Reflections

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The stock market and a different kind of investor

Those who have invested in the stock market over the past six months have probably gained some new grey hairs. It has been quite a roller coaster ride. Optimism in early 2020 was followed by fast-plunging share prices, then a period of sharp rebounds. Today many people are amazed by this rapid recovery and wonder if the stock market has gone crazy: ignoring all the problems, challenges and risks facing the world economy because of the COVID-19 pandemic. Stocks are also more expensive than for years. We must go back to the IT (dotcom) bubble to find higher price-to-earnings ratios than today. How should we view the stock market during the rest of 2020? What are the signs that the rally can continue? The following article is about this – and about a different kind of investor.

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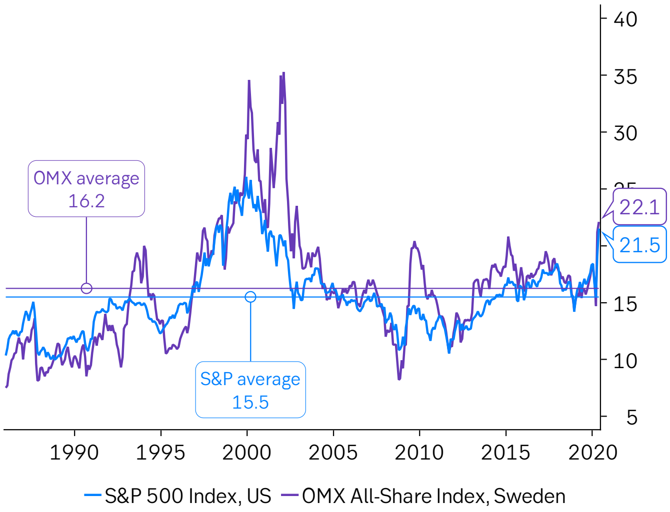
Put simply, stock market investments are about two things. First, how big profits you think a company will earn, and second, how much you are willing to pay today to buy a piece of these profits.

Let's begin with the size of the profits. This is determined by the economic situation and by changing demand and prices for a company's products. As we know, there is great uncertainty about economic trends and how quickly the world economy will recover. But there is a consensus that profits will be much lower this year than in 2019 and will not fully recover even in 2021.

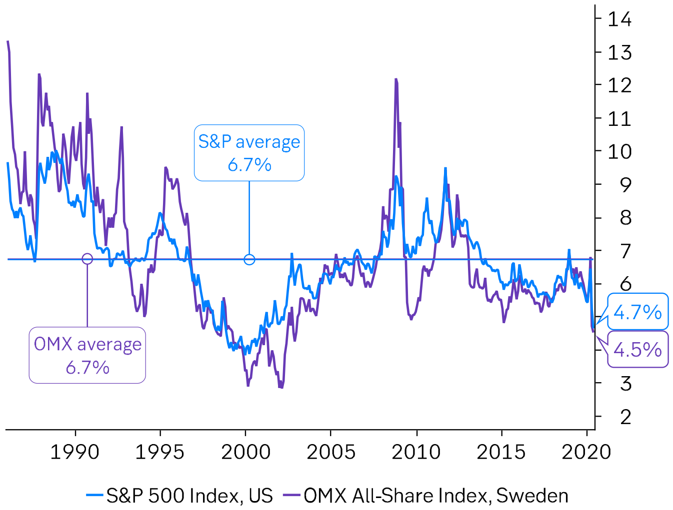
But the size of a company's profits must also be viewed in relation to its share price. This enables us to gauge its value. The simplest corporate valuation metric is the price to earnings (PE) ratio: how many years of profit a company's shares are valued at. Instead of using the most recently reported profit, we instead generally look at valuation in terms of the profit expected during the next 12 months (12-month forward-looking PE). If we look at how these forward-looking PE ratios have changed over the past three decades or so, today's valuations are clearly overstretched in a historical perspective. Both in Sweden and the United States, PE ratios are at their highest since the IT (or dotcom) bubble around the turn of the millennium (see chart). So it is hard to ignore the fact that there is plenty of room for prices to fall.

12-month forward-looking PE ratios



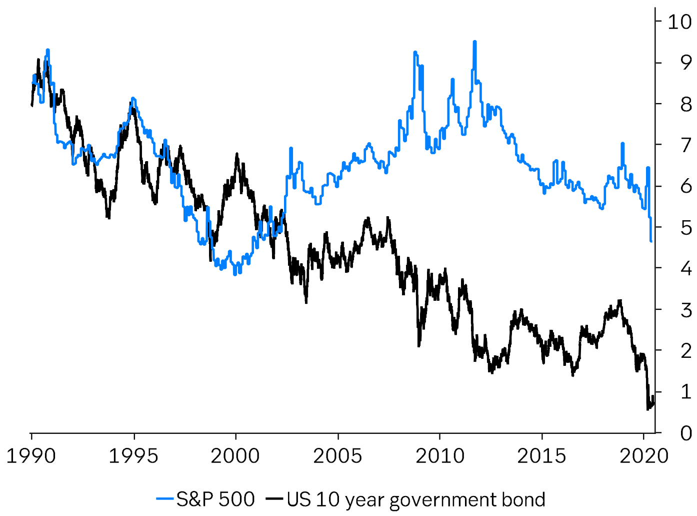
But the valuation of an asset class must always be viewed in light of what returns you receive if you instead choose to invest in something else. Expected stock market returns can be calculated by simply inverting the P/E ratio to obtain the earnings-to-price (EP) ratio. Historically, investors have required an expected return of 6.7% in Sweden and the US to invest in stocks. But today they are satisfied with about 4.5%.

Expected stock market return



Today stock market investors are accepting a lower return because the returns on alternative assets have fallen even more. Those who choose to keep money in an ordinary bank account receive a 0% return, and today a 10-year US government bond pays only 0.7%. In light of this, stocks look better than ever. To those with some knowledge of stock market theory, this is nothing new. The interplay between stock and bond market returns was observed as far back as 1997 by the economist Edward Yardeni. His model says that if markets are correctly valued, the expected return on a diversified portfolio should be the same regardless of whether you choose stocks or bonds. This formula was cited by other economists, including former US Federal Reserve chairman Alan Greenspan, and is usually referred to as the "Fed model". Otherwise the relative valuation argument we are hearing most often today is TINA (There Is No Alternative), which means that bond yields are so low that stocks are the "only" alternative.

Expected stock market and 10-year bond returns



Although the relative valuation approach indicates that there is no great reason to worry, we should be aware that historically speaking there has been no insurance against sizeable short-term crashes and corrections. So judging by historical PE ratio valuations, stocks look very expensive. But assuming continued very low interest rates, stocks look very cheap. It is indeed not easy to know which version to believe.

A different kind of investor

But let's ignore valuation metrics and profit expectations and instead look at stocks like any other product. In order for prices to rise, stocks don't necessarily have to be cheap. It suffices if, for some reason, the demand at a given point in time exceeds the supply. Supply and demand are ultimately what steers all free markets, and the stock market is no exception. As long as all investors behave rationally with the aim of maximising their returns, valuations and profit expectations will work smoothly over time to steer prices towards fairly reasonable levels. But what happens when an investor shows up with motives that are completely different from profit maximisation?

This is where central banks come into the picture. Central banks are interesting market players, since their motives for buying assets are completely different from those of ordinary investors. They don't buy bonds because they believe their prices will rise, making them a good investment. Instead they buy in order to push up inflation expectations in their economy, or in order to weaken their currency. Whether these purchases result in a profit or a loss is not the most important thing. For example, Sweden's Riksbank has clearly stated that it expects to see price declines in its bond portfolio, which totals more than SEK 500 billion today. If the Riksbank successfully pushes inflation higher, long-term yields will rise and the price of its bonds will fall. But for the Riksbank, this is just fine. The same is true of the Fed, European Central Bank, Bank of Japan, Bank of England, Swiss National Bank and all other central banks that practise quantitative easing.

Central banks around the world are busy "printing" money. They create new money out of thin air and use it to buy financial assets. Expectations are that QE will total a mind-boggling USD 6 trillion this year. So far these assets have mainly consisted of government bonds, but many central banks have also started buying corporate bonds. The Fed recently decided to start buying USD 250 billion worth of US corporate bonds. Some central banks, such as the BoJ and SNB, are also already buying equities.

This behaviour opens up opportunities for other investors. If an entity with unlimited resources and the ability to create money out of thin air says it will be buying and ignores whether this is expensive, there are good reasons to believe that we may see large divergences from normal valuations – not only due to the direct impact on prices caused by central bank purchases, but also because their purchases are a signal to other investors that they can make some free money if they just jump on the train. For ordinary investors, central banks will provide an important form of insurance. Even if there is a bubble, central banks guarantee that it will not burst – at least in the near term. The weaker the economy becomes, the greater the likelihood that central banks will do even more. If the economic downturn instead proves milder than many people fear, profits will recover faster and then share prices can climb without the help of central banks.

It remains uncertain whether the two largest central banks, the Fed and ECB, will actually begin buying stocks, but the step from corporate bonds to stocks is probably smaller than many people believe. A far more certain forecast is that central banks will, in any event, make sure that interest rates and bond yields will not climb before the economy has put the consequences of the pandemic behind it. This will take time. Low interest rates and yields will continue to prop up stocks and all other assets. Overall, there are good reasons to hope for a good stock market this autumn, despite the pandemic and historically high valuations.