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Investor Sentiment Reaches a Crescendo!

Why "Thrill and Euphoria" May Signal a Near-term Peak in the Stock Market

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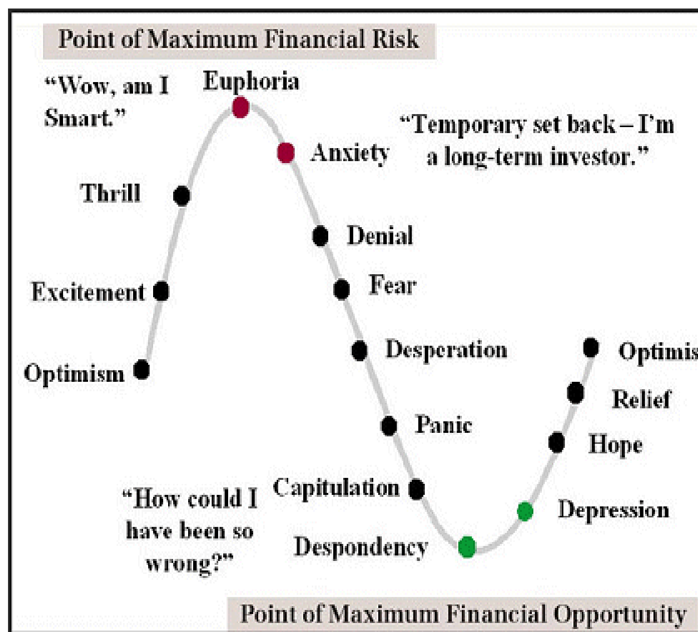
"I will tell you how to become rich…Be fearful when others are greedy. Be greedy when others are fearful." With these words, Warren Buffett neatly summed up the way investor sentiment should ideally mesh with stock market strategy to produce profits for the patient investor.

Understanding investor sentiment and the role it plays in stock market cycles, can inform our buy and sell decisions and make us better investors. A market where sentiment is depressed may offer good long-term buying opportunities, whereas a market where euphoria and greed reign, probably offers few. Euphoria often marks the peak in share prices after a long rise in the market, and often manifests itself in unmistakable ways, if we pay attention.

Between "Thrill" and "Euphoria"



Pinpointing where we are in the investor sentiment cycle is an art, as are many other aspects of investing. It requires keen attention and wide-eyed observation. Otherwise, atmospheric changes in mood can easily be missed.

The investment site Seeking Alpha, has a good schematic of the investor sentiment cycle, which I share with you on the left.

Note where "Thrill" and "Euphoria" appear in the cycle. They are near the very top of the bull market! These are the areas that Buffett characterized as signs of investor greed, and this is where I believe we are at this moment.

Let me offer a few personal anecdotes in support.

During the past few months, I have had conversations with several part-time investors who have been adding high momentum stocks to their portfolios, presumably because the stock market is going up and they don't want to miss out. High momentum stocks are ones that rise swiftly over a relatively short period of time. These stocks often look parabolic on the charts and are favorites of the risk-taking crowd no matter what underlying corporate fundamentals may be. Fundamentals matter far less to these investors than the sheer momentum of the trade.

Similarly, I have heard the stories of several do-it-yourself investors who have taken up options trading as a way to boost their investment returns. They say they are making money, and they may well be. Some of them are experienced in options trading, but most are novices. One of these newer traders has even set aside his normally lucrative day job to trade puts and calls. To him the profits seem easy and almost riskless.

In reality, according to the Options Clearing Corporation, which is the ultimate regulatory authority on the matter in the U.S., options and the strategies behind them can range in risk level from risky to very risky. This is why Warren Buffett once called options "financial instruments of mass destruction". There is no such thing as a riskless option. They are complex instruments that require considerable understanding, experience, and attention in order to be profitable. Unfortunately, they are now being marketed by a few of the larger brokerage houses as play things for ordinary investors who may be bored with the slower pace of stocks. Caveat emptor, let the buyer beware!

From an investor sentiment standpoint, these are the kinds of easy money stories that we hear during market tops when investing and trading seem like child's play. As the Seeking Alpha sentiment chart notes, this tends to be the "Wow, am I Smart" phase, just as the market peaks and prepares to fall.

Thrill and Euphoria are Unsupported by the Economic Outlook

Investor sentiment is one thing, but the economy and how it affects corporate fundamentals is another.

It should come as no surprise to anyone who follows the news or lives in the real world that the U.S. economy continues to be weak. For sure there are pockets of strength such as online retailing and healthcare, and some economic indicators have recovered substantially from the depths of March 2020, but overall the pandemic-driven shutdowns and slowdowns of the past nine months continue.

While U.S. unemployment at its broadest U-6 level has declined substantially to 12% from its March 2020 peak of nearly 23%, it remains well above its January 2020 low of 6.9%. At the depth of the Great Recession in 2008/2009 it hit a peak of roughly 17%. The U.S. economy is almost 70% consumer driven, so the current U-6 figure is unwelcome news.

Consumer sentiment meanwhile stands at 89 on the Conference Board's Consumer Confidence Index. This is not an encouraging number either. It indicates that consumers do not see a bright future for themselves at the moment. The Conference Board attributes this primarily to the effects of the pandemic. In February 2020, just before the pandemic-induced closing of the economy, the same index stood at almost 131.

Business sentiment on the other hand, is more encouraging, and stands at 101.17. Just prior to the pandemic it stood at 101.57, and fell to 98.35 at its lowest point in May. Likewise, the Conference Board's index of leading economic indicators has bounced back from its April 2020 low of 97 to now stand at 109.1. Prior to the pandemic it had stood at 112.1.

This is clearly a mixed bag of indicators on the health of the economy and what the future may hold. A more telling indication of the economy's prospects in the near-term comes from the actions taken by leaders in Washington.

For their part, the Trump Administration, Congress, and the Federal Reserve have pumped more than $4 trillion into the economy to keep it afloat during the pandemic. Some have described this effort as economic life-support, and I would agree with that characterization. The extra injection of cash has done nothing to regenerate businesses for the long-term or to restore employment to normal levels. Its purpose has been to keep a large swath of the population from financial ruin and the economy as a whole from descending into full-scale depression.

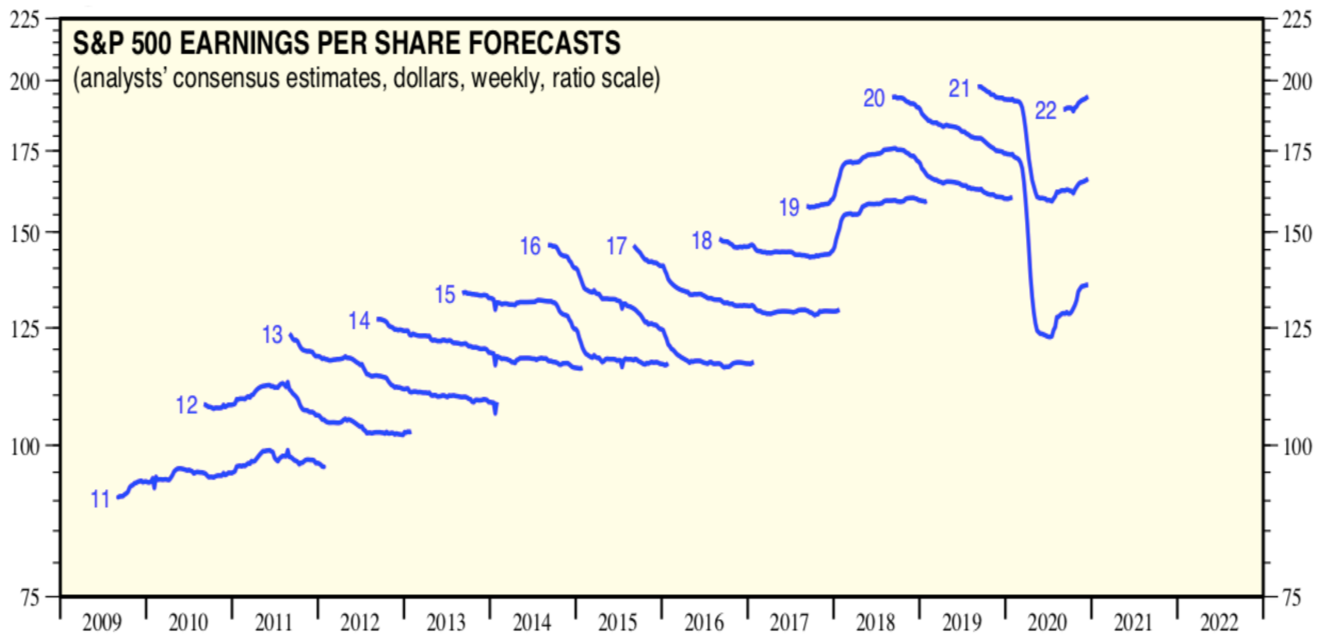
Thrill and Euphoria are Also Unsupported by Corporate Earnings

Corporate profits growth stagnated throughout 2020. Factset Research which keeps track of corporate statistics, estimates those full-year profits for S&P 500 companies will be down about -13.6% in aggregate for all of 2020. Last year S&P 500 earnings were down -0.1%.

FactSet's survey indicates that Wall Street analysts expect corporate profits in 2021 to rise by +22.1% due to favorable comparisons with depressed earnings in 2020 and because of organic growth in the economy. These analysts expect S&P 500 sales to rise by +7.9% for the same reasons.

The chart below, produced by Yardeni Research, provides a good view of the pattern that Wall Street's aggregate earnings estimates normally take. Please note that in 7 of the last 10 years, estimates have started at higher levels of optimism and then trended down over the course of the year until the final, actual, lower figure is reached. What this chart implies is that the current FactSet earnings expectations for 2021 may be too high and may trend lower over time as analysts incorporate new data into their models.

The uncertainties in the economic and political spheres are still sufficiently significant that they could continue to impact expectations for corporate profitability over the course of 2021.



Money Printing and Inflation

In the midst of the economic weakness and the massive money printing, inflation has taken center stage in the minds of both consumers and investors. Will the increased $4 trillion+ money supply lead to high inflation in the months and years ahead? If yes, then when?

So far, despite loose monetary and fiscal policies, inflation has been relatively subdued. The overall rate of inflation at the end of November 2020 (the latest reported period) was 1.2%. The Fed has been targeting a 2% inflation rate which they view as a sufficient level to allow the economy to grow in a steady trend, balancing supply and demand.

Certain categories of consumer goods have in fact been seeing larger-than-usual price increase since the start of the pandemic. Used cars for example, are up more than 10% year-over-year to November, while food and medical services are up 3.7% and 3.2%, respectively. Those have largely been offset, however, by the -9.4% drop in fuel prices.

The table below shows inflation levels for various categories of goods and services.

Table A. Percent changes in CPI for All Urban Consumers (CPI-U): U.S. city average

	Seasonally adjusted changes from preceding month							Un-adjusted 12-mos. ended Nov. 2020
	May 2020	Jun. 2020	Jul. 2020	Aug. 2020	Sep. 2020	Oct. 2020	Nov. 2020	
All items	-0.1	0.6	0.6	0.4	0.2	0.0	0.2	1.2
Food	0.7	0.6	-0.4	0.1	0.0	0.2	-0.1	3.7
Food at home	1.0	0.7	-1.1	-0.1	-0.4	0.1	-0.3	3.6
Food away from home[1]	0.4	0.5	0.5	0.3	0.6	0.3	0.1	3.8
Energy	-1.8	5.1	2.5	0.9	0.8	0.1	0.4	-9.4
Energy commodities	-3.5	11.7	5.3	2.0	-0.1	-0.5	-0.2	-19.3
Gasoline (all types)	-3.5	12.3	5.6	2.0	0.1	-0.5	-0.4	-19.3
Fuel oil	-6.3	10.2	4.3	3.9	-5.3	-0.3	3.6	-26.4
Energy services	-0.5	-0.2	0.0	-0.2	1.6	0.8	1.1	2.3
Electricity	-0.8	-0.3	0.3	-0.2	0.9	1.2	0.5	1.6
Utility (piped) gas service	0.8	0.0	-1.0	-0.2	4.2	-0.7	3.1	4.4
All items less food and energy	-0.1	0.2	0.6	0.4	0.2	0.0	0.2	1.6
Commodities less food and energy commodities	-0.2	0.2	0.7	1.0	0.8	-0.2	0.1	1.4
New vehicles	0.3	0.0	0.8	0.0	0.3	0.4	-0.1	1.6
Used cars and trucks	-0.4	-1.2	2.3	5.4	6.7	-0.1	-1.3	10.9
Apparel	-2.3	1.7	1.1	0.6	-0.5	-1.2	0.9	-5.2
Medical care commodities	0.1	0.2	0.0	-0.1	0.0	-0.8	-0.3	-1.1
Services less energy services	0.0	0.3	0.6	0.2	0.0	0.1	0.2	1.7
Shelter	0.2	0.1	0.2	0.1	0.1	0.1	0.1	1.9
Transportation services	-3.6	2.1	3.6	0.0	-0.9	0.1	1.8	-3.4
Medical care services	0.6	0.5	0.5	0.1	0.0	-0.3	-0.1	3.2

[1] Not seasonally adjusted.

With the trillions of dollars pumped into the economy this year, concerns over inflation and a continuing weak economy are justified. But what would a high inflation, low economic growth scenario look like if it materializes? It might look something like the 1970s.

A Brief Lesson from History: The Stagflation of the 1970s

Perhaps the best example of a time when inflation was high in the U.S. after a period of massive money printing, and during a recession, was the 1970s.

The '70s were a time of weaker economic growth than the 1960s. Inflation-adjusted GDP growth averaged 3.19% in the '70s versus 4.29% in the '60s. The Vietnam War may have been partly to blame for the slowdown. It had strained the nation's psyche and impacted consumer confidence. The war had been financed by both taxation and money printing.

Money printing is the process by which governments increase the supply of circulating currency in the economy. It is usually done in one or more of several ways. These may include direct creation of currency notes, government borrowing via treasury debt, or lowering bank reserve requirements to free up otherwise restricted cash for lending. In any of these cases, money printing can easily go unnoticed by the citizenry and requires far less public justification by politicians than direct taxation.

On top of the money printing, the OPEC oil shock of 1973 caused the price of oil to quadruple from roughly $3.00 a barrel to $12 a barrel. In the short-term, crude oil demand is relatively inelastic, meaning that an immediate increase in its price does not necessarily reduce its demand by consumers and industry. Consequently, the prices of associated goods such as plastics and gasoline can shoot higher - this is what we saw in the '70s. Inflation entered the economic picture, raised the price of a vital commodity, and resulted in higher costs and a recession.

In response, the Federal Reserve Bank, lowered interest rates to encourage borrowing. They believed it would revive the economy. It turned out to be the wrong policy move. It encouraged consumer and corporate spending during a time of already rising prices. It helped to fuel inflation. Bear in mind that at this point China had not yet opened its economy to foreigners or become the low-cost mega-factory to the world that it is today, and Japan was producing only low-end, low-tech consumer goods that did not compete with higher value American made goods. Globalization was minimal by today's standards.

As a result, the increase in the money supply from both the Vietnam War era and the later central bank printing meant that the extra dollars in the system were largely spent in the United States by American consumers. The United States was effectively a closed-loop economy for consumer products - consumers made their wages in the United States and then spent their earnings on U.S.-made goods such as cars and television sets. However, the supply of U.S.-made items was limited, meaning that a significant increase in demand by consumers would result in inflation. By the end of the 1970s, inflation in the United States stood at nearly 15%.

Inflation that materializes during otherwise weak, or stagnant, economic conditions is called stagflation.

While 1970s style stagflation may not be in our immediate future, the possibility should not be dismissed outright. Inflation tends to enter the economic scene with a lag. Although we still have cheap imports of consumer products from many low-cost parts of the world, supply shortages, increases in tariffs, or supply chain disruptions could produce an imbalance between supply and demand. This could lead to higher inflation. We are already seeing some of that during the pandemic as supply chain and production disruptions persist globally and demand stays level.

Stock Market Risk Outweighs Reward

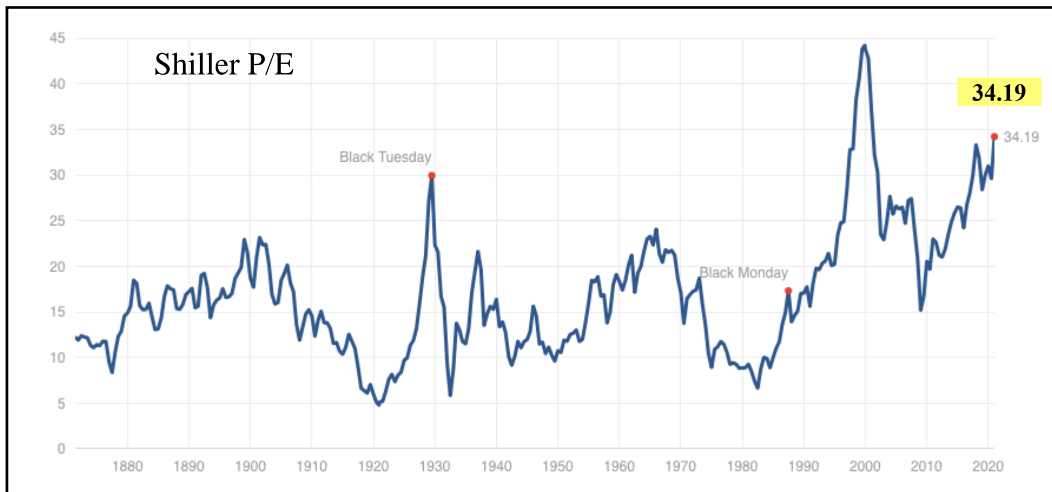
While stagflation is only one factor to be aware of at the moment and not a reality facing us imminently, the movement of the stock market over the last three years, mirrors the market of the 1970s. The timeframe is much shorter, but the market's steep declines followed by its steep rises are reminiscent of the 1970s, a time when stocks went sideways on a net basis.

Rising inflation combined with weak economic growth is a potentially negative scenario for the stock market. Inflation eats into consumer and corporate buying power and erodes the value of savings. Simultaneously, slow economic growth boosts unemployment and makes it difficult for consumers and savers to stay ahead of inflation. The stagflation scenario creates an atmosphere

of uncertainty and insecurity and social unrest. Over the next year or two we could see these sentiments reflected in the mood of the stock market as the economic picture unfolds.

When combined with persistently high stock market valuations and uncertain corporate profits growth, this lack of clarity continues to skew the stock market's risk/reward scenario far more toward risk than to reward. The economy is still officially in recession and the Covid-19 pandemic continues to cloud future economic and business prospects.

Continue to Minimize Risk and Focus on Quality



The stock market stands at an even higher valuation multiple today than it did at the end of the third quarter. The chart above shows that the Shiller P/E now stands at 34.19, 116% above its historical median average of 15.81, and 11% higher than its third quarter 2020 level of 30.79. If anything is empirical proof of the market's "thrill and euphoria" sentiment, this may be it.

Further proof of this sentiment is the boom in margin debt that investors and traders have taken on in order to leverage their participation in the stock market. Over the past several months, the increase in margin debt has reached levels not seen since just before the 2000 and 2007 stock market peaks. It is a clear sign that investor sentiment is now somewhere in the thrill and euphoria stage.

In addition to anecdotes, and high valuations, high margin debt is yet another warning sign that investors should heed.

Last quarter, I recommended that investors who need to use their assets in the next 12 to 24 months should take a cautious approach to their investments and should minimize risk rather than succumbing to FOMO, or fear of missing out. They should avoid diving headlong into the stock market with its current high valuation. That advice is truer today than it was last time.

As in all times of elevated investor sentiment, it pays to know where we stand and what we can expect. It also pays to focus on quality. Companies with earnings growth, dividend payments, low debt, sound management, and world-class products and services, are always preferable to the latest short-term high flyer that trades more on “thrill and euphoria” than on proven fundamentals.

V. Henry Astarjian

Disclosures

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