Global Research & Investment Strategy

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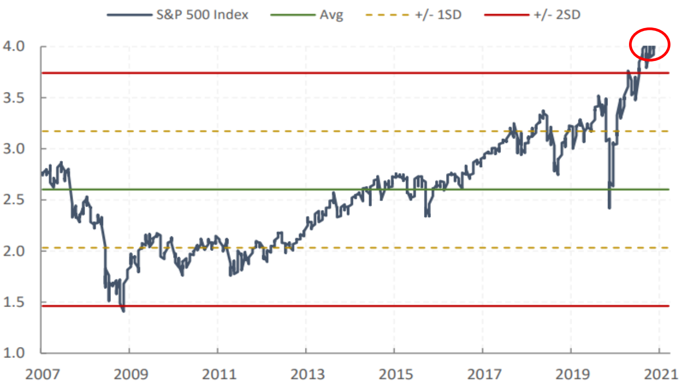
US Equities Risk-Reward Fading

We are starting to fear there is potentially more downside risk than upside on the S&P 500 Index through year-end and wanted to use this note to communicate this view to clients.

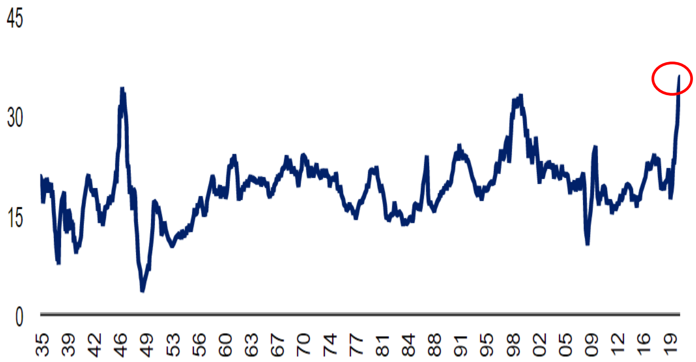
The S&P 500 remains expensive on most metrics. The price-to-book ratio **(Chart 1)** of 4.2x is 2.2 standard deviations above the average since 1978. Forward and Shiller price-to-earnings ratios offer the same conclusion. The S&P 500 Index is priced for perfection. The "Rule of 20" has generally been a good strategy - when the sum of S&P 500 trailing P/E ratio and inflation (CPI) was below 20, stocks returned +11% over the subsequent 12 months (74% hit rate) vs. just +4% when it was above 20 (64% hit rate). But today, not only is the measure above 20, but it's also at the highest level in history since 1935 at 36x, topping 30x only for the third time in history **(Chart 2)**. The "Rule of 30" would suggest downside risk: the S&P 500 fell 2.1% on average (44% hit rate) over the subsequent 12 months when the reading was >30.

Chart 1. S&P 500 Index Price-to-Book Ratio



Source. MAM Research

Chart 2. S&P TTM P/E Plus CPI (1935-Today)

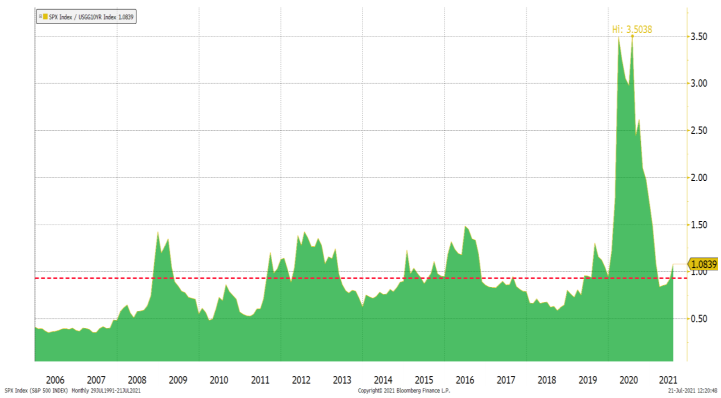


Source. BofA Global Research

The only exception is when we look at Equities relative to Bonds. With the US 10-yr yield falling 55bps since the March peak, the ratio of S&P dividend yield vs. the 10-yr yield rose to 1.08x, the highest level since February and in line with the post-GFC average **(Chart 3)**. But given the lowest dividend yield since 2001 (1.3%), the ratio could quickly fall if rates start moving higher again (our house view) and pose downside risks to the market, especially amid record duration risk.

Sentiment in equity markets is close to euphoric, at a time when other asset classes are starting to sound the alarm. The recent US 10-yr yield's correction, the appreciation of the USD and the correction of highly speculative instruments such as Bitcoin, or all sign-posts of uncertainty ahead.

Chart 3. S&P Div. Yield / 10-yr Bond Yield



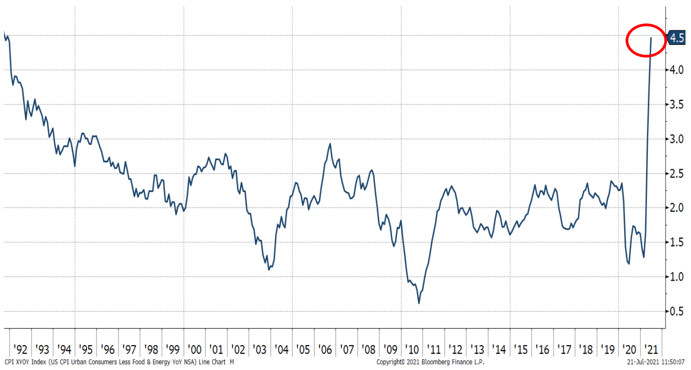
Source. Bloomberg, MAM Research

What is driving this? The delta variant spread is likely to accelerate further in the US and Europe in September. With vaccination rates only at 60%+, the risk of renewed hospital saturation is high. This is happening at a time when inflation especially in the US is rising rapidly **(Chart 5)**. The US Central Bank is cornered between the need to remain accommodative to support the economy further while also starting to control inflation. The room for error is very limited. The next big event for the Fed is the September 22nd meeting. The market is extremely divided on the outcome. Will Covid and the Fed put downward pressure on growth and inflation or will inflation persist.

Beyond the macro concerns, we are noticing some cautiousness at the corporate level. 20% of the S&P 500 Index companies have reported Q2 results. The proportion of companies beating earnings is positive. However, while still early, a handful of companies has warned about rising cost pressure (Delta Airlines, Fastenal, Conagra, McCormick…). The margin outlook can be particularly challenging for companies facing slowing demand against continued upward cost pressure. Margin pressure is rarely a positive recipe for equity market multiples and future returns.

Where does MAM stand on this? We remain convinced that inflation in the US is not transitory. Supply bottle-necks remain while demand should continue to be supported as the vaccine roll-out expands. We believe US 10-yr bond yields will resume their uptrend towards 2% exerting pressure on “growth stocks” heavy US indices (S&P 500 Index, Nasdaq Index) and favouring a renewed rotation to “value stocks”. Credit markets are too expensive. We remain bearish. We are still long-term commodity bulls and believe Gold and Silver will start performing again towards year-end. As such, we believe that the underperformance we have suffered the past few weeks will revert to outperformance into year-end. Conscious of the downside risk in US equity markets and the speed at which these corrections can take place, we are reducing equity market risk across portfolios. Also, conscious of the significant exposure to the rising inflation thesis in portfolios, we have decided to increase USD exposure in EUR accounts to balance this positioning. While fundamentals all point to a weaker USD longer-term, the short-term relief rally in the USD may have further room to run **(Chart 6)**. Our short-term target for the EUR/USD exchange rate is 1.15.

Chart 5. US Core CPI YoY



Source. Bloomberg

Chart 6. USD Index (Weekly)

Source. Bloomberg

Investment Implications

In light of the view aforementioned, we are implementing the following in portfolios:

1. Reduction of equity market exposure in balanced portfolios from 50% to 37.5% through either:
   a) Purchase of S&P 500 ETF 100%-85% Put Spreads with a maturity of January 2022, or
   b) Outright sale of investments primarily in the US.
2. Increase of USD exposure in EUR accounts from 10% currently to a target of 20%.

As usual, please let us know if you have any comments or questions.

Kind regards,

MAM Investment Team

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