



US STOCKS: OF BUBBLES AND COUNTERS!

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A Market Post?

- I don't write much about equity markets collectively, for two reasons.
 - ▣ The first is that there is nothing particularly new or insightful that I can bring to overall market analysis, and I generally find most market punditry, including my own, to be more a hindrance than a help, when it comes to investing.
 - ▣ The second is that I am a terrible market timer, and having learned that lesson, try as best as I can to steer away from prognosticating about future market direction.
- As markets test their highs, talk of market bubbles has moved back to the front pages, and I think it is time that we have this debate again.

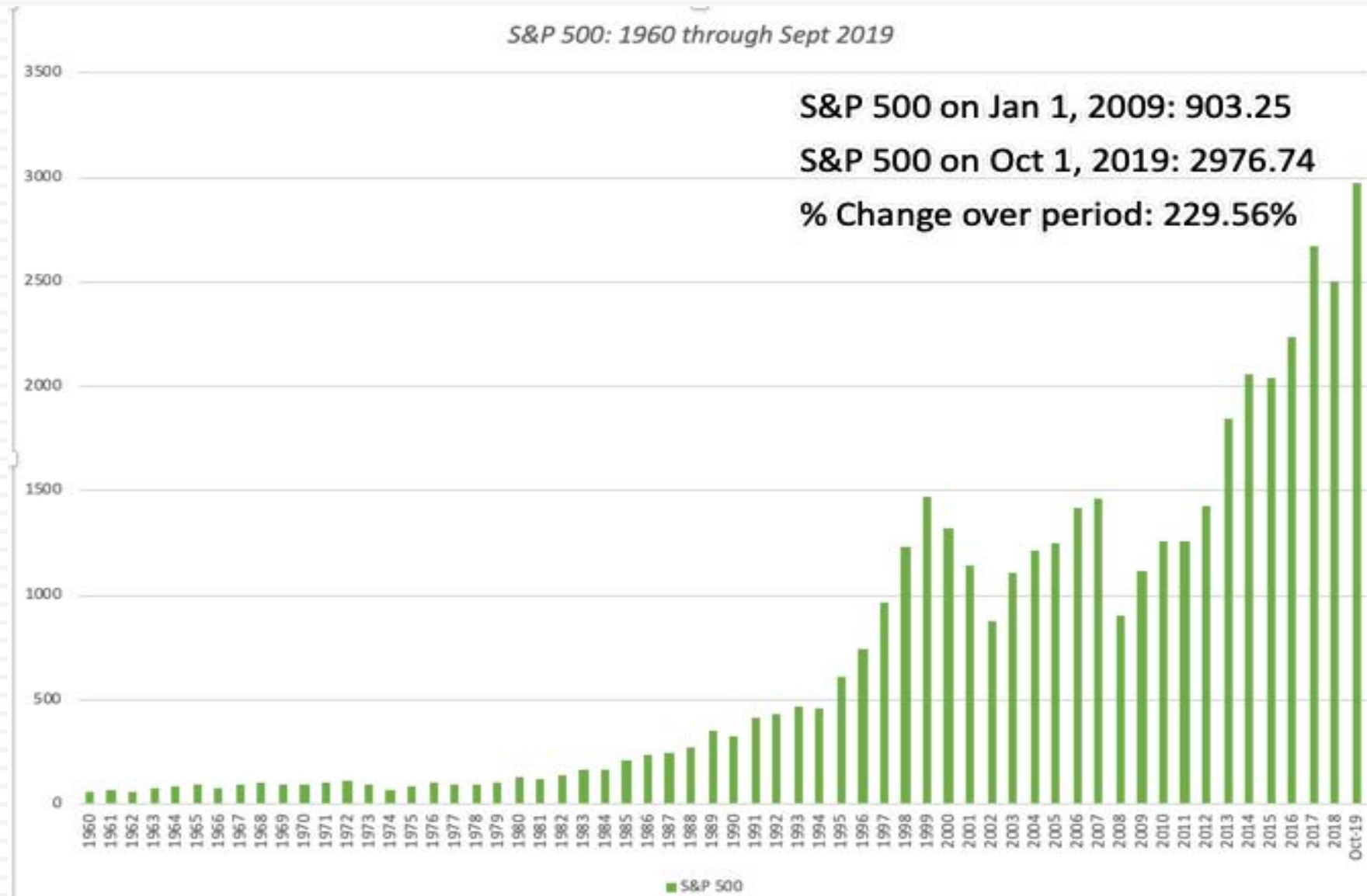
Who are you going to believe?

- There are clearly political and economic storms on the horizon but there seems to be no consensus on what those storms will mean for markets.
 - ▣ The US equity market itself has been resilient, taking bad macroeconomic and political news in stride, and a bad day, week or month seems to be followed by a strong one, often leaving the market unchanged but investors wrung out.
 - ▣ Investors themselves seem to be split down the middle, with the optimists winning out in one period and the pessimists in the next one.
 - ▣ Market and macroeconomic experts seem for the most part either terrified or befuddled.

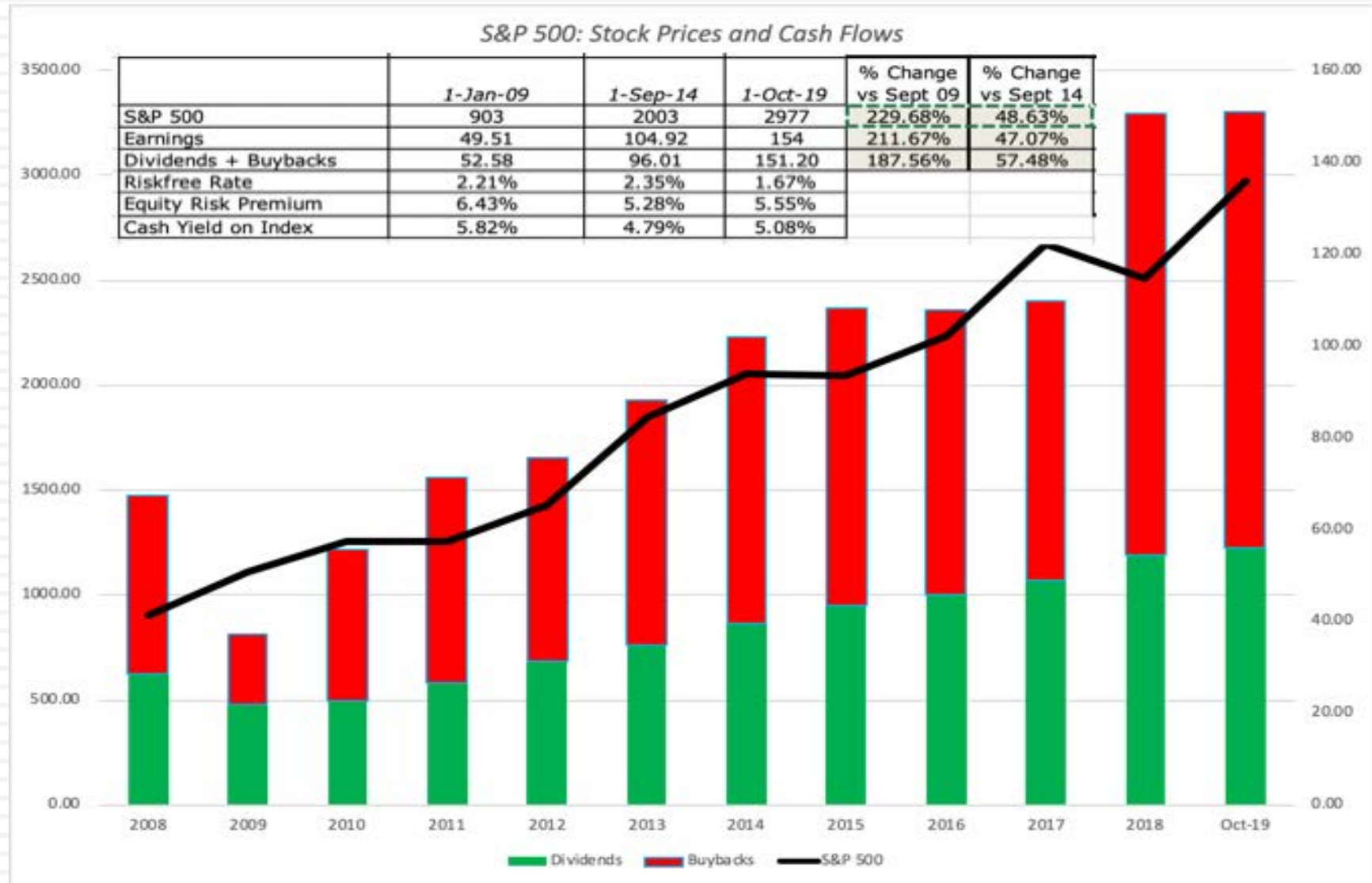
A Bubble or Not a Bubble?

- Why do so many people, some of whom have solid market pedigrees and even Nobel prizes, believe that markets are in a bubble?
 - ▣ The two most common explanations reflect a trust in mean reversion, i.e., that markets revert back to historic norms.
 - ▣ The third one is a more subtle argument about winners and losers in the market, and in the economy.
 - ▣ The final argument is a conspiratorial one, requiring that you buy into central banking cabals and market co-conspirators.
- With each argument, though, there are solid counter arguments and in presenting both sides, I am not trying to dodge the question, but I am interested in looking at the facts.

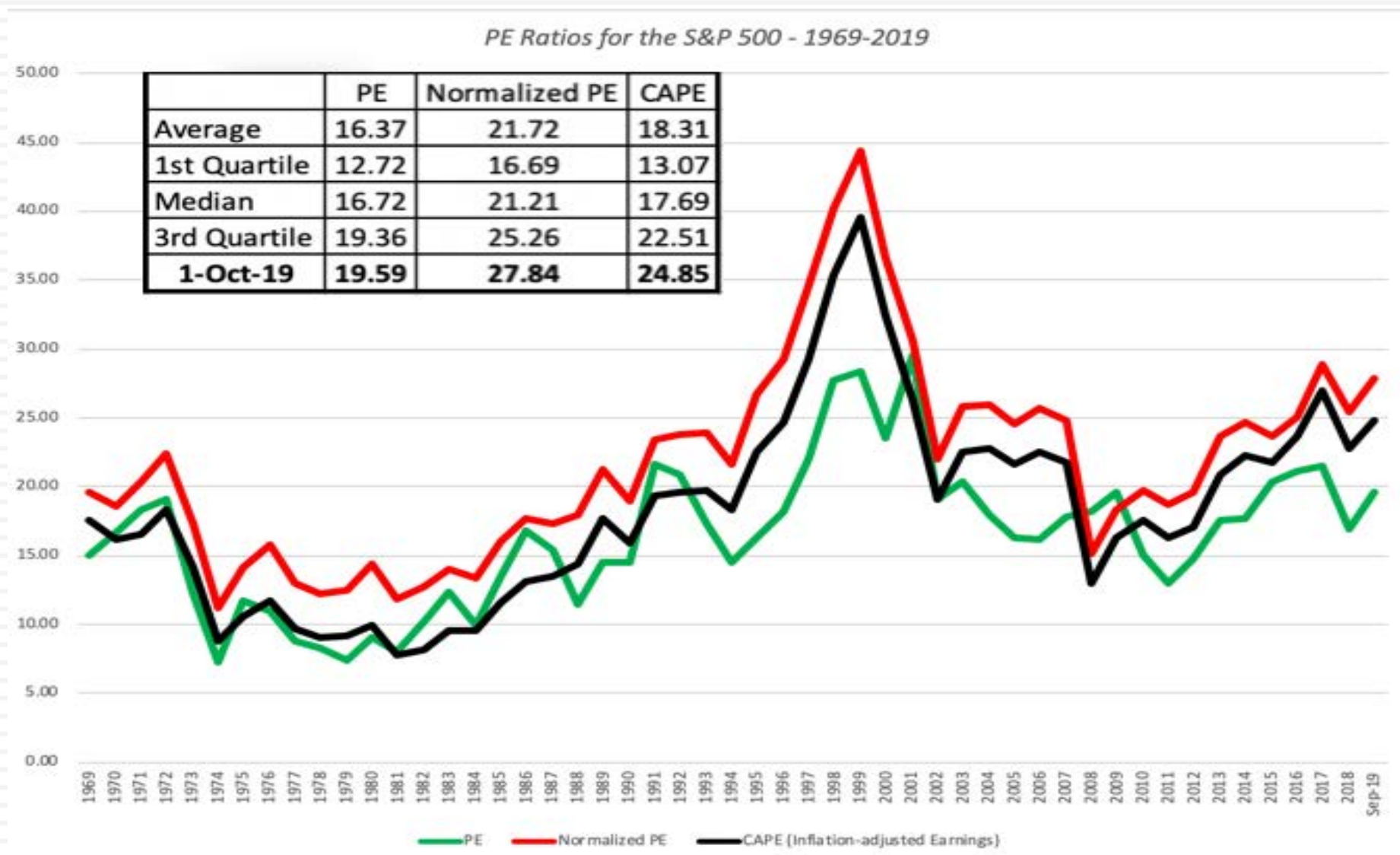
Bubble Argument 1: What goes up has to come down...



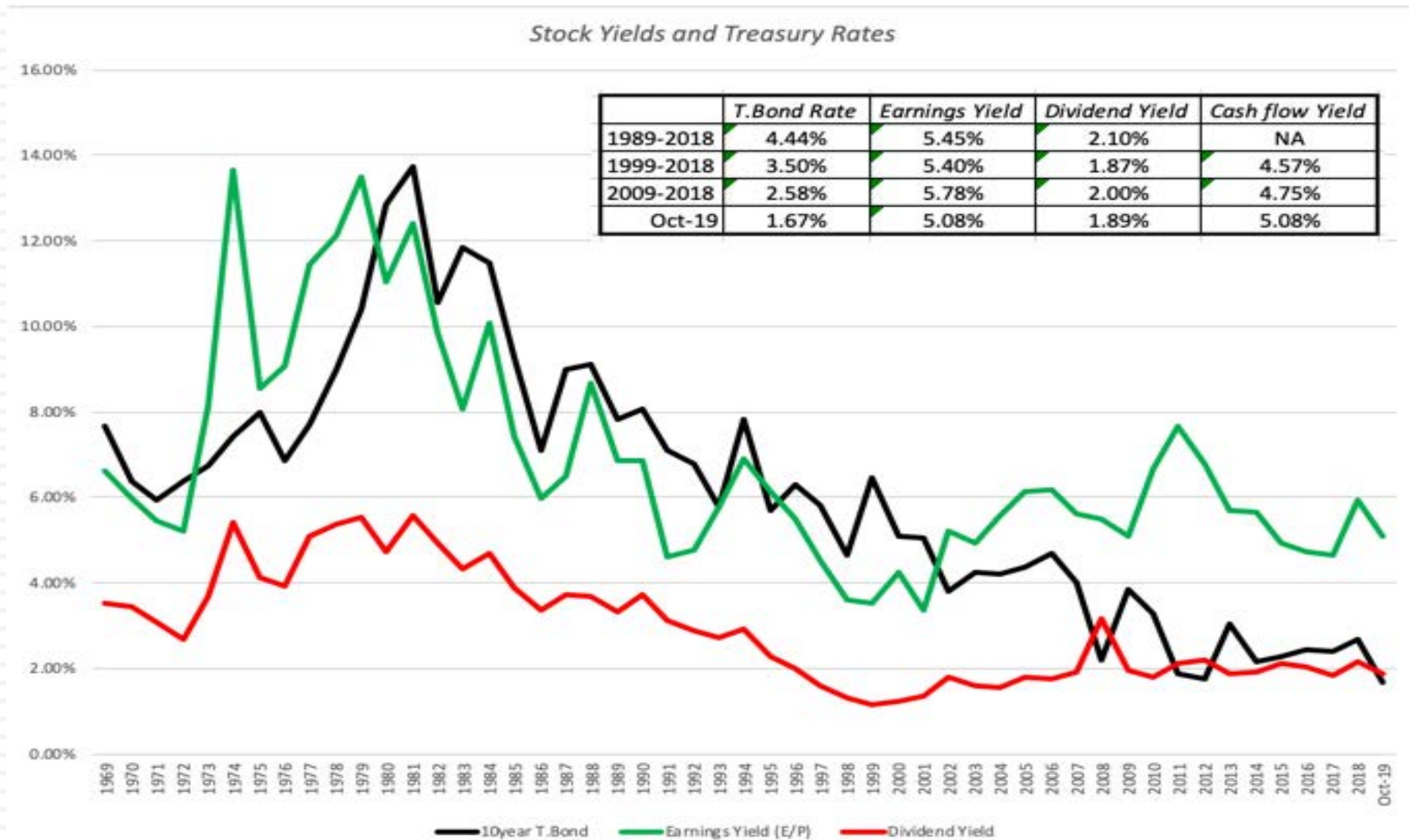
Counter Argument 1: It's not just stock prices that have gone up...



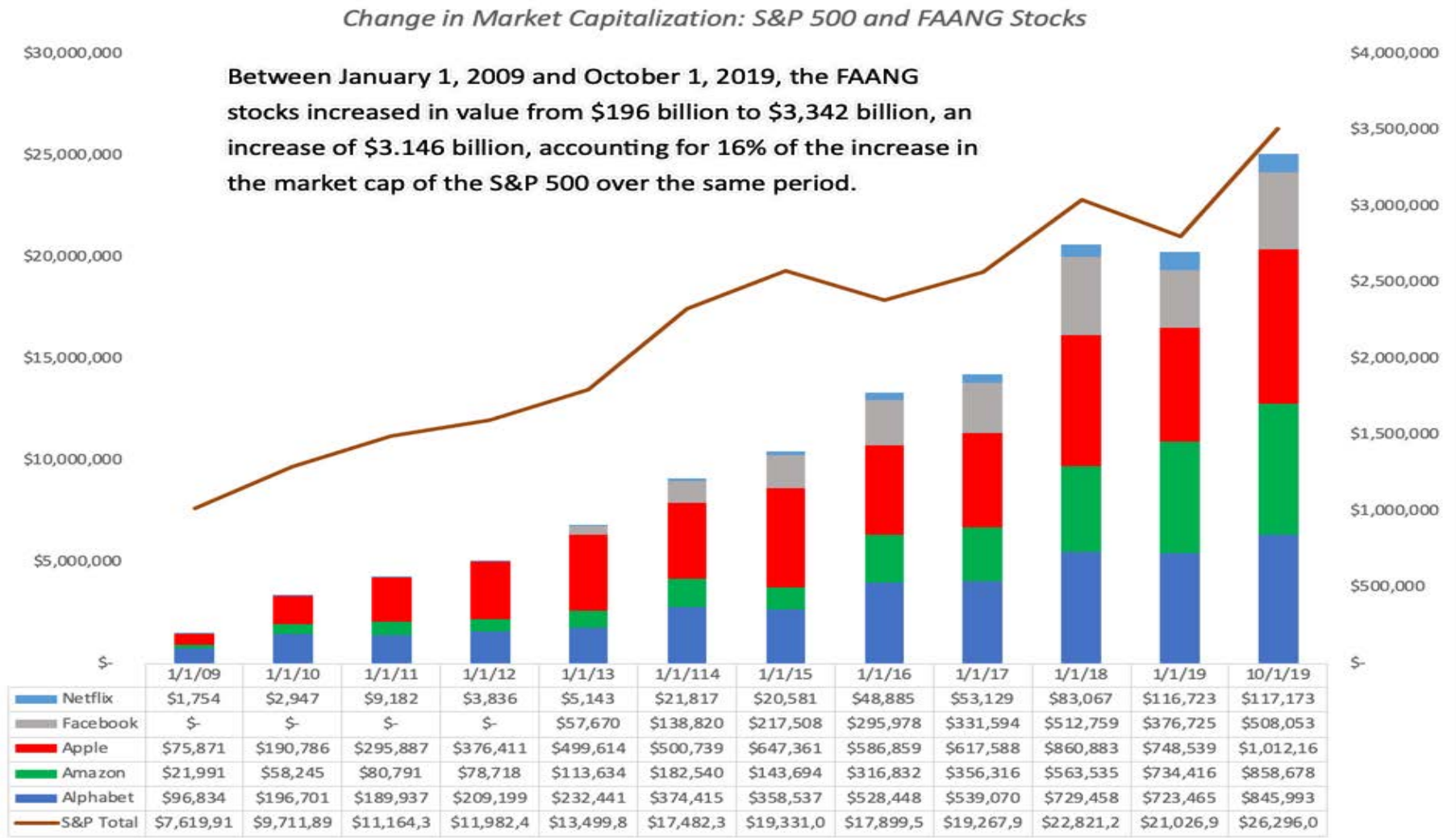
Argument 2: Stocks are expensive (relative to earnings) and relative to history...



Counter Argument 2: But so are the alternatives to stocks..



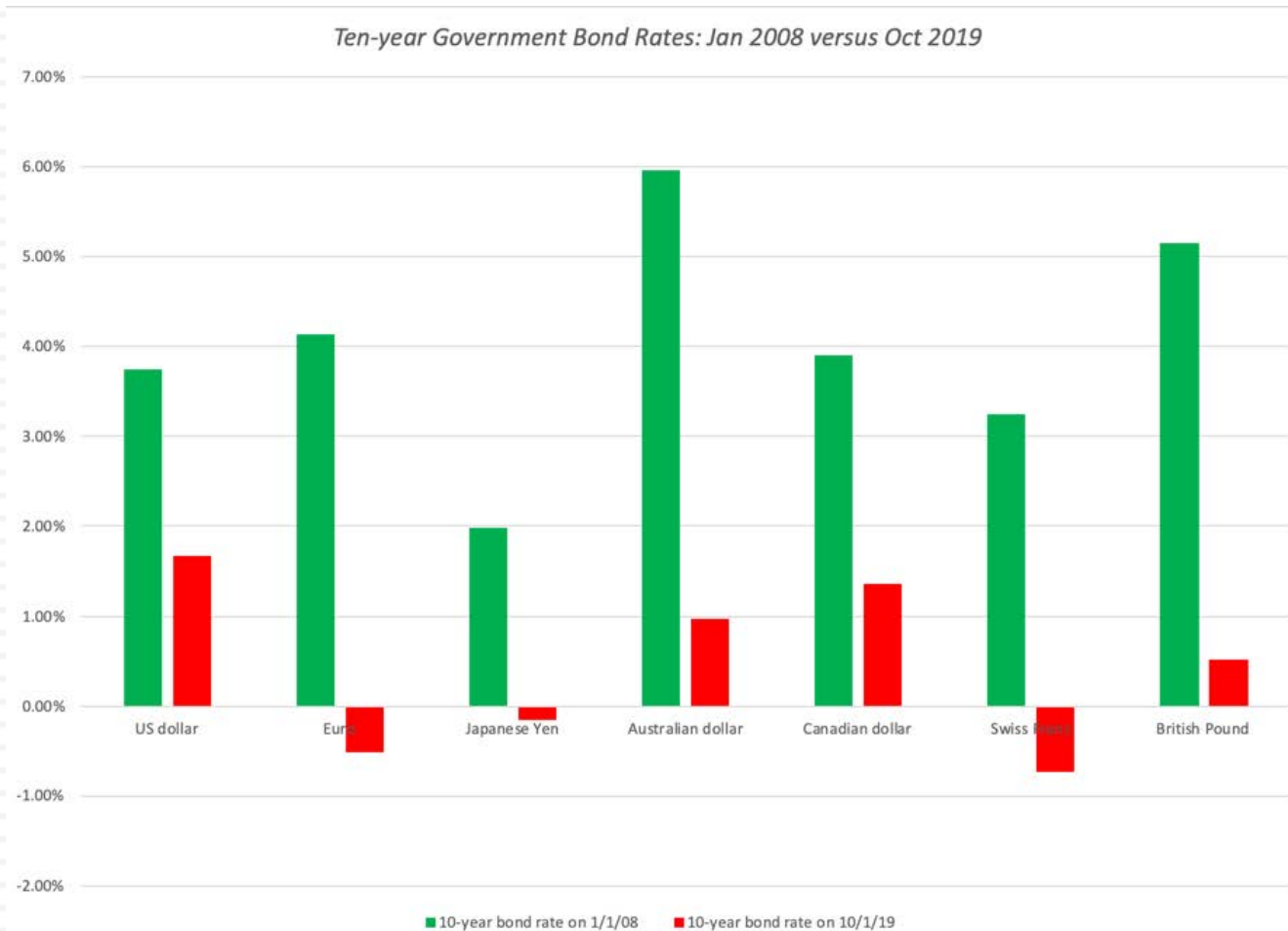
Argument 3: The market has gone up, but the gains are from a few stocks...



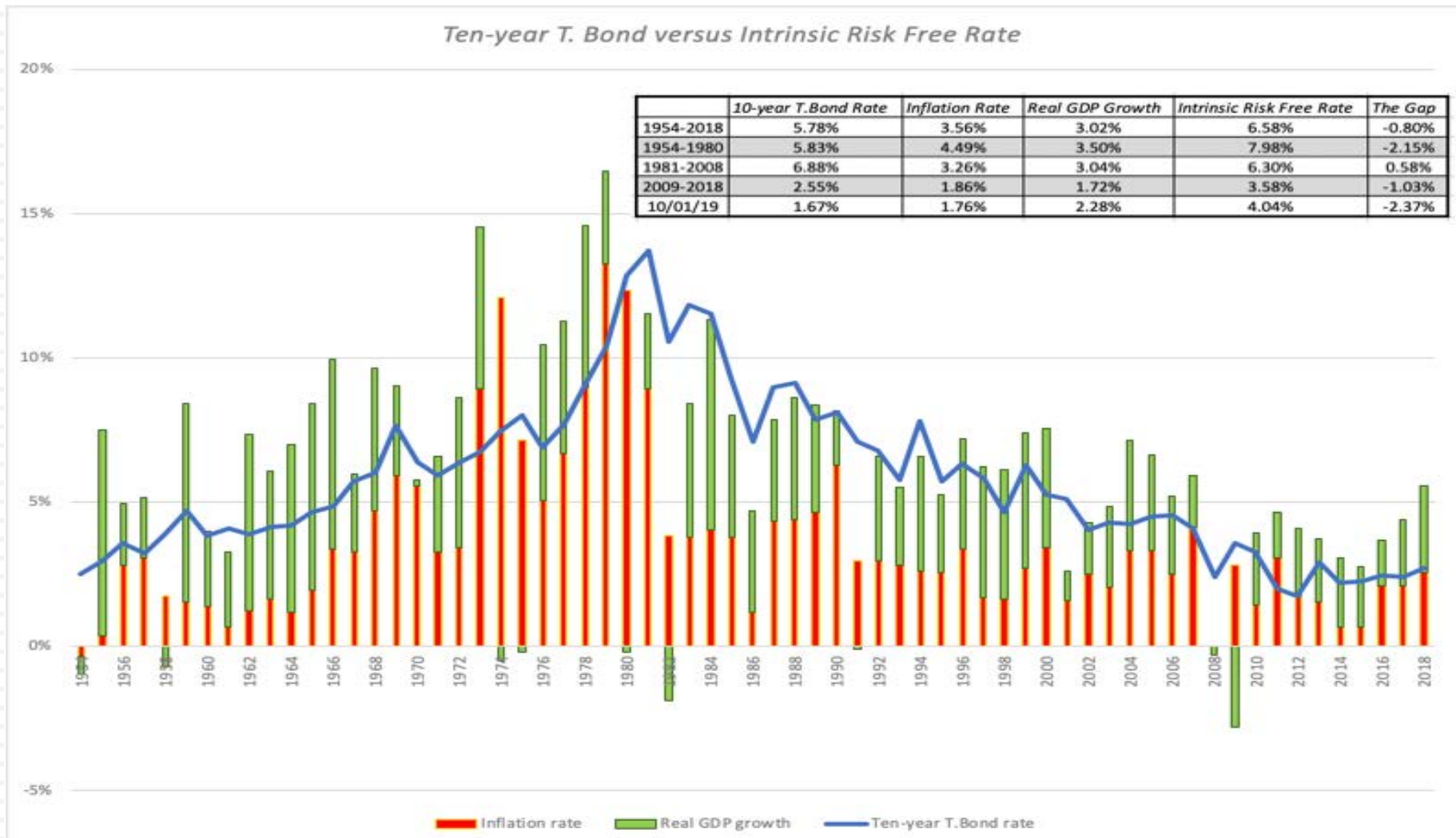
Counter Argument 3: Not uncommon and what if?

- Not unusual: There have been very few bull markets, where companies have shared equally in the gains, and it is more common than not for market gains to be concentrated in a small percentage of companies.
- Economic shifts: Each of the companies in the FAANG, for instance, has disrupted existing businesses and grabbed market share from long-standing players in these businesses and the nature of their offerings has given them networking benefits
- Regulatory backlash? It is possible, maybe even likely, that we will see anti-trust laws rewritten to restrain these companies from growing more or even breaking them up. While that would be bad news for investors in these companies, those rules are also likely to enrich some of the competition and push up their earnings and value.

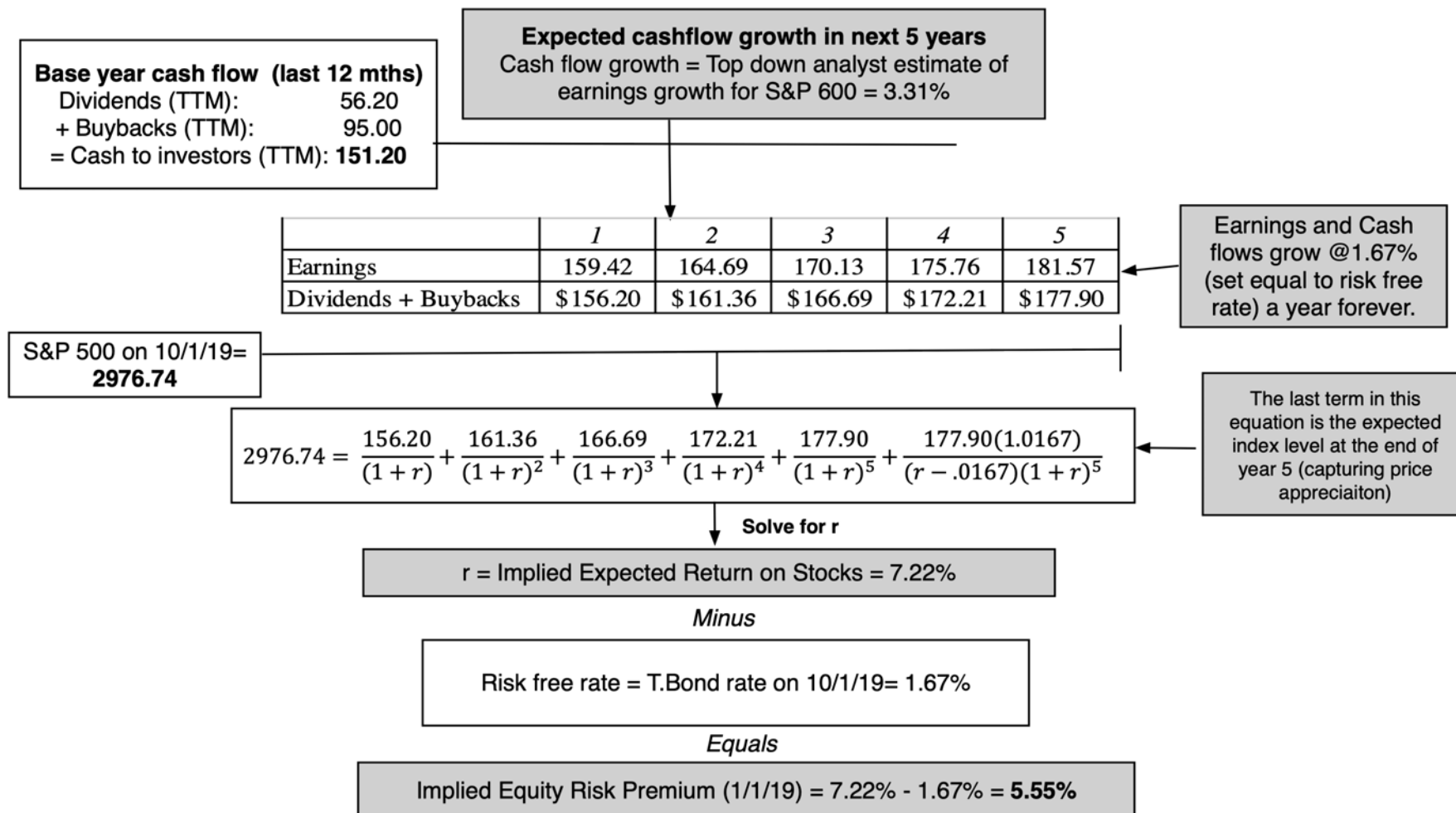
Argument 4: A Central Banking Prop up?



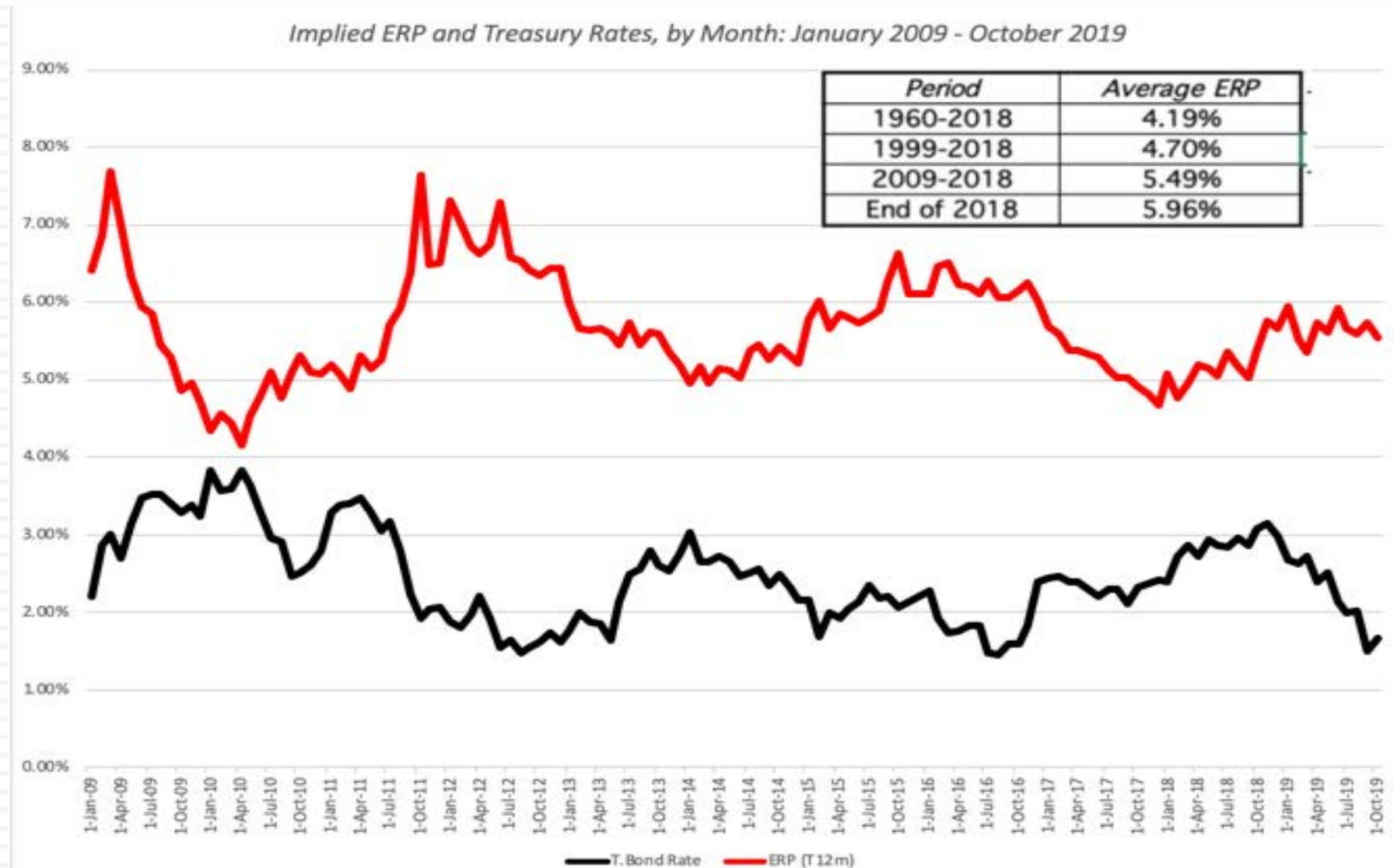
Counter Argument 4: Interest rates would have been down anyway...



A Composite Indicator: The Implied ERP



Reading the ERP: 2009-2019



Market Correction?

- At this point, you are probably putting me in the bullish category, but I am neither bullish nor bearish, just market-neutral.
- In other words, my investment philosophy is built on valuing individual companies, not taking a view on the market, and I will take the market as a given in my valuation.
- Does this mean that I am sanguine about the future prospects of equities? Not in the least! With equities, it is worth remembering that the coast is never clear and that the reason we get the equity risk premiums is because the future can deliver unpleasant surprises.

Scenario 1: An Implosion in Fundamentals

- Slow or negative global economic growth: The global economic slowdown picks up speed, spreads to the US and become a full-fledged recession.
- Cash flow pullback: This recession in conjunction with a large crisis (Hong Kong spins out of control, Brexit takes down the EU with it, political upheaval in Saudi Arabia) causes earnings to drop and companies to drastically reduce stock buybacks.
- T. Bond rates start to move back up towards normal levels: Higher inflation and central banks losing their persuasive power cause rates to move back up.

Scenario 2: A Global Crisis with Systemic After Shocks

- There are multiple potential crises unfolding around the world and one of these crises may be large enough, in terms of global and cross sector consequences, to cause a major market pull back.
- The triggering mechanism for the meltdown will be a jump in equity risk premiums to higher levels, as investors reassess market-wide risk, but for the crisis to have sustained consequences, it has to then feed into economic growth (perhaps through a drop in consumer and business confidence) and earnings and cash flows.
- After a decade of false alarms, investors are jaded, but the crisis calendar is full for the next two months, as Brexit, impeachment, Middle East turmoil and the trade war all play out, almost on a daily basis.

Bottom Line

- I am going to pass on market timing, accept the fact that the markets of today will be globally interconnected and more volatile than the markets of the last century, and stick to picking stocks.
- I hope that my choice of companies will provide at least partial protection in a market correction, but I know that if the market is down strongly, my stocks will be, as well.
- I know that some of you will disagree strongly with my market views, and I will not try to talk you out of them. If you are a master macroeconomic forecaster who believes that a perfect storm is coming where there is a global recession with a drop in earnings and a loss of corporate confidence (leading to a pull back on buybacks), perhaps accompanied by high inflation and high interest rates, you definitely should cash out, though I cannot think of a place for that cash to go, right now.