

Active is: Investing with conviction

With equities looking expensive, where should investors turn?

by [Stefan Hofrichter, CFA](#) | 20/05/2021   



Summary

US stocks are highly valued, and our 10-step checklist suggests they're close to bubble territory. Non-US equities offer better value, but we still don't think investors should drastically pare back their US holdings at this time.

Key takeaways

- Equities, especially in the US, are very expensive – around the level last seen before the tech bubble burst in the late 1990s
- High valuations are one of the 10 characteristics of an asset bubble that we've identified – and the majority are showing red flags
- But until the Fed starts to "taper" its bond purchases, likely in 2022, US equities may very well bubble up further
- We still prefer risk assets at this time and have a bias for value stocks, which are trading at a multi-decade discount to growth stocks
- Non-US equities – particularly in Europe, Japan and emerging markets – are much more reasonably priced than their US counterparts

For more than a decade, stocks have been on a steady march upwards – and not even the global downturn caused by the Covid-19 pandemic has thrown them off for long. So are equities, particularly in the US, too expensive? Could they even be in bubble territory? If so, when might they pop?

To answer these questions, we developed a 10-criteria "bubble checklist" inspired by the work of Charles Kindleberger, an economic and financial-market historian. Each asset bubble throughout history has been unique in its own way – yet with few exceptions, each one also met essentially all 10 of these criteria.

Our analysis indicates that today, US equities demonstrate most of the characteristics of an asset bubble. Yet there are also compelling reasons to think that in the near term, US stocks will continue to move higher. As such, we still favour US equities and other risk assets – albeit with some hesitancy. That's why we don't think now is a good time for investors to drastically pare back their positions in risk assets, though it may make sense to shift to a more neutral to slightly "long" stance.

Criteria (and colour status)

1	Historically high valuations
2	Overvaluations of multiple asset classes
3	High hopes for a "new era"
4	Ultra-easy monetary policy

5	Financial-sector deregulation
6	Rising leverage
7	A boom in "innovative" financial instruments
8	Overtrading and exponential price moves
9	An influx of foreign money
10	A rise in serious fraud

less of a concern  more of a concern

10 signs of a market bubble

1 Historically high valuations

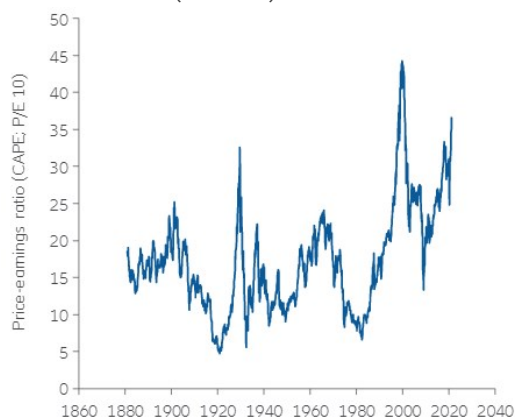
In our view, valuation is the most important metric and US equities in particular seem expensive. We base this on the valuation measurement that we think is cleanest from a theoretical and empirical perspective: the cyclically adjusted price-earnings ratio (CAPE). This is the de facto industry valuation standard – and it is revealing.

- At the end of April 2021, the S&P 500 traded at a CAPE of 37 – a reading last seen in late 1998 during the tech bubble (see Exhibit 1). It reached a peak of 44 in early 2000 before the bubble burst.
- The Nasdaq tells a similar story. Its CAPE of 55 in April 2021 is similar to its March 1998 level. But notably, today's high US valuations go well beyond the tech sector. Almost all sectors, with the exception of consumer staples and banks, are trading at high multiples.

In comparison, we don't find non-US equities to be at stretched valuations (see Exhibit 2). European, Japanese and Asian equities are trading at or below their long-term average valuation multiples. This points to another way in which today's elevated markets are different from the tech bubble of the late 1990s and early 2000s: back then, equity markets around the world were at elevated valuation levels.

Exhibit 1: US stocks seem expensive, reminiscent of previous market peaks

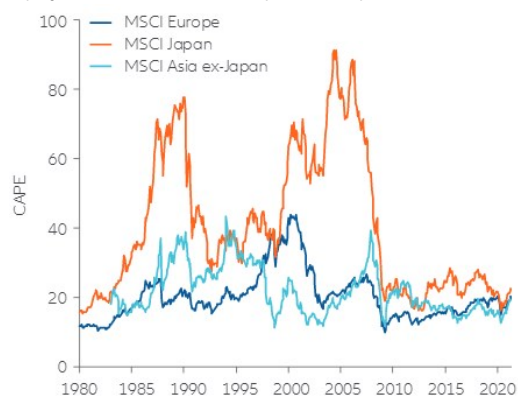
S&P 500 Index CAPE (1881-2021)



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

Exhibit 2: Non-US equity markets seem more reasonably priced

Equity market CAPE: MSCI Europe, MSCI Japan, MSCI Asia ex-Japan (1980-2021)



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

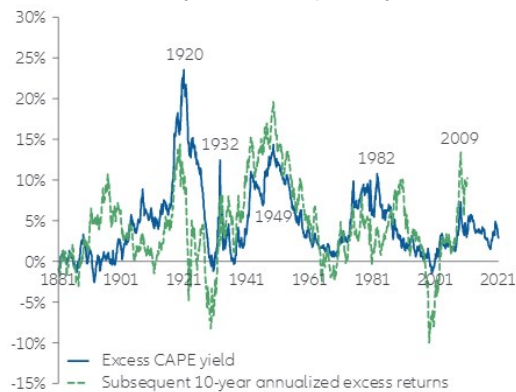
And we are not convinced that high valuations can be justified by ultra-low bond yields. Low real yields

have historically typically implied rather low multiples, since low yields point to a slow-growth environment and a higher risk of recession. Clearly, some other market forces are at work today, since yields are near historic lows and equity valuations (at least in the US) are near historic highs. Monetary policy over the decades has lifted investors' risk appetite to extremes, powering the run-up in equities.

Still, today's ultra-low bond yields can tell us something about the equity market outlook. While US equity returns are likely to be low, on average, over the coming decade, they are still likely to outperform US bonds. We can estimate this based on the work of Robert Shiller, using the excess earnings yield of equities relative to bonds. (This can be calculated by subtracting the current bond yield from the equity earnings yield; see Exhibit 3.) Using the late April 2021 yield of 1.6% for 10-year US Treasuries, we can estimate that in the US, equities are poised to outperform bonds by around 2.6% per year over the next 10 years.

Exhibit 3: Over time, the excess earnings yield has helped explain the relative performance of equities to bonds

S&P 500 excess CAPE yield and subsequent 10-year annualized excess returns



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

2 Overvaluations of multiple asset classes

US equities are not the only highly priced asset class – so are sovereign bonds, as our proprietary valuation approaches indicate. There are two reasons for this:

- Short-term interest rates are ultra-low, in some instances even negative, due to the interest-rate policies of central banks globally.
- The term premium for longer-dated sovereign bonds remains around 100 basis points below the long-term average of late April 2021. This is due to years of ultra-easy monetary policy.

3 High hopes for a “new era”

History has shown that bubbles occur alongside the perception of a “new era” – such as new technological breakthroughs or major political changes that cause widespread optimism. Clearly, this is true today, with major innovations in the field of artificial intelligence feeding these high hopes. Some call this the “fourth industrial revolution” or the “second machine age”; The Economist has even nicknamed the current decade the “roaring 20s”. In line with this optimism, US bottom-up earnings growth expectations for the next three to five years soared. At one point in early 2021, these earnings expectations even dwarfed those seen in 2000, at the height of the tech bubble. Members of the tech-heavy FANG+ index were the key drivers for this sudden shift.

Even so, expectations for long-term economic growth overall remain rather moderate – though there is strong optimism for a continued rebound in 2021. The sharp rebound after the peak of the Covid-19 crisis certainly played a role here, and the economic outlook is very much dependent on continued fiscal and monetary policy stimulus in response to the pandemic.

4 Ultra-easy monetary policy

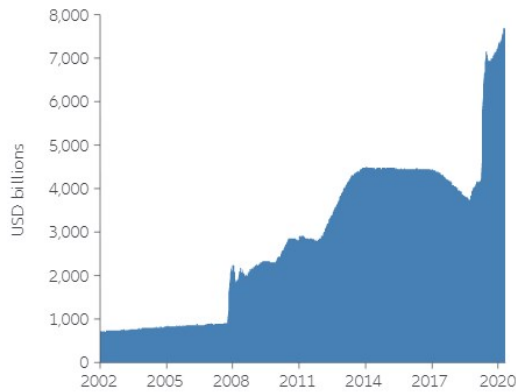
All financial bubbles in history took place against the backdrop of “easy” financing conditions provided by central banks. In that respect, this bubble indicator is clearly present today. Central banks have not only cut rates close to zero – or even lower – but they have flooded the system with levels of liquidity that are unprecedented in peacetime. (Exhibit 4 shows how the Fed massively expanded its balance sheet through asset purchases.)

This trend started with the financial crisis of 2007-2008, but it took off in 2020 during the coronavirus crisis. There has been massive growth in the supply of “narrow money” (such as coins, cash and highly liquid bank accounts) and “broad money” (which can consist of narrow money plus longer-term deposits) on the back of huge, “war-like” monetary stimulus measures. In fact, US broad and narrow money

aggregates have grown at a rate that dwarfs any seen in peacetime. In developed economies, the growth rate was around 17% – around four to five times the trend growth rate of nominal GDP. All major central banks have pledged to keep rates unchanged in the coming years, and to continue buying sovereign bonds.

Exhibit 4: The Fed’s balance sheet expanded rapidly during the Covid-19 crisis

Fed balance sheet (2002-2021)



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

Covid-19 caused a deep economic downturn – and a massive surge in equity performance

When the coronavirus outbreak became a global pandemic in March 2020, it triggered the deepest global economic downturn since the Great Depression in the 1930s. Major equity markets fell within five weeks by around one-third. But equities began to recover at the news of new fiscal and monetary policy stimulus measures – the scale of which was unprecedented in peacetime.

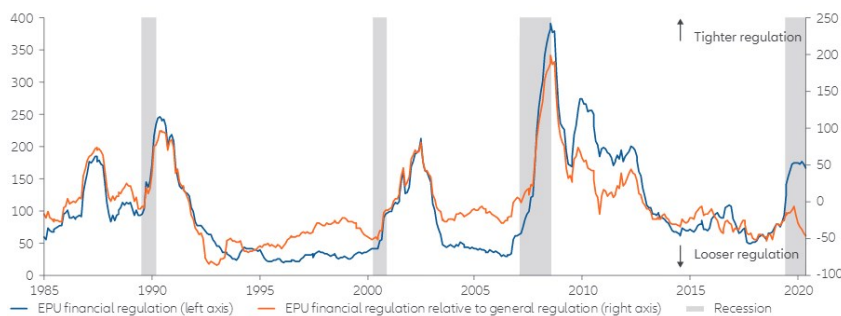
- US stocks in particular turned around sharply. In the 12 months following the trough in the S&P 500 on 23 March 2020, the index rose by 75%. Since late March 2021, US equity prices have moved up even further.
- In the same time period, the tech-heavy Nasdaq rose by 95% and the NYSE FANG+ Index rose by a staggering 146%.
- Non-US equities, measured by the MSCI World ex-USA Index in local currencies, rose by “only” 50% over the same time period – still a very impressive number.

5 Financial-sector deregulation

Deregulation in the financial sector is another typical feature of any asset bubble. Here we can tick the box as well – at least in the US. After a brief bout of re-regulation around the time of the financial crisis, US regulations have gradually been scaled back. During the administration of former President Donald Trump, the financial sector was freed from many regulations – as seen in the US Economic Policy Uncertainty Index devised by Scott Baker, Nicholas Bloom and Steven Davis (see Exhibit 5).

Exhibit 5: Since 2010, the financial sector has become less regulated

US Economic Policy Uncertainty Index (EPU): EPU financial regulation (absolute and relative to general regulation)



Source: Refinitiv Datastream, AllianzGI, Baker Bloom Davis. Data as at March 2021.

6 Rising leverage

The combination of ultra-easy monetary policy, financial-sector deregulation and the Covid-19 crisis have contributed to a sharp rise in private-sector leverage – the debt of private businesses and individuals (see Exhibit 6). But the question of whether this does or doesn't indicate we are in bubble territory requires a nuanced answer.

In the US non-financial business sector in 2020, the gross and net debt-to-GDP ratios climbed to all-time highs. But it's a different story in the private household sector: even though the gross debt-to-GDP ratio of private households temporarily shot up during the Covid-19 crisis, it is far below the 2007 level. Moreover, private households today are sitting on excess savings.

As a result, while leverage is certainly high in some areas, we believe that financial-stability risks are rather low, and that a repeat of the financial crisis is not on the cards.

Exhibit 6: Trend shows leverage rising for non-financial businesses

