly, to come back down to historically more "normal" asset valuation levels.

Just a few weeks ago, Allan Greenspan warned that the concept or term *irrational exuberance* could very well be used to describe the current situation on the US bond market. Thirty years of bullishness on the bond market can now only end in a trend reversal and an interest rate rise. In fact, this rate increase is already underway, and will certainly continue with the Federal Reserve's monetary policy normalisation. This point of view is now widely shared, but long-term rate increases are still perceived as very gradual, and therefore insufficient to cause the bond bubble to suddenly burst.

What can be said in this context of risk on equities? Is it fair to speak of irrational exuberance already?

Since 2009, the rise in US equities has lifted the S&P 500 index from 666 points to 2597 points, which represents an annualized performance of nearly +18%. This is nearly twice the historic annualized performance of US equities. It has risen +22.5% over the last twelve months, since Donald Trump's election; this once again shows that performance has picked up the pace in 2017, with it racing ahead over the past two months.

However, this latest spurt has not affected the 500 companies in the S&P 500 in the same way. On the contrary, we have seen enthusiasm focused on a relatively small group of digital stocks, such as Google, Apple, Amazon and Facebook, the stock market capitalisations of which have climbed significantly, and the valuations of which have hit extreme heights in some cases. Amazon shares are trading at 1,100 USD, but the profit per share is only 4.2 USD, a valuation multiple of 265x. Prospects are certainly exceptional, but profits would need to double every year between now and 2021 for it to be trading at current prices based on a valuation reduced to less than 20x profits.

Irrational exuberance or just excessive optimism?

Founder and CEO Jeff Bezos perhaps has his own ideas on the issue, given that over the past few days he has sold around 1 billion dollars' worth of equities in his own company.

This handful of digital stocks (5 out of 500) has very much dragged the index as a whole upwards this year, maybe especially so in October. It is estimated that nearly two thirds of the index's growth is down to key technology stocks.

Market Capitalisation Gains in October

Market capitalization gain (in value)		
Company	*Weight in S&P 500*	*Market cap. Gain (30.09.2017-31.10.2017)*
Apple	4%	77 billion
Amazon	2%	71 billion
Microsoft	3%	68 billion
Google	3%	42 billion
Facebook	2%	27 billion
S&P500		**463 billion**
Total		285 billion
		61%

Sources: Bloomberg, BBGI Group SA

As such, the rise on the S&P 500 was largely achieved thanks to the increased valuations of these 5 equities that only represent 1% of stocks on the index, and 14% of total capitalisations.

One therefore had to remain fully invested in these few stocks with extreme valuations in order to partake in the rise on the US equity market.

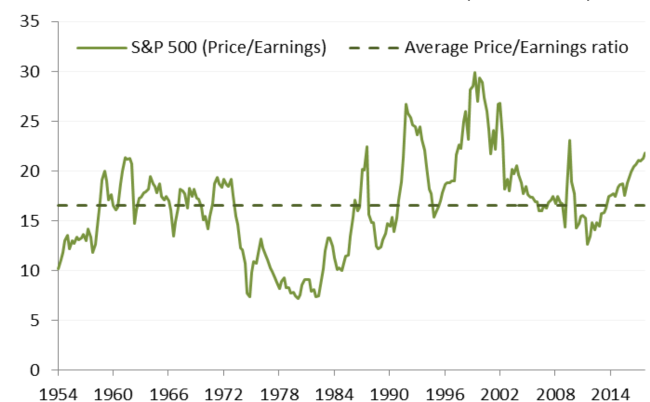
Does such a concentrated performance constitute irrational exuberance, or is it just excessive optimism in the short term?

Whatever the answer to this question, no rational investor could ignore this fact and would certainly consider that risks of a correction of these extreme valuations have certainly risen in October 2017. Unless, that is, momentum is reason enough for the current trend to continue until the end of the year.

Extreme valuation of the S&P 500 in 2017?

Since 2009, valuations of the S&P 500 have increased regularly, from 12x profits at its lowest point (March 2009) to 22x profits today. As such, in November 2017 the valuation of US equities is now twice what it was at the start of the bull market. Current valuation is also nearly 30% higher than the average of the past ten years (17.3x). Whilst not extreme in the same way as could have been said of the dot-com bubble while it was forming at the turn of the millennium- when the market's PE headed north of 30x profits- we can still see that valuation has only very rarely surpassed current levels, as shown on the graph below.

Valuation of the S&P500 – PE (1954-2017)



Sources: Bloomberg, BBGI Group SA

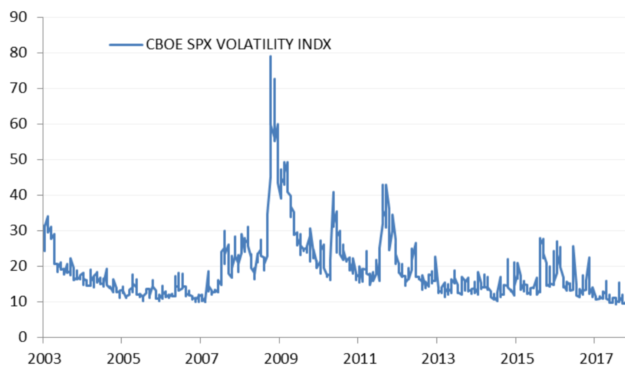
The average PE of the S&P 500 since the 1950s stands at 16.5x if we exclude the dot-com bubble. Current levels of 22x are extreme, which has nearly always led to a considerable market correction.

Irrational exuberance also seems to be affecting the equity market, with a "digital bubble" forming. In some respects, this bubble calls to mind the euphoria that preceded the huge slump in technological stocks and global indices in 2000.

Implied volatility points to high levels of complacency and risk

The VIX indicator, which measures the average level of implied volatility of CBOE options for equity markets such as the S&P 500 are traded on, is once again at historically low levels. At just 9.9%, this level of volatility hit an extreme low again in October, sliding to just under levels seen in 2007, right before the financial crisis hit. The graph below indicates that most of the time this yardstick oscillates between 10% and 25%, except in periods of major concern and crisis when implied volatility exceeds 30%, such as in 2008, 2010, 2011 and 2015.

VIX Volatility Index (S&P500)



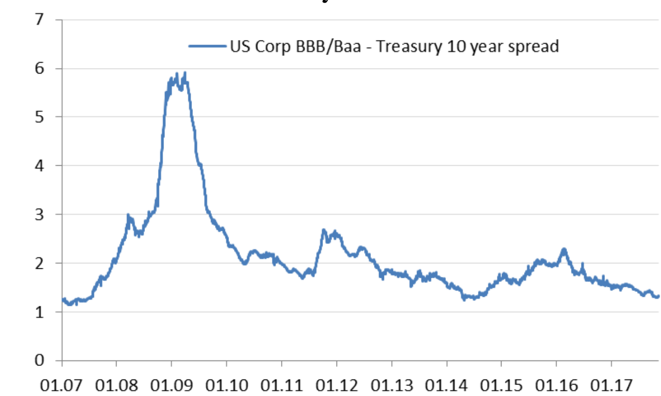
Sources: Bloomberg, BBGI Group SA

We can therefore deduce that different volatility regimes and evaluations of risk can come one after another, depending on investors' points of view and their assessment of the likelihood of a value correction or a crash (high volatility or low volatility regime). Today, we can see that the volatility regime- in other words, risk perception- is of low volatility in 2017. However, at 9.9%, this is not only extreme when compared historically, but is also extreme within the fluctuation limits of a low volatility regime.

The contraction of the interest rate risk premium shows irrational complacency

In the United States, normalisation of monetary policy is continuing, and excellent economic results have also sparked the beginnings of normalisation of long term interest rates. Investors are now aware that growth could still shore up a little more at the end of 2017. It could hit a good clip of nearly 3% for the third consecutive quarter. Inflationary prospects suggest that investors are realistic, expecting inflation to recover beyond 2.5% to 3%. Nonetheless, real terms rates remain close to zero because the rise in ten-year nominal rates has temporarily stabilised at 2.5% since the first step in normalisation in the second half of 2016. This was marked by an increase in rates from 1.35% to 2.5% in the wake of the presidential election. One might think that bond market perception is relatively optimistic, given the likelihood of the economy speeding up. However, this optimism seems increasingly extreme when looking at the developments in the risk premium. The yield differential between BBB grade borrowers (right up to the investment grade universe) and the US Treasury is very low. Whilst not at an extreme level in absolute terms, the graph below serves as a reminder that this risk premium only stands at 1.34%, which is relatively low in past comparison. It is particularly worrying that it is as low as it was before the subprime crisis hit.

US BBB – Treasury Bond Risk Premium



Sources: Bloomberg, BBGI Group SA

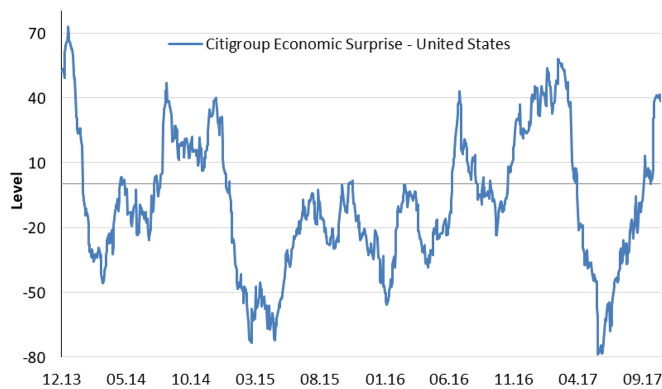
In 2007, when we drew investors' attention to this aspect, which we believed demonstrated dangerously excessive confidence, we clearly highlighted the fragile situation on financial markets. We believed that financial markets were shaped by an extremely concerning level of complacency. Today's situation does not seem to be very different to us. The risk premium has once again fallen, and we believe it is showing the same level of complacency and the same devil-may-care attitude as right before the financial crisis struck. There is therefore undoubtedly some level of irrational exuberance setting in; more generally, this would suggest that overall sentiment is still not very sensitive to evaluations of risk, and even less so to how they are taken into account by investors.

Ongoing indifference to political, geopolitical and institutional risks

Widespread confidence is buoyed up to a considerable degree by an influx of positive macro-economic news and by often better than expected company results. However, it also stayed strong despite geopolitical risks (North Korea, Qatar, etc.), political risks (Catalan crisis in Europe, impasse in the Brexit negotiations, German elections), and institutional risks (Special Prosecutor Mueller's probe into Russian involvement in the US presidential campaign). This is particularly surprising, as in a different context this would have been enough to trigger renewed uncertainty and a change in attitude to the perception of investment risks and opportunities. This

was not at all the case, and it also underscores the high levels of investor confidence at the end of 2017. This atmosphere could still last some time, but it certainly points to an upcoming change in the evaluation of risk. Although it is still difficult to predict where risks might crop up, it is now high time we were prepared for the prospect of a surprise that could challenge current prospects and trigger a new phase of uncertainty, which would be synonymous with renewed volatility on financial markets. Economically, the positive trend has lent support to forecasts that are perhaps overly optimistic.

USA Economic Surprises Indicator



Sources: Bloomberg, BBGI Group SA

The economic surprises indicator is once again rather high, which could suggest a cyclical correction, and that uncertainty will make a come-back. This week, the tax reform that Donald Trump had so vaunted was finally presented in slightly more detail than in April. We believe that disappointment in its content and the methods for implementing specific fiscal reforms could be one of the elements that triggers the upcoming change in anticipations.

Failure of the reform could cause Wall Street to nosedive

On the 2nd November 2017, the tax reform that Donald Trump had been promising for a year was finally presented by the House of Representatives' Committee on Ways and Means.

We had to wait nearly a year to the day after Donald Trump's election to finally find out what he considers to be the most ambitious tax reform in history. This reform had been one of the significant factors propping up the equity market following the election. A lower tax burden on businesses was to have a considerable impact on their results and on profit growth. Since the election, the equity market has grown nearly +25% on the back of the good behaviour of the US economy, as well as the expected effects of this reform. For now, we are looking at an impact to the tune of 150 billion USD for company profits, which could add up to +10% in extra cash-flow.

But is this really a surprise? For twelve months, investors had almost certainly taken it for granted that there would be a tax reform in 2017, and that it would pass through the Senate and the House of Representatives, both Republican-controlled, with no problem. Any remaining uncertainty was probably more closely linked to the breadth of tax cuts and how they would be implemented than whether or not the reform would be adopted. The announcement of the reform plan did not trigger any fresh enthusiasm or particular disappointment, but we do not believe that the reaction should be long in making itself felt, particularly when negotiations regarding amendments get underway. These will not be in short supply from either the Democrat or the Republican sides. Postponing such a long-anticipated reform could well cause Wall Street to plummet.

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