September 17, 2021

MARKET SIGHTLINES

Risks to the Stock Market

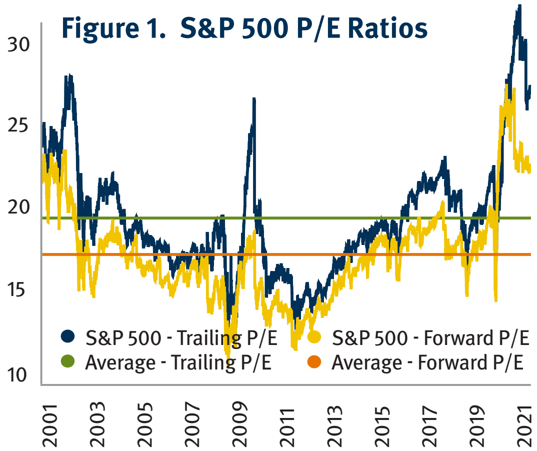
by Michael O'Keeffe, *Chief Investment Officer*

As I engage with clients, I am often asked, "Where are stocks going from here?" While we do a lot of work modeling the long-term average return and annual risk of the broad stock market, this question is always about the short term. Where are stocks headed for the rest of this year? For the next year? Now? In this week's Sight|Lines, we review stock market valuation levels, risks to the market, and tailwinds that may drive prices even higher.

Stock Market Valuation Levels

Figure 1 shows the price-earnings ratio (or P/E) for the S&P 500 using both forward-looking and backward-looking earnings. In each case, P/E shows the market as richly valued by historical standards. In fact, P/Es rose dramatically in 2020 as stock markets recovered and earnings declined.

Figure 2 presents a second, less-known measure, the cyclically adjusted price-earnings ratio, or CAPE, which measures the real (inflation-corrected) S&P Composite Index divided by the ten-year moving average of real earnings on the index. By this measure, the market is more richly valued than at any time except during the dot-com boom.

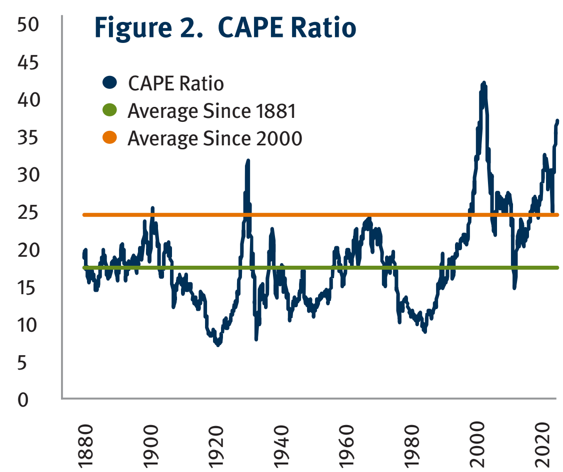


Source: Stifel Investment Strategy via Bloomberg, as of September 15, 2021

The Interest Rate Effect

When we consider P/E, it is important to understand the effect of the level of interest rates on this measure. To say it another way, we'll want to understand how the earnings yield, the reciprocal of P/E, or E/P, compares to the yield available from fixed income. We consider two fixed income yields as a reference, the 10-year Treasury rate and the yield on the Bloomberg Barclays Aggregate Bond Index.

Figure 3 shows the results. We analyze the S&P 500 earnings yield against both forward- and backward-looking earnings, comparing these earnings yields to the two fixed income benchmark yields mentioned above. The takeaway from this analysis? Each of these excess yields is just above its median excess yield, looking back over the last 20 years. By these bond market yield-adjusted measures, markets are fairly valued.



Source: Stifel Investment Strategy via Robert J. Shiller, as of September 15, 2021

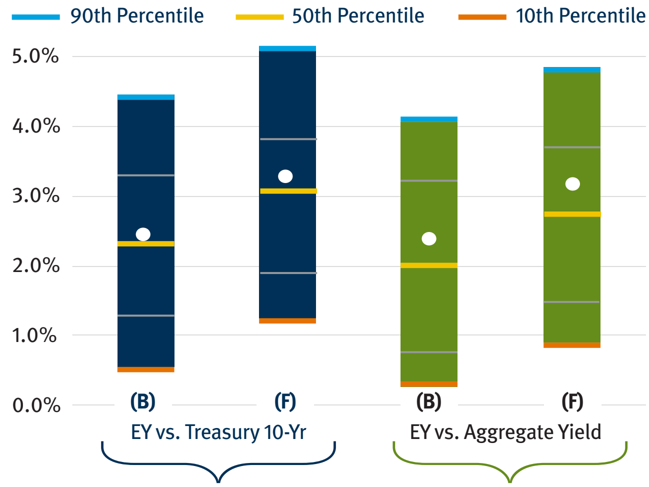
Current Risks

As my team and I analyze the current macro and market environment, we remain positive looking forward as a result of three themes driving our views: 1) We believe that we remain on the path to herd immunity, the delta variant surge is likely peaking soon in the U.S., and any impact to economic activity will be manageable; 2) Unemployment should continue to recover, and the rise in inflation will prove to be transitory; and 3) Monetary and fiscal policy will be recalibrated but still remain supportive.

While we view our base case as the most likely outcome, a focus on risks is foundational to our process. And we see a number of potential risks that could trigger stock market volatility, including a market correction or even a bear market. For example, the delta variant is causing trouble, and we see reopening slowing down some as a result. People are reengaging, but perhaps not as much as if this highly contagious variant wasn't such a risk. But the emergence of a vaccine-resistant variant is also possible. Should a variant that is vaccine resistant and/or much more lethal develop, markets would undoubtedly react.

Another risk in focus is inflation, which has heated up in 2021 due to frictions in the supply chain and the stages we're going through to reopen the economy. The Federal Reserve, and seemingly investors on average, believe this inflation is transitory and will calm down in 2022. So sustained higher inflation can trigger market weakness.

Figure 3. Excess Yield
(Earnings Yield vs. 10-Year Treasury & Aggregate Bond Index)



Source: Stifel Investment Strategy via Bloomberg, as of September 15, 2021. EY - Earnings Yield, (B) - Backward-Looking, (F) - Forward-Looking. Dots represent current values. Aggregate Bond Index is the Bloomberg Barclays U.S. Aggregate Bond Index

A third risk worth mentioning is geopolitics. Here in the U.S., the government is pursuing trillions of dollars in spending and higher taxes. And if the market hasn't yet "priced in" these higher taxes, this legislative or budgetary action can increase volatility. Outside the U.S., we will keep an eye on elevated tensions between the U.S. and China, the U.S. and Russia, and the U.S. and the Middle East.

Conclusion

Clients often ask: Where are stocks headed from here? When we look simply at common valuation metrics, like P/Es, stocks are richly valued, which often means a move down is more likely. But when we adjust for the level of market interest rates, one can make the case that stocks are, in fact, more fairly valued. And yet, we're mindful of a macro and market environment with risks that create a strong possibility of increased market volatility, including downside risks from here.

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